Wedgewood Partners Second Quarter 2022 Focused SMID Cap Client Letter

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*

Review and Outlook

	2Q	YTD	1-Year	3-Year	Inception
Wedgewood SMID Composite Net	-14.1	-25.4	-17.6	11.0	10.3
Russell 2500 Index [i]	-17.0	-21.8	-21.0	5.9	4.9

Top performance detractors for the second quarter include Saia, Burlington Stores, Acuity Brands, Maximus, and Steve Madden. Top second quarter performance contributors include Texas Pacific Land, Landstar, OTC Markets, First Republic Bank, and Broadridge Financial Solutions.

During the quarter we sold Cooper Companies and trimmed Chemed, Helen of Troy, MSC Industrial Direct, and OTC Markets. We increased Steve Madden, Poolcorp, Take-Two Interactive Computer Services, and Saia.

Q2 Top Contributors	Avg. Wgt.	Contribution to Return
Texas Pacific Land	4.75	0.35
Landstar	1.99	-0.06
OTC Markets	2.38	-0.08
First Republic Bank	1.28	-0.12
Broadridge Financial Solutions	2.07	-0.14
Q2 Bottom Contributors		
Saia	4.51	-1.07
Burlington Stores	3.79	-1.06
Acuity Brands	4.89	-0.98
MAXIMUS	6.24	-0.98
Steve Madden	5.58	-0.96

[1]

[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. Inception June 30, 2018. Past performance does not guarantee future results. Additional calculation information is available upon request.

Saia was a top detractor from performance despite posting a nearly +20% increase in revenue (excluding fuel surcharges) and more than doubling operating income on a record-low first quarter operating ratio of 84.4. Saia is a best-in-class operator that should be able to drive a long-term operating ratio into the 70's. In addition, Saia's increased investments in capacity should allow the Company to post attractive growth throughout economic cycles. After a dramatic pullback in shares year to date, we added to positions during the quarter as we think the market has overshot on pricing in a downturn in Saia's business.

Burlington Stores posted a difficult quarter of results, with comparable store sales ("comps") declining -18%. The reported comp was against a steep year ago result that was boosted by stimulus spending, but the Company also was caught off-guard by dramatic short-term shifts in consumer behavior in the most recent quarter. Further, inflation in the Company's supply chain has more than offset the margin benefits of ample merchandise availability. While other off-price retailers have also been challenged recently, we think Burlington is further behind the maturity curve in fully embracing the off-price model, so it is not overly surprising that Burlington's results have been weaker. The Company has multiple levers to pull over the next several years that will lead to better returns, regardless of macroeconomic pressures.

Acuity Brands detracted from portfolio performance despite posting continued impressive growth in the face of a particularly difficult inflationary environment. The Company's fiscal third quarter results reflected +15% organic revenue growth, with +19% growth in operating profit. Acuity is managing inflationary pressure by constantly re-engineering its lighting and control products while also enacting more than a half-dozen price increases over the past two years. The Company's backlog continues to build as commercial office, education and industrial facilities owners invest in much needed renovations. Management also repurchased nearly 5% of shares during the quarter and have bought back over 15% of shares over the past 2 years at prices well below recent levels.

MAXIMUS also detracted from portfolio performance as investors continued to fixate on the near-term effects of the Biden Administration's prolongation of the 2020 COVID-19 public health emergency (PHE). The congressional legislation that funds the PHE incentivizes states to delay Medicaid redeterminations as long as the PHE is in effect. MAXIMUS has a meaningful amount of earnings power that is pent-up because of this delay in redeterminations and given the difficulty in assessing the timing of what we thought would become a political issue, we trimmed positions earlier this year, particularly after the stock held up relative to the market. The removal of the PHE now represents substantial upside. Furthermore, we expect the Company to continue to drive attractive organic growth as a result of governments worldwide enacting post-COVID-19 policy measures.

Steve Madden reaped the results of its competitively advantaged supply chain and generated a +55% increase in revenue while tripling earnings per share. Many retail vendors have been struggling to replenish their own stores let alone wholesale customers with inventory, but Steve Madden has done an excellent job fulfilling customer needs and is able to take ample pricing as a result. Many of the Company's smaller competitors cannot meet demand as they were hobbled, if not completely wiped out, by COVID-19 induced shutdowns over the past

few years. As economies continue to reopen, Steve Madden should continue to compound its market share gains at increasingly attractive returns, not unlike how the industry evolved in the aftermath of the 2008-2009 financial crisis. With the stock trading at a multi-decade low forward earnings multiple, we viewed the pullback in shares as an attractive opportunity and added to positions in the portfolios during the quarter.

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.

Landstar reported +53% revenue growth during the quarter which drove over +60% growth in earnings per share. Despite the strong results over the past few quarters, the stock peaked back in November of 2021 as investors have begun trying to time the end of the economic cycle, using Landstar as a proxy for economic activity. We are less concerned about where we are in this particular macroeconomic cycle, not only because the market has already discounted a slowdown but also because the underinvestment in long-haul drivers has been a multi-decade phenomenon that will not likely be solved even if consumer demand normalizes over the next few quarters. We think Landstar should generate excess returns over time because it has been one of the few companies that has been steadily investing in drivers while there has not been a concomitant increase in competitive capacity.

OTC Markets generated flat revenue growth on an extremely difficult +60% year ago growth comparison. The Corporate Services segment grew a robust +50% as OTC-listed companies subscribed to OTC Market's monitoring, disclosure, and news services to maintain compliance with a recent SEC rule (15c2-11). This growth offset the decline in transaction activity on OTC Link as the Company laps historically high market activity from a year ago. Although it is difficult to predict the trading volume in any one quarter, OTC Markets has done an excellent job diversifying into non-transaction, service-based revenue streams that are much more predictable and can be scaled across its growing, listed-Company and broker-dealer subscriber bases.

First Republic Bank grew revenues over +20% as it flexed its differentiated business model in the face of rising interest rates. Despite dramatic declines in mortgage origination activity at large money-center banks, First Republic drove over +20% growth in origination activity as it took share using its high-touch service model. Even as rates have continued to rise since the Company's reported second quarter, we think it should be able to sustain industry-leading loan growth rates as it enables more purchase volumes and takes share from lower-touch competitors. Given the exceptional credit quality of its loan portfolio, solid expense discipline, and balance sheet capacity, we think it is reasonable to expect double-digit earnings growth this year.

Broadridge grew its core recurring revenue at a +6% organic rate driven by the increase in the number of open equity and ETF positions at its platform customers. We think this increase in position count was a pleasant surprise compared to the downturn in asset prices seen during most of the quarter. Broadridge customers include large online brokerage providers that have expanded into the mass market. As more investors carry more positions and instruments (regardless of size) Broadridge's services are necessary to connect these investors with corporate governance communications from issuers and other service providers. All told, we think the expansion of capital markets is a healthy long-term trend that Broadridge should continue to benefit from.

