Zeo Capital Advisors

investor.relations@zeo.com | 415.875.5604 | www.zeo.com

ZEO QUARTERLY LETTER: 4Q2021

Wall Street had a moment in 2021. The S&P 500 hit 70 new highs last year – *more than 1 in 4 trading days*. To put this in perspective, the last time this happened was in 1995, and before that, it was… never. Even with the recent pullback in January, FOMO still weighs heavily in the minds of investors. Every sell off seems to be accompanied not so much by fear of losses but by hope that the market's pressure relief valve has been opened just enough to keep the good times rolling for a bit longer.

Fundamentally, rampant inflation and supply chain disruptions have not seemed to hurt the enthusiasm of consumers, who are delivering many companies their best earnings season in some time. The economy seems ready for this to continue; the market has only recently acknowledged the impact of a rise in interest rates on the cost of capital for investors and companies liberally using leverage to profit from this environment. Meanwhile, the risk of increased regulation seems to be declining with every Democratic legislative defeat.

The one blemish on this apparent Goldilocks scenario for corporate America is the labor market. Employers are having trouble filling jobs. Employees are quitting at historically high rates. The cost of labor has increased in a way that may look similar to past economic data but could be different this time around. In our opinion, today's omnipresent chatter about inflation and interest rates should be viewed through the lens of the current labor market and by contemplating different scenarios of its impact on corporate earnings, consumer sentiment and the overall economy.

Labor Costs: Wall Street Cried Wolf, Now Investors May Get Eaten

Shortly after the initial economic shock of the pandemic, many economic analysts on Wall Street began to pay closer attention to wage inflation to get some insight into the nature of the subsequent recovery. One of the most common measures used for this purpose are the year-over-year change in average hourly earnings as published by the US Bureau of Economic Statistics. However, this particular statistic is flawed, and it has led many analysts astray for more than a year now.

As we can see in Figure 1, the highest wage growth periods according to this measure take place during times of economic stress. Why? Because when workers are being laid off en masse, the layoffs tend to disproportionately affect lower-wage hourly employees across the economy. The more expensive manager-level employees may also lose their jobs, but not to the same proportional extent. We only need to look at our corner retail stores during the pandemic to see example after example of this. As a result, the average hourly earnings of the remaining workforce, when compared to the year prior, would appear to have increased substantially.

To be clear, a trained economic analyst would not entirely miss this realization. It would be hard to mistake the spike in average hourly earnings at the start of the pandemic as a sign of a robust hiring environment. However, memories are short, and there were more than a few who argued the increased year-over-year comparisons at the tail end of 2020 and again in recent months were signs of true wage inflation. They are only half right, and the truth is somewhat more nuanced. Unfortunately, as we have discovered time and time again throughout our careers, Wall Street does not do nuance well.

Aside from its counterintuitive direction, the volatility of this metric is another red flag that it is not what it seems. A more interesting statistic also published by the US Bureau of Labor Statistics is the employment cost index, though it is followed less closely due to its quarterly rather than monthly release frequency. We have included its year-over-year changes in Figure 1 as well. In this less volatile measure of employment costs (which also aims to capture benefits, taxes and other employment-related costs), we can find insights not as clearly found in average hourly earnings

