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The HBWM Quarterly Roundup

4Q 2022

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Market Overview

2022 was the worst year for almost all financial assets for decades. A truly global dynamic, central banks around the world raised interest rates to quell inflation. Despite markets' numerous attempts at rallies these rate increases determined outcomes for the full year.

The data has been widely reported already, but it is worth a brief recap here. Global equities and bonds lost more than $30 trillion. It was the worst year for equities since 2008. The MSCI All World index declined 20%. The S&P 500 index declined 19%. The NASDAQ index declined 33%.

> Rising interest rates are always difficult for financial asset prices.

It is the combination of these equity market returns with rising bond yields (falling bond prices) that makes the multi decade comparison necessary. For almost the first time in 40 years both asset classes declined in tandem. Market articles of faith, such as the 60:40 portfolio for all times, the dominance of momentum/growth investing, TINA (there is no alternative to equities), and BTD (buy the dips) may well prove to be confined to the dustbin of investment history.

Looking further inside the broad data is helpful. Large technology stocks had led market returns on the way up for many years. In 2022 they led markets down. Tesla and Meta (Facebook) fell by almost two thirds. Alphabet (Google) fell by 40%. Apple and Microsoft fell by nearly 30%.

The market concentration that augmented returns on the way up damaged them on the way down. Within the S&P 500 all sectors declined except energy which rose strongly, and utilities which gained slightly.

Rising interest rates are always difficult for financial asset prices. But the failure of crypto currencies, the demise of SPACS (special purpose acquisition companies), and the failure of many deconstructed finance business models (DEFI) such as BNPL (buy now, pay later) lead one to question how much these were meaningful innovations or merely the result of years of extremely cheap money.

In the first days of 2023 markets are looking for the positives. These arguments are that inflation appears to be moderating in the US. Interest rate increases should slow and may even cease if the economy slows. If a recession can be avoided, a soft landing may be achieved. If a recession cannot be avoided, interest rates will be quickly cut. China has performed a Covid policy U-turn, is opening again, seems less confrontational geopolitically, and growth will accelerate. The weaker US$ is positive for non-US economies, and China and the emerging markets are investable again. The weaker US$, the unusually warm winter, Russia's stymied military campaign in Ukraine, and the possibility that inflation will soon be contained in Europe as in the US, combine to make a positive investment case for exposure there.

Against these positive views should be set the warnings on recession from senior US bankers and asset managers as well as financial authorities. There are similar warnings that inflation will not be as easily suppressed. The war in Ukraine continues at a higher tempo. Russia is increasing its attacks on Ukrainian civilians and infrastructure, and western powers are increasing shipments of powerful weapons to Ukraine in the belief that there is no acceptable end possible without a significant Ukrainian military advantage having been achieved. The “chip” war with China is just beginning, and Taiwan is at its center. Chinese growth will put upward pressure on commodity prices, especially oil, at a difficult time. Chinese accommodative monetary policy to stimulate growth and ease real estate market pressures will hinder US and European attempts to suppress inflation. China has let the Covid genie out of the bottle with unknowable consequences. Labor markets in the US and Europe are tight. A debt ceiling impasse looms in the US and Japan may be at the beginning of the end of its almost decade long yield control policy. The Bank of Japan owns more than 50% of all outstanding Japanese government debt. The consequences for Japanese financial markets are hard to imagine. There will be implications for global financial markets as the yen-based carry trade behind Japanese global investment is removed.

In the short run, markets are trading on sentiment around these two sets of views. Sentiment changes on news flow and fresh data points. But this is a complex matrix with many variables, and complexity is the enemy of attaching too much importance to any single data point. Using the framework of asymmetry, we think that the starting point of lower asset prices does not necessarily mean that assets are cheap. It is our view that continued high leverage in the global economy with higher interest rates implies that markets could fall further if things go badly, more so than they can rise if things go well. We cannot predict the precise path of inflation or interest rates, nor can we know how geopolitics will unfold.

