Hughes Investment Advisory Service LLC

October 1, 2023

Dear Clients and Investors,

The S&P 500 which had been up nearly 20% for the year in July is now hanging onto a 12% increase and was down 3.6% in the most recent third quarter. The DJ Industrial Average is now about flat for 2023. The AGG or US Aggregate Bond Fund Index is down about 4.5% YTD, on pace for its 3rd down year in a row! The equal weighted S&P 500 which counts each of the 500 stocks in the index equally tells a more negative story showing a negative 2% return YTD. The only area of strength in the markets in 2023 has been with the Nasdaq and the large cap Big 7 stocks that have carried the index higher so far in 2023. In other words, we have had a very narrowly focused market with 7 large cap growth stocks responsible for almost all of the market's gains.

The recent bond market selloff has crushed the idea that a soft landing is possible for the US economy. The understanding that interest rates will be higher for longer is finally registering with the markets and they don't like it.

My long-held concerns over the widening federal budget deficit continues to mount. The 10-year Treasury bond has dropped 46% since peaking in March 2020 almost equaling the 50% plunge seen in the US Stocks after the Great Financial Crisis in 2008-2009 and I don't think that this bond market selloff is finished.

The argument all year has been about whether the Fed is done or close to done raising interest rates and if we will have a desired soft-landing. The trouble is that the central bank doesn't set interest rates anymore. The bond market does. The Fed has increased its short-term policy rate by only 0.25% since May 3 but the interest rate that matters most to the economy, the 10-year Treasury note, is up by over .75% during the same time span. And it's up nearly 1.5% points since the spring, and up about .75% point in the last month. As a result, I expect the most significant tightening to the real economy to begin around the end of this year. At 4.75%, the benchmark Treasury yield is at its highest level since 2007. That date coincides with the beginning of the global financial crisis.

The US is courting trouble. The federal government is 43% larger than it was 4 years ago, and its reach is growing rapidly! Much of this spending can be traced to government subsidies, credits, and handouts. The chosen recipients benefit, but the rest of the economy is burdened by higher interest rates and higher taxes.

US Gov't bond issuance is increasing dramatically because of the massive federal deficits that must be rolled over and funded. One statistic that I often cite is that in 2000 total US accumulated debt was 5.6 trillion dollars, now after the War on Terror, the Global Financial Crisis, the Covid-19 pandemic, and general deficit spending in Washington that number is 34.5 trillion. The Treasury Dept should have refinanced the entire US debt load 3-5 years ago when rates were at a rock bottom level of 1-3% - it was discussed but never acted upon. Now it is too late. This year interest on this debt will equal about three-quarters of discretionary, non-defense spending. By 2031 it will be as large!

Consider that three quarters of Treasury's debt must be rolled over within 5 years. If we add just 1 percentage point to the average interest rate in the current forecast, it results in an additional 3.5 trillion in debt by 2033. The governments annual interest bill alone would then be about $2 trillion. For perspective, this year's individual income taxes are set to bring in only $2.5 trillion. Suffice to say that the numbers just do not add up and the recent spike in interest rates worsens all these numbers radically. The worst part is that if investors lose faith in our government's ability to service all this debt the situation can spiral out of control with rates continuing to rise, deficits growing larger resulting in further reductions in the governments credit rating like what we saw last summer. Who will buy all this new debt? The 4 traditional large buyers of our debt were the Fed itself, but they are now sellers also called QT or quantitative tightening. China which is now pulling back from our debt markets. Japan but they are now raising interest rates at home and will therefore more likely be a much smaller buyer of US debt. Large US financial institutions but they are already reeling with huge losses from their existing portfolios of "risk free" long-dated Treasury bonds.

In 2024 the government will be auctioning approximately 25% more bonds every Monday at rates closer to 5% rather than the 1-2% for the last 15 years. Additionally, the US government debt rating has been reduced recently by Fitch which Washington laughed off but was in fact on point and a bad omen for the country. "Bizarre" was the word that the Biden administration used to describe the timing of Fitch's downgrade of America's credit rating this summer. I would argue that it's Bizarre that it didn't happen sooner. Predicting when markets will get

seriously concerned about this debt problem is hard to know exactly but I'm sensing that it is happening now.

Other debt related concerns are record consumer credit card debt which is over 1 trillion dollars for the first time in history. The average interest rate on this debt is now over 20%. Resumption of Student Loan debt repayments. Commercial real estate is another concern mostly for the mid-sized banks. The biggest banks and the mid-sized bank's ability to lend is undergoing a serious curtailment because of the massive losses on their bond portfolios which at the end of the day represents the banks capital or net worth. The banking crisis from earlier in the year has not ended and is only being made much worse with each tick higher in interest rates – I predict that we will see more casualties soon. The last banking report that I saw stated that about 800 billion of banks bond portfolios were pledged to the Gov't program allowing them to mark the bonds at par, 100, in return for paying a nominal interest to the Fed – in other words the Fed is backstopping the US banking system beyond what is commonly understood!

Outside the US rates are also climbing across the board. Europe is in recession. China once considered our friend, and a favored trading partner is currently dealing with their own massive real-estate bubble and our two countries are de-coupling as fast as possible from a trading perspective. The war in Ukraine is dragging on Europe and Russia. Net net there exist many drags on world growth at a time when the US is just beginning to grapple with our debt and interest rate related problems mentioned above. I believe the result of all this will in fact be a debt crisis followed by a recession.

So far in 2023 S&P 500 earnings are holding up. Stronger than expected GDP growth is the reason. In January we estimated S&P 500 earnings at $225 and that level still looks on target. Heading into the 4th quarter I am very cautious however and am now expecting that the US economy is probably entering a recession despite the current strong growth numbers. This would mean lower earnings but also hopefully an end to fast paced rise in interest rates. It's not a very good set-up for risk assets overall in my opinion.

Specifically, given the above concerns where do I find attractive investments today? US corporations are standing tall as the best place to look for solid leadership at all levels of corporate governance and profitability. US corporations continue to expand their overall lead in almost every area of business around the globe.

Traditional investment vehicles that we favor like dividend paying stocks, corporate bonds, municipal bonds are now finally yielding good rates of return after the close to 3-year pounding that they have suffered through. Short term T-Bills are providing 5% (annualized) returns. Gold is providing a hedge against inflation. 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. I view Risk/reward equally between equities and fixed income – Utilities, MLP's and specialized bond/income funds provide steady income. I believe that our portfolios are 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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