5 Predictions for the Next 5 Years

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INTRODUCTION

The Wildness Lies in Wait

At the end of every year, whenever I read through a newspaper, magazine, or web story, I'm reminded of this curious duality:

- Predictions about the market, the economy, or business are so wrong so often.
- And yet, we love reading them.

There are few narrative structures in media as well-worn as the look-ahead/preview/prediction piece. (Trust me, I'm also a former journalist who published quite a few—because there was a lot of audience demand for them!)

We're well aware of the difficulty of predictions—who foresaw Russia's invasion of Ukraine, the 60/40 portfolio disappointment, or four-decade-high inflation this time last year? That said, investing is inherently an act of prediction—you're making choices today based on expected outcomes (or probabilities of expected outcomes) in the future. Even passive investors who own index funds are making assumptions and predictions!

So as we approach the finish line on what has been a turbulent year in the stock market, I asked the 1623 Capital team to make a prediction for the next five years. Each chapter in this whitepaper represents something we believe will play out in the market through 2028:

1. Energy underinvestment will cause a second surge in inflation
2. Big-cap tech will resume its outperformance
3. With an assist from the taxman, online sports betting will exceed already lofty growth expectations
4. The current bear market will bottom before the recession ends
5. Earnings and dividends will matter much more than multiple expansion

We offer them up as humbly as possible—we very well might be dead wrong on any or all of these. But that's part of the fun.

We wish you a healthy and prosperous 2023. Before we get to the first five-year prediction, I'll leave you with a great G.K. Chesterton quotation that captures the challenges of forecasting, as quoted by Howard Marks:

> *The real trouble with this world of ours is not that it is an unreasonable world, nor even that it is a reasonable one. The commonest kind of trouble is that it is nearly reasonable, but not quite. Life is not an illogicality; yet it is a trap for logicians.* ***It looks just a little more mathematical and regular than it is; its exactitude is obvious, but its inexactitude is hidden; its wildness lies in wait.*** *[emphasis added]*

~ Brian Richards

1. Energy Will Cause a Second Surge in Inflation Sooner Than Later

~ By Paul Chi

For a long time, we've gotten used to cheap energy, cheap money, globalization, and other favorable tailwinds. We started thinking that things would stay that way forever. Unfortunately, that's just not the case—especially with energy. World energy capital expenditures peaked in the mid-2010s and have been on a very worrisome downward trend since. Meanwhile, the world's demand for energy continues to grow. Except for 2020 (which, I probably don't need to remind you, featured worldwide lockdowns), every other year in the past decade has seen the world use more energy than it did in the previous year.

Energy is crucial for all aspects of life. Energy allows us to run factories, heat and cool our homes, make fertilizer to increase crop yields so that we can all eat, create various materials, fly around the world, and more. Increase consumption over time without increasing investment in new sources of energy and eventually, the world finds itself with shortages. That's exactly the situation that we face right now. I believe that even if broader inflation measures do come down in 2023, we are headed toward a second wave of inflation in the coming years due to energy shortages. We cannot defeat inflation for good unless we fix our energy shortages.

It's common to hear that by invading Ukraine, Putin caused the energy crisis reverberating around the world. In reality, both European natural gas and coal prices started to rise well above five-year average levels in the second half of 2021. Even

before the war, the demand for energy was already starting to slowly exceed the world's ability to supply it effectively. Russia's invasion of Ukraine made the situation much worse, but it exacerbated a situation that was already brewing. This year, Europe has responded to the shutdown of Russian natural gas supplies by buying significant supplies of liquefied natural gas (LNG) cargoes that used to go to Asia. As a wealthy region, Europe was able to fill its storage rather admirably. However, since those cargoes used to go to Asia, we're now seeing blackouts in Central Asian countries such as Kyrgyzstan, Uzbekistan, and Kazakhstan and in South Asian countries such as Pakistan, Sri Lanka, and Bangladesh. A recent article from Dawn.com on Pakistan's electricity situation detailed blackout plans for the coming winter: 8 hours on, 16 hours off each day.

