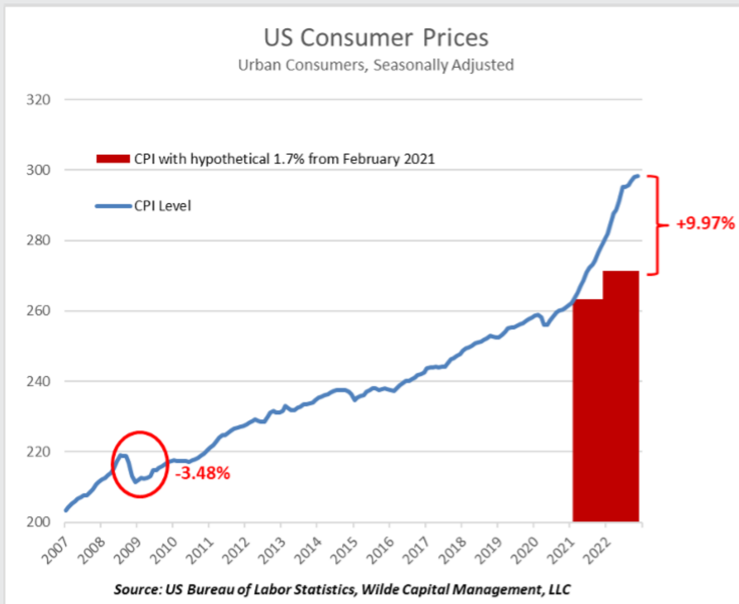
WILDE CAPITAL MANAGEMENT

Newsletter and Capital Markets Review

Holiday 2022

It is a holiday newsletter, but not with the most festive tone. Markets have tempered their decline some, but the challenges remain in front of rather than behind us.

As expected, the US Federal Reserve increased the Fed Funds target rate by an additional 50 basis points at the conclusion of the December 14th FOMC meeting to bring the range to 4.25% to 4.5%. Expecting what was being characterized as a “dovish pivot” to less restrictive Fed policy, US stocks rallied from their October lows, with the S&P 500 climbing over 14% through early December, only to retreat after Chairman Powell reiterated a commitment to harnessing inflation through more restrictive policy in 2023.



Even with that retracement, inflation may be more problematic than is currently perceived (or priced) by market participants. Headline inflation has begun to successively decline from its peak of 9.06% in June to the November reading of 7.1%, but consumer price inflation has persisted above 7% since the end of last year. Inflation first surpassed 2% in March 2021 and the compounding effect appearing in higher prices since then is burdensome for many families, individuals and small businesses across the nation.

The accompanying chart shows the price level of US Consumer Prices as reported by the US Bureau of Labor Statistics. We highlighted the steep incline (blue line) beginning in early Spring 2021. In the decade prior to that moment, Consumer Price inflation averaged approximately 1.7% annually. To get a sense of how outsized inflation has become we calculated what a theoretical price level would have been using the previous inflation rate of 1.7% applied to the March 2021 price level (red columns on right side of chart). The gap between current prices and where they might have been had we tracked with the previous 1.7% inflation rate is a stinging 9.97% higher, a level that will likely be permanently embedded in the economy. Do not light a candle for price relief though even if policymakers manage to rein in the current situation. Consumer prices generally rise over time and only contract during crises such as the brief retreat during the pandemic-motivated economic shutdown in 2020 (before stimulus kicked in), or the 2009 Financial Crisis when prices declined a more substantial 3.48% as noted on the chart.

The high level of aggregate prices and high inflation makes the Fed’s policy efforts very challenging on their own. Yet the Fed has to deal with the inflationary consequences of trillions of fiscal stimulus dollars and an accompanying oversized expansion of the money supply since early 2021. Lingering fiscal expenditures may reinforce inflationary pressures, limit Fed policy effectiveness and lead to even more restrictive monetary conditions in the near future.

