EDGEMOOR
INVESTMENT ADVISORS

# Edgemoor's Quarterly Report

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**July 2024**

**Positive Momentum Continues in Q2 2024**

The stock market carried its strong momentum from the last several quarters into the second quarter of 2024, driving most equity indices to record highs. The S&P 500 Index alone set more than *thirty* new 52-week highs in the second quarter, one of the highest numbers ever recorded in a single quarter.

Bolstered by the combination of a resilient U.S. economy, solid corporate earnings and GDP growth, and continued strong momentum in the technology sector, the market rally that started in late 2023 has forged ahead in 2024.

The strong second quarter gains also came despite several factors that could have caused stock prices to fall, including sticky readings on inflation and diminished expectations for significant Federal Reserve interest rate cuts this year. Once again, the market shrugged off these potentially negative factors, handing another pleasant surprise to investors.

**Stocks and Bonds Rise in Q2**

The S&P 500 index posted a 4.3% total return in the second quarter, putting its total return for the first half of the year at 15.3%. This marks the second year in a row that the S&P 500 has notched double-digit gains in the first six months of the year. Both the S&P 500 and the Dow Industrial average hit new benchmark levels during the quarter, with the S&P topping 5,500 and the Dow surpassing 40,000 for the first time ever, only to retreat slightly at quarter-end.

The bond market, as measured by the Bloomberg Barclays Aggregate Bond Index, reversed losses from the first quarter to post a slightly positive 0.1% total return in Q2 2024. For the year, however, the bond market remained in negative territory, returning negative 0.7% in the first six months of 2024.

The equity markets have also been characterized by continued low volatility, as measured by the CBOE Volatility Index, or "VIX." At the end of Q2, the VIX stood at approximately 13, which was at the low end of its 52-week range of 11-23 and well below its average market reading of 20.

**All-Time Highs Can Be Bullish for Stocks**

Despite stocks reaching all-time highs during the quarter, investors should not assume that markets have peaked and they've missed out on a rally. Since 1950, each time the S&P 500 hit its first all-time high during a year, stocks then delivered a 17% average return for the subsequent twelve months. The only exception to this was at the start of the global financial crisis in 2007.

Of course, market declines are also inevitable. However, they don't change the long-term, positive trajectory of the stock market. In fact, bull markets have historically lasted much longer than bear markets, meaning that even new highs within a cycle may still be good entry points for long-term investors.

**The Fed Holds Steady**

As expected, the Federal Reserve held its benchmark fed funds rate steady at 5.25% - 5.5% at its June meeting, continuing a pause in interest rate activity that began in mid-2023. The Fed also signaled just one 25 basis point cut (one-quarter of 1%) in late 2024, though some members believe that two 25 basis point cuts are still possible. Given the sticky state of inflation, Chairman Powell has continued to insist that more data is needed showing inflation moving closer to the 2% target before the Fed can start cutting rates.

**Inflation Cools**

The Consumer Price Index, or CPI, rose 3.0% for the twelve months ending in June 2024, below the consensus estimate of 3.1% and lower than the 3.3% rate in May. The overall decline in the costs of consumer goods and services in June marked the first such monthly decline since the start of the pandemic in 2020. Notable declines included prices for gasoline and fuel oil, which more than offset increases in food, shelter, and medical services.

While many believe this slowdown in inflation could compel the Federal Reserve to cut interest rates in September, others are waiting to see a meaningful break below 3% before the Fed acts.

**U.S. Economy Remains Resilient, but Slowing**

The world's largest economy continues to show remarkable resilience despite elevated interest rates and inflation still above its 2% target. The International Monetary Fund forecasts that the U.S. economy will expand in 2024 at more than twice the rate of other major developed countries, predicting U.S. GDP to grow at a 2.7% annualized rate, versus 0.8% for Europe. Major drivers of U.S. economic growth include a strong labor market, sustained consumer spending, and increased investment in new domestic supply chains by manufacturers.

