RIVERSTONE
ADVISORS, LLC

April 4, 2022

Dear:

First-quarter was a wild ride. The press has been on repeat with: "War," "Correction," "Inflation," and "Recession". Bad news has outweighed good, and we are here to sift through these headlines for you.

As projected last year, we finally hit a "true" correction in the market. Remember, a "true" correction is a market decline of 10% or more. On March 14th, the market was down 12.4% year-to-date. Fortunately, there has been a steady increase in the market since then.

While volatility like this is uncomfortable, corrections are healthy. They allow the market to reset and pull cash in from the sidelines. This is how normal markets behave. This letter will discuss whether we consider this market normal and how we are adjusting portfolios.

Wild Ride

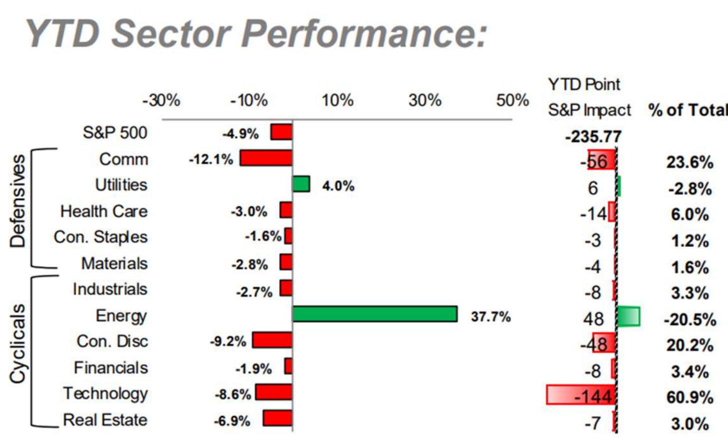
To begin the year 2022, the market focused on worries and was down -5.3% in January and down -3.8% in February. The Ukrainian war began on February 24th. The market spent two weeks up and down digesting the war and then bottomed on March 7th, rallied for one week, and then bottomed again on March 14th. Next it set the war aside and took off on a 9.6% runup. The runup was most enjoyable.

The market is climbing "a wall of worry."

The market takes in data, processes it, and expresses its opinion up or down. As you know, its opinion seems illogical at times.

Investment Performance

The war threw the economy into disarray and the first quarter was a loss. Year-to-date, all eleven market sectors were negative except for energy and utilities. The only way to have a positive return was to only own these sectors. Fundamentally this does and didn't make sense. Energy returned +37.7% due to the tightening of supply from Russia's war. Utilities returned 4.0%. The chart shows all sector performance. Your stocks returned -8.7% relative to the S&P 500 at -4.6% and NASDAQ at -9.1%. Your overall return was -7.7%.



The market rotated out of growth stocks the last two quarters in reaction to higher interest rates. We explained the math last quarter; let us know if you want the refresher. This happens periodically and does not overly concern us.

First, the fundamentals of growth companies haven't changed; they still have strong revenue and earnings growth. The correction in growth stocks has been overdone. When this occurs, we evaluate the portfolio holdings' fundamentals. We have completed this work and are comfortable with the companies.

Of the seven stocks down meaningfully in first quarter, the expected upsides to their target stock prices are good: 13%, 18%, 27%, 38%, 18%, 110%, and 78%. It is too early in their growth cycles to leave. Most growth companies look relatively cheap historically. We have data on this and are happy to talk in more depth if you would like. We have been doing some trimming where positions are outsized.

Wall Street throws declining stocks overboard so that clients' statements won't show declines. We don't do "window dressing" because these are good investments with plenty of gas in their tanks. We believe our clients are rational. We understand this doesn't make it easier for you. We feel your pain as we personally own the same companies you do.

Cut to the Chase

The bricks on the wall of worry are connected via cause-and-effect. Their connections brought us to this point in the economy:

During the Covid shutdown, consumers' pocketbooks were supported by the government and the Fed. Demand for goods jumped. Companies' just-in-time inventory couldn't meet this demand. Orders for more goods and supplies swamped the supply chain ergo inflation. Lather, rinse, repeat.

At this point, most professional investment managers and many economists are in general agreement that a recession is coming. It is plastered on every news site. Sometimes this is enough to push consumers to slow their spending. This would benefit our economy as it would take down the consumer side of the inflation issue.

