Richard Bernstein Advisors

Pactive® Approach to Investing

Insights

February 2025

Historically confident investors meet historically uncertain world

- Investors are historically confident, are shunning diversification, and are taking historic portfolio risk.
- That extreme risk taking is juxtaposed with a world that is historically uncertain.
- Investors are looking at diversification as a lead weight on performance rather than as a time-tested risk-reduction tool.
- We're not bearish. Narrow markets suggest index funds might face headwinds as 2025 progresses, but broader markets continue to present generationally attractive opportunities.

Excitement surrounding the current bull market seems to be reaching a crescendo. Individual investors who were very fearful of equities at the beginning of the bull market in 2009 are today historically bullish and willing to take extreme portfolio risk.

Investors are throwing caution to the wind. They seem historically confident despite that uncertainty is rapidly growing, and a broad array of uncertainty measures are at or near historic highs.

Bull markets often begin with significant investor fear and doubt despite improving clarity, but we are seeing the opposite today. Investors have

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 that are innovative, risk-controlled, and focused on overall portfolio construction instead of individual stock selection.

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virtually no fear despite fundamentals growing increasingly nebulous and uncertain.

Investors are historically confident...

Investors are historically confident today regarding future stock returns. By some measures, investors have never been so ready, willing, and able to take significant portfolio risk. Some commentators have derisively suggested diversification has become "diworsification" because diversifying a portfolio simply constrains the potential for high equity returns.

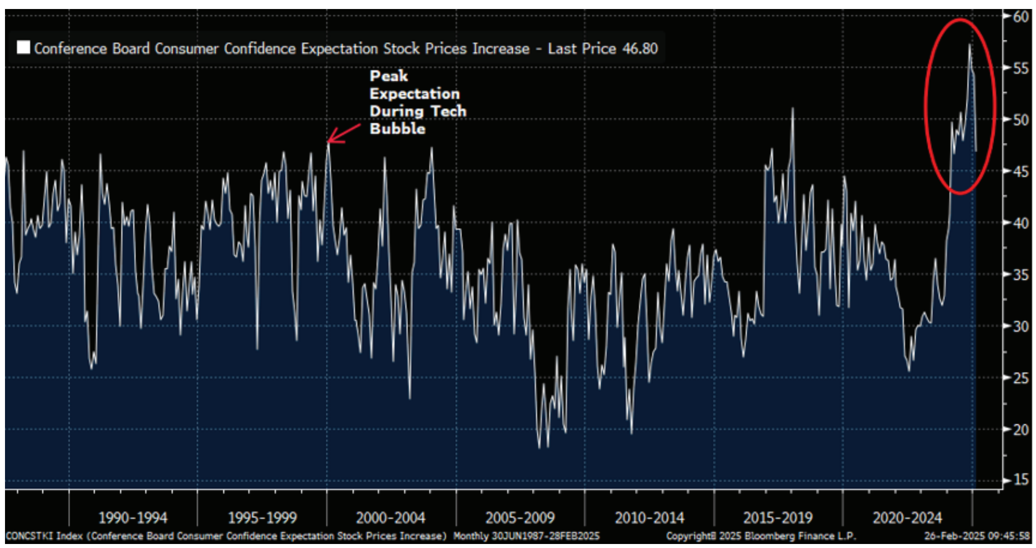
Investors' risk-taking during the Technology Bubble in 1998/99 seems small in comparison to today's aggressive portfolio positioning. Chart 1 shows the Conference Board's monthly consumer confidence question as to whether the stock market will be higher 12 months hence. Their recent responses are considerably more bullish than those during the Technology Bubble.

Investors surpassed the optimism of the Technology Bubble in January 2018 just prior to the imposition of tariffs, and stocks fell 10-15% (depending on the index) between January 31st and December 31st.

CHART 1:

Conference Board Consumer Confidence Expectation Stock Prices Increase

(Feb. 28, 1987 – Jan. 31, 2025)



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

Individual investors are not simply bullish. They are taking historic amounts of equity risk to express that bullishness. Chart 2 shows the equity beta of private client portfolios. At the beginning of the bull market in 2009, when opportunities by definition were the greatest, their equity beta was 0.75. Today, in the 15th year of the bull market, investors' beta is a mind-boggling 1.70!!

