PMI

INSIGHTS

April 3, 2024

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3rd Floor, Suite 1, Omar Hodge Building,
325 Waterfront Drive, Road Town,
Tortola VG1110, British Virgin Islands

Tel.: +1 (284) 494-4484/5
Email: corpcomm@pmipensions.com

THE LAST MILE.

by Ryan Seale, BBA, CIM - Senior Portfolio Analyst with PMI

For 2023, Artificial Intelligence (AI) and the technology sector were the dominant themes with the Magnificent 7 stocks carrying the market, contributing 59.23% of the S&P 500 Index's (SPX) 23.91% (price appreciation basis) return for that year (See **Figure 1**).

On a year-to-date basis (YTD), AI continues to be the main driver for the market. However, NVIDIA has been doing all the heavy lifting, contributing a massive 28.37% of the SPX Index's 9.74% return. It should also be noted that the top 7 contributors highlight some rotation by investors into other sectors, i.e., healthcare (LLY) and financials (BRK/B), with AAPL, TSLA, and GOOGL falling out of their previous rankings (See **Figure 2**).

With NVDA being the top contributor to the market's YTD returns, it poses a concentration risk (more on this later). However, even considering its massive returns to investors over the past 12 months, the stock is trading at a premium of 23.96% to its intermediate median forward p/e multiple (38.41x versus 30.99x), which given its strong forecasted earnings growth profile makes it still attractive relative to the majority of its current Magnificent 7 peers (See **Figure 3**).

Figure 1

Name	Ticker	% Contribution to Index Return
Microsoft Corp	MSFT US	13.27%
Apple Inc	AAPL US	12.13%
NVIDIA Corp	NVDA US	11.09%
Amazon.com Inc	AMZN US	7.80%
Meta Platforms	META US	6.70%
Tesla Inc	TSLA US	4.30%
Alphabet Inc	GOOGL US	3.94%
	Total	59.23%

Source: Bloomberg/ PMI

Data from 1/1/23 to 12/31/23

Figure 2

Name	Ticker	% Contribution to Index Return
NVIDIA Corp	NVDA US	28.37%
Microsoft Corp	MSFT US	10.19%
Meta Platforms	META US	8.88%
Amazon.com Inc	AMZN US	6.29%
Eli Lilly & Co	LLY US	3.86%
Broadcom Inc	AVGO US	2.73%
Berkshire Hathaway Inc	BRK/B	2.56%
	Total	62.88%

Source: Bloomberg/ PMI

Data from 1/1/24 to 3/22/24

Figure 3

	Forward P/E at 01/01/24	Forward P/E at 03/22/24	Intermediate P/E Median Multiple*	% Above Median
MSFT US Equity	32.10	34.67	21.44	61.71%
AAPL US Equity	28.43	25.44	25.15	1.16%
NVDA US Equity	23.93	38.41	30.99	23.96%
AMZN US Equity	32.96	34.48	33.47	3.02%
META US Equity	19.70	24.06	16.61	44.85%
TSLA US Equity	63.11	58.78	31.11	88.94%
GOOGL US Equity	19.20	20.23	15.45	30.94%
LLY US Equity	47.25	61.87	18.23	239.39%
AVGO US Equity	22.10	26.93	15.87	69.70%
BRK/B US Equity	20.39	22.78	19.76	15.29%
SPX Index	22.13	21.71	20.46	6.11%

