Q2 2024 Investment Update

Current Observations

- ***THE BIG PICTURE***: inflation has been a problem since COVID's eruption in 2020, with massive government spending overwhelming a "shutdown" economy that wasn't producing very many goods. The result was a not-so-surprising jump in inflation from barely noticeable to barely bearable. The Federal Reserve Board swung into action a bit late to curtail inflation, beginning its long campaign in early 2022 to raise interest rates from microscopic levels close to zero to 5.5% currently—designed to halt inflation's rise and bring it down over time. Almost two and a half years later, inflation has declined from a peak of 9% to the current roughly 3% level. The Fed's target is 2%...so some room to go…currently there is speculation of one rate cut this year…we'll see.

- Why is this important? Interest rates are the lifeblood of the economy, impacting spending on homes, automobiles, commercial real estate, business spending on factories, capital equipment, and inventories. Interest rates also impact investments in a couple of ways. First interest rates impact the value of assets such as real estate and common stocks. Higher rates depress asset values, while lower rates raise asset values. In addition, when investors can earn 5% risk-free then the required returns must be higher on alternative options such as stocks, bonds, and real estate to attract investment capital.

- As longtime clients know, and we preach perhaps too frequently, we don't attempt to forecast the economy, inflation, interest rates, stock market directions, or any other short-term investment factors. Why not, you might ask, aren't they important? Yes, but they're also largely unknowable. In the short term. Over the longer term, say 3-5 years, we have more confidence in assessing what might happen. Think about all the recession talk we've endured over the past two years or so, as pundits proclaimed higher rates would clobber the economy. Well, the clobbering has been postponed. So far. Eventually, we'll have a recession. And…that's OK…our economy has survived every recession we've gone through over the past 75+ post-World War II years. But those who made long-term investment decisions with an eye toward swerving around the next recession are kicking themselves. The old saying **"*You gotta be in it to win it*"** applies big time in the investing world.

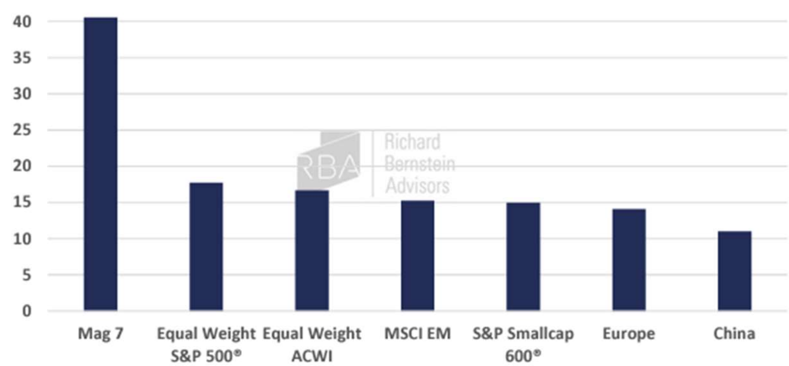
- Similarly, those who thought inflation wouldn't decline and invested on that basis might have regrets. Again, we don't know (nor does anyone else), if the Fed will reach its 2% inflation goal. The Fed's public comments indicate a serious determination to get inflation back down to the 2% level. So far, inflation is moving in the right direction, lower. But progress might be halted. We always seek to prepare for a range of scenarios.

- The global political situation remains as complicated as any since perhaps World War II. The Dictators Club of China, Russia, Iran, and North Korea—we've dubbed them Club CRINK—continues to help each other to undermine global democracy and freedom. China is covertly supplying Russia with plenty of support in its war in Ukraine, getting cheap oil, natural gas, and other commodities from Russia in return. Iran is also helping Russia with military support. Not to be outdone, North Korea is also involved, aiding Russia with arms and getting food and other necessities in exchange. In our view, since the Dictators Club controls only about 20% of the world's population, and many of their own populations despise them, the Dictators need to stick together.

- Most relatively free countries also despise the Dictator's Club, although acknowledging such sentiments in public doesn't usually happen. At this juncture, it seems likely the free world will be dealing with these autocrats as a combined group, based upon common mutual interests, if not love for each other. Meanwhile, Dictator-led economies continue to exhibit what you'd expect from a command-driven economy—problems. Misallocation of resources (Chinese real estate), wars to distract their citizens from the economy (Russia with Ukraine), internal social unrest (Iran), growing global pariah status (well…all of them!)—these are just a few of the Dictator's Club "accomplishments."

