

# outlook

A recent survey found that inflation is the most critical issue facing the U.S.

## Mid-Year Review

Fed chair Jerome Powell, on July 2, made comments at a central banking forum in Sintra, Portugal. He acknowledged the progress made in taming inflation, but said he wasn't ready for rate cuts due to the strong labor market. Our newsletter readers shouldn't be surprised, as this has been my position for the last six months. Since the beginning of the year, economists have been calling for six or more rate cuts this year. I still believe we won't have any, and if I'm wrong, I expect we'll see tiny token rate cuts that will be more symbolic than anything else.



Bob Hofmann  
President

A recent survey of 60,000 U.S. adults found that inflation is the most critical issue facing the U.S. In May, Core Personal Consumption Expenditures (PCE) increased by .1% and rose by 2.6% year-on-year. This is the slowest price increase in six months, a significant improvement from the 4% increase a year ago. Even though we're making progress, we're still shy of the Fed's 2% target. It looks ever more likely that the U.S. will have a soft landing where inflation cools without a recession and steep unemployment. Prices are still rising, but the rate of increase is much more tolerable. I don't expect prices to fall, that would be deflationary. The Fed doesn't want deflation, no

central bank does. Deflation can cause a downward spiral in prices. As prices fall, people pause their purchases and wait for a lower price. If prices continue to fall consumers will continue waiting for the bottom, which could take years. This puts a wet blanket on consumer spending and the economy. Also, lower prices affect business profits, prompting employers to lay off workers and lower wages to maintain profit. Imagine if the value of your home kept falling year after year. Your mortgage wouldn't deflate, but the value of your home would. Why would anyone buy a house in this environment? Although many people would like lower prices on groceries, gas, housing, and almost everything else, we don't want deflation - at least not long-term. Japan has been dealing with deflation for a long time.

Japan had a 25-year battle with deflation before it finally eased in 2022. One of the worst deflationary episodes in Japan began in 1999, lasting six years. Deflation then ended for several years before returning in 2009 for another five years. Deflation is the Fed's biggest fear because there's not much they can do about it. The famous economist John Maynard Keynes wrote in 1923, "Thus inflation is unjust, and deflation is inexpedient. Of the two, perhaps deflation is ... the worse; because it is worse, in an impoverished world, to provoke unemployment than to disappoint the rentier." The U.S. hasn't experienced deflation since 1865, and that episode lasted until 1900!

In past newsletters, I've discussed the concentration of the top stocks in the S&P 500 index. The top ten stocks now make up 35% of the index! Past periods of concentration have occurred before but nothing like this. Although ten companies comprise 35% of the index, they comprise 39% of R&D spending, 23% of free cash flow, and 16% of capex. This isn't 1999, when a stock market bubble formed on the back of unprofitable young companies. The new leaders are incredibly strong. Year to date, the S&P 500 is up about 15%, and the top ten stocks contributed 11%, or 73% of the index's 15% return! This market is being led by a handful of companies: NVIDIA, Microsoft, Amazon, Meta, Eli Lilly, Alphabet, Apple, Broadcom, Berkshire Hathaway, and JP Morgan. Since the beginning of 2023, the S&P 500 is up about 45%, but if you remove the top five holdings, the index is up only 23%. A small group of companies are responsible for a significant part of the market's gains. In the coming year, I expect broader participation as our resilient economy boosts a more comprehensive range of

*Continued on page 2*

### Inflation Has Come Down, But High Prices Are Here to Stay

Cumulative vs. year-over-year change in consumer prices in the U.S. since Jan. 2020\*



\* Based on the Consumer Price Index for All Urban Consumers: All Items; seasonally adjusted  
Source: U.S. Bureau of Labor Statistics



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companies.

The S&P 500 is now at an all-time high, which is the most over-feared phrase when investing. Investors are traditionally wary of investing when the market is at or near a high. In late 2021, the market hit an all-time high, only to sink during the 2022 bear market. In October of 2022, the S&P 500 reached its low point, and the recovery began. On Jan 19, 2024, the S&P 500 made a new all-time high, the first in over two years. This two-year stretch without a new high was the longest stretch since 2008. The worst bear market I've ever experienced was the 2008 financial crisis. The market didn't reach its 2007 peak until 2013. In the year that followed, the market had 52 new all-time highs. If you go back to 1929 and examine the data, all-time highs often occur in clusters. Since 1988, the S&P 500 has reached new highs twenty times per year on average. According to JP Morgan, "Nearly 85% of the time, one-year forward returns from these highs were positive. In fact, during this period, one, two, and three-year forward returns were more favorable when investing at all-time highs compared to a random day." Sure, a correction will happen, but predicting when is impossible.