CHART 2:
Top 10 GWIM Stocks, 1-Year Beta to SPX

Source: BofA Global Research. Reprinted by permission. Copyright © 2025 Bank of America Corporation ("BAC"). The use of the above in no way implies that BAC or any of its affiliates endorses the views or interpretation or the use of such information or acts as any endorsement of the use of such information. The information is provided "as is" and none of BAC or any of its affiliates warrants the accuracy or completeness of the information.

Institutional investors also seem quite bullish, although not at the record setting levels seen among individual investors. A recent BofA Securities Fund Manager Survey[1] noted the following regarding fund managers' sentiment:

- Cash levels are at 15-year lows.
- 77% of fund managers expect the Fed to cut at least once during 2025. Only 1% expect a rate hike.
- 82% of fund managers believe there is no chance of a recession, which is the highest since early 2022.

Speculative enthusiasm doesn't appear to be limited to equity investors. Near-historically narrow high yield bond spreads reflect similar optimism to that seen among equity investors. Chart 3 shows the Bloomberg High Yield Bond Spread, and today's narrow spread echoes those during the Technology Bubble and those immediately before the Global Financial Crisis.

CHART 3:
Bloomberg US Corporate High Yield Bond Spread
(Jan. 03, 1996 – Feb. 20, 2025)

Source: Bloomberg Finance L.P

[1] BofA, "BofA February Global Fund Manager Survey", February 18, 2025.

...but uncertainty is also hitting records.

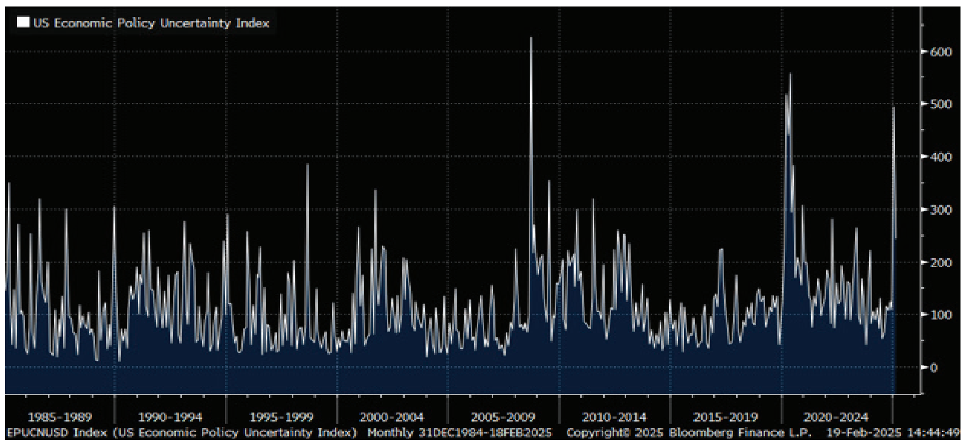
One could understand investors' historic bullishness and risk-taking if the US and global economies were on a transparently smooth path. However, the fundamentals look cloudier than ever.

Chart 4 shows the widely monitored Baker, Bloom, and Davis measure of US economic uncertainty, based on media reports. The measure has recently retraced some, but it recently hit the highest levels in the past 40 years except for readings associated with the Global Financial Crisis and the pandemic.

CHART 4:

US Economic Policy Uncertainty Index

(Dec. 31, 1984 – Jan. 31, 2025)



Source: Bloomberg Finance L.P

There is a similar measure for trade uncertainty (see Chart 5). Not surprisingly given the recent talk of tariffs and other deglobalization forces, trade uncertainty is rapidly rising. It rose after NAFTA was enacted in 1992 because of the uncertainty surrounding the beginning of modern globalization. Uncertainty rose again in 2018 and currently because of the risks associated with de-globalization and global supply chains.