As we have argued over the last two years, we prefer to use an analysis of long-term change to inform portfolio choices. Structural and secular changes are observable and continue through the short-term movements of financial markets. Aspects defining the last 15 years in financial markets such as low interest rates, low inflation, outsourcing to China, tech stock dominance, and adding leverage to boost financial returns are undoubtedly over. What is the process by which the economy and markets adjust, where are the positive asymmetries to be found, and last and most speculatively, what might be the new prevailing financial and economic winds?

Investment Outlook

There are three topics that interest us most as we interpret long term change. First, the effects on the economy and financial asset prices over time of higher interest rates and, related to this, the assumption of liquidity. Second, the implications for broad economy and company returns of higher capital expenditures driven by both the energy transition and changing geopolitical arrangements. And third, the negative asymmetries in the interplay between inflation and interest rates both with respect to economic activity and company margins and profits.

Central bankers constantly remind us that higher interest rates work their way through the economy over time. We must also remember that financial asset prices rise and fall in spirals. As the value of collateral (underlying asset prices) rises, so the amount that can be financed/leveraged rises in a compounding process. In the same way, as interest rates rise and asset prices fall, this spiral goes into reverse, becoming more and more acute as asset prices fall. For example, mortgage rates adjust upwards quickly, but demand for houses and house prices adjust downwards initially only slowly. Now house prices are falling quite sharply in Canada, Australia, New Zealand, and the UK. They are beginning to fall here in the US as credit pressures build.

What are the economic implications? Credit card interest rates are high, and outstanding balances are building quickly. What are the implications for consumer credit? Over the next couple of years companies will need to refinance facilities taken on during the low interest rate era.

What are the implications for availability of credit and company margins and profits as the cost of capital rises? Will balance sheets shrink, and what does this imply for margins and profits? While net interest margins are rising, banks are providing for higher future credit losses. How does this play out? Companies are raising capital through convertible bonds, which have low coupon rates.

What does this imply for EPS (earnings per share) dilution? What are the implications for leveraged private assets which are not subject to the same mark to market provisions as public assets? Will private assets be marked down? At what rate? It is still early in the process through which higher interest rates play out in the economy and in asset prices.

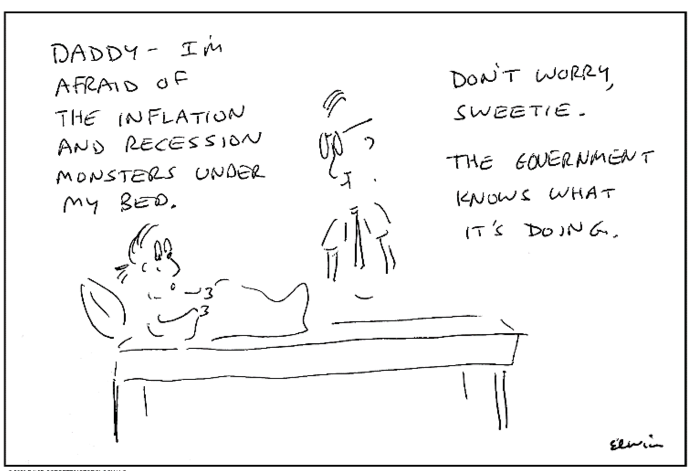
Related to this is the question of liquidity. As asset prices fall, will liquidity become an issue? There are already signs. Blackstone has gated its large real estate REIT, as investor demands to sell in anticipation of falling asset prices overwhelmed prescribed liquidity arrangements. We may be far from general market liquidity issues today, but we should recall that wider market dysfunction. As in the Global Financial Crisis, would cause central banks to cut rates regardless of the inflation background. There are many questions for which there are few, if any, good historical precedents. HBWM continues to think it prudent to avoid leverage and leveraged financial assets.

