FORTHRIGHT PARTNERS, LLC

Investment Letter, Second Quarter 2022

EXECUTIVE SUMMARY

Our 2022 investment strategy remains the same: defensive, opportunistic, flexible.

Recession is the least of our worries.

Valuation does matter.

Long-term challenges: a changing regime, debt, low population growth…

THE CONTINUED UNRAVELING OF THE VIRTUOUS CYCLE – A REGIME CHANGE

As we noted in our first quarter investment letter, the global regime that had been in place over the past 50 years driven by free trade, relative world peace and technological progress continues to disintegrate. We believe the new regime will be more regionalized and conflict-prone but shaped by common challenges such as decarbonization and low population growth.

Russia's invasion of Ukraine, now in its sixth month, not only caused unfathomable suffering for the Ukrainian people, but also food and energy insecurities for the entire world. Investors have been pummeled by 40-year high inflation numbers, and global stock markets have retreated roughly 20% in the first half of the year. The real hardship, however, is being borne by global citizens in the lower economic echelon who are disproportionally impacted by rising food and energy costs.

Declining standards of living caused by inflation has many implications. It can lead to political upheaval and reactionary policy changes because of a disenfranchised citizenry. While potential political fallout is beyond the scope of this letter, we are cognizant of the risks posed by unexpected policy/government changes.

ECONOMIC CYCLE

Thus far, global stock markets have focused on the negative impact of inflation and rising interest rates on economic growth. This year's market weakness has been driven by a combination of rising interest rates, recession fears and valuation compression. Economic growth has clearly slowed and the bond market is pointing to a potential recession (please see Second Quarter Market Highlights). The upcoming earnings releases will shed light on companies' financial health given rising labor/material costs and slowing demand.

Recession, the least of our worries?

The US entered its last recession in 2009 following the financial crisis. That was thirteen years ago. Younger generations may not have experienced a recession (and 3%+ mortgage rates) before. For the rest of us, recession is part of a natural business cycle and a relatively short-term phenomenon. The stock market is a leading indicator of economic health; thus, this year's price decline is likely discounting recessionary risks. However, we continue to face many uncertainties: ongoing geopolitical conflicts and resultant inflationary pressures, new COVID variants, high sovereign debt levels…

"History doesn't repeat itself, but it often rhymes."

Mark Twain

A WORLD AWASH IN DEBT

Many of us are not old enough to remember the days when Sri Lanka was better known as Ceylon. The island nation off the coast of India, known for their tea and cinnamon, received its independence from Great Britain some 70 years ago. The country of 22 million is in economic and political turmoil, having collapsed under the weight of a pandemic-driven tourism freeze combined with policy mismanagement and political corruption.

The country owes foreign creditors $50+ billion and cannot make interest payments on that debt. Their local currency has fallen 80% and they have no money to pay for imported food and gas. To avoid further economic devastation and political chaos, they are feverishly working with foreign creditors, primarily the IMF, the G7, China and India, on emergency relief measures.

Sri Lanka is not alone, as close to 20 other emerging market nations are undergoing their own respective debt crises. Even though these countries are very small and will unlikely cause any meaningful financial contagion, with interest rates across the globe going up, it poses a higher risk of global political instability in the short-term.

