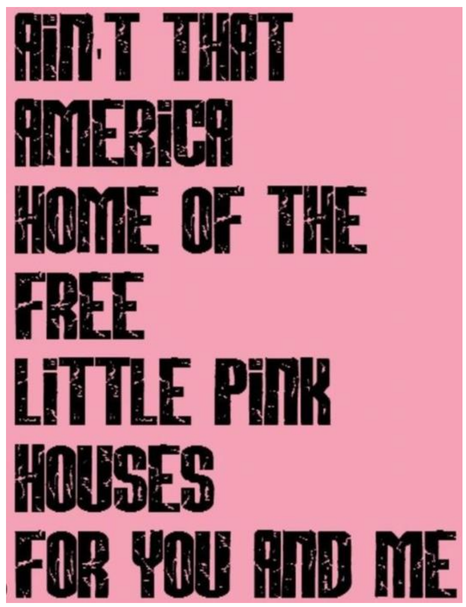
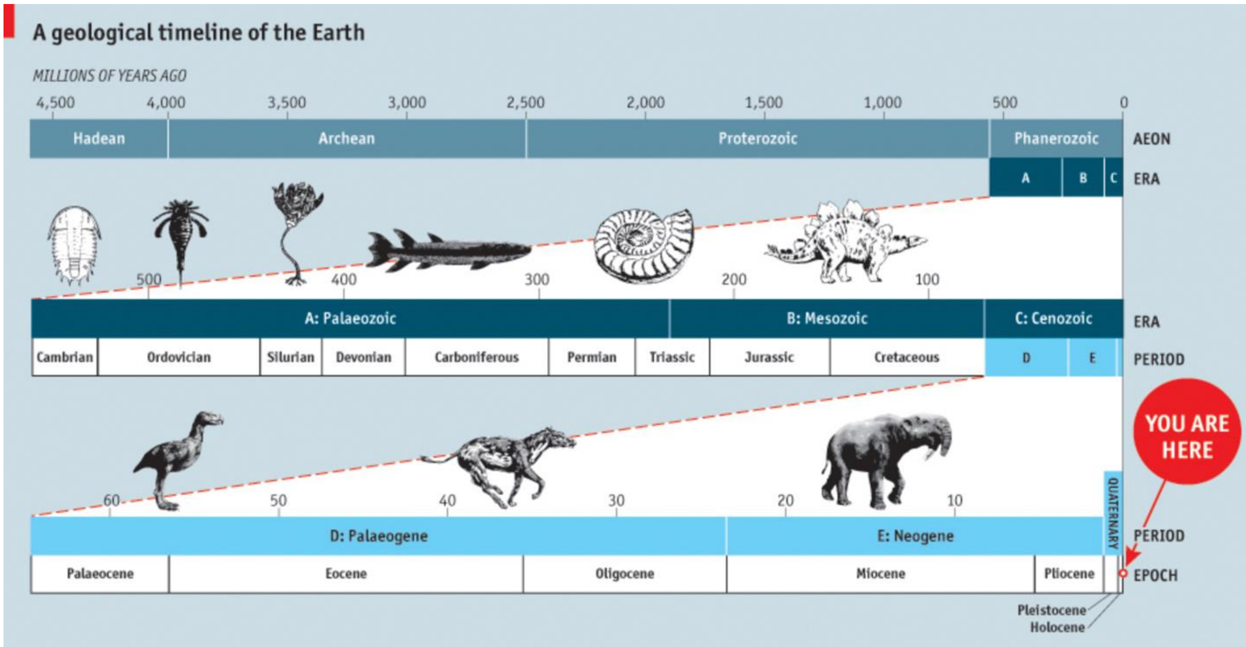
November 2023 Market Commentary

