



Wedgewood Partners Second Quarter 2022 Client Letter

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Fund Letters

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Summary

- Wedgewood Partners is a money manager founded in 1988 with the goal of providing investors with a superior approach to managing investment portfolios.
- The collective drop in both stock markets and bond markets is one for the record books – and we haven't even experienced the usual financial shock when the Fed is steadfast in tightening.
- A growing list of market price declines (stocks, bonds, and commodities) have become notable enough to suggest that peak inflation may be behind us.



Avalon_Studio

Life Imitates Art. Investing Imitates Baseball.



Mickey Mantle, 1965. John Dominis

"The pressure never lets up. Doesn't matter what you did yesterday. That's history. It's tomorrow that counts. So you worry all the time. It never ends. Lord, baseball is a worrying thing."

—Stan Coveleski

"The game has a cleanness. If you do a good job, the numbers say so. You don't have to ask anyone or play politics. You don't have to wait for reviews."

—Sandy Koufax

"Baseball fans are junkies, and their heroin is the statistic."

—Robert S. Wieder

"The game isn't over until it's over."

—Yogi Berra

"[Baseball] breaks your heart. It is designed to break your heart."

—Bart Giamatti

"We count everything in baseball. I mean, God, that's all we do."

—Billy Chapel, *For the Love of the Game*

	<u>2Q</u>	<u>YTD</u>	<u>1-Year</u>	<u>3-Year</u>	<u>5-Year</u>	<u>10-Year</u>	<u>20-Year</u>
Wedgewood Composite Net	-17.2	-26.0	-16.5	12.4	13.2	11.5	10.5
Standard & Poor's 500 Index	-16.1	-20.0	-10.6	10.6	11.3	13.0	9.1
Russell 1000 Growth Index	-20.9	-28.1	-18.8	12.6	14.3	14.8	10.3
Russell 1000 Value Index	-12.2	-12.9	-6.8	6.9	7.2	10.5	7.9

i Returns are presented net of fees and include the reinvestment of all income. "Net (Actual)" returns are calculated using actual management fees and are reduced by all fees and transaction costs incurred.

Review and Outlook

Top performance detractors for the second quarter include Meta Platforms ([META](#)), PayPal ([PYPL](#)), Alphabet ([GOOG](#), [GOOGL](#)), Apple ([AAPL](#)), and Taiwan Semiconductor Manufacturing ([TSM](#)).

Top second quarter performance contributors include Texas Pacific Land ([TPL](#)), UnitedHealth Group ([UNH](#)), Progressive ([PGR](#)), First Republic Bank ([FRC](#)), and Old Dominion Freight Line ([ODFL](#)).

During the quarter we sold Starbucks ([SBUX](#)) and trimmed Progressive, Tractor Supply Company ([TSCO](#)), and Visa ([V](#)). We bought Pool Corp. ([POOL](#)) and increased First Republic Bank, PayPal, and Old Dominion Freight Lines.

Q2 Top Contributors	Avg. Wgt.	Contribution to Return
Texas Pacific Land	2.87	0.19
UnitedHealth Group	5.34	0.07
Progressive	3.83	0.04
First Republic Bank	3.60	-0.32
Old Dominion Freight Line	2.92	-0.37
Q2 Bottom Contributors		
Meta Platforms	7.77	-2.30
PayPal	4.85	-2.19
Alphabet	7.29	-1.63
Apple	7.10	-1.61
Taiwan Semiconductor Manufacturing	5.40	-1.18

¹ *Portfolio contribution calculated gross of fees. The holdings identified do not represent all of the securities purchased, sold, or recommended. Returns are presented net of fees and include the reinvestment of all income. "Net (actual)" returns are calculated using actual management fees and are reduced by all fees and transaction costs incurred. Past performance does not guarantee future results. Additional calculation information is available upon request.*

Meta Platforms (formerly known as Facebook) detracted from performance during the quarter. Meta's core Family of Apps revenue grew +10% (currency-adjusted) over 2021 and are up almost +60% over the past 2 years as pandemic-driven behavior has driven an influx of advertisers to Meta's platforms. Meta's stock trades close to just 12X consensus estimates for 2023, which is a substantial discount to the market and very attractive for a business that has monopolistic type returns on capital. Meta's returns are particularly impressive, given that nearly all the Company's growth over the past five years has been through organic, internal research and development initiatives. For example, nearly half of user engagement is dedicated to consuming video content, compared to just a fraction of that just five years ago. Meta effectively built user product rivals to both TikTok and Snapchat and is quickly scaling them across Meta's over 3 billion daily users. Over that time frame, Meta has doubled revenues and maintained returns on invested capital well above +20%. We continue to think the Company's competitive positioning and attractive valuation makes it a rare asset deserving of a top weighting in the portfolios.

PayPal Holdings detracted from performance despite the Company generating healthy growth. Revenue grew +8%, but closer to +15% when adjusted for the well-telegraphed roll off of its eBay relationship. As the Company laps the headwinds of eBay and difficult year ago comparisons, we expect PayPal should drive long-term growth in the mid-teens. Much of this will be driven by further penetration into the Company's nearly 450 million active users. PayPal's user base has grown by +50% since the onset of the pandemic so it makes sense for management to focus on driving higher transactions per account and better monetize this historical windfall of users. In our opinion, the shares have discounted away all of PayPal's pandemic user and revenue gains, so we added to positions during the quarter.

Alphabet grew its core search revenues +24% on a +30% year-ago comparison. Despite this stellar top-line performance, shares sold off as the market began to discount fears of a recession. However, the stock has outperformed relative to other holdings as core Google Search has been less affected by disruptions related to Apple's privacy initiatives. Alphabet's Cloud segment is generating revenue at a \$24 billion run rate but is still running at a loss. We think this business can generate much better margins at some point. In the meantime, the Company has 4% to 5% of shares authorized for repurchase which is an attractive use of capital as the stock trades for about just 18X 2023 consensus estimates.

Apple grew revenues +9%, driven by +17% growth in the Services segment. While iPhone revenues grew a modest +5%, it was on an exceptional year ago comparison of +66%. iPhone continues to capture most industry smartphone profits by focusing on high-end price tiers. Apple is taking nearly two-thirds of the revenue share in the premium (\$400 and above) smartphone segment. Further, most of the growth was driven by expansion in the “ultra-premium” price tier of \$1000 or more per unit.^[1] As we have highlighted in the past, Apple’s relentless focus on the development and integration between hardware (especially integrated circuits) and software continues to add significant value for customers of its products and services. We expect this favorable competitive dynamic to continue for the foreseeable future.

Taiwan Semiconductor detracted from performance despite business performance that saw revenue accelerate to over +30% growth. The Company is one of the few fabs in the world that is capable of manufacturing leading-edge integrated circuits (IC). The Company’s leading-edge capacity is being absorbed by high-performance computing applications, particularly by Apple, which has become an integrated circuit powerhouse over the past decade. The Company’s aggressive investment in leading-edge equipment, tight development with fabless IC designers, and embrace of open development libraries, should continue to foster a superior competitive position and attractive long-term growth.

Texas Pacific Land was a top contributor to performance during the second quarter. Revenue skyrocketed +75% as oil and gas royalties more than doubled. Most of this was driven by higher realized prices on the production of oil and gas on the Company’s acreage, but production of oil and gas also grew +23%. The Company’s royalty interests span over 880,000 acres in West Texas. Most of this land is in the highly productive Delaware Basin of the Permian Basin. We expect that development activity will continue to grow at a rapid pace in this region, primarily driven by both domestic and multinational producers looking to maximize returns on increasingly scarce oil and gas capital expenditures.

UnitedHealth Group also contributed to performance during the quarter. United's operating income grew +3% on difficult year-ago comparisons as benefits members utilized more services compared to last year. Optum Health grew operating income +40% as more patients are enrolled in the Company's value-based care services. The Company estimates nearly a third of all medical care is unnecessary and represents opportunity to capture savings for both patients. Optum's integrated platform of patient data, IT, and service providers are focused on driving out these unnecessary costs and should serve as the engine for long-term, mid-teens earnings per share growth.

Progressive Corp had a positive contribution to performance during the quarter. Net Premiums Written (NPW) grew +12% as the Company grew both policies in force and took rate to offset higher loss cost trends that are being driven by inflation. For example, we estimate accident severity for personal auto are up +35% since the beginning of the pandemic. However, this is partially offset by a 20% decline in frequency, due to people driving fewer miles. Progressive is making up for this net rise in cost by raising policy rates in the mid-teens percentage range. Progressive has been relatively early to take rate compared to industry peers, so the Company should be able to aggressively compete for share as competitors play catchup.

Company Commentaries

First Republic Bank

First Republic Bank is one of the most differentiated business models in our large cap universe. What makes the Company so different is not necessarily the activities that it does, but the activities it does not do. These trade-offs are an incredibly important strategic decision that every company must make. However, in our experience, rarely are these forgone activities lauded or even recognized as critical differentiators. The Company does mention these foregone activities, on [page 45](#) of its most recent investor presentation appendix.

When we consider the financial industry, especially banking, is fraught with competition, simply being better than any of the other massive money-center banks is not enough to sustain many decades or even years of superior performance. Rather than try to outcompete every bank in the country, First Republic's competitive strategy of doing only a handful of things well, results in a superior value proposition to its customers. These trade-offs are easy to understand, but difficult to copy, given widespread competitive and institutional imperatives that pressure management teams to revert to the mean.

First Republic organizes its entire business around keeping long-term relationships with its bankers and clients. This strategic decision contrasts with competitors that have underlying strategic goals to drive as much client activity as possible. As a result, client development activities at First Republic look very different from those of its competitors. For example, while most companies strive – or at least market – to provide excellent client service by bombarding clients with digital touchpoints, First Republic will not open an account with its typical well-heeled client without first engaging in a personal conversation. For many, this sounds like an arduous and inefficient task that can be handled or even automated by scores of digital software solutions. Paradoxically, First Republic has outgrown its peers over the past several years. The Company compounded revenues at an +18% rate from 2016 to 2021 and is now one of largest single family mortgage lenders in the U.S.

Despite this impressive top-line growth, particularly in first mortgages, First Republic doesn't even make the top-10 list of annual mortgage volume generators. In contrast to the vast majority in the banking industry that sells its mortgages to government-sponsored enterprises (GSE), First Republic keeps nearly all its mortgage underwriting loans on its balance sheet. Part of this is because of necessity – First Republic underwrites mostly nonconforming or “jumbo” mortgages that are ineligible to be purchased by GSEs. But the strategic decision to avoid the correspondent mortgage industry aligns the Company with its customers and shareholders because a long-term servicer and underwriter relationship favors more prudent underwriting standards and more favorable long-term economics. This is borne out in the Company's industry-low, net charge off ratios over the past few business cycles.

And more recently, the dramatic rise in long-term interest rates has caused mortgage industry underwriting volumes to plummet – mostly due to a decline in refinance activity. Despite this, and admittedly to our surprise, First Republic turned in an astonishing +23% growth rate in mortgage originations during the second quarter of 2022. That is not to say things won't slow from here, given the continued rise in rates, but it was another important, contrasting data point of how the Company's business model differs from most large money-center peers. Competitors' overwhelming reliance on the securitization markets as well as mortgage correspondent mass-market focus was in no small part to blame for the industry slowdown. As First Republic keeps these functions in-house and focuses mostly on jumbo mortgage financing, there were no third parties or vendor partner upheavals that the Company had to contend with to continue providing its customers with reliable mortgage underwriting service.

