RIVERFRONT INVESTMENT GROUP

Weekly View

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SUMMARY

- A "higher for longer" rate environment creates headwinds for markets, in our view.
- In the face of these headwinds, US Large Cap earnings have proved resilient.
- Other markets have not fared as well, with the exception of Japan.

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Q1 Earnings Recap: US Large Caps Climb the "Wall of Worry"

Earnings Growth Outweighs Stagflation Fears in US Large Cap

"The only thing we have to fear is fear itself" **– Franklin Delano Roosevelt**

Within the world of investing, there is a continuous argument between bullish and bearish investors. This argument often boils down to whether the stock market can "climb a wall of worry." Beginning in 2022, the markets began focusing on the threat of 'stagflation' as the current 'wall of worry'. As background, stagflation is a challenging environment where inflation is elevated and persistent, even in the face of rate increases, which forces the Federal Reserve to keep rates high and restrict money supply even as an economy slows and unemployment ultimately accelerates.

Stocks Climb the "Wall of Worry"

From a macroeconomic standpoint, the second quarter was one where the "wall" seemed to heighten. The market has backed off its expectation for 6 rate cuts in 2024 and there is some evidence of re-emerging inflation. These fears have caused the US 10-year rate to briefly touch 4.7%. Along with rising geopolitical tensions in the Middle East and an upcoming election, there is plenty to be concerned about as we contemplate the "wall of worry". Despite all these issues, the stock market continues to rise. We believe the strong performance of stocks is because earnings have been strong despite these headwinds.

We believe earnings analysis is valuable in situations like this because it provides a "financial checkup" for publicly traded companies on how Fed policy and the economic backdrop is impacting earnings and growth. If stagflation is going to be a persistent issue, it should show up in two key ways in corporate earnings:

1. **Top-line revenues get hit:** Higher inflation and rates can restrict customer and business spending, which will show up in reported revenues.

2. **Bottom-line earnings get hit**: Higher interest costs can put a dent in earnings for the company, forcing them to either make less money on projects or generally engage in less activity.

Not All Markets Doing as Well as Large Caps

What we see in looking at earnings is very market dependent – US Large Caps are holding up well, while other geographies, markets and segments are struggling to varying degrees. As long-term investors, we must monitor data and stay vigilant should US earnings' resilience begin to waver. Yet we must also not overreact to market fears, as these are often exaggerated, in our view. Consequently, our balanced portfolios continue to be positioned for the bull market to continue. However, we must also balance other notions that we view as less likely - which is how we view stagflation risk. To this end, we are recapping first quarter earnings in this week's *Weekly View*, identifying where we believe higher rates have already taken a toll on earnings, where they haven't, and what opportunities we see going forward.

