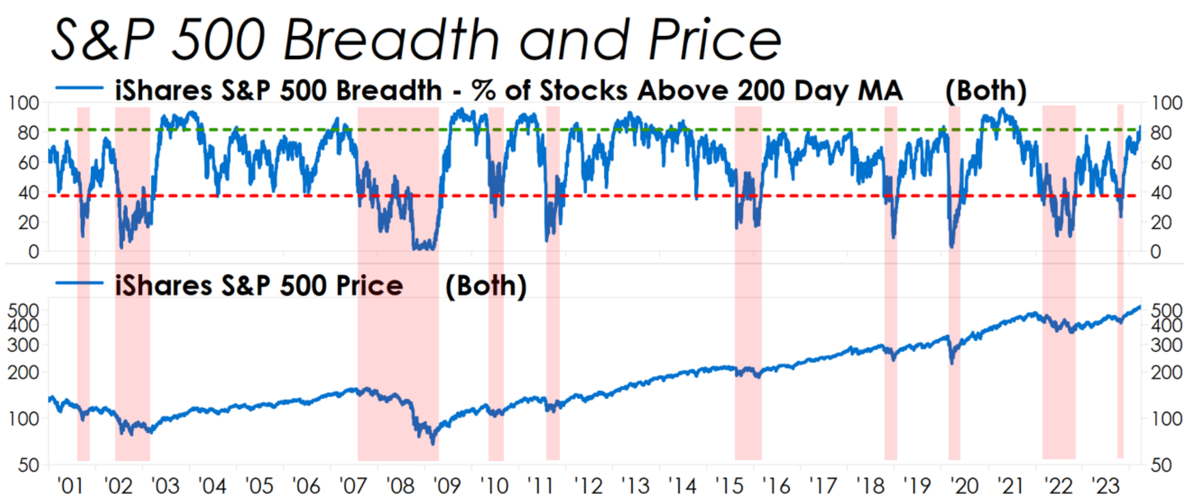
Taking A Deep Brea(d)th.

"The height of the pinnacle is determined by the breadth of the base."
– Author, Ralph Waldo Emerson (1803-1882)

In physics, an object's center of gravity relative to its base can help determine its stability. Without being a physics major, most of us intuitively know that taller and skinnier objects are easier to topple than shorter and wider ones. That's the reason formula one race cars hug the turns at high speeds as opposed to double decker buses. In short, the wider the base, the greater the stability.

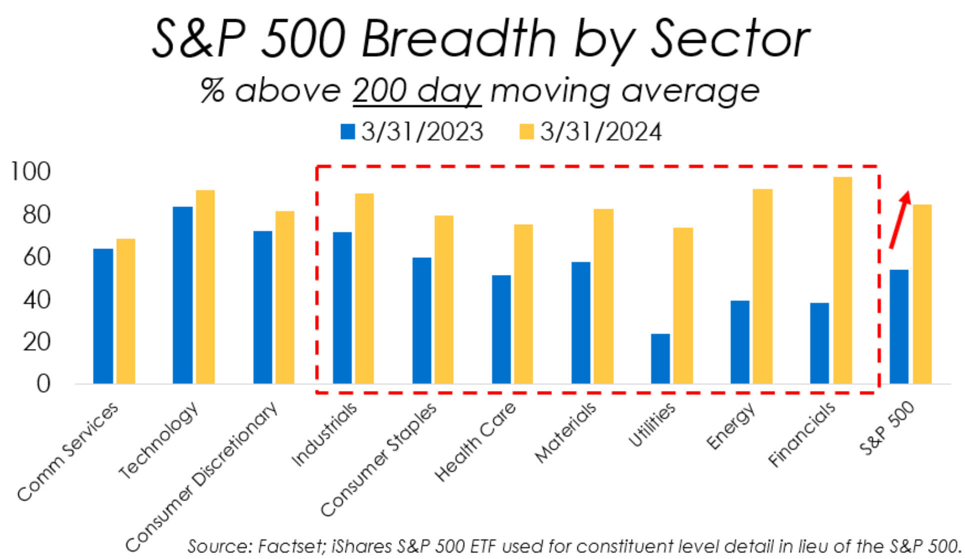
We can draw very similar parallels to the technical conditions that describe the market – often referred to as market breadth. <u>Breadth is often defined by the number of companies that participate in the move of an index. Breadth is generally considered narrow or broad. Like the physics intro – the better (or broader) the breadth, the healthier (and more stable) the market.</u> As can be seen below, when fewer companies are able to stay above their 200-day moving average (top chart), the price index (bottom chart) becomes less stable and tends to suffer more significant drawdowns (red shaded regions).

