

Another Reversal With A Side Of Rotation

“You can observe a lot by watching.”

– Yogi Berra (1925-2015)

Forecasting the weather is an extremely difficult job. It’s no wonder given the frequent changes perhaps best described by Mark Twain noting that, “In the spring, I have counted one hundred and thirty-six different kinds of weather inside of four and twenty hours.” We all can sympathize with the notion that ‘if you don’t like the weather, just wait a few minutes’.

That sentiment represents a good parallel to how investors might be feeling after recent observations in the stock market. As can be seen in the chart below, the back half of July and especially the first few days of August saw a quick drop in the market amid the resumption of recessionary fears. But as quickly as that change in tone emerged, a ‘reversal of that reversal’ led to a rally that left the S&P 500 just a hair shy of its previous record high at month’s end. With hindsight being twenty-twenty, a couple observations can be drawn.

- First, the very abrupt change in tone might suggest that many investors recognize the appearance of a business cycle in the latter innings. As such, any hints of that confirmation will trigger a pivot toward “risk off”.
- Second, hints of that confirmation ultimately proved fleeting in August with data that showed the underlying real core growth of the US economy as robust – north of 2% as of the latest estimate for

Reversal of the Reversal



Source: Factset

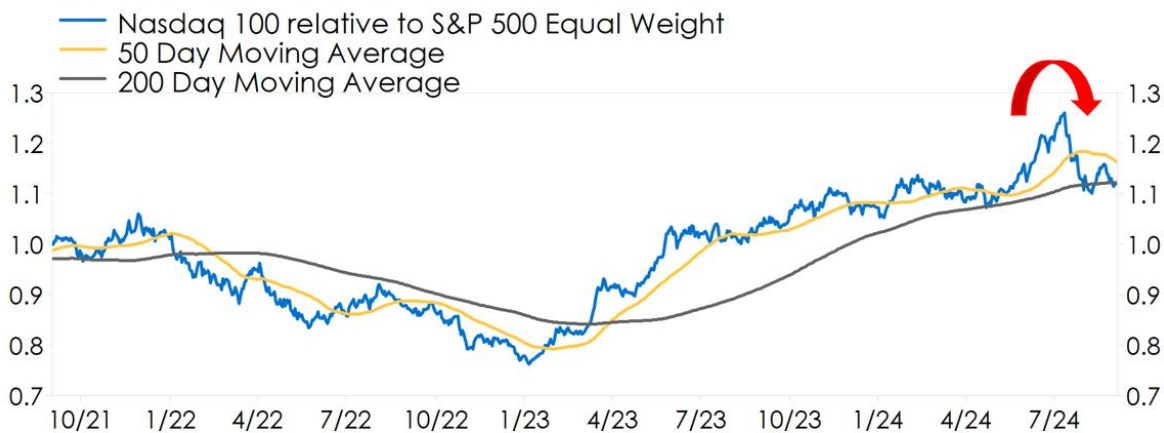


2Q GDP. That was further emphasized by S&P 500 earnings growth tracking to be up 11% (quarter over quarter) in the second quarter with the majority of companies having now reported at the time of this writing.

And so by the end of August we're quickly back to where we were just a month and a half ago when looking at the price level of the S&P 500 index. Yet, according to some measures, things look decidedly different. In July, we discussed the notable changes in the Rate market that's anticipating an acceleration of rate cuts from the Fed. That continues to be the case with the Fed Funds futures market still pricing in a little over 200 bps (2%) of cuts by the end of next year. As a consequence, 2 Year Treasury yields have fallen quicker than 10 Year Treasury yields resulting in the 10 to 2 Year yield curve nearing an un-inverted status – another indication of typical late cycle dynamics.

At the same time, internals of the equity market have gotten healthier with a broadening of participation that started with an 'under the surface' rotation beginning in July and continuing since then. There are multiple ways to measure this but one of our favorites is comparing a broad index to a narrow one. The S&P 500 Equal Weighted index is a proxy for the former which includes an equal representation of the 500 largest US based companies in the benchmark. As such, it's often been called a good depiction of the "average" stock. The latter is the much narrower universe of the Nasdaq 100 index – representing some of the largest US companies in the growth arena. As the moniker suggests, this index has fewer constituents with more than half of the benchmark comprised of the Tech sector. As can be seen in the chart below – following a peak narrowing of the market culminating near mid-year, the "average" stock has turned the corner and is now sitting on the favorable side of the relative 50 and 200 day moving averages. This squares with the broadening of growth anticipated in the consensus view of forecasted earnings as well as its natural maturation. We're keeping an eye on market conditions, which like the weather, can change quickly – though we think this rotation might, ultimately, be indicative of the natural evolution of the profit cycle.

