



**Sound Income Strategies, Monthly Equity Update**

**May 31, 2024**

Monthly Maxims

"The search for talent and progress is a never-ending story. The day that I tell you that I have everything we need is the day you should put me out." – Carlos Tavares, CEO Stellantis

"The fundamental algorithm of life is to repeat what works." – Charlie Munger

**Executive Summary**

**Macro:** In May, the same "good news is bad news" and vice versa schizophrenia we experienced in March and April continued. Again, mostly stronger than expected data pushed back the timing for the Fed to cut the overnight lending rate and the amount expected. These disappointments undermined the market's post-Fed-Pivot rise. AI and technology sales have been doing their part to bolster sentiment, while slowing inflation in goods and labor have also helped, but with the equity market trading at 21X current year estimates, for stocks to sustain their current levels or go higher, equity investors need more good news. Investors are getting some of it from economic improvements in Europe and China, strength in Wall Street deal-making and heavy Government spending, but these factors are largely priced in. On the downside, with real GDP slowing to 1.3% in Q1, and Biden's onerous 2025 tax hike plans not yet getting challenged in this election year, the risks of a serious miscalculation or correction have risen as we approach mid-year.

The war in the Ukraine continues to slog ahead, with Russia gaining. China surrounded Taiwan in an elevation of its annual naval exercise, and Israel is still battling Hamas in Palestine. So, while we finished May on an upswing, the macro environment remains uncertain, with plenty of worry walls to climb, and investors still waiting for the Fed to start lowering interest rates, above all else. Late Q3 / Q4 '24 is now the consensus forecast.

**Markets:** US stocks were choppy in May, but finished on a high note, as the final May inflation report was in-line to lower than expected, led by weaker than forecast consumer retail activity. This news sent Treasury yields lower and cyclical and value stocks higher in the final week, lifting their weary heads after a brutal two months of declines. AI, semiconductor and social media stocks, which have led the market higher for the last 18 months, gave back some gains, but still out-performed in May and account for nearly all of the S&P 500's EPS growth for the last 12 months and more than half of its price gains.

**Portfolios:** The Sound Income portfolios inched higher in May, ahead of the DOW, but not as much as the tech stalwarts again. We did not make any portfolio changes this month, mostly due to not reaching conclusions on new names, though we kicked a lot of tires. There are fewer high quality, high yielding stocks around today than normal. Those that are available are clustered in financials, where we already have a lot of exposure, or in the

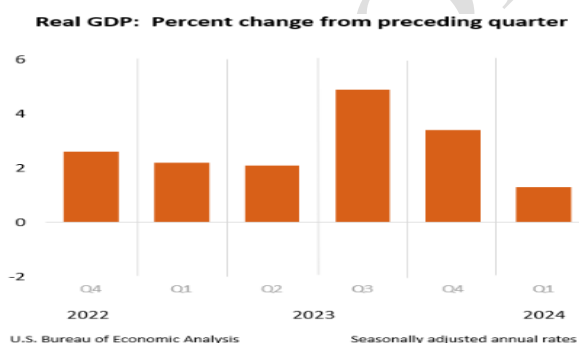
defensive areas of utilities, consumer staples and healthcare, where the cheap names don't have much growth. We would like to find ideas with both high dividends and reasons to expect that their EPS growth rates will improve, but we have not found any incremental names that see durable yet.

## Part I: Macro Factors and Thoughts

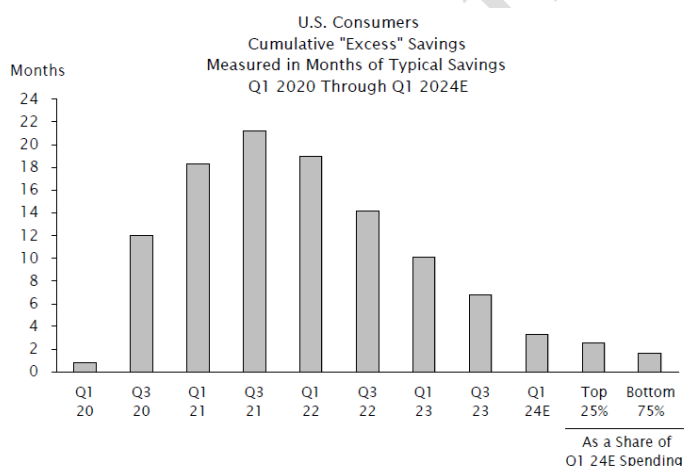
### Not So Fast, Tortoise Crossing

As reported on May 30<sup>th</sup>, US GDP rose at a slower pace in Q1 than initially reported. The BEA noted that softer consumer spending on goods led to a reduction in its core GDP estimate. This negative revision underscores the loss of economic momentum that was evident at the end of 2023 and at the start 2024, when Q3'23 GDP was 4.9% and Q4'23 GDP was +3.4%. (Tables from Bloomberg, BEA).

Metric	Revision	Initial Estimate
GDP	+1.3%	+1.6%
Consumer spending	+2.0%	+2.5%
Nonresidential investment	+3.3%	+2.9%
Residential investment	+15.4%	+13.9%
Government spending	+1.3%	+1.2%



It is worth noting that residential investment and Government spending were revised higher, as both higher interest rates and higher government outlays have contributed to not only inflation but also a squeezing out of consumers' discretionary income, now that the savings rate has reverted to normal, and nearly all of the excessive pandemic savings have been spent. (Courtesy of Empirical Research)

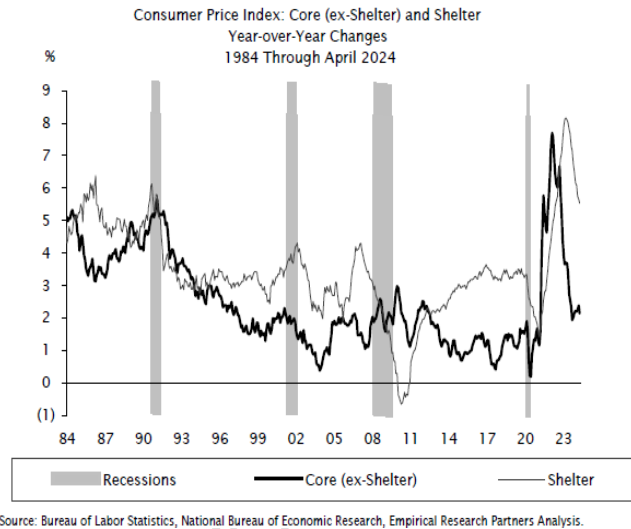
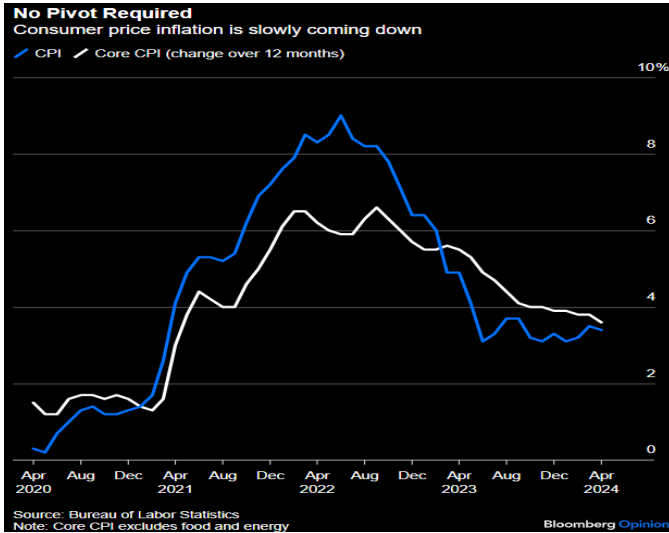