For the rest of the letter, we will address the good (ways recession could be avoided) and the bad (risks that could push us into recession).

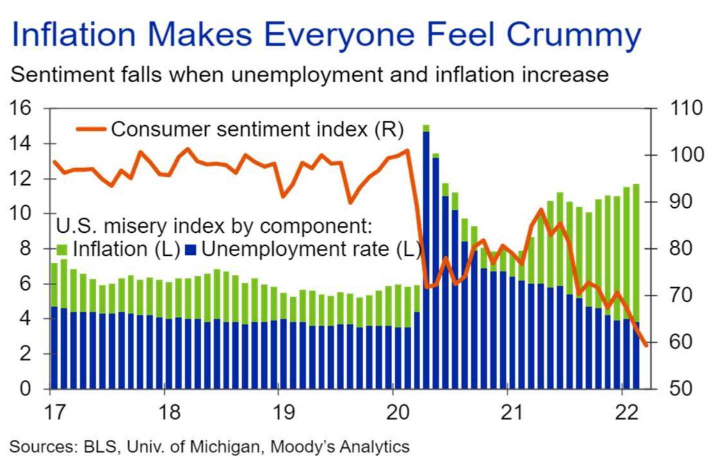
THE GOOD

A recession might be avoided for the following reasons:

- The economy could slow on its own, and inflation ebb. This would be the easiest solution but unlikely.
- Consumers could stop spending. Consumers are still spending the stimulus money received during the pandemic. However, they are now starting to eat into their balance sheets. The U.S. personal savings rate is down to 6.3%. This is lower than the pre-Covid rate of 7.8% and the 7.2% average rate from January 2010 to February 2020. This is telling as consumers are starting to feel themselves spending their personal savings. Threats of recession might drive consumers to batten down the hatches.
- The Fed might fold after four rate hikes leaving the Federal short-term rate at 1.25%. This could happen if economic numbers start slowing.
- Higher mortgage rates appear to be slowing house buying as existing home sales in February fell 7.2% compared to January after falling for several months prior. The concomitant buying of household gewgaws may fall off as well.
- The Fed implemented monetary tightening in 2021 and this may help slow the economy soon.

When consumers received their stimulus money, some of it was used to pay off credit card debt. Consumers have been running up their credit card debt again and are about halfway back to their 2019 high water mark. They might come to their senses.

See the red line in the chart below from the Bureau of Labor Statistics. Consumer sentiment measures are <u>leading indicators</u> i.e., a harbinger of what is to come. The trend is a sharp decline. The bars in this chart show the inflation rate and the unemployment rate <u>added together</u> (inflation rate sitting on top of the unemployment rate). The sum is called "the misery index." This index has risen steadily over the last year.



THE BAD

Let's look at the risks to the economy. The two largest risks to the markets are the Fed and the war in Ukraine. The largest risk over the coming 6-12 months is the Federal Open Market Committee's (a.k.a. The Fed) actions of raising interest rates to stem inflation. The war is a shorter-term risk which the market has taken in stride. We will discuss the Fed in more detail.

The Fed

The mandate for the Federal Reserve is to conduct monetary policy "to promote effectively the goals of **maximum employment**, **stable prices**, and **moderate long-term interest rates**." This is from their website. Employment is strong, interest rates are moderate, but prices are ballistic.

The government handouts of 2020-2021 fueled unprecedented consumer spending on goods which, in combination with supply chain issues, led to our current high inflation of 7.5%.

The Fed is now trying to bring down inflation by raising short-term lending rates. This action flows to all bond products such as mortgages, commercial lending, auto loans, etc. The Fed's decision making is inexact as they do not know how much to raise rates to slow the economy; no one does. We think of this as "wherever you go, there you are". They will raise rates, watch for an impact, and raise rates, watch for an impact. As it sounds, this is a cause-and-effect process.

