

## **Between a Rock and a Hard Place**

“One thing is certain: To be effective, the Fed will have to inflict more losses on stock and bond investors than it has so far; market participants expect higher short-term rates to undermine economic growth and force the Fed to reverse course in 2024 and 2025 - but these very expectations are preventing the tightening of financial conditions that would make such an outcome more likely.” - *Former Federal Reserve Governor Bill Dudley*

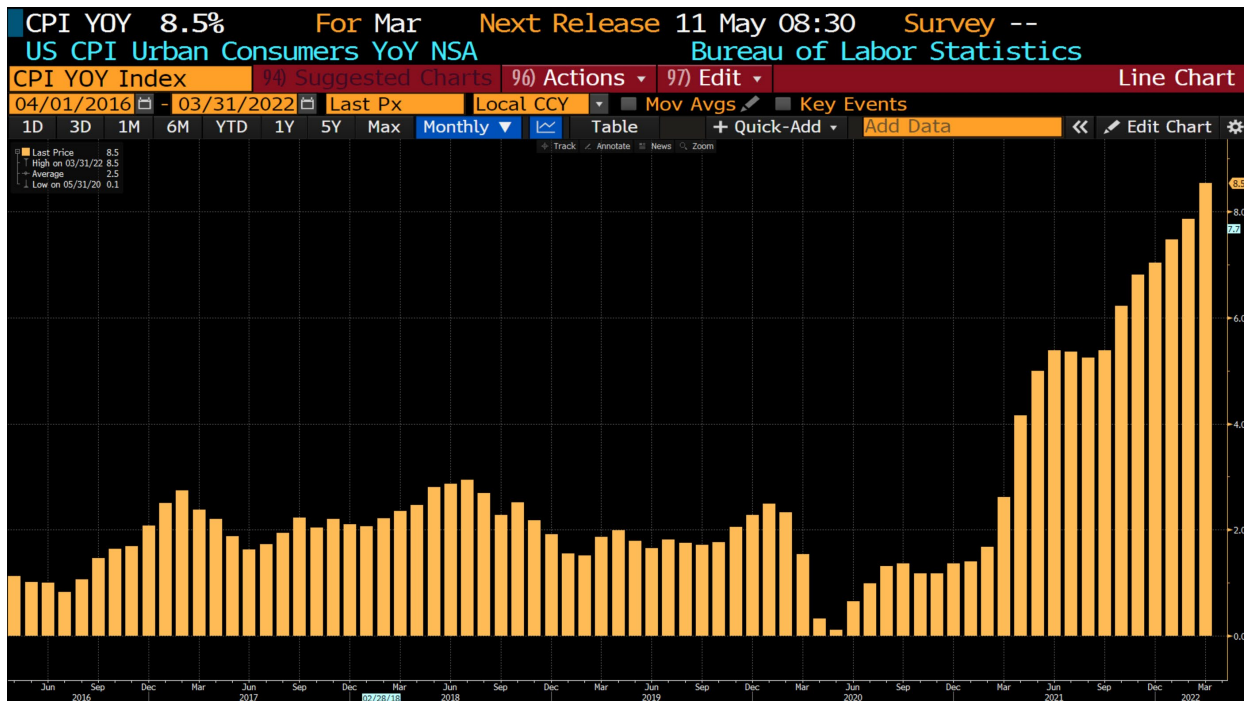
We would submit that this direct quote is one of the most extraordinary statements we have ever heard from a well-respected former Federal Reserve Bank official. It also explains in very straightforward language exactly what a uniquely tight spot that policy makers find themselves in at this moment in history. Current levels of inflation are raging far beyond what policy makers thought possible, even a year ago and while current levels of business activity seem to have given the Federal Reserve Bank (the “Fed”) some room to tighten financial conditions to bring inflation under control, the U.S. economy’s sensitivity to even small increments of financial tightening have become so acute that the Fed may, in practice, not be able to tighten enough to crimp inflation without sending markets into a tailspin. In essence, financial markets are playing chicken with the Fed, with investors becoming increasingly uneasy as to whether the Fed will blink.