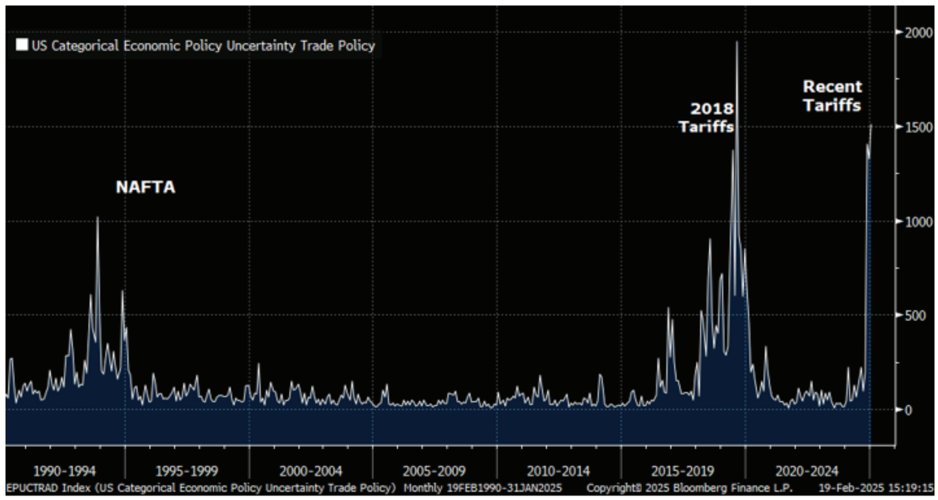
This is important for stocks for two reasons. First, the massive US trade deficit demonstrates the US is highly dependent on the remainder of the world for a broad range of manufactured intermediate and consumer goods. The US economy does not have the available productive capacity to make up for supply disruptions or to offset government policies like tariffs.

Deglobalization, therefore, can be viewed as a giant supply-chain disruption which implies more inflation rather than less as goods become scarcer and as production shifts to less efficient locales.

Second, equity valuations theoretically should be lower as globalization contracts because of higher inflation and because a large proportion of S&P 500® sales and earnings come from abroad. Earnings and sales growth will likely slow if operations in non-US countries become constrained or prohibited.

Investors seem to be totally ignoring that deglobalization suggests both slower earnings growth for multinational companies and lower valuations.

CHART 5:
US Uncertainty Trade Policy Index
(Feb. 28, 1990 – Jan. 31, 2025)



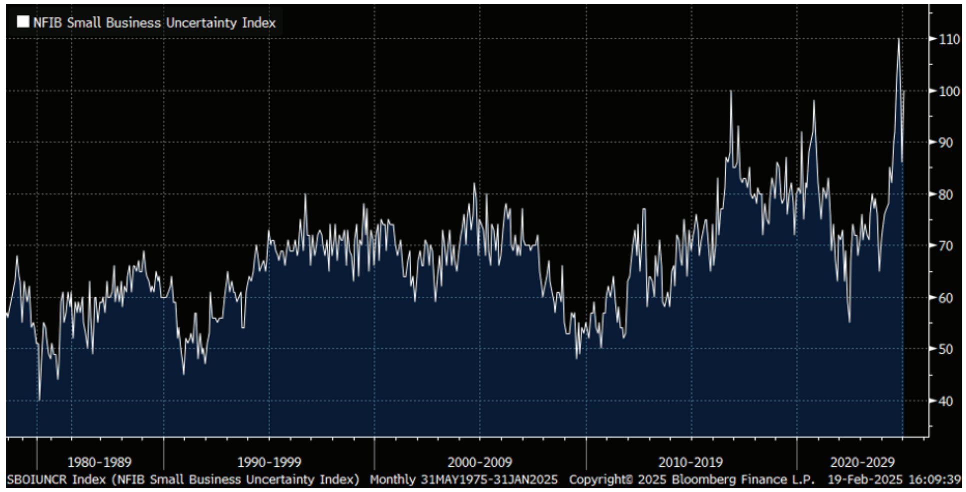
Source: Richard Bernstein Advisors LLC. Bloomberg Finance L.P

But domestic fundamentals also seem confusing, and small businesses believe they are now facing the greatest uncertainty ever. The National Federation of Independent Businesses (NFIB) is the lobbying organization for US small businesses. Each month they conduct a survey of their members, and Chart 6 depicts the resulting NFIB Uncertainty Index.

Small businesses are currently facing what they perceive to be the most uncertain business environment in the near 50-year history of the survey.

This chart shows an interesting difference between today's readings and those at the beginning of the bull market in 2009. In 2009, investors were very hesitant to take equity risk (i.e., the beta in the earlier chart was only 0.75), but small businesses saw a relatively certain environment. Today, investors are taking historic risk (i.e., beta is 1.70) when small businesses see unprecedented uncertainty.

