Q1 2024 IN REVIEW

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The stock market started the year with a bang – but with stock prices up and estimated earnings down, where do we go from here?

Chief Investment Officer, Nick Nejad, CFA® and the BHPW Investment Committee share their thoughts.

If you would like to discuss any of these topics in more detail, please call us at 310-388-3800.

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PRIVATE WEALTH

SUMMARY

Stocks kicked the new year off in a robust fashion, with the MSCI All-Country World Index ("ACWI") of equities finishing the quarter up +8.2%. It was the best start to a year in half a decade, with returns that were remarkably consistent throughout the period. One out of every three trading days ended at a new all-time high. And, each month finished positively, extending the streak of winning months to five.

Including year-to-date gains, stocks have now returned +24% since the end of October. *Importantly, all those gains have come from higher market valuations*. Earnings estimates are actually down over that stretch, meaning stocks today are a fair bit pricier than they were just five months ago. We don't think it's time to ring the alarm bells just yet. But speculation and exuberance are certainly bubbling up, especially here in the US, and we believe it's important to be prudent by trimming exposures where momentum has gotten carried away. We'll discuss this and more portfolio implications at the end, but first we begin with a quick quarterly recap.

Q1 OVERVIEW

Markets picked up where they left off to start the new year, with investor optimism buoyed by three key factors: the resilience of the global economy; the expectation of several imminent interest rate cuts; and the promising new potential of AI (artificial intelligence). It was due to this last factor that gains started the period primarily in Technology. However, returns broadened as the quarter progressed, with most sectors ultimately finishing up high single to low double digits. The best performing sectors were Communication Services, Financials and Energy. Meanwhile, the worst performers were Real Estate and Utilities, with Real Estate having the notable distinction of being the only sector to finish in the red.

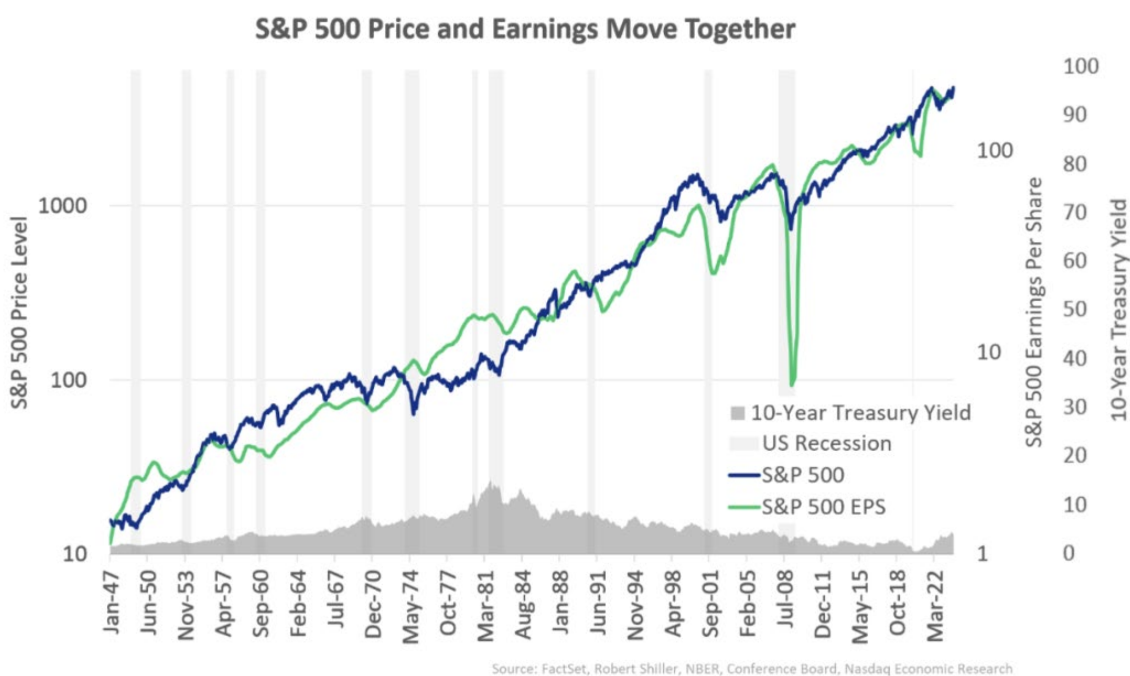
Geographically, returns varied more widely. Among the major markets, Japan was a top performer, with its stock market surging by +11.0% in dollar terms, bringing it within striking distance of its historic *1989* peak. Its 35-year stretch of underwater performance underscores the perils of beginning at a high valuation – estimated to be around 65x earnings in Japan at that time! Elsewhere, the US posted strong returns with a +10.6% increase, while Europe and emerging markets lagged.