Source: Barbiero, O. and Dhiren Patki, 2023. "Have US Households Depleted All the Excess Savings They Accumulated During the Pandemic?" Federal Reserve Bank of Boston Current Policy Perspectives, de Soyres, F., Moore, D. and Julio Ortiz, 2023. "An Update on Excess Savings in Selected Advanced Economies," FEDS Notes, U.S. Department of Commerce, Empirical Research Partners Analysis and Estimates.

### Inflation is Coming Down; Rates Will Follow, But When?

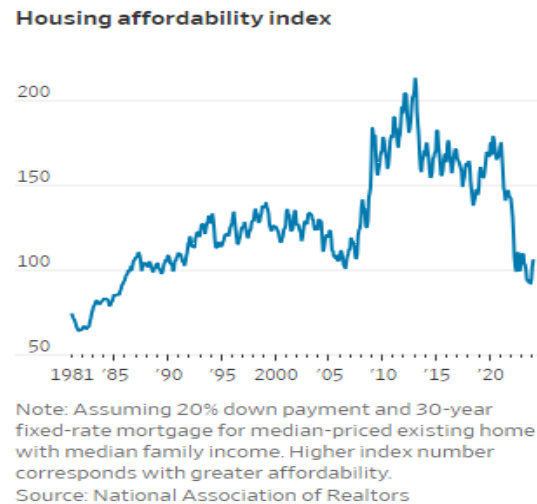
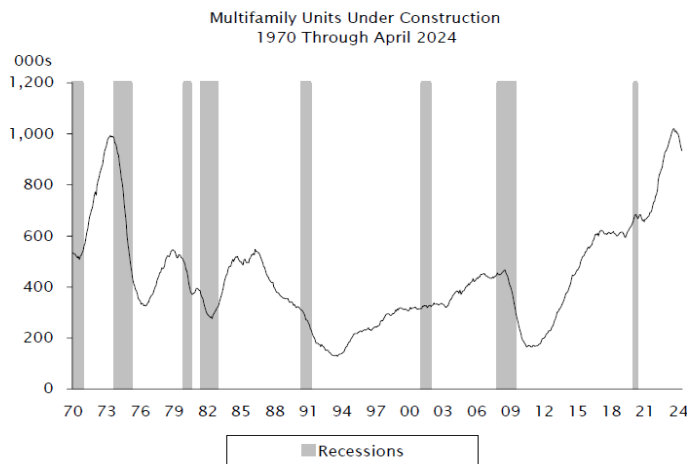
We have been tracking and writing about inflation for nearly four years now, which is typically how long an inflation cycle lasts, except that every time the disruptions and factors that matter most are a little different. As the chart on the right below illustrates, shelter remains the biggest factor holding up

inflation this time around, though it is not the only thing, wages are a factor too, as well as lag effects from prior goods inflation. However, the costs of shelter, outside of interest rates are coming down.



Last month we discussed how shelter price declines were inexorably declining, supported by a chart that showed how new-tenant rents, a spot pricing data series, was back at zero percentage year-over-year price increases, and how this data series led the 12-month average series that is in the inflation calculations, called owners' equivalent rent (OER), by six to nine months. Both are still falling and drive core PCE below the Fed's desired sub-2% range by year end.

This month's addition to that thesis comes on the supply side, where we have learned of an explosion in multi-family apartment construction that is forecast to not only neutralize year-over-year price gains by year end, but to lower prices in select markets, such as Texas, where heavy population growth and building have taken place. As the chart on the RHS shows, with housing affordability at 20-year lows, this increase could not come at a better time. So, for those of you looking to sell your Texas rental properties, right after the Fed starts cutting rates could be an optimal time, as supply might start pressuring rates during your 2025 rent renewal negotiations, and certainly by 2026.

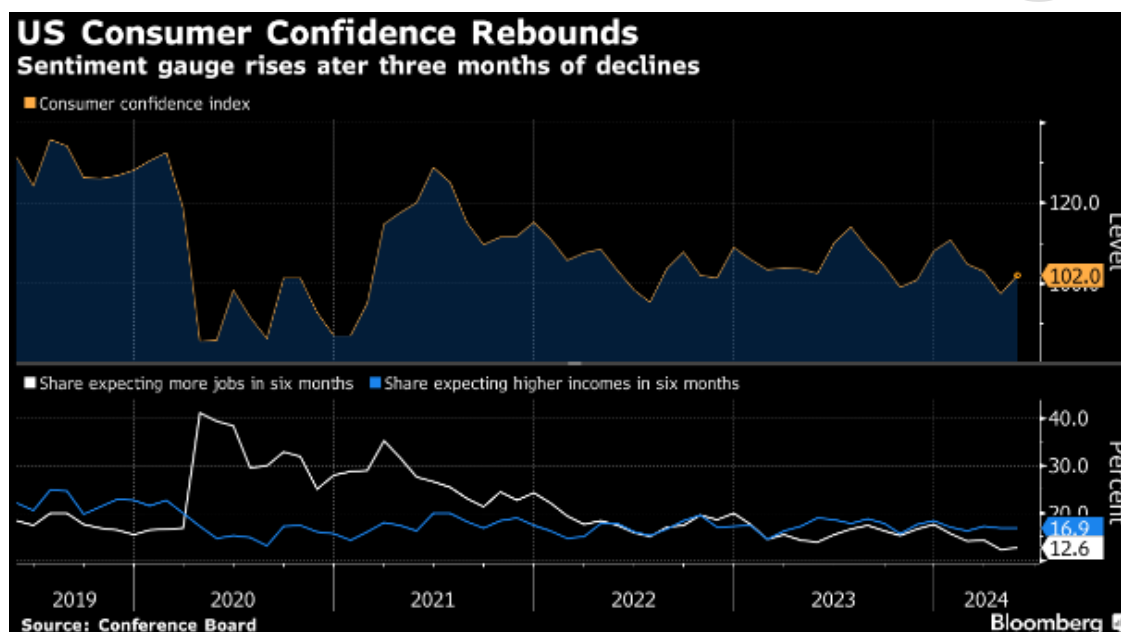


Putting this altogether, along with the slow year-over-year drop in wage growth and gradual employment and job opening declines, and we still see core CPE inflation getting down into the zone