In response to the shortage of LNG around the world, coal prices have increased significantly as well. Coal hit an all-time high of more than $400 per ton in September. If you told me five years ago that coal would hit that kind of price in 2022, I wouldn't have believed you. In the U.S., we've been shutting down coal plants left and right for a long time. But as energy shortages have manifested themselves, we're rushing to secure whatever fuel we can get. This *New York Times* headline from September tells us just how acute our energy shortages are: "Europe Is Sacrificing Its Ancient Forests for Energy." We're even burning wood on a large scale!

With energy supplies hard to come by, one would think that it would be much better to secure long-term contracts for fuels than to buy on the spot market. Companies have indeed been investing in LNG projects and signing customers to long-term contracts years before the projects are even built. The next cycle of export projects is already in the works, but these are huge—and complex—projects that take years. Japan recently warned that global LNG supplies are sold out for years. That doesn't bode very well for electricity prices until 2026, when significant additional supplies should finally start to come online.

For years, Europe has been heavily pushing renewables, investing in solar and wind while shutting down fossil fuels and nuclear. Energy transitions can't be done so quickly—they have to be done gradually over decades. In my opinion, it is folly to aggressively get rid of both fossil fuels and nuclear at the same time. Solar, wind, and hydroelectric power cannot carry 100% of the burden of any country's robust electricity generation portfolio. From my vantage point, it seems like Fukushima scared many nations into shutting down perfectly safe nuclear plants. Nuclear, despite being quite safe, carries enormous shock value. We vividly remember the nuclear accidents of the past, even if the industry has provided an immense amount of electricity with

relatively few deaths in relation to other fuels. It's kind of like comparing airplane accidents to automobile accidents, only on steroids.

Oil and refined products are in quite a predicament as well. In many countries, oil companies have been accused of profiteering. They've had spotty profitability for several years, but now that they're finally making strong profits at an inopportune time, politicians are predictably blaming the so-called evil corporations. I expect governments around the globe to continue to exacerbate the oil undersupply situation before finally facing the music. All we've seen thus far are discussions about windfall taxes, price caps, and stimulus for the consumer. All of these policies either reduce supply or increase demand, exacerbating the undersupply situation.

There's a famous saying in economics that "the cure for high prices is high prices." When prices are high, producers can invest and earn a favorable rate of return. Eventually, shortages cause prices to rise high enough to incentivize producers to produce (even despite the risk of windfall taxes). Government policies will likely continue to exacerbate the situation in the near-term, causing prices to rise even further. Eventually, basic supply and demand will take over and profit-seeking corporations will invest heavily in supply. It won't be an easy road, however. Oil and gas unemployment is already extremely low in the U.S., for example. And these companies are facing inflation for items such as downhole steel pipe and other commodity inputs in the production process.

Currently, the Fed's interest rate hikes are causing the economy to slow. A recession seems likely at this point. Recessions are quite effective at lowering the rate of inflation by reducing demand. They don't fix supply, but they buy a little time to hope for supply to catch up. It's very logical to expect inflation to come down in 2023. Whether it gets all the way down to 2% is anyone's guess.

My prediction, however, is that unless central banks around the world reduce demand for several years (which would be untenable), the energy shortages I've discussed will cause inflation to come roaring back and cause a second spike in inflation in the coming years. This is not without precedent. The inflation of the 1940s and the 1970s each had multiple spikes. The 1970s even featured its own energy crisis. Given that history, it seems quite strange to expect that we can conquer inflation in one try this time around.

2. Tech Leaders Will Resume Outperformance

~ By Jeff Fischer

Investing isn't easy, but it can be simple. When you remove active trading, chart reading, and emotions from the equation, investing at its core is about owning an asset that grows in value. The word "invest," taken from the Latin word "investire," originally meant to "clothe in, cover, surround"—in other words, to wrap oneself in something of value, and live in it.

In modern-day investing, we're happy to wrap ourselves in businesses that have extraordinary financials and all the hallmarks of continued success. What causes an investable asset to sustainably grow in value? The entity needs to generate growing free cash flow, whether it's private real estate or a public company. That's all investing is about, and that's how cut-and-dry it can be: It's about more and more Benjamins being earned, and making sure from the beginning that you're paying a reasonable sum for this growing stream of cash.

My prediction for the next five years is that technology leaders will be able to generate enough new free cash flow that, writ large, from recent levels the largest tech stocks will resume a pattern of market outperformance starting in a few years, and continuing to the end of this five-year period.

