Hughes Investment Advisory Service LLC

April 1, 2022

Dear Clients and Investors,

For Q1 the S&P 500 was down 4.9%. The AGG, or overall bond market, was down 6.2%

Some key additional early 2022 data points:

- Estimated 2022 Q1 GDP growth .9% (Atlanta Fed Reserve GDP NOW)
- Estimated 2022 Q1CPI Inflation +7.9%
- Final 2021 S&P 500 Earnings of $208.53 - a new record.
- 2022 S&P 500 Estimated Earnings of $225 – Yardeni Research Inc.

The first quarter ends today, and it's been a quarter to remember. This is the first quarterly loss in two years after hitting new all-time highs at the start of the year as investors bet that the global economy would continue to re-open post covid. This momentum lost steam as concerns took hold regarding surging US inflation and tighter Federal Reserve monetary policy - both of which pushed the S&P 500 into a -10% correction and NASDAQ -20%. Next came the start of the Russia-Ukraine war and associated surge in oil and other commodity prices further fueling inflation.

The markets will be ending Q1 on a high note however, with the S&P 500 rising more than 3.5% in March, cutting the loses from earlier in the quarter. Will this upward momentum continue as we head into Q2 as inflation surges higher and the war in Ukraine drags on? In a nutshell that will depend on whether the Federal Reserve can pull off a "Soft Landing" What is a "Soft Landing"? In Fed speak a "soft landing" in the business cycle is the process of an economy shifting from growth to slow-growth to potentially flat, as it approaches but avoids a recession. It is caused by Federal Reserve attempts to slow down inflation. **My best guess and base case scenario of the Fed achieving a "soft landing" result is 50/50 at best this time.**

Wow – what a world and confluence of significant events that have unfolded in the last 2 years starting with Covid and now the war in Eastern Europe. Last quarter I wrote about the Worlds authoritarian leaders in Beijing, Moscow, Tehran, Pyongyang being nervous because of strong US economic growth and leadership. Now we have seen the results with China and Russia signing a roadmap agreement for military and economic cooperation that has "no limits" whatever that means. Then came the invasion of Ukraine by Russia. Now come the questions, post-invasion with the US and NATO trying to punish Russia militarily by 1. aiding Ukraine militarily and 2. economically with punitive sanctions against Russia. Do these sanctions carry over to China if China and Russia are now cooperating militarily/economically?

What about US companies that have spent decades and billions of dollars establishing themselves in China, Russia and elsewhere? In other words, has Globalization, as envisioned by some for 25 plus years ended abruptly? I would say, yes it has! How can Western companies quietly operate in countries that do not have the same values, rule of law and political systems that we value in the West? I do not believe it is possible and the period ahead will be at least a partial unwinding of Globalization of the economic and financial system that we operate in today. This will have immense impacts on countries, companies, currencies, and the flow of goods and people around the globe. How this situation plays out in the period ahead will greatly determine the winners and losers whether we're talking about companies or countries.

What about energy? While Russia invests and grows their oil and gas sectors creating a situation of willing dependency for Germany and other Western European countries the US, through voluntary regulations, shrinks our energy complex with the idea that solar and wind energy solutions will fill the gap. It has now finally become painfully obvious, to most everyone, that our energy industry needs a better approach. My observation is that this situation in Ukraine is bringing a dose of necessary reality to Western Europe and the US that the pathway to a clean energy future will be a 20 plus year endeavor that will include increased oil and natural gas exploration as well as new nuclear energy and hydrogen technology solutions to be accompanied by increasing use of wind, solar and energy storage advancements. It's well past time for the two sides to come together for a mutually beneficial path forward to a new clean energy future that does not bankrupt the lower and middle classes on the way or render us helpless to dictators and communist countries with large oil and gas reserves. As I write this, it was just announced that Washington has just released another large part of the SPR, Strategic Petroleum Reserve. Moves like this are all politics and not even a short-term solution to the multi-decade solutions needed to avoid harming our economy and the American people along the pathway to a new clean energy future. At the end of the day, energy is a national security issue and too many wars have been and are being fought because of bad policy. Time to get serious! Fortunately, the US has the natural resources, technology, and financial wherewithal to accomplish these desired mutual long-term goals. I hope it finally happens for all of our sake and I know that fantastic investment opportunities will surface along the way.