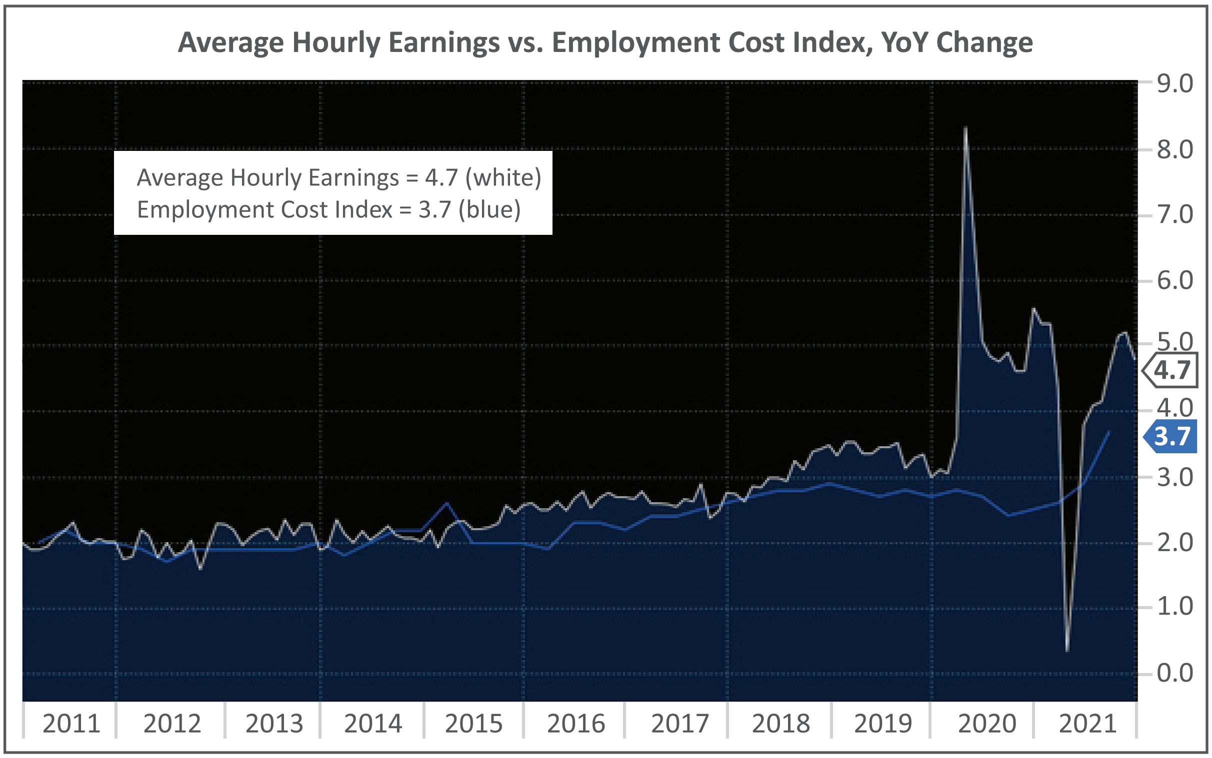

Figure 1: Year-over-year change in average hourly earnings (white) and employment cost index (blue) since 2011. (Source: Bloomberg Finance LP, US Bureau of Labor Statistics)

Note that, when normalized, we can see these two measures deviate during times of economic stress, further reinforcing that average hourly earnings may not be what they seem. In 2016, 2018 and 2020, we see the employment cost index decline (as we would expect in periods when the economy was shaken, which should shift the employment power dynamic toward employers) while average hourly earnings remained steady or even increased. In late 2020, Wall Street economists were insistent that wage inflation was a sign of a rapidly recovered economy. However, one can clearly see the correlation between the increases in average hourly earnings and the public policy changes (and resulting low-wage job instability) in response to the ebbs and flows of the COVID-19 pandemic; the same goes for the first half of 2021. The employment cost index, meanwhile, remained stubbornly unimpressed. Had the Fed reacted with the same vigor as those economists to reign in its loose monetary policy at that time, they would have likely shocked the economy further; exacerbated what turned out to be an already problematic inflation situation; and hurt the pocketbooks and employment status of many Americans just getting back on their feet.

However, those economists may very well turn out to be right for the wrong reasons this time around. Without realizing that the measure they track most closely is flawed, they are once again citing wage inflation as worthy of the Fed's attention. The sudden upturn in the employment cost index makes the case that recent average hourly earnings numbers are telling a different story than they have over the last two years. Specifically, the increase seems to finally be a sign of rising labor costs.

The problem is this: Because analysts have unknowingly cried wolf for so long, we believe many have become complacent about the impacts of an uptick in their favorite wage inflation metric. For sure, there has been a lot of focus on record-setting levels of inflation. Many understand the role that supply chain disruptions have played in causing that inflation. But there is also a general assumption that higher wages have played a much bigger role than they actually have. As a result, the thinking goes, companies have figured out how to manage around the increased labor costs, and though this is a useful metric in thinking about future inflation (i.e. higher wages = more spending = more inflation = Fed, lookout!), the analysis and modeling stops there, short of what we believe to be the true insight.

