March 2023 Market Commentary

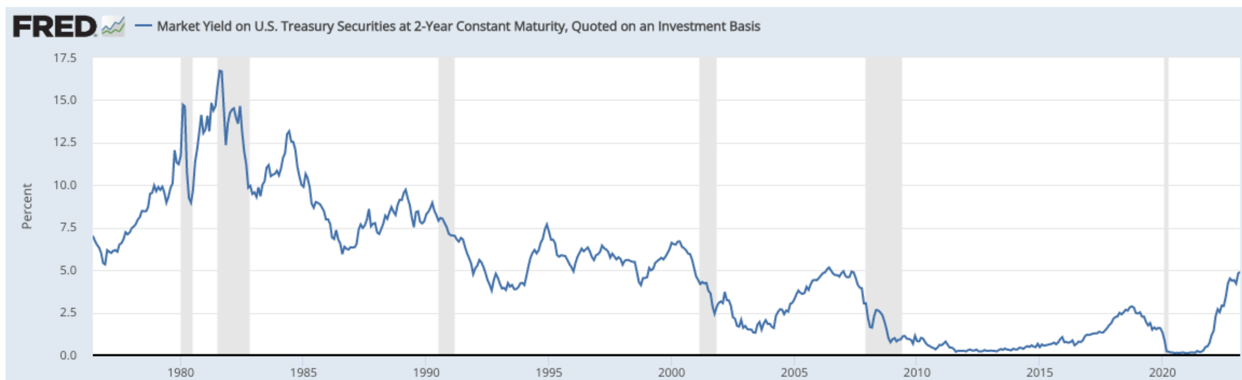
Live and Let Die

When you were young and your heart
Was an open book
You used to say live and let live
(You know you did)
(You know you did)
(You know you did)

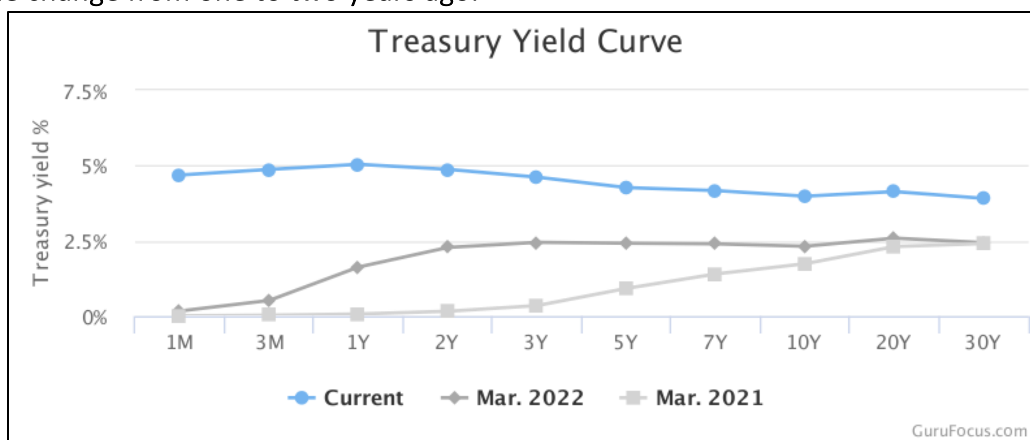
But if this ever changin' world
In which we're livin'
Makes you give in and cry
Say live and let die
Live and let die
-Paul McCartney & Wings ***https://www.youtube.com/watch?v=wYQZHNwIUq8***

Bond is back baby! After we were sure he was dead and buried, here he comes, like a phoenix rising from the ashes, to save the world yet again. Not James Bond (at least not yet), but Mr. Bond Market. The hero of savers the world over, offering them a competitive lower risk return, and striking fear in the hearts of spendthrift politicians. We're not all the way back to those heady days of the 80's (Bonfire of the Vanities), or the Great Bond Massacre of 1993 when James Carville famously said, ***"I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody."***

No, we're not back to those exhilarating times yet, but for the first time in 16 years you can now get a reasonable 5% yield on 2-year U.S. Treasury Notes.

