Independence | Asset Advisors

MARKET MATTERS: 3RD QUARTER 2024

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"Diversification of risk matters not just defensively, but because it maximizes returns as well, because we expose ourselves to all of the opportunities that there may be out there." – Peter Bernstein

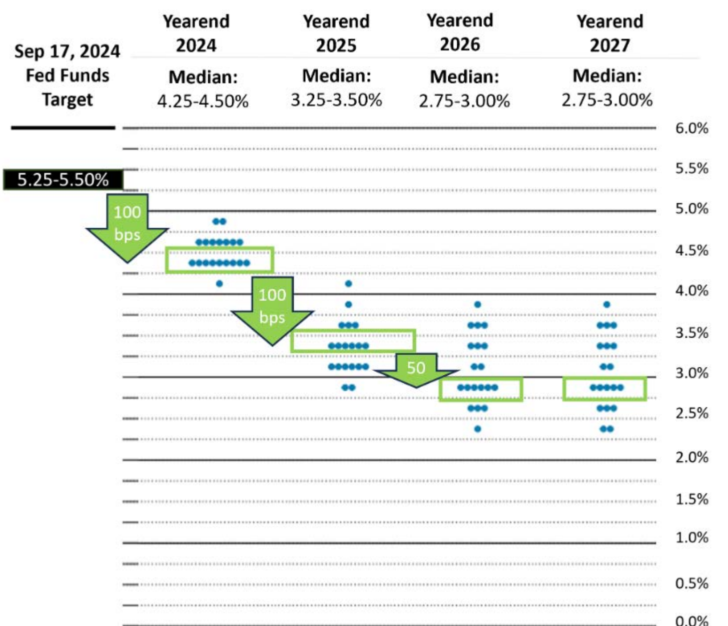
TAKEAWAYS

- Interest rates are high-impact across asset classes.
- As Fed hawkishness fades and is replaced by dovishness, portfolio migration out of cash and into broad asset diversification will help preserve defensiveness while keeping capital working.
- Don't nest in cash or soar with growth: broaden your wings.

THE FED PIVOT: OUT WITH THE HAWKS, IN WITH THE DOVES

The elusive, long awaited, long anticipated interest rate cut has finally come to pass. **In September, the Federal Open Market Committee cut its base rate by 50 bps, or 0.5%, taking the target rate from 5.25-5.5% to 4.75-5%.** The timing is coincidentally fitting. This time of year, millions of hawks complete their migration south, exiting the familiar territory where they have nested for some time to seek out new terrain for winter months. The Fed's hawkishness is likewise taking its leave as our turbulent economic expansion starts to cool. The cycle is at its peak.

Bonds had largely priced in the cut prior to the announcement, but equities experienced a strong uptick, hitting a new high. The Fed is projecting another 50 bps total in cuts before year-end, bringing rates down to 4.25-4.5%. Current projection is for rates to fall 1% further in 2025, bringing rates down to 3.25-3.5%. These forecasts could prove inaccurate if the current trajectory of a soft landing turns harder due to endogenous recessionary forces or exogenous shock, or if inflation ticks up significantly. However, the consensus now is the tight monetary policy we have lived with since 2022 is finally loosening and is expected to continue to do so.



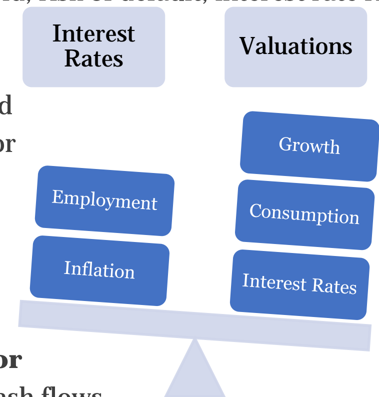
Falling rates provide a valuation boost for bonds, as they have explicit (mathematical) duration, or price sensitivity to interest rates, but **changing interest rates affect asset classes across the board**. While bonds have a more straightforward way of "pricing in" interest rates, inflation, and expectations for both, equities are significantly impacted, as well. For bonds, longer duration equates to a more pronounced effect from interest rate changes. Longer duration typically goes hand in hand with longer maturities and/or lower coupon yield. The longer it takes for an investor to recoup

Sources: Hedgeye by Bob Rich, JP Morgan, Morningstar, Bondsavvy, Bloomberg, MacroMicro, Apollo, RBC Global Asset Management

their investment, the more sensitive a bond is to changes in rates. But interest rates don't only affect bond valuations. Just as longer-lived bonds are more interest rate sensitive, longer-term ownership stakes are affected, as well.

