



Independent Investment Strategy

Diversifying Beyond Mega-Cap Tech

**FPA Dallas/Fort Worth
4th Annual Virtual Super CE Day**

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Salvatore Ruscitti

Strategist, U.S. Equities

salvatore.ruscitti@mrbpartners.com

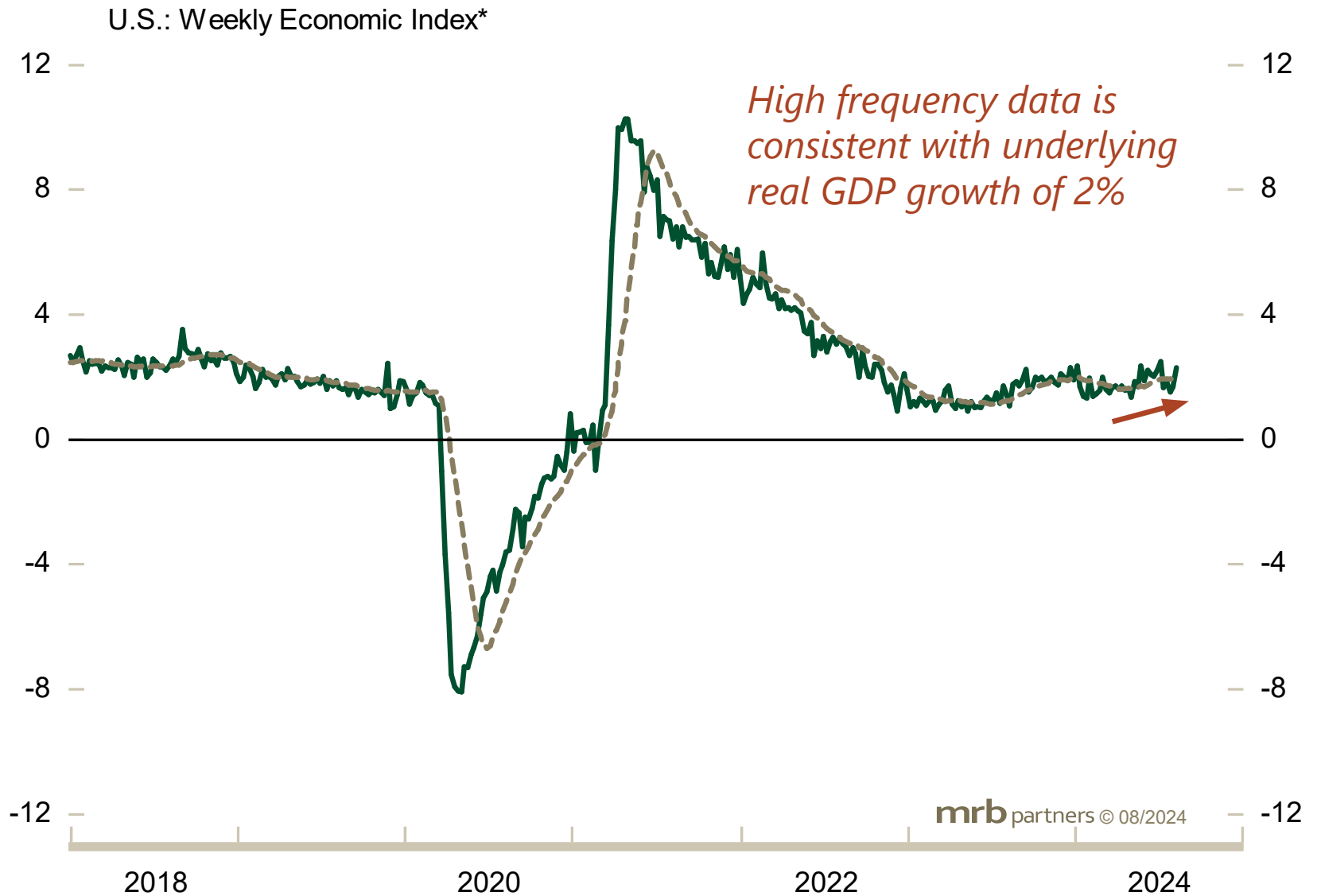
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Main Highlights

- The investment backdrop remains positive for U.S. equities, but performance will likely be choppy in the near run given negative seasonality and uncertainties related to rising geopolitical tensions and policy ahead of the November presidential election.
- The U.S. and global economic expansions will remain intact, thereby providing ongoing support to corporate profits. Earnings growth should become more balanced across sectors and drive a broadening of equity market leadership.
- Rate cuts by the Fed and other central banks will extend the economic cycle, and reinforce the positive trend in earnings, especially for economically-sensitive sectors.
- However, markets are overestimating the magnitude of Fed rate cuts, which along with sturdy economic growth, heralds higher bond yields on a 6-12 month horizon.
- Against this backdrop, we recommend a mildly pro-growth stance. Diversification is your friend.
- We favor financials (mega-cap banks) and energy stocks for exposure to cyclicals, balanced by an overweight stance on the defensive health care sector, which provides exposure to quality/stability at reasonable valuations.
- The risk-reward trade-off for the Magnificent 7 stocks is unappealing given their elevated valuations, moderating earnings momentum, and growing questions about whether A.I. investments will generate attractive returns. Accordingly, we are underweight on the technology sector, while holding communication services at neutral.

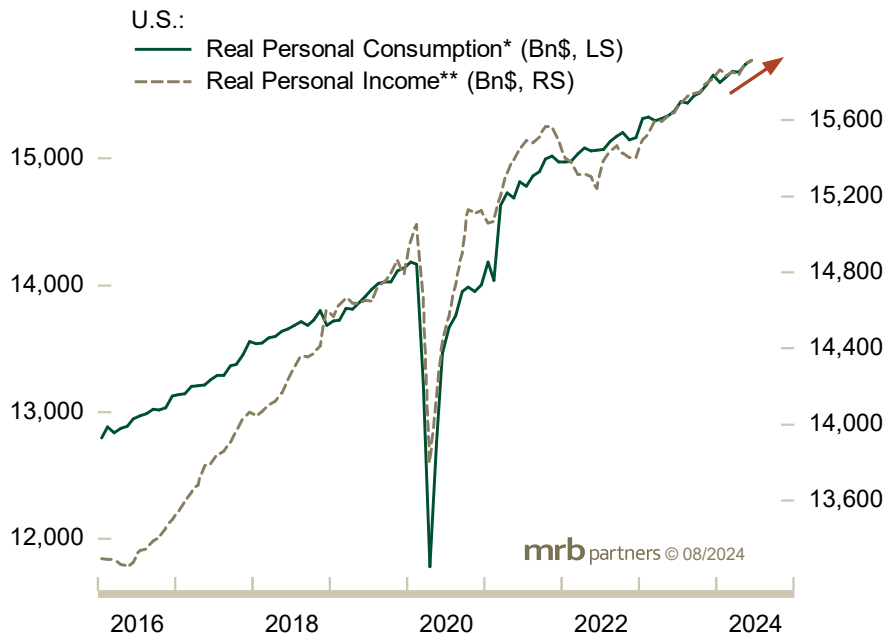
Economic Activity Is Resilient



* Source: Federal Reserve Bank of Dallas
Note: - - - 13-week moving average

Solid Floorboards Under Consumer Spending

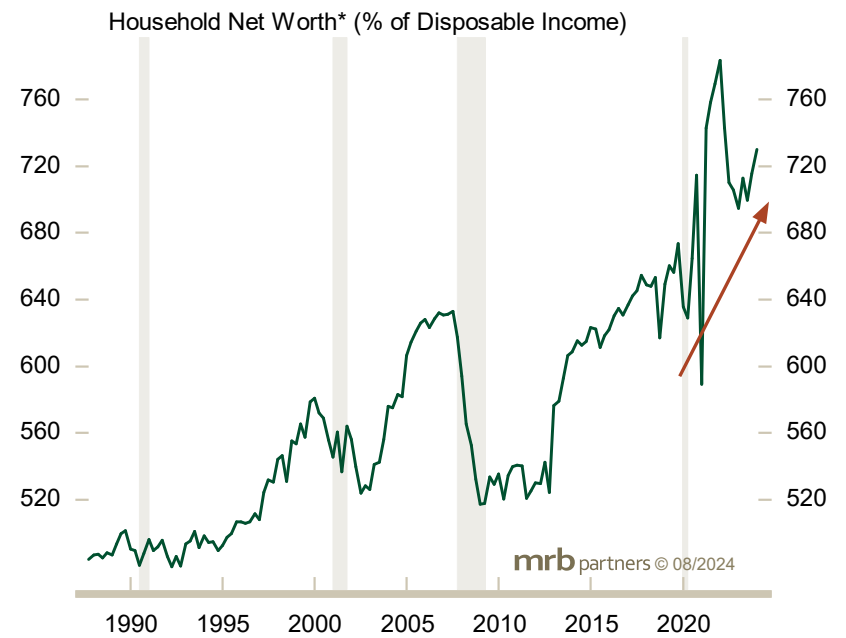
- Rising real incomes are supporting consumption



* Source: U.S. Bureau of Economic Analysis

** Excluding current transfer receipts; source: U.S. Bureau of Economic Analysis

- Households are also benefiting from a significant positive wealth shock



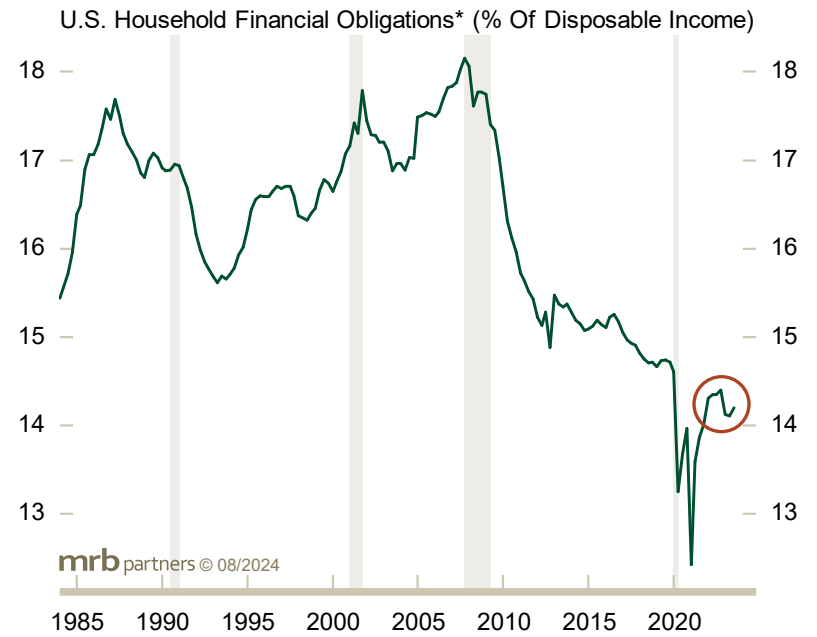
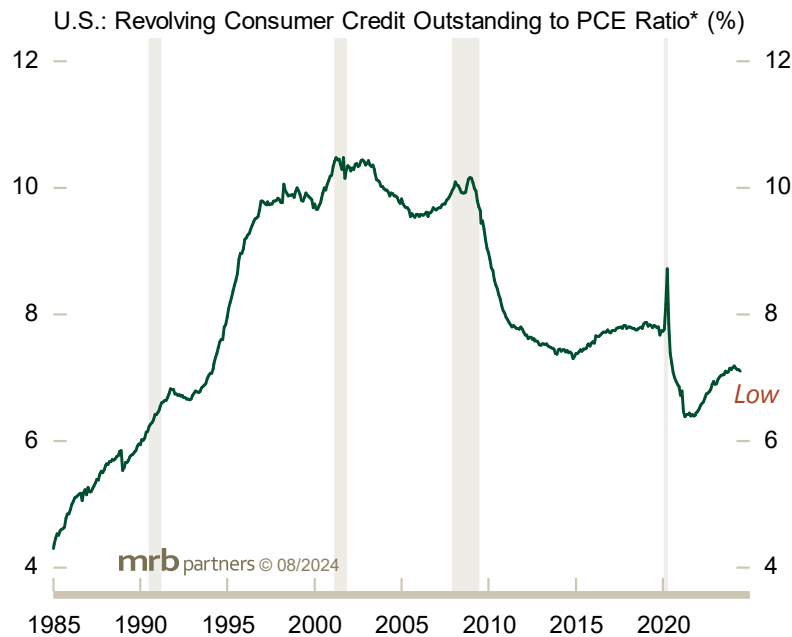
* Source: U.S. Bureau of Economic Analysis

Note: Shaded for NBER-designated U.S. recessions

Solid Household Balance Sheets Have Made Consumers Less Sensitive To Interest Rates

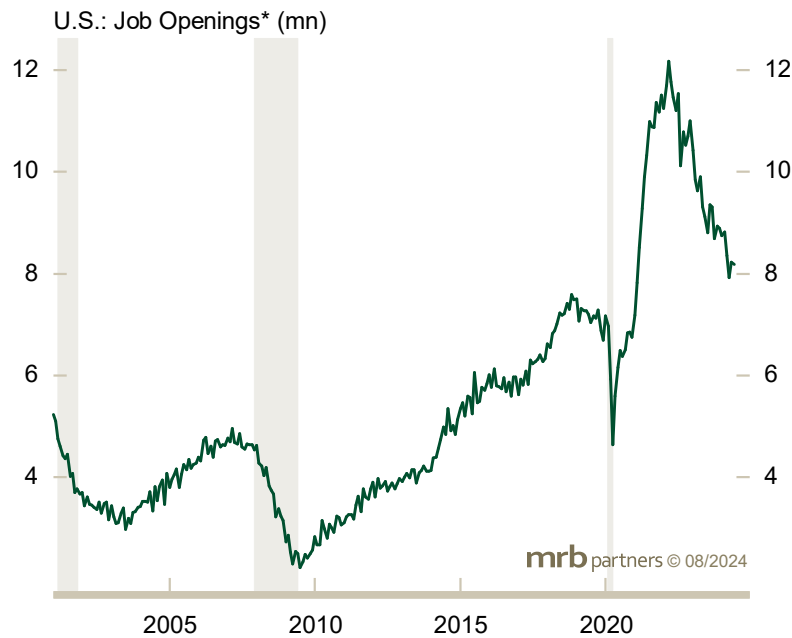
- Debt has not been fueling spending

- Debt service burdens have been manageable



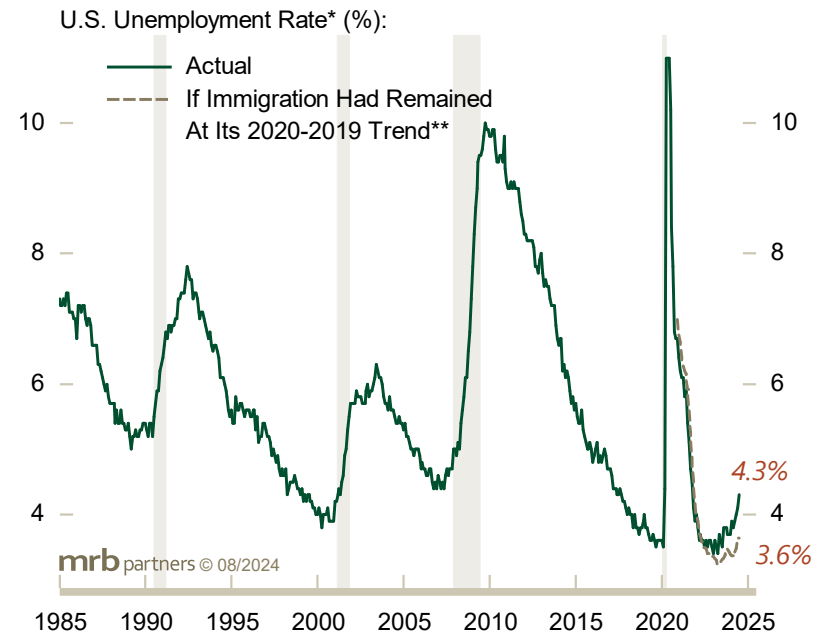
The Job Market Is Cooling

- Labor demand has eased



* Source: U.S. Bureau of Labor Statistics
 Note: Shaded for NBER-designated U.S. recessions

- Above-trend immigration has driven much of the rise in unemployment

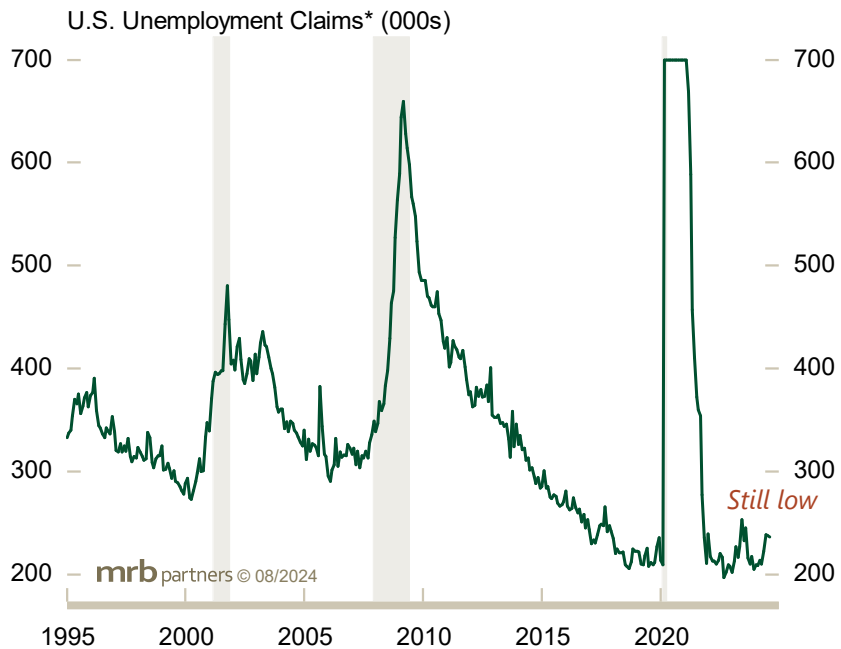


* Truncated at 11.3%; source: U.S. Bureau of Labor Statistics
 ** MRB calculation

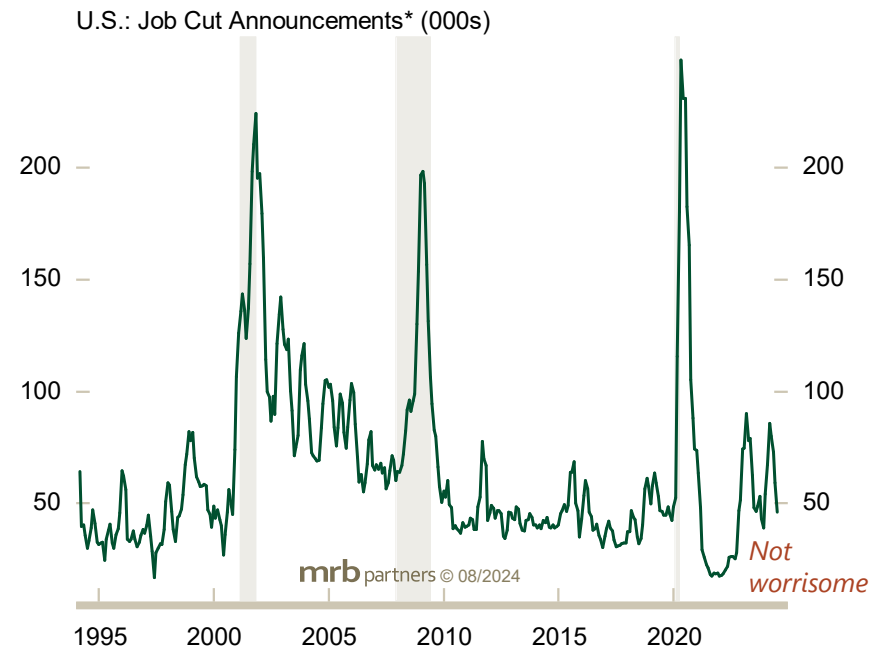
Labor Market Conditions Are Still Solid

- Unemployment insurance claims remain at historically low levels

- Job lay-offs are not surging



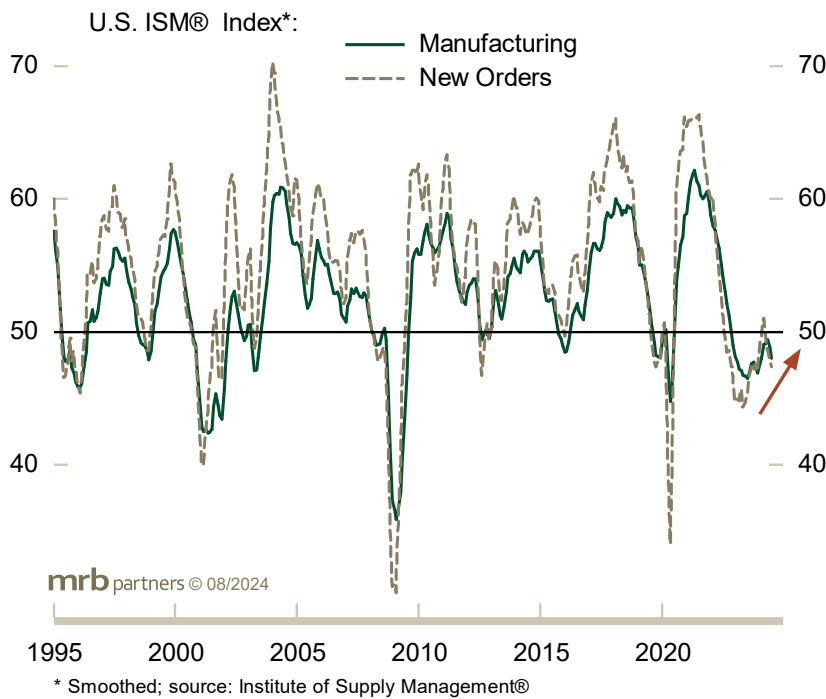
* Truncated at 700,000; 4-week moving average
Note: Shaded for NBER-designated U.S. recessions



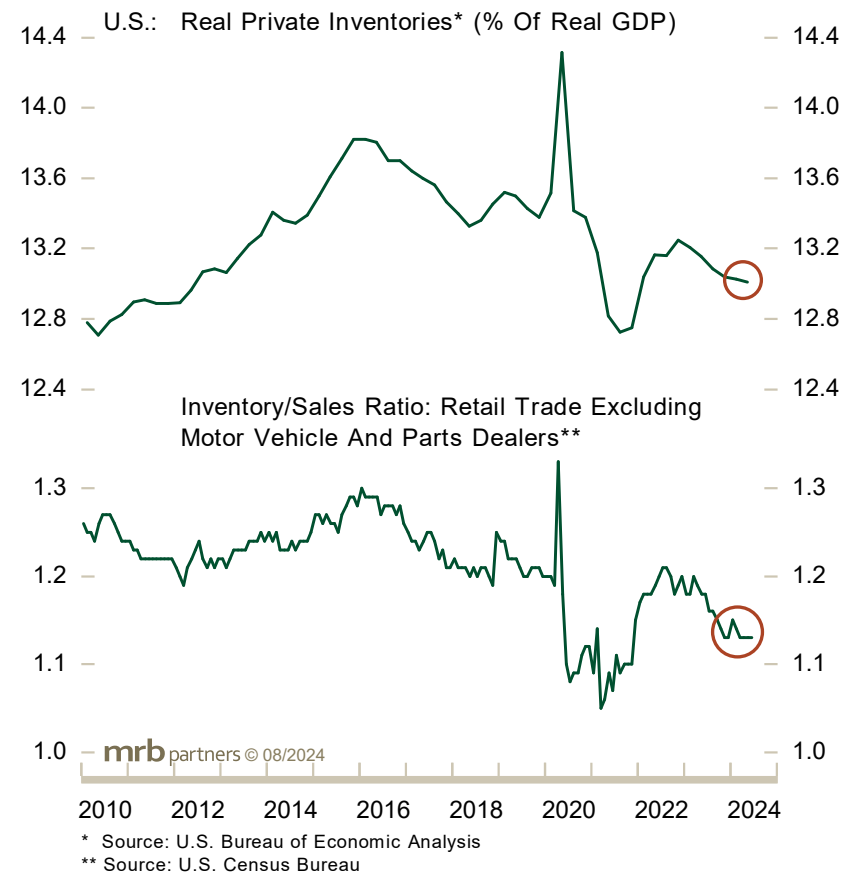
* Smoothed; truncated at 260,000 million; source: Challenger, Gray and Christmas
Note: Shaded for NBER-designated U.S. recessions

