Equity Newsletter

2nd Quarter 2024

Although markets seem to be driven by momentum and speculation at times, investors still should keep an eye on what matters: Earnings!

The performance of the Magnificent 7 stocks in 2023 was stunning. The basket accounted for 58% of the 26.23% gain in the S&P 500 Index and the 7 stocks increased by an average of 76% for the year.

Earnings growth for the Magnificent 7 was incredible in 2023 (Chart 1). NVIDIA had a massive increase in profits on strong demand for its Artificial Intelligence (AI) semiconductor chips. Apple, Google, and Microsoft had solid earnings growth, although Tesla saw earnings decline. The real earnings stars though were Meta and Amazon. Both saw huge earnings increases in 2023 due to significant cost cutting and easy comparisons to the disastrous earnings both companies reported for 2022. Meta increased earnings by nearly 70% in 2023 after seeing a 37% decline in earnings the prior year. Amazon actually lost money in 2022 after earning over $30 billion in 2021. This past year they again earned over $30 billion. Both companies rebounded and earnings growth was off the charts compared to 2022 declines.

First quarter earnings are expected to still be dominated by the Magnificent 7 (Chart 1) and Tech+ (Chart 2), but earnings growth rates for those names are anticipated to slow over the balance of the year, while earnings growth for the rest of the market is expected to accelerate. By the 4th quarter of 2024, the rest of the market is expected to be growing as fast as the Mag 7 and the Tech+ group.

If investors keep their focus on earnings, we believe stocks with similar earnings growth and much better valuations will get their attention long before the first earnings announcements in 2025. **We expect the market to continue to broaden as earnings drive stocks throughout the rest of the year.**

Chart 1: S&P 500 Index Stocks Quarterly EPS Growth Year-Over-Year – Magnificent 7 vs. Remaining 493

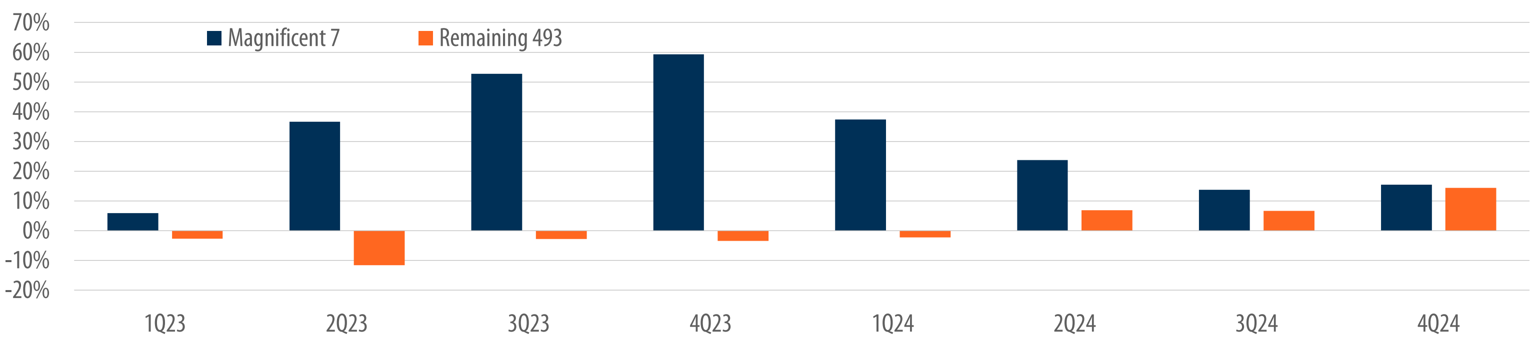
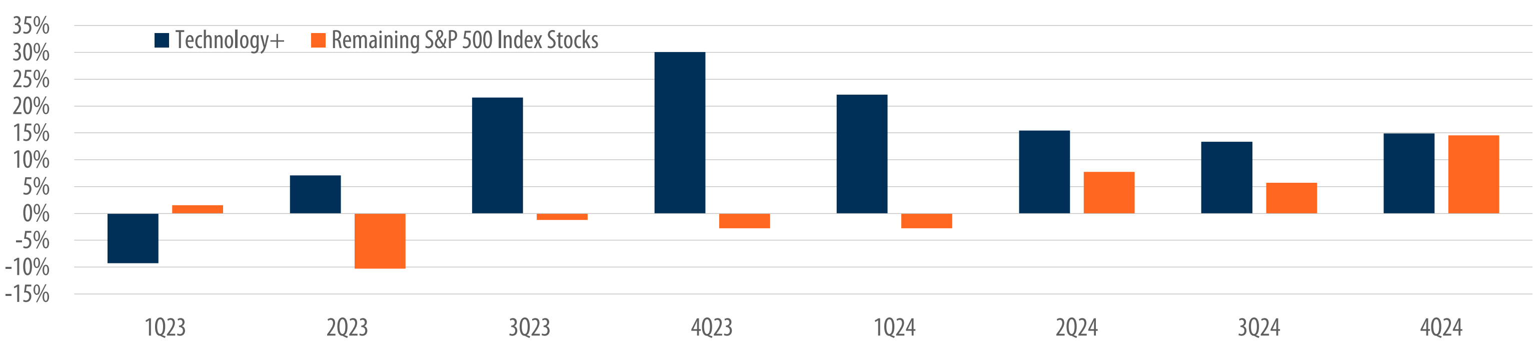


