



Sound Income Strategies, Monthly Equity Update

April 30, 2024

Monthly Maxims

"Whoever controls the volume of money in a country is absolute master of all industry and commerce."
– James A. Garfield

"Blessed are the young, for they shall inherit the national debt." – Herbert Hoover

Executive Summary

Macro: In April, stronger-than-expected inflation and economic data pushed back the timing for the Fed to cut the overnight lending rate, undermining a core catalyst for the stock market's post-Fed-Pivot rise. This sentiment was echoed by hawkish Regional Fed-head commentaries, which sent rates higher and security prices lower all month. Ironically, the seeds for lower inflation and slowing economic growth were evident in the reported data, but backward-looking headlines again got more attention than forward-looking analyses. In the case of inflation, new tenant rents are already near zero, so by mid-year, rent inflation will be cooling quickly. Similarly, earnings estimate cuts outside of technology foretell of an economic slowdown in the second half. However, when you dig below the surface, the lower-than-expected GDP report also wasn't as bad as the headline. So, the only way we could get into deep trouble on a full-year basis seems to be if the Fed's "higher for longer" goes too long, or there is a meaningful exogenous surprise.

Adding to the drama of the recalcitrant Fed and the ongoing wars in Israel and Ukraine, President Biden rolled out higher personal and corporate tax rate proposals that will add to market uncertainty as the November elections come closer. Further, he made no mention of cutting Government largesse to help lessen deficit spending.

Markets: Most US stocks fell in April, on the higher interest rate pressures & rising uncertainty mentioned above. Q1 earnings season has amplified the fundamental gap between AI technology-driven demand and slowing demand elsewhere. Capital goods spending and housing turnover have slowed in response to higher interest rates, while lower-cost consumer activity, such as restaurant, travel, and apparel sales have held up, but their outlooks too are dimming. In the end, only the utility sector gained in April, as investors braced for both higher-for-longer rates and a resulting economic slowdown in 2H'24.

Portfolios: The Sound Income portfolios were battered in April, as even strong earnings reports were punished by sell-offs in cases where management did not raise guidance. In particular, stocks with known problems saw sharp declines, as investors took down cyclical risk and bet on companies with momentum rather than on turn-around stories. The silver lining in this volatility is that we are getting shots at upgrading our portfolio quality when good companies get over-sold on bad news. For example, in April, we took positions in Lysol's

parent Reckitt Benckiser and LKQ Corp., a unique aftermarket auto parts maker, when their shares dropped precipitously on problems that appear likely to be cured.

Part I: Macro Factors and Thoughts

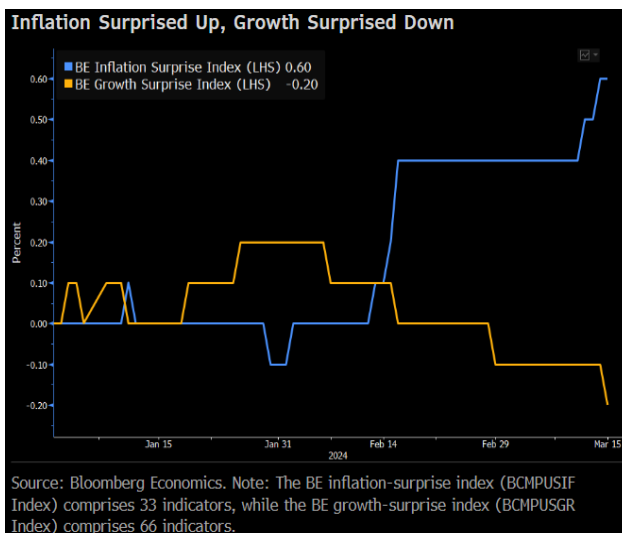
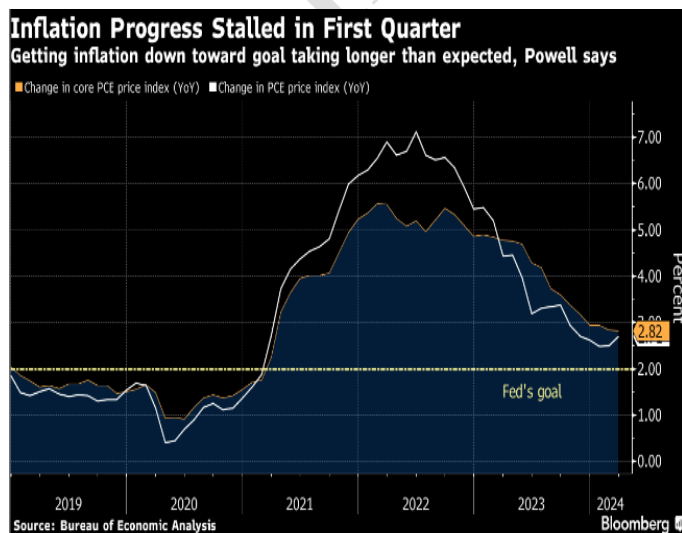
Too Much Rear-view Data and Not Enough Forward Thinking

Every month, ~125 US-focused economic reports produced by Government agencies, universities, and the private sector are published on many topics, including labor, trade, business trends, GDP, sentiment, inflation, and money supply. Each data set provides some evidence of how the US economy is performing relative to expectations, but most of it is backward-looking, as the data reports what has happened, rather than extrapolates into what is likely to happen. For insightful forecasts, we need analysts, from which divergent interpretations often emerge. Unfortunately, this divergence sometimes creates as much uncertainty as the unanalyzed reports themselves.

To help put these releases in context, Bloomberg rates their relevance on a scale of 0 to 100, based on the historical significance of the data. While helpful, this system doesn't always get it right, so no one cites a report's relevancy score before trumpeting its findings. Plus, the data deluge is so great, most news services only have time and resources to report the headlines and a few pundit-proffered take-aways, without doing much real analysis into what it all means. Hence, we get a steady torrent of superficial news that is repeatedly blasted across all forms of media, such that it stirs emotions into sometimes powerful reactions that can harm investors, just as often as it helps them.

