STRATIGRAPHIC ASSET MANAGEMENT, INC.

ALAN S. BERNSTEIN

July 8, 2024

To the Clients of Stratigraphic Asset Management:

U.S. equity markets in the first half of 2024 extended the exceptional gains experienced in 2023. The S&P 500 Index recorded a total return including dividends of 15.3%, which was realized on top of the 26% return of the Index last year. However, the 3-year return of the Index through June 30, 2024, considering the 19% loss experienced in 2022, was only equivalent to about 10% per annum. The net effect of the outsized gains over the last 18 months was to bring Index returns back in line with its long-term trend.[1]

As was the case last year, first-half performance was largely concentrated in a few high-technology companies, recently referred to as the “Magnificent Seven.” The stocks of these companies contributed a whopping 61% of the total return of the Index.[2] Bear in mind that the Index is weighted by the market capitalization of the individual component companies, meaning the largest market-cap stocks disproportionately determine Index performance. The total return of the Index in the first half expressed on an equal-weighted basis was only 5.1%. It is noteworthy that shares of companies in six of the 11 sectors of the Index declined: healthcare, real estate, financials, energy, industrials, and materials. The bottom line is that portfolios lacking exposure to the leading technology companies probably underperformed.

The strong equity market over the past six months was surprising because many strategists and portfolio managers expected the market to generate either low or negative returns in 2024. The cautionary signs included elevated

[1] Bloomberg. The 50-year return of the S&P 500 Index was calculated at 9.5% per annum if dividends are not reinvested in the Index; and at 12.1% if dividends are reinvested in the Index.
[2] The Magnificent 7 are: AAPL, AMZN, GOOG, META, MSFT, NVDA, TSLA. (Our clients own meaningful positions in four of the seven companies.) JPMorgan Asset Management, *Guide to the Markets 3Q 2024*, June 30, 2024.

7307 LOS PINOS BOULEVARD • CORAL GABLES, FLORIDA 33143
TELEPHONE (305) 447-0300 • WWW.STRATIGRAPHIC.COM

inflation, high interest rates, a weakening economy with a possible recession looming, and lofty stock valuations. Here is what happened. The economy remained fairly strong, and fears of recession receded. Following its peak in mid-2022, inflation rates have been trending down and further deceleration is anticipated in the near term. Elevated interest rates have not had an adverse impact on consumers, who have maintained high levels of consumption. Most important, corporate earnings in the first half were better than expected. Despite the appreciation of the market, the forward P/E of the Index is at nearly the same level as the beginning of the year.

Fixed-income returns were disappointing in the first half. Investors were hoping that the Fed would ease short-term rates in line with the decline in inflation, which would cause long-term rates to fall. Instead, the Fed maintained its target rate for federal funds at peak levels as inflation rates remained elevated. The Fed’s inaction caused monetary conditions to tighten. The yield on the 10-year Treasury, which is the bellwether for interest rates, rose from 3.88% at year-end to 4.40% at mid-year, an increase of nearly 14%. The Bloomberg U.S. Aggregate Bond Index, our benchmark in measuring fixed income performance, had a negative return of -0.7% in the first half. Stratigraphic accounts generally had positive returns on their bond portfolios in the 1% to 2% range. Cash balances have been invested in money markets or the equivalent, yielding 5% per annum or more. As has been the case for the last 10 years, total portfolio returns have been largely derived from equity holdings, not fixed-income securities. However, as interest rates trend lower when the Fed begins to ease monetary policy, fixed-income returns should significantly improve. An important indication of improved prospects is the current yield to maturity of our bond portfolios, which is currently more than 6%.

The Investment Outlook

As long-term investors, our views on the investment outlook are mainly shaped by the prospects for the U.S. economy, the growth in corporate profits, and common-stock valuations. Here is our take on these three areas.

