TUFTON CAPITAL MANAGEMENT

Viewpoint

FALL 2024

With class officially back in session, it is perhaps fitting to greet fall with the words of an author familiar to most every American student. "October," wrote Mark Twain, "is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August and February."

If there's any truth in numbers, it appears Mr. Twain was at least partially mistaken. Rather than unleashing "peculiar" peril, October (as of this writing) has offered the kind of across-the-board gains to which American investors have, by this point, become accustomed. This follows a very healthy third quarter where the S&P 500, Dow Jones and NASDAQ notched gains of 6%, 9% and 3%, respectively. Driven in large part by continued robust earnings growth and Federal Reserve support, each index closed out September at or near record highs, with heavy lifting occurring in each of the three months. From a macroeconomic perspective, the story stays much the same since real GDP growth remains healthy, the Federal Reserve continues its accommodative stance, and consumer and executive confidence remain high.

Yet (to invoke the spirit of Huck Finn) there's always the prospect of mischief hiding in the rafters, and in case you haven't heard, there's a fairly heated presidential election underway. Here's a proposition that you won't see aired in too many headlines. No matter how feverish the partisanship gets, our country, by design, will be just fine. Since its framing, this republic has operated under the principle that no single government actor can truly rock the boat on *his* or *her* own. Though this concept is a mainstay in the context of schoolchildren learning about "checks and balances," one often finds it conspicuously absent in election-season cocktail conversation. In that setting, America's fortunes always seem to turn exclusively on the next president. With all due apologies to the next alarmist you encounter, this is simply not the case. As James Madison observed in 1788, our constitutional framework consists of "several constituent parts," which, "by their mutual relations," are "the means of keeping each other in their proper places." So too, I'd humbly posit, in 2024—no matter if it is *him* or *her* entering office come November.

Granted, investor anxiety is inevitable in the context of any historic bull market run. There is, one might say, an intuitive logic to looking for one's chair once the record starts playing on repeat. But setting that generalized anxiety to the side, it is also clear that a new consensus is forming around the market's former "can't miss" stocks. While the Magnificent Seven will almost certainly turn in respectable year-over-year growth, their status as the horses pulling the cart appears shakier by the day. So with all manner of portends, both favorable and fearsome, swirling around the marketplace, where exactly is your team of investment professionals turning its attention? Put briefly, towards opportunity—the sort that the "can't miss" crowd often overlooks. As some cracks may begin to show on some of the higher-valued equities, we believe investor attention will continue to drift towards our more value-oriented neck of the woods. As it does, we are uniquely well positioned on your behalf to capture the upside of a "sector shift".

From all of your advisors here at Tufton Capital, we thank you for the trust you have placed in us, and we remain committed to the steadfast pursuit of your interest, all twelve months of the year.

Chad Meyer, CFA
President

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The Third Quarter of 2024: The Hits Just Keep on Coming

