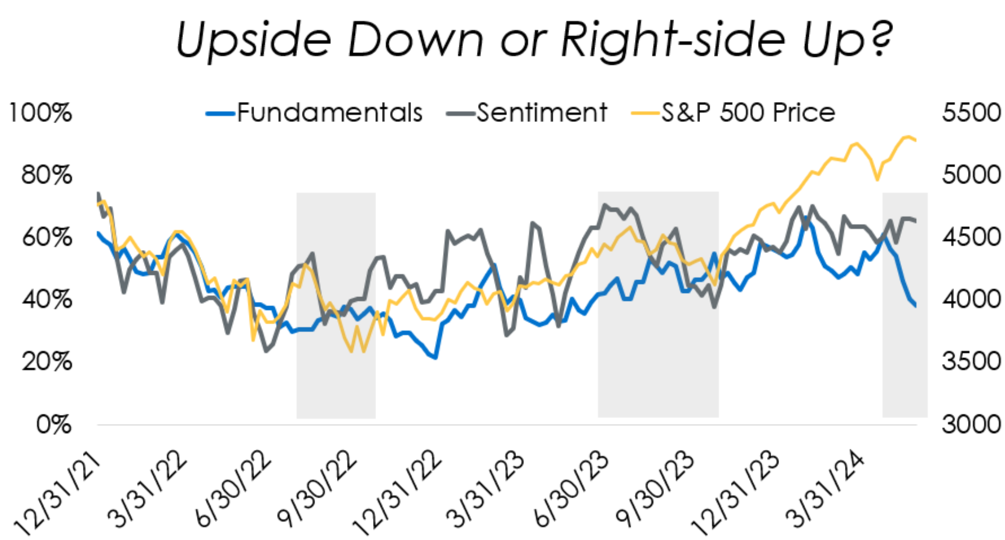
Upside Down or Right-side Up?

"Well, if you were directly above him then how could you see him?

...Because I was inverted." – Top Gun (1985)

You know the scene. Top Gun fighter school – Miramar, California – where Maverick explains his close contact with a MiG-28. Keeping up "foreign relations" while being inverted was an instant classic. One might find that scene analogous to last month's investment landscape in the sense that equity markets seemed to find themselves "Right-side Up" despite some "Upside Down" data. Let's explain.

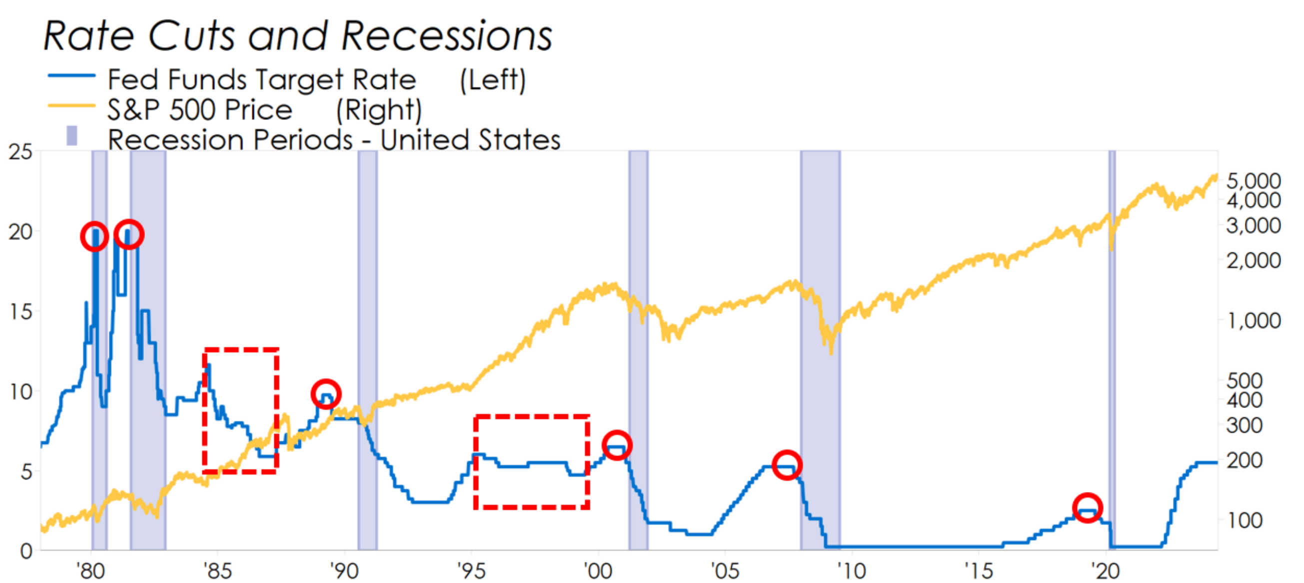
In investment speak, the above loosely describes the "Bad News is Good News" (or conversely "Good News is Bad News") commentary that was increasingly cited in May. With such a paradox, it's easy to get disoriented in proverbial space. In our view, the durability of these contradictions is often fleeting and tends to warrant a resolution one way or the other.