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: https://ir.firstrepublic.com/static-files/ece71088-a3ee-41de-b58c-5f2bffc4bc2c.

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-healed 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 non-conforming 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.

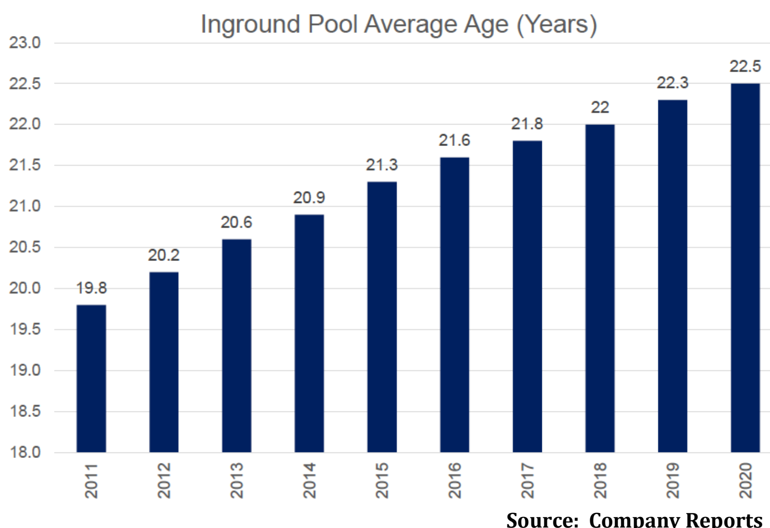
In conclusion, while being the most profitable or fastest growing business are certainly the goals most businesses strive for, we are steadfast in our view those goals must be by-

products 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.

Poolcorp

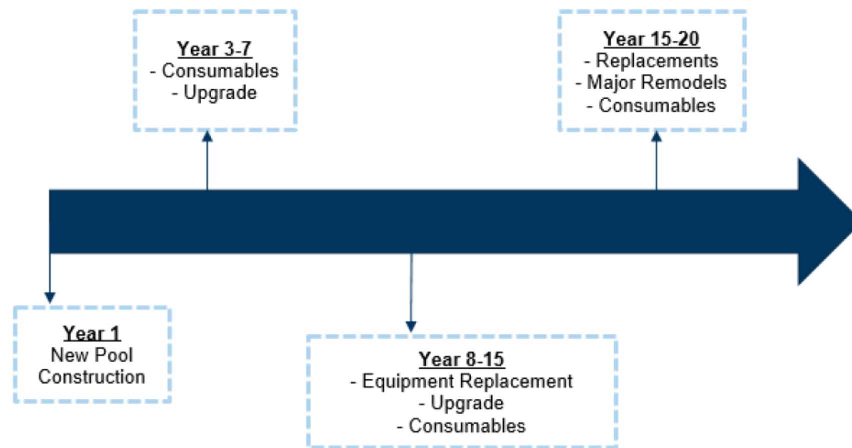
Those of you who own a backyard pool already know the Poolcorp story quite well. (Honey, why is the pool water green?) Those who don't own a pool, well, we recommend a little rent-seeking on your neighbor's pool by owning these shares. The Poolcorp strategy is beautifully simple; build a pool and become 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 Poolcorp.

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: Company Reports

Exhibit 10: Pool Industry Has Significant R&R Activity



Source: Company data, Goldman Sachs Global Investment Research

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: Company Reports

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. Poolcorp 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. Poolcorp founders would no doubt make Alger proud.

Source: Company Reports

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 Poolcorp substantial opportunities for expansion.

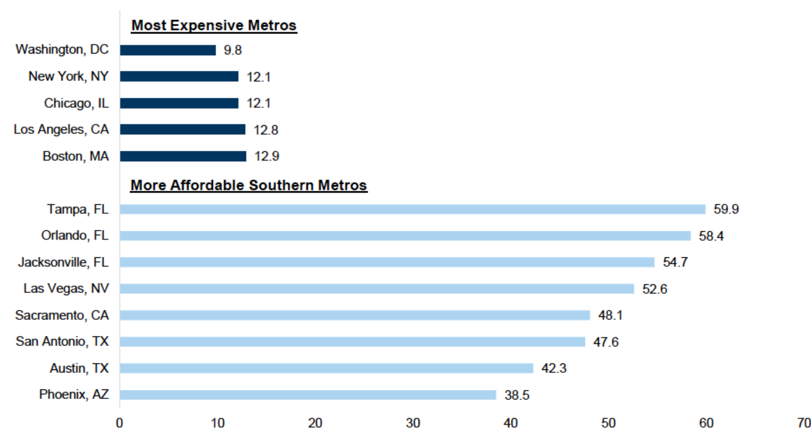
Most of the Company's business mix, 90%, is derived in the U.S. Canada is 5% and Europe is 5% too. 60% of the Company's business revolves around the installed base of pools (and spas). Pool renovations and upgrades are 20%, and new pool construction is 20% as well. Its typical customer, +80%, are local 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).



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.")
Poolcorp 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 Poolcorp.)
- 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 late-2022/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.

<u>Whip</u> <u>Inflation</u> <u>Now</u>

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.

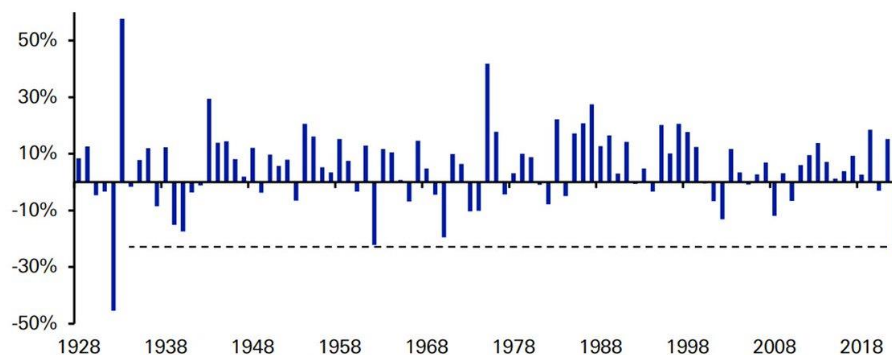
If former Major League Baseball commissioner, Bart Giamatti was an investment manager, he may well have been quoted, *"The Fed breaks your heart. They're designed to break your heart."*

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.

