Davenport Asset Management Quarterly Update | Q4 2022

December 31, 2022

Market Returns	Q4 2022	2022
U.S. Large Caps	7.6	-18.1
U.S. Mid Caps	9.2	-17.3
U.S. Small Caps	6.2	-20.4
International Developed Markets	17.3	-14.5
Emerging Markets	9.7	-20.1
Intermediate Term Bonds	1.5	-8.2

Source: Morningstar Direct. Please see index for definitions.

We doubt many investors will be very upset about waving goodbye to 2022. Indeed, it was a tough year for stocks as evidenced by declines of 18.1% and 20.4%, respectively, for the S&P 500® Index and Russell 2000® Index. The NASDAQ® Composite was even worse with a 32.5% swoon, and the top four technology companies (Apple, Microsoft, Alphabet and Amazon) lost roughly $3 trillion of value. Of note, this was the worst year for the major indices since 2008. Was all this to be expected after an impressive multi-year run? Some moderation certainly seemed warranted, but it was painful nonetheless.

Let's take a walk down memory lane. We started 2022 expecting a year of transition as COVID receded, consumer behavior normalized, government stimulus waned and monetary policy began to tighten. We were then dealt a curve ball with Russia's invasion of Ukraine, which caused prices for oil and other commodities to spike. This dynamic, coupled with pandemic bounce back demand and associated supply chain challenges, caused inflation to reach 40-year highs and ultimately prove stickier than expected.

Consequently, the Federal Reserve embarked on an aggressive campaign to quell inflation and raised interest rates seven times. Ultimately, rates reached their highest levels in 15 years, putting a major damper on stocks as economic growth started to slow and bonds became a much more attractive alternative for investors. As the cost of borrowing increased, investor speculation waned and companies began to place much more of an emphasis on cost cutting than growth. Gone were the days of cheap money, limitless borrowing and investors' willingness to pay seemingly infinite multiples for "story stocks". Not surprisingly, beneficiaries of prior years' speculation fared much worse than the broader market indices.

As we enter 2023, inflation and Fed policy are still front and center. Inflation remains uncomfortably high. Yet, there are signs it has peaked. We expect inflation to recede as commodity prices normalize, home prices fall, supply chain issues abate, inventories rebuild and we begin to lap lofty Consumer Price Index (CPI) readings from 2022. The Fed remains very vigilant and has signaled their intent to continue raising rates and keep them elevated for the sake of winning their war on inflation. But, the pace of rate hikes is slowing and we believe we are closer to the end than the beginning of this tightening cycle.

More subdued inflation and slowing rate hikes should be good things for markets. The lingering question, however, is the health of the economy. Many fear we are on the cusp of entering a recession as the full effect of Fed policy takes hold. Growth is clearly slowing as evidenced by weaker retail sales, softer manufacturing data and slackening corporate profit growth. Not surprisingly, a recession seems to have become the consensus prediction among CEOs, economists and Wall Street strategists. Should one occur, it may be the most well-advertised recession in history.

Any good news to consider? There is still a chance we see a "soft landing". This outcome would entail the Fed threading a needle by engineering a slowdown in growth without tipping us into recession. Such a rosy scenario currently seems implausible to most. However, just because we are seeing a slowdown doesn't mean the economy will be in shambles. For one, the economy enters this next economic chapter at near full employment with corporate and consumer balance sheets in relatively good shape. Furthermore, expectations for economic and profit growth have been adjusted downward and sentiment is quite dour. Perhaps we will see a manageable slowdown and widespread trepidation will prove unwarranted. Stocks could do okay in this scenario, especially after having already discounted a fair degree of duress.

This brings us to current valuation levels. The S&P 500 currently trades at a price-to-earnings (P/E) multiple of roughly 17x forward earnings estimates, down from 21.4x at the beginning of 2022. The former multiple was justified by near zero percent interest rates, a condition that no longer exists and likely won't anytime soon. In our opinion, stocks are clearly a better deal than they were a year ago; however, current valuation levels seem fair (i.e. not overly cheap or expensive) in light of new interest rate levels and growth expectations. As such, we would still argue equity investors could attain decent returns in coming years, but a moderation from the turbo-charged "cheap money" era.