[Chart by Wilde Capital Management LLC from data from Us Bureau of Labor Statistics (c)2022]

Market Review [cont'd]

Capital markets are currently not positioned for that kind of grinding environment and rather anticipate a "Fed put" that has been delivered periodically since the 1990s. After decades of intervention by the Fed, not direct but still material, in the capital markets it is not an entirely irrational expectation. The Fed also has a fairly well established track record of overshooting in both directions. So, it is only slightly magical thinking to believe that the Fed will do both – they will overshoot with their tightening regime and then ease off (the put) when markets sputter. But, despite a general mood in the economy that feels recessionary, the job market is still tight, inventories are tight (but loosening), and earnings are decent. We could be on the precipice of a recession, but nothing present or severe enough to be actionable by the Fed yet. A lot of the legislated stimulus still has not been fully deployed much less metabolized, inflation is not at Venezuela levels but is still multiples higher than it was pre-Pandemic, and money supply is still above trend. The Fed is the only systemic player that is trying to reel it all in. If they maintain focus on the dual mandate of maximum employment and price stability and are not cowed into prioritizing the markets, there are few reasons to believe the "put" is coming any time soon.

Portfolio Positioning

Our outlook and portfolio decisionmaking in early 2022 has, regrettably for the capital markets, proven correct, and we are maintaining that stance as the markets continue to swoon. In the first half of the year, we took steps to reduce our exposure to equity risk as the capital markets digested their nearly unprecedented run- up since the pandemic nadir in March of 2020. Our feeling has been that signals of transient inflation are becoming more systemic and, combined with a regime change from the Federal Reserve from stimulating to tightening, the short-term prospects for equities are less attractive. Since that time markets took a brief respite and even rallied a bit before continuing to grind and sometimes lurch lower. We subsequently took a further incremental step away from equities in both US and foreign markets as we look for the catalyst that will define the bottom of this downward trajectory, the recent bear market rally in US equities notwithstanding. Within our ETF models, we made the shift primarily in US large cap growth and in Developed Europe equities, and in our ESG models through core and growth-biased large cap equities and broad international equities. All proceeeds were committed to cash and cash equivalents for the moment.This further reinforces our underweight allocation to equities overall as well as keeping a modest underweight in fixed income, with cash now even more overweight. Within global equities, we materially lowered US exposure, kept an underweight in Emerging Markets, and established an underweight with respect to Eurozone stocks while continuing an underweight in Japan. Within fixed income, we are overweight in the US with a preference for mortgages and investment grade corporate credit.

We have little to no exposure to non-US fixed income except through Green Bonds in our ESG series portfolios. All portfolios holding fixed income maintain lower duration than the benchmark.

Risk Review

We are continuing with our "dirty dozen" factors that continue to challenge the real economy as well as the capital markets. Some areas have evolved slightly, and we have adjusted our thoughts to recognize the pig working its way through the proverbial python.

Inflation – Energy, Commodities, Housing

Even with signs of moderation, mostly emanating from declining oil prices, inflation is locked in and it is global. When we first started talking about inflation during the pandemic, we saw it as localized around specific circumstances related to the pandemic from the now almost-cliché supply chain disruptions to worker shortages in service-related businesses to dislocations in very specific industries like the "crack spread" between lumber at the stump vs. milled and ready for use. These economic kinks did not have an opportunity to work themselves out before trillions of dollars of stimulus and new money were poured into the economy driving increased appetite, and as a result there is demand and price pressure exceeding a still-disrupted global economy's ability to satisfy from microchips to chicken. Add in the effect of the Russia-Ukraine war and related sanctions regime on gas, oil, grains, steel, etc. and we anticipate some extended inflationary pain until global economies can work off the pandemic spending that compounded latent problems with overly accommodative policy since the Financial Crisis. Supply chain issues are not what they were earlier in the pandemic cycle, but consumer price inflation is now baked in. We have seen energy markets adjust and housing is heading for a historically large setback while automobile and other inventories build, so watch this space.