To understand this further, we should remember how the typical Wall Street equity analyst evaluates companies. Ultimately, all the management calls, competitive analysis, channel checks and a variety of other tasks are performed in service of building a model to determine the value of the company being analyzed. If you look closer at a typical model, you will often find detailed projections of drivers, i.e. key input metrics that drive the output of the model.

So, for example, a deeper dive into an airline will not simply project revenue by growing past revenues by some projected growth rate. Rather, there will be more granular drivers to project with more confidence, such as revenue per seat and load factor on flights. Such measures, which are easier to project, enable the analyst to get a high degree of confidence in her forward-looking revenue expectations. The same process goes for cost of goods and services, some of which have market-observable projections (such as fuel in the airline example). However, when projecting other line items in a financial model, analysts tend to fall back on a less detailed approach. Advertising costs, for example, may be projected as a percentage of revenue or as a cost grown at a constant pace. Deviating from such assumptions is rare and usually only happens when a company guides the analyst community to do so.

When it comes to labor costs, we fear that most analysts are not recognizing the potentially huge impact of what seems to be the first real uptick in wages after several head fakes. Between their assumptions that wage inflation is not new news and the need to factor in an unexpected growth rate into their models without company guidance to do so, we expect this line item in most models is too low.

Meanwhile, the impact on a company's ability to capitalize on the current environment of consumer spending is meaningful if the workforce isn't there to do so. After all, no matter how strong the economy might be, if there are fewer employees to make, transport and sell a company's goods and services, a company's ability to capitalize on the strong economy will be impaired. For example, Steven Oakland, the CEO of Treehouse Foods[1], specifically cited the need to "pivot our labor strategy" during their most recent earnings call alongside a disappointing decline in their gross margins due to unexpected cost increases, including labor. This is an urgent issue for Treehouse and many other manufacturing companies, and the current labor markets "require a more progressive strategy to staff our plants effectively." Meanwhile, American Greetings, maker of Hallmark greeting cards, is a great example of a company who understands that their workforce is not just a cost but a key ingredient in the short- and long-term success of the business. In the process of finding ways to overcome a revenue decline in their 2021 fiscal year to deliver a +13% EBITDA increase, they showed an unwillingness to use headcount as a lever to reduce costs. Since then, their most recent quarter saw revenue increases with steady EBITDA margins, showing no reversal of the prior year's bottom line gains. While many factors beyond their approach to their workforce led to this subsequent success, they have shown that committing to their employees and strong performance are not opposing forces and may very well be correlated.

Between labor cost assumptions and the actual impact on some companies, we expect Wall Street is being too optimistic in its margin and earnings assumptions for many (but not all) companies, and since equity values are often set as a multiple of earnings, in its valuations overall as well. At Zeo, labor costs are at the front of our minds when we are evaluating companies. Because we focus in on a smaller universe of issuers, it is easier for us to consider such line items on a company-by-company basis. Meanwhile, it is important to recognize that our view that ESG factors are credit factors also goes a long way to heading off such issues. By including labor relations in our creditworthiness evaluation, we end up selecting companies who are likely to be less susceptible to these issues as they play out over the coming years. After all, in our experience, happy employees tend to mean productive companies.

This is not to say that we are predicting that the current market declines will continue or lead to a more meaningful correction. We have seen too many downside risks dissipate due to unforeseen circumstances. But we do believe recent data points to a potential paradigm shift, with a new labor market dynamic that is not yet properly understood by the markets, in part because it might look more like the past than it actually is. Whenever we see this sort of potential misunderstanding, we tend to proceed cautiously, and we would suggest readers do the same.

