GENTRUST

Mid-Year Outlook | 2024

GENTRUST | JULY 2024

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Executive Summary

Q2 '24 Recap – Global equities (ACWI) are +12% YTD[1]. Inflation data continued to moderate in the second quarter, and fixed income (BND) is +0.2% YTD. Estimates of GDP for Q1 '24 came in at just 1.3%, down from the 3.4% growth we saw in the 4th quarter of 2023. Employment data continues to exceed economists' expectations despite the unemployment rate ticking up to 4% in May.

Encouraging Inflation Trend – Month-over-month core inflation dropped to just 0.16% in May, or 1.9% annualized. Core services inflation declined as many of its components such as transportation, recreation, and other personal services have turned negative. Excluding shelter, the average month-over-month inflation rate for core services was 0% in May.

Labor Dynamics – Since 2021 there has been a surplus of jobs. The job workers gap peaked in March 2022, coinciding with the start of interest rate hikes. We project that the job workers gap will close in February 2025.[2] If this were to happen, we believe it could cause a spike in the unemployment rate and ultimately lead to a recession.

Powering Artificial Intelligence (AI) – It is estimated that the global energy demand from data centers will more than double over the next 3 years.[3] We believe that nuclear energy will play a pivotal role in meeting this demand and nuclear energy is a far more reliable source of renewable energy compared with alternatives such as wind and solar.

International Diversification – S&P 500 companies obtain more than 40%[4] of their revenue outside the US and most large businesses outside the US are global rather than local. Correlations between international equities have risen which has diminished the benefits of diversification. We explore an alternative approach to diversifying portfolios internationally.

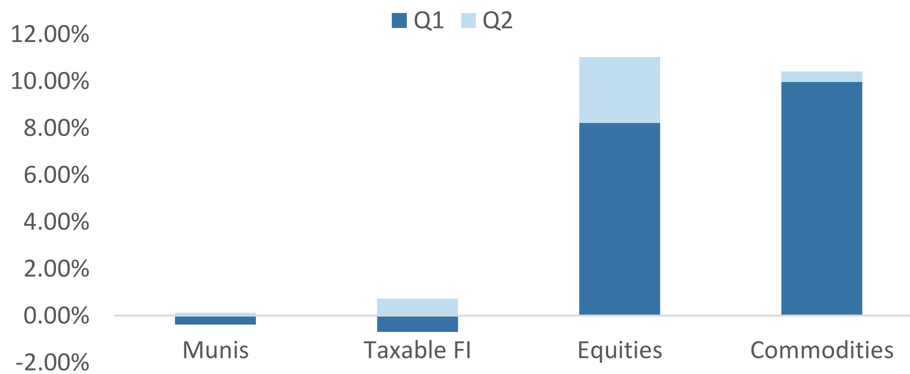
Market Concentration – The global equity index known as the MSCI ACWI is highly diversified across almost 50 different countries and nearly 3000 different constituents. NVDA and MSFT now represent over 8%, the highest concentration seen in decades.

[1]YTD return numbers are from Bloomberg as of 06/25/2024. ACWI is the iShares MSCI ACWI ETFs, BND is the Vanguard Total Bond Market Index Fund ETF and GSG is the iShares S&P GSCI Commodity-Indexed Trust ETF. [2]Model utilized is a linear regression model based on job market gap data from March 2022 until May 2024. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past results do not guarantee future results. Real results may vary.
[3]Source: https://www.iea.org/reports/electricity-2024/executive-summary
[4]Source: https://www.globalxetfs.com/sector-views-sp-500-sensitivity-to-global-factors/#:~:text=Roughly%2040%25%20of%20S%26P%20500.sales%20were%20sourced%20from%20abroad

Q2 ‘24 Market Performance

Risk assets continued their grind higher in Q2 2024 against a backdrop of mixed economic data. Global equities (ACWI) were +2.8% on the quarter and US large cap equities (SPY) were +4.2%. That said, equal-weighted US large cap equities (RSP) are down -2.6%, underscoring how important a few mega cap tech companies have been to driving equity index returns. European equities (VGK) were +1.6%, while EM equities (VWO) were +5% driven by stimulus measures in China and the reelection of Indian Prime Minister Narendra Modi. Fixed income markets have also rallied given the sharp decline in 10-year interest rates from a local peak of 4.7% in April down to 4.2% near the end of the quarter. As a result, the US aggregate bond index (BND) was up +0.7% in Q2. Finally, commodities (GSG) were the worst performing major asset class this quarter given the decline in inflation expectations and returned +0.5%.[5]