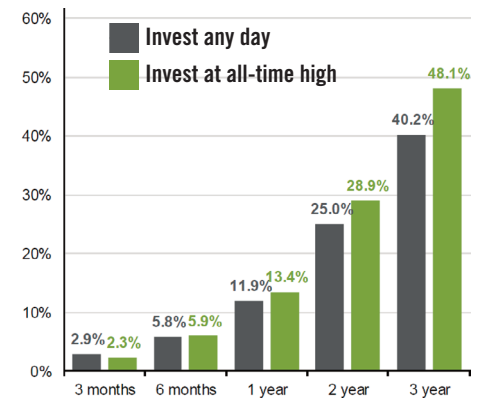
Between now and the end of the year,

there will be an opportunity for fixed-income investors. If I'm correct, we'll see rates decline in 2025, putting immediate pressure on money market accounts. According to the Investment Company Institute, there is \$6.10 trillion sitting in money market funds. With current rates above 5%, I can understand the appeal. However, once the Fed begins to lower rates, money market rates will drop in lockstep. Now is a great time to lock in higher rates by investing in a bond ladder. I wouldn't fear locking in higher rates with longer maturities. I expect interest rates to go down in 2025; however, over the next decade, I believe interest rates will again trend higher as the world begins to normalize after the decade-long low-rate environment that started in 2008 because of the financial crisis. On Mar 09, 2020, believe it or not, the ten-year Treasury Bond yielded only 0.52%! That is the all-time low, surpassing the low interest rates from the Great Depression. As of today, the ten-year Treasury sits at 4.2%.

If you would like to review your overall allocation and financial plan or discuss how to put additional cash to work, please get in touch with your Roffman Miller Investment Advisor. On behalf of our whole team, thank you for your trust and confidence.

Bob Hofmann, President

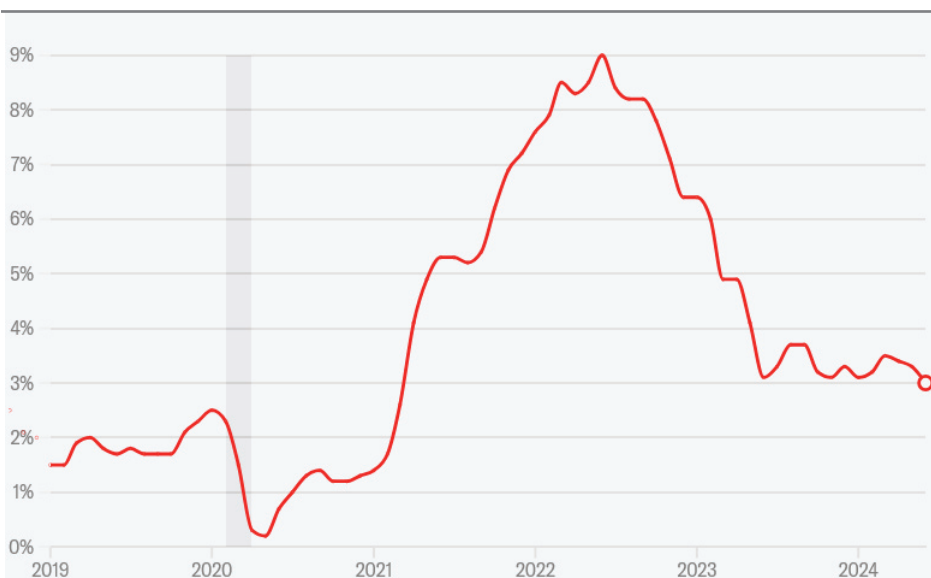
## INVESTING AT ALL TIME HIGHS



Source: JP Morgan

*Between now and the end of the year, there will be an opportunity for fixed-income investors. If I'm correct, we'll see rates decline in 2025, putting immediate pressure on money market accounts*

## INFLATION IS SUBSIDING, BUT NOT YET AT TARGET



Stock prices reflect two things, corporate earnings and optimism about the future

# Earnings and Optimism

US banks are licking their lips in anticipation of lower interest rates. In a nutshell, banks make most of their money on net interest margin, or NIM, which is the difference between what they pay depositors and what they charge borrowers. After peaking at about 8% in October of last year, 30-year mortgage rates are now down around 7% on average. If banks are paying 4% to depositors, the net margin is 3%.



