Opus CAPITAL MANAGEMENT

Rationalizing the Rally

Quick Look

- Over the last five months, U.S. Large Cap stocks are up over 25%. Among rolling historical five-month periods looking back 40 years, that is in the 99th percentile of returns.
- The combination of disinflation, economic resiliency, easing financial conditions, and investor exuberance have all contributed to the recent rally in stocks.
- The rate of inflation has been declining since its peak in June 2022. Stocks perform best in disinflationary periods.
- Economic growth continues to improve, and growth for 2024 is now forecast to exceed 2%. Stocks perform best during low and rising economic growth.
- Financial conditions began loosening in October 2022, which, not coincidentally, was the same month stocks began their recovering from their 25% drawdown.
- Investors are banking on double-digit earnings growth in 2024 and 2025, led by the optimism that generative AI-related productivity gains will lead to higher profits.
- All-time highs for stock market indices are not, on their own, a reason to sell stocks. Historically, stocks have traded at all-time highs nearly 30% of the time.

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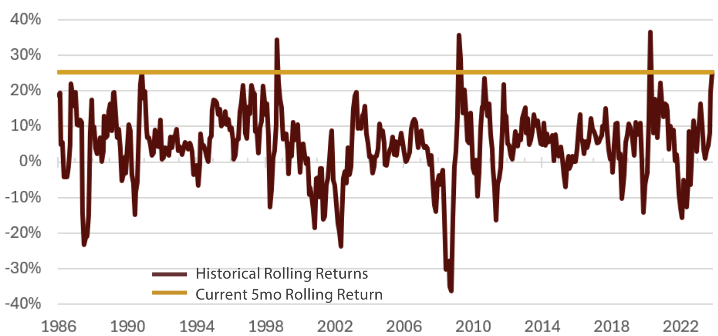
Opus Capital is an evidenced-based investment advisory firm driven by our overriding mission to help people. We believe the marriage of comprehensive financial planning + statistically proven investment principles creates the clearest roadmap to long-term success.

We are independent and transparent in all aspects of investment management decision making and financial planning. We selectively partner with like-minded individuals and families, endowments, foundations, and 401(k) plans in over 30 states.

Quarterly Investment Letter, Q1 2024

Perhaps you have noticed, but U.S. stocks are on quite a heater! Over the last five months, U.S. Large Cap stocks are up over 25%. Among rolling historical five-month periods looking back 40 years, that is 99th percentile good. The S&P 500 Index has blasted above the 5,000 milestone, while the NASDAQ is back above 16,000, as both indices spent the quarter marking fresh all-time highs. The Dow Jones Industrial Average is on the verge of eclipsing 40,000 for the first time in its history. All three major indices have more than doubled since their March 2020 lows. For U.S. stock investors, it has all been really, really good.

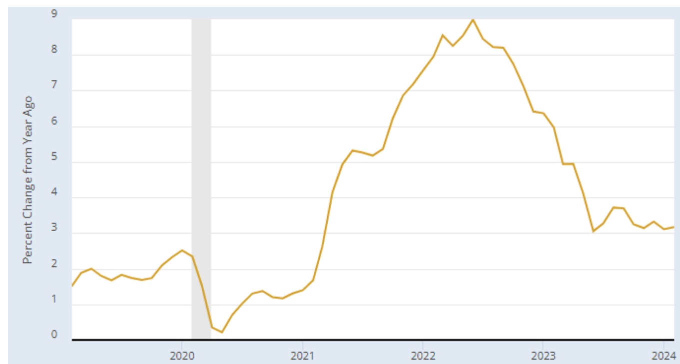
Historical S&P 500 Rolling Returns (5-month)



Source: Morningstar

80% of those periods, with annualized average gains of 15%. Conversely, the periods in which inflation is above 5% and rising were the worst investing environments, with stocks down an average of -8% annualized and losses occurring 78% of the time. Bonds fare almost equally as bad, down -6% annualized in hot inflationary periods[1]. These historical findings correlate with both the Year 2022 drawdown, which was spurred from unexpectedly hot inflation, as well as the strong recovery in stocks since during this current disinflationary period.

