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In our most recent commentary, which we published on December 16th, we concentrated on the fact that the U.S. stock market was nowhere as strong as it appeared on the surface, and that it was being distorted by six stocks (Apple, Microsoft, Alphabet, Amazon, Meta Platforms [formerly Facebook] and Tesla) that represent about 25% of the S&P 500 and about 40% of the NASDAQ, and which were dramatically outperforming virtually everything else.

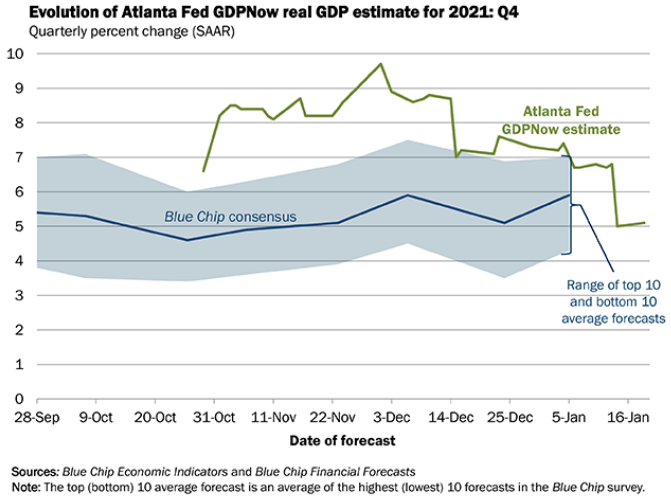
We had concluded that this extraordinarily poor market breadth was "more indicative of bear market activity than what you normally see in a bull market, and [that] one could certainly make the argument that we are in the midst of a 'stealth bear market' that is being concealed by the massive outperformance by these very heavily-weighted mega-cap stocks". Unfortunately, this conclusion, which seemed so controversial just five or six weeks ago, now seems increasingly prescient, and perhaps even increasingly self-evident.

This very poor market breadth has been an issue for quite some time. The difference now is that those previously seemingly-unassailable, mega-cap stocks have finally succumbed to the current combination of high valuations, high inflation, tighter monetary policy and slowing economic growth, and have finally joined in the decline, and this has left the broad market largely unmoored.

Further complicating matters is that the Federal Reserve, which has a long history of riding to the rescue every time that the financial markets suffer a significant decline is, in our opinion, likely to be handcuffed this time by the current surge in inflation, which is arguably the biggest risk to the U.S. economy, and the fact that any steps that the Fed could take to support the financial markets would likely simultaneously exacerbate inflation. In other words, we believe that the so-called "Fed Put" has been effectively retired, at least until inflation is under better control.

Recent polls confirm that Americans now (we believe quite appropriately) see inflation as a much greater threat than is the pandemic, and the Fed needs to raise interest rates and constrict the supply of money to battle what is currently the highest level of inflation in 39 years. The current 7% year-over-year rate is sufficient to double the cost of living for the American consumer approximately every ten years.

However, this time, the Fed is faced with a dilemma, as they are being forced to pursue these restrictive policies, which will almost certainly slow the economy, at a time when the economy is already showing signs of notable slowing. Normally this is not an issue, as inflation has traditionally been caused by the economy growing too fast. This time is different, as inflation was caused largely by massive doses of monetary and fiscal stimulus, which totaled approximately one-third of the entire size of the U.S. economy, and global supply chain snafus, which are a by-product of the pandemic.



The historic levels of stimulus injected over the past one and one-half years included five fiscal stimulus packages totaling more than $5 trillion, plus $4.5 trillion of monetary stimulus.

Just as we believe that inflation will limit the Fed's ability to intervene in the financial markets to help cushion a substantial decline, we believe that they will be similarly constrained in their ability to come to the economy's rescue, if it starts to slip into recession. You could say the same about Congress and the White House, in light of the already massive deficits and current levels of political angst and dysfunction.

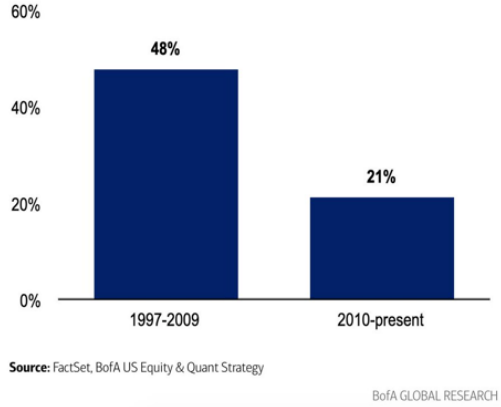
In the simplest terms, with the exception of the infrastructure bill, which we do not expect to be particularly stimulative because of how long it takes to get projects up and running, and the fact that it is being stretched over ten years, the U.S. is starting to run out of fiscal stimulus. Further, due to a sharp reversal in policy on the part of the Federal Reserve, monetary policy is in the process of going from being a massive tailwind to a significant headwind.