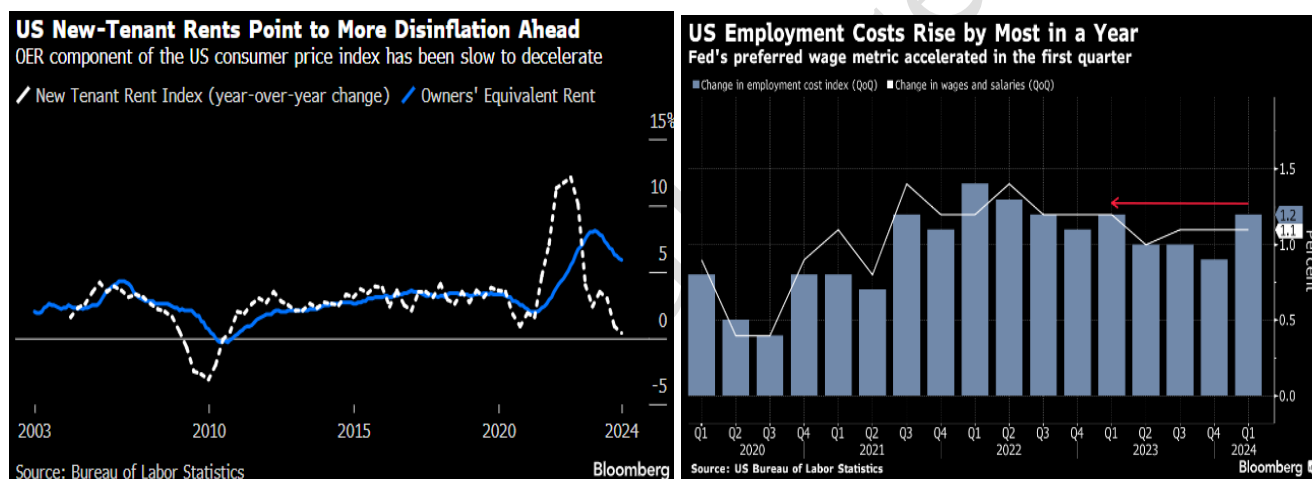
Making matters worse, today, natural language trading algorithms pick up on the tone of these flimsily analyzed reports and then effect trades that move security prices in response to the media hyperbole. While these over-reactions should wash out and create opportunities for those who can see through prices that are not soundly based on fundamentals and wait out the pendulum swings, it doesn't always play out that way, which reminds us of Maynard Keynes' famous line "markets can remain irrational longer than you can remain solvent." So, we sometimes suffer long bouts of what seems like irrationality that never come back to equilibrium, as media prophecies can be self-fulfilling.

Well, this backward-looking, headline-hawking news cycle is going on now full bore with regard to inflation and the economy. As the charts below show, we are now mostly on the other side of the inflation surge, but backward-looking data have continued to come in hot, as this month's CPI, PCE, and wage reports showed, so the Fed's "data dependent decision making" has begun to backfire.

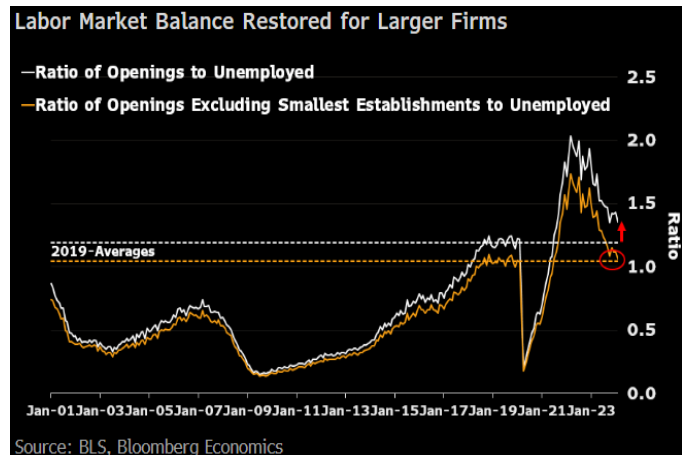
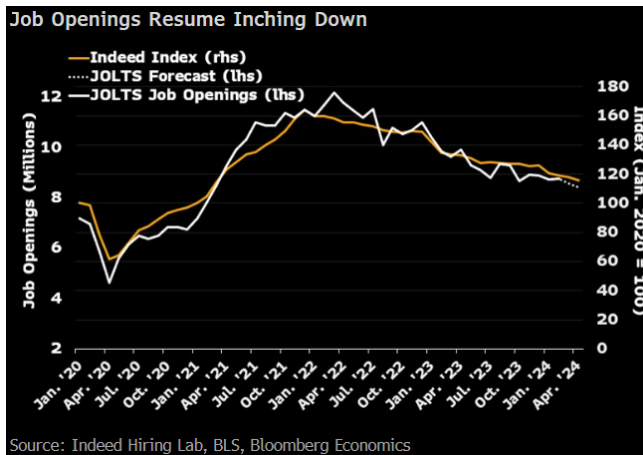


If you look at any economic data series, including the inflation drop from its mid-2022 peak, illustrated in the chart above, there is a certain amount of saw tooth movement akin to the old line, “two steps forward, one step back.” Indeed, it is unreasonable to expect a data series to not have some amount of retrograde and Chairman Powell knows this, but... he is caught in a trap of his own making. He laid out a 2% core PCE goal without getting any assurances that fiscal policy might cooperate with his tightening or recognizing that raising interest rates is inflationary to owner’s rent equivalents because landlords pass along higher mortgage interest costs in the form of higher rents, and higher rates mean fewer homes are built, so there is less supply to meet naturally growing demand. So, we have to wait until the Chairman can save face and say he didn’t risk re-igniting inflation by cutting too soon.

