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SUMMARY

- US large-cap earnings have continued to grow and surprise to upside.
- Europe, Japan and US small-cap, while weaker (and cheaper) are improving.
- If this proves sustainable, we see a potential rotation from Growth to Value and International.

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Q2 Earnings Recap: US Earnings Surprise to the Upside

Small Cap, Europe and Japan Improve as Well

At Riverfront, we use our 3 'Earnings Principles' (detailed in this *Strategic View* commentary) 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/Revenue Surprises:** Were analysts' opinions and corporate results out of alignment with expectations?

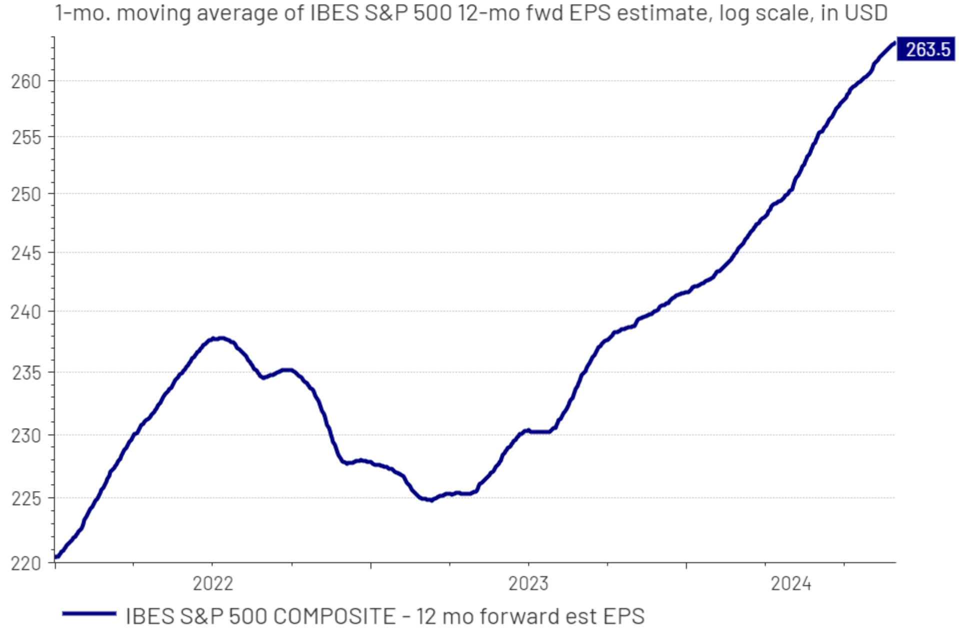
2. **Analyst Adjustments:** What do analysts think, and how did it change after the announcements about the future?

3. **Earnings/Revenue Trends:** What is the long-term earnings trend after the announcement?

Starting our analysis with surprises, the S&P 500 Index (representing US large-caps) had a strong second quarter relative to expectations (*note all quarterly references are based on rolling 90 days as of 8/15*). According to Bloomberg, earnings were 5.7% higher than anticipated, with only the Communications services sector missing analyst expectations in aggregate. Revenue was 0.8% higher than expected by analysts and was higher in all sectors except for Staples, Materials and Utilities. We expected the high short-term interest rate environment to create a difficult environment for defensive/low-growth sectors like Utilities and Staples, but issues in Materials were somewhat unexpected; we will continue to monitor this as a potential sign of global economic slowdown risk.

Chart1: Earnings Resume Uptrend

1-mo. moving average of IBES S&P 500 12-mo fwd EPS estimate, log scale, in USD



Source: LSEG Datastream, RiverFront. Data weekly as of August 29, 2024. Chart right shown for illustrative purposes only. Past performance is no indication of future results.

Analysts responded to earnings results by keeping numbers largely in line with expectations before the quarter. We would say this is positive overall – Chart 1, above, points to having strong earnings since 2022. We would also note unlike Q1 of 2024 earnings, estimates for 2024 declined slightly. While we believe this is not alarming, we will watch carefully for deterioration in the quarters ahead.

Finally, the trend of US large-cap earnings quarterly growth continues to be positive at +9.4% overall, supported by revenue growth of +4.7%. Important to our thesis, earnings for 'growth' sectors (Technology, Communication Services and Discretionary) are maintaining strong top line and bottom line results, and some 'value'-oriented sectors (Financials, REITs, Utilities and Energy) are growing earnings despite a tough rate environment. As we contemplate the possibility of an investor rotation into value stocks, we are hoping these numbers strengthen in the quarters ahead. On balance, a positive trend growth rate, coupled with updated analysts' views of growth into 2024 and 2025 provides an overall 'healthy' diagnosis for US large-cap stocks in our view.

