Inside This Issue

p.1 The US Economy, Inflation and Interest Rates *By Carl Terzer*

p.1 2nd Quarter Economic and Market Review *By Greg Hahn*

p. 7 US Inflation: Past the Peak but a Long Descent Ahead *By Jeffrey Brothers*

p. 8 Upcoming events

The US Economy, Inflation and Interest Rates

The US Economy

The most common measurement of the status of the US economy is GDP (gross national product*). Over the last 74 years, the US GDP Annual Growth Rate has averaged 3.14%. An all-time high of 13.40% was reached in the fourth quarter of 1950 and a record low of -9.10% was reached in the second quarter of 2020 as a result of the Covid pandemic.

For 2021, the US achieved exceptionally strong economic growth rebounding from the effects of the 2020 economic shutdowns. While a positive growth rate (see the 10-year average annualized 2% GDP trendline on p.4) is the expected norm, Q1 2022 had a -1.6% growth rate, meaning a contraction of economic activity. Two consecutive negative quarters generally signifies an economic recession.

While official Q2 GDP numbers were

Continued on page 4

2nd Quarter Economic and Market Review

Economy

Monetary policy in the first half of this year stands in stark contrast to the past 15 years and investors are navigating capital markets that no longer have government support.

The cumulative budget deficits, trade tariffs, supply chain disruptions and rapid money growth have pushed the rate of inflation to 9.1% measured by the Consumer Price Index (CPI), its highest level since 1981. The Fed's response is to ween the capital markets off the support of the central bank and increase short-term interest rates, which have been pushed higher by 1.25% so far this year. This is an important contrast to the past 15 years in which the Fed stepped in at the first sign of trouble to support economic growth and asset values with accommodative policies.

There are several consequences to the new Fed policy regime. First, we do not expect the Fed will step in to help support asset prices. We believe the Fed will sacrifice economic growth for the perception that it is diligently fighting rising inflation. Perception is half the battle; if the Fed is viewed as laissez-faire, the market will adjust to the perception that inflation will continue to rise.

Second, the U.S. dollar will

Continued on page 2

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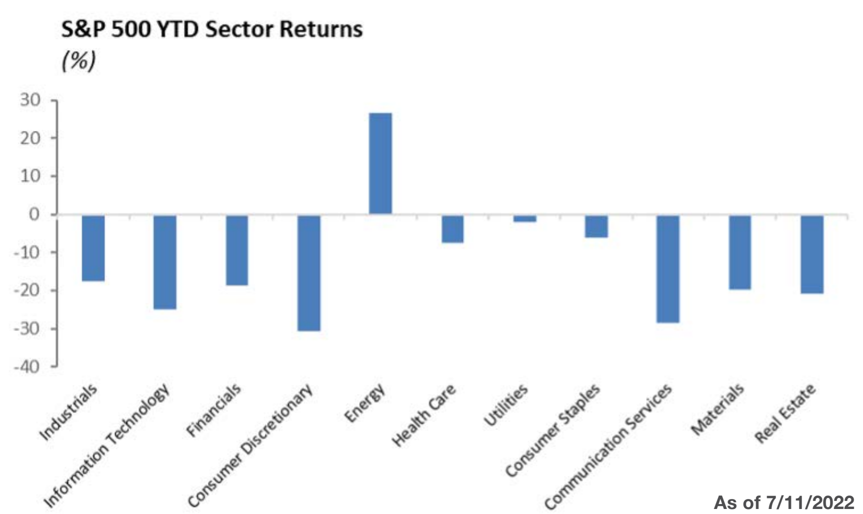
2nd Quarter Economic and Market Review

Greg Hahn: Prior to forming Winthrop Capital Management, Greg was the Chief Investment Officer and Senior Portfolio Manager for Oppenheimer Asset Management and its subsidiary, Oppenheimer Investment Management. Greg also served as the Chief Investment Officer and Senior Portfolio Manager with Conseco Capital Management (40|86 Advisors). Greg was President and Trustee of the 40|86 Series Trust and the 40|86 Strategic Income Fund. Also, Greg had responsibility for the $1.2 billion real estate and private equity portfolio.

strengthen relative to other currencies. This makes U.S. goods more expensive overseas, and foreign goods such as cars and electronics cheaper in the U.S. As a result, imports increase and U.S. exports decline. We are early in the currency adjustment; however, we expect the response by the central banks of other developed countries is to raise their short-term interest rates to force a relative strengthening of their currencies.

