Eubel Brady & Suttman
INVESTMENT + WEALTH MANAGEMENT

Investing in You

MARKET REPORT
FOURTH QUARTER 2022

Key Points

- The fairy tale has ended.
- Many bubbles burst in 2022.
- Yields increased spectacularly.
- We conclude our capital allocation series, discussing acquisitions.
- Monetary policy changes have a delayed effect on the economy. The U.S. will likely be a continued beneficiary of global unrest.

Total Return as of December 31, 2022						
				Annualized		
	QTD	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**10 Yr.**
S&P 500	7.6%	-18.1%	-18.1%	7.7%	9.4%	12.7%
NASDAQ	-0.8%	-32.5%	-32.5%	6.2%	9.7%	14.7%
Russell 3000						
Index	7.2%	-19.2%	-19.2%	7.1%	8.8%	12.1%
Value	12.2%	-8.0%	-8.0%	5.9%	6.5%	10.2%
Growth	2.3%	-29.0%	-29.0%	7.3%	10.5%	13.8%
Russell Mid Cap						
Index	9.2%	-17.3%	-17.3%	5.9%	7.1%	11.0%
Value	10.5%	-12.0%	-12.0%	5.8%	5.7%	10.1%
Growth	6.9%	-26.7%	-26.7%	3.9%	7.6%	11.4%
Russell 2000 (Small Cap)						
Index	6.2%	-20.4%	-20.4%	3.1%	4.1%	9.0%
Value	8.4%	-14.5%	-14.5%	4.7%	4.1%	8.5%
Growth	4.1%	-26.4%	-26.4%	0.7%	3.5%	9.2%

A Review of 2022

The fairy tale of “ultra-low interest rates without consequences” has ended, finally. The Federal Reserve (the “Fed”) rocketed interest rates higher during the year to slow the economy, improve supply and demand imbalances and attempt to regain price stability. Our value-oriented equity and fixed-income strategies held up well from our vantage point.

Unfortunately, for many credulous market participants who believed interest rates would stay “lower for longer” and sky-high valuations of public and private companies were therefore “justified,” the fairy tale ended unhappily. Speculators who purchased richly valued IPOs, including SPACs, crypto-related issues and highly regarded technology companies generally endured the most pain.

On the geopolitical front, Russia's invasion of Ukraine and cozier relationship with China and Iran have widened and deepened the cracks in the foundation of globalization.

U.S. Equities

S&P 500 Total Returns											
	Energy	Materials	Financials	Industrials	Cons. Discret.	Tech.	Comm. Serv.	Real Estate	Health Care	Cons. Staples	Utilities
4Q 2022	22.8%	15.0%	13.6%	19.2%	-10.2%	4.7%	-1.4%	3.8%	12.8%	12.7%	8.6%
2022	65.7%	-12.3%	-10.5%	-5.5%	-37.0%	-28.2%	-39.9%	-26.1%	-2.0%	-0.6%	1.6%

The U.S. equity market (S&P 500) had a rough year. Nine of the 11 economic sectors logged losses. Energy and utilities were the only bright spots. Communication services and consumer discretionary issues led to the downside.

