Are You Confused/Concerned – Let Me Try to Explain

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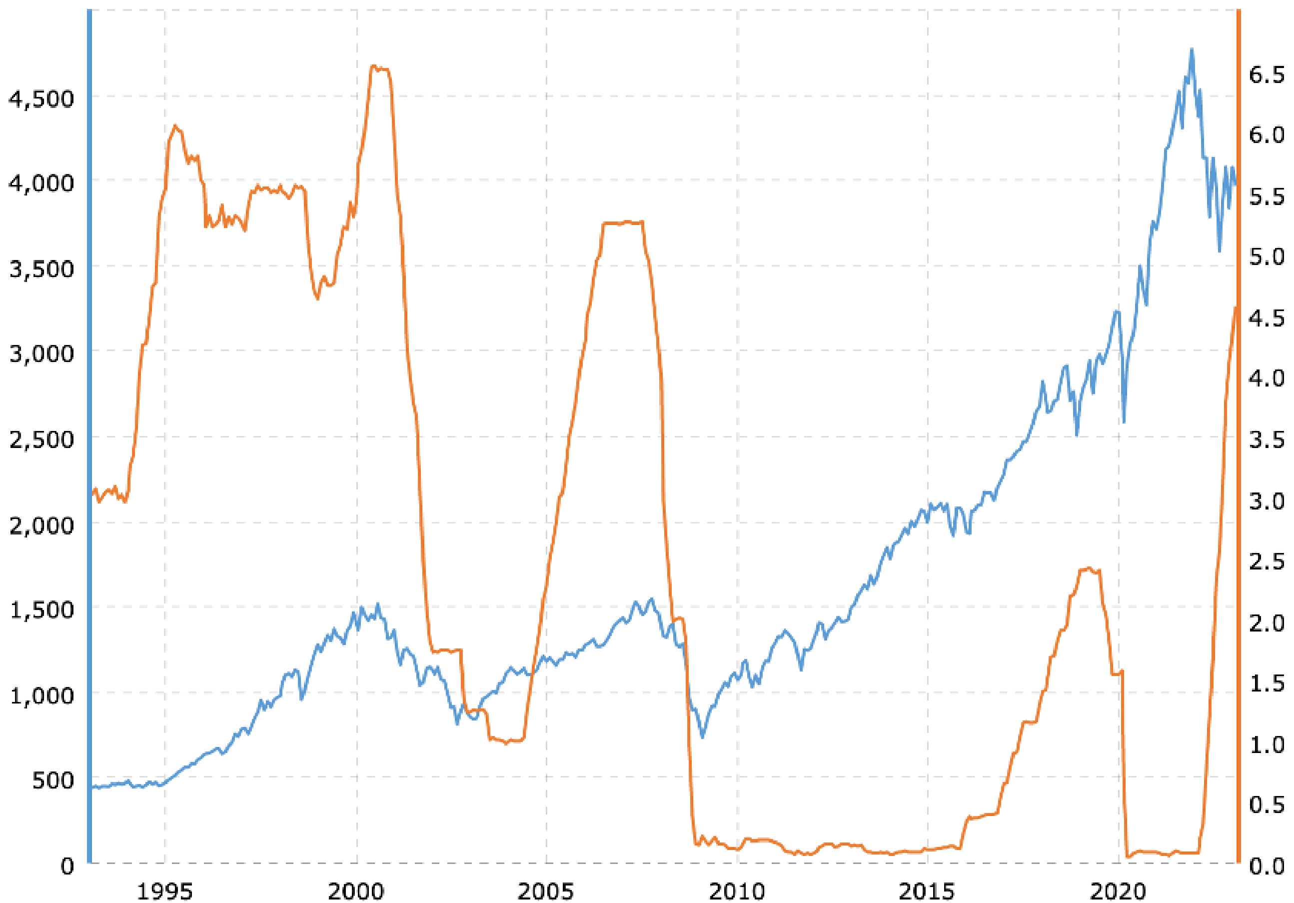
I wrote this commentary before the failure of Silicon Valley Bank and Signature Bank, the forced sale of Credit Suisse, and the problems at First Republic Bank. However, what contributed to the failure of these banks and prompted the FDIC and Federal Reserve to step in and provide assurances to the American public that their bank accounts are safe is the concept that I discuss at the start of this commentary.

