

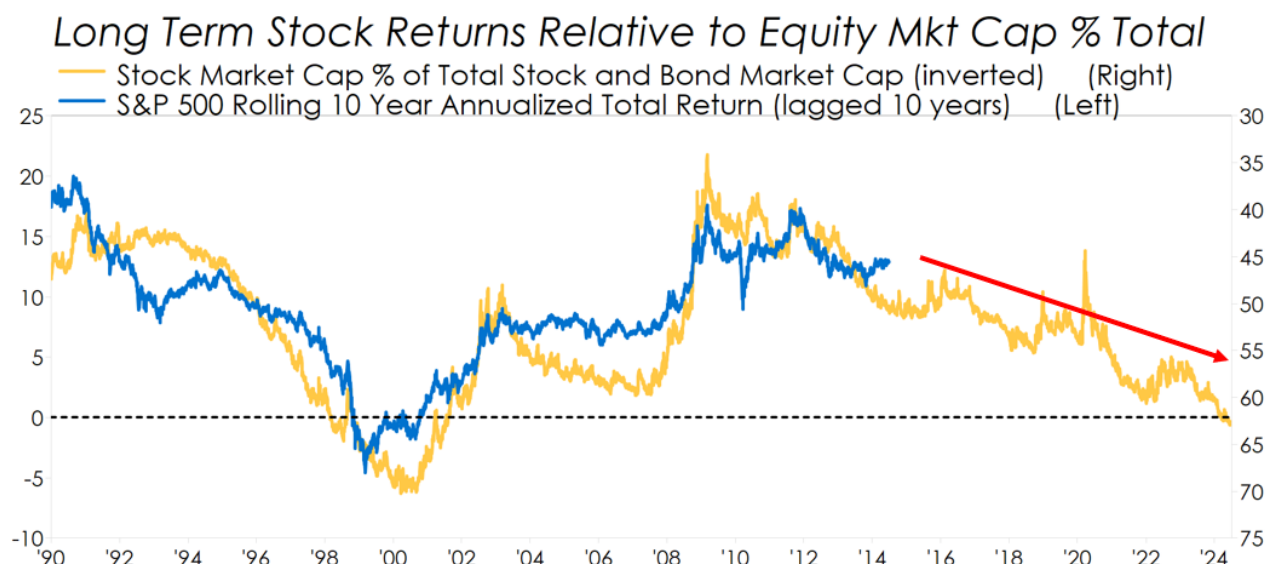
I See Better Than I Hear

“Popularity is the one insult I have never suffered.”

– Oscar Wilde (1854-1900)

Life can, at times, feel like a popularity contest – often seeking but never satisfied. The age of social media has helped to accelerate this innate nature of running with the pack where success is often defined by number of followers. Identifying what’s trending has never been easier with just a few clicks of one’s phone or tablet. It should be no surprise that what’s trending in markets today is “AI” or Artificial Intelligence. In fact, according to Google Trends, the search term “AI” in the United States is just slightly off its parabolic popularity peak last month after being relatively undiscovered until late 2022. Today, it’s hard not to catch a headline, read an article or listen to a podcast without that two-character reference. While one might be hard pressed to bet against the long-term capabilities imagined by AI, the merits of how far those capabilities extend might end up being a much more controversial topic that borders on the philosophical. We’ll leave that there for now and focus on the markets.

As investors – especially during times like this – it’s important to remember understanding the stock is as critical as understanding the story though in practicality this is easier said than done. That’s because the market is made up of human emotion and people always like a good story. But a good story might be different than a



Source: Factset; Stock and Bond Market Cap is defined by the S&P 500 Stock Index and the Bloomberg US Aggregate Bond Index.



