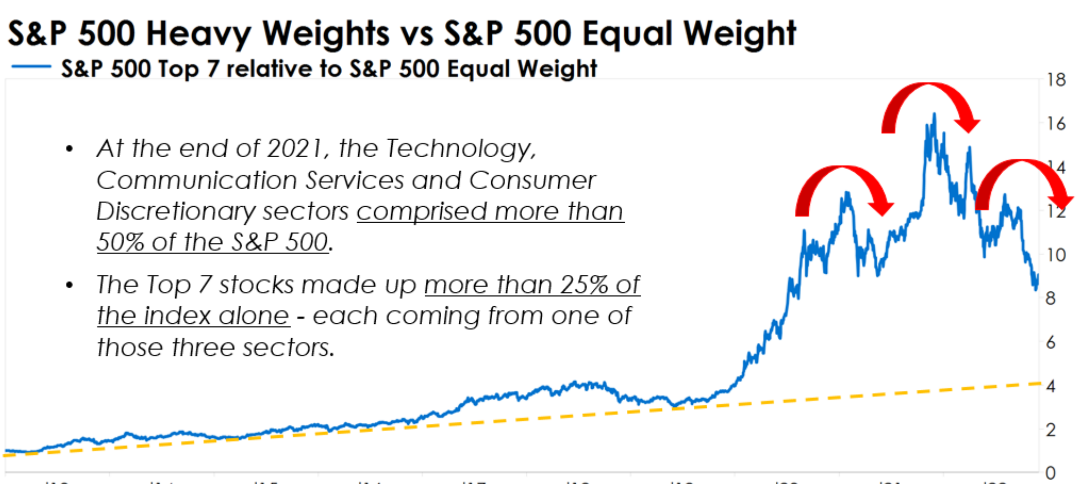
The Top Continues to Top

"In bear markets, stocks return to their rightful owners."

– John Pierpont Morgan (1837-1913)

The term "Top Heavy" is defined as to be disproportionately heavy at the top so as to be in danger of toppling. Top heavy items can be used to describe everything from pieces of furniture to organizational hierarchy to animals (the gangly giraffe or moose come to mind). We also think "Top Heavy" is an apt description of how the equity market has evolved over the last decade or so.

This becomes especially evident when one considers how the composition of the S&P 500 index has changed over the recent past. At the end of last year, the concentration of sectors and companies became especially pronounced. Amazingly, just three of the eleven sectors – Techology, Communication Services and Consumer Discretionary – were so dominant in the ten years prior that they represented more than 50% of the total index to begin this year. Just as incredible, the top seven companies in the index made up more than 25% of its market cap – each one coming from one of those three sectors. As can be seen in the chart below, comparing the performance of these top seven stocks relative to an equal weighted S&P 500 index shows the dramatic run up – and now – the dramatic reversal. While the global pandemic and economic shutdown supercharged the performance among these heavyweights, the interest rate and inflation regime shift has placed a heavy burden on their valuations.

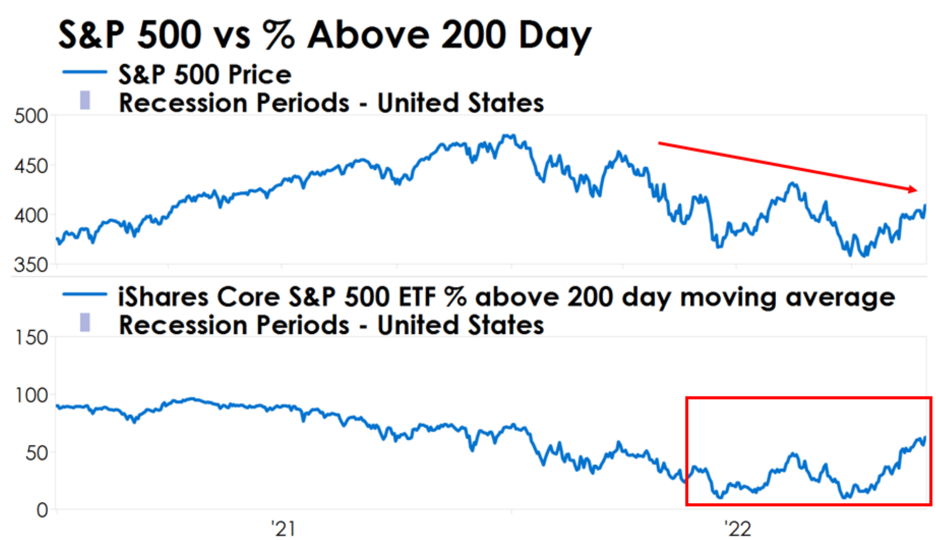


Source: Factset; Top 7 comprised of equal weighted composite of AAPL, MSFT, GOOGL, AMZN, TSLA, META and NVDA.

