VAIL VALLEY
ASSET MANAGEMENT

Quarterly Letter to Clients 4Q 2022

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Ryan Phinney, CFA

Mr. Phinney is a Portfolio Manager at Vail Valley Asset Management and works within the firm's investment management and risk management functions where he researches, constructs, and monitors portfolios. Mr. Phinney earned his B.A. and an M.B.A. from the University of Denver. He is a CFA charterholder.

MARKET SUMMARY

Ryan Phinney, CFA

The equity markets domestically and internationally largely hit their 2022 lows in October and rebounded for the rest of Q4. Quarterly performance was better, but overall annual performance for US and international equities was among the worst in modern history. While the Federal Reserve signaled a slowdown in the pace of rate increases, they still signaled that the Fed Funds rate will go higher. As you can see from the table below, negative performance across major equity market indices has continued:

Index (as of Dec 30)	2022 Q4 Performance	2022 Annual Performance	3 Year Annualized
S&P 500 Total Return	7.56%	-18.11%	7.66%
NASDAQ	-3.23%	-33.89%	16.23%
Dow Jones Industrial Average	15.39%	-8.78%	5.12%
MSCI World ex USA	16.26%	-13.82%	1.77%
MSCI Europe	9.55%	-9.49%	3.07%

According to Edward McQuarrie, a professor emeritus at Santa Clara University, fixed income markets have experienced the worst performing year since 1793. As the Fed engages in the fastest rate hiking cycle in history to combat inflation, bond prices have collapsed – especially longer dated bonds. The Bloomberg U.S. Aggregate Index, an index covering the U.S. investment grade fixed rate bond market, was up 1.87% in Q4 of this year but is down 13.01% for 2022. Similarly, the Bloomberg U.S. Treasury Index is now down 13.48% YTD. Corporate bonds did not fair much better as the Bank of America Corporate Investment Grade Corporate Bond Total Return index was down 14.64% for 2022.

The Federal Reserve’s rate hikes in response to inflation have been the dominant factor in 2022. While the Fed has indicated they plan to slow the pace of rate hikes, they still point to the risk of high inflation. While December CPI data was recently released showing headline inflation at 6.5% and “Core” inflation at 5.7%, this is still roughly 3x the Federal Reserve’s stated goal of 2% annual inflation. In reviewing the futures curve of the Fed Funds rate as of Jan 13, it appears as though market participants are pricing in a Fed Funds rate peaking in June of this year of 4.9%, but anticipating rate cuts to 4.5% by the end of the year:

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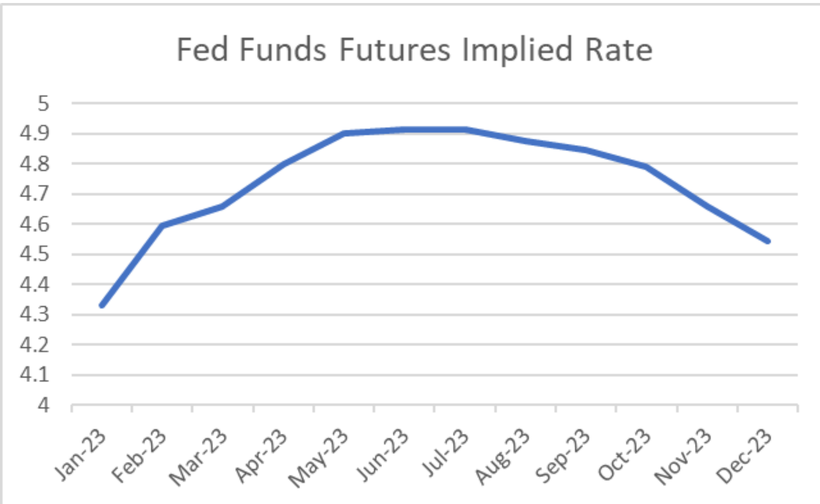

For this to come to fruition, the Federal Reserve would need to embark on a series of rate cuts immediately upon hitting a terminal rate of between 4.75% to 5.00% in June. This appears at odds with recent commentary from Federal Reserve officials. The FOMC's December meeting minutes state on Page 9: "*No participants anticipated that it would be appropriate to begin reducing the federal funds rate target in 2023*". It may be that the market is underappreciating how dedicated the Federal Reserve is to stamping out inflation. As a result, I question whether the market is prepared for a "higher for longer" scenario – which could contribute to a recession in 2023 that is deeper and longer lasting than is currently priced in.

