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Investment Management

Market Review Commentary

1Q
2024

Market Review

The U.S. equity market experienced a strong start to the year with the S&P 500 Index advancing 10.56% in the first quarter. This is the index's largest first quarter gain since 2019. Large cap growth stocks, as measured by the Russell 1000 Growth Index, were the best performers in the quarter gaining 11.41%. Value stocks, as measured by the Russell 1000 Value Index, lagged growth stocks returning 8.99% in the first quarter. Small capitalization stocks underperformed their larger cap counterparts with the Russell 2000 Index advancing 5.18%. International and emerging market stocks continued to lag U.S. markets. The MSCI EAFE Index advanced 5.78% in the quarter while the MSCI Emerging Markets Index increased just 2.37% over the same period.

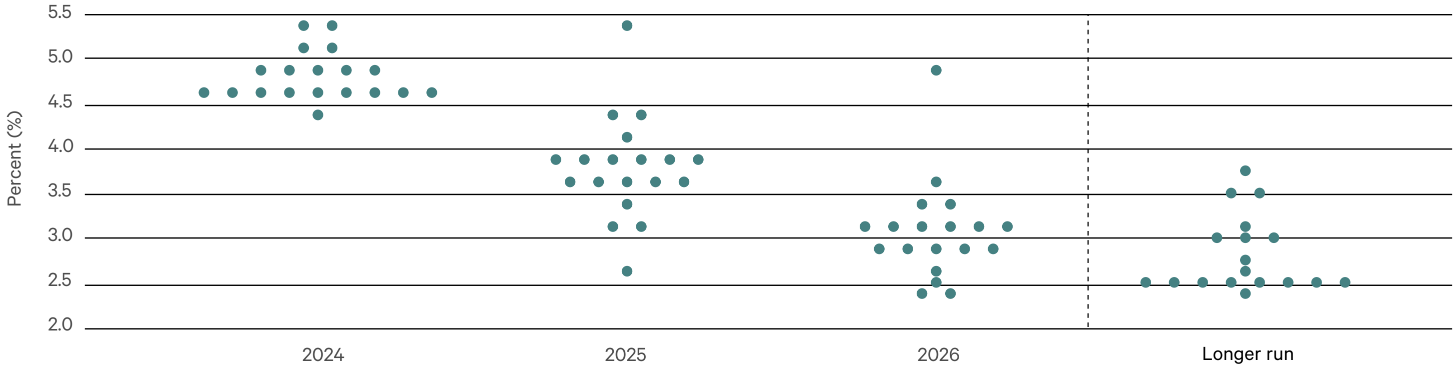
Fixed income predominantly experienced negative returns during the first quarter. The Bloomberg U.S. Aggregate Bond Index declined 0.78% during the period as the 10-year U.S. Treasury yield had a volatile quarter beginning the period at 3.88% and ending the quarter at 4.20%. High yield, as measured by the ICE BofA U.S. High Yield Index, was the standout fixed income performer advancing 1.51% in the quarter. Municipal bonds also declined during the quarter with the Bloomberg Municipal Bond Index returning -0.39%.

With the strong but also divergent performance of the markets in the first quarter and given the vast amount of information (or noise) that is available to investors, we narrowed our focus to the three questions that we believe are top of mind and most important to understanding what the drivers behind market performance were during the quarter.

1. What is Happening with Interest Rates?

At the start of the year, futures' markets were predicting as many as six 25-basis-point interest rate cuts in 2024. Since then, the economy has experienced somewhat higher-than-expected growth and inflation rates. As of the most recent meeting on March 20, the Federal Reserve expects three rate cuts this year. However, there is wide dispersion among Fed officials regarding the trajectory of rates (see Figure 1). For 2025, four of the 19 Fed officials see the federal funds rate at 4% or above. One expects a federal funds rate just above 2.5%. The chart is a baseline of estimates, and we know that exogenous shocks or financial disruptions can change things quickly. This disparity, however, leads us to believe the longer-term outlook for rates is still quite uncertain which is why we favor businesses with low leverage.

