First Quarter 2022 Comments

"Such fair and foul storms of uncertainty hitting markets I have not previously seen. Whether it's the end of the QE market picnic, Central banks hiking rates, the rising risk of monetary and fiscal policy mistakes, the pandemic, the approaching cost of living shock about to crush consumers, inflation, recession, or possible stagflation, broken and rebroken supply chains, rising geopolitical instability, and – as the icing on the cake – let's throw in the largest most bloody European conflict since 1945 with a not intangible possibility of nuclear war….
But, where's the panic? The markets seem to be thriving.
The market is not a rational beast."[1]

Bill Blain

"Jerome Powell upped the ante in a speech yesterday, indicating that a more aggressive tightening pace is in store following last week's 25 basis point hike to the benchmark funds rate. 'There is an obvious need to move expeditiously to return the stance of monetary policy to a more neutral level and then to move to more restrictive levels if that is what is required to restore price stability,' the Fed chair told the National Association for Business Economics. As for a previous consensus among the monetary mandarins that inflation would peak this quarter and moderate in the back half of the year, 'that story has already fallen apart,' Powell admitted."[2]

"It's hard to know how much the US Federal Reserve will need to do to get inflation under control. But one thing is certain: To be effective, it'll have to inflict more losses on stock and bond investors than it has so far…investors should pay closer attention to what Powell has said: Financial conditions need to tighten. If this doesn't happen on its own (which seems unlikely), the Fed will have to shock markets to achieve the desired response. This would mean hiking the Federal Funds rate considerably higher than currently anticipated. One way or another, to get inflation under control, the Fed will need to push bond yields higher and stock prices lower".[3]

William Dudley, former NY Fed President

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[1] Bill Blain, The Morning Porridge, 8/22/22
[2] NABE luncheon, 3/21/21, as relayed by Almost Daily Grant's, 3/22/22
[3] Bloomberg Op Ed piece, 4/7/2022

"Now people say to me: No cycle ever dies of old age. I get that. But, they die at the hands of the central bank. The Fed. Each cycle has died at the hands of the Fed. Every bear market ended by the Fed. Every recession ended by the Fed. By the same token every bull market/expansion, the Fed has its thumb prints over every expansion. There is nothing more important, not fiscal policy, not trade policy. Nothing is more important for what we do than Fed liquidity".[4]

David Rosenberg

"Think about it a second – central bank policies holding interest rates artificially low and then standing ever-ready to support global markets from the consequences of induced bubble conditions – have been the dominant theme of market for 12 years now. A whole generation of very clever bankers and investment managers are maturing into senior positions across the global financial industry having known nothing else. ***No One Working In Global Finance Today Under the Age of 32 has ever known markets that were undistorted by QE!"***[5]

Bill Blain

That litany of uncertainties ticked off by Bill Blain in the opening comment includes new items along with some that have been floating around out there for a while. Among the latter are many which have featured in prior discussions, in these letters and otherwise; I know this because I just re-read the last 2 years' worth of quarterly comments to make sure, on your behalf, that I don't go repeating myself too much. On the other hand, some things *bear* repeating. At any rate, while Russia was clearly up to *something* as the quarter began, I don't think that anyone (including quite likely a significant percentage of the Russian troops engaged in nearby war games beforehand) had on their year-ahead prediction radar the notion that Russia would launch an unprovoked attack on Ukraine. And, once launched, and with the Ukrainians, and their military, not folding like the proverbial cheap lawn chair, it would have been hard to imagine that they would still be at it, eight weeks after crossing the border on February 24th. However, as one analyst put it *"When you have a guy in the Kremlin who is being absolutely delusional about the real situation in Ukraine, you can't speak in terms of a coherent foreign policy"*[6] Unfortunately, he goes on to say that, *"Putin's usual way out of trouble is to escalate even more".*

