Eulogy for the Fed Put

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The Fed Put was always there when we needed him. When the markets hiccupped over the Asian financial crisis in 1998, he cut the fed funds rate even though U.S. unemployment was just 4.5%. As the ensuing tech bubble deflated from 2000-2003, our caped hero intervened, introducing investors to the new millennium's sub 1% fed funds rate era. When the subsequent real estate bubble popped and Global Financial Crisis raged from 2007-2009, he summoned a zero-interest rate policy and tripled the Fed's balance sheet via purchases of U.S. Treasuries and mortgage-backed securities. Like Atlas, he kept holding those trillions of extra bonds in response to the bond market's 2013 taper tantrum. Finally, when the pandemic threatened in 2020, he bravely doubled the Fed's bond holdings to $9 trillion and slashed interest rates to a negative rate adjusted for inflation.

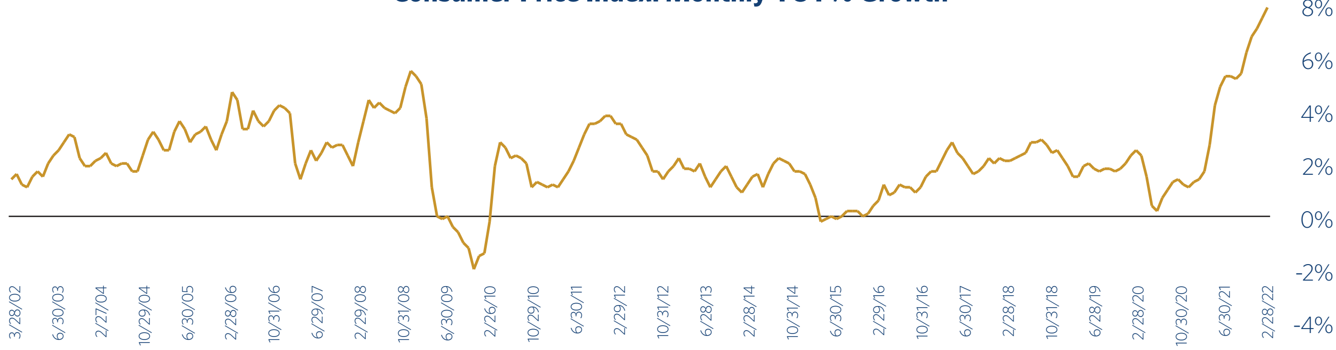
A whole generation of new investors can be forgiven for recency bias—"Buy the dip!"—since our hero delivered so much for so long. Over the past 14 years, he has brought us an average fed funds rate of just 0.51%. His free money made even unworthy assets worthy.

Recently, he unfortunately flew into his kryptonite meteor shower—the highest inflation rates (February CPI of 7.9%) since the 1980s. For decades he enforced one half of the Fed's dual mandate—maintaining full employment—with impunity. There was no fear his prodigious actions could impact the prices consumers and businesses paid for things. However, with supply chain-driven inflation now embedded in more persistent and large areas of the economy, like wages and housing, Federal Reserve Chairman Jerome Powell and company must shift their focus to the Federal Reserve's other mandate—price stability. Our hero, the Fed Put, can no longer patrol the skies, neutralizing threats to economic growth and the stock market. May he rest in peace…for now.

Late-Cycle Positioning without a Fed Put: Earnings Sustainability and Value

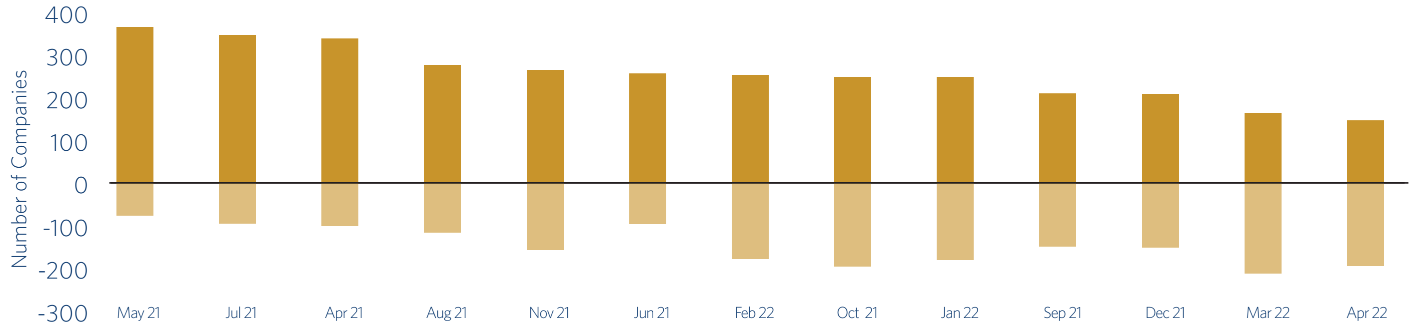
The unprecedented amount of U.S. government pandemic stimulus, over 50% of GDP, supercharged the speed of the current economic and market cycle. While we are only two years removed from the 2020 recession, the briefest on record, we have already witnessed classic late-cycle signals. Corporate earnings, profit margins and GDP growth peaked in 2021 as did leading economic indicators like the ISM

