As we anticipated in our April Market Update, last month proved to be challenging for equity and fixed income markets alike. The S&P 500 fell 4.1 percent and the Bloomberg Aggregate Bond index declined 2.3 percent – the damage to bond markets happened earlier in the month and was followed by a selloff in equities that continued right through to April 30th. The equity declines were broad and extended to midcap, small cap, and international stocks, as well as every sector of the S&P 500 save utilities.

Despite the pull back, our team remains cautiously optimistic about 2024 returns for both stocks and bonds. As noted in this month's On the Markets, Ellen Zenter, Morgan Stanley's chief US economist, "raised her 2024 and 2025 estimates for real activity by 70 basis points each, to 2.3% and 2.1%." In other words, she is revising her economic growth predictions upwards. We continue to believe that inflation will prove stickier, and rates will remain higher for longer, than many expect. That said, we also think earnings and real growth may surprise to the upside too. That's not a terrible environment for stocks, though it may suggest benefits to shifting from more traditional fixed income exposures toward floating rate and inflation protected bonds.

This month, our Global Investment Committee " implemented a tactical portfolio guidance change, increasing focus on large-cap quality stocks and real assets (energy and power-generation infrastructure) while eliminating exposure to small caps and reducing exposure to duration. Investment themes, the new inflation regime and diversification remain our focus." We agree with some of this and disagree with other parts. We generally think Morgan Stanley research has the right idea with regard to duration. Higher-for-longer rates with more inflation volatility will mean optimized portfolios require more income producing investments with less interest rate sensitivity (duration means sensitivity to interest rates changes, not a length of time, in fixed income mathematics.) Especially for more conservative investors – for example retirees living off portfolio income – that means a fundamental strategic shift with regard to fixed income allocations.

On Tuesday April 30th, we had a conference call with a senior portfolio specialist at Vanguard, Elizabeth (Liz) Muirhead, CFA, who works on their inflation protected bond team. She formulated Vanguard's thinking differently but comes to a very similar conclusion: more aggressive portfolios have a natural inflation protection as a direct consequence of their large equity allocations; but as portfolios grow more conservative and equity allocations shrink, they become more inflation sensitive unless steps are taken to introduce other types of fixed-income investments. Consequently, Vanguard allocates more generously to inflation protected bonds as a percentage of the fixed income portfolio the greater the overall fixed income allocation. For our team, that translates not just to treasury inflation protected securities, but also to floating rate bonds, private credit and real assets. To be clear, this does not mean we don't want to own traditional bonds as treasuries and high-quality municipals are still the best hedge we have against recessions and economic decelerations – which over a long enough period of time are certain to occur. Rather, we mean that we need to strategically diversify within fixed income because we believe inflation variability will remain an issue going forward.

On the other hand, we are not as confident in the GIC's call to underweight small caps. Earnings season so far has been good – and not just for the magnificent 7 stocks. So far, 80 percent of the S&P 500 has reported earnings with 77% of companies beating expectations with an average beat of 7.5 percent. Those are about average numbers in the last five years. That said, it looks like earnings growth for the quarter is going the highest since late 2022. Furthermore, earnings growth seems to be accelerating, not decelerating. Earnings growth was also good in the small cap space, though the market seems to be pricing small cap stocks only with regard to the chance of fed cuts, and with no regard to underlying earnings.

For this reason, we are more in the camp of Richard Bernstein with regard to equity allocations – we expect a broadening of the markets – not further narrowing into mega-caps. In other words, we favor everything but the magnificent 7, which would include allocations to small and midcap stocks. Bernstein makes the point with a simple chart that shows all the companies expected to potentially grow earnings by 25% or more in the next 12 months globally – of those, only 3 of the 140 are magnificent 7 companies. The magnificent 7 companies however, trade at prices that are roughly twice as expensive in relation to earnings as the average of the other 137. While it's not just the magnificent 7 growing their earnings, only the magnificent 7 appears to have been rewarded. We think most investors today are chasing the momentum trade – the magnificent 7 whose multiples have already expanded dramatically – while ignoring the earnings growth and return potential of literally thousands of other opportunities.

As always, if you have any questions or concerns, please don't hesitate to reach out to any member of the team.

Morgan Stanley Wealth Management
2000 Westchester Avenue, Purchase, NY 10577-2530 USA

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