Some measures of breadth still indicate a narrow and top-heavy market. For example, the largest companies are still contributing a disproportionate amount to the return of the index. Year to date, the "Top 10" companies in the S&P 500 have contributed about half of the return of the entire index. So far, this "Top 10" contribution ranks fifth out of all the positive return years since 1990. However, one shouldn't necessarily conclude that the market is becoming increasingly unstable on this one metric alone.

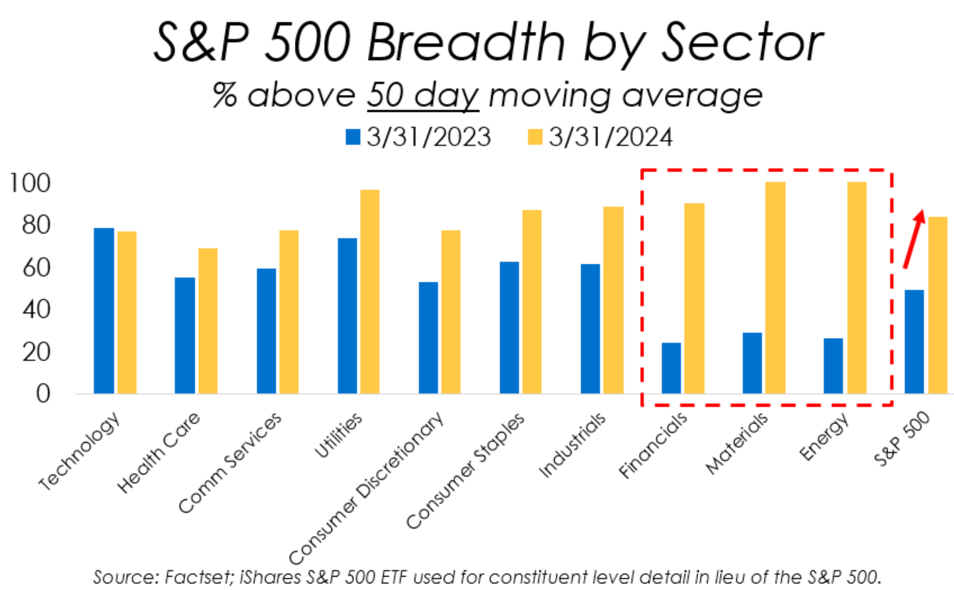


Source: Factset; iShares S&P 500 ETF used for constituent level detail in lieu of the S&P 500. Price is on a log scale.

As can be seen in the chart immediately below, market breadth – as defined by the percentage of companies trading above their 200-day moving average – has improved from a year ago across all sectors in the S&P 500. This has resulted in a marked advancement in breadth for the index as a whole. What's more notable is that the biggest improvement in breadth from a year ago has come from sectors outside of market leadership (Communication Services, Technology and Consumer Discretionary). The breadth across sectors has now become more balanced with the biggest improvements coming from Financials, Energy and Utilities.

