



AUGUST 2022



John Buckingham
PRINCIPAL
PORTFOLIO MANAGER



Jason R. Clark, CFA®
PRINCIPAL
PORTFOLIO MANAGER



Christopher Quigley
SENIOR RESEARCH
ANALYST



Zack Tart
PORTFOLIO &
RESEARCH ASSOCIATE

Although the increase in the Consumer Price Index in July was not as high as in June, inflation is front and center in the minds of economists, market watchers and everyday folks. U.S. inflation was ramping up towards the end of 2021 and soared subsequent to the onset of the Russo-Ukrainian War in February. The impact on the stability of European economies was immediate, effects of which destabilized prices and supplies of food, fuel and a host of consumer products. Certainly, price jumps have been noticeable, even as U.S. incomes have risen smartly (5.2% in July) on a nominal basis.

Established as a figure with tremendous impact on policy decisions, consumer behavior and business operating costs, it is less clear in simple terms what “inflation” is actually measuring. In fact, there are two primary gauges of inflation, often used interchangeably despite having different calculation models. Yes, the headline figures generally end up in the same ballpark (which explains some of the interchangeability), but the underlying measurements frequently have wide dispersion.

CONSUMER PRICE INDEX

The U.S. Bureau of Labor Statistics (BLS) defines the Consumer Price Index (CPI-U or CPI) as “a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.” The basket of goods and services evolves over time; the goal is to provide an accurate reflection of consumer spending habits. The latest rejiggering occurred in 2020, using data from 2017 and 2018, which studied 24,000 consumers over the two years, using weekly diaries and quarterly interviews to determine each category’s weight in the final CPI figure.

The Bureau’s process to determine which goods and services to price is based upon a probability-weighted selection of the most popular version of an item. With a specific item determined, it is priced on a monthly or bimonthly basis for four years. A wide variety of types and brands are selected, such that the price reporting can take place across the United States.

With basket components and specific sample items set, the BLS uses U.S. Census data to determine urban areas, then statisticians assign certain items to be priced at specific retail outlets based on samples from the spending habit surveys. The weights are allowed to vary by region based on consumer survey preferences and are a combination of “geographic areas, retail establishments, commodities and services.”

AN ALTERNATIVE

Personal Consumption Expenditures (PCE) is the Federal Reserve Board’s preferred method for tabulating inflation. The figure is calculated by the Bureau of Economic Analysis (BEA). In addition to tracking purchases of new goods and services, PCE includes purchases from the government and for employer-paid items such as health care, life insurance and pension plans. PCE sometimes uses derived values to mitigate noise arising from the way something is carried out, such as rented housing vs. owned or cash payments vs. in-kind transactions.



Three broad categories make up PCE: durable goods (average useful life greater than 3 years), non-durable goods (average useful life less than 3 years) and services (products that cannot be stored or inventoried such as medical care). Periodic estimate data are adjusted for coverage and timing, and are sourced from the Census Bureau, BEA, BLS, Treasury Department and Agriculture Department. To estimate quantities of items purchased, the BEA uses deflation (the statistical technique of taking the current-dollar value of a given component and dividing it by an appropriate price index), quantity extrapolation or direct valuation methods.

Special estimates are a unique feature of PCE and are required to accurately estimate inflation components that are difficult to measure. Key components receiving special attention include purchases of new vehicles (unit sales estimates are provided by R.L. Polk & Co or Wards Intelligence and expenditures are provided by J.D. Power & Associates), gasoline (quantity of fuel purchased for personal use multiplied by the average retail price per gallon for several fuel types), and rental of tenant- and owner-occupied housing (rent paid data is sourced from the American Community Survey and estimates of rent are derived using a rental equivalence approach).

