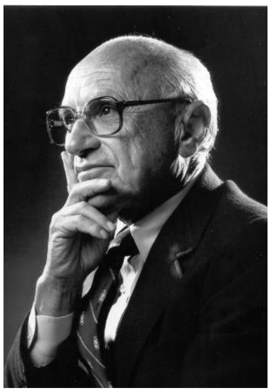
Knightsbridge
WEALTH MANAGEMENT

July 13th, 2022

Summer Quarterly Commentary



"Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output"

Milton Friedman, PhD (1912-2006)
Economist, Nobel Laureate

The second quarter of 2022 extended one of the worst starts to the year in modern market history. The stock market's 20% decline is not so uncommon. What makes this pullback exceptional is that bonds are also being punished. The bond market's 10%+ decline represents the worst year-to-date start in history. Other records are being set. Treasury bonds (we don't own any) are having their worst start to the year since *1788* and the Dow Jones Industrial Average delivered the most down weeks in a twelve-week period (eleven) since its 1896 creation. Under more normal circumstances, stocks and bonds tend to move in opposite directions. For this reason, they are commonly combined in portfolios to offset each other. But this diversification proved no protection in the second quarter, making it an especially tough time to be watching investment portfolios.

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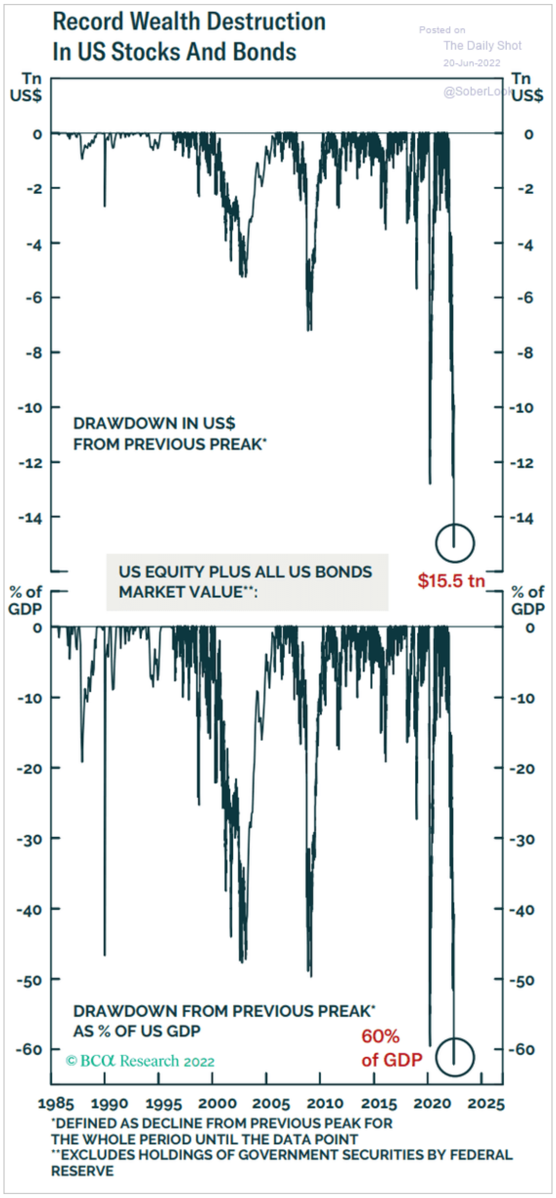