Third, the result of a drastic push higher in short-term rates is that the global growth will slow. First quarter 2022 U.S. economic growth measured by Gross Domestic Product was -1.5%. We expect GDP growth for the second quarter to also be negative. Fourth, the Fed will once again be in a position to lower interest rates once it views inflation as under control. Up to this point, with short-term interest rates near zero, lowering rates wasn't a thing.



Equities

Investors are navigating market conditions that we haven't experienced in nearly 40 years. After declining -20.6% in the first half of the year, the S&P 500 started the second half of the year on a positive note, rising 3%. This was the largest six-month loss for the start of the year for the S&P 500 since 1970.

The most beaten down sectors in the first half of the year – consumer discretionary, communication services, and information technology – provided a lift to the index to start the third quarter, with all three increasing over 5%.

The energy sector finally gave back some ground as WTI Crude oil prices fell below $100 briefly and closed the week at $97.30, well below its recent highs. Commodities prices across the board continue to decline. The Bloomberg All Commodity ETF began the year with a 35% rise and has lost 20% just in the last month alone. This will have a muting impact on July's PPI inflation figures. From a sector perspective, we see both the technology sector and the healthcare sector as attractive picks moving forward. The tech sector has fallen -25% this year and offers several high-quality names with great

Continued on page 3

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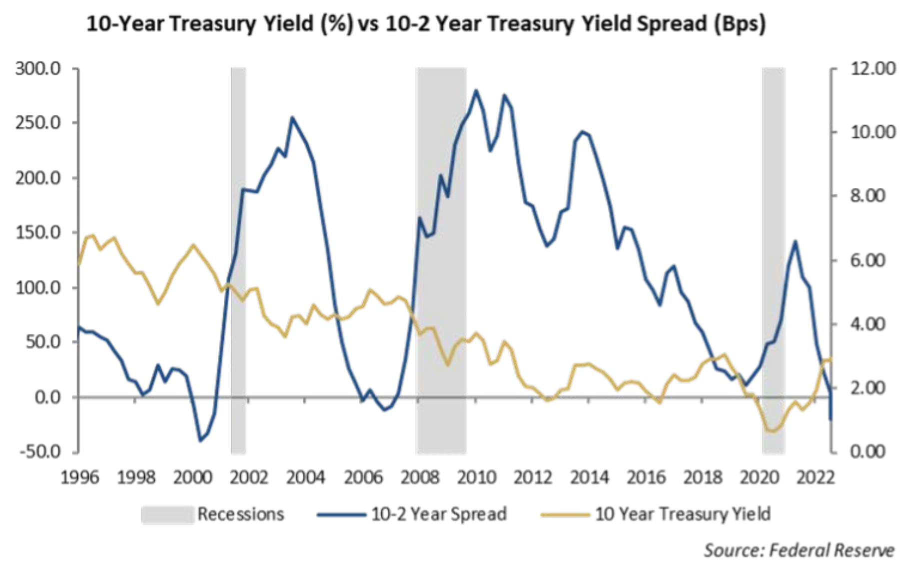
2nd Quarter Economic and Market Review

business models, high free cash flow, and cheap valuations. The sector includes companies such as Apple [AAPL], Microsoft [MSFT], Nvidia [NVDA], and Adobe [ADBE], which we believe are core holdings within a diversified equity portfolio. Also, the healthcare sector has outperformed the general market so far this year, falling just 7%. However, the S&P 500 Healthcare P/E is just 15.8x. This is lower than the general market and still lower than the historical averages for this sector at over 20x earnings. There is plenty of room for this sector to outperform from current valuations. Companies have strong balance sheets for M&A to build their pipelines and demographic trends will continue to help this sector given an aging global population.



