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Quarterly Commentary
April 2022

What a quarter. My goodness, where to start? I begin prepping for the commentary a few weeks before the quarter ends and this quarter it has been particularly difficult to wade through all the noise and pull out the most important information to build a commentary that will add value to my client's understanding of the current market environment. Even my kids knew I was struggling with what to write. A few weeks back we were all sitting around a campfire down in Athens, and while I was supposed to be cooking hotdogs and tending to the fire, I was sitting there chatting away with myself attempting to figure out how to best sum up the quarter and the remainder of the year. The kids laughed again as earlier they had called out my internal monologue going public as we hiked through the woods enjoying my favorite activity to clear my head. The kids think my talking to myself is hilarious, especially the second time on the same day. I was discussing with myself that the campfire (actually more of a bonfire - I like my fires big) represented our real-time, albeit mostly ignored, economic experience. I'll circle back to the fire in a bit.

During my conversation with myself, I decided I'm going to set aside Russia, not because I don't think it's important, quite the contrary. Our government's actions such as using the SWIFT system for sanctions and the weaponization of the dollar (effectively encouraging the world to find an alternative reserve currency) will have dire economic consequences for Americans, the long-term severity of which would be difficult to overstate. The consequences of the Russian invasion of Ukraine and Washington's ill-advised response, as serious are they are, are still a distraction from the fundamentals of the US economy - a misdirection of sorts because the consequences of the Russian invasion and the economic consequences of missteps by our Washington leadership are not imminent, meaning likely to take full painful effect within the next 6 months, though the symptoms may begin to present during that time. However, the data pointing to the degradation of our economic situation is right in the faces of those who care to look, and the consequences have already begun - in fact, they are all around us.

The past is prologue

To understand our current situation, we need to step back in time. In 2008 the words Quantitative Easing went mainstream when, in November of that year, the Federal Reserve deployed $300 Billion in Treasury purchases as part of QE1. This action flooded banks with ***excess liquidity (cash in their reserve accounts) which in turn can increase the money supply i.e., the***

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dollars circulating in our financial system. The excess liquidity put a downward influence on short-term interest rates, or the borrowing rates between banks, known as the federal funds rate. It took the Fed more than a year to deploy $300 billion in 2008. ***In response to COVID, the Fed purchased $300 billion in Treasuries in just three days.***

In 2010, the Fed believed QE2 was required. It took the Fed nearly 8 months to buy $600 billion of US Treasuries. ***During the COVID outbreak, the Fed made $600 Billion in additional Treasury purchases in six days.***

And, in 2012, QE3 took the Fed 22 months to carry out $1.5 Trillion in Treasury purchases which until COVID was considered an epic program, but during COVID ***they matched this $1.5 Trillion in Treasury purchases in just over a month.*** And ***then they continued buying treasuries at a rate of $80 billion per month, or nearly $1 trillion a year for the next year and a half through late 2021 before finally starting to wind the program down.***

The sheer insanity of the printing over the past two years while much of the time the economy was closed preventing people from spending money, created the very definition of demand-pull inflation – too many dollars chasing too few goods. The likely results of the Fed's actions were so obvious it led to my openly mocking the insanity of both the Fed and the Treasury throughout last year's commentaries as Jerome Powell and Janet Yellen insisted the inflation was "transitory". The Federal Reserve and Treasury messaging is political, not financial. I guess if they stick with transitory on a long enough timeline, inflation will indeed go away, proving the transitory argument. But I digress. The Fed has been wrong on an epic scale for 14 years and we are supposed to believe they can drain the excess liquidity and navigate a soft landing in the economy? A soft landing - something which the Fed has never in its history pulled off. I don't think so. I was probably more patient than I should have been, but they lost me at transitory.

As I watched the bonfire in Athens, which in my excitement to make it bigger, became too large to be close enough to cook hot dogs on our 3-foot-long pokers, it occurred to me in my discussions with myself that the Fed had done something similar. The monetary timber the Fed has piled on over the past 14 years, but especially over the past 24 months has created a raging fire. The Fed knows they need to pull logs out of the fire to avoid burning down the cabin, but at this point, it's too hot to pull logs out without significantly hurting someone. What is the Fed to do? They must choose - to watch the fire grow and burn down the cabin and surrounding acreage of woods or create immense pain for someone as burning logs are pulled out of the fire.

