SEVEN SUMMITS CAPITAL

The "Real" Deal

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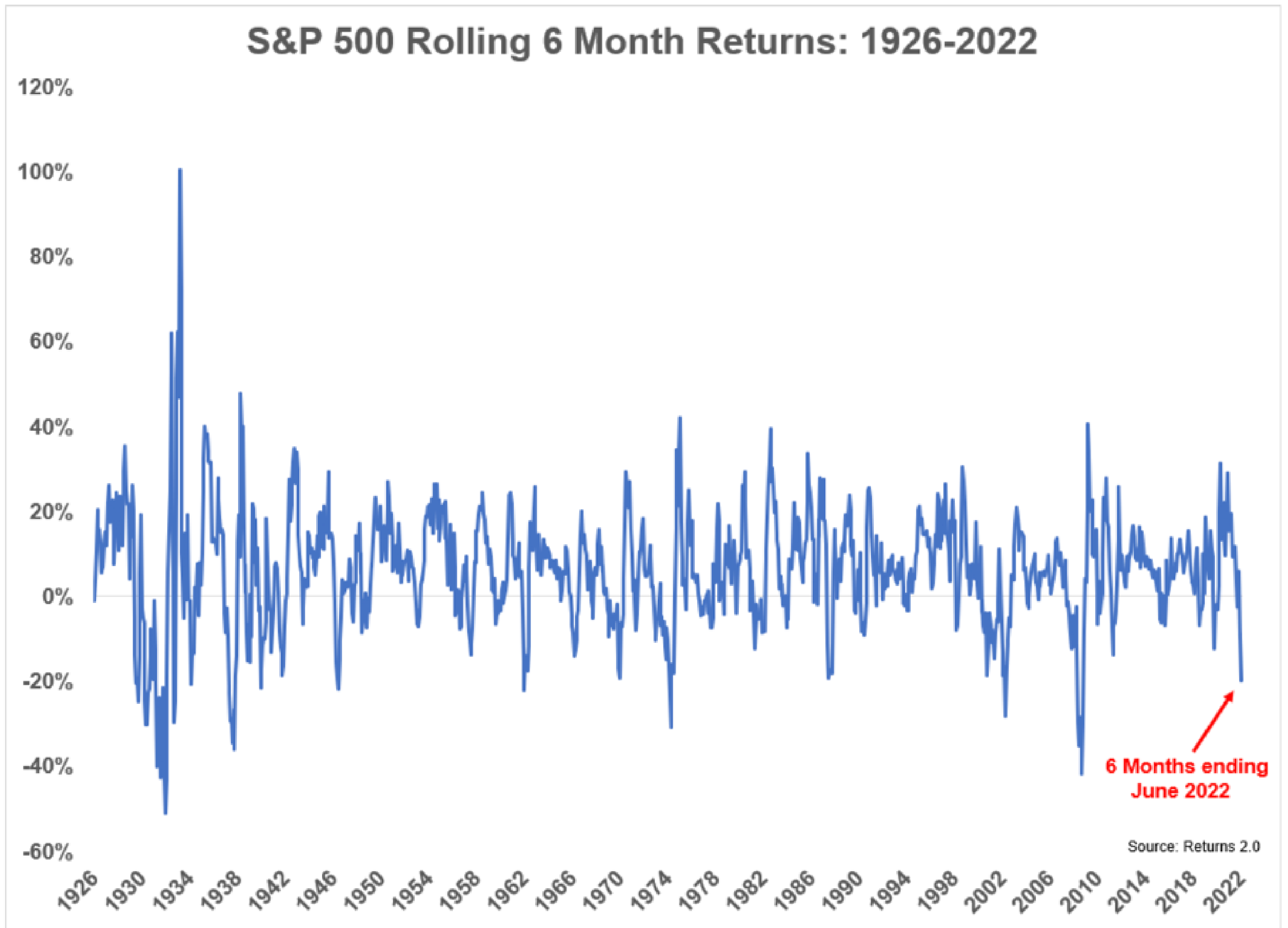
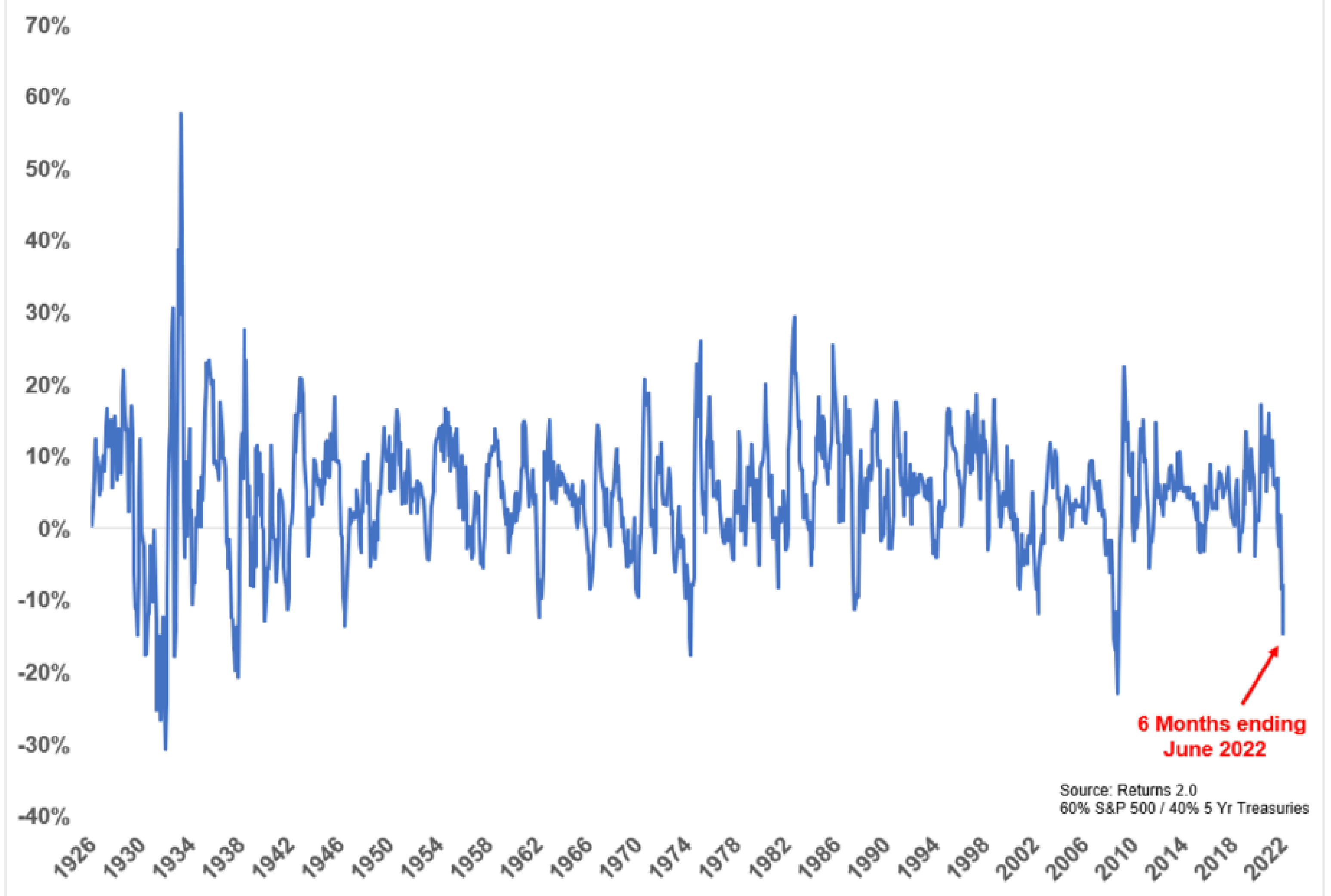
It would be insincere to minimalize how bad the first six months of 2022 were for both stock and bond investors. Ben Carlson, in his Absolute Returns blog, wrote on July 3, 2022, “The period ending June 30, 2022, ranks in the worst 3% of all 6-month returns since 1926. The only 6-month performance numbers that were worse than what we just lived through occurred during the Great Depression, 1937 crash,

