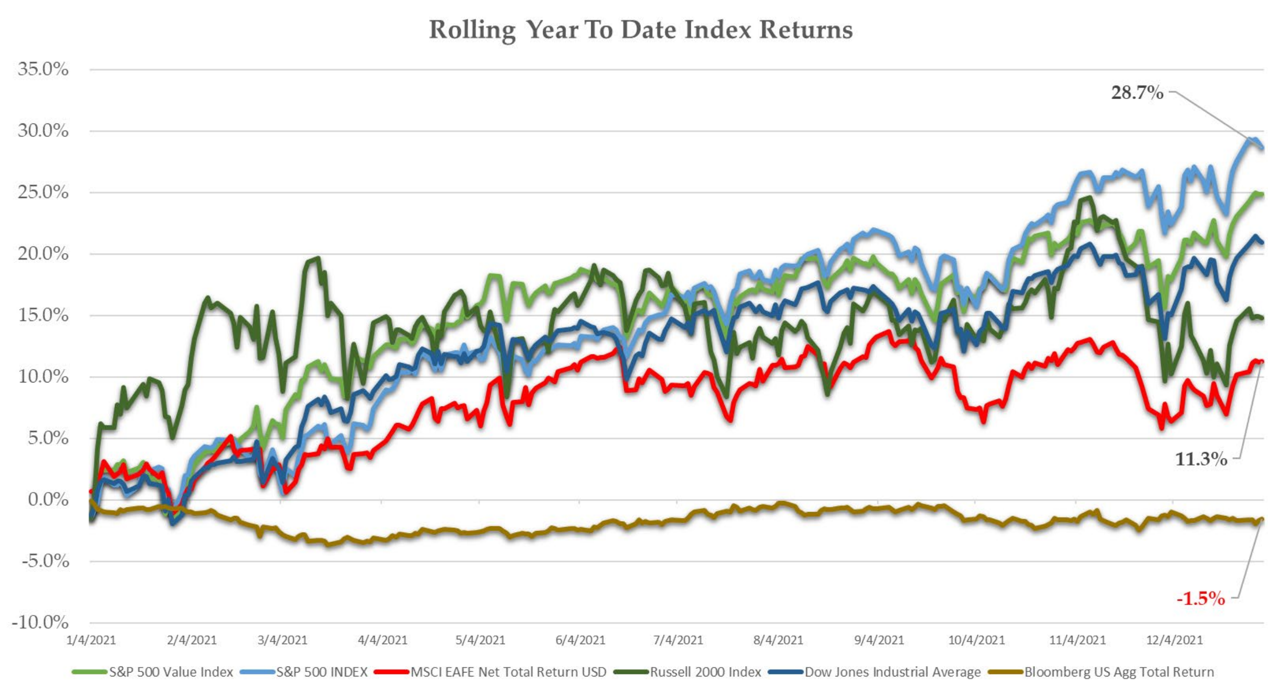
Dear Turtle Creek Client,

The U.S. stock market posted strong results through the fourth quarter, bringing to close a year that saw domestic stocks dramatically outperform their global counterparts while fixed income and cash assets struggled against rising inflation and the relaxation of recent, historic financial stimulus.

The backdrop for global markets shifted noticeably throughout the year. 2021 began with economic growth and corporate profits accelerating in most parts of the world, fiscal and monetary authorities firmly committed to unprecedented levels of economic support, and most economic indicators still lagging pre-COVID levels. By year end, economies had regained almost all lost ground, troublesome side effects such as inflation had emerged, profit growth had begun to moderate, and monetary and fiscal authorities were planning the reversal of many crisis-era measures.

Turtle Creek continues to be constructive about the longer-term outlook for risk assets such as stocks, especially considering the challenged outlook for fixed income and cash markets. Still, the current backdrop of rising interest rates, slowing growth, and tightening financial conditions in many ways represents middle or even late cycle economic behavior. These periods historically have featured greater market volatility, shifting leadership in stock performance, and lower investment returns in aggregate. Clients should be prepared to endure greater gyrations in the months ahead as the Federal Reserve and other global Central Banks normalize interest rates and many of the pandemic-related, one-time boosts to corporate earnings fade to more typical, long-run patterns.

