The Sizemore Income Letter

Late August 2022

Powell Plays Hardball

By Charles Lewis Sizemore, CFA

Note: Due to productions delays in July, we skipped the regular July issue of the Sizemore Income Letter and instead published an Early August issue followed by a Late August issue.

"We must keep at it until the job is done."

-Federal Reserve Chairman Jerome Powell, August 26, 2022

Well, he did it this time!

Fed Chairman Powell did the metaphorical equivalent of winding back and suckerpunching the market on Friday with his direct and to-the-point statements that he would continue to aggressively hike rates "until the job is done." This killed any wishful thinking that inflation would moderate slightly, any recession would be mild, and things would just sort of muddle through. The Dow closed Friday over 1,000 points lower and failed to recover much on Monday.

It's good that he did. In fact, I wish he had done more sooner. We're in the mess we're in today precisely because the Fed under his leadership kept policy far too loose for far too long.

It's better for him to come out and say it than to let Wall Street wistfully hope for the best only to be disappointed later.

Like it or not, the Fed is biggest driver of market returns (or losses!) at the moment. So, it's important we understand what they are thinking. It directly impacts our bottom line.

So, I'm going to reprint snippets of his speech from last week to pick out the parts that are most relevant. Bolded sections are for emphasis.

Figure 1

> *The Federal Open Market Committee's (FOMC) overarching focus right now is to bring inflation back down to our 2 percent goal. Price stability is the responsibility of the Federal Reserve and serves as the bedrock of our economy.* ***Without price stability, the economy does not work for anyone.*** *In particular, without price stability, we will not achieve a sustained period of strong labor market conditions that benefit all. The burdens of high inflation fall heaviest on those who are least able to bear them.*
>
> *Restoring price stability will take some time and requires using our tools forcefully to bring demand and supply into better balance. Reducing inflation is likely to require a sustained period of below-trend growth. Moreover, there will very likely be some softening of labor market conditions.* ***While higher interest rates, slower growth, and softer labor market conditions will bring down inflation, they will also bring some pain to households and businesses.*** *These are the unfortunate costs of reducing inflation. But a failure to restore price stability would mean far greater pain.*

Powell really comes out swinging and leaves absolutely no doubt that killing inflation is his top priority… and he's willing to inflict pain to make it happen because the alternative is ultimately more pain if he doesn't.

> *While the lower inflation readings for July are welcome, a single month's improvement falls far short of what the Committee will need to see before we are confident that inflation is moving down.*
>
> *July's increase in the target range was the second 75 basis point increase in as many meetings… Our decision at the September meeting will depend on the totality of the incoming data and the evolving outlook. At some point, as the stance of monetary policy tightens further, it likely will become appropriate to slow the pace of increases.*
>
> ***Restoring price stability will likely require maintaining a restrictive policy stance for some time. The historical record cautions strongly against prematurely loosening policy.***

In other words, get ready, because more 75-basis-point hikes could be in the cards, and we still have a long runway before the Fed feels it necessarily to slow down. And there's more! Powell has three lessons for us:

> *The first lesson is that central banks can and should take responsibility for delivering low and stable inflation… Our responsibility to deliver price stability is unconditional. It is true that the current high inflation is a global phenomenon, and that many economies around the world face inflation as high or higher than seen here in the United States. It is also true, in my view, that the current high inflation in the United States is the product of strong demand and constrained supply, and that the Fed's tools work principally on aggregate demand. None of this diminishes the Federal Reserve's responsibility to carry out our assigned task of achieving price stability. There is clearly a job to do in moderating demand to better align with supply. We are committed to doing that job.*

This is as close to a "my bad" as we're going to get. Powell points out, rightly, that a good chunk of the inflation we're dealing with is a global phenomenon driven by the post-COVID supply chain mess. But the Fed still fueled it… and now the Fed is making up for lost time in killing it.

