ALTA
CAPITAL MANAGEMENT
A member of Guardian Capital Group Limited

MARKET LETTER

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"It's not the heat, it's the humility"

During the second quarter, the S&P benchmark declined 16%. Bonds, emerging markets, and cryptocurrencies all posted steep losses as well. Inflation accelerated to the highest level in 40 years. As the Federal Reserve feels the heat and raises interest rates in a bid to tame inflation, concerns are mounting that inflation is already out of control or that the Fed will overshoot and throw the economy into recession. Given the unusual circumstances by which we have arrived at this point, conflicting market data is unusually difficult to read, and the Fed finds itself in uncharted territory. Unsurprisingly, uncertainty and volatility prevail. As much as this can be unnerving over the short term, it is worth bearing in mind that uncertainty and volatility are part and parcel to markets. The best course of action is always time in the market, as opposed to timing the market, as we again observed most recently in the spring of 2020. At Alta Capital, we remain focused on investing over the long term.

For almost four decades, the US and most developed economies experienced slowing population growth, unparalleled productivity improvements, and increased globalization, culminating in persistently low inflation. As a result, deflation was global central bankers' greatest concern until recently. Very quickly the world changed. The US economy and the world endured an extraordinary set of shocks to the system, starting with the first pandemic in a century, central banks' rapid and strong response, the recovery (more pronounced in the US than in other regions), supply chain bottlenecks, the first invasion of a sovereign European nation since World War II, and rolling Covid lock-downs in China. The highly unusual whipsaws of the pandemic made the inflation situation difficult to assess: all spending collapsed in the spring of 2020, and people stayed home, received stimulus, and ordered goods online as experiences were no longer available, creating supply chain issues and a work-from-home housing boom. As Covid restrictions eased, bottlenecks appeared in services, particularly for airport and airline staffing, as consumers book "revenge travel." Understandably, the next whipsaw is impossible to predict.

In the meantime, inflation expectations have already started to cool. The yield on the 10-year Treasury bond is back under 3%, 60bps lower than its recent peak. Commodity prices have rolled over, and excess inventory at retailers is likely to be discounted. While the labor market, household spending and corporate balance sheets all still look relatively strong, the economy is widely expected to soften. With a slowing economy, a strong dollar, and, importantly, current population growth of 0-0.5%, it is hard to imagine a return to 1970s-style inflation, a time when population was growing at 2.5% annually.

As Jeremy Rudd of the Board of Fed Governors wrote in May, "Our understanding of how the economy works—as well as our ability to predict the effects of shocks and policy actions—is in my view no better today than it was in the 1960s." While this may cause investors some consternation, it's a useful reminder that while economic data is instructive on likely behaviors or tendencies, it often only holds limited predictive power. The lesson to be drawn for investing is similar. The market, made up of individual investors who are neither objective nor rational, tends to overshoot and overcorrect. Case in point, the long run market return is 10% but very rarely are yearly returns even within an 8-12% range. Put another way, even though underlying market fundamentals are never as great or as horrible as investors tend to think, market performance reflects the cycle of bullish and bearish psychology. The silver lining to all the current consumer and investor handwringing is that it is a contrarian indicator. When the market suffers big losses, more than 15%, during the first half of the year, it has finished higher every single time and with an average second half return of 24%. In addition, fund managers reportedly have larger than average cash positions and a high degree of pessimism, as measured by the bearish sentiment indicator at 59%, which is its highest level since March of 2009. Now *there's* a great reason to be optimistic.

Underlying company fundamentals remain strong within the Alta portfolios. Our companies enjoy strong balance sheets, defensible moats, many avenues for growth, high levels of product innovation, and a myriad of solutions to improve productivity or automation. We believe companies with secular growth drivers, operating in large addressable markets, and offering a real value proposition to customers will outpace peers and the broader economy during these trying times and over the long term.

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