October 2023 Market Commentary

## *Takin' Care of Business*

***You get up every morning from your alarm clock's warning***
***Take the 8:15 into the city***
***There's a whistle up above and people pushin', people shovin'***
***And the girls who try to look pretty***
***And if your train's on time, you can get to work by nine***
***And start your slaving job to get your pay***
***-Bachman-Turner Overdrive***
***https://www.youtube.com/watch?v=0y-_WGjZgD8***

The photo above is from a recent trip my wife and I took to Sicily. We stayed at a truly magical place on the slopes of Mt Etna overlooking the Ionian Sea, Monaci delle Terre Nere, which in Italian means "monks of the black lands". This refers to the Augustinian Monks who in the 1600's settled on Monaci's rich, dark volcanic soil and started cultivating the land. Which today, nearly 400 years later still produces exceptional wine.

While relaxing poolside sipping the fruits of their labors, it was impossible to imagine the serious, physical, work that went into carving (literally hand-carving) 25 hectares of terraced vineyards out of black volcanic rock. I am so thankful that all over the world we've had amazing hard-working individuals who've created such wonderful sights, and I'm equally thankful that through innovation and productivity we no longer have to physically toil like this.

It's funny what incredibly beautiful surroundings and a little wine will get you thinking about. For me it was just how far we've come as a species, and where we might be headed. You can crudely tell the story of our species in three stages. In the first, which lasted for the vast majority of our time on Earth, from the emergence of Homo sapiens over 300,000 years ago to about 12,000 years ago, humans lived largely nomadic lifestyles, subsisting through hunting and foraging for food. In the second, lasting from about 10,000 BC to around 1750 AD, humans adopted agriculture, allowing for a more secure supply of food and leading to the establishment of towns, cities, even empires.

The third period, in which we all live, is characterized by an unprecedented phenomenon: sustained economic growth. Quality of life went from improving very gradually if at all for the vast majority of human history to improving very, very quickly. In the United Kingdom, whose Industrial Revolution kicked off this transformation, GDP per capita grew about 40 percent between 1700 and 1800. It more than doubled between 1800 and 1900. And between 1900 and 2000, it grew more than fourfold.

What today we'd characterize as extreme poverty was until a few centuries ago the condition of almost every human on Earth. In 1820, some 94 percent of humans lived on less than an inflation adjusted $2 a day. Over the next two centuries, extreme poverty fell dramatically; in 2018, the World Bank estimated that 8.6 percent of people lived on less than $2 a day. And the gains were not solely economic. Before 1800, average lifespans didn't exceed 40 years anywhere in the world. Today, the average human life expectancy is more like 73.

