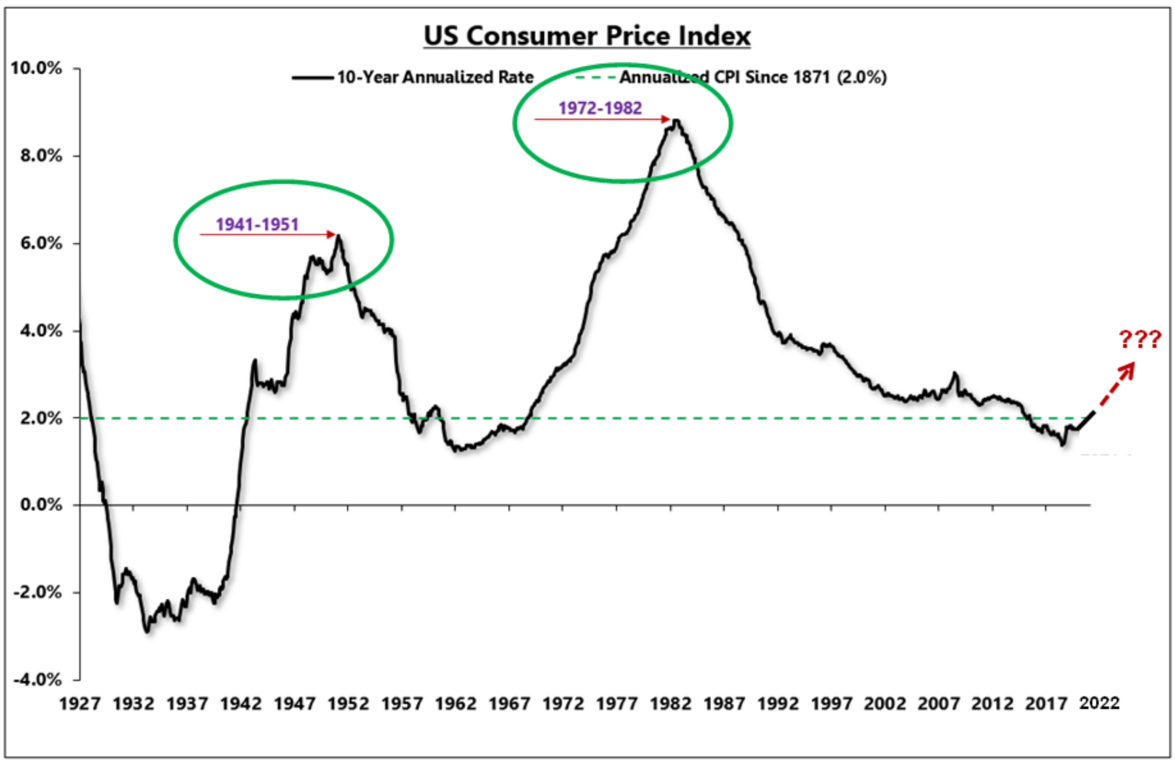
Covered Call Commentary

October | 2022

<u>Inflation Outlook:</u> *Will the 2020s Look More Like the 1970s or 1940s?*

One of the biggest debates these days is whether inflation has peaked. Market bulls believe it has, while market bears tend to believe it has not. As always, we prefer to look at long term macro trends rather than argue about short term market direction. In that spirit, we want to see what we can learn from history on this topic.

There have only been two "inflationary decades" in the past 100 years. For this exercise, we are defining "inflationary" as a 10year average CPI > 5%. These two decades are the 1970s and the 1940s. See below.