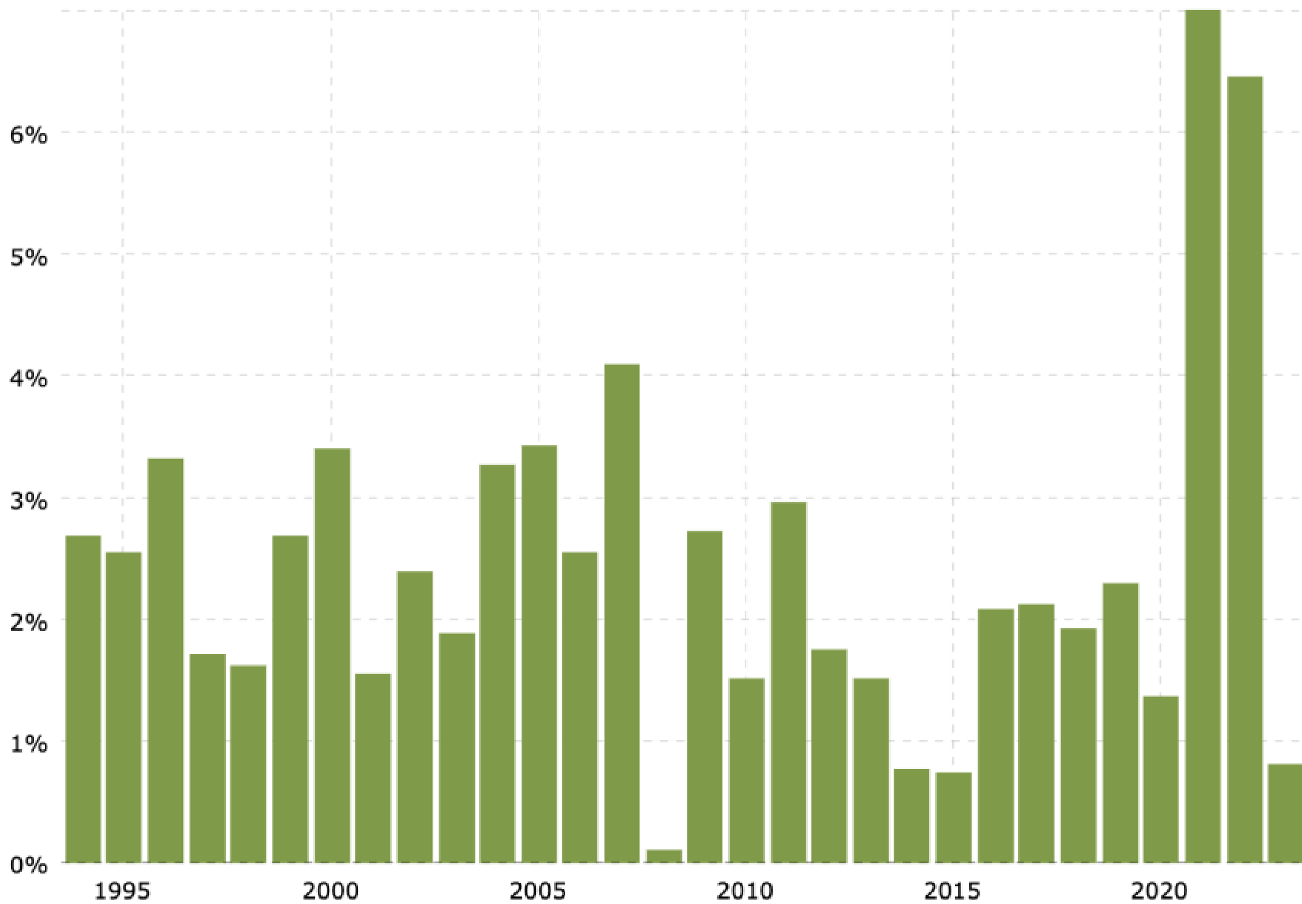
Over the last twelve months, the Federal Reserve has increased the overnight rate that it charges financial institutions to borrow money, called the Federal Funds Rate (FFR), by more than 4%. The casual observer equates higher interest rates with higher borrowing costs relative to mortgages, credit cards, and automobile loans. Some people familiar with how financial instruments, such as bonds, are priced understand that the price of bonds, usually issued in $1,000 increments, is inversely related to interest rates. In other words, as interest rates rise, the market price of a bond issued in the past when interest rates were lower will decline. For instance, the price return of the Vanguard Intermediate-Term Bond ETF (BIV) fell 11.28% from March 1, 2022, to March 1, 2023. A straightforward mathematical equation mostly dictates this inverse interest rate/price relationship because, with risk-free bonds such as Treasury securities and most high-quality bonds, variables such as term, coupon rate, and credit risk are well known. This inverse mathematical relationship between interest rates and the market price triggered the stress on many smaller banks' capital reserves, typically held in high-quality treasury or mortgage-backed securities. As interest rates were pushed higher by the Federal Reserve, these reserve accounts' market values were marked down on paper. Under ordinary circumstances,

these reserves and the bonds that make them up are considered "hold to maturity" investments, and being marketed down on paper does not trigger a liquidity crisis. However, when these paper losses coincide with much higher than normal deposit withdrawals, paper losses turn into real losses and adversely impact a bank's capital base.

