2022
4TH QUARTER
QUARTERLY COMMENTARY

ANGELES INVESTMENT ADVISORS
429 SANTA MONICA BLVD, SUITE 650
SANTA MONICA, CA, 90401
PHONE: 310.393.6300

375 PARK AVENUE, SUITE 2209
NEW YORK, NY 10152

WWW.ANGELESINVESTMENTS.COM

Horace Vernet—*On the barricades on the Rue Soufflot, Paris, 25 June 1848*

Kapitalismus

Revolution spread like wildfire throughout Europe and around the globe in 1848, seemingly out of nowhere. There were early uprisings that year in Sicily and elsewhere, but revolutionary fervor arose most dramatically in France. On 22 February, crowds of merchants, students and factory workers gathered in defiance of King Louis-Philippe's order banning public assemblies. They demanded political liberties, and that evening the King fired his prime minister to assuage the mob. The next day, the crowd continue to agitate for rights, and Louis-Philippe ordered his soldiers to disperse the crowd, which they did by killing fifty civilians. On the 24th, insurgents overran the Château d'Eau, a tower guarding the Tuileries Palace, capturing weapons and converting most of the soldiers to its side. King Louis-Philippe sensed his cause was lost, and abdicated that evening. The next day, the Second Republic was declared.

This astonishing turn of events sparked insurgencies across Europe. In Germany and Austria new liberal constitutions were forced on princes and emperors. In Denmark and the Netherlands, the absolute monarchs were forced to adopt constitutions for the first time. In Switzerland, the independent cantons gave up their autonomy and formed a federal republic. Rebels in Galicia won autonomy from the Austro-Hungarian Empire, including the right to teach the Ukrainian language in schools. Additional uprisings occurred that year in Sweden, Poland, Belgium and Ireland, and spread across the ocean to Canada, Colombia, Chile and Brazil. Revolution eventually reached China, where Taiping rebels sought to overthrow the Qing Dynasty, a civil war that killed 20 million people.

Of course, political events do not spontaneously erupt. Food shortages precipitated revolutions throughout history, in France (1789), Russia (1917), and the Arab World (2011), for example. A potato fungus and poor wheat, barley and rye harvests in Europe in 1845-46 left millions starving. Urbanization and industrialization brought millions of workers into the cities where they could more easily organize to demand better working conditions.

Still, the revolutions of 1848 erupted so suddenly and spread so quickly that even those monarchs that held on to their thrones were forced to cede authority and grant new political liberties to citizens. The kings and princes of Europe were not prepared for the upheavals that befell them that year. No one saw the revolutions coming. No one, except one, very unlikely, man.

Unlikely because he was born into a prosperous family. His father was a prominent lawyer who owned vineyards in the Moselle Valley. His mother was Dutch, and her family would go on to found Philips Electronics. Unlikely because he was kicked out of college for drunkenness and dueling. Unlikely because he would die penniless, his death unnoticed.

But in the first weeks of 1848, he published a pamphlet that predicted, and called for, overthrowing the monarchies of Europe. Within days of its publication, revolts swept across Europe. He was thus thrust into international prominence. His rise and fall, then his rise and fall again after his death, give us a lens to examine the events in the markets this past year.

Equities fell 19% last year. Over the past forty years, only 2008 and 2002 were worse years in the stock market. Yet in the history of bear markets, this one has been relatively mild, well ahead of the median bear market decline of 33%.

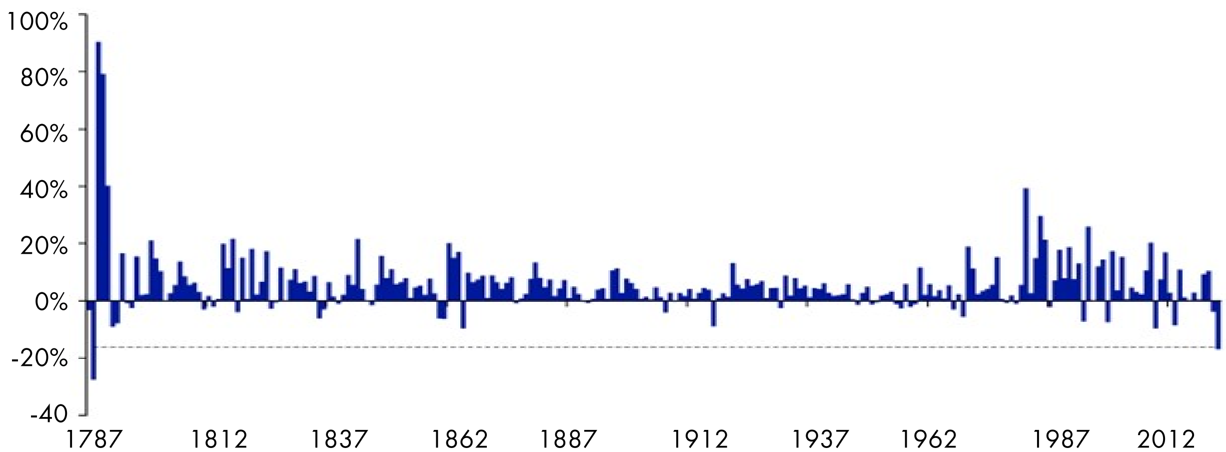
Yet, 2022 may have been the worst year on record for investors because the equity bear market was accompanied by the worst bond market in history. The Federal Reserve raised overnight rates by more than 400 basis points, the largest absolute tightening since 1973, and the most, in percentage terms, ever (Chart 1). This resulted in the worst bond market in

