Second Quarter 2024 Investment Outlook

Diworsification

"For whatever reasons, markets now exhibit far more casino-like behavior than they did when I was young. The casino now resides in many homes and daily tempts the occupant."

– Warren Buffett – Berkshire Hathaway 2023 Annual Shareholder Letter

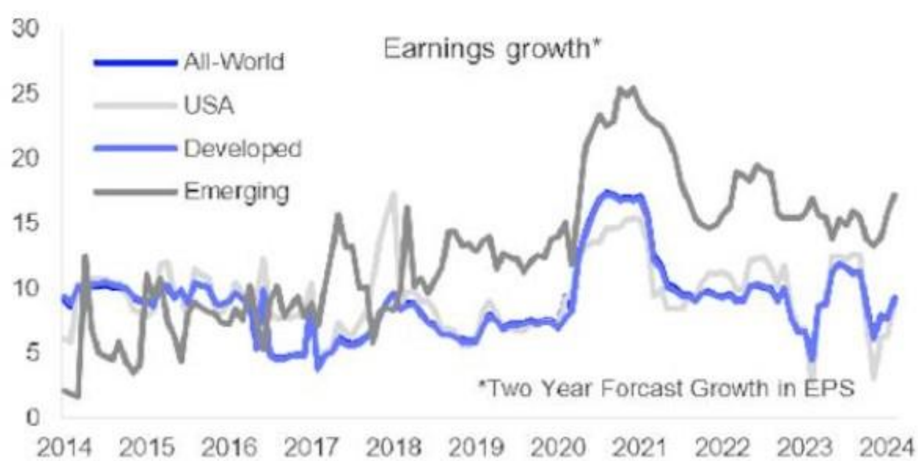
"The 1929 boom was, in fact, quite a narrow and selective one. It was a boom of the handful of stocks that figured in the daily calculations of the Dow Jones and New York Times indices, and that is why those well-publicized indexes were at a record highs. But it was emphatically not a boom of secondary stocks in which perhaps as many investors were interested."

– John Brooks – Once in Golconda - 1969

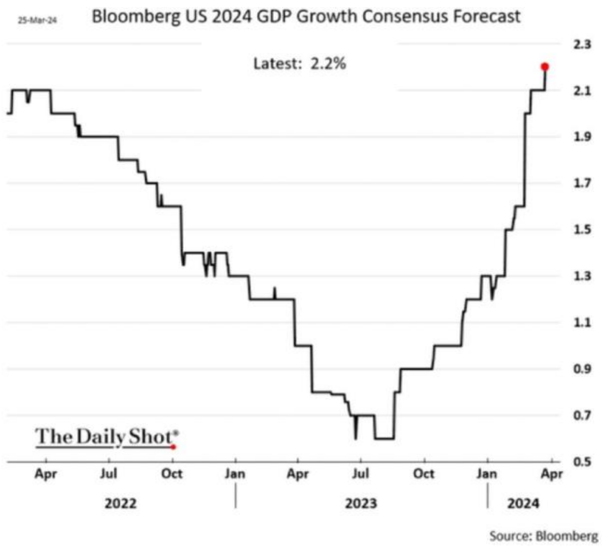
"The Nifty Fifty appeared to rise up from the ocean; it was as though all of the U.S. but Nebraska had sunk into the sea. The two-tier market really consisted of one tier and a lot of rubble down below. The delusion was that these companies were so good that it didn't matter what you paid for them; their inexorable growth would bail you out."

