The Long Run

INVESTMENT LETTER
JULY 2022

REYNDERS, MCVEIGH CAPITAL MANAGEMENT, LLC

"What are we going to do now?"
—The Clash

In January, we noted that the S&P 500 index had finished 2021 with its second best three-year winning streak in history—and that the probability of a poor year for stocks was higher than it had been in many years. Unfortunately, that probability has become a reality as stocks have declined sharply over the past six months. The S&P 500 index has been ransacked, dropping by 21.28%. The growthier, technology-heavy NASDAQ index plunged 31.0%. With a sharp correction already in place, what do we advise now?

WILL INFLATION STAY OR WILL INFLATION GO?

Ask economists why stocks have fallen this year and most will cite higher than expected inflation. On January 5, minutes released from a meeting of the Federal Reserve indicated that they saw rising inflation as a major risk to the economy and they would have to raise interest rates sooner than expected. Gone was Fed Chairman Jerome Powell's earlier belief that inflation was a transitory phenomenon and would pass as the economy and supply chains returned to normal following COVID-induced lockdowns. High inflation and higher interest rates reduce the value of long-term assets like stocks, bonds, and speculative investments such as cryptocurrencies.

With July inflation reaching 9.1%, a 40-year high, it would seem like the Federal Reserve got it right and interest rates should be raised at a rapid pace to counter inflation.

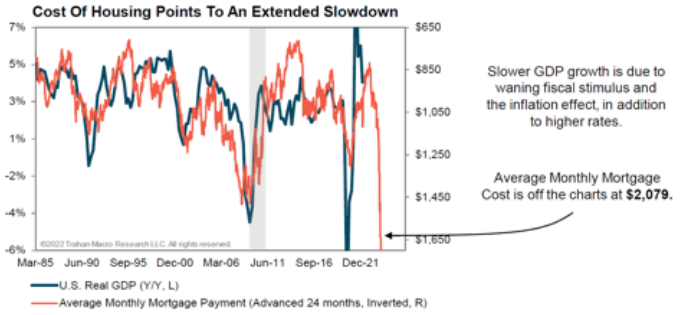
And yet there are some signs that inflation has peaked, and the real concern should be the health of the economy. We got this inflation because the government closed down the economy to fight COVID, while at the same time, it rightfully injected $6 trillion into the money supply and consumers' pockets. For those who believe inflation is a supply/demand problem, the extra cash created increased demand for products at the same time that supply chain problems couldn't get goods to the shelves. For those who believe inflation is always a monetary phenomenon, this massive growth in the money supply ignited price inflation. Either way, we are now seeing a reversal in the causes of inflation. Supplies of goods are increasingly reaching retailers and some, such as Target and Wal-Mart, are now suffering from bloated inventories. Likewise, the money supply has now contracted sharply and should lead to a lowering of inflation pressures over the next 6–12 months. Since the beginning of June, the prices of economically sensitive commodities, such as copper and oil, have fallen by 29% and 19%, respectively.

Source: Bureau of Labor Statistics/Haver Analytics

THE CLAMPDOWN

While higher interest rates have not always led to a recession, every recession has been preceded by higher interest rates. Since the end of WWII, the Federal Reserve has raised interest rates 13 times. All 13 times have resulted in a slower-growing economy—though only 10 entered official recessions. Soft landings were accomplished three times, where growth continued and inflation cooled.

The best predictor of whether or not the economy has a soft or hard landing has tended to be the resilience of the housing market, since home equity is most individuals' primary savings vehicle. We are already seeing the number of pending home sales dropping to below pre-pandemic levels as rising mortgage rates and high prices are making homes less affordable.



If the Fed moves to more aggressively raise interest rates to control inflation, will a recession follow? We are currently seeing an inversion in the yield curve which is a fairly good predictor of economic weakness/recession. As the Federal Reserve clamps down on inflation, the odds of a recession are growing.

THE RIGHT PROFILE

Higher interest rates to counter inflation will result in a slowing economy and lower corporate profits. While the decline in prices of financial assets so far this year is discounting this outcome, we believe there certainly could be more volatility ahead—and recommend holding high-quality assets, which is central to our investment philosophy. Doug Clinton recently paraphrased Warren Buffet on the difference between being a speculator and an investor. If you are a speculator, you look at what the price of your investment is doing. If you are an investor, you look at what the asset is going to do. We believe investing is a long-term activity. You benefit from the accumulation of cash flows over an extended period of time.

Prices of investments will fluctuate depending on interest rates, inflation, economic growth, and levels of optimism. Two years ago, we saw exceptional returns on stocks we held for clients. This year has seen a retrenchment. Underlying this is our belief that the companies we invest in build cash flow and become more valuable entities over time. We continue to believe this is the right profile to meet your long-term needs.

TEXAS CALLING

We would be remiss if we did not give some acknowledgement to the human and environmental tragedy that continues to unfold in Ukraine. We hope for a resolution as soon as possible. There is little we can add about the emptiness of war, except maybe to counter one prevailing argument: that environmentally concerned investors are somehow partially responsible for this tragedy by not supporting the development of more fossil fuel production, thereby leaving the world too dependent on Russia. Texas has even gone so far as to penalize investment firms that choose not to invest in fossil fuels. Our response is that the world has not moved fast enough to develop local, renewable sources of energy—and that rather than seeking to punish, Texas should be talking more about pursuing the path they have started on. Texas is the #1 renewable energy generator in the country, with nearly 38% of the state's electricity being produced by renewable energy. In fact, a recent study indicated that it would only take one-third of the already proposed solar and wind projects to almost completely phase out the use of coal in Texas. The state also led the nation in new renewable energy projects last year, installing almost three times as many megawatts as the runner-up, California. Its concern extends to helping remove gasoline-powered cars from the road. Texas recently provided a reported $65 million in subsidies to attract Tesla to make electric vehicles in the state.

Please let us know if you have any questions or would like to discuss your goals in light of world events. RM

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