SPRING 2022 | VOL. 30 | NO. 2
QUARTERLY PERSPECTIVE

DVI
DAVID VAUGHAN INVESTMENTS

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Will Williams *Chairman, President & CEO*

NEW TERRITORY

In late December, as 2021 was winding down to a close, most economists were of the mindset that the rate of inflation would moderate in 2022. At that time, it was believed that many of the demand-driven inflationary pressures stemming from the recovery of the global economy would normalize. Fast forward to today, most economists are convinced we will see improvement in the back half of the year, but full year expectations are now much higher with inflation rates in the range of 5.0 to 5.5 percent. Despite the fact we might see some relief later in 2022, there are several economic factors that would suggest that the days of 2.0 to 2.5 percent inflation rates are now long over. These factors include: (1) real interest rates, (2) wage growth and (3) the emerging trend towards trade De-globalization.

Real Interest Rates

Not since the mid-1970s or early 1980s have we experienced negative real interest rates (interest rates less the current inflation rate) in the United States. Negative real interest rates contribute towards strong demand fundamentals as you are in effect being "paid" to borrow money. Under these unique circumstances, the price inflation of the underlying asset is growing at a faster rate than your cost of interest. As of the end of March, the U.S. Treasury 10-year note has a real interest rate of negative 4.06 percent. So, when market analysts describe the Federal Reserve as being behind the curve, they are referencing the fact that Fed policy is far too accommodative for the current inflation environment.

Wage Growth

The Labor Department released March's payroll data and the 3.6% unemployment rate was the lowest rate since February of 2020 and near the all-time low of 3.4% registered back in the early 1960s. The Bureau of Labor Statistics previously released their average hourly earnings data and it increased on a % Year-over-Year basis of over six percent. There is just no question that the current labor market is tight and, with over 11.3 million current job openings, this environment will likely not change overnight.

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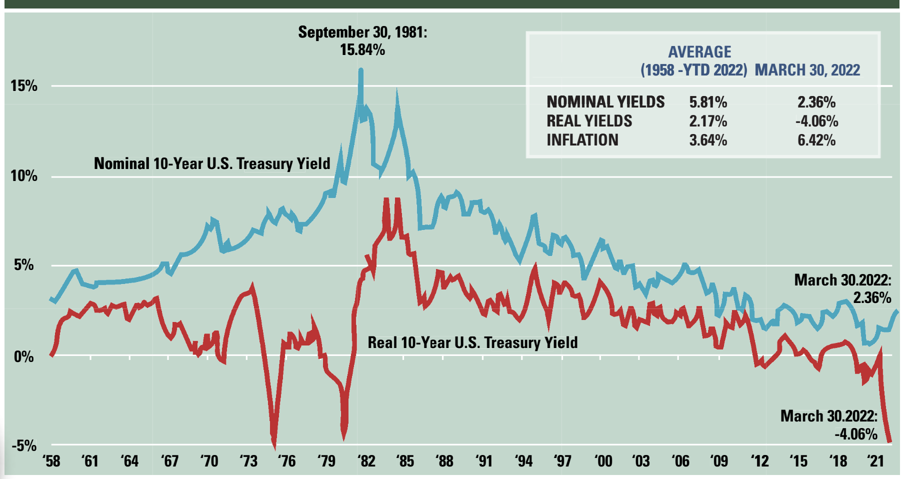
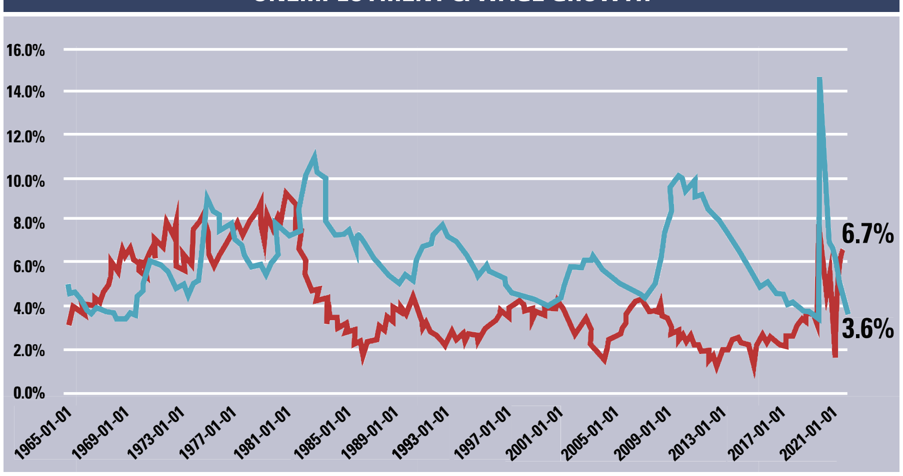
REAL VS NOMINAL 10-YEAR TREASURY YIELDS



