Miller Howard INVESTMENTS

Challenges Ahead

QUARTERLY REPORT 1Q 2022

Fear of inflation loomed over the market from the outset of the first quarter, only to be joined by a new risk in February—fallout from the Russian invasion of Ukraine.

Military conflict inserts a new set of risks into the global market, just as investors were anticipating an economic rebound from the easing of COVID restrictions.

Despite the new challenges facing the markets, the labor market remains exceptionally strong, providing a counterbalance to surging inflation and the fallout from war.

No one has a crystal ball when it comes to the conflict in Ukraine.

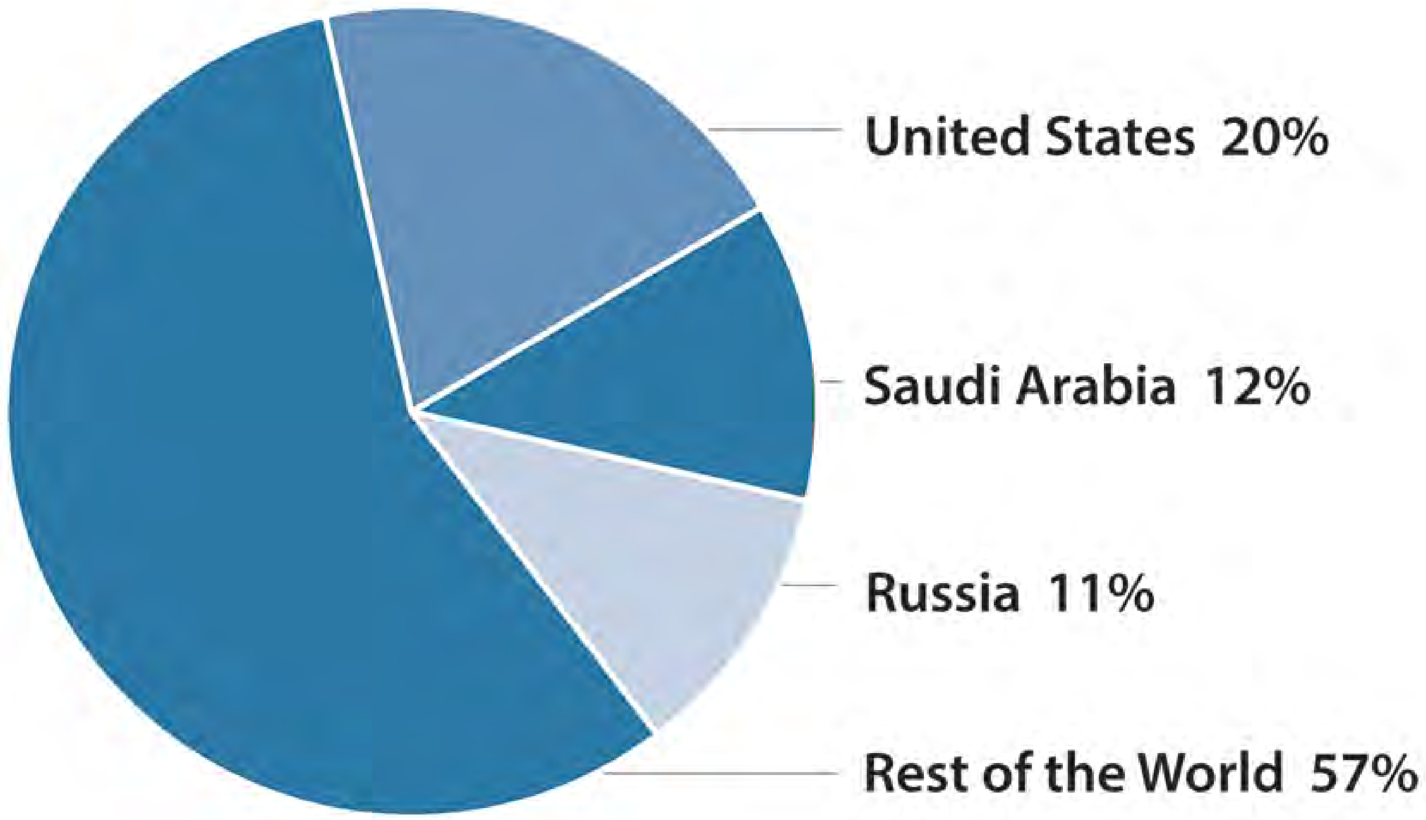
The stock market's reaction has been mild with the S&P 500 Index actually up 5.8%* since the first day of the invasion, February 24th. The ultimate downside could be significant if the war expands beyond Ukraine.

For now, the direct impacts stem from international sanctions, including the barring of Russian banks from much of the global payment system, the freezing of central bank assets, prohibitions on specific imports and exports, restrictions on Russian ships and aircraft, and punitive measures taken against the Russian oligarchs.

* As of March 31, 2022

Global Oil Production

By Country



As of December 31, 2020. Sources: The US Energy Information Administration (EIA).

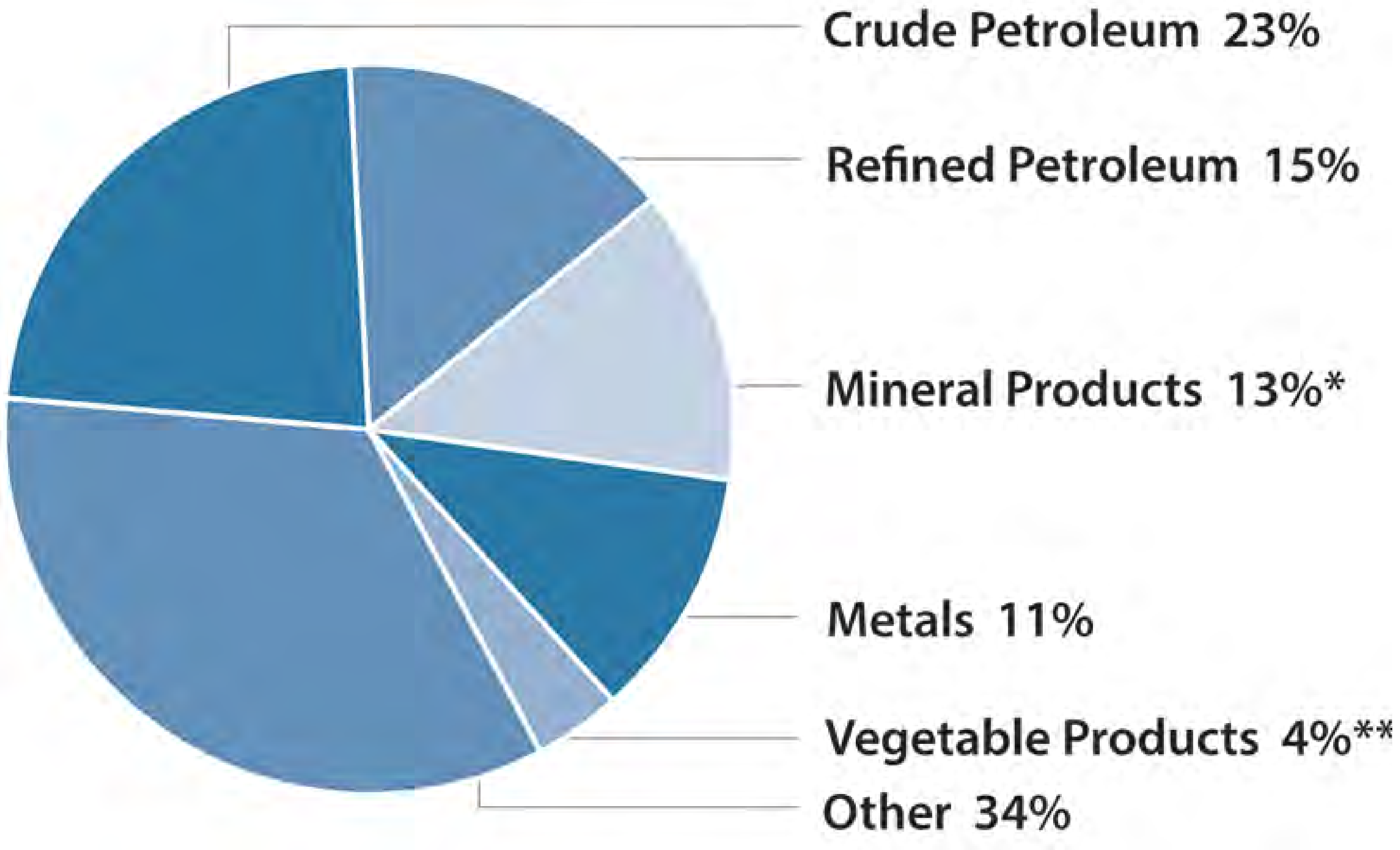
In many ways, **Russia is a small player in the global economy. Total exports out of Russia account for only 2% of world trade.**

That is less than Mexico or Belgium (as of 2020). However, Russia is the world's third largest exporter of crude oil, and the world's largest exporter of wheat. Ukraine is also a major exporter of wheat, and combined Russia and Ukraine account for 30% of global production.

Global prices for both oil and wheat spiked following the beginning of hostilities. Both prices have come off their highs but remain significantly elevated. Food and energy prices were already contributing substantially to inflation prior to the invasion, and these recent increases will add to the pressure.