The good news is that the current state of the world appears to be a “cycle within a cycle”, reflecting the rapid damage of the COVID recession, the unprecedently quick recovery, and the eventual unwinding of the massive government policy responses that drove the recovery. Looking to the other side of these trends, we remain as optimistic as ever regarding the long-run potential for your investments. Over the near-term, scrutiny of your portfolio is warranted to ensure your immediate needs are safeguarded.

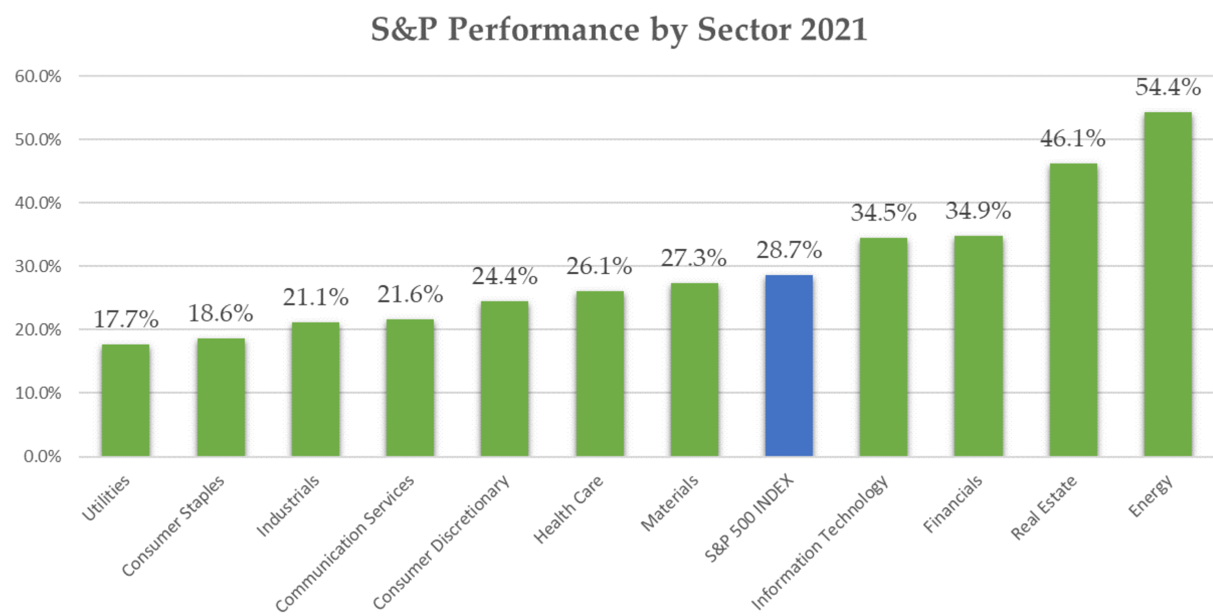


Source: Bloomberg

Fourth Quarter and Full Year Stock Market Performance

The S&P 500 Index advanced 11% through the fourth quarter, pushing its full year return to more than 28%. The cyclical trends characterizing markets in the initial stages of the COVID recovery persisted throughout the year, as rate-sensitive financial companies, real estate, and commodity businesses lead overall market returns. Traditionally defensive companies in the Consumer Staples and Utilities sectors lagged the market as did Consumer Discretionary companies. Online retailers experienced slowing sales growth as pandemic related binge buying rolled over. Travel and leisure stocks also sold off late in the year due to the emergence of the Omicron variant.

Unlike the narrow, technology-driven market performance of recent history, 2021 stock market returns were broad-based with most every investing strategy and market capitalization group producing double-digit gains. The Russell 2000, the commonly accepted proxy for smaller companies, posted the lowest index return for domestic stocks at a still impressive 15%.

