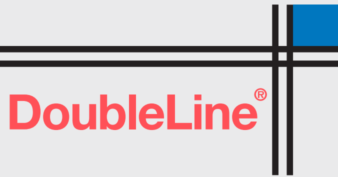


Portfolio Managers' Commentary

Emidio Checcone and **Brian Ear** | First Quarter 2022

Emidio Checcone, CFA
Portfolio Manager,
Equities

Mr. Checcone joined DoubleLine in 2014. He is the Portfolio Manager of the Equity Value strategy. Prior to DoubleLine, Mr. Checcone spent six years at Huber Capital Management, where he was a Principal and Portfolio Manager. Prior to that, he worked at PRIMECAP Management Co. for six years, where he was a Principal and Financial Analyst. Mr. Checcone holds a B.A. in Social Studies from Harvard College and a J.D.-MBA from Harvard Law School and the Harvard Graduate School of Business Administration. He is a CFA® charterholder.

Brian Ear, CFA
Portfolio Manager
Equities

Mr. Ear joined DoubleLine in 2016 as an Equity Analyst and is now a Portfolio Manager. Prior to DoubleLine, he spent two years at Compass North Advisors as a Consultant and six years at Palmyra Capital Advisors LLC, where he was a Principal and Portfolio Manager. Prior to that, Mr. Ear worked for five years at Hotchkis & Wiley Capital Management as an Equity Analyst. He holds a B.S. in Economics from the Wharton School of the University of Pennsylvania. Mr. Ear is a CFA® charterholder and a licensed CPA (inactive).

Economic medicine that was previously meted out by the cupful
has more recently been dispensed by the barrel.
These once unthinkable dosages will almost certainly
bring on unwelcome after-effects.
Their precise nature is anyone's guess,
though one likely consequence is an onslaught of inflation.

- Warren Buffett

I do not think it is an exaggeration to say history is largely a history of inflation,
usually inflations engineered by governments for the gain of governments.

- Friedrich August von Hayek

The first panacea for a mismanaged nation is inflation of the currency;
the second is war. Both bring a temporary prosperity; both bring a permanent ruin.
But both are the refuge of political and economic opportunists.

- Ernest Hemingway

The U.S. equity market started 2022 rather poorly, recording its first down quarter after seven consecutive quarters of positive performance. Overall, the S&P 500 Index was down 4.6% during the period while the Russell 1000 Value (RLV) Index fell 0.7% but greatly outperformed its growth counterpart, the Russell 1000 Growth Index, which was down 9.0%. Against this backdrop, the representative portfolio of the DoubleLine Equity Value strategy (the "Portfolio") returned negative 0.6% and outperformed its benchmark, the RLV, by 10 basis points (bps).

The relative outperformance of the RLV in the most recent quarter aligns with our past commentaries, which noted the higher growth prospects and lower valuation multiples of value names, and which cautioned of the risks of holding richer-multiple growth names in the face of rising rates. We see this dynamic continuing even now as we progress further through the economic and business cycles, and our preference remains for later-cycle names balanced against defensive stocks that can better weather rising risks we see on the horizon.

Indeed, economic data points became still more mixed during the quarter, with continued indications of economic strength and sustained post-pandemic recovery increasingly offset by worrying signs of rapidly rising inflation. The Consumer Price Index print of 7.9% for February (reported March 10) continued a problematic trend of rising prices seen since the start of the year. Import and export price hikes for February (reported in mid-March) were still higher, at 10.9% and 16.6%, respectively, perhaps indicating where the true rate of cost increases lies before hedonic adjustments. Meanwhile, the five-year breakeven inflation rate, which reflects forward expectations over a longer time horizon, moved up to 3.3% at the end of the quarter from 2.9% at the end of last year, suggesting that long-run inflation expectations have perhaps shifted permanently higher.

One key development during the quarter was the broadening of inflationary pressures. It appears that COVID-19-related supply chain challenges (e.g., chip shortages), which are obviously transitory in nature, are no longer the only driver of rising inflation. The aggressive increases in money supply from the fiscal stimulus amid the pandemic lockdowns are now (belatedly) finding their way into the real economy as money velocity recovers. Meanwhile, labor scarcity and accelerating nominal wage growth are threatening a potential wage-

price spiral. Moreover, surging real estate values are translating into higher rental costs that will only add to the need for higher labor compensation. Energy prices, which have been rising for about a year now, reflect still another tax on consumers, either directly via gas prices or indirectly through food and other energy-intensive products. Critically, the outbreak of war in Ukraine only exacerbates inflationary pressures given the interruptions to key supplies of commodities (e.g., energy, fertilizer, agricultural products, strategic metals and industrial gases) from both Russia and Ukraine. Finally, China has recently locked down its most important trading city, Shanghai, and more recently declared that lockdown indefinite, thereby exacerbating the supply of key inputs and finished goods. All of these inflationary pressures – supply chain, monetary, structural and geostrategic – are raising the risk that growth might burn itself out amid an economy running too hot.