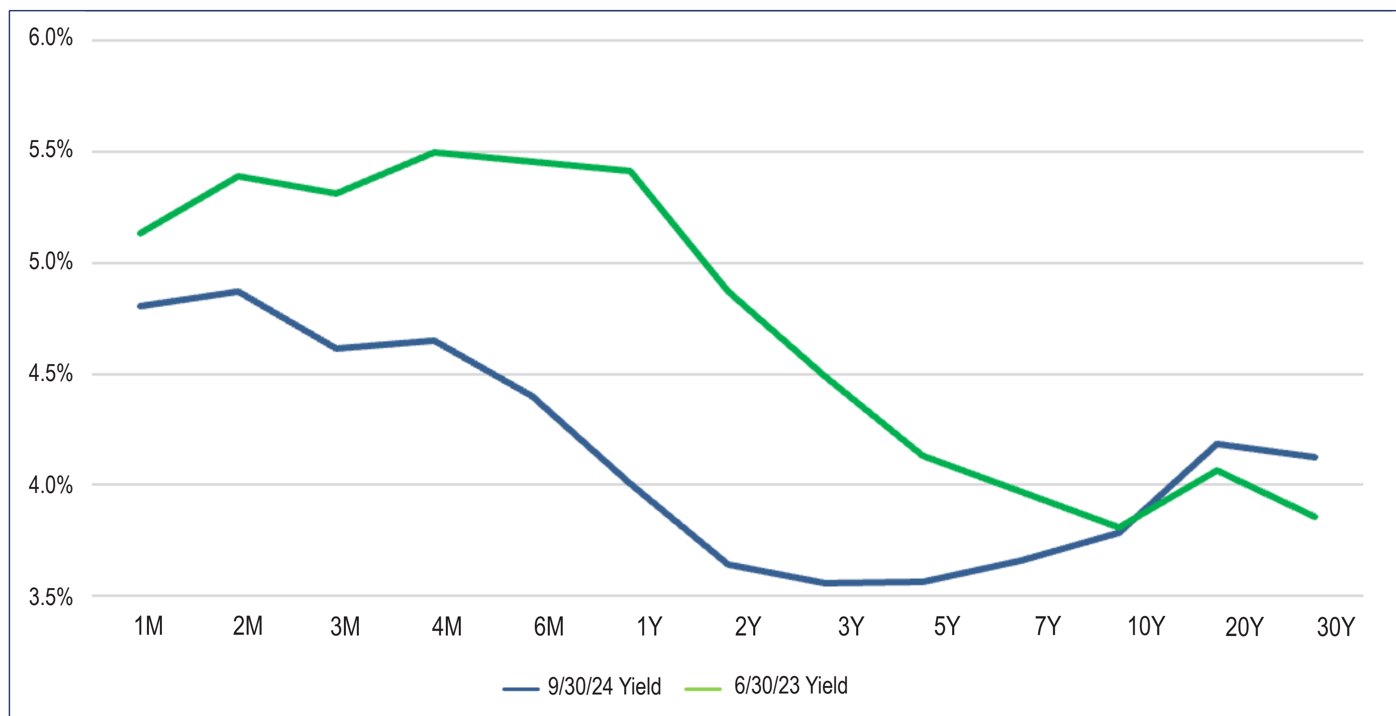
Eric Schopf
Director of Research/ Partner

As the air grows cooler and the daylight hours grow shorter, the dreams of the boys of summer have once again been dashed. For the second consecutive year, the young hopefuls of Camden Yards suffered an early exit from the American League Wild Card series, scoring just one run over two games. The same, however, cannot be said for the U.S. stock market. Its winning streak continues following robust third quarter results. The broad market delivered a total return of 5.89%, bringing the year-to-date total to 22.08%. While the market is short of the 30% returns delivered in 1997, it has still managed returns greater than 20% throughout the first three quarters of the year. Alas, the Orioles won the American League East in 1997, but the Cleveland Indians clinched the pennant and advanced to the World Series.

The bond market settled down in the third quarter with interest rates declining across the yield curve. The exception was in yields for bonds due in ten years or greater where the rates ticked higher. The Federal Reserve finally delivered the long-anticipated interest rate cut in September. However, the 50-basis point (one-half of one percent) cut was not widely anticipated. Although not unprecedented, cuts of that magnitude have typically been reserved for crisis-type events, such as the Dot Com bubble in 2001, the Great Financial Crisis in 2007-2008 and the Pandemic of 2020. The Fed typically moves in measured 25-basis point increments.

