PMI

INSIGHTS

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PMI is an independent, privately-held financial services firm specializing in the provision of financial solutions in the areas of:

- Investment Management
- Pensions
- Private Wealth Management

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VIEW FROM THE TOP.

by Ryan Seale, BBA, CIM – Chief Investment Officer with PMI

The market as represented by the SPX Index is at all-time highs having returned 16.84% (in price appreciation) on a YTD basis (as at 08/07/24). A peek behind the curtain reveals that the Information Technology sector stocks (S5INFT Index) were the biggest performers during the period, returning 33.66% followed by communication services at 29.70% (See **Figure 1**). Within Information Technology, Super Micro Computer Inc and Nvidia Corp were the two best performers at 216.38% and 158.87%, respectively.

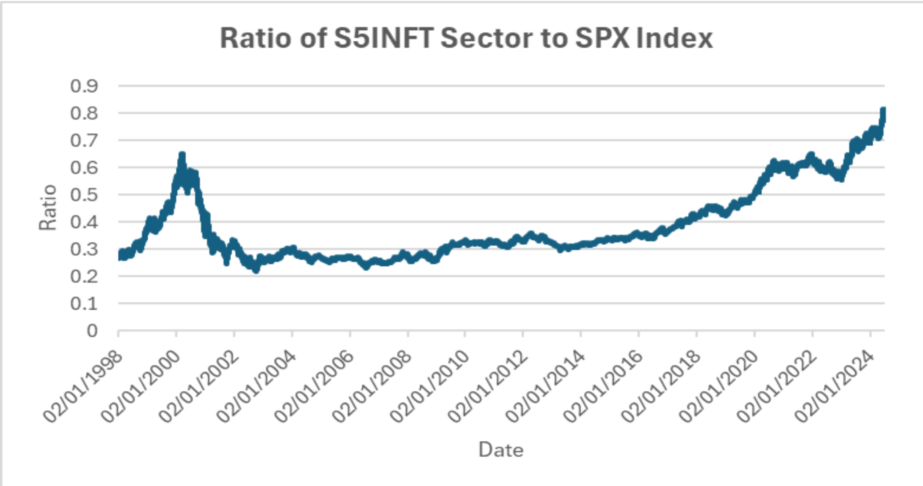
For perspective, the ratio of Information Technology sector stocks within the SPX Index relative to the SPX Index on a price basis, has well surpassed their highest level during the peak of the tech market bubble in 2000. This outsized contribution by the sector increasingly becomes concerning where it stands at risk for a mean reversion as higher interest rates can affect valuations (See **Figure 2,** on the next page). This industry group currently trades at a forward P/E multiple of 35.35x or 65.19% premium relative to its intermediate median multiple 21.40x (as at 08/07/24).

Figure 1

	YTD Return (%)
SPX Index	**16.84**
Real Estate	-4.27
Materials	2.94
Health Care	5.79
Industrials	6.51
Energy	7.07
Utilities	8.27
Consumer Staples	8.43
Consumer Discretionary	9.16
Financials	10.09
Communication Services	29.70
Information Technology	33.66

Source: Bloomberg/ PMI
Data as at 08/07/2024

Figure 2

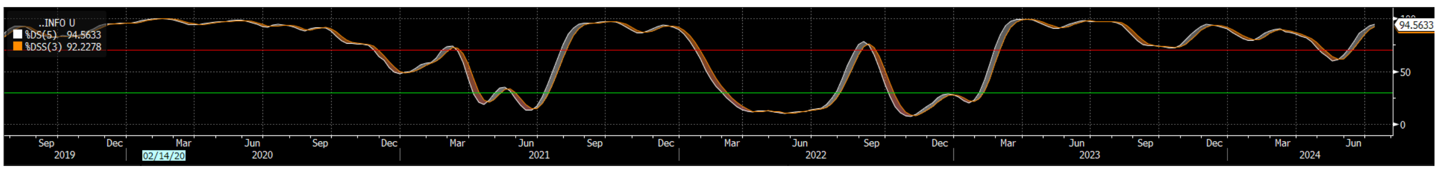


Source: Bloomberg/ PMI
Data as at 08/07/2024

Using stochastics (weekly) as a momentum indicator, the sector recently became "overbought" (after a brief pull back) relative to the SPX Index with the slow stochastic indicator registering a buy signal (See **Figure 3**, below). Therefore, this out performance may still have room to run yet.

