Transitory: Inflation, Stock Prices, and Fear
Secular: Economic Growth, Intrinsic Value, and Optimism

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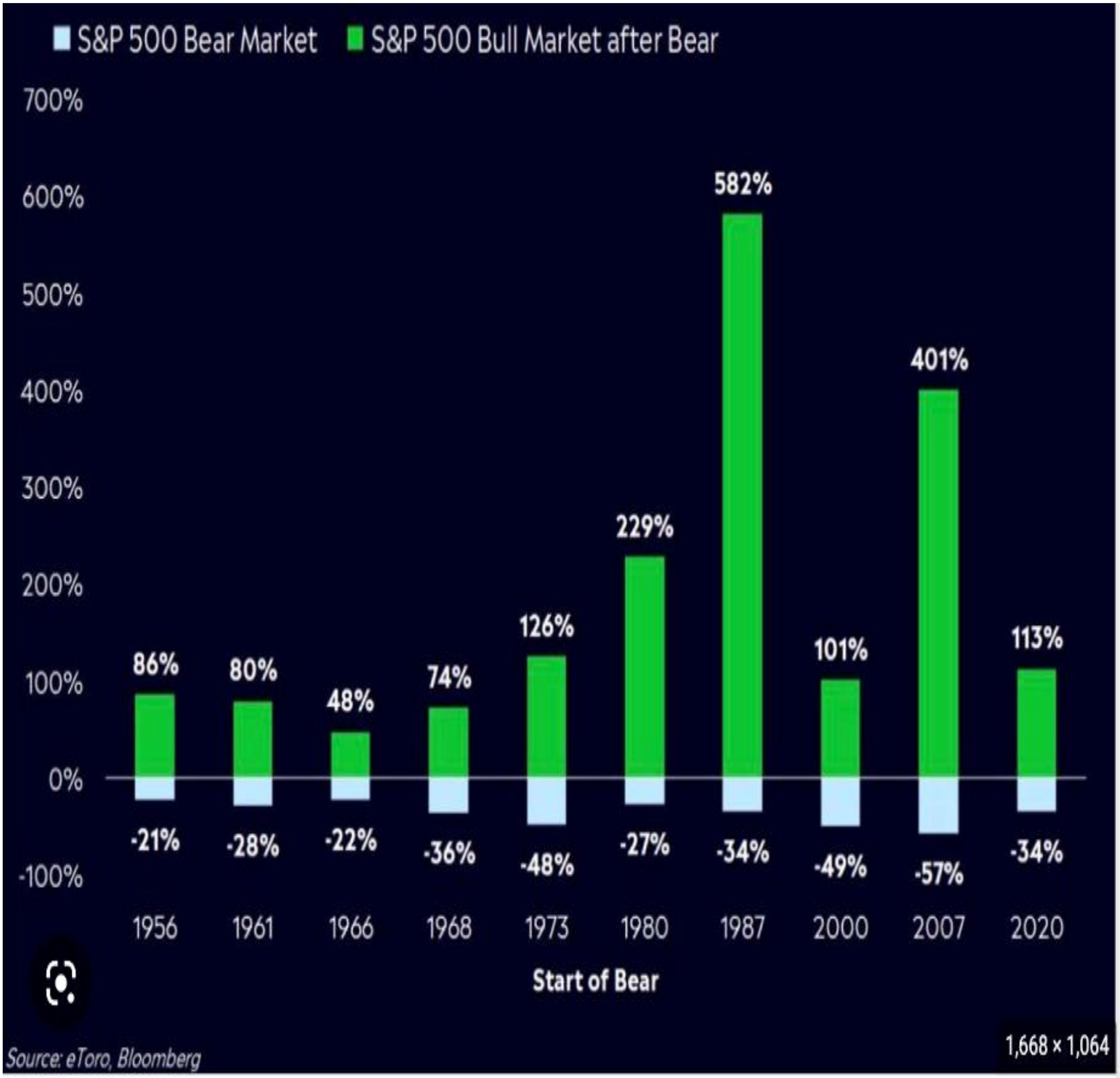