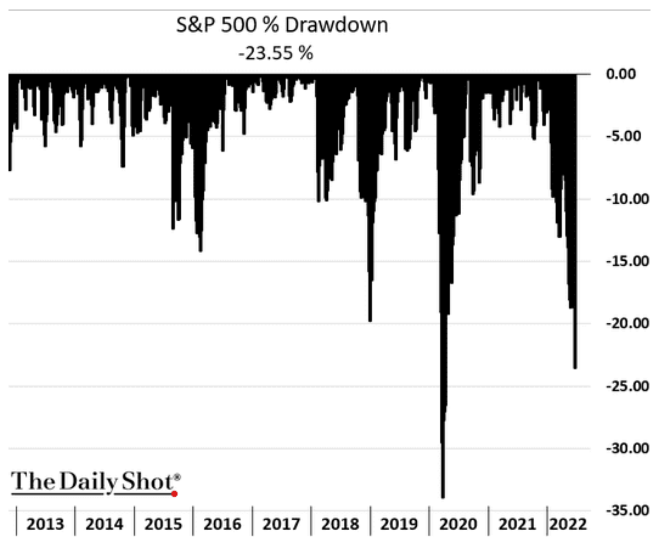
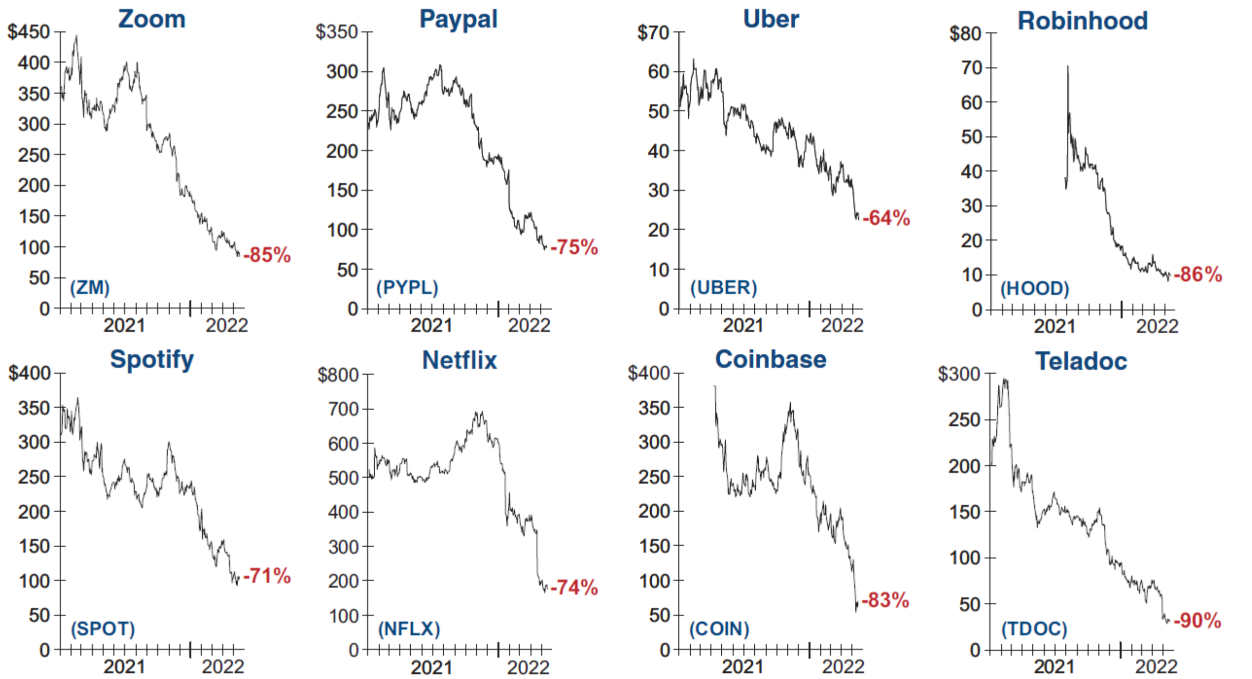




While losses in the broader stock and bond market indices have been painful, there are investment areas that have experienced outright destruction. Barely profitable or unprofitable tech stocks have been hit especially hard, with many formerly high-flying household names experiencing 70% to 90% declines.



Cryptocurrency markets, those white-hot centers of speculation, have been hard hit as well. Bitcoin, which was designed to issue a finite number of coins in response to financial crisis-era money printing, has fallen over 70% from its high last September. So far, it is not delivering the inflation-fighting attributes its creator envisioned. Picking the 20th most valuable cryptocurrency at random (Litecoin), we can see it is down more than 85% from its peak last year.

In general, the era of easy money is ending. The air is flowing out of highly inflated speculative assets, as well as from good assets whose prices got ahead of themselves. The Illusion of Prosperity we have previously described is being dispelled.