What are we doing in this environment? As noted in our last letter, we remain focused on buying businesses with structural, long-term advantages that trade at attractive prices even when considering the potential for slowing growth. We've seen some opportunities appear as investors have broadly fled risk and think we can earn respectable returns even if the near term gets choppy. Remember, we are investing for more than one year. 2023 may indeed be a tough period for the economy. Over time, however, we believe Gross Domestic Product (GDP) and earnings will continue growing and stocks should yield solid results as they have for many decades. With that in mind, we intend to use our long-term time horizon to our advantage should volatile market conditions ensue. Happy New Year, and thank you for your trust.

What a difference a year can make and Happy New Year!

The dominant narrative of 2022 was runaway inflation, contrasting with the Federal Reserve's belief that it was a "transitory" phenomenon. The Covid-era liquidity infusion and negative interest rates reversed to such a magnitude that Japanese interest rates turned positive across its curve as the Bank of Japan ever so slightly relaxed historical interest rate caps. Geopolitical pressures and a labor market imbalance also captured investor attention last year.

Bloomberg Market Returns	2021	2022
U.S. Govt/Credit	-1.7	-13.6
U.S. Govt/Credit Interm	-1.4	-8.2
High Yield Corporate	5.3	-11.2
Municipal 1-10Y Blend 1-12Yr	0.5	-4.8
U.S. Govt/Credit 1-5 Yr	-1.0	-5.5
U.S. Govt/Credit 1-3 Yr	-0.5	-3.7

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

As we enter 2023, inflation persists but we now have higher interest rates that present a vastly different year-over-year backdrop. Recession talk has entered the conversation. Driving inflation down may likely come with the cost of an economic contraction. Inflation may have leveled off but remains nearly three times the Fed's 2% inflation target.

We expect inflation challenges to persist. Prices for goods seem to be stabilizing as supply chain constraints improvements appear to continue. Pricing pressure remains more entrenched in the services sector due largely, in our opinion, to a labor market imbalance.

Below are our key convictions that underpin our fixed income portfolio positioning:

- **Quality** (credit risk) – Short maturity Treasuries offer attractive relative value. The 2-year United States Treasury (UST) has risen ~370 basis points (bps) and offers a ~4.4% yield. We continue to see limited value in moving significantly down the ratings spectrum for incremental additional yield. We see credit markets near fair valuation with a higher probability for spread widening on recessionary headwinds.
- **Duration** (interest rate risk) – We do not see much risk/reward benefit to extending duration with such an inverted yield curve. The 2-year UST yield's ~4.4% versus the 10-year UST yield of ~3.7%. This translates to almost an additional 70 bps with much less duration risk.

We also thought it would be helpful to highlight the most consistent questions we have received in recent weeks.

1. Why not take on more duration if we are heading into a recession that will result in Fed rate cuts?
   - We believe there will be a time to look at longer maturity debt. The view that the Fed could pivot seems overly optimistic. Rates might not move much higher but they are also unlikely to be cut in the near to medium term.
2. When is the right time to reduce floating rate debt exposure?
   - Don't fight the Fed. As stated above, our base case is that rates could remain higher for longer. Our Treasury floating rate positions continue to see their coupons reset higher and will likely continue with further rate hikes. Unlike Treasury Inflation Protected Securities (TIPS), this exposure has no duration risk. Many investors were surprised to see long maturity TIPS down over 30% last year (akin to the 30-year UST total return) as inflation rose but didn't offset the high level of embedded duration which outweighed the benefits of a rising CPI.
3. What are your high conviction calls as we enter 2023?
   - We are very constructive on fixed income this year and forecast positive total returns. That's not to say we have no concerns. Corporate credit sector correlations remain high, limiting the sector and security selection opportunity. In our view, the most value remains in higher quality and shorter duration assets.
   - Volatility is unlikely to go away any time soon but we must remember that all our bond positions mature at par when the mark-to-market swings become overwhelming. Additionally, fixed income is now producing more income that provides a ballast to market swings.

Comparative Total Returns

- 2022 proved to be a tough year across asset classes. Fixed income did not provide the historic hedge to offset a down year for equities. As we move into 2023, we see fixed income returning as a natural equity portfolio hedge.
- Rising interest rates were the biggest headwind for performance. Fortunately, we took a cautious view on duration (interest rate risk) that allowed relative outperformance versus our strategies' respective benchmarks.
- Credit spreads were the second contributor to the challenges of 2022. Credit spreads were volatile throughout the year as many monetary and economic trends acted as a collective headwind.

