Davenport Asset Management Quarterly Update | Q1 2023

March 31, 2023

Stocks managed to perform surprisingly well in the first quarter despite the double whammy of hawkish talk from the Fed and turbulence in the banking system. However, it wasn't always smooth sailing. In early February, the S&P 500® Index was up 9% and looked to be on its way to a swift recovery from 2022 losses. However, this proved too good to be true, as recession fears ultimately resurfaced and prompted stocks to decline from early February to mid-March. After a late-March rally, the S&P 500 and Russell 2000® Index finished the quarter up 7.5% and 2.7%, respectively. Growth-oriented areas like technology (up 21.8%) dramatically outperformed more cyclical sectors such as energy (down 4.7%) and financials (down 5.6%) as recession risks grew.

Market Returns	Q1 2023	2022
U.S. Large Caps	7.5	-18.1
U.S. Mid Caps	4.1	-17.3
U.S. Small Caps	2.7	-20.4
International Developed Markets	8.5	-14.5
Emerging Markets	4.0	-20.1
Intermediate Term Bonds	2.3	-8.2

Source: Morningstar Direct. Please see index for definitions.

What caused the wild ride? Stocks started the quarter with a bang as hopes for an economic "soft landing" sprung eternal. But, inflationary pressure proved more persistent than hoped and prompted the Federal Reserve to renew its commitment to containing price increases with interest rate hikes. "Hawkish" policy aimed at subduing inflation naturally raises the risk of economic slowdown. As an important aside, higher interest rates have also made fixed income vehicles (Treasuries, CDs, money market funds etc.) more competitive when compared to stocks. For sure, it makes more sense to consider a 6-month T-bill when yielding nearly 5% as compared to roughly 1% a year ago.

Later in the quarter, stress in our banking system took center stage. Silicon Valley Bank (SVB) collapsed after large investment losses and deposit flight caused its equity value to evaporate. While a somewhat unusual situation, SVB's failure led to pressure elsewhere in the regional banking system and created fear of broader financial contagion. The mess appears to have been contained with the help of the federal government. Nonetheless, it has brought about an incremental threat to the economy. Indeed, deposit flight and heightened regulation may impair the ability for many banks to lend, and capital could become more expensive. This is not to mention the negative impact to consumer confidence created by these recent headlines.

Recession risks have clearly risen as a result of the banking debacle and most economists now believe there's greater than a 50% chance economic growth turns negative before year end. However, there is a positive flipside to this coin that supported stocks late in the quarter. While still focused on quelling inflation, the Federal Reserve now seems more attuned to heightened economic risks and may start to slowly back away from restrictive policy if inflation subsides alongside economic duress. At a minimum, it already appears the pace of interest rate hikes is peaking. Some are even predicting interest rate cuts within the next 12 months. Barring a severe recession, "looser" policy and lower interest rates should be a positive for asset classes such as stocks.

Putting it all together creates a tricky conundrum for investors. On one hand, we clearly have ongoing inflation pressures as well as heightened economic risk. On the other hand, the interest rate hikes that were the primary headwind for stocks in 2022 may be coming to an end. Acknowledging these fighting forces, we reiterate our comments from year end. We noted that the stock market's overall valuation level seemed fair (i.e. not overly cheap or expensive) and returns should moderate when compared to the turbo-charged "cheap money" era. Adding to that, we also think investing in high quality business models with durable growth and low debt levels makes more sense than ever. We continue to seek out such opportunities at reasonable prices and have added some new names to our portfolios.

In further news, we are pleased to announce we have moved to a team management structure for both the Core Leaders and Value & Income Portfolios as of March 31, 2023. Individual portfolio decisions will be made at a team level similar to the Equity Opportunities Portfolio and Small Cap Focus Fund. We believe having dedicated teams will allow for greater flexibility, focus and accountability when managing the portfolios. The new portfolio teams are as follows:

- Davenport Core Leaders Portfolio: George Smith, Chris Pearson, Jeff Omohundro
- Davenport Value & Income Portfolio: George Smith, Adam Bergman, Mike Beall

While the new teams will take on the responsibility of daily investment decisions, it is important to acknowledge the Investment Policy Committee (IPC), which includes the members of the portfolio teams, will remain an integral part of Davenport Asset Management. The IPC will continue to provide guidance, ideas and market perspective on a weekly basis.

Bloomberg Market Returns	Q1 2023	2022
U.S. Govt/Credit	3.2	-13.6
U.S. Govt/Credit Interm	2.3	-8.2
High Yield Corporate	3.6	-11.2
Municipal 1-10Y Blend 1-12Yr	2.0	-4.8
U.S. Govt/Credit 1-5 Yr	1.8	-5.5
U.S. Govt/Credit 1-3 Yr	1.5	-3.7

Source: Morningstar Direct.
Please see last page for index definitions.

