Gore Capital Management

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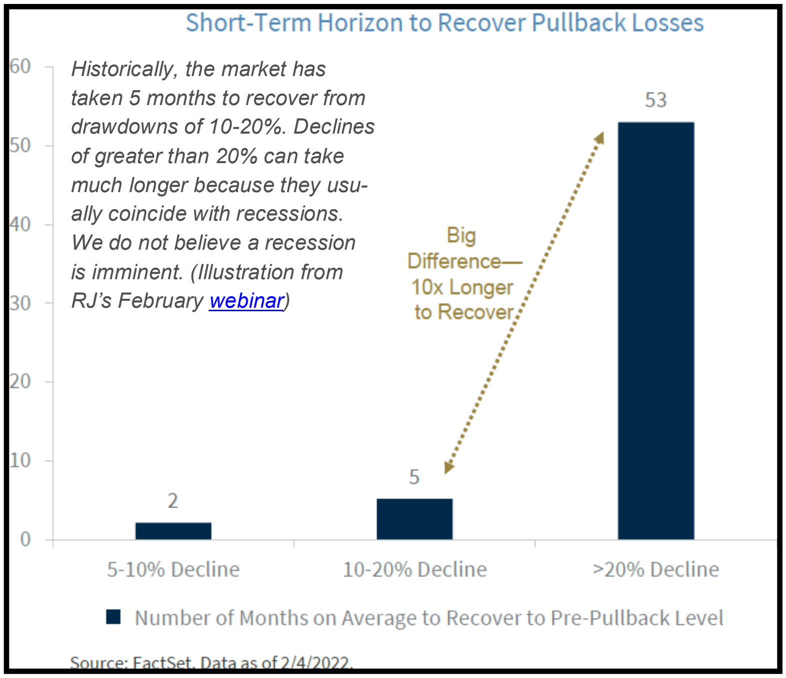


The volatility experienced almost immediately after the year began threw many for a loop. We had all just enjoyed a very strong 2021 and many late-year projections were for continued growth. At the time of this writing, the S&P 500 is approximately 5% below the all-time high it reached on January 4th, having made up a little bit of ground from the near-10% decline suffered mid-month. As we emphasized in our late January letter, it's important to remember that market volatility is normal; drawdowns of 10%+ have occurred, on average, at least once a year. While we can't predict where we go from here, we can assess the data and make some fact-based observations.

As always, to earnings first. We're not quite finished with this quarter's earnings results; a little over half of S&P 500 constituents have reported results for the fourth quarter of 2021, but the companies that have reported thus far are the most significant contributors to the index. Think Amazon, Google, Microsoft, and so forth. Although there have been a couple of high-profile misses (looking at you, Facebook), the majority of earnings reports have been very strong. Of the companies that have reported, 76% have beaten earnings estimates by an average of 8.2%. If these figures hold, year-over-year growth in earnings will exceed 25% for the fourth straight quarter. For the full calendar year 2021, corporate earnings are expected to have grown in excess of 45% versus 2020 (Factset). You may say that these figures are somewhat skewed by the poor results of 2020, and that's true. However, calendar year 2021 earnings are estimated to exceed calendar year 2019 earnings (the pre-pandemic record) by about 36%. (YCharts). Put into context, the market's strong performance over the past 18 months starts to make sense.

That's not to say there aren't some yellow flags. Valuation, a subject we've covered a number of times over the years, suggests stocks are overpriced compared with history. According to Factset's most recent calculations, the forward price-to-earnings ratio for the S&P 500 is now a hair under 20. While this is down from 21.3 in December and a post-COVID peak of around 24 achieved in late 2020, the five-year average P/E for the market is around 19 and the ten-year average P/E is around 17 (Factset). This means that investors today are willing to pay, on average, 15%+ more for a dollar of earnings than they were just 10 years ago. Why? Though market forces can be complex, we believe there are at least two very simple reasons.

First, the composition of the S&P 500 index looks very different today. The technology sector, which often carries higher valuations due to its growth profile, now represents more than a quarter of the index. Just 15 years ago, lower-growth (and lower valuation) industries such as banks, energy, and industrials, represented more than 40% of the index, roughly double the percentage they represent today (dws.com). As higher-growth stocks continue to take a larger slice of the pie, it's natural to see average valuations rise alongside.

Second, all markets (stocks, bonds, flea) are driven by supply and demand. With bonds and cash paying low rates of interest, demand for stocks is high. Stocks currently offer attractive yields in the form of dividends plus the prospect of growth. An increase in demand for stocks naturally drives prices higher. Since rates are forecast to rise slowly and steadily over the next few years, we believe this trend will continue to limit the attractiveness of assets like bonds and cash and may justify higher valuations for stocks.

