

Overall, A Healthy Economy

As 2023 comes to a close, the economy has continued to trend in a positive direction. The Federal Reserve's (The Fed) preferred inflation measure, Core PCE, fell to a 3.5% year-over-year rate. The unemployment rate has fallen to 3.7% compared to the historical average of 5.7%. Wages last month remain elevated, rising at a 4% annual rate.

Consumers are still pulling out their wallets and charging their credit cards. Accounting for two-thirds of the economy, consumer spending bolstered gross domestic product (GDP) with an impressive 5.2% increase last quarter, revised up from the previously reported 4.9% pace by the Commerce Department's Bureau of Economic Analysis (BEA). It was the fastest pace of expansion since the fourth quarter of 2021.

Will It Last?

Challenges remain: While inflation is currently decelerating, it remains elevated. Bringing it further down gets harder from here.

Consumer disposable income also is waning due to depleting pandemic savings. Credit card balances, interest rate payments and delinquencies are rising. Rents/home prices are still high. Housing sales are depressed due to higher interest rates. And, the Leading Economic Indicator Index (detailed in our last newsletter) remained in a steady decline at the end of October.

KEY DATES

- 1.1 New Year's Day
Stock Market Closed
- 1.5 Unemployment Report
- 1.11 December CPI
- 1.15 Martin Luther King Jr. Day
Stock Market Closed
- 1.26 GDP 4Q Advance Estimate
- 1.31 FOMC Press Conference
- 2.2 Unemployment Report
- 2.13 January CPI
- 2.19 Washington's Birthday
Stock Market Closed
- 2.23 GDP 4Q Second Estimate
- 3.8 Unemployment Report
- 3.12 February CPI
- 3.20 FOMC Press Conference
- 3.29 Good Friday
Stock Market Closed
- 3.30 GDP 4Q Third Estimate



Higher For Longer?

The Fed's most aggressive rate increasing episode appears to have come to a close. Many market participants believe The Fed will start cutting rates in early 2024. Forecast cuts range 0.75% to 2.0% by end of the year.

Unless the labor market goes into a tailspin, The Fed will not enact large rate cuts while inflation declines. Energy prices are the wild card. If they continue to weaken, inflation could moderate further leading to more dramatic interest rate cuts.

The more likely scenario for the coming year is The Fed cutting overnight interest rates slightly while continuing quantitative tightening (QT) for longer.

The Fed began shrinking its balance sheet (QT) in May 2022, removing money from the system to help combat inflation. It is not reinvesting some of its maturing U.S. Treasury bills/notes/bonds (USTs), thereby reducing its balance sheet by \$60 billion per month. The Treasury Department needs to issue bonds to pay back maturing debt and fund new government spending. The supply of treasuries issued will continue to grow. Meanwhile, the largest historic buyers of USTs (i.e., The Fed and several foreign central banks) are reducing purchases, thereby lowering the overall demand for USTs.

Who will buy the vast amounts of reissued government debt? Who will buy trillions of new government debt? In order to entice new buyers, expect long-term premiums and real interest rates to rise, albeit remain within their historical norm range of 3%-6%.

Are 5% Treasuries Worth It?

With overnight rates higher than they've been in 23 years, should one invest more in CDs, bonds...what Wall Street calls "fixed income?"

Let's look at this example:

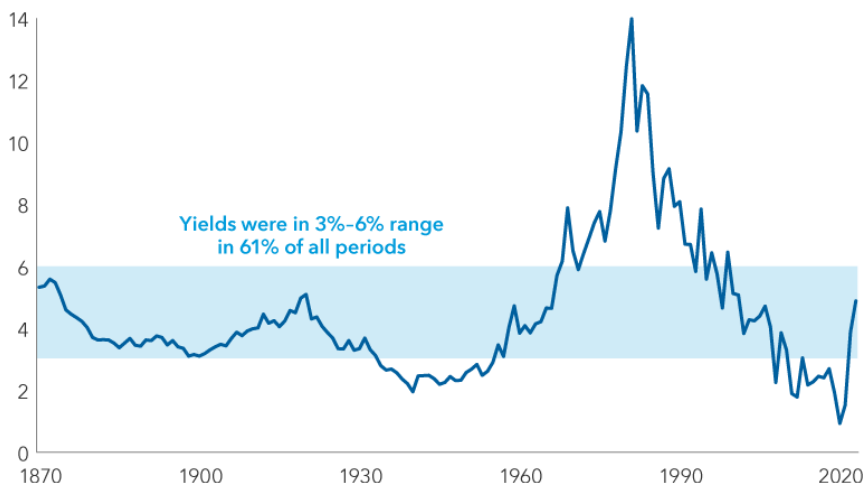
An investor buys long-term US Treasury bonds at 5%. Let's assume his/her investment is subject to the following:

- Federal income tax rate of 37%
- Distribution rate at 4% for annual RMD, mandated trust distribution, administrative fees and/or living expenses...
- Inflation rate at 3%

Here is the math. Taxes reduce the 5% bond coupon to 3.15%. Distributions lower the bond portfolio value to -0.85%, below the beginning of year value. Don't forget about the moderating inflation at 3%. In today's dollars, the year-end value of the 5% bond portfolio is actually -3.85%

Interest Rates Today Are Within The Range Of Historical Norms

U.S. long-term government bond yield (%)



SOURCES: Federal Reserve, Robert Shiller. Data for 1871–1961 represents average monthly U.S. long-term government bond yields compiled by Robert Shiller. Data for 1962–2022 represents 10-year Treasury yields, as of December 31 each year within the period.

