THE PRUDENT SPECULATOR

2022 Outlook Mid-Year Update

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To say that 2022 has been a tough year in the financial markets would appear to be a major understatement. After all, the S&P 500 tumbled 8.4% in June, skidded 16.5% in Q2 and plunged 20.6% in H1. Not surprisingly, the media was quick to trumpet that stocks posted their worst first half of the year since 1970. This sounds far more dramatic than stating that June marked the biggest downturn since the 8.8% drop in the S&P in April 2022 or that the second quarter was the weakest since that venerable index's 20.0% devastation in Q1 2020.

To be sure, the press must sensationalize almost everything these days to attract eyeballs, so we suspect that there is an outsized media impact on the mood of investors. Incredibly, the weekly Bull-Bear Sentiment Survey from the American Association of Individual Investors (AAII) recorded two of its seven most Bearish readings in its 35-year history in Q2 2022, with the level of negativity trailing only four tallies in the last trimester 1990 and March 5, 2009. Interestingly, those were all fantastic weeks to be buying stocks, not selling, as the average gain for the Russell 3000 index (R3K) over the ensuing six months was 30.5%

We also note the latest read on the Univ. of Michigan's Consumer Sentiment gauge was the lowest in its history...worse than when inflation was in the double-digits in the early 1980's...and after the Crash of '87...and after the Gulf War Meltdown of '90... and after 9/11...and at the end of the Tech Wreck...and during the Great Financial Crisis...and after the downgrade of the U.S. credit rating. Believe it or not, the prior 8 cyclical lows, on average, proved to be great times for long-term-oriented investors to be adding to their equity exposure, with Value stocks soaring 34.1% on average over the next 12 months.

We realize that the paper losses suffered this year are painful, with the average stock in the Russell 3000 index down 22.1% in the first half of 2022, but market volatility is normal, and the magnitude of this decline is hardly unusual. Indeed, the average stock plummeted 40.5% during the R3K's six-week peak-to-trough 02.19.20 to 03.23.20, 24.6% from 09.20.18 to 12.24.18 and 23.6% from 06.23.15 to 02.11.16.

Of course, different from prior downturns, there have been few places to hide this time around as debt instruments endured their worst first six months of a year since the late 18th century, according to analysts at Deutsche Bank, with the U.S. Aggregate Bond index retreating 10.4%. Foreign stocks and bonds also were deep in the red in H1, and those who turned to alternative investments like cryptocurrencies suffered massive losses.

Certainly, we respect that there is plenty about which to worry today, including the war in Ukraine, supply-chain disruptions, inventory management woes, corporate-profit question marks, higher inflation readings and the increased risk of recession, not to mention comments and actions from the Federal Reserve. However, we believe that a significant amount of bad news that may or may not materialize has now been discounted, given the significant pullback, while we think the headwinds will eventually blow less fiercely, as always has been the case after every prior scary selloff. Happily, despite all of the disconcerting events investors have faced through the years, those who have stuck with equities through thick and thin have enjoyed terrific long-term returns over the past 95 years, ranging from 9.6% per annum for Growth Stocks to 13.2% per annum for Value Stocks.

That does not mean that the road ahead won't be bumpy as anything can happen, so our nerves are steeled for more turbulence. We also know it is not easy to dismiss recent comments from Jamie Dimon: "That hurricane is right out there down the road coming our way. We just don't know if it's a minor one or super storm Sandy or Andrew or something like that and you better brace yourself." Same thing goes for Mark Zuckerberg's recent warning, "If I had to bet, I'd say that this might be one of the worst downturns that we've seen in recent history." However, like them, we are investing for the long haul, so we are pleased that the JPMorgan Chase CEO green-lighted a substantial increase in expense spending at the financial titan for 2022 and the Meta Platforms founder will still hire 6,000 to 7,000 engineers at the social media giant this year.

We do not benchmark ourselves to the S&P 500, as the Russell 3000 Value index is a better measure of our strategy, but we look for a much improved second half of 2022 for the broad market, especially as commodity prices have retreated and it would seem inflation may have peaked in June. True, COVID-19 is still with us, many think analyst earnings expectations for the balance of the year are too high and some high-profile hedge funds have gone bust, with near-term negative implications for risk assets the result, but we would not be surprised if the S&P 500 cut most, if not all, of the current losses by year end. Believe it or not, such was the case in 1970, when that year's 21.0% first-half plunge was followed by a 26.7% second-half rally.