I lack the expertise to even begin to opine on where this goes, and for how long. For the moment, the Russians seem to be getting more practice in the strategy they employed so well in the past in Chechnya and Syria, doing their best to "level the grid", and, as one of my clients (you know who you are) remarked after reading an analysis of the situation*, "Does anyone besides me note the similarities here to World War I?"*. Without meaning to belittle the humanitarian crisis unfolding in Ukraine, and the countries bordering it, or the geopolitical stakes, whatever else happens, the current situation is not

[4] *David Rosenberg, at Grant's 2018 Spring Conference*
[5] Bill Blain, The Morning Porridge, 7/8/2-021
[6] Andrei Soldaton: The Octavian Report

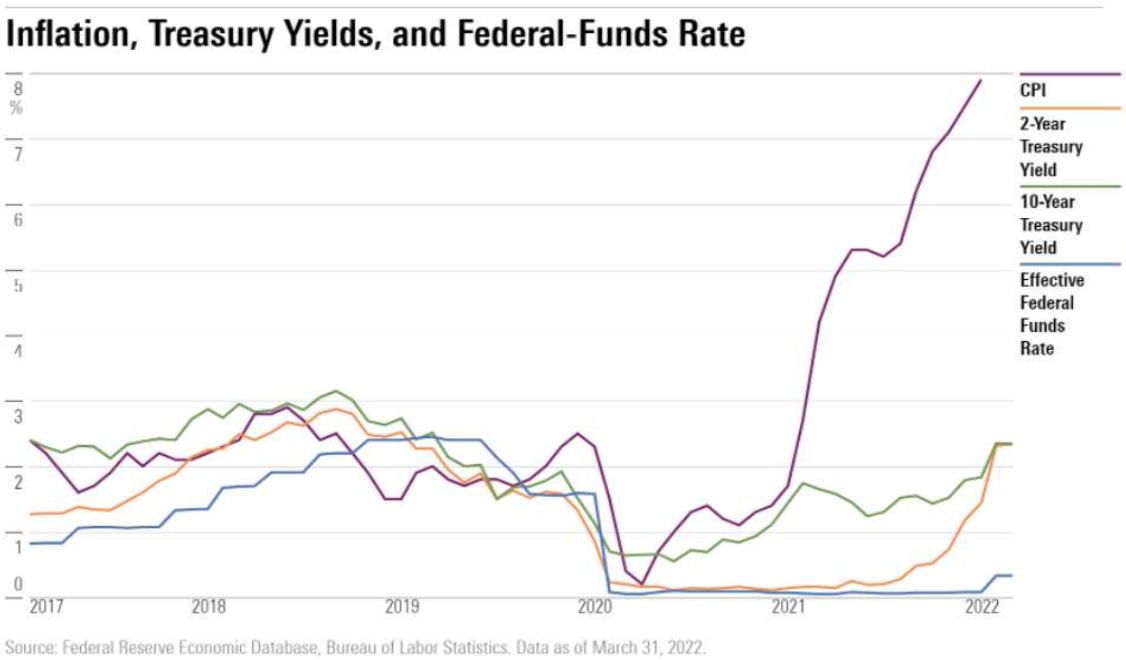
likely to promote solutions for any of the other uncertainties on Blain's plate, and is in fact making a lot of them worse, while helping to toss "globalization" out of the window.

Having re-read the prior letters, it occurs to me that I was maybe a little harsh at times on Federal Reserve Chair Powell. On the other hand, maybe not harsh enough? At this point last year, we were talking a CPI number of about 2.6%, above the Fed's 2% target range to be sure, but since the inflation jump was deemed to be "temporary", and they were all for letting things run above-target for a while anyway, well, no big deal.

However, the latest published figure for March headline inflation was a CPI of +8.5% year-over-year, a 41-year high, with the "core" CPI (ex-food and fuel) delivering a still high +6.5%.

