Richard Bernstein Advisors

The Leaders In Pactive® Management

Insights

May 2024

Richard Bernstein Advisors

Richard Bernstein Advisors LLC (RBA) is an investment manager focusing on longer-term investment strategies that combine top-down, macroeconomic analysis and quantitatively-driven portfolio construction. We strive to be the leading provider of innovative investment solutions for investors, and our competitive edge is our research-driven macro style of investing.

Our top-down macro approach differentiates our firm from the more common, traditional bottom-up approach of most asset managers. Our extensive array of macro indicators allows us to construct portfolios for clients that are innovative, risk-controlled, and focused on overall portfolio construction instead of individual stock selection.

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Something's gotta give

Summary:

- Financial cycles repeat and current speculation that "this time is different" is likely incorrect. The gap between perception and reality creates a significant investment opportunity.
- High yield bonds and small cap stocks typically move in line with each other, but the two have diverged since 2022.
- We see three plausible explanations for this divergence, all of which imply a more favorable outlook for small cap stocks over high yield bonds and large cap stocks.

There are many historical relationships within financial markets based on sound economic theory, which accordingly repeat cycle after cycle. RBA has for decades studied the consistency of cycles, and profit and economic cycles are a cornerstone of our investment process.

Financial market speculation is largely based on believing history won't repeat and that the basic tenets of finance and economics don't apply to a unique situation. But cycles do repeat or at least resemble each other, and investment opportunity arises when there is a meaningful difference between fundamental reality and speculative perception.

There seems a very sizable gap between perception and reality in today's financial markets. Consensus seems to be that we are experiencing a unique stock market cycle (perhaps fueled by artificial intelligence), yet financial history suggests that is highly unlikely to be true.

The magnitude of the current markets' atypical behavior makes it unusually important to consider potential outcomes. In particular, the bond market seems to be suggesting broad economic and profits health, whereas the equity market seem to be forecasting a depression or at least a steep economic decline.

Junk bonds and junk equity are telling different stories

Historically there has been a close relationship between the performances of high yield (junk) bonds and smaller capitalization (junk) equities. In fact, the performance of lower quality investments across asset classes tends to have high correlations because the risk of lower quality investments fluctuates in tandem as the economy and profits expand and contract.

Junk bonds tend to outperform quality bonds when the economy expands because 1) their higher yields and lower durations protect against rising interest rates, and 2) credit quality improves when the nominal economy expands because corporate cash flows and balance sheets strengthen. Junk bonds underperform during economic slowdowns or recessions because the opposite occurs, i.e., longer duration assets outperform when interest rates fall, and credit quality deteriorates.

Junk equities similarly outperform during expansions because their operating and financial leverage cause their cash flows and balance sheets to significantly improve. The opposite occurs during economic downturns.

Chart 1 shows the relationship over the last 10 years between high yield corporate spreads and large versus small stock performance. Historically, large cap stocks (higher quality) tend to outperform smaller cap stocks (lower quality) when high yield credit spreads are widening (high quality bonds outperform low quality bonds).

However, the relationship has reversed since the end of 2022. Large cap stocks have outperformed smaller stocks despite credit spreads narrowing. This is quite rare and conflicts with sound economic theory.

There seem to us to be three potential reasons why this would occur each with differing outcomes. Again, we do not adhere to the notion that "this time is different" because the basic centuries-old principles of finance haven't changed regarding the consistency of high and low quality valuations and performance.

CHART 1:

High Yield Credit Spread & Relative Performance of S&P 500® to Russell 2000®

(Apr. 30, 2014 – May 28, 2024)

Source: Richard Bernstein Advisors LLC., Bloomberg Finance L.P.

Explanation #1: Large Cap Bubble

A somewhat obvious explanation for this divergence between junk bonds and junk equities given the extremely narrow equity market leadership (i.e., the Magnificent 7) is large cap stocks are in a bubble and ignoring economic fundamentals. Although those advocating investing in large cap growth stocks might scoff at this notion, fundamentals argue this could very likely be the case.