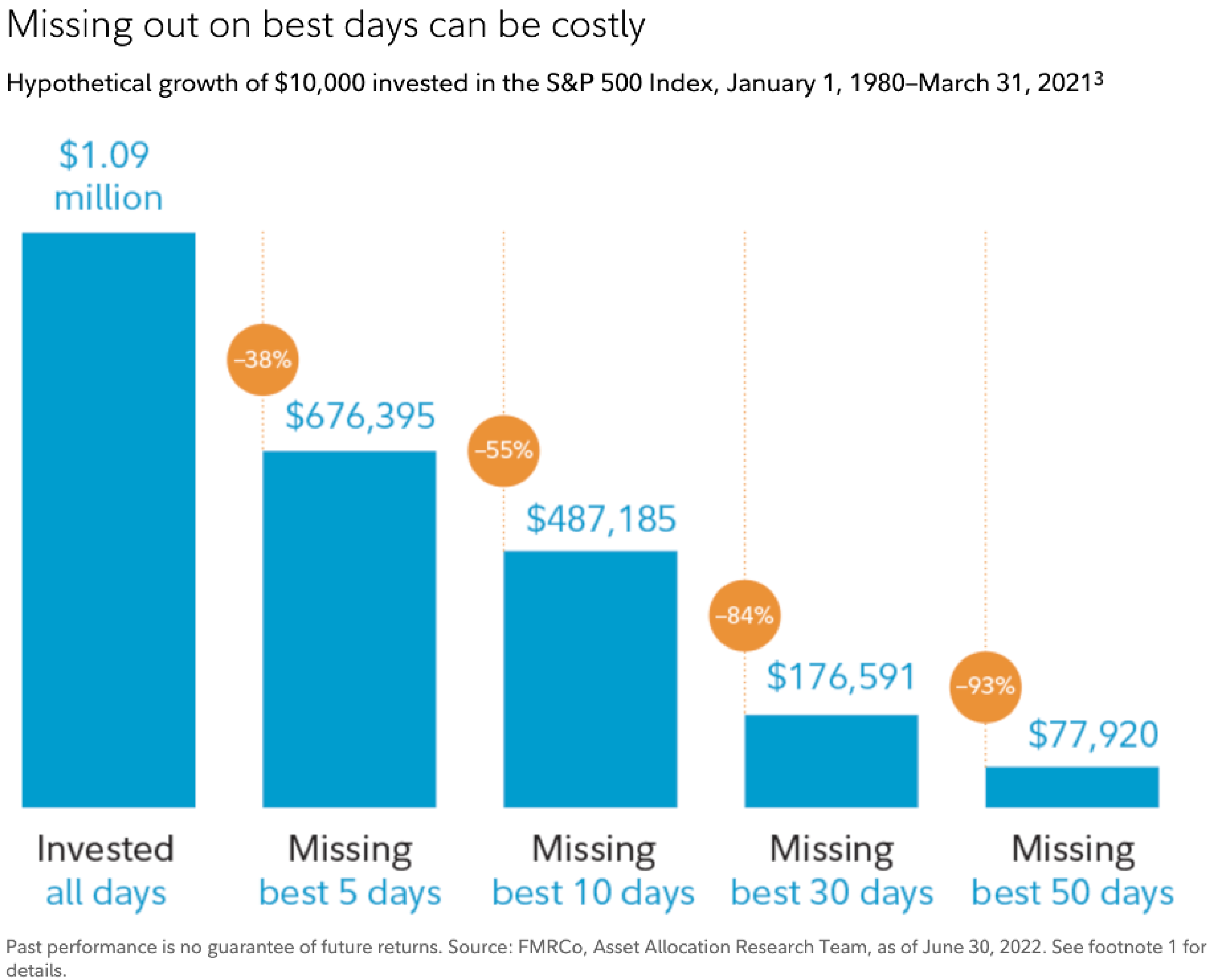
Below is an illustration of why successful investors tolerate being exposed to the inherent risk of a year such as 2022 happening at any given time:



