Economic & Market Review

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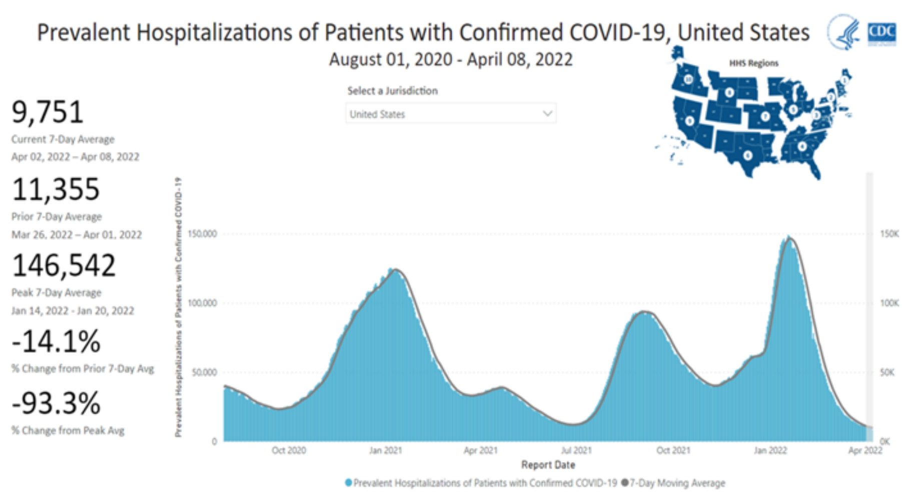
As Of 03/31/2022*	1st Qtr 2022	Last 3 Years	Last 5 Years	Last 10 Years
50/50 Balanced World Index	-5.7%	1.1%	7.2%	6.7%
World Equity Index	-5.5%	6.3%	11.4%	10.0%
U.S. Large Cap Equities	-4.7%	15.2%	15.4%	14.0%
U.S. Small/Mid Cap Equities	-7.5%	-1.3%	13.2%	13.2%
Foreign Equities	-5.6%	-1.3%	6.9%	5.8%
U.S. Bonds	-5.9%	-4.2%	2.1%	2.2%
Global Bond Index	-6.2%	-6.4%	1.7%	1.0%
Cash & Equivalents	0.0%	0.1%	1.1%	0.6%

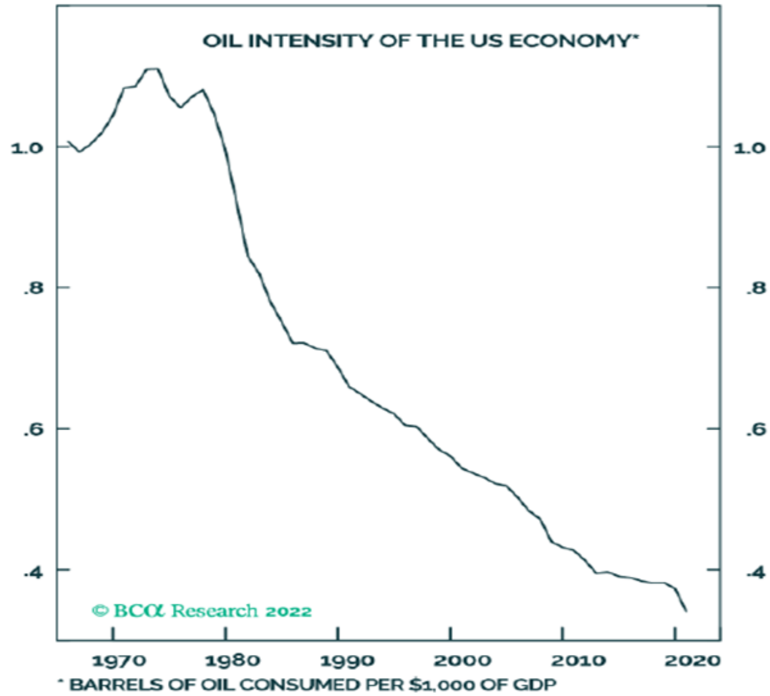
Dear Clients and Friends,

Most everything was down in the first quarter, with the exception of commodities, including oil. You might say it is somewhat surprising that it wasn't worse. With inflation surprising on the upside, a war in Europe, and interest rates spiking, a loss of only 5% doesn't seem that bad. That mild decline masks the intra-quarter volatility though. At its low point on March 8th, the S&P 500 was down 13% from its high on January 3rd. International indexes had drops of 16% - 17%. The damage from U.S. bonds was unusually and surprisingly bad. The 5.9% drop in U.S. bonds was the worst quarter since 1980. What should we expect for the balance of the year? As usual it will be determined by the economy, interest rates, earnings, and valuation – and short-term swings due to sentiment. Let's take a look at each.

