ARPG
INTELLIGENT INVESTMENT

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Third Quarter Newsletter, 2022

S&P 500 YTD (-24.77%)[4]

MSCI ALL WORLD ex US YTD (-27.97%)[4]

"Your love is like bad medicine
Bad medicine is what I need"[1]

Looks like the Fed has given everyone lots "Bad Medicine"[1], taking the markets from from "I'll be there for You"[1] to "Wanted Dead or Alive"[1]… And if this year has taught us anything… The Fed is good with dead. Are they though? Although markets have seemingly gone from bad to worse the underlying reason for 2022's volatility is simply a shift away from accommodative monetary policy, not some larger structural economic problem. So is the "Runaway"[1] volatility we've endured this year the new normal?

Let's first put into context just how volatile has this year been. The entirety of 2021 saw 7 market days with a 2%+ move. The first three quarters of 2022 witnessed 34 of these 2%+ days. Unfortunately, the majority of those days have "Shot Through the Heart"[1] of the both equity and bond markets causing a loss of almost $10 trillion[6] for Americans in 2022.

The question we all are asking… Will the markets return to their far more comfortable bull trend soon? Or are the markets "Livin On A Prayer"[1] with the Fed continuing to hike interest rates thus taking markets down in a "Blaze of Glory"[1] for the foreseeable future? I believe the answer to that question is relatively simple. The markets will likely recover in two phases. Phase 1. Inflation shows signs of material deceleration for an extended period of time. Phase 2. The Federal Reserve

pivots away from the current restrictive monetary policy to a neutral or even a moderately accommodative policy.

Where are we in this phase 1 / phase 2 analysis? Good news I believe we are in the early innings of phase 1, but we simply do not have enough data to support an inflation deceleration narrative… yet… However, there are burgeoning signs the inflation train may be slowing rather sharply. From Guggenheim "The Consumer Price Index (CPI) inflation began to moderate in July with the downturn in commodity prices, supply side improvements, and signs of demand destruction in the broader economy. There is still ground to cover to get closer to the Federal Reserve's (Fed) target, but we expect these trends to continue, which should help support the long end of the yield curve.

Both headline and core CPI cooled in July, with headline CPI down 0.2 percent annualized over the month, and core prices rising at a 3.8 percent annualized monthly pace. Falling energy prices drove most of the outright decline in headline CPI, with gasoline prices down 7.7 percent unannualized over the month. Notably, airfares, hotels, and used vehicles also declined. The continued decline in energy prices and high frequency data suggesting more deflation in airfares and used car prices in August should drive another low headline number next month.

Lower inflation was also driven by a broad-based sequential deceleration in core goods inflation excluding vehicles, which moderated to 3.7 percent annualized after rising 7.1 percent in June. Continued supply chain improvement and lower import prices should continue to drive disinflation in this category."[2]

Although the August numbers disappointed with higher-than-expected CPI readings, we know inflation will not take a one-way trip to cooler temperatures. There will be fits and starts as demand reduces and supply chains ease. This begs the question if inflation is beginning to moderate, when will the Fed begin to turn away from these outsized rate increases and / or stop hiking interest rates altogether?

Most economist surveyed are predicting a terminal rate of 4.25%-4.75%[3]. As of September 30th the Fed Funds rate sits at 3.25%[3] with two more Federal Reserve meetings scheduled for 2022. ARPG believes this level will be reached this year via an additional 1.00%-1.50% of rate increases spread out over the next two meetings. However, subsequent to the December 14th meeting there very well may be a pause in rate increases.

The Fed is most certainly aware of financial market volatility and the associated risks specifically as it relates to the availability of credit. The old saying "fix the roof when the sun is shining" is particularly apropos. As treacherous as markets have been in 2022 the economy is in good condition. Although Q1 and Q2 saw negative GDP prints, unemployment remains very low at 3.5%[3], consumer credit and consumer balance sheets are not showing any signs of stress and consumer spending which accounts for 72% of US GDP[6] has proven resilient with consumers spending 10%[6] more than one year ago. The time NOT to fight inflation with higher interest rates is during a time of high unemployment, elevated credit usage and weak discretionary spending. So as difficult as it has been to take our "Bad Medicine"[1], it's better to take it now and "Keep the Faith"[1] the economy and markets will maintain their resiliencies.

We will soon be waving good bye to 2022, and not a moment to soon. Although this year has not been a "Bed of Roses"[1] we know trees don't grow to the sky and markets can't go up every year. In any market ARPG will continue to practice our approach to value investing, "Intelligent Investment is Investment on Value"[5]. This is what sets ARPG apart from the rest. As always, we thank you for your confidence and are humbled by your trust. Please feel free to contact us at any time.

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Sincerely,
Matthew D. Dahl
Chief Investment Officer

1. Bon Jovi
2. Guggenheim
3. Factset
4. ARPG / Stockcharts.com
5. Matthew Dahl
6. CNBC

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