Consumer Price Index: Monthly YOY% Growth



Sources: Bloomberg, Scharf Investments.

Monthly EPS Revisions Upward/Downward



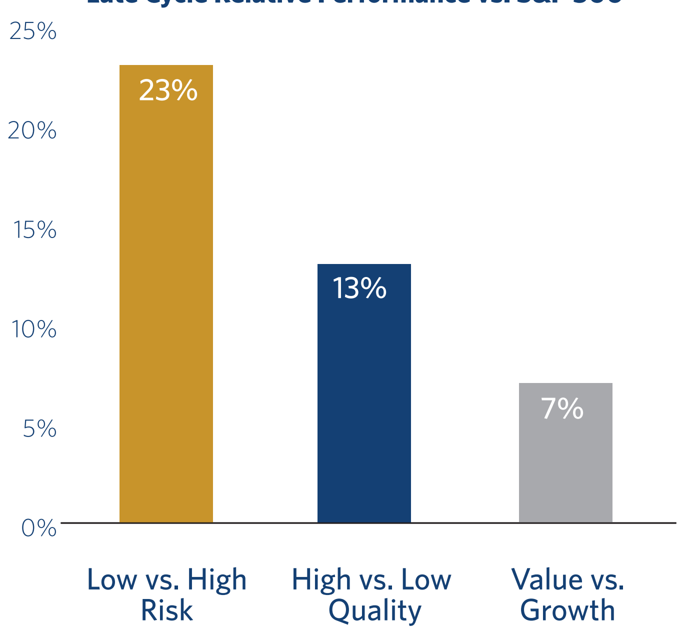
Sources: Factset, Scharf Investments. Universe reflects companies in the S&P 500.

survey. With the Fed's hawkish pivot towards controlling inflation, it is clear the Fed's intent is to slow economic growth.

After 2021 operating margins for the S&P 500 exceeded 13%, their highest on record and nearly double their long-term average, it is not surprising that inflationary pressures and poor consumer sentiment stand poised to erode profit margins. The earnings upward to downward revisions ratio has notably deteriorated over the past 12 months.

The good news is that there are always investment opportunities, even in volatile markets. Investors who de-risked their portfolios of high-flying tech names before the tech bubble burst in 2000 went on to experience solid returns the following decade. When we look at several historical market cycles, the successful playbook for outperforming in a late-cycle environment has been to allocate towards low risk vs. high risk, high quality vs. low quality, and value vs. growth factors.

Late Cycle Relative Performance vs. S&P 500

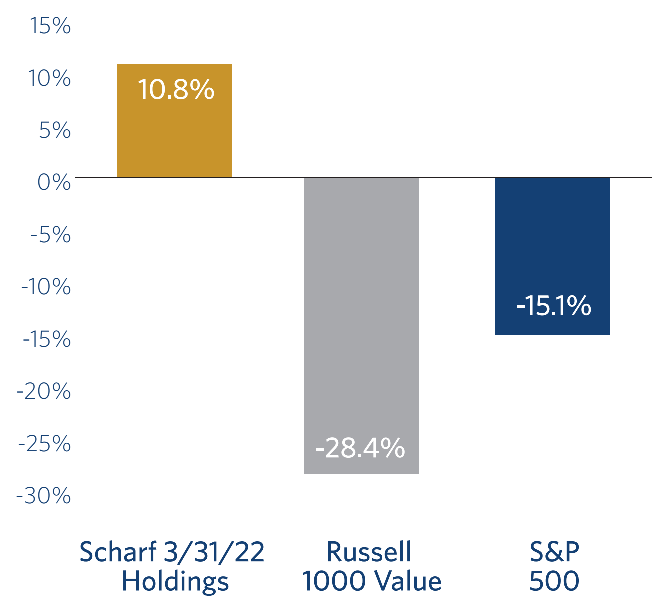


Sources: BofA, Scharf Investments. Style returns relative to equal weighted index during historical late cycle phases.

