CHARTWELL INVESTMENT PARTNERS

# Chartwell Strategies Current Outlook and Investment Strategy

*"Age is no barrier. It's a limitation that you put on your mind"*
*-Jackie Joyner-Kersee, Olympic track and field gold medalist.*

**Summary**

- *After a weak first quarter of the year, stock prices fell again across a broad front in the second quarter with the NASDAQ and Russell 2000 Indices moving into bear market territory, down over 20 percent for the six-month period.*
- *For the second quarter, Chartwell-managed accounts fell in-line with their respective index benchmarks, however, the Chartwell Dividend Model outperformed by a significant margin versus its benchmark.*
- *Stock market weakness was precipitated by a rise in interest rates, orchestrated by the FRB, to mitigate the inflationary pressures created by pandemic-related supply chain difficulties and excessive Government spending.*
- *The sharp rise in inflation may be peaking as basic commodity prices are beginning to decline, however, the duration of this inflationary period will depend on many factors including domestic energy policy, government spending and the speed with which the international supply chain is reconstituted.*

## Background

Stock prices fell sharply, and bond prices weakened under the weight of higher interest rates during this year's second quarter. The Dow Jones Industrial Average (DJIA), S&P 500, NASDAQ and Russell 2000 retreated 10.78 percent, 16.11 percent, 22.27 percent, and 17.21 percent, respectively. Weakness in the financial markets was precipitated by continuing inflationary pressures which are necessitating the Federal Reserve Board (FRB) to raise the federal funds rate in order to reduce borrowing and slow the economy; in addition, the FRB stated that it would begin to reduce the size of its balance sheet by not reinvesting cash received from its bond maturities. Together, these actions communicate an unmistakable resolve by the FRB to reduce inflation, even at the expense of a slower economy.

The prices of gasoline and diesel fuel, which have more than doubled over the past two years, have held center stage as basic living costs for American consumers have risen across a broad front. For example, according to the Bureau of Labor Statistics, in May the food price index advanced 10.1 percent year over year; airline fares are up in the 35 percent range and the labor market remains tight and more expensive. Blame has been given to the war in Ukraine and the refusal, or inability, of our domestic oil industry to "lift" and refine more oil.

There is no single reason for the global rise in the prices of goods and services, however, the COVID-19 pandemic that disrupted global manufacturing and international supply chains, coupled with excessive government spending as world economies were beginning to recover, have been two primary factors in this phenomenon.

The FRB's fight against inflation may be in the early stages, however, there are signs that inflation is beginning to moderate and that higher interest rates may not throw the Nation into a deep recession. One positive sign is a pullback in basic commodity prices. Important commodities such as oil (down 19.7 percent), copper (down 29.5 percent) and lumber (down 55.4 percent) have experienced significant declines from early March, when their prices peaked. The Bloomberg Commodity Index, shown in Figure 1 on the next page, has retreated sharply since June and does not appear to be positioned to reach new highs in the weeks, and perhaps months ahead.

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ONE YEAR GRAPH OF BLOOMBERG COMMODITY INDEX
7.24.21-7.24.22


**Figure 1.** Since mid-June, the advance of commodity prices has ended.
*Source: BLOOMBERG*

Another encouraging factor is the behavior of the U.S. dollar in the foreign exchange markets. Normally, a weak currency is associated with a country experiencing a high inflation rate. However, the U.S. dollar has been very strong, which lowers the price of imports and attracts foreign capital to our shores. Without the need to defend the dollar, the FRB has more flexibility in its operations which, in our opinion, could result in a faster resolution to the inflation problem than otherwise anticipated. Nevertheless, it is also possible that inflation may recede, but at an unacceptably high number that requires years to fully correct.

Related to a strong U.S. dollar is the weak price performance of precious metals. Normally, higher gold, silver and other precious metal prices are characteristic of an inflationary period, and they are higher when measured in some foreign currencies, but not when priced in U.S. dollars. Figure 2 illustrates the prices of gold and silver over the past two years in U.S. dollars, a period of relative weakness for these two precious metals.

