Alley Company Quarterly Letter
Word of the Year

January 10, 2023

For Oxford dictionary, the Word of the Year is chosen to represent "a word or expression that reflects the ethos, mood, or preoccupations of the past twelve months." The winning selection for 2022 was "goblin mode."

goblin mode (gob-lin mohd) – *"a type of behavior which is unapologetically self-indulgent, lazy, slovenly or greedy, typically in a way that rejects social norms or expectations."*

We readily admit to having to use the Oxford dictionary to look up the definition of this new, popular expression. So for us, while goblin mode has apparently entered the mainstream lexicon, it also captures the feeling that 2022 was an atypical and unsettled year!

Turning to financial markets, there was a hands-down winner for "word of the year:" **inflation**.

In 2022, high and persistent inflation burdened consumers with elevated food and energy costs; it challenged American businesses to manage increasing cost pressures and end-product pricing; and it forced the Federal Reserve to quickly and aggressively tighten monetary policy. While a modest level of inflation is desired for a healthy economy, deleterious effects occur when it runs too hot.

As the Fed raised interest rates to fight inflation, financial markets endured a challenging year. As 2023 begins, however, the investment landscape has changed, in some cases significantly, as highlighted in the exhibit below.

	12/31/2021	12/31/2022
S&P 500 Index	4,766	3,839
P/E Ratio	21.2	16.7
10-yr. U.S. Treasury Yield	1.52%	3.88%
Federal Funds Rate	0.00%	4.50%

Source: Guide to the Markets – J.P. Morgan Asset Management. P/E ratio is based on forward 12 month estimated earnings per share.

Despite the S&P 500 Index declining, corporate earnings have actually chugged along and thus the price-to-earnings (P/E) ratio for the market has become more attractive. The resiliency of

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Corporate America has been on display over the past few years with earnings now roughly 35% *higher* than 2019 (pre-Covid) levels. However, the Fed's resolve to tame inflation could result in recession and will likely slow earnings growth in 2023. But the more important question for long-term oriented investors is: what will earnings be a few years out? To that end, we believe that Corporate America is always innovating, driving efficiencies, and is poised to deliver increased profits in the years ahead.

Bond yields have risen to levels where investors can now earn a reasonable amount of interest on cash and fixed income investments relative to a year ago where the ten-year government bond yielded a paltry 1.52%. Credit quality in the fixed income arena has largely remained strong. While stocks continue to be the favored vehicle for long-term growth of purchasing power, bonds offer an improved nominal yield and volatility-dampening potential for a portfolio over time.

A year from now, we know that Oxford dictionary will move on from goblin mode to another word that captures the mood of 2023. Hopefully the aggressive Fed tightening policy over the past year will continue to moderate inflation and we can also move on to a more productive word for the financial markets. With that in mind, there are some favorable trends that have recently developed:

- After peaking at a 40-year high of +9.1% in June, the consumer price index (CPI) annual rate has declined to +7.1% as of November.
- The monthly CPI statistics from July through November show a material easing of inflation down to an annualized rate of +2.6%.
- The prices of crude oil and natural gas have declined by 35% and 55%, respectively, since June.
- Fourth quarter 2022 wage growth on an annualized basis came in at +4.1% compared to +6.1% a year ago.

<u>Principles</u>

The challenges of 2022 have reminded us of some "time tested" investment principles that should give investors peace of mind and provide a strong foundation for long-term success:

1) *"Understand what you own"* – In recent years, the allure of cryptocurrencies stirred the speculative impulses of many market participants. The recent unraveling of the industry highlights the ever-important axiom that understanding what you own should be foundational to one's investment program.

2) *"Quality matters"* – Economies can go through choppy periods as we are currently experiencing. Owning quality companies, defined as having demonstrated long-term track records of success, strong market power, dependable balance sheets, and astute management teams, can provide relative comfort. As famed investor Peter Lynch once said, "time is on your side when you own shares of superior companies."

3) *“Adhering to a disciplined investment philosophy”* – Successful investing requires having a well thought out approach that focuses on long-term results. Staying true to that philosophy is the key.

Looking forward, we know that markets have at least to some degree discounted an economic slowdown. Cash and fixed income securities offer investors better nominal yields than the recent past. Corporate America has displayed a level of resilience and stocks now trade at statistically more attractive prices relative to earnings expectations. Whatever 2023 has in store, we will continue to abide by our long-standing principles outlined above.