by year end, and the slowing economic data along with that should be enough for the Fed to cut before year end. I would rather that they did now wait for the economy to stall, but my feelings don't count, rather, an accurate reading of the data should. We are all hoping the Fed sees what we do.

### **Sentiment Confusion**

The Conference Board's consumer sentiment index was another data series that put the markets and economists on edge in May. While the underlying data hardly budged, trend-wise, it was reported as if it were a massive sentiment reversal into positive territory by ticking up slightly in May, after falling for 3 months. This over-characterization of the shift sent shares lower. As the chart below shows, the underlying data move was a whole lot of nothing, as it showed continuing trends of lower expectations for income and jobs growth -- though against easier comparisons, these data did show improvement. However, the reporting, partially generated by AI bots reading real language changes and amplifying their significance, created real problems for investors, as they promoted the change as if there was a real spike in growth and income expectations when there wasn't. This example highlights that all media reports, not just the Internet, CNN and Fox demand fact checking.



### **The Drumbats Calling the US the Next "Stagflation Nation" Continue**

Last month, we dismissed the stagflation case, with both GDP growth and inflation slowing down, but every day it seems that fear finds another headline or editorial. So, instead of pointing out that inflation is not accelerating while growth is slipping into contraction, which is the #1 baseline definition of stagflation, this month we will briefly talk about the gradualism of stagflation characteristics, which are visible if we squint a little at the data, to further clarify the situation.

So, while we don't have true stagflation data, we do have some of its peripheral conditions, namely:

- The Fed has tightened rates to fight inflation, which is slowing down the US economy.
- Stocks and bonds are moving in synch, with rates driving much of the action.
- Equity market sentiment is schizophrenic, jumping from optimism to pessimism, without any clearly durable trends.
- Cash is outperforming on both a nominal and real basis.
- Investors are more complacent than active, as they think the Fed can turn on the economy with rate cuts faster than it really could.

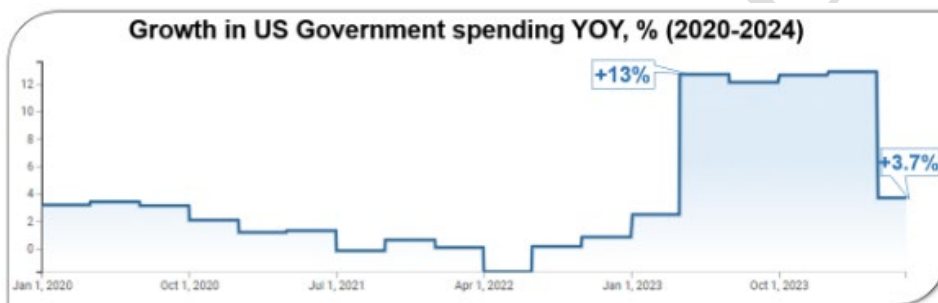
Examples of stagflation occurred in the 1970s, 1989 and 2008.

More than inflation picking up however, with China shipping more and US labor pressures easing, it seems certain that the US economy will continue to slow further, until interest rates come down and spur capital spending. US Government spending remains heavy, which is setting up for much higher taxes next year, as indicated in Biden's proposed budget and the reality of record high deficits. Higher taxes will further slow the US and could lead to a sharp recession and stock market correction, if there aren't offsetting gains in the private sector. I am not optimistic for this to happen. However, if by some unexpected turn of events, Republicans retain and gain seats in the house, then maybe a less onerous budget could be enacted, which might not bring about a recession. We shall see.

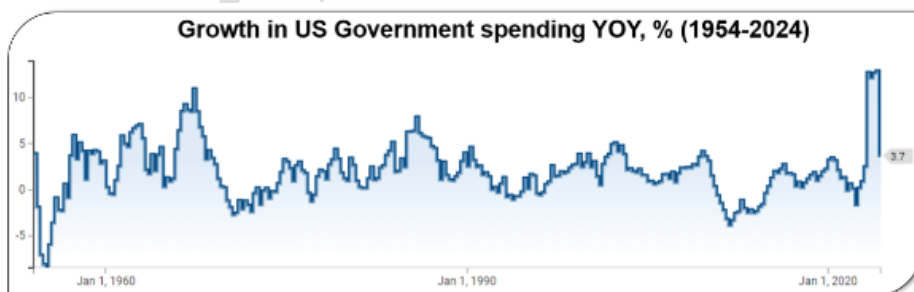
### **Biden vs. The Fed, or Why Raising Interest Rates Has Not Yet Killed Inflation or the Economy**

As we have noted before, there has been a stark contrast between monetary and fiscal policy over the last two years, with monetary policy attempting to slow down the economy, to fight inflation while fiscal largesse has only expanded, undermining the Fed's efforts. This contrast was picked up this month by Konstantin Fominykh, who puts out the TenViz global investing newsletter. In his May 28<sup>th</sup> report, Konstantin illustrates and notes the following data:

"The magnitude of US Government spending in 2023 was unprecedented (during a time of peace), which led the US to have the highest inflation rate among the G7 countries, by nearly 70 bps."

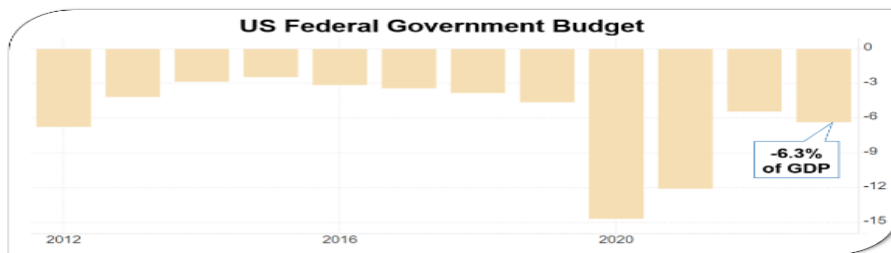


"This 13%+ Y/Y growth in spending was the largest jump in 70 years (since WWII)." Now, we have to think about that for a moment. The US administration has been spending like it did in WWII, and only 2% of that was for Ukraine. What would happen if the US had a real WWII like crisis today? It could theoretically go bankrupt, or at least run out of enough credit to do what could be needed.