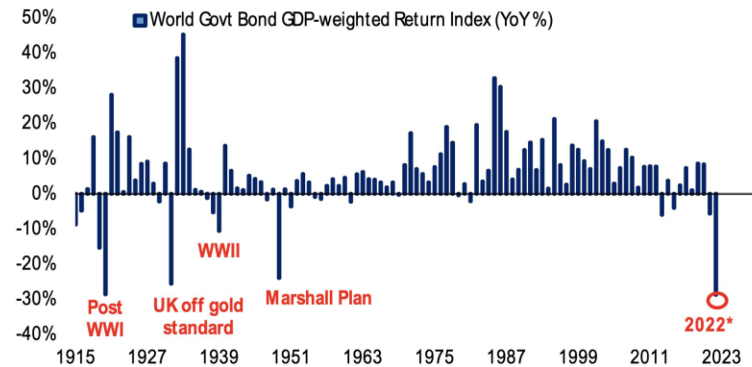
Figure 1: S&P 500 Performance during H1 in total return terms.. will this be the worst H1 since 1932?



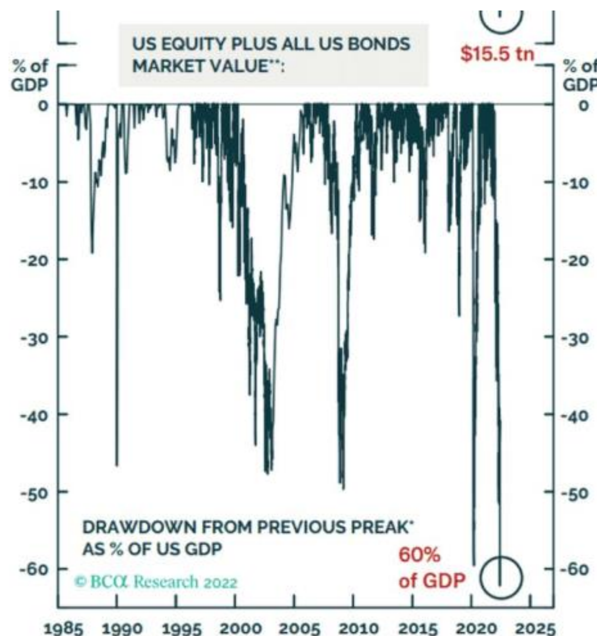
Source : Bloomberg Finance LP, Deutsche Bank

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 48-month period.

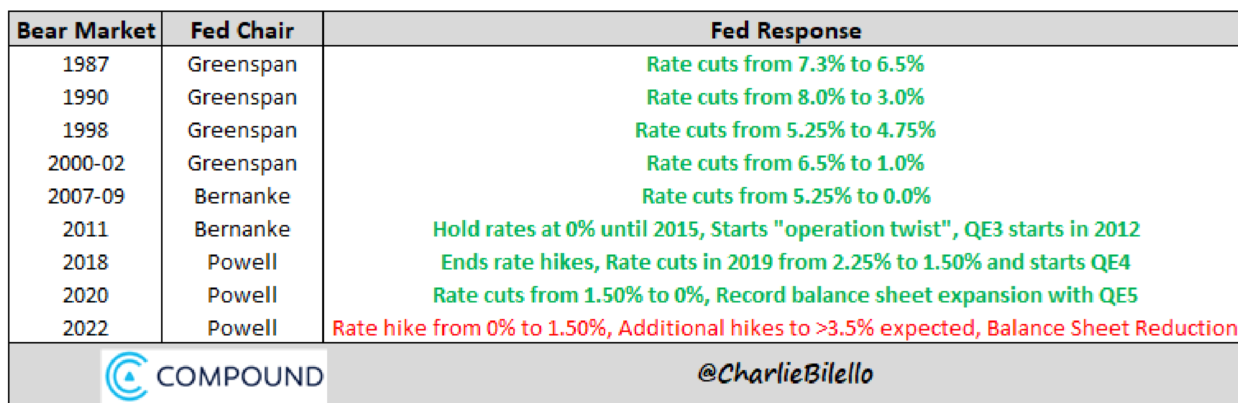
The bond market hasn't been spared from Powell & Co.'s channeling its inner Paul Volcker Whip Inflation Now wrath either. With literally zero buffer of any yield, bonds have suffered a generational beating. Those investors with a traditional 60/40 to allocation stocks and bonds have suffered a historic 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.



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!



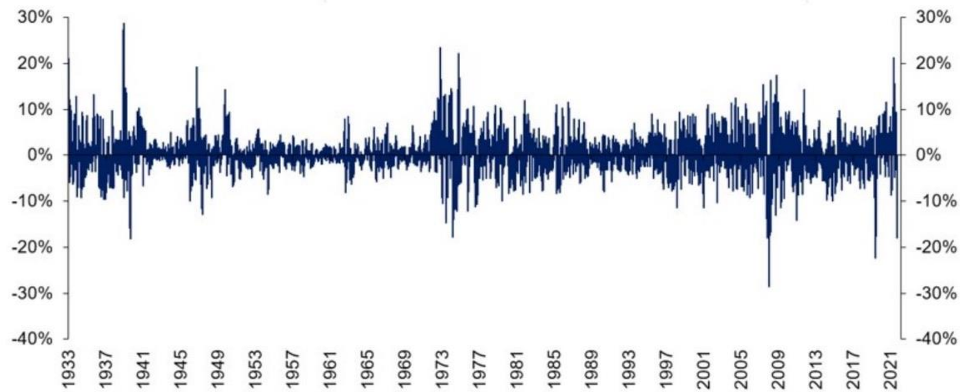
Bear Market	Fed Chair	Fed Response
1987	Greenspan	Rate cuts from 7.3% to 6.5%
1990	Greenspan	Rate cuts from 8.0% to 3.0%
1998	Greenspan	Rate cuts from 5.25% to 4.75%
2000-02	Greenspan	Rate cuts from 6.5% to 1.0%
2007-09	Bernanke	Rate cuts from 5.25% to 0.0%
2011	Bernanke	Hold rates at 0% until 2015, 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
COMPOUND		@CharlieBilello

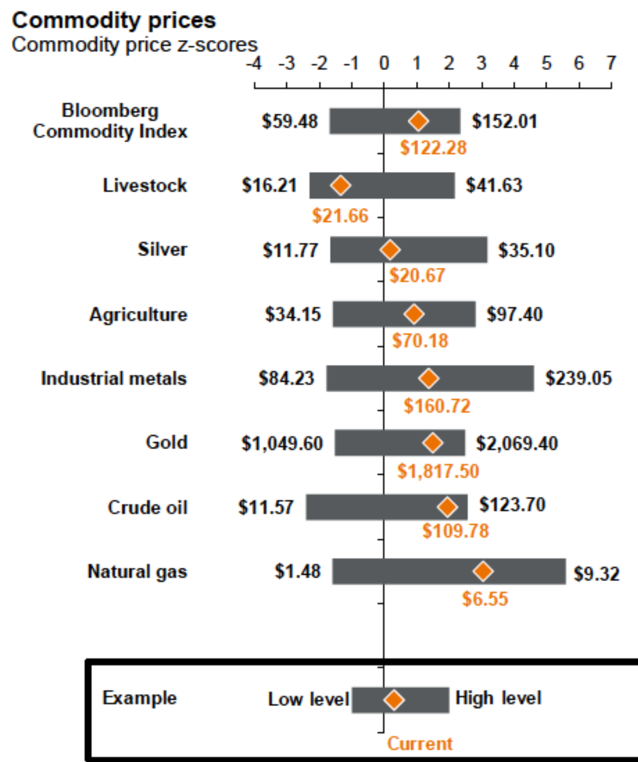
A growing list of market price declines (stocks, bonds, and commodities) have become notable enough to suggest that peak inflation may be behind us. In addition to the sharp declines in stocks and bonds, it is noteworthy that the rolling 20-day decline in the Bloomberg Commodity Index is the third-largest 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.

