The Essence

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Bah Humbug

Perhaps it was because the penning of this edition of *The Essence* began on "*The Most Dreaded Day*" of crafting its subject (refer to our January 2013 edition); perhaps it was because we just came through a U.S. election season whereby nary a positive word was spoken; perhaps because most financial journalists always see the "glass as half empty" (shouldn't pay attention to them anyway!); perhaps because there's extensive focus on the U.S. Federal Reserve's (Fed's) actions on short-term interest rates; or, just because many of the very best holiday movies start out with a depressing tale:

"The secret to humor is surprise."

➢ "*It's a Wonderful Life*" – George Bailey (played by actor Jimmy Stewart) runs a Savings & Loan. Then there was a run on the bank caused by a misunderstanding of George's uncle. "*I wish I'd never been born!*" exclaims George. Poof!, an angel (Henry Travers) is sent to earth to make George's wish come true. One sad tale after another is told about how the world (or at least Bedford Falls) would have evolved for the worse without George Bailey. It was heartbreaking.

➢ "*The Wizard of Oz*" – "*Somewhere Over the Rainbow*" is sung by Dorothy (played by Judy Garland – the mother of Liza Minnelli, in case you didn't know) about a place much better than her home in Kansas. Poof! and Dorothy gets transported (via her flying house) to the land of Oz. "*Now I know we're not in Kansas anymore, Toto,*" she exclaimed as one bad adventure follows another. Some scarier than others, "oh, my!"

➢ As defined by the Cambridge Dictionary, "Bah Humbug" is "*… an expression used when someone does not approve of or enjoy something that other people enjoy …. The expression was used* [extensively] *by the character Ebenezer Scrooge in the story* 'A Christmas Carol' *by Charles Dickens.*"

Mr. Scrooge epitomizes how we felt. Even with the joy-filled holiday season upon us, with all the above, it was hard not to be in a Bah Humbug mood at the time of this writing.

Yet each of the movies above, when it seems like it cannot get any worse (with Dorothy, for instance, cornered by the witch's flying monkeys), a miraculously 'happy ending' ensues ("*I'm MELTING … Melting … melting … Oh, what a world!*" says the Wicked Witch after being doused in water). It's always the darkest before the dawn; this in the movies, and perhaps this, too, with investing.

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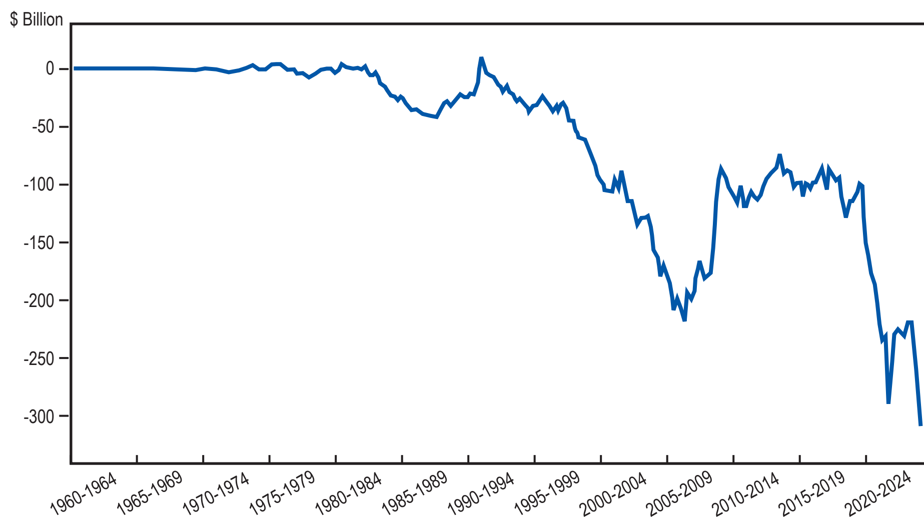
Focus on the 'BAD'/Invest for the 'GOOD'

The following is a graph that could keep anyone "awake at night."



