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THOMPSON DAVIS ASSET MANAGEMENT

THE INVESTOR INSIGHT

APRIL 2022

INSIDE:
How to Hedge Inflation at Home

Q1 Commentary

A multitude of negative factors set U.S. stocks up for a difficult start to 2022, with the S&P 500 recording its worst January since 2009 and officially hitting correction territory in February, which led to the worst Q1 in more than three years. Growth-oriented stocks were at the epicenter of the pain amid fears of rising rates and a slowing economy. According to Bloomberg Analytics, at the end of Q1, the percentage of NASDAQ stocks down 50% or more hit a new record—more than 60% of the index, a record not seen since the 2000 Tech bubble.

We see both a short and long-term opportunity taking shape. In the near term, we believe indiscriminate selling has created attractive entry points, particularly into some value stocks with good funding tailwinds. At the same time, we believe investors should prepare for a long-run regime shift as the once-familiar slow-growth, low-rate environment transitions to a new world order that may warrant greater selectivity and a rebalance toward value.

The investing backdrop seems mired in uncertainty. Just as the global economy is looking to emerge from pandemic malaise, a heartbreaking, unforeseen war has applied new pressures to a global system that was looking to normalize interest rates and process the effects of the highest inflation seen in decades. Intraday market volatility has been dramatic and stock selling has become indiscriminate, as is often the case in big market swings. We believe this has opened attractive entry points, particularly into value stocks that have been punished beyond what their fundamentals would imply.

The prevailing backdrop highlights the importance of building resilience into portfolios. We believe at this point this is best achieved by focusing on domestically oriented companies with growth drivers, particularly stocks of companies with strong balance sheets, healthy free cash flow characteristics, and a strong macro-outlook.

Amid the uncertainty, one thing we feel relatively certain about is that we are exiting the investing regime that has reigned since the 2008 Global Financial Crisis. That was marked by low to moderate economic growth, alongside low inflation and interest rates. The new environment is still taking shape, but we believe it will entail higher inflation and rates than what we saw from 2008–2020. The Fed seems determined to raise rates dramatically faster than investors thought at the end of 2021. We are likely to see two 50-basis-point increases over the next two meetings, and between seven and nine rate hikes during this cycle. My feeling is if the Fed does raise 50 basis points during the next two meetings, it is likely to be more "data dependent" after that, as there are clear signs that the economy is already slowing.

This period reminds me of the steady march of rates in 2000, when the Fed raised rates seven consecutive times to stamp out unbridled tech stock speculation. This time around, the Fed is fighting inflation, but inflation that is caused by dramatic, unforeseen supply chain disruptions and not runaway growth. These supply chain disruptions are caused by three main factors: (1) the continued fallout due to the pandemic, (2) lack of labor, and (3) a war. This has impacted most every sector and stock in some way and unfortunately it will remain with us—at least for now.

We see stock selection becoming more important as companies navigate

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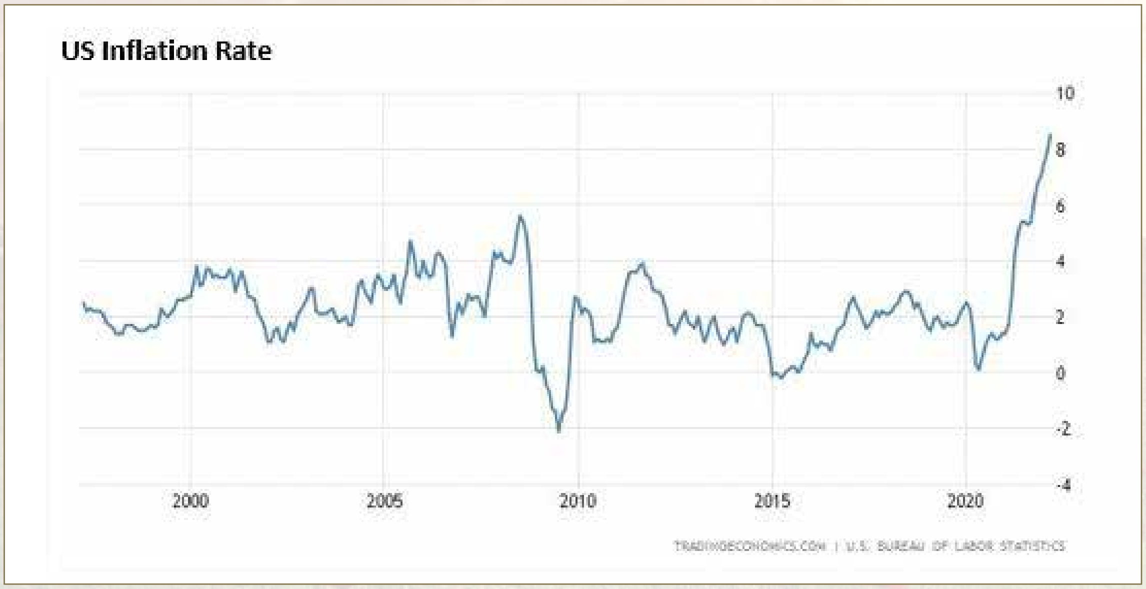
How to Hedge Inflation at Home

