MARKET COMMENTARY **April, 2022**

Conditions shifted rapidly the first quarter of 2022 and the macro environment investors face today is the most difficult in some time. Under pressure from rising inflation and interest rates, a born-again hawkish Fed, and the Russian invasion of Ukraine, the S&P 500 declined 5% in the 1Q after being down more than 12% at the low. Inflation was already running hot before Ukraine, but the war has sent commodity prices soaring and disrupted a global supply chain still in Covid recovery. The Bloomberg Commodity Index shot up 28% in the first quarter with most of the damage in food and energy (WTI +33%, Brent +39%, U.S. retail gas prices +43%, Natural Gas Futures +51%, wheat +30%, corn +26% and soybeans +22%). Not surprisingly, investor sentiment is now very bearish. Last week the American Association of Individual Investors (AAII) reported that bullish sentiment, those who expect stock prices to rise over the next six months, fell to 15.8%, the lowest level since 1992. From a contrarian perspective, pessimistic individual investor sentiment is a positive signal and this extreme reading provides some encouragement that the equity secular bull market may not be over despite its current challenges. According to Bank of America, when the AAII Bulls moves below the 20% level the S&P 500 has generally had strong returns for the ensuing one month to two years following the signal.

Currents and Crosscurrents

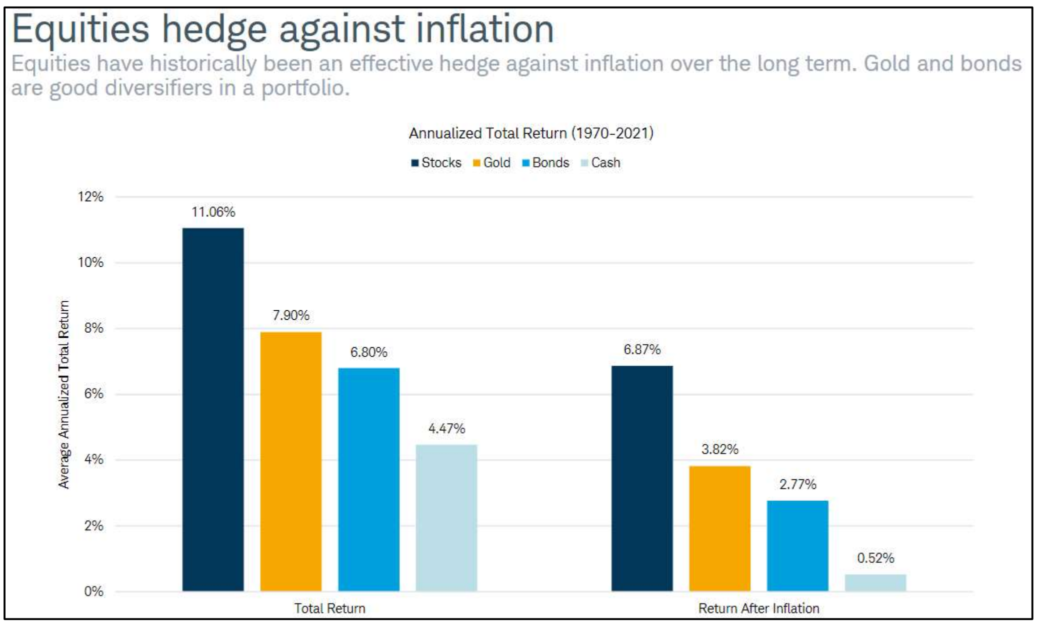
In almost 40 years in the business, we cannot recall a period in which so many extraordinary things are going on simultaneously in the world: the ongoing Covid -19 pandemic which has been one of the most severe in modern history and continues to have a widespread impact on health and to cause social and economic disruption around the world; the Russian invasion of Ukraine which threatens to be the worst war in Europe since WW2 and has changed the face of Europe and disrupted the world order; a rapid rise in inflation and interest rates at the same time as rising fears of global slowdown and recession; and in the midst of the above a hawkish turn in Fed policy following a period of unprecedented central bank stimulus.

Despite all the turbulence, a recession in the U.S. is unlikely over the next couple of years and inflation may now be peaking but remain at elevated levels over the next 4 quarters or so. The International Monetary Fund just updated its economic outlook and said the war in Ukraine will lead to a significant slowdown in global economic growth this year, cutting its global forecast to 3.6%. Europe takes the brunt of the hit and could face a recession. Growth is also slowing in China thanks to its draconian zero Covid policy and the ongoing massive lockdown of Shanghai, its largest city. As a result of these events, the European Central Bank has limited scope to tighten monetary policy to address inflation and China has already become more accommodative. In contrast thanks to a fundamentally strong U.S. economy anchored by a historically strong consumer and corporate sector, the Fed has headroom to raise rates at a rapid pace over the next two quarters.

