



CROWELL WEEDON ASSET MANAGEMENT
MONTECITO INVESTMENT PORTFOLIOS

January 1, 2023

Dear Fellow Investors,

We've outlined the major topics & takeaways of our annual letter below – details follow!

MAIN MESSAGE HIGHLIGHTS:

- It's rough out there - a disciplined process keeps us focused on the long-term
- Humanity has accomplished a lot and will continue to do so
- **PLOT TWIST** – The first 3 pages highlight the innovation taking place now
- We foresee massive gains in productivity, creativity, and intelligence
- Rapid growth related to transportation, communications, flight, and manpower to machine-power
- Human achievement is booming yet feelings of despair are skyrocketing – what gives?
- The Abundance Agenda – the US is getting back to building
- The future is bright – don't get discouraged

FORECASTS

- **Economy:** GDP up about 3%, eclipsing \$26.5 trillion
- **S&P 500:** earnings growth drives appreciation, S&P 500 above 4,000 by year-end
- **Short-term rates:** we're believing the Fed, short-term rates to at least 5%
- **Long-term rates:** yield curve flattens and 10 year yield approaches 5%
- **Oil prices:** geopolitics drives prices, oil averages approximately \$80/barrel for the year
- **Inflation:** wage / price spiral kept in check, rate drops below 5%
- **Commercial real estate:** a slight, but positive total return. We prefer sectors with a fundamental need.
- **Residential real estate:** migration from high cost to low cost continues. For the first time since 2007 – 2009, we predict a fall in the S&P Case-Shiller index

Two more forecasts not entirely investment related:

- Iger returns to Disney for one final deal
- Twitter, moving at Elon-speed, is ready to come back to the public markets before year-end

CONCLUSION

Dear Fellow Investors,

We understand that the current market and global environment may be causing fear and uncertainty for many investors. While we cannot control market returns, we want to assure you that we are closely following a tried and true disciplined process to help navigate through these uncertain times.

During times of uncertainty, fear, and discomfort, it can be beneficial to take a break from being plugged in to the daily news and instead focus on other aspects of life that prove to be far more valuable. This can help to reduce stress and anxiety, and can provide a much-needed distraction from the constant stream of negative news.

One way to take a break from the news is to focus on activities that bring you joy and fulfillment. This could include hobbies, exercise, spending time with friends and family, or pursuing personal interests. Engaging in activities that bring you happiness and satisfaction can help to improve your mental and emotional well-being, and can provide a sense of purpose and direction during difficult times.

When viewing the world through an optimistic lens, it is clear that humanity has achieved a great deal in the past. From technological advancements to social and economic progress, humanity has a track record of overcoming challenges and achieving success. This is why investing must be done by looking forward and not based on what has led in the past.

A few key accomplishments that humanity has achieved in the past 100 years:

- *Advances in medicine and healthcare have greatly increased life expectancy and improved the health of people around the world. Major medical breakthroughs such as the development of antibiotics and vaccines have saved countless lives and reduced the burden of disease.*
- *The advancement of technology has also had a major impact on society. The invention of the internet has connected people from all over the world and made information more accessible than ever before. In addition, advances in transportation, communication, and computing have made it possible for people to live and work in ways that were unimaginable just a few decades ago.*
- *In the area of equality and human rights, there has been significant progress in many parts of the world. Many societies have become more inclusive and accepting of diversity.*
- *On a global scale, the world has become more interconnected and interdependent. International organizations such as the United Nations have played a crucial role in promoting cooperation and addressing global challenges such as poverty, disease, and climate change.*

Overall, when viewing the world through an optimistic lens, it is clear that humanity has achieved a great deal in the past and has the potential to continue to do so. This is why investing must be done by looking forward and not based on what has led in the past.

OUR DISCIPLINED PROCESS

We cannot control the returns earned in the market, as the market is constantly changing and is influenced by a wide range of factors. However, we can control the criteria through which we make consistent investment decisions by following a disciplined research process. This involves carefully researching and evaluating potential investments based on specific criteria, such as the financial health and performance of the company, industry trends, and management team. By following a disciplined research process, investors can make more informed and consistent investment decisions. Additionally, by adhering to a disciplined research process, investors can also reduce the impact of emotional decision making, which can often lead to poor investment choices. By following a set of predetermined criteria, investors can avoid making impulsive decisions based on short-term market movements or other factors.

STAGES OF LIFE – ACCUMULATION, TRANSITION, DISTRIBUTION

Allowing where you are in your stage of life to dictate your asset allocation decisions can provide numerous benefits. Firstly, this approach can help to ensure that your investment portfolio is aligned with your financial goals and risk tolerance. For example, younger investors may be able to take on more risk in their portfolio, as they have a longer time horizon and can potentially ride out market volatility. In contrast, investors approaching retirement may need to shift to a more conservative investment strategy to preserve their capital and generate income.

Furthermore, this approach can also provide a framework for regularly reviewing and rebalancing your investment portfolio. By regularly assessing your stage of life and adjusting your asset allocation accordingly, you can ensure that your portfolio remains aligned with your financial goals and risk tolerance over time.

ASSET CLASSES WE USE TO CONSTRUCT PORTFOLIOS: HIGH GROWTH, GROWTH, EQUITY INCOME, REAL ESTATE, ASSET BASED, HIGH YIELD, INCOME, AND A PEACE OF MIND CASH RESERVE

HIGH GROWTH

These types of companies are often at the forefront of technological and industry developments, and their potential for growth can be significant as they disrupt traditional markets and create new ones. Additionally, investing in innovative companies can provide a hedge against inflation as these companies are often able to adapt and evolve with changing market conditions. Overall, the potential rewards of investing in innovative companies make them a valuable addition to any long-term investment strategy.

GROWTH

These companies often have a dominant market share and a strong competitive advantage within their industry. This can provide a level of stability and resilience to their business, even in times of economic downturn. In addition, industry leaders often have the resources and expertise to continuously innovate and adapt to changing market conditions, which can drive long-term growth. Additionally, investing in industry leaders can provide a sense of security knowing that these companies have a track record of success and are well-positioned for future growth.

EQUITY INCOME

Dividends provide a source of income. This can be especially appealing for investors who are retired or looking for a steady stream of income from their investments. Dividends can also serve as a sign of a company's financial stability and profitability, as companies are more likely to pay dividends if they have a consistent track record of earning profits. Additionally, dividends can provide a cushion against market downturns, as they can provide some level of return even if the value of the underlying stock declines. Overall, dividends can be a useful tool for investors seeking a combination of income and potential capital appreciation.

REAL ESTATE

REITs offer the potential for steady income, as they are required to distribute a significant portion of their earnings to shareholders in the form of dividends. This can be especially appealing for investors who are looking for a reliable source of income from their investments. REITs also provide exposure to the real estate market, which can offer diversification benefits to an investment portfolio. Additionally, REITs can offer the potential for capital appreciation, as the value of the underlying properties can increase over time. Overall, REITs can be a useful tool for investors seeking a combination of income and potential capital appreciation from their investments.

