

# To clients and friends of The London Company

Over the past few years, we've observed how adjusting monetary policy is somewhat similar to tempering a shower. If you've ever stayed in a hotel, you know the goal of finding a pleasant balance between hot and cold is a nuanced exercise in trial and error. The delayed response between faucet adjustments and the water temperature from the showerhead can make this tricky. This lagged effect raises the risk of overshooting from icy cold to scalding hot and vice versa. In the case of recent monetary policy, the Federal Reserve and central banks abroad injected historic levels of stimulus into the economy to combat fallout from COVID-19. A byproduct of this prolonged accommodative posture was a hot economy and generationally high inflation. In 2022, policymakers became historically restrictive to tame inflation, and now they risk sending the economy into an icy recession. This massive liquidity drain from the financial system led to the worst annual loss for the broader equity market since 2008.

Broad Market Performance	Q4	YTD
Russell 3000	7.2%	-19.2%

After three down quarters in a row, equity markets made some gains in Q4 to close out an otherwise rough year. During the quarter, economic data largely cooperated with the Fed's hope for a soft landing. Softening inflation and a slowdown in the pace of the Fed's tightening helped grant some relief for equity markets. For the full year, however, surging inflation and rising interest rates were the overarching focus for investors. Headline CPI reached a 9.0% y/y pace in June (its highest level since 1981) before beginning to taper off to a 7.1% y/y rise in November. The Fed delivered seven rate hikes totaling an increase of 4.25%—the most aggressive pace since the early 1980s. Amidst surging prices and a backdrop of soaring interest rates, the S&P 500 declined 18.1% for the year. Stylistically, this was the best year for Value's relative performance since the popping of the tech bubble in 2000. Across the market cap spectrum, expensive and unprofitable growth stocks were some of the hardest-hit areas of the market. There was a huge spread in sector leadership as well. Energy and the defensive sectors led, though Utilities, Healthcare and Consumer Staples were essentially flat. Despite oil and gasoline prices making a dramatic roundtrip, Energy was up 66% for the year—its largest outperformance versus the market in the history of GICS sectors. Turning to market factors, Value, Yield, Quality and Momentum had a positive impact this year; while, Growth and Volatility factors were negative.

## Respect the Lag

### Market Highlights

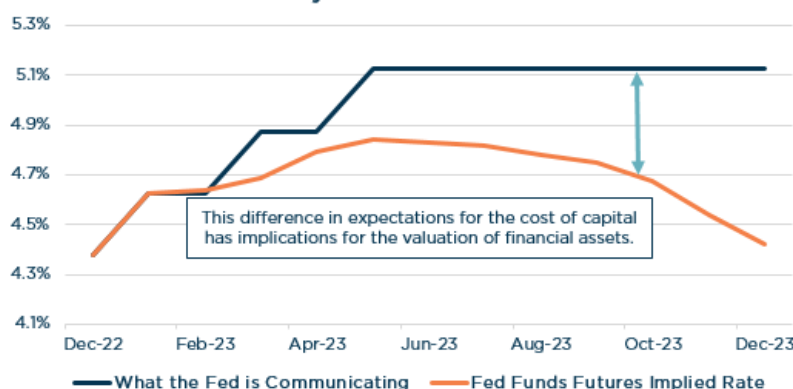
Are we at the beginning of the end or the end of the beginning with this tightening cycle? The market and the Fed disagree.

We appear to be in between the cause and effect of this bear market. Inflation and rates were the cause of 2022's market drawdown, and 2023 appears set to deliver the effect of weaker earnings and employment.

The cost of money matters once again, and it will likely shape the contours of the investment landscape for years to come.

The term 'fool in the shower' was first coined by renowned economist, Milton Friedman, who used the metaphor to highlight the risk that central bankers run with being too forceful with monetary policy. As he explained, changes in monetary policy operate with "long and variable lags." This makes overcorrection to policy changes based on immediate conditions a persistent hazard. Today, the market is flashing all sorts of warning signs that the Fed has overtightened and a recession is imminent. Housing has collapsed; commodity prices have rolled over; leading economic indicators have fallen to contractionary territory; and the inversion of the yield curve reached its deepest level since 1981. As a result, the market has pulled forward expectations for rate

