MORSE ASSET MANAGEMENT, INC.
23 Old Kings Highway South, Suite 200, Darien, CT 06820

January 18, 2023

2022 Q4 Investment Commentary

During the fourth quarter, the U.S. equity markets continued to be volatile and rangebound. The quarter began with a new low for the year, owing to the Federal Reserve continuing their unprecedented pace of rate increases. A notable rally followed due to surprise improvements in inflation, GDP, labor market strength, and consumer resilience. These positive trends have continued into the New Year. Nevertheless, markets ended the year with another sell-off, which was compounded by tax loss selling and year-end repositioning. Leading economic indicators continued to soften, earnings estimates were significantly cut, and the Fed continued to surprise with hawkish projections.

2022 was only the sixth time since the 1920s that both the S&P 500 and U.S. bond market declined. It is the only time on record where they both fell by more than 10%. The S&P 500 fell 18.1%, its worst year since 2008, and sixth worst on record. The Barclays U.S. Aggregate Bond Index was down -13.1%, its worst year on record. Back-to-back down years are rare and have only occurred twice since 1957 during severe recessions, which is not currently the base case. With inflation continuing to fade and fiscal policy on hold, the Fed is likely to end its tightening cycle in the coming months and could begin to ease before the end of 2023. The question of whether the Fed will still cause a recession remains the top concern for markets.

The rate of inflation has peaked and is trending lower (Chart 1). The December reading of the Consumer Price Index and the Producer Price Index reflected month/month deflation, led by goods and commodities. The year/year change in the CPI has tumbled from 9.1% in June 2022 to 6.5% over the last 6 months. The only category that has not yet peaked is Owner’s Equivalent Rent, which has a significant lag, but the current housing market decline is undeniable. The biggest risk to inflation will be in the service sector, where costs are most impacted by wages. There are concerns that the tight labor market will prevent a material inflation slowdown without significant job loss.

The Fed continued raising rates during the fourth quarter, by 0.75% in November and 0.50% in December to 4.25-4.5%. The FOMC participant targets for 2023 were also revised higher to 5.13%. Members have continued to hammer the hawkish narrative or “higher for longer” despite clear improvements in inflation, an economic slowdown, and an acknowledgement of the lag in response to policy. However, market expectations have diverged from Fed policy, as credibility has come into question. The yield curve has flattened, and futures are pricing in rate cuts beginning in June (Chart 2). The gap between Wall Street’s expectations and Fed targets may stem in part from the central bankers’ reluctance to come across as too optimistic fearing that a surging stock market will rekindle demand and reignite inflation. They do not want a repeat of the 70s and are willing to put the economy in recession, intentionally or accidentally, which is the top concern for the market.

There aren't many signs of widespread distress in the financial system yet, as consumer and corporate balance sheets remain healthy. Net leverage has significantly been reduced. The current consumer savings rate is below average, but households still hold significant balances accumulated during the pandemic that continues to provide support to spending (Chart 3). Credit balances continue to rise, but balances and delinquencies remain at or below historical trend and are not materially accelerating. CEO confidence remains extremely pessimistic reflecting recessionary concerns and as a result conservatism. Cash balances are healthy, and outlooks are not dire but there is a lack of commitment to capex and longer-term planning until there is more certainty around monetary policy.

The strongest argument against a recession is the strength in the labor market. There continue to be 1.7 job openings per unemployed American and the lowest level of unemployment since 1969. Initial jobless claims do not indicate a material shift and remain significantly below recessionary levels (Chart 4). However, job strength is a data point the Fed will use to justify not cutting rates.

According to Factset's January 13th *Earnings Insight*, estimates the Q4 2022 estimated year/year earnings decline for the S&P 500 is -3.9%. On September 30, the estimate had been for an increase of +3.5%. This massive reset in expectations extended to estimates for Q1 and Q2 of 2023, down to -0.6% and -0.7% respectively, projecting 3 straight quarters of negative year/year earnings (Chart 5). The decline in estimates is primarily attributed to contracting margins, which are now back to the 5-year average. On the bright side, expectations are for revenue to continue to grow each quarter. The dominant narrative is that we will return to strong growth in the back half and finish the year with annual earnings +4.6%. Valuations are again reasonable and at the 10-year average. The bottom-up target price for the S&P 500 is 4,515.52, which is 15% above current levels. Equity prices will follow earnings.

