Third Quarter 2023 Commentary

Bloomberg Economics is a division of the financial news behemoth that employs more than 25 professional economists, over 100 economic reporters, and offers a "comprehensive macroeconomic research" service that "includes rigorous, original thematic research supporting detailed economic forecasts." Its users pay Bloomberg a pretty penny for all of this, with a single subscription recently going for $30,000 per year. Anyway, on October 17, 2022, almost exactly a year ago, Bloomberg Economics published its forecast for the odds of a recession occurring in the U.S. over the ensuing twelve months. Any guess on how they handicapped this possibility? Well, they didn't just say it was possible. In fact, they didn't just say it was probable. They put the odds of a U.S. recession occurring by today at exactly 100%. Oops.

It probably should no longer amaze us how often economists get things wrong, but they seem to keep coming up with new and inventive ways to keep us entertained.

While we are not currently in the territory of a recession, the recent economic news has not been good across the board. Yes, the jobs report from earlier this month showed a continued robustness in non-farm payroll growth. And yes, the unemployment rate is still below 4%. However, wage growth has been slightly below expectations, and inflation remains above the Federal Reserve's long-term policy target of 2%.

Perhaps because of these factors—along with the ever-present political and international turmoil in the headlines—both stocks and bonds declined in the third quarter: the broad S&P 500 index by 3.3%, the aggregate U.S. bond index by 3.2%, and the Dow Jones Industrial Average by 2.1%. Stock market sentiment seems to be rather weak to us, which we find odd since the S&P 500 is still within 10% of its all-time high reached in late 2021. Plus, while the third quarter was weak, the year-to-date return on the S&P 500 through September 30 is still a healthy +13%.

Let's Talk About Bonds

Our bread and butter is, of course, selecting the stocks which make up the lion's share of your portfolio. Since you share the long-term outlook we have on preserving and growing wealth, we can afford to take the long view of things and commit the majority of our capital to stocks, which will in most market environments out-perform bonds over the long haul. But what is happening now in the U.S. bond market is fascinating and deserves our attention.

Bond prices and interest rates move in opposite directions, so it should be no surprise that bond prices have been falling over the last couple of years as the Fed has been raising interest rates. But the magnitude of the fall has been astounding:

U.S. Aggregate Bond Index: Longest Drawdowns Since 1976			
Start of Drawdown	End of Drawdown	# Months	Max Drawdown
Aug-20	?	38	-17.2%
Jul-80	Oct-81	16	-9.0%
May-13	Apr-14	12	-3.7%
Aug-16	Jul-17	12	-3.3%
Feb-94	Jan-95	12	-5.1%
Mar-87	Nov-87	9	-4.9%
Aug-79	Apr-80	9	-12.7%
Apr-08	Nov-08	8	-3.8%
Feb-96	Sep-96	8	-3.2%
Jun-03	Nov-03	6	-3.6%
Feb-84	Jun-84	5	-4.9%
May-83	Aug-83	4	-3.5%

source: Charlie Bilello at Creative Planning

This is both the longest-ever modern bear market in bonds, lasting 38 months so far, but also the deepest one as well, with bond prices declining by almost 20% from their peak in mid-2020. In practical terms, this means that investors in the U.S. Aggregate Bond index have barely made any money over the decade which ended on September 30:

returns >1 year annualized	3 months	1 year	3 years	5 years	10 years
U.S. Aggregate Bond Index	-3.2%	+0.6%	-5.2%	+0.1%	+1.0%

source: Bloomberg, Inkwell analysis

For those of our clients who utilize bonds in their portfolios, you will no doubt have noticed that we have been much more active in purchasing bonds over the last year or two. This is an exciting time to be a bond investor. We do not yet think that bonds represent a better value than stocks, so that we would include them even in our all-stock portfolios, but this is something we always keep our eye on. Never say never.

Berkshire for the Long Run

Your largest stock holding is Berkshire Hathaway (BRKB). Over the last decade we have noticed that some long-time Berkshire owners were growing restless with frustration related to BRKB's poor relative performance to the overall stock market. For an insurance conglomerate to keep pace with the Teslas and Nvidias of the world is a tall order, and it occasionally seemed to some that Berkshire was destined to be a perennial also-ran. True believers kept saying that, in the long run, Berkshire was indeed going to return to its days of out-performing the overall market, and we are pleased to report to you that the long run has officially arrived. As of September 30, Berkshire's stock has out-performed the S&P 500's total return for the preceding quarter, year, 3 years, 5 years, 10 years, and 20 years:

as of 9/30/23 *returns >1 year annualized*	BRKB	S&P 500	Difference
3 months	+ 2.7	- 3.3	+ 6.0
1 year	+ 31.2	+ 21.6	+ 9.6
3 years	+ 18.0	+ 10.2	+ 7.9
5 years	+ 10.3	+ 9.9	+ 0.4
10 years	+ 11.9	+ 11.9	+ 0.0
20 years	+ 10.2	+ 9.7	+ 0.5

source: Yahoo! Finance, Inkwell analysis

Benjamin Graham, mentor and hero of Berkshire's CEO Warren Buffett, said that the stock market is a voting machine in the short term, but a weighing machine in the long term. It is gratifying to see the market begin to recognize what we have seen all along.

Until Next Quarter

We continue our hunt for other companies that will eventually be afforded a more appropriate valuation by the stock market too. We are grateful for the trust you have placed in us for this task, and we look forward to reporting on our progress in early 2024.

Sincerely,

FELIPE

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