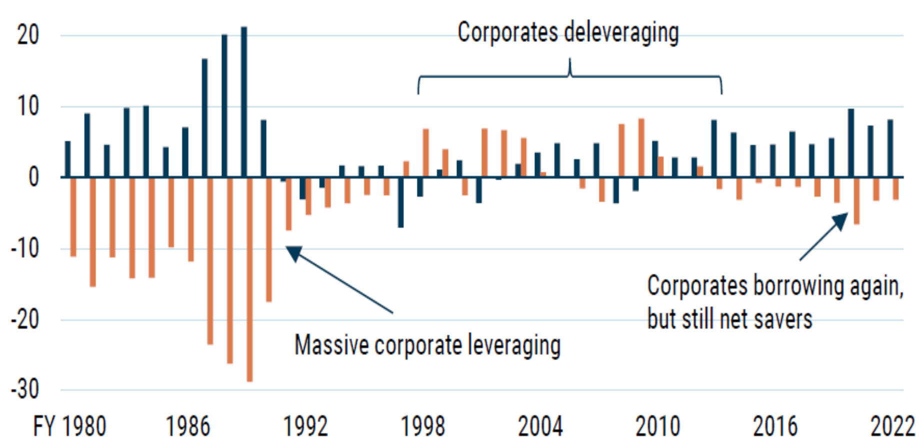
Holowesko Partners Ltd.
December 2023

When I first joined Templeton in 1985, Japan was on its way to creating one of the biggest asset bubbles in history. At the peak in property prices, if you opened up a magazine and laid it on the ground in the most expensive parts of Tokyo, the land area it covered was said to be worth $200,000. The absurd valuations allowed people to borrow against this land and put the money into stocks. The slide below shows the enormous expansion of Japanese corporate balance sheets during the 1980s. Since the market peaked in 1989, corporate Japan has been saving around 6½% of GDP per year, which has caused the current cash rich environment.

JAPAN INC. ASSETS AND LIABILITIES



Note: As of September 2023
Source: Japan Ministry of Finance

The Nikkei Index, propelled by speculation and fueled by borrowing against overvalued assets, eventually climbed to 38,000 by the end of 1989. 30 years later, the Japanese Index still hasn't returned to this level, after falling over 70% by the early 2003 period.

I took over as the manager of the Templeton Foreign Fund, a non-US equity Fund, in May of 1987 and continued to reduce the holdings in Japan started by Sir John Templeton prior to my appointment. Initially I thought the decision on valuation grounds was timely, as the market fell from October 1987 until January of 1988. However, the market went on a tear from 1988, when it climbed from 21,500 to 38,900 in just two years.

My initial disappointment in missing the speculative excess was misplaced. From 1990 onwards, when Japan had peaked at roughly 60% of the EAFE Index and 44% of total world market capitalization, I was either massively underweight, or had zero exposure in the Templeton Foreign Fund, to a market that went on to fall by over 70%.

JAPAN AS A PERCENTAGE OF WORLD MARKET CAPITALIZATION

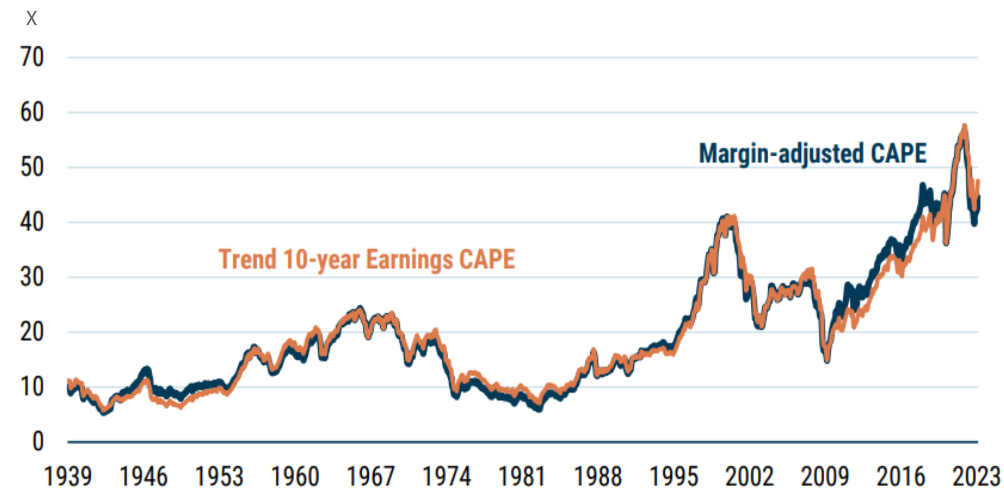
Note: Monthly data
Source: BofA Global Investment Strategy, MSCI, DataStream