Source: JP Morgan Asset Management

UNEMPLOYMENT & WAGE GROWTH



Source: St. Louis Federal Reserve Board (FRED)

Brian Christensen, CFA
Senior Vice President & CIO

HALF-FULL

I cannot remember a time when the financial markets had as many impactful issues to consider as we are witnessing today. War, inflation, rising interest rates, high energy prices, political discord, and recession worries to name a few. Shared below is our current perspective on several of these topics.

Interest Rates – The Federal Reserve started tightening on March 16th with a 0.25% increase in the Fed Funds Target Rate. That rate now sits at a range of 0.25% to 0.50% and represents the interest rate the Federal Reserve Bank pays on deposits. This rate is set by the Federal Open Markets Committee (FOMC) which is the monetary policymaking body of the Federal Reserve.

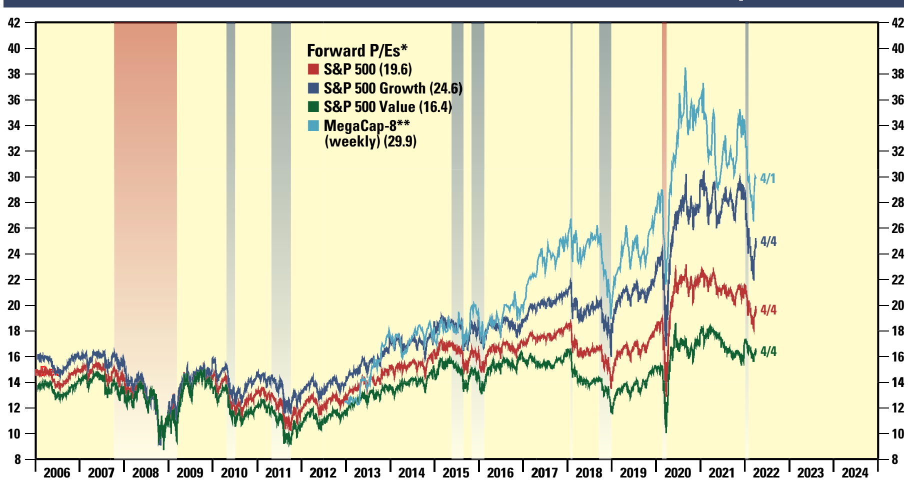
The median FOMC member now expects seven increases in 2022 (7 of 16 members expecting more than seven) and the Fed funds rate to end the year at 1.9%. This can be done in 0.25% hikes at every meeting or by using some 0.50% hikes intermittently. In 2023, the average FOMC member expects to end the increase cycle with the Fed funds rate reaching 2.75%, which is above the Fed's estimate of neutral at 2.375%.

Goldman Sachs and Bank of America are forecasting seven increases, Morgan Stanley six increases, and the Chicago Mercantile Exchange survey of traders says at least six increases. As for DVI, we are positioned for rising interest rates, regardless of the magnitude, by keeping bond maturities short-term and emphasizing stocks of companies that have above average dividend growth rates.

Valuation – As unapologetic value investors, stock valuations are always on our radar. The market correction we experienced during the first quarter of 2022 certainly improved valuations, but excess remains in some styles and sectors. Value, Mid-cap and Small-cap stocks offer the more attractive valuations today. The chart below, provided by Yardeni Research, compares price/earnings (P/E) ratios as of April 1, 2022 for large-cap stocks. The S&P 500 Value index continues to trade at a significant discount to its large-cap peers. The MegaCap-8 (Alphabet, Amazon, Facebook, Microsoft, Netflix, Nvidia and Tesla), despite having corrected substantially, continue to trade at an average P/E ratio of 29.9x or more than a 50% premium to the S&P 500.

