Sound Income Strategies
Quarterly SIS Client Newsletter

Quarterly SIS Client Newsletter Q3 2024

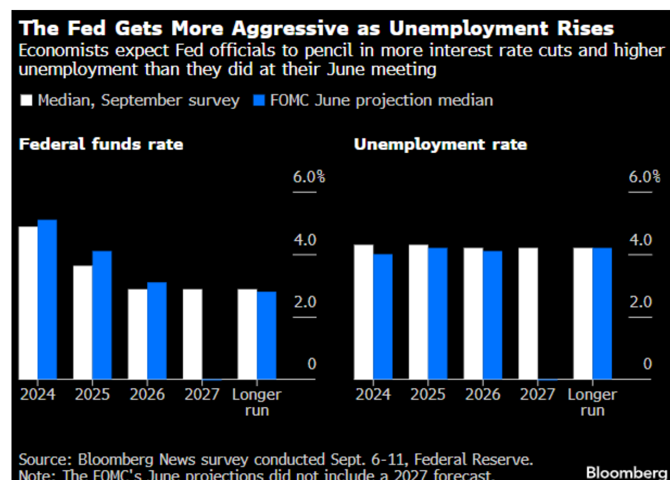
After some big bouts of volatility to start August and September, Wall Street finished the third quarter strong, with the S&P 500 up by 20.8% for the year, the NASDAQ up by 22.3%, and the Dow Jones Industrial Average up by 12.3%.[1] The volatility stemmed mainly from a combination of some weakening economic indicators and uncertainty over whether the Federal Reserve would finally get around to lowering interest rates. Ultimately, the Fed did cut rates for the first time in four-and-a-half years and the markets celebrated. That's great, but even the most bullish stock fan will agree the market is probably overvalued. Will the economy catch up quickly or is a correction in store? Before we address those questions, let's review.

After a fairly strong July in which the market saw the tech sector surrender a bit of its dominance, August kicked off with a route that culminated in Wall Street having its worst day in over a year. Several factors were to blame, including the release of downgraded earnings projections from some of the Magnificent 7 tech companies, another disappointing jobs report from the Labor Department, and the surprise announcement that Japan's Central Bank planned to start raising interest rates. While some volatility remained throughout the month, all three major indexes managed to finish August with slight gains.[2]

Then, on September 3, the big three indexes all plunged again: the Nasdaq by 3.3%, the S&P by 2.1% and the Dow by 1.5%, marking Wall Street's *second* worst day in over a year.[3] Triggering factors this time included the release of new data showing that the U.S. manufacturing industry could be weakening and worries over how the latest unemployment report might impact the Fed's decision to lower or not lower short-term interest rates at their coming meeting in September.

Fed to the Rescue

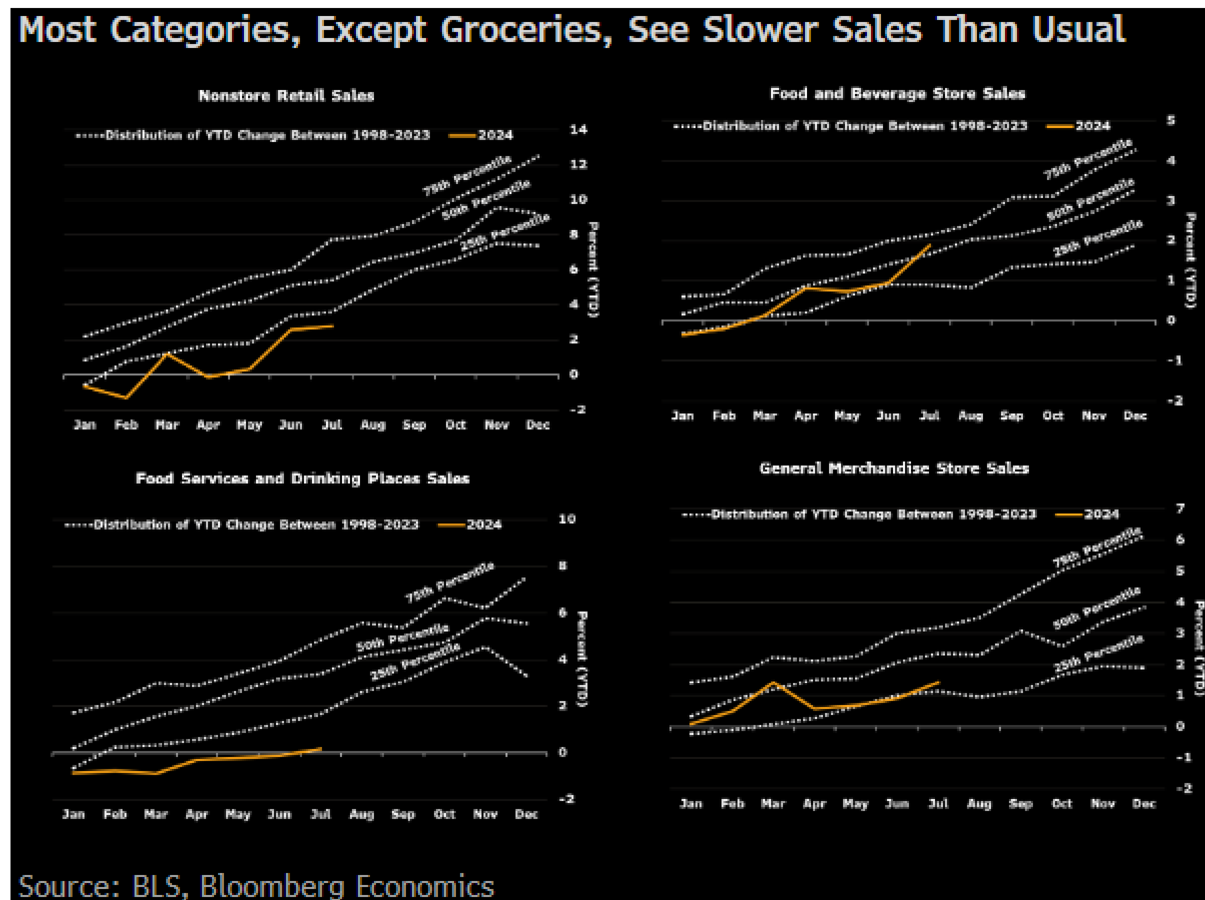
The good news, as mentioned, is that the Fed did, in fact, cut rates, and by an even greater margin than expected. The Fed approved a half-percent cut, which brought its benchmark rate down from a range of 5%-5.5% to 4.5%-5%. Fed Chairman Jerome Powell said the primary reason for the bigger-than-anticipated cut was the release of new data showing that the unemployment picture was even bleaker than previously reported.



