ALBION FINANCIAL GROUP

Guiding Clients
To A Lifetime of
Good Decisions

JULY 2022

IN THIS ISSUE
From John Bird's Desk **Economy & Markets** **Planners Corner** **Albion Community**

This being our 40th year in business, we invite you to *save the date* of **September 16th** to join us for an evening of celebration at the National History Museum of Utah. More details to come!

With the first half of the year behind us, what is the financial landscape for the remainder of 2022? This letter contains messages from our CEO John Bird, providing long-term perspective on interest rates, inflation, production, and supply; our CIO Jason Ware, describing the factors impacting a potential recession; and one of our Wealth Advisors Patrick Lundergan shares how to manage risk through asset allocation.

Also, Albion has grown! Read through to the end to get to know the newest member of our team.

FROM JOHN BIRD'S DESK

The triple hallmarks of the last forty years for investors have been a constant trend downward in interest rates and inflation, improved productivity due to technology, and streamlining of global supply chains delivering goods at ever lower costs.

The interest rate declines since the early 1980's when short-term rates were north of 20% and the ten year Treasury clocked in at nearly 13% have been extraordinary and a big driver of positive financial returns. These declines came as a result of Fed Chair Paul Volcker raising rates to crush inflationary pressures combined with productivity improvements driven by technology and globalization. For the

following decades, with a few exceptions, inflation has been pressed lower and lower to the point where we've come to accept 2-3% inflation as the norm.

By way of comparison today's three-month T-Bill pays 1.6% while a ten year note pays 2.83%. While up from the pandemic lows of two years ago, this is still extremely low relative to the early eighties.

Technology improvements continue to drive efficiencies and cost reductions across most all economic sectors - a trend that's unlikely to stop anytime soon.

But global supply chains remain a problem. The combination of ongoing Covid induced global manufacturing and shipping bottlenecks and the impact of Russia's Ukraine invasion on energy and commodities have constrained supplies pushing prices higher.

The potential for inflation was boosted by the Covid support packages crafted by both political parties to help keep the economy going in the face of the pandemic. Those additional dollars combined with the. tightened supply of goods created classic conditions for inflation – too many dollars chasing too few goods. We maintain the perspective that most of these inflation pressures are transitory.

We have seen loosening of bottlenecks and dropping prices across several sectors of the economy. Not enough yet to bring us back to the pre-pandemic, pre-Russian invasion levels but trending the right way.

Also, we believe Fed tightening – raising rates - is likely to persist at least through year-end and will have an uneven impact across companies and industries. They have clearly stated their intention of raising rates as necessary to bring inflation back down. Of course the higher cost of money (interest rates) slows economic activity.

It is a fine line between slowing the rate of growth and tipping the economy into a recession. And the Fed is working to walk this tightrope while Russia's war in Ukraine is wreaking havoc with global energy, commodity, and food prices while the war also may tip Europe into recession.

Resiliency in investments matters. In virtually every economic environment, including the current one, we believe it is essential to build portfolios around companies with strong balance sheets, solid earnings, and an ability to raise prices along with inflation. Such investments provide potential for both downside protection and inflation beating returns in the coming years.

It's worth noting that this environment has added tremendous uncertainty – i.e. "unpredictable outcomes" to companies that may not be resilient; rapidly growing firms that in pursuit of growth lose significant amounts of money year after year – the type of companies we avoid as we believe profitability matters. We have seen that uncertainty reflected in the thrashing of many high-flying companies' stock prices.

Uber is a well-known example. They provide a great service at a competitive price. However, they continue to lose money and bridge their deficit by raising funds from investors. This has worked well in an era of low interest rates and abundant investment capital.

Investors the world over are searching for the next big thing and are willing to back companies with ongoing losses if there is a chance it may become the next Amazon. But that means those of us who use Uber have been subsidized every time we catch a ride. Investors have filled the gap between what we pay and what it costs to provide the service.

With rising rates and tightening capital markets this has begun to change – Uber's prices have risen as company management sees they may not be able to go to the capital markets to finance ongoing losses. Suddenly that Yellow Cab at the curb doesn't look so expensive.

So is it inflation or just repricing to reflect the actual cost of service? While the net effect to consumers is the same, the mechanism causing the price increase is substantially different.

There are scores of others in the same boat – companies growing gangbusters but losing money with every sale. As this rationalizes and as they are forced to price their services based on actual cost there will most certainly be unintended consequences. Companies with a demonstrated capacity to be profitable will have a huge competitive advantage.

Ultimately investments will be priced on their ability to create, maintain, and expand profitability.

Yes, there will always be significant currents buffeting the prospects of companies, industries, and economies. Markets have always swung from being overly optimistic to overly pessimistic. Yet eventually valuation does matter and over longer time horizons financial markets will press investments toward rational valuations.

