

July 31, 2022

BLUME CAPITAL MANAGEMENT
Third Quarter Newsletter

The stock market correction accelerated in the second quarter of 2022 as investors reacted to several headwinds including higher inflation and commodity prices, rising interest rates, and tightening monetary policy. A “healthy” adjustment in valuations to reflect normalizing interest rates drove the initial phase of the sell-off. However, as expectations for more aggressive Federal Reserve action grew, markets quickly priced in higher recession risk across economically sensitive (or cyclical) areas of the market. The S&P 500 dropped 16.1% in the quarter and entered bear market territory (down >20% from highs) for the first time since March 2020. While every sector declined in the second quarter, defensive segments (health care, staples, utilities) outperformed, and only energy remained in positive territory for the year.

Foreign equity markets, as measured by the broader MSCI All-Country World Index Ex-U.S.^{1,2}, fell 13.7%. After factoring in a 6.5% headwind due to gains in the value of the U.S. dollar (assets priced in foreign currencies decline when the dollar appreciates), international stocks meaningfully outperformed U.S. shares because of a higher weighting to defensive and value-oriented sectors.

Bonds extended their losses from the first quarter as yields continued to climb (bond prices move inversely to yields). The 10-year Treasury yield surged from 2.35% to 3.01%, and U.S. bonds, as measured by the Bloomberg Barclays Intermediate U.S. Aggregate Index, lost 2.9%. According to a Merrill Lynch report, the first half of 2022 was the worst start of a year for bonds since 1865.

INDEX	Second Quarter <small>03/31/22 – 6/30/22</small>	Six Months - YTD <small>12/31/21 – 6/30/22</small>	Twelve Months <small>6/30/21 – 6/30/22</small>
S&P 500 Total Return ¹	-16.1%	-20.0%	-10.6%
DJIA Total Return ¹	-10.8%	-14.4%	-9.1%
MSCI All-Country World Index Ex-U.S. ^{1,2}	-14.3%	-19.1%	-19.9%
Barclays Int U.S. Agg. Bond Index	-2.9%	-7.5%	-7.9%

¹ Includes dividends in addition to index price appreciation

² The MSCI AC World Ex-U.S. index measures equity market performance in foreign developed and emerging markets excluding U.S.

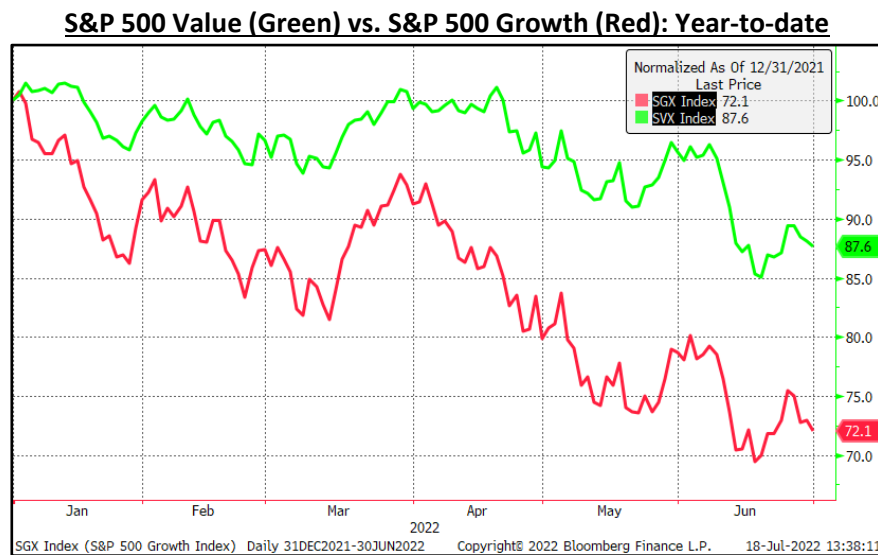
Market Perspective/Recap

In last quarter's letter we wrote that equity valuations would continue to adjust to rising interest rates and an environment where money is no longer "free". As noted above, bond prices move inversely to yields, and, all else equal, higher interest rates typically lead to lower prices for all assets (bonds, stocks, real estate, etc.).

Considering the simplest example of a bond, when interest rates (or yields) rise, the price of an existing bond must then fall to provide a prospective buyer with the higher yield now available in the market. The equivalent concept for stock investors is "earnings yield", or the ratio of company profits relative to the price of the stock. Our letters regularly reference "price-earnings multiples", which is the inverse of earnings yield (i.e. a 10% earnings yields equals a 10x P/E multiple).

