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# INFLATION'S TIE TO INTEREST RATES

Inflation impacts all of us in a number of ways, not just in a steady rise in the prices of the things we buy every day. One of the most complicated is how the monthly/annual inflation rate influences our interest rates—the rate at which we borrow money.

Really? In May the so-called core consumer price index—basically the CPI excluding food and energy costs—rose a modest 0.2%. Over the last year, the core CPI is up 3.4%, which is the slowest pace in three years.

The economists at the U.S. Federal Reserve Board watch these figures closely,

because they have a policy goal of reducing the inflation rate (the core rate is used as the target) to 2.0% a year. People with an extensive background in higher mathematics will tell you that 3.4% is higher than 2.0%, but the fact that the core index is dropping without any pressure or intervention from the Fed has given the Fed some space to keep interest rates the same, while it watches how the trend will play out.

If inflation starts rising again, the Fed might decide to raise rates. If inflation continues trending toward 2%, the Fed might feel com-

fortable lowering rates, perhaps to give the economy a boost or lower the unemployment rate. Either way, inflation and interest rates are linked through the eyes (and interpretations) of a small handful of economists.

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# PRIVATE EQUITY AND YOUR HEALTH

**W**e're starting to see private equity firms make short-term investments in companies all across the American business ecosystem. At best, they're looking to make a quick buck; at worst, they're looting the companies they 'invest' in and leaving others holding the bag. One recent example is the Red Lobster bankruptcy, which closed locations around the country and laid off 36,000 workers. A private equity company firm called Golden Gate Capital basically financed a takeover by selling the real estate under 500 of Red Lobster's restaurants for \$1.5 billion, and the purchasing company then charged premium lease prices from the restaurants. By 2023, the rents totaled \$200 million a year—amounting to 10% of total revenues.

You might have read that the 'endless shrimp' promotion was the cause of the bankruptcy, and it certainly didn't help. But a closer look reveals that this was part of the looting. A company called Thai Union Group bought the largest share stake in Red Lobster and then convinced the PE-installed CEO to make the endless shrimp a permanent menu item. This allowed Thai Union to dump its excess shrimp on the food chain—

basically investing in the company in order to create a market for the excess inventory.

An academic report has looked into companies bought out and indebted by private equity, and found that they go bankrupt 10 times more often than companies not purchased by these firms. You can bet that each of those bankruptcies enriched the 'investing' PE firms.

The private equity encroachment may actually be affecting our health. PE firms have become increasingly interested in for-profit hospitals, and the results of their efficiency measures (cutting staff and short-cutting procedures) are not encouraging. A Harvard Medical School researcher looked at data from 2009 to 2019 on 51 acquired hospitals vs. 259 hospitals that were not owned by private equity firms. The PE-acquired hospitals experienced a spike in infections, a 27% increase in patient falls, and a 38% rise in infections from IVs inserted to deliver drugs, fluids and other substances.

At least 460 hospitals are now owned by private equity firms—accounting for 30% of all for-profit hospitals in the U.S. Many of these are not places you would want to be in for a significant procedure. Lifepoint

Health, now owned by Apollo Global Management, has been cited for cutting staff and essential healthcare services, and selling off real estate for a quick buck. It ranks near the bottom of its peers in various measures of outcomes and health.

In addition, PE firms have purchased roughly 6,000 physician practices. And another study found that PE-owned nursing homes were associated with 20,000 additional deaths over a 12-year period. Until Congress or the regulators intervene, we can expect more of the same—but perhaps the outrage will start with healthcare.

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# AMERICANS' DECLINING FINANCIAL HEALTH

**T**he U.S. is experiencing a new epidemic: bankruptcies. Filings are up 28% from this time last year, for a total of 45,592 over the past 12 months. Commercial Chapter 11 filings, meanwhile, increased 40% to 542—meaning the contagion is not just confined to individuals who have maxed out their credit cards. Small businesses have seen their total filings increase 60%.

