Q2 Market Overview

Broadly speaking, the stock market and US economy enjoyed a strong second quarter, although Wall Street's strength was driven primarily by a rally in tech stocks, which favored high-risk growth investors over conservative income investors. Although the second quarter was calmer on the whole than Q1, a degree of volatility continued in both the stock and bond markets due to the continuation of the Federal Reserve's historically aggressive interest rate hiking program. The good news is that, with inflation now back down to near-normal levels, the Fed is almost finished raising rates—and they may be forced to finish sooner than planned if a recession hits (as many economists are still predicting) or problems worsen for struggling regional banks.

The Banking Scare

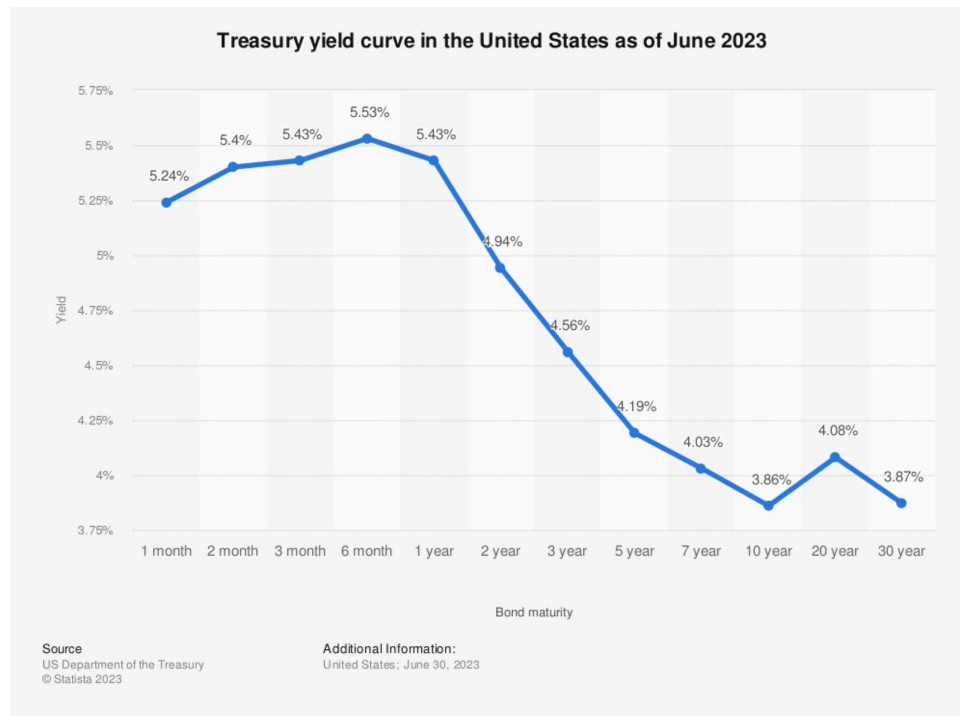
As you may recall, the markets were rocked in March when two regional banks—Silicon Valley Bank of California, and Signature Bank in New York—failed. The news prompted fears that another nationwide banking crisis might be brewing, on par with the one that triggered the Financial Crisis in 2008. Although the Fed moved quickly to cover account-holder losses and implement steps to protect other banks, the number of regional banks at risk has increased significantly in the past three months.

After a volatile March due to the banking scare, April was a refreshingly quiet one for the markets. The Fed didn't meet, so investors stayed focused on some positive economic data from the first quarter. Corporate earnings beat expectations and the inflation rate continued to fall. As a result, the S&P 500 finished the month up by about 1.6%. Investor optimism in April was also driven by confidence that the Fed would approve only another small, quarter-percent interest rate hike at their meeting in May. The Fed not only stuck to that plan but also signaled they would probably pause rate hiking altogether at their next meeting in June.

Despite the Fed's more dovish tone, May was ultimately a mixed bag for the markets for several reasons. The Dow Jones Industrial Average finished the month down by nearly 3.5%, although the S&P 500 rose by about 0.3% and the Nasdaq added a whopping 5.8%. Meanwhile, the bond market saw another pullback as long-term interest rates again took a big jump. Why were the S&P and Nasdaq up while the Dow was down in May? The answer is AI. Both the S&P and Nasdaq contain many technology-based companies, many of which are developing new tools and products in the field of artificial intelligence. While this AI tech bubble had been growing for months, in May it expanded greatly, and any stock even remotely related to AI took off. Naturally, the money used to purchase those stocks had to come from somewhere, and in many cases, it came from investors pulling money out of other more conservative stocks, which is why we saw the Dow go down in May as the Nasdaq and S&P both went up.

The Banking Scare Part 2

Another likely reason the markets were mixed in May was the release of a new FDIC report that put the regional banking issue in the spotlight once again. The report found that the number of regional banks at risk had risen from an estimated five in March to over 40 in May.* Although troubling to investors, the report came as no surprise to economists after a year of historically aggressive interest rate hiking by the Fed. The Fed's rapid pace has created many hardships for banks, which depend on an upward-sloping yield curve to make money. While the bond market accommodated the Fed for most of last year—with long-term rates rising out ahead of each short-term rate hike by the Fed—this year bond investors have been pushing back. As a result, the yield curve has become increasingly inverted.



While the Fed's benchmark short-term rate is now at 5%, long-term rates have remained in the 3%-to-4.2% range all year. When short-term rates are higher than long-term rates, banks must pay more to their depositors over time, but they can't raise the fixed interest rates on the loans in their books. This compresses their net interest margin, and it becomes cost prohibitive for them to lend money.

