

# INVESTMENT VIEWS

JUNE 30, 2022

## INFLATION IS HERE, NOW WHAT?

We have long warned that inflation would become a problem in the US and that many investors would be caught off guard. Now that inflation is here, investors need to know the causes of it, how long it will last and what policy makers might do in response. Importantly, they also need to understand the longer term effects of inflation on their portfolio.

### Root Cause - Physical Supply Shortages

Consensus is that the current bout of inflation is rooted in the policy response to the COVID pandemic. Most of the US and global economy was shut down for months or longer, including sensitive supply chains, as officials attempted to contain the spread of the virus. Of course, when the economies opened up again, demand increased much faster than supply could respond to. Additionally, sanctions put in place on Russia over their invasion of Ukraine have added to inflationary pressures. Many have argued that it is lower interest rates and “money printing” by the Fed, however these conditions existed for over a decade and did not produce any lasting inflation. There is very little that can be done other than attempt to reduce demand, which will hurt the economy.

### Solution - Time and Patience

It will take time and patience for inflation to subside as suppliers catch up to demand and supply chains normalize. Everyone wants immediate results, which cannot happen without serious risks to economic growth. For the time being we are seeing wages grow at a rate that is above inflation, meaning that the average worker can handle inflation for now. However, the Fed seems determined to raise rates to “do something” even though the risks for this course of action are high.

### Powell Is NOT Volker

Many investors reference the actions of Paul Volker who raised interest rates in 1980 to “kill inflation.” However, most do not realize that inflation was likely already peaking as supply, particularly in oil, had nearly 10 years to come on line and catch up. We are barely past 1 year in this trend of higher prices, giving supply very little real time to adjust. Jerome Powell is not Paul Volker and any hasty actions to imitate him would lead to a recession and be counterproductive in solving longer term supply issues.

### Energy - A Key Component

Oil and natural gas have become dirty words in the investment world. However the reality is that the entire world is still utterly dependent on them. As outlined in many previous newsletters, investment in new production has been non-existent for a number of years and the EIA just published a report concluding that oil supply is extremely tight. The US needs to rapidly expand supply at home as global supply and geopolitics are unlikely to be helpful in bringing down prices. Additionally, other commodities such as copper and wheat could also feel upward pressure as higher cost inputs work their way through.

### Wages - Workers in the Driver's Seat

Most everyone is familiar by now with the shortage of workers across all industries. From dishwashers to doctors and engineers, companies are scrambling and competing for just about anyone who is qualified for the open position. Obviously, this will put pressure on wages which is another key component of inflation. The reasons for the labor shortage include a COVID inspired baby boomer retirement wave, and reluctance by some younger workers to re-enter the workforce after being home during the pandemic. As wages rise, the labor shortage will ease, and employment supply and demand will find balance. This process will take longer if we are pushed into recession and the market for labor is frozen or reduced.

## Investment Implications

By now, investors have witnessed the volatility that inflation has brought to the market. It has upended valuations for tech stocks in particular, deflating the most speculative companies and investments, including cryptocurrencies. However, our approach to investing, namely picking individual stocks and sectors based on value, should work well in this difficult environment. We make decisions to buy, sell or hold each investment based on each stock's unique characteristics, instead of relying on broader measures of valuation. Additionally, on the fixed income side of the portfolio, we let interest rates guide our decisions on what is best to hold in portfolios, which until recently has been heavy in cash. Moving forward, we believe our approach will continue to keep us ahead of the general market and in the best position to profit long term.

## C3.ai, Inc. - Growth with Experience



C3ai (AI) is a growing artificial intelligence company that has not fared well so far in our initial purchases. It is a relatively small position and we feel comfortable holding it and adding to it at these lower prices. We believe that it has some of the best technology in the sector and it is led by a very experienced industry veteran, Thomas Siebel.

While the company is growing quickly, it is still losing money. However, Mr. Siebel has seen to it that the company is well financed to handle a very tough environment, with over 5 years of cash on the balance sheet. In a recent interview, he reiterated his conviction that growth at the company will continue and our work agrees with him. Artificial intelligence will transform our society in the coming years and C3ai is likely to play a big role in it.

## TECHNICALLY *Speaking*

In our last couple newsletters we discussed a few points that could be indicating that a bottoming process may be starting in the markets based on history and sentiment readings. The big issue is, sentiment can change quickly and history doesn't always repeat. While they can be useful in pointing out potential changes in direction, they are not as useful as what the market is actually doing.

The chart shows the S&P 500 since the lows of the Credit Crisis with a regression channel run up to the COVID lows. This channel encapsulates the two ultimate lows in the market in that period and its center line mimics a trendline along the intermediate lows. We have added the blue dashed lines to extrapolate out the regression to show potential support in the future. As you can see in June we crossed below the center line (as well as testing the 200 week moving average) and this is not a positive sign. If we do not recover the center line and maintain above the 200 week average, we feel there could be more downside in the market. The bottom window of the chart measures that strength of the trend and this correction is continuing to gain strength. It attempted to turn during the first quarter, but resumed its surge after continued rate hikes by the Fed. We will want to see this move down to start feeling like the bear trend is losing steam. The Fed "blinking" in the eyes of weakening economic data could cause this to happen.



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