Source: Bureau of Economic Analysis

This graph depicts the U.S. current account as part of the balance of payments. It represents all non-financial transactions as a balance between imports and exports. It includes merchandise/goods, services (such as travel & tourism), income and outright transfers. Note that through much of history, the balance of payments was, well, **balanced**! Beginning in the 1990s, the U.S. imported more goods than it exported while U.S. consumers went on more overseas trips than did their foreign brethren. With a brief reversal during the Global Financial Crisis (GFC), that negative trend has continued largely unabated.

What, then, may produce a "happy ending" from this? First is to consider the reported reasons for this imbalance: (i) the U.S. economy has been stronger than most and, thus, consumers are buying more imported goods; (ii) the U.S. dollar remains a pillar of global transactions and, thus, its strength makes it more expensive to buy U.S. goods; (iii) the U.S. is one of the most "open" markets in the world allowing for ease of import, but relative difficulty of export; and other reasons, but you get the picture.

So, all this "weakness" in the balance of payments may actually be due to some enormous intractable ***strengths***. This could make for a "happy ending" indeed. We shall see. Our point is that by focusing on and understanding the Bah Humbug of international trade, we may still be comfortable in investing in a very strong U.S. economy – international too.

The topic of this edition of *The Essence* may serve as a reminder of Aristotle Capital's investment process. We spend the vast amount of our efforts understanding the **negatives**. We analyze our estimation of the **downside**. We try to uncover some of what is **<u>not</u>** said by management or our other information sources. We literally have "WAWI" discussions ("*Why Are We Idiots?*") to ensure we've covered as many facets of downside as possible. During some time periods, this could cause Portfolio Managers to appear *too* pessimistic. The year just past is one example where momentum "mania" took hold at various times. Aristotle Capital was under-represented in some of the "hotter" areas.

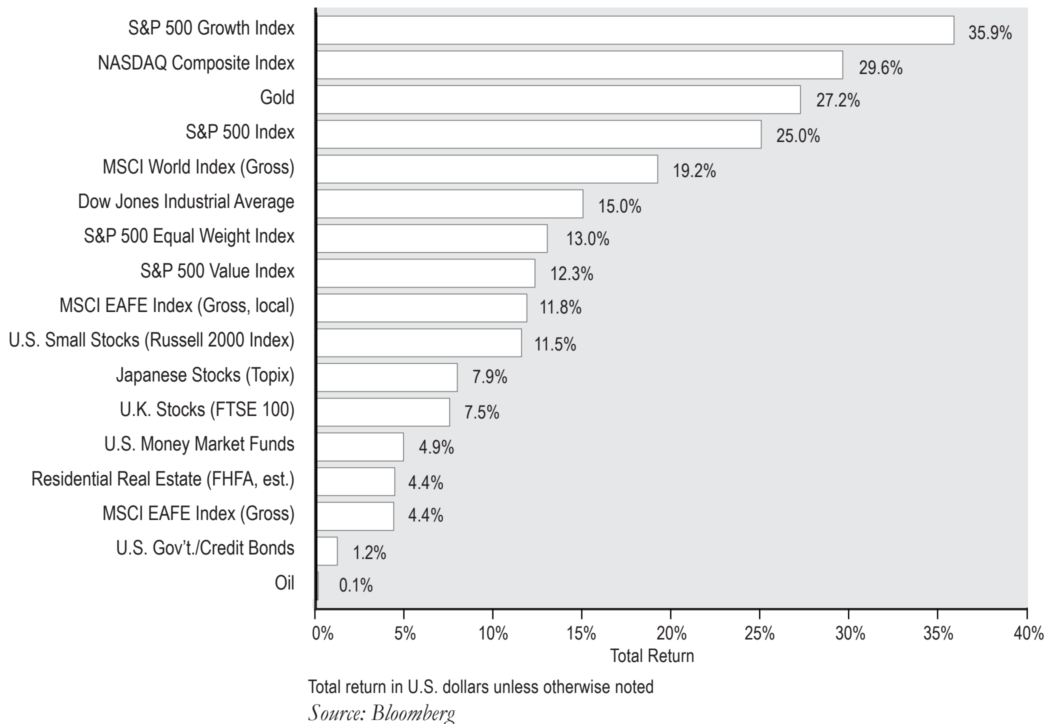
We do all this and could be made to feel sad along the way, because only when we can become comfortable that the downside is manageable may we truly understand the risks of our investments. So, even on "*The Most Dreaded Day,*" we power through, continue our long-term investment process and create an explanation or two, like what you are reading here today.