The Inventory Backdrop Looks Benign

- Manufacturing activity is cyclically depressed and is more likely to rebound than sink further

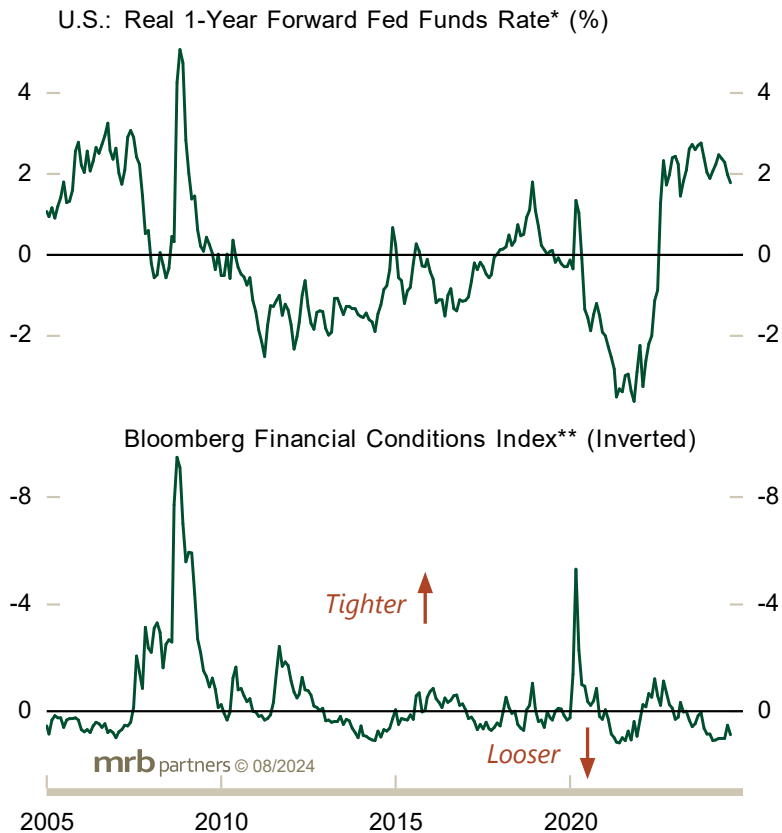


- Inventories are low by pre-pandemic standards



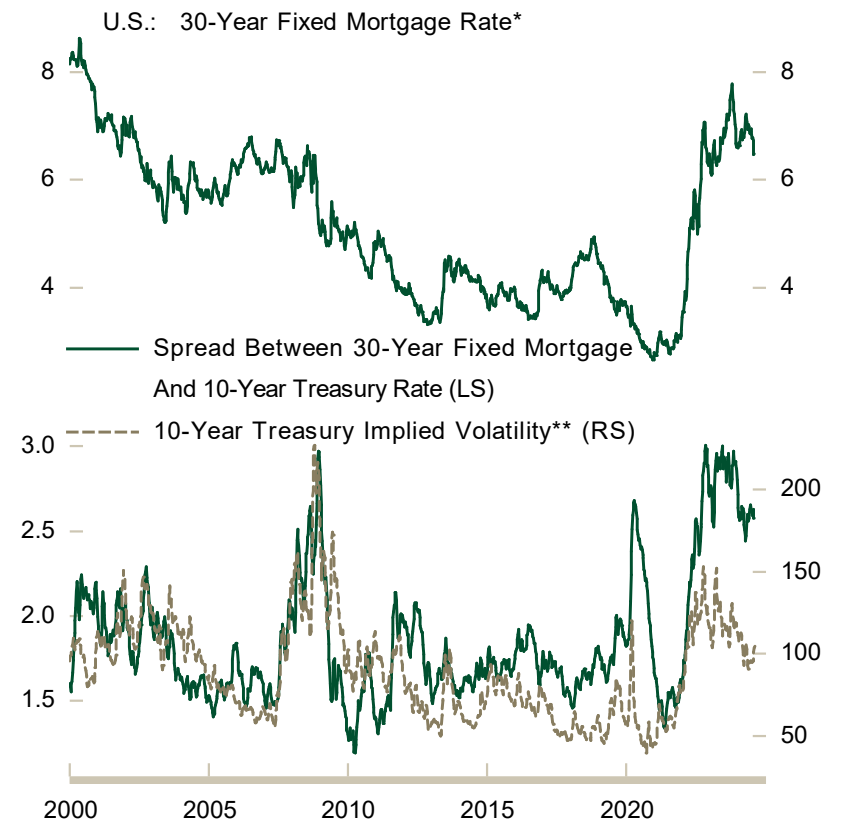
How Tight Is Monetary Policy?

- Financial conditions have loosened despite higher real rates



* 1-year forward fed funds rate deflated by 1-year CPI swap rate; source: Bloomberg
 ** Source: Bloomberg

- Elevated bond market volatility has been keeping mortgage spreads wide

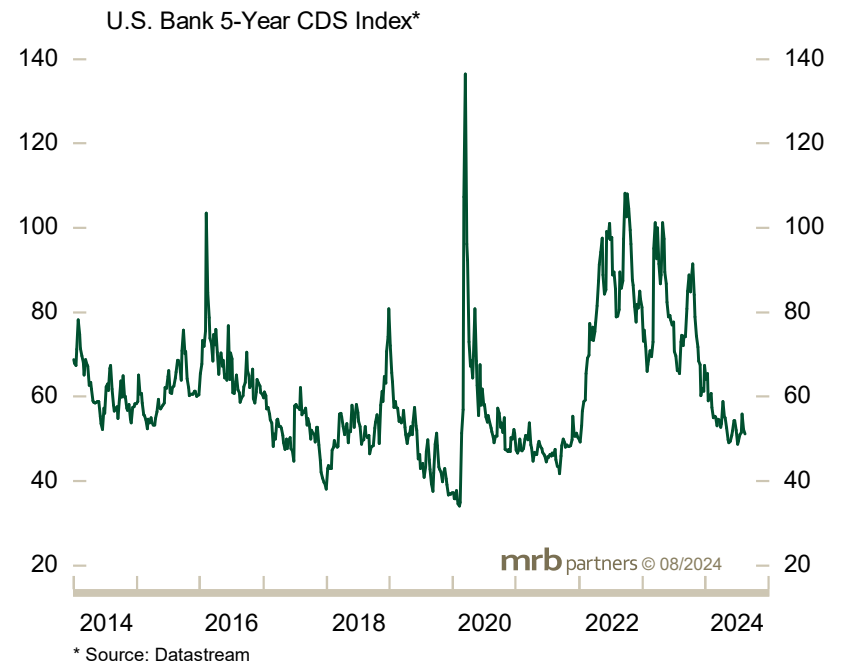


* Source: Freddie Mac
 ** Source: Bloomberg

Credit Markets Are Not Suggesting That Monetary Policy Is Excessively Restrictive

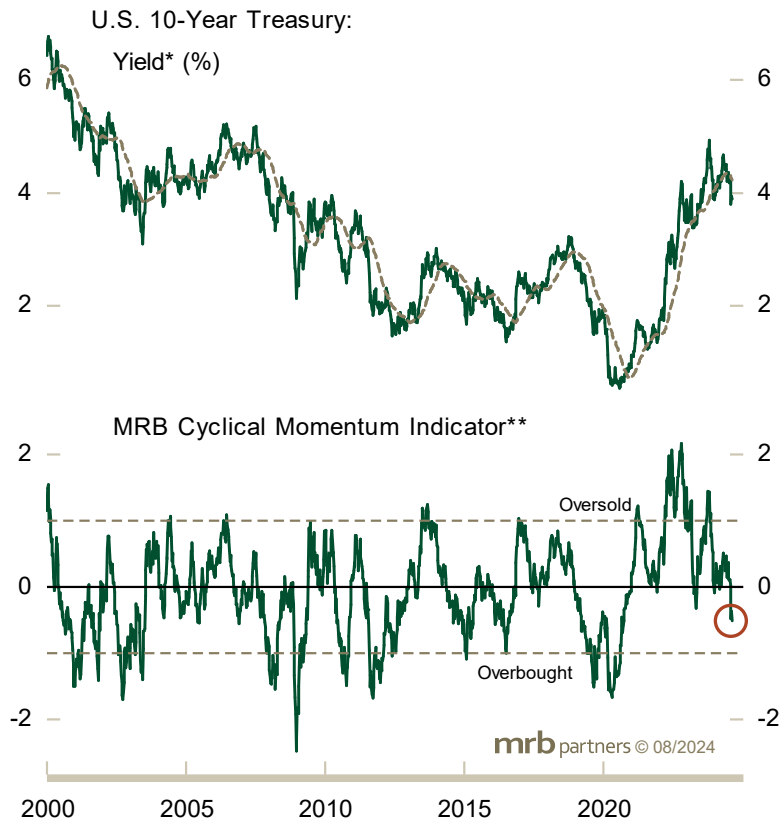
- Medium-grade credit spreads are well behaved

- Cost of insuring against bank losses has been falling



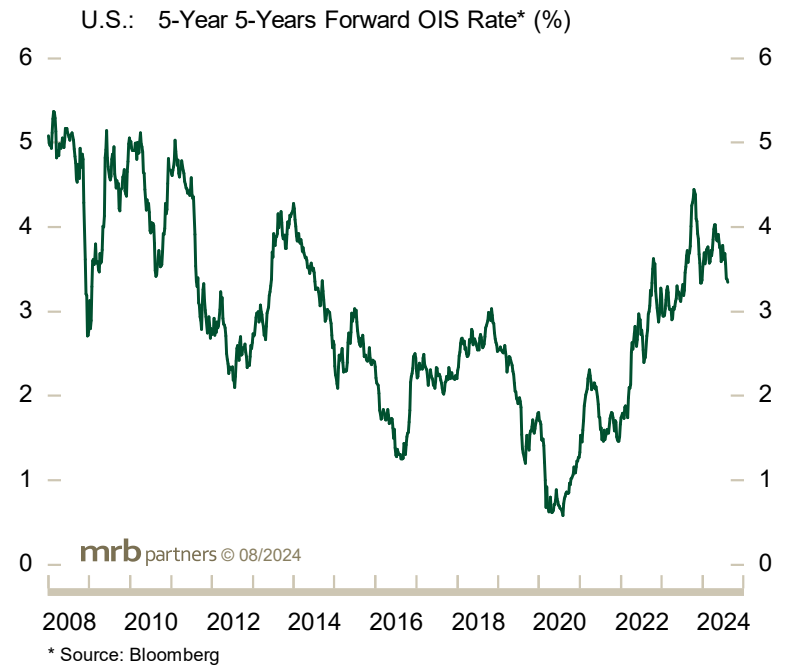
Bonds Are Still Not Compelling

- Technical conditions are modestly overbought



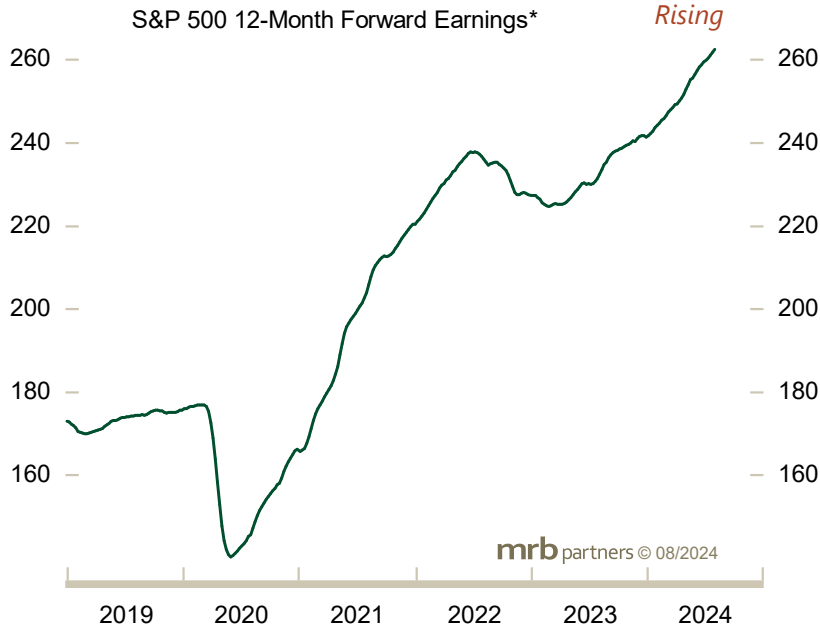
* Source: Bloomberg
 ** Standardized
 Note: - - - 40-week moving average in panel 1

- A market proxy of the terminal Fed funds rate is above 3%

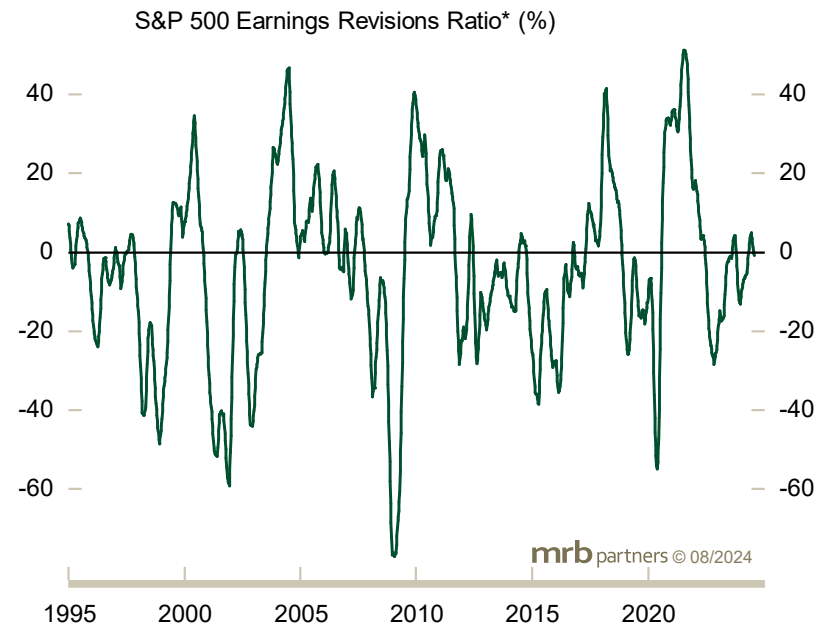


The Earnings Backdrop Is Supportive

- Forward earnings are at a new high
- Net earnings revisions are neutral



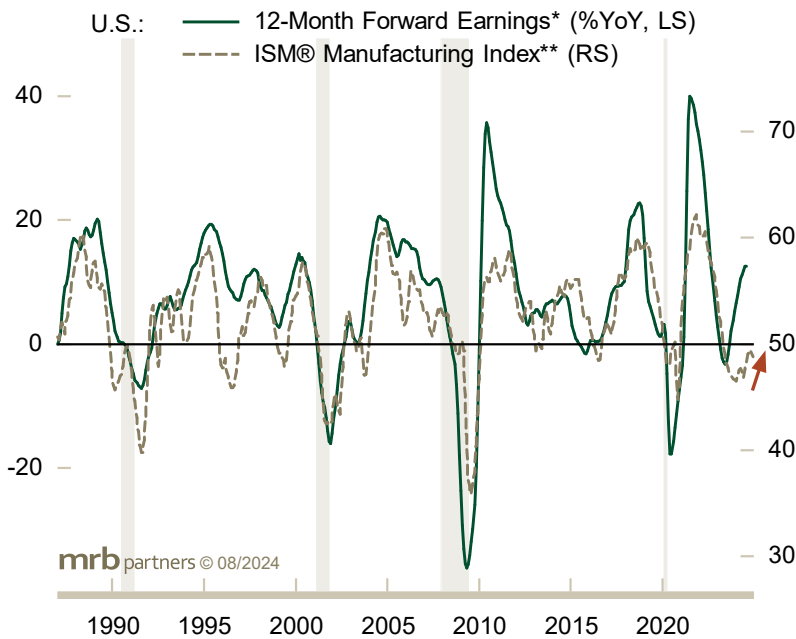
* Source: Refinitiv I/B/E/S Global Aggregates



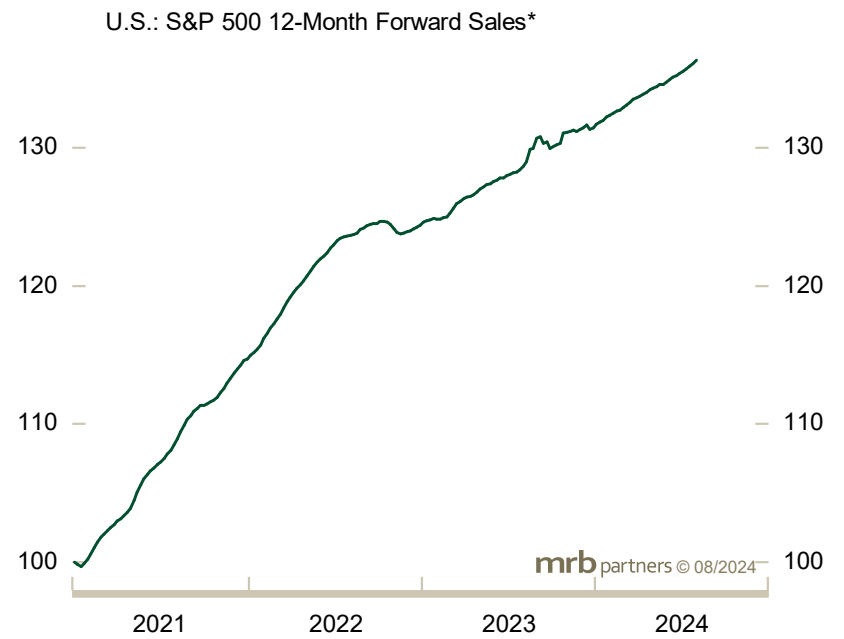
* Upward revisions minus downward revisions divided by total revisions; 13-week moving average; source Refinitiv I/B/E/S Global Aggregates

The Overall Profit Cycle Has Been Recovering

- Growth in forward earnings will improve further if factory activity firms
- Rising sales expectations reinforce the constructive earnings outlook



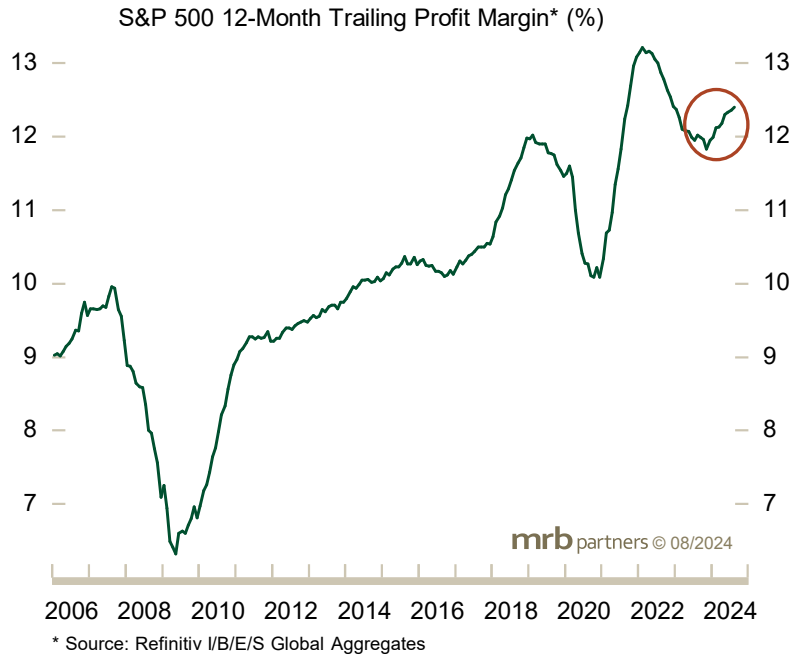
* Smoothed; source: Refinitiv I/B/E/S Global Aggregates
 ** Advanced 6 months; smoothed; source: Institute of Supply Management®
 Note: Shaded for NBER-designated U.S. recessions



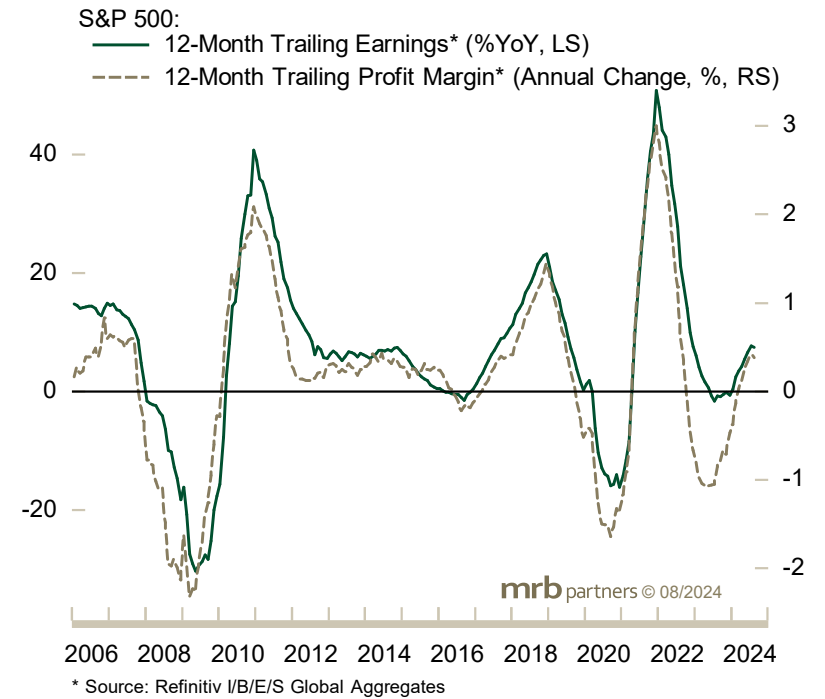
* Smoothed; rebased; source: Refinitiv I/B/E/S Global Aggregates

Profit Margins Are Critical To The Earnings Outlook

- Profit margins have been resilient



- Profit margins are a key driver of earnings growth



Consensus Earnings Forecasts Embed Lots Of Optimism About Profit Margins

| S&P 500 | 2023 (Act.) | 2024 (Est.) | 2025 (Est.) | 2026 (Est.) |
|---------------------|-------------|-------------|-------------|-------------|
| Earnings/Share | \$217 | \$239 | \$274 | \$309 |
| <i>Growth (%)</i> | | 10.3% | 14.8% | 12.5% |
| Sales/Share | \$1,812 | \$1,902 | \$2,013 | \$2,128 |
| <i>Growth (%)</i> | | 5.0% | 5.8% | 5.7% |
| Profit Margin (%) | 12.0 | 12.6 | 13.6 | 14.5 |
| <i>Change (bps)</i> | | 60.5 | 106.3 | 88.4 |