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The sharp pause in tech performance being witnessed on Wall Street in 2022, and also in 2021 by many measures, may continue into the first half of 2023 as a recession is likely (count that as another prediction if you like), and as earnings estimates come down (another bonus prediction). However, as we get into late 2023 and 2024, when it's likely that the economy can resume decent growth again, dominant tech companies will likely show some of the strongest free cash flow growth rates on the

market, helping them regain outperformance status. (This whole paragraph is one big prediction, reminding us one way in which investing is not simple: It's all about the future.)

Why do I predict that big tech will please investors again? Partly because the tech meltdown of 2022 has very few of the characteristics of the much-deserved Nasdaq shellacking from 2000-2002. Yes, many of the stocks down this year by the greatest degree—70%, 80% or more—lack profits, and many were recent IPOs. Many deserve their new prices or lower. But the tech leaders that weigh heaviest in the major market indexes are mature, highly profitable, well run, and serve growing markets with compounding tech needs. Also, perhaps most importantly, there aren't that many of these dominant tech companies to invest in, and in my view, they're by and large trading at reasonable valuations. Further, once interest rate hikes have peaked, the narrative for "growth" businesses can turn more positive.

If one wants to speculate on younger technology companies, have your pick; the Nasdaq is littered with them, and some may become outstanding, large businesses by 2028. We're fishing in those promising waters, too, for new investments. But if you want to own proven tech leaders, you only have so many to choose from, and they won't likely be displaced in the next five years. Instead, they appear to have all the momentum of growing larger. And that's what investing is about: Higher free cash flow. Trading at a reasonable multiple. And with all the promise of continuing to grow. We want to own that. We even want to wrap ourselves in it, and live in it for these five years.

P.S. As a bonus prediction: the long-rumored **Apple** (Nasdaq: AAPL) car will launch by 2026.

3. Aided By Uncle Sam, Online Sports Betting Will Explode

~ By Mark Reagan, CFA

For many years, the topic of gambling has been met with contempt—as a hobby and even as investment class, being lumped in with "vices" like tobacco and alcohol.

However, the industry benefitted massively from a legal catalyst—if not a public relations one as well—in 2018, when the U.S. Supreme Court declared that a 1992 law

prohibiting sports gambling in most states was unconstitutional. If you've watched any live sporting event in the past month, you won't be surprised to know that the ruling opened the floodgates—gambling companies have become more mainstream, and billions of dollars in value has been created.

The sports betting market in 2021 was valued at over $76 billion and is forecasted to grow to $167 billion by 2029, a 10.26% compound annual growth rate, according to Data Bridge Market Research. **But my prediction for the next five years is that the industry's growth rate will be even higher.**

Partnership with states

Let's not forget one big winner of the nascent industry: the ta authorities. State governments are poised to cash in on revenues attributed to taxing gambling winnings. Each state has different tax rates, of course, ranging anywhere from an effective rate of 3.4% in Michigan to 51% in Rhode Island on the gains, according to BettingUSA.com.

In 2022, with just the states that have approved online sports gambling, tax revenue has already exceeded $1 billion year-to-date. Given the high tax rates in some of the states, a black market for sports gambling will likely persist, but I believe each year it will become less prevalent when it's just so easy to place a wager online or on an app so safely, legally, and conveniently. As politicians look for new sources of tax revenue, I would expect more states to legalize online gaming in the near future, too.

Expansion into other verticals

The "$167 billion by 2029" cited earlier only represents online sports betting—not any card/table games, slots, and so forth, which represent further opportunities with a strong base of customers.

After the Supreme Court ruling, and after acceptance came to state legislatures across the country, companies have been on an advertising blitz. Sports gambling has given consumers such an ease of entertainment, allowing folks to place a wager on a game at home to become fully invested in a game for a few hours rather than watching a movie, playing video games, or reading a book. It's also got incredible unit economics. DraftKings, one of the largest sports betting companies, reportedly has a customer acquisition cost of around $371, but the lifetime value of a customer is $2,500, roughly 6.7x. There's a reason why online gaming companies have become omnipresent advertisers online and on television.

Gaming companies like MGM are trying to find audiences online. It's been rumored that Yahoo!, a native Internet portal that already has an audience, may merge with a gaming company.