What's causing all this market carnage? It's no secret that it is inflation, and the corresponding response by central banks to tighten financial conditions, which is bringing on the aforementioned end of an era. With inflation taking center stage on world markets, the following is a semi-deep dive on the topic, what's causing it, and where it's headed.

First a simple definition: inflation is a rise in prices. However, usually when people talk about inflation, they're really talking about *widespread, sustained* inflation, i.e. the prices of most goods going up, and up, and up, on a continuing basis. Further, prices represent the amount of money being spent to purchase goods and services in proportion to an economy's ability to produce those goods and services. Prices *balance* the amount of demand in dollars to the amount of supply in goods and services. Prices can be thought of as a ratio: Spending / Capacity to Produce. Inflation is an upward move in that ratio. Anything that

increases spending will increase prices[1], as will anything that reduces capacity to produce. Sustained inflation is a continual increase in that ratio.

Consider recent auto production given chip shortages; fewer cars produced meant higher prices. However, such bottlenecks are usually one-offs and reversed, e.g. the chip shortage doesn't get worse every year. Reductions in production capacity also tend to be localized to specific products as opposed to generalized across the economy[2]. Thus, while reductions in capacity to produce can raise prices, they rarely produce the *widespread, sustained* inflation which is of primary concern.

The real action on inflation, especially sustained inflation, is on the spending side, because under the right conditions, increases in spending can occur year after year after year. What can affect how much money is being spent in the pursuit of goods and services in the economy? A lot of things!

One of the most impactful factors affecting spending and inflation is the one Milton Friedman referenced in our opening quote: the money supply[3]. Obviously, with more money can come more spending. However, there are other factors to consider, such as who has the money, what are their desires and needs, how are they feeling, and what is their mindset about where prices are going (do they need to spend their money NOW because they believe it will lose value?[4]).

With all respect to Dr. Friedman, we are saying that Spending / Capacity to Produce is what drives inflation, not Money Supply / Capacity to Produce. Money must get into the hands of those who want to spend it! Let's think through some examples. What if you printed a few trillion

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[1] That is, so long as such an increase in spending is not met by an increase in production.

[2] A potential exception to this relates to oil. So many things require transportation such that oil is a ubiquitous input to other products. When the capacity to produce oil - whether domestic or foreign - is low, this scarcity limits the capacity to produce nearly everything else, sending many prices higher.

[3] There are also a lot of factors which determine just what exactly is the money supply. A full discussion of this topic is beyond the scope of this letter, but you can look up M1, M2 and M3 to see the definitions. The complexity arises from the fact that in truth most money isn't currency, but rather credit. For example, you might think your bank account represents money, but it's really credit; a promise from the bank to deliver money on demand. Given this reality, what's happening with credit is extremely important to the money supply in total. Currency can be increasing (money printing) while credit is contracting, and that would likely mean an overall contraction in the money supply. This is one of the reasons money-printing doesn't always lead to inflation.

[4] This would be an inflationary mindset, one that has come to expect future inflation.

dollars and gave it to someone who promptly stored it in a warehouse? Would that increase inflation? Of course not, because no one would be spending that money. What if you printed a few trillion dollars and then bought the Lakers? Well, the Buss family would go from being extremely rich to exorbitantly rich. The price of collectable Lamborghinis and L.A. mega-mansions might go up as the family spent part of its windfall...but they were already rich to begin with and so realistically, they'd probably invest rather than spend most of the money. We would see inflation in investment assets. Now what would happen if you printed that few trillion dollars and started dropping it from helicopters in public places? The price of everyday stuff would rise! Perhaps the most important determinant of spending, at least in the U.S., is how much money do regular, everyday people have in their control. Regular folks tend to go out and spend most of the money they have.

The previous paragraph explains why the economy never experienced the substantial inflation that many expected after the unprecedented money printing that followed the 2008 Great Financial Crisis[5]. The Fed used its (digitally) printed money to buy bonds instead of spending it in the real economy. Those who sold their bonds likely wanted to continue saving and thus reinvested their proceeds elsewhere. More recently lot of money was printed in response to the COVID crisis. However, we believe it is the absolutely massive government stimulus spending that is driving inflation because it put money into the hands of everyone. Thus, we would modify Milton Friedman's famous quote to read, "Sustained inflation is usually a spending phenomenon, a very important determinant of which is an increase in the money supply, but it matters greatly what is done with the money." We agree the original reads a little better.