I often think of this experience and compare it to the US market now at 69% of the World Index, selling at extreme valuations (although Japan was much more expensive. The conviction level I had back then to underweight the Japanese market that represented 60% of an index the Templeton Foreign Fund was being compared to, was bolstered, not only by the extreme valuation of Japan's equity market, but by the opportunities available outside of Japan. It was an allocation driven by ideas, not by the pressure to match an index. Many of the managers I met back then also believed Japan was massively overvalued, but they couldn't "afford" to be underweight a market so large.

We hold a similar conviction today. We believe the extreme US valuations and the opportunities outside of the US are a compelling reason to be underweight the US, and in fact, give investors an historic opportunity.

Relative to 10-year average earnings, the US market valuation is historically high.

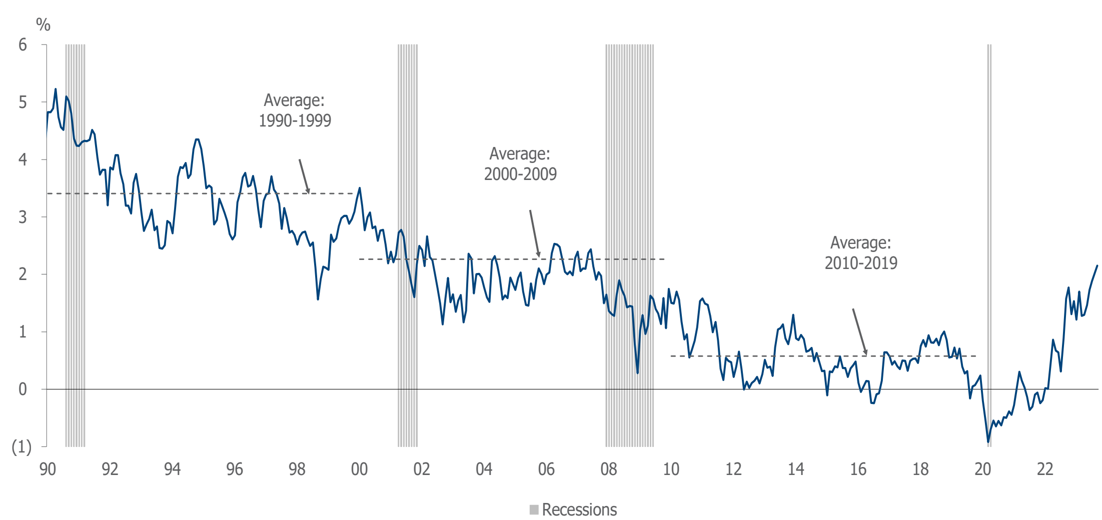
US
Cyclically Adjusted Price to Earnings Ratio



Note: Margin-adjusted CAPE based on standard Shiller CAPE multiplied by the ratio of 10-year average margins to long-run margin (John Hussman). Trend 10-year Earnings CAPE based on trend 10-year earnings (James Montier).
Source: GMO

Much of the recent move, as we have mentioned in previous reports, was driven by an abnormal period of extremely low interest rates. '08 to '22 was not normal. Interest rates today really are not high in absolute terms or relative to history. Quantitative Easing distorted company valuations (abnormally low interest rates), especially growth companies. A return to more normal interest rates will be positive for value investing.