Reduction in monetary expansion

The proverbial punchbowl has finally been taken away. Central banks are printing less, quantitative easing is giving way to neutrality or even quantitative tightening, and policy rates are rising. There is less money (M2) being created and the cost to borrow it is going up. Even though it can be credibly argued that central banks, and in particular the Federal Reserve, remained expansionary for too long and this is a healthy and necessary change, it is still a regime change that has consequences after a decade-and-a-half going the other direction, and the steepness of the rate of change is inflicting meaningful short-term pain, particularly for those closest to the economic fringe. More ideal would have been the Fed moving much sooner and more incrementally instead of having to slam hard on the proverbial brakes and bang everyone's foreheads on the dashboard. Or, as Professor Steve Hanke of Johns Hopkins University has repeatedly pointed out, if those with control of the presses had printed less new money from the beginning of this crisis, inflation would not now be the entrenched problem it is with the only real solution being an undershoot on money creation to bring us back to normal.

Rising interest rates

Which brings us to rates more specifically. To put the clamps on inflation the Fed and other central banks will continue to withdraw stimulus and raise rates. There is certainly a benefit to savers that, for the first time in nearly a generation, savings accounts, time deposits, CDs and money markets are paying decent rates rather than just providing stability and safekeeping. But, inflation is more than doubling those rates so real returns are still negative. At the same time, the cost of capital to individuals, businesses and governments is rising which will make debt service more expensive and slow new borrowing. That is the intended effect, slowing economic activity and cooling inflation. But, higher rates will filter down through the economy and make goods and services more expensive and put housing further out of reach for many families while making variable rate debt like credit cards more expensive and more likely to tip borrowers into default or bankruptcy. For those with greater wealth security, the idea of bonds as an investable safe harbor is sorely challenged and will force a change in ownership patterns. Collective vehicles like mutual funds and exchange traded funds investing in bonds will be treated as riskier because of price volatility when not holding individual issues inside the funds to maturity.

Risk Review [cont'd]

Widening US High Yield interest rate spreads

Low-quality debt (junk) issuers have enjoyed an extended period since 2017 of economic advantage where it has been fairly inexpensive to borrow as the market has not demanded a significant risk premium for lower-rated issuance. All of the many strains on economies and markets are forcing a re-rating of junk bonds and a return to a historical spread over investment grade corporate or Treasury bonds to pay for the additional risk. This will become more of a self-fulfilling prophecy as rates continue to climb and it becomes harder for risky enterprises to borrow at interest rates they can sustain without default. In some cases the environment will force companies to clean up their balance sheets to lower their cost of borrowing, and in other cases Warren Buffett's maxim "It's only when the tide goes out that you know who's been swimming naked" will be in effect.

Full, although declining, equity market valuations

This risk may be declining, although only by virtue of a significant grind lower already in the books interrupted by brief bear market rallies. Valuations are definitely below where they were when we described them as "full", but conditions have also changed (see the 11 other risks) and based on today's macro outlook even priced at a lower valuation equities may still be characterized as full.

Corporate earnings still growing but the pace is slowing

Corporations have been able to capitalize on various price dislocations from food and basic materials to oil, airlines and automobiles to keep the good times rolling even into the current challenging market conditions. But, 15+ years of cheap capital are over with easy Fed policy giving way to QT and rising rates, which combines with rising wages, supply chain costs and less liquidity for consumers to put margins under pressure. Quality will certainly matter more both in terms of how capital is obtained and deployed and how crisp business execution is in order to sustain and even grow earnings.

Negative real wage growth

Wages are rising which is a hard-won victory, but inflation is rising faster, erasing those gains in real terms at the kitchen table. That reality reverberates through the economy as purchasing power for those most likely to spend their paychecks – the middle class and the working poor – declines.