Not surprisingly, we continue to favor stocks trading for lower valuation metrics that we have long championed. In addition to the valuation gap between Value and Growth being as wide today as it was at the peak of the Tech Bubble, our study of the historical evidence suggests that higher inflation and rising interest rates have previously coincided with superior performance, on average, for inexpensive stocks versus their pricier peers.

There are no guarantees that history repeats, but we sleep much better at night with the discounted metrics for our portfolios. Believe it or not, TPS Portfolio trades for respective average trailing and next-12-month P/E ratios of less than 12 and less than 11, versus 19 and 17, respectively, for the S&P 500, while the dividend yield comparison is 2.9% to 1.7%.

DON'T BOX US IN: ACTIVELY FINDING VALUE

While equity indexes generally focus on one or a couple valuation measures (e.g. price to book value) to segregate the market into Value and Growth divisions, we have long been equal opportunity stock pickers, focusing not just on backward-looking income statement and balance sheet calculations. Yes, we think these are important, and we will not consider a stock for purchase unless it ranks highly in our proprietary scoring system, but the markets are littered with the bones of stocks that had at one point traded for a single-digit P/E ratio or at a big discount to book value, only to see profits evaporate and assets written down to next to nothing.

We cannot always avoid the so-called Value traps, but we have long added qualitative reviews of our companies to the mix to ensure a viable business model, healthy competitive position, able management and, in the case of many cyclical companies, the wherewithal to make it through to the next upswing. Further, and perhaps most importantly, our Target Prices incorporate our view of each company's long-term growth prospects, so that the stocks we choose to buy offer significant total return potential (capital appreciation and income) relative to the risk we think is inherent in our ownership.

The Prudent Speculator is now in its 46th year and we are always working to evolve our methodologies, but we think our unique and disciplined approach to navigating the equity markets will continue to serve us well as we believe that there is plenty of Value available in individual stock picking. That in mind, we detail seven themes and specific stocks which we think those who share our long-term view should be considering as we head into the second half of 2022 and beyond.

BABIES THROWN OUT WITH THE BATH WATER

Given that the price of the average stock has been in a Bear Market, most stocks have endured significant selling pressure this year, often with little regard for the long-term business prospects or the caliber of the company. No doubt, there are headwinds facing much of Corporate America, but we think there are opportunities today to pick up ownership of higher-quality, well-known companies at attractive price tags.

The quality label is somewhat subjective, but if we look at reasonably priced names with a long-term credit rating from Standard and Poor's of "A-" or better and a share price at the time of this writing down more than 22% in 2022, we would highlight software titan **Microsoft (MSFT)**, asset management giant **Blackrock (BLK)** and diversified healthcare concern **Abbott Labs (ABT)**. Each of those clocks in with a "AA-" or better S&P rating, while we also like "A-" or better **Comcast (CMCSA)**, the media and broadcasting concern, **Air Products (APD)**, the industrial and specialty gases leader, and **3M (MMM)**, the conglomerate with operations in numerous industries.

As dividends are part of the total return equation, we also like that each of these stocks offers a payout, ranging from 1% for Microsoft to over 4% for 3M.

CONSUMERS MAY BE DOWN BUT THEY ARE HARDLY OUT

Obviously, inflation at its highest level in decades has been eating into discretionary income, but consumer spending has managed to hold up reasonably well in 2022. No doubt, an unemployment rate of 3.6%, decent wage growth and substantial savings accumulated over the last couple of year provide consumers with the means with which to keep spending. Indeed, folks have higher-than-average bank account balances and substantial home equity, plus spending had been delayed due to COVID-19 restrictions so we think the consumer is in good shape to weather any potential storm while there is still plenty of pent-up demand for goods and services.