Mid-cap and Small-cap stocks, as reflected in the next chart, offer even more attractive valuations as they currently trade at P/E ratios not seen since the pandemic driven bear market in 2020 and the correction in 2018.

FORWARD P/E RATIOS: S&P 500, GROWTH & VALUE (daily)



* Price divided by 12-month forward consensus expected operating earnings per share. Monthly through December 2005, weekly and daily thereafter.

** MegaCap-8 stocks include Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Netflix, NVIDIA, and Tesla. Both class are included.

Note: Shaded red areas are S&P 500 bear market declines of 20% or more. Blue shaded areas are correction declines of 10% to less than 20%.

Source: yardeni.com & I/B/E/S data by Refinitiv and Standard & Poors.

Earnings and Revenue Growth – Consensus estimates for S&P 500 revenue growth is + 8.8% year-over-year in 2022 and +5.3% year-over-year in 2023. Consensus estimates for S&P 500 earnings growth is +9.3% year-over-year in 2022 and +9.7% year-over-year in 2023. Stock prices follow the direction of corporate earnings. As companies report their 1st quarter results in April and May, a clearer picture will develop as to the impact of inflation on their businesses. Those companies who have been able to raise prices while maintaining solid demand for their products and services are expected to lead the market. Inflation is likely to be a wash for earnings as long as revenues rise as fast as costs do.

Recession Risk – As I write this, the spread between the 10-year Treasury note and the 2-year Treasury bill is exactly zero. Both are yielding 2.42%. Concerns around a recession developing have increased as history shows inversion (short-term rates are higher than long-term rates) has preceded every recession since the 1950s. Significantly higher energy prices, supply-chain disruptions, and the global challenges presented by Putin's War are making the Fed's job more difficult in guiding the economy to a soft-landing. However, the economic tailwinds are significant as well. Above trend economic growth, a household sector with improved balance sheets

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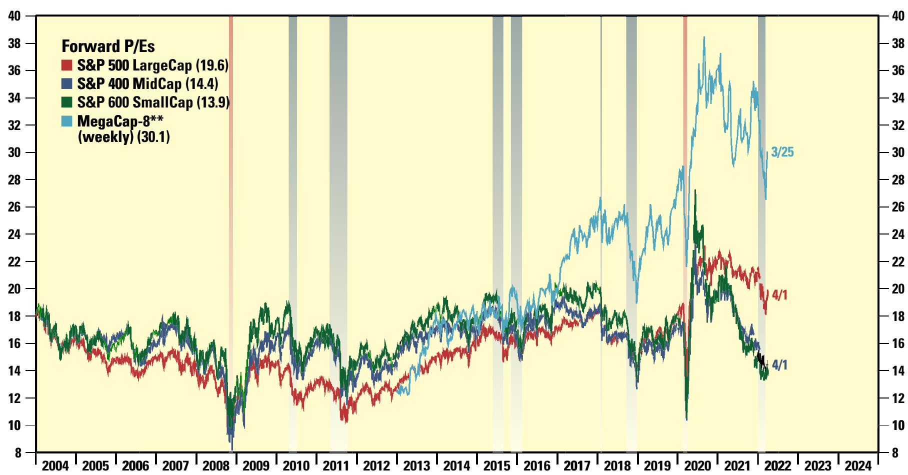
FORWARD P/E RATIOS: MEGACAP, LARGECAP & SMIDCAP (daily)



* Daily stock price index divided by 52-week forward consensus expected operating earnings per share.

** MegaCap-8 stocks include Alphabet (Google), Amazon, Apple, Meta (Facebook), Microsoft, Netflix, NVIDIA, and Tesla. Both classes of Alphabet are included.

Note: Shaded red areas are S&P 500 bear market declines of 20% or more. Blue shaded areas are correction declines of 10% to less than 20%. Yellow areas are bull markets.

Source: yardeni.com & I/B/E/S data by Refinitiv and Standard & Poors.

