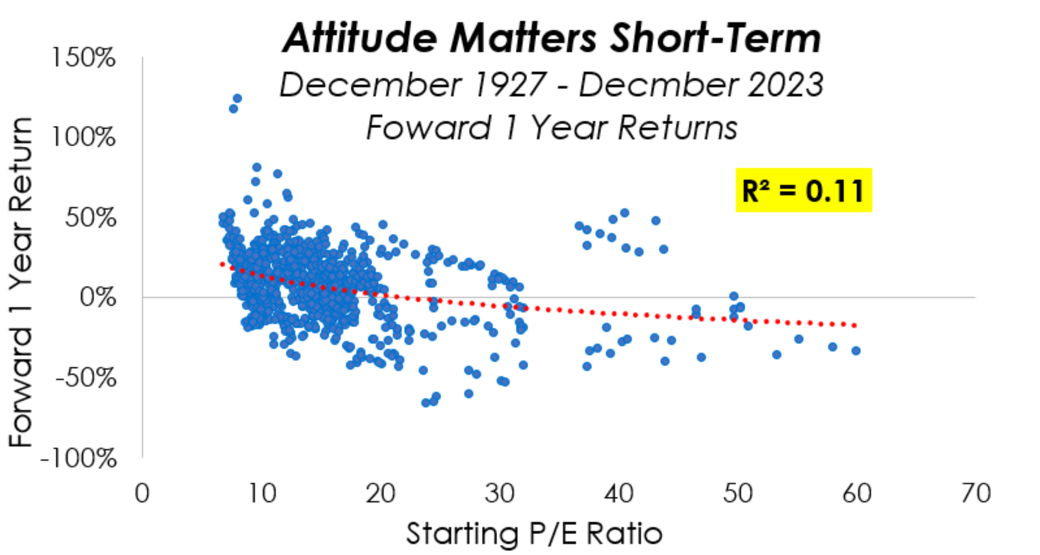
Attitude Matters ST, Altitude Matters LT

"In the short run, the market is a voting machine but in the long run, it is a weighing machine."

– Warren Buffett (1987) attributed to Benjamin Graham (1934)

Popular opinions are just that – popular. From hula hoops to pet rocks, hacky sacks to fidget spinners; certain items catch fire by capturing the attention of the public. Since 2020, it's been the well documented Stanley Quencher water bottle. According to CNBC, such popularity has taken this Seattle based company from $70 million to a projected $750 million in annual sales from 2019 to 2023. Social media influencers and the company's ability to market new "limited edition" colorways transformed this item from a mere liquid vessel to a piece now considered part of one's ensemble. Is there such a thing as too many?

Investors can be very similar in their attitudes towards stocks. Certain companies, industries and sectors can be viewed with such popularity that the demand for their respective shares seems insatiable. The old investment adage is "attitudes always follow price" and so it becomes a virtuous cycle. But virtuous cycles can turn vicious when things become extreme. Investors become so enamored that discipline and logic get put on the back burner. This behavior is not unique and can be seen in the chart above. One might define discipline and logic using the simple price to earnings

