SMEAD capital management

# Newsletter

**SMEAD US VALUE — 1ST QUARTER 2023 (3/31/2023)**

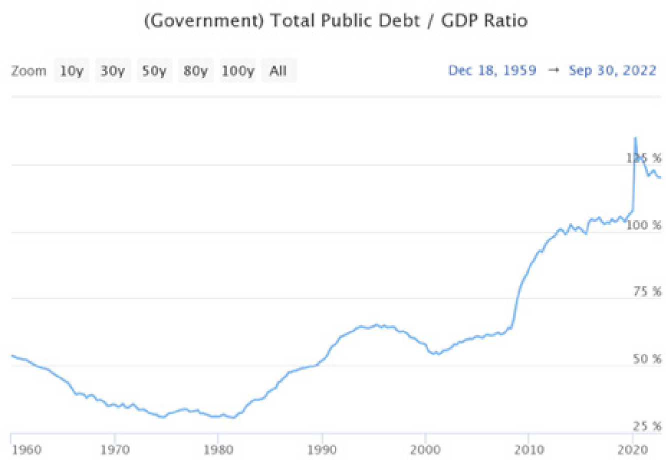
## Picking Among Poisons: Rich-cession or Recession

*To be, or not to be, that is the question:*
*Whether 'tis nobler in the mind to suffer*
*The slings and arrows of outrageous fortune,*
*Or to take arms against a sea of troubles*
*And by opposing end them. To die—to sleep,*
*No more; and by a sleep to say we end*
*The heart-ache and the thousand natural shocks*
*That flesh is heir to: 'tis a consummation*
*Devoutly to be wish'd.*

As we end the first quarter of 2023, the Federal Reserve Board is trying to decide whether "to be or not to be" the inflation fighter. The stock market is struggling with an effort by the Federal Reserve Board to strangle inflation with tight monetary policy. This is in response to their ignoring inflation 18 months ago by calling it "transitory." As James Grant said recently on *Bloomberg*, "They were in consensus that it was transitory and now they are in consensus that they need to tighten." In other words, should we suffer from "outrageous" inflation or "take arms against a sea of (economic) troubles."

The Fed has inverted the yield curve and tightened credit into a "sea of troubles" banking crisis. Three large banks have been crippled by the interest rate inversion of higher short-term rates relative to longer-term interest rates. Even though these banks all catered to the most aggressive side of the U.S. economy (high net worth investors, private equity and venture capital), those problems have caused doubts about the entire banking system. This has led to a significant correction in companies that require any future enthusiasm about the economy. Therefore, we will remind our investors why we are economic optimists and stock market pessimists.

Favorable demographics make favorable economics. At the Allen and Co. summit in the summer of 1999, Warren Buffett walked through the following contrast: from 1964-1981 the economy of the U.S. grew 4.3% and the Dow Jones Industrial Average went pretty much nowhere. From 1981-1998 the economy grew at 2.7% and the stock market exploded. The 1964-1981 economy was strong because baby boomers were growing up, forming households and living life. Second, the economy was strong because President Johnson escalated the Vietnam War and expanded Federal Government expenditures through his "Great Society" legislation in answer to the race riots of the 1960s. Federal borrowing relative to GDP was very high as shown by the chart below:




Source: https://www.longtermtrends.net/us-debt-to-gdp/. Data for the time period 1/1/1960 – 9/30/2022.

The sheer number of new drivers, new homeowners and new families made numerous necessity goods scarce. In other words, too many people with too much money were chasing too few goods. When the Arab oil embargo of 1973-74 hit, inflation exploded to the upside and didn't completely get cured until the mid-1980s. As interest rates rose in the 1970s, Price-to-Earnings ratios (P/E) contracted and stock indexes performed very poorly.

