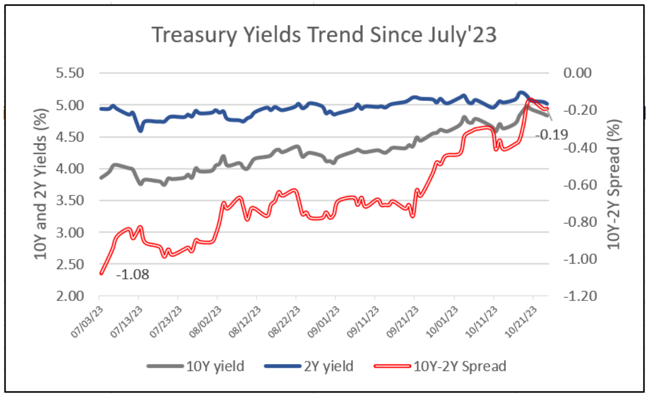
Energy and Artificial Intelligence lone market bright spots

In the Third Quarter of 2023, the S&P 500 returned -3.76%, the Russell 1000 Value returned -4.17%, and the Russell 1000 Growth returned -3.24%. Only two sectors in the S&P 500 had a positive return: energy (12.2%) and Communications Services (1.0%). Most of the S&P 500 returns in 2023 have been dominated by the technology and communication companies that have direct AI exposure. There has been a larger-than-normal dispersion of returns in the equity markets, which has presented a good opportunity for active equity management.

A stubbornly strong economy confounds rate expectations

Investors entered the quarter optimistic that the Federal Reserve had orchestrated a soft landing for the economy and that the rising rate environment would soon end. However, this enthusiasm withered during August and September as the prospect of rates remaining higher for longer became increasingly likely. Despite 18 months of Fed tightening actions, the economy still remains remarkably resilient. While inflation is slowing, it has remained firmly above the Fed's 2% target. The market now anticipates no further rate hikes and rate cuts no sooner than June 2024. This is perhaps due to the recent bear steepening of the yield curve and Fed commentary indicating a preference for keeping rates elevated for longer rather than continuing to hike aggressively.

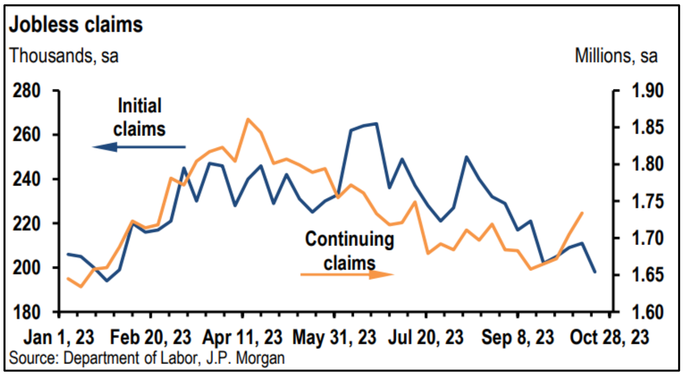


During Q3, 10-year Treasury yields experienced a noticeable surge, transitioning from below 4% to approaching 5% levels, while 2-year Treasury yields have been relatively steady at around 5%. As a result, the yield curve is now close to un-inverting after more than a year. Higher long-term treasury yields, if sustained, are likely to lead to a tightening effect on the economy with greater borrowing costs for businesses and consumers, thereby resulting in a cascading effect on spending behavior by affecting the demand side of the economy. These higher market yields could sufficiently restrict financial conditions, accomplishing the Fed's goals and reducing the necessity for further hikes.

Given these factors and downward trending inflation, we believe the Fed’s current policy rate of 5.25%-5.50% is sufficiently restrictive. However, we also view the “higher for longer” theme as the most likely scenario as the Fed proceeds cautiously with rate cuts, awaiting a notable moderation in inflationary trends and concrete evidence that the risk of inflationary resurgence is minimal.