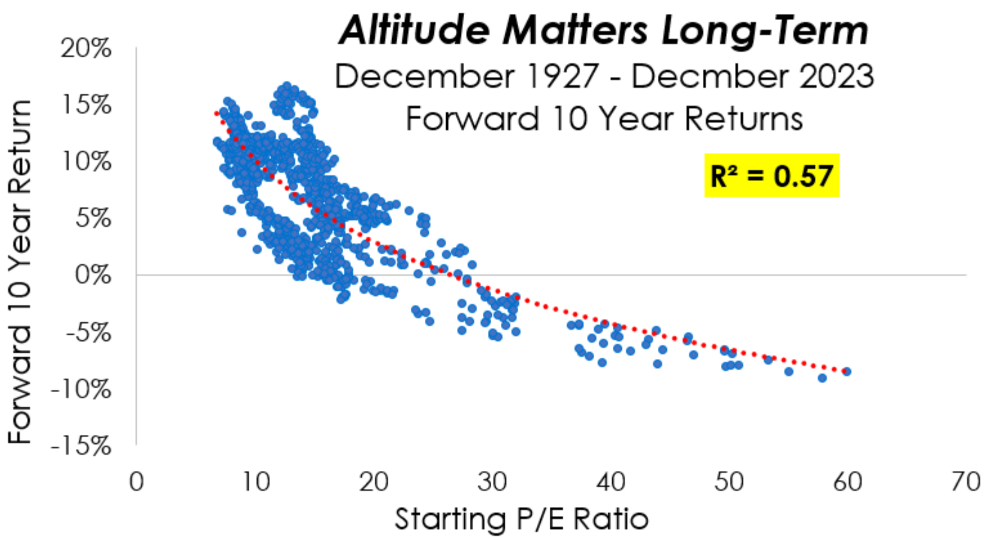


Source: PE ratios were calculated monthly based on the value of the S&P 500 and trailing 12-month S&P 500 Normalized Earnings. Normalized Earnings were calculated by determining the constant long-term growth rate that best fit actual S&P 500 earnings. This process is meant to smooth out short term fluctuations in earnings caused by the business cycle. Forward returns are price appreciation only and do not include dividends. Historical S&P 500 data was gathered from Robert Schiller's website (http://www.econ.yale.edu/~shiller/) and Factset.

ratio. This common valuation metric is used to help an investor understand how much they are paying for every dollar of earnings that a stock generates. Of course, that's overly simplistic because there are lots of other factors to consider like expectations around growth and capital allocation decisions along with overall financial profitability and health. But how much do those other expectations influence a stock's price in the short run relative to the long run? The answer is a lot.

The chart on the prior page shows just how un-influential the S&P 500's current valuation is to its return over the next year. Using regression analysis to explain the predictability of a stock's starting valuation yields an R2 of just 0.11 or 11%. This suggests that almost 90% of the forward one-year return is explained by factors beyond valuation. To us, this means that markets can very much be a popularity contest in the present – *"Attitude Matters Short-Term".*

However, when one runs the same analysis on a longer-term time horizon investors regain their discipline and logic. As can be seen in the chart at right, the S&P 500's starting valuation has a much bigger influence on its forward return over the next decade. Here the R2 is 0.57 or 57%, which suggets that almost 60% of the market's forward return is explained by the price investors were willing to pay for every dollar of earnings generated ten years earlier. Note that this analysis used a methodology to normalize earnings for the S&P 500 to smooth out the short-term fluctions caused by the business cycle. We've seen this same study conducted over different time periods and with different earnings methodologies and the conclusion is the same. In the long run, the elevation of a stock's valuation has a much larger bearing on the return one ends up getting – *"Altitude Matters Long-Term".*



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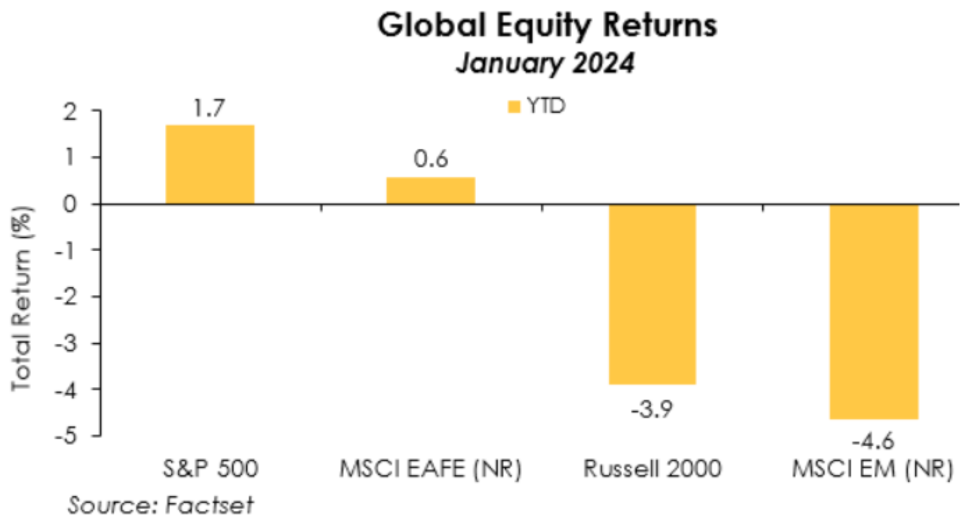
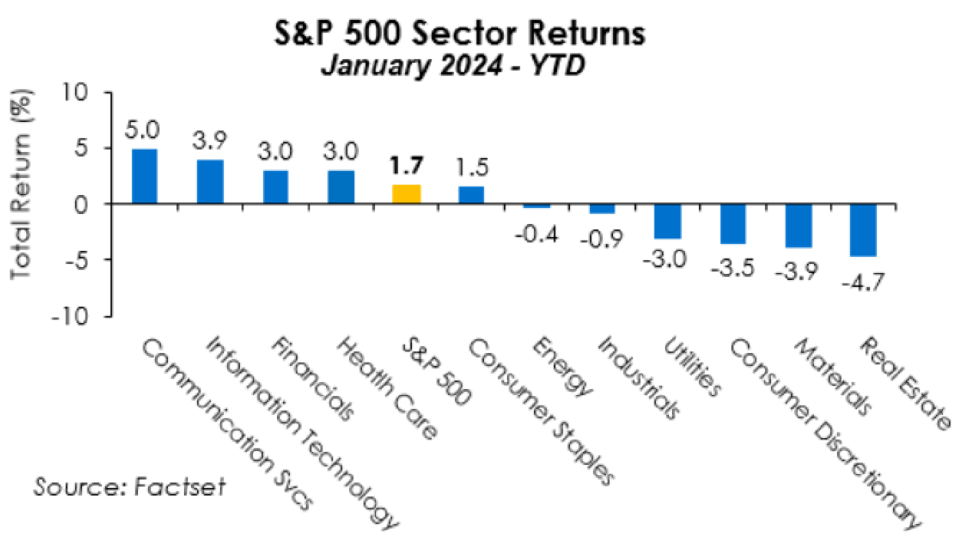
And so Attitude matters short-term but Altitude matters long-term. Popular opinions drive markets in the short run, but discipline and logic generally tip the scales in the long-run. No matter how much things seem to change, the psychology of markets seems to generally remain the same.

