JAG CAPITAL MANAGEMENT LLC

Quarterly Comments

Stormy Weather

As most of us are aware, the current European land war involving a nuclear-armed nation is unprecedented. Although much of the world has united to effectively "cancel" the entire Russian economy from the global community, Russia's vast oil, gas, and agricultural resources add enormous complexity to the situation. According to Reuters and other sources, Europe relies on Russia to provide 35% of its natural gas. This means that Russia's ostracization is thus far incomplete. Although it is difficult if not impossible to predict the short- and long-term implications of the conflict, we have updated some observations that we originally shared with clients after the initial invasion:

- The war raises the risk of an economic slowdown, especially in Europe. Given that the EU is generally unprepared to find substitute energy supplies in the near term, rising energy prices are likely to be acute in Europe. Although inflation is a global phenomenon, Europe is likely to feel its effects more strongly than the US.
- Supply chain disruptions caused by the US China trade war, the pandemic, and the Ukraine conflict will drive companies to accelerate efforts to move more of their production from overseas to at home or nearby stable countries. According to a March 17, 2022 article in the Harvard Business Review "**How the War in Ukraine Is Further Disrupting Global Supply Chains,**" major announcements of domestic manufacturing projects have been made recently by companies in electrical components, electric vehicle battery, solar panel, semiconductor, and biotechnology industries. However, as the same article outlines, this process will play out over years, not months. For example, Intel's (INTC) plan to spend $20 billion to build two new semiconductor factories in Ohio is ambitious, but the first chips will not be produced until 2025.
- As has been true since our nation's founding, the United States possesses several natural — and lucky — advantages. Geographically, we are flanked by two vast oceans to our east and west, and friendly neighbors to our north and south. We have abundant natural and agricultural resources, and our political and economic framework supports free markets and the rule of law. Although we have many problems in this country, the US economy is particularly well-situated to thrive in the coming decades.