In other words, the Fed's course reversal on interest rates was driven more by jobs than by the issue that prompted them to start raising rates in the first place. As you'll recall the Fed began raising in 2022 in response to the inflation rate, which was at a 40-year high of around 8%. Their goal was to bring the rate back down to a so-called "normal" level of 2%.

Based on the latest data, they're now very close to the target, with the Consumer Price Index at 2.5% year-over-year, and the personal consumption expenditure (PCE) at 2.2%.[4] That's good, and so is the fact that a new jobs report released a month later showed unemployment claims falling again.[5]

Nevertheless, the economy overall continued to show signs of weakening in the third quarter, so much so that many economists still feel a recession is possible, if not likely. Take consumer sales. As the illustration below shows, everything is trending below normal except for food at the grocery stores. Consumers are paying higher prices to sustain consumption, but generally cutting back on more expensive options like dining out.



Forward-Looking

Putting all these factors together, it seems clear the Fed is trying to be forward-looking by starting its easing cycle now while the economy is still relatively healthy, and the markets are up and stable. Many feel the Fed waited too long to start raising rates two years ago, and they

don't want to make the same mistake again, especially when the consequences could be a recessionary spiral. Most experts believe they will keep cutting at least until the short-term rate drops to 3%. If so, that should continue to bring down long-term rates, which, based on the 10-year government bond, dropped from 4.4% in early Q3 to 3.7% by early October.[6]

And it's not just our own Federal Reserve. Other central banks around the world are also lowering rates and implementing other forms of economic stimulus.[7] If the trend continues, it should be good news for investors overall because, as Warren Buffet observed, falling interest rates increase the value of all assets.

In fact, they have already done so, which largely explains why the stock market is overvalued, as mentioned earlier. Investors are already pricing in where they think rates are headed as opposed to reacting to where they are now. More accurately, they're betting on lower rates to revitalize all those areas of the economy that are now struggling in hopes that economic fundamentals will eventually justify the high valuations.

Our Take

As noted, despite markets' strong finish to Q3 and all the easing efforts underway globally, the possibility of a correction still exists when you consider all the potential spoilers in play, starting with the ongoing – and escalating – wars in the Middle East and Europe. The reality is, of course, that the possibility of a sudden drop *always* exists, particularly when the market is overvalued. It's important to remember that whenever you start feeling a twinge of "FOMO" about the stock market being up by 20%. That 20% gain could just as quickly become a 20% loss, or worse, at any time, which is why you made the switch to investing for income in the first place. With an income-first approach, your value fluctuations up or down are largely irrelevant because your interest and dividend return remain steady and unaffected.

Still, we understand that it always feels better psychologically to see your values growing instead of shrinking. The good news is that, overall, we're optimistic that with the Fed now lowering, we should continue seeing a positive impact on our portfolios as the year winds down.

[1] *"US Equity Market Attributes, September 2024," S&P Global, Oct. 2, 2024*
[2] *"Stock Market News, Aug. 30: S&P 500 Ends Rocky August with a Monthly Gain," The Wall Street Journal, Aug. 30, 2024*
[3] *"Wall Street Suffers Worst Day Since Early August Meltdown," Washington Post, Sept. 4, 2024*
[4] *Bureau of Economic Analysis, BEA.gov*
[5] *"Blowout US Unemployment Report Reinforces Economy's Resilience," Reuters, Oct. 4, 2024*
[6] *MarketWatch.com*
[7] *"China's Central Bank Unveils Most Aggressive Stimulus Since Pandemic," Reuters, Sept. 24, 2024*

Bonds and Fixed Income Securities Overview

Inflationary pressures are slowly continuing to deflate, with oil dropping by over 18% during the quarter, pushing gasoline supplies up versus demand. As noted, this, combined with a weakened labor market, prompted the Fed to pivot its policy to start cutting rates at their September 18 meeting.