As we turn to 2023, we remain focused on owning competitively advantaged companies, with persistent and above-average growth potential, the ability to compound earnings, outstanding management, and whose stocks trade at discounts to their intrinsic value. Despite poor performance in 2022, many of our portfolio companies grew revenue, cash flow, and earnings, some of them substantially. We recognize the economic risks ahead and yet we are confident that over the course of time, our investment strategy will deliver strong returns as it has in the past. We remain optimistic about the long-term opportunities for equity investors.

Our playbook continues to focus on significant secular, cyclical, and structural trends. We will continue balancing between high-quality growth at reasonable prices and stable businesses with relatively stable free cashflow. Portfolio risk will be adjusted according to the prevailing market environment and the shifting likelihood of recession.

The very near-term outlook is murky, but we believe that the stock market has likely discounted a short and mild recession. The probability of a "soft landing" is greater than that of a severe recession. However, the push and pull of positive and negative data points will keep the market rangebound and volatile. It can be hard to see past the valley, but bear markets eventually lead to bull markets. We are confident the inexorable growth of the U.S. Economy will be restored in time. We strongly believe that once we are on the other side of the inflation, we will enter a new and a powerful bull market. Patience and conviction will be rewarded.

Morse Asset Management Investment Team

Robert B. Morse, Jian Wang, James Cushing

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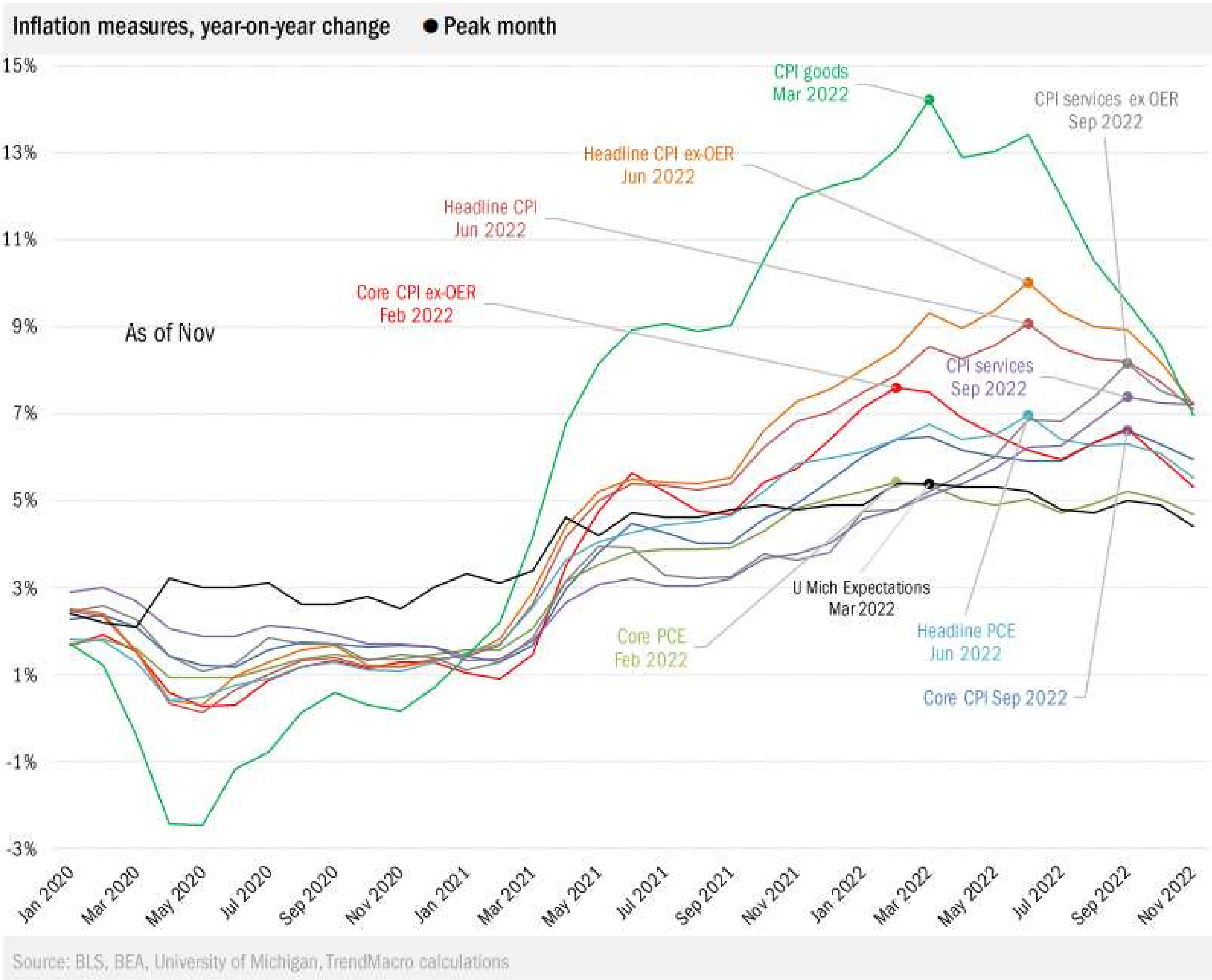