Chart 1 **Federal Funds Effective Rate, 1954-2022**

over 200 years (Chart 2). We covered much of this in our webinar two months ago, but Chart 3 shows what an outlier 2022 was for balanced investors over the past 150 years.

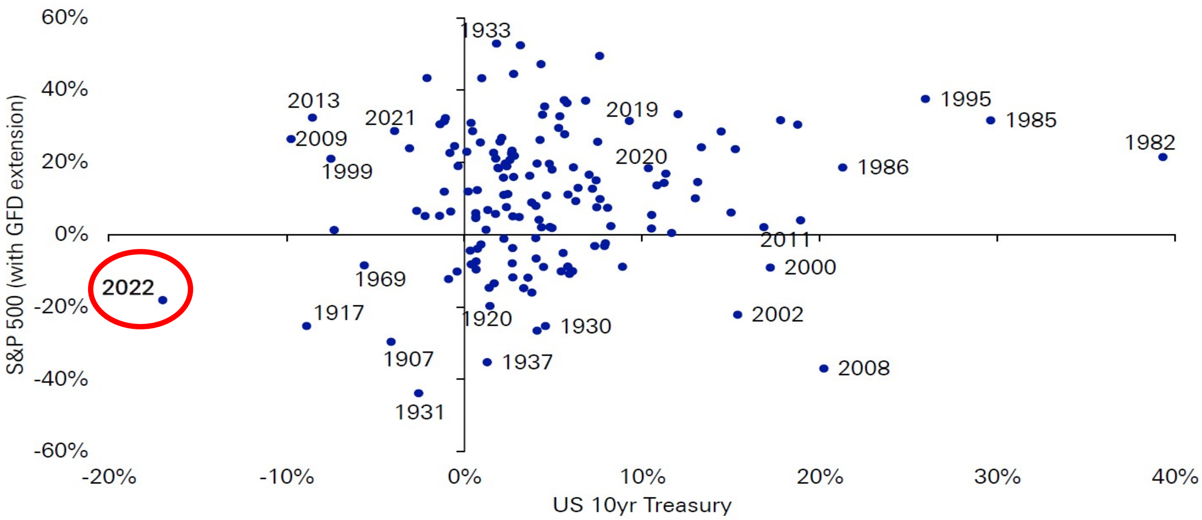
Stocks and bonds fell together for only the third time in the last 150 years, buffeted by the twin headwinds of rising inflation and slowing economic growth. Inflation jumped from 1.2% in 2020 to 4.7% in 2021 to 8% in 2022. US Real GDP rose 5.9% in 2021, but fell to 2% last year, and is poised to drop further, with a recession likely this year. Manufacturing is contract-

Chart 2 **US Ten-Year Treasury Total Return, Annually, 1787-2022**



Courtesy: Deutsche Bank

Chart 3 **Annual Nominal Returns for US Stocks and Bonds, 1872-2022 (%)**



Courtesy: Deutsche Bank

[1] https://www.angelesinvestments.com/insights/video_pdf_presentations/fat –bear-time-webinar.

ing (ISM below 50). Housing is already in a recession, as starts are running at an annual rate of 1.4 million units, down from 1.8 million units as recently as April, a 16% decline, the steepest since the Global Financial Crisis of 2008 (bar the pandemic lockdown of 2020—Chart 4).

Economic conditions are clearly important to investors. Slowing economic growth reduces profit potential. Rising inflation devalues future earnings and erodes the purchasing power of cash flows. Valuations adjust in the market to reflect these changing economic conditions, which is exactly what we saw in 2022. Bond yields jumped and equity multiples (Chart 5) fell in response to higher inflation data and weaker economic activity.

