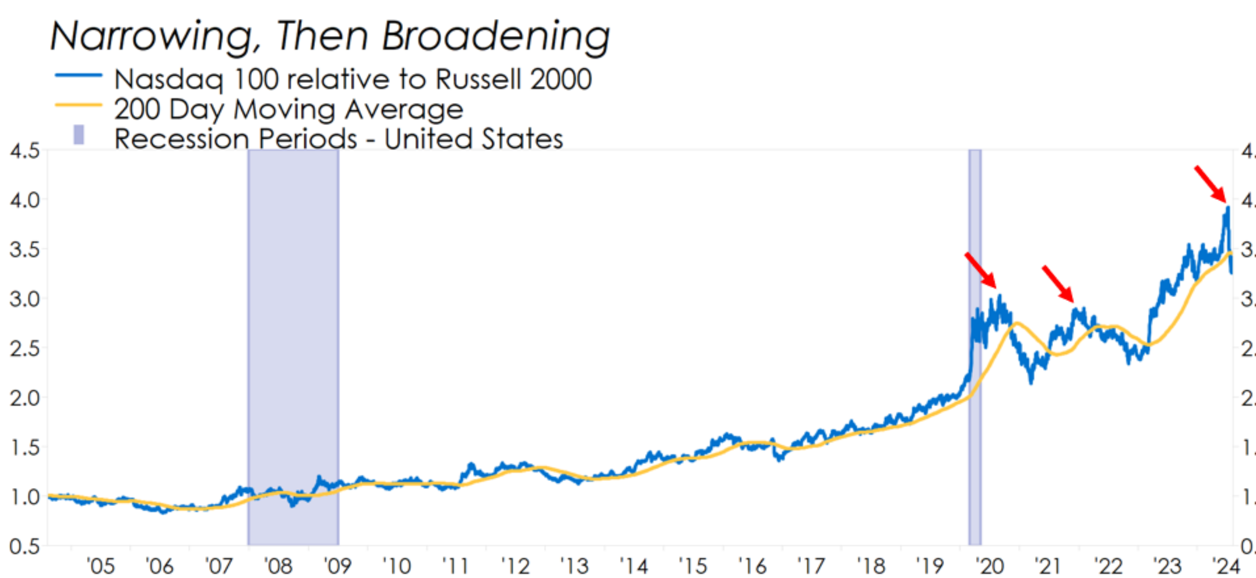
Slowly, Then Suddenly

"Summertime, and the livin' is easy…"

– George Gershwin (1934)

Midsummer days tend to bring to mind the notion of an easy-going, laid-back atmosphere – warm weather, tranquil breezes and a general slowdown of activity. Summer vacation has often been reserved for that getaway time. But investors that took a hiatus this summer may now be coming back to a market that's less recognizable from the one they've left. Let's explain.