While this is a quarterly note, the real storyline unfolded during the month of March. We entered 2023 on the heels of aggressive rate hikes that repriced fixed income markets, especially longer duration assets. Consensus saw another hike or two possible in 2023 but most believed monetary policy's heavy lifting was done. The outlook debate was whether rates would remain higher for longer or if rate cuts in 2023 were potentially in the cards.

On March 7 and 8th, Jay Powell addressed the U.S. Senate and House. The tone of his semi-annual monetary policy report took a hawkish tone, supported by sticky inflation and robust economic data. Markets quickly repriced the possibility for a 50-basis point hike in lieu of 25 at the following Federal Open Market Committee (FOMC) meeting, held March 21 - 22. The 2-year Treasury yield neared an intraday high of almost 5.1%. Then suddenly, attention shifted to bank run fears. Silicon Valley Bank (SVB) headlines flooded all media outlets. The 2-year Treasury yield fell to 3.7% on March 24th, approximately a 130 basis point drop. Recession fears were now not just whispers but a real conversation.

The risk-off pivot was most pronounced in banking and financial firm credit spreads which reacted negatively to an unclear but dark macro backdrop. Regional banks were the epicenter of concern as depositors and investors feared the worst. The ugly word "contagion" reemerged as markets witnessed the Credit Suisse acquisition by UBS, who had significant central bank support and encouragement.

All things considered, we remain optimistic on fixed income. The asset class is producing elevated yields as inflation, while sticky, trends downward. The recent volatility has created an all the more attractive entry point for available investment capital. By no means are we saying it won't be a bumpy ride (think mark-to-market swings) but ultimately investment grade debt matures at par with an extraordinarily low default rate. We continue to see the best value in shorter maturity debt that provides not only high income but low duration. Lower rates are inevitable and we remain focused on opportunities that lock in higher rates for longer and reduce reinvestment risk. The 10-year Treasury is the longest maturity permissible by the majority of our investment mandates. Our view is that fair value is closer to a 4% yield and we are not at that level yet. When buying longer corporate credit, the time window for things to go wrong increases, which is why thoughtful corporate analysis becomes critical. Our investment process remains rooted in fundamental credit analysis which we believe creates durable income generating portfolios, especially through turbulent times like these.

2-Year Treasury Yield 12/30/2022-03/31/2023

Source: Bloomberg

Implied Treasury Market Volatility (MOVE Index) 12/30/2022-03/31/2023

Source: Bloomberg

Important Disclosures

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The ICE BofA **US High Grade Corporate Master Index** tracks the performance of US dollar denominated investment grade corporate debt publicly issued in the US domestic market. The ICE BofA **US High Yield Master II Index** is an unmanaged index comprised of over 1,200 high yield bonds representative of high yield bond markets as a whole. All information provided by ICE is owned by or licensed to ICE. ICE retains exclusive ownership of the ICE Indices, including the ICE BofAML Indexes, and the analytics used to create this analysis ICE may in its absolute discretion and without prior notice revise or terminate the ICE information, Indices and analytics at any time. The **Bloomberg Municipal 1-10 Year Blend 1-12 Year Index** measures the performance of short and intermediate components of the Municipal Bond Index — an unmanaged, market value-weighted index which covers the U.S. investment grade, tax-exempt bond market. A **Treasury Index** is an index based on recent auctions of U.S. Treasury bills and is commonly used as a benchmark when determining interest rates, such as mortgage rates. A **High Grade Corporate Bond** is believed to have a lower risk of default and receive higher ratings by the credit rating agencies. A **Leveraged Loan** is a type of loan that is extended to companies or individuals that already have considerable amounts of debt or poor credit history. A **Municipal Bond**, commonly known as a muni, is a bond issued by state or local governments, or entities they create such as authorities and special districts. A **Convertible Security** is a security—usually a bond or a preferred stock—that can be converted into a different security—typically shares of the company's common stock. A **Preferred Stock** is a class of stock that is granted certain rights that differ from common stock. A **Mortgage Master** is an investment similar to a bond that consists of a bundle of home loans bought from the banks that issued them.

A security's credit rating is the grade a rating agency assigns to indicate the risk of default and, in some cases, takes into consideration the potential loss to investors in the event of default. Further information and a more extensive discussion on credit ratings can be found at www.sec.gov/ocr. Users are cautioned that rating agencies may assign different meanings to similar terms.

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