Public

This Month in the Markets

January 2022

Equity Commentary

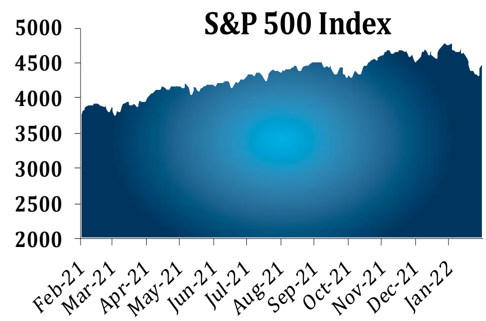
Voting Is Now Closed

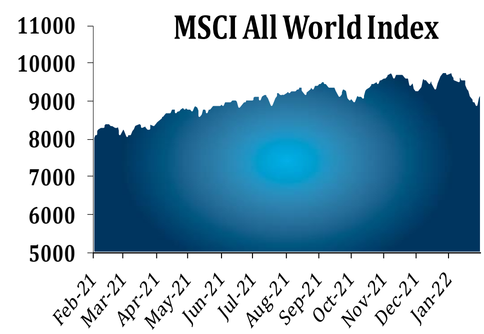
"In the short run, the market is a voting machine, but in the long run, it is a weighing machine." - Ben Graham

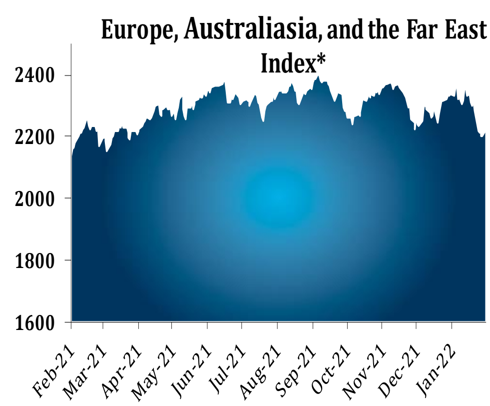
The MSCI ACWI Net Total Return Index ended lower with a -4.9% return in January. The S&P 500 fell 5.2%, while the MSCI EAFE Net Total Return Index declined 4.8%. Value held up significantly better than growth. The MSCI World Value Index fell only 1.3% compared to a 9.3% decline in the MSCI World Growth Index. The ACWI Energy Sector index was the top performer, climbing 13.1%. The MSCI ACWI Information Technology Sector was the under-performer with an 8.2% loss due to the compression of high multiple valuations caused by the rapid rise in interest rates and sentiment shift. Bath and Body Works was the largest detractor in the portfolio for the month, with a decrease of 19.7% on concerns of slowing consumer spending. The top performer in the month was Devon Energy Corp., which rose 14.8% on the back of climbing energy prices, which saw crude oil climb 17.7% and natural gas prices jump 37.0%.

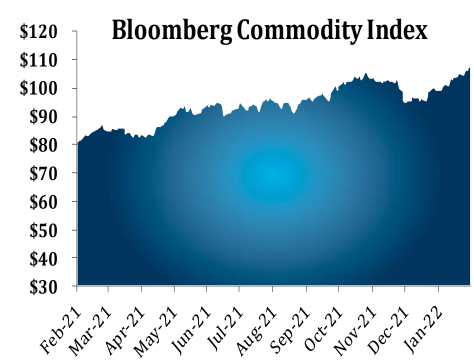
While there are periods of short-term volatility, things really don't change in the longer term. January continued to allow investors to see, in real-time, how markets can quickly "come to their senses" in terms of fundamentals. As the Ben Graham quote above suggests, anything can happen in the market in the short run. Stocks that are innovative, disruptive, and have fascinating stories can attract investor dollars in waves. During these periods, investors can be sucked into companies with questionable to possibly dubious business models without a path to true profitability. As a result, there are often periods where it seems "easy" to make money as speculative fever takes over, driving the prices of certain investments to levels of irrational extreme. FOMO (fear of missing out) dominates rather than FOOL (fear of obviously losing). We have now seen an epic collapse of speculation that the overall major markets have masked to some extent over the last few months. This continued into January. The IPOX Spac Index has been essentially cut in half from its peak. High priced, "meme" and/or unprofitable technology shares have also been crushed – examples include the following:

Name	% chg from 52 wk high
DOCUSIGN INC	-60.7
NIO INC - ADR	-63.3
PLUG POWER INC	-68.6
GAMESTOP CORP-CLASS A	-68.9
TELADOC HEALTH INC	-74.9
ZILLOW GROUP INC - C	-76.1
AMC ENTERTAINMENT HLDS-CL A	-77.0
PELOTON INTERACTIVE INC-A	-83.1