ASSET BASED

Investing in commodities and hard assets can be a valuable piece of a diversified investment portfolio because they can provide a hedge against inflation. Over time, the purchasing power of paper currency tends to decline, which means that the same amount of money can buy fewer goods and services in the future than it can today. This phenomenon is known as inflation. Commodities and hard assets, on the other hand, are tangible goods that retain their value over time. By including them in your investment portfolio, you can help protect your wealth from the effects of inflation. Additionally, commodities and hard assets can provide diversification benefits by offering a different set of risks and returns than other types of investments, such as stocks and bonds.

HIGH YIELD

Investing in high yield securities, such as preferred stocks, master limited partnerships, and closed-end mutual funds, can provide a number of benefits to investors. In addition to the higher yields, these types of securities can provide diversification benefits by offering a different set of risks and returns than other types of investments. This can help reduce the overall volatility of an investment portfolio and provide a more stable stream of income. Furthermore, high yield securities can offer investors the opportunity to invest in a wide range of industries and sectors, providing exposure to a variety of different economic conditions and business models.

INCOME

Government bonds can provide a stable source of income, as they often offer regular interest payments. This can be particularly useful for investors who are looking for a predictable stream of income to supplement their other sources of retirement income. Furthermore, government bonds can provide diversification benefits by offering a different set of risks and returns than other types of investments.

PEACE OF MIND

Allocating a portion of an investment portfolio to cash and cash equivalents can be important for several reasons. It allows investors to have a source of liquidity that they can tap into in the event of an emergency or an unexpected expense. This can help to ensure that they are not forced to sell off more volatile investments at inopportune times in order to meet their financial needs. Additionally, having a cash reserve can also allow investors to take advantage of opportunities that may arise in the market, such as purchasing undervalued assets or investing in new opportunities that have the potential for strong returns. Finally, holding a portion of a portfolio in cash and cash equivalents can also provide a measure of stability and diversification, which can help to mitigate the impact of market volatility on overall portfolio performance.

THIS YEAR'S REAL MAIN MESSAGE

Thank you as always for reading our annual letters. This year's has a bit of a plot twist..... None of the writing up to this point was actually done by us! Instead, we prompted [OpenAI's ChatGPT](#) to create it (we italicized everything created by ChatGPT). If you're not familiar with ChatGPT there are a few things to know. It is a large language model trained on a large amount of data. The specific details of the training are complex but at the end of the day it is trying to learn underlying patterns and relationships in text data to generate accurate and relevant responses to new inputs. To say the early results are impressive is a gross understatement as ChatGPT [surpassed 1 million users](#) in just 5 days. It took Netflix 41 months, Twitter 24 months, Facebook 10 months, and Instagram 2 ½ months to reach 1 million users!

Why are we highlighting this? We were tasked by one of our favorite, long-term clients this year to discuss something that is comforting in the world. The challenges, problems, and fears thrust in front of us each day can make life downright depressing. So we asked ourselves, what is comforting? What is good? In our opinion, the greatest driving force providing optimism for the future is innovation. The problem with innovation is that sometimes the potential is not well understood. It's why we wanted to show off some of the capabilities ChatGPT can perform today and circle back on the potential of this and other innovations as we look forward.

PRODUCTIVITY

Typically, we spend numerous weeks (sometimes months) preparing and crafting our main message. This year's opening by ChatGPT took about 10 minutes to create. Keep in mind that we're just now uncovering what the use cases for ChatGPT will be. Since its launch a few weeks ago, we've seen ChatGPT create:

- a [weight loss plan](#) complete with calorie targets, meal plans, a grocery list, and workout schedule
- a [commercial lease agreement](#) for a South Carolina based property with a 2-year term and eight 1-year extensions
- write a [deep-dive](#) for an investment newsletter summarizing a company's recent quarterly results

- draft a [letter of intent](#) for the merger between two companies complete with incentive terms if certain conditions are met
- create 15 clever names for a [hamster](#) that get less funny and more disturbing as the list goes on

As these models are trained to understand context of language, they're also very good at writing code. In a recent [podcast](#), Amjad Massad, the founder of Replit, said he believed the role of a software engineer is about to change. It will be more about project management and code review as these tools continue to unlock productivity gains. He believes in about a year they will be good enough to feel like you have a personal assistant. In about 3 – 4 years it will feel like you have 50 to 100 assistants. Said another way, the productivity uplift will be about 50 – 100 X from what we know today!!

CREATIVITY

Obviously, ChatGPT isn't perfect. As can be seen in the intro to the letter, it lacks our usual writing style and feel. But you can prompt ChatGPT to write in any style you would like and the pace of improvement is stunning. As quite the hit to our ego, prompting ChatGPT to write in the style of Blake Todd or Jarrett Perez isn't yet available. But do you know who is? Dr. Seuss. Here's something we asked ChatGPT to create for us:

Input To ChatGPT:

“Write a story in the style of Dr. Seuss about the battles you will face as an investor in the stock market. Talk about investing as being a journey with numerous obstacles to overcome. But once they are overcome true wealth can be had which wasn't about the money, but the freedom to do what you love.”

Output:

*In a world full of numbers, and charts, and graphs,
There was a young investor, named Tim, who wanted to take a chance.*

*He bought stocks, and bonds, and all sorts of things,
Hoping to make a fortune, and hear the cash register ring.*

*But the stock market is a wild and unpredictable place,
Full of battles and obstacles, that Tim had to face.*

*He fought through the ups and downs, and the good times and bad,
Determined to make a profit, and never to be mad.*

*He learned from his mistakes, and he grew more wise,
He diversified his portfolio, and he looked to the skies.*

*And as he journeyed on, he realized something true,
That wealth wasn't about the money, but the freedom it can give to you.*

*With his newfound wealth, Tim could do what he loved,
He could travel, and explore, and go where he dreamed of.*

*He could live life on his terms, and never again be a slave,
To a job he hated, or a boss he couldn't take.*

*So if you're an investor, and you want to succeed,
Don't give up, and don't be in need.*

*Keep fighting the battles, and you'll come out on top,
Just like Tim, in the world of the stock market, where anything can happen, nonstop.*

INTELLIGENCE

When we think of someone as intelligent what does that actually mean? They know how to do a lot of things? They know about a lot of things? They can help others do or learn about things? I think we have a pretty broad definition of what we think it means to be intelligent. With the digitization of knowledge and the boom in connectivity and processing power, there should be an acceptance that at some point in the future the ability for machines / programs to interpret, learn, and be knowledgeable will be greater than what humans are capable of. In numerous cases, this is already happening with AI models now competing and winning in competitions related to [gaming](#), [coding](#), and [strategy](#). They've unlocked new use cases such as [protein design](#). They're even making progress on passing exams like the Bar and [US Medical exam](#). We don't doubt that in the very near future we will see models built with specific domain expertise able to pass licensing exams related to [law](#), finance, accounting, and medical professions. We find it fascinating to witness a program create content in language and artistic form on par if not better than humans in a fraction of the time.

