SMEAD capital management

Missive

SEPTEMBER 12, 2023

Stock Investors in Barbieland

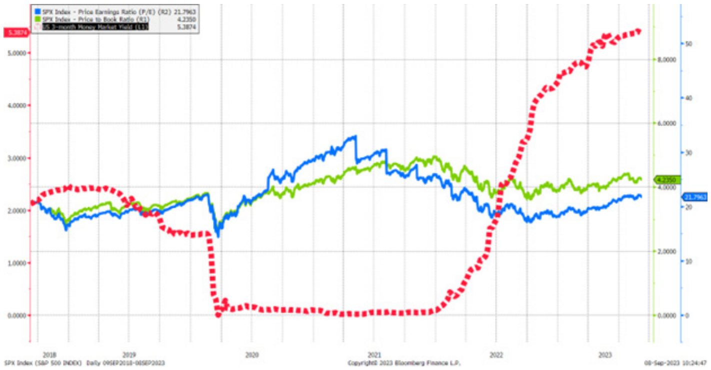
The *Barbie* movie has been a $1 billion blockbuster movie so far in 2023. While it is entertaining like a Mel Brooks-style comedy, it also leaves you to ask: What is the real world? (Spoiler alert) Barbie is living in Barbieland where everything is perfect for Barbie and the other Barbies. It is in essence a feminist utopia where the men, known as the Kens, are glorified male models.

Barbie has an existential crisis when she has thoughts of death and walks flat-footed, instead of her heels floating six inches above her toes. She goes to the real world to solve her problem, where she learns reality is messy with no simple answer. She learns it's a complex system. To not ruin the movie, I'll briefly say she rejects Barbieland in the end and wants to make her way in the real world. A stunning outcome from the supposedly perfect world where she started.

Stock investors seem to have an idyllic view just as Barbie had. They had thoughts of death during the violent, but quick, bear market in the spring of 2020. They also learned that six-inch heels didn't work for many formerly glamorous businesses as the declines in 2022 brought them back to the ground. Barbie was a pragmatist, though, and sought to get a check-up with her gynecologist at the end of the movie. Stock investors seem uninterested in finding out what is going on.

For most of my career, short-term rates have been laughable. No different than cowboys eating baked beans around a western movie campfire. However, the 90-day Treasury today pays 5.50%, a historically high rate. There is nothing laughable about that fact. It is an incredible risk-free return with great flexibility in relation to future inflation.

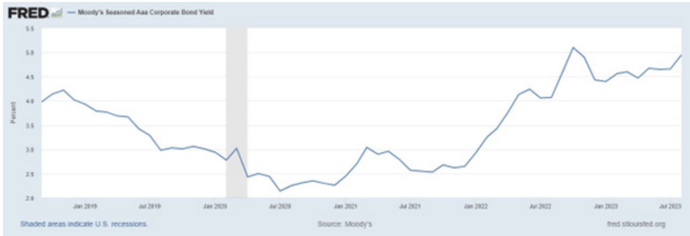
Ben Graham taught all investors that prevailing interest rates do affect what an informed investor should pay the net present value of the future income stream. He used the current AAA corporate bond yield to adjust for this. If you can make risk-free 5.5%, what should you expect out of your corporate bonds, and therefore, how should you value stocks based on those rates? Below is a chart that helps us understand where things are.



The chart above shows the short-term money market yield against the S&P 500 Index's price-to-earnings ratio (P/E) and price-to-book ratio (P/B). When rates dove to the floor, it makes sense that these metrics found new highs. What doesn't make sense is that they are not that far off their high when adjusted for interest rates.

In the Ben Graham model, he viewed 4.4% to be the long-term rate to adjust the prevailing AAA corporate bond yield against. A 1% higher rate for valuing a business would cause a 23% change in the price that you'd pay for the stock. What is hard to perfectly ascertain is what the actual discounting mechanism is, but when you see short-term rates move over 500 bps, something should markedly change in how investors value assets. To believe that the value of the S&P 500 has only changed by 35% based on the drop in P/E ratios or a 15% drop in P/B ratios after this tectonic rise leads you to believe that stock investors are just another Ken in Barbieland. After all, it's a fantasy land.

Our CIO, Bill Smead, explained in his recent missive, Inflation Expectations, how interesting the 30-year TIPs yield is right now. It provides a real rate of 2%. So, the question for investors is what will inflation be and how will it affect stocks? We believe it's like asking what happens when gravity shows up. In Barbieland no one gets hurt. The real world is different.



Focusing more on the stock situation, above is the chart of the AAA corporate bond yield. During the peak multiples of 2021, I would say it averaged somewhere closer to 3%. Today, it yields almost 5%. The market consensus view is that we are going back to 3% inflation. If you add the 2% TIPs yield to that, you are way up with the current rate of the AAA corporate bond yield. A 2% change from the high point of valuations would cause roughly a 45% decline in the hypothetical P/E multiple you would value a stock. **If inflation doesn't run at 3%, but instead runs at 4% or 5%, it only gets worse!** The higher nominal rates that inflation may cause are not being considered by stock investors in valuing individual businesses or the stock market at large.