Chart 4 **Newly Privately-Owned Housing Units Started, Pct. Change from a Year Ago, 2012-2022**

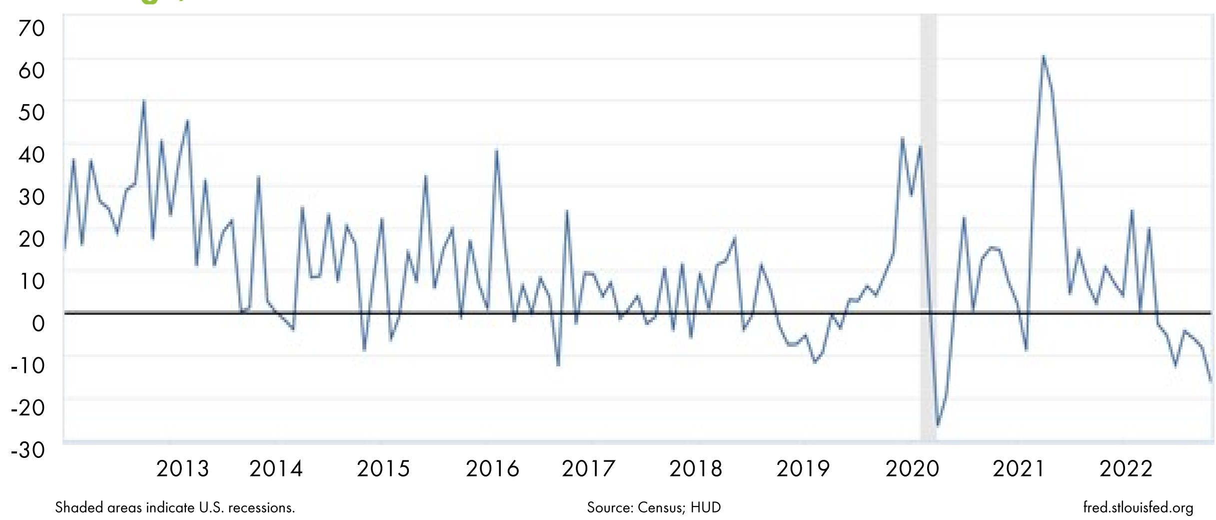
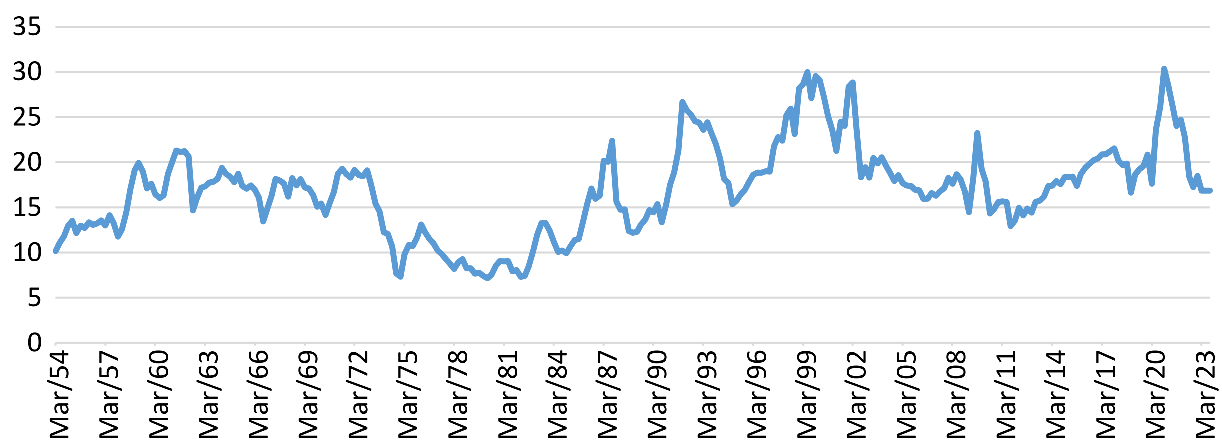