In previous letters we have discussed higher capital expenditures relating to the energy transition, and to changes in supply chains as companies build alternatives to outsourcing to China. The point here again is that it is still early in a long process which will involve enormous amounts of capital. (This reinforces the point that market leadership is most unlikely to return to large technology companies, however exciting the prospects of AI, for example, might be). Most important are the implications for margins, profits and whole economy returns, which it is only sensible to imagine must retreat from the all-time highs of the last decade or so. This is reinforced by higher interest rates. Another way of putting this is to point out that if companies keep their margins and profits while costs in the economy rise (in other words they can pass on higher costs), then inflation is here to stay. Perhaps this is a way to understand the resolve of central bankers.

> This may be a moment when years of confidence built up in microeconomic actors (companies) could be overwhelmed by macroeconomic necessities.

The last point is the observation that the interplay of inflation and interest rates represent a negative asymmetry for investors. Inflation, history has shown, erodes margins and profits. If margins and profits can be maintained, then, as we argue above, inflation stays high. Higher interest rates and a higher cost of capital should also erode margins and profits, unless these costs can be passed on, with the same negative implications for inflation as set out above. In the current market narrative, a slowing economy and a mild recession help the central bank deal with inflation. Let us hope that the Fed can fine tune economic activity so precisely in an economy laden with debt. The risk of a more severe recession cannot be dismissed, but either way a recession is

not good news for margins and profits. It is a case of being careful what you wish for. This may be a moment when years of confidence built up in microeconomic actors (companies) could be overwhelmed by macroeconomic necessities.
We do, of course, have views on inflation and rates, but we do not want to give them undue weight in investment policy because we know that unless we are very lucky, they will be precisely wrong. We think that inflation will prove sticky due to labor costs and the impact of China's easy money policy set for their domestic reasons, even as supply chain pressures ease. We think there are still important commodity bottlenecks, not least of which is energy. We think interest rates may not have to go up too much further in the US, but absent a financial crisis around liquidity in financial markets, they won't be cut much even if the economy slows. We hope that such a financial crisis can be avoided. Our central case then, as this section of the letter sets out, is that markets must adjust over time to rates at least at current levels.



Portfolio Positioning

Investment policy remains as set out last quarter. It continues to accommodate two key issues. First, there is a negative asymmetry in financial markets which are vulnerable both to higher rates, and to a possible recession. Second, we do not believe that financial markets are adequately discounting long-term structural and secular changes.

We therefore avoid leverage and credit risk. (This will help the portfolio deal with a possible debt ceiling issue in the US). We avoid taking a strong macro view on either inflation or a recession. We are not tempted to pursue large technology companies either as the antidote to slow economic growth or on the hope that they rebound after a poor year. We recognize that these network effect business models are facing increased regulation, and we believe priorities are now switching to the physical world. We maintain low exposure to domestic Europe due to its structural issues. We are a little more favorable to the emerging economies now that the US$ is weaker. We continue to avoid direct exposure to China because of the absence of property rights for foreign investors and the arbitrary nature of political decisions. This does not preclude non-Chinese investments that may benefit from higher economic activity there.

HBWM favors long duration, capital intensive assets where capital expenditure is needed. We favor innovation for its wealth creative qualities, of which technology and biotechnology are a key part. But under this heading we prefer specialist innovation. We find most of these opportunities in the US. Depending on client investment policy, we can access these opportunities in public and/or private markets.

We seek to take advantage of the growing energy intensity of the global economy. By this we mean not the amount of energy per unit of GDP, but its cost, which is increasing. The prospects for higher oil prices is strong as US shale production ceases to grow and as Chinese demand picks up, as does the long-term slow-motion process of investment in energy infrastructure.

We seek to avoid supply chain vulnerabilities and to gain advantage from geopolitical scarcities in a broad range of resources. We prefer investments in companies with long-term culture, enduring franchises, strong balance sheets and proven records of successful long term capital allocation.
We seek diversifying private investments exploiting manager investment skill uncorrelated to aggregate market returns. We also invest in special situations with distinct, autonomous return drivers - again uncorrelated to market returns.