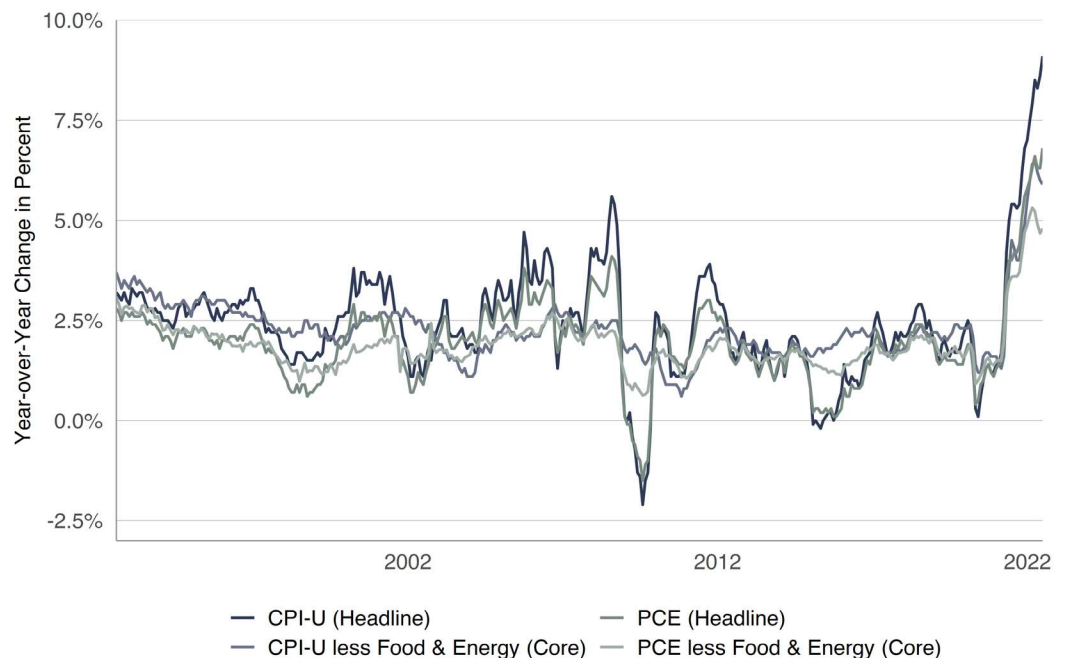
INFLATION COMES IN SEVERAL FLAVORS

In addition to a vast quantity of in-the-weeds tables accompanying inflation press releases each month, CPI-U and PCE come in two flavors. The first is core, which strips out more volatile food and energy factors from the measurement. Core inflation tends to be more stable, but we think it doesn't always reflect the true impact of price level changes being felt by consumers. The second measure, headline, includes everything in the core inflation figure plus food and energy price changes.

In Figure 1, we chart the two versions of PCE and CPI over the past 30 years. Headline CPI-U averaged 2.42%, while the core figure's average was 0.13% lower. On the PCE side, the headline figure averaged 1.98%, while the core's average was 0.08% lower. The darker lines are headline numbers, which in most circumstances are highly correlated with each other. Core inflation, plotted in lighter colors has also exhibited roughly half the volatility (standard deviation) of headline inflation over the past three decades.

Figure 1:
CPI and PCE
Inflation Over Time

From 07.31.1992 through 07.31.2022. SOURCE: Kovitz using data from Bloomberg Finance L.P.





DISAGGREGATED

We disaggregate June's inflation reports in Figure 2 by major category (July's PCE was not yet available as we went to press). The first and third columns are the estimated weights in the inflation index, while the second and fourth columns are year-over-year change in price. Even though we think it takes little away from the overall message, we note CPI and PCE use different categories, resulting in a fair amount of leeway required on our part to bring the table together.

The calculation of each inflation component basket differs between CPI and PCE, but we think the more consequential difference relates to the weights. CPI-U calculates the impact of inflation using a heavy weight in Housing & Shelter, as well as Energy, while PCE is lighter in those two categories and heavier in Medical Care, Financial Services and Recreation.