Input To ChatGPT:

"What are some topics or concepts that may be difficult for humans to understand, but will probably be easy for AI applications like yourself to understand?"

Output:

Here are some specific examples of topics or concepts that may be difficult for humans to understand, but easy for AI applications to understand:

- **Advanced mathematical concepts and equations:** AI applications can quickly process and analyze complex mathematical equations, such as those involving calculus, algebra, or trigonometry. This allows them to solve problems and find solutions that may be difficult for humans to understand or calculate.
- **The inner workings of complex systems or processes:** AI applications can easily analyze the components, relationships, and behaviors of complex systems or processes, such as those involving mechanics, electronics, or biology. This allows them to identify weaknesses, inefficiencies, or potential improvements that may be difficult for humans to discern.

- **The relationships between large and disparate sets of data:** AI applications can quickly and accurately identify relationships between large sets of data, such as those involving demographics, economics, or health. This allows them to find patterns and trends that may not be immediately apparent to humans, and to make predictions or recommendations based on that data.
- **The behaviors and patterns of large groups of people or animals:** AI applications can analyze large amounts of data related to the behaviors and patterns of people or animals, such as their movements, habits, or preferences. This allows them to identify commonalities, differences, or trends that may be difficult for humans to discern.
- **The subtle nuances and variations in large volumes of language or text:** AI applications can quickly and accurately analyze large volumes of language or text, such as books, articles, or conversations. This allows them to identify common themes, sentiments, or trends that may be difficult for humans to discern based on a smaller amount of text.

WE MUST BE AWARE OF WHERE THE FUTURE IS GOING

In 1998 Warren Buffet said, *“If I live X number of years, I’ll go through Y number of recessions. But if I spent all my time guessing cycles, Berkshire Hathaway would be \$15/share. You can’t dance in and out of businesses based on forecasts.”* As we are tasked with investing for the long-term and therefore thinking for the long-term, you get a sense of why today’s constant talk of CPI or interest rate hikes can have you miss the forest through the trees. We will certainly share our near-term financial forecasts with you later in this letter. But our long-term thoughts and outlook will be what drives decision making as we deal with the natural ebbs and flows of the economy and business cycles.

Some of our most significant long-term thoughts were laid out in our Roaring 2.0s letter a few years ago. This was a decade-long outlook driven by rapid growth in emerging technologies. With the decade now about 1/4 of the way done, we wanted to track the progress of the innovation we forecast.

TRANSPORTATION

Roaring 2.0s Prediction: *Transportation is on the cusp of a revolution. In the Roaring 2.0s we will see vehicles that are powered by electricity, have the ability to handle the majority of driving themselves, and become the ultimate mobile device. They can act as a large, distributed, mobile data center, capturing real-time information from across the globe. Car owners may be presented with the intriguing proposition of allowing their vehicle to operate in a ride-sharing fleet, allowing the owner to earn an income to help offset the cost of the vehicle. Should this happen, we could witness the entire equation of car ownership flipped upside down. The Roaring 2.0s will see Transportation as a Service (TaaS) fully blossom.*

Absolutely happening. Market share growth from EVs is faster than anticipated. Work on autonomy continues with several [geo-fenced](#) services operating today. The true game-changer will be in the form of Transportation-as-a-Service which will be achieved when a cost-effective, widely scalable, solution is real. This appears to be getting closer and closer each day. Based on the current rate of progress, we think 2024/2025 could be the time when robotaxis and autonomous vehicles begin to see

widespread adoption, causing the cost of transport to plummet, and forever altering how we think about transportation.

COMMUNICATIONS

Roaring 2.0s Prediction: *The creation of the smartphone allowed for an entirely new segment of the economy to form. Developers were free to use the capabilities of the device to put movies, games, friends and family, communication, work, banking, investments, news, memories, and much more right in the palm of our hand. The Roaring 2.0s will see the rollout of the 5G network across our country and much of the world. This will bring an increase in speed of about 10 times what we're currently used to. The first generation network brought us voice, the second was data, the third was basic mobile computing, and the current, fourth generation, has speeds that allow for the app-based economy to flourish. 5G speed will allow augmented reality, advanced robotics, and connected devices to boom.*

Absolutely happening. *We can also add SpaceX's [Starlink](#) satellite network that provides high-speed internet access nearly anywhere on the planet.*

NEXT GENERATION OF FLIGHT – SPACE

Roaring 2.0s Prediction: *This decade, the public will be introduced to space flight. The reusability of rockets has dramatically cut the cost of a launch (could you imagine the cost of flying in an airplane if they were all single-use machines) and will eventually make it affordable for all. SpaceX continues to cut their own launch cost estimates and believes they can reach a price below \$30 million, whereas the United Launch Alliance (consisting of Boeing and Lockheed-Martin) have charged nearly \$150 million in recent history. This will have a profound impact on all of humanity. Mankind has known one home for all of our existence. The Roaring 2.0s will most likely see this change. We envision many firsts during this decade when it comes to space. The first civilians taking a trip around the moon, the first lunar base established, and the first humans to set foot on Mars. We believe this could be one of the most unifying events in human history as the world comes together to celebrate mankind's accomplishment and spark an entirely new space economy.*

Absolutely happening. *SpaceX has changed the game. As of today, no other country is capable of going to orbit and re-landing a rocket!! If successful, [Starship](#) will represent another step-change, reducing launch costs to a fraction of what they currently are. Starship could be humanity's first fully reusable and rapidly refillable rocket. Numerous other space-related companies have launched with significant investor interest taking place.*

MANPOWER TO MACHINE-POWER

Roaring 2.0s Prediction: *The Roaring 2.0s will see two technologies evolve to become primary labor inputs – advanced robotics and artificial intelligence. We believe they will lead to productivity enhancements like never before. While robotics have been utilized for decades, they were limited to performing repetitive tasks that their engineers programmed them for. AI will bring advancements in:*

- *Machine Vision - will vastly improve depth and image recognition*
- *Scalability – machine learning will allow robots to handle new parts of a manufacturing process without needing to be reprogrammed, as these programs are typically cloud- based, learnings of one robot can be applied to an entire army of robots*
- *Intelligent Placement – the ability to carefully and neatly handle delicate items*