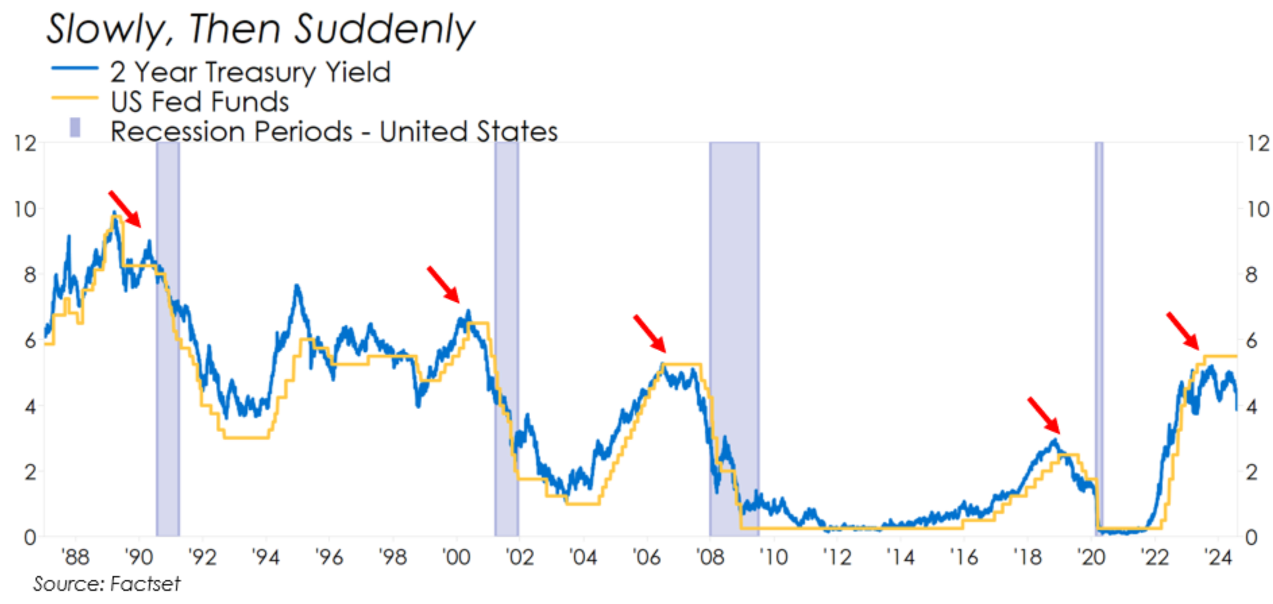
In June, we intimated that select pockets of the stock market had gotten increasingly expensive and incredibly narrow resulting in a very top-heavy S&P 500 index. In brief, the big continued to get bigger. The month of July was the antithesis of that with a major market rotation occurring. Examples abound. Consider that, in June, only three of the eleven US Large Cap sectors outperformed the index – Technology, Consumer Discretionary and Communication Services. That compares to nine of eleven sectors outperforming in July with the above three sectors moving from the top to the bottom of that list. Small Cap companies – as defined by the Russell 2000 index – went from being flat-to-down in June to rallying over 10% in July. Nowhere was this rotation more apparent, perhaps, than in comparing large cap Tech to Small Caps. As can be seen in the chart below, the Nasdaq 100 has outperformed smaller sized companies for the better part of the past two



Source: Factset

decades. Notable exceptions occurred at the end of 2020 (reopening of the post COVID economy) and during the majority of 2022 (big Tech reversal). The reversal in July was the sharpest yet and, in our view, was related to a combination of mean reversion along with investor belief in a true soft-landing scenario. Such a view was supported by the resumption of cooler inflation readings in May and June coupled with softening (but not soft) economic data. This set the stage for a more benign Fed rate cut scenario. But as quickly as that more favorable view came into focus, the last week of July saw another reversal – this time evidencing a more "risk off" tone.

As equity markets were broadening earlier in the month, the rate market was quietly suggesting something more sinister. Since its year-to-date peak of around 5% back in April, the 2 Year Treasury Yield had been slowly trending down – though by the end of July – the move was more sudden and pronounced. As of the time of this writing, the first few trading days of August saw an even sharper move lower. The culprit was deteriorating economic data in the form of a weaker ISM manufacturing report and softer labor market data in the form of weekly jobless claims and July payroll gains. Cyclical softening in some of the big Tech earnings reports added to the narrative. In short, the rate market went from anticipating a slow and benign Fed rate cut scenario to a sudden and more urgent one. This isn't terribly uncommon. As can be seen in the chart below, the 2 Year Treasury Yield tends to anticipate Fed rate policy especially during rate pause moments. Outside of the limited soft-landing sample sizes, the move tends to manifest itself "Slowly, Then Suddenly". Today's move in the 2 Year Treasury now suggests as many as five rate cuts with Fed Funds futures pricing indicating around nine by the end of next year! The point is that the rate market seems to be becoming more concerned about the fundamentals and stocks have started to catch on to the notion. As we've been suggesting for much of this year, investors will need to keep their proverbial "Head on a Swivel" to assess the degree to which a tipping point has been reached. We're staying tuned in.



