THE
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COMPANY

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To clients and friends of The London Company:

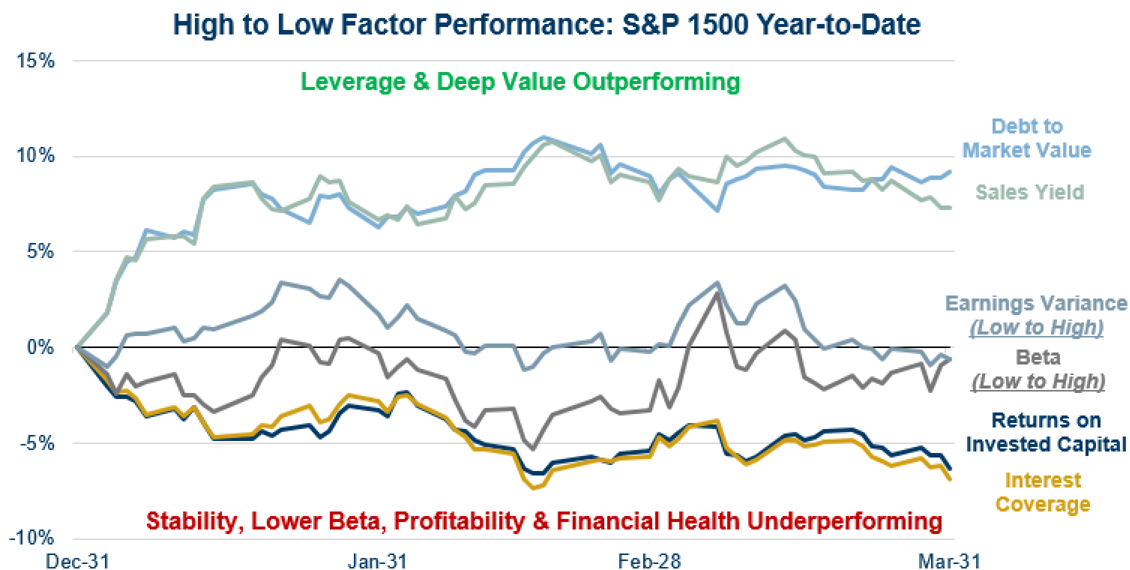
Spring is upon us, and the seasons are changing. Like many of you, we wonder if it will be a smooth transition with pleasant weather or a harsh jolt from winter chill to summer heat and humidity. Investors are also questioning the rate of change as it pertains to the current economic backdrop and the Fed's ability to smoothly transition out of this historic inflationary environment. We shut the economy down in 2020, resulting in the shortest recession in history. Then, like a light switch, we turned it back on and injected it with massive amounts of stimulus. As a result, we went from ice cold to very hot. US GDP and corporate earnings surged past prior cycle peaks in less than two years, marking one of the fastest rebounds in history. Now, symptoms consistent with late-cycle overheating are increasing, which typically precedes recessions. Those concerns were reflected in the performance of the broad market, which was down -5.3% for the quarter, as measured by the Russell 3000.

The path of least resistance was to the downside for most of Q1. Equity markets grappled with a litany of headline risks; the most dominant of which were the Omicron wave, the spike in inflation and aggressive monetary policy fears, and the war in Ukraine. The primary development revolved around the dramatic repricing of the Fed rate hike path, but Russia's invasion of Ukraine injected more uncertainty into an already volatile market. Moreover, it had the dual effect of exacerbating concerns over decelerating global growth and surging inflation, including the biggest rally in commodity prices in decades. While tragic, the war in Ukraine did not derail the Fed's plans to move forward with its tightening campaign. Bolstered by historically low unemployment and inflation at 40-year highs, the Fed hiked its benchmark interest rate 25 basis points in March. Internal Fed forecasts set expectations for 175 basis points of further tightening in 2022 alone. Further, the Fed indicated it was prepared to begin winding down its $9 trillion balance sheet beginning in May. The speed and magnitude of the policy shift is unlike any cycle in recent history. With the rapid change in the outlook, volatility spiked and the S&P 500 experienced its first correction (>10% decline) and first quarterly decline since the pandemic.