US Labor Market not indicating recession, yet

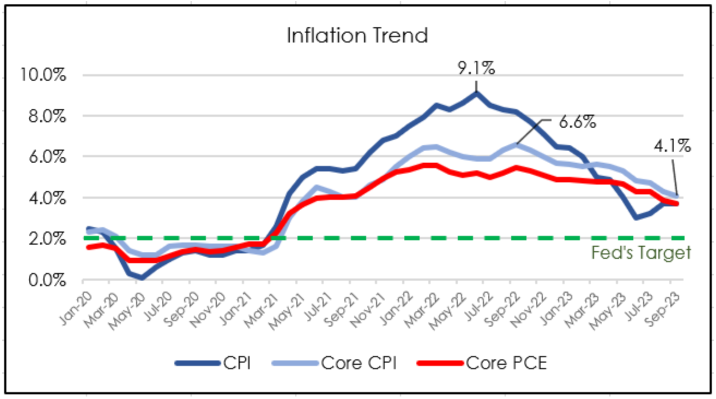
The unemployment rate inched up to 3.8% during Q3, though it remains close to historic lows. There are still approximately 1.5 job openings per unemployed person. Likewise, weekly initial jobless claims, a leading indicator, have consistently stayed between 200,000 and 250,000 throughout the quarter, well below the recessionary threshold. This indicates that the labor market remains robust. Furthermore, while wage growth has moderated in the last few months, it has started growing at a *slightly* faster clip relative to core inflation, attributable to the moderating inflation rate.



This not only safeguards workers' purchasing power in the midst of the high inflationary environment but also reinforces the overall strength of the labor market. We believe the resilient labor market continues to provide robust near-term support for the economy.

Inflation above Fed target, for now

The Consumer Price Index (CPI) ticked up in August, driven by elevated gas prices; however, core inflation continued its downward trajectory, albeit slowly relative to the Fed's liking. Inflation still remains well above the Fed's 2% target. High inflation has been met by continued robust consumer spending, but this is expected to recede due to diminishing cash buffers, record credit card rates, moderating wage growth, and student loan payment resumption. Moreover, higher borrowing rates and tightening lending standards for corporates would lead to lower capital spending activities, further reinforcing the continued downward trajectory of inflation.



Geopolitical uncertainty benefiting defense and energy overweights

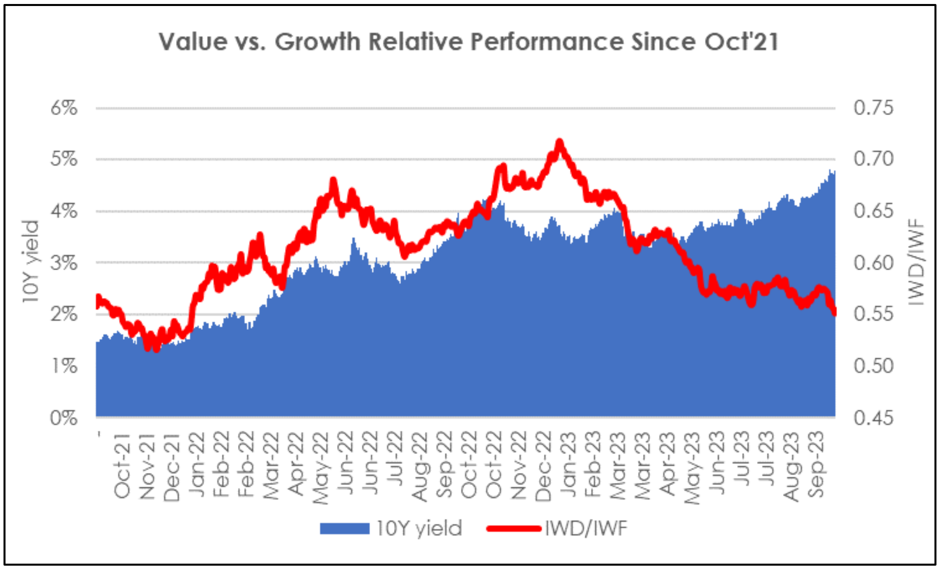
The prevalence of armed conflict across the globe has reached the highest level since World War Two. This is largely attributable to the maturing conflict in Ukraine and the pending escalation between Israel and the host of interests represented in Gaza. The conflicts in Gaza and Ukraine have implications for the global economy with the most acute impacts seen on the defense industry and energy sector. While both conflicts have remained limited in the scope of nations directly involved, there has been significant indirect involvement by developed countries to supply and support their allies. As a result, we are seeing a direct impact on the defense industrial base of developed countries, despite the lack of direct involvement. This aligns with our thesis and reasoning for an overweight in defense companies; while the US will seek to avoid conflicts that place American lives at risk, we are able to back our allies via the sale and/or donation of our advanced military technologies. Domestic defense companies do not require the US to be directly involved in a conflict to see an influx of bookings; rather, any significant global conflict or even escalation of tensions results in tangible benefits to order quantity.

Both regions are located near major energy resources and along strategy significant transit routes. The instability and violence pose risks to the security of supply and demand of oil, gas, and electricity, as well as to the infrastructure and facilities that produce and transport them. Rising energy prices could add upward pressure to inflation, hindering central banks' efforts to return inflation to their stated targets. Higher energy costs could also force businesses and consumers to reduce their level of investment and discretionary spending, respectively. That would probably sap growth but might also slow the economy enough to negate the need for an additional interest-rate increase.