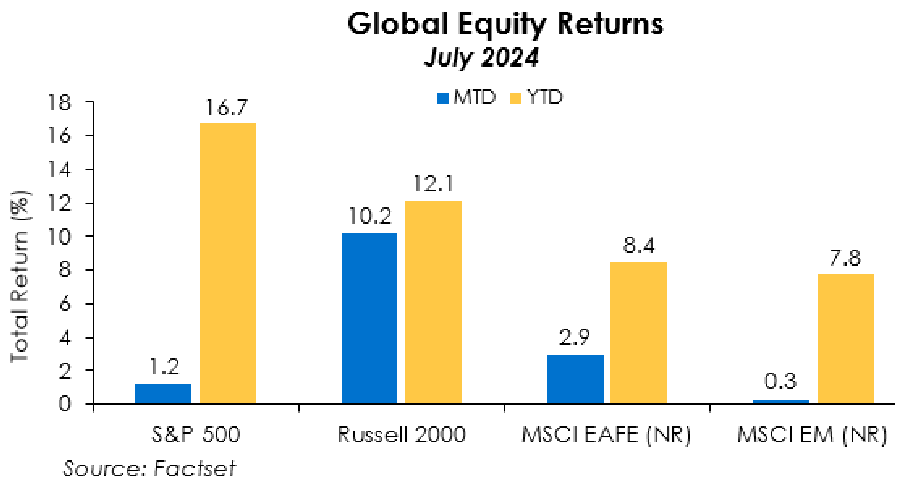
Source: Factset

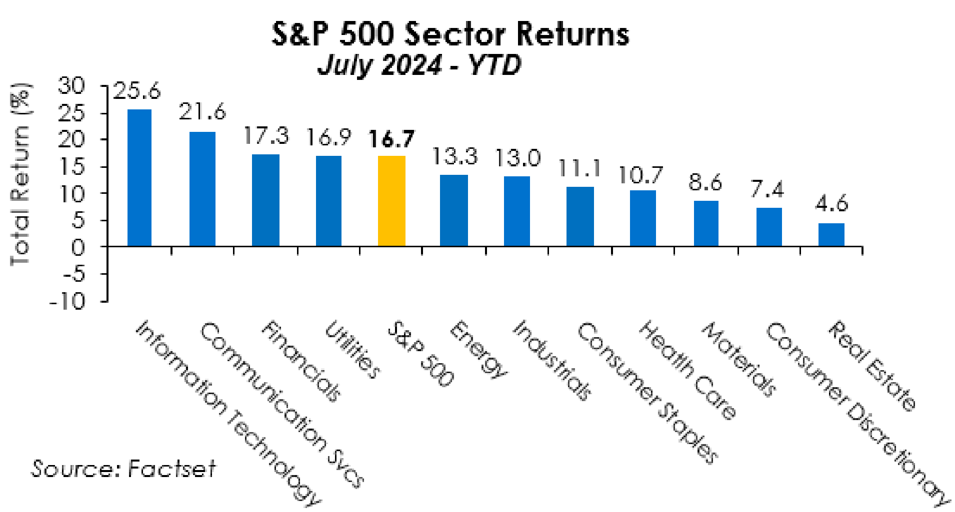
The information contained or topics discussed in this piece are not FDIC insured and are not bank deposit products.
EQUAL OPPORTUNITY LENDER EQUAL HOUSING LENDER FDIC

Stocks, Bonds, and REITs were all up in July while Commodities were negative for the second consecutive month. Year to date returns remain disparate and volatile with Stocks solidy positive and REITS trying to catch up, while Bonds (rallying) and Commodities (weakening) are relatively flat. The S&P 500 continues to lead global equity markets for the year given its growth oriented bias influenced by AI related enthusiasm though returns were much more subdued in July with the market rotation.

Stocks

Stock returns were mostly positive in July with US Small Caps (Russell 2000) leading by a wide margin followed by International Developed Markets (MSCI EAFE), US Large Caps (S&P 500) and Emerging Markets (MSCI EM). US Large Caps (S&P 500) continue to lead year-to-date, though participation broadened significantly in July with nine of eleven sectors outperforming compared to only two (Technology and Communication Services) in the first half of the year. US Small Caps (Russell 2000) surged during the month – significantly closing the performance gap with US Large Caps (S&P 500) – due to expectations of lower rates and an economic soft landing. Overseas, International Developed Markets (MSCI EAFE) have been buoyed by the easing of foreign central banks and improving inflation and (albeit subdued) economic data. Meanwhile, Emerging Markets (MSCI EM) have delivered comparable returns year-to-date, though recently have cooled over concerns of a slowing in China.