You Can't Outrun A Bear (Market), But You Can Be Prepared To Lie Flat

"The Great Resignation." "The Big Quit." "Antiwork." "Tang Ping." Whatever one wants to call it, there is no doubt that we are witnessing a labor market phenomenon today. Starting in early 2021, large numbers of workers have been quitting their jobs at a historic pace. From April to September, more than 24 million Americans voluntarily left the workforce. And this is not just happening here in the United States. Around the same time, China also experienced a well-publicized backlash to a culture of long hours and hard work. We expect it is only a matter of time before we see similar reports from across the globe, complete with a plethora of new terms for this labor market.

1 It is worth noting here that, for this and other reasons, Treehouse Foods is not currently a company that meets our standards for creditworthiness. We will be keeping an eye on the management team's new priorities to determine how deliberately and intentionally they address labor relations going forward.

However, whatever one thinks of the branding, the circumstances it aims to describe are incontrovertible: the labor supply is strained. Generally, labor markets have a cyclicality to them, which roughly correlates with the economy and who holds more sway in the power dynamic between employers and employees at a given point in time. For example, when the economy is strong and employers need to hire to keep up, workers tend to get multiple job offers, leading to a bidding war for their services. Meanwhile, when the economy is struggling, employers tend to lay off employees, resulting in a disadvantageous ratio of multiple job seekers for a given available job.

It does seem to appear that the labor power dynamic has recently shifted in favor of the workers. The rate at which Americans have been quitting their jobs over the last 20 years can be seen in Figure 2. The spike in the last year is unmistakable. Even when compared to the exuberant job markets just before the 2008 financial crisis and the COVID-19 pandemic, workers are voluntarily leaving their jobs at much higher rates. The most obvious takeaways from this observation will not come as a surprise to our readers. After all, much has already been written about the prevailing theory on what is causing people to quit their jobs in such large numbers.