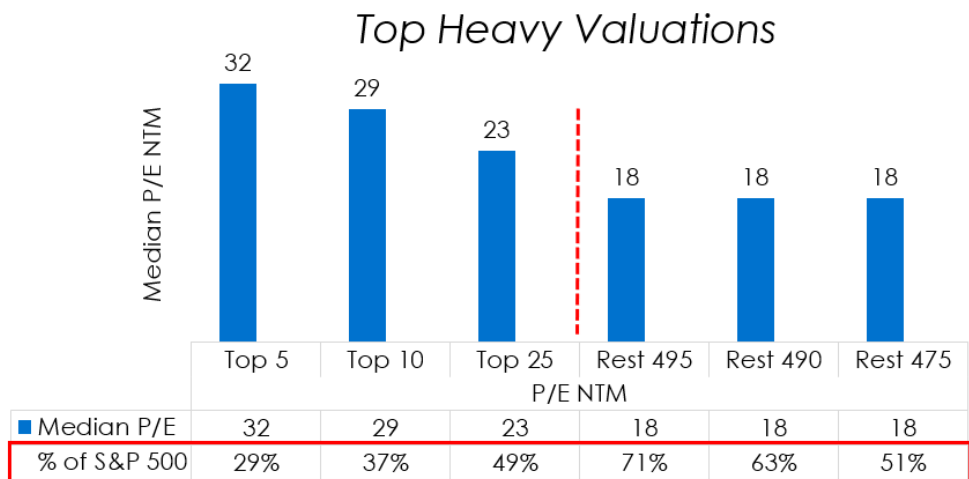
good stock. Said another way, sometimes “seeing is better than hearing”. What we see today is a stock market that has become increasingly popular. As can be seen in the chart on the prior page, the capitalization of the stock market (yellow line) is becoming progressively large in proportion to the bond market (note the inverted scale). The S&P 500’s current market cap represents 63% of the combined total stock and bond market capitalization – quickly closing in on the 2000 tech bubble peak of 70%. Also worth noting is how good this measure has been at tracking the directional trend of the prior 10-year rolling annualized returns of the S&P 500. It makes intuitive sense. As stocks become a disproportionately larger portion of the total capitalization of financial securities (and likely more expensive), forward 10-year returns are likely to be much weaker than their current double-digit pace. You would never know it given the popular sentiment for stocks that exists today but that seems to be how it normally works. Separating the story from the stock is crucial and requires the discipline of “seeing better than hearing” as well as the patience in recognizing that this is a long-term observation.

Still, it’s important to recognize that valuations at the index level give a very incomplete picture of the underlying constituents of which it is comprised. “It’s not a stock market but a market of stocks”, as they say. In examining valuations, the risk to long-term returns seems to reside at the top of the market. As can be seen in the table below, the expensive stocks (as measured by the median forward price to earnings ratio) remain generally in the Top 25 of the S&P 500 but particularly in the Top 10 and Top 5. Meanwhile, the median P/E for the rest of the S&P 500 trades closer to its long-term historical average valuation multiple. It’s also important

to note the market cap represented in each of these tranches. Not only is the top of the market the most expensive but it’s also the most concentrated and the least diversified. Consider that the S&P 500’s Top 25 constituents represent almost half of the index with almost one third coming from the Top 5. More than two thirds of

the Top 25 are represented by just three sectors; Technology, Communication Services and Consumer Discretionary with the Top 5 sharing 100% representation from these areas.

Like the good book says, we know not the day nor the hour – though we still think these are important observations to keep in mind for the long-term investor. Remember the mantra – “I See Better than I Hear”.



Source: Factset; iShares IVV ETF used for S&P 500 constituents.

