During the first quarter of 2024, the S&P 500 returned 10.16%. The market performance was fueled by the continued hopes of stabilizing inflation and Artificial Intelligence driven euphoria. Notably, the Technology and Communication Services sectors saw impressive gains of 15.6% and 12.5%, respectively, fueled by the excitement surrounding AI. Energy was also among the top performers, advancing 12.7%, spurred by concerns over geopolitical risks and supply disruptions driving up oil prices.

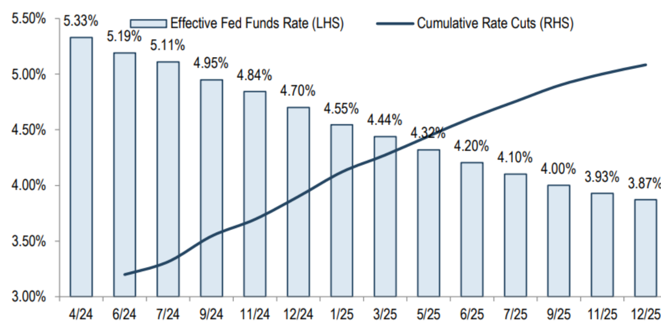
However, the influences shaping the stock market in Q1 extend beyond these factors. The combination of a strong economy, robust labor market, and resilient consumer spending, coupled with unexpectedly high inflation data, sparked speculation about the timing and frequency of rate cuts by the Federal Reserve this year. This uncertainty contributed to heightened volatility, particularly impacting rate-sensitive sectors such as Utilities and Real Estate, marking them as the quarter's worst performers.

Fed rate cut expectations move from 7 to 2 over the first quarter of 2024

In 2023, the U.S. experienced a phase of 'painless disinflation,' where inflation pressures decreased while the economy remained strong, boosting stock markets. At the beginning of Q124 the market expected 7 rate cuts during the year however by the end of the quarter that expectation had been cut to 2 rate cuts. Despite continued economic growth, inflation has proven more persistent, complicating the Federal Reserve's decisions on interest rates. March shows higher-than-expected core consumer-price index (CPI) increases, marking the third consecutive month of higher-than-forecast inflation rates. This trend suggests a possible annual inflation rate of over 4%, which is double the Fed's target of 2%. There is a possibility that the Fed may not cut rates at all before the November presidential election.

Figure 1: Market Now Expects 2-3 Rate Cuts by YE '24 ...

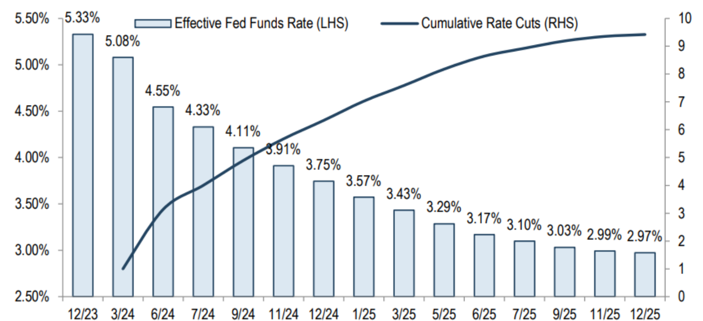
Implied Fed Funds rate from OIS futures, as of 4/1/24



Source: J.P. Morgan.

Figure 2: ... Versus 6 Cuts in 2024 Expected at YE '23

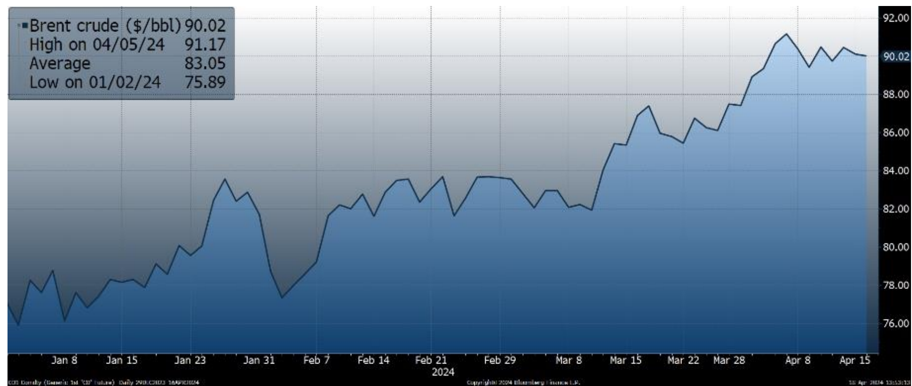
Implied Fed Funds rate from OIS futures, as of 12/31/23



Source: J.P. Morgan.