Plus, there are all the ancillary companies that have sprung up to form an ecosystem, such as handicapping companies that provide "picks" as a subscription service. It's like Stu Feiner yelling at you through the television in the 1980s pitching his services. The evolution of the industry has now made way for machine learning and artificial intelligence to analyze massive sets of data to make picks, run simulations, and so forth. Then there are companies who will carve their niche by aggregating all the lines on different books to show you who is offering the best odds. I think the expanding industry will also offer opportunities for growth in cybersecurity, insurance, and even commercial real estate.

First-mover advantages

After the Supreme Court decision, it didn't take long for companies (and states) to spring into action. Today, there more than 40 online sports books live in the United States across more than 30 different states. Many have partnerships with media networks such as ESPN, NBC, and Fox to drive customer acquisition and start establishing a loyal customer base. You would be hard-pressed to have watched any sort of sporting event recently and not seen countless advertisements from dozens of different sports books, vying for your business, offering all sorts of sign-up bonuses and promotions.

But as with tobacco, another "sin" industry, the product can be addictive, and sticks with you. Given all of the incentives in state legislatures and sports commissioner offices across the country, I think the projected 10% growth rate will be far bigger.

In June 2018, sports gamblers wagered $310 million, per Bloomberg. Just 40 months later, in October 2021, $7 billion was wagered, representing a 20x increase. This can obviously be attributed to the widespread access of online gambling—the accessibility (or omnipresence) of these apps means that it's never been easier to place a bet—but also to the impact of COVID-related lockdowns, where people were spending more time at home with higher savings and looking for entertainment.

Hooking new customers

As the industry gains more and more of the limelight, I expect it to move beyond the target demographic of males aged 18-34, and to shake out many of the smaller competitors—the first-movers will just be so much friendlier to customers with bonuses and other special offers that smaller players will have a hard time competing.

It's not hard to understand why companies are moving as quickly as possible to become the first mover. The market is huge. The good news for companies is that studies have found that sports bettors tend to lose in the long run.

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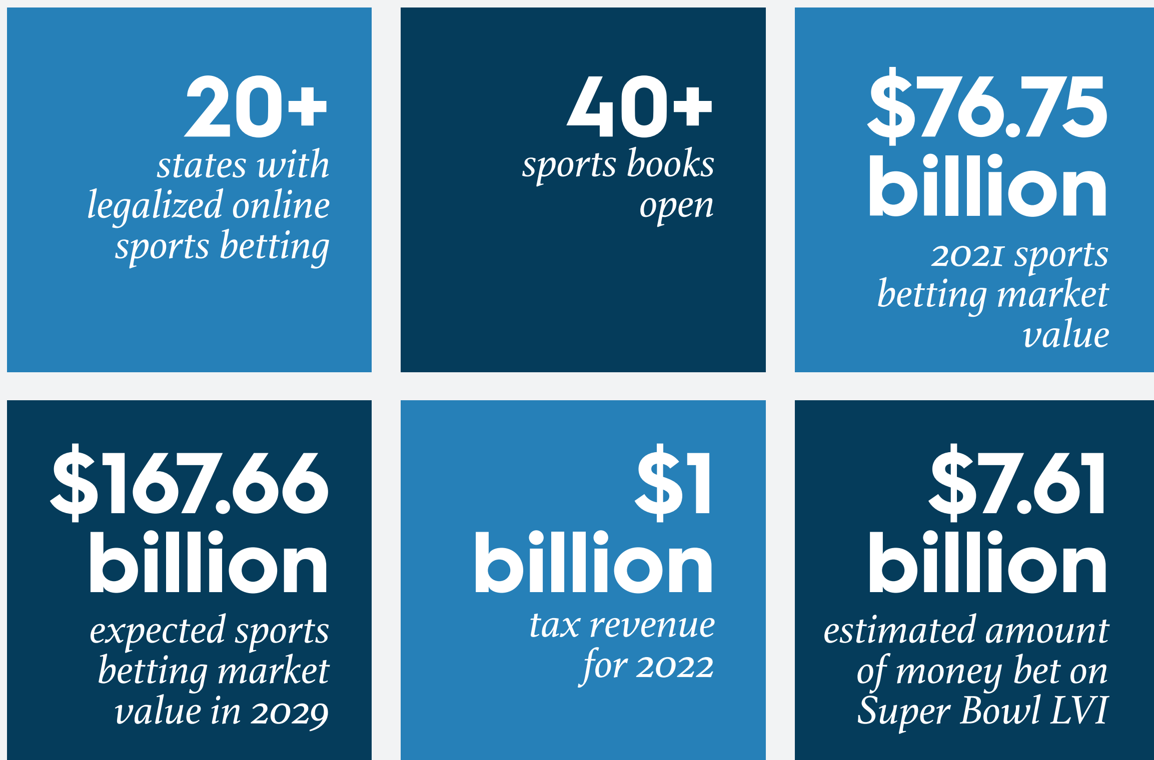
By the Numbers