We've referred to this dynamic by saying, "the Top Continues to Top" as investors are grappling with the notion that businesses (and stock valuations) geared to take advantage of the free money era that we've enjoyed over the last decade may now be ending. We think the bear market has signaled this changing leadership shift as illustrated by the chart on the prior page.

Our quote this month comes from the famed John Pierpont Morgan, who more succinctly described this concept more than a century ago. Bear markets often signal a leadership change whereby the winners of the past – with presumably elevated valuations – come back down to earth as the market separates the (fewer) owners from the (many) renters.

Another way to highlight the notion that "the Top Continues to Top" is to say that the average stock is gaining ground on the index. The charts below are one way to illustrate this idea by highlighting that the S&P 500 price (top chart) has recently been making lower highs while the % of stocks above the 200-day moving average (bottom chart) has been going the other way. This is often referred to as a positive divergence – generally an indication that something more favorable is happening under the surface of the market. In short, this implies that the heavyweights are feeling the pressure while the average stock is showing improvement.



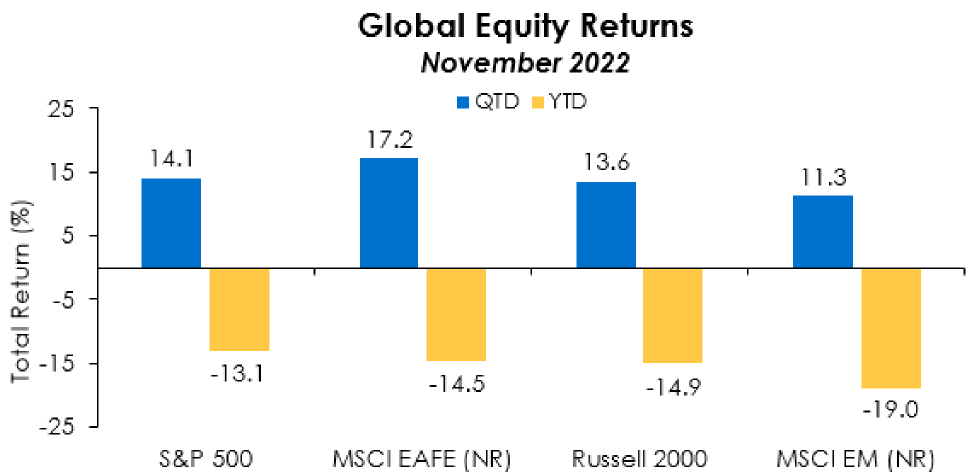
Source: Factset; S&P 500 based on ishares IVV ETF.

A similar dynamic played out in the 1999-2002 time period – nothwithstanding the recession impact that also occurred. This time period also had the historical parallel of a concentration buildup in the S&P 500 index related to the Tech bubble. According to S&P Dow Jones Indices, the top seven companies made up a little more than 20% of the index at the end of 1999 (since 1980, the only other times it eclipsed that concentration mark was in 2020 and 2021). The same three sectors (Telecom was reconsituted into today's Communication Services sector) dominated the index back then making up almost 60% of it at the peak on March 24, 2000.