Chart 5 **Price/Earnings Ratio, S&P 500 Index, 1954-2023**

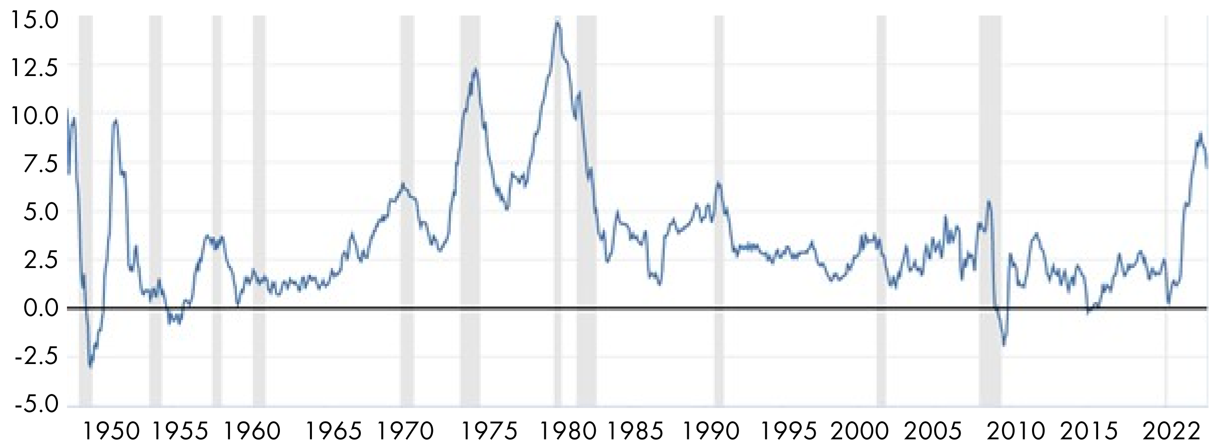


Source: *Bloomberg*

The US economy has experienced economic contractions and rising inflation in the past. Over the last 75 years, there have been 12 official recessions, most recently the brief pandemic shutdown in 2020, and five periods when inflation spiked above 8% (Chart 6—gray bars represent recessions).

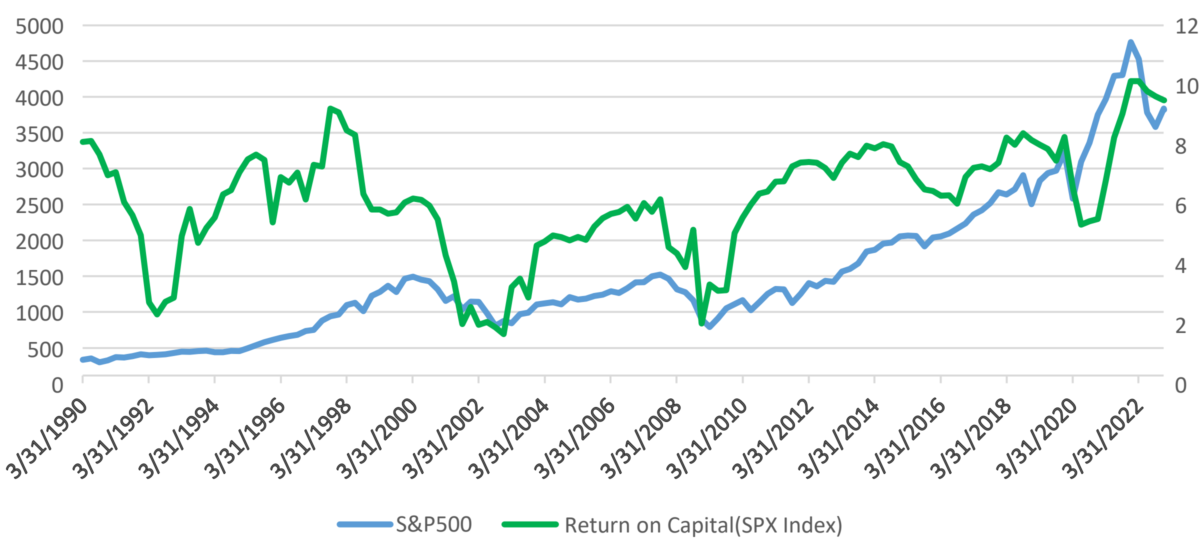
Yet companies, in the aggregate, found a way to remain profitable. Since 1990, for example, the return on capital for US companies has always been positive (Chart 7), and despite the four recessions and four bear markets in that period, equities have

Chart 6 **US Consumer Price Index, Pct. Change From A Year Ago, 1948-2022**



Shaded areas indicate U.S. recessions. Source: U.S. Bureau of Labor Statistics fred.stlouisfed.org

Chart 7 **Price Level (LHS) and Return on Capital (RHS), S&P 500 Index, 1990-2022**



Source: Bloomberg

Angeles

risen 1,000%. Dividends reinvested bring the total cumulative return to over 2,000% over the past 30 years (Chart 8).

Earning a positive return on capital, whether the economy is growing or contracting, whether inflation is low and moderate or surging higher, is the *raison d'etre*, the purpose, of every company. Not every company will be successful, and many will disappear, either acquired or bankrupt. Indeed, there is a long list of companies that have disappeared from the largest ranks, or have disappeared entirely. Not a single company of the ten largest today were in the top ten a generation ago (Chart 9).

This is worth emphasizing. Return on capital drives investment success. It determines which companies, and countries, will rise or fall. Growth in the economy, inflation and other economic data are secondary considerations for sustained economic success to

