



INFLATION IS EVERYWHERE

Spring 2022 Newsletter

April 2022

2022 started out as a year of hope.

After 2 years of living with Covid, Americans and people around the world were ready to get back to some sense of normalcy. It hasn't happened. Not necessarily because of Covid. 2 years later, virus cases have shrunk to the lowest levels since the pandemic began. New threats surfaced. Dual battles have been declared in 2022; one in Ukraine, the other on inflation. The Market has been taking it all very much in stride, all things considered.

Cold War and Hot War

The Russian invasion of Ukraine has rattled global norms and has shaken up the world order. The action has been reminiscent of the lead-up to the second World War. There has been a New Cold War brewing for years. It's been East versus West. Democracy versus Autocracy. The dominance of the 21st century is at stake. With the Russian invasion of Ukraine, this New Cold War got Hot.

This New Cold War will be much more focused on economic issues than the Post WW II period. Russia has long been considered a mighty military power, not an economic one. That said, its performance thus far in Ukraine is raising serious questions about Russian military might. Importantly, Russia is very much a 20th-century economy, with substantial dependence on Oil and Gas. The late John McCain often referred to Russia as the world's largest gas station. That says a lot.



So far in this young year, geopolitics have had a major impact on global stock markets. That does happen from time to time. But it's important to remember that over time, Corporate Earnings are the biggest driver of stock prices. Earnings estimates have actually held steady thus far. But inflationary pressures will definitely impact corporate profitability as well as spending from the American Consumer. We will learn a lot when Earnings Season begins in April.

Commodity prices have soared. Inflation was already an issue, but the war in Ukraine keeps fueling fears of further supply crunches. Commodity prices increased by the most on record in March, dating back to 1960. It's believed to be the biggest increase to start a year since World War I. That was a century ago. Wheat jumped to the highest level in a decade and a half. Ukraine and Russia account for a quarter of the world's wheat exports, commonly called the "Bread Basket." Crude Oil and Natural Gas prices went haywire as sanctions slowed Russian supplies.

Beyond the Now - The Battle for the 21st Century

The faces of this New Cold War are China and the United States. China is a much different threat than were the Soviets of the last century. China is innovative. The nation strives for Tech superiority and to win the 21st century. China is very deliberate

in its approach. But a miscalculation seems evident. China's alignment with Russia could be hitching its innovative engine to a 20th-century dead weight.

The new Chinese-Russian strategic relationship has these 2 nations closer than any other period in five decades. But China finds itself in a difficult spot. How much did China know about Russian plans? That remains unclear. The fact is, China does not want to pay \$100 for Oil. It is unlikely that China was totally surprised by the invasion. It is highly likely that China was surprised by the aggressive, coordinated response by the West. China does not like a united Western front.



The United States alone accounts for a quarter of Global GDP. China is second at 18%. But when you add America's allies to the mix, that number jumps to 60% of global economic activity. Compare this to China with Russia and North Korea, you barely get 20%. There are clearly other nations that fall in the middle, trying to stay somewhat neutral. You get the point.

Perhaps more important is the innovation and knowledge gap. Russia is stacked with Oil and Gas and other prized commodities. China is not. But the West dominates intellectual property as it applies to semiconductors, software and sophisticated industrial infrastructure. That's where China wants to be and plans to be.

China wants to dominate the Digital Age and the 21st century. The country has studied the Post-War American design and has taken advantage of fraying alliances and populist movements to offer an alternative path. Made in China 2025 and the Belt & Road initiatives are the chosen routes. Those routes have gotten pretty slippery of late. It's looking less appealing compared to the traditional western route. This matters a lot.

Covid and the Re-opening of America, Part 3



Dealing with Covid has certainly been controversial, no matter which continent you call home. China chose a zero-tolerance policy in response to the pandemic which started on its shores. America and the West have been less stringent, but that certainly varied from nation to nation, state to state, and county to county. The politics of Covid have been as divisive as anything.

The re-opening of America is an ongoing process with constant fits and starts. But progress is happening. Virus caseloads are back to the lowest levels since the pandemic began. The American people are out and about, with serious pent-up demand to travel, recreate, and see friends and family in person. Airplanes are full. Airports are buzzing with traffic. Hotels, restaurants, theme parks and sporting events are experiencing an explosion of traffic as the American people embrace Spring Break with Spring Fever. The US Economic engine is cranking it up a notch. A big issue for Consumers is their Dollars being soaked up by soaring food and energy prices. It's a reality for 2022 and a big risk for 2023 if not contained.

Around the World

Inflation is running at 40-year highs. Gas prices average over \$4 across the country and exceed \$6 in California. Food prices have skyrocketed too. The War in Ukraine and supply chain strain weigh heavy on prices. Companies have been trying to push higher costs to consumers. Consumers are starting to push back. Sales are slowing in Retail World. Sales for general merchandise, like sporting goods, shoes and toys, slowed 9 of the last 10 weeks. Americans are spending more at the Dollar Store. That's not good for the overall Economy.



