

FOCUS NEWSLETTER

A TIMELY UPDATE ON THE ECONOMY, FINANCIAL MARKETS AND INVESTMENT OPPORTUNITIES

SEPTEMBER 2023

A Resilient Economy

Generally speaking, the U.S. economy remains stronger than many predicted.

In aggregate, the U.S. consumer, representing roughly two-thirds of the economy, has kept its head above water. The unemployment rate remains near a 50-year low. Nominal wage growth is 3% above inflation, leading to robust consumer spending. Rising retail prices contributed to a better-than-expected July retail sales report. Albeit rising, consumer debt obligations remain relatively low. Corporate America provided positive impact, increasing investment in the second quarter at a 7.7% annualized rate.

These items, as well as increased government spending, contributed to an overall growing economy. Gross Domestic Product (GDP) came in at 2.0% in the first quarter of 2023 and 2.1% in the second quarter.

The Fed's Next Move?

Inflation peaked in June 2022 at 9.1% (a 40-year high). Most recently, the August 2023 reading on inflation was 3.7%. While much better than a year ago, inflation remains above the Federal Reserve's 2% target.

The Fed meets again on September 20 and November 1. It will assess the most recent inflation and employment trends in determining whether to increase overnight rates by another 0.25%.

Earlier this year many market participants forecasted the Fed to cut rates before year-end. We do not see that happening, nor do we expect cuts in early 2024. In fact, the Fed might increase overnight rates from the current 5.25% - 5.50% range to 5.50% - 5.75%.

KEY DATES

- 9.20 Federal Reserve Press Conference
- 10.6 Unemployment Report
- 10.12 September CPI
- 10.26 GDP 3Q Advance Estimate
- 11.1 Federal Reserve Press Conference
- 11.3 Unemployment Report
- 11.14 October CPI
- 11.23 Thanksgiving Day
Stock Market Closed
- 11.29 GDP 3Q Second Estimate



Warning Signs Still Ahead

Despite a resilient economy, a near-term recession remains possible for several reasons.

First, we haven't fully felt the impact of the Fed's tightening to date. The Fed raised interest rates 11 times in 17 months. It takes time for the ramifications of increased rates to work through the economy.

Second, inflation still persists in certain areas of the economy. As each of us purchase different baskets of goods and services (e.g., eggs, milk, gasoline versus fruit, cereal, fast food) we experience different inflation rates. The consumers feeling the most pain will cut their spending.

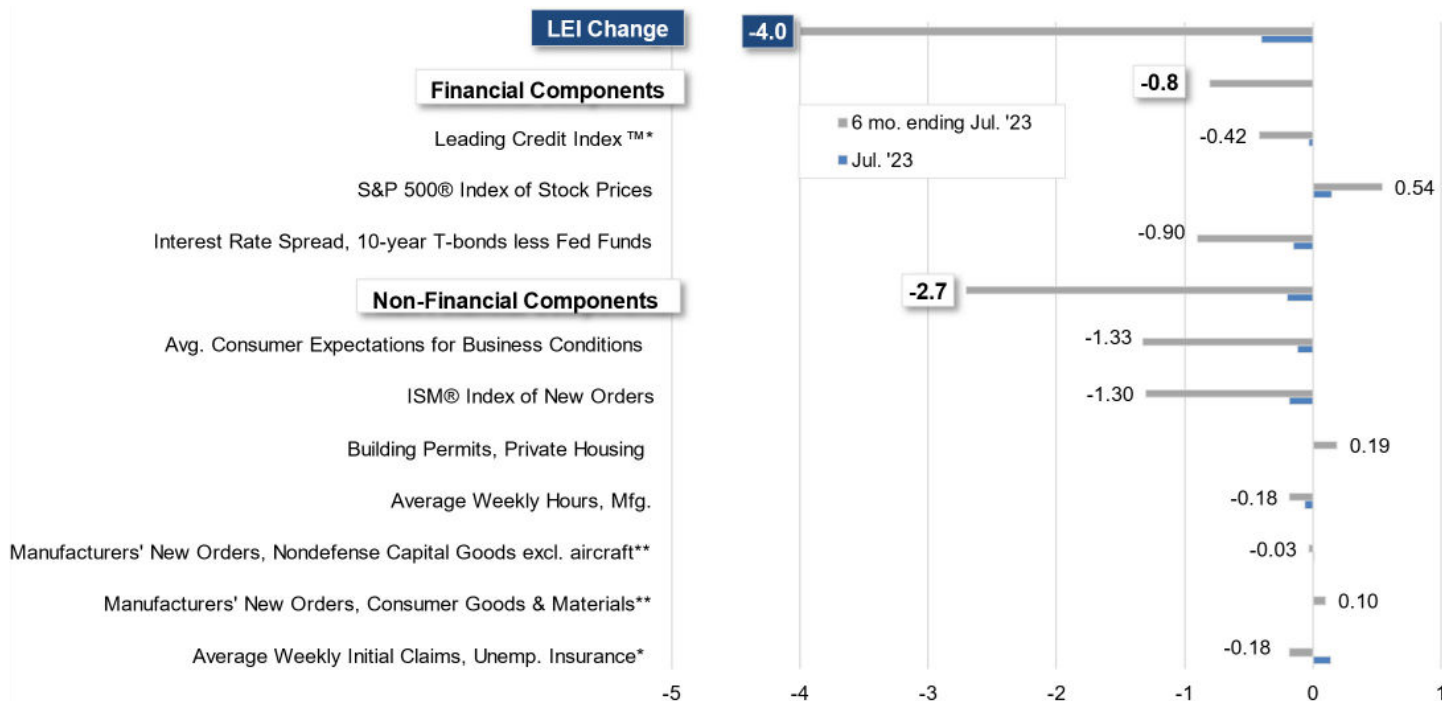
Third, the Fed intends to keep the overnight rate elevated to contain inflation. Continued high interest rates could weaken the economy and generate a downturn.

