FAYEZ SAROFIM & CO.

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**Economic Comment and Market Outlook**

In contrast to the relative tranquility that characterized financial markets throughout the previous year, 2022 ushered in a period of turbulence for equity and fixed income markets around the globe. Here in the US, the S&P 500 declined by 18.1%, and the Bloomberg US Aggregate Bond Index declined by 13.0%, representing the biggest decline in the fixed income market in decades. While COVID waves, supply chain difficulties, and Russia's invasion of Ukraine all contributed to the difficult period, the primary culprit for the markets' declines was aggressive monetary policy intervention from global central banks to combat inflation. These elevated levels of inflation represented a very concerning dynamic for both consumers and investors and catalyzed an aggressive shift in the Federal Reserve's policy, which moved suddenly from providing pandemic-related stimulus to fighting inflation via rapid and large hikes in short-term interest rates. Now that the Fed has raised interest rates by 425 basis points in a year, investors are apprehensive about an economic slowdown and the possibility of a recession. At Fayez Sarofim & Co., while we acknowledge these challenges and risks in the short-term, our conviction in the opportunities for long-term investors remains robust. We expect our portfolio companies to weather difficult periods of time and to emerge in an even stronger position to capitalize on their growth prospects. Our firm's 64-year history in a variety of market environments underlies that optimism for the long-term.

At the beginning of 2022, only two of the eighteen members of the Fed's rate-setting committee foresaw the Fed Funds Rate surpassing 1.0% by the end of the year; however, by the end of December, that committee had increased the rate from close to zero to a range of 4.25% to 4.50%. The primary driver was the rise in the inflation rate to levels not seen since 1981, peaking at a 9.1% annualized increase for the Consumer Price Index in the month of June. Since then, the CPI increases have slowed, but they remain at higher levels than desired, at 6.5% in the most recent report. Fed Chairman Jerome Powell and his brethren have repeatedly warned investors that the Fed is intent on preventing an inflationary mindset from taking hold and will maintain a policy of higher rates until inflation returns to the targeted annual rate around 2.0%. It remains to be seen how high the Fed will need to raise rates to reduce inflation to that level and whether those increases induce a recession. As such, we expect market volatility to persist until investors and the Fed believe that these actions have restored price stability.

Two Houston Center, Suite 2907 Houston, Texas 77010-1083 713.654.4484 www.sarofim.com

While corporate earnings proved resilient in 2022, rising inflation and interest rates resulted in a meaningful valuation compression as price-to-earnings valuation multiples declined back toward long-term averages. At the beginning of 2022, forecasters were expecting companies in the S&P 500 index to earn approximately $223 per share, which equated to a valuation of 21 times expected 2022 earnings at that time. In December, the consensus forecast for the index's earnings was still remarkably similar at $221 per share, but the market's decline translated to a price-to-earnings multiple that fell to approximately 17 times. Valuation declines were widespread, and increased interest rates honed the market's focus on the sustainability of profits. Financially sensitive sectors whose profitability is vulnerable to interest rate increases saw more significant compression. In addition, the market shunned more speculative, unprofitable companies, a reversal from the past few years. Our expectation is that this preference for current earnings and cash flow will persist for an extended period, which augurs well for the attractiveness of the highly profitable companies in our Sarofim portfolios.

At present, market participants are closely evaluating a number of factors to try and ascertain how much the Fed's monetary restraint is impacting an economy operating with considerable momentum. The Fed has made clear it is committed to reducing inflation even if it causes short-term economic pain. On the demand side, as central banks raise rates, we are seeing increases in financing costs lead to declines in housing and other big ticket spending items by businesses and consumers. On the supply side, continued normalization of the supply chain disruptions should permit goods and materials to be delivered closer to pre-pandemic timeframes and costs. The recent loosening of China's Zero COVID policy should further advance this recovery given that country's integral role in global supply chains. Resolution of these factors should alleviate some inflationary pressures, which will provide investors better visibility on the Fed's progress in containing inflation and the path of interest rates. Eventually, we believe that the combination of supply chain improvements and the Fed's actions will be successful in reducing inflation, heartening investors with that result.