China announced another lockdown in Shanghai as the city with a population of 26 Million has become the epicenter of its worst Covid outbreak in 2 years. This will hurt both the Chinese and Global economies. Shanghai is a major transportation hub as well as home to the world's largest container-shipping port. It is still early in terms of gauging impacts, but the decline in cargo throughput could easily exceed the Suez Canal blockage from a year ago. That froze roughly \$10 Billion in trade per day.

Crude Oil fell from the recent spike to \$130 on concerns about demand destruction from the shutdowns and disruptions. Europe is already facing recession, if not in it already, as gas prices quadrupled due to the situation in Ukraine. Russian gas accounts for 50% of supplies in Germany and Italy and nearly all of Finland. Travel and economic activity have slowed considerably throughout Europe in response.

Fed in a Tight Spot

Rising inflation and slowing growth are not a good combination. It's called stagflation and avoidance is recommended. The Federal Reserve has a tough task ahead. It needs to curb inflation without killing the Economy. It doesn't have a good track record for success.

The Market has already moved and jolted various asset classes along the way. The Bond Market has not been the safe haven that investors have come to rely on. When yields go up, Bond prices go down. March was the worst month for the Bond Market since 2016. It was down 6% in the quarter. Looking broader, since 2020, the Bond Market (as measured by the Barclays Aggregate index) is down 11%. This is the worst stretch for fixed income since the 1940s. Keep in mind, Bonds have only been down 5 years in the previous 40. It's a rare occasion. It's been decades since we have faced a rising rate environment. It's just getting started.

To close out Q1, the Stock Market went from fearing higher yields to embracing them. It's as if the Market is assigning more credibility to an aggressive Fed willing to fight inflation without hurting the Economy. The Market is now pricing in a 3% overnight rate by next year. It's been locked at zero since the Covid Crash in 2020 until just a month ago.



But higher rates slow the Economy. It's designed to do so. Something doesn't add up right now. Despite the pick-up in activity with the re-opening of America, inflation is sucking away more Dollars spent on food and energy that would normally flow throughout the system. The Fed is trying to avoid a hard landing. That's a tall order.

Inverted Yield-Curve



The Fed oversees the overnight rate. The Market drives everything else. The 5-Year Treasury yield closed out March at 2.46%. That is higher than the 10-Year at 2.32% and the 30-Year yield which stood at 2.44%. That pesky yield curve has been flat for months. It's now inverted. That's a sign of imbalance. Who wants to lend money for 30 years getting 2.44% in return every year when you can effectively get a better return for tying up your money 25 fewer years before getting your money back? The answer is not many, if any. Put another way, Banks lose money when lending long while short rates are higher. It's a sign of trouble brewing ahead.

The Bond Market suggests recessionary pressures are building and the Fed needs to be careful. However, a yield-curve inversion is not an effective market timing device. The lead time to a recession has ranged from as little as 6 months to as long as 24. A recession hasn't always followed. Historically, between the moment of inversion and an ultimate recession, stocks have done fairly well. The point is, an inverted yield curve is an important signal of trouble ahead, but it hasn't paid to get too defensive immediately. It takes time for the system to play out. The choppy price action should continue.

Housing Bubble?



Housing has been on fire. Asset prices were ignited by the historic low interest rates. Stocks have corrected their euphoric state. Houses have not. Homeowners on average in America, earned more from home appreciation than they did from work. That's about to change. Interest rates are the price of money. Money has gotten much more expensive, and fast.

Rising interest rates impact car payments and credit cards. Rates are still low by historical measures. But it's the direction of the move that matters most. The last time the 30-Year mortgage was above 4% was in 2019. The average house across the country was worth 25% less back then.

The Real Estate Market has been white-hot with rising prices and all-cash offers well above asking becoming the norm. We've seen this before. The house price/income ratio is back to its 2005 bubble peak. With mortgage rates rising, affordability is tenuous. 30-year mortgages went from 3% to 5% in just 4 months' time. Refinances fell 60% in March from a year ago. Here's an important calculation to think about: Every 1% move in mortgage rates requires a 10% adjustment in home prices to keep monthly payments unchanged. Americans can afford less house with higher rates.

Corporate America is Very Profitable



Earnings Season is just around the corner. It's a time for Corporate America to show investors their report cards. Revenues and profits are slated to grow 10% plus this year. The rate of growth is slowing, that's normal for this stage of the cycle. The question is the rate of slowing. With the Market, it's all about expectations.

The earnings comparisons get much tougher after seeing washed-out levels from 2020. But growth is growth. Companies are not experiencing contractions. Demand remains very strong. The key issue will be on profitability and if companies can handle the inflationary pressures effectively. Earnings are the primary driver of stock prices. We'll find out in April.