As one would expect, these various measures of yields are inter-related. For example, if interest rates rise, prospective buyers of a stock will likely no longer be willing to pay the same price, given they can now earn a higher return in a lower-risk bond. Consequently, stock prices must fall to find willing buyers. In general, the higher the price-earnings multiple (or lower the earnings yield), the more sensitive the stock price will be to changes in interest rates.

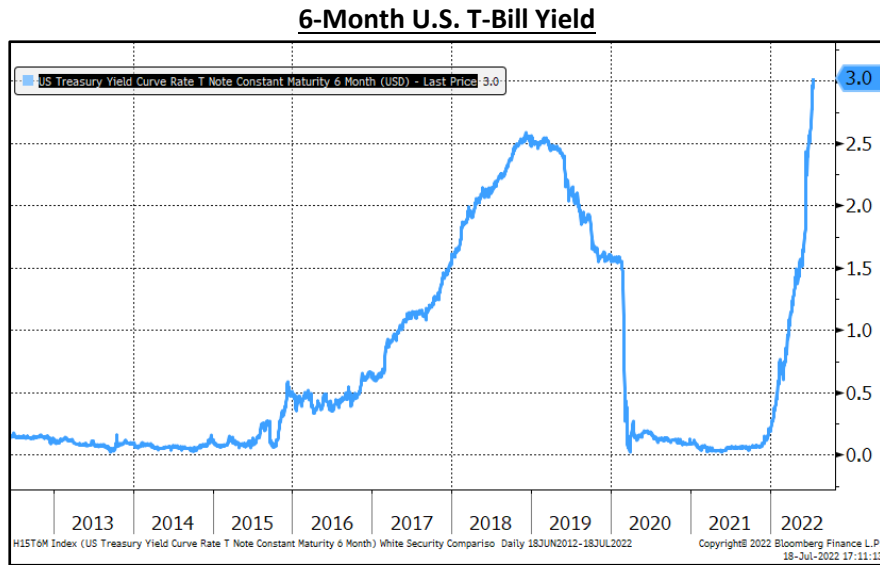
With this background, one can better understand the price action of markets in 2022. As the 10-year Treasury yield has nearly doubled year-to-date, the most speculative, or high-valuation stocks, have been decimated. As of June 30th, household names such as Netflix and PayPal have fallen 71% and 67%, respectively, while many smaller companies and shares of "pandemic darlings" are down even further. As shown below, growth stocks (red), which generally trade at higher P/E multiples, have declined 28%, while cheaper "value" stocks are only down 12%.



Source: Bloomberg

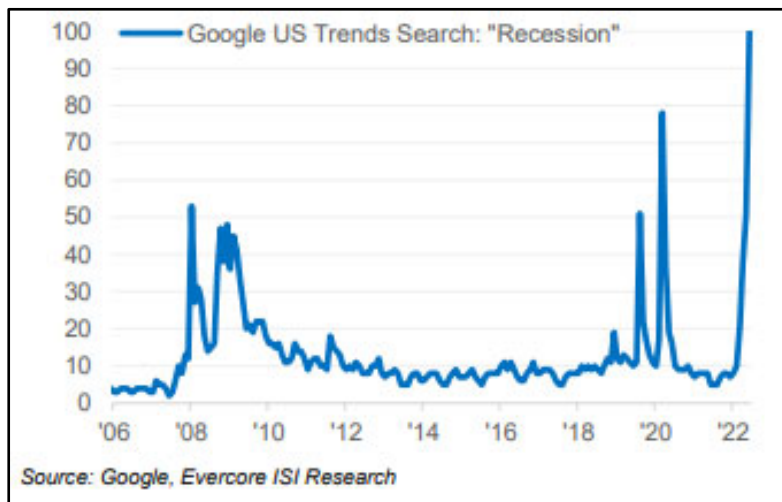
Everyone knew that interest rates would eventually normalize and function as a headwind to returns for higher valuation stocks. However, at the start of the year, and consistent with Fed guidance, investors believed this would happen very gradually. What the market did not adequately anticipate was that higher inflation levels would force the Fed to rapidly pivot and dramatically accelerate their tightening pace. The chart below

demonstrates how quickly short-term interest rates have adjusted, as the yield on the 6-month U.S. Treasury Bill has climbed from 0.2% at the start of the year to 3.0% today.



