TUFTON CAPITAL

MANAGEMENT

VIEWPOINT

WINTER 2025

In this space, a bit over twelve months ago, I admitted that I didn't have a clue what sort of market 2024 would bring. "Perhaps the economy will thrive... buoyed by the Fed's anticipated and continued monetary easing," I wrote. "Or perhaps...lower interest rates coupled with strong corporate earnings and healthy balance sheets *may* lead to another year of double-digit returns for the equity markets."

On Wall Street, however, where confidence is king, well-paid prognosticators were obliged to issue a more definite outlook. And as you may recall, that outlook was cautiously optimistic. At the beginning of last year, several financial networks reported that Wall Street's collective annual forecast was less than bullish. They pointed to worries ranging from continued inflationary pressures to political uncertainty in the White House to lofty valuations. We also heard from several major investment banks warning clients of possible "downward pressure" on U.S. equities. With sociopolitical tumult and a bull market that was officially long in the tooth, it seemed as though worrying over a slowdown was the respectable analyst's only prudent move.

What happened next is history. Over the last twelve months, that bull market has grown even longer in the tooth, surmounting the Street's "wall of worry" (and continued sociopolitical tumult) in truly rare form. In 2024, while volatility sat at historic lows, the S&P 500 rose 25%, posting its second annual double-digit gain in a row. Not wanting to be left out, the Dow Jones shot up 15%, another solid return for the index. So much, it would seem, for those January jitters.

Yet, pleasant as the market's surprises were in 2024, one question still looms large. What should investors expect in the year ahead? Given the relatively volatile start that U.S. equities have already had in 2025, it's no surprise that many dour pundits from this time last year remain a bit sour when looking at the year ahead. But for every market pessimist, there's always an investor taking the other side of the bet (isn't that what makes markets?). Open the morning paper, and you're likely to read the bulls forecasting another "record run" for the market, spurred on by an encouraging global economic outlook. As Goldman Sachs' asset management arm now succinctly puts it, "We think equities will continue to outperform in 2025."

We certainly hope Goldman Sachs' prognostication will prove to be the case. However, all good things must eventually come to an end, and we at Tufton Capital will continue to implement a bottom-up, value-driven investment philosophy that delivers performance in a strong market—and perhaps more importantly—provides peace of mind when things take a turn for the worse. For almost thirty years, this approach has kept our clients in good stead from the "Great Recession" of 2008 throughout the "great gains" of 2024.

As we charge into 2025, I will again forgo a firm "outlook", since Santa, yet again, forgot to bring my crystal ball. Instead, I offer this simple assurance. Above all else, your team of investment professionals at Tufton Capital remains honored by your trust and committed to your interests. From all of us here at Tufton Capital, Happy New Year.

Chad Meyer, CFA
President

Inside This Issue

The Fourth Quarter of 2024: Seeing Red

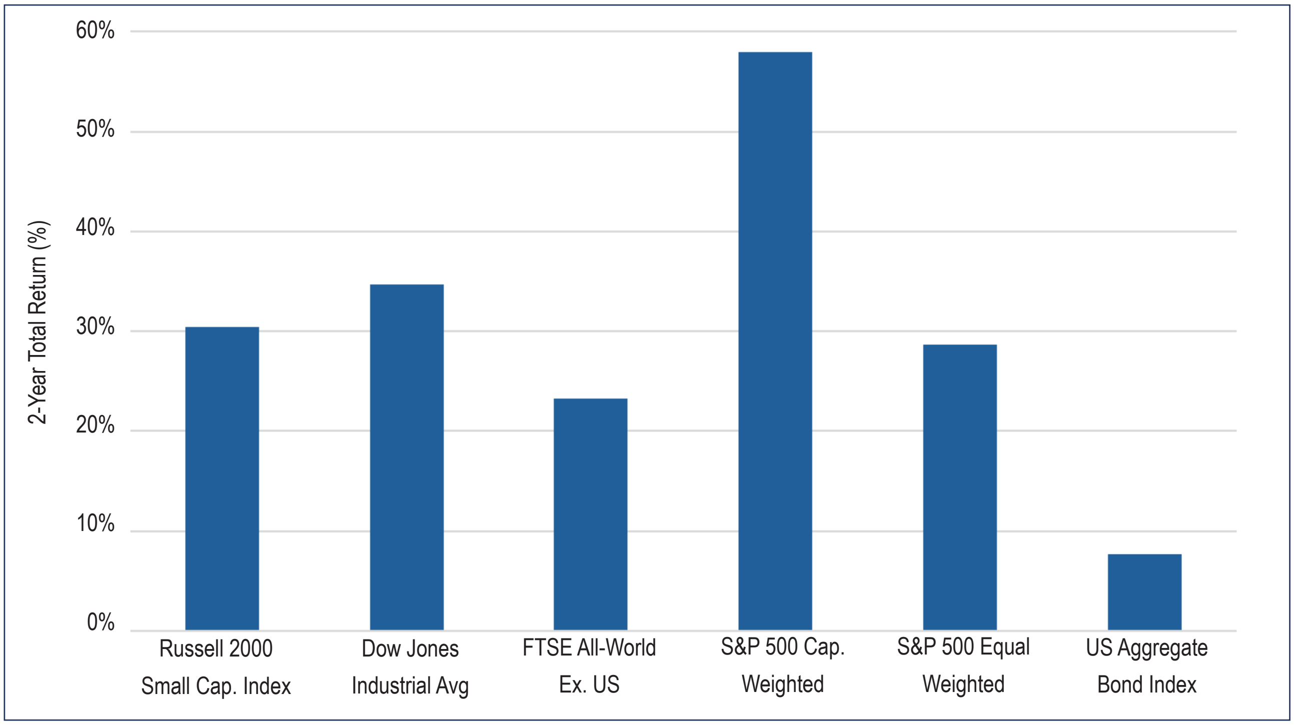
Eric Schopf
Director of Research/
Partner

The fourth quarter capped another good year for equity investors. The Standard and Poor's 500 gained 2.41% in the quarter and closed 25.02% higher for the year. The market had been up as much as 29.34% through December 6 before a late-year sell off. The trend of U.S. large capitalization growth stock performance continued in 2024. Most of the other equity indexes delivered more modest returns. For example, the Dow Jones Industrial Average advanced almost 15%, and the Russell 2000 Small Capitalization Index gained 11.54%. The Financial Times Stock Exchange (FTSE) All World Index, excluding the United States, which is a good proxy for international equity investments, logged a 13.27% gain. United States exceptionalism was again on full display in 2024. The exceptionalism, however, did not run deep. The equal-weighted S&P 500 was up only 13.01%, about half as much as the capitalization weighted S&P Index.

The bond market had a much rougher ride during the quarter. The U.S. Aggregate Bond Index, a measure of the total investment grade fixed income market, declined 2.61% in the quarter, reducing the year-to-date return to just 1.82%. The real return was negative when factoring inflation at 2.7%. The shift in the yield curve, which began in the third quarter following the Fed's first interest rate cut, accelerated in the fourth quarter. Although the Federal Reserve cut interest rates twice in the quarter, the 50 basis point aggregate reduction resulted in higher rates across the yield curve. During the third quarter, higher interest rates were felt in maturities beyond ten years. Weakness was visible in all maturities beyond one year with higher yields and lower prices.

The shift in interest rates has been challenging for fixed income investors. Cash money market funds have been about the safest investments. However, three interest rate cuts over the past four months have resulted in

U.S. Exceptionalism and Bond Market Challenges



Source: Factset

a big reduction in yield. Money market fund yields peaked at about 5.5% last May. Today, yields are now closer to 4.4%. Extending maturities to lock in higher rates has been fraught with risk as bond prices have dropped, reflecting the higher interest rate environment.

Bond market weakness and the late-year stock market sell-off reflect the uncertainty of the incoming administration. Gains by Republicans left the party in control of the Senate and the House of Representatives. President-elect Trump has articulated an aggressive agenda and appears to have the votes to bring his vision to fruition. He will use executive orders extensively to ensure that his policy initiatives are met. The initiatives, with the goal of making America great again, have made Wall Street skeptical, and the stakes are high given the bloated budget deficits and the level of federal debt.

In hindsight, inflation at the household level may have been the undoing for the Democrats. Fiscal policy was unconstrained. The American Rescue Plan, the Build Back Better Act and the Inflation Reduction Act cost nearly $6 trillion. When combined with the quantitative easing policy at the Federal Reserve and their accumulation of $9 trillion in assets by June 2022, it was only a matter of time before inflation became a problem. Inflation and high interest rates may persist if President Trump's plan doesn't work. With federal debt now at $34 trillion and equal to 123% of gross domestic product, there is little room for error.

The President-elect has shown little appetite for a reduction in spending. Additionally, he campaigned on a platform of extending tax cuts that he ushered in during his first term in 2017 and are set to expire later this year. He doubled down by promising no income taxes on tips, overtime pay or social security benefits. The gap between revenue and expenditures is to be filled by revenue collected through tariffs and greater tax revenue from a buoyant economy that is more U.S.-centric. The assumption is that exporting countries will eat the tax and accept lower profits or shift production to other locations, preferably

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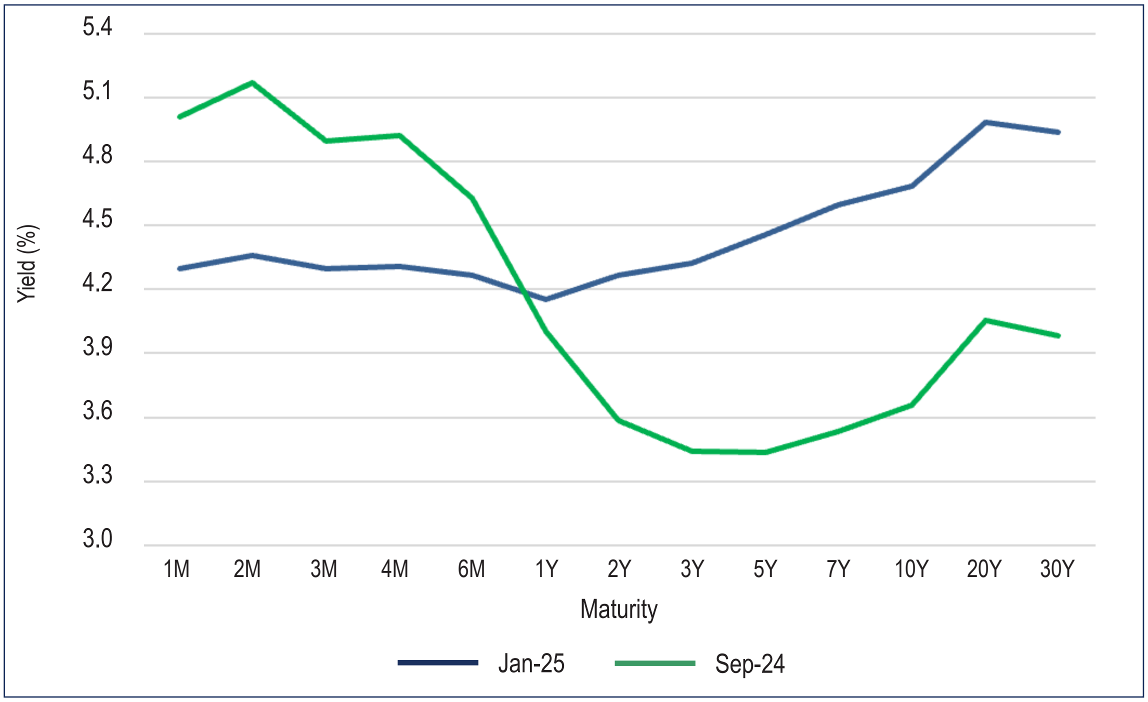
The Shift Towards a More Normalized Yield Curve



Source: Factset

Fourth Quarter... Continued from page 3.

the United States. Detractors point to the current unemployment rate of 4.1% and question the labor source for operations relocated to the U.S., a situation that would be exacerbated by strong rhetoric on closing the borders and deporting illegal immigrants. There is also some question as to whether exporters will simply pass the cost of tariffs on in the form of higher prices. We should expect our trade partners to retaliate through tariffs of their own on imported goods which might neutralize the entire exercise. There are also some questions as to the net impact of tariffs. The total value of all imports in 2023, the last full year of data, was $3.8 trillion. A 20% across the board tariff on all imports would only generate $760 billion. The extra revenue falls well short of current budget deficits and doesn't even cover the nation's annual interest payment of $1.126 billion. There is a slim possibility that an optimal tariff level is reached and the benefit of higher tax revenue will offset higher prices. Miscalculations, however, could easily result in sustained inflationary pressure, higher interest rates and slower economic growth.

Inflation never decreased to the Fed's target rate of 2%, even prior to their interest rate cuts. Given the potential for greater inflation triggered by economic policies, future rate cuts are now in doubt. Higher rates impact corporate profitability due to higher funding costs, and they also factor into equity valuations in discounting future cash flows. Recent volatility in the stock and bond markets is likely to persist until the impact of implemented policies becomes evident.

President Trump only has one term to leave his mark and will undoubtedly instigate for change, but success is not guaranteed. For example, he is keen on revving up the domestic energy industry to reduce imports, increase exports and improve our economy through job expansion. He seems poised, through executive order, to overturn drilling bans enacted by President Biden. However, with energy exploration and production now consolidated in the hands of fewer, fiscally rational players, their willingness to "drill-baby-drill" may fall short of expectations. The jury is still out on cost-saving initiatives implemented by the newly created Department of Government Efficiency, which will be co-led by Elon Musk. A similar undertaking, the President's Private Sector Survey on Cost Control, established by executive order during the Reagan administration, was unsuccessful. Musk, the chief executive officer and chief technology officer of SpaceX, has put people into space. He also successfully introduced affordable electric vehicles to the world. We will see if he has the same success wrangling control of the federal government.

Economists and politicians have been warning about the dangers of deficits and extended debt levels since the beginning of the republic. From the Revolutionary War in 1775 through the Covid-19 pandemic, the federal government has borrowed money to see the nation through hard times. The printing of excess money creates the opportunity to accumulate wealth. Austerity measures implemented to rectify fiscal imbalances pose a risk to that wealth. Thanks to the giant tax cuts implemented by President Reagan, President George H.W. Bush was confronted with yawning budget deficits and mounting debt when he took office in 1989. Although we read his lips as he pledged no new taxes, he reneged on that promise. The loss of consumer confidence along with restrictive monetary policy to help reduce inflation resulted in an eight-month recession.

History doesn't always repeat itself but sometimes it rhymes. We at Tufton are closely monitoring the changing of the guard in Washington. We will continue to preserve and grow our clients' portfolios by maintaining a disciplined and well diversified approach to investing. ■

Company Spotlight: Nike, Inc. (Ticker: NKE)

Scott Murphy
Portfolio Manager/Partner

When you think of athletic brands, Nike (NKE) is likely the first name that comes to mind. Nike is known for its iconic "swoosh", and it is one of the most recognized brand names in the world. While Nike has long been synonymous with innovation and cultural relevance, in the past few years it has suffered a few stumbles.

This past fall, Tufton initiated positions in Nike because we perceived a good buying opportunity. Missteps in vendor relationships and a slowdown in China, one of Nike's largest markets, caused the stock to trade at a discount. Nike has underperformed 70% since 2021, and the perfect investment opportunity emerged.

During the Covid-19 shutdowns in 2019-20, Nike pivoted to a direct-to-consumer model bypassing traditional outlets like Dick's Sporting Goods and Foot Locker. This strategy was an initial success. However, when these stores reopened, Nike found that their direct-to-consumer strategy had backfired, and they suffered strained relations with their partners which led to inventory buildups and margin pressures. There was also a slowdown in product innovation which let companies like HOKA and ON make small but significant inroads into Nike's market share.