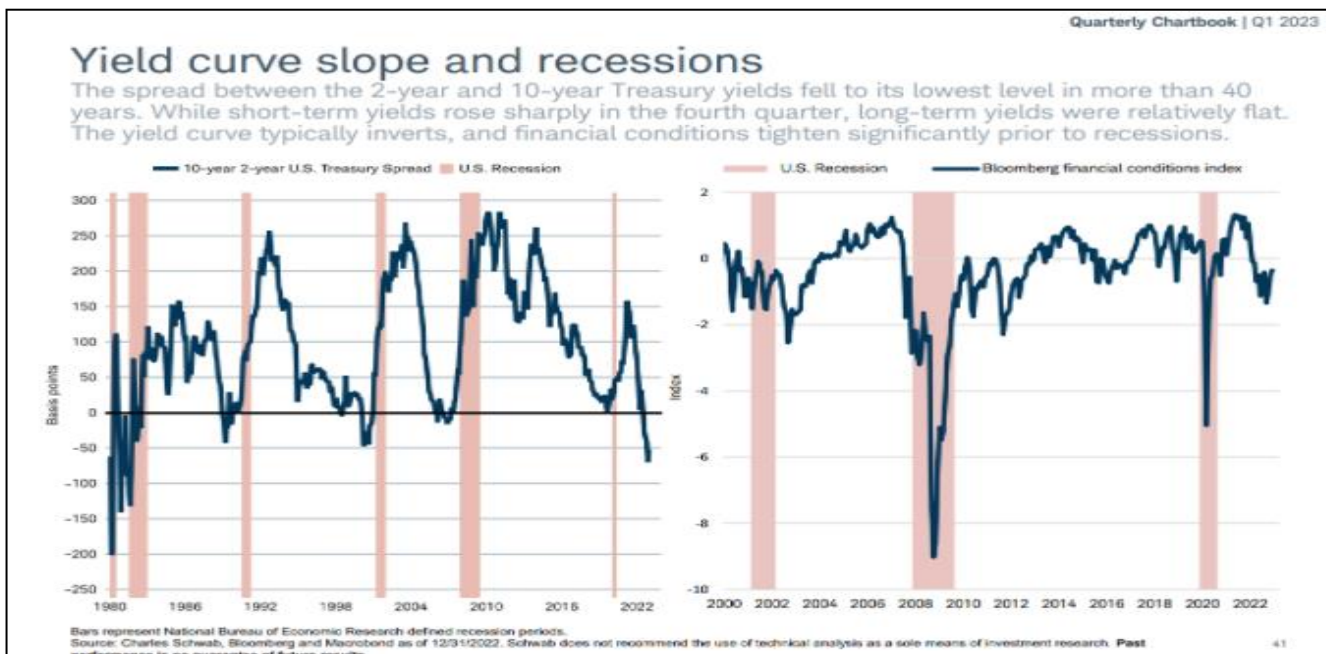
Many bubbles burst in 2022. Those stocks trading at the highest multiples of earnings or revenue (if they had no earnings) or hope (if they had no revenue or earnings) generally collapsed spectacularly. In many cases, capital has been permanently impaired. Several crypto-related companies imploded and filed bankruptcy. Ironically, the anonymity on which the crypto industry prided itself has, at least in some cases, been compromised as customers' names and coin balances were ordered disclosed in bankruptcy proceedings.

Fixed Income & Commodities

Corporate bonds' total returns, as measured by the ICE BofA U.S. Corporates 1-10 Yr. index, lifted 2.7% during the quarter yet were down 9.6% for the year. U.S. Treasuries and Agencies, as measured by a similar index, gained 1.0% and declined 7.6%, respectively.

Treasury yields rose during the year with the 2-Year ("2s") increasing 367 basis points to 4.43% and the 10-Year ("10s") increasing 237 basis points to 3.87% at year-end. With a negative 56 basis point (a basis point is 1/100th of a percent) spread between 10s and 2s, the yield curve is inverted.

An inverted yield curve often portends economic weakness, as illustrated by the blue line in the left chart **below** and shaded area (recession). The chart on the right below illustrates the Bloomberg Financial Conditions Index, an indication of financial stress in the system and recessions (shaded area).



As noted in the **table below**, Treasury and BBB yields rose the most at the short end of the yield curve. BBB credit spreads widened the most around the eight-year segment of the curve. Recall that there is an inverse relationship between a bond's yield and its price. As the yield rises, the price declines and vice versa. The remarkable move in yields during the year wreaked havoc on many fixed-income strategies that extended maturities and/or pursued lower credits to enhance yield in recent years. Our focus on shorter maturities and investment grade issues, on average, lessened the negative impact of the significant rate moves on our strategies. As yields rose throughout the year and we began receiving compensation for the risk taken, we extended maturities slightly. In our strategy calling for convertible securities, we increased our exposure significantly during the year as market dislocations served up opportunities. Waiting for the right pitch paid off.