Of course, equity market traders often shoot first and ask questions later, so most everything having to do with the consumer has been hit hard this year on the view that consumer spending will soon dry up. We respect that the near-term is very uncertain, but we think fickle investors will again return to beaten-down consumer discretionary stocks like they did after a COVID-19 purge in 2020. In our view, some of the hardest-hit stocks like discount superstore operator **Target (TGT)**, footwear and athletic apparel merchant **Foot Locker (FL)** and department store retailer **Kohl's (KSS)** are poised to rebound.

And, after going without for so long, we think folks are going to continue to travel, so battered stocks like cruise operator **Royal Caribbean (RCL)**, aviation support firm **World Fuel Services (INT)** and air carrier **Delta Air Lines (DAL)** offer turnaround opportunity, though with a much higher level of potential share-price volatility.

THE FED PUNCHES A HOLE IN THE PUNCH BOWL

With the invasion of Ukraine by Russia, alongside supply chain imbalances from the pandemic and broader price pressures adding to current and expected inflation numbers, Federal Reserve members have sharply increased their estimates for PCE inflation and their targets for the Fed Funds rate. The median inflation projection for 2022 now stands at 5.2% with the year-end forecast for the Fed Funds rate climbing to 3.4%, up from the prior 1.9% estimate offered in March.

In addition to the tapering of the Fed balance sheet, Jerome H. Powell & Co. have embarked on a series of rate hikes, with the 75-basis-point jump in June the most aggressive increase since 1994. What's more, the Federal Funds futures market now is estimating that the second half of 2022 will see another 200 basis points in additional upward rate moves, with the year-end projection for the Fed Funds rate standing at 3.6% as of this writing.

The decidedly less accommodative Fed has led to sharply higher interest rates across bond land, but this should benefit regional banks like **Citizens Financial (CFG)** and **Bank OZK (OZK)** that derive a significant portion of their income from the spread on interest earned from loans versus the costs paid on deposits. True, increases in short-term rates could affect funding costs, but we note that many (if not most) banks in our universe boast significant deposit balances relative to the loans on their books, so they have less of a need to aggressively raise incentives to attract more money.

We respect that many are worried that the Fed will not be able to engineer a so-called soft landing for the economy and that a recession will result, but most bank balance sheets are in fantastic shape, with plenty of loan-loss reserves and low levels of

non-performing assets. In addition, the large money-center banks like **Bank of America (BAC)** and **JPMorgan Chase (JPM)** have diversified revenue streams and reach extending to corporate and municipal issuers looking to finance investment at still relatively cheaper rates, given that the average Fed Funds rate dating back to the 1960s has been 4.9%.

To be sure, volatility in the U.S. Treasury yield curve will often drive daily movements of stocks in the financial sector. Of course, the group outperformed during the last Fed Tapering cycle (2012-2014) as longer-term government bond prices fell and yields rose with Uncle Sam's reduced buying pressure, so we do not want to forget that higher interest rates have also been a tailwind for insurance companies like **MetLife (MET)** and **Prudential Financial (PRU)**.

EV'S ARE ACCELERATING...BUT FOSSIL FUEL IS NOT GOING THE WAY OF THE DINOSAUR

Electric cars are hardly new, first appearing on roads (if they can be called that) in the early 19th century, but they fizzled out in favor of combustion engines due to the need for greater range and higher speeds. Major manufacturers **General Motors (GM)**, Ford and Toyota all took some half-hearted cracks at the technology, but it wasn't until Elon Musk's Tesla came along with a Lotus-based Tesla Roadster in 2008 that EVs started to gain traction.

The discovery, and subsequent fallout from **Volkswagen's (VWAGY)** 'Dieselgate' scandal, triggered a mad dash to develop electric vehicles, which aren't exactly zero-emission (the energy must come from somewhere), but they have promise to improve the business of people-moving on many fronts. Of course, we've kept our eye on Tesla over the past decade but haven't found it to be in the fundamental Value camp—or even close to it—at any time.

Despite starting very far behind, the major automakers are racing to catch up and deploying the capital necessary to make it happen. Fortunately, consumers have noticed and are rewarding the likes of Volkswagen and General Motors in such a strong way that many brands are moving up their 'electrification' plans by years, which is telling, considering carmakers are not known for being nimble. Governments are getting a move on too, funding infrastructure improvements, providing consumer subsidies and offering tax breaks.

