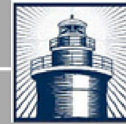
MARKET UPDATE

Spring 2022



The start of 2022 ushered in a level of volatility financial markets have not seen since the beginning of the COVID-19 pandemic. The S&P 500 Index had its worst four-month start of the year since 1939, down **-12.9%** and the Nasdaq Composite Index performed worse than that, down **-21.0%**. Interestingly, bonds, which historically have appreciated in value during stock market sell-offs, lost value as interest rates rose. The 10-year Treasury started the year with a yield of **1.51%**. As bond yields rise, prices fall, and by the end of April, the 10-year yield had risen to nearly **3%** and its price had fallen by **12.4%**. We thought we'd share our view as to why volatility has heightened and examine the key datapoints we are evaluating to assess what comes next.

Recent History: Over the last three calendar years investors in stocks have experienced returns which were well above long term average annual returns for the S&P 500, with the index up +31.5% in 2019, +18.4% in 2020, and +28.7% in 2021. While the S&P 500 experienced a large drawdown in March 2020 (COVID-19 pandemic), the drawdown quickly recovered by summer's end, and other than that there were very modest drawdowns over that 3-year period. Since 1950, the average intra-year drawdown (peak-to-trough decline) in the S&P 500 has been 13.6%, however in 2021, despite an outstanding return of ~30%, the largest drawdown was only ~5%, which defined extremely strong returns for the year with historically low volatility. Simply put, by the end of 2021, the market had gone on a substantial run largely uninterrupted and was likely to encounter volatility, which we anticipated and are now experiencing.

Inflation: The financial markets have been materially impacted by inflation this year. It has become evident that the Pandemic has created more persistent inflation and it is lasting longer than the Federal Reserve expected. Inflation has taken many forms of cost increases: wages, food, gasoline, housing, and rent coupled with numerous supply chain constraints. In the US, there is extremely strong demand for labor but a low supply of available workers: as of April, there are 11 million job openings with only 6 million people actively seeking work. Remarkably, the unemployment rate has dropped to a historically low level of 3.6%, meaning companies must incentivize (pay higher wages) to individuals in order to retain them or hire them away from their current employer. Wage inflation impacts corporations negatively as it can often reduce their profitability: if a company has to pay workers more but cannot increase prices, it will earn less. Alternatively, companies that do have “pricing power” can increase prices in order to maintain profitability, which in turn causes inflation for consumer goods. If it sounds like a big knot, it is, that is why the Fed is working diligently to try to engineer a “Soft Landing,” which in effect means adjusting interest rates in order to moderate inflation without pushing the economy into a recession.

US & Geo-Political Issues: While companies continue to fight wage inflation, they are also facing increased costs of commodities and encountering stubborn supply chain constraints. The war in Ukraine has had a material impact on commodity prices: oil surged from $77 barrel (start of the year) to over $100 barrel today. Wheat prices have increased 40% this year because Russia and Ukraine are two of the five largest wheat exporters in the world, accounting for ~25% of total global exports. Add to that, four of the five largest container shipping ports in the world are based in China, which due to COVID-19 are facing substantial lockdowns. All of these factors are impacting almost every company in the US today: most of which need to increase wages, pay more to procure goods (supply chain) and pay more for the raw materials (commodity prices). The convergence of these factors has led to a 40-year high in US inflation levels which is presently running in the 8%+ zone.

Bright Spots: Despite the present wave of negative news, the market is always forward looking and is trying to determine outcomes: uncertainty is what is driving volatility. Given the market sell-off to start the year, stocks have begun

to price in considerably bad economic data and geopolitical scenarios. Should positive datapoints emerge, such as signs that inflation has peaked or is abating, interest rates stabilize, a positive solution to ending the war in Ukraine, or China reopening, it is likely the market will respond favorably. Market sentiment is one factor that we consider when evaluating market dynamics and at present, market sentiment is showing levels of bearishness from investors last seen in late March 2020. As you may be aware, we often use these opportunities of extreme negativity in the marketplace to invest in blue-chip companies that we believe are now materially discounted.

Our Firm View: Over the last few years, we have seen corporate valuations in varying segments of the market become bifurcated into two distinct groups which internally we refer to as the "tortoises" and the "hares." When referring to "tortoises," those are companies generating consistent, predictable, and growing earnings. "Hares," on the other hand, had extremely optimistic revenue growth projections but uncertain paths to profitability. Over the last three years, the "tortoises" produced strong returns, however, they were not rewarded as much as the "hares." Subsequently, in 2022, the paradigm shifted: dominant players in their respective fields; Johnson & Johnson, McDonald's, and Pepsico (tortoises), have experienced modest declines (down ~2% on average) while conversely, Zoom, Teledoc, and DocuSign (hares), have fallen enormously, more than ~85% from peak valuations. The valuations of the "hares" were much too high and there was no clear path to long term earnings growth, which is not the case in many of the names we invest in within the technology space, such as Microsoft, Apple, and Google. During market times like this, sell-offs can offer exceptional opportunities to invest in high quality technology companies at reasonable prices. In times of extreme volatility, collateral damage occurs: investors exit areas entirely with no regard to management, balance sheet quality, or future earnings potential, therein lies the opportunity. Moving forward, we believe the paradigm outlined above will continue: the high-quality companies you own, with great business models, at reasonable valuations, with strong cash flows will be rewarded over time, conversely, the higher valuation companies with indeterminate earnings will continue to struggle and experience more volatility.

WhaleRock Market Outlook:

- **US Equities:** We are overweight Large-Cap stocks vs. Small & Mid-Cap. Large companies have economies of scale, a favorable quality to endure supply chain disruptions and more; Large-Cap stocks remain the core of our equity strategy.
- **International Equities:** We remain underweight both Emerging & Developed markets. We are concerned about corporate governance and currency risk in China. In Europe, we do not think the long-term growth prospects are strong.
- **Fixed Income:** For over five years we have owned shorter-dated maturity bonds due to the ultra-low rate environment. Today, interest rates are rising, bonds have become more appealing, and we are sourcing & buying longer dated, high-quality bonds. We continue to buy Governments, Municipals, Corporate bonds, and are selectively buying Preferred Stock. With few exceptions, we do not own or recommend owning, Fixed Income Mutual Funds or ETFs due to the risk of permanent principal impairment.
- **Commodities:** We own Best-in-Class companies operating in the Energy & Material space rather than own direct commodity-based investments. There is tax-inefficiency & heightened volatility when owning commodities directly.
- **Cryptocurrencies:** We do not own or recommend any exposure to cryptocurrencies at this time.

As always, should you want to discuss this further or have any questions, please call us: 401.228.7799.

Per the SEC's annual requirement, WhaleRock has updated our ADV to reflect any changes that occurred in 2021. This can be found on our website, www.wrpoint.com.