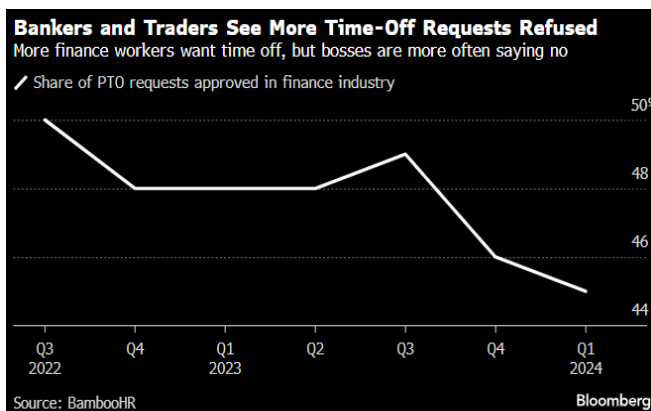
However, when we look at the biggest culprits for the stubborn inflation, the owners' rent equivalent (housing), insurance rates, and wages, they are all backward-looking and we can easily see the light of deflation peering through each measure’s tunnel of despair. Beginning with rents, the largest factor that has caused CPI and PCE inflation to be running hot. The monthly y/y New Tenant Rent Index peaked in May 2023 and has now fallen to near zero. The annual average OER will gradually reflect that drop, but with a six-to-nine-month lag. Already, the OER, as you can see in the chart below, is trending lower. It won’t get back to its 2.5% pre-surge level for another year, but it is on its way there.



Similarly, the 11% surge in insurance costs reflects the company’s passing along the higher cost to repair and replace goods, as prices have risen by 30% to 40% for goods & services over the past four years. This latest gap reflects a catch-up for the price increase through the prior year’s mid-point. With nominal inflation cooling to mid-single digits, the rate of insurance increases will gradually come down.



Wages too are another lagging story. They gapped up in the latest measure thanks directly to heavy organized labor contract step-ups for the automakers, the Federal Government, Airline mechanics, and even higher minimum wage laws enacted in California. Beforehand, they had been moving higher as job switchers have been able to get high single-digit salary gains on average by switching employers. However, as the labor charts above show, the scarcity of labor has greatly come down over the last 18 months. In fact, according to the Bureau of Labor Statistics, for larger companies the number of job openings no longer exceeds the number of unemployed people, so companies are paying up less, on the margin to secure new labor, and starting to tighten the screws on perks.



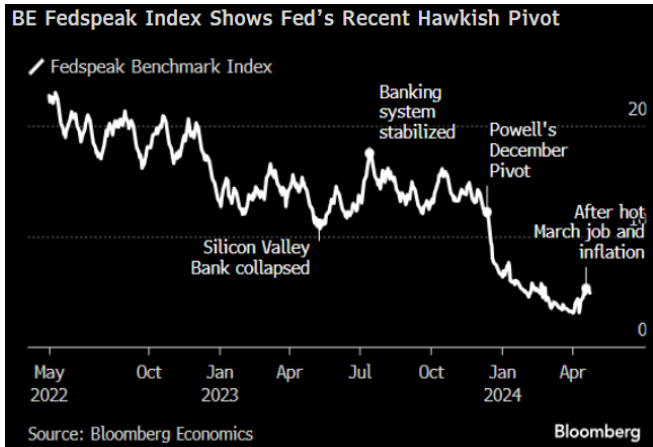
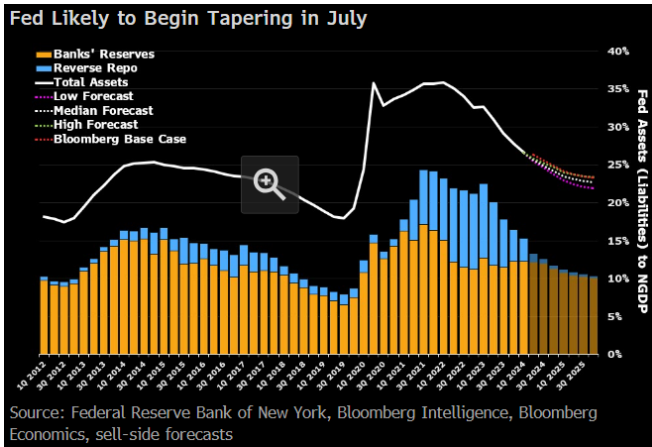
In fact, many forecast that after the Q4 labor contract surge, there won't be more surprises, as the lower-than-expected monthly hourly earnings data below suggests a slowdown.

Metric	Actual	Estimate
Change in payrolls (MoM)	+275,000	+200,000
Unemployment rate	3.9%	3.7%
Average hourly earnings (MoM)	+0.1%	+0.2%

It is also worth remembering that the incremental amounts that the core PCE numbers came in ahead of estimates were small, as illustrated below, so the data were more disconfirming than alarming. This marginality also indicates that the Fed is unlikely to pivot back towards tightening financial conditions, as some alarmists have suggested. In fact, most economists still forecast tapering in July.

Metric	Actual	Estimate
PCE price index (MoM)	+0.3%	+0.3%
Core PCE price index (MoM)	+0.3%	+0.3%
PCE price index (YoY)	+2.7%	+2.6%
Core PCE price index (YoY)	+2.8%	+2.7%
Real consumer spending (MoM)	+0.5%	+0.3%

Indicator	Actual	Estimate
GDP	+1.6%	+2.5%
Personal consumption	+2.5%	+3.0%
PCE price index, excl. food, energy	+3.7%	+3.4%



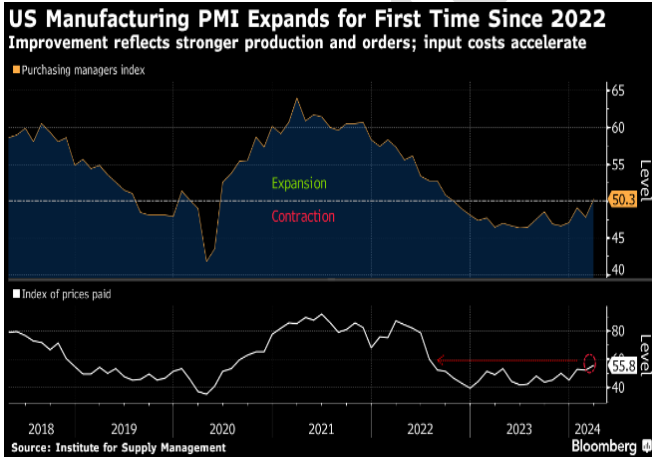
Other Notable Data

Retail Sales and Durable Goods orders, due to aircraft/defense, also came in stronger than estimates, but these too are backward looking (and personal consumption actually fell short of estimates). Within the retail sales beat 8/13 categories posted gains, led by e-commerce and gasoline, but higher cost items, like auto sales, fell, as higher financing and lower housing turnover dampened sales.

