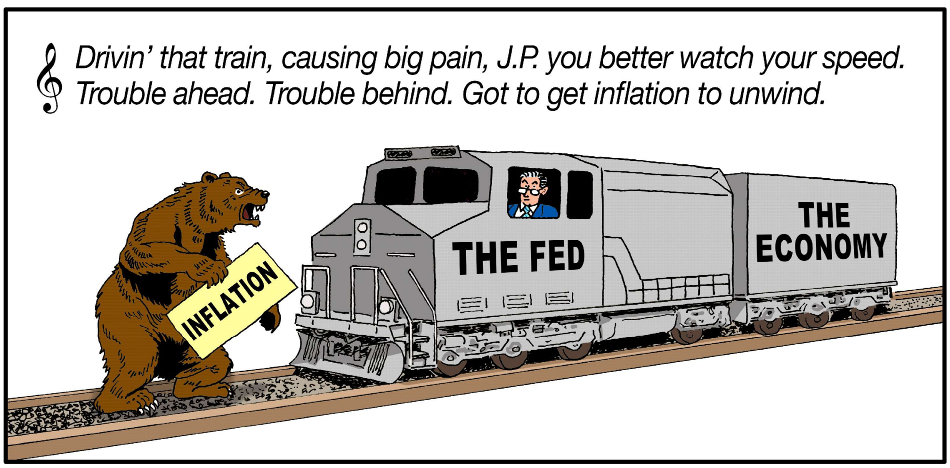
RIVERSTONE ADVISORS, LLC

July 4, 2022

Dear:

The economic train is on the track, and the Federal Reserve is driving it. Their intent is to squash inflation.



The Fed is using interest rate increases to slow the economy down. This year, the Fed raised short-term interest rates at their March, May, and June meetings. This increased the Fed Funds interest rate from 0% to 1.50%-1.75%. The Fed is targeting a rate of 3.375%, which is 1.625% in additional increases.

After increasing 0.75% in June, we expect the Fed to raise from 1.75% to 2.50% on July 27th. Further increases at their meetings on September 21st, November 2nd, and December 14th will be contingent on how the economy is faring then.

	Current Situation		Future Goal
Fed Funds Rate	1.750%	➡	3.375%
Inflation	8.6%	➡	2.0%

The stock market is forward-looking. Hence, its recent decline is in anticipation of the harm that higher interest rates might do to the economy. Already we see house buying declining due to the 5.7% mortgage rate, which is the highest since 2008.

We have been in an everything sell-off, and it is global. Overseas markets have sold off as much or more than the U.S. In addition to stocks, safe bonds have sold off. Metals have sold off. There is a race to cash. A race to cash always draws money to U.S. dollars and U.S. Treasury bonds. Our dollar is the strongest currency currently.

In our 30 plus years of market experience we have never wished for a weaker economy. For example, we usually root for consumer spending to be strong as it produces two-thirds of U.S. GDP (Gross Domestic Product). Consumer Confidence measures released for June were weaker than the month of May. We like this because we want consumers to stay home and not fill up their cars. A measure of future consumer expectations has declined to the lowest level in nearly a decade. Consumer spending fell in May for the first month this year. This negative news is good news as the sooner the economy cools the sooner the Fed will stop raising rates.

Fortunately, the jobs market continues to be strong. Consumers will stay employed; we just need them to take their foot off the gas figuratively and literally.

<u>Will We Have a Recession?</u>

You will continue to see many articles debating whether we will have a recession. We find this comical as we are already in an economic slowdown so why do they harp on recession? It's a bit like predicting a snowball fight when you are already in the middle of a snowball fight.

Layoffs are increasing; margins will decline as companies with too large inventory cut prices; real estate sales are beginning to feel the effect of higher interest rates, etc. You can watch for sales of goods that you might want.

The big question is how long and how deep a downturn will be. One could think that a recession could be quick given it is mainly being manufactured by the Fed rather than by a systemic issue in the economy (think the housing bubble bursting in 2008).

All this sounds a bit grim, but the market looks to the future, typically 6-12 months out, and will start to heal itself while the recession debate rages on. History shows the market does not wait for economists to proclaim a recession as recession readings are lagging indicators. The market has already swallowed most of its required medicine.

If you have income and/or lots of cash, enjoy your life and ignore the talking heads debating the obvious. Cash and income are kings in this kind of market. Having them allows you to ignore a recession.

<u>Performance</u>

We took pre-emptive action in the first quarter by raising cash across your accounts and/or maintaining an already high cash balance. 25.4% of your portfolio is in cash. This equates to $394,943. Your cash balance should be sufficient to carry you across this chasm. Your stocks are long-term assets invested for the long-term. We feel comfortable keeping these assets in the market during this economic downturn.