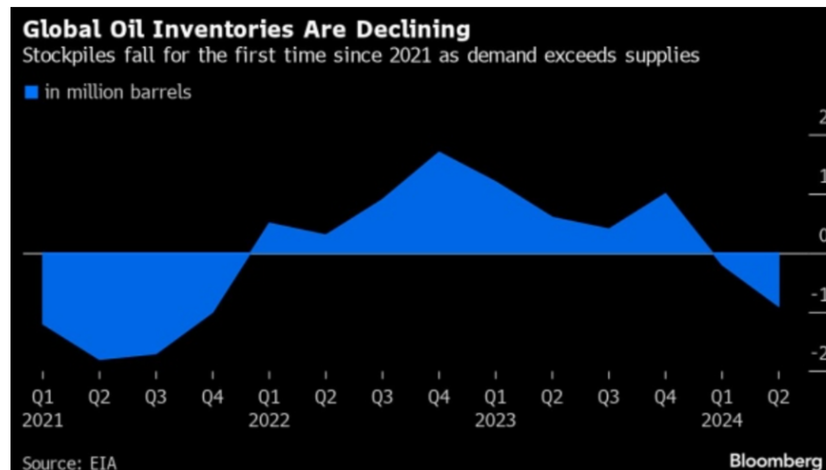
Energy and Geopolitics

In the first quarter of 2024, the price of Brent crude increased by over 13%. Interestingly, this increase can almost entirely be attributed to improving demand rather than geopolitical risk premiums. While there were spikes throughout the quarter caused by individual events, these were typically short-lived, and prices returned to a steady upward trend. This lends support to the conclusion that current energy prices are supported largely by supply-demand rather than risk premia.



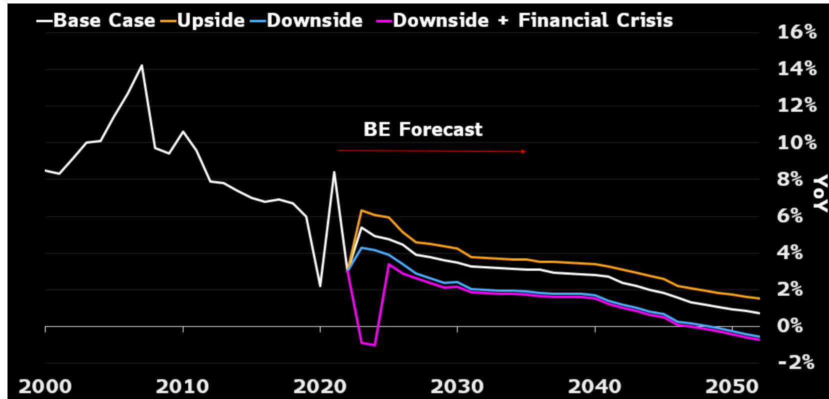
Source: Bloomberg

As a result, there is continued potential for volatile and elevated energy prices caused by geopolitical risks. The ongoing conflicts, specifically Russia-Ukraine and Israel-Iran/proxies, have been closely watched by markets due to the status of Russia and Iran as some of the top crude producers globally. The two countries represent about 17% of global crude production and capacity, with Russia at over 12% and Iran at about 5%. Ukraine struck numerous Russian oil-processing facilities throughout the quarter, significantly impacting Russia's refining capacity. Reuters estimates that 15% of Russian refining capacity has been damaged by Ukrainian drones and are offline. To support domestic gasoline supply stability, Russia announced a 6 month ban on gasoline exports. We see these events as having a relatively small impact on global market balance in the short term. However, these events have demonstrated Ukraine's willingness and, crucially, capability to strike major energy infrastructure targets deep within Russian territory.



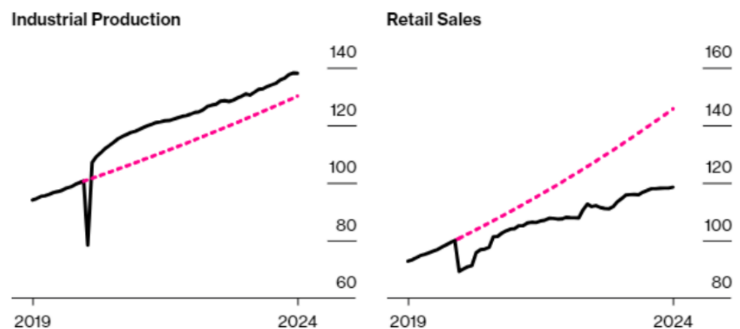
China's floundering centrally controlled economy and reliance on debt makes for an unreliable trading partner