Little Pink Houses

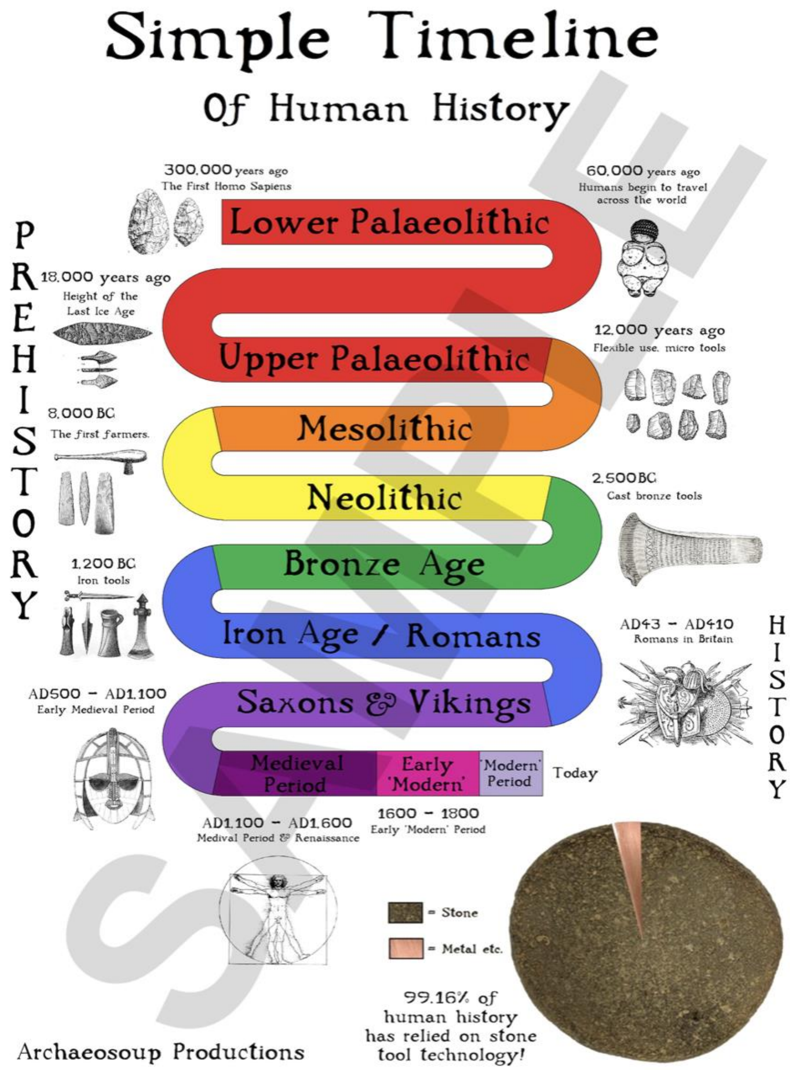


Pink Houses – John Mellencamp [***https://www.youtube.com/watch?v=qOfkpu6749w***](https://www.youtube.com/watch?v=qOfkpu6749w)

There's a very good series on Netflix right now, **"Life on Our Planet"**, directed by Stephen Spielberg and narrated by Morgan Freeman, which takes us through 4 billion years of life on our planet. Over that time, earth experienced four extinction level events (ELE's) in which 99.9% of all species that have ever existed have gone extinct.



Being the big brained narcists that we are, we generally think of history starting when we arrived on the scene, which is just a fraction of the time this big ball has been spinning. It is generally believed that the first Homo Sapiens appeared around 300,000 – 500,000 years ago.