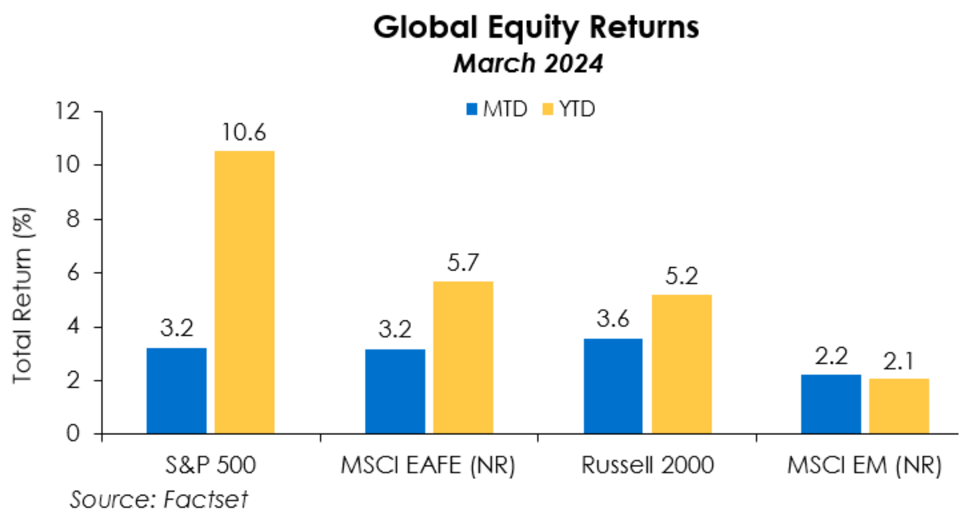


While the 200-day moving average is a good proxy for a stock's long-term trend, the 50-day moving average might be a good proxy for a stock's momentum relative to trend. As can be seen in the chart below, market breadth has markedly improved from a year ago on this measure as well. When analyzing the percentage of companies above their 50-day moving averages, all sectors have improved with the exception of Technology. Financials, Materials and Energy are most improved on this measure with high readings in Utilities, Industrials and Staples as well.



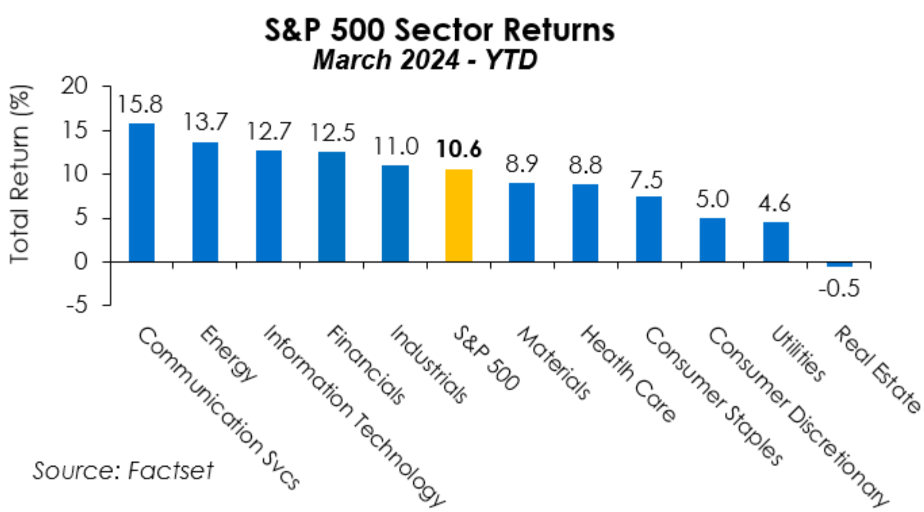
The main point is that, while the market remains top heavy, improved breadth indicates signs of increasing health with more stocks participating. Just like in physics, the bigger the base, the greater the stability.

While Stocks, Bonds, REITS, and Commodities all posted positive returns in March, returns across these asset classes have been more disparate year-to-date. Stocks have been particularly strong to start the year benefiting from solid economic growth, AI related enthusiasm along with an extended pause on short-term rate hikes. As a result, the S&P 500 turned in its best first quarter since 2019 and its eleventh best start since 1950. More rate senstive areas like Bonds and REITs have been held back by dampened expectations for rate cuts. Meanwhile, Commodities have posted positive returns with recent breakouts in gold, copper and oil.