GEOPOLITICAL EVENTS AND STOCK MARKET REACTIONS

Market Shock Event	Event Date	S&P 500 Index One-Day	S&P 500 Index Total Drawdown	Calendar Days To Bottom	Calendar Days To Recovery
Iranian General Killed in Airstrike	1/3/2020	-0.7%	?	?	?
Saudi Aramco Drone Strike	9/14/2019	-0.3%	-4.0%	19	41
North Korea Missile Crisis	7/28/2017	-0.1%	-1.5%	14	36
Bombing of Syria	4/7/2017	-0.1%	-1.2%	7	18
Boston Marathon Bombing	4/15/2013	-2.3%	-3.0%	4	15
London Subway Bombing	7/5/2005	0.9%	0.2%	1	4
Madrid Bombing	3/11/2004	-1.5%	-2.9%	14	20
U.S. Terrorist Attacks	9/11/2001	-4.9%	-11.6%	11	31
Iraq's Invasion of Kuwait	8/2/1990	-1.1%	-16.9%	71	189
Reagan Shooting	3/30/1981	-0.3%	-0.3%	1	2
Yom Kippur War	10/6/1973	0.3%	-0.6%	5	6
Munich Olympics	9/5/1972	-0.3%	-4.3%	42	57
Tet Offensive	1/30/1968	-0.5%	-6.0%	36	65
Six-Day War	6/5/1967	-1.5%	-1.5%	1	2
Gulf of Tonkin Incident	8/2/1964	-0.0%	-2.2%	25	41
Kennedy Assassination	11/22/1963	-2.8%	-2.8%	1	1
Cuban Missile Crisis	10/16/1962	-0.3%	-6.6%	8	18
Suez Crisis	10/29/1956	0.3%	-1.5%	3	4
Hungarian Uprising	10/23/1956	-0.2%	-0.8%	3	4
N. Korean Invades S. Korea	6/25/1950	-5.4%	-12.9%	23	82
Pearl Harbor Attack	12/7/1941	-3.8%	-19.8%	143	307
Average		**-1.2%**	**-5.0%**	**22**	**47**

Source: LPL Research, S&P Dow Jones Indices, CFRA, 01/06/20

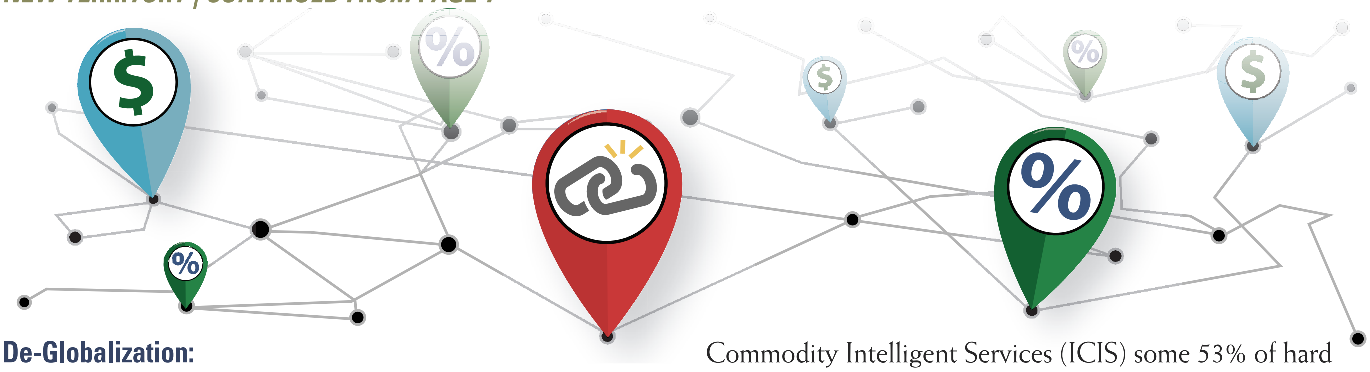
and higher cash balances, tight labor markets and rising wages, strong corporate profitability, and growing domestic investment all suggest economic expansion can continue. A 2018 paper from the Federal Reserve Bank of San Francisco stated, "Forecasting future economic developments is a tricky business, but the term spread has a strikingly accurate record for forecasting recessions." The paper also noted that the time between the inversion and subsequent recession varied between 6 and 24 months. Time will tell.