Source: Caglecartoons.com

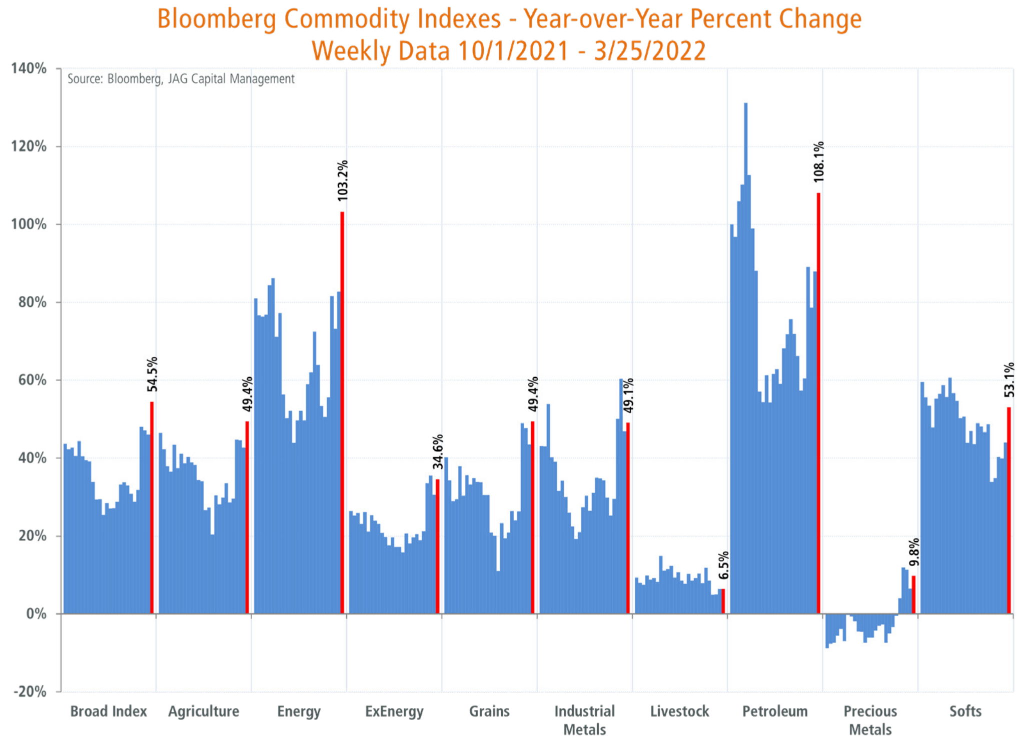
Firm Highlights

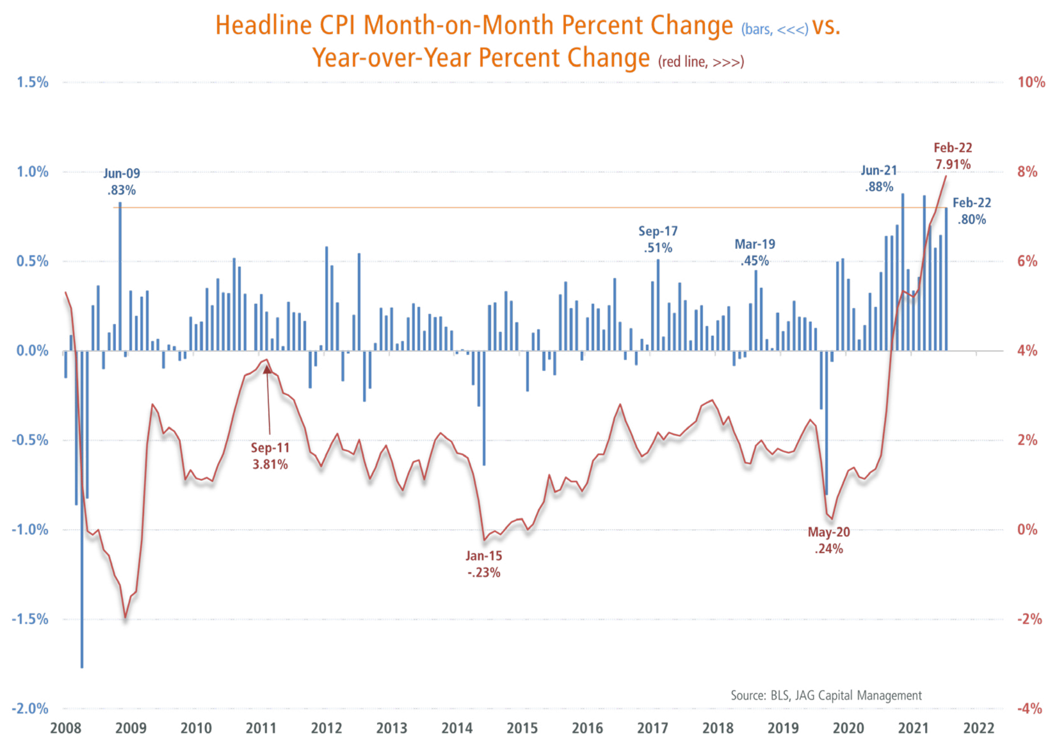
- **Welcome John!**

  John Krueger joined JAG as a Junior Equity Research Analyst with a focus on cyclical and consumer-oriented companies. John previously was an investment banking analyst at Cornerstone Business Services.