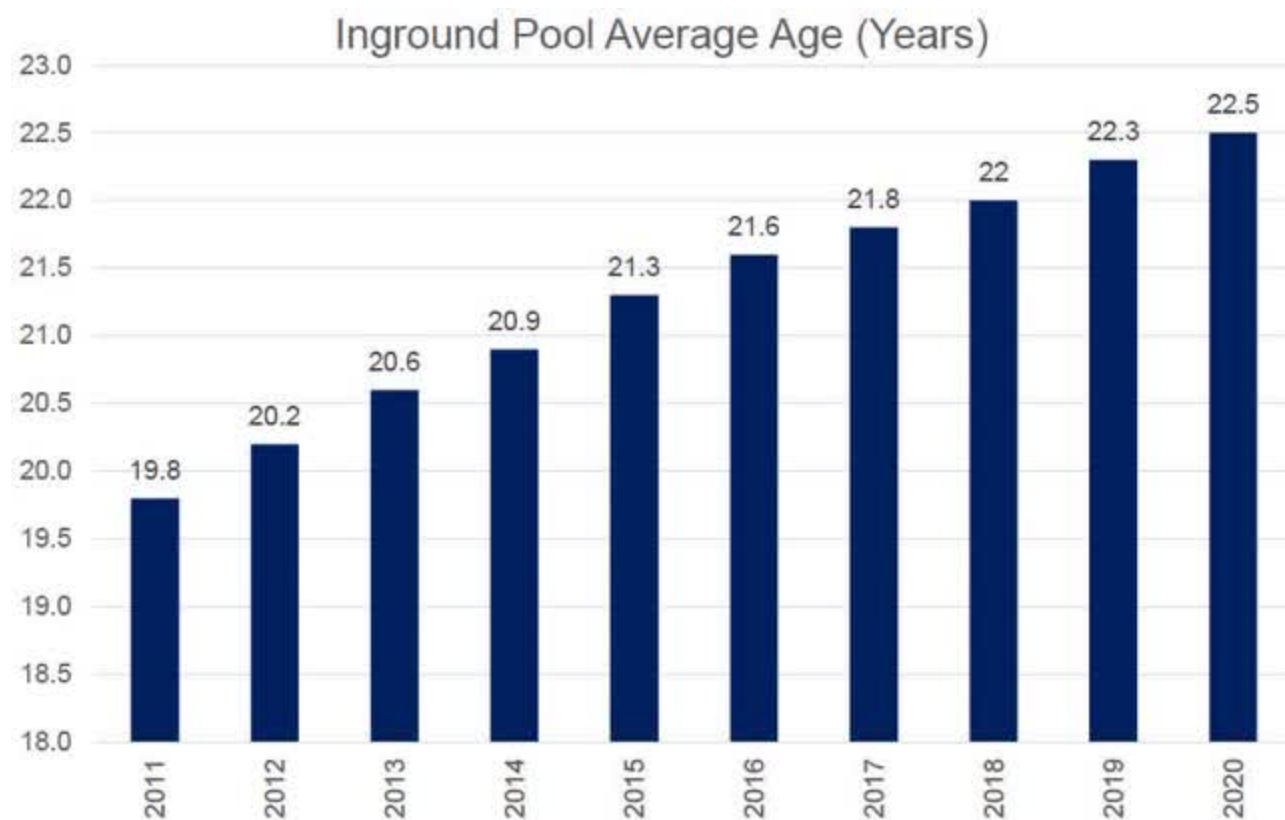
Of course, to execute this client-centric approach of providing superior customer service, the Company's entire capital structure must align to this goal. For example, banks are required to hold a larger buffer of capital for on-balance sheet mortgages than, for example, a mortgage-backed security. As a result, First Republic has less capacity to repurchase shares by holding on to mortgages. But again, paradoxically, First Republic equity has traded at premium earnings multiple relative to banking peers for the past several years, despite rivals that have been repurchasing tens of billions in shares. In addition, and unlike nearly all large cap banks in the U.S., First Republic does not offer any kind of credit card product to its personal banking customers. We think the advantages of this trade-off are multifold. First, credit cards are a low-touch business, where most of the interactions are between the customer and a merchant, so First Republic has very little ability to influence the customer experience in that framework. Second, credit card receivables take up a disproportionate amount of balance sheet capacity compared to other forms of lending, albeit at higher interest rates. The Company has chosen to preserve this capacity primarily for mortgage lending as we view mortgage lending provides a better opportunity for stable, long-term customer relationships rather than revolving consumer credit. Last, regardless of consumer credit quality, credit cards tend to have higher charge-off rates than other forms of secured lending, which helps the Company avoid spikes in charge-offs during inevitable recessions.

In conclusion, while being the most profitable or fastest growing business are certainly the goals most businesses strive for, we are steadfast in our view those goals must be byproducts of a differentiated competitive strategy. In the highly competitive industry of personal banking, First Republic has made a concerted effort to focus on only a handful of activities to excel at while actively avoiding many others, even when those activities might seem to be industry-standard offerings. First Republics' prudent and deliberate approach to trade-offs offers competitive differentiation that should continue to drive exceptional growth over the long term.

Pool Corp.

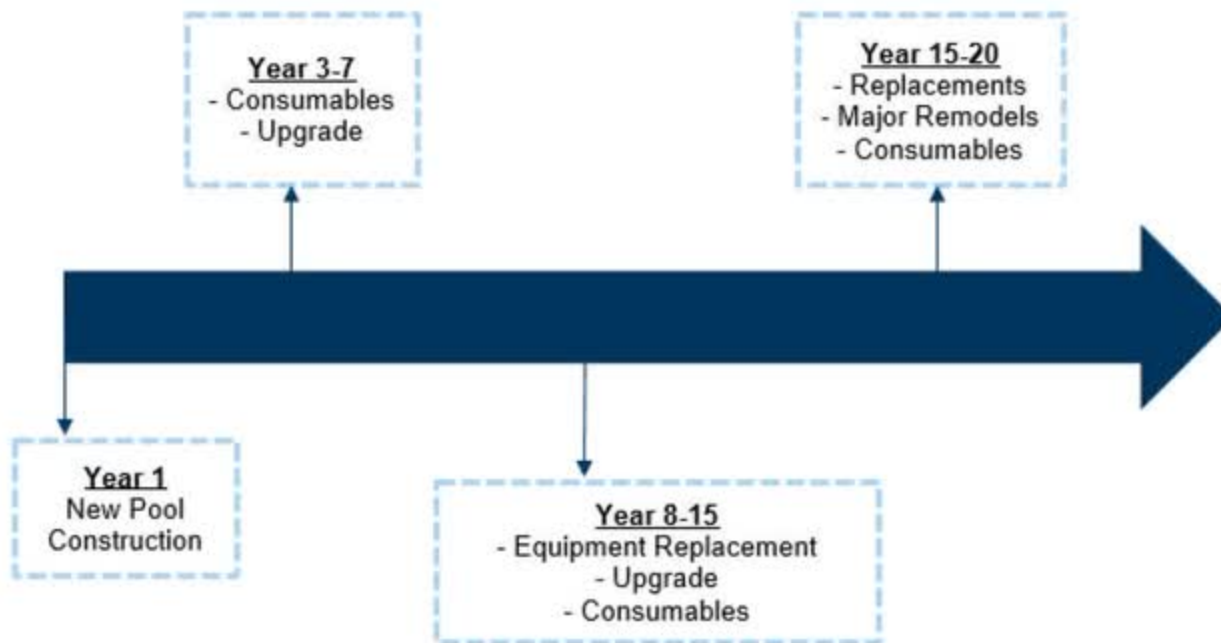
Those of you who own a backyard pool already know the Pool Corp. story quite well. (Honey, why is the pool water green?) Those who don't own a pool, well, we recommend a little rent seeking on your neighbor's pool by owning these shares. The Pool Corp. strategy is beautifully simple; build a pool and become its customer for life. Once the major discretionary expenditure of building a pool is made, that high-maintenance asset becomes an annual annuity for your local pool service company. Increasingly, that local pool service company could well be owned by Pool Corp.

Those who own older pools know quite well that pool maintenance is much more involved (read: expensive) than just annual chemicals in the early years. Once a pool reaches its early teen years (often sooner), maintenance reaches a very different level of (read: expensive) when every part of the pool's filtration system wears out. As the years progress, then pool/backyard rebuild kicks off. Well, that original pool becomes a brand-new second pool. Rinse and repeat. Your local pool-service company is assuredly not the lonely Maytag repairman.



Source: Pool Corp.

Exhibit 10: Pool Industry Has Significant R&R Activity



Source: Company data, Goldman Sachs Global Investment Research

Source: Pool Corp.

A decade or so ago, most backyard pools were simply pools surrounded by some type of hard coping. Fast forward to today, and our backyards have turned into major entertainment centers. We are spending much more time outdoors, and the backyard is now a focal point of our homes. Healthier outdoor living is now ingrained in our lifestyles and budgets. According to Zillow Research Surveys, respondents asked of the importance of a house with a pool (or spa) jumped to 35% in 2021, from 25% in just 2019.



Source: Pool Corp.

Pools are now surrounded by decking and patios, outdoor fireplaces and kitchens, majestic fireplaces and waterfalls, outdoor lighting, weatherproof speakers, hardscapes, landscapes, and irrigation – much of it connected to apps controlled by smartphones. Indeed, significant technological advancements are found across the entire spectrum of a modern pool, dominated by automation; sanitizing systems (salt systems, UV systems, ozone systems); heat pumps (which cool water too); robotic cleaners; whisper-quiet, variable speed pumps, and LED lighting. Pool Corp. distributed all this backyard evolution.

A short history of the Company may be in order now. It's rare that multibillion-dollar companies don't have some type of Horatio Alger founding, driven by a single-minded, focused individual with that unique combination of entrepreneurship, grit, and perseverance through adversity. Pool Corp. founders would no doubt make Alger proud.



Source: Pool Corp.

South Central Pool Supply was founded in 1980 by Frank St. Romain in Metairie, Louisiana. Metairie is a suburb of New Orleans, which is in South Central Jefferson Parish. Starved for capital, the Company's early years were marked by slow growth. In 1993 the Company was purchased by the Chicago-based private equity firm Code, Hennessey, and Simmons (CH&S). CH&S used the Company as a "platform company" to aggressively integrate vertically and horizontally. CH&S' capital would prove to be insufficient too for its growth desires, so, in 1995, the Company went public as SCP Pool. (CH&S would sell half of its stake in SCP in 1997 and exit the remainder in 1998.)

Then the POOL party commenced. The list of the Company's acquisitions are too numerous to list here, but here are the first two-decade milestones, post CH&S:

- 1996: 44 service centers.
- 1997: 85 service centers in 30 states, distributing 34,000 national brand and private products to 23,000 customers.
- 1998: Enters New England, New Jersey, New York, and Pennsylvania.

- 2000: 20th consecutive year of both sales and earnings growth. \$670 million in sales.
- 2001: 160 service centers in 35 states, distributing 52,000 national brand and private label products to 28,000 customers.
- 2006: 274 service centers; 70,000 customers. \$1.9 billion in sales.
- 2016: 344 service centers; 100,000 customers. \$2.6 billion in sales.

Today, the Company with \$5.3 billion in sales in 2021, is the world's largest wholesale distributor of swimming pool and related outdoor living products operating over 410 sales centers in 12 countries – North America, Europe, and Australia, distributing more than 200,000 national brand and private label products from over 2,200 vendors to roughly 120,000 wholesale customers.

Notable too is the Company's November 2021 acquisition of Largo, Florida-based Porpoise Pool & Patio, including its main operating subsidiaries, Sun Wholesale Supply and Pinch A Penny. Sun Wholesale Supply is a wholesale distributor of swimming pool and outdoor living products, including a key, state-of-the-art (chlorine) specialty chemical packaging operation, which until now only sold to Pinch A Penny franchisees. Pinch A Penny is the largest franchiser of pool and outdoor living-related specialty retail stores in the U.S. with approximately 260 independently owned and operated franchised stores in Florida, Texas, Louisiana, Alabama, and Georgia and brings Pool Corp. substantial opportunities for expansion.

Most of the Company's business mix, 90%, is derived in the U.S. Canada is 5% and Europe is 5% too. 60% of the Company's business revolves around the installed base of pools (and spas). Pool renovations and upgrades are 20%, and new pool construction is 20% as well. Its typical customer, +80%, are local maintenance contractors and professional builders. Local backyard-related retailers make up 12% and the rest is a small mixture of do-it-yourself customers and commercial customers (hotels, theme-parks, universities).