A similar relationship exists between interest rates and price among other investment asset classes, including real estate, common stocks, and hybrid securities such as preferred stocks. Still, unlike bonds, these investments introduce many additional, less predictable variables into the equation, thus leading to greater price volatility and much less predictability. The interest rate factor is a stealth one for many investors when it comes to equity price volatility. We have seen a rising FFR many times in recent histories, such as between 1994 and 2000, 2003 and 2007, and most recently between 2016 and 2018. Each of these periods was characterized by a strong to the moderate economic backdrop, a falling unemployment rate, and a rising stock market. See the 30-year chart from MacroTrends showing the Fed Funds Rate in orange and the S&P 500 in blue below:



We have witnessed four periods over the last thirty years when the Federal Reserve has embarked on a significant tightening campaign characterized by significant increases in the Fed Funds Rate. Each of these periods, except the current one, has coincided with a rising stock market. What is the difference this time? Is it inflation? Below is a MacroTrends chart of annual CPI inflation over the last 30-years:



This chart shows the recent spike in CPI inflation that we witnessed beginning in 2021 when CPI rose 7.0% and 6.50% last year. The Federal. Reserve kept the Fed Funds rate near zero percent for all of 2021 as the central bank deemed the 2021 inflation spike mostly related to the uneven reopening of the economy following the unprecedented action taken to contain the COVID-19 global pandemic that began in January 2020. Toward the end of 2021, seeing the inflation pressures were not abating but accelerating, the Federal Reserve signaled that it would begin to tighten monetary policy and raise interest rates. At the March 2022 Federal Reserve Open Market Committee meeting, the central bank announced that it was raising the Fed Funds Rate by 0.25%. In the second quarter of 2022, inflation continued to accelerate.