Fixed Income

Since 1955, the U.S has had 12 economic recessions. Economists measure a recession as two consecutive quarters of declining GDP growth. In that time span, the yield curve as measured by the spread of the yield of the 10-year and 2-year U.S. Treasury, has predicted all 12 of those recessions. There was one false positive, but in the world of investing, a 92.3% accuracy rate makes it a very good predictor. The forward indication comes from an inverted yield curve, where the interest rate on the 10-year bond is lower than that of the 2-year bond. We entered the realm of yield curve inversion again last week.

Why is this important?

Over the last week, the 2 -10 year yield curve inverted and has remained that way. At the same time, 1Q 2022 GDP figures showed a -1.5% decline year-over-year, and the minutes from the recent Fed meeting reinforced its intent to continue to tighten policy aggressively regardless of the impact on economic growth. Economic data shows an economy that continues to weaken and the U.S. dollar continues to strengthen relative to other currencies. We believe this circular feedback loop will ultimately translate into lower inflation, but at a significant cost to economic growth. Long term, growth is a more significant driver of interest rates than inflation and this is why we have yet to see rates increase to a level remotely close to current inflation.

What should we do about it?

We believe this decline in economic growth in the face of rising short term interest rates may signal that long-term interest rates may have hit their near term highs. This would warrant an extension in duration for fixed income portfolios and an increase in

Continued on page 4

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2nd Quarter Economic and Market Review

allocation to spread sectors.

Spreads in credit and structured securities sectors continue to widen on anticipation of the slowing global economy. The increased illiquidity in the bond market following the rise in rates also plays into the current spread widening. However, we have yet to see significant deterioration in the underlying credit markets. The domestic new bankruptcy filings are still at 10-year lows and the majority of companies were able to refinance their debt at low interest rates in 2020-2021, effectively kicking the can down the road. JPMorgan announced a sizeable increase to its loan loss provision this past quarter.

The massive government support injected into the economy and capital markets over the past several years has had the impact of lengthening the credit cycle. The recent dislocation in credit spreads provides investors an opportunity to invest that we have not seen in many years.

The US Economy, Inflation and Interest Rates

not yet available as of this writing, figure 2 indicates that the Atlanta Fed projects that the US economy is possibly already in a recession. Many economists think that a recession would be short-lived and some believe that it could be entirely avoided. However, there is a consensus around the fact that the economy will slow significantly during the inflation fight. It must!

Inflation's Role

Most Americans under the age of 50 will have no memory of the last time the U.S. suffered a nasty bout of inflation. It took place in the late 1970's, early 1980's. Then Fed Chairman, Paul Volcker, famously took unprecedently aggressive action jacking up interest rates by as much as three percentage points. That's about six times the pace seen in a more typical rate-hiking cycle, where the Fed moves in 0.25 percentage-point increments. Eventually, the Fed needed to move interest rates some five percentage points over the inflation rate. That drastic increase induced a sharp recession, but the result was that inflation eventually subsided.

Continued on page 5

Annualized Inflation Rates Figure 1

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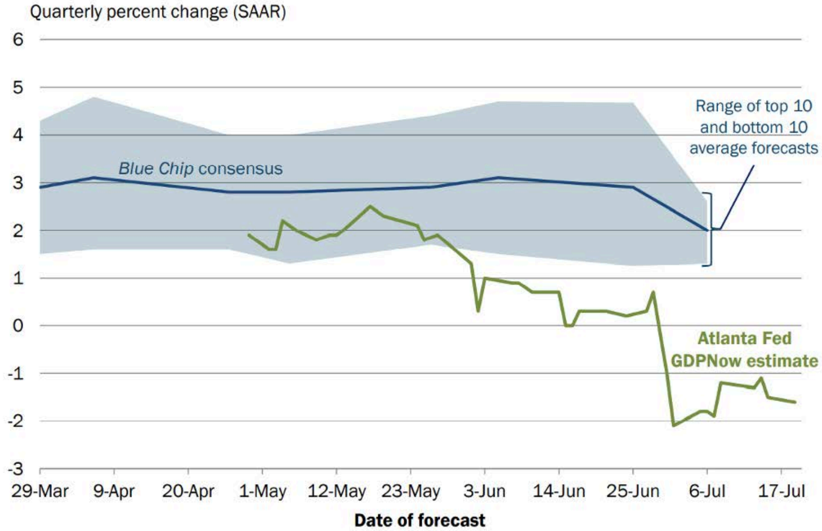
Evolution of Atlanta Fed GDPNow real GDP estimate for 2022: Q2 Figure 2
Quarterly percent change (SAAR)