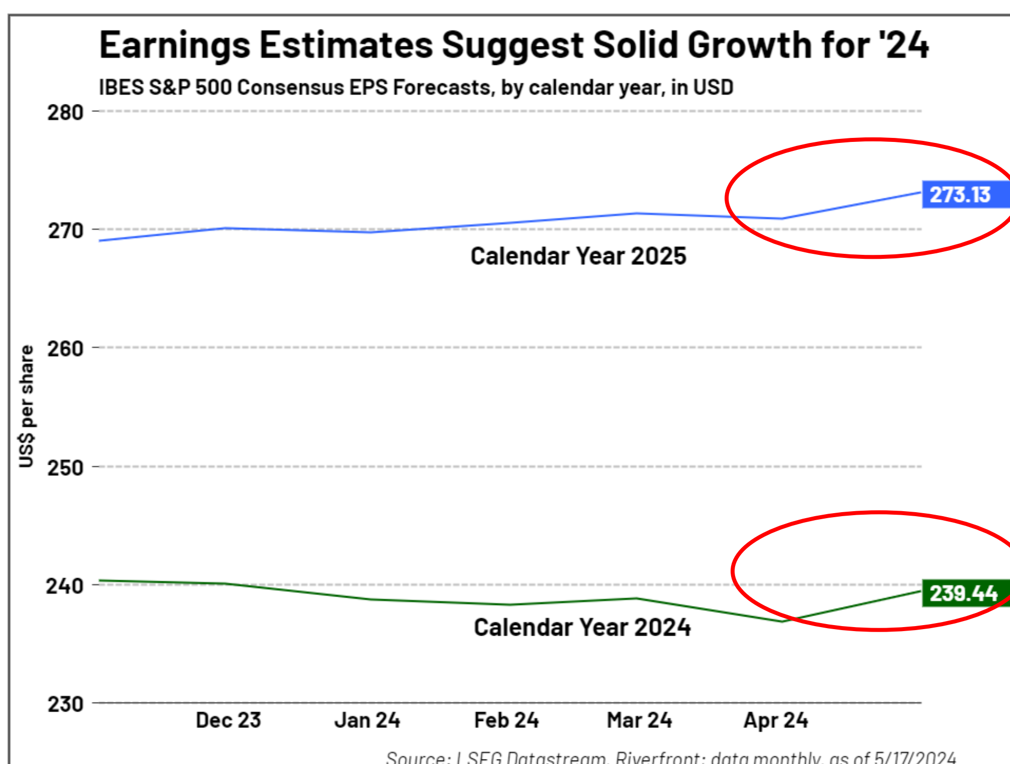
Q1 Recap: Large-Cap Earnings are Both Growing and Beating Market Expectations

At RiverFront, we use 3 'earnings principles' (detailed in this *Strategic View* from September) to create a framework for "Bottom-Up" analysis of earnings and revenue. Boiling this framework down, we believe there are three key elements to earnings:

1. **Earnings Surprises:** Were analysts' opinions and corporate results out of alignment with expectations?
2. **Analyst Adjustments:** What do analysts think, and how did it change after the announcements about the future?
3. **Earnings Trends:** What is the long-term earnings trend after the announcement?

Starting with surprises, the S&P 500 (our preferred US Large Cap Index) had a strong first quarter relative to expectations. According to Bloomberg, earnings were 8.5% higher than expected overall and were also higher than expected across all 11 sectors. Revenue was 1% higher than expected by analysts and was higher in every sector except Utilities. (We expected this as we believe Utilities will struggle to convince local governments to increase their billing at the pace of inflation).

Moving to analyst reactions, analysts responded to the earnings season by increasing estimates for 2024 and 2025 (see red circles on chart, right). This behavior is unusual since analysts are typically too optimistic at the start of the year, and so have to lower estimates throughout the year. The increase in estimates surprised investors, which led to the market's favorable response.



Source: LSEG Datastream, RiverFront. Data monthly as of May 17,, 2024. Chart shown for illustrative purposes only. Past performance is no indication of future results.

Finally, the trend of Large Cap US earnings year over year is also positive at 5.3% overall, supported by revenue growth of 3.7%. Unfortunately, it's not a universally positive picture across all sectors: Energy and Materials are struggling with both measures, Utilities are failing to grow revenue, and Healthcare companies overall have had a tough earning growth period. Technology and other growth themes more than compensated for this.

On balance, a positive trend growth rate, coupled with updated analysts' views of growth into 2024 and 2025 provides a 'healthy' diagnosis for US Large Cap stocks. Our portfolios continue to favor US large-caps relative to our overall stock exposure and most benchmarks. The strength of current earnings and their longer-term trend gives us confidence to pay a higher multiple for US earnings. A core part of our thesis on Large Cap companies is that the durability of these earnings for longer than the market expects. Market segments with less earnings durability and lower valuations may also begin to look attractive if the earnings and economic environment becomes more supportive.

US Small Cap and Europe Look Unhealthy; Japan Continues to be a Positive Outlier

One of the immediate challenges in each of these markets is that we have somewhat lower expectations. Here is a summary of our views on each of these markets as of the date of this publication.

