



The Hawk and the Bull

Last weekend, I noticed a pair of hawks gliding overhead. While marveling at the hunting prowess of these aerial carnivores, I glanced at my dog and wondered just how much weight those birds could carry. After doing some research, I was assured that my 70-pound dog was not at risk. Far heavier than a dog, a typical bull weighs nearly 2000 pounds. In the wild, a hawk is unable to carry a bull, yet in financial markets the opposite is true. ***It is our faith in another hawk, Fed Chairman Jerome Powell, that has us believing in another Bull run.***

After a brutal 9 months, with both bonds and stocks falling more than 20%, I thought it sensible to communicate my thoughts on the current state of both financial markets and inflation. While our returns are sub-par (-9.0% in September and -25.0% for and year), they are in-line with the Markets'.

Going forward, the key ingredient to positive returns lies in "Superhawk", Jerome Powell's ability to exterminate inflation. Given the magnitude of drawdown in total market capitalization of US equity and fixed income markets as depicted in the chart below, his efforts to slow aggregate demand are well underway. (I note that the \$57.8 trillion decline is more than 7x the magnitude of the \$8 trillion of monetary stimulus created during Covid).



The balance of this letter below is very long and I apologize for its lack of brevity. Nevertheless, you should read it. For those who choose not to, you should know that Powell, higher interest rates and a potential recession are not the enemy. Quite the opposite. They are what is required to kill inflation, paramount for the value of stocks to rise.

It is no longer a secret that stocks, like bonds, do poorly in an inflationary environment. We have been in such an environment for the past year, and it has indeed been a time of troubles for both stocks and bonds. But the reasons for the stock market's problems in this period are still imperfectly understood.

There is no mystery at all about the problems of bondholders in an era of inflation. When the value of the dollar deteriorates month after month, a security with income and principal payments denominated in those dollars isn't going to be a big winner. You hardly need a Ph. D in economics to figure that one out.

It has long assumed that stocks were something else. For many years, the conventional wisdom insisted that stocks were a hedge against inflation. The proposition was rooted in the fact that stocks are not claims against dollars, as bonds are, but represent ownership of companies with productive facilities. These, investors believed, would retain their value in real terms, let the politician's print money as they might.

For the past decade, this has been the case. Anyone who examines the aggregate returns that have been earned by companies during the past 25 years will discover something extraordinary: the returns on equity have expanded significantly over time. ***In fact, Return on Equity (ROE) of the S&P 500 index now stands at a record of 24%.***

The question for investors is whether that 24% coupon is immutable. Is there any law that says the corporate return on equity capital cannot adjust itself upward or downward in response to a higher average rate of inflation?

There is no such law, of course. On the other hand, corporate America cannot increase earnings by desire or decree. To raise that return on equity, corporations would need at least one of the following: (1) an increase in turnover, i.e., in the ratio between sales and total assets employed in the business; (2) cheaper leverage; (3) more leverage; (4) lower income taxes; (5) wider operating margins on sales; (6) stock buybacks.

And that's it. There simply are no other ways to increase returns on common equity.

Inflation will produce some modest gains in turnover ratios. While receivables and inventories by and large fluctuate with sales, returns on fixed assets should improve in the near-term dependent on the replacement cycle.

Cheaper leverage? Not likely. High rates of inflation generally cause borrowing to become dearer, not cheaper.

More leverage? American business already has fired many, if not most, of the more-leverage bullets once available to it. Proof of that proposition can be seen in some other S&P500 statistics – in 1975, stockholder' equity as a percentage of total assets declined for the 500 from 63% to just under 25% today. In other words, each dollar of equity capital now is leveraged much more heavily than it used to be.

Lower corporate income taxes seem unlikely going forward, although they have been a contributor over the past decade.

Wider operating margins on sales. Here is another way where corporations have achieved major gains. There is no proof that this cannot continue, but there are only 100 cents in the sales dollar and a lot of demands on that dollar before we get down to the residual, pre-tax profits. The major claimants are labor, raw materials, energy, and various non-income taxes. The relative importance of these costs hardly seems likely to decline during an age of inflation.

The last of our six possible sources of increased returns on equity is stock buybacks. Buybacks will simultaneously shrink shareholders' equity on the liabilities side by the same amount. As a result, ROE typically improves after a share buyback. This form of return improvement is only available to a select number of companies in the S&P500 that possess both substantial free cash flows, and little leverage.

Even if you agree that the 24 percent equity coupon is immutable, you still may hope to do well with it in the years ahead. It's conceivable that you will. After all, a lot of investors did well with it for a long time. ***But your future results will be governed by three variables: the relationship between book value and market value, the tax rate, and the inflation rate.***

Book versus Market Value

Let's wade through a little arithmetic about book and market value. When stocks consistently sell at book value, it's all very simple. If a stock has a book value of \$100 and an average market value of \$100, 24 percent earnings by a business will produce a 24% return for the investor. At a market value 2x book, the return drops to 12%. In other words, the higher the premium, the lower the return.

During the postwar years, the market value of the Dow Jones industrials has been as low as 84% of book value (in 1974) and as high as 445 percent (last year). Today, the multiple of book sits at 345%. On the current ROE of 24 percent, this suggests a de facto 7 percent return.

Taxes

How large a bite might taxes take out of the 7%. For individual investors, it seems reasonable to assume that federal, state, and local income taxes will average perhaps 25% on dividends and that payouts will approximate 30%. This means that of the 7 percent, 2 is paid out to shareholders, attracting a 25% tax rate, leaving 6.5 to the shareholder. **To relate this to a bond, the stock might be regarded as the equivalent, for individuals, of a 6.5 percent tax-exempt perpetual bond.**

Inflation

Which brings us to the crucial question – the inflation rate. No one knows the answer on this one – including the politicians, economists, and Establishment pundits. Nevertheless, because of Powell's aggressive stance, many signs seem positive for stable prices: Asset levels have moved lower; money supply is contracting; housing prices are declining; inventories are building; commodity prices have declined; and supply chains are easing. **As such, it seems quite possible to me that if Powell is successful, inflation rates will average 0% - 3% in future years.**

So, there we are: 7 percent before taxes and inflation; 6.5 percent after taxes and before inflation; and maybe 4-6 percent after both. **As a common stockholder you will have more dollars and more purchasing power.** In with Ben Franklin ("a penny saved is a penny earned") and out with Milton Friedman ("a man might as well consume his capital as invest it").

The arithmetic makes it plain that inflation is a far more devastating tax than anything that has been enacted by our legislatures. The inflation tax has a fantastic ability to simply consume capital. It makes no difference to a widow with her savings in a 5% passbook account whether she pays 100 percent income tax on her interest income during a period of zero inflation or pays no income taxes during years of 5 percent inflation. Either way, she is "taxed" in a manner that leaves her with no real income whatsoever. Any money she spends comes right out of capital. Even in a recessionary environment where returns decline, abating inflation has a much larger effect on our after-tax returns.

Despite the large drawdown we have experienced this year, I remind you that we own the largest and strongest companies in the world, and we are sitting on cash. Further, given my trading profits of over 500 bps to date, when the market bounces, ours should be higher. I remain positive on the future and forever keep in mind that hawk is no enemy of a bull (or a dog)! **I thank you for your continued support and note that if you found this letter too long or disagree with its analysis, speak to Warren Buffett – he wrote it in 1974 at the bottom of the market and during a similar period of inflation** (I did, however, update some statistics).

Sincerely,

Steven Tuchner
Founder and CIO

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