The war in Ukraine came just as the Covid19 news was getting better, with the Omicron wave sharply receding. As everyone knows by now, beyond the human toll, Covid 19 led to massive economic distortions in a number of unexpected ways. First was the global economic shutdown. The shutdown led to significant changes in people's behavior. Work from home (increased demand for real estate), less travel, more spending on goods, more e-commerce, and supply disruptions. Then came stimulus programs all around the world. Suddenly, demand picked up for everything, but supply was slow to recover. Even today because of a recent uptick in cases in China there are complete shutdowns of huge Chinese cities. This will lead to more supply chain problems. We'll look at this more later when analyzing inflation and interest rates, but from an economic perspective

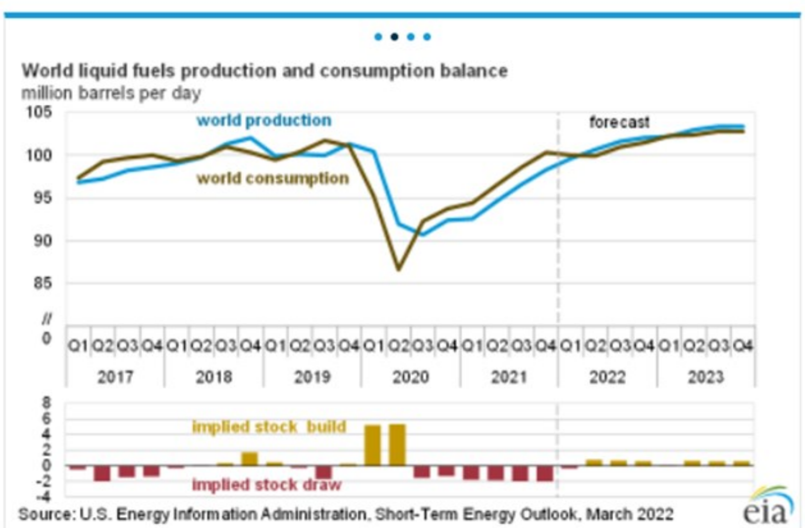


demand is still strong and expected to remain so. With the unemployment rate below 4%, we can expect demand to remain strong. There is some drag on economic activity due to rising interest rates and high inflation.



Of these, I believe the rise in interest rates, and its likely effect on housing, is more problematic. While gasoline gets a lot of attention, the overall effect on the economy from energy is not nearly what it used to be. Similarly, while food inflation is also high, and the cost of new and used cars is up a lot, I don't think those are enough to cause a recession. Housing, on the other hand, has often been the cause of economic slowdown. With mortgage rates now at 5% and rising, and because prices have risen so dramatically, I expect housing to slow. One idea I haven't heard about lately, but which I think could happen, is a type of rolling recession where one sector of the economy at a time goes through a slowdown.

The war in Ukraine has had a wide ranging but diverse impact on the global economy and individual regions. Given that Russia's economy is less than 2% of global GDP it is immaterial to the world's economic growth. They are, however, a major producer of energy, and both Ukraine and Russia are significant exporters of agricultural commodities and base metals. If you live in Germany or Italy, Russian natural gas matters a lot. Italy gets 100% of its gas from Russia. No gas, no electricity. That is why the West is unable to cut off Russian energy exports. As shown in this Energy Administration chart, supply and demand for oil are pretty much in balance now. If so, the negative effect of rising oil prices may be about over, and the positive effect on the energy industry is yet to come. Production is up to 11.6 million barrels per day compared to 10.9 million at this time last year. There are geo-political issues and climate issues that are beyond the purpose of this letter, so I won't opine on them. I only mention them because I know there are strong feelings on both sides, and I recognize they are valid.