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Put simply, the Fed is trapped. If the Fed does nothing and prices spiral up into an inflationary bubble, financially destroying the 55% of Americans who live paycheck to paycheck, this will reduce demand for goods while increasing the cost of materials and that leads to corporate profit declines, meaning not just the bottom 55% are injured, but also the equity owners, i.e., stock market investors. Or the Fed could significantly increase rates and crush demand by choking off the free money resulting in injury to all homeowners and individuals invested in the equity market. Either option damages you and me. The equities market is not in a position in the near term to be a "winner" regardless of which decision the Fed makes. The Fed's choice appears to be binary.

Inflation is real. Inflation is not now and has never been transitory. The printing of money was and is simply wallpapering over the cracks in the economy.

Cracks in the Economy

One of the most fundamental disconnects currently is between stocks and the economy. Historically when stocks have deviated from the underlying economy, the eventual resolution is lower stock prices. While stock prices can deviate from immediate activity, reversions to actual economic growth eventually occur. This is because corporate earnings are a function of consumptive spending, corporate investments, imports, and exports.

- Most of the growth in the US over the last decade was due to a variety of artificial inputs which are not indefinitely sustainable.
- While the interventions certainly salvaged the economy from a more prolonged recession in 2020, they also made the economy more fragile by dragging forward future consumption.
- As that liquidity reverses, and ***assuming interventions don't repeat***, the economy will reverse course rapidly.
- Over the past 24 months profit margins could be used to justify higher market returns, but high inflation and a tight employment market will soon compress margins.
- Already high price-to-earnings multiples are unlikely to be able to pick up the baton from weaker margins. Price-to-earnings ratios are likely to fall.
- The Michigan Consumer Sentiment Index (MCSI) **sank to a new decade-long low** in late March 2022. Over the past 50 years concerns about falling living standards were only higher during the worst recessions in this period, 1979-81 and 2008.
- Reversal of expectations of economic growth has already begun to be reduced with Goldman Sachs reducing its Q1 2022 GDP forecast to 0.5%. Folks, that's almost negative

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on the back of Q4 which showed 5% GDP growth. ***After revisions, I would not be surprised if come December, we find a recession began in Q2 2022.***

- In January 2008 during Chairman Bernanke's testimony to Congress he stated, "The Federal Reserve is not currently forecasting a recession." This statement is not unlike what we are hearing from Powell today. In hindsight, the official recession had already begun in December 2007.
- Over the summer of 2007 the S&P sold off 11.91% as the credit crisis took hold. The market scrambled all the way back to just barely make a new high in October before selling off 57.69% as the recession took hold in 2008.
- Like 2007, we've endured a nasty sell-off as the early indicators of recession have caused those who are closely paying attention to revise their investment strategies, but one last time, the "buy the dippers" came in and created a nice bounce through the start of the quarter.

In a bear market he who loses the least wins

"Ok, ok," I hear you saying, "I'm convinced. So now what?" First, we need to recognize where we are in the market cycle. Consider the chart below (Chart A) courtesy of Zero Hedge.

Chart A

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Understanding change is occurring is what is essential. Unfortunately, the reason investors 'get trapped' in bear markets is that when they realize what is happening, it is far too late to do anything about it. That's where I come into play. I don't want to be the most negative person you talk to each quarter, but I have a responsibility to evaluate the market on your behalf without rose-colored glasses.

Bull markets lure investors into believing 'this time is different.' When the topping process begins, that slow, arduous affair gets met with continued reasons why the 'bull market will continue.' For this reason, a review of historical charts leading into recessionary times shows an initial scary sell-off followed by a bounce driven by those who have successfully bought bounces throughout the duration of the bull market but haven't noticed, for one reason or another, the fundamentals have changed. Greed and Normalcy Bias are most often the culprits in bad decision-making at market tops. Normalcy Bias is a powerful cognitive bias that leads people to disbelieve or minimize threat warnings causing individuals to underestimate the likelihood of a negative outcome, when it might affect them, and its potential adverse consequences.

