BECK MACK + OLIVER

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As stock-pickers, we believe that our core competence resides in the evaluation of individual businesses, particularly with respect to their competitive advantages and financial prospects, the long-term growth characteristics of their end-markets, and the quality of their management teams. Our overarching objective is to identify truly excellent businesses that we refer to as "compounders"—i.e., those that can consistently grow their intrinsic value at attractive rates over long periods of time.[1] Once we identify such businesses, the next challenge is to ascertain whether the valuation, based on the share price, is sufficiently attractive to warrant the commitment of our clients' capital. Most businesses are not high-quality compounders, and most compounders, most of the time, are valued too richly to meet our demanding threshold for new investment ideas. This is why, in a given year, our team collectively can look at dozens or even hundreds of businesses, and we will be reasonably pleased if we can find just a few new ideas that we are excited about.

At the same time, we eschew prognosticating about the near-term direction of the financial markets and making precise predictions about the broader economy. For one thing, we are simply less skilled in those capacities than in analyzing businesses and picking individual stocks. But even if we did somehow possess clairvoyance about the market or the economy, it likely would not change our strategy for maximizing the long-term, after-tax, risk-adjusted returns of our clients' portfolios, which is to own a concentrated portfolio of great businesses over many years.

Nevertheless, there are a number of pronounced risks affecting the overall economy and market, and below we offer an incomplete set of related observations:

- With its prior sanguine predictions regarding the trajectory of inflation having been proved incorrect, the Federal Reserve now seems motivated to regain credibility, as it has already raised interest rates for the first time since 2018 and has communicated its intention to continue raising rates and to reduce the size of its nearly $9 trillion balance sheet. The Fed is likely to continue in this direction at least until the occurrence of a recession, a bear market or other financial disturbance, or a deceleration of inflation.
- The Fed may struggle to counteract inflation, which to an extent has been driven by supply chain problems—which have recently been exacerbated by the Russia/Ukraine war and new, more severe lockdowns in China—and by an extraordinarily tight labor market. Higher interest rates will on the margin discourage the kinds of consumption and investment that rely on debt financing, but will not directly unclog ports, increase the supply of commodities, or help match businesses with scarce labor.
- Furthermore, the Fed's stated intention to reduce the size of its enormous balance sheet is fraught with not only uncertainty regarding its practical implementation but also a lack of conceptual clarity on the underlying objective. The very notion that the size of the Fed's balance sheet is an important aspect of monetary policy that is separate and distinct from the short-term interest rates under its control was born in the wake of the 2008 financial crisis. The Fed's total assets jumped from less than $1 trillion in mid-2008 to approximately $4.5 trillion by the end of 2014, where they remained for the next three years. During these years following the financial crisis, economic growth trailed its historical average, but financial assets generally did quite well. The Fed managed to reduce its balance sheet to $3.8 trillion in 2019 when it

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[1] The long-term growth of a company's earnings or cash flow, on a per share basis, is usually a useful proxy for the long-term growth of its intrinsic value.

appeared to contribute to a disturbance in the repurchase (or “repo”) market and abruptly changed course.[2] The Fed’s balance sheet was more than $4 trillion by the time COVID arrived on the scene in early 2020 and in response the Fed more than doubled its balance sheet. We provide this historical sketch as context for our surmise that any material reduction in the Fed’s nearly $9 trillion balance sheet is more likely to cause ructions in financial markets—whether a garden-variety bear market or a more off-the-radar problem such as the 2019 repo incident—than to stymie real economic growth.[3]

- That elevated inflation has already been with us for several months has a few implications. First, at faster rates of inflation, we need to deliver higher nominal returns for our clients in order to deliver the same real returns. Second, inflation underscores the importance of a business having pricing power, which allows it to protect margins as costs increase and thereby maintain its rate of earnings growth. Finally, the negative consequences of inflation will manifest in a multitude of ways, some of which will be less obvious than others. As basic necessities consume a larger portion of household budgets, consumer credit, particularly among lower-income households, will begin to deteriorate, which will generate losses for lenders. Meanwhile, several countries—e.g., Turkey, Egypt, Peru, Argentina, Sri Lanka, Pakistan—are already experiencing inflation-related crises, which is affecting foreign exchange markets, which ultimately affect US dollar-denominated assets. In the US, inflation is likely to be a salient topic in the upcoming midterm elections, and our country will have to deal with the matter of the debt ceiling again next year.
- Economies are cyclical and therefore it is always a question of when rather than if a recession will occur. Yet despite various risks and headwinds, the US economy continues to expand. We track a broad range of economic variables, and one that catches our eye is the difference between the number of job openings and the number of unemployed people—at present, there are nearly 5 million more of the former, and historically it is much more typical for there to be more unemployed people than job openings, even during periods of economic growth. Granted, there are many unusual aspects of today’s labor market, including the impact over the last couple of years of excess mortality, lower immigration, early retirements, intra-US migration, and the rise of remote working. We are nevertheless impressed by an economy with approximately 11 million job openings but only 6 million people who want, but do not have, a job.

In any case, much more important than whether there’s a recession in, say, the next 12 months is whether the underlying productive capacity of the economy is higher in five, 10, 20 years than it is today. And part of what makes a business great is its ability to grow, on average and over long periods of time, more quickly than the underlying economy, and to take advantage at the expense of its competitors during downturns. So we will continue to conscientiously monitor economic and market conditions, while we stick to our knitting of finding great businesses and picking stocks.

Partners of Beck Mack + Oliver

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[2]The repo market involves short-term loans, typically between financial institutions, where securities, most often Treasury securities, are used as collateral. In September 2019, repo rates surged unexpectedly.

[3] The Fed’s balance sheet is largely composed of Treasury securities and mortgage-backed securities, and the balance sheet will shrink via a combination of selling those securities and letting them mature without reinvesting the proceeds.