Consumer Price Index Y/Y



Source: FRED

The Year 2022 market lows, which saw a 25% drawdown for stocks, are now 18 months behind us. Since then, stocks are higher by more than 40%, with the majority of those gains coming in the past five months. Yes, one could argue the market seems a bit stretched (the S&P 500 Index is 14% above its 200-day moving average), but rather than playing the skeptic, let's try to provide some rationale to the market's rally.

1. Disinflation: Not to be confused with deflation, disinflation is simply a decrease in the inflation rate. Prices are still rising, but they are now rising at a 3.2% annualized pace rather than the 9% annualized peak in June 2022. In the chart in the next column, you can see that since CPI's peak in June 2022, the inflation rate has been declining, so therefore, we can categorize the last seven quarters as a disinflationary period, which historically, have been the best environment for stock returns. Since 1925, the U.S. has experienced 20 periods of disinflation. Stocks are higher in

While the current environment remains directionally disinflationary, year-over-year headline inflation actually bottomed last June and has been moving sideways over the past eight months. Inflationary data continues to be a primary driver of equity markets, as the spike in inflation during the summer months of last year roiled stock indices, just as the modest alleviation of inflationary pressures over the past five months has contributed to its rally. Further market gains will likely be buoyed by continued disinflation towards the Fed's projected 2.4% for PCE inflation by year-end, in route to returning to their long-run 2% target.

2. Economic Resiliency: The consensus opinion in 2022 was that to achieve disinflation, it would require a trade-off in economic growth. Though widely expected, a recession has not materialized. In fact, the opposite has occurred: since year-over-year real GDP fell to 0.6% in the 4th quarter of 2022, it has since seen incremental improvement each quarter, and now

U.S. EQUITY RETURNS (%)

As of 3/31/2024	Q1 2024	1-Year	3-Year	5-Year	10-Year
S&P 500	10.6	29.9	11.5	15.1	13.0
Russell 1000 (Large Cap) Growth	11.4	39.0	12.5	18.5	16.0
Russell 1000 (Large Cap) Value	9.0	20.3	8.1	10.3	9.0
Russell 2000	5.2	19.7	-0.1	8.1	7.6
Russell 2000 (Small Cap) Growth	7.6	20.4	-2.7	7.4	7.9
Russell 2000 (Small Cap) Value	2.9	18.8	2.2	8.2	6.9

Source: Morningstar

Continued from page 2 . . .

stands at 3.1%. Historically, economic recovery periods (i.e. low and rising economic growth) have been the best environment for stock market indices, with stocks up 78% of the time during these 18 occurrences since 1925[2]. Annualized returns during recovery periods are 13%, even exceeding the annualized returns during boom times (high and rising growth).

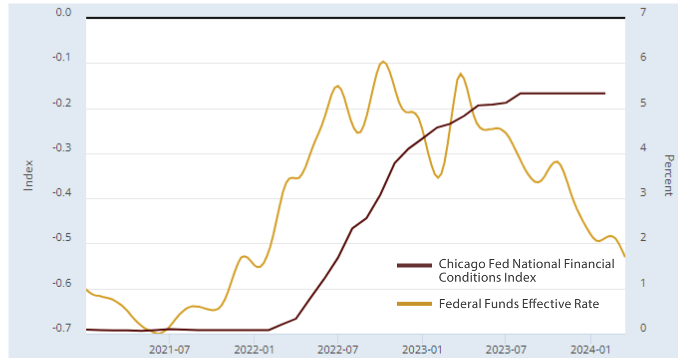
2024 U.S. GDP Growth Consensus Forecast

Source: The Daily Shot

As can be seen in the chart above, projected economic growth has improved markedly since last summer, at which point the consensus was that the expected recession was simply delayed into 2024. Instead, economic growth for this year is now forecast to exceed 2%, while recession odds have dropped from 55% to 35%, according to latest Bloomberg monthly survey of economists. Absent a rise in unemployment, consumer spending, which accounts for 70% of U.S. economic activity, will likely continue its resiliency given positive and rising real wage growth and overall consumer balance sheet strength.