### **How did we get here?**

Nobel Prize winning economist Milton Friedman famously said: **“Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output.”** The chart below highlights the extraordinary growth in M2 since 2020, the advent of the Coronavirus crisis.



In addition to the Fed’s money printing largesse, the U.S. government has spent an additional \$4.57 trillion across 44 U.S. agencies in Coronavirus relief since March of 2020. In addition, geopolitical stability has begun to unravel as well, culminating in the invasion of Ukraine, a nation of 44 million, by a manifest destiny-driven Russia. This has put at a new security premium on many different commodity markets, most prominently energy but important agricultural inputs from ammonia, potash, corn, soybeans and various precious metals and other rare earth elements. The broad effect of these price changes in commodities have yet to be felt by most economies as they must work their way through global economies and yet inflation is already spiking dramatically higher early in 2022. The chart below illustrates the percentage change in CPI year-over-year since April 2016



Source: Bloomberg

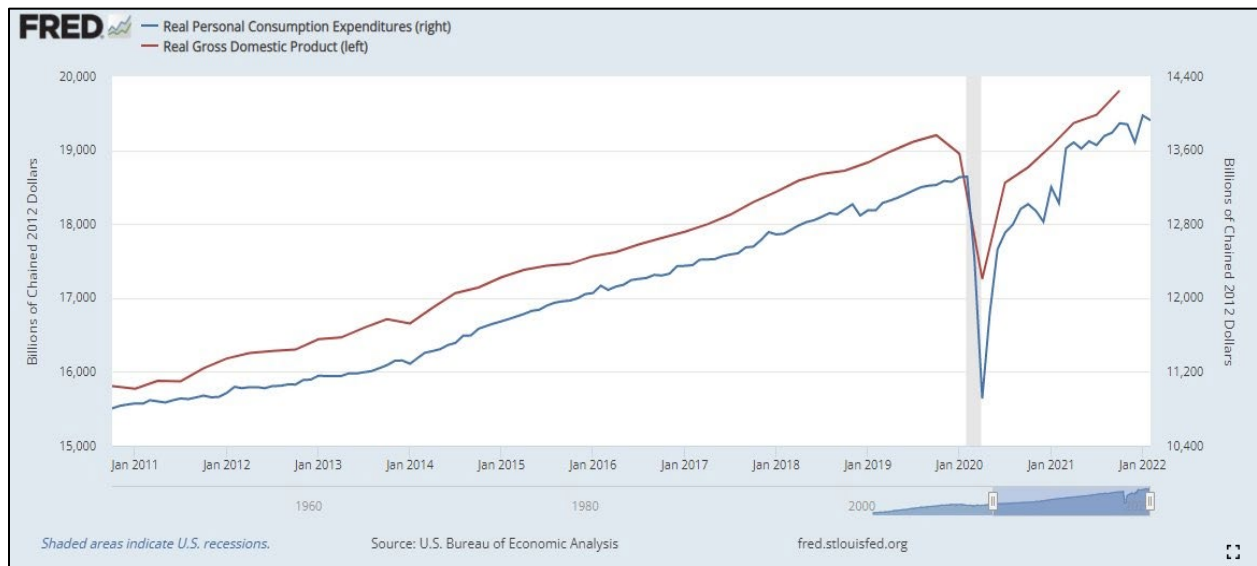
**“Inflation is as violent as a mugger, as frightening as an armed robber and as deadly as a hit man.” *Ronald Reagan***