Comparative Total Returns

Dec 30, 2022	Short-Term Cumulative Returns						Annualized Returns			
	YTD	WTD	1Mo	3Mo	6Mo	1yr	2yr	3yr	5yr	10yr
US										
Treasury	-12.86%	-0.59%	-0.53%	0.71%	-4.04%	-12.68%	-7.72%	-2.76%	-0.14%	0.60%
High Grade Corp.	-15.45%	-0.60%	-0.21%	3.52%	-1.77%	-15.26%	-8.41%	-2.79%	0.53%	1.99%
High Yield Corp.	-11.22%	-0.97%	-0.76%	3.98%	3.27%	-11.22%	-3.25%	-0.23%	2.12%	3.94%
Leveraged Loans	-0.63%	0.15%	0.43%	2.81%	4.22%	-0.60%	3.87%	3.62%	3.95%	3.90%
Municipals	-9.04%	-0.31%	-0.11%	4.02%	0.26%	-9.04%	-3.76%	-0.84%	1.20%	2.18%
Convertibles	-20.11%	-0.23%	-3.33%	0.70%	1.42%	-20.35%	-8.89%	8.98%	9.86%	11.19%
Preferreds	-14.60%	-1.49%	-1.92%	0.16%	-0.79%	-14.57%	-6.49%	-2.26%	1.01%	3.60%
Mortgage Markets										
Mortgage Master	-11.89%	-0.75%	-0.65%	2.06%	-3.43%	-11.75%	-6.68%	-3.23%	-0.51%	0.75%
US Equity Market										
S&P 500	-18.11%	-0.11%	-5.76%	7.56%	2.31%	-18.32%	3.00%	7.76%	9.42%	12.74%

Source: CreditSights, BofA/ML, S&P/LSTA, Bloomberg. Please see last page for index definitions.

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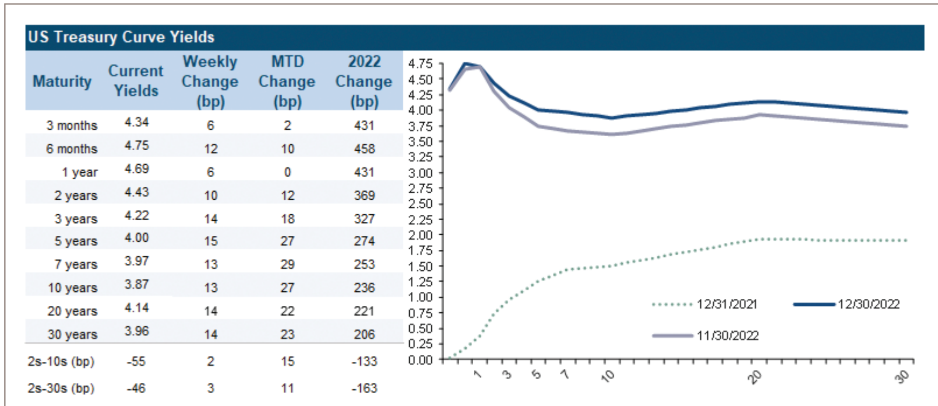
US Treasury Curve Yields

- The sheer magnitude of higher rates across the US Treasury curve was very pronounced in 2022 which underpinned increased coupon income.
- The second major takeaway was the development of an inverted curve which has historically been an accurate recession indicator.
- The advantage is we enter 2023 with much higher coupons that will partially cushion inevitable market swings predicated largely on inflation data and the Fed's response.



