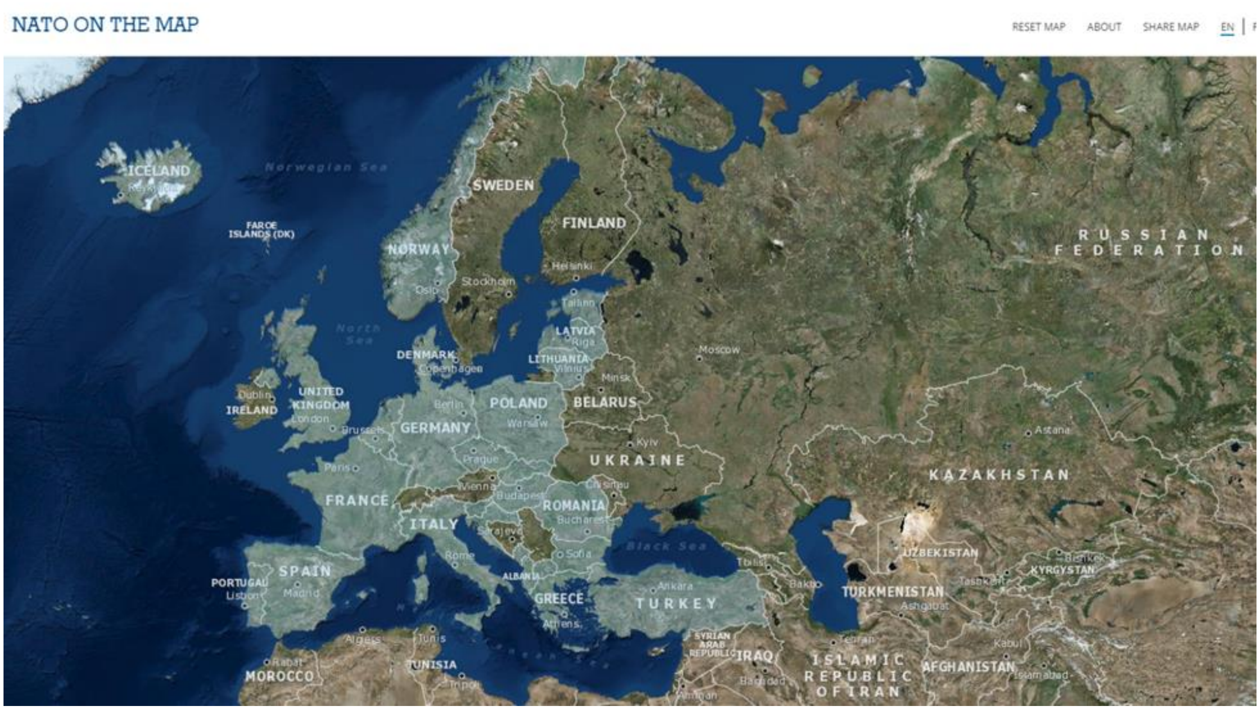
February 24, 2022

Dear Clients and Friends,

It is difficult at times like these to keep a clear head and not to lose one's nerve. This is serious stuff, and we cannot know how the geopolitical situation will unfold. I won't try and make predictions about things beyond my abilities, but I will share some research and market history that should make you feel a little better.

Ultimately, it will be the economic effects that will determine what happens to the markets; and my comments will primarily be focused there. But first, I need to explore the risks of whether this Russian invasion will extend beyond Ukraine and become a much larger war. I'll say again that no one can know, but I think it is unlikely Russia will challenge NATO. Shown below is a map of NATO countries (highlighted in grey). Any further movement westward by Russia would invoke NATO's collective defense clause (Article 5). Some analysts believe Putin would like to extend Russia's boundaries to include the old Soviet Union countries of Poland and the Baltic states of Estonia, Latvia, and Lithuania; but that seems foolhardy and I don't believe should be the base case expectation. So if an expansion of military conflict is unlikely, what are the most likely effects? For one, there will be a massive exodus of people from Ukraine into neighboring countries including Poland, Romania, Hungary, Slovakia, and Moldova. Next will come sanctions and isolation of Russia, and there will be economic, market, and political impacts.



As always, let's explore the fundamentals that drive our investment decisions: the economy, earnings, inflation and interest rates, and valuation.

The Economy
Russia and Ukraine have little impact on the global economy outside of oil and commodities, but they are significant producers of both. Together they account for about 29% of the global wheat export market. They also export corn, copper, nickel, and platinum. Assuming that sanctions interrupt their exports, there is likely to be further strains on already disrupted supply chains. However, the direct impact on the US economy should be very limited because Russia and Ukraine combined account for well under 1% of US imports and exports, and less than 2% of global GDP.

Inflation
We are likely to see even more inflationary pressures. Oil prices have risen to $100 and wheat and corn prices have also increased. Inflation is a big story right now in part because it is being used as a club by politicians. As financial planners, we help clients plan for the future and inflation is an important factor. One thing I have learned both by observation and by experience is that inflation is much more personal than implied by the national statistics. For example, if you have children in college or private schools you have a much different inflation than a retired person whose house is paid off. We are all emotionally impacted by the price of gasoline (except EV owners, like my wife), but gasoline only represents 3.75% of the Consumer Price Index. Here is a table showing the breakdown of some of the categories in the CPI:

Category	CPI Weight
Food	13.4%
Gasoline	3.7%
Electricity	2.5%
All types of energy	7.3%
New and used cars	8.2%
Medical services	7.0%
Shelter	32.9%

You can see that housing is the largest factor which, as stated above, will vary depending on whether you are a renter or own your home. The point is that while we are going to see increases in the cost of food and gasoline, for many people it is not a significant part of their budgets.

