
# Equity Newsletter

1st Quarter 2024

## We expect a broadening of the narrow equity market leadership the S&P 500 Index experienced in 2023:

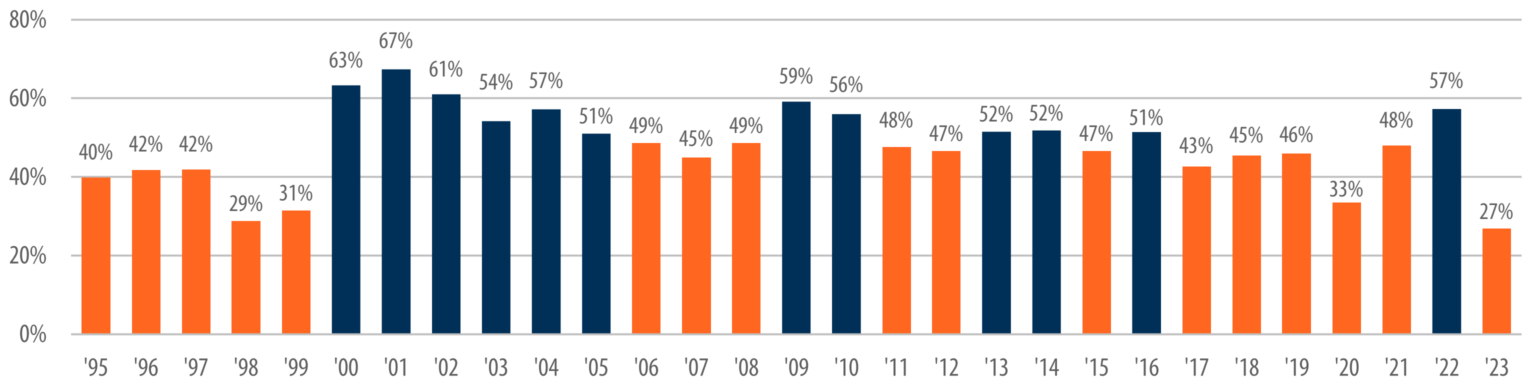
While the S&P 500 Index enjoyed a strong 2023 and returned over 26%, returns in the market were relatively narrow and top-heavy.

- Only 27% of S&P 500 Index members beat the index in 2023, which was the lowest percentage of outperformers going back to 1995 (Chart 1).
- By the end of last November, the top 10% of names by market capitalization comprised over 74% of the total weighting in the S&P 500 Index, indicating the market had become as concentrated as during the late 1990's dot-com bubble. (Chart 2)

We recommend investors stay in the market and own a broad array of equities as, in our opinion, there is a wider group of companies that will reward investors in 2024 than in 2023. That said, we retain a degree of caution towards U.S. equities, as further multiple expansion from here may be challenging.

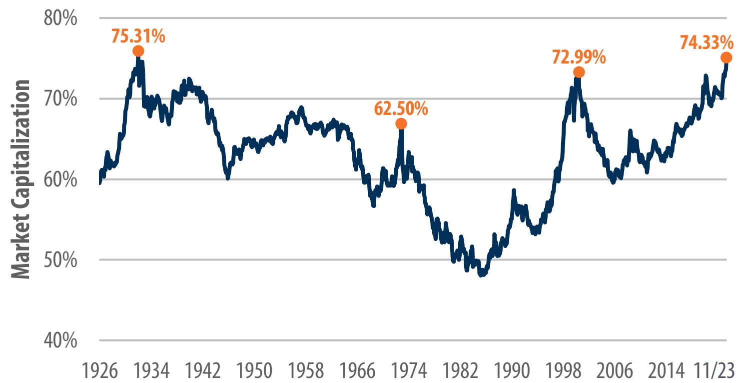
We favor value over growth, and increasingly prefer dividend paying equities. In our view, growth equities are priced at an unsustainably high premium to value (Chart 3), which may lead to the underperformance of growth equities if market leadership does indeed broaden, or if we experience a market pullback.

