Alley Company Quarterly Letter
<u>The Quarterly Letter Paradox</u>

April 12, 2022

At Alley Company, we have written quarterly letters religiously since 1998 with the objective of producing a meaningful essay that addresses the issues relevant to the current economic landscape in the context of investment concepts that give it "shelf life" for investors with a longer-term time horizon.

Some letters are easier to write (and read) than others, but looking back over 24 years makes us appreciate the process and conclude that the content has been quite useful for investors. One of the challenges in the quarterly writing exercise is addressing a world that is always fraught with problems: economic, social, geopolitical, regulatory, etc., etc. These problems, however, are in the context of a U.S. stock market that has appreciated 10.3% per year over the past 96 years. Herein lies the paradox – despite persistent global and domestic challenges, economic and corporate fundamental performance has pushed higher in a meaningful way that has rewarded long-term investors.

<u>Domestic/Global Events and Market Returns: 1999-2021</u>

Year	Event	Cumulative total return[1]
1999	Y2K	467.1%
2000	Tech wreck; bubble bursts	368.5%
2001	September 11	415.4%
2002	Dot-com bubble: market down -49%	484.9%
2003	War on Terror – U.S. invades Iraq	650.9%
2004	Boxing Day Tsunami kills 225,000+ in southeast Asia	483.5%
2005	Hurricane Katrina	426.2%
2006	Not a bad year, but Pluto demoted from planet status	401.6%
2007	Sub-prime blows up	333.2%
2008	Global Financial Crisis; bank failures	310.6%
2009	GFC: market down -56%; depths of despair	551.8%
2010	Flash crash; BP oil spill; QE1 ends	415.4%
2011	S&P downgrades U.S. debt; 50% write-down of Greek debt	347.9%
2012	2nd Greek bailout; existential threat to Euro	338.6%
2013	Taper Tantrum	278.1%
2014	Ebola epidemic; Russia annexes Crimea	185.6%
2015	Global deflation scare; China FX devaluation	151.2%
2016	Brexit vote; U.S. election	147.8%
2017	Fed rate hikes; North Korea tensions	121.3%
2018	Trade war; February inflation scare	81.7%
2019	Trade war, impeachment inquiry, global growth slowdown	90.0%
2020	*COVID-19 pandemic, U.S. Presidential Election*	44.5%
2021	Omicron variant, China regulatory crackdown, what's next?	22.0%

Source: J.P. Morgan Private Bank. FactSet. [1] Cumulative total returns for S&P 500 are calculated from December 31 of the year prior to January 31, 2022.

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Currently, Russia's unprovoked military invasion of Ukraine has caused unimaginable human suffering for a country trapped *geographically* and *philosophically* between the West and the East. The courage and resolve of the Ukrainian people has been remarkable and should remind us all that "democracy" should not be taken for granted. Putin's "unforced error" has strengthened NATO's resolve, and the swift action of the private sector along with crippling sanctions has likely set the Russian economy back many years. The global economic impact thus far has been to cause commodity prices - energy in particular - to skyrocket and put more upward pressure on inflation.

On the domestic front, unwelcomed inflation trends continue. The Consumer Price Index (CPI) rose 7.9% in February continuing a trend of persistently high inflation for the past twelve months. The stop/start dynamics of COVID coupled with substantial monetary and fiscal stimulus and now rising energy prices from the Ukrainian conflict have caused inflation readings to hit levels not seen since the early 1980s. As a result, Federal Reserve (Fed) policy is now shifting from extremely accommodative (zero percent interest rates and quantitative easing) to tightening mode in an effort to thwart inflationary pressures.

While the word "tightening" has an ominous tone, the change in Fed policy to a more normal interest rate stance can be viewed in a positive light. For the past ten years, the yield on the ten-year U.S. Treasury bond has hovered between 1.0% and 2.5%, slightly moving out of those boundaries for relatively short periods of time. Meanwhile, inflation, which plays an important role in the pricing of bonds, has hovered in the same range. This relationship is important to note because the investment objective for bonds is to earn a rate of return that outstrips inflation. If the Fed is successful in bringing inflation down, higher interest rates could allow fixed income investments to generate a positive real return, a welcome occurrence indeed. Also, a return to a more normal interest rate policy bodes well for the Fed's ability to provide assistance when we inevitably face future economic slowdowns.

To be sure, if interest rates continue to rise as the Fed brings its policy more in line with historical norms, bond investments in the near to intermediate term will experience negative total returns on paper as bond prices go down in a rising interest rate environment. While painful in the near-term, this is the price bond investors must pay to gain a positive real rate of return on investment. For income-oriented investors, we have long been advocates of investing in dividend paying equities that provide both an attractive upfront current yield as well as strong dividend growth. Simply put, a dividend equity portfolio that provides a competitive upfront current yield with a dividend income stream that can grow at a high single digit annual rate, is a powerful combination in today's interest rate environment. Further, the dividend income growth component can provide a valuable hedge against inflation.

Historically, there has always been a steady stream of domestic and global challenges, and yet in that context, the returns that have accrued to the long-term equity investor have been remarkable. The best explanation for this paradox is that the American experiment has served to unleash human potential in a way that no other economic or political model has before. Every day people keep putting one foot in front of the other in an attempt to move forward and improve their circumstances. As a result, the economy keeps growing and corporate earnings follow.

That said, the economy doesn't grow in linear fashion and neither do earnings given the natural ebb and flow of dealing with the aforementioned array of problems, but the direction is positive.

Will the stock market continue to be in corrective mode as we go through the coming months? Nobody knows for sure, but our answer is to make sure we are staying true to our asset allocation targets and disciplined with our philosophy of investing in high quality companies. Importantly, this will allow us to invest our client's money with a long-term thought process that respects today's current challenges, but does so against a backdrop where the economy and corporate America are predominately moving forward.