Insight Newsletter
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Litman Gregory
WEALTH MANAGEMENT

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Investment Commentary: Second Quarter 2024

Market Recap

In the second quarter of 2024, the U.S. economy remained resilient in an environment where inflation and interest rates remained higher than expectations. Tighter monetary policy was offset by accommodative fiscal policy, and a still strong US consumer.

The S&P 500 Index gained 4.3% in the quarter, reaching a new all-time high. Gains were again led by technology stocks, with the Nasdaq gaining over 8.0% in the quarter. Chip-maker Nvidia became the world's most valuable company in late-June after its share price climbed to an all-time high. We also saw the continuing trend of large-cap stocks (Russell 1000 Index) outperforming small-cap stocks (Russell 2000 Index) and growth (Russell 1000 Growth) beating value (Russell 1000 Value). Overseas, results were mixed with developed international stocks (MSCI EAFE Index) falling 0.4%, while emerging markets stocks (MSCI EM Index) gained nearly 5.0%. Within the bond markets, returns were positive across most fixed-income segments. The benchmark 10-year Treasury yield ended the quarter close to where it started, but interest rates were volatile in the period. The 10-Year Treasury yield started at 4.20%, rose to 4.70% before coming back to the mid-4.20% range. In this environment, the Bloomberg U.S. Aggregate Bond Index gained 0.1% while high-yield bonds (ICE BofA High Yield Index) finished the quarter up 1.1%.

Investment Outlook and Portfolio Positioning

During the second quarter, the U.S. economy began its fifth year of expansion after the brief pandemic-related recession in April 2020. Ongoing economic growth has defied widespread expectations of a recession that were present for most of 2023 and into the beginning of 2024.

Recent data, however, suggests that higher interest rates and inflation have started to take a bite out of the U.S. consumer. The University of Michigan Consumer Sentiment Index fell to a seven-month low in June, indicating a pessimistic view of personal finances. In the May retail sales report, growth was positive but slower than expected. This recent data point suggests consumers are exercising more caution amid tighter budgets. Specifically, headline sales rose 0.1% from the prior month versus the consensus for a 0.3% rise.

At this point, we would describe the slowdown in consumer spending as a normalization after a period of splurging, rather than something more ominous. So far, any concerns around the consumer have not seemed to scare investors as the S&P 500 has made 30 new highs and the economy has grown at nearly 3% (after inflation) over the past four quarters. Our

base-case is for the economy to continue growing, albeit at a slower pace, for inflation to grind lower, and the backdrop for risk assets to remain supportive (for at least a while longer).

Within U.S. equity markets a handful of U.S. mega-cap technology stocks continue to lead way higher. Through June, only 27% of stocks in the S&P 500 are outperforming the index, the lowest reading in more than 50 years. Moreover, the top 10 contributors accounted for 70% of the S&P 500's 15% year-to-date return. While the concentration levels at the index level are noteworthy, it's possible that this trend can continue. Afterall, the strong run for Artificial Intelligence (AI) stocks has been justified as companies such as Nvidia continue to deliver and beat earnings estimates. Moreover, expectations for future earnings growth are robust.

Outside of the U.S., there are many compelling opportunities in developed international and emerging-market stocks. Europe, for example, is home to several leading businesses in a range of growing and attractive sectors. Moreover, valuations for foreign stocks are trading at steep discounts to the U.S. All else equal, lower starting valuations imply better long-term expected returns.

Our fixed-income positioning has not changed much since last quarter. We believe that inflation is under control for now, and that short-term interest rates have peaked and will likely decline slightly over the course of the year. For corporate bonds, we do not foresee a near-term risk of a spike in default rates given still-attractive corporate fundamentals. In this environment we continue to take advantage of the inverted yield curve, emphasizing shorter-term higher-yielding securities with yields in the 6.5% to 7% range, while also maintaining some exposure to longer-term bonds with yields in the 4.5% to 5%, which can also provide protection in the event of a stock-market downturn. And if long-term rates climb, we'll look at adding exposure to capture these yields while adding defensive ballast to portfolios.

We also continue to like alternative and private investments that have differing return drivers from conventional stocks and bonds and that bring a valuable diversification benefit to our portfolios.