PRICES OF GOLD AND SILVER OVER TWO YEARS
7.24.20-7.24.22

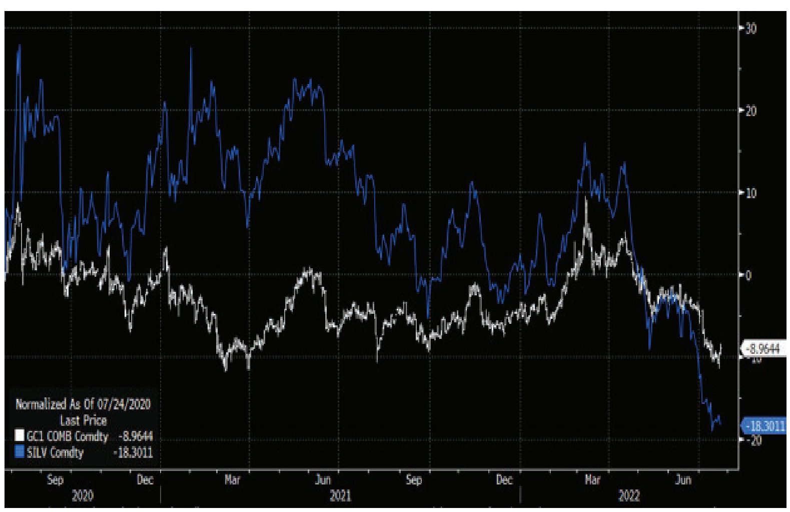


**Figure 2.** Prices of precious metals has declined over the past two years.
*Source: BLOOMBERG*

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The pandemic's impact on the supply chain, which has led to imbalances between the demand and availability of goods and services, is also moderating. In a May 26th article published by Morningstar, the mutual fund rating company, improving trends in the global supply chain are noted. One positive is the improvement of labor availability in key areas, such as shipping ports; Figure 3 illustrates the average delays and schedule-reliability in global shipping. Days delayed may have peaked at "eight" in January of this year, but improved in February and March. Similarly, schedule-reliability may have bottomed in the same month, January, at about 32 percent and rose to 36 percent in March.

### Average Delays and Schedule Reliability in Global Shipping

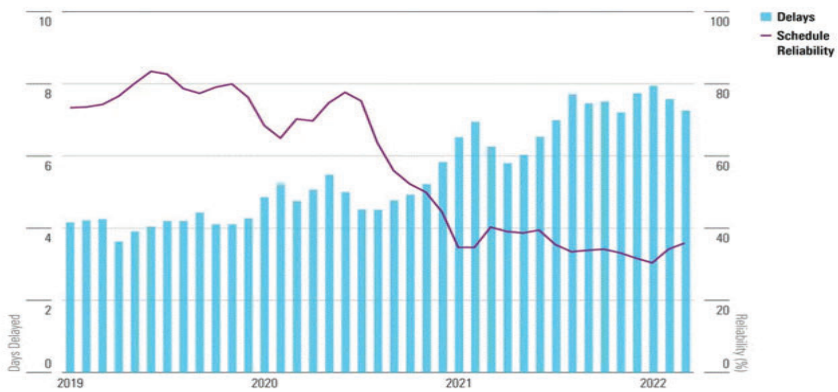


**Figure 3.** Global shipping delays and reliability might be starting to improve.
*Source: MORNINGSTAR*

The shortage of semiconductors has affected auto production such that light vehicle inventories have fallen from nearly four million to a little over one million. As shown in Figure 4, inventories have been stable since last October as the situation slowly improves. Supporting the belief that the industry is gaining on delivering the backlog of new car orders is the fact that used car prices also peaked this past January when the Manheim Used Vehicle Value Index reached 236.3 and fell to 219.9 in June, just a few weeks ago.