Yield & Credit Spread Data For the period: 12/31/2022 versus 12/31/2021										
	U.S. Treasury		Corporate Rating							
			A				BBB			
Maturity	Yield	Change	Yield	Change	Credit Spread	Change	Yield	Change	Credit Spread	Change
3-Mo	4.66	4.53	4.75	4.36	0.09	-0.18	5.18	4.63	0.52	0.10
6-Mo	4.75	4.55	4.80	4.35	0.05	-0.19	5.22	4.59	0.48	0.05
1-YR	4.75	4.36	4.88	4.31	0.13	-0.05	5.31	4.49	0.56	0.13
2-YR	4.43	3.67	4.88	3.98	0.45	0.31	5.35	4.19	0.92	0.52
3-YR	4.22	3.23	4.84	3.60	0.61	0.38	5.34	3.82	1.11	0.59
4-YR	4.10	2.94	4.82	3.35	0.71	0.40	5.35	3.57	1.25	0.62
5-YR	4.00	2.73	4.84	3.18	0.84	0.45	5.41	3.41	1.40	0.68
7-YR	3.97	2.55	4.92	2.94	0.95	0.39	5.54	3.21	1.57	0.65
8-YR	3.90	2.46	4.97	2.87	1.07	0.41	5.60	3.14	1.70	0.69
9-YR	3.87	2.41	5.03	2.82	1.16	0.41	5.67	3.09	1.80	0.68
10-YR	3.87	2.37	5.09	2.77	1.22	0.40	5.73	3.02	1.85	0.65
15-YR	3.94	2.32	5.35	2.58	1.41	0.26	5.95	2.74	2.01	0.42
20-YR	4.14	2.21	5.42	2.47	1.28	0.26	5.96	2.60	1.82	0.39
25-YR	4.14	2.19	5.36	2.39	1.22	0.20	5.83	2.51	1.69	0.32
30-YR	3.96	2.04	5.28	2.35	1.32	0.30	5.74	2.49	1.77	0.45

Note: Composite data illustrated.

Global negative yielding debt, after peaking north of $18 trillion in December 2020, came in close to zero at year-end. A level not seen since 2014. Although central bankers may resort to such strategies again in the future, at least for now, this is one more step toward normalizing monetary policy.

Higher mortgage rates slowed demand for housing as consumers process what a certain payment gets them today versus a year ago and many builders are modifying their offering. For context, an average 30-Year fixed rate mortgage sported a rate of 3.37% on December 31, 2021 and 6.69% at the end of 2022. This change in rate took a 30-Year, $400,000 mortgage from $1,767 per month to $2,578, a 46% increase. For payment-sensitive buyers, tradeoffs will have to be made.

Commodities, as measured by the Bloomberg Commodity Index, increased 2.2% for the quarter and 16.1% for the year. Oil (WTI) rose 1.0% during the quarter and 4.2% for the year. Leading up to year-end, there was much speculation as to how the $60 price cap on Russian crude in early December would impact global markets and pricing. So far, it has largely resulted in China and India becoming larger buyers of Russian crude at steep discounts and Middle East producers routing supply to Europe. Markets have a way of adapting.

