Edgemoor's Quarterly Report

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Markets Prove Resilient Though Volatility Continues

Stock and bond markets proved far more resilient in the first quarter of 2023 than most investors expected, though it was not without considerable choppiness along the way.

Both stocks and bonds started off the year with positive returns in January, only to retreat in February. And just as investors saw relative calm restored in early March, markets were hit by the shocking collapse of Silicon Valley Bank ("SVB") and Signature Bank within the course of just 48 hours.

Although the quick actions of the Federal Reserve and the Treasury Department seem to have averted a broader banking crisis, considerable uncertainty remains regarding the course of interest rates, the fight against inflation, and the threat of recession in 2023. Investors know all too well that markets do not like uncertainty.

First Quarter 2023 in Review

The S&P 500 Index posted a surprisingly strong 7.5% total return in the first quarter of 2023, while the tech-heavy Nasdaq saw an even better recovery from last year's losses, returning 17% for the quarter, its best quarter since the second quarter of 2020. The Bloomberg Aggregate Bond Index also returned a positive 3.0% in the first quarter, as long-term interest rates declined, sending bond prices higher.

The shock to the banking system by the sudden collapse of SVB in mid-March sent some financial stocks down 30% or more for the month, though the contagion hit mostly smaller, regional banks while larger, money-center banks fared much better. For the quarter, the S&P Regional Banking ETF was down 25%, while the broader Financial Sector ETF was off just 6.5%.

Information technology and communications services stocks, which plummeted last year due to rapidly rising interest rates and slower growth prospects, rebounded sharply in the first quarter (up 22% and 20%, respectively) as nervous investors flocked back to these highly profitable, cash-rich companies with lower average debt levels.

Bond investors saw prices climb and yields fall, particularly for ultra-safe Treasury bills, where demand from jittery investors has been high. The yield on the 10-year Treasury note, which influences everything from mortgage rates to car loans, fell to 3.5% by quarter-end from 3.8% at the end of 2022.

The Fed Slows Down

The heightened risk to the financial system from the bank failures likely impacted the Fed's decision to raise short-term interest rates by just

0.25% in March, despite an expected increase of 0.50% earlier in the month. The Fed also softened its language regarding future rate increases by omitting a prior forecast for "ongoing increases." This has raised hope among investors that the Fed may be ready to pause its rate raising campaign, despite the persistence of inflation. A recent survey indicated a 60% probability that there will be no rate hike in May.

The Fed further noted the US banking system is sound and resilient, but recent developments are likely to result in tighter credit conditions for households and businesses. As a result, a key factor in the Fed's future interest rate actions will be the extent to which banks curtail lending due to liquidity constraints and regulatory restrictions. Some economists have suggested that a contraction of bank lending could have the equivalent slowing effect of 0.50% - 1.00% of additional interest rate hikes.

The U.S. Economy

Notwithstanding the persistence of high inflation and slowing economic growth, there has been some positive economic data so far in 2023. The Atlanta Fed projects first quarter GDP growth of 2.2%, which, while down from fourth quarter GDP growth of 2.6%, nonetheless indicates a growing economy.

Economic activity in the services sector has been particularly resilient, with the Institute for Supply Management (ISM) reporting that the services sector expanded in March for the third consecutive month, albeit at a slower rate than in February. The sector has grown in 33 of the last 34 months, with the lone contraction in December of 2022.

The labor market also remains robust, although slowing. The U.S. economy added 236,000 new jobs in March, roughly in line with expectations. The unemployment rate slipped to 3.5% in March from 3.6% in February, and the labor force participation rate continued to rise, which is considered a positive. The U.S. has added more than one million new jobs in the first three months of this year.

Despite headlines about big tech companies laying off workers by the thousands, the overall U.S. labor market remains tight, with an estimated 9.9 million open positions, or roughly 1.7 jobs for every unemployed person.

Recession Risk Rises

There are other factors, however, weighing against this positive narrative. The Fed recently lowered its forecast for full-year 2023 GDP growth to just 0.4%. Given that estimates for Q1 GDP growth are in the range of 1.5%-2.5%, this suggests that the U.S. could see negative GDP growth in the coming quarters. Recession is generally defined as two consecutive quarters of negative GDP growth.

Additionally, the Fed is now predicting that unemployment will rise from the current rate of 3.5% to 4.5% by the end of the year due to pullbacks in hiring.

