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First Quarter 2022 Market Commentary

Inflation, even if it slows down later in the year, and a tighter monetary policy will put pressure on the market in 2022. We agree with legendary bond investor, Jeff Gundlach, founder of DoubleLine Capital, when he says, "The stock market, and risk assets broadly, have been supported for over a decade by the Federal Reserve's balance-sheet expansion. As we move into tapering and ultimately raising interest rates (as the Fed fights inflation), it's turning into a more volatile period for markets." We do not foresee the market completely falling apart, as corporations have already announced record share buybacks of $567 billion for this year according to Goldman Sachs, and there is still $2 trillion more in money market funds now than when before COVID started, according to Morningstar. This money will find its way into the market during sell-offs, which will likely cushion the sell-offs, but create much more volatility this year. In this commentary we will discuss inflation, a change in monetary policy, and its impact on the financial markets in more detail.

The economy has had two bouts of inflation since the beginning of COVID. The first wave of inflation was centered around the Federal Reserve's money supply growth of 41% over the last two years that was used to offset the decline in asset values as COVID shut down the economy. The massive quantitative stimulus (money printing) stopped the market free fall, which wiped out nearly 40% of the value of the S&P 500 in a little over a month at the start of COVID, and in turn set up a large market rally. The quantitative stimulus caused <u>asset inflation</u> as measured by higher stock market prices, as the money printing was centered around buying government debt and mortgage bonds. The Federal Reserve soon became by far the largest

owner of U.S. government debt and mortgages. In turn, the massive Federal Reserve buying of debt lowered interest rates. Since interest rates are the cost to borrow money, as the Federal Reserve printed trillions of new dollars, the cost to borrow money went to almost zero, and assets priced in dollars rose. On an individual level, as interest rates went close to zero, investors ditched bonds and purchased stocks that had better growth prospects and paid more income than bonds. As more investors purchased stocks, equity markets around the world rose, and as a side effect the lower interest rates also caused a large increase in home prices, as homebuyers could now afford to buy a more expensive home while still paying the same monthly mortgage. This asset inflation was largely successful in terms of reducing the COVID economic fear and generating a wealth effect for many Americans. During this time period, ordinary product inflation was still relatively tame as the monetary stimulus was largely contained in the financial system and financial assets. This quantitative easing program was an exact replica of the program the Federal Reserve Bank used to pull the country out of the Financial Crisis of 2008-2010, and that was also successful in creating asset inflation, but not producing product inflation.

Product inflation, the second bout of inflation, has just started to accelerate over the last several months. Congress, in addition to the actions of the Federal Reserve Bank, initiated its own multiple relief programs in response to COVID. The largest program was through stimulus checks. The first round of stimulus checks went out under the CARES Act to most Americans and totaled $1,200 to adults and $600 for children. This bill was passed on March 27, 2020. The second stimulus bill passed December 27, 2020, and added another $600 in payments to adults and children, and the third and largest stimulus bill named the American Rescue Act passed on March 11, 2021 and totaled $1,400 to adults and children (Congressional Budget Office).

Although the bills were well intentioned, inflation began to spike with the passage of the second stimulus package and accelerated with the American Rescue Act of March 11, 2021 (see chart below).

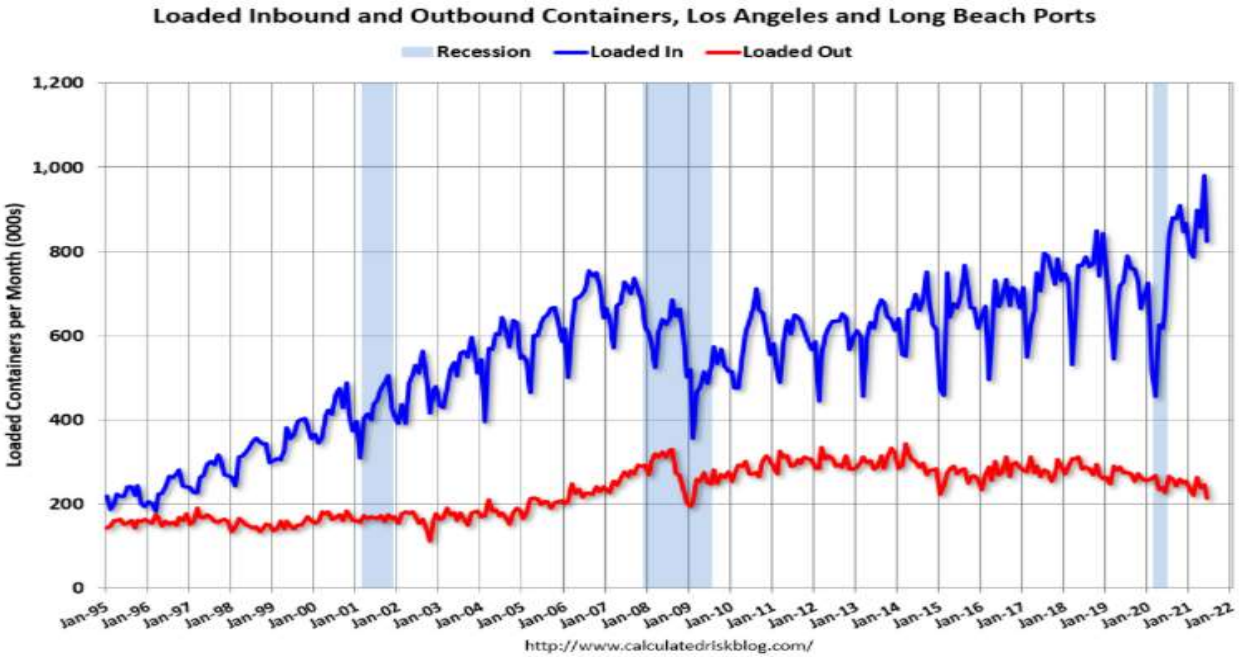
The reason for the spike of inflation was that as Americans received the checks into their bank accounts, the money was quickly converted into orders of consumer goods at the same time as the economy was just beginning to open up, and the supply chains and production capacity was not yet back to normal. So, between the pent-up demand from COVID and stimulus checks, the ability of industry to meet the rush of orders was quickly overwhelmed and prices escalated.