Mark Frombach  
Chief Investment Officer

That's a healthy number for banks – just imagine when mortgage rates were under 3%, NIMs were much lower. Short-term rates could drop soon in response to lower prices or a slowing economy. Banks will pay less to depositors long before they charge less to borrowers, and net interest margin will rise. Hence, banks will show greater profits just by doing the same thing as today but under a different interest rate scenario. Plus, lower rates will stimulate more home purchases and more loans. In anticipation of this scenario, large bank stocks have risen year to date. As I write this, both JP Morgan and Bank of America stocks are up over 20% in 2024. Smaller and mid-sized bank stocks, however, have not performed so well.

You may have heard me several times say that stock prices reflect two things, corporate earnings and optimism about the future. The large bank stocks are now reflecting the size and consistency of these organizations and also the positive outlook of the greater U.S. economy. We are living in amazing times where industries like healthcare and information technology are improving our lives, and that all means more economic activity. Most of that financial success trickles through banks at some point in the form of deposits, home mortgage lending, corporate lending, and credit card spending. Smaller banks will also enjoy the tailwind of a robust economy and lower rates, but they have left the investment community wondering about their portfolios of commercial building loans in a time where businesses don't seem to be committed to office space with the same enthusiasm of the pre-covid era. If those loans begin to underperform or go bad, those banks will suffer. Time will tell, and it is likely that time will heal

those wounds but not before we hear more about this topic.

PepsiCo, parent company of Pepsi and Frito-Lay, reported earnings this week that beat expectations. Sales, however, were a disappointment. If that seems like an incongruity, you're right - most of the time. Remember what happened over the past couple of years: due to the pandemic, costs for labor and raw materials rose more than normal. In response, Pepsi raised prices. This is what companies do to maintain profits. Either you get a smaller bag of chips at the same price or the same bag for a higher price, companies do what they need to do to protect their profit margins. As consumers we see this simply as inflation.

Corn prices have fallen dramatically over the past 18 months. That means the cost to make Fritos and Doritos is lower than last year. Pepsi is still charging the same price as last year for a bag of chips, so lower costs means they are able to make an impressive profit. Unfortunately this is a very simple example and hasn't accounted for the fact that prices for some consumer goods are elastic. That means if you raise the price of a bag of chips, fewer consumers will buy that bag. Hence while the company expects 4% revenue growth this year, they've only grown the top line 2.3% compared to last year. Specifically, lower income consumers' wage growth has not kept up with overall inflation, and they are reexamining their spending habits, often going without a salty snack or trading down to a cheaper brand.

Companies like Pepsi that grow their revenue consistently 3-4% per year and pay a decent, growing dividend have been out of favor in the stock market this year. Not including the dividend, Pepsi is down 5%. But that's part of the story Bob was trying to tell in his article – we get excited about newer technologies and there is certainly a reason to, but at the same time we forget about some of the companies that provide long-term, steady growth and income for us. The dividend yield for PEP is now 3.3% and growing each year, cash flow is increasing, share buybacks continue, and the headwind caused by a strong dollar could turn into a tailwind if lower U.S. interest rates tame the greenback.

Like Pepsi, I fully expect companies like Microsoft and Amazon to continue to grow over the next three-, five-, and ten-year periods. Our economy has become depend-

ent upon them. Right now their stocks are trading at premium market multiples that reflect that optimism. With ten stocks in the index contributing a vast majority of the 2024 gains (including MSFT and AMZN), there must be some underappreciated, underpriced stocks among the other 493. This year is so extreme, the S&P index is up by more than 3 times that of the average stock in the index. And also 3 times the DJIA, of which Microsoft is a huge contributor! The S&P is also tripling the small cap Russell 2000 index as well. It's possible that this will all change in the second half of the year; we'll remain balanced and continue to look for opportunities in all industries as we look out at the future of the U.S. economy.

As strong as the economy is, we still have weakness in areas like housing. Other industries are still working down Covid era inventory stockpiles and causing lower revenues upstream. Those are cyclical issues that ultimately resolve themselves and will reward patient investors holding companies like Home Depot and Texas Instruments. Looking out three to five years, our economy continues to have a growth bias that is supported by factors like population growth and industrial/technological sovereignty (i.e. making more of the things we need here in the U.S.). However, risks remain.

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Aside from inflation, we are currently faced with geopolitical challenges in China, Russia, and the Middle East. Climate change could affect our food supply. Western politics are in turmoil, reflecting upon recent elections in France, England, and the upcoming presidential race here in the U.S. We should neither worry nor ignore these risks. Instead, let's talk about the risks and opportunities ahead, then choose portfolio allocations that make sense for each of us as individuals. I look forward to speaking to many of you as the second half of 2024 unfolds.

