

July 13, 2022

The 2nd Quarter of 2022 firmly pushed markets into Bear Market territory. With the S&P 500 scoring its worst first six months of a calendar year since the early 1970s, Carderock stocks are down (-25%) on average. At this stage, Quality's virtues in moderating stock declines have yet to show their mettle – but they will. We strongly believe the companies we invest in will remain buoyant and come out on the other side intact and positioned to do well in the next cycle. In the meantime, the Federal Reserve's rate increases have crunched the resilience of bond values such that a portfolio balanced with a 55%-35%-10% (Stock-Bond-Cash) allocation fell approximately (-15%). This, too, will pass.

Unlike the “Pandemic Panic” of March 2020, there will be no rush of fiscal or monetary support headed our way, leaving investors largely dependent on the mix of their wits and patience to ride it out. Many suggest the Fed's narrowly reactive stance will fail, ending either with a shift to a more broadly grounded approach, or as history and the data suggest, cause a recession. In either case, the likelihood is that higher rates embed additional costs, cut growth, and prove ineffective at curbing supply-chain related inflation. Given this prospect, we see the glimmer of a silver lining in a few places:

- **Markets-** Speculation has been curtailed, and capital is being utilized more efficiently.
- **Technology-** Decades long advancements in processing speed have sown the seeds for high-level automation and artificial intelligence, which will boost productivity.
- **Labor-** Participation and wage growth remain strong, though re-training in certain segments of the economy will take time.
- **Production-** Logistical and supply constraints are easing, with high inventories stimulating price cuts.
- **Policy-** Infrastructure upgrades incenting investment over financialization will spark growth in new industries.

Furthermore, we believe we are getting closer to a turn in the markets, and our investment strategy focus is on the following:

Stocks

- The first half of the year saw narrow leadership in stocks, with Energy the only positive sector year to date.
- Shares of Quality Growth have been disproportionately punished relative to their strong future prospects. We expect a very robust recovery.
- We continue to rebalance toward a more even-weighted portfolio, capturing losses to offset heavy realization of gains earlier in the year.
- While the bulk of our stock positions remain intact, we will add a few new positions as trends shift and develop in the next economic cycle.
- The bottom line is that with 30% cash reserves, we have a store for defenses and ultimate redeployment, as rebounds inevitably comes more rapidly than expected.

Fixed Income

- Bonds prices fell in tandem with stocks as the Fed aggressively hiked interest rates during a period of slower economic growth.
- With a flat yield curve, short maturities offer attractive values.
- Similarly, municipals offer compelling returns relative to taxable bonds of similar maturities.

While it has undoubtedly been a rough start to the year, we remain optimistic that a turn is in the offing, and U.S. Growth stocks will once again prove out. Good times do in fact follow bad, and sure as we're currently being tested, the best fruits of recovery will accrue to those who remain invested, and continue their participation.

As always, feel free to give us a call to discuss any changes in your objectives, circumstances or with any questions you may have.

Warmest Regards,



Daniel A. Kane, CFA
President



James W. Mersereau, CFA
Portfolio Manager



Stephen F. Knapp, CFA
Director of Research and Quantitative Strategies

In compliance with Rule 204-2(a) of the Investment Advisors Act of 1940, we hereby offer our current Form ADV Part II as filed with the Securities and Exchange Commission through notice of its public posting on our website (www.carderockcapital.com). The Securities Exchange Commission's Investment Adviser Public Disclosure database can be accessed at their website (www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_Search.aspx). With reference to Rule 206(4)-2 Carderock urges you to compare the information on your statement with the statements received from your custodian. Please call if you have any questions.

Random Gleanings

“In contrast to the strong form of the efficient market hypothesis, money is not humanity’s best subject. The story of investing is the story of people coping, or trying to cope, through cycles. We over do it and are bullish at the top and bearish at the bottom. We’ve conducted ourselves this way under the gold standard, the gold-exchange standard, likely the Babylonian barley-cum-silver standard, and unsurprisingly are doing no better under today’s fancy Ph.D.’s Improv Standard.” James Grant, “*Leaving the hall of mirrors*”, **Grant’s Interest Rate Observer**, June 24th.

“U.S. gasoline consumption peaked in the years before the pandemic and now runs 5% below those levels. You might think that reduced demand, and the prospect of further future declines would put downward pressure on prices, and over the long run it often does. But along the way reduced incentives to invest in productive capacity and other factors can lead to some interesting dynamics. Shutting down production capacity and distribution networks too fast or in the wrong places is a sure path to price hikes amid declining demand. Consumers late in making the switch to alternatives will surely feel the squeeze.” Justin Fox, “*The Decline of Fossil Fuels Is Going to Be Expensive*”, **Bloomberg**, June 27th.

“Inflation is well above target everywhere. As in the 1970s, this is in part due to one-off shocks where the most important danger is that inflation becomes embedded in expectations and in economies as before. Much as our economies are more flexible now than in the 1970s, the upsurge in protectionism may lead to a reversal. Energy intensity has certainly fallen, too; but energy prices are still important. Much as fiscal policy is expected to be less expansionary this round, much depends on what policymakers actually do, and whether they can avoid the 1970’s mistake of allowing inflation to get out of control. They still have time to do this, but acting decisively creates dangers of an unnecessarily sharp slowdown, with the economic costs that could follow.” Martin Wolf, “*Policy Errors of the 1970s echo in our times*”, **Financial Times**, June 14th.

“From the peak of last November, Bitcoin and it’s like have lost between 70% and 90% of their value. Studies suggest 90% of these cryptocurrencies were a scams of one sort or another. But perhaps the most important point is that none actually meet the test as currencies. They fail to serve as units of account, a scalable means of payment, a store of value, or even enable a wide range of transactions. In contrast to Visa and Mastercard that offer endless transactions, Bitcoin permits only 7 transactions per cycle; goes up and down 10to 20% in value overnight; and can’t even be used to pay for attendance at crypto’s own conferences. And since every good or service seems to have its own favored token, it’s like going back to barter!” Stephanie Flanders, “*A Conversation with Nouriel Roubini*”, **Stephanomics**, Bloomberg, July 7th.

“The moving parts that are affected by putting up interest rates alone are not the ones many economists expect. While they’re not going to attenuate investment or consumption; they are going to cause a collapse in credit which will cause a downturn. Yet prices will likely continue rising because it is the costs of production which are being squeezed by all the supply chain issues together with the rising cost of energy and so on. And since that will probably get worse, we’ll likely end up with both higher interest rates and high inflation.” Steve Keen, “*How long before central banks realize they are making a big mistake?*”, **The Debunking Economics Podcast**, July 4th.