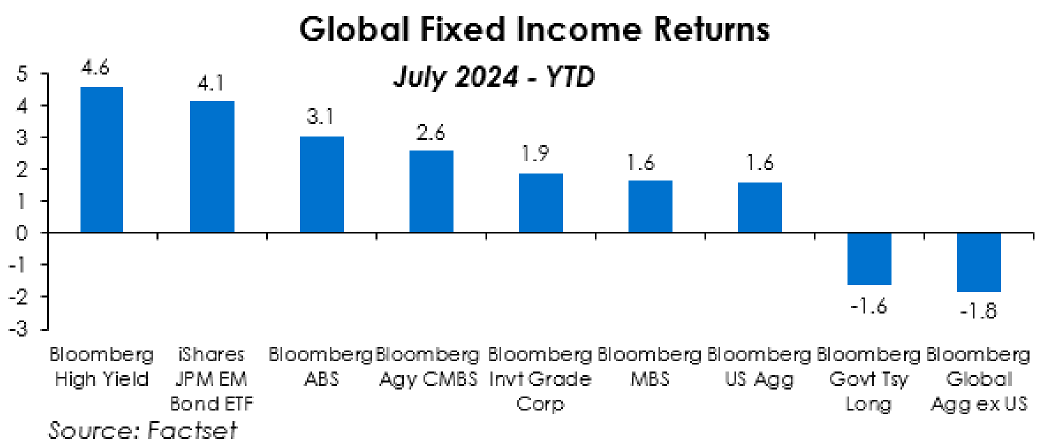


The information contained or topics discussed in this piece are not FDIC insured and are not bank deposit products.

EQUAL OPPORTUNITY LENDER · EQUAL HOUSING LENDER · FDIC

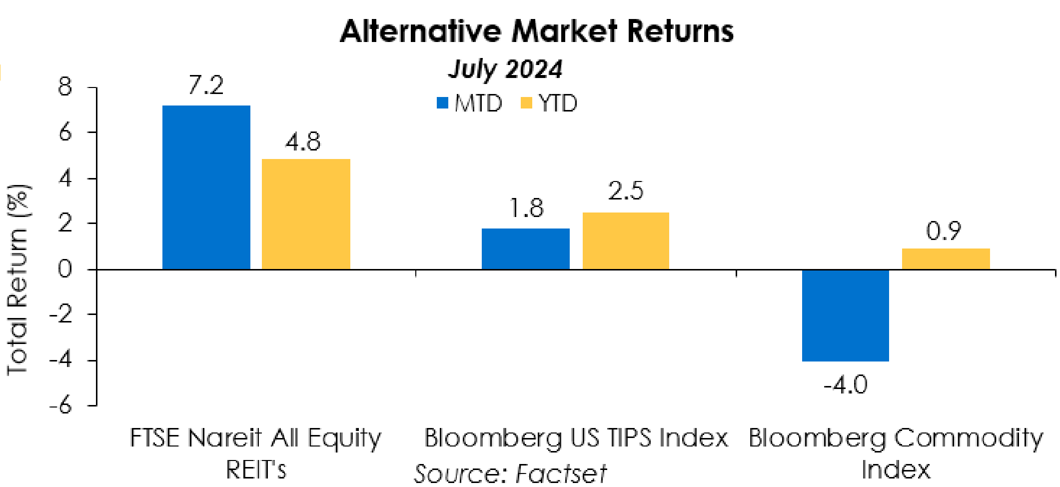
Bonds

Following aggressive moves by the Fed (Fed Funds at 5.25-5.50%) amid ongoing (albeit slowing) balance sheet reduction – policymakers have indicated a "wait and see" approach with rates unchanged at the last eight meetings. In July, the Fed highlighted risks to both sides of its dual mandate (price stability & full employment) while indicating an increased likelihood of rate cuts later this year. Subsequent weak employment and economic data, now have the bond market pricing in significant rate cuts through the end of 2025.



Consequently, Bonds rallied in July, though year to date returns have been more modest – generally in the low single digits. The exceptions were Long Dated Treasuries and the Global Agg ex US which have posted slightly negative year to date returns due to their longer durations.

Alternatives



Commodities traded lower in July and are now marginally positive for the year as strong returns in Precious Metals have been mostly offset by weakness in Energy and Agriculture. Meanwhile, publicly traded Real Estate (REITs) rallied notably this month as expectations for future rate cuts increased. Finally, returns on Treasury inflation protected securities (TIPs) underperformed nominal Treasuries as concerns about sticky inflation have begun to recede.

The information contained or topics discussed in this piece are not FDIC insured and are not bank deposit products.

