HUNT VALLEY WEALTH

A Connectus Partner

Market & Portfolio Commentary

Q1 2023

First Quarter Market Review and Commentary

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Stocks rebounded sharply from December lows, but we don't appear to be out of the woods just yet.

The S&P 500 index rose roughly 6%, while the NASDAQ advanced 10.72% in January to start the year. Over the next two months of the quarter, the S&P added another 1% while the NASDAQ tacked on another 6%. In summary, the S&P finished up 7% while the NASDAQ surged 17% for the quarter.

It seems that the rapid rate increases by the Fed over the past year are starting to show its effects on the economy. Inflation, while still elevated, appears to be waning. The February Employment Report showed that the upward pressure on wages might be easing. Housing and manufacturing are showing some weakness, and consumers are beginning to exhibit some hesitation to spend on certain items. Despite the progress, inflation is still above the Fed's 2% target, and it's still unclear if that goal can be achieved without risking a recession or systemic problems.

One such systemic disruption has shown up in the banking sector. During the month of March, two large regional banks failed; Silicon Valley Bank and Signature Bank. For a detailed explanation, see our letter that was sent out on March 16 (link). To simplify what happened, the banks invested in longer-term bonds that they could not readily convert to sufficient cash to meet large withdrawals from depositors. These events prompted the federal government to step in and protect deposits. Talks of a possible contagion still linger.

While the causes of bank failures are complex, Fed policy clearly played a role. Federal Reserve policymakers are walking a tightrope in a battle to tame prices. It remains to be seen if they will be able to do so without unintended consequences of a recession or other potential systemic problems. History has shown that periods of Fed monetary tightening have a strong tendency to "break something," as shown in the chart below from BofA Global Investment Strategists.

Fed tightening always “breaks” something

US Fed Funds target rate

Source: BofA Global Investment Strategy, GFD Finaeon, Bloomberg.

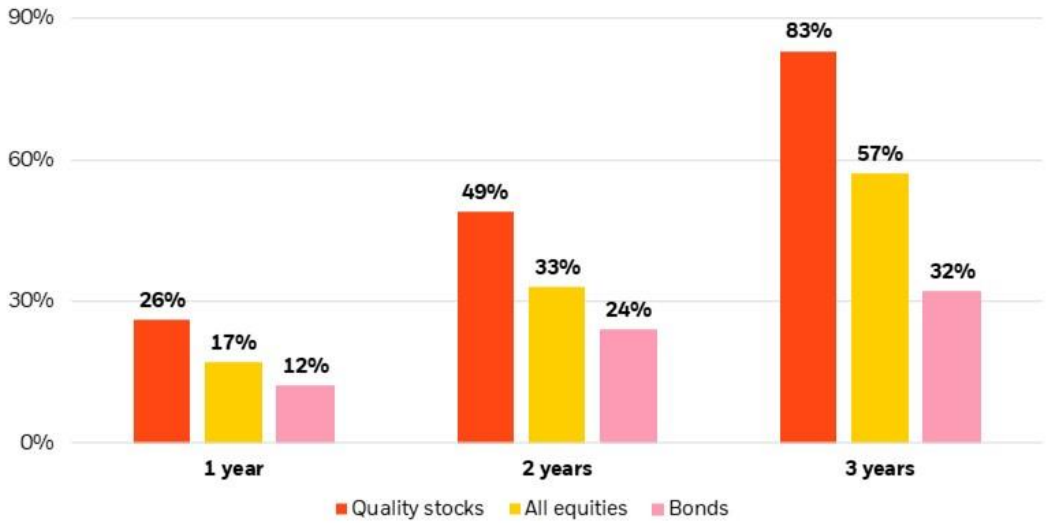
Looking ahead, it would stand to reason that the stress on the banking industry could make it difficult for them to provide loans to the private sector. Faced with perceived business risks, banks will seek to hold their capital more tightly. This would slow economic activity, which would help the Fed in its efforts to bring down the inflation rate.

Turning the attention to individual companies, the near-term earnings outlook appears uninspiring. Many companies are reducing staff as defending margins seems more important than business expansion. Facing an economic slowdown and having businesses pull back on growth may seem dire, but there could be some good news. We may be nearing the end of the Fed rate hike cycle. If that’s the case, and history is a guide, stocks have performed well after the last Fed rate hike.

The chart below, produced by BlackRock, shows the returns of Quality Stocks, All Equities, and Bonds after the Fed stopped raising rates from 1984 - 2021. The chart suggests that while all three asset classes performed well, “quality stocks” have outperformed. Their definition of a “quality stock” is proprietary, but you can get the idea.

Quality readying to lead?

Average returns after Fed hiking cycle ends, 1984-2021



Source: BlackRock Fundamental Equities, with data from the Board of Governors of the Federal Reserve System and Bloomberg, calculated from August 31, 1984-Dec. 31, 2021. Returns are calculated from the month when the Fed stops raising rates for peak rates periods in 1984, 1989, 1995, 2000, 2006 and 2018. All equities represented by the Russell 1000 Index and bonds by the Bloomberg U.S. Aggregate Index. "Quality" is defined as the top quintile of stocks ranked in the Russell 1000 Index using a proprietary research screen that assesses companies on 13 "quality" metrics. Past performance is not indicative of current or future results. Indexes are unmanaged. It is not possible to invest directly in an index.

When investing in stocks, it's important to remember that there will always be something to worry about. Nobody can predict interest rates or the future direction of the economy, and we are no exception. While the stock market can seem like a yo-yo at times, it's important to remember that businesses are not.

In spite of the uncertainty in the markets and economy, we continue to focus our attention on what's actually happening to the companies that we own or look to own in the future. If we should encounter a period of volatile market prices, we hope to take advantage of it.