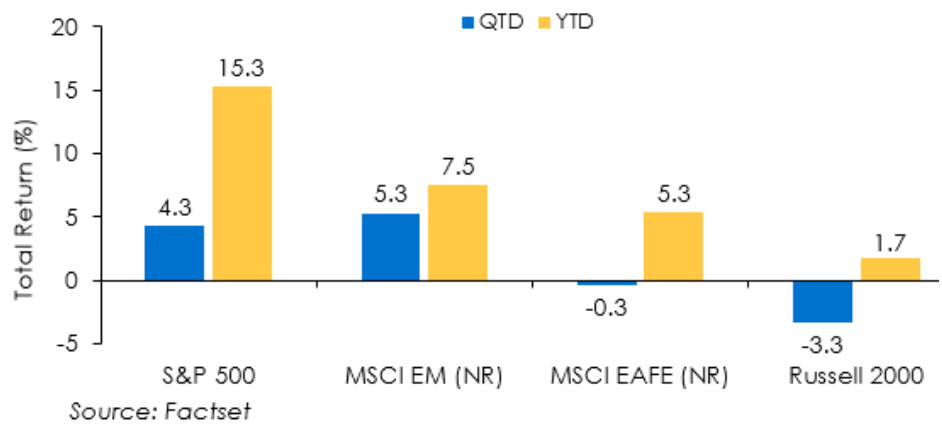


Stocks, Bonds, and REITs were all up in June while Commodities retreated. Year to date, however, returns across asset classes remain more disparate with Stocks and Commodities solidly positive with Bonds and REITs generally negative. The S&P 500 continues to lead global equity markets for the year given its growth oriented bias influenced by AI related enthusiasm. Rate sensitive areas like Bonds and REITs have been held back by dampened expectations for rate cuts. Finally, Commodities pulled back but still posted strong returns for the first half of the year on stickier inflation.

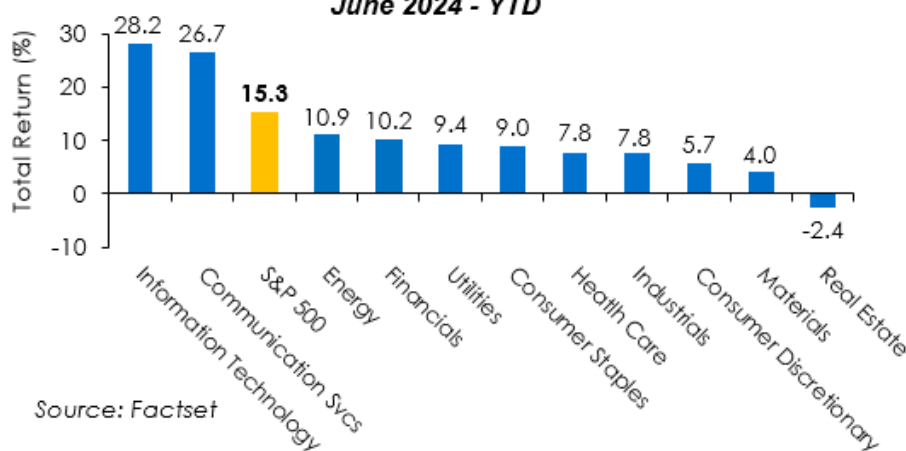
Stocks

Stocks returns were disparate in the second quarter with Emerging Markets (MSCI EM) and US Large Caps (S&P 500) up nicely while International Developed Markets (MSCI EAFE) and US Small Caps (Russell 2000) retreated. Year to date, US Large Caps (S&P 500) have been exceptional – though with just two sectors outperforming (Technology and Communication Services) while the other nine sectors have lagged. US Small Caps (Russell 2000) continue to lag due to their rate sensitivity and concerns around a higher for longer rate backdrop. Overseas, International Developed Markets (MSCI EAFE) have been buoyed by the anticipated easing of foreign central banks and improving economic data, notwithstanding some give back in the second quarter. Meanwhile, Emerging Markets (MSCI EM) delivered strong returns for the quarter and YTD as investors continue to expect foreign Central Bank rate cuts and additional Chinese stimulus.