We know inflation is currently running very high but where is it headed from here? Returning to our "Spending vs. Capacity to Produce" model of inflation, to know what will happen with inflation we have to think about everything affecting either of those terms.

Here are some of the most important <u>pro-inflationary</u> forces affecting <u>spending</u>:

- **On the heels of the massive pandemic-related government stimulus, U.S. household checking accounts stand at $18.5 trillion vs. $13.3 trillion prior to the pandemic.**

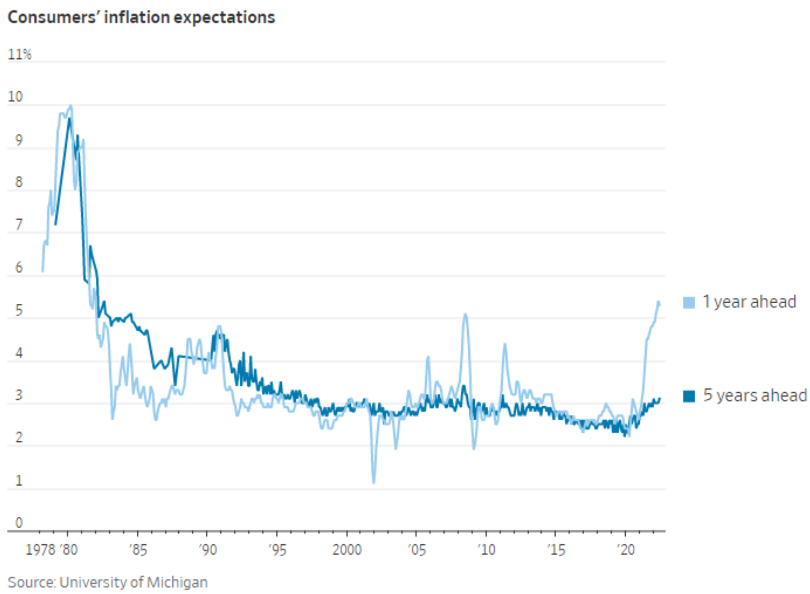
- **Until recently, the Federal Reserve was printing money and using it to buy bonds.**

- **Interest rates, despite rising this year, remain relatively low, making it easier for the financial system to create more credit/money.**

[5] In addition, as mentioned in our earlier footnote, the credit portion of the money supply was contracting.

- **Ongoing, non-COVID government deficit spending also drives aggregate spending (if the budget was balanced due to tax increases or expenditure decreases, either the public or the government, respectively, would be spending less).**

- **A growing inflationary mindset[6] pulls forward spending from people seeking to avoid their savings being eaten away by future inflation.**



Here are some of the most important <u>pro-inflationary</u> forces affecting <u>the capacity to produce</u>:

- **China's continuing COVID lockdowns inhibit productive capacity.**

- **Deglobalization, driven by COVID and political forces, makes it more difficult to produce goods cheaply.**

- **The shutdowns of oil production and refining capacity during the pandemic in response to low demand are difficult to reverse and continue to inhibit production (chart later in letter).**

- **Supply disruptions related to the war in Ukraine increase scarcity. Oil, natural gas, metals, grains, etc.**

- **An aging workforce reduces potential output.**

[6] As we have written, the Fed is extremely concerned with preventing the psychology of inflation from taking hold to avoid a pernicious, self-reinforcing cycle. The Fed has signaled it will raise rates aggressively to prevent such an outcome.