Market returns were mixed and narrowly led in January. Mega Cap growth stocks carried major stock indices higher on expectations for strong Artificial Intelligence (AI) related growth. Bonds and interest rate sensitive stocks (Small Caps, REITS & EM) struggled as strong economic data likely delayed the start and number of interest rate cuts expected from the Federal Reserve.

Stocks

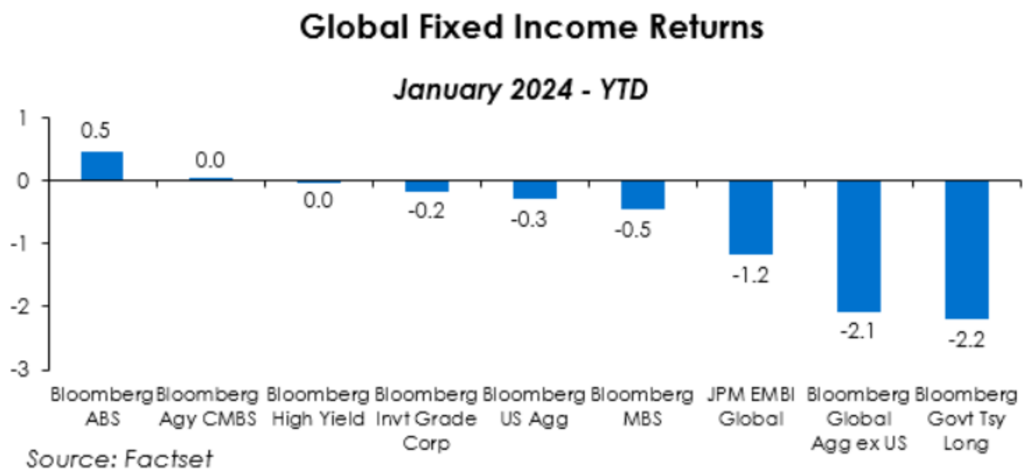


January's equity performance was led by US Large Caps (S&P 500) posting strong results particularly in the cyclical growth sectors of Communication Services and Technologies. Conversely, US Small Caps (Russell 2000) suffered due to speculation around the timing and extent of Fed interest rate cuts. Overseas, equity performance in International Developed Markets (MSCI EAFE) was up modestly. Meanwhile, Emerging Market (MSCI EM) returns declined as weakness in Chinese equity markets continued into the new year. As mentioned above, US Large Cap sector performance favored the higher priced cyclical growth sectors (Technology and Communication Services) while the Financial and Health Care sectors have performed better over the last few months.