Our work in the early-1990s demonstrated that stock market leadership narrows when profits cycles decelerate because fewer and fewer companies can accelerate or even maintain growth in an increasingly adverse environment. Markets effectively reflect Darwinistic survival of the fittest as earnings growth becomes increasingly scarce.

However, the opposite occurs when profits cycles accelerate. Markets tend to broaden as the cycle accelerates because an increasing number of companies are growing, and investors become comparison shoppers for growth.

Goldman Sach's research has pointed out that the Magnificent 7 effect is the most narrow stock market leadership in the US since the 1930s' Great Depression. Our theory suggests the Great Depression was indeed a period that should have had narrow leadership. Not only were most companies unable to grow earnings, many were going out of business. An extremely dire economic environment should translate to extremely narrow leadership.

There was a profits recession in 2023, but it was a typical one (S&P 500® earnings growth was down about 15%) and was not close to the dire economy of the 1930s' Depression. In other words, leadership should have narrowed in 2023 and defensive sectors should have led, but only 7 stocks leading 2023's stock market was an extreme underrepresentation of the breadth of corporate profits.

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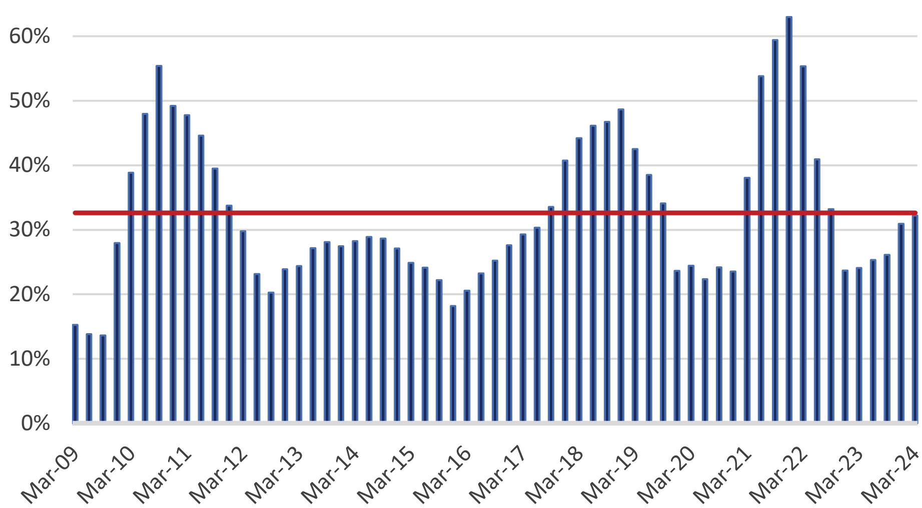
The profits cycle has begun to turn and so far in the latest reporting period there are more than 160 companies within the S&P 500® that are growing earnings 25% or more. The narrowing of junk bond spreads seems to be following the historical norm that an upturn in profitability and cash flow improves credit quality, but the equity market's ongoing narrow leadership continues to act as though earnings and cash flows are scarce.

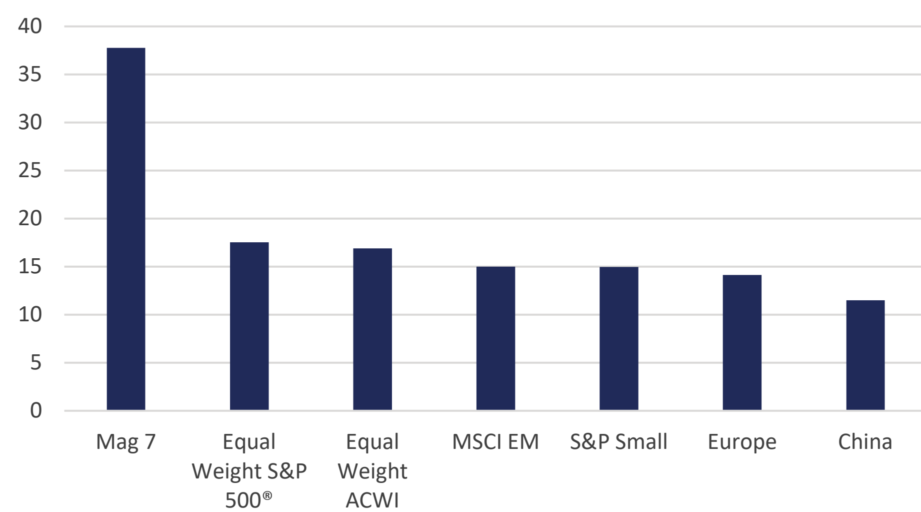
Chart 2 shows that earnings growth is indeed becoming more abundant, but Chart 3 shows the valuation of the narrow growth leadership (the so-called Magnificent 7) has not improved.