At 6.3% of GDP, the current deficit is actually less than during the financial crisis, as a percentage of GDP, but in absolute dollar terms, we are spending 3X more. What is noteworthy is that this deficit boom is coming at a time of high employment., which is when Government revenues usually surge, and expenses fall. Well, Government revenues are up, but spending is rising faster, and it is not just

inflation, it is programs. This level of profligacy is not only unsustainable, but likely to be destabilizing. If you want to screw up a company or an economy, lever it up and overspend. That is what the US Government has been doing. It needs to stop, but neither party seems willing to do so on its own. I cite this issue, not to tilt at windmills, but to highlight a growing risk for investors to pay attention to.



Similarly, Brenton Point Wealth Advisors, in their May 23 monthly market report noted that “total Federal expenditures averaged 20% of GDP between 1990 and 2019. During Covid, it spiked to 33% of GDP in August 2020, which dwarfed the 24% of GDP spent combating the financial crisis in 2008 and 2009.” The also noted that Federal outlays as a percent of GDP fell from 22% in 1992 to 17% in 2000, which coincided with inflation dropping from its more normal level of 3% to 1%. BPWA ignored the coincident fact that China also emerged at this time, flooding the world with low priced goods, which weighed on aggregate inflation. Nonetheless, their core point that a rise in Government spending has a direct historical link to elevated inflation is true today and has been historically.

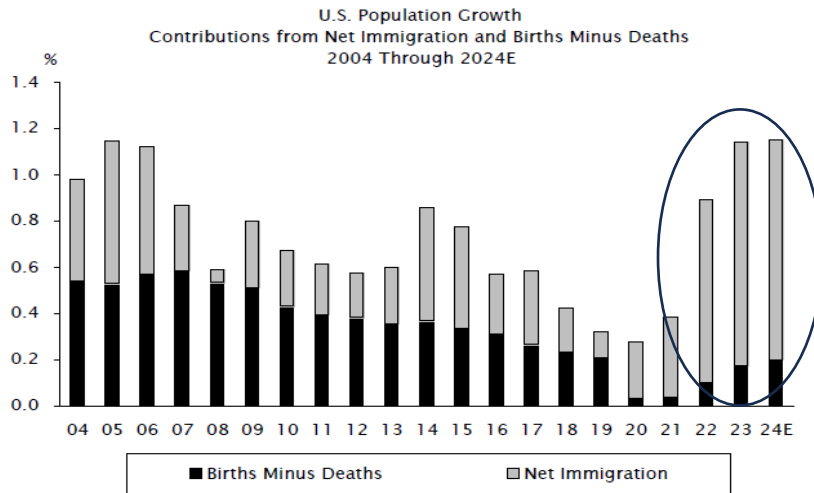
With the calendar 2024 Federal spending “only” growing by 3.7% y/y, still above the Fed's inflation target, there is more scope for GDP and inflation to slow down, but such level of spending is still expansionary, though it is borrowing from tomorrow to spend today. At some point, that will will come due in the form of either higher taxes, a default or an inability to borrow for a crisis, such as war, when we might need to. Something to think about for sure.

### **The Largest Immigration Explosion in 50 years Needs Reform**

As every economics student knows, a growing population of employed and law-abiding working age adults tends to lead to economic growth, so it would be natural for a carefully managed country to have a carefully managed immigration program that would grow its population with people who have desirable skills, as well as welcome a manageable number of refugees, who pass security clearance to enter the country. In this case, the US might seek to offset its declining birthrate with a careful immigration rise, such as increasing the number of H-1B, O-1 and EB-1A visas, to add economic heft and law-abiding citizens to its ranks. Unfortunately, that is not currently the case. Rather today, the open door illegal immigration that is being allowed is creating unnecessary social unrest and economic uncertainty, which is leading to serious problems, in terms of crime, free-riding and intractable regional discord.

Instead of growing legal immigration and choosing talented people in areas of need, the current administration has limited the H-1 visa program (for highly skilled labor) and instead opened its borders via sanctuary cities to anyone who can sneak in, which is very achievable across our largely open borders. The result has been an explosion in unscreened illegal aliens. While most of these people are believed to be genuine refugees from countries like Venezuela and Mexico who would like to become citizens if they could, an unknown number are also criminals and state sponsored terrorists. Whether they have good intentions or not, these people not only do not pay income taxes, because they lack proper work authorizations, but they add to the communities' overhead costs, in terms of healthcare, increased crime and benefits costs (school, police, fire, insurance, etc.). While some states willingly choose to provide these benefits to illegals, their presence is a burden to the economy and has

caused all kinds of conflicts with most border states, who don't like the rush of illegals overwhelming their communities. Consequently, many states, including Texas, Florida and Arizona have active programs to ship people to the states who voted to allow the illegals in, so they can experience the costs and disruptions that these policies have brought. It is a kind of economic warfare going on between the states, akin to the pre-cursing economic skirmishes that took place in Congress before the Civil War.



Source: Congressional Budget Office.

In fact, it was similar open border refugee policies that led England to break free from the EU and some editorialists to project another US civil war, as the cultural divide between the far left and right has become so great that people in office are doing things that don't make sense for the whole of the nation, but which rather create "winners and losers" instead of consensus policies.

As is often the case, politics is the allocation of resources based on sentiment of the majority, or an organized minority, not natural economic laws. As such, might makes right, though those who get trod upon don't like being run over. Natural economics in this case would be to behave rationally, and seek to control the flow of people across our borders and make sure those who arrive intend to be law-abiding and pay taxes, not be free riders. Rational policies would also entail working out a solution that does not pit one state against another, with issues that have major social and economic consequences.

Around year-end, the great Byron Wein used to make up a list every year of potential surprises that could have material effects on the economy in the coming year. If we were to make up such a list, the discord between the states over non-enforcement of laws, including immigration policies would be on it.

### **The Artificial Intelligence (AI) Revolution and Investment Gold Rush / Bubble**

The AI fad is more substantial than most, but it is not immune to the gravity of spending cuts, difficult baseline comparisons, and fickle investor sentiment. It is today's market-driving beast, with companies tied to it being the sole engines for the S&P 500's EPS growth over the past year and the top 5 companies making up half of the S&P's advance. It is awesome, and as indicated below, if prior investment bubbles are a guide, its peak impacts are far from over, but they will end at some point.