Fourth, the Leading Economic Index (LEI), an early indicator of the business cycle and economic direction, declined by 0.4% in July. This follows a decline of 0.7% in June.

The LEI tracks 10 forward-looking measures, including permits for future home construction, durable goods orders by manufacturers, jobless claims, etc. Seven out of 10 of the components were negative or neutral. Of the three positive measures, the S&P 500 index performance showed the largest gain.

Whether the economy just slows or enters a recession remains an open question. What is clear is a positive stock market year-to-date amidst a slow and possibly contracting economy.

The Conference Board Leading Economic Index® and Component Contributions (Percent)



SOURCE: The Conference Board

* Inverted series; a negative change in this component makes a positive contribution.

** Statistical Imputation

LEI change might not equal sum of its contributions due to application of trend adjustment factor

The AI Craze

After the first week of August, the top 10 stocks (including 7 mega-cap tech companies) represented over 30% of the S&P 500 index. These stocks had contributed 90% of the index's year-to-date gains.

Several factors supported these stocks' rise. The most obvious, and visceral influence is the "Artificial Intelligence" (AI) craze.

What started this craze is a what is called ChatGPT (generative AI). The technology identifies patterns and structures within existing data to generate new and original content such as videos, texts, articles, term papers, etc.

NVIDIA's CEO, the chip-making company that has benefited the most from this hype, claimed "a new computing era has begun." This is perhaps putting the horse before the cart since many businesses admit they haven't yet developed business models to generate new revenue streams around this technology.

AI has been around for a long time. We shared a cover story in Forbes about it. The publication date was 1988. So called "new" ideas or technologies that carry a lot of hype do not always turn out to be the best long-term investments. We've seen this FOMO (Fear Of Missing Out) behavior before in the late 90s and early 2000s with dot.com boom and devastating bust with vastly overvalued stocks.

AI may well be very valuable in the long term, but the value of the product is unlikely to be limited to just the technologies companies producing the AI. Other industries implementing AI to gain efficiency and other advantages will benefit as well. We believe in the promise of AI, but not at the hype level that is driving several stocks to excessive valuation levels.

Risks & Opportunities

If you read any investment article or report you are likely to see a disclaimer like this: *Past performance is no guarantee of future results.*

There's a good reason: it's true.

What is guaranteed is risk.

Corporate earnings growth has been mostly negative this year across the board. General stock performance has risen mainly due to companies beating low estimates. Mega and large-cap stock valuations are extraordinarily high and the Fed remains in restrictive mode. Their likelihood of cutting rates is slim at best.

History suggests current monetary policy and economic conditions do not warrant high mega and large-cap valuations. The largest components of the S&P 500 index are vulnerable for major disappointments.

Because the S&P 500 is market-capitalization weighted, more expensive stocks can represent a larger portion of the index.

Historically, large-cap stocks trade at lower valuation multiples than small and mid-cap indices. This is currently reversed.

S&P 500 Index Concentration



In aggregate, large-cap dividend yields tend to exceed the yields of small and mid-cap stocks. This historical trend is also currently reversed, partially due to some large and mega-cap valuations moving to lofty levels.

As mega-cap valuation multiples contract toward more normal levels, index returns should be subpar.

When one index is too expensive and not diversified, investors should redirect toward undervalued, growing, profitable, cash generating opportunities. We have meaningful exposure to many attractive sub-industries. We seek growing Cash Cows that are leaders of profitable niche industries with bright prospects.



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