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Prospector Partners Quarterly Commentary

Current Market Environment

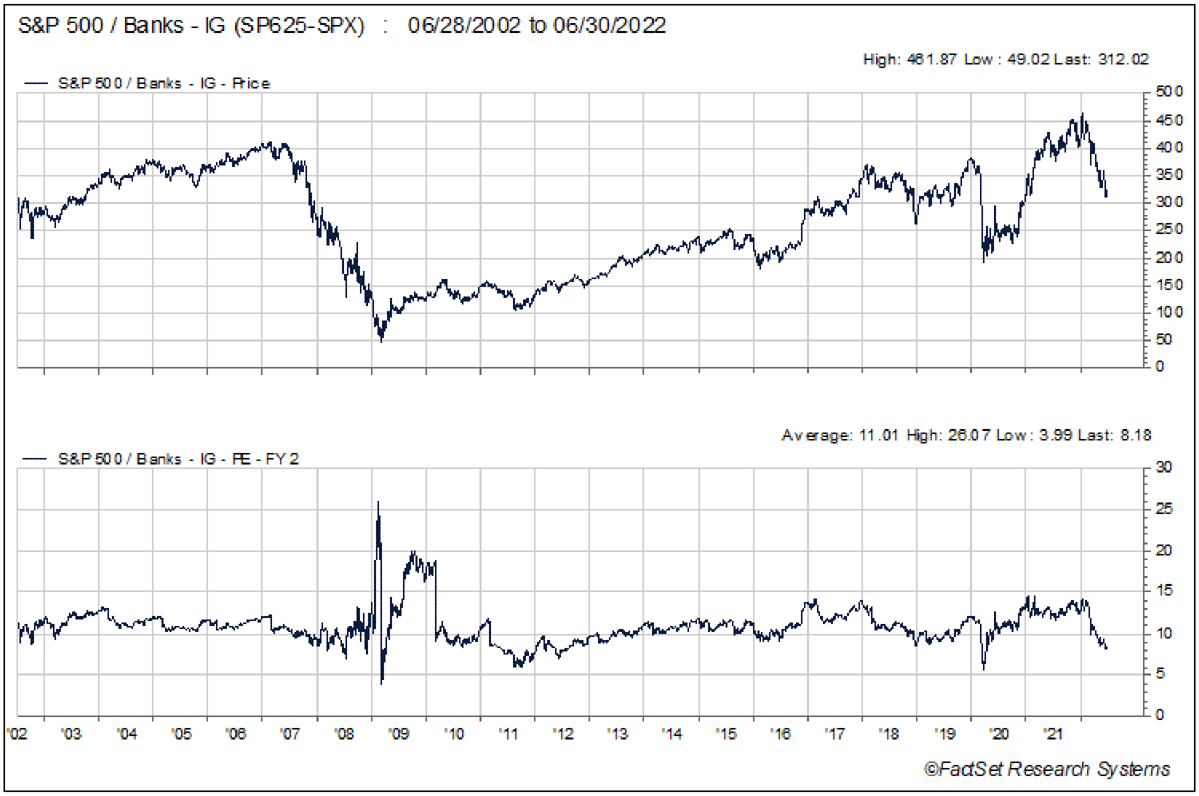
We find ourselves questioning the maxim, "Good things come to those who wait." After waiting years for interest rates to rise, thereby ushering in a value stock renaissance, "Be careful what you wish for." is perhaps a more appropriate sentiment. Indeed, while interest rates continued to rise in the second quarter, and value stocks outperformed, this came in the midst of a stock market selloff, which saw the benchmark S&P 500 enter bear-market territory in June. The 10-year Treasury yield, which ended 1Q22 at 2.34%, rose to a peak of 3.48% during the second quarter as inflation blew past expectations. Perhaps most concerning, food and energy prices continued to march higher, pinching consumers' pocketbooks and causing increased fears of a pullback and resulting recession. Meanwhile, the Federal Reserve remains in a predicament, aggressively raising interest rates, while attempting not to cause too drastic a slowdown in the economy. At the same time, they are surely taking note of many key commodities rolling over. For example, as of July 15th, oil is 25% off 2022 highs, lumber 56%, wheat 43%, corn 27%, copper 37%, etc. While these decreases have yet to work their way into lower prices for consumers, eventually they should, and the Fed risks being overly hawkish and sending the economy into a severe downturn.

