Alley Company Quarterly Letter
Navigating

January 14, 2022

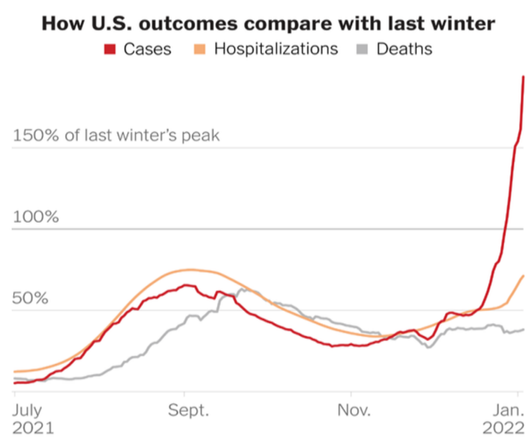
Two years into the global pandemic, the virus continues to be an unwelcome disruptor to both daily life and business activity. A recent spike in positive cases has pushed hospitalizations higher, upended family plans across the country, and added to labor shortages and supply chain bottlenecks.

While the path forward for public health, the Federal Reserve (Fed), and Corporate America will be bumpy, we are confident in the ability of humankind to "navigate" the environment and move in the direction of favorable outcomes! Investors, too, will need to navigate the terrain ahead and this is best done with discipline and a well-defined investment philosophy.

Public Health

The Omicron variant emerged on the scene in late 2021 and spread quickly around the world and throughout the United States. It is now estimated to account for 95 percent of new COVID cases in the U.S., according to the Centers for Disease Control and Prevention. As Exhibit 1 below depicts, however, the worst health outcomes have remained well below last winter's peak despite the recent surge in new case counts. This suggests that Omicron, while highly transmissible, is less virulent than prior variants (a welcome development and hopefully the case with future variants). The silver lining is potentially greater herd immunity that could help society navigate to a point where the virus has less influence on daily life.

Exhibit 1



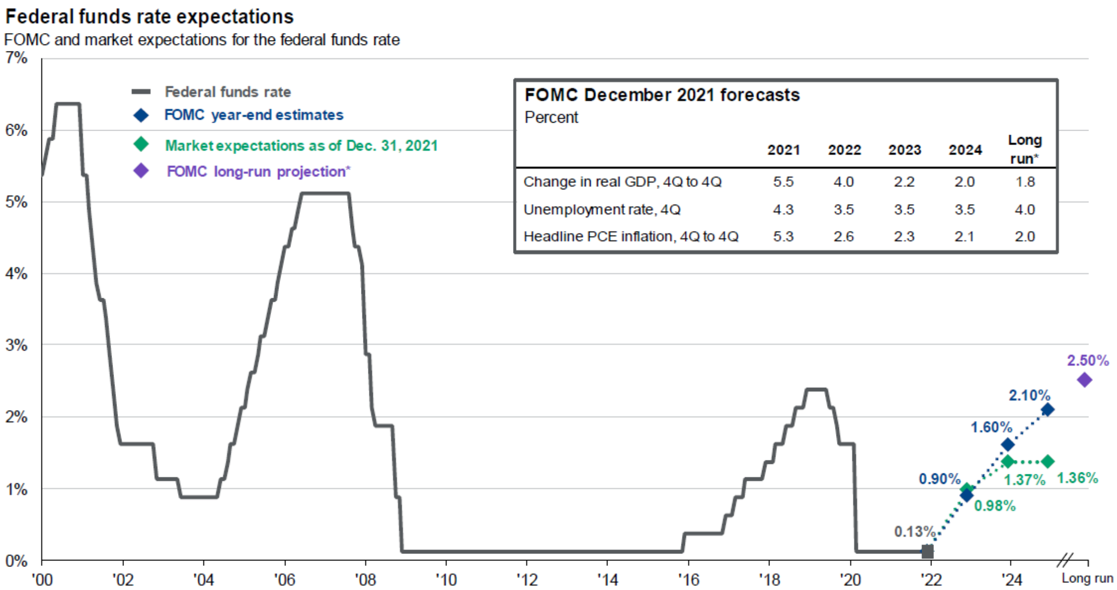
Source: New York Times database. Data as of 01/03/2022.

Alley Company LLC
585 Bank Lane, Suite 2400
Lake Forest, IL 60045
Phone 847-482-0938
Fax 847-482-1237
www.alleycompanyllc.com

Federal Reserve

While Omicron will take the edge off of near-term economic growth, the Fed must still address the implications of recent inflation readings that have persisted on the upside for a longer period than expected. At the end of 2021, headline inflation (including food and energy) was 5.3 percent, well above the Fed's long-run goal of 2.0 percent. Exhibit 2 below highlights the expected increases in the federal funds rate over the next few years as policymakers embark on the course of removing crisis-level accommodation. Led by Chairman Jerome Powell, Fed officials are expected to navigate this course gradually and with transparency.

