Client Letter – May 1, 2022

War & Peace

"You were given the choice between war and dishonor. You chose dishonor and you will have war."
– *Winston Churchill, 1938, in response to PM Neville Chamberlain's government accepting Hitler's seizure of the Sudetenland in 1938, believing it would avert military conflict*

Equity market conditions are undoubtedly difficult when investors pondering the initial months of a given calendar year ask themselves "Is this the worst four months to start the year since the 1970s, or since the 1930s?!" I don't have a precise answer to that question, but here's what I do know: after dropping 3.3% last week, the S&P 500 has fallen 13% in the first four months of the year, its worst start since 2020; the Dow Jones Industrial Average has slumped 9.2% so far in 2022, its worst start since 1939. Much of that carnage came in April, with the S&P and NASDAQ dropping 8.8% and 13.3%, respectively. Not even the likes of AAPL, TSLA and MSFT were entirely spared, despite all 3 reporting terrific numbers for Q1'21 in the last week of the month.

This might feel odd to clients who note that, despite a COVID pandemic that dragged on 6-12 months longer than expected, and a shooting war in Eastern Europe, the economy remains "robust" with unemployment near historical lows at 3.6%. So why do the financial markets seem to be suffering more than the Real Economy? The answers to complex questions are themselves typically complex and nuanced, but let's keep it simple: inflation. Why would one ignore a great labor market for workers, and instead focus on higher prices for fuel, food, autos, housing, to name a few? A recent article I read may hint at the reason, in that "unemployment is a some-people problem while inflation is an everyone problem."[1]

Throughout much of 2021 I was in the "inflation is transitory" camp, but I have changed my thinking. That is both because inflation persists to this day, and we have subsequently added to the mix an invasion and attempted annexation of Ukraine by Vladimir Putin, which has proven both very destabilizing and inflationary to the markets for energy, food and various other commodities. April's severe decline in equity prices reflects growing doubt amongst investors about the Fed's ability to tame inflation and engineer a soft landing for the economy. There was a widespread belief in 2021 that the Fed could curb levels of inflation not seen in 40+ years *without* dramatically raising interest rates and perhaps causing a recession; in other words, that they could have peace AND honor in the face of aggression. The Market is taking its cues from Winston Churchill and is waking up to the fact that the Fed is perhaps behind the curve, and as a result recession now feels far more probable. The debate is now whether it will be a mild one, or rather a severe, prolonged downturn characterized by the "stagflationary" combination of high prices and slow growth - a state of affairs that doesn't fit the definition of recession used by economists, but sure feels like one to consumers.

In their modeling of US economic conditions for 2022 & 23, the Strategas 'Weekly Economics Summary' published today assumes a 50% chance of US slowdown, 35% chance of recession and a 15% chance of an upside surprise. That sounds roughly correct to me, although I might place the odds of recession a bit higher.

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[1] "Why Everyone is Mad About the Economy" ~ Annie Lowrey - Apr 30, 2022 – *The Atlantic*

Investment Portfolios in Inflationary Times

The severe market declines that have occurred year-to-date might alarm some investors, but those folks should keep in mind that such swoons are not all that unusual. In fact, there have been no less than 25 four-month periods since 1992 when the S&P 500 dropped 10% or more[2]. What WAS unusual was the S&P's volatility-free 28.7% gain in 2021, a period during which the index never declined more than 5%. Going into 2022, given all the unknowns for the economy and coming after 3 straight great years for equities (as crazy as that sounds, given that one of those years was 2020), I was expecting some heightened volatility, and perhaps an "ugly" year. History tells us that equity gains of 25% annually are far above historical averages, and equity markets seemed overdue for a reversion to the mean by the end of 2021, and we accordingly took larger than usual capital gains and held elevated cash levels for many clients. In retrospect I'm glad we did it, although not sure all of you agreed with the strategy.

If I had to characterize the two most common criticisms I heard over the past two years, I would say that they were 1) "We're holding too much cash" and 2) "My cap gains in 2021 were awfully large". With rates normalizing off their historically low 2020 levels, there was the distinct risk that they would rise further & faster than many market participants were expecting. As such, I preferred cash over bonds, and where we did hold fixed income investments, we tilted towards shorter durations. As for stocks, by the end of 2021 the valuation on the S&P 500 was in the 25x earnings range, which was an elevated level not seen since the late 90s Dot Com days ~ a bubble that burst and was quite painful for a lot of companies and investors. So with both bonds and stocks rather expensive relative to historical levels, and with each asset class susceptible to rising interest rates, I felt that higher than usual cash balances and cap gains were appropriate in late 2021.

While it is true that portfolio adjustments made in 2021 have not provided clients complete insulation from the carnage in both stocks AND bonds in early '22, it does leave us well positioned to go bargain hunting. But I suspect we need not hurry: the Fed Funds rate currently sits at 0.25% - 0.5%, and many knowledgeable prognosticators believe that rate will need to rise to at least the 2.5% - 3.0% level (if not at as high as 5% or more) in order to tame inflation. This backdrop constitutes a significant departure from the environment over the past decade or so, where conditions in the financial markets rewarded investors for "buying the dip." While I feel good about the medium > long-term prospects for the stocks of well-managed, high-quality companies that offer products & services that consumers find delightful or essential, and we will look to add to such equity positions on weakness, I suspect that in 2022 patience is a virtue: my best guess is that such opportunities will be available to us (and perhaps at more attractive entry points) for many months to come. Our typical portfolio has plenty of equity exposure relative to client investment objectives in the event that I am exercising undue caution.

We look forward to catching up with all of you as the year progresses.

Adam Hamilton, on behalf of the Hamilton Group

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[2] *Barron's* - May 2nd, 2022 issue