Despite these positive factors, there have been signs that the U.S. economy is slowing. U.S. GDP slowed to 1.4% in the first quarter of 2024, down from 3.4% in the last quarter of 2023. But that slowdown may have been short-lived, as the latest GDPNow model by the Fed projects second quarter GDP growth to rebound to 2.0%.

In addition, corporate earnings have remained solid and are projected to accelerate in the latter half of 2024 and into 2025. For Q2 2024, the estimated year-over-year earnings growth rate for the S&P 500 is 8.8% which, if true, would be the largest quarterly growth rate since Q1 2022. The biggest drivers for this growth are double-digit earnings growth rates projected for the Communications Services, Healthcare, and Information Technology sectors.

For the full-year 2024, S&P 500 corporate earnings are projected to grow 11.3% year-over-year, accelerating to 14.4% for FY2025. The growth is also expected to be broad-based in both years, with all eleven sectors in the S&P predicted to report year-over-year earnings growth in 2025.

**The Broadening Impact of AI**

As investors have watched the artificial intelligence ("AI") race accelerate among technology providers, the less reported news is how AI is transforming a broadening scope of industries, from healthcare, to finance, to retail and manufacturing. From performing simple tasks to solving complex, cognitive questions, AI has become perhaps the most groundbreaking technology of the 21st century.

This presents compelling investment opportunities for investors in a variety of areas, from semiconductors (think Nvidia and Taiwan Semiconductor), to software (Microsoft), to energy (utilities, data centers) – all areas where we have exposure for our clients. While no one knows what the next big application will be for AI (business learning, cybersecurity, robotics), we are constantly looking for new opportunities to benefit from this transformative technology. Stay tuned.

**Some Cracks are Emerging**

Despite all this positive news, some cracks are emerging in the U.S. economy, which we are watching carefully. While we don't believe any of them are serious enough now to derail the U.S. economy and perhaps send it into recession, we are nonetheless monitoring them closely.

U.S. unemployment ticked up in June to 4.1%, compared to 4.0% in May and 3.6% a year earlier. The number of unemployed Americans grew 11% year-over-year to 6.8 million. Weekly jobless claims also grew more than expected in early June, pushing claims up to a ten-month high.

Housing starts fell 5.5% in May, their lowest level since June 2020. The positive momentum in the housing market from earlier in the year was slowed by a surge in mortgage rates, which hit a six-month high of 7.2% in early May. Confidence among homebuilders also hit a six-month low in June, with the National Association of Homebuilders stating that persistently high mortgage rates are keeping many prospective homebuyers on the sidelines.

Finally, consumer confidence was mixed in June, ticking down early in the month only to recover slightly by month end. Still, the consumer sentiment index stood at its lowest level in seven months on June 30th, as more Americans worry that persistent inflation and slower income growth could undermine their personal finances.

**Other Risks We are Watching**

There are numerous geo-political risks around the world that, if they intensify, could have negative impacts on the global economy. These include the conflicts in the Middle East, tensions between China and its neighbors, and the ongoing war between Ukraine and Russia. Any of these conflicts could expand and have broad implications for global energy prices, trade relations, and world economies.

And of course, there is the U.S. Presidential election in November. While there is much angst and uncertainty surrounding this election, what we know from history is that it is not likely to have a long-term impact on the markets. In other words, while elections can impact markets both positively and negatively in the short term, they tend not to be a long-term driver of market performance. Instead, economic growth, corporate earnings, and interest rates are far more important drivers of asset prices over the long term.

**Our Outlook**

Our outlook for the economy and markets in 2024 remains cautiously optimistic.

While the U.S. economy could slow in the near-term, our long-term outlook is for the economy to grow at a solid pace and for corporate earnings to continue to rise, both of which should be positive for long-term stock returns.

Other positive factors could include the resolution of geo-political conflicts, an economic recovery in China, and inflation and interest rates in the U.S. easing faster than expected, all of which would provide additional tailwinds for stocks.

Finally, the continued adoption of artificial intelligence across numerous industries and applications is expected to drive long-term growth and productivity in the U.S. economy.