Source: Bloomberg/ PMI

Data range * 03/22/2019 to 03/22/2024

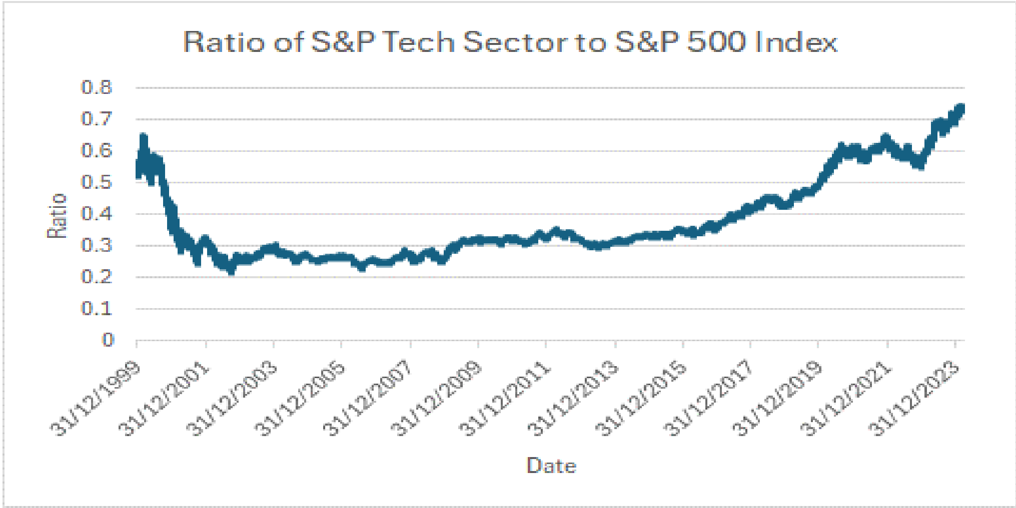
However, a look at the relative strength index (RSI) for NVDA highlights a "negative divergence," with the RSI trending downwards while the share price continues its upward trend (See **Figure 4**). As a momentum indicator, this may be an early sign of investor sentiment starting to wane on the stock at current levels. Given the concentrated risk, NVDA poses, (given its outsized return contribution to the SPX Index relative to other member stocks) and AI dominance, any weakness from here could lead to negative AI market sentiment and put pressure on the overall market returns. This is of further significance given that other AI tech names, such as Meta Platforms (META) and Microsoft Corporation (MSFT), are looking increasingly expensive, as highlighted earlier, in terms of their forward valuations.

Figure 4

Source: Bloomberg/ PMI

Figure 5

In addition, the technology sector as represented by S&P 500 Information Technology GICS level 1 Index (S5INFT), indicates that the S5INFT is trading around its all-time highs (bubble territory) relative to the SPX. This suggests an increasingly higher probability of a mean reversion with the SPX outperforming the technology sector in that event (See **Figure 5**).



Source: Bloomberg/ PMI
Data as at 3/26/2024

What this means is that investors should look to reduce some of their exposure to technology and add to other sectors within the market, which typically will participate in this late stage of the cycle as a hedge against a possible broad pullback in technology. In fact, as previously mentioned, we have already seen some signs of that occurring with names like LLY and BRK/B replacing some of the Magnificent 7 stocks.

Market technicals currently support this view, with broad market participation showing improvement to where the number of stocks trading above their 50 and 200-day moving averages is 77% and 80% (as of 3/22/24), respectively. At the sector level and leading the charge has been (as previously mentioned) Information Technology, Healthcare, Industrial, Materials, and Financials reaching new highs. They are followed closely by Energy, Telecommunication Services, and Consumer Staples, which at current levels are near to establishing new highs. Lastly, there is Consumer Discretionary, which is in an uptrend, and Utilities and Real Estate in an established downtrend.

Figure 6

	Forward P/E	Intermediate Median P/E	% Premium/ Discount
Infotechnology	38.61	27.47	40.55%
Materials	22.06	18.13	21.68%
Financials	16.15	13.77	17.28%
Healthcare	19.37	17.42	11.19%
Industrials	22.01	20.33	8.26%
Telecommunications	19.68	18.69	5.30%
Energy	12.74	12.58	1.27%
Consumer Staples	20.39	21.03	-3.04%
Consumer Discretionary	25.2	26.21	-3.85%
Real Estate	35.53	41.1	-13.55%
Utilities	15.85	19.44	-18.47%

Source: Bloomberg/PMI

Data as at 3/22/24

Figure 6 above shows all 11 sectors within the SPX Index and their % valuation premium/ discount. Of those sectors making new highs, Industrials trade at the most favourable valuation premium, while Utilities trade at the widest valuation discount. To diversify away from the AI-dominant theme, investors should consider adding to late-stage cyclical sectors such as Industrials and Energy, which still trade at favourable valuations, as well as defensive growth such as Consumer Staples and Healthcare.

The benefit is twofold. Over the expected easing cycle, cyclicals should outperform, and defensives will help weather any material pickup in market volatility, as the road to neutrality will not be without its hiccups. The S&P at a forward multiple of 21.71x is not cheap but not expensive relative to its intermediate term trend of 20.46x. This, along with improving broadening indicators, suggests that there may be more room for this current rally to run.