EQUAL OPPORTUNITY LENDER · EQUAL HOUSING LENDER · FDIC

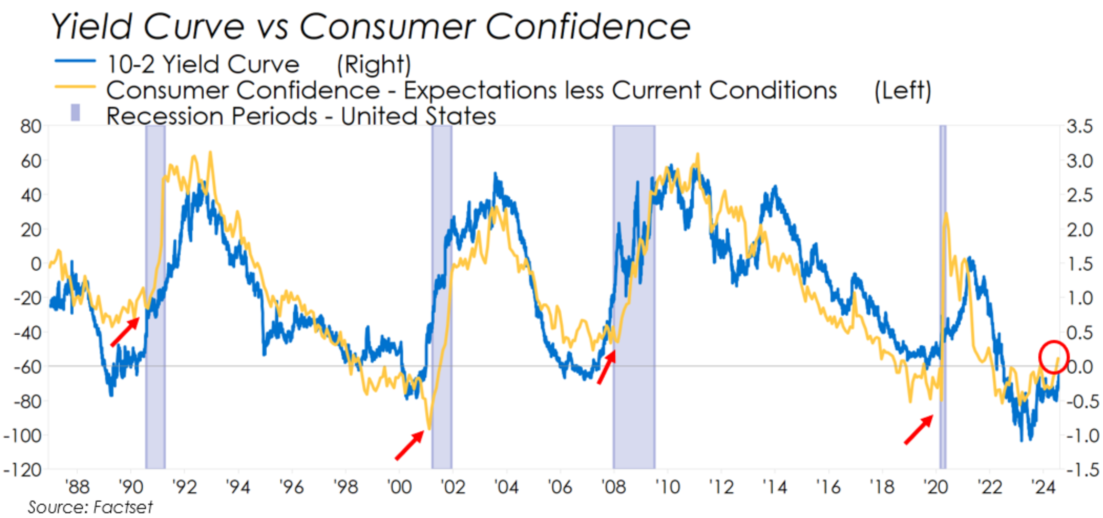
Market Outlook

"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.

While the secular view remains up for debate, 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) not to mention building pressures on the federal deficit.

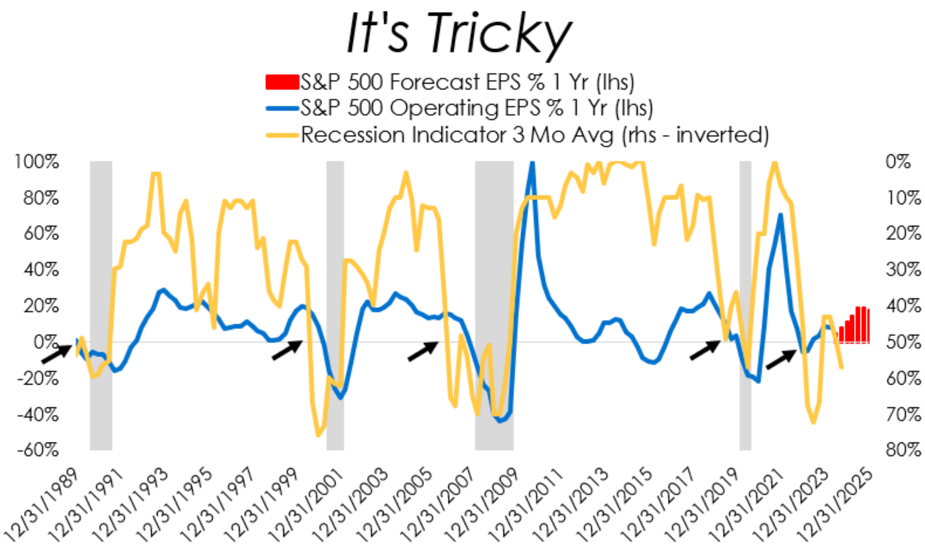
For now, those secular thoughts are taking a back seat to the cyclical view where the rate market is suggesting a material change in the growth and inflation backdrop. The "slow, then sudden" drop in the 2 Year Treasury yield is implying the need for an acceleration in Fed rate cuts that presumably gives way to a steeper yield curve. As can be seen in the chart at right, the yield curve tends to un-invert and steepen as current consumer



confidence conditions weaken relative to future expectations. This tends to be associated with a late-cycle environment that necessitates a need for an acceleration in Fed rate cuts. While this confidence measure is not yet as pronounced as its been in other periods, it's directionally moving in a way that is consistent with a steeper yield curve.