4. How the Remainder of the Bear Market Will Play Out

~ By Jonathan (JP) Bennett, CFA

Since we currently find ourselves in the claws of a bear market, I felt like it would be very appropriate to base my prediction around how I believe the remainder of the bear market is going to play out. And while I am not naïve enough to predict specifically when and why it will end, I do believe that the adage "history never repeats itself, but it does often rhyme" will hold true yet again. So, by looking at the past we can get clues for how things will likely unfold.

There are three main points I would like to stress with respect to major bear markets. The first is that bull markets are typically born out of bear market rallies. Excluding the 2020 bear market, which at just 33 days was the shortest bear market going all the way back to 1929, bear markets are typically punctuated by rallies within the larger downtrend. And sometimes these rallies are quite large—during the bear market that followed the dot-com bubble, the Nasdaq Composite Index experienced four bear market rallies of at least 20% (and on two occasions the index rallied more than 40% before going on to set new lows!).

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This type of behavior makes sense when you think about it—after all, the market is forward-looking. And this is why I say that bull markets are born out of bear market rallies. The start of every bull market is always met with a chorus of doubters proclaiming that there's no justification for a new bull market to begin. And in some respects, they're right. Historically, waiting for fundamental signs suggesting that we're in the "all clear" usually results in missing a sizable portion of the recovery. For example:

- In 9 out of the past 10 recession the S&P 500 bottomed before the recession was over and GDP growth returned.
- Waiting for the official report of when a recession is over leads to negative results since there is a lag between when a recession actually starts and when it is reported. The Great Recession of 2008 and 2009 was not declared over until September

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2010 (a full year later), and the S&P 500 was up more than 50% off its lows by then. Furthermore, the announcement of the start of the 2020 recession wasn't until June 2020, by which time the market had recovered more than 75% of its COVID-19 losses.

- In 10 out of the past 10 recessions the unemployment rate didn't peak and start to fall until well after the market had bottomed.
- Going back to 1990, the trough of the S&P 500 occurred either before or coincided with the bottoming of the S&P 500's EPS.
- Relatedly, going back to 1987, the American Association of Individual Investors Sentiment Survey has historically seen bullish sentiment bottom out near the trough of the market during a recession, exactly the point when investors should be getting increasingly bullish.

The second point is that, although I am confident that the market bottom will occur before economic indicators do, I am not confident on exactly how long it will take. The average length of time from peak to trough for the S&P 500 bear markets since 1929 was 344 days; however, the standard deviation for the 21 bear markets was over 250 days. However, I do believe the odds are favorable that we're higher five years from now. Assuming we're still in a bear market by year end, that would mean it's been roughly a full year since the S&P 500 peaked. And for the previous past 10 bear markets the average length of time it took to set new highs was 3.3 years (median 2.0).

And so, my prediction is less of an actual forecast than a reminder that:

1. Waiting for things to look better before getting back into the market will likely miss out on a large portion of the recovery
2. Lower prices today set the stage for higher returns in the future
3. Each day that passes brings us one step closer to the eventual recovery in the market

And the last, and perhaps most important, point I want to make is that there is a reason why I'm not providing a more specific outlook for the market or economy over the next five years. As Philip Tetlock, a University of Pennsylvania professor who has spent a good part of his career researching judgment and forecasting ability, noted when referring to what he found at the conclusion of a 20-year study on expert judgment:

> *It was easiest to beat chance on the shortest-range questions that only required looking one year out, and accuracy fell off the further out experts tried to forecast – approaching the dart-throwing-chimpanzee level three to five years out. That was an important finding. It tells us something about the limits of expertise in a complex world.*

While there are certain areas one can make reasonable five-year predictions, economics is simply not one of them. There are simply too many moving parts to try to account for when making economic predictions that stretch out over multiple years. After all, how many people were calling for a global pandemic to bring our economy to a standstill and the fastest 30% decline in the history of the S&P 500 at any point in the five years leading up to 2020?