Fed Positioning

The Fed is in the last mile of its road towards restoring inflation to its 2% neutral rate, which is often the most difficult part of the journey. Any policy mistake at this juncture can easily lead to them overshooting their mark, which in turn will shift the goal line from a soft landing to a hard landing. Data so far has been mixed and the Fed would rather see more signs of inflation coming down before giving the market the rate cuts it is looking for. Therefore, expect to see more uncertainty in the markets driven by macro volatility. However, interestingly, at their March 20th post-meeting conference, the Fed essentially upgraded their 2024 growth outlook for the US economy (See **Figure 7**) from where their expectations resided in December, with inflation remaining higher than previously forecasted. In addition, it kept its forecast for 3 rate cuts in 2024 and further stated that it would be appropriate to start easing at some point this year ("Dovish").

This supports a soft to no-landing narrative, and with the market focused on rate cuts, Fed futures now signal a 65% probability (at the time of writing) of the first cut happening in June.

Whether the Fed will actualize on 3 rate cuts this year is still questionable, as there are underlying signs supporting a higher-for-longer stance.

Figure 7

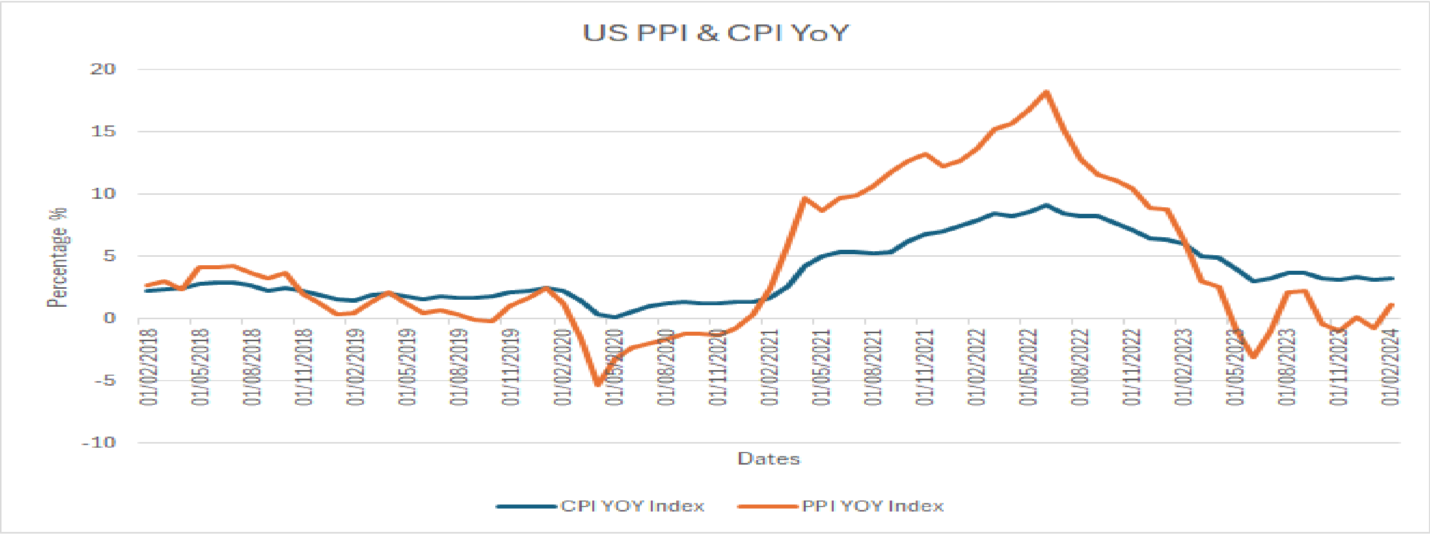
Fed Forecasts		
	December	**March**
GDP	1.40%	2.10%
PCE Headline	2.40%	2.40%
PCE Core	2.40%	2.60%
Unemployment	4.10%	4.00%

Source: FED

US PPI/ CPI

Both manufacturing inputs costs, as measured by the final demand US Producer Price Index (PPI), as well as Consumer Price Index (CPI) on a YoY basis have seen a recent uptick.

