Talbot Financial – Third Quarter 2022 Review

It has been a challenging year for the financial markets. We wanted to offer our investment view and outlook now, as opposed to waiting until you receive your quarterly Talbot Financial portfolio review in mid-October. Please note, your Schwab brokerage statement as of September 30, 2022, is available online by logging in to your account at www.schwaballiance.com.

We also want you to know we welcome the opportunity to review your investment portfolio by phone, a Zoom meeting or in person at our office in Bellevue.

In short, our investment strategy and outlook have not changed as a result of the near record setting negative sentiment in the financial markets this year. We can say this because we know what we own. Your portfolio consists of high-quality, industry leading companies that are well positioned to increase near-term market share gains and long-term fundamental value.

Why the market turmoil? Supply chain issues, Putin's war, and most influential, the Federal Reserve (the "Fed") making it clear its near-term priority is to combat inflation. To achieve this objective, the Fed has been aggressively raising short-term interest rates with the goal of increasing the cost of borrowing, reducing the rate of spending, and slowing the overall economy. However, the slowing of the economy does not happen overnight, and the Fed can overshoot its policy objective; thereby, pushing the economy into a recession. Our view is the U.S. economy will experience a somewhat mild and short recession in 2023. Importantly, historical data indicates that markets tend to be forward looking and can rebound in a recession within a relatively brief period of time.

The S&P 500 Total Return Index ("Equity Index"), Talbot Financial's benchmark, declined 4.9% for the third quarter and was down 23.9% year-to-date through September 30, 2022. The declines were broad as 10 of 11 industry sectors posted negative year-to-date returns. Bonds, typically viewed as a "safe haven" during market volatility, have also been hit hard during the downturn. The Bloomberg U.S. Aggregate Bond Index ("Bond Index"), a measure of the total bond market, dropped 4.7%, nearly as much as the Equity Index during the quarter. For the year-to-date period through September 30, 2022, the Bond Index is down 14.4%.

As previously stated, our investment strategy and long-term outlook remain intact. We are capitalizing on opportunities within your portfolio by trading certain securities along the way. The crucial point is every holding in your portfolio was vetted and then selected based upon superior balance sheet and cash flow characteristics. It is these characteristics that ultimately drive long-term returns.

Across the board, the companies in your portfolio maintain exemplary balance sheets and generate significant cash flows. The strength of their balance sheet serves as a shock absorber during economic turmoil. Their balance sheets are further supplemented by strong and sustainable cash flows. This means they are well positioned to manage their debt payments and less susceptible to higher borrowing costs as they are not pressured to issue new debt to fund growth. It also means they can continue to return capital to shareholders through dividends and share repurchases.

Looking forward, the strength of the balance sheets and cash flows provide an even greater competitive advantage during an economic slowdown. Weaker competitors will see their cost of borrowing rise and their cash flow, margins, and profitability decline, and in some cases turn negative. When this occurs, the less well capitalized competitors often falter and the companies in your portfolio tend to accelerate their market share gains.

An example of a company with these financial characteristics is Apple. The company has $180 billion of cash and cash-equivalents on its balance sheet, and $95 billion of debt. Thus, Apple has $85 billion more in cash than debt. The company is expected to generate about $110 billion in free cash flow this year. This significant level of cash flow will easily fund the dividend to shareholders, as well as up to $80 billion per year in share repurchases. The strength of Apple's balance sheet and cash flow represent a competitive advantage that no consumer-oriented technology company can match.

Costco is the newest holding in your portfolio. The company was founded on the belief that the consumer always comes first. They have long taken market share from less focused and not as well capitalized peers. Costco is conservatively managed and has one of the strongest balance sheets and best cash flows in the retail industry. During periods of economic slowdown, Costco's market share gains tend to accelerate. We expect the same to happen during the current economic cycle.

In summary, your portfolio was structured with strict quality criteria and all positions are on sound financial footing. They are well positioned to take market share during an economic slowdown and thrive during the next expansionary period.

Again, we welcome the opportunity to review your investment portfolio by phone, a Zoom meeting or in person at our office in Bellevue. Please contact us for a review or to answer any questions you may have.

Sincerely,

Talbot Financial, LLC

www.talbotfinancial.com