Either way, it is well in excess of the Fed's 2% target, and the biggest jump since the early 1980's. That said, since the Core number was a little "less worse" than feared. The post-announcement narrative was that March represented "peak inflation", and that it should be all downhill from here. However, the Producer Price Index, released a day later, printed at +11.2% year-over-year; "Core" was up 9.2%. Since producer price changes normally get passed along in the form of consumer price changes, in the service of preserving profit margins, this does not bode well for March being "peak inflation". At any rate, any pronouncements from Chair Powell and others at the Fed are now emanating from somewhere *wa-aay* behind the curve at this point.

A year or so ago, the futures-related betting was maybe one quarter point rate increase in all of 2022. Having done that last month, the discussion now revolves around how many half point increases they will undertake the rest of this year, (something not seen since 2000) with Bill Dudley up front saying what he could not while President of the NY Fed, namely that Powell may have to move far enough to "shock" markets in his efforts to tame inflation. At any rate, per the following chart from Morningstar, the Fed (blue line, bottom; Federal Funds Rate) does seem to be behind relative to inflation (the skyrocketing top purple line; CPI); either the Fed has to do some serious catching up, or inflation needs to "catch down", or both:



Even if the lines meet somewhere in the middle, that's still a higher interest rate level and a higher inflation level than have been the norm for some time.

Powell insists that the economy is robust enough to handle higher rates, and that the Fed will be able to engineer a "soft landing", although the historical record on that is not very promising. At any rate, in a recent letter I quoted an old Wall Street saying that "*The Fed raises rates until they break something*". They seem, finally, to be on their way to doing the former at least.

All of this higher rate talk had fairly immediate investment impact in the quarter. For starters, bond yields reacted to the threat of higher rates, with the Benchmark 10-year U.S. Treasury yield going from 1.51% on December 31st to 2.34% on March 31st; vs. that 1.51% starting annual income level, that represents a 10% capital loss in three months. Per Deutsche Bank's Jim Reid, that represents the seventh worst quarter for the 10-year or its equivalent since the Civil War. Radnor client bond portfolios generally have shorter average maturities in the 3 ½ year range, and therefore fared a good bit better, by design. It might be noted that as of this writing, with the 10-year at 2.93%, that bond has suffered an additional 5% + loss since the end of March, and so much, perhaps, for the "safety of bonds".

Meanwhile, over in stocks, the S&P 500, which was up 29% or so in 2021, ended the first quarter of 2021 off 4.6%, with the less-Tech-heavy Dow off about 4.10%.

The traditional point of having a "balanced" stock and bond portfolio is diversification and volatility reduction; generally, if one is doing poorly the other will offset with at least better relative performance, but it clearly didn't work this time around, something of a rarity. Here's another historical fact:

"Of the 185 quarters since 1976, a negative quarterly return for both stocks and bonds has occurred just 19 times, including the most recent quarter. Furthermore, over the same period, there are just four instances where both stocks and bonds are negative for two consecutive quarters, with three of those four associated with a recession."[7]

Here's hoping that this is a one-quarter-and-done occurrence.

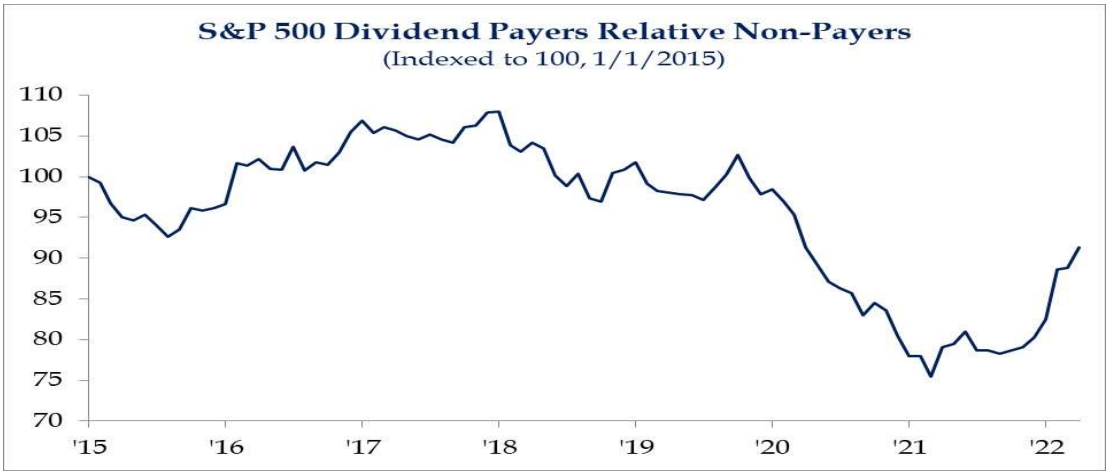
Meanwhile, looking under the hood in a bit more detail, and as we've discussed previously, higher rates have had a negative impact on the higher-flying sectors of the stock market, with SPAC's, Cryptocurrencies, and not least the FAAMG "Big Tech" names, all taking it on the chin.