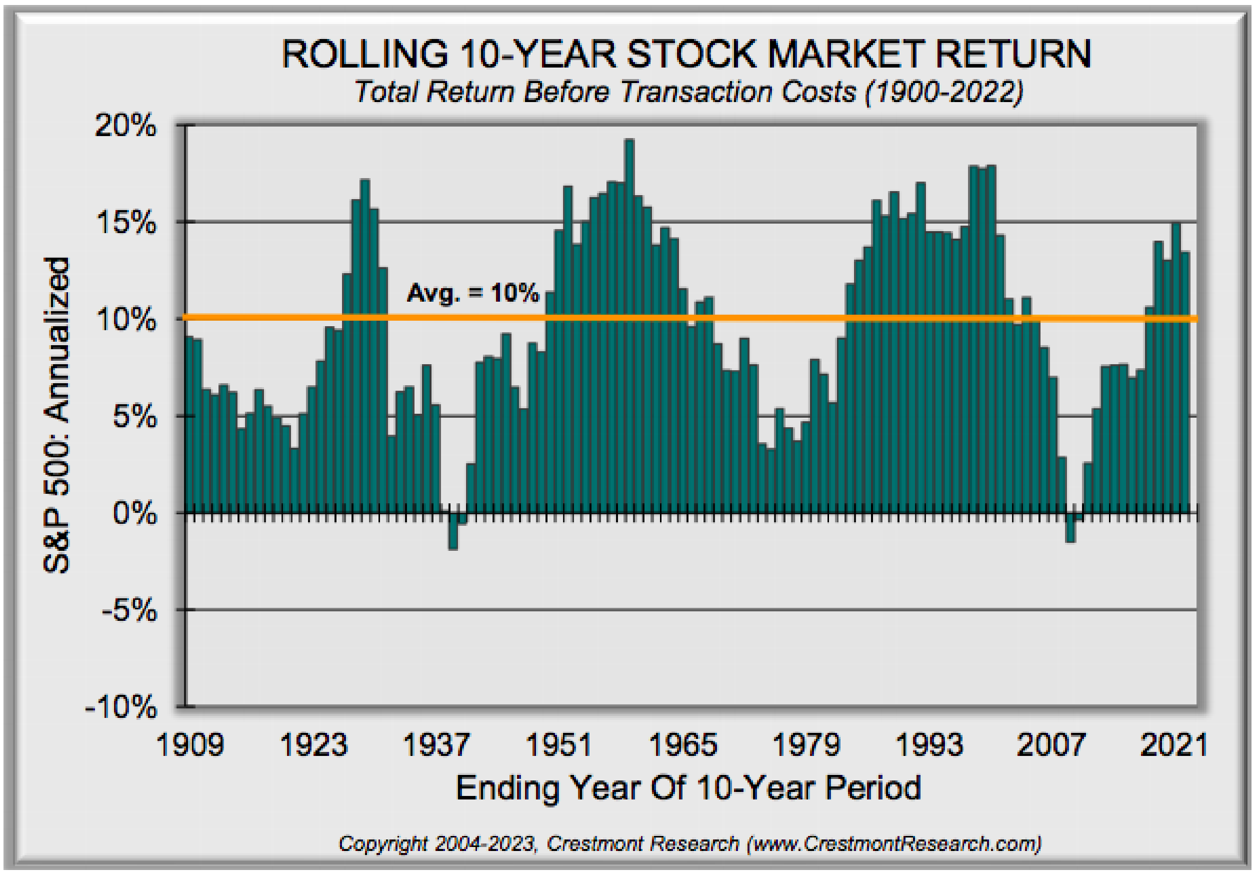
While advances in technology have occurred throughout history, from arrows, to tools, to wheels, it takes **sustained innovation to lead to sustained prosperity**. **Sustained innovation takes a culture that values work and supports innovation, protects property rights and limits confiscation by the government.** Most societies in world history had none of these features, let alone all of them. It took a while for all of these preconditions to coalesce in one nation, but once it did economic growth took off and spread.

The world became rich because of a massive increase in the rate of technological innovation. One thing the history of technology has taught us is that as long as the incentives are there for innovators to innovate, we will continue to be surprised. The most important new innovations are often impossible to foresee. Today, AI offers the possibility of such surprises (with major moral caveats).

Economic growth occurs when there is a sustained increase in economic prosperity and productivity. Today, I worry that this period of sustained growth may be coming to an end, or at least decelerating here in the United States. I am worried that we, as a country, are losing our will to hustle. Our culture is shifting away from valuing hard work, protecting property rights, and limiting government confiscation.

California is contemplating imposing a 32-hour workweek (while getting paid for 40 hours), while the UAW (with full support of the President) is asking for the same thing. I remember my wife and I both working 60-70 hour weeks for many years, as we sought to improve our life-style and give our children a better standard of living than we had. When I look at offices today you rarely see anyone working after 6pm, you rarely see anyone there on a Friday afternoon, and you never see anyone working on a Saturday or Sunday. Sure, the pandemic clearly influenced work ethics, but I sense something deeper at work, a collective psychology that just doesn't care that much about growth.

What does this have to do with the stock market? Everything! People like to say that the stock market returns 10% a year, and as the chart below shows for the last 122-years that has been the case. But, what if the conditions that were present for the last 100-years aren't present for the next 100-years?