Fed Pauses but Stays Hawkish

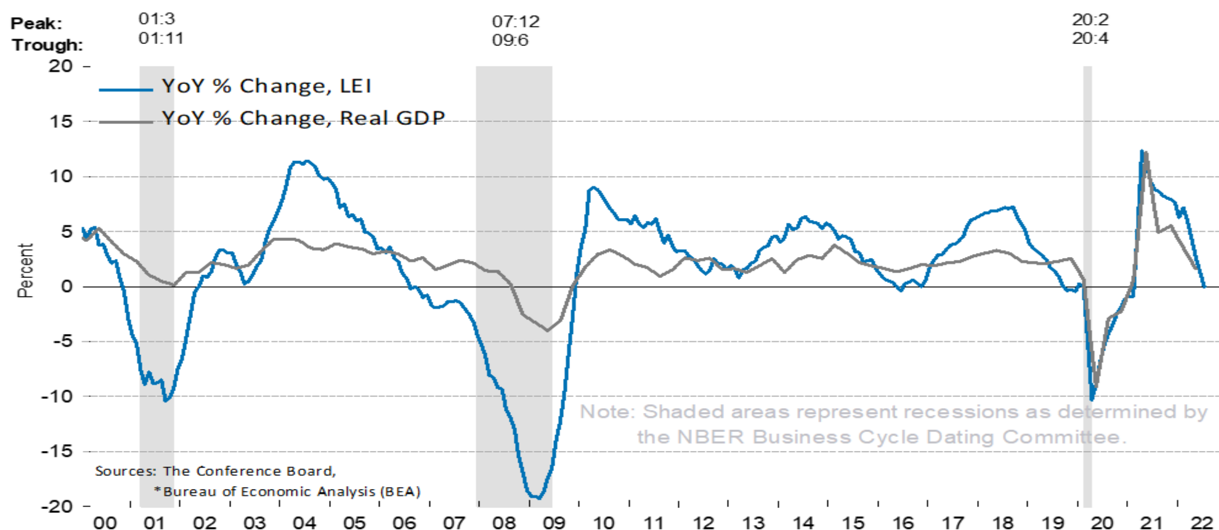
As expected, the Fed did pause rate hiking in June, marking the first time in over a year that they met without raising rates at all—but Chairman Jerome Powell did indicate they still plan to implement one or two more quarter-percent rate hikes this year. Although inflation has fallen steadily for nearly a year, the year-over-year rate is—at 3.3%—still slightly higher than the Fed's goal. That's why despite the regional banking issue and other risks caused by an inverted yield curve, the Fed's tone remains hawkish.

Also in June, the AI-focused tech bubble that expanded so rapidly in May slowed a bit. As a result, the markets' major indexes all saw more comparable performance, with the S&P finishing the month up by about 6%, the Nasdaq adding 6.6%, and the Dow rebounding with 4.56% growth. In other words, with tech stocks suddenly less popular, more conservative stocks were

able to catch up in June. Year-to-date, after two quarters, the S&P is up 16.8%, the Dow is up 4.9%, and the very tech-heavy Nasdaq is up over 30%.** The important point here, however, is that if you took tech stocks and the AI boom out of the equation, the market's overall growth for the year would be only about a third of what it is.

The Recession Question

The pushback from the bond market that is causing the inverted yield curve suggests that bond investors remain convinced that a recession is imminent, based on several ongoing indicators that the economy is slowing. Bond market prices and participants have been predicting a recession for the last 18 months, or longer. But, so far, the slowdown has been slower than predicted, and we haven't hit a recession yet—although 60% of economists still say we will within the next year, and the NY Fed recession model indicates a 71% likelihood. The Conference Board's Leading Economic Indicator Index (LEI) is also suggesting that we are heading towards a recession, and has been saying so for about eight months now. If you look at the chart below, you will see several head fakes (2003, 2013, and 2016) over the last 24 years, when the LEI was heading for a recession and the US economy didn't get there, which is just as many as the number of times when it did. In 2019, we also got to the line and seemed able to avoid a recession but then Covid-19 came along and created a flash recession.



Looking at past recessions such as 1990, 2001, 2008, and 2020 it appears that recessions officially started anywhere from 8 to 18 months after the Fed's final rate increase. If Jerome Powell follows through with another quarter-percent hike at the end of July and that's it, history suggests that a recession could start between March 2024 and January 2025. The yield curve inversion estimates recessions beginning 6-24 months after an inversion begins. Depending upon when you count this last 2yr/10yr inversion, April '22 or July '22 we are looking at a range of Q1 2023 to Q2 2024. Combining the two methods would give us Q2 of 2024 for an official recession. As you can see, predicting a recession can be as much of an art as a science. However, we don't need to use the "R" word to understand that corporate earnings are under pressure at a time when price-to-earnings ratios aren't cheap.

Our Take

Looking at forward indicators, the inverted yield curve, tighter bank lending standards, weaker manufacturing, and low overall consumer confidence are all at odds with strong employment and household spending. But the truth is, these latter positive factors could soon erode. Between the Fed's rate increases, hawkish talk, banks tightening credit standards, and various other factors, fuel for continued economic expansion is starting to look limited.

Whether or not the Fed can make good on its intention to raise rates one or two more times this year will depend heavily on whether the possibility of a recession starts to look more likely, and on whether things start to worsen for regional banks. If more banks fail or the list of at-risk banks continues growing, or if household spending suddenly takes a nosedive and companies stop hiring, we expect the Fed will have sense enough to finally put its historically aggressive rate-hiking program on indefinite hold. Moreover, we trust the Fed will also have the sense to start lowering rates again—as it has in the past—to fight a recession if and when one hits. As we've said in previous newsletters, since this recession would be 100% Fed-induced, we at least know the Fed is well-positioned to combat it.

**"FDIC Says Banks With Weaknesses Increased in Q1," Bloomberg, May 31, 2023*
***"The Stock Market's Surprising First-Half Strength," Axios.com, June 30, 2023*

Bonds and Fixed Income Securities Overview

During the second quarter, the overall bond market was more sanguine, reflecting the smart money's caution, given the continued potential of a pending recession. The Bloomberg Bond Aggregate was down -0.84% for Q2 bringing YTD returns to +2.09%, Corporate Credit was also down -0.28% bringing its YTD return to +3.2% and the 10yr UST was down -2% for Q2, and +1.8% YTD. Our Core+ continued higher at +1.87% Q2 bringing us to 6.8% YTD.