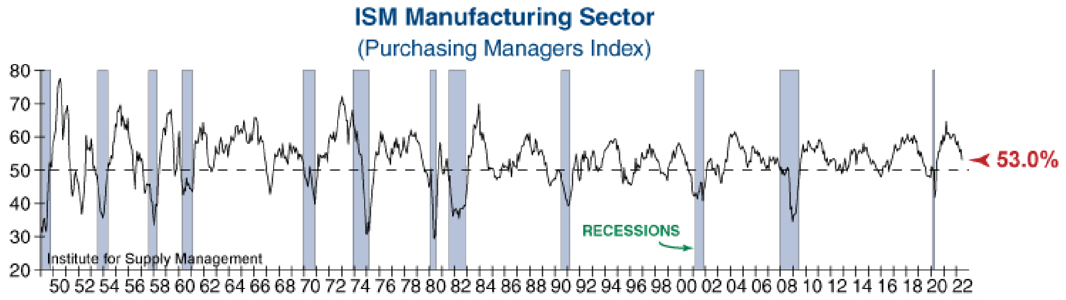
Yellow and a few red signs, are flashing everywhere.

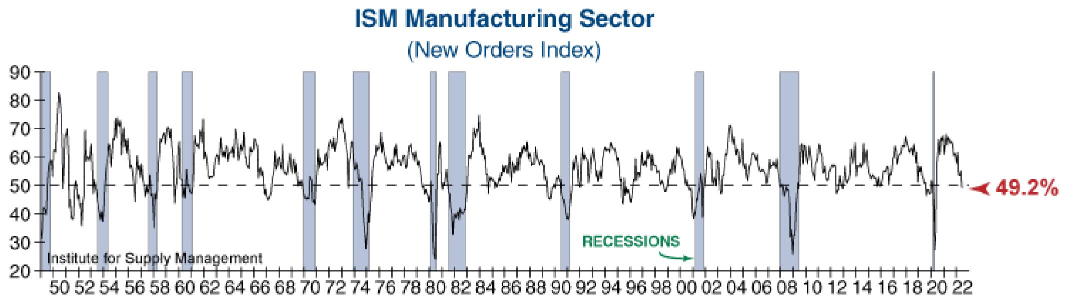
(We'll save the havoc in the home mortgage market for our next Letter. Suffice to say, the housing market has not responded kindly to 30-year mortgage rates doubling from the lows set at the start of 2021.)