> *The second lesson is that the public's expectations about future inflation can play an important role in setting the path of inflation over time…*
>
> *If the public expects that inflation will remain low and stable over time, then, absent major shocks, it likely will. Unfortunately, the same is true of expectations of high and volatile inflation. During the 1970s, as inflation climbed, the anticipation of high inflation became entrenched in the economic decisionmaking of households and businesses. The more inflation rose, the more people came to expect it to remain high, and they built that belief into wage and pricing decisions…*

This one is a biggie. Inflation can become a self-fulfilling prophecy. When inflation is high, workers demand more money, suppliers preemptively charge more, and retailers get used to automatically raising prices… all of which fuels inflation in a nasty spiral. This is what the Fed is desperate to avoid.

> *That brings me to the third lesson, which is that we must keep at it until the job is done. History shows that the employment costs of bringing down inflation are likely to increase with delay, as high inflation becomes more entrenched in wage and price setting. The successful Volcker disinflation in the early 1980s followed multiple failed attempts to lower inflation over the previous 15 years.* ***A lengthy period of very restrictive monetary policy was ultimately needed to stem the high inflation and start the process of getting inflation down to the low and stable levels*** *that were the norm until the spring of last year. Our aim is to avoid that outcome by acting with resolve now.*

Powell doesn't want to be Paul Volker. So, he's determined to kill inflation now so that he doesn't have to be Paul Volker later.

Great. What does all of this mean?

There's a lot to digest here, but I think the most important takeaways are these:

1. The Fed is perfectly comfortable pushing us into recession if that is what is necessary to kill inflation.
2. The Fed doesn't care what the effects on the stock market are, as in their view the longer-term factors in play are vastly more important than your quarterly 401(k) statement.
3. We should keep following my bear market gameplan to keep more cash on hand, keep position sizes a little smaller and be more opportunistic in our investing.

That's our plan. I'm of the opinion the Fed really screwed up by keeping the COVID stimulus in place for nearly two years. Six months likely would have been just fine. But what's done is done. They made a mess, and now they're cleaning it up. It's up to us to invest accordingly.

A Recession Proof Income Play

We're technically in recession, as GDP shrank in both the first and second

quarters. Though frankly, I don't think we should read too deeply into those numbers. 2021 GDP was goosed by COVID stimulus, and the mild shrinkage we've seen in 2022 was inevitable as that stimulus was taken away.

I think the "real" recession – with a loosening of the labor market and several quarters of lousy corporate earnings – is yet to show up in the data. But it will, and the harder the Fed has to work to crush inflation, the deeper it will get. Focusing on sectors of the economy that are inflation-resistant – or those that might actually *benefit* from recession – only makes sense.

So, with that said, let's consider the self-storage sector.

I will never understand the American need to squirrel away junk. I actually find it weirdly liberating to throw things away. Despite being an anti-packrat, after living in my home in Dallas for over a decade and raising three kids there, we still managed to accumulate a ridiculous amount of stuff: Baby equipment, assorted cables for electronics that were thrown out ages ago, souvenir beer glasses from brewery tours, random sports equipment we bought for an event and haven't touched in five years, tools purchased for long-completed (or forgotten!) projects, parts for machines I no longer own, kitchen appliances we got for our wedding and yet still sit in boxes…

I gave a ton of it to charity and yet still had enough left over to fill up a dumpster or two.

And again… I'm an anti-packrat who takes pride in living spartanly… and yet I still accumulated that much crap in a decade of living in my house. If that's me, I shudder to think what people who are less ideological than me accumulate.

But I digress…

When times are good, people tend to expand and buy bigger homes or rent bigger apartments… and then buy more junk to fill it up. But when times are lean, they downsize. They might even have to move in with friends or family for a while. And when they do, the excess stuff gets put in storage.

It's not just individuals either. Businesses will regularly rent storage units when they downsize, which is something else to consider given how overheated the labor market is right now.

Furthermore, once stuff goes into storage, it tends to stay there for a while because doing anything with it can seem overwhelming. The average length of time an American rents a storage unit is 14 months, but remember, that's the average. Half are well above that number. A quarter of storage rentals are over three years, about one in 25 is for over 10 years.