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

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The US Economy, Inflation and Interest Rates

As you can see from figure 3, it still took more than 6 years to get inflation under control!

Figure 3

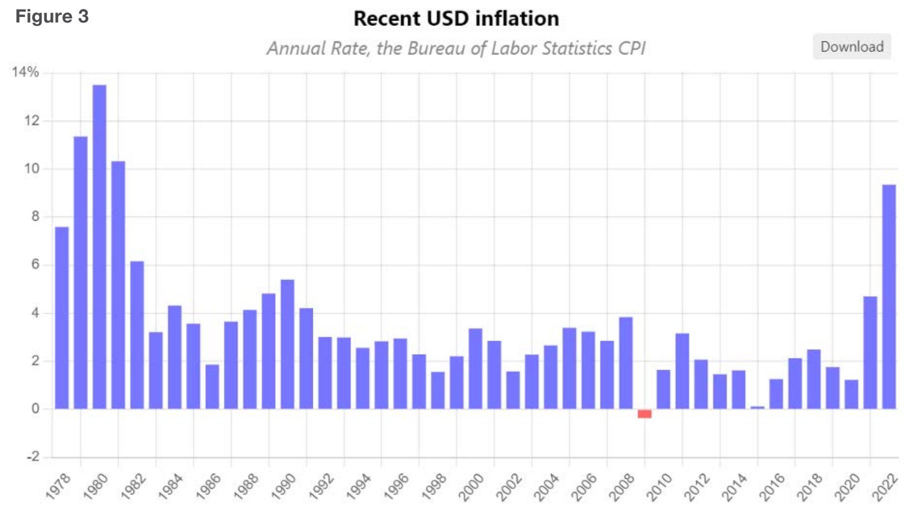
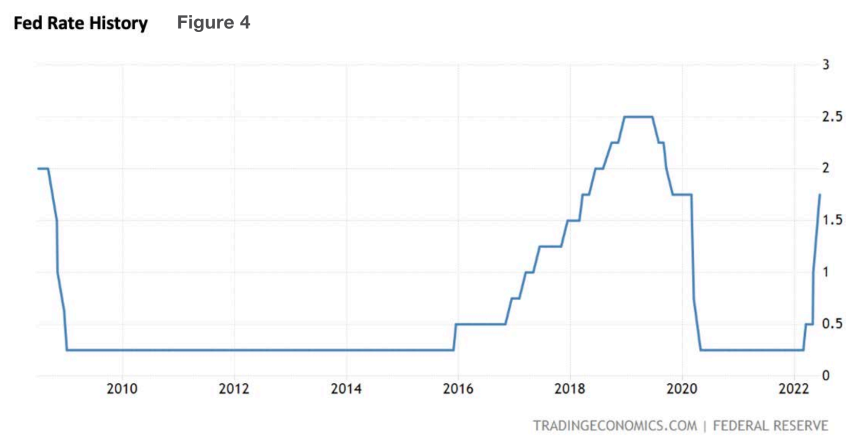


Figure 4



The Fed's directives are to maintain a monetary policy for the US that keeps inflation low (they target a 2%/year growth rate) and promotes full employment. Political pressures may arguably push the Fed to do more.**

Inflation is a primary example of policy excesses over the last 14 years. Perhaps oversimplified, too much money (excess liquidity in the economy) chasing too few goods/services generates inflation. High and uncontrolled inflation begets economic turmoil and often results in recession. Even today, after nearly a year of increasing inflation, we see household finances in a stronger position than they have been for many years meaning inflationary pressures due to excessive liquidity still exist.