The most interesting dynamic of the shift in interest rates took place in the 10- to 30-year portion of the yield curve. The decline in shorter-term bonds was to be expected because they are closely tied to the Federal Funds rate. The fact that longer-term rates, which are primarily set by market supply and demand conditions, edged higher gives us a glimpse into the future as the yield curve normalizes. The inverted yield curve (when short-term interest rates are higher than long-term

A Look at the Yield Curve: The Dynamic Shift in Interest Rates



Source: Factset

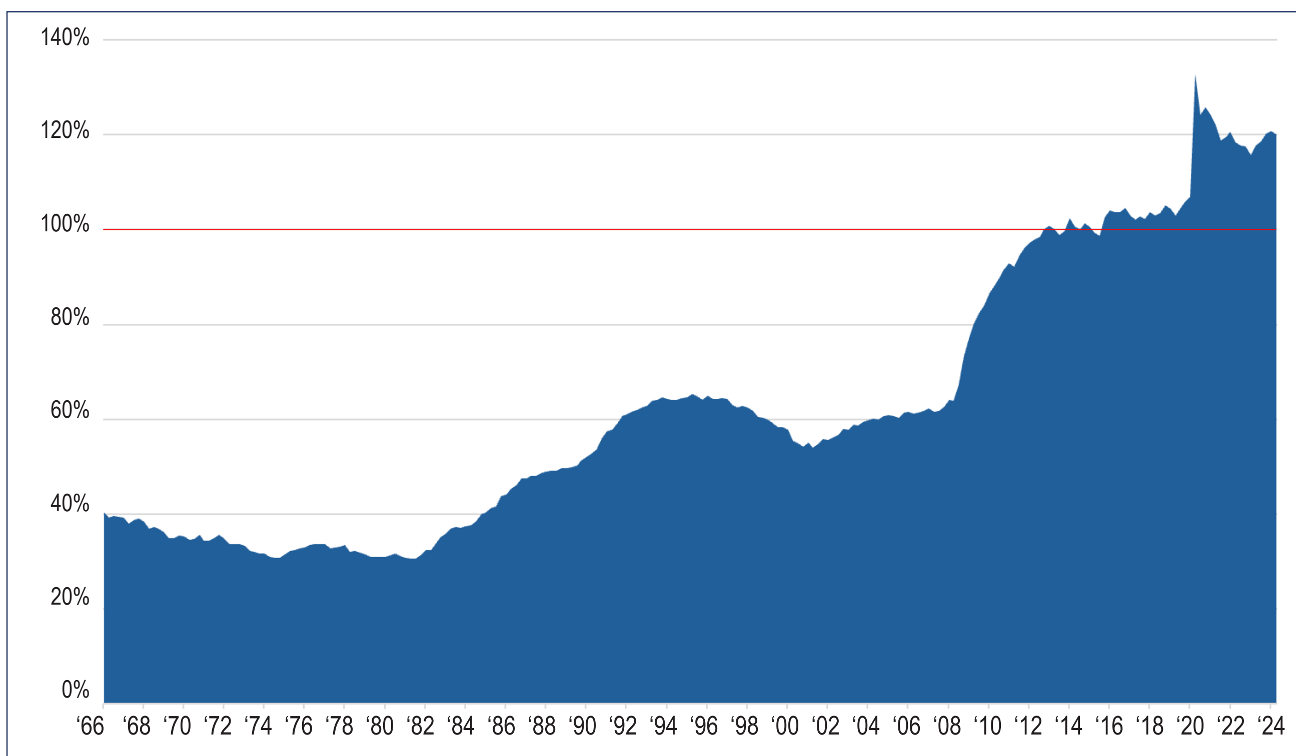
rates) present over the past two years has been very unusual for its lengthy duration.

The Federal Reserve has played a very active role over the past fifteen years as the economy lurched from one crisis to another. The Great Financial Crisis required a dose of lower interest rates combined with some financial gymnastics to keep the money flowing. Economic growth in the years following the Crisis was uneven, but inflation was stable and well below long-term levels. The Fed was steady at the helm and kept interest rates low. It wasn't until 2015 that economic growth and inflation began to accelerate. The Fed responded by raising interest rates. The Federal Funds rate moved from .25% to 2.5%. The Pandemic and brief recession resulted in rates once again being cut to .25% by May 2020. The aggressive and persistent monetary policy, combined with excessive fiscal policies, resulted in inflation levels not seen in the last forty years. We have now seen the first of what will most likely be many interest rate cuts on our way to a yield curve that is more normal in shape. There is a time-value aspect to finance that is very important—a dollar received today is worth more than a dollar received in the future due to the impact of inflation and the opportunity cost associated with investing that dollar today. An inverted yield curve disrupts this financial balance. The burgeoning federal debt has placed additional stress on interest rates and may keep longer-term interest rates elevated. The national debt now stands at roughly $36 trillion, equivalent to 125% of our gross domestic product. Prior to the Pandemic, the debt stood at $23 trillion, or 105% of our economic output.

