November 2023

It's the time of year when spirits rise. More importantly to a Capitalist economy, wallets open wide for the Holidays. In this letter: valuable tax-saving end-of-year planning items, an economic update, and notes from a First Trust investment conference. Let's begin with value-added planning items.

IRA Required Minimum Distributions (RMDs) must be satisfied by 12/31. As a result, discussions with tax-professionals about tax withholding and other tax-items, such as gain/loss tax-harvesting and Roth IRA Conversions, need to take place ASAP. Please let us know if you'd like us to coordinate with your other professionals.

Are you 73 or older? Do you make charitable contributions to qualifying non-profits? If so, speak with your tax professional about the virtues of *writing checks directly from an IRA account*. This strategy may help avoid income taxes. We provide the IRA checkbook. Call for details.

Regardless of your age, have you inherited a non-spousal IRA since 2019? The "10 year distribution rule" may apply to your RMDs! Please contact our office to discuss sensical withdrawal strategies. Significantly large distributions could be required in the 10th year, which can cause unanticipated income tax concerns. Forewarned is forearmed.

Do you use our Envision planner to project retirement goals? The Wells Fargo Investment Institute (WFII) updated its 2023 Capital Markets Assumptions (CMA) this past July, which in turn, is affecting the results of Envision and EMoney plans as of 22 October. Scores may have changed. Call us to review.

Let's jump into the economic analysis.

The FED kept rates steady for the second time in a row. This means that like Goldilocks, things aren't too hot nor too cold right now. However, unlike the fairy tale, that doesn't mean that 'things are just right'. Rather, it means that we don't need to heat up, or cool down, the porridge *at the moment.*

The Market's response to the FED's decision was swift, and interest rates fell across the yield curve. Interest rates on CDs and Treasuries, between 6 and 12 months in maturity, dropped as much at .25% in the last week. Stocks that are sensitive to interest rates jumped, and together with lower inflation numbers, the S&P500 is up in the last several days, sitting in the 4500 range as we write this.

This data may seem contradictory, and it is. On one hand we have the FED not raising rates because inflation and economic activity are slowing down, presumably toward recession. On the other hand, the stock markets are rising. Why the apparent dislocation? Why do the stock markets rise when we're presumably headed toward a recession?

At least one reason the markets continue to rise is that falling interest rates mean revaluations of appropriate stock prices. At a corner desk, an analyst hunches over the computer, crunching numbers. To the analyst, lower interest rates are a new data point in the calculation. Thus, stock prices *immediately* rise (because interest rates are in the denominator of the equation used to calculate them). Further, cooling inflation numbers lead investors to believe the FED may be done raising rates. Lower interest rates mean lower expenses for businesses, which is good news for stock prices. So, again, stock markets rise.

Meanwhile, the US Economy continues to soften. Consumer spending wanes and debt levels, such as credit card debt, are rising. Employment numbers are still good (anyone who wants a job can find one) and so income is steady, but Covid-related savings accounts are dwindling and this source of spending appears to be slowing.

As a result, discussions about a possible Recession continue in earnest. Will we have one at all, and if we do, will we experience a Hard or Soft landing? Historically, a Yield Curve Inversion, where short term rates are higher than long term rates, foretells of an impending recession. The historic average is 18 months from initial inversion to recession. The inversion started in July 2022. Year end 2023 will be consistent with historical timing. These are just averages, and many market forecasters believe a recession is coming later in 2024. Either way, a recession isn't likely to ensue until spending decreases.

In summary, as we head into year-end, 2023 market performance, which is positive for the year at the moment, primarily boils down to a handful of tech stocks that rose as a result of Artificial Intelligence excitement, smart accounting, and deficit-inducing government spending. We continue with our skepticism about the party continuing too much longer. As a result our portfolios are defensive. With money market and short term bond funds paying approximately 5.44% right now, we need strong justifications to add 'stock-buying-risk' to client portfolios.

