INVESTMENT COMMENTARY
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Market Review

Despite some interest rate volatility, overall financial markets experienced a relatively calm first half of the year. The global stock market rally continued, led by US technology and growth stocks, and fueled by optimism around artificial intelligence. However, in the month of July equity markets experienced a severe rotation out of US mega-cap growth stocks into cheaper, smaller-cap stocks. For example, the Russell 1000 Growth Index fell -1.7% compared to the Russell 2000 Value Index that gained +12.2%. It was the third best relative month for small-cap value versus large-cap growth stocks since the index inception in 1979, and best since the tech bubble bust of the early 2000s. This rotation occurred amidst better-than-expected inflation data. The June Consumer Price Index (CPI), a broad measure of costs for goods and services, declined -0.1% in the month, putting the annual rate at +3.0%, near its lowest level in more than three years.

So far in August markets have experienced significant volatility. Equities fell sharply earlier this month after a weaker-than-expected US employment report, which market participants seemed to interpret as a sign the US Federal Reserve (Fed) has waited too long to lower interest rates and that the economy is headed for a recession. The unemployment rate rose to a three-year high of 4.3% with only 114,000 jobs added in July, compared to expectations of 175,000. The selloff in risk assets was exacerbated by the technical unwind of the Japanese yen carry trade. For years Japan kept interest rates negative making it attractive to borrow against the yen to invest in higher-yielding assets and technology stocks. But the Bank of Japan recently raised its policy rate to 0.25% and suggested that hikes would continue, causing the yen's value to spike against the dollar and sending ripples through global markets.[1] The tech-heavy Nasdaq Index saw its worst start to a month since 2008 while Wall Street's "fear gauge" the CBOE Volatility Index (VIX) at one point registered its largest spike since 1990.[2]

Asset Category Performance (As of August 16, 2024)	YTD 2024	Full Year 2023	Last 5 Years*	Last 10 Years*
Fixed Income				
Municipal Bonds (Bloomberg 1-10 Year Municipal)	+0.8%	+4.6%	+1.0%	+1.9%
Taxable Bonds (Bloomberg Aggregate Bond)	+2.9%	+5.5%	+0.0%	+1.6%
High Yield Corporate Bonds (Bloomberg High Yield)	+5.3%	+13.4%	+4.5%	+4.6%
Equities				
Global Stocks (MSCI All Country World)	+13.7%	+22.2%	+12.0%	+8.8%
US Large Cap Stocks (S&P 500)	+17.5%	+26.3%	+15.8%	+13.1%
US Small Cap Stocks (Russell 2000)	+6.6%	+16.9%	+8.9%	+8.0%
Non-US Developed Markets Stocks (MSCI EAFE)	+8.3%	+18.2%	+8.3%	+5.0%
Emerging Markets Stocks (MSCI Emerging Markets)	+8.8%	+9.8%	+5.0%	+2.6%
Real Assets				
Commodities (Bloomberg Commodity)	+0.4%	-7.9%	+7.0%	-1.1%
Natural Resources (S&P Global Natural Resources)	-0.6%	+4.1%	+10.7%	+4.6%
Energy MLPs (Alerian MLP)	+17.6%	+26.6%	+13.7%	+1.9%
Global REITs (S&P Global REITs)	+5.9%	+11.5%	+2.9%	+4.7%

*Note: Data provided by Addepar. *Indicates annualized return. Past performance is not indicative of future results.*

Market Review (Continued)

While stock prices have recovered from their recent lows and the VIX Index has returned to a more "normal" level, it's notable how quickly market sentiment can shift. And these swings in investor emotions can dominate the short-run influence of fundamentals factors[3] (like corporate earnings growth). The narrative earlier this month quickly changed from expectations for a "soft-landing" to concerns about an immediate recession. Of course, the risk of recession is not a new one. For instance, the Treasury yield curve has been inverted for almost two years[4], flashing a warning signal, as the Fed hiked short-term interest rates to combat inflation. Historically, an inversion has been a fairly reliable leading indicator of economic recession, though the timing from inversion to onset of recession has been highly variable. Given the importance of the US consumer to overall economic growth, it's no surprise that the health of the labor market is closely watched. And data releases are likely to continue to cause market swings. For example, after a sharp decline in initial jobless claims was reported on August 8th, US stocks experienced their largest daily gain since November 2022, rallying +2.3%.[5]

Macro Backdrop

The US economy entered its fifth year of expansion following the brief (but very sharp) pandemic-related recession in April 2020. Ongoing economic growth has been more resilient than expected. Despite aggressive central bank tightening and geopolitical stress, robust consumer spending has supported economic activity—thanks to low unemployment and real wage gains. In contrast to previous Fed tightening episodes, households and the corporate sector have been protected from Fed rate hikes by locking in low rates on 30-year mortgages and longer-term corporate bonds.[6] Importantly, US households are not highly levered like they were prior to the 2008 Global Financial Crisis. The share of homes without a mortgage has risen to roughly 40% and nearly half of all mortgages outstanding have fixed rates below 4%.

