

President's Letter – July 2022

For investors, the second quarter of 2022 looked a lot like the first quarter of the year. Persistent inflation, continued turmoil in the Ukraine, and a focus on the Federal Reserve and their plans to raise rates. The culmination of these events served as a catalyst for market volatility and a continued sell-off across most asset classes. What we are seeing in the economy today is what you would expect to see in the tightening phase of an economic cycle. After years of easy money and very accommodative economic policy, put in place to provide the necessary support first from the financial crisis and then more recently from the ravages that COVID had on the economy in early 2020. This support served its purpose, first guiding the economy through the financial crisis, and then countering the massive disruption from COVID as the global economy shutdown. Entering this year, the job market was strong, so strong in fact that employers struggled to find workers to meet growing demands for their good and services. Wage increases, supply chain disruptions and higher energy prices have all stoked the inflationary pressures that we are seeing today.

Recognizing the problems that inflation is causing, the Fed has acted aggressively to combat this accelerated growth. After years of ultra-low rates, we are now in a position to see rates that offer an incentive for people to save. Said differently, with this new tightening it is going to get expensive for borrowers. For long-term investors, this change in policy is a welcome relief. Receiving adequate rewards (interest income) for funds that are invested in bonds is long overdue, but more importantly, putting a stop to the 'easy money' mentality that has existed for nearly 10 years makes good fundamental sense. The change from 'borrow and spend' to higher rates is not going to happen overnight. In an economy as large as ours, this will take time, but the wheels are already in motion and with each incremental hike by the Fed we get closer to a normal and sustainable rate environment.

As is often the case, when the economy goes through significant change in rate policy, it is rarely without a few bumps and bruises along the way. The Fed has continued to increase their commitment to getting inflation in line, while maintaining the flexibility to alter course if/when things start to slow. Despite the many challenges we are facing, our economy remains very strong (which is actually part of the problem). The job market remains very robust, consumers are in good financial shape, and we are starting to see resolution to some of the problems with manufacturing and the supply chain that COVID brought on.

The one area that remains problematic are the persistently high energy prices, which continue to be impacted by the war in the Ukraine but also from a recovery in the post-COVID economy. When there are supply and demand imbalances in such a large and complex market as the energy market, they take time to resolve. Higher prices are already starting to reduce the demand for gasoline, which will ultimately serve to take some pressure off of the prices. Supply of oil is also starting to recover from the damage caused during the COVID lockdowns, but this is likely to take a while. In the meantime, the US will have to reevaluate our own energy policy to ensure that our energy independence can be maintained. No one wants to rely on despots or dictators for their energy needs, just ask the Europeans.

While the US economy embarks on the gradual change of course to combat inflation, the stock market has reacted with increased volatility and somewhat erratic behavior. What investors sometimes forget is that the stock market is not a rationale being. In reality it's a discounting mechanism where market participants can 'place bets' on where they see things going. Many investors, driven by fear and greed, all trying to make decisions based on their specific set of circumstances. Market behavior is frequently very short-term focused, with the idea that you shoot first and ask questions later leading to overreactions both in terms of buying and selling. When there is a major economic change in the works, there tends to be an increase in the scrutiny placed on companies and their results. Good, but not great results can be viewed negatively. Bad results can be met with a severe reaction. Sentiment can be fickle and often it will elicit an emotional response.

One of the greatest challenges investors face is remaining calm during times of turmoil and change. It takes fortitude and perspective to be a successful investor. Ignoring popular sentiment, or as Warren Buffet says, "be fearful when others are greedy and be greedy when others are fearful" has proven to be a very effective long-term approach to investing. In order to accomplish this task, we must be comfortable with the companies that we are investing in. Strong balance sheets, high levels of cash flow, selling valuable products and services. These are the things that allow us to sleep at night, knowing that while the prices the shares may trade at will change, the intrinsic value in the companies remains in place. Over the last 20 years of investing at Hayek Kallen, I have come to understand that with every challenge comes opportunity. As markets sell-off they are effectively discounting the economic prospects for stocks, or for us value investors, "putting them on sale". The more a stock sells off, the more bad news the market is pricing in and the more upside that exists.

Investing is not easy, particularly during times such as these. Staying focused on our long-term goals, being mindful of the risk and keeping our emotions in check is a tried-and-true strategy that has proven time and again to work. The battleship that is our economy is turning to adjust to this new course, but it is happening gradually. As the measures put forth by the Fed and others begin to take hold, we will see inflation subside and the seeds for the next phase of economic expansion germinate. We own a portfolio of strong, cash flow rich companies who are well positioned to weather this storm and be in a position to thrive once the economic clouds dissipate. At Hayek Kallen, we remain focused on serving your interests as we work to achieve your long-term goals and objectives. We are grateful for your support and, as always, are available for any questions or concerns that arise.

Sincerely,

Eric Kallen
President, Hayek Kallen Investment