Reversal with a Side of Rotation



Source: Factset



Stocks, Bonds, and REITs were all up in August while Commodities were flat. Year-to-date returns remain tiered with Stocks up the most though with REITs continuing to close the gap. Meanwhile, Bonds (rallying) and Commodities (weakening) are 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 though returns continued to broaden out in August.

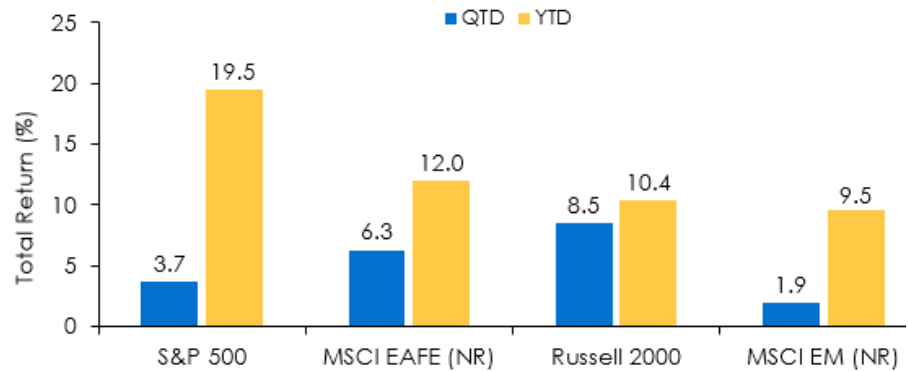
Stocks

Stock returns were generally positive quarter-to-date with a broadening tone. Results were led by US Small Caps (Russell 2000) followed by International Developed Markets (MSCI EAFE), US Large Caps (S&P 500) and Emerging Markets (MSCI EM). US Large Caps continue to

lead year-to-date – though with improved participation as seven of eleven sectors have outperformed so far this quarter compared to only two (Technology and Communication Services) in the first half of the year. US Small Caps (Russell 2000) declined modestly during the month, giving back some of July’s outsized gain on expectations of lower rates and an economic soft landing. Overseas, International Developed Markets (MSCI EAFE) have been buoyed by the easing of foreign central banks and improving inflation and (albeit subdued) economic data. Meanwhile, Emerging Markets (MSCI EM) have delivered comparable returns year-to-date, though recently have cooled over concerns of a slowing in China.