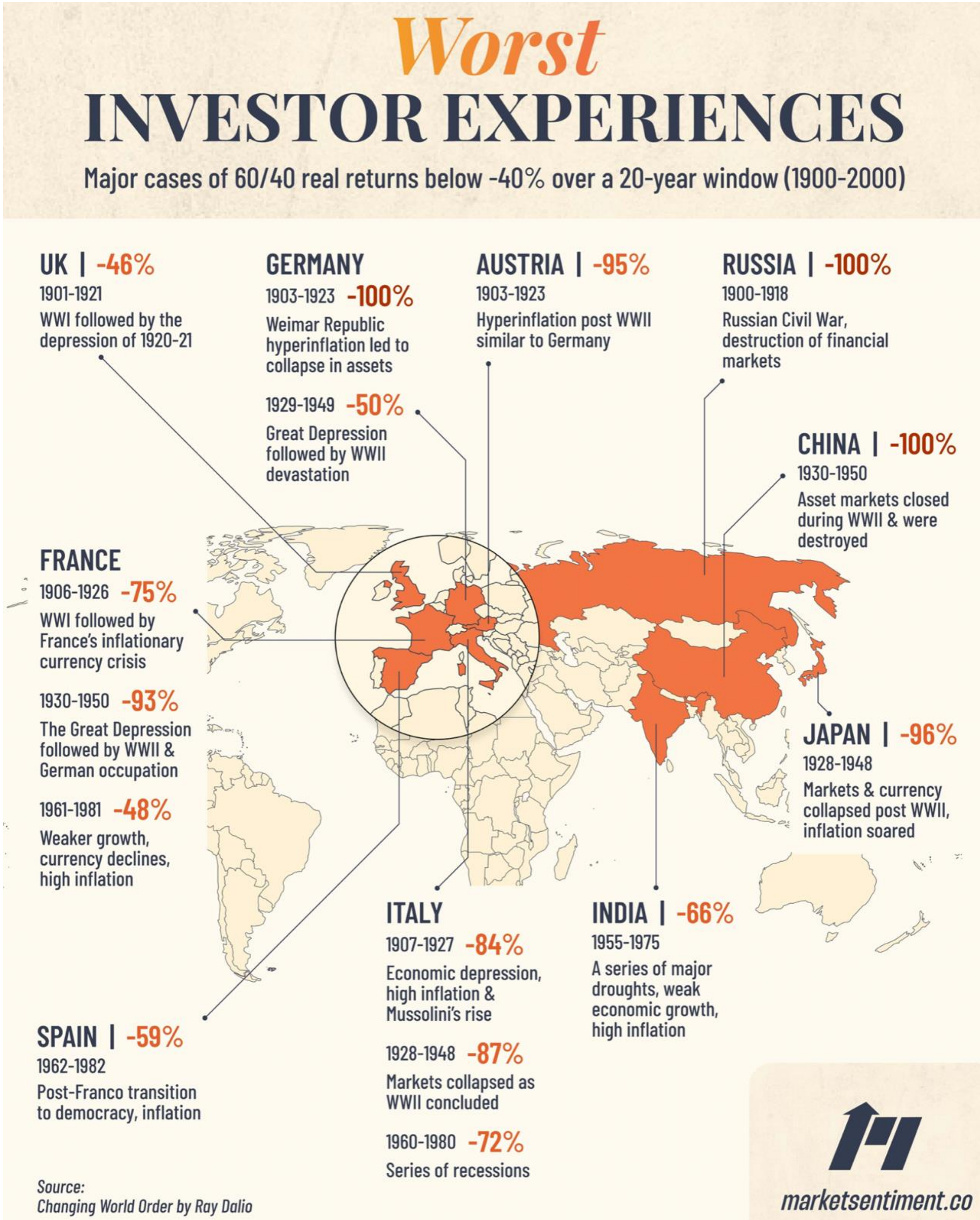


And, when it comes to economic or market history, we generally look at the last 100 – 200 years. We say silly things like, "this has never happened before" or "this is a once in a lifetime event". We state facts like, the average return on the S&P 500 for the last 150 years is 9%, the return on housing is around 7%, and the return on bonds is around 3%. Naively believing that just because something happened in the past it will continue happening. Here is the summary data for the S&P 500 for the last 150 years.

