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INVESTMENT COMMENTARY & OUTLOOK

July 2023

The breadth and power of the overall stock market improved notably in the second quarter. At the end of April, only eight NASDAQ stocks accounted for virtually all the S&P 500's year-to-date return. At the end of May, twenty stocks accounted for virtually all the S&P 500's year-to-date return as breadth and power improved. Then the annual June Russell reconstitution caused many small cap stocks to surge as liquidity improved.

The NASDAQ 100 (NDX) recently reduced the weight of its seven largest stocks by market capitalization and the other 93 stocks in the NDX index were the beneficiaries. The bottom line is the breadth and power of the overall stock market continues to improve as investor confidence and economic growth persists. The Fed signaled in its FOMC statement that it is effectively done raising key interest rates as inflation cools and as Treasury yields settle down.

We are now in the midst of the second-quarter earnings announcement season. Already many of our portfolios are exhibiting relative strength, which is a sign that money is gravitating to those companies that will post the strongest quarterly results and guidance. We are in the midst of a "rolling recovery" as our favorite economist, Ed Yardeni, likes to say. There are essentially four improving industry sectors where we can find stocks, namely (1) semi-conductors/cloud computing, (2) oil refining/integrated energy, (3) consumer discretionary, and (4) homebuilding.

There is no doubt that the AI craze is very viable in the wake of Nvidia and Super Micro Computer's positive guidance. The only glitch is the Biden Administration wants to restrict China's access to AI via cloud computing, but we suspect that will fail, since China is pretty good at outsmarting its trading partners.

The recent boom in energy stocks is due largely to margin expansion. The refiners are benefitting from high seasonal demand and wide crack spreads. In the meantime, integrated energy companies have boosted their production and no longer need high crude oil prices to improve their earnings. Finally, Russia remains a wildcard in the world energy market and it is widely perceived that their production will systematically decline when winter arrives.

As far as the consumer is concerned, we just have to follow where they are spending money, which lately seems to be home improvement, restaurants, travel, and entertainment. The service sector is responsible for virtually all the economic growth in the U.S., since the manufacturing sector is sputtering.

Finally, the homebuilding sector remains strong due to the fact that the inventory of existing homes remains suppressed, since homeowners with low mortgage rates are reluctant to sell. As a result, homebuilders have to build more homes to meet demand in growing areas. We should add that due to cooling inflation, mortgage rates are anticipated to continue declining in the upcoming weeks.

There is actually deflation on the wholesale level now, since the price of goods has fallen 4.4% in the past 12 months. Furthermore, the amount of goods that the U.S. imports from Asia has fallen dramatically in the past year, since consumers are spending less on goods.

Yet, there is unrest in the labor market, since the United Auto Workers (UAW) are gearing up to go on strike in the upcoming weeks. The timing is good for the UAW to influence a coalition government, since auto manufacturing plants are often retooled in August, plus there is a growing glut of vehicles on dealer lots, especially EVs. The UAW wants to get rid of a tiered wage system and have equal pay for all its workers. Furthermore, UAW President Shawn Fain said, "Well, I think they're doing layoffs under the guise of the EV transition." Fain added, "It's shameful to me, because as I've said before, these companies talk about transition to EVs and they talk about workers and call them family. I don't know how their family works, but my family don't roll that way."

Interestingly, the UAW has not endorsed President Biden for his re-election, since many UAW members expect to lose their jobs due to the transition to EVs, since EVs require far fewer components than vehicles with internal combustion engines. Obviously, this UAW dilemma many become a growing problem for President Biden, since he is a pro-union President. However, as Tesla (a non-union company) becomes more dominant, while Ford loses EV market share after slipping from #2 to #5 in the U.S. in EV sales in the past year, this falling market share is making many UAW workers very nervous. GM is now #3 in EV sales in the U.S. this year after Tesla and Hyundai/Kia, but GM will shut down its Bolt EV production at its Orion Assembly Plant in Michigan and start selling its Equinox EV that will be made in the San Luis Potosi Assembly Plant in Mexico. Although the Orion Assembly Plant in Michigan will be retooled to start building the Chevy Silverado and GMC Sierra EVs, many UAW workers remain uneasy as the inventory of EVs continues to rise on dealer lots. The fact that EVs are not profitable for the Big 3, especially Ford, if EVs eventually succeed like President Biden wants, more EV manufacturing will likely be moved to Mexico to save costs at the expense of thousands of UAW jobs.