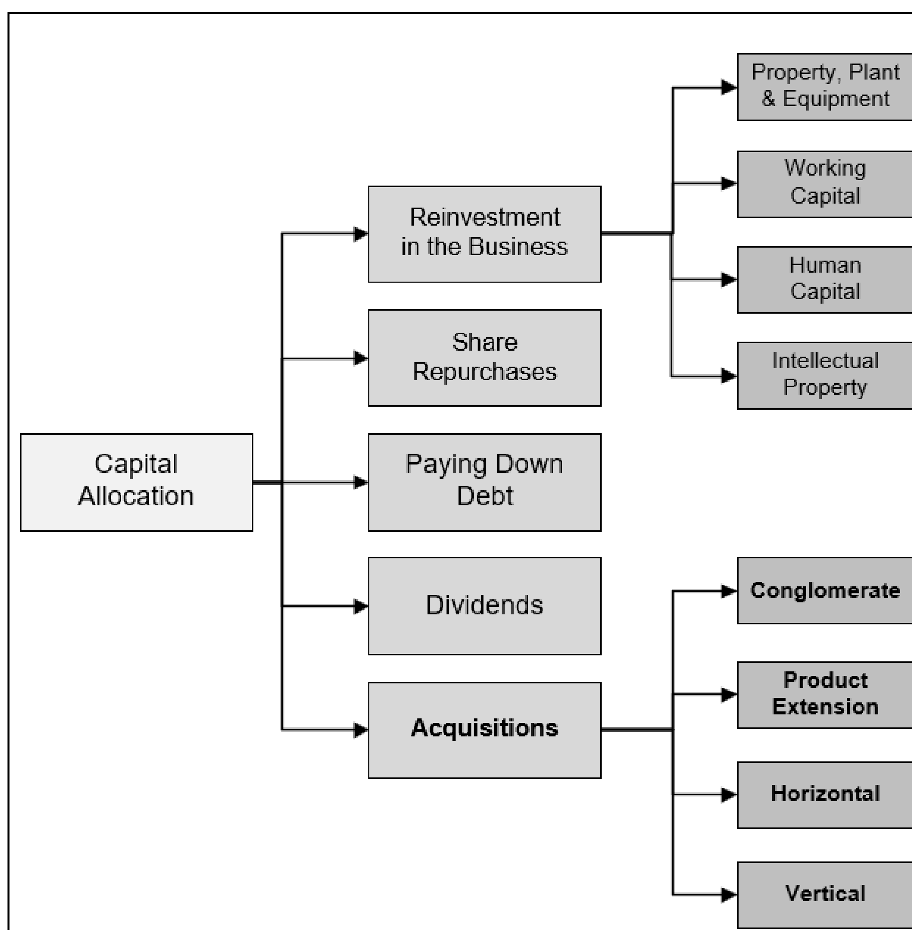
Capital Allocation Series

Capital allocation is the process of determining the most efficient investment strategy for a company's financial resources with the goal of maximizing shareholder value. We believe this is the single most important function of a company's management team.

Too often, management allocates funds in a manner that destroys shareholder value. If resources are allocated to projects that produce returns lower than a company's weighted average cost of capital or WACC (i.e., an acceptable minimum rate of return on capital projects), the value of the company will eventually erode. On the other hand, when capital is effectively allocated year after year to projects that produce returns above the company's WACC, the magic of compounding takes place and shareholders are rewarded in the long run through additional corporate value creation. To illustrate, take a company that has $100 million of equity capital on its balance sheet and earns 15% on its capital for five years: By the end of year five, the company will have over $200 million ($100 x 1.15 x 1.15 x 1.15 x 1.15 x 1.15) of equity. Management's diligence and capital allocation decisions over that period caused the equity **to double**.

We prefer companies that first and foremost have durable competitive advantages (moats), but also leadership teams that understand the importance of successful capital allocation programs and the compounding effect they can have on value.

Along those lines, management teams have numerous "levers" to pull when allocating capital and pursuing their goal of maximizing shareholder value. To date we have covered the following levers in this series: reinvestment in the business, share repurchases, paying down debt and dividends. This quarter we discuss **acquisitions**.



Acquisitions

An acquisition is a business combination that occurs when one company buys most or all of another company's equity. This is generally our least preferred capital allocation lever. Potential challenges include but are not limited to: overpaying, poor incentive structures, lofty synergy goals and integration risks.

