SMEAD capital management

Newsletter

SMEAD US VALUE — 2ND QUARTER 2023 (6/30/2023)

Stock Market Symmetry

In Warren Buffett's 1999 Allen and Co. talk in Sun Valley, Idaho, he argued that the stock market has historically had what he called a "Biblical kind of symmetry!" As we come to the end of the stock market's second quarter of 2023, we will ask the following question: Is the U.S. stock market bumping up against natural and historical limits? Here is how he saw things back then:

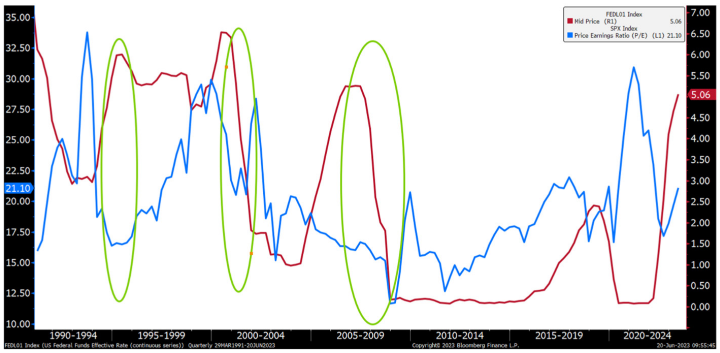
> *"Now, to get some historical perspective, let's look back at the 34 years before this one--and here we are going to see an almost Biblical kind of symmetry, in the sense of lean years and fat years--to observe what happened in the stock market." November 22, 1999 (FORTUNE)*

Buffett argued that the two factors that were the most important in the poor performance of stocks from 1964-1981 were the rise in interest rates to 14% and the decline in corporate profits as a percentage of GDP to 3.5% (the low end of the historical range). He then argued that the success of stocks from 1981 to 1998 was closely tied to the decline in interest rates from around 14.0% to 5.4% and the corporate profit margin rising to approximately 6.0% (Buffett considered this to be at the high end of the range).

We will make the case that a wide variety of parameters make Buffett's 1999 argument even better in the middle of 2023.

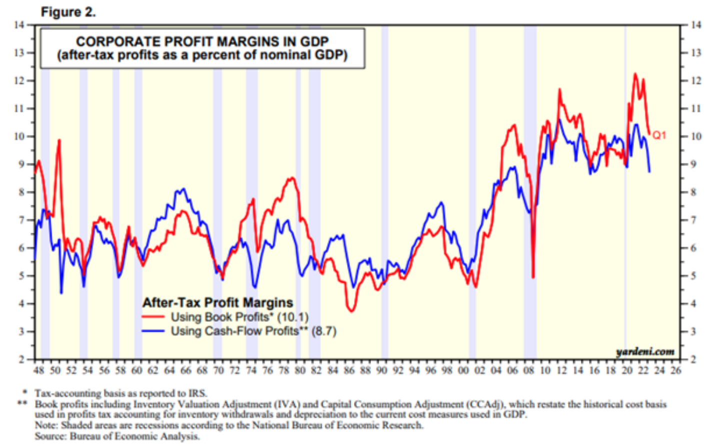
Interest Rates

Interest rates on Fed funds have moved from near-zero in late 2021 to 5.25% faster than at any time in U.S. history and the Fed Chairman is indicating additional rate increases. The chart below shows the price-to-earnings (P/E) ratio of the S&P 500 Index at prior rates of near-5% in the green ovals ranging between 12 to 17 times earnings. Today's market trades at 21 times earnings.



Source: Bloomberg. Data for the time period 3/20/1991-6/20/2023.

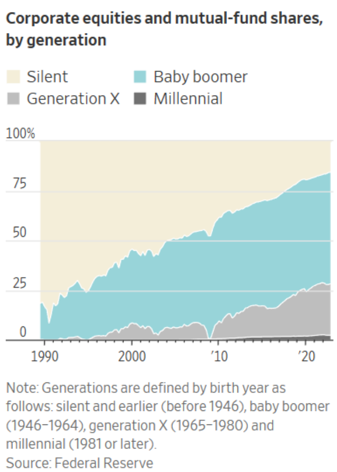
Corporate Profits as a Percentage of GDP



Source: Yardeni.com. Data for the time period 1/1/1948 – 3/31/2023.