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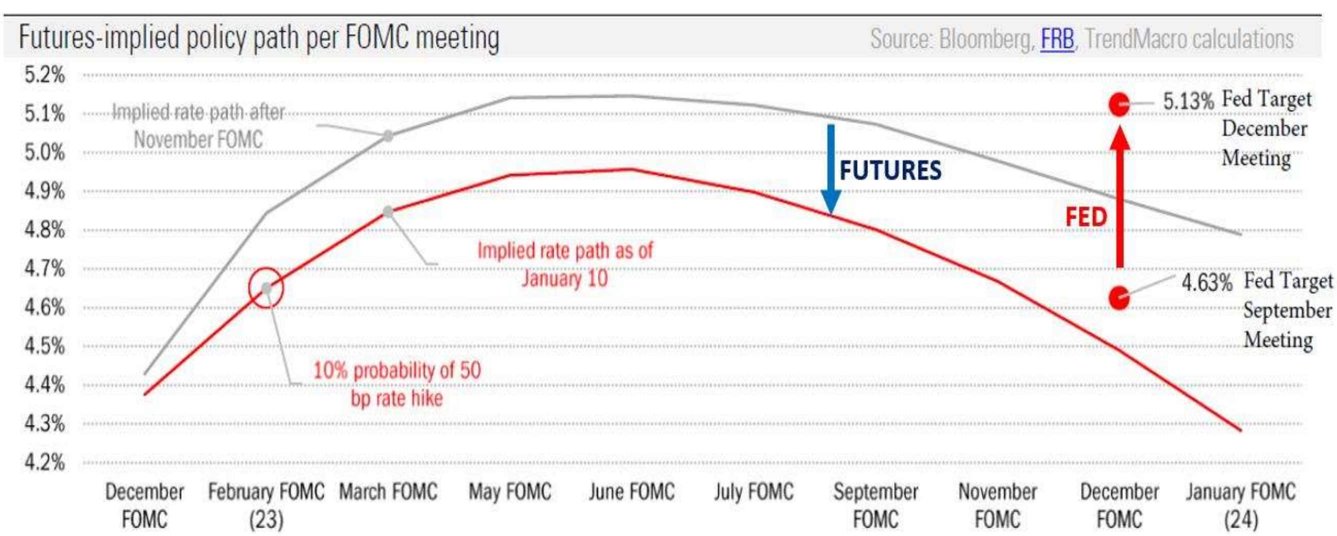