Beyond Large Caps: Other "Value-Led" Market Segments Improving

The table below summarizes the earnings picture for these markets and compares them to US large-cap results:

	US large-cap	US small-cap	Europe	Japan
Revenue Surprise	Positive	Positive (+)	Positive (+)	Positive
Earnings Surprise	Positive	Positive	Positive	Positive
Estimates for 2024 / 2025	Positive / Flat (-)	Positive (+) / Improving	Positive (+) / Improving	Flat / Improving
Revenue Trend Growth	Positive	Positive (+) and Improving	Flat (+)	Positive
Earnings Trend Growth	Positive	Negative but Improving	Positive (+)	Positive
Source : Bloomberg Estimates: -/+ indicates change from prior quarter				

Source: Bloomberg, RiverFront. Data quarterly as of August 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.

When looking at this table, we would emphasize the *improvement* of the three "value-oriented" market segments (US small-caps, Europe, Japan) versus their readings just a quarter ago, as denoted by the "+" signs in the table above. While this improvement could reverse if a recessionary or stagflationary environment should take hold, it generally aligns with our belief that a reflationary environment is the more likely outcome.

US small-cap – Earnings growth still slow, but improving: We believe small-cap companies have been challenged due to their much shorter debt maturities and relatively higher leverage, which hurt profit margins more than their larger counterparts. Rising interest rates also caused smaller lenders to cut credit availability, which magnified these challenges for small-caps. See this *Weekly View* on small-caps for more detail. Critically, we believe the shift in the market's expectation for short term interest rates, if realized, could "unlock" the banking system and improve liquidity. This could substantially improve the potential for small caps' earnings power as well as stock valuations. Thus, while small-cap earnings growth is weak currently in absolute terms, it is improving, and we know that any actual policy changes will show their impact with a lag. Assuming the Fed continues its course of lowering rates, we will look for continued improvement in the quarters ahead in small-cap earnings.

Europe - greatly improved from last quarter: We have long believed higher nominal growth from inflation should help value-oriented companies that are a hallmark of European equity markets. While the numbers are not as strong as US earnings yet, the marked improvement in earnings and surprises since last quarter provides some evidence that the environment is creating a fertile ground for earnings. The rebound in earnings momentum in Europe is interesting to us because, at a Price/Earnings ratio of 14.9x earnings, we think valuations are currently compelling.

Japan – steady on earnings, challenged with demographics and the yen: Japan continues to generate revenue and earnings that should be prized by investors. Unfortunately, the macro environment of Japan is challenging, debt and demographics are highly unfavorable. Furthermore, their attempts to bolster their undervalued currency in early August led to the worldwide collapse of what is known as the "carry trade" – where investors borrow money in Yen, where interest rates are low, to invest elsewhere. The sudden strength of the Yen forced investors to unwind their trades all at once. For Japan we believe the key to equity returns is successfully navigating these macro-oriented challenges.

Portfolio Conclusions: Still Favoring US Large-Cap Stocks; Leaning into Other Themes

From a portfolio perspective, we continue to favor stocks over bonds and there is little in the earnings analysis above to challenge that thesis. While inflation is slowing, we expect it to settle at a higher level than in the previous decade. Because of this belief, we think the benefits of sustained slightly higher inflation (higher nominal growth) are underappreciated by the market, which can lead to continued revenue surprises that should help all Equity Markets. We also prefer US Equities over international ones. This view is driven by the strong fundamentals of US companies, led by the biggest names, especially the technology-heavy "Magnificent 7". Large-cap US stocks have longer maturity, lower cost debt as well as large cash reserves which has made them more resilient to high level of interest rates. Also, due largely to the high weighting in Technology, we see sustained higher earnings growth rates which we think are not fully reflected in share prices. The shifts in earnings we see in small-cap, Europe and Japan also opens the door to an increased investment in these segments.

As always, selection is key, and merging bottom up and top-down insights is critical in examining how policy is affecting profitability and our portfolio positioning. Since the macro outlook remains unclear, our focus in these improving areas from a bottom-up standpoint is on higher quality companies. While the tone of the Fed has shifted, short rates have not yet moved, and we should expect that weaker companies in any market segment could face major setbacks if their financing is squeezed by current higher rates.

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.

Reflation is a fiscal or monetary policy designed to expand output, stimulate spending, and curb the effects of deflation, which usually occurs after a period of economic uncertainty or a recession. The term may also be used to describe the first phase of economic recovery after a period of contraction.

Inflation is a gradual loss of purchasing power, reflected in a broad rise in prices for goods and services over time.

The energy sector is a category of stocks that relate to producing or supplying energy. The energy sector or industry includes companies involved in the exploration and development of oil or gas reserves, oil and gas drilling, and refining. The energy industry also includes integrated power utility companies such as renewable energy and coal.

US Equities include stocks listed in the United States. Stocks represent partial ownership of a corporation. If the corporation does well, its value can increase, and investors can 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). Small/mid-cap equities, MLPs, REITS and alternatives equities are types of US Equities and assume further risks described below.

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.

A real estate investment trust (REIT) is a company that owns, operates, or finances income-generating real estate. Modeled after mutual funds, REITs pool the capital of numerous investors. This makes it possible for individual investors to earn dividends from real estate investments—without having to buy, manage, or finance any properties themselves. There are special risks associated with an investment in real estate and REITs, including credit risk, interest rate fluctuations and the impact of varied economic conditions.

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.