EBULLIENT CREDIT MARKETS AND A FLIGHT TO QUALITY

Sean Abbey, CFA

Mr. Abbey is the founder and Chief Investment Officer at Vail Valley Asset Management. Mr. Abbey earned his B.S. from Colorado State University and his M.B.A. from Yale University. He is a CFA Charterholder.

Sean Abbey, CFA

Despite a positive 4th Quarter for the Dow, the S&P500 and many international equity indices, 2022 was certainly a challenging year for both U.S. and Global Capital Markets. Fixed income markets finally experienced some relief as parts of the belly of the yield curve shifted lower and credit spreads tightened modestly- more on that below. 2022 was also a historically poor year for the classic 60/40 portfolio composed of 60% equities and 40% fixed income. 2022 ended as the 3rd worst year for the S&P500 since 1976 and the worst year for investment grade fixed income since 1976. Many investors who passively allocated to the classic 60/40 portfolio were unprepared for the depth of losses within their fixed income portfolios as equity markets corrected.

Our fixed income allocations during the 4th Quarter continued to position client portfolios with a bias towards low duration exposure and high credit quality. We continued avoiding fixed income instruments that typically exhibit negative convexity such as residential MBS, though the convexity profile of agency MBS has improved dramatically. We continued our higher than policy allocation of short-term treasury securities as the shape of the yield curve continues to offer attractive yields relative to higher duration investment grade credit. Through 4Q2022, our fixed income positioning allowed clients to largely avoid the worst of the 2022 declines in the fixed income markets mentioned above. While higher duration treasuries and investment grade bonds have delivered painful losses in 2022, low duration fixed income was a source of stability and attractive short-term yield for our clients.

We also continued to keep our clients' U.S. and international equities exposures lower than policy targets to reflect our bearish near-term view. To refresh our previously mentioned broad valuation measures, as of December 30, 2022, the Shiller total return CAPE Ratio remained high at 28.46, and the "Buffett Indicator" or the ratio of the Wilshire 5000 Total Market Index to U.S. GDP was approximately 148% and still above the March 2000 peak of 142%. Meanwhile, reported quarterly S&P500 operating profit margins have declined modestly but remain near all-time highs. In our last letter, we expressed our belief that high operating margins capitalized at relatively high multiples is a challenging setup for future real returns across large cap U.S. equities. In that letter, we did not mention another important factor- the "tail wind" or "lift" to domestic equities provided by the 40-year decline in interest rates after the Volker peak. The four-decade secular decline in interest rates culminated with an extraordinarily easy monetary policy from 2010 to 2021, providing support for the value of all assets including equities. The relationship between interest rates and asset values expressed within the basic concept of time value of money reduces the present value of future cash flows as the discount rate rises. Interest rates measured by the yield curve serve as a base component of all theoretical discount rates used within valuation models. Unacceptably high inflation within the U.S. has led to recent monetary policy actions to raise policy rates materially, breaking a 40-year trend. Fundamentally, the value of a company is the present value of all future cash flows, and higher interest rates and thus higher discount rates should reduce the current value of a company and its equity securities all else being equal.[1] A regime of higher interest rates will create a natural headwind to the performance of U.S. equities and aggravate the challenges to future real returns posed by high operating margins capitalized at high multiples.

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We want to reiterate our belief that valuations should not be used to make short-term trading decisions; rather, we believe valuations can be a useful tool to think about longer term expected returns. Given the current set up, we believe prospective real returns from U.S. equities will not resemble a repeat of the unusually strong returns during the post Great Financial Crisis period. Despite our near-term pessimism, we remain bullish over the long-term on U.S. equities and will continue to add modestly to long-term positions in select companies we find attractive.