The numbers get absurd. As of 2018 – and you know the number has only gotten larger – there were 52,786 storage facilities spread across the US. That's more than the number of Starbucks, McDonalds, Dunkin Donuts, Pizza Hut and Wendy's restaurants *combined*.

And that's facilities, not units. There were 23 *million* units.

You might think that with that many units, vacancy would be a problem. It's not. Occupancy is consistently over 90% industry wide, year in and year out.

I don't know how deep the recession will get. But I do know that self storage should do just fine no matter what happens… and the worse it gets, the better the economics of the industry are likely to be.

So, with all of that as an introduction, let me introduce **National Storage Affiliates Trust (NYSE: NSA),** a real estate investment trust (REIT) specializing in the sector.

We already have some exposure to the sector via **Public Storage (NYSE: PSA)** in the Forever Portfolio. I recommended that stock in the pits on the COVID bear market in March 2020, and we're up over 90%.

If you don't already own Public Storage, I still like it at current prices and still consider it a stock you can own until the day you die.

National Storage is a younger and smaller company than Public Storage with a market cap of $6.8 billion. That's not small by REIT standards and puts the company solidly in mid-cap territory. But it's also about 1/10 the size of Public Storage. This is a growth REIT with a long runway for expansion.

National Storage owns a diversified portfolio 1,061 properties with over 64 million square feet of rentable space (see Figure 5 on following page). The number of properties and rentable space have both jumped by more than a factor of five since 2015, and the growth only continues to accelerate.

Revenues have doubled since the onset of the pandemic and show no sign of slowing any time soon. The occupancy rate was a spectacular 95.3% as of the

National Storage Affiliates Trust

Figure 2

NSA Portfolio

Portfolio Metrics Update – 2022 Same Store Pool

Metric	Q1 2022	May 2022
Period-End Occupancy	94.8%	95.3%
Year-Over-Year Change in Period-End Occupancy	+140 bps	-60 bps
Year-Over-Year Change in Street Rates	+22%	+18%

Figure 3

NSA Revenues

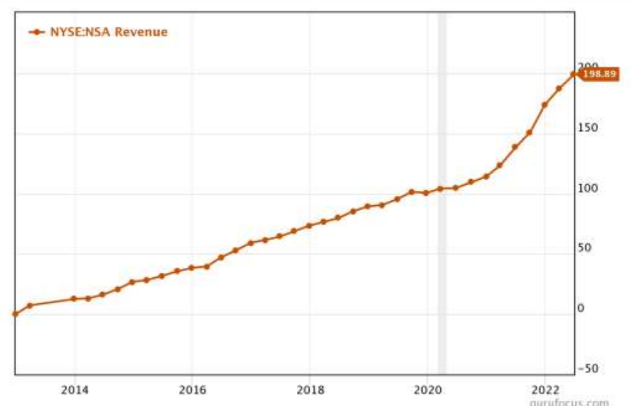

Figure 4

last quarterly results, and prices for new rentals jumped by 18%.

And again, this is all happening during a window of time that should be bad for the industry. The spike in demand that came during the pandemic when people needed to make room for home offices passed long ago, and we have the tightest labor market since the late 1990s. Imagine how much better results might look when the unemployment rate ticks up again and people need to downsize again.

Let's talk dividends. Today's quarterly dividend of $0.55 has roughly doubled over the past four years, and the REIT has raised its dividend for five consecutive quarters. At current prices, it yields 4.1%.

Now, you tell me. In a year like 2022, which nothing quite seems to be going right, what's not to like about a boring storage REIT with a not-so-boring growth rate and a yield over 4%?

There will come a point when the storage business is saturated, profits fall, and it no longer makes sense to invest. But we can make a lot of money before that day comes.

So, with no further ago…

Action to take: Buy shares of National Storage Affiliates Trust (NYSE: NSA) at market. Set an initial stop loss at $39.16 based on closing prices.

While the macro environment looks strong here, NSA's stock price is sensitive to changes in bond yields. The shares have traded in a fairly wide range of $45 - $70 over the past year. So, we could have a little volatility in this stock, particularly if bond yields spike again.