So the next time you hear someone in the financial media make a bold projection for the next few years, you should view that claim with skepticism. In fact, Tetlock made another interesting discovery in his research—forecasters with the biggest news media profiles tended to lose to their lower profile colleagues, suggesting an inverse relationship between fame and accuracy.

5. So Long, Speculation.
So Long, Multiple Expansion

~ By Brian Richards

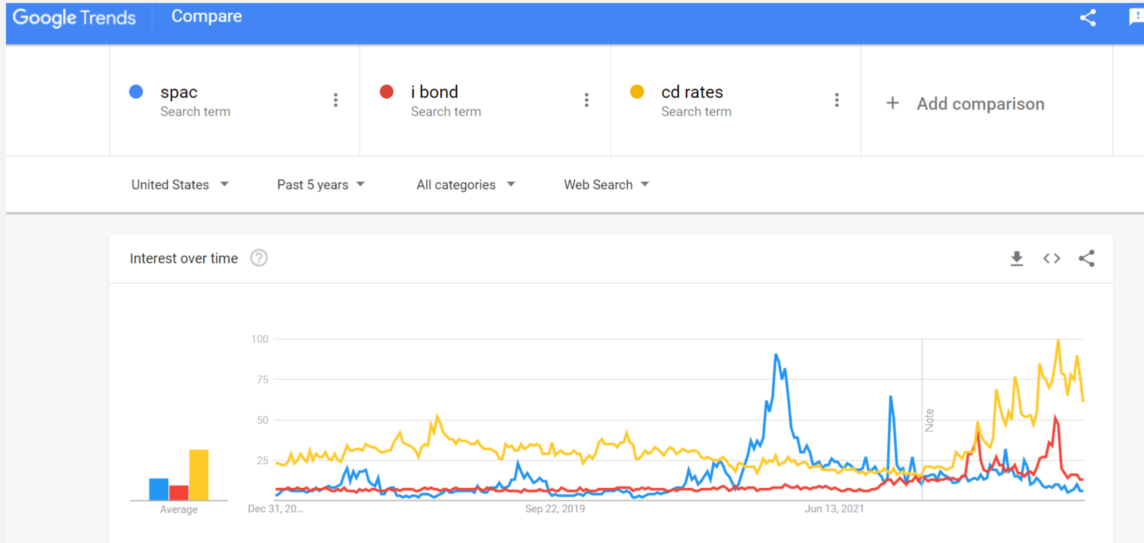
Just a few weeks ago, Howard Marks told the *Financial Times* (FT) that "risk aversion has replaced Fomo ['fear of missing out']." Characterizing Marks' mood, the FT wrote, "The pendulum of human emotion has swung towards hopeless and the bargain hunter's excitement is palpable."

This summary of our current sentiment reminds me of something the FT published 22 years earlier, on April 29, 2000, at the height of the dot-com boom: "'People are beginning to recognize that the basic fundamentals are still true and just adding a dotcom (to the company name) is an indication of nothing.'"

Robert Shiller, in his book *Irrational Exuberance*, quotes that April 2000 FT story and remarks on how the shifting media narrative created a feedback loop that would explain the Nasdaq's massive subsequent decline. Shiller writes: "That is what the article itself was: a public recognition, not a concrete news story. The fascination with the Internet stocks suddenly appeared to have been a silly, in fact embarrassing, fad. It was basically a change in perception."