The U.S. economy is expected to have solid real growth of around 2% per annum over the next couple of years. Consumption, which accounts for close to two-thirds of GDP, is expected to remain robust. The rise in household wealth related to the appreciation in home and equity markets, government stimulus programs, continued high employment, growing real wages and rising investment income are contributing factors. No wonder consumer balance sheets and the level of household debt-service burden in relation to disposable income remain in good shape by historical standards. First-quarter GDP slowed to 1.3% as inventory buildup and lower net exports masked strong final demand. The second quarter should show a solid gain of close to 3%. For the year, the Bloomberg consensus projects real GDP will advance at 2.3%, which is ahead of most developed economies. However, forecasts for 2025 and 2026 indicate that real GDP will advance at lower rates. Members of the Federal Reserve Board are forecasting growth in the 1.8% to 2.1% range per annum, which is consistent with the consensus of economists reported by Bloomberg.[3] **The point is that the stable and consistent growth of the U.S. economy at around 2% is an important backdrop to a sound investment outlook.**

The short-term outlook for inflation is less certain. The COVID pandemic led to massive disruptions in international supply chains and labor, which caused substantial inflationary pressures. Inflation peaked in mid-2022 when the consumer price index (CPI) reached the annual rate of 9%. Over the subsequent 12 months, the CPI remarkably declined to 3.1% per annum. However, in the past few months, no further progress in lowering the CPI has been achieved. Two components of inflation that have remained stubbornly high are auto insurance and rents (housing costs). Another factor may be the impact on shipping costs of Houthi rebel attacks on cargo ships and tankers in the Red Sea. The general expectation is that inflation will decline over the next 12 months to about 2.5%. Economist forecasts of the two-year and five-year U.S. inflation rate are in the 2% to 3% range.[4]

Reducing the rate of inflation below current levels is not critical to the investment outlook. Moderate inflation may be good for corporate profits as many of our large-cap companies have pricing power. In this regard, there has been no measurable deterioration in corporate profit margins. The percentage of corporate profits to gross domestic income has been rising generally over the last 18 months.[5]

While lowering interest rates will provide support for equity valuations, the timing of Fed rate reductions is not critical to the investment outlook. Short-term interest rates are determined by Federal Reserve monetary policy, which keys off its goals of reducing inflation to 2% per annum and achieving full employment. With the CPI remaining

[3] Economic Projections of Federal Reserve Board members and Federal Reserve Bank presidents, June 2024. Bloomberg.
[4] Federal Reserve Economic Data FRED, Federal Reserve Bank of St. Louis. https://fred.stlouisfed.org/series/EXPINF2YR
[5] Federal Reserve Economic Data FRED, Federal Reserve Bank of St. Louis https://fred.stlouisfed.org/series/W273RE1A156NBEA

over 3%, the Fed has already signaled a pause in dropping the target rate on Federal Funds. Nevertheless, the Fed will almost certainly lower its target rates one or two times in late 2024, with further decreases in 2025. From the standpoint of corporate profits, interest rates thus far have had little impact except in the housing and related industries because of high mortgage rates. The largest U.S. corporations have solid balance sheets with strong capitalization ratios. A substantial portion of corporate long-term debt was refinanced at low interest rates before monetary policy was tightened.

Corporate profits have become the most important part of the investment landscape. In 2023, Standard & Poor's (S&P) reported that Index company earnings rose 8.4% over 2022. Earnings growth based on current analyst forecasts is expected to accelerate to more than 12% in 2024 with further double-digit gains anticipated in 2025.[6] While it is likely that some downward adjustment in these admittedly optimistic forecasts seems inevitable, clearly the earnings outlook for large-cap companies is very favorable.

S&P 500 Index Levels, Earnings and Price/Earnings					
Current Price Earnings Ratios					
	2021	2022	2023	2024	2025
S&P 500 Index (at December 31)	4,766	3,849	4,770		
S&P 500 Index Year-Over-Year Change (Price Appreciation)	26.9%	-19.2%	23.9%		
S&P 500 Earnings, 2021 & 2022 Actual, Standard & Poor's	$208	$197	$214		
S&P 500 Price/Earnings	23.6	19.5	22.3		
Forward Price Earnings Ratios					
S&P 500 Index (at June 30, 2024)				5,461	5,461
S&P 500 Earnings, Estimated, Standard & Poor's				$241	$277
S&P 500 Price/Earnings				22.7	19.7