### U.S. Light Vehicle Inventory Levels

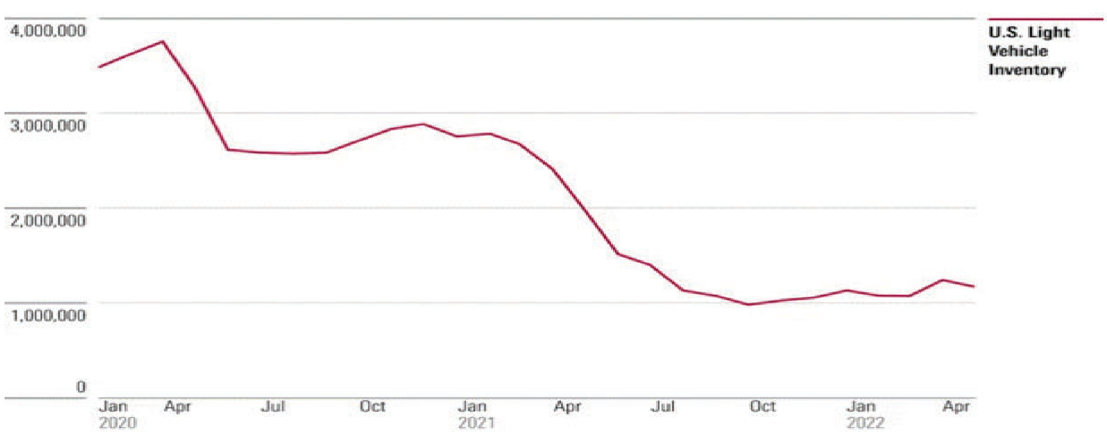


**Figure 4.** The semiconductor shortage has resulted a decline in automobile production.
*Source: MORNINGSTAR*

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The coal mining, natural gas and oil drilling, refining and utility industries have been under "pressure" from environmentalists, climate change extremists and "progressive" politicians for the past thirty years. Basically, these groups appear to want to destroy any industry engaged in the production or use of fossil fuels. The pressure has come in the form of stricter rules to obtain drilling permits, additional operational procedures, the clean-up of stack gases and the restriction of new pipelines. In fact, banks have been discouraged by politicians from lending to companies engaged in the production or use of fossil fuels. The result has been a limited amount of new investment into these industries, which is now causing higher prices as world demand improves following the pandemic.

Countries such as China and India, as well as many others, will meet their energy needs using a combination of coal, hydroelectric power, natural gas, nuclear, oil, solar and wind turbines. Germany, after unsuccessfully trying to meet their energy needs with solar and wind, have now resorted to coal-fired electrical generating plants and are considering the use of nuclear power plants, a technology they abandoned years ago. Germany's experience is an important lesson for the United States to learn. If we are to remain a vibrant force in the world, it is imperative that we become more realistic about developing a long-term and balanced plan that produces ample amounts of inexpensive, domestic energy sources for powering our homes, businesses, and transportation needs.

At the root of the energy problem is a citizenry that is divided on the issue of climate change. For more than thirty years, there has been a segment of society that believes climate change is an urgent issue. However, in a recent book*, Steven E. Koonin, former chief scientist in the Obama Administration, claims that his years of research have failed to find evidence that climate change has been occurring at a discernible rate. Some scientists agree with Koonin; however, in a major contrast, other scientists believe that the Earth entered a cooling period beginning about ten years ago. It would appear to be judicious that before we make major changes in the way that we live, that we understand the fundamental elements that cause climate change on Earth and that our computer models can predict future changes accurately. Currently, more than thirty computer models to forecast climate change are in use, but they all disagree with each other. To many observers, the assault on the fossil fuel industry has gone beyond the bounds of sound judgement and is now costing our society dearly.

In early July, the markets have stabilized and may have made an interim bottom, however, over the intermediate term their direction will, most probably, be determined by the supply chain's recovery to pre-Covid standards and the ability of the FRB to engineer a "soft landing" for the economy as interest rates rise to a more normal level. Although it is tempting to believe that our value-oriented stocks have bottomed, this stock market lacks homogeneity, is especially vulnerable to political developments at the federal level and continues to demonstrate high volatility.

## Current Strategy

As discussed above, the relatively benign correction of the first quarter snowballed into a full bear market in Q2. Stubbornly high inflation led the Federal Reserve (the Fed) to raise rates twice in the quarter, upping the ante to 75 basis points** at their June meeting. This, along with indications of a more restrictive monetary policy for at least the rest of the year, pushed markets lower as recession concerns became more real. The result was the worst first-half return for the S&P 500 since 1970. Bond prices fell as well, making the first half of 2022 one of the worst first-half performances for balanced portfolios. The Chartwell Growth Composite declined by 16.1%, slightly worse than both the Russell 2000 Value (-15.3%) and the Russell Midcap Value (-14.7%). The Chartwell Balanced Composite, down (-12.3%)***, was modestly short of the benchmark's drop of (-11.4%). Finally, our Dividend Equity Composite (-8.9%) fared much better than the Russell 1000 Value (-12.2%). Value based stocks outperformed stocks with higher price-to-earnings ratios ("P/E")*****, with large growth stocks being the the worst performers this quarter; the Russell 1000 Growth index fell 20.9%.

The three best performers for Q2 in the Growth and Balanced accounts were: Flowers Foods (FLO, 2.7%)****, up 3.3%; Constellation Energy (CEG 2.0%), up 2.1%; and Hess Corp. (HES, 3.0%), down 0.7%. The first two of these are in "defensive" industries, Consumer Staples and Utilities. Flowers is a primarily baked-goods company with strong revenue growth; Constellation is a clean-energy power company with positive exposure to higher natural gas prices, which rose significantly during the quarter. Hess also benefited from higher oil and natural gas prices and has now been on the top performers list for two successive quarters.

