WELLS TRECASO
FINANCIAL GROUP

Doug, Ralph, (sitting) Samuel, Alexa, Michelle, Andrea and Chris (standing)

Portfolio Talk May 2022

It has been said that "Bull markets climb the wall of worry"! What we are facing are head winds that scares even the bravest of investors. The three major events that are most obvious are:

- ✓ Inflation
- ✓ Russia/Ukraine war
- ✓ Market Valuations

While one or two of these would be a difficult pill to swallow, having all three sends us back to the drawing board to re-access portfolio strategies. Are we in the right positions to benefit from the current environment or should we adjust our thinking? These are strategic in nature, but this does not change our thesis that holding good companies for the long haul is not the correct strategy. What it does, it forces us to re-evaluate the forward growth assumptions in our holding. An example would be, does Alphabet (Google) have fewer clicks/views with inflation at its current levels? Or will we use our iPhones/iPads/streaming services less at Apple given the Russia/Ukraine war? The real issue we face is will earnings from the companies we own be effected dramatically given the events listed above. We do not believe so, but we'll be watching closely!

Looking at the first item on the list above, action was taken on Wednesday with the Federal Reserve increasing the Fed Funds Rate 50 basis points, the largest hike since May 2000. Will this be affective in slowing inflation? Maybe not right away, but most probably yes as they (the Fed) continue to raise rates in the coming six meetings scheduled for the rest of the year. Jeremy Siegel, the somewhat infamous professor from the University of Pennsylvania's Wharton School of Business who back in the 1980's predicted the Dow Industrials would reach 20,000 by 2015 (amazing given the Dow was in the 2,000 range), explained on Tuesday (May 3rd) on CNBC that increasing the money supply by some $4 trillion during COVID (bond purchasing program and stimulus checks along with PPP, etc.) took about 18 months for inflation to really ramp up and it could take about the same time as rates climb to get rid of it. The question we need to ask ourselves is how does this affect our portfolio? Here are the obvious effects:

- ✓ Bonds and fixed income instruments will lose value and longer-term maturities will get hit the hardest.
- ✓ The market earnings multiple will compress as growth stocks should suffer the most. Their valuations will compress as investors use higher discount rates to determine future values.
- ✓ Fear that a continuation of increasing rates will cause the economy to slow too much and push us into a recession.
- ✓ Consumers will lose confidence as cost-of-living increases and possible loss of employment.

Chairman Powell stated on Wednesday that given evidence that the consumer is strong, corporations are growing their earnings and cash on the side lines are at or near record levels, he and the board of governors see a high probability of navigating a soft landing. What this means is having rate increases that could slow growth and inflation without sending the economy into recession. Let's hope he's right, but if not how will inflation effect the markets? Lets take a look at the chart below:

Annual Averages per Decade

The following table shows average annual results for each decade:

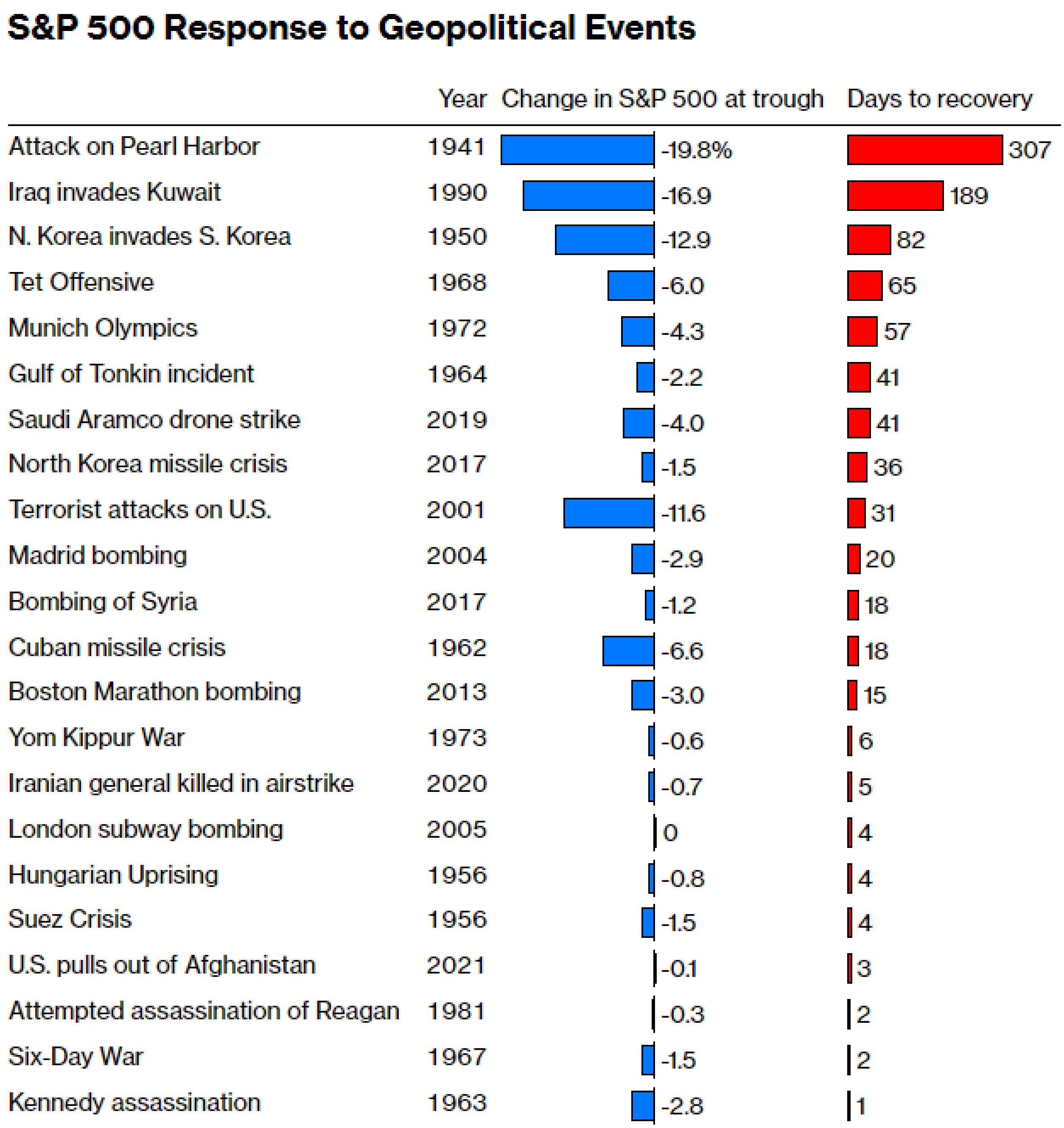
	Price Change	Dividend Dist. Rate	Total Return	Inflation	Real Price Change	Real Total Return
1950's	13.2 %	5.4 %	19.3 %	2.2 %	10.7 %	16.7 %
1960's	4.4 %	3.3 %	7.8 %	2.5 %	1.8 %	5.2 %
1970's	1.6 %	4.3 %	5.8 %	7.4 %	-5.4 %	-1.4 %
1980's	12.6 %	4.6 %	17.3 %	5.1 %	7.1 %	11.6 %
1990's	15.3 %	2.7 %	18.1 %	2.9 %	12.0 %	14.7 %
2000's	-2.7 %	1.8 %	-1.0 %	2.5 %	-5.1 %	-3.4 %
1950-2009	7.2 %	3.6 %	11.0 %	3.8 %	3.3 %	7.0 %

Notes: Figures for dividend distribution rates in the previous table present high uncertainty, of about ±5 %. Geometric averages were calculated for price changes, total returns and inflation. Raw data for this work was obtained from the following sources:

Standard & Poor's S&P 500
U.S. Department of Labor
Yahoo Finance
Data collected by Robert Shiller, from Yale University, for his book ***Irrational Exuberance: Second Edition***