War – Ned Davis Research examined more than fifty crises since the early 1900s and found a pattern. Using the Dow Industrial Average as the measurement, an average decline of 7% occurs in the immediate aftermath, followed by 4% increase over the following 3 weeks. Nine weeks later, the Dow had gained 6% and after 18 weeks was up an average 9.6%. On average, the S&P 500 has been down 6.5% three months following an armed conflict but up 13% twelve months after said conflict. Based upon the market action in the month of March, it seems this pattern has not changed.

Greater uncertainty breeds volatility, which we definitely experienced in the 1st quarter. Managing risk within our portfolio construction process remains our greatest priority. Big David often reminded me that to be a successful equity investor you must always view the glass as being half full, not half empty. Historically, the U.S. stock market has risen 70% of the time which seems to be more than "half-full" to me.

Will Williams
Chairman, President & CEO

NEW TERRITORY | CONTINUED FROM PAGE 1



De-Globalization:

When I settled upon using the phrase "Expect the Unexpected" as the appropriate lead in for DVI's 4th Quarter Newsletter, I was attempting to convey our sense that despite the wonderful market and economic backdrop in 2021, that there might be a few surprises lurking around the corner. Geopolitical tensions have been a common market concern since the beginning of time, but to think the unexpected would be a full-scale invasion of the Ukraine by Russia – it just was not on the radar screen. And beyond the pain and suffering that is being inflicted upon the people of Ukraine, what began technically as a regional dispute has snowballed into a diplomatic and economic crisis on the global stage.

Events such as these highlight the growing connectivity that local markets have on the global supply chain. Since the end of the Cold War in the early 1990s, countries have become increasingly comfortable and frankly reliant on other countries to supply mission critical commodities and manufactured goods. With the introduction of COVID-19 back in early 2020 and now the Russia-Ukraine War, countries are beginning to recognize both the economic and security repercussions of adopting this approach. The global trade model assumes just-in-time supply chain effectiveness, free trade and peace. If any of these critical components are compromised, it causes severe economic disruption and leads in most instances to price increases and supply shortages. In recent decades, global trade was dominated by one factor: gaining access to suppliers at the lowest delivered price. Countries are beginning to recognize the security and economic vulnerability caused by this past practice. They are now much more cognizant of the need to develop local sources of critical goods and services, but they also understand the requirement of embracing flexibility and redundancy when they execute their foreign trade policy. Price alone will no longer be the dominant factor.

As a painful example, it is hard for me to believe that the German government would desire an energy policy so reliant on just one country. According to the Independent Commodity Intelligent Services (ICIS) some 53% of hard coal, 35% of crude oil and 30% of natural gas supplies were imported by Germany from Russia in 2021. It comes as no surprise that Germany can ill afford to embrace the U.S. led economic sanctions that would prevent the purchase of Russian natural gas, crude oil and coal. In the near term, they simply have nowhere else to turn without facing severe economic consequences. Liquified Natural Gas (LNG) imports from the U.S. have increased in recent months, but the necessary infrastructure, specifically LNG terminals, are simply not in place to allow the substitution of U.S. LNG for Russian natural gas.

Lessons from the Past

We once again face a market landscape that is complicated to say the least. And for generations of investors, the current economic and inflation landscape is completely new territory. No one really knows when or and how the War in Ukraine will end. Commodity prices have risen, in some instances in dramatic fashion, mostly due to supply chain disruptions and the economic sanctions caused by the War. For now, we can only speculate as to the longer-term economic ramifications of trade de-globalization. The Federal Reserve appears to be on track for multiple interest rate increases and the initial unwinding of their quantitative easing strategy, and inflation is finally now viewed as more than transitory. Market volatility has increased in the near term, as there is still so much we simply do not know or are able to forecast with any degree of certainty.

Being able to maintain discipline in this environment is a challenge to say the least, but it is increasingly important. Embracing companies that pay dividends and increase dividends annually is one tactic that DVI relies on to offset the negative impact of inflation. Diversification among economic sectors, beyond traditional growth industries, has also proven to be a successful strategy when attempting to limit portfolio declines. When analysts suggest "this time is different", we grow in our confidence that we are pursuing both appropriate and prudent strategies.