While it takes serious sleuthing, we look for solid underpinnings for the investments in your portfolio while fully recognizing that the unemotional market mechanism has no concern for how any particular individual or group feels about how an asset is priced.

It is how the markets work. Is it comfortable? No. Are we experiencing radical changes to established norms? No. The financial markets are doing what they've always done; valuing companies based on the cumulative opinions of millions of market participants.

As Ben Graham said:

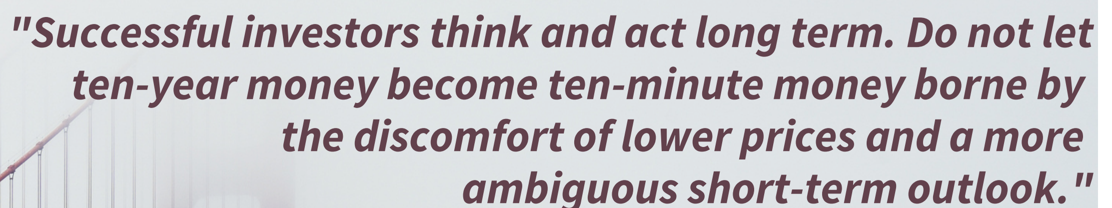
"In the short run, the market is a voting machine but in the long run it is a weighing machine."

At present political and social headlines dominate the votes of investors. Yet over time the strong underlying value of solid companies will shine through.

ECONOMY & MARKETS by Jason Ware

We are now halfway through 2022, and what a six-months it has been. Markets have grappled with several key macro items: Omicron, snarled supply chains, inflation, rising rates, war, and now recession fears. Consequently, it's no surprise that stocks coming into these worries headlong and at record highs (with elevated valuations) have faced significant volatility and a sharp drawdown. We are firmly in a bear market as a result. The worst start to a year since 1970. Yet from our perch the economy is likely not currently in recession (despite what Cathie Wood, Elon Musk, or others profess) leaving us asking the chief question: will we *soon* go into recession? Beyond the obvious economic importance of that inquiry, as it pertains to equities history instructs that *if we do* prices probably have further protracted downside ahead. But *if not*, if we avoid recession, then the worst of the bear's roar may be behind us.

Given this view, it's practical to ask – what will determine if we hit or elude recession? Well, in a word … the Fed (OK, two words). In our judgement, if not for the central bank *intensely* tightening monetary policy the health of the American business cycle *on its own* appears sturdy. On balance the consumer is solid, companies are too, enterprise investment is stable, and while clearly slowing ("normalizing") prior to Powell's pivot, the macro economy was poised to "settle into" a structural path not unlike the prior economic expansion (i.e., below trend growth, but still growth). However, that's not where we find ourselves. At the moment, the economy isn't left to fulfill its own destiny. Instead, the Fed's newfound determination to crush inflation means ratcheting rates at an *exceedingly* fast pace (swiftest in decades) carrying with it real implications. As Minneapolis Fed president Neel Kashkari recently observed, "*we are removing accommodation even faster than we added it at start of Covid pandemic.*" What's become evident is this situation will continue, even if it means tipping things into recession. Mr. Powell does not wish to be the first Fed chair in five decades to let the inflation genie out of the bottle. And while they'd surely prefer a "soft landing", Powell's *unconditional* inflation battle makes it ostensive their willingness to hard land the economy to accomplish that goal. This



"Fed policy error" is presently the largest *known* risk, and unfortunately there's noted historical precedence.

Meanwhile, markets are doing the work of repricing for the current environment, in both stocks *and* bonds, and it's not fun. The good news is we're already well underway in this process. A regular cleansing practice that restores longer run health and balance. The bad news is we may not be at the end, despite the damage that's already been done. Against this backdrop we have oversold conditions. Across sentiment indicators, technical metrics, breadth, and more the equity market – prone to extremes in both directions – appears overdone to the downside (for now). The result of such extremes can produce "bear market rallies." These bounces can be strong; moments representing "a bottom" in stocks and feelings of relief among the investor class. Nevertheless, we reason that "the bottom" will only materialize once markets feel confident that inflation has peaked, replaced by durable *disinflation*. Inflation is the crucial variable because if (when) it begins to fade the Fed can back off raising rates. Orchestrating this more dovish tenor thereby lessens recession risk and takes pressure off rising yields, the dual concoction ailing equities. Essentially, fix inflation and we fix financial markets.

This prospect brings a soft landing into view. Though to be clear, it's easier said than done; one of many potential outcomes. The Fed is trying to thread a needle and the outlook remains uncertain. Encouragingly, there are a variety of signs that inflation is moving, albeit slowly, in the right direction. In the absence of further shocks splashing over the transom, and with a bit of luck, we remain sanguine on the path forward.