Source: Refinitiv I/B/E/S Global Aggregates

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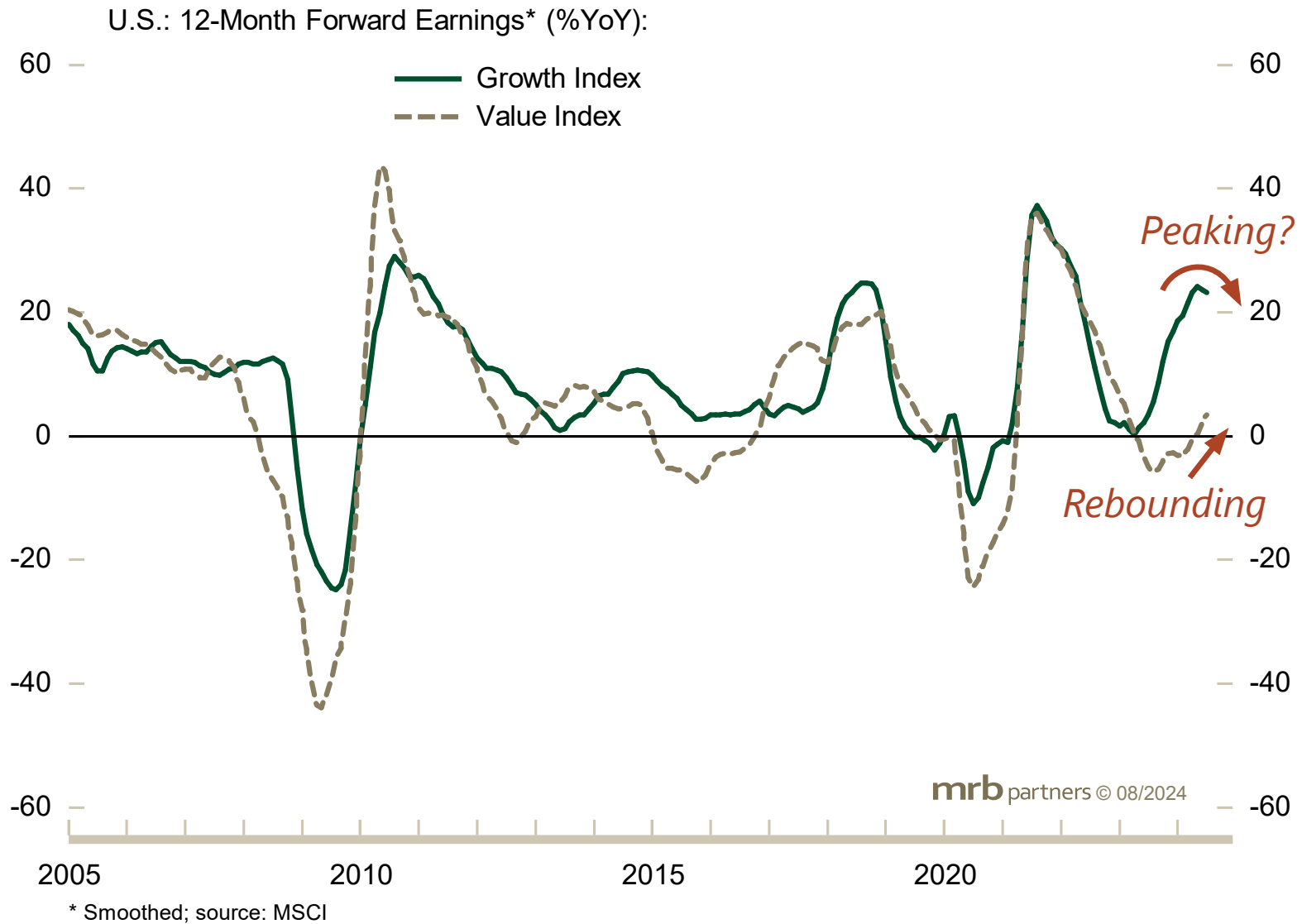
Earnings Growth Expected To Become More Balanced Across Sectors

| Sector | Earnings Growth (% YoY) | | | | |
|------------------------|-------------------------|-------------|-------------|-------------|-------------|
| | 2021 (Act.) | 2022 (Act.) | 2023 (Act.) | 2024 (Est.) | 2025 (Est.) |
| Communication Services | 34.5 | -21.7 | 25.5 | 23.8 | 12.7 |
| Consumer Discretionary | 73.8 | 1.3 | 47.7 | 13.1 | 14.2 |
| Consumer Staples | 11.2 | 2.3 | 2.5 | 4.4 | 7.0 |
| Energy | n.c. | 153.1 | -25.8 | -9.7 | 14.0 |
| Financials | 65.9 | -13.2 | 11.1 | 11.4 | 8.6 |
| Health Care | 28.6 | 5.5 | -19.9 | 6.2 | 20.8 |
| Industrials | 92.6 | 30.0 | 25.3 | 4.1 | 15.8 |
| Information Technology | 37.5 | 8.6 | 3.8 | 18.9 | 20.9 |
| Materials | 87.1 | 9.0 | -21.7 | -3.9 | 18.3 |
| Real Estate | 43.8 | 3.4 | -13.6 | 1.6 | 9.8 |
| Utilities | 3.5 | 2.0 | 7.2 | 12.5 | 8.7 |
| S&P 500 | 50.5 | 7.2 | 2.5 | 10.3 | 14.9 |

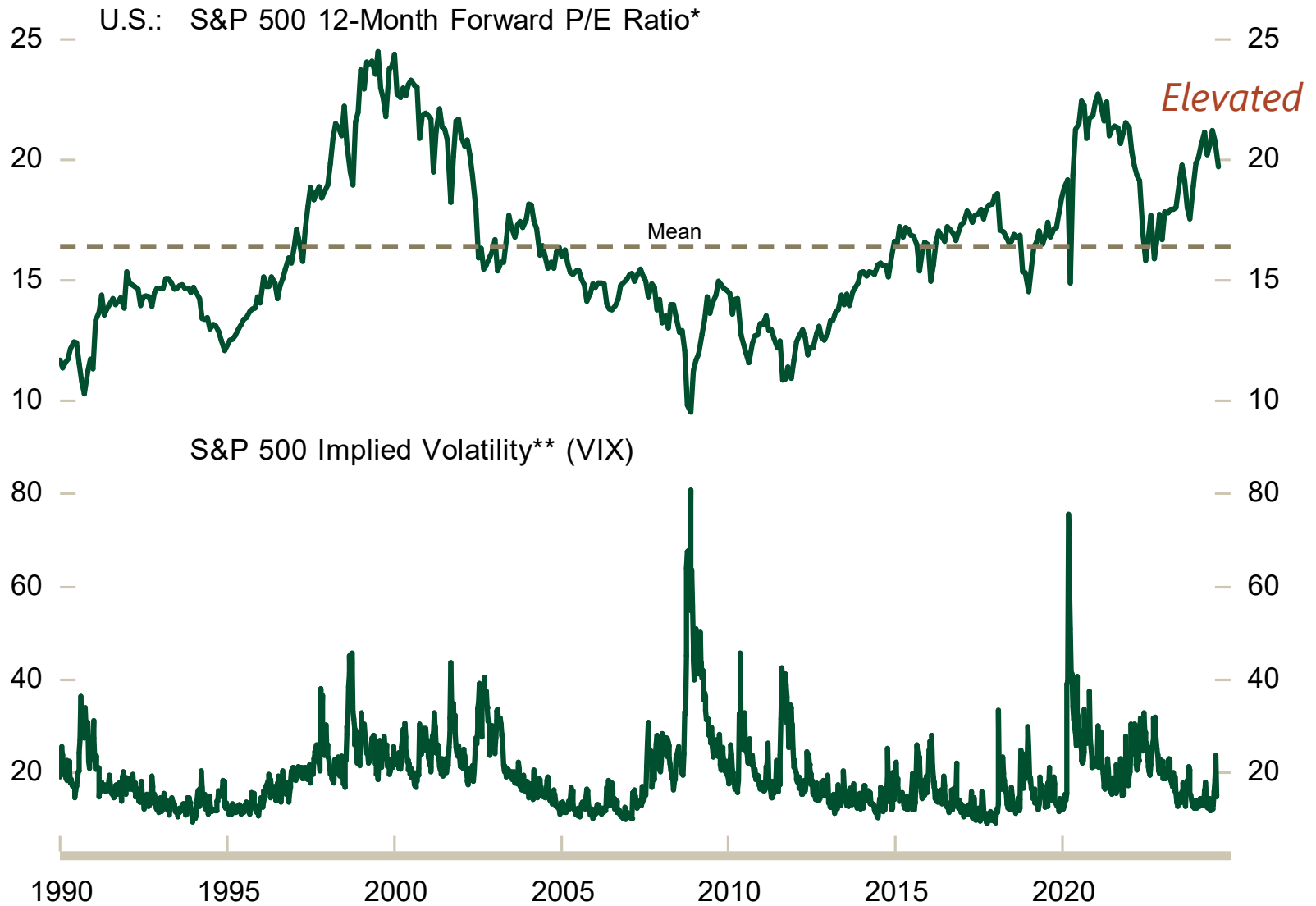
Source: Refinitiv I/B/E/S Global Aggregates; n/c = noncalculable due to negative earnings in 2020

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The Earnings Momentum Of Value Stocks Has More Room To Improve



High Valuations Leave The Stock Market Vulnerable To Adverse Developments



* Source: Refinitiv I/B/E/S Global Aggregates

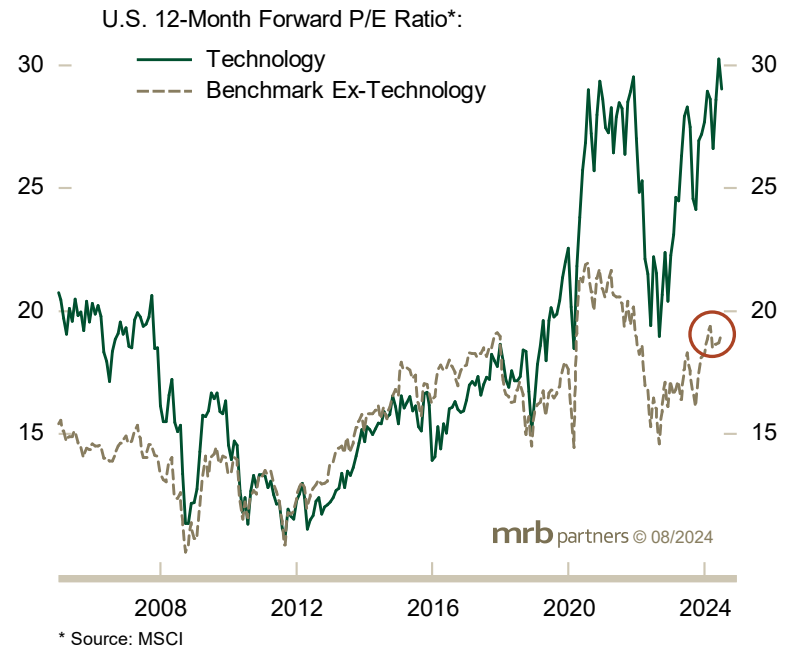
** Source: Bloomberg

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The Average Stock Represents A More Attractive Opportunity

- The average stock has lagged and has catch-up potential

- Valuations are more reasonable away from technology



MRB's U.S. Sector Recommendations

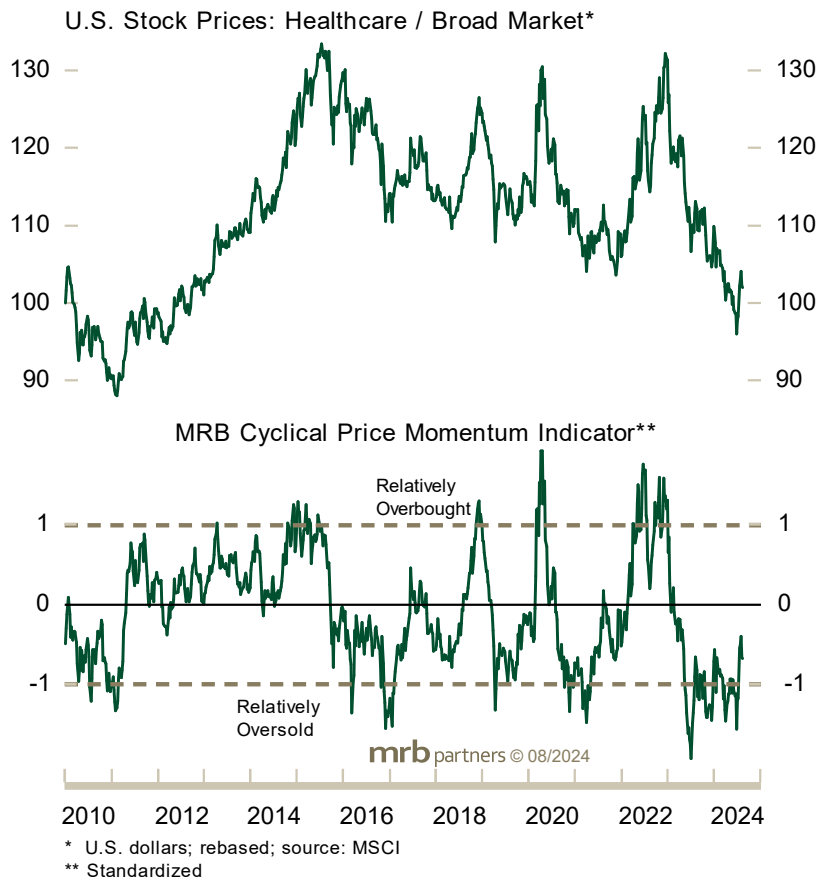
MRB U.S. Equity Sectors Allocation*

| | - | N | + |
|------------------------|---|---|---|
| Consumer Discretionary | ■ | | |
| Communication Services | | ■ | |
| Consumer Staples | | ■ | |
| Energy | | | ■ |
| Financials | | | ■ |
| Health Care | | | ■ |
| Industrials | | ■ | |
| Information Technology | ■ | | |
| Materials | | ■ | |
| Real Estate | | ■ | |
| Utilities | | ■ | |

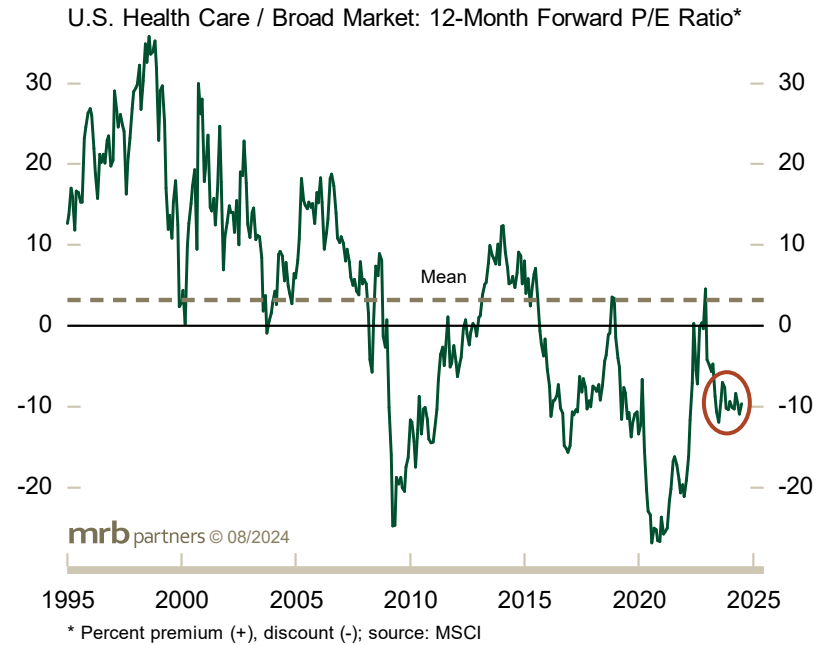
* 6-12 month horizon
 Note: + = overweight, N = neutral and - = underweight

Health Care: Quality At An Attractive Price

- Relative performance is rebounding from oversold levels



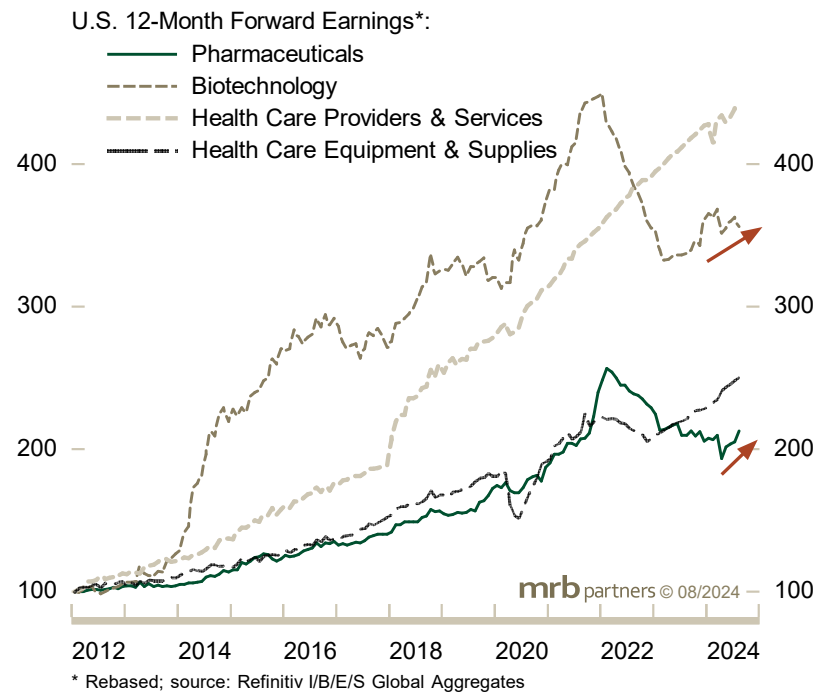
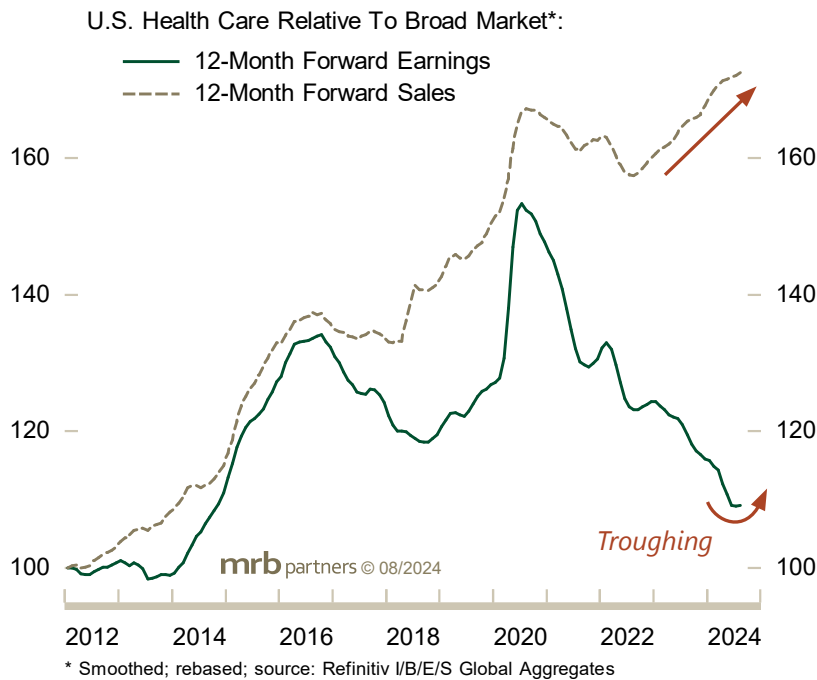
- Relative valuations are undemanding



Health Care: COVID Hangover Is Winding Down

- Relative earnings have weakened despite strong relative sale

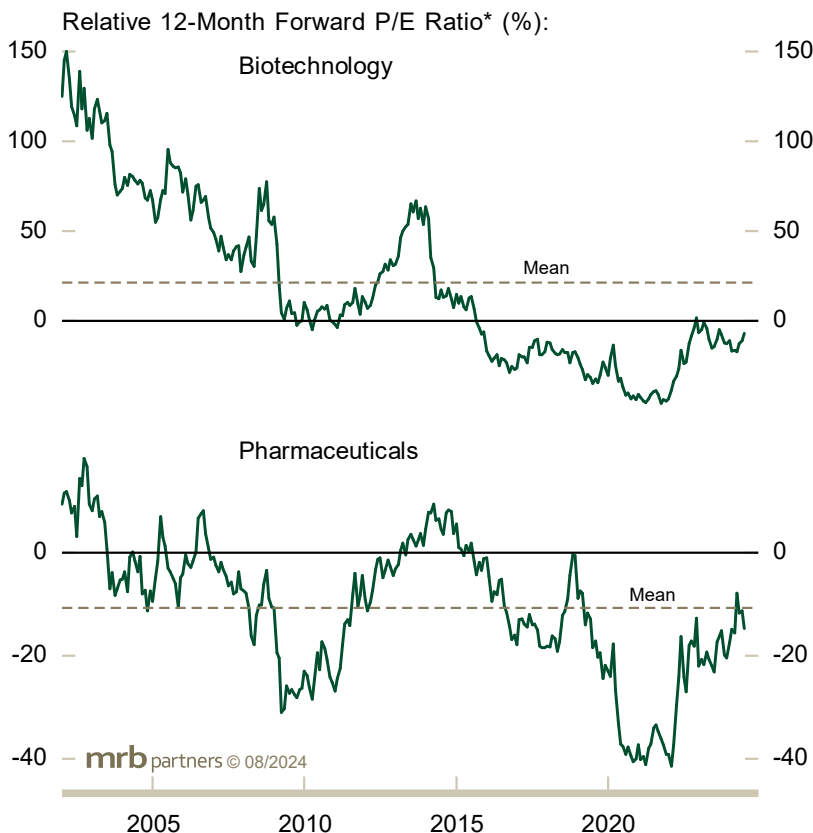
- The earnings declines at drug companies are ending



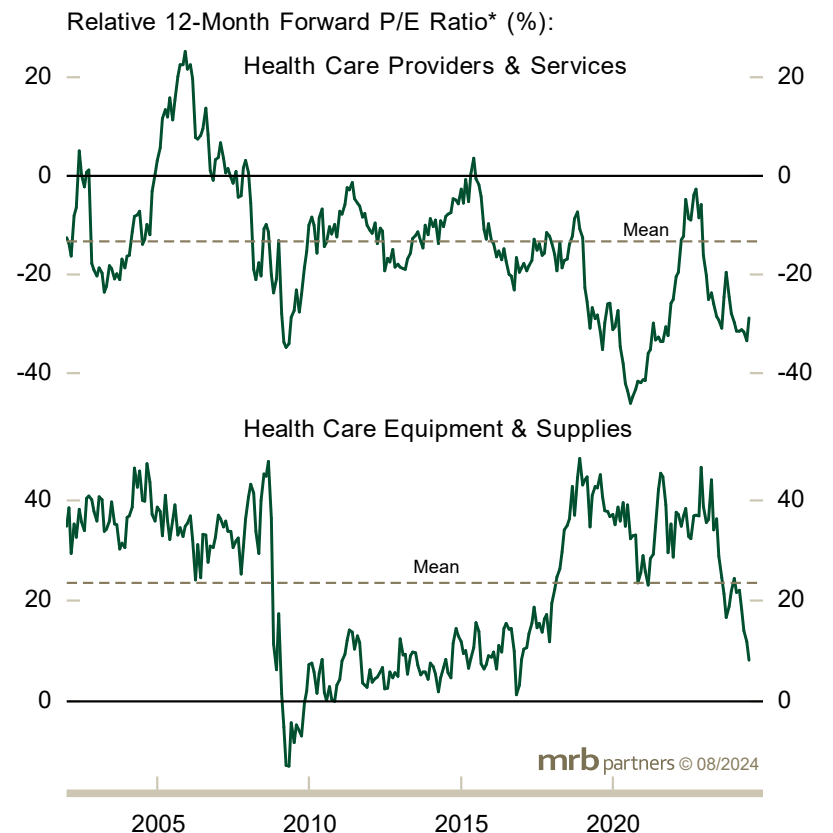
Health Care: Valuations Are Reasonable Across The Sector