The Fed's half-percent cut to short-term interest rates, along with the markets' expectations for future cuts, has finally pushed short-term rates down faster than longer-term rates, leading to a normal positively slopped yield curve. Still, treasury bills – one month through one year – will need further rate cuts to fall below the 10-year US Treasury.

Q3 Yield Curve movement:

Source: Bloomberg

YTD Yield Curve movement:

Source: Bloomberg

Most investment grade (IG) corporate bond yields continued to tighten in Q3, except for Autos, Energy, and Travel, while high-yield (HY) corporate bond yields actually widened by 0.07% for BB credits and 0.17% for single B credits. However, just about every sector in IG has compressed during 2024 in addition to the tightening of the Treasury curve.

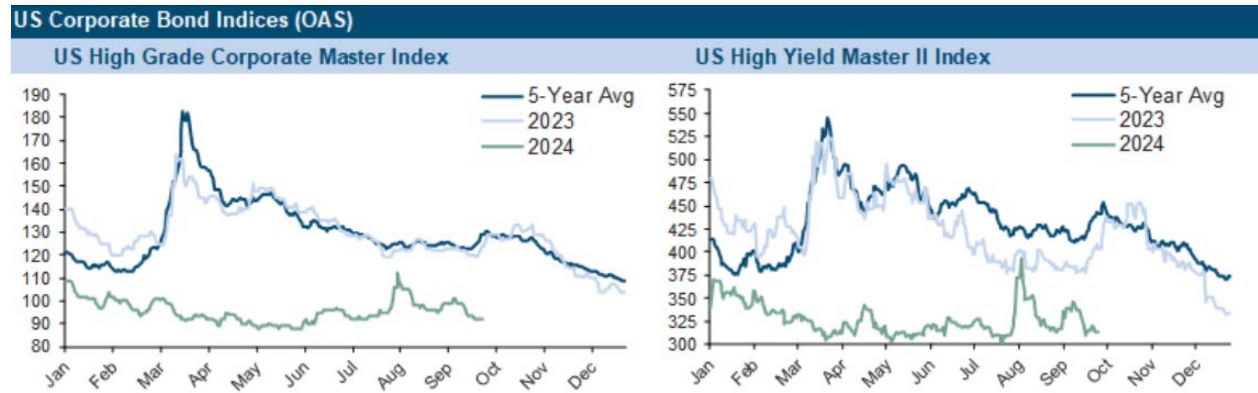
US Investment Grade Credit Performance

Sep 27, 2024					Change in OAS			Change in YTW			Excess Returns			Total Returns		
	OAS	YTW	Duration	Price	WoW	QTD	YTD	WoW	QTD	YTD	WoW	QTD	YTD	WoW	QTD	YTD
Investment Grade	**92 bp**	**4.69%**	**6.8 yrs**	**$96.29**	**-1 bp**	**-4 bp**	**-12 bp**	**-0 bp**	**-82 bp**	**-46 bp**	**0.07%**	**0.52%**	**1.75%**	**0.04%**	**5.96%**	**5.98%**
Ratings																
Sector																
Financials	**91 bp**	**4.61%**	**5.1 yrs**	**$98.43**	**-2 bp**	**-7 bp**	**-23 bp**	**-1 bp**	**-94 bp**	**-67 bp**	**0.10%**	**0.64%**	**2.35%**	**0.12%**	**5.43%**	**6.79%**
Banking	88 bp	4.55%	4.6 yrs	$99.09	-2 bp	-7 bp	-25 bp	-1 bp	-98 bp	-73 bp	0.10%	0.67%	2.41%	0.13%	5.28%	6.91%
Financial Services	91 bp	4.60%	5.1 yrs	$98.04	-2 bp	-4 bp	-20 bp	-1 bp	-92 bp	-63 bp	0.09%	0.58%	2.15%	0.11%	5.38%	6.58%
Insurance	104 bp	4.82%	7.0 yrs	$96.71	-2 bp	-5 bp	-23 bp	-1 bp	-80 bp	-55 bp	0.13%	0.65%	2.59%	0.10%	6.17%	6.68%
Industrials	**91 bp**	**4.70%**	**7.5 yrs**	**$95.28**	**-1 bp**	**-2 bp**	**-6 bp**	**+0 bp**	**-76 bp**	**-36 bp**	**0.03%**	**0.36%**	**1.32%**	**-0.01%**	**6.06%**	**5.47%**
Automotive	100 bp	4.63%	3.9 yrs	$99.38	+2 bp	+8 bp	-1 bp	+2 bp	-87 bp	-54 bp	-0.12%	-0.20%	1.06%	-0.07%	4.08%	5.56%
Basic Industry	108 bp	4.86%	7.1 yrs	$97.39	-3 bp	-2 bp	-21 bp	-2 bp	-76 bp	-50 bp	0.22%	0.39%	2.04%	0.18%	6.03%	6.31%
Capital Goods	84 bp	4.60%	6.8 yrs	$96.90	-1 bp	-5 bp	+3 bp	-0 bp	-83 bp	-30 bp	0.07%	0.66%	0.65%	0.04%	6.12%	4.93%
Consumer Goods	76 bp	4.54%	7.4 yrs	$96.56	-1 bp	-5 bp	-9 bp	-0 bp	-81 bp	-38 bp	0.03%	0.60%	1.44%	-0.01%	6.29%	5.63%
Energy	109 bp	4.91%	7.6 yrs	$97.06	+1 bp	+4 bp	-6 bp	+2 bp	-69 bp	-35 bp	-0.10%	-0.02%	1.70%	-0.15%	5.77%	6.00%
Healthcare	81 bp	4.64%	8.5 yrs	$95.13	-1 bp	-4 bp	-3 bp	+0 bp	-74 bp	-29 bp	0.03%	0.50%	1.19%	-0.05%	6.56%	5.21%
