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"IF YOU CAN'T CONVINCE 'EM, CONFUSE 'EM"
Harry S. Truman

Sometimes listening to our political leaders speak to the various daily developments may cause you to ask, "did I hear that correctly?" You might feel like you're back in the Yogi Berra era. Yogi, in answer to a question about an alleged statement he was supposed to have made, told a reporter, "I never said most of the things I said." Is Yogi Ghost writing the speeches for our most senior elected officials?

Probably not, he left this earthly plain back in 2015. But the spirit of Yogi's unique conversational style is apparently still very much alive. Yogi was a great baseball player, coach, and Hall of Famer. It remains to be seen how many of today's leaders will end up in the Hall of Fame. We know what Mr. Berra would remind us here, "It ain't over 'til it's over."

No worries, we are reassured by Yogi's well-known observation that "99% of the game is half mental." Maybe awareness of that comforting thought should be a requisite for anyone considering running for high elected office, even if you're only a quarter mental.

As mentioned in our past letter (7/31/22), economists and investors alike have been concerned about the possibility of a recession setting in since early 2022 and into

2023. Initially, much of concern had to do with the negative follow-on effects from the COVID epidemic and the impact from the enormous amount of stimulus and incentives employed to ensure adequate liquidity for the economy, our fellow citizens, and to preclude any possibility of slipping into a financial abyss. More recently, the cessation of the government stimulus programs, a more modest level of savings and the Fed's hawkish stance are rekindling concerns of recession.

While there has been much said about various signs pointing to a slowing of economic growth, many corporations have continued to maintain strong gross margins, report higher than expected earnings and have upgraded future expectations. This is despite other signs to the contrary, such as the purchasing managers index staying below fifty (normally a sign of impending recession). Other benchmarks too have suggested caution may be justified.

This is not to mention the conflict between Hamas and Israel in the Mideast, a sharp spike in interest rates, and more recently the UAW strike. The equity markets are holding reasonably well (S&P is up approximately 11% YTD). Of course, we all should remember that the S&P last year possibly "paid-in-advance" for a recession, that hasn't occurred yet, by declining 18.11% (Bloomberg). We'll see!

Fed Chairman Powell spoke to the Economic Club of New York recently (10/19/23) and stated that the Fed did not expect a recession, which is in keeping with what the Atlanta Fed said recently. The stronger than expected economy was surprising to many, including the Fed. They were pleased that the sharp spike in inflation, earlier this year, has softened significantly from 9% plus back to around 4% to 5% recently. Still the Fed is maintaining their target of 2% inflation over the next year (by year-end 2024). Fed Chair Powell said they were going to maintain their posture by keeping rates higher for now, until they see a more sustained level of lower inflation.

While consumer spending is still an important catalyst for stronger economic growth, we would point out that an increasing amount of the recent stronger sales numbers are being financed on credit cards, as savings numbers have fallen off. So, if we are going to be in a "higher for longer" interest rate environment it suggests that those credit card balances will be going up along with the increase rates. Considered against the likelihood of higher levels of unemployment in a potential economic slowdown, this suggests higher default levels and more slowed economic demand.

We note that employment is still near cyclical highs but likely to decline somewhat against higher rates. The Fed is perhaps less inclined to cut rates until they see inflation continuing to fall and unemployment starting to go up. A recession or at least modest slowdown seems likely in the first half of 2024. It's not a done deal but it's not out of the question. Our economics team expects the GDP to fall back from the 5.5% (we note the number was reported as up 4.9% for 3Q- less than Fed expectations but still a good quarter) in this years' third quarter (to be reported on 10/26/23 at 8:30am) to about 1% by year-end 2024. We all remember what John Kenneth Galbraith said, "the only function of economic forecasting is to make astrology appear respectable." No offense to any astrologers out there.

The chart below provides a brief picture of various indices at the end of the quarter.

	3Q 2023 (%)	YTD 2023 (%)
Dow Jones Industrials	-2.10	2.73
Standard & Poor's 500	-3.27	13.07
NASDAQ Composite	-3.94	27.11
Russell 2000	-5.13	2.54
Russell MidCap	-4.68	3.91
Russell 1000 Growth	-3.13	24.98
Russell 1000 Value	-3.16	1.79
Barclays Capital Govt./Corp. Bond	-3.00	-0.85
Barclays Capital 5 Year Municipal Bond	-2.03	-0.86

Morningstar

You'll note that growth stocks have had a resurgence in '23. Last year growth stocks took it on the chin. For example, the Russell 1000 Growth index declined by 29.1% (Morningstar) while the Russell 1000 Value declined by "only" 7.5%.

This year the Russell 1000 Growth has advanced by 24.98%. The Russell 1000 Value increased an unimpressive 1.79%. We believe that has much to do with concerns about a possible recession. You'll see similar results in contrasting the Dow Jones Industrials versus the S&P 500. The industrials lagged behind the S&P 500 by 10.34% at quarter end, same reasoning.