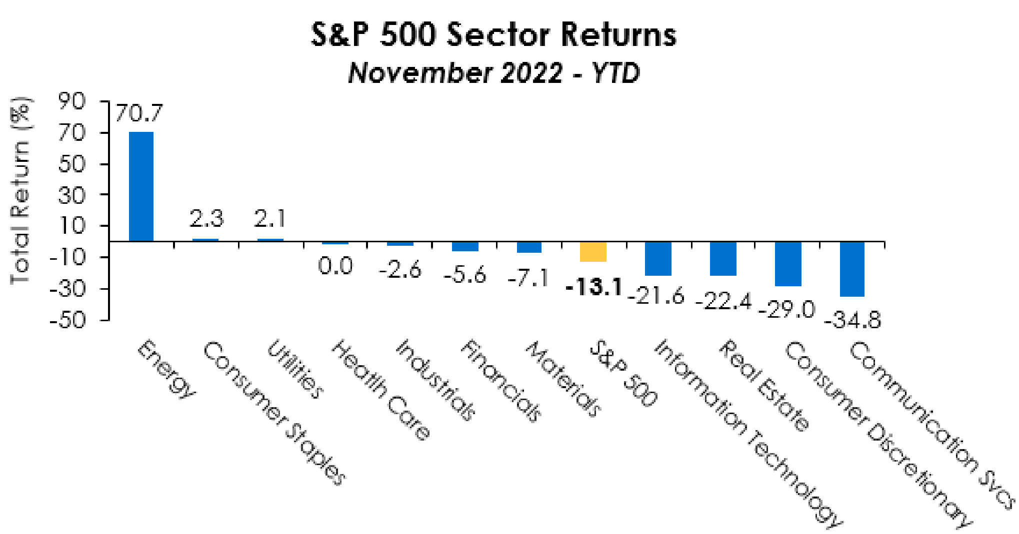
The bottom line is that we think – as much as investors might fight the urge to believe – bear markets often signal changes in leadership and this one looks to have started at the very top.

After heady returns for risk assets in 2021, performance reversed course in most of these areas in 2022. While the S&P 500 just turned in its best two-month rally since November-December 2020, earlier this year witnessed Stocks suffering their worst 12 month stretch since 2009. Similarly, Bonds have seen their worst intra-year drawdown dating back to the mid '70's. Rising rates and inflation have been the story while Commodities have been the lone bright spot year-to-date.

Stocks

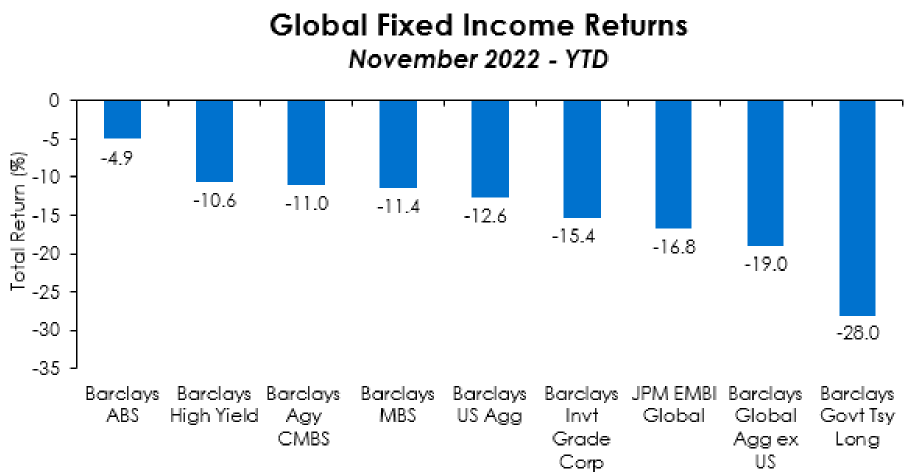


Stocks followed up an especially weak Sepember with a nice bounce back in October and November amid hints of cyclicality with a reversal of trends seen year-to-date. As such, International markets (MSCI EAFE and MSCI EM) were helped by a weaker dollar and positive returns were seen in every S&P 500 sector quarter-to-date (though this still only left three sectors in the black for the year). Sector performance has generally favored the less expensive, late cycle cyclicals (Energy, Industrials, Financials and Materials) along with the more traditionally defensive areas (Consumer Staples, Utilities and Health Care). Higher priced, early cycle sectors (Discretionary, Technology and Communication Services) along with Real Estate have been underperformers (up less quarter-to-date and down more year-to-date).



