J.W. Burns & Company
Investment Counsel
Quarterly Update - April 2023

Gloom and Doom Can Actually Be Good news

"Time, time, time...is on my side, yes it is!"
- *The Rolling Stones, 1964*

Dear Clients and Friends,

For the second consecutive quarter, stocks generated healthy returns. Driven by many of the technology stocks that were hammered in 2022, the S&P 500 Index climbed 7.5% for the first quarter, the blue chip Dow Jones Industrial Average was up about 1%, and international stocks, as measured by the MSCI EAFE Index, were up 8.90%. Bonds, which declined sharply last year, were also positive, with the U.S. Aggregate Bond Index up 3.2%.

All in all, it was a pretty solid quarter.

We are pleased with the first quarter performance of your portfolio holdings, a finely constructed mixture of high-growth equities, consistent dividend paying stocks and diversified index funds. Our overall focus remains on quality, growth, and dividends, and we are always ***very selective*** before adding any new investment.

In our January letter, we laid out our rationale for a recovery in financial assets this year. Specifically, history has shown that it is rare for the U.S. stock market to go down two years in a row, and 2022's sharp price decline drained much of the excess froth from the market. Furthermore, history heavily favors positive returns in the third year of the presidential election cycle with the average return clocking in around 16.7% since 1950.[1]

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As I write this, two significant economic data points have reinforced clear evidence that inflation is subsiding throughout almost all subsectors of the economy. The latest data on consumer inflation, as measured by the CPI, shows inflation has been declining at a steady basis for months and is now at its lowest level since May 2021. Inflation for producers of goods, as measured by the PPI, dropped precipitously from 6.2% in December to 2.7% in March. ***These are encouraging readings and confirm our view that Central Bank tightening in the U.S. is potentially near its end.***

However, easing inflation is only half the story. It is widely expected that the U.S. economy will fall into a recession of some magnitude in the coming quarters. With an inverted yield curve – historically a leading indicator of a coming recession – this seems likely. However, it remains far from certain, and even if the economy does fall into a recession, it is likely to be a relatively shallow one.

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In our view, the ongoing strength of the labor market and the reopening of the Chinese economy speak for the increasing possibility of both a pause in interest rate hikes, a soft landing and/or a shallow recession. Of course, only time will tell. But our song remains the same: ***trying to time the market's reaction to various economic data or predictions is impossible and will generate subpar returns over time***. Instead, we focus on what smart investors can control – ***superb portfolio construction and investing with a long-term mindset.***

For the past 15 months, investors have faced a never -ending deluge of bad news from the war in Ukraine, hot inflation, rapidly rising interest rates, and a slowing economy. Much of these headwinds are likely priced into the stock market. ***I am reassured that there is gloom and doom amongst investors and the financial media right now***.

As investing legend, John Templeton, once said, "Bull markets are born on pessimism."

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The current level of bearishness is, in fact, very high. According to Bank of America's 2023 Fund Manager Survey, bearish levels are at some of their highest levels since the Great Recession – from real estate and credit to the global economy as a whole. Furthermore, investors are holding their highest bond allocation since March 2009 – what then turned out to be the market bottom.[2]

The weekly AAII (American Association of Individual Investors) Sentiment Survey was equally miserable. Catch these stats:

Are you bullish or bearish in the next six months?

Bullish 19.2% (average 37.5%)
Bearish 48.4% (average 31.0%)
Neutral 32.4% (average 31.5%)
Source: AAII

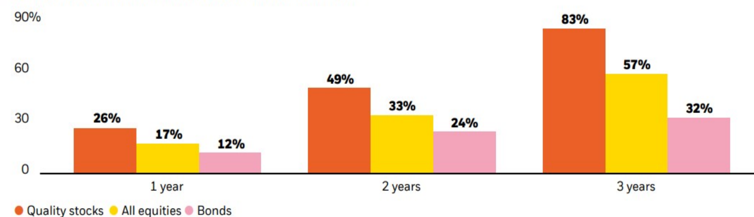
To quote CNBC's Bob Pisani: "The good news is that these are sentiment indicators. Two rules about sentiment indicators: 1) they are contrarian indicators, and 2) they are most useful when the readings are at extremes - as they are now."