Finally, as insurance against the risk in financial conditions of market disruption and geopolitical escalation, we maintain significant positions in gold and cash. Gold is held as a quasi-insurance policy against extreme political or financial system stress. This investment case was strengthened by recent non-US central bank buying for reserve purposes as geopolitical global fault lines develop.

The New Year is an opportune time to take an inventory of your holistic financial situation. As your investment advisor, we are in a unique position to help you consider and devise a thoughtful and integrated plan that includes estate planning, tax planning, generational planning, income and budget analysis, accounting, investments, and holistic asset reporting. Our full suite of family office services is notable. We are proud of Hollow Brook's growing team, which is qualified, dedicated, and competent. Our employees collectively have a diverse and enviable set of credentials which include Chartered Financial Analyst (CFA), Master of Business Administration (MBA), Certified Public Accountant (CPA), Certified Financial Planner (CFP) and licensed attorney. The vast knowledge and resources of our employees are always available to you. We are grateful for your continued trust, and we welcome the opportunity to discuss the contents of this letter or anything else that may be on your mind. We hope that 2023 brings you and your family abundance, joy, and happiness.

Sincerely,

The HBWM Team

Alan Bazaar
Co-Chairman,
CEO & Partner

Philip E. Richter
Co-Chairman,
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Wayne Nordberg
Co-Chairman & Co-CIO

Andrew Norris
Co-CIO

Equity Indices	Price	MTD	QTD	YTD
S&P 500	3,839.50	-5.77%	7.55%	-18.13%
Nasdaq	10,466.48	-8.66%	-0.78%	-32.51%
Dow Jones Industrials	33,147.25	-4.09%	16.01%	-6.86%
Russell 2000	1,761.25	-6.49%	6.20%	-20.46%
Russell 3000	2,217.15	-5.86%	7.17%	-19.22%
S&P 500 Sectors				
Utilities	358.48	-0.53%	8.64%	1.56%
Consumer Disc.	1,005.48	-11.26%	-10.18%	-37.03%
Telco	159.37	-7.84%	-1.38%	-39.89%
Consumer Staples	779.13	-2.82%	12.72%	-0.62%
Industrials	831.40	-3.00%	19.18%	-5.51%
Technology	2,172.17	-8.37%	4.74%	-28.19%
HealthCare	1,585.54	-1.91%	12.80%	-1.95%
Materials	489.55	-5.56%	15.05%	-12.28%
Financials	569.74	-5.27%	13.56%	-10.57%
Energy	672.34	-2.99%	22.74%	65.43%
Real Estate	229.77	-4.87%	3.55%	-26.09%
US Interest Rates				
3 Month	4.34	0.54%	33.77%	14176.92%
2-Year Note	4.43	2.68%	3.44%	504.47%
5-Year Note	4.00	7.15%	-2.11%	217.02%
10-Year Bond	3.87	7.47%	1.21%	156.59%
30-Year Bond	3.96	6.08%	4.96%	108.23%
Commodities				
Crude (WTI)	80.26	-0.36%	0.97%	6.71%
Brent	85.91	0.56%	-2.33%	10.45%
N. Gas	4.48	-35.43%	-33.86%	19.97%
Gold	1,824.02	3.14%	9.84%	-0.28%
Silver	23.95	7.93%	25.89%	2.77%
Currencies				
DXY	103.52	-2.29%	-7.67%	8.21%
EUR	1.07	2.87%	9.21%	-5.85%
CAD	1.36	1.06%	-1.99%	7.26%
GBP	1.21	0.21%	8.17%	-10.71%
JPY	131.12	-5.03%	-9.41%	13.94%

Source: Bloomberg as of 12/30/2022

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HBMW Quotes of the Quarter

To excel is to reach your own highest dream. But you must also help others, where and when you can, to reach theirs. Personal gain is empty if you do not feel you have positively touched another's life.