Compound that -3.85% annual portfolio value change for 11 years and over one-third of the bond portfolio value is destroyed.

Which investment goals were met by this strategy when inflation is at 3% or higher?

Wealth preservation? No

Long-term growth? No

Rising cash income? No

Now, let's look at stocks. The 50 & 100-year annualized return of US large-cap stocks is about 10%. Theoretically, this doubles your investment every seven years.

Some categories have generated even better results over the last 50 & 100-year periods:

- Small-caps have generated better returns than mid-caps which, in turn, did better than large caps,
- Dividend growers bested dividend payers which did better than the overall universe, and
- Stocks with low entry valuations in aggregate generated better results than expensive stocks.

Fixed income plays a role at short duration levels. We find select "cash equivalent" and ultra-short bond funds to be attractive for goal-aligned wealth plans. But it's important to remember stocks have outperformed bonds 85% of the time on a rolling 10-years basis since 1950.¹

1. SOURCE: J.P Morgan

Top-Heavy Market Risk

The S&P 500 remains heavily concentrated, even more than at the dot-com era peaks. By the end of November, the five largest companies in the S&P 500 accounted for 24% of the market capitalization of the index.

By mid-December, "Magnificent 7" companies — Apple, Meta, Microsoft, NVIDIA, Amazon, Alphabet and Tesla — accounted for a staggering 60% of the 500 stock index's year-to-date gain.

Looking at entry valuations today, large-cap stocks are overvalued and have plenty of room to fall. Some expensive tech leaders are reporting decelerating growth and lower order rates. Since entry prices matter, should one pay 30 times earnings for the largest holdings in the S&P 500?

Long-term Investment Principles

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What's your goal?

A. Wealth preservation

B. Long-term growth

C. Rising cash income

D. All of the above





Looking Ahead

Looking at CMC Cash Cow Model Portfolios, we estimate aggregate forward-year valuation multiples of 10-11 for our all-cap portfolios (Growth & Income, Dividend Appreciation, All-Cap Growth).

These portfolios contain attractive, niche leaders of all sizes (large-cap, mid & small-cap). They are a diverse, well-researched group of growing, profitable firms that generate excess cash. We expect long-term growth in earnings. Moreover, most, if not all, of these portfolio holdings pay dividends. Many of those dividend payors have a proven track-record of attractive, recurring dividend increases.

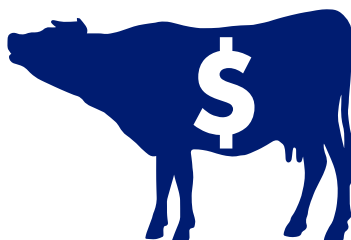
Our concentrated portfolios are focused on what we see as the best opportunities in diverse industries. For example:

- There's an undersupply of housing in the United States. It's why housing prices have remained high even with rising mortgage rates. Some holdings benefiting from this supply/demand dichotomy include Toll Brothers (luxury home builder), Lowe's and Carrier Global.
- The shift from bricks and mortar shopping to online commerce and advertising continues to grow. We own several leaders in this ecosystem such as UPS (more demand for shipping); Pitney Bowes (ecommerce logistics provider), Alphabet (Google advertising), Visa and MasterCard (online payment).
- Energy transformation to cleaner resources benefits our natural gas provider holdings: CNX Resources, ONEOK and Kinder Morgan. Two of our stocks are leading the way in the electrification industry. Livent is a large pure-play lithium (Li) miner & refiner for rechargeable batteries while Enersys (the only supplier of all mid-range industrial batteries) is a battery supplier and servicer for 5G transmission sites.
- Healthcare is undergoing a redefining transformation across many categories. We are excited for what the future holds for two of our stocks. Anika is introducing ground-breaking joint preservation and restoration products. Exelixis is innovating next-generation medicines and delivery regimens at the forefront of cancer care.

These examples and our other select opportunities are generating excess cash at attractive prices. They currently have higher potential than what we typically see.

In the short-term there always will be volatility. Long-term we expect to benefit from compounding returns. This not only protects wealth versus inflation, but also grows wealth over time.

We are excited about our portfolio and how we are positioned.



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CMC Cash Cow Model Portfolios

(As of September 30, 2023)

	<u>Forward PE</u>	<u>Dividend Yield</u>
Growth & Income	10	+5.1%
DVD (Dividend Appreciation)	11	+4.1%
All Cap	10	+2.7%
SMID (Small & Mid-Cap)	9	+2.8%



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