Government and politicking will affect the markets in the coming year. This was one cause of Moody's downgrading its rating of US Debt. It cut the outlook on U.S. Treasury debt from "stable" to "negative." Moody's remains the last of the major credit-scoring firms to give the Treasury its highest debt-rating, but it warned that the outlook is worsening because of political polarization, expanding federal budget deficits, and worsening debt sustainability. Watch the political rhetoric as we head into the 2024 elections. On the horizon are discussions of budget deficits, debt-ceiling, and the fact that tax-cuts from the 2017 Jobs Act expire/sunset at the end of 2025. New tax legislation may be difficult with slim majorities. But, without agreement, the tax-cuts WILL expire at the end of 2025.

In the post-script below, for those that are interested, I include notes from an investor conference and economic update that I (Chris) attended last week. The notes dive into detail and are somewhat technical. In one section, I discuss that forecasted Global AI Markets expect huge parabolic growth. But, AI, including Chat GPT for example, has a 'hallucination' problem. It doesn't know what's real and not real on the internet, so it draws from fake data. AI doesn't know when it's being duped. That's a problem for all of us. Don't trust everything you read (except this!)

As always, thank you for your continuing trust in our team. We wish you and your families a Happy Thanksgiving!

Sincerely,
Chris, Greg & Darcy

The following notes come directly from the speakers at the First Trust Conference in Nashville, TN on 11/9/2023. The notes are the thoughts of each of the specific speakers and are NOT reflection of the positions of the Yalanis Private Wealth Management Group, Wells Fargo Advisors, or of First Trust. Any reference to ETFs, stocks, or other such investments should NOT be construed as advice to sell or buy. These are simply academic discussions. Before each section of comments, the speaker's name is listed. The comments were made by that person.

<u>Chris' Notes from the First Trust Conference:</u>

These notes contain a number of comments and bullet points from the conference. I typed furiously while listening to the speakers, who were excellent. Presentations were cogent, well supported analyses. Many of these comments refer to slides that were presented simultaneously, but which are not part of this letter. Please feel free to reach out to Chris for a deeper dive.

This was my second Due Diligence trip with First Trust. Their research and economic analysis are excellent, thoughtful and data-driven. Note, they do tend to be fiscally conservative, which does reflect in the notes.

The meeting started with an introduction by Jim Bowen, CEO of the privately held firm since inception, 31 years ago. Jim always leads off the presentations, which illustrates his dedication to the business. His primary concern for investors is that after 40 years we now have to seriously deal with Inflation. Clients who understand the issues, and can remember the 1970's and 80's, are asking "Do I have enough?"

Jim doesn't believe we're talking about general problems associated with the concept of 'purchasing power'. We're talking about people who are filling up their vehicles with gas when they still have 3/4 tank and buying groceries at the beginning of the month, *because prices keep getting higher every day*!

Inflation - it's here, it's NOT Transitory. We've been forewarned. We must plan for it. No one under the age of 50 has any visceral understanding of Inflation. In general, rates will be much higher for much longer. Powell is Burns, not Volcker. Remember history. The fact is that only 37% of US population is over age 50. So, *two thirds of Americans haven't experienced an inflationary environment*.

When the Covid crisis started 3 years ago, our government was afraid of a 1918-like situation where millions of children could die. The data shows differently. As a matter of fact, very few children passed of Covid. 99.99% are fine. We KNOW this now. Children are 5x more likely to die of flu, as a matter of fact. Thus, we don't need to spend any time on Covid-related school policies . He encourages us to go to the school board and local politicians and make the DATA known.

With regard to the least health of our population, the facts show that Covid took people 'early' who were on the 'edge of life' already. Covid took the lives of 28-months' worth of folks who normally pass each year. Essentially, people who were statistically going to pass soon, passed earlier. (Chris' note: My apologies for this very frank, and seemingly heartless discussion of Covid related deaths.)