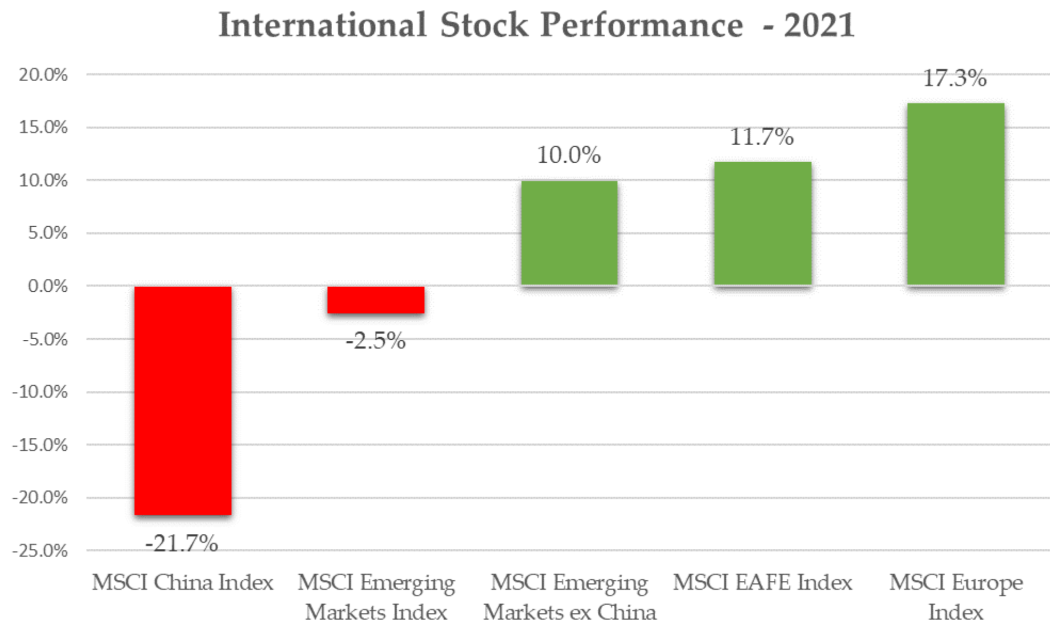


Source: Bloomberg

Developed-market international stocks also posted respectable results that nevertheless trailed U.S. markets to a notable degree. The MSCI EAFE Index delivered an 11.3% return for the year, driven primarily by strong returns in a resurgent Eurozone. European performance was offset by other developed markets such as Australia that continued to struggle with COVID lockdowns throughout the year.

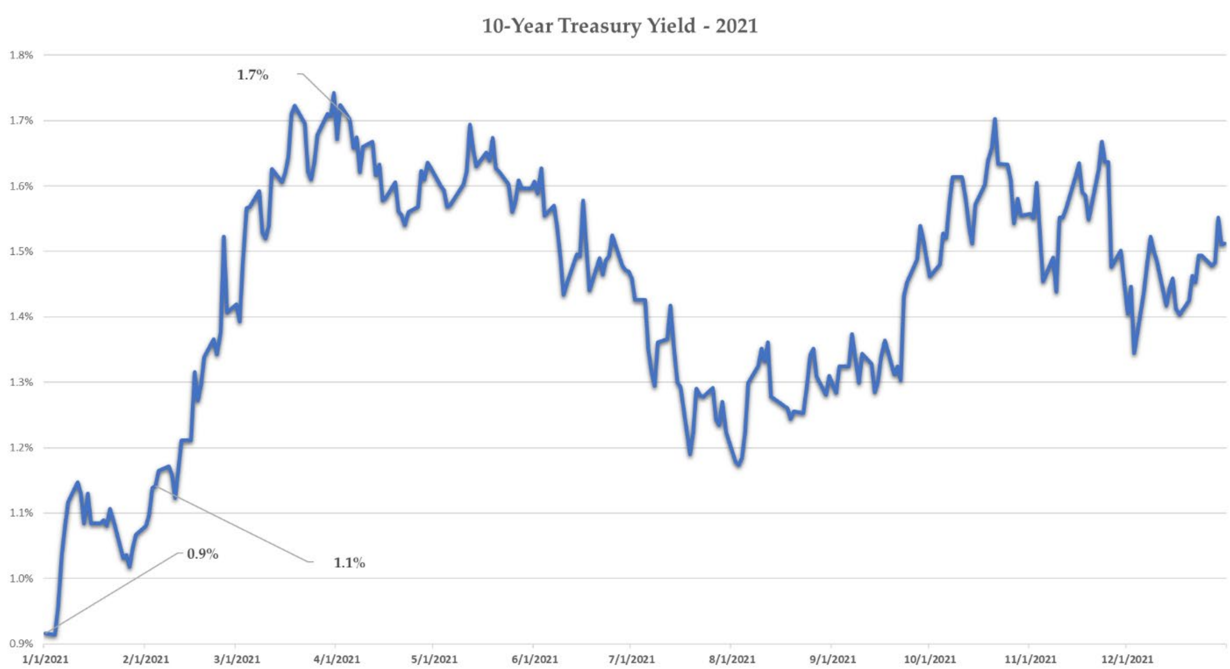
Emerging markets stocks should have kept pace with developed market peers, but large self-inflicted losses in Chinese equities dragged down emerging market returns in aggregate. The Chinese government continued with its "common prosperity" campaign, a new policy targeting equitable redistribution of corporate profits through onerous regulatory measures, elevated taxes, fines, and much greater state involvement in corporate decision making. Leading Chinese multinationals such as Alibaba lost more than half their value in response and Chinese equities posted a 21% loss in total for the year.

