October 23, 2023

Very little has changed in terms of the numbers, the statistical status of the financial world, since we last wrote to you. The stock market is up, but only a few very large names, 7 to be precise, carry the entire S&P 500 Index, while the remaining 493 languish. Interest rates are up, which means bond prices are down, and indeed 2023 has brought with it the worst bear market in bonds ever recorded. Speculative assets, cryptocurrencies, Special Acquisition Companies, or SPACs, and all sorts of IPOs, and venture capital start-ups, have seen prices crushed, and in some cases, their managements led off to jail. Foreign markets, particularly those tied to China, experienced stress to varying degrees as de-globalization and sundry political and demographic developments hobbled world economic growth and the world's second-largest economy.

Away from the financial news, you read the same papers I do and listen to the same broadcasts. You know that headlines are not pretty. War, political dysfunction, inflation, and rampant instability coupled with a disheartening lack of political leadership, hardly make for encouraging reading.

And yet, here we are, taking nourishment, going about our daily business in the usual way. The sun comes up every morning, reminding us that the world tends not to come to an end. Here in Southern New England, we are enjoying an unusually beautiful Autumn. And we are even a little wealthier than at the first of the year—Weybosset Research accounts are up low-single digits on a year-to-date basis. (Granted, that is against the backdrop of the S&P 500 which was up 12.5% for 2023 through the third quarter. But 90% of that return was due to the presence of the "Magnificent 7"; the remaining 493 did very little in 2023. Justin has more on that below.)

The net result is, we are close to or only slightly below where we finished 2021, before the onset of the bear market in 2022. Any progress from here will represent fresh profits, not retaking of lost ground. As I said before, I like that.

Bear markets are inevitable, an integral part of the market process. Having the fortitude, the patience, to wait out a bear market and thrive anew when the bear market is over, is the name of the game. So far so good in our case. I hope you agree.

One final matter before I cede the floor to Justin. We are often asked whether, given the severity of the bear market in bonds, we should not be putting money into this beat-up (very large) corner of the financial markets. In my opinion, not yet.

It's true selling has been frenzied in the wild world of bonds, and bonds are therefore far more attractive going forward than, say, a year ago. But that alone doesn't make bonds attractive on an absolute basis, simply because for the last 10 or 15 years they've been so unattractive. The 5% or so on offer today is obviously FAR better than the zero or so of a year ago, but the outlook going forward is not so great.

Inflation is running a little higher than 3% right now and the Fed's target is 2%. So, the real rate of return, the rate after inflation, is something like 3%. If you pay taxes, as much as half of that may wind up with the government. The net result is a return after taxes and after the hidden tax of inflation of not much more than break even.

I can't get excited about entering a transaction hoping at best to break even. Furthermore, it appears to me that we are in a period of increased and persistent inflation. Historically, fixed income is about the worst place to be in an ongoing inflation. That's because all a bond has to offer is an income stream, fixed at a certain rate, and, Lord's willing and creek don't rise, return of principal at maturity. Inflation steadily erodes the buying power of that income stream, while eroding the purchasing power of principal at maturity.

It's going to take considerably more mayhem in the bond market to get me interested in anything besides the most conservative strategy, but, anything can happen…Stay tuned!

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> "Interest rates are to asset prices like gravity is to the apple. They power everything in the economic universe."—**Warren Buffet**

Dear Fellow Investor:

In my last two letters I commented on the heavy macro problems confronting the markets--war (now on multiple fronts), inflation, bank failures, the national debt, ever increasing-interest rates--and observed that nevertheless the markets were holding their own.

Volatility picked up substantially in the third quarter, with large moves both up and down for the markets. The market reached its peak in mid-July with the accounts for which we are responsible reaching new all-time highs, to then swiftly correct.

The S & P 500 sold off roughly 10% from July to October 5th, as the 10-year Treasury yield screamed to nearly 5%, rising almost a full percentage point in less than a month, a parabolic move.

As I mentioned at the beginning of 2022, the world is entering a new regime, a regime in which the cost of money is no longer 25bps (¼ of 1%), rather it is now roughly 5% for the United States 10-year Treasury, 7%-8% for a 30 year fixed mortgage, and 7%-8% for an auto loan.

This shift in the cost of capital, plus inflation, has dramatic effects on the way people spend their money--think buying a house, a car, a washing machine, dinner-- and the way that markets perceive and price assets. Inevitability, growth slows, and people are willing to spend less and pay less for assets.