The average new car costs more than $40,000 these days, which at a household level could easily be the second-largest expense behind housing costs and deserves attention, but the EV boom does not mean that the conventional energy businesses are dead men walking, especially as more than two thirds of U.S. energy is consumed by a sector other than transportation. The opposite, we think, as lower investment in conventional sources and solid demand have resulted in higher energy prices across the board.

Layering on the massive upheaval in the energy markets from the war in Ukraine and frequent geopolitical spats over production levels and challenges finding new low-cost wells, we expect a flat-demand environment with tightening supply will result in higher prices overall, and therefore enhanced profitability for the likes of **Exxon Mobil (XOM)** and **EOG Resources (EOG)**, which also boast lucrative dividend payouts.

Even the oil majors are advancing new 'green' technologies and the R&D is being fueled by lucrative cash flow from existing revenue that is also utilized to fund generous shareholder capital return initiatives. Still, we think there will for some time to come be millions of new ICE cars driving billions of miles and those cars, trucks and SUVs will not only sell well, but also will need to be powered by gasoline, perhaps supplied by **TotalEnergies (TTE)**, which also is a major player in biofuels, natural gas and green gases, renewables and electricity.

Finally, we think the pullback in shares of lithium producer **Albemarle (ALB)** presents another nice entry point for a power play in the EV gold rush. The specialty chemicals producer just announced plans to build a new lithium processing plant in the U.S. that will double the amount of the EV battery metal that it presently produces.

TECHNOLOGY IS THE FUTURE

The rollout of 5G communications technology should continue to benefit major telecom outfits like **Verizon (VZ)**, which

generally stayed focused on its infrastructure and did not wade into the expensive content war like some peers did. 5G-capable phones are prevalent, often built with **Qualcomm (QCOM)** communications chips, and include the recent generation of **Apple's (AAPL)** iPhones and devices powered by **Alphabet's (GOOG)** Android operating system. City-dwellers should benefit the most in the beginning from the technology's speed advantage, where 5G (or 4G in some cases) is easier to deploy than in-ground connections in rural areas.

We expect to see renewed interest in **Digital Realty Trust (DLR)**, an owner and manager of data centers, **Cisco Systems (CSCO)**, a designer of network switching equipment, and hard-disk manufacturer **Seagate (STX)**. And we think there is tremendous value in the semiconductor space, especially as investors have pummeled share prices of late on worries that the recent chip shortage is giving way to a glut. The industry has often been characterized by booms and busts, but the average car, for example, is filled with 1,400 semiconductors, with even more going into many EVs, so we think there is little doubt that long-term demand for chips will continue to grow. As such, we continue to believe that inexpensive semiconductor stocks like chip-equipment provider **Lam Research (LRCX)**, as well as chip makers **Broadcom (AVGO)** and **Micron Technology (MU)**, will be long-term winners.

Last, but certainly not least, if "supply chain issues" became the universal excuse of 2021, then "cloud" was a universal winner. Subscription models paired with cloud hardware and software packages proved tremendously profitable for names like **NetApp (NTAP)** and **Oracle (ORCL)**, and we think the impact of a wide-scale technological rotation to on-demand computer processing capabilities will continue for many years.

IT'S A GREAT BIG WORLD OUT THERE

While foreign market performance was healthy in 2021, it generally lagged the major domestic indexes, and returns in the first half of 2022 were abysmal, especially in Europe. As such, we think significant opportunities exist to pick up selected and what we believe to be temporarily very depressed bargains. Diversification by geography is valuable, in our view, and fairly easy to implement, especially with American Depository Receipts (ADRs) traded on U.S. exchanges and foreign operations embedded in the multinational income streams for many of our U.S.-based holdings.

We take advantage of this ability with our ownership in a variety of foreign companies, from German parcel carrier **Deutsche Post (DPSGY)**, which derives 80% of revenue outside the Americas, to French drugmaker **Sanofi (SNY)**, which earns two thirds of its revenue abroad, has a robust therapeutics pipeline and reasonable valuation metrics. We also think the 40%+ bruisings for Dutch medical equipment maker **Koninklijke Phillips (PHG)** and German industrial giant **Siemens AG (SIEGY)** have been way too harsh.

