



To Our Clients and Friends of Parthenon LLC

The turn of the twentieth century brought about an inflection point in science fiction. In 1895, H.G. Wells' groundbreaking novel *The Time Machine* was published – a dystopian novel designed to be social commentary. However, it is now also recognized as the work that popularized the concept of time travel using mechanical means. It was certainly a clever storytelling device, but was it really possible?

Ten short years later, Albert Einstein would try to answer that question with his theory of relativity. Through his work, he would eventually describe time dilation – the idea that time is measured differently as one moves through space. This theory was tested in 1971 in the Hafele-Keating experiment. Four atomic clocks were sent on commercial airliners. After circling the earth, they compared the clocks to one that was stationed at the US Naval Observatory. The differences in the clocks were consistent with Einstein's theory, giving some hope that time travel to the future is actually possible.

As investment managers, you will have to forgive us for daydreaming about travelling into the future. Alas, our yearly exercise in time travel is relegated to being in the present and reflecting on lessons learned from the past. And this particular trip down memory lane is a painful one. The S&P 500 was down 18.1% in 2022 - the worst year since 2008. Volatility also returned with a vengeance. There were 46 trading days that saw the S&P 500 experience swings greater than 2% - another metric that hadn't been seen since the 2008-2009 bear market.

The pain was not limited to equities, however. Bond markets also fell prey to volatility. The Bloomberg US Aggregate Index experienced a 13% decline for the year, a painful reversal for a normally stable asset class. Stunningly, the 30-year Treasury bond had its lowest return in a century at roughly -35%. Last year was the first year in over fifty that both stocks and bonds experienced negative returns.

At the risk of sounding too simplistic, the market was primarily focused on three things in 2022: inflation, interest rates, and a possible recession. For the past several years, accommodative monetary policy in response to Covid-era challenges generated unprecedented stimulus for the economy. Although it took some time to feel the consequences, in 2022 the bill came due. Inflation numbers hit a 40 year high (9.1% was the peak CPI for the year). Conversely, unemployment numbers hit multiyear lows (3.5% - tying the lowest number since 1969). These factors were further complicated by geopolitical concerns (war in the Ukraine), supply chain issues, and varying countries' responses to Covid (most prominently, China).

With this confluence of events, inflation became public enemy number one in the eyes of both the consumer and the Federal Reserve. The Fed was not afraid to wield the weapon that gives it the most power to fight inflation – hiking interest rates. These hikes started in March, and continued over the course of the next nine months. The Federal Funds rate was raised by 75 basis points several times (large increments historically speaking) to 4.25%-4.5% by the end of the year. Furthermore, the yield curve became inverted, a condition where short-term yields are higher than long-term rates. This inversion became more pronounced as the year marched on. Historically, yield curve inversions are a classic recessionary signal, and that factor further spooked the markets.

And, as would be expected with a bear market, 2022 brought about the bursting of the most speculative investments of the past several years. Meme stocks, special purpose acquisition companies, non-fungible tokens, and cryptocurrencies all fell back to earth as the year ended. In last year's letter, we noted that extreme speculation often comes to a painful end. This end was more in view than we thought. The negative news cycle for these manias culminated in November, when major cryptocurrency exchange FTX faced insolvency and a trail of fraud accusations.

Armed with these facts, we wish we were stepping into our time machine to see what was in store for the upcoming year. We will have to settle by thinking through some of the questions that the market faces in the months ahead. Notably, these questions look similar to those that the market confronted last year. And, as you would expect, none have easy answers.

- **When will inflation cool?** – Although more recent inflation numbers have shown some positive developments, current inflation readings are not sustainable for the long term. The last time the market faced these levels was in the 1970s/1980s.
- **How will the Fed respond?** - The Fed seems determined to bring the inflation rate down, with current chairman Jerome Powell trying to work from the Paul Volcker playbook. However, will they go too far? Will there be a pause to determine outcome? Will they stick to their 2% target or allow a higher number in the short-term?
- **Will we enter a recession?** – It remains to be seen if a “soft landing” is still attainable, or if the economy will see a shallow or deep recession. Furthermore, it is hard to know how much of a recession is priced into the market at current levels.

These questions remind us of a party we read about – the tables were set, the hors d'oeuvres were ready, and balloons decked out the room.

No one came.

The reason: the invitations were actually sent out after the party, including precise GPS coordinates. And the host was world renowned theoretical physicist Stephen Hawking. Hawking, a sceptic of time travel to the past, was trying to provide experimental evidence that it wasn't possible. He deemed his experiment a success, despite having no one to socialize with for a few hours.

We find this outcome somewhat disappointing. We wouldn't mind talking to a few party crashers. However, in our many years of being investment professionals, we know one thing is certain: no one has all the answers to these questions. Without the benefit of traveling to the future (and back again), we just don't know what unexpected factors and forces will play a part as the future unfolds. And anyone who answers these questions with perceived certainty is spinning their own fictional tale.

Despite the challenges facing the economy in 2023, we are glad to be able to use the same approach that has benefitted our firm in times of lean and plenty. What we can say is that both stocks and bonds are more attractive than they were at this time last year. Owning stocks of companies with proven business models, strong cash flow, and healthy earnings power helps us sleep better at night, even though we don't know the future. We will focus on controlling what we can control, and not focus our efforts on futile attempts to discern the unknowable. One of our most important assets is being rational in the midst of panic and having a cool head when others are reacting on emotion. We will continue to draw on these strengths as we head into the new year.



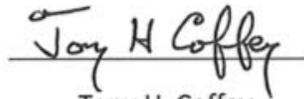
Matthew W. Carper



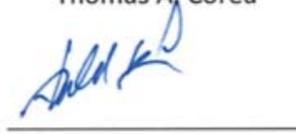
J. McFerran Barr, II



Thomas A. Corea



Tony H. Coffey



Todd P. Lowe