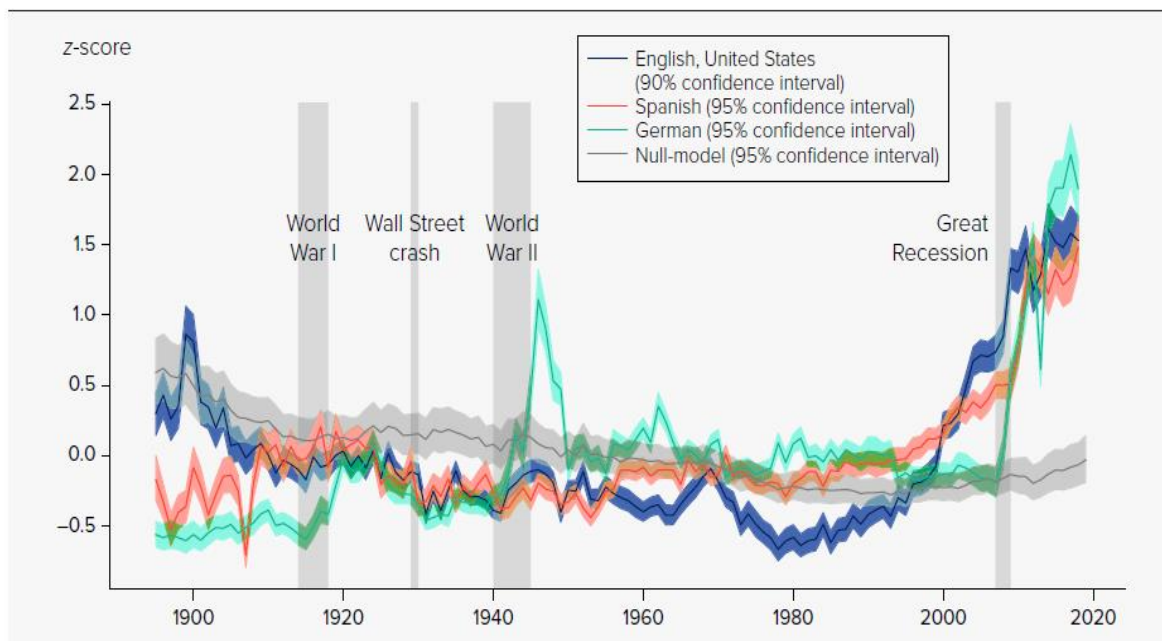
Machines will continue to be able to handle more and more tasks previously only thought possible to be

done by humans. We think the Roaring 2.0s will not only see this in industrial settings, but also see more and more consumer-focused solutions become common in households throughout the country.

Absolutely happening. Perhaps at a pace even surprising to many in the field. These models have shown stunning results when it comes to intelligence. Next, we expect to see the evolution of [robotics](#) going from industrial use cases to general use cases. Merging this with the rapid advancement in language intelligence produces something we've only seen or read about in science fiction.

HUMAN ACHIEVEMENT IS BOOMING YET HUMAN FEELINGS ARE PLUMMETING – WHAT GIVES?

Figure 5 Negative views about the world surges to unprecedented highs



Note: Negative views are defined as textual analogues of cognitive distortions in one- to five-word sequences reflecting depression, anxiety and other distortions, published in 14 million books in English, Spanish and German over the past 125 years. The prevalence of these word sequences in publications are converted to z-scores for comparability. They are compared with a null-model that accounts for over-time changes in publication volumes and standards. **Source:** Bollen and others 2021.

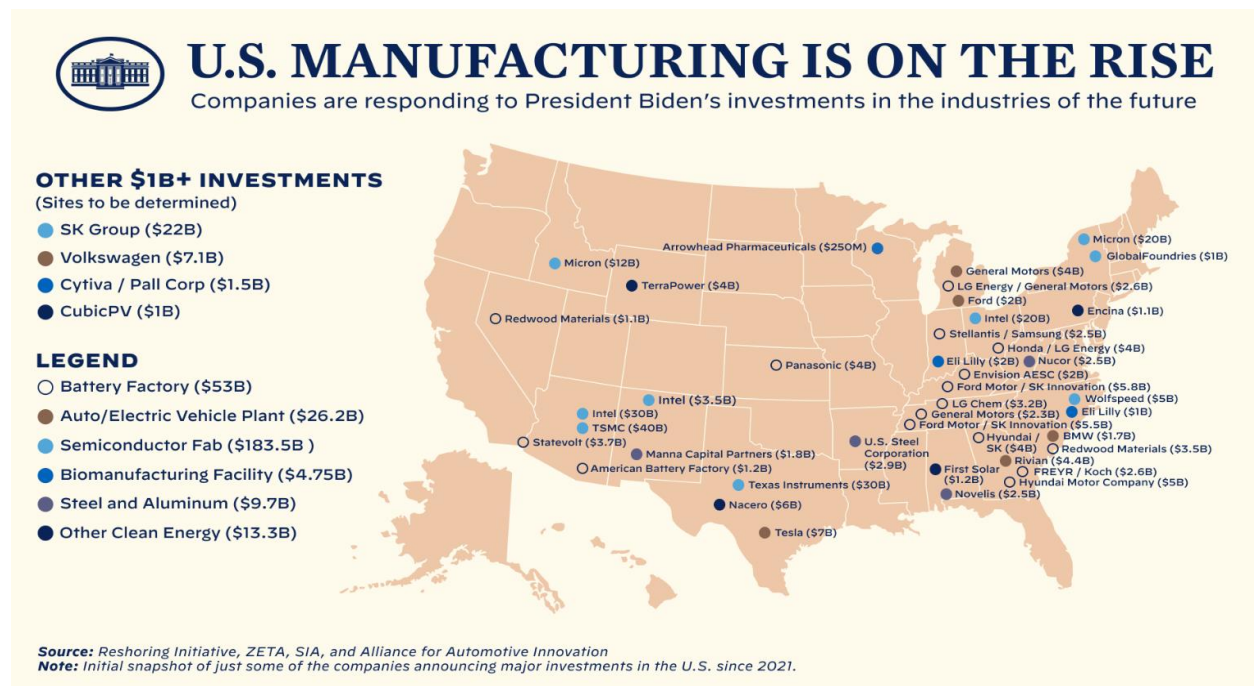
A report from the [UN](#) shows negative views about the world have surged to unprecedented highs. Feelings of insecurity, polarization, and lack of trust have never been higher. What gives? In our very simplistic analysis of the above chart, we would point out the surge in negativity starts to take place right around the year 2000. Many thoughts here, but certainly the terrorist attacks of 9/11 could be looked at as a turning point. However, we believe a great deal of this insecurity is correlated with connectivity, as right around the year 2000 we witnessed the birth of our connected world with PCs becoming affordable to most and the rapid growth of the internet. The connectivity wave hasn't stopped, with 2008 largely unlocking mobile communications and seeing the rise of social media platforms. With instant information and everyone "plugged in", creating narratives has never been easier. Knowing that fear sells, media companies have taken full advantage of this and painted a picture of a world that has never been more negative. What can change this?

