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Todd Asset Management

Rates Bite Stocks, Not Consumers

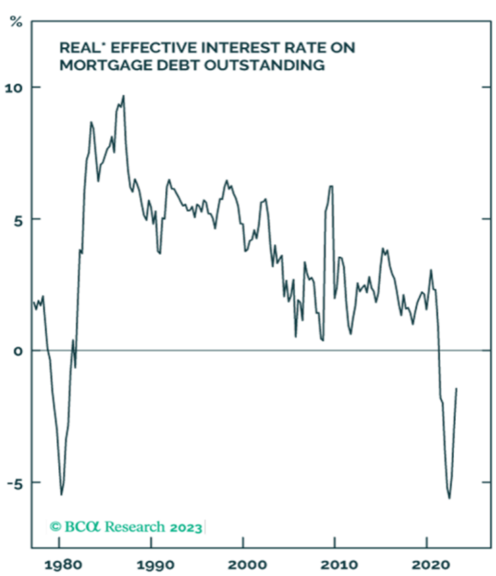
TAM US Q3 2023 Review and Outlook Chartbook

	3Q 2023	YTD	1 Year	3 Year*	5 Year*	7 Year*	10 Year*
S&P 500	-3.27%	13.06%	21.61%	10.15%	9.91%	12.24%	11.91%
Russell 1000 Value	-3.16%	1.79%	14.45%	11.05%	6.23%	7.91%	8.45%

* *Annualized Total Returns.*

Long term interest rates spiked in the quarter, taking a bite out of stocks. Ten-year yields increased from 3.8% to 4.8% from June 30 through early October, prompting a negative quarter for the indexes. Despite this, **consumers have remained resilient** and GDP estimates have increased for the third quarter. Why? We think the chart below sums it up well. Consumers are smart, and **when rates were low, they locked in long term fixed mortgages**. As long as they do not move and remain employed, **they are not feeling rate pressures**. **Many Corporations locked in low rates too**. This may complicate the Fed's attempts to slow the economy, but it makes a soft landing appear more likely to last.

Higher Rates Don't Change Existing Mortgages...



*DEFLATED BY HEADLINE CPI

- <u>**Real interest rates for existing mortgages are still negative**</u>.
- Existing homeowners feel locked in by low rates and are reluctant to move.
- Higher mortgage rates are not being felt by fixed mortgage holders, so consumption continues strong.

Commentary may contain subjective judgements and assumptions subject to change without notice. Commentary is based on information as of the date of this presentation. There can be no assurance that developments will transpire as forecast.

Other trends of note we saw in the quarter:

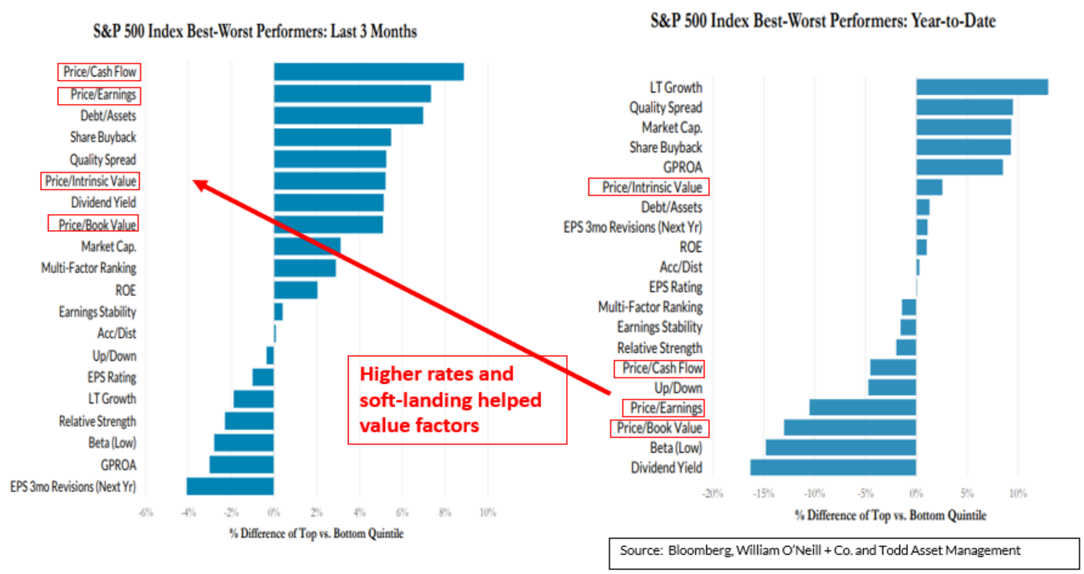
- **Higher rates allowed Value stocks to outperform**. The market has crowded into the Mega Cap Technology names in anticipation of the recession that has not come yet. The **longer we go without a recession, the more we believe markets need to broaden out** and value stocks should benefit.
- **Oil prices rose during the quarter**. West Texas Intermediate crude rose from ~$70 to ~$93 during the quarter, catching many by surprise. **Production cuts** from the Saudis and Russians coupled with a resilient economy led to higher prices. The recent war between Israel and Hamas probably keeps oil prices higher than they otherwise would be.
- **The Fed is probably finished raising rates**. At least for now. **Inflation is easing, labor markets are solid**, and markets have finally embraced the Fed's message. Also, investors may start to worry about a financial accident with rates moving this quickly. The **recent increase in rates feels market driven (fear of deficits), not Fed driven**. ***We think investors are embracing the risk of inflation being at least equal to the risk of deflation***. That is a sea change in sentiment from the past 20 years.
- **We still favor beneficiaries of a new Capital Spending cycle**. Much of the post covid **industrial fiscal stimulus** has not kicked in yet and **should begin in earnest in 2024**. Retooling the west will not be cheap. We favor **beneficiaries of higher rates**, **Energy and Commodities** due to underinvestment, the secular **application of technology** (electrification and AI), **corporate and government infrastructure** (materials, machines, and mechanics) and lastly ***Defense companies***. The period of ***the post-cold war peace dividend is over***, and all these areas are seeing (or likely will) industrial policy favor them.