Russia Exports

$407 Billion



As of December 31, 2020. Source: The Observatory of Economic Complexity (OEC)
* Excludes Crude and Refined Petroleum
** Includes Wheat

We expect the impact of sanctions on energy and grain prices to moderate over time, unless all large consuming nations block Russian exports.

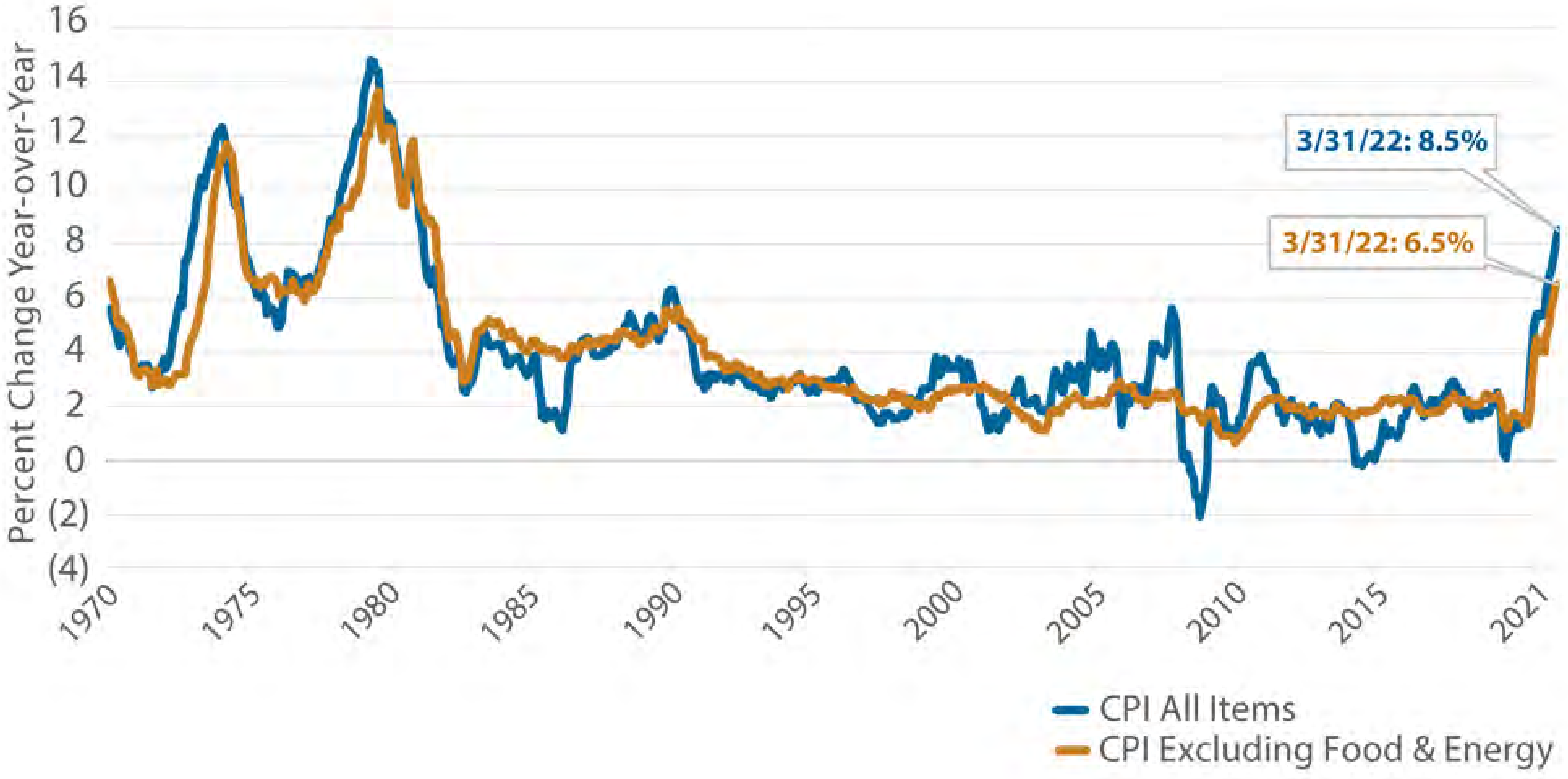
At this point, both China and India are willing buyers making it hard for the sanctions to keep Russia's supply completely off the market.

Both sanctions and the decision by private companies to exit Russia will make life difficult for the average Russian, but in our view, **their economy is simply too small to make much of a difference for US investors.**

Inflation continued to run hot in the quarter, leading the Federal Reserve to raise the upper bound of the federal funds target rate to 0.50% at their March meeting.

Inflation Continued to Run Hot in 1Q 2022

January 1971—March 2022



As of February 28, 2022.
Source: Bloomberg; Bureau of Labor Statistics. CPI = Consumer Price Index.

We can expect further increases.

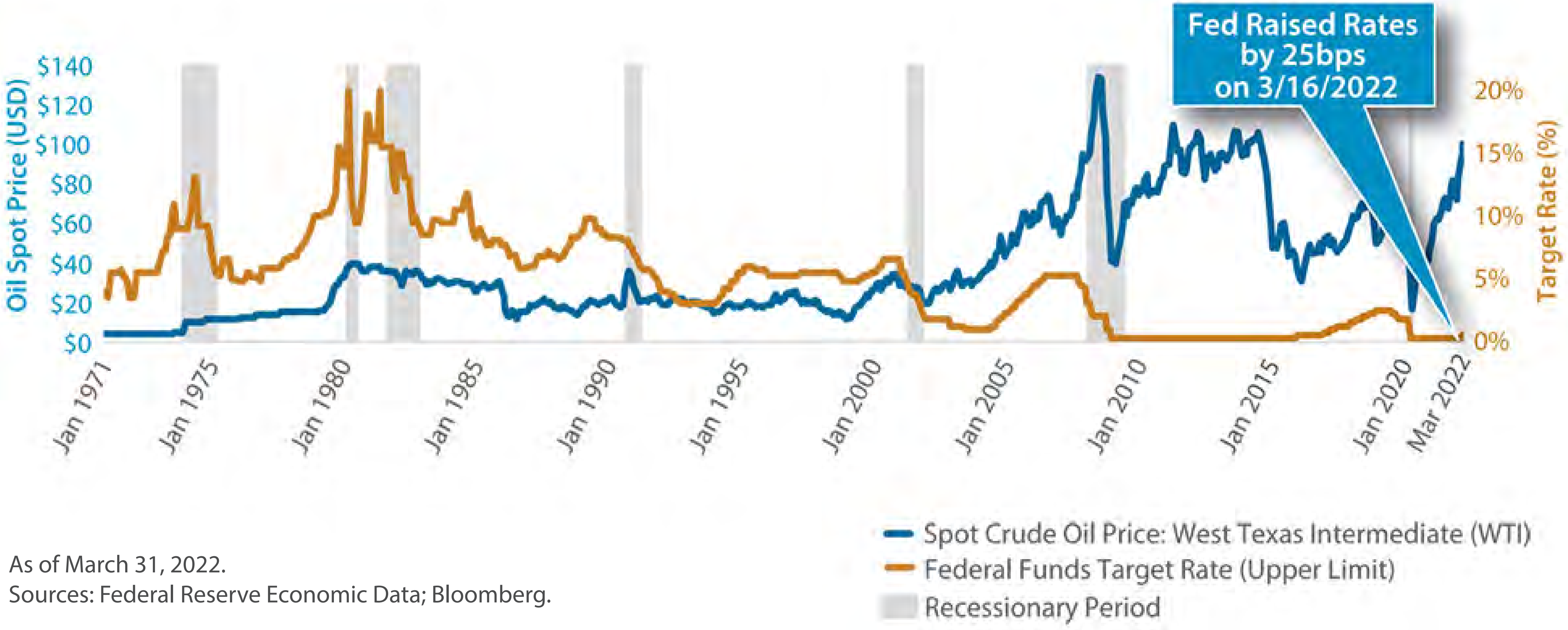
Forecasts by the Fed board members range from 1.4% - 3.1% by the end of 2022, and 2.1% - 3.6% by the end of 2023. Federal funds rates would still be substantially below today's level of inflation, even at the upper end of these ranges.

The Fed may have to be more aggressive than they currently admit.

The Fed has been widely criticized as being tardy in addressing the surge in inflation and, in our view, will likely continue their tightening program even if the war in Ukraine worsens or another COVID-19 variant wave emerges.

Past recessions have frequently been associated with spiking oil prices and a Fed tightening cycle that the market viewed as going too far. We are not believers in a mechanical relationship between these factors, but **we are clearly on a path that has a fair chance of ending in a recession.**

Increasing Oil Prices and Fed Funds Rates Have Frequently Preceded Recessions



As of March 31, 2022.
Sources: Federal Reserve Economic Data; Bloomberg.