TEN YEAR US TREASURY BOND REAL YIELDS
Less Ten-Year Inflation Expectations
1990 Through Early-September 2023



Note: Less the trailing three-month average of ten-year inflation expectations.
Source: Federal Reserve Bank of Cleveland, Federal Reserve Board, National Bureau of Economic Research

On a variety of valuation factors, the US equity market has rarely been more expensive over the last 100 years.

AVERAGE OF THE FOUR VALUATION INDICATORS

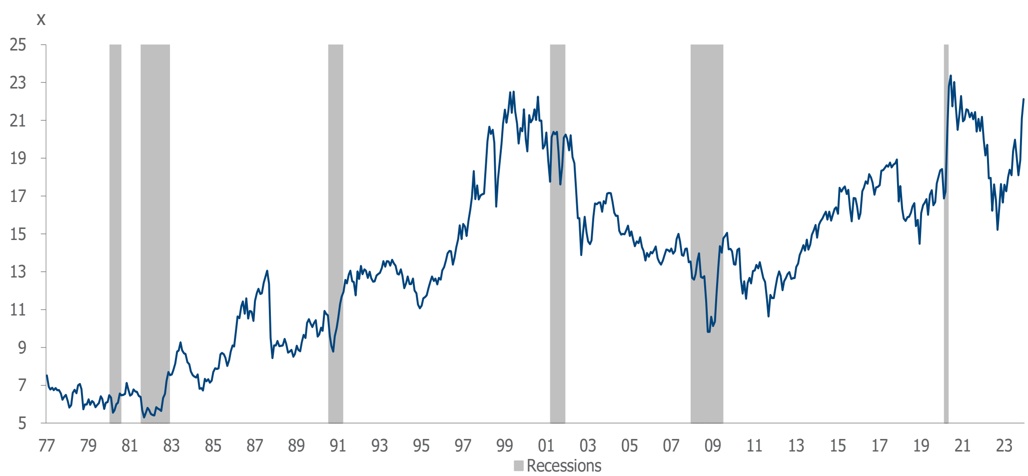
Source: Advisor Perspectives

Investors in the US equity market are now paying historically high multiples on earnings generated by historically high margins, which are now under pressure.