CHART 2:
Percentage of S&P 500® Companies with >25% Trailing 12-Month Net Income Growth
(Mar. 09 – Mar. 2024, quarterly)



Source: Richard Bernstein Advisors LLC, Bloomberg Finance L.P.

CHART 3:
PE Ratios
(as of 5/29/2024)



Source: Bloomberg Finance L.P.

If junk bonds are correct and large cap stocks are in a bubble, then the prudent portfolio allocation would be to favor mid- and small capitalization stocks based on the relationship between junk bonds and junk equities.

Explanation #2: The economy is heading for one heck of a credit event

Let's assume that the equity market is correct, the extreme outperformance of larger capitalization stocks is justified, and investors are speculating in junk bonds. If that is indeed the case, then the magnitude of the large cap stock outperformance suggests the economy could be heading for a significant credit event that would dramatically expand high yield spreads.

Several financial conditions measures suggest credit conditions have not significantly tightened and the Fed seems hesitant to raise rates further. In addition, bank balance sheets largely remain healthy. Major credit events are typically preceded by a combination of an overly aggressive Fed placing stress on a weakened financial sector.

Although the Magnificent 7 companies do have stronger balance sheets than most companies, the credit markets have yet to even hint at a credit event the size of which the Magnificent 7's outperformance would suggest.

Explanation #3: Smaller capitalization stocks are now "defensive"

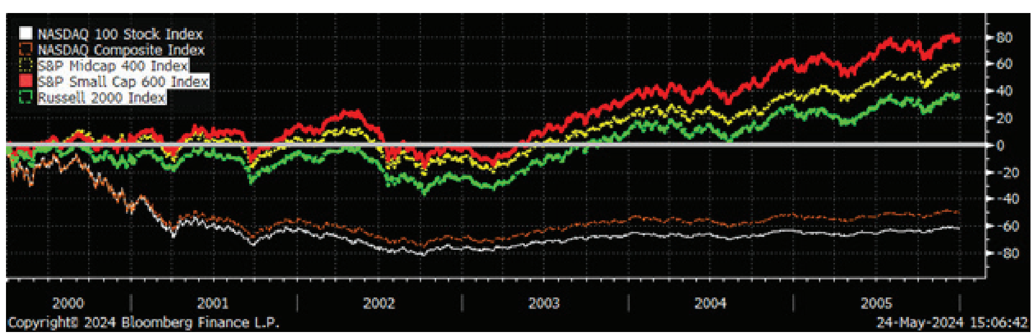
A third explanation is the liquidity fueling stock market speculation in the Magnificent 7 is the same liquidity tightening credit spreads and speculation in lower quality bonds. If this is true, then it argues that smaller capitalization stocks might be more defensive should the economic and profits cycles turn down.

This would be a "this time is different" argument. It is hard to believe that smaller and more economically sensitive companies could be defensive. However, it isn't unprecedented.

Chart 4 shows the performance of the NASDAQ® Composite, the NASDAQ-100®, the S&P 500®, the S&P Midcap 400 Index, the S&P Smallcap 600 Index, and the Russell 2000® Index during the five years after the peak of the Technology bubble. Small and midcap stocks did indeed act more defensively as profits disappointed in the Technology sector, but realistically everything but technology proved to be defensive.

