April 12th, 2022

Spring Quarterly Commentary

"Russia has never hatched, is not hatching and will never hatch any plans to attack anyone. Russia is a peaceful country, which is interested in good relations with its neighbors... We think that this hysteria, which is being whipped up in the U.S. and British media, in the Ukrainian mass media and is supported by Ukrainian politicians, including the head of state, is absolutely inadmissible."

Kremlin spokesman Dmitry Peskov
November 30, 2021, as quoted in China Daily

The less-good-times for markets we have been warning about arrived in the first quarter. Rising inflation had already placed investors onto an uncertain path, which turned outright tumultuous on February 24th, when Vladimir Putin surprised everyone by invading Ukraine[1]. The invasion by itself would not likely have hugely impacted the U.S. stock market. However, the West[2] in turn surprised everyone by unanimously implementing rather tough sanctions on Russia. Western investment in Russia is relatively limited, enabling most companies to pull out of the country with only a three to five percent drop in sales as the result. A much bigger impact was felt in commodity markets, which we will discuss in a minute.

[1] Well, Putin surprised everyone except U.S. Intelligence, which had vocally warned of invasion, thereby scoring a big win after a couple of tough decades.

[2] The "West" these days is less a geographical designation and more a political orientation, as it generally includes South Korea and Japan.

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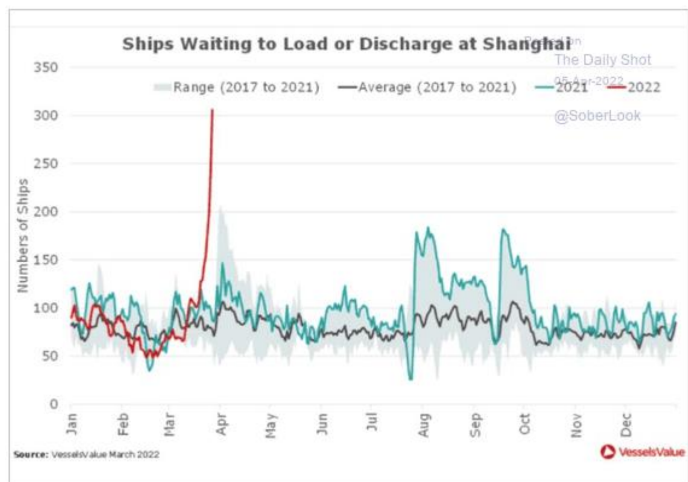
The invasion of Ukraine brings geopolitical risks as well as economic ones. We are less worried about World War III, but we are very worried the battle lines are hardening for what historians might eventually call Cold War II (Russia-China vs. Allied Democracies). Just prior to the invasion, as the Olympics opened, China and Russia announced a "No Limits" strategic partnership and China has since refused to sanction or even condemn Russia's actions[3]. Meanwhile, China will now be buying Russian oil and gas at a nice discount. It will be difficult to respond if China further collaborates with and supports Russia. Western companies would not willingly pull out of China and would fight sanctions tooth and nail. An economic decoupling with China is unthinkable. But if relations continue to deteriorate (perhaps over Taiwan) it is certainly not impossible.

Another ominous sign is that Russia and China are conducting more and more cross-border trade in their own currencies, insulating them from both current and potential U.S. sanctions and lessening the global demand for dollars.

There is, however, a bigger threat to the global hegemony of the dollar: U.S. and allied countries froze Russian central bank foreign reserves held by banks within their jurisdiction. This means much of Russia's $643 billion foreign reserves are likely frozen, depending upon where they are held. Can you think of another large and not-so-friendly-to-the-U.S. country which may now be more reluctant to hold U.S. dollars in the future?