**Portfolio Implications and Actions**

With respect to valuation, the broad S&P 500 index can be considered fully valued at approximately 21 times forward 12-month earnings, slightly above its 5-year average of nearly 19 times. However, not all stocks or sectors are fully valued, as there is a wide dispersion of valuation multiples across sectors and companies. We continue to look for and find pockets of opportunity, particularly in sectors which have lagged the overall market and are thus more attractively priced.

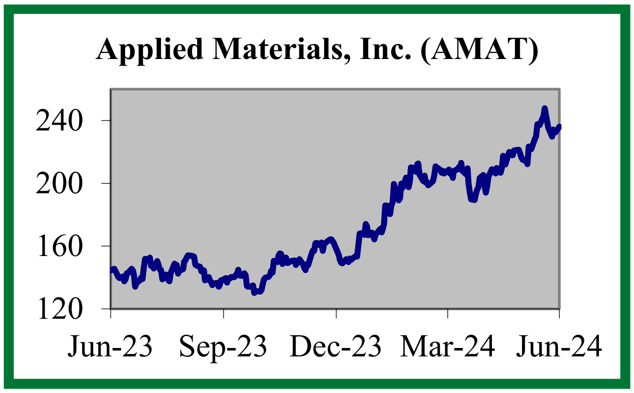
We expect value-oriented stocks, dividend-paying stocks, and other income-oriented securities to benefit from a broadening market rally and potentially lower interest rates in the future. In the meantime, we still find short-term Treasury bills and high-yielding money market funds attractive places to park cash at risk-free annualized yields around 5%.

Even though markets can be volatile quarter-to-quarter and year-to-year, we emphasize to our clients the importance of sticking with a long-term investment plan focused on their specific goals and objectives. Overall, we maintain a positive long-term outlook for the U.S. economy and markets, and we believe our patient, disciplined approach to individual security selection offers our clients strong long-term return potential in a cost effective and tax efficient manner.

## Analysis of Selected Securities

The following are analyses of three securities we are currently buying for client accounts:

**Applied Materials, Inc. (AMAT)**




Source for chart and financials: Yahoo Finance and Morningstar. Past performance is not indicative of future results. Please see disclosures on page 10.

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|---|---|---|---|
| Price (06/30/2024) | $ 235.99 | Forward P/E | 25.6 |
| Market Cap ($B) | $ 196.6 | Price/Book | 10.8 |
| Dividend Yield | 0.7% | Price/Sales | 7.5 |
| Return on Equity | 45.5% | Debt/Equity | 0.5 |

Applied Materials is a worldwide leader in semiconductor capital equipment, services, and software, with a focus on developing and selling systems and technologies for use in the front-end of the semiconductor manufacturing process. The company operates in three business segments: Semiconductor Systems (75% of fiscal year 2023 sales), Applied Global Services (22%), and Display and Adjacent Markets (3%).

As a global market leader in semiconductor fabrication tools and equipment, Applied Materials enjoys longstanding relationships with all major global chip manufacturers and has the broadest product portfolio in the industry, effectively offering one-stop shopping to its customers. The company has field engineers stationed in nearly every one of its customers' chip-manufacturing facilities around the globe, providing competitive insights into their needs and processes. As semiconductor fabrication has become increasingly complex, requiring more process steps and new manufacturing technologies, the company's existing relationships and insights into future technology needs have led to steady new orders for its state-of-the-art equipment.

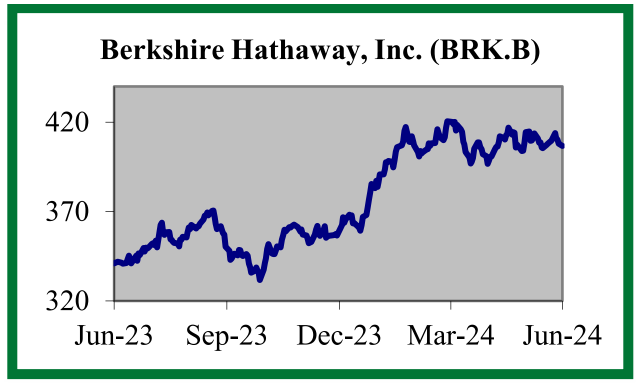
Signs continue to emerge that a semiconductor upcycle is in its early stages, mainly driven by the growth of data and emerging AI demand. Semiconductor companies are increasingly relying on Applied Materials, as well as other advanced equipment producers in the supply chain, to manufacture more complex and efficient AI-enabling chips.