WWII, 1970s bear market, bursting of the dot-com bubble, and 2008 crash. That's a who's who of terrible, no-good returns." He included the following two historical charts to drive home his point:





Investing is not supposed to be easy, and this year has exemplified this to the extreme. I stated last month that this market feels scary but is not particularly dangerous. When I say this, I am using 2008-09 as an analog. The market felt scary in late 2008 and early 2009 because the economy and financial system were on the brink of systemic failure and collapse. 2022 has not been a walk in the park due to very real hyperinflation forces and escalating geopolitical uncertainty around the globe. Unlike the recent hyperinflationary forces, which we believe will indeed prove to be mostly "transitory," with transitory meaning that temporary forces pushing inflation up will fade or be reversed by policymakers in the short term, we are very open to the likelihood that the Russian invasion of Ukraine will have long-lasting effects on both the geopolitical and economic landscape.

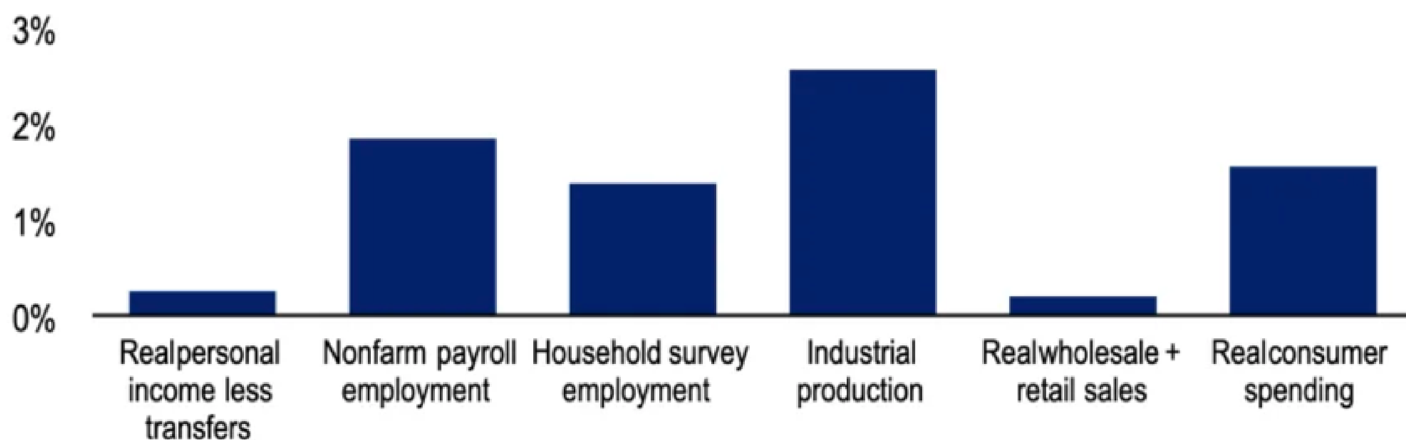
The market and the economy are very fickle and confusing subjects for most people. The market is not at all efficient on a day-to-day basis if you are a long-term investor. However, the market is very efficient when viewed myopically on any given day. What I mean by this is that the market quickly prices in new information each day, and that new information either confirms, contradicts, or muddles the outlook that the market priced in yesterday. As it was explained to me by a very successful market strategist whom I know, the long-term is made up of an infinite series of short-terms that are constantly adjusting to new

information. As a diehard long-term investor, Seven Summits Capital does not attempt to guess or "play" the daily, weekly, or even monthly market indecision, over-reaction, and chaotic gyrations that pave the path to the long-term. Our decisions are not substantially driven by ever-changing macro factors such as monthly economic statistics, commodity prices, and geopolitical events. Instead, we are focused on the fundamentals of our investments and those factors that, over time, will impact our fair market value assessments. Saying this does not mean that we ignore all macro events. We are active managers, and this means that we will, within the context of remaining fully invested, make certain security level decisions based upon our baseline assumptions and desire to maximize risk-adjusted returns.