Performance YTD



Source: Bloomberg. Performance YTD for the asset classes in the chart above is from 1/1/24 through 06/25/24. The Vanguard Tax-Exempt Bond Index Fund ETF returns is used for Munis, the Vanguard Total Bond Market Index Fund ETF returns is used for Taxable FI, the iShares MSCI ACWI ETF returns is used for equities, the iShares S&P GSCI Commodity-Indexed Trust ETF returns is used for Commodities. Past performance is not indicative of future returns and returns do not account for fees. Real results may vary.

Q2 ‘24 Macroeconomic Data

The macroeconomic data this quarter has been mixed. Inflation data continued to moderate following some higher-than-expected data points in the first quarter that were largely due to seasonal factors, as businesses tend to raise both prices and wages at the beginning of the year. Headline CPI for the month of May came in at 3.3% vs. 3.4% expected and core CPI, which excludes more volatile components like food and energy, came in at 3.4% vs. 3.5% expectations. Estimates of Q1 ’24 GDP came in at just 1.3%, down from the 3.4% growth we saw in Q4 ’23. Non-farm payrolls continued to exceed economist’s expectations, however, the unemployment rate ticked up to 4% due to a decline in the labor force participation rate.

[5]All market data is from Bloomberg from 03-31-24 until 06-25-24. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary. ACWI is the iShares MSCI ACWI ETFs, BND is the Vanguard Total Bond Market Index Fund ETF and GSG is the iShares S&P GSCI Commodity-Indexed Trust ETF,SPY is the SPDR S&P 500 ETF Trust, RSP is the Invesco S&P 500 equal weight ETF, VGK is the Vanguard European Stock Index Fund ETF, VWO is the Vanguard Emerging Markets Stock Index Fund ETF

Divergent Monetary Policy

After several years of highly correlated monetary policy across developed markets, central banks are starting to diverge. While the Federal Reserve continues to hold interest rates steady, and has indicated just 1 rate cut this year in their latest summary of economic projections, the European Central Bank delivered their first rate cut in June. Around the same time, the Bank of Canada also delivered their first rate cut this cycle. The Bank of Japan has remained largely independent of other developed market central banks, and is the only major developed market discounted to tighten through the end of the year.

Stepping Back: The Big Picture

In the years following the Great Financial Crisis, we were in an economic paradigm characterized by lower-than-expected growth and inflation, which enabled global central banks to stimulate the economy through low interest rates. Following the COVID-19 pandemic, governments responded with fiscal stimulus as well, which injected large amounts of money directly into the economy and the hands of consumers. As the world began to normalize, consumers flush with cash from government stimulus spent money at record levels while at the same time supply chains were heavily strained and commodities markets were upended following Russia's invasion of Ukraine. These dynamics ultimately led to the highest levels of inflation we have seen in 40 years and resulted in central banks raising interest rates aggressively to slow demand and reduce pricing pressure.