US Small Cap: We believe Small Cap Companies are being challenged due to their much shorter debt maturities which makes interest rate increases hit sooner. and challenges with lending availability in small cap banks (see our March *Weekly View on* Small Caps for more detail). Although Small Caps currently have more attractive valuations to us than Large Cap companies, we view large Small Cap as a "value-trap" until these financing issues have a plausible favorable resolution.

Europe: We believe higher nominal growth from inflation should help value-oriented companies, but we have not seen it come through in earnings or revenue consistently. While European stocks have compelling valuations, we need to see a positive trend to be more constructive.

Japan: Despite demographic challenges which we believe have made the economy stagnant, Japanese companies have grown earnings over 21% on average annually since 2010. We believe this is due to a successful focus on increasing margins, and revenue growth from a very weak Yen. We will be diving more deeply into this in a forthcoming *Weekly View*.

The table below summarizes the earnings picture for these markets and compares them to US Large Cap on the 5 key measures we discussed in detail:

	US Large Cap	US Small Cap	Europe	Japan
Revenue Suprise	Positive	Flat	Negative	Positive
Earnings Surprise	Positive	Positive	Positive	Positive
Estimates for 2024 / 2025	Positive / Improving	Negative / Improving	Flat / Improving	Mixed / Improving
Revenue Trend Growth	Positive	Flat	Negative	Positive
Earnings Trend Growth	Positive	Negative	Negative	Positive

Source: Bloomberg, RiverFront. Data quarterly as of May 15, 2024. Chart shown for illustrative purposes only. Past performance is no indication of future results. You cannot invest directly in an index. Not indicative of RiverFront portfolio performance. In the table above, US Large Cap is represented by the S&P 500, US Small Cap is represented by the S&P 600, Europe is represented by Euro Stoxx 50, and Japan is represented by Tokyo Price Index. See Disclosures section for definitions.

The table above reinforces our view of Europe and US Small Cap having structural challenges that are manifesting in poor revenue and earnings numbers, although there is some contrarian evidence in surprises that might turn things around – we will watch for more evidence there over the next few earnings seasons. It also elevates the need to do a deeper dive into Japanese equities, which is a topic for future RiverFront *Weekly Views*.

Portfolio Conclusions: Resilient Earning Favor US Large Cap Stocks

From a portfolio perspective, we continue to favor stocks over bonds, and US Equities over international ones. One of the beliefs that has shaped our equity positioning is that US Large Cap companies, led by the large technology-heavy "Magnificent 7", are highly profitable, have longer term debt and large cash reserves (which makes them more resilient to rate increases), and have stronger growth prospects because of those primary advantages that will persist longer than the market is paying for. We also believe that the benefits of inflation (higher nominal growth) are underappreciated by the market, which means we expect to see revenue surprises in most of the market.

Despite our optimism, we must remain aware of the rising "wall of worry." As such, our focus from a bottom-up standpoint is one on corporate resiliency; we are looking for companies that are resilient in a higher rate environment. We also evaluate other areas of the market that we are less heavily invested in to see if the playing field has shifted.

Our final takeaway is a reminder for us to maintain humility. While US Small Cap and Europe have underperformed US Large Caps over the past few years, there are some indications of potential surprises. In the case of Japan, we have preference there within our international selection and given the strength of their earnings coupled with some positive macro developments, we will continue keeping a close watch.

Risk Discussion: All investments in securities, including the strategies discussed above, include a risk of loss of principal (invested amount) and any profits that have not been realized. Markets fluctuate substantially over time, and have experienced increased volatility in recent years due to global and domestic economic

events. Performance of any investment is not guaranteed. In a rising interest rate environment, the value of fixed-income securities generally declines. Diversification does not guarantee a profit or protect against a loss. Investments in international and emerging markets securities include exposure to risks such as currency fluctuations, foreign taxes and regulations, and the potential for illiquid markets and political instability. Please see the end of this publication for more disclosures.

Important Disclosure Information:

The comments above refer generally to financial markets and not RiverFront portfolios or any related performance. Opinions expressed are current as of the date shown and are subject to change. Past performance is not indicative of future results and diversification does not ensure a profit or protect against loss. All investments carry some level of risk, including loss of principal. An investment cannot be made directly in an index.