Fast forward to today. There are 92 million millennials and as many folks below 25 years of age coming up through the pipeline. The COVID-19 quarantines and the $8 trillion of Federal Government borrowing have dwarfed President Johnson's "Great Society/Guns and Butter." On top of that, the Fed took rates to nearly zero for an extended period of time. Just imagine that they assumed that Dr. Rick will be wrong in the Progressive commercials as he argues that at age 55 the millennials will be "just like their parents." The fact that auto/home insurance companies are spending hundreds of millions of dollars to run their ads proves that we are headed to heavy necessity spending.

This time, the government borrowing is much higher as a percentage of GDP than it was in the prior inflation episode of the 1964-1981 period. Since that is the case, you must understand who benefits from inflation to understand where we are headed.

# Picking Among Poisons: Rich-cession or Recession

Inflation means that borrowers are paying back debts in inflated dollars. Let me give you a real-world example. In 1978, my dad (the consummate fisherman) was getting a new Bayliner fishing boat. Bayliner was offering an 8% interest rate on a four-year loan and my dad borrowed the money to buy the boat because inflation was rising much faster than 8% and was going to stay that way through the life of the loan. With the ability to deduct consumer interest expenditures against your income for tax purposes, he was going to be much better off than paying the cash that he could have paid at the beginning. In effect, he paid it back in much cheaper dollars.

The Federal Government is now in a position where the Fed tightening credit will threaten its ability to service the existing debts at much higher interest rates. As you can tell, this is a series of very difficult choices. Do you put the entire economy in the tank to solve the problem and get voted out of office, or do you accept the inflation that naturally comes with favorable demographics?

How does all of this affect our stock picking and portfolio management? We believe that we have entered an extended period of sticky inflation that will actually help the Federal Government solve its problem. They need the kind of solid economic growth of the 1964-1981 period and they need to pay their debts back in inflation-cheapened dollars. So, we want to own meritorious companies which provide the necessities to Dr. Rick's future 55-year-olds and take advantage of the scarcity of fossil fuels, attractive land, millennial home ownership and all the goods and services associated with being the most important drivers of our economy.

Therefore, we continue to like the oil and gas industry, home builders, mall REITs, major banks and retailers that cater to families. The current circumstances are the first major correction in our thesis and it is begging us to bend to the will of the Federal Reserve tightening as it squeezes out economic optimism. As Charlie Munger told Warren Buffett, "Warren, you are young and smart, but I'm right!" We believe in our vision for the next ten years and the last three years support that confidence.

*The heart-ache and the thousand natural shocks*
*That flesh is heir to: 'tis a consummation*
*Devoutly to be wish'd.*

As always, thank you for investing with us, and fear stock market failure.

**Bill Smead**
Chief Investment Officer

**Cole Smead, CFA**
CEO & Portfolio Manager

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# Invest With Us Today!

**Sales Desk** 877.701.2883 | **info@smeadcap.com**

The recent growth in the stock market has helped to produce short-term returns for some asset classes that are not typical and may not continue in the future. Margin of safety is the difference between the intrinsic value of a stock and its market price. The price-earnings ratio (P/E Ratio or P/E Multiple) measures a company's current share price relative to its per-share earnings. Alpha is a measure of performance on a risk-adjusted basis. Beta is a measure of the volatility of a security or a portfolio in comparison to the market. Growth investing is focused on the growth of an investor's capital. Leverage is using borrowed money to increase the potential return of an investment. Momentum is the rate of acceleration of a security's price or volume. The earnings yield refers to the earnings per share for the most recent 12-month period divided by the current market price per share. Profit margin is calculated by dividing net profits by net sales. Quality is assessed based on soft (e.g. management credibility) and hard criteria (e.g. balance sheet stability). Value is an investment tactic where stocks are selected which appear to trade for less than their intrinsic values. The dividend yield is the ratio of a company's annual dividend compared to its share price.

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SMEAD capital management

**smeadcap.com**

2777 East Camelback Road
Suite 375
Phoenix, AZ 85016

Sales Desk - 877.701.2883
info@smeadcap.com