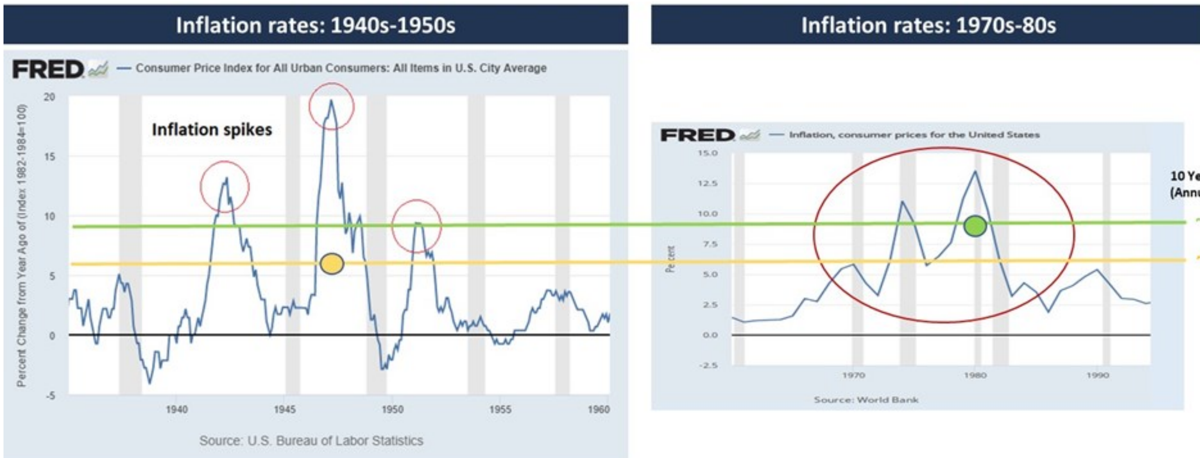


Two things to note about this chart:

- Looking at a 10year moving average, inflation appears to have been nastiest in the 1970s, a decade many of us actually remember. Its recency is likely one reason why we hear so many comparisons/fears about the 1970s today. We will compare it to the 1940s in more depth below.
- The current cycle is just getting started. Although CPI is currently over 8%, it comes on the back of a very deflationary decade, so the 10year average is currently only 2.2% (!!). But the key question is where is it headed?

Digging Deeper

Digging a little deeper into these two decades reveals some interesting differences between the 1970s and the 1940s. The green line in the graphic below represents the peak 10year average inflation of the 1970s, while the yellow line represents the peak 10year average of the 1940s. But the short-term fluctuations are very important. They are reflected by the blue lines in each period.



Three separate inflation spikes, with two higher than the 1970s peak

Lower Peak But Higher For Longer

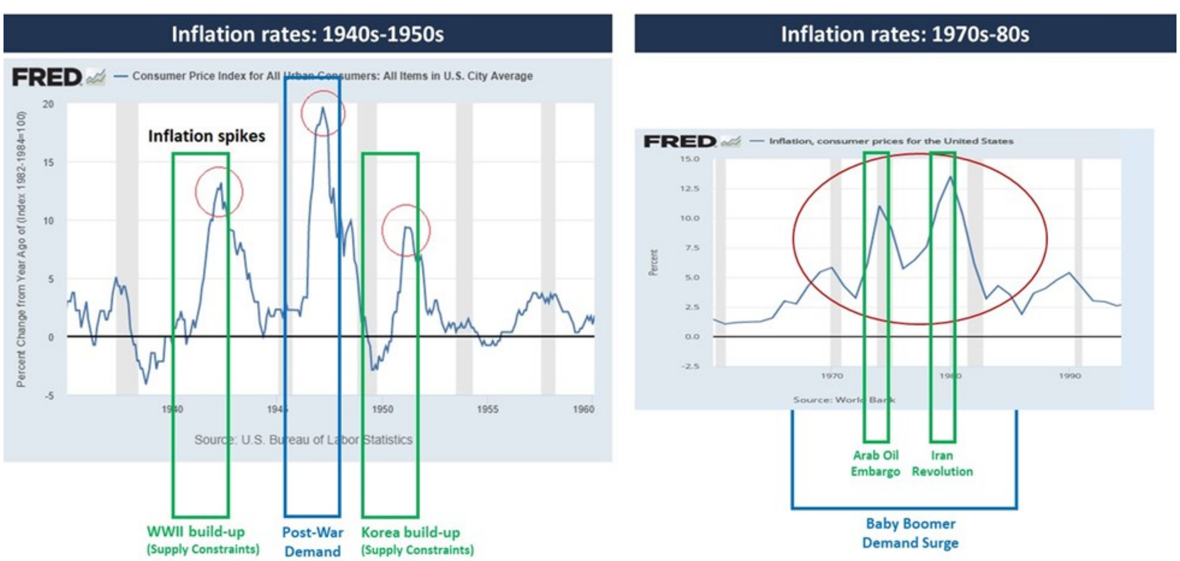
Key Points

- While the 1940s had lower ***average*** inflation, it was much more volatile, with two ***higher peaks*** than the 1970s and three ***lower troughs***.
- The inflation of the 1970s, while less volatile, was more persistently high.

