

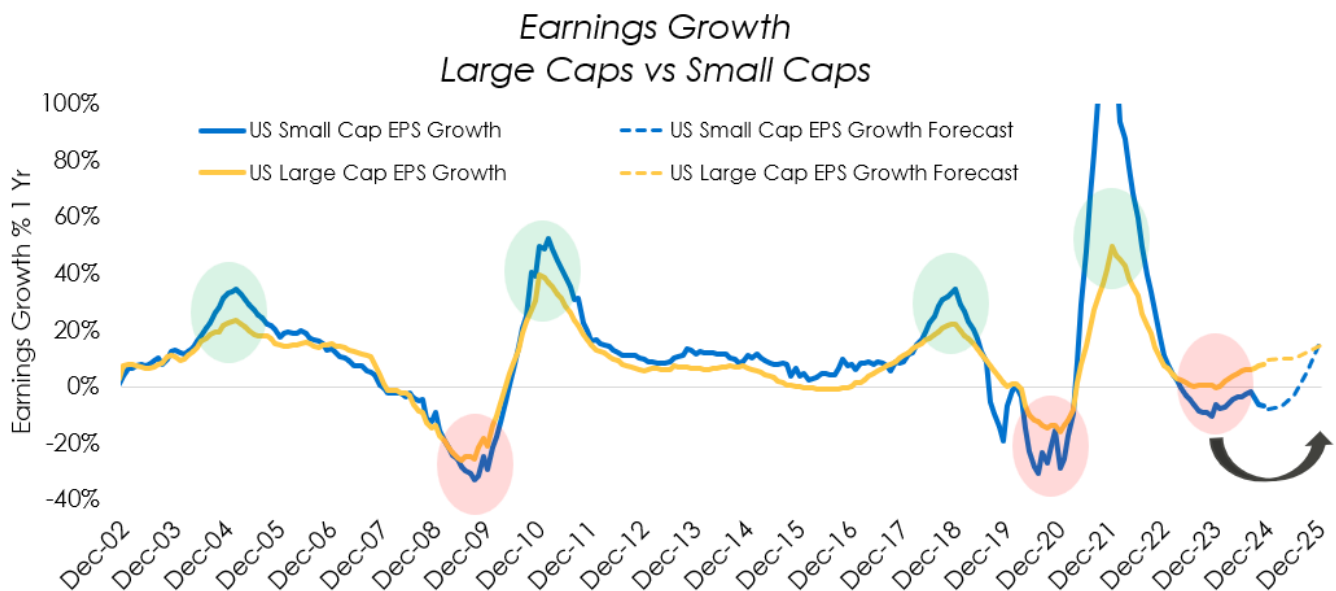
# Pick Your Persuasion

*“Whether you think you can, or you think you can’t – you’re right.”*

– Henry Ford (1863-1947)

It’s often been said that perception is reality. How one person perceives a situation might be decidedly different than another. Often, it’s the interpretation of the event that can influence the outcome. Investors are no different in how they might interpret the data. Prognosticating can be a fickle exercise where outcomes are anything but guaranteed. The best one might do is make observations and piece together context. We try to be as dispassionate as possible in doing just that so that the weight of the evidence might reveal which way the scale is tilted.

One of the more critical fundamental factors that we focus on is the corporate profit cycle. That’s because earnings are the structural building block in helping one determine the value of a company’s stock. As can be seen in the chart below which details the growth in earnings among Large Cap (S&P 500) and Small Cap (S&P 600) companies, corporate profit growth ebbs and flows. Sometimes earnings growth is accelerating, sometimes its slowing and sometimes its contracting. Also noteworthy is the greater magnitude in the peak and