Higher rates are worse for real estate, stocks and private equity investments. **Most classes of equity are inherently long duration, or interest rate sensitive**. High rates mean a higher cost of capital, entailing that a company's levered return is going to be lower. Debt, being higher in the capital structure, costs equity holders when it is more expensive. For small and growing companies, capital-fueled projects like acquisitions need to provide a higher level of return to be worth it. For stable companies, debt service may eat into profits. Even for the largest, most stable corporations, which are less affected by typical borrowing rates from banks and private lenders, a lower level of inflation from high interest rates leads to lower nominal earnings growth. **Together, this causes a lot of what we've seen recently: gridlock in housing, a frozen IPO market, private equity deals drying up, and small cap stocks sputtering and stumbling.**

There are more variables in the valuation of equity compared to bonds. In the bond world, risk of default, interest rate risk, and inflation are the main components of investment return. The direct effect of interest rates on cost of capital is only one component of what gets built into pricing equities. Economic growth, inflation, and consumption are important factors, all of which also feed into the Fed's interest rate decisions. This can cause a push and pull where good news for companies (high consumer demand, e.g.) is bad news because it increases the likelihood of a hawkish fed, and bad news (an uptick in unemployment) is good news because it increases the likelihood of looser monetary policy. These indirect effects pour into valuations.



The top of the market cycle, where we now find ourselves, is a mixed bag for equities. Growth stocks tend to have lower near-term cash flows for the investor, so cash flows are weighted further in the future, potentially giving them more interest rate sensitivity (like a long-term bond). However, there are other factors at play, including company competitiveness and defensive positioning. With more monopolistic market presence and a steady economic backdrop, lower rates may be a boon. But where barriers to entry are lower, a lower cost of capital (falling interest rates) could be linked to more competition. So, when stocks are in competitive spaces, falling rates may do some harm as well as good. Some growth stocks with quality characteristics may be defensive in part because they have an implicit monopoly. Others, like consumer discretionary companies, will be vulnerable at the top of the market. Value stocks offer more defensive characteristics in terms of represented sectors, but they may also suffer from competition and consumption changes.

In terms of returns, these competing forces may give growth some room to run. In terms of risk, however, the concentration in the growth realm has skyrocketed. As of mid-year, the Magnificent 7 (Apple, Amazon, Alphabet, Meta, Microsoft, Nvidia and Tesla) made up 31% of the S&P 500 by weight. While these companies have a competitive edge, they could suffer significantly from weakening in the consumer sector. **If the Fed begins to lower rates not simply because they are inherently restrictive, but instead because the economy is turning cold, these forces will likely overwhelm the boost from lower rates. In times of economic uncertainty and lagging consumer confidence, small changes or disruptions in consumer spending or supply chain dynamics can have an outsize effect on profits and margins. The tug of war between lower rates and weaker growth is likely to increase volatility.**

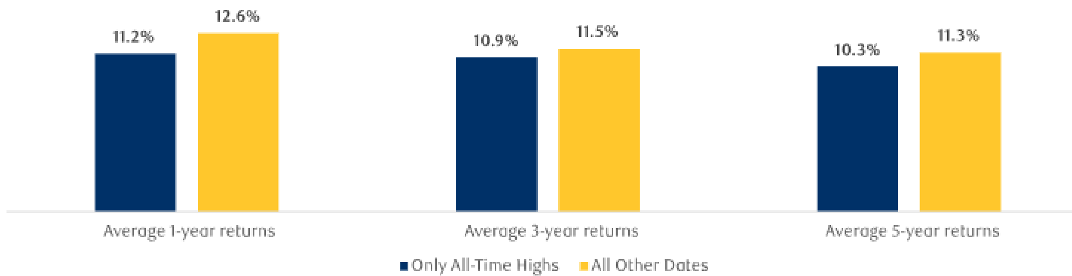
EQUITIES: WHERE DO WE GO FROM HERE?

Current valuations are constraining for future equities returns. Pricing is rich, with the S&P 500 valued at an average of 27x earnings. The tech sector, which makes up over 30% of the index, is valued at over 38x. Even with another 150 bps of potential rate cuts by the end of 2025, equities with these multiples will most likely not see the robust returns we have seen since the 2022 decline.