Receding inflationary pressure and a softening labor market provide the support for further rate cuts. The dual mandate boxes of full employment and price stability have already been checked. Hesitation on the part of the central bank up to this point can be linked to the unusual economic conditions in the years following the Pandemic. Many once-reliable economic

Continued on page 8.

U.S. Debt as a Percent (%) of GDP



Source: Factset

Company Update: Eli Lilly & Company (Ticker: LLY)

Eric Schopf
Director of Research, Partner

Eli Lilly and Company (Ticker: LLY) discovers, develops and markets human pharmaceuticals worldwide. The company was founded in 1876 and went public in 1923. LLY is headquartered in Indianapolis, Indiana and has a rich history of developing many important drugs. In the 1920s, they were the first company to mass-produce insulin, and in the 1940s they were the first company to mass-produce penicillin. In the 1980s they introduced Prozac for mental health conditions.

Today, their diverse therapeutic product portfolio addresses diabetes, immunology, neurosciences, oncology and weight loss. Their key products include Mounjaro, Trulicity and Jardiance for diabetes, Verenzio for breast cancer and Taltz for plaque psoriasis, psoriatic arthritis and other autoimmune disorders. The real growth driver, however, is Zepbound, a drug for the treatment of obesity. The active ingredient for the weight-loss drug is tirzepatide, the same ingredient found in Mounjaro. Mounjaro is a Food and Drug Administration-approved injectable drug that helps adults with type 2 diabetes control their glucose levels. During the trials, LLY observed that obese diabetes patients lost a considerable amount of weight during their treatments. After further studies, the same drug has been rebranded as Zepbound and has been approved by the Food and Drug Administration for the treatment of obesity.

Zepbound is a glucagon-like peptide 1 (GLP1) receptor agonist. GLP-1 drugs slow the movement of food from the stomach into the small intestine which makes a person feel full longer. People eat less while taking the medication and lose a considerable amount of weight. In a 72-week study of adults without diabetes, average body weight loss was between 15% and 21% of body weight, depending on the starting weight and dosage level.

Zepbound, which has only been available since December 2023, has shown tremendous growth. Revenue for Q2 2024 was $1.2 billion, and forecasts for the GLP-1 weight-loss market range as high as $150 billion by 2035. The only other GLP-1 drug on the