- Pharma and biotech stocks trade at attractive valuations

- Valuations for equipment stocks are no longer in nosebleed territory

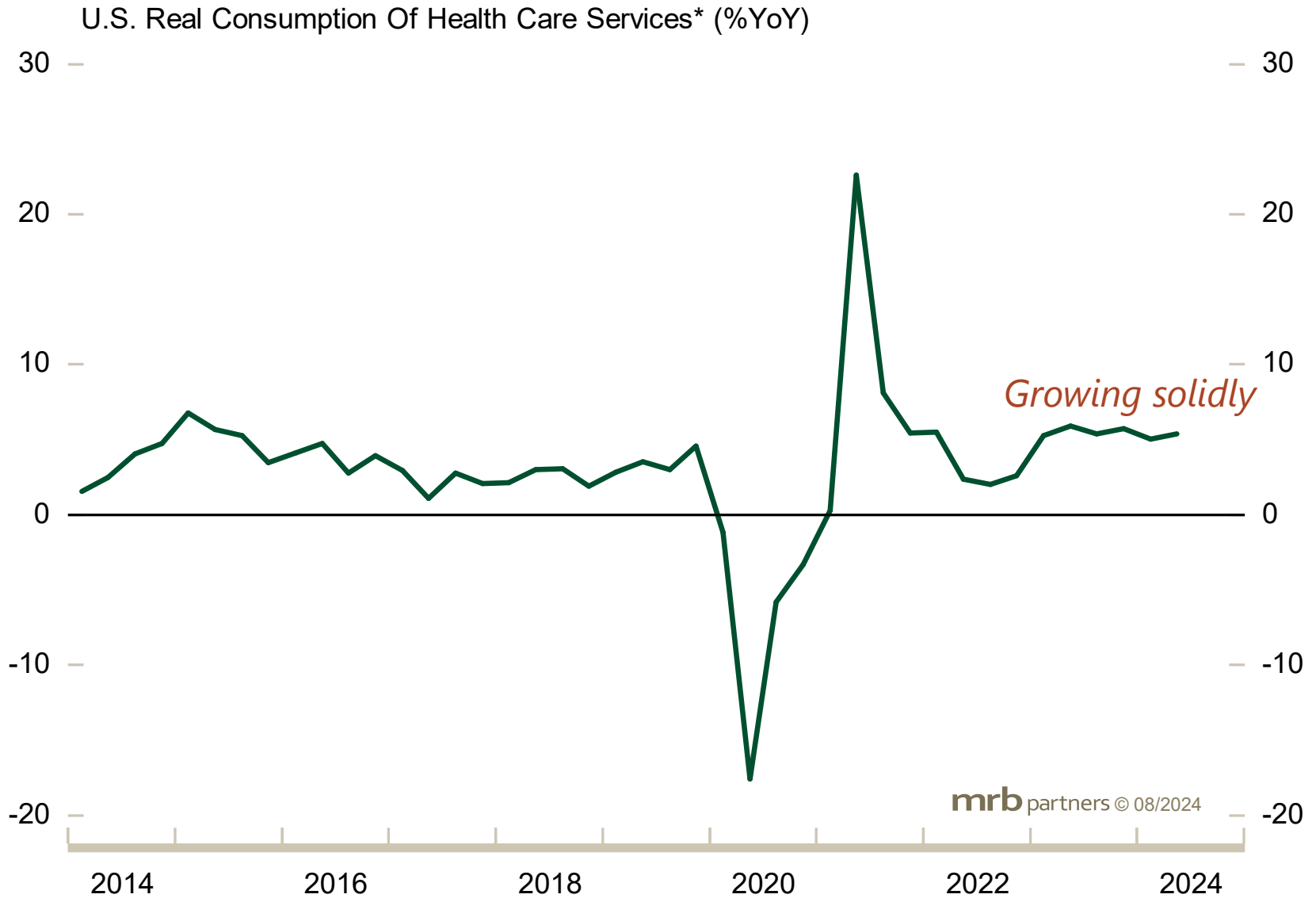


* Premium (+), discount (-) relative to broad market; source: MSCI



* Premium (+), discount (-) relative to broad market; source: MSCI

Health Care: Demand For Medical Services Has Been Strong Post-COVID

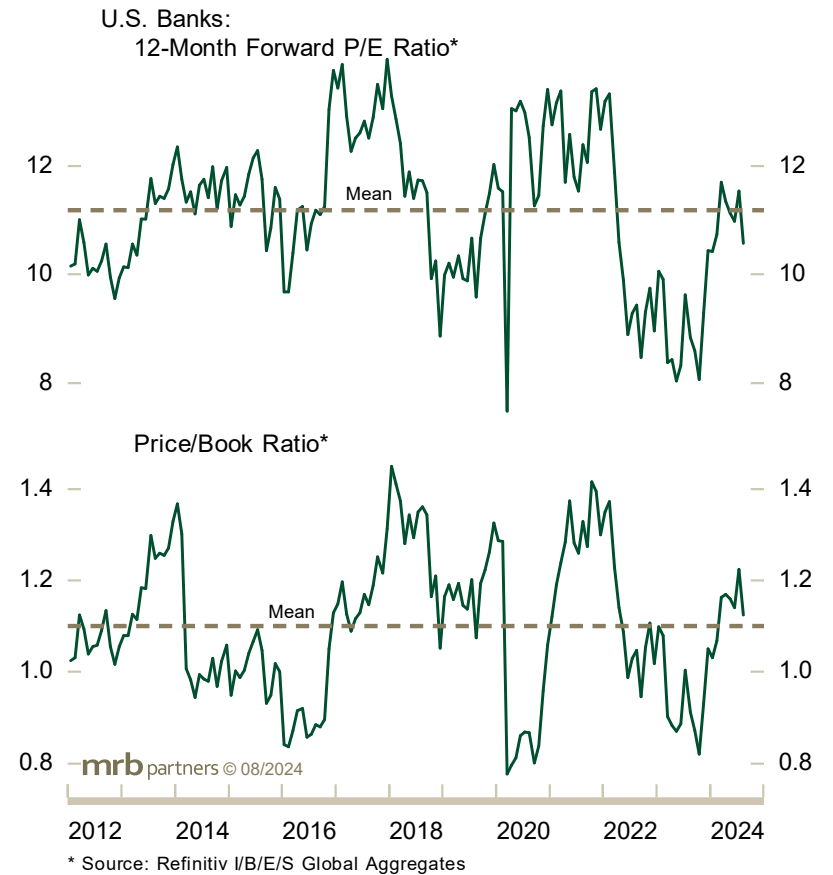
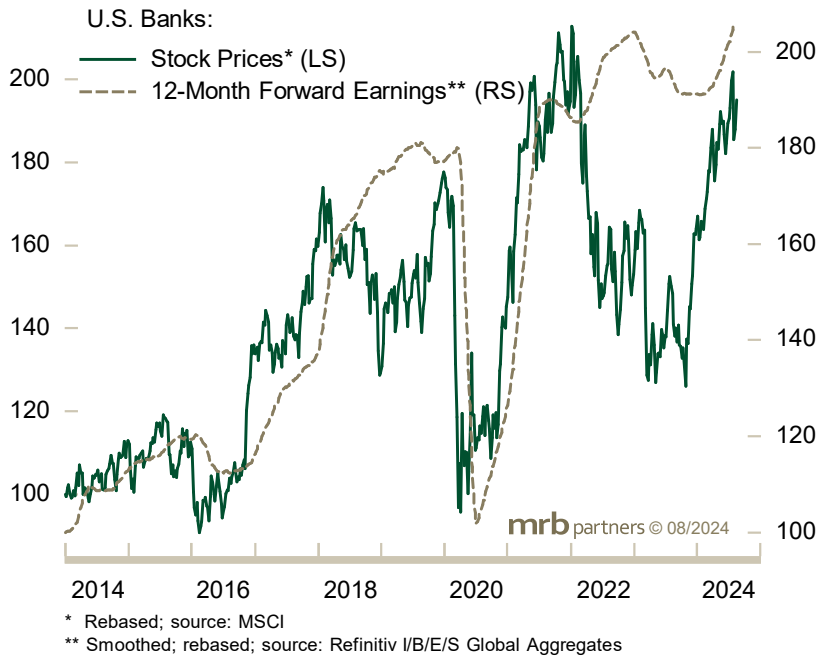


* Source: U.S. Bureau of Economic Analysis

Financials: Banks Are More Than A Re-Rating Story

- Resilient earnings have enabled bank stocks to reverse their earlier declines

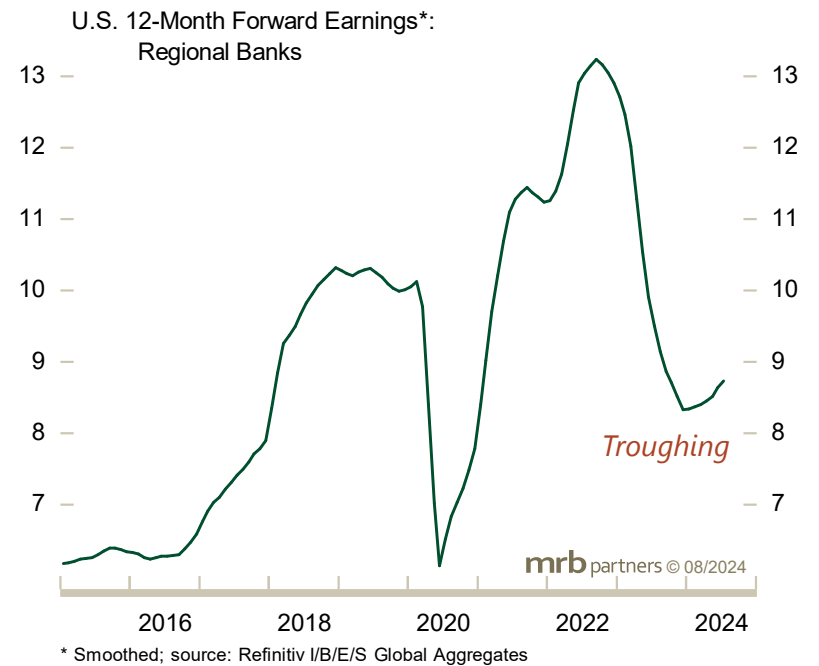
- Valuations are only at middling levels



Financials: Large Diversified Banks Have Been Fundamentally Stronger

- Forward earnings for large banks are accelerating

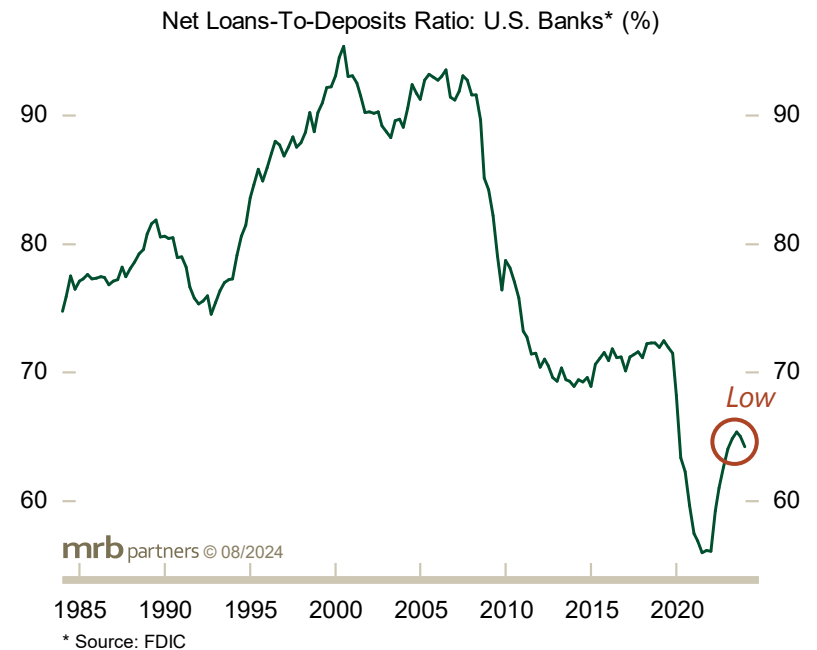
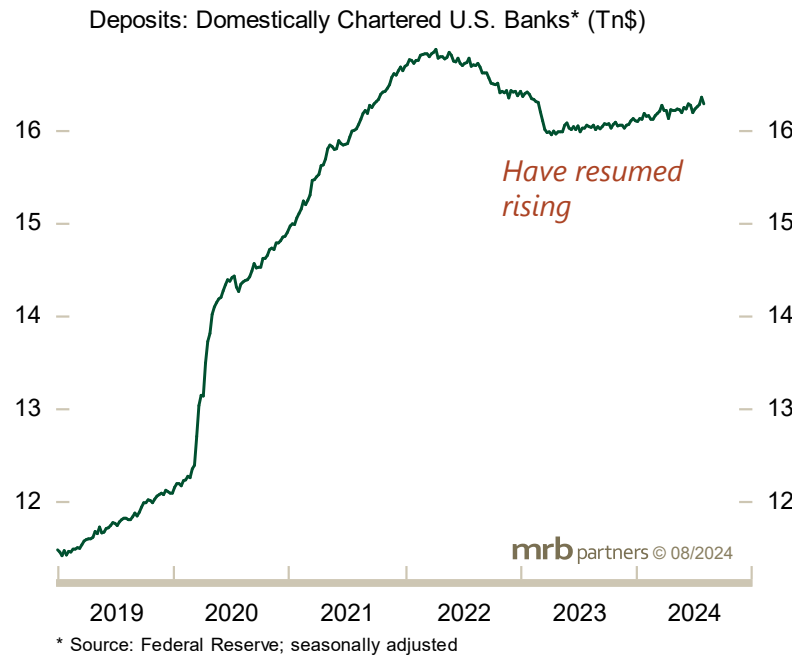
- ...while they have troughed for smaller regional banks



Financials: The Liquidity Position Of Most Banks Is Strong

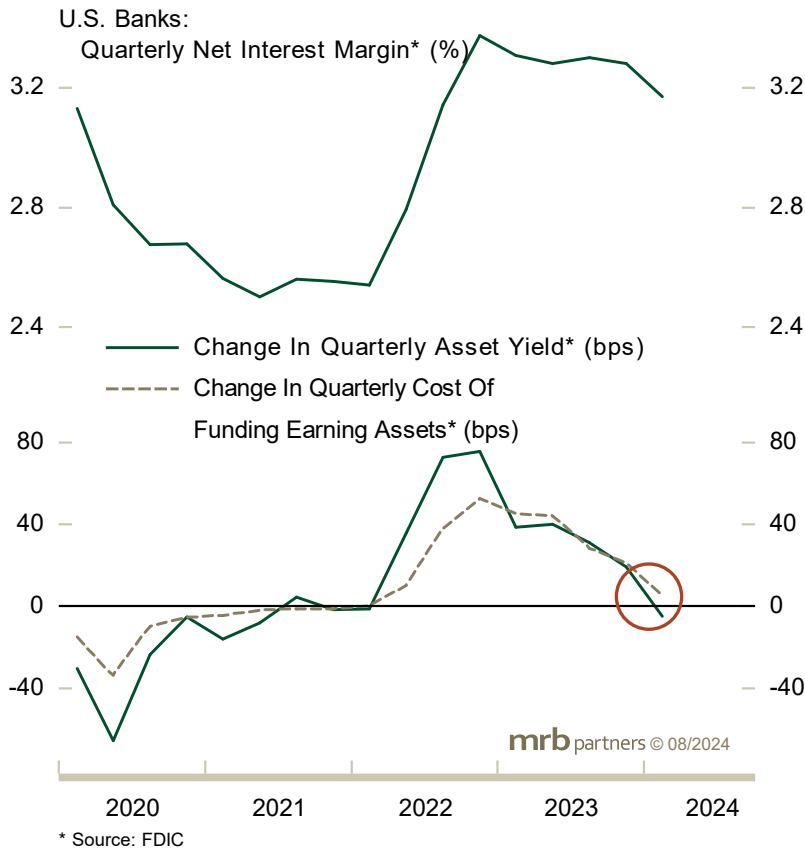
- The deposit exodus has ended

- The aggregate banking industry is operating with excess deposits

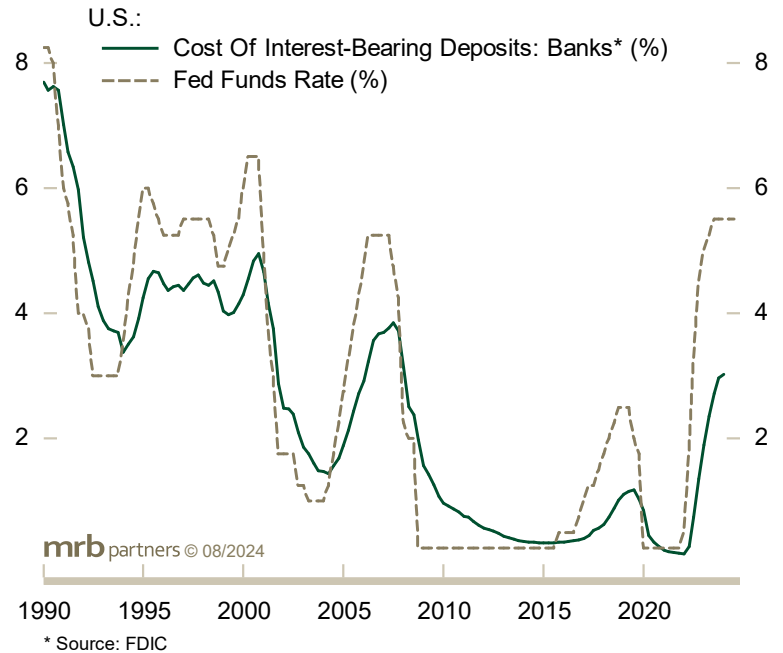


Financials: The Profitability Of Bank Lending Has Not Been Crunched As Some Were Fearing

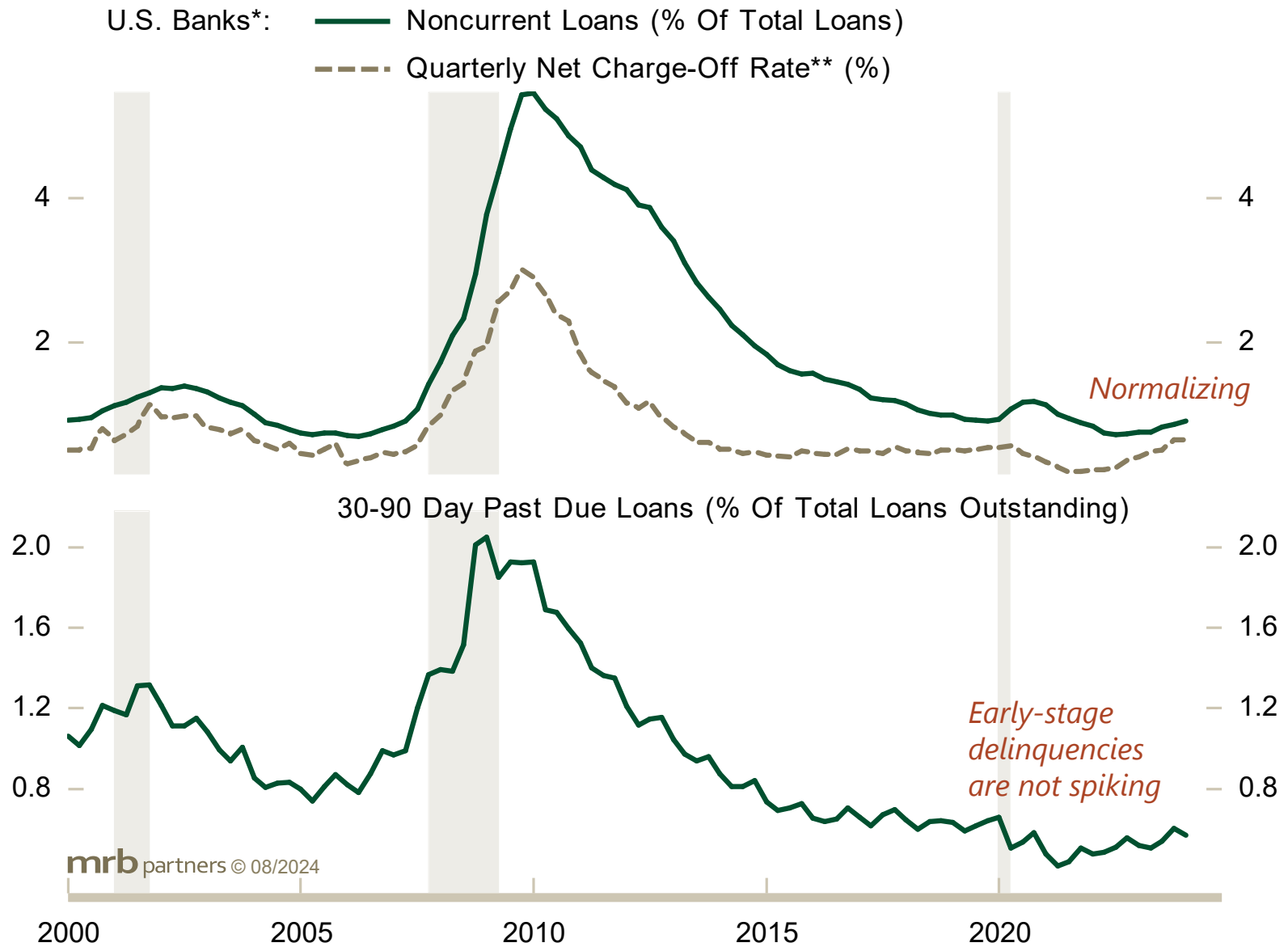
- Bank NIMs have eroded a little, but not imploded



- The rise in deposit costs has been muted given the level of the Fed funds rate



Financials: Credit Quality Remains Benign



* Source: FDIC

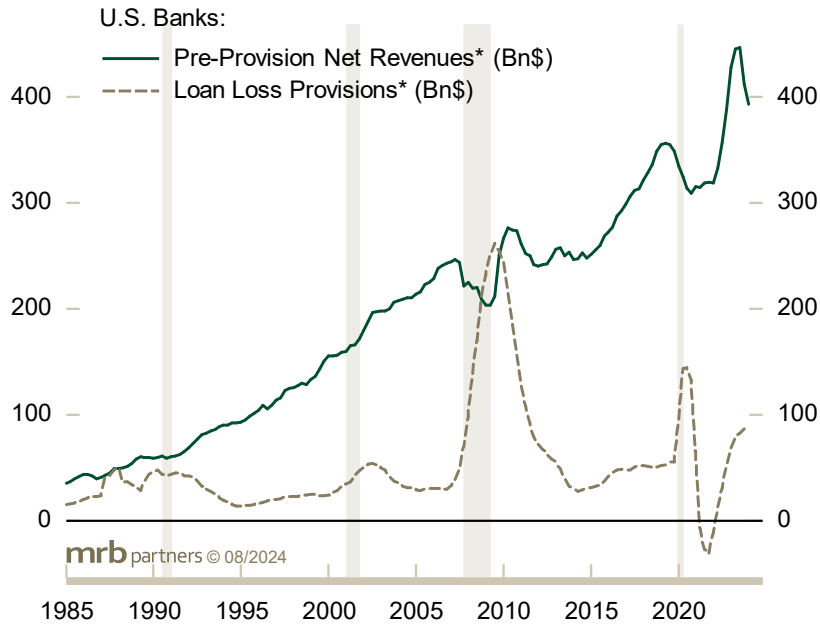
** Annualized

Note: Shaded for NBER-designated U.S. recessions

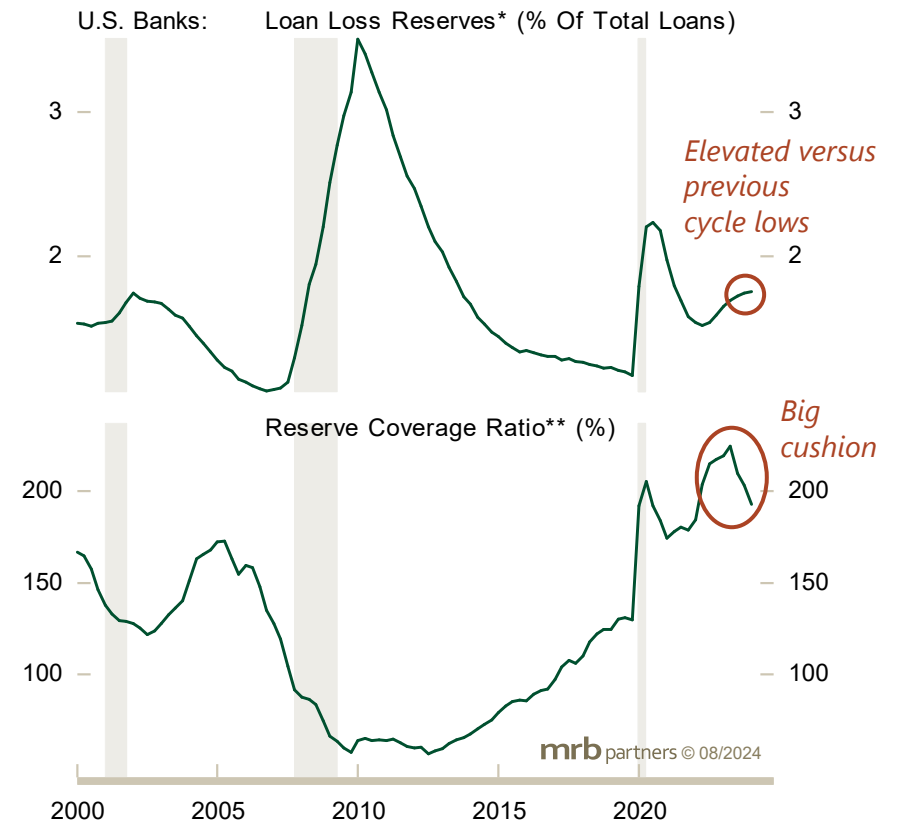
Financials: Banks Are Prepared For A Normalization Of Credit Costs