Finally, corporate earnings are contracting. S&P 500 earnings declined 4.6% in the fourth quarter of 2022 and are forecasted to decline again in the first quarter of 2023. The main drivers for the declines are higher input and labor costs, which are increasingly cutting into corporate profits, despite growing top-line revenues in many sectors.

Still, some argue that a recession is not inevitable. Those in that camp point out that inflation appears to have peaked, supply-chain woes have eased, China has re-opened its economy, and oil prices remain low. We'll see who is right.

World Markets

Looking beyond the United States, recent economic reports and stock performance have shown surprising strength abroad, despite some headwinds. A rebound in China, where stringent Covid restrictions have been lifted, and growth in Europe helped propel February global manufacturing output to its first increase in seven months.

The recession forecasted for the eurozone after Russia's invasion of Ukraine has, so far, not materialized, aided by falling energy prices and an easing of supply chain disruptions. Still, headwinds remain as eurozone inflation continues to be stubbornly high, the war in Ukraine shows no signs of ending, and increasing political tensions between China and the United States could derail the economic progress from re-opening.

Outlook

Given all the uncertainties, our outlook for the economy and markets is mixed.

We remain cautious on equities in the near term. Stock valuations, as measured by the S&P 500 Index, are neither overly expensive, nor are they cheap. The 12-month forward P/E ratio of the S&P 500 is currently 18.0 times, below the 5-year average of 18.5x but above the 10-year average of 17.3x.

The political landscape also remains uncertain, with the Congressional vote on the U.S. debt ceiling lurking. And OPEC's recent decision to cut oil production will likely send oil prices higher on the cusp of the busy summer driving season, further muddying the economic waters.

Therefore, we expect market volatility to remain elevated until there is more clarity on interest rates, inflation, corporate earnings, and world economic growth.

Portfolio Implications and Actions

While we are maintaining our long-term, value-oriented investment philosophy, we have taken a more cautious view of equity markets for the near term. Instead, beginning last fall, we have been deploying uninvested cash in short-term U.S. Treasuries at attractive, low-risk annualized yields of 4.5% - 5%.

Once the Fed signals that it is pulling back from its aggressive rate tightening, and economic growth and corporate profits have stabilized, we will resume deploying cash in long-term equities.

We continue to believe that our disciplined, active approach to individual security selection is more cost effective, tax efficient, and offers better long-term return potential over a full market cycle for our clients.

Analysis of Selected Securities

What follows is a review of three securities that we are currently buying for client accounts.

Apple Inc. (AAPL)

Source for chart and financials: Yahoo Finance and Morningstar. Past performance is not indicative of future results. Please see disclosures on page 9.

Price (03/31/2023)	$ 164.90	Forward P/E	27.9
Market Cap ($T)	$ 2.6	Price/Book	46.0
Dividend Yield	0.6%	Price/Sales	6.9
Return on Equity	147.9%	Debt/Equity	1.8

Founded in 1976 in Steve Jobs' garage, Apple has recently regained its status as the largest company in the S&P 500 Index as measured by its market capitalization of $2.6 trillion. Apple's ability to perfect a package of hardware, software, and services in sleek and intuitive devices has allowed the company to generate tremendous value for its shareholders over time.

Apple is best known for its iPhone, which was introduced in 2007 and accounted for 52% of revenues in fiscal 2022. Despite that longevity, the iPhone is still taking market share from its competitors, as measured by Apple's global smartphone revenue share reaching 50% for 2022, up from 44% in 2021.

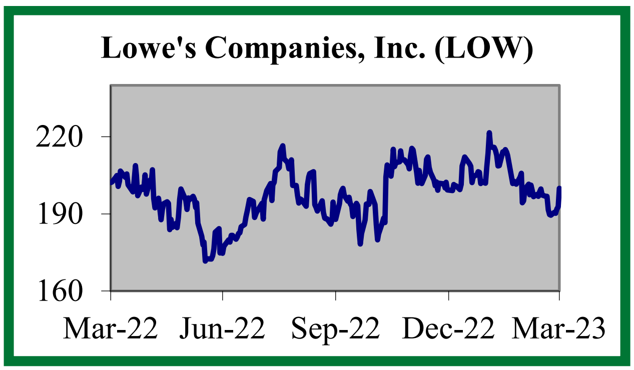
Beyond the iPhone, Apple's other key hardware products include the iPad, Mac, Apple Watch, and AirPods, each filling a niche that enhances the experience of the user. The integration of the iOS operating system across all Apple devices has created a unique ecosystem that leads to a seamless user experience, high switching costs, and unmatched customer loyalty.