Source: Bloomberg

Markets initially reacted to the rate increases in an orderly fashion, but, as the pace of interest rate increases steepened, markets quickly grew fearful of a Fed mistake and potential economic downturn. As shown in the chart below, Google searches for “recession” recently reached an all-time high.

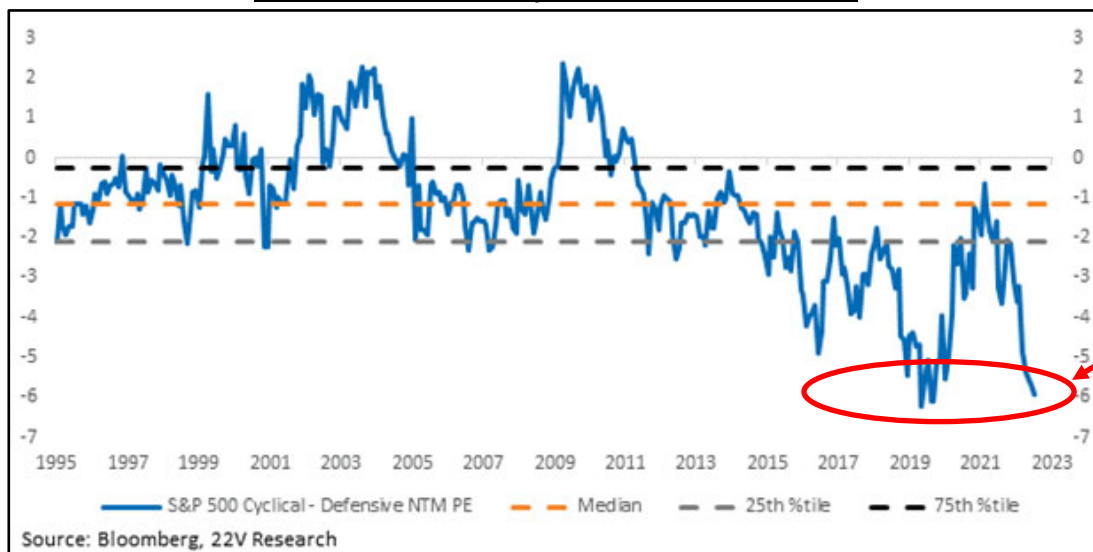


Source: Google, Evercore ISI Research

In response, the sell-off intensified, and, consistent with the short-term mindset (and computer models) driving trading today, investors mechanically followed the recession playbook of the 2008-09 Financial Crisis and Covid downturn. Stocks of cyclical companies (materials, energy, financials, semiconductors, etc.) declined rapidly, despite already trading at inexpensive valuations.

To be clear, we agree that the risk of a Fed mistake has increased. Monetary policy utilizes blunt tools that operate with a substantial lag, and, hence, tightening at a faster clip increases the probability of a misstep. However, with cyclical sectors now trading in the first percentile of valuation relative to defensive segments (see chart), we believe much of that recession risk may already be priced into these stocks.

Relative Valuation of Cyclical vs. Defensive Stocks



Accordingly, we have been utilizing this sell-off to trim or sell defensive stocks in client portfolios and reinvesting the proceeds into shares of high-quality, cyclical companies with superior long-term return prospects. Ultimately, corrections and the removal of speculative froth from markets are a healthy and welcome development for disciplined investors. While pockets of overvaluation remain across many areas of the market, we are seeing some of the most attractive investment opportunities available since the Covid depths.

Higher interest rates have also provided an opportunity to fill out client fixed income allocations, where we have been significantly underweight and sitting in cash due to an unattractive risk-reward (or as many commentators referred to it, “reward-free risk”).

Outlook

An old Wall Street adage says, “Don’t fight the Fed.” Investors have been well served by following that advice over the years and deducing the direction of monetary policy from here would certainly be helpful in guiding portfolio strategy. Furthermore, the key to assessing where the Fed is going is to determine how inflation data will evolve.

As regular readers of our letters know, we have written about the risk of inflation repeatedly over the past three years, when few were raising it as a concern. With the headline inflation rate recently touching 9%, we now have a chorus of commentators worried about rising prices and insisting that the Fed should immediately raise interest rates to much higher levels. At a minimum, we think this consensus view suggests that inflation risk is priced into markets, but, more likely, we believe these same commentators are attempting to “drive while looking in the rear-view mirror.”

