# Berkshire
DIVIDEND STRATEGY

**Gerard Mihalick, CFA**
gmihalick@berkshiream.com

46 Public Square, Suite 700
Wilkes-Barre, PA 18701
570.825.2600

**Dividend Growth Commentary**
2Q 2022

## 2Q 2022 UPDATE

Equity and bond markets endured a brutal first half of the year, and investors are looking for ways to shelter from the damage and/or wait out the storm. Most asset classes are down year to date, but we are pleased our strategies have been relative havens so far.

While our long-term outlook is positive, navigating tumultuous markets is never pleasant.

Here are our latest thoughts about some of the challenges investors are facing today. For example…

## INFLATION…EVERYWHERE AND FOREVER?

Inflation is clearly the most prominent financial, political and social headline right now. Inflation creates a not-so-stealthy tax on prosperity, purchasing power and wealth, because anyone who goes to buy a good or service suddenly finds they need a lot more dollars to buy the same amount of "stuff." Inflation impacts everything – from basics such as food and gas, to luxury goods and services, all the way to capital and – yes – your investment portfolio. Inflation lowers the standard of living for virtually everyone.

In nearly every case in recorded history, inflation arises from too much money chasing too few goods. It is simple supply and demand – if you create a large supply of money, its value goes down, so people want more of it to keep purchasing parity. Where does this money come from? Central banks turn the money supply on and off through monetary policy. Governments can create money by controlling spending and fiscal policy. And in recent years, both entities have been aggressively injecting money into the system.

For a while, our policy makers felt inflation was too low and flooded the system with dollars – think low interest rates, money printing and government spending. Feeling flush with dollars, people tend to spend and invest more, which people surmise is good for the economy. But money creation does not really spur *new* demand – it simply pulls future demand forward. That demand now exceeds our country's natural productive capacity, causing prices to rise to highly unwelcome levels.

Those who control the printing presses (The Federal Reserve and Congress) are now prioritizing inflation, and the Federal Reserve is clear: interest rates need to go higher, and there needs to be less credit in the system to cool things off. Congress has not gotten the memo and profligate fiscal spending is likely to continue.

Contrary, the stock and bond markets have benefitted greatly from years of loose monetary and fiscal policies, and they are now throwing a tantrum as conditions tighten.

There is some good news on the inflation front, however. The last month shows a host of data starting to tick downward. Key commodities like energy, materials, and metals are showing signs of rolling over. Rates are dropping a bit and the housing market is also cooling off. Higher interest rates and inflation itself might be curbing demand.

Berkshire Asset Management, LLC (Berkshire) is a fee based, SEC registered advisory firm serving the portfolio management needs of high net worth and institutional clients. Our guiding principle is a belief that success can be achieved by combining rigorous, well-crafted investment processes with an exceptional level of client service and attention to detail. Asset Management with a Difference... Diligence, Integrity and Focus. Berkshire Asset Management, Inc. was formed in 1986 as a SEC registered investment adviser. In 1999 the company was sold to Legg Mason. In 2007, senior leadership repurchased the firm, forming Berkshire Asset Management, LLC, the company built to serve you today.

## IN THIS REPORT

- Inflation… a monetary phenomenon
- Monetary conditions tighten
- Key inflation signals moderating
- Stock and bond markets endure a first half drubbing
- Berkshire results: attractive relative performance
- Is a recession inevitable?

## TOCK, BOND MARKETS: A BRUTAL FIRST HALF

The S&P is off to its worst start since 1970, down about 20% year to date. Growth stocks? Pounded – down nearly 30%. Crypto and other speculative nonsense? Pick a number. Many are down 30%-70% or more (good riddance).

The bond market has not been the usual safe haven in times of distress. It has posted its biggest loss YTD since 1842 as the Fed aggressively raised interest rates to combat inflation. Intermediate bonds are down -6.77% and longer-term bonds are down even more. Investors who stretched for yield or went long at a time when rates were at an all-time low are getting a rude awakening.

(Source: Bloomberg)

Equities are experiencing a 1-2 punch. The value of an asset is defined as the present value of future cash flow. When interest rates rise, future cash flows become worth less (not worthless!), and so present value declines. Also, many investors fear rising rates will create a recession. More on that later.

## RECENT RESULTS

We are pleased to report that amidst the carnage, equity portfolios managed by Berkshire are down substantially less than most widely quoted benchmarks. *

There's something to be said for classic investment principles and companies with strong fundamentals. The companies we own in our strategy, while down for the year, are still on track to deliver returns that will satisfy long-term investment goals. It's a far cry from the speculative strategies that may have little chance of a meaningful recovery any time soon (sometimes known as an "impairment of value").

Why are Berkshire stocks faring relatively well in the downturn? Quality and reasonable prices are back in favor. During the pandemic, growth stocks got extremely expensive – investors were willing to pay any price for the next big growth story. Now, investors realize these stocks can and do come back to earth, just like they did in 1999.

