Sound Income Strategies, Monthly Equity Update **September 30, 2023**

Monthly Maxims

"Though tempting, trying to time the market is a loser's game." – Peter Lynch

"It ain't what you don't know that gets you into trouble. It is what you know for sure that just ain't so." – Mark Twain

Executive Summary

Macro: The Fed's "higher for longer" rate outlook is driving a painful repricing of the yield curve, with rates rising across the middle and long end of the curve and credit spreads widening. This narrative is reducing expectations for short-end cuts and is putting more stress on the banking system and housing markets, which are two catalysts for economic growth. Wages, employment and consumption are generally growing, but slowing. Their general health has caused earnings and GDP estimates for 2023 and 2024 to move up slightly. However, in the Fed-fearing perversion of "good news is bad news," as soon as the positive data have emerged, the markets have sold off, fearing a more strident Fed, as its hawkish members are always quick to call for higher rates. Nonetheless, inflation, outside of the monetary variety caused by the Fed, and higher energy prices, is cooling, consistent with the post WWII period, which is the best historical precedent for today.

Outside of the US, stubborn inflation, war in Europe and economic softness in Europe & China are weighing on global demand. The uncertainty over Ukraine and Putin continue to escalate, as he is benefitting from oil riches and reaching out to source more weapons from North Korea and China, which could potentially embolden him, or all of the Communist nations, to push their luck further, with the US political situation in turmoil.

Markets: Markets fell sharply in September on higher interest rates and Fed recession fears. Only Energy stocks rose, due to foreign producer cutbacks and seasonal buying lifting prices.

Portfolios: Our portfolio returns were less negative than the S&P 500 in September, as some of the bigger tech names we don't own finally retreated. However, there weren't any magic formulas for yield investors to prosper in this sell-off -- except to think longer term and recognize that higher rates mean lower prices and better opportunities down the line. In Total Return Yield, we swapped the residual 1.3% of Hanesbrands into Levi Strauss & Company, which added yield, more reliable growth prospects and balance sheet safety.

Part I: Macro Market Factors and Thoughts

Another September Beat-Down is Thankfully Past

September has been statistically the worst month for US equity markets for the last 150 years, with a ~ (1.2%) return on average. February and May have been the other two loser months, but their losses have averaged < 20 bps, so their impacts have been lost in the wash, over the annuls of time. Historically, the US farm growing cycle played a roll in this seasonal "fall," but in modern times this end-of-summer swoon has generally has had to do more with anxieties over whether companies were still as confident in hitting their fourth quarter (biggest quarter of the year) results as they were in January or not. Also, the end of September is the beginning of portfolio clean-up season, as mutual fund's year ends typically conclude in October, so if there are losses to be harvested, or windows to be dressed, now is the time to get out before the rush sets in.

This time around, market got shallacked with a left, a right, another left, an uppercut, and a cross as the combination of higher oil prices, higher wages (amplified by the ongoing UAW strikes), the prospect for a Government shutdown, softening ISMs, weak retail sales, and higher borrowing costs all pummelled the top (earnings) line of the dividend discount model, while higher interest rates KOed the denominator -- because the Fed again said that the labor market is signalling that the fight against inflation is not done. In the end, every index fell and the only sector to rise was energy, which is benefitting from foreign production curtailments and the usual backwardation that occurs as the Northern Hemi-sphere starts to hedge its heating oil bets for the winter. Demand is still below pre-pandemic levels.

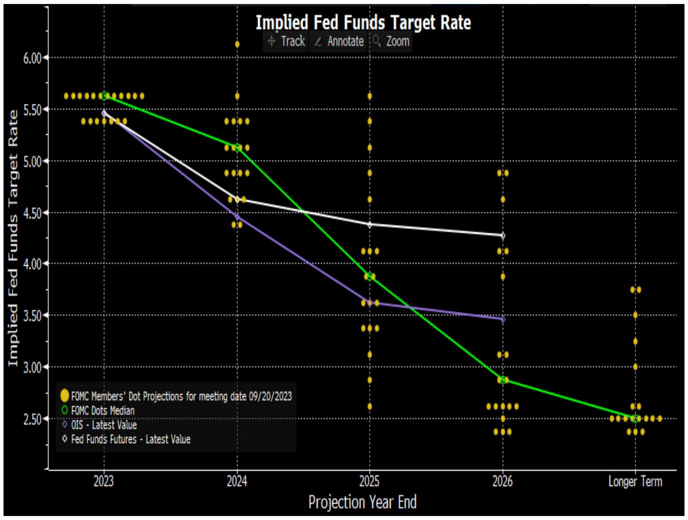
While all this anxiety has been bad news for US stock and bond investors in September, the good news is that we are now approaching the Santa Claus (rally) season, when stocks have historically taken flight as if with some magic corn, just like Santa's reindeer. After a sell-off running through mid October, stocks tend to rise as Q3 earnings come in and along with them guidance for the fourth quarter that is more often than not, better-than-feared. Also, with the window dressing out of the way by the end of October, all those names that no one wanted to own, suddenly become desireable at their over-sold valuations, so that beep-beep sound of long-only truck backing up to take them away tends to give the equity markets a goose in time for Thanksgiving and Christmas.

So, how good might the holiday season be this year? We clearly don't know, but according to Argus Research, Since 1980, the average quarterly returns for stocks have been 4.6% in Q4, which tops the 2.1% averge gain in Q1, the 2.9% average gain in Q2, and the skinny 0.3% average gain in Q. This data also refutes the old cliché' "sell in May and go away" and calls up the standard disclaimer, "past performance is not a guarantee for future results." Past performance however, is a fair starting point for making comparisons. This time around, we have a few trampling elephants in the room to consider too.

So, while the poop storm isn't quite over yet, as we enter October, we can lift our sagging heads a bit with this reckoning that we are about to pass into an historically joyful season for equity investors. After being punked by macro factors in Q3, we certainly deserve a little Holiday fiesta, no? By all accounts that historic playbook should still be effective this year, unless we get smacked with another negative surprise, like Russia attacking Estonia, China sacking Taiwan, Kamala Harris becoming President, etc.

Higher for Longer Spells Headwinds for Longer

On September 20th, Fed Chairman Jerome Powell got to show everyone who was boss of the economic world again, with his bearish pause and "higher for longer" rate guidance. While the Fed did not see enough evidence to raise the overnight rate another 25 bps this meeting, it is likely to do so next meeting, and that would likely be the last of the hikes, for now. But, the Fed was quick to emphasize that it expected interest rates to remain higher for longer than what was priced in the market, which then set off a dramatic repricing of global financial assets.



As the dot plot graphi above illustrates, the Fed's meeting and Board votes basically added 50 bps to rate expectations over the next three years at the short end. More impactfully, it has triggered a not-always-gradual roll up to higher rates for the 5, 10 and 30 year bonds, as the curve seeks to re-establish a positive slope, or forward carry. This raise in rate and rate expectations across the curve has been a headwind for the valuations of all risk assets, and even long term Treasuries, as the rise in the risk free rate makes riskier securities relatively less desirable.