Global Equity Returns

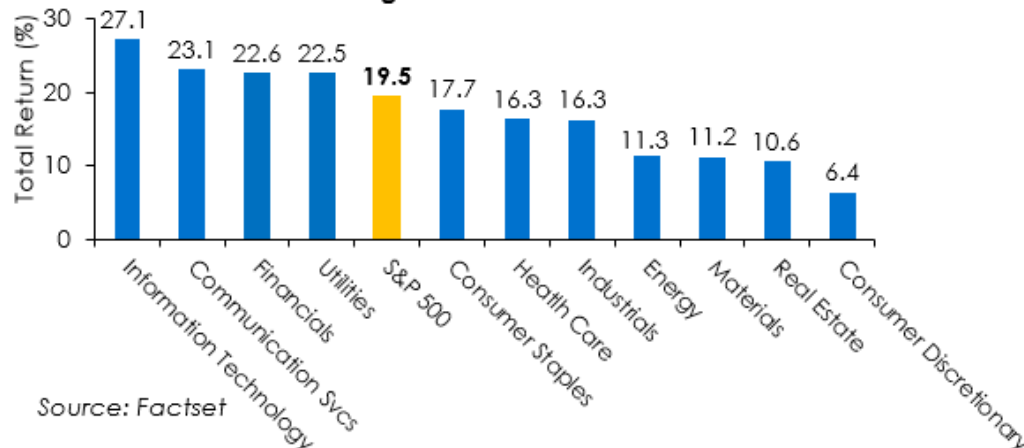
August 2024



Source: Factset

S&P 500 Sector Returns

August 2024 - YTD



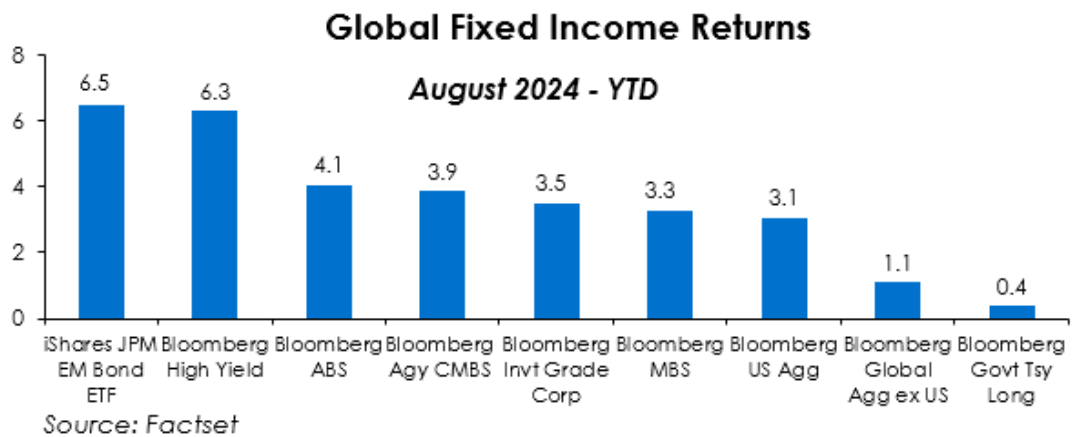
Source: Factset



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 eight meetings. In July, the Fed highlighted risks to both sides of its dual mandate (price stability & full employment) while indicating an increased likelihood of rate cuts later this year. Subsequent weaker employment data now have the bond market pricing in significant rate cuts through the end of 2025. Bonds continued to rally in

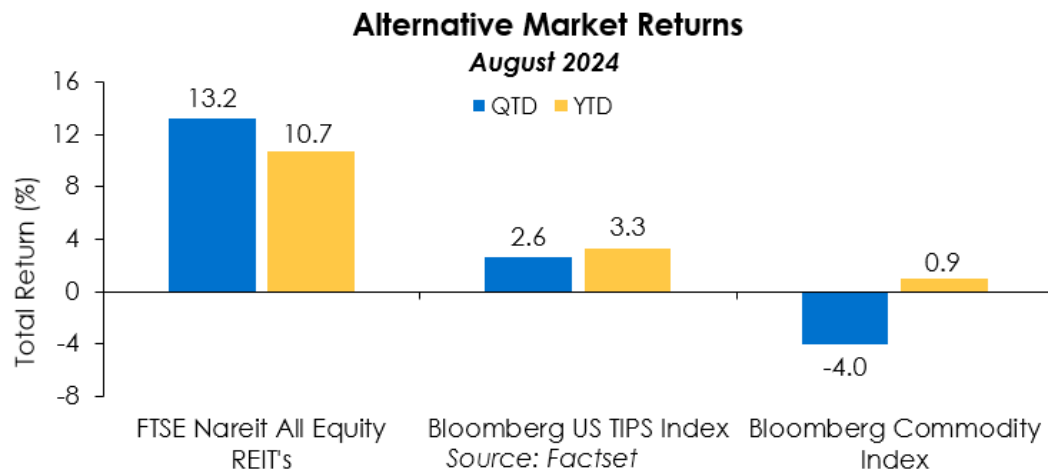
August, though year-to-date returns have been more modest – generally in the low/mid-single digits. Credit (High Yield) has been among the better performing areas



for the year, though Long Dated Treasuries and the Global Agg ex US have seen the best momentum of late amid lower rates and a falling dollar.

Alternatives

Commodities have been pressured of late and are marginally positive for the year as strong returns in Precious Metals have been mostly offset by weakness in Energy and Agriculture. Meanwhile, publicly



traded Real Estate (REITs) posted strong returns in the quarter as expectations for future rate cuts have increased. Finally, returns on Treasury inflation protected securities (TIPs) have recently started to underperform nominal Treasuries as concerns about sticky inflation have begun to recede.