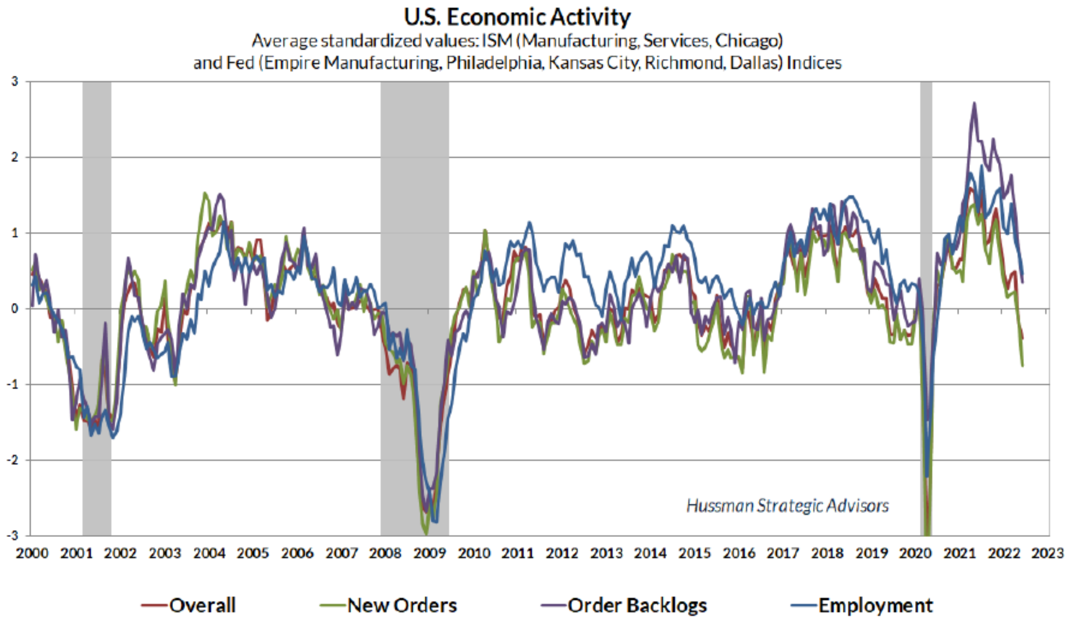


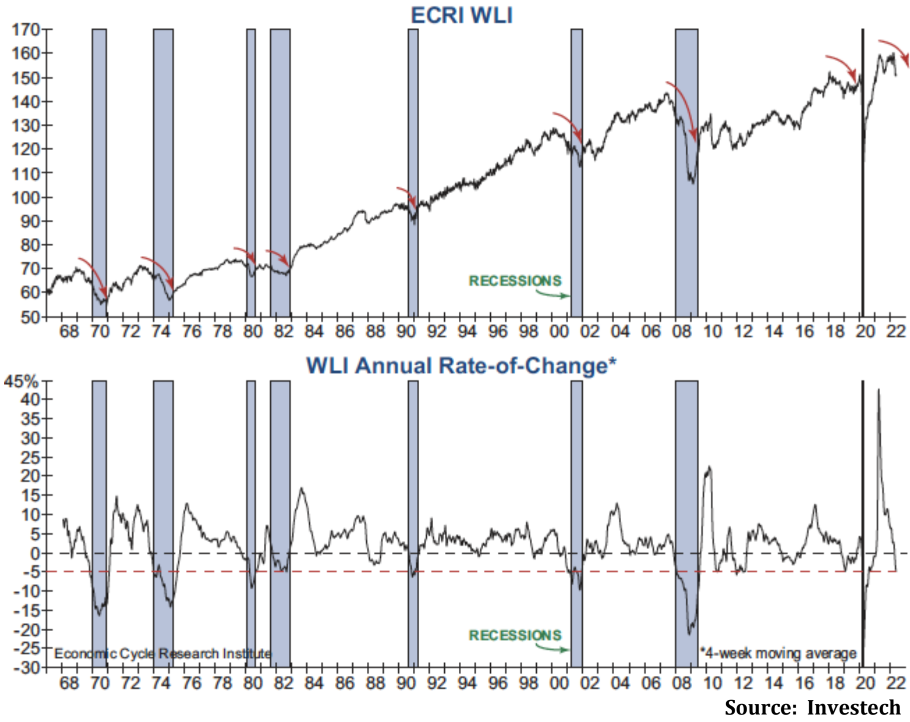
Source: Bloomberg





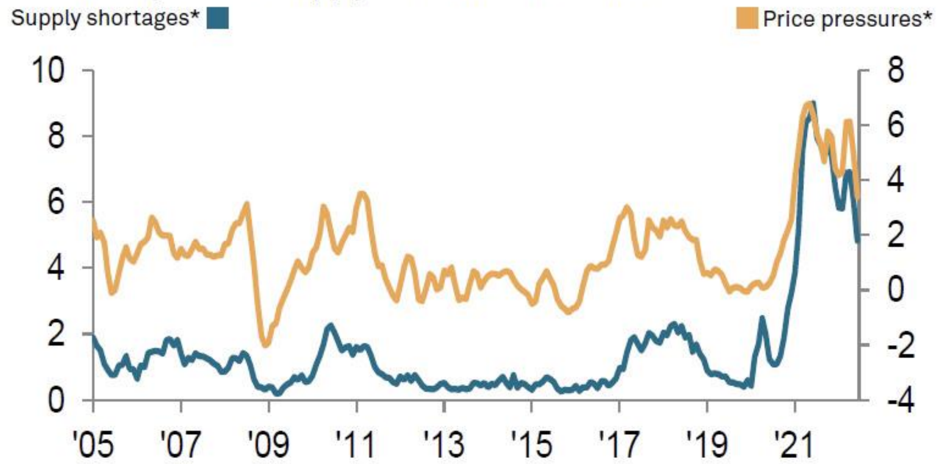
Source: Investech



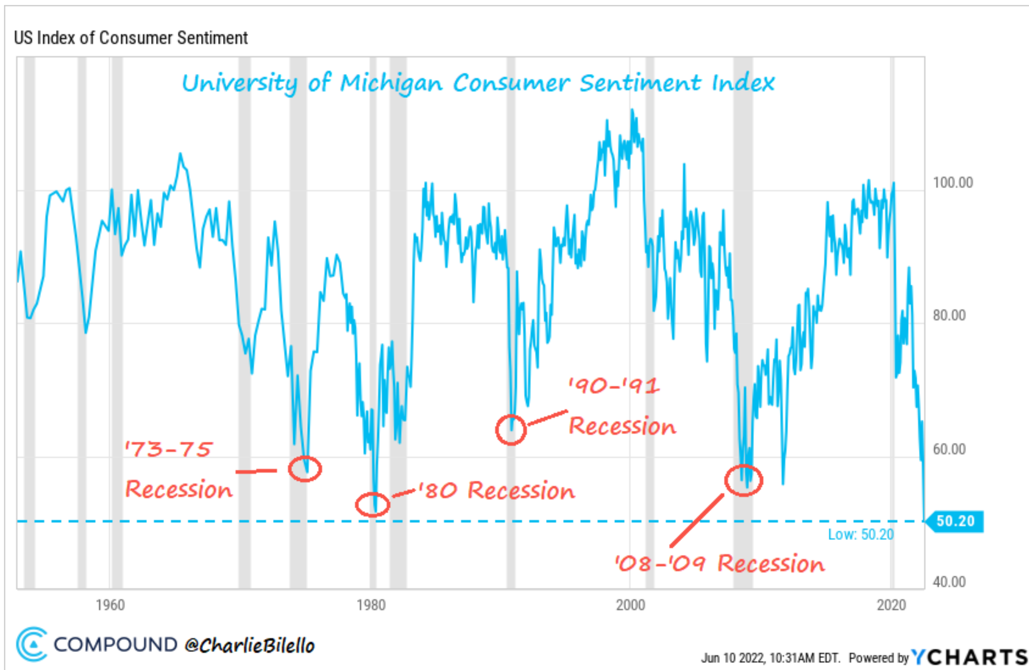