Indeed, with JPM offering affluent clients 6% 1 year CDs, and other banks offering 5.5% for 6 month and 5.4% for one year contracts, many investors are asking, "why not park my incremental money in Treasuries or government insured CDs and wait until the uncertainty passes before taking market risks?" The answer is that by doing so, you will likely miss the market bottom and have chosen a lower (but not bad) return for lower risk. With many more potentially rewarding choices to make now that say in 2020 and 2021, when equities where out-yielding many bonds, all cash options and growing, clearly investors are going to shift some capital out of stocks and low grade bonds into Treasuries and cash.

Looking back 18 to 36 months ago, when CDs were only paying 50 bps to 1%, it seemed like the opportunity to be able to own a diversified portfolio of stocks like ours paying 5% that also grew their earnings in line with nominal GDP was like finding “free money”. People got the memo, and the money poured into the markets and chased that opportunity while it was the best game in town through 2022. As interest rates started rising and cash investments started paying rates above dividends, the relative attractiveness of stocks fell. On the one hand, stocks offer theoretically better long term growth, on the othe hand, growth expectations are falling, so investors question where the bottom of that trend might be. This barbell dichotomy, where we are the monkey in the middle, should diffuse once the Fed rate threating, or inflation risk, seem to be clearly off the table. We had thought that would be the case in Q4’23 all year, but maybe that has been extended until after the Fed’s December meeting, when a final rate hike seems all but certain.

Note: Fed Hiking Cycles come and go, but stocks typically have risen 100% of the time, one year after the Fed starts hiking rates, as shown below. However, it has been 18 months, and while the chart below shows that stocks have generally risen from the levels of the first hike, in the current case, as illustrated in the value versus growth pictures in Section II below, the market is still down – lucky us.

What Happens After the First Fed Rate Hike?

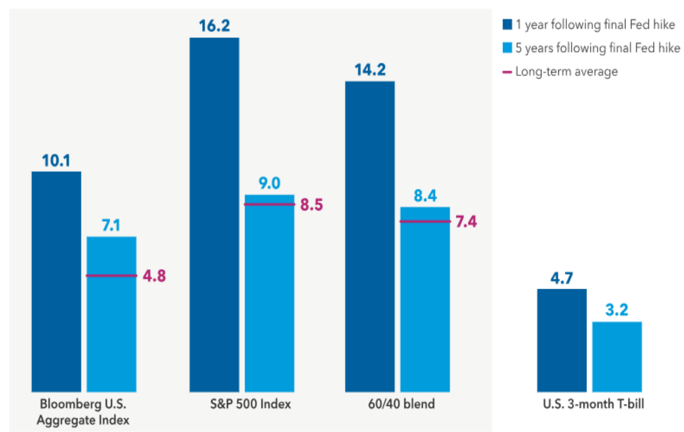
S&P 500 Index Future Returns

Date of First Hike	Next 3 Months	Next 6 Months	Next 12 Months
8/8/83	2.0%	-0.7%	2.1%
4/1/87	19.1	20.9	1.5
5/11/88	3.4	8.6	20.7
2/4/94	-5.9	-2.5	2.4
3/25/97	13.6	20.6	39.6
6/30/99	-7.6	6.6	6.0
6/30/04	-2.3	6.4	5.2
12/16/15	-1.1	0.1	9.1
Average	**2.7**	**7.5**	**10.8**
Median	**0.5**	**6.5**	**5.6**
% Positive	**50.0**	**75.0**	**100.0**

Source: LPL Research, Bloomberg

After Fed hikes ended, long-term results outpaced cash, with the first year contributing most

Results have been front-loaded following the final Federal Reserve hike in the last four cycles (%)



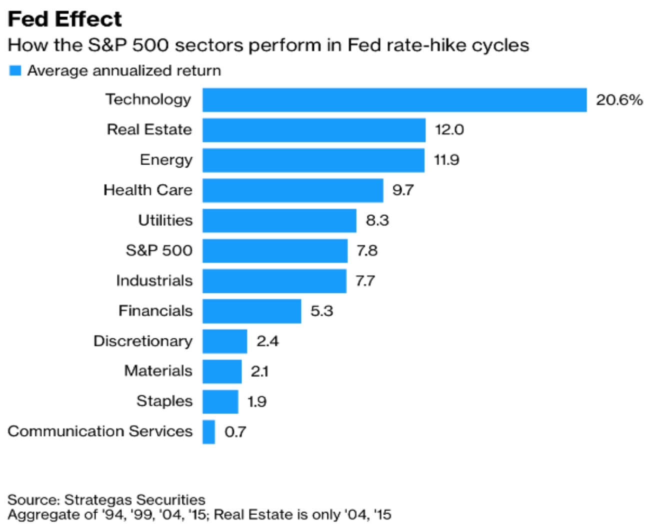
Sources: Capital Group, Morningstar. Chart represents the average returns across respective sector proxies in a forward extending window starting in the month of the last Fed hike in the last four transition cycles from 1995 to 2018 with data through 6/30/23. The 60/40 blend represents 60% S&P 500 Index and 40% Bloomberg U.S. Aggregate Index, rebalanced monthly. Long-term averages represented by the average five-year annualized rolling returns from 1995. Past results are not predictive of results in future periods.

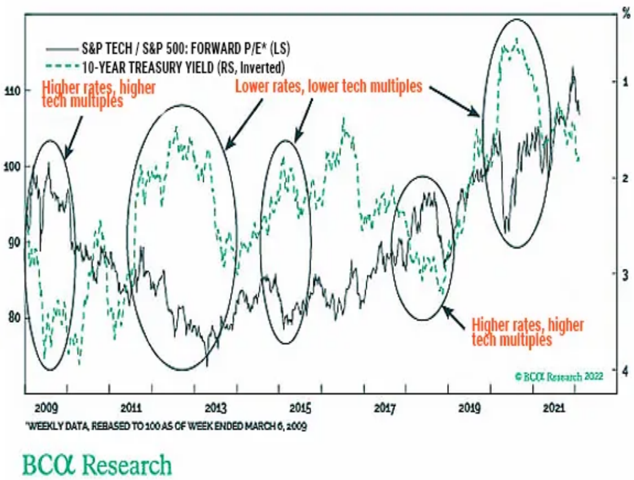
And predictably, this historical data shows that once the Fed is done, markets have quickly moved higher too. As illustrated in the Capital Market’s Group slide above (RHS), over the last four Fed cycles, that first year after the Fed was done, stocks racked up a 16% gain and bonds gathered 10%. This illustrates the risk in trying to step out of the markets to avoid the downside volatility. What often happens is you miss the upside spurt too and end up worse off than if you had stayed in the game. It echoes the more frequently cited historical data mine, “if you missed the 30 best days to be in the market over the last 50 years, you got only 25% of the return.” So, the bumps you get along the way, for those who can stay the course, have historically been rewarded by fat returns over time.

<u>Sometimes What We Think We Know Ain’t Quite So</u>

As we saw in 2022, when the Fed kicked off its 18 month long rate hiking escapade, technology stocks, which had the longest duration and the highest valuation multiples were the hardest hit. Adding to their rate sensitivity woes whas the fact that their earnings estimates needed trimming as pandemic order rates fell, once people got loaded up with the remote working doodads they needed, and orders shifted a bit back towards pre-pandemic levels. Well, dummies that we were, we felt that the duration math would lead to a more ongoing derating of the large cap technology names, even more so than the offsetting factor of the scarcity value of having secular growth at a time when growth was drying up.

