Davis ADVISORS

QUARTERLY OUTLOOK | First Quarter 2024

Goldilocks Recession or Goldilocks Expansion?

The risks of recession seem overstated based on the latest data. It depends a lot on where you look.

Following are highlights from an interview with Peter Sackmann, a 26-year veteran at Davis Advisors whose responsibilities have included portfolio management, institutional services, and serving on the firm's Portfolio Review Committee. Peter talks about the current state of the economy, the possibility of a recession, U.S. interest rate policy and the future yield curve, concentration and valuation in the equity markets, portfolio positioning and opportunities.

Peter was interviewed by Dodd Kittsley, Davis National Director.

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Macro Landscape

Dodd Kittsley: Let's start out with the health and current state of the economy. Is a recession right around the corner?

Peter Sackmann: From an economic perspective, we're obviously not in a recession right now. GDP grew 5.2% in the third quarter on an annualized basis, up from 4.9% the previous quarter. Inflation is down to 3.1% compared to over 8% two years ago. It was the 8% that prompted the U.S. Federal Reserve to take action in raising interest rates, which has determined its policy direction since then. And then the jobs market is significant. Overall unemployment is hovering around 3.7%. When you look more closely at Bureau of Labor data, most segments of the economy from an employment perspective are either stable or growing. You have some weakness in retail, but by and large the numbers look very good.

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Another prism that you can look through to learn more about the health of the economy, and consumer and credit conditions is company financial statements, particularly financial services companies. And there we would say that the risks of a recession seem overstated based on the data we see. If it were a recession, we would call it a Goldilocks recession. But it might equally be a Goldilocks expansion.

Dodd: If we were to enter a recession, give some perspective if it would be a hard or a soft landing?

Peter: The worst-case fear seems to be that we have a repeat of 2008–09. That was absolutely devastating. The reason we don't think we're headed for that scenario is that much of the leverage and the business practices that contributed to that recession have been regulated away. A lot of the companies that were complicit in pushing the housing bubble are gone. So we don't think we're going to have the same thing. We have burdensome regulation now on the lenders, more so than we have ever seen. And what we've given up in near-term momentum in those banks we believe we have gained in terms of the longevity and resiliency of their earnings power.

Let's stress-test this scenario for a moment. A lot of people are worrying about commercial real estate, and the office sector in particular. Take a company like Wells Fargo, which happens to have a relatively large office book as a percentage of total loans—it's about 4%. The question to ask is, what is their total loss absorption capacity? Wells Fargo earns about $22 billion in pretax, pre-provision in a year. In order to start taking down its capital, you would have to burn through $22 billion of current earnings first. Their charge-off rate right now is running about 2.5%. Their total loss absorption capacity, what they could sustain taking into account both earnings and capital, is about $250 billion. We have stress-tested this right and left, and the Fed has done so under even more draconian assumptions.

If we are talking recession, we would lean more towards it being a garden variety event than anything approaching 2008–09. The powers-that-be have engineered a slowdown to tame inflation, but if the Fed were to reverse course, become more accommodative and reduce interest rates, it could obviously benefit equities.

You also have to look at cash on the sidelines. Anecdotally there appear to be plenty of investors with 20–30% of their assets sitting in cash. It's not a guaranteed backstop, but it is absolutely a fundamental factor in terms of buying potential if we do have some type of pullback.

If a recession were to occur, it probably would be a consumer-led recession because this is a consumer-led economy. So the jobs numbers are all important to watch as indicators of consumer health. Right now they're tracking well. Bank charge-offs and provisioning should also be watched carefully. They too are tracking well. Beyond that, if there are pockets of risk, it's cause for a rethink in comparative valuations across various areas of the market to learn where you might have margins of safety.

Watching the Fed

Dodd: What Fed policy makes sense if we continue to see an abatement of inflation?

Peter: Well, if we're trying to engineer a slowdown in price increases, and that dragon can be slayed, the next question would be, what's the normal shape of the yield curve? If you want to give the banks incentives to keep supplying liquidity to the economy, you have to give them some profit opportunities. The net interest margin of banks does not change in real time with the yield curve, but over time the two will tend towards each other. It's not normal for the yield curve to be inverted for an extended period of time, as it is now. So the likely scenario is that if we get a reprieve on inflation and you have a slowdown, the Fed could be more accommodative.