THE ABUNDANCE AGENDA

The [Abundance Agenda](#) as proposed by Derek Thompson is a concept that has been gaining momentum, especially after COVID. We've come to realize the failure of not being able to produce enough stuff during COVID. We didn't have enough masks or test kits. We failed to invest in upgrading infrastructure like our ports leading to massive shipping delays. Our immigration policies are a mess and we seemingly have a shortage of labor. We saw a shortage of computer chips as nearly the entire industry has shifted to Asia. We've had a national failure to increase the supply of essential goods.

- Health care: the US has fewer physicians per capita than almost every other developed country
- Housing: unaffordable in most coastal cities. Regulations are preventing construction.
- College: not expanding the total number of admissions
- Transportation: building big projects on time and on budget is nearly impossible. Laws and regulations have stymied new building projects just about everywhere.
- Energy: US has closed more nuclear plants than we've opened this century. Even renewable projects like solar in Nevada get held up due to environmental concerns.

Most people will not support something if it means they must make great sacrifice. Humans enjoy big dreaming, thinking, and living. The Abundance Agenda is about the abundance of comfort, the abundance of energy, and the abundance of time. At its core, it is an agenda driven by building. As Thompson states, *"We must go from venting to inventing. This age of bits-enabled protest has coincided with a slowdown in atoms-related progress."* For some proof as to why we're optimistic that this is being adopted, look no further than the following map. There has been a resurgence in commitments to [building](#) things right here in the U.S. These commitments represent nearly \$300 Billion in investment related to manufacturing projects! You would probably have to go back numerous decades to find a time when so much manufacturing investment was taking place in the United States.



A RENAISSANCE MAY BE UPON US

While all of this innovation can seem scary we need to keep a few things in mind:

- [60%](#) of the people in this country are doing jobs that didn't exist in 1940.
- In 1870 the [work week](#) was over 60 hours
- During the 12th – 19th centuries, [infant mortality](#) was approximately 45% and [life expectancy](#) (excluding this mortality) was 55 years
- Modern day conveniences like electricity, indoor plumbing, telephone, washer, vacuum, refrigerator, dryer, freezer, water heater, dishwasher - were all introduced in the past 200 years

Change can take place quickly and currently it's gone [parabolic](#) when viewed on a timeline of human history. We now have actual proof that humanity is successful at creating high-output labor which we would define as programs and machines capable of completing tasks previously only reserved for humans. There is a [fully automated McDonald's](#) operating in Texas. Amazon is testing [Sparrow](#) – their pick and sort robot that can handle about 2/3 of their current items. The number of AI examples that we can show literally grows by the day. This shift from manpower to machine-power unlocks some interesting possibilities.

The Renaissance came about as growth of trade and commerce created prosperity and wealth allowing people the time to focus on education and the arts. With advancements in machine-power, we see the possibility for a modern-day Renaissance, allowing humans the ability to get back to doing what we instinctively enjoy. We are social creatures. Put a bunch of babies/toddlers together and watch them explore, learn, and laugh. What you won't see is them get in a line and start producing the same product over and over or separate themselves in little cubicles as they create report after report.

THE FUTURE IS BRIGHT

It's a sad state when we sound contrarian for painting a picture of a bright and prosperous future. Humanity is on the cusp of unlocking productivity gains that are difficult to fathom. We're now moving into the "second act" of this connected world that moves beyond merely receiving or sending information. It is a merging of the digital and real worlds with highly skilled tasks able to be handed off to these programs and machines. This opens up the possibility for a surge in productivity, output, and time being given back to people. This production of labor could untether us from jobs of boring, repetitive, dangerous tasks and allow us to once again be fulfilled by jobs that more closely align with our instinctive nature. We merely need to [look back](#) just a couple of generations to witness revolutions in what humans spent their time doing – moving from agriculture to industry and now to services. We believe we're in the midst of this shift yet again.

How many of us talk about the "daily grind". Ask someone what's new and you might hear, "same stuff, different day." COVID lockdowns gave us a glimpse into what happens when people are freed from the daily grind without having to worry about money. It's probably why we still have [10 million](#) job openings – a lot of people never really enjoyed their work and don't want to go back. Obviously, paying people to stay home and not work isn't sustainable but the progress taking place with machine-power absolutely is. This machine-power may initially be seen as a competitor and therefore feared. Eventually, we

believe it will be seen as the ultimate life-hack that provided freedom to the masses, unlocking our human spirit, and be a huge reason why that spike in despair will reverse.

Humans love to create, explore, be curious, and inspire. We haven't heard people talk about their displeasure with spending too much time with their loved ones. It's usually feelings of sorrow for being caught up in daily life, not detaching and taking a break, and wishing there was just more time to relive some of those amazing moments that are too often not appreciated. We envision an opportunity in careers that embrace the human spirit. That touch of humanity is something that machines and programs will struggle to provide (at least for the foreseeable future ☺). In our opinion, there will be significant opportunity for investors that can look beyond the current fears of today and recognize this tectonic shift taking place. What's interesting is that AI already seems to get it:

***And as he journeyed on, he realized something true,
That wealth wasn't about the money, but the freedom it can give to you.***

***With his newfound wealth, Tim could do what he loved,
He could travel, and explore, and go where he dreamed of.***

FORECASTS

This is the section of the annual letter where we discuss forecasts made in the past and discuss the bullets on the opening page of this annual letter. As we do every year, we remind ourselves it's a foolish section where we think we can actually make forecasts for the future! We enjoy using "What If" in our thought process as it allows for outside-the-box thinking and challenges our (and your) assumptions. As a reminder, these forecasts are our thoughts as of the writing of this annual letter in late-December. Markets are dynamic and ever-changing. When change occurs, so too must our thoughts to adapt to the then current investment environment. This is similar to our health. We get check-ups on a regular basis and develop a plan to maintain or improve ourselves. However, should we get sick we must be flexible enough to alter our plan to adapt to the new diagnosis we have been dealt.

We reiterate, our portfolios are managed substantially from the bottom up. This means we look at individual investments themselves and the long-term value they represent, knowing that quality companies at the right price represent value. With this reminder out of the way let us review our forecasts from 2022's annual letter and make some new and bold (and perhaps futile given our long-term perspective) forecasts for 2023.

For 2022 we had a mixed record, getting as many correct (5) as we got wrong (5). Not foreseeing the fastest interest rate hiking cycle in history, Russia invading Ukraine, or China's return to a zero-COVID policy, certainly wreaked havoc on our predictions.