The *real* standout performer this period wasn't a sector or geography, though. It was momentum – a factor which might not frequently make the headlines, but which has significantly dictated the market's direction over the past five months. We can see this with the S&P Momentum Index, which seeks to invest in companies showing recent relative strength. It has already risen by +22.3% this year, and by over 40% since October. That has important implications which we'll address later.

Finally, bonds did not fare as well as stocks over this three-month span. Interest rates drifted higher, causing prices to generally fall by more than their yields. As a result, the global aggregate bond index finished the period down -2.1%. High-yield bonds, cash, and short-duration securities typically outperformed, earning positive returns in most cases. Meanwhile, long duration assets and non-US dollar securities lagged versus the benchmark.

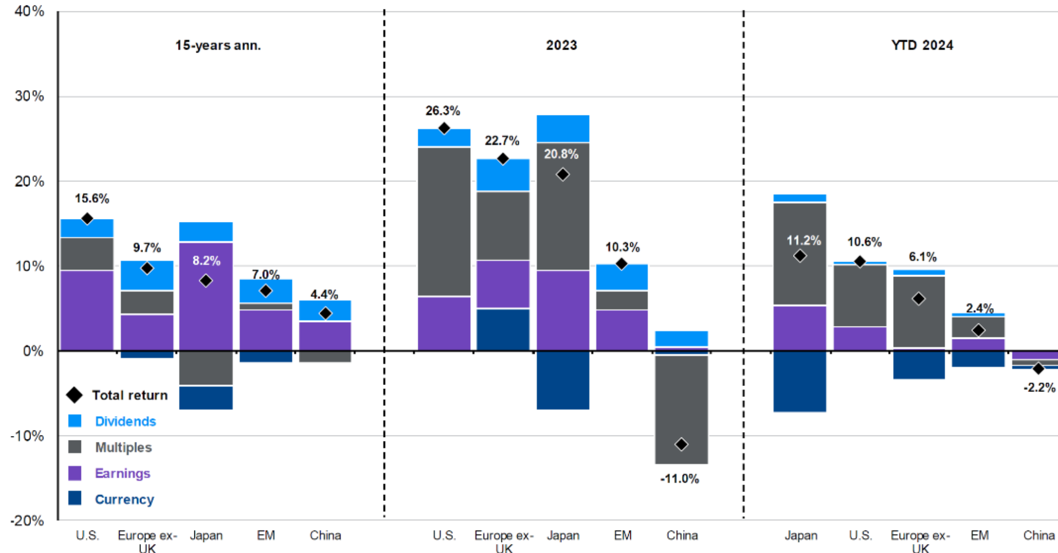
PRICES, EARNINGS, & EVERYTHING ELSE

Over the long term, stock prices follow their fundamentals. We can see this vividly in the chart below, which compares the S&P 500's earnings per share ("EPS") alongside its share price. The two have been closely correlated going as far back as the 1940s. Every individual stock is just a microcosm of this broader phenomenon.



But, while earnings growth plays a critical role in long-term stock results, several other components also influence the figure greatly, including dividend yields; changes in valuations; and even currency movements (if the investment is based internationally).

The chart below breaks down the returns of several major markets into their sub-components. Homing in on the 15-year chart, we can see that the US has just experienced an exceptional run of +15.6% annually. Almost 10% per year of that is attributable to earnings growth. However, the rest was due mostly to changes in valuations, as US stocks became more expensive over that time.



A March 2009 starting point certainly exaggerates the number here. If we started in January 2008, the total US return would be only +10.7%.

Here's what's interesting: Japanese earnings actually outgrew the US over this period. Yet, despite the faster increase, Japan still underperformed the US by a full seven percentage points annually. The swing factor was entirely multiples: US stocks became richer over this period, while Japanese stocks became cheaper.

One reason investing is hard (there are many) is because even *when* you have a correct grasp of the fundamentals, sentiment-driven factors *15 years later* can undermine your investment results. Imagine the investor who correctly pinpointed Japan's faster growth back then. Now, consider the environment that individual faced at that time: Were Japanese stocks really that expensive at a price-to-earnings ("P/E") ratio of 16 times earnings?

US investors staring at P/E ratios north of 20 times today may want to take notice.

SURE THINGS

But surely, *everyone knows* the US will continue to outperform, right? Well, making predictions 15 years out is very challenging. For those who disagree, consider all the widely held convictions of the last 15 years which have fallen in and out of favor. Everyone knew that we'd run out of oil supplies soon; then, everyone knew we wouldn't need the stuff. China would overtake our economy by around next year. Interest rates would stay low forever. Inflation would be permanently subdued by cheap imports. Globalization would only increase. Software would eat the world. The list goes on and on.