The Company operates four distribution networks: SCP Distributors (SCP), Superior Pool Productors (Superior), Horizon Distributors (Horizon) and National Pool Tile (NPT). The Company further breaks down its business lines into two categories – "Blue" for its pool related products and services and "Green" for its outdoor, primarily backyard living products. Blue represents about 84% of revenue, Green represents 8%, and the rest is from outside the U.S.

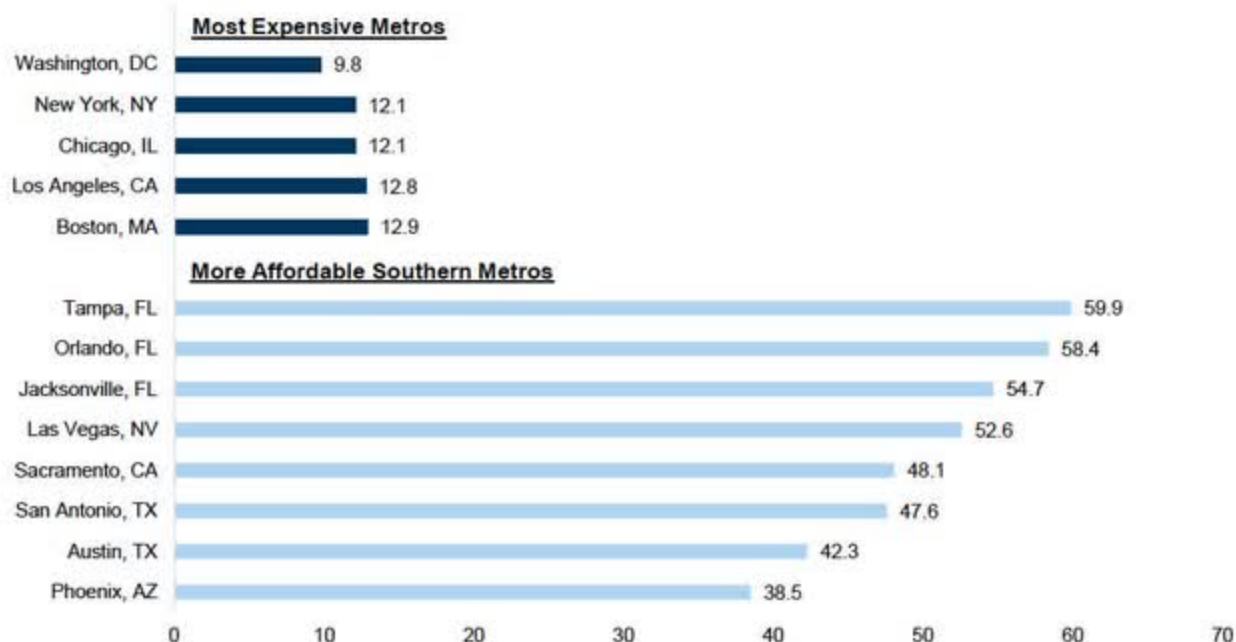
The Company estimates its U.S. share of the pool industry to be around 38% in the \$10 billion wholesale market (\$22 billion retail) – based on the U.S. installed base of 5.4 million pools. The Company is about four times larger than its only national competitor (Heritage Pool Supply – a division of SRS Distribution). Horizon (Green), the fourth largest landscape distributor in the U.S., with 81 locations largely in the Sunbelt, services into a \$14 billion national Green addressable market.

In addition to healthier outdoor lifestyles (plus the growing popularity of staycations), the Company also enjoys a significant tailwind of the migration to southern states. Such states include Arizona, Florida, and Texas. Texas is notable because its pool market is underdeveloped relative to other Sunbelt states. In U-Hauls annual review of interstate moves in 2021, it noted the following based on well over 2 million one-way U-Haul truck transactions:

- Texas narrowly beat Florida in transactions.
- Tennessee ranked third, followed by South Carolina and Arizona.
- California ranked 50th and Illinois 49th – both for the second consecutive year.
- 2021 migrations out of California weren't as bad as in 2020, but that was only due to the fact U-Haul ran out of trucks to meet demand in 2021.
- Three of the states with the largest net losses were New York (45th), Massachusetts (47th) and Pennsylvania (48th).

Exhibit 9: Americans Are Increasingly Interested In Moving To More Affordable, Weather Friendly MSAs, Which Have Greater Pool Demand

Percentage of Home Searches on RedFin from Out-of-Towners in 1Q21 In Select Markets



Source: RedFin and Goldman Sachs

The Company reports that +82% of the population in the Sunbelt lives within 20 miles of a Superior/SCP branch and 54% with 10 miles. (An industry joke: “No moving vans go north, right. They go north with oranges, south with furniture.”)

Pool Corp. has been a growth and profitability powerhouse for years. The Company reminds us of another powerhouse, Old Dominion Freight Line. Both share a long-ingrained culture of organic growth by nonstop capacity additions. Both too have surely benefited by strategic acquisitions, but at the end of the day, the consistent ability to serve more customers from existing locations is the seed-corn of organic growth. Such growth, on top of the long crawl of operating leverage is the mothers-milk of ever-increasing profitability.

Over the past 10 years or so, up to the pre-pandemic year or 2019, the Company’s operating margin increased slowly, but steadily from 6.3% to 10.7%., net profit margin from 4.0% to 8.2%, and return on invested capital from 12.3 % to 27.3%. And then the pandemic hit. The Company’s business boomed like no other time as the country was locked down in their residences. Consider the outsized the boom calendar years of 2020 and 2021 and the outsized stock performance, respectively:

- Revenue: +23% and +35%.

- Operating Margin: +110 basis points and +390 basis points.
- Operating Income: +36% and +79%.
- Earnings Per Share: +44% and +78%.
- Return on Invested Capital: 33% and 36%. (Per the Company's calculation, 44% in 2021.)
- Stock Price: +76% and +53%.

On the most recent earnings release and conference (1Q 2022, April 21st) demonstrated that the Company is still firing upon all cylinders. Here are the highlights of that call:

- *36 consecutive quarters of revenue growth.*
- Record 1st quarter sales. +33%.
- 2nd largest biggest quarter ever.
- 5th consecutive quarter with sales +\$1 billion.
- 2-year sales stack +108%.
- State revenue: Arizona +33%, California (even with migration out of that state), +31%, Florida +30%, and Texas (tough winter freeze comp.) +7%.
- Northern, Midwest seasonal markets +28%.
- PK Data: 2021 average price of pool \$56,000, +17% over 2020. +\$100,000 pools becoming commonplace.
- Outsized technology (automation-smartphone) gains notable gains new pool construction.
- Good news: renovation and remodel backlogs solid into early 2023; bad news: bigger backyard projects stressing already tight labor markets.
- Commercial markets still less than 10% of business, but grew +34% during the quarter, on top of +24% growth for calendar 2021.
- Chemicals +58%; 40% price, 20% volume; supply shortages improving; Suncoast Chemical (Pinch A Penney) significant on this score.

- Pool equipment +18%.
- Building materials (new construction, renovations) +29%.
- New construction/remodel 50/50 cash versus financing.
- Horizon +32%. 2-year stack +64%.
- Europe +5%, but rest of year awful given war-related inflation.
- Technology: Pool 360 app +28%.
- Pass-through price inflation continues (so far) +10%-12%.
- Gross profit +49%. Margin +330 bps.
- Operating income +83%. Margin +450 bps.
- EPS \$4.41 +82%.
- 420 locations by year-end.
- Migration from seasonal northern states to year-round southern states continues.
- Work from home continues to drive outsized pool, patio and outdoor kitchen spend.
- Market share take continues weaker competitors.
- Balance sheet strength continues to separate the Company from its few diminished peers and all the mom-and-pop shops.
- Inventory +68% year-over-year (nobody can access and stock supply like Pool Corp..)
- Capacity to serve more customers better than competitor's due to both vertically horizontally integrated acquisitions during the past couple of years, plus service center expansion to 420 in 2022.
- 80% of business in maintenance is non-discretionary – again, with more pools in year-round markets (reminder: poor water chemistry can destroy equipment after just a few months of neglect.)
- New pool construction is important, of course, but just 20% of business; such new pools dominate year-round markets, adding at the margin, to year-round installed base.

- PK Data reports 2021 new pool construction 117,000: +22% over 2020.
- Installed base continues to age – non-discretionary spending on failing equipment and pool infrastructure/decking a must after 7-10 years.
- Installed base still loaded with previous generation manual, analog equipment – smartphone app technology, plus more digital equipment (and automation) a major tailwind within aged installed base (high-efficiency equipment and LED lighting versus halogen lighting, high-efficiency heaters versus standard gas heaters or heat pumps, etc.)
- Assume most recent price increases will stick; some chemical prices may decline, but small declines only back to 2019 levels possible; input cost of manufacturing such chemicals has risen sharply too.
- Of course, the big question: After the past 2 stellar years, and a strong forecasted 2022 (everything backlogged, plus pricing), what about 2023? This question dominated the call; management laid out a cogent case of returning to industry leading growth of +6-9% in 2023.

While 2022 has started quite well for the Company, our growth expectations for late2022/early 2023 encompass a material decline in 2020-2021 growth rates. Namely, for calendar double-digit growth in revenues and low +20% growth in earnings per share – and back to high single-digit growth in each during 2023.

The current bear market has corrected the once excessive valuation in the stock. As of this writing, the stock has sharply declined by -38%, year-to-date and -43% from its mid-November high to its most recent low in mid-June. In terms of valuation, the stock is much more reasonably valued at 19X calendar year EPS expectations of around \$19 per share.

Starbucks

We exited our position in Starbucks during the second quarter. We do not mind admitting that there was a heated internal debate over this position, as there were several conflicting issues to weigh in our decision. Before the pandemic, we had been quite happy with the Company's execution and the stock's performance, and we were likewise happy with strategic decisions made during and immediately after the initial pandemic-related lockdowns in 2020, as we have written previously.

Despite our appreciation for the Company's execution during this period, it was dealing with some concerning issues. First, as a business reliant upon stores being open, the Company faced continuing risks from rolling pandemic-related lockdowns, particularly in China, which is the Company's second largest and fastest-growing market. A second and related issue was employee illness; even as stores were open, various pandemic waves (Omicron, for example) caused many employees to miss shifts, making it very difficult and expensive for Starbucks to keep its stores staffed properly.

The Company's stock, like most of the U.S. stock market, enjoyed a healthy recovery from the pandemic beginning near the end of 2020 and into 2021; at times, we believed that recoveries in many portions of the stock market happened well ahead of recoveries in fundamentals, or that individual stocks often didn't reflect still existing pandemic-related risks. Starbucks fit into this category for us at one point, and we would remind our investors that we earlier reduced our position in the stock for exactly that reason.

Then, at the end of October last year, when the Company reported its fourth quarter (ending September) results, it issued guidance for the new September 2022 fiscal year that included 400 basis points of margin pressure from additional "investment" in its employees, including pay, benefits, training, and additional hiring. While this weighed on projected earnings growth for the year, the Company still expected to deliver double-digit earnings growth, as its fundamentals continued to recover from the pandemic.

We viewed this as a rational – and not at all unprecedented in the history of Starbucks, for that matter – response to economic-wide realities, and we appreciated the Company being proactive about employee costs, rather than spending all fiscal year trying to catch up with higher costs. However, at this same time, some unionization efforts were underway at some of the company's U.S. stores, and the market jumped all over this employee "investment" commentary in the Company's fourth quarter earnings report and turned it into a major incident.