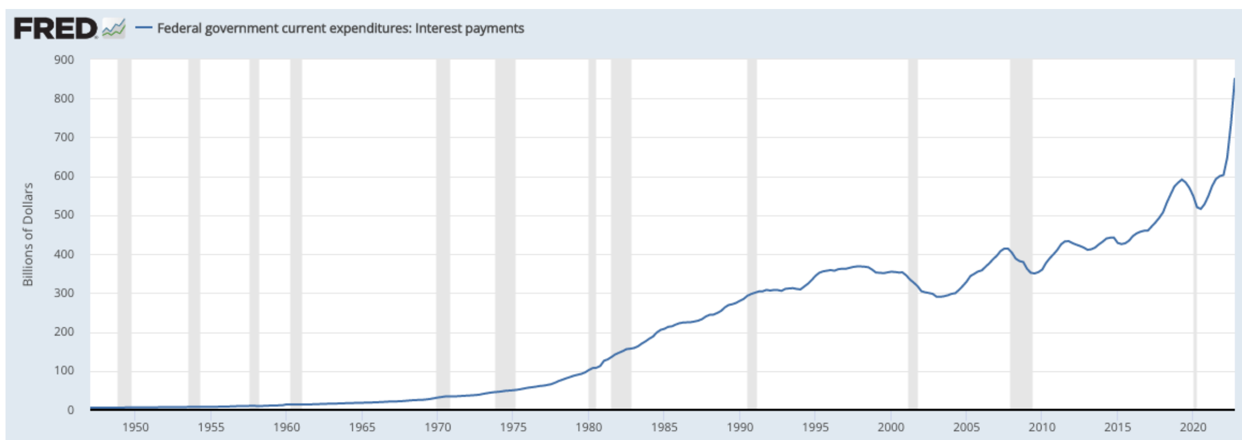


Actually the entire yield curve is now offering investors/savers returns of 4-5%, a dramatic and welcome change from one to two years ago.



Now you may ask, why would anyone be intimidated by the bond market, especially after nearly two decades of zero percent interest rates. The answer is simple, bonds are contracts and the payments of interest are enforced in courts of law, with the alternative being default. We currently have an entire generation that has been blissfully binging at the trough of low rates and easy credit, who are now faced with rising mortgage rates, car loans, and credit card payments. I'm afraid that the pain that is going to be felt by borrowers is just beginning to be felt.

And, of course, the biggest debtor of all is the Federal Government. The same Federal Government that saw zero percent interest rates as a way to give free money to nearly every citizen in the United States. Now our elected officials are faced with the harsh reality that interest payments on federal debt will soon exceed defense spending, and according to the Congressional Budget Office *"For every dollar that the U.S. government will borrow over the next decade, 50 cents will be just to pay interest on our national debt."*



If history has taught us anything it's that you don't want to make an enemy out of either James Bond or the Bond Market, both have a license to kill. It's okay to invest alongside Mr. Bond, you just don't want to owe him money. It was folly to believe that nearly two decades of "Fed Puts", "Quantitative Easing", and "Modern Monetary Policy" would result in just "Transitory" inflation.

In summary, if you haven't already done so get your house in order, pay down debts, and invest your cash in short-term bonds and stocks. Bonds are back, and savers are cool again. Live and let die!

<u>Thoughts on Equity Valuation:</u>

Last month I wrote about identifying companies with competitive moats, and how the most important competitive advantage is the ability to grow and evolve. I also stressed how these characteristics were important in both successful corporations as well as individuals. This month I thought I'd spend a few minutes talking about how I look at valuation.

Once we've identified companies that we believe offer long-term competitive advantages we then need to focus on valuation. In other words, what is a reasonable price to pay for that exceptional company. There are just about as many ways to value a stock as there are religions. In fact, it is often said that there are many different paths to investment heaven. The key is to find one that both fits your personality and works.

After nearly 40 years of exploration I think I've found one that works for me, I call it "Relative Multiple Valuation", and it is what I've taught in my Security Analysis classes. When I use the word "relative" I don't mean relative to other companies or relative to the market, I mean relative to the companies own trading history. No valuation methodology is perfect, but I've found this to help me identify reasonably attractive entries and exits. Again, we're assuming you've already identified an attractive company, now you're just trying to determine how much to pay for it.