– Forbes Magazine, The Nifty Fifty Revisited - 1977

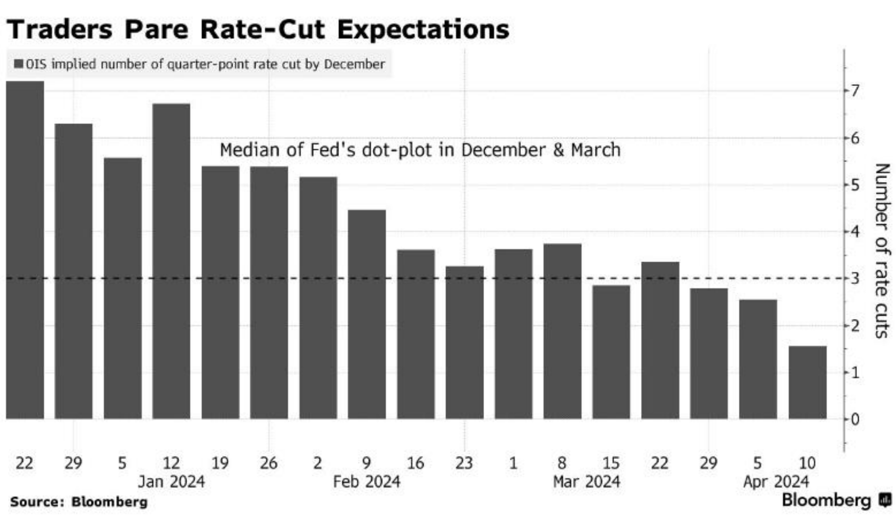
It has been an amazing five month run for U.S. stocks. From 11/1/23 to 3/31/24, the S&P 500 Index gained 26% and had its first back-to-back, double-digit quarterly return since 2012, a feat that has only happened eight times since 1950. There hasn't been a 2% stock market correction in over 150 days. The stock market gains were due to improvement in two important macro related factors. First, the earnings growth outlook has improved as shown in the next chart.



Second, the 2024 U.S. real GDP growth outlook has materially improved since last fall, about the time the U.S. stock market bottomed. This is quite a remarkable reversal in the economic growth outlook, which turned around investor confidence, which was at a low point last October.



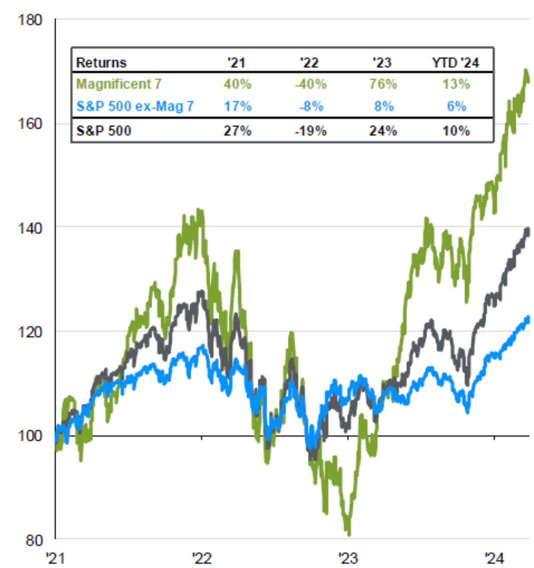
The improvement in the 2024 U.S. real GDP growth outlook, a resilient jobs market, and sticky inflation has dramatically changed market expectations for interest rate cuts during 2024. At the start of 2024, the market was expecting the Fed to cut interest rates six times during 2024 for a total of 1.50%. After the March CPI data was released on April 10th, which came in hotter than expected, interest rate cut expectations for 2024 fell dramatically to only one or two interest rate cuts or 0.25% to 0.50%. The market now sees only a 20% chance of an interest rate cut occurring in June and odds for a July interest rate cut have fallen below 50%.



The sizable 15% U.S. stock market rally during the last two months of 2023 was partly due to rising expectations the Fed would cut interest rates 1.50% during 2024. The broad U.S. stock market continued to rally another 10% during the first quarter of 2024 even though the market started priced out the majority of those interest rate cut expectations by 3/31/24. In its collective wisdom, the market is more confident the U.S. economy will avoid a recession and corporate earnings will be fine even if the Fed does not cut interest rates as many times or by as much as it previously expected.

After a 26% gain, it would be reasonable to think that a rising tide has lifted all boats and the majority of stocks have performed at a level similar to the broad market index but that has not been the case. The rally from last November has been a Have and Have Nots rally, with a select number of U.S. mega cap tech stocks, now referred to as the Magnificent 7 (a good Clash song by the way), generating a disproportionate amount of returns. Given that the Magnificent 7 (Amazon, Apple, Microsoft, Nvidia, Google, Meta (Facebook), Tesla) are also the largest weighted stocks in the passive benchmarks, they represent a disproportionate share of market returns and make the stock market advance over the past five months look stronger than it really has been for the average stock.