Meanwhile, the U.S. may already be in a recession. Real GDP declined 1.6% in the first quarter, consumer confidence is plunging as gas prices hit record highs, and retail sales fell 0.3% in May for the first time this year, falling short of consensus expectations for +0.1%. Recession or not, it is likely semantics — the economy is slowing. However, much as we were of the opinion last year that the stock market and Federal Reserve were underestimating prospects for inflation, we believe many of the draconian scenarios being discussed are likely overshooting the mark. Many believe that in order to tame inflation the Fed will need to continue aggressively hiking rates in 50 to 75 basis point increments for the next several meetings, and thus sending the economy into a severe recession. By way of reference, estimates in mid-June had the Fed Funds Rate reaching a high of 3.75% by April, 2023 (compared to 1.58% at the time), which we believed to be overly aggressive, as the already-slowing economy is doing some of the Fed's work for it. Notably, current expectations have been reduced to a high of 3.30%. As mentioned above, many commodities are well off peak levels, and gas prices have started to decrease. Additionally, supply chains are beginning to normalize, which will alleviate some of the resultant cost pressures. Notably, inflation expectations have also come in recently, as can be seen by the 5-year TIPS breakeven chart below.

In our estimation, the Fed will be less aggressive than current forecasts would indicate, and while we may experience a moderate recession, many stocks are already discounting that (or worse). As discussed further below, we see attractive opportunities in several cyclical areas, including (but not limited to) certain restaurants and banks.

Opportunity in Banks

We believe the bank sector offers an asymmetric risk-reward opportunity. Despite taking our sector exposure materially lower after strong price performance in 2021, we nonetheless remain overweight. Bank valuations today are attractive, currently in the bottom decile on forward price-to-earnings and bottom quartile on price-to-tangible-book-value. It is worth noting that forward estimates reflect a normalization of credit quality toward pre-COVID levels. At this point, investors are discounting a moderate recession in valuations, and investor sentiment is unsurprisingly poor. Given banks are dependent on consumer and business credit quality, on the surface it is understandable why investors have flocked from the sector. However, we are significantly more constructive on fundamentals.



Post the Great Financial Crisis, balance sheets have drastically improved which offers significant downside protection in the event that a recession takes place. Loan underwriting standards are very strong relative to long-term history, securities portfolios carry minimal risk, lenders are awash in liquidity, and banks maintain excess regulatory capital. While the introduction of Dodd-Frank and other regulatory burdens following the Financial Crisis have been a headache for banks, they have undoubtedly strengthened risk controls and oversight. It is also worth noting that while investors believe a major deterioration in credit quality is around the corner, credit quality and delinquency trends remain quite good.

Additionally, investors are overlooking the upside case for owning banks via earnings leverage to higher short and long-term interest rates. This can alternatively be viewed as an embedded hedge against the persistence of above-trend inflation. The loan growth outlook also remains strong for the sector, and many banks in your portfolio that we regularly meet with cite record loan pipelines. Compared to other sectors, banks remain shareholder friendly when it comes to capital return policies with regular stock buyback programs and attractive dividend yields. We also expect the bank consolidation trend to continue with multiple names in your portfolio as potential beneficiaries. In summary, we like owning banks at heavily discounted valuations with an embedded call option on higher rates and a less than severe economic downturn.

Dining on Restaurants

Restaurants are another cyclical area in which we see opportunity. As many have witnessed, restaurants were severely impacted by the pandemic-induced lockdowns of the past few years, with full service restaurants the most severely affected given their reliance on in-person dining. To help withstand the difficult environment, restaurants leaned into off-premise sales channels such as curbside and 3rd party delivery, menus were simplified to reduce food waste, and companies found more efficient ways to staff restaurants and run corporate operations. Eventually, COVID-19 vaccines were administered to the population, and legislators began easing the restrictions on in-person dining. Many restaurant stocks reached all-time highs as investors extrapolated the new, leaner, cost structures of these companies onto a sales environment of pent-up demand and looser restrictions. However, that optimism would prove to be short lived.

