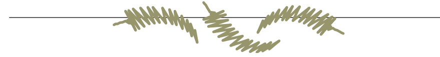
C Y P R E S S

Asset Management, Inc.



MARKET COMMENTARY **July, 2022**

The S&P 500 dropped 20% in the first half of 2022, the worst start to a year since 1962. The drawdown in assets was broad and not confined to equities. Almost everything went down. According to BAML, bond losses were the worst in decades as long-term treasuries fell 20% and investment grade corporate bonds declined 14%. And while international equity markets did somewhat better in local currency, the *MSCI World ex-US* benchmark returned a negative 18.2% in US dollars. Bitcoin fell more than 50% as cryptocurrencies and other speculative assets collapsed. Even gold is down for the year and has not provided much of a safe haven from inflation or global turmoil. As we discussed in our last commentary, investors today face one of the most challenging environments in many years. The highest rate of inflation in the US economy since the early 1980s, the ongoing war in Ukraine, and a continued lockdown of major manufacturing centers in China and still persistent global supply chain issues all present a formidable headwind to global growth and financial markets. We need to see improvement in at least one of these areas for stocks to regain their footing. However, we do not believe all is lost and see signs that Chairman Powell and the Fed may be starting to turn the tide in the fight against inflation.

The Fed, Inflation, and the Economy

There are an increasing number of trends that indicate inflation is cooling: 1) oil prices are down 20% from a high of $125, while average retail gas prices have declined nationally from $5.00 a gallon in early June to $4.49 according to the latest figures from the AAA National Gas price survey; 2) other commodity prices have plunged as well including copper, aluminum, wheat and corn , and the GSCI Commodity Index is down roughly 12% since the Fed raised rates by 75 bp on June 15; 3) the dollar as measured by the US Dollar Index (DXY) is up 12% thus far in 2022 to the highest level in **20 years** – a strong dollar pushes down inflation in general and commodity prices in particular; 4) U.S. 5 Year inflation expectations have dropped 100 bp from roughly 3.6% to 2.6% in the last 3 months, half of that occurring after the June Fed meeting driven by a decline in the 10 year treasury yield from 3.5% to 3%.

Global growth is also slowing as the Fed, the ECB, BoE and central banks from Australia to India are moving to raise rates and tighten monetary policy. We believe the US economy can avoid a recession on the strength of a strong consumer, healthy banking system, and strong corporate balance sheets. But it has already entered a slowdown and we are not likely to see better than 1%-2% growth in the second half of the year. Money supply (M2) growth in the US has slowed dramatically to 6% and will slow further as the Fed raises rates and shrinks its balance sheet in the second half of the year. Money supply growth is now running below the rate of nominal GDP. Economic activity and ultimately inflation will be restrained by the decline in the growth of money.

The first stage of this process has seen a drawdown in financial assets and equity valuations. Unprecedented monetary and fiscal largesse reached a point where bad capital was crowding out good capital. In general, the more expensive the stock, the more speculative the asset, the greater the decline. Growth stocks not supported by profitability and new asset classes like cryptocurrency with no underlying tangible value have been decimated. No doubt some gems have been discarded in the market carnage but on the whole a necessary cleansing has occurred. The second stage is the plunge in

commodity prices and a historically strong dollar that we noted above, much of which has taken place in the last 6 weeks. What remains is a much more attractively valued S&P 500 in a difficult macro environment. The final stage is a mid-cycle economic slowdown that is already underway and may be difficult to differentiate from a shallow growth recession: a slowing in new jobs, a rise in unemployment, slower wage growth, and a downturn in the housing market.

August 1982 and the Volker Bear Market

Forty years ago in August of 1982, Ronald Reagan was in his second year as President, mid-term elections were looming, economic times were hard and we were in a Bear Market. Inflation was high and unemployment was approaching double digits. The stock market peaked in late November 1980 just three weeks after Ronald Reagan was elected. Inflation was then at 13.6%.

In August of 1979, Paul Volker had been appointed as Chairman of the Federal Reserve by President Jimmy Carter. With inflation running double digits (it peaked in the summer of 1980 at 14.7%) Volker went all in to break the back of inflation. He raised the Fed Funds rate from 10.5% to a range of 19% - 20% where it remained throughout the summer of 1982. This took a toll on both the stock market and the economy. It contributed to the recession of 1981-82 and national unemployment over 10%. Inflation finally started coming down, but was still running above 7% in the summer of 1982.

The Bear Market of 1981 -1982, “Volker’s Bear Market”, then unexpectedly bottomed on August 12, 1982, down 27% from its peak. No one saw it coming. Unemployment continued to rise, hitting 10 % for the first time in September and reached 10.8% at the end of 1982 which was the high-water mark in post WW2 history. After bottoming, the market fully recovered its prior peak in less than 3 months. The market then continued its upward trend for another 11 months, and peaked in early fall 1983 up 70% from the bottom of the bear market. By the time the market peaked inflation had been reduced to 2.8%.