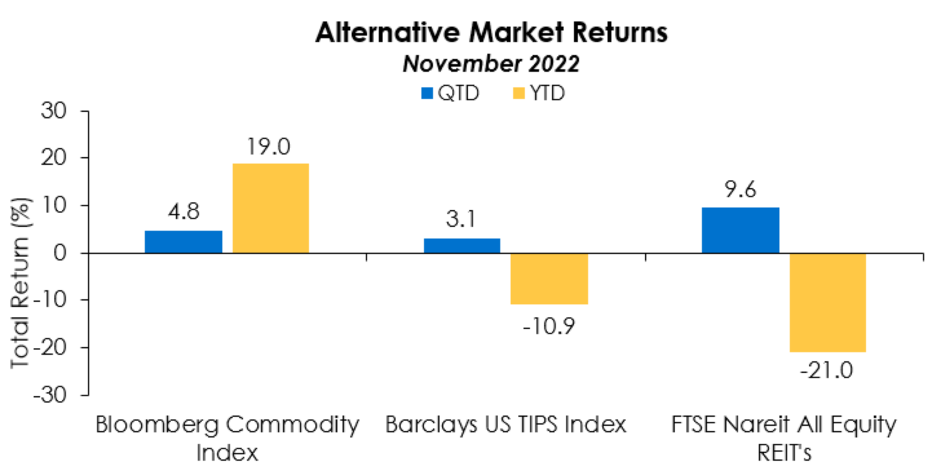
Bonds

For the year, bond returns remained in negative territory amid the continuation of an upward rate bias consistent with elevated and persistent inflation. As such, the Fed has hiked short term rates by 375 basis points (to 3.75-4.0%) and continues to reduce its balance sheet. While the Fed fights inflation as growth expectations slow, the yield curve has inverted and rates have recently moderated off their cycle highs especially on the long end. Meanwhile, Fed Fund futures pricing (~5.0%) remains modestly higher than Fed forecasts (4.5-4.75%). Year-to-date, bonds that carried shorter durations – namely Securitized Assets (ABS, MBS, CMBS) – were better insulated. Credit began to move wider last November (Omicron) and into this year (Fed and Russia) to levels not seen since mid to late 2020 – though have come in more recently given the more cyclical market tone. High Yield outperformed relative to Investment Grade corporate bonds – helped by higher carry and shorter duration positioning along with a tightening of spreads of late. The most duration sensitive areas including long-term Treasury bonds and Emerging Market Debt (Govt Tsy Long and JPM EMBI Global) were among the hardest hit. Long duration Treasuries remain most sensitive to inflation while International bonds have been hit by the material strength in the dollar – though both have posted positive returns quarter-to-date.



Alternatives

Alternatives generated the most disparate of returns year-to-date. Publicly traded Real Estate (REIT's) remained under pressure though saw a nice bounce quarter-to-date. Meanwhile, Commodities posted among the best (and positive) returns for the year – acting as a strong inflationary hedge with particular strength in Energy and Agriculture – though returns lagged other risk assets quarter-to-date.



Market Outlook

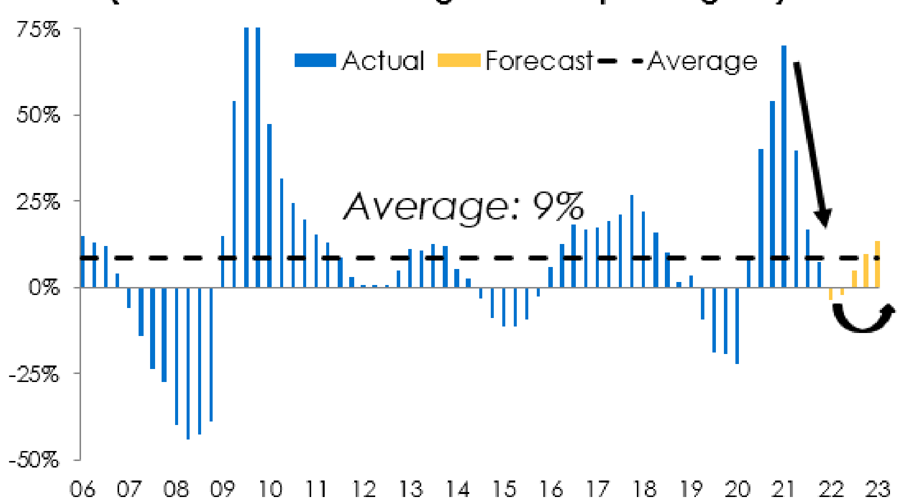
"Woods are not like other spaces…Stand in a desert or prairie and you know you are in a big space. Stand in the woods and you only sense it."