So, how did we get here amidst a Fed tightening cycle?

In late 2022, OpenAI launched ChatGPT, which empowered ordinary people with the ability to extract deeper answers to questions than could be derived by basic searches, from information posted on the

Internet and to extrapolate the pre-existing content into creating new content. Quickly, the extrapolation of content creation extended from formatted text into audio and visual outputs that could have all the hallmarks of known artists and even content creators. People have always dreamed of multiplying themselves and now with digital avatars and computer assisted extrapolations; suddenly, in 2022, this dream became a digital reality.

This powerful ability to create content, that could simulate human output in many forms set off an explosion in investments into expanding its access and race to find ways to be able to make money by charging for these cyborg abilities and save money by replacing humans with extrapolations.

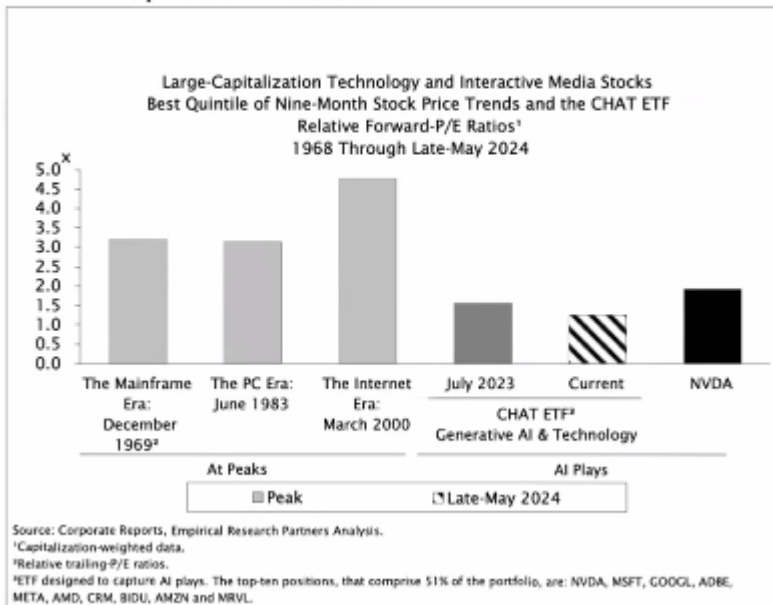
Make no mistake about it, the AI revolution is all about raising human productivity, which simultaneously means replacing marginally productive people with machines. Every person with a mental pulse can see the writing on the wall, first broadcast by Charles Darwin in the early 19<sup>th</sup> Century and now digitally amplified by the geniuses in Silicon Valley, “adapt or die.” The forecast net job death rate has ranged from 0% to 25% over the next ten years. Since nothing motivates human behavior more than mortal fear of death, including economic death, the only limit on how much capital people will throw at this realization is the constraint imposed by other mortal threats, like the lack of food, clothing, shelter, medical care, and if you buy into the AI Gore misinformation success, anthropomorphically caused global warming.

Just like with global warming and block chain technologies, not everyone agrees that AI is a black hole that is going to swallow everything in its path – at least not right away. For example, NYU professor and economics Nobel laureate Paul Romer likens the current AI arms race to the cryptocurrency hype bubble of two years ago and the autonomous driving hyperbole seven years ago. He notes that there are merits in these technologies, but they gained such cultural momentum and overconfidence that the long-term possibilities from these developments seem(ed) closer than they really were. In two years, he forecasts that people will look back at this run-up in investments and values related to AI and realize that it too was as much fad as fact and function.

For the record, I respect professor Romer’s points, but am more taken by AI than block chain, or narrow solution technologies such as autonomous driving; I believe that it has a long way to go before it reaches the “bubble” phase. As illustrated in the Empirical Research chart below, prior technology bubbles reached higher valuation levels than the current AI run-up has reached thus far.

Unlike autonomous driving, which has very clear technical limitations, not to mention legal frameworks that need to be worked out before that specific application can be broadly adopted, and the “transportation as a service” business models which raised capital pre-maturely can come back to life, “AI” encompasses a much more plastic and broadly useful set of tools. Already, simple AI tools have saved companies billions of dollars, even before ChatGPT, with robotic customer service applications. Indeed, right now entrepreneurs are making money renting out AI-programming bots, as if they were human, to solve programming tasks at half of the going rates for human programmers. I spoke to such a person, a professor at the University of Pennsylvania, and he says it takes him one hour to review the code that would have taken him two weeks to write, if he did it without AI. He says, the code is not optimal, but adequate and well worth what the clients paid. The only problem with the business model he says is that any of his students, if they could find the time, could become competitors right now. Ben Graham would call this condition a no moat problem, which means that margins for programmers should soon plunge. So forget about the lagging data that show outsourcing to India or Romania (two large sources for inexpensive programmers) displacing expensive US programmers, pretty soon, code editors will be the hottest ticket in IT.

- The valuation of the AI plays isn't anywhere near a point of excess...



## Part II: The Monthly US Equity Market Report

For the past 17 months, it has been a large cap growth market and for that time the Magnificent 7, now the Magnificent 5 have generated nearly all of the positive EPS growth and half of the share price gains for the US markets. While the fundamentals for these champions have legs, the overall market multiples of 21X current year estimates are high, solely because of the 32X average for the large cap champions. Without those giants, the average company is trading in line with the markets long-term averages, which is to say, a little rich, considering the modest EPS growth rate for the market outside of those names.

Simply put, the market is pricing in a Fed put, which is a nice way to say that investors believe a Fed rate cutting program will save them from calamity, should the fundamentals underlying stocks and bonds break down. After all, the market is driven by the combination of earnings and earnings growth in the numerator and the discount rate in the denominator. The discount rate is the more powerful of the two and the Fed has its hand on that lever. This logic makes some sense, except that the relationships are not constant and the transmission mechanism is not automatic, or set to a pre-determined level.