Leisure	108 bp	4.70%	4.1 yrs	$98.57	-4 bp	+8 bp	-8 bp	-4 bp	-86 bp	-55 bp	0.18%	0.16%	1.53%	0.22%	4.55%	6.20%
Media	125 bp	5.09%	8.7 yrs	$90.78	-0 bp	-1 bp	+2 bp	+1 bp	-71 bp	-22 bp	-0.07%	0.11%	0.70%	-0.15%	6.13%	4.58%
Real Estate	101 bp	4.69%	5.5 yrs	$94.88	-1 bp	-8 bp	-28 bp	-1 bp	-90 bp	-63 bp	0.11%	0.72%	2.46%	0.12%	5.79%	6.86%
Retail	70 bp	4.50%	7.8 yrs	$94.05	-1 bp	-4 bp	-3 bp	-0 bp	-78 bp	-31 bp	0.11%	0.67%	0.92%	0.05%	6.43%	4.98%
Services	78 bp	4.62%	8.0 yrs	$93.48	-1 bp	-4 bp	-11 bp	+0 bp	-73 bp	-36 bp	0.01%	0.26%	1.74%	-0.05%	6.24%	5.67%
Technology & Electronics	74 bp	4.53%	7.6 yrs	$93.63	-1 bp	-1 bp	-1 bp	-0 bp	-76 bp	-31 bp	0.03%	0.20%	0.83%	-0.02%	5.90%	4.86%
Telecommunications	95 bp	4.77%	8.5 yrs	$92.79	-2 bp	-2 bp	-6 bp	-1 bp	-71 bp	-30 bp	0.15%	0.39%	1.65%	0.08%	6.44%	5.57%
Transportation	94 bp	4.82%	9.1 yrs	$93.59	-1 bp	-3 bp	-5 bp	-0 bp	-72 bp	-29 bp	0.14%	0.52%	1.30%	0.05%	6.69%	5.16%
Utilities	**99 bp**	**4.83%**	**8.3 yrs**	**$95.67**	**-1 bp**	**-7 bp**	**-14 bp**	**-0 bp**	**-78 bp**	**-39 bp**	**0.14%**	**1.06%**	**2.40%**	**0.08%**	**7.07%**	**6.45%**

Source: CreditSights, ICE Data Indices, LLC

	OAS	YTW	Duration	Price	WoW	QTD	YTD	WoW	QTD	YTD	WoW	QTD	YTD	WoW	QTD	YTD
High Yield	**314 bp**	**7.00%**	**3.0 yrs**	**$96.55**	**-1 bp**	**-4 bp**	**-20 bp**	**-2 bp**	**-85 bp**	**-65 bp**	**0.05%**	**1.36%**	**3.57%**	**0.12%**	**5.30%**	**8.05%**
Ratings																
BB	191 bp	5.79%	3.2 yrs	$98.80	0 bp	+7 bp	-13 bp	-0 bp	-74 bp	-54 bp	-0.02%	0.21%	2.41%	0.04%	4.31%	6.86%
B	307 bp	6.98%	2.7 yrs	$98.45	0 bp	+17 bp	-35 bp	-2 bp	-65 bp	-79 bp	0.02%	0.83%	2.82%	0.08%	4.58%	7.26%
CCC	840 bp	12.06%	2.8 yrs	$84.31	-10 bp	-102 bp	-11 bp	-11 bp	-186 bp	-73 bp	0.46%	7.83%	10.88%	0.53%	11.61%	15.50%

Source: CS, Bloomberg, Bank of America – Merrill Lynch



Source: CS, Bloomberg, Bank of America – Merrill Lynch

Q3 New Investments

We added no new investments to our fixed-income portfolios in Q3.

Fixed Income Outlook & Perspectives

Right now, the Fed is suggesting that interest rates could fall another half to three-quarters-of-a-percent before the end of this year. But as we approach the next four years, there is great dispersion among the voting members of the Federal Reserve. Their uncertainty will likely carry over into the financial markets, leading to more volatility like we saw this past quarter, given that the markets don't like uncertainty. That said, we still believe the economic slowdown will likely continue until we reach a recession, regardless of how it is labeled by the media.

