



Our 2023 Playbook

January 19, 2023

Each year, we look back at the prior year's Investment Playbook to assess what we got right, what we got wrong, and what we learned in the process. We then turn to the coming year, putting our dominant ideas in writing, with hopes of gaining greater clarity on the factors that might drive our investment returns going forward.

This piece isn't meant to be detailed or comprehensive along the lines of the many forecast pieces that Wall Street publishes at the beginning of each year. Instead, it is meant to be a thought piece that will serve as a guide for us in framing our investment decisions in the coming year and one which may help you understand the primary influences that may affect those decisions.

How we react to changes and new information is a fluid exercise subject to our discretion, but always made with a longer term perspective in mind and the intent to drive superior returns over time. Thank you for your continued confidence in our approach and interest in our work!

Looking Back and Looking Forward: Our 2022 Playbook and 2023 Updates

In general, our 2022 Playbook served us well, cushioning us from what ended up being a far worse year for most growth stock investors. We only wish we had leaned into it more than we had!

Consistent with the past, we'll review our thoughts on the economy, the markets and the political environment from last year's Playbook, while also providing some tone on what might lie ahead in 2023 and beyond.

The Economy

Last year at this time, we stated the following:

"The economy should remain quite strong; we forecast GDP growth in the ballpark of 2-3%. We believe this figure will include an elevated inflation component, but that inflationary pressures should moderate as the year progresses. We believe some of the inflation spike will be transitory, particularly in goods where newfound pockets of oversupply could actually become deflationary, but also think that some inflation is likely to be persistent, particularly with respect to wages. We ultimately remain hopeful that inflation won't be problematic for the economy thanks to a continued emphasis by corporate America on productivity initiatives."

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Consistent with higher growth and inflation, we believe that the Fed will raise rates several times this year, but as has been the case with more recent tightening campaigns, it wouldn't surprise us if it isn't as prolonged or as severe as perhaps currently feared. Hopefully, the outcome is the best of both worlds – the end of the deflationary spiral of the last ten years, but also the quelling of 1970's style inflationary concerns. Long term interest rates are likely to increase, but we wouldn't be surprised if they struggle to break higher than 2.5% given growth dynamics and continued global uncertainties driving continued flight to safety demand for treasuries.

While our general views of where growth would be and how the inflation components would trend were pretty good, our view that inflation wouldn't be problematic, at least for the markets, was woefully off base as the Fed continued to raise rates at a clip far more quickly than what we expected. In spite of these issues, earnings remained stable and, outside of tech, were arguably even strong. The economy, in spite of fears, didn't succumb to recession.

As we look to 2023, we don't believe a recession is inevitable as many do; a soft landing is within the realm of reason, or at the very least, a no landing, as was the case in 2022. We see inflation trends continuing to improve, enabling the Fed to halt further hikes at some point during the year. Strength from a broadening set of economic sectors and healthy employment and wage gains should offset continued weakness from pandemic beneficiaries and the more interest rate sensitive sectors of the economy like housing.

The Markets

We've long held to a proprietary investment approach which postulates that three cycles determine overall value creation in the stock market. These three cycles include: *The Economic Cycle, the Innovation Cycle and the Credit Cycle.*

Last year at this time, we wrote the following:

Historically speaking, the Economic Cycle – the economy's natural movement from recession to recovery to expansion - has tended to have the greatest impact on market returns in any given year. Given the recent strength of the economy, we continue to see cyclical gains ahead and more elevated inflationary pressures than previously perceived, particularly with respect to wages. We continue to believe the Economic Cycle will have more influence on the markets than it has in the last ten years, given greater volatility along a whole host of variables including GDP, inflation and interest rates. Continued ESG mandates will likely contribute to this phenomenon.

Longer term, meaning more than a year out, we believe the Innovation Cycle will continue to be the dominant generator of alpha for investment portfolios. The pandemic has accelerated efforts in corporate America to achieve greater productivity gains, but at the same time, easy money policy in recent quarters has helped to finance a flurry of newly disruptive companies, many of which may not survive. If this is the case, the profit margins and sales growth of existing profitable innovators may be slower than it might have otherwise been, at least until any "excess" supply is liquidated.