DOES INFLATION IMPACT ME?

Whether presented as CPI-U, PCE or any derivative thereof, we think broad inflation measures may not reflect one's personal experience. We think it's fairly straightforward to calculate price changes in airline tickets, energy costs and food. However, infrequent transactions for major purchases like housing or auto sales means that the category's inflation figure can be a bit dodgy, and it can also have zero impact (or a major impact).

A household that purchased a new car in Q2-2022 and bought a new house is likely to feel massive year-over-year cost increases, while a household that skipped those transactions and has a fixed-rate mortgage should feel little inflationary pressure. Individual considerations vary widely and are not strictly related to large purchases.

The rising popularity of working from home could potentially lower the inflation bite for those afforded a flexible work setup. The decline in fuel usage for that cohort could potentially be offset by others' desire to get back on the road after being cooped up during the pandemic, thereby raising the inflation bite for those putting more miles on their vehicles. We understand individual circumstances vary widely and think nationwide inflation reports (whether 9.1% for June CPI-U inflation or 6.8% for June PCE inflation) can be useful for broad policy decisions, but do poorly to help individuals understand changes to their monthly expenditures.

Figure 2:
CPI and PCE Inflation
Vary in Many Ways

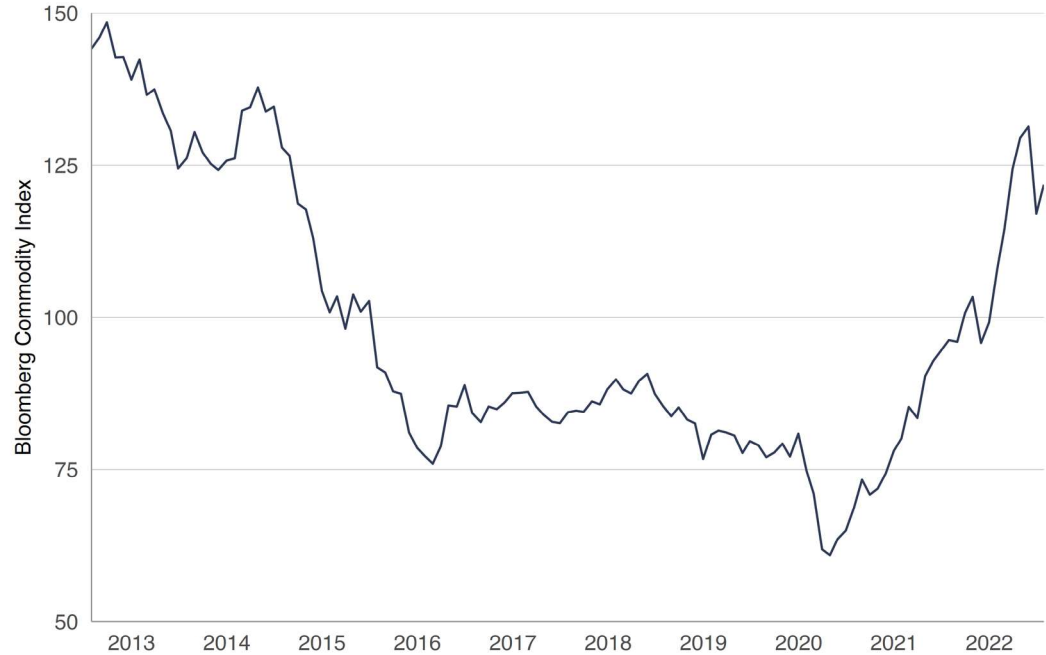
Through 06.30.2022. May not sum to 100 due to rounding. The categories generally default to those used for CPI-U as a baseline, appending PCE categories when deemed useful. For categories with multiple underlying components, a sum of the weights and an average of the year-over-year inflation rates were recorded. SOURCE: Kovitz using data from the Bureau of Economic Analysis (BEA) and the Bureau of Labor Statistics (BLS)