Furthermore, growth stocks usually don't fare well when interest rates rise. Their expected cash flows are usually well out into the future, which makes them more sensitive to interest rate increases.

Berkshire equity portfolios benefited from its relatively large exposure to health care stocks, which, as a group are actually UP for the year. Modest exposure to energy stocks, which are up big for the year, also helped. Our consumer names fared well. Many of our selections are posting solid results and showing they can manage inflation very well. Our industrial selections are down much less than the market. Many communication service stocks are down sharply, but our lone selection in this sector is actually up for the year.

Our modest exposure to technology stocks is a bit of a drag relative to the benchmarks, but we truly own the "best of breed" in the space. Investors like us who tend to own a lot of financials are in a bit of a conundrum. On the one hand, interest rates are going up (that's good) but on the other hand, there are fears of a recession brewing which could hurt loan performance (that's bad). Dividend increases in this sector have been a mixed bag. Each management team has a different view on which way the economy is heading.

## IS A RECESSION ON ITS WAY?

Berkshire is a dyed in the wool, bottom-up, stock picking shop. We generally eschew "macro". But the market does have a voice and it's important to discern what it's saying. We think the market is telling us: "We got this… sorta."

In other words, the market is behaving as if it is making a reasonable adjustment to a meaningful, but not unexpected, change in economic conditions. Although the market hit the free fall button when inflation first started spiking, it largely started to stabilize late in the quarter. Why? It seemed to reflect a growing sentiment that the right actions were being taken to get inflation under control.

Taking a deeper look at late quarter activity may be slightly more concerning. To us, it feels like market action is starting to signal "recession." Bond yields are falling fast, growth stocks are rallying, as well as defensive sectors like health care, utilities and REITS. Housing indicators are cooling somewhat and commodity prices are getting pounded. Whew. What a ride! Lots of drama, but also, lots of classic indicators investors are preparing for recession.

Moreover, policy makers face a conundrum. Raise rates too fast, and the economy might sink. Don't raise them enough, and inflation spikes again. Late in the quarter, Fed Chair Jay Powell said that if he has to pick his poison, the poison he will pick is… recession. That's a pretty clear signal.

Before everyone freaks out, though, we ask the following questions.

- What if a recession is already priced into stocks? We've had a huge decline already.

- What if we go into recession, but it's milder than people expect? It's possible, given the underlying strength of the economy.
- What if we have a recession, but loan performance remains strong? Bank underwriting and reserves appear solid, which greatly counters the risk of a negative credit cycle unfolding.

The media can be counted on to toss the word "recession" around. But these deeper questions lead us to believe we are not heading into a big crash like 2008.

As usual, our preferred method is not to time these shocks, instead own companies durable enough to handle them. There are good reasons to keep the faith. This year's declines may feel like yet another unsolvable mini crisis, but in time, great companies will likely adapt, grow and thrive.

*Investments are not FDIC-insured, nor are they deposits of or guaranteed by a bank or any other entity, so they may lose value. Individual account results may vary. Investors should carefully consider investment objectives, risks, charges and expenses.

## CONTACT BERKSHIRE:

**Gerard Mihalick, CFA** | Portfolio Manager

gmihalick@berkshiream.com
(570) 825-2600

**Jason Reilly, CFP®** | VP Advisor Distribution

jason@berkshiream.com
(570) 825-2600

[1] Past performance does not guarantee future results.

Registration with the SEC or any state securities authority does not imply a certain level of skill or training. The views expressed reflect those of Berkshire Asset Management, LLC (Berkshire) as of the date of this document. Any views are subject to change at any time based on market or other conditions, and Berkshire disclaims any responsibility to update such views. This information is not intended to be a forecast of future events, a guarantee of future results or investment advice. Because investment decisions are based on numerous factors, these views may not be relied upon as an indication of trading intent on behalf of any portfolio. The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by Berkshire as to its accuracy or completeness. Index performance discussed is for illustrative purposes only and does not predict or depict performance of any Berkshire investment strategy. While index comparisons may be useful to provide a benchmark for a strategy's performance, it must be noted that Berkshire's investments are not limited to the investments comprising the indices. Each of the strategy benchmark indices are unmanaged and cannot be purchased directly by investors. Risks: Past performance does not guarantee future results. All investing carries risk including risk of principal or income loss. Dividends are subject to change, are not guaranteed, and may be cut. Investing based on dividends alone may not be favorable as it does not include all material risks. There is no guarantee any stated (or implied) portfolio or performance objective mentioned by Berkshire can be met. Berkshire's equity style may focus its investments in certain sectors or industries, thereby increasing potential volatility relative to other strategies or indices.

*Berkshire Asset Management, LLC (Berkshire) is a fee-based, SEC registered advisory firm serving the portfolio management needs of high net worth and institutional clients. Berkshire Asset Management, Inc. was formed in 1986 as a SEC registered investment adviser. In 1999 the company was sold to Legg Mason. In 2007, senior leadership repurchased the firm, forming Berkshire Asset Management, LLC, the company built to serve you today.