April 18, 2024

Dear Clients and Partners:

After a strong Q4 2023 the equity markets kept right at it into Q1 2024. Bonds had a harder time with only the shortest-term showing a positive return:

Equities Q124

YTD

	Value	Blend	Growth
Large	9.0%	10.6%	11.4%
Mid	8.2%	8.6%	9.5%
Small	2.9%	5.2%	7.6%

Bonds Q124

	Yield		Return
U.S. Treasuries	3/31/2024	12/31/2023	2024 YTD
2-Year	4.59%	4.23%	0.24%
5-Year	4.21%	3.84%	-0.78%
TIPS	1.85%	1.72%	-0.08%
10-Year	4.20%	3.88%	-1.67%
30-Year	4.34%	4.03%	-4.06%

Source: JP Morgan

On the equity side two themes have continued:

- **Growth Leads**: Once again Growth has outperformed Value. After significantly underperforming in 2022, Growth has led the way for over a year

- **Large Cap Leads**: Large Cap has continued to outperform Mid and Small Cap.

Bonds have struggled some in 2024 as progress on inflation has slowed down. While we are nowhere near the peak in inflation, getting to the 2% threshold looks like it may take longer. Heading into 2024 the expectations were for around seven cuts of 0.25% each. That would take the Fed's rate down to around 3% which most people consider to be a "neutral" rate. A neutral rate is one that is neither stimulative nor restrictive to the economy. Those expectations for seven cuts have come down to around two cuts in 2024.

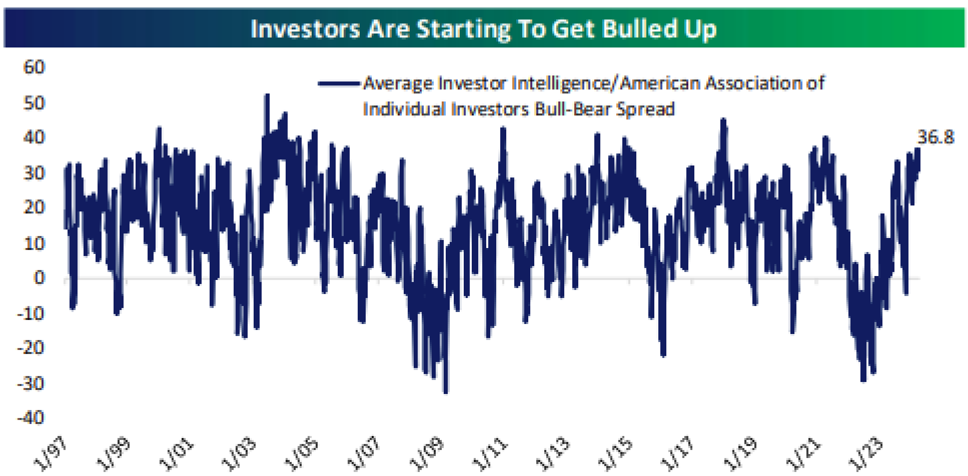
The equity markets have not been bothered by decreasing rate cut expectations as the soft landing scenario (no recession, inflation recedes) has gained steam. In many ways it looks like the economy is actually re-accelerating which is putting pressure again on inflation and negatively affecting bond performance.

Q2 2024

We always like to address where the markets stand heading into a given quarter. A single quarter's performance isn't a primary focus for us, but it is a common question.

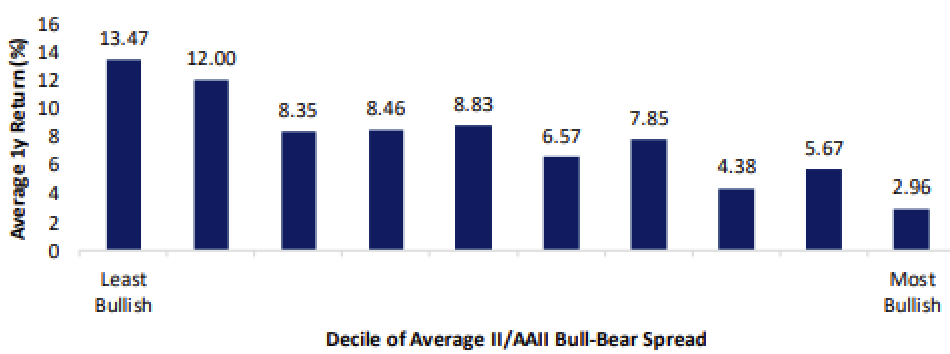
Markets are now priced around 21x forward earnings. These earnings are expected to grow over 10% in 2024 (earnings were roughly flat in 2023). Historically markets trade around 18x forward earnings.

As sentiment follows price, people are generally more excited after strong market returns and least excited after big pullbacks. This is what we see now. Currently market sentiment is in the strongest decile meaning more people feel bullish than bearish:



Source: Bespoke Research

As would be expected, the returns following the most bullish periods tend to be subpar and very strong when people are bearish. The below shows returns by decile:



Source: Bespoke Research

We are currently in the far right decile (most bullish sentiment). There are many reasons that people feel bullish right now:

- The economy has held in much better than almost anyone, ourselves included, would have thought

- Inflation is coming down although slower than one would like, especially lately

- There are real interest rates now. Earning 5% in a Money Market Fund and even more across different bond classes is real money that is being delivered, every month, into consumers' pockets. The offset is higher interest rates contribute to the large fiscal deficits our country is running. The government will likely kick that can down the road until they are forced to address it

- Stocks are up, meaning people are wealthier, and it is natural to be more bullish when you are wealthier

- The AI revolution does appear to be very real. How long it takes is up for interpretation, but this is real technology with real use cases that will reverberate across businesses and the economy

We certainly see the bullish case. However, pricing and sentiment do matter, so some sort of consolidation or pullback over the next year is very likely. As they say, nothing grows to the moon. That saying seems particularly relevant in the context of today's market.