However, the arguments for optimism still largely hold:

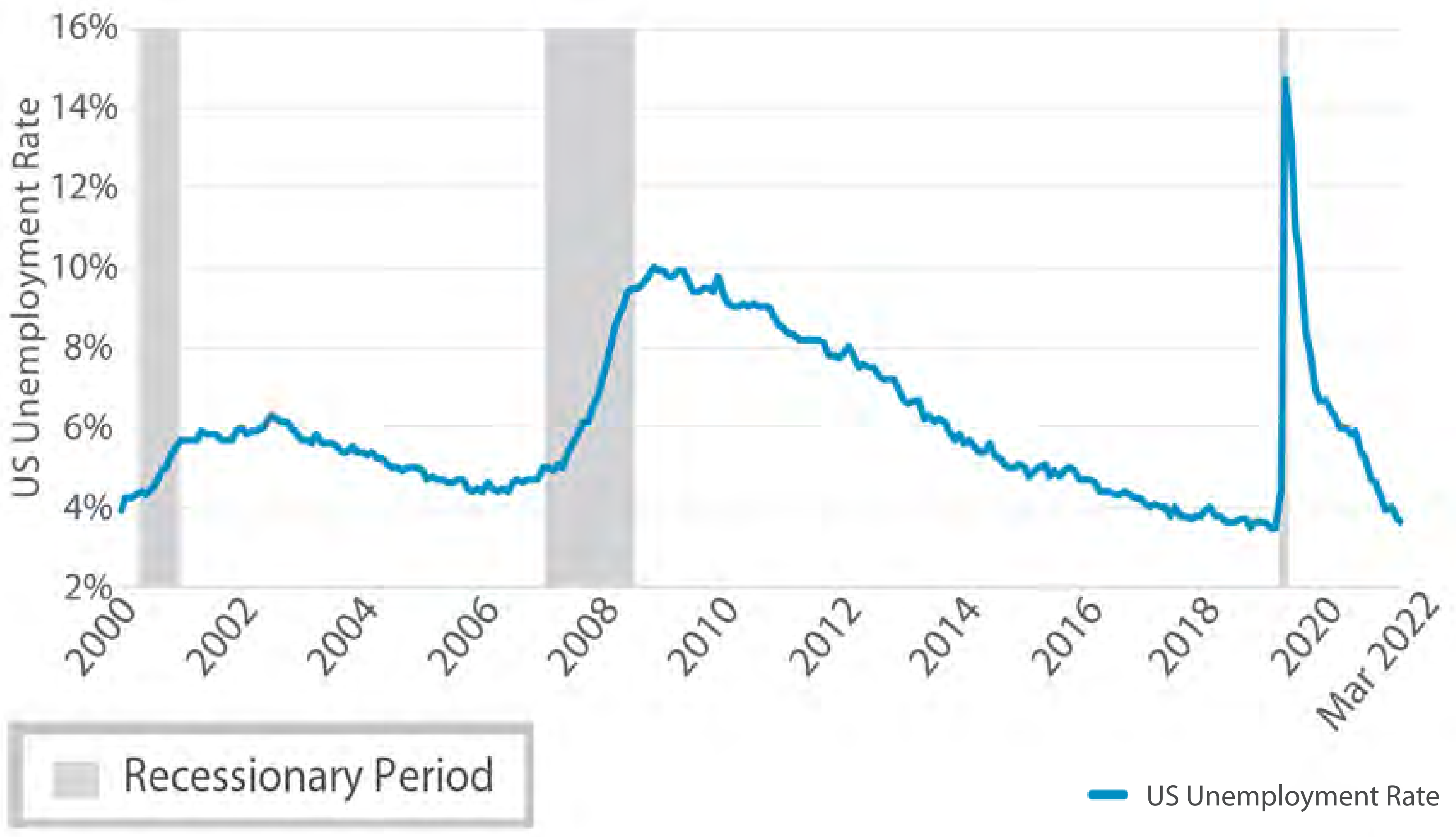
- Consumer and business balance sheets are strong.
- Credit performance continues to be pristine.
- Most importantly, the labor market is very tight.

Higher unemployment goes hand in hand with recessions, and at this point, we are seeing the exact opposite—the labor market continues to speed forward.

Bears argue that increasing inflation and interest rates will squeeze spending, causing economic growth to slow and unemployment to rise. While this could come to pass, unemployment is headed full steam in the opposite direction.

Unemployment ended the quarter at 3.6%, lower than 96% of months since 2000.

US Labor Market: Unemployment Rate

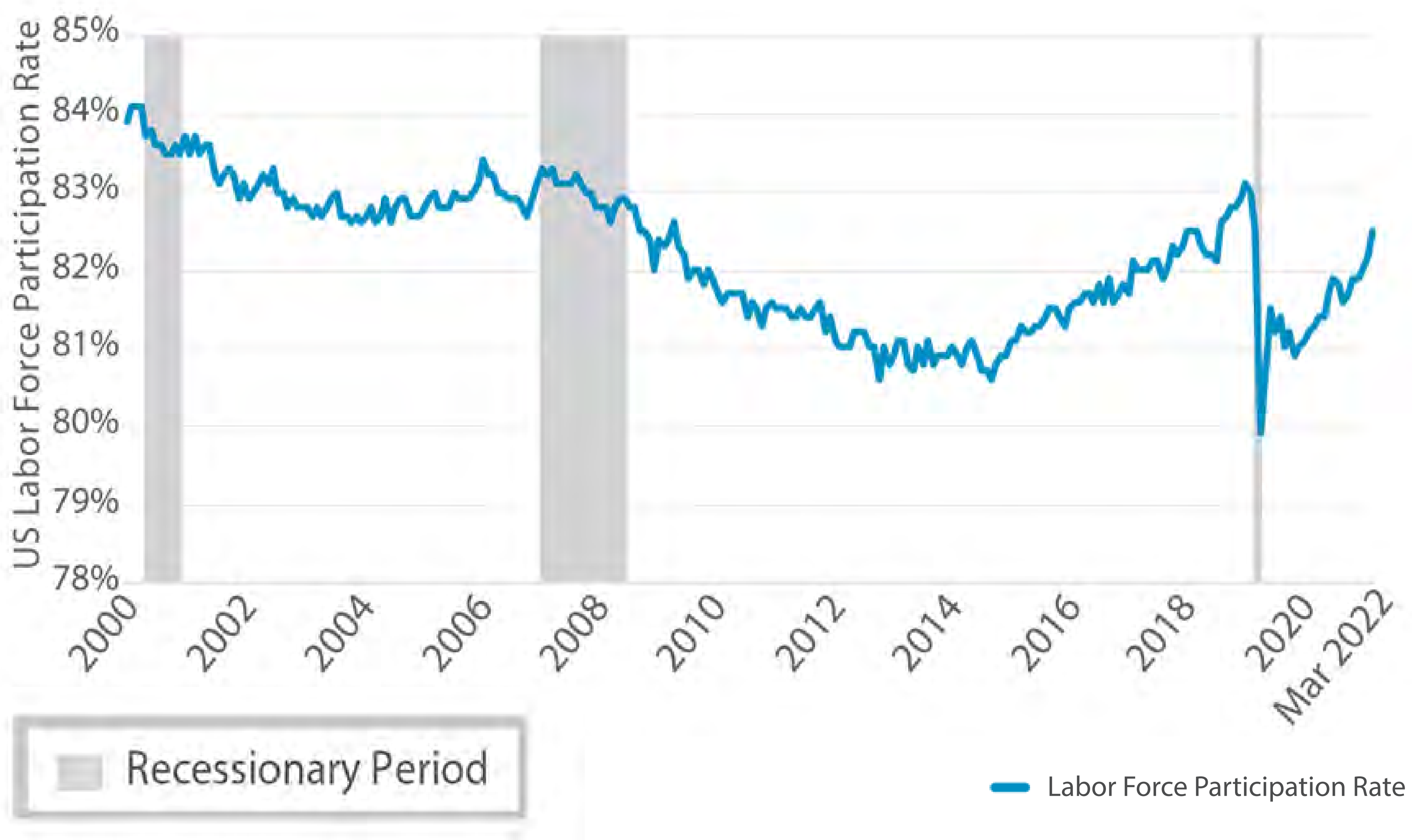


As of March 31, 2022. Source: Bloomberg. The unemployment rate tracks the number of unemployed persons as a percentage of the labor force (the total number of employed plus unemployed). These figures generally come from a household labor force survey.

The unemployment rate is low despite a massive influx of job seekers.

Many people could not or chose not to work during the pandemic. As these workers returned, the US labor market functioned smoothly, matching people with jobs at a rapid pace.

US Labor Market: Labor Force Participation Rate

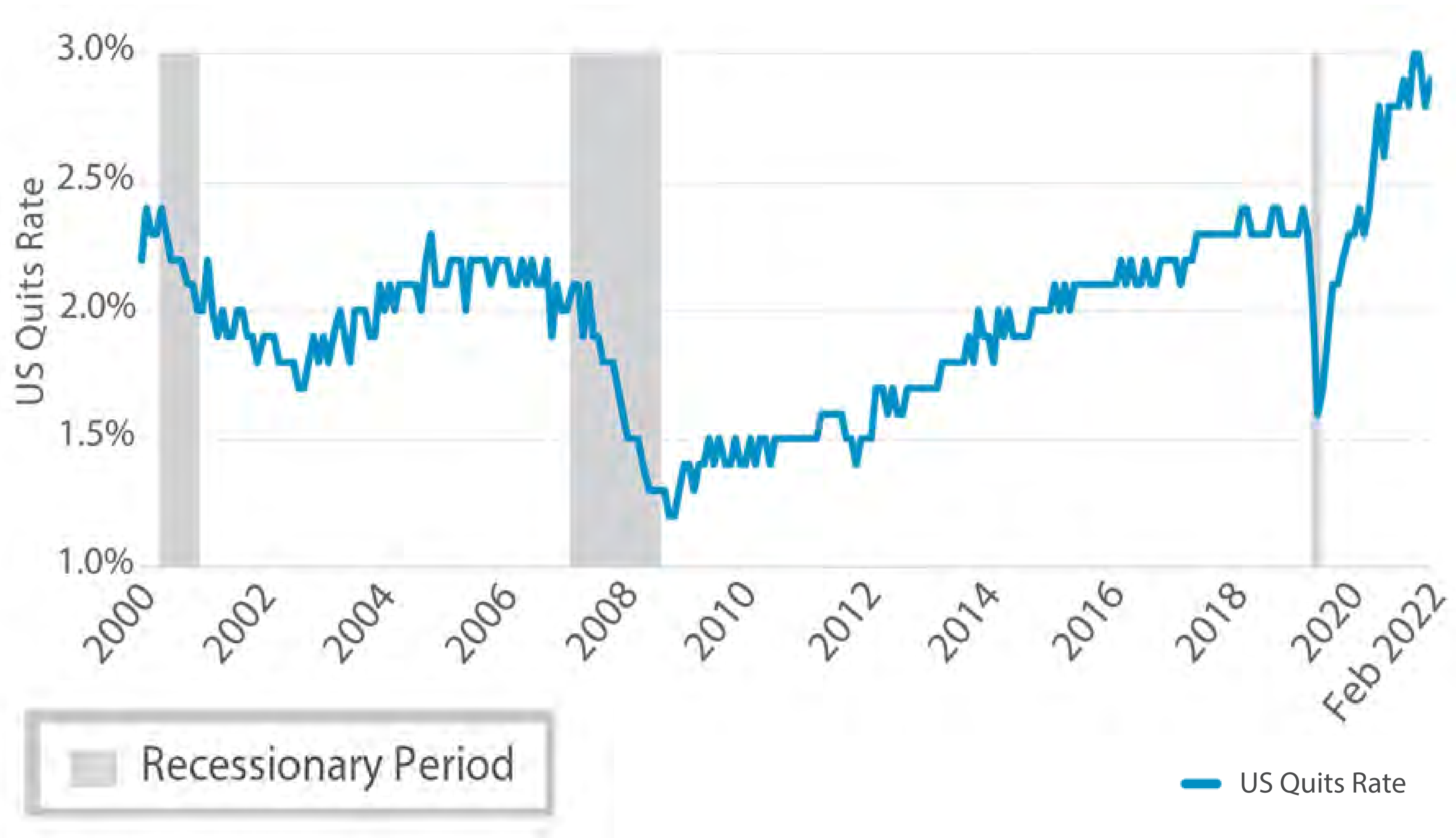


As of March 31, 2022.
Source: Bloomberg. The labor force participation rate is the total labor force as a percent of the working age population (25-54 years).

The tightness continues. The Bureau of Labor Statistics has long measured the percent of workers quitting on their own accord.

Quits are currently running near the highest level in two decades, suggesting employees are confident they can find a better gig.

US Labor Market: Quits Rate

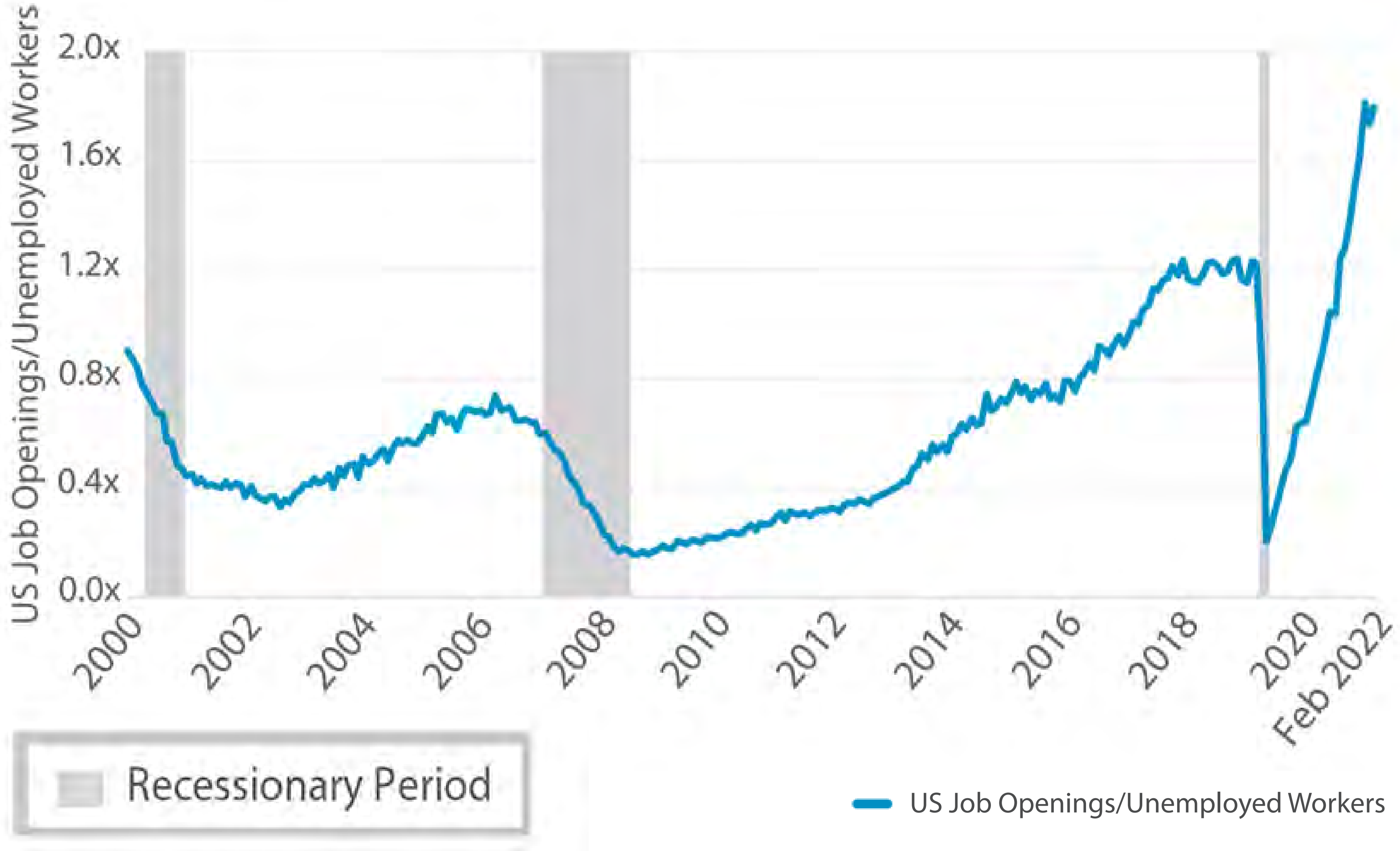


As of February 28, 2022.
Source: Bloomberg. Quits Rate: This concept tracks voluntary job separations initiated by the employee.

The ultimate measure of tightness is the number of new openings for each unemployed person.

Typically, there are fewer job openings than unemployed workers, but currently, **there are actually more openings than unemployed people**—the strongest reading in the past two decades.

US Labor Market: Job Openings/Unemployed Workers



As of February 28, 2022.
Source: Bloomberg. Job Openings is measured using the US Job Openings By Industry Total seasonally adjusted. This concept tracks the number of specific job openings in an economy. Job vacancies generally include either newly created or unoccupied positions (or those that are about to become vacant) where an employer is taking specific actions to fill these positions. Unemployed Workers is measured using US Unemployment Unemployed Workers Total in Labor Force. Unemployment measures the number of people who are without work (not in paid employment or self-employed), currently available for work and seeking work (taking specific steps to find work).

From all angles, the labor market still seems very robust.

Roughly 70% of GDP is consumer demand, so it’s hard to be overly bearish given the solid employment picture.

Commentary on inflation invariably makes the argument that it is hardest on those at the bottom of the income ladder. There is often concern for low-wage workers who may not get raises and are inexorably squeezed by higher prices, particularly for food and energy. Currently, we do not see this as representative of the US workforce.

