First Quarter 2023

Economic and Market Commentary

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There are some things we just take for granted that seem to have been around forever. Innovation by homo sapiens is what distinguishes us from all other animals. Here are just a few examples of innovation, and when they came about, that might surprise you. First, long before clothing came into fashion, cooking was the rage among homo erectus, direct ancestors of homo sapiens. Shortly after the discovery of fire, roughly 1.8 million years ago, early man recognized that by breaking down root vegetables and meats over an open fire, they needed to spend less energy breaking down their food. Less energy spent equaled more calories saved. Most scientists would agree that this major event in human evolution led directly to an increase in brain size.

European Neanderthals started making glue from the tar of birch bark. This glue was used to affix spearheads to the shafts of their spears, a complex process, but one that greatly enhanced their weapon-making capability. After all, a well-stocked cave is a happy cave.

Next up was the invention of clothing more than a million years later. Since furs, skins and textiles all disintegrate given enough time, it's the bone needles and stone scrapers that give us the insight that clothing started approximately 170,000 years ago. Many homo sapiens soon began to "accessorize" the way we do today, and so jewelry was invented some 140,000 years after. Archaeologists have discovered eagle claw necklaces in Croatia dating back more than 125,000 years ago. Moroccan digs have unearthed dyed pierced shell necklaces almost 100,000 years of age. These were not local fads but a global phenomenon. Burial sites in China have given up fox teeth arm and head bands more than 30,000 years old.

Not to be land bound, the invention of boats almost 50,000 years ago expanded food service through fishing and ushered in a new age of exploration with early man now able to traverse the seas, populating such lands as Australia, New Zealand and the Philippines just to name a few.

"Play Us A Song You're the Piano Man..."

Billy Joel

Just to be clear, our ancestors were not thuggish brutes. That's why the earliest musical instruments were created almost 45,000 years ago. Deep in the recesses of Germany's Hole Fell Caves, archaeologists discovered flutes made from the hollow bones of vultures along with horns made from mammoth tusks. To date, these are the world's oldest known musical instruments.

So now we have cooked food, clothing, jewelry, weapons, and music. It's high time we create vessels, pottery, in which we can store necessities such as food and water. And that's just what happened. Pottery was invented around 20,000 B.C.E. Caves in modern-day Czechoslovakia contained man-made ceramics in the form of animals, bowls and platters. Half a world away, Chinese caves revealed similar discoveries.

As time went on, maps were developed almost 15,000 years ago. Then came calendars, as man transitioned from hunter gatherer to an agrarian society.

Bread Or Beer, That is the Question

Some 9,000 years ago Agrarian society took hold. Animals were domesticated, and a new form of civilization took root. This society was based on permanent settlements, food reserves and the ability to assign specific jobs and assess taxes. But one debate that continues to rage on to this day amongst forensic anthropologists: what was the first commodity these farmers produced with their grains, beer or bread?

So What's Missing?

Granted this treatment has been greatly abridged, but we've just recorded nearly two million years of human innovation. Let me ask you, does something jump out at you as being painfully missing? Something that affects our daily existence each and every day? You bet it does—where is the wheel? Surprisingly, the wheel is a very recent invention and appears very late in our timeline. The wheel is fewer than 6,000 years old. It originated in what would be modern Iraq.

Originally, the wheel was invented as an aid to pottery production. Think of a "potter's wheel." The wheel's story starts with the known fact that no wheels exist in nature. Unlike the fork, whose design is inspired by forked sticks, or the airplane inspired by gliding birds, the wheel is a 100% human invention. It took almost 300 years of people staring at a potter's wheel going around and around before they figured out you could put two of them together at opposite ends of an axel, thereby enabling them to haul things around much easier in carts than dragging loads on sledges or frames pulled by animals like horses and dogs.

All of a sudden, civilization was able to efficiently harness energy in a way that transformed forces. How? By vastly reducing friction. Lots of energy is needed to overcome friction. For thousands of years, Native Americans used an "A" shaped dragging frame which lifted part of the load off the ground, lowering the friction and thus requiring less energy to pull the load.

Eventually, people discovered that wheels were force multipliers. The larger the wheels, the better they would work. (Just like levers do.) Think of it this way: If you had a heavy box on the ground, and you went to pull it, tremendous energy would be required because of the friction involved. Now take that same box and put it on a wheeled cart. The vast majority of the friction is between the smooth interior of the wheels and the axles. Now the box is far easier to move. Why? Because of the wheel's rotation.

Rotation

Broadly speaking, there are many forms of rotation which describe the action or process by which an object moves around a central axis. Examples exist everywhere. The word rotation can be used to describe the earth's rotation around its axis. (That's what gives us day and night.) The word can also be used to describe crop rotation. In this case, the axis is the land, and the crops are rotated in order to not drain the land of its minerals and nutrients that are essential for a successful crop harvest. Next, the word is used in finance to describe the various stages in an economic cycle as well as the various sector (types of industries) rotations that take place during the economic cycle. This includes both industries that are in favor as well as those out of favor.

Let Me Bring It Home

You'll recall that part two of this three-part series referenced market leadership in the First Quarter of 2022 taking hold with energy, utilities and consumer staples taking center stage and impressive returns in the high single digit, low double-digit range. On the other hand, large cap tech companies took it on the chin and represented the biggest losers in that quarter.

Fast forward one year at the close of First Quarter 2023, we now see energy companies, utilities and consumer staples getting hammered, and large tech far outperforming the broad-based market. Sector rotation in action. Remember, the labor market is a trailing indicator showing you where the economy has reached. This past week the Department of Labor greatly revised its jobless numbers upward, indicating higher unemployment— or underemployment— than previously thought.

On the other hand, the stock market is a leading indicator that gives clues as to where the economy is heading. Considering that the year just ended with both the stock and bond markets suffering double digit losses for the first time in the modern era; inflation having gone on a tear, with $7 heads of lettuce, and at times, $7 per gallon gasoline; nine consecutive hikes in interest rates; along with the largest land war in Europe since 1945, most market analysts feel that the economy has been surprisingly resilient. By no means should that be mistaken for complacency. Many of last year's challenges still exist: retooling the supply chain, hostilities in Europe and a pending debt ceiling battle, that if not handled well, could result in a self-inflicted wound to the dollar.

Conclusion

First Quarter 2023 results appear surprisingly healthy in light of the recent bank crisis, continued Fed rate hikes and tighter bank lending. Where 2020 and 2021 saw companies rewarded for increasing sales growth even if there was little in the way of earnings, 2023 and beyond will reveal a very different paradigm. The companies that will be rewarded in this next stage will be those with strong balance sheets, pricing power and stable cash flow that are trading at reasonable valuations. In a market with elevated volatility, it is those companies with increased earnings ability resulting in increased dividends that will end up doing well by their shareholders.

As increasing inflation pressures fade and interest rates moderate, the U.S. economy may very well find itself back on a course that will look much like the late 2010s with slow growth, low inflation, moderate interest rates and strong corporate margins. By 2024, this combination of factors could very well produce strong financial markets.

Until our next talk, stay safe and well. As always, with ...

Best Regards,

Ray Lent
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Enclosures