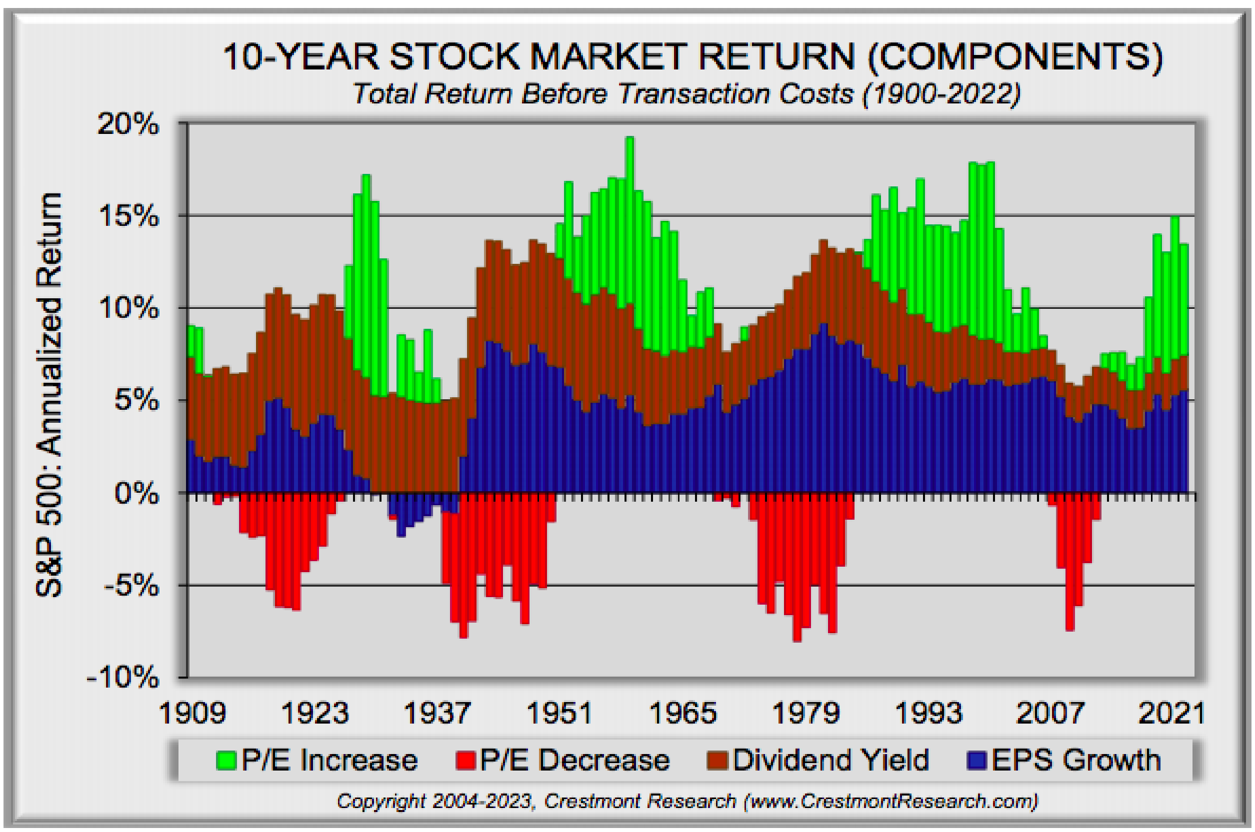



What if the rule of law, property rights, and tax collections are materially different than what they have been? And, more importantly, what if the will to work, to be productive, is less than it has been in the past? We know what this looks like, we've seen it happen in many European countries, and many other places around the globe. There is a reason that the U.S. stock market has significantly outperformed International markets, and there is a reason that nearly all of the greatest companies in the world are American.