– Bill Bryson, *A Walk in the Woods* (1998)

We're dubbing our main theme for next year as "Seeing both the Forest AND the Trees". As such, we think it's especially important to have 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 economic paradigm is changing to one that ushers in the potential for more persistent inflation which is likely to result in a higher cost of capital world. We find historical parallels today to the higher 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 doesn't wish to repeat any time soon. Additionally, we believe there are structural considerations that exist today that might also support this changing paradigm including; a step change in the money supply, contracting globalization as well as structurally tight labor markets and the energy complex.

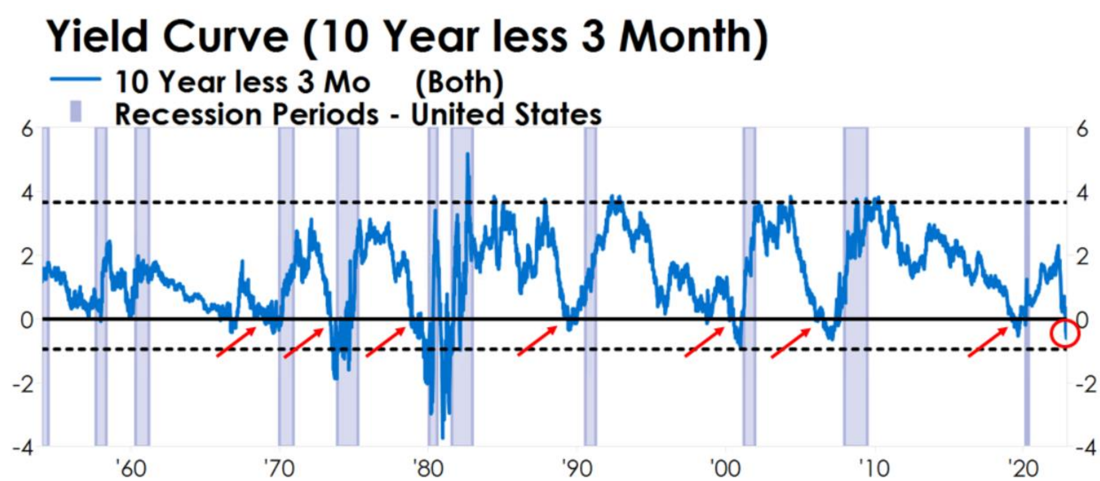
The S&P 500 Profits Cycle (Year-on-Year % Change in TTM Operating EPS)



Source: S&P Dow Jones Indices

At the other end of the spectrum is the cyclical perspective, which we think is more important right now given its more immediacy and current divergence from the secular view – at least for a time. For much of this year, we've used the phrase "Moderate Resilience" as a way to best describe the fundamentals. It's clear that growth is moderating and is expected to continue to do so as the cycle matures. However, growth in nominal terms has been somewhat resilient for much of this year given the lagged effect of well above average liquidity from last year. In essence, companies have raised prices on goods and services with minimal demand destruction because of the influx of cash from the prior two years. That may be starting to change as the Fed continues to tighten policy and as savings rates have dramatically declined. In short, liquidity is being drained from the system which acts with a lag on growth. As we look into 2023, one question to consider is whether the emphasis will be more on moderation or resilience. In other words, will late cycle conditions lead to a "pause and refresh" or a "profits/economic recession"? As can be seen in the chart on the prior page, the consensus believes in the "pause and refresh" story as indicated by the reacceleration of earnings growth shown in the yellow bars. Given the late cycle setup, we think the risk for earnings estimates is to the downside especially in the absence of an obvious growth catalyst.