The chart above was referenced in an Investing.com article titled, S&P 500: How to Prepare for Even More Pain, published on October 3rd, 2022.

Throughout 2022, I have fielded many questions regarding why we do not sell stocks and raise cash to be able to buy in at lower prices in the future. This question is logical, and the practice sounds very simple when markets are in a period of persistent declines. The problem with this logic is clearly illustrated in a chart published within a December 19, 2022, article published by Fidelity Investments titled 3 reasons to stay invested right now:



Footnote #1 from the referenced Fidelity article: Bloomberg Finance, L.P., Standard & Poor's as of 12/31/21.

Footnote #3 from the referenced Fidelity article: The hypothetical example assumes an investment that tracks the returns of the S&P 500® Index and includes dividend reinvestment but does not reflect the impact of taxes, which would lower these figures. There is volatility in the market, and a sale at any point in time could result in a gain or loss. Your own investing experience will differ, including the possibility of loss. You cannot invest directly in an index.

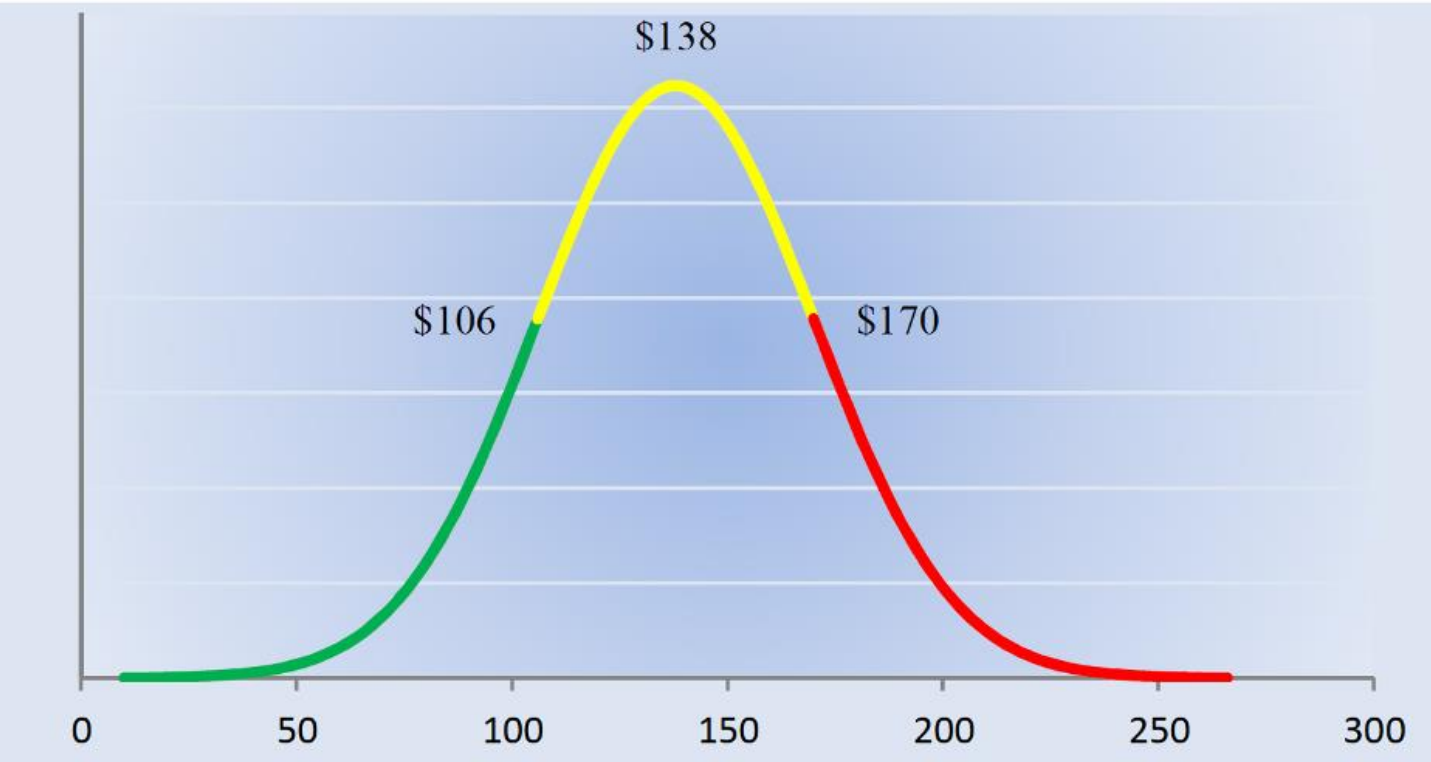
Keep in mind that investing involves risk. The value of your investment will fluctuate over time, and you may gain or lose money.

Neither asset allocation nor diversification ensures a profit or protects against loss.

Because I have professionally managed stock portfolios for over half of the years covered by Fidelity's illustration, I have seen firsthand how futile attempting to time market moves can be and how pessimism naturally gets over-amplified during Bear Market periods and causes otherwise long-term investors to make poor decisions driven by short-term considerations.