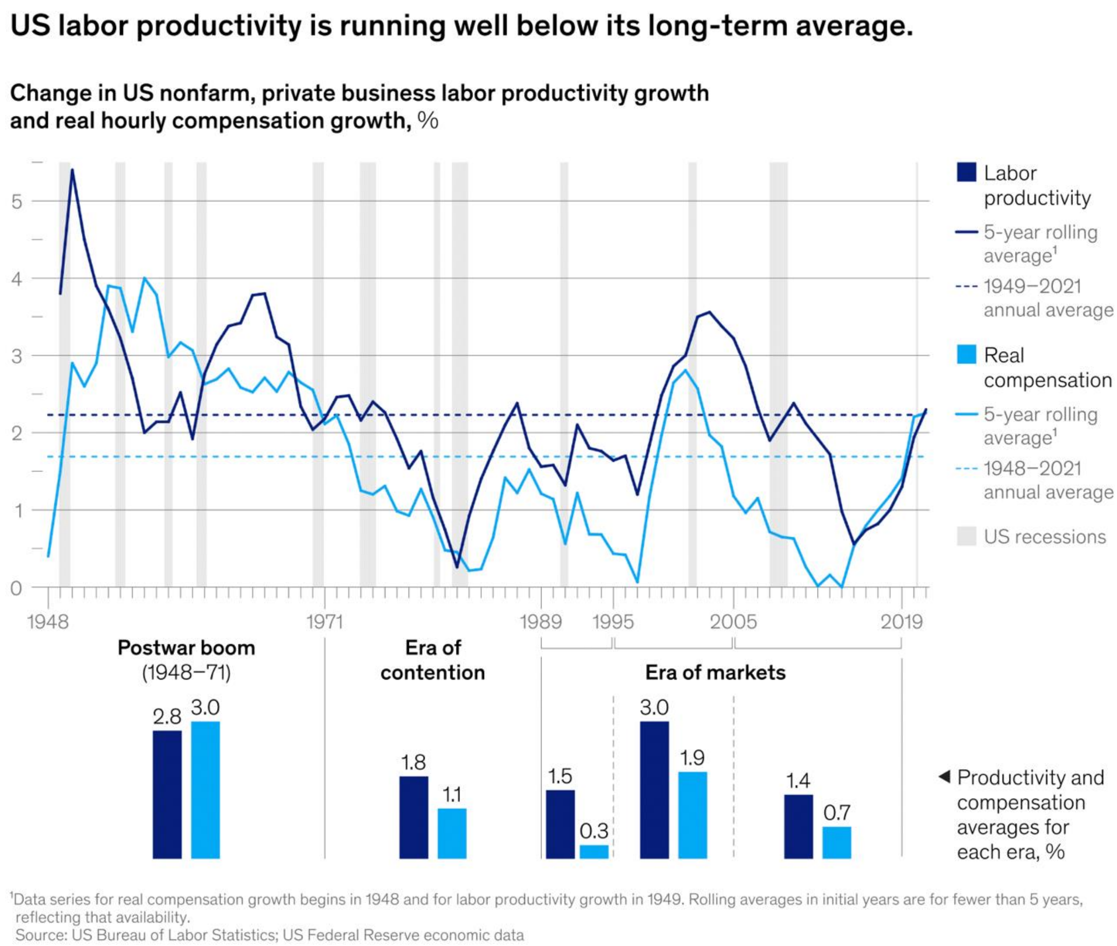
I have always been a big believer that capital (money) flows to where it is treated the best. In other words, money (like most things in life) flows to where it has the greatest chance to grow. And it grows where the conditions for that growth are most favorible. A place where the rule of law is strong, where property rights are respected, where taxes are low, and most importantly, where workers want to work and improve their standard of living.

The best visible example of this growth is the P/E ratio. The Price-to-Earnings ratio is a reflection of what investors are willing to pay for a companies growth. When PE's expand, investors are confident in future growth and willing to pay for it. When PE's contract, investors are less confident in that future growth and therefore asign a lower valuation.

The chart below shows four periods in the last 122-years where PE's contracted and 10-year annualized returns fell significantly below their long-term average of 10%. Those periods were times when productivity fell dramatically either from deep recessions and high unemployment, wars, or rising interest rates that restricted the flow of capital.