On the other hand, here are some of the most important <u>anti-inflationary</u> forces affecting <u>spending</u>:

- **The end of COVID stimulus programs sap spending power.**

- **The Fed is now anti-money-printing. They are effectively selling bonds and destroying money, intending to vaporize $1 trillion over the next year.**

- **The Fed raising rates, which has two effects on inflation. The first is that it becomes more difficult for the financial sector to create more credit, which is part of the money supply. Secondly, it slows down spending in certain interest-sensitive industries like housing. Both can tip us into recession, which is then very negative for inflation because consumers cannot spend when they do not have incomes.**

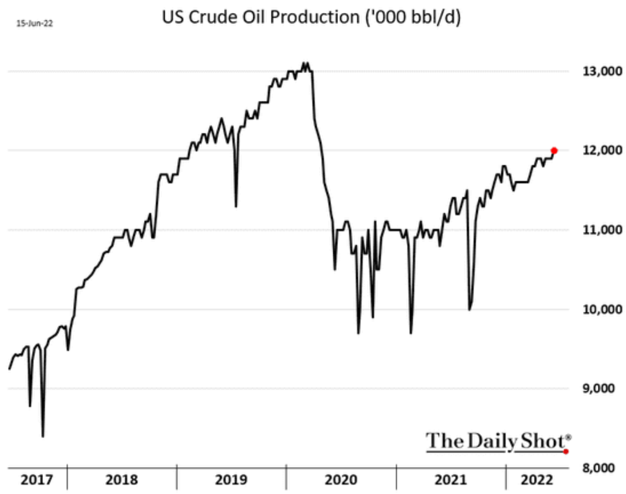
- **A reverse wealth effect takes place when people see their declining investment accounts and don't feel like splurging.**

- **The tendency of money in the economy is to eventually flow into the pockets of the rich, who are less likely to spend it on goods and services, instead sending it to the bank or investment markets.**

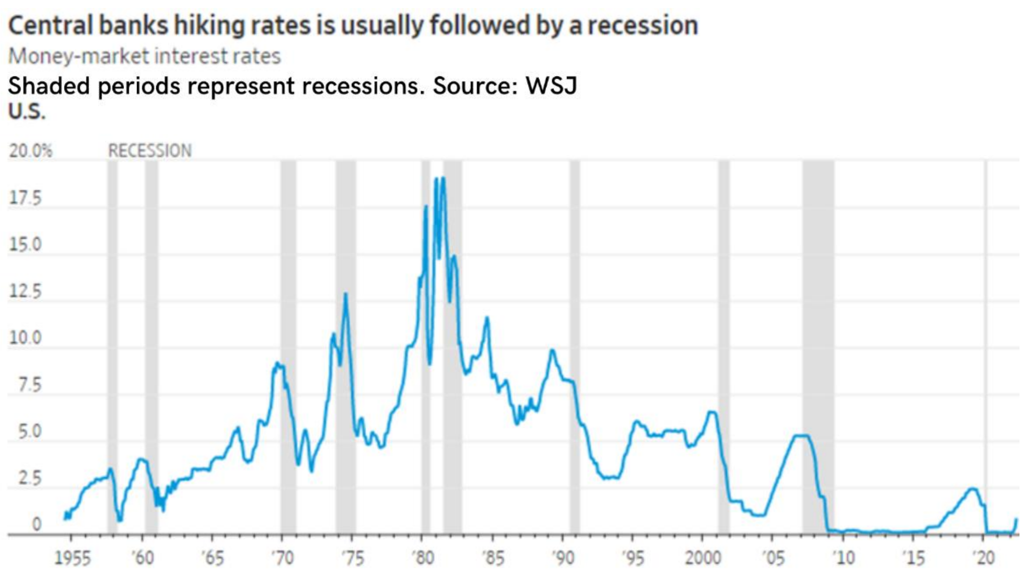
Finally, here are some of the most important <u>anti-inflationary</u> forces affecting <u>the capacity to produce</u>:

- **People are returning to the labor force for multiple reasons, such as pandemic unemployment stimulus expiring, crypto bros going back to working reality, early retirees reconsidering, and the extremely COVID weary beginning to reenter society.**

- **The economy is adapting and capitalism is working to increase output capacity. The most important example is oil production beginning to increase again (see below chart). Another example would be the building of new chip fabrication plants to address shortages. Still another example would be people buying more fuel-efficient cars to help them do more work with less oil.**