According to the Atlanta Fed:

- **The vast majority of workers received a wage increase over the past 12 months.**
- **The average wage increase is running at 5.1%—still less than inflation, but positive and trending up.**

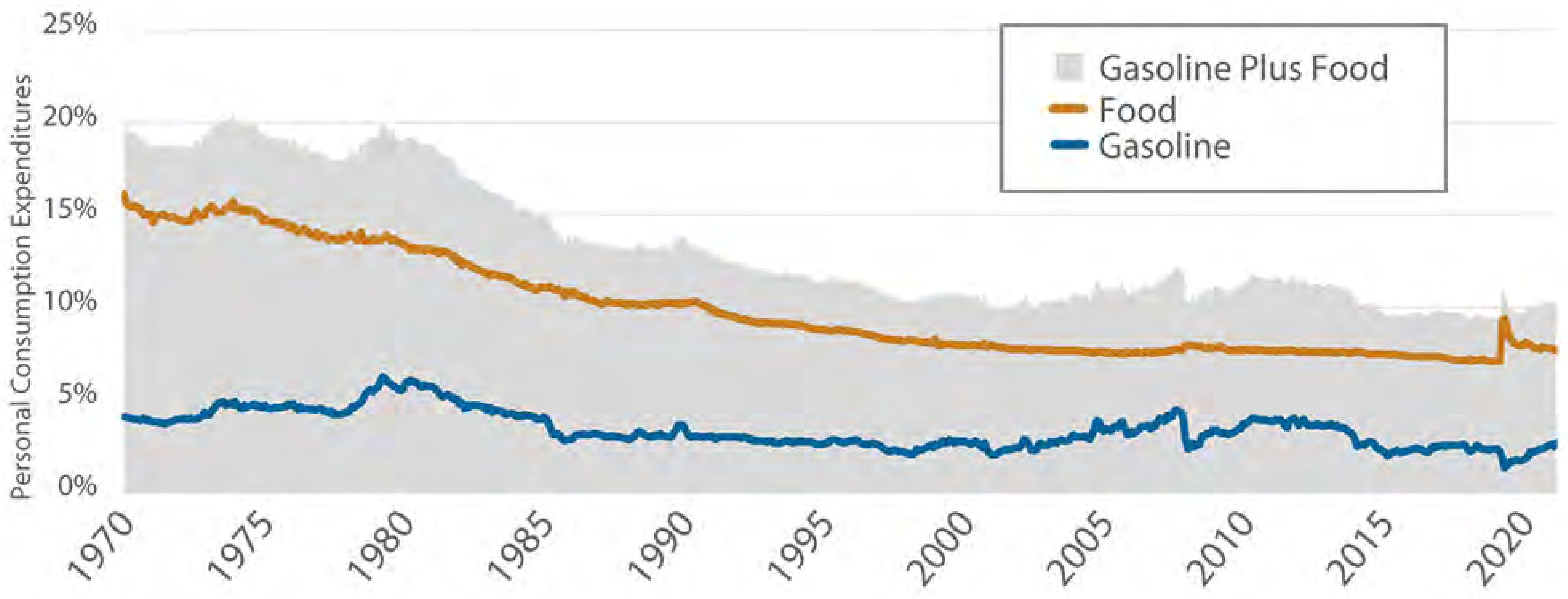
Inflation warnings frequently evoke the 1970s without acknowledging how dramatically our economy has changed. It's true that both the 1970s and early 2022 saw oil and grain price inflation.

The difference is that both energy and food are much smaller fractions of consumer spending today, with the combined total dropping from roughly 20% to 10%.

Even if we see further spikes in oil and food prices, the categories now matter less.

US Food and Gasoline Spending

Percent of Personal Consumption Expenditure



As of February 28, 2022.
Sources: Bloomberg;
Bureau of Economic Analysis.

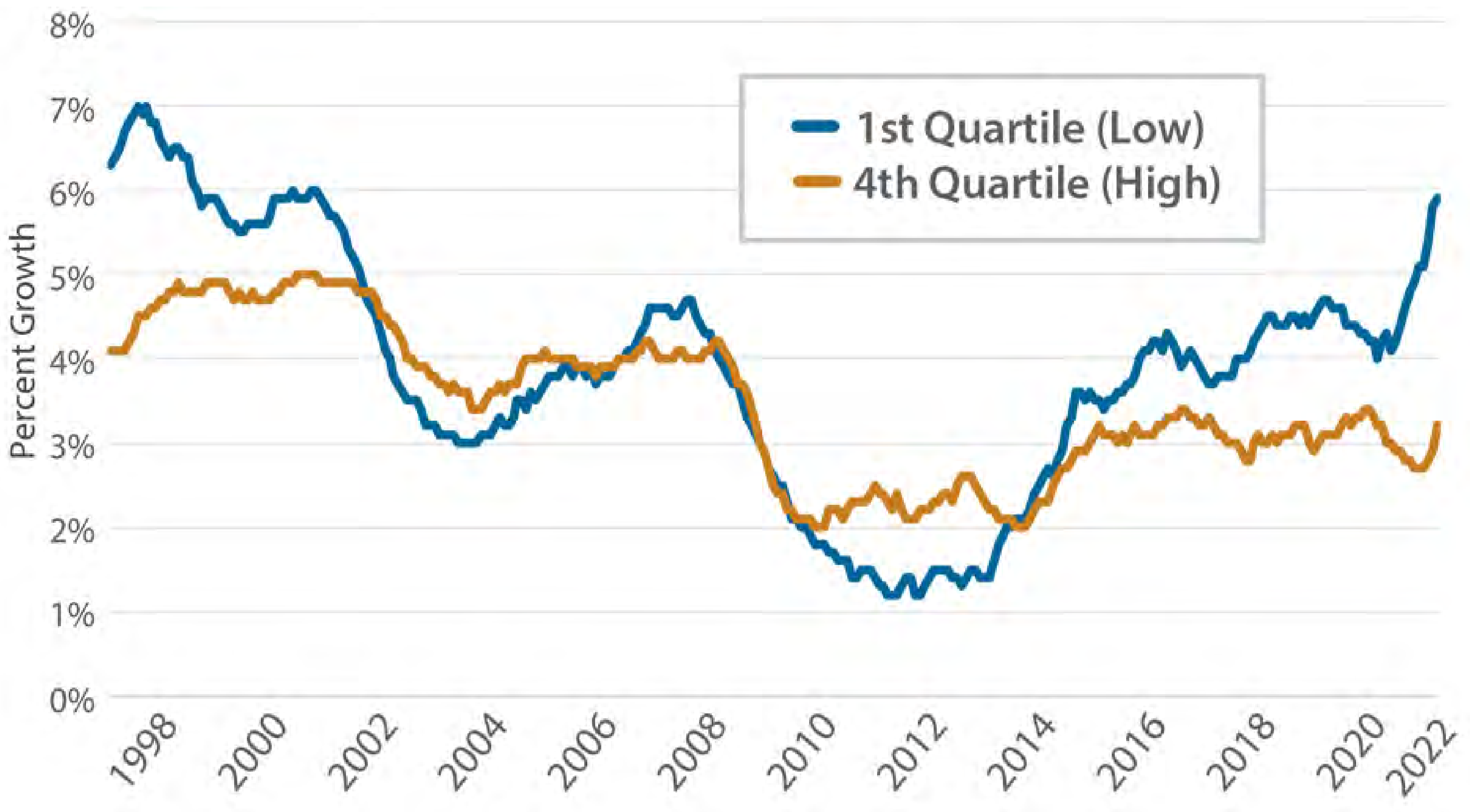
One underappreciated characteristic of the current situation is that **wages are increasing faster for low-wage workers than high-wage workers.**

The pandemic disrupted many industries that use lower-wage hourly labor.

Employers now must pay up to attract these workers back.

Wage Growth

Lowest Earners vs Highest Earners



As of February 1, 2022.
Source: Current Population Survey, Bureau of Labor Statistics; Federal Reserve Bank of Atlanta Calculations. The data are 12 month moving averages of monthly median wage growth for each averge wage quartile. Wage computed on an hourly basis. Ranking based on the distribution of average hourly wage in the current month and a year ago. Those in the lowest 25 percent of average wages are in the 1st quartile and those in the highest 25 percent of average wages are in the 4th quartile.

Inflation matters more to low-income consumers, *but their wages are rising faster than average.*

Our view is not that inflation does not matter, but that the impact on investors is primarily through its influence on interest rates.

Higher rates threaten housing demand, capital spending, and any other spending funded by borrowing. Prices for bread and gasoline matter, but the real risk for the markets is how much the Federal Reserve needs to raise rates to tame aggregate inflation.

Aside from the risk of a recession, **the key inflation question is whether firms will be able to pass along cost increases.**