S&P 500

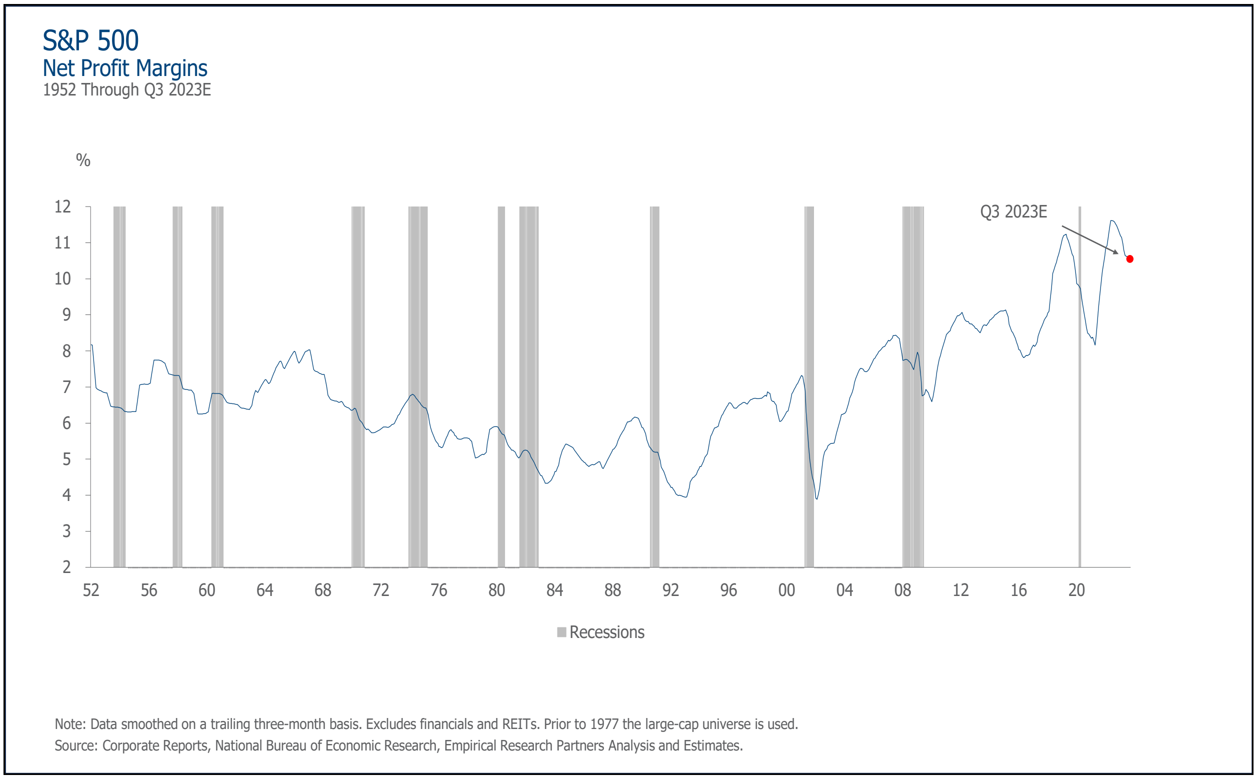
Forward Price to Earnings Ratios

1977 Through December 2023

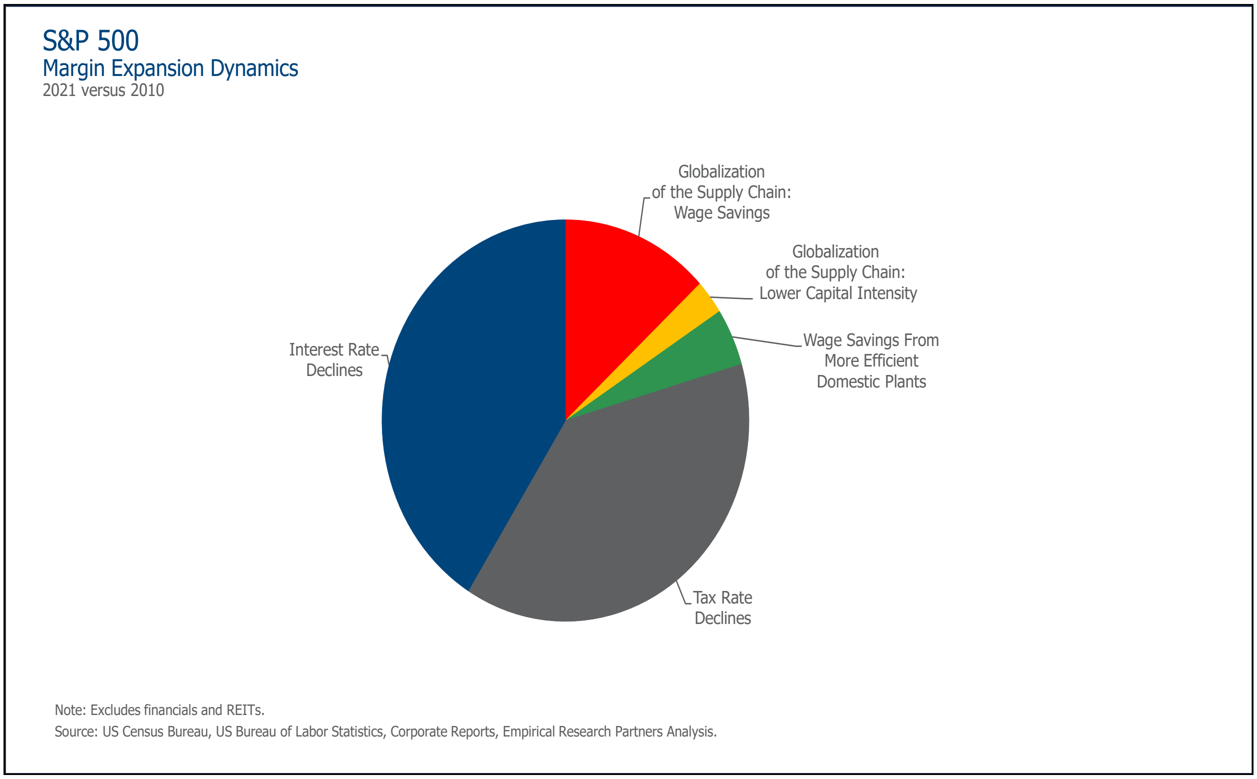


Source: Corporate Reports, National Bureau of Economic