



MITCHELL SINKLER & STARR

Second Quarter 2022 — Economic and Capital Markets Commentary

Pushed & Pulled by Inflation



“There are decades where nothing happens; and there are weeks where decades happen.”

– Vladimir Ilyich Lenin

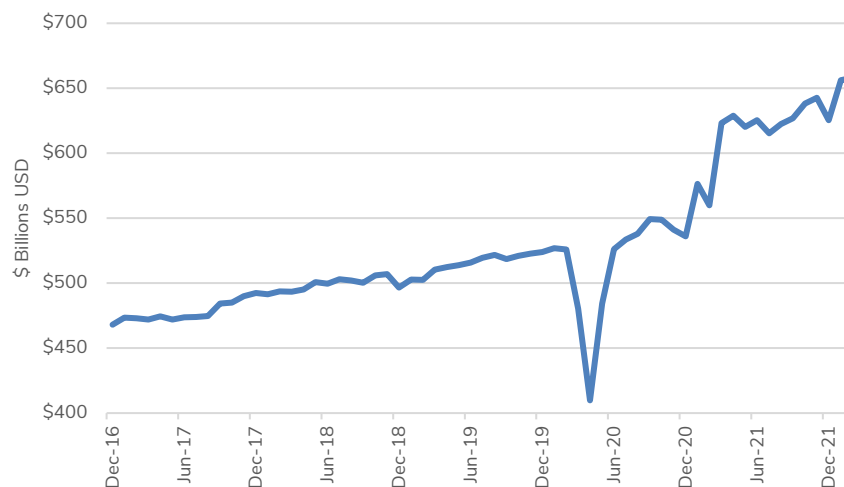
We debated using a quote from one of the worst villains of the 20th century for our commentary this quarter, but we felt it perfectly described the massive geopolitical and economic shift that occurred in such a short period of time. The post-cold war political landscape has now been redrawn. The economic globalization that had allowed low-cost goods to proliferate and global trade to rise significantly over the past several decades has been halted. For the time being, these factors may cause the developed world to experience inflation it has not seen in real significance in over 40 years.

The U.S. Consumer Continues Spending

We wrote previously about the massive increase in consumer spending that took place in 2021 due to government stimulus measures and the spending of pent-up 2020 savings. So far in 2022, that spending

spree has continued.

U.S. Monthly Retail & Service Sales



The U.S. consumer remains quite financially healthy, with over \$2 trillion in personal deposits sitting in U.S. banks that would most likely not be there if not for the pandemic. As a result, many price hikes by retailers have been absorbed by consumers without too much “demand destruction” (a long-lasting or permanent change in consumer behavior or spending choices due to higher prices).

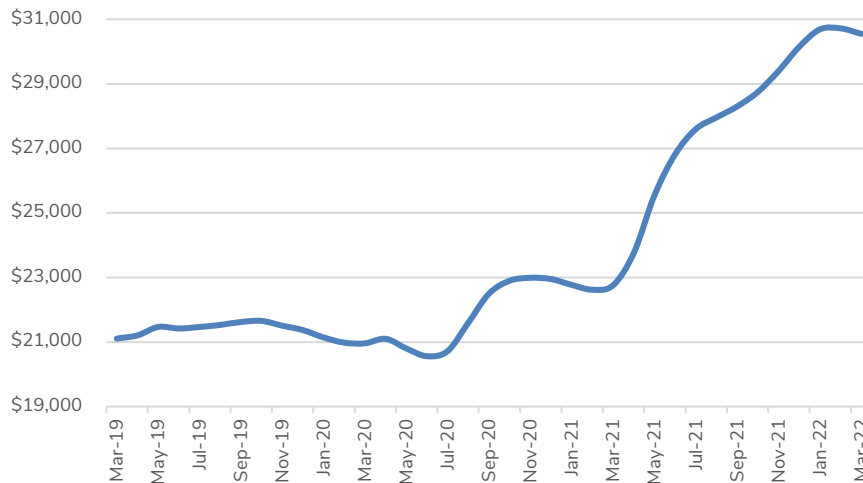


"Demand-Pull" Inflation

The high inflation that the U.S. saw in 2021 due to this ramp up in consumer spending could be considered an example of **demand-pull** inflation. Consumer demand increased so rapidly that supply could not keep up and prices were *pulled* higher. In other words, too much money was chasing too few goods. Typically, this type of inflation is short-lived and rare.

An example of this phenomenon can be seen in the used car market. In 2021, demand for new cars initially slumped, only to shoot back to pre-pandemic levels by the middle of the year, while inventory and production continued to sit at decade lows. As a result, demand for used cars also jumped, spurred by buyers who could

Average Used Car Price



not acquire new cars, *pulling* used car prices higher by over 40% in a very short period of time. In response, some car owners were selling their one-to-two-year old cars for more than they purchased them for originally, a previously unheard of occurrence.