FLIGHT TO QUALITY

In 2022, the Dow outperformed the S&P 500, while the S&P 500 outperformed both the Russell 2000 and the NASDAQ. As rates increased and the extreme valuations within many of the NASDAQ leaders declined, the Dow has been resilient. The relative

[1] This is a simplistic view and does not account for changes in growth and profitability of an individual company. Low interest rates flow through to other aspects of fundamental company performance such as improvements in company profitability through reduced interest costs. Lower interest rates also reduce the overall cost of capital creating more opportunities for financial engineering through recapitalizations and lowers the barriers to funding new projects by increasing the value of future project cash flows and increasing the availability of capital.

outperformance of the Dow looks more like a flight to quality to large cap blue chip names versus an improvement in the fundamental outlook for the Dow constituents. Indeed, valuations on the Dow look high, particularly if we experience a weaker economic environment. The recent Dow outperformance looks more like a "narrowing phase" where a smaller number of blue-chip names lead the market while more speculative names get taken out. We believe several individual securities within our equities portfolio have benefited from the same factors that have allowed the Dow to outperform other major indices as investors allocate towards established, higher quality, and non-cyclical companies. Our commentary on the relative performance of major equity market indices is only a hindsight observation and does not weigh on our equity portfolio investment decisions, which are driven by the attractiveness of a company's fundamentals and valuation. Our broad view is that the shift in the yield curve under the Fed's monetary tightening regime has increased the cost of capital across the economy and as a result every asset is being repriced- the blue-chip Dow constituents should not be immune to these forces.

CREDIT MARKETS

"***The sanguine credit market environment is a source of concern for us considering the economic headwinds and the historically long economic expansion.***"

2022 losses across the U.S. fixed income universe varied considerably by credit market segment. In 2022, higher duration AAA investment grade credit was down roughly 20% while high yield B credit was down roughly 10%. Meanwhile, lower duration and/or floating rate credit such as Leveraged Loans were only down roughly 0.60% and AAA CLOs actually experienced a small positive return of 1.1%. Duration and the Fed's rapid monetary policy actions were the main drivers of negative returns across credit markets rather than credit losses. Credit market stress is still remarkably low. For example, the ICE BofA US High Yield Index Option-Adjusted Spread narrowed slightly over the 4th Quarter and was at 4.79% as of 12-30-22, still well below previous periods of credit market stress. Outside of a brief widening in 2016 and the brief but deep dislocation during COVID, credit market stress has been extraordinarily low since the GFC as an active Fed eagerly dampened every episode of heightened risk in credit markets. The period since the GFC (discounting the COVID disruption) has also been the longest economic expansion in history. The sanguine credit market environment is a source of concern for us considering the economic headwinds and the historically long economic expansion. We do see some pockets of attractive nominal yields within moderate and higher risk segments of the credit markets; however, security selection and adequate risk control is warranted for investors looking to take advantage of the improved return outlook in certain areas of the credit markets. We remain cautious with our credit risk exposure and will continue to be vigilant if economic conditions deteriorate further.

INFLATION AND THE FED

What will the Fed do and when will the monetary policy driven pain in higher duration fixed income and other risk assets subside? While many macro forecasters have a prediction on this important topic, we believe that no one knows for certain, and we do not base our investment decisions on macro forecasts. Our current view is that the Fed will be data dependent and err on the side of a tighter policy stance to avoid a repeat of the stop and go period of the 1970s that culminated in the vicious inflationary resurgence of the late 1970s and early 1980s.

*"**The previous tensions between price stability and maximum employment during inflationary environments may have evolved into a more complex "tripartite trade-off" with the addition of the Fed's activism under the goal of financial stability."***

After Volker, the Fed and many central banks enjoyed a roughly four-decade disinflationary environment, garnering significant credibility. Ensuing market panics and financial crises resulted in an expansion of central bank activism and the addition of the unofficial "third mandate" of financial stability to complement the congressionally mandated goals of price stability and maximum employment. While previous inflationary periods such as the 1970s and 1980s created tension between the dual mandates, we find the introduction of the Fed's post GFC activism under the guise of financial stability to be a new source of complexity for the Fed's current array of challenges. Namely, how to cool the highest inflation in a generation while avoiding dislocations in financial markets.

The recent period of extraordinarily high equity market valuations, ebullient credit markets, frothy real estate markets, and speculation across risk assets occurred under an active Fed and were certainly enabled by the exceptionally long period of easy monetary policy. The previous tensions between price stability and maximum employment during inflationary environments may have evolved into a more complex "tripartite trade-off" with the addition of the Fed's activism under the financial stability goal. Persistent inflationary readings or further unexpected increases in inflationary pressures would likely erode confidence in the Fed's ability to achieve its price stability mandate, particularly after the Fed's delayed reaction to 2021's inflation surge. In short, we feel that the Fed's credibility is at stake, and in a fiat system credibility is everything.

We look forward to continuing to serve our clients and welcome any questions you may have about your portfolios or our views on markets.