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Earnings Trump Oil Prices

Points of Interest:

* Iran & Oil
* The Fed & New Chairman Warsh
* Japan
* Employment
* Inflation
* Earnings
* AI
* Social Security

Second quarter returns were shaped by the Iran conflict but dominated by exceptional corporate earnings. The Dow and the S&P 500 were both up over 9 percent during the quarter. Amazingly, these results were outshone by the Emerging Markets MSCI index and the Russell 2000 posting of 24 and 21 percent respectively. The Japanese Yen reached its lowest level versus the US dollar since 1986. An improving employment market and an inflation spike greeted our new Fed chairman, Kevin Warsh. The US trade imbalance continues, and social security's imminent shortfall becomes more dire.

Higher fuel prices due to the conflict with Iran made their mark on consumers and contributed to the highest inflation reading in over 3 years. Iran closed the Strait of Hormuz shortly after the fighting began and choked off the flow of 20 percent of the world's oil supply. Iran also targeted their neighboring countries' strategic oil operations, and many wondered why the price of oil did not exceed the peak of $120 per barrel. A US-Iran ceasefire was declared June 18 and as I write this has been voided by President Trump. With this volatile situation, the price of oil will have a big influence on inflation.

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Trump Accounts, a Pathway to Tax Free Millionaires

Trump accounts went live July 4th of this year. Most of the attention is focused on the $1,000 that is available from the treasury to fund them if you have a child born between 2025-2028. These new accounts have tremendous opportunity. You are able to contribute up to $5,000 per year from the time your child is born until they turn 18. Your employer may also contribute $2,500 per year. These accounts are unique from custodial Roth IRA's in that the child does not need to have earned income to make a contribution. On January 1 of the year the child turns 18, these accounts convert to a traditional IRA. This could be a great opportunity to convert these traditional IRA funds to a Roth IRA while the child has little to no income. In the child's young adult years they are typically in a very low marginal tax rate, allowing them to pay very low taxes on the conversion. With additional Roth contributions and the compounding market returns, it is easy to see how these young investors could become tax free millionaires in their 30s or 40s.

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Kevin Warsh's first meeting as the Fed Chairman went smooth, though with a few surprises. The Fed held their Fed Funds Rate steady at 3.5 – 3.75 percent but indicated a willingness to raise rates if inflation persists. Their meeting minutes showed half of the Fed Governors supporting this and only one suggesting an interest rate cut before year end. These minutes showed a new potential source of inflation, artificial intelligence (AI). In the race to build vast data warehouses to power technology and communications companies AI models, some prices are going up. The most obvious has been the price of consumer electronics due to scarcity of semiconductors. Many companies, including Apple, Nintendo and Ford have all begun raising prices. AI has been a contributor to higher utility prices due to their insatiable need for power and water. Warsh and the Fed will set policy based on where inflation and employment go, and as of now higher rates may be in the forecast. If inflation comes down due to lower fuel prices, the Fed's current guidance to raise rates might act like a cut when they are able to remain where they are since the markets have already priced in a move up.

Hiring in the US has not boomed, but it is much better than it was last year. Even though June's report was a disappointment with only 57,000 new jobs created, the average for the year stands at 92,000 per month. The unemployment rate moved down to 4.2, unfortunately for the wrong reasons. The number of Americans who are employed or seeking employment declined and has been trending this way for the past 6 months. This is likely due to baby boomers retiring and the impact of the administrations immigration policies. AI looks to make its mark on employment as it gains in adoption and capability. Policy making is well behind technological improvements to AI models. Employment has thrived despite the invention of automation, personal computers, the internet and cell phones; AI could be different. Policy makers need to incent corporate behavior to reward companies that prioritize pro jobs in conjunction with pro productivity restructuring, or we could see employment numbers take a quick turnaround.

Quarter 1 earnings were for the record books, with 25 percent growth in net income compared to the previous year. This type of growth is typically only seen during economic recoveries, not 6 years into an expansion. The earnings growth we are seeing is not mainly from consumer spending, which has been the case in past bull markets, but from corporate cash being deployed. Until this recent AI boom, corporations were more focused on paying cash out to investors with dividends or share buybacks. Direct capital investments in plant, property, equipment and processes are a great driver of revenue growth. There is a little accounting irregularity lurking in earnings though. Several large technology companies used an obscure accounting rule that allowed them to show earnings growth on valuation increases of unlisted companies like Open AI and Anthropic that they have stakes in. It is not likely that these unlisted companies will continue to grow at these same paces and some even go down when they have their IPO.

The Japanese Yen reached its lowest level versus the US dollar since 1986. No wonder I know so many friends and clients that have visited there lately. The Japanese Central Bank has recently raised their rate to 1 percent, which is amongst the lowest in the world. If they continue to raise rates, there could be larger implications for other economies. Higher rates could draw Japanese savers that spread their money throughout the world for higher rates to come back home. Japan is one of the largest investors in US Treasury Bonds, so losing their funds could lead to higher US borrowing costs. Hedge funds borrow at the current low rates for investment and would be more likely to cash in, causing asset sales in things like growth stocks. The last time this happened was July of 2024 at a similar exchange rate, and Nasdaq lost 13 percent in a matter of weeks.

The course our nation's finances are on is not sustainable, yet very few in our federal government care to address it. Social Security has been in the headlines lately with warnings that benefits could be reduced as soon as 2032. A bipartisan group of house representatives have proposed a bill to establish a 13-member bipartisan commission tasked with studying the programs finances and recommending solutions. This is a welcome sign to a problem. Senators that will be elected this mid-term election will be the first to face the looming problems our imbalances pose.

The second quarter was one to celebrate. I worked with many clients to take some profits from equities and add to bonds and cash for more income and future buying opportunities. I look forward to meeting with you all to discuss this economic environment to maintain your healthy portfolio.

If you need additional copies of this newsletter for friends, family or neighbors please let me know. I am grateful for any opportunity to get in front of other investors like yourselves. Please keep me in mind to help others you know that may need financial advisory assistance.