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The Kreitler team offers insights into what is happening in the market and how we might be thinking about those changes.
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CHARLIE'S CORNER

Something amazing happened when I stopped watching the news on t.v. a few years ago.
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WHAT'S INSIDE?

THOUGHTS ON INFLATION...

Inflation has been making news for the first time in decades. In May, it reached an annualized 8.6% year over year, a 40-year high that turned some heads. Understanding what causes it may help us to understand where it might be going and how we should prepare for it.

There is good inflation and there is bad inflation. In the past two years we experienced a good bit of both.

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Actual Bears seen at Charlie's house Sunday, 6/11 before the S&P reached bear market territory

5 AMAZING THINGS HAPPENING NOW

Electric vehicles are becoming mainstream with car registrations for electric cars spiking 60% in the first quarter of 2022 (1)

Doctors implanted the first genetically modified pig heart into a living human patient. (2)

Helion, a startup company, believes they will have the first energy net-positive fusion reactor running in 2024. (3)

The global economy is forecast to reach $100 trillion for the first time in 2022. (4)

Private spaceflight is cheap enough that commercial satellite launches are commonplace. Space-based internet connectivity is now possible across much of the globe. (5)

1. https://www.usatoday.com/story/money/cars/2022/05/16/electric-vehicle-registration-soars/9798645002/
2. https://www.medicalnewstoday.com/articles/first-successful-pig-to-human-heart-transplant-may-offer-new-options-for-patients#Recovering-after-surgery
3. https://www.forbes.com/sites/jamesconca/2021/11/09/helion-energy-raises-500-million-on-the-fusion-power-of-stars/?sh=41c3d6786ce8
4. https://fortune.com/longform/global-gdp-growth-100-trillion-2022-inflation-china-worlds-largest-economy-2030/
5. https://hbr.org/2021/02/the-commercial-space-age-is-here

CHARLIE'S CORNER

cont. from p. 01
by Charlie Kreitler

> *Pessimists sound smart. Optimists make money.*
>
> *-Nat Friedman*

I stopped watching the news a few years ago. It wasn't a conscious decision at the time; I just took a break. But what happened afterward was surprising.

I became happier. My decisions were clearer. My stress level went down.

What was going on? It wasn't until I removed television news from my day that I realized how it constantly bombards us with negativity, designed to create anxiety in an attempt to hold our attention.

Small issues are blown out of proportion to fill slow times. Big issues are over simplified to create controversy and emotion.

Remember, if something is free, then we are what's for sale.

Pay for quality news to get perspective by subscribing to a quality newspaper. Put yourself on a media diet that limits negativity. Intentionally surround yourself with positivity. You'll make better decisions and feel better for it.

Thoughts on Inflation *continued from p. 01*

Good inflation is when the assets that I own increase in value faster than other assets. When a portfolio goes up because asset prices rise, that is good inflation. The same goes for the increase in the value of my home, assuming I am the owner not the renter. Inflation may also increase revenue. If receipts increase relative to fixed costs such as debt service, this is a net positive.

Action Steps

- Price timing. For example, if you can wait to buy a new car, you may find dealers more flexible in their pricing when supply disruptions subside.
- Consider buying out your lease. Auto leases establish the residual value of the car that you can buy it for at the end of your lease. With used car prices up, many times the residual is a significant discount from the car value. You might consider buying the car even if you immediately sell it to pocket the difference.
- Pantry loading. Don't be afraid to buy in bulk for shelf-stable goods that you know you will eventually use.
- Perform a cash flow analysis. With prices for many goods and services higher, it's worth being confident you're hard-earned dollars are being spent where you want. Subscription services that accumulate on your credit card and are often unseen are prime candidates for review.

Bad inflation, on the other hand, might be simply defined as the increase in price of the goods and services I need to purchase. Grocery bills have trended higher, dining out is getting more expensive, and even a haircut costs more. I recently set a personal record when I put $130 into the gas tank of the family Yukon. Yikes! If I am a renter, rising prices can shut me out of the housing market. And for businesses, rising input costs may crimp profits if they are not able to pass the costs through to consumers.

Causes

Economists have debated the causes of inflation since there were economists. There are academic volumes filled with treatises on the causes of inflation. In the spirit of simplification, let us offer two broad explanations.