Once again, the yield curve continues to invert as the short end of the curve increases due to continued hawkish talk by the Fed. For us, this has presented an opportunity to pick shorter-duration IG bonds with significant yields. Normally, before a recession, you'd want to extend the duration of your portfolio, anticipating that the Fed is going to lower rates. Therefore, you'd have higher price increases due to longer cash flows being discounted at lower rates. However, given that many longer-duration Investment Grade names could get called away, if and when rates fall, and if you go too far out on the duration curve during a recession you could see material credit spread widening even though the bond math tells you to increase duration. That said, we have picked up a few new bond names during the quarter shown below.

2Q New Investments

<u>Fifth Third Bancorp - FITB 3.95% 3/14/28 (Baa1/BBB+/A-) @ 5.80%</u>

Fifth Third Bancorp is a diversified financial services company that operates banking centers in the Midwestern and Southeastern regions of the US. Primary business includes retail and commercial banking with some investment advisory and data processing. The bank has a little

over $211 billion in assets in over 1,000 branches across 11 states. The main segments are commercial banking, branch banking, consumer lending, and wealth/asset management.

Catalyst:

- Given the mini-banking crisis a month ago, smaller regional bank credits have widened out, some to decade highs. Granted, some regional banks are healthier than others and Fifth Third Bancorp's spreads are offering us an opportunity at +250 over comparable Treasuries and are quickly tightening, but this, along with other issues are still wide of the +150 average. The Fed's new Bank Term Funding Program is not only providing liquidity to the banking sector but also a do-over for those banks that extended their portfolio duration too much during the period of low interest rates.
- Fifth Third's securities portfolio is mostly in the AFS bucket, with a -8.3% unrealized loss for 2022, where the median was about -9%. The portfolio's effective duration was in the middle of comps at 5.4. The bank's deposit profile is one of the most stable in the regional banks with a low % of uninsured deposits. Fifth Third's coverage ratio of cash + AFS/uninsured deposits is about 91%. Almost one-third of their assets are cash and Available for Sale securities.

Risk & Outlook:

- Management plans to resume share repurchases, but given the healthy CET1 ratio of 9.3%, Tier 1 capital ratio of 10.5%, Total capital ratio of 12.8%, all with over a 2% cushion, buying back shares shouldn't be an issue for management with a 36% dividend payout ratio. During Q4 FITB's net interest margin was at 3.03% vs 2.60% during 2021.
- Regardless of if/when NBER were to call a recession last year, this year, or next year, we have been in a slowdown, this combined with rapid increases in interest rates can hurt NII for banks. If we do enter a deep or prolonged recession, we could see Fifth Third, (FITB) along with the other regional banks stay wide or widen a little further on their debt. Revenue guidance for Q1 is estimated to be down 4-5% due mostly to higher deposit costs offsetting better fees. Loans are up 1% and deposits should only be down about 1%. Estimates of $0.79 EPS vs Q4's $1.04 will be due to an absence of a recurring Q4 fee gain and higher expenses due to seasonal compensation.
- Normally we try to avoid financials in our bond line-up as we have a healthy exposure to financials in our preferred securities. However, given the overdone sell-off in some regional bank names adding one or two financials to the bond allocation makes sense.

Recommendation:

Diversified revenue streams, sold profitability, lower exposure to office and CER, low amounts of uninsured deposits, and steady balance sheet growth over the years lead us to believe that purchasing 5-year bonds at over 200 bps to the curve is an opportunity for our bond line-up and why we added this financial credit.

<u>Amgen Inc. - AMGN 5.25% 3/02/30 (Baa1/BBB+/BBB+) @ 5.20%</u>

Amgen is an independent biotechnology medical company that develops, manufactures, and markets drugs for chronic diseases. Their most successful drugs are Enbrel, Prolia, Neulasta, Otezla, XGEVA, Aranesp, and Repatha. The areas of illness AMGN focuses upon are inflammation, oncology/hematology, bone health, CV disease, nephrology, and neuroscience. The US accounts for about 70% of revenue and its operations and sales are global.

Catalyst:

- AMGN recently announced its $28 billion acquisition of Horizon Therapeutics to bolster its market share in autoimmune, inflammatory, and rare diseases. While AMGN has a strong line-up of drugs many are beginning to come off their patients and therefore management is looking to pick up a new pipeline of rare disease drugs that have already been proven money makers. The bond issues we're considering will be called away at $101 if the deal ends up not going through and if the deal does settle then AMGN will be picking up some high-margin drugs such as Tepezza, Krystexxa, and Uplinza with some phase two drugs in the pipeline.
- If the deal falters, Amgen, given its low 2x leverage, will probably look for smaller bolt-on acquisitions to deal with upcoming drugs such as Enbrel coming off patent.

Risk & Outlook:

- The largest current risk for AMGN is that some of their best drugs will be coming off patent over the next few years. While they have a decent pipeline of second-phase drugs to help with any revenue declines, the Horizon purchase would be of great benefit immediately. The fly in the ointment is the Federal Trade Commission, (FTC) which is suing to block the deal altogether. Normally when the FTC tries to block mergers in the pharmaceutical industry it's because of monopoly issues where two companies have competing drugs and the FTC is worried about a monopoly's effects on a class of drugs. This time the FTC is worried about a practice called bundling, where the company offers discounts to insurance companies and pharmacy benefit managers in exchange for favoring their drugs versus other possibly less expensive drugs. Bundling is commonly used to prevent competitors from gaining market share. Amgen has promised the FTC that they have no intention of bundling.
- If the FTC does end up blocking the merger, then Amgen would end up calling $24 billion of their IG debt as many notes outstanding would have to be redeemed at a special price of $101.00.

Recommendation:

Given that Amgen has low 2x leverage and though this Horizon deal brings net leverage to roughly 3.5x, the acquisition should significantly bring in near-term growth and help diversify AMGN's product line. There is a path for management to bring net leverage back down to the 2.5x area within 3 years. The other caveat would be the repatriation of Horizon's revenue given that they are now headquartered in Ireland. If the deal goes through, then Amgen has roughly a 3.8x gross and 3.5x net leverage given proforma data and it should be able to service its debt. If the deal doesn't go through, then bonds will be redeemed above our purchase price on top of a

5.25% coupon. We don't have a lot of big pharma exposure and adding AMGN bonds will also diversify our holdings.