Improving profits and returns-on-capital in the energy sector led those companies to be notable exceptions to the disappointing returns for all other sectors of the market. After a "lost decade" following excessive levels of capital investment at low rates of return, energy company management teams have demonstrated much greater focus on generating profits and free cash flows for the shareholder. The industry has rationed its capital investments in recent years, limiting the prospects for new supply growth. We increased our investment in several energy companies in which we have confidence that the management teams will continue to allocate capital favorably for long-term shareholders. During 2022, the war in Ukraine also emphasized the need for economies and companies to ensure that they have access to reliable and dependable sources of energy commodities. In addition, it has become increasingly clear that the development of renewables and alternate sources of energy will occur over a multi-decade period and that conventional sources of energy are required to support economic

growth and development. At present, the energy sector accounts for 5% of the S&P 500's market value while providing 10% of its earnings and dividends. With a greater need for resources and little supply growth in the near future, it is more likely that commodity prices will remain at an attractive level for the producers. Finally, through our meetings with the management teams of our energy holdings this year, we gained additional confidence that our companies will continue to act wisely and responsibly to the benefit of their shareholders.

Given how infrequent recessions have been for the past generation, investors may have become extra cautious as they anticipate a slowdown. For several reasons, the US economy has experienced much longer expansions in recent decades. In fact, there have only been four recessions in the past 35 years and 13 recessions since World War II. Since we invest for longer periods of time, our investment approach must allow for the likelihood that the economy and markets will experience setbacks with some regularity. In every case of a recession, the economy and the stock market declined, but both subsequently rebounded and went on to establish new highs. We construct portfolios that hold investments in financially strong, industry-leading companies led by skilled managers. Furthermore, our research team focuses on avoiding companies that are overly capital-, energy-, or labor-intensive. We believe these businesses naturally exhibit higher margins and returns-on-capital, giving them an advantage in dealing with changing economic conditions and in consistently generating free cash flow. A typical Sarofim portfolio currently exhibits these characteristics. For example, our portfolio displays higher gross and operating margins, higher return-on-equity, higher profit-per-employee, and lower capital spending-per-dollar of sales when compared to the S&P 500. If you combine those characteristics with what we believe is strong pricing power, our companies possess a compelling recipe for dealing with the current inflationary period. Superior balance sheets and resilient cash flows also protect our portfolio companies from some of the risks inherent in a recession. Importantly, we seek companies that are positioned to do more than just survive a recession; we expect our companies to improve their competitive position, make new investments, and plant additional seeds for long-term growth during a downturn.

As our clients know, in addition to the challenges created by volatile financial markets, our firm has also been mourning the passing of our founder Fayez Sarofim. We were saddened to announce his passing in May of this past year at the age of 93. In a tumultuous year for the markets, Fayez's lessons assisted us in navigating a volatile market while focusing on serving our clients. Our entire firm is immensely grateful for your support in this difficult time and resolutely focused on continuing to deliver strong investment results for our clients. Fayez's example and beliefs provide us with an excellent guide for achieving that objective. Even in challenging times, his calm demeanor reflected an unwavering conviction in the ability of well-capitalized, industry-leading companies to build immense value for their shareholders over the long-term. Today, it is not hard to imagine him reminding us of the futility of trying to time

the market and to remain focused on companies with solid pricing power, high margins, and secure balance sheets. While we do not see reasons to be overly aggressive while the Fed is raising interest rates, we do see an opportunity to invest in dominant businesses at increasingly attractive valuations. As Fayez would frequently mention, his investing career included nine recessions, financial crises, 13 presidents, multiple wars, double-digit inflation and interest rates, deflation and zero interest rates, and countless other world events. He joked that he might not have entered the business if he had known all that would transpire! However, through all of these events, it paid immense dividends to remain invested in the high-quality companies that form the foundation of our investment portfolios.

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