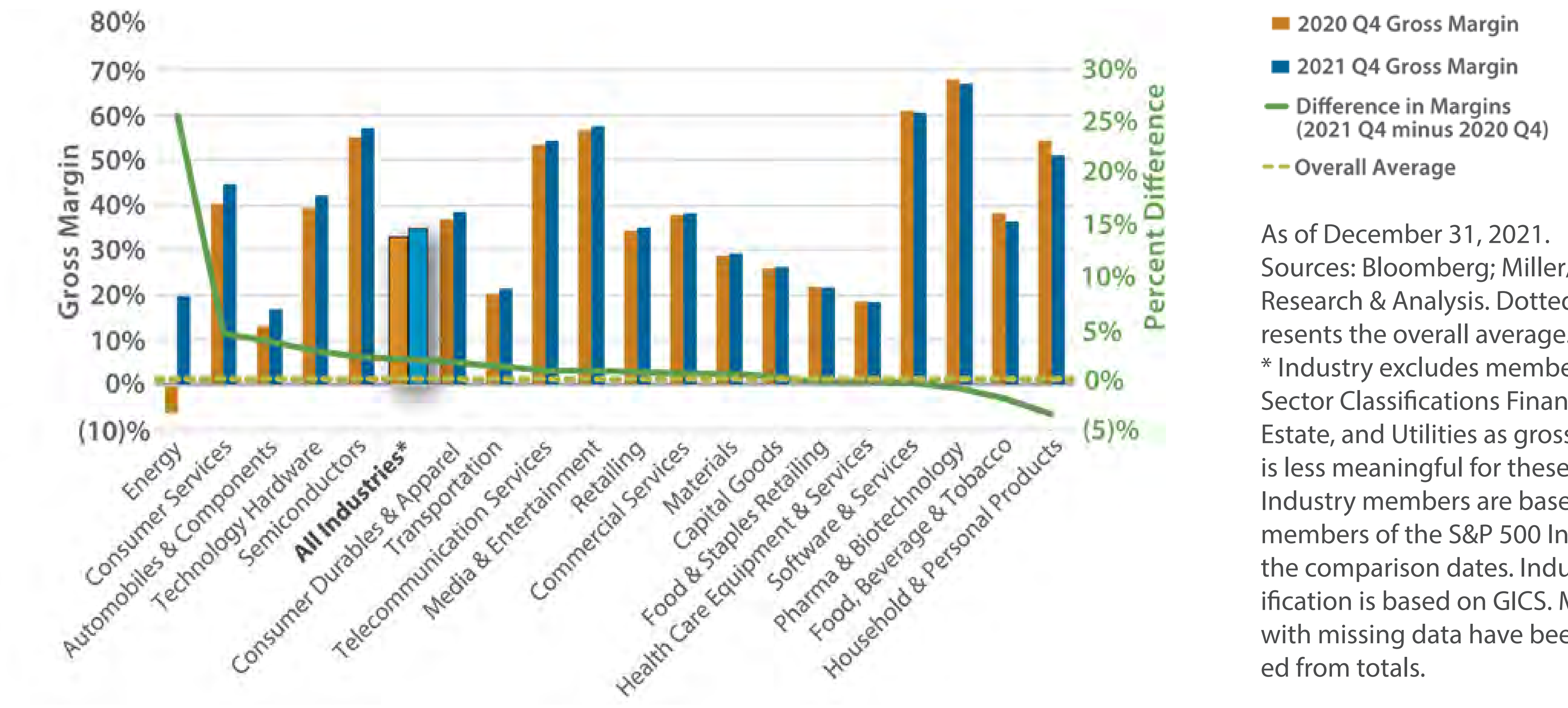
Investors tend to view firms as being incapable of raising prices to keep up with cost increases.

We should point out that there is a logical fallacy in this argument: *One company's products are another company's costs, so it would be virtually impossible to own a diversified portfolio of stocks in which all firms face rising costs but flat prices.*

The question still remains how well on average companies are maintaining margins in the face of rising costs.

Last quarter, we showed that gross margins for companies in the S&P 500 Index expanded by 1.1 percentage points in the third quarter, demonstrating that higher costs were not causing a margin squeeze. Inflation is now even higher, so we checked fourth quarter earnings for signs of margin squeezes.

Change in Gross Margin by Industry



As of December 31, 2021.
Sources: Bloomberg; Miller/Howard Research & Analysis. Dotted line represents the overall average.
* Industry excludes members of GICS Sector Classifications Financials, Real Estate, and Utilities as gross margin is less meaningful for these sectors. Industry members are based on members of the S&P 500 Index as of the comparison dates. Industry classification is based on GICS. Members with missing data have been excluded from totals.

Some sectors are experiencing difficulty passing along higher costs, most notably consumer staples. Gross margins on average, however, rose during the fourth quarter by 1.9 percentage points.

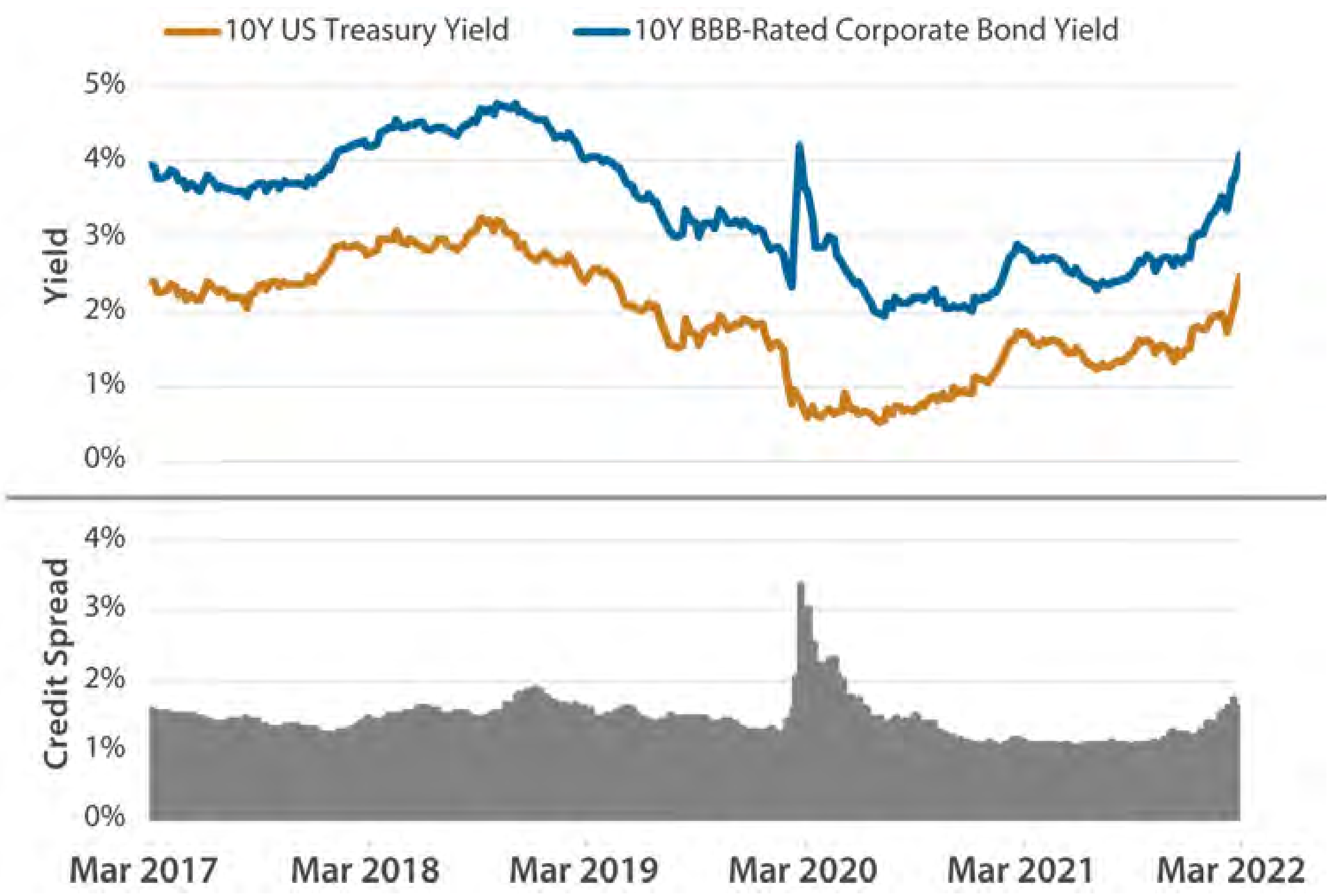
Our conclusion is that most firms have been able to raise prices enough to grow margins despite the challenge of inflation.

For companies, **the primary risk posed by inflation is not a margin squeeze but the threat of higher interest rates**, in our view.

Economic activity is more linked to long-term rates and those have started to rise, reflecting higher inflation expectations.

One cautionary signal coming out of the bond market is that credit spreads are widening, indicating that bond investors are seeing a potential risk of credit problems.

Interest Rates over Time



As of March 31, 2022. Source: Bloomberg.
The yield on BBB-rated corporate bonds reflects Bloomberg's estimated yield using unsecured fixed rate bonds issued by US companies with a Bloomberg composite credit rating of BBB+, BBB, or BBB-.

In addition to inflation and any expansion of the war in Ukraine, **the other key risk we are monitoring is COVID-19.**

Regardless of whether we get another wave in the US, we believe that our population has enough immunity, both natural and vaccine-induced, to mitigate the economic impact of an additional surge.