Chart B

Chart B, above, is the S&P500 since August of 2021. This is a zoomed-in timeline only covering 8 months. This chart shows what may be the first wave down and first bounce up, not unlike 2007.

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Just below, you will find Chart C. This expanded chart from 2007 shows roughly 26 months and the 3 waves of selling with several bounces until capitulation when investors gave up all hope. Chart C overlays in a similar fashion to all past significant recessionary periods - not exactly in scale and timeline, but close to the rhythm of the way the market moves in downward cycles.

Chart C

So, back to chart A. Where are we? I believe we are in the Anxiety stage and have just experienced the first bounce up. Investors feel in their gut something isn't right, but unless they are someone who dedicates 70 hours a week to the market, they have difficulty putting their finger on what exactly the concern should be. After all, avoiding the cognitive bias we all struggle with can be a challenge for even the most ardent professional.

Warren Buffett became one of the most successful investors in the world by resisting the bandwagon effect. His famous advice to be greedy when others are fearful and fearful when others are greedy is a denouncement of this bias. He has also been excellent at avoiding confirmation bias, by not only listening to those who agree with him but seeking out those who disagree and who may poke holes in his investment theses. Investors feel better when they are investing along with the crowd. But as Buffett has proven, an opposite mentality, after exhaustive research, may prove more profitable.

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Recessionary periods almost always indicate a change in market leadership. In 2000, the market leadership shifted from Tech and Large Growth to Value, Small Cap, Mid Cap, and International. Following the 2008-2010 recessionary period, leadership shifted back to large-cap growth, especially Tech. I believe we are in the midst of such a paradigm change so I have begun to push client portfolios toward value.

While growth is exciting and certainly has been the place to be invested over the past decade, Nobel Prize laureate Eugene Fama noted from 1927 through 2019, over rolling 15-year time periods, value stocks have outperformed growth stocks 93 percent of the time. The core of my value investment theses is that an inflationary, rising rate environment raises the cost of capital for Growth companies and will expose those companies who were able to paper over weak or struggling business models with cheap money. As Buffett said, “When the tide goes out, you see who is swimming naked.” Cheap money has allowed companies to make poor decisions, take risks they shouldn’t, and cover up problems on their balance sheets. When that cheap money goes away there will be a few companies everyone thought were strong that turn out to be “swimming naked.”

Over the past few quarters, I have been focused on looking deeply through each client portfolio to minimize risk while slowly leaning toward value. In volatile markets, it is important to stay nimble and recognize when the data changes (could be economic data or data within individual investments), undermining your operating investment theses. There were two unique trades that impacted many of our clients during Q1.

Financials

I spent most of 2021 overweighting financials, in fact buying them all the way through January because financials outperform in a rising rate environment. As the Fed indicated more and more rate hikes, now indicating possibly raising 50 basis points at the next three meetings (an extraordinarily high rate of increase) the likelihood of a recession has exponentially increased. The pressure of rising rates increases default risk for banking clients. If consumers and businesses are unable or unwilling to repay their debts, it will result in losses for the banking institution. In addition, the Russia-Ukraine situation has exposed potential counterparty risk in debt repayment. We don’t know who owns Russian debt or investments linked to Russian debt. Should Russia decided not to repay its debt, it’s likely the US banks will have at least some exposure to that default. Over in China, they are dealing with the Evergrande default. Evergrande currently has $22.7 billion worth of offshore debts, including bonds, project loans,

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and private financing, many of which are held by US banks. The US Federal Reserve has warned that stresses in the Chinese real estate sector from Evergrande's debt crisis could spill over to the US.

The risk-reward paradigm no longer favors an overweight in financials. This is a much quicker change than I typically make, moving from overweight to underweight, but I believe it is critical to acknowledge when the basis that supported the original investment no longer exists. Most clients are now underweight financials.