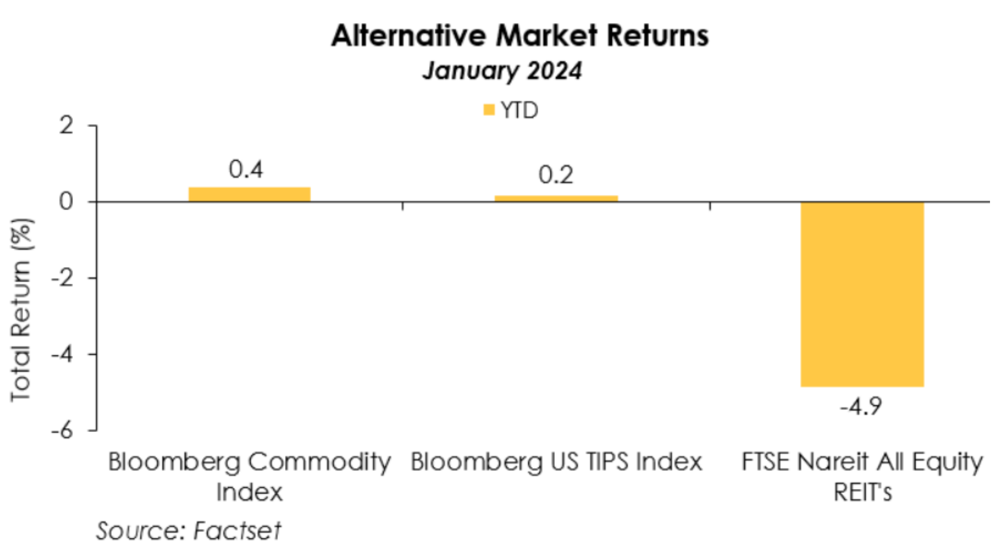
Bonds

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 in the last four consecutive meetings. The market dialed back more aggressive rate cut expectations following the most recent Fed meeting and a strong January jobs report. Rates have remained volatile with market participants trying to anticipate policymakers next course of action. Meanwhile, the yield curve remains inverted but has steepened off the lows. Bonds returns were generally flat to down in January with longer duration assets (Investment Grade, US Agg, MBS, JPM EMBI, Global Agg, and Govt Tsy Long) down the most as long-term interest rates increased in the month. Shorter duration assets (ABS, CMBS, and High Yield) performed better as short-term interest rates were relatively flat in January.



Alternatives

Commodities traded slightly higher with positive returns in Energy which offset weaker prices in Agriculture, Precious and Industrial Metals. Meanwhile, publicly traded Real Estate (REIT's) lagged on less aggressive expectations for interest rate cuts. Finally, Treasury inflation protected securities (TIPs) benefited from the positive carry in bonds, while inflation expectations moved sideways to down.



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by Yellow Cardinal Advisory Group

MARKET UPDATE
January 2024

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)

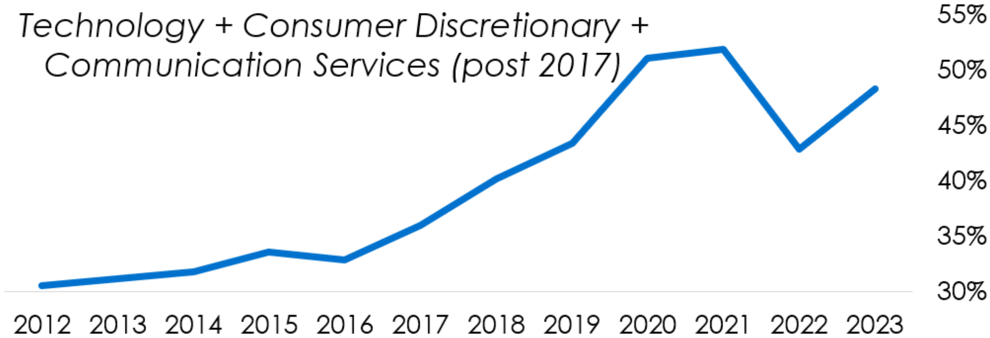
We continue to believe that it's important to maintain two frameworks for managing portfolios – the cyclical (shorter-term) and the secular (longer-term). The cyclical perspective is an attempt to assess where we are in this particular business cycle while the secular perspective evaluates where the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

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. 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 meaningfully above its long-term trend so if policymakers ease 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".

Source: Dow Jones S&P; www.spglobal.com. S&P US Broad Market Cap relative to S&P Global Broad Market Cap.

Meanwhile, the cyclical perspective has, admittedly, gotten more "Tricky" of late. Part of this tricky backdrop is related to the disparity among valuations which has been driven by the increased concentration of the market. This imbalance can be seen in several ways. The chart at right highlights that the market cap weighting of the US relative to the Global index has increased substantially – recently hitting a new record high.