That would potentially be very bullish for big bank stocks that are trading at or below tangible book right now. This valuation level implies that they will lose money on a net basis. Compare it to our valuation assumption of 9–11x earnings. These are businesses that are likely not only to defy the prediction of losing money, but could generate net capital in droves, especially if the yield curve normalizes.

Of course, the Fed has to be data-driven and negotiate the balance between the state of the economy and jobs, and inflation and price stability. We think they do a reasonably good job, even if they are sometimes slow on the draw.

Concentration and Valuation

Dodd: The markets have been fragmented with the Magnificent Seven[1] up over 80% while the other 493 stocks in the S&P 500 Index were up only 4%. How do we make sense of this?

Peter: There's a perception now that you can't invest in equities without overpaying, and that is actually not true. Our portfolios, while they have many companies in common with the S&P 500 Index, have a core P/E of about 13x versus 21x for the S&P 500 Index. You've got a big delta there. We're actually below the S&P Value Index valuation of 15x. What we're trying to do is build in a margin of safety on one hand, and a springboard for better returns on the other, without sticking our necks out on the risk curve too much. Conversely, we also have interesting growth characteristics. In Davis New York Venture Fund and Davis Opportunity Fund, for example, over the last five years we've had an 11–12% Compound Annual Growth Rate (CAGR). That is comparable to or better than the core indexes, which have a lot of technology.

The stock market really is a market of stocks, and the key question is how you weight your positions versus everything else. Is your allocation of capital efficient and is it prudent? The indexes don't approach allocation from the lens of attractiveness, but from market-cap, or size. It doesn't seem prudent to structure an active portfolio in that way. But the good news is there are plenty of alternatives to what we're seeing in the index's weighted average valuation and concentration profile. If you know that those are the dangers, you can start looking explicitly for strategies that avoid those issues.

Dodd: Has there ever been such concentration in the indexes as we see today?

Peter: Never, not even at the height of the 1990s bubble with Cisco Systems at a hundred times earnings. At that time, the ratio of the largest company to the average company in the S&P 500 Index was over 20x. Now it's over 34x. Not many people would've guessed that today you'd have a handful of companies like the Magnificent Seven at over $2 trillion in market cap when the median size of an S&P 500 Index company is more like $30–40 billion. We have never seen the index so concentrated in such high-valuation names. At the same time, many of the other stocks in the index are trading at reasonable valuations by contrast. The story is not that it's too late to invest. It comes down to being selective.

Dodd: With an average portfolio P/E ratio of 12x to 14x, nearly a 40% discount to the market, it seems that the research team is finding opportunities in attractively valued stocks?

Peter: Yes, and you don't have to confine yourself to the highest growth names to get a good return. As an example, Owens Corning, which owns businesses in fiberglass, roofing, insulation and glass composites, is up over 50% this year. We were buying it at 8x earnings and, even after its run, it's still very reasonably priced. In terms of the growthier names, we were buying Meta a year ago at 9–10x earnings. Of course, now it's catapulted upward, but its earnings have also rebounded, so it's close to about 18x now. That means we have doubled on the

The average annual total returns for Davis New York Venture Fund's Class A shares for periods ending December 31, 2023, including a maximum 4.75% sales charge, are: 1 year, 23.82%; 5 years, 10.89%; and 10 years, 8.18%. The average annual total returns for Davis Opportunity Fund's Class A shares for periods ending December 31, 2023, including a maximum 4.75% sales charge, are: 1 year, 16.32%; 5 years, 12.07%; and 10 years, 9.34%. The performance presented represents past performance and is not a guarantee of future results. *Total return assumes reinvestment of dividends and capital gain distributions. Investment return and principal value will vary so that, when redeemed, an investor's shares may be worth more or less than their original cost. For most recent month-end performance, visit davisfunds.com or call 800-279-0279. Current performance may be lower or higher than the performance quoted. The total annual operating expense ratio for Davis New York Venture Fund Class A shares as of the most recent prospectus was 0.92%. The total annual operating expense ratio for Davis Opportunity Fund Class A shares as of the most recent prospectus was 0.94%. The total annual operating expense ratio may vary in future years. Returns and expenses for other classes of shares will vary.*

1. "Magnificent Seven" refers to the biggest stocks in the S&P 500 Index, namely the mega-cap tech companies Nvidia, Tesla, Meta Platforms, Apple, Amazon.com, Microsoft and Alphabet.

multiple yet tripled on the price because the earnings have grown more than the stock price. So the question to ask is where can you find well-priced securities while reminding yourself that the S&P 500 Index is not the stock market, it is a portfolio.