Consumer sentiment – lowest since August 2011

Declining sentiment tracks with inflation overriding wage gains. The various components of inflation as experienced by consumers further aggravates those negative sentiments. Even if a consumer commits personal capital to make purchases, goods have been harder to get and pricing power is currently vested with merchants over consumers, leaving a palpably bitter taste. Automobile supply, for instance, remains tight and has opened the door to almost predatory pricing on dealer lots as even very ordinary and utilitarian vehicles are being sold for thousands over MSRP. This kind of disempowerment of consumers is discouraging current purchasing behavior and is very likely to come back around in the next stage of the economic cycle as the proverbial shoe ends up on the other foot when supply chains catch up and the power is vested back in the hands of those same consumers.

Supply chain issues

We have seen graphic examples of how interdependent world economies and supply chains are and how fragile they were with just-in-time inventory management. While investors have extolled just-in-time inventory since Toyota popularized it, it introduced an inelasticity into global supply chains that was not capable of absorbing the blow of COVID. We liken this to everyone on the highway cruising at 70 MPH riding bumber-to-bumper and doorhandle-to-doorhandle. It works fine until somebody swerves or stamps on their brakes. This was further exacerbated by climate-related issues, international conflict, and ongoing concentrated lockdowns in China. The results were issues such as a microchip shortage affecting the ability of factories to finish automobiles for delivery. The global sanctions regime surrounding Russia will also continue to play in, challenging energy markets and holders of Russia debt, which will almost certainly add volatility to the inflation situation. In the meantime, as investors and market watchers, we are looking at the confluence of business practices that are not sustainable, resilient or adaptive and externalities like global health, territorial conflict and climate change which can and will disrupt businesses and markets again.

Risk Review [cont'd]

Slowing home sales

As we have been cautioning for some time, we see housing as ripe for a significant correction, compounded by the current state of affairs. This market cycle is unlike any previous one because we have what we would characterize as an unnatural market participant – private equity firms – not present in prior cycles. Where home ownership was concerned, financial products related to homes were largely derivatives of the actual dwelling, like mortgage portfolios. PE firms went a step further and rather than accepting the dwelling as collateral for a mortgage, they purchased the actual home, effectively "productizing" it. Now you have institutional-scale market players that are strictly governed by the economics of the assets (homes), and not the intangible value an individual or family derives. This introduces new opposing forces because an institutional owner is more likely to want to sell the asset when the market is under stress because of economic conditions, while a traditional homeowner is more likely to hunker down in place and use the home as an anchor of stability. At the same time, the pandemic accelerated what we see as five to ten years of outward migration by Millennials and others from the urban cores to suburbia into the two years of the pandemic, which converged with historically low mortgage rates to drive a bubble in home prices. While we do not expect the same kind of damage in housing as was left in the wake of the Financial Crisis, we do anticipate homeowners will be frozen in place because housing values will fall, destroying equity, and rising rates will make it very unappealing to obtain a new mortgage for a different home because the exact same mortgage amount would be substantially more expensive to finance in a new loan.

Waning fiscal stimulus

"Waning" might be too passive a term to describe conditions. The US Congress is likely done with major spending legislation for the foreseeable future, particularly with the House of Representatives changing hands for the new session. The Federal Reserve is aggressively drawing down QE and raising rates to reel in inflation and move us back to some semblance of a historical normal. Easy money for financial institutions, corporations, mortgagees, consumer borrowers and the US Government, States and municipalities is over. This regime change which combines the end of at least 15 years of stimulative support and more than 40 years of declining rates will change the growth dynamics in capital markets for the foreseeable future.