Reflecting on the past couple years, the primary forces boosting inflation were massive fiscal spending, unprecedented monetary stimulus, rising commodity prices, supply chain disruptions, higher housing prices, and, to a lesser extent, labor shortages as people exited the workforce during Covid. Looking forward, the first three factors have all abruptly reversed as fiscal spending contracts, the Fed rapidly tightens monetary policy, and commodities have retreated significantly from their highs (as we write, gasoline prices have fallen 38 days in

a row). Moreover, supply chains are improving (finally), home sales have declined for five months in a row as mortgage rates have spiked, and, while the labor market remains tight, hiring has slowed and layoffs are rising.

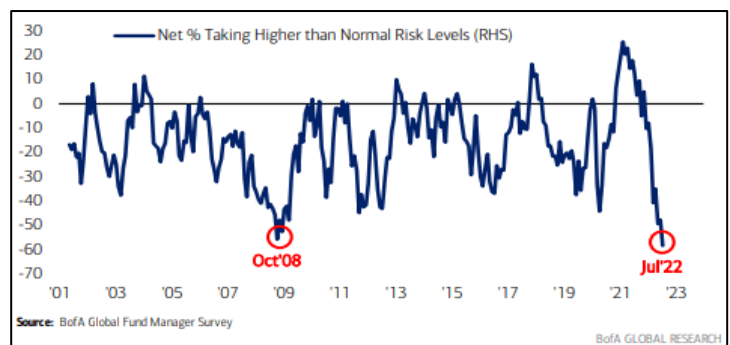
The rise in interest rates so far in 2022 is already the fastest and largest ever experienced in history. As noted previously, monetary policy operates with a significant lag, meaning the moves already made will work to slow the economy in late 2022 and through 2023. After being wrong about “transitory” inflation during the pandemic, the Fed politically had little choice but to turn more aggressive. However, their actions to date just accelerated their path to a “neutral” level of interest rates (not stimulative or restrictive of growth), after which they still plan to remain data dependent. Looking forward, we believe slowing inflation will allow them to ease the pace of their tightening.

As shown in the chart below, the bond market appears to agree with our assessment. The market measure of 5-year inflation expectations has declined from ~3.7% in March ~2.7% today.

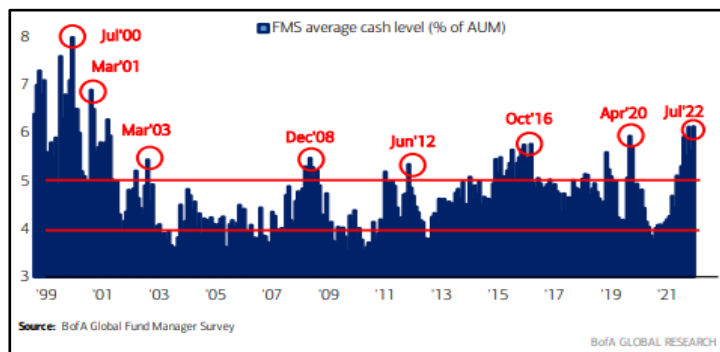


Source: Bloomberg

It is difficult to overstate the current level of negativity in financial markets. Growing fears of a Fed-induced hard landing have provoked investors to sell stocks and crowd into expensive safety trades. According to a recent Merrill Lynch report and as shown in the accompanying charts, the percentage of fund managers taking a “higher than normal” level of risk is the lowest since the depths of the 2008-09 Financial Crisis. Additionally, cash balances are the highest since 9/11 (2001)!



These kind of extreme data points following large price declines are often powerful contrarian (i.e. positive) indicators. Obviously, they do not guarantee that markets will turn around, but they do suggest that there may not be many investors left to sell, barring incremental bad news. Furthermore, given the cash balances accumulated on the sidelines, any positive developments could trigger a sharp rebound.



Of course, we could endure a recession in the next year or two, but, if we do, it is likely to be far milder than 2008-09 given the lack of the systemic imbalances and the solid state of consumer and corporate credit. Further, it is helpful to remember that recessions are temporary. As long as your investments have the wherewithal to reach the other side, recessions provide the opportunity for high-quality companies to enhance their long-term return prospects through corporate initiatives such as buybacks of their own, now cheaper, stock, lower priced acquisitions, and improving cost structures.

As always, please don't hesitate to reach out with any questions or concerns. We hope everyone is enjoying a wonderful summer.

Sincerely,

Peter B. Reidenbach

Jeffrey V. St. Claire

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