Research, Empirical Research Partners Analysis.

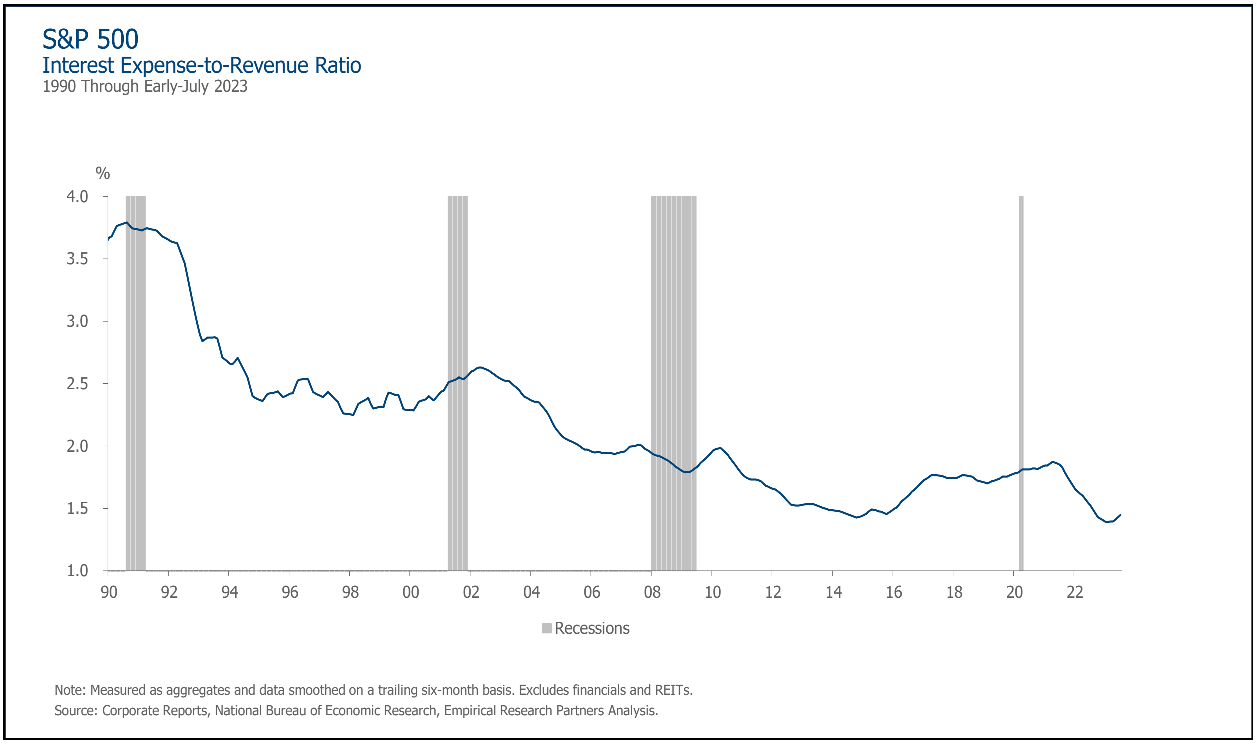
Prior to Quantitative Easing in 2008, the S&P 500 net profit margin peaked at around 9% versus over 11% today.