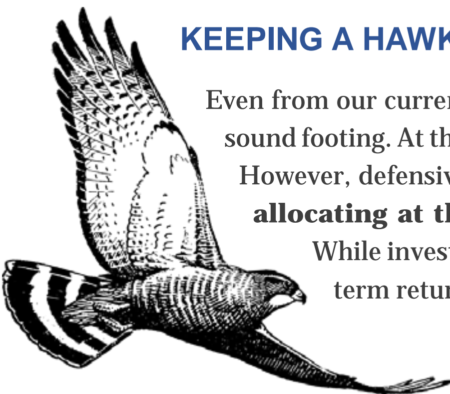
Sources: Hedgeye by Bob Rich, JP Morgan, Morningstar, Bondsavvy, Bloomberg, MacroMicro, Apollo, RBC Global Asset Management

However, other sectors are more fairly priced. Energy, utilities, and communication services offer multiples of 13x, 18x and 22x, respectively, representing fair comparative pricing to history. The Russell 1000 Value index, for example, is priced at 15x earnings, almost 50% less per dollar of company earnings than the S&P 500. Quality and value funds may also be far less concentrated. The top 10 holdings in the value index, including Berkshire, JPMorgan, Exxon and UnitedHealth, comprise only 17% of total assets. **Risk can still be put to work while the market cycle runs its course, but broadening out to diversify across risk assets and opportunistically buying at times of high volatility is practical.** The underlying fundamentals supporting the economy have not shown signs of decay, though they are weakening compared to earlier market cycle metrics. By either shifting weight or adding to defensive sectors with better relative value, investors can protect themselves from high volatility of late-cycle weakening and get into equities at fairer prices. Investing at market highs still brings good returns in the long run (*time in the market beats trying to time the market*), even though high prices imply lower future returns.

Investing at all-time highs vs. all-dates



Source: Bloomberg, RBC GAM. Data for S&P 500 as of January 1, 1950 to March 2024. All-dates refers to rolling 1-, 2- and 3-year returns starting from each trading date during this time. Returns in U.S. dollars. An investment cannot be made directly into an index. The graph does not reflect transaction costs, investment management fees or taxes. If such costs and fees were reflected, returns would be lower. Past performance is not a guarantee of future results.

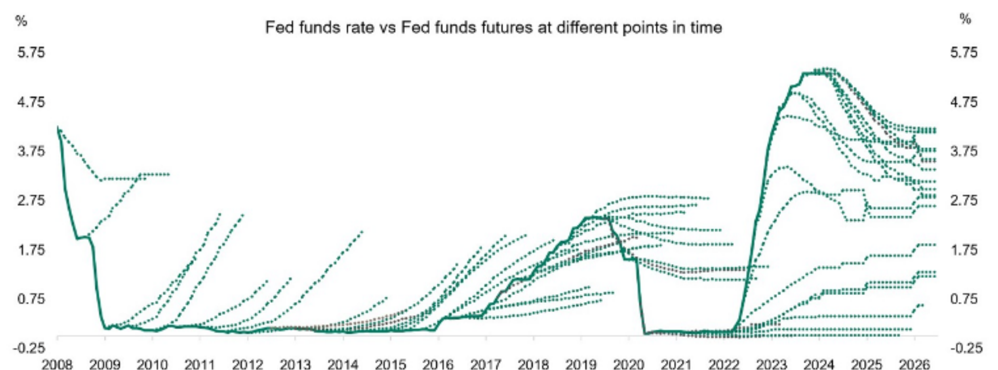


KEEPING A HAWKISH EYE ON A DOVISH LANDING

Even from our current peak, growth may have room to fly higher, given that the economy seems to be on sound footing. At this point in the interest rate cycle, there is return to be earned by holding growth stocks. However, defensiveness starts to play a more important role, and investors should be cautious. **When allocating at the top of the market cycle, avoid paying top of the mark when possible**. While investors may be rewarded for a continued hold period, they won't be as rewarded with long term returns for buying in at stretched valuations.