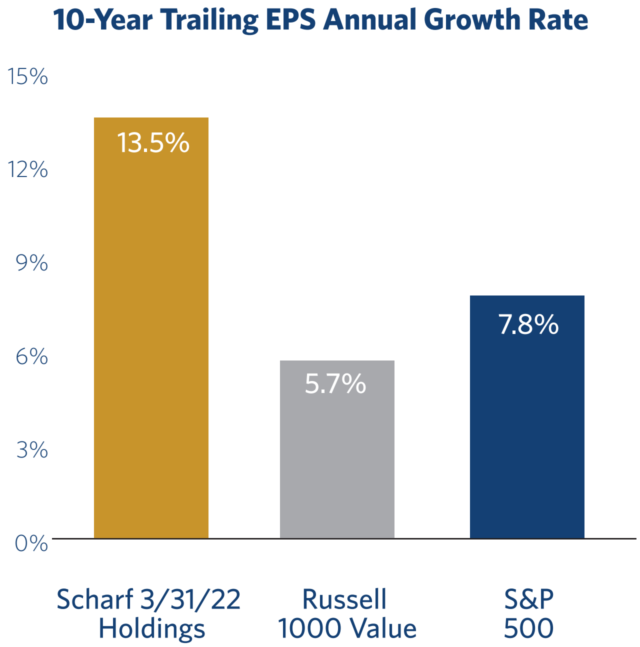
We believe the Scharf Portfolio is well-positioned as the Fed attempts to thread the needle between price stability and full employment. The high-quality and low-risk health care sector remains the portfolio's largest overweight and has already smoothed returns during the market's recent volatility. Our exacting investment process emphasizes companies with sustainable earnings trading at compelling discounts to fair value. We seek to buy stocks with 30%+ upside to our price targets and limited downside. Historically, this long-tested investment process has helped us add value for investors during adverse markets.

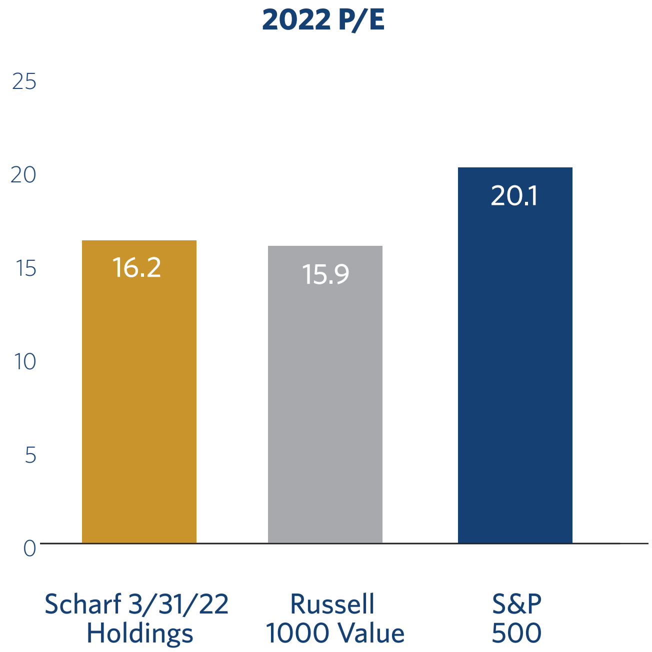
Our current portfolio holdings' earnings have been highly resilient, as most notably displayed in 2020 when the world literally stopped.

2020 EPS YOY Growth Rate



Sources: Bloomberg, Scharf Investments.





Sources: Bloomberg, Scharf Investments.

Over the last 10 years, the current holdings have grown EPS at an annual rate of 13.5%, far outpacing relevant market indices. We model continued double-digit portfolio EPS growth over the next three years and consider the valuations to be attractive for such earnings sustainability.

While the Fed Put is kaput, investing in quality businesses at reduced valuations remains the order of the day.

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