The U.S. inflation rate was already approaching 8%, and then came war between Russia and Ukraine—two countries that generate a large share of agricultural commodities and energy that are consumed throughout the world.



The Federal Reserve hopes that raising interest rates will help moderate inflation, but that remains to be seen. In the meantime, seeking out higher-returning, lower-risk investments, and reviewing your budget (or creating one) are a few ways to mitigate the pain of inflation.

Series I Savings Bonds

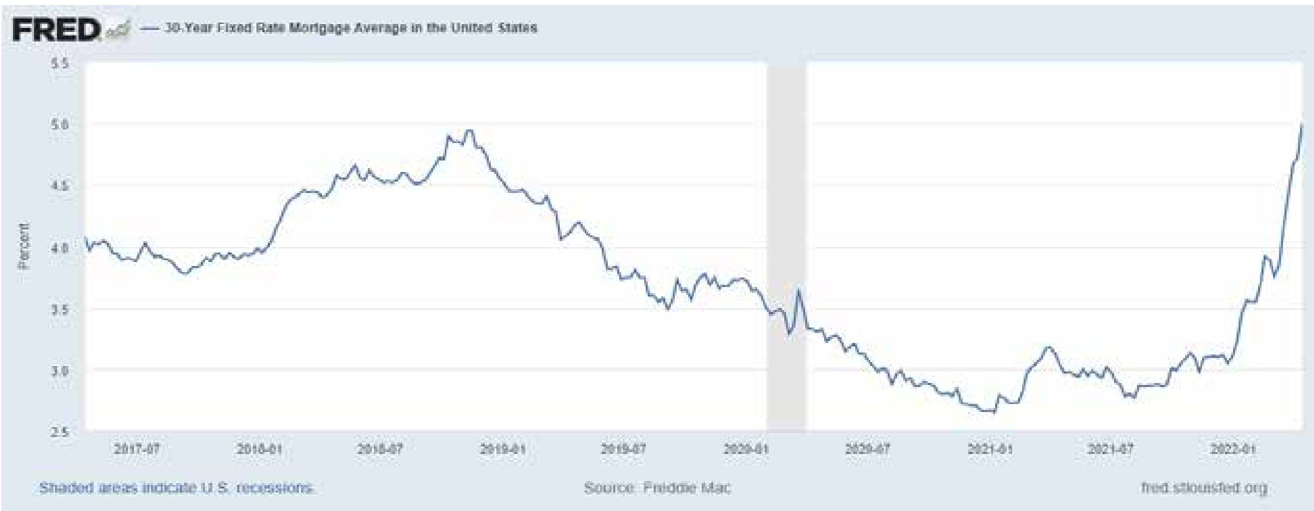
What is an I bond?
An I bond is a type of U.S. savings bond that can protect the purchasing power of your cash from inflation. Interest rates are adjusted to keep up with rising prices.

