Kevin R. O'Brien
Portfolio Manager

Jason A. Kish
Portfolio Manager

Steven R. Labbe
Portfolio Manager

John D. Gillespie
Managing Member / Founder

Q1 2022

Prospector Partners Quarterly Commentary

Current Market Environment

The new year started as we expected: inflation continuing to rise, the Federal Reserve getting increasingly hawkish, interest rates rising, and with a rotation out of growth stocks into value. However, in mid-January, the market's attention turned to Russia's building of troops on Ukraine's border, and ultimately to Vladimir Putin's and Russia's invasion - the consequences of which are myriad. Unprecedented sanctions were quickly imposed by much of the world, impacting Russia's ability to export goods and services and limiting their ability to travel as airspaces across Europe and North America were closed off to Russian aircraft. Many businesses around the globe made independent decisions to cease doing business in and with Russia. The impact of these sanctions worsened the pandemic-induced supply shortage seen in many industries and further fan the flames of inflation.

Brent crude oil, which was rallying as demand from the economy's "reopening" outpaced growth in supply, spiked 35% in a little over a week on the prospects of Russia's supply (estimated at 12% of worldwide production) being taken off the market. Wheat rose over 50%, given Ukraine and Russia combined produce almost 30% of worldwide supply. The shortage of automobiles was further exacerbated, as many manufacturers rely on wire harnesses produced in Ukraine. These are examples of the many commodities and products which have been dramatically impacted by the outbreak of war, causing fears of uncontrolled inflation and even stagflation. Against this backdrop, both stocks and bonds sold off during the quarter (although the S&P 500 staged an impressive late-quarter rally, ending the quarter about 10% above the lows hit on the day of the invasion). The benchmark 10-year Treasury ended March at 2.32%, 83 basis points higher than where it stood at year end.

So, what does this all mean to Prospector? While our portfolios have no direct investments in Russia or Ukraine, a handful of investments generate a modest amount of revenues from the region. Given our largely domestic focus, we made only minor changes to our portfolios based on potential impacts from the conflict. However, the far reaching impacts of the war have implications for portfolio positioning. Europe's economy will likely be hit harder than the U.S., especially given the continent's reliance on Russian natural gas. Russia is Europe's largest external source for gas, providing over 30% of their supplies, and any material reduction coming from Russia will have serious implications for Europe's economy. Thus, our predilection for domestic investments remains in place. Domestically, unemployment levels are below 4%, and the U.S. consumer continues to be in great shape partially as a result of trillions of dollars of pandemic stimulus. However inflationary pressures cannot be ignored. Wages are growing, but costs of goods are growing faster. Odds of a slowdown have increased in our estimation and we have gradually reduced exposure to cyclically-exposed companies, including lowering our large bank bet by trimming certain names we deemed as more exposed to credit should the economy turn. Additionally, we have modestly increased exposure to defensive sectors such as healthcare and property-casualty insurers.

Outlook

2022 is setting up to be a pivotal year. Much will depend on how successful the Federal Reserve is at transitioning from an ultra-stimulative posture, to a less accommodative one (the elusive soft landing), while the U.S. and rest of the world is dealing with the impacts of Russia's invasion of Ukraine. The U.S. consumer remains resilient, with healthy balance sheets following trillions in fiscal stimulus. The impacts from the COVID-19 pandemic are waning and immunity from prior infections, increasing vaccinations, and release of anti-virals should help further the reopening of our economy.

Interest and mortgage rates have lifted off historically low levels, with 30-year mortgage rates recently topping 5% - potentially a psychologically important level. We are seeing reinflation in many areas of the economy, and are watching this closely given the historically high levels of government spending here and around the world. Unemployment has shown significant improvement, but labor continues to be an issue as the participation rate continues to be low and labor shortages are impacting many industries.

In our estimation, overall equity valuations remain at elevated levels. Treasury and high-grade corporate bond yields look unattractive. In any case, we believe value investing is ripe for a period of decent performance. Meanwhile, we still believe equities represent a superior asset allocation alternative to bonds over the longer term

PROSPECTOR PARTNERS

WWW.PROSPECTORPARTNERS.COM

370 Church Street, Guilford, CT 06438
203-458-1500