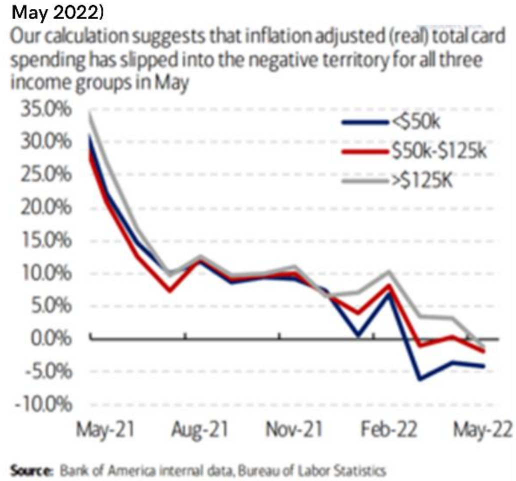
Weighing the balance of these opposing forces, we think there are a lot of good reasons inflation will start coming down, with the key reason being lower government and consumer spending due to the expiration of COVID stimulus. But regardless of whatever would happen naturally, the Federal Reserve can smash spending (and inflation) if it is determined enough. In our opinion, the Fed is very serious about inflation, and it will throw the economy into recession if needed[7]. The Fed Chairman wants to be remembered as an inflation fighter, in the same vein as Paul Volker, and not like his asleep-at-the-wheel predecessors. As former Fed economist, John Roberts, recently put it in a Wall Street Journal article, "Getting it wrong in the direction of not tightening enough has much bigger consequences than the other way around." We believe this reflects the predominant thinking at the Fed today.



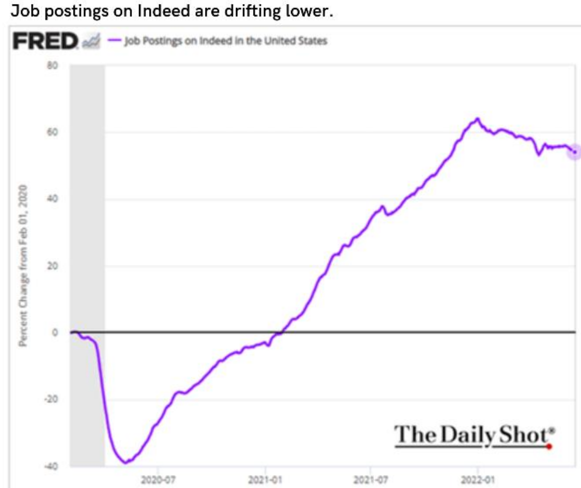
[7] In a recession, everyone tries to pull back on their spending, thereby dousing inflation.

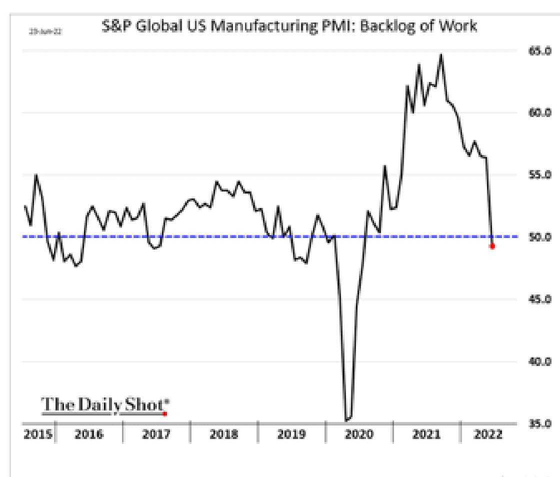
In general, as reflected in the above chart, rate-rising cycles usually end in recession and that's what we feel is happening now. Thus, when it comes to the stock market, we are less worried about continually rising inflation (and interest rates) but more worried about a coming recession and a drop in corporate earnings which remain elevated relative to pre-pandemic levels. Indeed, there is already substantial evidence the economy is slowing. Real consumer credit card spending has turned negative as have job postings on website Indeed.com. The Purchasing Managers Index (PMI) survey, an important leading economic indicator, shows new orders declining (i.e. a reading below 50) alongside disappearance of last year's work backlog.

Inflation-adjusted ("real") total card spending by income groups (%yoy, seasonally adjusted, monthly, data as of May 2022)



Job postings on Indeed are drifting lower.



