Hughes Investment Advisory Service LLC

July 1, 2023

Dear Clients and Investors,

Happy July 4th. We are now at the mid-point in the year and as usual, it's been an interesting six months in both the markets and in the world at large.

In another bifurcated quarter, Q2 results showed large discrepancies between different market sectors. YTD the Dow Jones Industrial Average is up 3.7% the S&P 500 16%, the Equal Weight S&P 500 5.9% and the NASDAQ 31%. The Barclays US Aggregate Bond Index, or AGG, is up 1%. In January I predicted a gain of 14% for the S&P 500 in 2023 which at the time seemed like a very bold call being much higher than the consensus at that time but look where we are now! As usual these markets continue to surprise and humble many market observers and investors.

What do the above returns tell us about the market so far in 2023? During 2022's bear market, dividend paying stocks were favored by investors and had superior returns over growth stocks. So far in 2023, a highly concentrated group of about 7 large cap tech stocks are where all the returns have been and these companies weightings in the indexes have been responsible for most of the positive returns across the board. Apple, Microsoft, Amazon, Google, Tesla, Nvidia Meta, is where the positive action has been. Some of these are long-term holding for us. Thankfully, in recent weeks, there are signs of the market broadening out.

This YTD return discrepancy between growth and value is the biggest we have seen since 2009. At the start of 2023 most were predicting a repeat of last year with higher interest rates and lower stock prices for growth stocks. Instead, despite continued increases in the Fed Funds rate, growth stocks have resumed their steady ascent on hopes that AI (artificial Intelligence) represents a new era for computing and growth, something that I agree with. Personally, I never bought into the idea that higher interest rates alone were an overriding reason not to own high growth technology stocks – another false narrative that persisted in 2022. What is the lesson here? Own a diversified portfolio of the best companies that fit our criteria and be patient when necessary.

Despite the first half gains the market outlook for the rest of 2023 is not at all clear. Why? The Fed has maintained that it plans to keep raising interest rates to continue the inflation battle. The economy may be slowing, and the market rally has been very narrow as described above. The debate continues as to whether we are in a rolling recession which will evolve into a rolling recovery or are we headed for a hard landing and more significant recession? At this time, it appears to me, to be a rolling recovery that has begun. There are many pockets of strength in the economy and sectors of the economy that weakened first are now starting to recover. The labor market remains strong with wages and salaries still growing. Another plus is that there's 49 million senior citizens, 65 and older, many retired who continue to travel, dine, see the doctor etc. creating demand for workers in restaurants and hospitality, leisure, and healthcare. Additionally, as I expected, company earnings are holding up much better than many predicted a few quarters ago. While we didn't see an earnings expansion last year, we certainly didn't see earnings crater as many predicted and minus a hard economic landing scenario, we appear headed for steady record S&P 500 earnings in 2023, 2024 and 2025.

Another positive new development, especially over the short/medium term, is the underrecognized $2 Trillion of spending coming out of Washington in three bills: the Infrastructure Investment and Jobs Act, The Semiconductors and Science Act, and the Inflation Reduction Act. The amount of money is huge as is its impact on certain industries and the business momentum it should create. The US may be in the early stages of a manufacturing super cycle with renewable energy, electrical vehicles, batteries/charging stations, semiconductors, ports, highways, electrical grid, and airports all up for massive new projects. Manufacturing construction outlays are projected to increase fourfold from a decade ago to $200 billion this year alone.

Of course, there will be a downside to this government spending with politicians deciding which industries to favor. We're seeing failures now with companies like Lordstown Motors and Nikola either going under or being close to bankruptcy. It's always messy when Washington gets involved with free market capitalism and much of this is deficit spending which will need to eventually be accounted for but in the near-term it should provide a significant boost to GDP.

Foreign companies have taken note with FDI, Foreign Direct Investment, into the US going from $150 billion in 2020 to over $350 billion this year. This is double the FDI into China this year! For example, Panasonic is opening 3 new giant EV battery plants in the US working with Tesla and on their own. French and British companies are also making similar moves towards the US for manufacturing. This is all a result of these spending bills being passed along with our low-cost natural gas energy infrastructure and a strong legal system protecting foreign companies assets and proprietary capital as they invest in the USA. The opposite is happening in China, Russia and other totalitarian countries who are seeing the opposite occurring.

On March 19th, 2023, I wrote a mid-quarter client update expressing concern about the banking crisis that was unfolding at the time. Despite what appears to be a resolution to that crisis, including positive results from last week's bank stress tests, I remain concerned about the nation's banks overall financial health and ability to continue healthy lending given the large unrealized losses on their US bond portfolio's. The commercial real estate sector, while concerning, only represents a relatively small percentage of total real estate loans on the nation's top banks balance sheets. Commercial real estate does remain a concern for the mid/small banks due to the higher percentages that it represents on their overall loan portfolios.

While I remain open to the possibility that the worst of this banking crisis has passed, my concerns regarding the health of the nation's banking system remains high. Large interest rate hikes that the Fed has had to implement over the last 16 months have resulted in a serious reduction to the net capital levels of all the banks. Thanks to the surprising strength of the economy and persistent shortage of workers, inflation will remain an ongoing problem, requiring further rate hikes or at a minimum persistently higher for longer than expected interest rates. What will this mean for the financial sector going forward is an open question and a concern for me that I am watching carefully. This means that the Federal Reserve will continue to walk this tightrope in its battle to tame inflation without tipping the economy into recession or the banking system back into crisis.

Specifically, given the above concerns where do I find attractive investments today? Gold is providing a hedge against inflation. Short term T-Bills are providing 5% (annualized) returns. In equities the Cloud and AI, Defense, Infrastructure, Medical/Drug/Biotechnology, EV's, Farming, Energy especially clean energy such as Hydrogen, Nuclear and Natural Gas and the general re-shoring of manufacturing. These are the growth areas where the US is playing the leading role for future world and US economic growth.

Overall, 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 now slightly favors equities over fixed income – Utilities, MLP's and specialized bond/income funds provide steady income. I believe that our portfolios are well positioned to produce consistently attractive long-term risk adjusted returns while preserving capital. Please do not hesitate to give me a call to discuss the above analysis.

Sincerely,

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