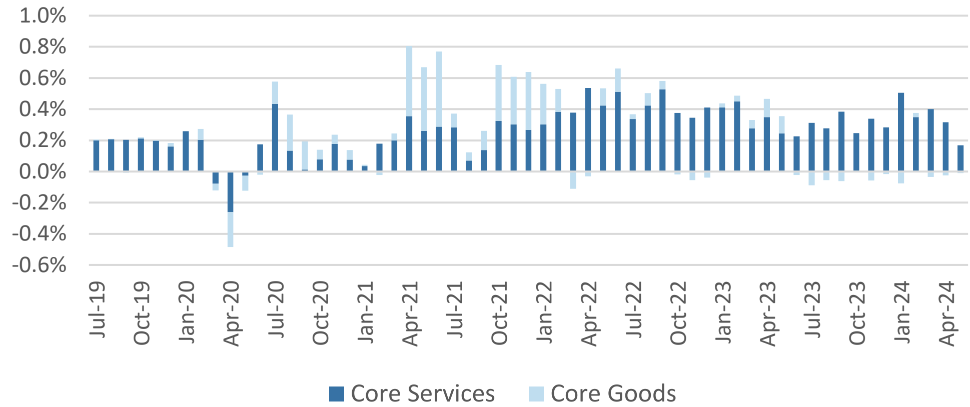
We are currently 27 months into this hiking cycle which began in March of 2022. History has shown that the impact of higher interest rates flows through to the economy with long and variable lags, with the average recession beginning around 2 years after the first rate hike. Over the last several years, there have been multiple forces that have helped the US economy avoid a recession, including the wealth of savings that was built up by consumers during the early days of the pandemic and the developments in artificial intelligence that may prove to be highly accretive to productivity. This has caused risk assets to perform well and the economic data to remain strong for much of the past 2 years. That said, we are starting to see signs of deterioration in the macroeconomic data. The Bloomberg economic surprise index, which measures the difference between actual economic data and analyst's forecasts, is near its lowest level of the past 5 years. Ultimately, there is a narrow path that central banks are trying to achieve where inflation returns to target without a material slowdown in growth.

Inflation

Inflation remains a key focus for markets. After some elevated inflation data to begin the year, particularly in core inflation, the latest inflation data was a step in the right direction, with month-over-month core inflation dropping to just 0.16%. Most notably, core services inflation fell significantly, from a peak of 0.51% in January of 2024 to just 0.17% in May of 2024.

Excluding shelter from the core services, the average month-over-month inflation rate in May was 0%. We believe this is an encouraging sign for near-term inflation projections.

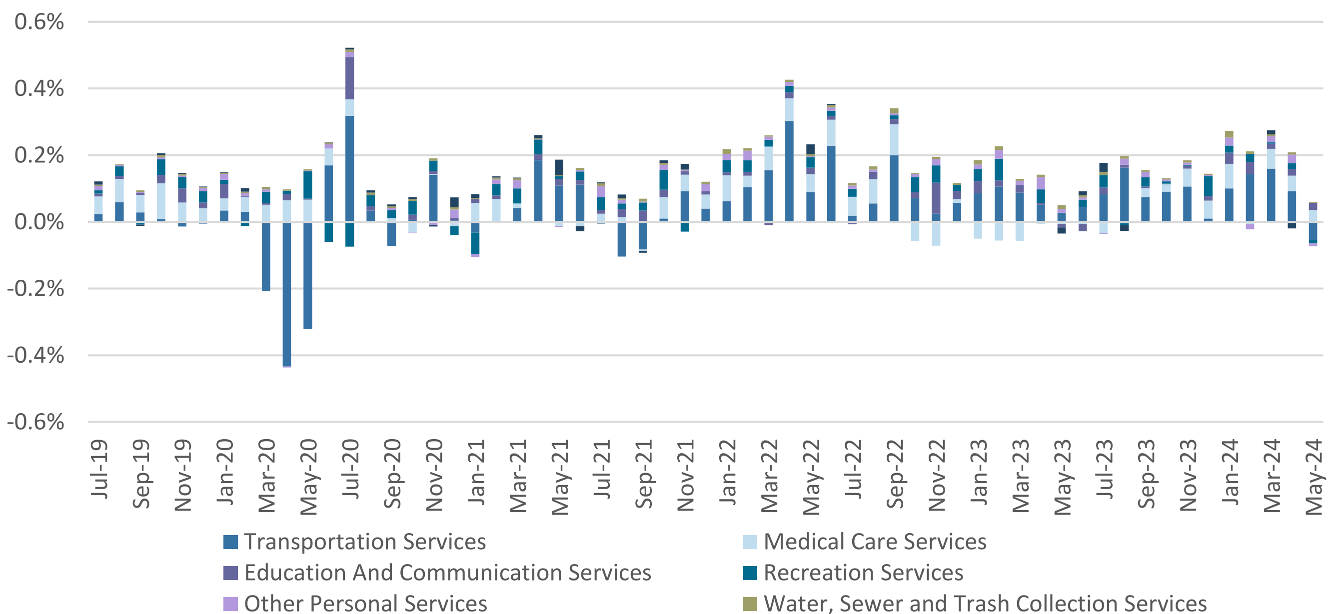
Core MoM CPI Goods vs. Services



Source Bloomberg as of 06/26/24. Core Goods CPI (focuses on the price of goods excluding services) and Core Services CPI (includes services less energy services) month over month returns from 07/31/2019 until 05/31/2024. Past results are not indicative of future results and may vary.