How much interest does an I bond earn?
Interest on I bonds uses a composite rate formula—a combination of a fixed interest rate that lasts for 30 years, and an inflation-adjusted rate that is set twice a year. For bonds issued from November 2021 through April 2022, the combined rate is 7.12%.

Is an I bond taxable? How much can I buy?
Series I bonds are exempt from state and local income taxes, but they are subject to federal income tax. The maximum purchase per calendar year is $10,000. More information is available at https://www.treasurydirect.gov/indiv/myaccount/myaccount_treasurydirect.htm.

30-year Fixed-rate Mortgage

The combination of rising home prices and low mortgage rates has made the housing sector a great inflationary hedge for many Americans. And while this month has seen the rate for a 30-year fixed mortgage move above 5% for the first time in a decade, today's rates are still below average from a historical perspective. And if you bought or refinanced in the last few years, your rate is probably below 4%.



Think of it like this: with debt, it's your liability that loses value over time and that's a good thing. You've leveraged the bank's money and now have a fixed payment for 30 years. At 8% inflation over the past year, last year's $1,450 mortgage payment technically would be worth more like $1,335.

Get Creative with Budgeting

As you look at expenses, can you swap out comparable products or services? The ability to pivot to a cheaper option could help your bottom line. I've noticed a gradual increase in delivery fees for services such as Uber Eats and DoorDash. Maybe that $20 upcharge for DoorDash isn't worth it anymore, and you pick up the pizza instead of having it delivered. Or maybe you skip going out to eat 1 or 2 nights of the month, to offset higher utility bills.

Saving money should always be a priority for you and your family's financial future, but when prices are rising across the board, it becomes increasingly harder to do so. While these suggestions can help, a prolonged period of high inflation could put a serious damper on household spending. However, one item has remained at the same price point since inception: the Costco hotdog and drink for $1.50. So maybe dining at Costco is the best hedge against inflation?

— Brant Jones, CFP®

higher inflation and rates with varying degrees of agility. Higher inflation than the roughly 2% we knew before the pandemic will challenge companies' cost structures. Investors must discern which companies are most impacted by rising costs, and which have the pricing power to pass those higher costs through to consumers and maintain their profit margins. From there, the question is how much of this is (or is not) reflected in stock prices. As part of our analysis, we look for companies with unique products or services, durable cost advantages, or that operate in consolidated and rational industry structures. Domestically oriented value stocks continue to be our focus. As in 2000 (when the tech bubble burst), many value stocks thrived, but only after emerging from the "throw the baby out with the bath water" stage in which we currently still find ourselves mired. During these periods, basically everything falls. The proliferation of index investing over the past decade can exacerbate the situation, and is, in our opinion.

Inflation has implications for both the overall level of the market and for market internals, particularly the "value versus growth" debate. Value stocks fared better so far this year as rising rates weighed on pricy growth stocks. Growth stocks are considered long duration because their cash flows are realized further into the future. Higher rates drag on the present value of these future cash flows. Value stocks, meanwhile, are shorter duration with cash flows that are front-end loaded, so capital is returned to shareholders earlier in the investment lifecycle. The period of extremely low interest rates was particularly good for growth stocks, and quite challenging for value investors. The road ahead is likely to be different, restoring the appeal of a value strategy.

Times of uncertainty can test investors' fortitude. But these are times when exceptional values can be discovered. As Warren Buffett famously said, "you pay a dear price for a cheery consensus," that can be seen with most all of the very pricey stocks that dominated these past few years come down significantly. He also added "you have to buy when there is blood in the streets." These are easy to read, but difficult to implement for most investors, but I believe during these periods you must think differently. It requires not only the stamina to hold through these difficult corrections (if the thesis for holding remains intact) but also the ability to take advantage of beaten-down opportunities, even in the face of the negative news flow that accompanies bear markets. These periods, like those prior to this (even the 2008–2009 Great Recession) are temporary, and they can provide tremendous opportunities for patient investors who think differently and avoid following the crowd. We believe these are the moments when active, fundamental-based stock selection can create exceptional returns. Our team will continue to navigate the current treacherous waters and seek those opportunities that are surely being created in this down cycle.

Kind Regards,

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