The Economy:

Last year we forecast that **GDP numbers would be strong and by the 3rd quarter of 2022 eclipse \$24 trillion**. While the headlines were as negative about the economy as any we have read in a long time, the reality proved to be quite different. The Bureau of Economic Analysis detailed that the 4th quarter of 2021 and the 3rd quarter of 2022 showed strong growth that more than made up for slightly down 1st and 2nd quarters of 2022. By the end of the 3rd quarter of 2022 the Current Dollar GDP stood at \$25.72 trillion, well above our forecast – **Full point here!**

By the 3rd quarter of 2023 we are forecasting that the US economy will continue to show a year over year increase and eclipse \$26.50 trillion. This is a significant departure from most of Wall Street which is forecasting that higher interest rates will slow the economy into a recession and see economic output shrink. We believe the following will anchor economic output during 2023:

- the on-shoring / re-shoring of industry
- a robust service economy
- job openings greater than the number of unemployed
- strong consumer and corporate balance sheets
- disruptive technology driving productivity enhancement

While the economy may slow due to higher interest rates, even experience a quarter or two of stagnation, we still believe it will be higher on a year-over-year basis.

Source: FactSet

Inflation:

Last year we warned of inflation posing a significant threat to economic growth and that once the inflation genie was out of the bottle it would be very difficult to get back in. Once the wage / price spiral has started, it is tough to stop absent an economic slowdown. **We thought the supply chain disruptions that kicked off inflation would be overcome and inflation would finish the year at 4%.** We did not anticipate the Fed raising short-term interest rates at the fastest pace ever, trying desperately to slow the economy, and reversing emergency monetary policies adopted during the COVID induced recession of 2020. Inflation rates have spiked to over 8%. While we warned of higher inflation, we were totally wrong on the magnitude and earned **no point here.**

It is easy to forget the regularly occurring, sub 2% inflation rates seen since the Great Recession of 2008 / 2009 are not normal. The average percentage change in CPI since 1948 is actually just over 3.5% with the rate being 2% or less just about 1/3 of the time. The risk to inflation staying higher for more than a couple of years results from the wage / price spiral we referred to last year. The Fed is engaged in a program of hiking rates to bring the cost of capital to a more normalized level which should calm the current inflation breakout over the long-term. However, we need to give a forecast next year. **For 2023, we see the wage / price spiral being kept in check by technology driven productivity enhancements and job openings across many of the highest employment sectors in the economy being met by a continued wave of immigration. These factors should mean we have indeed seen “peak inflation” and possibly see the rate approach 5% sometime during 2023.**

Source: FactSet

Short-term rates:

Last year we believed that the Federal Reserve would start to bring interest rates back to a neutral rate without disrupting the economy. We believed the pace of increases would be moderate as inflationary pressures led by supply chain disruptions would gradually work its way out. **We forecast two rate increases but not three, taking the Federal Funds rate to a range of .75% - 1%.** We did not foresee inflation being higher for longer during the year and the Federal Reserve taking aggressive action to combat it. **We get no point here!**

The Federal Reserve has turned hawkish and is now acting aggressively to unwind:

- supply chain inflation
- the fiscal stimulus provided by Congress in the name of combating the impacts of the COVID pandemic
- their own accommodative money supply policies

In our opinion, these aggressive actions are certainly needed but were not anticipated. One could argue that the change in control of the Presidency and houses of Congress in 2020's elections allowed for the rewarding of constituents and supporters to the new party in power and that was responsible for the extra trillions of dollars of fiscal stimulus. Hopefully, that is the case and the government's checkbook can be closed for a bit to allow Federal Reserve policy to unwind the elevated money supply that is still pulsing through the economy. Balance sheets of consumers and corporations are in a low leverage position. With a rise in sentiment and confidence, this could create an expansion of money supply that would be very inflationary. The Federal Reserve is trying to head this off at the pass by making the cost of that money more expensive. **For 2023, we have no reason to believe that the Fed will not be resolute in their battle and continue to raise the Federal Funds rate to at least their target of 5%. Further, as a 5% Federal Funds rate is not much above the long-term historic average (unlike Volker's rate hikes of the early 1980's) we would not be surprised to see it stay above 5% through the end of the year. If we are wrong, it may be because the rate is higher than 5%, but we are not forecasting it to be eased below 5%.**

Source: FactSet

Long-term rates:

Last year we believed long-term (10 year Treasury) interest rates would trend higher, but not rise above 3%. We saw the low velocity of money countering the money supply growth and corporations not leveraging up their balance sheets. Much of this was correct. However, we did not anticipate runaway fiscal stimulus and the Federal Reserve's desire to combat the emerging inflation in an aggressive manner. While long-term rates did not rise as much as the Federal Funds rate, they nevertheless did go above 3%. In fact, long-term rates breached 4% for a bit and we will finish 2022 with an inverted yield curve. While we had the direction right, we did not have the correct pace and end point – **no point here.**

The risks for higher long-term interest rates in 2023 are:

- persistent inflation
- a government that opens the checkbook like a drunken sailor
- corporations seeing an end to an economic slowdown and starting to leverage up their balance sheets

Higher interest rates should have a dampening effect on Congressional giveaways as the government now faces higher interest payments on the massive amount of debt recently added to the balance sheet. We're hopeful that members of Congress accept the regime change taking place as markets demand fiscal responsibility and topics like raising the debt ceiling become a major battlefield for a split Congress. The age old solution to the US Government debt problem has been to inflate our way out, paying off yesterday's borrowings with cheaper dollars in the future. That equation works as long as the interest burden does not detract from the economy so much that taxes have to increase to cover the debt service. Rising taxes could slow the economic productivity needed to generate the extra tax revenue to cover the higher debt burden. Our belief is that while we are in the midst of disruptive revolution in our economy, productivity enhancements should allow the economy to grow to service the bloated government debt load. Investment in new plant and equipment, industries of the future, and enhancements to our everyday lives will continue to drive the economy. The balancing act will be how much corporate debt is taken on now to see a benefit a few years down the road. Keep in mind, a long-term yield just north of 4% is right around average and represents a level with ample historic evidence of solid economic expansion. **For 2023, we forecast the yield on the 10 year US Treasury will stay below the Fed Funds rate but the yield curve will flatten and see the rate approach 5% by year-end.**

Source: FactSet

Stock Market:

To reiterate, we believe successful investing requires a multi-year time horizon. However, we will hazard a forecast for every year. We believe that owning assets – such as shares of great companies – is the best way to create wealth on a long-term basis. **Last year we thought rising interest rates would be more about the economy doing well rather than the fight against inflation. Therefore, we saw earnings expanding in a good economy and a bit of TINA (There Is No Alternative) sentiment still in place. This would imply a higher year-end level for the stock market.** We did offer a cautionary note that a 20% decline was possible during the year, but thought it would be short-lived and be overcome before year-end. We were wrong. The 20% decline happened but we are still yet to recover. **No point here.**

Our valuation tools like the Fed Model still shows stocks as attractive relative to bonds and equity market multiples seem to be at attractive to discounted levels based on fundamentals. However, with the rise in interest rates we now have an alternative to stocks. Our belief that interest rates remain high in 2023 translates into a headwind for any type of multiple expansion. Due to the loss of the TINA narrative, for 2023 we believe that stock market returns will follow earnings. Analyst estimates are currently predicting earnings growth of 5.5% (below the average 8.5%) even though almost all analysts are predicting a recession in 2023. Perhaps, this is the most predicted recession in history! **Adding the**

current dividend yield of 1.7% to the 5.5% earnings growth gives us a respectful expectation of 7.2% total return from stocks for 2023. For the S&P 500, this translates to a target of just over 4,000 by year-end.