Information Technology relative to SPX Index

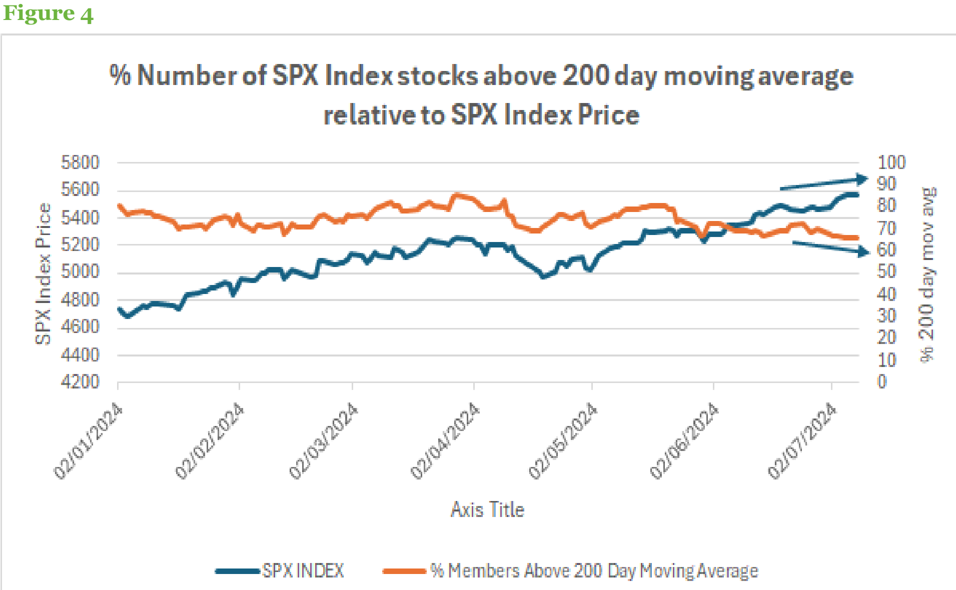
Figure 3



Source: Bloomberg

Interestingly, the S&P 500 Equal Weighted Index (SPW Index) which is the equal weighted version of the SPX Index but allocates a fixed weight to each company (and therefore can be used as a gauge towards backing out the outsized weightings that AI themed stocks within the infotech and communication sectors have had on SPX Index returns) is only up 3.85% (as at 08/07/24). Therefore, if we look beyond these two sectors, the rest of the market, while positive, has been relatively modest in its participation as further highlighted through the SPX Index's poor breadth.

Figure 4



Source: Bloomberg/ PMI
Data as at 08/07/2024

The percentage number of stocks trading above their 200-day moving averages (See **Figure 4**), continues to display a negative divergence with the SPX Index. This type of chart is not supportive of a continuation of a market making new highs as it signals a high likelihood of a market correction as breadth continues to deteriorate.

In summary, market technicals are flashing caution at this point with market leadership still highly concentrated in a few names which are trading at lofty levels relative to the broader market. While this condition can persist for an extended period, it is not the hallmark of a healthy market as we would like to see broader participation across other market segments.

Figure 5

Source: Bloomberg/ PMI
Data as at 08/07/2024

For example, small caps (RTY Index), which typically would benefit from a market anticipating an easing of financial conditions, should be exhibiting greater performance participation at this stage. YTD (as at 10/07/24) they are only up 1.22% and are trading at one of the cheapest levels relative to their large cap counterparts (going all the way back to 01/05/01) at which point they were starting to outperform in anticipation of the Fed's easing cycle (See **Figure 5**).