Will there be a recession? Someday, but probably not yet. We are wary of several things that could shock consumers into spending less, but they do not seem to have enough traction yet. The **government uncertainty does not help matters**, especially as the deficit spending is accelerating during a period when unemployment is low. Interest payments have hit the level where the government has started discussing austerity in the past. The deficit may have woken up bond vigilantes for the first time since the Clinton administration. **There is a manufacturing slowdown**, though we think restocking probably prompts a pickup later this year. **Higher oil prices** could rekindle inflation, but that probably takes time. **Higher labor wage settlements** could play into that as well. *Still, against all of that, we see strong labor markets, good consumption, and earnings recovering. Until the yield curve un-inverts, history suggests no recession yet.* Without a recession, markets probably stage a fourth quarter recovery from the poor third quarter showing.

Charts We Are Sharing with Our Clients

US Factor Analysis- Recent Rotation to Value

As of 09/30/2023

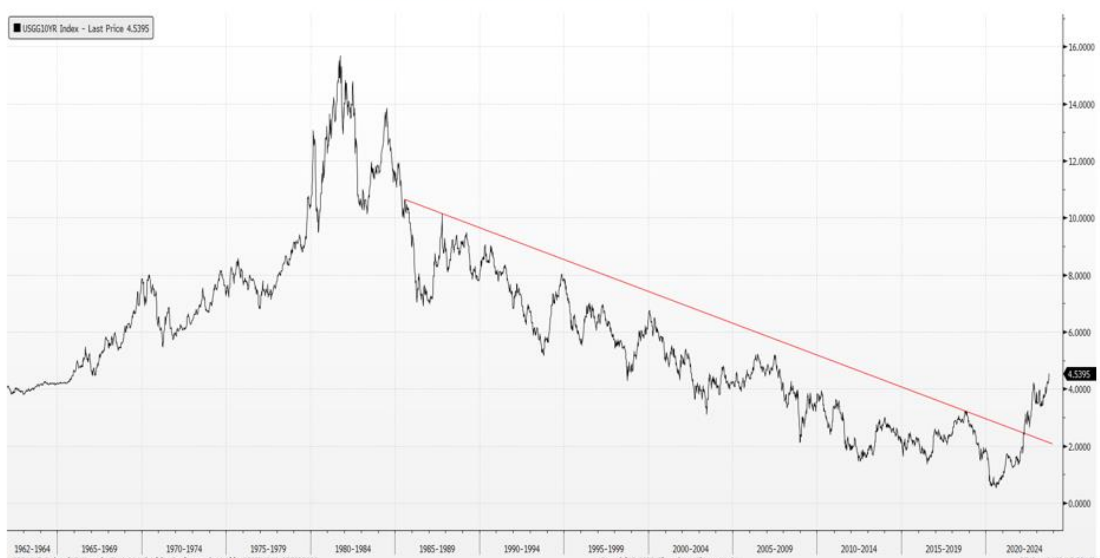


Source: Bloomberg, William O'Neill + Co. and Todd Asset Management

Data Source: Bloomberg, William O'Neill & Co. and TAM. The noted index is unmanaged, and not available for direct investment; it includes reinvestment of dividends; it does not reflect management fees or transaction costs. The volatility of the index and a client account will not be the same.