As for the economy, the present debate is whether we are in a recession. Many people have learned more about what a recession is and what it isn't over the last month than they ever thought that they needed to know. Simplistically, a recession is defined by two consecutive negative quarterly Real Gross Domestic Product (GDP) after revisions, but that is not the entire story. Here is a short overview of how the definition of a recession has changed over time. Dr. Tony Lima, Ph.D. Economics, Stanford University wrote on July 26, 2022, "In the distant past, there was a formal definition: two consecutive quarters of negative GDP growth. But starting in 1978, the definition of a recession was (correctly) expanded to include additional factors. To a certain extent, this was motivated by the stagflation of the 1970s, triggered by OPEC tripling oil prices twice. The 1970s and 1980s saw a significant revision of the entire field of macroeconomics. In 1978 the Business Cycles Dating Committee was formed and tasked with declaring the beginning and end of recessions." The committee of economists, which officially determines whether a downturn in the economy is a recession or not, looks at the following broad data points:

Exhibit 1: Variables used by the NBER in making its recession determination (% chg. From Dec '21)

All six variables used by the NBER to make its recession determination have expanded since Dec '21



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, Federal Reserve Board, Haver Analytics. Latest month difers by indicator

BofA GLOBAL RESEARCH

As can be seen in the chart above, all six broad economic categories were positive during the first six months of 2022. Because of the pandemic, the stimulus that followed, the resulting damage that was done to global supply chains, and most recently, the Russian invasion of Ukraine and the associated sanctions which followed, we are in uncharted economic territory. It is understandable, given the unique nature of the current circumstances, that markets, economists, and policymakers are struggling to figure out how to react.

I won't pretend that I have it all figured out, but I am likely less frustrated and confused than many because the investment process that I have developed over the last several decades relies less on trying to fit current conditions into a historical construct and more on simply looking through the near-term to more predictable long-term fundamental factors. In other words, I look through near-term uncertainty and chaos to a more predictable "smoothed" forecast of factors that will prove to be meaningful to the fundamentals that underpin our investment decisions.

I regularly read commentaries from proven investors whom I admire and respect. One commentary that really resonated with me recently was written by Samantha McLemore, CFA of Miller Value Partners, published July 15, 2022. Miller Value Partners is the investment management company of Bill Miller, one of the most successful equity mutual fund managers of all time. I include the following major excerpt from her recent commentary because I believe that her blunt and honest assessment of the current environment puts forth an important message that should resonate with many of my clients and commentary subscribers. I have always admired Bill Miller's unconventional approach to value investing. Please enjoy the following words from Samantha McLemore and Miller Value Partners.

The markets humble you. It's one of the things I love about markets. Well love-hate really. There's never a dull moment and you're always learning. False bravado gets rooted out quickly. Just when you think you understand something, the world changes.

The extreme economic and market conditions of the past few years are little short of astounding, reinforcing the notion that forecasting is an exercise in futility. Our expertise lies in analyzing company fundamentals, and how those compare to expectations we believe are baked into stock prices, which is much more straightforward.

To recap: the new decade began on solid footing with early year gains, only to succumb to a devastating pandemic. The Covid crash started in February 2020 and culminated in the fastest 30% decline in S&P 500 history. Entire economies shut down. One could hardly imagine a worse economic environment. Unemployment came close to 15%, the highest since the Great Depression. Oil prices went negative. Bill Ackman warned of a Depression era period saying, "Hell is coming." A financial apocalypse to be sure.

Who could be bullish in that environment? Yet that was exactly the right position. Prices were way off the highs. Massive monetary and fiscal stimulus saved the day (over $5T in fiscal spending and a Fed balance

sheet expansion nearing $5T). Consumers benefited immensely. We experienced a severe recession with virtually no credit losses, a pairing previously unthinkable.

The world completely changed virtually overnight. Third quarter 2020 GDP growth measured a whopping 33%, the highest since the Bureau of Economic Analysis (BEA) started publishing the data in 1947. Had we finally cracked the nut on how to avoid recessions? Pundits discussed the possibility of another "roaring 20's" with high economic growth and strong markets. People believed elevated spending in areas like ecommerce had experienced a permanent upward shift. It was hard to find much not to like (in hindsight, the biggest warning sign of all and one we wish we heeded).

