4TH QUARTER 2023 CLIENT LETTER

January 12, 2024

"I think that a life properly lived is just learn, learn, learn all the time."

Charlie Munger, 2017 Berkshire Hathaway Annual Meeting

Investing in financial markets is a constant education.

A year ago, a Bloomberg survey of economists forecasted a 65% probability of recession for 2023. As the year progressed, there were plenty of reasons to be pessimistic. In February, Fed Chair Jerome Powell warned that the inflation fight would take "a significant period of time". In March, a bank run forced Silicon Valley Bank and Signature Bank into FDIC receivership, the largest bank failures in the U.S. since the Great Financial Crisis. Banks tightened lending standards and the housing market slowed to a crawl with mortgage rates climbing to 8%. Earnings rolled over for S&P 500 companies, with three consecutive quarters of year-over-year profit declines as of Q2 2023.

Despite the gloomy mood, the U.S. economy and markets chugged right along. Real GDP growth clocked in at 1.7%, 2.4%, and 2.9% through the first three quarters of the year. The unemployment rate wavered between 3.4% and 3.8%. Labor force participation has increased, and total non-farm payrolls reached an all-time high of over 157 million workers.

In markets, the S&P 500 posted a total return of 26.29% including dividends. Despite all of the talk about the "Magnificent 7" (i.e. the largest companies in the S&P 500 – Microsoft, Apple, Amazon, NVIDIA, Alphabet, Meta, and Tesla – roughly 30% of the index weight) carrying market returns in 2023, the total return on the equally-weighted S&P 500 index was a respectable 13.87% with dividends.

While the stock market surprised forecasters in 2023, it's important to keep in mind that the S&P 500 index level has yet to recapture its all-time closing high from January 3, 2022. After two years, the index is essentially flat (or up slightly when you include dividends). Over that same stretch, the Bloomberg US Aggregate bond index posted a *negative* total return of -8.3% (through January 10, 2024).

To be sure, we may not be out of the woods. The yield curve has been inverted since the summer of 2022 (meaning the 2-year Treasury rate is higher than the 10-year Treasury rate). Higher short-term versus long-term interest rates make it difficult for banks to extend credit to borrowers. If a bank's cost to borrow is higher than its compensation to lend ("borrow short, lend long"), its business model breaks. Hence, the economy (typically) slows or contracts when the yield curve becomes dysfunctional and credit growth slows.

In addition to the recession "signal" that the yield curve has been flashing for the last ~18 months, you can hunt around for other signs that the economy is slowing. But it's also instructive to look at the positive side of the ledger and note that, perhaps, things aren't all bad:

- The Federal Reserve's preferred measure of inflation, core personal consumption expenditures (core PCE), fell to 1.9% on a six-month annualized basis in November.

- Since the spring of 2023, wage gains have outpaced inflation, meaning workers are finally experiencing real income growth and purchasing power gains.
- U.S. labor productivity (an admittedly difficult number to calculate) was up 4.7% in Q3 2023, higher than any other non-recessionary period over the last 20 years.
- Household debt service payments as a percent of disposable income are historically low at 9.8% and are well below the 40-year high of 13.3% we saw on the eve of the Great Financial Crisis in 2007.
- A record ~40% of American homeowners own their home outright with no mortgage.
- Total annualized construction spending on manufacturing in the U.S. hit a record high of ~$210 billion in November 2023 and is 55% higher than the same pre-pandemic figure from November 2019.
- Social Security recipients received an +8.7% cost-of-living adjustment to their payments in 2023; meanwhile, inflation continues to cool.

In these quarterly letters, we often provide an update on the state of the economy and markets chock full of facts and figures. I should note, however, that these observations are not a driving factor in our discipline as portfolio managers. It's anyone's guess whether the next move in the stock market is up or down or whether a recession will strike in 2024 (or not). Our goal is not to time these moves.

When it comes to the stock side of a portfolio, our goal is to pay a reasonable price to own a small piece of some of the best businesses in the world. Over time, we anticipate that these businesses will navigate the challenges that the economy and markets throw their way, building and innovating to provide greater value to their customers. Over reasonable periods of time, we believe these businesses will generate positive earnings growth and reasonable returns to shareholders.

Long-term investing is an exercise in optimism and open-mindedness. It's an exercise in balancing our innate skepticism and risk-aversion with the belief that the future is – potentially – brighter. In the face of seemingly insurmountable challenges, humans are constantly striving and working towards that brighter future.

We hope this letter finds you and your family well. We appreciate your business and we continue to work hard to earn the trust that you have placed in us. Please let us know if you have a friend or a family member who could use our assistance.

Johnny Russell, CFA