*MSCI EAFE Index

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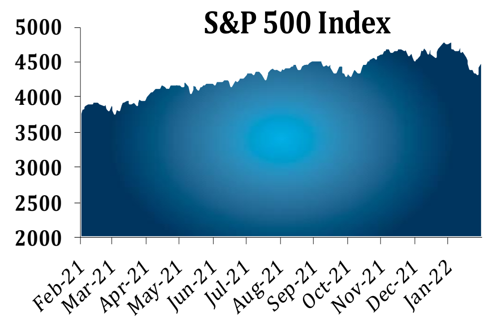
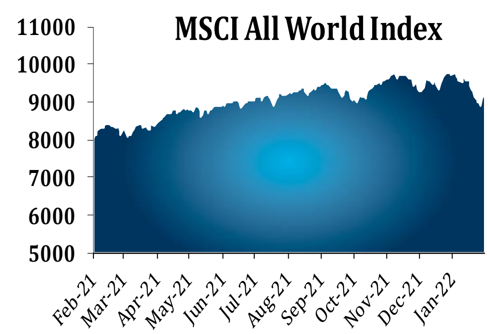
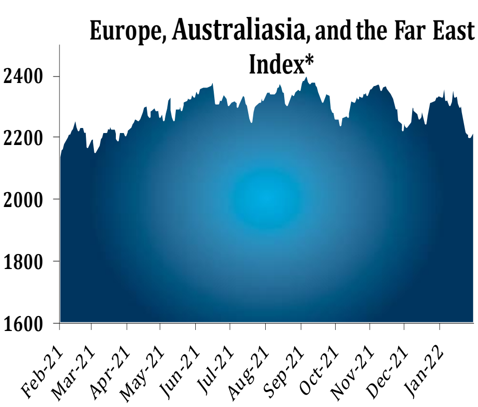
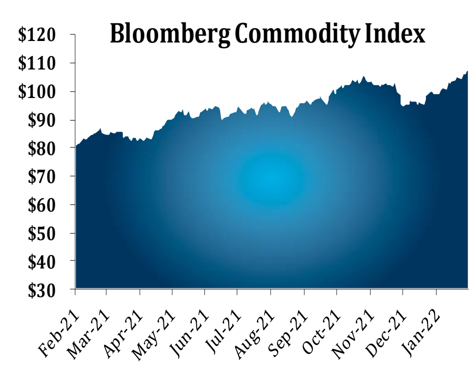
While some companies like those listed above don't have cash flow, not to mention free-cash-flow, there are "high" multiple companies with solid fundamentals. Alphabet (Google) posted a free cash flow margin of ~25% while growing its top line by over 30% in the latest quarter. It does sport an enterprise value to EBITDA multiple of ~20x. Still, it is also projected to grow EBITDA on average about 20% per year for the next three years. We feel it is always critical to correctly assess the actual business dynamics of a company compared to its valuation. Not just what is to be expected but also what one is paying for these expectations.

During the month, we exited Salesforce.com Inc. and CoStar Group Inc. mainly to reposition the portfolio more towards a shift in near-term value and away from longer-dated growth. While we continue to monitor both companies, we respect the fundamental reality that rising interest rates impact discounting and disproportionately punish growth companies with higher multiples. It's also worth noting that technology shares have recently benefited from a digitization acceleration that is likely to slow in growth rate (but still grow). At the same time, some "old school" economy stocks are now witnessing accelerating growth that may be sustained for some time and offer much lower valuation multiples. The additional cash in the portfolio helped mute the downturn in January and provides us with buying power as we move through this earnings season which is currently showing to be full of land mines. We see some attractive options after the selloff. We are looking to deploy this liquidity as the annual reporting season progresses.