Geopolitical flashpoints

There are too many to count, but the Russia-Ukraine conflict is a leading example of the risks. As we have written previously, neither country is particularly large in terms of GDP when compared to greater Europe, North America, Japan or China. But, cutting off "Europe's breadbasket" and disrupting steel and other industrial materials flowing from Ukraine to Europe and beyond, combined with the consequences of the global sanctions regime against Russia, which is basically a petrostate, have turbocharged inflation in food and fuel globally. China of course is still for the most part the world's manufacturing floor and their flexing over Hong Kong and Taiwan, both significant global economic engines in their own rights, poses military as well as economic risks globally. Looking to the future China's aggressive moves in Africa to secure access to natural resources may become the source of future contests as well. More regionalized but hardly less concerning, a bellicose North Korea poses threats to both South Korea (#13 largest economy by nominal GDP) and Japan (#3 behind the US and China).

ESG Considerations

As we approach the end of the year and reflect on what ESG adoption in investing has and has not achieved. New figures are in from the US SIF Foundation's biennial study entitled "US Sustainable Investing Trends". Our expectation, tracking from immediately pre-Pandemic to this year, was that we would have seen a round trip on asset levels since the market ballooned and then deflated as we have discussed extensively in other parts of our writing. The last report put professionally managed assets in the US at $51.4 trillion (end of 2019), of which $17.1 trillion were tagged as "sustainable investing assets". The newest report, based on year-end 2021 data before the markets really started to retreat, put US managed assets at $66.6 trillion, but sustainable investing assets at only $8.4 trillion. What happened?

We have regularly conveyed in our discussions with trusted advisors and clients about the market landscape that we considered the $17 trillion to be a wildly overcounted figure because of issues with the methodology and a desire by US SIF historically to be extremely inclusive to be taken seriously by the broader market. While only an educated guess, we pegged a more credible figure at 2X to 3X less, which still left it representing a massive pool of managed assets. Without getting into a desert-dry essay on study methodology, this new $8.4 trillion number for 2021/2022, while still extremely generous, appears to be more representative of market reality.

The reason we raise these market stats is not as a counting exercise, but to underpin an examination of the purpose of ESG investing. It is necessary to recognize the deliberateness of investment motivations and the centrality of outcomes when it comes to ascribing assets to ESG. Absent deliberate philosophy and process choices and the pursuit of purposeful outcomes, counting assets as ESG is either incidental to other objectives, or entirely coincidental. We broadly group motivations and outcomes into two categories each. Motivations generally fall out into values-based and commercial areas. Outcomes group into participation and catalyzation.

Values-based motivations are those driven by religious, generational or ethical priorities, while commercial motivations are those driven by opportunity, risk and return. Participation we define as partaking of positive change (or avoiding involvement in negative change). Catalyzation we define as directly influencing or changing outcomes based on investment or other decisions (aka "impact").

ESG Objectives & Outcomes

Values-based	Commercial
Participation	Catalyzation

It is critical to point out that motivations and outcomes often but not always combine. All four boxes could blend and interact in various proportions. But, and this is an important but, it is not ESG if none of the boxes are filled, and it is debatable if only one of the boxes is filled. This is all to say that for ESG to be real and be countable it has to be intentional. Having a good climate or human rights footprint for a portfolio as an accidental byproduct of an investment process is not a bad thing, but it should not count as ESG because it could be something else tomorrow. That extends to processes that include ESG information but those ESG observations are not consistently determinant of portfolio decisions.

What to look for? A clearly articulated philosophy that addresses, above and beyond basic economic objectives, whether ESG is incorporated to align with a personal or institutional values framework, or to manage risk or uncover future opportunities, or both. Then, look to outcomes. The use of ESG to participate in trends or avoid issues and controversy, or to create material and durable positive change through investment, or again, all of the above.