China faces severe economic challenges, the most serious since Deng Xiaoping initiated the major reforms in the 1990s. China is experiencing a slowing growth rate, demographic issues with a declining workforce, a collapsing property market, and a fracturing global trade system. In response, President Xi Jinping is pursuing an ambitious strategy to reshape China's economy through substantial investment in advanced manufacturing and high-tech industries, aiming to make China self-sufficient and dominant in future industries like electric vehicles and biomanufacturing.



Source: Bloomberg

Xi's strategy neglects consumer spending, which is vital for economic stability, and underestimates the global shift away from free trade, which could hinder China's ability to export. Xi's stance is not conducive to entrepreneurship and sports an oppressive regulatory environment that stifles innovation and will likely lead to capital flight and emigration of business leaders.



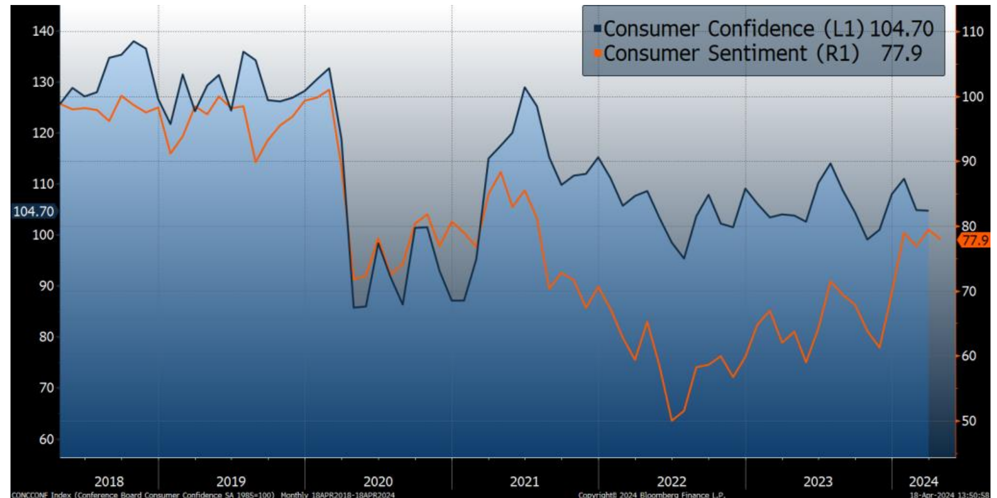
Source: Bloomberg Economics based on National Bureau of Statistics

In response to this goal of China to have a more domestic economy, the US private and public sectors are increasingly moving critical manufacturing capabilities not only out of China but back to the US to insulate our economy from China's dependency. The United States government announced over $6bn in subsidies to Tiawan's TSMC, which produces over 90% of the world's most advanced semiconductor (with node sizes below 5 nanometers or smaller) nano chips to build a new plant in Arizona, followed by providing a similarly sized subsidy to Samsung to do the same in Texas. These nano chips are critical for many applications anticipated (including AI) to drive the economy for years to come and are currently stoking market exuberance.

Unless China revises its strategy, it risks economic stagnation similar to Japan's in the 1990s, which could exacerbate international trade tensions. Our Brookmont strategies are positioned to take advantage of this theme of "slobalization" and reshoring of manufacturing activity.

Retail and consumer

Retail sales have displayed resilience and steady, but slowing, growth. In contrast, both consumer sentiment and consumer confidence have yet to return to their pre-COVID levels. Based on anecdotal evidence (a quick google on "why is my grocery bill still high?" or a similar search), there seems to be a significant disconnect with the general population, as well as many media and political sources (but these are for clicks and votes), as to the difference between disinflation and deflation. The US consumer has been inundated with headlines and speeches for the past year discussing how inflation is slowing. To many, it seems that these headlines have created the expectation that prices will return to pre-COVID levels. A lower rate of inflation indicates a slowing in the pace of price increases, not a decrease in overall levels. Consumers are increasingly vocalizing their dissatisfaction with this outcome and also becoming more selective about their purchasing. Our portfolios favor companies with more of a consumer staples vs discretionary profile.