EQUITIES STRATEGY

While we report asset performance each year at this time, we do so not because of the relevance we ascribe to such short-term "point-in-time" figures. Alternatively, we delve into these results as a way of catching up with longer-term trends and what they may portend for future years and decades. While on the surface it seems like there was little Bah Humbug in the world's equity markets last year, some of the reasons for the joy should be discussed. The results seem unprecedented. That's actually been the word for many topics over the past several years. Some of the examples of the "unprecedented" nature of returns, together with our Bah Humbug points, include:

➢ We've highlighted Apple many times over the years. For 2024, the equity gained +31%, including its small dividend. What is unprecedented is that during the time of this hefty gain, ***earnings*** were roughly flat. Similarly, Tesla's stock price rose +62% with no dividend – after <u>doubling</u> in 2023 – even though it reported annual EV car sales ever so slightly ***less*** in 2024 than the prior year's 1.8 million. While we in no way diminish the fundamental successes of these unique businesses, we do marvel at the continuing momentum of their valuations in the face of slowdowns in the momentum of their sales, not only last year, but in recent years as well.

➢ Momentum to a whole new plane. The level of concentration in the U.S. equity market is unprecedented, even including similar past periods such as the "dot-



Total return in U.S. dollars unless otherwise noted
Source: Bloomberg

com bubble" of the 1990s. While gaining +25% is not unprecedented for a single year, the S&P 500 Index doing at least that for two *consecutive* years hasn't happened since the time leading up to that "dot-com bubble" (a quarter-century ago).

➢ This year, we have added the S&P 500 Equal Weight Index as another unprecedented result. The equal-weighted S&P 500 gained a "*mere*" +13% versus the capitalization-weighted index's rise of +25%. From January 1990 through December 2022, the two indices have nearly equaled each other, yet in just the past two years, the delta is almost <u>double</u> (+25.6% per year versus +13.3%). This is a Bah Humbug worth taking note of.

➢ The U.S. has been the only country over the past decade to witness a booming equity market fueled largely by higher and higher valuation levels. Most other countries' markets have been far less robust (all as measured in U.S. dollars including income).

➢ Even credit markets gained ground. Not Treasuries of greater than two years, but ***spreads*** to Treasuries as they narrowed to near record level lows, even in the face of some signs of a deteriorating U.S. economy.

➢ Cryptocurrencies soared; Bah Humbug. Even stablecoins (theoretical dollar-denominated digital tokens) have gained in popularity even though – skeptics might say "due to" – being associated with unregulated criminal activity. We remain of the view that blockchain technology can be used for enormous "good" and the efficient/effective transfer of value across geographies and asset classes. Should it be completely untethered and "let the user beware"? Or should it be tightly controlled/regulated as are banks? We suspect this discourse to be repeated while we will be taking notice with a dose of skepticism.

➢ The unprecedented longest-living president of the United States, Jimmy Carter, sadly passed away on December 29, 2024. He recently turned 100 years old. With political "splits" sharper than they have ever been, Mr. Carter, regardless of affiliation, was a beloved man, and we mourn his passing while reveling in his impact and clarity, even through his golden years. And speaking of presidents, Donald Trump is only the second person in U.S. history to be elected to two nonconsecutive terms. Democrat Stephen "Grover" Cleveland served from 1885 to 1889 and from 1893 to 1897. Also within politics is an unprecedented slimmest of majorities (in the past 100 years, according to the U.S. House Office of the Historian) by either political party. This could make passing each piece of legislation a nail-biting tumult.