"Cost-Push" Inflation

On the flipside, **cost-push** inflation is more common and potentially longer lasting. Simply put, when the supply of goods is

limited and the cost to increase the supply rises (due to raw material, labor, or transportation prices), the cost of finished goods is *pushed* higher. The environment for this type of inflation began brewing with the onset of the pandemic, as COVID shutdowns and shipping constraints snarled supply chains and created shortages in raw materials, from oil to coal to other base metals.



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Some of these effects had started to reverse in early 2022. On February 24, however, this progress was upended by Russia's invasion of Ukraine.

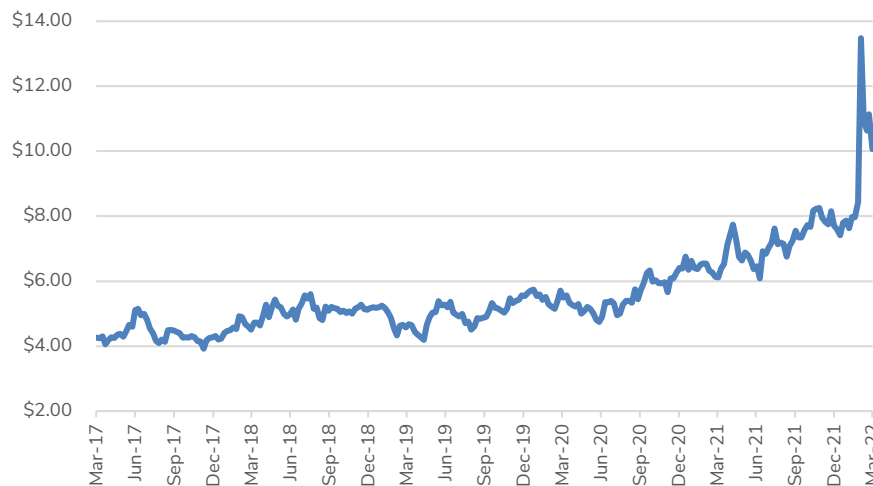
While Russia, and indeed Ukraine, are only a small part of the global economy, their production and supply of raw materials for finished goods is quite another matter:

- Russia supplies 45% of the world's palladium, 15% of the world's platinum, and 5-10% of many other of the world's precious and industrial metals.
- Ukraine supplies 50% of the world's neon gas, used to produce semiconductors (which were already in short supply).
- Russia and Ukraine combined supply 25-30% of the world's exported wheat.

Some of these raw materials will continue to ship, but there is a distinct possibility that additional international and corporate self-imposed sanctions may further cut back the supply of these goods.

Wheat prices are a good example of cost-push inflation. Demand for wheat is fairly stable over time, in the

Wheat Prices (USD/Bushel)



U.S. and even abroad. However, the possible shortage of wheat and more importantly the rising cost of producing all crops due to higher fertilizer costs (which are tied to the price of natural gas) are creating a one-two punch of reduced supply and higher input costs.

Cost-push inflation, exacerbated by the war in Ukraine, has become an unwelcomed addition to the *demand-pull* inflation we saw in 2021.

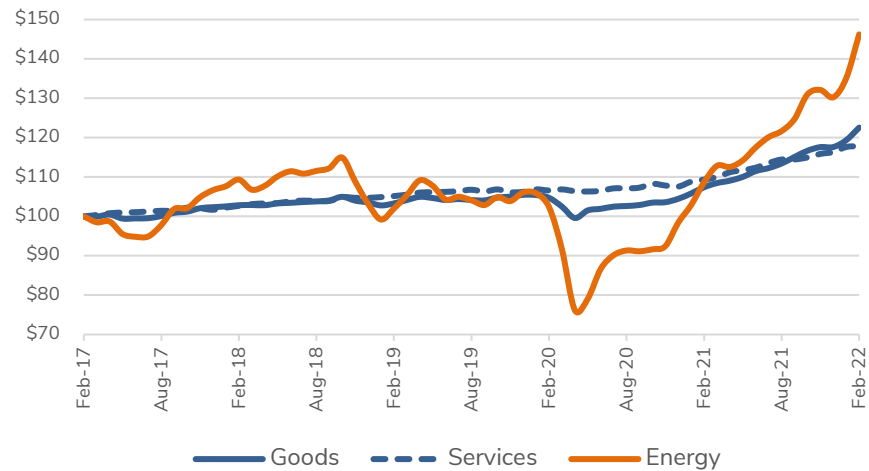


The Net Effect

These two types of inflationary effects have pushed overall headline inflation to 7.9% (as of February 2022), a 40-year high.