Cleveland - Cliffs Inc- CLF 5.875% 6/01/27 (Ba3/BB-/BB-) @ 6.45%

- Cleveland-Cliffs Inc. manufactures custom-made pellets and hot briquetted iron (HBI), flat-rolled carbon steel, stainless steel, electrical steel, plate steel, tinplate steel, and long-steel products, along with carbon/stainless steel tubing. The company is located in Cleveland, Ohio, with employees spanned across the US and Canada. CLF is one of the main suppliers of iron/steel to the automobile industry and the largest domestic flat-rolled steel and iron ore pellet producer and can trace its roots back to 1847.

Catalyst:

- CLF's acquisition of AK Steel, ArcelorMittal USA, and Ferrous Processing & Trading Company have transformed CLF into one of the largest and strongest steel producers. Since CFL works on fixed contracts they aren't nearly as affected as competitors on steel/iron commodity price fluctuations and their internally sourced iron ore pellets and HBI. Back in 2017, CLF announced plans to construct a hot briquetted iron plant in Toledo, OH, which has now helped CLF produce enough iron, (1.9million metric tons), for internal use and improve costs and productivity while reducing coke rates and cutting their carbon emissions.
- Despite spot steel price increases of 80%, annual fixed price contract negotiations repricing higher and auto end-market demand improving, CLF bond spreads have widened out versus its steel peer group. CLF's management has fairly conservative financial policies and with good operating fundamentals management will end up reducing net debt by another $1.5 billion by the end of 2023 down to $3 billion total.

Rick & Outlook:

- Though management seems committed to deleveraging, there is an ABL loan with a $4.35 billion cap due in 2028. Only 50% of this loan has been utilized, leaving almost another $2.2 billion available giving CFL ample financial flexibility. However, CLF has material exposure to the automotive industry with 36% directly and 25% indirectly through OEM part suppliers. Any material issues or change in the auto industry's outlook could lower the ABL available amount, thus reducing financial flexibility. While CFL has fixed contracts an extreme fall in steel commodity prices could affect the roll rate of those contracts.

Recommendation:

President Biden signed a $1.2 trillion infrastructure bill into law on November 15, 2021. The infrastructure package includes $550 billion of new federal investments (over five years) in transportation, broadband, and utilities, including $110 billion on roads, bridges, and major projects; 66 billion in freight and passenger rail; and $59 billion in public transit systems. This could equate to a 5% demand increase for steel each year beginning this year, 2023, for the next five years. Given the low exposure to this industry in our portfolios and the current

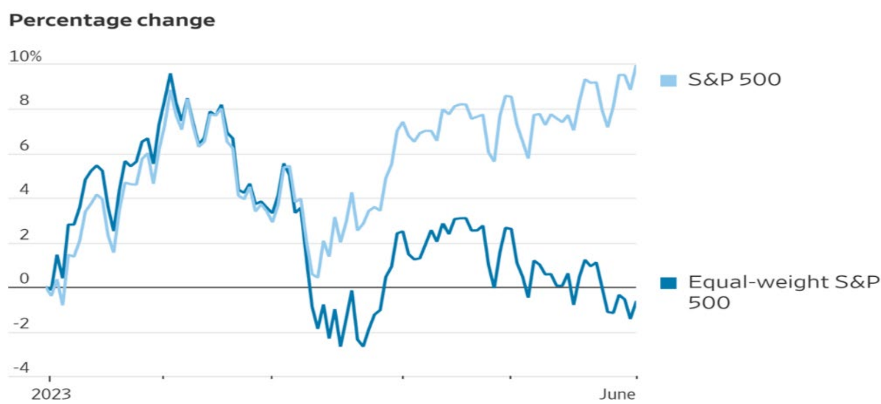
yield of 6.45% for a four-year bond including credit “friendly” management, we are adding this name to our bond allocations.

Fixed Income Outlook & Perspectives

We live in the post-Covid era, where inflation, interest rates, and equity valuations are all higher. The global supply chain has still not fully recovered, and we have fewer workers as the Baby Boomers age out of the workforce, increasing labor costs. Add in switching costs to green energy and this keeps some pressure on inflation, which is still decelerating, just not as fast as we or the Fed would like. Given the size of the Fed’s balance sheet, they might be in a position where they’ll be less friendly about backstopping government spending than they have been in the past. All this to say that inflation will, more than likely, continue to fall over time and at some point, the Fed will discuss lowering rates, but until that happens, we can use this time to lock in 5-7% Investment Grade and a few BB+ names to increase our portfolio yields.

Equities Overview

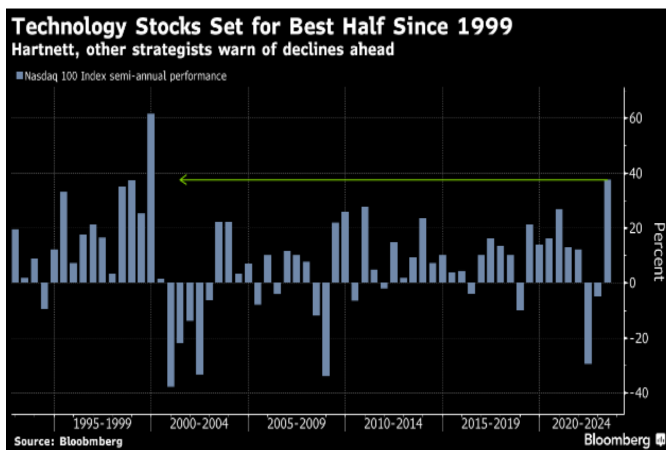
The Magnificent 7 technology stocks (Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia, and Tesla), all with some minor or major association with generative artificial intelligence (AI) continued to lift the NASDAQ and S&P 500 to unprecedented levels in June. As reported by Barron’s, “AI technology’s surprise emergence has almost single-handedly driven the Nasdaq Composite up 32% in 1H 2023, the tech-heavy index’s best start to a year since 1983.”