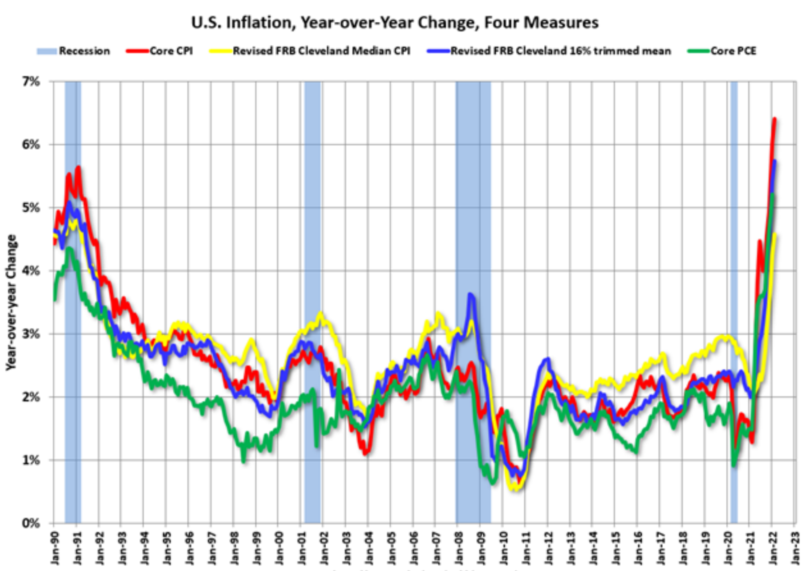
Inflation & interest rates

As mentioned above, energy is less of a factor on the US economy and on the consumer price index as shown below. It matters… just not as much as it used to, nor as much as the press it gets. Shelter, on the other hand, accounts for 33% of the CPI. The good news is that over the last 12 months it is up only 4.7%. The bad news is that it is probably going to rise more. The methodology for shelter is a bit convoluted. It's called "owners equivalent rent". For homeowners, increases in home prices don't increase their costs. It only affects new home buyers and renters. The CPI tries to measure this. It will rise, but not at the 20% rate that housing increased over the last year.

Consumer Price Index - All Urban Consumers		
Category	Weight	12 Mo's ending 2/28/22
All items	100.0	7.9
Food	13.4	7.9
Food at home	8.2	8.6
Food away from home(1)	5.2	6.8
Energy	7.4	25.6
Energy commodities	4.0	37.9
Fuel oil	3.8	43.6
Gasoline (all types)	3.7	38.0
Energy services	3.4	12.3
Electricity	2.5	9.0
Utility (piped) gas service	0.9	23.8
All items less food and energy	79.2	6.4
Apparel	2.5	6.6
New vehicles	4.1	12.4
Used cars and trucks	4.2	41.2
Medical care commodities(1)	1.5	2.5
Services less energy services	57.4	4.4
Shelter	32.8	4.7
Medical care services	7.0	2.4
Transportation services	5.6	6.6

As I write this, the inflation rate was reported at 8.5% in March, and the core rate was 6.5%. The reasons behind an inflation surge such as this are complicated and murky. If your favorite news source tries to simplify it and blame it on either the Fed or government policies, don't believe them. Yes, in hindsight both monetary and fiscal policy were either catalysts or accelerants or both, but the supply disruptions from Covid 19 was the primary reason. The labor market, which has been repressed for decades, seems to be undergoing a change. The shortage of workers is and will continue to give labor more power in wage negotiations. The rise in inflation threatens to become a vicious cycle as labor demands more wage increases.

Besides rising prices, the impact of inflation is a rise in interest rates. This happens at both long term maturities, which the market controls; and at short term maturities, which the Fed controls. Investors in long term bonds face negative returns when adjusted for inflation, so rates rise to where investors believe they will receive a positive inflation adjusted return. With 10 year Treasury yields at 2.7%, the market is telling us it believes inflation is going to average something like 2.5% over the next 10 years. This might be too low, but it's clear that investors don't expect the current inflation rate to stay this high.



Why will inflation come down? The Fed has a playbook for reducing inflation. Unfortunately, the medicine is sometimes worse than the disease. Basically, the Fed raises interest rates which reduces demand until the economy slows. If they raise rates too far or too fast the economy slips into recession – unemployment rises, and prices fall. Every time we are in this situation, there is speculation about whether the Fed can orchestrate a 'soft landing'… meaning an economic slowdown without recession. A few times they have, but more often a 'hard landing' is the result. Historically, there has been a lag of a year to eighteen months between the start of rate increases and economic slowdown. We only had our first rate increase last month, so the probability of recession for 2022 is still low but it is rising.

The bottom line is that rates still could rise more until we see a peak in inflation and a slowdown in the economy. Many analysts think we may be seeing the inflation peak now (literally). The pace of its decline will be an important factor as well as the longevity. Therefore, we remain defensive on bonds, but the inflection point on inflation could be an inflection point on long term rates and we are preparing for an eventual move to a more neutral position on bonds.