** "Unsettled – What Climate Science Tells Us, What It Doesn't and Why It Matters", Koonin, Steven E., BenBella Books Inc., 2021.*
*** The definition of a basis point is one hundredth of one percent.*
****All composites reflect net-of-fee returns.*
*****The numbers in parentheses following each company mentioned reflect the percentage of the portfolio's net assets comprised of such securities as of 06/30/2022. Holdings are subject to change. A full listing of portfolio holdings is available upon request.*
******P/E is the Price to Earnings Ratio and is used to determine the relative value of a company's shares. To calculate, it is the price the stock is selling at divided by the annual earnings.*

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The three worst performers in the Growth and Balanced accounts were: Travel + Leisure (TNL, 1.6%), down 32.4%; United Rentals (URI, 1.9%), down 31.6%; and Hain Celestial (HAIN 1.5%), down 31.0%. Timeshare company TNL actually posted a solid quarter, but the market seemed to not care, as heightened recession fears trumped all else. United Rentals suffered a similar fate, even though they are not seeing any slowing yet in non-residential construction, and the secular move toward more use of the rental channel is intact. Hain's woes were somewhat self-inflicted: disappointing quarterly earnings accompanied by a guide-down of expectations for the upcoming quarter. The European business was especially weak, and margins were hurt from rising input costs. We are maintaining patience as the company implements price increases.

In the Dividend Equity accounts, the three best performers in Q2 were: AT&T (T, 2.5%), up 17.1%; General Mills (GIS, 3.2%), up 12.2%; and Merck (MRK, 3.6%), up 12.0%. AT&T completed the spin of the WarnerMedia business (HBO, CNN, etc.), and the market seemed to like the "back-to-basics" approach. Also, the telco business is expected to do relatively well in an inflationary environment. General Mills benefitted from the combination of being in a very defensive industry as well as demonstrating solid business momentum; margins have been particularly impressive, following price increases. Merck, like other pharma companies, is in a defensive business, but the stock also did well as peak-sales estimates for their flagship drug, Keytruda, have gone up (JPMorgan estimates $32 billion in sales by 2026).

The three worst-performing stocks in the Dividend Equity accounts were: Hanesbrands (HBI, 1.1%), down 30.1%; Lincoln National (LNC, 1.9%), down 27.9%; and General Motors (GM, 2.4%), down 27.4%. Hanesbrands' management is executing well, but the challenging environment includes supply-chain headwinds, higher input costs and some post-Covid inventory build-up. Lincoln's quarterly results were weak in both life insurance and annuity sales, but we remain positive on the stock given the company's ongoing de-risking initiatives, leverage to higher rates, and discounted valuation. GM posted solid first-quarter earnings, but, supply issues continue to be a headwind and the market appears to be "pricing-in" at least a mild recession. The question seems to be: by the time the supply constraints are resolved, will we be in a much-worse economic scenario that will "hit" the demand side?

After a couple quarters of higher-than-average trading, Q2 was extremely light in both the Growth & Balanced and Dividend Equity accounts (see below). After trimming GM earlier in the year at much higher price levels, we added back to the position. Now trading at $32 per share, GM's P/E multiple on 2022 earnings estimates is below 5 times its annual earnings per share, which we think is very attractive and is already pricing-in at least a mild recession. We also took advantage of the sell-off in boat & engine manufacturer Brunswick Corp. (BC, 2.3%) and added to the holding. This stock sells at less than 7 times its annual earnings per share '22 EPS estimates. The company recently held an analyst briefing and quantified the downside to sales, margins, and earnings in an economic downturn. We think the stock is attractively priced even in that scenario and that it is a long-term double-digit-percentage earnings grower. Hess was a trim on strength after a very strong 6-month move (up 43% 1H '22). We sold the full position in fertilizer company CF Industries, which also had a 20%+ YTD return (through 6/30), as we had concerns that the company would announce capacity additions, which would negatively impact nitrogen pricing. Additional sales in taxable accounts (later repurchased) for the purpose of "harvesting"* losses were: NCR Corp. (NCR), Hain Celestial (HAIN), and Hanesbrands (HBI). In the Dividend Equity accounts, we also added to the position size of General Motors, as described above.

