

# To clients and friends of The London Company

We are officially one year into this campaign to tame inflation and normalize monetary policy. Like a long road trip, the journey has been exhausting and disorienting at times, and the first quarter of 2023 was no exception. In the three short months to start the year, there were at least as many sharp turns along the way. Continued pain from the Fed's 2022 tightening was evident across economic and corporate data, but results this quarter were generally mixed—giving fodder to bullish and bearish investors alike. As the quarter progressed, we also witnessed the 2<sup>nd</sup> and 3<sup>rd</sup> largest bank failures in US history. So, even though the broader market delivered solid gains in Q1, for most investors the moves along the way were much more white-knuckle inducing than the headline index suggests.

Broad Market Performance	YTD
Russell 3000	7.2%

Equities surged to start the year, but major indexes gave back some of their gains as the quarter progressed. Early optimism was fueled by the notion that the Fed was nearly done tightening, mortgage rates were falling, employment remained healthy and nothing in the economy had “broken.” As Q1 progressed, however, it became evident that the Fed was not done tightening yet. Further, it had been premature to claim victory on a soft landing for the economy and nothing “breaking.” Undoubtedly, the biggest news in Q1 was the bank run and subsequent failure of Silicon Valley Bank and Signature Bank. These events led to fears of a broader banking crisis, but they did not stop the Fed from continuing its fight against inflation. The central bank delivered two 25bps rate hikes, bringing the total hikes since last March to 4.75%—more than the entire 2004-2006 tightening cycle. The Fed slowed the pace of rate hikes, but it also reiterated how rates will likely need to stay higher for longer, given the stubbornly sticky services inflation and the strength of the labor market. Due to the flip-flopping of Fed expectations, treasury yield volatility surged. Net net, the two-year treasury yield actually dropped during Q1, marking the first quarterly decline in short-term rates since 2020. The victims of 2022's rapid rise in rates were some of the biggest beneficiaries of the Q1 rate reprieve. Stylistically, growth stocks outperformed value across the market cap spectrum, and large cap equities outpaced small caps. From a sector standpoint, the notable outperformers during Q1 (Tech, Comm. Services & Cons. Discretionary) were the biggest laggards of 2022. Turning to market factors, investors flocked toward the perceived safety of high quality companies and balance sheet strength. Some of the best performers were mega-cap tech companies, which helped the S&P 500 finish +7.5% for the quarter.

## Risk Happens Gradually, Then All at Once

### Market Highlights

When the Fed drains liquidity from markets it places strain on the financial system, and unforeseen 2<sup>nd</sup> derivative risks typically emerge with each tightening cycle. This cycle was no exception.

Growth appears set to overtake inflation as the main concern for investors.

The recent swings in market leadership could make you car sick, but quality market factors have shined amidst the weakening earnings backdrop and rise in solvency concerns.

“When the Fed slams on the brakes, something goes through the windshield” is a classic investing axiom that was reaffirmed once again in 2023. We highlighted the risk of such a thing occurring last March when the yield curve first inverted. When the Fed engages in monetary tightening, it drains liquidity from markets and places strain on the financial system. Often unforeseen 2<sup>nd</sup> derivative risks emerge and something “breaks,” as the chart on the next page illustrates. The collapse of Silicon Valley Bank & Signature Bank are this cycle's most notable casualties of monetary tightening. While the woes of these institutions can be tied to their own idiosyncrasies, most would argue that this wouldn't be happening without the extreme interest rate volatility that has been brought on by the Fed's tightening campaign. The Fed appears to be looking through the rearview mirror as it drives the car, calibrating policy with a bias toward backward-looking data (e.g. headline inflation & employment). Meanwhile, forward-looking data (e.g. leading economic indicators) continue to flash hazard lights, suggesting a hard-landing recession is imminent. We do not think there is a systemic issue plaguing the entire banking system, like in 2007 to 2009; however, these events are likely to have a negative impact on economic growth at a time when growth is already weakening.