Source: Factset; FFWM Research. Each reading is a proprietary composite score using a weighted average of multiple metrics tracked within each respective category.

Each week we track a composite of Fundamental and Sentiment readings to help us understand the composition of factors that influence the stock market. The Fundamental composite includes metrics like earnings revisions and jobless claims while the Sentiment composite includes things like stock valuations and credit spreads. As can be seen in the chart above, there are moments when the Fundamental and Sentiment data might diverge but, ultimately, come back together. In some cases, the Fundamental data bounces back leading to a more benign move in the overall market. At other times – as can be seen in the shaded regions – Sentiment data might reset lower triggering a more adverse move in the S&P 500. Recently, we've observed a similar looking disconnect between the Fundamental and Sentiment measures that further widened in May. To be fair, most of the deterioration we've seen in the fundamental data has been economic as opposed to earnings related but it's caught our attention, nonetheless, along with the limited impact it's had on stock valuations. The justification for resilient Sentiment data has been that "Bad News is Good News" – weaker Fundamental data might give the Fed enough of a reason to start cutting interest rates. And lower interest rates should be good for stock multiples. The implication is that the Fed engineers a soft landing that allows for rate cuts to occur without stoking the inflationary coals.

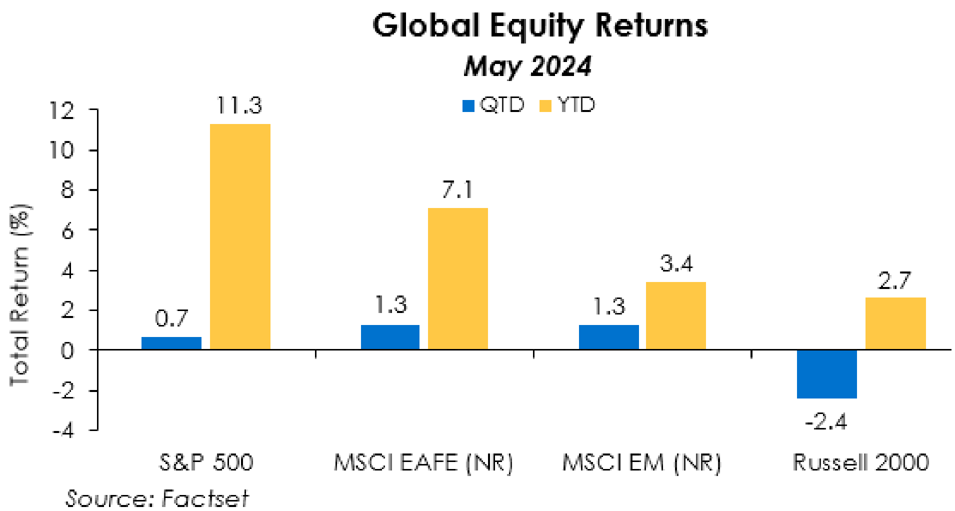
All of that sounds reasonable though, in practice, that scenario seems to be more the exception than the rule. As can be seen in the chart below, since the mid '70's, there have been eight Fed rate cutting cycles. Only two of those instances (dashed boxes in the mid '80's and mid '90's) resulted in a soft(ish) landing though the former did include the crash of 1987. The latter was more of a true soft landing though had fewer rate cuts, much higher stock prices and an eventual equity market bubble. Meanwhile, the other six cycles (red circles) culminated in recessions. From our standpoint, rate cuts tend to come with the disclaimer caveat emptor – "buyer beware". That's because, more times than not, the Fed is materially cutting interest rates to respond to poor fundamental data. In our view, absent material fundamental weakness, rate cuts will likely be modest and not necessarily the panacea that investors might suggest when using the "Bad News is Good News" rationale. If rate cuts are more material, it probably will be in response to weaker than expected fundamental data. For now, the disconnect between the Fundamental and Sentiment composites isn't fatal for stocks, but it does raise our guard in the shorter term. Markets can be disorienting for a time, but generally these disconnects eventually get resolved.