Social psychology is a powerful force when it comes to economics, and it is also one of the hardest to understand. What we do know is that lower productivity leads to lower economic growth, and lower economic growth leads to lower long-term returns on stocks.




Maybe technology and artificial intelligence will fill the gap from workers not wanting to work, but only if they are allowed to grow without the government confiscating their profits. As we enter political season, think about which politicians will do the most to foster an environment and culture where economic growth is rewarded and not penalized.

***And I'll be taking care of business (every day)***
***Taking care of business (every way)***
***I've been taking care of business (it's all mine)***
***Taking care of business and working overtime, work out***

**<u>Market Commentary:</u>**

September continued its reputation as one of the toughest months to invest in stocks. With interest rising sharply, stocks had a very tough time finding firm footing. Here are some

September total returns: S&P 500 -4.7%, Nasdaq 100 QQQ -5.1%, Russell 2000 Small-Caps -5.9%, All-World ex US -3.2%, Emerging Markets -3.1%, Aggregate Bond -2.6%.

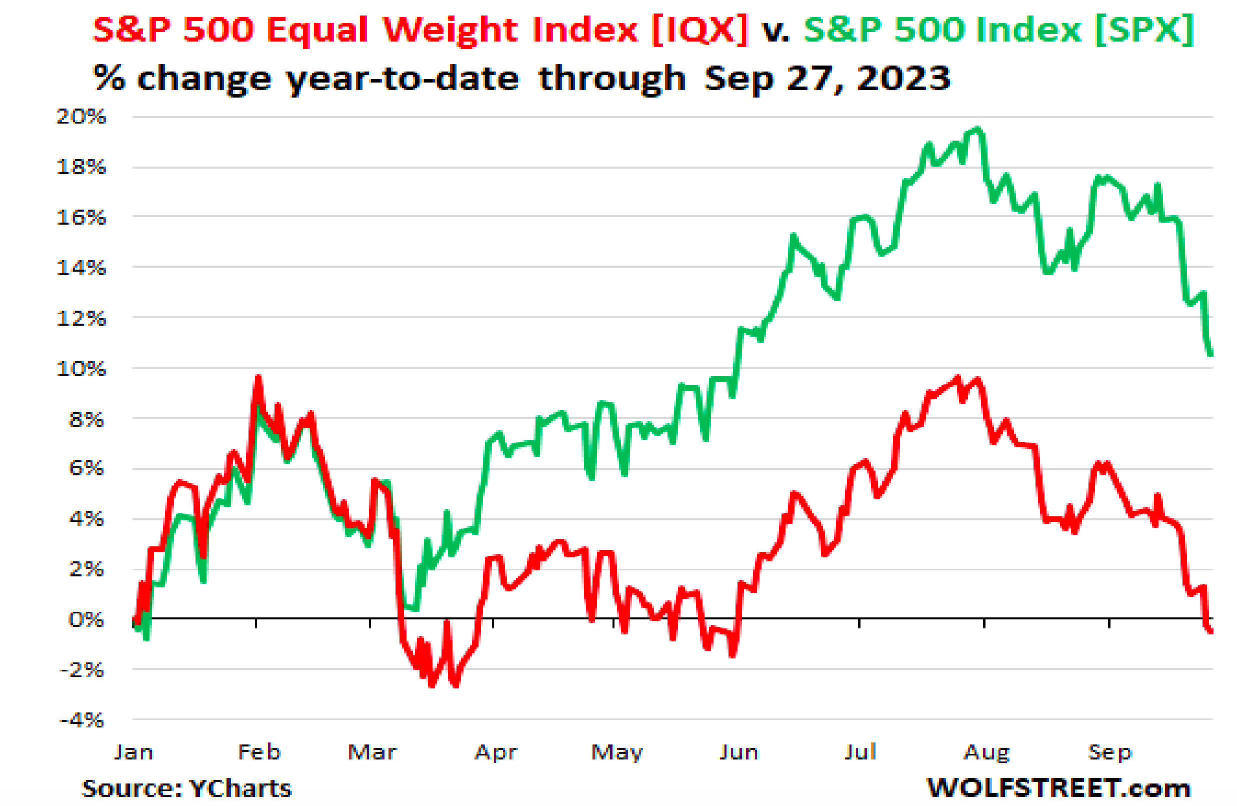
Even though the third quarter has been tough for most markets, one-year returns for many markets continue to be very positive. As the table below shows, other than fixed-income equity markets still have double digit one-year returns.