CHART 4:

Performance after the Peak of the Technology Bubble



Source: Bloomberg Finance L.P

Something has to give

Individual investors are enthusiastic investors in the Magnificent 7 and in lower quality and private debt. This seems very inconsistent to us.

The Magnificent 7's outperformance seems to be forecasting a dire economic future with significant credit problems, whereas the flows into private debt are suggesting the Magnificent 7 is in the midst of a speculative period or even a bubble.

The divergence in the performance of large and small capitalization stocks and high and low quality bonds is highly unusual and extremely inconsistent. Something has to give.

We continue to believe that economic precedent will hold. Profits are accelerating and credit conditions remain healthy. The broadening of fundamentals suggests it is the Magnificent 7 that will be the assets to "give" and substantially underperform.

INDEX DESCRIPTIONS:

The following descriptions, while believed to be accurate, are in some cases abbreviated versions of more detailed or comprehensive definitions available from the sponsors or originators of the respective indices. Anyone interested in such further details is free to consult each such sponsor's or originator's website.

The past performance of an index is not a guarantee of future results.

Each index reflects an unmanaged universe of securities without any deduction for advisory fees or other expenses that would reduce actual returns, as well as the reinvestment of all income and dividends. An actual investment in the securities included in the index would require an investor to incur transaction costs, which would lower the performance results. **Indices are not actively managed and investors cannot invest directly in the indices.**

S&P 500®: The S&P 500® Index is an unmanaged, capitalization-weighted index designed to measure the performance of the broad US market. The index includes 500 leading companies covering approximately 80% of available market capitalization.

S&P Midcap 400®: Standard and Poor's Midcap 400® Index is a capitalization-weighted index which measures the performance of the mid-range sector of the U.S. stock market. The index was developed with a base level of 100 as of December 31, 1990.

S&P Smallcap 600®: The Standard & Poor's Smallcap 600® Index is a capitalization-weighted index that measures the performance of selected U.S. stocks with a small market capitalization. The index was developed with a base value of 100 as of December31, 1993.

Small Caps: Russell 2000. The Russell 2000 Index is an unmanaged, market-capitalization-weighted index designed to measure the performance of the small-cap segment of the US equity universe. The Russell 2000 Index is a subset of the Russell 3000® Index.

Mag 7: The Bloomberg Magni icent 7 Total Return Index. The Bloomberg Magnificent 7 Total Return Index is an equal-dollar weighted equity benchmark consisting of a fixed basket of 7 widely-traded companies classified in the United States and representing the Communications, Consumer Discretionary and Technology sectors as defined by Bloomberg Industry Classification System (BICS). These consist of AAPL, AMZN, GOOGL, META, MSFT, NVDA and TSLA.

Nasdaq®-100: The NASDAQ-100 Index is a modified capitalization-weighted index of the 100 largest and most active non-financial domestic and international issues listed on the NASDAQ. No security can have more than a 24% weighting. The index was developed with a base value of 125 as of February 1, 1985. Prior to December 21,1998 the Nasdaq 100 was a cap-weighted index.

Nasdaq® The Nasdaq Composite Index: The NASDAQ Composite Index is a broad-based market-capitalization-weighted index of stocks that includes all domestic and international based common type stocks listed on The NASDAQ Stock Market.

About Richard Bernstein Advisors

Richard Bernstein Advisors LLC is an investment manager focusing on long-only, global equity and asset allocation investment strategies. RBA runs ETF asset allocation SMA portfolios at leading wirehouses, independent broker/dealers, TAMPS and on select RIA platforms. Additionally, RBA partners with several firms including Eaton Vance Corporation and First Trust Portfolios LP, and currently has $15.4 billion collectively under management and advisement as of December 31, 2023. RBA acts as sub-advisor for the Eaton Vance Richard Bernstein Equity Strategy Fund, the Eaton Vance Richard Bernstein All-Asset Strategy Fund and also offers income and unique theme-oriented unit trusts through First Trust. RBA is also the index provider for the First Trust RBA American Industrial Renaissance® ETF. RBA's investment insights as well as further information about the firm and products can be found at **www.RBAdvisors.com**.