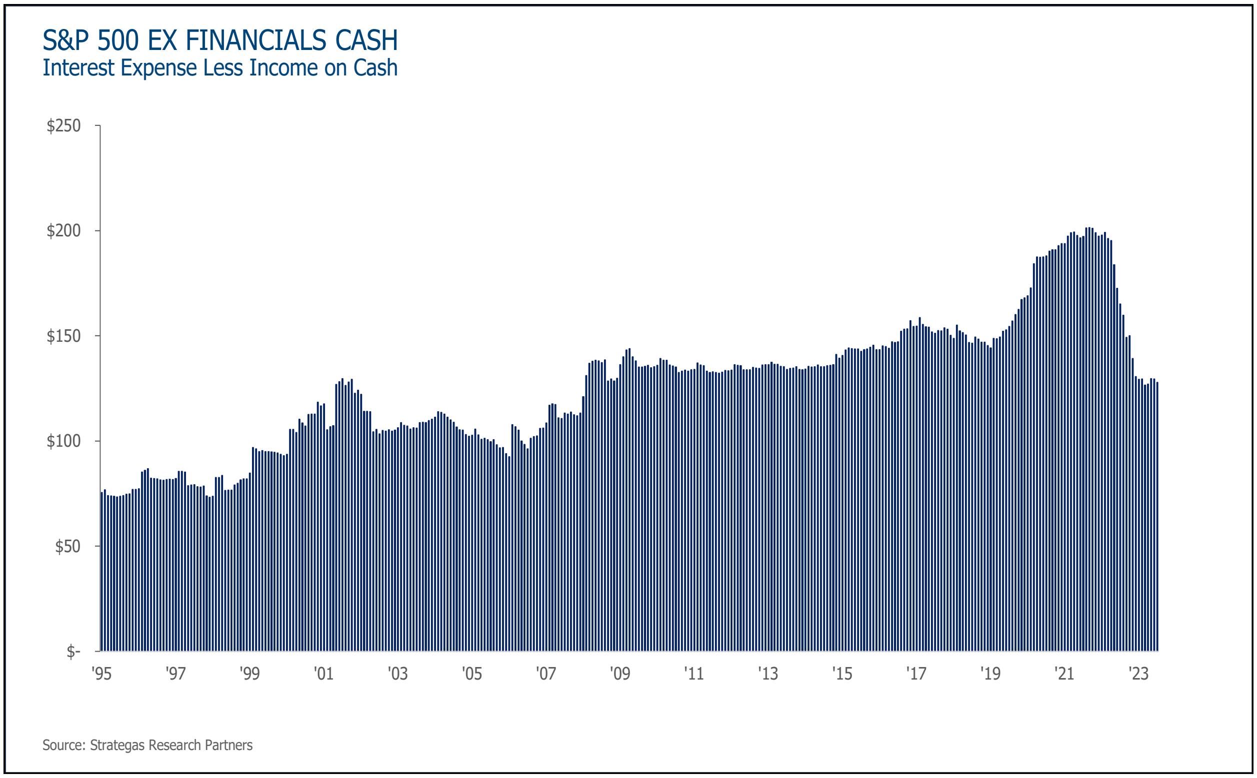
The vast majority of margin expansion between 2010 and 2022 came from lower interest rates, lower taxes and wage savings from globalization. All of these are now reversing and should be a drag on US profit margins.



For example, interest expense as a percentage of revenues for the S&P 500 declined from roughly 3.7% in 1990 to less than 1.5% today.



However, net interest expense has not yet increased significantly, despite high interest rates. Only 6% of S&P debt is floating. For the Russell 2000 it is 31%. Only 2% of S&P debt matured in 2023, with 6% maturing in 2024 and 8% in 2025. 46% of debt comes due after 2030, so higher rates haven't had a big impact, yet. Actually, because of significant cash on many company balance sheets, higher rates have temporarily driven down "net interest expense".