Core services inflation, which includes components such as shelter, transportation, medical care, and other services has proven to be very sticky. One reason for this is that the largest component of core services is shelter (~60%), which has been highly insulated from the increase in interest rates. While headline rates for new mortgages are above 6%, many borrowers have locked in low fixed rate mortgages back when interest rates were much lower. For this reason, the effective interest rate of outstanding mortgage debt in the US is just 3.78%, below where it was in 2019. If we exclude shelter from core services, we find a significant weakening in services inflation in May, with many components including transportation, recreation, and other personal services turning negative. In fact, the average month-over-month inflation rate for core services excluding shelter was 0% in May. Ultimately, this is a very encouraging sign for the near-term inflation outlook given that services tend to be the most stubborn components to bring down following a period of high inflation.

Core Services Excluding Shelter MoM Inflation %



Core Services month over month returns is from 07/31/2019 until 05/31/2024. All Consumer Price Index data referenced above is from Bloomberg as of 06/26/24. Past results are not indicative of future results and may vary.

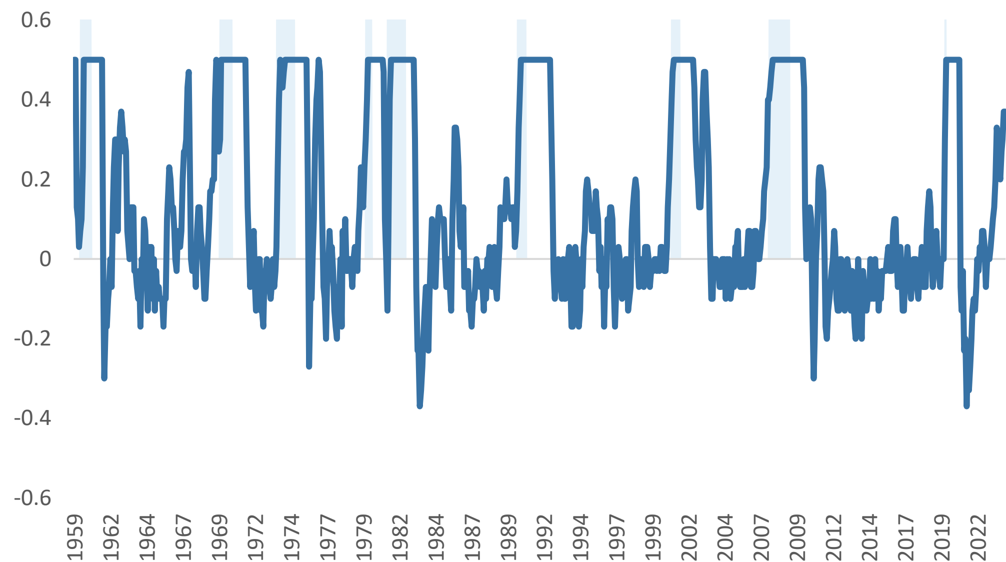
While there are certainly some upside risks to inflation in the medium to long term, in the near term we are less concerned about a significant uptick in inflation and more concerned about a downward shift in growth.

Labor Market Dynamics

The relative resiliency of the labor market over the last couple of years is also of significant importance to markets. Headline US non-farm payroll growth has averaged roughly 243k over the last 18 months, which is above the 5-year average of 190k from 2015-2019. Despite these strong headline numbers, we believe the labor market data is starting to show signs of deterioration under the surface.

Economist Claudia Sahm is credited with creating the “Sahm Rule” which has become a widely followed labor market indicator given its historical accuracy at predicting recessions. The rule posits that when the 3-month moving average of the national unemployment rate rises by at least 0.50% relative to the minimum of the 3-month averages from the previous 12 months, this indicates the onset of a recession. Currently, the indicator is at 0.37%, the highest reading since the last recession.

