TOWLE & CO.
DEEP VALUE INVESTING
(303) 731-2494

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Rerate! The cost of capital may be climbing as the Fed must fight inflation for the first time in decades. Global central banks have rung the bell. The U.S. Federal Reserve is set to increase the Fed Funds Rate three or four times in 2022, the Bank of England just raised its benchmark rate from 0.10% to 0.25%, and members of the European Central Bank signal similar moves.

While the uncertainty of Omicron pushed investors back towards long-duration, mega-tech companies in the fourth quarter, a rising interest rate environment tends to favor "real economy" stocks with near-term earnings. This shift, combined with abundant private sector liquidity and improving supply chains, should bode well for the undervalued, pro-cyclical Towle portfolio.

Towle Deep Value Composite returns are highlighted below with periods greater than one year annualized.

Periods ending 12/31/21	*Towle DVC (Gross of fees)*	*Towle DVC (Net of fees)*	*Russell 2000 Value*	*S&P 500*
3 months	2.97	2.79	4.36	11.03
1 year	27.33	26.42	28.27	28.71
3 years	19.05	18.19	17.99	26.07
5 years	6.21	5.43	9.07	18.47
10 years	13.65	12.85	12.03	16.55
20 years	12.30	11.46	9.18	9.52
30 Years	15.19	14.36	11.12	10.65
Inception (1/1/82)	15.49	14.66	11.94	12.35

Returns are preliminary and subject to change. Past performance is no guarantee of future outcome.
Please refer to the last page for additional disclosures.

Investment Environment

The U.S. 10-year Treasury yield, commonly used as the "risk-free" cost of capital, eclipsed 15% in 1981 and bottomed at 0.55% in July of 2020. In the first 10 calendar days of 2022, the yield on the 10-year U.S. Treasury rose to 1.78%, up a whopping 17% from its 2021 close. While it's impossible to predict the timing, magnitude, and impact of interest rate changes, consensus expects sustainably higher interest rates. In our judgment, there are three important implications for equity investors to consider in a rising rate environment.

Near-Term Earnings Increase in Value

In classical finance, valuation begins with discounted cash flow (DCF). Simply stated, the value of any asset is the sum of its future cash flows discounted to present value. A quick conclusion from DCF analysis is that as discount rates increase, near-term, lower-growth profits become relatively more attractive compared to long-duration, higher-growth, or distant profits. The laws of valuation simply demand greater profits today as the opportunity cost of capital (the returns available elsewhere) increases. We believe the undervalued holdings of the Towle portfolio as a collective exhibit attractive near-term profits relative to price and should outperform in a rising rate environment.