Demand for consumer durables (goods expected to last three years or more) is up in many cases over 20% over the last year above trend line. The supply chain was not designed to handle a 20% spike in demand even in good times, nor less in a year in which employment is still 4 million people below when COVID started[1]. As demand increased more than capacity, companies increased prices. In fact, according to FactSet Research, the majority of companies

[1] Fortune Magazine January 2022 Page 85

in the S&P500, the 500 largest companies in the USA, increased their profit margins last year because they simply passed on their higher inflation to their customers[2].

This is not to say that the supply and production chains are sitting back and doing nothing. The Port of Los Angeles, the largest port in the Western Hemisphere, has handled record port traffic in 2021 of 10.87 million container units, versus the 9.68 million container units in the pre-COVID year of 2019[3]. This also does not include the 80+ ships still waiting outside of the port waiting to be unloaded. So, a large factor in the inflation that we have been seeing is not a breakdown in the supply chain throughput, but rather a large increase in demand as stimulus checks sent out by the U.S. government were quickly converted into a wide range of orders for consumer goods, most of which have been imported, overwhelmed what the supply chain could actually deliver. The record demand for goods can also be seen by the November trade deficit which jumped to $97.8 billion or $1.1 trillion annualized. (U.S. Dept of Commerce).



[2] Fortune Magazine January 2022 p.28
[3] www.portoflosangeles.org/business/statistics

This surge in orders has caused the most recent inflation data to spike to almost 7% annually (Inflation data.com), which is the most since the 1970's, which in turn has caused the Federal Reserve to begin to reverse its pro-growth monetary policies. The Federal Reserve Bank has traditionally fought inflation by raising interest rates and reducing money supply growth, both of which reduce the value of stocks.

Most of Wall Street uses the Discounted Cash Flow model (DCF) to value companies. The DCF model uses a firm's cash flows, in conjunction with a terminal value to value an enterprise. The terminal value (TV) captures the value of a business beyond the projection period in a DCF analysis, and is the present value of all subsequent cash flows. When interest rates are zero or near zero, the present value of future cash flows is almost the same as the future cash flows. This means that Wall Street firms can pay up for a future earnings stream when interest rates are low, but cannot do that when rates are high. So, as rates rise, future earnings streams are not worth as much today, which causes traditional price/earnings ratios to compress, and stocks to be worth less.

So, when the Federal Reserve Bank announced it would start increasing interest rates this year, investors worried that stock prices would sell off. Moreover, on Wednesday, January 5th, 2022 meeting, the Federal Reserve released the notes of their December 2021, revealing that the Federal Reserve Bank was not only considering raising interest rates, but also stopping its quantitative easing program, and reducing its balance sheet, which is another constrictive move, and one which the market was not expecting.

We believe that the proposed changes to monetary policy are already affecting the leading sector of the economy and market-technology companies. Technology companies trade at some of the highest valuations and now those valuations have begun to compress. Over the last several months, we have seen a decoupling of the high flying, smaller market capitalization

technology stocks and the overall market. In the past, when this has happened, it has served as a warning that valuations across the market will soon compress. Cathy Woods, one of the country's best aggressive growth research managers, whose funds have seen stellar returns, saw her flagship fund (ARKX) lose -24.02% last year for 2021. Cathy's funds specialize in investing in innovation platforms such as artificial intelligence, DNA sequencing, robotics, energy storage, and autonomous vehicles. Nasdaq.com, which specializes in higher growth, higher valuation companies, is already showing that 38% of the companies currently trading on the Nasdaq Exchange are trading -50% below their 52 weeks high as of January 6, 2022. [4] The Nasdaq itself was down almost 5% for the first week of the year and the Russell 2000, which includes the smaller, faster growing companies in the market is now down -11.6% from its highs in last November (William O'Neil & Company).