### **Inflation Expectations Rocket Higher**

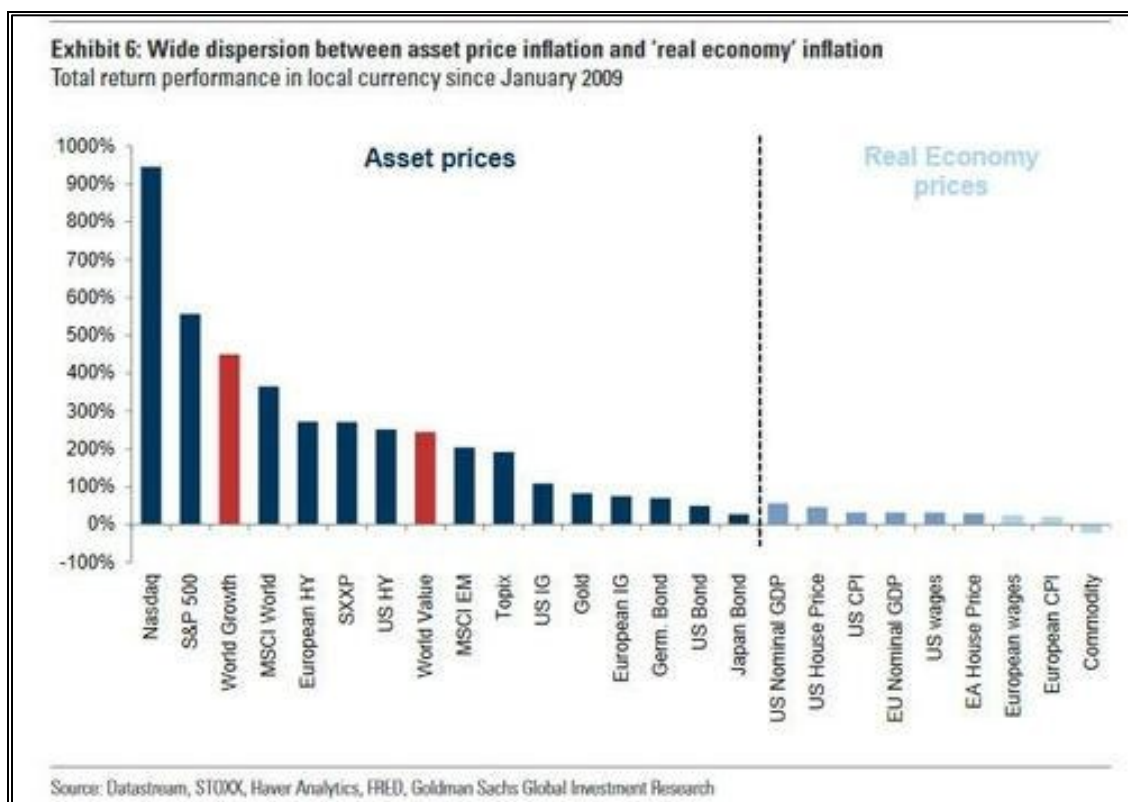
Indeed, the average consumer is feeling as though they’ve been mugged as real incomes have turned negative, which may relieve some of the inflationary pressures on the economy as consumers cut back on discretionary items to pay their significantly higher bills for food, transportation, housing and other essentials. This will also lead, however, to increased pressure on wages, which may explain why 12-month forward inflation expectations are also rapidly rising. The so-called wage-price spiral has not been a part of the U.S lexicon for several generations and U.S. employers will come under significant pressure to increase wages for the vast majority of their workers just to help them maintain living standards that existed only two years ago. The following chart shows the increase in annualized inflation expectations one year from now; the ascent is striking.