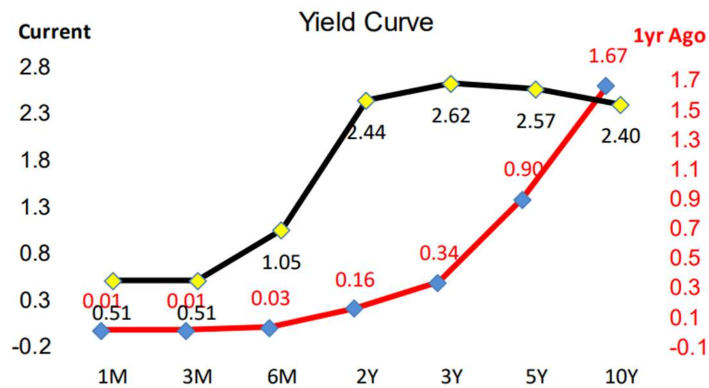
We believe the Fed should have raised rates sooner. On March 16th they started with a rate increase of 0.25%. This one-quarter of one percent increase was the first increase since 2018. The Fed has six more meetings in 2022 with the next meeting set for May 3rd. They are telegraphing a 0.50% increase then. We wish they would do it now. We need a bit of shock and awe from the Fed.

The most significant risk that investors face over the next six months is the risk of excess rate increases from the Fed. The Fed is against a wall as they play catchup.

The yield curve has started to flatten after one rate increase (see the following graph), and we are already seeing many news articles pointing to curve inversion as a recession indicator.

You might be asking, what is the yield curve? For our long-term clients, you may remember 2019 when the last yield curve inversion happened. The yield curve maps out U.S. Treasuries of various maturities, and usually shows higher income yields for longer-dated Treasuries (like those with 10-year or 30-year maturities). Shorter dated Treasuries are 3-month or 2-year maturities. The market is willing to pay you more for investing in longer-term securities.

This is normal. When the yield curve inverts, the shorter-term securities have higher yields than longer term bonds. See the chart below comparing today's yield curve (3.31.2022) to the yield curve a year ago. This is abnormal. Let us know if you would like our past work on yield curve inversions and how to think of them with regard to recessions.



For the TLDR (Too Long; Didn't Read) version, yield curve inversions are often followed by recessions. This can be worrisome, but you can still achieve strong investment returns from the time of inversion until the time of the recession which historically has varied from eight months to two years in each of the last eight recessions. We need to look at other economic indicators to get a better idea of timing.

What do we think and how do we plan? Assuming inflation remains high, and the Fed raises rates quickly, we are de-risking portfolios by raising cash balances. However, if inflation naturally comes down as consumers tame spending, then it could cause the Fed to change their course on rate rises. This is the ideal scenario, but we are prepared for both.

Pandemic

It appears the U.S. is stuck at vaccination rates of 66%. True immunity is higher due to Covid cases in unvaccinated people.

There is no doubt there will be another round of spiking cases. Medical knowledge and treatment have improved so deaths will be much lower going forward. The market is beginning to yawn at new spikes in Covid. If we do still face lockdowns in the future, we can expect that supply chain issues will be present. This could further drive the Fed to raise rates quickly to slow down inflation pressure.

China persists with pervasive lockdowns. Their government has set 5% as their GDP target for 2022. The current lockdown in Shanghai may have enough economic impact to lower that rate to 4.5%.

Conclusion

We are uncomfortable with the current economic and market conditions. The pandemic gave our economy a work-out, a yoga class, a face lift, and a body lift. Our economy is in fighting shape except for the remaining supply chain kinks. The Russia war has shown no impact on the U.S. economy in first quarter. However, our markets are abnormal, and the bond and stock markets are in disagreement on the direction forward.

We are in the process of trimming positions to reduce risk. We will continue this until we see market stability and inflation pressure decline. Despite all these worries and macroeconomic concerns, we expect to see a market relief rally if the war ends with Russia giving up their grip on the Ukraine.

Our view on the yield curve inversion differs from our view during the 2019 yield curve inversions because high inflation eats purchasing power. The Fed and the politicians can't ignore this, but we are not sure they have the stamina to course correct. We are staying very aware of the moving parts.

Sincerely,

Leslie J. Lammers, CFA
President and Co-Chief Investment Officer

John A. Hanson, CFA
Co-Chief Investment Officer

Enclosures

[1] Sources: *Birinyi, BCA Research, Moody's Economy.com, BLS. Returns are Time Weighted Returns and Net of Fees.*