FIGURE 1: FOMC PARTICIPANTS' ASSESSMENTS OF APPROPRIATE MONETARY POLICY
Midpoint of Target Range or Target Level for the Federal Funds Rate



Data as of March 20, 2024. Data is obtained from the FOMC and is assumed to be reliable. Each shaded circle indicates the value (rounded to the nearest 1/8 percentage point) of an individual participant's judgment of the midpoint of the appropriate target range for the federal funds rate or the appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. One participant did not submit longer-run projections for the federal funds rate.

Despite the uncertainty regarding the longer-term outlook, we are seeing early signs of a less constricted interest rate environment with lower mortgage rates (still high, but trending in the right direction) and compressed credit spreads. We believe continued rate declines would support both asset prices and better earnings growth for companies.

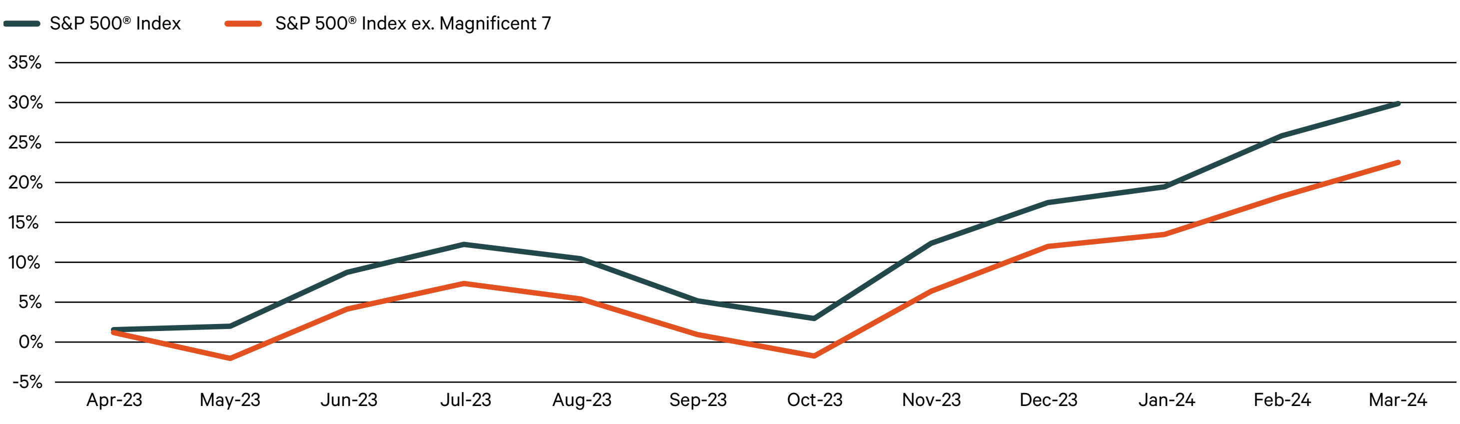
2. Are We Worried About the Narrowness of the Market?

While a broadening of the market would be a welcome sign for equity investors, we do believe the narrowness of the market makes sense.

As we have all read about endlessly, the major driver of equity index performance has been the Magnificent 7 technology stocks. These are Apple, Amazon, Meta, Tesla, Alphabet, NVIDIA, and Microsoft. These companies have been seen as direct beneficiaries of the recent advances in artificial intelligence (AI), most notably, generative AI.

The magnitude of the outperformance of these AI-fueled names has distorted market metrics. If we exclude the Magnificent 7 from the S&P 500, we see that stock performance in the last year has been much more uneven.