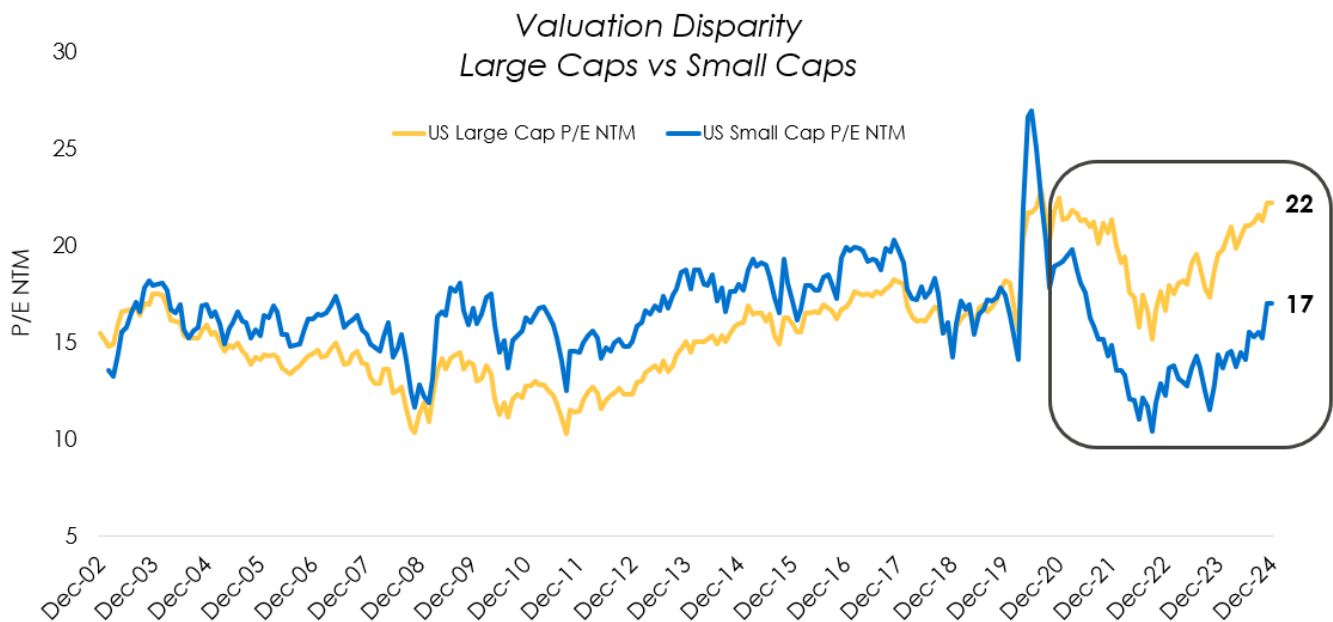
Source: Factset. US Large Cap EPS growth is sourced from the iShares S&P 500 ETF (IVV). US Small Cap EPS growth is sourced from the iShares S&P 600 ETF (IJR). Earnings growth is calculated using the year over year change in the trailing twelve month operating earnings. Forecasts are based on consensus operating earnings. September 2021-January 2022 is truncated for US Small Cap EPS Growth post COVID.



trough among smaller sized companies as can be seen in the shaded regions. That dynamic is largely associated with a company’s operating leverage or the degree to which its earnings growth is levered by its revenue growth. Smaller companies tend to have a higher proportion of fixed (versus variable) costs resulting in higher operating leverage and therefore a more magnified profit cycle.

This year, we’ve observed that large cap earnings growth has recovered from the very modest profit’s recession witnessed last year. Small cap earnings growth, on the other hand, has continued to endure a more pronounced earnings degradation associated with the operating leverage dynamic (as mentioned above) along with their greater financial leverage (higher debt costs) and the impact of higher interest rates. As we roll the calendar forward, 2025 earnings forecasts suggest a much better year for smaller sized companies as earnings growth accelerates and closes the gap with their larger cap brethren. The rationale for this might be a host of reasons: the natural evolution and base effect of the profit cycle, the Fed now lowering interest rates (75 bps or 0.75% at the time of this writing) or the fiscal backdrop suggestive of de-regulation and extended tax cuts. Whatever your persuasion, the extent to which earnings growth accelerates and broadens should be favorable for smaller sized companies that have the leverage to benefit.

The other noteworthy observation is the valuation difference that exists up and down the market cap scale. As can be seen in the chart below, the valuation dynamic between smaller versus larger companies has completely flipped. The valuation premium that once existed for smaller sized companies has now become a notable discount. If earnings growth accelerates and broadens, one wonders if investors will start to recognize the attractiveness exhibited among smaller sized businesses. Time will tell if this perception becomes reality.



Source: Factset. US Large Cap EPS P/E NTM is sourced from the iShares S&P 500 ETF (IVV). US Small Cap EPS P/E NTM is sourced from the iShares S&P 600 ETF (IJR).