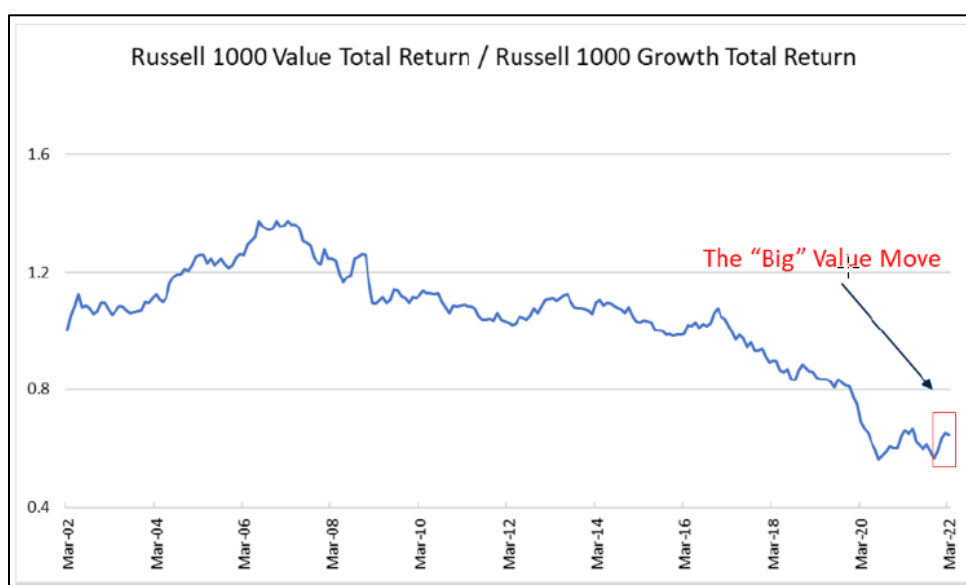
With the spectacular growth in both liquidity (M2) and outright financial largesse (fiscal stimulus), a reasonable observer might question why economic output has not skyrocketed, after all real GDP growth is barely back on trend after the precipitous decline due to the Coronavirus related economic disruption of 2020? The following chart shows Real GDP, the Coronavirus related plunge, and the recovery since then.



The answer brings us back to Bill Dudley and his shockingly candid statement about the quandary that the FED finds itself in today. Where did all the money go, if not moving through the real economy? The answer is, the financial asset economy. We have waxed on rather repetitively about valuations in technology equities, the explosion in cryptocurrency-related assets and other areas where speculation seems to have become untethered to any possible economic reality. The following chart, however, puts the overall situation in deeper relief, and, unfortunately, puts the Fed, the federal government and policy makers in general in a very poor light.



Is it possible that the combination of exploding money supply and nearly \$5 trillion of direct spending into the economy would result in only trendline GDP growth? The chart above tells the true story (albeit a gross simplification of that story). A great deal of the excess liquidity that has been pumped into the economy has found its way into financial assets both in the U.S. and abroad. It is in this way that asset markets have become the tail that wags the dog, in a very meaningful way. This chart is what Bill Dudley is worried about: How does the Fed tighten financial conditions in a way that defeats the worst inflation in several generations without cratering the very financial assets that their previous policies helped to inflate in the first place? The financial world will be watching their every move as usual; however, in the current environment, the stakes are once again extremely high.



## Quarterly Performance

Our 1st Quarter 2022 return for the Hahn Capital Management Mid-Cap Value Composite was -9.20% gross of fees. For the quarter, we underperformed our primary benchmark, the Russell Mid-Cap Value Index, by 7.38 percentage points. The underperformance was split almost equally between stock selection and sector selection. Our absence of exposure in Energy, Consumer Staples and Utilities were the main cause of sector selection underperformance, particularly Energy, which dramatically outperformed all other sectors during the quarter. The most significant relative performers during the quarter were Virtu (VIRT), Euronet Worldwide (EEFT), Jacobs (J), and Becton Dickinson (BDX) while the most significant underperformers were Black Knight (BKI), Keysight Technologies (KEYS), First Republic (FRC), and CBRE Group (CBG).