Figure 6

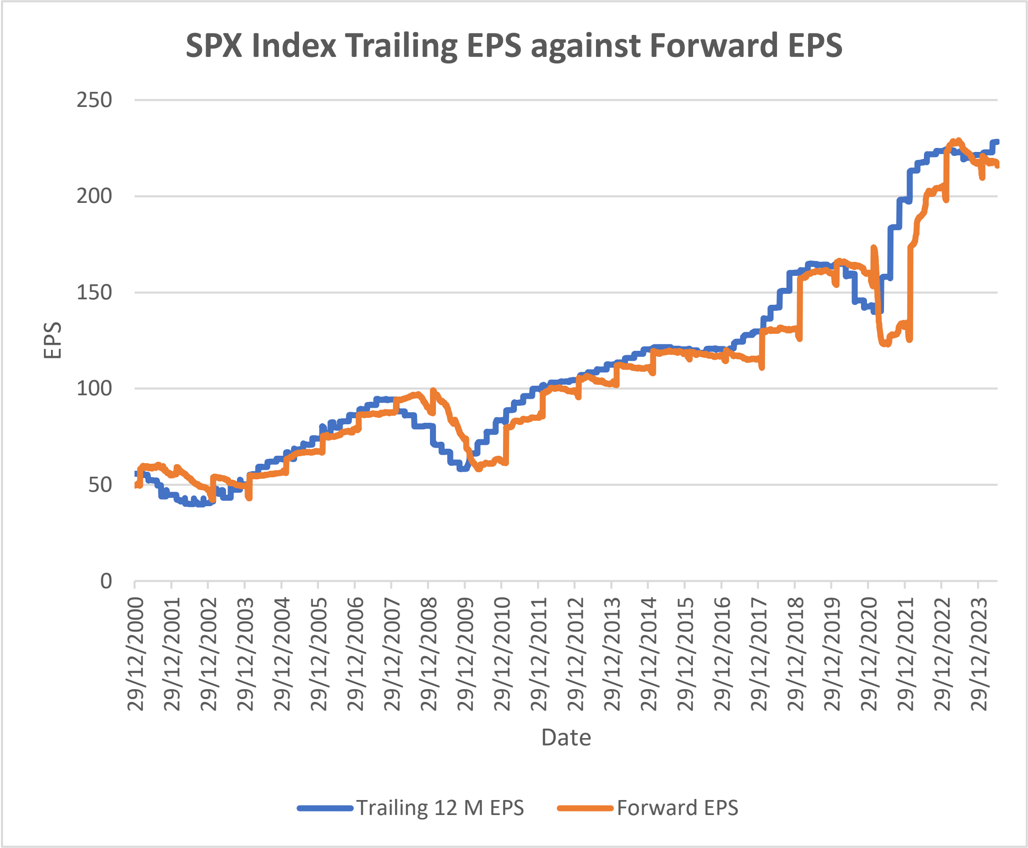
Source: Bloomberg/ PMI
Data as at 09/07/2024

On the earnings front, the backdrop remains favourable as Q2 earnings season is upon us. Investors will be taking their cues from those companies that continue to outperform by not only beating the streets' earnings estimates, but also that issue upwards earnings revisions (which is a sign of fundamentals improving and supportive of higher valuations). According to research published by Factset on July 3rd, the number of S&P 500 companies that issued negative EPS guidance for Q2, 2024 is within historical average levels. This is a welcome sign given the weakening in market internals and can be viewed as a near term positive for the market at current levels.

In addition, analysts remain "bullish" on the market (see **Figure** 6) with EPS estimates in aggregate estimated to be at $253.28 or 10.91% higher on a forward 12m basis.

To the extent that these forward-looking estimates are realized will be hinged on a data dependent FED and their ability to deliver an economic soft-landing as the market currently is expecting. If the past is any indicator, during prior cycle slowdowns analysts' estimates tend to be overly optimistic going into economic declines and pessimistic going into economic recovery. **Figure** 7, which highlights forward EPS estimates moved forward by 12 months (to coincide with actual trailing 12m EPS), shows that actual earnings tend to fall before analysts' forward estimates going into the end of previous cycles with the reverse during the start of a new cycle.