As shown in the accompanying Price Level chart, inflation has accelerated dramatically since 2021. As 2020 began, Americans might have paid \$105 compared to what they paid \$100 for in 2017, which could be considered manageable inflation. By 2022, those prices had increased to anywhere from \$119-\$145, dwarfing any inflation the country had seen over the past several decades.

Price Level (Base 2017 = \$100)



So far, the American consumer has been

able to adjust to this inflationary environment thanks to sizeable savings created by the pandemic. Whether they will continue to do so in the future or whether we see "demand destruction" will be the question for the remainder of 2022. Meanwhile, at Mitchell Sinkler & Starr, we will continue to use this opportunity to invest our client's assets for the long term in high-quality companies that may be selling for discounted prices compared to 2021.

We are appalled at the unprovoked aggression of the Russian government against Ukraine, and hope all our clients, especially international ones, are safe and healthy during this time.

- Mitchell Sinkler & Starr's Portfolio Managers



Economic and Capital Markets Data

	March 31, 2022	March 31, 2021	March 31, 2017
S&P 500 Index	4530	3973	2363
Price / Earnings Ratio	23.3	32.4	21.8
Dividend Yield	1.37%	1.46%	1.97%
Federal Funds Rate	0.50%	0.25%	1.00%
10-Year U.S. Treasury Yield	2.34%	1.74%	2.39%
Gold	1949	1707	1249
Oil (Brent)	100	64	53
GDP* (Annualized)	6.9%	5.9%	1.8%
Unemployment	3.6%	6.0%	4.5%
Inflation** (Annualized)	7.9%	2.6%	2.4%

First quarter 2022 earnings from most S&P 500 Index companies were generally positive; over 75% beat earnings estimates. However, over half of companies that provided forward-looking guidance adjusted their outlooks downward for the second quarter. Most cited increased labor, raw material, and supply chain costs, which could not be completely passed through to the consumer in such a short period.

* GDP Data as of 12/31/2021

** Inflation Data as of 2/28/2022

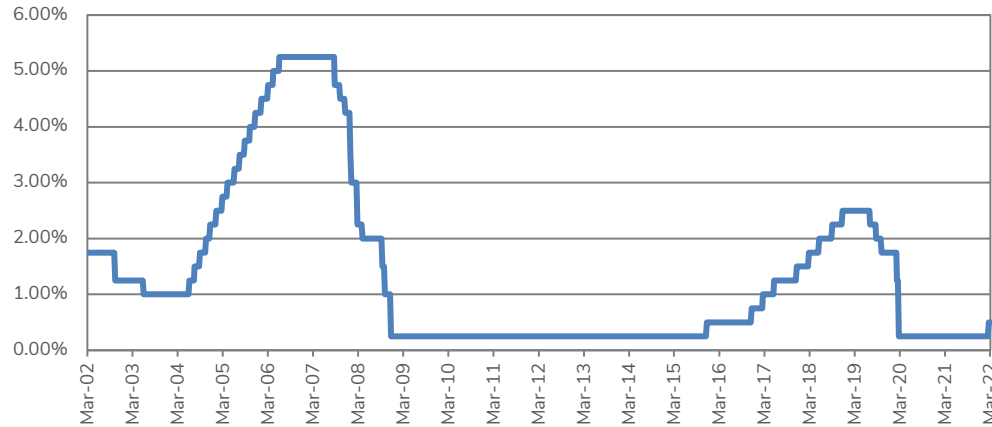


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Quarterly Charts

A brief selection of quarterly charts offering insights relevant to the current period.

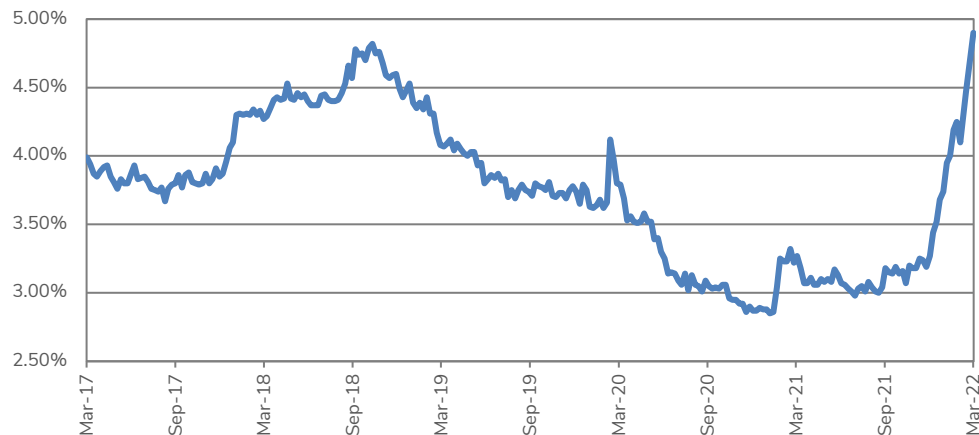
Federal Funds Target Rate



The Federal Reserve raised the Federal Funds rate 0.25% in March. With the country effectively back to "full employment," the Fed is now mainly concerned about inflation. A further six rate increases are projected for 2022.

