October 1, 2022

Dear Clients and Friends,

The American Diplomat and architect of the Cold War policy of "containment" of the Soviet Union, George Kennan, would not have been surprised when Vladimir Putin embarked on his cynical and bloody war in Ukraine. It has been 76 years since Kennan sent his famous "Long Telegram" from Moscow. He wrote that the Soviet Union could not foresee "permanent peaceful coexistence" with the West. This "neurotic view of world affairs" was a manifestation of the "instinctive Russian sense of insecurity." As a result, the Soviets were deeply suspicious of all other nations and believed that their security could only be found in "patient but deadly struggle for total destruction of rival power." Although the Soviet Union was "impervious to logic of reason," it was "highly sensitive to logic of force." Therefore, it would back down "when strong resistance is encountered at any point." The United States and its allies, Kennan concluded, would have to offer that resistance.[1]

Putin's war of choice in Ukraine has upended the conventional view many held a year ago that a more aggressive Fed, a declining fiscal deficit, repaired global supply chains and a post-pandemic shift in the mix of demand in favor of services and away from goods, would make inflation a "transitory" phenomenon. The war has created an energy crisis on the European Continent that rivals anything experienced since the Second World War. Putin is teaching Europe the price of dependence for its energy supply on an enemy of Western values. Many other countries are struggling to feed their populations as supplies of essential grains and fertilizers are trapped by Russian blockade. In China, a shockingly inept response by the Chinese government to COVID-19, has led to further disruptions and delayed repair of supply chains.

Forty years ago when we last experienced a period of high inflation, aggressive action by Paul Volker's Federal Reserve to raise interest rates induced a steep recession. Since then, the offshoring of manufacturing and supply chains during a period of rapid "globalization," ushered in by Nixon's opening the door to China, kept a lid on inflation by suppressing domestic wage growth and offering consumers ever cheaper goods made abroad. During that time, a vast amount of new wealth accrued to investors in equities of companies uniquely positioned to benefit from globalization. Our own portfolios at Douglass Winthrop have for years held many such companies, including Apple, Nike, Nestle and MasterCard. In a new era of economic sanctions, tariffs and technology export bans, the era of "peak globalization" seems behind us. Increasing costs will be imposed on consumers as we bear the price of supply security.

A Perfect Storm

The Nobel Prize winning economist, Milton Friedman, famously said, "Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output."[2] When the pandemic hit, central banks around the world fearful of a general economic collapse flooded the global economy with liquidity. In the months of 2020 following the outbreak of Covid the Federal Reserve increased its asset purchases to $3.2 Trillion, a 76% increase of its balance sheet.[3] Simultaneously and continuing into 2021, the US Federal Government appropriated over $7 Trillion to protect the economy from the impact of Covid.[4] This flood of new liquidity coincided with a contraction of output caused by the pandemic. This combination of increased liquidity and reduced output constituted Milton Friedman's "perfect storm" for inflation. Because of Putin, China's

[1] https://digitalarchive.wilsoncenter.org/document/116178.pdf
[2] https://www.hoover.org/research/inflation-true-and-false
[3] https://www.federalreserve.gov/monetarypolicy/bst_recenttrends.htm
[4] https://www.pgpf.org/blog/2021/03/heres-everything-congress-has-done-to-respond-to-the-coronavirus-so-far

floundering response to the pandemic, the rethinking of globalization, and an excessive Federal response to the pandemic, inflation is proving more durable than expected.

Now the Fed is aggressively attempting to make up for this pandemic-profligacy, mopping up excess liquidity by raising interest rates and engaging in quantitative tightening. Just as the Fed overreacted to the threat of Covid, we believe it likely the Fed will be too aggressive in reigning in inflation. Cracks have already begun to appear in the economy. While the Consumer Price Index for the year ended August 31, 2022 rose a daunting 8.3%, month over month inflation was only 0.1% after registering a 0% increase in July.[5] Higher interest rates have led to a collapse in new mortgage applications.[6] Economically sensitive metals have shown recent price weakness: since a March high, copper is down 30% and iron ore is down 37%. Lumber is down 70% over this time frame while WTI crude oil is down 31%.[7] A 45% decline in the wait time for container ships since last October reported by the Port of Los Angeles suggests supply chains are beginning to heal and retail inventories suddenly seem well stocked.[8] Real GDP shrank slightly in both the 1st and 2nd Quarters this year.[9] Despite these signs of weakness we expect the Fed to continue raising rates and quantitative tightening.

Storm Clouds to Part?

The Fed's action leads us to expect continuing elevated volatility in the stock market. Investors will likely remain cautious until it is clear that inflation has peaked and the Fed will stop tightening. We believe earnings estimates should turn downward to reflect a slowing or contracting economy. Additionally, the strengthening US Dollar tends to depress US corporate earnings because roughly 30% of all the earnings of the companies in the S&P 500 index are derived from abroad.[10] While the headlines remain bleak for investors, we think it makes sense to begin thinking about what could go right that investors don't currently expect. According to the American Association of Individual Investors, sentiment is broadly negative while optimism continues well below its historical average.[11] The broad equity market as reflected in the Russell 3000 is already down about 25% year to date. If the recent more benign inflation data becomes the trend, the Fed may have room to relax a bit.