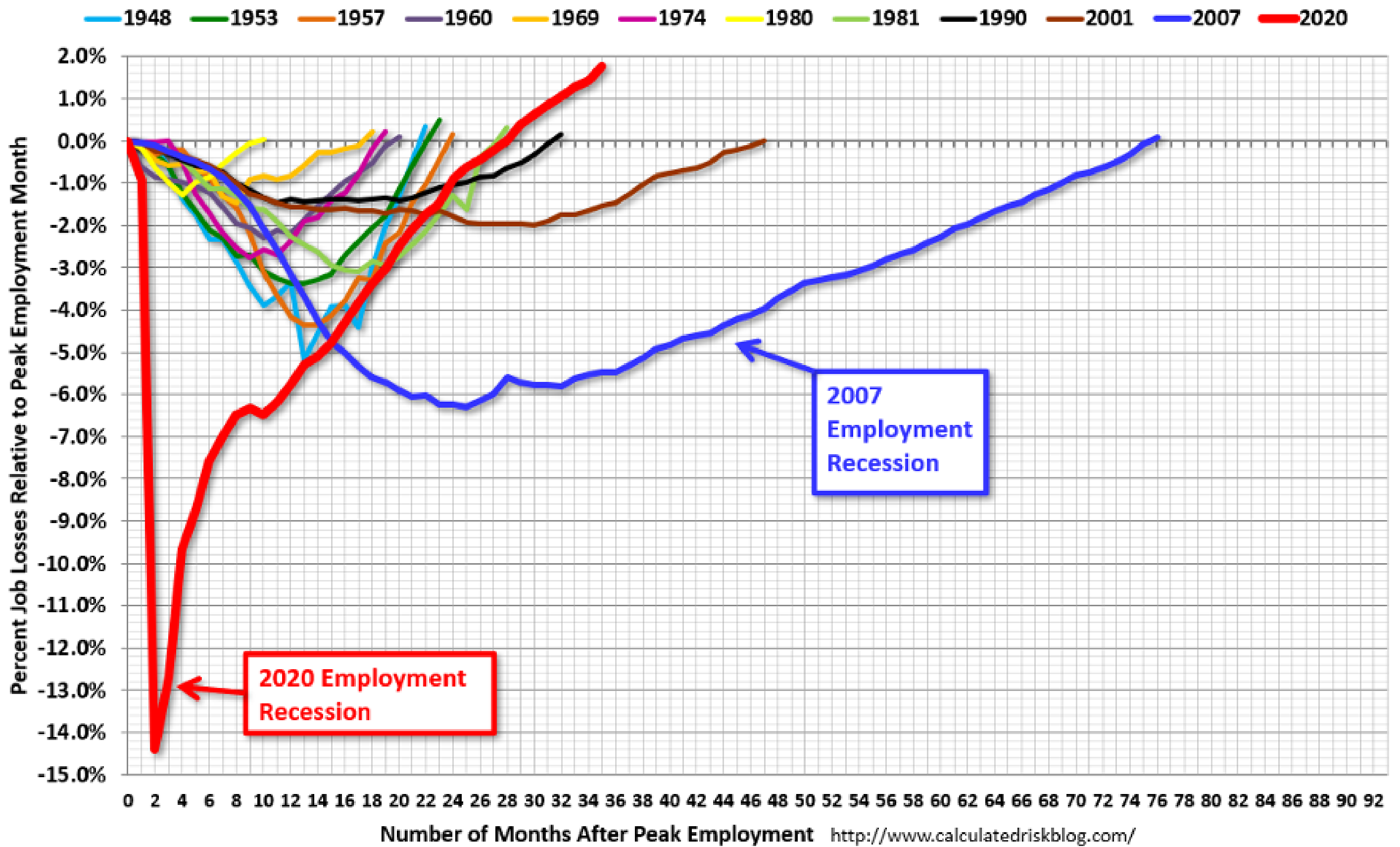
The chart above shows that over the last thirty years, annual CPI has only been outside the 1.50% and 3.00% range ten times, with 2021 and 2022 representing the highest upside variance to that range. The chart shows CPI for 2023, representing only two months of data. My assessment of where annual headline CPI inflation will be at mid-year and end of 2023 is 3.30% and 2.80%, respectively. Based on my forecast, this means that headline year-over-year CPI for 2023 should be back within the range that has made up two-thirds of the last thirty years.

Below, from Forbes, is a chart of the Federal Reserve's Fed Funds Rate action over the last 12 months:

FOMC Meeting Date	Rate Change (bps)	Federal Funds Rate
Jan 31 to Feb 1	+25	4.50% to 4.75%
Dec 14, 2022	+50	4.25% to 4.50%
Nov 2, 2022	+75	3.75% to 4.00%
Sept 21, 2022	+75	3.00% to 3.25%
July 27, 2022	+75	2.25% to 2.50%
June 16, 2022	+75	1.5% to 1.75%
May 5, 2022	+50	0.75% to 1.00%
March 17, 2022	+25	0.25% to 0.50%

As can be seen from the chart above, the Federal Reserve raised the Fed Funds Rate by 0.50% in May and then aggressively embarked on four consecutive 0.75% raises between June and November. This was the most aggressive monetary policy action the Central Bank has taken since the early 1980s. But we must remember that this aggressive rate hike followed the most aggressive monetary policy easing in history immediately following the onset of the COVID-19 pandemic in early 2020.

With the emergence of the first global viral pandemic in 100 years, global central banks and governments took unprecedented actions in early 2020 to avert the possibility of the first economic depression since the 1930s. These actions were successful in averting a significant economic contraction. Still, the actions were so significant that they created a pace of economic activity that a pandemic-fractured global supply chain could not handle. This dynamic averted a spike in layoffs, unemployment, and bankruptcies but set off a supply/demand-driven spike in inflation that peaked in the first half of 2022. To illustrate just how unprecedented the immediate job-related economic impact of the COVID-19 pandemic was, see the CalculatedRisk.com chart below:

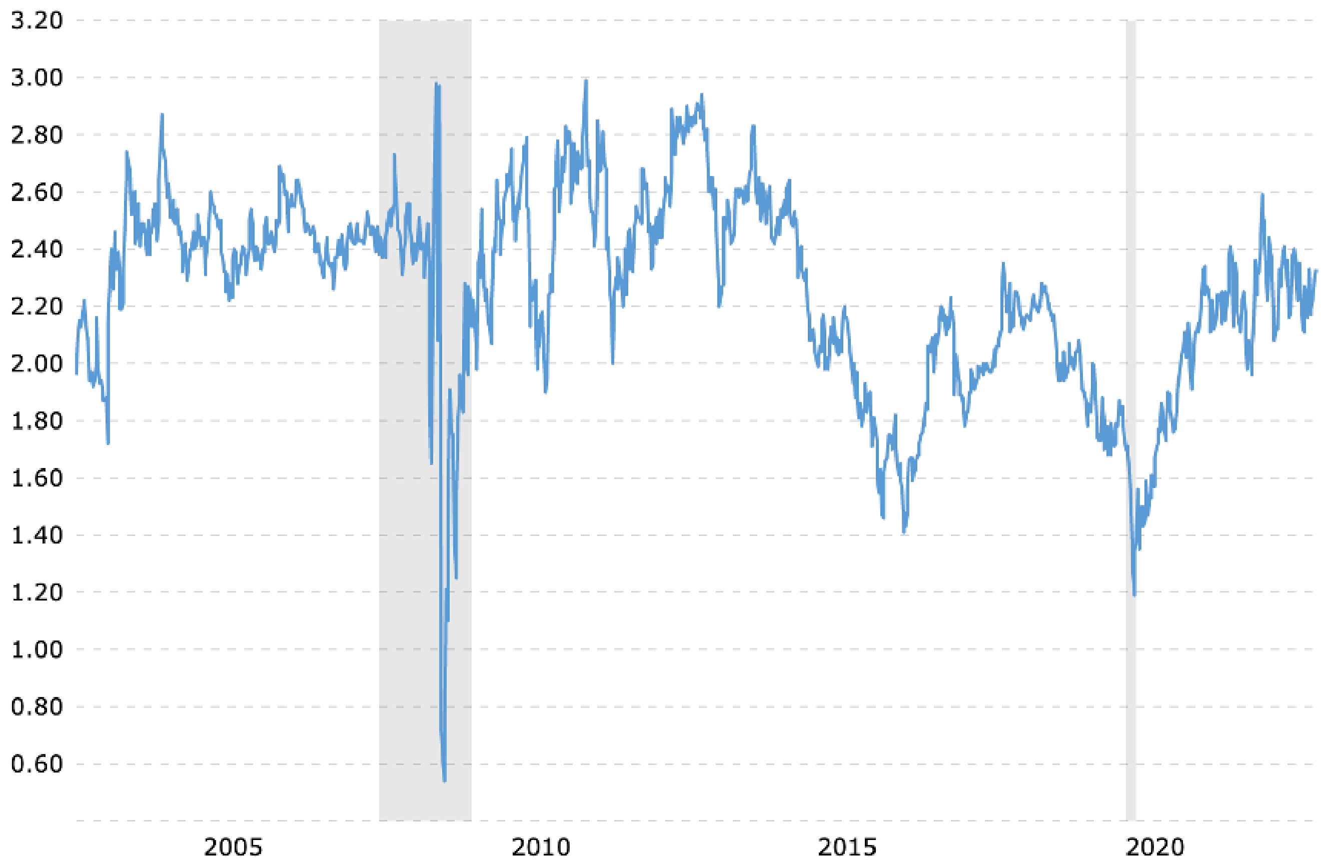


Anyone who chooses to second guess the fiscal and monetary policy reaction to the economic impact of the pandemic needs to look at this chart to see that job losses were initially more than double the percentage of job losses compared to the Great Financial Crisis period during 2008-09. As shown above, even ten months after the beginning months of the pandemic, job losses were sitting at levels near the highest jobs losses seen during the Great Financial Crisis.

With the recent focus on the inflation that followed the economy's unprecedented fiscal and monetary support following the pandemic, it is easy to forget just how bad the economy was in early 2020. Over the last twelve months, the narrative has been that the inflation we have experienced since early 2021 is similar to what the U.S. experienced during the 1970s. This hyperinflation exploded once the restrictive pandemic mitigation began to loosen with the advent of vaccines in late 2020 and finally began to subside in the middle of 2022. This can easily be seen below in the tradingeconomics.com charting of MoM CPI inflation rates going back five years:

As seen in the chart above, inflation plummeted immediately after the emergence of the pandemic. Still, it quickly normalized with the introduction of coordinated massive global monetary and fiscal stimulus during the second quarter of 2020. After normalizing during the second half of 2020, inflation became more volatile, and an upward trend emerged. That upward trend in inflation in late 2020 broke by the middle of 2022, shortly after the Federal Reserve raised the Fed Funds rate by 0.75% for the first time.