### 2023 Federal Funds Rate Expectations: What the Fed Says vs What the Market Has Priced In



Source: Strategas

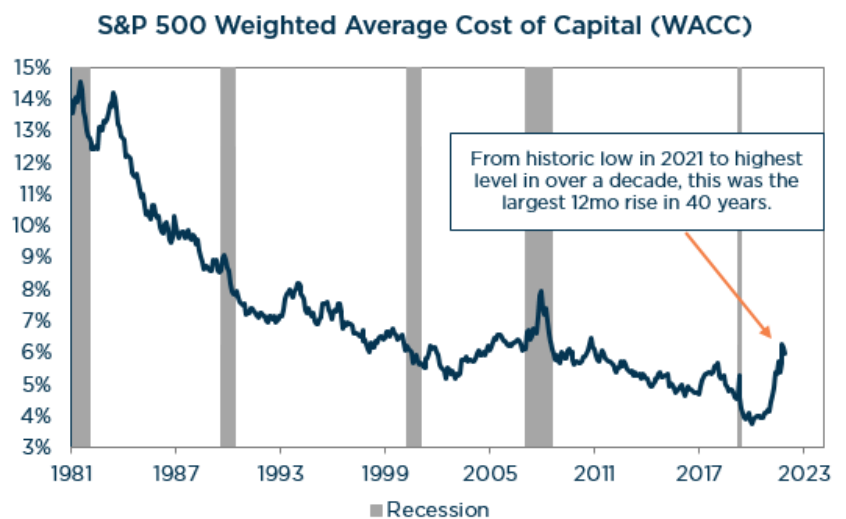
cuts in 2023, presuming we're at the beginning of the end for this tightening cycle. On contrary, the Fed continues to signal that we're just at the end of the beginning. The Fed can't telegraph all of its future moves, but it has espoused a "higher for longer" posture to ensure it brings inflation back down to its 2% target. Sticky services inflation and a tight labor market remain key concerns for policymakers. The Fed understands there are "long and variable lags" with its cumulative rate hikes and quantitative tightening thus far, and it has conceded the path to a soft landing is a narrow one. However, the Fed has also been clear in expressing a desire to avoid the fits and starts of monetary policy that

characterized the era of the 1970s. Barring some instability in the financial market plumbing, the Fed seems to believe that continued restrictive monetary policy is the lesser of two evils, if it ensures price stability is restored. For investors, it was a losing bet trying to call the Fed's bluff in 2022. Now, with many investors wishing for a cutting cycle, we're inclined to be more cautious. If cuts were to occur, it likely means economic conditions are weakening and/or something is on the cusp of breaking. For us at The London Company, we choose to accept the world as it is, not as we wish it to be. We're long-term owners of businesses, not short-term renters of paper. Our focus remains on the economics of our underlying businesses, not the consensus forecasts for short-term movements in stock prices or the Fed's next move.

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To us, the path of earnings and employment represents the next potential source of cold shock facing investors in 2023. The sequence of collateral damage we've seen thus far has followed the roadmap of prior tightening cycles of the past. There is a lagged effect when financial conditions tighten or ease. Housing, the most interest rate sensitive, is first to get impacted, followed by leading economic indicators (e.g. PMIs) which point to whether the business cycle is expanding or contracting. The business cycle leads the profits cycle, and the profit cycle leads the labor market. In 2022, we saw housing get hit hard and the business cycle go into contraction. Valuation multiples de-rated early in 2022, but we've only recently see the spillover effect on Q3'22 earnings. Consensus estimates for 2023 still call for earnings growth and margin expansion, but that appears overly optimistic. The confluence of an economic slowdown, wage pressures and elevated input pricing makes for a challenging backdrop for earnings and margins. Employment trends have the longest lag, but there is generally an inverse relationship between profit margins and unemployment claims. If we see margins come under pressure in 2023, we would expect to see unemployment tick higher. Historically, quality market factors tend to outperform on a relative basis during recessions and when the employment backdrop is deteriorating.

As we've highlighted throughout the year, we believe we're living through a reset, and we're entering an era where the cost of money matters once again. Companies fund their operations through a combination of debt and equity, with each source possessing an associated cost. As the chart illustrates, in 2022, the weighted average cost of capital (WACC) spiked to the highest level in a decade. The immediate impact of this sharp rise in the cost of capital has been the drop in equity valuations. Longer term, as monetary policy normalizes, we believe a higher cost of capital environment will shape the contours of the investment landscape for years to come. Case in point, corporate debt levels are at all-time highs and nearly half of the S&P 1500's debt is coming due in less than five years. In a higher rate environment, the interest expense on that debt will inevitably consume a greater share of corporate cash. In the short run, companies with weaker profitability, vulnerable cash flows, and high debt levels could get hit doubly hard in a slowdown if they also receive credit downgrades. Taken together, we believe companies with strong balance sheets and the ability to self-fund their operations should have a structural advantage in 2023 and beyond.