Well, as the historical evidence illustrations below show, technology stocks have tended to benefit more from multiple expansion, due to the scarcity of growth during slowing times than they have been hurt by the dividend discount model duration math.

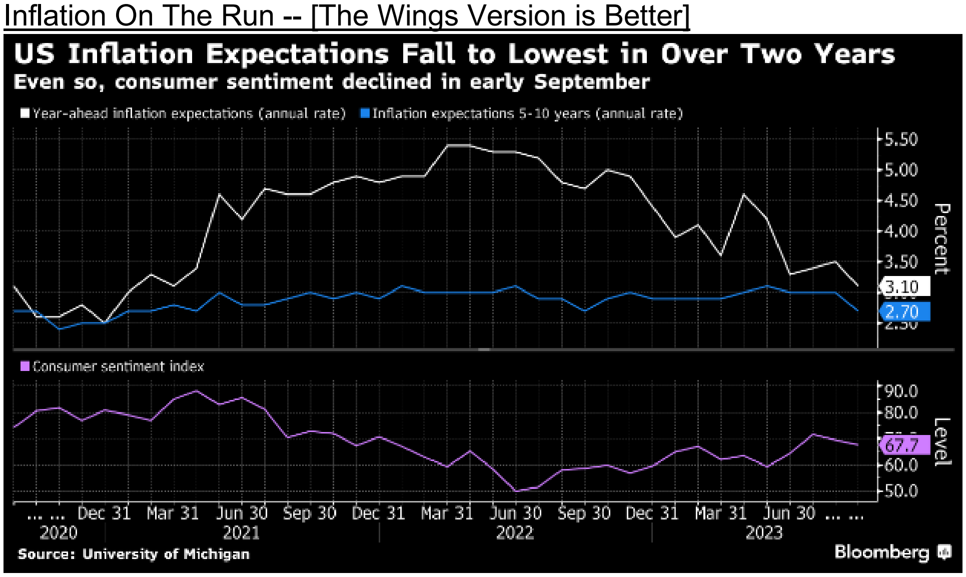




While this insight would not have lead us us to abandon our high dividend, value strategy for high multiple growth names, it would probably have motivated us to squeeze in another tech name.

Unfortunately, such historical guideliness are imperfect, as evidence by the fact that Energy, Heatlhcare and Utility names have historically out-performeds during Fed rate hike episodes, yet all three are lagging this time around, so far. In particular, the healthcare drag has really nicked our results, thanks to the President's actions to negotiate drug prices, more directly for the first time. Again, it is just as Mark Twain observed, "it's what you think you know that ain't so" that gets ya. So far, these latter three bets have not stuck to the historical script, and our odds-on bets have not panned out yet.

Inflation On The Run -- [The Wings Version is Better]

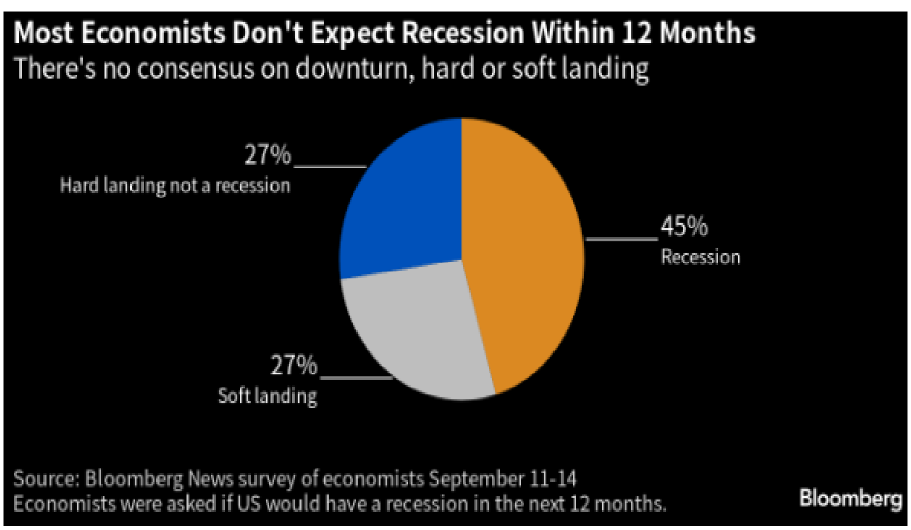


However, 30 Year Fixed Mortgage Rates Rose Nearly 1% to 7.5% in September!

And mortgage rates have more than doubled since the Fed started hiking (see below) Banks need to earn a spread somewhere, but unfortunately, rates at this level have housing affordability at its lowest level in four decades (according to Black Knight, a mortgage data provider) and that will have materially negative knock-on effects for both housing turnover, which is already at its lowest level since the rate hiking began, and all of the related demand items that are associated with people fixing up and moving their abodes, from carpeting, to housewares, to wood and copper. Similarly, home servicing contractors, such as painters, electricians, HVAC, etc. will also be hurt by the slowdown in activity.

Recession Expectations Have Fallen – Despite Rising Rate

We have been through the emotional ringer, with two years of recessionary forecasting, followed by roller coaster bouts of belief in a soft land ing or a "no landing" consenus, and only to now be in a confused room of economists babbling over some kind of landing, but not a recession. Yes, something will happen, but the professional talking heads don't seem to have any conviction whatsoever as to what it will be.

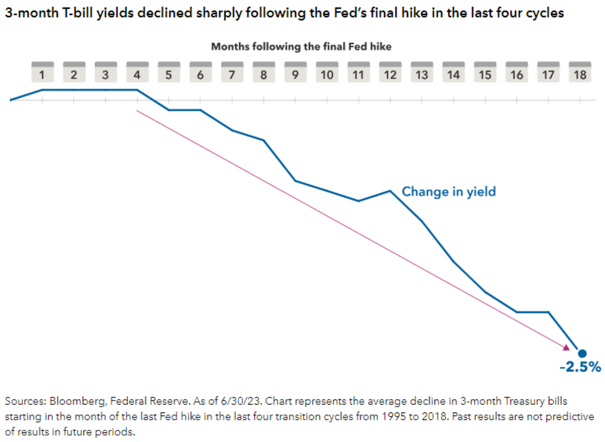


Our view, which has been more consistent than the consensus, is that rates would peak in Q3'23, and then the short end would gradually start falling in 2024, which would make bonds quite attractive to buy this year, with a slow declining rate tailwind for the next few years. This backdrop would also be constructive for yield oriented stocks. For the last two years, I wasn't in in the recession camp, on account of all the capacity that was needed to be built / rebuilt due to the covid shutdown policies, but acknowledged that the Fed has overtightened 80% of the time, so it could happen. Now, I am less confident that the Fed isn't going too far.

Things have changed recenently in a material way, with mid and long term rates blowing out. We complained about 7% mortgages last month as being untenable, now they are nigh 8%. As is frequently pointed out by the bond scare bears, "the Fed has caused 9 of the last 13 recessions," so their track record is ugly, especially when they seem to be pressing, as they are now. Indeed, if we annualize the last 3 months core CPE figures, the data are already at the Fed's stated target, so how much insurance do they need before they break something else (after cracking the regional banks)?