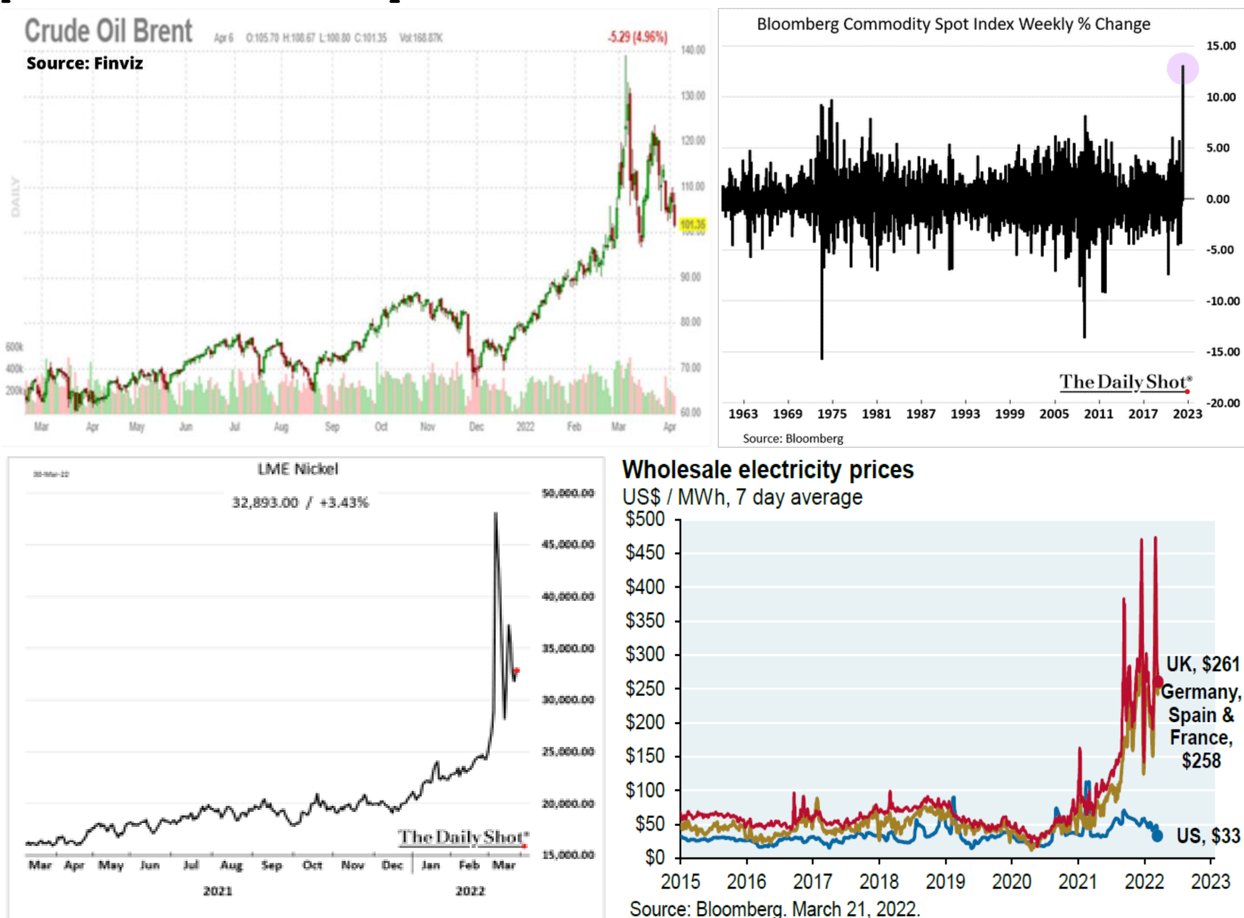
Speaking of China, it is now dealing with its own major problem: COVID. China has famously enacted a draconian, but to this point largely effective, Zero Covid policy, with massive lockdowns and aggressive testing at the first sign of infections. Chinese leadership seems terrified of a serious outbreak, and not without reason. Only 50% of those older than 80 have been vaccinated and domestic vaccines



[3] China is far from the only country unwilling to upset Russia by joining the sanctions/commendations, but it is the most concerning.

are less effective against new variants. Currently, the entire city of Shanghai, 25 million people, is on a lockdown that keeps getting extended[4]. This illustrates how China's Zero Covid policy will continue to create global supply chain issues. Many Chinese factories which produce global products are currently shuttered or unable to effectively ship their goods. These snarls are inflationary and will be even more so if they (along with geopolitical tensions) contribute to "de-globalization" (companies pulling back from overseas production).

As noted earlier, the biggest economic impact of the war in Ukraine and associated sanctions is in the world of commodities. Russia is a large player in energy markets, especially in Europe[5], and a huge supplier of metals. Already on the rise before the war due to rapidly increasing energy demand, the global benchmark for oil has been on a wild ride, spiking to $140 per barrel before recently retreating to around $100. These events contributed to the largest weekly increase in commodity prices in at least 70 years.