Earnings & valuation

S&P 500 operating earnings grew 70% last year. This year's estimate is currently for another 8.5% increase over 2021. The forward (based on estimated earnings 12 months ahead) P/E is 19.5 vs. a 25 year average of 16.8. We are 16% above the long term average. P/E ratios have a mathematical component and an emotional one. The P/E ratio is a simplified valuation too. It usually looks only one year ahead or one year backwards. As any investor in a private business would tell you, a buyer is looking further ahead. The intrinsic value of an investment is the present value of future cash flows. Mathematically, that means that an increase in interest rates lowers the intrinsic value as does a decrease in growth expectations. The emotional part comes from whether investors are willing to look further into the future or are willing to only pay for what they can see in the near future.

Due to rising interest rates, and a somewhat cloudy future I would expect valuations to decline closer to the long term average. Maybe not all the way, but some. There are two ways to get there. Either the market falls, or the market goes sideways while earnings rise. That's what happened from 2000 to 2012. Over that period earnings doubled, and the market went nowhere (although in a volatile manner). It doesn't have to be that dramatic this time. If earnings rise 8.5% this year and 9.5% next year as expected, and the market finished the year about where it is now, then it would be trading at 18x forward earnings… somewhat above the LT average, but reasonable considering alternatives and a number of other factors.

What about large cap tech and other highflyers that have come down… are they now attractive? I am an old school financial analyst who got his Chartered Financial Analyst (CFA) certification 30 years ago. Valuations were a lot different then, but so was the economy and the market. Companies with the growth and profitability of Apple, and Google, and many others, did not exist. Even Microsoft had not really taken off (who remembers Windows 95?). They deserve to have premium valuations as long as their growth and margins continue. What I don't understand are companies that trade at multiples of revenue with little to no earnings. Rather, I should say I understand it I just don't agree with it. The analytical approach would be to estimate future revenues, and then assume at some point that they become profitable, and then assume a multiple on those earnings. In many cases, it requires assumptions so optimistic that it's really impossible to make sense of it. In those cases, in my opinion, it's a greater fool's game. There's the pretense of justifying the value based on growth, but at the end of the day what an investor gets is earnings. You can't calculate intrinsic value on something that doesn't exist. Investing in companies with little or no earnings is speculating in my view, not investing. We'll leave that to others.

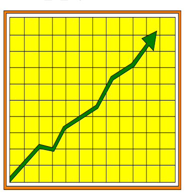
Sentiment

Fear and greed have long been considered drivers of the market. I've quoted this before, but it's one of my favorites from Warren Buffett… "In the long run the market is a weighing machine, in the short run it's a voting machine". Market sentiment has swung wildly this year and that is likely to continue. If the war in Ukraine were to suddenly end there would likely be a 10% rally. Similarly, if NATO is somehow dragged in, expect a sharp decline of a similar magnitude, maybe more. There is an election in November, which always creates consternation. The polls indicate the Republicans are likely to win the House and maybe the Senate as well. For better or worse, this means nothing of significance will get done for the next two years, and nothing gets done in an election year. So you don't need to worry about tax rates changing or big government spending projects, but neither are we going to see progress on climate change or other important issues. Inflation and the war in Ukraine seem likely to be the main drivers of sentiment, although there is also the possibility of another Covid19 surprise.

Conclusions

If I'm right about interest rates being near their peak and about the stock market in a consolidation phase, then this will be a difficult year to make a positive return. When investing new money, we will try to be patient and buy after declines. For portfolios that are fully invested, we don't try to time every dip or rally. We have made several changes to increase the weighting of value stocks, but longer term we still have a bias toward growth. Energy has been the best performing sector this year, and we are woefully under-weight which has hurt our relative performance. But longer term, who believes energy is going to outperform technology? We proceed with humility. The future is uncertain. But we will maintain our discipline… invest for the long term in companies that grow above average at reasonable prices. Select managers that have shown the ability to outperform their peers. Maintain steady asset allocation policies with periodic tactical changes within predetermined and reasonable ranges. Avoid making big mistakes. As always, we thank you for the confidence you place in us.

Happy returns,



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**Indexes*
We don't want to offend anyone's copyrights or pay any of the index providers for using their names or numbers. Suffice it to say the numbers shown in the table on page one are from common indices reported every day in newspapers and on television. There are different indexes for every asset class. If they are slightly different, we believe that is immaterial. They are meant to represent the environment and market conditions we are experiencing.

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