### Chart 1: Percentage of S&P 500® Index Members Outperforming the Index



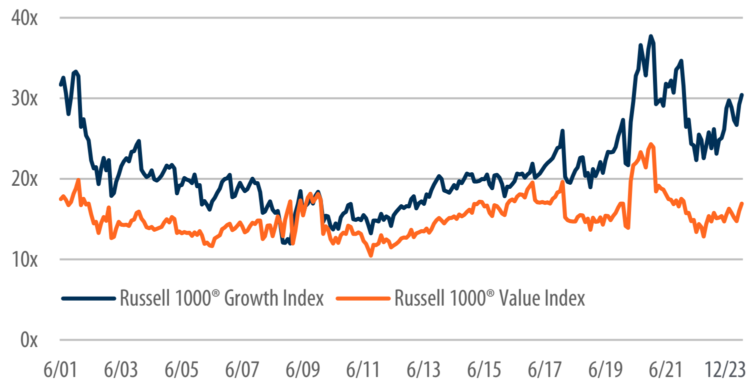

Source: Capital IQ. As of 12/29/23.

### Chart 2: Largest 10% of Stocks - Percentage of Total Market Cap




Source: Kenneth R. French Data Library. Data from 7/31/1926 - 11/30/2023. Universe includes all NYSE, AMEX & NASDAQ stocks.

### Chart 3: Russell 1000® Growth vs Value Forward P/E




Source: Bloomberg. Data from 6/29/01 - 12/29/23.

**Past performance is no guarantee of future results.**

# Sector Views

## Communication Services
- Digital advertising spending is improving and benefits from election cycle tailwinds.
- After taking steps to rationalize costs, 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, higher interest rates and higher than normal inflation are key risks to sector.
- Services industries, such as travel and dining, may be more attractive than goods producers.
- 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.
- Declining U.S. drilling activity limits further U.S. oil shale supply growth, supporting oil market fundamentals.
- OPEC production cuts remain in place, supporting prices. 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.
- Net interest margin on loans gradually compressing as deposit rates have increased.
- 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 quite 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 negatviely impacted sentiment towards medical device companies.
- Healthcare providers and services industries stand to benefit from normalization of elective procedures and office visits, as cost headwinds from contract healthcare workers moderate.
- 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 than benefits sector, as firms are motivated to reshore supply chains and increase productivity in a tight labor market.
- Sector benefits from fiscal spending on infrastructure as well as national defense.
- ISM Manufacturing PMI index continues to indicate a cyclical contraction in industrial activity, as firms reduce precautionary inventories built up during supply chain difficulties.
- Weak international macroeconomic growth may be a risk to exports.
- Defense industry names may benefit from increasing geopolitical risk.
- We believe valuation in sector is reasonable.

## Information Technology
- Key innovations such as AI and process automation may 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.
- We see cyclical risk to semiconductors overall, and we expect semiconductor capital equipment growth to slow. That said, key semi end markets such as AI and vehicle electrification 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 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.
- Office REIT fundamentals remain challenged as shift to work from home has impacted occupancy, although utilization of office space may improve over time.

# International Views

## DEVELOPED MARKETS

### Europe

- Inexpensive valuation in comparison to U.S. stocks, but no clear near-term catalyst.
- Uneven industrial activity and softening services point to risk of recession.
- 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

- Labor market is robust and wage growth is elevated.
- Inflation is easing but still impacting households.
- Manufacturing PMI surveys point to industrial weakness.
- Bank of England may be done with its tightening policy as inflation is easing.
- Fiscal policy less supportive in 2024.
- Weakness in U.K. housing market impacting economy.
- Inexpensive valuations in comparison to U.S. stocks.

### Japan

- Robust wage growth, improving near term domestic demand prospects are driving inflation and corporate pricing power.
- Rising wages and core inflation raise possibility that the Bank of Japan may revise its "yield curve control" policy, 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 recently 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 with U.S. 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. The Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. Forward Price-to-Earnings (P/E) is the price of a stock divided by estimated forward earnings. Investors cannot invest directly in an index. Market (cap) capitalization is the total dollar market value of a company's outstanding shares of stock and is calculated by multiplying the total number of a company's outstanding shares by the current market price of one share.

References to specific securities should not be construed as a recommendation to buy or sell and should not be assumed profitable.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