Open the Aperture in '24

"I'm trying to free your mind Neo. But I can only show you the door. You're the one that has to walk through it."

– Morpheus, *The Matrix* (1999)

Winning many accolades, *The Matrix* is considered to be one of the greatest science fiction movies of all time. In it, the prophetic Morpheus – captain of the Nebuchadnezzar – offers Neo the choice to understand the truth in contrast to the alternative perception in "the Matrix". Neo takes the red pill and frees his mind.

With great distortions in 2023, we wonder if investors will be able to free their minds in the coming year. Let's explain.

The main investment story for 2023 was the incredibly narrow market as evidenced by "The Magnificent 7" – a group of stocks including Apple, Microsoft, Google, Meta, Amazon, Tesla and Nvidia – that were up over 75% for the year. Meanwhile, the 493 other stocks in the S&P 500 were "only"up in the mid teens. Therefore, the market cap weighted S&P 500 index, in aggregate, did a lot better than the "average" stock within it.

While the extreme narrowness at the top of the market was the investment story of this past year, it's actually been going on for quite a while. As can be seen in the table at right, ranking the S&P 500 "Top 10" annual contribution to performance (during positive return years) since 1990 includes three of the last four years (and five of the last seven) near the top of the list. Investors have grown

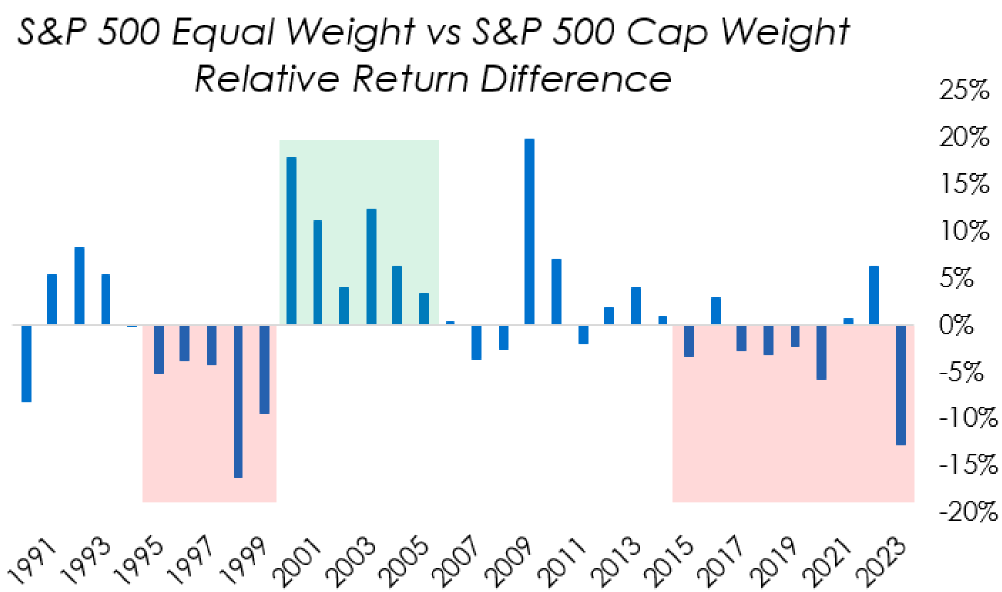
S&P 500 "Top 10" Contribution During Positive Performance Years Since 1990

Year	Top 10 % of Total	S&P 500 Return
2007	78.7%	3.5%
2023	68.4%	24.2%
2020	59.9%	16.3%
1999	54.5%	19.5%
2021	45.0%	26.9%
1998	36.8%	26.7%
1996	33.9%	20.3%
2017	33.3%	19.4%
2019	32.8%	28.9%
1991	28.6%	26.3%
2006	27.6%	13.6%
2016	26.6%	9.5%
2003	23.6%	26.4%
1995	22.3%	34.1%
2014	22.2%	11.4%
2004	21.1%	9.0%
2005	20.5%	3.0%
2010	19.6%	12.8%
2012	19.2%	13.4%
1997	19.1%	31.0%
2013	17.6%	29.6%
2009	15.5%	23.5%
1992	14.9%	4.5%
1993	12.2%	7.1%

Source: Strategas Research Partners, Factset. S&P 500 Return is price return only. The ishares S&P 500 ETF was used to calculate the 2023 Top 10 contribution with Top 10 based on ending weights.

accustom to succeeding with much less diversification. Owning the "Top 10" in the S&P 500 index has accounted for about half or more of the entire return in three of the last four years. Can that continue?

