January 17, 2023

Quarter Ending December 31, 2022

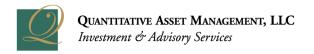
Quarterly Performance	Q4 Index	YTD	Close
Dow Jones Industrial Average	15.4%	-8.8%	33,147.25
NASDAQ Composite Price	7.1%	-33.1%	10,466.88
Standard & Poor's Averages	-1.0%	-19.4%	3,839.50

As we mentioned in our Q3 letter, broad-based market volatility continued into the 4th quarter of 2022 with both stock and bond markets suffering significant setbacks. Market volatility was driven by investor concerns over rapidly rising interest rates, inflation, geopolitical uncertainties, and the possibility of a recession. The S&P 500 index finished down 19.4% and the Barclays Bond Index ended the year down 13%. One of the worst performing indexes was the heavily tech weighted NASDAQ, which finished the year down 33.1%.

2022 will be remembered not only for the severity of losses, but also for their breadth. 2022 is the first year since the 1870s that both US stocks and long-term bonds fell more than 10%. And for only the third time since 1926, both U.S. stocks and bonds lost money in 2022 (the other two occurrences were 1931 and 1969). U.S. Treasury 10-year notes, which are AAA-rated and fully guaranteed by the U.S. government, returned -16%, the worst return on record. The only two broad based sectors that generated positive returns were: energy and utilities. The only "safe haven" was to be sitting in cash.

While there were other factors involved, when it came to market performance and investment returns in 2022, there was one clear dominant force driving the markets, inflation. Since 2020, the financial markets and U.S. economy have been chugging along on all cylinders. Some of the success happened organically; however, things were kicked into overdrive by the \$5 trillion dollars in stimulus injected into the economy by the Federal Reserve (but this, of course, excludes the tens of trillions of monetary stimuli injected by other central banks). This excess liquidity needed to find a home and pushed the economy, prices, and valuations to unsustainable levels. During the quarter, inflation surged to its highest level since 1981.

In a desperate attempt to reverse rising prices, the Federal Reserve has been dramatically increasing interest rates. By raising rates, the Fed is intent on reducing the money supply and slowing down the economy. The Fed's directive and course of action, based upon economic data, is very counter intuitive. "Good news" or positive economic data is now viewed as bad news for investors. For example, the US Government released stronger than expected job/payroll numbers in December. In a normal economic cycle, this would be viewed as good news, pointing to a strong vibrant economy. However, today, strong economic news confirms to the Fed that they need to continue with tightening monetary policy. In



reality, the Fed is forcefully trying to slow down the economy in order to get inflation under control. To compound the inflation problem, the Federal Reserve is having to raise interest rates during an economic slowdown, which could lead the U.S. economy into a deeper recession.

Although not perfect, there is a very high correlation between stock prices and the direction of Fed policy. Easy Fed policy, including lower interest rates and quantitative easing, tends to correlate with higher stock prices. Former Fed Chair Ben Bernanke stated, "Easier monetary policy, for example, raises stock prices. Higher stock prices increase the wealth of households, prompting consumers to spend more – a result known as the wealth effect." Equally important, higher rates and quantitative tightening have been associated with lower stock prices. There were some extenuating circumstances that added to the market crash of 2008; however, the last cycle of Fed policy tightening was 2005-2007.

Moving forward, we expect to see more volatility. The U.S. economy is showing some signs of slowing as recent data indicates declining industrial production and a contraction in manufacturing, services, and retail sales. With a slowing economy, we should also expect to see unemployment numbers rise.

Our long-term value-based investing approach has stood up relatively well during these volatile times. Focusing on valuations and fundamentals has allowed us to avoid some of the major market pitfalls experienced by the broad-based markets. Remember, when it comes to investing, market volatility cannot be completely avoided, but it can be mitigated.

We will leave you with some good news for the broad-based markets. Statistics show that two consecutive down years are rare for major equity markets. The S&P 500 index has fallen for two straight years on just four occasions since 1928, and they usually coincide with major market events (Great Depression, World War II, the 1970s oil crisis, and dot-com bubble). While we don't anticipate any systemic events taking place, we also don't see 2023 producing outsized returns.

We wish you a happy and healthy New Year, and if you have any questions or thoughts, please reach out to us!

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