- One further thought on staying the course, having a long-term mindset, and above all, exhibiting patience and discipline. The stock market this year has been led by the so-called "Magnificent Seven" stocks. Alphabet (aka Google), Amazon, Apple, Meta (aka Facebook), Microsoft, Nvidia, and Tesla. They've accounted for most of the year's gains in the S&P 500. As you should expect, this "lovefest" by investors for a very small slice of the stock market has repercussions. Here's the problem, in our view:

CHART 2:
PE Ratios
as of 6/30/2024

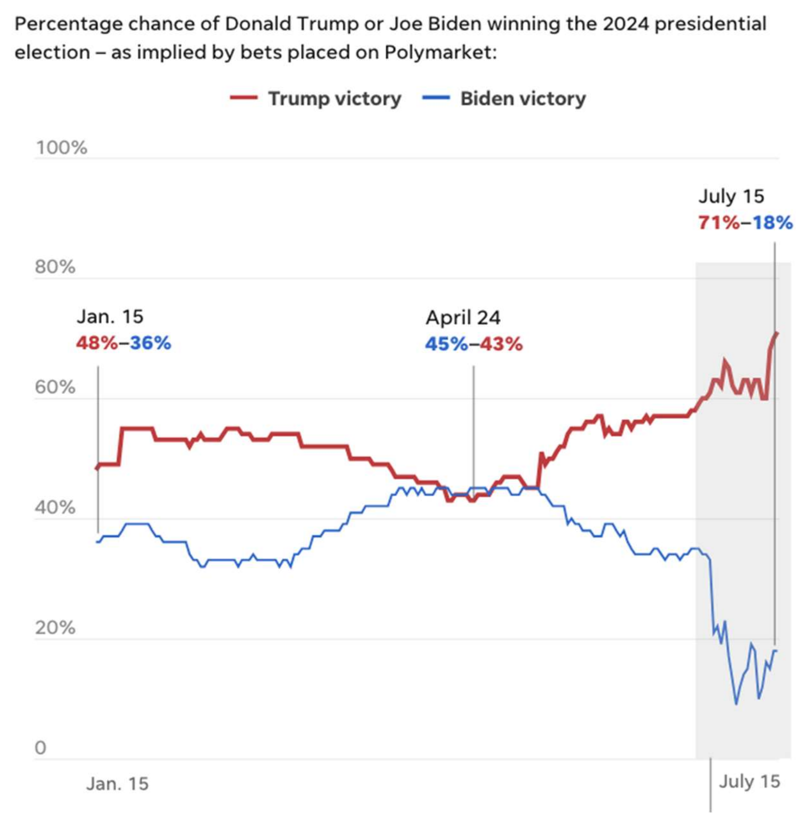


Source: Bloomberg Finance L.P.

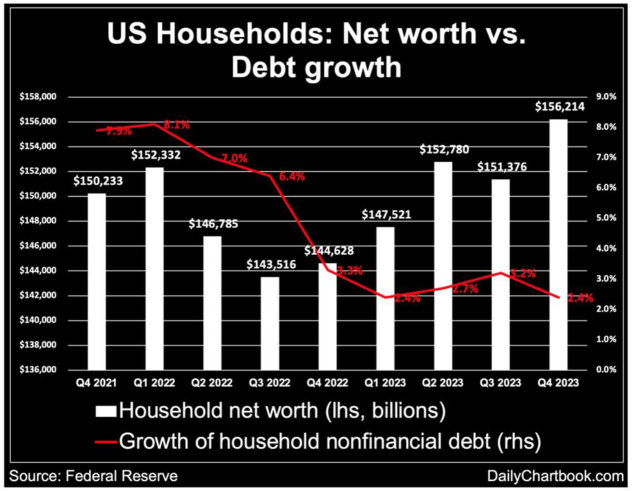
- The Mag 7, as the traders call them, are now extremely pricey, selling for roughly twice the overall stock market level. A bubble, you might conclude. Bubbles have happened in the past, and they'll happen in the future, simply because the stock market is controlled by humans. Humans make mistakes, sometimes large mistakes. FOMO, otherwise known as the "fear of missing out", is a real phenomenon in markets. We attempt to avoid this feeling by staying rational and sticking to our discipline. In periods of rampant speculation, such as we have now, it could mean not reaping short-term rewards. But we seek to avoid the long-term wipeout that can happen when you blindly invest based upon little more than a rapidly rising stock price. And you'd be surprised, there are plenty of "professional investors" who do this. They believe that they'll be smart enough to sell before the party ends…"leaving the ball just before Midnight" as Warren Buffett has described…a difficult task. Just as the Mag 7 has driven the S&P 500, the opposite could well happen. If investors decide to dump the Mag 7, we could see a lopsided impact on the index, only this time in the opposite direction…down.