As the Federal Reserve has begun raising rates, yields on treasury bonds and, indirectly, mortgages, have increased at a brisk pace, moving up over 1.5% in the first quarter alone. This may have an impact on the housing market in the second half of the year.

30-Year Mortgage Rates

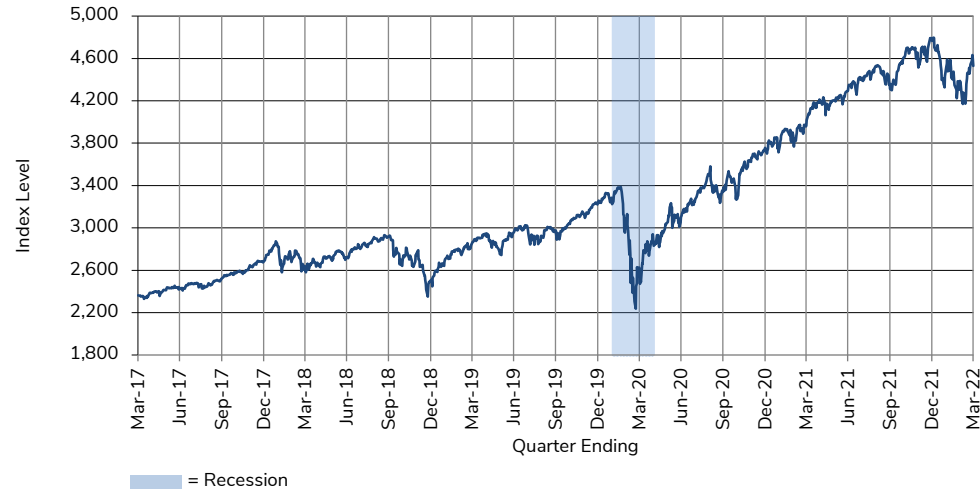




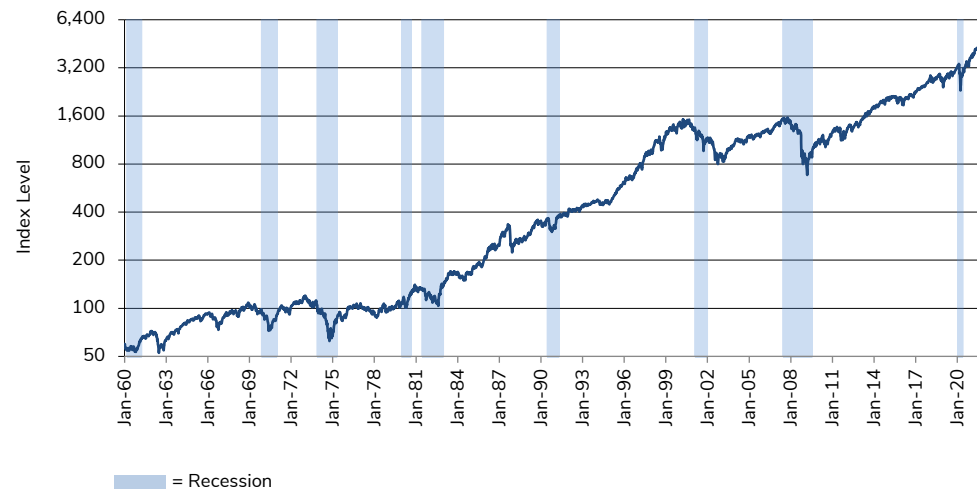
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After a very strong 2021, U.S. stocks declined during the quarter; the first quarterly decline since COVID struck in March 2020. In early March, before recovering somewhat, U.S. equities were down 12%, a relatively normal annual occurrence, historically (except for the past several years).

S&P 500 Index - 5 Years



S&P 500 Index - Since 1960



Over the longer term, and especially in a low interest rate environment, we believe stocks remain the only liquid asset class with potential for growth in excess of inflation.

Source for table & chart data: U.S. Federal Reserve, Bloomberg Finance L.P., CarGurus.com