As interest rates moved lower and labor lost its bargaining power, corporate profits benefitted immensely.

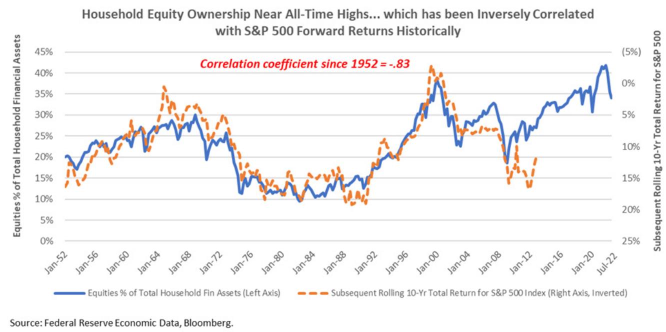
Ownership



Source: Federal Reserve. Data for the time period 1/1/1990 – 3/31/2023.

In a recent *The Wall Street Journal* article titled, "Boomers Got Hooked on Stocks. Now They Can't Let Go," the writers pointed out that nearly two-thirds of U.S. adults aged 65 and older have money in stocks. In other words, at the time of life when Americans normally seek income and safety, they are keeping the pedal on the metal and are relying on capital gains to give them money to live on. This has kept equity ownership at Dotcom Bubble Era levels!

Stock Market Symmetry



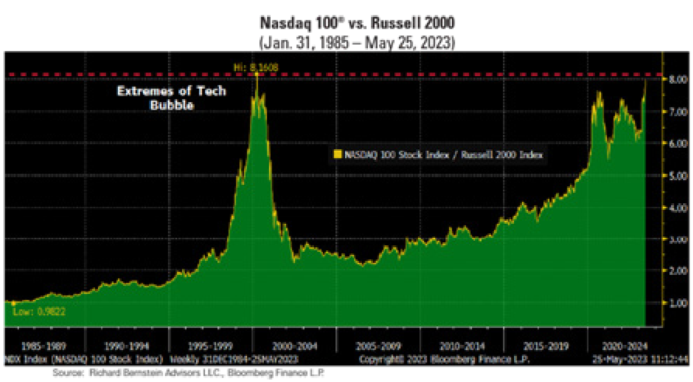
Source: Federal Reserve, Bloomberg. Data for the time period 1/1/1952 – 6/30/2022.

The WSJ writers continued:

> *"Many baby boomers began investing during a period of stock-market success in the 1980s. They have witnessed market crashes—from Black Monday in 1987, to the bursting of the dot-com bubble, to the 2008 financial crisis, to the onset of the Covid pandemic—and have seen stocks recover and climb higher again and again.*
>
> *Individuals who have experienced high stock-market returns over the course of their life report higher financial-risk tolerance and are more likely to invest in the stock market and allocate a greater share of their portfolio to equities, according to research by finance professors Ulrike Maeander and Stefan Nagel."*

Speculation

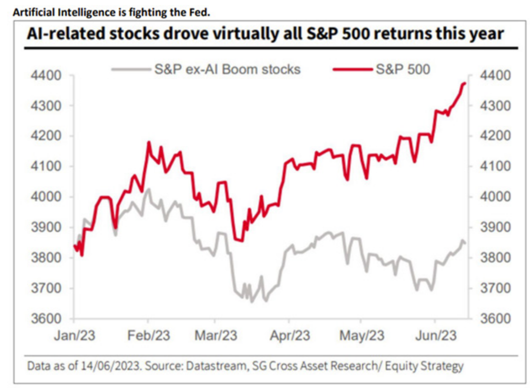
Numerous charts prove that speculation is historically high and dangerous.



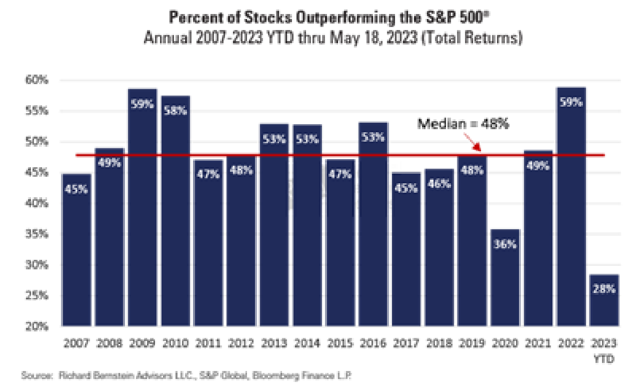
Source: Richard Bernstein Advisors, Bloomberg. Data for the time period 1/1/1985 – 5/25/2023.

