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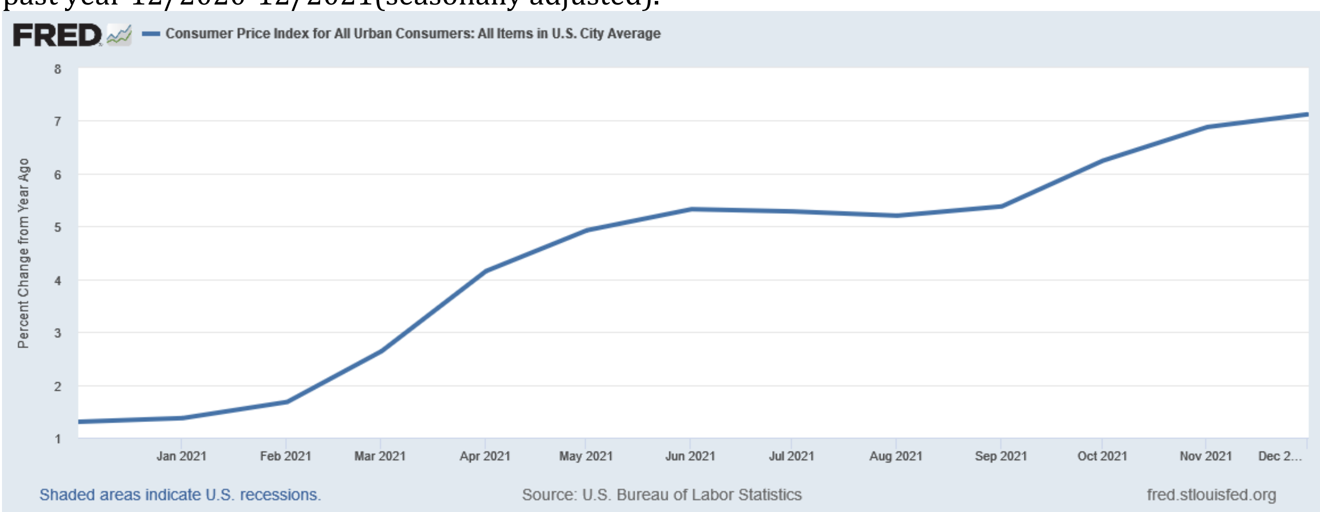
**Inflation - Interest Rates - Valuation**

The phrase “inflation is transitory” has been hammered into our consciousness for the better part of the past year by the Federal Reserve Board. Although most inflation could technically be classified as “transitory” when viewed on a long enough timeline, a threshold was finally crossed at the November 2021 FOMC meeting when the Fed decided to retire the term.

The future investment landscape appears far less forgiving compared to the past two years. The Fed stance change on inflation, ending monthly asset purchase programs in March 2022, and projecting the first interest rate hike for June 2022 – all point to a direct impact on current market prices of assets.

CPI is the most widely used measure of inflation - it tracks change over time in prices paid by consumers for certain goods and services. The graph below displays the monthly rise in CPI over the past year 12/2020-12/2021(seasonally adjusted).