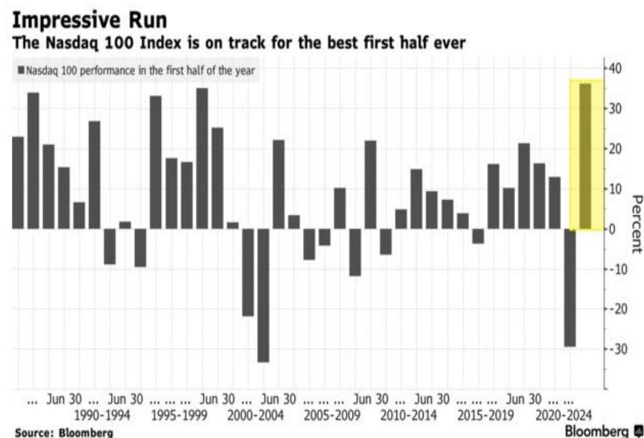


As this WSJ/Factset slide from early June shows, the average stock was down YTD, but the mega tech nifty names had really lifted the benchmarks and given all of the value and income folks serious cases of FOMO. The good news is that the performance of the market broadened out in June, so we are finally starting to get some appreciation in 2023 to go along with our income – despite the Fed’s hawkish rhetoric.

Growth vs. Value

As shown in the graphs below, large-cap tech/growth names have continued to log their best relative performance in many years so far in 2023. As we have mentioned, so far 2023 has had the third largest performance gap of growth over value since 1998 and 1999, and the same could be said of the gaps between the NASDAQ and DJIA.





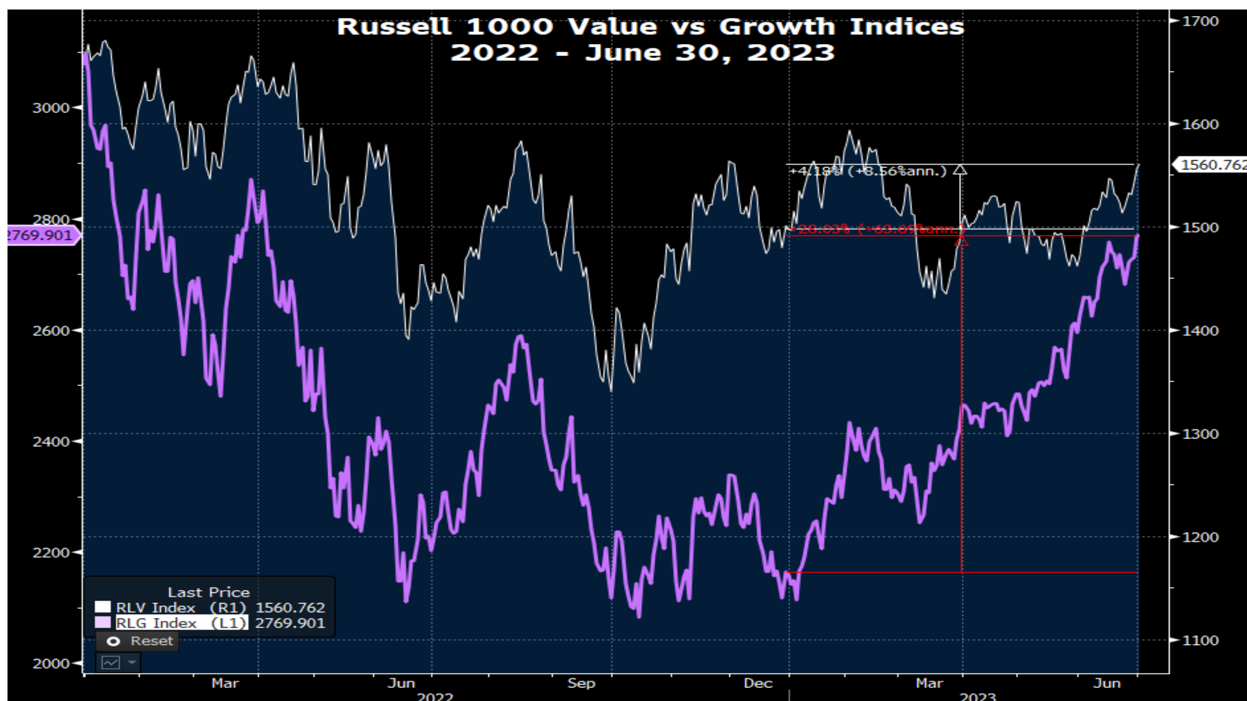
All styles of value and growth had their best months YTD in June, lead by a broadening out of the market, due to jumps in consumer sentiment on the Fed's rate hike pause, strong employment, and a rise in GDP estimates. As stated earlier, the economy is slowing, but doing so slower than expected, so the prospects for a soft landing, or even an ultra-short recession have improved, which for the moment has taken the worst-case fears (i.e. Fed causes a deep recession) off the table for the time being. If they raise rates at the next meeting, however, all of those fears could return and a sharp sell-off could occur.

On a total return basis in June, the total rates of return for the various popular indices were:

Russell 1000 Value (RLV)	+6.64%	Russell 1000 Growth (RLG)	+6.84%
S&P 500 (SPX)	+6.61%	Dow Jones Industrial Average	+4.67%
NASDAQ (CCMP)	+6.66%	iShares Select Dividend ETF (DVY)	+4.15%
		Sound Equity Income ETF (DIVY)	+5.76%

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

Russell 1000 Value	+5.10%	Russell 1000 Growth	+29.01%
S&P 500	+16.9%	Dow Jones Industrial Average	+4.94%
NASDAQ	+32.32%	iShares Select Dividend ETF (DVY)	- 4.52%
		Sound Equity Income ETF (DIVY)	+0.31%



As you can see in the chart above. Growth has been beating value since the start of 2023, however, over the last 18 months, value still has a point-to-point out-performance lead. This fact highlights that as strong as the tech rally this year has been, it has not yet filled the hole from the losses that it took in 2022, when the Fed started raising rates and technology orders slowed down sharply, as the pandemic spending patterns shifted back, for a time, as companies and people shifted their consumption patterns from work at home, to live and invest elsewhere.