Financial conditions (liquidity, interest rates, access to credit, etc.) have been running at among the most stimulative levels ever, and markets are adjusting to the fact that these financial conditions are on the verge of doing an abrupt about-face.

If anyone doubts that this market correction is being driven largely by these anticipated changes in financial liquidity, consider the all-encompassing nature of the decline. As of the date of this report, the NASDAQ is more than 12% off of its recent highs, the S&P 500 has fallen by over 7%, the Russell 2000 small cap index has declined by over 17%, 10-year Treasury bills have lost 11.1%, the Bloomberg U.S. Aggregate Bond Index has declined by 4% and bitcoin has declined by 39%. When water gets drained out of a lake, all boats are lowered at the same time, albeit at different rates. This is not much different.

Since the days of the Global Financial Crisis (GFC), the markets and the economy have been "drunk" on stimulus and the Federal Reserve's distorting of market pricing through its massive purchases of financial assets ($9 trillion in total and over $4 trillion since the start of the pandemic). It looks increasingly likely that the "bill" may finally be coming due.

Exhibit 99: Earnings explained ~50% of market returns pre-GFC, but just 21% of post-GFC returns
R-sq of S&P 500 fwd EPS YoY vs. S&P 500 price returns on a monthly basis (May 1997-present)

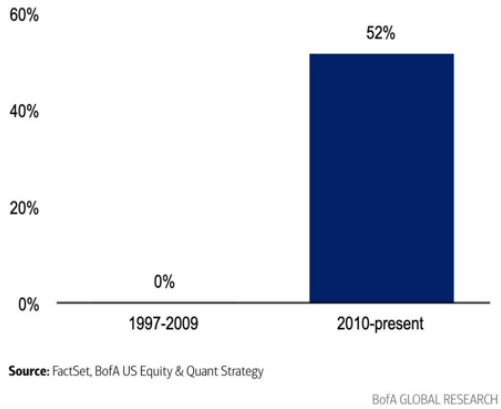


Recent research from FactSet and Bank of America helps to quantify just how impactful this massive expansion of the Fed's balance sheet (i.e., the size of their investment portfolio) has been on the stock market.

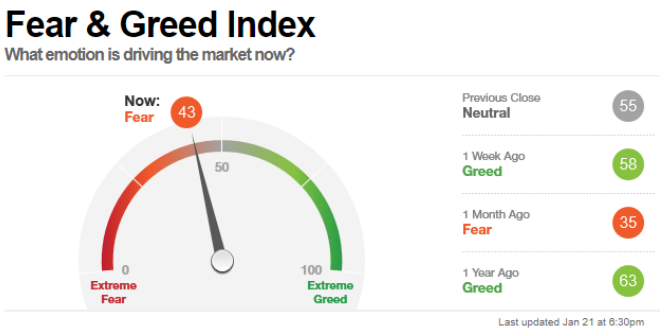
Equities are priced based upon a variety of factors, the most influential of which are almost certainly earnings and interest rates. As is illustrated by the "Exhibit 99" chart, in the twelve years prior to the GFC, earnings were responsible for almost one-half of the appreciation in stock prices. However, once the Fed started directly distorting the markets through its quantitative easing (asset purchase) programs, that changed entirely. Since the start of the GFC, earnings account for only about one-fifth of a stock's return.

Even more amazing is the change in equity prices catalyzed by factors other than earnings ("Exhibit 100"), and how, since the GFC, the growth of the Fed's balance sheet has been responsible for more than half of non-earnings-based price appreciation. In plain English, it means that the Fed's ballooning balance sheet has been pushing equity prices higher.

Exhibit 100: 52% of non-earnings driven market cap changes was explained by Fed balance sheet expansion since GFC
R-sq of Fed balance sheet YoY vs. YoY change in S&P 500 market cap that is not driven by earnings (May 1997-present)



As monetary conditions reverse, it is only reasonable that much of their previously beneficial impact on the market should reverse as well.