The main cause of the bankruptcy wave seems to be consumer debt, which is now above \$5 trillion in total (counting credit card debt, student and auto loans)—a milestone that has never before been reached in Ameri-

can history. Household debt, which adds in mortgage debt, now totals an aggregate \$17.29 trillion. At the same time, total consumer savings, which peaked at \$2.1 trillion in August of 2021, has dropped precipitously over the last few years, to less than \$200 billion today.

As consumers take on more credit card debt (\$43 billion in the last quarter alone), they pay interest at rates not seen in decades—currently a paralyzing 28.15%. That's potentially troubling for an estimated 48% of citizens who rely on credit cards to cover essential living expenses. Over half of Americans (53%) have reached their credit card limit.

Most companies rely on the financial health of the American consumer, so the wave of bankruptcies, higher interest rates and lower savings are a hidden risk factor for lower sales, lower earnings—and potentially more corporate bankruptcies in the future.

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## OLDER CARS, THRIFTIER DRIVERS

There are two kinds of car owners in this world: the people who buy a new car every few years, and the people who continue driving their older cars until the transmission drops out onto the pavement. A recent study shows that a growing number of people are shifting from the former to the latter, and the trend has been going on for a while. In 1977, only 16.9% of cars on the road were at least 10 years old. Today that figure is just under 45%.

What's going on? There are several factors at play. One is the increased durability of cars manufactured in the recent past vs. a decade or two ago, which means they can stay on the road for any more miles. A vehicle owner with a reliable car might

be hesitant to trade it in for a new model that is pricier (especially at today's interest rates), and which also has more built-in electronics that can malfunction and increase repair costs. The average price of a new vehicle is \$46,660, compared with \$39,950 three years ago. Repair and maintenance costs are up 8.2% in the past year alone, and insurance prices are up a painful 22.2% over this time last year.

As more drivers are squeezing more miles out of their existing cars, it has become increasingly common to find odometers above 200,000 miles, and even 300,000. This, of course, assumes that the car is durable enough to last that long. Lexus and Toyota vehicles have a reputation for giving

their owners the fewest repair problems, while electric vehicles in general have been less reliable.

But, as mentioned earlier, it all comes down to preferences. The financially-minded person might compare repair costs on the existing vehicle with the cost of a new one, and conclude that repair is the less expensive option. Others like the idea of hitting the road in a shiny new ride.

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# 2024 SECOND QUARTER INVESTMENT REPORT

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The U.S. and (to a lesser extent) global equity markets continue to generate positive returns for investors, the bond market is settling down and the long-predicted recession keeps being moved back by the market pundits. It's almost easy to forget that bear markets ever happen, given the returns of last year and this year's first two quarters.

The gains have slowed down from the red-hot first quarter, but they are still historically robust. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—gained 3.31% for the year's second quarter, and stands at a 13.58% gain since January 1. The Russell 3000 index has gained 13.56% so far this year.

Looking at large cap stocks, the Wilshire U.S. 2500 Large Cap index was up 3.43% for the second quarter, with a 13.79% gain so far in 2024. The Russell 1000 large-cap index is up 14.25% so far this year, while the widely-quoted S&P 500 index of large company stocks gained 3.92% during the year's sec-

ond quarter, and is now sitting on a 14.48% gain for the year so far.

Meanwhile, the Russell Midcap Index is up 4.96% in the first half of 2024.

As measured by the Russell 2000 Small-Cap Index, smaller companies posted a 1.73% gain in the year's first six months. The technology-heavy Nasdaq Composite Index has gained 18.13% so far this year.

Foreign markets are up for the year as well. The broad-based EAFE index of companies in developed foreign economies has gained 3.51% in the first half of 2024. Emerging market stocks of less developed countries, as represented by the EAFE EM index, have gained 6.11% in dollar terms so far this year.

Real estate securities posted an essentially flat quarter, with the Wilshire U.S. REIT index down 0.25% for the quarter and down 0.26% for the year so far. The S&P GSCI index, which measures commodities returns, lost 0.70% in the second quarter, but still hold a 7.98% gain in 2024 so far. Gold

prices are booming, up 12.83% for the quarter to a near-record \$2,327 an ounce.