Short Equity Duration securities benefiting from higher for longer

Because of Brookmont's focus on current cash flows and those within our 3–5-year investment horizon, our investments tend to have a shorter "equity duration" than much of the market. An example of a longer "equity duration" company would be one that has a disproportionate amount of its valuation derived from its cash generation potential 10+ years in the future. These companies tend to be dominated by a growth narrative versus current business operations (non-megacap tech companies and EV companies are good examples of this). In general, higher rates are considered neutral to positive for short-duration value stocks and negative for long-duration growth stocks. The shorter "equity duration" of companies within our strategies results in less volatility and overall sensitivity to changes in interest rates. As interest rates have increased, with the yield of the US 10-Year Treasury Note increasing by 0.3% over the past 1.5 weeks, Brookmont's strategies have outperformed their respective indices due to their shorter "equity duration."

Value stocks poised for success



The graph to the right illustrates the performance of the Russell 1000 Value relative to that of the Russell 1000 Growth since October 2021. Typically, during periods of rising rates, value stocks outperform growth, which was the case until early 2023, when the AI-led tech rally dramatically impacted the market. The unwinding of the expected performance discrepancy, despite the underlying driver remaining intact, potentially positions value stocks to outperform the broader market as the trend resumes in a higher for longer rate environment.

A backdrop of higher for longer rates caused by persistent inflation and strong employment, slowing consumer spending, and increased geopolitical tension, the team at Brookmont thinks that focusing on companies with solid balance sheets and durable business models is the best way to minimize risk. The current late market cycle that the US economy is in right now favors those companies that have been disciplined with their capital and have the opportunity to take advantage of their peers' weaknesses. The wide dispersion of returns and higher interest rates favor an active manager who can find strong businesses with attractive secular growth drivers.

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Brookmont Capital is defined as an independent investment management firm that is not affiliated with any parent organizations.

A complete description of Brookmont's performance calculation methodology, including a complete list of each security that contributed to the performance of this Brookmont portfolio is available upon request.

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The Brookmont Dividend Growth Strategy returns are based on an asset-weighted composite of discretionary accounts that include 100% of the recommended holdings. Individual accounts will have varying returns, including those invested in the Strategy. The reasons for this include 1) the period of time in which the accounts are active, 2) the timing of contributions and withdrawals, 3) the account size, and 4) holding other securities that are not included in the Strategy. Dividends and capital gains are not reinvested. The Strategy does not utilize leverage or derivatives. Returns are based on U.S. dollars. The inception of the Strategy is January 1, 2008.

The Brookmont Dividend Growth Strategy Composite contains fully discretionary accounts with similar value equity investment strategies and objectives. For comparison purposes, the Dividend Growth Strategy Composite is measured against the Russell 1000 Value Index. The Russell 1000 Value Index measures the performance of the large-cap segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. There is no representation that this index is an appropriate benchmark for such a comparison. You cannot invest directly in an index, which also does not take into account trading commissions and costs. The volatility of this index may be materially different from the performance of the strategy.

Brookmont's returns do include reinvestment of dividends and are shown gross-of-fees. All transaction costs are included. The Russell 1000 Value cumulative return includes reinvestment of dividends and capital gains. During a rising market, not reinvesting dividends could have a negative effect on cumulative returns.

Gross returns will be reduced by investment advisory fees and other expenses that may be incurred in the management of the account. Net-of-fees performance was calculated using actual management fees. Additional information regarding the policies for calculating and reporting returns is available upon request.

Your account returns might vary from the composites returns if you own securities that are not included in the Strategy or if your portfolio dollar-cost averaged into the Strategy during the reporting period.

The firm maintains a complete list and description of composites, which is available upon request. Results are based on fully discretionary accounts under management, including those accounts no longer with the firm. The composite policy requires the temporary removal of any portfolio incurring a client-initiated significant cash inflow or outflow of at least 15% of portfolio assets. The temporary removal of such an account occurs at the beginning of the month in which the significant cash flow occurs and the account re-enters the composite at the beginning of the month which follows the cash flow by at least 30 days. Additional information regarding the treatment of significant cash flows is available upon request.

Brookmont Capital Management claims compliance with the Global Investment Performance Standards (GIPS®). To receive a complete list and description of Brookmont's composites and a presentation that adheres to GIPS standards, please contact Suzie Begando at 214-953-0190 or write Brookmont Capital Management, 5950 Berkshire Lane, Suite 1420, Dallas, TX 75225.

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