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INVESTMENT COMMENTARY & OUTLOOK

October 2023

The good news is that we survived September and the threat of a federal government shutdown. The bad news is that we started October with surging Treasury bond yields, so concerns over out-of-control federal spending persist. The federal debt ceiling was lifted with a 45-day funding plan, and when it has to be renewed in November, it should pass, since Congressional members like to go home for Thanksgiving.

The public fascination with government bond yields has gone viral. For example, Treasury bonds were recently #2 in Google's search engine, behind only the Taylor Swift/Travis Kelce relationship. This is undoubtedly undermining confidence in the federal government, since there is a perception that many things are out of control, including the southern border, which caused former President Bill Clinton to say that work restrictions on illegal immigrants make no sense. The U.S. budget deficit is also running out of control, due to many factors, like the ongoing aid to Ukraine, which is funding a proxy war with Russia.

Treasury bond yields have moderated somewhat in October, despite disappointing inflation data for both the Consumer Price Index and Producer Price Index in September. Furthermore, the Federal Open Market Committee (FOMC) minutes revealed that many Fed voting members were definitely hawkish, because these minutes said the Fed will keep key interest rates high for the foreseeable future. Specifically, the FOMC minutes said that public communications "should shift from how high to raise the policy rate, to how long to hold the policy rate at restrictive levels." As a result of these FOMC minutes, as well as the September inflation results, a Fed rate cut at its December FOMC meeting now seems to be off the table.

We feel that the Fed will have to cut key interest rates in early 2024, otherwise the risk of a recession increases. The Fed does not want to be part of the political debate in a Presidential election year, so they will likely cut rates to avoid causing a recession.

As Israel experiences its own version of 9/11, a new war in the Middle East seems to be continuing and escalating. Already, Hezbollah launched rockets into Israel after Hamas's surprise attack. A spokesman for Hamas, Ghazi Hamad, told the BBC that Hamas received support from Iran for its surprise attack. The catalyst for Iran instigating Hamas to invade Israel was likely the pending Israel/Saudi Arabian peace agreement, which infuriated Iran, so it will be interesting to see if the fighting in the Middle East spreads beyond the Israeli conflict with Hamas and Hezbollah, both of which are funded by Iran.

Essentially, the U.S. now has two wars to fund, namely the proxy war against Russia via Ukraine and Israel's counter-offensive to oust Hamas. Meanwhile, the U.S. government lacked a House Speaker for a while, so the government could not authorize spending, but a new Speaker should fix that. Since the USS Gerald Ford aircraft carrier and multiple support ships have been diverted to Israel, it will be interesting to see if the U.S. gets involved, since at least 25 Americans were killed by Hamas and some hostages may be Americans. Israel has never asked for the U.S. to intervene in its military fights, but if there is ever a time for the U.S. to help Israel, now may be such a time, especially for military and logistics aid.

Of all our portfolios, the ones that should benefit most from the Israel offensive would be those in our dividend growth portfolios, which hold (1) defense stocks, (2) energy stocks and (3) those that benefit from moderating bond yields. Previously, higher bond yields impeded many dividend growth stocks this year, but now that there is a "crack" in long-term bond yields, yield-sensitive investments are resurging.

Amazingly, the Atlanta Fed is now estimating 5.1% for annualized GDP growth in the third quarter, which is well above most private economists' estimates of 1.5% to 3.9% annual GDP growth. The primary reason that GDP growth is strong when consumer spending is slowing is due largely to rising energy exports and a shrinking trade deficit.

If you want to see a preview of what might be happening to U.S. Treasury bonds, just look at Italy. Prime Minister Giorgia

Meloni is now struggling with a shrinking economy. Her attempt to tax banks with a windfall profit tax was not well received by Italy's powerful business community. As a result, as confidence in Meloni ebbs, Italian bond yields are rising. Of course, chaos is normal in Italy, which is why they have so many prime ministers. Prime Minister Meloni was elected in a populist movement that wanted to push back on some EU reforms, so she may stay in power, since she defends Italian culture.