I think 2023 will end up being a better year than what most experts are forecasting. Attempting to put a precise percentage gain for the remainder of 2023 is nothing more than a guess, so I will take a pass. However, I do believe the trend is ascending and there is fertile ground for upside surprises, especially among the blue-chip dividend growers, which have lagged the S&P 500 Index so far this year. ***We remain bullish.***

As I write this, we are in the early innings of first-quarter earnings season, and the results thus far have been better than expected. The earnings power of your portfolio companies remains better than the market as a whole and, the quality of their balance sheets is unsurpassed.

And, as always, we are investing your money for the long term. As Warren Buffet says, "***The stock market is a device to transfer money from the impatient to the patient***."

Quality readying to lead?
Average returns after Fed hiking cycle ends, 1984-2021



Source: BlackRock Fundamental Equities, with data from the Board of Governors of the Federal Reserve System and Bloomberg, calculated from Aug. 31, 1984-Dec. 31, 2021. Returns are calculated from the month when the Fed stops raising rates for peak rates periods in 1984, 1989, 1995, 2000, 2006 and 2018. All equities represented by the Russell 1000 Index and bonds by the Bloomberg U.S. Aggregate Index. "Quality" is defined as the top quintile of stocks ranked in the Russell 1000 Index using a proprietary research screen that assesses companies on 13 "quality" metrics. **Past performance is not indicative of current or future results. Indexes are unmanaged. It is not possible to invest directly in an index.**

Now, let's try to answer some of your questions:

Q: Many economists/analysts believe that the banking crisis is not over and will cause repercussions for years to come. This contrasts with your client communique in March. Have you reevaluated your position?

A: Not really. All our work indicates that most of the banking system is better capitalized than it has ever been, and the major banks are able to withstand significant stress. It should be noted that the U.S banking system has been undergoing significant consolidation, dropping its number of banks by 70% over the last 40 years without missing much of a beat.[3]

So, even if there are more regional banks that fail, I think the weeding out of weaker players in the banking system is healthy in the long run. This is especially true if the Federal Reserve remains committed to backstopping depositors, and the mega-cap banks continue to step in and pick up the pieces from any further fallout among the regional banks.

Q: With the market in a six-month uptrend and economic activity slowing, do you worry that stocks are expensive at current levels?

A: Great question. Currently, the S&P 500 trades at 18.3x forward earnings, which makes it neither cheap nor expensive as a whole. However, the index is led by several mega-cap stocks (FAANG) who trade at significant premiums to the overall market. If we remove these outliers, the S&P 500 is trading at a much lower multiple - around 14.8x forward earnings vs. the 5-year average of 18.5x and the 10-year average of 17.3x.[4] This means the "average" stock is trading at a discount, and there are opportunities for bargain hunters and those looking for value.

While we could certainly see some further valuation compression in the short term should we go into a deeper recession, I continue to be bullish on stocks over the next several years as today's valuations provides a reasonably good entry point for investors.

Q: The U.S. National Debt continues to skyrocket with no end in sight. Are you concerned about this and what happens if Congress can't agree on raising the debt ceiling?

A: I am concerned. The current debt ceiling is $31.4 trillion and our government has run a $1 trillion deficit every year since 2001[5]. The polarization between the two political parties is as wide as it has ever been, so the threat of defaulting on our debt can not be ruled out.

It is unfortunate that there is such rancor in politics today.

I don't think politicians on either side will benefit if the economy takes a hard leg down because of no agreement.

My best guess is that there will be a lot of theater and drama around the debt ceiling debate, it will likely go down to the last minute, and some sort of deal will be struck to prevent default.

They are, after all, politicians!

So, we are into earnings season and will be closely reviewing the revenues, profits, and forward guidance from your portfolio companies. We will be doing the same with the equities on our watchlist of potential investments.

From an economic standpoint, the key drivers for a continuation of the market recovery depend on moderating inflation, a Fed pause from raising interest rates, and potential for a soft landing in the economy. The trend is upward with inevitable fits and starts and challenging volatility along the way.

But, we are confident that over time, great companies – such as the ones in your portfolio – will generate strong returns.

Enjoy the spring!

Best Wishes,

James C. Burns, CFA
President & Chief Investment Officer

J.W. BURNS & COMPANY, INC.

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1 LPL Research/Factset
2 CNBC All - American Economic Survey
3 Federal Reserve Bank of St. Louis
4 Tom Lee, head of Research at Fundstrat Global Advisors
5 Council of Foreign Relations