*Merrill Lynch Global Broad Market, Ex US Dollar Index

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Fixed Income Commentary

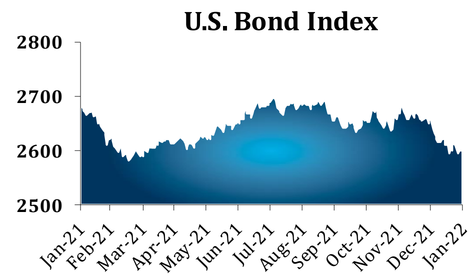
Wings of the Hawk

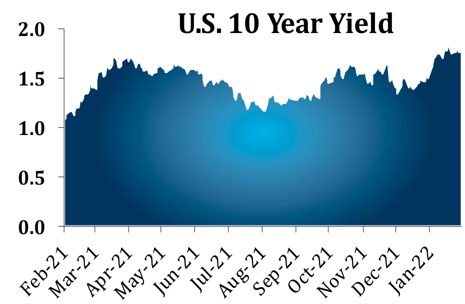
January was a difficult month for fixed-income investors to navigate. Geopolitical tensions between Russia and the West rose dramatically. At the same time, the December Consumer Price Index (CPI) came in at 7.0%, the highest level since the 1980s. The net result was wider credit spreads and higher treasury rates. Regarding credit spreads, the widening was concentrated in the high yield market, while investment-grade spreads experienced only marginal widening. Despite this, high yield credit spreads remain well below the long-term average. As of the end of January, the spread-to-worst of the ICE BofA High Yield Index was 3.82% compared to a long-term average (since January 1999) of 5.44%. It was encouraging to see credit spreads largely hold up given the severe volatility in the equity market. Investment-grade new issuance reached $142 billion in January compared to $127 billion in January 2021, reflecting strong investor demand for corporate credit. Nonetheless, on the margin, we continue to hold a cautious view on corporate credit given the combination of stretched risk/reward trade-off and a more hawkish Fed.

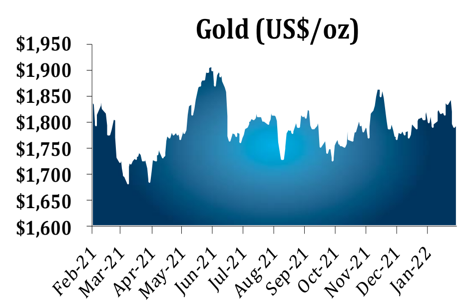
Speaking of the Fed, the question-and-answer session of Chairman Powell's January 26th press conference was illuminating. He was explicitly asked about the likelihood of a 0.50% rate hike in March and if the Federal Open Market Committee (FOMC) would consider hiking in meetings when it does not produce a dot plot and economic forecasts (quarterly). Powell didn't rule out the possibility of either. As such, Powell explicitly didn't rule out the most hawkish scenarios contemplated by the market. Indeed, Bank of America have recently publicized that they expect seven(!) rate hikes in 2022 (not a typo); this would mean a rate hike in each meeting this year. Since the press conference, the market has priced in almost five 0.25% rate hikes in 2022 (up from just under four hikes pre-meeting), according to fed fund futures. Given the difference between the 10-year treasury and the 2-year treasury rate is only 0.63%, if they raise rates five times, it's highly likely they will invert the yield curve (unless the long end of the curve also shifted upwards). An inverted yield curve is a widely accepted leading indicator of a recession. The yield curve continued the flattening trend from 2H21 in January, suggesting the bond market believes the fed will over-tighten monetary conditions.

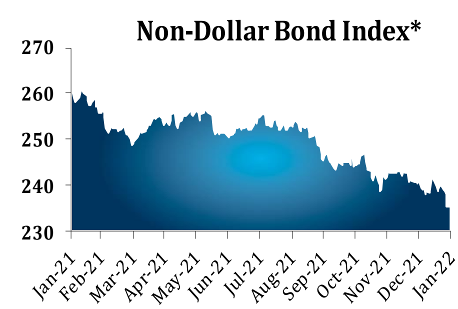
When asked about reducing the size of the balance sheet ("quantitative tightening"), Powell stressed that inflation is much higher and the labor market tighter than in 2018 (the only other time the Fed has reduced the size of its balance sheet). As such, he believes the Fed has more room to tighten monetary policy - increase short-term rates and reduce the balance sheet. It's worth noting that the only other time the Fed reduced the balance sheet and lifted the fed funds rate concurrently ended in January 2019 when Powell made the first "Powell pivot", as he backtracked after significant market stress (equity sell-off, credit spread widening, high yield market new issuance collapse - wide-spread elevated volatility). This was seen in the Bloomberg Financial Conditions Index, which turned sharply negative in late 2018.

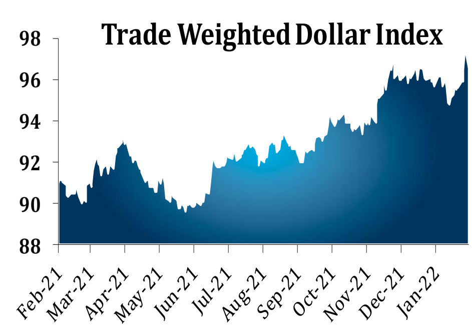
While we do not have a crystal ball, we expect elevated volatility if the Fed overdoes (or is about to imminently overdo) monetary tightening. Where that possible pinch point will/could be is impossible to say. We will continue to monitor the yield curve and credit spreads as a gauge of market fears in this respect. The Fed is under pressure politically to reduce inflation. After all, there are mid-term elections this year, and a large portion of the U.S. population is feeling the pinch of higher prices. Despite having a trove of economists, they failed to forecast a material rise in inflation in 2021. Moving forward, they will seek to walk a tight rope to restore the Fed's credibility by reducing inflation (one mandate), while also avoiding a sharp drop in financial conditions, which would threaten their second mandate (full employment).











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