The S & P 500 finished the third quarter up 12.50% year-to-date, the accounts for which we are responsible at Weybosset were up single digits. The market has been **extraordinarily bifurcated**. Though the headline number sounds great, **only 7 stocks** have accounted for 90% of the market's performance, the other **493** (!!) are flat-to-down on the year--not surprising to us in a world with so many headwinds to asset prices.

The rout in US Treasurys is now the worst bond bear market of all time, according to Bank of America Research. Bond prices have dropped by 50% in 2023 (bond prices fall as yields go up). Small cap and micro-cap stocks are down roughly 10%-20% on the year, with unprofitable companies down 90% (they are the most sensitive to interest rates). The KWB regional banking index is at a 26-year low (!!) We are in and have been in a **bear market in everything-**-other than the 7 largest tech stocks.

Sounds like a dangerous world with all sorts of asset prices succumbing to inflation and interest rates. Indeed, as I surveyed our results and the inner workings of the markets and their performances, I pronounce myself for the most part satisfied (I hope you are too!)

One of the key drivers in markets is what is called "rate of change". Investors tend to extrapolate moves in asset prices as if they will go on forever, occasionally creating panic and hysteria along the way. Case in point, the most recent move in the 10-year Treasury.

The 10-year yield rallied from a 4% yield to 4.89% in a month, a dramatic and parabolic move, that brought along with it calls for interest rates to go to 5,6,7,8, I even heard 13% over the next year!! This caused panic amongst bond investors, equity investors, and the average American watching his portfolio drop 10% in 3 months as measured by market indicators (the vix, put call ratio, and the McClellan oscillator).

Sell offs are a natural product of markets. We don't have to like them, but we do need to acknowledge their inevitability, so we shouldn't get flustered or panic when sell offs come.

Though it is not my business to make predictions, I will say we have probably seen mass interest rate hysteria in this most recent move. Parabolas usually reverse as quickly as they came (remember inflation at 9% dropping to 3.3% in less than 9 months) and that seems to be the case in the last week. Why would I say that?

The average yield on the 10-year Treasury has been 4.8% over the last 100 years. The aberration in markets was the last 14 years since the fed induced emergency lending during the 2008 Global Financial Crises. Today we are just getting back to a **normal** interest rate environment.

Most recent economic indicators have shown that the United States economy is most resilient and increasing quite rapidly. GDP grew at 3.6% while unemployment remains low and inflation, though still high for the Fed at just above 3.3%, has come down dramatically from a year ago (9%). The economy has proven we can live with 4.5-5% interest rates.

In general, positive GDP growth, plus improving earnings, and a Fed that pauses are a bullish environment for stocks. According to the Chicago Mercantile Exchange's Fed watch tool, investors think the fed is done raising rates.

Though history does not repeat, it rhymes. There are many similarities in today's market with that of the 1994-95 scenario. Back then the Fed raised interest rates rapidly to combat a bout of inflation. Once inflation was curbed, with positive GDP, we had a decade run of increasing stock prices, and guess what, the average interest rate was 5% during that period.

As always, the environment and markets take time to change and digest; the silver lining for the patient investor: the more frustrated investors get, assets declining or going sideways (the average investor is still down 15-20% from his or her all-time highs and hasn't made a dime in two years), **the more bullish**

the environment will be when inflation and interest rates subside. The good times will surely come; however, this is a time for **patience**.

Therefore, we are mindful that we need to stay with the highest-quality investments. Companies with excellent balance sheets, little to no debt, and management that have the experience to grow their companies through any economic environment.

The best quality securities do not always perform best in the short run; however, over the long haul, they always outperform, and they always beat inflation. We will keep an eye out for future beautiful babies that have been thrown out with the bath water.

The third quarter earnings season is upon us, and Wall Street analysts' expectations have come down dramatically, *they are not expecting great news*. For the contrarian investor, it seems that stocks could be setting the stage for a year-end rally.

I want to assure you that we are not complacent. The world is a dangerous and fragile place, a fact of which we are fully aware. Our goal is, and always has been, to earn the best possible return for you consistent with the least possible risk.

Thank you again for the confidence you have placed in us. We welcome any and all questions, comments and complaints, so don't be shy, get in touch with us. We'd love to hear from you.

Yours very truly,

Justin Edward Deutsch