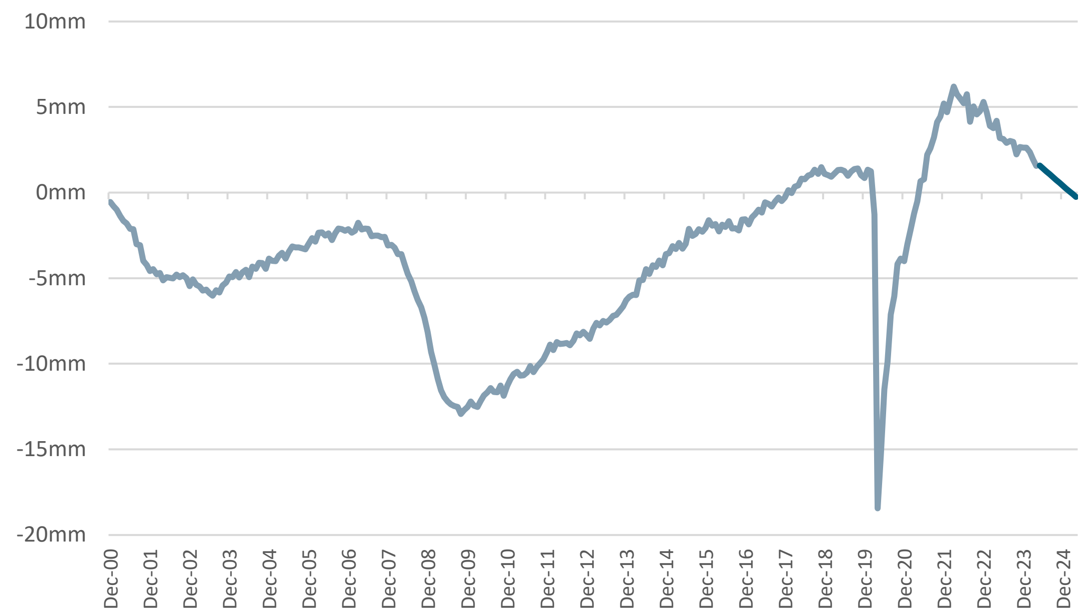
Sahm Rule Indicator vs. Recession



Source: Federal Reserve Economic Data https://fred.stlouisfed.org/series/SAHMREALTIME from12/01/59 to 05/01/24. Monthly data represented in percentage points units. Sahm Recession Indicator signals the start of a recession when the three-month moving average of the national unemployment rate (U3) rises by 0.50 percentage points or more relative to the minimum of the three-month averages from the previous 12 months. This indicator is based on "real-time" data, that is, the unemployment rate (and the recent history of unemployment rates) that were available in a given month. The BLS revises the unemployment rate each year at the beginning of January, when the December unemployment rate for the prior year is published. Revisions to the seasonal factors can affect estimates in recent years. Otherwise, the unemployment rate does not revise. Past results are not indicative of future results and may vary.

Another concerning dynamic playing out underneath the surface is the rapidly closing job-workers gap. Empirically, the strength of the labor market can be assessed through the lens of supply and demand. When there are more jobs available than workers seeking to fill those jobs, there is a jobs surplus and the labor market is strong. When the opposite is true, there is a labor deficit and the labor market has more slack. Following the reopening of the economy in 2021, there was a massive surplus of jobs as businesses reopened and resumed hiring which led to a massive increase in job openings. The supply of labor was not great enough to meet these demands, which ultimately led to an incredibly strong labor market. The surplus of jobs ultimately gave workers greater bargaining power, which drove wages higher and helped contribute to the surge inflation. The job workers gap peaked in March 2022, coinciding with the beginning of interest rate hikes. Using a linear regression model beginning in March 2022 when the gap peaked, we project that the job workers gap will close in February 2025. If this happens, it could be the catalyst that ultimately leads to a recession.

Historical Job Workers Gap (grey) and Projected (blue)



Source: Federal Reserve Economic Data and GenTrust Calculations https://fred.stlouisfed.org. Monthly data is from 12/01/2000 until 05/01/2024. Units are in thousands of persons and seasonally adjusted. Data after 05/01/2024 are forecasts only and expressions of opinions are subject to change without notice and are not intended to be a guarantee of future events. Forecasts are based on a linear regression model based off data from March 2022 to May 2024 assuming a linear relationship between variables. It suggests that changes in one variable (dependent) are directly proportional to changes in another (independent) variable. Real-world data often exhibits non-linear relationships, which may require more complex models. Past performance is no guarantee of future results. Real results may vary.

