

Third Quarter 2024 (October 1, 2024)

The equity markets posted further gains in the third quarter. Supporting factors include the lower inflation rate and the Federal Reserve's first reduction in the target interest rate since 2020. As the year has progressed, the economy has seen shifts in consumer spending, and pullbacks in some segments, as the cost of living remains stubbornly high in many areas, especially housing. From a global perspective, the wars between Ukraine-Russia, Israel-Hamas and China's economic woes continue to impact U.S. companies serving customers in those regions. Many corporations have reported strong profit growth which has supported the equity markets so far this year, although we are seeing some signs of slower revenue growth. Corporate spending on productivity initiatives such as Artificial Intelligence remains robust, though down from the highest levels. Businesses that serve consumer needs from autos to appliances, home goods to apparel, and necessities are experiencing mixed results. Some of the best performing businesses today and in the past few years are also the largest in the world. With the election just ahead of us, we will offer our customary thoughts.

Election Ahead

In our realm of responsibility as investment managers, our observation is that our elected officials only have a limited impact on the economy predominately in two areas, taxation and regulation. We live in a double taxation society, where corporations pay taxes on their profits, and as owners of corporations we pay again when companies distribute a portion of those earnings in dividends, and yet again if we sell our ownership at a later time. Taxation is an important subject, and lower corporate taxes make U.S. businesses more competitive globally, as well as allow businesses and individuals to allocate more dollars to investment in future growth and employment. High taxes stifle growth and innovation. Regulations ebb and flow over history with different administrations. Our opinion of regulation, which has not changed in our 25+ years at SEM, is that it is mostly backward looking. By the time the government targets a corporation, that business is fighting competitors who are introducing new innovations in a marketplace with evolving needs, effectively eroding any advantage of the target company. We talk a bit more about this and its current impact on a few our companies in our **SEM-Select Growth** letter this quarter. Suffice it to say we will always be in the camp for lower taxes and less regulation. Over the years we have observed that whoever gets elected, and whatever new changes are put into policy, corporations and investors allocating their capital adjust and move forward. The only certainty we would consider expressing is that elections generate a lot of news. News, fake or otherwise feeds emotions and emotions drive markets in the short run. So, we could have a lot of volatility until the election is complete.

The Importance of Innovation

While the election is causing near term uncertainty, as long-term investors we believe advances in productivity and innovative new products and services are what’s more important. Our **SEM – Disciplined Investment System (SEM-DIS)** requires that our businesses not only grow sales and earnings, but also generate high returns on capital and robust free cash flow which allows them to invest in efficiency as well as future growth opportunities. Consistently allocating funds to research and development is one way to generate long term growth. Although not all businesses list their R&D budgets on their income statement, we offer a few examples from each of our portfolios below.

Suncoast Growth Portfolios

<u>Select Growth</u>	<u>R&D as %</u>		<u>Dividend Growth</u>	<u>R&D as %</u>		<u>SMID Growth</u>
	<u>Sales</u>			<u>Sales</u>	<u>Sales</u>	
Adobe	13.3%		Apple*	7.8%		Checkpoint Systems
Alphabet (Google)	14.8%		Eli Lilly*	27.3%		Edwards Lifesciences
Intuit	13.0%		Merck	50.8%		Fair Issac Corp.
Nvidia	10.1%		Microsoft*	12.0%		Nice LTD
Salesforce	11.3%		Stryker*	6.8%		Veeva Systems

Source : 2023-2024 Annual Reports

* Also in Select Growth

No Longer Firing on All Cylinders

In mid-September, the Fed lowered the benchmark federal-funds rate by 0.50% to a range of 4.75 – 5%. The Fed explained that the rate cut is a policy shift from fighting inflation, towards maintaining strength in the labor market. The economy is showing weakness. Retailer **Dollar General (DG)**, which we do not own, reported sales that were markedly weaker in each month during its quarter ending August 2nd. Dollar General's core customer base consists primarily of lower-income consumers. More than 60% of DG’s customers said they had to pull back on necessities because of higher prices, and that they are worse off financially than just six months ago. Middle to higher income consumers with steady employment are supporting certain retailers whose results were relatively good this past quarter, including **Wal-Mart (WMT)** and **Target (TGT)**. These two retailers have been cutting prices and WMT said its market share is growing among higher-income consumers, which shows those consumers are looking for savings. This same group of consumers have curtailed spending on recreation. Following extra cash and social distancing during the pandemic, sales of RV’s, boats and snowmobiles hit multi-year or all-time highs.

Now the cost of living has increased, corporations are getting less supportive of remote work, and the interest rates to finance these purchases are higher. Boat sales new and used, are expected to be down 22% from their 2021 peak and RV sales were already down about 50% from their 2021 peak. Boom and bust periods are not uncommon in the boating and RV market and some businesses such as **Brunswick Corporation** (BC) are trying to stem some of the decline through the sale of replacement motors and services such as the Freedom Boat Club, which effectively allows boaters to rent various types of watercrafts through a subscription model.

The biggest expense for most consumers is housing. The housing affordability index dropped to its lowest level since September 1985. Established by the National Association of Realtors, this index incorporates median single family existing home prices, mortgage rates and median family income. While mortgage rates have come off recent highs and supply is getting a bit better, new supply may remain low and keep existing home prices higher than they should be, unless home building costs decline as well. Other costs of home ownership, including property taxes and insurance, have also risen substantially in some areas of the country and are impacting Americans' wallets.

The stock market so far this year is being led by the economic strength of U.S. corporations concentrated in industrial sectors as well as robust technology spending, especially in Artificial Intelligence. This is driving the earnings of some of the largest companies in the world including our portfolio holdings **Microsoft (MSFT)** and **Nvidia (NVDA)**, among others. While we believe the Fed has a direct influence on short-term rates, we don't believe they have much influence on long-term rates. It could be that the decline in the 10-year U.S. Treasury to 3.8% from a high of 4.7% in April is reflecting concerns over a slowing economy. We will be watching the upcoming earnings releases of our businesses for further data points that they're executing despite any slowdown.

Closing Thoughts

Emotions drive the markets in the short-run and the election is an emotionally driven event just ahead of us. In the long run we believe our nation is the absolute best, with our entrepreneurial culture we drive innovation. Businesses that can grow their profits and intrinsic value over time, in turn grow the value of our savings and financial well-being.

Our thoughts above on the election were intentionally brief. As long-term investors we spend very little time thinking about politics because we do not believe it has much long-term effect. We stress that as a nation our responsibility and the respect we can bestow on the men and women that serve our country, is to provide them the great leaders they can be proud of. With bad actors, small groups or nation states, the leaders of the free world and free markets must accomplish peace through confidence and deterrence. We are truly a great nation, and we are the “good guys” of the world; we need to step it up, and come together no matter the challenge, as we have done in the past. Despite the current political and global climate, we are optimistic about our future and, as always, we remain invested alongside our clients, and we thank you for your confidence.

Sincerely,

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