- In the political realm, we all have heard about the attempted assassination of Presidential candidate Donald Trump. Whatever your political affiliations, we can all condemn this horrible act. As an aside, the Secret Service seems to be clueless, as well. What are the potential ramifications? Trump has picked up more support since the shooting, and his poll numbers are up, pointing to a big win in November. We mention this because the stock market is seemingly realigning itself based upon a Trump win, and this along with recent declines in the highly priced Mag 7 stocks has given a bit of a boost to our stock holdings over the past week or so. Another reason why we say, ***you can't predict, but you can prepare***.

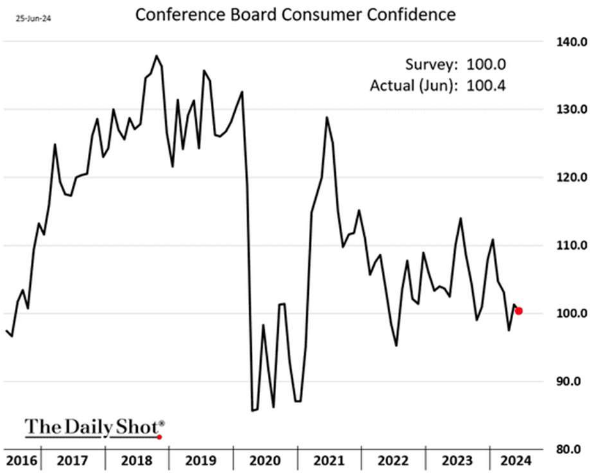
- The chart on the next page shows Presidential election odds since early this year. Trump got a bump after the shooting and is now a heavy favorite with a 70% chance to win, compared to a tossup early this year (we'll see how this changes with Biden stepping away and Harris as the likely nominee as of this writing):


Percentage chance of Donald Trump or Joe Biden winning the 2024 presidential election – as implied by bets placed on Polymarket:
Trump victory
Biden victory
100%
80%
60%
40%
20%
0
Jan. 15
48%–36%
April 24
45%–43%
July 15
71%–18%
Jan. 15
July 15

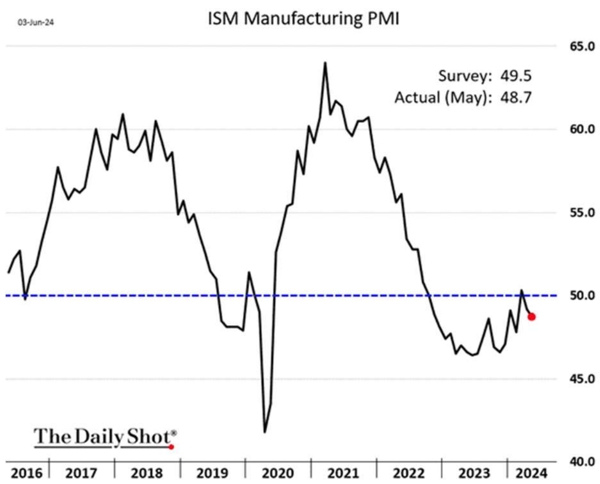
Next, let's look at a few more charts that can help to explain where we are now, and what we might expect over the balance of this year and next year. First up, the Fed's rate increases haven't yet pushed the economy into recession. Yet. Maybe this has something to do with it:



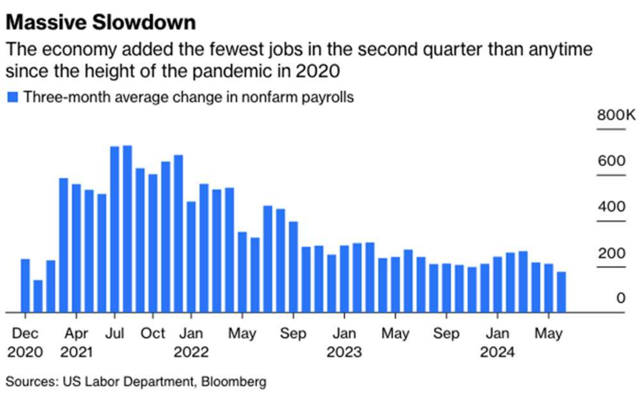
Household net worth has held up despite interest rate increases, while debt burdens have declined. Yet if you look at consumer confidence, there doesn't seem to be a lot of it:



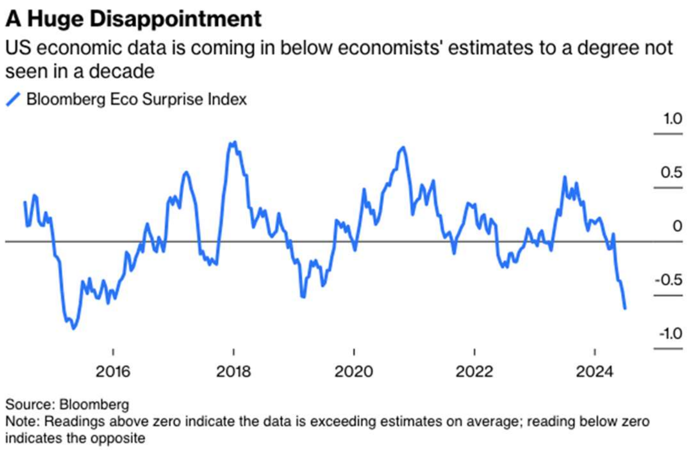
Consumer confidence plummeted in the COVID era but rebounded somewhat after plenty of government aid arrived. Then, as that stimulus petered out and interest rates rose, consumer confidence resumed its decline. We'd say there is more confidence among higher-income consumers, while the broad middle- and lower-income levels see increasing stress. Even business has been feeling not so great over the past couple of years, with manufacturing activity dropping to levels that indicate recessionary conditions (below the 50.0 level):



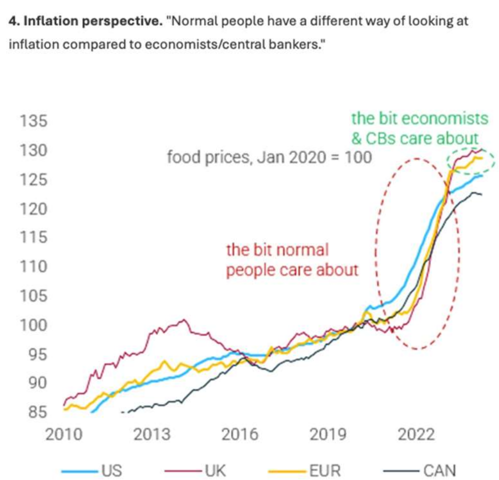
And yet, despite all the gloomy consumer and business sentiment, the economy has continued to chug along. However, things might be changing, and not for the better. Jobs growth has been slowing, threatening a key element of the economy:



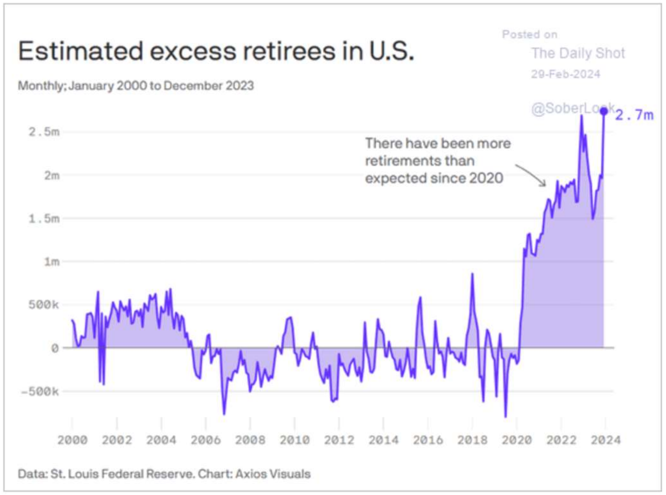
As should be expected, the impact of higher interest rates over the past 2+ years seems to be having an impact on the economy and jobs, at last. Overall economic data has taken a decidedly weaker turn:



But inflation is still an issue for the Fed, and the tug of war currently is between keeping rates high enough for long enough to reduce inflation, without causing a major recession. The chart below depicts why inflation has been a big issue for consumers and could influence the November elections. For the average consumer, it's less important that the current inflation rate has dropped, which is seemingly what economists focus on. What's more important is that the price of eggs, milk, and a McDonald's Big Mac remain at elevated levels:



While price increases have moderated of late, the overall LEVEL of prices is still much higher than 5 years ago. One factor in higher prices is a labor shortage. A reduced supply of labor means higher wages need to be offered to entice people to enter the workforce or to change jobs. The shortage is attributable to deaths and sickness from COVID, along with a wave of Baby Boomer retirements, as the next chart shows:

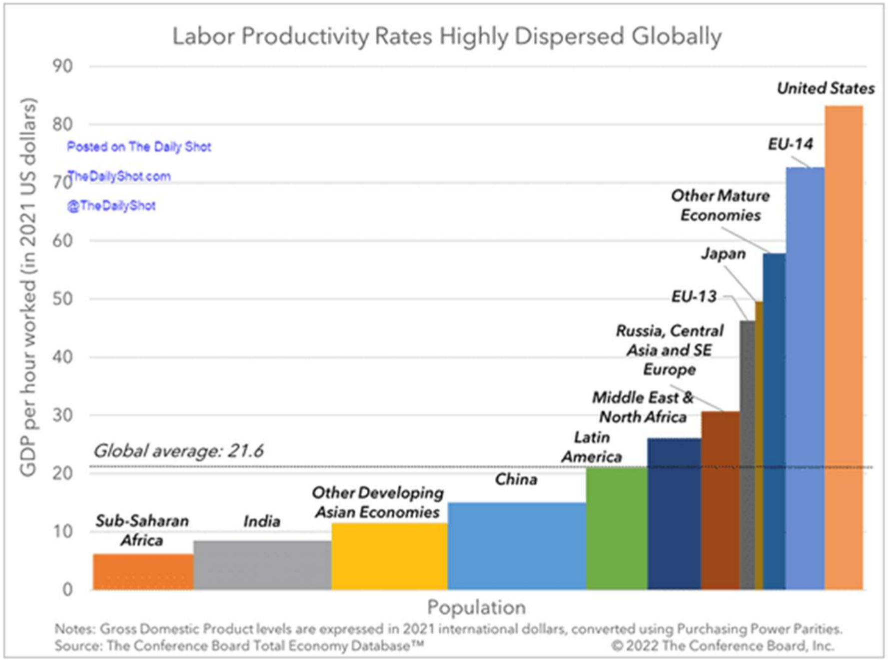


That's why you see McDonald's and others offering historically high wages to induce workers to flip burgers or work the cash registers.

While we can't know for sure, historically, higher interest rates have typically led to an economic slowdown or outright recession. As for inflation, it's still unknown if the inflation dragon will be slain. We have several forces pushing upward on inflation over the foreseeable future:

