Investment Review and Outlook - Spring 2022

"Stop the World – I Want to Get Off"

Given the world in which we all live today, this may be what you are thinking at times. This is the title of a 1961 Broadway musical with wonderful songs that was successfully revived in 1978, starring Sammy Davis Jr. During the 60's, this was also a time when the U.S was in the midst of the very controversial Vietnam War and saw wide-spread civil unrest across the country, the latter not too dissimilar from what we witness at times in America today. Many are perplexed about where we are headed as a country, disillusioned by the political discord all around, tired of the past couple of years of Covid-19 related restrictions and personal sacrifice and, more recently, accelerating inflation that threatens our livelihood. However, before we despair and signup for Elon Musk's Space X voyage to Mars, let's look at some facts and trends in the landscape, both positive and challenging.

The U.S. Economy:

An important bright spot in the economy is the robust business capital spending that ultimately results in increased productivity. Since there is a significant labor shortage in the economy, this is helpful. This also explains why non-defense capital goods orders increased approximately 20% over the past 24 months through Q1 2022. In addition, consumer consumption spending is still showing a positive comparison with the year-earlier when the pandemic impact discouraged outlays. As progress continues to be made against the virus, consumer services should also improve. Together, these two spending measures represent approximately two-thirds of the overall economy.

During March, a positive development on the labor front was reported with 431,000 jobs created during the month and highlighted a pickup in the more highly-compensated manufacturing and professional segments. Business service job growth, especially in travel and leisure, was stronger. For the first calendar quarter, an estimated 1.7 million jobs were created, as Covid-19 concerns eased. The unemployment rate also fell to 3.6%. In addition, the Labor Department recently reported encouraging weekly jobless claims figures, with the most recent seven-day stretch, through mid-April, showing a drop in those applying for unemployment protection. The figure fell from an already low 184,000 to 180,000 in the latest period and the lowest since before the pandemic.

On the other hand, this week we received disappointing data on the U.S. economy when the Commerce Department reported that the initial GDP (gross domestic product) estimate for Q1 2022 showed a decline in annualized growth of -1.4%. The Conference Board, a global independent business and research association with over 1000 members, had estimated Q1 2022 GDP growth to be a positive 1-2% compared with 6.9% growth in Q4 2021. The latter period benefitted from much easier comparisons a year earlier as the economy was recovering from the pandemic. Results of the recent period were likely affected by the Omicron variant of the coronavirus at the beginning of 2022. Together with a disappointing reading on consumer confidence from the Conference Board for March, these reports add to the growing concern that the U.S. economy is slowing more than anticipated and is being impacted by historically high inflation.

<u>Earnings Season – Mixed Results:</u>

First-quarter earnings season did not get off to a rousing start. Major U.S. banks reported year-over-year declines in earnings due to higher operating expenses along with weaker asset management and investment banking activities. However, in general, corporate earnings growth has mostly continued to improve. With 20% of S&P 500 companies reporting Q1 2022 results, over two-thirds have exceeded earnings estimates. The winners appear to be companies with a track record of earnings consistency in the consumer staples industries and selected pharmaceuticals while those that have struggled are more concentrated in the high growth arena, namely technology and industrial cyclicals.

<u>Inflation Trends – Accelerating "Core" Rate:</u>

The possibility of sustained inflation within the U.S. economy for some time to come and its impact on the cost structure on corporate America may be difficult to fully overcome for a while. As we have written in the past, we did not believe inflation was transitory, given the significant stimulative Federal Reserve policies that have been in place for a long period of time, massive government deficit spending and historically low interest rates. The Federal Reserve has finally acknowledged this isn't transitory.

The all-inclusive Consumer Price Index (CPI) accelerated in March by 8.5%, a four-decade high. However, looking at the all-important "core" inflation rate, which excludes items known for their volatility – namely, food and energy, is very troubling. The core number still surged an alarming 6.5% for the 12 months ending March 2022, the largest since August 1982. A year earlier, ending March 2021, the 12-month core rate was only 1.6%. The current core inflation rate compares with 6.4% in February and 6.0% January 2022. The trend has been moving sharply higher in recent months: 5.5% in Dec., 4.9% in Nov., 4.6% in Oct., 4.0 % in Sept. Regarding recent fuel prices, natural gas prices surged to a 13-year high while gasoline rose 48% year/year through March, nearly a 14-year high.

Stubborn high inflation is weighing on the U.S. consumer. Retail sales figures for March showed elevated prices for food, energy and other necessities which significantly increased monthly bills for U.S. households. This is also likely to ultimately force consumers to defer purchases of other discretionary items that could negatively impact GDP growth in the upcoming spring and summer months. The mettle of the U.S. consumer, who led the recovery back from the coronavirus-driven 2020 recession, will definitely be tested over the next several quarters.

<u>The Federal Reserve – Transparent Policy Expectations:</u>

High current inflation has put the Federal Reserve in a difficult position and is bringing more restrictive monetary policy comments from the Board of Governors. It now appears the central bank is poised to increase short-term interest rates by one-half percentage point at both its May and June meetings of the Federal Open Market Committee (FOMC) in an attempt to rein in surging prices at both the producer and consumer levels. The goal is for the benchmark federal funds rate to be in the 1.75%-2.00% range by year's end. The rate was raised by a quarter-point, to a range of 0.25%-0.50%, during its March 2022 FOMC meeting for the first time in three years with signals of more rate hikes ahead.

Central bank leaders have also discussed plans, perhaps as early as May, to aggressively begin reducing its balance sheet. The Feds asset holdings rose sharply to nearly $9 trillion, following massive stimulus measures, including monthly bond <u>buying</u>, that flooded the financial system with liquidity at the height of the pandemic. Such a reduction by, <u>selling</u> bond holdings or allowing them to mature, would remove excess liquidity from the financial system that has been contributing to the inflation problem.

As a result of the planned restrictive monetary measures, the next 12 to 18 months will be challenging times for the Federal Reserve. There are already signs that U.S. economic growth is moderating. If the central bank "pumps the monetary brakes" too hard, the risk is that they could nudge the economy further toward a deeper slowdown or a recession and flirt with stagflation - a very difficult period of high inflation, slow economic growth and accompanied by rising unemployment. While we are a ways from that reality, it is important to understand the potential risks in a restrictive monetary policy era, following massive government stimulus that we witnessed during the Covid-19 pandemic.

Investment Strategy – Staying Defensive:

The current investment environment has become more challenging, given the aggressive Federal Reserve's posture of a more rapid increase in interest rates and reducing liquidity in the financial system. Higher rates impact companies' cost of capital that have relied on low-cost debt to fuel their growth. Companies will also need to refinance their maturing debt obligations at a higher cost. Those that are highly debt-leveraged struggle during periods of rising inflation and interest rates with both their growth and profitability impacted. One of our long-standing securities research tenets is favoring investments that have strong balance sheets with below-average debt levels and a healthy component of cash / liquid assets. We apply this discipline during periods of economic expansion as well as those that are more challenging during business slowdowns.

For the period ahead, as inflation eats into profit margins of corporate America, we are doubling our research effort to identify investment vehicles that boast strong balance sheets, managements with proven records, good market share and bright earnings prospects along with the ability to increase prices.

We believe a well-diversified portfolio of high-quality equities remains the best investment strategy as interest rates continue to rise and bond prices are under pressure. We favor those companies that are in the defensive camp such as consumer staples, selected health-care and telecoms, along with those that fashion historical records of increasing dividend payouts to shareholders.

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