Chart 2: S&P 500 Index Stocks Quarterly EPS Growth Year-Over-Year – Technology+ vs. Remaining S&P 500 Index Stocks



Source for Charts: S&P Capital IQ. Data as of 3/28/24. There is no assurance any forecasts will be achieved. See definitions on page 3.

Past performance is no guarantee of future results.

Sector Views

Communication Services

- Digital advertising spending is robust, and benefits from election cycle tailwinds.
- After taking steps to rationalize costs in 2023, internet and streaming firms are investing in Artificial Intelligence (AI) to increase monetization and improve efficiency.
- Risk of increasing regulation.
- Focus on quality within sector.

Consumer Discretionary

- Low unemployment and strong wages are positives for consumption, but dwindling excess savings, still elevated interest rates and any rebound in inflation are key risks to sector.
- Services industries, such as travel and dining, more attractive than goods producers.
- Weak electric vehicle cycle impacts premium auto sales.
- Valuation not particularly attractive, in our view.

Consumer Staples

- Defensive sector but offers what we see as relatively meager growth.
- Consumer staples retailers and grocers face risk of reduced pricing power as inflation slows.

Energy

- Continue to see strong free cash flow generation as exploration & production companies have maintained capital expenditure discipline.
- Resilient US economy supports oil market demand.
- OPEC oil production cuts currently remain in place, and Russia has also recently announced its intention to curtail production. We see downside risk if this policy changes, or if OPEC coalition fractures and compliance with cuts diminishes.
- Geopolitical risks to oil supplies are re-emerging.

Financials

- Loan growth is mixed, as tightening lending standards and higher interest rates have resulted in less commercial lending and mortgage borrowing, while consumers are increasing credit card utilization; loan growth may accelerate if Fed begins to cut rates.
- Net interest margin (NIM) on loans have been gradually compressing as deposit rates have increased; NIM may stabilize in upcoming quarters if deposit rates have peaked.
- Credit quality remains reasonable, and banks are increasing reserve provisioning for potential future loan losses.
- Investment banking and trading revenue may improve in 2024 after a weak 2023.
- While risks remain in the sector, current valuations are attractive, providing a compelling long-horizon opportunity, in our view.

Healthcare

- Provides opportunity to invest in sector with growth potential that is less correlated to the business cycle.
- Popularity of GLP-1 weight loss drugs has negatively impacted sentiment towards medical device companies.
- Healthcare providers and services industry stand to benefit from strong utilization and growth in elective procedures and office visits. Additionally, cost headwinds from contract healthcare workers maya moderate over time.
- Biotechnology stands to benefit from secular innovation and potentially increasing merger activity as cash rich Big Pharma is motivated to replenish their pipelines, but higher interest rates have impacted funding costs for smaller biotechnology firms.
- Relatively weak performance in 2023 offers valuation opportunity, in our view.

Industrials

- Demand for capex is a secular driver that benefits sector, as firms are motivated to reshore supply chains and increase productivity in tight labor market.
- Sector benefits from fiscal spending on infrastructure as well as national defense.
- ISM Manufacturing PMI index continues to indicate cyclical weakness in industrial activity, as firms reduce excess inventories.
- Weak international macroeconomic growth may impact industrial exports.
- Defense industry names may benefit from increasing geopolitical risk.
- We believe valuation in sector is reasonable.