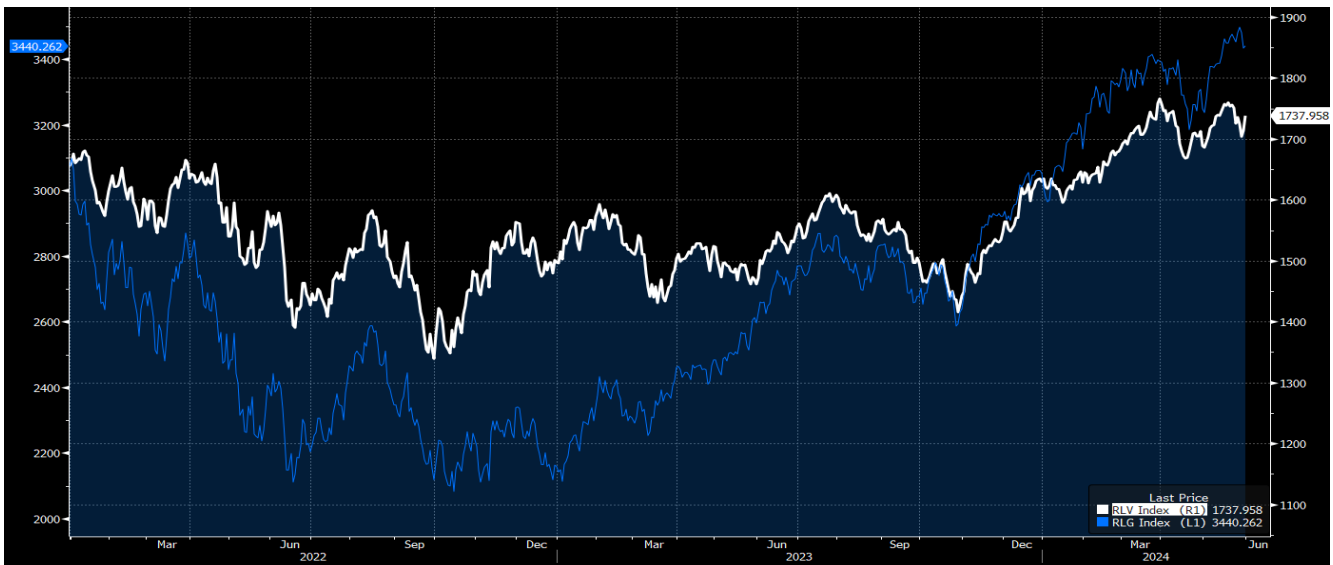
This variability in factors and relationships is why we see economists and strategists arguing over seemingly academic things like what is the neutral rate, or the target risk free rate and other esoterica. They are simply trying to improve the accuracy of their models, using historical spreads and business cycle analysis with today's data.

These are noble efforts, but with the combination of monetary and fiscal policy at odds, heavy deficit spending, and the markets now being controlled by AI-driven algorithms, very little today works the way it did even five years ago. So, the best we can do is look at the fundamentals and to a lesser degree technical factors and go to where the imbalances lie and look for reasons why either breakdowns or equilibriums should or could occur and set up for them in advance.

## Russell 1000 Value Versus Russell 1000 Growth – Last 29 Months

After a brief outperformance of value versus growth in April, growth stocks continued their trend of outperforming value stocks, until the last week in May. As you can see below, since January 2023, once the Fed began raising interest rates, Meta got serious about cutting expenses and Chat GPT started driving positive earnings revisions in select technology shares, growth stocks have trounced value shares, particularly slower growing, higher yielding shares like ours.

This trend should abate as lower rates make yielding stocks relatively more attractive, and the growth rate for the cyclical shares improves, making the total returns of more pedestrian shares more attractive relative to the big cap technology names that have been driving the market. Also, the baseline comparisons for technology shares will become higher and more difficult to beat in Q4, which should set the stage for some multiple contraction in those names, akin to what we saw last week, which should improve our relative performance versus the large cap growth giants that have carried the market for 17 months now.



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

Russell 1000 Value (RLV)	+3.17%	Russell 1000 Growth (RLG)	+5.99%
S&P 500 (SPX)	+4.96%	Dow Jones Ind'l Average (INDU)	+2.58%
NASDAQ (CCMP)	+6.98%	iShares Select Dividend ETF (DIVY)	+4.25%
		Sound Equity Income ETF (DIVY)	+2.60%

DIVY performed below DVY and the Russell 2000 Value Index due to a handful of decliners that impacted the portfolio.

- a) Walgreens lost 7.6%, following CVS's earnings miss, which translated into more concerns for the pharmacy sector, as highlighted by a grim WSJ cover story which regaled all the problems in the industry. Beneath the surface, WBA went the distance with the JP Morgan analyst and appeared to support her conclusion of baseline EPS of \$3+ per share, and sustaining the dividend. WBA has problems, but a stock trading at 5X EPS with a 6% yield and very low expectations seems like a good set up for sub-2% position. We would increase the position size if we saw changes to the store format to include more convenience store food items, which drive traffic and margins to those similar businesses.
- b) MSC industrial lost 5.7% after an analyst downgraded the stock, due to the lack of a sale / merger after the company declassified its shares. The analyst is correct that a deal was expected, and machine tool sales should be slowing, but the company didn't unwind its

declassification, and is generating enough cash flow to continue its bolt-on growth strategy, while paying a 3.9% dividend. Its ND/EBITDA of 1X is quite appealing to investors and suitors.

- c) Kraft Heinz fell by 3.7%, on a report questioning its long-term growth, just as the company has pivoted from being a cost-cutting story to an invest for growth story. The author has a point that KHC has not yet delivered much growth YTD, after a strong +7% 2023, but the 4.6% dividend is fat, and it takes time to shift gears. Management and consensus is for mid-to high single digit EPS growth in 2H 2024 and beyond.
- d) Hasbro fell 2.3% on reports of slowing consumer spending, and
- e) Carters dropped nearly 2% on the same issue.

Overall, our stocks rose and paid their dividends, but showed signs of the general slowdown that is affecting the US economy. We out-performed the Dow Jones, but again the technology names really

## Monthly US Equity Market Report

5/31/2024

Fundamental, Technical, and Valuation Snapshots

**Fundamentals: Revisions rose in May, but mostly due to IT; otherwise, the economy slowed.**

**Trends: Growth is slowing, input costs are falling now too, including wages, but rates are still too high.**

(+)	Communications	AI, marketing share gains & cloud spending are lifting social media cos.
(+)	Financial Services	NIM pressure, but Wall Street & better than feared credit lifted estimates.
(+)	Energy	Higher prices, thanks to global supply constraints have lifted estimates
(+)	Real Estate	Higher rents and occupancy creep are offsetting rate concerns for now.
(+)	Materials	Chinese demand & stable price/cost trends have halted estimate cuts.
(+)	Information Tech	AI demand & rising chip margins are offsetting soft commercial demand.
(+)	Consumer Discretionary	Low-end is slowing, but high-end spending & rising prices have lifted #s.
(+)	Consumer Staples	Price & cost pressures continue to abate, with stable volumes.
(+)	Utilities	Rising capacity investments & lower rate outlook are lifting estimates.
(-)	Industrials	High interest rates, strong dollar & weak exports are overcoming stimulus.
(-)	Healthcare	Lower pricing & utilization have offset recent obesity drug boost.