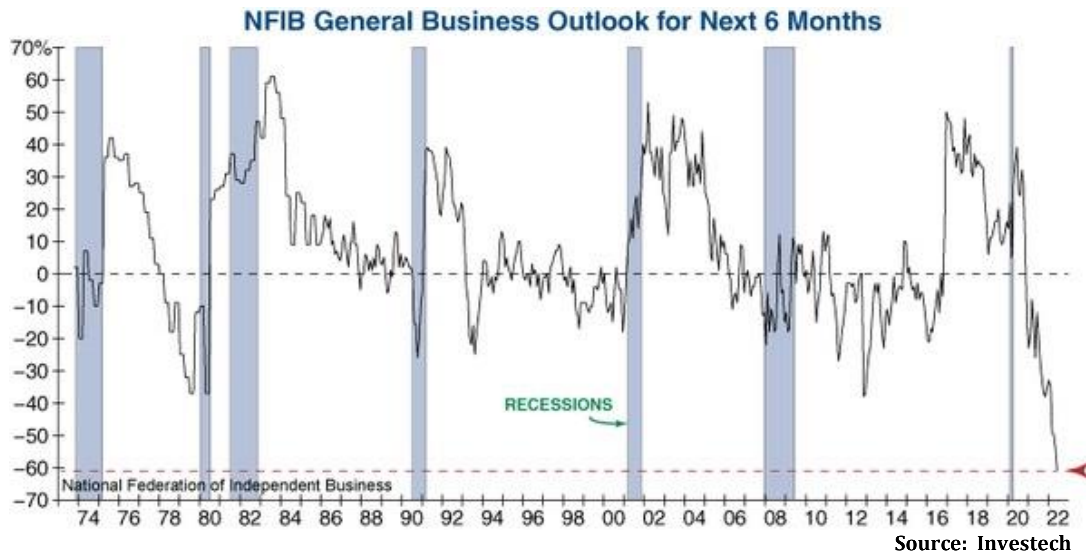
Source: Investech

Commodity Price & Supply Pressures: All Items

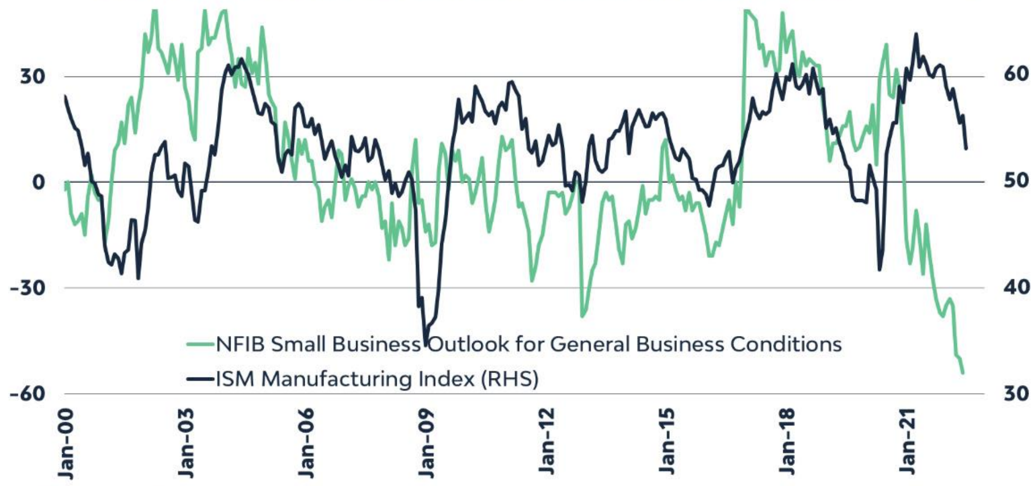


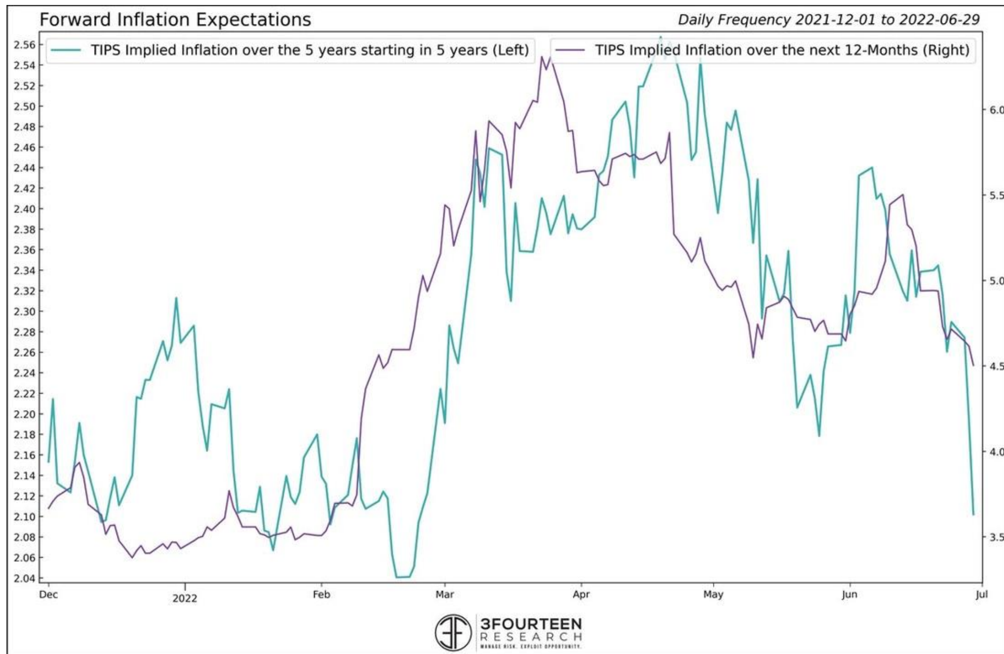
Source: S&P Global.
multiple of long-run average