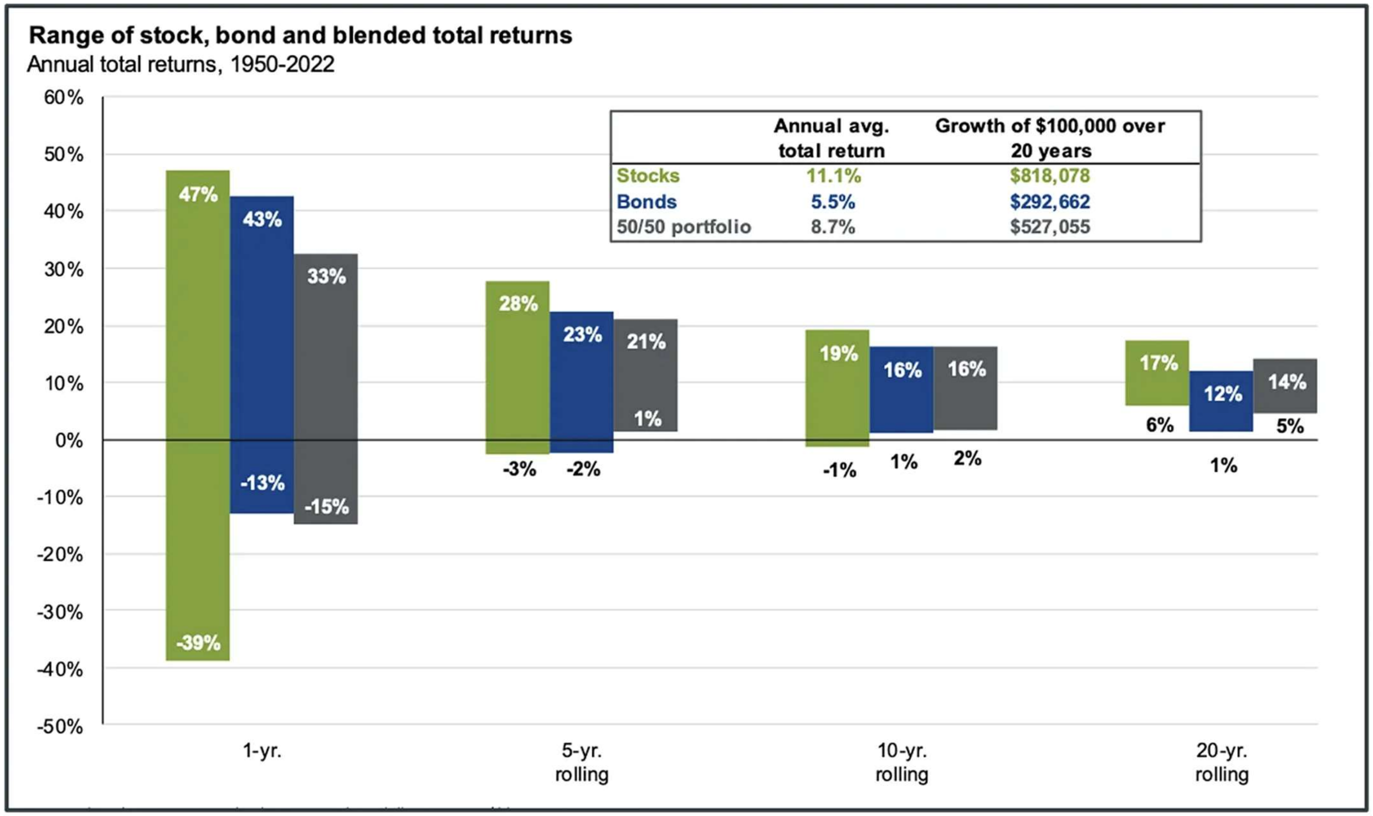
- Ongoing trade disputes, such as with China, and even friendly Europe, often lead to higher prices globally
- Climate change and the energy transition from oil and gas to solar and wind power will take decades and cost trillions of dollars
- Public infrastructure spending for our crumbling roads, bridges, schools, etc. will put upward pressure on labor and materials prices
- Onshoring or near-shoring of manufacturing to ensure stable supplies given ongoing geopolitical tensions creates additional spending
- Defense spending is going up around the world, and past defense spending increases led to higher inflation

We don't want to give the impression that it's all gloom and doom, for it's not. While inflation and interest rates may be higher in the future than in the recent past, we still live in a remarkable country. Entrepreneurial spirits, free enterprise, competitive markets, and the rule of law combine to make the United States the best large country in the world for investors. We have world-class companies, the best universities, a well-trained workforce, and the highest labor productivity on the planet. The chart below shows that the U.S. produces much more per hour worked than anywhere else on the planet:



Labor productivity is important for one reason: it's through higher productivity and a growing workforce that we get major improvements in living standards. More workers making more stuff per worker is the magic key to greater prosperity for countries. In fact, it's the only way to improve living standards. Technology has revolutionized our country and the world and is a big factor in the rise of living standards both here and abroad. With the advent of Artificial Intelligence and other technologies, along with improvements in medicine, we should see many more decades of rising incomes and greater prosperity. Assuming we don't enter World War III and blow up the planet. That's about the only risk we can't sufficiently guard against. We pray that our leaders have the wisdom and courage to avoid this cataclysmic event.

We think it's helpful to periodically remind ourselves of history. Investment progress comes ONLY over long periods, as the short-term ups and downs of the economy and markets tend to be smoothed over time. This chart shows that as you extend your investment time horizon, the probability of earning a positive return increases. In simple terms, anything can happen over one year, whether it's big gains or big declines. As you extend out to 5-, 10- and 20-year rolling periods, we've seen positive results in just about every period under consideration since 1950. Something to remind yourself the next time the financial media talking head screams at you to dump your investments.



