Warren Financial
Investing for a Greater Purpose

Warren Financial
Q3 2022
Market Strategy

INSIDE THIS EDITION

"HEY SIRI, DOWNLOAD THE WARREN FINANCIAL APP"

INSIGHTS

- Inflation is running hot
- But is it getting hotter? Or is inflation beginning to cool? Currently the economic numbers show: “neither”.
- Commodity prices are cooling.
- Manufacturing is not hot
- Only JOBS continue to be hot
- And the Supply Chain is still broken but definitely healing
- China is open again which should help the supply chain but put some marginal extra demand on energy.
- Mortgage rates have already doubled! Rates have not waited on the Fed to raise rates but have jumped ahead – causing the housing market to lose its froth and begin cooling
- Housing prices won’t likely go down much because there simply are not enough houses to accommodate household formation for millennials. And there are not enough houses to accommodate re-positioning of people out of cities.

Cash Is King

During these trying times, when markets, gold, bonds, and everything else are all going down, you will find that when we sell something as protection from downside, we often just sit on the cash and don’t reinvest. This is temporary. When the market heals and the economy looks better, when the Fed is done (or close to done) raising rates, and the stock and bond markets start going up again…. Then the cash we have sitting on the sidelines, can and will be used to invest in great companies at cheap prices.

For example, I never thought I’d see Apple trading in the $133 range. We even used a little cash in the WSEF to buy a bit more Apple at the “great” price of about $150/share. But the market has a way of inflicting pain during these times. So, it decided to take Apple even lower than $150.

Clearly, these prices on these great companies are temporary and very attractive. Can the market go lower? Yes. But companies like Apple, Google, Home Depot, Lockheed and others are the kind of companies that will rebound and take the market higher again.

HOW? Dollar Cost Averaging

So, assuming we have great companies in all our portfolios, (Google, Microsoft, Apple, Stryker, Home Depot, Costco, Lulu, Amazon, Visa, American Exp, Chevron, Exxon, Nvidia, Chipotle, ETC…) but now we also have some cash, how do we take advantage of these low, low stock prices?

The short answer is “Dollar Cost Averaging”. This is a strategy we have been using for decades and it works! First we decide what additional stocks we want to purchase. Second we BEGIN to purchase them. For example, in a client portfolio, if we want to puchase $20,000 worth of new Apple stock (Apple is just an example), we

- start by purchasing $3000-5000.
- Later (couple weeks) as we see more about where the markets are going, we buy another $3000-5000 of Apple stock.
- Later (couple weeks or a month or two), we continue making purchases, until we use up the $20k planned. This ensures that even if Apple goes down after our initial purchase, we get another opportunity to buy MORE Apple, at still lower prices. We all know that eventually Apple will recover and eventually (probably in 6-7 months) the stock will rebound.
- The outcome is that we didn’t have have a crystal ball to figure out exactly which day of the year to purchase our stock (Apple in this example). We many not have purchased it at the low, but we got good prices and now the stock is rising again and make everyone money.

When?

In this case, we begin as soon as we see any economic number that provides some clear evidence that inflation has already peaked and has begun to fall. We don’t want to wait until it’s “all clear”. But we also don’t want to try to out-guess the economy and the marketplace. As of June 30, we’re still waiting for any economic number that provides evidence.

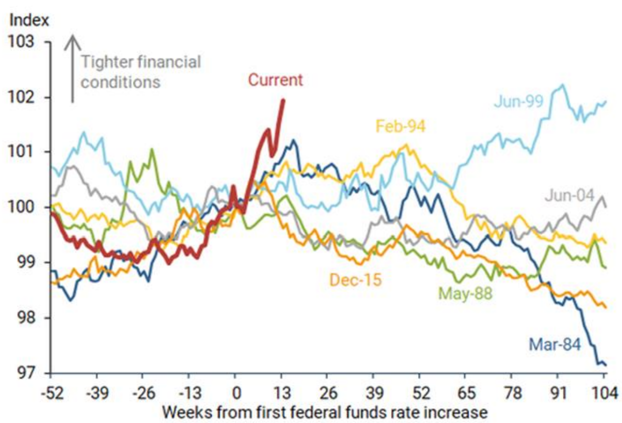
Will there be Recession?

All this is economic talk is not really about the Fed and interest rates, but rather the effect that the Fed and interest rates have on the economy and most important – the effect on our portfolios! In other words, will the Fed raise rates so fast and tighten financial conditions so much that they actually CAUSE a recession?

And if the Fed causes a recession, what kind of recession? And how negatively will corporate earnings be affected?