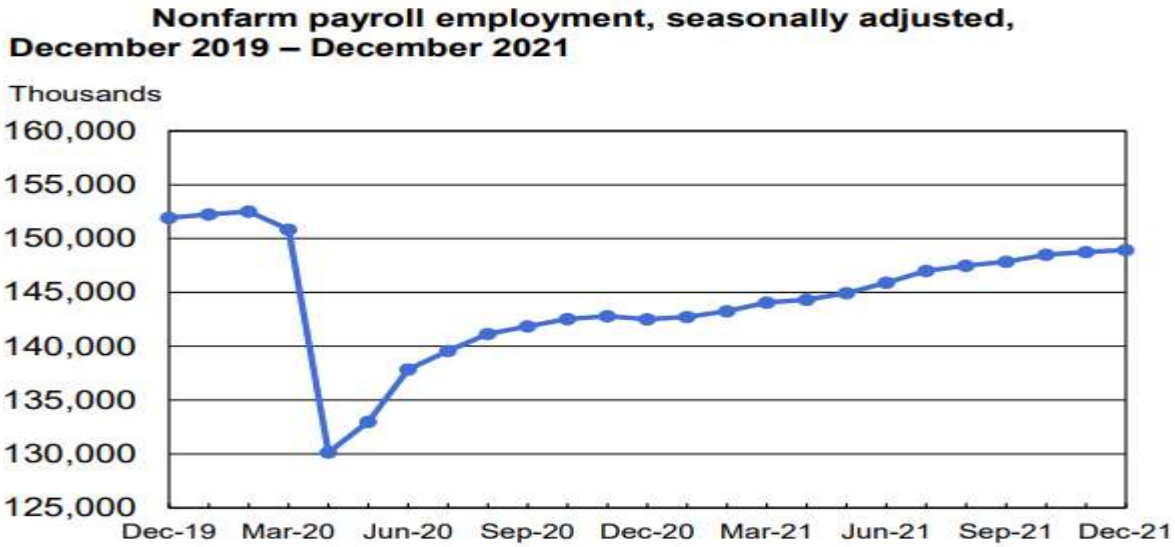
In some respects, a sell-off is not unexpected after the large three-year gains that the markets have just experienced, and mild sell-offs prevent larger sell-offs from happening in the future. So, a sell-off that brings valuations back to closer historical levels is not bad in the long term, especially since some sectors of the market are overheated.

That being said, since corporations have already announced record share buyback programs, and since most of these programs buy stocks on market dips, we think the share buybacks will cushion any market sell-offs. And remember, according to Morningstar Research, cash levels are still $2 trillion higher now than before when COVID started. Investors will likely use this cash to buy stocks on any weakness. Moreover, the Census Department reports that almost 10,000 Americans turn age 65 every day, and since 90% of these people do not have pensions, and because interest rates are still low, and are expected to remain relatively low even

[4] Barrons Magazine, Looks like the Fed Wasn't Bluffing This Time, January 7,2022

after rate hikes, these people will also likely be buying stocks into any market sell off to meet their income needs. So, we think the combination of these two opposing forces (a more constrictive Federal Reserve Bank versus lots of cash waiting to be invested) leads to a market with lower returns than we have seen over the last few years and much more volatility.

We also believe that the Federal Reserve's initial assessment that inflation will be transitory will eventually prove to be true, but the term transitory will expand from the Federal Reserve's initial belief of inflation pressures mitigating in six months, and instead may take one to two years. The Federal Reserve predicted inflation would increase as the economy re-opened last year and that there would be a burst of pent-up demand, which was in part fueled by government stimulus checks. The Federal Reserve also predicted that as the economy re-opened, and as generous unemployment benefits ended late last year that more people would return to work and supply chains would ease and production would increase. To some degree workers have returned to the workforce, and the labor force is now 4 million people below the pre-pandemic workforce participation (which is horrible), but it is better than the 10 million people not in the workforce when the Federal Reserve made its predictions (See Bureau of Labor Statistics chart below).



As vaccines improve and the country learns to live with COVID, labor participation will likely continue to increase. Moreover, as labor force participation increases, production and transportation capacity will also increase, which will help supply issues in the economy improve. As old stimulus checks are used up, excess demand will dampen and revert towards trend, which will in turn lower inflationary pressures. The prices that companies raised on goods already are here to stay, but future increases will likely slow as these forces play out. If inflationary pressures slow as the year goes, the Federal Reserve may become less restrictive with their monetary policies, which could give the market a boost later in the year.

In conclusion, given a Federal Reserve that proceeds with raising interest rates until inflation is beaten, and reducing market stimulus, traditional valuations, return of capital (dividends and share buybacks), and strong corporate balance sheets will become more important. Moreover, many of the stocks that have driven the market higher over the last several years will most likely continue to grow but may see their valuations compress, which might create buying opportunity down the road. In the meantime, we continue to believe that focusing on companies that provide goods and service which consumers and business use on a daily basis, who are returning cash back to investors, and who have strong balance sheets, offer the best risk-adjusted returns in a potentially volatile year. We thank you for your continued support.

Sincerely,

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