All eyes are on the consumer, whose health remains strong in terms of conventional measures but whose future activity could be far weaker amid the advent of 40-year-high inflation. U.S. employment growth remains solid, with the March report showing job gains totaling 431,000 – the 11th consecutive month of employment gains exceeding 400,000. Meanwhile, wages continue to rise in nominal terms, as average hourly earnings on nonfarm payrolls increased 5.6% year-over-year (YoY). Finally, American consumers still appear to have healthy private balance sheets, as about $2.5 trillion in excess savings were accumulated since the start of the pandemic, largely due to stimulus support from the federal government. Of course, wage gains exceeding 5% are still not keeping up with inflation, so real wages actually are falling and, thus, supportive of less consumption than a year ago. Perhaps reflecting this, consumer spending slowed during the quarter, as February spending rose a scant 0.2% on a seasonally adjusted basis versus a revised 2.7% growth in January – prompting many economists to project a negative print for March. Meanwhile, measures of consumer confidence have continued to lose momentum since recovering from pandemic troughs, although these tend to be backward-looking. Specifically, the most recent readings in March were down month-over-month for both the Conference Board and University of Michigan consumer surveys, with the latter showing particular weakness. Finally, with President Joe Biden's signature Build Back Better bill apparently stalled by Senators Joe Manchin and Kirsten Sinema, another $1.7 trillion in stimulus is still delayed, and with it, any hopes for further governmental support for consumer spending.

Beyond inflation, the other key risk undoubtedly remains the actions from the Federal Reserve to contain it. Unsurprisingly, the Fed became much more vocal in its hawkishness during the quarter, and initiated a rate-hiking cycle by lifting off the zero bound. No longer viewing inflation as transitory, the Fed has signaled the possibility for one or more 50 bp rate hikes, while the bond market is projecting a greater than 50% probability of at least 10 quarter-point rate hikes by the end of this year. Time will tell if the Fed will be able to sustain such a rate liftoff given the recent high dependency of global economic growth on loose fiscal and monetary conditions, the high levels of public debt and continued deficit spending requiring low rates, and historically high asset valuations that appear vulnerable to corrections on such an aggressive rate-hiking cycle. In addition, and perhaps more importantly, the Fed is guiding to a faster-than-expected reduction in the size of its balance sheet, which would be the quantitative tightening (QT) effort to undo prior quantitative easing (QE) policies employed in record scale during the pandemic lockdowns. Such tightening implies additional constricting of financial conditions beyond the rate hikes. This profoundly more hawkish stance of the Fed will raise concerns about an adverse hit to the economy, putting it on the clock for an eventual recession if history is any guide. Importantly, Fed actions also raise key risks for the equity market in terms of slowing growth, further valuation-multiple pressure and less supportive liquidity. The last piece is an important consideration: Because the creation of enormous liquidity via QE was highly correlated with the tremendous stock market returns seen over the last two years, and really over the last 12 years, the reversal of such excess liquidity should be properly viewed with great wariness by all equity investors. *(Figure 1)*

Correlation Between the Value of the Stock Market and Fed Balance Sheet Has Been High

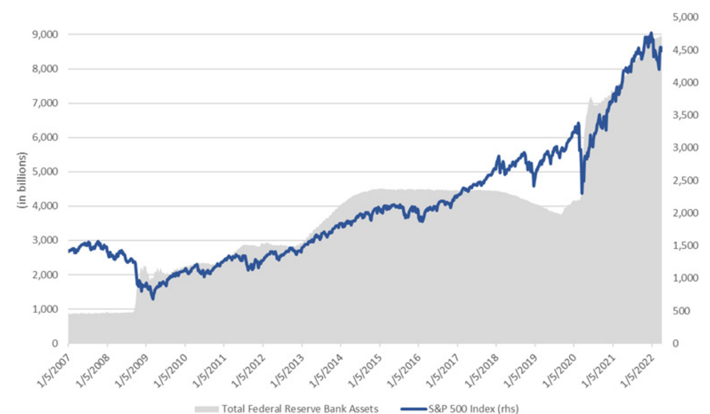
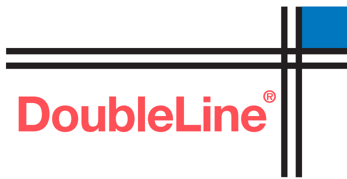