Inflation has cooled off substantially over the last seven months, and the month-to-month inflation volatility is becoming similar to what we experienced before the pandemic. In terms of interest rates and monetary policy from now on, the critical measure of sustained success in arresting high and volatile inflation is ensuring that long-term inflation expectations remain well contained. This is because if long-term inflation expectations rise above the normal trends established over the last 10-15 years, these expectations will impact both consumer and capital markets behavior in ways that will keep inflation stubbornly well above the Federal Reserve's 2% target. Below is a chart produced by MacroTrends, which shows the five-year inflation expectations embedded into markets:



What I see when looking at five-year forward long-term inflation expectations charted over the last 20 years is that despite the recent bout with near-record inflation levels, long-term inflation expectations peaked in mid-2022 at 2.60%. Overall, long-term inflation expectations have been well grounded in the 2.30% level, which is lower than it has been for most periods over the last twenty years.

I covered a lot in this month's commentary. In summary, I attempted to show that recent history shows us equity markets can perform well during periods with higher inflation expectations than today and when the Federal Reserve has been tightening monetary policy by raising its Fed Funds Rate. To listen to many market pundits, one would conclude that an inflation rate higher than 2% and a Federal Funds Rate rising or remaining above the level of long-term inflation expectations prevents strong equity market performance. I have been either professionally analyzing businesses, performing equity research, and/or managing investment portfolios for over 34 years. One truth stands out over those 34 years, placing too much emphasis on macroeconomic or geopolitical forecasts and pundits vying for media attention is foolish and counterproductive. The future is uncertain; that is all we know for certain. What we can be more confident in as investors are individual company fundamentals and the inherent value creation that results from investing in American-style capitalism.

The long-term success of our clients relies upon finding opportunities that have a high probability of creating significant capital appreciation. Finding such opportunities is not dependent on making short or intermediate-term macro forecasts. Below are two very different examples of what we view as high-probability capital appreciation investments:

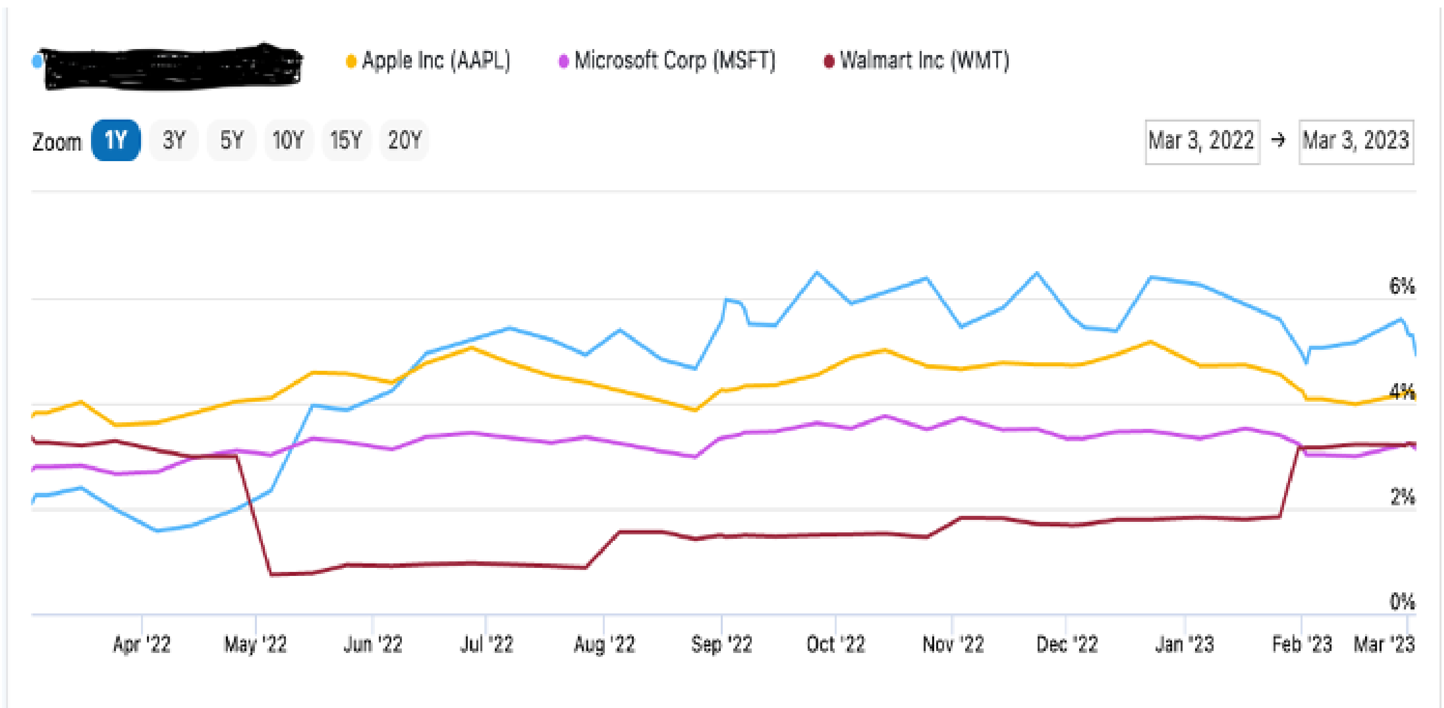
- A cumulative preferred stock at a discount: We own and continue buying a preferred stock issued by a recognizable large U.S. retailer. Below are the specifics:
- $100 par value
- Coupon Dividend Yield: 8.00%
- Recently selling at a discount between 50-55% to the par value.
- Callable in 2025 at $110 per share.