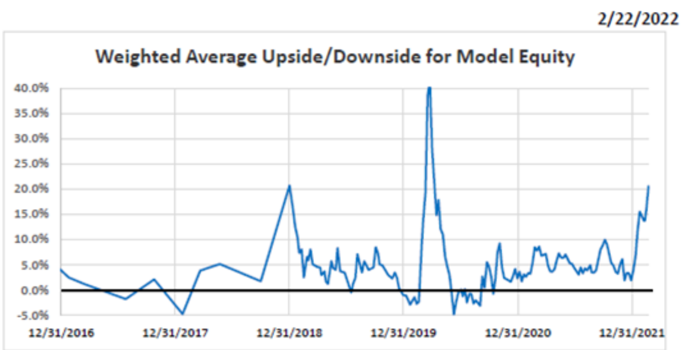
Interest rates
Generally, I argue that interest rates will always follow inflation. The Federal Reserve can control the level of short-term rates, but if inflation rises long-term rates will rise and ultimately the Fed will have to raise ST rates too. That is the situation we are in today. One caveat to that is that when there is a significant risk event, investors seek a safe haven and US Treasuries are the asset of choice. This year we have seen the yield on the 10 year Treasury rise quickly from 1.5% to 2.0%. This morning the yield dropped to 1.9% on the Ukranian news, but has since moved back to 1.96%. I have argued, and still believe, that rates will pause their upward move at this level at least for a while. Furthermore, from a monetary policy perspective, the geopolitical situation and the supply side issues have the potential to weaken economic growth. The Fed and other central banks are less likely to aggressively raise interest rates. The Fed meets on March 16th and while it was expected they would raise rates by 0.5%, it is now as likely that it will only be 0.25%.

Earnings
At this point, it is unlikely that the conflict will have a material impact on earnings. There is the potential that higher energy costs, tighter financial conditions, or businesses getting more conservative could slow the economy and earnings, but for now earnings estimates have not changed. The S&P 500 is expected to earn about $225 / share (about 10% higher than 2021).

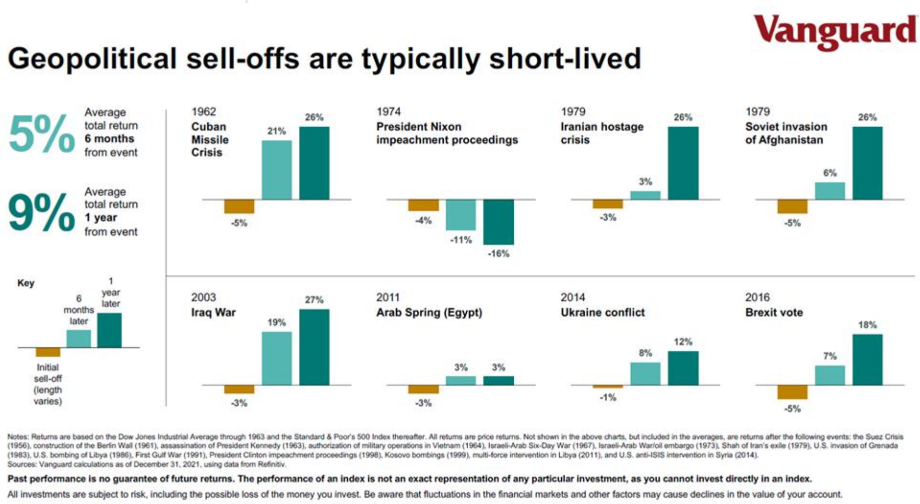
Valuation

Using $225 of estimated earnings, the S&P is trading at a P/E of 18.9x. I think that somewhere around the current level, or perhaps a little lower at 4100, is the level that the market sees value. It's interesting that the market rebounded today at 4,115. That level is by no means guaranteed to hold, but valuation is what puts a floor under the market.

One additional chart to show you is our internal valuation history of our Model Equity Portfolio. We calculate an intrinsic value for each portfolio company, and along with other sources, we come up with a target price for the 40 companies in this portfolio. Shown here is a chart indicating that in the last 5 years the portfolio currently has more upside than downside at any point, except after the 20% decline in the 4th quarter of 2018, and the meltdown in the 1Q20. Subsequent returns were very high after both periods.



In sum, it is a difficult time for investors. We are hard at work trying to understand these markets and make appropriate adjustments. It's never a good idea to panic. Stay the course and remember that long term investing requires holding your nerve sometimes.



Thank you,

Brad Bickham, CFA, CFP®
Managing Partner | Chief Investment Officer
And Your Entire Colorado Financial Mgmt. Team

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10 Year Treasury Note Yield Index (TNX-X): Represents the United States current 10 Year Treasury bond market interest rate. The 10-year Treasury note is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance.

S&P 500: The S&P 500® is an unmanaged index that is widely regarded as the best single gauge of large-cap U.S. equities. The index includes 500 leading companies and captures approximately 80% coverage of available US market capitalization.