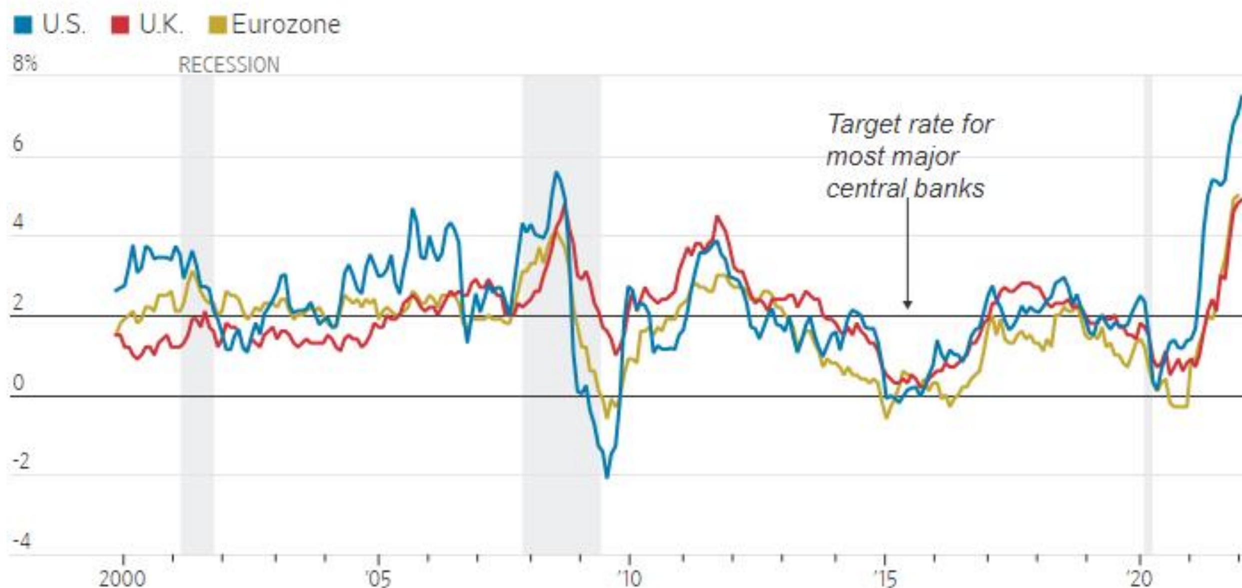


[4] To put this in perspective, 25 million is approximately the entire population of Australia.

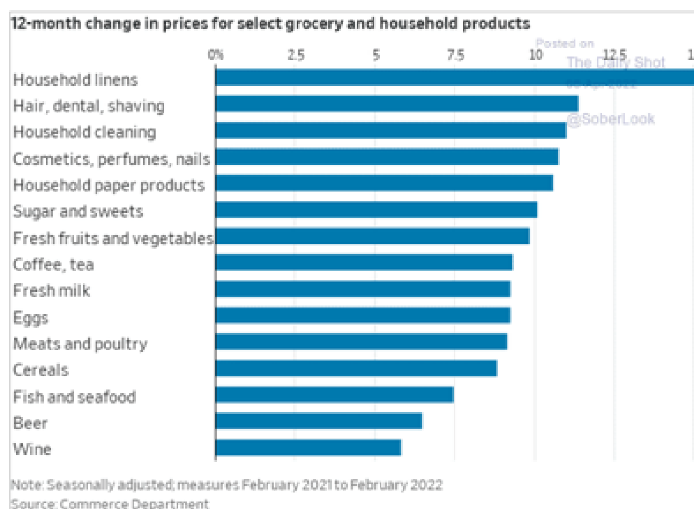
[5] See the chart of European electricity prices. Though Russian natural gas is still flowing to European power plants, these supplies are clearly at risk. This is reflected in increased prices.

The spike in commodity prices couldn't have come at a worse time for markets. The largest threat to asset prices is rising interest rates; rates had already been rising to counter the pre-existing, pre-war inflation. Rising commodity prices will exacerbate the current inflationary pressure, which will in turn motivate central bankers to raise rates faster and higher.

Inflation rates



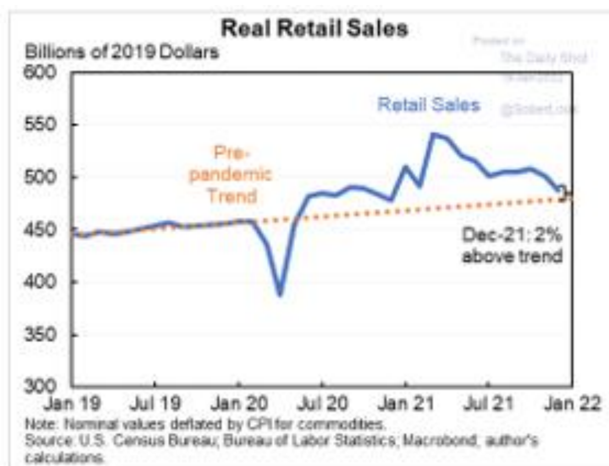
Source: Organization for Economic Cooperation and Development



Central bankers are in a pickle. Rising commodity prices (especially oil) are likely to *both* slow the economy *and* increase inflation. Do central bankers really want to raise rates to fight inflation when the economy is likely to slow anyway? The key to answering this question lies in long-term inflation *expectations*. What central bankers really, really don't want is for long-term inflationary expectations to become "embedded", that is, widely held. If this were to happen, inflation would become so hard to combat that central banks would have no choice but to really crank up interest rates, sending the economy into a deep recession, as legendary Fed Chairman Paul Volker did in the early 80s.