Portfolio Focus

Dodd: Being selective in this market is important. Where else is Davis finding opportunities?

Peter: Well, one area is financials, but not all financials are alike. There are three classes of financial stocks that interest us right now. One is non-financial financials like Berkshire Hathaway and Markel. These are primarily multi-industry conglomerates with asset management-like capital allocation on top. Very interesting, but not lenders per se. If anything, they're tied to insurance and reinsurance businesses, which are exposed more to weather and natural disasters than to the capital markets. As a result, they tend not to be very correlated. These are about a third of our total financials position.

Another third would be select mega banks, with JP Morgan Chase and Wells Fargo being the most significant of those. The final third of the financial sector is consumer finance companies like Capital One and American Express. They have been through so many downturns and slowdowns in their histories that it's remarkable that they are not valued more.

Looking at technology, we have never ever seen an era where the setup was as propitious as it is today. Back in the 1990s, you had PCs and semiconductor-related tech, and some communications. Now we have e-commerce, and social media, which didn't exist then and we have online search—it used to be newspapers. We have cloud computing versus PCs, and we have semiconductors in a highly advanced state as an industry doing Artificial Intelligence (AI). So that's the technology sleeve. We have some of the Magnificent Seven in there where we can justify the valuations.

Finally, in healthcare we favor services, like Cigna Group and Quest Diagnostics. We also have a position in generics with Viatris, which is the cheapest stock right now on a free cash flow basis in the S&P 500 Index. It's about 4x free cash flow, which it generates net of debt service cost.

Questions from Financial Advisors

Q. *Banks have numerous headwinds, including pressure from legacy loan books and unrealized loss factors. Why do insurance companies, trading at or near all-time highs, not have the same overhang as they also have massive loans and unrealized losses?*

Peter: It's a good question. If you take a company like Bank of America (BoA) for example, and say it has a lot of unrealized losses, the question to ask is whether it will have to realize those losses against equity. In BoA's case, the answer is that it has enough other assets and liquidity. When people talk about unrealized losses, especially on the bond side, there is a notion that there isn't liquidity coming through the door in droves. As long as the size of the unrealized loss is contained within a much larger infrastructure of liquidity and other liquid assets, you can forestall realization of losses over time.

The reason insurance companies are able to sustain losses is because of premium inflows. These tend to be uncorrelated with capital market conditions. The other thing to consider with insurance companies is the rate of growth of the float. With higher interest rates, cash will generate a lot more investment income. Insurance investment income could soar while premiums remain steady. As long as those inputs are large enough to offset the need to liquidate and to realize losses, it's basically a matter of timing. It could actually become a bull case as low interest loans get rolled over at much higher rates.

But it is a slow-moving process and it could become a problem in some smaller banks that don't have the scale to manage it.

Q. *How concerning is the Federal deficit? What are the implications for the yield curve?*

Peter: The problem with the deficit right now is it leads to a paucity of available money for other things. Let's walk through some of the implications where the government plays a large role in an industry, assume that this line item will be under the microscope. Take healthcare, for example. Why are we in cheap services versus branded pharma? Well, branded pharma is entering a three-year price negotiation with Medicare. And since healthcare spending is already approaching 20% of the nation's GDP, it seems there is not much flexibility on price which has negative implications for the margin structure of these companies. That's one of the reasons we are circumspect. We would rather buy Viatris at 4x free cash flow than some of these other names at 16 or 18x that are running at fully optimized margins.

Another is that the yield curve could normalize more if you have a downgrade on U.S. Treasuries and a run on the dollar—not a complete run, but just less enthusiasm for the dollar. In that case, you would expect intermediate and long rates potentially to be sticky or higher. If that happened and if the Fed-engineered slowdown resulted in a sloth-like growth rate in the economy, then you would expect rates at the short end to be revised downwards. All this is within the Fed's control. Absent terrible things happening in the economy, it would be a palliative for earnings and a respite for some companies' debt service costs.

Q. *What's the catalyst to get Viatris out of its own way?*

Peter: With Viatris, the free or cheap option we see right now is on the 1,400 approved therapeutic patents they have. Most of the pharma industry has two to five blockbuster drugs propelling them. In Viatris' case, you've got a large pool of potential chips on the table, any one of which could hit. So, that's one—it's a probabilistic framework to some extent.