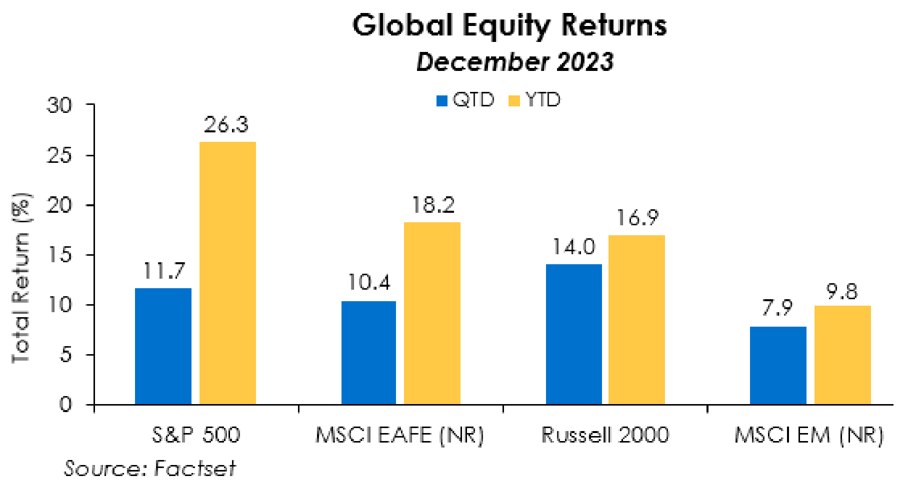
We're skeptical. As can be seen in the chart below, the last time the "average" stock – as defined by the S&P 500 Equal Weighted index – underperformed by this much relative to the S&P 500 Cap Weighted index was in the late '90's. Back then, Tech mania – driven by the advent of the internet – drove such performance disparity. While, the "average" stock suffered in relative terms in each of the last five years of that decade, a resurgence occurred in the next six years of the following decade.



Source: Factset; Return difference is based on price return only.

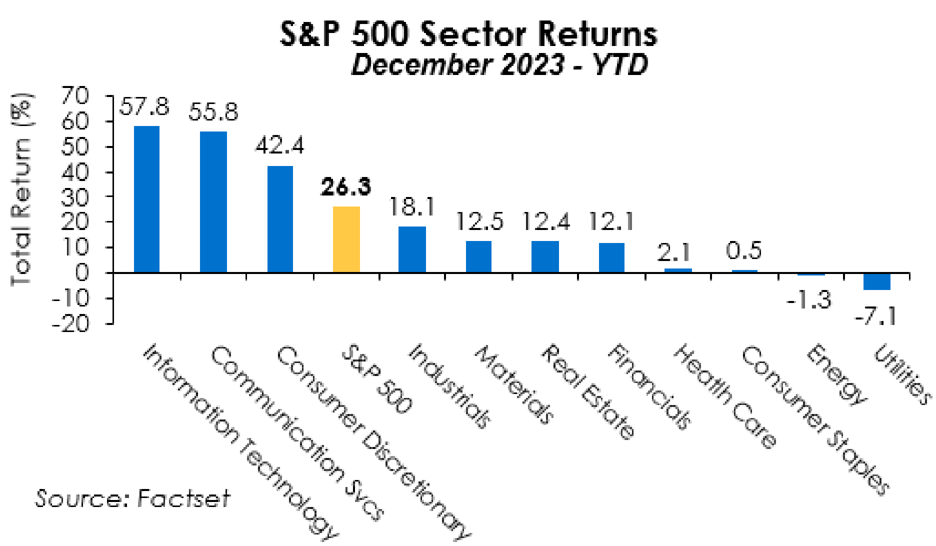
As stated previously, the market was incredibly top heavy in 2023, but the narrowing of the market has been evident for a while now. As can be seen in the chart, the "average" stock has most recently underperformed the cap weighted index in six of the last nine years. While the story on Tech has evolved from the "internet" to the "internet of things" and now "AI", the performance disparity in the stock market has, once again, become pronounced. According to a Vanda Research study done back in mid October, almost 40% of the average investor's portfolio is held in just three names. Based on this research it would appear that the average investor has very little exposure to the average stock. This conjures up the notion of a listing ship at sea. We can't help but wonder if diversification might, once again, become treasured as opposed to shunned like it has of late. In order for that to happen, growth might have to be more widely recognized outside of the megacap behemoths. After suffering an earnings recession in the first half of last year, we wonder if the profit recovery seen of late might be the catalyst that frees up the minds of investors to recognize that there are more attractive growth opportunities beyond those represented at the top of the market. In short, will investors take the blue pill and believe in the "same as it ever was" market mantra or will investors take the red pill and seek to uncover new opportunity? With history (and Morpheus) as our guide, our view is the latter.