Exhibit 2



	2021	2022	2023	2024	Long run*
Change in real GDP, 4Q to 4Q	5.5	4.0	2.2	2.0	1.8
Unemployment rate, 4Q	4.3	3.5	3.5	3.5	4.0
Headline PCE inflation, 4Q to 4Q	5.3	2.6	2.3	2.1	2.0

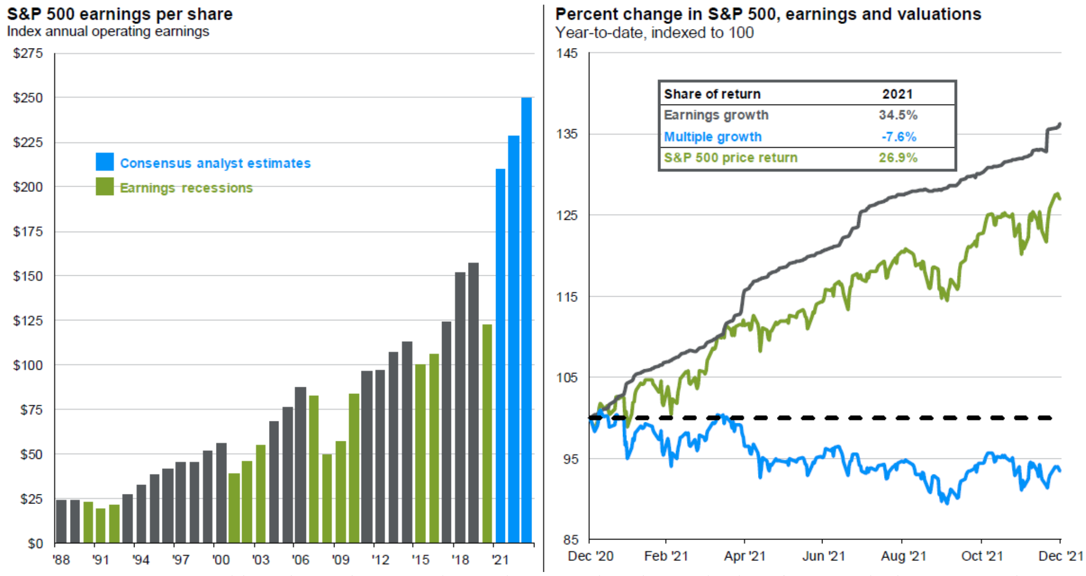
Source: J.P. Morgan Guide to the Markets. The Federal Open Market Committee (FOMC) reviews economic and financial conditions, determines the appropriate stance of monetary policy, and assesses the risks to its long-run goals of price stability and sustainable economic growth. *Long-run projections are the rates of growth, unemployment, and inflation to which a policymaker expects the economy to converge over the next 5-6 years in absence of further shocks and under appropriate monetary policy.

Corporate America

Businesses have collectively navigated the global pandemic remarkably well to this point. From lockdowns and stay-at-home orders to disrupted supply chains and tight labor markets, managers and employees alike have kept productivity high under challenging circumstances.

Strong topline results in a recovering economy, along with adept expense management has led to corporate profit margins holding near record levels. And as we wrote last quarter, skillful capital allocation via acquisitions, share repurchases, capital investments, and dividends can add additional value for shareholders over time. All told, per-share earnings recovered smartly in 2021 (see Exhibit 3 below) and importantly are expected to still grow at an above average clip in 2022 and 2023.

Exhibit 3



Source: J.P. Morgan Guide to the Markets. Earnings estimates are based on projections from Standard & Poor's and FactSet. Past performance is not indicative of future returns.

Investors

The stock market advanced 27 percent in 2021 reflecting the aforementioned fundamental performance of corporations. Interest rates, as measured by the 10-year U.S. Treasury bond, increased to 1.5 percent from 0.9 percent over the course of the year and thus the total return from the bond market was slightly negative.

Inflation and rising interest rates caused price-to-earnings (P/E) multiples in equity markets to *contract* in 2021 (depicted in Exhibit 3) and while this will be a closely watched variable in 2022 and beyond, it is also important to understand how long-term earnings growth can offset valuation multiple contraction that occurs from time to time. While bonds are susceptible to negative total returns in rising interest rate environments, they still have volatility dampening qualities for a portfolio and investors can benefit from re-investing at higher yields as bonds mature.

The best way for investors to *navigate* the road ahead is through disciplined portfolio balance and adhering to a well-defined investment philosophy. We believe that a diversified portfolio of high-quality companies with leadership market positions, pricing power, and astute management teams can afford investors the opportunity to increase the purchasing power of assets over time with a keen eye on the level of risk being taken.