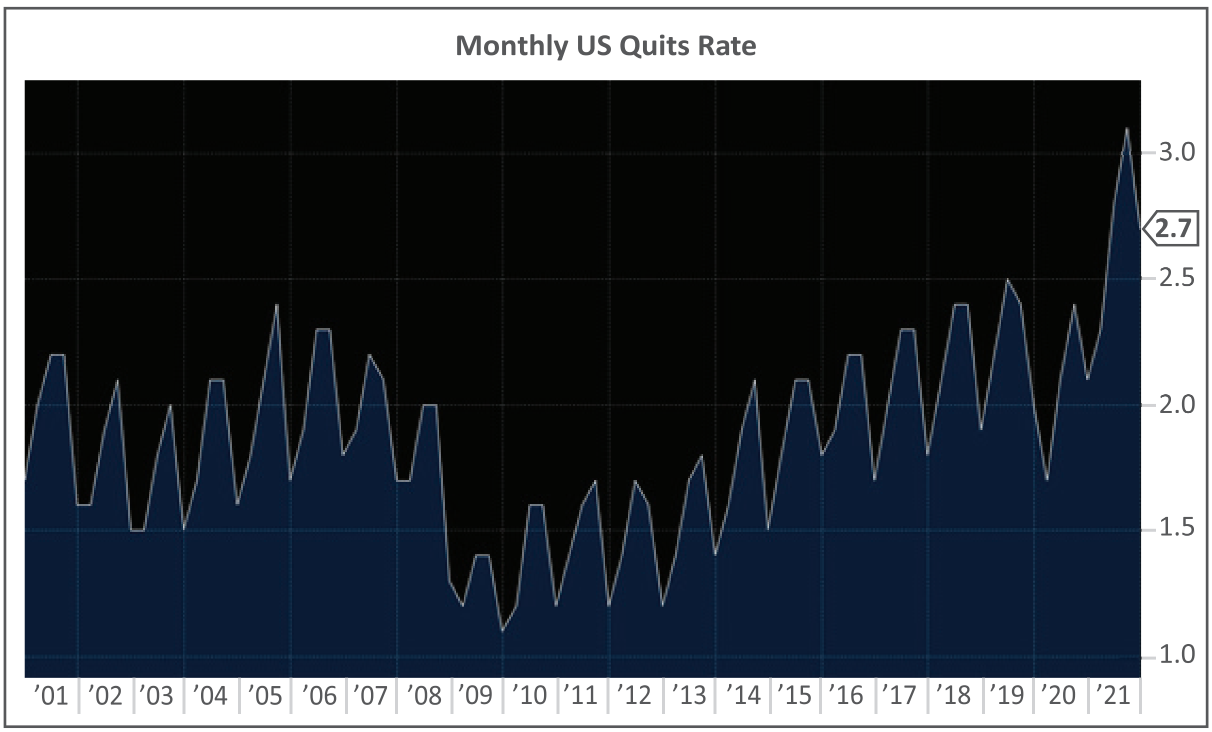

Figure 2: 20-year history of the monthly US Quits Rate, which tracks voluntary job separations initiated by employees in the United States per month as a percentage of total employment. (Source: Bloomberg Finance LP, US Bureau of Labor Statistics)

First, it should be noted that approximately 40% of the resignations in the workforce are in hospitality, leisure, healthcare and industrial/manufacturing jobs, where workers have long complained about pay, benefits, hours and general working conditions dating back to before the pandemic even began. It would seem that people who once felt they had to put up with these conditions are finally saying they have had enough. In part, a reorienting of priorities took place as the global community faced a threat which cut across social, political and financial boundaries

– "family first" and "gratitude for what we have" became steadier mantras for many.

But it probably didn't help that the period immediately following the initial shutdown in 2020 resulted in a widening gap between haves and have-nots. Some people benefited from the opportunity to work from home; had savings which increased substantially in the Fed-fueled financial markets; and could afford to supplement their children's education during school closures. Many others, on the other hand, put themselves at risk daily to earn meager paychecks or had to choose between being able to pay rent and having to care for and/or become de facto substitute teachers to their children. That this divide continued to grow in "bad times," building on a decade-old debate about excessive executive compensation that started during "good times," laid bare the systemic disadvantage some members of our society face.

As with every major labor relations issue in recorded history, there comes a breaking point, and this just might be that for the current times. For a long time, corporate executives have been focused on short-term profitability, leading them to take their workforce for granted. But assuming employees are satisfied simply because they are showing up to work is inviting the workforce to call their bluff and not show up. And that seems to be what workers are doing today. In response, corporate managers are slowly coming to grips with the need to improve pay, benefits and working conditions to attract the people they need to operate their businesses, as Treehouse Foods openly recognized in the earnings call we quoted earlier in this letter. Once again, this is an extension of the pre-pandemic pressure they faced to rationalize the astronomical compensation increases paid to top executives, while rank-and-file employees saw few gains at all. We discussed the potential impact to corporate earnings of this trend in the previous section of this letter, but here, we will highlight a view of the same data from a different angle.

One alternative explanation of the recent quits rate is tied to the topic du jour: inflation. The economy closed 2021 with historic levels of inflation. While it is true that supply chain issues increased the cost of goods across most industries, we should not lose sight of two observations. First, part of the supply chain disruption came because of a shortage of workers to transport goods. That is, this very phenomenon contributed to a key driver of recent inflation measures. However, the supply side of the economic equation is not all to blame. There is a general consensus among many analysts that inflation has also been fueled by increased consumer spending. Some, including we at Zeo, argue that there is pent-up discretionary spending demand due to the pandemic-induced shutdowns in 2020, either because decisions were delayed or because consumers have discovered money burning a hole in their pockets. (Incidentally, this is also part of the explanation for the early-2021 Reddit- and Robinhood-fueled boom in retail market behavior.) As we noted before, labor cost increases in recent months have been real and significant as well, throwing more fuel on this inflation fire, though not as early in the inflation story as many analysts argued.

Unfortunately, the inflation numbers themselves obscure the metrics most commonly used to evaluate consumer spending, the personal consumption spending index, which aims to capture the value of goods and services purchased by consumers. With inflation rampant, the value of those goods and services increases proportionally with or without demand changes. As a result, it is difficult to glean insight into the potential increase in actual spending decisions being made. Or is it?