Figure 1
Source: Bloomberg



History shows that stocks typically rise after the initial liftoff in rates and a brief bout of elevated equity volatility, especially in the minority of cases in which a rate-hiking cycle does not cause a recession (i.e., three of the last 11 cases in the post-WWII period). In fact, equities have posted double-digit returns on average in the 12 months following the initial rate liftoff. Moreover, given that real U.S. Treasury yields are still negative, incentives to hold equities remain compelling. However, most of the historical record involves interest rate liftoffs that occur before inflation has reached such heady levels, and also those liftoffs usually were launched with stock valuation levels sitting lower than where they currently are. And while negative real yields might incentivize investors into risky assets, they are likely to eschew those same assets if stock prices begin to fall to avoid the insult of capital losses on top of the injury of inflationary erosion. Critically, the risks of a Fed policy error leading to a market correction and/or a recession have likely increased, given that the Fed appears behind the curve, stock valuations are at elevated levels, and the dependence of the economy on deficit spending and debt for growth remains high. As noted in previous letters, we see the high valuations of many stocks as particularly vulnerable to downward re-rating amid interest rate normalization and QT, and our view has not changed as those rate hikes are now upon us. What is new, however, is the growing concern over growth of the economy, and of corporate profits and cash flow, and this would seem to imply a greater need for high quality and resilience in one's equity portfolio.

Critically, the risks of a Fed policy error leading to a market correction and/or a recession have likely increased, given that the Fed appears behind the curve, stock valuations are at elevated levels, and the dependence of the economy on deficit spending and debt for growth remains high.

Looking at the prospects for corporate earnings just ahead of the release of quarterly reports, the picture at first glance appears healthy in terms of growth and reasonableness of analyst expectations. Wall Street consensus projections for S&P 500 company profit margins, at 12.1%, reflect the third sequential decline from the 13.1% peak in the second quarter of 2021. However, such profitability would remain above the 11.2% five-year average level, implying quite healthy margins despite many sources of input cost inflation. Similarly, the assumed earnings growth of 4.5% over the prior year, incorporating as it does tougher YoY comparisons and one-off impacts in certain sectors (i.e., mostly the financials sector), reflects a normalization of growth rates and a reasonable level versus the five-year median level. The assumption held by Wall Street analysts appears to be that U.S. companies retain pricing power, and the current level of inflation has been well managed in the quarter just completed. The critical determination, of course, lies in the forward guidance, particularly since the sales and earnings estimates for the second half of 2022 have actually increased over the course of 1Q22 even as inflationary pressures and threats to growth have appeared to rise. This would imply that investors have not incorporated into their expectations as of yet, but actually have so far further discounted, the growth and profitability risks for companies in a high-inflation environment. Given what we see as a disconnect between those consensus expectations and inflationary risks, we believe that the upcoming earnings season – especially the forward-looking commentary of management teams – will be particularly important for determining the true rate of revenue growth, margin development and earnings, and cash flow relative to those still sanguine Wall Street expectations.

Notwithstanding the cloudier backdrop confronting investors at the end of the quarter, we believe investment managers (and their clients) are best positioned to create lasting value by seizing upon opportunities created by that short-term volatility while keeping their focus primarily on the long-term fundamentals of each portfolio name. As the investing environment becomes choppier, we continue to believe that active investment management will increasingly shine, particularly if the rising uncertainties lead to greater dispersion in valuations and price performances of individual stocks within broader sectors, styles or factors.

In terms of positioning, we continue to favor value over growth. Historically, value stocks have tended to outperform in periods of economic expansion and manageable levels of inflation, and the superior earnings prospects of value names remain in the current cycle as well. Moreover, the large valuation discount of value versus growth has created a particularly long runway of opportunity for relative value outperformance during the current cycle, especially since lower-multiple shares should face

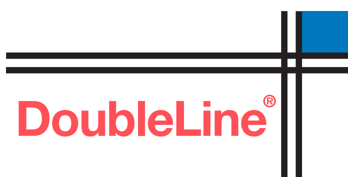
less pressures from the ongoing downward re-rating of equity multiples. Additionally, U.S. value stocks on average pay a higher dividend yield than the broader market, with many names showing good dividend growth as well. Hence, we still believe this combination of favorable relative valuation, along with superior earnings prospects, continues to support the ongoing growth-to-value rotation.