Thus, out of all the economic indicators out there, the most important ones to watch relate to expectations of future inflation. We believe central bankers will act decisively[6] if inflation expectations spin out of control in order to prevent a return to the stagflationary "Misery Index" days of the 70s[7]. Unfortunately, these all-important inflation expectations have indeed been rising. The below left chart shows the annual bond-market-derived inflation expectation for the next five years at 3.7%. More importantly, the chart below on the right shows inflation expectations for the following five years (2026-2031) at 2.49%. We are watching closely.

There is, however, some cause for hope when it comes to inflation. As we have previously written, we believe the main driver of inflation has been the absolutely massive global COVID stimulus spending, which in the U.S. amounted to roughly five *trillion* dollars since 2020, much of which was just given away to businesses and individuals. It would have been crazy if we *didn't* experience any inflation. This stimulus is unlikely to be repeated, and consumer spending (when adjusted for inflation) has already fallen back to pre-stimulus trend. Thus, there is some reason to think the inflationary impulse will fade. Cross your fingers.



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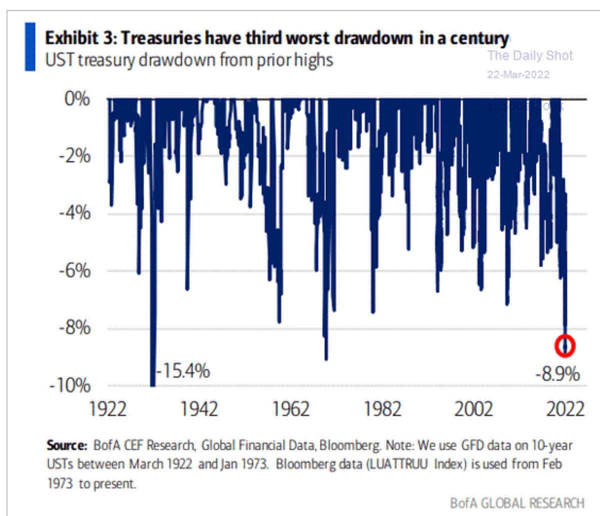
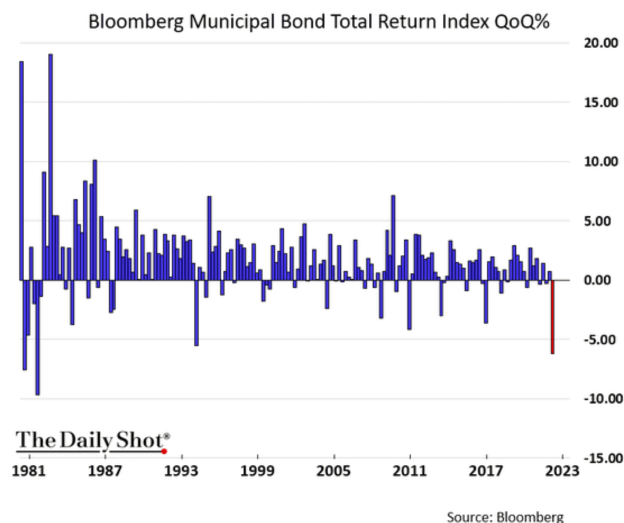
6 By "acting decisively" we mean "raising rates quickly", which will slow the economy quickly, possibly resulting in a recession... and falling asset prices.

7 Stagflation is the rare circumstance when the economy experiences both high unemployment (stagnation) and inflation at the same time. The Misery Index is the sum of the unemployment and inflation rate.

Even though the Federal Reserve has only just started hiking overnight rates, longer-term, market-based interest rates have been rocketing higher, wreaking major havoc on the bond market. The "riskless" U.S. Treasury index declined 5.6% in the first quarter, the worst quarterly showing in its 100+ year history. U.S. Corporate bonds recorded a 7.7% loss in Q1, their worst quarterly return since Lehman Brothers failed amid the 2008 financial crisis. Municipal bonds too had their worst quarter in over 40 years. While further pain may lie ahead, the silver lining is that bonds today offer more attractive yields going forward.