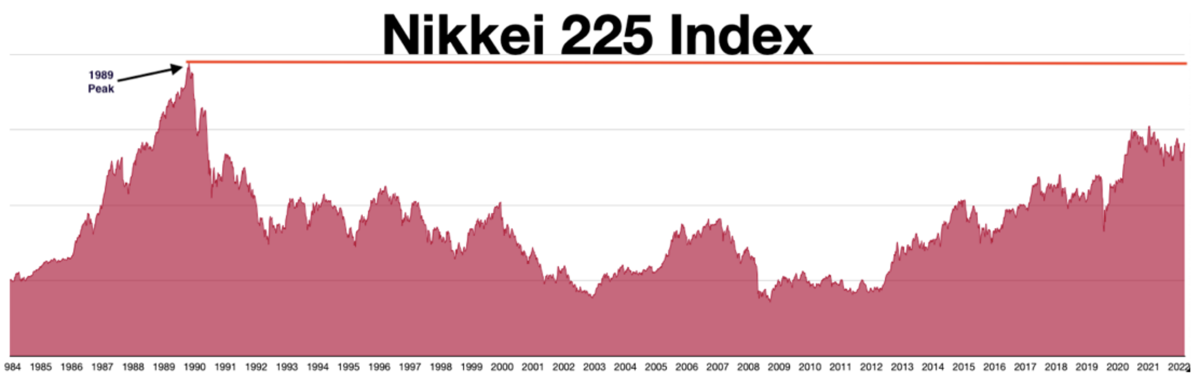
Years Averaged (as of the end of September 2023)	Stock Market Average Return per Year (Dividends Reinvested)	Average Return with Dividends Reinvested & Inflation Adjusted
150 Years	9.199%	6.895%
100 Years	10.53%	7.389%
50 Years	10.757%	6.59%
30 Years	9.862%	7.146%
20 Years	9.66%	6.915%
10 Years	12.078%	9.066%
5 Years	10.495%	6.221%

When you look at the table above, it is very easy to wrap yourself in the comforting, warm belief that the U.S. stock market is **THE** place to invest over time. But even though we constantly remind people that "past performance is no guarantee of future performance" everyone looks at the table above and smiles.

The thing to remember is that not only is this a rather short period of time, it is also just the 500 biggest and best companies in the United States. Just because the last 150 years saw the United States ascend to become the world's economic and military leader, doesn't mean that it will continue ascending for the next 150 years. If history has taught us anything, it should be to expect the unexpected. As the graphic below shows, there have been many major economies over the last 100 years where investors have experienced significant drawdowns.



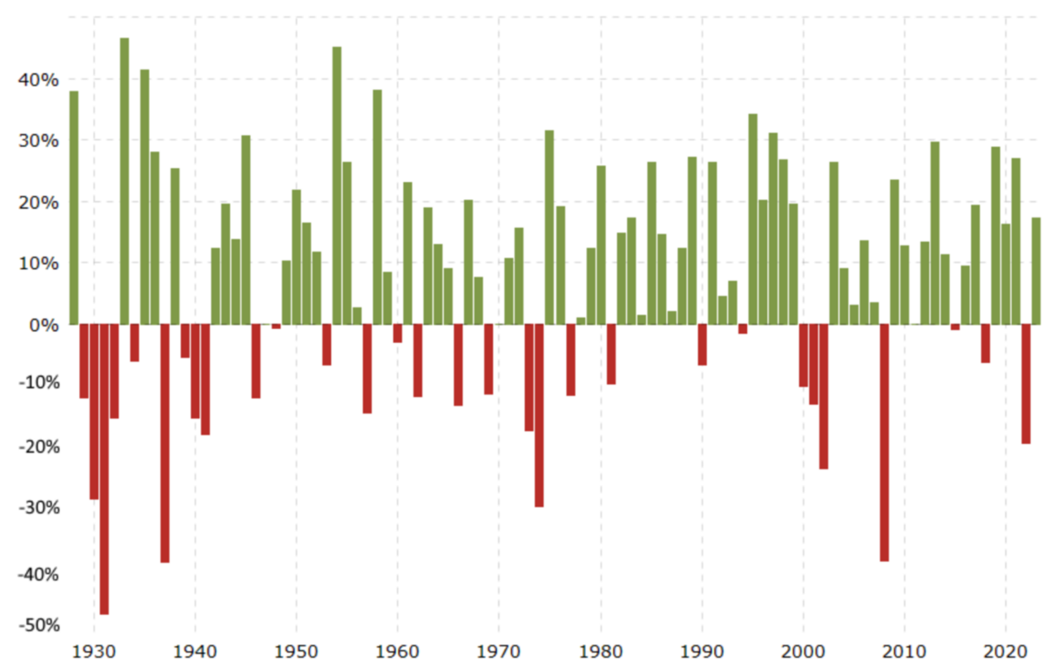
Let's take a quick look at Japan, which saw their markets collapse by 96% at the end of World War II. During the post war years of reconstruction Japan's real estate and stock markets soared in value. By the late 1980's Japan's stock market was the largest in the world, and their real estate was so overvalued that Tokyo's Imperial Palace was worth more than the entire state of California. To combat this rampant inflation the Bank of Japan jacked up rates which caused real estate prices to fall 70% and the stock market to experience a 60% decline, which it has yet to recover from.