More encouraging than these figures for manufacturing was the ISM PMI increase, against easy comparisons. However, Manufacturing is less than 14% of the US economy, so this pickup is not as meaningful as the slowdown in services also reported. In fact, leading up to the Q1 earnings reports and on the calls, company managements in aggregate have been lowering expectations, with the noted exception of technology, Internet, and AI-related offerings.

Metric	Actual	Estimate
Retail sales (MoM)	+0.7%	+0.4%
Sales ex. autos, gas (MoM)	+1.0%	+0.3%
'Control group' sales (MoM)	+1.1%	+0.4%

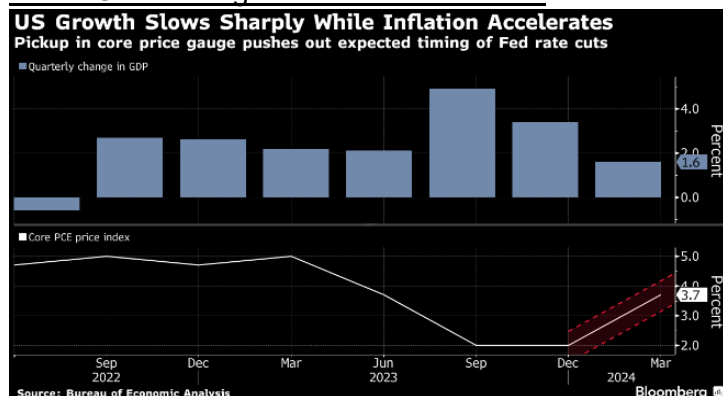
Metric	Actual	Estimate
Durable goods orders	+2.6%	+2.5%
Capital goods orders ex-defense & aircraft	+0.2%	+0.2%
Capital goods shipments ex-defense & aircraft	+0.2%	+0.2%



We should note that the surge in AI investments is a direct attempt to increase working productivity to offset the massive wage increases realized over the last few years. While it sounds glamorous, AI is just another form of automation, akin to ordering kiosks at McDonald's and ATMs. Companies that compete with low-cost labor or hyper-scale peers have no choice but to invest in order to stave off

extinction. As any behavioral model will show, there is an infinite value to survival, which implies that the only limit to what companies will spend to survive is the extent of their resources and credit lines.

Weak GDP? Stagflation? We Think Not.



A lot of alarm bells went off when the Real GDP Growth Report indicated a sharp slowdown in Q1 to 1.6% annualized from 3.4% in the 4th quarter. This slowdown sounds stark and sends off all kinds of Stagflation alarm bells, but if one dissects the numbers underneath the headline, the economic growth really has not slowed much, but the effects on the data from inflation, inventory adjustments, and Government spending muddy the waters so much, few people really know what the figure means. To help unravel this ball of twine, there was some truly great reporting in the April 29 Barron's column Up and Down Wall Street picking apart some of the data noise including the GDP Report, as shown below. The net of it is that the economy is growing closer to 3% on a real basis and 5% to 6% nominally. Things are slowing down, but the annualized real growth rate did not halve in 3 months.

...Higher prices and other factors also made the initial estimate of first-quarter gross domestic product look rather lackluster. Real GDP growth slowed to a 1.6% annual rate from the fourth quarter's 3.4% pace. But excluding government spending (which slowed sharply in the quarter), inventory swings, and exports (influenced by foreign demand), you're left with consumption plus business fixed investment and residential investment.

This measure, called real final sales to private domestic producers, is the best underlying measure of what the Fed is trying to influence, argue John Ryding and Conrad DeQuadros, economic advisors to Brean Capital.

In real, inflation-adjusted terms, this metric grew at an annual rate of 3.1% in the first quarter, following advances of 3.3% and 3.0% in the two preceding quarters. Measured in current dollars, this metric has grown at a 5.6% nominal annual rate over the past three quarters and 6.1% in the latest quarter. "This simply cannot be seen as soft," they write in a client note."

Higher Rates Are Hiking the Dollar and Slowing the Economy

As reported in the April 19th WSJ, rising rates are becoming a problem for the housing market, which in turn has historically led to a broader slowdown and seems to be doing so again.

"Home Sales Plummet As Rates Top 7% (WSJ, 4-19-24) The average rate on the standard 30-year fixed mortgage jumped by nearly a quarter percentage point to 7.1%, (peaked at 7.51%) according to a survey of lenders released Thursday by mortgage-finance giant FreddieMac. That is the highest level since late 2023 and the largest weekly increase in nearly a year. Existing home sales in March,

meanwhile, fell 4.3% from February in what was the largest percentage decline on a monthly basis since November 2022, the National Association of Realtors said Thursday.

Similarly, renovation spending is expected to fall in 2024, according to the Leading Indicator of Remodeling Activity, which was developed by Harvard University's Joint Center for Housing Studies. Americans are expected to spend \$449 billion this year on home renovations and repairs, down from last year's record of \$481 billion."

Also, the dollar has strengthened as a result of the back-up in US rates and global uncertainty. The problem with the strong dollar is that it makes US exports less competitive, and it lowers corporate earnings as sales made overseas are translated back into fewer dollars, which hurts large-cap companies reported EPS. This too is a headwind, potentially reducing forward earnings expectations.



Biden's 2025 \$7.3T Budget & \$5.3T Tax Hike (over 10 years) & Other Tax Proposals

Based on his proposals, it appears that the President is not concerned that higher interest rates and higher annual budget deficits mean higher expenses and lower degrees of freedom for the US Government. He also seems unconcerned with either the disincentives created by raising taxes or the flight of entrepreneurs and businesses to less costly jurisdictions, which virtually came to a halt when his predecessor lowered the US Corporate tax rate to be more in line with peers.

Indeed, his \$7.3T 2025 budget proposal is an eye-opener, not only because of the spending increases, on top of already inflated Covid-era spending, but because of the tax increases he is proposing in an election year to help fund it. Clearly, this move shows he has confidence that he is likely to win, as candidates rarely propose tax increases leading up to an election.