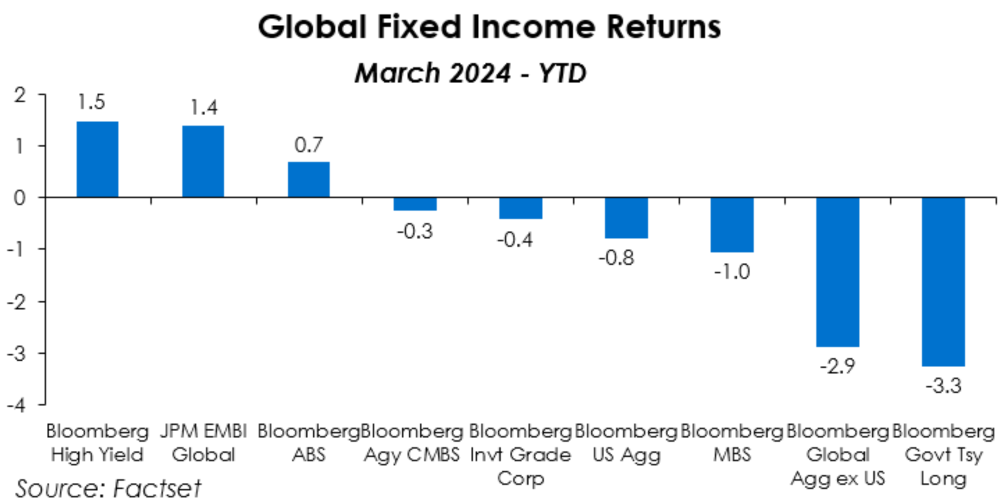
Stocks

Stock returns in March were uniformly strong with US Small Caps (Russell 2000) leading the way. For the year, US Large Caps (S&P 500) continue to lead but with participation broadening to sectors like Energy, Financials, and Industrials – all of which have outperformed along side last year's leaders in Communication Services and Technology. Overseas, International Developed Markets (MSCI EAFE) rallied, in part, on the anticipation of an easing from global central banks and excitement from health care innovations. Meanwhile, Emerging Markets (MSCI EM) were up, but less so, as returns were held back by lackluster performance in China.



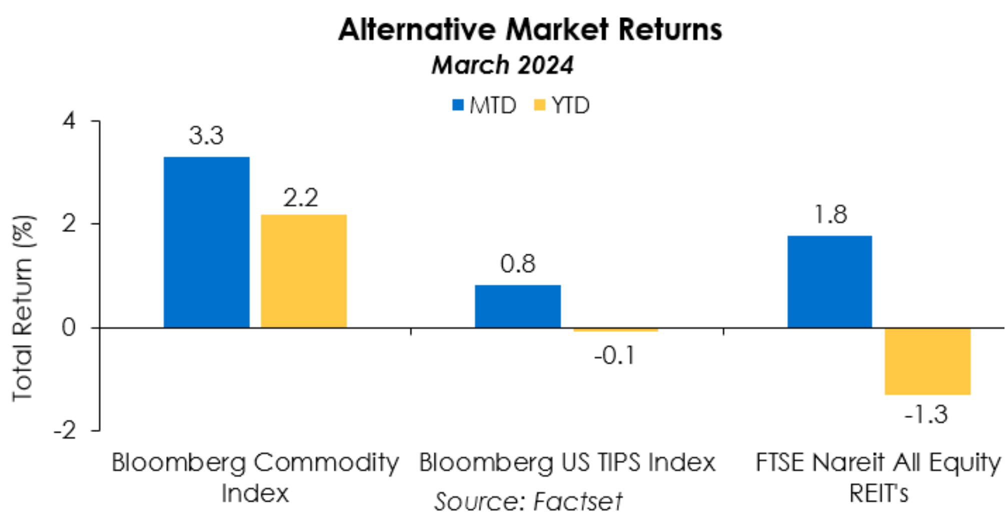
Bonds

Following aggressive moves by the Fed (Fed Funds at 5.25-5.50%) amid ongoing balance sheet reduction – policymakers have now indicated a "wait and see" approach with rates unchanged at the last five meetings. The Fed continues to indicate they expect three rate cuts this year while, at the same time, revising growth and inflation expectations higher. Meanwhile, the bond market dialed back its earlier and more aggressive rate cut expectations and is now aligned much closer to Fed forecasts. Longer term rates have risen for the year but were down modestly in March while the yield curve remains inverted (albeit off the lows from last year). Year-to-date, Bond returns were mostly down amid lowered rate cut expectations. The exceptions were positive returns in EM Debt (JPM EMBI) and High Yield corporate bonds – both of which benefited from higher starting yields and tightening credit spreads.