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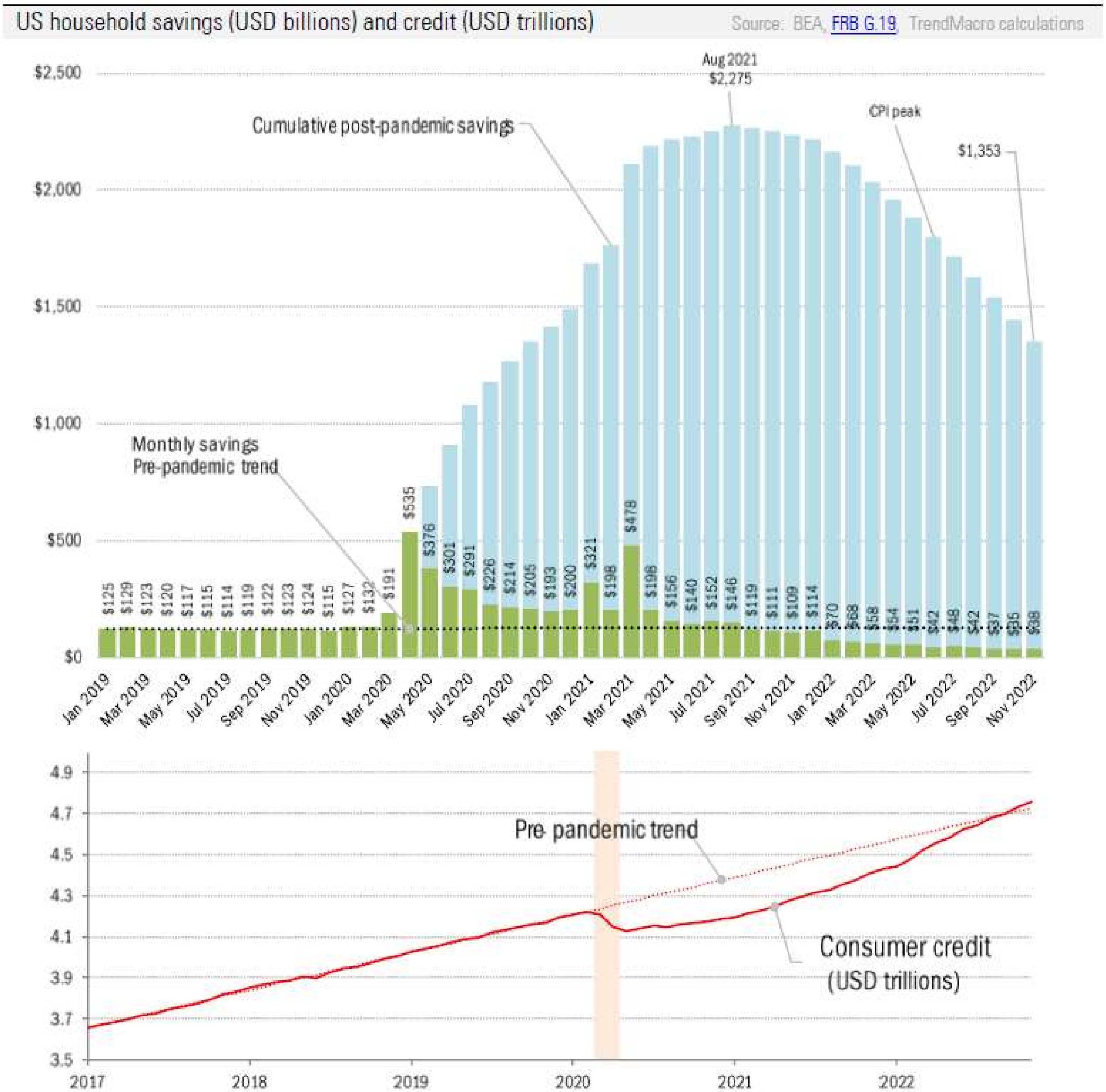
