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THOMPSON DAVIS ASSET MANAGEMENT

THE INVESTOR INSIGHT

JULY 2023

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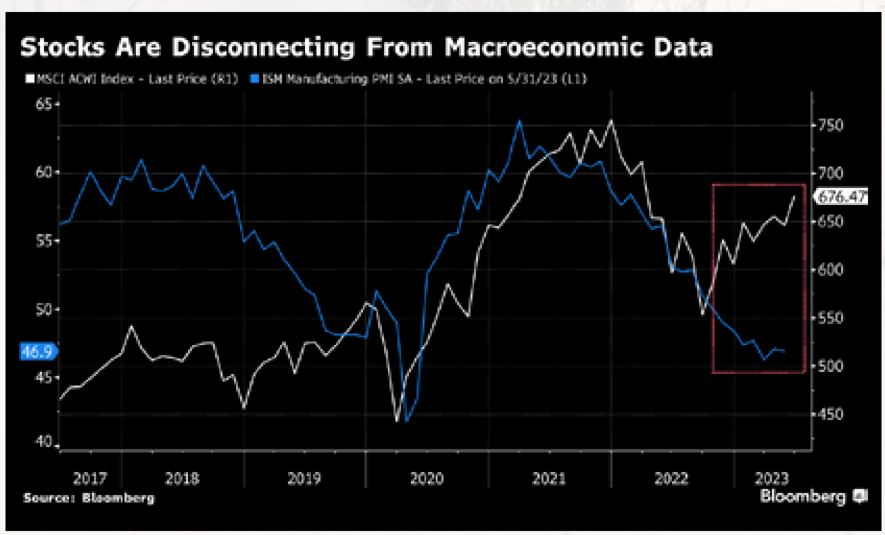
CELEBRATING 20 YEARS AS AN INDEPENDENT RIA

2023 Midyear Outlook

Equities in the first half of 2023 continued to disconnect from a worsening economic backdrop as profit warnings and rising rates dealt a blow to soft-landing scenarios. Growing corporate profit warnings (especially from consumer-facing companies) and the seemingly resilient markets could be sowing the seeds for fragility down the line. The most expected recession in history is *still* not upon us, but many economists currently believe that recession *will* come, when the lag effects of the most aggressive Federal Reserve rate hikes in history eventually start to take hold.

Increasingly hawkish central bank rhetoric and a slew of profit warnings are slowly eroding the optimism of a soft landing, after an action-packed first half that included a US regional banking crisis and a speculative technology bounce (powered by the hype around artificial intelligence). Rising rates are likely to remain a key theme for the rest of the year, in our view. Fed officials have recently voiced this to the markets through several interviews and testimony to Congress, where they forecast at least two more 25-basis-point hikes to come, and some Fed voting members predicting more may be needed. They also predicted keeping rates higher at a restrictive level for longer. Expectations for Federal Reserve rate cuts have now been pushed out into 2024. Since consumer spending comprises nearly 80% of US GDP, this is likely going to continue to put pressure on consumers, who have seen financing rates on big-ticket items, such as homes and cars, more than double in the past 12 months. Historical data suggests a high probability of a recession to some degree if the Fed does keep raising rates. This can be seen in the most inverted yield curve in history, 13 straight months of declines in leading economic indicators, and the aforementioned earnings misses by companies that are levered to a stretched consumer.

During the first half of 2023, the market remained extremely narrow, with just seven stocks making up the vast majority of the gains, while others struggled to make headway in a slowing environment—due to what



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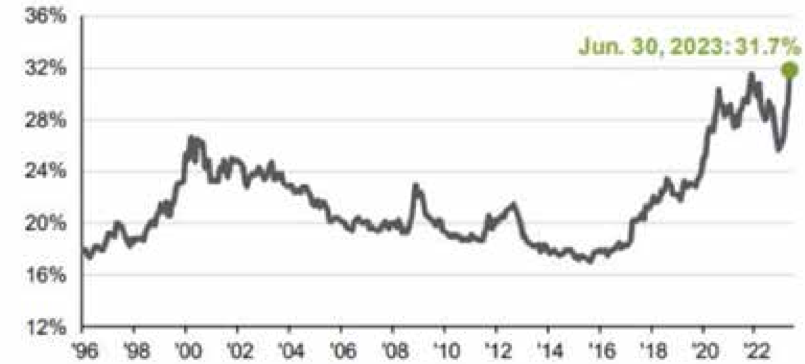
I believe is overly aggressive, backward-looking Fed action. We have observed numerous charts illustrating the rise in concentration among the largest companies in S&P index. In contrast, there are few charts that document the notable decline in the earnings contributions of these same companies, as shown in the chart below.

This does not seem sustainable going forward. There are stark differences among the performance of the Dow, the mid-caps, and the small-caps. For example, small caps are near levels they saw five years ago, and yet they are selling at much more attractive forward multiples—half that of the S&P and a third that of the NASDAQ. Small-cap stocks recently have been trading at their largest discount to large-cap stocks since the turn of the century. Moreover, these stocks tend to receive less research attention from major research firms, leading to increased market inefficiencies, which can be exploited through fundamental research. We believe there will likely be a reversion to the mean, given the vast valuation disparity that currently exists.