Closing Thoughts

The U.S. economy looks set to benefit from a continuing gradual moderation in growth, inflation, and jobs, creating a backdrop that could support risk assets. As was the case last quarter, the stock market hit new highs as economic growth continues to benefit corporate earnings. U.S concentration remains high with the so-called "Magnificent Seven" representing over 25% of the S&P 500. There's no doubt that the other 493 stocks of the S&P 500 have struggled on a relative basis, but they could be set to move higher if the key economic drivers outlined above continue to fuel the economy. That said, fears of a recession haven't completely abated. Looking out to the end of the year and into next year, the question remains whether a recession will be avoided or delayed. As such, we are keeping a close eye on the typical drivers of recession, including the labor market, consumer spending, and corporate earnings, where a deterioration in these variables could influence portfolio positioning.

Heading into the second half of the year, we continue to anticipate pockets of volatility given headline risks related to Fed policy, geopolitical events, and the upcoming U.S. presidential election. In the event of volatility, we will look to take advantage of any attractive risk/reward opportunities that arise.

—We thank you for your continued confidence and trust. Litman Gregory Wealth Management
(Written 7/11/2024)

Insights on Recent Stock Market Volatility

The market's decline and spike in volatility seen in early August appeared to have been prompted by a weaker-than-expected jobs report, which followed the FOMC holding the Fed Funds rate unchanged in a range of 5.25% to 5.50%. With unemployment climbing to 4.3%, a three-year high, and only 114,000 jobs being added in July, (compared to the 175,000 that economists estimated) investors seemingly viewed this as a clear sign that the Federal Reserve (the "Fed") has waited too long to lower interest rates and that the U.S. economy could be heading for a recession.

In addition to weaker jobs data and a disappointing Manufacturing ISM (Institute for Supply Management) number on August 1st , another catalyst to the volatility had been the technical unwind of the Japanese yen carry trade. This happened when the Bank of Japan (BoJ) raised interest rates, and thus prompted investors to unwind their borrowing in Japanese yen and reduce their corresponding investments in other, riskier, markets.

Japanese equities as well as long positions on the Australian dollar and Mexican peso have been the most affected by brutal capitulation, which has spread over other asset classes, especially those which have so far benefited from strong momentum. The yen's recent appreciation against the U.S. dollar started in early July and has accelerated over the past week. Prospects of further BoJ tightening, U.S. Fed easing, and increasing geopolitical tensions in the Middle East are all spurring the sell-off of the safe-haven yen. Government bond prices in the main developed economies have also rallied by August, with the U.S. 10 Year Treasury yield heading below 3.8% by August 5th.

While there is in fact some weakness in the jobs market, we did not shift our outlook nor rule out the possibility of a "soft landing." Our second quarter investment commentary covers some of the risks to the economy, including the high level of interest rates and cracks in the labor market. And with the Fed continuing to keep rates high, they are walking a fine line between fighting inflation and risking economic weakness. While near-term inflation has been under control, the CPI may continue to decline over the remainder of the year. Looking ahead to the last few months of the year, the Fed is expected to be cutting rates, with the only questions on timing and magnitude of those cuts. Meanwhile, the economy is continuing to grow, albeit slower than the last two years, and corporate earnings are expected to finish the second quarter at a healthy 11% year-over-year rate.

Market declines and periodic corrections are normal, and yet the volatility in early August seemed to be quite a strong reaction to only one month of data. With that said, there has been a lot of volatility this year following the release of economic data points. Recall that at the beginning of the year, the market anticipated up to 7 cuts for the Fed Funds rate, then went to expect almost no cuts, and now is expecting 125 basis points (bps) cut for the rest of 2024 with a high probability of a 50bps cut in September. We expect there will be more ups and downs in the main financial parameters in the coming months as the market attempts to forecast the outcome of the Fed's actions.

In sum, the current take on the volatility seen in early August was that we had not yet seen sufficient evidence to shift our view of the economy, but as always we keep a close eye on economic data. It's worth a reminder that periodic shorter-term volatility is a normal part of investing in stocks and other risk assets, and selling when short term discomfort is high can significantly compromise long-term returns. Our approach is to remain on the lookout for opportunities that present themselves in the financial markets, and to take advantage of them if we are convinced doing so will increase longer-term returns.