- Monetary inflation. Milton Friedman famously stated that "Inflation is always and everywhere a monetary phenomenon." We simply refer to this as the 'big bucket of money theory of inflation'. Imagine a bucket with water in it. The water represents the total supply of money in circulation. Assets such as stocks, houses, and other investments are floating in the bucket. When central banks add additional money to the bucket, as they did during the Covid 19 pandemic, all the assets float higher. This doesn't happen at the same rate. In 2020, stocks reacted, followed by housing, and then wages. Similarly, if liquidity is drained from the bucket, prices may fall.
- The balance of supply and demand. There is a constant ebb and flow between the producers of goods and the consumers of goods. Prices go up when there are more potential buyers than there are goods. Prices go down when there are more goods than potential buyers. During the pandemic, disruptions to production lead to shortages on everything from cars to appliance parts. When vaccines and an improving health landscape freed consumers to spend again, they were met with fewer choices and rising prices. Now the Ukraine crisis is causing spiking energy and food prices.

Solutions

The path out of this is not clear. The Federal Reserve is attempting to cool the high rate of inflation with higher interest rates and reduced money supply without causing a recession.

Our best guess is that they will be successful in bringing down inflation. As of June 30, the markets expect 10-year inflation to be 2.3% based on 10-year TIPs implied inflation.

At 2.3% inflation, $100 will buy approximately $80 of 'stuff' in 10-years time. While dollars in the bank feel 'safe', the saver may be locking in a slow but inevitable loss. That is the cancerous and insidious nature of inflation. Investors need to have a strategy that permits them to hold assets that can outperform inflation over the long run, even if it can be uncomfortable during inevitable periods of volatility.

2022 Mid-year Market Update

The roller coaster ride of the last two years continues without a break. The pandemic sparked by Covid-19 and the lockdowns that followed inevitably led to record inflation and a period that, so far, investors would like to forget. After two terrific years in the stock market, 2022 has started off with the dubious distinction of being one of the worst starts to a year for both stocks and bonds.

Inflation hit a rate of 8.6% year over year in May. The bond markets have experienced a huge selloff, with the Bloomberg U.S. Aggregate Bond down over 10% as of June 30th. Stocks reached bear market (typically defined as down 20%) territory on June 13, 2022 and are down 20.6% as of June 30th as the market reacts to rising inflation, rising interest rates, and the potential that it may take a recession to get inflation under control.

In this newsletter we will review the first half of 2022, explore some of the possible causes, and address how investors can manage the uncertainty we face in the coming months.

How we got here

It's helpful to zoom out and look at the root cause of the situation. The 2020 pandemic caused panicked authorities around the world to impose lockdowns to prevent the spread of COVID-19. Fearing the economic consequences of having much of the global workforce stay home, governments around the world unleashed enormous support in the form of direct cash subsidies to individuals and companies combined with ultra-cheap interest rates and a flood of money into the system. In the US, the 10-year treasury hit an all-time low yield of 0.54% in 2020, and the government used quantitative easing to push more than $3 trillion into the economy. This set the stage for monetary inflation. Stocks soared on the flood of new cash, with the S&P doubling in value from the pandemic low in March 2020. Other assets like real estate also increased in value.

Meanwhile, lockdowns caused disruptions to the global supply chain, creating a shortage of goods at a time when consumers were holding record amounts of cash in their bank accounts. Too many dollars chasing too few goods set the stage for supply side inflation.

Then, just when things seemed to be improving, as they had been before the pandemic as a result of globalization and technological innovation, Russia invaded Ukraine. The major effect of the invasion was that the taboo (in place since World War II) against taking one's neighboring territory by force, thereby reshuffling global alignments and adding huge amounts of risk and uncertainty to the markets, was broken. Energy and food prices soared around the world as supply again fell below demand.

Review our thoughts on inflation here. See p. 01

Inflation eats away at the value of your wealth in a variety of ways:

- The value of cash savings declines in purchasing power.
- Anyone on a fixed income finds the dollar stretches a little less far.
- Families are forced to shift their spending as gasoline and grocery bills rise.

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Market Review - YTD as of June 30, 2022

Market Index	YTD Return
Bloomberg Barclays US Aggregate Bond Index	-10.35%
S&P 500 Composite Index	-19.96%
Russell 2000 Index	-23.43%
MSCI EAFE Index	-19.25%
MSCI EM (Emerging Markets) Index	-17.47%

*Source: YCHARTS

The Federal Reserve is combatting this in two ways.

First, they are raising interest rates. This is the visible action they can take and makes borrowing more expensive.

Second, they are removing the money they pushed into the economy during the pandemic, replacing "quantitative easing" with "quantitative tightening." It's important to note that the debt created by the Treasury during the pandemic's quantitative easing process doesn't go away. As interest rates rise, the cost of servicing that debt increases. This will be a topic for another day.