In this example, instead of analyzing an individual company I'm going to use the S&P 500. The first thing I do is lay out 15+ years of basic valuation metrics; sales, earnings, dividends, and

book values. This allows me to look at historic growth rates as well as both the high and low multiples assigned to those growth rates. In other words, I'm building a framework that tells me what reasonable valuations for this company (or in this case the market) have been historically.

I like to make sure we have at least one market cycle of data available. You want to see how your target company has performed in both bull and bear markets, as well as see how it was valued in those differing periods. The table below shows how the S&P 500 has performed both fundamentally and valuationally over the last 17 years.

Historic Multiple Valuation	*3/2/23*	Recent Update	2/28/23															
Company	*S&P 500*																	
Current Price	*$3,970.00*																	
Target Price	*$2,777.50*	Wtd Target	*$3,167.51*	*-20.21%*														
Potential to Weighted Sell Target				*-16.61%*														
	Average	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022 est	2023 est
Price High		$1,576.09	$1,471.77	$1,130.38	$1,262.60	$1,370.58	$1,474.51	$1,849.44	$2,093.55	$2,134.72	$2,277.53	$2,694.97	$2,940.91	$3,107.10	$3,393.52	$4,809.00	$4,793.54	$3,474.08
Price Low		$1,363.98	$741.02	$666.79	$1,010.91	$1,074.77	$1,258.86	$1,426.19	$1,737.92	$1,867.01	$1,810.10	$2,245.13	$2,346.58	$2,447.89	$2,191.86	$3,662.71	$3,577.00	$2,645.36
Sales per sh		$1,025.08	$1,042.46	$908.40	$962.71	$1,052.83	$1,092.37	$1,116.81	$1,163.32	$1,127.13	$1,149.18	$1,231.57	$1,343.01	$1,415.20	$1,359.41	$1,568.40	$1,750.00	$1,825.00
Growth Rate	4.10%	7.62%	1.70%	-12.86%	5.98%	9.36%	3.76%	2.24%	4.16%	-3.11%	1.96%	7.17%	9.05%	5.38%	-3.94%	15.37%	11.58%	4.29%
High P/S	1.87	1.54	1.41	1.24	1.31	1.30	1.35	1.66	1.80	1.89	1.98	2.19	2.19	2.20	2.50	3.07	2.74	
Low P/S	1.45	1.33	0.71	0.73	1.05	1.02	1.15	1.28	1.49	1.66	1.58	1.82	1.75	1.73	1.61	2.34	2.04	
Earnings per sh		$82.54	$49.51	$61.95	$87.02	$98.89	$105.21	$111.45	$119.06	$118.75	$119.31	$133.61	$161.93	$162.97	$139.76	$208.53	$219.00	$222.00
Growth Rate	7.52%	-5.91%	-40.02%	25.13%	40.47%	13.64%	6.39%	5.93%	6.83%	-0.26%	0.47%	11.99%	21.20%	0.64%	-14.24%	49.21%	5.02%	1.37%
High P/E	19.04	19.09	29.73	18.25	14.51	13.86	14.01	16.59	17.58	17.98	19.09	20.17	18.16	19.07	24.28	23.06	21.89	
Low P/E	14.40	16.53	14.97	10.76	11.62	10.87	11.97	12.80	14.60	15.72	15.17	16.80	14.49	15.02	15.68	17.56	16.33	
Dividends per sh		$37.46	$38.31	$29.44	$29.42	$33.22	$38.61	$42.60	$47.66	$52.04	$53.70	$56.31	$60.70	$64.30	$63.48	$61.46	$66.00	$68.00
Growth Rate	4.38%	7.06%	2.27%	-23.15%	-0.07%	12.92%	16.23%	10.33%	11.88%	9.19%	3.19%	4.86%	7.80%	5.93%	-1.28%	-3.18%	7.39%	3.03%
Low Yield	2.21%	2.38%	2.60%	2.60%	2.33%	2.42%	2.62%	2.30%	2.28%	2.44%	2.36%	2.09%	2.06%	2.07%	1.87%	1.28%	1.38%	
High Yield	2.93%	2.75%	5.17%	4.42%	2.91%	3.09%	3.07%	2.99%	2.74%	2.79%	2.97%	2.51%	2.59%	2.63%	2.90%	1.68%	1.85%	
Payout Ratio		45.38%	77.38%	47.52%	33.81%	33.59%	36.70%	38.22%	40.03%	43.82%	45.01%	42.15%	37.49%	39.46%	45.42%	29.47%	30.14%	30.63%
Growth Rate	1.07%	13.78%	70.50%	-38.58%	-28.86%	-0.64%	9.24%	4.16%	4.73%	9.48%	2.71%	-6.36%	-11.06%	5.25%	15.12%	-35.11%	2.25%	1.64%
Book Value per sh		$529.59	$451.37	$513.58	$579.14	$613.14	$666.97	$715.84	$726.96	$740.29	$768.98	$826.52	$851.62	$914.49	$927.52	$1,008.02	$1,000.00	$1,025.00
Growth Rate	4.45%	5.00%	-14.77%	13.78%	12.77%	5.87%	8.78%	7.33%	1.55%	1.83%	3.88%	7.48%	3.04%	7.38%	1.42%	8.68%	-0.80%	2.50%
High P/BV	3.09	2.98	3.26	2.20	2.18	2.24	2.21	2.58	2.88	2.88	2.96	3.26	3.45	3.40	3.66	4.77	4.79	
Low P/BV	2.37	2.58	1.64	1.30	1.75	1.75	1.89	1.99	2.39	2.52	2.35	2.72	2.76	2.68	2.36	3.63	3.58	