### Hahn Capital Quarterly Performance Attribution – 1Q 2022

LINKED PERFORMANCE BY SECTORS											
BENCHMARK: Russell Midcap Value Index											
PORTFOLIO: Model Account											
GICS Sector	PORT Weight	BENCH Weight	DIFF Weight	PORT Return	BENCH Return	DIFF Return	SECTOR SELECT	STOCK SELECT	ACTIVE CONTR	PASSIVE CONTR	TOTAL CONTR
Financials	21.80%	16.94%	4.87%	-1.68%	-2.46%	0.79%	-0.09%	0.17%	0.08%	0.00%	0.08%
Information Technology	17.86%	9.66%	8.20%	-17.10%	-9.46%	-7.64%	-0.65%	-1.44%	-2.09%	0.00%	-2.09%
Real Estate	17.72%	11.45%	6.27%	-11.41%	-3.55%	-7.86%	-0.11%	-1.45%	-1.56%	0.00%	-1.56%
Industrials	13.49%	14.72%	-1.23%	-3.43%	-8.50%	5.07%	0.12%	0.69%	0.81%	0.00%	0.81%
Health Care	11.64%	7.76%	3.87%	-10.93%	-4.88%	-6.05%	-0.12%	-0.75%	-0.87%	0.00%	-0.87%
Consumer Discretionary	8.48%	9.93%	-1.45%	-21.61%	-12.89%	-8.72%	0.15%	-0.82%	-0.67%	0.00%	-0.67%
Materials	2.63%	7.72%	-5.09%	-5.21%	5.63%	-10.84%	-0.35%	-0.25%	-0.60%	0.00%	-0.60%
Communication Services	1.69%	3.56%	-1.87%	10.44%	-1.07%	11.51%	-0.01%	0.19%	0.18%	-0.01%	0.17%
Energy	0.00%	6.39%	-6.39%	0.00%	40.98%	-40.98%	-2.06%	0.00%	-2.06%	0.00%	-2.06%
Consumer Staples	0.00%	4.59%	-4.59%	0.00%	7.67%	-7.67%	-0.38%	0.00%	-0.38%	0.00%	-0.38%
Utilities	0.00%	7.28%	-7.28%	0.00%	3.77%	-3.77%	-0.36%	0.00%	-0.36%	0.00%	-0.36%
Cash	4.69%	0.00%	4.69%	0.04%	0.00%	0.04%	0.03%	0.00%	0.03%	0.00%	0.03%
<b>Total Portfolio</b>				<b>-9.33%</b>	<b>-1.82%</b>	<b>-7.51%</b>	<b>-3.84%</b>	<b>-3.67%</b>	<b>-7.51%</b>	<b>0.00%</b>	<b>-7.51%</b>

### Relative Performance by Stock – Quarter Ended March 31, 2022

Quarter Ended 03/31/2022 - Portfolio vs Russell Midcap Value Index											
Top Four Holdings			Bottom Four Holdings			Top Four Sectors			Bottom Four Sectors		
Total Attribution			Total Attribution			Total Attribution			Total Attribution		
1	VIRTU FINANCIAL INC-CLASS A	1.04%	1	BLACK KNIGHT INC	-0.85%	1	Industrials	0.81%	1	Information Technology	-2.09%
2	EURONET WORLDWIDE INC	0.64%	2	KEYSIGHT TECHNOLOGIES IN	-0.64%	2	Communication Services	0.17%	2	Energy	-2.06%
3	JACOBS ENGINEERING GROUP INC	0.31%	3	FIRST REPUBLIC BANK/CA	-0.50%	3	Financials	0.08%	3	Real Estate	-1.56%
4	BECTON DICKINSON AND CO	0.29%	4	CBRE GROUP INC - A	-0.49%	4	Not Classified	0.03%	4	Health Care	-0.87%

## HCM MID-CAP VALUE COMPOSITE PERFORMANCE HISTORY

<b>% Annualized Returns As of 12/31/2021</b>	<b>1Q 2022</b>	<b>1 Year</b>	<b>3 Years</b>	<b>5 Years</b>	<b>7 Years</b>	<b>10 Years</b>	<b>Since Inception 06-30-88</b>
<b>HCM Gross of Fees</b>	-9.20%	7.24%	13.42%	11.86%	9.66%	11.53%	13.91%
<b>HCM Net of Fees</b>	-9.45%	6.18%	12.31%	10.77%	8.58%	10.44%	12.83%
<b>Russell Mid Cap Value Index</b>	-1.82%	11.46%	13.69%	9.99%	9.30%	12.01%	11.57%
<b>Russell Mid Cap Index</b>	-5.68%	6.92%	14.89%	12.62%	10.68%	12.85%	11.70%

[Link to: HCM Performance Disclosures](#)

### PORTFOLIO ACTIVITY

#### New Positions

There were no new positions added during the quarter.

#### Positions Increased

There were no positions increased during the quarter.