The next chart offers a good visual representation of how the current market dynamic has played out over the past several years. The green line represents returns for the Magnificent 7 and the blue line represents returns for the remaining 493 stocks in the S&P 500 Index. Since the November 2023 stock market low, notice how the green line has gone vertical and substantially outperformed the blue line. Since the start of 2023, the Magnificent 7 gained 99% while the remaining 493 stocks in the S&P 500 Index gained only 14%, proof of the Have and Have Nots market setup over the past 15 months.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

The degree of return disparity between the Magnificent 7 compared to the rest of the broad stock market was very extreme during 2023, when the Magnificent 7 as a group returned 76% while the remaining 493 stocks in the S&P 500 Index returned only 8%. During 2023, the entire S&P 500 Index returned 26% so any investor owning an index fund felt all was right in the world. However, if you owned anything outside of large/mega cap U.S. stocks, as is typical in most diversified balanced portfolios, then 2023 was not as great of a year as the major U.S. stock market indices would have indicated.

This return disparity trend continued during the first quarter of 2024. Investors owning an S&P 500 Index fund were once again pretty satisfied with a 10% return but if you owned any stocks outside of that index in a portfolio then returns were not as robust. For example, U.S. small caps returned 5.2%, emerging market stocks returned 2.4% and developed markets non-U.S. stocks returned 5.8%. These are decent returns for one quarter but well below the 13% return generated by the Magnificent 7.

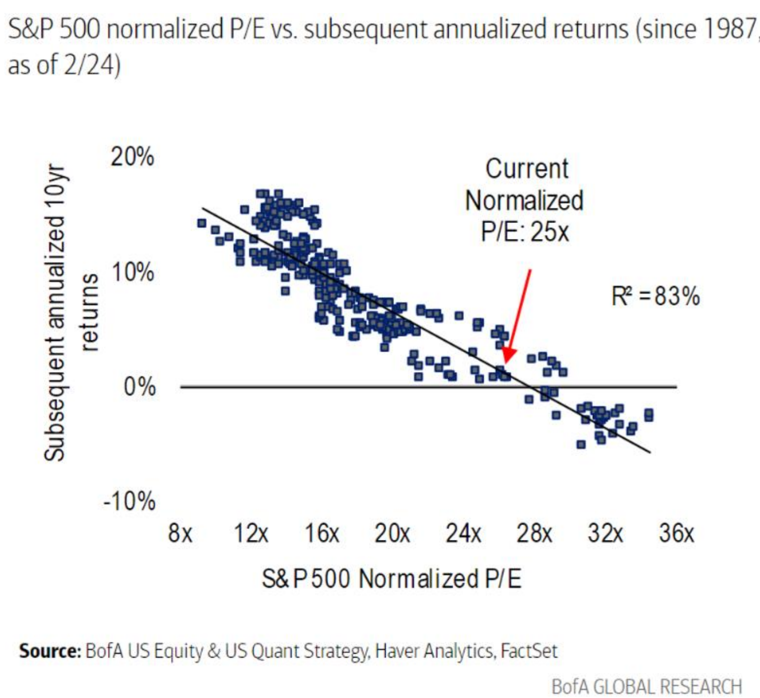
One of the foundational tenets of investing and portfolio management is the long-term benefits of diversification. Diversification is a concept of allocating a portfolio across major asset classes (stocks/bonds/cash) or sub-groups within an asset class (large cap stocks, small cap stocks, international stocks) such that when combined together in a portfolio, the portfolio has a lower return volatility profile but at the same time a wider set of return opportunities. A simple way to explain diversification is via the famous phrase don't put all your eggs in one basket. The concept of diversification falls under Modern Portfolio Theory, which was developed by Harry Markowitz when he was a 24 year old graduate student at the University of Chicago. Four decades later, in 1990, Markowitz was awarded a Nobel Prize for his groundbreaking research. Markowitz's idea was there is a trade-off between return on the average in the long run and the variability of return. Nowadays, market practitioners call it the risk/return trade-off. In the long run, an investor can achieve higher returns but it requires accepting higher levels of risk to do so. By allocating across different asset types that have different risk/return profiles, an investor can reduce overall portfolio risk. The development of balanced portfolios, which typically include stocks/bonds/cash and sometimes other assets such as real estate, commodities, and alternative investments, were based off of Markowitz's research work.