**Quarterly Market Performance Barometer**

| | Performance (%) | | |
|---|---|---|---|
| **U.S Equities** | **Q3 2023** | **Q2 2023** | **1 Year** |
| U.S. Market | -3.19 | 8.49 | 21.00 |
| Value | -1.91 | 3.86 | 17.04 |
| Growth | -5.92 | 11.64 | 20.73 |
| Dividend Composite | -2.49 | 3.24 | 15.09 |
| Wide Moat Composite | -3.53 | 12.10 | 28.01 |
| **Global Equities** | | | |
| Developed Markets ex-US | -3.84 | 3.13 | 23.95 |
| Emerging Markets | -1.54 | 1.77 | 13.54 |
| **Fixed Income** | | | |
| U.S. Core Bond | -3.18 | -0.82 | 0.66 |
| U.S. Treasury Bond | -3.01 | -1.37 | -0.78 |
| U.S. High Yield Bond | 0.57 | 1.65 | 10.30 |
| TIPS | -2.57 | -1.45 | 1.29 |
| 10+ Year Treasury Bond | -11.91 | -2.35 | -9.24 |

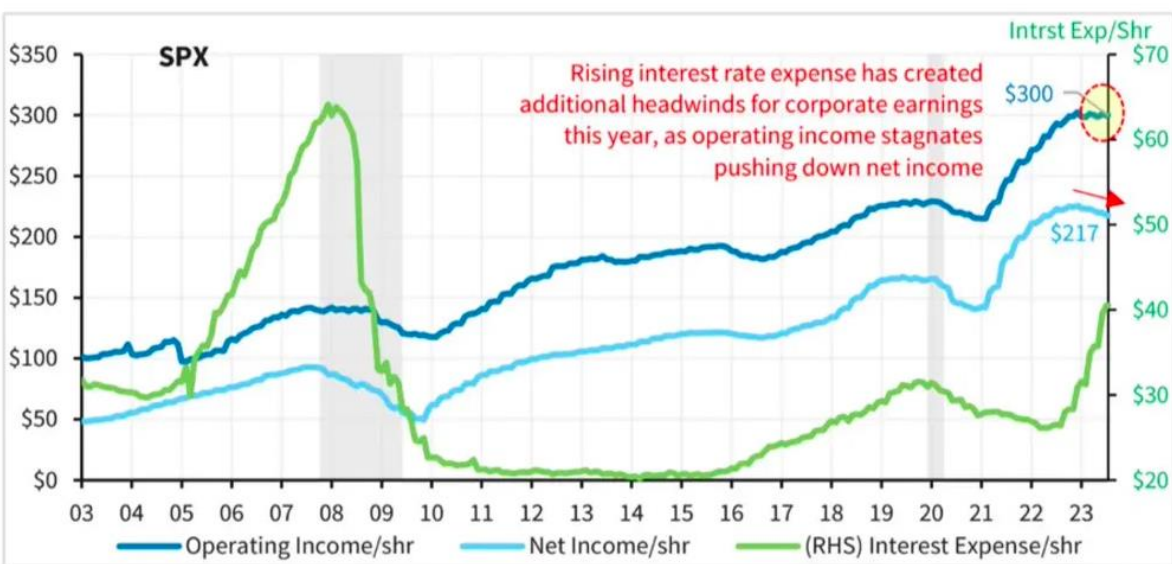
Source: Morningstar Direct. Data as of Sept. 30, 2023.