My experience has taught me to see opportunities when security prices move beyond a normal distribution's mean tendency, indicating long-term opportunities to buy an under-valued security or sell an overvalued security. This concept of value is driven by long-term, fundamentally measured outcomes rather than short-term investor sentiment. At the same time, there will always be a range of opinions about both short- and long-term prospects, translating to heightened price volatility relative to value. For these reasons, "value" should not be considered a specific price level but rather a range.

For an example of how such a normal distribution of values looks, see the illustration below of our fundamental research partner's (Valuentum) fair value range for Dick's Sporting Goods (DKS). Dick's is one of Seven Summits Capital's most widely owned stocks. In this chart, Green indicates undervalued, Yellow indicates Fairly Valued, and Red indicates Overvalued:



2022 was a terrific year to be building a position in DKS because the Bear Market volatility and off-again, on-again recession prognostications provided many opportunities to purchase this company's stock at the very low end of the fair value range (Yellow) and, at times, well into the undervalue range (Green). See the 2023 stock chart of DKS below:

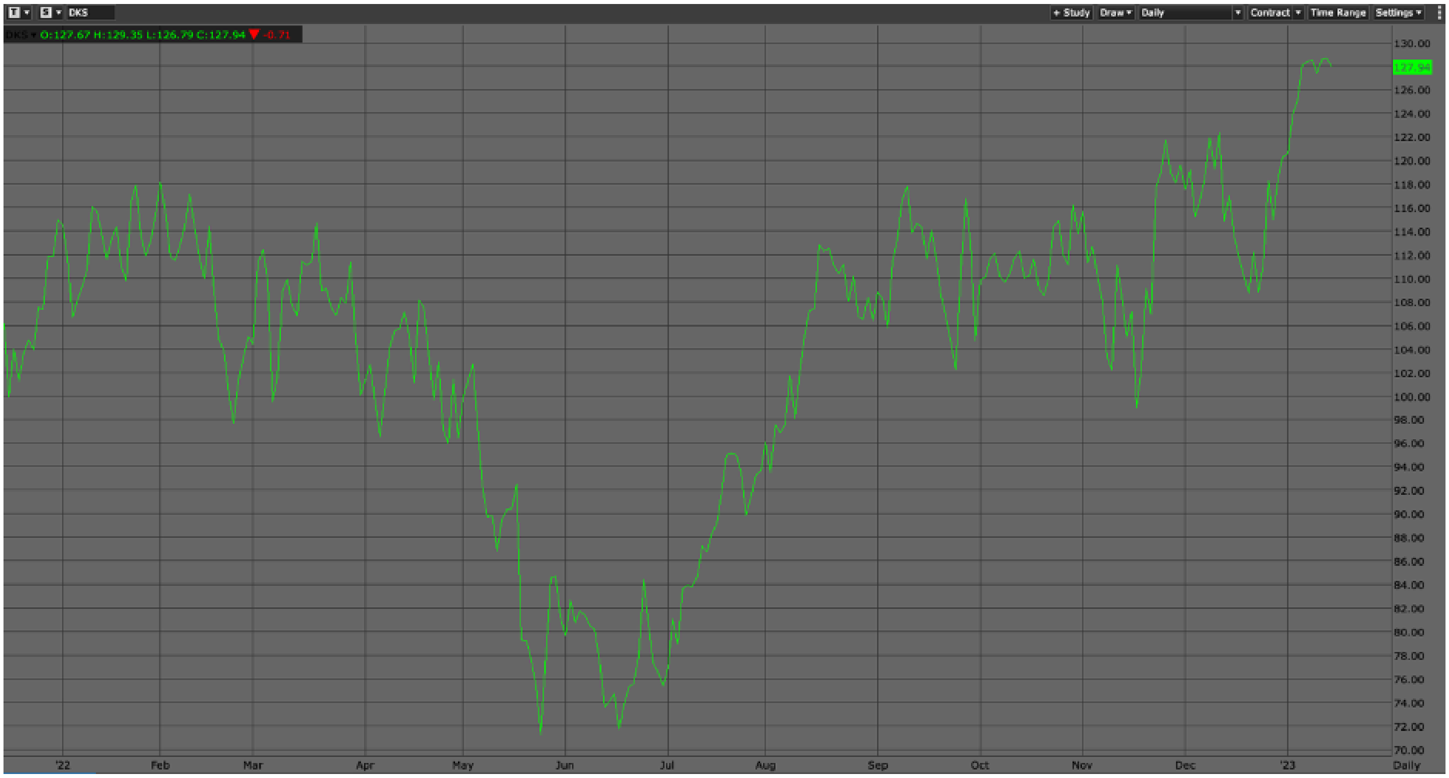


Chart by QUODD

When I review our DKS stock positions today, I see average costs per share ranging from $75.31 to $115.30, with a median value of around $104.00. Over the first two weeks of this month, DKS traded intraday over $130 for the first time since August 2021. I often describe a stock's price during a volatile market period as "a price" and not a rational or fair representation of value. ***Price is important if you are trying to buy or sell something, but if you already own something, price swings are not all that important.*** The DKS stock chart illustrates this sentiment very well. As a buyer of DKS stock, we were very happy to see the stock's price trade down frequently, often falling 15-20% or more over a very short time. However, as an owner of DKS stock throughout the year, these sharp selloffs were inconsequential, as we had a strong conviction that the true value that the stock should be reflecting was much higher and that the stock price would ultimately reflect this value.