In May 2022, inflation surged to a four decade high of 9.1% and Fed officials were worried enough to entertain the prospect of a 1 percentage point rate hike at the next FOMC which meets later this July. However, it is more likely that we will see another 75 bp increase that follows the 75 and 50 bps increases of June and May respectively. Such a move would raise the federal funds rate to a range between 2.25% and 2.5%, still 6 percentage points below the current headline inflation rate.

Interest Rates

The cure for runaway inflation is a nasty dose of rapidly increasing interest rates. That is, dramatic Fed action is required. Many say the Fed should have started raising rates in the 3rd or 4th quarter of 2021 when the inflation momentum was growing. As early as March 2021, the US inflation rate was at 3.7%, nearing twice the Fed's 2% target rate. However, the Fed and the Administration believed inflation to be "transitory" at that time notwithstanding the warnings of many economists.

Their position was that inflation was simply the byproduct of disruptions in the economy primarily attributable to the pandemic shutdowns and resulting supply chain kinks followed by the snap-back in demand when the lockdowns ended. As evidence, the Fed decided to hold rates at near zero until their May 2022 meeting. Big mistake, in retrospect! Even notable backers of the transitory inflation theory such as Noble Prize-winning economist, Paul Krugman, now have conceded that "Team Transitory" got it wrong.

Continued on page 6

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The US Economy, Inflation and Interest Rates

Conclusions

We are coming out of an anomalous time period 2008-2022, when levels of Fed monetary policy action, that is interest rate manipulation, were historically unprecedented. Rates were held at or near zero for about 70% of this lengthy period – please see figure 4 on page 5. Even during the most recent cycle of raising rates, the Fed's rate never exceeded 2.5% - still low by historical standards. For perspective, interest rates in the US averaged 5.44% from 1971 until 2022, reaching an all-time high of 20% in March of 1980 and a record low of 0.25% in December of 2008.

We have written in previous editions of this newsletter how recent Fed policy, coupled with the history of accommodative Fed monetary policy since 2008 helped keep the US economy going. Unfortunately, as a presumably unintended consequence, it has also served to create the fictious investment environment with a near zero cost of capital – "free money" that found its way into the markets pushing asset prices higher. As a result, the stock market experienced it longest and strongest bull run in history. Late in the bull cycle, we witnessed "buying the dip" on every dip, as though the market would always turn quickly upward again. This market optimism progressed more recently into signs of highly speculative investment behaviors. Examples of these excesses were quite evident as we witnessed somewhat unconventional, if not irrational, trading in GameStop, AMC, bitcoin, and others. Momentum trading went "viral" and crowdsourced trade ideas dominated the market while market and credit fundamentals were increasingly ignored. Historians will note that we have seen this before: the tulip crazy of 1634 and the dot com bubble of 2000-2001. We know how those stories end.

The painful market correction of 2022 has brought the US stock market Forward P/E ratios from 21.4% in January 2022 to 15.9% as of 6/30, more in line with historical norms. However, most other market corrections/crashes ended with Forward P/E's at even lower rates. Therefore, many argue that there is still another 10-20% drop in the stock market that is possible. Counterbalancing this opinion, we have many sectors of the market operating well and producing good results. Coupled with elevated household finances and low unemployment rates, many are calling for a mild recession. Europe and Asia may experience worse.

> “Inflation is a primary example of policy excesses over the last 14 years. Perhaps oversimplified, too much money (excess liquidity in the economy) chasing too few goods/services generates inflation.”

Of course, in addition to global macro-economic factors, we have global political factors to consider. A change in US Congress this fall, possible resolutions to the Ukrainian/Russian war and potential for increased turbulence in US/China relations will all play into the US economy's and the market's progress for the remainder of 2022.