Eli Lilly & Company (Ticker: LLY) Stock Chart

Source: Factset

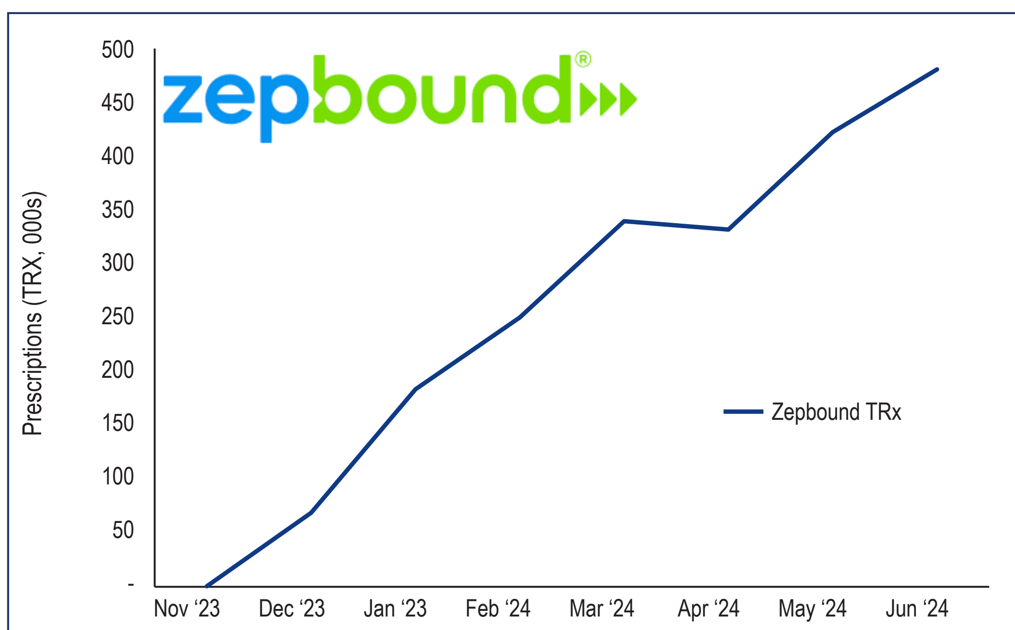
market today used for weight loss is Wegovy, which is manufactured by Novo Nordisk. The primary difference between Zepbound and Wegovy is that Zepbound is a GIP receptor and GLP-1 receptor agonist, whereas Wegovy is only a GLP-1 receptor agonist. Zepbound activates receptors (signaling proteins) in the brain that natural GIP and GLP-1 turn on. These signals make people feel less hungry, causing them to eat less and ultimately lose weight. Zepbound has been shown to provide superior results due to this dual action of the drug.

Research has shown that GLP-1 drugs may also be beneficial in treating cardiovascular disease, obstructive sleep apnea, fatty liver disease and certain cancers. LLY has a first-mover advantage and has committed considerable research and development efforts to expand the label. They have also spent billions of dollars to expand their manufacturing capability to ensure a steady supply to meet growing demand.

Eli Lilly faces several hurdles in gaining wide GLP-1 acceptance. The price of the drug is prohibitively high at about $1,060 for a one-month supply. Due to this high cost, most insurance policies do not cover the drug for obesity. Furthermore, side effects including nausea, diarrhea, vomiting, indigestion, heartburn and hair loss often result in patients discontinuing treatment.

Looking at the stock price, LLY's price-to-earnings (P/E) ratio is much higher than that of the overall market as well as of other health care stocks. This can certainly cause heartburn among investors. The price is high and so are expectations for growth. The stock trades at 58 times expected 2024 earnings, and the dividend yield is only 0.60%. Failure to meet expectations leaves the stock vulnerable to sharp corrections. We acknowledge the risk and classify the stock as a "special situation". We have limited initial position sizes in our clients' portfolios. ■

Growth of Zepbound Prescriptions Since Introduction in December 2023



Source: Q2 2024 Lilly Presentation, IQVIA Monthly NPA data through June 2024

Are you FED Up?