The chart below shows the current revenue and earnings estimates for the S&P 500. The market at the time of writing this report, was selling at 21x 2024 estimated earnings assuming a 12.9% net margin, up from 12.2% in 2023. If we take the 2024 revenue estimate and assume net margins fall back to the previous "peak" prior to Quantitative Easing in 2008, the earnings estimate would be $169, 30% below the earnings estimate for 2024 on Bloomberg. The market trades at 28x earnings assuming pre-Quantitative Easing peak margins. If you put a more normal 15x multiple on those "normalized peak earnings", the market would have to fall 47%. Based on the last 8-year relationship between the S&P 500 12-month forward P/E and US 10-year real yields, the current forward P/E should actually be close to 12x.

S&P 500

S&P 500 = 4,780

		Revenue	Earnings	P/E
2021	=	1,487.24	198	24
2022	=	1,712.37	223	21
2023	=	1,784.62	222	21
2024	=	1,876.94	242	19

1,879.97 @ 9%[1] = 169 earnings

4780/169 = 28x

169 x 15 = 2,535 (-47%)

Note: [1] Previous peak net margin prior to QE

Source: Bloomberg, HPL

A 47% fall may seem dramatic, but it would be similar to the average bear market decline since 1926. We are not predicting the timing or magnitude of a bear market, but the risk is certainly worth noting.

BULL AND BEAR MARKETS

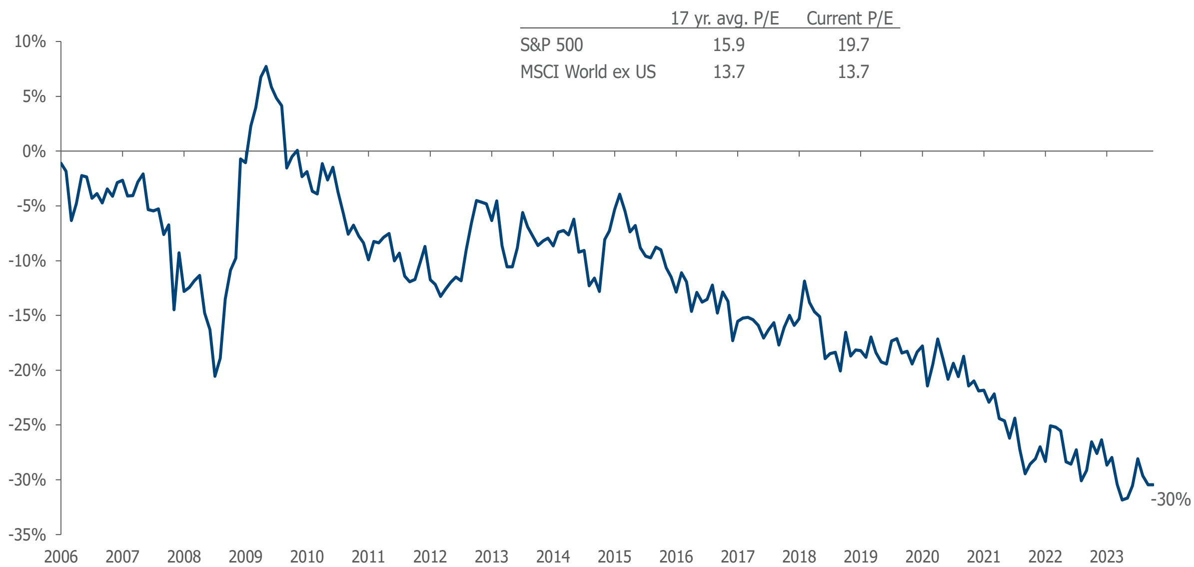
Bull Markets			Bear Markets		
Bull Begin Date	**Bull Return**	**Duration (months)**	**Market Peak**	**Bear Return***	**Duration (months)**
Jul 1926	152%	37	Sep 1929	-86%	32
Mar 1935	129%	23	Mar 1937	-60%	61
Apr 1942	158%	49	May 1946	-30%	36
Jun 1949	267%	85	Aug 1956	-22%	14
Oct 1960	39%	13	Dec 1961	-28%	6
Oct 1962	76%	39	Feb 1966	-22%	7
Oct 1966	48%	25	Nov 1968	-36%	17
May 1970	74%	31	Jan 1973	-48%	20
Mar 1978	62%	32	Nov 1980	-27%	20
Aug 1982	229%	60	Aug 1987	-34%	3
Oct 1990	417%	113	Mar 2000	-49%	30
Oct 2002	101%	60	Oct 2007	-57%	17
Mar 2009	401%	131	Feb 2020	-34%	1
Mar 2020	114%	21	Jan. 2022**	-25%	9
Averages	**162%**	**51**	**-**	**-41%**	**20**