Nike recognized these problems and decided to make a change in leadership. They brought back Elliott Hill as CEO. Hill, a seasoned thirty year employee and former President of Consumer and Marketplace, might be the ideal person to right the ship. He is a well-respected leader who is extremely qualified to address inventory issues, mend vendor relationships, refocus on innovation and bring Nike back to its former glory.

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Nike, Inc. Stock Chart (Ticker: NKE)

Source: Factset

Hidden in Pl*AI*n Sight

Alex Olshanskiy
Investment Analyst

Artificial Intelligence (AI) isn't a genie that magically appeared from a lamp in late 2022. It has been hiding in pl*AI*n sight, evolving steadily over the years under various names—machine learning, neural networks, data science—and is becoming increasingly integrated into our lives and businesses. It's not a sudden breakthrough, but rather the result of years of innovation, research and trial. Companies like Alphabet, Carrier, Chevron, Digital Realty Trust, Eli Lilly, Exxon, Capital One Financial and others in your portfolio have been instrumental in not only advancing AI technology but also positioning it as a key driver for future growth. These organizations are shaping the landscape and ensuring that AI isn't just a tool of today but a cornerstone for tomorrow's business strategies. As we look ahead, it's clear that AI is no longer a distant concept, but it is an essential force that is already transforming industries, solving complex challenges and opening doors to new opportunities.

The goal of any company is survival, but not just survival. The company must also *grow*, and one factor that can help with growth is *productivity*. This is easier said than done. While recent creations like Chatbots are sometimes fun to *talk to*, they can be pretty boring to *talk about*. Conversations about AI often get stuck in a rut, fixated on the well-worn, almost cliché image of a future where robots rule the world. Attention to productivity is an essential criterion for companies that we choose for our investors. Tools like the plow and steam engine revolutionized manual labor and enabled humans to accomplish physical tasks more efficiently and on a larger scale. Similarly, technology has long been a tool for mental labor, helping thinkers, innovators and creators process complex information and solve problems more quickly. But AI takes this evolution a step further. It has shown its potential to amplify human cognitive abilities, not just as a tool to assist, but as a partner that can analyze vast amounts of data, uncover hidden patterns and make decisions with speeds and accuracies beyond human capacity. AI will not replace the thinker, but it will empower the mind, allowing us to tackle even greater challenges, unlock new realms of creativity and propel innovation in ways we've only begun to imagine. The question is no longer *if* AI will transform the landscape, but *how* it will redefine the limits of human potential.

AI is also revolutionizing healthcare, with applications in predictive analytics, personalized medicine and enhanced diagnostics. AI algorithms can interpret patient data to identify potential health risks, predict disease progression and recommend personalized treatment plans. This not only improves patient outcomes but also helps optimize healthcare delivery and reduce costs. Eli Lilly's CEO David Ricks is investing in artificial intelligence and machine learning in areas including drug discovery, natural-language generation, robotic-process automation and chatbots. The goal is to grow what Lilly calls its "digital worker-equivalent workforce."

In the energy sector, AI is being used to optimize energy consumption and reduce operating costs by sifting through substantial amounts of data. AI algorithms can identify patterns and trends in energy usage which enables companies to maximize energy consumption and reduce their environmental impact. Chevron, ExxonMobil and Enterprise Products Partners L.P. are leveraging AI to enhance productivity and sustainability in the energy sector. Chevron uses AI for predictive maintenance, exploration advancement and carbon management, while ExxonMobil applies it in refining, energy efficiency and supply chain development. Enterprise Products Partners utilizes AI for pipeline monitoring, energy trading and asset management. These companies are harnessing AI to improve operations, reduce costs, improve safety and lower environmental impacts, making it a key driver for their future growth and long-term competitiveness in the global energy market.

Furthermore, generative AI is showing great promise in transforming customer experiences, particularly in the financial sector. AI-powered chatbots and virtual assistants provide personalized financial advice, answer customer queries and assist with complex tasks like retirement planning or mortgage selection. This not only heightens customer satisfaction but also improves efficiency and brings down costs for financial institutions.