As we have indicated previously, in an environment of zero rate "free money", investors are more attracted to heady revenue growth, unburdened by current earnings or dividends; when rates increase, returns in the here-and-now quickly become more important. The investment performance of boring established operating companies with actual earnings, clean balance sheets and reasonable dividends is therefore starting to look better. Among other things, the Morningstar Large Value Index delivered returns of +2.35% in the quarter, while the Large Growth Index came in at -11.97%[8]; on a similar track, the Tech – heavy NASDAQ was down 20% at one point in the quarter, and ended off a shade under 10%.

[7] Strategas, 4/7/22

[8] https://www.morningstar.com/articles/1087132/13-charts-on-the-markets-first-quarter

A little closer to home, looking at Dividend Payers vs. non-payers in the S&P 500, and despite higher rates overall, the following chart from Startegas shows a marked turnaround after a couple of years of less-than-index-results:



The same report also noted that the dividend payout ratio is close to the lows for the better part of the last 80 years. Come what may on the price side, that ought to provide ample cushioning for maintaining current dividend payouts, if not continuing to increase them over time.

Finally, there are many factors behind the current inflationary trend; prior Fed policy, Covid, continuing post – Covid supply chain problems, and not least price trends in Commodities, have all had some impact. Commodity prices have bounced back from the lows much more forcefully than in prior business cycles, and those input costs get passed through to everything.

More specifically within this trend, conventional Energy - Oil & Gas - has played a big part. West Texas Intermediate Crude- the flavor we mostly use on these shores- noodled along at a range of about $50 per barrel for the last 4-5 years, hit negative $30 (!) in futures trading for about ten minutes at "Peak Covid" at the end of the first quarter of 2020, and has subsequently risen sharply, currently at $100+ as of this writing (another item that wasn't on very many prediction lists a year ago) off only slightly from $116 about a month ago. This price rise has led to this:

But also to this:

…which shows the price of one of the largest Energy Exchange Traded Funds (ETF's) this year (57% of this fund is in 5 names: Exxon, Chevron, EOG, Resources, Conoco, and Schlumberger). As in , Energy stocks have been doing very well, and have helped to lead the above- mentioned Value resurgence, while also helping clients here at Radnor, where we remain overweight in Energy in most portfolios.

Unfortunately, we may be in this shock-at-the-pump pricing environment for a while. While the world at large is moving towards renewables, the fact remains that we will likely be dependent on conventional Energy for a longer-than-expected period. The transition will take time, and unfortunately there is also not a lot of slack in "conventional" at the moment, here or abroad. Some amount of excess production capacity does reside in Russia (the "+" in OPEC +), but for obvious reasons those supplies have been

curtailed or eliminated, to the particular consternation of Europe. Germany, which assumed that it could always rely on Russian gas piped in from the East, is now actively considering restarting three of its remaining six nuclear power generation facilities, which were only just turned off in January.