A reflection on the last 15 years' worth of certainties would lead to the conclusion that "sure things" are just as likely to be wrong as not.

> *"The future is never clear, and you pay a very high price for a cheery consensus. Uncertainty actually is the friend of the buyer of long-term values."*
>
> *– Warren Buffett*

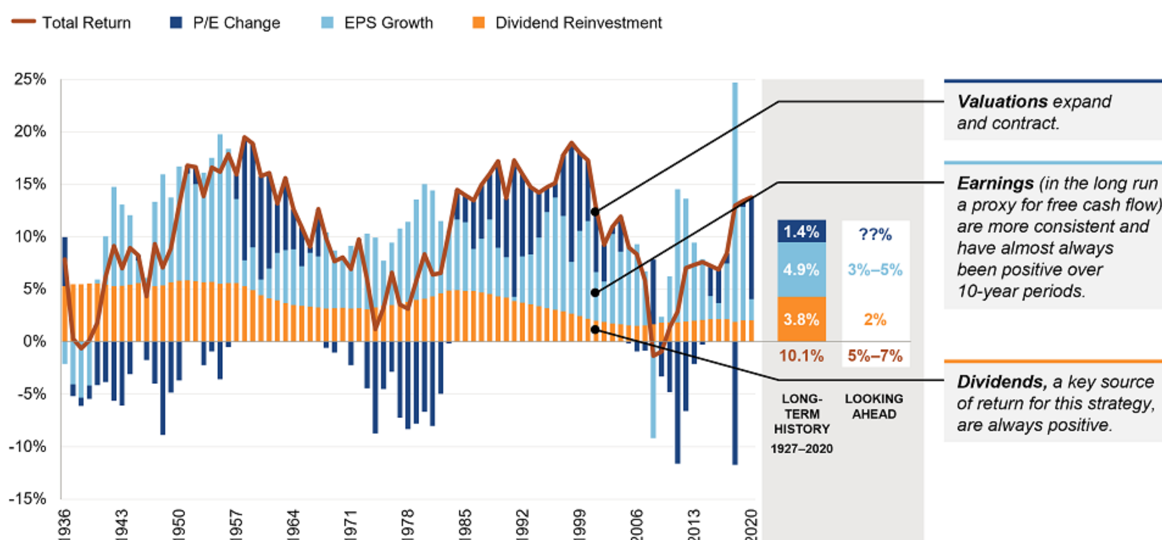
Thankfully, there are steps we can take to increase our chances of successful investment outcomes. The secret is valuations: buying securities when they are cheap – or at least reasonably priced.

The benefits of doing this are twofold. First, cheap valuations often go hand-in-hand with higher dividend yields, which are the most reliable source of long-term investment results. Although these yields are very low in the US right now – at 1.4% – they have historically been much greater, averaging 3.8%. Moreover, they still remain at those levels in markets outside the US.

Second, starting cheap also increases the likelihood that multiple shifts work in our favor. When P/E ratios are low, they are more likely to go up. On the flip side, high starting valuations risk severely undermining results – a lesson that Japanese investors of the last four decades know all too well.

We can see both effects in the following chart, which breaks down 10-year returns for the US going back to the 1930s. From this, we can see that dividend yields and earnings growth emerge as the two most stable contributors to results. Meanwhile, changes in the P/E ratio, represented in dark blue, can be much, much more erratic.

EARNINGS, DIVIDENDS AND VALUATION: RETURN CONTRIBUTIONS FOR ROLLING 10-YEAR PERIODS
(S&P 500 Index 1936–2020)