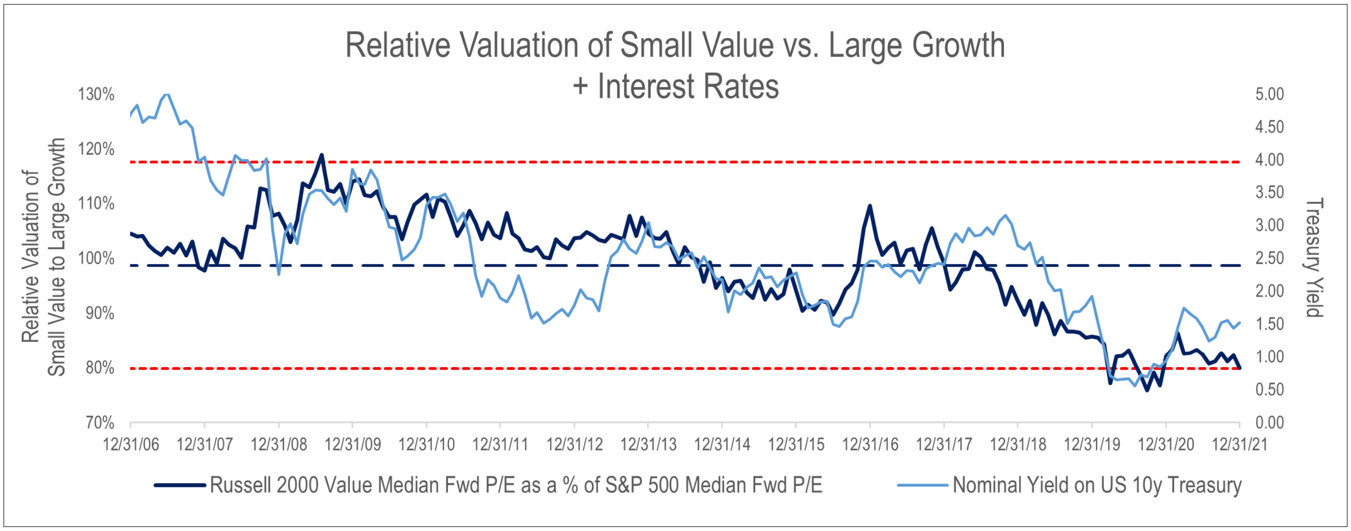
Speculation Recedes

When the interest rate on borrowings is near zero, money is effectively free. We have experienced times when free money fuels speculation and disincentivizes the prudent spending and allocation of capital. As the cost of capital rises, this incentive dynamic flips. Discretion, diligence, and rationality begin to rule when there is an opportunity cost and debt service enters the equation. Investor sensitivity to valuation likely returns in earnest as capital costs rise. If this proves correct, we expect a continued rotation towards companies with real, current profits.

Real Assets Win

The competitive advantage of businesses that own factories, trucks, heavy equipment, real estate, airplanes, and refineries widens when the cost of building a rival operation rises. Plus, these types of businesses can benefit from inflation as their pricing power increases along with the rising value of their asset base. If interest rates are indeed set to increase, owning a portfolio of companies that control real assets could be a strategic advantage. The Towle portfolio holds such companies.

To conclude our thoughts on interest rates, long-duration assets, and near-term earnings, we revisit the relative valuation chart published in several of our recent letters. Dotted red lines indicate the two standard deviation range around the 15-year average Russell 2000 Value to S&P 500 ratio in dark blue, as before. New to this chart is the market yield on U.S. 10-year Treasuries. Two things seem clear to us: small cap value remains historically cheap relative to large cap growth; and the valuation dispersion will likely close if interest rates rise.



Source: S&P Capital IQ, Federal Reserve Bank of St. Louis

Portfolio Review

This section has been removed for compliance reasons to exclude discussing specific securities transactions.

Looking Ahead

We suspect that the Federal Reserve's ability to manage inflation represents the biggest risk to capital markets. Will the Fed raise rates too slowly and allow inflation to spiral out of control? Will the Fed raise rates too quickly and inhibit aggregate demand? No one knows. In any case, as communicated clearly by Jerome Powell and the Fed's dot plot, interest rates are headed higher.

However, our view is that underlying economic fundamentals are healthy and could support the weight of measured rising interest costs. On the demand side, households, which represent over 70% of GDP, currently sit with record levels of net worth and liquidity, and wages are rising across the income spectrum. On the supply side, businesses constrained by labor should be able to improve production as processes are re-engineered and workers return. As discussed in our letter last quarter, production needs to not only meet current demand but also to refill depleted inventories economy-wide. A sustained inventory rebuild should benefit hard asset production companies like those in the Towle portfolio.

With over 40 years of investment history, Towle & Co. is no stranger to cycles influenced by pockets of elevated valuation, prospects for rising inflation and interest rates, and burgeoning economic potential. In our history, these periods have tended to activate a gravitational pull downward on long-duration, high-multiple stocks, and a resulting rotation that has benefitted low-multiple stocks with real earnings.

The "perennially great" mega-techs whose market caps have long enjoyed disinflation, low interest rates, and anemic economic growth may finally get an overdue valuation compression. Rationality may return to a market distracted by cryptocurrencies, NFTs, SPACs, and meme stocks. If we're right, and capital flows begin to favor earnings over dreams and revenue growth, the unloved and under-appreciated "real economy" stocks may finally have their day in the sun.

The Towle team believes that deep value investing works because valuation matters. And while past is not prologue, we look forward to the opportunities ahead.

We are very pleased to announce that Brooke Hofer joined us on December 1st as Director of Business Operations. Brooke jumped off the management fast track at Waste Management to bring her operational skills to Towle & Co. She exhibits a high capacity to make things happen and is directing all corporate and fund administration activities. Her growth mindset and disciplined work ethic will undoubtedly add substantial value to the firm's ongoing development. Brooke relocated to Colorado in December and will work in our Denver office.

Christopher D. Towle
Peter J. Lewis, CFA
James M. Shields, CFA
Wesley R. Tibbetts, CFA
G. Lukas Barthelmess