3. Improving Financial Conditions: While monetary policy technically remains in a tightening cycle, the November 2023 Fed meeting marked a turning point in policy direction, where Fed Chair Powell intimated that rate increases were likely over. One can trace the origins of the current five-month stock rally to Powell's pivot, as markets turned their attention to the onset and frequency of Fed rate cuts. Historically, stocks have produced more than double the annualized gains during monetary loosening as compared to tightening phases, and markets have been front-running the impending policy change. Interestingly, despite raising their inflation and growth estimates for 2024, the Fed maintained its projection for three rate cuts this year, with the most likely scenario being an initial rate cut in June, followed by cuts on a quarterly schedule to sidestep the appearance of political persuasion in front of the November election.

Financial Conditions vs Fed Funds Rate



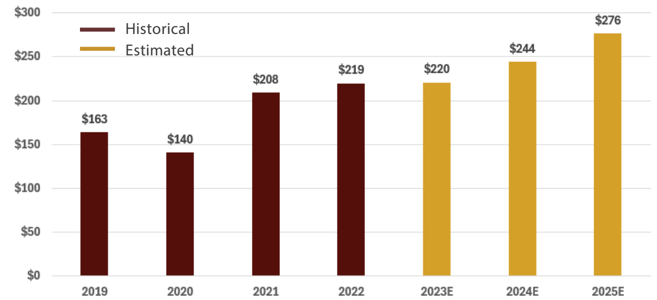
Source: FRED

The Chicago Fed's National Financial Conditions Index is a weighted average of more than 100 indicators designed to capture the pricing of risk, credit, and leverage in financial markets. Per the chart above, financial conditions began loosening in October 2022, which, not coincidentally, was the same month stocks began their recovery. Since that time, conditions have become even more accommodative, despite Fed rate hikes of another 2%. The Index currently suggests that financial conditions have eased to the level they were before the Fed began tightening in 2022, fully digesting 5.25% of rate hikes. That is a striking statistic, but accurately reflective of the current credit spreads and implied options volatility pricing, which are both back to pre-pandemic lows. At his most recent press conference, Powell downplayed the relevance of the various financial conditions measurements, but it will be interesting to see if it alters the Fed's planned course of action. Does the economy really need three rate cuts, potentially running the risk of fueling demand-side inflation?

4. Investor Exuberance: On November 30, 2022, OpenAI released a demo of ChatGPT, captivating investors on the potential of artificial intelligence and its impact on business and productivity. Proponents of AI believe the technology is every bit as revolutionary as the internet, and enthusiasm around its potential helps, in large part, explain the outsized performance gains of mega-cap tech stocks in 2023 in relation to the other S&P 500 constituents. As generative AI technology takes off, there has a feverish demand for chips that can handle the processing power required of these new programs. Stock prices for seemingly all chipmakers have been surging. Nvidia has been the shining star of the AI-boom, and its soaring stock price is arguably without historic precedent, given its size of the company. Though valuations for Nvidia are sky high, earnings quadrupled over the past four quarters, and are projected to double again over the next four quarters. After three consecutive years of stagnant S&P 500 operating earnings, investors are banking on double-digit earnings growth in 2024 and 2025, led by the optimism that tech sector AI-related productivity gains will come to fruition.

1,2 Source: "Regime-Based Investing" Henry Neville, CFA, Man Institute (2024)

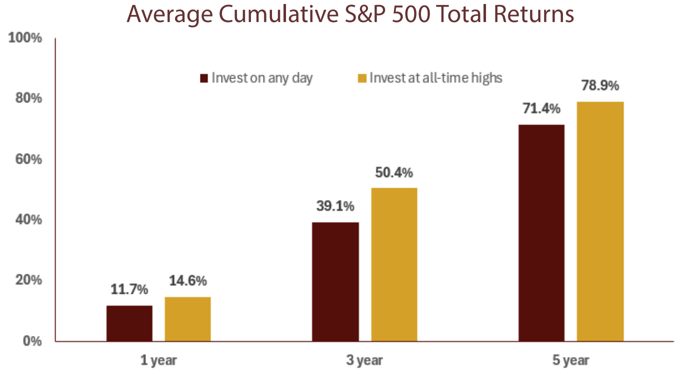
S&P 500 Bottom-Up EPS Actuals & Estimates