Note that the S&P rebalanced the sectors a few years ago, to distribute technology names into other areas and reduce that sector's weight below 30%. In so doing, by moving things like Amazon, Tesla, eBay, and Etsy to the Consumer Discretionary sector, the traditional signals from price moves and correlations among the sectors no longer apply. For example, when Tesla and Amazon are up, and all the other names are down, the sector will often be up because of the massive weight on those two, which ironically are disrupting the remaining names. Similarly, Google and Meta, among other former Technology companies now labeled as Communications stocks, drive that sector's performance more than any of the traditional names. So, when you look at the table above and see that Communications stocks, as a sector, are up 34.9% YTD. Just a few of them are up 50%+, while the majority of them are flat or down. Same story with Consumer Discretionary's 31.2% rise. Give Tesla most of the credit for that one. Most of the traditional retail apparel stocks are also performing well below the S&P 500 average.

Monthly US Equity Market Report

6/30/2023

Fundamental, Technical, and Valuation Snapshots

Fundamentals: Demand for technology, and tech names in other sectors has lifted the S&P

Trend Negative estimate revisions in 8 of 11 sectors but the pace of revisions is slowing.

(+)	Information Tech	AI demand, cost cutting, & BTE orders have lifted #s, despite weak chips
(+)	Industrials	Good backlogs and re-domiciling investments have lifted estimates
(+)	Consumer Discretionary	Tesla, travel, services and select consumer products again saw gains
(--)	Healthcare	Pricing pressure and weaker outlooks are nicking estimates.
(--)	Financial Services	Positive stress tests & asset price gains have offset low volumes
(--)	Communications	Google, Meta & AI enthusiasm are lifting estimates, telecom is slipping.
(--)	Utilities	Soft demand, rising interest rates and operating costs nicked etimates.
(--)	Consumer Staples	Cost pressures are overwhelming companies ability to raise prices.
(--)	Materials	Prices are slipping, but the outlooks are better than feared.
(--)	Real Estate	Rising rates and poor office occupancy are causing estimates to fall.
(--)	Energy	Russian dumping oil, on top of high inventories has been reducing est.

	6/30/2023		Earnings Revisions			Performance (Total RoR)		
	Mix		3 Mo.	6 Mo.		MTD	QTD	YTD
S&P 500			-0.4%	-1.2%		5.3%	7.4%	15.5%
Communications	8.8%		-0.6%	6.2%		1.6%	12.0%	34.9%
Consumer Discretionary	10.9%		2.1%	15.8%	Best =>	10.6%	13.0%	31.2%
Consumer Staples	6.5%		-0.7%	3.5%		2.3%	-0.5%	0.3%
Energy	4.8%	Worst =>	-7.8%	-27.8%		6.0%	-1.5%	-6.1%
Financial Services	11.2%		-0.5%	-2.4%		5.7%	4.4%	-1.4%
Healthcare	14.4%		-0.3%	-9.0%		3.2%	1.9%	-2.5%
Industrials	7.8%		2.3%	12.3%		10.3%	5.6%	9.2%
Information Tech	27.1%	Best =>	2.6%	-0.8%		4.7%	15.1%	40.2%
Materials	2.8%		-2.4%	-17.8%		10.0%	2.3%	6.7%
Real Estate	2.8%		-2.5%	-17.2%		5.0%	1.3%	3.2%
Utilities	3.0%		-0.7%	4.6%	Worst =>	0.4%	-3.7%	-6.8%

Portfolio News and Changes

We made a handful of adjustments to both our dividend portfolios in May, with the goal of enhancing their yields and reloading their total return upsides. In one, we trimmed Abbvie, Greif, Omnicom, and Valero, added to Entergy, OneOK, Pfizer, and Walgreens Boots, exited Northwest Energy, and initiated a new position in inland refiner HF Sinclair (DINO), as discussed below.

We trimmed AbbVie and Greif because they were oversized positions, suffering from incremental negative revisions that we felt could be a drag on the portfolio. We do still think there is an upside to those names, to go along with their fat dividends, but not as much upside as the things we added too. Similarly, Omnicom has been terrific and remains cheaper than its metrics suggest it should be, but it has been going up, is getting closer to our price target, and was approaching our 6% max position size. So, with less upside and a large position, we trimmed it. We also trimmed

Valero, which we think is the best refiner in the US, to help fund the addition of HF Sinclair, which has a higher yield and more upside in the next two years, with a bit more risk. The combination effectively increased our US refining exposure slightly. Both have fundamental improvement stories underway.

We added to Entergy, OneOk, Pfizer, and Walgreens after speaking with the companies and getting quantification on the potential upside from portfolio repositioning in Entergy's case, and synergy upsides on the Magellan acquisition, in OneOk's case. PFE has upside from the Paxlovid (covid) approval and sales to Europe and China, as well as some promising pipeline drug data, including Danuglipron, a highly effective weight loss and anti-diabetes drug, which is entering phase III trials. Note, PFE has been under heavy pressure due to its aggressive $30B acquisition spree, which offers little near-term sales, but a handful of products that could launch in late 2024/ early 2025, when its next raft of patent expirations hit. We added to Walgreens Boots when the company explained to us that it is on track to achieve strong second-half gains, as its medical service acquisitions are integrated and cost initiatives begin to bear fruit. Also, CEO Roz Brewer bought 10K shares, her first open market purchase since taking the job, and the company indicated that it would only sell Boots at a price that would be accretive. Recall that there was much speculation that WBA might accept a very low bid for Boots, the leading UK Rx franchise. However, what WBA's IR rep told us is that bank funding for the deal dried up and WBA backed away when it could not get its price. This was a good sign, although we would rather they keep the business, which has superior margins and an insurmountable market presence in the UK.