- Strong cash flows give banks significant loss-absorbing capacity

- Banks have been managing their reserves conservatively



* Trailing 12-month figures; source: FDIC
 Note: Shaded for NBER-designated U.S. recessions



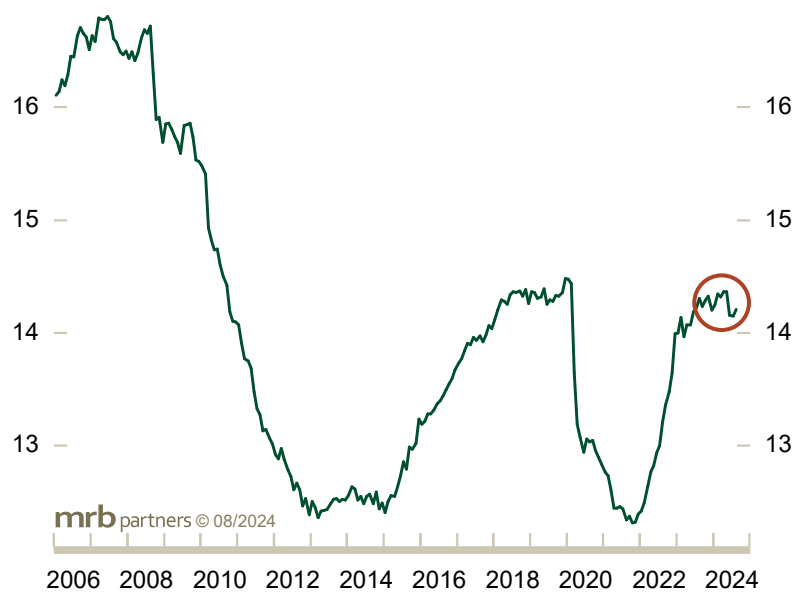
* Source: FDIC

** Loan loss reserves as a percent of noncurrent loans and leases; source: FDIC
 Note: Shaded for NBER-designated U.S. recessions

Financials: Commercial Real Estate Is A Much Bigger Risk For Regional Banks

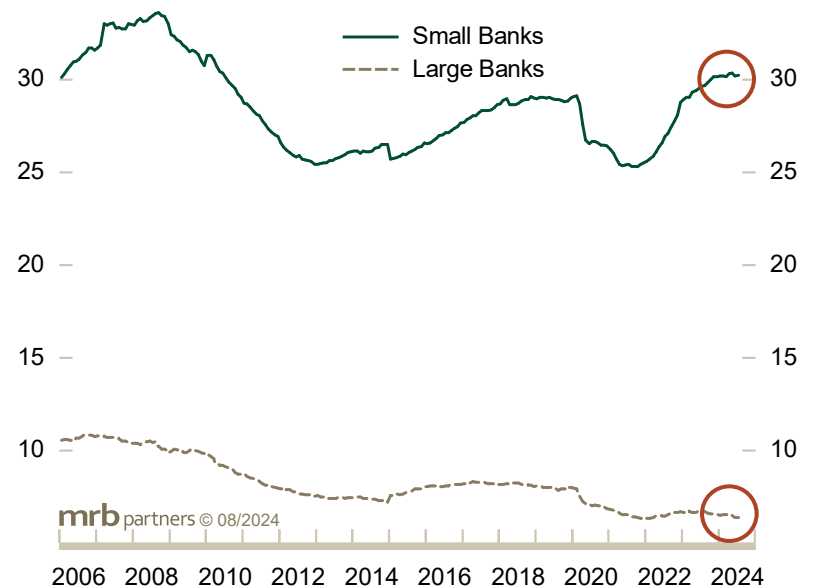
- CRE loans are a lower share of total bank assets than in 2008
- The exposure to CRE loans is a lot larger for small banks

U.S. Domestically Chartered Banks:
Commercial Real Estate Loans* (% Of Total Assets)



* Source: Board of Governors of the Federal Reserve System (US)

U.S. Commercial Real Estate Loans* (% of Total Assets):

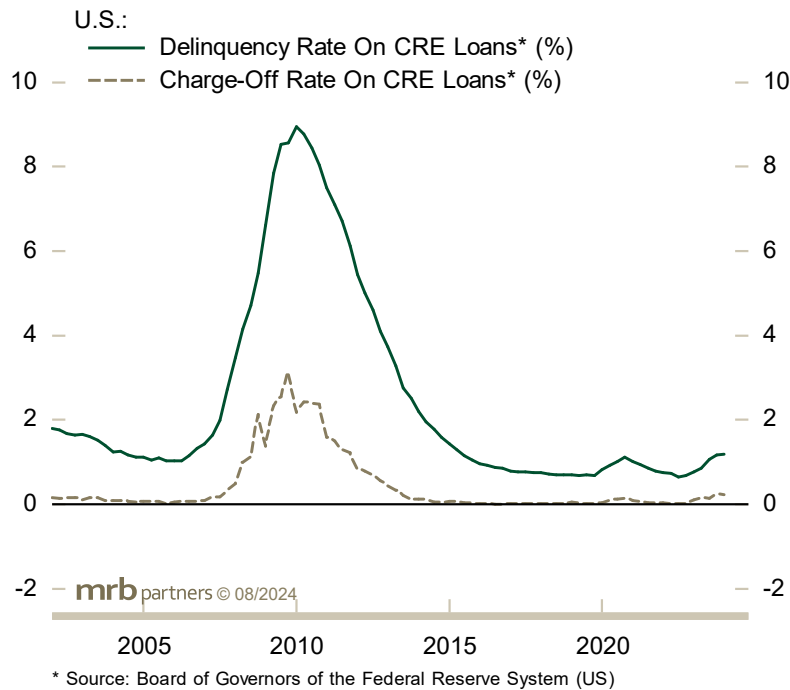


* Source: Federal Reserve

Note: Large banks are defined as top-25 banks ranked by assets, while small banks are banks not included in the top-25

Financials: Key CRE Developments To Monitor

- Losses in CRE loans remain low



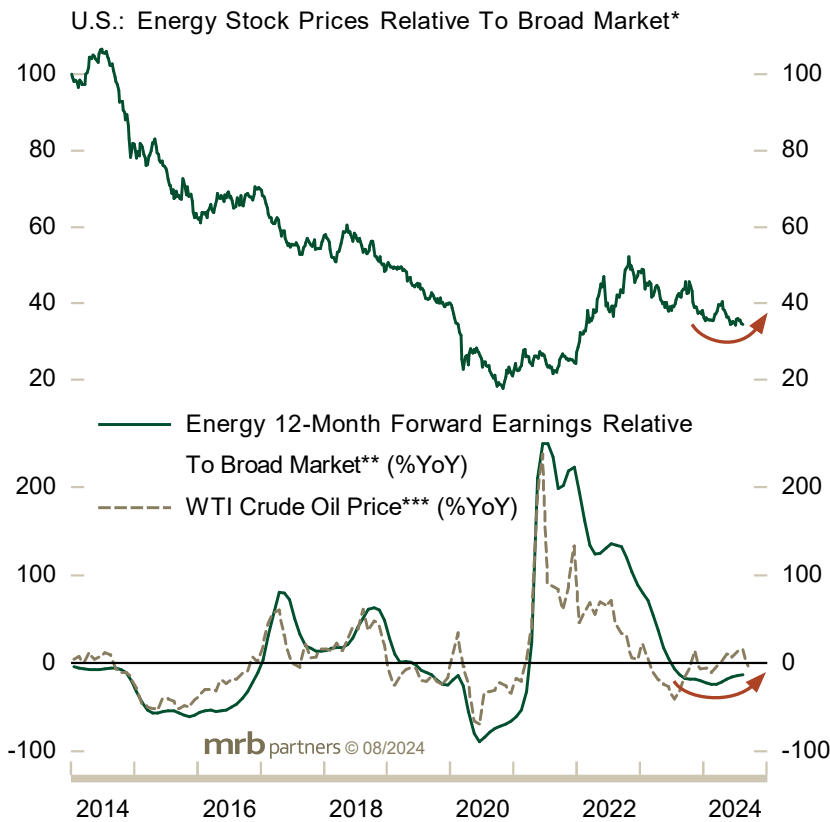
- Vacancy rates for apartments bear watching



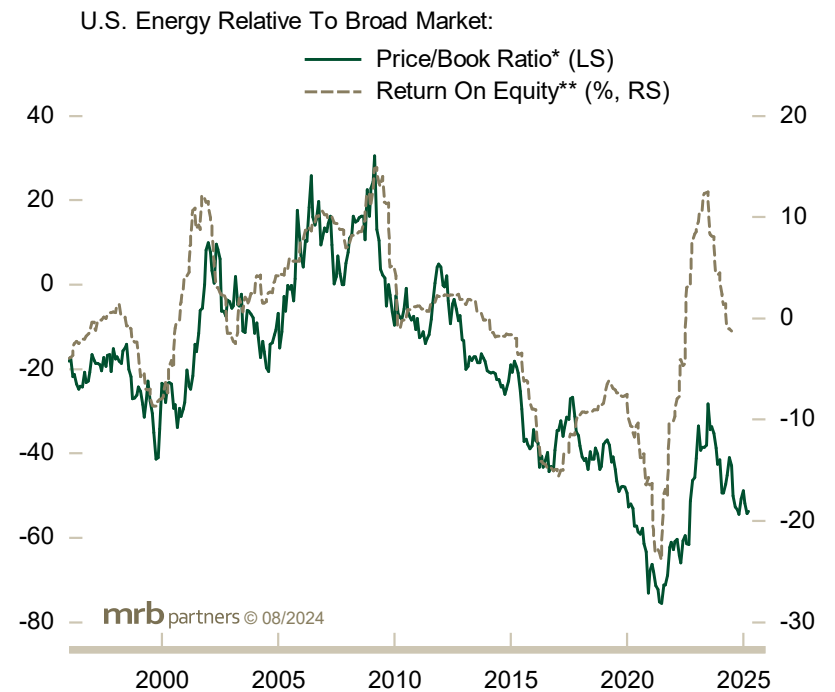
Energy: Oil Prices Should Firm If Our Constructive Outlook For Global Economic Growth Pans Out

- Firmer oil prices should strengthen relative earnings momentum

- Relative valuations have discounted a pessimistic outcome for relative ROE



* Rebased; source: MSCI
 ** Truncated above 250; smoothed; source: Refinitiv I/B/E/S Global Aggregates
 *** Advanced 2 months

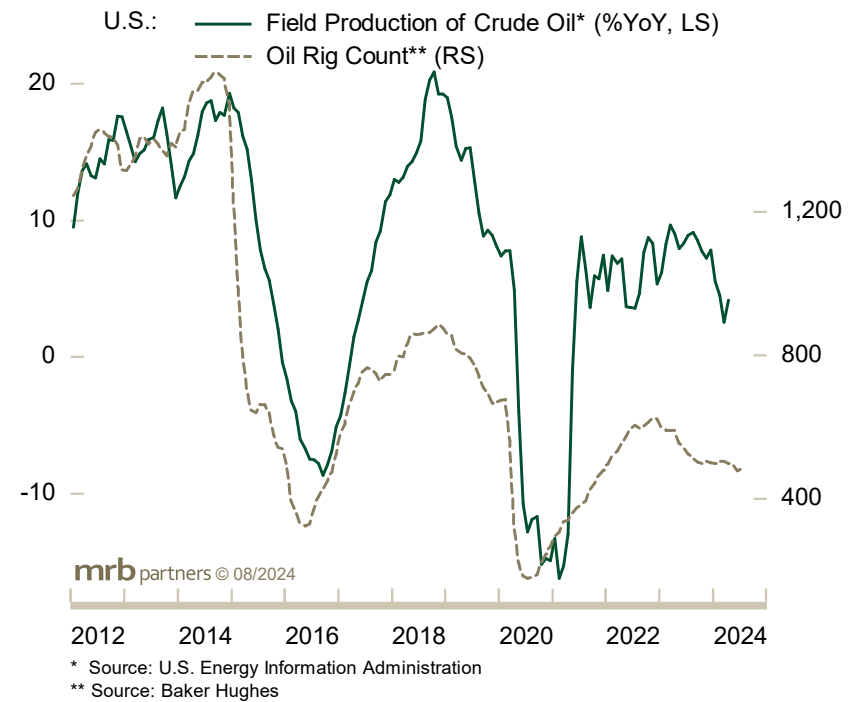
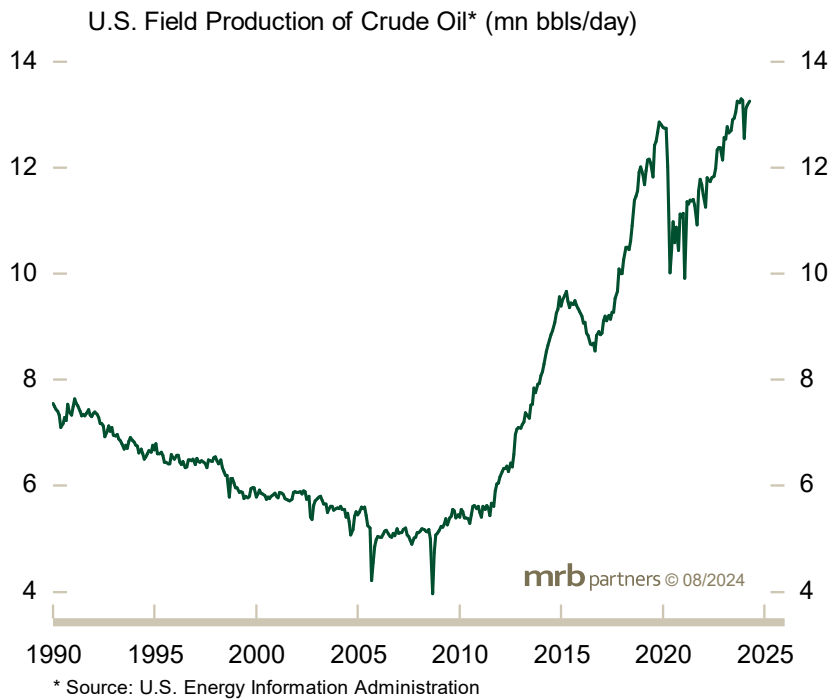


* Advanced 9 months; source: MSCI
 ** Percent premium (+), discount (-); source: MSCI

Energy: U.S. Oil Production Shows Signs Of Slowing

- U.S. crude oil output is near its highs...

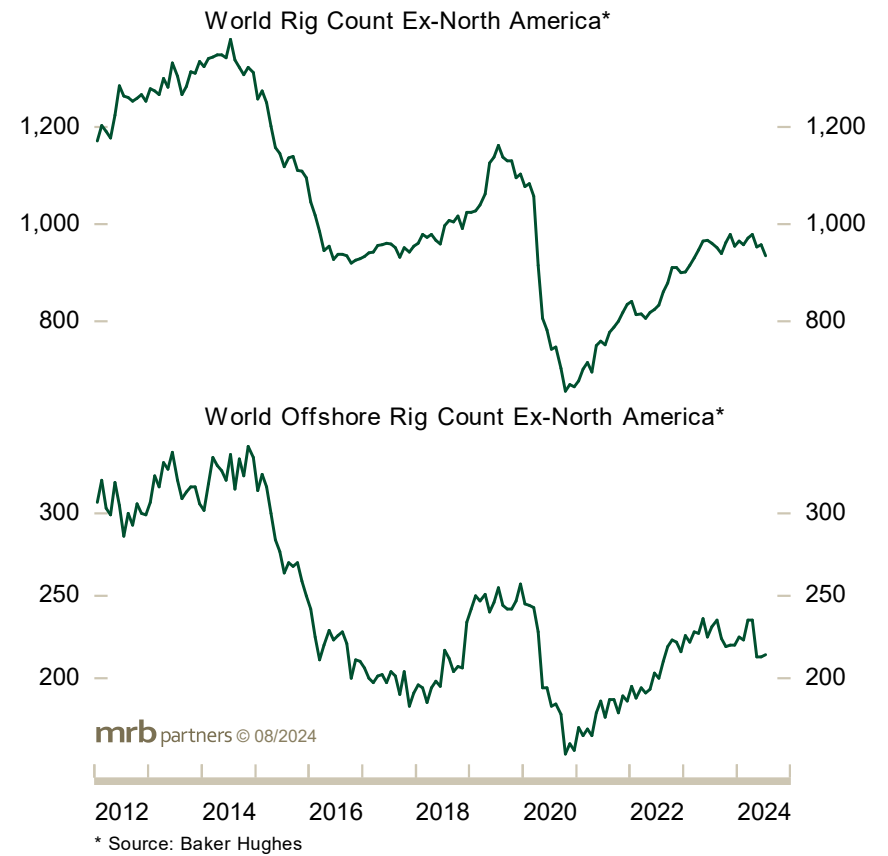
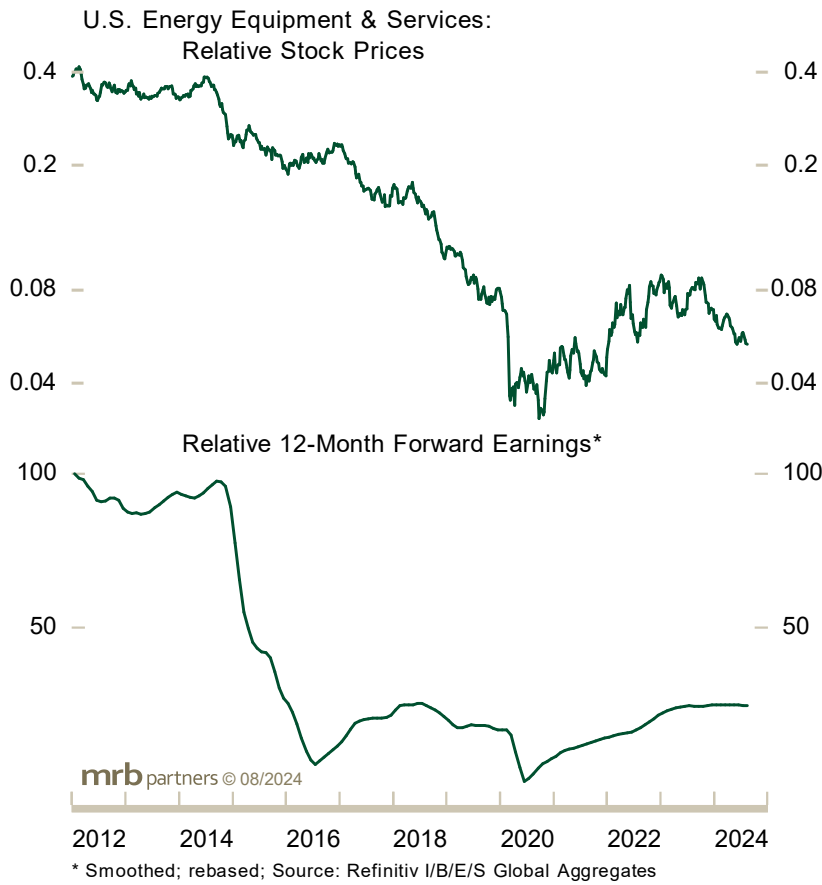
- ...but the declining rig count points to slowing production growth



Energy: Oil Services Are Benefiting From A Durable Upcycle In Global Offshore Drilling

- Recent pullback in relative performance is a buying opportunity

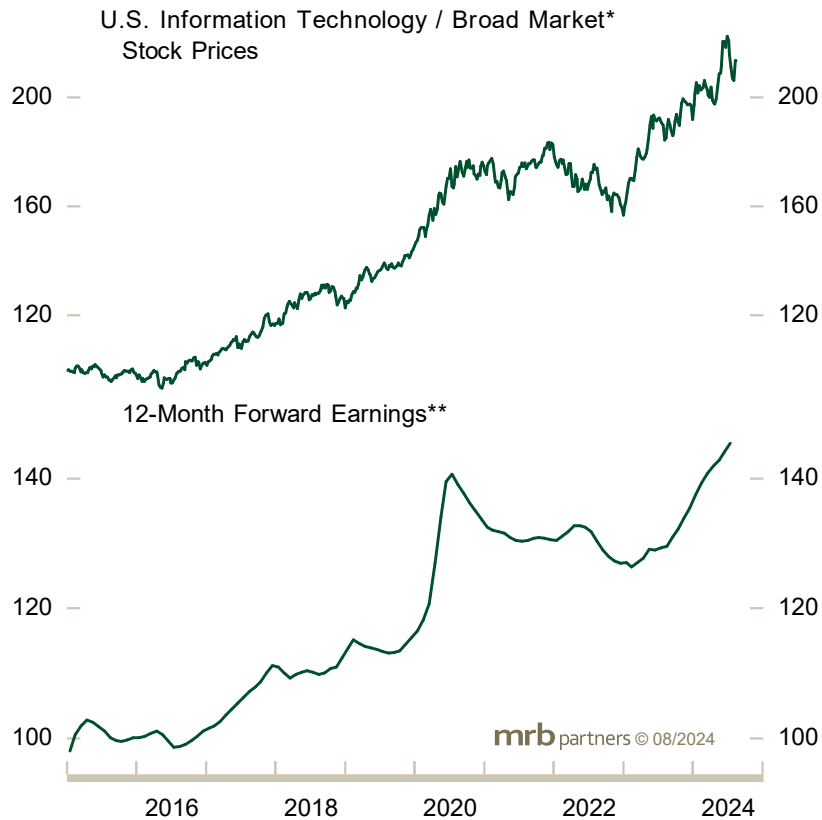
- Drilling activity in international markets has become a key earnings driver



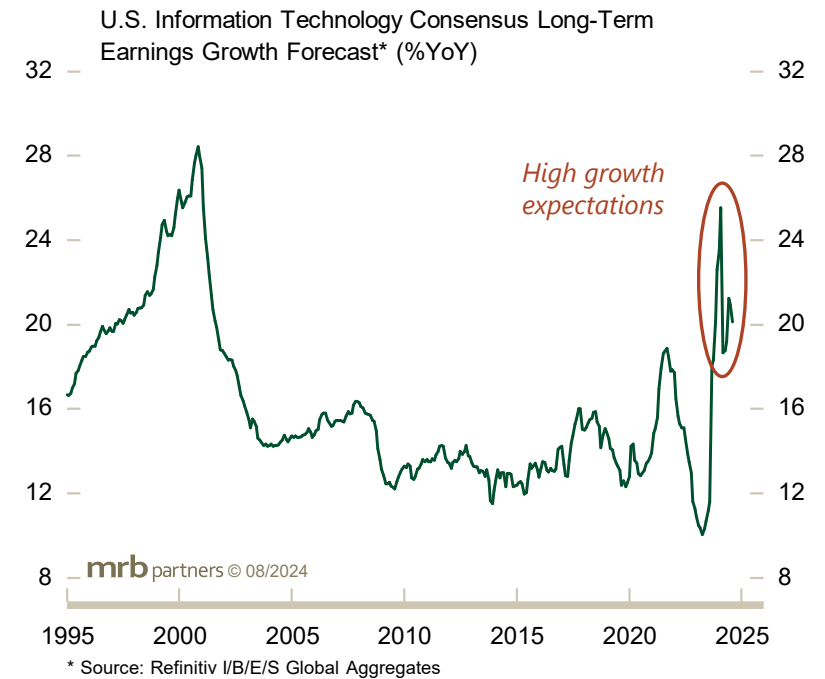
Technology: Strong Earnings Follow-Through Will Be Needed To Sustain The Outperformance Trend