Nikkei 225 Index Performance

While the chart above looks horrifying, the real-life implications are even worse. Let’s consider a Japanese worker who started working and investing in 1980. Assuming the worker invested $10,000 yearly for 30 years, and enjoyed the big runup to the 1989 peak, by 2010 when they retired their $300,000 of invested capital would have turned into $207,100 – **a -31% return on invested capital over 30 years!**

Most investors base their expectations on what they have experienced in their lifetimes. And when looking at how blessed the U.S. has been in the last 100+ years, it is easy to get complacent believing that our average annual returns should be 10%. But as Howard Marks said, ***“The concept of surviving on average is irrelevant. You have to survive every day. Which means, really, that you have to survive on the bad days.”***



S&P 500 Returns by Year

Throughout human history men have fought for power, the last major fight was World War II and the United States emerged as the victor and set the new world order. In 1945 we had 80% of the world's money, half of the world's GDP, and we were the military powerhouse. The U.S. set the world order, and our currency became the reserve currency.

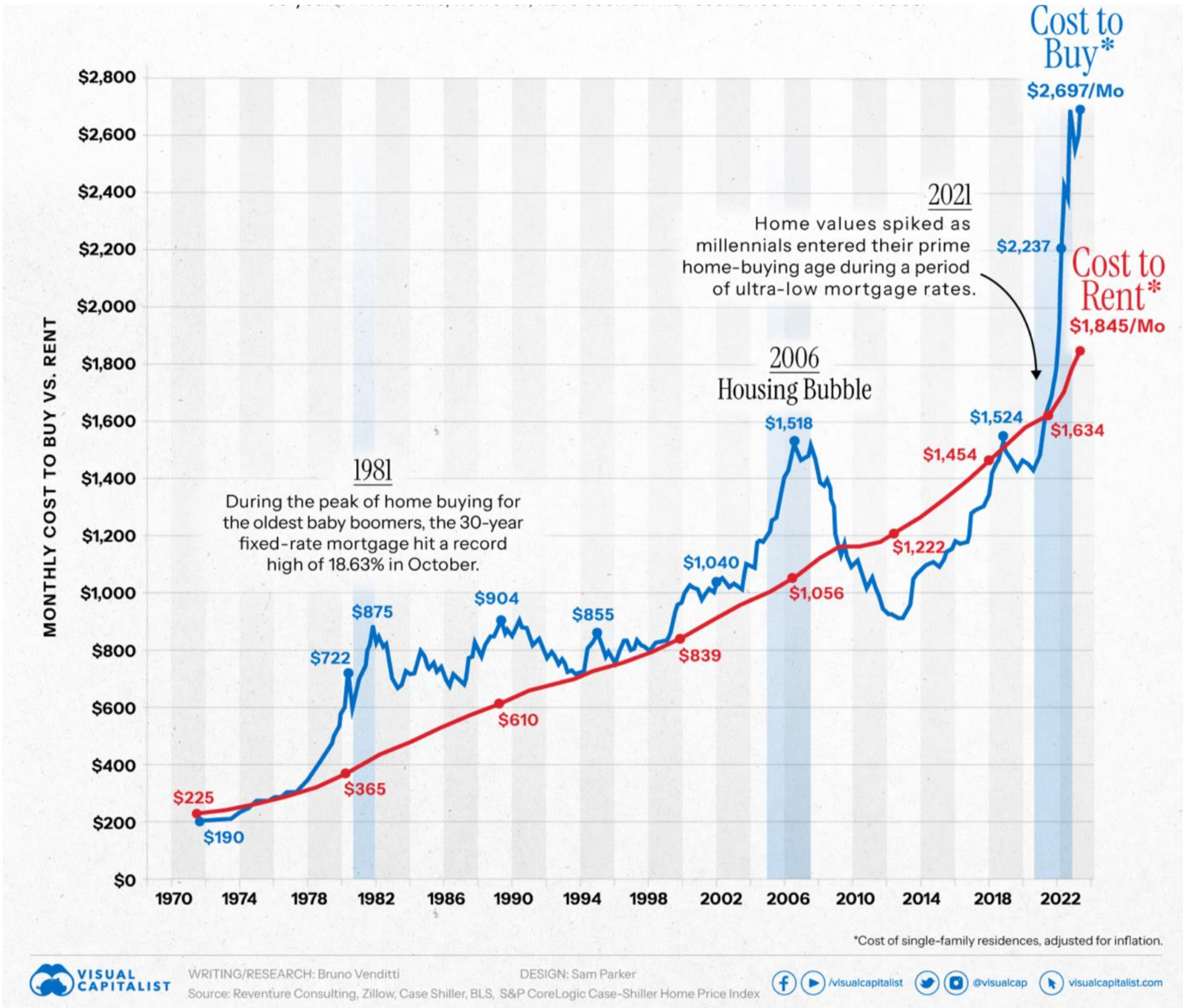
But as history has shown power is fleeting, and we may be nearing a pivot in world order. Since the U.S. became the world's leader, we have used the printing of money to support our reign, that printing of money has caused the devaluation of our currency, i.e., inflation. This prolonged period of excess has also caused a large wealth and values gap within our country. We have disenfranchised citizens on both the left and the right who want politicians who will fight for them, they do not want compromise. This internal strife has weakened us from within. And lastly, we have a powerful force rising to challenge us. China and its allies are looking to reset the world order.