Just as cheap and plentiful money pushed asset prices up, higher interest rates and reduced monetary supply can push prices down. Fed Chairman Jerome Powell made it clear in June that they will raise interest rates to cool inflation, even if it risks a recession. The markets listened.

Stock markets saw a broad-based selloff, with the biggest losers being the pandemic highfliers. Technology stocks, like Netflix and Peloton. Some of the value oriented investments we have used outperformed growth. Still, the sell-off has been broad-based and left little places to hide within the stocks.

Increasing interest rates have caused a decline in bond prices. We have been concerned for some time about the impact of ultra-low rates and have used bonds that have a shorter maturity in client portfolios. These bonds tend to be less affected by interest rate changes, and these positions helped to mitigate some of the bond losses. The 10-year US Treasury bond's yield has moved from 1.63% at the beginning of the year to 2.98% as of June 30. Short term, rising rates are painful as prices drop. Longer term, savers are better compensated due to the higher interest rates going forward.

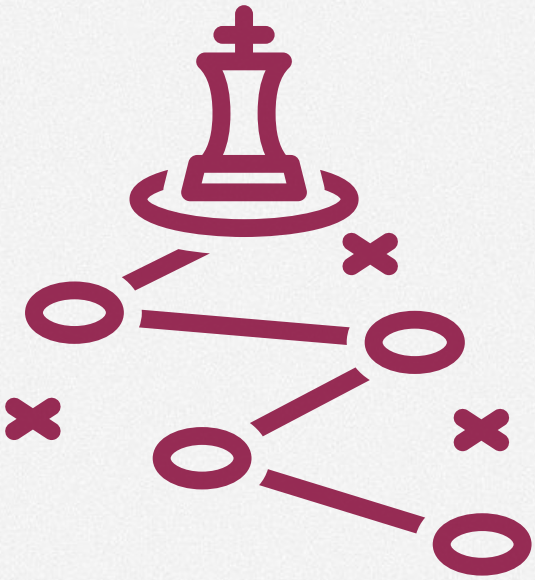
Diversification has also proven helpful. Investors normally hope that conservative investments like bonds will rise, or at least hold value, when stocks fall. Direct participation real estate fared better and was one of the few bright spots for those diversified portfolios that include it.

Investment Strategy

What should investors do? Inflation is eating the value of cash. Stock market volatility remains high, and bonds have disappointed.

Bear markets are a normal, if unpleasant, part of investing. In challenging times, investors need to focus on their long-term strategy. The rational course for investors is to have a strategy that allows you to hold assets that can beat inflation over the long term, even though those assets have higher volatility.

Holding these riskier assets requires you to hold enough 'safer' assets like cash or government bonds to meet liquidity needs, even in tough times and even if the cost of holding these assets is that they may not hold their purchasing power if their return is less than future inflation.



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Unfortunately, we can't know whether the worst has passed or there is more to come. Much hinges on whether inflation begins to cool, allowing the Fed to slow interest rate increases. The war in Ukraine remains a significant variable. The Fed could trigger a recession, and while stock prices have come down they are still based on fairly optimistic forecasts of growing corporate profits. For investors with far-off horizons and strong stomachs, this may be a buying opportunity. Our sense is that markets have priced in much of the negative news, but this could play out for some time to come.

Risk management is something that should be done in advance of bad markets, using a portfolio strategy that attempts to weather the inevitable market downturns investors face. A good investment strategy must recognize that the future is unknowable, yet we need to be able to meet goals during both good and bad periods. Those who are compelled to sell in the middle of a bear market risk turning temporary volatility into a permanent loss.

Often the markets' best days come in the early days of a recovery. Missing them can be painful, as illustrated by this chart from PGIM Investments. Investors need to be willing to stay invested to get the markets' long term returns.

MISSING THE BEST DAYS IN THE MARKET SUBSTANTIALLY REDUCED RETURNS

January 2001—December 2021	S&P 500 Annualized Total Returns	Growth of $10,000
All 5,036 Trading Days	9.52%	$61,685
Missing 10 Best Days	5.33%	$28,260
Missing 20 Best Days	2.63%	$16,804
Missing 30 Best Days	0.43%	$10,904

As of 12/31/2021. Source: Morningstar and PGIM Investments, S&P 500 TR USD Index. This example is for illustrative purposes only and is not indicative of the performance of any investment. It does not reflect the impact of taxes, management fees, or sales charges. The S&P 500 is a weighted, unmanaged index composed of 500 stocks believed to be a broad indicator of stock price movements. Investors cannot buy or invest directly in market indexes or averages. Past performance is no guarantee of future results.

Hang in there. We encourage you to speak with us if you have questions about your particular situation.

Percentages source: YCharts