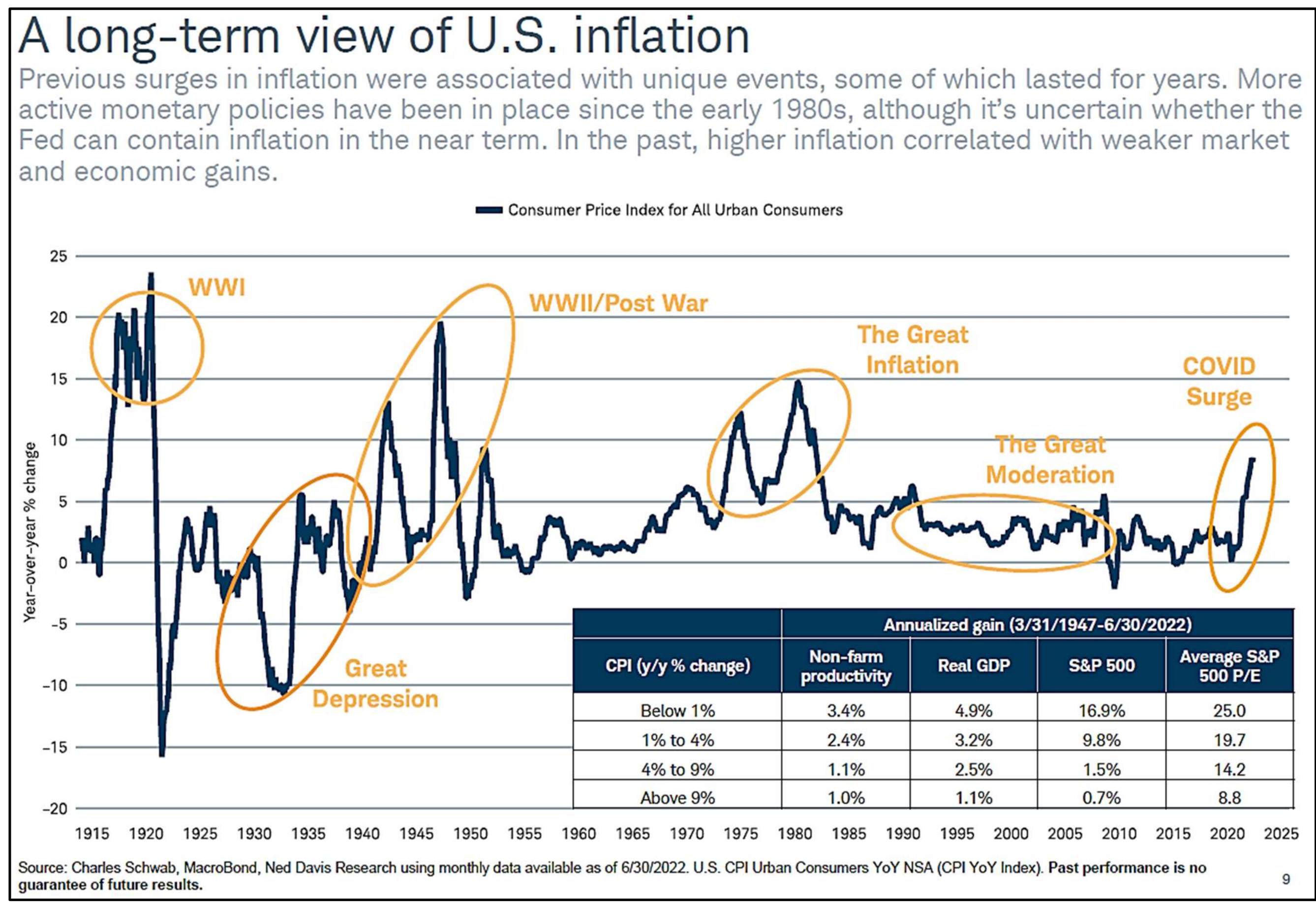
The quick and unexpected recovery from Volker’s Bear shows that economic hardships do not always require low interest rates or government stimulus to aid recovery. This Bear Market also teaches that even in the midst of double-digit inflation and unemployment it is still better to be invested than not. This was a time where it was better to be in the market a year too early than a month too late. For investors the key to long term returns is time in the market, not timing the market.

Summary

We face yet another watershed moment in the market. Much like 1982, Powell’s Fed has risen to the occasion. Higher rates to stifle inflation, tighter money policy to mop up all the historically excessive liquidity from Covid relief policies should eventually bode well for the economy, corporate earnings and ultimately stock prices. As noted, in this case the medicine is likely bitter, the cure is not the easy way out. But the crucial lesson gleaned from this market meltdown is one we have seen before and yet another reminder of how and why we construct Cypress portfolios. Much as we saw in the 2000 market following the dot.com tech bubble, it is more important than ever to own companies with proven businesses, that make good money, and have fortress strong balance sheets and enviable cash flows and can withstand a difficult and volatile environment. The stock market will bottom before skies brighten, before reported inflation returns to benign levels and before a slowdown or a recession is over. The companies we own make vital, desirable, valuable things and provide services basic to our domestic and global economy. They are market leaders that will come out of this in an even stronger position. Market declines like this are both challenges and opportunities for dominant companies and long-term investors alike. The equity

market is much more attractively valued than it has been in a couple of years and presents a good long-term buying opportunity.

But as rates rise and money tightens, more speculative investments will likely continue to decline in value and lack appeal. Once again, investors learn – or relearn - the lesson that quality reigns supreme. A rising cost of capital, higher hurdle rates, greater scrutiny and a decline in the availability of new speculative capital all mean that high quality, dependable stocks – stocks that offer long term growth at a reasonable price– will be relatively more highly valued. We believe our Cypress portfolio remains well positioned for the current challenges and for the future and look forward to the opportunities that this market presents.



	Annualized gain (3/31/1947-6/30/2022)			
CPI (y/y % change)	Non-farm productivity	Real GDP	S&P 500	Average S&P 500 P/E
Below 1%	3.4%	4.9%	16.9%	25.0
1% to 4%	2.4%	3.2%	9.8%	19.7
4% to 9%	1.1%	2.5%	1.5%	14.2
Above 9%	1.0%	1.1%	0.7%	8.8