"It isn't what you make; it's what you keep that matters."

SKBA gave voice to this idea over a dozen years ago and it could not be more relevant for investors than it is today.

This adage is a critical reminder of the importance of downside protection in volatile markets. It is a principle that is especially true today, given that year-to-date to their June lows, the S&P 500 and the NASDAQ index prices fell over 20% and 30%, respectively. Any nearly flat total return this year is a huge victory for the protection of wealth. The current environment further highlights the terrible flaw in simply buying a market index to passively manage a client portfolio. Only active portfolio management can hope to offset some of this overall weakness in financial market indices and ultimately help investors "keep" more of their wealth.

Yet, how did the markets go so awry from the uptrend off the lows of 2020? Investors, the Federal Reserve Board, and the federal government believed that serious price inflation would never reappear, even if the money supply growth and government deficit spending were horribly mismanaged. It's almost as simple as that.

While today's problems were certainly exacerbated by the emergence of the COVID 19 pandemic, and further by the war between Russia and Ukraine, the adoption by the Fed of MMT (Modern Monetary Theory) long predated the pandemic as easy money and ZIRP (Zero Interest Rate Policy) led markets to take excessive risks in bidding up the prices of risky assets. MMT has now been tested and found horribly wanting.

Yet before this current reality set in, growth stock valuations soared to heights not seen since 1999, and even without the pandemic, such valuations were long overdue for correction. The pandemic pulled forward corporate revenue growth into 2020 and 2021 for a significant portion of the broad market index. In the same manner as tech spending required to solve the Y2K problem of the late 1990s, investors falsely believed the pandemic acceleration of revenue growth for these companies was permanent. A quick examination of the recent revenue shortfalls at the likes of Zoom, Peloton, Netflix, and Amazon now disabuse the notion the change was permanent. When revenue and earnings growth falls short of expectations, high flying Price/Earnings ratios become unsustainable, leading to huge and lasting contractions in stock prices.

The reopening of the economically sensitive parts of the U.S. and world economies were repeatedly hindered by the waves of COVID cases brought on by the various variants. While the recent Omicron variants continue to spread, they appear progressively less virulent, allowing economies to reopen and recover. The majority of the world is learning to live with this now endemic disease even though we are still uncertain of all of the virus' lasting effects.

The great exception to this story is China, which is attempting to stop the spread of Omicron variants by closing down its economy. Their efforts appear to be futile, however, and the repeated closures of factories and cities have added to the supply chain disruptions that have contributed to upside price pressures on goods and services around the world. Even if China weren't struggling with COVID's inevitable spread—as we have previously stated—we believe that supply chain problems would not be easily solved. Normal inventory levels need to be raised, just in case. Furthermore, from the perspective of price inflation pressures on commodities, intermediate and finished goods (and services), the backward shift in supply curves and outward shift in demand curves lead to higher prices at all levels of output and consumption. This cannot be easily resolved and as we have clearly stated in "The Great Inflation Awakening," our newsletter of February 2021, price inflation pressures are not transitory.

It's déjà vu all over again as the Federal Reserve Board is having to relearn the lessons of the late 1970s and early 1980s that excessively easy monetary policy maintained for long enough creates accelerating price inflation pressures. While the initial phases came in a booming economic recovery as we saw with 2021's 6% real GDP growth, eventually out of control price increases lead to demand destruction and stagflation. This is now our highest probability outcome for the next two years. The political will to tackle the inflation problem even at the expense of economic growth was finally reached when President Carter appointed Paul Volcker as Chairman of the Federal Reserve Board in 1979. The current question is: Does Chairman Jay Powell have the fortitude to fix today's problem of 8.6% year over year price inflation? "Caesar" Powell has downplayed the problem while "Rome" burned.

Any investment related to cryptocurrencies like Bitcoin and Ether have also recently been disastrous, as rash speculation about dollar prices never coming down must have the tulip bulbs merchants smiling. Just as during tulip mania, valuations soared to the stratosphere based on pure speculation.

Contrary to current fears, we believe higher interest rates will eventually be a benefit to the U.S. private economy as it restores normal bond price discovery, higher income production, better risk management, and reduced speculation in the parts of markets that possess almost no sound underpinning to valuations. Over the near term, however, the widespread loss of wealth is painful for many investors.

We continue to spend our time focusing on investments with low valuations that benefit from high inflation, stagflation (low real growth high price inflation), have pricing power, and appear to us to be less sensitive to the excessive valuations of the recent years.
