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Conversations with Commerce Trust podcast
September Episode: A Look at Equity Markets

David Hagee: Hello, and welcome to *Conversations with Commerce Trust*, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust. Today, we're reviewing equity markets with KC Mathews, our Chief Market Strategist and our newest member of the investment leadership team here at Commerce Trust. Welcome to the podcast, KC.

KC Mathews: Hi, David. Really excited to be part of the Commerce Trust team. Thanks for having me on your program today, we have lots to talk about.

David: First and foremost, we couldn't be more excited to have you as part of the Commerce Trust team. You're a seasoned investor, been in the industry for 30-plus years, and a very, very strong addition to the investment leadership team here at Commerce Trust.

Maybe the best place to start would be doing a little bit of a recap of where we've been: 2022, as we know, was a remarkably tough year. No place to hide. Equity markets were down, fixed-income markets were down, tough place. In 2023. It turns on a dime and starts to really work up. As we sit today, we're up about 15% on the S&P 500 (Index), and it has been a unique market. KC, what are your thoughts around the market action side 2023?

KC: Well, you saw a big transition, right? As you mentioned, 2022, it's a tough market. Really, the place to be was in value-type investments, low-beta, decent valuation type stocks. Then the leadership transition at the beginning of this year into high beta, growth-type stocks was really led by the technology sector, and that (is) what has driven the market this year. You could even say more granular not only the sector but really, what, six or seven stocks have really driven domestic large cap returns this year.

David: That's a great point, whether you call them the Magnificent Seven, which I personally prefer, or the MegaCap Seven — Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and Meta, formerly known as Facebook — they've accounted for such a big portion of the market returns. Through the first six months of the year, those seven stocks were up 61%. The rest of the S&P 500 was up about 5.8%. Really, they've been that primary driver around market returns inside the US for 2023. Any thoughts around that narrow leadership and what that could mean or what that says about the markets today?

KC: Well, one thing that I think about David, and you and I have been in the business for quite some time is, typically, the market is driven by a small number of companies, so perhaps it's not as unique as one might think, but what we believe in is diversification. That's why we own more than one stock. Last year, those Magnificent Seven stocks did not perform that well. Like I said, you saw the transition of leadership early in the year. Diversify your portfolios. You're always going to get some sector, a few names of stocks, that drive performance. I think you're going to see that year in and year out.

David: That's a great point on diversification. As we look at the other asset classes inside the equity markets, looking at, say, smaller US stocks, whether that be small cap or mid-size US companies, or even international stocks, I'm struck by what a difference their performance has had for '23 as opposed to those large US stocks that roll that Magnificent Seven inside there.

KC: You got to be careful for valuation traps, though. You got to be on the lookout for those. What we do know, domestic large caps using the S&P 500 as a proxy was the returns this year were really driven by multiple expansion. Beginning of the year, the S&P (500) traded at 17 times earnings. Today we're at 20 times earnings. For the most part, the returns were driven by valuation expansion, P/E (price/earnings) expansion.

Now, when you look at some of these sub-asset classes like the Russell 2000 (Index) and international markets, I'll throw that in as well, valuation starts to look attractive, but there lies the potential value trap, where the growth isn't there. There's a reason they trade at a discount to domestic markets. If you look at international using the MSCI EAFE Index, pretty standard developed market international index, trades at 13 times (earnings) and the emerging market benchmark trades at 13 times (earnings) as well. They just don't have the growth that is expected in domestic markets. You got to be careful when you look at valuations to understand why these asset classes trade at a discount.

David: That's a great point. As we start to dissect this valuation question a little bit more, what's the price people are willing to pay for things? In the US, maybe because of the dynamic nature of the US economy, people are willing to pay a higher multiple at this point. We've talked about the price side of it. Let's talk a little bit about the earning side of it and then how that works with our forecast for a little bit of economic turmoil moving ahead. Any thoughts around the earnings side of the market?

KC: Well, we know it’s economic conditions typically drive earnings. What you see here domestically is next year, in 2024, right now earnings expectations are approximately 12%. What we know is, typically, analysts are a little overzealous. Throughout the year they adjust their earnings down. Commerce Trust, we think that 12% earnings number is a little high, so therefore, we're a bit cautious when it comes to risk-based assets. This year we're going to see domestic large-cap earnings down 4% and yet the market has performed so well. As I alluded to, it's all value, multiple expansion driven. Then if we move to sub-asset classes, you look at spaces like the Russell 2000 which would be a small-cap index or benchmark, well, 42% of those companies inside that benchmark are not profitable. You really have to understand what you're getting into and what you own.