Overall growth in semiconductor demand is expected to broaden out to other areas such as electric and autonomous vehicles, industrial "Internet of things" (IOT) applications, 5G networks, and eventually AI-enabled smartphones. Applied Materials is well-positioned to benefit from these long-term growth trends given its immense capabilities in cutting-edge chip manufacturing.

The chip industry is inherently cyclical, but Applied Materials' large scale, efficient operations, and huge installed base of customers and products allow it to weather business cycles better than its competitors. In addition, the company's growing stream of recurring revenues from service-based businesses contributes to the stability of earnings.

Applied Materials is financially strong and shareholder friendly, with a goal of returning ~80% of free cash flow to investors over the long term through dividends and share repurchases. The company has increased its dividend by nearly 12% annually over the past ten years, while at the same time reducing its share count by 30%. The stock has a strong track record of outperformance, and we believe there is more long-term potential upside for AMAT due to its unique competitive advantages, strong growth prospects, and significant cash flow growth and high returns on invested capital.

**Berkshire Hathaway, Inc. (BRK.B)**




Source for chart and financials: Yahoo Finance and Morningstar. Past performance is not indicative of future results. Please see disclosures on page 10.

| | | | |
|---|---|---|---|
| Price (06/30/2024) | $406.80 | Forward P/E | 21.0 |
| Market Cap ($B) | $ 875.5 | Price/Book | 1.5 |
| Dividend Yield | 0% | Price/Sales | 2.4 |
| Return on Equity | 12.7% | | |

Berkshire Hathaway, one of Edgemoor's largest and longest-held stocks, is a holding company with multiple subsidiaries in a variety of industries, including property and casualty insurance, freight rail transportation, utility and energy generation and transmission, financial products and services, manufacturing, retailing, and newspaper publishing. In addition to its operating businesses, Berkshire manages a $336 billion portfolio of publicly traded equity securities and holds a $182 billion cash balance as of 3/31/2024.

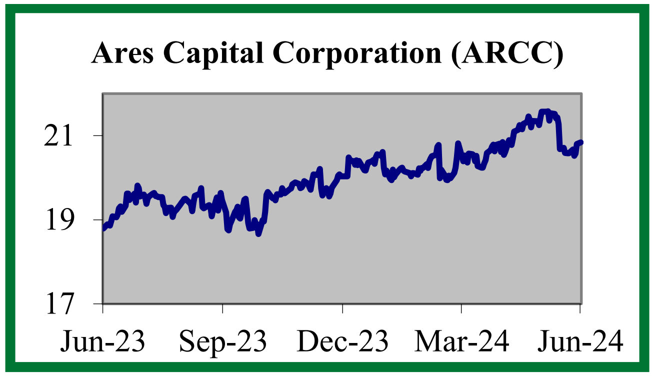
Run by Chairman and CEO Warren Buffett since 1965, Berkshire operates on a decentralized basis with the managers of each operating subsidiary empowered to make their own business decisions, leaving Buffett to focus on investments and capital allocation. This highly successful formula has enabled Berkshire to generate stock returns in excess of the S&P 500 index over the company's 58-year history. Specifically, Berkshire stock delivered an annualized return of 20% between 1965-2023, compared with 10% for the S&P 500 index over the same period.

The engine of much of Berkshire's success is the insurance business segment, which includes GEICO and General Re. The insurance businesses generate significant cash from premiums, called "float", which the insurer receives in advance of any payout. This low cost or cost-free capital has always been one of the most compelling advantages of Berkshire's business model. When combined with the operating cash flow of Berkshire's non-insurance businesses, this float, which stood at $168 billion as of 3/31/2024, provides Buffett with a massive trove of capital to invest in public equities and opportunistic private deals.

