ACADEMY
CAPITAL MANAGEMENT

October 31, 2023

Enclosed is your statement for the third quarter of 2023.

In our third quarter letter, we have a tradition of addressing broader issues that go beyond specific portfolio holdings. In prior letters, we have discussed investment themes, such as "digital real estate." Last year, we shared that the Fed would win the battle with inflation and that our portfolios would survive and ultimately prosper from the stresses of that battle.

Since then, we have consistently reduced the risk profile of our portfolios by selling the stock of most of our "cyclical" holdings while also selling the stock of some of our "equity bond" holdings. We have used these proceeds to purchase short-term U.S. Treasury bills at attractive yields. In our prior discussion, we stated that the Fed's battle with inflation is one with four phases. To refresh, phase one is the Fed raising rates. Phase two is the Fed holding rates constant. Phase three is a system-threatening financial breakdown. Phase four is the Fed dropping rates. In this letter we share our current outlook as we have moved from phase one to phase two.

The Fed's inflation-fighting tool is an indirect one – to raise interest rates. Most people consider the Fed's actions to be counter-cyclical because the Fed cools a hot economy and heats a cool one. However, on closer inspection, the Fed is pro-cyclical. The recent arrest of a Pittsburgh-based fireman charged with repeated arsons provides an apt analogy. As inflationary fires spread of the Fed's making, the Fed jumps into heroic action with a "counter-cyclical" set of cooling actions. After the cooling sets in with a recession, news services pin the blame for the ugly economic bust on greedy banks and businesspeople while the Fed's role goes unnoticed.

In some ways, the current cycle is business as usual with the Fed in the background driving cyclical forces and then emerging front and center to counter those forces. While this "what goes up must come down" is normal Fed policy, the numerical size is abnormal. Fiscal and monetary policies worked together with novel approaches at massive scale to stimulate a home-bound economy. Amazingly, the monetary experiment worked, and we avoided a recession. However, the side effects of built-up savings and pent-up demand created an explosive inflation that the Fed did not anticipate.

In phase two of the Fed's battle with inflation, we are now undergoing a significant credit crunch as banks stop lending and beg for deposits. We've quickly moved from "cash is trash" to "cash is king." Housing and car affordability measures have collapsed. Higher

500 NORTH VALLEY MILLS DRIVE, SUITE 200
WACO, TEXAS 76710
254-751-0555 P 254-751-0611 F
www.academycapitalmgmt.com

labor costs and higher corporate profit margins have combined to exhaust pandemic savings, while also contributing to what could become a painful downturn. In phase one, savings dropped, and interest rates rose. Bond yields became increasingly attractive relative to stock dividend yields. Now in phase two, those effects are increasing. Here's what we presented two quarters ago, updating the chart with new numbers in bold:

"The easiest measure to compare stocks and bonds is to contrast the dividend yield against the 10-year USG bond yield. Typically, the measure for 40 years or longer, has been Aesop's "a bird in the hand is worth two in the bush" – meaning that the earnings yield should be twice that of the bond yield. Another way to state this is that *the dividend yield should be roughly equal to the bond yield* as the dividend yield generally represents half of the earnings yield. This relationship has proven true – especially when one adds back roughly 30 basis points to account for share buybacks (using Shiller's studies on his website)."

Here are the past 10 years:	Div. Yld	Bond Yld	Adj. Div. Yld
2013	1.94%	2.90%	2.24%
2014	1.92%	2.21%	2.22%
2015	2.11%	2.24%	2.41%
2016	2.03%	2.49%	2.33%
2017	1.84%	2.40%	2.14%
2018	2.09%	2.83%	2.39%
2019	1.83%	1.86%	2.13%
2020	1.58%	0.93%	1.88%
2021	1.29%	1.47%	1.59%
2022	1.64%	3.62%	1.94%
3.6.23	1.67%	3.97%	1.97%
Now	**1.62%**	**4.85%**	**1.92%**

In 2020, dividend yields were higher than bond yields – an indication of how expensively bonds were priced. Since then, the investment returns of bonds have been awful. Currently, Aesop's pricing is basically "*a bird in the hand is worth one in the bush*." This occurred before during the Volker tightening in the early 80s. Subsequently, bonds generated stock-like returns despite having far less risk.

Remarkable in the chart above is the continuation of an increase in the bond yield over the stock yield. An unusual dynamic accompanies this spread – GDP continues to increase in the face of rapidly dropping inflation and declines in bank lending. Normally a drop in inflation and bank loans occurs *only* in a recession. The disconnect between GDP and these other economic markers causes some to believe that a recession will not occur, while others believe a recession will occur as GDP is a lagging indicator. We are in the latter camp.

Since World War II, the average lag between monetary actions and economic reactions has been five to nine quarters. At this point, we are seven quarters along since the Fed

began tightening. Given the size of consumer savings coming out of the pandemic, as well as the pent-up demand, it seems reasonable that we will experience a larger than historical lag time but may also experience a larger than normal downturn. The yield curve has been a 100% reliable indicator for over 70 years, and it continues to indicate an upcoming recession. We hope that the indicated downturn is minor and not part of a "bigger they are, the harder they fall" dynamic. However, our concern is increasing. We have not only continued to raise cash but are also considering an increase in the maturity of our U.S. Treasury holdings for the first time in decades.

We hope that this discussion has shed some light on what we see as relevant in this environment and how it affects the investment decisions in your portfolio. In the spirit of our partnership, we want to provide insight into our process as if you are present at our investment committee. Briefly returning to our investment report, we present the results for the third quarter. *

If you're new to Academy, past quarterly letters may be useful and may be obtained through your financial advisor or our office. In addition, our website (at www.academycapitalmgmt.com) has our investment reports on the individual holdings in your portfolio. If you would like a copy of Academy's updated Form ADV Part 2A Disclosure Brochure, please contact our office.

As always, we appreciate the stewardship responsibilities you entrust to us and your patience with our investment process.

Academy Capital Management

*It is important to reiterate that because we manage individual portfolios but write a general letter, your portfolio may vary from the stocks assumed in our discussions.