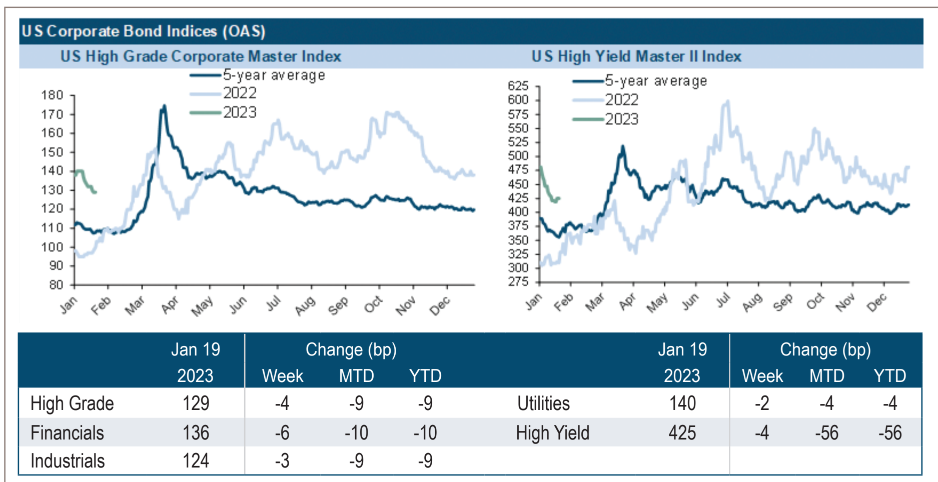
US Treasury Curve Yields

Maturity	Current Yields	Weekly Change (bp)	MTD Change (bp)	2022 Change (bp)
3 months	4.34	6	2	431
6 months	4.75	12	10	458
1 year	4.69	6	0	431
2 years	4.43	10	12	369
3 years	4.22	14	18	327
5 years	4.00	15	27	274
7 years	3.97	13	29	253
10 years	3.87	13	27	236
20 years	4.14	14	22	221
30 years	3.96	14	23	206
2s-10s (bp)	-55	2	15	-133
2s-30s (bp)	-46	3	11	-163

Source: CreditSights, Bloomberg. Data as of 12/30/2022

US Corporate Bond Indices

- Along with earlier mentioned rate volatility, credit spreads also experienced large moves throughout 2022. The overall trend saw spreads widen, even with bouts of temporary spread tightening.
- Looking at relative value, the credit market trades wider than its 5-year average. We believe this is justified pricing with recessionary concern on the horizon.
- We continue to have bias to higher quality issuers that have stronger fundamentals (balance sheet strength and cash flow generation) that should mitigate downside risk as market challenges grow in 2023.



	Jan 19 2023	Change (bp) Week	MTD	YTD		Jan 19 2023	Change (bp) Week	MTD	YTD
High Grade	129	-4	-9	-9	Utilities	140	-2	-4	-4
Financials	136	-6	-10	-10	High Yield	425	-4	-56	-56
Industrials	124	-3	-9	-9					

Source: CreditSights, BofA/ML Indices (C0A0) (H0A0)

US Investment Grade & High Yield Corporate Yield to Worst*

- The aggressive rate hike regime of the Fed throughout 2022 has led to a much more attractive investment landscape in 2023. With corporate yields now well above 5%, we believe investors are receiving appropriate compensation for all the risks including inflation and growth concerns.
- We continue to maintain our tilt towards shorter maturity and higher quality issuers as well as leveraging both corporate and Treasury floating rate notes. The yield curve inversion presents a challenging risk adjusted return profile with longer maturity debt facing elevated duration risk.
- As the table below illustrates, extending maturity or increasing risk does not, in our view, offer a very compelling yield pick-up.

US IG & HY Corporate Yield to Worst (%) by Rating, Tenor

	IG	AAA	AA	A1	A2	A3	BBB1	BBB2	BBB3	BB1	BB2	BB3	B1	B2	B3
Index	5.51	4.68	4.89	5.14	5.26	5.38	5.55	5.73	6.24	6.88	7.30	7.51	8.49	9.29	10.81
3Y	5.34	4.68	4.83	5.04	5.20	5.32	5.37	5.50	6.00	6.69	7.25	7.58	8.52	10.10	11.36
5Y	5.40	4.49	4.67	5.03	5.20	5.31	5.36	5.51	6.18	6.93	7.42	7.41	8.52	9.06	10.72
7Y	5.50	4.42	4.68	5.04	5.26	5.31	5.47	5.69	6.17	7.00	7.17	7.52	8.40	8.89	10.10
10Y	5.63	4.62	4.74	5.16	5.35	5.43	5.65	5.87	6.34	6.94	7.15	7.55	8.16	8.35	10.67
30Y	5.66	4.76	5.07	5.34	5.35	5.49	5.73	6.03	6.57	7.06	8.56	7.89	9.97	N/A	7.45

Source: CreditSights, ICE Data Indices, LLC. Data as of 12/30/2022

*Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting.

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