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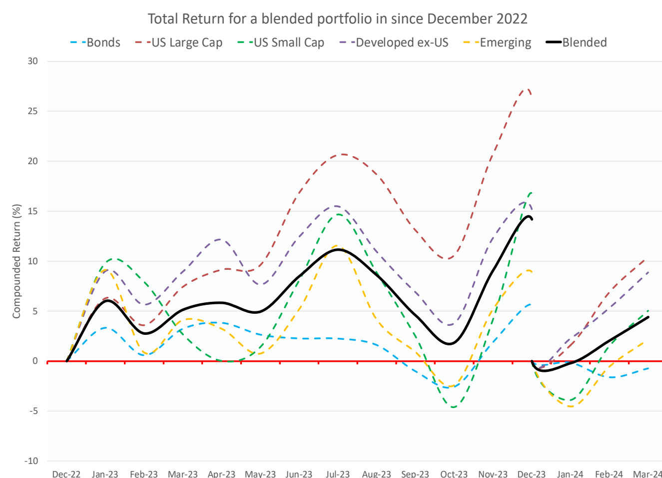
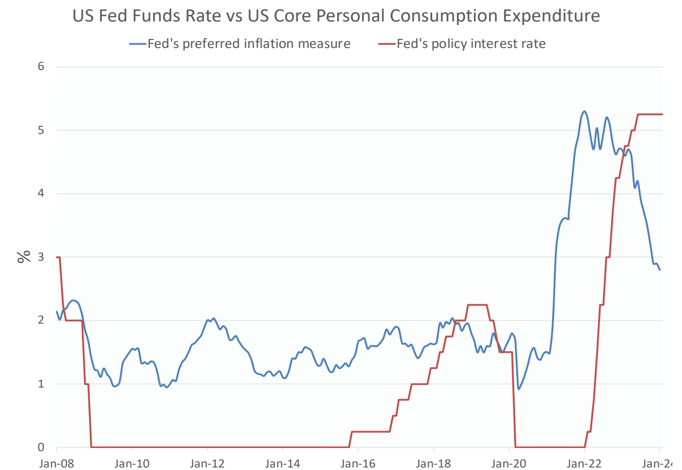
WHERE WE STAND – Q1 2024

In Q1 of 2024, a typical blended portfolio* of securities had a total return (capital appreciation plus income) of 4.4% (black line in the chart below). Leading advancers were US Large Capitalization stocks with a +10.4% return in the quarter. Developed Markets ex-USA were up 8.9%, led by the exemplary performance in Japanese stocks. US Small Cap stocks and Emerging Markets lagged with 5.0% and 2.2% returns respectively. The latter being dragged down, notably, by continued underperformance of Chinese stocks. Bonds were negative on the quarter by 0.7%, taking a breather from the good performance in Q4 of 2023.



*A typical blended portfolio would be comprised of 60% equities and 40% bonds. For a benchmark, such a portfolio would arguably be 30% large cap US stocks, 10% US small caps, 10% developed markets ex-US, 10% emerging market stocks and 40% US government, investment grade corporate and GSE bonds.

Markets continued to debate the likelihood of a soft-landing in the US economy – where inflation will move towards the Federal Reserve's target of ~2%, without the Fed having to induce an economic slowdown through sharply restrictive monetary policy. Year-on-year inflation trends continue to ameliorate, and the Fed continues to signal that interest rate cuts are coming during 2024. The chart at the top of the next page shows the Fed's preferred inflation measure (the core-PCE deflator) plotted against the Fed's policy rate (Fed Funds), since the great recession. As can be seen from the chart, there is a tale of two economic/financial conditions. From 2008



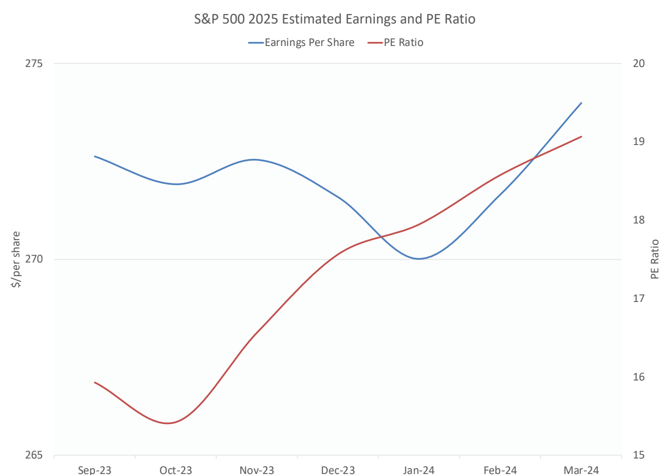
to around 2017, the Fed was dealing with an inflation rate that was consistently below its target of 2%. In late 2016 the Fed began to raise interest rates, realizing that the economy had recovered sufficiently and that a negative real rate (where the policy rate is below the inflation rate) was unwarranted, and threatened to restoke inflationary pressures. This process was interrupted by the pandemic, where the Fed was forced to return interest rates to zero (accompanied by massive fiscal stimulus by the Treasury). This and other exogenous variables, like supply-chain issues, caused inflation to become a problem. The Fed ultimately responded by tightening interest rates very aggressively. Inflation measures responded to this tightening, and now for the first time since 2002 we have positive real interest rates in the USA.