Figure 8

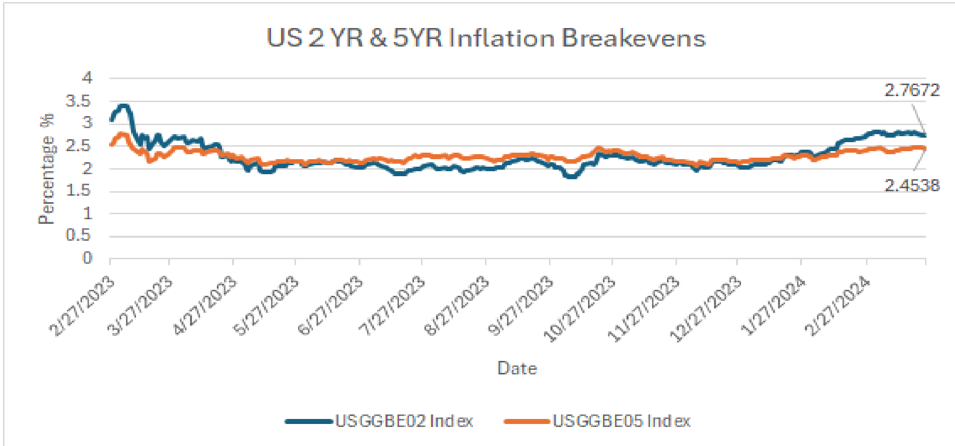


Source: Bloomberg/ PMI

Inflation Expectations

Figure 9

US 2-year and 5-year breakeven expectations are still above the Fed's 2% target and signaling the bond market's view of a higher inflation outlook above the Fed's target rate. **Figure 9**, at right, highlights the 2-year breakeven rate at 2.77% and the 5-year at 2.45%.

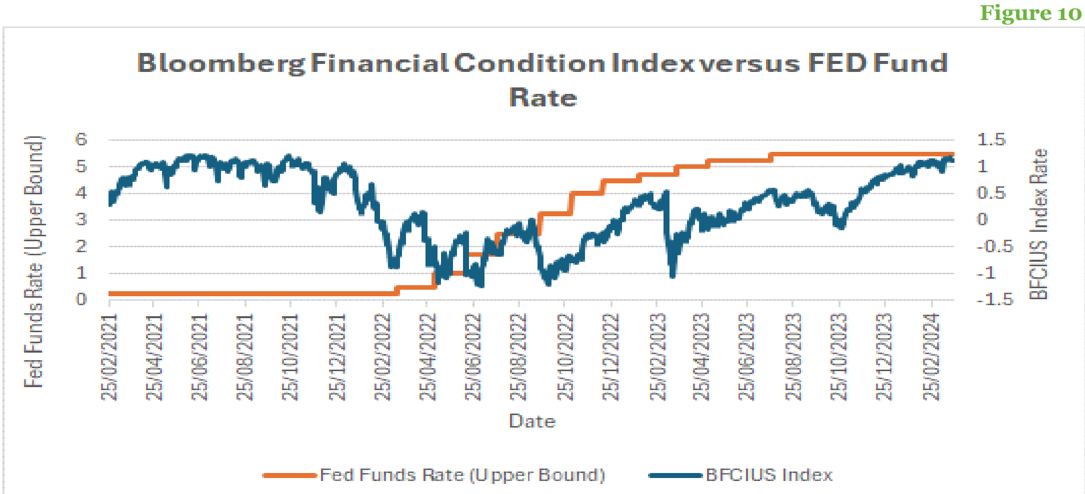


Source: Bloomberg/ PMI

Figure 10 below shows that financial conditions are now just as loose as they were prior to the 1st rate hikes back in March, 2022. This is counterintuitive, as restrictive monetary policy should serve to tighten financial conditions and not the other way around. Therefore, as long as financial conditions remain loose, 3 rate cuts might now become 2 rate cuts or even 1 for this year, as inflation could remain sticky.