The light trading in the quarter reflects the fact that we are taking a "wait and see" approach to the portfolio. We moved to an incrementally more-defensive posture in Q1, but the additional sell-off in stocks has now taken us from a "correction" to a full-blown bear market. We now are sitting on the precipice of either a recession or – in a more-favorable scenario – a "soft landing" for the economy, as the Fed continues to move from accommodative to restrictive monetary policy – by their own admission. Chairman Powell has put the inflation-reduction mandate ahead of all else, so a weak (or worse) economy is likely to unfold in the coming months, even as today's readings are decidedly mixed. Many observers believe that the market (and certainly some parts more than others) has already discounted a mild recession, so perhaps additional downside will be limited. Given these critical and very difficult to determine uncertanties ahead of us, we are in somewhat of a holding pattern. However, we are always on the lookout at the individual-stock level for dislocations that provide attractive long-term buying opportunities (see examples in Trades section above). Similarly, if any of the current holdings experience fundamental deterioration, or unusual challenges from the current scenario that we think portend ongoing underperformance, we will eliminate those stocks from your portfolio. The net of this is that we have been "letting" cash build, as we have made some sales but are waiting for the right buy-point on some stocks that are candidates for purchase (and we also want to wait for quarterly reports on some).



*Harvesting is the process of selling some investments at a loss to offset gains realized by selling other stocks at a gain.*

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## Chartwell News

We hope everyone is enjoying the start of your summer. Here at Chartwell, we are getting settled in with our new parent as of June 1, Carillon Tower Advisers, the asset management subsidiary of Raymond James Financial, Inc. We are excited about this new partnership! As previously mentioned, there will be no changes to your account management. Your account(s) will not change custodians, investment, or client service personnel. As reflected in the Quarterly Strategy Letter ("QSL"), the economy and markets continue to experience turmoil and declines. It is times like these where active management and client servicing counts. Despite the uncertainty, we will continue to work hard looking for great companies at good values. While our QSL is a good medium to communicate with our clients, as always, and especially during market unrest, we do welcome any requests for in-person meetings and/or conference calls.

Thank you for the continued trust you place with Chartwell Investment Partners. We wish everyone a safe and healthy remainder to summer! As always, if you have any questions regarding your account performance, or want to discuss changes in your investment objective, please do not hesitate to call Mike Magee (610.407.4867) or Pete Schofield (610.407.4858).



*The Chartwell Growth Strategy Composite includes all fully discretionary, fee-paying equity accounts with a growth objective whose asset size is $300,000 or greater at the beginning of the measurement period. For individual bond holdings the fee is 5/8 of 1% and for bond mutual funds, including exchange traded funds, the fee is 3/8 of 1%. The fee for these accounts is negotiable.

*The Chartwell Balanced Strategy Composite includes all fully discretionary, fee-paying accounts with a balance between growth and income as a principal objective whose asset size is $300,000 or greater at the beginning of the measurement period. For individual bond holdings the fee is 5/8 of 1% and for bond mutual funds, including exchange traded funds, the fee is 3/8 of 1%. The fee for these accounts is negotiable. The composites do not include accounts where total cash flows exceed 10% of the account's value during any quarterly period or accounts holding securities purchased by anyone other than the Advisor. No accounts using leverage or short positions are included in the composites. An individual client's account may have performed better or worse than the composites' returns presented above. The composites contain taxable and non-taxable accounts. The returns are before taxes and net of all advisory fees and commission charges. The net performance results for each composite are presented after deducting the actual fee charged to each account in the composite based on the management fee schedule in the Firm's Brochure or the fee negotiated between the account holder and Chartwell. Returns include the reinvestment of dividends and interest (total return). Returns for other Chartwell composites are available upon request.

As of 06/30/2022 Chartwell managed $10.4 billion in assets, $9.8 billion as advisor and $638 million as sub-advisor. During the most recent quarter, the Chartwell Growth Strategy Composite consisted of 9 accounts which represented 8.3% of total Chartwell Strategy Individually Managed Accounts and 0.1% of total Chartwell assets. During the most recent quarter, the Chartwell Balanced Strategy Composite consisted of 19 accounts which represented 35.5% of total Chartwell Strategy Individually Managed Accounts and 0.4% of total Chartwell assets. The Chartwell Growth Dividend Strategy Composite consisted of 6 accounts which represent 3.6% of total Chartwell Strategy Individually Managed Accounts and less than 0.1% of total Chartwell assets.

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