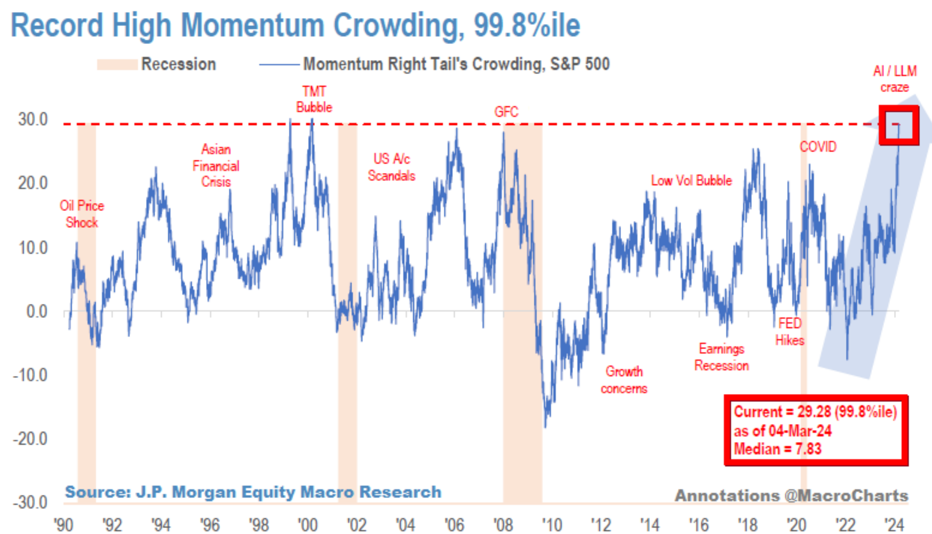


Sources: Epoch Investment Partners, Inc.; Standard & Poor's.
Note: We use U.S. historical data as a proxy for global markets because similarly detailed data is not available for non-U.S. markets.

A MOMENTUM-DRIVEN RALLY

Linking this back to present circumstances: stock prices have now risen by +24% since the end of October. Yet, estimates for S&P 500 earnings have actually fallen over that span, weighed by higher debt and labor costs. This divergence between rising stock prices and declining earnings has made the US significantly more expensive than just a mere five months ago.

If fundamentals are not behind the latest move, what is? We conjecture that it's the twin excitement over anticipated interest rate cuts and the limitless potential of AI. Whatever the reason, the situation has sparked a surge in speculation and risk appetite reminiscent of 2021. For example, cryptocurrencies have regained in popularity; SPACs have made a comeback; and the markets have not seen a -2% pullback for over 5 months. But, perhaps the clearest indicator of all may be the strength of the momentum factor, which has recently emerged as a significant driver of equity returns. In fact, the last time crowding in the best performing momentum stocks was this intense was during the dot-com bubble.



Interestingly, the names comprising the momentum index are surprisingly diverse this time. "Exciting" AI and chip stocks are undoubtedly on the list, but so too are "boring" names from sectors like Healthcare and Industrials. Even the likes of Berkshire Hathaway, Costco and JPMorgan made the cut, which says that value and growth portfolios alike have benefitted recently from this momentum factor. There have also been winners and losers in nearly every sector.

It would not surprise us to see a significant unwind soon of this anomaly. And unfortunately, US valuations won't be very supportive when that sentiment sours. With just a 1.4% dividend yield and a starting P/E ratio that's 35% above its own long-term average, the US market could face considerable challenges if conditions normalize. *Caveat emptor*.

BHPW POSITIONING

With the broader US markets feeling a bit overheated, we believe now is an opportune time for prudence. Here are several steps we are taking to protect client portfolios.

First, we are taking advantage of the recent momentum to trim winners as they reach or exceed our fair value. There are more instances of this than you'd imagine: for example, 31 out of the 74 stocks in the BHPW equity model have risen by more than 30% since October. By reducing these exposures, we free up capital to reinvest in newer, more attractive values. One area we have been adding to recently is Energy, where many companies still boast double-digit free cash flow yields. We are also gradually shifting the portfolio towards more defensive categories, as we sense a pullback is due.

Second, we think it makes a lot of sense to add to international exposures. Foreign markets have simply not experienced the same level of multiple expansion that we've witnessed here in the US. Valuations are now very compelling abroad, with a starting P/E ratio of just 13.7x and dividend yield north of 3% for the overall basket. We believe this is fertile hunting ground for new investments.

International valuations and dividend yields

GTM | U.S. | 45

Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of March 31, 2024.

J.P.Morgan ASSET MANAGEMENT

Fortunately, unlike our passive benchmarks, we don't need to own every company headquartered internationally. Rather, our strategies allow us to focus on companies with proven management teams, great business models, and a strong track record of growth. By doing this, we aim to capitalize on the fact that 33 of the 50 best-performing companies each year typically are based outside the US.

Finally, within our fixed income sleeves, we continue to be very conservatively positioned. Over 80% of our credits are A-rated or better, and our duration remains slightly below that of our benchmark. When we do diverge from that core positioning, it is only where the yields more than adequately compensate us for the additional risks. As one example, we are finding special situations offering double-digit yields with maturities of less than 9 months. The risk on these short-term obligations is very low.

Overall, while the opportunity set is not as uniformly appealing as it was just six months ago, we remain confident that solid, double-digit returns are still achievable in stocks. This is particularly true for strategies that can be tactical and reposition their holdings towards more attractive segments of the market. Meanwhile, within fixed income, returns should also be favorable, especially versus recent history. We believe mid-to-high single-digit returns are attainable while maintaining a conservative risk posture.

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