Inflation Calculation Methodology Differences				
Expenditure Category	CPI Weight (%)	CPI Inflation (%)	PCE Weight (%)	PCE Inflation (%)
Inflation, All Items		9.1		6.8
Energy	8.7	41.6	3.0	61.6
Food & Beverages	13.4	10.4	14.7	9.0
Commodities less Food and Energy	21.2	37.5	N/A	N/A
Housing & Shelter	33.8	16.6	20.3	8.4
Transportation	5.9	8.8	7.4	3.7
Medical Care	6.8	4.8	15.7	2.7
Recreation	3.1	4.7	6.9	3.2
Education and Communication	5.3	1.7	N/A	N/A
Financial Services	0.0	0.0	7.6	0.2
Other Goods & Services	1.4	6.7	21.2	4.1
Final Consumption of Non-Profits	0.0	0.0	3.2	8.7
Total Weight	100		100	



Figure 3:
Commodity Prices
Remain Volatile

From 07.31.2012 through 07.31.2022. SOURCE: Kovitz using data from Bloomberg Finance L.P.



INPUT PRICES

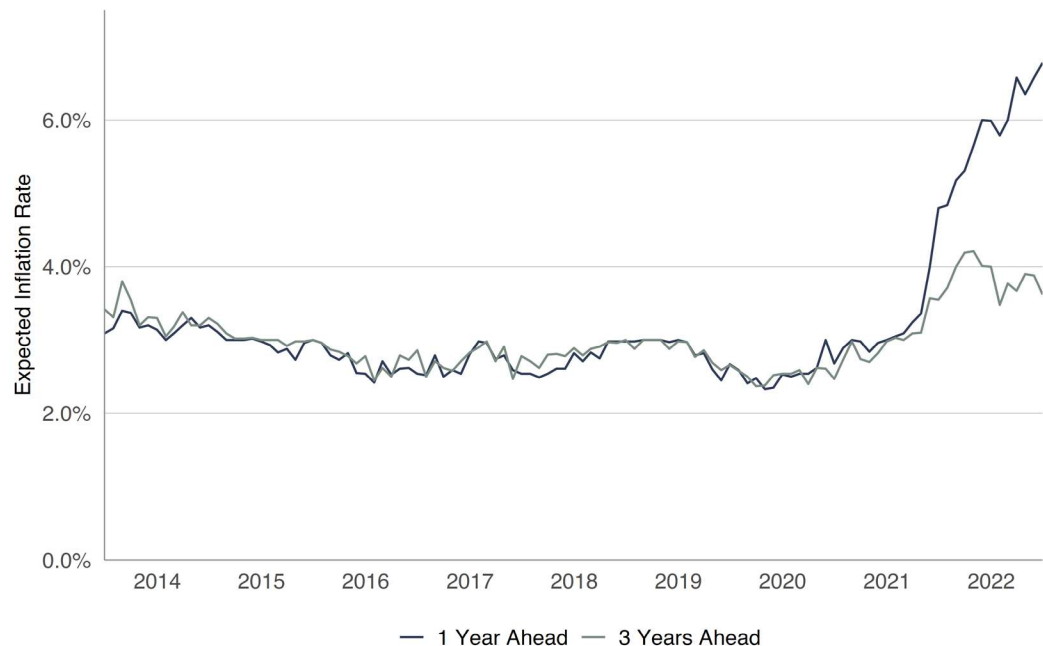
While it hasn't returned all the way to earth, the Bloomberg Commodities (BCOM) index, shown in Figure 3, has pulled back recently. The broadly diversified index includes a 40% weight in Energy (including 20% oil, 15% natural gas and 5% fuel), 29% in Metals (13% gold, 4% copper), 21% in Grains (11% soybeans and 5% corn), 5% in Soft Commodities (2% sugar and 2% coffee) and 5% in Livestock (3% cattle, 2% hogs). No doubt, June and July were volatile months for commodities.