The belief that the Fed may be getting closer to keeping rates unchanged at the next meeting with inflation levels declining are custom made for outperformance of growth stocks. And let's not forget that the AI stocks, the so called "magnificent seven," were the predominant stocks powering the S&P 500.They were dominating 30% of total S&P 500 capitalization according to Bank of America Global Research. For those who care, those companies were: Alphabet Google, Amazon, Apple, Meta Platforms (formerly Facebook), Microsoft, Nvidia and Tesla. Some of the small/mid-cap names underperformed their larger brethren (as seen above) as higher interest rates can have a dampening effect on their performance; the theory is that smaller companies may have a harder time raising capital either from bank loans or public offerings. Hence, liquidity in the markets is very important to small caps. It always makes sense to consider the balance sheets of small/mid-cap companies. Those with low or no debt will perform better because they aren't likely to have debt issues.

We believe that the AI inspired names will continue to garner attention. More broadly, the question remains, will the whole AI universe end up as the latest bubble in financial markets? Thus far, that's not been the case as many of the companies have strong balance sheets and decent earnings, so we're not talking about companies selling at 100x sales and earnings (as was the case in 2000-2001).

We want to address the somewhat unanimous view that you need to aggressively add fixed income to your portfolios. We've seen a lot of research currently authored by many analysts across Wall Street.

It's useful to refine the "hey, you just can't miss" mindset. Yes, there have been a lot of years when you were not paid for the potential risks of buying bonds aggressively, given that we were potentially at the end of the long secular decline in interest rates. If our memory serves, the cyclical peak in interest rates was in 1986 (August). It was the beginning of the long decline in the high mortgage rates that came out of the inflationary 1970's and the long cyclical decline in interest rates that ended last year (36 years later) when the Fed sharply raised rates in attempt to cut off another steep and damaging spike in inflation. Thus far, it appears to be working. But that steep increase in rates from near zero to 5 ¼% to 5 ½% was a real shocker to financial markets, given the speed with which it was executed.

It should be pointed out that the 36-year decline in rates from August 1986 until last year set off one of the most incredible bond market rallies in our lifetimes. Don't expect the decline in rates that may occur when the Fed finally cuts rates this time to have as dramatic an effect as the above referenced 36-year period. Rates may drop by a few percentage points. Government Bond yields in the 1980's peaked in the high teens and fell to low single digits. A drop of 2-3% seems more likely this time around.

The 10-year Treasury is currently yielding 4.845%. And during last week it touched just over 5%. On August 4th of 2021, the 10 year was trading at 1.217%. A year earlier it traded around 76 basis points. On a short-term basis this sharp move in the 10-year Treasury has been reflected across many fixed income markets. Even municipal bonds have felt the pressure. All were subject to mark-to-the-market price declines that needed time to readjust to the new Fed environment.

What we are trying to convey here is that we generally agree that bonds at these levels can be an attractive addition to portfolios but not necessarily to buy and forget. Yes, you can just buy and hold to maturity, but there may be times when, for a number of reasons, you may wish to adjust your portfolio should market conditions dictate, or your needs change.

Consider municipals: there are 4.8%/4.9% current yields, Federally tax exempt, with average duration of around 4 years. The 4.8% translates to a taxable equivalent yield over 8.45% for those in the highest brackets. If you purchased a taxable corporate bond of say 8.45% and paid about 43% tax, you'd keep 57% of the 8.45% after taxes which would be around 4.7% - 4.8%. So, you should always look at what your after-tax yield is and compare it to tax advantaged municipals. This is just to illustrate a point. If you're putting bonds into an IRA, then the gross yield of 8.4% in corporate bond might be the better choice to a municipal because the IRA already provides some shelter from tax on a current basis. There are other factors, but we're not going into those in this space.

Back to questions on buying bonds here. They certainly can add value to your portfolio but should be considered too relative to your total portfolio. Don't forget, if the Fed decides they're not going to cut rates but increases them further it would put downside pressure on your bond values for the short term. So, when constructing the bond portion of your portfolio, you should consider whether you may need cash in the next few years beyond the cashflow generated by the bonds. If so, you may want to make sure that potential cash needs are provided for in your planning.

Ok, enough of that for now.

We have always stressed the importance of maintaining a balance in your portfolio, inclusive of equities and alternative investments.

In this environment, quality dividend paying stocks and fixed income securities make sense. Interest payments on bonds will stay static until they mature but well-chosen dividend paying equities will continue to increase the dividends into the future which builds future value into your portfolio. Keep in mind too that dividend payments generally increase annually by about 7%, often in keeping earnings growth assumptions.