The S&P 500 utilities index, a broad measure of the performance of utility stocks, is churning along with a 3.85% return for the most recent quarter, now delivering 7.58% for the year.

The bond markets seem to have settled into stability, though we are still experiencing an inverted yield curve. Yields on 10-year Treasury bonds rose slightly from 4.32% at the start of the quarter to 4.40% currently. 30-year government bond yields have risen incrementally from 4.46% in the first quarter to 4.56% today.

But with the inverted yield investors can get higher returns on, respectively, 12-month Treasuries (5.11% rate, 6-month government (5.32%) and 3-month Treasury bills (5.35%). Five-year municipal bonds have risen from a 2.44% aggregate yield to 2.96%, while 30-year munis moved from roughly 3.75% in the first quarter to 3.79% today.

The markets seem to be testing new highs every week or so, but the first thing you notice, if you

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look closely at the numbers, is the more modest returns experienced in the second quarter compared with the first. The commentators and pundits interpret that as the markets ‘running out of steam,’ as if daily and monthly price movements are produced by some kind of mechanical engine. They’re not. The early part of the year might be fairly described as a period of over-enthusiasm, while today investors seem to be more relaxed about the possibility of ‘missing out.’

The chief worry as we enter the third quarter is that much of the equity returns are coming from small handful of AI-related companies. The companies that are most closely associated with AI developments—Nvidia, Apple, Amazon, Meta and Microsoft—are soaring even as the rest of the market is taking a pause. As a result, the S&P 500 is also soaring, on a very thin number of big winners. Microsoft has seen its shares soar nearly 75% since the beginning of last year, after announcing its OpenAI initiative. NVIDIA’s share

price has increased 149.48% in the first two quarters of this year. Amazon, which provides extensive server farms, is up more than 27% this year.

Analysts and investors with long memories are telling us that they’ve seen this movie before: new technology promises to change our economic landscape, creating vast efficiency improvements and permeating every aspect of our lives. The new technology actually does that, but in the process, investors in the new technology lose billions. The market reminiscence is the Tech boom of the 1990s and the massive collapse of stock prices—known as the tech wreck—that ushered in the new millennium.

Will companies find a way to use AI technology in a way that benefits their bottom line? Eventually, yes. But currently, the new technology is a cost rather than a source of revenue for all but a small handful of companies. Yes, Nvidia, the chip maker, is generating record profits—and gains. Apple Computer plans to harvest AI

in its iPhones, but does that mean it will sell more phones than it has in the past? Microsoft, which pioneered ChatGPT, hasn’t yet seen the investment generate a boost to the bottom line, and, well, other than writing college essays and maybe having computers man the phone lines to handle FAQs that are also posted on the website, what’s the use case? A recent study found that, as of today, fewer than 6% of large firms are using AI-related technologies in a meaningful way.

A secondary worry is how AI models are straining our energy systems—which, of course, are also the utilities that run our air conditioners in the summer. A number of reports have suggested that our electrical systems are groaning under the weight of this new AI-driven demand; a generative AI system uses 33 times more energy than computers running task-specific software, and the computations rely on giant data centers that suck up energy.

In 2022, the last year we have statistics, data centers used 450 terawatt hours of electricity, and that is expected to double in the

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# 2024 SECOND QUARTER INVESTMENT REPORT

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next two years. At that time, the demand consumption will be roughly equivalent to the electricity consumption of Japan.

We are starting to hear ordinary people talking about their investment portfolios, and the AI sector of the stock market, in cabs, hair salons and dinner conversations.

Whenever that happens, you can fairly suspect that there's a bubble forming in whatever they're talking about. There is no question that AI will change our business and personal lives, perhaps dramatically, the way software and information technology have done. But history has shown that

investing in transformative technologies can be tricky at best. The bigger question, that will be answered in the next 12 months, is whether the rest of the market will hold up if there is a (perhaps temporary) pullback in the highest-performing tech stocks in our investment indices.

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