Barbara Walters

One of the most important lessons in my life is this: leave more on the table for the other guy than he thinks he should get. And one of the most important rules in capitalism is incentive.

Ken Langone

American Businessman and Investor

So much of Tesla's share price is based on hype and the pixie dust that Elon Musk is so good at putting out there. When he risks puncturing that image, it doesn't just reflect on Twitter but Tesla, SpaceX, and everything else he is doing.

Bradley Tusk

Tusk Ventures Co-Founder & Managing Director

I don't know that it ever comes back. Most of the value investors have been put out of business. It used to be we could buy something at a reasonably low multiple, whatever we thought it was, see the company do somewhat better, benefit from it doing somewhat better, and realize that other investors would see what we saw six months later or a year later and would re-rate the shares so you'd buy something for 10 times earnings... you'd get another 3 points on the multiple and you would make 50% after three years. That isn't happening anymore because there's nobody to notice what actually happened to these companies... Nobody knows what anything is worth.

David Einhorn

Founder and President of Greenlight Capital

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4Q 2022: What Happened and What Mattered

Pope Benedict XVI Passes

Pope Benedict XVI passed away at the age of 95. He served as the head of the Catholic Church from 2005-2013 and became the first pope to resign in 600 years.

Truss Resigns

British Prime Minister, Liz Truss, announced her resignation in October after just six weeks in office and became the shortest serving Prime Minister in U.K. history.

Canada Bans Handguns

Regulations in Canada that ban the sale, purchase, and transfers of handguns within the country went into place in October.

Trump Announces 2024 Presidential Bid

Former President Donald Trump announced he will be running for president in 2024.

Merriam-Webster Announces Word of the Year

In November, Merriam-Webster announced it had selected "gaslighting" as the 2022 Word of the Year. Gaslighting, defined as "the act or practice of grossly misleading someone especially for one's own advantage" increased in search popularity by 1,740% in 2022 compared to last year.

FTX Files for Bankruptcy

The crypto exchange, FTX, filed for bankruptcy in November. Founder and CEO, Sam Bankman-Fried, was arrested in December for multiple counts of fraud.

Brittney Griner Released

WNBA star, Brittney Grinner, was released by Russia in a prisoner exchange with the U.S. in December. Grinner was arrested in a Moscow airport with possession of vape cartridges with hashish oil. In exchange for Grinner, the U.S. released convicted arms dealer, Viktor Bout.

S&P 500 Has Worst Year Since 2008

The S&P 500 closed out 2022 with his worse year in performance since 2008 with an annual loss of 19.4%.

Argentina Wins World Cup

Argentina emerged victorious over France to win the World Cup final in a 4-2 shootout. This win marked Argentina's first World Cup title since 1986.

Southwest Cancels 70% of Flights

Over the holidays, Southwest Airlines cancelled about 70% of their flights in the wake of major storms across the country. These widespread cancellations left thousands of customers stranded during the busiest time of the year for travel.

King Charles' Coronation Date Set

King Charles III's coronation date was announced for May 6, 2023. His wife, Camilla, will be crowned queen consort in the same ceremony which will take place at Westminster Abbey.

Beyonce Leads 2023 Grammy Nominations

The 2023 Grammy nominations were announced in November, with Beyonce leading with nine nominations. Kendrick Lamar received the second most nominations with eight, and Adele and Brandi Carlile each received seven. The awards are set to take place on February 5th.

Barbara Walters Passes

Renowned anchor and interviewer, Barbara Walters, passed away at the age of 93. She broke many glass ceilings including being the first female anchor of a network evening news program and the first female co-host of the Today show.

Political Change Ups in Washington

This Fall, while the midterms were not quite the "red wave" Republicans had expected, they were able to edge out the Democrats and secure control of the House. House Speaker Nancy Pelosi also announced she would not be staying on as leader of House Democrats.

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