The fact is, according to Jim's research, that *if you're likely to die of Covid, you already have*.

As a result of the Covid-scare America spent money to address the problem, to fix a problem that we now know that we don't have. As a result, assets and credit market debt exploded in size as we spent Trillions. There was a Global Supply Chain breakdown, madness in the world, and in spite of that, we had the 10 most profitable quarters in the history of mankind. This terrific performance was a 'Sugar high' from all the cash injected into the economy.

Now, we have to deal with the cost of servicing the 33+ Trillion in debt. Who knows what a Trillion is? only Dr. Suess! It's the sum of paying $1 a second, for 32,000 years! (I tried the math…it works). How will we do it? The US has a history of dealing with debt. President Clinton ran surpluses in his second term. LBJ created the 'great society' and loaded up debt. Bill Clinton almost paid it all off. So, we're going to pay it down. We've done it already.

How will America do this? Americans are industrious. This morning at 5 am, someone was UP already, awake and working, adjusting knobs, working hard and making things better. Ingenuity and progress lead our attitude. Look at Bezos and Musk, they're flying private rockets? 15 years ago, this was a cartoon - today it's a near-flawless process.

We're unaware of how often this type of ingenuity and American success happens. In 2023, Elon Musk, every 4.1 days, has shot up a rocket and caught it on the way back. It can be reused, with one reaching 19 times of reuse already. How much money has been saved? A lot!

Look at the Starlink orbit network. It enables Wi-Fi calling. Look at 'Flipper', the burger flipping machine. <u>A McDonalds in Fort Worth has NO humans serving</u>. It's a Self-Serve and drive through location. White Castle has 20 flipping kiosks. And 'Flippy' makes avocado guacamole too. Technology is incredible.

What about Global Warming? Bowen grew up in southern CA and then fled to Illinois. Then he moved to Naples. He knew earthquakes, now, he knows Hurricanes. He watched the Naples pier disappear. The hurricane hit on a Thursday, he landed in Naples at the airport at 5:00 p.m. on Friday. Six of the eight houses in his neighborhood were lost. He had 4' of water in his garage. He said we need to pray for the folks in Ft Myers beach, where a 'wall of stuff' destroyed 100 year old structures…that are now GONE. No cell service for weeks, Wi-Fi was missing for months.

Protestors said the hurricane was evidence of global warming. So, he looked for the data. What he found is that there is no appreciable impact from hurricanes, according to the data, over the past 20 years.

Jim's point: be wary of the 'media narrative'. (Note, Chris discussed a similar point in last month's letter). Many decisions have been made by politicians in the name of global warming. Look at Germany, which launched the New Green Deal several years ago under Merkel. They closed all Nuclear power plants. Then, they ran out of electricity, so they built coal power plants, the dirtiest in the world. Then energy prices tripled and CO2 production went up 22%. The whole effort was built on narrative. Was it misguided?

In the US, California tried to a nuclear power plant. It was fought off and they kept the plant. Then, an off-shore windmill farm off NJ, that was killing whales, was stopped. Which was the right move?

Capitalism is making great strides around the world. The world-wide poverty rate was 44% in the mid-1980s. Today, the rate is less than 9.5%. Every US President's getting into China and India has helped to reduce these numbers.

Why is poverty less of a problem? In his opinion it's based upon 3 things: The Rule of Law, a functioning Democracy, and Property Rights. The most populated Country on Earth has these things. That's why there's less poverty. ---end Bowen----

This next section will have bulleted comments. Dave McGarel, First Trust Chief Information Officer had the following to say:

This is "The Most Challenging Environment in which to Forecast the Economy"
Stocks prices have been affected by higher interest rates.

Logically we should be in Defensive stocks, but Utilities are getting hammered in 2023, down 5%, due to rising rates.
For the past few years we've asked why should we extend Duration in portfolios when there's no return? Now that the yield curve is higher, there's a reason to consider adding duration.