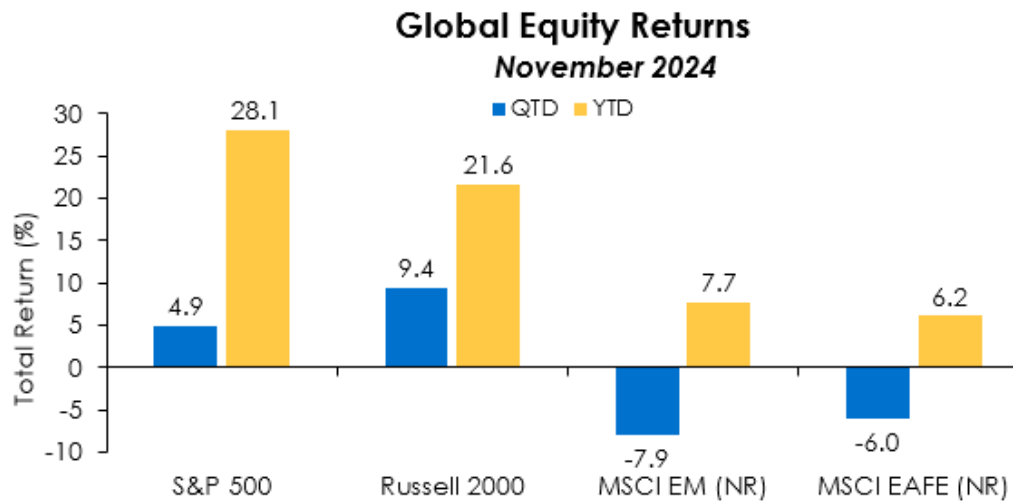


Domestically oriented Stocks, Bonds, and REITs all posted positive returns in November as investors embraced President Elect Trump’s promises of de-regulation and tax cuts. Year-to-date returns remain tiered with Stocks and REITs up the most while Bonds and Commodities are generally up low to mid single digits. The S&P 500 continues to lead global equity markets for the year given its growth oriented bias influenced by AI related enthusiasm.

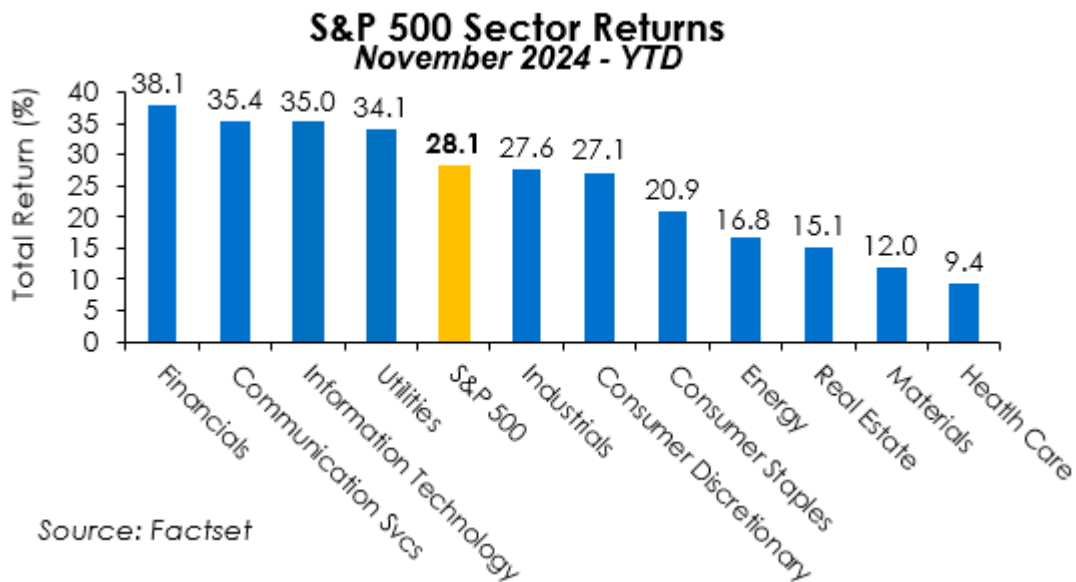
## Stocks

Domestic stocks posted strong returns for both the month and quarter-to-date with weak results in international markets as

the U.S. dollar continued to strengthen. U.S. Large Caps (S&P 500) continue to lead year-to-date – but gave up ground during the month as the market broadened out. US Small Caps (Russell 2000) surged in the quarter – mostly in November – as investors bet interest rate & tax cuts along with deregulation would benefit smaller companies. Overseas, International Developed Markets (MSCI EAFE) were down as the dollar rose and money flowed into domestic equities. Emerging Markets (MSCI EM) lagged amid ongoing questions regarding the effectiveness of China’s stimulus programs and the impact that US tariffs might have.