Dramatic change happened again when the inflation genie escaped the bottle. At first it was dismissed as transitory, but time made matters worse not better. CPI hit a level not seen in 40 years, yet another extreme. A behind-the-curve Fed has been forced to aggressively play catch up. Meanwhile, a market bubble popped in innovative disruption stocks. At the same time, a normalizing economy faced excess inventories as consumer spend shifted to services. Last but not least, Russia's invasion of Ukraine created the most fraught geopolitical landscape in decades.

This takes us to where we are now: the worst first half market performance since 1970 (SPX down 20.6%), over 50 years ago! Rack up another extreme…enough to give you whiplash. What happens from here? Another dramatic change, or more of the same?

We've eaten enough humble pie on macro thinking to avoid any prognostication. Many questions weigh on investors' minds. Has inflation rolled over? Will we enter a recession or not? Have we entered a new era of geopolitical turmoil and elevated energy costs? Can China sustain its economic recovery while pursing zero-Covid?

No one knows any of these answers. People struggle to understand what a recession is, let alone predict when one will occur. A recession is not two consecutive down GDP quarters as often cited. National Bureau of Economic Research (NBER) defines it as significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.

Here's what we do know. Economic growth has slowed dramatically. GDP growth in the first quarter was negative (mostly due to inventories) and the Atlanta Fed predicts Q2 real GDP growth of -1.2%. The surge in interest rates slammed mortgage demand, which hit the lowest level in 22 years early in June. Refi's are down nearly 80% year-over-year. Housing activity has slowed.

Inflation has remained stubbornly high, but forward indictors of inflation have rolled over. Commodity prices have broken down sharply leading Ned Davis' model to issue a sell signal. Monetary growth has plummeted, and financial conditions have tightened dramatically. Both equities and bonds sold off simultaneously, while

credit spreads widened. Inflation breakevens have plummeted. In early July, the 5-year breakeven fell back below 2.5% for the first time since September 2021, down from a high of ~3.8%. The 5-year forward rate in 5 years sits at ~2.1%, not far above the Fed's 2.0% target.

Yet employment, a coincident to lagging indicator, remains strong. There has never been a recession without employment deterioration. Consumer balance sheets remain in great shape with approximately $2.3T in excess savings. Demand for services remains strong, and banks remain upbeat about consumer behavior and demand.

Where do we go from here? The cone of uncertainty about the future is always wide, but it currently seems particularly extreme. A return to the low growth, low interest rate environment of the past decade seems quite plausible, as does the emergence of a new, higher inflation regime. The market will likely remain volatile as it figures out the answer.

Yet, a dramatic market decline has lowered expectations across the board. A peak-to-trough S&P 500 drop of 24.5% ranks as the 12th worst in the post-Depression period. Historically, an investor has earned above-average returns buying after a 20% market decline. The market averaged low-to-mid teens annualized returns over 1, 3 and 5 years whether we faced a recession or not. While we could expect more downside to the ultimate low, it hasn't historically taken that much patience (1 year) to be nicely in the green.

Howard Marks, one of the best contrarian value investors, recently said he's seeing good values and buying aggressively. Valuations have come down nicely. The S&P 500 currently trades for 16.7x this year's earnings. The attractiveness of that valuation is highly sensitive to inflation and interest rates. The current multiple is about average for periods when the Fed's favored measure of inflation (core PCE) sits between 3-4%, which happens to be where the 1-year inflation breakeven lies.