There was a broad sell-off in all categories last quarter. Last quarter, your stocks were down -20.0% relative to the S&P 500 at -16.1%. Your total account was down -15.4% for the quarter. May and June had rays of hope in that the market declined in both months for the first two weeks of the month, but then rallied strongly in the back half of the months. Buyers are on the sidelines waiting with bags of money.

From Where is the Inflation Coming?

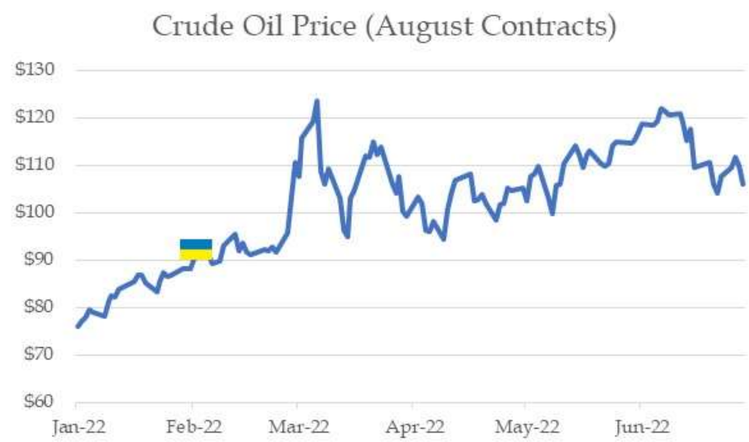
As we said at the beginning of the letter, cutting inflation is priority number one for the Federal Reserve. The sources of inflation pressure have morphed over last two years. Initially, we had strong consumer demand and supply chain shocks. Now, we have the Ukrainian war and continued supply chain disruptions while consumer demand between goods and services is more in balance. The primary sources of current inflation stem from:

1. a mismatch in global energy supply and demand
2. low housing inventory relative to buyers
3. global trade and supply chain issues stemming from Covid-19

These three are responsible for 70% of the increase in inflation. Perhaps if we look at each of these, we can ascertain how the upward pressure on prices can become downward pressure. Doing so helps us think about the timing of a decline in inflation.

Energy

About 41% of inflation is being driven by energy. Oil was already rising in early 2022 before the war began. Oil was $78.90 on January 1st and rose to $91 right before Russia invaded Ukraine on February 20th. Oil went to $120+ immediately after the invasion and is now bouncing around $109. The Ukrainian flag marks the date of the Ukraine invasion.



Getting energy back in balance depends on two factors: more supply and less demand. Demand will fall due to high prices at the pump as high prices destroy demand. As the economy weakens and the summer passes, demand will fall slightly. Re-arranging supply sources will help on the supply side. The energy markets are very responsive to small changes in supply and demand. As more supply comes on, prices will fall.

Unfortunately, an end to the war will not solve the high prices. Every day the war continues, countries will further eradicate Russian oil from their supply sources. In the early days of the Ukrainian war, countries still were using Russian oil, but this dependency has decreased steadily. The oil and gas from Russia that the Europeans have rejected will stay in a small counter-market supplying countries who are willing to do business with Russia (India and China at this time). This bodes well for U.S. domestic and non-Russian oil companies. Consumers? Not so much.

The decline in domestic refining is accentuating high gas prices. Crude oil prices account for roughly 55% of the cost of retail gasoline and diesel. U.S. refinery capacity has consistently declined since the start of Covid. Refinery capacity has decreased from just under 19 million barrels per day down to 17.9 million barrels per day. This is at the worst time as the European Union needs other countries to step up and provide increased supply of diesel, gas, and crude to offset the lost Russia supply.

In summary, long-term prices will be higher until:

1. more drilling, pumping, and refining occurs

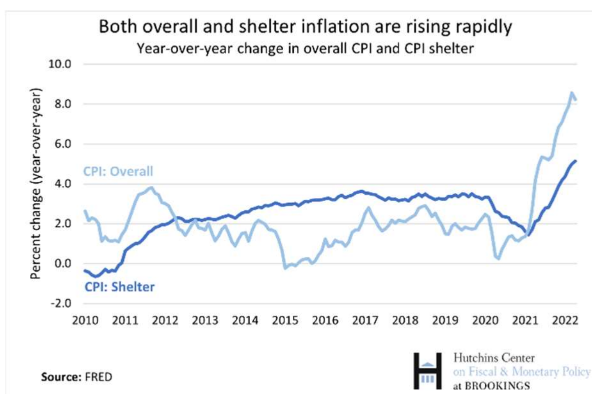
2. more green solutions are implemented
3. drivers leave their cars in their garages and/or replace them with more efficient vehicles

We embrace the adage that the cure for high prices is high prices, but there is no quick fix for energy. As this problem is significant and long-lasting, we invested in three oil stocks in June. The steady pressure on higher oil and gas prices bodes well for holding energy companies.