As Josh Brown recently avowed…

"*Someday things will start looking up. Some of the cautious or panicked behavior of today will end up looking silly through the perfect lens of hindsight. 'I could have bought Starbucks at $70! I could have bought Home Depot in a -40% drawdown!' It'll happen. But we must find a way to get from here to there. Here being the mushy middle, where decision making is hard and abstinence from further risk-taking just feels right.*"

Admittedly, it's a terse summary around a complex set of issues. But it leaves us with the *most important* question of all: how do we manage this tricky landscape? At the top of the stack, arranging the proper asset allocation for your goals, timeline, and risk profile is paramount. Second, we diversify. Wall Street loves to debate value vs. growth, domestic vs. international, this sector or that, but the simple fact is sensible diversification is *always* in fashion. And it's episodes like now that highlight this concept's eminence. Next, we own great companies (investments). Quality businesses with skillful management teams sporting wide moats, scale, dominant positioning, pricing power, robust revenues, cash flows, returns on capital, and score well on the balance sheet. Finally, we behave ourselves. As we often say, investment *behavior* matters as much as investment analysis. After all, what good is a sound portfolio of securities if we can't stick with it? Successful investors think and act long term. Do not let ten-year money become ten-minute money borne by the discomfort of lower prices and a more ambiguous short-term outlook.

So that's the playbook. And history, both broadly defined as well as our own 40 years of experience, teaches that following this playbook works. Hence, we'll carry forward under this framework continuing to prudently manage your wealth with time-tested principles. We will also, when possible, capture enterprising opportunities amid the bear rubble to complement the portfolio strategy. Thanks for your unrelenting trust in us.

PLANNERS CORNER by Patrick Lundergan

A critical part of financial planning involves addressing the possible risks someone may face in their lifetime. When the outcome could be financially catastrophic, we recommend insurance as it is an excellent tool for low probability – high consequence events. Generally, health, life, disability, and auto insurance are must-haves. So, when a friend jokingly asked me if it's possible to buy insurance for retirement, I laid it out for him. Retirement is a high probability – high consequence event. It is something to save and plan *for*, not insure *against*.

The insurance industry does offer annuity contracts which in some instances may be a piece of a comprehensive savings and investing plan. While not insurance in the traditional sense one can pass some of the risk of outliving assets to the insurer. Yet there are a few simple reasons annuities are not on every advisor's "must-have" list. In return for the promise to pay for life, they require purchasers to pay high fees and commissions, accept low or in some instances negative returns, and endure lousy lock-up periods while retaining limited control over their investments. Further they typically require the purchaser give up the asset in favor of the promise of an annual cash flow. On the other hand, proper asset allocation is on every advisor's "must-have" list. The appropriate asset allocation can provide superior returns, intelligent downside protection, retained ownership of assets, and flexibility across time.

Asset allocation is an investor's mix of investments which may include categories such as stocks, bonds, real estate, closely held businesses, and cash. The proper allocation should align with individual goals and time horizons while considering risk tolerance and capacity. Risk tolerance addresses how much risk someone is willing to take. Risk capacity is understanding how much risk they can afford to take. Marrying these two risk categories into an appropriate asset allocation creates a way to stay on course in scary markets.

No matter how often I see the markets decline as they have in 2022 - it feels like the first time. There is always something to point to that makes the more recent iteration different, scarier, worse. It's amplified for those approaching a financial milestone, like funding college or retirement. Yet I can't remember even a fraction of the 10%-20% drops I have seen - although they occur, on average, once per year. Currently, I can point to the rapid transition from a low rate, low inflation environment to high inflation, high-interest rate environment. We are navigating disease, war, and aggressive monetary policy - all of which can make this time feel different and more significant. When uncertainty permeates almost all aspects of our reality, it's best to rely on a plan instead of hitting the panic button. In the case of personal finance and investing - asset allocation is our north star; in many ways, it is our insurance policy against market risk events.

Defining how much risk someone can handle emotionally (risk tolerance) is a more accessible, albeit subjective, measurement when compared to evaluating how much risk they can take (risk capacity). Participation in the financial planning process is the most effective way to extract the information needed to measure risk capacity. It can help determine if someone's appetite for risk aligns with their current situation and future goals. The ultimate benefit of financial planning is coming up with a roadmap for financial goals and then changing and adjusting behaviors, when necessary, based on what is happening

in real time rather than at an arbitrary age or life event. Ultimately, we are building maps with a start point, path, and destination, but the path and destination are constantly changing due to an evolving landscape. We can better navigate the unknown path with the correct asset allocation as our compass.

ALBION COMMUNITY UPDATE

We are delighted to announce that Adam Haynes has joined the firm as a Financial Planner to work on a team with Advisors Dani Gregory and Sara Dewey. Adam will perform cash-flow planning and provide clients with financial clarity by better understanding their financial goals, investment time horizons, and risk tolerances. He is Albion's third Brigham Young University alumnus and we welcome him to our community!