#### Positions Reduced

There were no positions reduced during the quarter

#### Positions Sold

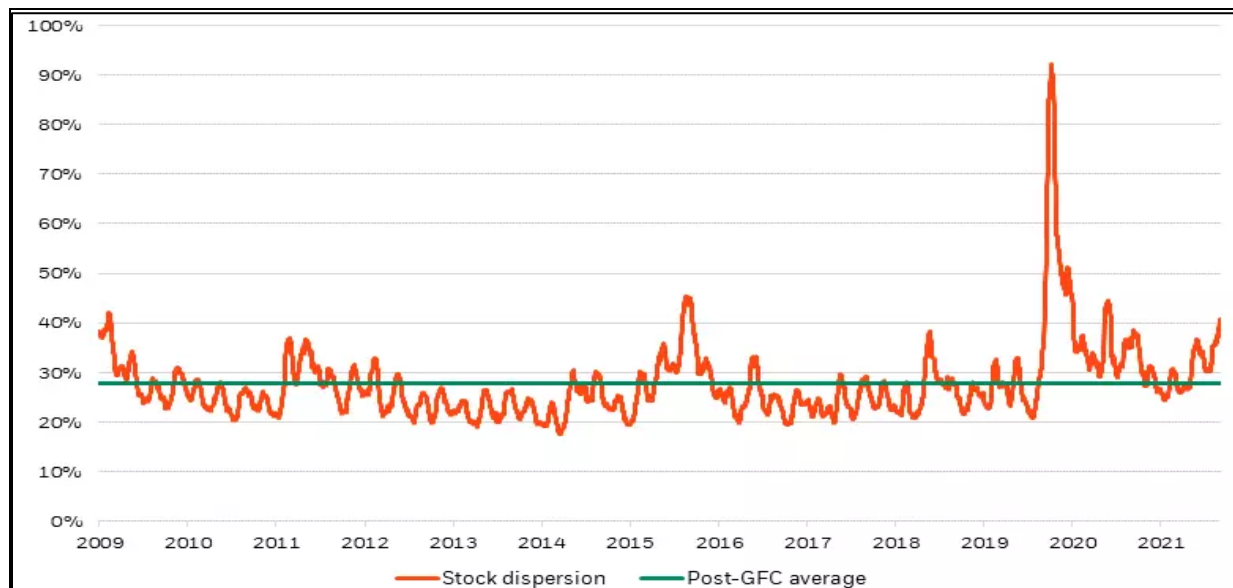
There were no Positions sold during the quarter

#### Outlook

The investing backdrop is mired in uncertainty. Just as the global economy is looking to emerge from pandemic malaise, a callous war has applied new pressures to a global system that was looking to normalize interest rates and process the effects of the highest inflation seen in decades. Intraday market volatility has been dramatic and stock selling has become indiscriminate, as is often the case in big market swings. We believe this has opened attractive entry points, particularly into some growth(ier) stocks that have been punished beyond what their fundamentals would imply. The prevailing backdrop highlights the importance of building resilience into portfolios. We believe this is best achieved through diversification and a focus on quality — particularly stocks of companies with strong balance sheets and healthy free cash flow characteristics.

We see stock selection becoming more important as companies navigate higher inflation and rates with varying degrees of agility. Stock dispersion, a measure of the potential risk/return outcomes for individual stocks, already sits well above its average since the GFC, as shown in the chart below.