Not all stocks have been as reactive and resilient as DKS stock. However, the principle remains the same. Price is only actionable if, as an investor, we know where that price falls relative to a company's fair value range. Absent the ability to gauge price versus a fair value, the price of an investment can only be compared to the price originally paid, creating a sense of pain or joy depending on the whims of the market. A person who thinks like a trader is only concerned about price relative to where the price has been in the past. For an investor, price is only relevant if it can be compared to a fair market value, which is inherently derived from forecasts of future cash flows.

The biggest misconception I see with many investors is routinely reinforced by how the stock market is reported on and discussed by so-called experts. Many investors fall into the trap of equating price with a gain or loss of wealth. There is a big difference between paper wealth and durable wealth. It has recently been reported that Elon Musk set a record for the absolute dollar loss of wealth. This loss of wealth was primarily driven by his largest asset, Tesla Motors' stock price falling by over 60% in 2022. CNN reported on January 2023 in an article titled, Elon Musk has lost a bigger fortune than anyone else in history, that "Elon Musk's wealth destruction has become historic. The CEO of Tesla (TSLA), SpaceX, and Twitter is worth $137 billion, according to the Bloomberg Billionaires Index, good enough for second place on the list of the world's richest behind LVMH (LVMHF) Chairman Bernard Arnault. But at its peak in November 2021, Musk's net worth was $340 billion. That makes Musk the first person ever to lose $200 billion in wealth, Bloomberg reported last week.” The article also mentioned this, “critics have long questioned whether Tesla was ever worth the trillion-dollar valuation it had at the start of 2022. At its peak, Tesla was worth more than the 12 largest automakers on the planet combined, despite having a fraction of their sales,” and this gets at this misconception between paper wealth and real wealth. Musk’s paper wealth was an illusion created by an irrational and highly speculative public stock market. The reality is that Musk still has substantial wealth because he is a large owner of several very good companies with spectacular growth opportunities in the foreseeable future. His ownership of highly competitive, innovative, and growing companies is the source of his real wealth. The prices that the fickle public marketplaces on the shares of these companies at any point in time are a mirage, not a measure of real wealth.

