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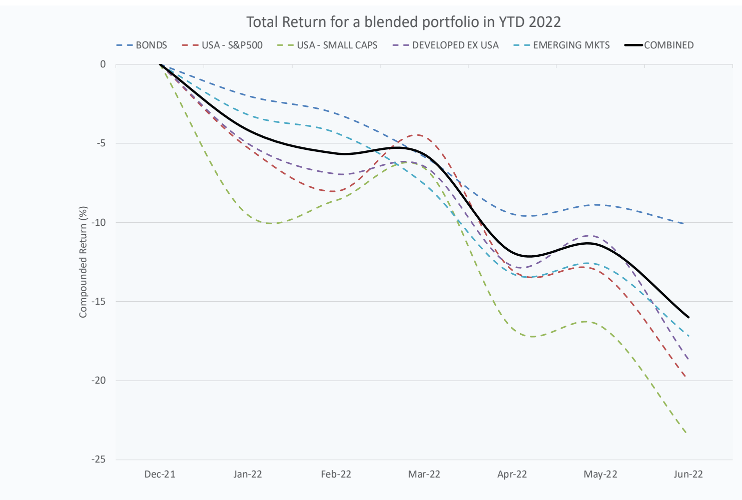
RYE, NY
914.282.0941
WWW.BLUMBERGADVISORS.COM

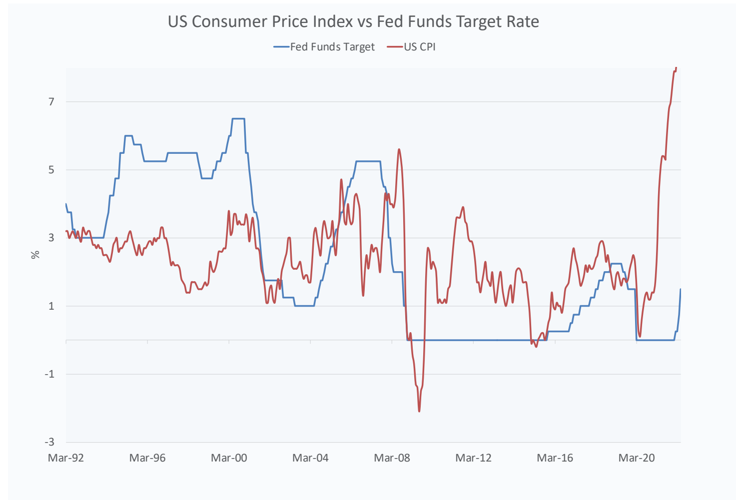
WHERE WE STAND – Q2 2022

A blended portfolio* of equities and bonds was down 10.9% (on a total return basis) in Q2 2022. For the year to date, down 16.0%. See the black solid line in the chart below. US small capitalization stocks (-23.5% YTD), US large caps (-20%), developed markets ex-US equities (-18.7%), Emerging market equities (-17.2%) and US investment grade bonds (-10.1%), all declined. See the colored broken lines in the chart.



*A typical blended portfolio would be comprised of 60% equities and 40% bonds. For a benchmark, such a portfolio would arguably be 30% large cap US stocks, 10% US small caps, 10% developed markets ex-US, 10% emerging market stocks and 40% US government, investment grade corporate and GSE bonds.

The Federal Reserve hiked its benchmark short-term rate twice during the quarter, first by 50bpts in May and then by an aggressive 75bpts in June. This followed the 25bpts hike in March and brings the policy rate quickly to 1.75% after 2 years of a pandemic-induced zero rate target. Additionally, after halting quantitative easing in March (the buying of bonds by the Fed to introduce further liquidity into the system and to keep longer term rates low), the Fed began quantitative *tightening* in June. All this aggressive tightening of monetary conditions by the Fed, is a reassessment of their early thinking that inflation in the US economy was a ‘transitory phenomenon’, to the realization that it isn’t. See red line for the concerning rise in inflation in the following chart.



In the process, consumer borrowing rates have risen substantially, and financial assets have fallen sharply, and while the employment rate has for now remained low, there are increasing signs of the US economy slowing markedly.
As the quarter rolled into June, the now dual concerns of inflation *and* recession began to dominate investors’ minds and resulted in intense liquidation of most financial assets. For the typical 60:40 (Equity:Bond) portfolio, the YTD drawdown is the worst since the 1970s. By a long way.