2023 finished strong with robust December returns in a year where all asset classes, except Commodities, posted positive returns. Continued optimism around moderating inflation, Fed rate cuts, and an increased likelihood of a soft landing contributed to the strength. Year-to-date, Stocks led all asset classes with REIT's and Bonds also delivering solid returns. Commodities were the outlier, declining high single digits.



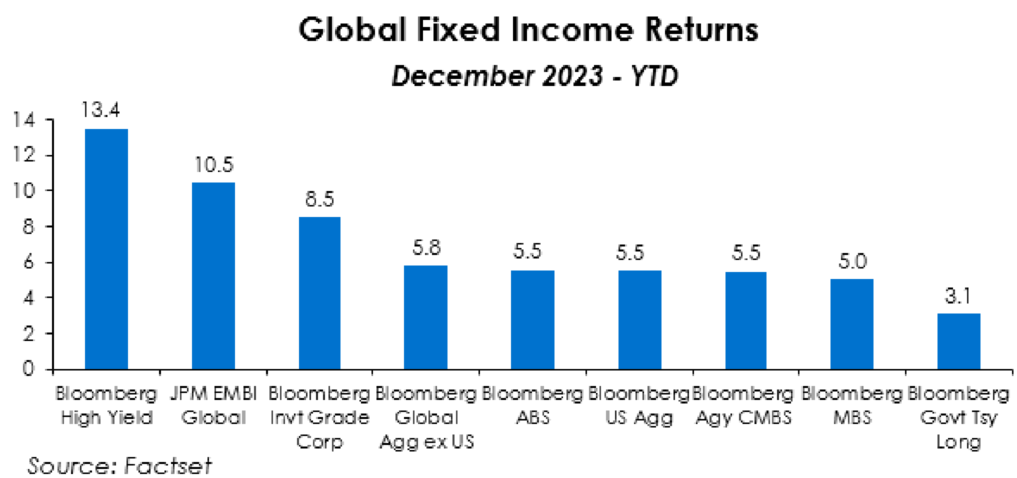
Stocks

Equity performance continued to broaden in December with strong returns across size and geographic factors but especially in US Small Caps (Russell 2000) – posting double digit returns due to declining interest rates and optimism around a soft landing. Still, a narrow subset of U.S. Large Caps (S&P 500) dramatically led for most of the year. Overseas, equity performance in International Developed Markets (MSCI EAFE) remained solidly positive – helped by resilient earnings and progress on inflation in Europe as well as optimism around corporate governance in Japan. The return in Emerging Markets (MSCI EM) was up in December and for the year but lagged on a relative basis given weakness in China. Meanwhile, US Large Cap sector performance favored the higher priced "Magnificent 7" within the cyclical growth sectors (Technology, Discretionary and Communication Services). Conversely, both cyclical value (Energy, Materials & Financials) and defensive sectors (Health Care, Utilities and Staples) starkly underperformed.