- The dividend Yield based on the stock price as of March 3rd was 16.87%.
- Annualized total return to maturity: 22.17%
- Aggregate Value created through dividends and cash returned at maturity of $10,000 invested as of March 3rd: $ 59,656.67 based upon a future value calculation using the 22.17% annualized total return figure over eight years.

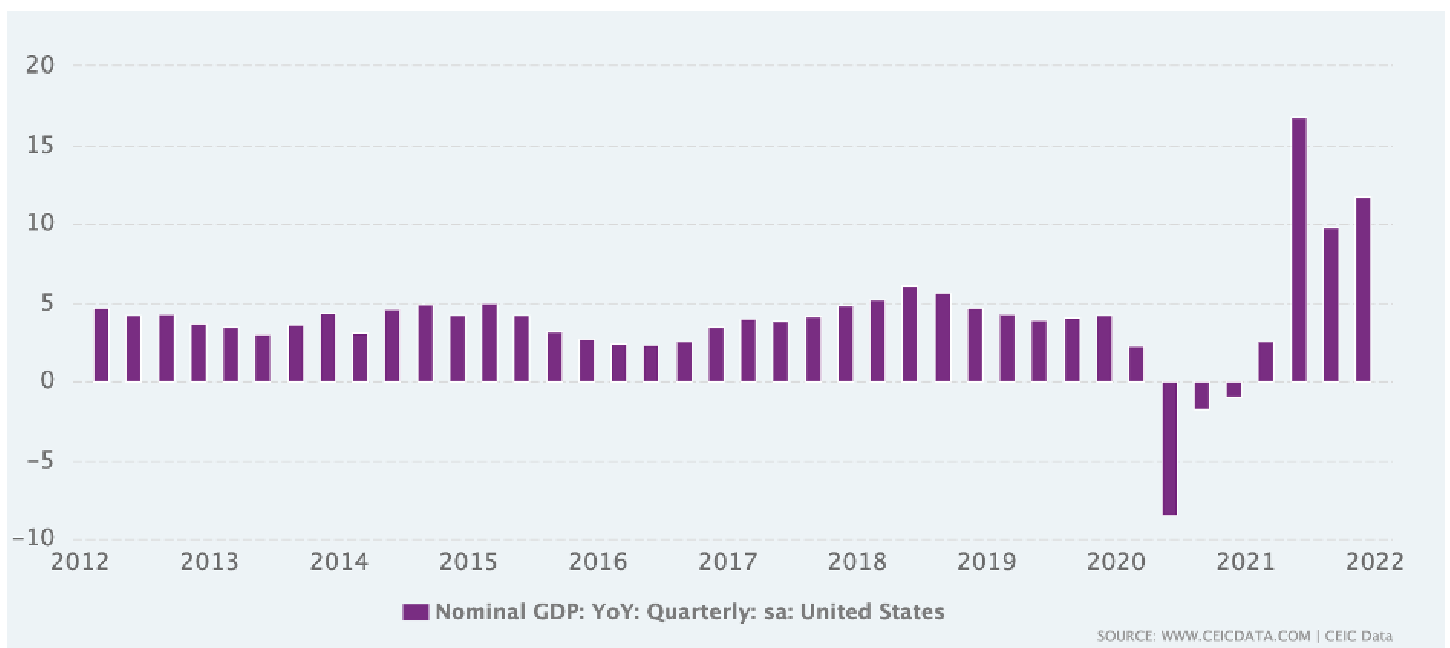
Summary:

With a preferred stock, an investor benefits from bond-like characteristics such as a Par Value, a fixed or variable interest rate, and a maturity date. Additionally, a preferred stock owner has preference over a common stock owner in terms of claims against company assets in the case of liquidation under bankruptcy proceedings. With such bond-like characteristics, bankruptcy is the only risk to an investor's capital under a hold-to-maturity scenario. In the case of this particular preferred stock, it is cumulative, meaning even if the issuer cuts or eliminates the dividend, the issuer owes that dividend, and it must be paid to the investor before or at maturity.