Source: FactSet

As always, we will update you on our thinking with our quarterly updates. It would not surprise us to see a capitulation decline in 2023 that typically marks the end of a bear market. Fear is now prevalent in many investors' minds, but we're not sure if we've witnessed the pure panic that marks the end of many down cycles. These declines usually happen very quickly and recover very quickly. After capitulation, markets usually start the next bull phase that climbs a constant "Wall of Worry" before people actually believe it. Although we believe capitulation could take place in 2023 we also believe our market forecast could prove to be too conservative as we do see the possibility that earnings and the economy are stronger than many expect. Further, if we get some positive surprises related to inflation slowing more than expected, the Russia/Ukraine conflict, China's economic reopening, and a pause or cut in interest rates, we could see a much more optimistic tone take hold in 2023. This could set the stage for a healthy, prolonged bull run driven by ample production, innovation, opportunity, and a normal cost of capital.

As you can see from some well-reasoned thinking, trying to guess the timing of when all this actually occurs is next to impossible. Our advice (backed by a library of historical evidence) shows that attempts to time short-term market movements just aren't worth it. Timing leads to emotional decision making that causes investors to deviate from their long-term asset allocation and your long-term [asset allocation determines about 90%](#) of your investment return.

Oil:

Last year we did not anticipate a total disruption in energy markets brought about by Russia's invasion of Ukraine. **We thought OPEC would manage to keep the price of oil in the \$80 area on average for the year.** In 2022, we saw oil hit a high of \$130/barrel and stay above \$100/barrel for much of the first half of the year. While oil appears to be ending 2022 below \$80/barrel, due to the significant spikes earlier in the year **we cannot take a point for this forecast.**

For 2023 we believe that global climate conversations will continue to be a political hot potato as there are currently proposals designed to monetarily [compensate countries](#) impacted by climate change and plans to [shutter family farms](#) that produce livestock. The reality of trying to change the trajectory of the climate is more than a dollars and cents proposition. It is one that entails changing habits and dependencies worldwide. Sustainable energy, led by solar and battery storage, will continue to gain more and more advocates and greater adoption. But the harsh reality is that a meaningful transition to a renewable energy future will take time. However, we would be hard pressed to find a point in time in which much of the world received such an abrupt wake-up call about the importance of energy and energy independence. If Europe doesn't show a path forward very quickly into shoring up their energy situation, they run the very real risk of decimating their [industrial base](#).

For 2023, oil prices may be driven more by geopolitical pressures than by actual demand. Most OPEC countries need prices to remain above \$80 a barrel to balance their budgets and allow them to invest in

the future of their countries. Wars and supply disruptions will remain the wildcards. A resolution to the Russia / Ukraine conflict could see supply restored to pre-war levels and upward pressure on prices removed. **OPEC could then become swing producers yet again and most likely limit production to maintain the average \$80 price for the year.**

Source: Refinitiv

Commercial Real Estate:

For 2022 we wanted to focus on REIT allocation in the warehouse, industrial, and manufactured home sectors. We were fortunate to have a couple of our holdings in the apartment space (BRG) and industrial space (MNR) be acquired early in the year. As we warned last year, rising interest rates are a headwind to the valuation of REITs. While rent increases should allow valuations to eventually recover, in the near-term, prices will decline. With the rise in rates commercial real estate was certainly challenged with the overall REIT index seeing a significant decline. However, due to the buyouts taking place in a few of the sectors we favored, our overall returns from commercial real estate were significantly better than the overall index – **we will take a point here.**

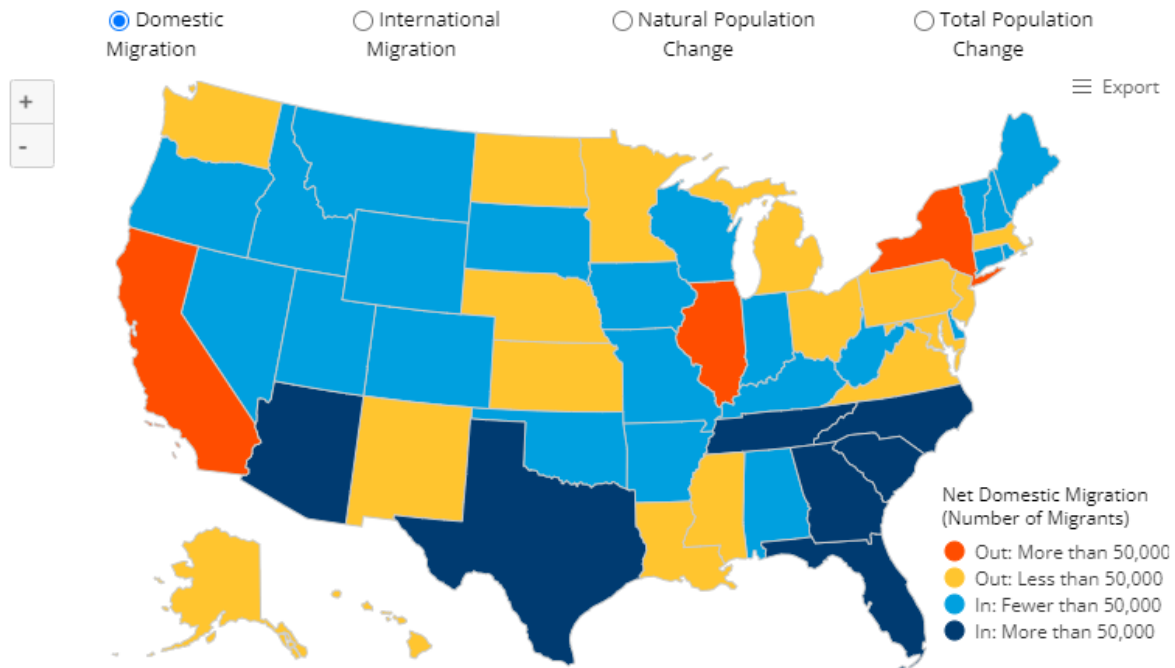
With our belief that long-term interest rates will be approaching 5%, there will be a continuing headwind for REIT valuations. However, the inflation of last year is being passed through, as rents increase and leases are renewed. Over the next ten years we would continue to prefer owning quality REITs with rising income streams as opposed to a fixed coupon from the 10 year treasury. Further, as rent increases are implemented and value-added real estate projects take shape, eventually this should be reflected in share prices adding an appreciation component to an investor's return. **For 2023, we forecast a slight positive total return from REITs and would position portfolios into the sub-sectors that still have a fundamental need in the economy – manufactured housing, industrial warehouses, data centers, and health care (but not hospitals).**