Digging Deeper Still

Overlaying the geopolitical events of these decades reveals more interesting insights. And requires an understanding of the different types of inflation:

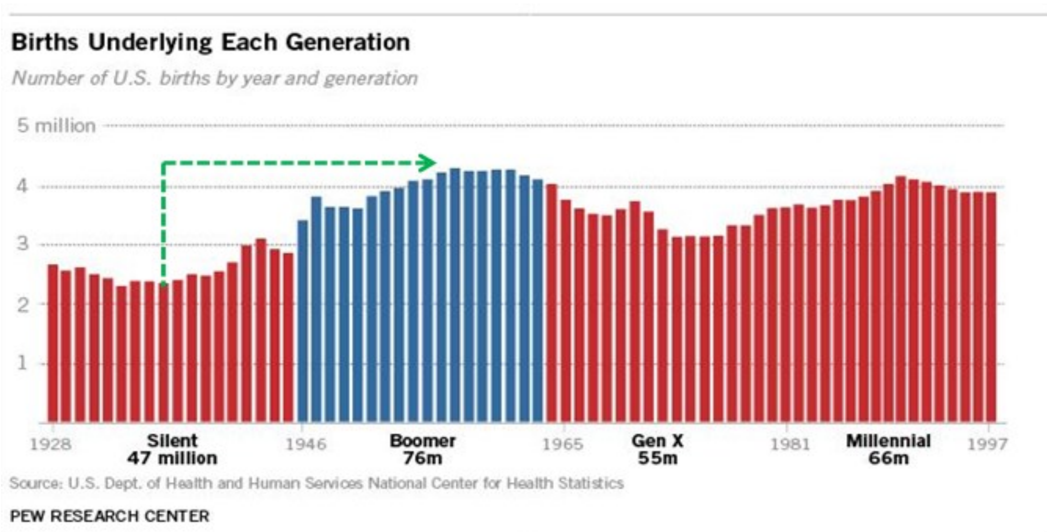
- Demand driven inflation: Supply is not constrained, but demand outstrips supply
- Supply driven inflation: Higher prices driven primarily by supply constraints



Key Points

1. The 1940s had a large spike of demand driven inflation in the middle of the decade, as US soldiers came back from the war and people started consuming again (similar to what happened in 2021 when the economy opened back up from covid). But there were ***two*** periods of supply driven inflation during the decade, as the country shifted its manufacturing efforts towards the war efforts (first WWII and then Korea). The demand surge in the middle of the decade was relatively short lived compared to these two periods of constrained supply. So you might argue that the ***inflation of the 1940s was largely supply driven***.

2. Things were very different in the 1970s. There were two very brief supply shocks in the oil market (fist the Arab Oil Embargo and then the Iran Revolution), but the larger driver of inflation was demographic. The largest generation in US history was born after WWII, between 1946-1964. These so-called Baby Boomers hit their most productive (and highest consumption) years during the mid-late 1970s. ***The predominant inflation driver of the 1970s was demand driven***.



Key takeaways

There are some important takeaways from this analysis.

- Demand-driven inflation and supply-driven inflation are very different things. Our post-covid reopening was an example of demand-driven inflation, as was the demand surge we saw after the end of WWII.
- We should not underestimate the impact of demographics. The emergence of the Baby Boomers was a key driver of the inflation of the 1970s, just as they have been a driver of deflation over the past decade as they have retired.
- While we believe today's inflation has elements of the 1970s, overall we believe it has more in common with the 1940s, at least so far. With the Boomers retiring, demographics have turned into a headwind. The largest inflationary forces have been supply-driven (Ukraine war, Chinese supply constraints). And with a recession looming, a prolonged period of elevated demand-driven inflation seems unlikely. We believe it is more likely that we see spikes and troughs, of ***both inflation and deflation,*** over the coming decade, much like we saw in the 1940s.

Cont'd

- There is one other key point of comparison. US debt was at record highs in the 1940s, as it is today (roughly 130% of GDP). In the 1970s, this ratio was in the 30-35% range. Overleverage is a supply constraint in and of itself, and a contributor to market volatility.
- Income strategies should continue to outperform growth strategies, as they have so far this year, and as they did in both the 1940s and 1970s.
- This is a great environment for options strategies, particularly covered calls, as persistent volatility will continue to result in above average options premiums.