David: I couldn't agree more that having people doing your homework, making sure that we understand fully what we own and what it can do inside different environments is the key to having a successful investment experience right now.

As we talk about that environment, here we're in the midst of Jackson Hole, the Kansas City Fed's annual conference or economic symposium. The tagline out of Jackson Hole is Chairman (Jerome) Powell says, "We will proceed carefully with any rate rises." We could be at the end of an interest-rate hiking cycle, but I'm struck by, maybe, some other pieces there. We have the money supply which the Fed (Federal Reserve) was printing since 2012 starting to contract, so you have less dollars in search of an asset. You also have a higher interest rate environment which we're starting to see longer rates catch up to, shorter rates a little. It's still inverted. What are your thoughts around how that's going to affect valuation and what other impacts we could see off the monetary policy out of the Fed?

KC: One, given the Fed's statements, it's exactly what I would expect the Fed to say. Right? There's nothing new there. [laughs]

David: Consistent: "Proceed carefully." That doesn't tell you much.

KC: Right. I do think, David, history can tell us something. Maybe it was Mark Twain who said, "History doesn't repeat itself. Perhaps it just rhymes." As we listen to the markets and the economy, we're hearing a lot of rhyming. History tells us that when we're close to the end of a Fed tightening cycle, the market prices in, believe it or not, a soft landing. They want to be optimistic, but that rally happens regardless of the outcome. Regardless, if you have a hard landing: a recession, or you avoid a recession: a soft landing. That's exactly what we're seeing right now. This rally with the expectations that we're pushing off a recession into next year and, perhaps, the odds of a soft landing increase.

We are close to the end of a Fed tightening cycle. When it ends, I think the indicator there, we'll have to watch the labor market. Typically, we look at initial (unemployment) claims which still is -- Let's call it a green territory. Then, all of a sudden, if the Fed keeps raising rates, there's a chance they raise one more time this year. Low probability of that 30% to 40% looking at the futures market. The economy is going to slow down, and then earnings will slow down for a number of reasons: restrictive monetary policy, high cost of capital (and) I think consumer balance sheets are changing. That will cause the market to reprice securities, and you'll see some softness in markets going forward.

David: As we start to look forward, love to discuss a couple of ideas that we've talked about today. One is this idea around a value trap. That it looks cheap therefore I should buy it. Oftentimes, as we've experienced with international over the past decade, it has stayed cheap, and so it hasn't had the performance of the US-based securities. Looking forward, let's talk a little bit about what we would expect from international investments and maybe even emerging markets.

Certainly, a longer-term theme that we've been considering is this idea of slobalization, of reshoring, of "friend-shoring." I think that changes supply chains and put some of the other BRICS, which is a collection of emerging market countries — Brazil, Russia, India, China, and South Africa — into greater focus as people pivot away from China, potentially. Then also, more broadly, emerging markets before we start talking about the U.S. markets.

KC: You're spot on that there's an incredible opportunity across the ponds, in the international space. One, you could say just population growth. We know that China has a population of approximately 1.4 billion people and, this year, I believe India will surpass China as far as population. When you have population growth, typically, you have labor force growth, and labor force growth leads to economic growth. Economic growth leads to earnings growth, and you start to put the pieces of the puzzle together.

But there will be opportunities in these foreign markets, in these emerging markets. You have to be a little careful when you think about the benchmarks or passive investments, so when you look at some of these standard benchmarks or indexes, you have to understand that the MSCI emerging market index is dominated by China. 29% of those assets are in China and 15% are in India, so you have to understand what you own before you allocate capital to these benchmarks or indices.

China has all kinds of structural problems. We could list a number of them. From bankruptcies in the real estate space, to all kinds of political tension between China and Taiwan. You see economic growth slowing due to call it a struggling reopening in China after a closed economy due to COVID. These are things that we watch very carefully. There will be a time to increase exposure to those asset classes, but at this time, with all that uncertainty, it's probably best to stay close to shore.

David: I do think it's a strong reflection that as we stay a little more conservative when it comes to equities, well aware of the valuation that you could see inside of some of those equities, that it's just a time where we continue to remain cautious but continually survey the investment landscape for opportunities out there that could poke up.

With that, KC, it's been great having you on the podcast today. Thanks for the interesting discussion. Thanks for joining us on *Conversations with Commerce Trust*. I'm David Hagee. We'll talk again soon.

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