Rates won't likely peak now until Q4, when the Fed raises short-term rates for hopefully the last time, and now the middle and long end of the curve are moving higher than we expected, which is pushing out the peak in rates and most ideal bond and dividend stock buying window probably by a quarter, from Q3 to Q4'23. [As hinted in the chart below, the actually drop in ST rates now expected at start of Q2'24 and investors buy six months ahead].

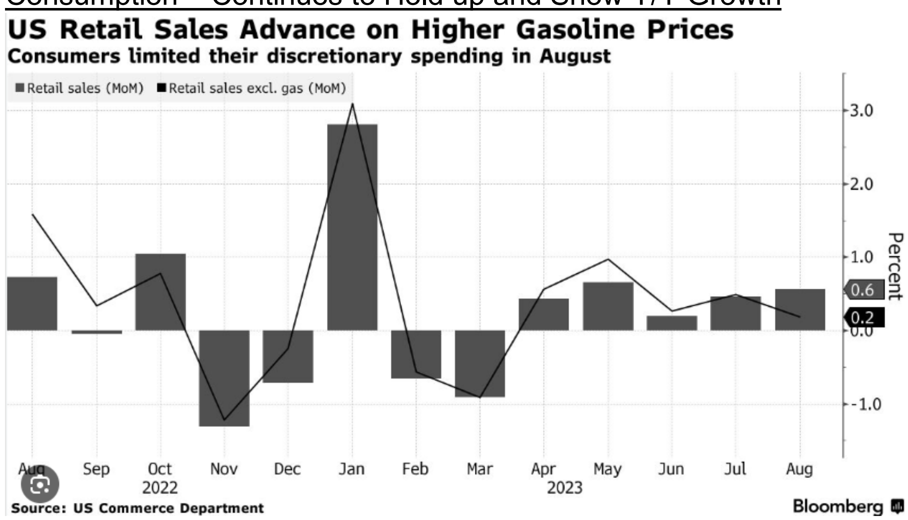
As shown in the chart below, the markets tend to shorten the low end of the yield curve to rates below the Fed Funds rate several months after the Fed is down with its tightening – presumably it takes this long before the market has confidence the Fed is done. Also, by then, the maximim pain will very likely be pushing the US towards no growth or worse, which 1/3 of economics / strategists are saying will be when the Fed has to start cutting short term rates. While the no growth would not be welcome, a respite in rate hikes is long overdue.



OECD Cuts Global Growth Outlook

IT now projects global GDP to decline from 3% in 2023 to 2.7% in 2024, with global headline inflatin of 2.6% in 2024, and core G20 inflation to be 2.8%. "Headline and core inflation are falling, but the effect of higher interest rates and weak pace of true economic reforms is a slowdown in trade, growth and productivity." OECD Chief Economis Clare Lobardelli believes that policies which encourage more global trade, encourage greater skills development, and reduce government overspending would be the most helpful policies at this time. "We don't need stimulus right now; we need more trade and cooperation." We agree with Clare's prescription. Now, we just need to find politicians of any stripe, in any part of the world who have the courage to say, "vote for me and we will spend less."

Consumption – Continues to Hold up and Show Y/Y Growth



This data is attributed to the stong employment and 4.1% wage growth that US workers are enjoying y/y, which exceeds the current rate of inflation. Again, with housing prices rising, consumption patterns remain more skewed towards services over goods, and as discussed below, some folks have found other ways to save on goods… they just steel them, which makes paying for lattes at Starbucks a lot easier.

Bonsus Bit: Despite the Bromide that "Crime Doesn't Pay" – Clearly In the Modern World, It Does

One contributing factor to inflation, which is lifing the cost of goods and shrinking our portions sizes has been a material rise theft from retail and other business. As part of the "defund the police" and Black Live's Matter riots and reactions, many muncipalities decided to reduce the prosecution and sentencing for property crimes, like theft and vandalism. Very much like a union negotiation, the politicians caved to the rioters demands and lowered the penalties for commiting these crimes, to avoid further violence. So just like basic supply / demand economics predicts, when the prices (penalties for doing a crime) go down, the volume (of crimes) go up. So, maybe we need a new movement? Instead of defunding the police, can we defund criminals, by making them pay for their crimes, instead of making society pay to capture, house and feed them? Because right now, this theiving business is way out of control. As reported in Bloomberg:

"The National Retail Federation estimates the cost of "shrink" and other inventory losses has climbed to almost $100 billion a year, ranging from small-time pilfering to Mafia-type cargo heists. Mentions of "theft" and "shrink" have more than doubled in company earnings calls since the first quarter of this year, according to a Bloomberg transcript analysis, with Dick's Sporting Goods Inc. missing analysts' estimates largely because of theft.

*"**Losses from theft are at historical highs**, and I'd say, we find it unacceptable," Erik B. Nordstrom, chief executive officer of the eponymous department store chain, said during an earnings call last month. "We're looking at everything we can do to make our stores are safe and secure."*

Critics say better prevention and surveillance won't ultimately solve the problem, and instead point the finger at lax prosecution as a factor contributing to the jump in flash raids.

Los Angeles, for instance, no longer requires cash bail for suspects charged with nonviolent misdemeanor penalties, allowing many people accused of low-level crimes to be released without having to post a bond. Petty larceny — theft of goods valued at $950 or less — is a "cite and release" offense in California, according to Rachel Michelin, chief executive officer of the California Retailers Association. Many participants in flash mob incidents started out as small-time shoplifters, who graduated to more serious offenses after getting away with a hand slap for entry-level theft, she said.

"When people realize there's no consequence, that behavior is going to escalate," Michelin said.

The crimes are having a ripple effect on local economies, said Michelin. Sales tax revenue falls as fearful shoppers stay away from stores, leading to closures and demoralized workers, making it harder for cities to pay police or clear sidewalk vagrants camped outside vacant storefronts, further discouraging new businesses from opening.

When the Nordstrom in the Westfield San Francisco Centre announced in May that it was closing, the mall's owner, Unibail-Rodamco-Westfield, blamed "unsafe conditions for customers, retailers, and employees." This week, American Eagle Outfitters sued Westfield, accusing it of letting the mall "deteriorate into disarray" and exposing its staff to violence and robberies, according to a complaint filed in Superior Court in San Francisco County.

"This type of criminal activity places an enormous burden on our local businesses and is an assault against our entire community," Los Angeles County District Attorney George Gascon said in a statement this month. But retailers have criticized Gascon for his progressive stance on petty crimes, which they say encourages retail thefts. Gascon was elected in 2020 on a platform of reducing racial disparities in the criminal justice system.