That said, the lagged effects of monetary policy tightening are starting to show, and the economic outlook is uncertain. Recent data has pointed to declining consumer sentiment as a potential warning sign for spending ahead. Lower income households are feeling the impact of higher rates on their credit cards and auto loans, while the jobs market has cooled. Hiring has slowed from the overheated levels seen two years ago and companies are posting fewer job openings.[7] Meanwhile, inflationary pressures have eased. The Fed's preferred measure of consumer prices—the personal consumption expenditures (PCE) price index excluding food and energy—was up 2.6% in June from a year ago, not far from the central bank's 2% objective.

Since the last hike in July 2023, the Fed has pursued an extended policy rate pause at 5.5%—the highest level in over 20 years. As inflation declined, this stance has become increasingly restrictive. And with the Fed continuing to keep rates high, they are walking a fine line between risking further economic weakness and fighting inflation. Arguably, there's plenty of room to cut rates to support the economy, but policy changes have "long and variable" lags. It's widely expected that the first rate cut will occur at the FOMC's regularly scheduled September meeting. Fed officials have said they are putting increased weight on their full employment mandate. Based on Fed Funds futures prices, investors expect the policy rate to be reduced to 3% by mid-2026.

Acknowledging the difficulties in economic forecasting, we don't attempt to make predictions about the future, but seek to frame the backdrop by considering a range of potential outcomes. Despite the spotty track record of achieving a so-called "soft landing," we think the odds favor a continuation of the current economic cycle—but at a slower pace of growth. The recession scenario, although a lower likelihood, is certainly possible given the historical precedent. While a potential recession may be somewhat mild (given the strength of corporate balance sheets, for example), this risk may be underappreciated by financial markets.

A number of potential factors could alter the economic outlook, yet the upcoming US presidential election is likely to garner a disproportionate share of attention. Obviously, meaningful differences exist between the policy agendas of Former President Trump and Vice President Harris. However, what each candidate can ultimately achieve will depend on what happens further down the ticket. History has shown that it's notoriously difficult to forecast political results—and, often, the ultimate effect on economy and markets is different than expected.

Market Outlook and Portfolio Strategy

The uncertain macroeconomic environment combined with stretched valuations in some market segments suggests that volatility will remain elevated. But experiencing volatility is the price of admission to owning stocks and riskier assets. While our base case assumption of continued economic growth (albeit slower) should remain supportive of corporate profits, we worry that equity markets may be overly sanguine about the risk of recession. The S&P 500 Index is currently trading at 21x forward earnings, which is above the 5-year average of 19.3x and above the 10-year average of 17.9x.[8] This suggests that further upside is likely to be driven by earnings growth rather than increased valuations (or price-to-earnings multiples). Importantly, earnings growth has started to broaden outside of mega-cap technology stocks. Bloomberg data shows that earnings for S&P 500 companies excluding the "Magnificent 7"[9] are set to grow +7.4% in the second quarter from the same time a year ago, coming after five straight quarter of declines.[10]

While US stocks trade near peak valuations, various international developed and emerging markets appear more reasonably priced, either trading near or below their long-term average price-to-earnings multiples. As a result, the valuation disparity between US and non-US equities is much wider than usual, indicating a favorable long-term backdrop for international stocks. Non-US companies could also enjoy a more significant recovery in revenue and earnings from current levels as their economies were less resilient after the pandemic than the US economy, which benefited from much larger fiscal and monetary stimulus.[11]

After a period of ultra-low interest rates following the 2008 Global Financial Crisis, yields across most fixed income categories are near the highest levels in 15 years and close to their long-term historical averages. Therefore, we see better value in investment grade, high-quality bonds. In terms of riskier, credit-oriented investments, spreads are tight but absolute yields remain compelling. Our base case assumptions of moderating inflation and monetary policy easing would present an attractive scenario for most fixed income investments.

Within the context of a sound, long-term asset allocation framework, we believe that an active, flexible approach can enhance returns. In the current environment, we recommend minor tilts away from an appropriate strategic asset mix, but a readiness to take advantage of opportunities that may arise. Our tactical portfolio positioning themes are summarized below.

- **Remain fully invested in core/investment grade fixed income.** In addition to better forward-looking return prospects, higher starting yields also improve the potential diversification benefits of investment grade bonds in risk-off scenarios. We believe the asset class offers both attractive income and potential downside cushion.