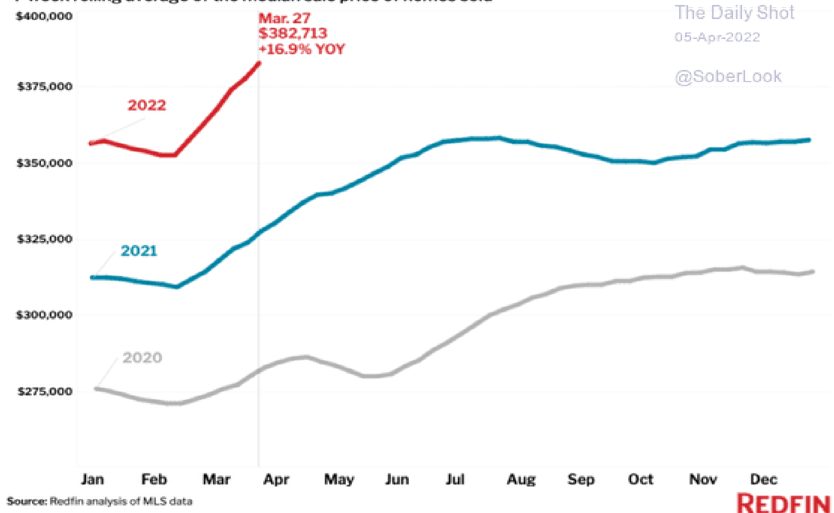
One bright spot in our fixed income portfolios was our Managed Income strategy, of which some longtime readers may not be aware. This strategy came to us through our merger with Buffalo Capital Corporation, when Kurt, Jeff, and Erica joined the team. This conservative strategy, which normally is invested in high yield bond mutual funds, aims to avoid large drawdowns by using a sophisticated model to occasionally go completely to cash. A move to cash is exactly what happened around Thanksgiving[8], when the model flashed a "sell" signal. When we sold these bonds, they were yielding around 4.7%, and we are pleased that, while we have been sitting in cash, yields have risen to around 6.5%. This means that we successfully avoided a drawdown, and when we get the signal to reinvest, we will be buying back at more attractive yields, with increased potential for capital gains.

This strategy is available on a standalone basis[9] and is also part of our more diversified fixed income portfolios. If your Knightsbridge investment portfolio includes fixed income, your quarterly report will

[8] A similar sell signal in February 2020 resulted in this strategy performing admirably through the COVID market sell-off as well.

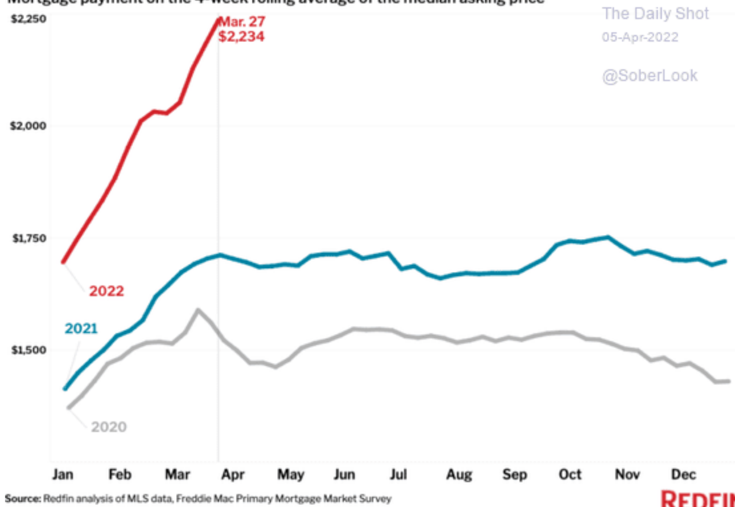
[9] For those greatly concerned about the stock market and/or inflation, our Managed Income strategy may be a good way to put money safely to work. We would consider it superior to the alternative of selling stocks and then holding cash long-term.

feature an asset allocation pie chart which shows a slice of your assets invested in "Managed Income Cash". Your elevated cash position is an intentional effort to preserve capital as we await the right time to reinvest.



One place where higher interest rates have yet to have a detrimental impact is the housing market, which is still going bonkers. The median price of a house in the U.S. is up 17% over the past year and many housing markets, including our local one, are even more extreme.

But that is only half the story. Mortgage rates have risen an astonishing two percentage points to near five percent in just the past few months. What does this mean for affordability? Well, the median house might be 17% more expensive to buy than a year ago, but with the higher mortgage interest costs, the mortgage payment on that house has gone up a full 30%.