Research Update: Drivers of Equity Returns Likely to Shift Going Forward

Predicting stock market returns is famously difficult, with so many variables – many beyond anyone's control – combining in unpredictable ways to humble even the most knowledgeable experts at times. Bonds, to those with even a passing knowledge of how their math works, seem easier to analyze with confidence given their more predictable cash flows and reactions to interest-rate changes. While bonds may seem more "mathematical" in how their returns are generated, stocks are nonetheless governed by three factors that in fact are also quite straightforward.

Equities derive their gains (or losses) from dividends, growth in earnings per share, and fluctuations in valuation. How these three interplay over time can be difficult to predict, but we can identify obvious headwinds and tailwinds for each that stem from the broader macroeconomic environment. Unpredictable shocks like the pandemic or Russia's invasion of Ukraine can throw wrenches into the engine of the global economy, but once those effects become clear we can factor them into the longer-term equity return assumptions that influence our portfolio asset-allocation decisions.

We'll give a quick refresher on how each return driver works, and then look more closely at how the changes to the overall global economic environment influence our expectations going forward versus what they were in the prior period beginning after the 2008-09 financial crisis.

Dividends are the payments a public company distributes to its shareholders from the profits that it earns. Some (usually rapidly growing) companies opt not to pay much, if any, of their earnings in dividends based on management's belief that reinvesting those cash flows into the business to drive further profit growth can generate higher long-term returns for shareholders.

Earnings growth and valuation changes are related. Valuation, measured as the price-to-earnings multiple (P/E) reflects how much investors are willing to pay for a share of a company's stock per unit of earnings. If a company earns profits of $1 per share and the share price is $20, the P/E multiple is 20x. The idea of what investors are willing to pay for a dollar of earnings is a useful framework. If a company's earnings grow from $1 to $1.50 per share, and the P/E multiple remains at 20x, a company's stock price would increase from $20 per share to $30 per share. This is how earnings growth contributes to rising stock prices (and it works in reverse, of course).

When it comes to valuations, however, investors are typically willing to pay more for a dollar of current earnings if they expect future earnings to be higher. And if investors perceive a risk to future earnings — from business challenges like increased competition or a declining industry, for example — they may pay a lower P/E multiple for that company. An example of this would be a company that manages to increase current earnings from $1 to $1.50 despite a dim outlook for future growth, and as a result the share price remains at $20. In this case, the P/E multiple would contract from 20x to 13.3x. Investor expectations about future earnings are the reason why earnings growth and valuation changes can be highly interconnected.

Back to the drivers of return: if investors are willing to pay more for a dollar of earnings in the future than they are today (e.g. P/E multiples expand) then stock prices will increase even if earnings remain flat. Though in truth a likely driver of investors' willingness to pay more is positive expectations about earnings, and so the two can reinforce one another.

That said, positive earnings expectations aren't the only reason investors might pay more for a dollar of earnings. At the broader economic level, interest rates and risk perceptions are drivers as well. When rates are lower, stocks have less competition from generally safer investments like bonds, and investors are typically willing to pay more for a dollar of earnings from stocks. On the other hand, if investors become risk averse, as they were through the 2008-09 financial crisis or the onset of the pandemic, their fear in owning stocks is expressed in the form of lower valuations and P/E multiples contract.