Ford slashed the price of its F-150 Lightning recently by as much as 16.6% on some models to get ready to compete with the Tesla Cybertruck that according to Elon Musk is designed for the "zombie apocalypse." Currently, there is an 88-day supply of the F-150 Lightning, so Ford has to discount these EVs anyway to clear its existing inventory. Ford is very serious about electrification, and the F-150 Lightning should be one of the best-selling EV trucks. It will be interesting to see when Ford will break even on EVs. Since the F-150 is the best-selling truck in America, we suspect the F-150 Lightning will eventually be profitable.

Tesla announced its second-quarter results and its sales, earnings, and operating margins were all impressive. However, Elon Musk cautioned investors that further price cuts might be necessary, despite price cuts of 14% to 28% this year on its EVs. Furthermore, Musk said that Tesla would scale back its production in the third quarter to update its factories. Finally, Musk said that Tesla is investing heavily into supercomputers to develop autonomous driving based on all the data that its cars collect on the road. Musk's comments about Tesla's autonomous driving development apparently hurt the stock, since the company abandoned lidar systems to see animals and people to avoid collisions. No matter how much data Tesla has, a lidar system is superior to Tesla's camera system to protect occupants from hitting deer, pedestrians, etc.

Finally, auto repositions are rising, so used car prices will likely be falling as these vehicles are resold. There is no doubt that consumers remain pinched, since credit card debt continues to rise, which is causing banks to increase their loan loss reserves. Typically, credit card companies expect a 1.5% default rate on credit card debt, but based on new higher loan loss reserves, banks seem to be anticipating a 3% or higher default rate.

We should add that consumers are even more grumpy in Europe, due largely to inflation from green policies, so right wing parties are rising. Spain just elected a far-right party to lead a coalition government for the first time since the Franco dictatorship ended in 1975. Italy is led by an anti-immigration and pro traditional family Prime Minister, Giorgia Meloni that has widely rejected many European Union (EU) reforms. In Germany, the support for the far-right Alternative for Germany (AfG) is now at a record 22% and undermining Chancellor Olaf Scholz's ruling coalition of three parties. Growing discontent over issues ranging from record immigration, persistently high inflation, and costly climate-protection measures has fueled the rise of AfG. The movement in Germany is similar to the rise of the BoerBurgerBeweging (BBB) in the Netherlands, which is a farmer-citizen movement that won 15 of the 75 seats in the Senate back in March and is now blocking legislation to seize more farmland, since the Netherlands was striving to have 30% of its land in a "natural state" to comply with EU's climate goals. The bottom line is going green is expensive, which causes higher prices for food and electricity, so big groundswell revolts are under way within Europe.

In preparation for the upcoming G20 meeting, several countries, led by Saudi Arabia, rejected the G20's goals for reducing fossil fuels. The U.S. recently dispatched John Kerry to China to attempt to restart climate negotiations. After Nancy Pelosi's visit to Taiwan, China cut off any climate talks. Since China dominates the production of solar panels, lithium batteries, and electric vehicles (EVs), it is profiting from the green agenda, even though it is not following it and still building coal-fired power plants. John Kerry's main goal was to convince China to transition away from coal for electricity generation, but he had virtually no success. India is also pro-coal, like China, and has no intention of complying with any green agenda. Specifically, India's minister of power, RK Singh, acknowledged that the reduction of fossil fuels production was a "sticking point." Finally, Japan is striving to blend ammonia with coal, so it burns cleaner, and is obviously reluctant to shut down its coal plants that generate approximately a third of its electricity. As a result, there will be no updated green energy mandate at the upcoming G20 meeting.

Obviously, our energy stocks are benefitting from rising global demand for fossil fuels from emerging markets, as well as strong seasonal demand in the U.S. Furthermore, the chaos in Russia makes them an unreliable source for crude oil, despite the fact that Russia is currently producing more crude oil than Saudi Arabia after its two million barrel per day cut. Western sanctions and harsh winter weather are anticipated to continue to curtail Russia crude oil production long-term.