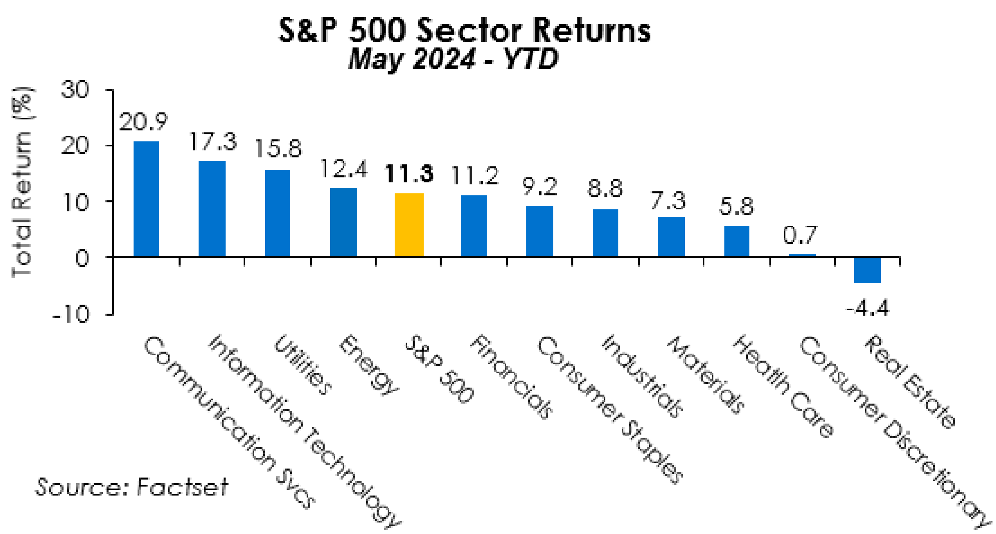
Souce: Factset; S&P 500 (right hand side) is on a log scale.

Stocks, Bonds, Commodities, and REITs all posted positive returns in May. Of note, Stocks rallied following weak performance in April, as softer economic data was viewed as a positive from an inflation and rate cut perpective. Year to date, returns across asset classes remain disparate with Stocks and Commodities solidly positive and Bonds and REITS generally negative. The S&P 500 continues to lead global equity markets for the year given its growth oriented bias. Rate senstive areas like Bonds and REITs have been held back by dampened expectations for rate cuts. Finally, Commodities continued their winning streak with another month of solid returns.

Stocks

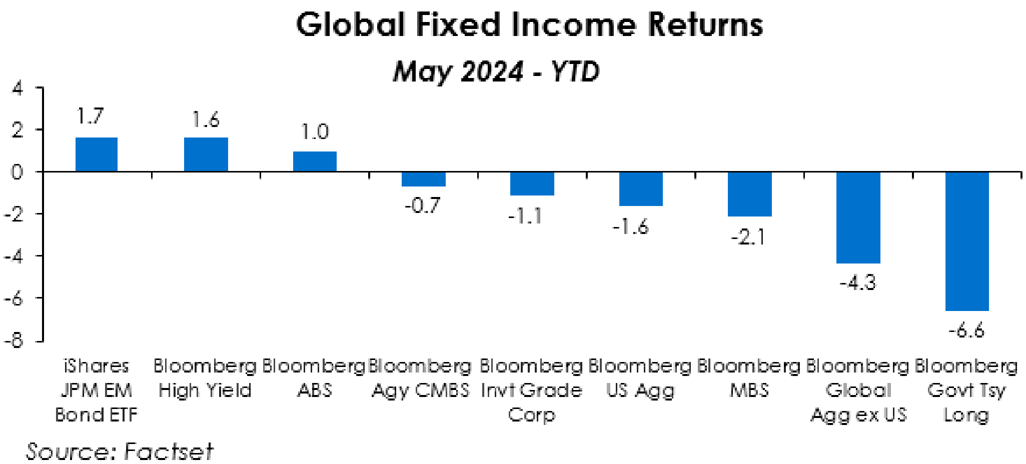


Stocks posted strong returns across size and geopraphical factors with US Large Caps (S&P 500) and US Small Caps (Russell 2000) leading in May. Year to date, US Large Caps (S&P 500) continue to outperform with last year's leaders in Communication Services and Technology reasserting themselves while Utilities and Energy have also outperformed. US Small Caps (Russell 2000) rallied in May – turning positive for the year – but continue to lag due to their rate sensitivity and speculation of rates staying higher for longer. Overseas, International Developed Markets (MSCI EAFE) have been buoyed by the anticipated easing of foreign central banks and improving economic data. Meanwhile, Emerging Markets (MSCI EM) delivered another month of positive returns as Chinese equities continued to rally.



