CARDEROCK
CAPITAL® MANAGEMENT, INC.

April 10, 2023

The first quarter has seen a complete reversal of trends we saw throughout 2022. Sectors that were punished heavily last year such as Consumer Discretionary and Technology have led the way, while Energy and Consumer Staples have lagged. The consensus on inflation has also flipped, going from "transitory" to "embedded" and now to a middle ground. Large ticket items such as automobiles are still seeing price pressures due to disruptions in production, while wages, rents and home prices are decelerating as a result of high interest rates.

We are optimistic about both inflation and the prospects for our Quality Growth stocks. Markets have shown tremendous resilience to start the year considering many negative events that could have tipped stocks back towards lower prices, most notably the failure of several regional banks. We do not see these issues as a systemic problem akin to the Great Financial Crisis of 2007-2008, but they nevertheless should give Federal Reserve officials enough reason to take a wait and see approach as lending is expected to decline.

Looking to the rest of the year, we believe the following themes will drive our decision-making:

- Because Carderock Quality Growth Stocks exhibit higher Returns on Capital and Earnings Growth than the average S&P 500 company, prices will continue to command a premium should economic growth decelerate.
- Strategically, we will continue to avoid Financials and Energy Stocks as Growth tends to be short-lived and volatile in these sectors, as exhibited during the 1st Quarter.
- Having lowered our target cash reserve in our Equity portfolio to 25%, we have been putting money back into markets, with purchases exceeding sales at a ratio of nearly 5 to 1 since the beginning of December.
- The benefits of scale in large Technology firms have paid off via advancements in Artificial Intelligence, which will boost productivity and profitability, while adversely affecting other sectors (Media).
- Labor markets should remain resilient and signs of a looming spike higher in unemployment will continue to be hard to find.
- Inflation should continue to decelerate toward the Federal Reserve's goals in tandem with slower economic growth, increasing the likelihood that we will avoid further stress in financial assets.
- Investment in the US industrial base as well as green technology will continue unabated while a "soft decoupling" with China will likely gain more traction.

Lastly, we had a small year-end restructuring where we've combined the responsibilities of portfolio management and administration for each of our managers. This means you will want to contact Dan, Skip or Stephen directly whenever a need arises. For us and for many others as well, this change reflects the separation of our long-term Administrator, Lynda Elliott. She will be greatly missed and there's simply no escape from how critical her dedication, service and personable style have been in getting so many of the important details done at Carderock Capital over the years. We extend our deepest gratitude for the exceptional service she provided and wish her all the best as she pursues new opportunities and passions. And to you, we extend our continuing commitment to excellence when servicing your needs.

As always, we welcome your calls and thank you for your continued support and confidence in Carderock Capital Management.

Warmest Regards,

Daniel A. Kane, CFA
President

James W. Mersereau, CFA
Portfolio Manager

Stephen F. Knapp, CFA
Director of Research

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

"The divergence of national profits (still right near peaks) and public company profits (clearly falling) is important because the national data is better quality than the company data. If profit margins are barely falling, this has important implications for where are in the business cycle. Companies respond to margin compression by firing people. In that sense, falling profitability contributes to, and is therefore a leading indicator of recessions. The national data is not particularly timely, going only through the fourth quarter of last year. But all the same it suggests that worries about imminent recession may be over-egged. If you want to make a case for recession, you have no choice but to look beyond what is happening to what might happen next." Robert Armstrong and Ethan Wu, *"No Margin Compression, No '23 Recession"*, **Financial Times,** April 6th, 2023.

"Everyone knows that the effects of interest-rate increases come with a time lag. It's tempting to think it's like pressing the brake in a car: Central banks push the pedal a bit, then a bit more and eventually the economy steadily starts to slow down. Monetary policy is more like an elastic band: You can pull on it for ages and nothing seems to move until suddenly the other end comes pinging right at you. The supposed choice between worrying about inflation or financial stability is false. At a certain point, bank stability *is* monetary policy. The US has reached a moment where monetary tightening is accelerating like a slingshot through the banking system." Paul J. Davies, "Why Fed Rate Increase Are Hitting All At Once", **Bloomberg**, March 19th, 2023.

"Small bank funding to commercial real estate is now tightening. As a recent TS Lombard note laid out, the level of real estate debt maturities in 2023 is expected to be high. This means asset managers may be forced to go to investors for more capital (which will be a tough negotiation at the moment) or sell property out of their portfolio to cover loans. This has the feel of a doom loop to me. Big real estate indices had already turned negative in 2022. It is possible that concerns about commercial real estate will start to expose other vulnerabilities — or at the very least asymmetries — in the financial system and shadow banks in particular." Rana Foroohar, *"Shadow Banks Could Yet Cause Trouble",* **Financial Times**, April 2nd, 2023.

"China is striking back at America in the global battle for semiconductors. After the Biden administration blocked China's ability to buy powerful artificial intelligence chips and advanced chip-making equipment last year through additional export controls, the Asian country recently has decided to retaliate against U.S. companies. While the moves have generated a lot of attention, there isn't much more China can do against Silicon Valley. The strategic importance of chips to maintain military capability and economic security can't be understated. We can expect more grumbling and noise from China over semiconductors but little actual impact. Simply put, the U.S. holds all the chips." Tae Kim, *"China Can't Win Its Chip War Against the U.S. Here's Why"*, **Barron's**, April 5th, 2023.

"The slowdown in world trade, the shift towards economic nationalism and the growing demands in the west, and especially in the US, for decoupling from China are reshaping the global economy. Ever since the protectionist disaster of the early 1930s, the thrust of US policy has been towards creating an open and rules-governed trading system. These policies created a more prosperous world economy. Today, however, Donald Trump and Joe Biden, who disagree on almost everything, both agree that this has been a mistake — a swindle on American working people. Moreover, it is not just policies at the border that are changing. The US is also embracing aggressive industrial policy, backed by generous subsidies. Behind this and strengthening it, is the great power conflict with China. We are indeed entering a new world." Martin Wolf, *"Waging War on Trade Will Be Costly"*, **Financial Times**, April 4th, 2023.