Source: FactSet

Residential Real Estate:

Last year we forecast that increases in residential prices would be in markets with solid job growth, nice weather, and favorable tax policy. In addition, as the disparity grows between high price markets such as California and New York, there will continue to be a migration of those seeking affordability. Further, for Baby Boomers who may need to tap into the dramatic growth of their home equity to help fund retirement plans, there will be a certain amount of migration due to economic necessity. As the following chart indicates, we believe those trends are taking place:

FIGURE 1. MIGRATION AND POPULATION CHANGE VARIED BY STATE DURING THE PANDEMIC



Source: [Harvard Joint Center for Housing Studies](#) tabulations of US Census Bureau, 2021 Population Estimates Program.

For 2022, we predicted that the S&P Case-Shiller index would increase again, mostly from the rest of the nation catching up rather than a continuation of the dramatic increases in a select, few markets. In October of 2021 the index stood at 296.8 and one year later it stood at 312.2 – an increase of 15.4 points or just over 5%. **We will take a point here!**

For 2023 we see a continuation of a multi-year trend driven by affordability. The least affordable areas of the country have an affordability index below .46 – people just cannot afford to buy at those prices with higher interest rates on mortgages. Further, many long-term homeowners in high-priced locations have built up significant equity affording them the luxury of selling, moving, and making all cash offers in lower-priced markets. Even with higher mortgage rates, we believe the migration will continue.

Lower priced markets should see more appreciation while higher priced markets may actually see a noticeable contraction. What impact will this have on the S&P Case Shiller index? We are not sure if the magnitude of declines in some markets will be offset by some increases in lower priced areas. We think geography will mean more to residential prices than a national index. However, not having another way to measure this, **we will say that for the first time since the over leveraged real estate bubble popping in 2007 – 2009, that the S&P Case-Shiller index will decline year over year.**

Source: FactSet

Fun Forecasts 2022

We touch on a few non-investment forecasts every year to broaden our thought process. **Last year we forecast that the demand for NFTs would drive mainstream adoption of blockchain technologies.** As we pointed out last year, cryptocurrencies had gone from a handful of coins a decade ago to over 6,000. However, despite the surge in popularity, we felt that most people still didn't see the need to own any other than for price speculation. We've certainly seen absolute carnage in the crypto space with massive exchange failures and one of the biggest [financial scandals](#) of all time. Despite this, blockchain technology should continue to improve efficiencies in our financial system and use cases for NFT's continues to grow. 2022 saw [El Salvador](#) and the [Central African Republic](#) both adopt bitcoin as legal tender. There are numerous music streaming services built on blockchain such as Royal, OneOf, BitSong, and Audius. Shopify launched their [token-gated commerce](#) allowing merchants to connect with fans and drive sales and even former [President Trump](#) sold 45,000 NFTs for \$99 each. As noted in our 2022 letter, *"in reality, one year is too short a time-frame for something like this"*. Nonetheless, we believe we saw plenty of progress take place with blockchain / NFT adoption to **take a point for this forecast!**

Our second fun forecast was **First, Robo-taxis. Next, Robo-Tractors. High-tech farming is on the rise.** Sometimes there's no better way to prove a point than to turn to the internet. This [TikTok](#) video shows just how rapidly agriculture is advancing. No question – **we get a point for this one!**

Fun Forecasts 2023

In year's past, we've often made our fun forecasts lay-ups. It was certainly part of the reason why our track record for 2022 was even respectable. For 2023, we want these forecasts to be more challenging and really put some concrete predictions out there.

Our first fun forecast is about Disney. We predict that Bob Iger's return as CEO is being done as a way for him to engineer one final deal. **We predict Iger will focus on a mega merger / acquisition with a company looking to invest heavily into what is quite possibly the greatest film / television content portfolio of all-time.** Iger has been the mastermind behind four significant deals while he ran Disney: Marvel, Lucas, Pixar, and 20th Century Fox. At this point, we don't believe they have a content hole to fill. With their valuable franchises, library of characters, dominance in sports, and loyal fans, we believe a tech-centric partner could take their experiences to a whole-new level.

Our second fun forecast is about Twitter. Twitter is now moving at Elon speed and we predict they will roll out new features at a pace never seen when it was a public company – video, audio, payments, etc. The transparency they will bring to the platform will make Twitter a leader when it comes to restoring trust in independent, investigative journalism. While the first few weeks seemed chaotic, **we believe the transformation will be so dramatic that talks of an IPO will be happening by year-end.**

CONCLUSION

We will always strive to cull through information, ferret out the important from the unimportant, and take short-term emotions out of the long-term investment process. Our goal is to help our investors achieve their financial independence and the freedom to focus on what they want to do in life and not what they have to do. As always, we welcome your feedback and would love to talk about these and

other topics that may be important to you. We thank you for your continued confidence and the opportunity to manage your investments. We take very seriously our responsibility. **Montecito Investment Portfolio's Mission: To provide diversified, disciplined long term investment solutions, service and guidance to help our clients achieve, and maintain, their "Financial Independence".**

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The Dow Jones Industrial Average is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the NASDAQ.

The Standard & Poor's 500 Index is a capitalization weighted index comprised of 500 widely-held stocks on US stock exchanges. Companies included in the index are selected by the S&P Index Committee, a team of analysts & economists at Standard & Poor's.

S&P 500 Total Return Index is a measure of the price movement of The Standard & Poor's 500 index and including the dividends paid by the companies in the index.

S&P Case Shiller Index – a group of indexes that tracks changes in home prices throughout the United States. Case-Shiller produces indexes representing certain metropolitan statistical areas as well as a national index.

GDP – the monetary value of all the finished goods & services produced within a country's borders in a specific time period.

The MSCI US REIT Total Return Index is an index that broadly represents the price and income movement of the equity REIT universe in the United States. The Index represents approximately 85% of the US REIT universe.

The Barclay's Aggregate Bond Index – includes government securities, mortgage-backed securities, asset-backed securities and corporate securities to simulate the universe of bonds in the market. The maturities of the bonds in the index are more than one year.

P/E Ratio is a valuation ratio of the company's current share price compared to its per-share earnings.

Past Annual letters are available by request. 2016, 2017, 2018, 2019, 2020, & 2021 Letters are available on our website at: <http://www.cwam.davidsonfa.com/Our-Commentary.4.htm>