Chart 8 **Total Return S&P 500 Index, 1990-2022**

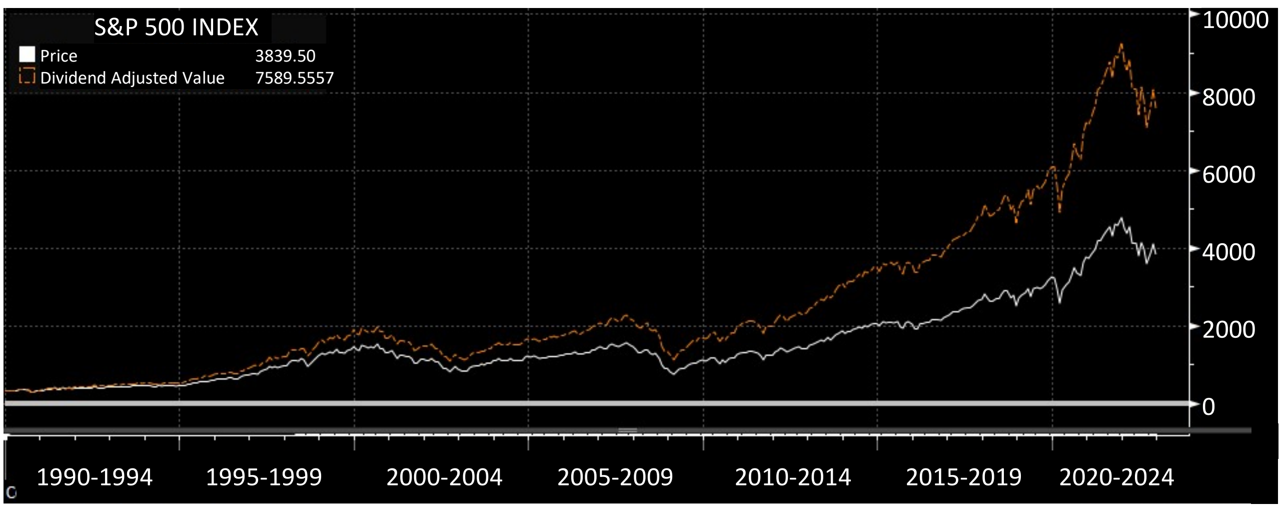
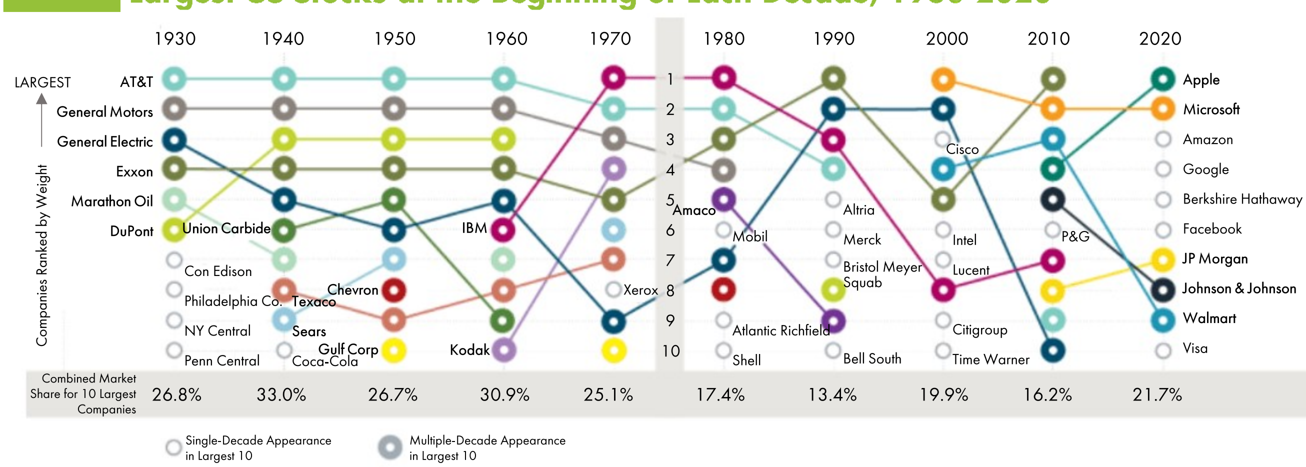


Chart 9 **Largest US Stocks at the Beginning of Each Decade, 1930-2020**



Source: Dimensional, using data from CRSP and Compustat. Incudes all US Common stocks. Largest stocks identified at the end of the calendar year preceding the respective decade by sorting eligible US stocks on market capitalization using data provided by the Center for Research in Security Prices, University of Chicago.

return on capital. This is best illustrated by examining the Asian economies.