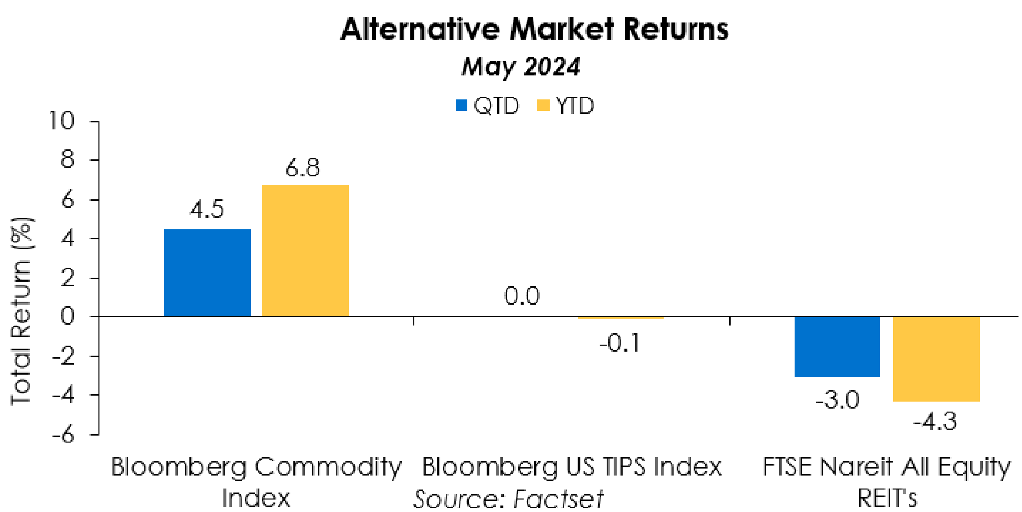
Bonds

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 six meetings. The Fed has recently become less confident on inflation moving sustainably lower but, at the same time, has suggested rate hikes are less likely. Meanwhile, the bond market dialed back its more aggressive rate cut expectations and is now forecasting less easing than the Fed. Longer term rates have risen year-to-date but declined in May while the yield curve remains inverted. Bond returns rallied in the month but generally remain down for the year amid lowered rate cut expectations and the back up in rates from year end. The exceptions were positive returns in EM Debt, High Yield corporate bonds and Asset Backed Securities (ABS) – all of which benefited from higher starting yields and tightening spreads.



Alternatives

Commodities traded higher year-to-date with solid returns in May, particularly in Precious Metals. Meanwhile, publicly traded Real Estate (REITs) has lagged – hurt by dampened rate cut expectations due to stickier inflation data. Finally, returns on Treasury inflation protected securities (TIPs) were subdued though outperformed nominal Treasuries on stickier inflation data.



Market Outlook

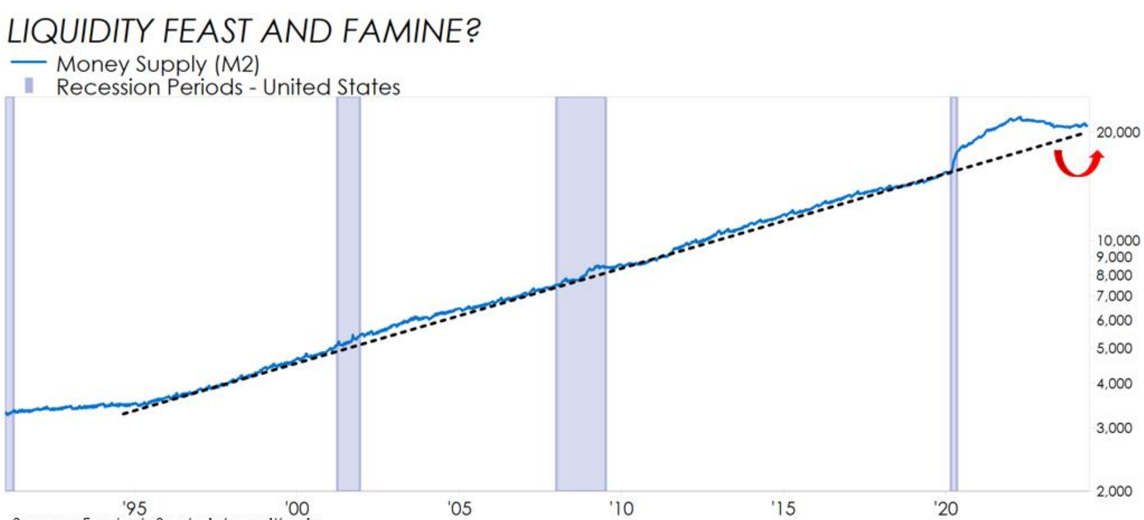
"It's Tricky to rock a rhyme, to rock a rhyme that's right on time. It's Tricky."