Mark Frombach, Chief Investment Officer

Empower businesses to harness the full potential of AI

## Microsoft's Bold Vision: Transforming the Future with AI

Microsoft has long been at the forefront of technological innovation, and its ambitious plans for leveraging artificial intelligence (AI) are poised to revolutionize industries and everyday life. With a robust strategy that integrates AI across its suite of products and services, Microsoft aims to enhance productivity, drive business growth, and foster a new era of technological advancement.

### EMPOWERING BUSINESSES WITH AI

One of Microsoft's primary objectives is to empower businesses to harness the full potential of AI. Through its Azure AI platform, Microsoft provides a comprehensive suite of tools and services designed to enable companies to build, deploy, and manage AI applications at scale. Azure AI offers cutting-edge capabilities, including natural language processing, computer vision, and machine learning, which businesses can integrate into their operations to optimize processes and gain actionable insights.



Kevin Cooke  
Senior Investment  
Manager

A notable example is the Azure OpenAI Service, which allows organizations to leverage powerful models like GPT-4. By integrating these models into their workflows, businesses can automate customer service, streamline operations, and innovate product offerings. Additionally, Microsoft is committed to ensuring that its AI solutions are accessible to enterprises of all sizes, from startups to Fortune 500 companies.

### ENHANCING PRODUCTIVITY WITH AI-DRIVEN TOOLS

Microsoft Office, a staple in workplaces worldwide, is undergoing a transformation with AI-driven features designed to enhance productivity and collaboration. The integration of AI in tools like Word, Excel, and

PowerPoint offers users intelligent assistance that simplifies complex tasks, such as data analysis and document generation.

For instance, the new AI-powered Copilot feature acts as a virtual assistant within Microsoft 365 applications. Copilot can draft emails, create summaries, and even generate creative content, allowing users to focus on higher-value activities. This innovation is part of Microsoft's broader vision to make AI an integral part of the daily workflows of millions of professionals globally.

### AI FOR SOCIETAL IMPACT

Microsoft is also deeply committed to leveraging AI for societal good. The AI for Good initiative encompasses various projects aimed at addressing some of the world's most pressing challenges, including healthcare, environmental sustainability, and accessibility.

In healthcare, Microsoft's AI-driven solutions are helping to advance research, improve patient outcomes, and optimize healthcare delivery. For example, Project InnerEye uses AI to assist clinicians in diagnosing and treating diseases more accurately and efficiently. In environmental sustainability, Microsoft's AI for Earth program provides resources and tools to organizations working on environmental conservation and climate change mitigation.

### ETHICAL AI AND RESPONSIBLE INNOVATION

As AI technology evolves, so too does the importance of ethical considerations. Microsoft places a strong emphasis on responsible AI development, ensuring that its AI systems are designed and deployed in ways that are fair, transparent, and accountable. The company has established clear principles for ethical AI and invests in research to mitigate biases and ensure privacy and security.

Microsoft's AI ethics framework guides the development of AI technologies that respect human rights and align with societal

values. By fostering an environment of trust and responsibility, Microsoft aims to lead the industry in creating AI that benefits all of humanity.

### THE ROAD AHEAD

Looking forward, Microsoft's strategic investments and innovations in AI promise to shape the future of technology and its impact on society. The company is not only focused on advancing AI capabilities but also on creating a collaborative ecosystem where businesses, developers, and individuals can thrive.

Through initiatives like the AI Business School and partnerships with academic institutions, Microsoft is also dedicated to upskilling the workforce and preparing the next generation of AI leaders. By providing educational resources and fostering a community of innovators, Microsoft is ensuring that the benefits of AI are widely shared.

In conclusion, Microsoft's vision for leveraging AI is both ambitious and inclusive, aimed at driving technological progress while addressing global challenges. As AI continues to evolve, Microsoft's leadership in this space will undoubtedly play a critical role in shaping a future where technology empowers people and transforms industries.

The above article was written by Microsoft's ChatGPT. I simply entered the prompt, "Write a newsletter article discussing Microsoft's plans for leveraging AI," hit the enter button, and 18 seconds later this summary amazingly appeared.

While AI is only in its infancy, we're witnessing the hype turn into reality, one baby step at a time. This article is a real-life example of AI's ability to help a typical hardworking guy like me. Okay, maybe not so hardworking in this instance.

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