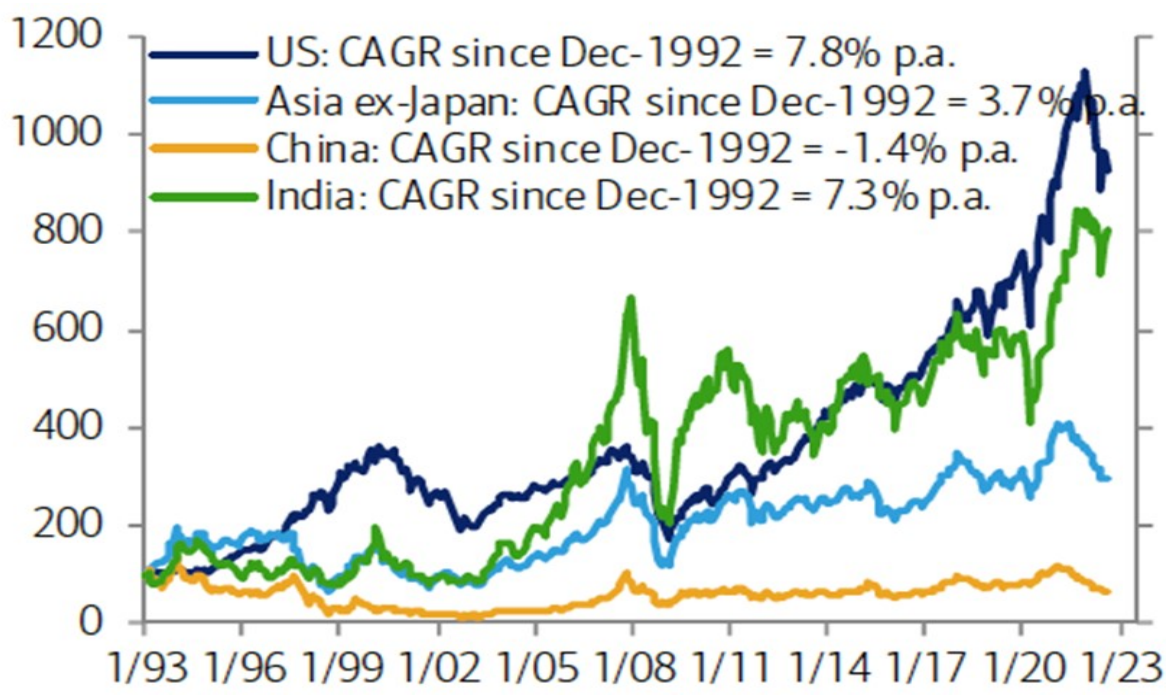
China was added to the MSCI indices in 1992. In the 30 years since, the economies of Asia (ex-Japan) grew nominal GDP at a 9 ½% annual rate, more than twice the 4 ½% pace of nominal GDP growth in the US. In these past 30 years, revenue growth for Asian (ex-Japan) companies compounded at 14.8% p.a. versus only 6 ½% for US companies. Earnings grew 12.6% p.a. in Asia ex-Japan, faster than the 10% pace for US companies. So the macroeconomic conditions in Asia ex-Japan were far stronger over the past three decades than in the US. Asian companies benefitted from this strong underlying economic environment with substantially higher growth in revenues and income.

Since 1992, US equities returned 7.8% p.a. Asia ex-Japan equities returned just 3.7% p.a. China, with the strongest economic growth in the region, had equity returns of -1.4% p.a. (Chart 10).

Let that sink in: China, with GDP growth exceeding 9% p.a. for 30 years, saw equities decline 35% over this time. Stock performance has nothing to do with GDP growth, or revenue growth, or even net income growth.

Two factors explain the poor investment returns in Asia ex-Japan. The first is return on capital. US companies averaged returns (on equity) of 15% over the past 30 years, versus 11.2% in Asia ex-Japan. Secondly, Asian companies significantly diluted their earnings. Earnings *per share* for Asian companies

Chart 10 Equity Performance of US, Asia ex-Japan, China, India, 1992-2022



Courtesy: BofA

[6] *A term of endearment (?) for the Bank of England*

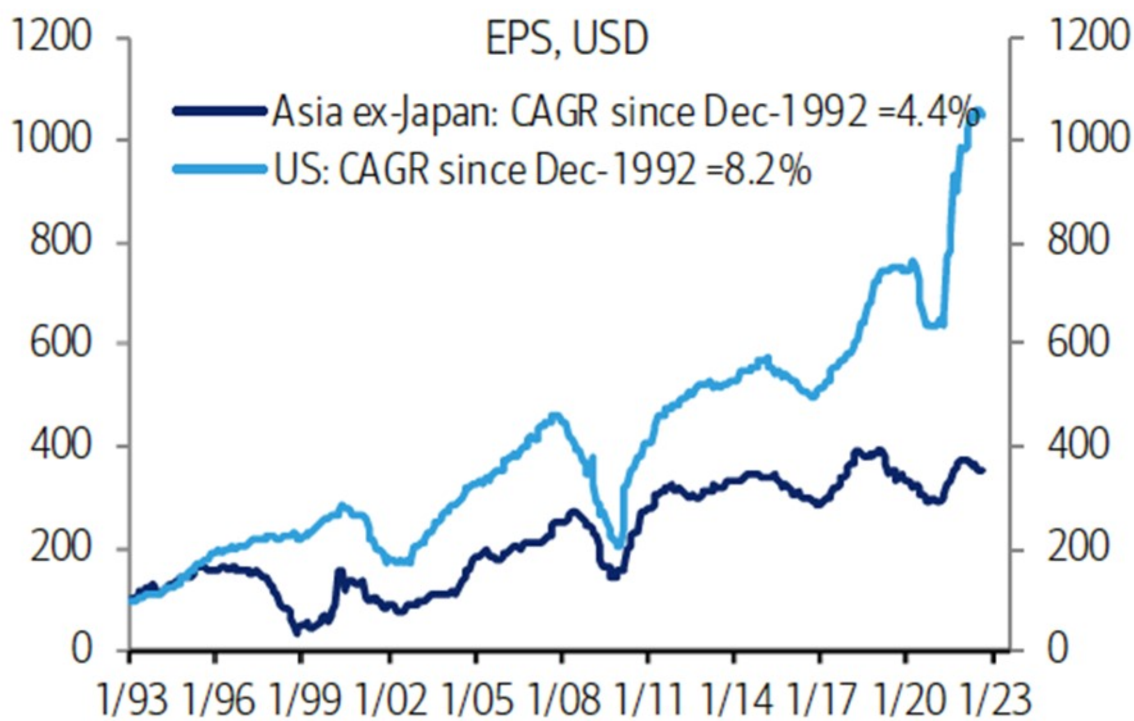
averaged just 4.4% p.a. since 1992, versus the 12.6% growth in net income they enjoyed. For US companies, EPS grew at 8.2% p.a. against earnings growth of 10% (Chart 11).