The recent passing of Buffet's long-time partner, Charlie Munger (at age 99), has heightened investor focus on Buffet's own mortality. But in 2021, Greg Abel, CEO of Berkshire Hathaway Energy, was named Buffet's successor, a significant step toward easing investor uncertainty. Abel has spent decades with Berkshire and is regarded by investors as a capable leader who will uphold the same principles that have made the company so successful over the past six decades.

Berkshire shares have massively outperformed the S&P 500 index over the long term, and we expect these high-quality shares to continue to reward shareholders going forward.

**Ares Capital Corporation (ARCC)**




Source for chart and financials: WSJ and MarketWatch. Past performance is not indicative of future results. Please see disclosures on page 10.

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|---|---|---|---|---|
| Price (06/30/2024) | $ | 20.84 | Forward P/E | 9.2 |
| Market Cap. ($B) | $ | 12.8 | Price/Book | 1.1 |
| Dividend Yield | | 9.3% | Price/Sales | 4.8 |
| Return on Equity | | 11.6% | Debt/Equity | 1.2 |

Ares Capital Corporation (ARCC) is a specialty finance company that provides debt and equity financing primarily to private, middle-market companies in the United States. The company invests in multiple industries, including business services, healthcare services, and consumer products and services. With a market capitalization of $13 billion, ARCC is the largest business development company regulated under the Investment Company Act of 1940.

Ares Capital's investment objective is to generate both current income and capital appreciation by investing principally in first and second lien senior secured loans and mezzanine debt, including, in some cases, an equity component. As a regulated business development company, Ares Capital is required to pay out 90% of its taxable income in the form of dividends to its shareholders to avoid corporate-level taxation. As a result, ARCC pays an attractive and growing dividend, currently yielding more than 9%.

Since its initial public offering in 2004, Ares Capital has invested approximately $142 billion in more than 2,100 transactions, realized a gross IRR of 14% on its investments, and generated an average annual return to shareholders of 13%. The company's current investment portfolio totals $23 billion invested across over 525 companies in thirty-three diverse industries. Largely comprised of senior-secured, floating-rate loans, the portfolio is well positioned to continue benefiting from elevated interest rates.

With cash and investments at fair value of approximately $24 billion, Ares Capital's balance sheet has ample liquidity. Ares enjoys an investment grade debt rating from all three credit rating agencies. We believe ARCC is an attractive, long-term income investment due to its leading market position, conservative investment philosophy, and attractive and stable dividend.

*Source for text and charts: FactSet, Morningstar, S&P/CFRA, Schwab, ValueLine, Black Diamond Performance Reporting, Yahoo Finance, Bank of America, JP Morgan Markets, MarketWatch, WSJ and Argus reports.*

*Edgemoor Investment Advisors is an independent wealth management firm providing investment and financial planning advice to individuals, retirement plans, trusts, family foundations, and an equity mutual fund. We manage approximately $1.3 billion as of June 30, 2024, for our clients and focus on long-term capital appreciation, preservation of capital, and income generation through disciplined management of value-oriented equity and income portfolios. Please contact us if you would like more information.*

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The S&P 500 index is an unmanaged market-capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance. The S&P 500 index is discussed for comparative purposes only. The comparisons have limitations because the indexes have volatility, investment, and other characteristics that differ from the investment strategies of Edgemoor. Further, it is not possible to invest directly in the indexes.

The Barclays U.S. Aggregate Bond Index is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. The Index is frequently used as a stand-in for measuring the performance of the U.S. bond market. In addition to investment grade corporate debt, the Index tracks government debt, mortgage-backed securities (MBS) and asset-backed securities (ABS) to simulate the universe of investable bonds that meet certain criteria. In order to be included in the Index, bonds must be of investment grade or higher, have an outstanding par value of at least $100 million and have at least one year until maturity.

The MSCI ACWI ex USA Index captures large and mid-cap representation across 22 of 23 Developed Markets (DM) countries (excluding the US) and 24 Emerging Markets (EM) countries*. With 2,308 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

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