"The problem is with the DA's office," said Rick Caruso, owner of the Americana at Brand mall in Glendale where thieves looted the YSL store. "You can have all the task forces in the world, but if nobody's being held accountable, it doesn't matter," Venusse Navid, a spokesperson for the DA, didn't directly address a question about criticism that Gascon has gone easy on criminal suspects. She said

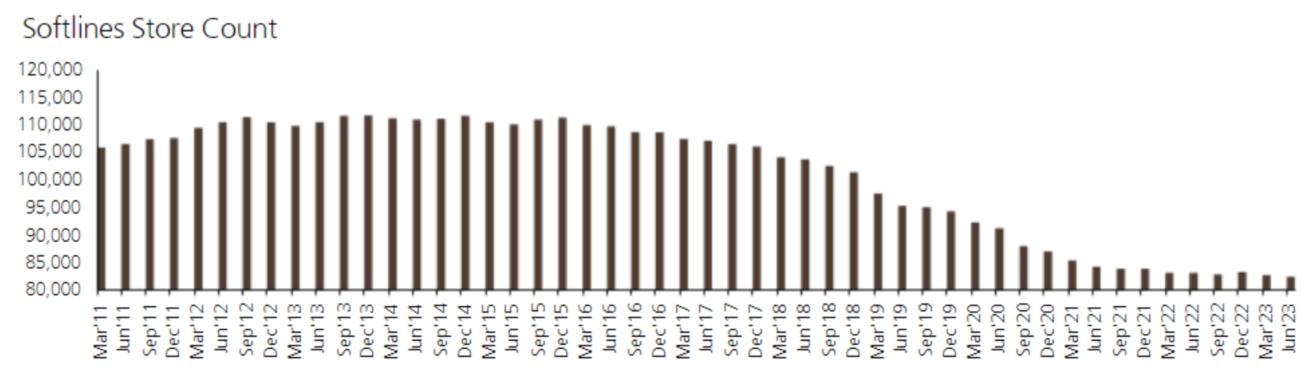
Gascon has started requesting bail for organized retail theft offenders. At least 19 suspects have been arrested and charged since mid-August, and some remain in jail. One 32-year-old suspect is being held on bail of $1.2 million because of additional charges from prior convictions.

“We view them as organized crime,” Gascon said during a press conference when asked about retail theft rings. “And we will use every tool available under the law, when there is an arrest made.”

<u>The Decline in Retail Locations</u>

Even before the pandemic and shutdown policies that put many mom and pop retailers out of business in 2020 (about 15% of the total disappeared in 2020) , there were already too many retail stores per capita in the US. When you combine that crises and the Amazon effect before it, alone with the rise of theft, it is no wonder than the US retail landscape continues to shrink, as illustrated below (for apparel companies only). Post pandemic, this trend has slowed down greatly, but it has not stopped.

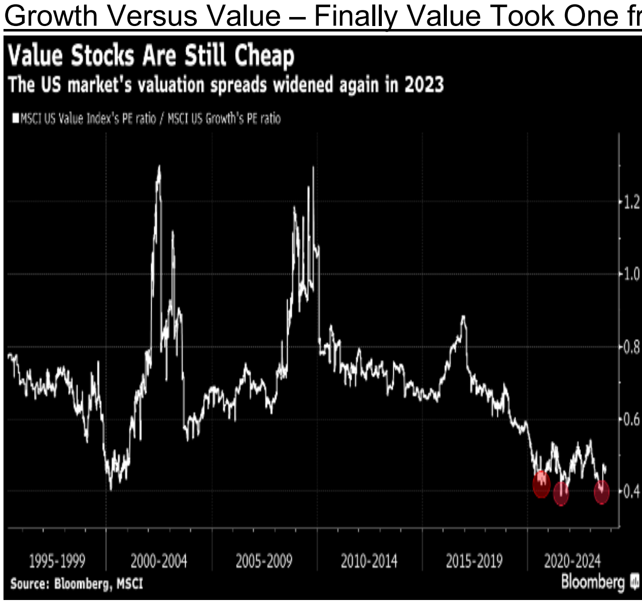
Figure 1: The US Softlines industry store count has declined to 82,450 stores in June 2023, from a peak of 112,441 in 2013.

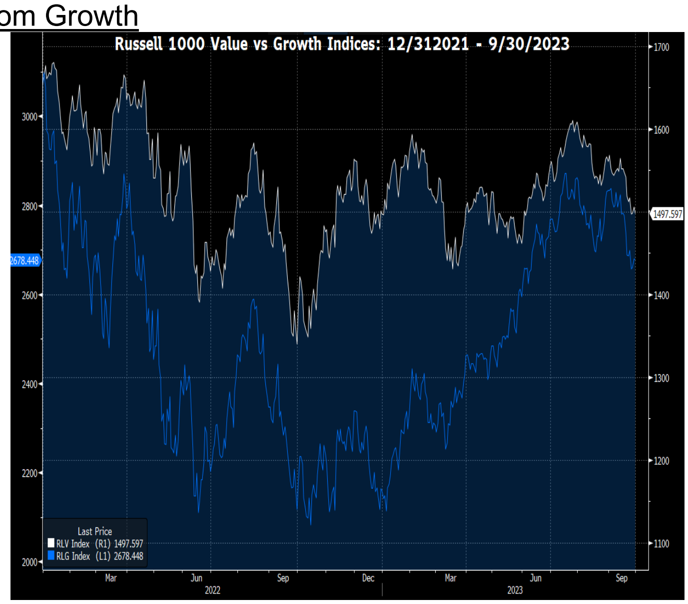


Source: UBS Evidence Lab (> Access Dataset)

Part II: The Monthly US Equity Market Report

<u>Growth Versus Value – Finally Value Took One from Growth</u>





As shown in the graphs above and tables below, while large cap tech / growth names have logged their best relative performance in many years in 2023, in September, they pulled back more than value did as rates backed up, and investors took profits. While large cap growth has been this year's best bet, they are still down since the Fed started raising interest rates in Q1 last year, and the total return still lags value if you start counting at the start of last year through month end. As discussed in the Macro section above, while higher rates should lead to value stocks having better relative performance due to their shorter mathematical duration than growth names, the scarcity of growth can overcome this math late in a business cycle, as we are now in.

On a total return basis in September, the total rates of return for the various benchmark were:

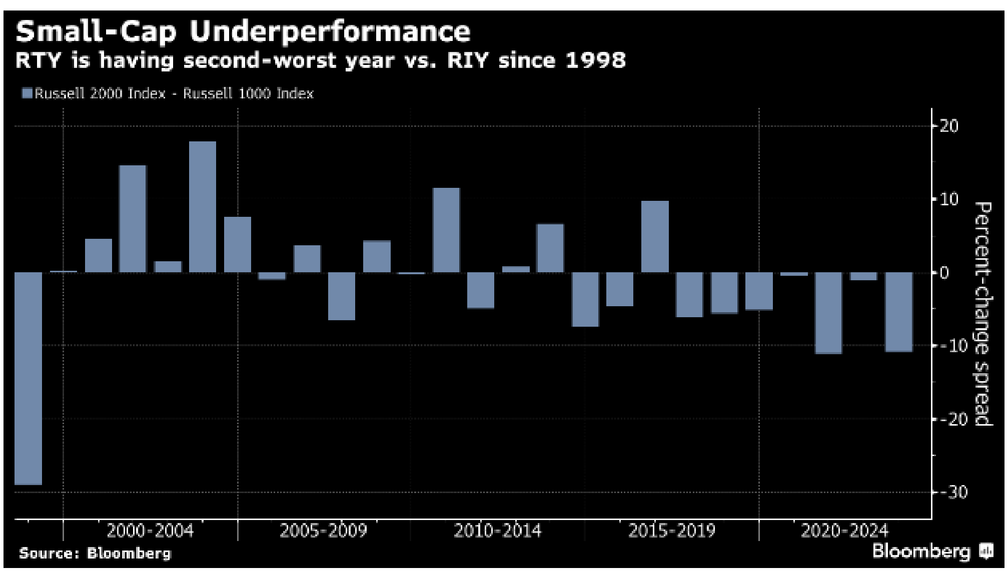
Russell 1000 Value (RLV)	(3.86%)	Russell 1000 Growth (RLG)	(5.44%)
S&P 500 (SPX)	(4.77%)	Dow Jones Industrial Average	(3.42%)
NASDAQ (CCMP)	(5.76%)	iShares Select Dividend ETF (DVY)	(3.89%)
		Sound Equity Income ETF (DIVY)	(3.39%)

YTD, the total returns for the various benchmarks, **assuming reinvestment** has been:

Russell 1000 Value	+1.77%	Russell 1000 Growth	+24.97%
S&P 500	+13.06%	Dow Jones Industrial Average	+2.73%
NASDAQ (CCMP)	+27.11%	iShares Select Dividend ETF (DVY)	(8.05%)
		Sound Equity Income ETF (DIVY)	(0.71%)

While we all learning in economic history that small cap stocks deliver higher returns than large caps over time, that has generally not been the case since the so called Financial Crisis, when quantitative easing drove more index capital into equities than ever before.