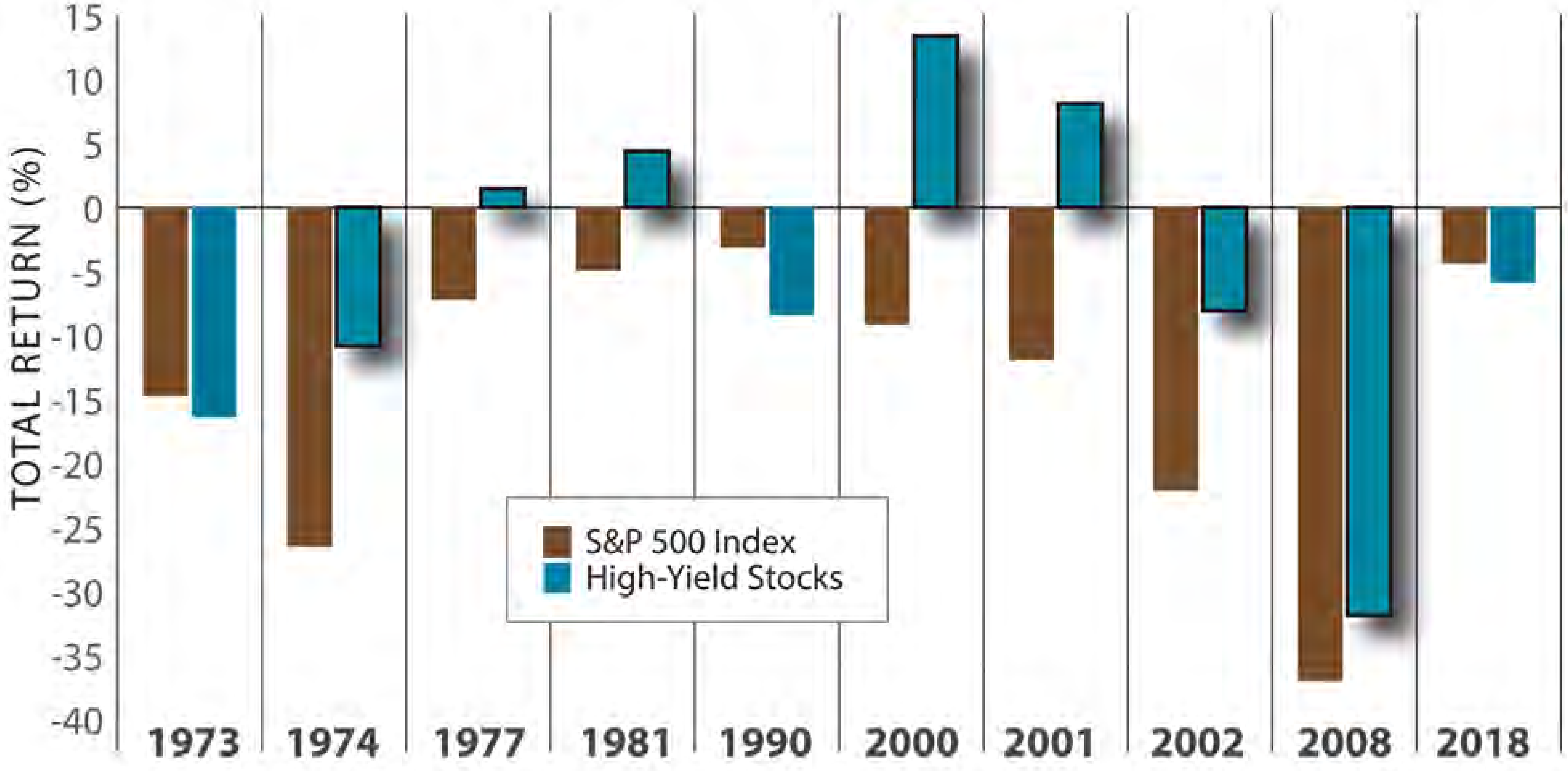
A COVID-19 outbreak in China, in contrast, would present a major hurdle for the global economy. China's "zero-COVID" policy has led to dramatic shutdowns in response to any evidence of new cases. Factories closing in China have reverberated around the world—for example, the current shortage of semiconductors has reduced US auto production.

China's zero-COVID policy has kept case counts low, but that is a mixed blessing because now the Chinese population has little natural immunity. Combined with the use of less efficacious vaccines, China is ill-equipped to face a virus that seems to be evolving to be more contagious. There have been reports that the Chinese government is reconsidering its zero-COVID policy, but for now, a widespread Chinese COVID-19 outbreak remains a key risk that we are monitoring.

Given the risks we have discussed and the market's rocky start to the year, a fair question to ask is, **"How do income stocks perform in down markets?"**

Looking back at the last 50 years, the S&P 500 Index has had 10 down years.

Dividend Stocks in Down Years (1971 -2021)



As of December 31, 2021. Sources: Morningstar Direct; Fama/French Research data library; Miller/Howard Research & Analysis. Based on the rolling 10-year annualized total returns, ending each calendar year. *High-Yield Stocks data are provided by the Fama/French Research data library. The High-Yield Stocks portfolio uses Deciles 7 through 9 of portfolios created by dividend yield (value weighted returns), where 1 is the lowest and 10 is the highest.

High-yield stocks* outperformed the S&P 500 in 70% of the down years, and actually had positive absolute returns 40% of the time. Overall, high-yield stocks outperformed the S&P 500 by almost 9% during the down years.

The fact that high-yield equities have provided better downside protection than the broad market is not a surprise, in our view.

Committing to a regular dividend requires management to feel confident that their business can endure economic or competitive challenges, yet still generate the cash flow needed to make their dividend commitments. Generally, this implies fairly consistent cash flow and a strong balance sheet.

Naturally, some management teams make a commitment when they should not—*that is why fundamental research is required.* But as we showed in our 2Q 2021 Quarterly Report, dividend cuts happen every year but have always been, even in stressful years, outnumbered by dividend increases.

Management teams make a judgment when establishing a regular dividend, sending a useful signal to investors that the company's cash flow should prove to be dependable. **Oftentimes, this same resilience that allows the dividend to continue can provide downside protection in tough markets.**

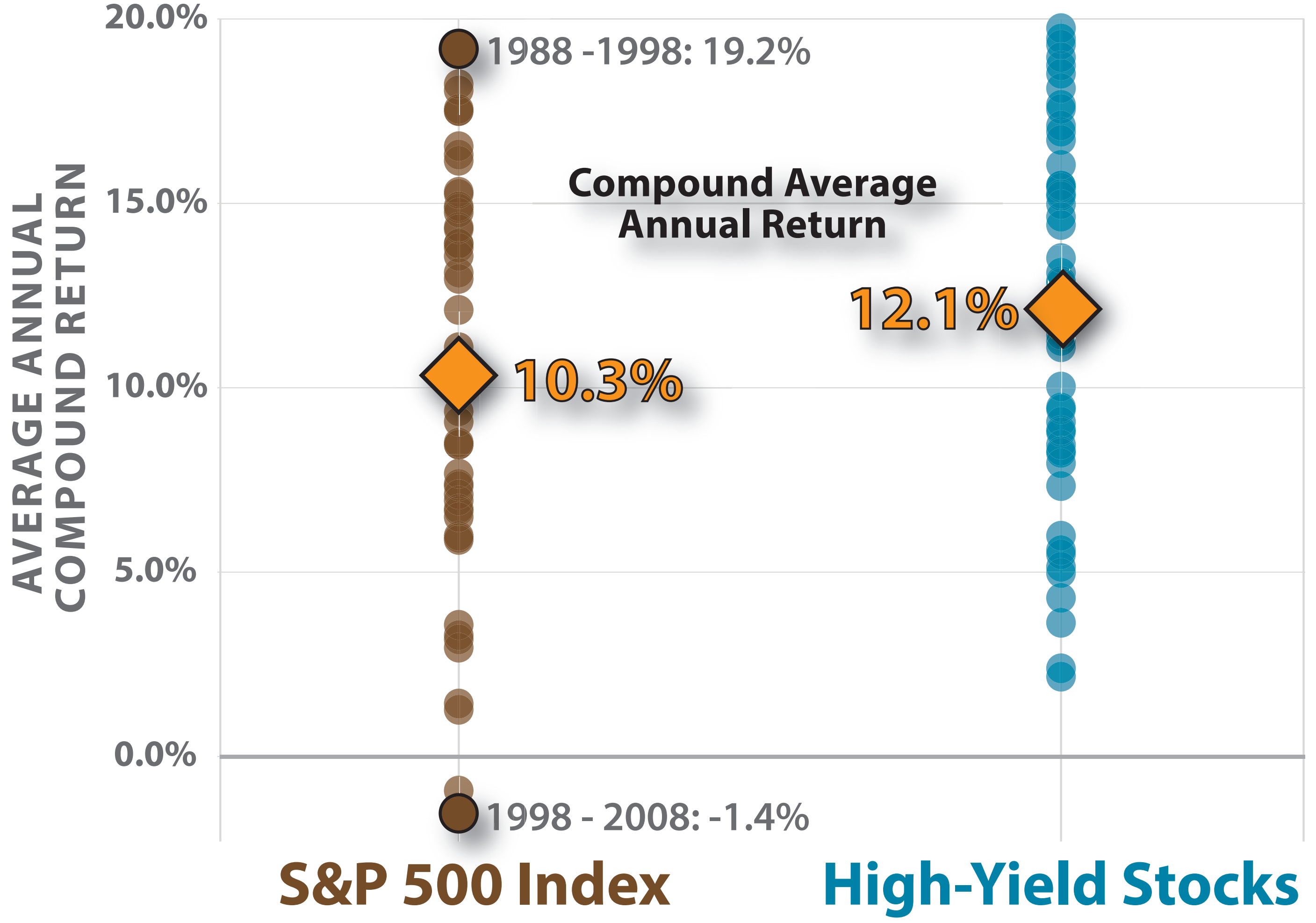
While it's gratifying to know that income stocks tend to outperform in down years, our view continues to be that it's best not to try to time the market. Fluctuations in the overall market are very unpredictable, but **buy-and-hold investors are typically well rewarded.**

Looking at the total return for 10-year holding periods ending over the past 50 years, investors in the S&P 500 saw a compound average annual return of 10.3%.

But **the range of outcomes was large**—with the maximum annual return of 19.2% for the 10-year period ending in 1998 and a -1.4% annual return for the period ending in 2008.

Returns on 10-Year Holding Periods

(1971-2021)



As of December 31, 2021. Sources: Morningstar Direct; Fama/French Research data library; Miller/Howard Research & Analysis. Based on the rolling 10-year annualized total returns. Each dot represents the trailing 10-year annualized total return, ending each calendar year. High-Yield Stocks data are provided by the Fama/French Research data library. The High-Yield Stocks portfolio uses Deciles 7 through 9 of portfolios created by dividend yield (value weighted returns), where 1 is the lowest and 10 is the highest.