CHART 6:
NFIB Small Business Uncertainty Index
(May 31, 1975 – Jan. 31, 2025)



Source: Bloomberg Finance L.P

Even the fixed-income markets see more risk than does the typical investor. Chart 7 shows the spread between the US 10-year Treasury and the comparable 10-year German Bund. When both the German Bund and the US Treasury were AAA-rated, their yields traded within a reasonable band, i.e., generally within 100 basis points of each other. However, US Treasuries have traded with a consistent yield premium once the US was downgraded from AAA.

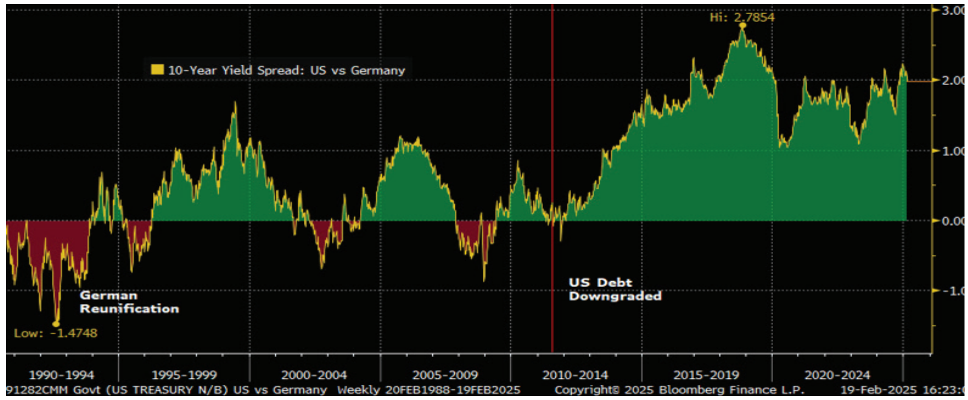
Riskier, lower quality bonds should trade with a risk-premium yield (i.e., "junk" bonds have higher yields than quality bonds), and the US Treasury has appropriately traded with a risk premium yield since the downgrade.

The outperformance of US stocks during this bull market has made investors seem very confident regarding "US exceptionalism". However, it appears that bond investors don't agree with that assessment of US quality.

CHART 7:

10-Year Yield Spread: US vs. Germany

(Jun. 30, 1990 – Feb. 20, 2025)



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

Headwinds for index fund investors but diversification pays off

As it did during the Tech Bubble, narrow equity market leadership has led some investors to decide that equity index funds are a superior strategy to broader diversification. In normal markets, the tradeoffs between index funds and active management are a viable discussion. However, when index funds are dominated by a few stocks, broader diversification has historically proved beneficial.

As we've previously discussed, we view 2025 as a two-act play in which the nominal economy is stronger than consensus during Act 1. Act 2 sees higher volatility as Act 1's stronger growth forces the Fed to disappoint those looking for continued interest rate cuts.

Some view the two-act play as being very bearish. We totally disagree.

The narrow market implies that investors in index funds might indeed have some performance headwinds during 2025 as "the market" (which is effectively 7-10 stocks) has to contend with reduced economic liquidity. Judging by the post-Tech Bubble's "lost decade in equities," index funds might secularly underperform.

However, the post-Tech Bubble period also shows that diversified portfolios were rewarded. Positive absolute returns broadened, and a growing list of sectors, styles, and countries outperformed, even as standard US equity indices posted negative returns.

So 2025 and beyond might be a difficult period for index fund investors and "the market" might post negative returns, but diversified equity portfolios might be entering a secular period of not only relative outperformance, but also positive absolute returns. That doesn't seem bearish to us at all.

Where will the next "golden age" be?

Reflecting investors' seemingly unbridled bullishness, someone recently stated that the US is entering a "golden age of investing". That seemed curious to us because the US realistically entered that golden age 15 years ago when the secular bull market began. Today, the bullish suggestion of unending US outperformance apparently ignores the historic levels of fundamental uncertainty.

Our work at RBA continues to uncover where the next "golden age" will occur and accordingly manage both the potential returns and risks of our portfolios.

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 $16.1 billion collectively under management and advisement as of December 31, 2024. RBA acts as sub-advisor for the Eaton Vance RBA Equity Strategy Fund, the Eaton Vance RBA 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**.