CARDEROCK
CAPITAL® MANAGEMENT, INC.

April 11th, 2022

During the quarter, the speed and magnitude with which narratives have shifted in both Bond and Stock markets since year end has been remarkable. Growth stocks went from a highly prized treasure to a dispensable asset. As a result, our stocks fell on average 12% as investors rotated toward lower quality cyclical and energy related sectors. In our view, the market's reaction to rising interest rates and commodity prices have ignored the attractive relative fundamentals and prospects, both of which remain far stronger for our Quality Growth stock holdings.

With this trend in place, our activity for the period focused on raising our Equity cash reserve target from 10% at the beginning of the year to 25%, taking advantage of higher rates in fixed income and reducing risk in your portfolio. We expect to reinvest your cash reserves over the next few quarters as the market settles in, and, in our view, rotates back towards Quality Growth stocks and bonds at higher yields.

You may recall that we faced a similarly tough environment in the first quarter of 2021, only to end the year roughly even with major indices. But this year will be more complicated, with rising interest rates, a slowing post-Covid recovery and higher commodity costs all weighing on future growth prospects and equity valuations. In short, volatility is here to stay, but it should provide us with opportunities as earnings continue to grow amidst a relatively strong economic background.

Looking ahead, we are staying open-minded as the narrative continues to shift, and will be focusing on the following key themes:

- Our top holdings are in well-established profit machines, unlike the "technology bubble" of the late 1990s.
- Today's "frothy" behavior is largely confined to alternative markets (Cryptocurrency, SPACs, venture capital, et. Al).
- Constrained housing supply and higher rates will hamper single-family home sales in 2022, and thus durable goods demand.
- Labor markets have fully recovered to pre-Covid levels and wage growth is strong. With strong consumer demand, unionization is succeeding (Amazon, Starbucks) and employee benefits are surging (Walmart).
- Corporations are starting to re-orient from the long dominant shareholder first objective and increasingly towards the multi-stakeholder milieu of the late 1970's.

We see our investment prospects for the balance of the year driven by the following:

- Short of a recession, inflation will continue – higher than the Fed's 2% goal but less than present levels. Recalibrating portfolios on this basis will evolve over time.
- We are biased toward shorter maturities in **Fixed Income**, with the view that the current cycle of rising rates will likely run 18-24 months.
- Green energy and Technology will continue to offer superior returns and investment opportunities, as global economies transition out of oil and gas.
- While we have not completely written off the oil industry, we believe it offers limited opportunities as most stocks in the sector do not fit our typical investment criteria.

Overall, we believe that sticking with highly profitable companies with strong balance sheets to withstand market volatility will prove to be a winning strategy over the coming quarters and years, despite their current woes. As the Federal Reserve begins its process of pumping the brakes on the economy, our Quality Growth stocks should fare better than the alternatives.

As always, feel free give us a call to discuss your investment progress or any questions you may have regarding our outlook.

Warmest Regards,

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President

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Director of Research and Quantitative Strategies

In compliance with Rule 204-2(a) of the Investment Advisors Act of 1940, we hereby offer our current Form ADV Part II as filed with the Securities and Exchange Commission through notice of its public posting on our website (www.carderockcapital.com). The Securities Exchange Commission's Investment Adviser Public Disclosure database can be accessed at their website (www.adviserinfo.sec.gov/IAPD/Content/Search/iapd_Search.aspx). With reference to Rule 206(4)-2 Carderock urges you to compare the information on your statement with the statements received from your custodian. Please call if you have any questions.

Random Gleanings

"U.S. Federal Reserve Chair Jerome Powell cited three historical examples — the tightening cycles of 1964, 1984 and 1993 — as evidence that the Fed can achieve a "soft landing," slowing growth and curbing inflation without precipitating a recession. I disagree with both. The Fed's application of its framework has left it behind the curve in controlling inflation. This, in turn, has made a hard landing virtually inevitable. To create sufficient economic slack to restrain inflation, the Fed will have to tighten enough to push the unemployment rate higher. Which leads us to the key point: The Fed has never achieved a soft landing when it has had to push up unemployment significantly." Bill Dudley, *"The Fed Has Made a U.S. Recession Inevitable"*, **Washington Post**, March 30, 2022.