Stock prices are likely to rebound well before it becomes obvious a recovery is occurring. As there is no way to predict the timing of any rebound, it is important for investors to remain invested in a high quality portfolio of companies characterized by high returns on invested capital, large and growing markets and capable management teams aligned with shareholders. We also insist our companies have strong balance sheets that can help them navigate periodic financial stress. The average company in the DWA flagship portfolio has a ratio of net debt to cash flow of 56% vs. 120% for the S&P 500. In addition, the average company in the DWA portfolio has a return on capital of 35.5% vs. 15% for the S&P 500. We believe our insistence on quality creates resilient portfolios that should position our clients to participate in an eventual recovery.

Why Moats Matter

In an inflationary environment, companies without an enduring competitive moat struggle to maintain profit margins and pass along cost increases by raising prices. A dominant fortress-like market position is a quality we look for in every company we consider. Our

[5] https://www.bls.gov/news.release/pdf/cpi.pdf
[6] https://www.mortgagenewsdaily.com/data/mortgage-applications
[7] https://tradingeconomics.com/commodity/natural-gas
[8] https://kentico.portoflosangeles.org/getmedia/364e98ad-6c0d-44d9-a6e9-4686dec2d71a/import-container- dwell-report
[9] https://www.bea.gov/news/2022/gross-domestic-product-second-quarter-2022-advance-estimate#:~:text=BEA%2022%2D36-,Gross%20Domestic%20Product%2C%20Second%20Quarter%202022%20(Advance%20Estimate),real%20GDP%20decreased%201.6%20percent
[10] https://www.kiplinger.com/investing/stocks/605095/stocks-winners-and-losers-from-the-strong-dollar
[11] https://www.aaii.com/sentimentsurvey

portfolio companies, Mettler Toledo (MTD) and TransDigm Group (TDG), are good examples of companies with wide and defensible competitive moats.

Mettler Toledo is the global leader in precision weighing and inspection equipment. These products find use everywhere from research labs and drug manufacturing facilities to metal production. It is critical they work within precise tolerances in order to avoid defects in lab results or fabrication. MTD's products are central to its customers' operations while remaining low cost relative to the total cost of production. 75% of MTD's products command first place market share. MTD's smaller end-market sizes are unattractive to larger tools manufacturers, while smaller players are unable to compete with MTD's scale advantages, R&D investments and extensive service offerings. The company sustains its wide moat by employing a difficult to replicate global sales and service network. MTD has consistently taken market share and raised prices over the past two decades. This quality midcap company has managed to produce compound annual earnings growth of 16.5% over the past five years. In the long run, structural changes to MTD's end markets could cause risks to our moat thesis, while, in the short run, a strong US Dollar could pressure MTD's ability to raise prices. We will monitor these risks closely, however, we feel our investment thesis remains intact.

While we have owned it in the past, TransDigm Group is a recent addition to the Douglass Winthrop portfolio. TDG is an aerospace manufacturing firm that provides highly engineered, niche components for use on commercial and military aircraft. Management runs TransDigm like a private equity firm. They acquire aerospace parts companies, cut costs, raise prices, improve availability and quality, and reinvest the profits in more acquisitions. The vast majority of the company's profits come from aftermarket sales of products for which it is the sole supplier. With the cost of parts failure high, aircraft operators are hesitant to trust new suppliers for critical components that are a low percentage of the total cost of an airplane. Many of these parts require FAA approval. Once designed into a particular airframe, the product becomes an annuity for the life of the aircraft. TransDigm's customers are more concerned with availability and quality than price. As a result, TDG has strong pricing power, which it exercises aggressively. The company produces high levels of predictable free cash flow. About 50% of sales are for defense applications less exposed to the economic cycle than commercial aviation. A risk to our investment thesis in TDG is that its high margins would encourage competition or even the aircraft OEMs themselves to attempt to make the products TDG produces. Another risk would be if regulators were persuaded by defensive contractors to interfere with TDG's pricing power. While we are monitoring these risks carefully, we are somewhat comforted by TDG's nearly 30 years of executing its business model.

Final Thoughts

George Kennan warned "The truth is sometimes a poor competitor in the marketplace of ideas – complicated, unsatisfying, full of dilemmas…."[12] Kennan's remark in 1951 might be even more true in this world of 24/7 news cycles. Investors are bombarded with negative news and fear inducing headlines. Putin, China, the Fed and inflation are a potent witch's brew for negative sentiment. It is hard to keep in mind that the seeds of recovery are already planted. We can only guess the timing of the recovery, however, we can be nearly certain that patient investors holding positions in high quality and resilient companies will be rewarded in the long run.

In closing, we are grateful to our clients for the privilege of serving as their trusted advisors while we navigate these complex times together. We hope we will continue to earn your trust through whatever challenges may lie ahead, and we wish you a healthy and happy Fall and Holiday Season. Please feel free to contact us or, better yet, stop by for a visit.

Sincerely,

Douglass Winthrop Advisors LLC

[12] https://www.goodreads.com/review/show/1823587795