December 31, 2022

Quarterly Letter to Investors
Fourth Quarter 2022

CRAWFORD
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In 2022 both stock and bond investors suffered bear markets. In the midst of Covid, high inflation, the war in Europe, and sharply rising interest rates, all investors were tested, and all are ready for a new opportunity in 2023.

"Life can only be understood backwards, but it must be lived forwards."
- Soren Kierkegaard

Kierkegaard, the famous Danish philosopher of the 19th century, often considered the father of existential philosophy, was also a theologian, social critic, and poet. Despite this range of talents and elevated intellect, Kierkegaard was able to distill wisdom into simple yet profound quotes, such as the above. When he wrote this sentence, no doubt the farthest thing from his mind was the investment world, yet this philosophical rule can certainly be applied to investing. This is particularly so as we begin a new year looking forward. At the same time we can look back to lessons learned from our past that will better prepare us to live our investments forward.

UNDERSTANDING BACKWARDS. Considering a few of the more pressing issues that the economy and markets have been working through this past year, we will review in order some of what we have learned. 1) Sometimes it is important to be on recession watch, 2) we need to be reminded that inflation can be conquered, and 3) in not only the last year, but over the course of our history as a firm, we have learned the value of quality as a very important aspect of long-term investing.

While the normal course of our economic history has featured an upward sweep of economic growth and corporate success, we know that from time to time things get out of balance in such a way that excesses have to be corrected. Sometimes the correction comes naturally; other times monetary policy must be used as a corrective measure. Currently the U.S. and global economies are out of balance in one major way: inflation, and monetary policy is being committed to bring it under control. Often, because of the extensive lag time from a change in monetary policy to its effect on the economy, there is room for error. During the lag time it is very difficult to measure the extent to which policy is actually affecting various economic factors. The risk is that the Federal Reserve (Fed) can go too far with interest rate increases, thus causing a recession, or not go far enough and thus lengthen the process and eventually require more stringent measures. In either case, during the lag time, it is important to be on recession watch.

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At our firm we are watching certain indicators that can warn of recession, such as the yield curve, the index of leading economic indicators (LEI), and employment data, including initial unemployment claims and wage growth. At this point initial claims are very low, a good sign, and wage growth, while higher than desired, is not yet signaling a wage-price spiral. The yield curve and LEI, however, are sending different messages. A lesson from the past is that one of the more reliable recession warning signs is an inverted yield curve. Inverted means that short-term interest rates are higher than longer-term ones. Normally, the yield curve slopes upward across the maturity spectrum so that holders of longer-term maturities are paid more to compensate them for future interest-rate risk. Currently the curve is severely inverted in the important 90-day to 10-year portion, as well as in the 2-year to 10-year range. When these two measures have been inverted at the same time, the indications have been strongest that a recession is on the way. In addition, when the LEI turns negative in conjunction with an inverted yield curve, as it recently has, it is an even more powerful signal that recession pressures are building.

However, even though we are on recession watch, we are not predicting a recession. There is still the hope that the Fed will be deft enough to pull off a “soft landing” where economic growth slows but does not reverse, and inflation comes down to the target. One factor that makes this scenario somewhat more plausible is the fact that supply disruptions continue to ease. Perhaps this will allow the expected decline in inflation to come faster and require less economic pain.

We have also learned, not this past year but over time, that inflation can be tamed. This should be encouraging to all investors and consumers. As discussed above, it is not easy, and it usually involves some economic pain, but it can be done.

Stated simply, our inflation problem is a result of an imbalance of supply and demand. And it arose due to the Covid pandemic and the monetary and fiscal response that followed. After Covid arrived the economy was shut down, Gross Domestic Product (GDP) collapsed, unemployment went up immediately to 15%, and deflation occurred. Understandably, the monetary and fiscal authorities went into emergency mode. Money in vast amounts was created and distributed, thereby causing excess demand at a time when supply chains were either shut down or disrupted. The result: an excess of demand over supply that led to rising prices.

Now, however, monetary policy is in negative response. The Fed cannot improve the supply side, but they can reduce demand by raising interest rates. Their goal is to bring supply and demand back into balance and thus restore a low inflation environment. The target is 2% inflation, and while we are a long way from target, progress is now being made. From a peak of 9% inflation as measured by the Consumer Price Index (CPI) in June, the November number came in at 7.1% year-over-year. It may be safe to say that inflation has peaked, and other indicators suggest that the trend lower should continue. How long it will take to reach the 2% target, and how high and for how long interest rates will have to stay high, nobody knows, not even the Fed. Our position is that the Fed will be successful; they really have no choice. But our optimism is tempered by the realization that conquering inflation is never easy, and the battle may go on for some time. At the least, however, we know that inflation can be controlled.

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Last year in particular reinforced a lesson that we learned a long time ago, that in uncertain times the best place to be invested is in high-quality securities. 2022 was a challenging year for investors, but we believe the investment results for the portfolio were very acceptable, considering all of the circumstances. And to this we can attribute quality as the primary reason.

Almost every quarter we write about quality as a central element in the way we invest. Sometimes clients ask us what quality really means. To us, quality is a composite characteristic that resides in an enterprise that provides the investor a higher degree of predictability of the investment's eventual outcome. In common stocks, quality emanates from the consistency and stability of the underlying business, steady demand for their products, financial strength, scale, clear delineation of goals by management, and shareholder friendliness through dividends and buybacks. In bonds, quality resides almost exclusively in the strength of the balance sheet.

Kierkegaard would likely say that for any individual to lead a successful life there must be an organizing principle around which that person defines the way he/she lives. Likewise, an investment management firm must have an organizing principle that centers, focuses, and drives the consistency of investment. Our organizing principle is quality. It has been from the start, and will continue to be. Last year it served us well, and we believe it will in the future.

LIVING OUR INVESTMENTS FORWARD. We enter the New Year glad to turn the page on a challenging 2022 and hopeful that 2023 will bring a more satisfying environment. As always, the future remains uncertain, but we proceed in the belief that we are girded with the elements of eventual success because of how we invest. We seek to narrow the range of outcomes, thereby heightening the chance of success in our investments. We may have a recession, but if we do, we believe we will be reasonably protected from it; we believe that inflation will be trending downward this year; and we believe our emphasis on quality will be a sustaining force as we move through the year.

It is a privilege for our firm to have the opportunity of working with you toward the attainment of your investment goals. For that we are ever grateful, and we commit to our best efforts on your behalf.