Charlie Munger said in late 2021 that this is the biggest financial euphoria episode of his career (75 years) "because of the totality of it." Look how long we have maintained the dot-com bubble level of euphoria in the last five years!

This has resulted in the narrowest stock market of our 43 years in the investment business.

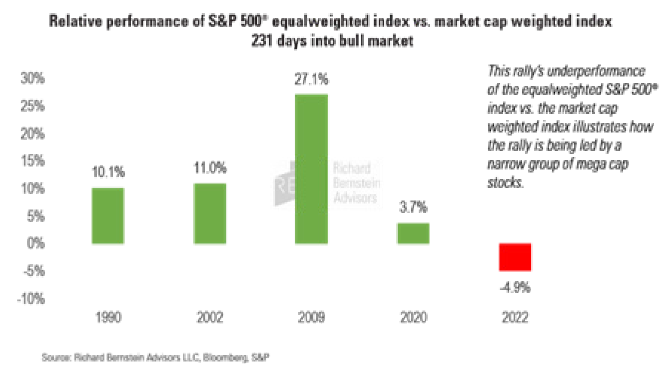


Source: Datastream, SG Cross. Data as of 6/14/2023.



Source: Richard Bernstein Advisors, Bloomberg. Data for the time period 1/1/2007 – 5/18/2023.

Which evidenced itself in the wildest outperformance by mega-cap stocks relative to equally weighted indexes in 16 years:

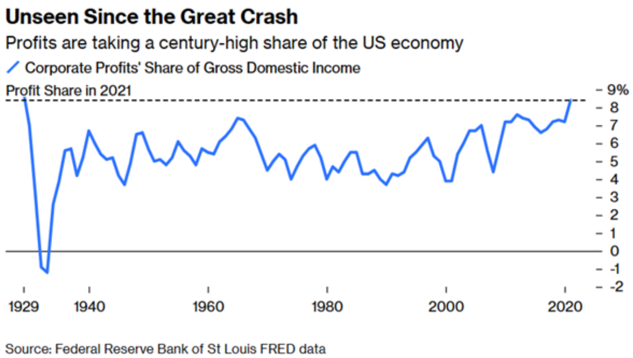


Source: Richard Bernstein Advisors, Bloomberg. Data for the time period 1/1/1990 – 12/31/2022.

Labor and Real Assets

The combination of advances in technology, declining interest rates, reduced labor bargaining power and a bear market in commodity prices has caused corporate profits share of gross domestic income to hit record levels:

Stock Market Symmetry



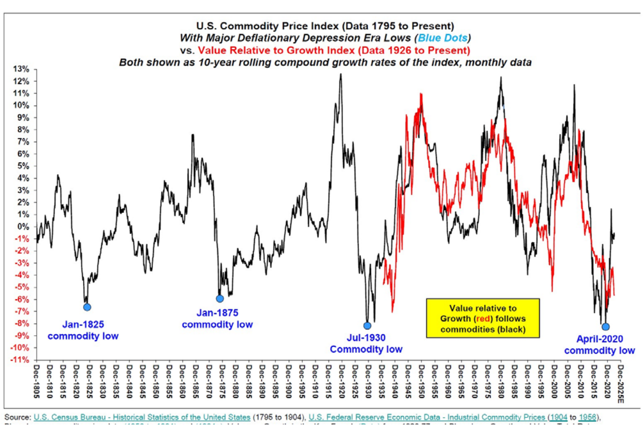
Source: Federal Reserve Bank of St. Louis FRED data. Data for the time period 1/1/1929 – 12/31/2021.

Let's pull this all together. How do you make money in the stock market if the positive forces from 1981 to today disappear? First, interest rates on six-month T bills remain at a higher level than in the past 20 years.

Source: Bloomberg. Data for the time period 203 – 6/22/2023.