- **Target an underweight position in US large cap equities while emphasizing reasonably priced high-quality stocks.** Heightened valuations and greater concertation pose a risk to US large cap stocks. Thus, we recommend an underweight position, along with a tilt towards higher quality companies (those with strong balance sheets, stable earnings, and high margins) trading at reasonable valuation multiples.

- **Increase small cap stock exposure to an overweight position.** Small cap stocks have significantly trailed their large cap counterparts this cycle. We believe the asset class appears attractively priced and could benefit from structural shifts in the economy, like deglobalization and reshoring. However, given the number of unprofitable companies in the small cap universe, we also recommend a quality tilt.

- **Maintain a slight overweight position in real assets.** Commodities and commodity-producer stocks can offer a potential hedge against surprise increases in inflation. A prolonged period of limited supply-side investment along with the secular transition toward renewable energy sources could further support commodities prices.

- **Where appropriate, continue to develop private equity and real estate investment programs.** Because of the associated illiquidity and inherent inefficiencies, private assets typically compensate investors with a premium return. The more challenging current fundraising environment may create attractive opportunities for patient investors. We also continue to view the venture capital space as a compelling way to invest in innovation.

The table below illustrates our current tactical asset category views.

Asset Category Tactical Views	Strong Underweight	Underweight	Neutral	Overweight	Strong Overweight
Cash					
Cash and Short-Term Bonds			✓		
Fixed Income					
Investment Grade Municipal Bonds			✓		
Investment Grade Taxable Bonds			✓		
Bank Loans and High Yield Credit			✓		
Equities					
US Large Cap Stocks		✓			
US Small Cap Stocks				✓	
Non-US Developed Markets Stocks			✓		
Emerging Markets Stocks			✓		
Real Assets					
Commodities and Natural Resources				✓	
Flexible/Alternative Strategies					
Diversifying Hedge			✓		

Note: Based on research and opinion provided by Greycourt & Co. Tactical views reflect a three-year investment horizon. Suggested asset class weights are used as a starting point in assessing client portfolio weights against strategic targets which typically reflect a ten-year investment horizon.

Special Topic: US Equity Market Concentration

A defining characteristic of equity market performance over the past few years has been the narrow leadership from US mega-cap technology stocks. A small number of these companies have driven most of the gains for the broad-based S&P 500 Index. Last year just 30% of stocks within the S&P 500 outperformed the index. This was a historically low figure—a level not seen since the late 1990s. Yet, so far in 2024, the concentration of returns moved even higher with only 27% of stocks outperforming the S&P 500 (through June). This is the lowest reading on record going back more than 50 years. The 10 largest stocks in the S&P 500 now account for over one-third of the index. This is the most concentrated that the US equity market has been in decades.

Source: AdvisorIntelligence and Ned Davis Research as of June 30, 2024.

The technology bubble of the early 2000s and the Nifty Fifty era that started in the 1960s marked the last two major periods of high market concentration. Each was resolved by a change in the business cycle, a recession, and a change in stock market leadership driven by the bursting of a valuation bubble.[12] However, according to GMO, if we compare today's markets with the market top in 2000, there is less to fear today on both the fundamentals and valuation multiples. The current S&P 500 top 10 stocks are higher quality companies (based on stability of profitably and balance sheet strength) with a median price-to-earnings ratio (P/E) of 27x. In 2000, the median P/E of the top 10 was 60x.[13]

Strategas Research Partners recently provided the following observations:

> *To the extent to which the 10 largest stocks make up 38% of the Index and also 31% of net income, it should not necessarily be surprising or worrisome. The very largest companies are de facto monopolies whose earnings are growing far faster than both the economy and the earnings of the "average" stock. Still, an examination of the data reveals that there are other things to keep in mind: 1) the gap between the performance of the market cap and equal weighted index has only been this wide in two other cycles – the late 90s and the late teens; 2) reversals from such wide gaps are often severe and rapid; and 3) the valuation difference between these two indices is also historically wide. Given the enormous amounts of cash flow these companies generate, one could be forgiven for saying "so what?" In the short term, professional investors are far more likely to be fired for not owning Nvidia than owning it in size. At the same time, experience tells us that the risk is often greatest when an investment thesis seems unassailable. For the long-term investor, it seems reasonable and prudent to think about diversification within the large cap universe itself.*[14]

Indeed, the extreme market concentration has produced a significant headwind to active management's relative returns over the last couple of years. Yet, as the S&P 500 Index has become increasingly titled towards growth stocks with stretched valuations and elevated expectations, we advocate maintaining a more balanced approach and tilting towards reasonably priced high-quality large caps. We also recommend leaning into market segments that are trading at more attractive valuations. Small cap US stocks, for example, are trading at valuations relative to large cap stocks that have not been seen in years, dating back to the late 1990's.

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