Global Equity Returns June 2024



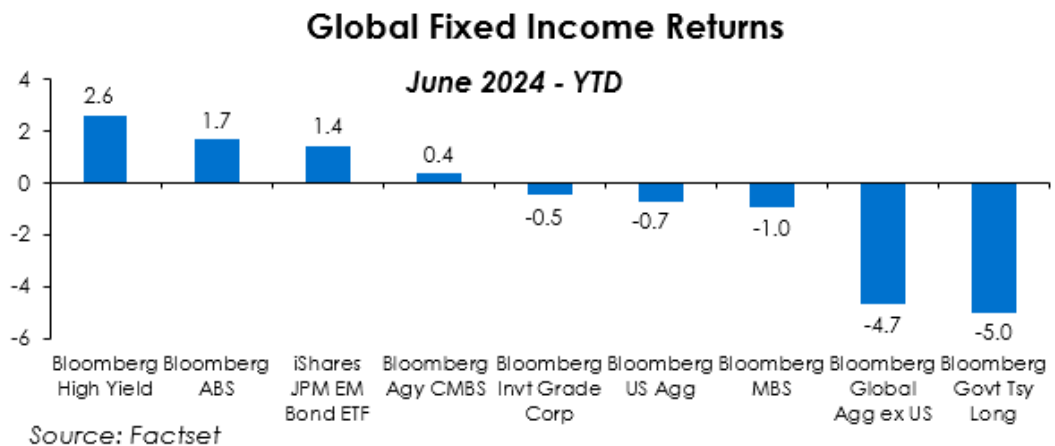
S&P 500 Sector Returns June 2024 - YTD



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 seven meetings. The Fed has recently become less confident on inflation moving sustainably lower and has suggested fewer near-term rate cuts which has moved their rate forecast higher and more in line with the bond market for this year and next.

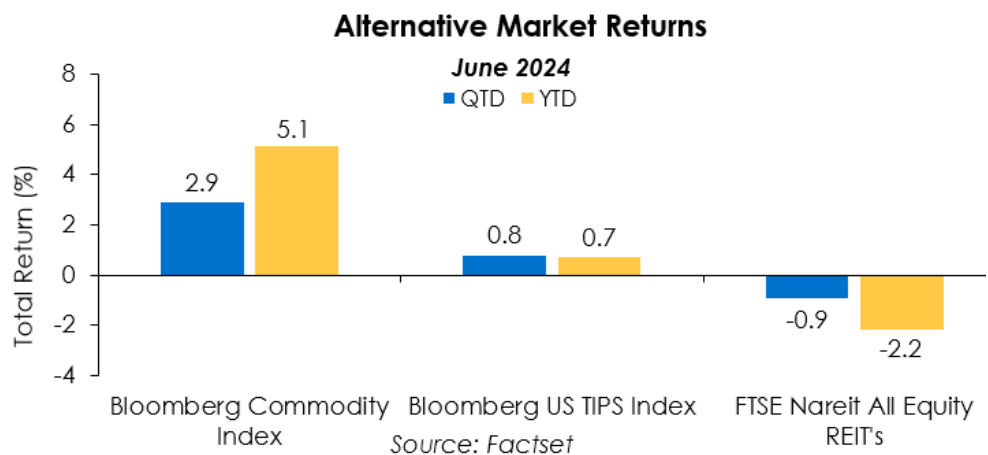
Consequently, bond returns remain generally lower year-to-date amid lowered rate cut expectations and the back up in rates from year end. The exceptions were



positive returns in High Yield corporate bonds, Asset Backed Securities (ABS), Emerging Market (EM) Debt and Agency CMBS – all of which benefited from higher starting yields and tightening spreads.

Alternatives

Commodities traded higher for the quarter and year-to-date with strong returns in Precious and Industrial Metals. Meanwhile, publicly traded Real Estate (REITs) has lagged – hurt by dampened rate cut expectations. Finally, returns on Treasury inflation protected securities (TIPs)



were subdued though outperformed nominal Treasuries on the stickier inflation data.