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All charts shown for illustrative purposes only. Technical analysis is based on the study of historical price movements and past trend patterns. There are no assurances that movements or trends can or will be duplicated in the future.

Stocks represent partial ownership of a corporation. If the corporation does well, its value increases, and investors share in the appreciation. However, if it goes bankrupt, or performs poorly, investors can lose their entire initial investment (i.e., the stock price can go to zero). Bonds represent a loan made by an investor to a corporation or government. As such, the investor gets a guaranteed interest rate for a specific period of time and expects to get their original investment back at the end of that time period, along with the interest earned. Investment risk is repayment of the principal (amount invested). In the event of a bankruptcy or other corporate disruption, bonds are senior to stocks. Investors should be aware of these differences prior to investing.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa). This effect is usually more pronounced for longer-term securities). Fixed income securities also carry inflation risk, liquidity risk, call risk and credit and default risks for both issuers and counterparties. Lower-quality fixed income securities involve greater risk of default or price changes due to potential changes in the credit quality of the issuer. Foreign investments involve greater risks than U.S. investments, and can decline significantly in response to adverse issuer, political, regulatory, market, and economic risks. Any fixed-income security sold or redeemed prior to maturity may be subject to loss.

Investing in foreign companies poses additional risks since political and economic events unique to a country or region may affect those markets and their issuers. In addition to such general international risks, the portfolio may also be exposed to currency fluctuation risks and emerging markets risks as described further below.

Changes in the value of foreign currencies compared to the U.S. dollar may affect (positively or negatively) the value of the portfolio's investments. Such currency movements may occur separately from, and/or in response to, events that do not otherwise affect the value of the security in the issuer's home country. Also, the value of the portfolio may be influenced by currency exchange control regulations. The currencies of emerging market countries may experience significant declines against the U.S. dollar, and devaluation may occur subsequent to investments in these currencies by the portfolio.

Foreign investments, especially investments in emerging markets, can be riskier and more volatile than investments in the U.S. and are considered speculative and subject to heightened risks in addition to the general risks of investing in non-U.S. securities. Also, inflation and rapid fluctuations in inflation rates have had, and may continue to have, negative effects on the economies and securities markets of certain emerging market countries.

Technology and Internet-related stocks, especially of smaller, less-seasoned companies, tend to be more volatile than the overall market.

Index Definitions:

Standard & Poor's (S&P) 500 Index measures the performance of 500 large cap stocks, which together represent about 80% of the total US equities market.

S&P 600 is a benchmark index for small-cap stocks. To be listed on the S&P 600, stocks must have a market cap of $850 million to $3.6 billion, preventing overlap with S&P's larger cap indices.

EURO STOXX 50 is a stock index of Eurozone stocks designed by STOXX, an index provider owned by Deutsche Börse Group. The index is composed of 50 stocks from 11 countries in the Eurozone. EURO STOXX 50 represents Eurozone blue-chip companies considered as leaders in their respective sectors.

The Tokyo Price Index, known as TOPIX, is a Japanese stock market index calculated and published by the Tokyo Stock Exchange (TSE). TOPIX tracks domestic companies in the exchange's first section, which represents Japan's largest firms by market capitalization.

Definitions:

Stagflation is an economic cycle characterized by slow growth and a high unemployment rate accompanied by inflation. Economic policymakers find this combination particularly difficult to handle, as attempting to correct one of the factors can exacerbate another.

Small-, mid- and micro-cap companies may be hindered as a result of limited resources or less diverse products or services and have therefore historically been more volatile than the stocks of larger, more established companies.

The Magnificent Seven stocks are a group of high-performing and influential companies in the U.S. stock market: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

When referring to being "overweight" or "underweight" relative to a market or asset class, RiverFront is referring to our current portfolios' weightings compared to the composite benchmarks for each portfolio. Asset class weighting discussion refers to our Advantage portfolios.

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