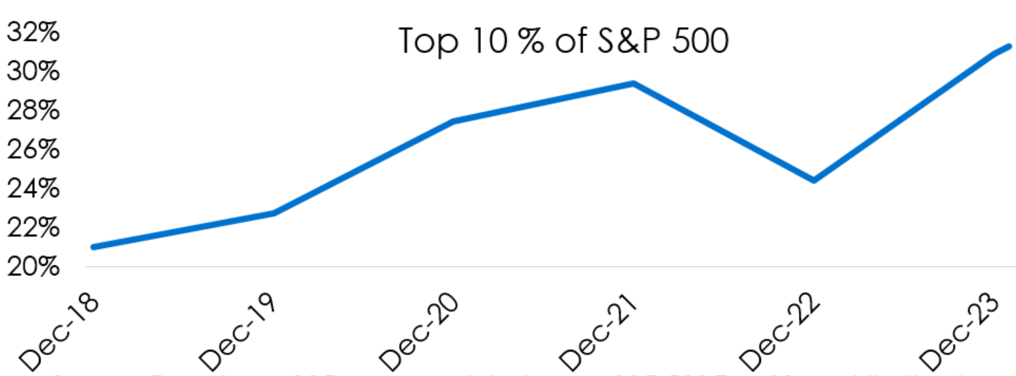


Source: Dow Jones S&P; www.spglobal.com. S&P 500 Sector contribution by market cap. Communication Services was added post 2017 due to material reconstitution and renaming of Telecommunications.

US market cap dominance has largely been attributed to the success of US cyclical growth sectors. As can be seen in the chart at right, the market cap sector weightings of Technology, Consumer Discretionary and Communication Services (post 2017) have disproportionately gained ground relative to all other sectors in the S&P 500 – currently sitting just below the 2021 high water mark.

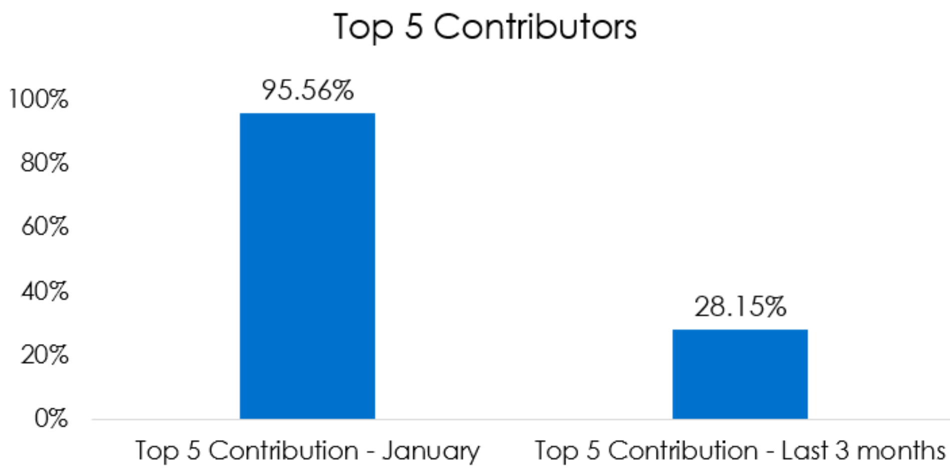
Drilling even deeper, the top ten constituent weights within the S&P 500 index have also gotten more extreme – as can be seen in the chart bellow – registering a recent record high.

<u>Each of these charts highlights the central idea that investors have grown accustom to succeeding with much less diversifcation than in the past (which we don't believe is particularly healthy).</u>



Source: Dow Jones S&P; www.spglobal.com. S&P 500 Top 10 contribution by market cap.

The chart on the next page suggests some goods news and bad news. The good news is that the months of November and December were much broader in participation such that, over the last three months, the top five weights of the S&P 500 contributed 28% to the total return of the index. The bad news is that the most recent month of January reverted back to the narrow conditions as described above. Incredibly, the top five weights contributed over 95% to the total return of the index.



Source: Dow Jones S&P; www.spglobal.com. S&P 500 Top 5 contribution to S&P 500 Total Return over the last month of January and last 3 months November through January.

As we look into 2024, 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 the concentrated focus of a few select investments.

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. In the latter, our bias has generally been to have more exposure to less expensive areas (broader vs top) while maintaining a bit more balance of late by adding to late cycle cyclicals at the expense of defensives. As such, we've moved to a greater OW in Cyclical Value relative to Defensives 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. Our US Core Bond managers are slightly OW corporate bonds, though we've previously moved up in credit quality by adding some Treasuries and lengthening duration (along with the adjustment from a barbell to belly approach). Our bias towards this higher quality segment means that we remain UW the most cyclical parts of the bond market where spreads have tightened considerably (High Yield and Emerging Market Debt).

Within alternatives, we're slightly OW and remain fairly balanced by recently reducing 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.