We sold Northwest Energy only because we felt that Entergy and OneOK had more upside with similar risk characteristics. NWE has been performing inline a little better than other Utilities, but frankly had not been able to close on the asset purchases that made us want to buy it in the first place. These deals would have expanded its asset base and greatly improved its relative cost position, but the sellers recanted and after 18 months, it appears that the company will have to build more than buy, which will take some time.

Dallas Texas-based HF Sinclair (DINO) is a $7.8B market cap inland refinery (7 refineries, over a dozen formulation locations, and a network of pipeline and storage facilities) formed by the combination of Holly Frontier and Sinclair in early 2022. It trades at 5.6X current year earnings and pays a 4.2% dividend yield (It paid a 4.5% dividend when we began buying it, after it had fallen 40% from its November 2022 high). DINO currently trades at 4.2X 2024 estimated EBITDA, whereas a more normal peer multiple would be 6X. Getting closer to the mid-cycle peer average implies over 50% upside.

Since its formation, DINO has undergone a significant integration, restructuring, and management realignment program that has led to the ascension of Timothy Go from President / COO to CEO, and a dozen other senior management changes. Mr. Go is an efficiency "expert" that has been elevating the throughput and lowering the cost per unit at DINO over the last 18 months. With three refineries still significantly under-utilized, DINO has more room for gains to be realized, which should drive its midcycle sales, earnings, and FCF higher. In addition to operating improvements to the existing footprint. DINO has proposed to buy and consolidate the 53% of the Holly Energy Partners MLP it does not currently own (which consists of pipeline and storage

facilities that are 90% used by DINO). This action is expected to be free cash flow accretive to DINO and offer it further efficiency/restructuring opportunities if consummated. However, the all-equity deal also presents some arbitrage risk, should many HEP shareholders choose to hedge the deal premium before it closes, or sell afterward. Consequently, we only took a 1.5% position in DINO because of the uncertainty and potential share price dip that could occur depending on how many HEP shareholders chose to sell the DINO shares they received as payment for their HEP shares. Normally a starting position size for us would be 2% and a full position ~3%. If the stock drops back below $40 per share, we will likely add more.

In our other dividend portfolio in May, we also trimmed the AbbVie and Greif positions to initiate a new position in Tyson Foods (TSN), the largest producer of chicken and beef in the US, and the #13 producer of pork.

Springdale, AR-based Tyson has an $18.5B market cap and a 3.7% dividend yield. It is trading at 11.9X trailing 12-month earnings, but its 2023 earnings have collapsed, due to high feed costs and low meat prices, as farmers have over-harvested their herds to lower their carrying costs. As a result of this temporary phenomenon, TSN, which has over $8 of earnings power, is expected to earn less than $2 this year. Consequently, the stock has dropped by 50%, from a peak of $99 in February 2022, to a low of $47 in May 2023. We bought shares at ~$51, after insiders backed up the truck, and vowed to sustain the dividend, even if they needed to borrow to do so, akin to what Valero management said in 2020. We are familiar with the 18-month cyclicality of the protein industry, and recognize that things are not expected to improve before year end, so another dip is possible. So, far, TSN is only a 1% position, but we would like to add more, as enthusiasm over the insider buying wanes. Based on historical cycles, we anticipate that TSN can close half the gap between its 2023 EPS estimates and normalcy in 18 months, which should send the stock up 50% from here, In another 12 months, it should be earning over $8 per share again, which should send the stock back up towards $100 per share. When you add the dividend to that, we think TSN should double from here in 2.5 years.

June Changes

We also made a few adjustments to the portfolios in June, to help improve their prospects and try to reduce their risk profile, without giving up much yield.

In one of our dividend portfolios, we reduced our stake in Truist, after talking with the company. It appeared that they were getting pressure from regulators to raise their capital levels, which could reduce their growth rate further. Plus, if the Fed raises the overnight lending rate more, it could force TFC to sell the remainder of its insurance company, or even cut the dividend, though both of these outcomes seem unlikely now. What we grew concerned about was the change in tone of our back and forth. In prior conversations, the company had been more forceful that the dividend was secure and the insurance business would be retained. TFC’s new IR spokesman was less confident about that outcome in a scenario where short-term rates rise further, so we decided that prudence was the wiser course than valor.

We put those proceeds into AT&T after talking with the Morningstar Analyst and listening to the company management at conferences. AT&T sold off in Q2 on concerns that it would not hit its

$16B FCF target for the year, after a heavy capital investment period in Q1. Subsequent to the selloff, T's management has been adamant that they will hit the target and we think that is likely too, as the company has had many chances to pull back on this goal, but has not done so. If AT&T posts a jump in free cash flow, as expected in Q2, we believe the stock will jump about 10% higher.

In our other dividend portfolio, we sold all of our Truist and Synchrony Financial, to make capital available to take starter positions in two new Materials companies, Sealed Air (SEE) and International Flavors and Fragrances (IFF). We also sold small pieces of Greif (GEF/B) and Molson (TAP), and added to Citigroup, after its stress test results came back favorably. We also added a half percent to our tiny position in Tyson Foods (TSN), on favorable comments about the outlook for chicken in 2024.

In June, we also took a 1.5% "starter" position in Charlotte, NC-based Sealed Air (SEE). SEE is a $6B market cap protective (55%) and meat (45%) packaging company. It is most known as being the creator of bubblewrap, but today is as much of an automation company as a polyethylene film and bag maker. SEE trades at 11.6X depressed 2023 EPS, 7.4X EV/EBITDA, and pays a 2% dividend yield. These figures are ~30% below its long-term average multiples. At $40 per share, SEE is down by ~40% from its 2022 high of $70 due to declines in online purchases, following the post-pandemic reopening of retail stores, which meant fewer things were ordered online and packed in SEE's protective packaging solutions. These declines are nearly annualized, so that drag is ending. This sales normalization and the benefits of bolted-on acquisitions are expected to lead the company back to normal mid-single-digit top-line and low double-digit EPS growth going forward. As the company demonstrates a return to normalcy and growth, we expect its earnings and valuation multiples to reinflate. A secondary concern is that meat volumes, which are inflated this year, due to excessive beef harvesting in the US may fall next year. The company has told us that any fall in the US meat business (56% of the total) in 2024 would very likely be offset by growth in South American and Asian sales. Putting this all together, we have a $56, twelve-month price target, which along with the dividend would be 40% upside. Getting back to $70 in two years would be a 79% two-year pre-tax rate of return. This is an example where we took an above S&P 500, but below portfolio average, dividend yield in order to capture above average sales and EPS growth, and total return prospects.