➢ Betting/gambling continues to grow in an unprecedented fashion. Not merely of the horse racing or even Las Vegas kind, but "bets" on politics (found out to be more accurate than traditional polling), sporting (are we still sure this won't affect outcomes?) and, we kid you not, even the outcome of murder trials. In our estimation, something <u>**not**</u> good could eventually be borne of this. For sure, in our view, Bah Humbug!

➢ Even civilian aviation was unprecedented as several tragic incidents – including two deadly ones at year-end – came in 2024 after "*a year of not a single fatal accident among the 37 million commercial aircraft movements in 2023…,*" according to the Aviation Safety Network.

➢ We seem unable to get by another year without a Bah Humbug shout-out to Artificial Intelligence (A.I.). Last July, in our edition of *The Essence* entitled "*The Day That Harriet Went Missing,*" we discussed what we see in A.I. We described it as a **transformative** technology, but not necessarily (not yet, anyway) a **creative** one. Still, the hopes surrounding its

rollout have, thus far, been unprecedented. While we will continue to analyze A.I.'s long-term ramifications, to-date value has been realized almost entirely from the "build it and they will come" model whereby:

A.I. software, and
silicon chips that enable it, and
the servers that the chips run on, and
the computer racks the servers reside on, and
the datacenters the racks live in, and
the chillers that cool the racks, and
the electricity providers that power the chillers, …

are the companies to actually realize revenues and profits from this nascent industry. What benefits does it provide in a broader sense? We will have more to say about this topic over time, but we must have, at least in the distant back of our minds, prior examples of historically promising businesses such as:

Grocery home delivery, and
5G wireless technology, and
electric vehicles, and
streaming video services, and
underwater cable, and
fake meat, …

each of which have yet to fully prove themselves as truly sustainable value-added business models. Each of the above having built large businesses, but, thus far, many cease to actually turn cash profits. *The Bank Credit Analyst* has referred to the promise of A.I. as, metaphorically, the current "gold rush." Let us understand its downside better.

INVESTMENT ACTIVITY

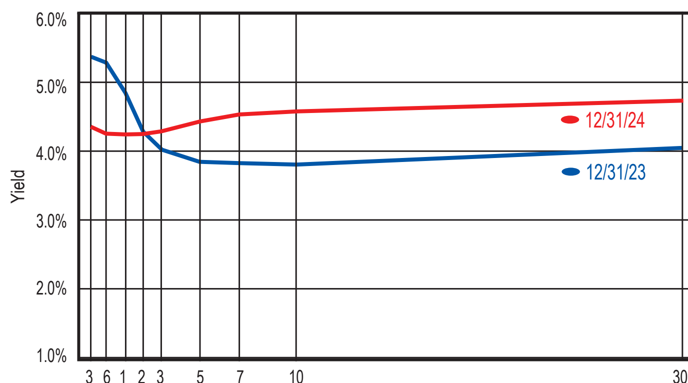
We would now like to highlight a recent addition to one or more Aristotle Capital equity portfolios.

- **American International Group** [AIG] is a wholly changed company from its former self, largely unwound since the GFC. We had previously invested in AIA Group, the Hong Kong-based insurance company serving Asia, spun off from AIG in 2009. Our investment in AIG now is due to our belief that, from a corporate business and financial perspective, AIG has or soon will regain its lustre, lost during the host of issues it faced during the GFC. Divesting its Life & Retirement business (Corebridge Financial) is the last "piece" of that process and has presented a unique *catalyst*. The company may now refocus on profitable improvements and regaining historically lost market share. New management, led by Peter Zaffino since March 2021, have proven track records in the insurance industry – evidenced by AIG's combined ratio now approaching the company's "best" peers, compared to being way above (meaning less profitable) for years. Other *catalysts,* we believe, may include: a return to profitability in personal lines, driven by "non-admitted" business; overseas expansion; normalization in property coverage limits (within reason); "Specialty" insurance such as Excess & Surplus, Lloyds and Cyber becoming ever-more required by businesses; and FREE cash flow to be used for share repurchases and dividend increases. We are aware of potential Bah Humbugs and will monitor potential risks including: "social" inflation leading to higher legal costs; weather-related catastrophes not appropriately priced; a (secularly?) "hard" market attracting irrational competitors; and a still "commodity-like" industry with less room for differentiation.