As noted earlier, the increasing escalation in the Middle East is another concern that could also add volatility to the markets this quarter, along with the slowing economic outlook and unknown interest rate expectations. With all this in mind, we believe we could see a material dip late in the quarter, which could be a buying opportunity for many. Obviously, these opportunities will need to be evaluated against a continued climb in valuation.

Ultimately, what we do know is that interest rates still have further to fall, and it looks like equity markets have started to rotate over to more defensive value/dividend equities versus the mighty growth/tech names. Therefore, we do expect another positive quarter for our portfolios, although probably not as strong as Q3.

Equities Overview

Stocks and bonds tend to do very well during rate cut regimes, and despite the duration math supporting growth over value in low rates, history has shown value stocks, which tend to be more cyclical, benefiting more than growth stocks on rate cuts – although it takes time for that broadening to show.

The good news is that we have seen a broadening out in the sector performance already, and some whiffs of value beating growth, in July and August. If the money flows into value ETFs that picked up in the summer (as shown below) continue, we should see more such months, although value funds today aren't what they used to be. In digging into some of the top value

labeled funds, by size and performance, we see they held more mega-cap growth names (that have been working) than true value stocks. This tells us that when true value really does start out-performing, these guys are going to play catch-up and drive the stocks up to silly levels. Until then, we just have to wait.

Russell 1000 Value Versus Russell 1000 Growth – Last 33 Months

While history suggests value should come back and outperform growth with the Fed easing, the AI phenomenon is real, so maybe the comeback won't be so great or immediate this time around as in past episodes. Certainly, there will be a reversal sooner or later, but after the last 20 months of growth winning 80% of the time, the question is when?

Transportation Blues

At the end of Q3, we saw a raft of negatives hit the transportation industry and related companies. Boeing (BA) has had quality control issues for the last couple of years and now it is dealing with a strike, where workers rejected a 30% pay increase, at a time when BA can least afford it. This is great news for Airbus, but not for BA, whose profits and market position continue to be stressed. Technicians say BA's chart looks near a bottom, but it is hard to justify BA at $150+ per share when it hasn't made a profit since 2018, and its all-time peak EPS was $16, achieved once. With no dividend and future earnings likely lower with new pay concessions, it is hard not to predict more downside from here.

In trucking, FedEx and UPS have both reduced expectations over the last few months, as their customers have economized, at the same time that online sales growth has slowed. Oftentimes, the express package companies can blame their woes on short-term episodes of stress, like a spike in fuel prices, Amazon taking more business in-house, or a business cycle slowdown. This time, the problem seems a little deeper, along the lines of a price versus value calculation that could stick around. With the US longshoremen on strike, both companies overnight expedited air shipments could be temporary winners in Q4, but until there is more consumer strength and business optimism, some of the better analysts are predicting a few more negative revisions. We would love to own either at the right price, at the right time, but we are leery that the current price and time do not include a wide enough margin of safety, considering the recent trends.

In automobiles, China's slowdown and massive EV capacity build has suddenly become everyone's problem. To help itself first, the Chinese government is driving its domestic consumers to buy Chinese EVs over foreign makes, which, along with the slowdown in Chinese growth has meant that Western auto companies' sales in China are down. On top of that, China has 19MM surplus EVs that it intends to export to the ROW, which also is seeing a slowdown in demand, in part because consumers don't want the EVs that their governments are forcing on them. The resultant mismatch in supply and demand has led to a buildup of inventories on dealers' lots and a near-universal reduction in 2H24 car production and sales estimates by the top ten global automakers.

The fact that the average car life is older now than before doesn't matter. What does matter is that car prices have gone up 30% in the last five years to ~$48,401 (Kelley Blue Book, 7/24), especially leases and financed cars, and consumers are choking a bit on the prices. This means that car companies's sales and the profitability of their average sale will continue to slip, as consumers hold off and trade down. Lower rates will help lift auto sales in 2025, but the inventory overhang could take half a year or longer to burn off.

Technicals: Overall Bullish

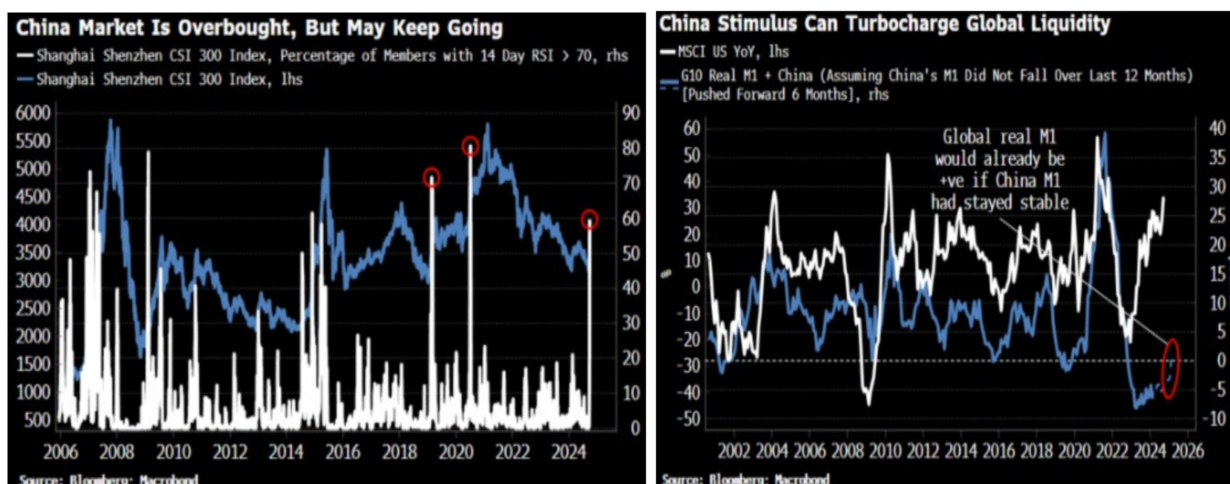
Technicals: Overall Bullish: ST & IT Bullish; LT Neutral: per StockTA.com