There was also a recent shake-up in Germany's regional elections, where the center-right Christian Democratic Union won 34.6% of the vote in the central state of Hesse and 37% in Bavaria, in the south. However, the Alternative for Germany, which is a far-right, anti-immigration party, had a strong showing and was second with 18.4% of the vote in Hesse and 14.6% in Bavaria, so between the Christian Democratic Union and Alternative for Germany, there is over 50% majority to make a ruling coalition.

Chancellor Olaf Scholz's STD party took third in Hesse with just 15.1% of the vote and an even more pathetic fifth place in Bavaria, with just 8.4% of the vote. As a result, climate goals may be scaled back to save key industries in Hesse and Bavaria. Additionally, immigration standards may also be tightened.

Bond markets tend to punish countries with large budget deficits and leadership that seems to be cast adrift. That is where we are in America, as well as some nations in Europe. The Wall Street Journal recently had a great article entitled, "Rising Interest Rates Mean Deficits Finally Matter." They made the point that it is very odd for Treasury bond yields to rise when inflation is moderating and the economy is still growing. The cause of rising yields, they said, is rising debt service more than rising inflation.

The good news is no matter how dysfunctional the federal government is, what makes America great is that our states like to compete with each other. Each state is a unique economic laboratory. Since Americans are mobile and willing to move, the states with the most pro-economic policies are prospering, so despite the chaos in Washington, the dollar remains strong, which helps push down prices on imports. This deflationary pressure is most obvious in the price of wholesale goods in the Producers Price Index.

October is a seasonally strong month, and November is even stronger. A strong U.S. dollar may hinder the earnings of some multi-national stocks, which should help trigger a shift to more domestic, small-to mid-capitalization stocks. Regardless, the seasonally strong time of year has arrived and an "early January effect" should follow. We are expecting seasonal strength for small-to mid-capitalization stocks that should persist through May. We also want to point out that forecasted earnings are expected to steadily improve for the next four quarters, due to easier year-over-year comparisons, especially for energy stocks.

Leading the earnings surge for the next few quarters will be energy stocks, now that crude oil inventories are at the lowest level in 14 months, crude oil prices are at the highest level this year and natural gas prices are rising in anticipation of a start to seasonally cold weather. Specifically, natural gas prices perform well in hot, miserable summers (for peaker power plants) and very cold winters (for heating).

This winter is forecasted to be much colder for both Europe and North America due to an El Nino weather pattern, which bodes well for higher natural gas prices. Specifically, an El Nino weather pattern controls the flow of the sub-topical jet steam over the southern U.S. On the other hand, the real jet stream that emanates from the Arctic will be trapped by El Nino sub-tropical jet steam, so that means it will be cold for the Northern U.S., which is great for creating higher natural gas demand.

Mostly due to energy exports, the Commerce Department recently announced that the U.S. trade deficit declined 7.3% in August, since imports declined by 1.2%, to $253.1 billion, while exports surged 2.2%, to $168.8 billion. Clearly, higher energy prices are helping shrink the trade deficit and boost GDP growth.

There is a lot of labor unrest, as the UAW strike demonstrates. The UAW strike has now been expanded to include even more plants and workers. I would counsel UAW works to take as much money as possible now, since they may not have a job in the upcoming years if the Biden Administration continues with its EV mandate. It will be interesting to see how the negotiations end, but profit sharing from the Big 3 may be the only long-term solution. However, as China and Mexico increasingly dominate battery and EV production in North America, the Big 3 may soon have to make a Chinese alliance to stay competitive in EVs, just like VW Group recently paid $700 million for a 5% stake in China's XPeng Motors.