If this turns out to be nothing more than stocks and bonds enduring a necessary adjustment to prices and sentiment, after reaching very unhealthy levels of investor complacency and overconfidence, it could run its course in only days or weeks, as the stock market is already getting modestly oversold from a short-term, technical perspective, and investor sentiment has already turned relatively bearish. Moreover, one of the unique characteristics of bear markets is that, once everyone finally realizes that we are in one, it usually means that the decline is already in its later stages.

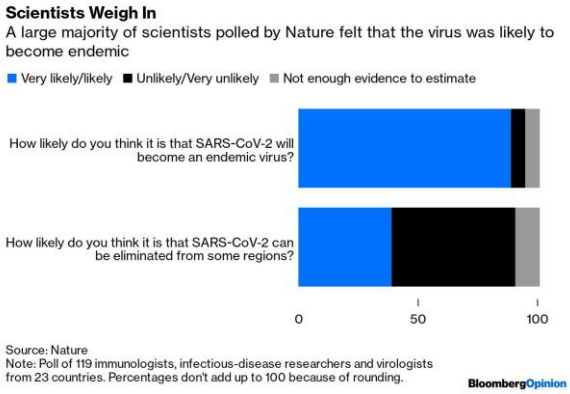
However, if this decline turns out to be the start of what we consider to be the ultimately necessary unwinding of more than ten years of stimulus and speculative excess, it is likely to take weeks or months to unfold, and will likely favor high quality stocks with strong balance sheets, predictable earnings, reasonable valuations, and high levels of free cash flow.

At present, while we are certainly not prepared to say that this decline is in its final throes, we will note that we are already starting to see some of the early signs of the kind of capitulation that often leads to (at least temporary) market bottoms.

From our perspective, the single most important thing to remember is that market declines tend to end long before the fundamental news gets better (earnings improve, interest rates and inflation decline, etc.). Instead, markets tend to bottom once the vast majority of bad news is known and understood by the vast majority of investors.

We view this as a period of adjustment, and that the markets are being repriced to reflect a more aggressive than expected turn in Federal Reserve policy, and a coming-to-grips with the inevitability of this turn. There is a reason that every experienced money manager knows the credo that "You never fight the Fed"!

Is a bear market inevitable? In our opinion, absolutely, but that does not mean that this is necessarily the start of it. Indeed, we could certainly envision any number of scenarios where news coming out better than expected could prolong the bull run, or even lessen the severity of any decline.



For example, if the inflation outlook turns out to be better than expected, as is suggested by some recent data, that might justify a less aggressive Fed, which would likely be very bullish for equities. Or, if Omicron is actually on the verge of peaking, and that it will be the turning point that changes COVID-19 from pandemic to endemic, as is being suggested by much of current research, it would help to untangle the world's supply chains, thus lessening inflationary pressures, and allowing for a less aggressive response by the Federal Reserve. Or, if corporate earnings manage to exceed greatly-lowered expectations, and thus once again drive stock prices higher.

As noted, our opinion is that the current decline is just the markets being repriced, in acknowledgement that the path forward will be more challenging than investors previously thought. Look for signs of capitulation, and look for evidence that the news has started coming in better than expected, as those are often two of the most reliable signs of a market bottom coming into view. Remember the words of Sir John Templeton, who noted that "Bull markets begin in despair, grow on pessimism, mature on optimism, and die in euphoria". Look for those signs of investor despair and capitulation!

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The Goldman Sachs Financial Conditions Index is defined as a weighted average of riskless interest rates, the exchange rate, equity valuations, and credit spreads, with weights that correspond to the direct impact of each variable on GDP.

The Standard & Poor's 500 (S&P 500) is a market-capitalization-weighted index of the 500 largest publicly traded companies in the U.S with each stock's weight in the index proportionate to its market. It is not an exact list of the top 500 U.S. companies by market capitalization because there are other criteria to be included in the index.

The Russell 2000 Index measures the performance of approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest U.S. stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

The Bloomberg Barclays US Aggregate Bond Index measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, MBS (agency fixed-rate pass-throughs), ABS and CMBS (agency and non-agency).

The CNN Fear and Greed Index (FGI) was developed by CNNMoney to measure two of the primary emotions that influence how much investors are willing to pay for stocks. It is based on the premise that excessive fear can result in stocks trading well below their intrinsic values, and that unbridled greed can result in stocks being bid up far above what they should be worth. CNN examines seven different factors to establish how much fear and greed there is in the market, scoring investor sentiment on a scale of 0 to 100.

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas. Average price data for select utility, automotive fuel, and food items are also available.

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