Key Positive indicators:		All EMAs, ST MACD, RSI, TDD, ST & IT Fibonaccis, Lows & Stochastics					
Key Negative indicators:		IT & LT MACD, LT Fibonacci, Highs, IT & LT Lows & Trends					
(+)	Trend	9/11 sectors & indices rose on Fed cut & Chinese stimulus plans.					
(+)	Fund Flows	Fund flows finished positively, after a mid-month dive.					
		Price	**30 Day**	**50 Day**	**100 Day**	**200 Day**	
(+)	Golden Cross [50 dma > 200]	5,762	5,611	5,530	5,467	5,229	
(+)	Price / Moving Average [4 / 4 are "> 1"]		1.03	1.04	1.05	1.10	
(+)	Support Levels are Plentiful	5,720	-0.7%	5,642	-2.1%	5,594	-2.9%
(+)	Only One Resistance Point	5,784	0.4%				
(--)	Volatility, (VIX)	VIX rose by 1.72 to 16.73 as early sell-off reversed on rate cut & China.					
(+)	Trading Volume	Trading volumes rose Y/Y, as investors piled in after rate cut & China.					

It is worth noting that the CBOE Put-Call-Ratio of 0.55 (down nearly 25% from last year) suggests that the market is closer to a sell than a buy, due to an imbalance of call buying versus put buying, but is not at an extreme. Hence, it implies we could go higher still, despite the lofty valuations. Similarly, the AAII sentiment survey is strongly bullish, at 57%, which tends to be a contrary indicator, though it too is not yet at an extreme level.

Putting these technical and sentiment gauges together, it is clear that the market is trading ahead of fundamentals on expectations that company economics are going to improve materially next year. This view looks right, but the market's current levels do not reflect any margin of safety for deviations from a perfect run and gun plan. As such, we expect higher volatility and potentially a meaningful correction if any large shocks occur, like a new conflict or unrealized capital gains tax plan to gain momentum. Having markets priced to perfection usually does lead to a rise in anxiety, and volatility, so be prepared.

The Chinese Example: Overbought but Likely to Move Higher Still



As the chart on the LHS above illustrates, even when China's RSIs had spiked in the past, Shenzhen moved higher until there was a clear obstacle, or catalyst to stop it. Many traders are looking at this example of a textbook model of how government stimulus can create investing momentum that goes beyond what fundamentals and even normal technical indicators suggest.

Further, they suggest that the massive global stimulus efforts underway now, led by China, the U.S., and the EU, means that backward-moored valuations are poor indicators of where the new bull is going because we haven't seen anything like this kind of multi-verse stimulation since the financial crisis. Directionally, this is correct, but the magnitude of today's problems and stimulus are both smaller than they were then, so don't mortgage your house to load up on NASDAQ of Shenzhen futures just yet.

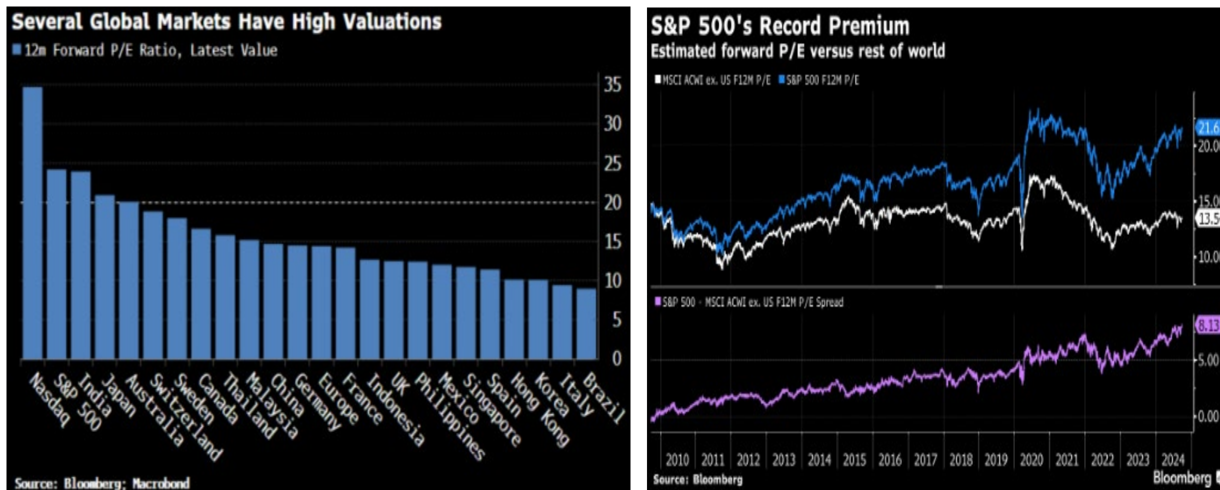
With the Chinese RIS blow-through examples in mind and the strong momentum in US stocks, led by infinite AI demand and the Fed's double-barreled rate cut, several talking heads (sell-side strategists promotional hedge fund types, etc.) are saying that the stretched valuations in the U.S. aren't an obstacle impeding this market to climb higher, so long as there is belief that the Fed's bazooka, in concert with Europe and China's easy money are going to re-ignite the US business cycle over the next year.