Watch the 10-year US Treasury yields. If the 10 yr. yield keeps going higher - then stocks will be a problem.

What about Growth? Historically, the US doesn't start projects and GROW in this type of interest rate environment. The FED is trying to slow things down with rate hikes.
Comparatively, we're in a better place than we were in during the Financial Crisis of '09. We don't have the type of naked-debt that we had in '09.

CEOs will be more sober going forward, and credit will be watched more carefully, but growth can still continue.

The 'opportunity set' going forward is questionable. 28% of US companies outperformed the index 20 years ago. What about today? It's a much smaller percent, recently.

He thinks things will look historically more normal, going forward, where more companies outperform, versus a few companies (like we've seen in 2023 thus far).

Speaking of 2023 performance, there's a 35T market cap in growth sectors such as Tech (Nvidia, Amazon), Services (Meta, Google), and Discretionary.

When rates were low, Utilities did well. Then, as a result of FED increases, they were washed out of the bond-proxy trade when rates came up. They also have high debt levels. Defensives are finally trading like defensives. They'll look better when they trade at 11x earnings. Investors don't need the bond proxy with yields at this level.

2023 performance has been dominated by 7 companies. These are some of the best companies in the world.

Look at AAPL. Steve Jobs died in 2011. Tim Cook has been CEO since 2012. He's still doing terrifically. But, look at Luca, the CFO. He's a smart CFO. He had 26.4B of outstanding stock and cash on hand. They bought back stock. Almost 11B shares of stock - 38% of the company. Now, they have 120B of debt and 160B of cash on hand. The debt is at 75 bps!!! But, these 75bps bonds are going to reset over the next few years, at higher rates. That'll affect Apple's bottom line, unless they choose to pay it off.

In 2012 AAPL had a 45M profit. Those numbers are doubled now. EPS (earnings per share) quadrupled when debt decreased. Here's the issue: Apple can't keep doing this forever, they simply don't have enough cash. Further helping their meteoric price rise, we, the market, agreed to pay higher multiples (26x instead of 16x). So, AAPL is great, but PE ratios and financial engineering made the growth great. Can it continue? Will growth stocks like this, continue to outperform? Is it time to realize gains on AAPL?

What about International Stocks? What's the thesis for future outperformance? None. The US is the world's Tech giant. No one is close. The rest of the world is more cyclical. It's good for Value.

Don't chase the growth of the Big 7 stocks. ---END---

The next section is presented by Brian Isaakainen

'Recency Bias'. Watch out for this. Big Tech may not continue to lead. The upcoming slowdown or Recession will affect companies that can't afford the interest expense in the next few years.

S&P500 Market Breadth is very NARROW right now. So, it's difficult to stock-pick in these narrow years.
Will we see broadening that we saw '00-'05, where more stocks outperform the index? There's currently a myth perpetuating of beating the S&P500 because it's been hard since 2017.

The S&P500 appears overvalued, historically, similar to 1999 (before the tech crash). THEREFORE, consider MID CAP stocks in portfolios.

Forecasted Global AI Market has huge parabolic growth. But, AI, including Chat GPT for example, has a 'hallucination' problem. *It doesn't know what's real and not real on the internet, so it draws from fake data*. Watch out - NVDA appears very expensive right now.

DATA: There's a factory-building boom in the US right now reflecting an industry move back from China.
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The next section is from Brian Wesbury, Chief Investment Officer and Economic Analyst. Note, First Trust won an award for most accurate economic forecasting. And, Brian believes this is the hardest time to ever forecast the markets.

Data shows us that Covid caused people to coop up indoors, with money. So, bored, they bought stuff on Amazon. Today, they're outside again! As a result, ''Goods' are done (manufacturing is slowing). Services are back to historic trends, but slowing. Put them together - Recession is coming.