We are encouraging our insurance clients to explore asset classes that may be less correlated or have no correlation to their core holdings of investment-grade bonds and S&P 500 stocks. Many are looking to the non-public securities market, some of which are now offering investment-grade credit rated securities, with shortened lock-ups for improved liquidity, and low minimum investment levels. High Yield bonds, while struggling of late, offer additional yield and are among the strongest rebounding asset classes after market setbacks. For those willing to be contrarians and enter the stock market at discounted prices, dollar cost averaging into the market has been a desired approach with the expectation of continued volitility. All of these approaches have received positive receptions at recent board meetings.

In this heightened risk environment, we encourage readers to re-evaluate their insurance company's financial strength and correspondingly reassess their risk and return expectations. An understanding of liquidity requirements can help determine the options available to successfully navigate upcoming quarters and the expected continuance of high volitility. Put on your seat belts: 2022 probably represents a transition to a new and potentially different investing cycle than we have had for many years. ☐

*Investopedia: Gross national product (GNP) is an estimate of the total value of all the final products and services turned out in a given period by the means of production owned by a country's residents.

** Full employment general means an unemployment rate of about 3-5% due to naturally occurring factors such as structural, frictional, institutional and cyclical unemployment

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US Inflation: Past the Peak but a Long Descent Ahead

Jeffrey Brothers, CFA
Mr. Brothers serves as Chief Investment Officer, leads the Investment Policy and Strategy Committee and is a member of the Executive Committee of the firm. Mr. Brothers joined Bradford & Marzec, now part of Ducenta Squared Asset Management, in 1994 and has 35 years of investment industry experience. Mr. Brothers earned a Bachelor of Arts degree in economics from the University of California at Los Angeles and Master of Business Administration degree with an emphasis in investments from the University of Southern California. He is a CFA® charterholder and a member of the Los Angeles Society of Financial Analysts.

Consumer prices moderated in April as the annualized headline CPI fell from 8.5% to 8.3% and the Core CPI, which excludes food and energy, slipped from 6.5% in March to 6.2%. The decline, however, provides little consolation to consumers, as price increases are proving more persistent and are rising at the fastest pace in 40 years. While we may have reached the peak in inflation, the descent from the summit back to the Federal Reserve's 2% target could be a long and difficult journey.

The April headline CPI decreased notably from 1.2% to 0.3% as energy prices declined but food prices continued to rise sharply. Food prices are now running at a 9.4% annual pace. The core CPI increased 0.6% versus consensus estimates for only a 0.4% rise. The stronger than expected core increase was primarily attributable to the pandemic reopening rebound in airfares (+18.6% m/m) and lodging (+1.7% m/m). The record increase in airfares alone contributed 0.13% to the overall increase in core CPI. Goods prices, which recorded outsized demand and price increases during the pandemic, did soften but are proving less transitory than originally expected. As consumers shift away from goods spending, service prices saw broad based gains and are now up by 4.9% over the past year. Shelter inflation, which tends to be slower moving but more persistent, continued its upward momentum with a 0.5% increase in April to a 5.1% annual pace.

We do believe inflation has reached a peak for the economic cycle, but unfortunately will stay hot for the remainder of the year. We see core CPI declining from the current 6.2% to 4.5% by the end of the year. Price pressures have become broader based and entrenched in the price setting for the economy. We do expect improvement to come from cooling goods prices as supply chains normalize and reopening pressures fade. Risks and uncertainties to the supply chains, however, have increased with the Russia-Ukraine conflict and covid lockdowns in China.