New Regime- Interest Rates Broke a 40 Year Downtrend

US Government 10 Year Bond Yields



Source: Bloomberg, Todd Asset Management as of 9/25/2023
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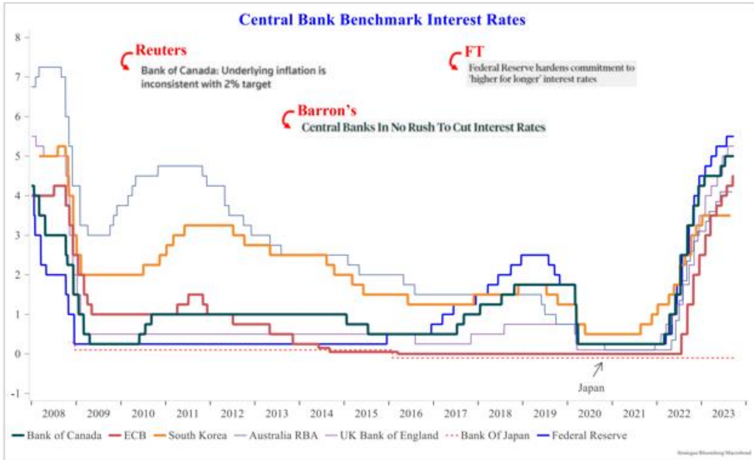
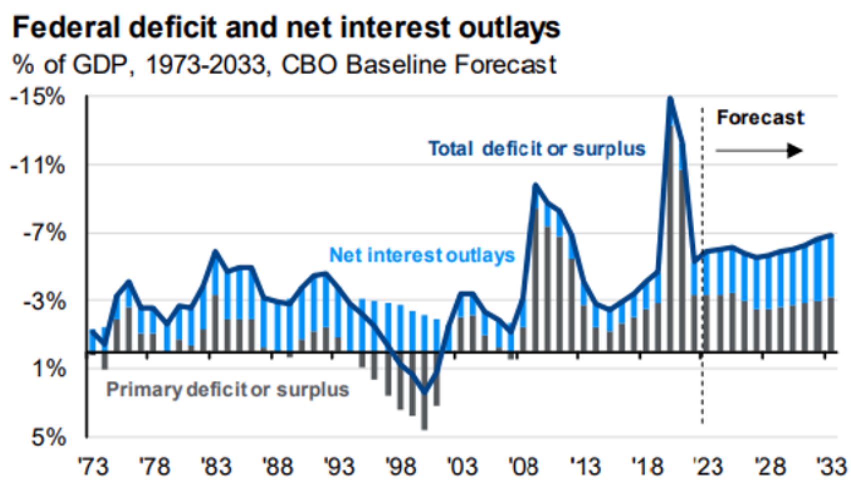
Concern: Higher for Longer is Finally Being Embraced

DESPITE NUMEROUS CENTRAL BANKS HINTING AT A PAUSE,
"HIGHER FOR LONGER" IS THE NEW MANTRA



Source: Strategas Weekly Recap in Charts 9-22-23

Concern: US Fiscal Policy Prompting Higher Deficits



Source: JP Morgan

Budget Deficits are higher, along with interest rates and bond issuance. These do promote better growth, but interest payments as a percent of the budget have reached levels where spending restraint happened in the past.