Those companies that can earn a high return on capital will supplant those who cannot. This explains the shifting ranks of successful companies over the years, and refutes the notion that economic growth translates to investment success. Economic conditions matter, but the competition to earn a high return on capital defines sustained success, for companies and for countries. It is this defining feature of capitalism that creates wealth and eludes its critics, most notably those who still embrace the ideas, or "ideals," of that young pamphleteer of 1848.

That prescient pamphlet that predicted the revolutions of 1848 began with these words: "The history of all hitherto existing society is the history of class struggles." The author argued that human activity is a battle against nature to supply our needs, which are fulfilled through labor. Thus, through labor is human potential achieved. But capitalism alienates the worker from his own worth by requiring workers to produce more than they consume, thereby leading to the inevitable class conflict between the worker (proletariat) and the capitalist (bourgeoisie). The revolutions of 1848 seemed to validate the arguments of this manifesto of the newly formed Communist League.

Within the year though, most of the rebellions had been crushed. Karl Marx, the author of the manifesto, was kicked out of France, Prussia, Belgium and eventually settled in England where he began to work on his *magnus opus*, *Das Kapital*. In it, he elaborated on the theme of surplus value, created only by labor, and appropriated by capitalists. Marx saw the race to automate, to replace labor with machines, as sowing the seeds of the destruction of capitalism because

Chart 11 **Earnings Per Share Growth, Asia ex-Japan and US, 1992-2022**



Courtesy: BofA

machines could not create surplus value, only labor could.

Whereas Adam Smith saw capitalism as an "obvious and simple system of natural liberty,"[2] Marx saw the hidden exploitation of labor. Marx's argument was picked up in 2013 in the surprise best-selling book by French economist Thomas Piketty[3] that claimed that capitalism *fundamentally* creates concentrated wealth through ever-higher returns on capital over labor, thus requiring confiscatory taxes in order to redistribute wealth.

Marx made the fundamental mistake of assuming that the sole source of value comes from workers producing more than they consume. He missed completely Adam Smith's insight that value derives from productivity, that workers specializing in narrow tasks are more productive collectively than if each had to perform every task. He also completely ignored David Ricardo's related insight that specializing in the area of comparative advantage creates a more efficient and productive economy. Likewise, Piketty mistakes labor's lower share of income today as a perpetual trend, when in fact it has fluctuated around a steady mean over the past 300 years. The rich do not get richer, as Piketty claims, as evidenced by the absences of once powerful companies from the top ranks. One hundred years ago, half of the ten largest companies in the US were Bethlehem Steel, Armour & Co., Swift & Co., International Harvester, Midvale Steel and US Rubber. Fifty years ago, Eastman Kodak, Polaroid, Sears Roebuck, Texaco and Gulf Oil comprised half of the ten largest companies in the US. All are gone, subsumed into other entities, or simply gone.