Equity valuations are high by historical standards. P/Es are still well above the 30-year average of 16.7x. Currently the multiple on estimated 2025 earnings is 19.7x, indicating that the market is not more expensive than at the beginning of the year. The premium in P/Es is attributable to the weighting of the Magnificent Seven in Index averages. As the table on the next page shows, **the equal-weighted Index has a multiple on 2025 earnings of only 14.9x. On this basis, it can be argued that the market as a whole is not overvalued.**

---

[6] Standard & Poor's Dow Jones Indices, https://www.spglobal.com/spdji/en/indices/equity/sp-500/#overview

The Magnificent Seven and other technology companies have outperformed in the market and command premium P/Es because of their powerful earnings record. The table below indicates that the four-year earnings growth (2022 through 2026) is twice the rate of the Index and nearly 5x the rate of the equal-weighted Index. In the first half of 2024, the top 10 companies contributed more than 25% of total Index earnings!

Magnificent Seven								
Metrics Compared to S&P 500 Index and Equal Weighted Index								
					Price Earnings			
	Price 7/2/2024	Current Mkt Cap (Billions)	Weighting % Total	EPS 4 Yr Growth	2024	2025	2026	Total Return 3 Yrs P.A.
Apple (FY 9)	$220.00	$3,367.6	20.8%	6.1%	33.3	30.1	28.4	16.1%
Microsoft (FY 6)	$458.40	$3,405.9	21.0%	14.2%	38.8	34.4	29.2	19.2%
Alphabet	$186.50	$2,294.5	14.2%	14.2%	24.5	21.6	19.1	13.6%
Amazon	$200.00	$2,077.7	12.8%	39.5%	37.9	30.9	25.4	4.0%
Nvidia (FY 1)	$122.70	$3,019.4	18.7%	88.8%	45.1	34.2	28.9	83.7%
Meta	$508.50	$1,293.8	8.0%	33.2%	24.3	21.3	18.8	13.3%
Tesla	$228.50	$723.3	4.5%	2.7%	94.0	69.9	50.6	-4.4%
Total (Weight Adjusted)		$16,182.2	100.0%	22.6%	37.1	31.3	26.8	19.6%
S&P	$5,500.00	$47,820.0		11.1%	22.7	19.7	18.3	10.0%
S&P Equal Weighted	$6,611.00	$47,820.0		3.9%	16.8	14.9	13.7	4.8%
Source: Bloomberg								

The prospects for information technology companies seem very attractive because of the rapidly growing demand for software and computer processing capacity to implement artificial intelligence (AI) and related technology solutions across industries and businesses. In April, we published a memorandum on AI that asserted widespread adoption of

AI could lead to a significant boost in productivity and economic growth in the United States.[7] Real growth could be lifted from the long-term forecast level of 2% to 3%. If these gains are realized, the impact on corporate profits, household income, and the standard of living in the United States would be meaningful. We even pointed out that the rise in GDP as a result of productivity gains could lead to a reduction of federal debt levels. Such forecasts, of course, are fraught with risk. It is far too early to calibrate the timing and impact of AI. What we can say is that **the new technologies being implemented have the potential of being transformational and very rewarding to long-term investors.**

For investors who can absorb the volatility and short-term losses in equity markets, particularly in technology companies, that most assuredly will come, we are staying the course in our weightings and asset allocations. For other investors who look to their portfolios for current income and who cannot tolerate losses, consideration should be given to adjusting asset allocations and rebalancing equities.

The benefits of AI are potentially massive and may be enough to secure the leadership of the United States in the world and the wellbeing of our next generation. Lest you become too complacent in such felicitous contemplations, we should be mindful of the significant risks that brought down past great societies: imperial overreach (Thucydides); runaway debt (Paul Kennedy), and climate change collapse (Jared Diamond).[8]

I hope you enjoy your summer reading,

Alan S. Bernstein

[7] The paper can be downloaded from the Stratigraphic website: http://www.stratigraphic.com/Stratigraphic-Artificial-Intelligence-Perspective.pdf

[8] Thucydides, *History of the Peloponnesian War*; Paul Kennedy, *The Rise and Fall of the Great Powers: Economic Change and Military Conflict from 1500 to 2000*; Jared Diamond, *Collapse: How Societies Choose to Fail or Succeed*.