	Annual avg. total return	Growth of $100,000 over 20 years
Stocks	11.1%	$818,078
Bonds	5.5%	$292,662
50/50 portfolio	8.7%	$527,055

Source: JP Morgan Guide to the Markets

And finally, we love this chart…it reminds us that investors have been rewarded over time despite enduring numerous crises, pandemics, natural disasters, recessions, political upheaval, rising interest rates, wars, terrorism, market declines, inflation, deflation, etc. The stock market has historically provided above-inflation returns to those who remain patient, accept periodic volatility as a normal market function, and stay focused on their long-term goals.

Important Beliefs

- Whether it's retirement funding, income replacement, travel, charitable contributions, college costs, or financial assistance to children or grandchildren; our job is to help you determine your future needs and chart a course to help get you there. To accomplish these long-term objectives, ***you need a long-term plan***.

- Regarding your investment policy, nothing has changed, because nothing ever changes. That is: ***we are long-term, goal-focused, plan-driven equity investors***. We own diversified portfolios of quality companies; these companies have demonstrated the ability to increase earnings (and in many cases dividends) over time, thus supporting increases in their value.

- The graphic below provides a good visual of how to think about financial matters and your emotional well-being. Focus on those things within your control and try to avoid the all-too-human tendency to dwell excessively on those things well beyond your control. Yes, it's easy to say, and more difficult to do. We acknowledge that. We're ALL subject to these occasional feelings. ***Recognizing these feelings but not acting upon them is a critical part of long-term success.***

General Principles

Together, we are **long-term, goal-focused, planning-driven investors**. We've found in our experience that the best course for you is to formulate a financial plan—and to build portfolios to serve the plan—based **not** on a short-term view of the economy or the markets, but on **your most important lifetime financial goals**.

- Since 1960, the S&P 500 Index has appreciated approximately **76 times**; the cash dividend of the Index has gone up about **33 times**. Over the same period, the Consumer Price Index has increased **10 times**. So historically, equities have functioned as an extremely efficient hedge against long-term inflation and a **generator of real wealth** over time. We believe this is likely to continue in the long run, hence our investment policy of primarily owning successful companies rather than lending to them.

- We believe that **acting continuously on a rational plan**—as distinctly opposed to reacting to current events—offers the best chance for your long-term investment success. The best recent example of sticking to the plan was seeing the market's reaction to COVID. Simply stated: **unless our goals change, there is little reason to alter your financial plan**. And if our portfolio is well-suited to that plan, we don't often make significant changes to that, either.

- **We do not believe the economy can be consistently forecast, nor the markets consistently timed**. We're therefore convinced that the most reliable way to capture the long-term return of equities is to ride out their frequent but ultimately temporary declines. In practice, this means being mentally prepared to handle roughly 15% short-term declines annually, and roughly 33% declines every 5 years or so. **Avoiding costly changes in reaction to short-term volatility provides you the potential to earn higher long-term returns.**

- The performance of your portfolios relative to their benchmark(s) is irrelevant to your investment success as we define it. **The benchmark we care about is the one that indicates whether you are on track to achieve your financial goals**. One of the biggest goals is making sure you don't run out of money during your lifetime.

- Our investment philosophy is to invest in businesses with a history of providing essential products and services. We prefer significant management ownership to create an alignment of interests with us. We seek to invest at reasonable prices and hold these exceptional businesses for many years. Assuming no nuclear annihilation or World War III…we expect this approach will do well over long periods.

As always…please keep us updated with any changes to your financial situation that might suggest altering your asset allocation and investment portfolio and let us know if you'd like a current copy of our Form ADV Part 2.

Your LOYALTY and PATIENCE remain our secret weapons. We value our relationship with you and appreciate the opportunity to continue to serve you and your family. Thank you for being our client. It is our privilege to serve you.

Sincerely,

John Heldman, CFA

Dave Hutchison, CFA

July 22, 2024

"The best way to measure your investing success is not by whether you're beating the market but by whether you've put in place a financial plan and a behavioral discipline that are likely to get you where you want to go. In the end, what matters isn't crossing the finish line before anybody else but just making sure that you do cross it."

-Benjamin Graham, <u>The Intelligent Investor</u> (and Warren Buffett's mentor)

"Forecasts are highly uncertain. Forecasting is very difficult. Forecasters are a humble lot with much to be humble about."

-Jerome Powell, Federal Reserve Board Chairman