Note: *A bear market is defined as 20% or more decline from the previous market high. The related market return is the peak to trough return over the cycle. Bear and bull returns are price returns. **The bear market beginning in January 2022 is currently ongoing, with the "bear return" and duration for this period calculated from the January 2022 market peak through current trough in October 2022. Averages for the bear market return and duration do not include figures from the current cycle. *Guide to the Markets – U.S.* Data are as of June 30,2023.

Source: FactSet, NBER, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management.

However, investors don't have to be fully exposed to this large risk as non-US markets trade at such a large discount to the US and offer compelling "absolute" valuations.

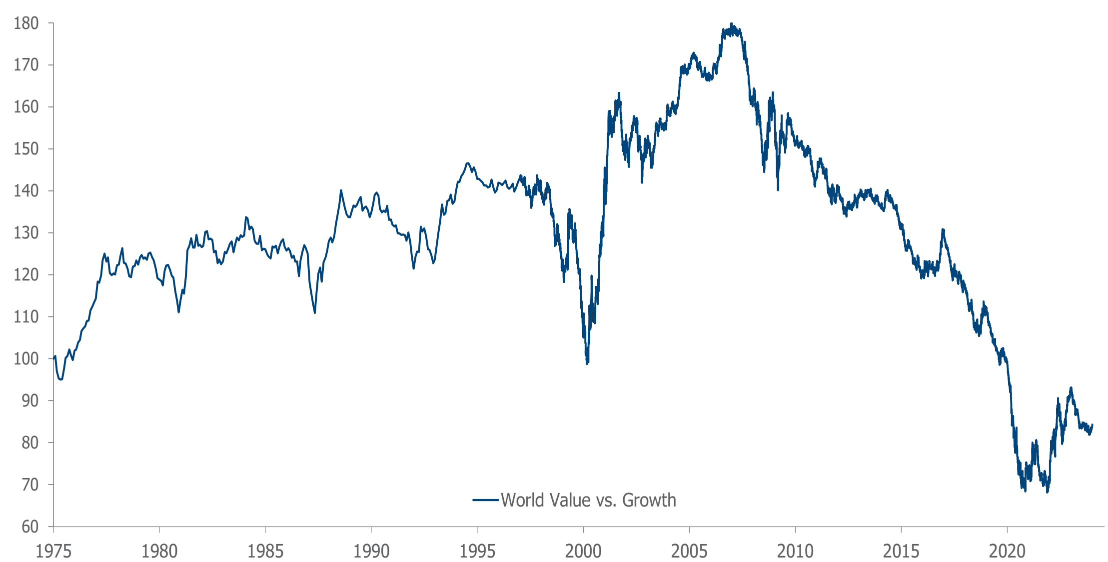
PRICE TO EARNINGS DISCOUNT - MSCI AC WORLD EX-US VERSUS S&P 500 INDICES (NTM)



Source: Bloomberg, Holowesko Partners

In addition to extreme US valuations versus the world, extreme growth versus value valuations make us equally excited. As the chart below indicates, the underperformance of value around the world has been unprecedented.

MSCI VALUE VERSUS GROWTH



Source: Datastream, Goldman Sachs Global Investment Research

This underperformance has left value companies, both in the US and around the world, at historic P/E discounts to growth companies.