### U.S. Stock Dispersion, 2009-2022



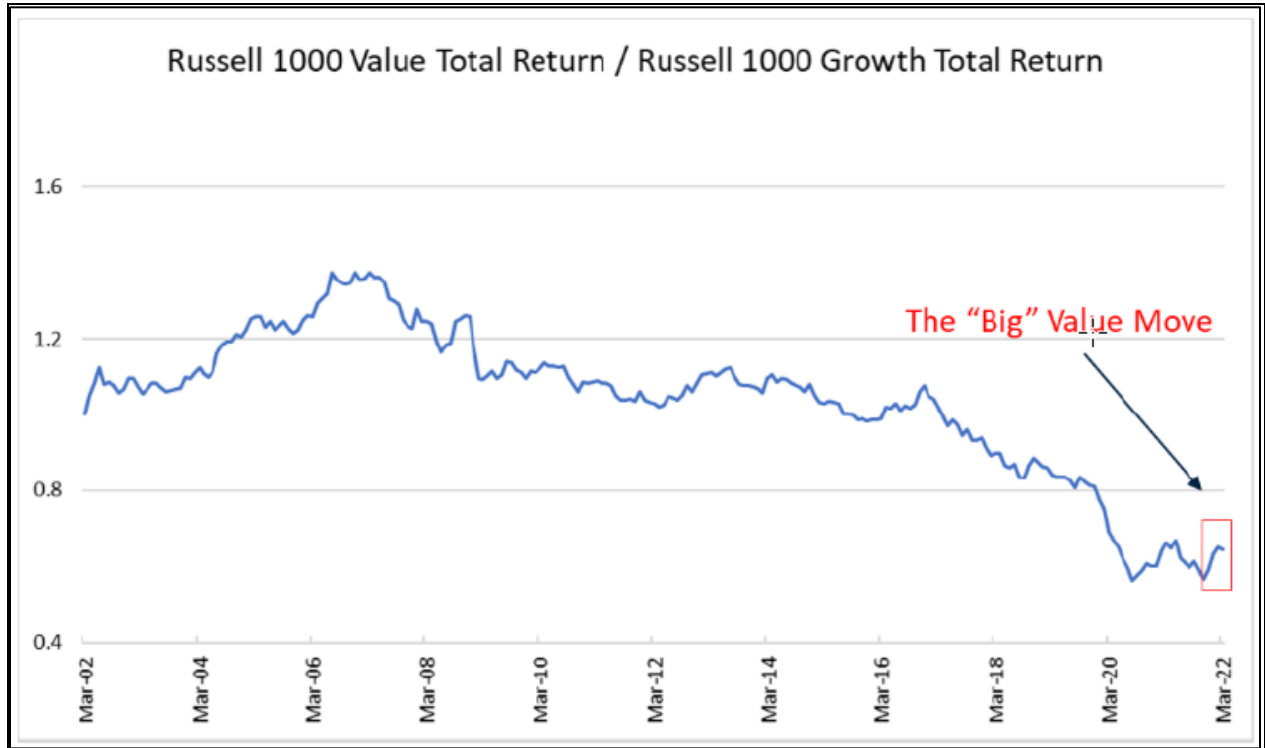
Source: Blackrock

Higher inflation than the roughly 2% we knew before the pandemic will challenge companies' cost structures. Investors must discern which companies are most impacted by rising costs, and which have the pricing power to pass those higher costs through to customers / consumers and maintain their profit margins. From there, the question is how much of this is (or is not) reflected in stock prices.

As part of our analysis, we look for companies with unique products or services, durable cost advantages, or that operate in consolidated and rationale industry structures. We think businesses selling labor-saving equipment and technology will benefit as companies seek to offset higher wages. Software solutions and some industrial equipment are two potential beneficiaries.

Inflation has implications for both the overall level of the market and for market internals, particularly the value versus growth debate. Value stocks have dominated so far this year as rising rates weighed on growth stocks. Growth stocks are considered long duration because their cash flows are realized further into the future. Higher rates drag on the present value of these future cash flows. Value stocks, meanwhile, are shorter duration with cash flows that are front-end loaded; capital is returned to shareholders earlier in the investment lifecycle. The period of extremely low interest rates was very good for growth stocks — and very challenging for value investors. The road ahead is likely to be different, restoring some of the appeal of a value strategy.

## Is it too late to invest in Value?



Source: Bloomberg

We would like to thank all of our clients for their continued support as we enter a more volatile and unpredictable market environment in 2022 and beyond. It is your support and confidence in our methodology and execution that allows us to create value through our patient, very long-term-oriented investment style. We always try and remind everyone we speak to about our investment process that it thrives the most and creates the most future opportunities at the exact time when faith and patience are at their dearest. Please come see us this year or let us come see you, it's been long-overdue and we look forward to interacting with you in person in 2022.

Sincerely,

John Schaeffer  
President and CIO

Michael Whitfield  
Dir. of Research and Co-Portfolio Manager