Source: FactSet

Only time will tell if the enthusiasm around generative AI is justified or irrational. Aside from that pocket of the market – which is a large pocket, admittedly – it is difficult to classify overall investor sentiment as euphoric. While there have been meaningful flows into Tech stocks, the broad stock market has seen net outflows from equity mutual funds and ETFs over the past two years. Yes, stocks are again at all-time highs, but all-time highs are not necessarily a threat on their own. Historically, stocks have traded at all-time highs nearly 30% of the time. Perhaps surprisingly, the 1-, 3-, and 5-year forward returns are higher during all-time highs than as compared to the overall track record of the U.S. stock market.

Average Cumulative S&P 500 Total Returns



Source: JPM & AWOCS

Through the first quarter of 2024, gains within the S&P 500 Index have been more widespread amongst constituents than what we saw in 2023, with 25% of S&P 500 members now at 52-week highs and 80% of members above their 200-day moving average. Cyclical stocks have outperformed defensive stocks, which is in line with the disinflation + improving growth combo outlined above.

INTERNATIONAL RETURNS (%)

As of 3/31/2024	Q1 2024	1-Year	3-Year	5-Year	10-Year
Int'l Developed ex US	5.8	15.3	4.8	7.3	4.8
Emerging Markets	2.4	8.2	-5.1	2.2	3.0

Source: Morningstar

Circling back to the strength of the five-month rally, only three other rolling five-month time periods have been stronger over the past 40 years. Those were January 1999, August 2009, and August 2020, all of which are noteworthy investing periods. 1999 was the heart of Dot-Com, though the bubble was still 18 months from bursting. August 2009 was the rising from the ashes from the Great Financial Crisis. Those initial gains were, in hindsight, the green shoots of an early-stage bull market. August 2020 was the rally following the COVID-precipitated market swoon. While the five-year forward returns from this small sample were mixed (starting valuations eventually mattered), one-year forward returns all provided continued strong returns. In regards to valuations, stocks are currently priced in between the goal posts that were the bargain prices of 2009 and the irrational exuberance of 1999.

Forward Returns Following +25% 5mo Rolling Periods (%)

	1yr	3yr	5yr	CAPE Ratio
1/31/1999	10.4	-2.9	-1.0	41x
8/31/2009	14.3	14.6	16.9	18x
8/31/2020	25.1	10.5	-	31x
3/31/2024	-	-	-	34x

Source: Morningstar

Looking ahead, with the admission that the outcomes are wide and the future is unknowable, the most obvious stumbling blocks preventing further gains might be a reversal of the positive trends outlined above. Progress towards the Fed's 2% inflationary target could stall, deterring the Fed from starting rate cuts. Job losses could upend recent economic strength and increase recessionary odds. Underwhelming profitability from AI could lead to a retrenchment in mega-cap tech, challenging further equity index advancement without participation from its largest sector. Diversification across factor-based investment styles, non U.S. equity markets, and bonds, which hold much greater appeal than in recent years given their prevailing yields, could help to somewhat mitigate any corresponding travails should U.S. stock momentum dissipate.

FIXED INCOME RETURNS (%)

As of 3/31/2024	Q1 2024	1-Year	3-Year	5-Year	10-Year
Aggregate Bond	-0.8	1.7	-2.5	0.4	1.5
Muni	0.1	3.3	-0.4	1.4	2.1
Int'l Bonds	-1.5	2.2	-3.5	-0.6	0.4
High-Yield	1.7	10.2	1.8	3.4	3.4
Short-Term	0.9	4.9	0.4	1.5	1.5
90-Day T-Bill	1.4	5.6	3.0	2.2	1.5

Source: Morningstar

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