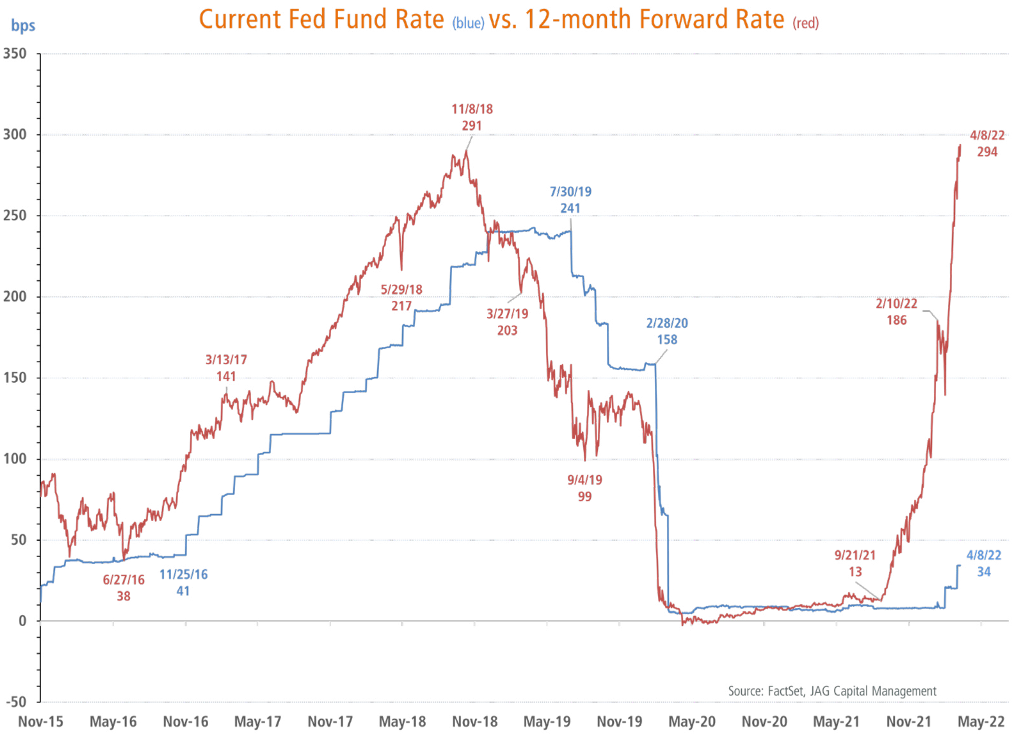
  John earned a BS in Business Administration and a Master of Accountancy, Taxation, Accounting from The University of Arkansas, Sam M. Walton College of Business. He is a Level III Chartered Financial Analyst (CFA®) candidate and regularly attends CFA Society meetings.

Over the very short term, volatility in the capital markets will continue to fluctuate, sometimes dramatically, in response to all these economic and geopolitical concerns. Because of our human tendency to place too much emphasis on recent events, investors tend to respond to downside volatility by becoming more pessimistic about the future. Stock market corrections almost always exacerbate investor fears. Most recently, this phenomenon was reflected in JAG's own internal sentiment indicators, which reached extreme levels of bearishness in mid-to-late March. As we described in a recent **JAG Team Insights: Sentiment Index**, negative extremes in investor sentiment tend to appear at or near intermediate-term lows for stock prices. As it turns out, this most recent sentiment extreme was indeed followed by a meaningful bounce in the broader market. We note that the S&P 500 gained 5.8% according to FactSet between the 2/24/2022 start of the Ukraine invasion through the end of March. Although it seems counterintuitive that stocks would make gains in the face of such awful news, it is yet another reminder that markets excel at frustrating and exhausting investors.





Price inflation began to rear its head last year, initially as a function of the collision between strong post-COVID demand and pandemic-clogged supply chains. At the time, we (and the Federal Reserve) were optimistic that inflation would cool as the supply side re-adjusted after the pandemic. This has not proven true, and the war in Ukraine has almost certainly made the situation worse. The Fed has changed their tune and is aggressively signaling their intent to tamp down inflation. During their March 2022 meeting, they hiked the Fed Funds rate by 0.25%,the first such increase since 2018. According to CNBC, the median member of the Federal Open Market Committee (FOMC) expects roughly six more rate hikes this year, which would bring the Fed Funds rate up to nearly 2%. Markets expect even more tightening, with futures indicating Fed Funds increasing to almost 3% by this time next year.