To further support that view, most of the macro fundamental data is evidencing a slowdown and our leading profit cycle indicators point to the continuation of a growth deceleration ahead. If forward earnings estimates prove to be too optimistic and need to fall further (NTM EPS is 3% off the highs), then stocks might be more expensive than they appear (18.5-19.5X vs current 17.6X). This comes at a time when stocks have not quite fallen to levels where multiples have typically bottomed over the past thirty years (10-15X). Similarly, more of our leading recessionary indicators are getting triggered suggesting that while recession isn't necessarily imminent, the storm clouds are brewing for one on the horizon. To that point – this past month – further yield curve measures reached inversion status. That is to say that longer term interest rates fell below shorter term interest rates. Historically, this is an abnormal economic condition that usually signals a late business cycle setup consistent with eventual economic recessions. As can be seen in the chart below, a negative interest differential between the 10 Year Treasury and the 3 Month Treasury has been among one of the better signals for recessions (shaded regions) over the past 50 years. Essentially, this is confirmation that Fed policy works – and works with a lag. We also find it notable that the bond market is now pricing in significant Fed rate cuts by year end 2024. And, since 1980, Fed easing cycles have coincided with recessions 75% of the time.



Source: Factset

In short, we think investors have to contend with three headwinds right now (1) valuations that might still have to reset a little further (2) earnings that may prove to be too optimistic (3) and a Fed that is aggressively tightening to catch up to inflation. While investors remain extremely hopeful for a Fed pivot, we can't help but wonder if markets are just trading one cyclical risk (Inflation) for another (Recession). All of this is to suggest that, not surprisingly, it doesn't appear to be a great set up for risk assets from a cyclical point of view.

So what are the implications and key takeaways for portfolios?

With an eye on both the Secular and Cyclical views, we think it might makes sense to keep two simple phrases in mind – *"Do the Opposite"* and *"Buy the Boring"*:

Seeing Both the Forest AND the Trees

Secular View (Longer-Term)	Cyclical View (Shorter-Term)
"Do the Opposite"	*"Buy the Boring"*

- From a longer-term point of view, if the economic paradigm is changing, then it may pay to *"do the opposite"*. In other words, the relative winners over the past 10-15 years may not be the same winners over the next decade. Businesses that took advantage of free money to leverage up their balance sheets in the hopes of high growth payoffs far out in the future may now offer greater risk in a higher cost of capital world. Conversely, the losers over the past 10-15 years may now become the new areas of opportunity. These might include companies built to be a bit more insulated from inflation with more balanced business models, more immediate cash flows and a focus on the bottom line.
- From a shorter-term point of view, late cycle conditions that might suggest we're trading one cyclical risk (Inflation) for another (Recession) argue to *"buy the boring"*. Should growth continue to slow leading to a profit and/or economic downturn, it might be more beneficial to buy the things that people need over the things that people want.

From a portfolio positioning perspective, we continue to believe that it's important to "See both the Forest AND the Trees". To us, that means managing the overall exposure and mix of risk assets consistent with a maturing cycle (i.e. Cyclical) while also being cognizant of the potential changing paradigm (i.e. Secular). Over the last several months, we've given an increased weight to the cyclical over the secular as we've reduced portfolio risk. Broadly, this involved (1) reducing risk assets by trimming Stocks and REIT's and adding to US Bonds (2) lowering the beta within US LC Equities by trimming our OW to Cyclical Value sectors and adding to our OW in Defensive sectors and (3) lowering the beta within US Bonds by lengthening duration back to a net long posture. In essence, we continue to downshift risk in portfolios given the late cycle setup.

Within equities, our positioning is in line but continues to favor a value sector tilt while also leaning toward the more traditionally defensive sectors (Staples, Health Care, Utilities) within our US LC exposure. We continue to be decidedly UW the most expensive, cyclical growth areas (Tech, Discretionary, Communication Services).

Within fixed income, we remain UW the most cyclical parts of the bond market (High Yield and Emerging Market Debt) while our US Core Fixed Income exposure remains among our biggest OW in portfolios. Our US Core Bond managers are modestly OW corporate bonds, though we've recently moved up in credit quality by adding some Treasuries and lengthening duration consistent with a downshifting of risk in portfolios.

Within alternatives, we're OW in aggregate with a bit more defensive skew. We remain the most OW to Diversified Alternatives which provides some hedge against market volatility (especially in an environment where there's lower correlations between stocks and bonds). We're more modestly OW to Commodities as a way to bolster inflationary hedges. Meanwhile, Real Estate was trimmed of late as a way to further reduce overall portfolio risk.