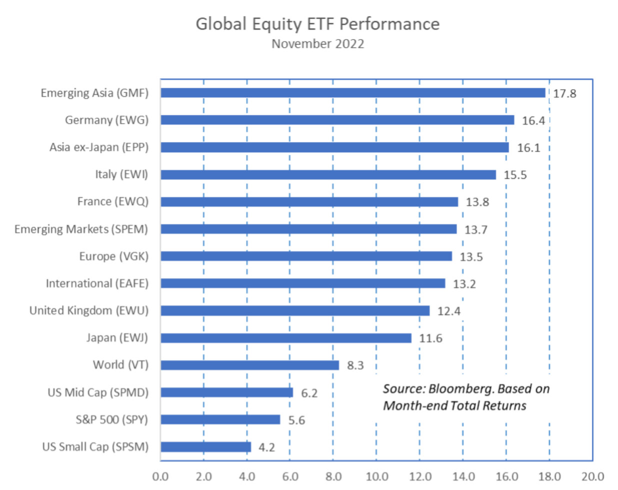
WILDE CAPITAL MANAGEMENT

Holiday 2022 Capital Market Review

Wall Street has always been a good place to go for colorful metaphors. The early and mid-Fall provided what we are kindly calling a bear market rally, which is to say the market took a pause to build a little excitement around some of the extremely early green shoots, but this enthusiasm was already waning at the time of this writing. Inflation is climbing less steeply, but it is still a meaningful positive number. The Fed is still tightening. The pandemic is still raging. Russia is still bombing. The more graphic visual is a dead cat bounce. The market fell steeply and hard, and we got a rebound without really establishing a solid bottom. Now markets are headed down again to retest and possibly break those lows. But, if there is a real bright spot taking the longer view, October and November demonstrated that there is still very much an appetite for risk assets and the potential for a significant rally is there once the many challenges we have outlined approach end-of-life and hopefully are not replaced with more.

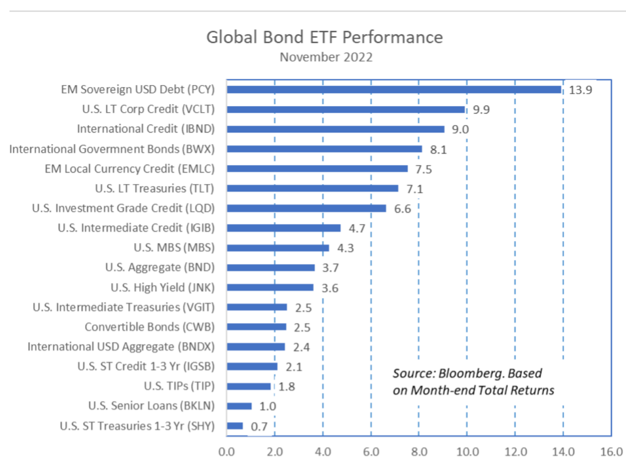
Equity Markets

The first part of the fourth quarter saw a significant recovery in regions that were hit hardest as Summer came to a close. Asia in particular rallied hard in November with the greatest favor shown to emerging Asia. Japan was still a strong contributor in its own right (EWI 11.6%) but was actually a laggard looking at the rest of the region (EPP 16.1%) or emerging Asia (GMF 17.8%) on its own. Europe (VGK 13.5%) had some much needed relief, primarily driven by its industrial heart in Germany (EWG 16.4%), Italy (EWI 15.5%) and France (EWQ 13.8%). The US came in at a small fraction of those returns largely because it had booked a chunk of its recovery the prior month while Europe and Asia were still looking for solid ground.



Fixed Income Markets

Similarly to equities, emerging and international markets came to play in November, posting equity-like positive returns particularly at longer durations. Dollar-denominated EM sovereign debt (PCY 13.9%) led, with international credit (IBND 9.0%) and international government (BWX 8.1%) not far behind. Long-duration US credit (VCLT 9.9%) was right in the mix, but long Treasuries (TLT 7.1%) trailed by more than their European cousins. Mortgages (MBS 4.3%) filled the middle although they are showing increasing signs of strain, and short duration everything provided asset class-appropriate returns. Convertible bonds (CWB 2.5%) and high yield (JNK 3.6%) were not major contributors in November even in a target-rich equity environment.



The returns cited reflect total return performance of exchange traded funds listed in the corresponding bar charts

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