Market Statistics	Jan '22	YTD	2021	3-Year Annl.	5-Year Annl.
S&P 500	-5.17%	-5.17%	28.71%	20.71%	16.78%
Dow Jones Ind. Avg.	-6.66%	-6.66%	18.37%	15.91%	13.41%
Russell 2000 (Small Cap)	-9.64%	-9.64%	14.49%	11.58%	9.28%
MSCI EAFE (Foreign)	-4.83%	-4.83%	11.26%	9.34%	7.85%
MSCI ACWI (Global)	-4.91%	-4.91%	18.54%	15.42%	12.64%
MSCI Emerg. Mkts. Equity	-1.89%	-1.89%	-2.54%	7.19%	8.30%
Barclay's Aggregate Bond	-2.15%	-2.15%	-1.54%	3.67%	3.08%
iShares Gold ETF (GLD)	-1.40%	-1.40%	-4.14%	10.26%	7.73%

Source: Morningstar, as of 2/1/22

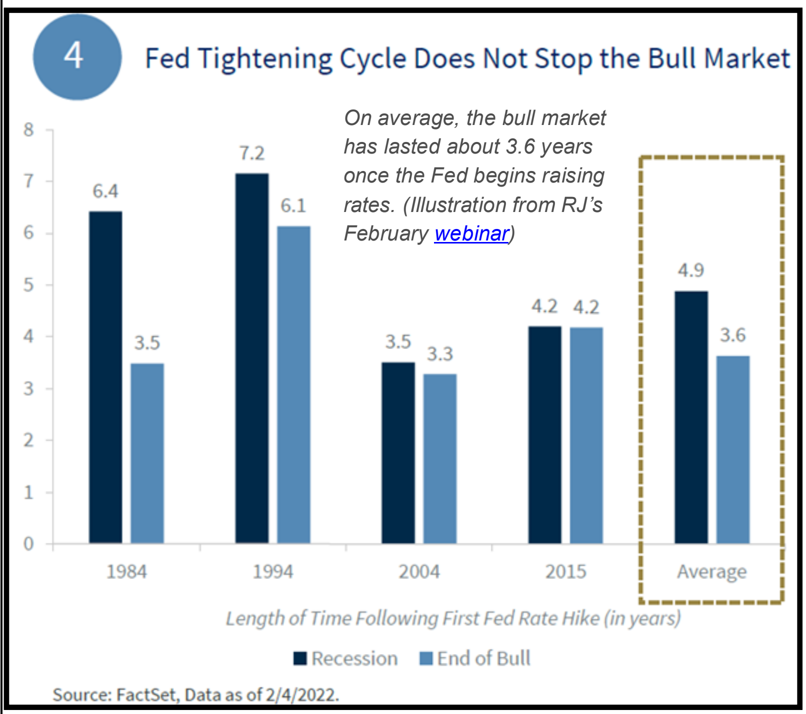
Onto our "big story" for the quarter. Inflation, and the Federal Reserve's response to inflation, represents perhaps the biggest wild card which will influence market performance through the rest of the year (and probably beyond).

The Federal Reserve has a "dual mandate" of price stability and full employment. Full employment is typically considered to be achieved when the unemployment rate is around 4%. Price stability is typically recognized as an inflation rate of around 2%. The Fed has allowed inflation to run "hot" (above their target) for some time now in order to encourage economic expansion and bring the rate of unemployment down. Now that unemployment has been holding steady around 4% for the past few months and inflation is proving to be more persistent than many initially expected, the Fed must turn its attention to combating rising prices.

Year-over-year inflation for January 2022 was reported to be 7.5%, slightly over expectations and well over the rate of inflation we saw for calendar year 2021 (about 6%)(BLS). Many economists are still blaming the supply chain issues for much of the pricing pressures we're experiencing, and there is a fair bit of data to support this thesis. The current consensus forecast seems to be for inflation to begin to moderate after the first quarter of this year. However, consumers are starting to become skeptical that inflation can be brought under control. Yale professor Robert Schiller recently wrote an op-ed in the New York Times about the impact this mindset can have on the economy. In the interest of keeping our newsletter short, we won't discuss it here but it is encouraged supplemental reading (link here).

The Federal Reserve has two primary tools to influence the economy: quantitative easing (buying bonds, usually Treasuries, from banks and giving them more cash to lend to their customers/borrowers) and the discount rate (the rate at which the Fed lends money to banks). The Fed announced a few months ago a plan to significantly reduce their quantitative easing program, an action which most people seem to agree makes sense. The Fed has also said they plan to begin raising the discount rate in March and there is a very real concern that they will either a) raise the discount rate too quickly to stave off inflation that is naturally moderating on its own, or b) not raise the discount rate quickly enough as inflation becomes unstoppable. They will have to thread a very fine needle to get this right.

We believe they can get it right. The Fed has demonstrated what they call a "data driven approach" to making decisions and they have *a lot* of data. Raising rates a little is not a bad thing; the fact of the matter is that our economy is robust and businesses can handle higher borrowing costs. Historically, rising rates have not necessarily killed bull markets. Most importantly, raising rates now gives the Fed the ability to lower rates in the future when the economy needs some support.