However, Biden's tax proposals have a decidedly anti-business, soak-the-rich theme to them that plays well with most of his base, but may cost him some donors, who are not going to fare so well if these plans become law. Not only is Biden planning to let the Trump-era tax cuts expire, but he asking for even higher taxes, namely:

- Raise the top Federal income rate from 37% to 39.6%, for those who make \$400K or more.
- Raise the capital gains tax rate from 20% to 39.6% for those who earn \$1MM per year.
- Raise the Obamacare investment tax from 3.8% to 5%, for those who earn more than \$400K.
- Eliminate Section 1031 which permits like-kind exchanges for real estate and other like assets.
- Eliminate carried interest as a capital gain and tax it as ordinary income. This provision is cited as a loophole for hedge fund managers, but it also applies to businesses like developers with large working capital needs, where they would need loans to pay the taxes on tied-up capital.

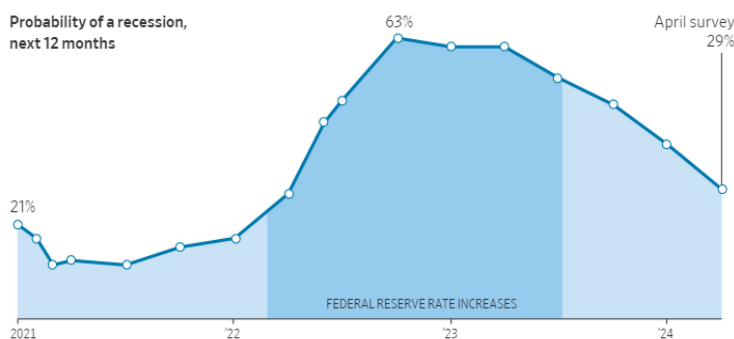
- f) Enact a wealth tax of 25% on the assets of households with a net worth exceeding \$100MM.
- g) Increase the tax on small businesses from 20% to 41%, which will cost jobs.
- h) Increase the corporate tax rate from 21% to 28%, retroactively to BOY 2024, which is expected to clip GDP by 9/10 of a percent per the Tax Foundation, and cost 192K jobs.
- i) Lower the Estate Tax ceiling to \$3.5MM from \$14MM, and tax the excess at 45%. This will be very destructive for family businesses, which may have to be sold to pay the taxes.
- j) Eliminate the ability to convert regular IRAs to Roth IRAs for individuals earning \$400K or couples earning \$450K.
- k) Force individuals with over \$10MM in retirement plans to withdraw the amount above \$10MM in a lump sum and pay taxes on it. There would be a 25% excise tax on under-withdrawals, on top of the ordinary income taxes due.

These “soak the rich” taxes might play well with his constituents, but they provide great disincentives to savers, investors, and entrepreneurs who make up the productive backbone of the economy. According to the non-partisan Tax Foundation, these proposals will cumulative reduce GDP by 2.2%, reduce employment by 788K, and reduce wages by 2%. Stocks would not react favorably to these outcomes.

While not all of these items are a lock to be enacted if Biden wins reelection, most of them are likely to be, especially if the Democrats re-take the house, as expected. I mention this now because investors will likely become increasingly concerned about the harmful effects of these proposals as the election gets closer if they are not taken off the table. These concerns could lead to aggressive asset sales to avoid paying taxes at higher rates, at a minimum.

Part II: The Monthly US Equity Market Report

After the S&P logged its first two back-to-back 10%+ quarters in 12 years in March, April was a real stinker, ironically consistent with the historical data we noted last month that a pullback was likely. However, the strength in Technology capital investment in AI and related productivity enhancements is still gaining momentum, and despite this month’s massive barf in cyclical and value names, and the slightly negative aggregate revision we saw in earnings estimates this month, we remain constructive on the market through year-end, on our belief that the Fed will get around to cutting interest rates and the economy is not going to roll-over into a recession, even though the “higher-for-longer” rate regime will compress results.



Source: Wall Street Journal surveys of economists

As soon as the Fed does cut rates, it is expected that housing, capital goods, and cyclical areas of the market will improve and companies that need to refinance debt will get some valuation compression relief. At present, companies with above 3X net debt to EBITDA ratios are trading at steep discounts to their normal levels, and smaller companies that might normally be take-over targets for peers or private equity sponsors are trading down several multiple points below “normal” due to higher financing costs/discount rates, as well as the Justice department’s anti-deal policies.

After One Month of Value Beating Growth and Dividends Leading Value, The Pattern Reversed

Again, Growth crushed value, as positive revisions and massive earnings beats at Microsoft, Google, and Nvidia sent growth giants soaring, while higher interest rates trashed cyclical and value names.

Russell 1000 Value Versus Russell 1000 Growth – Last 28 Months

As illustrated below, Growth stocks resumed their recent trend of out-performing value stocks, thanks to the jitters in the market created by the backup in interest rates, which are reducing lending activity, squeezing companies with refinancing needs, and generally slowing and adding stress to the economy. In particular, higher dividends and cyclical stocks moved lower, as investors shifted towards safer, less interest-sensitive stocks and bonds.

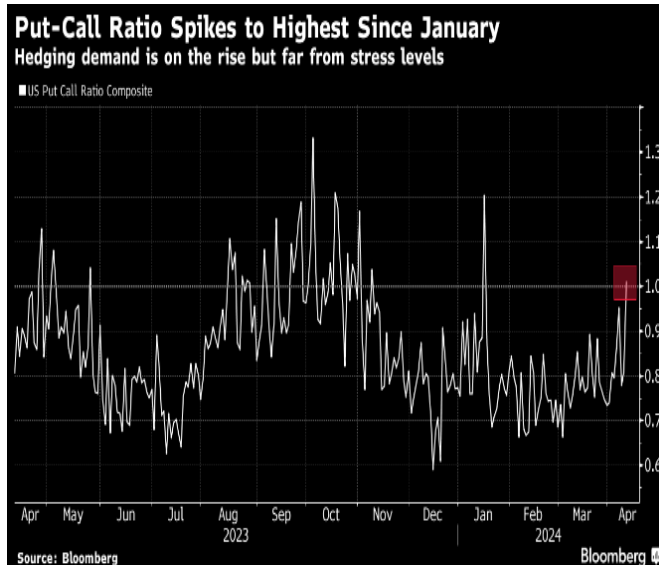


Looking at the April results, the total rates of return for the various benchmarks were:

Russell 1000 Value (RLV)	(4.27%)	Russell 1000 Growth (RLG)	(4.24%)
S&P 500 (SPX)	(4.08%)	Dow Jones Ind'l Average (INDU)	(4.92%)
NASDAQ (CCMP)	(4.38%)	iShares Select Dividend ETF (DIVY)	(3.07%)
		Sound Equity Income ETF (DIVY)	(5.67%)

DIVY performed below average, due to meaningful drops at Abbvie, Xerox, IBM, Sinclair, Franklin Resources, Kenvue, Carters, and Walgreen’s Boots, as their prices reacted to cautious commentary on these companies’ earnings much more strongly than normal, reflecting a risk-off mood in the markets.