RANK	YEAR	TOTAL RETURN
1	2022	-16.0%
2	2008	-6.7%
3	2002	-6.4%
4	1984	-3.6%
5	1994	-3.6%
6	2001	-2.6%
7	1982	-2.0%
8	2010	-1.9%
9	1977	-1.7%
10	1981	-0.5%

So, what began in late 2021 as a punishing liquidation of more speculative ‘growth’ assets (as discussed in previous updates) has continued into 2022, intensifying in the second quarter to the point of being as much 75%

off the highs and back to the post-pandemic lows. The chart below shows the collective performance of a basket of these stocks, including some very well-known household names like Teladoc, Roku, Twitter, Zoom, Spotify, Tesla etc.

The damage has been widespread and to one degree or another includes high-yield bonds, long US Treasuries, municipal bonds, private equity investments and crypto. Finally, in June selling spilled over into even the bluest chip indices as mentioned above.

Towards the end of the quarter, it became apparent that the Fed is very serious in reestablishing its inflation fighting credibility, even if its to the point that in the process they push the US economy into recession. The financial markets now realize that we are in new investment waters and that weakness in financial assets (in and of itself) will not cause the Fed to become more dovish…not until there is strong evidence that inflation is very much under control.

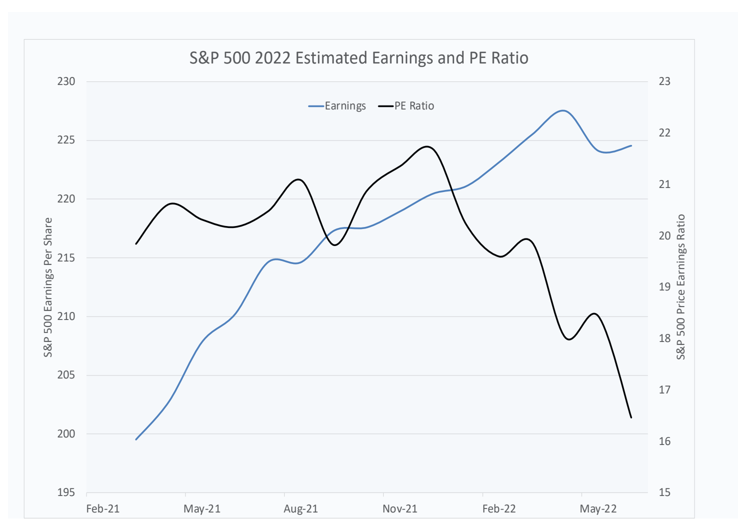
With the ever-increasing likelihood of a recession developing as the Fed raises interest, long duration assets, particularly those with scant or negative free cash flows, have come under extreme pressure. So, for example, Utility and Health Care (solid cash flow, conservative growth) stocks are down only 2% and 9% YTD respectively, while Technology and Consumer Discretionary stocks are down 27% and 33%.

These hindsight observations need to be viewed within the context of how investors were positioned a priori and how investor sentiment has changed over the observed period.

We know that positioning has been heavily tilted to risky, long duration assets. By long duration is meant that the cash flows that the asset will generate are far in the future and therefore less certain (like Roku, which has never made a profit), rather than being a certain cash generator (like Bristol-Meyers Squib). See charts to the right for how these two stocks have behaved.

And we know too, that investor sentiment has soured markedly, in certain instances pushing valuations even lower than perhaps they ought to go.

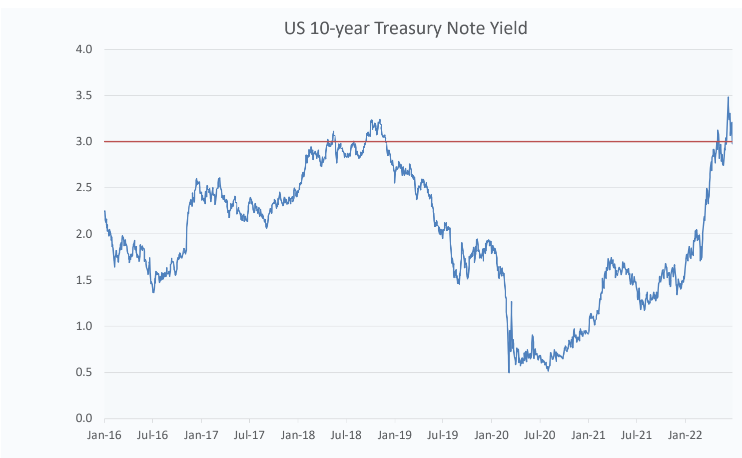
Notwithstanding prognostications of pending recession, estimates for earnings of US companies remain relatively optimistic. These earnings estimates are calculated in a 'bottom-up' manner: i.e., by looking at each individual company and discussing its prospects with management. So, they tend to have an optimistic bias. But still, for now they are holding up, perhaps buoyed too by the fact that corporate top-lines (sales) grow in nominal terms. Given the current inflation rate of say 6-8% and with operating and financial leverage still positive for large cap, cash flow positive companies, this is a supportive variable for EPS of these companies. The next chart shows earnings