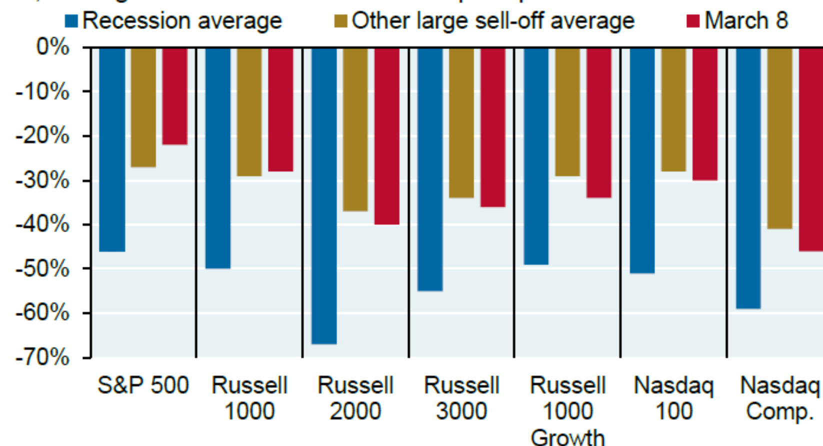
Can home prices continue to increase in the face of rising mortgage rates? While it is true that we collectively have not built enough homes over the past decade, and thus inventories remain low compared to sales, affordability has to matter at some point. We are not predicting another 2008 collapse but can assure you that *all* asset prices have the ability to move in both directions.

The stock market moves faster than the housing market and experienced a nasty pullback in January. While recently recovering some, we expect readers might be interested in our thought process during the Q1 decline. Upon the invasion of Ukraine, the U.S. stock market was *already* in a "correction", i.e. off 10%. Knowing that geopolitical shocks tend to produce moderate declines, we chose to not take any evasive action, as we know most market declines of 10% to 20% represent *buying* opportunities.

Reaction to Select Geopolitical Events

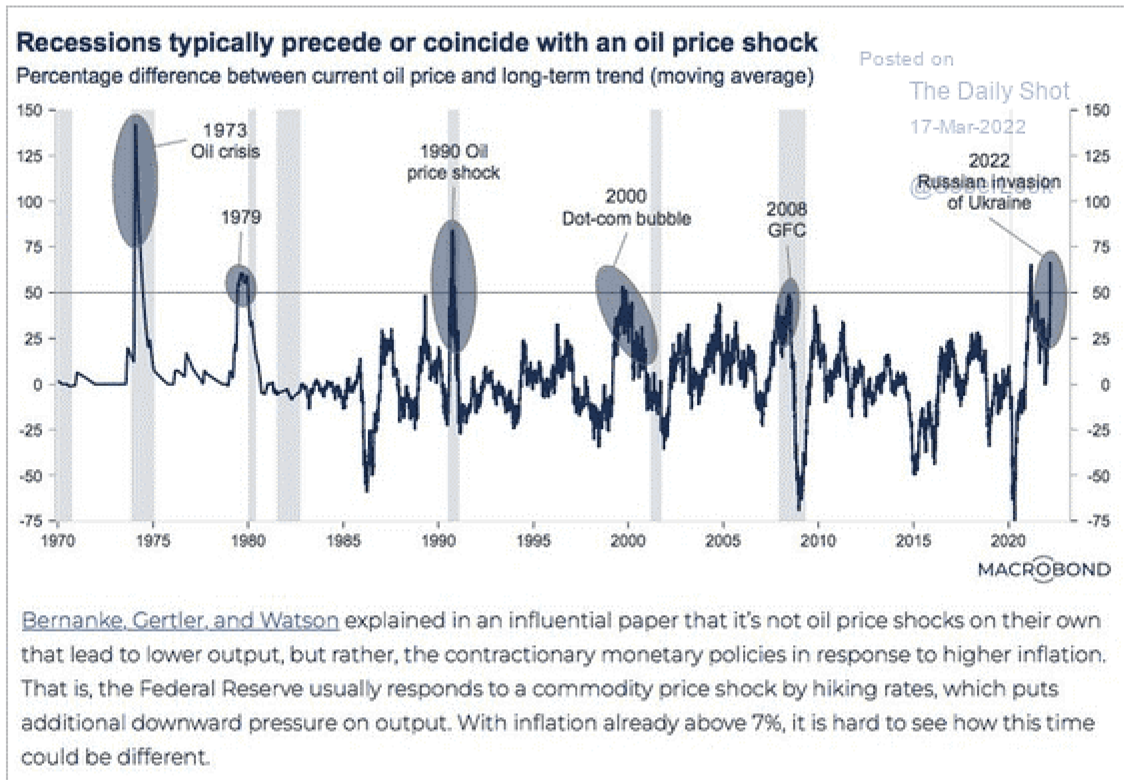
Event	Fed Policy Stance	S&P 500		
		Next Day	30-Day	To Worst
Downing of MH17 (Jul-2014)	Steady	-0.2	-1.3	-3.6
Crimea Conflict (Feb-2014)	Steady	0.8	0.7	N/A
US Invasion of Iraq (Mar-2003)	Easing	2.5	2.2	-3.0
September 11 Attacks (Sep-2001)	Easing	N/A	0.4	-11.6
Iraq Invasion of Kuwait (Aug-1990)	Easing	-3.0	-9.3	-16.9
Iran-Iraq War (Sep-1980)	Tightening	0.1	2.1	-4.4 (-27%)[1]
Arab Oil Embargo (Oct-1973)	Tightening	-0.2	-5.7	-16.4
Gulf of Tonkin Incident (Aug-1964)	Steady	-0.2	-1.2	-2.2
Cuban Missile Crisis (Oct-1962)	Tightening	-3.8	9.4	-3.8
Invasion of South Korea (Jun-1950)	N/A	-5.4	-10.0	-12.9
Pearl Harbor Attack (Dec-1941)	N/A	-3.8	-2.9	-10.2
World War II (Sep-1939–Sep-45)	N/A	1.1	14.4	-33.2 (-44%)[2]