Source: Factset



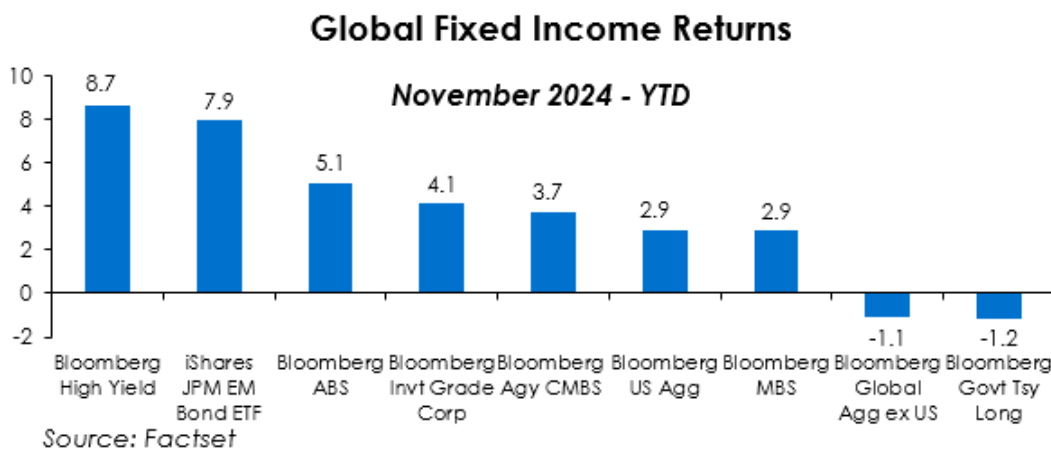
Source: Factset



## Bonds

Amid ongoing (albeit slowing) balance sheet reduction – policymakers have now pivoted to an easing bias by reducing the Fed funds rate by fifty basis points at their September meeting and another twenty five basis points at their November meeting (Fed Funds at 4.50-4.75%). This easing bias is the first in over four years as policymakers have emphasized balanced risks to both sides of their dual mandate (price stability & full employment). The Fed is now forecasting about four to five additional rate cuts (25 basis points per) through the end of 2025.

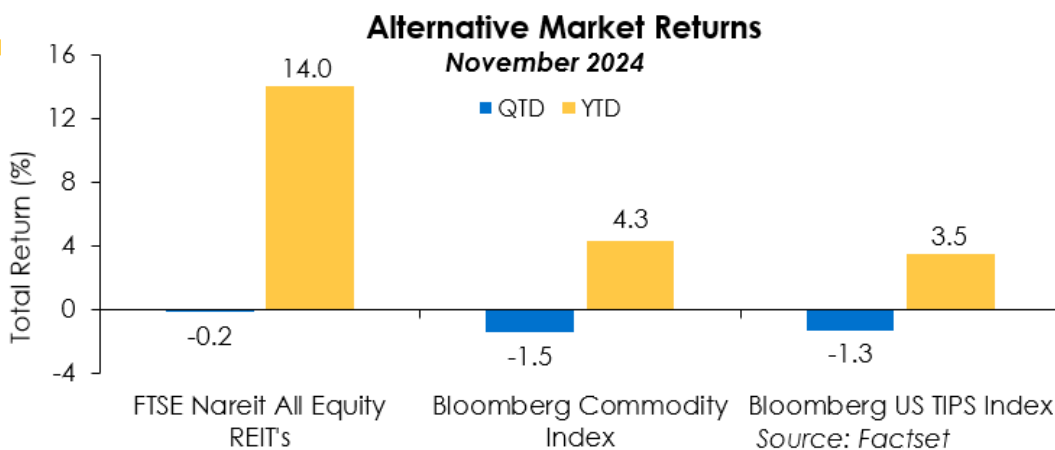
Bond returns were modestly positive in November helped by declines in longer dated yields (following their notable rise immediately after the Fed's first round of rate cuts). Year-to-



date, Bond returns have been modest compared to Stocks – generally in the low-single digits. Credit (High Yield) and Emerging Markets (JPM EM) have been among the best performing areas for the year. Long duration Treasuries and the Global Agg ex US continue to lag as rates have risen and the dollar has rallied.