The biggest story in the stock market in 2023 continues to be the outperformance/dominance of the largest US stocks. The eight largest stocks in the S&P 500 index account for 29% of the index's weight and have accounted for most of the benchmarks year-to-date return. As the graph below shows, while the market-cap weighted S&P 500 is up about 11% YTD the equal-weighted S&P 500 is actually negative YTD.



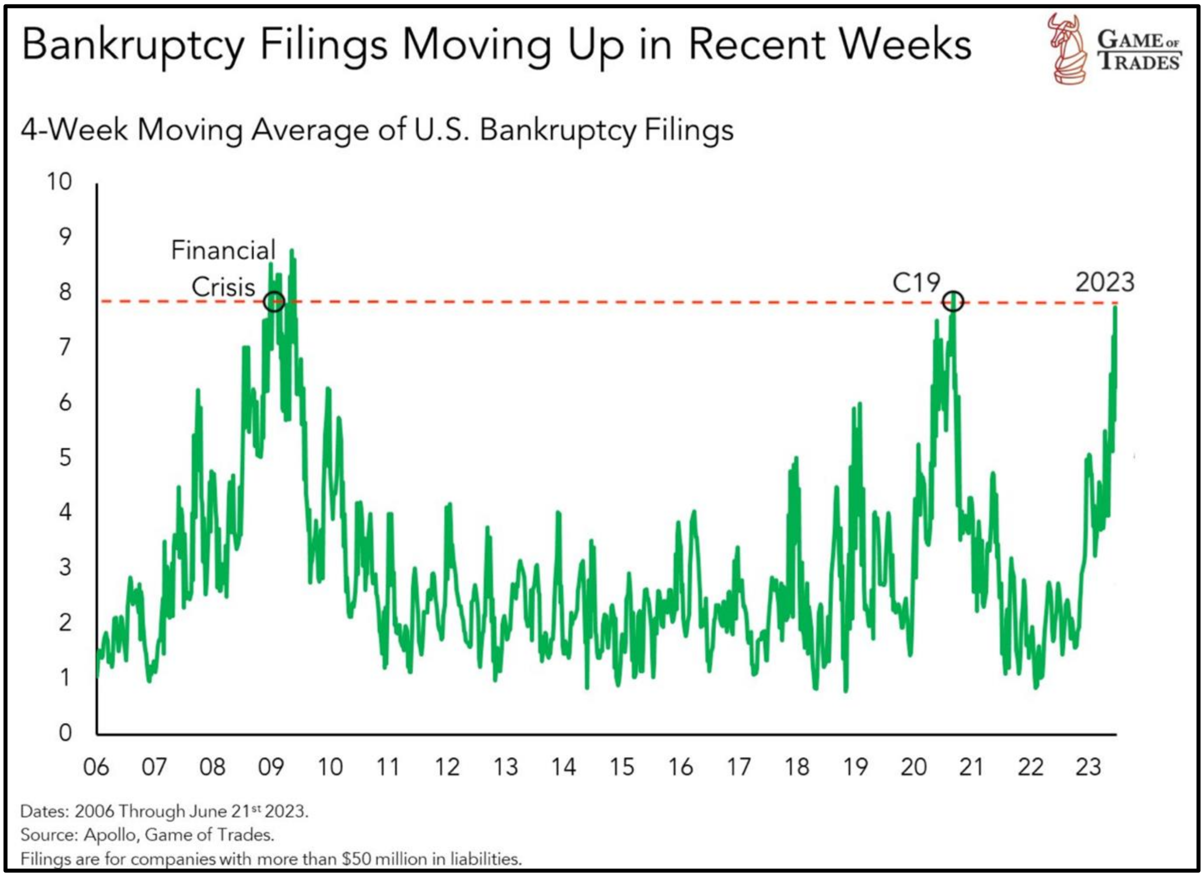

Rising interest rates are finally starting to bite into corporate profits. As the chart below shows, as interest expense rises sharply, net income is starting to decline.

