Morris Capital Advisors, LLC

Investment Commentary
June 30, 2022

The Slinky Market

The Slinky is a helical spring invented in Philadelphia by Richard James, a naval engineer, in 1943. It stretches itself and returns to its original form with the aid of gravity and its own momentum. It is a simple toy, but its physical properties are articulated by mathematical equations that express its oscillations, equilibrium, and acceleration based on the Slinky's length, mass, and spring constant. It "walks" down steps and moves rapidly from end to end, but it is challenging to try to limit its momentum potential while trying to balance an equal weighting on each end.

The Fed's attempt to balance the dollar, inflation, and economic growth for so long proved to be challenging, as well, resulting in a dramatic momentum shift in the economy and financial markets as that balancing act became more precarious. The stock and bond markets closed 2021 at, or near, all-time highs as the economy continued to grow despite supply chain issues and labor shortages in many industries. While commodity prices in energy and construction materials began to stabilize at higher levels, inflationary pressures continued to mount. The Fed was slow to react and was forced to confront the reality that excess liquidity in the form of a rapid expansion of the M2 money supply measure drove the inflationary pressures. As inflation soared above 9%, a level that conjured memories of the inflationary extremes of 1974 and 1980, the financial markets adjusted to the possibility that dramatic measures would be needed. In the space of just a few months the momentum reversed, stocks declined by more than 20% and a sharp increase in interest rates triggered negative returns in the bond markets.

The Fed exerted increasing influence over the economy and financial markets in the years since the Great Financial Crisis of 2007-2008. It attempted to spur economic growth by creating a "wealth effect" via stock market gains, using low rates and liquidity injections. More recently, the Fed's influence was amplified by massive fiscal stimulus bills in the aftermath of the COVID shutdowns. But, as is often the case with artificial market influences, the fiscal and Fed stimulus led to unintended consequences. These policy tools can help to offset temporary undesirable outcomes but often become ingrained, resulting in an overshoot of their intended targets and added instability. This was certainly the case as supply chain disruptions, labor scarcity, and inflationary pressures forced the Fed to reverse course.

Through the early part of 2022 Fed chairman Powell and the Biden administration insisted that inflationary pressures were "transitory" despite clear evidence to the contrary. The Fed maintained its accommodative stance and the Biden administration proposed another massive stimulus package. As inflationary pressure mounted the Fed began to act, moving gradually at first, raising rates by just 0.25% in March and 0.50% in May. As inflation spiraled higher the Fed raised rates by 0.75% in June and conceded that inflation had indeed become a systemic problem. Despite the rate hikes, it was apparent that the Fed was behind the curve and the markets reacted negatively. As Slinky demonstrated, the delicate balance shifted rapidly in the other direction.

It is understandable that investors feel battered by this recent market volatility. Corrections of this magnitude throughout the financial markets in such a short time frame are unsettling, but successful investors know that these corrections can often create the potential for a rebound. Think of that Slinky compressed on one side. Some good news on the economy or corporate earnings, or the lack of more bad news, could get the momentum moving in the other direction. One bit of good news at this point could be that stocks are now trading at attractive levels. The Price Earnings ratio (PE) of the S&P 500 index fell below 15, less than both its 5 and 10-year aver-ages. That valuation provides a good basis for a rebound if the economy and corporate earnings continue to grow. Historical market performance is also encouraging. Based on data com-piled by Bespoke Financial, the stock market has experienced declines of more than 15% eight times since World War II. Following those declines, stocks registered a positive return 7 times over the next quarter, averaging a return of more than 6%. Returns on stocks were positive in all eight instances over the next six and twelve month periods, with average returns of more than 15% and 26%, respectively.

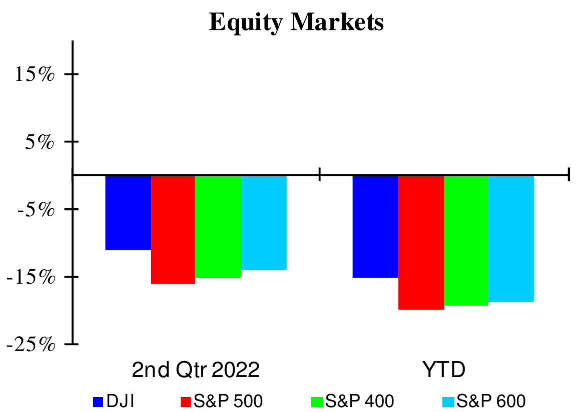
Our experience tells us that we could also continue to experience a shift in market leadership as more conservatively valued names outperform the "high duration" (high valuation) growth stocks that led the market since the Great Financial Crises of 2008. Our portfolios are well positioned to take advantage of this shift and have contributed positively to our performance over the past several months. We continue to believe that our focus on high quality companies trading at reasonable valuations will provide the best opportunity to generate consistent returns. Our investment process will continue to search for growing, well-managed, companies trading at reasonable valuations. Our portfolio holdings, balanced between growth and valuations, should give us the best opportunity to keep the momentum moving in the right direction.

Sincerely,
Daniel A. Morris

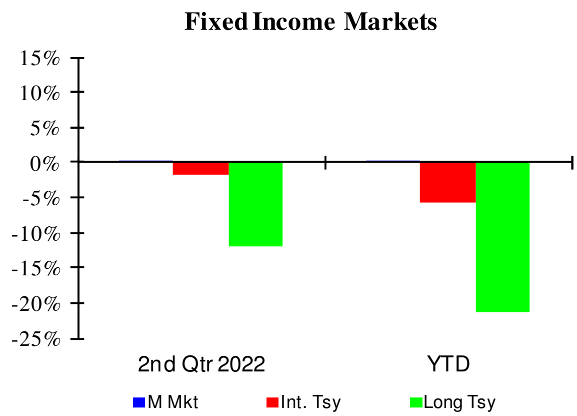
Market summaries on reverse page

Morris Capital Advisors, LLC

Market Summary
June 30, 2022



The stock market declined again during the 2nd Quarter of 2022, extending its previous decline and falling to its lowest level since December 2020. The decline was fueled by investor concerns about rising inflation, the prospect of Fed interest rate hikes, and the risk that a recession could negatively impact corporate earnings. In addition, Geopolitical risks and COVID lockdowns in China heightened fears that supply chain issues would persist, contributing to continued shortages of essential components and consumer goods. Growth stocks substantially underperformed value names as many of the large-cap tech names led the decline. Large-cap stocks outperformed more economically sensitive small-cap stocks, but only by a small margin. As might be expected, defensive sectors (consumer staples, health care and energy) outperformed, while the tech, communication services, and consumer discretionary sectors underperformed.



The bond market declined during the 2nd Quarter of 2022, extending losses suffered in the previous quarter. Fed rate hikes of 0.50% and 0.75% pressured fixed income investments, and comments by the Fed indicating that they would remain aggressive in raising rates to curb inflation contributed to the decline. In addition to the rate hikes, the Fed indicated that they would begin to reduce their purchase of US Treasury and mortgage-backed securities, thus draining reserves from the financial system. The combined impact of this policy shift could constrain economic growth, prompting investor concerns that the aggressive policy shift could trigger a recession. The rise in rates triggered negative returns among short, intermediate, and long term bonds. Credit spreads widened, late in the quarter as high yield corporate debt markedly underperformed investment grade debt. Late in the quarter the yield curve inverted as yields on longer term debt fell below short term paper. This inverted yield curve often proceeds an economic recession.