– 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).

There's no doubt that inflation has moderated with the Consumer Price Index (CPI) now well below its peak of 9.1% back in June 2022 suggesting the first wave of inflation (while persistent) 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.

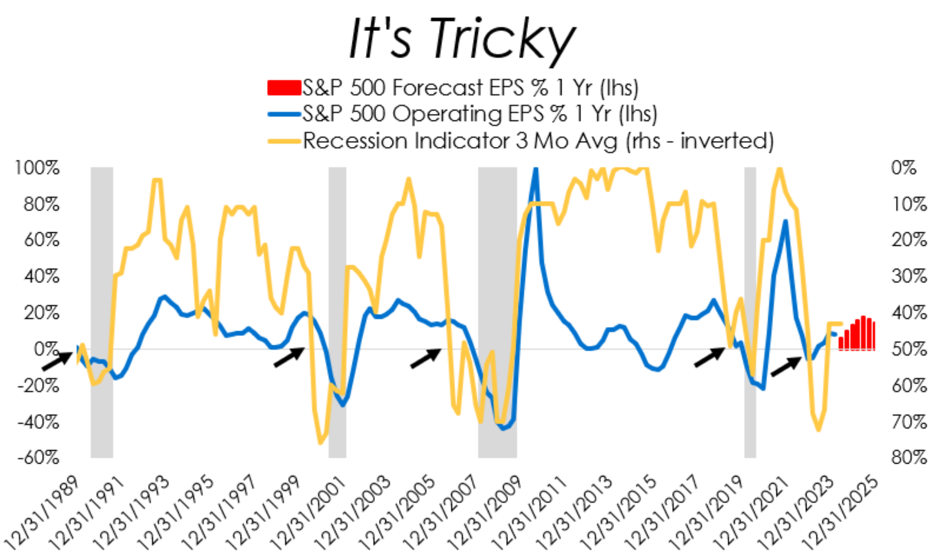


Source: Factset; Scale is logarithmic.

As can be seen in the chart on the prior page, the money supply (effectively how much cash is in the economy) is now beginning to level off above its long-term trend. "Cash in hand fuels demand" so when too many dollars chase too few goods or services, prices rise (and vice versa). If policymakers ease too agressively at a time when the money supply levels off, we wonder if a second wave of inflation eventually takes shape. <u>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".</u>

<u>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.</u>

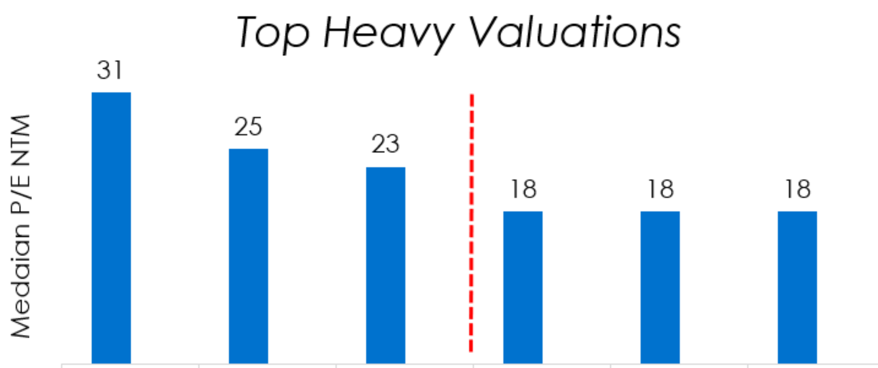
With regards to the first point, an extended inversion of the yield curve and limited incremental economic capacity suggests that we remain closer to the end than the beginning of the business cycle. However, the earnings recession that occurred last year is now resolving with an upturn in profit growth expected throughout this year. The chart at right evidences both of these conditions. Our recession indicator has previously registered comparable late cycle levels while the consensus forecast for S&P 500 earnings growth shows a re-acceleration into next year. <u>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.</u>



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 much higher price to earnings ratios than the majority of its members. As can be seen in the chart on the next page, the median forward price to earnings ratios for the "Top" constituents in the S&P 500 carry premium valutions relative to the median multiples of the "Rest" of the index. Also of note – the "Top 25", for example, represent just 5% of the index by number of stocks but almost 50% of the market weight of the index (by virtue of the market cap difference). The bottom line is that higher valuations are concentrated in the hands of the largest 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 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.



P/E NTM	Top 5	Top 10	Top 25	Rest 495	Rest 490	Rest 475
Median P/E	31	25	23	18	18	18
% of S&P 500	25%	35%	48%	75%	65%	52%

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

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 senstive area.