Another is that people are drilling down on the stock because of the debt load and because of where interest rates are. However, Viatris has been carefully working down its debt load over time, disposing of assets and paying off loans. The leverage ratio is about 3x, which is sustainable, if not ideal. Also, the debt is termed out such that the company actually generates a lot of levered free cash flow, and half of that free cash flow goes to paying the 5% dividend and buying back shares. It's potentially a very interesting capital allocation "shrink to greatness" case.

People have trouble absorbing this because it's so rare. You first have to have management that thinks that way, and you also need an idiosyncratic situation with all the

different pieces and parts in place. How do you frame it analytically? We think Viatris looks really good, and believe we will be paid at the end of the day for the time we've had to wait.

Q. *The P/E of Davis International Fund is in single digits. Are we in a fight with a strong U.S. dollar before we see growth in this fund, or in international stocks in general?*

Peter: The strong U.S. dollar definitely is a headwind to international shares. The U.S. markets right now reflect a healthier growth picture overall—a more resilient, robust and vibrant economic picture—certainly relative to China and probably Europe as well, which appears to be tipping into a quasi-recession. You get these cheap multiples, but you have to deal with why they're cheap.

There are certain international stocks that have roared this year. If you look at Danske Bank in Copenhagen, for example, it has really soared because it's coming from a position that's unique to it right now. It is past a money laundering scandal[2] and has a long runway, especially in terms of return of capital. It has a Tier 1 capital ratio of about 18%, and probably needs only 15%, so that is 300 basis points of capital that will likely be returned 100% to shareholders through dividends and buybacks. The bank has instituted an interim-period dividend—its dividend yield could be 7–10% this year. And then all future earnings net of credit losses are promised to be returned to shareholders.

Another company we like in the international category is Development Bank of Singapore (DBS). It is uniquely tied into the potential growth of the Pan-Asia-Pacific super-region, which will probably have over 60% of the world's middle class and a huge percentage of its intercountry commerce. DBS has an interesting relationship with both China and India. India could be a bigger opportunity than even China due to the size of its unbanked population. We are certainly willing to wait. In the meantime, DBS has a 19–20% capital ratio and has historically grown net income about 13% per year over the past decade with few interruptions. They also have a huge stakeholder in Temasek, the Singaporean sovereign wealth fund.

We like select international stocks, but if you told us to buy international equities because they're just cheaper superficially, we wouldn't do it.

Q. *Can you talk about the Japanese equity market compared to the U.S.?*

Peter: Japan is interesting on two levels. Economically speaking, if they meet inflation with positive higher interest rates, then it is conceivable that the yen, being one of five reserve currencies, could look relatively good compared to European currencies. Japan has always been strong in very advanced technologies. The country absolutely has another shot at playing on the world stage. Look at companies like Tokyo Electron, which is kind of an equivalent to Applied Materials here but facing the Asia-Pacific region.

Q. *Financials have historically had low P/E ratios as a sector. What catalysts would cause your financial portfolio holdings to reach their estimated intrinsic value?*

Peter: Let me explain how we think about the true fair value of a lot of financial companies. It's based approximately on book value. Take a stock that is really cheap today, like Capital One, trading at 0.84x book. The market is discounting the book value and almost implying that there will be a net loss. Here's what is interesting: What if, over time, you have positive net earnings, and then again positive net earnings, and so on? All the earnings that you retain get stacked on top of your book value. Your book value grows therefore as a function of your retained earnings.

That's the bootstrap dynamic that we look for. Warren Buffett often says that he would rather have Berkshire Hathaway trade roughly at intrinsic value, over time to eliminate the temptation to buy it terribly. Similarly, with the financial group, there is the notion that they have to be revalued up to some level to make our thesis correct. This is a show-me industry and always has been. The reality is that you have some tremendous

2. In December 2022, Danske Bank agreed to pay approximately $2 billion in fines and forfeitures to Danish and U.S. agencies to settle charges related to money-laundering violations that took place in the bank's Estonian branch from 2007 to 2016.

earnings platforms. Take JP Morgan Chase as an example of a market leader in what had been a lagging sector. The company today earns $64 billion pretax, pre-provision. Five years ago, it earned about $46 billion meaning that there has been an increase in earnings power of almost 40% in five years which included the COVID period. Interestingly, the company's stock is up from about $103 in December 2018 to the high $160s today, or up over 60%. Among other things, this demonstrates that the perceptions holding down the multiple of the financials sector do not have to be a hindrance to good performance, if the fundamentals move in the right direction over time.

