Hughes Investment Advisory Service LLC

October 3, 2021

Dear Clients and Investors,

For Q3 the S&P 500 was up .6% and is up 15.9% YTD. Overall, the US economy was gaining a little steam as the 3rd quarter came to an end, even as the stock market was falling. Behind this better business tone were increases in industrial production, steady housing starts and building permits and a very strong showing in retail sales. Despite this economic spurt, the resumption of a choppy growth pattern is likely.

Why choppy? The Federal Reserve has started moving towards a less accommodative stance. After the latest FOMC meeting, the Fed declared some late 2021 tapering of asset purchases and eventually an increase in interest rates, though not for several quarters into 2022 – at least according to their current course. More on this issue and how inflation may alter the Feds preferred plan below. Another factor is the gridlock in Washington. I don't happen to be in favor of the 1 trillion-dollar infrastructure stimulus bill nor the massive Biden 3.5-5.0 trillion-dollar spending binge but in any case, both bills are stalled in Washington and may not get passed or at a minimum will be vastly scaled down from their current versions. So, less accommodation from the Fed and less spending out of Washington would leave the economy to fend for its own for the first time since Covid hit almost 2 years ago.

Unfortunately, as I've been writing about in previous letters this year, inflation has become a very big problem for the economy and the Federal Reserve. How bad? Core inflation was up +3.6% in August from a year ago, the biggest jump in more than 30 years. Energy prices are skyrocketing due to pipeline cancellations, lower investment in the oil/gas space, OPEC trouble, strong demand globally and supply chain bottlenecks across the board. This inflation problem will pressure the Fed to accelerate the taper process outlined above. I don't believe that the markets are prepared for an accelerated taper! Wall Street will not welcome an earlier than planned step away from easy money policies due to surging inflation.

The biggest question of all is whether the Fed can raise interest rates again without significant pain and huge dislocations in the global economy? The dollar is the reserve currency of the world. The great benefit of possessing the world's reserve currency is that America can float its ever- growing debt despite large and growing long-term liabilities. A remarkable 51% of US sovereign debt matures in three years. The weighted average cost of the US outstanding debt is only 1.38%. With more than 22 trillion in debt owed to the public, relatively small changes in interest rates could greatly increase the federal deficit. Making the Fed's job even harder is the fact that the current administration is asking the Fed to use monetary policy to solve a variety of social and political ills, from climate change to racial injustice. It's debatable that the Fed can solve their traditional tasks never mind these new ones.

There is no doubt that the Fed has the tools to tame inflation, similar to what Paul Volker did in the 1980's when interest rates were above 15%. But the question remains whether it has the political will- given the size of overall financial assets relative to the economy, the potential effects of tightening on the federal budget, and the growing list of other new Fed responsibilities.

Other concerns revolve around China and the potential implosion of their real estate sector with Evergrande nearing a bankruptcy filing. This alone might not be enough to send China's economy into a downturn but if Evergrande turns out to be the tip of the iceberg in a deteriorating Chinese real estate sector, fears legitimately revolve around a Chinese Lehman 2008 type financial crisis with possible contagion throughout Asia and who knows where else the contagion could lead.

On the concerns front I can't leave out the threat and likelihood of higher business, personal and capital gains taxes currently planned by the Biden Administration. Higher inflation, higher interest rates, higher taxes, more regulation…. I'll only briefly mention the federal debt ceiling which needs to be raised immediately for the government to continue paying its bills without a default or debt rating downgrade. There's no doubt the ceiling will be raised but there's no telling how difficult the process will be and if it will result in a debt downgrade or worse. Currently I am assuming the ceiling will be raised before serious consequences occur. I'm not sure how much the American economy can take without it leading to an economic and business downturn.

What about corporate earnings? Earnings continue to be a bright spot! I continue to be pleasantly surprised by the overall earnings picture. Yardeni Research currently projects 2021 S&P 500 earnings to reach $210, up 50% from 2020. Yardeni Research is expecting 2022 S&P earnings of $220, again another record, but only modest growth of 5% year over year. If we do achieve 2022 S&P 500 earnings of $210, despite being another record, 5% earnings growth is not anything to write home about if P/E ratios are in the high teens or 20 plus level – so we are potentially looking at peak earnings for this cycle in 2022 possibly giving equities a reason to stall or drop especially if interest rates rise giving competition to equities.

Given the above concerns where do I find winning industries and companies today? Companies with well-defined earnings prospects that can hold their own during periods of moderating economic growth. Companies that can benefit from rising rates, have pricing power, and deliver dividends. Technology, defense, pharma, med tech, energy/water infrastructure and biotechnology. The Utility and Consumer Staples sectors stand out as income producers in a low-rate environment. I am expecting the Utility sector to be a surprise winner from the EV and green energy revolution with required infrastructure investments needed throughout the system. True, the current backdrop as described above, is not idyllic but with interest rates near record lows and alternatives to stocks few, the best option appears to be to stick with the winning companies that fit the above criteria.

At this time, I continue to favor large-cap, dividend paying, US based multi-national companies with strong balance sheets. We love businesses with irreplaceable brand names, wide moats, high margins, grow their dividends, and have modest debt. Risk/reward continues to favor equities over fixed income. A few select REIT's and specialized bond/income and alternative funds continue to look good as income producers. I will continue upgrading and adjusting portfolios accordingly and look for special situations as conditions on the ground change. Please do not hesitate to give me a call to discuss the above analysis.

Sincerely,

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