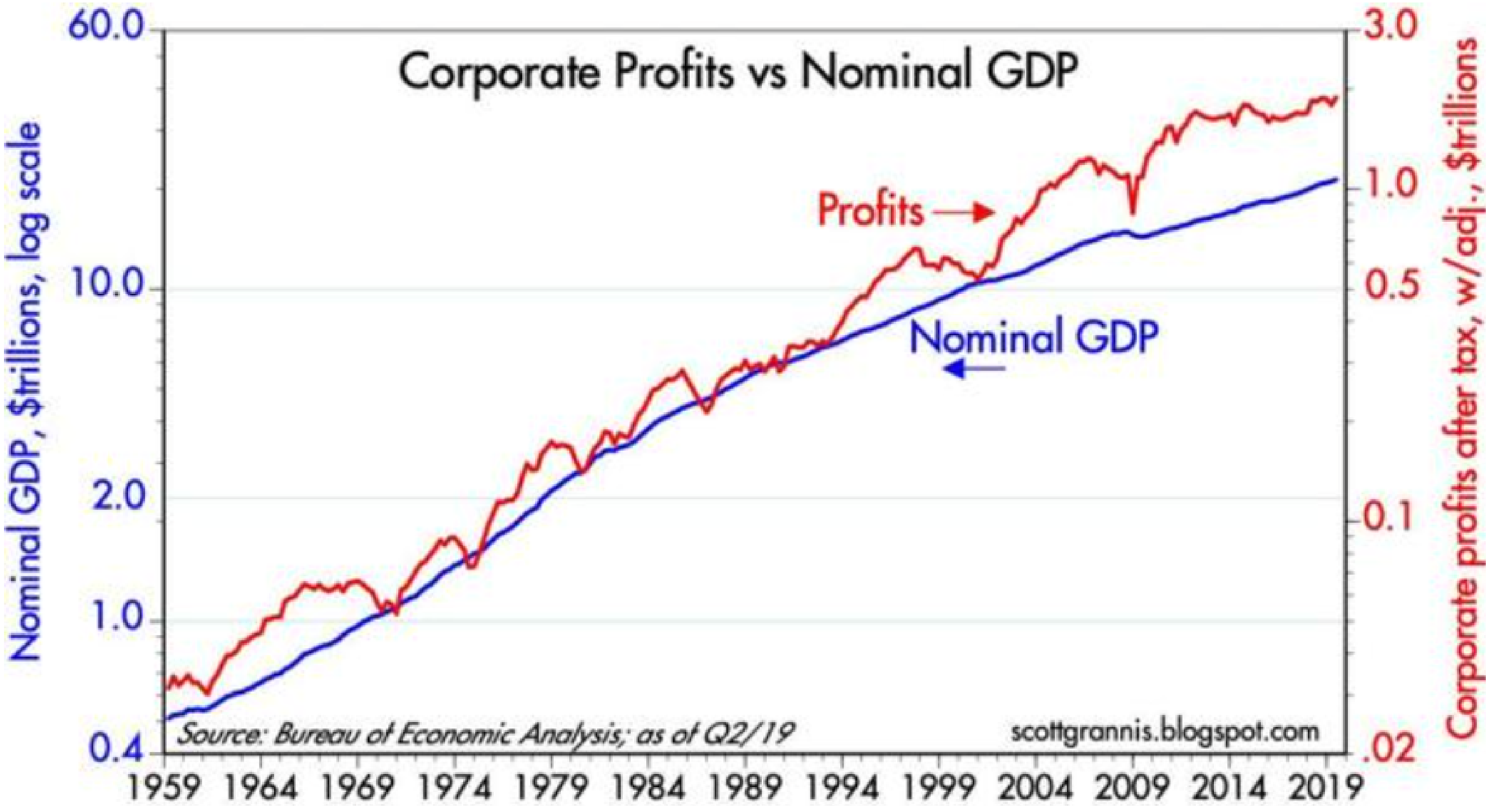
If inflation falls below 3%, as suggested by longer term breakevens, there's room for multiple expansion to the historical average multiple of 19x+. The reverse is also true. Higher than expected inflation would continue to weigh on market valuations as multiples averaged 13x with inflation above 4%.

In a market driven by fear rather than fundamentals, we think the rewards for being long term will be outsized. We believe extreme times in extreme markets call for extreme patience. We have a diverse mix of businesses that should help us do well in a variety of environments. We have high confidence in our process, which offers the unique combination of a long-term focus, a flexible approach, and valuation-centricity.