	5/31/2024		Earnings Revisions			Performance (Total RoR)		
	Mix		3 Mo.	6 Mo.		MTD	QTD	YTD
S&P 500			0.6%	7.6%		5.0%	0.7%	11.3%
Communications	9.5%	Best =>	3.5%	14.1%		6.6%	4.4%	20.9%
Consumer Discretionary	10.2%		0.7%	11.5%		0.3%	-4.0%	0.8%
Consumer Staples	6.5%		0.6%	3.6%		2.5%	1.5%	9.2%
Energy	3.8%		2.6%	-4.2%	Worst =>	-0.4%	-1.1%	12.4%
Financial Services	12.4%		3.2%	6.0%		3.2%	-1.1%	11.2%
Healthcare	12.0%	Worst =>	-5.7%	8.8%		2.4%	-2.8%	5.8%
Industrials	8.5%		-2.2%	4.5%		1.7%	-2.0%	8.8%
Information Tech	30.2%		1.5%	12.1%	Best =>	10.1%	4.1%	17.3%
Materials	2.3%		1.8%	-1.1%		3.2%	-1.5%	7.3%
Real Estate	2.1%		1.9%	3.6%		5.1%	-3.8%	-4.4%
Utilities	2.4%		0.6%	9.3%		9.0%	10.9%	15.9%

Manufacturing: The Chips Act has had a greater effect on boosting capital goods companies than the domestic production capacity it has generated or has even been the forecast for it. As you can see in the estimate revision table from we built from Bloomberg data, and in the Yahoo Finance exhibit below, industries estimates have actually been coming down, which has made us hesitant to add to MSC or other industrial names that do not have a lot of Chinese order exposure.

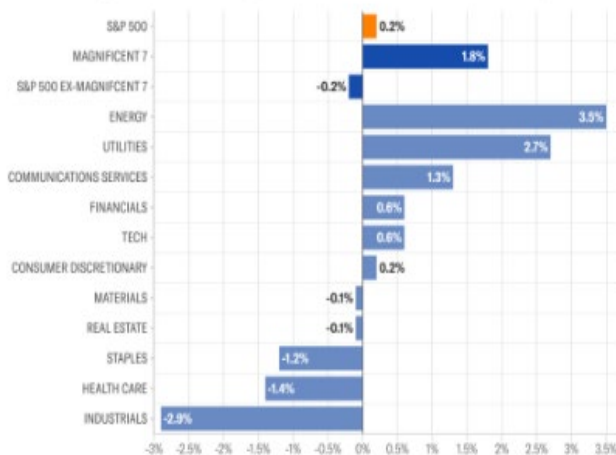
Energy stocks: These have benefitted from higher pricing, that could change, so the markets are hesitant to bid them up with the US slowing down. However, energy producers are generating unprecedented levels of FCF because they are investing less in replacing lost production than ever before. This is unusual, as the history is that the industry puts everything back into the ground. However, the green revolution, punitive policies for fossil fuels production, and shift to renewables have deterred re-investment. This shift makes adding to more commodity exposed energy positions appealing, rather than our pure volume processing (toll collecting) bias.

As many investment strategists have noted, outside of the AI and related cloud infrastructure trade, which has been dominating the markets, GARP Y FCF Generators has been the next best winning strategy, but these rarely have the kind of high dividends we need for our mandates. Right now, the market is paying investors to buy more staples, relative to historical valuations, healthcare (which has negative revisions outside of the GLP-1 drug stocks), and utilities, which are down on rising rates.

Note of these have cyclical rebound characteristics that we would like to ride, in the event that the Fed cuts rates. The banks and insurance companies do have some of this coiled-spring effect, so we are facing a tough decision: counter-trade and buy what is cheap, which usually works, or try to set up for the next up-cycle, which may be premature, but which will outperform. We are trying to do a little of both. To pull that hat trick off, we are sticking with our heuristic of adding the dividend yield to the EPS growth rate to come up with a combined expected return. Our ideal target for a new name is 30% over two years or 40% over three years. These are hard to find.

### EARNINGS ESTIMATES FOR THE REST OF 2024 AREN'T MOVING LOWER

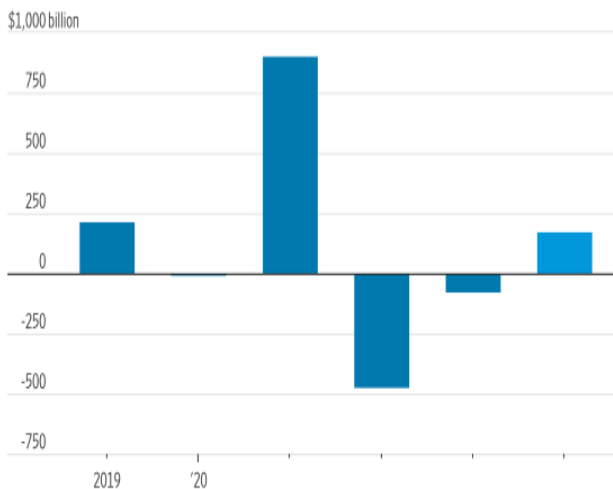
Change in consensus earnings estimates for Q2 2024 to Q4 2024 since April 1



SOURCE: FACTSET, BOFA US EQUITY AND QUANT STRATEGY

yahoo!finance

### Net flow to U.S. mutual and exchange-traded funds



Note: 2024 figure is through May 15. Money-market funds are excluded.

Source: Investment Company Institute

### Technical: Overall Bullish, but Neutral Long Term: per StockTA.com

**Key Positive indicators:** All EMAs, All Fibonaccis, RSI, ST Highs, ST Trends, ST & IT Lows

**Key Negative indicators:** All MACD, TDD

(+) Trend 10/11 sectors rose in May, led by technology, Utilities & Communications.

(+) Fund Flows Rebounding from April's sell-off, equities saw positive flows after week 1.

	Price	30 Day	50 Day	100 Day	200 Day	
(+) Golden Cross [50 dma > 200]	5,278	5,187	5,181	5,086	4,774	
(+) Price / Moving Average [4 / 4 are "> 1"]		1.02	1.02	1.04	1.11	
(+) Support Levels are Plentiful	5,249	-0.5%	5,173	-2.0%	5,131	-2.8%
(+) Resistance Points Offer Gaps	5,325	0.9%	5,438	3.0%		
(+) Volatility, (VIX)	The VIX fell by 273 bps to 12.92, on improvement in the inflation rate.					
(+) Trading Volume	Month-end volume surged, as slowing sentiment & inflation lifted spirits.					

