Hendershot INVESTMENTS

10-17-22

WEEKLY UPDATE

Market Performance

MARKET INDEX	CLOSE 10-14-22	WEEK GAIN/LOSS	Y-T-D GAIN/LOSS
DJIA	29,634.83	+1.2%	-18.4%
S&P 500	3,583.07	-1.6%	-24.8%
NASDAQ	10,321.39	-3.1%	-34.0%

The stock market experienced mixed results amid continued volatility due to high inflation reports with the Dow gaining 1.2%, the S&P 500 falling 1.6% and NASDAQ dropping 3.1% for the week.

Economic Releases

A summary of economic releases during the past week which may impact the financial markets:

For the week ending October 8, initial jobless claims increased by 8,000 to 228,000, while continuing jobless claims for the week ending October 1 increased by 3,000 to 1.368 million. Initial claims are still running at relatively low levels, indicating a still tight labor market.

The Consumer Price Index (CPI) was up 0.4% month-over-month in September. Core CPI, which excludes food and energy, jumped 0.6% month-over-month. On a year-over-year basis, total CPI was up 8.2%, versus 8.3% in August, but core CPI was up 6.6% versus 6.3% in August, reaching the highest level in 20 years. While headline inflation moderated due to lower energy prices, core inflation has worsened driven by widespread pricing pressures that included another 0.7% increase in the shelter index. This inflation report cemented expectations for a 75-basis point rate hike at the next Fed meeting in November and raises concerns that the Fed will stay on an aggressive rate-hike path longer than hoped.

The Producer Price Index for final demand increased 0.4% month-over-month in September. On a year-over-year basis, the index for final demand was up 8.5% versus 8.6% in August. Producer inflation is sticking at high levels that will pressure profit margins and raise concerns about negative pass-through effects to the consumer which will likely result in further Fed interest rate hikes to combat inflation.

Total retail sales were unchanged month-over-month in September suggesting consumers were pulling back on spending activity in the face of high inflation.

The preliminary October University of Michigan Index of Consumer Sentiment rose to 59.8 from the final reading of 58.6 for September. In the same period a year ago, the index stood at 71.7. Inflation expectations for the year ahead increased to 5.1% from 4.7% while the five-year period expectations rose to 2.9% from 2.7%, creating uncertainty about the strength of consumer spending activity in coming months. With inflation expectations rising, the Fed will have more ammunition to raise interest rates.

Across the pond, Bank of England bond interventions have been spooking the global market. Dueling fiscal and monetary policies in the U.K., along with margin calls on pension funds, have contributed to the interventions.

HI-Quality Company News

A summary of important earnings and/or capital allocation news announced during the past week from the high-quality companies held in most client portfolios. For new clients, these companies may become investment candidates as valuations appear attractive and cash is available:

UnitedHealth Group-UNH reported third quarter revenues rose 12% to $80.9 billion with net income and EPS each jumping 29% to $5.3 billion and $5.55, respectively. The strong revenue growth during the quarter included double-digit growth at both Optum and UnitedHealthcare, as the company is seeing a steady return to more normalized care since the pandemic. Margins improved as the business laps the negative impact from increased Covid costs last year. Cash flow from operations in the third quarter was $8.8 billion-- or 1.6-times net income. **Free cash flow increased a healthy 66% during the first nine months to $28.8 billion. Year-to-date, the company returned $10.5 billion to shareholders through dividend payments of $4.5 billion and share repurchases of $6 billion.** UnitedHealth Group ended the quarter with $84 billion in cash and investments, $45 billion in long-term debt and $78 billion in shareholders' equity on its healthy balance sheet. Return on equity of 28.5% during the quarter reflected the company's sustained growth and efficient capital structure. **Management raised their full year 2022 EPS outlook to a range of $20.85 to $21.05.**