This is normal. Negative real interest rates are aberrational: they existed in a meaningful way for a 10-year period after WWII and during the 1970s, which is considered a policy mistake by the Fed that led to the inflation late in that decade. At the same time its relatively safe to say that interest rates are somewhat restrictive now and that there is no longer the need for further rate hikes.

All the while that inflation has been improving since 2022, the US economy has been growing. For 2023, economic growth was a real 3.1%. (Nominal growth of almost 6%!). In its summary of economic projections last month, the Fed indicated it expects growth to slow to 2% over the

next 2 years. The Fed for now is in a holding pattern, realizing that easing too soon would 'result in a reversal of progress' on inflation, but that 'reducing policy restraint too late or too little could unduly weaken economic activity and employment'.
Net of all these considerations, the Fed's reaction function is to say that: 'the appropriate level of Fed Funds will be 4.6% at the end of 2024, 3.9% at the end of 2025, and 3.1% at the end of 2026'. This implies 0.75% easing this year; 0.7% in 2025 and 0.8% in 2026. If these Fed projections do turn into fruition, they provide a very supportive backdrop to asset valuations.

Meanwhile, it is apparent that US business is humming along. There is a manufacturing boom across the country. Productivity (a pillar of non-inflationary economic growth) is on the rise and could be enhanced over the next few years through technological advancements. As a result, even though interest rates have risen, estimates for earnings for the S&P500 have held firm around $270 per share for 2025. However, investor exuberance has outmatched earnings expectations. The index has rallied 25% since it became apparent the Fed was done with raising interest rates in October 2023 and in so doing, the forward PE ratio has risen from ~15x to now, a not inexpensive, 19x earnings. See chart below.



Where We Stand

The 'good probability' forward-looking conditions, as explained in the previous section are:

- Inflation in the US economy is moderating and possibly heading towards the Fed's target of 2%.
- Economic growth, while moderating, is not indicative of a pending recession.
- Interest rate increases are likely over in this cycle, and there are potentially, meaningful cuts on the horizon.
- Estimates for S&P500 earnings for 2025 are for $270 per share, up 14% from 2024.
- Investor sentiment for the S&P500, as a whole, is to say the least buoyant (and therefore vulnerable to exogenous shocks).

The chart above shows the S&P500 (SPY) in orange. The S&P500 is a market capitalization index and has therefore become dominated by mega-cap constituents. The equal capitalization S&P500 index (RSP) shown in blue, is constituted by the same 500 stocks, but in equal weights.

The two tables on the next page show the top ten holdings (out of 500) that each of these indices holds.
The S&P500 has a full 32% of its value in its top ten holdings. All excellent performers (by definition, the best performing stocks in a market-cap weighted index rise to the top), that have accounted for the outperformance of SPY vs RSP as shown in the chart.

SPY top ten holdings:

Top 10 Holdings

Name	% Holdings
Microsoft Corporation	7.11 %
Apple Inc	5.71 %
NVIDIA Corp	5.06 %
Amazon.com Inc.	3.73 %
Meta Platforms Inc - Ordinary Shares - Class A	2.47 %
Alphabet Inc - Ordinary Shares - Class A	2.02 %
Berkshire Hathaway Inc. - Ordinary Shares - Class B	1.72 %
Alphabet Inc - Ordinary Shares - Class C	1.70 %
Lilly(Eli) & Co	1.41 %
Broadcom Inc	1.32 %
Percent of Portfolio in Top 10 Holdings	32.25 %

RSP top ten holdings:

Name	% Holdings
Micron Technology Inc.	0.24 %
Fedex Corp	0.23 %
PayPal Holdings Inc	0.22 %
Archer Daniels Midland Co.	0.22 %
Oracle Corp.	0.22 %
McCormick & Co., Inc. - Ordinary Shares (Non Voting)	0.22 %
Freeport-McMoRan Inc	0.22 %
Valero Energy Corp.	0.22 %
Conoco Phillips	0.22 %
General Motors Company	0.22 %
Percent of Portfolio in Top 10 Holdings	2.26 %

The move towards passive investing (holding index funds rather than actively managed funds) has contributed to this concentration in S&P500 Index funds. For context: the average of the top 10 holdings in the index has been 20%. And at the peak of the Tech bubble in 1999, was 25%. Today: 32%.

The point here is not to pass an opinion on the valuation of the top ten names (we hold some of these names in our portfolios), but rather to add a variable to the forward conditions we pointed out at the beginning of this section:

- Investor sentiment in many of the S&P500 stocks is quite negative and if the scenario that the Fed is proposing is correct, then these stocks still have substantial upside.
- Many of these stocks have excellent cash flow, reasonable valuations and substantial dividends that afford the investor the luxury of time should economic developments be less sanguine, or an unexpected exogenous shock happen.

For value investors, opportunities are abundant. The types of equities mentioned above stand to benefit over the next few years as investors focus on locking in these values and dividend payouts.

Same can be said for various fixed income paying instruments like high yield bonds and preferred equities.