Predicting tops and bottoms in markets, and when (or if) a recession occurs, is difficult. Our belief continues to be that the Fed started too late and has gone too far, too fast. In our view, there will be something that

Weight of the top 10 stocks in the S&P 500

% of market capitalization of the S&P 500



Earnings contribution of the top 10 in the S&P 500

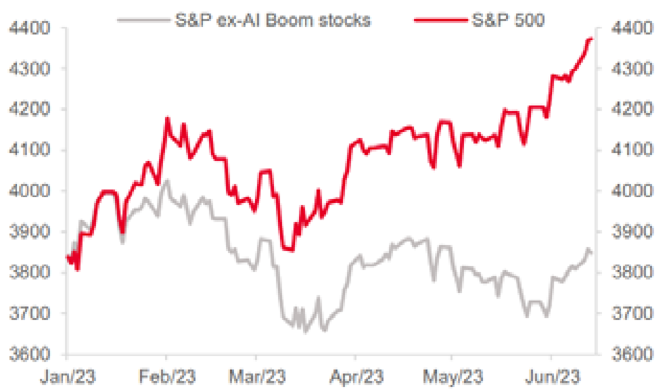
Based on last 12 months' earnings

"Predicting tops and bottoms in markets, and when (or if) a recession occurs, is difficult. Our belief continues to be that the Fed started too late and has gone too far, too fast."

EXHIBIT 88: Small-Cap Stocks Remain Historically Cheap vs. Large-Cap Stocks, Trading at 20-Year Lows (-30% Below Long-Term Average)

Note: Valuation analysis excludes outliers and non-earners. Data as at April 30, 2023. Source: BofAML Global Research, FactSet.

AI-related stocks drove virtually all S&P 500 returns this year



Data as of 14/06/2023. Source: Datastream, SG Cross Asset Research/ Equity Strategy

breaks because of this action (we saw the first signs of that with the five bank failures). Having said that, one can pay close attention to valuations and attractive sectors where funding is ample and still get caught up in FOMO (fear of missing out) by jumping headfirst in a sector that has already made a large move.

While all the factors we list above could lead to corrections and recessions (all part of investing), opportunities can emerge in any market cycle. While consumers clearly are impacted by the rapid rise in rates, we maintain our focus on sectors that are not (or as) dependent on the consumer. Some examples: infrastructure, where the US is implementing a five-year infrastructure spending bill, the largest in its history; medical technology and healthcare, with the aging US population's pent-up demand for elective surgery post-COVID lockdowns); clean air, water, and energy; and various other special situations where we believe valuation and upside catalysts exist. Our research efforts will continue to vet these attractive areas as we navigate an environment where we believe the Fed has pushed too far, too fast.

Kind regards,

William D. Davis Jr.
CEO and Portfolio Manager

5 Ways to Lower Taxable Income

When it comes to paying taxes, we all wish we could reduce the amount we owe. Taxable income is the amount of money you earn that is subject to taxation. Reducing taxable income not only means you pay less in taxes, but it can also help you maximize your tax refund. In this article, I will discuss various ways to lower taxable income, including retirement contributions, tax credits, charitable contributions, business expenses, and more. We will also answer some common tax questions you may have.

Increase Retirement Contributions

One of the most effective ways to lower taxable income is by increasing your retirement contributions. You can contribute to traditional or Roth IRA/401k accounts. Traditional contributions reduce your taxable income, while Roth contributions are not tax-deductible but provide tax-free withdrawals in retirement. Increasing your retirement contributions not only lowers your taxable income but also helps you save for retirement.

Claim Tax Credits

Tax credits are another way to lower taxable income. Tax credits are subtracted from the amount of taxes you owe, not just your taxable income. Some common tax credits include the earned income tax credit, child tax credit, education tax credit, and retirement savings contribution credit. By claiming tax credits, you can reduce your tax liability and potentially increase your tax refund.

Contribute to Health Savings Account (HSA)

Contributing to an HSA is another way to lower taxable income. HSA contributions are tax-deductible and grow tax-free. HSAs are designed to help you save for healthcare expenses, and the funds can be withdrawn tax-free if used for qualified medical expenses. Contributing to an HSA not only lowers your taxable income but also helps you save for future healthcare expenses.

Charitable Contributions

Charitable contributions can also lower taxable income. Donating to qualified charitable organizations is tax-deductible and can reduce your taxable income. Make sure to keep receipts and documentation of your charitable contributions to claim the deduction on your tax return. Charitable contributions not only benefit the community but also provide tax benefits for the donor.

Business Expenses

If you are self-employed or own a business, you can deduct business expenses from your taxable income. Business expenses can include office supplies, travel expenses, equipment, and more. Make sure to keep accurate records of your business expenses and consult with a tax professional to ensure you are claiming all eligible deductions.

In conclusion, lowering taxable income can help you save money on taxes and potentially increase your tax refund. By taking advantage of retirement contributions, tax credits, charitable contributions, business expenses, and other deductions, you can reduce your tax liability and save for the future. It is important to consult with a tax professional to ensure you are maximizing your tax benefits and making informed financial decisions.

— Brant Jones, CFP®

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