That said, we also view the current cycle as one now in its later innings. Hence, we increasingly prefer high-quality, late-cycle value stocks (i.e., cyclical stocks such as energy, materials and industrials names), which are better poised to benefit even amid the moderating economic growth and rising input costs. Many of these names can pass along input cost inflation and actually benefit from higher levels of inflation to obtain such pricing. Moreover, the continued recovery from the pandemic, particularly in non-U.S. markets, provides additional support to such names. Even if the U.S. economy is now on the clock for an eventual recession, late-cycle shares often continue to rise for several months leading up to such a downturn, so we remain constructive on these areas within the portfolio.

Recognizing that many value stocks are more sensitive to economic and business cycles, we also now prefer defensive names within the portfolio, including consumer staples, healthcare and certain communication services and information technology shares. The rising risks to growth highlighted earlier suggest that it is increasingly important to maintain healthy weights to those companies with superior pricing power, more-stable sales profiles (even in recession), higher margins and more-resilient earnings and cash flow. These sector exposures constitute a complementary ballast in the portfolio, thereby providing balance and support should economic growth decelerate faster than expected.

As always, we continue to follow our differentiated fundamental value investment strategy, seeking attractive long-term investment ideas and maintaining a prudently positioned portfolio, which strikes reasonable balances between those investment ideas offering safety in increasingly uncertain times and those holdings representing compelling long-term value.

We thank you for your continued interest in DoubleLine Equity. ■



DoubleLine Equity Value Composite | Additional Information as of March 31, 2022

						Annualized	
		3-Month	6-Month	Year-to-Date	1-Year	3-Year	Since Inception (10-12-18 – 3-31-22)
DoubleLine Equity Value Composite	Gross	-0.47	6.19	-0.47	10.70	16.63	14.97
	Net	-0.56	6.01	-0.56	10.31	16.22	14.57
Russell 1000 Value Index		-0.74	6.98	-0.74	11.67	13.02	12.35
Gross Excess Return		27 bps	-79 bps	27 bps	-97 bps	361 bps	262 bps

Source: DoubleLine. Performance presented is supplemental to the DoubleLine Equity Value Composite Report below this table.

Past performance does not guarantee future results.

DoubleLine Equity Value GIPS Composite Report | October 12, 2018 to December 31, 2020

Year	Composite Gross Return (%)	Composite Net Return (%)	Russell 1000 Value Index Return (%)	Composite 3-Yr St Dev (%)	Russell 1000 Value Index 3-Yr St Dev (%)	Number of Portfolios	Internal Dispersion (%)	Composite Assets ($M)	Firm Assets ($M)
2018	-7.86	-7.93	-7.29	N/A	N/A	1	N/A	67	119,510
2019	29.47	29.03	26.54	N/A	N/A	1	N/A	60	147,985
2020	9.98	9.59	2.80	N/A	N/A	1	N/A	46	135,069