STANDARDS OF LIVING / INTEREST RATES COMMENT

During 2024, the Fed began to lower short-term interest rates for the first time since its unprecedented tightening cycle began nearly three years ago. Three times rates were lowered during the year for a total of 1.0%, with the fed funds rate ending the year at 4¼-4½%. Uncharacteristically, though, long-term interest rates ***rose*** meaningfully as these short rates declined, with the 10-year U.S. Treasury yield ending the year at 4.6%, versus the 3.9% it ended at in 2023, itself mostly flat with '22.

U.S. Treasury Yield Curve
12/31/23 versus 12/31/24



Source: Bloomberg

By many (most?) measures, economic, financial and market conditions are now back to pre-pandemic levels. Labor markets, employment rates, hiring intentions, consumer spending patterns and, yes, even office attendance (for many) are within ranges established in 2019. Even inflation, as measured by the Consumer Price Index (CPI), at 2.9% year-end, is only marginally above the average of the 2009-2019

period. We said at the time, and believe it has mostly worked through, that the occurrence of Covid-19 accelerated many trends already in place.

Looking to other parts of the world, in unprecedented fashion, at least for most of the past twenty years, the Bank of Japan ***raised*** interest rates in 2024 (while much of the world was busy lowering). Negative interest rates are now gone. While the policy (short-term) rate is still just off zero, longer-term rates rose, with the Japanese 10-year yield closing the year at 1.08%. For now, at least, it does seem like the "back of deflation" is broken in Japan. This could portend well for consumer spending, wage growth and perhaps even the financial markets and investing.

We have previously written about central bankers the world over – including the U.S. Fed – trying, with each passing economic cycle, to get it "just right" so that they slow down overheating economies with just the right force to accomplish their missions without causing undue economic harm (or recessions). Has this cycle been the "charm"? It is increasingly looking that way. Despite a few "false starts," overall credit default rates have remained benign in the U.S. and mostly the world over. Or so (consistent with our Bah Humbug mentality) we **FEAR**. Why so?

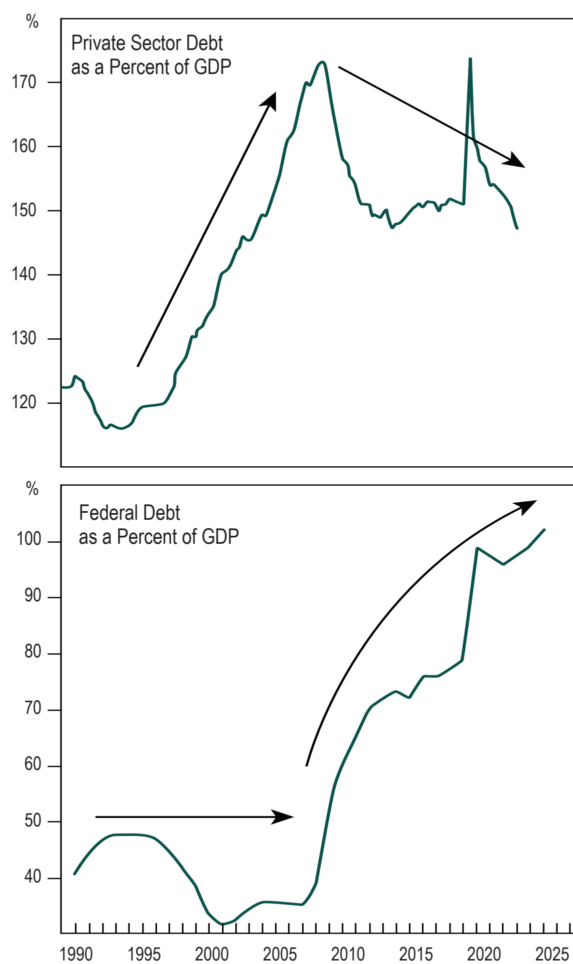
As stated in a recent edition of *The Bank Credit Analyst*, "*… in the olden days, excesses built up during economic booms were washed out during downturns. Thus, each new upturn began with relatively clean balance sheets. That no longer happened once governments (both fiscal and monetary) intervened to smooth out the cycles. The excesses* [still] *built up, but they were not fully cleansed during* [shorter and shallower] *recessions. Thus, each upturn began with debt and imbalances higher than in the previous cycle. So has gone the steady rise in private sector indebtedness. Government sector (over) spending has only exacerbated this.*"