Market Outlook

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

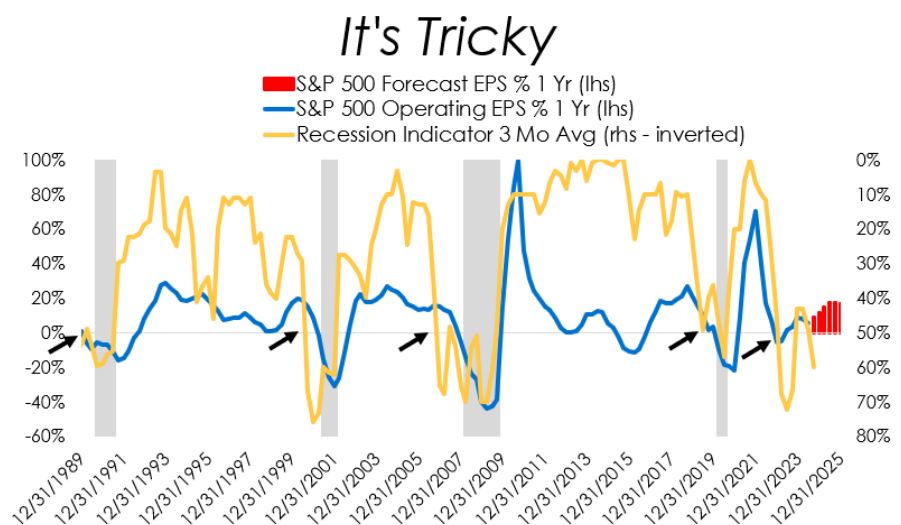
– Run DMC, *It’s Tricky* (1986)

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.

While the secular view remains up for debate, 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.

For now, those secular thoughts are taking a back seat to the cyclical view which remains in “Tricky” territory. That’s partly because the fundamental data has, for now, evidenced a late cycle economic frame but earlier profit cycle picture.

The potential un-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



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.



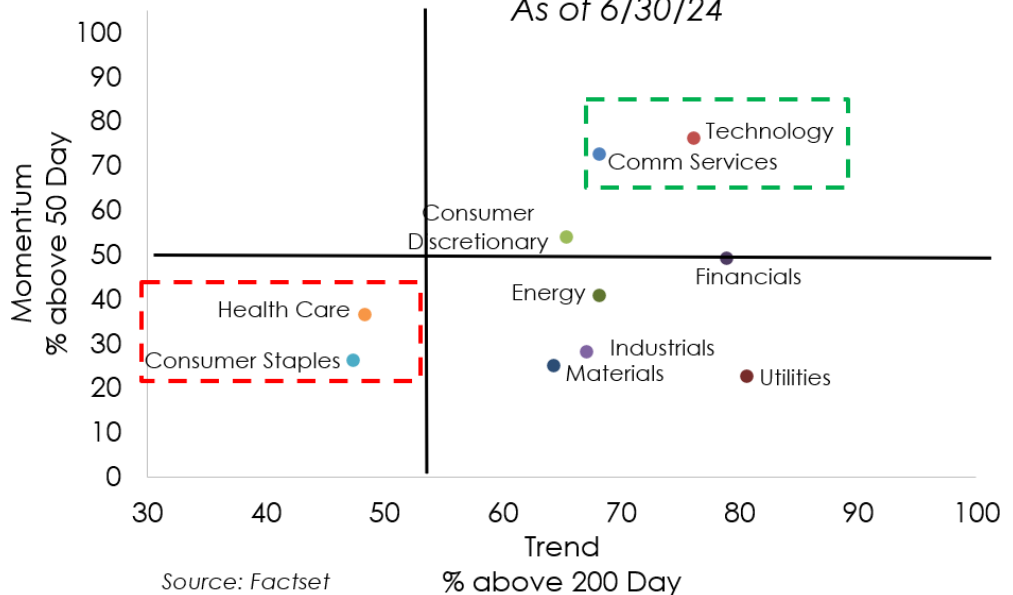
last year is now resolving with an upturn in profit growth expected throughout this year. The chart above evidences both of these conditions. Our recession indicator continues to register comparable late cycle levels while the consensus forecast for S&P 500 earnings growth shows a re-acceleration into 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.