This battle has already started. First, we have a trade war, a technology war, and a geopolitical influence war. Then it escalates into capital and economic warfare, before finally culminating in military conflict.

When John Mellencamp wrote "Pink Houses" in 1983 it was meant to be a sarcastic and cynical view on race and class survival in America. Showing that the American dream was very different for large swaths of our population. Looking at the chart below, in 1983 you can see a spike up in the cost to own a home relative to renting was at that time one of the highest in history.

Fast forward to today. After over a decade of zero interest rates, which saw asset values (especially housing) skyrocket, we have the Fed rapidly raising interest rates to combat inflation. This combination of record high housing prices and skyrocketing mortgage rates has led to an explosion in the cost to buy a home.

And there's winners and there's losers
But they ain't no big deal
'Cause the simple man, baby
Pays for thrills
The bills the pills that kill
Oh, but ain't that America



Life on Our Planet makes it very clear that the species that survive are the ones that can adapt rapidly to unexpected change. As investors, we cannot fall for the siren's call of average annual returns of 10%, and just assume that because something occurred in the past that it will continue into the future. As Jeff Goldblum (Ian Malcolm) says in Jurassic Park, *"Life breaks free. Life expands to new territories. Painfully, perhaps even dangerously. But life finds a way."*

I don't know if America's economy and stock market have seen their best days, the roadside is littered with prognosticators who've wrongly predicted peak USA. But I do think that we are at a rather precarious point in history.

Survival is job #1. We must remain vigilant, diversify, and be ready to adapt to the potential of a new world order. Hope for the best, prepare for the worst. Common sense tells us to make sure we take care of the simple things; pay down debt, save more, and spend less. From an investment perspective we are leaning into a more conservative posture. Cash, and short to intermediate-term fixed-income instruments are offering very competitive returns to equities and we want to make sure that we have appropriate allocations to these more conservative assets.

On the equity front, companies with the strongest balance sheets, and little to no need to access the capital markets to grow, have held up best in the recent sell-off. We are finally seeing Zombie companies (those companies that have been kept alive by free money) start to die off. This is actually great news, as this misallocation of capital has been detrimental to the competitive environment. Another thing to be mindful of is which companies will be hurt or benefit from escalating trade wars.

I know, I know, I sound pretty dire in this newsletter, and I'm aware that I may be letting the negative news environment affect my mood, but I'm paid to make sure my clients' assets as well as my own survive. Again, it's all about survival.

Be careful out there,

Chris Wiles, CFA

Where trust is Earned