- Stocks prices are discounting a huge upside breakout in relative earnings

- Earnings growth expectations are very high



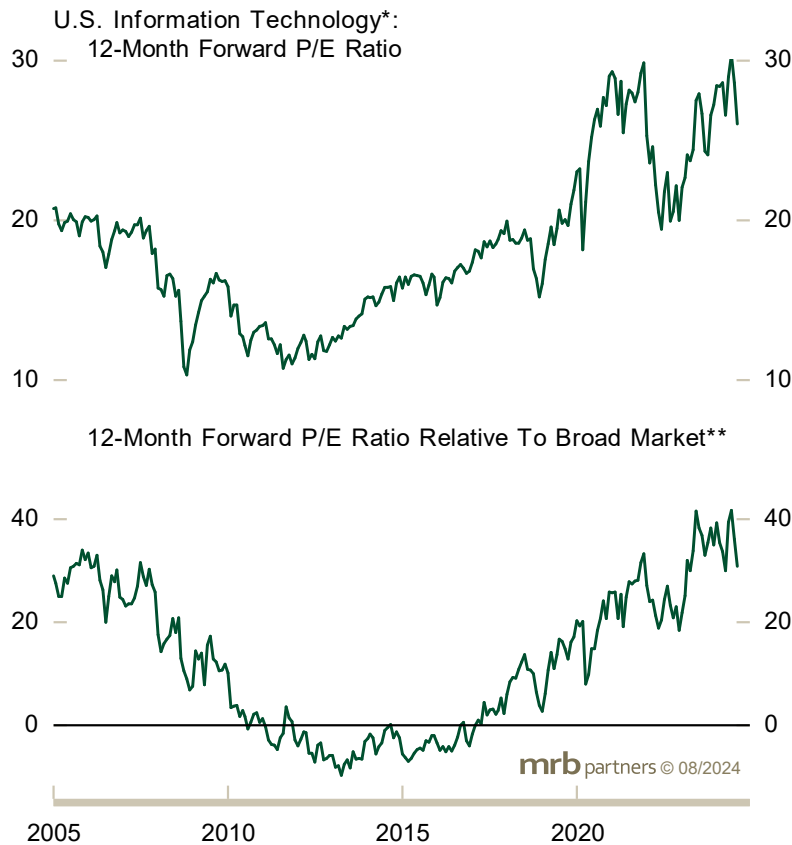
* U.S. dollars; rebased; source: MSCI
** Smoothed



* Source: Refinitiv I/B/E/S Global Aggregates

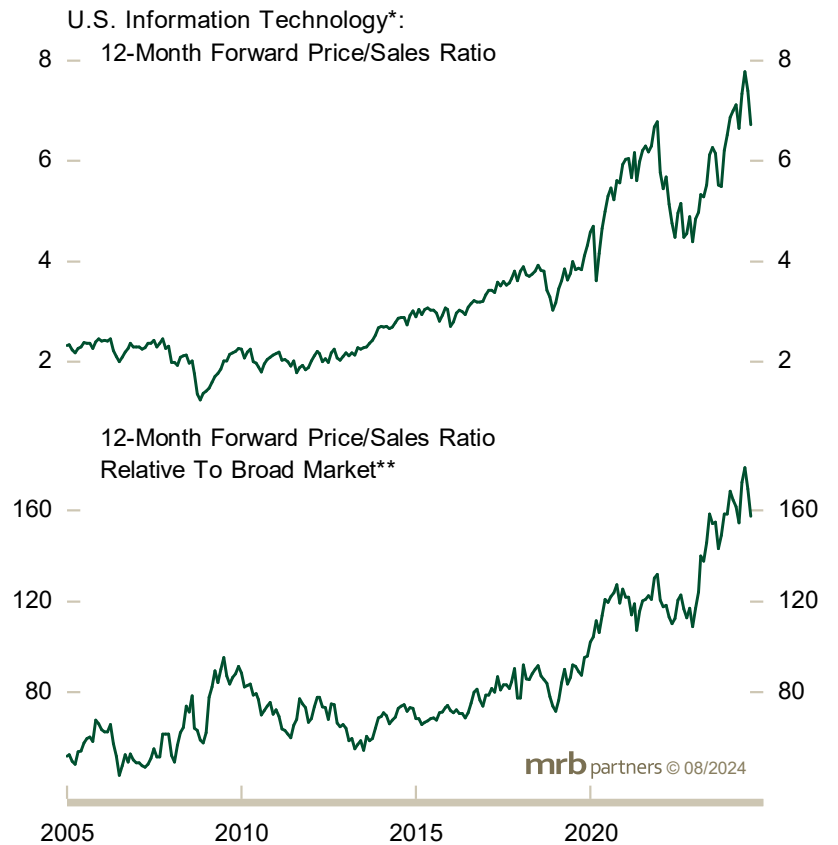
Technology: Valuations Provide Little Cushion Against Adverse Developments

- The forward P/E premium remains elevated



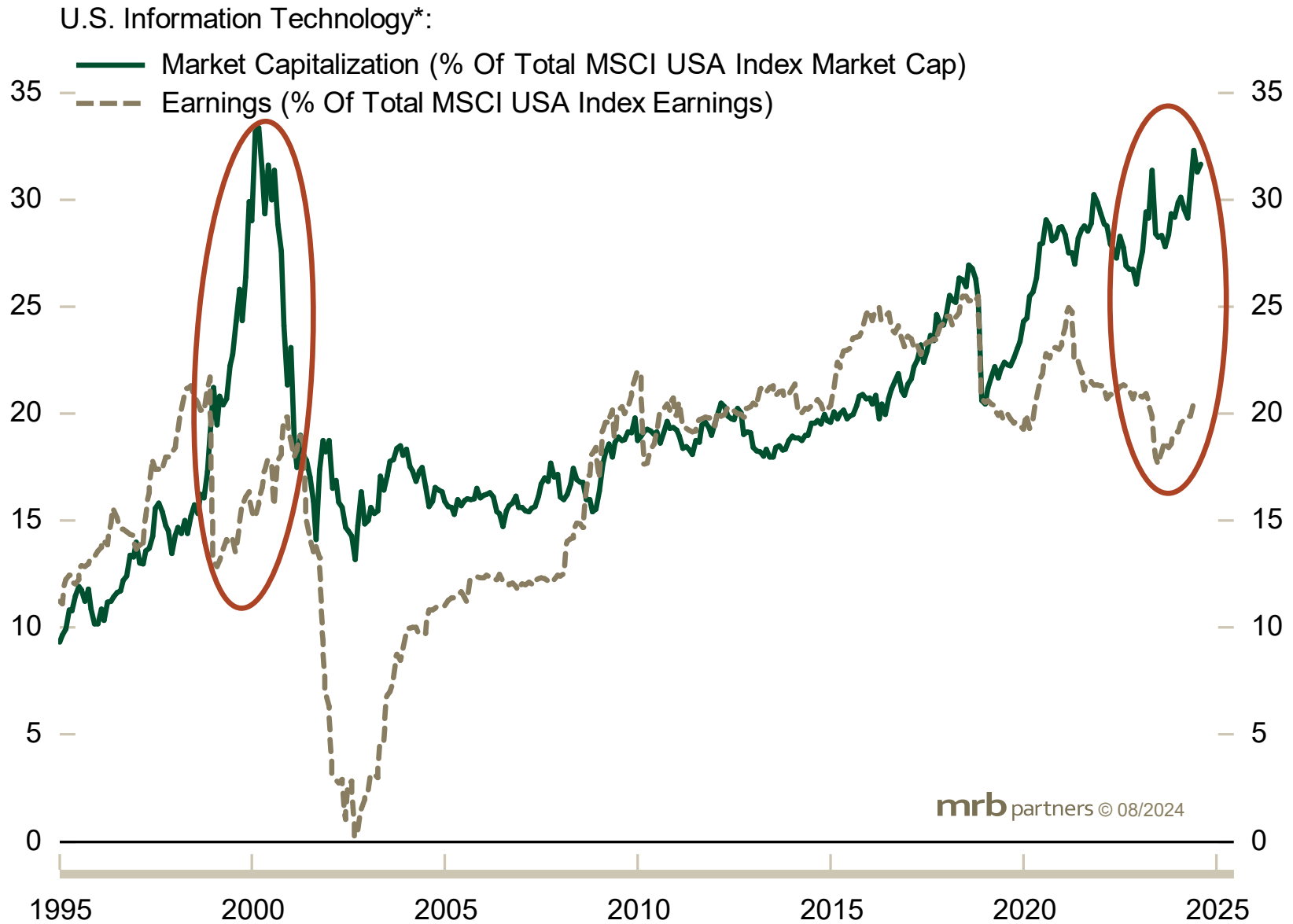
* Source: Refinitiv I/B/E/S Global Aggregates
** Percent premium (+), discount (-)

- The premium based on the P/S ratio is near a post dot-com bubble high



* Source: Refinitiv I/B/E/S Global Aggregates
** Percent premium (+), discount (-)

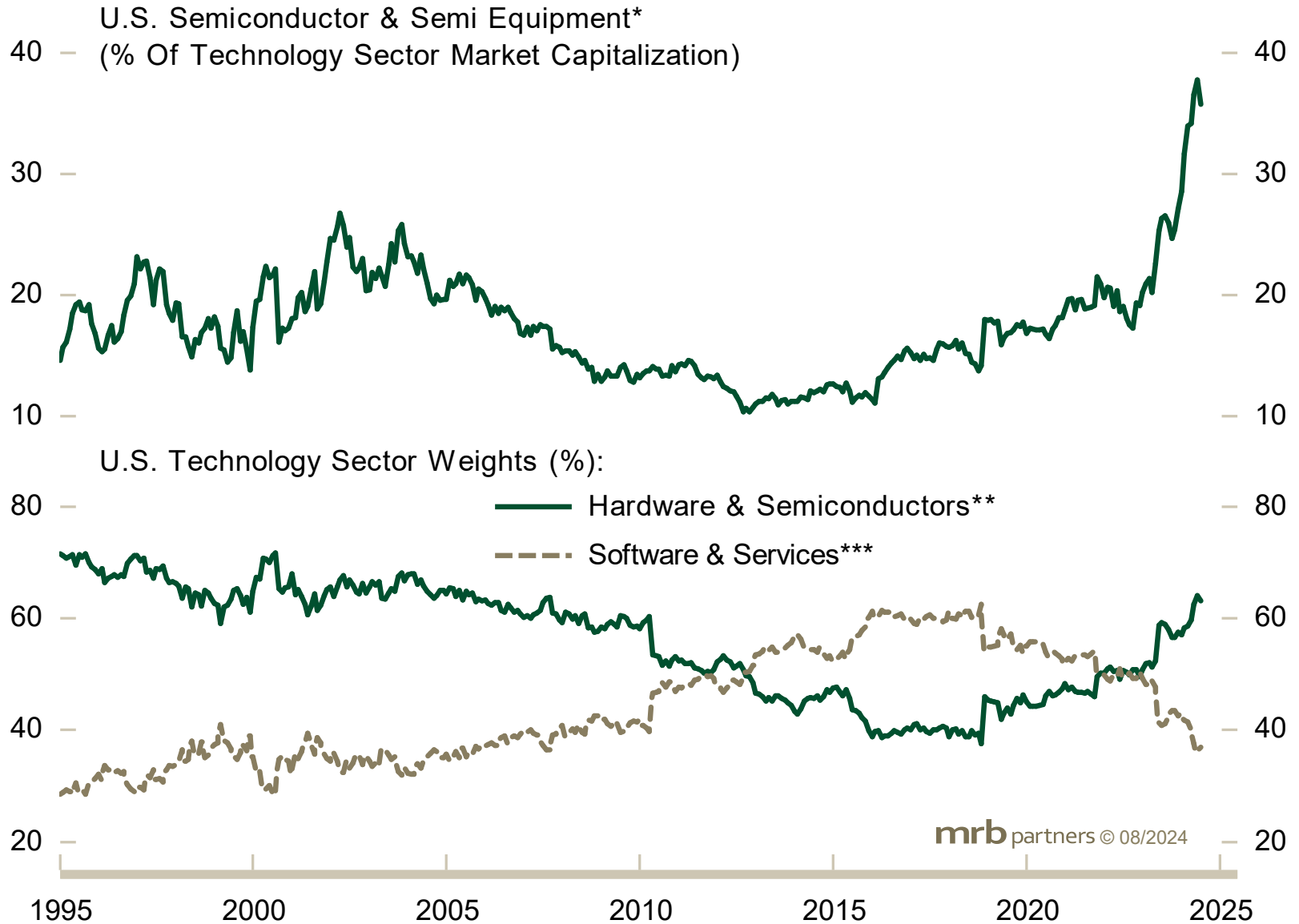
Technology: Tech Stocks Have Not Been Earning Their Weight In The Index



* Source: MSCI

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The Tech Sector Has Become Less Defensive

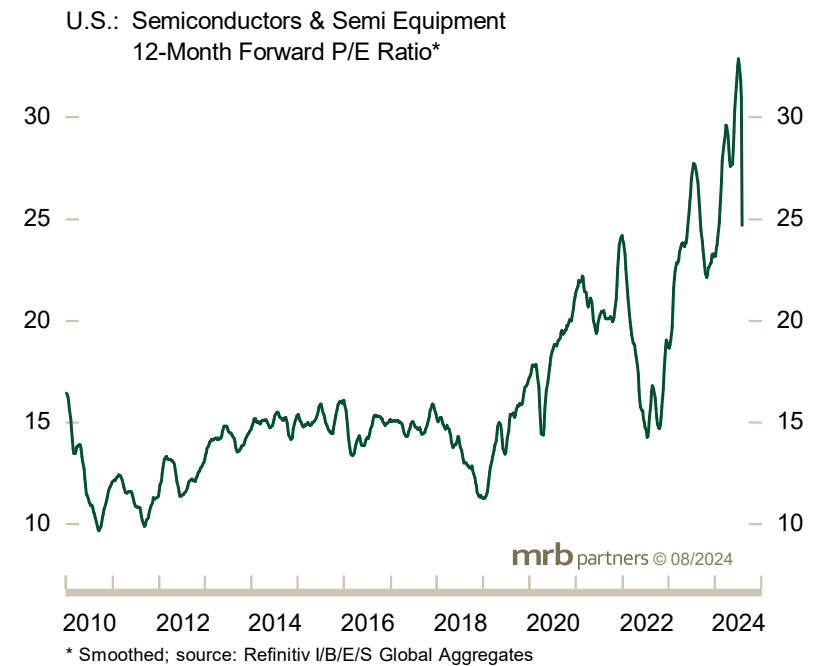
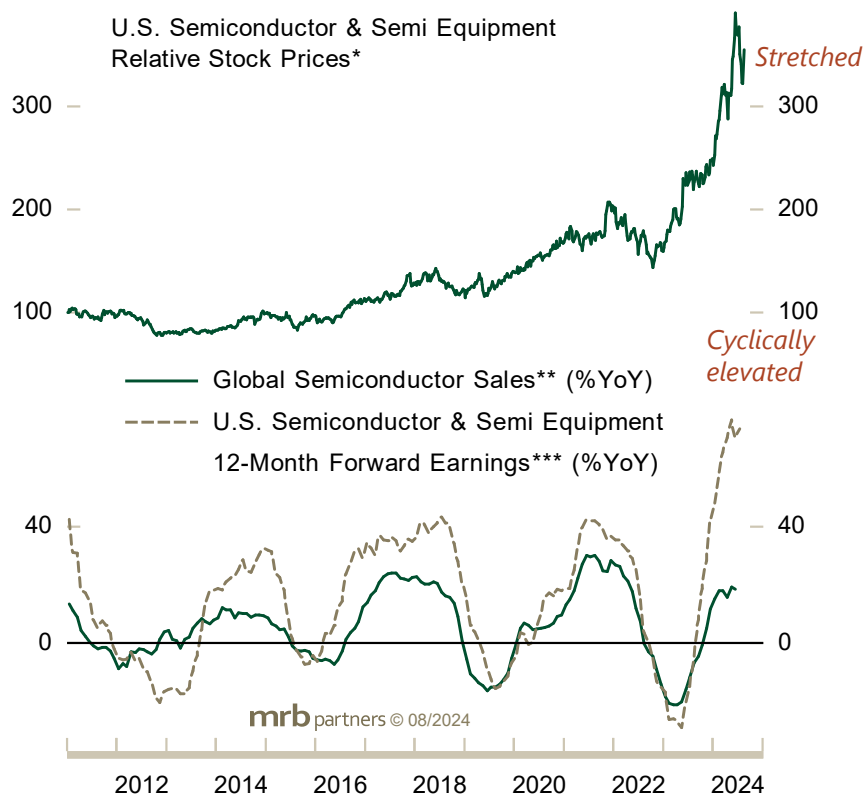


* Source: MSCI
 ** Includes Technology Hardware & Equipment and Semiconductors & Semiconductor Equipment; source: MSCI
 *** Includes Software and IT Services; source: MSCI

Technology: Semiconductor Stocks Leave No Room For Error

- Relative performance is stretched

- Valuations are rich by historical standards

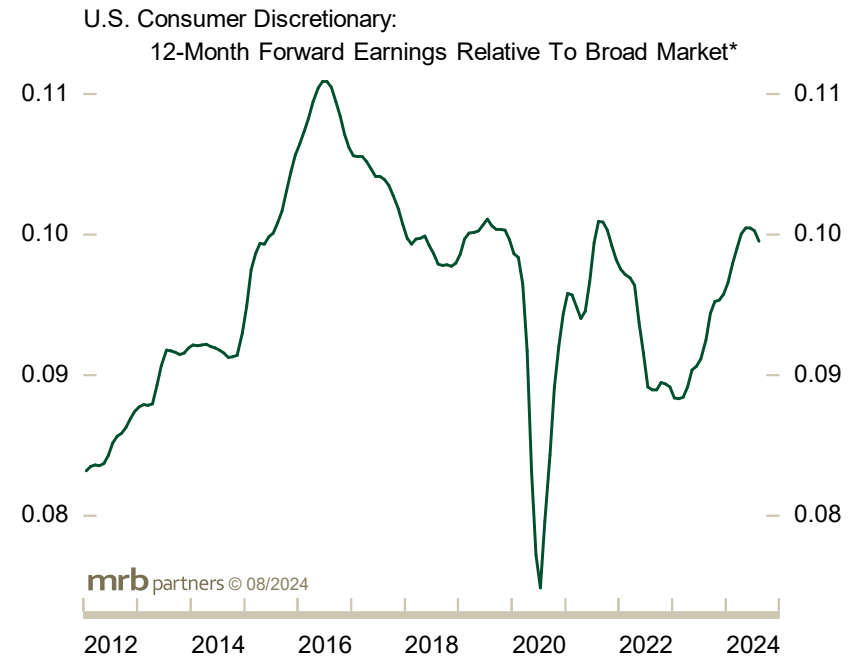


* Relative to the U.S. broad market; rebased; source: Standard & Poors
 ** Source: Semiconductor Industry Association
 *** Source: MSCI

Consumer Discretionary: Underlying Fundamentals Are Uninspiring

- Relative forward sales have been soggy

- Relative forward earnings have not made a new high since 2016



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* Smoothed; source: Refinitiv I/B/E/S Global Aggregates

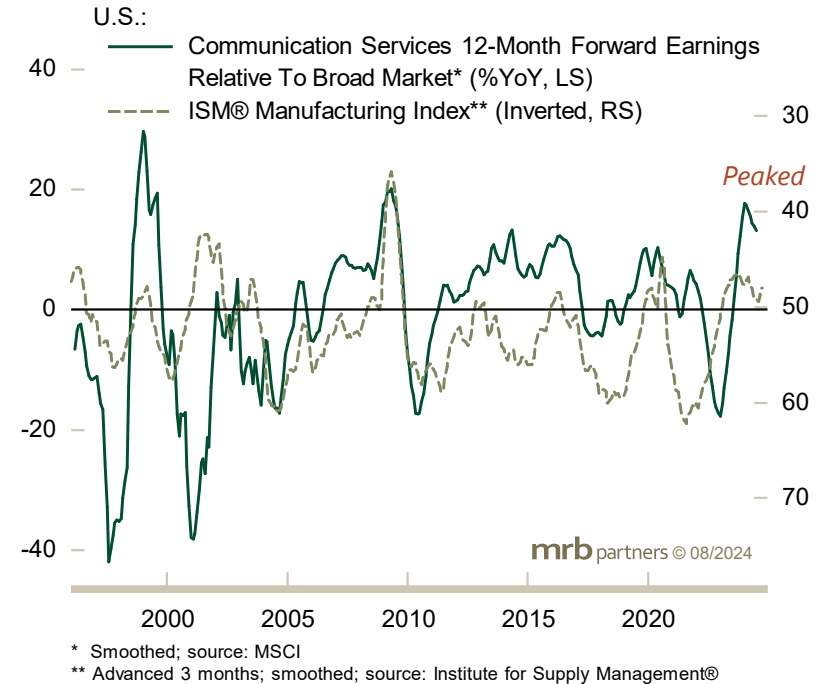
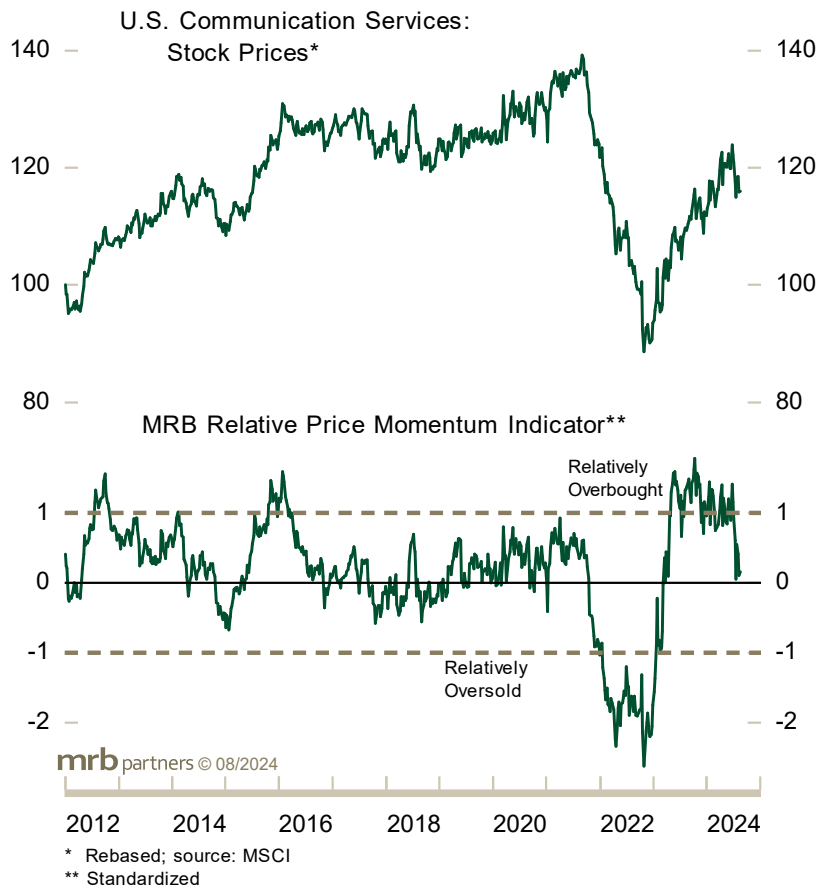
* Rebased; source: MSCI