While this view is plausible, it is also disproven daily by the names that have had fundamental weaknesses, like the autos and energy stocks that are trading down hard on near-term revisions. Clearly, if the view was that falling rates and easy money would lift all cyclical boats, these industries would not be trading down as harshly as they are on "temporary" setbacks. Hence, there is still evidence to doubt the everything rally thesis, and it seems that fundamentals and valuations do matter, when the trends aren't as rosy as in the AI and GLP-1 drug spaces.

Moreover, if you look at the relative global equity market valuations, as captured in the PE chart below, and gaze at the far left-hand side, you will see that the AI-technology-led NASDAQ & S&P 500 are much richer than the rest, by a wide margin. Seeing the magnitude of that

differential should raise a few hairs on the back of your neck, especially if the last two years of the stock rally have made you feel richer than you were before. Most likely, a recalibration downward is coming, though we can't precisely identify the catalyst of timing. What we can say is that in the past when the US got this expensive, it didn't last more than 18 months.

What this chart does not show is each market's relative growth rates. If we were to build a Price to price-to-earnings growth (PEG)-forward chart, the US and Japan would still be on the left, but India would be cheaper, as it has much higher growth.



Q3 Portfolio News and Changes

The following equity securities were added to some of our portfolios this past quarter – although these positions may or may not be included in your individual account. Each client's portfolio is customized, so please refer to your account statement for verification. For further clarification, please see the attached disclosure, and if you have any questions, contact your advisor.

Sonoco Products

South Carolina-based Sonoco Products (SON) is a $5.1B market cap, global leader in consumer and industrial packaging, out of wood fiber, hard and film plastics, and metals. It is in the process of acquiring Eviosys, one of the largest metal can producers in Europe for $3B, in what promises to be a company transformative acquisition, that management believes will be 30% additive to the company's profits per share. While the company has historically traded at north of 15X current year EPS estimates, it is currently trading at 10X (a 33% discount) and the stock is at near a four-year low, due to a slowdown in sales corresponding to the slowdown in global GDP. In response to this slowdown, management has been cutting costs, and high-grading its portfolio, with over $1B of products set to be sold. The net of the acquisition, divestitures, and restructuring is that management and Wall Street analysts foresee Sonoco generating mid-teens EPS growth for the next three years. The combination of this earnings growth, the company's 4% annual dividend, and a reversion to Sonoco's historical valuation multiples implies 20%+ annual compounding returns in the 2025 through 2027 period.

Perrigo

Michigan and Dublin Ireland-based Perrigo (PRGO) is the largest private label OTC and self-care products company in the US, with products sold worldwide. The 4% dividend-paying stock is trading at 5-year lows in response to the high costs of its restructuring program that was partially instigated by the baby formula shortage crisis a few years ago, due to a plant catastrophe at Abbott Laboratories, the market leader. This restructuring program is on-plan to be completed by year-end, upon which time, Perrigo's sales and earnings are expected to begin growing steadily again, after plummeting in 2021 and hitting a flat spot in their recovery this year. PRGO enjoyed peak EPS at over $4 per share in the 2020 and prior year periods. However, its EPS dropped to just $2.06 in 2021 and 2022, rising to only ~2.58 in 2023 and 2024e, as the management sought to recertify plants, install a new ERP system, and shed old facilities.

Looking ahead, management (which is personally buying the stock) sees earnings growing steadily at a high-single-digit to low-double-digit pace in the years ahead, as it rebuilds shelf space in infant formula, and continues to gain share in its other categories. Thematically, consumers have been shifting to private-label goods globally to economize and Perrigo is a clear beneficiary of that trend. If we apply a below-historical 15X PE on $3.50 in EPS, for 2026, it yields an FMV of ~%53 per share, nearly double today's price. When you put the 4% annual yield on top of that gain, it works out to a target annualized return of ~28% per year, pre-tax.

To fund the additions of Perrigo and Sonoco Products, we trimmed some positions and exited MSC Industrial (MSM), which failed to sell itself, and reduced its outlook enough that we felt it offered less near-term upside than the others.

ADT

Headquartered in Boca Raton, Florida, ADT is a company we have researched since it became public again, post its LBO, but held off on investing in because of its high debt load and relatively weak customer economics versus some of the newer alternatives. Both of these issues have been improved upon, so with interest rates falling and housing turnover likely to pick up, which tends to correspond to new customer and revenue growth, we added a 2% position in the 3% yielder to one of our portfolios.