Our energy stocks have also been aided by the tension in the Middle East as Iran continues to hijack ships. As a result, the U.S. Navy dispatched two amphibious warships and thousands of Marines to the Middle East to counter Iranian threats. China imported 11.4 million barrels of crude oil per day in the first six months of this year, which is 11.7% higher than a year ago. Interestingly, 2.13 million barrels per day of crude oil came from Russia, and China has boosted its stockpile of crude oil to take advantage of cheaper Russian crude oil. Overall, due to China stockpiling crude oil and the tension in key crude oil shipping lanes, like the Strait of Hormuz and Gulf of Oman, crude oil prices may continue to meander steadily higher.

Russia recently announced it is pulling out of the international agreement that allows Ukraine to export much of its Black Sea grain, which will raise concerns about global food supplies. Specifically, Russia said that it would rejoin this export agreement if Western nations allow Russia to export its own grain and fertilizers. Russia also recently seized the operations of Carlsberg and Danone and is becoming increasingly hostile to the West. Carlsberg has eight breweries with 8,400 employees in Russia, while Danone is the largest dairy company in Russia.

The bridge linking Russia to the Crimean Peninsula was attacked again and Russia is blaming Ukrainian forces that used naval drones to attack the bridge. This bridge collapse will hinder Russia supplying its troops in southern Ukraine. Previously a dam break in Ukraine also cut Crimea off from its fresh water source. Finally, an oil depot in Crimea was blown up by Ukraine to further isolate the peninsula. It is becoming increasingly hard for Russia to supply Crimea, so its residents are becoming more restless.

Clearly, the world is a confusing place. The green agenda and the chaos in Ukraine are causing global food prices to rise. Energy prices are expected to remain firm, simply because there are too many global uncertainties. In the U.S., we are fortunate to be food and energy independent. However, many workers are upset that their wages are not keeping pace with inflation, like UPS workers. Furthermore, the UAW is worried about losing their jobs due to the transition to EVs as GM and Ford move their EV production to Mexico, so they are not endorsing President Biden's re-election yet.

Amidst all this chaos, an investor's best defense is a strong offense of fundamentally superior stocks. Our average stock is characterized by strong average annual sales growth and thanks to margin expansion, even stronger average annual earnings growth. Additionally, the analyst community has revised their consensus earnings estimate up higher in the past three months, which are all characterized by positive earnings surprises. So, we expect it to be every stock for itself during the second-quarter announcement season and our dividend and growth portfolios should continue to lead the way.

SUMMARY

Our fundamentally superior stocks are "locked and loaded" for another quarterly announcement season. Our dividend and growth stocks are increasingly breaking out as market leaders. The bottom line is the breadth and power of the overall stock market continues to improve as investor confidence and economic growth persists.

We are effectively in a "rolling recovery" thanks to Baby Boomers with cash to spend. Specifically, economic growth has picked up due to an improving service sector as well as strong consumer confidence. So all that can go wrong is if the Fed continues to raise key interest rates, despite ample evidence of inflation cooling. However, we are more confident than ever that the Fed has decisively hit the "pause button" after its latest FOMC statement.

It is very unfortunate that the Fed relied on lagging economic data that is tainted by wild seasonal adjustments as well as seemingly endless revisions. The good news is the Fed likes to stay out of the political spotlight, so we expect that they will commence cutting key interest rates in December and continue to cut in the first half of 2024 to stimulate overall economic growth.

This is a good time to remind you that the third year of a Presidential election term, namely 2023, is the best performing year in the four-year Presidential election cycle. The fourth year, namely 2024, is traditionally the second-best performing year in the four-year Presidential election cycle. The Presidential debates will commence soon and although the two oldest candidates do not seem to want to participate, they will probably be forced to debate sooner or later. The candidates with the most inspirational messages are expected to break out as the leaders.

So, we want to assure you that everything is about to get better. The Fed will no longer be raising key interest rates. The Consumer Price Index (CPI) and Producer Price Index (PPI) recently proved that inflation has cooled immensely. Corporate earnings are forecasted to improve steadily for the next four quarters. There are at least four improving industry sectors where we can find strong stocks to buy. Although we are in a rolling recovery, more sectors are now participating. What makes America great is that our states are great economic laboratories, so even if NYC wants to kill one of its most famous industries, namely pizza, other states will succeed and prosper.

Our best defense remains a strong offense of fundamentally superior dividend and growth stocks. We are more confident than ever after our dividend and growth portfolios demonstrated relative strength. This is a good omen that money is moving around and gravitating to stocks that are prospering in the current economic environment. We are immensely proud and we believe that our dividend and growth stocks represent a "silver lining" and critical path as we strive for all investors to prosper!

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