Alternatives

Commodities traded higher year-to-date with stronger returns coming in March particularly in precious metals. Oil and copper have recently broken out as well. Meanwhile, publicly traded Real Estate (REIT's) has been held back given its more rate sensitive nature. Finally, returns on Treasury inflation protected securities (TIPs) were subdued though outperformed nominal Treasuries on the recent rise in inflation expectations.



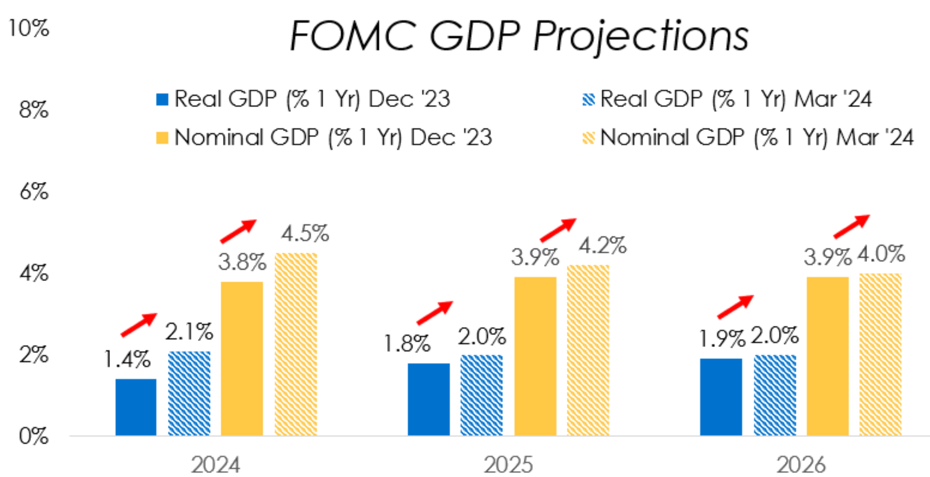
Market Outlook

"It's Tricky to rock a rhyme, to rock a rhyme that's right on time. It's Tricky."

– Run DMC, *It's Tricky* (1986)

We continue to believe that it's important to maintain two frameworks for managing portfolios – the cyclical (shorter-term) and the secular (longer-term). The cyclical perspective is an attempt to assess where we are in this particular business cycle while the secular perspective evaluates where the structural tendencies might be over multiple business cycles.

From a secular lens, we remain sympathetic to the notion that the paradigm is changing to one that ushers in the potential for more persistent and volatile inflation. Such a backdrop might set the stage for a higher cost of capital environment acting as a weight on stock valuations along with changes in market leadership. We find historical parallels today to the higher and more volatile inflation regime that existed back in the '60's-80's and we think the Fed is re-learning the painful lesson of falling behind inflation – one that it hopes not to repeat any time soon. Additionally, we believe there are structural considerations that exist today that might also support this changing paradigm including changes to both aggregate demand (money supply) and supply (de-globalization, labor markets, energy complex).