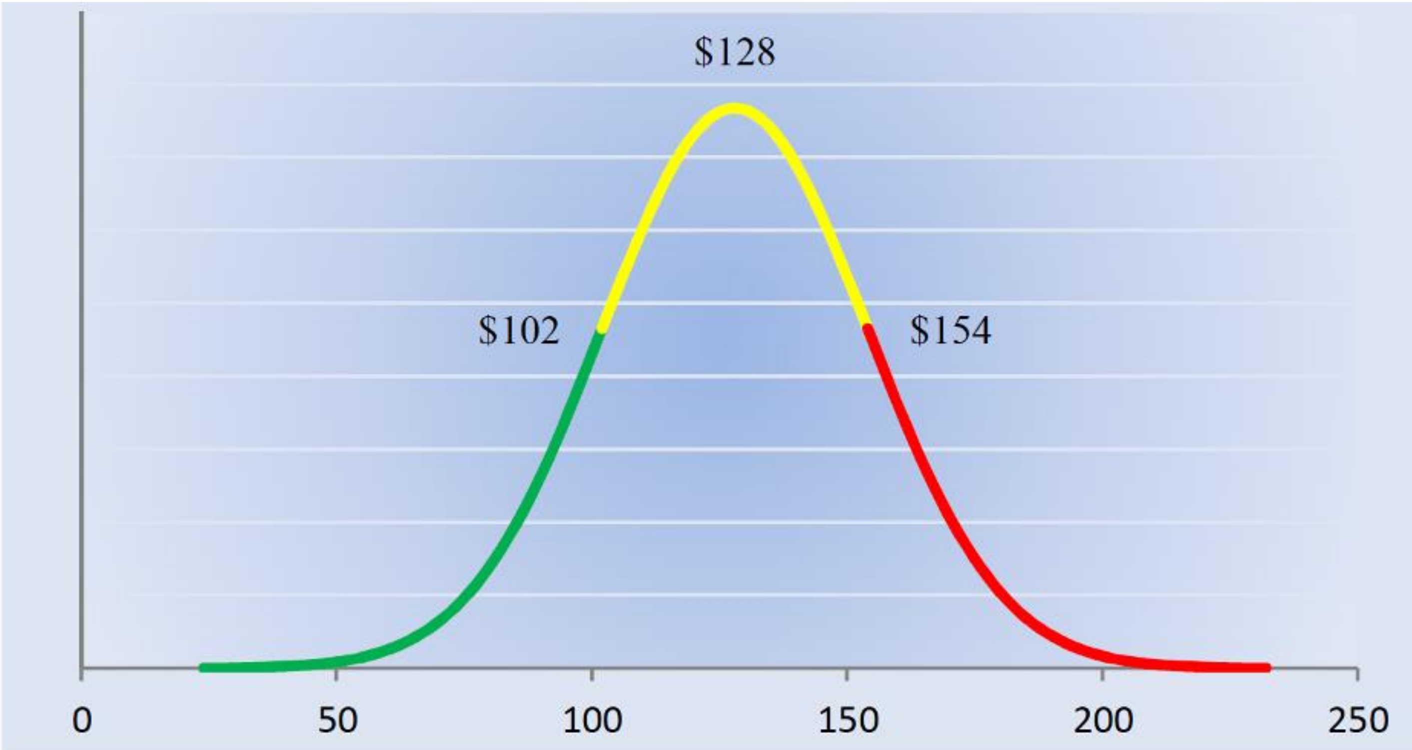
In 2022, investors witnessed substantial paper wealth destruction among some of the world's best and most valuable companies. The illustration below from Bespoke Investments shows the extent of “paper” wealth destruction for the twelve months ending December 31, 2022:

FAANG+ Stocks In 2022

				Market Cap (bn $)			YTD %
Ticker	**Name**	**Sector**	**Price**	**End of 2021**	**Current**	**Change**	**Change**
AAPL	Apple	Technology	130.03	$2,913.28	$2,068.53	-$844.75	-26.77
AMZN	Amazon.com	Cons. Discret.	83.04	$1,691.00	$847.15	-$843.86	-50.19
GOOGL	Alphabet	Comm. Svcs.	87.39	$1,921.78	$1,134.61	-$787.16	-39.67
MSFT	Microsoft	Technology	236.96	$2,525.08	$1,766.41	-$758.67	-29.54
TSLA	Tesla	Cons. Discret.	109.10	$1,061.29	$344.51	-$716.78	-69.03
META	Meta Platforms	Comm. Svcs.	116.88	$935.64	$306.48	-$629.16	-65.25
NVDA	NVIDIA	Technology	141.21	$735.27	$347.38	-$387.90	-51.99
NFLX	Netflix	Comm. Svcs.	284.17	$266.85	$126.46	-$140.39	-52.83
AMD	Advanced Micro Devices	Technology	63.27	$173.78	$102.01	-$71.76	-56.03
SNOW	Snowflake	Technology	137.76	$103.76	$44.30	-$59.46	-59.33
			Total:	**$12,327.74**	**$7,087.85**	**-$5,239.89**	

Chart by Bespoke Investments

What do these drawdowns in stock prices of some of the world's greatest companies have ever seen tell us about the prospects of these companies in the future and the economy overall? Nothing! These price swings tell us that the market temporarily overpriced these companies’ stocks and is currently, and most likely, temporarily underpricing them relative to their intrinsic value. For example, again using our equity valuation research partner’s (Valuentum) recent analysis (12/24/22) of Alphabet (GOOGL), the following illustration shows that Alphabet’s (GOOGL) price of $89.70 at the close of the NYSE on January 3, 2023, was well below its forward-looking fair value range:



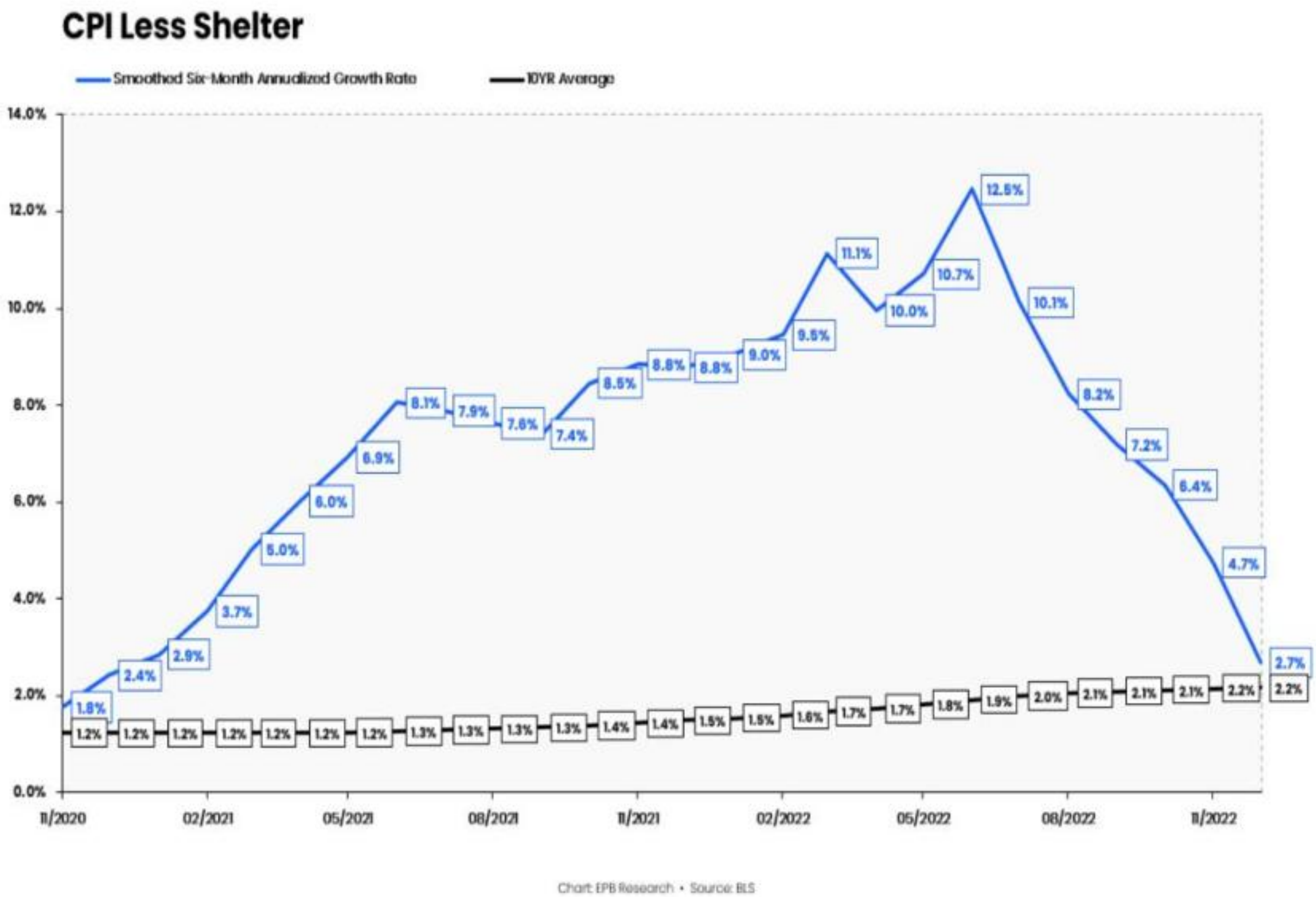
Therefore, when we see Alphabet's (GOOGL) stock price trading under $100 per share, we do not think about the price we paid in the past; instead, we see an opportunity to add more shares at a price significantly lower than our assessment of future value.