ECONOMIC GROWTH GLOBALLY EXPECTED TO BE MODERATE

UBS forecasts anticipate that inflation will show moderation from 2022 though 2024. The Eurozone specifically is forecasted to decline from 8.4% in 2022 to 2.4% in '24.

The US forecast calls for a decline from 8% in '22 to 4.2% and 2.4% in '23 and '24 respectively.

The World Real GDP is being forecast 3.4%, 3% and 2.6% for 2022, 2023 and 2024.

Real GDP in the US '22 through '24 is currently forecast at 1.9%, 2.4% and 1%.

It is not anticipated that world growth will be a barn burner nor is inflation seen as increasing from current levels. Real GDP is seen approaching 0.6% (Eurozone) and 1% (US) by 2024. A bit of a ho hummer but for investors it's a positive, benign environment through 2024 for equity markets.

Granted, geopolitical issues such as conflicts in Israel/Gaza or Ukraine could develop more negative aspects than currently. If peace could be negotiated in these regions, though not currently foreseen, it could have a dramatic effect on global markets.

Oil issues could continue to put pricing pressure on consumer inflation levels causing a bleed through into related commodities, although analysts do not see that as a high likelihood.

Other unforeseen flash points could develop between China and Taiwan. North Korea similarly could also provide a source of angst for some global players. It's always important to reflect on the possibility that current market prices may have already, to a large degree discounted, potential developments.

Strategists expect to see decent earnings growth and lower inflation levels. And at this point, they are not calling for a recession.

David Lefkowitz, one of seven strategists (and one of our favorites), has been quite good on his forecasts over the years. Okay, he's not flawless. We're still looking for someone who is. However, he is a very bright, thoughtful guy who is not afraid to go against consensus thinking.

As David presented earlier this past summer, only in hindsight will we know if this has simply been a bear market rally or the end of the bear market. Since World War II there have been "four instances of gains of more than 20% within a bear market but with what one can see presently, it appears with the S&P more than 20% above its closing price low of last October, that we are in a bull market," says David. A market that rallies above 20% historically is deemed to be a prerequisite for a bull market. That doesn't mean that we won't be subject to occasional down drafts, such as currently.

Yes, equities are not cheap at 4224 (current closing S&P 500 price) and $226 in S&P 500 operating earnings. That's just a shade over 19x earnings. That is less expensive than 20.5x earnings seen a couple of months ago. So, not cheap, but less expensive and earnings forecasts are still rising.

If the low achieved last October was a bear market bottom, it would have been accomplished at the highest multiple in the last 60 years according to David. Wow!

Further the strategy folks estimate that the S&P target for June of 2024 is 4500 and 4700 December 2024. That would be approximately a 14% gain between now and next December should that forecast prove out. These objectives are discussed in our US equities publication of October 3, 2023.

Changing gears briefly, we want to point out that the Eurozone, as mentioned in our past letters, is selling at a14x multiple (on cash earnings). Additionally, regulators in the Eurozone have several times mentioned in the popular press and in various televised media, that banks in the Eurozone, are being encouraged to build their loan books back following COVID and the difficult environment. As we all know, bank loans are an important part of encouraging business investments (CAPEX) and M&A activity. That would suggest that these catalysts, should they come to fruition, may provide an incentive for cashflows to be directed to euro-based equities by global investors. It can increase risk appetites.

The other message is, as always, maintain your balanced portfolios to help reduce portfolio volatility. The short-term yields of between 4 ½% - 5 ½% are worth adding to portfolios at this point. They provide a reasonable place to hold cash.

Also, dividend paying equities as mentioned before should be considered. Those stocks were hampered earlier this year as utility stocks pulled back but are now at more reasonable values.

Additionally, because of the concerns many executives had over a possible recession, they reduced their expected dividend increases from the usual 7 ½% to 8% increase, to around 4 ½%. It is expected that dividend payouts will likely move back up to 7 ½% to 8% over the next couple years. The payout ratio of dividends to earnings is currently about 30%. That is, 30% of earnings are paid out to shareholders, The range, over the last 20 years, has been from around 27% to 42%.

Some corporate bonds or municipals should be considered along with some of the higher quality high-yield bond portfolios as these levels. We are referring to the high-yield bonds just below investment grade. Many of you have owned them over recent years—often through managers like Seix. It’s an area where you want to have demonstrated successful specialists running that part of your portfolio. And don’t forget, equities earnings growth is still expected to be in the 7% area over the years ahead according to our capital market assumption.

As we approach the holiday season, we wish you all great health, happiness and higher markets.

We remind you again, that our office is moving to the top floor (Floor 35) at the One Post Office Square building on the 27th of October.

Thank you, as always, for the confidence that you have placed in our team, it means a great deal to all of us. Part of the joy of this business is to get to know and work with great people like you.

Be well!

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