FIGURE 2: S&P 500® INDEX VS. S&P 500® INDEX EX.-MAGNIFICENT 7 STOCKS

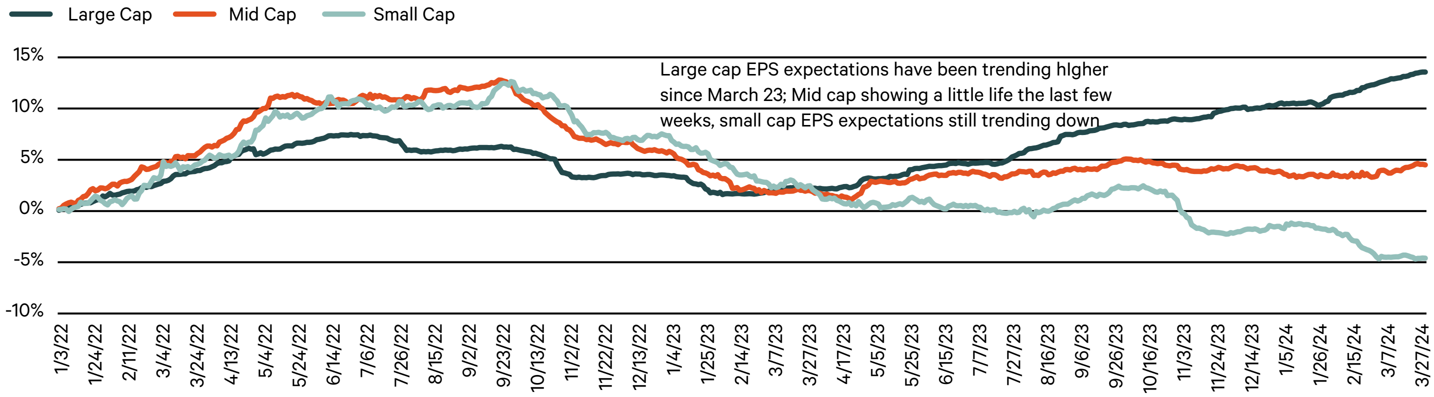


Data is for the 12 months ending March 31, 2024. Data is obtained from Factset and is assumed to be reliable. The Magnificent 7 stocks include Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla. The information provided in this chart is for illustrative purposes only. The indices presented above are not actively managed and do not reflect the deduction of any investment management or other fees and expenses. Indices are not available for direct investment. ***Past performance is no guarantee of future results.***

But we do not believe this rally is wholly unjustified. Investors are simply going where the earnings are growing.

FIGURE 3: CONSENSUS EARNINGS PER SHARE (NEXT 12 MONTHS)

Indexed to December 31, 2021

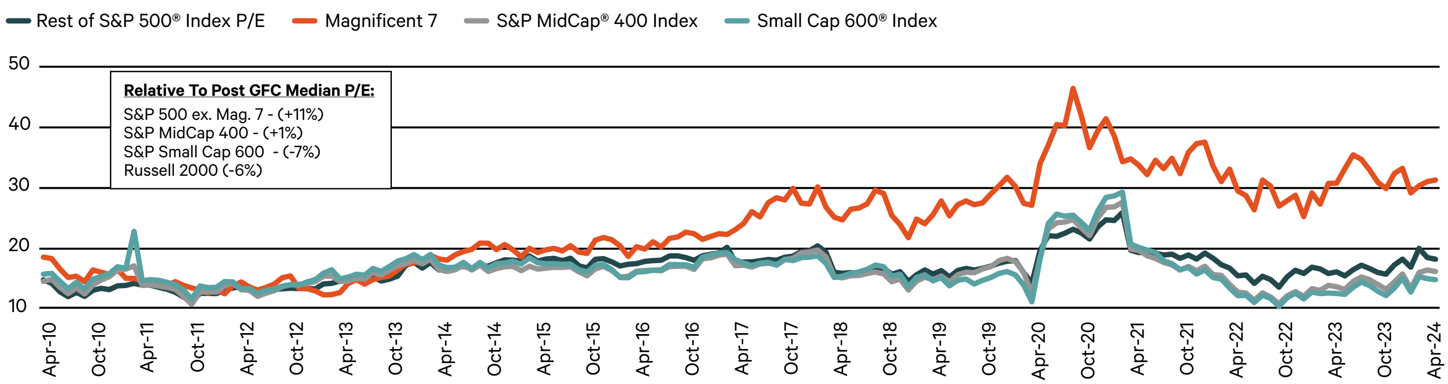


Data as of March 27, 2024. Data is obtained from Factset and Raymond James and is assumed to be reliable. The information provided in this chart is for illustrative purposes only. The indices presented above are not actively managed and do not reflect the deduction of any investment management or other fees and expenses. Indices are not available for direct investment. ***Past performance is no guarantee of future results.***

Earnings expectations for large capitalization stocks (with outsized representation of the Magnificent 7, which account for 18% of S&P 500 earnings) are clearly well ahead of mid and small caps. Expectations in mid-caps have found their footing, while small-cap earnings are still challenged. This has translated to stock valuations directly.