During this time, we were also keenly aware of the information contained in the following chart. Specifically, the stock market had *already* dropped as much as it normally does during a pullback that isn't accompanied by a recession.

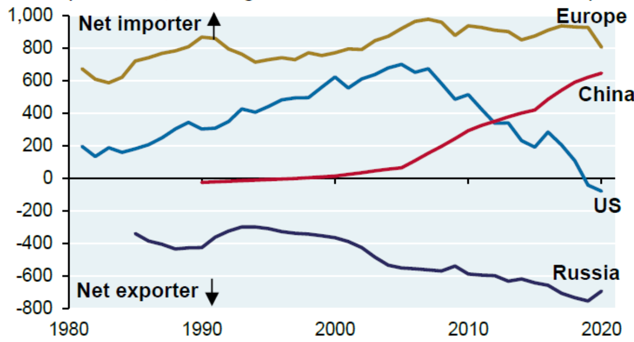


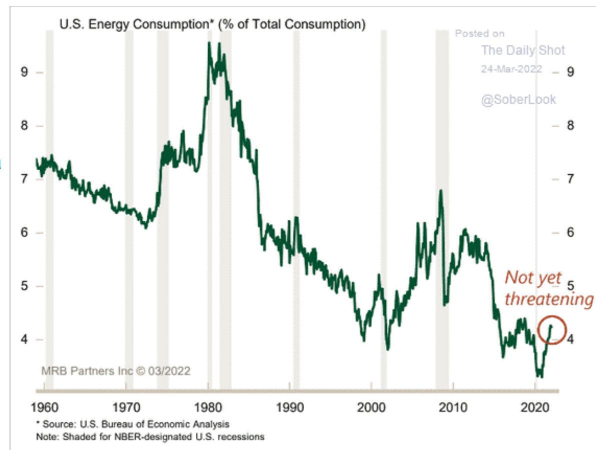
Source: JP Morgan Equity Research. March 17, 2022.

Thus, our question at the time was: "Are we going to have a recession soon?". If we deemed the answer to be yes, then defensive action (selling stocks) would prove advisable. If not, we should sit tight. We ultimately decided we were unlikely to have a recession right away. The trick is the stock market will likely peak several months ahead of the next recession and so we will vigilantly keep asking ourselves this question.