While it is true that consumers may spend more, it is also true that there is more flexibility when it comes to discretionary spending. If consumers were being "forced" to spend too much overall, we would likely see them pull back in some optional areas. Empirically, this doesn't seem to be happening, and one data point worth watching to get a sense of this is the Federal Reserve's consumer credit measure. Figure 3 shows the year-over-year change in consumer credit across the economy over the last 40 years. The Fed is seeing a clear increase in consumer credit to record growth numbers right now. While some of this could be from consumers who are taking on debt to cover their day-to-day living expenses, corporate earnings among companies who benefit from discretionary spending are telling a different story. Put simply, we believe what we are seeing is, at least in part, an intentional spending spree by the US consumer.

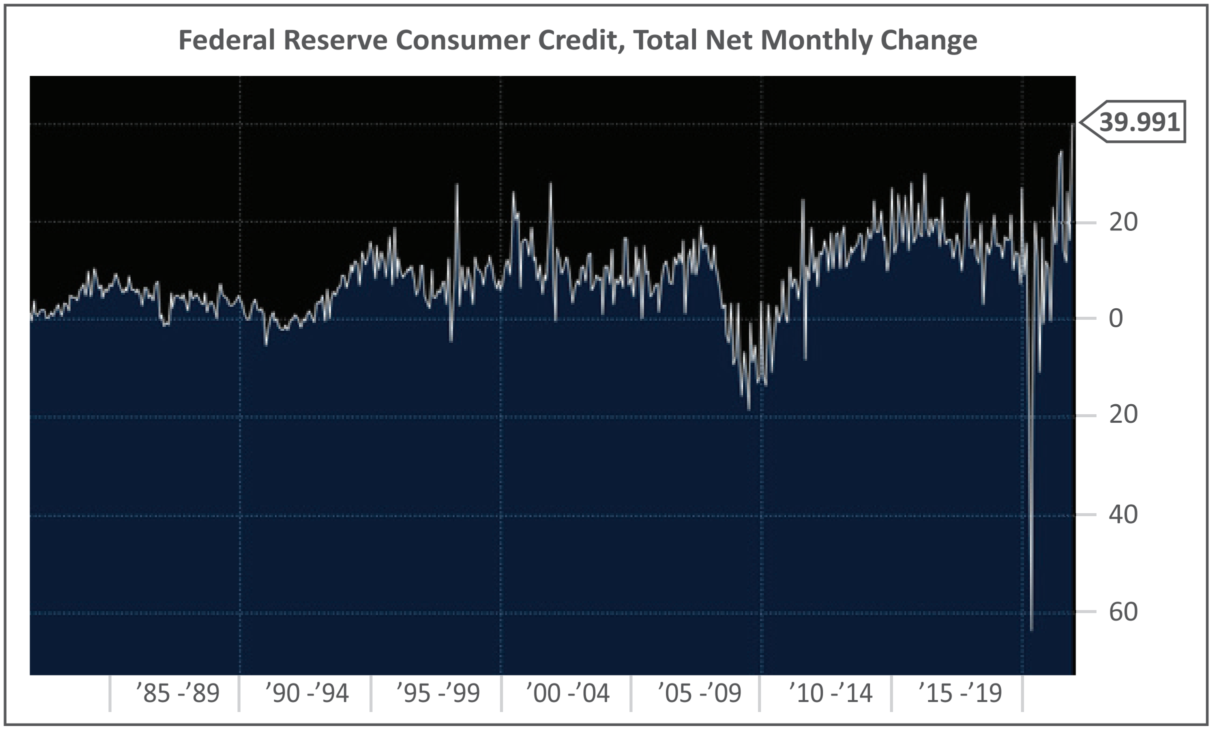

Figure 3: 40-year history of total seasonally-adjusted net monthly change in the Federal Reserve Consumer Credit (also called Household Credit. This measure tracks the outstanding amount of credit (or loans) used by consumers to finance purchases of goods or services. It can include everything from credit card lending to auto loans, to lines of credit, but it excludes mortgage loans. (Source: Bloomberg Finance LP, Federal Reserve)

This is where the labor market quits rate has the potential to foretell two different scenarios:

One is the tale of a consumer who misinterpreted a temporarily strong bank account as a windfall, providing the confidence needed to tell her boss to "take this job and shove it." In this story, our protagonist (the consumer, not the employer) realizes later that she has burned through her short-term funding from the reduced spending in the pandemic and with a little assistance from the US government. The power she held to make demands of her employer may give way to a more conciliatory tone as she finds herself in more urgent need of a job. If this were to be how this economy plays out, employers may once again regain the power to keep costs in check, but consumer spending and credit would almost certainly take a dive. The risk of a stagflationary environment, in which inflation remains an issue for structural reasons but the economy begins to stagnate, becomes real. Stories of Japan from the 1980s may once again start circulating around Wall Street, as they have every few years for the last two decades.

The second scenario is that the data we are discussing is a sign of a systemic change in the labor market, one that does not just predate the pandemic but predates most current Wall Street careers. Figure 4 shows the US labor force participation rate since 1947. It is hard not to notice that an increase in labor force participation coincided with the coming of age among the baby boomer generation. It is also interesting to note that, among the people quitting their job in frustration are people choosing to use the pandemic as a catalyst for retirement. As it turns out, the current labor force participation is only now returning to levels the economy last saw in the 1970s – around the time the boomers entered the workforce.

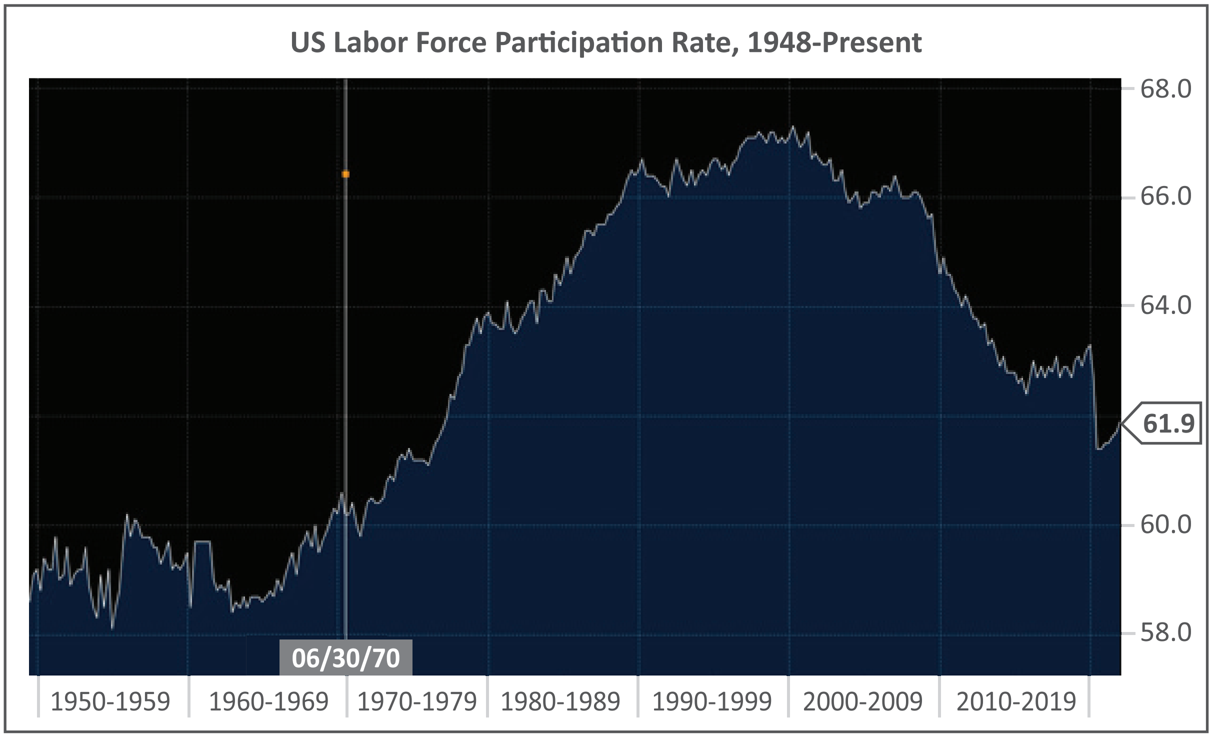

Figure 4: The US Labor Force Participation Rate tracks the total labor force as a percentage of the working age position in the United States. (Source: Bloomberg Finance LP, US Bureau of Labor Statistics)