Figure 7



Source: Bloomberg/PMI

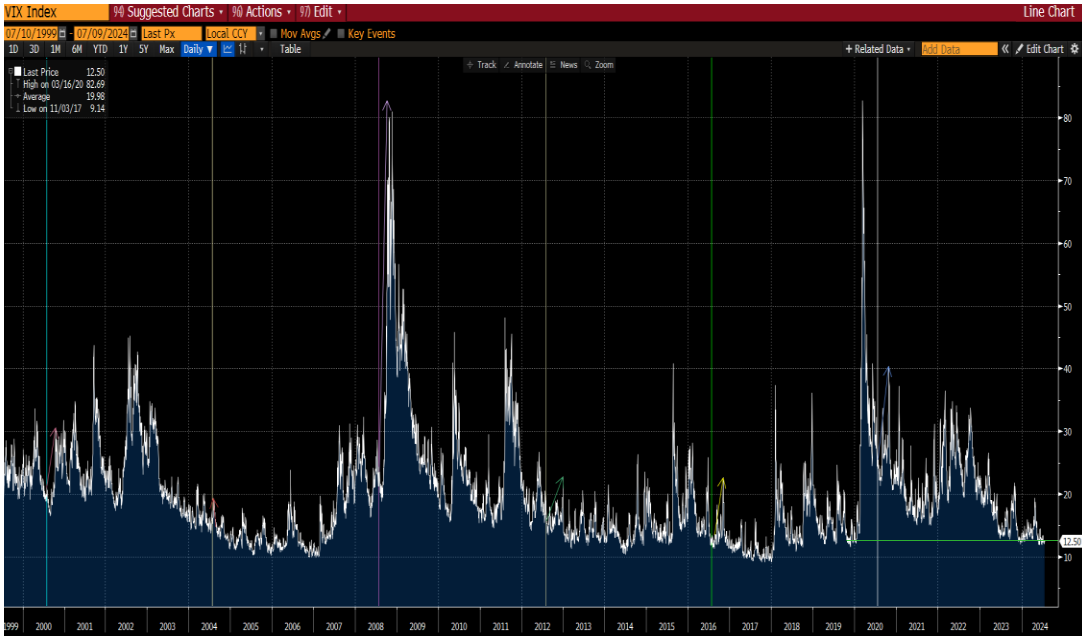
The Economy

Economic conditions remain mixed. While CPI YOY inflation has come down to where it resides at 3.3%, it is still somewhat above the 2% target. The recent US Flash Manufacturing and Services numbers accelerated higher in June which is not a sign of a cooling economy. On the dis-inflationary side, recent non-farm payrolls suggests the job market cooled in Q2 along with a softening in average hourly earnings and an increased unemployment rate to 4.1%. There are also signs that consumer sentiment is waning with the University of Michigan consumer sentiment Index falling to a seven-month low in June and US retail latest numbers slightly rising in May (with previous number revised lower).

What does this mean for investors?

Investors should be prepared for a pick-up in volatility given mixed economic signals which can lead to uncertainty around the FED and the timing of rate cuts. This is also compounded by the fact that we are in a US election year.

Figure 8



Source: Bloomberg/ PMI
Data as at 09/07/2024

Figure 8 highlights that volatility normally picks up in an election year from this point forward into the election.

While the earnings backdrop is still constructive, market internals are not. Valuations across many sectors are looking expensive and market leadership still resides concentrated within AI driven tech names.

With early signs of a slowing economy, a soft landing is still the majority consensus. However, it is concerning that areas of the market such as small caps are not showing a level of participation that is commensurate with such an outlook. While signals are conflicting, there are no areas that are fundamentally broken, and measured expectations is the order of the day. In response, we at PMI while still "bullish" on the equity markets, will continue to pay attention to valuation, income awareness and earnings quality as markets typically do not like uncertainty.

Figure 9, highlights that defensive sectors e.g. Utilities & Consumer Staples which are the 5th and 6th best performing sectors (respectively) on an YTD basis, are still cheap in terms of their forward P/E multiple relative to their 10 yr median multiple. However, Health Care is expensive at 19.28% premium. Except for Energy and Real Estate (and excluding the aforementioned), all other sectors are trading richly in terms of valuation. This is where diversification and individual stock picking becomes of paramount importance relative to index investing and we recommend a barbell approach between cyclical growth and defensives.

Figure 9

SPX Index	Forward P/E	10 Yr P/E Median Multiple	% Above/ Below
Energy	12.79	18.91	-32.36%
Utilities	17.10	17.96	-4.79%
Consumer Staples	20.57	20.63	-0.29%
Health Care	20.60	17.27	19.28%
Industrials	21.86	18.66	17.15%
Financials	15.93	14.11	12.90%
Materials	21.00	18.06	16.28%
Consumer Discretionary	26.00	22.28	16.70%
Information Technology	35.68	21.42	66.57%
Real Estate	35.90	38.21	-6.05%
Communication Services	20.57	15.93	29.13%

Source: Bloomberg/ PMI
Data as at 10/07/2024

Notwithstanding the above, AI will continue to be an important theme moving forward and investors should be positioned within those sectors that stand most to benefit from productivity gains through its integration within their business models. The rotation effect from this should also serve to improve market breadth.

Gold, as a hedge against market uncertainty, has been posting new all-time highs and on a YTD basis (as at 10/07/24) is up 14.99%.

Lastly, investment grade Fixed Income remains attractive at the shorter end of the curve, wherein investors can still benefit from yields between 5.00 to 7.00%. PM