Natural gas futures averaged \$7.62 per 10,000 MMBtu during June but traded for \$8.23 at the end of July. West Texas intermediate crude averaged \$114.35 per barrel and was \$99 at the end of July. Soybeans and corn averaged \$1690 and \$758 per 5,000 bushels in June and ended last month at \$1637 and \$616, respectively.

We think it's important to note that many commodities in the BCOM index don't show up directly in inflation reports,

Figure 4:
Long-Term Inflation
Expectations Have Cooled

From 07.31.2012 through 07.31.2022. SOURCE: Kovitz using data from Bloomberg Finance L.P.





but underlying commodity prices have a significant impact in the manufacturing sector where closely watched economic barometers are published by the Institute for Supply Management (ISM).

UP SHARPLY, THEN DOWN

It's not wrong to be concerned about inflation. On June 15, Fed Chair Jerome Powell fielded a question on its persistence, "I think if you look across that broad range of data, what you see is that expectations are still in the place, very much in the place, where short-term inflation is going to be high but comes down sharply over the next couple of years...We're absolutely determined to keep [inflation expectations] anchored at 2 percent." Consistent with Mr. Powell's comments, Figure 4 shows a wide gap between near-term inflation expectations (navy line) and longer-term expectations (green line).

It's impossible to accurately predict the direction of inflation, especially considering that components of the measurements frequently head in opposite directions. We continue to like our broadly diversified portfolios of value-oriented stocks, which have historically been a good inflation hedge and we think long-term inflation expectations are still relatively well-anchored to the lower end with Fed comments and actions aligned to reduce inflation. Fortunately, markets seem to believe the Fed is serious about not letting high CPI or PCE persist for too long.

WHAT ABOUT STOCKS?

"Fear cannot be banished, but it can be calm and without panic; it can be mitigated by reason and evaluation." This favored Vannevar Bush quote seems especially apt these days, with the media fixated on and pundits fretting about weak economic numbers, signs of recession and sky-high inflation readings. We respect these can be serious headwinds for corporate profits, but running the historical return numbers for inflation and subsequent returns (Figure 5) shows little reason for folks to be selling stocks today. In fact, there seems to be support for adding to equity exposure, particularly for those in the fundamental Value camp.

Figure 5:
High Inflation Hasn't
Doomed Stock Returns

From 03.31.1957 through
04.30.2022. SOURCE: Kovitz
using data from Professors
Eugene F. Fama and Kenneth R.
French and Morningstar

Inflation Above 9.0% & Subsequent Stock Returns						
Metric	Value Stocks 3 Months Forward	Growth Stocks 3 Months Forward	Value Stocks 6 Months Forward	Growth Stocks 6 Months Forward	Value Stocks 12 Months Forward	Growth Stocks 12 Months Forward
Arithmetic Avg. Return	3.9%	3.4%	8.7%	7.2%	22.9%	18.0%
Geometric Avg. Return	3.3%	2.5%	7.6%	5.3%	21.8%	15.5%
Median Return	4.7%	3.1%	7.0%	6.4%	20.7%	21.5%
Max Return	39.6%	32.9%	63.0%	60.8%	60.2%	63.4%
Min Return	-16.5%	-27.6%	-26.4%	-35.9%	-8.8%	-22.2%
# of Instances	55	55	55	55	55	55
Inflation Below 9.0% & Subsequent Stock Returns						
Metric	Value Stocks 3 Months Forward	Growth Stocks 3 Months Forward	Value Stocks 6 Months Forward	Growth Stocks 6 Months Forward	Value Stocks 12 Months Forward	Growth Stocks 12 Months Forward
Arithmetic Avg. Return	3.8%	2.8%	7.7%	5.8%	15.8%	11.8%
Geometric Avg. Return	3.3%	2.4%	6.7%	4.8%	13.7%	9.9%
Median Return	4.1%	3.3%	8.1%	6.0%	17.3%	13.0%
Max Return	37.8%	32.5%	68.5%	49.8%	105.8%	93.6%
Min Return	-39.5%	-34.9%	-54.2%	-41.7%	-52.2%	-48.0%
# of Instances	724	724	721	721	715	715