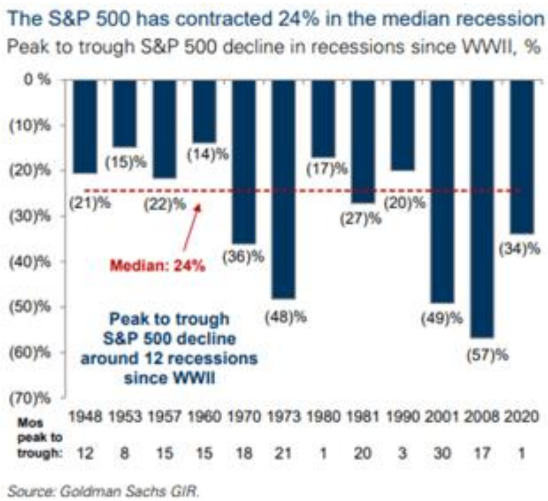


So where does all this leave us in terms of positioning investment portfolios? Our economic concerns have us holding more cash than usual. Rising short-term rates mean we are back to running periodic checks to make sure that any cash is invested in the highest yielding cash fund available.[8] The positioning of our flagship Opportunistic Value Equity strategy is reasonably defensive, with a roughly 10% cash position. We also maintain an approximately seven percent position in the carbon allowance market, which should be less correlated to the stock market. Finally, we've held onto an eight percent position in Cornerstone Building Brands which will imminently be acquired, generating a nice profit as it turns into cash. These factors together mean this strategy is only about 75% exposed to traditional equities.

We've outlined that we think we're headed into a recession, with corporate earnings at risk. Thus the natural question is whether we should take even further evasive action. The short answer is that we see our bearish economic forecast as more of a reason to maintain our defensive positioning as opposed to expanding it. Why wouldn't we expand it? First, investor sentiment and positioning are incredibly bearish, which tends to be a good contrarian indicator of positive returns.

[8] Due to post-financial crisis reforms, we view these money market mutual funds as essentially riskless in all but the most extreme environments, and thus we mostly look to the highest available yield at a given time. When performing this exercise, we take into account factors such as the tax status of your account and your estimated tax bracket.

The second reason is that it generally is not a winning strategy to sell stocks after they have already declined close to 25%, as most indices did at their low point. That level of decline, achieved by the S&P 500 in mid-June, surpassed the median recessionary bear market decline since World War II. The other below chart illustrates the upshot explicitly by providing the performance of the S&P 500 Index in the three, six and twelve months following the start of a bear market (i.e. after being down 20%).



Stocks Do Well After They Go Into A Bear Market

S&P 500 Index Performance After Going Into A Bear Market (1950 - Current)

Date Bear Market Starts	Trading Days To Enter Bear Market	S&P 500 Index Returns: 3 Months	6 Months	12 Months
10/21/1957	305	5.2%	9.3%	31.0%
5/28/1962	115	7.3%	11.2%	26.1%
8/29/1966	139	7.9%	17.6%	24.6%
1/29/1970	288	-4.9%	-8.9%	10.7%
11/27/1973	221	0.7%	-9.2%	-28.1%
2/22/1982	310	3.0%	1.3%	32.1%
10/19/1987	38	10.9%	14.7%	22.9%
3/12/2001	242	6.3%	-7.4%	-1.2%
7/9/2008	188	-20.0%	-27.2%	-29.1%
3/12/2020	16	21.0%	34.6%	59.0%
Average		3.8%	3.6%	14.8%
Median		5.8%	5.3%	23.8%
Higher		8	6	7
Count		10	10	10
% Higher		80.0%	60.0%	70.0%

Source: LPL Research, FactSet 05/20/22
All indexes are unmanaged and cannot be invested into directly. Past performance is no guarantee of future
Performance back to 1950 incorporates the performance of predecessor index, the S&P 90.

This time may very well be different, and the major changes in U.S. monetary and fiscal policies have us worried. But knowing the base odds keeps us from taking more extreme defensive action. In other words, we are closer to being a buyer than a seller of stocks. Over time, the stock market goes up and that's why we mostly intend to be invested. It is the down markets, like the present, which set the conditions for the next up market.

We thank you for your continued confidence in us as we work to be the best possible stewards of your capital.

Sincerely,

John G. Prichard

Miles E. Yourman

Kurt Beimfohr

Jeff Vieth

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