As discussed in the fundamental and technical exhibits below, the S&P’s 4.1% decline was due to multiple compressions more than earnings revisions, as the PE for the markets fell. Nonetheless, earnings expectations did weaken nearly everywhere except for in Energy, Internet, and IT and the market reached oversold levels, based on RSIs. Similarly, the Put Call Ratio also suggested some level of rebound should be in order.



Monthly US Equity Market Report

4/30/2024

Fundamental, Technical, and Valuation Snapshots

Fundamentals: Positive in Internet, most IT and energy, but increasingly negative overall.

Trends: Growth is slowing, input prices are falling slower than expected; wages & rates are still high.

(+)	Information Tech	AI demand & chip turn are offsetting soft commercial demand.
(+)	Communications	AI, share gains & election spending are lifting Internet & select media cos.
(+)	Consumer Discretionary	Low-end slowing, but real income growth & pent up demand are lifting #s.
(+)	Energy	Higher prices, thanks to global supply constraints have lifted estimates
(+)	Real Estate	Higher rents and occupancy creep are offsetting rate concerns for now.
(+)	Consumer Staples	Price & cost pressures continue to abate, with stabile volumes.
(+)	Financial Services	NIM pressure, but equity underwriting, credit health & rate optimism good.
(+)	Utilities	Rising capacity investments & lower rate outlook are lifting estimates.
(--)	Industrials	High interest rates, strong dollar & weak exports are overcoming stimulus.
(--)	Materials	Soft demand, falling prices & rising costs continue to hit estimates.
(--)	Healthcare	Lower pricing & utilization have offset recent obesity drug boost.

	4/30/2024	Earnings Revisions		Performance (Total RoR)		
	Mix	3 Mo.	6 Mo.	MTD	QTD	YTD
S&P 500		1.6%	7.9%	-4.1%	-4.1%	6.0%
Communications	9.3%	4.2%	17.1%	-2.1%	-2.1%	13.4%
Consumer Discretionary	10.8%	2.5%	13.3%	-4.3%	-4.3%	0.4%
Consumer Staples	6.6%	1.3%	3.3%	-0.9%	-0.9%	6.6%
Energy	4.1%	2.0%	-3.9%	-0.8%	-0.8%	12.8%
Financial Services	12.6%	0.5%	6.4%	-4.2%	-4.2%	7.7%
Healthcare	12.1%	Worst => -5.6%	7.4%	-5.1%	-5.1%	3.3%
Industrials	8.8%	-0.8%	5.7%	-3.6%	-3.6%	7.0%
Information Tech	29.1%	Best => 7.7%	12.0%	-5.4%	-5.4%	6.6%
Materials	2.3%	-2.7%	-3.8%	-4.6%	-4.6%	3.9%
Real Estate	2.1%	1.4%	2.0%	Worst => -8.5%	-8.5%	-9.0%
Utilities	2.2%	0.2%	9.2%	Best => 1.6%	1.6%	6.3%

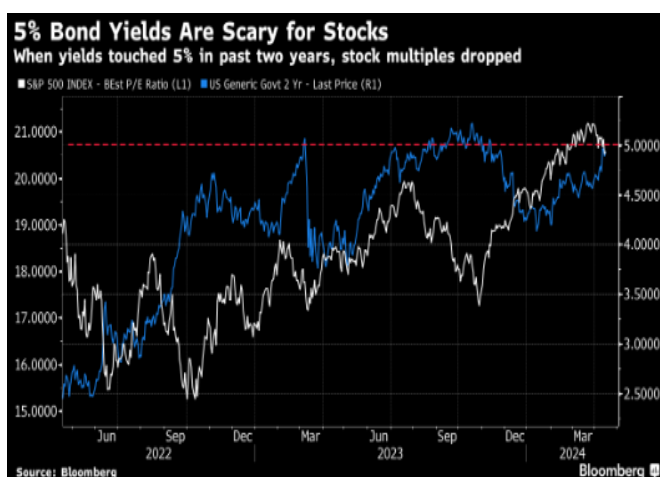
Technical: Overall Marginally Bullish on a 1 Month Outlook: per Tradingview.com

Key Positive indicators:	Most moving averages, MACD say buy
Key Negative indicators:	Oscillators (stochastics, momentum) say sell
(-) Trend	10/11 sectors fell in April, led by RE, IT & HC on Inflation / Rate concerns.
(-) Fund Flows	Complete reversal of strong March with very negative flows in April
	Price 30 Day 50 Day 100 Day 200 Day
(+) Golden Cross [50 dma > 200]	5,036 5,146 5,126 4,965 4,693
(-) Price / Moving Average [2 / 4 are "> 1"]	0.98 0.98 1.01 1.07
(+) Support Levels are Plentiful	5,026 -0.2% 4,998 -0.7% 4,977 -1.2%
(+) Resistance Points Offer Gaps	5,072 0.7% 5,121 1.7% 5,165 2.6%
(-) Volatility, (VIX)	VIX rose 264 bps to 15.65, on inflation / rate concerns.
(-) Trading Volume	Trading volume was up year / year on a down tape.