The Fed is hoping that their rate increases will prove to be enough to dampen demand and slow the pace of inflation, without tipping the economy into a recession. If they are successful, it would represent a so-called "soft landing" for the US economy. Historically, this has proven to be a tricky task, as eight out of the last 11 tightening cycles have been followed by a recession.

That said, a recession is possible but hardly a certain outcome in the near-to-intermediate term. The US labor market remains strong, with unemployment at only 3.8%. According to Barron's, household net worth climbed 37% between the beginning of 2020 and the end of 2021. In short, consumers remain in good shape, which probably gives our economy a bit of a buffer against the headwinds of higher rates and more persistent inflation.

Outlook

Consistent with our **Fourth Quarter Commentary**, we expect elevated market volatility to persist over the short-to-intermediate term. To borrow a phrase from the late Donald Rumsfeld, markets are wrestling with an unusually complex mélange of "known knowns" and "known unknowns." We know that the Fed will continue to hike rates, but we do not know how far they will go. We know life has returned to more normalcy compared with 2020/2021, but Covid variants continue to pop up and we do not know the frequency, severity or consequences of future outbreaks. We know that the war in Ukraine has been devastating and horrific, but we do not know when it will be over. Even beyond the current war, markets are also processing the profound and long-lasting geopolitical changes that it will leave in its wake. Besieged by crushing economic sanctions, Russia is well on their way to becoming an isolated pariah nation. However, the fact that Russia maintains the world's largest nuclear weapon stockpile makes it difficult to completely disengage with them. The "known unknown" of Russia's territorial ambitions combined with their weapons arsenal could be a source of complex geopolitical risks for years to come.

In the meantime, NATO and the broader EU alliance have committed to much higher defense spending, as well as more investments in energy infrastructure and sourcing. Ukraine will eventually need to be rebuilt, in some areas literally from the ground up. Putting it all together, we think the next several years could represent the most significant period of capital investment in Europe since the fall of the Berlin Wall. If the past is prologue, the post-war rebuilding in Europe will present some great investment opportunities.

The US corporate sector continues to be healthy, and operating earnings for the S&P 500 are expected to grow more than 8% over the coming 12 months. The index now trades at approximately 20x forward estimated earnings, equating to a forward earnings yield of roughly 5%.

S&P 500 Fwd P/E Ratio

Forward Earnings Yield for S&P 500 (blue line), Baa Yield (red line), 10 Year Treasury Yield (grn line)

By these measures, we view stocks overall as being fairly valued rather than objectively inexpensive. We see limited room for significant multiple expansion over the next year, especially if interest rates remain in an uptrend. For the broader market, this implies that earnings growth could need to carry the load for equity returns over the intermediate term. Given "higher for longer" inflation pressures, we favor companies with strong pricing power for their goods and services. These types of companies can pass on higher input costs to their customers, thereby protecting their margins.

Environmental, Social, and Governance (ESG) Update

There is a rapidly growing awareness of ESG investing among our clients and the companies we invest in. Most corporate earnings calls now address their approaches to ESG, and we have found that many companies on our surveillance list are committed to taking sensible steps to improve their environmental footprint, optimize how they treat their employees and stakeholders, and emphasize strong corporate governance practices.

JAG has decades of experience in responsible investing, and we became a signatory to the UN Principles for Responsible Investment years ago. We believe that incorporating ESG factors into our portfolio decisions can help us identify attractive securities while mitigating security- and industry-specific risk. Our investment strategy teams have access to Sustainalytics as our primary ESG data source, which can then be integrated into individual portfolios. In addition, we collaborate with our clients and others in the industry to support our ESG efforts. Typically, JAG uses ESG data to allow us to focus on companies demonstrating leadership and/or improvement in their performance on material ESG issues.

Warm regards,

Norm Conley
CEO, Chief Investment Officer &
Portfolio Manager

Mike Kimbarovsky
Managing Director &
Portfolio Manager

Disclosures

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