Back home in the U.S., policy stands in the way. Those on whom irony is not lost will appreciate the following:

Rather than actively encouraging on-shore U.S. Oil and Gas exploration and production (no geopolitical risk) and/or encouraging the building of additional pipeline capacity to the U.S. from Canada (no geopolitical risk), we are instead in active discussions with Iran on a deal to allow them to keep developing their nuclear capacity (big geopolitical risk) in exchange for oil, pleading with OPEC to increase supply (hint: they are having difficulty even fulfilling their own prior pledge to increase production by 400,000 barrels a day) and meanwhile drawing down our own Strategic Petroleum Reserve (SPR) to "fight high gas prices". Such actions have had negligible impact on said prices, while reducing the SPR, and our strategic flexibility, by 12% year-over-year. At current levels, the SPR has about 570 million barrels of oil in storage. The Administration has pledged a further release of 1 million barrels a day from the SPR for 180 days which, if activated, would take it below 400 million barrels by November, not coincidentally the timing of Midterm Elections[9]. Meanwhile, Bloomberg reports that at least some of that released oil will be heading to Europe, all of which - you guessed it- further limiting our ability to weather big geopolitical risks.

And of course, now that the major oil companies are actually making money again, there are those in Congress advocating for a 50% "windfall profits tax" on oil company earnings. Seems to me that if you want more oil- because prices are high due to there being not enough oil- then taxing "excess profits" ultimately reduces oil companies' financial capacity to drill for more oil.

And finally, how "excess" are those profits anyway? If we take the same top 5 names in the above Energy ETF, and look at fourth quarter 2021 gross revenues and net income, we get a profit margin of 11.85%. In contrast, the profit margin for Apple in the same period was 27.9%, and for Microsoft it was 36.3%[10] . When was the last time you heard your favorite Congressperson fulminating against *Big Tech* excess profits? And yet…

At any rate, Energy was the best -performing sector in 2021, at +53.4% total return vs. the S&P's +28.7%[11] (that compares to Energy's negative 32.8% in 2020, by the way), and that streak continued in the first quarter, with the Energy sector clocking in at +37.7% vs. the S&P at minus 4.6%.[12]

Looking (not too far) ahead, as we get into first quarter earnings season, overall earnings growth for the S&P is expected to be +6% or so. Looking under the hood, all but one percentage point of that is expected to come from Energy [13]

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[9] Hat tip to David Hay, Crude Calculations, 4/15/22

[10] Factset; Radnor Capital Management Analysis

[11] https://www.fool.com/investing/2022/01/10energy-was-the-best-performing-stok-sector-2021/#:~:text=the%20sector%20produced%20a,S%20500's%2028.7%25%20total%20return.

[12] https://www.yahoo.com/video/p-500s-q1-energy-winners-135101705.html

[13] Strategas; Daily Macro Brief, 4/11/22

Quite a turnaround.

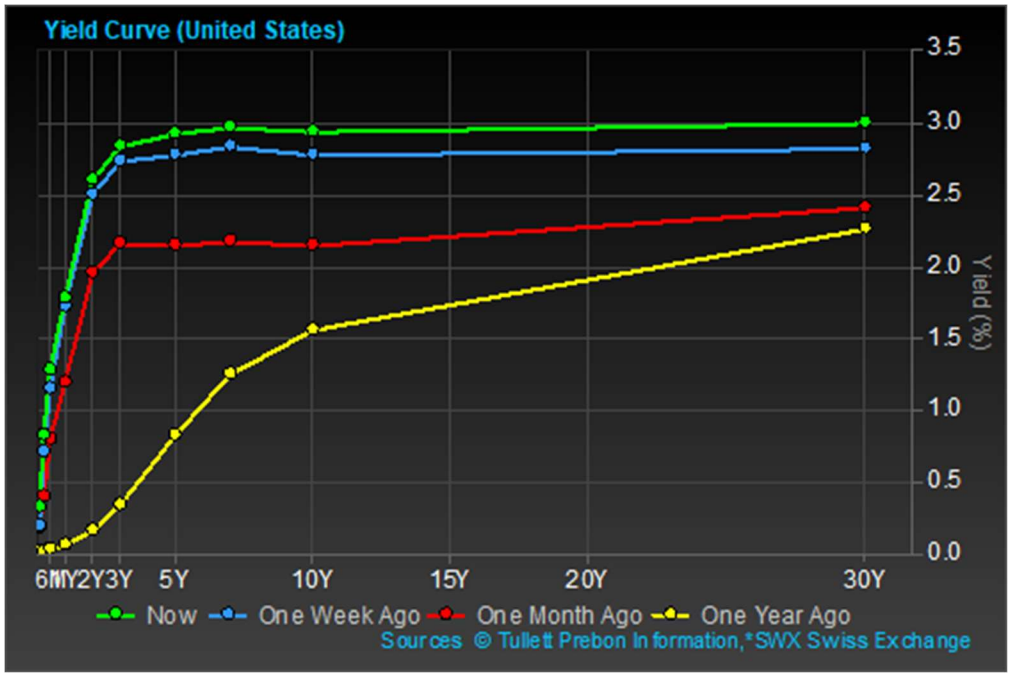
Finally, and again for perspective, even with the outperformance of Energy in the last year, that sector is still only a little over 4% of the S&P 500, off a low last year of about 2%. This compares to 25.4% in 1980, and 10% as recently as 2010[14].