Information Technology

- Key innovations such as artificial intelligence and process automation offer substantial secular growth opportunities.
- We expect IT corporate spending to remain relatively stable in 2024, but a recession would negatively impact IT budgets. Additionally, technology stocks are still too expensive relative to value stocks.
- Prefer quality within the sector, particularly firms with strong corporate balance sheets and reasonable valuation.
- High multiple, unprofitable cloud software names are still risky, in our view, although lower rates may improve access to risk capital.
- Key semi end markets such as artificial intelligence, high bandwidth memory, and vehicle electrification stand to benefit from secular tailwinds. Valuation is a risk for some well-known semis benefiting from investor enthusiasm towards AI. Due to geopolitical tensions with China, increased export restrictions are a risk to the industry.

Materials

- Materials sector poised to benefit from policies designed to reshore supply chains amid geopolitical tensions.
- International economic weakness, especially weak Chinese construction, is a key risk.
- Incremental demand from clean energy grid infrastructure and electric vehicle transition is a secular positive.

Utilities

- Low growth sector but its defensive, dividend paying nature is more attractive in times of macroeconomic uncertainty.
- Interest rate sensitivity less of a concern post Federal Reserve tightening cycle.

Real Estate Investment Trusts (REITs)

- Higher yielding sector and has been sensitive to rising interest rates, stands to benefit if rates have peaked.
- Data center REITs may provide strong secular opportunity, but an IT spending slowdown would impact the industry.

DEVELOPED MARKETS

Europe

- Inexpensive valuation in comparison to U.S. stocks, but no clear near-term catalyst.
- Inflation is easing, but economic growth remains sluggish. Uneven industrial activity and soft exports are key areas of weakness.
- European Central Bank is expected to remain data dependent as economic activity slows and may begin policy easing around mid-year.
- Any re-acceleration of growth in China potentially stimulates demand for Europe's exports, but Chinese growth has recently been disappointing.
- Geopolitical risk from Russia's war on Ukraine.

United Kingdom

- Manufacturing PMI surveys point to modest improvement in industrial activity.
- Bank of England may be begin cutting rates as inflation is easing.
- Fiscal policy less supportive in 2024.
- U.K. housing market showing signs of stabilization.
- Inexpensive valuations in comparison to U.S. stocks.

Japan

- Robust wage growth and improving near term domestic demand prospects are driving inflation and corporate pricing power.
- Rising wages and core inflation has led the Bank of Japan to embark on a monetary tightening cycle, potentially lifting the Yen.
- Japan benefits from "friend-shoring" and increased secular demand for advanced technology exports such as automation equipment.
- Structurally low return on equities, although some corporate governance reforms have been implemented by the Tokyo Stock Exchange.
- Challenging demographics limit long-run potential economic growth.

Australia

- Commodity exporter which benefits from higher commodity prices.
- Exports of raw materials to China key driver of economic growth.

Canada

- Energy and metals exporter which benefits from commodity inflation and would suffer from a U.S. recession.

EMERGING MARKETS

Emerging Asia

- Despite monetary easing and limited fiscal policy stimulus, recent Chinese economic growth remains underwhelming. The beleaguered Chinese property market continues to weigh on fixed asset investment and is a source of downside risk to growth, while solid demand for services is cause for optimism.
- Rising geopolitical tensions between U.S. and China present risk to supply chains for key technologies and materials, and complicate U.S. firms' decisions to invest in China.
- India is experiencing robust economic growth, driven by strong consumption trends and infrastructure investment; we believe valuation is a risk.

Latin America

- Mexican economy benefits from exports to U.S. but would be negatively impacted by U.S. recession. Over time, supply chain diversification away from China may be a structural tailwind to exports.
- Brazil and Latin America overall are sensitive to demand for commodity exports, and commodity price inflation.
- Multiple central banks have begun policy easing in the region, including the central banks of Brazil, Colombia, and Chile.

Definitions

The S&P 500 Index is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability.

Magnificent 7 (Mag 7): AAPL: Apple Inc. MSFT: Microsoft Corporation. NVDA: NVIDIA Corporation. GOOGL: Alphabet Inc. AMZN: Amazon.com, Inc. META: Meta. TSLA: Tesla, Inc.

Technology+ (Tech+): Companies within the Information Technology sector in addition to companies within the Interactive Media & Services, Interactive Home Entertainment and Transaction & Payment Processing Services industries.

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