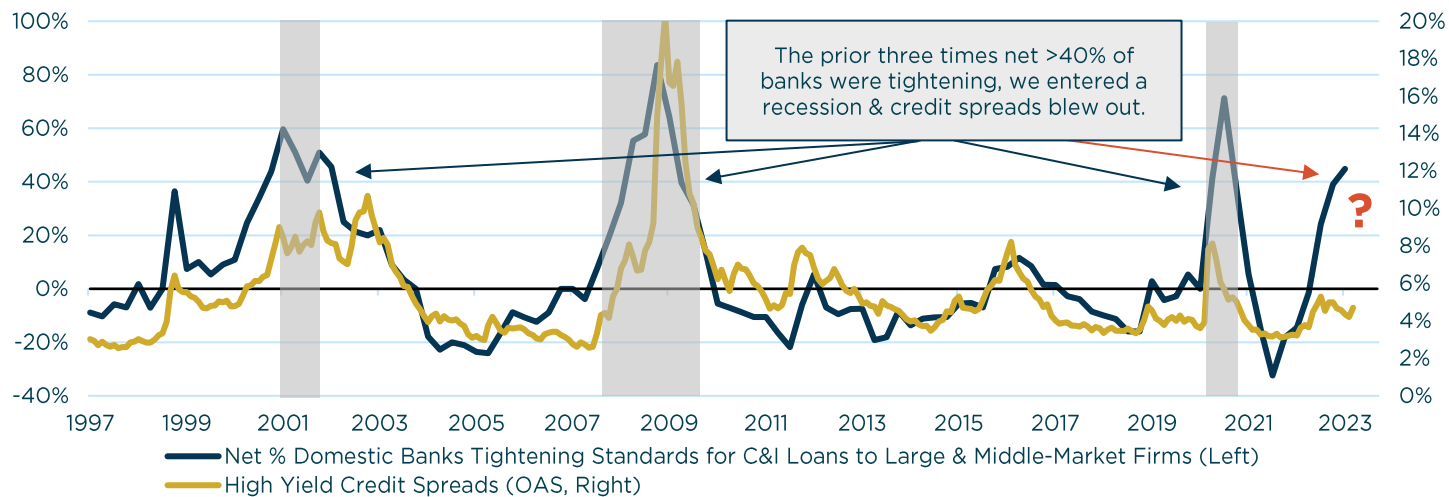
## Fed Tightening Cycles Historically End with an “Event”



Source: Federal Reserve Bank of St. Louis

As we explained at the end of last year, we believe we're in between the cause and effect of this bear market, and slowing growth appears set to overtake inflation as the market's biggest concern. Last year, the market downturn was fueled by higher inflation fears and all of the Fed tightening that came along with it. So far in 2023, the rally has been fueled by investor optimism that the Fed is nearly done tightening and growth has been resilient. That said, the long and variable lag of Fed tightening has only recently begun to take a bite out of corporate profits. The advent of the banking crisis will only serve to exacerbate the slowdown that was already in motion. The speed of the bank failures was alarming, but the risks have been building gradually over the past year. Banks had been tightening their lending standards before the Silicon Valley Bank incident, and we believe such tightening will become even more prevalent in the months ahead. That has implications for economic and earnings growth, because tighter lending standards result in less lending and credit availability. The negative knock-on effects include lower business optimism, a rise in delinquencies and eventually cracks in the labor market. As the chart below illustrates, it can become a vicious cycle that puts upward pressure on credit spreads and ultimately result in recession. We think it's premature to assume the labor market can make it out of this tightening cycle unscathed, and the risk of a credit crunch has materially increased.

