StraightTalk

PROVIDED BY STRAIGHTLINE FINANCIAL OF RAYMOND JAMES

VOLUME 5 OCTOBER 2023

ALFRED L. STRATFORD, III
Chartered Retirement Planning Counselor (CRPC®)
Managing Director

Year-End in Sight

As we begin the fourth quarter, the markets remain on edge. Not only have we just finished the seasonally weak period of August and September, but a long simmering conflict in the Middle East has burst upon the global news scene. Images of innocent civilians mowed down by terrorists from Hamas have flashed on every screen in the world, and sparked protests on college campuses and in several cities across our great country. It is an open question if it remains a battle just in the Gaza Strip, or if Syria and Lebanon, with financing from Iran, create a growing regional war.

However, as I remind you frequently, we do not own the countries, we own the companies. Just as Russia's unprovoked move into Ukraine rattled markets in the short term, this will likely dominate headlines for the next several weeks. It is the news media's job to present the negative facts in any situation, and today they seem to amplify them without much regard for fact checking. In fact, the Los Angeles Times was forced to retract a story after publishing it, and Twitter (now X) is a minefield of half-truths and unsubstantiated "facts."

It has become increasingly more difficult to get unbiased news without a negative tilt in recent years, and viral social media sources are making it all so much worse. Israel's response will undoubtedly create a humanitarian crisis in Gaza, a strip of land measuring only 140 square miles that is home to over 2 million people. And video footage documenting that crisis will likely be on every cell phone screen in the developed world shortly. *But this is not why we own the great companies of America and the world.*

What is happening in the world at any given time – or more important to your portfolio – what is happening in the <u>economy</u> at any given time, is never the issue. It is how you react or choose not to react to that news that truly matters. We are owners of durable businesses that are continuing to improve over time, while the share price does what it does in the short-term. Sooner or later, the prices will reflect the enterprise value of those companies, despite never ending broader news negativity.

Historically, the end of the calendar year has been a favorable time for market rallies, and I do not think this year will run counter to that trend. Herewith is a list, in no particular order, of five reasons the market could be higher in the coming months, despite ongoing dismal world news headlines.

1. *The job market finally appears to be softening.* Not every week, and not in every sector - but the massive shortage of labor that has been a notable hangover from the Covid lockdowns finally appears to be normalizing. Unemployment claims and payroll reports go up and down each week, but the trend is one of improvement. And, equally important, average hourly earnings have come down. Both will mean the Fed is close to the end of their rate hike cycle, and markets have historically moved higher once the Fed stops raising rates.

2. *Inflation numbers are dramatically lower.* Again, not every input (energy and shelter costs being the outliers), but a headline number in the mid 3's is undeniably lower than inflation at 9.1% just one year ago. Fed policy is completely ineffectual in controlling petroleum costs - that has much more to do with our own energy policy and geo-politics, which is a discussion for another day. However, in case you missed it, there was a pretty big petroleum merger announced earlier this month, a signal that there is continued upside in the Permian basin, and that our economy will continue to run on fossil fuels in the near-term. The other inflation outlier is shelter (i.e., rent and mortgage costs) which always lags the other inflation inputs due to how the data is collected. Rent

increases have slowed down, and the home buying market is being driven more by a supply shortage than interest rates. It is important to remember that, according to research from Federated, 42% of all American homes are owned outright. Additionally, for those homes that do carry a mortgage, 75% of them are at a fixed rate under 4%. I do expect the shelter inflation numbers to come down over the next several quarters, which will help inflation to continue to decline in 2024.

3. *The mergers and acquisitions, and initial public offering markets have come back.* For the better part of the last two years, the deal-making part of our capital markets was in hibernation. Even with the cost to finance these mergers or acquisitions higher than it was before Covid, more and more deals are being announced. M&A activity is the lifeblood of our dynamic marketplace – it allows for strategic combinations and divestitures for companies across all sectors of our economy. And our IPO market is critical for the world's newest and most dynamic companies to access capital and fuel their future growth. A return to normal for both is a healthy signal for the overall economy.

4. *Return-to-office.* We demonstrated as a nation that we could be just as productive working from home as we were in the office for the 3-6 months that Covid required. Maintaining corporate culture and continuing that efficiency for 3-6 years appears to be another story altogether. Most corporations have now implemented requirements for professionals to be in the office several days a week, if not all the time. This is a net positive for all those businesses that rely on foot traffic or commuters to survive, like local convenience store owners, restaurants, and dry cleaners. One of the largest real estate companies in the world recently announced they are investing $1 billion in an office project next to New York's commuter hub, Penn Station. Since companies always try to make rational decisions regarding return on their capital, this only makes sense if commuters are coming back to that city. And, if they are coming back in New York City, they're coming back across America, which is unalloyed good news for our national economy.

5. *Earnings have bottomed and are rising again.* I recently posted a chart showing fourth quarter earnings estimates right at the level where they peaked early last year. Based on analyst's research and corporate conference calls, I expect the overall level of earnings for the great companies to be at new all-time highs in 2024. We may or may not have a recession next year, but the number of publicly traded companies that would be surprised by any recession is exactly zero. In executive boardrooms across America, discussions about (and plans for) a recession have already taken place, and I expect earnings to hold up for 2024, and be higher still in 2025. Which, I remind you, is why we own the great companies in the first place.

You may have been able to find this list from your preferred news source, but likely these five would have been sandwiched between hundreds of negative news reports. Bad news happens quickly, and is sensational, while good news happens gradually, and is generational. If we can all try to think in terms of decades of improvement, rather than weeks of turmoil – we will have less stress and less temptation to buy into the bad news narrative.

We know the companies in the index change over time. But you may not know that nine of today's ten largest companies in the S&P 500 were not only not in the index in 1970 – they did not yet exist!

Wharton Professor Jeremy Siegel takes this "decade view" approach even further. He has researched how the great companies have grown since America began. It may surprise you to know that U.S. companies have been compounding at seven percent above inflation since Thomas Jefferson's first term. A track record that long doesn't come from luck – there is something magical in the rational profit motive that just works – *if we give it time to do so.*

So, my advice is to sit back and enjoy the fall season, and the holidays that follow the changing of the leaves. Soon enough, the year will end, a new one will begin, and with it, better things ahead…

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804.225.1143 | straightlinefinancial.com | 5820 Patterson Avenue, Suite 100 | Richmond, VA 23226