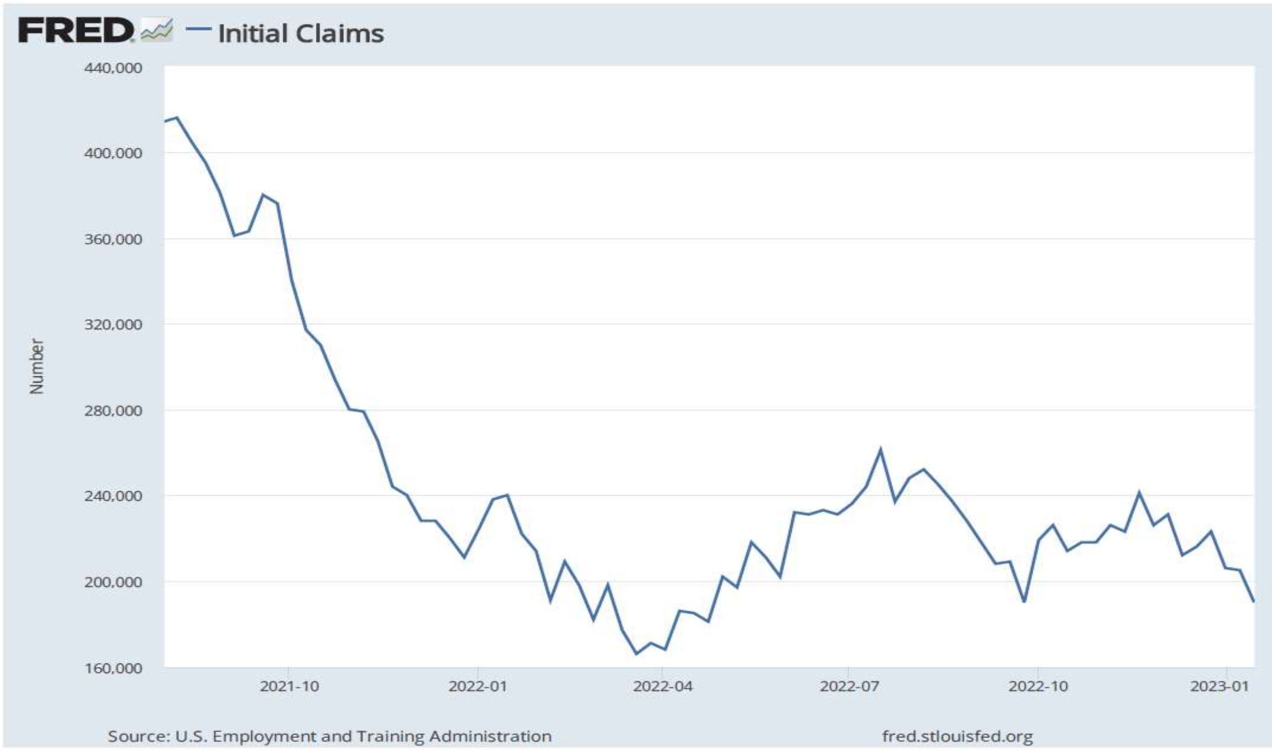
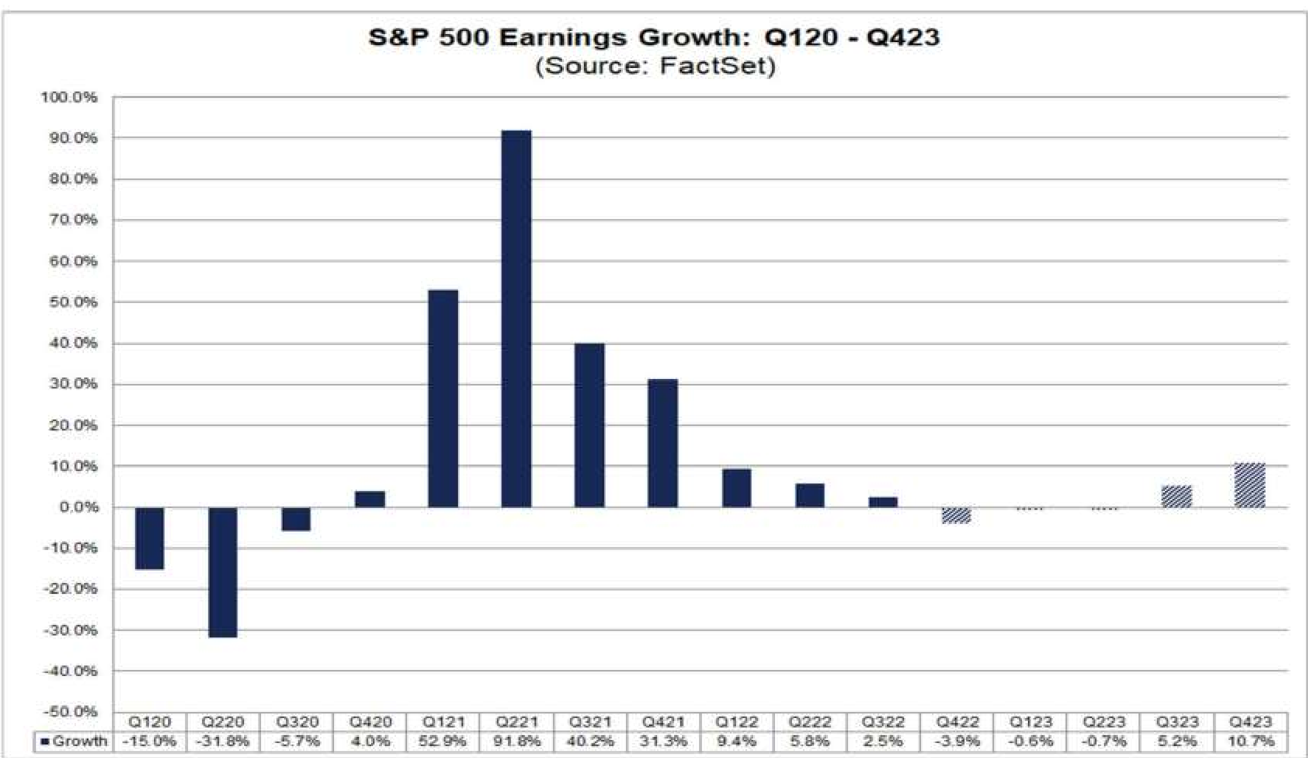