Source: Bloomberg

Artificial Intelligence (AI) exuberance is justifying historically high valuations

Artificial Intelligence (AI) has catalyzed surges in company valuations and investments influenced by AI developments. For instance, Dell saw a 30% increase in share price due to AI-driven sales expectations, while Nvidia's valuation soared from $300 billion to $2.3 trillion since the launch of ChatGPT in November 2022.

There are direct implications for participants in the AI "stack," which includes hardware, AI models, cloud computing platforms, and AI-powered applications. This includes players like the independent AI model-makers seeing immense growth in valuation due to their intellectual property despite intense competition. OpenAI, for example, is estimated to be worth $100 billion.

However, the broader implications are more far-reaching. According to Goldman Sachs, over 36% of the S&P 500 companies referenced AI during their 2023 fourth-quarter earnings calls. AI-driven software solutions are emerging in effectively every sector of our economy. These innovations show promise of increasing earnings per share both from decreasing expenses and expanding revenue. However, handicapping how long it will take to realize these AI-driven benefits and efficiencies are unclear.

The use of AI varies greatly across sectors, with technology and media companies more likely to utilize AI for product development compared to manufacturing and healthcare sectors (although Pharma could significantly benefit).

Companies are exploring how generative AI can be integrated into various business processes, but there are challenges, including data silos, concerns over intellectual property, and the accuracy of AI systems. AI is poised to revolutionize various aspects of business; widespread productive use and integration into core business functions are still in progress.

Overall, the story of AI in the corporate world is one of cautious exploration and incremental adoption, with significant potential yet to be fully realized. However, in the longer term, it is clear that these technologies will revolutionize businesses across all sectors. At Brookmont, we evaluate the ability of the management teams of each of our portfolio holdings to innovate and grow, specifically evaluating their plans for AI adoption.

Why Brookmont

With geopolitical, election, and rate uncertainty, investing in fundamentally sound companies at reasonable valuations is more important than ever. As always, the team at Brookmont carefully evaluates the company's cash flows from operations while considering investing and financing cash flows to understand the ability of a company to meet its capital allocation needs. We do not believe that any of our holdings are short-term investments, and continuously evaluate them to provide assurance that their fundamentals align with our prioritization of long-term growth and stability of free cash flows and dividends. This highlights the importance of Brookmont's process and its success in accomplishing its goal of participating in market upside while having relatively low downside capture.

Brookmont's philosophy of investing in companies with strong balance sheets and disciplined management with well covered dividends continues to represent an attractive allocation for strategic investors in the equity market. This, coupled with rate volatility, represents greater relative value compared to fixed income alternatives. The team at Brookmont is happy to share additional thoughts on the markets and our portfolios.

Disclosures

This letter may contain "forward-looking statements" which are based on Brookmont's beliefs, as well as on a number of assumptions concerning future events, based on information currently available to Brookmont. Current and prospective clients are cautioned not to put undue reliance on such forward-looking statements, which are not a guarantee of future performance, and are subject to a number of uncertainties and other factors, many of which are outside Brookmont's control, and which could cause actual results to differ materially from such statements. All expressions of opinions are subject to change without notice.

Brookmont Capital Management is a registered investment advisor that invests in domestic and global securities.

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.

Certain economic and market information contained herein has been obtained from published sources prepared by other parties, which in certain cases has not been updated through the date of the distribution of this letter. While such sources are believed to be reliable for the purposes used herein, Brookmont does not assume any responsibility for the accuracy or completeness of such information.

These individual securities do not represent all of the securities purchased, sold, or recommended for this Brookmont portfolio and the reader should not assume that investments in the securities identified and discussed were or will be profitable.

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.

The Brookmont Core Dividend 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 in U.S. dollars. The inception of the Strategy is January 1, 2015.

The Brookmont Core Dividend Strategy Composite contains fully discretionary accounts with similar value equity investment strategies and objectives. For comparison purposes, the Core Dividend 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 than expected growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbaised barometer for the large-cap value segment. There is no representation that this index is an appropriate benchmark for such 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.

The Brookmont Quality 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 in U.S. dollars. The inception of the Strategy is January 1, 2015.

The Brookmont Quality 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 Index. The Russell 1000 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 than expected growth values. The Russell 1000 Index is constructed to provide a comprehensive and unbaised barometer for the large-cap value segment.

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.

The Brookmont Dividend Growth Strategy is available through several institutional platforms and registered investment advisors that are not affiliated with Brookmont Capital Management. Required minimum investments and advisory fees differ from one firm to another.

Brookmont Capital does not provide comprehensive portfolio management services for investors who have not signed an Investment Management Agreement with our firm.

Past performance is not indicative of future results.