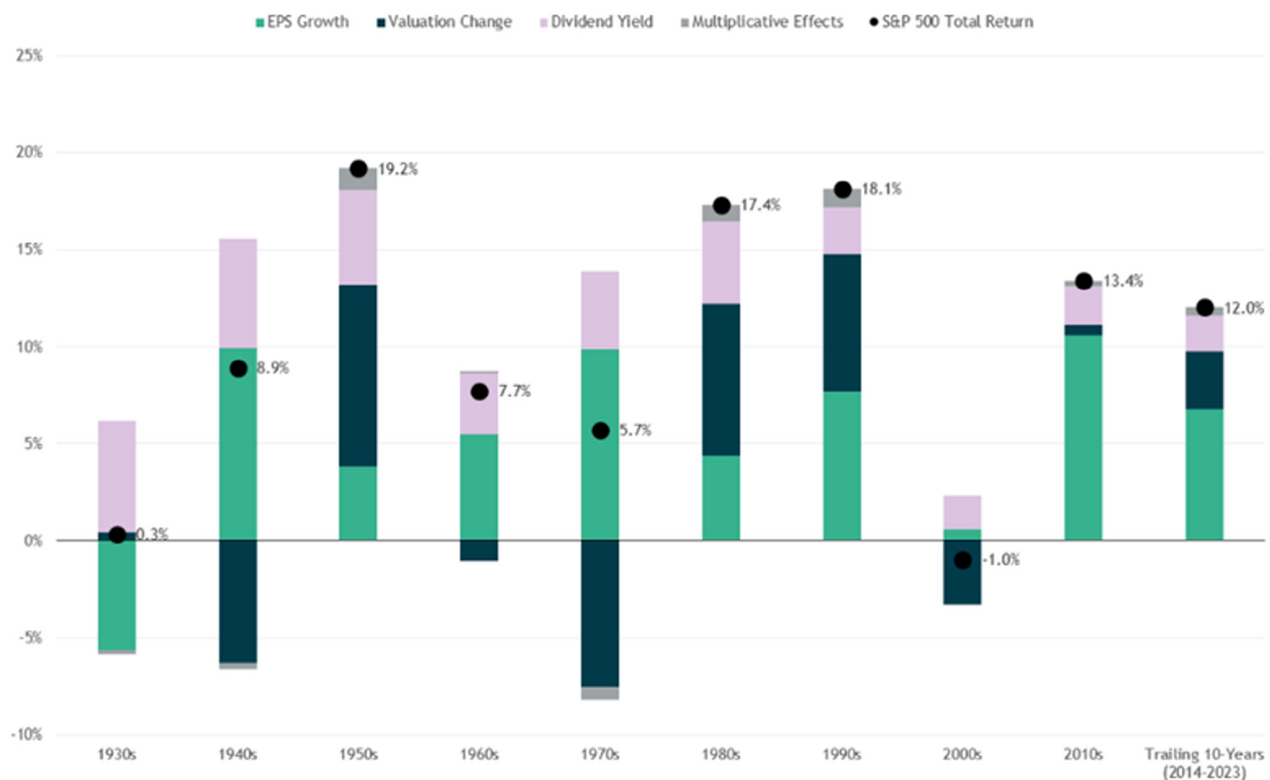
If you think of a dollar of earnings as a product you buy, it makes clear the timeless investment adage (from Warren Buffett and others) that stocks are the rare product that people hate when they're on sale and love when they're most expensive.

The Interest-Rate Environment Has a Big Influence on Equity Returns

Looking backward, the biggest driver of equity returns during the ultra-low interest rate and inflation regime during the decade from the start of 2014 through the end of 2023 was earnings growth, which accounted for a little more than half of the S&P 500's approximately 12% annualized gain during the decade. Earnings per share nearly doubled over that period, or just shy of 7% annualized.

Meanwhile 12-month trailing P/E multiple climbed from 18.5x to 26.8x during the same span (meaning investors went from paying $18.50 per share for each $1 of the index's earnings to $26.80). This accounted for roughly a quarter of the S&P 500's 10-year gain. Dividends contributed roughly 15% to returns (multiplication effects among the three make up the remainder) History shows, however, that valuation changes tend to have less impact over longer periods, suggesting this period may have been anomalous. The chart below shows the contribution of each return driver by decade going back to the 1930s. Dividends by definition are always a positive contributor but the magnitude has varied widely, and earnings growth has been positive every decade except the 1930s. Valuations, meanwhile, have both contributed and detracted meaningfully in past decades.

S&P 500 Total Return Decomposition By Decade



Source: Ned Davis Research

Looking again at the past decade, the historically ultra-low interest-rate environment not only decreased competition to equities from safer investments like bonds (which helps justify higher valuations) but it also contributed to profitability and earnings growth because access to cheap capital reduces companies' borrowing costs and encourages growth-oriented capital expenditures.