US household savings (USD billions) and credit (USD trillions)
Source: BEA, FRB G.19, TrendMacro calculations
Aug 2021
$2,275
Cumulative post-pandemic savings
CPI peak
$1,353
Monthly savings
Pre-pandemic trend
$2,500
$2,000
$1,500
$1,000
$500
$0
$125 $129 $123 $120 $117 $115 $114 $119 $122 $123 $124 $115 $127 $132 $191 $535 $376 $301 $291 $226 $214 $205 $193 $200 $321 $198 $478 $198 $156 $140 $152 $146 $119 $111 $109 $114 $70 $68 $58 $54 $51 $42 $48 $42 $37 $35 $38
Jan 2019 Mar 2019 May 2019 Jul 2019 Sep 2019 Nov 2019 Jan 2020 Mar 2020 May 2020 Jul 2020 Sep 2020 Nov 2020 Jan 2021 Mar 2021 May 2021 Jul 2021 Sep 2021 Nov 2021 Jan 2022 Mar 2022 May 2022 Jul 2022 Sep 2022 Nov 2022
Pre pandemic trend
Consumer credit
(USD trillions)
4.9
4.7
4.5
4.3
4.1
3.9
3.7
3.5
2017 2018 2019 2020 2021 2022

4.


FRED
Initial Claims
440,000
400,000
360,000
320,000
280,000
240,000
200,000
160,000
Number
2021-10
2022-01
2022-04
2022-07
2022-10
2023-01
Source: U.S. Employment and Training Administration
fred.stlouisfed.org

5.


S&P 500 Earnings Growth: Q120 - Q423
(Source: FactSet)
100.0%
90.0%
80.0%
70.0%
60.0%
50.0%
40.0%
30.0%
20.0%
10.0%
0.0%
-10.0%
-20.0%
-30.0%
-40.0%
-50.0%
Q120 Q220 Q320 Q420 Q121 Q221 Q321 Q421 Q122 Q222 Q322 Q422 Q123 Q223 Q323 Q423
Growth -15.0% -31.8% -5.7% 4.0% 52.9% 91.8% 40.2% 31.3% 9.4% 5.8% 2.5% -3.9% -0.6% -0.7% 5.2% 10.7%