GREY OWL®
CAPITAL MANAGEMENT

April 28, 2022

"Invest in inflation. It is the only thing going up."

– Will Rogers

Dear Client,

In the first quarter of 2022, financial markets abruptly reversed course and volatility increased significantly. While new trends were already in place, the moves intensified when Russia invaded Ukraine on February 24th. It is probably hard to remember, but the S&P 500 was up 11.1% in the fourth quarter of 2021 and commodities (up 1.5%) were the worst performing of the major asset classes.

In an about-face, from January to March, commodities were up 32.4% and the S&P 500 was down 4.6%. Gold was up 5.7%, but "safe haven" US Treasury bonds were down 10.6%. Grey Owl's All-Season strategy finished the quarter down 4.4%. In comparison, a 60/40 benchmark was down 5.7%.[1]

In our last quarterly letter, we emphasized how narrow the US equity market had become beginning around mid-year 2021. We wrote that the narrowing "presaged the current market downturn and a likelihood that the downturn continues for several months or quarters." We maintain that perspective as the narrow market persisted (and intensified) through the first quarter. While the S&P 500 was down, it held up much better than small capitalization stocks (down 7.5%), technology stocks (down 8.8%), and innovative growth companies represented by the ARK Innovation fund (down 30%).[2]

The sell-off has accelerated through April. Through April 27th, the S&P 500 is down 7.6% for the month. The Nasdaq Composite and the ARK Innovation fund are worse: down 12.6% and 25.2% respectively. Throughout the month, Grey Owl's All-Season relative performance has continued to improve.

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[1] The Grey Owl All-Season strategy performance is taken from an individual representative account. The 60/40 benchmark is 60% ACWI and 40% AGG for the iShares Core U.S. Aggregate Bond ETF.
[2] Small capitalization stocks are represented by the Russell 2000 ETF (IWM), technology stocks are represented by the Nasdaq-100 Index ETF (QQQ), and the ARK Innovation fund ETF is ARKK.

By late January, we had made significant adjustments to our model portfolio selling the majority of the more speculative ("reopening") equity positions, raising cash, and increasing our exposure to "defensive" equities. Regrettably (at least for now), we also began to build positions in long-dated US Treasury bond ETFs.

The most unusual aspect of financial markets during the first three months of 2022 was the simultaneous sell-off in both equities and government bonds. Typically, US Treasury bonds perform well during equity market sell-offs. That has not been the case so far this cycle. Given the recent retrenchment in the price of oil and other leading indicators of inflation, we are optimistic that Treasury bonds have a high probability of positive performance going forward as economic growth, inflation, and corporate profits are all positioned for considerable deceleration.

Market Internals Remain Weak

Similar to what we wrote in our last letter, market internal weakness persists. For example, Lowry's Buying Power remains in a one-year downtrend and Selling Pressure in a one-year uptrend. Selling Pressure continues to hold above Buying Power.

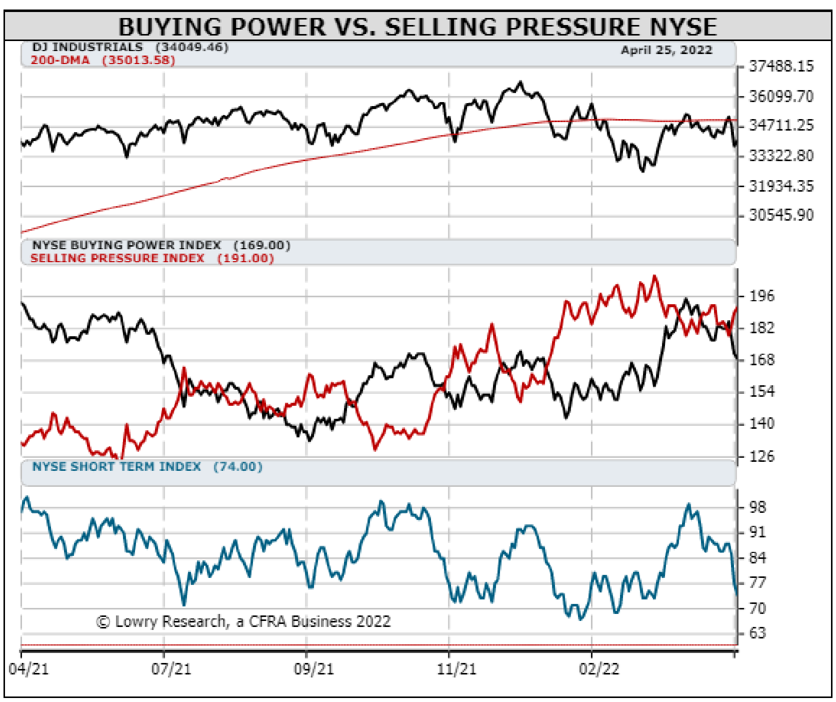

Figure 1 - Buying Power & Selling Pressure[3]