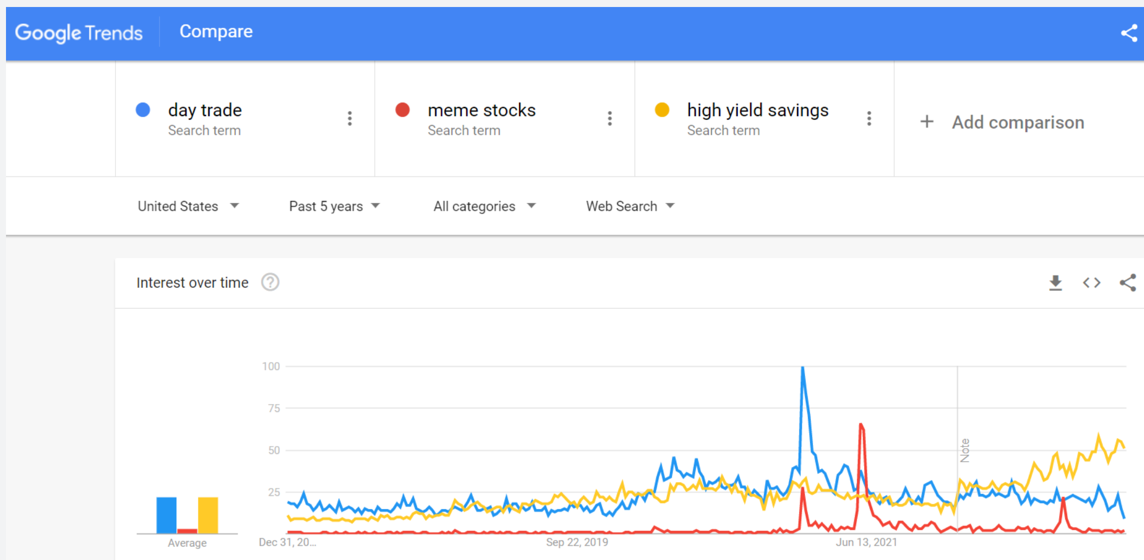
I think we're at a similar moment now. The fascination with SPACs, meme stocks, options trading, and crypto, which, I'd argue, defined the #FOMO period, is waning.

Here's a five-year trend line from Google Trends, showing search engine demand for SPACs, I-bonds, and CD rates:



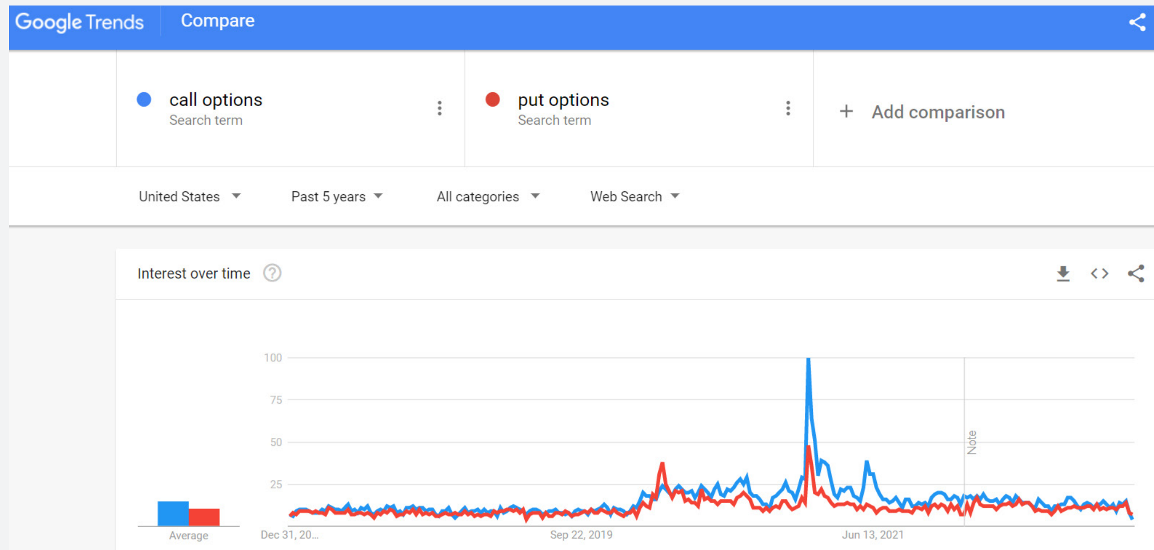
Source: Google Trends.

Here's meme stocks and day trading, versus high-yield savings accounts:



Source: Google Trends.

Here's search term data for keywords related to simple options strategies (recall that in 2021, options trading reached a record high—a 35% year-over-year lift—driven by retail traders):



Source: Google Trends.