We would note that pretty much every Company in America, publicly traded or private, has been struggling with labor shortages during the post-pandemic era, and this has caused significant margin pressures on most or nearly all companies, whether that has been in the form of higher wages (planned or otherwise), higher benefits, greater turnover, and higher recruiting costs, etc. We believe that by proactively addressing the issue and telling the market about it, Starbucks inadvertently caused itself a problem by giving the market something over which to obsess. We also note that the Company's fiscal year ends in September, three months before most companies' fiscal years, so Starbucks offered a view of 2022's labor market three months before most companies; perhaps investors who hadn't been paying much attention to inflation or labor market dynamics were surprised to hear about the potential for these pressures to continue into 2022. Those investors certainly have heard a lot more about it now from every corner of the economy. In any case, most of us on the team believe the public discussion around Starbucks became more than a little irrationally focused on one issue, which definitely is not unique to the Company, after its initial fiscal year 2022 guidance commentary.

While, in a vacuum, pressures to unionize are not positive, it also could be argued that the unique labor conditions post-pandemic have created an ideal time for labor unions to make gains, after decades of irrelevance. Therefore, of course organized labor will try to make some noise, and not only at Starbucks. However, it still is not completely clear to us what meaningful changes, if any, a union may be able to influence at the Company. Starbucks has been well known for decades – since 1988 – among its labor pool for proactively offering health and other benefits to part-time employees, in an industry where any benefits at all are still uncommon.

As part of the Company's response to this current labor debate, founder Howard Schultz has returned to the Company as a replacement for the retiring Kevin Johnson. We do believe this is a decent PR campaign, as Mr. Schultz, the executive who instituted the Company's generous benefits program decades ago, should have a lot of credibility with the labor force. However, one genuine issue we have with the longer-term outlook for Starbucks is that we actually were big fans of the outgoing CEO, Mr. Johnson, and we agreed with basically every one of his strategic and capital priorities both before and after the pandemic. So, we do put his loss in the negative column for the stock. His departure, as well as resulting potential changes to the Company's stock buyback plan, is one of the factors that convinced the portion of the team that had been more reticent to sell the stock to exit our position, in the end.

On the labor front, we expect the Company to remain vocal about its commitment to its employees, and to continue to highlight the financial aspects of this commitment. While this is just good business, and while it isn't much different from the Company's normal behavior for decades, we expect the market to remain fixated on this for some time. We also would note that rolling COVID lockdowns in China, a phenomenon for which we see no end in sight at the moment, certainly remain unhelpful to the Company's near-term fundamentals, considering China's importance to the Company. We certainly acknowledge the drag on the business from the Chinese government's COVID policies; in fact, as mentioned above, we trimmed our Starbucks position in the second half of 2021, when it was apparent to us that the market was not factoring any COVID-related risks into the valuation of the stock.

All in all, we do not believe anything is broken about this Company's long-term business model or its competitive position, and we still strongly believe the Company emerged from the pandemic in a better competitive position rather than a worse one. We believe the labor issue upon which the market is fixated to the exclusion of all else now is an issue being faced by pretty much every company in America. In general, the team believes the valuation of the stock has been driven to something at or near trough levels, which also made our decision to sell more difficult; however, the broad market sell-off we have seen this year has left many stocks trading at attractive valuations, as well. In the end, as a team, we agreed to disagree about whether this was the ideal time to sell this one stock, in isolation. From a portfolio standpoint, though, and taking all the near-and intermediate-term possibilities we could foresee for both Starbucks and for potential replacements for our position, we agreed to allocate the funds in our Starbucks position into better expected returns elsewhere.

Whip Inflation Now



In our last Letter we opined the following:

How far do we think the Fed will go in their new excellent adventure of QT? We don't know. The Fed's new mission will be to put a top in inflation, not a bottom in asset prices. Another easy forecast based on the Fed's long history, we are sure they will proceed until Powell & Co. breaks something – the bond market, the stock market, or the junk bond market.

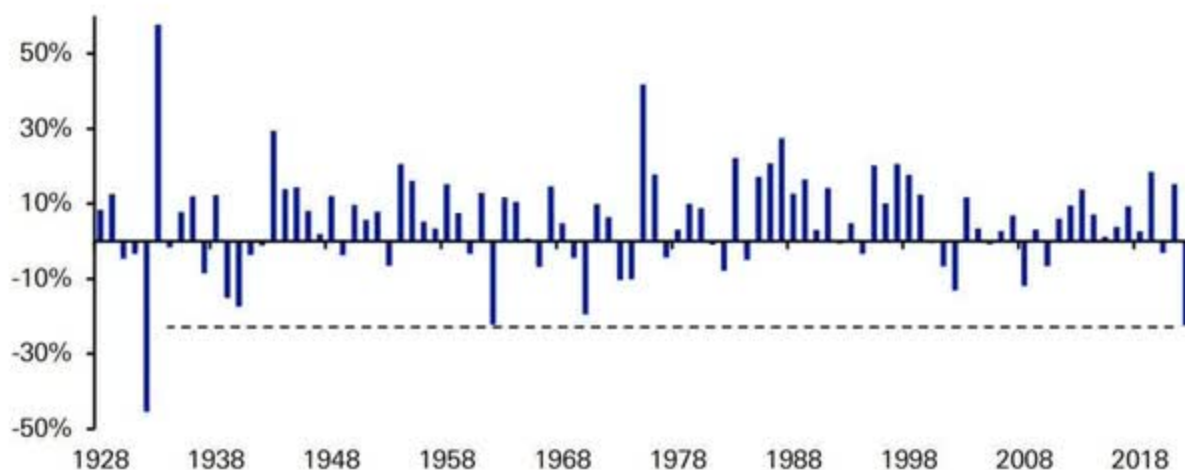
If former Major League Baseball commissioner, Bart Giamatti was an investment manager, he may well have been quoted, *"The Fed breaks your heart. They're designed to break your heart."*

In 1889, Oscar Wilde opined that, *"Life imitates Art far more than Art imitates Life."* If we are Being Earnest, how can we deny that investing doesn't imitate baseball? We can't.

We agree too with Billy Chapel, that we measure everything in investing too – to the absurd extreme. And halfway into the 2022 season, this is turning out to being one heck of a lousy season. Although 2022 isn't over until it's over, the bear market that started last November is already one for the record books. The first-half decline of -20% for the S&P 500 Index is the worst since 1970. The sharp drop of -30% in the NASDAQ 100 is the worst since 2002. If it weren't for a rally over the last two weeks of the quarter, the stock market was on track for its worst start of a calendar year since the 1930's.

That said, the bear market decline in the S&P 500 Index has masked brutal bear market declines (collapses, really) in countless stocks. Our two ugly standouts in the current bear market are PayPal and Meta Platforms – of which we have been buyers during their respective declines.

Figure 1: S&P 500 Performance during H1 in total return terms.. will this be the worst H1 since 1932?



Source : Bloomberg Finance LP, Deutsche Bank

Source: Bloomberg

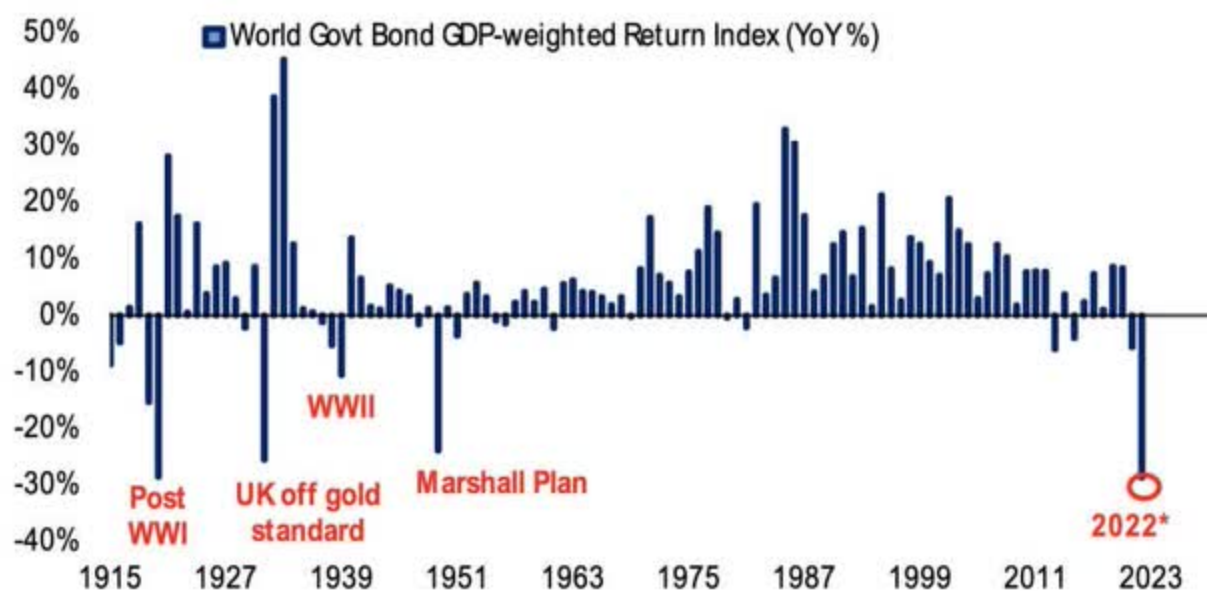
The Fed's on again, off again, on again monetary policy since 2018 has created a whirlwind of historic market volatility. Indeed, according to the Leuthold Group, since 1950, prior to 2018, the S&P 500 Index has never booked three -19% bear market corrections over a 48month period.

The bond market hasn't been spared from Powell & Co.'s channeling its inner Paul Volcker

Whip Inflation Now wrath either. With literally zero buffer of any yield, bonds have suffered a generational beating. Those investors with a traditional 60/40 to allocation stocks and bonds have suffered a historic drawdown too. Indeed, according to Ned Davis Research, a 60/40 portfolio suffered its worst first-half calendar year performance since... 1932! We're talking about the 1962 New York Mets or the 2003 and 2019 Detroit Tigers here – heck, or the 1916 Philadelphia Athletics or the 1935 Boston Braves.

Chart 2: Government bonds on course for the worst year since 1865

World govt bond annual returns

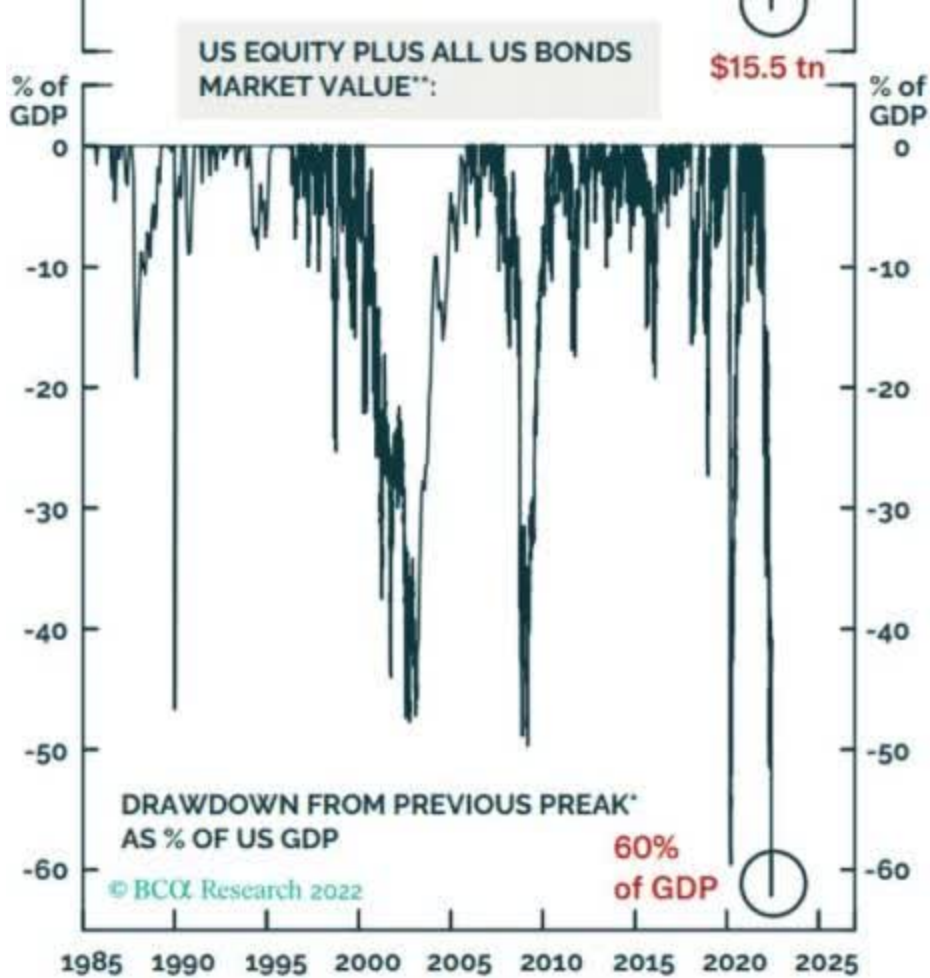


Source: BofA Global Investment Strategy, Global Financial Data, *2022 YTD annualized

BofA GLOBAL RESEARCH

Source: BofA

All told, the collective drop in both stock markets and bond markets is one for the record books – and we haven't even experienced the usual financial shock when the Fed is steadfast in tightening.



