Newsletter

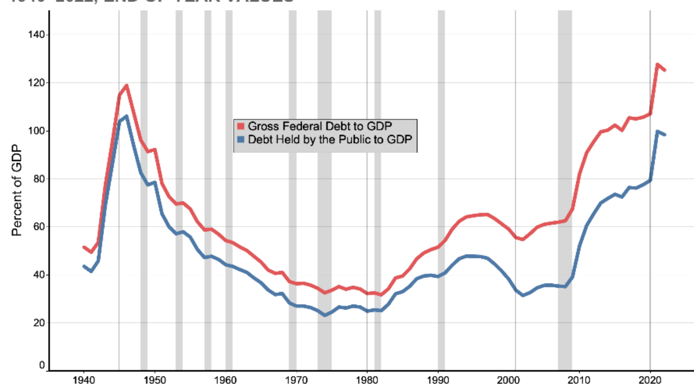
SMEAD INTERNATIONAL VALUE — 1ST QUARTER 2024 (3/31/2024)

Higher Natural Rates

As we finish the first quarter of 2024 and look ahead, global stock investors are looking for lower short-term rates from central banks. The question remains whether they will get them. Looking back since the beginning of the pandemic, the Federal Reserve Board and its Fed futures market have been bad predictors of central bank policy. This debate has been better served in the psychological or intellectual realm. In this letter, we would like to explain part of the reason why we think it will be tougher to tackle inflation and why we have to deal with Higher Natural Rates.

Books like Dror Goldberg's *Easy Money* explain how the government's spending money to fight wars has always caused inflation throughout the last 1000 years. Harold James's book *Seven Crashes* eloquently argues that the pandemic caused war spending. We believe this paradigm may be glossed over, but below is a look at where federal debt to gross domestic product (GDP) stands now.

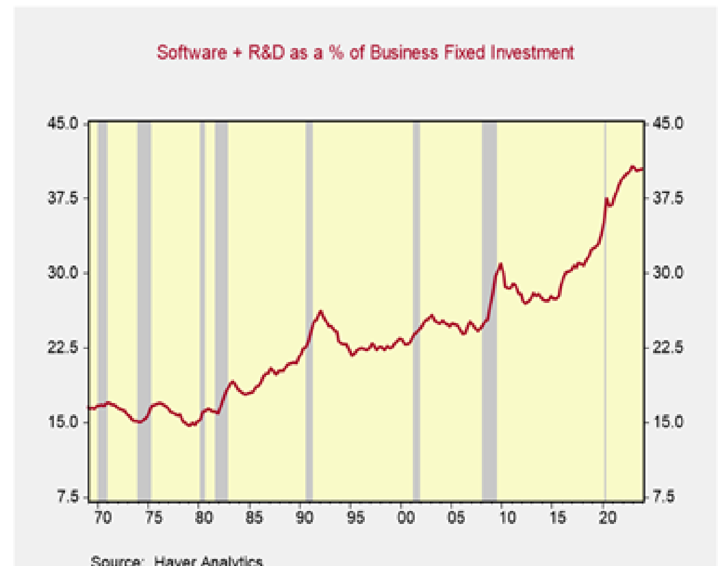
Like in the past, government spending currently needs to be paid back later and is causing pricing issues. The Federal Reserve and other central banks are trying to counteract that with tighter monetary policy but aren't having success because of the sheer size of the federal largesse.



Source: Urban Institute & Brookings Institution Tax Policy Center. Data for the time period 1/1/1940 - 12/31/2022.

Normally, when interest rates get tight, the economy stumbles and the Fed can point to lower prices. However, today's economy isn't the old credit-sensitive juggernaut it was in the past. You don't grow your company by buying land and building a plant like in the past. Those were a capitalized expense. Today's companies, and thus the economy, are more asset-light. Instead of capitalized expenses, we deal in more operating expenses, particularly software. The software at the core of a services business is likely to be their largest expense outside of people. Mickey Levy of Hoover Institute shared the chart below with our firm.

Software and research are growing to be a far larger part of business fixed investment than in the past. This operating expense isn't credit sensitive. If the Federal Reserve Board raises rates, software and R&D are not affected like capitalized expenses were in the past.



Source: Haver Analytics. Data for the time period 1/1/1970 - 12/31/2023.

Higher Natural Rates

At an event in Phoenix in March, Larry Summers said that the natural rate of interest is higher based on this and other factors. It's interesting to think about Larry saying this as he had argued that we were in secular stagnation. He was pushed to answer why he had gone from that view to a view for higher natural rates. He quoted Keynes who said, "When the facts change, I change my mind. What do you do, sir?" Larry is being pragmatic in his approach to analyzing what is going on in the world and what policy best fits those needs.

Stock investors and the market operators are frankly not. They are praying for a world of low inflation and low-interest rates but will have trouble finding them. They are praying for the perceived winners to continue their run but will have trouble doing that. They are anchored in the past. A pragmatist would see that places like energy and banking have low valuations and are producing attractive returns on capital. These have been good recipes for common stock investing before. A pragmatist would see that government spending globally continues to buffer economic outcomes in such a way that businesses are acting less cyclical than in the past. For each of us as investors, the question becomes, are we willing to adapt to higher natural rates?

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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