FIGURE 4: P/E OF MAGNIFICENT 7 TECH STOCKS VS. REST OF S&P 500® INDEX, MID, AND SMALL CAP INDICES

GAAP, Current Year



Data as of March 31, 2024. Data is obtained from Factset and Raymond James and is assumed to be reliable. The Magnificent 7 stocks include Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla. The Russell 2000 Index excludes companies with negative earnings. The information provided in this chart is for illustrative purposes only. The indices presented above are not actively managed and do not reflect the deduction of any investment management or other fees and expenses. Indices are not available for direct investment. ***Past performance is no guarantee of future results.***

What is notable is that the increase in small-cap valuations is not being driven by higher stock prices, but rather weaker earnings. Until earnings bottom, we would expect valuations awarded to small-capitalization companies to remain pressured.

Given the large-cap bias in the market, we continue to believe that the small-cap universe has many high-quality businesses that are now trading at attractive valuations. Thus, we maintain that active management within small caps makes sense in avoiding the 42% of the index that does not generate earnings.

Julie Biel, CFA
Chief Market Strategist

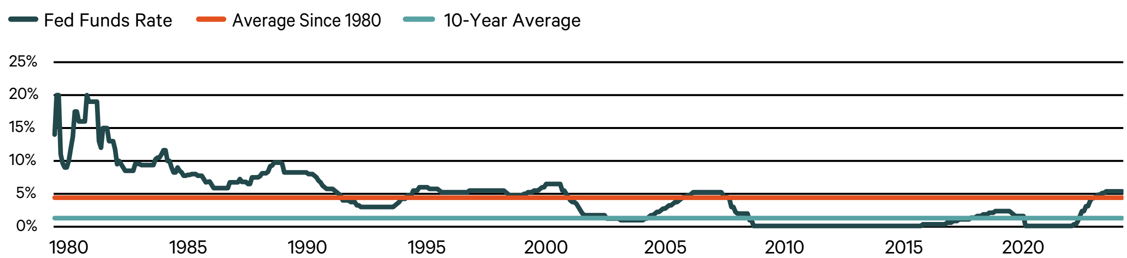
Julie Biel, CFA is Chief Market Strategist, Portfolio Manager, and Senior Research Analyst with primary research responsibilities for the small and mid-capitalization information technology and health-care sectors. Ms. Biel began her equity research career in 2004.

3. How Much Growth is Due to Exogenous Factors?

One large challenge coming out of the pandemic is trying to parse the underlying strength in the economy. Our supply chains were whipsawed, our employment patterns changed dramatically, and we saw unprecedented monetary and fiscal support. Given these factors, it is hard to gauge how much of the strength in the U.S. economy is due to fundamentals versus other exogenous effects.

What we do know is that we have a very large Federal deficit and that while interest rates may have peaked, they are unlikely to return to the basement rates we enjoyed in the pandemic in the near-term. So despite rates having increased materially in a short period of time, they are only modestly restrictive compared to the long-run average.

FIGURE 5: RATES ARE NOT THAT HIGH RELATIVE TO HISTORY
Interest Rates Remain Above the 10-Year Average but Near the Long-Term Historical Average



Data as of March 31, 2024. Data is obtained from The Federal Reserve Bank of St. Louis and Factset and is assumed to be reliable. The information provided in this chart is for illustrative purposes only. This material is not intended to be relied upon as a forecast, research or investment advice, and is not a recommendation, offer, or solicitation to buy or sell any securities or to adopt any investment strategy. KAR does not undertake to update the information presented. KAR makes no warranty as to the accuracy or reliability of the information contained herein. ***Past performance is no guarantee of future results.***

As a result of low rates and strong government support during the pandemic, we believe the tide lifted all companies and made it easier for everyone to prosper. However, without this assistance, we expect that more fundamental factors will drive corporate profits and thus equity performance going forward. We see this already in the Magnificent 7.

Assuming less exogenous support, we believe companies who are competitively advantaged with better profitability, cash flow, as well as lower leverage, will be able to better distinguish themselves going forward.

We will continue to focus on finding quality companies with durable competitive advantages for our clients despite the ever-shifting macroeconomic environment. We thank you for your trust and confidence in managing your assets.