Put another way, it is entirely possible that employers would be mistaken to wait for their former employees to get desperate and come back hat in hand asking for their old jobs back. We may be witnessing a structural reset of the labor market to participation rates which represent a more sustainable level given the aging baby boomer population. If this is indeed the case, employers will need to chase every possible worker, invest heavily in productivity and innovation and do whatever else will be needed to maintain their ability to operate their businesses and deliver on the ever-increasing and potentially unrealistic expectations of their stakeholders. It may be too late to just pay more. If this is the case, this impact won't be a one-time blip as in years past but a potential long-term paradigm change to which Wall Street and Main Street will need to adjust.

That said, we don't believe it is wise or necessary to try to predict which of these two scenarios will come to pass, and it's possible that neither will. There are countless potential outcomes which can be imagined from the data. But this is the key to a resilient fundamental portfolio. By planning for many plausible scenarios and assembling issuers who have risk profiles which can withstand or thrive in them, one is not just preparing for the known potential outcomes. Broad and continual scenario analysis also leads to portfolio characteristics which tend to be generally resilient. In this way, one can build confidence in the portfolio's ability to perform as expected even in scenarios that have not been contemplated. This stands in contrast to the more common strategy of aiming to identify the right scenario and positioning to profit if it happens. This approach is high risk/high reward, but it does save the manager a lot of work and analysis. And it may work for a time, especially in FOMO-driven markets like today, with pundits competing to see who can come up with the cleverest term to describe what they are predicting. Until it doesn't.

If only the markets put as much time and energy into understanding and preparing for the consequences of these labor market circumstances as they put into branding them. Personally, we are partial to "Lying Flat." After all, that *is* how one can avoid getting mauled by a bear… or a bear market for that matter.

Our investment approach is designed to identify resilient companies, with strong fundamentals regardless of what happens in the markets and the economy. We are not trying to be on the right side of directional moves, outlooks or predictions of what will happen in the future. To do so runs counter to the risk management philosophy that underpins our investment process. We believe the factors that impact creditworthiness should persist across scenarios, both known and unknown. It has been our experience that a focus on resiliency characteristics – cash flows, liquidity, responsible corporate behavior and disciplined financial strategy – can differentiate the companies who will thrive in the coming uncertainty around interest rates, inflation, labor costs and politics which make the next few years among the least predictable in the last several decades for the markets.

As always, we are available for your questions, comments or feedback. We thank you for your continued support and confidence in our management.

Sincerely,

Venkatesh Reddy
Chief Investment Officer

investor.relations@zeo.com | 415.875.5604 | www.zeo.com

Important Disclosure Information

Please remember that past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product (including the investments and/or investment strategies recommended or undertaken by Zeo Capital Advisors, LLC ["Zeo"]), or any non-investment related content, made reference to directly or indirectly in this newsletter will be profitable, equal any corresponding indicated historical performance level(s), be suitable for your portfolio or individual situation, or prove successful. Due to various factors, including changing market conditions and/or applicable laws, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Zeo. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. Zeo is neither a law firm, nor a certified public accounting firm, and no portion of the newsletter content should be construed as legal or accounting advice. A copy of Zeo's current written disclosure Brochure discussing our advisory services and fees is available upon request or at www.zeo.com/disclosures. If you are a Zeo client, please remember to contact Zeo, in writing, if there are any changes in your personal/financial situation or investment objectives for the purpose of reviewing/evaluating/revising our previous recommendations and/or services, or if you would like to impose, add, or to modify any reasonable restrictions to our investment advisory services. Zeo shall continue to rely on the accuracy of information that you have provided. Please Note: If you are a Zeo client, please advise us if you have not been receiving account statements (at least quarterly) from the account custodian.