## Alternatives

Commodities were slightly lower quarter-to-date while posting positive returns for the year – primarily due to the strength of precious metals. Meanwhile, publicly traded Real Estate (REITs) was flat in the quarter but up more comparably with Stocks for the year. Finally, year-to-date returns on Treasury inflation protected securities (TIPs) outperformed nominal Treasuries amid rising inflation expectations of late.



## 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)

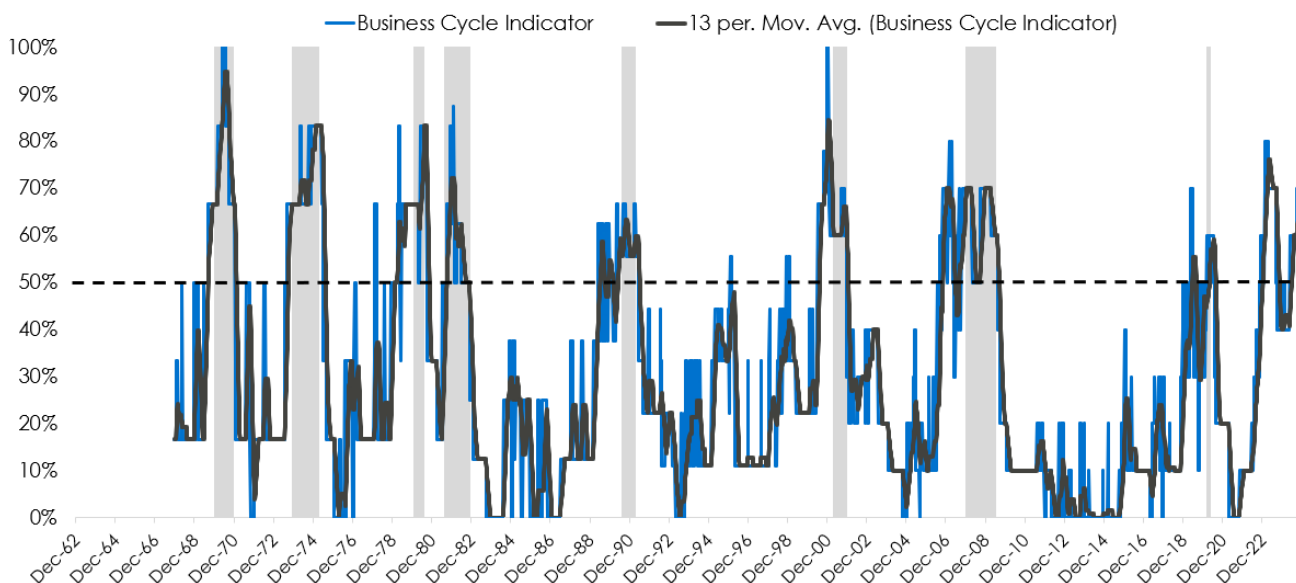
As the page will soon turn to 2025, we’re focused on a “three cycle” framework – one later (Economic Cycle), one earlier (Profit Cycle) and one decidedly different (Fed Cycle). This makes for the continuation of a Tricky backdrop that requires investors to keep their proverbial eyes up and “Head on a Swivel”.

### *It's Tricky*

Cycle	Stage
Economic Cycle	Later
Profit Cycle	Earlier
Fed Cycle	Different

While only four years removed from the (short) COVID induced recession, we’re more than fifteen years removed from the one prior to that. But its not just the duration that suggests were on the later side of the economic cycle. Several fundamental data points including the yield curve, leading economic indicator composites and especially labor market measures suggest a similar conclusion. As can be seen below in our business cycle indicator, an increased percentage of measures being triggered is additional confirmation that we remain at comparable late cycle levels in the economy (with recessions designated by shaded regions).