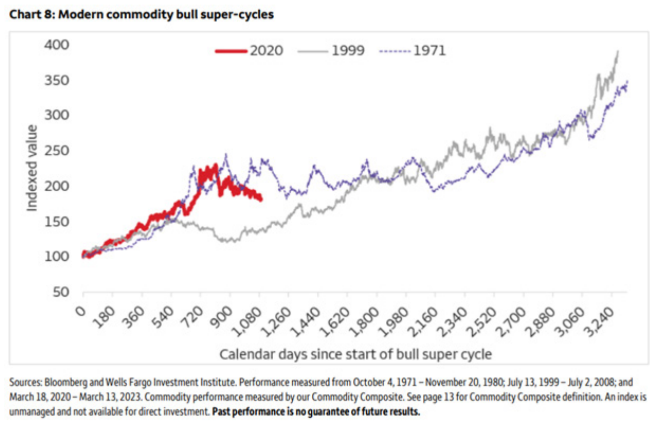
This fact automatically reduces corporate profits and lowers the bar for P/E ratios.

Second, commodities outperform most other asset classes:



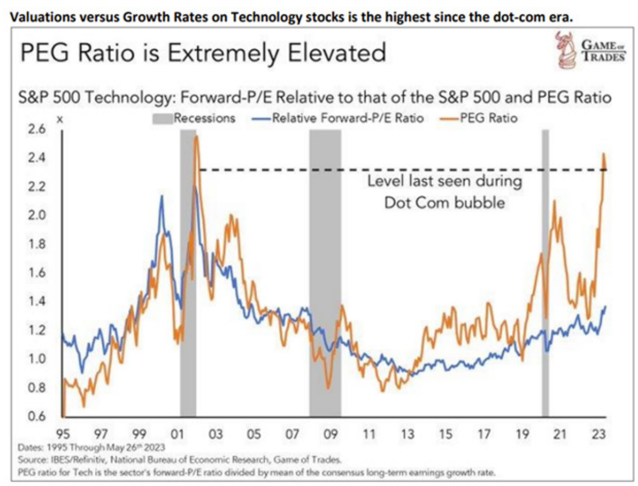
Source: Stifel. Data for the time period 1/1/1805 – 6/30/2023.

We are coming off the cheapest commodity indexes have been relative to stock prices in 220 years of data. The first move was very positive and matched the last two commodity super-cycles:



Source: Bloomberg and Wells Fargo Institute. Data for the time period 10/4/1971 – 3/13/3023.

Thirdly, P/E ratios contract to more normalized levels and go at times well below average.

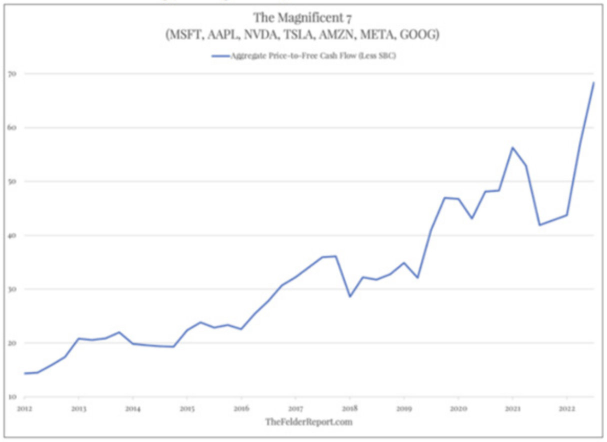


Source: IBES/Refinitiv, National Bureau of Economic Research, Game of Trades. Data for the time period 1/1/1995 – 5/26/2023.

As you can see, we have spent very little time at elevated PEG ratios in tech stocks, and you must ask yourself if you want to fight the biblical symmetry. Check this latest look at the maniacal pricing of today's tech darlings:

Stock Market Symmetry

Valuations on 2023's Darlings, the Magnificent 7, are at nosebleed levels.



Source: TheFelderReport.com. Data for the time period 1/1/2012 – 12/31/2022.

Do you want to keep asking this stock market to do what it has never been able to do before? The answer for us is we will go where we believe your money will be treated the best. We want to be in the oil and gas business, the real estate business via class A/outlet malls. We want to build homes to give millennials access to being their own landlord and invest in other businesses that can prosper in a solid economy and a sub-par stock market. And, as always, we will fear stock market failure.

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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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