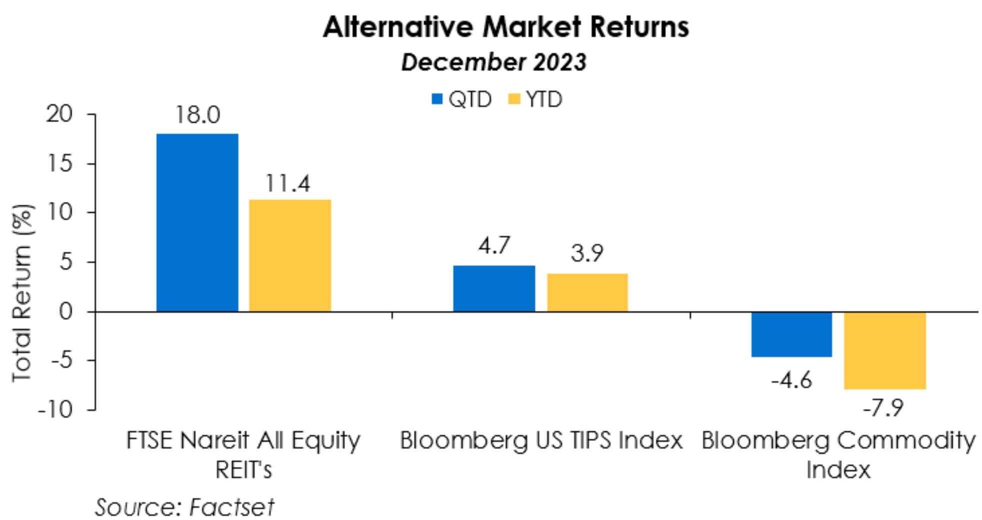
Bonds

Following aggressive moves by the Fed (Fed Funds at 5.25-5.50%) amid ongoing balance sheet reduction – policymakers have now indicated a "wait and see" approach while the market has priced in significant rate cuts for 2024. Rates have been volatile, with 10 Year Treasury yields declining over 100 bps in November and December after increasing roughly 80 bps from August through October. Meanwhile, the yield curve remains inverted but has steepened off the lows. Bonds ended the year with solid returns (US Agg) due to the recent decline in longer term interest rates. Year-to-date, the notable tightening of credit spreads led to outperformance in corporate bonds (High Yield and Invt Grade) and Emerging Market Debt (EMBI). Conversely, longer duration securities – represented by Long-Term Treasuries (Govt Tsy Long) – lagged due to higher rates for much of the year, though have been much improved since the end of October.



Alternatives

Commodities were the outlier, trading lower for the year with negative returns in Agriculture, Industrial Metals and Energy. The exception was Precious Metals, including Gold. Meanwhile, publicly traded Real Estate (REIT's) ended the year up nicely after a strong fourth quarter rally. Finally, Treasury inflation protected securities (TIPs) benefited from the positive carry in bonds year-to-date, while inflation expectations moved sideways to down to finish the year.



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.

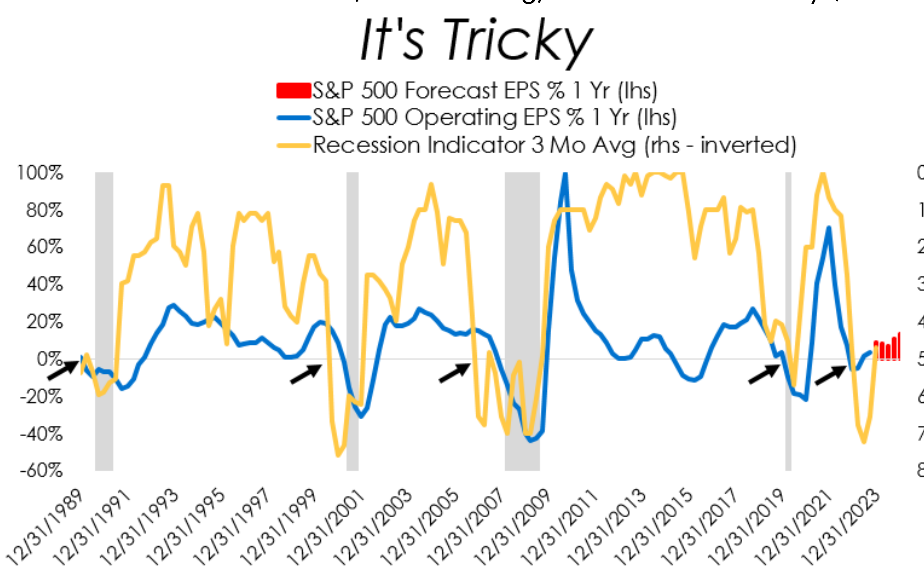
From a secular lens, we remain sympathetic to the notion that the paradigm is changing to one that ushers in the potential for more persistent and volatile inflation. Such a backdrop might set the stage for a higher cost of capital environment acting as a weight on stock valuations along with changes 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).

	Gravity	ZERO G	
	1963-1997	1998-2022	Current
10 Year Yield	7.8	3.4	3.9
CPI	4.9	2.4	3.1
P/E	15.7	22.7	24.1

Source: Factset; 10 Year Treasury Yield and CPI measures are averages over the respective time periods. P/E is a trailing twelve month median calculation based on company reported earnings. Historical earnings are taken from Robert Shiller's U.S. Stock Markets 1871-Present and CAPE Ratio (http://www.econ.yale.edu/~shiller/data.htm). Current 10 Year Yield and P/E as of 12/29/23, Current CPI as of 11/30/23.

