CARDEROCK
CAPITAL® MANAGEMENT, INC.

October 11, 2023

After a positive month in July, the Stock Market gave back its gains and then some over the last few weeks as interest rates rose to levels not seen since the Great Financial Crisis in 2008. With mortgage rates above 7% and Oil prices climbing 15% during the quarter in conjunction with employment gains and solid consumer spending, investors continue to worry about the Federal Reserve keeping interest rates higher for much longer than expected just a few short months ago. As a result, both stock and bond values fell during the period.

Since the Federal Reserve started raising rates in 2022 off a zero-bound level, the magnitude and speed of this interest rate cycle has been unprecedented. As a result, an extremely narrow range of Stocks has kept markets afloat. The largest seven companies measured by market capitalization have averaged a year-to-date total return of 92%, while the remaining 493 Stocks in the S&P 500 Index averaged only 0.1% for the same period. Therefore, Carderock's Quality Growth stocks unsurprisingly have continued to underperform. And while many of our holdings have broadly been shunned during this high inflationary period, we believe market breadth and diversified portfolios will come back in favor as downtrodden sectors rebound, interest rates stabilize and wage growth moderates.

In our view, "Growth with low inflation" is not out of reach heading into 2024 as Labor markets remain strong, Capital spending has boosted our long dormant industrial sector and China's slowing economy should keep prices subdued. While structural challenges remain in the U.S., we are optimistic that the benefits of current capital investment will accrue throughout the economy, and to our Quality Growth companies as well.

Our recent activity can be summarized accordingly:

- Cash reserve targets stand at 12.5% - close to historical norms and inside our Risk Management midpoint.
- Stocks purchases have brought Cash Reserves down from nearly 40% in 2022.
- We have added new names in the Healthcare and Industrial sectors, as we see a turnaround starting to form.
- We continue to vigilantly allocate excess cash into Treasury bills with short-term rates remaining attractive.

For the remainder of the year and beyond, we are focused on and will respond accordingly to the following factors:

- Stocks generally fare well following the last Federal Reserve rate hike.
- Current selloffs represent attractive buying opportunities.
- Economic growth continues unabated despite the Federal Reserve's best efforts at slowing things down.
- Broad unionization has put a floor underneath Labor, making it unlikely high interest rates will lead to higher unemployment.
- Investment in capital intensive, productivity enhancing projects will take precedent over financial engineering (e.g., stock buybacks, speculation and IPOs) to enhance shareholder value.
- The narrative on Artificial Intelligence has been the primary driver of Stocks in 2023, but its promise of enhancing profitability is unproven thus far.

Finally, we highly encourage you to view your 2023 realized capital gains shown on page two in the report section or on your Schwab monthly statement. On average, these gains are much less compared to 2022 which may affect your 4th Quarter estimated tax payment. Please check with your tax advisor to confirm.

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

Warmest Regards,

Dan | Skip | Stephen

Daniel A. Kane, CFA President	James W. Mersereau, CFA Portfolio Manager	Stephen F. Knapp, CFA Director of Research

Random Gleanings

"The Federal Reserve's hawks have been back on the speaking circuit, and markets are abuzz that rates may have to move higher than previously expected. What is missed is the fact that a lot of tightening has already happened since the Fed's last rate hike. The average for a 30-year fixed-rate mortgage has climbed to 7.31% from 6.78% in July and is now the highest since 2000. Policymakers must bear in mind all of the de facto tightening that has already occurred. Ultimately, they should continue to wait cautiously and see how far this recent bout of passive tightening will carry them." Jonathan Levin, "*Jamie Dimon's 7% Rates May Come Even Without the Fed's Help*", **Bloomberg,** September 29th, 2023.

"It looks as though China's unbalanced economy is now being stopped by a mighty property crash. The danger is not one of a huge financial crisis, but rather one of chronically weak demand. The obvious solutions are higher public and private consumption, neither of which seems likely. If the government recognizes that the old high-saving, high-investment model is broken, it can generate reasonable growth with a more balanced consumer-led economy." Martin Wolf, "*How China Can Avoid the Japan Trap*", **Financial Times,** September 26th, 2023.

"The era of no-rates-worth-talking-about, from 2009 to 2016, and again from 2020 to the first quarter of 2022, promoted yield overreach, magical thinking, leverage buildup, unicorn breeding and federal-debt accretion. No doubt, entrepreneurs turned some of the free money to a constructive purpose, but the long frolic had other consequences too, including inflation, weakened balance sheets, and all-around financial fragility. America's economy has shown its famed resilience by remaining upright and more than fully employed in the face of the Fed's 18-month zero-to-5.5% onslaught, but cracks and stress points are surfacing." Jim Grant, "*In the Absence of Interest Rates*", **Grant's Interest Rate Observer**, September 1st, 2023.

"Sellers rushed to list their homes in the second quarter of 2022 as mortgage rates surged to get ahead of a possible crash, but the listings deluge turned into a drought as we ran out of anxious sellers. The well-discussed 'mortgage rate lock-in effect' has been the story of the housing market this year, with a lack of sellers keeping home prices elevated. By now, the market is used to elevated mortgage rates. A year later, incremental life events will make it harder to hold on to homes that no long suit people's changing situations." Conor Sen, "*A Glimmer of Hope in a Dysfunctional Housing Market*", **Bloomberg**, September 28th, 2023.

"Few have so far felt pity for the holders of Microsoft, Apple, Amazon, Google-parent Alphabet, Tesla, Facebook-parent Meta, and Nvidia, which have seen gains this year ranging from about 35 per cent (Apple and Microsoft) and more than 200 per cent (Nvidia). In the nine months to the end of September, a basket of the seven had risen just over 50 per cent, according to Goldman Sachs. Without them, the S&P 500's rise of 14 per cent at that point shrank to a miserly 4 per cent." Jennifer Hughes, "'*T-Bill and Chill' Strategy Challenges Stock Investors*", **Financial Times,** October 9th, 2023.

"We know that for much of the past 3.5 years, many workers chose to stay on the sidelines for a variety of reasons. If they believe employers are willing to accommodate their needs, such as through flexible work arrangements, they are more inclined to enter the labor force and look for a job, which they are now doing in droves. This development is a huge help to the Federal Reserve in its efforts to tame inflation." Karl Smith, *"We May Finally Be Witnessing a Normal Labor Market"*, **Bloomberg**, September 1st, 2023.