Google is at the forefront of the AI revolution with its significant investments in AI research and development across various domains. The company's new AI chip, Trillium, is a testament to Google's commitment to the advancement of AI capabilities. Trillium offers unparalleled performance and efficiency which allows faster AI training and handling of massive datasets with ease. This breakthrough technology is powering Google's latest AI model, Gemini 1.5 Pro, which represents a significant leap forward in AI capabilities.

Gemini 1.5 Pro can process up to one million tokens, equivalent to approximately 1,500 pages of text, allowing it to analyze and understand extensive documents and datasets with exceptional accuracy. This enhanced capability opens up new possibilities for AI applications, including deep research, complex problem-solving and more sophisticated human-computer interactions. At the core of Gemini 1.5 lies a new version of the Mixture-of-Experts (MoE) architecture, which allows the model to learn and selectively activate the most relevant pathways within its neural network, thereby increasing efficiency and performance.

Google's Deep Research feature in Gemini is transforming how research is conducted. By leveraging AI's advanced reasoning and long-context capabilities, Deep Research can autonomously explore complex topics, compile comprehensive reports and provide detailed insights with minimal human intervention. This groundbreaking tool has the potential to revolutionize research across various domains, from academia and science to business and industry.

In addition to Trillium, Google has also developed the Willow quantum chip, which significantly reduces errors as it scales up, marking a major breakthrough in quantum error correction. Willow has demonstrated its potential for solving complex problems beyond the reach of classical computers, with applications in fields like medicine, energy and Artificial Intelligence. This achievement highlights Google's diverse AI research efforts and its determination to push the boundaries of AI technology.

The rise of AI is driving an exponential increase in data generation and processing which is leading to a growing demand for data centers. This surge is further fueled by the increasing adoption of emerging technologies like AI, which require specialized infrastructure to support high-power densities. Digital Realty Trust (DLR), a leading provider of data center solutions, is leveraging AI to facilitate data center operations and enhance efficiency. AI-powered predictive analytics enable DLR to anticipate and manage workload distribution, improve resource allocation and minimize downtime. AI also plays a crucial role in boosting data center security by detecting anomalies, identifying threats and protecting valuable data in real time.

The increasing demand for data centers also benefits companies like Carrier, a global leader in intelligent climate and energy solutions. Carrier provides high-performance HVAC (heating, ventilation, and air conditioning) systems that are essential for cooling data centers and ensuring optimal operating temperatures for servers and other critical equipment. As data centers grow in size and complexity, Carrier's advanced cooling solutions are becoming increasingly vital for maintaining efficiency, reliability and sustainability.

The AI revolution is well underway, and its impact is being felt across industries from finance to healthcare to energy. AI is transforming the way businesses operate and compete by optimizing operations,

Nike....continued from page 5.

Despite its recent challenges, Nike remains the undisputed leader in athletic footwear. As of 2024, Nike held a commanding 16.4% global market share, far outpacing Adidas (9%) and Puma (3%). New entrants into the footwear market like HOKA and ON have garnered some attention, but their market shares remain below 3% globally. Nike also has maintained the "cool" factor among teenagers with 59% of them naming Nike as their favorite footwear brand. For perspective, Adidas comes in at 7% in that teenage survey.

While Wall Street is cautious as the company navigates these transitions, we at Tufton see it as an opportunity to accumulate shares of a proven market leader at a discounted price. Nike's market leadership and commitment to innovation tie in with our focus on long-term value creation. Under new and experienced leadership, Nike should capitalize on the turnaround and reap the rewards as it regains its stride. We believe that Nike will make a meaningful recovery, and it will be a winning stock for the patient investor. Taking some of Nike's advice, we will "just do it". ■

Hidden....continued from page 7.

enhancing customer experiences and driving scientific breakthroughs. We at Tufton are looking for those companies that are revolutionizing business as usual. We are positioning your portfolios for future growth and helping our clients translate what is hidden in pl*AI*n sight. ■

TUFTON CAPITAL MANAGEMENT

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