Emerging market stocks outside of China did post strong results, but the large role played by Chinese companies (accounting for over 30% of emerging market stock indices) resulted in a slight loss of 2.5% for emerging market stocks in total for the year.



Source: Bloomberg

Bond rates fluctuated through the year, pulled between the competing future scenarios of ongoing pandemic-induced economic distress on one hand and the potential for an overheating economy and above trend inflation on the other. The hawkish, inflation sensitive scenario won out in the fourth quarter as inflation metrics continued to exceed forecasts and the Federal Reserve and other global Central Banks reversed their previously dovish policy stances. The Federal Reserve is now forecasting imminent rate hikes and faster than expected reductions in other policy measures to reign in the highest rates of inflation since the early 1980s. Rates ground steadily higher in response, resulting in either minimal gains or losses for most bond indexes during the year.



Source: Bloomberg

Lessons from the 2021 Market Year

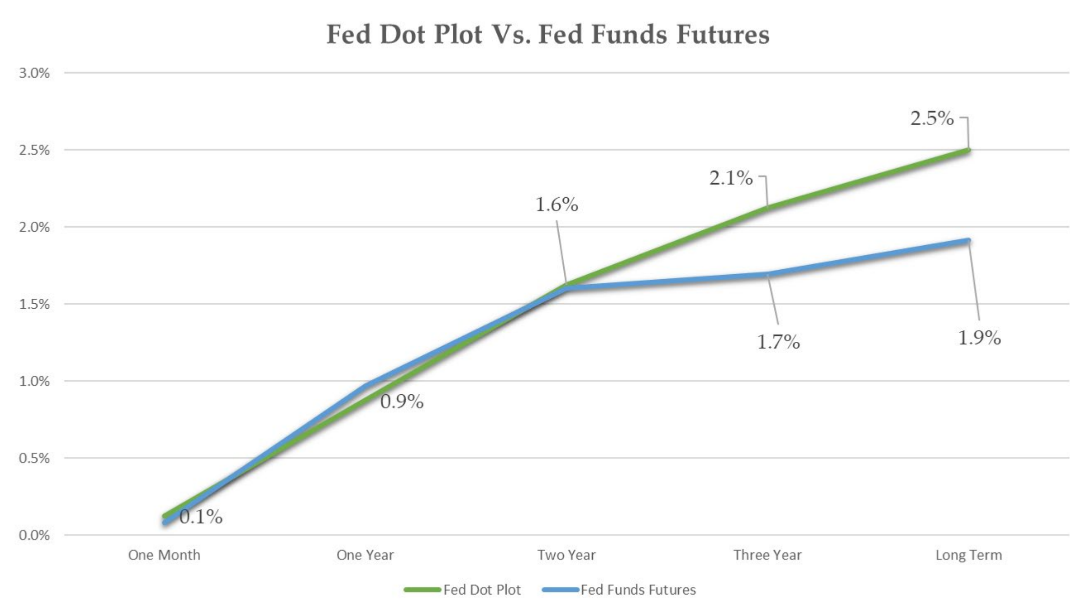
2021 was an excellent reminder that successful investing requires intellectual flexibility, and portfolios should be adapted to shifting circumstance. Investors can be forgiven for being lulled to sleep by the last decade; a period that saw interest rates drop steadily, growth-oriented investment strategies consistently outperform all other approaches, and a consistently placid economic backdrop deliver tame inflation and steady growth. There was for a long stretch only one game in town. The economic shifts brought on by both the global COVID Pandemic and the extraordinary government response have overturned many recent trends while reviving old risks such as inflation that had laid dormant for some time. Investors now face a less certain future that could follow several paths.