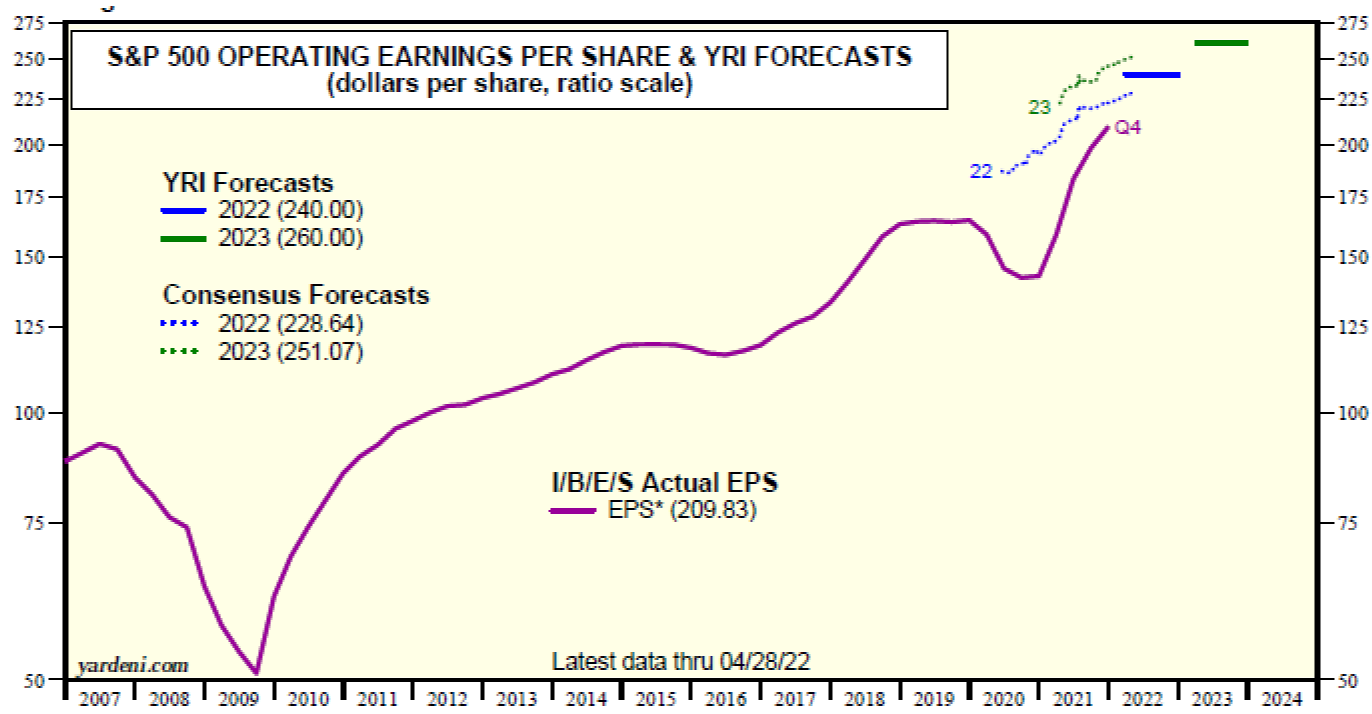
The time period that many have focused on to see the effects of inflation on the markets is the decades of the 70's and 80's. The 70's was the time when inflation took off and got as high as 13.5% in 1980 as measured by the Consumer Price Index, CPI. Real market returns were -5.4% and if dividends were reinvested, -1.4% annually compounded. Not good! However, as we rolled into the 80's when the CPI was 10.3% in 1981 and 6.1% in 1982, short term interest rates climbed to over 20% causing the economy to fall into recession. The markets did perform quiet well though having an annual return of 7.1% and if you reinvested dividends 11.6% annually compounded. Where are we….in a 70's environment or an 80's one? If we are already seeing some evidence that the supply chain constraints are easing, commodity prices are stabilizing, employment costs are leveling off and inventories are seeing some relief we can argue that we are more 80's than 70's. Time will tell, but we are hopeful!

The second item that has everyone's attention is the war in Ukraine. Russia continues to hammer areas of Ukraine and there appears to be no relief in sight. Putin's word is useless as promises made are not kept. Russia's isolation from the rest of the world seems to be working, but it'll take time. Our hope is that his generals and/or Russian citizens will revolt and Putin will be removed from power. But, as long as the military are behind him there's little hope that the population can sustain a coup. So, lets look at what happens to the stock market during war times. The chart below illustrates that when conflicts/war occurs markets do react negatively. What's interesting is how long it takes to recover from the initial reaction. When the Japanese attacked Pearl Harbor the market fell 19.8%, but it only took 307 days to recover. The terrorist attack on 9/11 caused the markets to fall 11.6% and 31 days later we regained the loss. Will we have the same recovery with the Russia/Ukraine war? History does tend to repeat itself……



Source: LPL Research, S&P Dow Jones Indices, CFRA

And finally, market valuations! As we've said all along, equities are only worth what they can earn long term. Keeping that in mind, the S&P 500 booked earnings in 2021 of $209.83. That puts the current market multiple at 19.6x earnings as of 5/6/2022. Average over the last 40 or so years is between 17-19x. That means we are currently neutral/average in valuations. However, we rarely trade at average. When investors are positive on the economic outlook they push prices higher thereby market multiples move above average. Conversely, when investors are negative on the outlook prices go lower and so do multiples. Hopefully investors will focus on projected earnings in 2022/2023. Both are projected to grow to $240/$260 in 2022/2023. Applying a 20x multiple could see the S&P 500 grow to 4,800 and 5,200. The chart below illustrates the projection by Yardini and Associates as well as the Consensus. Earnings will drive prices as long as the market multiple stabilize at current levels. Something we'll be watching closely!



* Four-quarter trailing sum of operating earnings per share.
Source: I/B/E/S data by Refinitiv.