Moreover, a slowing global economy will serve to temper demand and restrain inflation. A strengthening dollar (up 10% over the past year reflecting the relative strength of the US economy and now made more attractive by higher U.S. bond rates) increases dollar purchasing power and puts downward pressure on domestic inflation. Earlier this month, yields on China's 10-year government bonds fell below US

Treasury yields for the first time in 12 years. This inversion of bond yields has come about as China eases monetary policy to support its slowing economy (a slowdown caused by its own inscrutable zero Covid strategy) as the Fed raises rates to combat inflation here at home. And until U.S. inflation comes down and Chinese growth picks up again, Treasury yields could move higher relative to Chinese government bond yields.

The bond market has already done much of the Fed's work. The 10 Year has risen to 2.95% while the Fed funds rate remains at .5% and the yield curve maintains an upward slope. The equity market has successfully navigated Fed rate hike cycles and rising rates in the 1980s, 1990s, and more recently in the 2017-2019 soft landing. While the consensus is for another 200 basis points in rate hikes over the next 12 months, we believe the Fed will become increasingly flexible and attune to growth after it gets a couple of rate hikes under its belt. It has already changed the environment simply by jawboning the market over the past month. The Fed will likely pause if inflation retreats and global growth slows as forecast or change course if the yield curve inverts signaling recession. We expect the Fed to pay close attention to financial conditions and the need to nurture growth and to remain flexible in its policy.



Source: Schwab Center for Financial Research

The Era of Globalization Comes to a Close

Finally, the era of economic globalization, the overarching trend since the end of the Cold War of an increasingly synchronous and coupled global economy, has ended. The trend goes back to the liberal world order established in the aftermath of World War II and its framework of international economic governance including the WTO, the IMF, and World Bank which promoted "Openness" with a goal of free movement of goods, services, technology, and capital across borders. Economic liberalization, or Openness, a global economy without borders, sought to replace what was seen as the flawed economic and political nationalism of the first half of the 20th century.

The Covid -19 pandemic highlighted the weaknesses inherent in complex global supply chains, creating supply shortages and now the war in Ukraine is endangering food and energy security. Nations and their citizens have quickly realized the downside of an integrated global economy and supply chains. In the words of Oaktree Capital's Howard Marks:

"The availability of ever-cheaper goods like cars, appliances and furniture produced abroad was a major contributor to the benign U.S. inflation picture in this quarter-century. On the other hand, offshoring also led to the elimination of millions of U.S. jobs, the hollowing out of the manufacturing regions and middle class of our country, and most likely the weakening of private-sector labor unions. The recognition of these negative aspects of globalization has now caused the pendulum to swing back toward local sourcing. Rather than the cheapest, easiest and greenest sources, there'll probably be more of a premium put on the safest and surest."

Peak global trade was actually reached about 6 years ago, as trade abuse, intellectual property theft and one-sided benefits dismantled the ideal of a level playing field. The ongoing trade war with China is now but a part of a broader geopolitical struggle between our two nations and systems. In response to its invasion of Ukraine, the U.S., Europe and their allies seek to isolate the Russian economy and remove its products from global trade. The era of globalization and open trade has come to a close, returning almost full circle to the Cold War era. The framework still exists like an old edifice but the ideal of global free trade, openness, and economic world order has collapsed.