FIGURE 1. **Rising interest expense has helped to drive a widening gap between operating income and EPS**

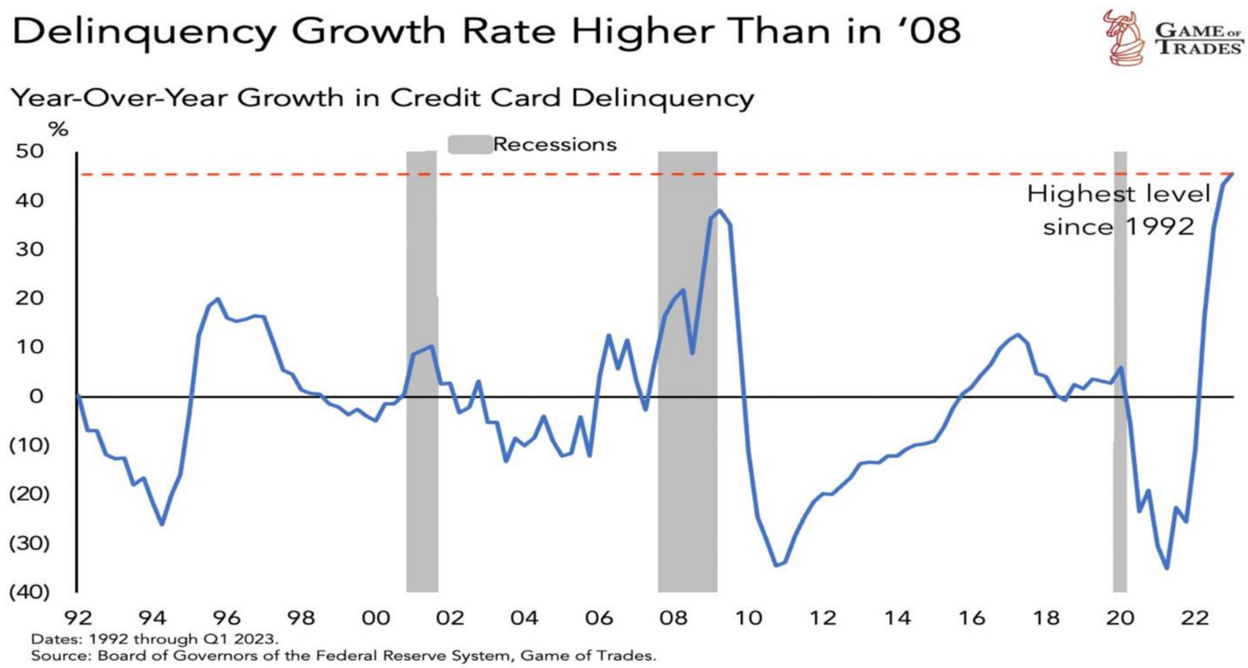



Data as of 9/12/2023. Operating income = EBIT. All items use LTM values.
Source: Refinitiv, Bloomberg, Barclays Research

And for those companies with more leveraged balance sheets, rising rates and tougher refinancing conditions, are leading to a markedly increased rise in bankruptcy filings.




And corporations aren't the only ones starting to feel the constricting effects of higher interest rates, consumers are also struggling with surging rates and are increasingly delinquent on their credit card payments.




This is exactly what the Fed is trying to orchestrate. Higher interest rates are intended to slow the economy and bring down stubbornly high inflation. It has taken some time, but we are clearly seeing the tightening of monetary policy impact the broader economy. Whether this leads to a full blown recession or not is anyone's guess. What is clearer is that higher rates are leading to PE contraction and much more attractive yields on fixed income.

As we move into the final quarter of 2023, we are probably getting closer to the end of the Fed's restrictive policy. I'm not saying they are going to ease anytime soon, just that the beatings are getting closer to ending. That combined with some pretty negative investor sentiment may lead to a little rally into year-end.

As always, be careful out there.

Chris Wiles, CFA

Where trust is Earned