Valuation: Tight vs. Bonds	PE		EPS		
	2023	2024e	2022	2023	2024e
Yields fell, spreads widened					
'24 PE is ~4.6 points > LTA	23.8	21.6	\$ 223.7	\$ 221.4	\$ 244.7
10 Year US Treasury: (1/r) = PE Equivalent	22.2	22.2	13%	-1%	11% = y/y %
10 Year BBB: (1/r) = PE Equivalent	17.3	17.3	'2024 EPS est. rose slightly in May		
<b>Stocks are Slightly Cheap Relative to Bonds based on LT Spreads</b>			<b>Upside For Stocks Relative to Bonds</b>		
10 Yr Treas.: LT Avg (1/r) relative to S&P PE	1.0	1.0	vs. 10 yr	-7%	3%
10 Yr BBB: LT Avg (1/r) relative to S&P PE	0.7	0.7	vs. BBB	5%	16%
S&P 500 Earnings Yield (E/P)	4.20%	4.64%	<= Earnings yield up; risk premium down		
10 Year US Treasury Yield (-18 bps in May)	4.50%	4.50%	10Y Tr. Downside to Parity		-1%
Spread (E/P minus 10 Yr. %)	-0.30%	0.14%	<= PE fell, risk premium narrowed		
<b>BBB widened vs. Treasuries, as rates fell 10 and 18 bps respectively</b>					
10 year BBB Corporate Yield	5.79%	Norms	<- Fell by 10 bps in May		
Yield Spread of S&P E/P minus BBB	-1.59%	-2.68%	BBB downside to normal SPX		-21%
Yield Spread of BBB minus 10 Yr T	1.29%	2.20%	BBB upside to LT Spread vs. T		-14%

### Part III: Portfolio News and Changes

There were not any significant portfolio position changes in May.

Performance (non-GIPSS)	Q1	April	May	YTD
Dividend River (est.)	+4.82%	(5.55%)	+2.89%	+2.01%
Total Return Yield (est.)	+9.49%	(4.77%)	+2.23%	+6.82%
DIVY NAV (Toroso)	+4.94%	(5.72%)	+2.89%	+1.80%
DIVY Price (Toroso)	+5.10%	(5.67%)	+2.60%	+1.71%

### Characteristics – Much Cheaper Than the S&P 500, With Lower Betas and 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 May 31st, Dividend River was paying a 4.5% dividend yield, >3.1X that of the S&P 500 at 49% below its 2024e PE price, while the Total Return Yield was paying a 3.5% dividend, 2.4X the yield of the S&P 500, at 51% below its PE price. Dividend River has an 10.1% weighted average 2024e EPS growth forecast that is 40 bps below the S&P 500, while the Total Return portfolio is expected to grow EPS 12.3%, 1.8% 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 14.6% versus 12.0% for the index, while the Total Return Yield portfolio should theoretically outperform the S&P 500 by 3.8% 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					
May 31, 2024						May 31, 2024					
SECTOR WEIGHTS	SIS	SPX	KEY METRICS *	SIS	SPX	SECTOR WEIGHTS	SIS	SPX	KEY METRICS *	SIS	SPX
Communications Services	9.7%	9.5%	Dividend Yield	4.5%	1.4%	Communications Services	7.6%	9.5%	Dividend Yield	3.5%	1.4%
Consumer Discretionary	5.5%	10.2%	2024e PE	11.1	21.6	Consumer Discretionary	12.7%	10.2%	2024e PE **	10.5	21.6
Consumer Staples	8.1%	6.5%	EV/ EBITDA	13.6	15.6	Consumer Staples	9.5%	6.5%	EV/ EBITDA	12.0	15.6
Energy	17.2%	3.8%	PB	4.1	4.8	Energy	12.3%	3.8%	PB	4.9	4.8
Financial Services	13.8%	12.4%	2024e Sales Growth	2.1%	5.5%	Financial Services	16.6%	12.4%	2024e Sales Growth	3.6%	5.5%
Healthcare	17.6%	12.0%	2024e EPS Growth	10.1%	10.5%	Healthcare	10.3%	12.0%	2024e EPS Growth	12.3%	10.5%
Industrials	2.3%	8.5%	BETA	0.8	1.0	Industrials	7.3%	8.5%	BETA	0.8	1.0
Information Technology	9.7%	30.2%	EPS Gr. + Div %	14.6%	12.0%	Information Technology	10.7%	30.2%	EPS Gr. + Div %	15.8%	12.0%
Materials	10.7%	2.3%				Materials	13.0%	2.3%			
Real Estate	0.0%	2.1%				Real Estate	0.0%	2.1%			
Utilities	5.5%	2.4%				Utilities	0.0%	2.4%			
Totals	100.0%	100.0%				Totals	100.0%	100.0%			

### Looking Ahead

Our crystal ball has been out for repairs for the last 12 months, but we understand it should be back in good working order by year end, after the election has passed, next year's Federal budget and tax policies are clear, and the Fed has moved off its john to lowering short term interest rates, which will be a catalyst for many virtues, including the carry trade, housing turnover, a falling dollar and increased economic activity in the US.

Between now and then, we expect more volatility as global uncertainty persists, and growth picks up overseas, but slows in the US. During this shift, the valuation disparity between expensive US stocks and cheaper foreign names could potentially leads to a rally in overseas shares – despite the headwinds they will face from a falling dollar, that will help lower the price of US goods, and the heightened geo-political risks from Russia slowly strangling the Ukraine and China threatening Taiwan, where most of the essential chips for AI are made.

Also, if rates come down, and the rest of the world picks up, the effects of AI on the markets will ebb. In that case, or in the case of Biden's extreme tax hike budget comes to be, the cartoon below might come to pass with one meaning or another.



*"Good news -- remember all those growth stocks I sold you?  
They're now value stocks."*

*CartoonStock.com, From David Einhorn's presentation at the 2024 Ira Sohn Conference.*

In either case, our high yield portfolios will continue to generate superior yields in a lower rate environment, which means that they should not only generate cash flow to fund your clients, but their relative performance should greatly improve, after being miserable for the last 17 months.

If only that crystal ball would come back sooner.

As always, we remain grateful for your faith in us and your belief in the virtue of cash flows over speculations, in this time when high expectations stocks have captured more headlines and returns than good old cash flows names have. Historically, such episodes burn out, and when they do, it sure will be nice to have money to spend.

May you and your families enjoy these times healthfully and well.

Equitably yours,

Eric

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