### Business Cycle Indicator

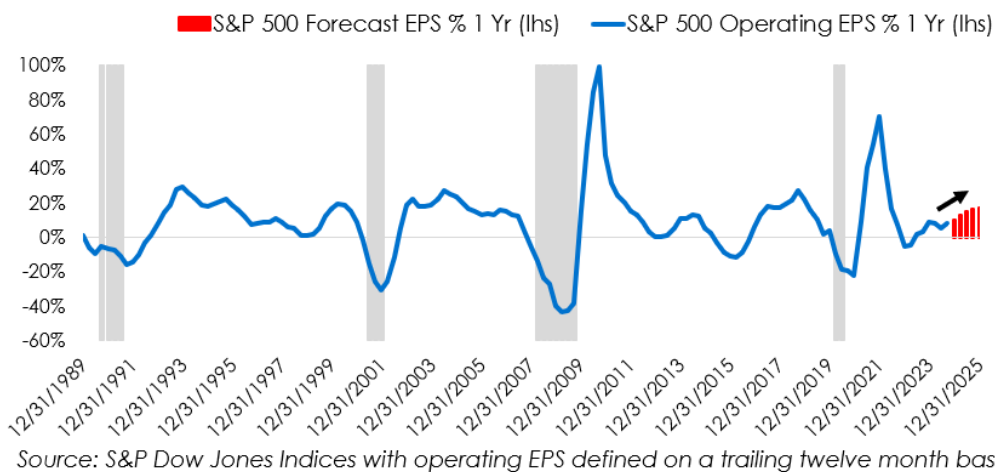


Source: Yellow Cardinal Research; the Business Cycle Indicator is a proprietary dashboard of financial conditions that historically have provided some context of business cycle duration and lead time on recessionary events. When more than half of the weighted average signals were triggered, this often preceded a recession. The Business Cycle Indicator is a weekly signal with the 13 week moving average smoothing the volatility.



And yet from a profit cycle perspective, we don't look nearly as late. In fact – as can be seen in the chart below – profit growth continues to ramp off of the earnings recession trough in 2022. As expectations point to an earnings acceleration through much of 2025, this would argue for being at an earlier respective stage in the profit cycle.

### Earnings Growth Continues to Ramp

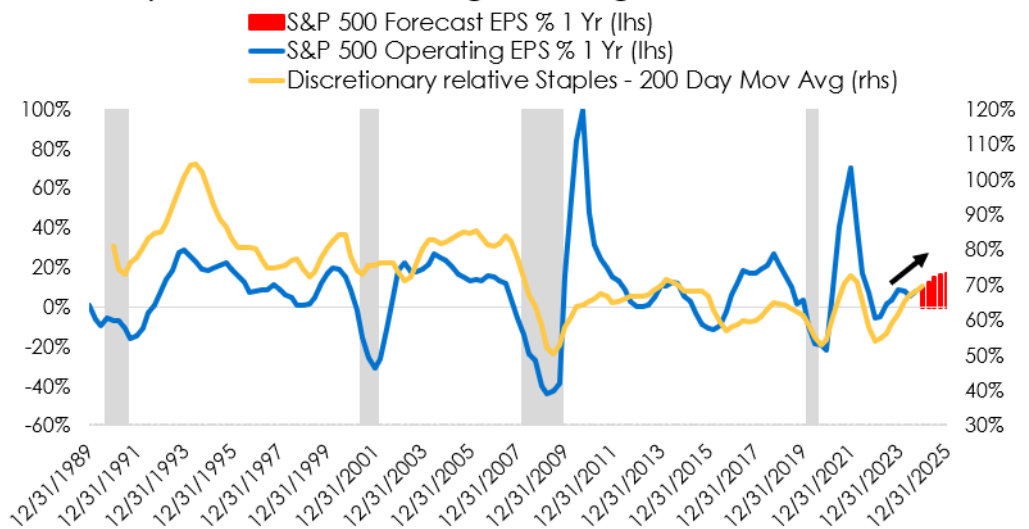


Last month, we highlighted that the price action in the equity market seems to be confirming the cyclical improvement in corporate profits. As noted in the chart below, when comparing the Consumer Discretionary sector against the Consumer

Staples sector (both on an equal weighted basis using the relative 200 day moving average), the pro-Discretionary tilt implies a cyclical bias that tends to directionally coincide with S&P 500 earnings growth.

Growth acceleration favors the cyclical (Discretionary) tilt while deceleration the defensive (Staples) tilt. The bottom line is that investors continue to favor stocks that benefit consumer wants over consumer needs which seems to be consistent with a broadening growth backdrop as earnings accelerate.