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With respect to the Credit Cycle, there is no doubt that the Fed seems to be far more hawkish than it was even one month ago. Not only will rate hikes be in the cards, but some recent proceedings suggest the Fed may not only taper, but also start to sell their excess treasury holdings. On this front, we're not sure – we believe the economy is strong, but there remain enough concerns that the Fed may not be able to be as forceful as currently anticipated.

Based on an analysis of prior rate hike cycles not ending in recessions, market corrections can be expected, but are often not durable enough in nature to be noticed for more than a few months and sometimes just weeks. While we tend to focus on the worst of the worst, more often than not market corrections are much tamer than anticipated. As always, the key to success is having a longer term investment horizon, recession or not.

Again, our thoughts as they relate to the Economic Cycle, Innovation Cycle and the Credit Cycle were generally on track. Economic factors clearly had a larger influence on the markets than in recent history, and broadening the portfolio's exposure beyond Innovation Cycle names made a great deal of sense. The Credit Cycle remained a headwind, however, as the Fed hiked rates far more aggressively than we would have thought. As a whole, the economy didn't experience a landing at all, hard or soft, but the stock market did undergo a double digit decline as it digested the effects of higher interest rates on earnings multiples. We believe that 2023 will be more about the impact of earnings than the impact of multiples, the former which we believe will be relatively resilient.

So, where do we go from here in 2023 and beyond?

In general, most of what we believed in 2022 with respect to the Economic Cycle, Innovation Cycle and Credit Cycle still applies. The effects of supply and demand imbalances should continue to support a broadening in stock market participation, particularly at the sector level, as China finally reopens and as difficulties on the geopolitical front remain.

We believe Innovation Cycle names, and in particular, non-profitable, pandemic beneficiaries, will likely remain dead money if not on an absolute basis then at least on a relative basis. Profitable, established tech names may find some support as earnings stabilize, but the quality of those earnings, particularly stock based compensation and any GAAP to non-GAAP adjustments, will remain highly scrutinized. We believe quality of earnings will be an important factor in 2023.

Given our view that the Fed will likely pause but not pivot in 2023 for fear of reigniting inflation as occurred in the 70's, the markets as a whole should stabilize and perhaps bounce some as short sellers, in particular, begin to cover their bearish bets. However, given the still significant concentration of the tech sector in many broad market indices like the S&P 500, these broader measures of market health may continue to struggle or at the very least experience additional churn. Investors who press bets away from the common tech heavyweights may have a greater chance of outperforming in a sideways market. Key to this thesis is that the Fed doesn't pivot as inflation comes down.

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For context, we'll share some thoughts gained from our experience investing in the tech bubble in early 2000. While the periods are not the same, they are similar. Starting in 2000, the S&P 500 had three consecutive years of negative returns, a highly unusual and of course depressing set of circumstances for investors. During this time, most sectors of the market treaded water, or even performed quite well. However, these areas were not enough to mask tech's depression – and the whole index performed quite poorly for three years.

At that time, the overall economy did catch tech's cold and succumbed to a mild recession as layoffs that had been centered in tech broadened out. But this period was also the springboard from which new areas of growth took root, not completely obvious at first in the indices as a whole, but with hindsight becoming quite apparent over subsequent years. Areas of strength outside of tech included those associated with China's global expansion (materials and energy in particular), the banking sector, and housing.

We suspect a similar pattern could unfold today, but don't see quite as dire an outcome. The tech space is far more profitable as a sector than it was at that time, particularly relative to its size in the index. In the tech bubble, some companies didn't even have revenues, let alone profits. Layoffs will likely remain centered in tech, but strength in other areas of the economy may pick up the slack. The Credit Cycle may offer us important clues on areas of opportunity based on an understanding of what has been under and over capitalized in recent years and thus contributing to supply based pressures on inflation.

Something that many investors may not know is that many of the most popular indices are "momentum" based strategies. Stocks are allocated a percentage in the index based on market cap. This means that the stocks that increase the most in value make up an increasingly large portion of the index. Passive investing has been a fantastic strategy for much of the last decade+; the biggest companies grew earnings at the fastest rate, and investors were rewarded handsomely for following the money. As money continues to flow into the same sectors of the economy, bubbles and overvaluations naturally form. These bubbles either burst suddenly, as in the early 2000s, or deflate more slowly, as they have in 2022. Either way, it remains true that the leaders of the previous cycle rarely lead in the next; as investors wise up, the sting of past losses remains fresh in their minds, and the promise of new opportunities calling, oftentimes underappreciated and undercapitalized by investors of the past.