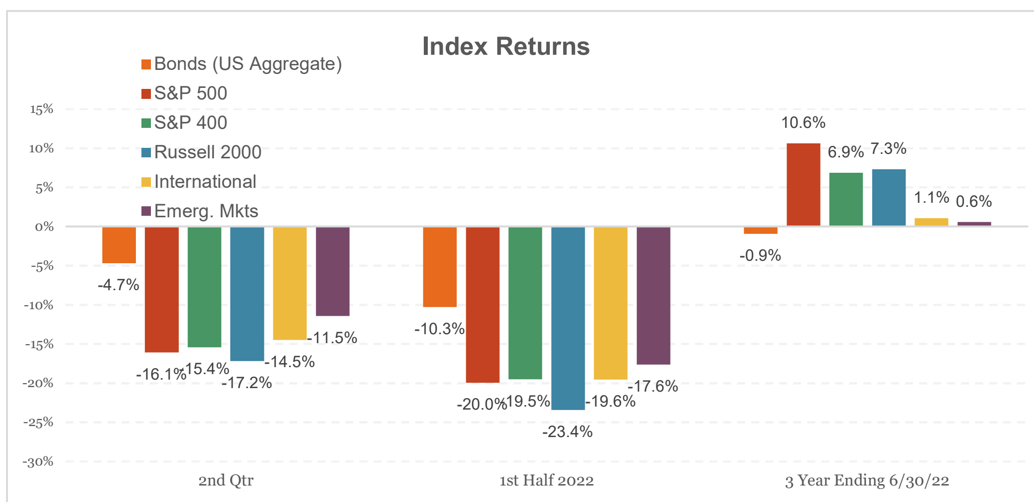
Developed countries also carry a lot of debt. The debt-to-GDP ratios are 240% for Japan, 124% for the US and 99% for France. If interest rates continue to rise, governments will have to spend more and more of their budgets on interest costs. This is a potential longer-term problem. There are ways to tackle high debt, but they mostly entail higher taxes, lower benefits and lower economic growth. It is as much a social issue as an economic issue.

INVESTMENT STRATEGY

The key elements of our investment strategy for 2022 (defensive, opportunistic, flexible) remain unchanged. We are slightly underweighted in stocks. The tremendous volatility in the stock market has provided us with a few attractive opportunities. We continue to trim more expensively-priced stocks to make room for quality companies that trade at more modest valuation levels. In this uncertain environment, valuation does matter. On the fixed income front, we continue to favor short-term bonds, which allow us to re-invest at higher rates in a rising interest rate environment.

SECOND QUARTER MARKET HIGHLIGHTS

After a volatile yet relatively "benign" 1st quarter, the proverbial bottom fell out of the markets in the 2nd quarter. In fact, it was the worst 1st half since 1970. There was nowhere to hide, as bonds were down 10% and most equity indices fell 20% year-to-date. Sectors most exposed to high-growth fully-valued companies and shaky consumer spending fared the worst (Technology (20.4%), Communications (20.8%), Consumer Discretionary (26.3%)). Many of the pandemic trades that had done so well in 2021 due to low interest rates and speculative froth suffered even greater losses. Names such as Snap, Shopify, Zillow and Zoom have experienced declines of 60% or more over the past 6 months. On the other hand, there are signs that the value segment of the markets is separating themselves from the growth segment after underperforming for the past 3 years, perhaps indicating that reasonably-priced companies with strong balance sheets and operating fundamentals will weather the concurrent economic and political storms better than their more expensive brethren. The Staples, Healthcare, Energy and Utilities sectors all meaningfully outperformed the aforementioned sectors.



The Fed Reserve's outsized rate increases have resulted in greater expectations of a recession. Currently, the 2-year Treasury rate stands at 3.2% and the 10-year Treasury rate yields 3.0%. This "yield curve inversion" (short-term rates higher than long-term rates) is often a reliable signal of a recession. With a Federal Reserve that is bent on "taming the inflation tiger" and ongoing geopolitical risks, the investment landscape remains challenging. However, the widespread carnage in the stock market this year has created interesting opportunities for long-term investors. It will not be smooth sailing, but patience is often rewarded. After all, even with a 20% loss this year, the 3-year annualized returns for the US stock markets remain firmly in positive territory (Large-cap +10.6%, Mid-cap +6.9%...). To quote Warren Buffett, "Be fearful when others are greedy, and be greedy when others are fearful." This is the time to find good companies selling at reasonable prices.

CONTACT INFORMATION

Baoky Vu, bnvu@forthrightinvestments.com

Beverly Kelly, bwkelly@forthrightinvestments.com

Hong-Tsun Simon, CFA , htsimon@forthrightinvestments.com