Regarding what the stock market tells us about the economy, it tells the long-term investor nothing of great importance. To look at the stock market's performance this year and conclude that we're headed for a sustained economic downturn would be a mistake. A CNBC report published on February 4, 2016, titled Can the markets predict recessions? What we found out., written by Steve Liesman, looked into the market's predictive value. The article discussed economist Paul Samuelson's famous 1966 quote, which stated that the stock market had predicted nine of the previous five recessions, and presented the conclusions of a 2016 CNBC study, which found that in the postwar era, 13 bear markets—usually defined as a sustained period of a 20 percent market decline—only seven were followed within 12 months by actual recessions. We accept that markets consistently overreact to both optimism and fear. In 2022, the overreaction to fear had very little to do with the fundamental factors we look at to determine what investments we buy, sell, or hold in a portfolio. The market was myopically focused on macroeconomic issues, particularly inflation and interest rates.

I am sharing a passage from John Calamos Sr.'s year-end 2022 commentary. John Calamos is the founder of the Calamos Funds. He founded the now multi-billion-dollar investment firm nearly 50 years ago. Calamos Funds is widely considered the pioneer of convertible bond investing. Mr. Calamos wrote (about 2022), "the turbulent environment reflected the market's singular focus on macro considerations, most notably the Federal Reserve's decision to go "all-in" to try to stop inflation. This move dealt an especially painful blow to longer-duration assets like growth companies. In addition, investors grappled with the implications of the war in Ukraine, Covid lockdowns in China, global supply chain disruptions, and US fiscal policy uncertainty. This all-in or all-out analysis caused markets to swing widely, and only a few companies were able to move against the tides." We saw the impact of this singular market focus in our client accounts, which are mostly designed as long-term capital appreciation portfolios. This over-arching long-term strategy will lead to significant exposure to long-term secular growth-driven companies if we are true to our word of not being market timers and having a long-term focus.

We have been arguing that the root of all macro concerns last year, inflation, peaked in June and has sharply decelerated since that time. For many months it was hard to see this in the widely watched inflation figures released each month because of how the "headline" year-over-year CPI is calculated. However, with the release of the December CPI number on January 12th, a negative month-over-month inflation reading finally seems to have gotten the attention of economists, policymakers, and the stock market. With the December CPI release, our expectation for the widely watched headline year-over-year CPI is to be under 2.5% by mid-summer. A few stubborn inflation areas, such as the all-important shelter and wages, will likely remain elevated. But overall, over the next six to eight months, we expect broad inflation to settle back into the 2% range that the Federal Reserve targets.

Below is a dramatic illustration, using BLS (U.S. Bureau of Labor and Statistics data) of CPI minus the lagging shelter component that clearly shows how inflation has dramatically declined since June 2022 and is now (12/31/22) back to a level consistent with a ten-year trend of that statistic. Notice that this decline did not being in December, it began in July:



It is often unfashionable to buck consensus perceptions even when you have reality on your side. Perception is a function of a person's or a market's adopted narrative. Once that narrative is adopted, it is very difficult to shake it, even when faced with overwhelming data that contradicts it. We have been proverbially "singing to the choir" for many months regarding falling inflation and the economy's resilience. However, as a professional investor with clients to answer to, I know all too well that being right rings hollow until the market agrees. Although the bond market has been signaling since mid-October that inflation had peaked and meaningfully declined, equity markets were not embracing that conclusion until shortly into the new year. Instead of seeing falling inflation, the equity markets chose to pessimistically view a falling 10-Year Treasury Yield as a certain indicator of a meaningful recession, not an indication that inflation was normalizing. That narrative dominated equity markets until recently when markets saw overwhelming evidence that an economic “soft-landing” looks increasingly probable as we likely exit the Federal Reserve’s tightening cycle over the next several months.

We are conviction investors. We analyze data, extrapolate trends, and apply judgment to form our base case assumptions. What the market is doing at any given time will rarely ever be a meaningfully input into our decision process. Paraphrasing Warren Buffett’s mentor, Ben Graham, in the short-term, we are cognizant that a market is a voting machine, while in the long-term, it is a weighing machine. What is popular in markets, whether acting on fear or greed, is rarely the most profitable course of action over the long term.

Now that 2023 has arrived the market is finally catching up with many realities we identified months ago. Given how much pessimism has been priced into equities over the last fourteen months, we are confident that prices can better approximate fair values as we progress through the year.

Curt R. Stauffer

President & CIO

Seven Summits Capital

Disclosure:

Advisory services are offered through CS Planning Corp., an SEC-registered investment advisor.

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