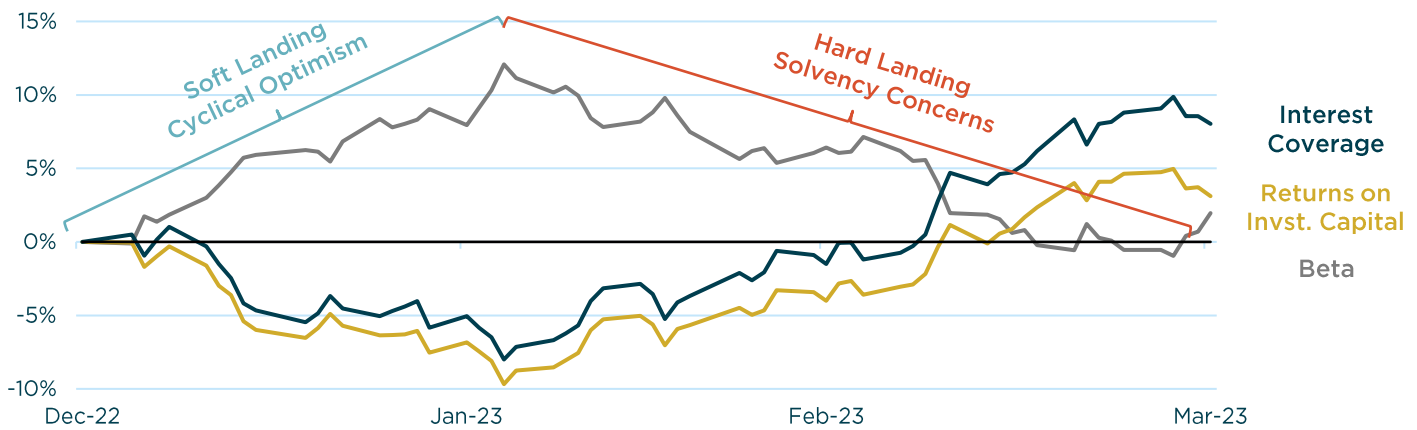
## Lending Standards vs High Yield Credit Spreads



Source: Federal Reserve Bank of St. Louis. ICE BofA US High Yield Index Option-Adjusted Spread

The soft vs hard landing tug-of-war raged on in Q1, with sometimes violent swings in market leadership. Historically, markets tend to rally near a Fed pivot, both in soft and hard landing scenarios. This year was no exception, but the early surge in equities, led by cyclicals and lower quality factors, was wildly disconnected from economic reality. Both the manufacturing and services side of our economy have dipped into contraction, and corporate profits have only recently begun to deteriorate. Nevertheless, the magnitude of the early rally in high beta equities and cyclicals was akin to that of major economic recoveries (i.e. 2009 & 2020). As the quarter progressed, euphoric soft landing hopes were usurped by hard landing solvency concerns. There was a sharp reversal in market leadership, and investors gravitated toward companies with durable profitability, strong balance sheets and low levels of leverage. Looking back at last year's valuation driven sell-off, balance sheet strength was more of a luxury than a necessity. Investors largely sought downside protection through cheap stocks, often overlooking fundamentals. Flash forward to 2023, concerns over slowing growth and solvency led to investors bidding up companies with high interest coverage and fleeing highly levered companies. This risk-off leadership momentum is likely to continue if the economic backdrop deteriorates and credit concerns escalate.

## YTD High to Low Factor Performance: Russell 3000



Source: Piper Sandler. Period 12/31/22-3/31/23. Measures the forward price return of the names in the Russell 3000 high and low quintile basket of stocks by factor. Factors are sector neutral, and quintile baskets are rebalanced monthly at the beginning of each month.

## Strategy Recap

Turning to our performance, The London Company portfolios produced mixed results amidst the various macro crosscurrents. Down the market cap spectrum is where our quality orientation shined brightest. Our Mid Cap, SMID and Small Cap portfolios all produced strong relative and absolute performance that exceeded expectations. Our Large Cap and Income Equity portfolios fell short of our 85-90% upside capture expectations versus their respective core benchmarks, the Russell 1000 and S&P 500. Income Equity, however, outperformed its primary benchmark the Russell 1000 Value. The aforementioned rate

reprieve and flock toward balance sheet strength led to a large mega-cap growth rally, pushing valuations for Tech back to record highs. Eight stocks accounted for ~85% of the S&P 500's return in Q1—all P/E valuation multiple expansion. Underexposure to this group was a headwind for our Large Cap and Income Equity portfolios versus the Core indexes. That said, the balance sheet strength of all our portfolios helped them outperform the lower quality Value indexes, which are characterized by having significantly higher leverage ratios and weaker profitability.