Market Outlook

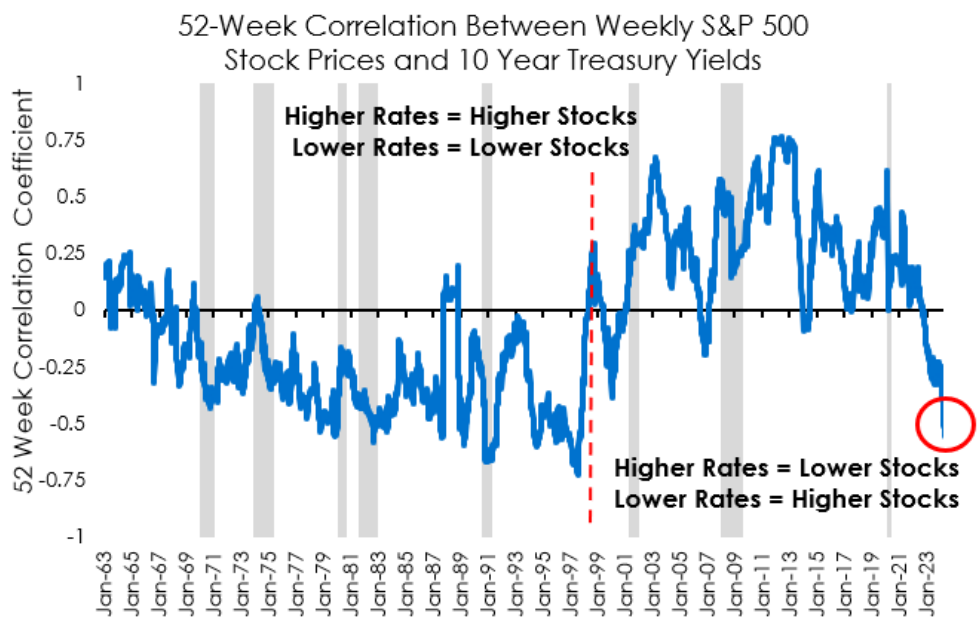
“It’s Tricky to rock a rhyme, to rock a rhyme that’s right on time. It’s Tricky.”

– 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) not to mention building pressures on the federal deficit.

Note the chart at right highlights the rolling 1-year correlation between stock prices and the yield of the 10 Year Treasury bond. The notable shift in the correlation between stocks and rates is an observation that looks more similar to the higher and more volatile rate regime that existed some 50-60 years ago rather than anything we’ve seen for most of the last three decades. One



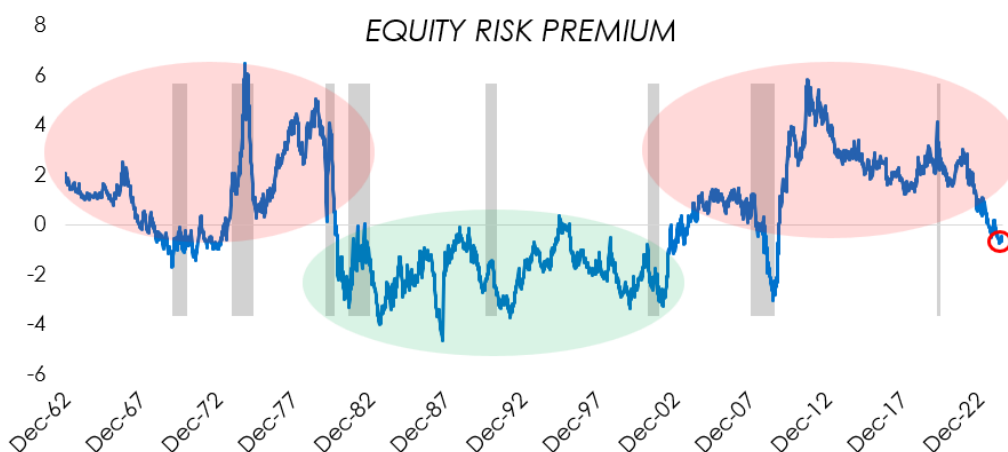
Source: Factset



measure that remains wildly inconsistent with that reference, however, is the reaction of stock valuations to this change. In the past, a rising and more volatile rate and inflation environment generally led to lower stock multiples as opposed to the expanding valuations that we're observing today.