### Cyclicals Confirming Earnings Acceleration



So what do we make of this de-synchronous

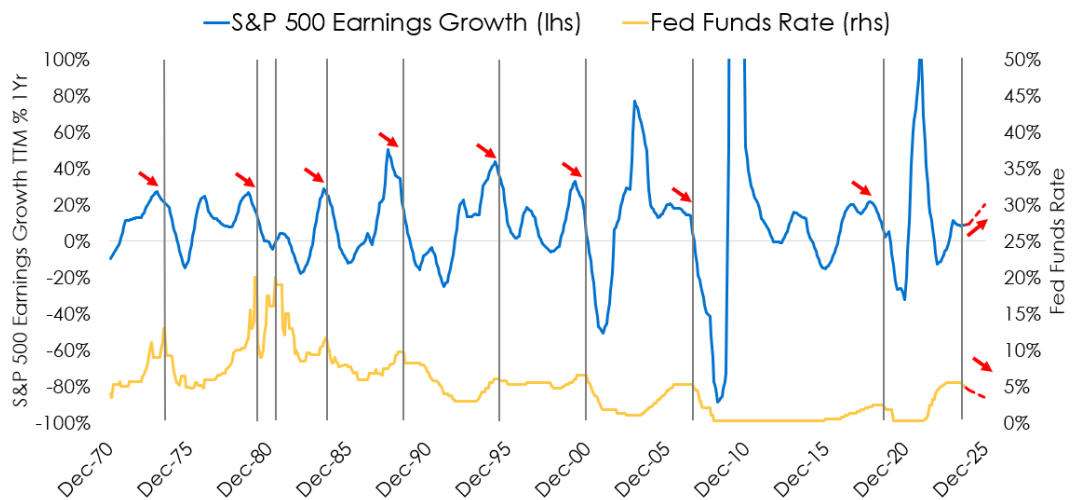




setup – are we early or are we late? History tells us that the disconnect between the economic cycle and profit cycle tends to be uni-directional. An earnings recession can occur without an economic recession ('15-16) but generally not vice versa. This implies that the economic state can remain in an extended late cycle position until earnings materially weaken.

Add to that the third leg of the stool – a Fed Cycle that looks decidedly different than it has historically. The chart at right highlights the nine other Fed easing cycles (i.e. cutting rates) over the last half century. Acting as a countercyclical body, the Fed has almost always started its rate

### Fed Easing Cycles vs Earnings Growth



Source: Factset; historical monthly earnings data smoothed over each quarter from Robert J Shiller; www.shillerdata.com. Earnings growth is calculated based on trailing twelve month reported earnings figures. Next twelve month forecast for earnings based on bottom up analyst estimates for S&P 500 reported earnings using the S&P Dow Jones Indices datasets; www.wpglobal.com. Next twelve month forecast for Fed Funds rate based on FOMC projection from the September dot plot and forecast exhibits; www.federalreserve.gov.

cutting cycle after earnings growth has peaked. Should earnings growth continue to ramp in 2025, such would not be the case in this current Fed cycle. We remain mindful of how such an occurrence might impact both growth and inflation.

To the extent that this aids an accelerating and broadening of the earnings growth backdrop, this could unlock a recalibration of valuations. 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 about a 20% 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 still rather extreme – not far off from their disparate readings witnessed back in late 2021 and before that, the Tech Bubble peak. The bottom line is that the highest valuations still 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 diversification than in the past – regardless of the building valuation (and mean reversion) risk and at a time when growth might be becoming more balanced.



As we look ahead, we think investors might have to think differently or “Open the Aperture”. Alternative scenarios to pre-existing leadership trends might be beneficial to consider. Given the (still) narrow 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. Earnings growth accelerating as the Fed is easing might be a catalyst to consider.

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, consistent with the above “Tricky” setup, we continue to emphasize a degree of balance across asset classes and market segments while remaining UW to the most expensive and concentrated areas.

Within equities, our positioning incorporates balance geographically and within our US Large Cap exposure. Acknowledging the more constructive profit cycle with prospects of a broadening, our bias has generally been to have more exposure to less expensive areas (down market cap vs top). As such, we’ve maintained a larger 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 have previously repositioned our Treasury exposure in acknowledging the steepening yield curve. This exposure remains our biggest OW in portfolios for diversification purposes though we’ve also 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 expensive part of the bond market (High Yield) where spreads remain tight. High Yield corporate bonds tend to benefit from cyclicalities though their incredibly tight credit spreads suggests this might already be fully recognized.

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 sensitive area and are now bottoming consistent with the Fed easing cycle.





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