estimates are still at around $225 for 2022 (blue line),

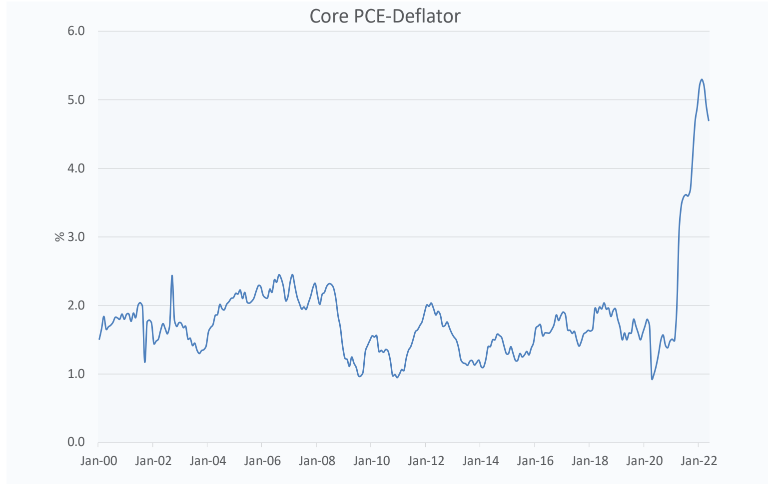
which means that the sell-off this year has been largely based on multiple contraction: from 22x 2022 earnings to around 16x (black line).
For 2023, earnings estimates are for $248 per share (10% increase over 2022) and therefore the implied forward 2023 multiple is around 14.8x earnings. These are interesting, if not enticing, valuations especially if the US growth slowdown is mild (so called soft-landing) and inflation pressures start to ameliorate. Similar attractive valuations have manifested in fixed income assets like long municipal bonds and high-yield bonds.

By the end of the quarter, even though equities continued under heavy liquidation pressure, the long-dated treasury yield, which had risen above the 3% level, started to regain some ground and fell from as high as 3.5% to marginally back below 3%, a nod to increased trust in the Fed's inflation fighting rhetoric and in acknowledgment of anecdotal evidence of easing price pressures in housing and autos (due to higher borrowing costs) and consumer goods (due to inventory



overstocking). Industrial metals, grains and even gasoline and natural gas prices came off the boil by quarter end.
Also of note, is the Core-PCE deflator, the Fed's favorite inflation guide when it comes to monetary policy, has had three months of successive declines, which is somewhat soothing. See chart at top of next column.

As we enter the second half of the year, the jury will be out on the ongoing trade-off between inflation and growth and how the Fed reacts. For now, equity sentiment is too depressed at sub-15 times forward earnings if economic slowdown will be mild and inflation reverts towards, say 3%. On the other hand, if the geopolitical conditions worsen, inflation proves stubborn and the Fed is forced to induce a hard landing by raising



rates aggressively, there will be an ongoing search for a valuation bottom at lower levels.

Where We Stand

Our internally generated risk premium* for equities is as high as it has been since the sharp equity sell-off in early 2020.

*Equity Risk Premium=Potential Forward Return on Equities minus 10-Year risk free rate on US Treasuries. The higher the ERP, the cheaper the implied cost of equities.

Granted, these models involve making certain assumptions regarding future earnings, dividends and valuations. If economic slowdown is harsh, interest rates are forced to go higher and/or investor confidence falls further, these assumptions could prove too sanguine.
Our strategy has been one of taking advantage of the sell-off that has spread to wide-moat, cash flow positive, dividend paying blue chip companies to invest funds, as we said we would, when opportunities like the current one arises. And if current valuations are going to be tested further, the quality of our portfolios give us staying power to benefit when the cycle turns upward without having to face existential issues until that time. (I should point out that the investment landscape has been littered with these existential issues over the last quarter which should imply we are closer to recovery than sentiment implies).
Going forward, we will continue to build our portfolios with the next cycle in mind. If markets continue to 'deteriorate' (or as we see it provide further opportunity) we will continue to allocate spare cash to both equity and fixed income opportunities. In the meantime, all our investments pay attractive dividends and have ample free cash flow which gives us time to wait out a recovery in financial assets into the next cycle.