Figure 5

Figure 6

I consider that risk one I'm willing to take. And if things get choppy in the market, that's fine. We'll just follow our stop and move on.

Have a good week, and until next time, keep cashing those dividend checks!

P.S.: Apart from writing this newsletter, I run a full-service wealth management firm along with my colleagues. At **Sizemore Capital Management**, we

build income portfolios like those I write about in the *Sizemore Income Letter*.

But we also do a lot more than that. We manage a suite of low-volatility strategies offering low correlation to the S&P 500. If you think your portfolio is a little too exposed to the stock market right now, let's talk. I may have some alternatives that can offer competitive returns without the heartburn. If you'd like for me to take a look at your portfolio and offer some recommendations, contact me at info@sizemorecapital.com.

The Sizemore Income Letter Portfolio

Stock	Ticker	Entry Date	Buy Price	Recent Price	Stop Loss	Yield	Cumulative Dividends	Total Return	IRA Friendly?	Action
National Storage Affiliates	NSA	8/30/2022	$52.95	$52.95	$39.16	4.08%	$ -	0.00%	Yes	Buy
Cheniere Energy Partners	CQP	8/4/2022	$46.49	$56.30	$33.01	6.92%	$ -	21.10%	No	Buy
Citigroup Inc	C	6/23/2022	$47.34	$49.38	$32.57	4.39%	$ -	4.31%	Yes	Buy
ONEOK, Inc.	OKE	4/28/222	$65.50	$64.50	$47.91	5.73%	$ 0.94	-0.10%	Yes	Buy
Digital Realty Trust	DLR	3/24/2022	$136.79	$123.97	$118.15	3.57%	$ 1.22	-8.48%	Yes	Buy
Vertical Capital Income Fund	VCIF	1/27/2022	$9.99	$9.46	$8.95	9.23%	$ 0.37	-1.60%	Yes	Buy
Energy Transfer Partners	ET	12/27/2021	$8.16	$12.31	$7.79	7.42%	$ 0.38	55.45%	No	Buy
EPR Properties	EPR	11/29/2021	$47.78	$44.95	$33.92	6.28%	$ 1.83	-2.10%	Yes	Buy
Chevron Corporation	CVX	9/30/2021	$103.33	$164.63	$130.77	4.62%	$ 4.18	63.37%	Yes	Buy
ClearBridge Energy Midstream Opportunity	EMO	5/26/2021	$21.94	$30.14	$20.49	7.10%	$ 1.65	44.90%	Yes	Buy
Magellan Midstream Partners	MMP	1/29/2021	$44.41	$52.74	$41.78	8.65%	$ 6.20	32.71%	No	Buy
Healthcare Realty Trust	HR	7/20/2022	$24.37	$25.28	$22.12	4.72%	$ -	3.73%	Yes	Buy*
Physicians Realty Trust	DOC	11/20/2020	$17.80	$17.23	$15.30	4.49%	$ 1.38	4.55%	Yes	Buy
Main Street Capital	MAIN	9/25/2020	$29.74	$42.17	$35.50	5.93%	$ 4.63	57.36%	Yes	Buy
Iron Mountain	IRM	8/25/2020	$30.22	$54.01	$42.57	5.30%	$ 4.95	95.11%	Yes	Hold
Starwood Property Trust	STWD	8/25/2020	$15.70	$23.34	$18.15	7.38%	$ 3.36	70.06%	Yes	Buy
Dow Inc.	DOW	6/24/2020	$38.45	$53.57	$48.78	4.53%	$ 5.60	53.89%	Yes	Buy
Ecofin Sustainable and Social Impact Term Fund	TEAF	6/24/2020	$10.73	$14.61	$12.53	6.14%	$ 1.79	52.80%	Yes	Buy
LyondellBasell Industries	LYB	5/22/2020	$60.39	$85.85	$79.23	4.27%	$ 15.11	67.18%	Yes	Buy

* Position resulted from merger with HTA

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