ADT is a $6.7B market cap leader in the US home and small business security systems sales and monitoring market. It has the #1 position in the industry with just over 50% market share. Its range of security and home automation services includes sensors and cameras for monitoring burglary, fire, water, smoke, gas temperature, and medical alerts. Its revenues in its current configuration are about $5B per year, and 85% of them come from recurring subscriptions. From here, ADT is expected to generate steady-state sales growth of about 5% per year, and EPS growth of double that, due to operating leverage and improved cost management. It currently trades at 6.4X EV/EBITDA, 4.1X trailing FCF, and 10.9X 2024e EPS, less than half of the S&P 500. Its normal EV/EBITDA is 7.3X. Getting back there implies a 73% upside, including the 3% annual dividend. We think it will take a couple of years for that happy result to manifest.

ADT has been around in one form or another for over 130 years. Apollo took the company private a little over a decade ago, leveraged it up, and spun it back out to public investors in 2018 with almost $11B in debt on the balance sheet. After selling off the commercial business and closing the money-losing solar operation, as well as using free cash flow from operations, ADT's debt load is down to 7.8B or ~3X forward EBITDA, which is acceptable for a company with 85% recurring revenues, and the company is profitable again, as the post-LBO period resulted in some early EPS losses, despite positive FCF.

We feel the security is undervalued because of its unattractive first five-year, post-LBO re-emergence period, (Apollo still owns 49%) and because of the emergence of less expensive alternatives, such as SimpliSafe that advertise home security and monitoring for a lower cost than ADT and traditional vendors and can be bought everywhere from Amazon to Costco.

It took some time for these models to find their niches, as they offer less robust protection and customer service for a lower price, in a "you get what you pay for" scenario. So, while these entrants gained market share when they came out a decade ago, that share came more from market expansion than from displacing traditional vendors. In this manner, they actually have helped ADT by providing an entry-level solution from which consumers can upgrade later on.

As part of its rebuilding process, ADT has developed strategic partnerships with Google (which owns 6.6%), State Farm Insurance (which owns 15%), and Amazon, which owns ~5%. In particular, ADT has become a key vendor for Google's Nest home automation solutions. While these strategic partnerships with deep-pocked shareholders don't guarantee success, they have resulted in significant co-marketing and product development efforts, which have benefitted public shareholders and Apollo, who will eventually exit its position.

This overhang has suppressed the shares to some degree, but it also offers a well for other strategic shareholders to draw from, should they emerge. We don't expect Google, Amazon, or State Farm to buy ADT, but we would not be surprised if another nationwide subscription-based home service company did, such as Servicemaster or Verizon, which could leverage the truck rolls and interdependency. Such an outcome would be icing on the cake. More likely, if the now slimmed-down and simplified company can deliver on its earnings expectations, we anticipate its valuation to rise. It will take some time for lower rates to light the fuse of rising housing starts. In the meantime, based on our conversations with ADTs installation staff, the demand for integrated camera systems, akin the the Ring doorbell, which lets people see and talk to folks at home even when they are not there, is lifting sales, along with annual price increases.

In addition to these acquisitions, we sold GM in response to the deterioration being reported in the auto sector (discussed above), as nearly every major car maker cut estimates, yet GM was still up 30% YTD. We added a sliver of the GM proceeds back into Stellantis (aka Chrysler, Dodge, Jeep, Fiat), which has gone down 33% YTD and is, therefore, more undervalued than most other autos in a normalization scenario. Hence it has more upside potential next year, if the new model transitions and plant closures transpire, and lower interest rates reignite auto sales, as hoped. Also, Stellantis pays a fat dividend (10% trailing) versus 1% for GM.

Characteristics: Less Costly 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. Year to date, our performance has lagged behind the technology-weighed indices because our high-yield mandates have prevented us from investing in the expensive, low or no-yield growth stocks that have lifted the S&P and NASDAQ higher, thanks to their positive sales momentum and strong fundamentals. But as we saw this month and last, and have discussed, these high multiple stocks can't lead forever.

Equities Outlook & Perspective

With interest rates falling around the world and fiscal policies fairly loose, it seems reasonable to expect the global economy to begin another growth cycle, despite the challenges of ballooning Government debt and hot wars that have the potential to spiral out of control. Usually, such easing cycles are very good for high-dividend-value portfolios like ours. So, we believe we have just a few more months of discordant data to go before the improving trends and rising tide should lift all boats including ours.

Further, if these wars don't metastasize, but rather end and lead to the rebuilding of the war-torn landscapes, such periods have typically been propitious for global growth. That outcome could be part two of an extended up-cycle, should it occur in the next year or two.

In the meantime, there is still plenty to make investors nervous, including the aforementioned wars, political discord, strikes, natural disasters, and unforeseeable shocks which should create some volatility on the road to Nirvana. While negative events are often shocking when they occur, it is important to remember that setbacks are normal and often welcome, in that the displacements they create should allow us to upgrade and reload our portfolios at attractive prices for the next leg up.

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