Leadership Keeps Rotating



Tech came back to life after some serious corrective price action. Fast-growing, innovative company stocks do well when interest rates are low. Low rates make them more attractive because cheap money encourages speculation. The Fed flooded the system with liquidity. That's what triggered the rally in 2020 and into 2021, after the Covid crash. Cheap money chased assets higher and higher. The flipside is true too: Growth stocks tend to underperform a rising rate environment because they are generally less profitable today and are all about tomorrow. That makes future cash flows worth less, so investors are unwilling to pay up. That's what's going on now. It's all about predictable profits paid today. The transition is bumpy.

Consumer Staple stocks, Utilities, Health Care as well as the Tech Titans do better when the focus is on the now. Quality and Defensive characteristics are desirable. We see that continuing into Summer as the Fed tightens the financial system. We are positioned for it.

We also maintain significant positions in Energy and other Commodities. It's a theme that should last. Energy companies have never been more profitable. \$100 Oil falls straight to the bottom line, as many Energy companies are breakeven at \$40. After being left for dead for years, Energy is back.

Employment

1.7 Million jobs were created in Q1. Many were in the retail and hospitality industries, which is key for the re-opening of America. The unemployment rate fell to 3.6%, approaching a multi-decade low. Importantly, the participation rate has increased. People have gone back to work. That's a really big deal. The record savings built up around Covid in 2020 seem to have burned off. If you want a job, you can definitely get one. There are still more jobs available than unemployed people at this point, as Consumers get out and about. The American engine is revving.



Here's another important point: American workers are making more money. Wages are higher. They are not quite keeping up with the excessive inflation. Remember, we had been importing deflation this whole century, mostly from China. Cheap manufacturing overseas led to cheaper imported products as well as outsourced labor. That trend has reversed. China is no longer the cheapest solution and supply chain strains have a focus towards onshoring again, which will cost more in Dollars, but might provide the benefits measured in national security. While we expect this current bout of inflation to peak in the coming months, we still anticipate prices to stay higher than we became accustomed to the past two decades.

The World Still Runs on Crude



The Energy industry has been completely disrupted by Russia. It will likely stay that way. Even when the war ends, whenever that is, things are not going to go back to normal. Russia is a major Oil producer. Global Oil companies don't want to do business in Russia. The capital markets won't open back up in Russia like before. Few countries, let alone companies, are interested in doing business with Russia.

There is a major shortage of supply of Oil. What's left cannot meet demand. The power dynamic in Russia will remain unstable, which means it will take years to balance out global supply and demand. The White House plans to tap the Strategic Petroleum Reserve for the 3rd time in a year. The talk is 1 Million barrels released every day for 6 months. That is a temporary solution that doesn't have a great track record. It doesn't go far enough. Keep in mind, the sanctions may result in 3 Million barrels of Russian Oil production being shut down.

Renewable Energy will play a huge role in solving this energy crisis. But it's still a ways out. Oil and Gas companies simply cannot pivot fast enough to make up the current supply deficits, despite the calls for action. It's an 18-24-month process to get there. We like Energy in 2022. We like Traditional Energy companies, and we like Renewable Energy too.



The Path Ahead

So, what's the set-up for the rest of the year? We prepared for increased volatility with a downward bias as we started the year. We've gotten it, and then some. We think it continues. March was strong. There was a powerful rally to close out the month and Q1 after hitting deeply oversold lows. Those lows were meaningful in a potential bottom formation. The Stock Market erased all the losses experienced since the beginning of the invasion of Ukraine. It's far from over.

There is no clear solution for peace in Ukraine. The Market is more focused on earnings, inflation and the Fed. The Stock Market just gave a green light for the Fed to be more aggressive in tightening. It's already started with the first 1/4-point hike in years. That happened in March. The next one might just be a 1/2-point in May. That said, the March rally felt like a Bear Market rally to us. There's so much yet to be resolved. The uncertainty continues.

We remain on the defensive, with a yield-curve inversion, slower earnings and economic growth ahead, reduced stimulus, stagflation risks and heightened geopolitical uncertainty. That's quite a list. The biggest issue for the Market is sky-high prices. Inflation is everywhere. The economic and geopolitical costs of the war in Ukraine will extend well past the end of hostilities, no matter when peace comes or what shape it takes. If earnings continue to grow, the Market should hold in ok. The risk is a faster slowdown and earnings misses.

We are long-term investors. But we find ourselves still hyper-focused on the short-term right now. There has been a rolling correction beneath the Market surface for months. We do like what we see ahead, later in the year. It's the now that presents the biggest challenges. The American Consumer is in good shape and demand to get out and about is real. That is great news for the US Economy. But the risks are many. We aren't getting too comfortable. We think the volatile price action will continue. We have been successfully navigating this bumpy stage. Keep those belts buckled.

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