"We own publicly traded stocks based on our expectations about their long-term business performance, not because we view them as vehicles for adroit purchases and sales. That point is crucial: Charlie and I are not stock pickers; we are business pickers."

- Warren Buffett

John Heinlein

Managing Director,
Chief Investment Officer

Q1-2023

Company Spotlights

Apple Inc. (AAPL)

Apple is the leading smartphone manufacturer in North America and narrowly the second-largest in the world. The company's brand is world-renowned, and its community of users is large and fiercely loyal. This user base may also be Apple's greatest asset.

Our estimates suggest that Apple's user base is not only vast but also well-positioned to generate new profit streams. *Optionality* is a virtue we greatly value when building an investment case, and Apple's future certainly has it. We have seen this with recent product releases like the Apple Watch and Air Pods and service offerings like Apple Pay and Apple TV. With the benefit of a large and loyal existing user base, Apple has no shortage of paths for growth. Each new device or service offering also further embeds Apple into the lives of its users, making it difficult to change and leave its ecosystem.

In the modern tech world, Apple acts as a gatekeeper to the mobile internet – meaning a significant portion of commerce done via mobile phones must flow through Apple's ecosystem. Here are two examples:

- Apple (along with Google) facilitates the majority of mobile application sales (apps) outside of China. App developers rely on Apple's distribution to sell their products and reach a broader audience. For this, Apple takes a percentage of app and in-app purchases – often as high as 30%.

- As the device manufacturer, Apple can also, in part, dictate how a user's data is collected, stored, and transmitted. This is especially important for digital advertisers, who rely on this data to identify potential customers and deliver targeted ads. Apple allows its users to restrict access to this data through its App Tracking Transparency (ATT) setting. When this setting is turned off, it is much harder for advertisers to identify and target these customers.

This puts Apple in a position of strength as the company can dictate how commerce takes place on mobile devices, which have become the predominant medium of consumption. Apple is also *facilitating* business in this case and simply taking a cut of the transaction rather than generating business. This concept may sound familiar, as we have discussed it in previous letters with other portfolio companies. Facilitating transactions is a much more profitable business than selling devices. Fortunately for Apple, this is one of its faster-growing segments, too.

Apple has drawn its share of critics who argue that the company holds too much power. In our experience, this often signifies the presence of an *economic moat*. Without this moat, other companies vying for a share of the profits should be able to disrupt that competitive advantage. But since it maintains such a strong position in the industry, these companies resort to critiques and lobbying in an attempt to disarm the competitive advantage.

We view Apple as a core holding and will continue holding as long as it maintains its stronghold. The company's shares sell at a premium, and deservedly so. However, we require an appropriate level of upside potential, which is why we have not bought more recently and have trimmed overweight positions at elevated share prices.

Matthew Holman, CFA

Portfolio Manager

Booking Holdings Inc. (BKNG)

Booking Holdings is an Online Travel Agency (OTA) that facilitates transactions between travel service providers and consumers in exchange for a commission. The company operates Booking.com, Priceline, Agoda, KAYAK, and OpenTable.

Hotel rooms are perishable products, meaning a vacant room on a given night cannot be sold once that night passes. At the same time, hotels have mostly fixed expenses (e.g., rent and wages), and it costs very little to sell each additional room once those expenses are covered. These two factors lead to a very logical incentive for hotel owners: fill as many rooms as possible each night, even if it requires offering discounts or paying someone to help you fill those rooms. This is where Booking enters the picture, acquiring customers on behalf of hotels and passing savings to those customers in the form of discounted rates. In return, Booking receives a percentage of the gross bookings. Everyone wins.

In our opinion, Booking runs one of the most efficient performance marketing operations in the world. It has optimized its platform to obtain low-cost Google Ads, while also converting traffic more efficiently than competitors due to its breadth of accommodation inventory. It has built an increasingly loyal user base through effective brand marketing and established mutually beneficial relationships with hotels around the world. All these strengths combine to create a customer acquisition machine with one purpose: to fill rooms for hotels that are willing to share their profits. Booking's services are especially valuable to independent hotels that lack large marketing budgets and loyalty programs. These hotels are more common in Europe, which is where Booking has the largest relative market share.

It would be an understatement to say the last few years have been challenging for Booking. The pandemic created record-low occupancy rates, shrinking demand for the company's services. The war in Ukraine has generated instability in Europe – the company's most lucrative market. We accumulated shares of BKNG during this period because we were confident in the business model. In our view, Booking's ability to rapidly increase or decrease marketing spend (its largest expense) in anticipation of travel demand is greatly underappreciated. We also believe its executives are disciplined capital allocators and aligned with shareholders. They continue to invest in the company's strengths while returning excess capital through share repurchases. In 2022 alone, after generating record free cash flow, management repurchased 8% of Booking's outstanding shares, meaningfully increasing our ownership stake in the company.

Management's ultimate vision is to create "The Connected Trip," where all travel needs can be facilitated on its platform – hotels, flights, alternative accommodations, rental cars, restaurant reservations, etc. While we do not believe achieving this vision is a requirement for our investment to be successful, we think it provides optionality and the potential to grab a larger share of the consumer's wallet. Additionally, as more transactions move through the company's internal payment platform, Booking can take a greater percentage of the economics. We view this as an optimal time to invest in this venture as consumers form new travel habits on the other side of the pandemic.

Louis Foxwell, CFA

Portfolio Manager

We are here to support you and your wealth management objectives.

Especially now, we invite you to connect with your advisory team to discuss the markets, inflation, or your personalized wealth management strategy. We remain committed to your goals, both near and long-term.

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