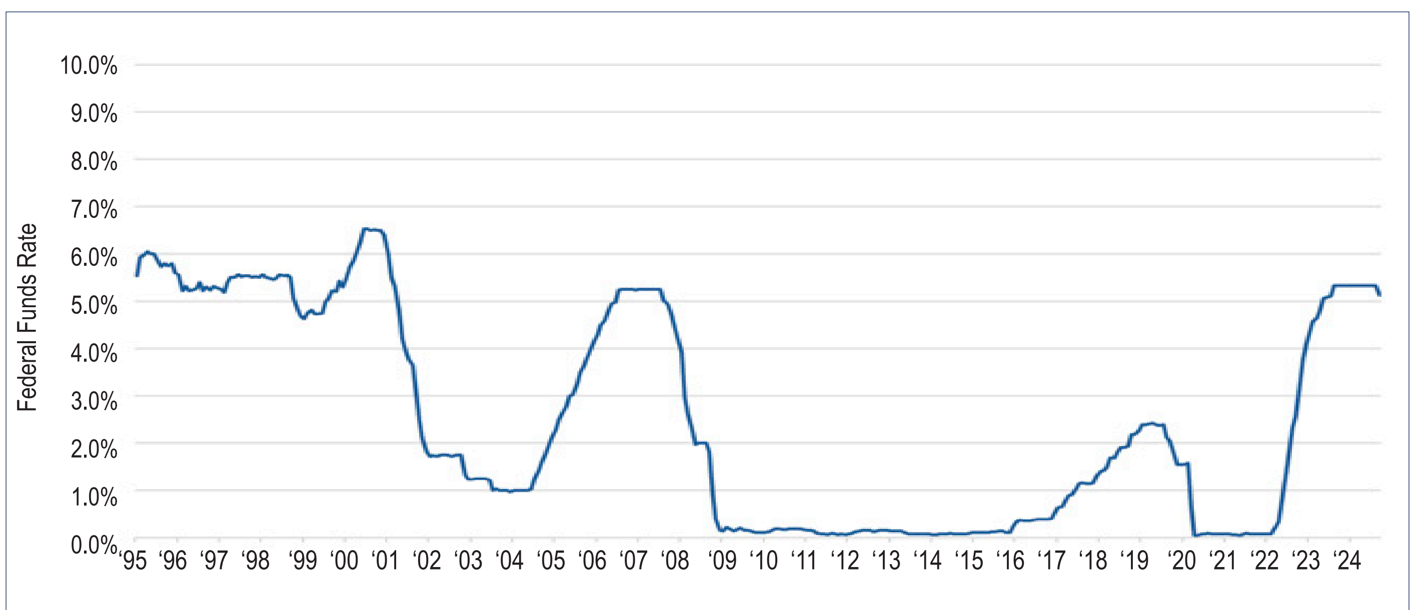
On September 18, the Federal Reserve's (Fed) Open Market Committee made headlines by announcing a rate cut that exceeded market expectations. This decision, long anticipated and hotly debated throughout 2024, is being viewed as a potential catalyst for significant movements in both interest rates and stock prices.

Market reactions have been mixed following the announcement. There was a notable initial dip, but the markets rebounded the next day, indicating a more nuanced response to this pivotal change. The Fed's recent actions may ripple through various industries and financial markets, and although every situation is different, there are certain insights that help us navigate the evolving economic landscape.

The theory is that by cutting rates, borrowing costs will decrease, which will prompt businesses to take out loans, to hire more people and to expand production. This logic works in reverse when the economy is hot. However, the Fed sets only one interest rate—the Fed Funds rate—and that none of the rates we encounter in our lives, whether as consumers (on mortgages, credit cards or fixed deposits) or businesses (loans and bonds), are directly set by or even indexed to this rate. The Fed Funds Rate is an overnight intra-bank borrowing rate that primarily affects short-term lending between banks. This means that while the Fed can influence overall borrowing costs, the relationship is not direct. Instead, various factors including inflation, market conditions and risk perceptions also play significant roles in determining the interest rates consumers and businesses actually face.

What happens after the Fed begins to cut interest rates? Based on the last four first-rate cuts after rate-hiking cycles, the S&P 500 has generated mixed returns (on a cumulative basis). After twelve months,

U.S Interest Rates (1995 - Q3 2024)



Source: Factset

the average return is 0.32%, and after two years, the average return is 16.55%. Although the Fed controls the Federal Funds rate, its effects eventually trickle down to lower discount rates, which can enhance the present value of future cash flows for businesses. This, in turn, tends to boost investor sentiment and drive equity prices higher over time.

This sure does sound good, but why does the Fed cut rates? One interpretation is that the Fed is finally convinced that inflation has been effectively tamed, and that lower inflation may persist. However, the decision to implement a fifty-basis point decrease—double the anticipated twenty-five basis points—suggests that the Fed may be responding to more concerning signs of an economic slowdown that aren't fully reflected in public employment and growth data.

With an election looming there is a more cynical perspective to consider. Some critics argue that the Fed's decision to cut rates could be less about addressing inflation or fostering genuine economic growth, and more about political considerations.