Good News: Recessions Usually Start AFTER The Curve Un-Inverts

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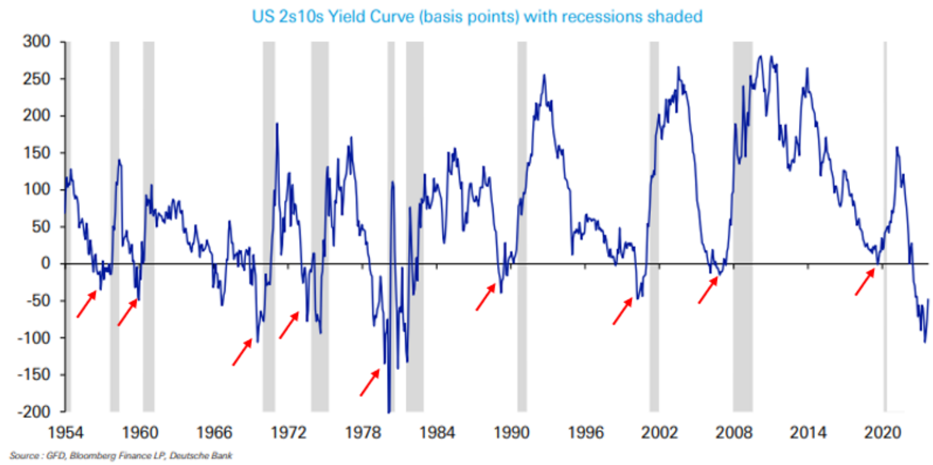

Source: Deutsche Bank

- Recessions occur after the yield curve steepens and (usually) post Un-Inversion.
- ***<u>Recession? Not yet, but not never.</u>*** Bond markets forecast un-inversion in 2025. Equity markets should broaden as investors start believing this.

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Opportunity: Manufacturing Turning?

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Manufacturing ISM Purchasing Managers Survey

Source: Bloomberg, Todd Asset Management

- Manufacturing **PMIs just ticked up** from a low level normally associated with turns in this index. **A restocking cycle is overdue.**
- **PMIs always recovered to expansion (over 50)** after a sharp uptick like this.

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Good News- US Earnings Estimates Heading Higher

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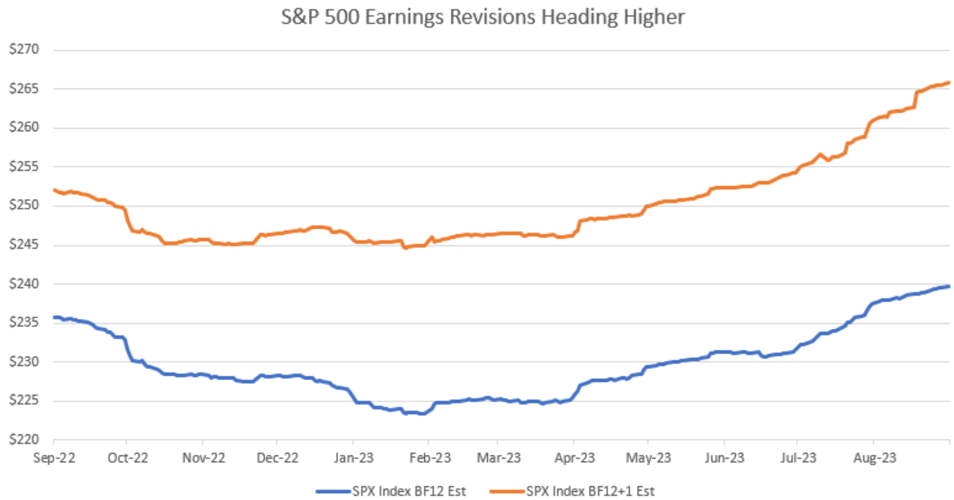

Source: TAM, Bloomberg- Data through 9-25-23
Lines measure S&P 500 earnings estimates as of the date mentioned for the next 12 months (blue line) and the same measure for one year from the measurement period (yellow line).

Source: Bloomberg, Todd Asset Management as of 9/25/2023
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Corporations and Consumers Benefit From Higher Rates!

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Source: Deutsche Bank, Bloomberg Finance

US companies fixed their debt at low rates, and still hold excess cash that is earning higher rates. The result? Net interest payments have declined (dark blue). **Consumers (light blue) are also collecting more interest.**

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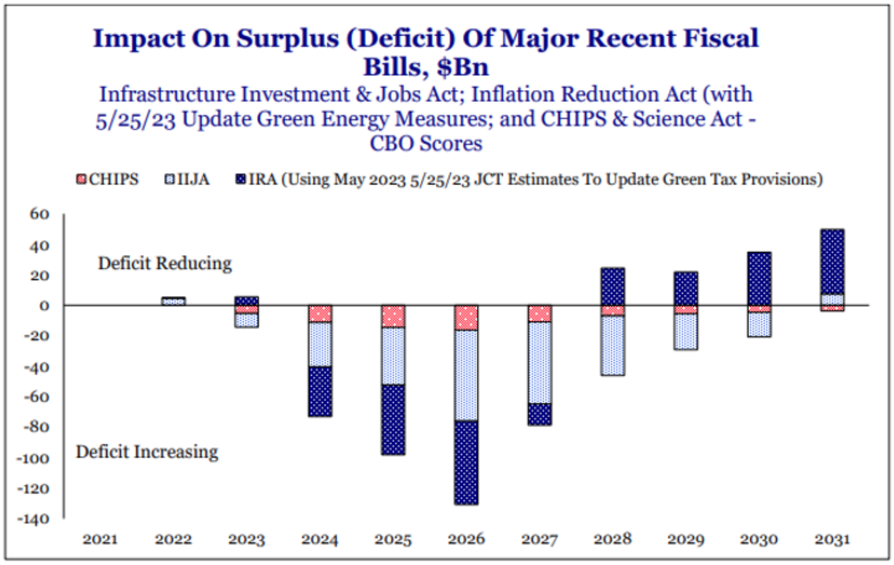
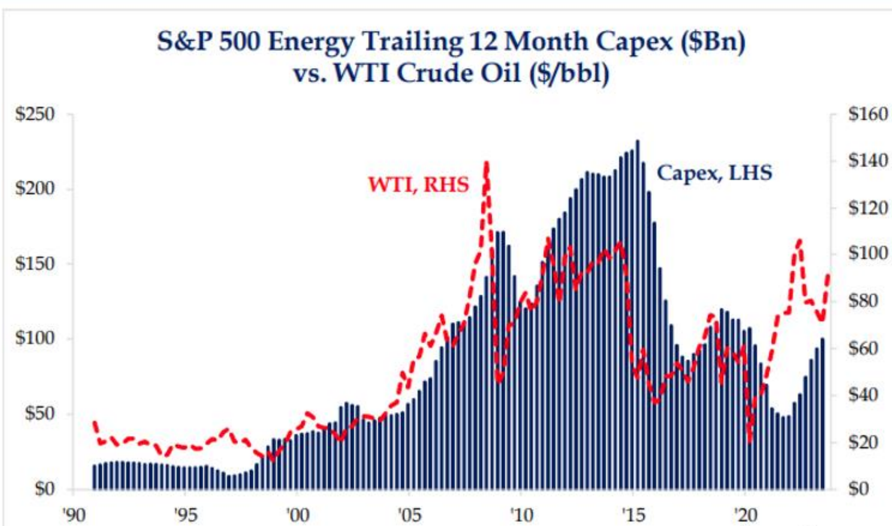
Industrial Fiscal Stimulus Starts in 2024



Source: Strategas

Consumer fiscal stimulus is over. A **multiyear Industrial fiscal stimulus starts in 2024.**

Oil Prices Remain Firm as Capital Discipline Continues



Source: Strategas

Oil companies slashed investment in drilling after the Saudis price war in 2015. Companies are **unwilling to increase drilling budgets** now.

Defense Spending Targets Spike

Source: Daily Shot

The "Peace-Dividend" Era is over and defense budgets are rising. Given the direction of geopolitics, the targets for spending may prove low.

Summary

Strategists are still angry that they have missed the no-recession call. We think several factors have aided the economy and delayed the traditional onset of a recession, maybe for years. The market fascination with the largest 7 stocks is a result of recession anticipation, as they are viewed as recession proof. **We believe the new capital cycle is likely to keep the economy afloat**. If it can allow for better productivity, it could delay the onset of recession for quite some time. **That should allow broader market participation** and the non-megacap tech names should work in that environment.

As always, if you need any additional information, please feel free to contact any of us.

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10/18/2023
S&P 500 – 4,315
Russell 1000 Value –1,482

The indexes used in this letter are unmanaged, and not available for direct investment. They do not include the reinvestment of dividends, nor do they reflect management fees or transaction costs.

S&P 500 Index is a widely recognized index of market activity based on the aggregate performance of a selected portfolio of publicly traded common stocks. The performance data was supplied by Standard & Poor's. It is included to indicate the effect of general market conditions.

Russell 1000 Value Index is a widely recognized index of market activity based on the aggregate performance of common stocks from the Russell 1000 Index, with lower price-to-book ratios and lower forecasted growth values. The performance data was supplied by Frank Russell Trust Company.