Fastenal-FAST rang up a 16% increase in third quarter sales to $1.8 billion with net income and EPS up 17% to $284.6 million and $0.50, respectively. **Fastenal achieved double-digit daily sales growth in all nine product categories,** including 18.2% for fasteners and 12.4% for safety. Increases in unit sales on **strong demand and price increases** drove third quarter sales higher. Solid demand in markets tied to industrial capital goods and commodities more than offset declines in markets tied to consumer goods and construction. Foreign exchange headwinds and the impact from Hurricane Ian negatively affected sales by 60 basis points and 50 basis points, respectively. Pricing actions taken over the last twelve months to mitigate product and transportation cost inflation added 550 to 580 basis points to the year-over-year sales increase, down from 660 to 690 basis points during the second quarter. Contributions from price increases will continue to moderate during the fourth quarter as comps become more challenging. During the quarter, Fastenal signed 86 new onsite contracts, bringing the total active onsite locations to 1,567 and recorded 5,187 FASTBin and FASTVend signings and installations, bringing the final installed base to 99,409, up 10% from last year. Gross margins declined 40 basis points to 45.9% and operating margins increased 50 basis points to 21.0%. While spot prices for many inputs including fuel, transportation services and steel began to decline from peak costs, it will likely take several quarters before input cost declines are reflected in cost of goods sold due to Fastenal's long supply chain. During the quarter, Fastenal generated $257.9 million in operating cash flow, or 90.6% of net income. **Free cash flow increased 75% from last year to $209.9 million with the company returning $273 million to shareholders through dividends of $177.5 million and share repurchases of $95.3 million.** Fastenal ended the quarter with $231.5 million in cash and equivalents, $404.7 million in long-term debt and $3.2 billion in shareholders' equity on its sturdy balance sheet. While Fastenal recorded healthy sales trends during September, feedback from the field suggests pockets of increasing customer caution.

PepsiCo-PEP reported third quarter revenues rose 9% to $21.9 billion with net income up 21% to $2.7 billion and EPS popping 22% higher to $1.60. Organic revenue increased 16%, representing the fourth consecutive quarter of double-digit organic revenue growth. **PepsiCo's top-line performance was broad-based across**

geographies as their North America and International businesses each delivered 16% organic revenue growth reflecting the company's pricing power. These results reflect the continued strength of the company's diversified portfolio and the **resilience of the company's global beverage and food businesses**, which delivered 12% and 20% organic revenue growth, respectively. Free cash flow decreased 14% during the first nine months to $6.3 billion. PepsiCo returned $5.7 billion to shareholders through dividend payments of $4.6 billion and share repurchases of $1.1 billion of its common shares year-to-date. **The company continues to expect to return approximately $7.7 billion to shareholders in fiscal 2022, comprised of both $6.2 billion in dividends and $1.5 billion in share repurchases.** For the balance of the year, PepsiCo's North America snacks and beverage businesses is expected to remain resilient, and PepsiCo remains focused on accelerating their cost management initiatives and further sharpening their revenue management capabilities as consumers adjust and adapt to persistent inflationary pressures. For the full 2022 year, **management raised their revenue and earnings outlook with organic revenue growth expected to be about 12% and core EPS growth of 10%.** PepsiCo's management does not see signs of a recession as consumers continue to buy its "small affordable luxuries" despite inflation.

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Inflation remains stubbornly elevated, which will likely result in another 0.75% interest rate hike in November. The Fed's minutes from the September meeting revealed, "Many participants emphasized that the cost of taking too little action to bring down inflation likely outweighed the cost of taking too much action." If the U.S. Federal Reserve tips the economy into a "mild" recession to cure inflation, it'll be a better outcome than a long period of stagflation, which is inflation combined with lower growth.

Inflation and recession concerns have led to high volatility in the stock market. Last Thursday, after hot inflation numbers were released, the S&P 500 dropped sharply then roared back. The S&P 500 closed up 2.6% after swinging more than 5% during the wild trading day. The rally was driven by computer programs buying when the S&P 500 fell below 3,500, which effectively marked a 50% retracement of the pandemic rally. The S&P 500 put in a new low for 2022 (3491.58) before it started on its massive rebound. That rebound was likely helped by short covering activity. The Dow bounced 1400 points from its low that same day as some attributed the bounce to another call for peak inflation.

When we invest in a business, we focus on the cash flows the business will generate over its lifetime, which will include periods of both inflation and recession, and then determine what is a fair price to pay for those cash flows to provide us with solid long-term returns. We compare those expected stock returns with interest rates on fixed-income investments, which may provide competition for the first time in years as interest rates rise and normalize. We do our best to ignore the wild computerized stock price swings based on technical factors and Mr. Market's Tarzan yells, which just create noise and distraction for the long-term investor.

This week **PepsiCo**, **Fastenal** and **UnitedHealth** all reported double-digit growth in sales and earnings for the third quarter with strong cash flows. All three companies are returning substantial cash to shareholders through growing dividends and share repurchases. Fastenal is seeing strong demand for its industrial products while UnitedHealth is seeing healthcare normalizing with profit margins improving. PepsiCo reported the strongest organic revenue growth in years and sees no signs of a recession. Both PepsiCo and UnitedHealth raised their earnings outlook for the balance of the year. These solid fundamental financial results from our ***HI***-quality businesses are no monkey business, even if Mr. Market continues to wildly swing back and forth like Cheetah.

If you have any questions, please let us know.

Sincerely,

Ingrid R. Hendershot, CFA

President