The Long Run

INVESTMENT LETTER
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"Time is your friend; impulse is your enemy."
—John C. Bogle

As of this writing, the U.S. market is almost myopically focused on inflation — and the battle to choke it off. In recent months, well-documented supply chain issues have blossomed into inflation spikes across a wide range of industries.

FACTORS DRIVING INFLATION

It's no secret that energy and food prices have been rising over the past year, and the Ukraine conflict has piled on additional supply shocks that have increased prices further in 2022. (The European Union receives about 40% of its natural gas from Russian pipelines, and Russia and Ukraine together export more than a quarter of the world's wheat.)

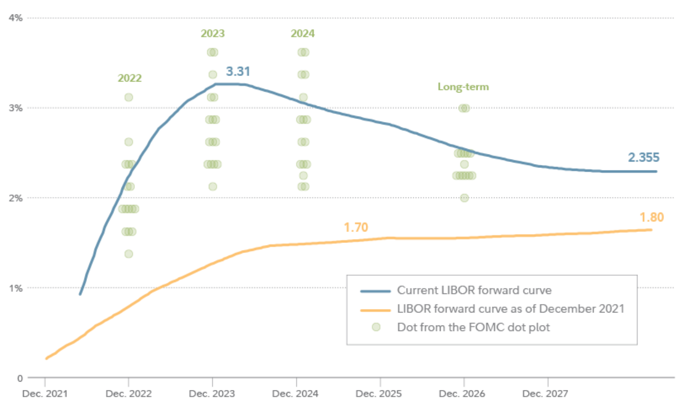
To add fuel to the fire, labor markets are at their tightest in decades. At the end of the first quarter of 2022, there were a record 5 million more job openings than unemployed. The idea that "transitory" inflation might peak and fade by the end of the spring has been replaced by concerns that stagflation (slow growth and rising prices) could be with us into 2023 and beyond.

THE FED RESPONSE

Reacting to inflation data, the Federal Reserve ("Fed") has embarked upon an aggressive rate-hiking program and plans also to begin shrinking its balance sheet in the near term. The primary purpose of these initiatives is to mute demand and slow economic activity enough to calm the inflation in the system. The longer-term intent is to bring U.S. interest rate levels back to historic norms. This comes after more than a decade of an extraordinarily accommodative policy, during which the Fed has figuratively been stacking economic sandbags to avoid a flood of systemic failures in the face of a global financial crisis and a pandemic.

For those concerned that the Fed's incremental actions will take too much time in the face of the current wave of news about inflation, the following chart shows how the bond market can get ahead of the Fed when it comes to interest rate moves. In its March meeting, for example, the Fed raised rates by 0.25% and announced that they were committed to additional increases in each of their six remaining meetings during 2022 — with some Fed officials even looking at individual 0.50% increases to fight inflation more aggressively. The chart below shows that the bond market has tightened significantly, with current rates already pricing in all of the potential Fed increases for 2022 and the first half of 2023 combined.

Implied interest rate expectations



Source: Bloomberg, FMRCo.
The LIBOR forward curve shows implied estimates for future interest rates that are embedded into current yield curves.
Each dot represents a Federal Open Market Committee participant's assessment of appropriate monetary policy for a future period, based on the dot plot released March 16, 2022.

INFLATION VERSUS RECESSION

This data suggests that a good deal of preventive medicine is already in the system fighting the onset of inflation, and there are signs of demand destruction already. With 30-year fixed mortgage rates now above 5%, the Mortgage Bankers Association said it expects overall mortgage originations (which include refinancing loans) to total $2.58 trillion in 2022, a 35.5%

decline from last year. Last month, sales of used cars less than 10 years old were down 27% compared with March 2021. Just as inflation hawks today are determined to have the Fed continue to raise rates to defeat inflation, recession hawks argue that the shocking rise in interest rates this year may be driving an already weakening economy into imminent recession.

It's not as though we haven't been here before. The 10-Year Treasury yield spiked above 3.20% as recently as 2018 (the last time the Fed attempted to normalize rates). A flattening yield curve and fears of a recession then forced the Fed to back off from interest rate hikes, and rates dropped back down to historic lows. The spread between the 2-Year Treasury and the 10-Year Treasury has been flattening since the middle of 2021 — and actually went negative during March, flashing a warning signal that a recession may not be far off. The chart below, however, shows the sharp recent reversal of last month's inversion in the yield curve as new data countered some inflation fears.

LOOKING AHEAD

The economic reality ahead is likely somewhere between these poles. There is evidence that some global supply chain issues may be improving, easing inflation pressures a bit. The speed of container ships at sea is increasing, for example, indicating they expect faster throughput when they arrive at port. Consumers today are sitting on an enormous pile of savings, but it is hard to judge today how much inflation will rob them of purchasing power in the months ahead. It will take some patience — and more data over the coming quarters — for any of us to have a clear sense of where rates should and will ultimately go in this cycle.

This severely polarized and narrow view of potential outcomes has contributed significantly to market volatility, and this turbulence has been amplified by excess liquidity. The last two years have seen an enormous influx of new investors into equity markets. These investors were rewarded for chasing short-term momentum in 2020 and 2021, and now find themselves crowding into any investment that might be rising in the current market. Last year's record margin debt has also added another powerful accelerant to today's volatility: deleveraging. Many investors are now being forced to sell assets at any price (just as they bought assets at any price on the way up) to meet loan requirements. We suspect that the volatility in global markets could be with us for some time as we work through these market excesses.

Our focus has always been to invest in a portfolio of companies that can sustain profits through a range of economic environments. If inflation should continue to rise, we hold companies with pricing power that have long histories of increasing dividends for shareholders at a much higher rate than inflation. If interest rate spikes prove too sudden and throw the economy into recession sooner than we might expect, we own companies in industries where demand is steady — with balance sheets and cash reserves that afford them the ability to buy up weaker competitors that may not be able to manage the environment as well. If, to everyone's surprise, we see rates fall and growth stocks roar back, we own companies where growth is based on innovation and large new market opportunities. Many of the core investments in our portfolios meet all of these criteria.

OUR PHILOSOPHY

We believe that sustained earnings growth across a wide range of economic cycles is what drives equity performance over time. As traders today react in real time to incremental economic surveys and lurch from inflation protection to meme stocks, we are studying the balance sheets and income statements of corporate leaders to understand what parts of the economy are recovering — and how.

To that end, we are finding many companies with excellent prospects for sustained, long-term earnings growth trading now at more reasonable prices. We will, however, continue to be patient and disciplined with investments as the global economy works to regain its footing.

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