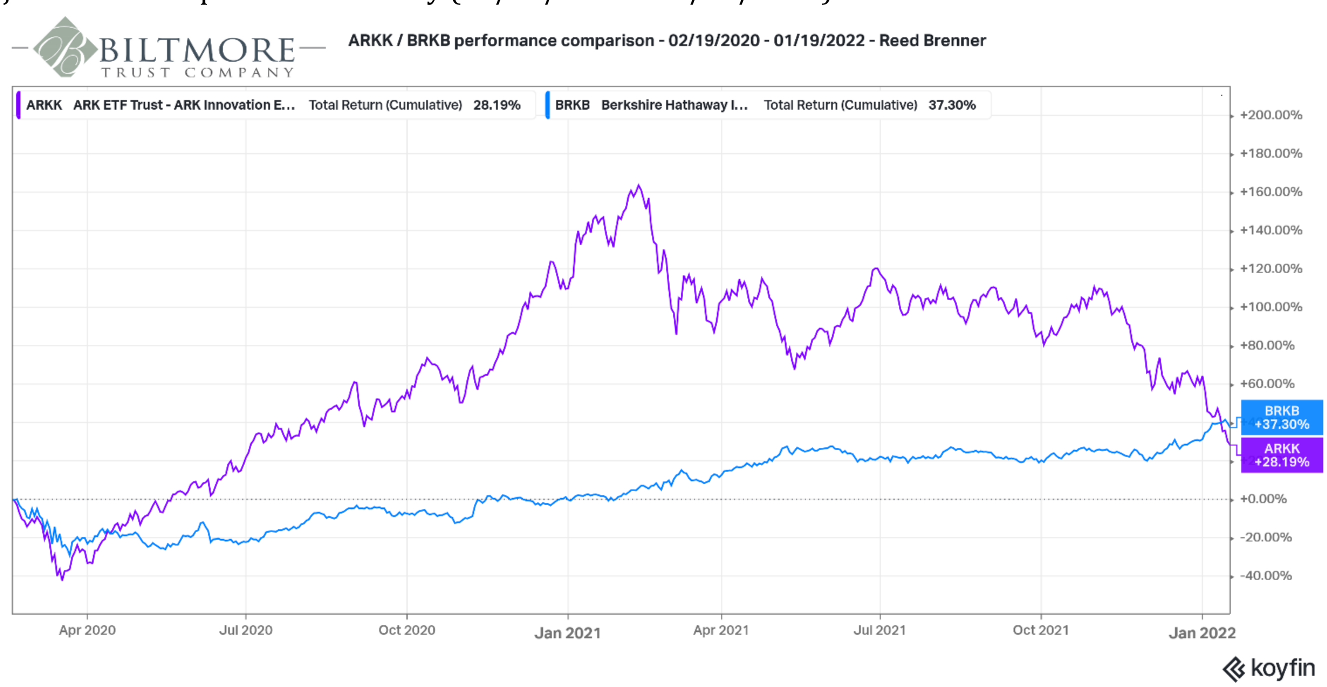

As of December 2021, inflation measured as CPI sits at 7.12%. One could argue that the real inflation rate is much higher using the controversial Shelter component as an example. Shelter is derived from the cost of rent for renter-occupied housing, in addition to an implicit rent estimate for current homeowners. It’s the single largest component of CPI at 32% and appears drastically underreported – coming in 4.1% higher for December 2021 compared to December 2020. Home prices for October 2021 (the most recent available data) rose 19% year over year, and the national average U.S. monthly rent rose 18% year over year for the same period. Home prices are not factored into the Shelter calculation but its logical to conclude homeowner implicit rent would rise as home prices increased.

A sustained period of high or rising inflation negatively impacts bonds/financials and raises the required real rate of return for investment portfolios. The projected interest rate hikes forecasted to begin in June 2022 present an additional headwind for many asset classes.

“Interest rates are to the value of assets what gravity is to matter.” -Warren Buffett

Fundamental analysis, valuation, and price always matter. The market mirage of recent years is a temporary distortion many are unable or unwilling to see beyond. Light refracted through the heat of historic liquidity injections and cool calming 0% interest rates, project an optical illusion where boundless valuation multiples are justified and prices only rise. This extreme environment has proven to be more sustainable and persistent than anyone believed possible. Its longevity has enhanced the perceived clarity of the mirage deceptively validating its authenticity - drawing investors further out the risk curve and deeper into the desert.

I would like to direct your attention toward the performance of two very different publicly traded equities ARKK and BRKB. ARKK is an actively managed ETF that invests in higher risk asset themes they define as “disruptive innovation”. Their three largest portfolio holdings are Tesla, Zoom Video, and Teladoc Health. I generated the chart below comparing performance of ARKK and BRKB starting just before the pandemic to today (02/19/2020 – 01/19/2022).




The comparison above shows two radically different paths traveled to arrive at the following result - BRKB share price increased 37.30% for the period, while ARKK share price increased 28.19%. This is an excellent example of the classic tortoise and hare scenario, and not meant to be securities selection advice. Calculating performance for the average dollar invested paints a less favorable return picture for ARKK when accounting for fund flows – but that’s a separate topic entirely. I would point you to my previous letter highlighting several market structure issues related to fund flows and passive investment vehicles.

It’s essential to maintain discipline and avoid getting swept up in the gambling mentality too prevalent in today’s markets. Interest rates at 0% cannot last forever and in economics as in life, actions have consequences. History has proven no substitute exists for fundamentals-based value investing over the long term. Focus on allocating your hard-earned capital toward exceptional businesses you desire to own during the good times and the bad.

This will help ensure your investment path leads toward an oasis of quality assets and not a “transitory” mirage in the middle of the desert.