QUARTERLY LETTER, JANUARY 2023

Fellow Investors,

2022 was the year inflation ended ultra-low interest rates. Inflation, as measured by the U.S. Consumer Price Index (CPI), began the year at 7.0% and was still at 7.1% in November, having peaked at 9.1% in June. The ongoing high levels of inflation prompted the U.S. Federal Reserve to reduce the assets on their balance sheet and to raise their target for the Federal Funds Rate (the interest rate at which the Fed makes short duration loans to banks) beginning in March. As a result, assets held by the Fed at year end sum to $8.56 trillion, down 4.5% from the April peak of $8.96 trillion while the Federal Funds Target Rate increased from .25% at the beginning of the year to 4.25% at the end of the year. Other interest rates similarly moved higher, with the yield on 2-year treasuries moving from .73% at the start of the year to 4.33% at year's end, the yield on the 10-year treasury bond moving from 1.49% at the start of the year to 3.84% at the end of the year and conforming 30-year mortgage rates moving from 3.3% at the beginning of the year to 6.57% at the end of the year. The Fed's goal in raising interest rates and pulling cash out of the banking system by shrinking their balance sheet was to reduce demand for goods and services and thus reduce prices.

To an extent they are succeeding. In the housing market, for instance, new homes sold in November were 640,000 (Source: U.S. Census Bureau), about the same level as March 2020 and median new home prices in November are down about 3% from their October peak. Essentially the housing industry is in a recession as buyers have become scarce. Rising interest rates also popped the bubbles in cryptocurrencies and profitless tech companies, kicked off a bear market in the broader U.S. stock indices, and resulted in losses of between 13% and 18% in bonds, with high-yield bonds losing less than government bonds. It's been a long time since both stocks and bonds declined simultaneously and anyone who was counting on their bond portfolio to offset declines in their stock portfolio was disappointed this year.

Throughout the year we talked about four other changes that we thought would be meaningful and we should keep an eye on. We'll discuss each of them briefly below, but the summary is that none of them created a crisis that disrupted global financial markets in 2022.

China continues to struggle due to the collapse of their housing industry and the economic impact of their "Zero COVID" policy. The recent end of that policy has coincided with a wave of COVID infections which will probably disrupt their economy for a while as workers stay home to recover from the illness. Will this create a new round of global supply chain disruptions? We're not sure, but it could. We continue to keep an eye on China.

European countries continue to work through the energy problems created by the Russia-Ukraine War, and so far they are managing better than we expected they would. Other than a hiccup in the UK bond market in the 3rd quarter nothing happened in Europe that impacted the global financial markets. So far so good.

Foreign currency turbulence caused by rising U.S. interest rates has been sporadic. The Bank of Japan has been controlling the yield on government bonds as part of an inflationary policy. Rising U.S. interest rates made dollars more attractive to Japanese investors than yen and we saw a rapid decline in the value of the yen versus the dollar. In response, the Bank of Japan has intervened in currency markets at least once and has raised the upper limit on the yield of the 10-year Japanese Government Bond from .25% to .50%. If Japan ended its yield-curve control and interest rates in Japan became economic again, it could trigger a sizeable move in currencies as Japanese investors repatriated overseas money. It hasn't happened yet, but the possibility remains.

Finally, there are ongoing efforts to diversify global trade out of the dollar and into other currencies. Russia is now selling energy in rubles and Saudi Arabia is selling oil in the Japanese yen, so to a small degree it is happening. Will these sorts of trades grow in size and frequency and start to impact the value of the dollar? Perhaps, but it isn't certain.

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That pretty well covers what happened in 2022 and provides an update on our major concerns for the year. As we look forward to 2023, we think there are three important questions:

- Will inflation remain high? If so, how high will it be?
- Will the U.S. enter a recession? If so, how bad will it be?
- Will a financial crisis erupt that prompts the Federal Reserve to drop interest rates and perhaps restart quantitative easing in response? If so, will this cause inflation to run up again?

Here is the concise version of our thoughts on these questions:

- Inflation is likely to remain higher than the last decade, probably on the order of 4-5%.
- The U.S. is likely to enter a recession in 2023, we don't really have an estimate regarding how deep it might be.
- It is possible that a crisis of some sort erupts that prompts a Fed response—interest rates are rising globally and typically higher interest rates create problems for shakier borrowers.

Here's the longer version:

While inflation is measured as an increase in prices, we view it as a decline in the purchasing power of the dollar. We think it is mostly caused by an increase in the supply of money greater than the simultaneous increase in supply of goods and services coupled with stability or an increase in the velocity of money—this is largely Milton Friedman's thinking on the matter. We also think feedback loops play an important role in continuing inflation. In the '70s, economists talked about the wage-price spiral. We observe that such a feedback loop is likely to operate again in '23 as workers continue to demand higher wages based on price increases they saw in '22. As an example, Social Security benefits increased by 9% in January 2023 due to inflation in '22. I suspect most government employees will see similar wage increases. Higher wages will prompt companies to try to increase prices to maintain their margins—to the degree they are successful, you will get a positive feedback loop driving prices and wages higher. Additionally, we also note that in the late '70s and early '80s it took more than just Fed action under Paul Volcker to bring inflation down—regulatory change was also necessary to free up the productive capacity of the economy. We don't see similar de-regulation initiatives today, in fact, we see the reverse. Finally, it is likely that either a recession or a financial crisis, or both, forces a change in Federal Reserve Policy before inflation is back down to the 2% Fed target. This has been our view for about six months, we hold it lightly, and stand ready to change our minds if we start to see events unfold differently than we currently expect.

Our portfolio reflects that view of the immediate future. We continue to hold unusual amounts of cash as markets have not priced in a recession, a crisis, or higher inflation for a long period of time. We have significant investments in energy companies both because of the investment cycle of the energy industry and because commodities often do well in inflationary environments. Our health care investments should be relatively indifferent to a recession in terms of their revenues and earnings. We also note that for the first time in a decade money market funds generate a significant yield—currently a little over 4%-–making them an attractive cash alternative. We continue to look for good companies at bargain prices and will put our cash to work when we find them.

As always, if you have questions or comments, write or give us a call. We'd love to hear from you.

With our best wishes for your continued success and good health in the New Year.

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***CPI** – The Consumer Price Index ("CPI") measures the average change in prices over time that consumers pay for a basket of goods and services, commonly known as inflation. One cannot invest directly in an index.*

The comments made in this letter are opinions and are not intended to be investment advice or a forecast of future events.