Valuation: Tight vs. Bonds	PE		EPS		
	2023	2024e	2022	2023	2024e
Yields rose, spreads widened					
'24 PE is ~4.7 points > LTA	22.7	20.7	\$ 223.8	\$ 221.5	\$ 243.8
10 Year US Treasury: (1/r) = PE Equivalent	21.4	21.4	13%	-1%	10% = y/y %
10 Year BBB: (1/r) = PE Equivalent	17.0	17.0	'2024 EPS est. were flat in April		
Stocks are Slightly 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	-6%	3%
10 Yr BBB: LT Avg (1/r) relative to S&P PE	0.7	0.7	vs. BBB	8%	19%
S&P 500 Earnings Yield (E/P)	4.40%	4.84%	<= Earnings yield up; risk premium down		
10 Year US Treasury Yield (+48 bps in Apr)	4.68%	4.68%	10Y Tr. Downside to Parity -1%		
Spread (E/P minus 10 Yr. %)	-0.28%	0.16%	<= PE fell, risk premium narrowed		
BBB widened vs. Treasuries, as rates rose 48 and 56 bps respectively					
10 year BBB Corporate Yield	5.89%	Norms	<- Rose by 56 bps in April		
Yield Spread of S&P E/P minus BBB	-1.49%	-2.68%	BBB downside to normal SPX -21%		
Yield Spread of BBB minus 10 Yr T	1.21%	2.20%	BBB upside to LT Spread vs. T -14%		

It is worth highlighting, that even with the stock market's pull-back in April, with bonds also pulling back, stocks are closer to being fairly valued relative to bonds than at any time since the Financial Crisis. This means the equity risk premium is no longer as fat as it was, which explains why so many insurance companies and institutional accounts have been buying more bonds than stocks, as their multi-asset risk models have suggested that bonds look better now relative to stocks than they have in a decade. We expect this relative attractiveness to quickly pass, once the Fed does get around to cutting rates. In the meantime, we can fully appreciate why investors want to lock in today's relatively high bond yields. As the chart below shows, when US Gov't bond yields have reached 5% historically, stock multiples have retreated, for a short time, and then rebounded.

Also worth noting, the historical, "sell in May" heuristic, has been more often wrong than right.



Part III: Portfolio News and Changes

Performance (non-GIPs)	January	February	March	April	YTD
Dividend River (est.)	(52 bps)	+0.34%	+5.16%	(5.55%)	(0.86%)
Total Return Yield (est.)	+1.29%	+1.34%	+6.89%	(4.77%)	+4.49%
DIVY NAV (Toroso)	(58 bps)	+0.32%	+5.22%	(5.72%)	(1.06%)
DIVY Price (Toroso)	(37 bps)	+0.23%	+5.25%	(5.67%)	(0.86%)

April was a real punch in the nose to our portfolios, as even better-than-consensus earnings reports were often met with sell-offs due to concerns about the direction of the economy and headwinds that could undermine their turn-arounds down the road.

As the saying goes, "It is tough to catch a falling knife." With us having to sell stocks to buy them in a difficult market, we did a little trading, but not as much as we expected. However, the sell-off should give us some opportunities to upgrade the quality of our holdings, as better names come under fire. Towards that end, we added one position to each portfolio this month.

In Dividend River and DIVY, we sold some HRB and initiated a 1% position in Reckitt Benckiser's ADR (RBGLY), discussed below. The stock is illiquid, and it began moving higher on an upgrade shortly after we initiated it. We will likely add more if it pulls back. We trimmed HR Block because of a computer breakdown that prevented them from filing electronic returns on April 14th might nick earnings.

In Total Return Yield, we initiated a 2% position in LKQ, which stands for Like Kind Quality, as discussed below. To fund this investment, we exited Warner Brothers Discovery whose turn-around is expected to take longer than that at LKQ. We also trimmed AT&T and IBM to fund the purchase.

Reckitt Benckiser ADR (RBGLY)

London-based Reckitt Benckiser is a \$40B market cap global household, personal care, and food products company. Some of its well-known brands include Lysol, Vanish, Airborne, Mucinex, Finish, Durex, Airwick, and Mead Johnson (Enfamil / Similac). RBGLY trades at 13.9X current year EPS (6 points below its long-term average), and 10X CY EV/EBITDA, which is very cheap for a global personal care products company. RBGLY pays a 5.2% dividend, and its EPS are expected to grow in the mid-single digits per annum over the next 3 years. RBGLY's EPS growth numbers are middling, in part because of the volatility following a global baby formula shortage in 2022 and 2023 which has now been largely resolved. After some further difficult comparisons in 1H'24, this business (nutrition) is expected to start growing again by year-end, along with growth in the Hygiene and Health segments.

The stock is cheap because of an unusual legal situation. Reckitt is one of two companies that makes specialized, cow-based baby formula for pre-mature infants as prescribed in hospitals. In cases where the mother's or human-based surrogate milk is available, it is preferred, due to safety issues, but it is not always available. One of the known risks of cow-based formulas for pre-mature infants is a higher incidence of deadly necrotizing enterocolitis (NEC). Still, cow-milk-derived formulas lead to better survival outcomes than non-animal-based options, when mother's milk is not available. Regrettably, a baby that was prescribed Reckitt's pre-mature baby formula died from NEC and an Illinois jury found Reckitt negligent for not warning the mother – even though a warning is on the label. With these facts in mind, the \$60MM jury award is being appealed and the medical community is supporting Mead Johnson / Reckitt in its appeal. Still, the stock sold off sharply, as attorneys swiftly began seeking additional plaintiffs, and analysts extrapolated similar awards for every premature baby death.

When we looked at the math with Morningstar, in a highly unlikely worst-case scenario, the cumulative payout would be a year's worth of FCF that would take a dozen years to materialize, if Reckitt kept losing – which no one expects to occur. Moreover, because there is an NEC warning on the label and the company does not interact with patients, the entire neo-natal community is befuddled by the jury award and expects it to be overturned. Even if the appeal fails, the 5% dividend is both sustainable and attractive. Plus, the company's most recent sales report suggests the company should begin growing again in '24. Putting a 15X multiple on 2026 estimates suggests a 27% upside, while putting its historical average 20X multiple implies a 70% upside, before factoring the 5.2% annual dividend. Chicago-based LKQ Corp (LKQ) is a global aftermarket and recycled automotive collision repair parts company. Approximately 55% of the company's business is in North America (by sales) and 45% in Europe, but operating profits are 2/3 NA and 1/3 Europe. The company is a beneficiary of inflation because auto insurance companies are increasingly seeking out its parts and services to lower repair costs, over higher-cost OEM options. However, business is still cyclical, as people perform fewer repairs in recessions and the European business, due to its smaller scale operations, is likely to continue to generate sub-par margins. Following a 30% sell-off in its shares, due to weakness in the European business, the company has an \$11.5B market cap, trades at 11.1X current year EPS, and pays a 2.8% annual dividend. Management has said that this weakness should be over by the end of the year. Meanwhile, U.S. business is growing nicely.