[3] www.lowryondemand.com

While broad equity indices did show modest signs of strength from mid-to-late March, Lowry's notes that even that attempted advance was narrow:

> In a broad-based advance, more than just the top tier of stocks should be directionally pacing the major price indexes – so, too, should the weakest/bottom tier. However, on April 20, the Percent of OCO Stocks 30% or More Below 52-Week Highs remained elevated at 24.37%, near its March 7 multi-year high of 28.58%. Robust participation, which defines sustainable market advances, should push this sensitive indicator swiftly lower.[4]

To summarize: the stocks that were already down the most hardly recovered during the bounce. Consistent with the Lowry's analysis, in the last few days, the late March advance collapsed.

Economic Growth and Corporate Profits

The US ISM Manufacturing Purchasing Manager Index (PMI) has been slowing since November. While still in growth territory, the deceleration is meaningful. The ISM PMI is a reasonably accurate leading indicator of overall economic growth. Its slowdown portends a decelerating US economy.

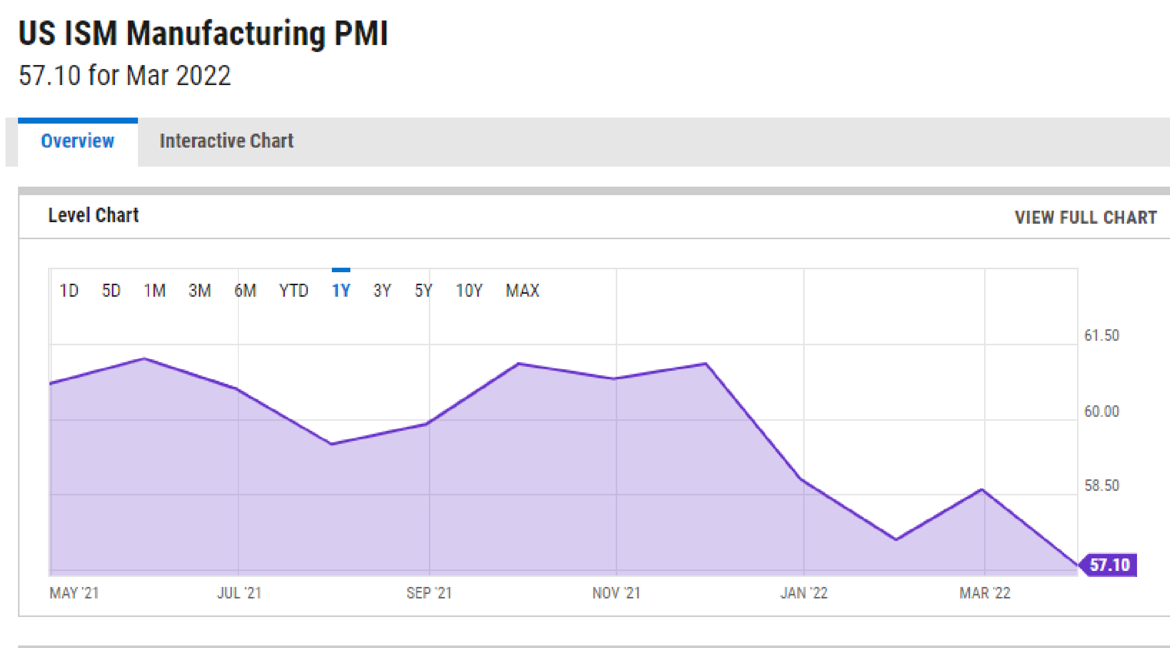

Figure 2 – US ISM Manufacturing PMI monthly[5]

[4] https://www.lowryondemand.com/members/wpdfserver.cfm?filename=wmta220422.pdf
[5] https://ycharts.com/indicators/us_pmi

On the corporate front, with one-fifth of S&P 500 companies reported, earnings are negative on a year-over-year basis. This is a tough environment for equities and risk assets generally.

