Spring 2022

"Those who do not remember the past are condemned to repeat it." ~ George Santayana

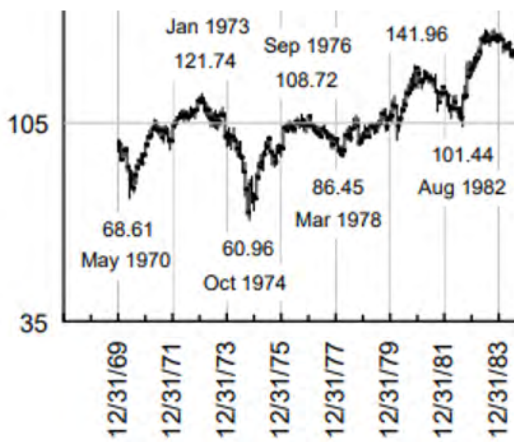
For the first time in several years equity markets have experienced negative returns for several consecutive months. As of May 31st, 2022, the year-to-date returns for the S/P TSX, S&P 500 and NASDAQ have been (1.3)%, (12.8)% and (22.8)%, respectively. The reasons for these negative returns are rising inflation, rising interest rates and the war in Ukraine.

For many years, the typical response to market declines has been to "buy on the dip". This strategy has been effective in the recent past. Investors have relied on what has come to be known as the "Federal Reserve Put" whereby market participants have come to believe that Central Bankers and governments will step in and support markets. As a result, investors and financial advisors have come to expect that anytime markets go down five to ten per cent it is time to jump into the equity markets. This may not be the case this time.

The current period resembles the Nifty Fifty era during the late 1960's and early 1970's. At that time, market valuations were extremely high as a group of companies known as the "Nifty Fifty" rose dramatically in value and came to dominate U.S. equity markets. This group included consumer brand name companies such as Coca-Cola, Proctor & Gamble and Kodak. It was believed that these businesses would grow at very rapid rates due to extremely high consumer awareness in North America and explosive international growth.

Compounding the risk that came along with extreme valuations, inflation began to take hold in the early 1970's. The oil crisis of 1974 added fuel to the inflationary flames. Consequently, interest rates started to rise as well. From their peak in 1972 markets declined by over 50%. Equity indices did not recover their full value for more than ten years, as the graph below indicates. Furthermore, most of the "Nifty Fifty" did not get back to their peak share prices for more than twenty years.

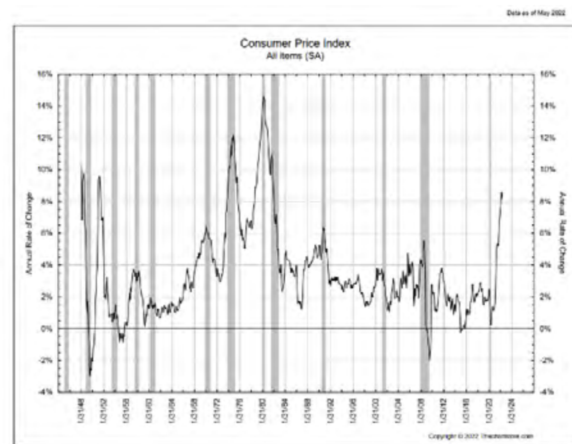
Chart 1
S&P 500 1973 to 1983



Source: The Chartstore.com

Today's economic situation mirrors that of the early 1970's. Inflation is taking root. U.S. consumer inflation reached an 8.6% annual rate in May, its highest level in more than four decades, as Chart 2 below indicates. The cause of this inflation is rooted in very loose monetary and fiscal policies implemented by central banks and governments around the world. Supply chain disruptions due to the pandemic and war in Ukraine, higher energy prices and higher food prices have accelerated inflationary pressures.

Chart 2



Today, we also have a comparable situation in the equity markets as existed in the early 1970's. Equity indices are dominated by large companies, namely technology and other high growth businesses. Like the Nifty Fifty, these businesses are expected to grow exponentially well into the future. The valuations of these companies are also extremely high and are driving elevated valuations across the entire market.

Again, as in the 1970's high rates of inflation inevitably will lead to higher interest rates. And as inflation rises

higher, equity valuations will fall lower. We are now seeing this process being played out. Rising interest rates are having a negative impact on equity returns. Year-to-date returns have been negative across most global equity markets. Although interest rates have indeed gone up, they are still at extremely low levels by historical standards, and we believe have a long way to go to quell the current bout of inflation.

"Buy on the dip" may not work this time. We do not believe that inflation is transitory. While inflation may fall from current levels, rising prices are here to stay for quite some time. The many years of excess government spending and central banks printing money has embedded inflation. Central Banks are now in a "Catch 22". Raise rates to tame inflation and markets fall. Do nothing and inflation continues to increase causing markets to fall. To top it all off, equity markets are still at excessive valuations despite the recent declines. Buying overvalued securities is always risky and even more so in a rising rate environment.

The current investing environment has many investors quite concerned. To the contrary, we are extremely comfortable with our current portfolio positioning. We have taken substantial profits and currently hold large cash balances. Furthermore, a large number of our holdings provide above average and growing dividends, an important benefit in a time of rising inflation. Even with our large cash balances our portfolio yields approximately 3%.

The period from 1971 - 1983 not only provided lessons on the corrosive impact that overvalued markets, inflation, and rising rates have on long term equity returns but it was also an excellent opportunity for value investors then and for current investors to learn from them. High interest rates and panicked markets drove equity valuations to incredibly attractive levels. Investors who followed the principles espoused by Benjamin Graham, the "father" of value investing, were able to purchase equities at deep discounts to their true worth. In many cases these securities had high and growing dividend yields. Consequently, value investors of that era were able to generate positive long term returns as true economic value was eventually realized, irrespective of market conditions.

Like the value investors of the 1970's we would welcome a market environment that gives us the opportunity to purchase businesses at very attractive prices. We are looking forward to equity markets that present widespread investments that give us the potential to construct fully invested portfolios with the potential to earn rates of return well in excess of inflation.

True to our contrarian nature we are quite excited as we enter this next market phase.

Thank you for your continued confidence and support.

Vito Maida

PCM
Patient Capital
Management Inc.
patiently creating wealth.®