** Smoothed; source: Refinitiv I/B/E/S Global Aggregates

Communication Services: Slowing Relative Earnings Growth Will Hamper Relative Performance

- Relative performance is no longer overbought

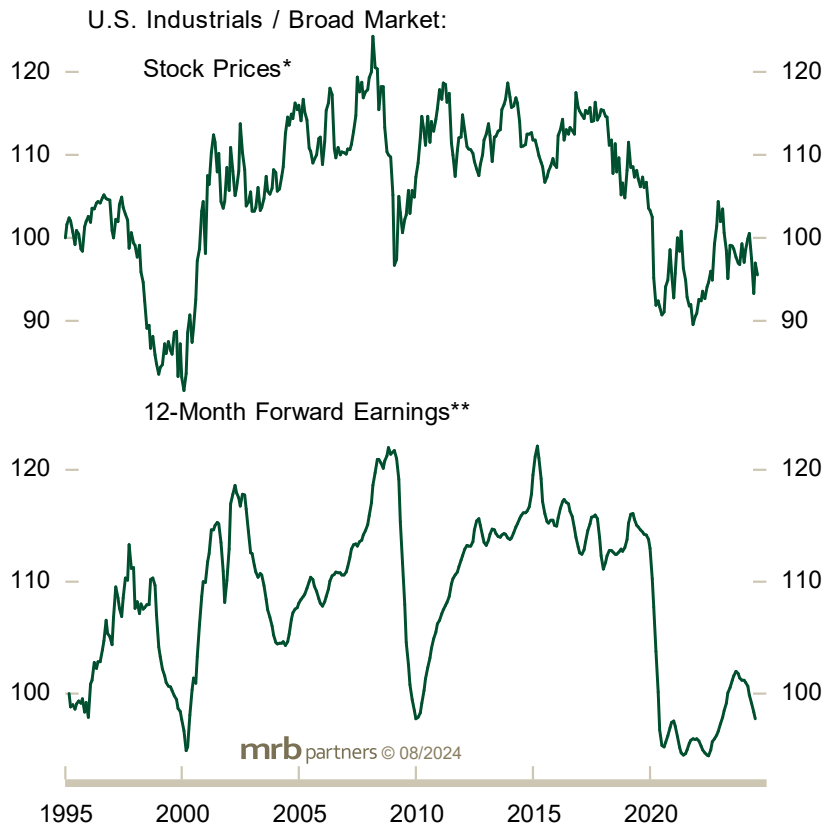
- However, relative earnings momentum has likely peaked



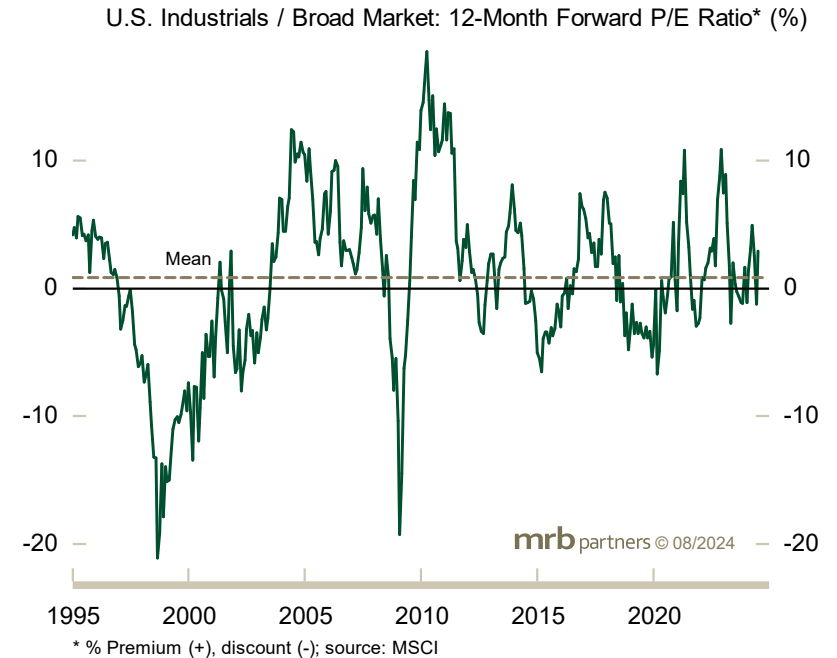
Industrials: Crosscurrents Keep Us Neutral

- Relative earnings have recently weakened

- Relative valuations are near their long-term average



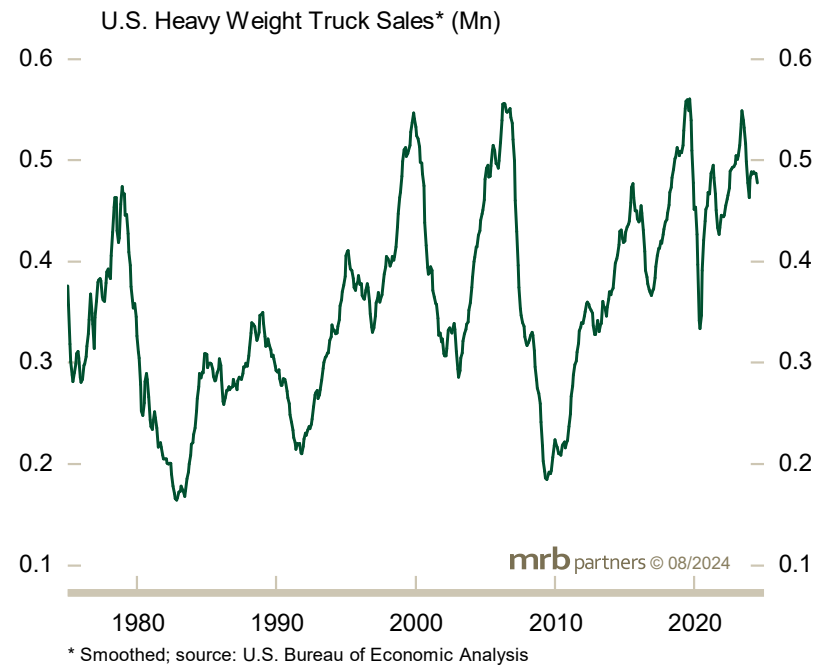
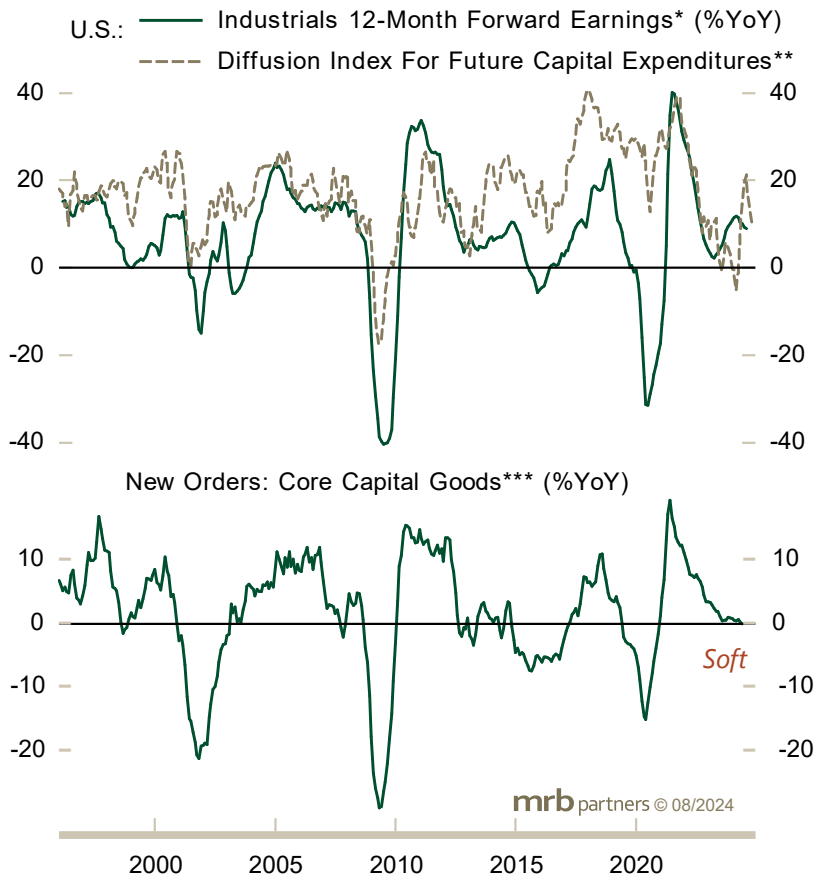
* Rebased; source: MSCI
 ** Rebased; smoothed; source: MSCI



Industrials: Spending On Capital Equipment Has Been Soft

- Not clear how much capex will increase ahead of the election

- The upside for heavy truck sales looks limited

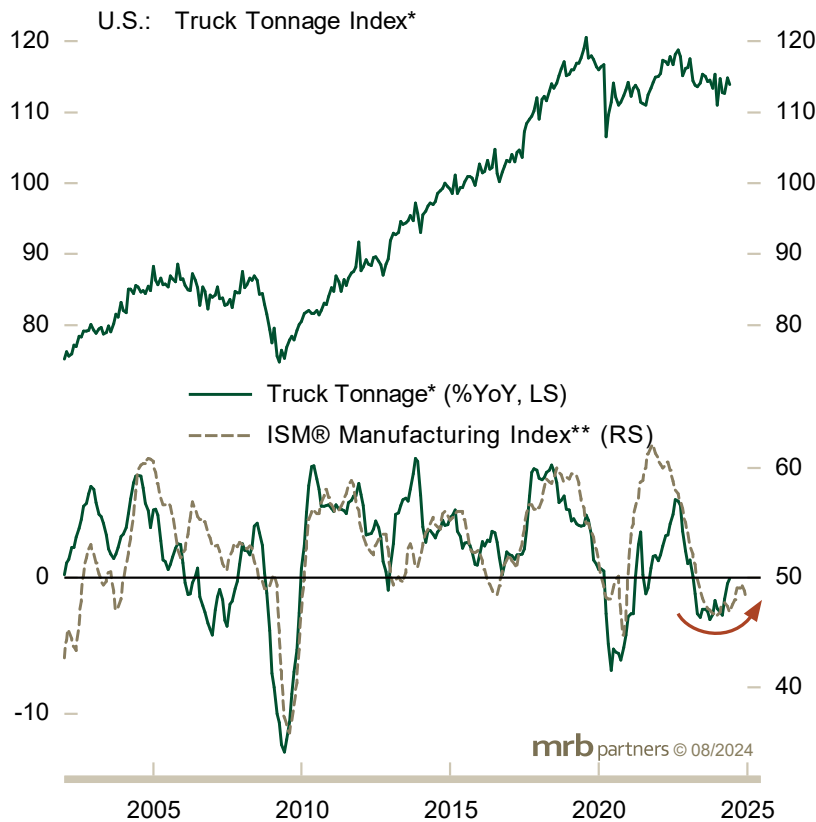


* Smoothed; source: Refinitiv I/B/E/S Global Aggregates
 ** Advanced 3-months; smoothed; source: Federal Reserve Bank Of Philadelphia
 *** Orders for nondefense capital goods excluding aircraft; smoothed; source: U.S. Census Bureau

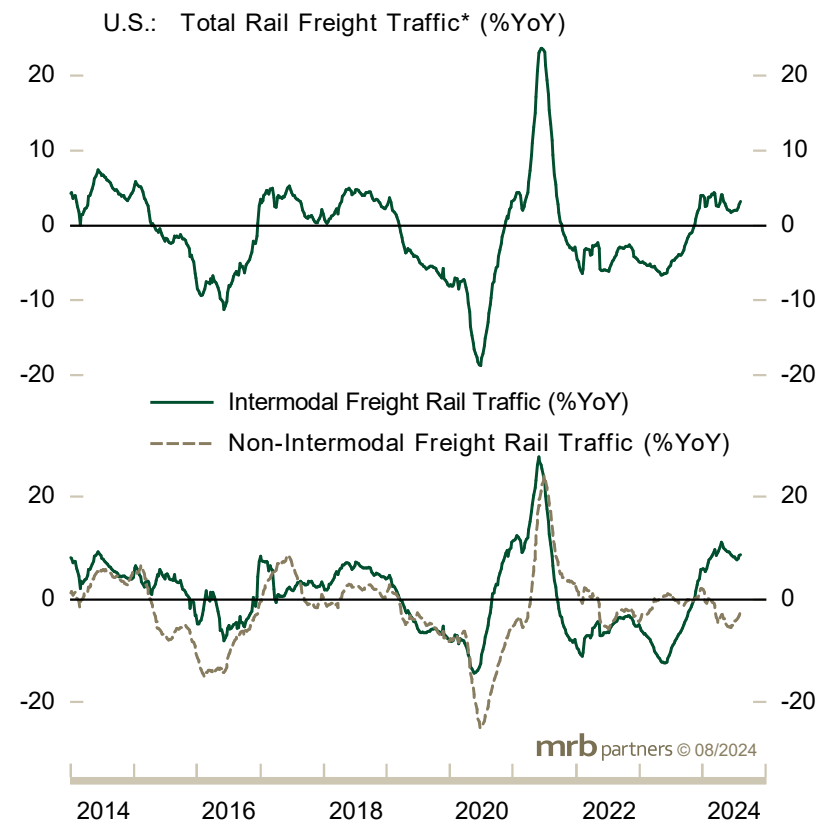
Industrials: The Transportation Industry Should Start To Exit The Freight Recession

- Growth in truck tonnage will improve as factory activity and trade firm

- Rail freight traffic has improved thanks to intermodal cargos



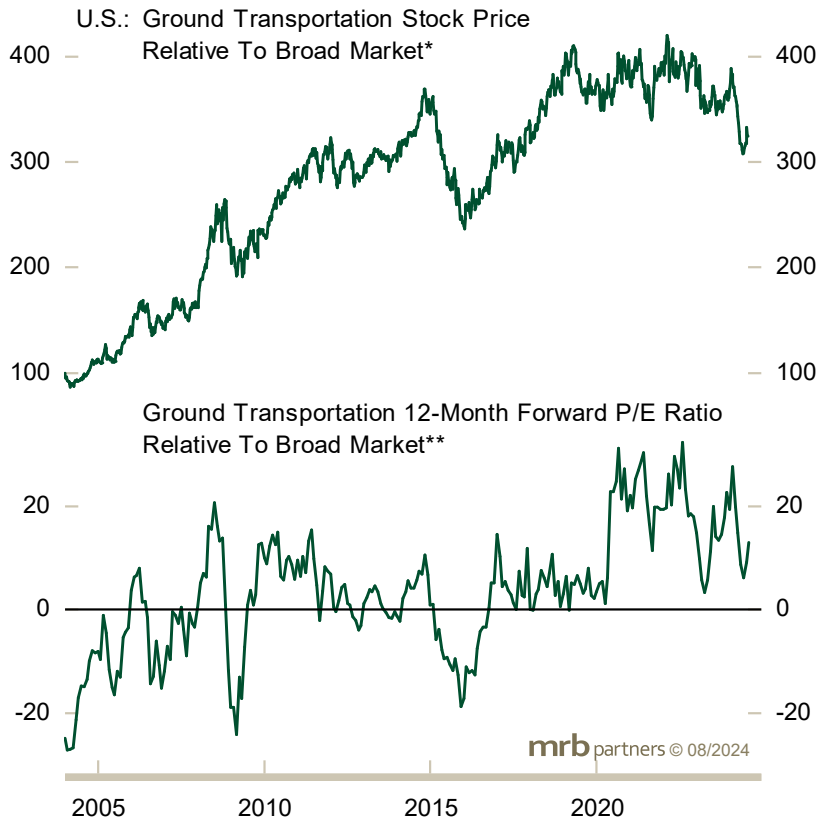
* Source: U.S. Bureau of Transportation Statistics
** Advanced 6 months; smoothed; source: Institute for Supply Management®



* Includes intermodal units and non-intermodal carloads;
source: Association of American Railroads

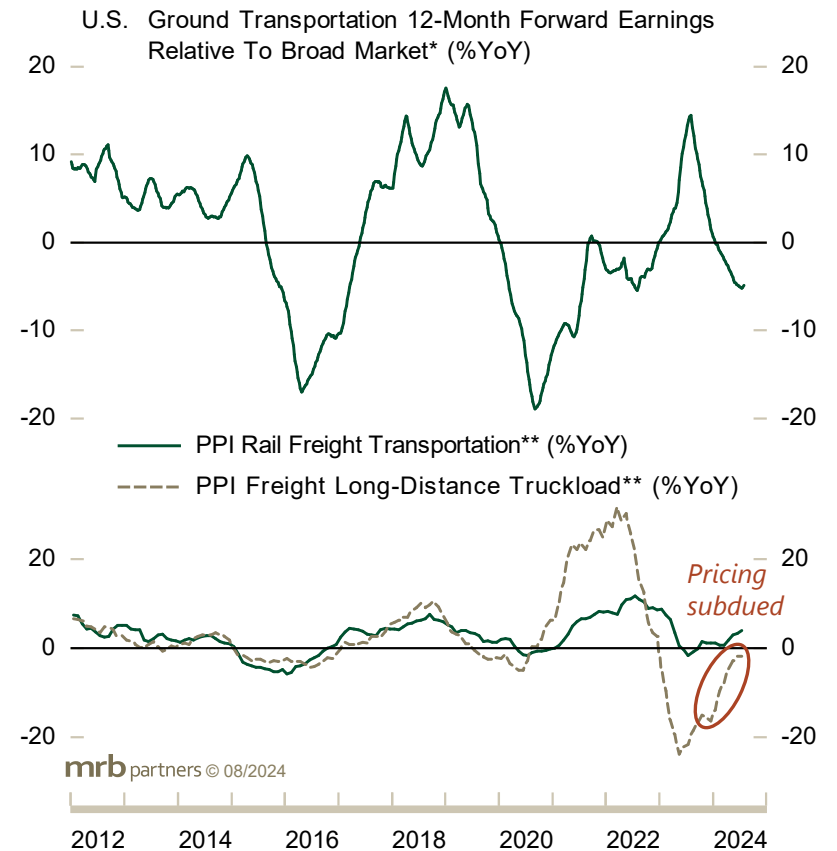
Industrials: Ground Transportation Stocks (Railroads) Are Dependent On A Relative Earnings Upswing To Drive Outperformance

- Relative valuations have recently corrected



* Rebased; source: Standard & Poor's
 ** Percent premium (+), discount (-); source: Refinitiv I/B/E/S Global Aggregates

- Higher freight rates are needed to strengthen relative earnings growth

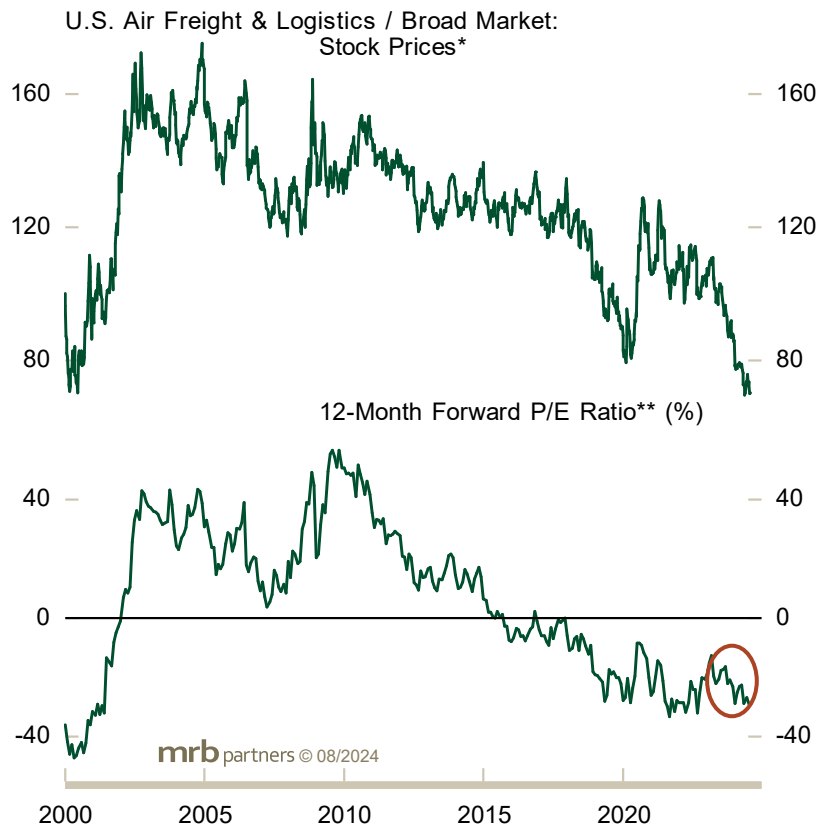


* Source: Refinitiv I/B/E/S Global Aggregates
 ** Source: U.S. Bureau of Labor Statistics

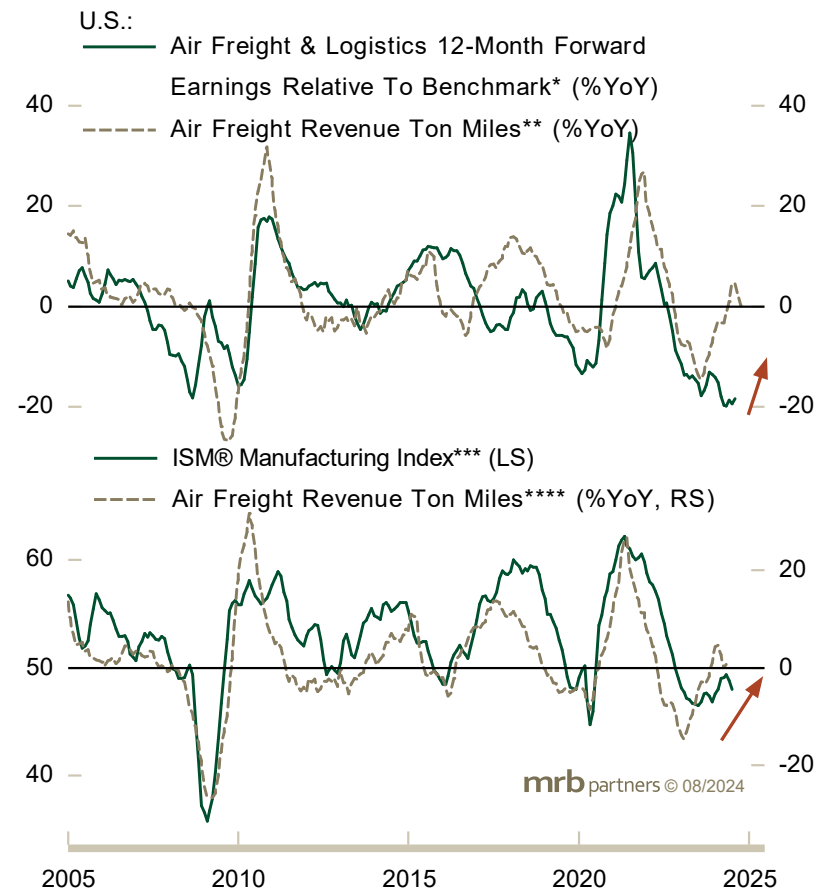
Industrials: Air Freight Stocks Have Significant Relative Upside From A Recovery In Air Freight Demand

- Relative share prices and valuations are depressed...

