January 11, 2023

To reach a port we must sail, sometimes with the wind, and sometimes against it. But we must not drift or lie at anchor.

\- Oliver Wendell Holmes Sr.

Dear Clients:

We think we can all agree that 2022 is a year better left in the rearview mirror.

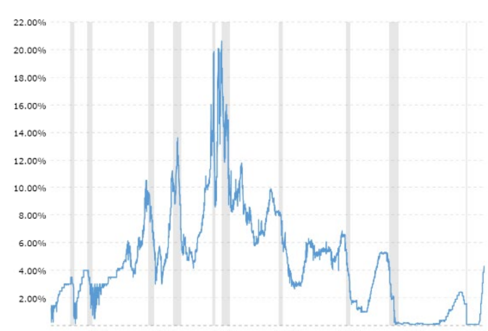
Negative headlines dominated the news cycle. While there was plenty of positive economic data, it seemed to move markets in the opposite direction one would expect. With robust job growth, historically low unemployment, a surge in corporate earnings and S&P 500 companies delivering record dividends to shareholders, investors cared about only one thing: how high would the Federal Reserve drive interest rates.

At the close of 2021 we expected company earnings to continue to grow, firms' balance sheets to remain strong, and consumer activity to persist buoyed by the strength of labor markets. We also believed caution was advised given the exaggerated valuations of many asset classes. While these expectations proved correct, the aggressive action taken by the Federal Reserve provided headwinds that were all but impossible to overcome. From U.S. to international stocks, large cap to small cap equities, corporate to municipals bonds, high yield to TIPS, real estate to precious metals, most asset classes had negative returns for the year. Commodities proved to be the sole exception on an inflation adjusted basis. However, timing was key, as those returns came in the first six months of the year.

2022 was particularly cruel to those investors who were exposed to the most speculative of investments – yet to be profitable growth companies (NASDAQ Index -32.5%), startups (IPO –57%), and cryptocurrencies (Bitcoin -65%). Those areas of the market were particularly sensitive to rising rates, as capital became more difficult to access and more costly when available. As a result, many investors who looked brilliant at the end of 2021 where particularly humbled by the end of 2022.

Ironically, the turmoil the Federal Reserve created in 2022 by raising interest rates is merely returning the world to a more "normal" investment environment – one we have not seen since the Great Financial Crisis. As depicted below, the average Fed Funds rate from 1963-2008 was over 4%.

Federal Funds Rate



Source: Macrotrends

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With higher interest rates and moderating inflation, investors should once again be able to earn a real inflation-adjusted return on fixed income. With cost of capital rising for companies, their managements are likely to be more thoughtful in its allocation. Strong stewardship of capital is a quality that we seek as it often results in superior earnings over time.

We would expect this normalization of interest rates to broaden investment opportunities. When Fed Funds were at 0%, the investment mantra was TINA (there is no alternative [to stocks]). With those rates over 4%, investors can consider cash, bonds, as well as stocks. The result requires investors to be far more selective in their investment decisions. There are likely to be casualties from this higher cost of capital as companies without strong balance sheets or thoughtful capital structures will face challenges. However, businesses who have been prudent with their finances will have opportunities to capture market share as their competitors are forced to retrench. Moreover, it is likely that earnings will play a larger role in companies' valuations as multiple expansion is typically more muted in higher interest rate environments.

The course from an overly accommodative monetary policy to that which resembles a far more traditional one is never direct. In 2022 we saw many of those adjustments play out as the Federal Reserve tightened fiscal conditions rapidly. How much more the Fed has instore is unknown. It is likely the most significant policy changes are behind us. However, this does not mean the all the storm clouds have parted. With a slowing economy and the risk to earnings that may accompany it, we would expect that careful stock selection, diligent research, strong management acumen, and superior capital structures will be invaluable. We have navigated these turbulent seas many times over our 50 years without losing sight of our destination, which is your financial success.

We wish you a healthy, happy and prosperous 2023!

Sincerely,

The Partners of CANNELL & CO.