"Think about what the Fed did with QE. It was designed to push investors out the yield curve in search of yield, and once it did that, it pushed them out the credit curve, and then out the corporate structure curve to equities. What happens when this reveres? There is reason to think that shrinking the Fed's bond portfolio (because of its effect on liquidity) matters more to stocks and other risk assets than to Treasury yields." Robert Armstrong and Ethan Wu, "*What happens When the Fed balance sheet shrinks? (Not even the central bank as a clear idea)*", **Financial Times**, January 19th.

"Ultimately, the Fed's central policy error may have little to do with the speed at which it tapers its asset purchases, or the timing of the next few rate increases. Instead, the critical policy error may prove to be the consequences of discretionary policy on the financial markets. The Fed has encouraged a decade of yield-seeking speculation, as investors try to avoid being among the holders of $6 trillion in zero-interest hot potatoes. By relentlessly depriving investors of risk-free return, the Fed has spawned an all-out speculative bubble that may now leave investors with little but return-free risk. " John Hussman, *The Fed policy error that should worry investors*", **Financial Times**, January 26th.

"The Institute for International Finance (IIF) notes that the US real consumption has by now fully returned to its pre-pandemic trend. This never happened after the 2008 financial crisis. Business and residential investment is also extremely robust. The recovery has been stronger than other big high-income countries because of the fiscal stimulus. Labor conditions are consistent with maximum employment, and the Fed has already fulfilled its jobs mandate. Contrary to the belief that inflation is due to just a few items, the IIF shows that inflation is running at over 2% on over 70% of the index items: The price surge is no limited phenomenon. Containing inflation without having to inflict a recession is going to be extremely hard to pull off. Policymakers just do not know enough about the post-pandemic economy to calibrate the needed policy changes – especially as they are clearly too late." Martin Wolf, "*The Fed is too late to remove the punchbowl*", **Financial Times**, February 9th.

"The first three months of the year have been brutal for investors. All of the major indices sold off hard in January and continued to trade erratically in February and March. What's up one day is down the next – and every headline about the Fed, surging inflation and the war in Ukraine continues to impact investor's mood and drive market action. While none of us have a crystal ball and can predict what will happen or where the market is headed next, the one thing we know for certain is inflation will remain elevated for the foreseeable future." Louis Navellier, ***Growth Investor***, March 25, 2022.

"The US government is already testing its ability to micromanage complex private-sector supply chains. Biden is implementing the domestic-content provisions for car production inherited from the Trump administration, and wants to add tax credits for using union labor for electric vehicle production. Biden has also proposed reshoring subsidies for semiconductor manufacture. And ultimately these could prove as expensive and suboptimal as ethanol subsidies a decade or two ago.

It's a reasonable contention that the advanced economies need a dose of government support to encourage resilience, focused narrowly on excessive dependence on particular inputs. But at least these ideas should run through institutional policy filters to screen out the misguided projects. And despite its interventionist instincts, the EU has such mechanisms and cash (not entirely by design), and the US far less so, and it is very possible that Europe's protectionists will be saved from themselves." Alan Beattie, "*When it comes to protectionism, the restricted EU is better off than the US*", **Financial Times**, January 19th.

"European scientists have set a new record for the most energy generated from nuclear fusion. In a half century of experiments, scientists have previously been unable to generate more energy from a fusion reaction than the power-intensive system consumes. But Eurofusion produced 59 megajoules from a five second reaction which is nearly industrial scale. Unlike nuclear fission, fusion does NOT produce significant radioactive waste." Tom Wilson, "*European scientists in landmark nuclear fusion breakthrough*", **Financial Times**, February 9th.

"A better balance between growth and value seems sensible, but a modest retreat from 'peak growth' does not mean that value is now the only game in town. The US is the most important stock market in the world and it's where growth is still to be found. Profits at US companies are growing four times faster than those in the rest of the developed world – and many of these companies have competitive advantages that are hard to catch up with or duplicate. Growth stocks have outperformed value almost without challenge for the past 15 years – so a period of catch-up should come as no surprise. Scoop up some value opportunities, but be wary, and leave room for the argument that pure growth strategies will continue to thrive in a world where there is still a scarcity of widespread growth." Maike Currie, "*US Stocks and the market regime change"*, **Financial Times**, January 26th.