We’ll be watching our leading profit cycle indicators to help catch any changes in earnings growth expectations in the outer months. To that point, we’ve started to observe a leveling off in some of our top-down measures as well as in bottom-up earnings estimate revision trends. This leveling off, while not disastrous, does indicate a maturation in the profit cycle with the debate over how quickly that’s occurring.

Historically at these earnings transition points, sector leadership begins to transition as well. We think that might be what we’re seeing today with the rotation that’s occurring under the hood of the S&P 500. Each month we track the underlying technical health of each S&P 500 sector by monitoring both trend and momentum readings at the constituent level. As can be seen in the chart below, the more stocks within each sector exhibiting positive trend and momentum characteristics, the healthier the technical conditions of that sector. We call this the sector matrix by splitting the scatter plot into four quadrants. Strongest readings are in the top right and weakest in the bottom left. At the end of June, sector leadership was decidedly narrow and growth oriented with just a few sectors in the top quadrant.

The sector matrix at the end of August was decidedly different. As can be seen in the chart on the next page, sector leadership broadened out to a combination of mostly Defensive (Utilities, Health Care) and Cyclical Value (Financials, Industrials) areas. These tend to be sectors that have higher hit rates (greater frequency of outperformance) during the slow down phase in earnings growth. This

*S&P 500 Sector Matrix
As of 6/30/24*



leadership shift might also be consistent with one that pressures the index given the softening seen in the Tech sector and its top-heavy influence on the benchmark.

To that point, the top of the market still carries with it a much higher price to earnings ratio than the majority of its members. According to Factset data, consider that since the end of 2009, the “average”

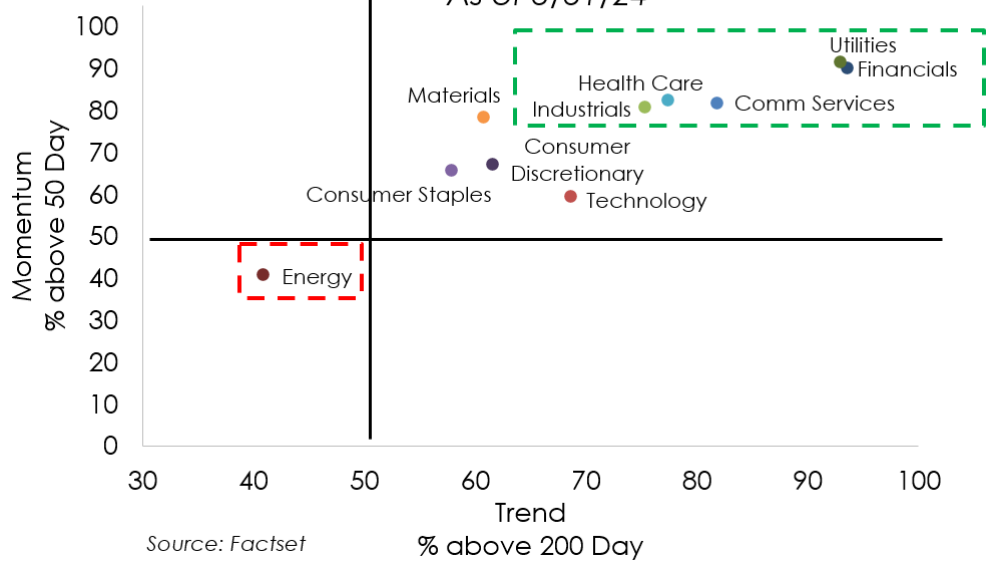
stock (as defined by the equal weighted S&P 500) is trading at a 20% discount to the market (as defined by the cap weighted S&P 500 index) versus its historical discount of about 5%. Similarly, the valuation difference between the S&P 500 Growth and Value indices are still rather extreme – not far off 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.

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 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. In addition to the profit cycle evolution, we think the recent market rotation might be the beginning of this recognition.

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 earlier profit cycle setup – albeit within a late-cycle frame (i.e. Cyclical).

S&P 500 Sector Matrix
As of 8/31/24



Within equities, in acknowledging the more constructive profit cycle year-to-date, 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 slightly 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 actively repositioned our Treasury exposure to take advantage of the steepening yield curve. This exposure remains our biggest OW in portfolios for diversification purposes though we've also recently 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 cyclical and expensive part of the bond market (High Yield) where spreads remain tight.

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 lower trend in rates.

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