- **Overpaying** – Acquirers typically pay a premium to purchase the target company. Management must complete their due diligence and correctly assess a target's intrinsic value to determine how much they are willing to pay. Too often management pursues a growth-at-all-cost strategy, leaving them with a bloated balance sheet and subpar returns on investment.

- **Incentive Structures** – When assessing a company, we prefer management be well-aligned with shareholders. Sometimes management compensation is primarily tied to growth, no matter the cost to shareholders. In those instances, management

may be more focused on their compensation than on the economic benefit to shareholders.

- **Synergies** – Acquisitions are often rationalized by touting potential cost savings and efficiencies gained by combining businesses. Synergies can exist and in many cases do; however, forecasted synergies often come in lower than expected. We believe it is important to follow management teams who are known to fairly assess acquisition targets, and take a realistic view of potential cost savings and synergies.

- **Integration Risks** – Combining different operating systems, cultures, people and processes can be difficult. If not well-planned, combining two businesses can be messy. These risks, if realized, can erode expected cost savings and lower shareholder returns.

There are typically four types of acquisitions: Conglomerate, Product Extension, Horizontal and Vertical.

- **Conglomerate** – Acquirer and target are in unrelated industries. The expectation is that the combination provides diversification. A risk of conglomerate type acquisitions is management reaching beyond their core competencies and running a business they aren't qualified to lead. We prefer to see management teams with a "hedgehog" mentality. This means they focus on what they are deeply passionate about, best at and what can drive the greatest economic returns.

- **Product Extension** – Two companies operating in a common industry, selling different products. Synergies may be realized if the companies use similar distribution channels, production processes, marketing or technology. Companies can benefit from increased market share and expanding product lines.

- **Horizontal** – Involves acquiring another company in the same business which could be a competitor or a company in a new market.

- **Vertical** – One company acquires another in the supply chain. This type of acquisition can bring new income streams and create production and operational cost efficiencies.

Acquisitions are our least preferred capital allocation tool due to overpaying and integration risks. However, if successfully executed, acquisitions can benefit shareholders through

accelerated corporate value creation. A properly incented and disciplined acquisition team with an established process is key to success on this front.

Looking Ahead

When monetary policy changes are made, it takes a while for the full impact of those changes to be felt throughout the economy. We would not be surprised if the Fed's 2022 tightening actions are felt with greater intensity in 2023. If short-term oriented investors put enough selling pressure on companies meeting our criteria, we will use the opportunity to refresh a portion of our portfolios and set the stage for additional compounding over the next 5-7 years.

As you know, we believe the price-to-value relationship of an investment is generally a good indicator of its future long-term return. The more an investment is discounted relative to its intrinsic value, the greater the margin of safety and potential return.

The daily grind of a well-designed sports training program can be glamourless and boring but yield favorable results on gameday. Our investment process is similar. On any given day, we simply go about executing our time-tested investment process. There is little excitement as we simply stick to our routine of assessing the quality and value of businesses while striving to be conservative in our thoughts and assumptions. Occasionally, the market will quickly recognize the favorable attributes of an investment we have identified and drive the price higher to reduce the discount to intrinsic value. However, at other times the investment price declines or is stagnant for an extended period while the underlying business fundamentals remain favorable and intrinsic value grows. Patience is an important element of long-term investment success, in our view.

The U.S., given its rule of law, access to cheap energy, infrastructure, geography and deep capital markets will likely continue to experience reshoring for the foreseeable future and be a favored locale for large corporate projects. New chip plants are a recent example, but challenges should be expected as corporations must navigate the U.S. regulatory maze, relocate key skillsets to the U.S., re-recreate foreign manufacturing ecosystems finetuned over many years and train a domestic workforce. All of this will take time and be inflationary, in our view.

Past performance is not indicative of future results. Market and economic data have been provided by third party sources. This data, while believed to be reliable, has not been independently verified by EBS.