So this is the way you grow value, even if the multiple stays the same. Can you build net earnings and layer on intrinsic book value over time? It tends to be a pretty good guide for a financial stock/company. You don't need multiple expansion. We would expect the multiple to revert back to book at least, so, if you're at 0.84x, you've got a 20% lift, potentially, just in the reversion. Beyond that, it's going to stack based on your return on equity and your earnings.

Q. *You spoke earlier about the likelihood of the inverted yield curve reverting to a more normal pattern. What are your views on how that could happen and over what time period?*

Peter: In our view, short-term rates are most likely to come down. What's going to dictate that will be inflation trends among some other factors. If we need some stimulus in the next two years, that could tip us into a positively upward sloping yield curve again. The focus is on the short end because the intermediate and long end of the yield curve could be sticky and higher based on concerns about the country's creditworthiness and the relative attractiveness of the U.S. dollar and economy.

Without making a prediction, there is certainly the possibility of further credit downgrades for the U.S. The further out you go on the yield curve, the more likely it is investors will demand an uncertainty premium.

We think the short end could be variable. After the inflation beast is killed, the Fed has intimated that it is open to easing off a bit on the pedal. It would help alleviate the burden of higher financing costs on consumers and businesses. A normalization of the yield curve might also be very beneficial to spreads earned by banks. It is possible in theory that the longer you go with an inverted yield curve, the more you actually push the economy towards a recession. We don't think the Fed wants to do that, but they need an excuse to back off, and that would be based on trends in inflation and price levels.

Q. *What are your thoughts on capital spending at Texas Instruments?*

Peter: Texas Instruments is, in our opinion, one of the finest and most important semiconductor companies in history. Where they are now, and where the chip industry is in general, is in expansion and investment mode. It will be very interesting to see whether the government actually does deliver on the $38 to $46 billion that's earmarked from the CHIPS Act.[3] In addition, there is a geopolitical imperative now to onshore the semiconductor industry.

The semiconductor industry is investing ahead of many of the trends that are coming. We're talking about going down to under single-digit nanometers in chip manufacturing. This is going to require nontrivial investment. It's going to be huge worldwide. But at the same time, what are the spoils? It could turn into a $1 trillion market by 2030 from $400 billion today. It's really impressive. So spending can sometimes be bad and sometimes be very bullish. If you're spending ahead of growth, that's oftentimes a sign of confidence more than a defensive measure. In this case we think it's confidence.

> **Dodd:** Thank you for your valuable insights. We look forward to talking again in future market updates.

3. The CHIPS and Science Act is a U.S. federal statute enacted in August 2022. It authorizes approximately $280 billion in new funding to boost manufacturing of semiconductors on U.S. soil.

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As of 12/31/23, the top ten holdings of Davis New York Venture Fund were: Meta Platforms, 8.49%; Berkshire Hathaway, 8.04%; Wells Fargo, 7.68%; Capital One Financial, 6.71%; Amazon.com, 6.39%; Applied Materials, 4.91%; U.S. Bancorp, 3.66%; Viatris, 3.33%; JPMorgan Chase, 3.28%; and Bank of New York Mellon, 3.19%.

As of 12/31/23, the top ten holdings of Davis Opportunity Fund were: Wells Fargo, 6.58%; Quest Diagnostics, 6.07%; Capital One Financial, 5.86%; Viatris, 5.62%; Cigna Group, 4.57%; Owens Corning, 4.55%; Teck Resources, 4.54%; Schneider Electric, 4.02%; UnitedHealth Group, 3.92%; and U.S. Bancorp, 3.81%.

As of 12/31/23, the top ten holdings of Davis International Fund were: Danske Bank, 10.20%; Samsung Electronics, 8.33%; DBS Group, 7.27%; Hollysys Automation Technologies, 6.11%; AIA Group, 5.55%; Julius Baer Group, 5.30%; Tokyo Electron, 5.03%; Prosus, 4.91%; Naspers, 4.90%; and Schneider Electric, 4.61%.

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We gather our index data from a combination of reputable sources, including, but not limited to, Lipper, Wilshire, and index websites.

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