Some interesting observations. The S&P 500 has grown sales at about 3.91% annually, which is about the same pace that U.S. GDP has grown, 3.14%. This should make sense since the growth in corporate America is directly tied to GDP growth. What is interesting is that the consensus estimate for 2023 sales growth is 4.29%, but GDP growth estimate is only 1.30%, a fairly large spread. Also, notice that the consensus forecasts for 2023 are still projecting no recession, analysts are looking for a soft landing.

S&P 500 Seventeen Years of Compound Annualized Growth 2006 – 2023 est.		
S&P 500	Compound Annualized Growth Rate	Current Consensus Estimates for 2023
Sales	3.91%	4.29%
Earnings	5.70%	1.37%
Dividends	3.91%	3.03%
Book Value	4.25%	2.50%
GDP	3.14%	1.30%

Once I have this data compiled, I then calculate a target price for a company or the market, that I believe is reasonable based on the companies (or markets) own history. Of course there are other variables that come in to play. You have to determine whether you agree with the consensus estimates for the current year, or whether you have a different outlook. You also have to consider the interest rate environment over the prior years and compare it to our

current environment. If interest rates were exceptionally low then valuations can be higher, but if interest rates are higher you should expect lower valuations.

It's not easy, you have to combine both science and art to make a reasonable estimation. We're not dealing with exactitude; we're dealing with probabilities. Using this method, I arrive at a reasonable valuation for the S&P 500 of about 3,165, or about 20% below the current price of 3,970. This doesn't mean that the market necessarily falls 20%, it may just experience muted performance as fundamentals catch up to the current price.

Again, this is not a "holy grail", it is simply a tool to be used when valuing individual stocks. It helps us determine entry points, exits, and appropriate weights.

Market Update:

Coming off of a very difficult 2022, the new year started with a bang with the S&P 500 up 6.29% in January. Then in February one bad week followed another and the S&P 500 gave back 2.51%, leaving us up 3.62% year-to-date. The key difference between January and February is the expectation for inflation and subsequently interest rates.

January's higher-than-expected core personal-consumption expenditures price index reading suggests that Federal Reserve chairman Jerome Powell will have to keep rates higher for longer. An economy that stays stronger for longer, means that interest rates most likely stay higher for longer, and stocks aren't as appealing as cash.

I believe we are entering a period where savers/investors will be rewarded, while speculators will be sacrificed. Live and let die.

As always, be careful out there.

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