If wars, inflation and valuations seem to be obstacles we can navigate around, could we be experiencing just a good old correction, one that tends to surface annually? The chart below shows us that the market tends to decline 14% intra-year on average, but has a positive return 32 of 42 years, or 76.2% of the time with a 9.4% annually compound rate of return! Good odds, right? Maybe its just like spring cleaning, you sweep, dust and throw out the things you don't use or that are broken. Maybe its not a bear market, but just a correction.

Annual returns and intra-year declines

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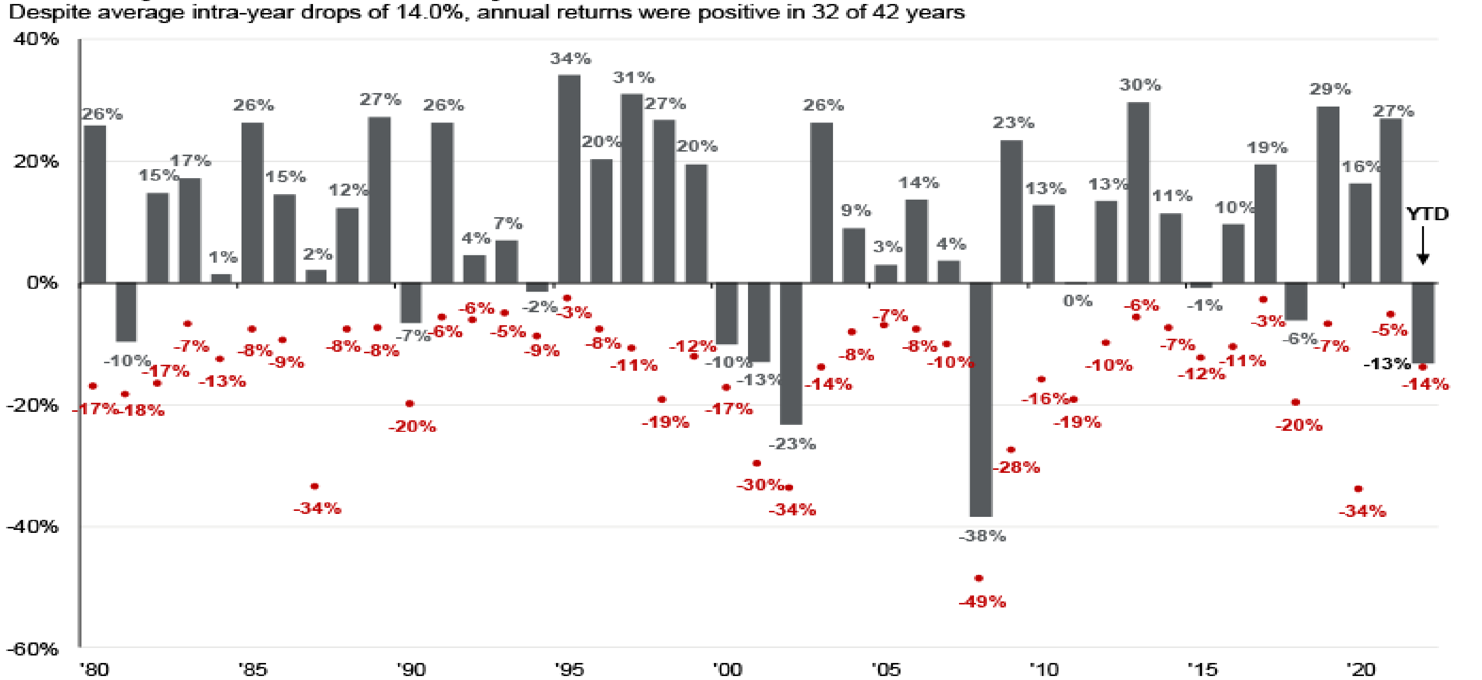
S&P intra-year declines vs. calendar year returns
Despite average intra-year drops of 14.0%, annual returns were positive in 32 of 42 years



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2021, over which time period the average annual return was 9.4%.
Guide to the Markets – U.S. Data are as of April 30, 2022.

J.P.Morgan
ASSET MANAGEMENT

While we are cautious, we are still in the camp that believes a recession is not in the cards near term, maybe 2023/2024. That being said we are still very watchful, looking for any evidence of a slowing economy or stressed consumer. Balance sheets for both consumers and corporations are in very good shape as corroborated by Chairman Powell on Wednesday. Demand is still strong for housing, cars and durable goods (refrigerator, washers, dryers, TV's, etc.). China's zero COVID tolerance is still an issue for the supply chain, but hopefully that will resolve itself soon. All in all, the economy is strong.

Please know that we are available to discuss any concern you may have as we move through these market gyrations. Please continue to stay safe as we trend back to a new normal.

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