As can be seen in the table at right, correlation changes between stock prices and interest rates over the past 60 years have led to the demarcation of two different regimes that we've dubbed the "Gravity" Regime and the "Zero G" Regime. The former witnessed a period where interest rates and inflation were higher and more volatile creating a gravitational pull down effect on stock valuations. The latter period saw the opposite – whereby lower and less volatile interest rates and inflation removed the gravitational pull down effect and allowed stock valuations to expand. Currently, there's no doubt that inflation is moderating with CPI now well below its peak of 9.1% back in June 2022 – suggesting the first wave of inflation 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. By our estimates, money supply growth is still sitting meaningfully above its long-term trend so if policymakers ease agressively, we wonder if a second wave of inflation takes shape. As a result, we can't help but wonder if today's current environment might have shifted to be a bit more like the former regime than the latter one. 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".

At the other end of the spectrum is the cyclical perspective which, admittedly, has gotten more "Tricky" of late. A broadening package of both Fundamental measures (manufacturing/service sector surveys, building permits/home prices, core retail sales, core durable goods, unprocessed goods inflation, copper prices, and the leading economic indicator composite) and Liquidity measures (lending standards, yield curves, money supply growth) appear to be in some stage of bottoming. Perhaps not coincidentally, corporate profit growth is also forecasted to improve (based on an operating trailing twelve month basis) as we move into 2024.



Source: Factset; S&P Dow Jones Indices with 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.

At the same time, we remain committed to the idea of being late in the business cycle with current conditions that have often been precursors to recessions historically. In fact, while our recession indicator has recently improved, that's not unprecedented in other eventual recessionary patterns. As can be seen illustrated in the chart above, the recession indicator remains at comparable late cycle levels while earnings growth is bottoming and forecasted to improve. This makes for a desynchronized setup between the business cycle and the profit cycle – perhaps driven by the lingering aftermath of the COVID shut-downs. The combination of the two makes for a "Tricky" cyclical backdrop with sustainability of profit growth improvement unclear and largely contingent on labor market and inflation trends.

For now, we think it's important to acknowledge the recent improvement in Fundamentals and Liquidity and reposition portfolios from a defensive to a more balanced tenor. We believe one of the bigger opportunities exists in the "average" stock which has already experienced valuation pressure from the earnings recession that we've now exited. While the market cap weighted S&P 500 is trading at an elevated valuation (20X vs LT average 18X), more attractive valuations are apparent in the "average" stock (with the equal weighted S&P 500 trading at a more modest 16X). To the extent that there's some degree of cyclical improvement, this disparity in valuations might begin to close.

The bottom line is that late-cycle conditions make growth sustainability unclear, however, we've noted cyclical improvement in the Fundamentals and a bottoming in earnings growth. As such, our view is becoming more balanced while keeping in mind the "Tricky" setup calls for that "Head on a Swivel" mantra.

As we look into 2024, we think investors might have to think differently or "Open the Aperture" from both a cyclical and secular lens. Alternative scenarios to the "same as it ever was" view might be beneficial to consider.

"Open the Aperture"

Cyclical View (Shorter-Term)	Secular View (Longer-Term)
Late cycle	*Changing paradigm*
Profit Improvement	*Persistent and/or more volatile inflation*
Unclear growth sustainability	*Higher cost of capital*
Disparate Valuations	*Lower multiples*
"Head on a Swivel"	"Do the Opposite"

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, we 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). While we entered 2023 with an UW to risk assets, we've let that UW lessen amid the past year's market rally as Fundamentals appear to be bottoming. We recently adjusted our positioning within US Large Caps to more of a balanced posture. We accomplished this by adding to some late-cycle cyclicals along with a smaller cap size bias and did so at the expense of more defensive oriented exposures.

Within equities, our Large Cap positioning has now shifted toward more balance between traditionally defensive sectors (like Staples, Health Care, Utilities) along with the recent add to late cycle cyclicals (like Energy, Industrials) and the "Average" stock (Equal Weighted S&P 500). We continue to be decidedly UW the most expensive, cyclical growth areas (Tech, Discretionary, Communication Services) as investors have taken on a "Heads I Win, Tails You Lose" mentality with speculative fervor. This remains where the most concentrated and most expensive stocks reside.

<u>Within fixed income,</u> we remain UW the most cyclical parts of the bond market where spreads have tightened considerably (High Yield and Emerging Market Debt) while our US Core Fixed Income exposure remains among our biggest OW in portfolios. Our US Core Bond managers are slightly OW corporate bonds, though we've previously moved up in credit quality by adding some Treasuries and lengthening duration (along with the adjustment from a barbell to belly approach).

<u>Within alternatives,</u> we're slightly OW in aggregate. We remain OW to Diversified Alternatives which provides some hedge against market volatility. We're relatively EW to Commodities as a way to bolster inflationary hedges. Meanwhile, we're slightly UW Real Estate.