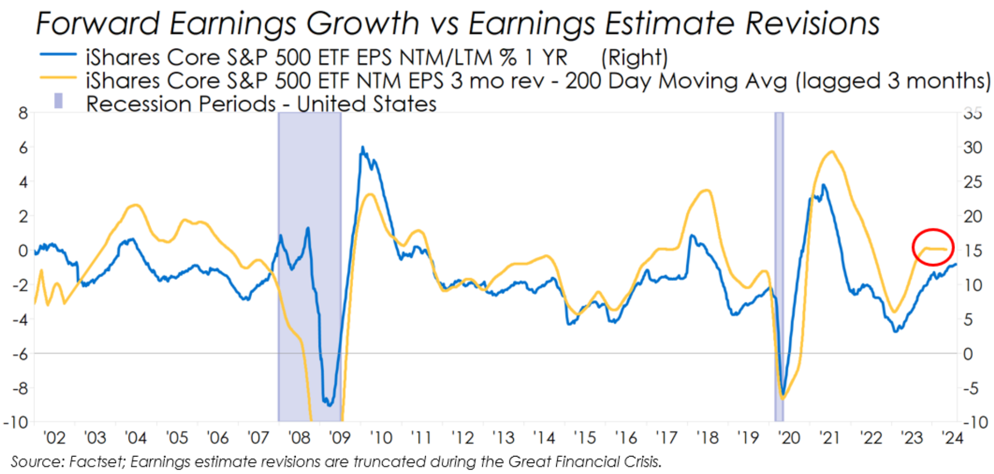
The above suggests that the cyclical perspective remains in "Tricky" territory. That's partly because fundamental data has, for now, evidenced a late business cycle frame but earlier profit cycle picture.

The potential un-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 throughout this year. The chart at right evidences both of these conditions. Our recession indicator continues to register comparable late cycle levels while the consensus forecast for S&P 500 earnings growth shows 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 operating 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.

We'll be watching our top-down leading profit cycle indicators to help catch any changes in earnings growth expectations. To that point, the latest ISM manufacturing report indicated some weakness though we'll want to see this carry through to some other indicators as well. Bottom-up earnings estimate revisions should be another good signpost. Here the results indicate a plateauing effect. As can be seen in the chart below, the trend in earnings estimate revisions (yellow line) has leveled off which has yet to be seen in the (next twelve month) earnings growth rate (blue line). This leveling off, while not disasterous, does indicate a maturation in the profit cycle with the debate over how quickly that's occurring.



Source: Factset; Earnings estimate revisions are truncated during the Great Financial Crisis.

While there's been some recent valuation adjustments for Stocks, significant disparity remains particularly within US Large Caps. To that point, the top of the market still carries with it a much higher price to earnings ratio than the majority of its members. According to Factset data, consider that since the end of 2009, the "average" stock (as defined by the equal weighted S&P 500) is trading at a 21% discount to the market (as defined by the cap weighted S&P 500 index) versus its historical discount of about 5%. Similarly, the valuation difference between the S&P 500 Growth and Value indices are just off the extreme readings witnessed back in late 2021 and before that the Tech Bubble peak. The bottom line is that the highest valuations remain concentrated in the hands of the largest and growthier weights in the index. A key takeaway for us is that this kind of market action has conditioned investors to become accustomed to succeeding with much less diversifcation than in the past – regardless of valuation (and mean reversion) risk.

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 pre-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. We think the recent market indigestion might be the beginning of this recognition.

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 earlier profit cycle setup – albeit within a late-cycle frame (i.e. Cyclical).

Within equities, in acknowledging the improvement in the profit cycle year-to-date, our positioning incorporates 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 and a lesser OW in Defensive sectors combined with a smaller sized 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 – where we are longer in duration and are actively repositioning our Treasury exposure to take advantage of the steepening yield curve. This remains our biggest OW in portfolios for diversification purposes though we've also recently added to International Fixed Income, where the end of negative interest rate conditions has led to more attractive opportunities. Maintaining a higher quality bias means that we still remain UW the most cyclical and expensive part of the bond market (High Yield) where spreads remain tight (though have recently started to widen).

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 and are now bottoming consistent with the lower trend in rates.

The information presented in the material is general in nature and should not be considered investment advice, is not designed to address your investment objectives, financial situation or particular needs. Information is gathered from sources deemed reliable but its accuracy or completeness is not guaranteed. The opinions expressed herein may not come to pass, are as of the date of publication and are subject to change based on market, economic or other conditions.

You cannot invest directly in an index. Indexes are unmanaged and measure the changes in market conditions based on the average performance of the securities that make up the index. Investing in small and mid-cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. Asset allocation and diversification does not ensure a profit or protect against a loss.

Yellow Cardinal Advisory Group, a division of First Financial Bank, provides investment advisory, wealth management and fiduciary services. Yellow Cardinal Advisory Group does not provide legal, tax, or accounting advice. The products and services made available by Yellow Cardinal Advisory Group:

Not Deposits | Not FDIC Insured | Have No Bank or Federal Government Guarantee | May Lose Value