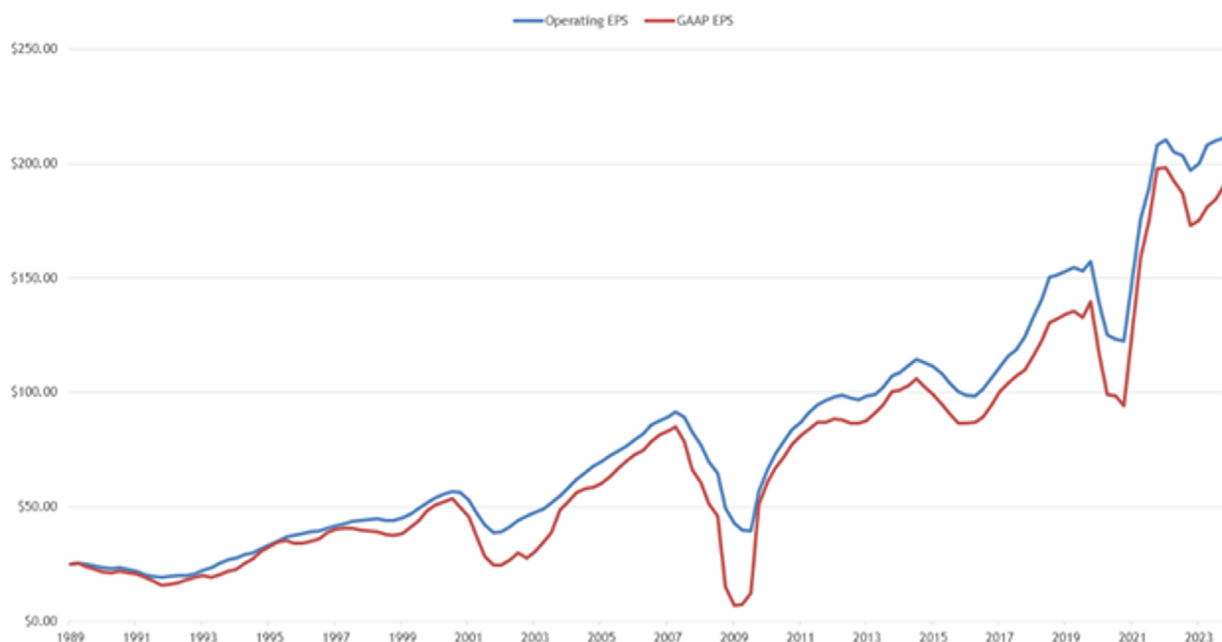
Looking forward, the inverse to points we've made about interest rates become more important given that we are now in a meaningfully higher rate environment than most of the past decade. The headwind to valuations from higher interest rates comes in the form of increased competition from lower-risk fixed-income investments that now boast higher yields, and because a common methodology of analysts who determine what they're willing to pay for a stock is based on the present value of future cash flows. A higher interest rate in that calculation results in a lower valuation for the same level of future earnings.

Looking ahead we don't expect P/E multiples to contribute to returns as they have in the past year or in past decades. With P/E multiples nearing 25x, valuations are elevated relative to history, and if one assumes inflation of 3%, history suggests a P/E of around 17x is appropriate. Therefore, in our base case we expect a mild contraction of valuations creating a modest headwind to equity returns, and flat P/Es (meaning valuations don't change) would be a positive outcome in our view.

That leaves us with two horses to pull the return cart down the track: earnings growth and dividends. Dividends are even lower now than just over a decade ago at the beginning of 2013. The S&P 500 currently has a dividend yield in the neighborhood of 1.4% versus close to 2% a decade earlier. And for dividend yields to contribute more to returns would require an offsetting decline in valuations (which pushes dividend yields higher) so all we in aren't likely to see much contribution from dividends.

That all said, if most of your return is going to come from a single horse, earnings growth is the horse you want. Over the long term, earnings growth has been about 6% and has been the largest driver of equity returns. After a lull in 2022, earnings growth picked back up last year — as the most anticipated recession ever did not materialize — to reach all-time highs, as the chart below shows. The big question looking forward is whether earnings will continue to accelerate in the near term amidst a "goldilocks" economic scenario (not too strong or too weak) or if the economy slows. Over the longer-term, which is the basis for our investment decisions, we think earnings could grow in the mid-single-digit range, with overall equity returns in the same range given the contribution from dividends being offset by valuations pulling back a bit. A more-optimistic scenario is also plausible with equity returns reaching high single- or low double-digit levels. In fact, this is in line with long-term historical averages.

