KEIM ASSET MANAGEMENT, LLC
Preserving Your Lifestyle

June 28, 2022

WITHDRAWING STIMULUS

Dear Investor:

This is one of those times when investors everywhere are losing money. I realize that it can be very scary, and it's certainly no fun for anyone. There are two main emotions that generally drive investors: Desire for Gain, and Fear of Loss. Obviously, right now, Fear of Loss is the dominant emotion. When markets are down, and everything looks terrible, our main worry can become losing even more money. This Fear of Loss can lead to bad decisions. I hope to lay out a brief review of our current situation and how we got to this point. This may require a little patience as I attempt to skim over two and a half years of recent economic history, but I think it will make it easier for you to understand and endure this current bear market, however long it lasts.

We need to look at this year, including the rest of 2022, in conjunction with the last two years as one three-year block of time. It will be easier to understand the current picture with that framework in mind. The Fed had raised rates quite a few times during 2018, and it looked like we were getting back on stronger footing. As we moved into 2019, the economy began to slow down, as there was a lot of tension between the US and China over trade policy. The Fed eventually cut rates three times in the second half of 2019, and that kept us going forward. The title of my letter in early January 2020 was, **"The Expansion Rolls On".**

As we rolled into 2020, we ran straight into the worldwide pandemic caused by the coronavirus. No need for me to discuss that at length here. I want to focus only on the financial side right now. The title of my next letter on April 3, 2020 was **"The Bull Market Ends".** You may remember all the stories about how the bull market lasted 11 years and was one of the longest on record. The SP500 lost approximately 34% from mid-February to the end of March, so that ended the bull run. The outlook was very dark, and there was reason to believe things were going to get much worse.

My letter in July of 2020 was titled, **"War on the Coronavirus"** and began to discuss the response to the economic damage caused by the pandemic. At that time, we had stay at home orders for most businesses, and the unemployment rate was rocketing higher. The Fed immediately went into action and cut interest rates to zero. They also resumed the QE programs (printing money) that had been used during the Great Recession. The government created a myriad of relief programs and began sending out money all over the country to various groups of people. This massive amount of stimulus/relief caused the market to rebound in a way that would have seemed impossible a few months earlier. Most everyone was convinced we had just dodged a depression.

From that point on the economy was in a rebuild mode, and things generally improved each quarter as economic activity increased and unemployment declined. The market ended 2020 around

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15% higher than the beginning of the year. However, there was an underlying issue here. Earnings for 2020 were down around 15%, so the market was paying a big price for the earnings that were produced. Thus, the market was very expensive on a P/E basis, and was in line with a few other very high points of the last 100 years. Market veterans know that this is a scenario that cannot stay in place for an extended period of time. Things would change at some point. This was clearly the product of the massive stimulus created to fight the pandemic. This "wealth" was not created by productivity. It all came from borrowing and printing. There's No Free Lunch and that has set up our current situation.

My letter in April 2021 was titled, **"Inflation Expectations".** I will quote a couple of lines from there. **"The Fed has insisted they will keep their foot on the monetary gas pedal until unemployment drops back down to levels seen before the pandemic." "This super loose monetary policy is leading to many discussions of rising inflation. As they continue to focus on the labor market, there is a heightened risk of prices and inflation beginning to accelerate."** The accelerating economy and the rock bottom rates led to a booming stock market. In the same letter, which was written over a year ago I stated the following in a discussion of various ways things could play out, **"A third scenario could occur if there is strong economic growth and inflation that distinctly gets ahead of the Fed. This could force them to respond with higher rates on a timetable that is more aggressive than we would like. I would expect this to cause a significant and relatively painful market correction."** Unfortunately, we have ended up with option three. I do believe this is exactly where we are now.

As we saw throughout the rest of 2021, the Fed did come to the realization that they were wrong on inflation and clearly behind the curve. I discussed this in two more letters, **"Time to Taper"**, and **"The Powell Pivot".** They have admitted this publicly, as has Secretary Yellen. While that's helpful, it won't make the problem go away. We are now facing very high inflation numbers. This is a direct result of the massive stimulus/relief enacted to fight the coronavirus for the most part. The supply chain figured into the mix, but that also came from the pandemic. Now we have the war in Ukraine on top of everything else. We know this is affecting food and energy and helping drive those prices higher.

The Fed has begun to move rates up at a faster pace, and they are beginning to shrink their balance sheet. This necessary withdrawal of stimulus has led to big stock market declines as we expected, and fears of recession. The odds of recession are moving higher. We don't know how things will play out. Right now, the Fed has stated they intend to stay on a path of raising rates until they see some clear evidence of inflation turning down. This is not as simple as it sounds as there is lag time between rate increases and the effects in the real economy. This can be as long as 6-12 months, making it very hard to judge results. The war is a big factor here, as we have no control over that and it adds another element of uncertainty to the outlook. However, at some point, the higher rates will be cutting into the economy and slowing things down. Unfortunately, that's the way our system works. Unemployment will rise, and in various ways, we will all have less money to spend. Recession is a word that scares people, but the reality is a recession can be shallow or deep, short or long, so we should not assume the worst if we do have one. If Q2 GDP is negative as Q1 was, we would technically be in a recession now as that's two quarters in a row of negative growth.

Hindsight is 20/20, or so they say. I sure wish the Fed had figured out much sooner that inflation wasn't transitory. I know chair Powell feels that way too, because he has said so. If that had

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been the case, the pace of withdrawing the stimulus could have been more gradual, and the market adjustment would have been less severe. While I do think a significant amount of the correction is behind us, we should expect the rest of 2022 to be pretty tough. There looks to be several more rate increases coming this year. How big they will be and when there will be signs of inflation easing can only be guessed at. However, at some point there will be improvement, and there will be a pause or an end to rate hikes. The bear will leave the market and walk back up into the woods. Things will stabilize and companies will have an easier time making money again. Consumers will have an easier time paying their bills and the economy will grow again, hopefully on a steadier path that can be maintained. In the meantime, we have to keep calm and realize these cycles are a normal part of investing. This has all happened before. We need to turn down the Fear of Loss, and stay focused on long-term investing success.

Best Regards,

David E. Keim

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