OCTOBER 18, 2022

I. Market Overview

Over the last few years, we have written extensively about Federal Reserve policy and interest rates. In our view, the supply of money (which is controlled by central banks), its ebbs and flows, and the general level of interest rates have had a significant impact on asset prices, especially since the Great Financial Crisis. While central bank policy remains important, we think business fundamentals – actual corporate profits – will garner increased attention.

Why now? Because, in words and actions, the Fed has moved from easy money to tight money. Interest rates have risen dramatically, causing a rapid decline in the prices of financial assets (stocks and bonds around the world). This is no coincidence. Higher interest rates reduce the present value of long-term investments. This is also old news. The yield on the benchmark 10-year U.S. Treasury note started the year at approximately 1.5% and recently touched 4%. The impact of that change has already been felt.

	12/31/2021	9/30/2022	Change
S&P 500 Price*	4,766.18	3,585.62	-24.77%
2022 Earnings Estimate	221.74	221.84	0.05%
Price Earnings Ratio	21.49	16.16	-24.80%

*Index value only. Excludes dividends.

The simplest and most common way to look at the valuation of a stock (or a collection of stocks like the S&P 500 in the above example) is to divide the current price by earnings per share. The result is the "Price Earnings Ratio." Stock price changes result from either a change in earnings or a change in the P/E ratio.

As we can see from the table, the S&P 500 has dropped roughly 25% (excluding dividends) so far this year, while earnings estimates have actually risen a tiny bit. The decline in price is entirely explained by the decline in the P/E ratio. In turn, P/E ratios are heavily influenced by interest rates (as rates rise, P/E ratios typically fall).

Looking ahead, we believe that company earnings will take center stage and will be the more significant determinant of stock prices. We are not alone in believing that corporate profits are likely to be challenged over the next several quarters. Fundamental headwinds are well known. China's zero-Covid policy has made a dent in the global economy. The organization of Economic Cooperation and Development (OECD) estimates that the war in Ukraine has reduced total output by $2.8 trillion. Inflation has begun to undermine consumer confidence and impact corporate profit margins. The unusually strong dollar hurt U.S. companies with global operations and foreign buyers of U.S. goods and services.

As investors and market observers begin to factor in a possible recession, inflation, currency movements, lingering supply-chain issues, and geopolitical risks, we can expect to see some earnings estimates decline. Company specific analysis will become increasingly important. In a challenging economic environment, investors will become more particular about individual stock holdings. Weaker companies with more rapidly falling earnings will be jettisoned in favor of stronger, more resilient businesses.

We believe our portfolio of companies:

- Have resilient earnings in a variety of economic scenarios
- Maintain strong balance sheets relative to cash flow
- Generate excess cash after investing in their core businesses
- Is well positioned to weather, and ultimately benefit from, this difficult environment

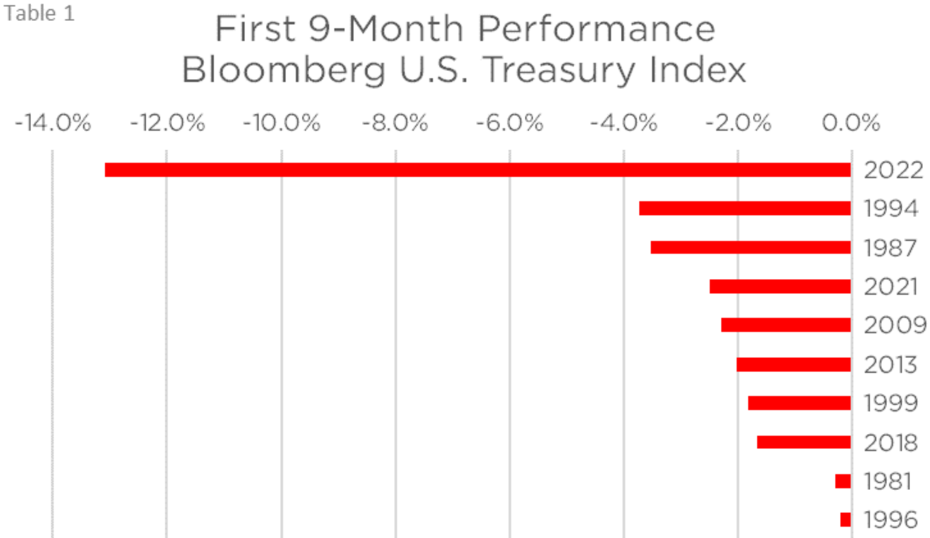
We believe this is an environment that presents careful investors with attractive opportunities. It has been our experience that stronger companies will become even more competitive. The very best will attract more investor interest at the cost of weaker, less established businesses. If markets continue to be volatile, it will be critical to follow three important tenets:

- Know exactly what you are invested in
- Hold on to those companies that are strengthening their competitive positions
- Take advantage of bargains created by emotional or distressed sellers

We will implement this strategy to manage through this bear market and, as importantly, position our portfolios well for the future.