- ...as is relative forward earnings momentum



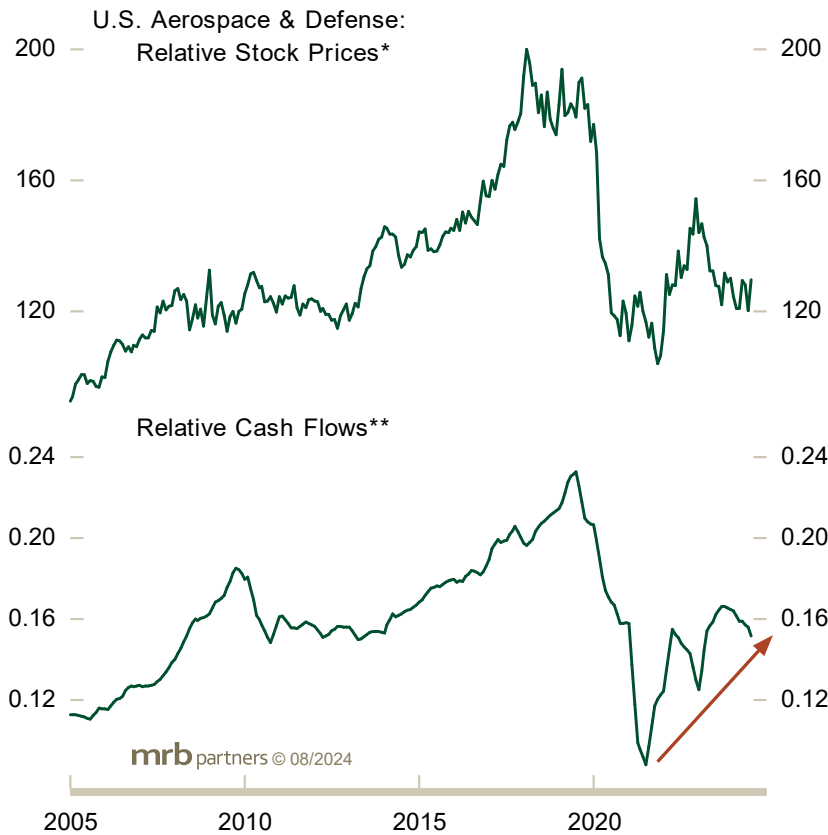
* Rebased; source: Bloomberg
 ** Percent premium (+), discount (-); source: MSCI



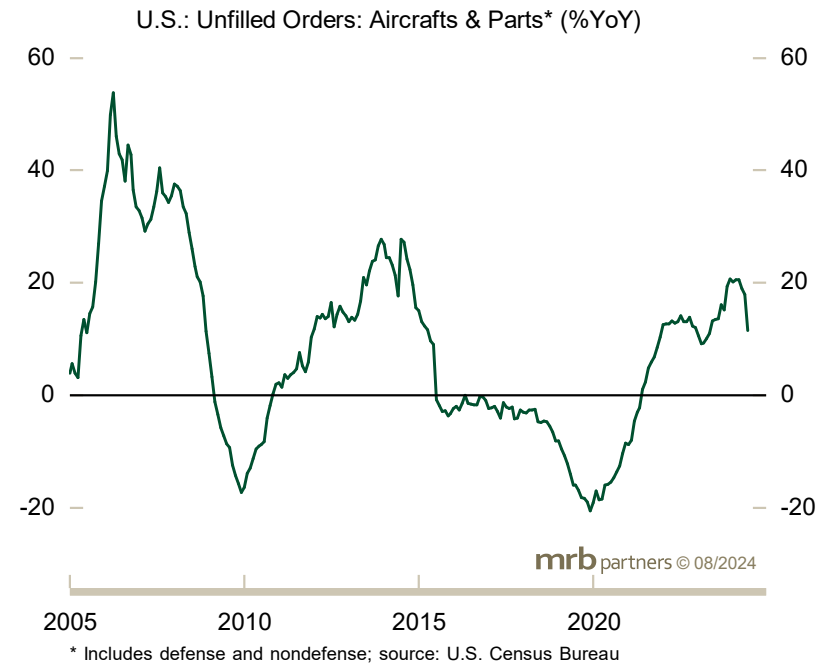
* Smoothed; source: Refinitiv I/B/E/S Global Aggregates
 ** Advanced 6 months; smoothed; source: U.S. Bureau of Transportation Statistics
 *** Smoothed; source: Institute for Supply Management®

Industrials: The Long-Term Outlook For Aerospace & Defense Stocks Is Positive

- Lots of room for relative cash flows to improve as aircraft deliveries increase
- The growth in backlogs provides long-term earnings visibility

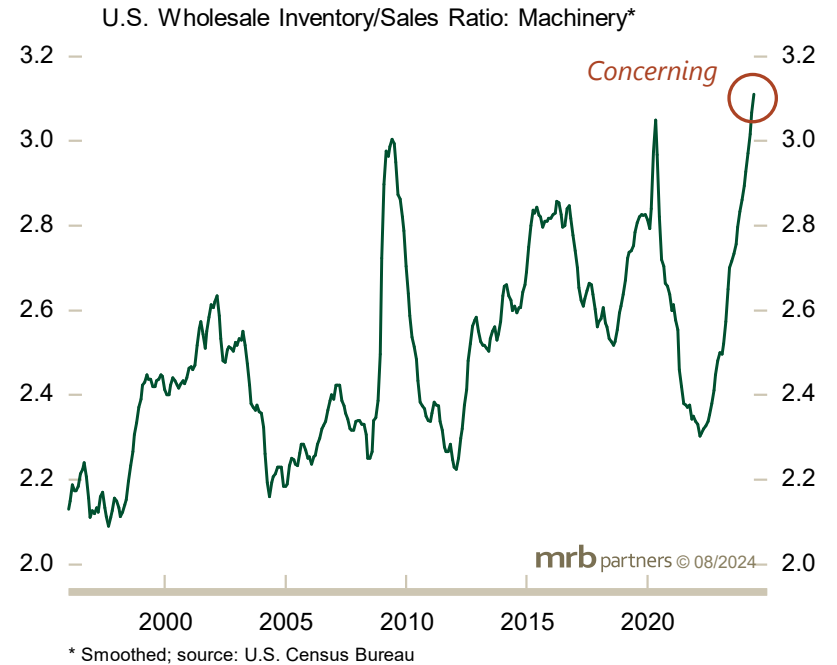
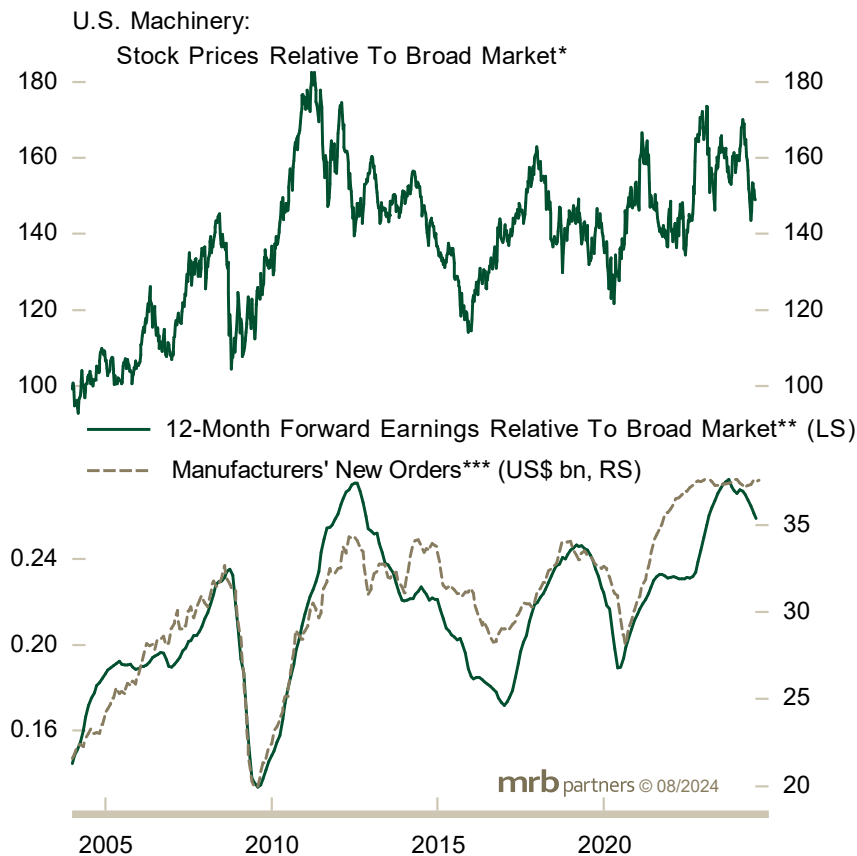


* Relative to the U.S. equity benchmark; rebased; source: MSCI
 ** Relative to the U.S. equity benchmark; smoothed; source: MSCI



Industrials: Machinery Stocks Have An Unappealing Risk-Reward Trade-Off

- Machinery orders and relative forward earnings are both historically elevated
- High dealer inventories are a threat to future machinery orders and shipments

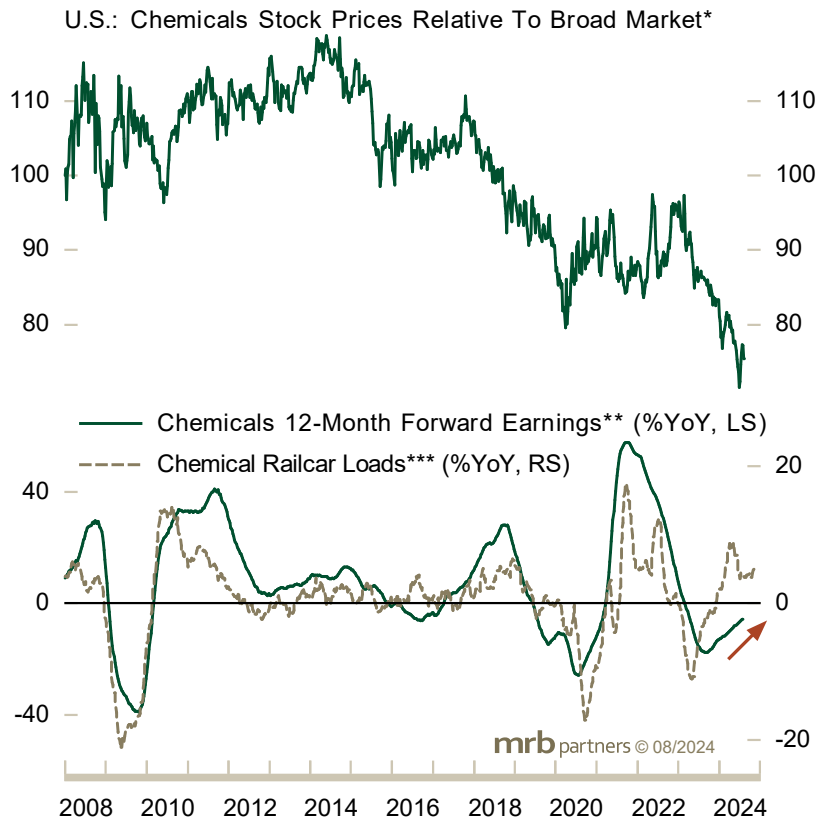


* Rebased; source: Standard & Poor's
 ** Smoothed; source: Refinitiv I/B/E/S Global Aggregates
 *** Advanced 3 months; smoothed; source: U.S. Census Bureau

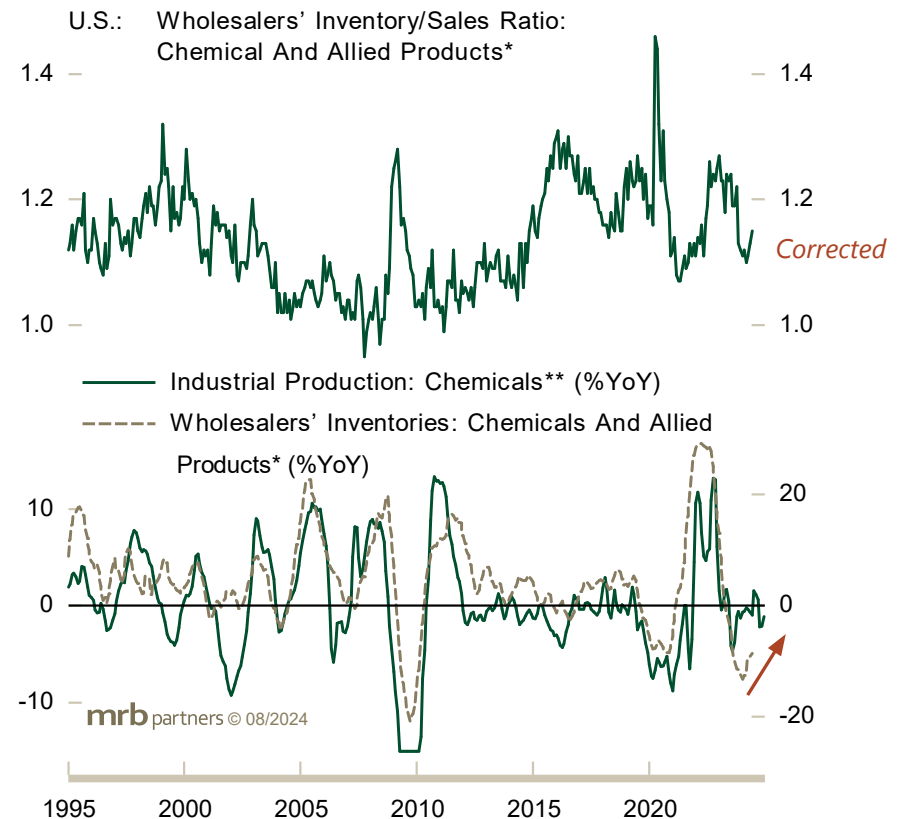
Materials: A Cyclical Upswing May Be Brewing For Chemical Stocks

- Chemical rail shipments point to a trough in earnings growth

- Depleted inventories suggest that chemical industry output will increase



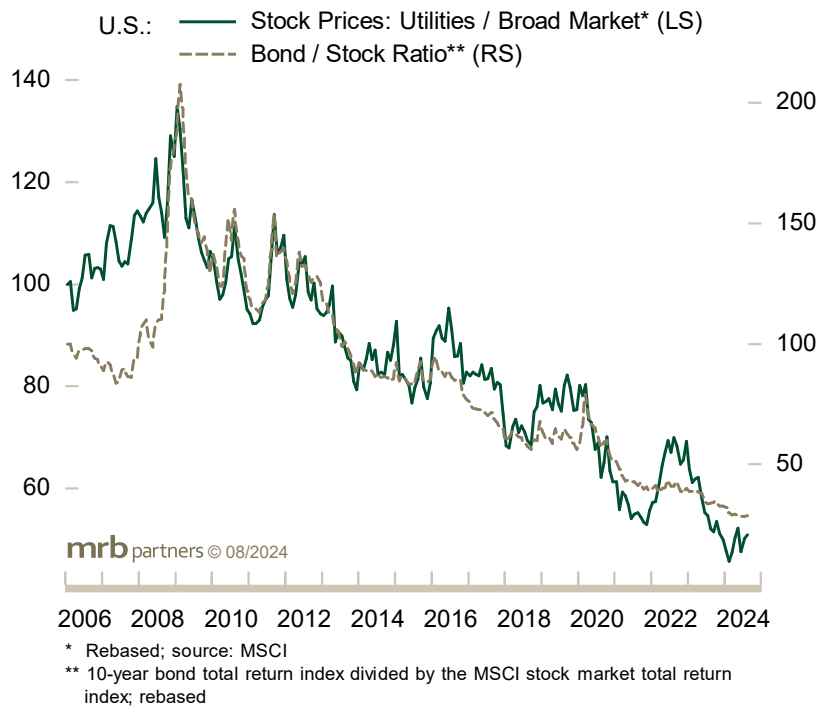
* Rebased; source: Standard & Poor's
 ** Smoothed; source: Refinitiv I/B/E/S Global Aggregates
 *** Advanced 3 months; source: Association Of American Railroads



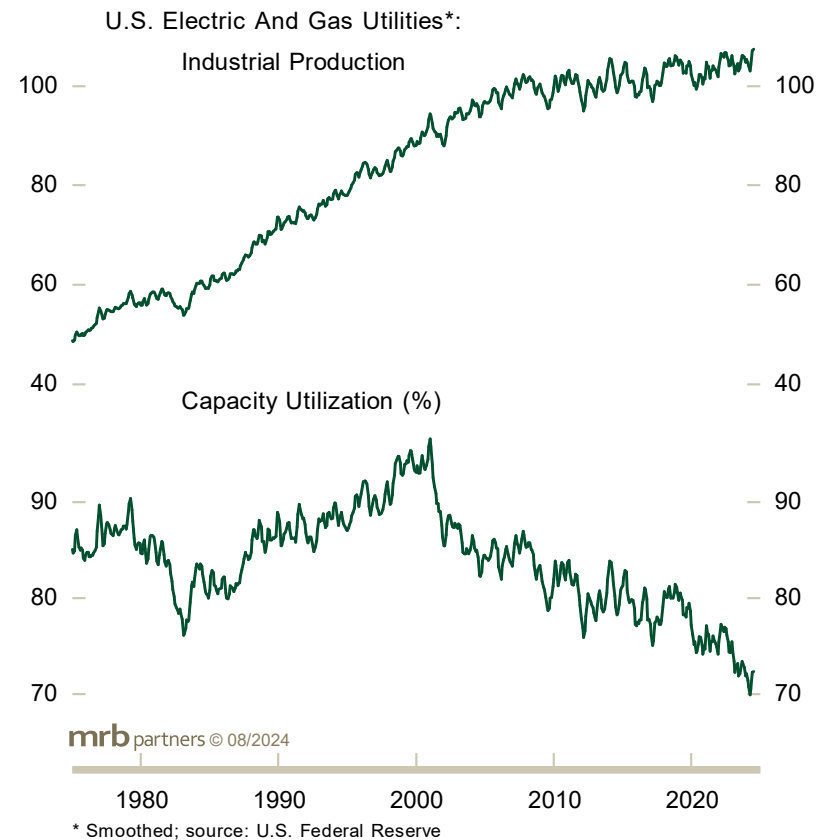
* Source: U.S. Census Bureau
 ** Excludes pharmaceuticals and medicines; advanced 7 months; truncated below -15
 source: Board of Governors of the Federal Reserve System (US)

Utilities: Don't Chase The A.I. Power Demand Narrative

- The sector tends to lag when the bond/stock ratio declines

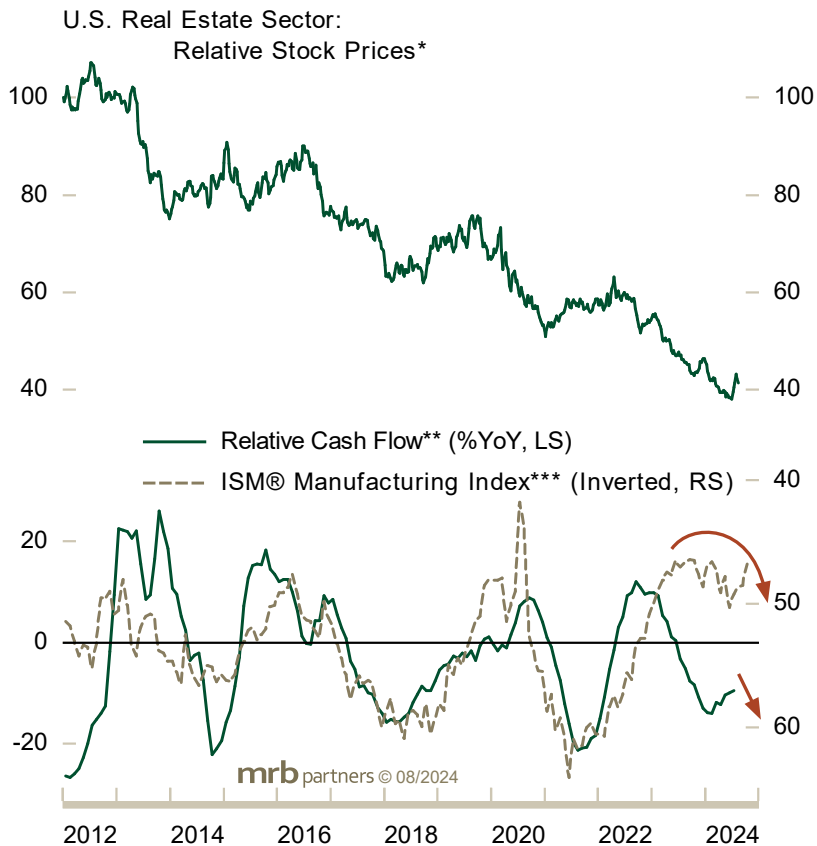


- There's no evidence that tailwinds from electrification are taking hold



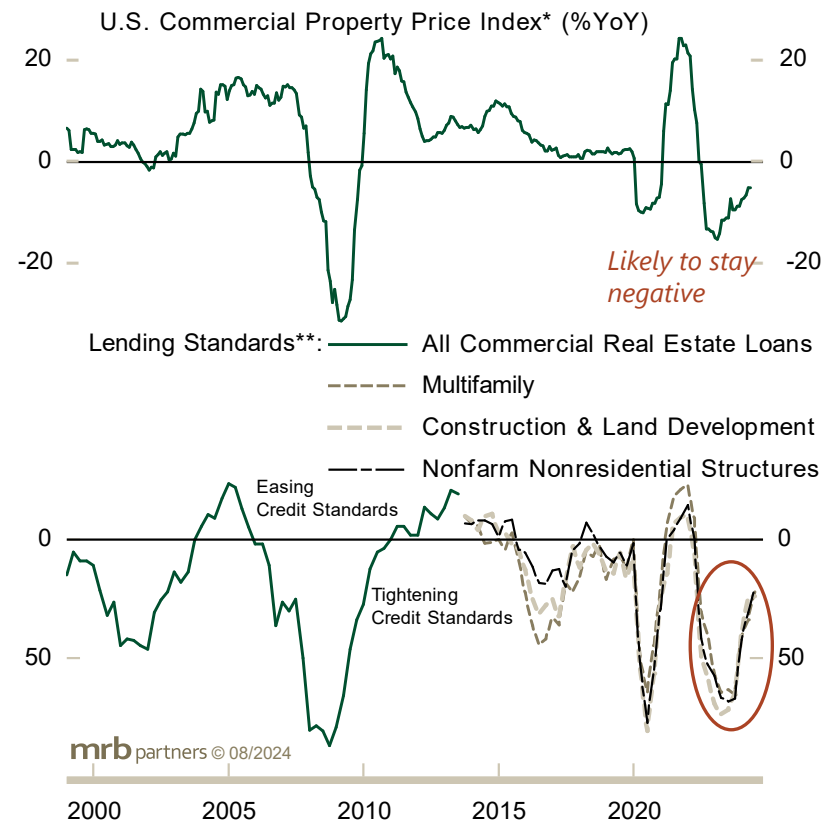
Real Estate: Relative Performance Is Washed Out, But The Prospects For An Improvement In Underlying Fundamentals Look Dim

- A Turnaround in relative cash flows is improbable



* Rebased; source: MSCI
 ** Smoothed; source: MSCI
 *** Advanced 3-months; source: Institute for Supply Management®

- Property prices are unlikely to find a stable floor unless banks become more willing to lend



* Source: Green Street Advisors®
 ** Scale inverted; source: Federal Reserve

Potential Winners And Losers Under Each Nominee

| Sector/Issue | Harris Victory | | Trump Victory | |
|-----------------------|---|---|--|---|
| | Winners | Losers | Winners | Losers |
| Health Care | Medicaid-exposed insurers Hospitals | Pharma, biotechnology Medicare Advantage carriers | Medicare Advantage carriers | Medicaid-exposed insurers Hospitals |
| Energy/Climate Change | Solar companies, EVs Electrical equipment Building products | Broad energy sector Coal producers | MLPs, LNG producers Energy equipment & services Coal producers | Solar companies, EVs |
| Financials | | GSIB banks, Regional banks Consumer finance, capital markets | GSIB banks, Regional banks Consumer finance, capital markets | |
| Defense | | | Defense contractors | |
| Trade Tarrifs | | | Steel companies | Retailers China-exposed companies |
| Immigration Reform | | | | Hotels, restaurants & leisure Retailing Construction, Agriculture |

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ClientRelations@mrbpartners.com

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London 24 Old Bond Street, 3rd Floor
London, W1S 4AP, United Kingdom
Tel +44 (0) 20 3523 9618

Montreal 1275 Avenue des Canadiens-de-Montréal, Suite 500
Montreal, Quebec H3B 0G4
Tel +1 514 558 1515

New York 380 Lexington Ave, 17th Floor,
New York, NY, 10168, United States
Tel +1 212 390 1148

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