We initiated a 2% position in LKQ after the Q1 earnings report sell-off. After three years of European struggles, the outlook is for improvement by year-end and double-digit EPS growth to resume in 2025. Just assuming the stock gets back to where it was less than a year ago (\$60 per share) implies a 40% upside. However, if the company resumes its acquisition program, earnings growth could exceed the 10% annual forecast. In the meantime, we shall enjoy clipping the 2X the S&P 500 dividend rate.

Characteristics – Still Cheaper Than the S&P 500, With Higher Yields

Our portfolios are ~50% cheaper than the S&P 500 on a 2024e PE basis, with higher dividend yields and EPS growth expectations. Nonetheless, they are lagging the benchmark because they cannot own higher multiple secular growth names that have been lifting the index for the last 15 months.

On April 30th, Dividend River was paying a 4.6% dividend yield, >3.0X that of the S&P 500 at 47% below its 2024e PE price, while the Total Return Yield was paying a 3.5% dividend, 2.3X the yield of the S&P 500, at 50% below its PE price. Dividend River has a 10.6% weighted average 2024e EPS growth forecast that is 60 bps above the S&P 500, while the Total Return portfolio is expected to grow EPS by 13.1%, 3.2% above the popular benchmark. With Betas at 0.8X the Index, both portfolios should be less volatile than the S&P, based on the historical movements of their constituent shares. The EPS growth plus dividend lines in the tables below indicate that our expected forward total returns

for both portfolios should exceed those of the S&P 500 in 2024. These figures suggest that the Dividend River total return could be 15.1% versus 11.4% for the index, while the Total Return Yield portfolio should theoretically outperform the S&P 500 by 5.2% before fees. These estimates are based on consensus EPS estimates, and the gain forecasts imply that the relative valuation multiples remain the same.

As you know, stock prices are often based on discounted future cash flows that look beyond the current year. Nonetheless, the simple CY EPS growth + dividend yield heuristic has proven to be an accurate guide over time.

Dividend River Portfolio Characteristics						Total Return Yield Portfolio Characteristics					
April 30, 2024						April 30, 2024					
SECTOR WEIGHTS	SIS	SPX	KEY METRICS *	SIS	SPX	SECTOR WEIGHTS	SIS	SPX	KEY METRICS *	SIS	SPX
Communications Services	9.5%	9.3%	Dividend Yield	4.6%	1.5%	Communications Services	7.5%	9.3%	Dividend Yield	3.5%	1.5%
Consumer Discretionary	5.6%	10.8%	2024e PE	10.9	20.7	Consumer Discretionary	12.6%	10.8%	2024e PE **	10.3	20.7
Consumer Staples	8.4%	6.6%	EV/ EBITDA	12.6	14.7	Consumer Staples	10.0%	6.6%	EV/ EBITDA	11.5	14.7
Energy	17.4%	4.1%	PB	3.8	4.6	Energy	12.5%	4.1%	PB	4.4	4.6
Financial Services	13.6%	12.6%	2024e Sales Growth	2.3%	5.4%	Financial Services	16.9%	12.6%	2024e Sales Growth	3.8%	5.4%
Healthcare	17.2%	12.1%	2024e EPS Growth	10.5%	9.9%	Healthcare	10.9%	12.1%	2024e EPS Growth	13.1%	9.9%
Industrials	2.5%	8.8%	BETA	0.8	1.0	Industrials	6.4%	8.8%	BETA	0.8	1.0
Information Technology	9.8%	29.1%	EPS Gr. + Div %	15.1%	11.4%	Information Technology	10.6%	29.1%	EPS Gr. + Div %	16.6%	11.4%
Materials	10.8%	2.3%				Materials	12.7%	2.3%			
Real Estate	0.0%	2.1%	* Based on Bloomberg consensus data.			Real Estate	0.0%	2.1%	* Based on Bloomberg consensus data.		
Utilities	5.3%	2.2%				Utilities	0.0%	2.2%	** excludes WDC		
Totals	100.0%	100.0%				Totals	100.0%	100.0%			

Looking Ahead

Last month, we wrote that we expected the market would sell off before too long, but we did not expect it to happen so quickly or that the coming beat down would play out the way it did, hurting value names more than growth names. However, that's what happened because most of the expensive large-cap growth stocks that took the market higher in the last year again raised their expectations for 2024 after they reported Q1, while most high-dividend value stocks did not. So, we got a reminder that growing companies are the best antidote to rising inflation there is and there are not many of them paying fat dividend yields. Thankfully, inflation is coming down, though the Fed does not recognize it yet.

By year-end, we do expect these beaten-down names to regain some or all of their losses as it becomes clear that inflation is coming down along with growth, which should be apparent in the data the Fed looks at by the middle of the summer. Once that happens, the Fed should have enough evidence to take back some of its rake hikes, which will lift stocks and bonds heading into the election, which is something every incumbent in Washington is focused on. At the same time, we will likely see more election-year carrots get laid out, to soften or remove some of the specific elements and bitterness from Biden's higher tax proposals, which could also help stocks in late Q3 and Q4. However, if there aren't any carrots to go along with the sticks, then a further sell-off is possible. I don't expect this outcome, based on prior election years, but must concede that past precedents do not always repeat.

In addition to helping incumbent politicians retain their spots, rising stock and bond prices are also a great tonic for the investment advisory business. After 18 months of the Fed squeezing, we could all use a respite from living in the uncomfortable epoch of hot and cold moments, without much confidence in the powers that be to do the right things.

We do however have great confidence in you, our trusty advisors, and we remain grateful for your trust in us through these volatile times.

May the balance of 2024 turn out to be much better than what we have experienced this month.

Gratefully yours,

Eric

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