S&P 500 Earnings Per Share



Source: S&P Dow Jones

The rest of the context for our analysis of the drivers of equity returns is what it means for portfolio allocations. With lower-risk fixed-income and alternative investments generating much higher yields and potential returns now in early 2024 than just a few years ago, their appeal is greater now compared to stocks than it has been in a long while. We have to take that into account as we make portfolio allocation decisions. Some final context to the analysis of equity return drivers and how they impact our portfolio decisions (or any research topic for that matter) is to remind everyone that the macroeconomic situation changes both gradually and at times suddenly, and requires a consistent analytical toolkit. We give more weight to factors that can be assessed with higher confidence and over longer timeframes, and with a healthy appreciation for the unforeseeable. These are reasons we don't typically make big tactical portfolio bets and why we believe diversification is critical to long-term success.

Cybersecurity Announcement

This summer, there has been a disturbing and unfortunate spike in cybercrime attempts experienced by our clients and many other people. Because of this rise, we wanted to take this opportunity to remind all of our clients to remain vigilant and cautious when receiving phone calls, text messages, and emails that appear to ask for a response. It is very important to confirm that you are receiving the message from a trusted source, and not someone impersonating them. When in doubt, always double check by finding a separate way to directly contact the source, whether it be your banking institution, your brokerage firm (Schwab or Fidelity), or even the team here at Litman Gregory Wealth Management.

Below we share articles that we have previously written with important reminders for protecting your personal and financial information.

If you have any questions, or suspect that you have been involved in a fraud attempt please reach out to your Advisor and/or our Client Service Team.

Insight Posts:

https://lgam.com/cybersecurity-awareness-month-protecting-against-imposter-scams/

https://lgam.com/3-tips-for-protecting-against-cybersecurity-risks/l

Save the Date for our 2024 Symposium and Reception

Please save the afternoon and evening of October 9th to join us for our Client Symposium and Reception, hosted at the beautiful Commonwealth Club of San Francisco with valet parking available.

The Symposium will include two presentations: The first will be a panel presentation on the financial markets, economy, and investment opportunities. The second will be a guest speaker on Artificial Intelligence, and an outlook for trends in AI.

The Reception will follow with a cocktail hour and then rooftop dinner stations with beautiful views of the Bay.

More details to follow soon.

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The Standard & Poor's 500 Composite Stock Price Index is a capitalization-weighted index of 500 stocks intended to be a representative sample of leading companies in leading industries within the U.S. economy. Stocks in the Index are chosen for market size, liquidity, and industry group representation.

The MSCI ACWI Index represents the performance of large- and mid-cap stocks across 23 developed and 24 emerging markets. The index covers 2,900 constituents across 11 sectors and approximately 85% of the free float-adjusted market capitalization in each market.

The MSCI EAFE Index is an equity index which captures large and mid-cap representation across 21 Developed Markets countries around the world, excluding the US and Canada. With 799 constituents, the index covers approximately 85% of the free float- adjusted market capitalization in each country.*

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The MSCI Emerging Markets Index consists of the following 23 emerging market country indexes: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Russia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates.

The Bloomberg U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar- denominated, fixed-rate taxable bond market.

The US High-Yield Market Index is a US Dollar-denominated index which measures the performance of high-yield debt issued by corporations domiciled in the US or Canada.

The ICE BofA US High Yield Index is market capitalization weighted and is designed to measure the performance of U.S. dollar denominated below investment grade (commonly referred to as "junk") corporate debt publicly issued in the U.S. domestic market.

The ICE U.S. Dollar Index is a geometrically-averaged calculation of six currencies weighted against the U.S. dollar.

The S&P/LSTA Leveraged Loan 100 Index (LL100) dates back to 2002 and is a daily tradable index for the U.S. market that seeks to mirror the market-weighted performance of the largest institutional leveraged loans, as determined by criteria. Its ticker on Bloomberg is SPBDLLB.

The MSCI Hedged Indexes include all of the securities and weights of each corresponding unhedged MSCI Parent Index, enabling investors to measure the impact of hedging currency, for all the constituents of the Parent Index.

Contact

Contact our team for more information on our services

415-461-8999 | INFORMATION@LGAM.COM | WWW.LGAM.COM