Different sectors in the market perform differently after an initial rate cut. Defensive sectors (such as Consumer Staples and Healthcare) tended to outperform after one and two years after the first initial cut after a restrictive monetary policy.

Returns After the First Cut		
First Rate Cut	**+12-months**	**+2-years**
7/6/95	21.45%	72.85%
1/3/01	-12.37%	-30.55%
9/18/07	-18.91%	-26.26%
7/31/19	11.09%	50.16%
Average	**0.32%**	**16.55%**

Index: S&P 500 (SP50) *Source: Factset*

The future remains uncertain. Here at Tufton Capital we find and invest in companies that can maintain or even increase cash flows, regardless of the rate cycle. We identify businesses with strong fundamentals, robust cash flow generation and competitive advantages that enable them to weather and thrive in varying economic conditions. As we navigate this shifting landscape, it's essential to remain adaptable and informed, and we will continue to monitor indicators such as inflation trends, employment figures and consumer sentiment that will assist us in making strategic investment decisions. ■

Fed Funds Cut and Impact on Returns

Returns After the First Cut: +12-months				
Sector	**7/6/95**	**1/3/01**	**9/18/07**	**7/31/19**
Energy	24.81	-9.21	-11.32	-38.26
Materials	5.30	6.51	-10.23	6.28
Industrials	25.09	-5.37	-19.88	-5.70
Cons. Disc.	12.47	-4.57	-18.99	21.57
Cons.Stap.	30.49	-1.52	5.28	8.14
Health Care	37.67	-7.98	-9.63	18.77
Financials	28.73	-10.67	-39.71	-12.81
Info.Tech.	8.61	-26.84	-18.84	38.91
Real Estate	-	-	-8.23	0.16
Comm.Serv.	19.81	-17.68	-28.62	14.76
Utilities	13.37	-23.66	-12.89	5.83

Returns After the First Cut: +2-years				
Sector	**7/6/95**	**1/3/01**	**9/18/07**	**7/31/19**
Energy	75.68	-17.26	-24.54	-10.83
Materials	32.25	1.21	-20.14	50.41
Industrials	76.13	-28.26	-31.74	38.09
Cons. Disc.	38.58	-26.23	-23.28	53.66
Cons.Stap.	86.76	-4.00	-2.74	27.81
Health Care	115.01	-21.53	-14.46	51.22
Financials	111.67	-21.30	-53.67	35.32
Info.Tech.	78.00	-55.31	-14.60	94.51
Real Estate	-	-	-39.96	32.90
Comm.Serv.	41.85	-44.58	-31.50	65.15
Utilities	25.72	-45.08	-19.95	18.57

Source: Factset

Third Quarter...continued from page 3.

indicators whiffed in their predictive capacities. The Index of Leading Economic Indicators, the inverted yield curve and the Sahm rule, all highlighted in previous *Viewpoints*, provided false positive recession signals. The current economic backdrop signals a soft landing, with the economy slowing down enough to reduce inflation without causing a recession.

Perhaps the greatest risks lie outside of our borders. The situation in the Middle East is different this time. The attack on Israel one year ago has provoked an unwavering Israeli response that is now expanding geographically. The scope, scale and duration of the conflict indicate a great level of uncertainty. Our relations with China are deteriorating, which pushes them further to expand their relations with Russia. Trade agreements and the availability of goods impact employment as well as inflation. The Russian invasion of Ukraine almost three years ago continues to drain U.S. resources and goodwill.

The state of the economy cannot be overemphasized as we approach election day. The presidential election will clearly be close, and many congressional seats will be in the balance. In attempts to win over the electorate, Vice President Harris and former President Trump continue to introduce competing programs affecting taxes, trade and immigration. Predicting the winner and gauging policy implementation is nearly impossible. We continue to monitor the elections and will do our best to position your portfolio for success.

The economic backdrop that portends a soft landing today can quickly change as employment and inflation conditions are altered. Given the uncertainties, we at Tufton Capital will monitor the elections and do our best to position your portfolios for optimum financial success. ■

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