Keyword search tools are admittedly unscientific, but my prediction for the coming years is that this "feedback loop," to borrow a Shiller term, would mean the more speculative tendencies of investors will taper off even more than they already have in 2022.

Earnings + dividends > multiple expansion

It would also mean different forces are going to drive equity returns for the coming years.

Shiller's historical data on the stock market shows the contribution of three components to U.S. large-cap stocks over a 140-year time frame:

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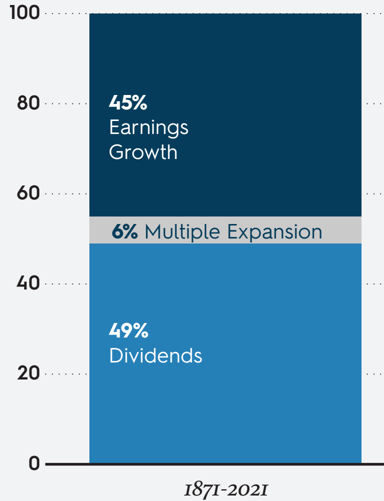
Components of Stock Returns (S&P 500)

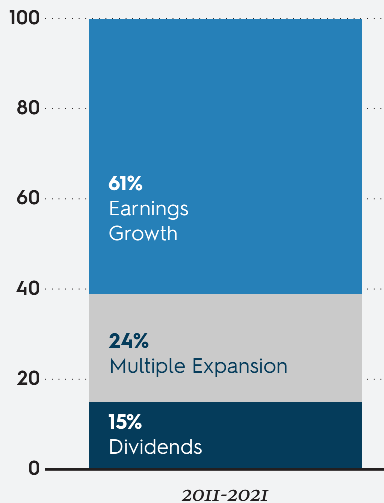


Data from Robert Shiller, as presented in [this excellent article](), "Why Fundamentals Matter," by Jamie Catherwood.

Over long stretches of time, the data show that stock returns are primarily driven (94%) by growing earnings and dividends—the observable outputs of businesses. Multiple expansion, or how much an investor is willing to pay for a dollar of earnings, is a distant third (6%) in long-run returns.

The bull market we just lived through, though, was vastly different. In the #FOMO years, multiple expansion played a far bigger role in driving bull market stock returns:

Components of Stock Returns (S&P 500)



Data from Robert Shiller, as presented in [this excellent article](), "Why Fundamentals Matter," by Jamie Catherwood.

You can see the effects of cheap money in all three components here. When interest rates are low, as they've been since the Great Financial Crisis, dividends matter less to investors. The well-documented "TINA" effect ("There Is No Alternative" to stocks) shows up in the 4x increase in the contribution of multiple expansion. As my colleague JP Bennett has written, investor sentiment is hard to measure and even harder to predict—but you can pretty clearly see the buoyed sentiment of the past 10 years in Shiller's data set.

Implications

This year, as inflation has soared to levels we haven't seen in decades, the Federal Reserve's stance has been aggressively hawkish. The era of cheap money is over—and, I predict, so is the #FOMO investor sentiment that drove at least the end of the bull run.

Shiller wrote in *Irrational Exuberance* that in 2000, the fascination with all things dot-com all of a sudden appeared like a fad—even an embarrassing one. I suspect some things will appear the same way (SPACs and crypto are the most likely). The stories we tell about new ways of bringing companies to the public markets or new ways of enabling smart contracts or cross-border financial transactions may give way to a more skeptical, and conservative, perspective.

The "ends of new eras seem to be periods when the focus of debate can no longer be so upbeat," Shiller writes. Such a feedback loop in the present moment has a few implications, I think.

There will likely be a return to fundamentals. I believe investors will show more skepticism of the "what could be" in favor of the more concrete current realities. Dividends and buybacks will likely play a bigger role. Earnings growth will likely trump revenue growth.

This, of course, would mean that multiple expansion would mean-revert in terms of its overall contribution to stock returns. Value investing may finally have its heyday in the sun. Dividend stocks will likely be a bigger focus in the financial media. Options prices may normalize to their long-term levels.

Importantly, I'm *not* predicting that speculation in the stock market will entirely disappear. It won't! But I do think it will take another form—and as a bonus prediction, I'll posit that we'll see an uptick in penny stocks, online sports betting (see essay 3), and high-yield seekers turning to mortgage REITs.

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