Source: Goldman Sachs

## Strategy Recap

For The London Company portfolios, our strategies produced mixed results during Q4, but performance for the year was solid. Our investment process focuses on limiting downside risk, so we typically excel in periods of distress and volatility. In robust return environments like Q4, we aim to keep up. For the quarter, we mostly achieved our objective. Our Large Cap and Small Cap portfolios outperformed their primary benchmarks, and our Income Equity portfolio outpaced the S&P 500. Our SMID portfolio slightly trailed its benchmark but performed within expectations. Our Mid Cap and Income Equity portfolios lagged their primary benchmarks and fell short of our 85-90% upside capture expectations. Fortunately, our portfolios performed as they are designed to do and provided solid downside protection in the worst year for equities since 2008. Our Large Cap, Mid Cap, SMID, and Small Cap portfolios outperformed their primary benchmarks for the year. Our Income Equity portfolio split its benchmarks—handily outperforming the S&P 500 but finishing behind its primary Russell 1000 Value benchmark. For such a macro-dominant year, we were encouraged to see the quality of our portfolios overcome some significant obstacles. Each of our portfolios produced positive stock selection for the year, but they battled substantial sector headwinds along the way—particularly being underweight Energy. Moreover, this valuation-driven selloff largely favored cheap stocks over fundamentals. So, even though we benefited from investors' increased attention to profitability, we believe the full advantage of our portfolios' quality characteristics wasn't fully realized. If economic conditions deteriorate further, we believe the benefits of sustainably high returns on capital and balance sheet strength will stand out in a meaningful way.

## Looking Ahead

Turning our attention to 2023, investors are facing a markedly different backdrop than 2022 and several big questions remain. To our eyes, we appear to be in between the cause and effect of this bear market. Inflation and rates were the cause of 2022's market drawdown, and 2023 appears set to deliver the effect of weaker earnings and employment. One huge question for next year is how the Fed calibrates the "long and variable lags" of its rate hikes and quantitative tightening from 2022 into its navigation of 2023. Reconciling the market's expectations for rate cuts with the Fed's "higher for longer" signaling could be a headwind for equity markets. While the equity market doesn't appear to be out of frigid downpour just yet, there are still some significant tailwinds worth noting. The labor market is still very tight and the service side of our economy remains strong. Inflation and gas prices have eased from their recent peaks, providing some relief for consumers. China has emerged from its multi-year lockdown and the U.S. dollar's strength has sharply rolled over, dynamics that could help support the global economy. Sentiment and U.S. equity positioning remains deeply depressed, providing fertile ground for an upside surprise. At the end of the day, however, the next phase of this slowdown will likely hinge on the path of earnings, credit spreads and employment. Meanwhile, unprecedented uncertainty is likely to keep volatility levels elevated.

For us at The London Company, we have decades of experience dealing with finicky fixtures and temperature extremes. A lot of ink has been spilled with predictions for 2023 and calls for how these macro-dynamics will all play out. We don't have the answer to what's around the corner, but we do believe it's an advantage that our investment decisions are based on tangible, company-specific factors rather than macroeconomic predictions. In the years ahead, as the Fed normalizes policy, multiple expansion may be challenged and companies will likely need to earn their returns. In an environment of modest equity returns, total shareholder yield (dividends + net buybacks) could play a significant role in investors' portfolio performance. As the Fed's intervention finally retreats, the backdrop could be favorable to active managers who can uncover predictable, highly profitable business models that have limited downside risk. As we look at our portfolios today, we believe they're well-positioned for an uncertain future and possess the fundamental ingredients that stand the test of time: wide moats, durable profitability, strong free cash flow, healthy balance sheets, and attractive shareholder yields.

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It's been said that cold showers are good for your health. The current cold shower cleansing equity markets has certainly been uncomfortable and the chill appears set to overstay its welcome. Having said that, we prefer to take a constructive view on the situation. This cold shower is part of a broader, healthy reset that will ultimately lay the foundation for the next bull market. Bear markets are notoriously challenging to navigate, but portfolio results aren't improved by reflexive contraction or frenzied movement. We remind ourselves and our clients to breathe gently, remain patient and calmly focus on the long term.

#### Important Disclosures:

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