Speaking of fundamental value, the S&P 500 Pure Value Index (SPXPV) is defined by S&P Dow Jones Indices as a style-concentrated index designed to track the performance of stocks that exhibit the strongest value characteristics by using a style-attractiveness-weighting scheme. Not surprisingly, given what has transpired during previous bouts of high inflation, the SPXPV has been the best performing equity index in 2022, with its total return as of this writing exceeding that of the market benchmark S&P 500 by more than 10 full percentage points, or more than 1000 basis points.

TEN STOCK PICKS FOR AN INFLATIONARY ENVIRONMENT

For those interested in stocks with the strongest value characteristics, we have more than a few recommendations in *The Prudent Speculator* that reside in the S&P 500 Pure Value index. Ten of these names include:

Communication Services stocks like advertising concern **Omnicom Group (OMC)** and telecom titan **Verizon Communications (VZ)**

Consumer Staples stocks like agricultural giant **Archer-Daniels-Midland (ADM)** and protein producer **Tyson Foods (TSN)**

Financial stocks like regional bank **Citizens Financial Group (CFG)** and insurer **Prudential Financial (PRU)**

Health Care stocks like drug distributor **Cardinal Health (CAH)** and integrated pharmacy concern **CVS Health (CVS)**

High-Yielding stocks like energy behemoth **Exxon Mobil (XOM)** and Arizona utility **Pinnacle West Capital (PNW)**



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

For more details about our wealth management and asset management services, kindly reach out to:

Jason Clark, CFA
Principal, Portfolio Manager

949.424.1013
jclark@kovitz.com

DISCLOSURES

Definition of the Firm: Kovitz Investment Group Partners, LLC (Kovitz) is an investment adviser registered under the Investment Advisers Act of 1940 that provides investment management services to individual and institutional clients. From October 1, 2003 to December 31, 2015, the Firm was defined as Kovitz Investment Group, LLC. Effective January 1, 2016, Kovitz Investment Group, LLC underwent an organizational change and all persons responsible for portfolio management became employees of Kovitz. From January 1, 1997 to September 30, 2003, all persons responsible for portfolio management comprised the Kovitz Group, an independent division of Rothschild Investment Corp (Rothschild).

GIPS: Kovitz Investment Group Partners, LLC (Kovitz) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. Kovitz has been independently verified for the periods January 1, 1997 through December 31, 2018. The verification report is available upon request. Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards. Verification does not ensure the accuracy of any specific composite presentation. A complete list of firm composites and performance results is available upon request.

The description of products, services, and performance results contained herein is not an offering or a solicitation of any kind. Past performance is not an indication of future results. Securities investments are subject to risk and may lose value.

All returns are geometric average unless otherwise stated. The geometric average is a mean set of products that takes into account the effects of compounding.

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 portfolios 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.

Kovitz Investment Group Partners, LLC ("Kovitz") is an investment adviser registered with the Securities and Exchange Commission. The information and opinions expressed in this publication are not intended to constitute a recommendation to buy or sell any security or to offer advisory services by Kovitz. The material has been prepared or is distributed solely for information purposes and is not a solicitation or an offer to participate in any trading strategy, and should not be relied on for accounting, tax or legal advice. This report should only be considered as a tool in any investment decision matrix and should not be used by itself to make investment decisions.

Opinions expressed are only our current opinions or our opinions on the posting date. Any graphs, data, or information in this publication are considered reliably sourced, but no representation is made that it is accurate or complete, and should not be relied upon as such. This information is subject to change without notice at any time, based on market and other conditions. Past performance is not indicative of future results, which may vary.