1. DoubleLine claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS standards. DoubleLine has been independently verified for the periods January 1, 2010 through December 31, 2020. A firm that claims compliance with the GIPS standards must establish policies and procedures for complying with all the applicable requirements of the GIPS standards. Verification provides assurance on whether the firm's policies and procedures related to composite and pooled fund maintenance, as well as the calculation, presentation, and distribution of performance, have been designed in compliance with the GIPS standards and have been implemented on a firm-wide basis. The Equity Value Composite has been examined for the periods October 12, 2018 through December 31, 2020. The verification and performance examination reports are available upon request.
2. For the purpose of complying with the GIPS standards, DoubleLine ("the Firm") consists of the assets under management of DoubleLine Capital LP ("DoubleLine Capital"), DoubleLine Equity LP ("DoubleLine Equity") and DoubleLine Alternatives LP ("DoubleLine Alternatives", formerly known as DoubleLine Commodity LP). Defining the Firm for GIPS purposes as "DoubleLine" is not intended to imply any legal affiliation among DoubleLine Capital, DoubleLine Equity and DoubleLine Alternatives. Effective January 1, 2017, the assets of DoubleLine Alternatives LP and DoubleLine Capital LP were added to the Firm definition.
3. As of January 1, 2017, the Firm was redefined to reflect an expansion of products within organization.
4. Results are for accounts that are in the Composite for the specified periods. The Composite includes all accounts, except for accounts subject to material client restrictions and deemed non-discretionary. When a new composite is formed, the first account is included as of the account's inception date.
5. A list of Composite descriptions, pooled fund descriptions for limited distribution pooled funds and a list of broad distribution pooled funds is available upon request.
6. The internal dispersion of annual returns is measured by the standard deviation across equally-weighted portfolio returns represented within the composite for the full year and is calculated using gross returns. For those periods where less than six (6) accounts are in the composite for the full year, or where the period is less than a full year, standard deviation is not presented.
7. Performance is reported in U.S. dollars and reflects the reinvestment of dividends and other earnings.
8. Gross returns do not reflect the deduction of management fees, custodial fees and other administrative expenses. Including these costs would reduce the returns shown. Net returns reflect the deduction of model management fees. The model management fee is the higher of the maximum standard fee charged to U.S. institutional clients without considering any applicable breakpoints, or the highest fee paid by any account in the composite. Certain clients could pay a significantly higher or lower fee which would result in different net returns. By way of example a fee which is 0.5% higher than the standard U.S. institutional fee will result in the total return being reduced, over five years, by 2.53% on a compound basis. Net returns do not include the deduction of custodial fees or other administrative expenses, which will also reduce the returns shown.
9. DoubleLine makes no representation that future investment performance will conform to past performance. Past performance is no guarantee of future results. It is possible to lose money when investing in this strategy.
10. Policies for valuing investments, calculating performance, and preparing GIPS Reports are available upon request.
11. This Composite was created on October 12, 2018.
12. The Composite includes accounts that are managed to outperform the Russell 1000 Value Index over the long term by primarily investing in companies of any market capitalization that are considered to be undervalued. The strategy primarily invests in U.S. listed stocks. Portfolios in the Composite may also invest in foreign equities, including via American Depository Receipts (ADRs), private placements, preferred securities and convertible preferred securities.
13. The Russell 1000 Value Index measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values. Benchmark returns are not covered by the report of independent verifiers. You cannot invest directly in an index.
14. The U.S. institutional fee schedule is as follows: 0.35% on all assets under management in this strategy.
15. Leverage or derivatives are not used in the management of the accounts within this Composite.
16. Three year annualized ex-post standard deviation of the Composite measures the variability of the composite and the benchmark returns over the preceding 36-month period and is calculated using gross returns. The three-year annualized ex-post standard deviation of the Composite and the benchmark are not presented when 36 monthly returns have not yet been generated by this Composite.
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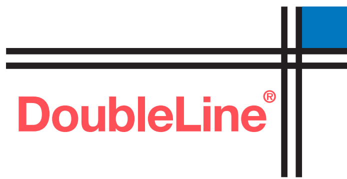

Select Definitions

Beta – Measure of the volatility – or systematic risk – of a security or portfolio compared to the market as a whole.

Consumer Price Index (CPI) – This index, compiled by the U.S. Bureau of Labor Statistics, examines the weighted average of the prices of a basket of consumer goods and services, such as transportation, food and medical care. It is calculated by averaging price changes for each item in the basket. Changes in the CPI are used to assess price changes associated with the cost of living. The CPI is one of the most frequently used statistics for identifying periods of inflation or deflation.

Core Personal Consumption Expenditures (PCE) Price Index – This index, published by the U.S. Bureau of Economic Analysis, measures prices paid by consumers for goods and services, excluding the volatility of food and energy prices, to gauge underlying inflation trends. It is the Federal Reserve's preferred index for tracking inflation.

Federal Funds Rate – Target interest rate, set by the Federal Reserve at its Federal Open Market Committee (FOMC) meetings, at which commercial banks borrow and lend their excess reserves to each other overnight. The Fed sets a target federal funds rate eight times a year, based on prevailing economic conditions.

Price-to-Earnings (P/E) Ratio – This ratio for valuing a company measures current share price relative to earnings per share (EPS). The P/E ratio is also sometimes known as the "price multiple" or the "earnings multiple." A high P/E ratio could mean that a company's stock is overvalued, or investors are expecting high growth rates in the future.

Russell 1000 Growth (RLG) Index – This index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes Russell 1000 Index companies with higher price-to-book ratios and higher forecasted growth values. Growth stocks are shares in a company that are anticipated to grow at a rate significantly above the average growth for the market.

Russell 1000 Value (RLV) Index – This index measures the performance of the large-cap value segment of the U.S. equity universe. It includes Russell 1000 Index companies with lower price-to-book ratios and lower expected growth values. Value stocks are shares of a company that appear to trade at a lower price relative to the company's fundamentals.

S&P 500 Index – This unmanaged capitalization-weighted index of the stocks of the 500 largest publicly traded U.S. companies is designed to measure performance of the broad domestic economy through changes in the aggregate market value of the 500 stocks, which represent all major industries.

One cannot invest directly in an index.

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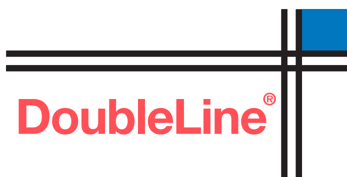

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