Probabilistic thinking, scenario planning, and uncertainty analysis are all varying terms for the same process of classifying the likelihood and implications of future events. The recent, historic degree of government support for the economy made the probability of negative outcomes much lower. As the Federal Reserve steps away from stimulus, the likelihood of slower growth and (at some point) even a recession increases. As the economy moves past the early phases of economic recovery and the outlook for inflation and commodity prices remains uncertain, the potential paths of corporate earnings are much more disparate than in the recent past. Weighing all these potential outcomes and adjusting your portfolio's investment policy and underlying holdings in response is an important process at this juncture.

Investment Strategy

Turtle Creek views certain near-term outcomes as more likely than others. With Central Banks clearly signaling multiple rates increases over the next several years, the outlook for fixed income investments remains challenging in almost any scenario. Cash holdings will also be a headwind to portfolio performance even in the scenario that yields on idle cash finally trend up from the current near zero levels.

Over the longer-term, Turtle Creek, and markets in general, do not envision the sort of significant rate increases that occurred during other periods of elevated inflation. We discussed in previous letters both the unusual nature of current inflation, owing to short-term supply chain snarls than any other factors, and the longer-term secular forces pressuring rates. Markets seem to agree, already casting doubt on the Fed's plans as signaled in their "Dot Plot" Forecast.



Source: Bloomberg

Federal Reserve governors are now forecasting hikes in the Fed Funds rate of up to 2.5% over the next three years and beyond. The futures markets are signaling no more than 2%. Other measures like the treasury yield curve agree, with long bond rates still hovering near 2%, well below the Fed's forecast.

The most likely scenario for equities continues to be a period of ongoing earnings expansion providing stability to stock returns while market valuations continue to compress towards longer run averages. This implies positive returns that should trail the historically above average stock market performance of recent years. This was our base-case for the 2021 market year, and we were proven far too conservative in estimating the impressive profit growth registered by corporations throughout the year despite wage and commodity inflation pressuring margins.

Diversification of stock holdings is an important theme. The secular growth prospects for technology and communications companies remains intact but their premium valuations could be pressured. The recent surge in commodity and bank earnings could prove to be unsustainable as the economic cycle matures. The risk of tilting your stock portfolio to any specific theme is elevated at this moment.

We of course can't totally discount more turbulent future economic scenarios. As COVID taught us, the future can always bring unforeseen shocks. Clients with clear near-term withdrawal needs must weigh the costs of overly conservative investment planning against the benefit of guaranteed stability in the funding of your withdrawal needs.

Over the longer-term, we have not wavered in our belief that high quality, advantaged, compounder business will endure whatever economic scenarios present themselves and provide you excellent portfolio outcomes. Staying true to this philosophy while positioning your portfolio for near term uncertainty is the winning strategy.

We look forward to exploring in greater detail these topics or any other questions or concerns soon. As always, we appreciate the trust and faith you have placed in our firm.

Sincerely,

TURTLE CREEK MANAGEMENT, LLC
TURTLE CREEK TRUST COMPANY, LTA