Current Research Focus

From nuclear energy to international diversification, our research efforts are focused on areas we believe will be the most relevant to investors over the next several years.

Powering AI

At GenTrust, we are big believers in the long-term capabilities of AI. From an investment perspective, we believe there is a ripe opportunity set of potential beneficiaries of AI. Currently, investors are narrowly focused on selecting a small number of companies that they believe will dominate the AI market over the next several years. The most obvious example of this is NVIDIA, which as a result of its dominant 80% market share of the AI chip market, has seen its stock rise 174% YTD[6] to become the largest publicly traded company in the world as of June 18th. That said, picking the long-term winners in a nascent industry is always a challenging task which evokes memories of IBM's once 80% market share of the personal computer industry in the early 1980s.[7] Regardless of which companies come to dominate the AI market over the next several years, we believe there are key areas outside of technology where AI will help drive returns.

Nuclear Energy

We have had a tilt towards uranium in our real asset bucket since the beginning of 2021. At the time, the primary thesis was centered on the supply/demand imbalance in the uranium market, which we believed would be exacerbated by the continued adoption of AI. The international energy agency estimates that the global energy demand from data centers, which help power artificial intelligence, will more than double over the next 3 years. Roughly 1/3 of the global increase in energy demand over the next 3 years is projected to come just from data centers.[8] In our view, nuclear energy will play a pivotal role in meeting this demand. In the same report from the IEA, they project that global CO_2 emissions from electricity generation are expected to fall over the next 3 years. This likely will not be possible without increased adoption of nuclear energy. Nuclear energy is a far more reliable source of renewable energy compared with alternatives such as wind and solar—making it the best energy source to meet both increasing demand for power while also meeting environmental goals.

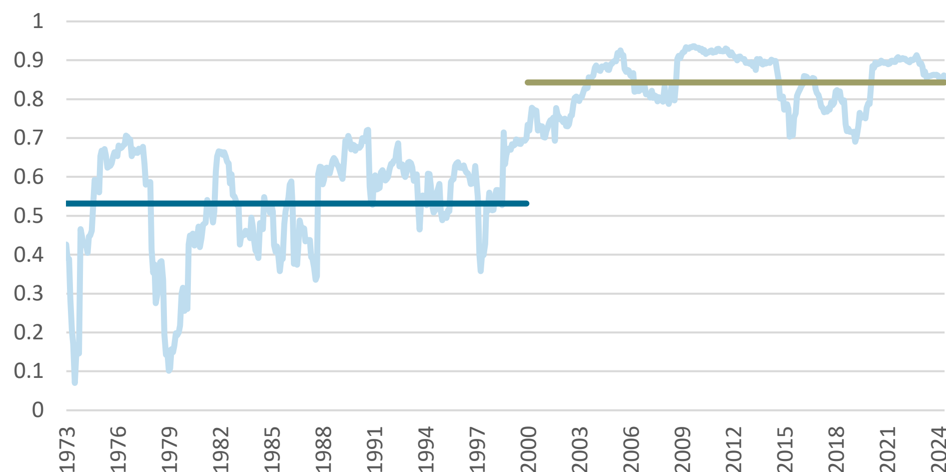
International Diversification

Decades ago there was a lot of value to investing outside the US because country's economies were only moderately linked and companies within each country primarily did business within their respective country. Additionally, equity returns outside the US were competitive compared with US markets. In this ideal paradigm, globally minded portfolio managers could have achieved both high expected returns with lower portfolio volatilities benefiting from lower cross-market correlations.

Globalization has changed this. S&P 500 companies obtain more than 40% of their revenue outside the US and most large businesses outside the US are global rather than local. The old classification of grouping companies by their headquarters is less meaningful today. As a result, correlations between international equities have risen which has diminished the benefits of diversification. From 1970 – 2000 the rolling 3-year correlation of monthly returns between US and European equities was 0.53. From 2000 - 2024 it was 0.84.