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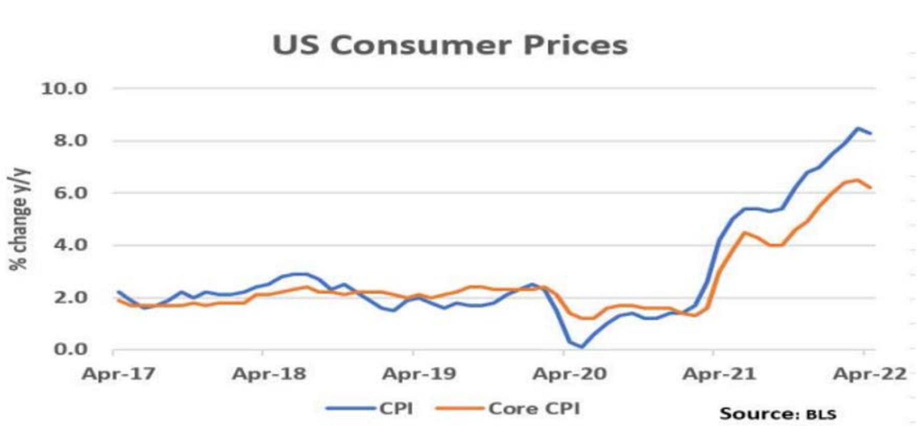

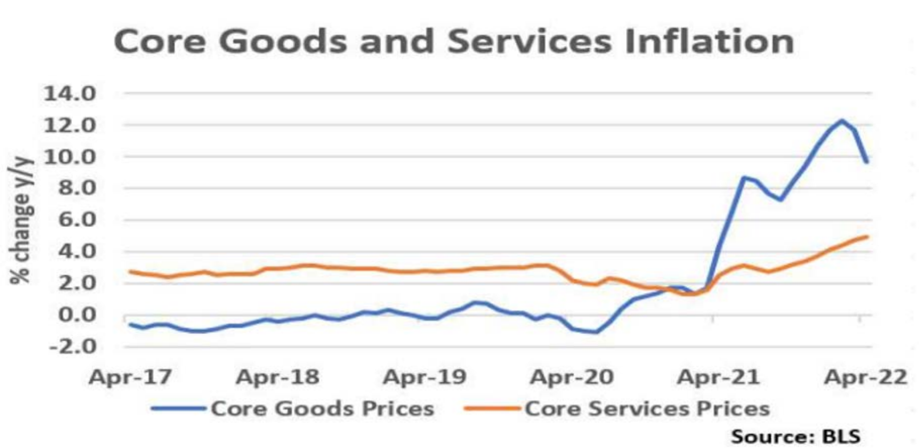

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US Inflation: Past the Peak but a Long Descent Ahead

Energy prices improved in April but have started to rise again ahead of expected strong summer demand. Rent prices move with a lag, which indicates upward shelter prices in the pipeline even if home prices begin to moderate. Lastly, inflation pressures may also remain stubbornly high due to the overheated labor markets. Wage pressures, with robust demand and record job openings, continue to build and average hourly earnings rose at a 5.5% annual rate in April.

Upcoming Events

1. The *Bermuda Captive Conference* is coming up on September 12th-14th. Carl Terzer is speaking in the session, "Captives, Risk Management and the Cost of Capital. " Travis Terzer will also be in attendance.

2. Carl Terzer and Travis Terzer will be attending the *NAMIC Annual Convention* in Dallas on September 18th-21st. We hope you stop by our booth #719.

3. *SCCIA*'s *annual conference* is being held on September 20th-22nd in Charleston, SC. Travis Terzer is speaking in a session entitled, "Captive Cash Flow Strategies: Collection, Technology & Investment." Carl Terzer will also be in attendance.

4. On September 26th and 27th, Carl Terzer will be in Washington, DC for the *CIC-DC Annual Conference*. Carl is on the board and will be moderating a session entitled, "Fresh Ideas for Captive Insurance Investment Policies in Turbulent Times." The session is scheduled for 11:15 on the 27th. We hope to see you there.

5. The *TCIA annual conference* will be taking place in Nashville on November 11th-15th. Carl Terzer will be speaking about asset allocation ideas for captives. Connect with CapVisor's LinkedIn page for more details.

6. CapVisor will be attending the *Cayman Captive Forum* on November 29th - December 1st. We look forward to seeing you there.

Carl E. Terzer, Principal & Editor in Chief CapVisor Associates, LLC

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