We have entered a challenging time for markets. Economic growth and corporate earnings are strong and are forecast to remain strong, but Fed activity and inflationary pressures have investors nervous. Investors tend to cause extreme price swings when they're nervous. On the balance, we remain "cautiously optimistic" that the market can finish 2022 higher than where it started the year, but we believe it will be a volatile ride to get there and the outcome will be heavily dependent on interest rates and inflation (throw never-ending COVID in there as well). As always, we can't emphasize enough the importance of reviewing your risk tolerance and ensuring you are comfortable with your portfolio's composition. If you have any questions on this or would like to review your unique situation in detail, please don't hesitate to reach out.

Ben's Corner

My editorial column has always sought to explore the most pressing issues of the day. I can remember examining the taste and cost differences between store-brand peanut butter and Jif®, as well as several high-profile capers including one in which the criminal attempted to pass off a million-dollar bill as genuine. One wonders how I've remained so well-adjusted despite the gravity of the subject matter I cover and the lengths to which I will go to extract the truth. Jokes aside, this quarter's theme poses a question which I think merits genuine substantive discussion: should members of Congress be allowed to trade stocks?

A little background first. Back in 2012, Congress passed the STOCK Act (Stop Trading on Congressional Knowledge… they love acronyms). The law states, "that a Member of Congress and an employee of Congress may not use nonpublic information derived from such person's position as a Member of Congress or employee of Congress or gained from the performance of such person's official responsibilities as a means for making a private profit." (Congress.gov) Sounds reasonable enough. The law also requires members of Congress to disclose their investment transactions no more than 45 days after they occur. The problem is that the standard fine for violating the STOCK Act is $200 (that's right, TWO HUNDRED DOLLARS), which can be waived by a Congressional ethics panel (Business Insider).

On January 24th 2020, Georgia Senator Kelly Loeffler attended a briefing on the Coronavirus pandemic which was exclusive to members of the Senate Committee on Health, Education, Labor, & Pensions. Between January 24th and February 14th of 2020, Loeffler and her husband (who happens to be the CEO of Intercontinental Exchange, the parent of the New York Stock Exchange), sold several million dollars of their stock holdings while also buying the stock of Citrix, a company involved in remote work technologies. You'll note that the COVID-induced market selloff didn't really begin until February 21st or so. Although the story got a few headlines at the time, the Senate Ethics Committee later determined Ms. Loeffler had not violated federal law and the Department of Justice announced they would not be pursuing a case. Other members of Congress who were accused of trading stocks before the extent of the Coronavirus pandemic was widely understood include Dianne Feinstein and Richard Burr (CNN).

The SEC defines a corporate insider as, "an officer, director, 10% stockholder and anyone who possesses inside information because of his or her relationship with the Company or with an officer, director or principal stockholder of the Company." The SEC requires insiders to file publicly-available documents when they engage in transactions of their company's stock, in most cases within two days (not 45) of the transaction (SEC). Corporations will often adopt much stricter policies, including pre-clearance of trades in company stock and/or approved "windows" during which trades may be made, in order to avoid even a whiff of impropriety.

Insider trading is defined as, "buying or selling a security...while in possession of material, nonpublic information about the security" (SEC). Penalties for violating insider trading laws are stiff and can include hefty civil fines, jail time, and even a lifetime ban from participating in securities markets. The DOJ and SEC are well-known for hammering the wealthy elite (the non-Congresspeople ones, at least) who get caught with their hands in the cookie jar. Martha Stewart famously spent 5 months in jail, another 5 months under house arrest, and paid fines of more than $200,000 over insider information which allowed her to avoid a loss of about $45,000 on a stock in her portfolio.

Members of Congress sometimes possess material nonpublic information about a specific company (for example, some government contracts), but frequently possess material nonpublic information about industries (a hypothetical drug pricing bill) or the stock market or economy as a whole (like the Loeffler, et al. story). For these reasons, I think they meet the SEC's definition of "insiders." Even if they're not CEOs of publicly-traded companies, they are most certainly officers and directors of the United States of America and have access to nonpublic information about its business affairs. The unique type of information they possess necessitates a broader definition of what constitutes insider trading which goes beyond the SEC's take. I think the prohibition outlined in the STOCK Act and quoted above covers this broader definition adequately. However, the Act is not being enforced properly and the penalty for violating it (assuming one is assessed at all) is hilariously miniscule.

So, we've confirmed there is a problem but how do we go about answering the question? I admit my coverage of this story is biased (that's the great part about an editorial!). I tend to take ethics, especially around financial matters, pretty seriously. Beyond that, I have a dim and distrustful view of politicians. However, I also acknowledge that members of Congress are participants in our great capitalist experiment just like the rest of us. Whether or not individual stock trades continue to be allowed, Congresspeople clearly need more scrutinous (and independent) oversight, heightened disclosure requirements, and meaningful penalties for violations - akin to how corporations and the SEC handle insiders. News has recently broken that Congress is considering some edits to the STOCK Act. I'm glad to see this, but my cynical side can't help but think they'll figure out a way to leave themselves generous loopholes. If you'd like to read more, check out Unusual Whales, a blogger who tracks Congressional stock disclosure forms and wrote a report on their activity last year.

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