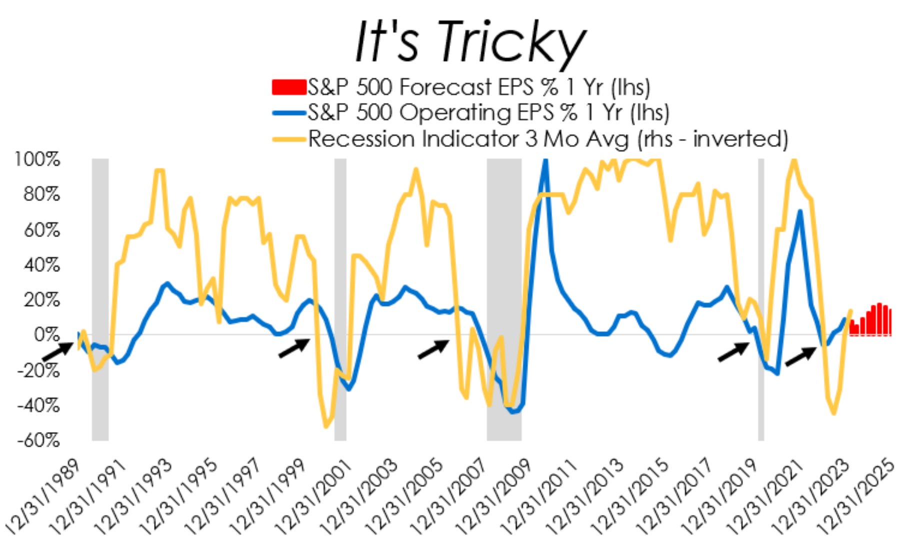


Source: FOMC; Projections of change in Real GDP are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. Nominal GDP projections incorporate the Real GDP projections plus PCE inflation projections. Projections are based on the Fed forecasts at the December 2023

Currently, there's no doubt that inflation is moderating with CPI now well below its peak of 9.1% back in June 2022 – suggesting the first wave of inflation is over. However, according to Strategas Research Partners, historical bouts of meaningful inflation evidence multiple waves more often than not. Recent inflation data has been hotter than expected and, per the chart above, Fed forecasts for GDP growth (both real and nominal) were revised higher (most notably for this year) at their recent FOMC meeting this month. At the same time, policymakers maintained their forecast for three rate cuts this year, next year (one fewer than in December) and the following. As we move toward the trough of this inflationary wave, much will depend on how the Fed reacts. By our estimates, the money supply is still sitting above its long-term trend so if policymakers ease too agressively, we wonder if a second wave of inflation takes shape. If so, this might have implications for a company's cost of capital, a stock's valuation multiple and changes in market leadership. As a result, we've referred to this secular mantra as "Doing the Opposite".

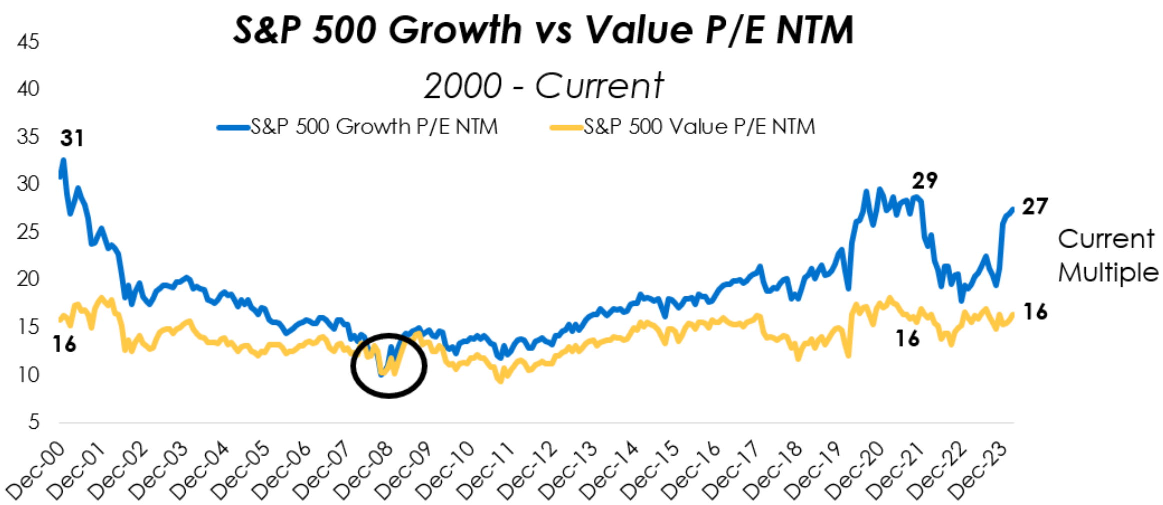
Meanwhile, the cyclical perspective has, admittedly, gotten more "Tricky" of late. Part of this tricky backdrop is related to: (1) being late in the business cycle but earlier in the profit cycle and (2) the disparity among valuations driven by the increased concentration of the market.