AI and Growth

In many ways, it feels like the country and the world has been "stuck in a rut" for awhile. There are a lot of obvious reasons for feeling this way. The world feels unsettled. Covid threw a wrench in everything that we are not fully recovered from. There are multiple wars going on, none of which currently affect the US directly but have the chance to. Inflation is incredibly unsettling and a real mental burden.

The mental impact of inflation is something that is not really talked about enough. In general, most people who talk about money will fixate on the year over year inflation rate. But inflation like anything else is cumulative. The broad basket inflation figure is up 20% or so post-Covid. That is a very real cost to all of us. We are reminded of it almost every day when we buy gas, or go to the grocery store, etc. We will work our way through inflation and adjust, but we should not understate the damage it creates.

This leads us to why the AI revolution is so important. Human beings need to grow, and we need to push things forward. Stagnation creates a lot of issues mentally and physically. Many of the smartest people in the world have spent the last 10-20 years focused on optimizing advertising yields. The AI revolution is the next big push for us as humans and has the potential to redirect all of that human talent towards creating real efficiencies for the human race. It will create a lot of disruption as every major technological advancement does, but that is very likely to be offset by all of the advantages.

Critically it also gives us a "push," and it gives creators a purpose. It will also give everyone that sense of wonder that comes along with each new major technological improvement. It will likely also free up a lot of mundane tasks that can be filled with more productive things whether at work or at home. We need a "push" to get us out of the "rut". We believe this can be that push.

And this leads us back to investing and capturing that growth.

Large Cap

Everyone knows the concept of "more risk, more return". Traditionally this has meant you will see greater returns for certain asset classes. Staying just in the US, for example, traditional finance would say Small Caps should produce the highest returns because they are most risky with Mid Caps second best and Large Caps third best.

The last decade has in no way corresponded with this traditional financial concept. In fact, it is exactly backwards:

10-year annualized

	Value	Blend	Growth
Large	9.1%	13.0%	16.1%
Mid	8.7%	10.1%	11.5%
Small	7.0%	7.8%	8.1%

Source: JP Morgan

10 years is a long enough period of this being backwards that it should be examined. Large Cap has, generally, always been our largest exposure. We also tend to be more US focused than Internationally, which we have discussed at length historically.

We believe there are a few reasons for Large Cap's dominance over the past decade:

- First, performance begets performance. The markets are simply a collection of buyers and sellers. With the rise of index funds, it is very easy to simply buy the S&P500. We see this in client portfolios. Whereas traditionally many people's 401(k)s would have been in a mix of different funds (or a target date fund), it is now much more common to see someone with just a S&P500 Index fund. This makes sense; people look at returns (like the above) and say why not just buy the one that has done the best and has the lowest risk. This means the "flows" are on the side of Large Caps, and that is unlikely to change anytime soon

- Second, Large Caps are generally better businesses. Especially the Mega Caps. The world has never seen businesses with network effects and economic moats like MSFT, GOOG, AMZN, etc. The ability to not only be able to have extremely high margins but also be able to re-invest those at similar rates is somewhat unprecedented

- Third, because these online business models often lend themselves to offer cheaper prices or better services for consumers, they take the majority of the market share making competition very challenging. For example AMZN can ship cheaper per unit the more customers they serve, and Google search gets better the more people that use it. It also makes antitrust very difficult as our laws are focused on consumer harm, and these companies tend to make things cheaper

For example, in tech, there are really only three companies that can provide cloud computing at scale (MSFT, AMZN, GOOG). It would take hundreds of billions of dollars to replicate what they have built. They are already growing almost exponentially since they can reinvest their tens of billions of dollars of annual profits. This also goes across most industries. The big are getting bigger and more entrenched with higher returns as their fixed costs are spread out across more customers. In banking, JP Morgan continues to grow while the regionals struggle. In processing, Visa and Mastercard continue to grow with no real competition in sight. This is evidenced by the fact that if you had $100B you likely couldn't replicate the networks Visa and Mastercard have. In Industrials, most key products are dominated now by one or two large firms. Same with Medical Devices or Biologics, Health Care Insurers, etc. The list goes on and on

- Finally, as the big companies get bigger they are also able to outcompete on hiring. The big tech companies can offer total compensation that even twenty years ago was unimaginable. This is similar across most industries. The better your business is, the better the compensation and, generally, the better your hiring will be. Many people will want to work for start-ups and small companies as the ability to affect change is greater, personal growth can be greater, etc. But it leans towards the large companies in terms of hiring talent

Eventually, as we have seen, almost every large company runs into significant issues. The list of the largest companies from even 20 years ago is drastically different from today. But, critically, the ones that have replaced them are better, larger, stronger businesses. AI is highly likely to disrupt many businesses, but the ones that replace them will likely be even better. And they are likely to be Large Caps. And they are likely to be Large Cap Growth companies. This would play into continued Large Cap out-performance.

We will continue to study this. Expect to hear a lot more from us on this topic.

Conclusion

A strong Q1 2024 followed a strong Q4 2023 which has led to rising bullishness. We are mindful of the market's likely need to consolidate over the next year but continue to be very excited about the future, including whether AI can give us the next big "push" forward.

We look forward to speaking with you all soon.

Regards,
Your Fortis Team

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