As shown in the chart below, consistent with the market's "risk-off" trading in 2H 2023, in the face of higher interest rates, a slowdown in forward growth expectations, and the significant narrowness of the market, with mega-cap growth stocks pulling the indices higher, we have seen a predictable relative weakness in small cap returns versus large caps. Also hurting the small caps is that they tend to need to borrow more because they typically have higher capital needs per their level of sales, and therefore are more interest rate sensitive.



Once the mega caps start to falter, as the did in the aughts, small caps should again outperform. This will probably happen when other sectors of the market, besides technology, show more reliable growth prospects.

Monthly US Equity Market Report *9/30/2023*

Fundamental, Technical, and Valuation Snapshots

Fundamentals: Tech still in drivers seat; Better than feared, due to employment & falling costs.

Trend Economy is growing, overall revisions are positive due to technology spending & falling costs.

(+)	Information Tech	AI demand, cost cutting, and BTE orders have lifted #s & outlooks.
(+)	Consumer Discretionary	Online, Tesla, hotelsl, and dining rose, retail & apparel estimates fell.
(+)	Communications	Positive revisions for Google & Meta; Media, Advertising & Telcos fell.
(+)	Consumer Staples	Falling food, materials and logistics costs have lifted margins.
(+)	Energy	Higher prices due to prod'n cuts have lifted energy co. estimates.
(+)	Real Estate	Higher rents are marginally offsetting lower occupancy & higher rates.
(+)	Industrials	Capacity additions are allowing companies to work off backlogs.
(--)	Utilities	Soft demand, rising interest rates and operating costs nicked etimates.
(--)	Financial Services	Inverted curve is hurting bank volumes & margins, inflation P&C results.
(--)	Materials	Strong dollar, falling prices and softening demand are nicking estimates.
(--)	Healthcare	Biden drug price policies & soft procedure volumes are reducing est.

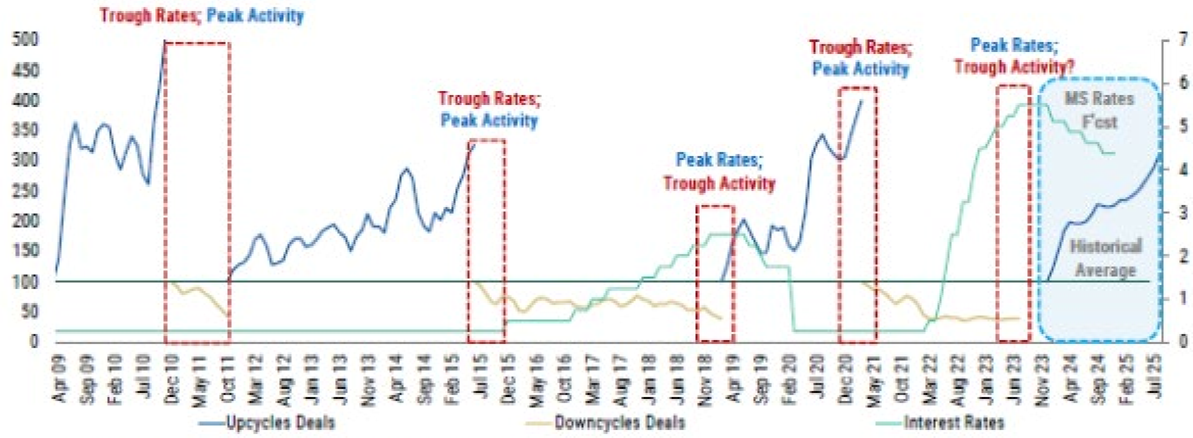
	9/30/2023		Earnings Revisions			Performance (Total RoR)		
	Mix		3 Mo.	6 Mo.		MTD	QTD	YTD
S&P 500			**1.6%**	**1.2%**		**-4.8%**	**-3.3%**	**13.1%**
Communications	8.8%		4.4%	3.6%		-3.3%	3.1%	40.4%
Consumer Discretionary	10.9%		6.3%	8.9%		-6.0%	-4.8%	26.6%
Consumer Staples	6.5%		1.9%	1.2%		-4.5%	-6.0%	-4.8%
Energy	4.8%		1.0%	-7.3%	Best =>	2.6%	12.2%	6.0%
Financial Services	11.2%		-0.4%	-1.2%		-3.1%	-1.1%	-1.7%
Healthcare	14.4%	Worst =>	-4.7%	-5.2%		-3.0%	-2.7%	-4.1%
Industrials	7.8%		0.1%	2.5%		-6.0%	-5.2%	4.5%
Information Tech	27.1%	Best =>	7.4%	10.2%		-6.9%	-5.6%	34.7%
Materials	2.8%		-3.7%	-5.7%		-4.8%	-4.8%	2.6%
Real Estate	2.8%		0.4%	-2.0%	Worst =>	-7.2%	-8.9%	-5.5%
Utilities	3.0%		-0.2%	-0.9%		-5.6%	-9.2%	-14.4%

As show in the table above, Information Technology (think Nvidia, Microsoft, etc), Communications (think Google and Meta, over AT&T), and consumer discretionary (think Tesla, Amazon) have all seen nice lifts in their earnings estimates, as demand has turned out to be better than feared. Even falling costs have allowed consumer staples and industrials companies to raise estimates, despite significant headwinds to demand, which is pressuring volumes.

The effects of rising rates are marginally pressuring the financials, but their impact on materials stocks has been great, with steel, copper and wood demand falling, as well as pulp and resins for packaging coming down. Energy is benefitting from cutbacks in production and higher prices, but demand there too has weakened for gasoline, jet fuel and chemicals.

Getting back to Financial's briefly, the chart below shows what a drag and relief rate movesments have been to deal making activity. Once rates start to drop, investment banks do so very well…

Exhibit 6: Capital markets cycles (rebased to 100 at peak and trough) versus US interest rates [RHS] - 2009-2025e



Source: Bloomberg, Pitchbook, Morgan Stanley Research

As touched on all year, the best talk of the markets still has to do with AI, which offers productivity and labor cost savings at time when skilled labor is scarce and expensive.

