Everyone is Bearish

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Almost everyone on Wall Street is bearish, at least that's what they say when asked. In many ways, the bear case makes sense. War in Israel and Russia, a potential Chinese invasion of Taiwan, sky-high mortgage rates, runaway inflation and a host of other stories threaten future market performance. We understand the bear case and have engaged in thoughtful risk management for client portfolios accordingly. In bad times, investors favor short term assets over long term assets, but remember, markets are forward looking. Stocks sold off 20% last year, in anticipation of bad times in 2023. Turns out, earnings have outperformed analyst expectations, and the S&P 500 Index is up over 15% year-to-date. Most of the return in 2023 has been largely driven by technology. The doom and gloomers are now pointing to tech's outperformance, declaring we're in the end times. In our opinion, this is bad analysis.

Last year, tech stocks got crushed in anticipation of higher interest rates. (remember, stocks are forward looking). Cathie Wood's ARK innovation fund was down a staggering 67%. At the same time, value stocks did just fine, down only 1.2%. This year, the opposite is true, tech is rallying and value is down about 5%, a return to normal. While there's a flight to short term assets during high interest rate times, there's also a flight to quality, which can be highly subjective. It seems obvious, but quality should be the only factor portfolio managers use to buy companies. Depending on your definition of quality, we should only own top companies with resilient business models, conservative management teams, strong balance sheets and a significant degree of operating leverage. We want to own companies with high gross margins that scale quickly. Because we're buying mature companies, we look for high return on equity and return on asset statistics. We also want to avoid companies subject to significant regulatory risk – which is why don't buy Chinese stocks. The opposite is true with large U.S. tech companies. The Magnificent 7 nearly perfectly meet our definition of quality which is why they dominate the S&P 500 Index. It's not a bad thing that the best companies have risen to the top, it's just part of life as an investor.

With this definition of quality established, we've essentially narrowed our portfolio down to a few dozen of the largest companies on earth, all of which are U.S. domiciled. Some pay dividends, many process billions in annual buybacks, and almost all produce top line revenue growth over the long run. This methodology doesn't completely insulate us from corrections and recessions, but statistically, 90% or more of the names we own should make it through nearly every cycle intact. During the bad times, investors find out not every company or management team is created equally, which is why we've advocated for active portfolio management as opposed to owning everything, hoping it works out. For example, there's a big difference between ExxonMobil and BP, JP Morgan and Wells Fargo, Lockheed Martin and Boeing, and the list goes on. Not every company is worth owning, many burn horrendous amounts of cash and produce abysmal returns year after year.

At some point, the U.S. economy will enter recession. Every firm on Wall Street has a doomsday forecast and virtually none of them will be right. We also live in the information age and markets price in bad news almost instantly. There are very few investors who don't understand the bear case and think the economy is in perfect shape. Because of this, markets could completely surprise investors and do much better than expected even amidst a potential recession in 2024 or 2025. It's possible most of the bad news is already priced in and markets are forecasting an economic rally for the next three years. 2025 earnings estimates for the S&P 500 Index are now $277. With an average forward price-to-earnings ratio of 18, we continue to believe the S&P's fair value is 5,000 points the next 12-months, total return potential of 16.5%. If we're wrong and it takes 2 years, stocks will still produce close to 9% nominal returns the next 2 years, far better than bonds that are projected to return 5%. Stay invested, you may be surprised things aren't nearly as bad as you think the next few years.

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