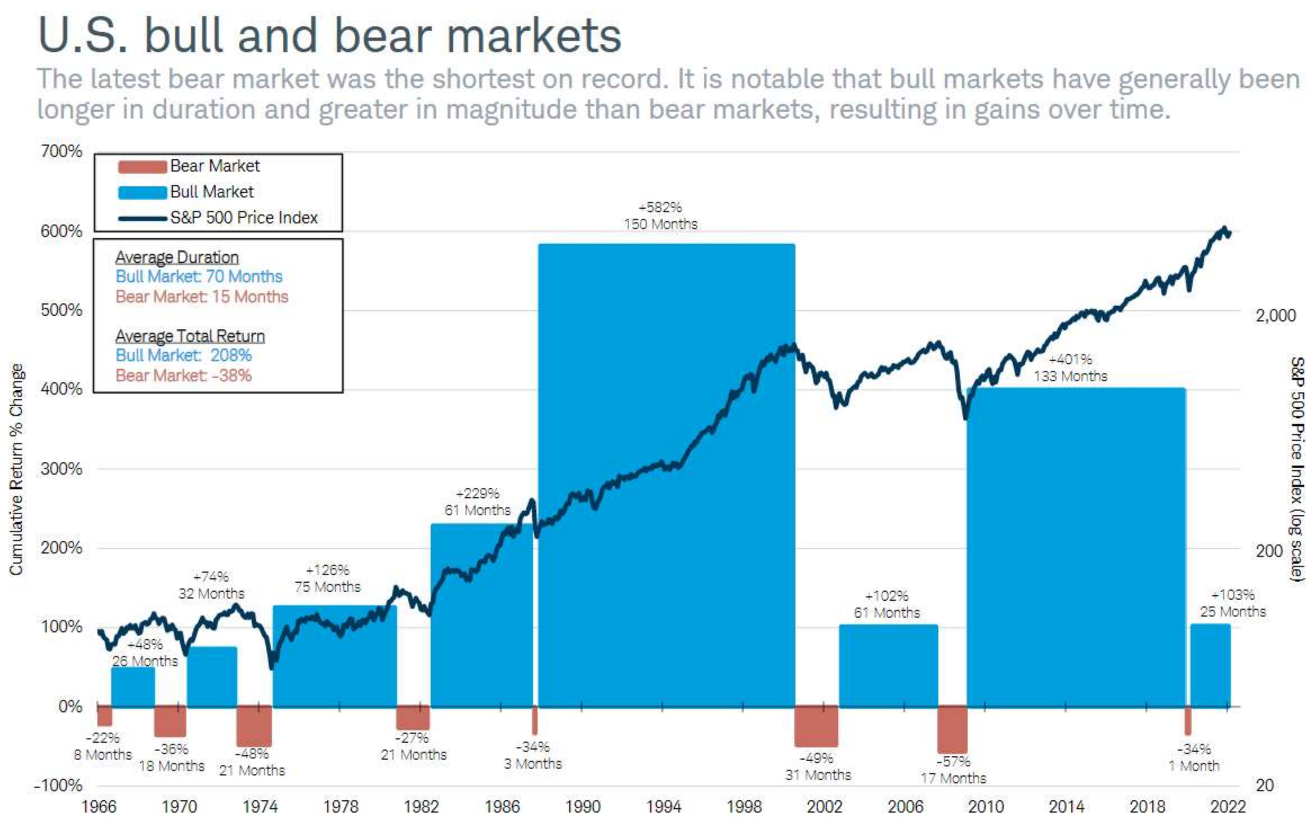
American Exceptionalism

The U.S. begins this new era with both unmatched strengths and resources and glaring vulnerabilities. It relies on the Chinese economy for much of what it consumes and its industry relies upon. The island of Taiwan off the China coast is home to the biggest and most technologically advanced semiconductor manufacturing capacity in the world and much of our critical chip production. The three essential building blocks of the modern economy are semiconductors, oil and food. The U.S. has been the global leader in all three: we were the largest producer of oil and gas in world in 2019 and could easily regain the position; the U.S remains a huge agricultural producer and the top global exporter (North America is blessed with a disproportionate share of the world's best agricultural soil. It is no coincidence that the U.S. is one of the few countries that's a net exporter of food – North America has 17% of the world's arable land, but less than 7% of the world's population); the semiconductor industry was invented in Silicon Valley and the U.S. remains far and away the leader in intellectual property and advanced technology and chip design, and is trying to regain the manufacturing leadership it previously held.

America, for all its internal discord and a fraying sense of national identity and citizenship, retains the strengths of its constitutional foundation, rule of law, transparent accounting, proven financial institutions, and faster growth market economy that provide unique advantages. In shifting and uncertain times global capital is looking for the safest harbors and the U.S. remains the best investment and safest port. There a few, if any, alternatives.

We think it is particularly important for investors to note that we live in a world where the largest American corporations are far and away the most powerful, most well-funded, most capable corporations in modern history. They command incredible market shares in vital global industries; they are the biggest corporate entities the world has ever known. Moreover, within each of these mega cap companies (e.g. Alphabet, Amazon, Apple, Microsoft and Berkshire Hathaway) there are 10-20 big, significant standalone entities. They buy big, valuable companies every year and fold them into the leviathan. In the times that we have been investors, we have never seen anything like them. They are a unique store of relative value in the current investment landscape.

This is a world fraught with worry and questions. To us, in this volatile environment, we believe that the most important lesson being learned right now is that Fortress America, the American dollar and American corporations are the singular most valuable store of wealth in the world. So, when the market chooses to rerate valuations of various industries (tech seems to be the flavor of the day), we think it is well worth remembering that these are the gems of the US economy. We added up the cash and cash equivalents total of the 10 largest US corporations as measured by stock market capitalization and the total was $711 billion dollars of bedrock strength. These dominant US corporations are the linchpin of the US economy, the home of innovation. The American system solves problems, makes products and services quickly and with quality, pays attention to clients' needs, moves quickly to adapt. American business competes every day; creating a better answer to logjams and inefficiencies and shortages is a fundamental strength of the US economy. The US economy and corporate America are a difficult team to bet against. We recognize that the world is going through a tumultuous period but we remain cautiously optimistic that America can thrive in this challenging new era.



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