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Beyond our quality orientation, an underweight to Banks served as a tailwind to relative performance. While we own a couple of banks across our portfolios, this general underweight is a byproduct of our investment process. We get our downside protection through quality, which we define as durable competitive advantages, strong returns on invested capital, and balance sheet flexibility. We like companies that have more control over their own destiny. Our issue with banks is a general lack of competitive advantages and a dependence on the unpredictable interest rate environment. Banks are also very cyclical and can be volatile during periods of economic distress or instability as we saw in Q1. That said, banks can be a meaningful part of the benchmark (~9% of the Russell 2000 & ~6% of the Russell 1000 Value Index), and we recognize there are some periods when they deliver strong performance. For us, however, we tend to gravitate towards businesses that can weather the full economic cycle and steadily compound wealth over the long term.

## Looking Ahead

It hasn't been an easy ride for investors, and the road to the end goal is now less clear. The banking crisis doesn't help the broader economic situation, and the story of instability in the industry may continue to unfold. Even before the banking turmoil, the earnings landscape was already on the precipice of decline due to the lagged effect of the Fed's tightening. The addition of tighter lending standards could spell trouble ahead. According to Piper Sandler, every recession since 1960 was preceded by a Fed tightening cycle, above-average inflation, and tighter lending standards. Further, the yield curve has been inverted for a year at this point. If a recession is avoided, it would be a historical first. Despite those sobering stats, valuations and general market complacency actually rose late in Q1, as greed for rate cuts seemed to outweigh fears of recession. The headwinds appear to outnumber the tailwinds, but there are still some encouraging dynamics that should not be ignored. Even if it is a lagging indicator, the labor market has been incredibly resilient. One year and 475 basis points later, the current 3.5% unemployment

rate is actually lower than it was in March'22. Further, we've had eight consecutive months of lower CPI inflation readings. In somewhat of an ironic twist, the unintended bank failures may help the Fed achieve its intended goals. The disinflationary impulse from the tightening of lending conditions could very well reduce the need for further rate hikes from the Fed. Plus, from a contrarian point of view, depressed sentiment readings and elevated money market balances have historically been great indicators for long-term investing. With everything taken into account, the macro environment may likely get worse before it gets better, and risks appear skewed to the downside.

For us at The London Company, we continue to focus on what we can control. As bottom-up stock pickers, this past year reminds us of a Charlie Munger quote, "Microeconomics is what we do and macroeconomics is what we put up with." The relentless waves of monetary policy and macro developments have been dizzying at times, but our focus remains on the economics of our underlying businesses. We don't know with any certainty whether a soft or hard landing is around the next turn in the road. Here's what we do know: large corporate debt levels, slower earnings growth, and a paradigm shift higher in the cost of capital is a problematic combination. We believe such conditions are favorable to fundamental active managers who can uncover quality companies that can self-fund their operations. By that measure, we take comfort in the durable profitability, strong free cash flow and balance sheet flexibility of our companies. Moreover, the total shareholder yield (dividends + net buybacks) for each of our portfolios is very attractive and could play a significant role in investors' total returns, should we experience a prolonged stretch of muted performance for equities. Taken together, we believe our portfolios have a tangible advantage as we enter a world that is more unpredictable with greater economic volatility.

The destination of tamed inflation and normalized interest rate policy hasn't changed, but now the path is more treacherous. As we explained last year, fighting inflation will be more of a process than an event. Even though we all wish this was a highway or a dragstrip, the journey from here will likely continue to be a meandering country road. Fortunately, for us at The London Company, we believe the quality of our portfolios provides us with a sturdy grab handle and a secure seat belt. We're buckled up and ready for whatever twists and turns may be ahead.

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#### Important Disclosures:

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The London Company of Virginia is a registered investment advisor. More information about the advisor, including its investment strategies, fees and objectives, are fully described in the firm's Form ADV Part 2, which is available by calling 804.775.0317, or can be found by visiting [www.tlcadvisory.com](http://www.tlcadvisory.com).

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