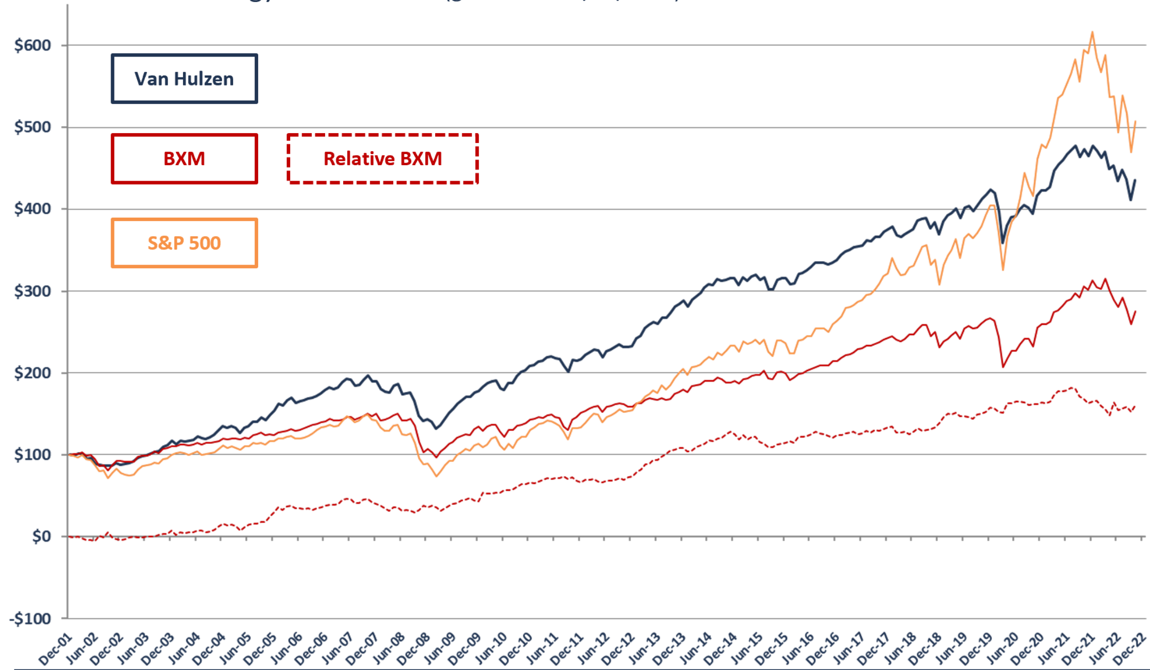
October Performance

Our strategy had a strong October, turning in a +5.9% return. We are 3.2% ahead of our benchmark (the CBOE buy-write index, ticker BXM) year to date, and 5.1% ahead of the high yield bond index, which we are being benchmarked against more and more as investors look for higher quality income solutions.

Van Hulzen Covered Call Strategy

The Van Hulzen Covered Call strategy invests in US companies that we consider to have high shareholder yield (dividends and share repurchases) and uses call options with the goal of reducing portfolio volatility and creating incremental income. The goal is a portfolio that has equity exposure while seeking higher than average annual income (target of 6-8% annual), although there is no guarantee that the strategy will achieve its objective, generate profits or avoid losses. Below you will find the graph of the Van Hulzen Covered Call Strategy and the Covered Call Index BXM.

Covered Call Strategy Performance (gross as of 10/31/2022)



Returns (annualized)*	Oct 2022	3M	6M	YTD	1 Year	3 Years	5 Years	7 Years	10 Years	Inception
Van Hulzen (Gross)	5.9%	-2.7%	-2.9%	-8.7%	-8.0%	1.9%	3.5%	4.8%	6.5%	7.3%
Van Hulzen (Net)	5.8%	-2.8%	-3.1%	-9.2%	-8.5%	1.4%	3.0%	4.2%	5.9%	6.4%
BXM	6.1%	-5.6%	-8.3%	-11.9%	-10.0%	1.8%	3.0%	4.6%	5.5%	5.0%
Difference (Gross-BXM)	-0.3%	2.9%	5.4%	3.2%	2.0%	0.1%	0.5%	0.2%	1.1%	2.3%

*Inception date : 12/31/2001. Figures greater than one year are annualized. Van Hulzen returns represent actual returns from composite of accounts

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