BROADEN OUT TO BRING IN DIVERSIFICATION

When the Broad-winged hawk migrates south in the fall, like many other birds, it doesn't expend too much energy trying to get to its destination quickly. Often, they will simply ride air currents down the coast as these carry the creatures hundreds or thousands of miles. Investors could do worse than attempting a similar strategy. Instead of chasing quick returns, broadening out across assets and diversifying within core classes, as well as diversifiers themselves, will provide lofty support when big tech and other major drivers run out of steam and/or correct. Signs point to a soft landing. However, **it's worth acknowledging that projections, including the Fed's own expectations, are *usually* wrong**. If forecasters were any good, the dotted lines and solid line would converge with a high frequency to the right. They don't. Instead, the market expectations for the fed funds rate are historically much more likely to branch out from what actually materializes than to overlap with it. There are simply too many factors with outsize influence on economic



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activity for even the best analysts to correctly predict all of them. **The global playing field in which investors are embedded is constantly evolving in both its opportunities and difficulties.**

ASSET CLASS MIGRATION

For investors with growth exposure that has grown overweight, beginning to rebalance at this point may earn a premium going forward. Whether this premium is material depends a lot on timing, and trying **to time the market is unfeasible. But rebalancing by selling "winners" and buying "losers" maintains a lower risk-level and better diversification.** It lowers concentration and reduces downside risk by trimming assets that would otherwise dominate returns. When the tides turn, winners often lose the most and losers the least.

Exhibit 1 – Simulated Impact of Rebalancing on Terminal Wealth (TW) Outcomes (10-Year Horizon)

Measure	Buy & Hold	Rebalance	Impact
Mean TW	$2.71	$2.71	Same mean
Median TW	$2.51	$2.54	Higher median
90th percentile	$4.11	$4.05	Lower best cases
10th percentile	$1.55	$1.59	Higher worst cases
90th-10th Range	$2.56	$2.46	Narrower range
Volatility	12.1%	11.5%	Lower volatility
Max Drawdown	-18.3%	-16.9%	Smaller drawdowns

High quality, large cap stocks are appropriate for top of the market cycle positioning. Opportunities to diversify may be found in less cyclical, more defensive sectors, like utilities, telecom, infrastructure, and healthcare, many of which are relatively lower priced. Actively managed international equities offer favorable valuations, but selection is key. REITs are diversifiers at a buy point, as well.

Private equity can help diversify on the small size end of the spectrum, giving investors exposure to the 99% of businesses that are privately held. This asset class is long duration, as well, as an ownership class of investment. Since private equity often has a small company focus and uses some amount of leverage, high interest rates effect PE investments significantly. This may show up in valuations, but it is also likely to be evidenced by deal flow slowing, exits/realizations grinding to a halt, and distributions drying up. Valuations may remain stable on paper, but investors are made worse off by an extended lack of liquidity. As always, manager selection is critical in this space, where the dispersion between value creation and value destruction is wide. Lower interest rates are likely to provide tailwinds to PE investors by increasing company cash flow that does not need to be allocated to debt service, increasing deal flow, decreasing investment hold periods, and putting returned capital back to work in an environment where the cogs in the machine are turning again.

RECESSION RISK: NOT IF, BUT WHEN

Currently, recession risk looks muted at home, but not completely absent. An uptick in unemployment, consumer debt and defaults, and slower wage growth is squeezing consumers, who represent a large portion of the economic activity in the country. Internationally, Europe, Great Britain and China have struggled to find their post-pandemic expansion after a period of below-target growth or mild recession. Geopolitical conflict in the Middle east is spreading. Ukraine and Russia are locked in a smoldering war. Large parts of Africa are suffering from civil war, climate-change-induced migration, and militant extremism. **The risk of economic breakdown usually doesn't come from the factors, like inflation and unemployment, that we happen to be paying the most attention to. Any one of war, weather, other supply shocks, pandemic, or government policy errors at home or abroad could bring the current expansion to an end.** We don't know what will happen or when, but we know at some point the music will stop.

Cash, the volatility buffer of choice, will soon no longer be earning a real return. Excess cash should be put to work productively, opportunistically, and according to a client's strategic asset allocation. To continue to be defensive, diversification should take the lead – diversify not just among explicit diversifiers but also within asset classes. Diversification to mitigate risk means not only including more asset classes, like real estate and infrastructure, but also holding equities that aren't the top 10 holdings of the index. Participation in the market does not entail buying heavily into the names that dominate the headlines. Allocate broadly to participate on the upside while protecting on the downside.

Sources: Hedgeye by Bob Rich, JP Morgan, Morningstar, Bondsavvy, Bloomberg, MacroMicro, Apollo, RBC Global Asset Management

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