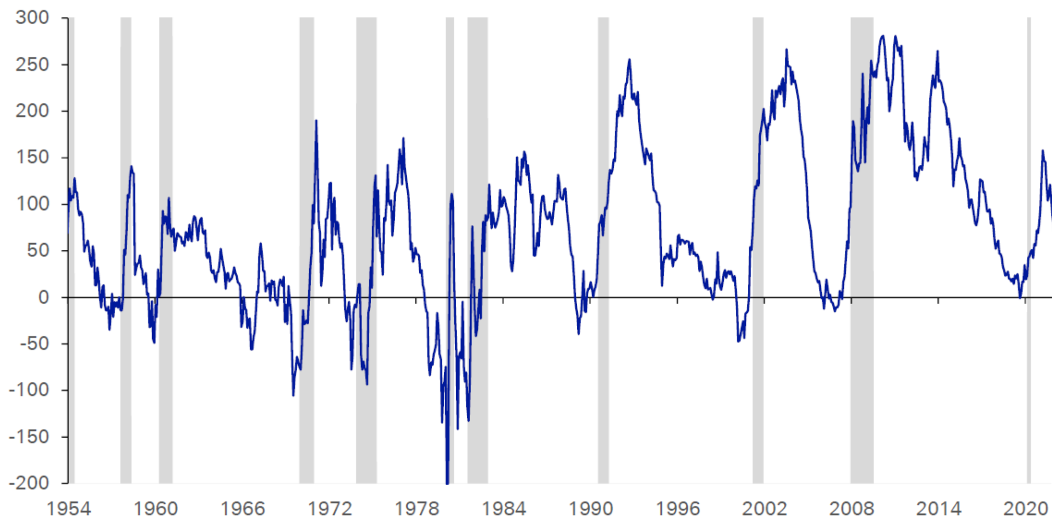


Oil is fueling recessionary risk. When the price of oil exceeded $130 per barrel, we thought that alone could derail the U.S. economy into recession. However, the price quickly receded and, further, we wonder if the historical connection between oil price spikes and recessions holds as strong today. There are two main reasons an oil price spike shouldn't be as damaging now as in the past. The first reason is that the U.S. now pumps much of its own oil. While a high price at the pump is still bad for anyone with a car, it is very good for those involved in the energy production sector, and that second factor is a lot more important than it used to be. The second reason is that Americans these days spend less of their budget on energy, thus a price spike doesn't hurt as much.





Another cause for recessionary concern unfolded in the past two weeks. The dreaded "yield curve inversion", whereby the 2-year Treasury yield atypically exceeds the 10-year Treasury yield, once again briefly reared its ugly head. Without spilling too much ink on why this is a troubling sign, we will simply say that this condition is the bond market's way of saying, "The Federal Reserve is about to raise interest rates too high over the next two years, and in doing so, will cause economic problems which will encourage the Fed to turn around and lower rates back down longer term." Yield curve inversions matter because they have happened before every single U.S. recession, even somehow managing to predict the brief but deep COVID recession[10]. However, as the chart below helpfully notes, historically there has been an average of 18 months from the time of yield curve inversion to the beginning of recession[11].



[10] Importantly, the opposite is not true: recessions do not occur following all yield curve inversions.

[11] As is typical with economic charts, the grey vertical bars represent recessionary periods.

When it comes to the stock market, most of the time the best thing to do is to ignore the headlines and sit tight. This is demonstrated in the adjacent table which shows that even if you *knew* the yield curve was successfully signaling a recession, you would have typically been better off holding onto your equity portfolio.

S&P 500 returns following 2s10s UST yield curve inversions (%)

Inversion	1m	3m	6m	12m	24m	Time to recession
Dec-65	2	(5)	(6)	(12)	2	49 months
May-68	4	2	8	9	(14)	20 months
Feb-73	(1)	(5)	(10)	(19)	(31)	10 months
Aug-78	(1)	(11)	(6)	1	16	18 months
Dec-88	2	6	18	25	16	20 months
May-98	4	(1)	5	25	34	35 months
Feb-00	(2)	4	3	(5)	(18)	14 months
Dec-05	1	4	(0)	13	17	25 months
Aug-19	4	8	18	18	53	7 months
Median	2	2	3	9	16	20 months
% positive	67	56	56	67	67	

Source: Goldman Sachs Global Investment Research

If you are left somewhat confused after all this back and forth, please don't worry. That means you are getting it. We don't know exactly what is going to happen. We continue to believe the likely investment path forward will be less rewarding than the past couple years. But that's not really the question. The question is, is the path likely bad enough to be outright negative. So far, we say, "Not yet." In the meantime, we remind ourselves (and our readers) that our stock portfolios represent partial ownership of good, productive companies, which should continue to produce value over time, and that our fixed income portfolios have been thoughtfully constructed.

We wish to express our utmost gratitude for the trust you place in us.

Sincerely,

John G. Prichard

Miles E. Yourman

Kurt Beimfohr

Jeff Vieth

Knightsbridge Wealth Management reviews and updates Form ADV at least annually to confirm that it remains current. No material changes were made since the last update to Knightsbridge's brochure dated October 1, 2020. Our complete Form ADV Part 2A & 2B may be requested by contacting our firm at (949) 644-4444 or by email at knightsbridge@knightsb.com.

Please remember to contact us if there are any changes in your financial situation or investment objectives.

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