High-yield equities have fared better.

The average annual return for high-yield equities held over 10-years was 12.1%, well ahead of the S&P 500 average return.

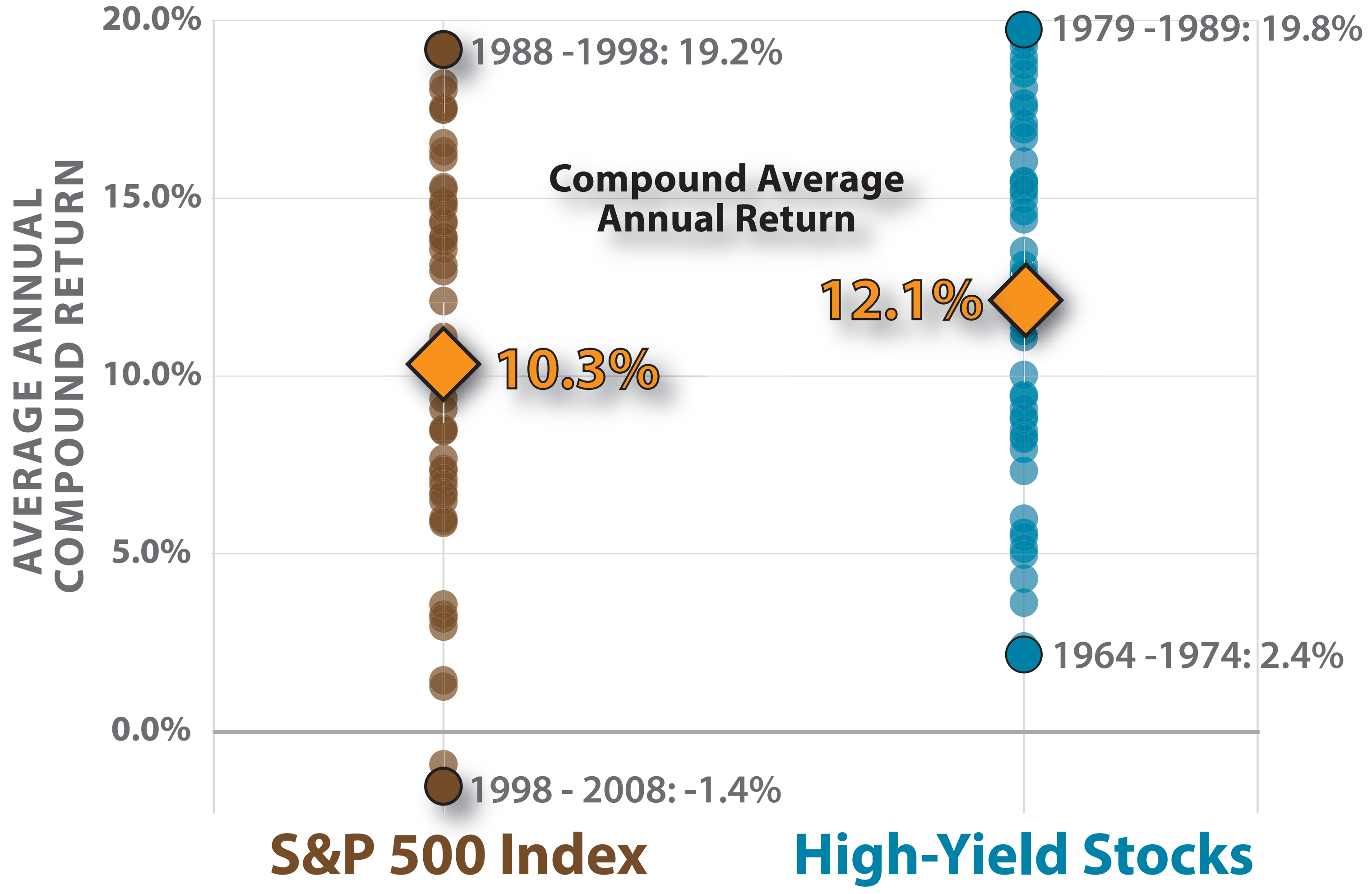
The range of outcomes was also wide with the best 10-year period coming in at 19.8% and the worst period at 2.4%.

While rare, there were two 10-year periods, those ending in 2008 and 2009, in which the S&P 500 produced negative returns.

In contrast, over the last 50 years high-yield equities did not have a single 10-year period with a negative return.

Returns on 10-Year Holding Periods

(1971-2021)



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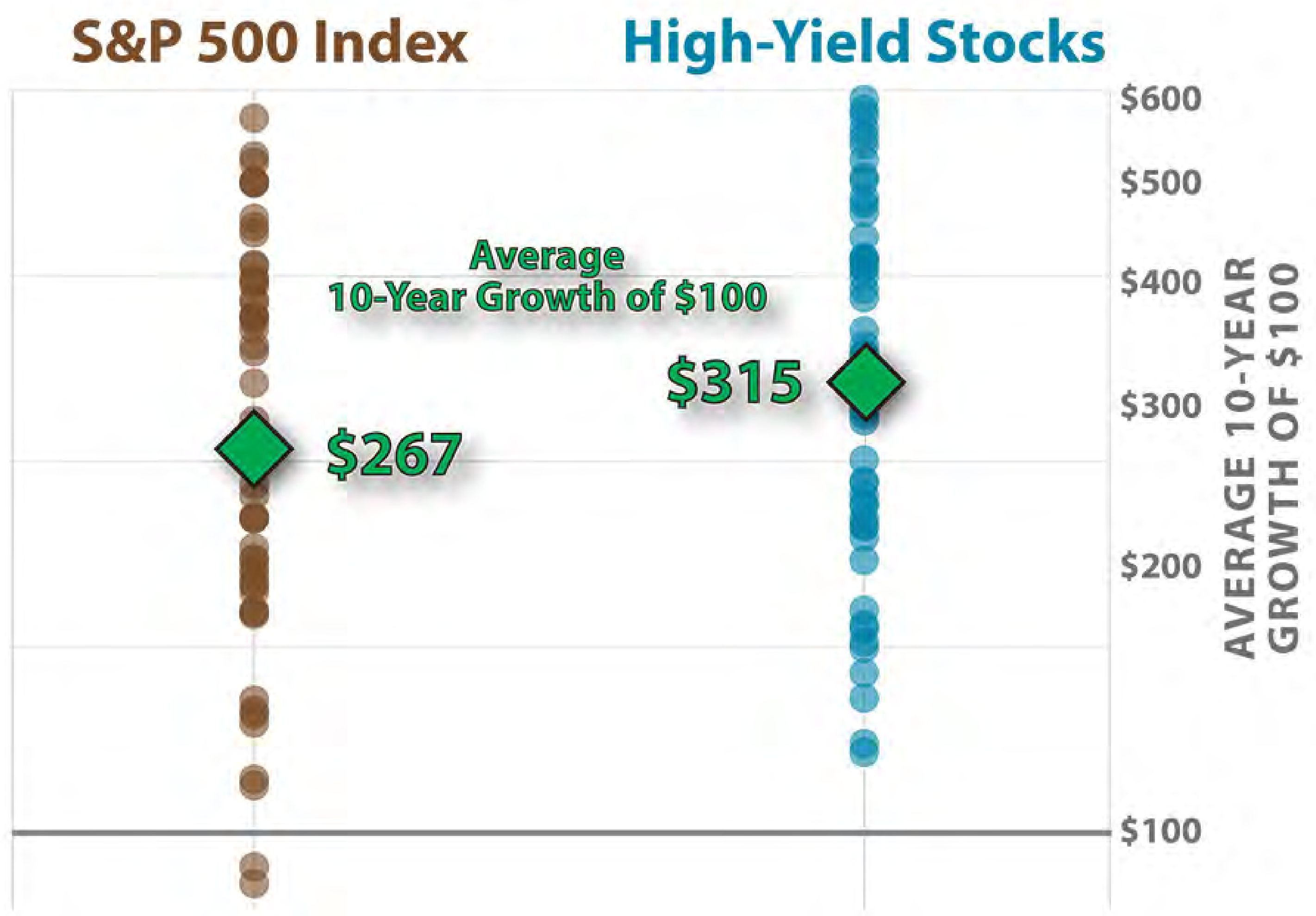
Looking at this chart differently, a $100 investment in the S&P 500 grew to $267 on average over 10 years, whereas high-yield stocks grew to $315.

While results can vary, high-yield equities have historically offered both better downside protection and higher average returns over long holding periods.

To read our 1Q 2022 Quarterly Report, please visit **www.mhinvest.com**

Returns on 10-Year Holding Periods

(1971-2021)



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We continue to evolve and develop strategies that strive to provide investors with various levels of current income and dividend growth. Our objectives are to generate total returns in line with the broad equity market and provide a high and rising stream of income with the lower volatility that an investor might seek from bonds or other income alternatives. With a primary goal of reliable income and long-term returns, coupled with a belief that investors can play an important role in securing a sustainable future, our shareholder advocacy efforts include environmental, social, and governance (ESG) research and/or screening, direct engagement with companies, filing shareholder resolutions, proxy voting, coalition building, and public policy involvement.

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DEFINITIONS: S&P 500 Index® widely regarded as the best single gauge of large-cap US equities and serves as the foundation for a wide range of investment products. The Index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

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