Housing

The strong housing market is about 11% of U.S. inflation. House sales are beginning to weaken due to higher mortgage interest rates which average 5.7% nationally. The longer the economy stays weak the more house prices may decline. The economy is not particularly weak yet but given the Fed's determination it will weaken.

The following chart clearly shows the impact of the housing shortage on inflation as measured by the Consumer Price Index (CPI). The dark blue line is shelter inflation, both house buying and renting. The light blue line is total inflation (CPI). They stepped-up in tandem.



The 2008 housing bust is the genesis of our shelter inflation When house prices declined in 2008, builders cut back on building. During 2008-2012, they built an average of 63% fewer houses each year than they did in the five years preceding 2008. Because of this, the U.S. does not have enough housing.

Housing inflation will fall when buyers stop being willing to compete to pay ever higher prices. This won't happen until a larger percentage of buyers accept being priced out of the housing market. At some point, mortgage rates will decline, and this will ease the housing price burden.

In summary, the housing market should slow in the face of higher interest rates. Consumers will probably put filling up their gas tanks ahead of buying a house.

Global Trade

Supply chain problems continue to push up inflation and are estimated to be the source of about 18% of current inflation. If it takes longer to make or process an item and it takes longer to transport an item, the price of the item must be higher.

China is a major supplier to the U.S., Asia, the EU, and the U.K. China's Covid-19 policy calls for locking down the populace when cases come to light. This policy delays shipments and increases costs for world trade. In April and May, China shut down Shanghai, their largest city and port, due to Covid-19 infections. Shanghai has a population of 25 million. Total retail sales dropped in that period, with the economies of Beijing and Shanghai the worst hit. China's exports to the U.S. in April fell 11.8% or $5.6 billion.

China has a high vaccination rate, but their most common vaccines are Sinovac and Sinopharm, which are considered significantly less effective than mRNA (Moderna) vaccines in preventing illness and are especially problematic against the latest Omicron variant of SARS-CoV-2.

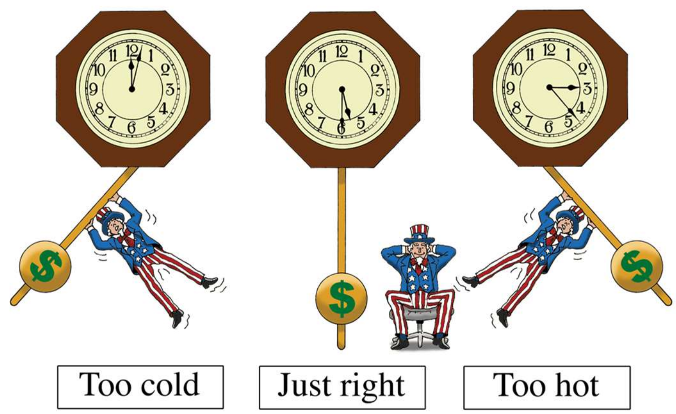
To stir the pot, the Chinese elderly population has a lower vaccination rate than the younger generations. As of March 2022, only around half of people aged above 80 were fully vaccinated, while less than 20 percent had their booster vaccinations.

Supply chain hitches continue to scramble world trade but at a lower incident than in 2021.

It is interesting to note that companies reacted to outsize consumer demand by stocking up their inventory levels in a big way. Now they find they have too much inventory and have begun slashing prices on certain goods. While this is not good for the companies, this is good for inflation and consumers. Unfortunately, China is unlikely to relax its zero Covid policy so lockdowns will continue to occur and supply chains will be impacted.

Conclusion

The economy continually expands and contracts. When it goes too far one way, problems ensue. A recession is just a loss of faith in the future. The economy swings like a pendulum. As investors, we must adjust as conditions ebb and flow. The economy expanded too much after the pandemic and was unable to keep up with itself. Now, it needs to contract a bit. We have been conservative in our asset allocation up to this point, but we will be watching for our indicators to signal better conditions ahead. Once this occurs, we will put some cash to work. We are keeping a close eye on this on your behalf. Trust us. We do not like sitting on cash any more than you do, but it has been essential.



Sincerely,

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John A. Hanson, CFA
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Enclosures

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