[6]As of June 25,2024 Source: Bloomberg.
[7]https://www.ibm.com/history/personal-computer#:~:text=IBM%20architecture%20became%20a%20standard,20%25%20a%20decade%20later.%E2%80%9D
[8]https://www.iea.org/reports/electricity-2024/executive-summary

Rolling 3yr Correlation of US Equities to European Equities



Source: Bloomberg, Y-Charts and GenTrust Calculations as 06/25/24. Correlation illustrated for US Equities is for the SPY – S & P 500 and for the European Equities is average monthly return of Germany, France, UK, and Switzerland 01/31/1973 until 01/31/2024. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

As a result, we have found a growing number of market participants begin to question whether they should remain internationally diversified. In our view, the answer is still a resounding "yes". That said, we are currently investigating whether a more active approach to portfolio construction might be warranted to achieve the desired diversification benefits.

When we examine the international equity landscape, we find that certain countries are better diversifiers to US equities than others. Typically, these countries have more closed economies, and their corporations tend to derive most of their earnings domestically. Currently the MSCI ACWI, which is a market cap weighted equity index that we are benchmarked to, has its largest geographic allocation outside the US to Europe. As we have shown above, Europe is not particularly diversifying.

In our last quarterly update when we examined the benefits of active vs. passive management, we wrote the following.

"GenTrust strives to have a comprehensive, timeless, research-driven investment process. Part of that process is to continually question ourselves about decisions we've made, even fundamental core value decisions such as the choice of using primarily passive vehicles. We are continually analyzing the prospects of active management and testing our approach. We approach such analysis from both a conceptual as well as data driven basis. Conceptually, we believe markets are mostly efficient, which would imply market capitalization weighted indices are the ideal investment choice (they also have the added advantage of being tax efficient as well)."

The same is true here regarding international diversification. The bar to deviate from a market cap weighted index will always be high for us. That said, it will always be valuable for us to challenge our own assumptions in the pursuit of a more optimal portfolio.

Market Concentration

In our view, the lack of breadth in the recent equity market rally has caused the indices to become highly concentrated. Consider the MSCI ACWI, which is highly diversified across almost 50 different countries and nearly 3000 different constituents. NVDA, AAPL and MSFT are a combined almost 13% of the ACWI.

This is not the first time in history that markets have become very concentrated. Many market participants have begun comparing this current period to the late 1990s, which was the last time markets were this heavily concentrated. According to Goldman Sachs Research[9], the 10 largest companies in the S&P 500 now comprise over 30% of the index which exceeds the peak of around 25% in the early 2000s. However, there is one silver lining. The earnings per share of the 10 largest companies as a percentage of the S&P 500 is also at all-time highs of roughly 25%. Comparatively, in 2000 they were just 15%, implying that the current market concentration is more justified from a valuation perspective.

Valuations aside, increased market concentration also increases the risk of a portfolio, and therefore there are limits to how much market concentration would be acceptable in a portfolio. One tool we have considered when thinking about managing market concentration risk is shifting towards an equally weighted index as opposed to a market cap-weighted index. Over the last 35 years the S&P 500 equal-weighted index has outperformed the market-cap-weighted S&P 500 by 69bps annualized, making it a compelling choice.[10] That said, this does not take into account the additional fees charged for the equal weight ETF or any real-world friction costs from internal transactions.

For this reason, we have been hesitant to make this shift, which has proved prudent as markets have become increasingly more concentrated. However, if these trends continue going forward, the benefits of making this shift may outweigh the costs.

Positioning

We came into 2024 marginally overweight fixed income and underweight real assets, with positioning much closer to neutral than usual. As we sit here today, equity valuations look rich because the indices have become highly concentrated with large but fast-growing companies. Despite encouraging headline data on inflation and employment, we are starting to see cracks emerge beneath the surface. For these reasons, we shifted to a more cautious stance in Q2 by increasing our overweight to fixed income and reducing our exposure to equities. Finally, we have reduced the number of tactical tilts we are taking to keep our portfolios more nimble and focused on responding to the evolution of events.

[9] https://www.goldmansachs.com/intelligence/pages/is-the-sp-too-concentrated.html
[10] Source: Bloomberg data from 12/29/1989 to 05/31/2024

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