We also took a 1% position in New York City-based International Flavors and Fragrances (IFF). IFF has a $20.4B market cap and by sales is the second-largest flavor and scent ingredients company in the world after France-based Givaudan. The stock normally trades at 27X current year earnings, but is trading at 16.7X because of customer destocking and a slowdown in its food business, which caused management to miss and reduce earnings expectations by 16% in 2023, a rare setback for the firm. This disappointment coincides with a transition in management, which has caused investors to wonder if the new team is any good, and if IFF has lost its edge over peers. Further, the dive in earnings has lifted IFF's ND/EBITDA to 4.8X, which is well above the company's stated targets of 3.5X or less. Consequently, the company is not in a position to raise its 4.2% dividend yield any time soon or to buy back any stock. These issues drove IFF down 50% from its 2021 high of $156 to a low of $75 in 2023.

By looking over IFF's financials, its earnings and investor meeting transcripts, and those of its peers, we believe that the issues are more due to European industry contraction issues than poor execution on the part of management. Further, the old management team is the one that elevated the debt, by overpaying for acquisitions, and they are gone. So, this new team is selling off non-core assets to pay down debt and recently hired a new President to run Nourish (the food ingredients business) with a greater customer orientation, which sounds very encouraging. Unfortunately, we could not get the company to return our calls and had to rely on third-party feedback alone, which explains why IFF is a 1% position and not a 3% position. However, assuming almost no multiple expansion, and just assuming that the company can grow sales off of the depressed 2023 figures by 4% (in part due to divestitures), we see a 25% upside in the shares. If they get the benefit of multiple expansions, to previous levels, the stock could double, while paying a 4.2% dividend on the purchase price. We think the issues will take at least two years to fix.

Performance

In June, our portfolios rose and performed nearly in line with the S&P 500 for the first time in months. However, YTD, the S&P 500 and NASDAQ still have very large leads over value and dividend investors like us, thanks to those popular benchmark's heavyweights in the large-cap technology names that have been soaring all year, which do not pay any dividends or the kind of yields that we seek.

In June, one of our dividend portfolios saw its NAV rise by 5.44%, 45 bps shy of the S&P 500, while our other dividend portfolio rose by an estimated 6%, about 25 bps ahead of the S&P. In comparison, the Russell 1000 Value index captured a 6.64% total return, which bested both of our portfolios for the first time in a while, due mostly to the above index drag from our pharmaceutical and consumer staples names. Just like in football, playing too much defense and not enough offense has hurt us more than it helped us this year. The President's new laws to force drug companies to give back price increases and allow Medicare to directly negotiate drug prices going forward certainly did not help the value of our pharmaceutical positions. These legal changes were made quickly and have not been implemented, but the market is predicting significant earnings pressure to result from them, which may warrant selling them sooner than we planned. The research on this topic is ongoing.

YTD, one of our dividend portfolios is estimated to be up about 10 basis points and the ETF NAV is down 10 bps, but its market return has been +31 bps, as the ETF traded slightly above its NAV. Our other dividend portfolio is estimated to have captured a 1.11% total return YTD. Again, these results came in below all the major benchmarks, but above the iShares Select Dividend ETF, a popular alternative.

Stepping back from the short-term frustration of lagging the price performance of the large indices YTD, it is helpful to remember that we have fulfilled our yield goals of delivering superior cash flow to our clients and all of our portfolios have meaningfully out-performed the S&P 500, Russell 1000 Value and even the NASDAQ since their inceptions. If we have another year like the first half of 2023 however, we may have to revise that claim.

Characteristics: Still Appealing vs. the S&P 500

The characteristics of our portfolios show that they are still ~44% to 45% 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 the end of June, one of our dividend portfolios was paying a 4.6% annual dividend 2.9X that of the S&P 500 for 44% below its PE price, while the other was paying a 3.6% dividend, 2.3X the yield of the S&P 500, at 45% below its PE price. The first portfolio has a 2023e EPS growth forecast that is 7.5% above the S&P 500, while the second is expected to grow EPS 11.6% 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.

Equities Outlook & Perspective

While forward estimates continued to fall, as higher interest rates reduce consumer and business demand for incremental projects that require financing, such as housing and construction, demand for services have continued to surprise on the upside, while falling prices in some areas, especially gasoline and full employment have kept consumers and investors spirits up and lifted stock prices.

Looking ahead, we think the equity market is bifurcated, with high-tech winners pulling up the index valuations to overbought levels, while the average stocks are still trading at discounts to normal, in anticipation of cooling demand and possibly a recession. This schizophrenia can go on for a while, as it did in 1998 and 1999, but it cannot last forever. Sooner or later, the high fliers will come back to earth (or at least stop rising) and the more pedestrian stocks will trade up to more normal spreads to the risk-free rate. With the risk-free rate back into positive territory, on long-term models, this implies PE ratios closer to long-term averages, which would be about 16X for large-cap US stocks. With our portfolios running at 11.5X or less, we have plenty of scope for positive revaluations in a more normal world.

In every environment, our objective is essentially the same: to find the most propitious looking high-yield, value-with-a-catalyst stocks we can find, that will pay high dividends to our clients and capture price appreciation, when the companies fix the reasons why they came to trade so cheaply that we were drawn to them. Since this confluence of virtues requires cooperation by our companies, business conditions, and factors well beyond anyone’s control, the timing of when our clients and we can book the anticipated wins will always be uncertain. But, just as hyper-growth stocks cannot orbit so high above the earth forever, lowly valued high dividend stocks cannot trail forever either.

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