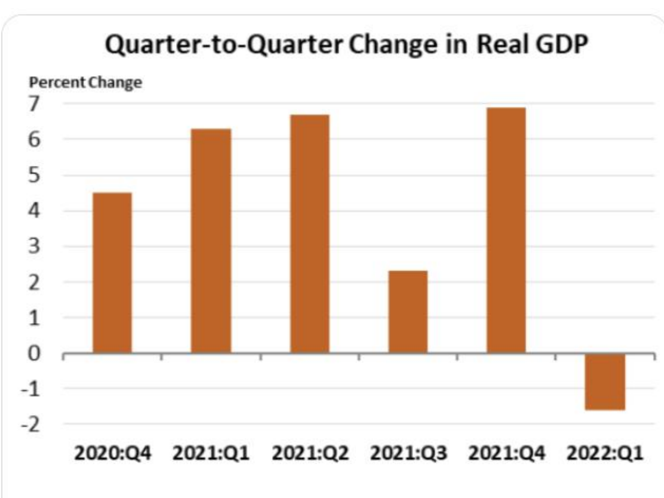
The answer according to the chart below is a pretty clear, "YES", the Fed and higher rates will cause a recession in their attempt to tame inflation. The chart below shows how FAST the Fed is tightening financial conditions.

Financial conditions around federal funds rate increases



Source: Goldman Sachs US Financial Conditions Index and FRBSF staff calculations.

The chart below shows that the economy contracted in Q1 – probably also in Q2 (Atlanta Fed GDP-Now calculates Q2 at -1%). Two consecutive shrinking quarters = definition of recession. The only remaining question is: how much of the recession is already incorporated in stock/bond prices? Answer = most of it is already incorporated into stock/bond prices and the market should go up between July-Dec31, 2022.



WHAT'S NEW?

Alternative opportunities…

We are biding our time, waiting for the right opportunities. We are not motivated by 9% IRR type returns. We are looking for stronger opportunities for you.

Things to Worry About

The list remains long – as usual,

- Higher inflation
- Higher interest rates
- Supply chain shocks
- US Fed bond tapering
- Fed rate hikes this year
- Mortgage demand drops
- Consumer Price Index peaking
- Stock market volatility

And there are probably more….

The Bottom Line

Look forward to small gains in 2022, maybe 6% in equities and some pretty sizable losses in bonds. Yes, we still believe the market can make us all some money this year.

Instead of investing in bond funds, we find bond ladders to be more effective in this environment. Ask us for more info…

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WARREN SAFER-EQUITY FUND

The Warren Safer-Equity Fund

* Hedging has not been very effective in this environment because the market declines are too slow – spread out over weeks and months, rather than quickly over days/weeks.
* We are always ready to hedge but the models are not currently predicting large, short-term down moves.
* The hedging is designed to avoid extreme rapid losses of 20% or more. The hedging can not avoid slow moving losses, even large slow moving losses can't be avoided.
* Instead of hedging we use our old friend Tactical Asset Allocation In the current slow moving, grinding lower market.
* So, while the hedging was helpful in 2020, it has not been helpful in 2022. Tactical Asset Allocation has been helpful in this market.

Do you have a friend?

Show them the Warren app you have on your phone!

We love to help people – let us help your friends and family.

And we always appreciate your referrals.

What's Going On?

- Inflation is running very hot
- Core personal consumption expenditures prices (excluding food & energy) rose 4.7% from last year (slightly less hot than expected). The inflation price level rose 0.6% in June which is near the highest level since 1982.
- Commodity prices fell this past month. Even energy prices fell in June -10%, but we don't expect them to stay down. The only way energy prices really fall is if the Fed destroys demand by causing a nasty recession – this could happen.
- The Fed is raising interest rates, but the market is anticipating a few rate hikes this year; so long term rates, like mortgage rates are rising ahead of the Fed
- Corporate earnings growth forecasts are being reduced, but still positive
- Q1 was technically a quarter of shrinking economic growth (-1.6%). Q2 may also be a GDP shrinking quarter. Two consecutive quarters of shrinking growth = the definition of a recession. (see orange bar chart on the previous page)
- The SP500 is down about 20% - A true bear market
- Corporate earnings have continued to be strong, but just like you, CEOs see all the bad news and begin to worry. Therefore, CEO forecasts are lower.
- Corporate buybacks of their own stock remain strong, but are slowing.
- Supply chains are being fixed, but shortages persist
- The Fed seems VERY likely to raise rates about 0.75% in July
- By September, if the economy shows signs of cooler inflation, the Fed may stop short and not raise (or not increase rates by much)
- The stock market will LOVE it when inflation cools and the Fed steps to the sidelines with little or few small rate increases.
- The PCE indicator, CPI, PPI, and the monthly JOBS number will give us a very early signal regarding the direction of inflation and therefore, also, the direction the Fed will take. So far, economic numbers show inflation hot, maybe cooling just a little, but not enough to make any difference yet.

Strategy Update for Q3 2022

1) There is hope for our portfolios.
2) A looming recession, but the impact of the recession on stocks is "mostly", already calculated into the -20% SP500 this year. Downside is over, or close to over. Upside is near, or close to near.

Steps for profits in the next bull market...

1. Wait for signs that inflation is no longer running super hot – signs that inflation is actually cooling off and the Fed can step to the side with fewer/smaller rate increases in September and later months.
2. Buy more great companies. Use "Dollar Cost Averaging" (see previous page). Try to get in early, without jumping in too heavily and without trying to predict the future (which no one is very good at anyway).