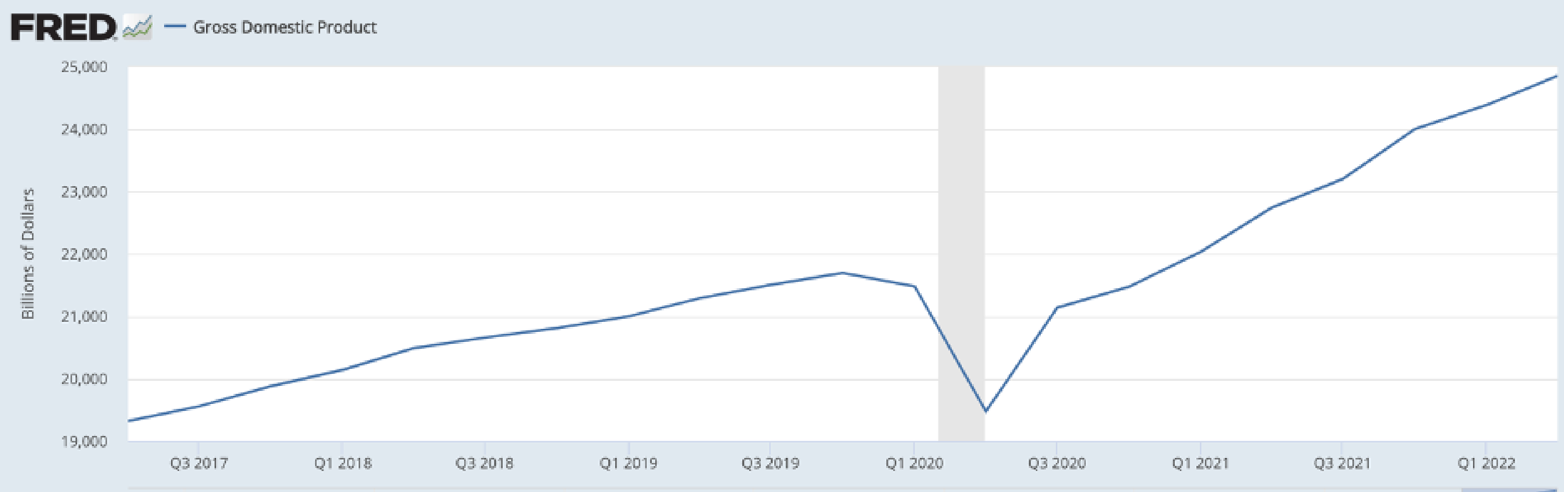
Franklin Delano Roosevelt famously told the American people that "the only thing to fear is fear itself." For the U.S. equity investor, most Bear Markets end up being far more scary than dangerous so long as one does not succumb to the fear emotion and cause self-inflicted severe financial harm. At this stage in the 2022 Bear Market, I am not alarmed by the current hyperinflation or the small negative Real GDP, which mathematically has resulted from robust nominal GDP growth being canceled out by unusually high

inflation. I remain convinced that over the next several years, it is much more likely that inflation will be under 3%, and Real GDP growth will settle into a more historically normal two percent range, meaning that the economy will generate nominal growth of more than 5% on average. Such an economy should be a healthy backdrop for investors presuming they know how to estimate intrinsic values and continuously seek out inefficient prices relative to real-world values.