Ford recently announced the suspension of construction of its $3.5 billion electric battery plant in Michigan in conjunction with its joint venture with China's CATL. This plant was scheduled to open in three years and employ 2,500 workers. Ford said the suspension of this battery plant would remain in place until it was sure it could operate the plant competitively. This is obviously a blow to current UAW negotiations. The other factor that is likely weighing on Ford is that CATL is building excess capacity in China, so its battery plant in Michigan may not be able to compete with CATL's Chinese-made batteries.

Breaking China's dominance on EV supply chains is obviously proving to be very difficult. For example, China dominates anode and cathode components, as well as battery manufacturing. China is also dominant in everything from mining raw components and material processing. Both Europe and the U.S. are struggling to compete with China, which is apparently why Ford suspended its battery plant with CATL. GM is betting on South Korea's LG Energy Solutions, but has no plans to manufacture cheaper LFP batteries that China's CATL and BYD now dominate. Ironically, Ford had the right idea to team up with CATL, but the fact that its cannot be competitive with CATL's Chinese made batteries, bodes poorly for domestic transition to EVs, which candidate Trump highlighted in a recent speech in Michigan.

The latest gossip on the UAW negotiations form Autoline Daily is that Ford and GM are fed up with the UAW demands and President Sean Fain's antics and accusations. Furthermore, the UAW demand that Chinese (CATL) and South Korean (LG Energy Solutions) battery plants be unionized, even before they are staffed with workers, has become a stumbling point and may be illegal, since those unnamed workers have to vote to have UAW representation. As a result, the UAW strike may persist well into January.

Due to slowing worldwide economic growth, we expect inflation, excluding energy, to continue to ebb. Furthermore, due to the anticipation of 4% unemployment due to the expanding UAW (and other) strikes, we are anticipating that the Fed will cut key interest rates in early 2024. We are optimistic about the upcoming third-quarter earnings announcements. Looking further out, easier year-over-year comparisons should propel our dividend and growth stocks higher through next summer.

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 as the analyst community continues to revise their consensus earnings estimate higher.

President Biden will launch his re-election pitch during the Super Bowl game, but in my opinion, he is too old and fragile to mount an aggressive campaign. Former President Trump is also close to Biden in age but has enough energy to campaign and remains a formidable opponent, provided he is not derailed by seemingly endless legal charges. In fact, Trump has a 10% lead in recent polls.

The UAW is just one of many strikes that has rippled through the U.S. When workers are not happy, they want change, and nothing makes workers more upset than higher gasoline prices. When Californians see that it costs over $100 to fill up the gas tank of a small car, you know that California Governor Gavin Newsom is not the right person to replace Joe Biden, when California is leading a natural gas ban and an EV transformation that is not well received with the UAW and many folks in the heartland of America.

The bottom line is that for the next year, our political leaders will be promising everything and anything to get elected. Even though most promises will not come true, consumers like to hear the promises. Any progress on lowering key interest rates and inflation will be well received. The war in Ukraine remains a wildcard, but it is expected to help keep energy prices high for the foreseeable future. The Middle East is a tinder box again as Israel attempts to oust Hamas after suffering a brutal terrorist attack.

Despite all this chaos, things are about to get better. The holidays are a happy time of year and should help consumer sentiment. Since we have been in the midst of an uneven economic recovery that has left many folks behind, it is imperative that our elected leaders inspire us, and the Fed begin to reduce key interest rates and spread growth to more sectors. All these events should occur no later than in early 2024.

Much of the recent inflation is tied to higher energy prices. The rest of the world is struggling with higher food and energy prices, so economic growth is slowing outside of North America. The bottom line is the U.S. is an oasis and despite an 11-month manufacturing recession, the American consumer continues to propel the U.S. economy, plus surging energy exports.

Amidst all this uncertainty, an investor's best defense remains a strong offense of fundamentally superior stocks. The overall earnings environment is improving fast. We are also now in the strong time of year. Furthermore, November is even seasonally stronger, since Americans tend to be in a good mood as the holidays commence. We believe the Fed will cut rates by early 2024, so we expect a Happy New Year.

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