S&P 500 INDEX

Surprise | Growth

Sector (BICS)	Reported	Sales Growth	Earnings Growth
11) All Securities	111 / 499	7.65%	-2.38%
12) > Materials	6 / 28	29.46%	65.17%
13) > Industrials	15 / 69	26.71%	N.M.
14) > Consumer Staples	10 / 35	-0.16%	5.38%
15) > Energy	4 / 23	3.99%	-11.19%
16) > Technology	11 / 79	4.31%	10.53%
17) > Consumer Discretionary	11 / 57	32.68%	143.69%
18) > Communications	5 / 25	-5.59%	-4.08%
19) > Financials	34 / 61	-0.70%	-25.19%
20) > Health Care	9 / 64	12.55%	5.69%
21) > Utilities	2 / 28	-8.88%	6.25%
22) > Real Estate	4 / 30	14.58%	39.41%

Figure 3 - The Bloomberg

Inflation and Bond Bulls?

With the March Consumer Price Index (CPI) print of 8.6% year-over-year, the most common gauge of inflation is at its highest level since the early 1980s. Inflation has now been accelerating twenty-two months. Even the Federal Reserve finally admits it has not been "transitory."

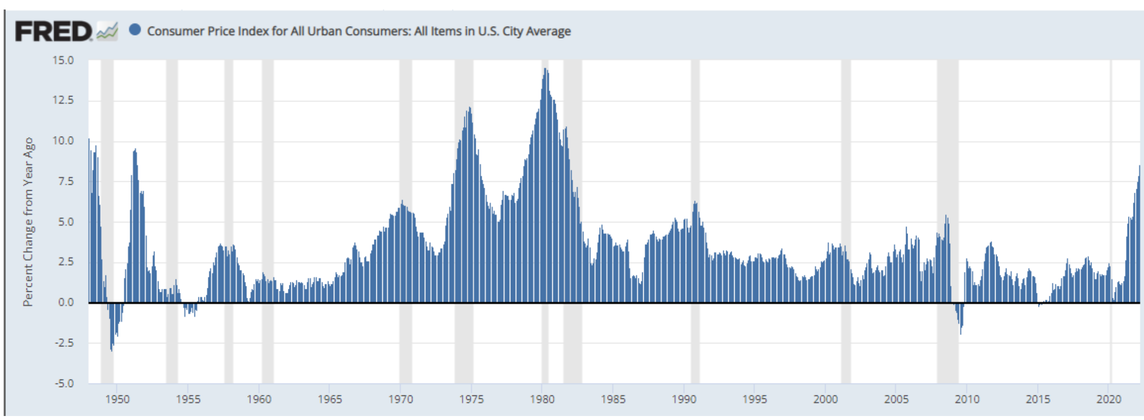

Figure 4 - Consumer Price Index[6]

Despite the rising CPI, we have built positions in long-dated US Treasury bonds because a) US Treasury bonds typically act as a portfolio ballast during equity market sell-offs (especially when sell-offs become panicky) and b) while we see the potential for inflation to remain elevated on a multi-year basis going forward, the rapid rise in inflation that has already occurred almost by definition makes a deceleration inevitable.

[6] https://fred.stlouisfed.org/series/CPIAUCSL#0

Hoisington Investment Management has been one of the most steadfast bond bulls for several decades and while they too admit the four-decade bond bull market may be ending, they are bullish short term. It is impossible to make the case any more thoroughly and concisely than they do:

> At this current level, the long-end treasury market has value considering the impending recessionary conditions which have always reduced inflation and interest rates. The economic data suggesting negative growth ahead include the following factors 1) the largest twelve month decline in real weekly earnings of 3.3% since this series began in 2000 which covers 72 million people. 2) Real per capita disposable income now stands 1.8% below one year ago levels and has fallen for seven consecutive months. 3) The composite index of the NFIB Small Business Survey sank to 93.2 in March the lowest since April of 2020. 4) Interest rate sensitive sectors such as housing and autos are already declining. 5) Inventories are rising rapidly and will accelerate further with any softness in demand causing cutbacks in production. 6) Fiscal policy turns restrictive in 2022 and there is just a hint of early restraint in Fed policy as total reserves declined by $425 billion since December and the main component of M2, other checkable deposits, has shown just 3.7% growth over the last three months.[7]

Positioned for Economic Deceleration and Market Volatility

As we wrote last quarter, beginning in late 2021, but more aggressively in January 2022, we shifted the Grey Owl All-Season portfolio to a decidedly more "all-season" stance from the more "risk-oriented" positioning late in the third quarter of 2021. Our "safe haven" positions are the largest they have been in several years and our equity positions are small and focused on low-volatility and staples. Following Will Roger's advice on inflation, gold (GLD) is now our second largest position.

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As always, if you have any thoughts regarding the above ideas or your specific portfolio that you would like to discuss, please feel free to call us at 1-888-GREY-OWL.

Sincerely,

Grey Owl Capital Management

Grey Owl Capital Management, LLC

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[7] https://hoisington.com/pdf/HIM2022Q1NP.pdf