In our past Letters, we’ve chronicled the Fed’s manifest error in its long-held forecast that stubborn increases in inflation were “transitory.” Is there a new risk unfolding as the Fed stubbornly Whip’s Inflation Now, given that we are in the second bust mode of the pandemic’s bust-boom-bust mode that market forces themselves have begun the cyclical process of inflation reduction? (Perhaps we should have titled this Letter, *The Hangover?*) In other words, is Powell & Co. fighting the last war and is once again behind the market’s curve? We think so. Just in terms of the current bear market in stocks, the Fed seems woefully behind – and creating its next policy mistake as the Fed has *never* tightened monetary policy during a bear market in stocks. Note too, the Fed hasn’t even begun to shrink (quantitative tightening) it’s \$9 trillion balance sheet yet!

Bear Market	Fed Chair	Fed Response
1987	Greenspan	Rate cuts from 7.3% to 6.5%
1990	Greenspan	Rate cuts from 8.0% to 3.0%
1998	Greenspan	Rate cuts from 5.25% to 4.75%
2000-02	Greenspan	Rate cuts from 6.5% to 1.0%
2007-09	Bernanke	Rate cuts from 5.25% to 0.0%
2011	Bernanke	Hold rates at 0% until 2015, Starts "operation twist", QE3 starts in 2012
2018	Powell	Ends rate hikes, Rate cuts in 2019 from 2.25% to 1.50% and starts QE4
2020	Powell	Rate cuts from 1.50% to 0%, Record balance sheet expansion with QE5
2022	Powell	Rate hike from 0% to 1.50%, Additional hikes to >3.5% expected, Balance Sheet Reduction

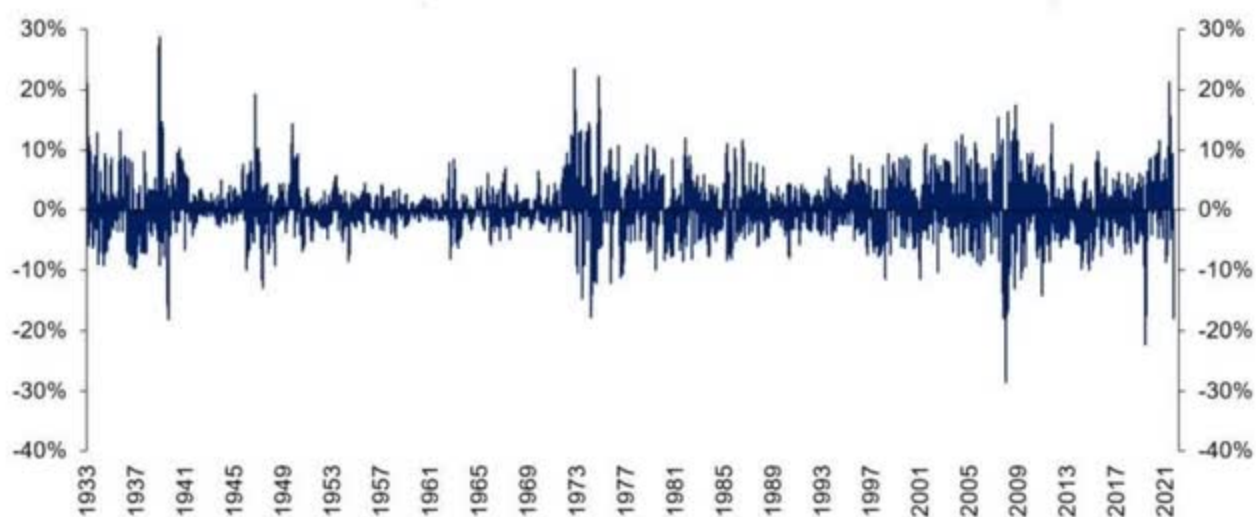
A growing list of market price declines (stocks, bonds, and commodities) have become notable enough to suggest that peak inflation may be behind us. In addition to the sharp declines in stocks and bonds, it is noteworthy that the rolling 20-day decline in the Bloomberg Commodity Index is the third-largest decline in 90 years. Such market price declines coupled with a growing list of leading economic indicators, plus consumer and business sentiment surveys, and inflation expectations point to a marked slowdown in economic activity. According to S&P Global, worldwide supply shortages have fallen to 17-month low, and price pressures have declined to an 18-month low.

Note the key graphic of New Orders Minus Inventories. Note too, the drop in the money supply has completely reversed the pandemic surge and is now flat over the last three months – the lowest growth rate in over a decade. If the Fed’s planned QT goes full bore, resulting in a meaningful decline in the money supply, well then, Katie bar the door.

Yellow and a few red signs, are flashing everywhere.

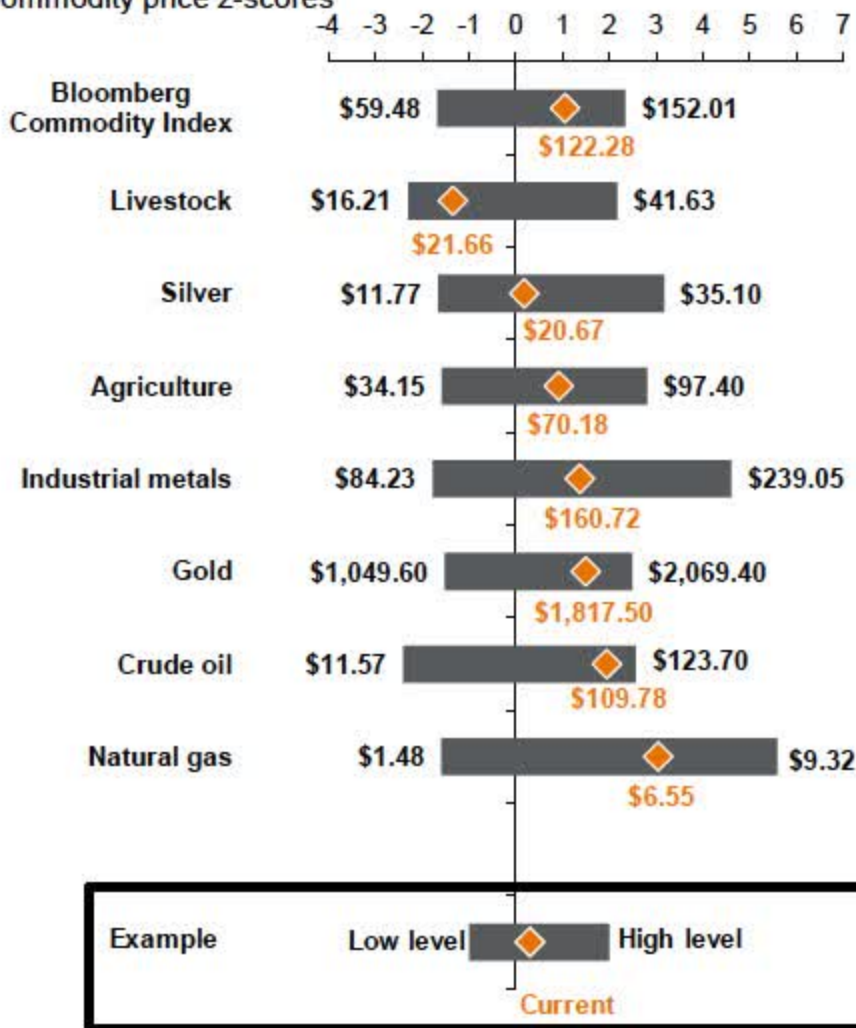
(We’ll save the havoc in the home mortgage market for our next Letter. Suffice to say, the housing market has not responded kindly to 30-year mortgage rates doubling from the lows set at the start of 2021.)

Figure 1: Rolling 20 trading day change in Bloomberg Commodity Index.. current point around third largest fall in 90 years...



Source : GFD, Bloomberg Finance LP, Deutsche Bank

Commodity prices Commodity price z-scores

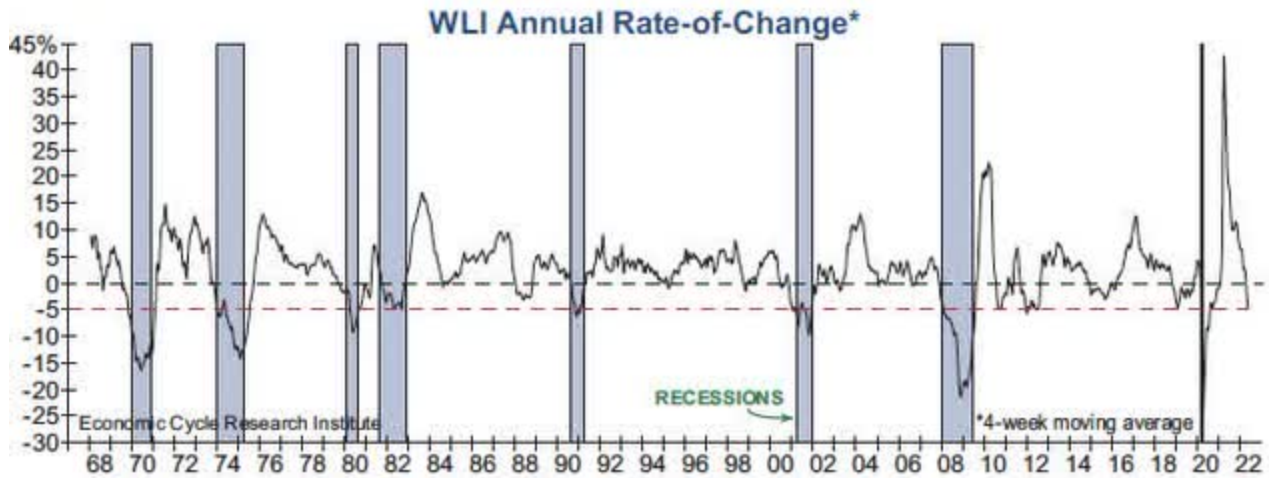
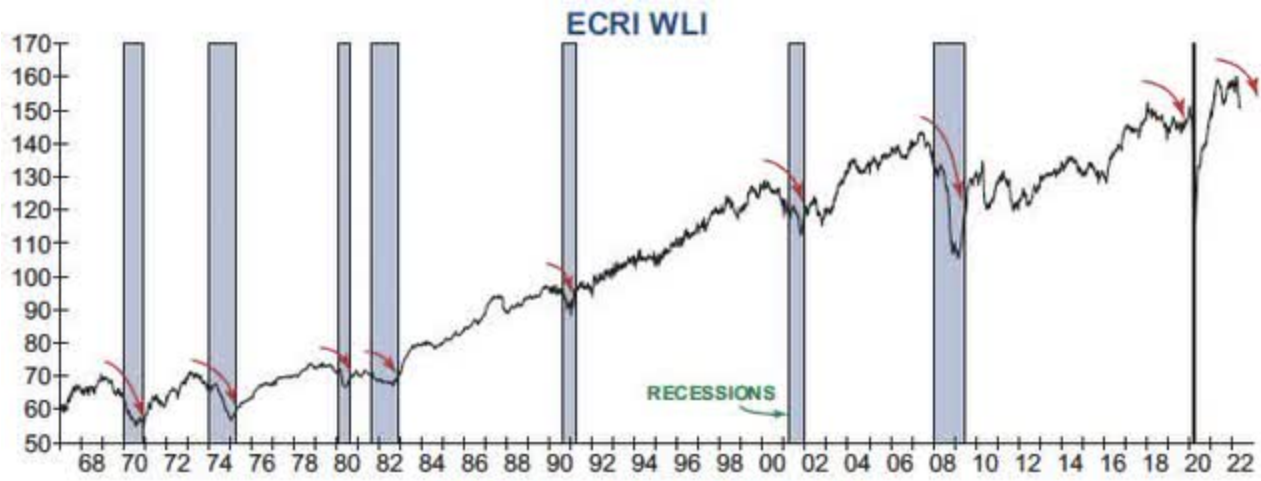