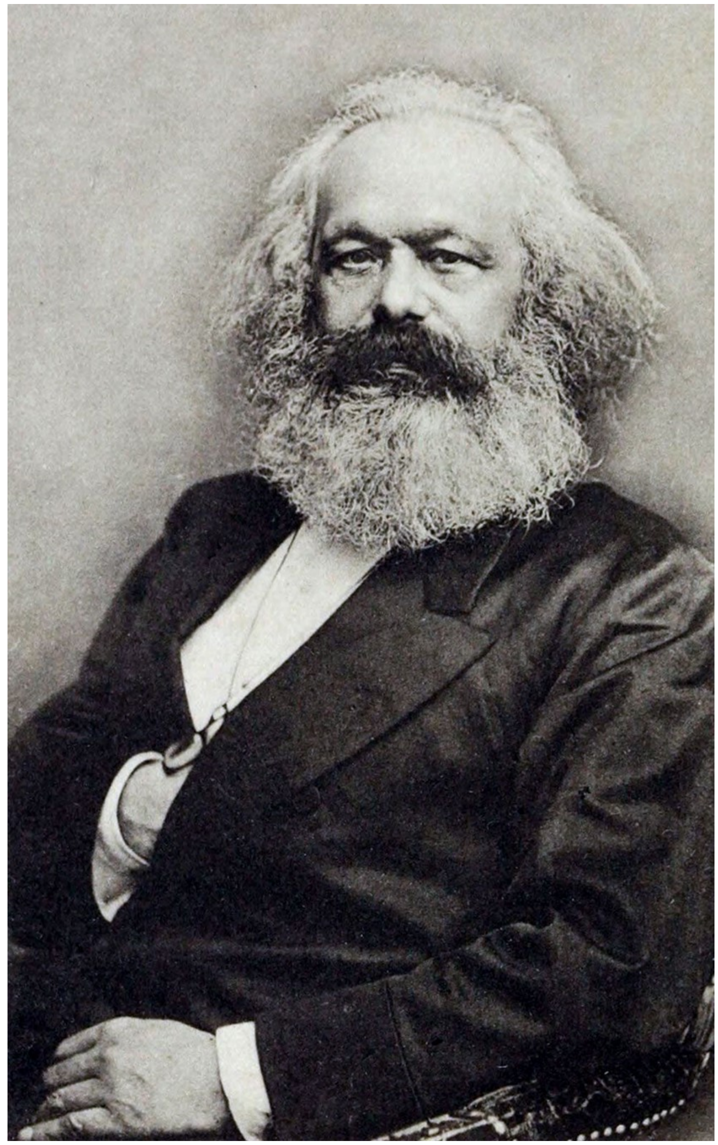
The dynamism of capitalism, its "creative destruction" in the words of Joseph Schumpeter, is the engine of wealth creation, for countries, for labor, for owners of capital. It is why investors must own equities. The names will change over time, as successful ones, that is, companies that earn a higher return on capital, supplant those who fail to earn an adequate return. The past century has seen multiple world wars, great depressions, soaring inflations, political upheaval, and through it all, capitalism has delivered unimagined wealth to those who have embraced it (Chart 12).

Chart 12 **S&P 500 Index, 1928-2022**

SPX Index (S&P 500 INDEX) Monthy 30Dec1928 –30Dec2022 Copyright 2023 Bloomberg Finance L.P.

[2] Adam Smith, *Wealth of Nations*, Book IV, Chapter IX.
[3] *Capitalism in the Twenty-First Century, 2023*

Marx was buried in an unmarked grave in London in 1883.[4] His fleeting moment of fame may have stayed buried with him but for a student who discovered his writings after his death. Vladimir Ilyich Ulyanov absorbed and expanded on Marx's doctrine and, in 1917, with his revised dogma and a new name,[5] led a revolution in Russia. A century later, and tens, if not hundreds, of millions of deaths in its name, we should be able to re-bury Marxism as its abject failures, its subjugation of human dignity and economic repression, are all too evident.



The revolutions of 1848, predicted and encouraged by Marx, failed to overthrow the existing political regimes, but within a generation, reforms, better working conditions and expanded political liberties, had been accepted by most of Europe. Most countries today have adopted the demands of those revolutionaries, from universal enfranchisement to minimum health and safety requirements for workers.

Marx was correct in identifying the source of wealth as adding economic value. He was completely wrong about how that happened, and more wrong about how to improve the lives of workers. Value, wealth, for workers, for companies, for countries, come from the constant pressure to produce profits, or more specifically, to earn a return on capital. Those who fall short are replaced by those who do. Recessions, inflations, wars do not alter this fundamental truth, that wealth derives from the value created by capitalism.

In a year that was particularly painful for investors, Karl Marx reminds us of why we are capitalists.

[4] Highgate Cemetery (East) in North London. A statue and gravestone were added in 1956.

[5] V.I. Lenin.

Michael A. Rosen

Principal & Chief Investment Officer

January 2023

Please follow the Angeles Insights by Michael Rosen at

https://www.angelesinvestments.com/insights/home

CONNECT WITH US

LinkedIn Twitter Facebook

Founded in 2001, Angeles is a multi-asset investment firm, building customized portfolios for institutional and private wealth investors.

If you would like to receive a copy of our Form ADV Part 2A free of charge, please email Steve Smetana, Chief Compliance Officer, at ssmetana@angelesinvestments.com, or call 310.393.6300.