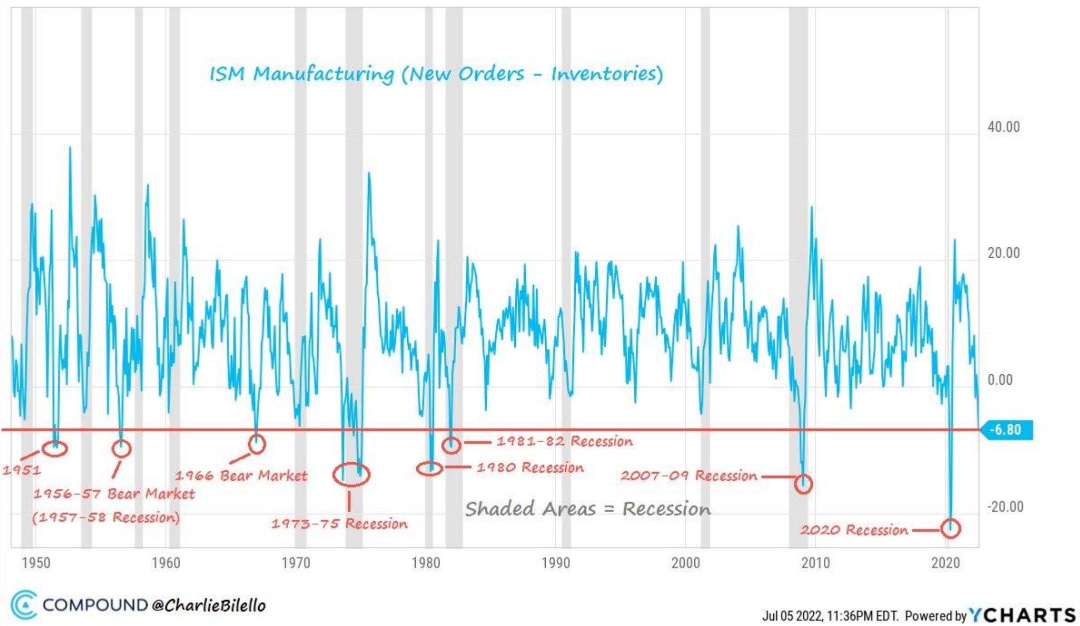


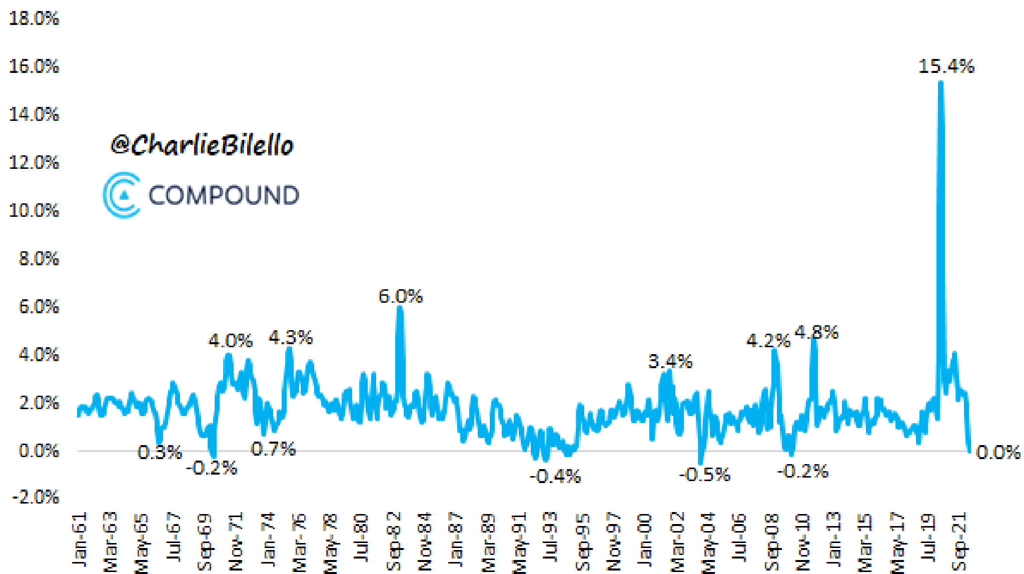
Source: Investech


US - Small Business Outlook - Business Conditions
true insights
30
0
-30
-60
60
50
40
30
NFIB Small Business Outlook for General Business Conditions
ISM Manufacturing Index (RHS)
Jan-00
Jan-03
Jan-06
Jan-09
Jan-12
Jan-15
Jan-18
Jan-21
Source: True Insights, Investing.com


Forward Inflation Expectations
Daily Frequency 2021-12-01 to 2022-06-29
TIPS Implied Inflation over the 5 years starting in 5 years (Left)
TIPS Implied Inflation over the next 12-Months (Right)
Dec
2022
Feb
Mar
Apr
May
Jun
Jul

3FOURTEEN
RESEARCH


US ISM Manufacturing New Orders Index - US ISM Manufacturing Inventories Index
ISM Manufacturing (New Orders - Inventories)
40.00
20.00
0.00
-6.80
-20.00
1951
1956-57 Bear Market
(1957-58 Recession)
1966 Bear Market
1973-75 Recession
1980 Recession
1981-82 Recession
2007-09 Recession
2020 Recession
Shaded Areas = Recession
1950
1960
1970
1980
1990
2000
2010
2020
COMPOUND @CharlieBilello
Jul 05 2022, 11:36PM EDT. Powered by YCHARTS


US M2 Money Supply: 3-Month % Change
(Jan 1961 - May 2022)
@CharlieBilello
COMPOUND
15.4%
6.0%
4.0%
4.3%
3.4%
4.2%
4.8%
0.3%
-0.2%
0.7%
-0.4%
-0.5%
-0.2%
0.0%
18.0%
16.0%
14.0%
12.0%
10.0%
8.0%
6.0%
4.0%
2.0%
0.0%
-2.0%
Jan-61
Mar-63
May-65
Jul-67
Sep-69
Nov-71
Jan-74
Mar-76
May-78
Jul-80
Sep-82
Nov-84
Jan-87
Mar-89
May-91
Jul-93
Sep-95
Nov-97
Jan-00
Mar-02
May-04
Jul-06
Sep-08
Nov-10
Jan-13
Mar-15
May-17
Jul-19
Sep-21

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

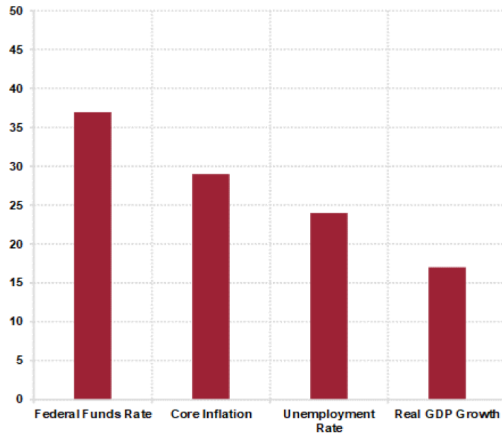
United States
(percent)

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)



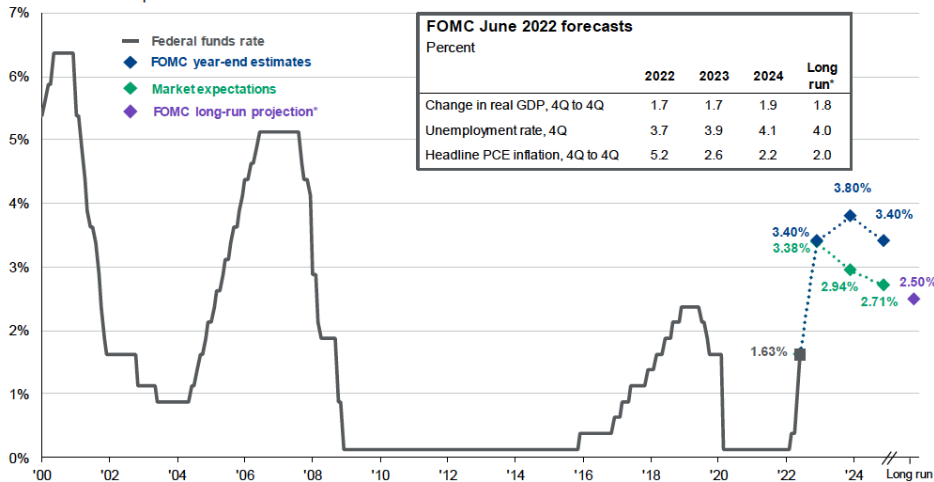
Source: FRB of Governors Tealbook, Haver Analytics, Rosenberg Research

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



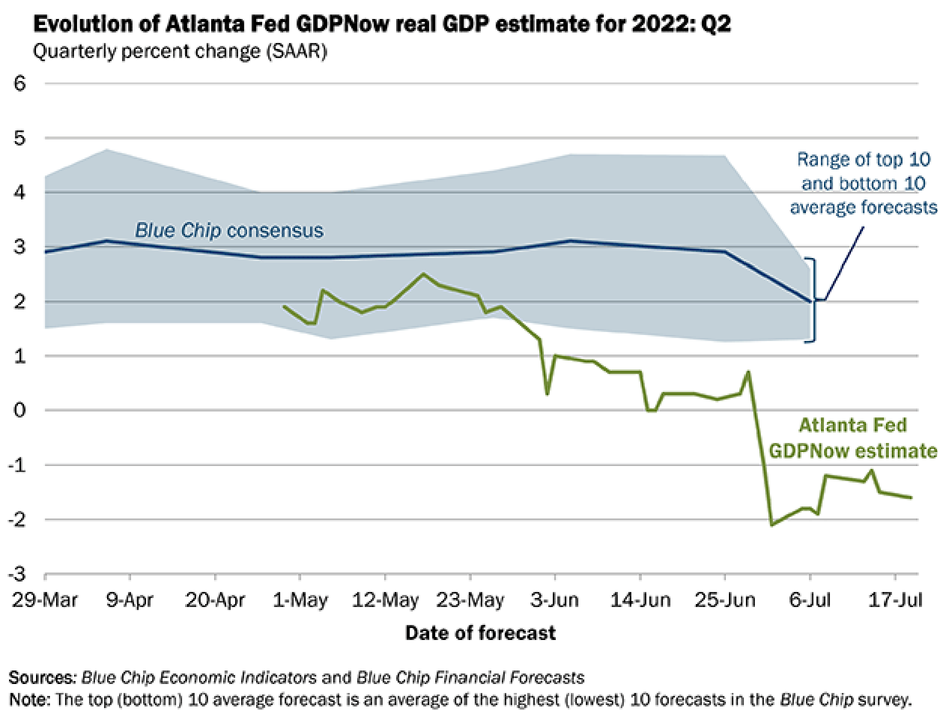
	2022	2023	2024	Long run*
Change in real GDP, 4Q to 4Q	1.7	1.7	1.9	1.8
Unemployment rate, 4Q	3.7	3.9	4.1	4.0
Headline PCE inflation, 4Q to 4Q	5.2	2.6	2.2	2.0