Source: Bloomberg



Source: Investech

U.S. Economic Activity
 Average standardized values: ISM (Manufacturing, Services, Chicago)
 and Fed (Empire Manufacturing, Philadelphia, Kansas City, Richmond, Dallas) Indices

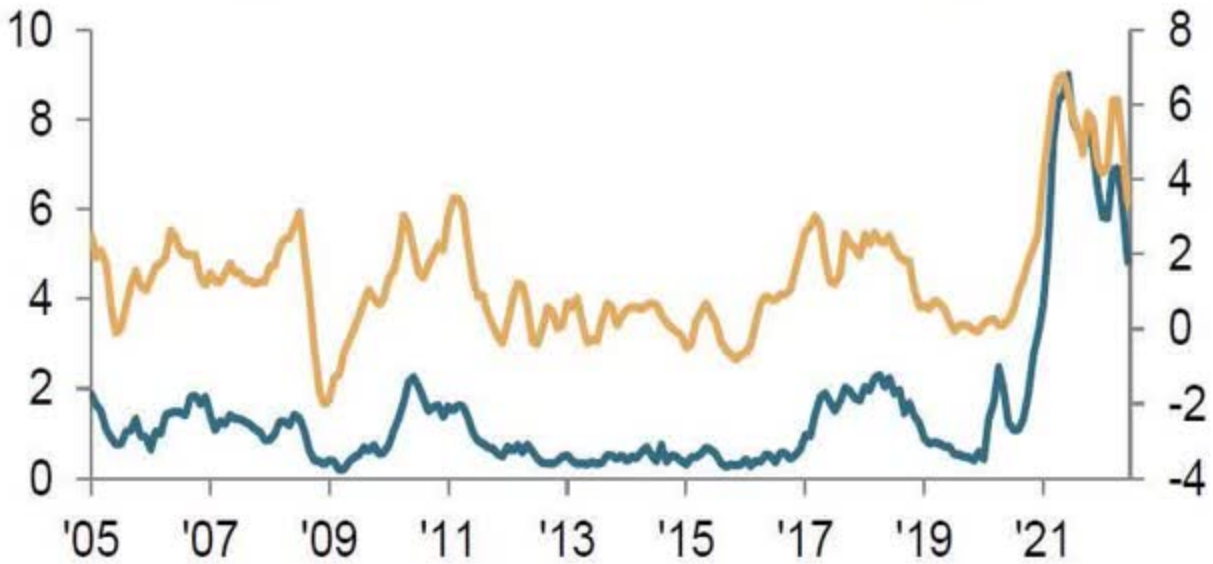


Source: Investech

Commodity Price & Supply Pressures: All Items

Supply shortages* ■

Price pressures* ■

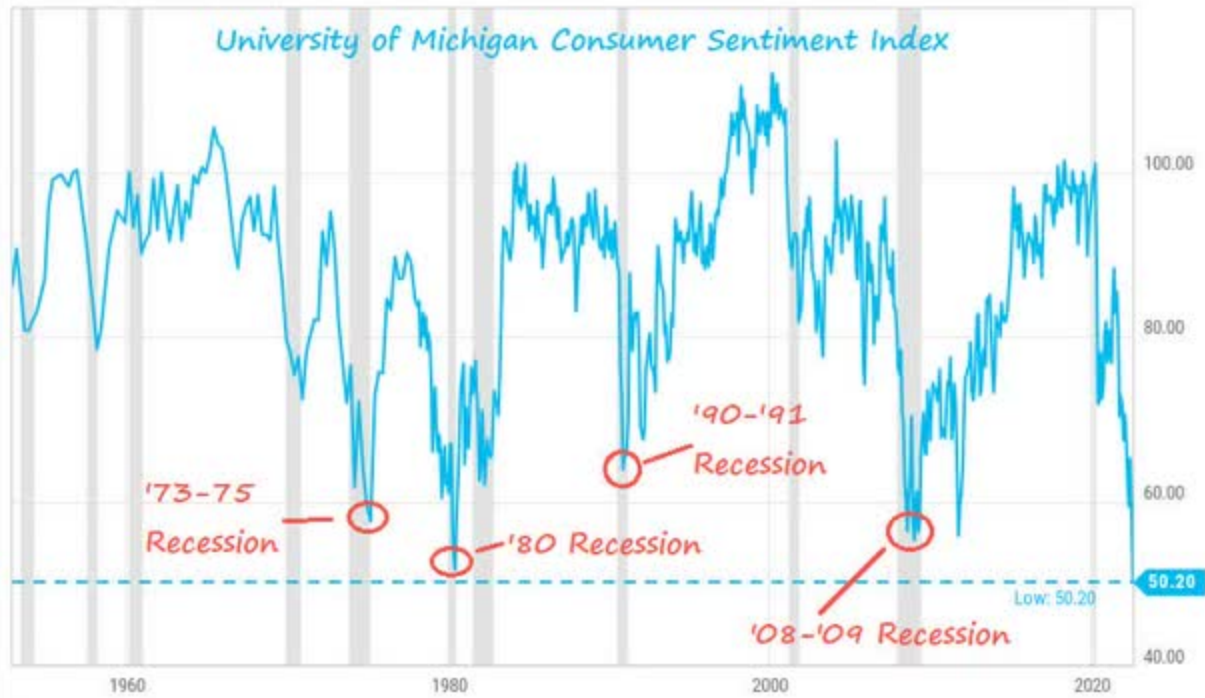


Source: S&P Global.

*multiple of long-run average

Source: S&P Global

US Index of Consumer Sentiment



COMPOUND @CharlieBilello

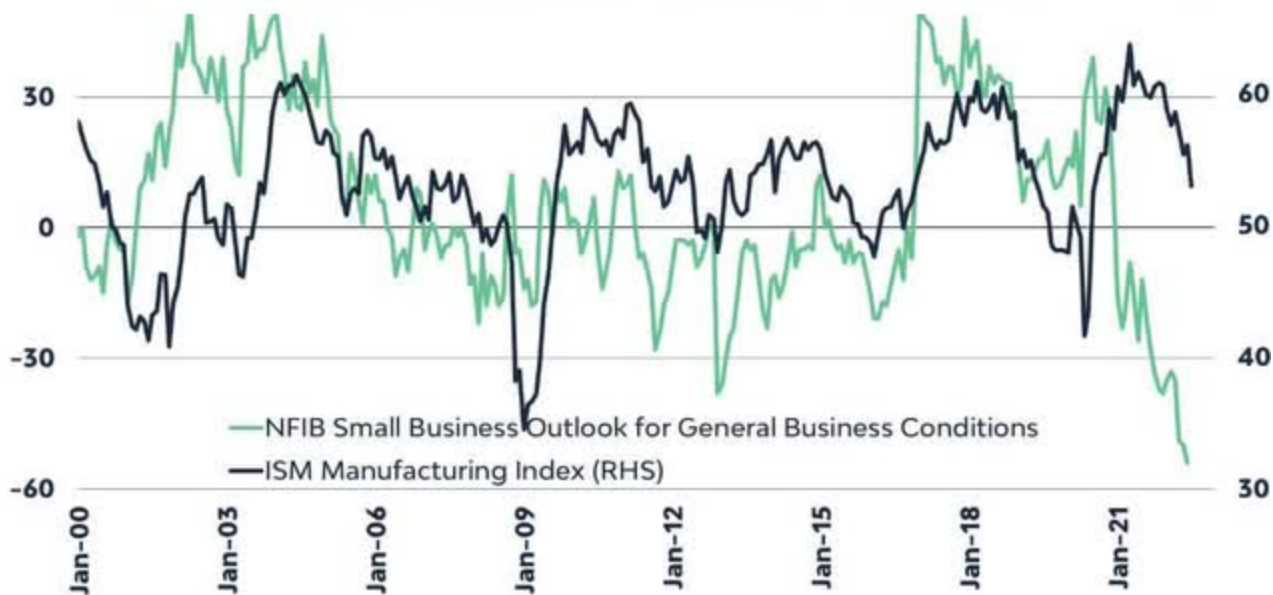
Jun 10 2022, 10:31AM EDT. Powered by YCHARTS