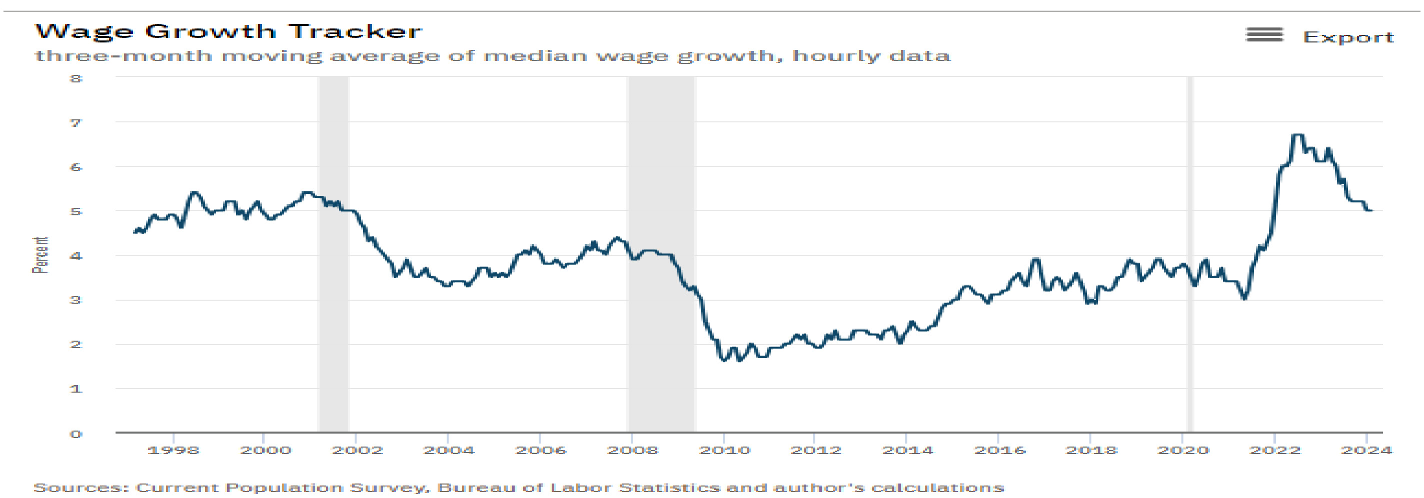
Figure 10

Median wage growth, according to the latest Federal Reserve Bank of Atlanta data at 5.0% (as at February 2024), is still higher than that of inflation at 3.2% CPI YoY. This is supportive of higher for longer (see **Figure 11**, below).



Source: Bloomberg/ PMI

Figure 11



Source: Federal Reserve Bank of Atlanta

In this last mile towards neutrality, with a market that may yet have more room to run, it makes sense that investors should take advantage of the broadening market (away from the Magnificent 7) and allocate to those cyclical sectors that offer a better risk/ return trade-off e.g. Energy & Industrials. This serves to diversify portfolios and still offer the potential for upside participation as the current market rally plays out amidst a still resilient US economy. In the event that volatility picks up, then broader exposure to defensive growth sectors (e.g., Consumer Staples and Healthcare) should provide some downside protection.

Gold, as a hedge against financial uncertainty and a safe-haven asset, has been making new all-time highs. As at 3/22/24, it was up 18.14% from its October 6, 2023 lows compared to 21.48% for the SPX Index. Given its low correlation to equities, an allocation to investors' portfolios as a means of insurance may not be without merit.

Fixed income at the shorter to intermediate part of the curve still looks attractive. We recommend owning investment grade corporates as investors can still lock in decent rates (5% or greater), which will generate income within your portfolios and provide further diversification. However, high-yield bonds trading at some of the narrowest spreads in years is a declining value proposition, in our opinion, as investors are not being compensated for the additional risk. PMI

Did you know?.......

- **Dovish (Monetary Policy)** – refers to actions taken to guard against deflation, stimulate economic growth, and reduce unemployment by increasing money supply by means of lower interest rates.
- **Hard landing** - refers to a marked economic slowdown or downturn following a period of rapid growth leading to a recession.
- **Inflation** - is characterized by a general increase in the prices of goods and services throughout the economy, gradually eroding the purchasing power of consumers and businesses alike.
- **Mean reversion** - is a fundamental financial principle essential in shaping investment strategies. It hypothesizes that asset prices and returns eventually converge to their long-term mean or average.
- **Recession** – is a slowdown in general economic activity recognized after two consecutive quarters of negative GDP growth.
- **Soft landing** - refers to a moderate economic slowdown following a period of growth typically resulting from increased interest rates that aim to curb inflation.