- An innovative healthcare cost containment company that is the market leader in its growing category with a significant patent-protected competitive advantage which provides a high likelihood that it will be able to retain its market leadership position for the foreseeable future.
- The company has grown its revenues by an annualized rate of 37.30% over the last five years, tripling its revenues to slightly more than $750 million in the most recent fiscal year.
- On December 31, 2022, it had slightly more than $800 million in cash on its balance sheet. As of March 3, 2023, the company's market value was based on its current share price, was $2.18 billion. We are attracted to this business at the current valuation level based upon current cash flow, profit, and revenue multiples relative to the future growth that we expect.
- We were originally attracted to this company by its "asset-light" business model, high gross profit margin (91% in 2022), and free cash flow (FCF) yield. Asset light means that the company's growth does not require an ongoing significant reinvestment in personnel and things like real estate, equipment, and technology. The drop in the price of this company's stock during 2022 due to systematic weakness in the markets and a non-recurring event that impacted this company's revenues beginning in the second quarter of 2022, with that impact peaking in July, has created a very attractive opportunity in our assessment. The revenue impact rapidly declined by the end of the fourth quarter of 2022. At the recent price levels, this strong cash-flowing company produces an FCF yield better than several historically strongest cash-flowing companies, Apple, Microsoft, and Walmart. See this comparison over the last twelve months in the financechart.com chart below:



Although some highly cyclical sectors such as Energy, Industrials, and Basic Materials historically show the strongest FCF yields, FCF yield is not in and of itself a great indicator of superior wealth-compounding companies. I have learned that superior stock appreciation over time combines FCF Yields above 3% and revenues that can reasonably be expected to grow above nominal GDP. Nominal GDP is not the reported GDP number that most people see, which is "real" GDP (Nominal GDP less PCE inflation). Corporate profits and cash flow are not reported in "real" terms; thus, when comparing a company's growth to the overall economy, one must use nominal GDP for the proper apples and apples comparison. Below is a ceicdata.com chart showing U.S. Nominal GDP, annualized by quarter, over the last ten years:



In this ten-year chart of U.S. Nominal GDP, we see that absent the last three years, which were highly distorted by the pandemic, nominal GDP has typically fallen within a range broadly between 2.50% and 6.00%.

The healthcare cost containment stock I highlighted above has shown strong FCF growth over the last several years, except for 2022, due to the non-reoccurring issue I mentioned. The company is expected to resume strong FCF growth going forward over the next several years. Based on our expectations for FCF growth, we expect that figure to grow from $143 million in 2022 to over $250 million by 2026. At between $250 million and $275 million in FCF, applying what we deem a reasonable 30x FCF multiple to this 2026 forecast, we expect the stock to rise at least 200% over the next 1-3 years.

I will conclude this commentary by warning investors not to fall into the trap of listening to pundits who attempt to boil down their stock market forecasts to one or two macro factors, such as the direction of central bank interest rate actions and current backward-looking inflation levels. Equity markets will certainly react to incremental short-term data points, but this reaction is simply volatility and should not be meaningful to longer-term investors.

Many people are drawn to simple explanations applied to complex circumstances. One must be highly suspect of those who claim that reliable correlations can be drawn from history to predict future stock market performance. Such simplified explanations and supposed correlations make for good television and social media posts, but that's about it. We do not want to "miss the forest for the trees." We form broad, long-term base case assumptions and do not let shorter-term focused speculation on macro factors cloud our view. Our longer-term base-case assumptions are generally based upon relatively high probability trends and fundamental assumptions. This is the approach that we use to build and manage portfolios. Because we do not play the short-to-intermediate macro speculation game, we can look out of step for short bouts of time. Still, with patience and discipline, our commitment and diligence reveal the rewards of investing in businesses and giving management teams and secular growth tailwinds the time to create significant wealth for their investors.

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Disclosure:

Advisory services are offered through CS Planning Corp., an SEC-registered investment advisor.

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