Meanwhile, the risk premium that equity investors have demanded historically has largely been dependent on the anticipation of the secular trend in interest rates or, more recently, the renewed understanding of equity volatility. Rising rates required a greater premium (lower stock multiple) to take on risk and vice versa. As can be seen in the chart below, that resulted in a positive equity risk premium for much of the '60's and '70's (when rates were rising) and a negative risk premium for much of the '80's and 90's (when rates were falling). Since 2000, the risk premium trended higher and back into positive territory (despite the continuation of falling rates)

– largely a reflection of the aftermath from the Tech Bubble, Great Financial Crisis and Covid. Today, the risk premium has all but evaporated once again. We think that suggests that investors believe that either (1) rates will be in a perpetual low/falling trend or (2) we're entering a



Source: Factset; Equity Risk Premium is defined by the difference between the Earnings Yield (or inverse P/E) and the Bond Yield. P/E is a trailing twelve month calculation based on company reported results from Factset as of April-June 2024. Historical earnings are taken from Robert Shiller's U.S. Stock Markets 1871-Present and CAPE Ratio (<http://www.shillerdata.com>). Current 10 Year Yield and P/E as of 6/30/24, Current CPI as of 5/31/24.

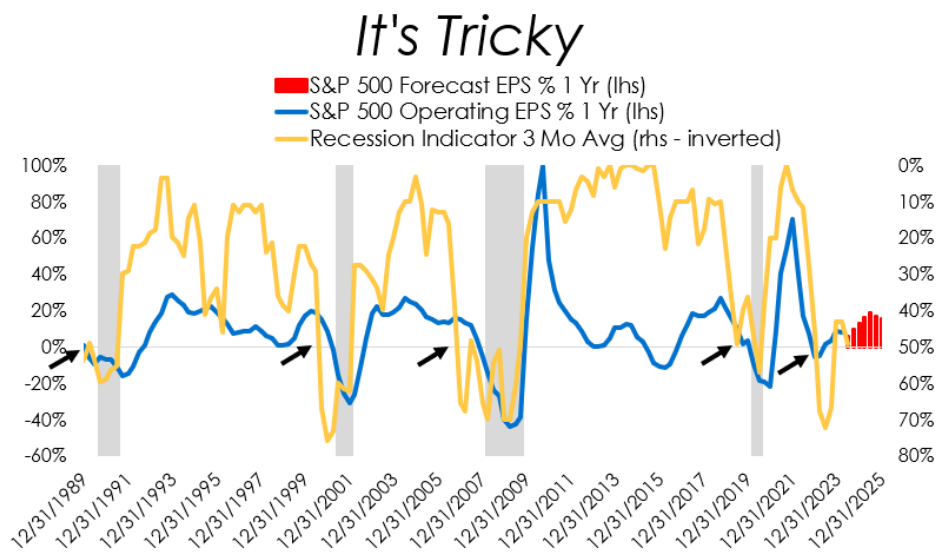
more benign risk world or (3) policymakers have exhibited, time and again, that risk seekers will be rescued. The end result today is a much greater appetite to accept risk, which comes in the form of higher multiples (lower risk premiums) – especially in those mega-cap growth stocks.

How investors interpret the rate, inflation and risk backdrop will have implications for a company's cost of capital, a stock's valuation multiple and changes in market leadership. It may not be unreasonable to assume an entirely different investment landscape if the underlying building blocks are shifting to a different state. As a result, we've referred to this secular mantra as "Doing the Opposite". The jury is still out on this debate but we think its worth the thought exercise especially in light of the aggressive investor risk appetite.



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 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.

With regards to the second point, leadership in the growthier corners of the market has led to extended valuations and concentrations relative to the rest of the market. To that point, the top of the market carries with it a much higher price to earnings ratio than the majority of its members. According to Factset data, consider that since 2009, the “average” stock (as defined by the equal weighted S&P 500) is trading at a 25% 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 about as extreme as they were back in late 2021 and before that the Tech Bubble peak. The bottom line is that higher valuations are 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 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 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.

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 bottoming in the profit cycle, 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 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 International Fixed Income, where the end of negative interest rate conditions has led to more attractive opportunities. 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 sensitive area.



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