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 *-1.6%* – 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.

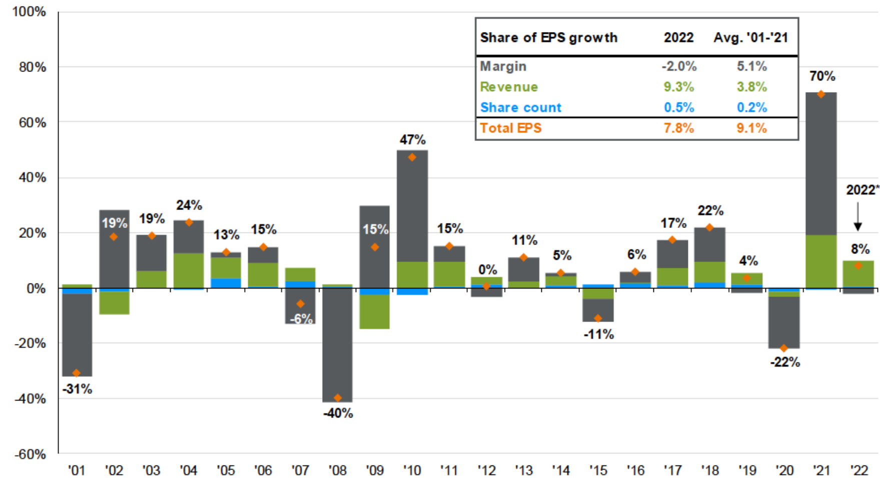


The stock market's decline is both part and parcel of overvaluation, punctuated by higher interest rates, plus weak first quarter earnings releases back in April; and the prospect of even worse reports for second quarter announcements. A graphic that we have featured in our past two Letters is reprinted 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

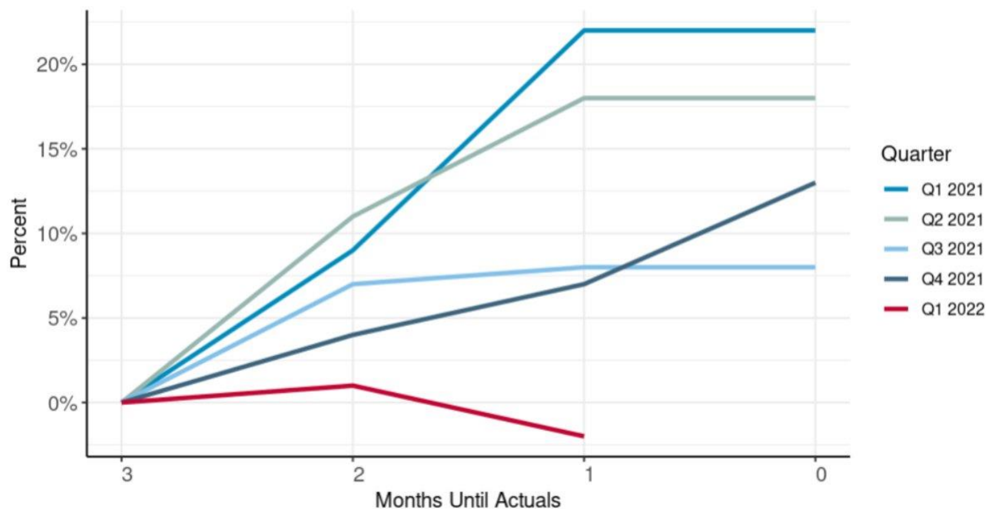


Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.
EPS levels are based on annual operating earnings per share. *2022 earnings figures are based on weekly operating earnings estimates from Standard & Poor's. Percentages may not sum due to rounding. Past performance is not indicative 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



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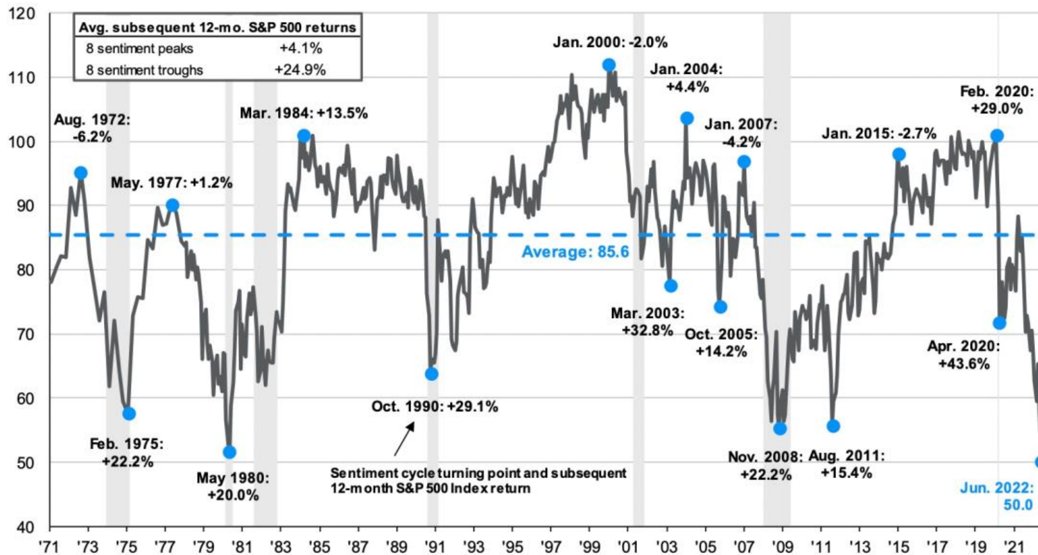

Source: J.P. Morgan Asset Management

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	Michael X. Quigley, CFA	Christopher T. Jersan, CFA
Chief Investment Officer	Senior Portfolio Manager	Portfolio Manager

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[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.