II. Fixed Income Commentary

Table 1



This year marks the worst nine-month start for the Bloomberg U.S. Treasury Index by a wide margin (Table 1) since its inception in 1974. Every area of fixed income has shown significant weakness, from municipal bonds, to U.S. Treasuries and corporate debt. However, the common theme has been that the longer dated a security is, the worse performance has been. For example, the U.S. Treasury issued a note last year with a 11/15/2051 maturity. With the increase in interest rates this year, the note is down over 32%. While the note continues to be backed by the full faith and credit of the U.S. Government, and thus is not likely a credit concern, the mark-to-market in its value has been extreme.

The increase in interest rates is mostly due to investors recalibrating how much the Federal Reserve will have to tighten monetary policy in order to tame volatile inflation figures. At the beginning of the year, markets were predicting that the overnight Fed Funds rate would end 2022 at 0.83%[1]. The current expectation is that the Fed will end its rate-raising campaign at close to 4.50% sometime in early 2023.

This is the steepest Fed tightening in 41 years, and we doubt that raising rates above 4.50% will be necessary to achieve the Federal Reserve's policy goals. This suggests that the worst of the interest rate increases is over.

Our belief that the Fed is almost complete with its rate-rising campaign is not to suggest that there are no longer potential pitfalls ahead. Emerging market and high yield debt still face significant challenges, and while both may cause contagion fears in markets, neither should pose

1 According to the implied overnight rate for the U.S. futures model tracked by Bloomberg.

a systemic risk. For bond investors, we continue to preach knowing what one owns via individual securities, while focusing on quality and matching maturities to meet spending needs.

III. Equity Market Commentary

The market – commentators and investors – often treat the large technology companies (like Apple, Microsoft, Amazon, Meta and Alphabet) as if they are one monolithic entity, referring to them in shorthand as "Big Tech" or by the acronym FAAMG (which is more accurately MAAMA after Facebook changed its name to Meta and Google to Alphabet). Although these stocks are widely held by investors, this group treatment means that the fundamentals and prospects of the individual businesses can be overlooked.

Take for instance, Alphabet nee Google. Alphabet's primary business, paid search, remains one of the best businesses we've come across, with high incremental margins and a winner-take-all market structure. While it has matured, it continues to grow at a double-digit rate.

But Alphabet is no longer a one-trick-pony. YouTube is now a $30 billion revenue business, recently growing 10%-15% per year. We couldn't help but notice the ubiquity of YouTube a few weeks back when in the morning we tuned into YouTube for Volvo's debut of its next generation DX safety platform and then returned to YouTube in the afternoon for the livestream of Jerome Powell's Federal Open Market Committee press conference.

And the list of other promising large-scale businesses within Alphabet goes on. Google Cloud is the third largest cloud platform in the U.S., with annualized revenue in excess of $30 billion, growing at better than 30% per year. The Android operating system powers almost 70% of smartphones globally. And Waymo, Alphabet's autonomous driving unit, logged 2.3 million autonomous test miles in 2021, more than half of all miles logged in the state by all manufacturers combined according to California DMV data.

We think the case is clear that Alphabet is a better than average business, and it definitely has a better than average balance sheet, with over $100 billion of net cash (cash minus debt). However, at quarter end, Alphabet traded at a very average valuation. In fact, Alphabet traded at 16 times consensus estimates for 2023 earnings, slightly below the 25-year average forward P/E for the S&P 500. We believe that, over the coming years, Alphabet is likely to grow earnings at a better than average rate and deserves a better than average valuation. The result should be a better than average return for investors.

IV. Personal Finance

Recently, we were reminded of an important tax provision for those who make charitable gifts. In her July 22 WSJ column, Laura Saunders reported on the case of a taxpayer who was denied her claimed charitable deduction of $464,000(!) because she did not have the proper acknowledgment from the recipient stating if any goods or services were received in return. The code states that this acknowledgment needs to be in the taxpayer's hands before filing the return. The IRS did not dispute – nor did the court - that the taxpayer made the gift; it did not dispute the value of that gift; it did not dispute that indeed no goods or services were received by the donor. It did not disagree that the museum was willing to provide the properly worded acknowledgment post-facto. But the deduction was nonetheless denied as the taxpayer did not abide by the strict letter of the law.

As we enter the quarter when many charitable gifts are made, we gently remind you to ask for a properly worded acknowledgment that specifies the value of the donation and indicates if any goods or services were received, and their value if they were received – even if the gift is made to a private foundation. Also, if property is being donated, it is critical to have a contemporaneous third-party professional appraisal. This is another technicality that the IRS will likely not forgive, even if you substantiate the value at a later date. And, of course, don't forget that despite this year's drop, you likely still hold securities that have appreciated significantly since their original purchases; for many people gifting these securities instead of cash can be beneficial. As with all tax reminders, please consult with your tax professional about your own individual circumstances. We are happy to work with you and your tax professional to determine what we believe would be the most efficient way to make a charitable gift.

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