Over the past 18 months, restaurants have faced a variety of issues which negatively impacted company fundamentals, investor sentiment, and ultimately, stock prices. Staffing has been a challenge, with companies struggling to recruit and train employees in a tight labor market, especially as various waves of COVID drove increased absenteeism and reductions in the workforce. Restaurants were forced to either increase their wages or fail to service demand. Company margins were further pressured by increasingly elevated food procurement costs. Combined, these cost buckets have a major impact on overall restaurant profitability, with food & beverage plus labor costs typically accounting for 60% of a restaurant's revenue. As a result of these pressures, the prospect of ever-expanding margins were deemed too optimistic and investors reduced their outlook for the restaurant industry's prospective earnings power.

Fast forward to mid-year 2022, and investor concern has shifted from margins to consumer demand. Cost inflation across a wide range of essential products and services has led to declining consumer sentiment and a lower level of discretionary funds available. Additionally, the Federal Reserve is tightening financial conditions to slow economic activity and fight inflation. Slowing economic activity and more cautious consumer spending habits are not typically favorable for discretionary activities like dining out. Given this backdrop, restaurants stocks have sold off considerably. Earnings estimates for the broader S&P 1500 Restaurants index have fallen >7% this year to reflect cost inflation across both food and labor, and a weakening demand environment. The index price is down 21% year to date, as the broader market environment has reduced the multiples investors are willing to pay for a given level of earnings. Our preference for "quality" or strong businesses with best-in-class management teams is only heightened during times of volatility or economic stress. With earnings estimates for the group revised lower and investor sentiment largely negative, we are taking this opportunity to increase our exposure to certain franchises we deem to be best-in-class operators.

Not-So-Safe Havens?

As an offset to these opportunities, we have reduced exposure to names we see as inordinately exposed to the lower-end consumer, who will likely be hurt the most from the current inflation-induced slowdown. We are also leery of areas like consumer staples, where investors appear to be "hiding" given recession fears. Examples would include companies which sell a variety of merchandise at discounted prices and primarily serve customers with low or fixed incomes. In times of market and macroeconomic stress, it is common for investors to flock to safer and more defensive industries such as consumer staples, whose results are less impacted by the cyclical gyrations of the broader economy. More specifically, there is a belief among investors that discount retailers, for example, will see an influx of new customers as shoppers are squeezed by inflation and are forced to trade down away from traditional grocers and retailers. We believe some of these stocks are discounting this benefit, and then some. Additionally, as these companies work to offset their own cost inflation (product costs, logistics, labor, etc.), we believe they may have a hard time passing on price increases to their lower-income customers. In the event The Federal Reserve successfully executes its "soft landing" and we avoid a recession, we believe investors would abandon these so called "safety stocks" and move on to more cyclical industries.

Outlook

Equity and bond market declines have been pronounced, and we are only half way through 2022. The Federal Reserve has started its aggressive campaign to lower inflation, and equity and bond markets are likely to remain volatile until investors can adequately discount the degree and duration of interest rate increases. The U.S. and rest of the world continue to manage the impacts of high inflation, Russia's invasion of Ukraine, and China's "zero-COVID" policy. In our assessment, markets reflect a reasonably high probability of recession.

Employment remains a bright spot in this economy. Supply/demand imbalances in the labor market bode well for the health of the consumer given full employment and the prospect for further wage gains, which partially mitigates the impact of inflation on the consumer. While there are rising concerns regarding affordability, the housing market should be buttressed by a shortage of affordable housing after over a decade of underinvestment post the Financial Crisis. Lower-income consumers have been most impacted by the current inflationary environment, but consumer balance sheets remain generally healthy for the majority of Americans. COVID mortality has improved and related pent-up demand is impacting many areas of the economy. These are reasons to believe a recession could be less significant than the previous two recessionary periods.

Following years of lower interest rates helping to drive ever-higher growth-stock valuations, we feel value investing is ripe for a period of outperformance. Further, given the recent market correction, we are finding opportunities to invest in quality businesses with solid balance sheets and cash flows, whose share prices have detached from our assessment of the fundamentals. The bargains inherent in your portfolio should attract acquirers and other investors over time.

Steadfast, we remain committed to making you money while aiming to protect your wealth.

Respectfully Submitted,

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