Even before its first hike, concerns of a Fed policy misstep intensified. During the quarter, the treasury yield curve flattened to the point of inverting, with short-term interest rates exceeding long-term rates. Curve inversions are notorious for predicting recessions. There have been six recessions since 1978, and the 10-year yield dropped below the 2-year yield ahead of each recession by an average of 14 months.
Importantly, curve inversions do not mean a recession is imminent. Inversions signal concerns over future growth or a monetary policy misstep. For instance, the Fed may trigger a "hard landing," where it raises interest rates too aggressively to tame inflation and accidentally causes a recession. In general, the Fed has a poor track record of engineering "soft landings," though there have been tightening campaigns in the past that didn't result in a recession. Even still, nearly every tightening campaign has led to an earnings recession, and tightening cycles always worsen financial strains. After years of an accommodative Fed, we worry that too many market participants are conditioned to believe the Fed is market driven and not economic driven. That perspective may get tested in the coming months, as the Fed appears resolute on getting inflation under control. Those investors who take the Fed for granted and bet on it backstopping equity market upheaval once again may likely be in for a rude awakening.

Whereas 2021 was all about the micro and earnings, thus far 2022 has been entirely about the macro and valuation multiples. Valuations were extended coming into 2022, and the aggressive policy shift from the Fed took some of that froth out of the market. At its lowest, the S&P 500 declined 13%, but it clawed back for a quarterly loss of 4.9%. Contracting P/E multiples drove the entire pullback, as earnings expectations actually rose for the year. While corrections are very normal, this pullback was notable for its speed. The S&P 500 headed into correction territory after just 16 trading sessions, only matched a handful of times historically. The hawkish Fed policy shift drove a big backup in bond yields. This provided an outsized headwind for growth stocks, where there were already longstanding concerns about crowded positioning and stretched valuations. As a result, this was the worst start to the year for growth versus value in decades. We finally saw the headline indices join some of the churn that had been bubbling under the surface for some time. The movement of the headline equity indices; however, paled in comparison to some of the violent moves at the individual stock level. Similar to Q4'21, expensive, unprofitable companies were hit hardest. Roughly 40% of the Russell 2000 and 50% of the NASDAQ experienced a drawdown of 20% or more during Q1.

The correction to start the year was atypical for several reasons. Though risks rose sharply, there wasn't a traditional flight to safety. Overall leadership had a more cyclical tilt, and defensive, risk-off attributes surprisingly lagged. In the QE (quantitative easing) era, this marked the first correction where interest rates actually rose and the Energy sector outperformed. As the chart illustrates, high leverage and deep value market factors outperformed stability and quality factors, adding to the atypical nature of this correction. Risk-off leadership typically picks up once earnings revisions decelerate, PMIs (i.e. leading economic indicators) decline, and credit spreads widen. While these risk-off conditions have yet to materialize fully, economic data has been trending lower. **<u>If that persists and conditions devolve into a true risk-off environment, we would expect our quality orientation to stand out in a meaningful way.</u>**



Source: Piper Sandler

The London Company's portfolios saw mixed results. Our portfolios finished in negative territory like the indices, but most fell short of our long-term downside capture expectations. Our Income Equity portfolio split its benchmarks. It exceeded our 75% downside capture expectations versus the S&P 500, but it trailed its primary benchmark, the Russell 1000 Value. Our Small Cap portfolio finished slightly ahead of its benchmark. Our Large Cap, Mid Cap, and SMID portfolios gave back much of their strong Q4'21 performance and underperformed their primary benchmarks by more than we would typically expect. Several holdings across these three portfolios were caught in the crossfire of Q1 volatility, but the