Since the GFC, however, private debt (which built enormously during the prior decade), has declined as a percent of GDP. The top half of the following chart depicts this trend.

But, Bah Humbug, all is not well. For the bottom half of the chart shows that government debt (mostly federal as state balance sheets are, by and large, governed by law to remain in balance) is unprecedented. Note that since 2008, when the federal government stepped in to "bail out" financial institutions, each successive instance of trouble has been met with more government issuance of debt, attempting to stabilize the "problem of the day" (Covid being most recent).

Natural business cycles have, we believe, a curative element that may be required to maintain a long-term stable economic system. Sort of like the culling of a herd of elephants. Excesses always get built up, while recessions serve the purpose of relieving the pressure and cleansing the system

The Debt Supercycle Moves to the Public Sector



Source: BCA Research

of those excesses. Without cycles, the pressures will naturally build. Unfortunately, like happened during 2008-2009, without smaller periods of relief, the "bubble" may burst on its own.

The author quoted above concluded "*…Governments have a great ability to dig themselves into a deep debt hole.*" Further, "*… voters … despite their rhetoric, are unlikely to vote for politicians whose platform is austerity.*"

But we are also reminded that the U.S. consumer (like many developed countries) is a net **creditor**. This could be a reasonable explanation for why the decline in (yet still high by recent standards) short-term interest rates in 2024 was met by consumers with ***increased*** spending and by investors with ***increasing*** long-term interest rates. However, as opposed to this near-term reaction, we at Aristotle Capital are more concerned about the opposite. That is, a continuing build-up of debt could lead NOT to higher **in**flation, but to a resumption of the prospect of **de**flation. In our view, this is a much worse outcome for global economies and

something to be carefully monitored. This ultimate Bah Humbug is that the same debt utilized to fuel the "good times" could be, if left unchecked, the undoing of years of future productive growth.

We are not presently forecasting this dire outcome. We think a material downturn, if any, could be years away. But it is one of those risks we must monitor, as we continue our focus on understanding individual businesses, in this very unprecedented financial world.

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CONCLUSION

This year-end edition of *The Essence* is now published mid-January. We may delay even a bit further in coming editions. "Years" are random points in time, not particularly relevant to understanding, and investing in, businesses for the long term. We publish such data as our readers are curious, more to "file away" than utilize. Think of all the New Year's resolutions that by the time of your reading this have likely been made, tried and themselves "filed away." We continue to hone/refine/update/modernize our investment process – that is ongoing and will never cease – with an eye towards assisting our business client partners achieve their goals.

A subtitle of this edition of *The Essence* could be "*Focus on the 'bad' while investing for the 'good.'* " While our topic of Bah Humbug may imply a certain negative view on our part, it is not meant to convey such. We remain quite optimistic about the future prospects of economic activity in the U.S. and throughout much of the world – with a long-term, multi-year focus, not necessarily every quarter, nor every year. Our point is that to participate in this rosy scenario, we at Aristotle Capital delve into the *negatives* as much, if not more, than the *positives*.

We are deeply saddened by the natural and man-made disasters around our world. As we publish, the devastating Los Angeles wildfires are ongoing, disrupting the lives of thousands. Our deepest sympathies are with all, and we sincerely wish you and all those you care for remain safe during this most challenging time.

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