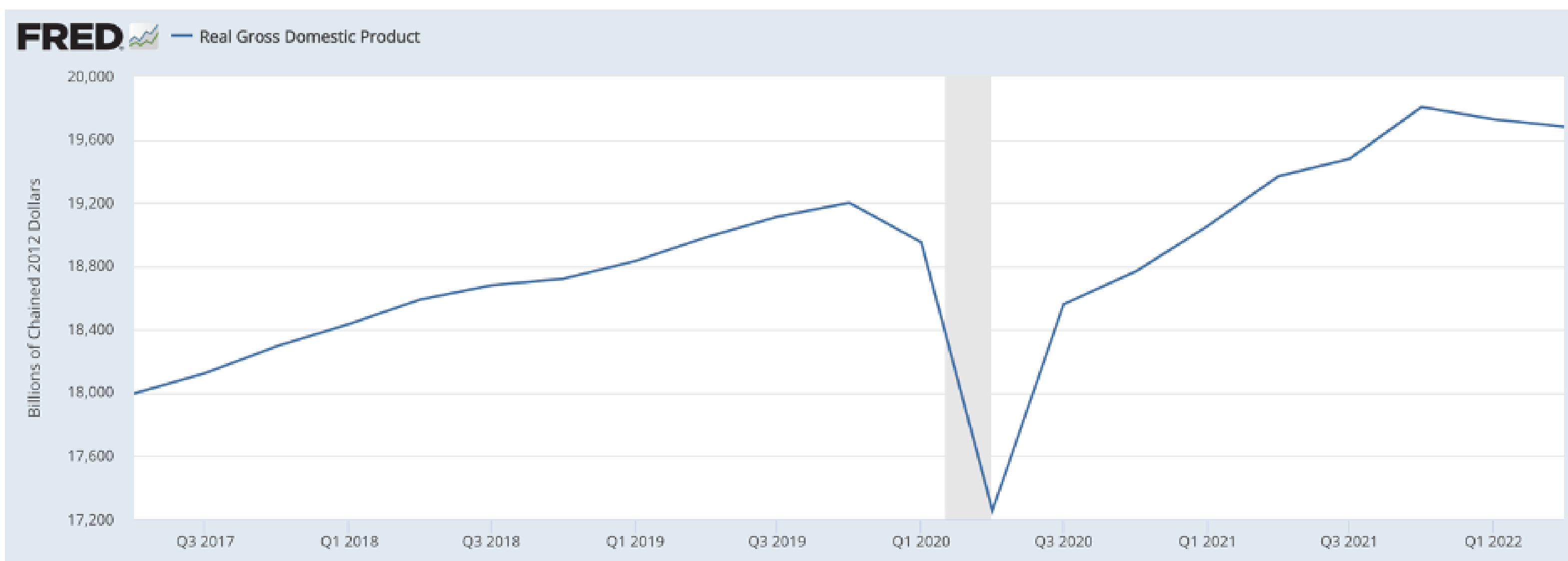
It is essential to understand the difference between nominal GDP growth and Real GDP growth to understand how corporate profits can continue to grow while Real GDP contracts. Stock prices are driven by nominal profits and cash flows. Please see the graph of nominal GDP and corporate earnings over time:



Below is a graph produced by the St. Louis Federal Reserve Bank showing U.S. Nominal GDP over the last five years through June 30, 2022:



Below is the same graph showing Real GDP over the last five years through June 30, 2022. Please note the slight decline beginning at the end of 2021:



As we progress through the back half of the year, we do not expect a meaningful economic downturn. The tightening of financial conditions that will result from the last two Federal Reserve three-quarter percentage point interest rate increases and the reduction in the size of the Federal Reserve's balance sheet has theoretically not even slowed financial conditions yet. The lag time for monetary policy actions is typically at least six months. Thus, the current signs coming from the housing market and consumer spending in the lower income population quartiles of a slowdown are occurring in advance of the impact of monetary policy actions. Since June, we have seen a significant drop in the price of oil and gasoline, and many other base commodities, some of which peaked in price in March and April. We may have seen the peak of inflation, which should provide some relief for those consumers who have felt the pinch of higher prices the most.

I expect the inflation trend to turn down and job creation to modestly slow over the next quarter or two. Should this occur, we should see the resumption of Real GDP growth in the third quarter and provide an opportunity for the Federal Reserve to achieve the historically elusive "soft landing." As investors, we have a significant stake in a "soft landing" outcome because such an outcome would prevent a substantial

contraction in corporate profits, which were beginning to be priced into equities in May and June. Thus far, earnings have generally come in at or better than expected. These earnings, along with promising signs that inflation has peaked, created a backdrop that allowed stocks to recover the sharp losses experienced in June. To build on July's stock gains, economic and earnings data need to continue to support the "soft landing" scenario. We adopted the "soft landing" scenario as our base case several months ago, and so far, the income data is validating our view.

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Disclosure:

Advisory services are offered through CS Planning Corp., an SEC-registered investment advisor.

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