Parnassus

Parnassus Core Equity is a top 3% performer over the past decade and a top 1% performer over the past 15 years, averaging 11.83% annually, which doubled an investment every 6.1 years. For many years our clients have benefited greatly through their ownership of Parnassus. Over the past 3 months, Parnassus has increased its exposure to Microsoft and Alphabet to nearly 14% of the fund. This increase in tech exposure conflicted with my desire to trim large-cap tech within client portfolios. In addition, Parnassus is a 100% equity fund with significant gains in many client accounts. I took the opportunity to rebalance Parnassus by selling roughly 35% for most clients. We don't want to completely eliminate a fund with a track record such as Parnassus which has thrown off no sell indicators. In consideration of the current market environment, the need to reduce stock exposure, and the need to reduce tech exposure, the timing made sense to proactively harvest gains from an outstanding long-term holding.

Looking forward

Cash balances have been allowed to build since late last year. I completely understand the argument that during inflationary environments cash is guaranteed to lose due to the degradation of purchasing power. When I hear that argument, I point to the data of Q1. In Q1, the Nasdaq fell 8.9%, the S&P fell 4.6% and the ten-year US Treasury notes (investor's "safe" money) fell 5.5%, the worst quarterly performance ever for those bonds. All those investments lost principal ***and*** purchasing power. Cash was the least ugly, only losing purchasing power. While cash is not an investment class we want to hold long-term, there are times when greater allocations to cash make sense.

With the market near all-time highs and seemingly out of steam while the Federal Reserve maintains a strong commitment to significantly increasing the cost of capital, it makes sense to have some dry powder. Cash not only defends against principal loss, but gives investors the

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opportunity to take advantage of significant selloffs when companies who don't deserve to be sold off get "thrown out with the bathwater." During a significant sell-off, an investor with cash is in a much stronger position than an investor who is fully invested and must sell a depressed position to generate capital to initiate the new holding.

As evidenced by the Q1 performance of the 10-year treasury, in a rising rate environment, bonds will lose money. In addition to trimming equity exposure, I intend to limit fixed income exposure, opting instead, over the short term, for cash. The Vanguard Balanced fund was recently sold in its entirety for the purpose of reducing tech exposure and perhaps more importantly, reducing exposure to longer-term bonds which will certainly struggle in the coming period.

I am always looking for individual companies that get unfairly or unreasonably beaten down in price. Recently, solid opportunities in individual securities have been difficult to come by. In a rising rate, inflationary environment, there are three identifiers I look for first when evaluating potential new investments:

1. Does the company have a strong balance sheet? Does the company hold a lot of cash and has it managed its debt by limiting interest rate risk?
2. Can the company easily pass on input costs to end consumers? I'm looking for companies that have inelastic demand. For example, it is easier to pass on input costs through higher prices to a consumer who smokes cigarettes or drinks alcohol than to the consumer who already has a television and can delay or forgo an upgrade.
3. Does the company I'm evaluating have an ongoing capital-intensive business? Examples would be automakers, railways, and airlines. These types of companies will face continued price increases with each capital investment they make whereas consulting, software development, finance or any type of virtual business would have a very low need for facilities or equipment to invest in or maintain. We seek to avoid those companies that have ongoing and significant capital expenses.

Additions to portfolios over the coming quarter are expected to include broad based positions allowing everyone to remain highly diversified. Near-term additions are likely to include an ETF focused on exclusively value investments along with investments providing exposure to cybersecurity.

Our overweight to Aerospace, up 8.6% YTD, and Energy, up 40.74% YTD, has allowed most clients to outperform their respective indexes by a couple of percentage points over just the past 3 months. Additional Aerospace, Defense, and Energy are likely to be added in the coming months.

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All in all, over the past quarter we played solid defense, trimmed positions that were not working, added to positions that should prove relatively strong in an inflationary and rising rate environment, and continued to batten down the hatches for storms ahead. While I always seek to do better, performance results were in line with my expectations considering the significant market dislocations. This is going to be one of those years and I look forward to helping you navigate the challenging market environment. I'm always available for in-person meetings or conference calls if there are any issues you would like to discuss.

I look forward to working with you through the coming quarter and the remainder of the year.

Sincerely,

Michael R. Harding, CFP