Apple has further capitalized on its ecosystem by expanding into software and services to boost margins and create more sustainable revenue streams. Revenues from services, which include the App Store, iCloud, Apple TV+, AppleCare, licensing and other services, totaled over $78 billion in fiscal 2022 (20% of total revenues) and grew at an impressive 14% annual rate. The company now has an active installed base of 2 billion devices and more than 935 million paid service subscriptions.

Given this massive installed base and the continual need for device upgrades, we expect the company to continue to generate significant cash flow that is increasingly returned to shareholders through share repurchases and dividends. In 2022, Apple added another $90 billion to its share buyback authorization and increased its dividend by 5%. The company ended calendar year 2022 with $54 billion of net cash on its balance sheet and is expected to generate north of $100 billion in free cash flow in fiscal 2023.

Apple's stock trades at a forward P/E multiple of 27.9x, which is a premium to its peers and to the market. However, we believe that premium is justified given its strong cash flow generation, growing installed user base, and increasing higher-margin services revenue. In addition, management has a proven track record of innovation, execution, and the ability to generate demand for Apple products in seemingly any type of economic environment.

Lowe's Companies, Inc. (LOW)



Source for chart and financials: Yahoo Finance and Morningstar. Past performance is not indicative of future results. Please see disclosures on page 9.

Price (03/31/2023)	$ 199.97	Forward P/E	14.5
Market Cap ($B)	$ 120.9	Price/Book	NM
Dividend Yield	2.1%	Price/Sales	1.3
Return on Equity	NM		

Lowe’s is a Fortune 50 company and the world’s second largest home improvement retailer, generating $97 billion in annual sales and operating 1,738 home improvement stores throughout the United States. The four states with the highest concentration of Lowe’s stores are Texas (8% of stores), Florida (7%), North Carolina (7%), and California (6%). Lowe’s recently completed the sale of its Canadian retail business, which operated 232 stores in Canada and serviced 210 dealer-owned stores, which should lead to better margin performance and higher capital efficiency for the company going forward.

The home improvement market is highly fragmented, and Lowe’s enormous size and scale afford it numerous advantages over smaller competitors, including an extensive distribution network, economies of scale, and the brand awareness it has built with consumers and professionals. To efficiently serve its stores and meet customers’ expectations for fast fulfillment and delivery, Lowe’s owns and operates more than 100 supply chain facilities in its network. It is also building out a professional fulfillment network across the country to service the highly lucrative professional contracting market.

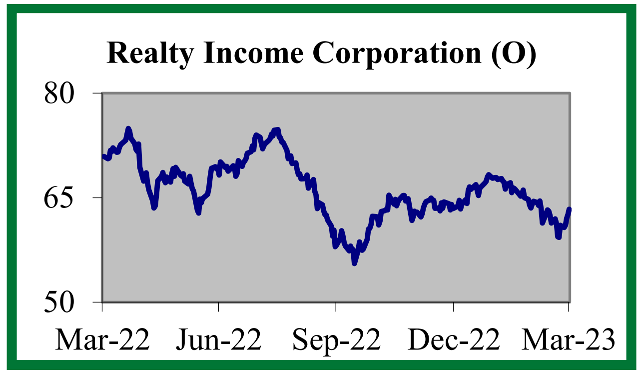
In fiscal year 2022, Lowe’s generated $6.8 billion of free cash flow from $8.6 billion of operating cash flow, posting an impressive conversion rate of 79%. Lowe’s repurchased roughly 71 million shares for $14 billion during fiscal year 2022, which was higher than anticipated, reflecting better-than-expected operating performance and the company’s commitment to return excess capital to shareholders. Combined with $2.4 billion of dividends paid, the company returned $16.5 billion to shareholders through share repurchases and dividends in fiscal year 2022.

CEO Marvin Ellison joined Lowe's in 2018 (from JC Penney and Home Depot) and has worked to improve the company’s operations. Since taking the helm, Mr. Ellison has improved the company’s supply chain, inventory control procedures, and customer engagement efforts. These improvements along with others have enabled Lowe’s to capture a higher percentage of earnings from its growing revenue. Net sales have grown 41% from $69 billion in 2017 to $97 billion as of 2023, while adjusted diluted earnings per share increased 215% from $4.39 in 2017 to $13.81 in 2023.