Now back to the economy, markets, and our investments. Again, here we are at a major turning point where the path forward is not at all clear. During my 40 plus years of investing I have not seen a situation like what we are looking at now. How so?

The Federal Reserve, inexplicably, for at least 12 months has failed to realize the severity of the inflation problem facing the economy – a situation that they created and was clearly chronicled here and elsewhere. Was it a coincidence that the Fed finally changed course the moment Jerome Powell was re-nominated by President Biden? Amazingly, as late as January 2022, just 3 months ago, the Fed was stating that they believed inflation was a transitory problem. QE or Quantitative Easing is just ending now! The Fed, at Washington's behest, pumped over 5 trillion dollars into the economy just in the last 24 months during a period of zero interest rates! And somehow, we are supposed to believe that inflation would be transitory?

Bottom line, because of the above situation and then the invasion of Ukraine and related supply chain issues, we are all seeing the painful inflationary results. The highest inflation since Jimmy Carter's Presidency when Fed Chair Volcker raised interest rates to 20% to reverse the inflation spiral occurring at that time. The clear result of this next inflation fight by the Fed will likely result in Stagflation at a minimum. What is Stagflation? Slow economic growth with high inflation.

Where should investors be allocated during periods of Stagflation? There are very few places! Primarily, if not solely, in US dollar-based assets, companies, and markets. Why? The dollar remains the premier currency and US companies are growing faster and have healthier more transparent balance sheets. I believe that extreme risks are present with many investments outside the US especially in China, Russia, and many other markets. China and Russia are uninvestable today.

Where else to invest? Cash and short-term bond and money funds are currently losing 7% due to inflation. Real estate can be an inflation hedge however the asset class has already had a strong run up and with interest rates rising the real estate market may be peaking. Other "real asset" classes include commodities, timber, land, gold etc. These all look attractive now but have also already run up significantly in price and may be fairly or overvalued depending upon the extent of the inflation problem going forward.

Despite everything mentioned above, the US is still experiencing strong FDI (Foreign Direct Investment) and global investment inflows. To me this means that despite Stagflation, a Fed that is no longer an investors friend due to rising rates and QT (Quantitative Tightening), the US looks to be the best place to invest in a bad neighborhood. Thankfully that also means that the companies that we focus on which are companies with irreplaceable brand names, wide moats, high margins, grow their dividends, and have modest debt remain the best place to be invested in under these conditions.

The challenges of continued US growth and continued global influence are not insignificant but when looking at the worlds other major players and the systemic problems inherent in their political and economic systems it brings to light the superior aspects of all that the US has to offer.   US corporations continue to be the superior engines of growth, technological progress, profits, and flat out solving the worlds problems whether it's Pfizer, Apple, Microsoft, Thermo Fisher etc. These companies solve the world's problems while paying taxes, creating jobs and wealth along the way.

Specifically, given the above concerns where do I find attractive investments and companies today? I'm focusing on equities with well-defined earnings prospects that can pass on higher input costs and prosper during periods of moderating economic growth and high inflation.   Areas of focus include pharma, technology, defense, energy, infrastructure, and biotechnology. The Utility and some Consumer Staples sectors have done very well of late but continue to stand out as income producers in a lower-rate environment. I am still expecting the Utility sector to be a surprise winner from the EV and green energy revolution which require infrastructure investments needed throughout the power grid system.

Overall, I continue to favor large-cap, dividend paying, US based multi-national companies with strong balance sheets. We love businesses with irreplaceable brand names, wide moats, high margins, grow their dividends, and have modest debt. Risk/reward strongly favors equities over fixed income. A few select REIT's and specialized bond/income and alternative funds continue to provide income. I believe that our portfolios are well positioned to produce consistently attractive long-term risk adjusted returns while preserving capital. Please do not hesitate to give me a call to discuss the above analysis.

Sincerely,

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