The way we see it, there is a fantastic opportunity for active management to shine, especially for those who are bold enough to press bets both in the direction of new opportunities and away from the winners of the past.

Politics

Last year, we wrote the following perhaps unsurprising statements with respect to the political environment:

The nation remains highly polarized.

As we stated in our most recent [quarterly update](#), one way we might as a nation temper these views could be by recognizing the beneficial role and value that those with

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differing functions and points of view have on the whole, and how our unique contributions –even in “backward looking” industries like fossil fuels -- can help us get to the future we envision. If our economy is able to collaborate successfully, perhaps value and growth stocks can both do well in 2022 once again.

An analysis of the history of midterm elections could suggest a rockier year ahead as 2022 is a midterm election year. Given the strong returns of the last few years, we wouldn't be surprised by such an outcome, but remain hopeful that barring a recession, we'll still end the year in the positive column.

It is safe to say that the nation remains polarized, but there are signs of hope. The midterm elections proved far less decisive for Republicans, suggesting that if they are really about the “economy stupid”, then perhaps things aren't all that bad.

On the subject of politics, two thoughts come to mind for the pages of our 2023 Playbook. First, as capitalists, we believe the invisible hand of Adam Smith may be taking action on the hot button political issues surrounding income inequality. Perhaps old industries and their blue collar workers will see some better days ahead as much needed reinvestment occurs in the face of increased geopolitical uncertainty, trends towards de-globalization, and domestic population migration following the pandemic. At the same time, white collar tech workers may need to come to grips with the idea that stock based comp sometimes doesn't pay the bills as well as cash based comp. (We wouldn't be surprised if SBC gets a closer look politically in 2023, just as it did following the tech bubble.)

Before we go offending anyone, it is important to see the nuance here in our thought process. Equality of incomes isn't the end goal, but if higher wages is what the free market requires to smoothly function, more equality is what we likely get. In the environment we envision, the prospect for good returns in once forlorn areas may do a decent job of accomplishing more equality, not because things should be that way, but because they reflect the underlying supply and demand drivers that have the potential of making it so. Call us cynical, but perhaps the ESG craze had the backdoor effect of enabling elite tech companies to keep their multiples high at the expense of other less glamorous industries. If these views are reasonable, then perhaps one of the issues that has politically divided our country in recent years may soften as an influence.

The second thought that comes to our mind with respect to political discord in this country may relate to the notion of what is true. Too often we fight with each other when the difficulty of holding two truths in tension exists. If I lost you there, perhaps an example would be helpful. Just as many liberal elites rolled in the dough of an economy that has favored established tech and tech startups (what's wrong, this economy is great!) another truth reflected the reality of Trump deplorables (this economy has no jobs) screaming an alternate view while simultaneously under attack that all their dirty jobs must go.

A unifying reality within these two truths (the economy is great, the economy sucks) is that both situations have been true for those that have held them; it isn't either or. C.S. Lewis touches on the reality of two truths in tension in his classic book *Mere Christianity*. In the last chapters of the book, he discusses the truths about who we are; on the one hand we are unique individuals crafted by God with different talents and traits. In this sense it would be wrong to expect

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everyone to be the same or “equal”. But on the other hand, we are all members of a community, and for Christians, this is the church, a living and breathing organism in its own right.

While we all can and should pursue our own individuality, if one of us suffers or is sick and those that are well off ignore it or, worse yet, deny it, the entire body suffers. This isn't conservative and liberal ideology that should threaten one another, but a new truth that perhaps can better unite us.

What does this have to do with the playbook? Well, as 2022 comes to a close and 2023 begins, the loudest megaphone in the media may fail to tell the entire story. If you are in the tech sector, a recession may be all you can see and feel, but if you're in fossil fuels or a part of industrial society, your truth could look far different. Trying to claim one truth is correct and the other one is wrong may be like having to choose between air or water to live. Hard landing, soft landing or no landing, there is undoubtedly a bull market somewhere!

We'll close our 2023 Playbook as we have always done, by reminding investors that our business is never easy, but it's always an intellectual challenge worth pursuing.

May God bless you abundantly in the coming year, even if it comes in ways you don't expect!

Kindest Regards,

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