fundamentals of our businesses did not notably deteriorate. As noted earlier, we experienced an atypical correction, and surprisingly our high-quality orientation was a net headwind throughout the volatile Q1. Another headwind to performance across our portfolios was our underweight to the Energy sector, which was up ~40% across most indices. This underweight is a byproduct of our investment process. We prefer companies with durable competitive advantages and greater control over their own destiny. Energy companies, on the other hand, are largely beholden to the unpredictable price swings of the industrial commodity complex. While this underweight can work against us at times, we would much rather own a high-quality business with durable competitive advantages over a full market cycle. We believe much of the leadership we've witnessed this quarter isn't sustainable, and much of the consensus positioning is more akin to simple trading versus long-term investing. Given our high conviction, differentiated approach, short-term results can be impacted by narrow leadership or outlier sector returns, as was the case in Q1. This is why we don't get too high or too low on quarterly performance. As a bottom-up manager, we're conditioned to seeing fundamentals take a backseat to the macro. While macroeconomic developments can whipsaw portfolio performance over the short term, we know that quality fundamentals ultimately dictate long-term performance. Given the speed and magnitude of the changes during this recovery, we believe it requires a longer lens to assess the broader picture.

As we look ahead, the range of possible outcomes is especially wide, including unprecedented tail risks. Aspects of the current economic and market conditions are analogous to other periods in history, but frankly we're in unchartered territory. The Fed is poised to raise rates and unwind its $9 trillion balance sheet while growth is slowing. Equity valuations are still elevated—2nd only to the levels seen with the tightening campaign before the Tech Bubble—and we face pandemic, war in Europe, ongoing supply chain complications, and surging prices for commodities. Fortunately, there are still noteworthy tailwinds to acknowledge. Growth may be decelerating, but our manufacturing and services business segments remain in expansionary territory. Labor markets are strong and the economy continues its post-pandemic normalization. Household and corporate balance sheets remain very healthy and well positioned to handle a period of higher prices. Incidentally, slowing global growth could accelerate a decline in inflation, which could reduce the pace and magnitude of tightening required by the Fed.

We approach the path ahead with humility, simplicity, and discipline. We know that owning high-quality businesses can provide a measurable advantage over full market cycles. Even though some ominous signs are piling up, we find comfort in what we own. To paraphrase Liz Ann Sonders, Charles Schwab's Chief Investment Strategist, "panic is not an investment strategy;" neither is "get me out" nor "get me in." Investing is a process that requires patience and discipline. We feel our businesses possess impressive competitive advantages, and they are helmed by quality operators who are great stewards of capital. The compelling pricing power of our businesses can help insulate profitability amid periods of inflation, and their flexible balance sheets can help them weather an economic downturn. Although 2022 is off to a bumpy, macro-driven start, we believe taking a long-term view is still the best course of action.

As long-time readers will know, we avoid the temptation to make predictions about macroeconomics and the markets—that aversion extends to the weather too. We're not sure what the next few seasons have in store for us, but some storm clouds are clearly brewing. Our goal is to be your all-weather portfolio but especially your umbrella for when it rains.

As always, we appreciate and highly value the trust you have placed in us.

Best Regards,

The London Company

Important Disclosures:

Past performance is no guarantee of future results. This report is for informational purposes only. The statements contained herein are solely based upon the opinions of The London Company and the data available at the time of publication of this report, and there is no assurance that any predicted results will actually occur. Information was obtained from third party sources which we believe to be reliable but are not guaranteed as to their accuracy or completeness. This report contains no recommendations to buy or sell any specific securities and should not be considered investment advice of any kind. In making an investment decision, individuals should utilize other information sources and the advice of their investment advisor. All data references are as of March 31, 2022 unless noted otherwise.

The source for the market factor illustration is Piper Sandler & Co. The period is 12.31.21– 3.31.22. The chart measures the forward price return of the holdings in the S&P 1500 based on high and low quintile basket of stocks by factor. Factors are sector neutral, and quintile baskets are rebalanced monthly at the beginning of each month.

The London Company of Virginia is a registered investment advisor. More information about the advisor, including its investment strategies, fees and objectives, are fully described in the firm's Form ADV Part 2, which is available by calling (804) 775 0317, or can be found by visiting www.tlcadvisory.com.

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