<u>Hence…Artificial Intelligence Will Remain a Genuinely Transformative Hot Topic For Years to Come</u>
After 50 years of being little more than a digital automation tool, the technology's ability to do real language processing on the cheap has made capabilities that were only possible with super-computers, like IBM's Watson, ten years ago, now accessible to ordinary people, and extraordinary ones – which is were there is risk. Just imagine what Vladamir Putin's hack-boys are doing with their chat GPT subscriptions to steal your everything?

Large Language Models: By Design, More Inputs = Better Quality Outputs

These outputs then, become further inputs that can help to form further refined outputs, if some filtering (which may even be human editing) is done along the way. With this value chain, it seems almost impossible that Google should not become an Artificial Intelligence monster, once it can adapt its own search engine funnels into becoming AI learning devices. Maybe Microsoft's AI enabled Bing browser has better tools for now, but it doesn't have the same marketshare, and hence data feed that Google has, so in the race to build the best AI platform, leading on the first lap is probably not enough to win the race. We shall see.

<u>Technically Speaking – We Are Back in Neutral</u>
As indicated below, last month's neutral to bullish technical readout has been flattened by the market's repricing actions and rising volatility. Are these indicators useful? Probably not, as rates have been the whole story for the last six months and that hasn't changed.

Technicals: Overall Neutral: ST Bearish, IT Neutral, LT Neutral.							
Key Positive indicators:		IT Fibs, IT & LT Highs, IT & LT Lows					
Key Negative indicators:		All EMAs, All MACDs, RSI, TDD, ST & LT Fibs, ST Highs, Stochastics					
(-)	Trend	10/11 sectors closed down in September, leaving only 6/11 up YTD.					
(-)	Fund Flows	Started & finished down, but there was a strong positive burst midmonth.					
		Price	**30 Day**	**50 Day**	**100 Day**	**200 Day**	
(+)	Golden Cross [50 dma > 200]	4,288	4,420	4,458	4,385	4,198	
(-)	Price / Moving Average [3 / 4 are "< 1"]		0.97	0.96	0.98	1.02	
(-)	Support Levels are down > 2%	4,202	-2.0%	4,157	-3.1%	4,107	-4.2%
(-)	Resistance levels are < 2%	4,315	0.6%	4,336	1.1%	4,363	1.8%
(-)	Volatility, (VIX)	Volatility rose 3.95 as stocks dove following the Fed's higher for longer bit					
(=)	Trading Volume	Year over year volume was slightly down y/y.					

Valuation: Positive vs. Bonds	PE		EPS			
Treas. yields rose, credit spreads narrowed	**2023e**	**2024e**	**2022**	**2023e**	**2024e**	
'23 PE is 3.2 points > LTA	19.2	17.4	$ 223.0	$ 223.2	$ 246.0	
10 Year US Treasury: (1/r) = PE Equivalent	21.9	21.9	12%	0%	10% = *y/y %*	
10 Year BBB: (1/r) = PE Equivalent	15.8	15.8	'23 & '24 EPS est. ROSE slightly in Sept			
Stocks are Cheap Relative to Bonds based on LT Spreads			***Upside For Stocks Relative to Bonds***			
10 Yr Treas.: LT Avg (1/r) relative to S&P PE	1.0	1.0	vs. 10 yr	14%	25%	
10 Yr BBB: LT Avg (1/r) relative to S&P PE	0.7	0.7	vs. BBB	20%	32%	
S&P 500 Earnings Yield (E/P)	5.20%	5.74%	<= Earnings yield is down / risk prem. up			
10 Year US Treasury Yield (+47 bps in Sept)	4.57%	4.57%	10Y Tr. Downside to Parity			-9%
Spread (E/P minus 10 Yr. %)	**0.63%**	**1.16%**	**<= PE fell, risk prem narrowed**			
BBB narrowed vs. Treasuries, as rates rose 37 & 47 bps respectively						
10 year BBB Corporate Yield	6.31%	**Norms**	<- rose by 37 bps in September			
Yield Spread of S&P E/P minus BBB	-1.11%	-2.68%	BBB downside to nomal SPX			-18%
Yield Spread of BBB minus 10 Yr T	1.74%	2.20%	BBB upside to LT Spread vs. T			-7%

The equity risk premium has fallen, like it typically does when the Fed hikes rates, and then it will likely widen out when the Fed is done. So, are stocks still cheap versus bonds? Yes, but the spreads between stocks and bonds are closer to normal now than they have been since QE started, thanks to the surge in bond yields. Once could argue tha stocks are closer to being fairly valued today, relative to bonds and historical measures than in the last 12 years.

One interesting datam, the spread of the BBB corporates to Treasuries narrowed in September, as Treasury yields blew out more. This move and the equity risk premium drop is ironic as the restrictive pressures of higher rates should increase the changes of economic distress and not reduce them. Such is another case for the inefficient markets hypothesis being alive and well.

Part III: Portfolio News and Changes

In September, the only notable portfolio change was that we sold the remaining piece of Hanesbrands (HBI) out of Total Return Yield after the company announced that it was considering selling its primary growth business, Champion. We redeployed the 1.3% proceeds into Levi Strauss & Co. (LEVI) discussed below.

We did not really want to sell Hanesbrands where it was, but similar to our first disappointing sell-down of the company, the feedback were were getting from the company was different than the feedback we were hearing elsewhere. Basically, the company made it seem like the conditions were better than perhaps they were, and the surprise announcements, be that the dividend cut in Q1, or the Champion sales process in Q3, appear to have been driven by creditors looking to improve their interest coverage, with the threat of raising the cost of debt, if the company did not go along. Had the "strategic alternative" discussion for Champion been initiated by an external inquiry, most likely HBI would be trading much higher, as the bid for price would likely be interesting. However, the company indicated that was not the case, but rather they wanted to get a sense for what it might be worth. At this time, with the entire apparel industry under duress, in the post-pandemic spending shift, it is not an ideal time to be selling brands. So, we capitulated and took our chips off the table, and the new mean expected value for HBI dropped on the news.

With the proceeds, we did not want to give up on the depressed apparel industry, as apparel is normally a GDP+ category, that benefits from globalization, on top of fashion replacements that typically exceed functional consumption. The company that best met our high-dividend, value with a catalyst inclinations, with a much better balance sheet than HBI was Levi Strauss & Co. (LEVI).

San Francisco based LEVI has the #1 share in the global denim market, predominantly catering to men. It has successfully deleveraged itself since the family controlled LBO went public again in 2019 and has since been expanding its women's lines, including its acquistion of Beyond Yoga three years ago. The $5.3B market cap company is trading at ~$13 per share, down 57% from $30 per share in 2021, as the same apparel slowdown that hit HBI has also hit LEVI. However, LEVI looks poised to bounce next year. Currently trading at 11.6X depressed EPS, with a 3.6% dividend yield and EPS expected to grow 20% in 2024 and 14% in 2025, LEVI has some attractive metrics, that imply the company's stock price should move higher.

Fundamentally, LEVI is pursuing a classic globalization, adjacency expansion strategy, by investing in overseas distribution, growing its women's, topls and accessories lines (to augment its strong bottoms franchise), and increasing its direct-to-consumer (DTC) sales. As expected, women's is now the fastest growing category for the company, consistent with most apparel companies, and this expansion still has a long way to go.

The firm's DTC strategy is centered less on growing its 1,500 company owned stores and more towards online sales. To help improve its online presence, CEO Chip Bergh hired Michelle Gass, who used to run Kohls, and led their online business, to replace him as CEO in 2024. She is now leading the company's online efforts, with the goal of accelerating the company's sales.

