CANNELL &CO.

July 11, 2023

The more I learn, the more I realize how much I don't know.

-Albert Einstein

Dear Clients:

Wall Street is a humbling place. Just when one thinks they know what is likely to occur, the opposite happens. History is littered with the prognostications of market gurus that are just plain incorrect. It would be reasonable to expect that the empirical data of these failed predictions would temper the certainty of those forecasts. Unfortunately, just read a newspaper or turn to any business channel on TV and you can take your pick of the prediction de jure, many of which may prove unprofitable. One often wishes that they were as self-aware as Albert Einstein.

The market's performance during the first half of 2023 was a prime example of actual outcomes flying in the face of expectations. As we discussed in last quarter's letter, the first three months of the year were highly volatile mostly due to governments continued tightening of financial conditions and the associated failure of certain banking institutions. That markets would end the quarter in positive territory was thought to be unlikely at 2022's close or during the regional bank crisis.

The predictions of a looming recession grew louder in the second quarter. Rising interest rates and the tepid post-covid Chinese recovery were just two of the headwinds that pundits sighted in their call for caution. In contrast to the many calling for a recession, there were others who saw investing salvation in the form of Artificial Intelligence (AI). With predictions of productivity gains associated with the universal integration of AI into our daily lives, the equity rally gained steam during the quarter lead by ever higher tech valuations.

Why are so many "experts" seemingly proven incorrect right after their predictions are aired? The simple answer is that the information from which they are building their forecast is often conflicting. Moreover, we all bring biases to the table that influence our view. By way of example, let's look at two of the major issues that are currently confounding professional investors.

As we have discussed before, the tightening of global credit to combat inflation has been *the* major story for the financial markets for last 18 months. There are expected outcomes. For instance, typically, when interest rates rise, businesses and individuals cut back on acquiring big ticket items for which they need to borrow. Simply, these goods become too expensive when factoring in the burden of the higher financing cost. Two prime examples are home purchases and cars sales. In turn, business sectors see a slowdown in sales and respond by laying off employees. Often labor reduction in these sectors can help push an economy into recession or at least cool it. In this current cycle, this expected outcome has not occurred. In the early part of 2023, builders, architects, engineers, real-estate agents, and vehicle manufactures have increased employment (WSJ 7/1/23). While the structural imbalances of the post-pandemic economy have driven this outcome, the result is that the forecasts for an expected recession continued to be pushed out as

545 Madison Avenue, 11th floor, New York, NY 10022, United States ■ +1 (212) 752 5255 ■ cannellco.com

the labor market stays resilient. And while one should not expect this strong employment to remain indefinitely, it has left many of the loudest doomsayers appearing to be incorrect. Alternately, there are those who have been trumpeting the new bull market. While a superficial examination of the market indexes could lead to this conclusion, closer examination tells a much different story. Again, this is something we touched on in last quarters letter.

The equity market indexes in 2023 have continued to be pulled along by some very outsized gains in a relatively few names. Mega-cap technology-oriented companies road the tailwind of AI euphoria to account for an ever larger percentage of the market (as of the writing of this letter, they represent almost 30% of the S&P 500 Index). In contrast, the broader market reflects a modest environment where many stocks, small caps in particular, have barely risen.

Cannell & Co. has always understood how much we do not know – trying to predict the future is a fool's errand. It is why we build portfolios from the bottom up, focusing on the value of each company in which we seek to invest relative to its price, the quality of its management, its competition, and prospects. This approach allows us to avoid being either too pessimistic or too optimistic. For example, we maintained our investment discipline and your allocation to equities in the face of all the stresses of the second quarter (rising interest rates, recession fears, the debt ceiling negotiations, and geo-political anxieties). Simultaneously, we control our exposure to different sectors of the economy. This allows us to benefit from new and exciting business opportunities but reduces our potential risk from the current market darlings (currently AI), understanding that investor enthusiasm can be fickle.

Over the past 50 years, we have witnessed a wide array of market conditions, from the most ominous to the ridiculously euphoric. There are parallels that can be drawn between the current market environment and past ones which may be instructive (the overweight percentage of mega-cap technology companies is reminiscent of the energy companies' dominance in the market at the start of the 1980's). These patterns certainly inform us and help guide us in our decision making. However, they do not have the final say. We will always return to fundamentals of a company's performance with the humility that we cannot predict the future.

The current environment continues to warrant caution. There are reasons to expect a slow down in the economy given the more difficult credit environment. We also see forces at work that will continue to provide a tailwind to the stock market. However, predicting which will be the stronger influence is nearly impossible. Therefore, we will maintain our diligent research efforts and watch our companies closely. For those clients who need more security, the rising interest rate environment has made it reasonable to use fixed income as an asset class than can hedge the likely volatility in stocks. Please reach out to us if you would like to review the allocation of your account.

Thank you for your continued trust. We maintain our commitment to you and your families.

The partners of CANNELL & CO.