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QUARTERLY INVESTOR LETTER

Federal Reserve Chairman Powell recently addressed the unsettled debate as to whether the Fed acted too deliberately regarding inflation. During testimony, he acknowledged monetary policy cannot resolve supply issues contributing to higher prices. The Fed can only curtail demand through liquidity removal. In the process, the Fed's efforts to mitigate inflation risk engineering a recession.

During the Second Quarter, the Fed responded to criticism with an unprecedented 0.75% increase in policy rates, a maneuver last used in 1994. Stock and bond markets adjusted violently to both the Fed's aggressive policy shift and higher than expected inflation measures. Toward the end of the quarter, however, financial markets seemed to appreciate the Fed's commitment to stabilize prices. Market narratives also appeared to shift away from uncontrolled inflation toward rising recession risks. Both consumer surveys and market-based estimates of forward inflation expectations dropped sharply from peak levels. However, numerous indicators suggested surging food, materials, and energy costs were reducing demand for discretionary items.

It is well understood that COVID lock downs in China contributed to global supply chain disruptions. Recent academic studies demonstrate supply shortages account for about half of the inflation experienced this year. The studies support the argument that removal of pandemic-related restrictions should ameliorate inflationary pressures as fewer bottlenecks allow supply to meet demand. Recent data confirm supply chains now operate more efficiently than earlier this year. At the same time, food, fertilizer, and energy prices should remain elevated for an extended period because of the war in Ukraine. In addition, exhaustion of excess savings and high prices are likely to dampen consumption. However, low unemployment and pent-up demand seem sufficient to avoid recession. Overall, the outlook for the economy is unclear and will depend, in part, on how markets respond to incremental data.

Following one of the worst first halves in fifty years, the markets enter the Third Quarter at a critical juncture. Rising interest rates reduce the present value of all financial assets. Consequently, bonds lost value and failed to protect portfolios from stock market weakness. In the second half of the year, we expect bond values will stabilize because inflation expectations have moderated. Additionally, market yields have risen in advance of actual policy adjustments. Thus, the market has already priced in additional rate increases. More important, bonds now offer attractive yields for investors who need current income. For these reasons, the bond market is appealing for the first time in over a decade.

The stock market's decline to date partly reflects a valuation adjustment to the new monetary policy regime. The correction has spared very few sectors, and many individual stocks now trade at attractive valuations. Whereas recovery for the market will depend on expectations for earnings growth, fundamental prospects should determine performance of individual companies. We believe a selective and opportunistic approach to market volatility could be well rewarded in the long term.

For the balance of 2022, we believe stock market performance will be highly correlated with inflation expectations. In turn, inflation expectations, both survey-based and market-based, will remain sensitive to incremental economic data. Markets should respond positively to data that confirm expectations, particularly with respect to inflation. However, market volatility will rise sharply if incremental data exacerbate uncertainty. COVID and Ukraine are two factors that render most forecasts unreliable and contribute to a breakdown in traditional market relationships. While we acknowledge the challenge of investing during highly uncertain times, we believe visibility should improve in the second half of the year, particularly as the impact of the pandemic continues to wane.