When you add together the company's revenue and margin targets, the company projects to generate 10% to 12% CAGR EPS over the next 5 years, pluse pay a 2%+ (now 3.6%) dividend. Simply hitting the consensus forecast for fiscal 2024 and returning to a more normal 13.5X PE, LEVI has ~40% price upside on top of its dividend, which would be a solid 12 month return if it comes to pass. They report on October 5th. The risk is that the ongoing apparel slowdown gets a little worse before it gets better. Offsetting that risk to some degree has been recent weekly retail sales data that show Levi's to be gaining market share versus their competitors. So, LEVI may just be the tallest midget, with its strategies working better than others. Either way, the stock looks cheap and if the progress that the company has made over the last 4 years can continue, this name should be money good for the next few years at least.

<u>Performance – Relatively Better in September, but Still Lagging the Growth Indices</u>

	September	**YTD**

Dividend River (est.)	(3.06%)	(0.15%)
Total Return Yield (est.)	(2.78%)	+0.72%
DIVY NAV (Toroso)	(3.15%)	(0.87%)
DIVY Price (Toroso)	(3.39%)	(0.71%)

For the month, all three of our portfolio's captured smaller declines than the 4.75% drop for S&P 500, which got hit on profit taking in its large cap technology champions from their highs. This profit-taking hurt the S&P and NASDAQ more than the value names frankly because there was more gain to be had be selling the winners than downside to protect by selling the value names that have been essentially + or minus 5% on the year. For October, we expect more tax loss selling to drag on the value dogs, which should set up for some large reversals between mid-October ajd January.

As you are no doubt tired of reading, the technology-led S&P 500 and NASDAQ indices remain ahead of the value benchmarks, thanks to the massive gains captured by the so called magnificent 7 names, which do not meet our high dividend yield and valuation criteria. Last year, when dividends where more scarce than secular growth, dividend stocks out-performed massively. This year, growth has become more scarce, so those stock have triumphed. We believe that once interest rates stop rising, the market's favoratism pendulum will gradually sway back towards a more central or balanced position, which should take dividend paying companies out of the penalty box they are now in.

In the meantime, with so many stocks under pressure, our goal is to try to dance between the raindrops and upgrade our holdings, when upgrade opportunities present themselves. we remain diligent in our quest to upgrade our positions and continue to execute our mandate, which is to generate relatively high dividend income, and positive net returns for our clients.

<u>Winners and Sinners</u>

Winnners			**September**	**Notes**
Western Digital	WDC	TRY	9.8%	Positive storage demand & outlook for NAND prices.
Valero	VLO	Both	7.9%	Rising energy prices should widen crack spreads.
HR Block	HRB	Both	7.8%	Beat expectations, raised dividend and outlook.
Total Energies	TTE	Both	4.0%	Rising oil prices & analyst day lifted expectations.
Glaxo-Smith-Kline	GSK	DR	2.1%	Company raised outlook on strong HIV agent sales.
Sinners				
Hansesbrands	HBI	TRY	-29.0%	Company announced intent to sell Champion brand.
Warner Bros. Disc.	WBD	TRY	-16.1%	Writers & actors strike drove negative est. revisions.
Southwest Airlines	LUV	TRY	-14.9%	Rising fuel costs, traffic slowdown & pilots strike.
Walgreens Boots	WBA	DR	-12.9%	CEO was fired, creating doubt in company strategy.
Greif, Class B	GEF/B	Both	-12.4%	Volumes fell (margins rose) led to '24 est. concerns.

<u>Characteristics – Still Cheap, With Higher EPS Growth Than the S&P 500</u>

The characteristics of our portfolios show that they are still ~42% cheaper than the S&P 500 on a PE basis, with much higher dividend yields and expected EPS growth, but lower weighted average sales growth expectations than the popular benchmark.

As of month-end, Dividend River was paying a 4.7% annual dividend 2.8X that of the S&P 500 for 43% below its PE price, while the Total Return Yield was paying a 3.8% dividend, 2.3X the yield of the S&P 500, at 42% below its PE price. Dividend River has a 2023e EPS growth forecast that is 4.9% above the S&P 500, while the Total Return portfolio is expected to grow EPS 10.1% above the benchmark. Also, their Betas are 0.7X the Index Beta, which means that they should go up and down less than the

S&P, based on the historical movement of their constituent shares. The EPS growth plus dividend lines in the tables below indicate our approximate expected forward total returns for both portfolios relative to the S&P 500, based on consensus estimates.

Dividend River Porfolio Characteristics

September 30, 2023

SECTOR WEIGHTS	SIS	SPX
Communications Services	7.5%	9.2%
Consumer Discretionary	7.8%	11.0%
Consumer Staples	5.1%	7.1%
Energy	17.3%	4.7%
Financial Services	16.0%	12.4%
Healthcare	17.7%	13.3%
Industrials	2.8%	8.3%
Information Technology	10.2%	27.0%
Materials	10.8%	2.4%
Real Estate	0.0%	2.3%
Utilities	4.8%	2.3%
Totals	100.0%	100.0%

KEY METRICS *	SIS	SPX
Dividend Yield	4.7%	1.7%
2023e PE	11.2	19.6
EV/ EBITDA	11.2	13.7
PB	4.2	4.1
2023e Sales Growth	2.3%	4.4%
2023e EPS Growth	5.0%	0.1%
BETA	0.7	1.0
EPS Gr. + Div %	9.7%	1.7%

* Based on Bloomberg consensus data.

Total Return Yield Porfolio Characteristics

September 30, 2023

SECTOR WEIGHTS	SIS	SPX
Communications Services	8.9%	9.2%
Consumer Discretionary	9.6%	11.0%
Consumer Staples	9.7%	7.1%
Energy	12.5%	4.7%
Financial Services	15.7%	12.4%
Healthcare	10.3%	13.3%
Industrials	6.3%	8.3%
Information Technology	11.9%	27.0%
Materials	15.2%	2.4%
Real Estate	0.0%	2.3%
Utilities	0.0%	2.3%
Totals	100.0%	100.0%

KEY METRICS *	SIS	SPX
Dividend Yield	3.8%	1.7%
2023e PE **	11.3	19.6
EV/ EBITDA	9.8	13.7
PB	3.8	4.1
2023e Sales Growth	2.6%	4.4%
2023e EPS Growth	10.2%	0.1%
BETA	0.7	1.0
EPS Gr. + Div %	14.0%	1.7%

* Based on Bloomberg consensus data.
** excludes WBD, WDC

As we enter the final quarter of 2023, we are optimistic that nearly all of the pressure from the Fed's rate hiking actions are priced in. October is typically the turning point when most of the tax loss sellling and window dressing are done, which should make for merrier returns as we close in on the new year.

The last eighteen months of fighting the Fed have not been very fun or productive for stock and bond market investors, but we really do believe that what we are doing is helping our clients have income through good and bad times, and be in good positions to capture more upside, as soon as the rate pressures above.

In all times, we feel grateful and blessed to be able to work with you towards that common goal of taking care our deserving clients as best as we can.

Thank you for entrusting us with this noble task.

Equitably yours,

Eric Beyrich, CFA, CFP
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Sound Income Strategies