NFIB General Business Outlook for Next 6 Months



Source: Investech

US - Small Business Outlook - Business Conditions true insights



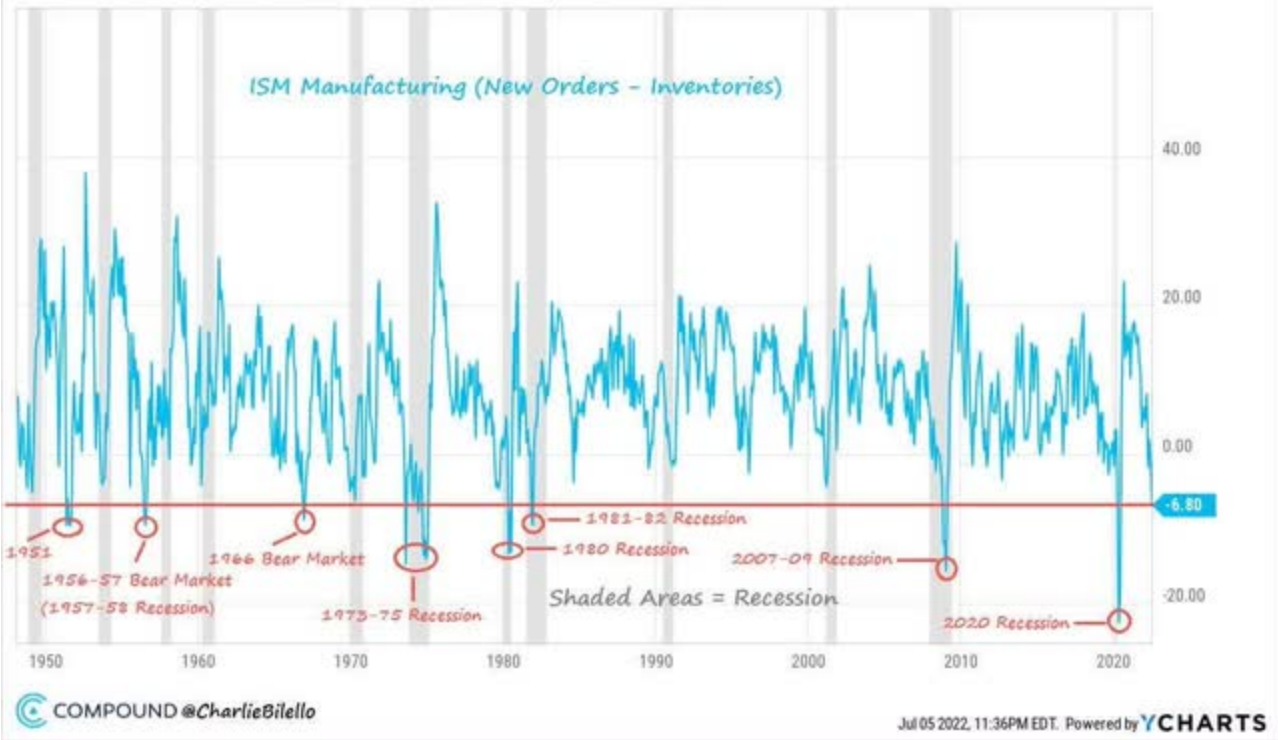
Source: True Insights, Investing.com

Forward Inflation Expectations

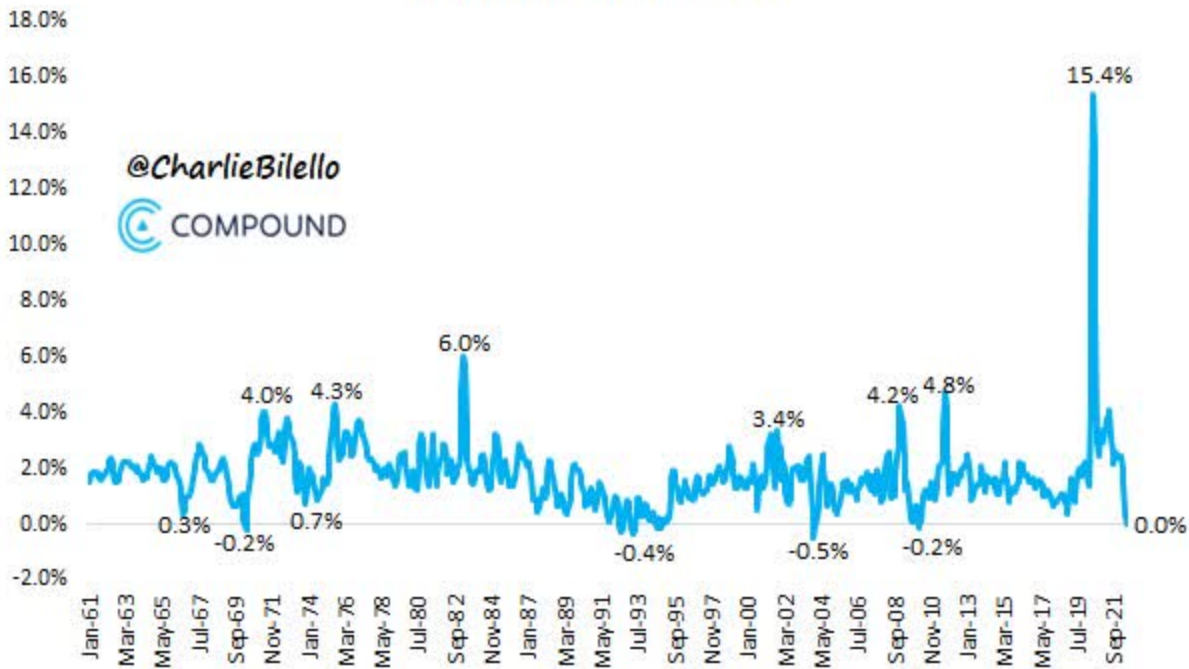
Daily Frequency 2021-12-01 to 2022-06-29



US ISM Manufacturing New Orders Index - US ISM Manufacturing Inventories Index



US M2 Money Supply: 3-Month % Change (Jan 1961 - May 2022)



Is “recession” the new, new “transitory” Fed policy error? Well, it never ends. Lord, investing is a worrying thing. Are we worried? Yep. We are most worried about a corporate earnings recession.

What about the consumer? Consumer spending remains robust. Consumer balance sheets are quite healthy. What’s the recession worry here? Well, according to Rosenberg Research, inflation-adjusted incomes have contracted *eight* months in a row and have declined at a rate of -3.0% over the past year. This pace of decline last occurred in 1970, 1974, 1980, 1990, 2001, and 2008 – all recession years.

But back to the Fed...

Powell & Co., former Fed Chair Yellen are already on record pooh-poohing the mere idea of recession risk:

Janet Yellen (Treasury) June 9: “*Recession unlikely...*”

Loretta Mester (Cleveland) June 19: “*Not predicting a recession...*”

Jay Powell (Chair) June 22: “*Recession not likely...*”

James Bullard (St. Louis) June 24: “*Too early to have a debate about recession...*”

Place your portfolio bets folks. The Fed's career stats are not the stuff Cooperstown plaques are made of.

TABLE 1: Fed GDP Growth Forecasts Versus What Actually Happened

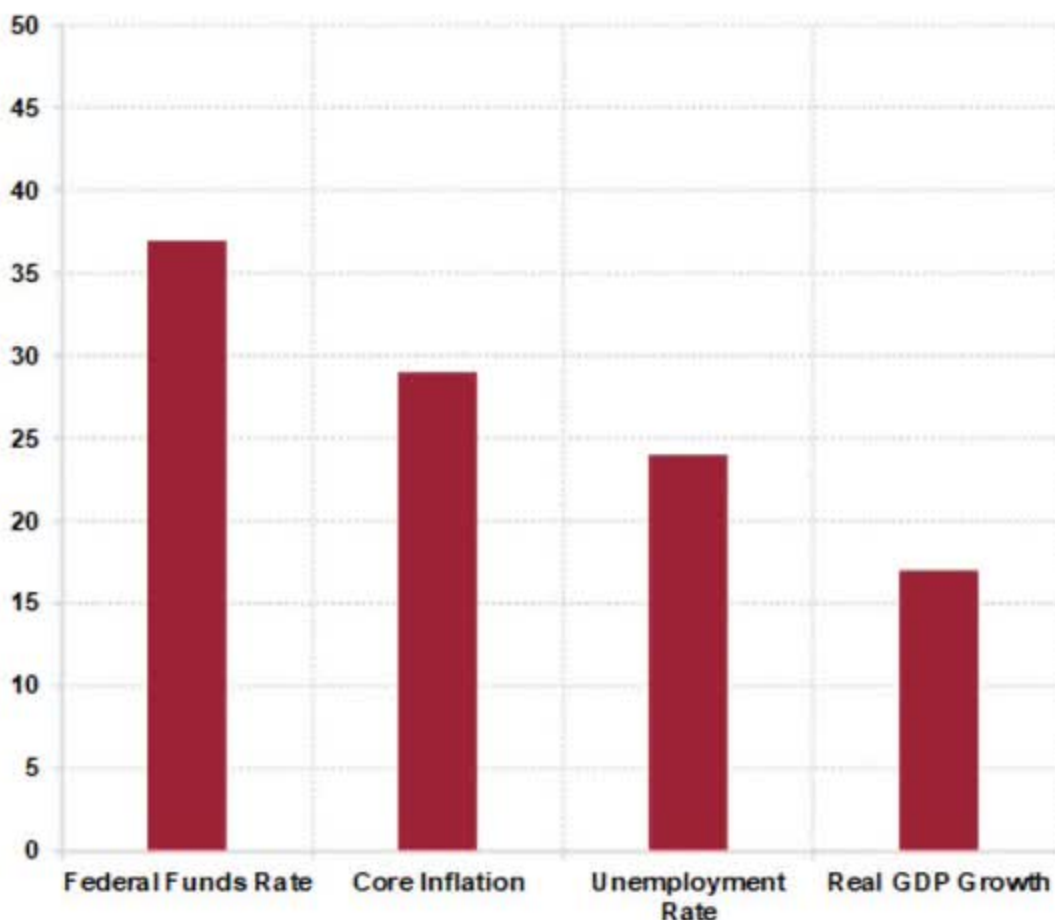
United States
(percent)

Recession Start	Forecast Growth Coming Year (%)	What Actually Happened (%)	Delta (%)
Dec-69	1.2	-0.1	-1.3
Nov-73	2.4	-1.9	-4.3
Jul-81	0.9	-2.6	-3.5
Jul-90	2.0	0.0	-2.0
Mar-01	2.6	1.4	-1.2
Dec-07	1.3	-2.7	-4.0
Mar-20	2.0	-2.3	-4.3
Average	1.8	-1.2	-2.9

Data represents four quarter average of subsequent QoQ (annualized) GDP growth
Source: FRB of Governors Tealbook, Haver Analytics, Rosenberg Research

CHART 5: Fed Forecasts Accuracy Rate

United States
(percent)



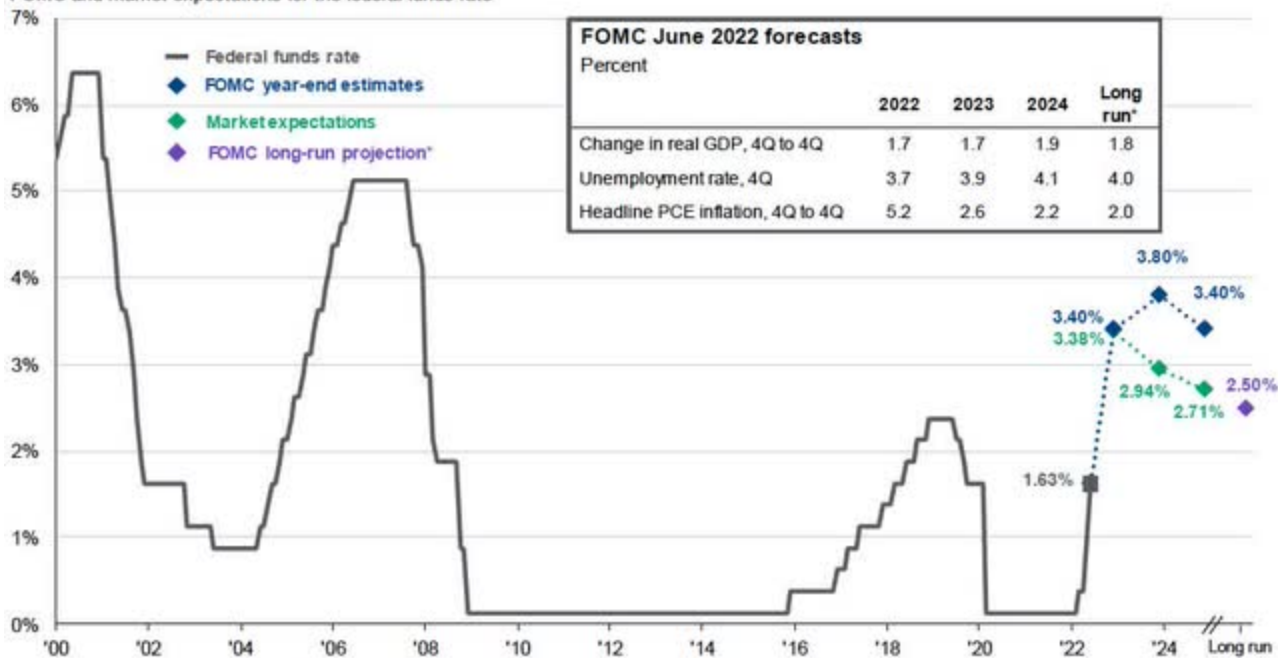
Source: FRB of Governors Tealbook, Haver Analytics, Rosenberg Research

The markets are as skeptical as we are. Would you believe with all the talk of “inflation,” the bond market has *already* priced in *three* rate cuts in 2023?! Powell & Co. steer the conversation about their goal of a soft landing, but the market certainly disagrees. To the market’s disagreement, in the year starting six months from now, the market expects at least three rate cuts – and one more after that. Note that the last three recessions have been accompanied by similar expectations for rate cuts after 6 months. Stan Druckenmiller recently chimed in on the Fed’s new, new policy error:

Fed engineered “soft” economic landings are rare. The U.S. economy has never landed “soft” once inflation rose over 4.5%. Biggest risk to markets right now in my view (& I could be wrong) is that the Fed remains stubbornly on an aggressive rate hike path to 3%+ not for economic reasons but for political reasons because they locked themselves into a false narrative again. Over the last 60 years, every time the U.S. Conference Board Leading Indicator recorded 4+ consecutive negative monthly readings we were already (!) in a recession. The count so far stands at 3. On July 21st, we will likely get a 4th consecutive negative reading.