During Covid, the US Gov't borrowed funds (7Trillion) and then taxed it as it ran through the system. Taxes were paid to States too. As a result, the tax receipts all went way above trend and they're coming down now. *Tax receipts are plummeting*. Profits were artificially boosted too - and these are following. This is the base case for the economy.

Watch the M2 Money Supply! Brian follows Milton Friedman. Recession should follow since M2 is down 3.6%.

When we add a dollar to the economy, we should get a dollar of spending. Thus, we should have 5.4T of GDP with 5.4T of M2 added to economy. *PROBLEM: There's still 500B missing, which hasn't hit GDP yet. (he thinks that Americans couldn't spend it all). When this 500B is gone - then the Recession comes*.

Last year's US Budget deficit was 1T, this year was 2T. When this overspending changes, then spending falls and recession ensues.

The Fed Funds Rate was increased in order to address rising Inflation. Bernanke kept rates low for 7 years. Powell kept rates low for 2 years. This may have contributed to inflation, but inflation comes from money supply changes, not interest rates.

Question: if you had 33T of outstanding debt, and you got to set the interest rate, what would you set it at? Zero? Europe set theirs at a Negative number!

Today, government is too big and manipulative. Guns-n-butter caused inflation in 70's. Today it's solar panels and wind farms. We're still not done paying the price for last 15 years of low rates.

The First Trust Capitalized Profits Model says the S&P500 is overvalued. But, just because we're overvalued doesn't mean it can't go higher. That said, they feel the risk is to the downside.

Our system of government is about “Wealth CREATION and REDISTRIBUTION of that wealth.” The creation of wealth is driven by the US constitution, and Freedom.

Technology builds wealth. Redistribution hurts it. This lowers productivity.

45% of everything we produce is redistributed. 17 out of every 100 people are living off the government.

In 1840 we couldn’t have done this. Kids worked on farms!

The only reason we can do it today is because we’re so productive. Technology is so powerful, that we could continue to hit new market highs. ---END Wesbury----

Next, Robert Stein, Deputy Chief Economist
He’s not going to be the bearer of good news. Recession is coming.
This is the most reckless and irresponsible budget in the history of US. Bob defended the budget under Obama and Trump. This is NOT a political comment.

Federal Budget Madness. The annual budget was 5.5% of GDP in 2022, and went up to 6.3% of GDP in 2023. Under Reagan, the largest Budget/GDP ratio was 5.9% in 1982. Back then, the excuse was that they were fully funding a military buildup and experienced unemployment of 10%. But recent unemployment has been 3.6% over last year. 1/3rd of Reagan’s numbers! So, why the debt???

The 5.5% FY 2022 deficit included plan to forgive student loans. Assessment has to do with future reductions of student loans present valued back to today. Without this discount, budget deficit would have been 4.0%. The Supreme Court strikes down the proposal. So, instead of a reduction, the DOE gets to write off the value of the loans. 7.5% FY 2023 instead…highest EVER!

Going back to Civil War 1860, has there been any other year where budget grew by 3.5% of GDP, without either a recession or major war as the cause. We have neither. Not Civil War, WWI or WWII.

We are currently running the most reckless budget ever, which has postponed the Recession.
His current guess is that Recession starts in early 2024. But he expects a Mild Recession Ahead”. Not like 2020, not like 2009 with 10% unemployed. More like 1991. Unemployed might go up to 5.5%.

He thinks the Fed is done raising rates and won’t cut till ‘see the whites of recession’s eyes’. 40% chance of 1 more rate hike. We could see 4-6 rate cuts in 2024 IF the recession starts early.

Residential Real Estate: construction costs matter to the price of houses. Relatively speaking, we haven’t seen a Covid RE bubble because prices rose with construction costs.
But, compared to rents, we’re in a bubble. He expect rents to drop relative to housing prices. Houses may rise slightly, but not as fast as they’ve risen recently.

Politics:

Tax Hikes are coming from both sides. Jan 1, 2026 earliest. Trump 2017 tax cuts expire end of 2025.

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