With regards to the first point, an extended inversion of the yield curve and limited incremental economic capacity suggests that we remain closer to the end than the beginning of the business cycle. However, the earnings recession that occurred last year is now resolving with an upturn in profit growth expected for this year. The chart below evidences both of these conditions. Our recession indicator remains at comparable late cycle levels while the forecast for S&P 500 earnings growth is for a re-acceleration into next year. We believe this setup requires investors to keep their proverbial "head on a swivel" in recognizing the cyclical earnings improvement while also understanding that its sustainability remains up for debate.



Source: Factset; S&P Dow Jones Indices with EPS defined on a trailing twelve month basis. Yellow Cardinal Research; the Recession Indicator is a proprietary dashboard of financial conditions that historically have provided some lead time on recessionary events. When more than half of the weighted average signals were triggered, this often precluded a recession. The Recessionary Indicator is a weekly signal with the 13 week moving average smoothing the volatility.

With regards to the second point, leadership in the growthier corners of the market has, once again, led to an extended valuation premium that highlights this valuation disparity. As can be seen in the chart on the next page, the forward price to earnings valuation multiple for the S&P 500 Growth index currently trades at 27X versus the S&P 500 Value index at 16X. That eleven multiple point difference is closing in on the other extreme periods back in 2000 and, more recently, at the end of 2021. This valuation disparity has led to a meaningful concentration in the growth index with its "Top10" holdings making up almost 60% of the composite! A key takeaway for us is that this kind of market action has conditioned investors to become accustom to succeeding with much less diversifcation than in the past – regardless of valuation risk.



Source: Factset; ishares S&P 500 Growth and Value ETF used to calculate P/E NTM data. Data as of 3/28/24.

As we look ahead, we think investors might have to think differently or "Open the Aperture" from both a cyclical and secular lens. Alternative scenarios to the existing leadership trends might be beneficial to consider. Given the narrowing set of market conditions, expanding one's investment field of view might lead to the realization that the future opportunity is now in the diversity of the investment universe rather than in the concentrated focus of a few select investments. As noted in the opening, we're encouraged by the expanding market breadth that's been evident more recently and think this market rotation makes sense within the context of the above valuation disparity.

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, consistent with the above view, we continue to emphasize balance across asset classes and market segments while remaining UW to the most expensive and concentrated areas. We also continue to believe that it's important to be cognizant of the potential changing paradigm (i.e. Secular) while also recognizing the recent improving profit cycle setup – albeit within a late-cycle frame (i.e. Cyclical).

Within equities, in acknowledging the increased evidence of a bottoming in the Fundamental data, we recently adjusted our positioning to incorporate more balance geographically and within our US Large Cap exposure. While taking profits in the latter, our bias has generally been to have more exposure to less expensive areas (broader vs top). As such, we've maintained a greater OW in Cyclical Value relative to Defensive sectors combined with a smaller cap bias. We remain UW the most concentrated and expensive Cyclical Growth areas.

Within fixed income, we remain biased toward the higher quality US Core Fixed Income segment – which remains our biggest OW in portfolios for diversification purposes notwithstanding a recent trim of that exposure. Those proceeds were recently redeployed to Emerging Market debt, where we've moved back to equal weight given more attractive spreads and improved fundamental and liquidity conditions. Maintaining an OW to the higher quality US Core Fixed Income segment means that we still remain UW the most cyclical and expensive part of the bond market (High Yield) where spreads have tightened considerably.

Within alternatives, we remain fairly balanced having previously reduced our UW to Real Estate and our OW to Diversified Alternatives as we think valuations in the former have come down to reflect the challenges of this interest rate senstive area.