The long-term benefits of portfolio diversification are tried and true but there are periods of time when diversification feels more like diworsification and we are now in such a time. The term diworsification was originally coined by famous Fidelity Investments portfolio manager Peter Lynch in his 1989 book, "One Up On Wall Street". Diworsification happens when a narrow group of financial assets generates outsized returns and having exposure to other assets causes a portfolio to have lagging performance and an investor feels like they are missing out on higher returns. Such is the market dynamic today with the Magnificent 7 massively outperforming everything else. The current market dynamic has happened several times in history. The opening quotes of this Investment Outlook were selected specifically to highlight this fact. Three major stock market tops were the right before the 1929 crash, during the early 1970s period called the Nifty 50 era, and during the Tech Bubble of 1999-2000 when tech related stocks massively outperformed everything else. The news headlines during those times raved about how well the stock market was performing just as the headlines do today. During times of outsized returns, investors begin to exhibit poor decision making by chasing and crowding into the market leaders because they become a must-have investment, regardless of the valuations paid for the stock. The same is true today for stocks related to the artificial intelligence mania.

The next chart shows the size of the Top 10% of stocks in the U.S. stock market going back to 1925. The U.S. stocks market is currently in a rare market setup with the Top 10% of stocks currently at levels that existed right before the 1929 stock market crash and the Tech Bubble peak of 1999. This chart is not being presented to suggest a stock market crash will occur as happened in those two prior time periods but it is a good visual representation of how disproportionately large (nearly 75%) the top 10% of stocks based on market cap have become of the total U.S. stock market. In the prior two incidences, the top 10% of stocks eventually fell back to the 100 year median historical level (63%) but it can take several years for that to happen. Looking at this chart, it should be obvious that the current massive outperformance of the Magnificent 7 can't be sustained relative to all other stocks globally. At some point there will be a reversion, just as there always has been in the past when the broad stock market got too much out of kilter and weight imbalances became extreme.

During extreme periods when a narrow group of stocks are dominating market returns, it is important to remember that diworsification is a rare event and that positive aspects of diversification will ultimately prevail and deliver valuable risk and return benefits to an investor over time.

There is another important investment tenet that has held true over time and that is the idea that paying higher valuations for financial assets today usually means that future returns will be lower. Conversely, you increase the odds of achieving higher future returns if you purchase assets today with lower valuation profiles. This next chart has been shown in previous Investment Outlooks but it carries a strong message and is worth presenting again.



The vertical axis represents 10-year annualized S&P 500 Index returns and the horizontal axis represents valuations using the normalized price/earnings (PE) ratio. Each square in the chart represents an actual 10-year annualized return for the S&P 500 Index paired with the valuation level of the S&P 500 Index at the start of each 10-year annualized period. Notice the best fit line is downward sloping to the right, which means future returns are usually lower when current valuations are higher. In addition, notice how there are fewer observations of higher future returns when starting valuation levels are higher (PE levels of 20x or higher) compared to more observations of 10-year annualized returns of between 10% to 20% when the starting PE level at the time of purchase is 16X or lower. The arrow shows the 3/31/24 normalized PE valuation profile of the S&P 500 Index was 25X. Should the next 10-years play out like past periods when the starting S&P 500 Index PE valuation profile was at a similar level, then investors buying the S&P 500 Index today may experience only low single-digit annualized returns over the next 10 years out to March 2034.