Turning our attention to U.S.-based corporations, heavy equipment maker **Caterpillar (CAT)** gets more than half of total sales abroad, with the company likely to continue to benefit from increases in end-market demand. Finally, staffing services provider **ManpowerGroup (MAN)**, which derives 67% of its revenue from Europe, has deftly navigated through previous expansions and contractions across the Continent, rewarding shareholders with sizable profits and generous dividends through thick and thin.

GOOD THINGS COME IN SMALL (AND MID) PACKAGES

While small capitalization stocks (defined as the smallest 2,000 companies in the broad-market Russell 3000 index) had enjoyed very good performance over the first nine months of 2021, the nine months since have seen a sharp pullback. The declines have added to the returns gap with the large-cap Russell 1000 index, expanding the valuation disparity between the two and creating more chances to pick up overlooked gems.

Our all-cap value flagship strategies include small and mid-cap names, but we also offer our asset management and wealth management clients a Small-and-Mid-Cap Dividend (SMiD) managed account strategy. The forward P/E ratio on the SMiD portfolio is near 9, compared with 17 for the Russell 1000 index and 13 for the reasonably priced Russell 1000 Value index.

Considering our SMiD strategy, a few names we highlight for 2022 and beyond are electronic component distributor **Avnet (AVT)**, regional bank **Eagle Bancorp (EGBN)**, construction equipment maker **Terex (TEX)** and recreational vehicle manufacturer **Winnebago (WGO)**.

Spanning our ValuePlus and Dividend Value strategies, we favor *Prudent Speculator* recommendations like energy concern **Civitas Resources (CIVI)**, specialty retailer **Dicks Sporting Goods (DKS)**, industrial battery producer **Enersys (ENS)**, railcar manufacturer **Greenbrier Cos (GBX)**, optical and photonic product supplier **Lumentum (LITE)** and homebuilder **MDC Holdings (MDC)**.

While historically more volatile, we like small- and mid-cap stocks for their enhanced upside potential, in addition to the generally less expensive valuations. Our go-anywhere approach allows us to find Value across the equity universe and we think the SMiD pond is presently a well-stocked one in which to fish.

CLOSING

Those that have been reading these semi-annual Outlooks should not be surprised to see that our themes changed little. After all, we are buying our undervalued stocks for their three-to-five-year or longer potential, with the intention of holding them through a business cycle or two. We think the market is offering those with long-term time horizons substantial opportunity as evidenced by the litany of names mentioned above, while most offer generous dividend payments, with that income helping investors better navigate the inevitable volatility of the share prices.

Of course, one must still construct a diversified portfolio of these stocks, so we offer the reminder that we have wealth and asset management services available. After all, we have long thought that the secret to success in investing is not simply to select good stocks, but to not get scared out of them.

Vannevar Bush said, “Fear cannot be banished, but it can be calm and without panic; it can be mitigated by reason and evaluation,” so for our newsletter subscribers and managed account clients, we make good use of our nerves of steel by offering extensive written perspective each week on the goings on in the equity markets. Indeed, we have made money over the years from our stock holding as well as our stock picking.

For additional information about subscribing to the *The Prudent Speculator* newsletter, please call Phil Edwards at 800.258.7786 or email pedwards@kovitz.com.

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The dividend-weighted portfolio data is from Eugene F. Fama and Kenneth R. French. The dataset is broken into five groups: non-dividend paying, top 30% of dividend payers, middle 40% of dividend payers, bottom 30% of dividend payers and all dividend payers (weighted 30% of top dividend payers, 40% of middle dividend payers and 30% of low dividend payers). The capitalization and factor-based (book value-to-price) portfolio data is from Eugene F. Fama and Kenneth R. French. The dataset is broken into four groups: large value, large growth, small value and small growth. The aggregate Value and Growth porfolios are monthly averages of the two returns.

The Standard & Poors 500 index (S&P 500) is a broad stock market index based on the market capitalizations of the largest 500 companies listed in the U.S. Small company stocks, via Ibbotson Associates, are the bottom twenty percent of the New York Stock Exchange. Large company stocks, via Ibbotson Associates, are represented by the S&P 500 index.

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