If, as one of my old partners used to state, "*Regression to the mean is one of the most powerful forces in the universe*"[15] then there is certainly scope for a higher S&P weighting in Energy going forward.

To sum up, where do we go from here?
Well, if, all of the PhD's at the U.S. Federal Reserve couldn't see inflation coming (what bond guru Mohamed El-Erian has called "*the worst inflation call in the history of the Federal reserve*"[16]), and the current era's equivalent of "The Smartest Guys in the Room" in Washington didn't see Ukraine coming, then anything I might say in this regard should be taken with a grain of salt, or two. However, a few thoughts, based on what we know and can see:

- If, as indicated above, all but one percentage point of the predicted 6% earnings increase for the S&P 500 in the first quarter is coming from Energy, then it's not too much of a stretch to assume that the earnings growth of "everything else" has likely slowed markedly from last year's torrid pace. This would at least line up with broader economic projections, including GDP Growth; the Blue Chip consensus estimate for first quarter GDP Growth has gone from +3.5% on January 1st to about 1% now, with the Atlanta Fed GDPNow estimate in the same range.
- Some of that is clearly due to inflation (from whatever sources) and the inability of companies to fully pass along higher input costs in finished goods prices, whether we are talking peanut butter or tractors. This can lead to reduced profit margins, and therefore pressure on earnings. To the extent that the Fed and/or market forces cannot slow or reverse current inflationary pressure, this trend could persist, to the detriment of earnings and the valuation that the market assigns to those earnings (see aforementioned relative behavior of Value vs Growth names).
- Meanwhile, until recently, if you were looking for investment <u>income</u>, we had gotten used to invoking **TINA**, as in **T**here **I**s **N**o **A**lternative to stock dividends, with bond rates so low. However, given the market's reaction to very modest (so far) tightening efforts by the Fed, there suddenly <u>is</u> an alternative, at least on a relative basis. 2-year U.S. Treasuries currently yield 2.54%, which compares favorably with the S&P 500 index yield of 1.41%, and the Dow at 1.80%. Of course, on an <u>absolute</u> basis, against an inflation rate of 8%+, none of the above are generating net after-inflation <u>real</u> returns, but at least you can get a relatively "better" and higher quality income stream, without stock exposure, for the first time in years. That's new competition for investor dollars.
- Meanwhile, meanwhile, the Fed's modest tightening so far, along with plenty of telegraphing that "this time we mean it", market tantrums or not, has pushed short term rates higher, and at a faster rate than long term rates, hence a change in the shape of the "yield curve". Bond yields are supposed to reflect risk, and risk grows with time; all else equal, the risk of something going unpredictably wrong is probably higher in five years vs one year, and in ten years vs five, so investors usually demand a higher return as compensation for that risk for each year of longer maturity. This usually results in a positively sloped yield curve, the plot of bond yields vs maturity. This would classically look like the yellow line in the Bloomberg chart below, showing the curve a year ago:

[14] https://www.dws.com/globalassets/merill-lynch/pdfs/cio_view_sp_500_sector_composition.pdf
[15] F.W.Elliott Farr
[16] As quoted in Things That Make You Go Hmmm, Tales of the Expected, April 2022



Since then, in response to the inflation spike, and much "Fed speak" about doing something about it, the curve has gotten a lot flatter, (red line, one month ago), and for a very brief period (blue, one week ago) actually "inverted" in spots, ie., the yield for a longer year was less than for a shorter year. We are now (green) back to at least flat-ish again, but this inversion has gotten the commentariat spinning at high RPM's, because there is an annoying tendency for inverted yield curves to be a pretty good predictor of recessions. To be more specific, not every Fed hiking cycle has led to a recession, but all hiking cycles that invert the curve have led to recessions.

If past is prologue, then a recession may be in the offing, but, like using market valuations levels for predicting the short-term direction of stocks, the predictive power of an inverted yield curve is often lousy on timing, and in the case of recessions, an inversion may predate an actual economic downturn by as little as a few months, or by year or more.

And right now, things still look to be in pretty good shape. For instance, if you are looking for a job, prospects have almost never been better; last week, U.S. jobless claims- as in, first-time applications for unemployment benefits- came in at the second- lowest level in the 55 -year history of this Labor Dept data series.[17]

There are also those who opine that, since inversions are also associated with Fed tightening, an inversion can signal instead an upcoming "policy mistake" on the part of the Fed… which is a pretty harsh judgement after one quarter-point increase, but there it is.

John Mauldin, in a recent letter, likens an inverted yield curve to a fever. A fever is not the cause of sickness per se, but is a signal that there's something wrong, somewhere, with your body. If nothing else, the recent inversion may signaling something amiss with the Body Economic. Even if we can't see it

[17] https://www.zerohedge.com/personal-finance/initial-jobless-claims-crash-2nd-lowest-level-record-55-years

yet, we should be alert to the possibilities, and the risk of a U.S. recession does seem to be a significant concern among market participants, according to recent surveys:

71% of respondents to the April Bank of America Global Fund Manager Survey expect growth to decelerate, edging out the October 2008 figure for the most lopsided reading on record…and just over a quarter of respondents cite a global recession as the top risk, ahead of Ukraine.[18] Meanwhile, a Wall Street Journal poll[19] shows recession odds in the next 12 months up to 28% from 18% at the turn of the year, and 13% a year ago. David Rosenberg points out, with reference to these odds, that you don't need this metric to go to 100% to end up with trouble; it peaked at 34.8% just six months ahead of the 2020 downturn.[20]

Finally, the folks at the International Monetary Fund are calling for 3.6% Global growth this year, vs. 6.1% last year, a marked deceleration. Back on these shores, higher prices usually lead to lower consumer spending, and since, last time I checked, "Consumer" was about 70% of GDP, current price trends are bound to have some negative impact.

At any rate, as the following chart[21] shows, economic forecasts are falling even as inflation expectations continue to rise:

… which, if the above projections come to pass, could also lead to a reprise of late - 70's – style Stagflation. Time, as they say, will tell, but Mr. Market seems nervous...
Enough said! As is usually the case, best intentions for writing a shorter letter thwarted once again, but there was a lot to cover. I will end with this 1997 cartoon by the New Yorker's Robert Mankoff, which shows once again that there is not much new under the sun, at least when it comes to finance:

[18] Almost Daily Grant's, 4/18/22
[19] WSJ; Risk of Recession Appears to Grow, 4/11/22
[20] Breakfast with Dave, 4/11/22
[21] Zero Hedge , 4/8/22

"I told you the Fed should have tightened."

I hope that you found this material useful. Thank you for your continuing confidence in our efforts on your behalf, and please let me know if you have any questions on either the foregoing, or the enclosed portfolio materials.

Pierce Archer
4/25/2022

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