The home improvement industry should benefit from a multi-year secular shift in consumer habits and the wealth effect from higher home prices, which should continue to spur home improvement retail demand. Higher interest rates and inflation remain as risks, but unemployment is historically low, and Lowe's should benefit from the long-term work-from-home preference held by many companies and individuals. Also, a shortage of existing homes for sale means most households with record home equity value are staying put and remodeling their homes.

Lowe's shares currently yield 2.1% and trade for 14.5x fiscal year 2023 earnings, which is well below their 5-year average of 17.6x, as well as the S&P 500's forward price/earnings ratio of 18.0x. Given the company's dominant market position, durable earnings, and robust cash flow, we believe Lowe's is a high-quality business with a long runway of growth ahead. Its shares are also currently priced at an attractive discount to its long-term average valuations.

Realty Income Corporation (O)



Source for chart and financials: WSJ and MarketWatch. Past performance is not indicative of future results. Please see disclosures on page 9.

Price (03/31/2023)	$ 63.32	Forward P/FFO	15.2
Market Cap ($B)	$ 41.5	Price/Book	1.5
Dividend Yield	4.8%	Price/Sales	11.6
Return on Equity	3.2%	Debt/Equity	0.6

Realty Income is a real estate investment trust that owns, develops, acquires, manages, and leases primarily retail properties across the United States. It is the largest triple-net REIT in the United States with 12,237 properties, comprising 236 million square feet and located in all fifty states as well as Puerto Rico, the United Kingdom, Spain, and Italy. The company's top seven markets, accounting for 44% of rental revenue, are Texas, the United Kingdom, California, Florida, Illinois, Ohio, and Georgia.

The company's retail properties are typically freestanding buildings with a single tenant. Over 80% of those tenants are focused on defensive industries like services or non-discretionary goods, making them relatively insulated from recessions and e-commerce threats. For example, the company's top industry exposures are to grocery stores (10.0% of annual rent), convenience stores (8.6%), dollar stores (7.4%), quick-service restaurants (6.0%), drug stores (5.7%), and home improvement centers (5.6%). Realty Income has a history of strong underwriting, and top tenants include investment grade-rated companies such as Dollar General, Walgreens, 7-Eleven, Dollar Tree/Family Dollar, and FedEx.

A tenant base of high-quality retailers and service providers has allowed Realty to enjoy high occupancy levels, consistently in the range of 97%-99%, even during the Covid-induced shutdowns. Its triple-net lease structure, which means tenants are responsible for all maintenance, repairs, and taxes, has similarly produced consistent same-store rent growth as the leases contain built-in rent escalators. These leases are also long-term, frequently 15 years with additional extension options, providing Realty Income with a steady, stable stream of income.

This steady cash flow has enabled Realty Income to deliver a strong dividend track record, with 114 dividend increases since going public in 1994, making it one of only three REITs to be included in the S&P 500 Dividend Aristocrats Index. Realty Income's shares currently yield an attractive 4.8% and dividend growth over the past three years has averaged 3.1%, a trend we believe will continue.

Finally, the company's balance sheet is strong, with a debt-to-EBITDA ratio of 5.5x, combined with a well-laddered debt schedule. In addition, 85% of its debt is fixed rate with a weighted average interest rate of 3.4% and a weighted average term of 6+ years. Realty reported a strong $1.7 billion of liquidity at year-end 2022 and carries solid investment grade credit ratings of A- from S&P and A3 from Moody's.

In our view, Realty Income's strong market position and finances, combined with a high and growing dividend, make it an attractive income investment.

Source for text and charts: Morningstar, S&P/CFRA, Schwab, ValueLine, Black Diamond Performance Reporting, Yahoo Finance, Bank of America, JP Morgan Markets, MarketWatch, WSJ and Argus reports.

EDGEMOOR
INVESTMENT ADVISORS

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The Barclays U.S. Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. The Index is frequently used as a stand-in for measuring the performance of the U.S. bond market. In addition to investment grade corporate debt, the Index tracks government debt, mortgage-backed securities (MBS) and asset-backed securities (ABS) to simulate the universe of investable bonds that meet certain criteria. In order to be included in the Index, bonds must be of investment grade or higher, have an outstanding par value of at least $100 million and have at least one year until maturity.

The NASDAQ stock exchange is the first electronic stock market listing over 5000 companies. The NASDAQ stock market comprises two separate markets, namely the Nasdaq National Market, which trades large, active securities and the Nasdaq Smallcap Market that trades emerging growth companies.

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