Federal funds rate expectations

FOMC and market expectations for the federal funds rate



Source: J.P. Morgan Asset Management

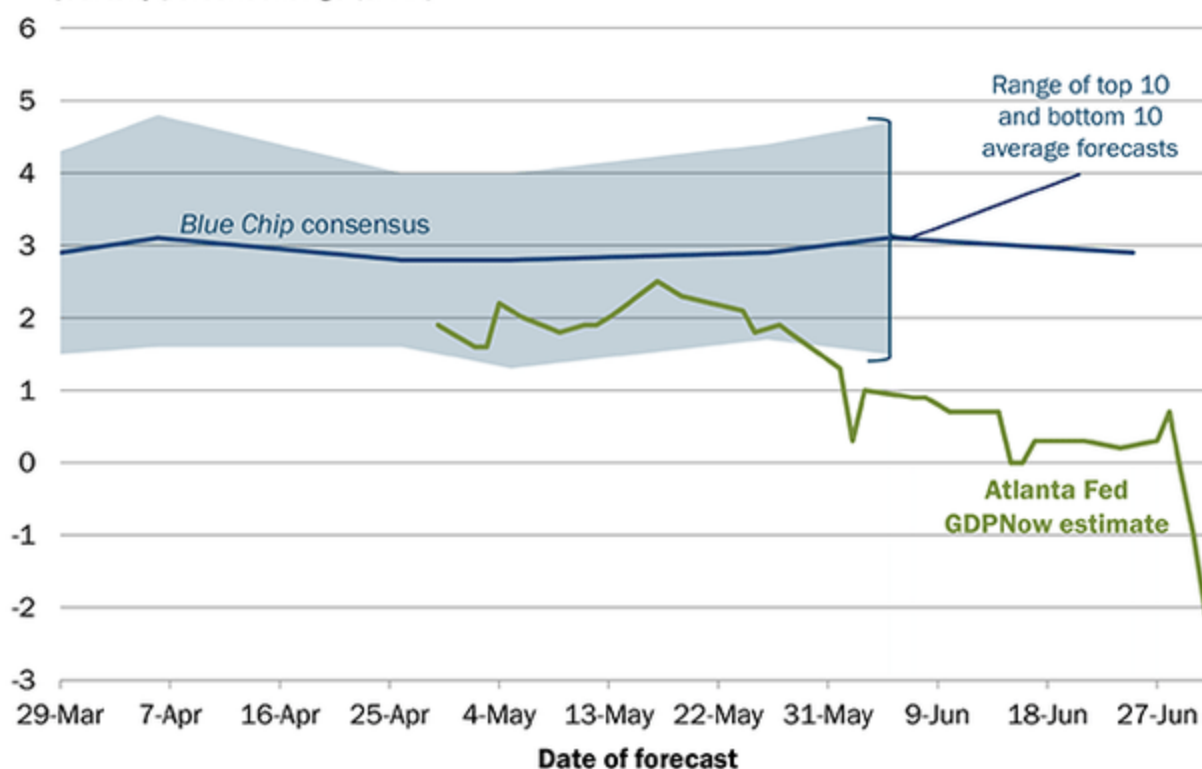
In just the past month and a half, the Atlanta Fed GDPNow estimate has collapsed from the Fed’s +2% forecast to -2.1% – after first quarter’s GDP contraction of -1.6%, that’s two quarters in a row. We must note that this measure is quite volatile, so a reversal isn’t out of the question – particularly in the absence of an inverted yield curve. That caveat aside, Bianco Research notes the following:

Has the actual GDP release beaten an Atlanta Fed GDPNow forecast made within 30 days of the GDP release, like (their) Q2 forecast was, by more than 2%? Since Atlanta Fed GDPNow was created in 2011, it has only happened once. Q2 2020 when the forecast was -35% and the actual was -32%. So, a beat by 3%! Of course, this was the unprecedented COVID shutdown of the economy, which is not the case now.

Other than that, we have no example of a 2% beat for any Atlanta Fed GDPNow made within 30 days of the release. So, a -2.1% forecast is big enough that HISTORY SAYS we should expect a second consecutive negative GDP forecast and the technical definition of a recession. In fact, since 2011, the average "error rate" between Atlanta Fed GDPNow and actual GDP is miss is -0.3%, meaning the average GDP release is worse than this forecast.

Evolution of Atlanta Fed GDPNow real GDP estimate for 2022: Q2

Quarterly percent change (SAAR)



Sources: Blue Chip Economic Indicators and Blue Chip Financial Forecasts

Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the Blue Chip survey.

The stock market's decline is both part and parcel of overvaluation, punctuated by higher interest rates, plus weak first quarter earnings releases back in April; and the prospect of even worse reports for second quarter announcements. A graphic that we have featured in our past two Letters is reprinted below. Note again how bountiful margin expansion was in 2021. Note too that margin expansion has all but disappeared in analysts' forecasts.

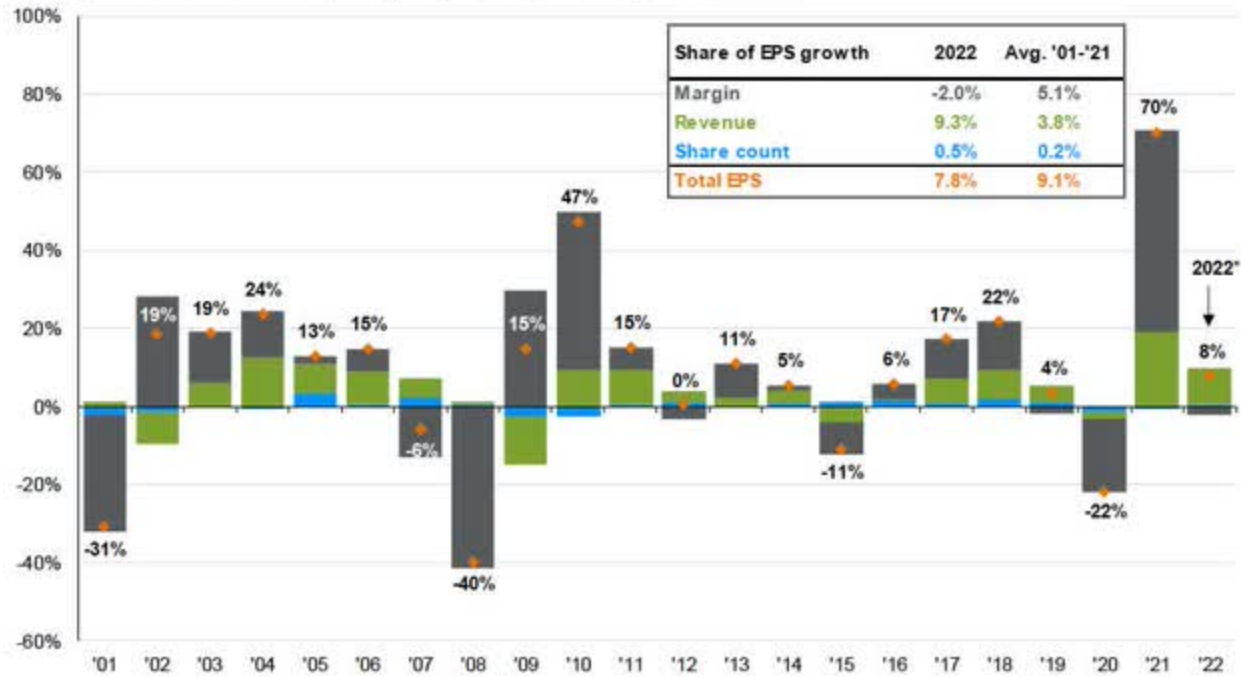
Even if inflation recedes below current, evolving expectations, Corporate America still faces higher levels of sticky cost structures that may take a few years to claw back. Margin headwinds may dominate earnings well into 2023. Needless to say, we expect second quarter earnings (and third quarter forecasts) to add another whirlwind in stock prices.

Sources of earnings per share growth

GTM U.S. 8

S&P 500 year-over-year operating EPS growth

Annual growth broken into revenue, changes in profit margin & changes in share count

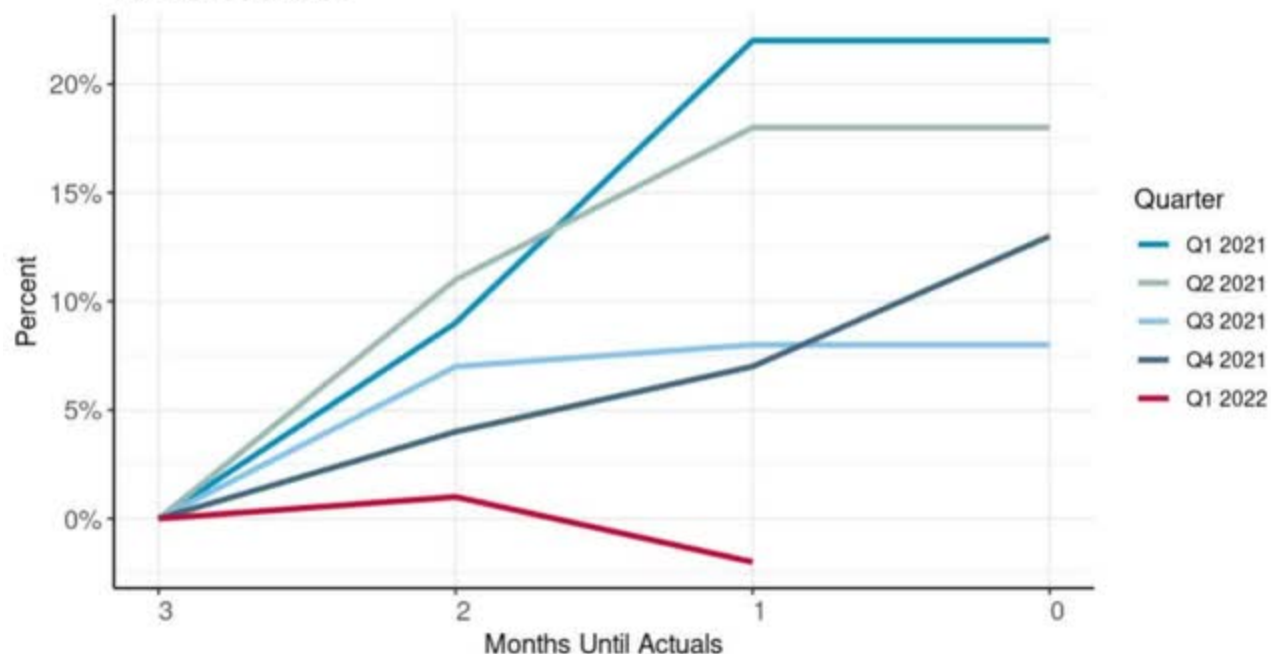


Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management. EPS levels are based on annual operating earnings per share. *2022 earnings figures are based on weekly operating earnings estimates from Standard & Poor's. Percentages may not sum due to rounding. Past performance is not indicative of future returns. Guide to the Markets - U.S. Data are as of June 30, 2022.

J.P.Morgan
ASSET MANAGEMENT

Final Three Months of Earnings Estimates

Q1 2021 - Q1 2022



Consumer Sentiment Index and subsequent 12-month S&P 500 returns



Source: J.P. Morgan Asset Management

Source: J.P. Morgan Asset Management

Investing does indeed imitate baseball. We measure everything. The pressure never ends. The worry never ends. If you do a good job (or a bad job), the numbers say so. Yet unlike baseball, there isn't an off-season. And the game is *never* over. Investing is a *beautiful thing!*

July 2022

David A. Rolfe, CFA, Chief Investment Officer

Michael X. Quigley, CFA, Senior Portfolio Manager

Christopher T. Jersan, CFA, Portfolio Manager

Footnotes

[1] <https://www.counterpointresearch.com/apple-takes-62-premium-market-q1-2022/>

Original Post

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