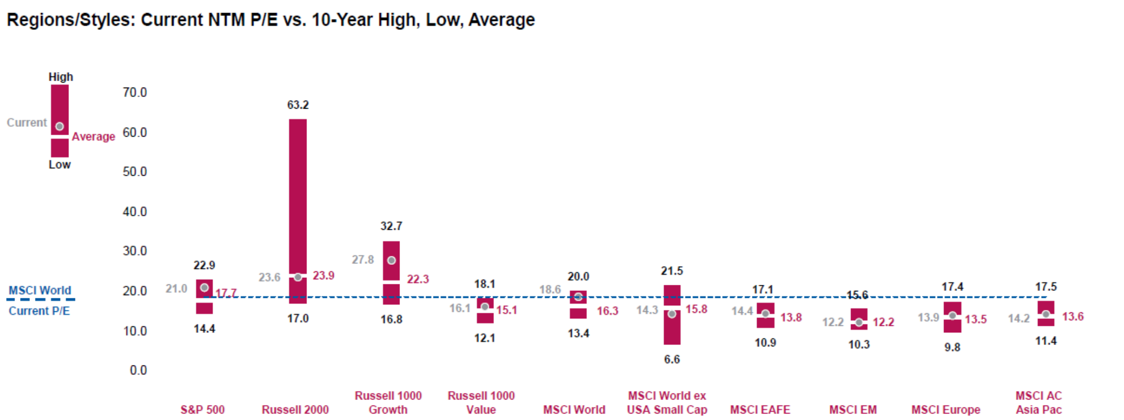
The next chart provides a breakdown of forward PE valuations within the S&P 500 Index. The Top 10 largest stocks, representing 33% of the weight of the S&P 500 Index, trade at a 28.4X PE based on the next 12-month forward earnings or 40% above the long-term average (since 1996) of 20.3X for these 10 stocks. The remaining 490 stocks have an 18.5X PE profile or 17% higher than the long-term 15.7X average PE. The entire S&P 500 Index has a forward PE of 21.0X, which is 27% above its long-term 16.5X average PE. This data shows the Top 10 stocks in the S&P 500 Index are the primary reason U.S. large cap stocks currently trade at high valuations and mostly due to the high valuations of the Magnificent 7.

P/E ratio of the top 10 and remaining stocks in the S&P 500
Next 12 months, 1996 - present

	Current	Average	% of avg.
Top 10	28.4x	20.3x	140%
Remaining stocks	18.3x	15.7x	117%
S&P 500	21.0x	16.5x	127%

Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

The next chart compares the forward PE valuation profiles of all global equities as of 3/31/24, both against their own trailing 10-year range (red bar) and to each other. U.S. stocks are to the left and non-U.S. stocks to the right of the MSCI World Index. Grey numbers are the forward 1-year PE valuation profiles as of 3/31/24. For example, the S&P 500 Index currently has a 21.0X forward PE profile. The highest PE valuation globally is the Russell 1000 Growth Index at 27.8X, an index where the Magnificent 7 are 49% of the index weight. The dashed blue line is the current PE valuation profile (18.6X) of the MSCI World Index, which represents all global stocks. Notice how valuations for the U.S. stock market indices on the left are all above the dashed blue line whereas all of the non-U.S. indices valuation profiles are all below the dashed blue line. The MSCI Emerging Markets Index currently has the lowest forward PE profile at only 12.2X.



	S&P 500	Russell 2000	Russell 1000 Growth	Russell 1000 Value	MSCI World	MSCI World ex USA Small Cap	MSCI EAFE	MSCI EM	MSCI Europe	MSCI AC Asia Pac
High Date	8/20	6/20	8/20	3/21	8/20	8/20	8/20	1/21	6/20	1/21
Low Date	12/18	9/22	2/16	9/22	12/18	9/22	9/22	10/18	9/22	12/18

Source: FactSet as of 3/31/24. NTM P/E is market price per share divided by expected earnings per share over the next twelve months. Data provided is for informational use only. See end of report for important additional information. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

When taking into consideration all of the data shown in the prior three charts, it should become evident that the odds of capturing higher future returns will increase if an investor diversifies and increases or at least maintains exposure to stocks beyond the S&P 500 Index and the mega cap tech stocks currently dominating global stock returns. The probability of generating higher future returns will decline if an investor increases the weight to the S&P 500 Index or the Russell 1000 Growth Index and the stocks that have the biggest weights in both of those indices, which trade at valuation profiles well above the rest of global stock opportunities. As sexy and thrilling as it may currently feel, avoid the siren song of diworsification and stick with the long-term, time-tested, and Nobel Prize validated benefits of diversification. It may not feel that way now, but in 10 years you will be very happy you did.

Summary

Most investors with broadly diversified, global balanced portfolios are currently experiencing diworsification, a rare investing malady caused when a narrow segment of financial assets produces a disproportionate amount of market returns. When diworsification hits, other asset returns look lame in comparison. U.S. mega cap techs stocks have dominated global equity returns over the past fifteen months and the return spread is extreme. Since these stocks have the largest weights in passive benchmarks like the S&P 500 Index, news headlines reporting strong U.S. stock performance don't provide a complete and clear picture of broad market returns. There have been previous periods in stock market history where diworsification occurred but it eventually ended and the time tested benefits of diversification came back to the fore. Diversification has always had an investor's back and this time will be no different.

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IMPORTANT DISCLAIMER: