TAKE 5 VIEWS

Spotlight on large-cap managers

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In this edition hear from large-cap managers on several topics' investors may find interesting. First, a look back at historical correlations between equity and fixed-income and what they may be signaling for the future. Then, a shift to comments from Loomis Sayles and J.P. Morgan on AI and the opportunities and disruptions the technology may bring. In our fourth article, Avantis Investors® provides a fascinating discussion on the relationship between interest rates and GDP growth while also reminding investors of the uncertainty of market and economic predictions. Finally, we close with a value story highlighting how this beat up sector may be ready for a come back. Enjoy the read and happy new year.

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1 The Far-Flung Past is Prologue

Robert M. Almeida, Jr.
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MFS Investment Management

Does a fish know it's swimming in water? Probably not until it's no longer submerged. This, I hope, illustrates that it can be difficult to know — never mind understand — the paradigm you're living in until there is an abrupt change.

The water we used to swim in

In the 2010s, the economic and financial market waters were comprised of suppressed rates that, at some points, reached the zero-bound and into negative territory. Financial markets swam in waters comprised of extraordinary returns, below normal volatility and lower than average correlation and thus historically good Sharpe ratios. Until 2022, when the water (or paradigm) shifted.

(continued on next page)

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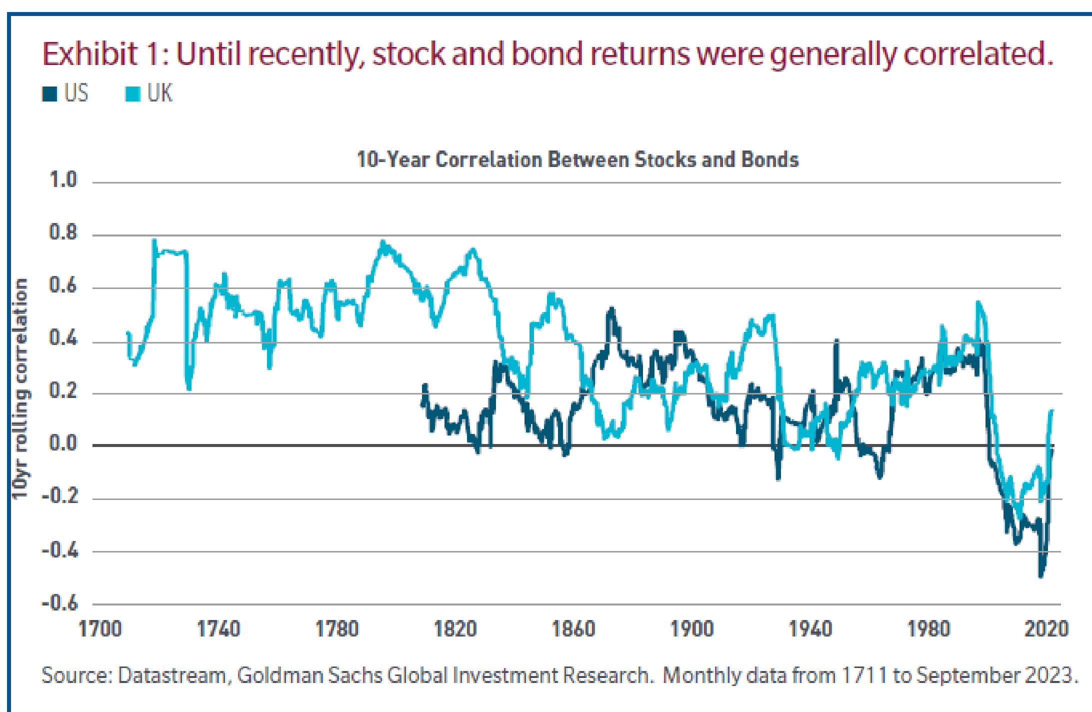
Three decades versus three centuries

Still reeling from the interest rate shock of 2022, investors have been forced to confront what looks like an anomaly: the positive correlation between stocks and bonds.

However, the painful reality is that 2022 wasn't so anomalous when viewed through a long-term prism. It was an example of the dangers of allowing the recent past to obscure protracted historical patterns. The water, or paradigm, is merely shifting back to its natural form as the hurdle rate for all investments, interest rates, has begun its normalization process.

In a November 2021 piece titled *Respecting Three Centuries of Correlation*, we highlighted the positive long-term correlation between nominal stock and bond returns and warned that recent decades of negative correlation were unsustainable. The historic correlation is illustrated in Exhibit 1, going back three centuries in the United Kingdom and two in the United States.



Long-term positive correlation explained

Like the fish in the parable, this comes as a surprise to many today because it's not what their experience has taught them.

While there have been and will remain diversification benefits between equities and fixed income securities, those benefits have been overstated in recent decades due to low inflation and artificially suppressed interest rates. Investors who were allocated across stocks and bonds not only enjoyed outsized returns with abnormally low volatility, but also uniquely high risk-adjusted returns, in part due to this negative but unsustainable negative covariance.

Why is this important?

The inflation and interest rate shock of 2022 has changed the water.

While we can't predict the terminal value of real interest rates, we're certainly closer to a more normal rate environment than before, which would imply a normalization of the long-run stock/bond relationship. Investors who have targeted future Sharpe or information ratios based on the recent past may be set up for underperformance.

2 Growth Trends with a Long Runway

LOOMIS | SAYLES

Aziz V. Hamzaogullari, CFA®
Chief Investment Officer and Portfolio Manager, Global Growth Equity
Loomis, Sayles & Company L.P.

What is Aziz Hamzaogullari, CFA®, Founder, Chief Investment Officer, and Portfolio Manager, Loomis Sayles Growth Equity Strategies, focused on as we move into 2024? The same key drivers as in 2023 – businesses offering quality, growth at attractive valuations, and value over a long time horizon. In a recent interview he shares perspectives on:

- Profitable businesses participating in secular growth trends
- Being selective within the AI value chain
- How yesterday's underperformers may be today's winners
- A long-term structural and permanent view of risk

(Transcript below)

Only within the context of quality and also attractive valuation that we focus on sustainable growth businesses. And for us, growth also needs to be both profitable and secular. Within that context, some areas that we focus on in our portfolio are AI, obesity and cystic fibrosis in health care. Within beverages, we focus on energy drinks. We have a company that we invested in shift to cloud computing, shift to e-commerce, also shift to electronic payments, as well as shift to streaming. The key for us is that all these businesses also need to have diverse cash flow growth drivers, meaning that they are not highly correlated with each other.

The key is to understand that AI is truly disruptive, like e-commerce was, like shift to internet-based computing was. And we believe that like other disruptions, market participants will underestimate the size of the opportunity, but overestimate the number of winners, meaning we believe that you have to be very selective in choosing which businesses will be the winners within this value chain. And for us, the key is the platform companies. We believe that you have to have a platform that attracts developers and all other participants within the value chain to be successful in the long term. And that by itself becomes a barrier to entry. For example, one of our largest holdings is a company that focuses on chips in AI computing.

Our best performers this year are the very same companies that were underperformers last year. So it really points out, again, the importance of long-term time horizon and looking at things beyond a 12-month time frame, as we do focusing on the next decade for success.

So when we look at our portfolio, we take a permanent and structural approach to risk, which means that by definition, we try to diversify our business drivers, owning companies with different cash flow drivers, so as a result, in any given short term time frame, like a 12-month time frame, some may be underperforming. Some may be outperforming. But that's by design. Our focus is really for the next decade or longer, trying to find the long-term winners cycle over cycle.

It's very important to remember that when you look at last 100 years of history of the markets, you will find that there has been many different regimes for discount rates or interest rates, as well as very significant unexpected geopolitical changes or risks.

Through all of that, you have great businesses with great growth prospects flourishing and doing really well. And this is a great example of understanding how having a structural and permanent view about risk, and understanding that great businesses can flourish through very significant disruptions.

J.P.Morgan ASSET MANAGEMENT

3 Thoughts on AI from Giri Devulapally, CFA®

An excerpt from the EIM October 2023 Markets and Investing Podcast, Full podcast is available on 1290funds.com

Kenneth Kozlowski, CFP, CLU, ChFC, Chief Investment Officer, Equitable Investment Management:

We can't talk about large-cap stocks today without mentioning artificial intelligence. Can you help us understand the AI landscape as you see it? Where is there potential for disruption?

Giri Devulapally, CFA, Portfolio Manager, J.P. Morgan Asset Management:

I think everywhere we look probably has some potential for disruption. I was an engineer by educational background and started my engineering education in the 1980s. There was talk about artificial intelligence back then, so this is something that's been around for decades. It's the tools and the technology that have evolved to a point where it can be operationalized in a significant manner today. And so, I think we are at the cusp of really exciting happenings related to AI. My team and I think AI is going to create a huge demand for computing power and technology enablers; chip companies like NVIDIA and Broadcom, and some of the cloud service providers like Amazon, Microsoft, and Google, will be beneficiaries. At current, we are looking for the initial winners we think will be the enablers, the computing centers or companies that have a rich proprietary data set that can really be mined for more information using the more powerful techniques of AI. Meta, the old Facebook, is an example, but there are a lot of software or business service companies that we think could be beneficial. Over time, we think that the power of AI has huge implications in healthcare and in drug discovery, but it's going to really spread its tentacles into every sector and every industry and the companies that are able to take advantage of the power of AI and better mine their data to create business advantage, we think, will be the winners and those are going to be really exciting. And then the last pool of winners probably doesn't even exist right now as a public company, if we think of AI as a big platform chain similar to the Internet that happened 25 years ago. Some of the biggest winners of the Internet were not even part of the boom of the late 90s; Google and Facebook didn't exist as public companies, Amazon Web Services didn't exist back then, Netflix was shipping DVDs by mail. And so there are going to be huge winners that we don't even know about today because they don't exist. We're very open to identifying those winners as well in the years coming forward.

4 The Certain Uncertainty of Short-Run Economic Predictions

Avantis Investors®

Avantis Investors® By American Century Investments®

Does Economic Growth Require Low Interest Rates?

A central tenet to many predictions of slowing economic growth and an impending recession is that rising interest rates would weigh on businesses and consumers. The Fed began raising rates in March 2022 and has taken the federal funds rate from effectively zero to north of 5%.

While it's clear that higher rates should have some effect, a relevant question for predicting economic growth in the future is whether growth requires low interest rates or if growth is precluded at today's higher rates. We present findings from our analysis in **Figure 1**.

We start with a reminder in **Panel A** that while rates are higher today than in past years, today's levels aren't outside the norm if considered within a historical context. After living through more than a decade where rates were most often near zero, it may be easy to forget that the economy has gone through many periods of similar or even higher rates than we see today.

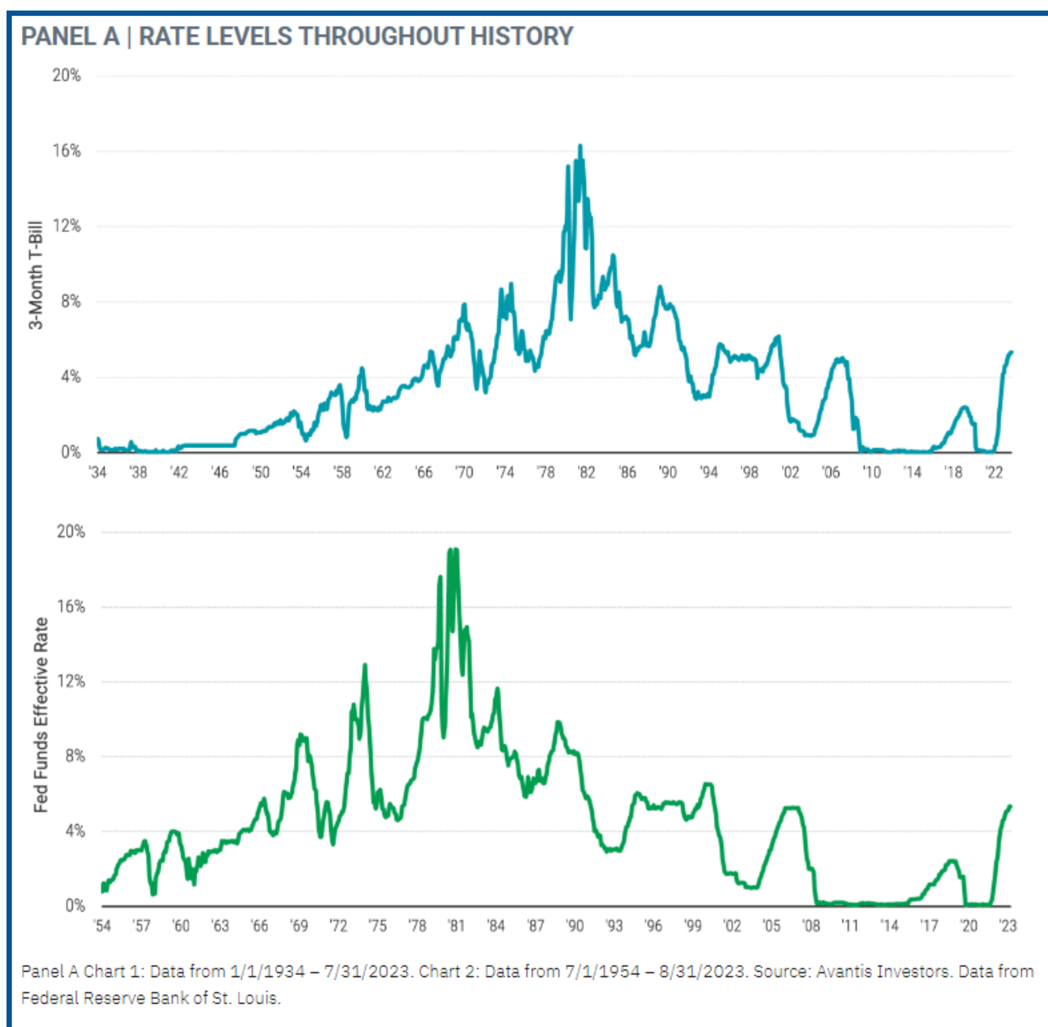
Panel B plots historical rates at the end of each quarter going back to 1947 versus the subsequent one-year GDP growth rate. The results are similar, whether using the federal funds rate or the three-month Treasury bill (T

-bill) rate. We observe that the relation is quite noisy with no clear pattern.

There have been periods of strong, positive GDP growth when rates were lower as well as when rates were higher. At the same time, there have been periods of lower, or even negative, GDP growth when rates were higher and, in some cases, when rates were low or near zero!

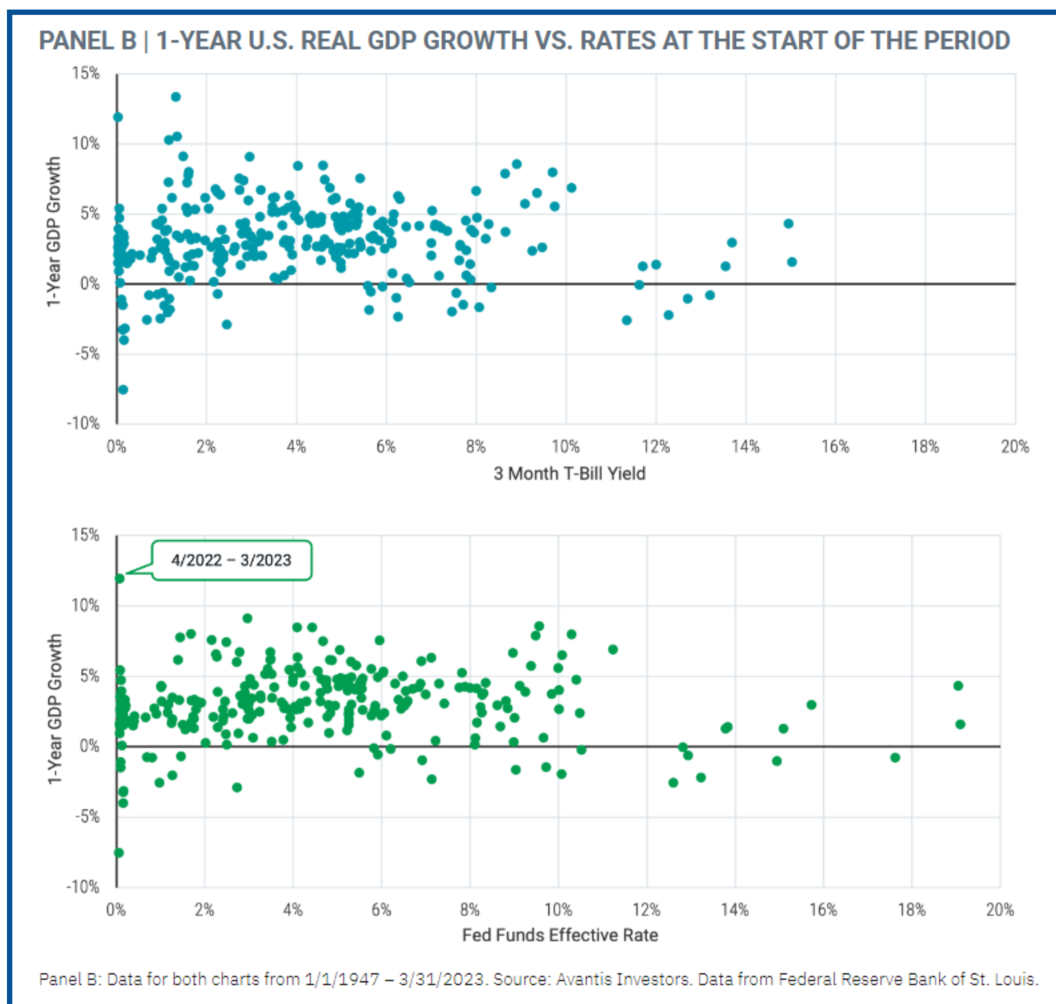
We already know from what we've seen in 2023 that GDP growth doesn't require near-zero interest rates, and higher rates don't guarantee that future economic growth will suffer. The historical evidence shows us that current rate levels offer little information about future economic growth.

Figure 1 | Historically, Economic Growth Has Occurred During Periods of Higher and Lower Rates



Panel A Chart 1: Data from 1/1/1934 – 7/31/2023. Chart 2: Data from 7/1/1954 – 8/31/2023. Source: Avantis Investors. Data from Federal Reserve Bank of St. Louis.

Figure 1 | Historically, Economic Growth Has Occurred During Periods of Higher and Lower Rates (continued)



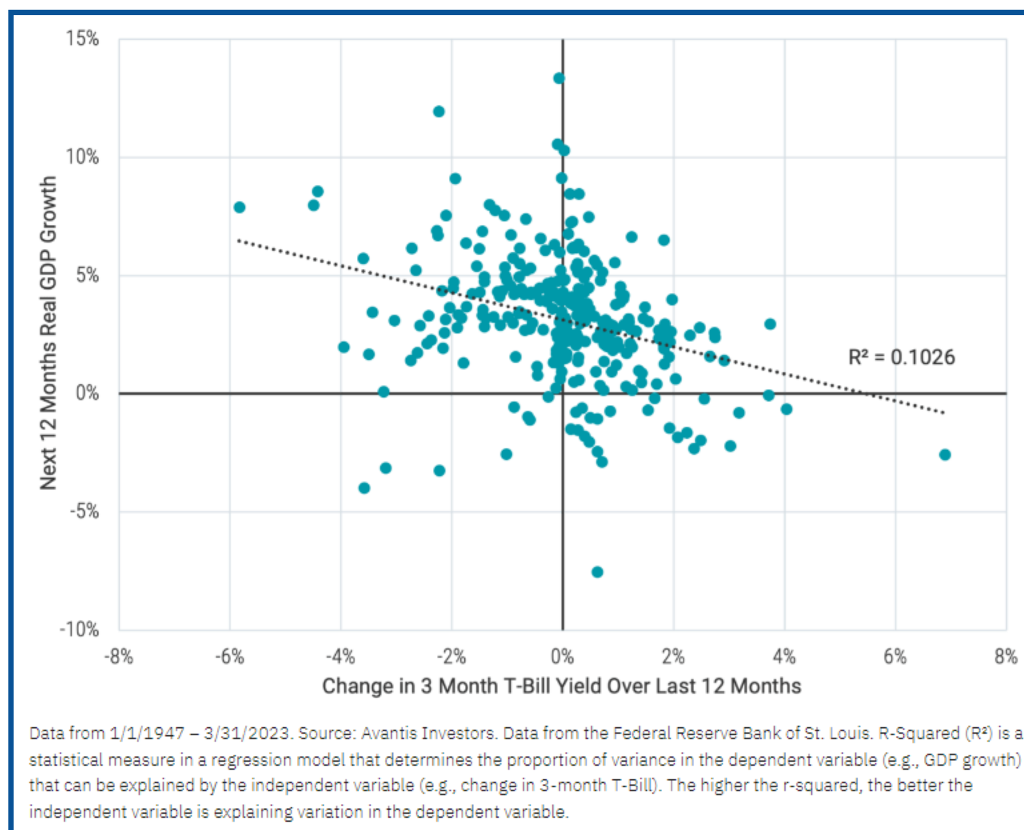
Panel B: Data for both charts from 1/1/1947 – 3/31/2023. Source: Avantis Investors. Data from Federal Reserve Bank of St. Louis.

Do Quickly Rising Rates Guarantee That Economic Growth Will Suffer?

We can also look beyond just the level of rates, as examined in **Figure 1**, to consider the pace of change. From **Panel A** in **Figure 1**, we can see that rate increases over the last 1.5 years have been steep but not unprecedented. Does this rate of change tell us something that rate levels alone don't?

In **Figure 2**, we examine the relationship between the change in the three-month T-bill rate over the last 12 months versus GDP growth over the next 12 months.

Figure 2 | The Relationship Between Rate Changes and GDP Growth Is Noisy



Data from 1/1/1947 – 3/31/2023. Source: Avantis Investors. Data from the Federal Reserve Bank of St. Louis. R-Squared (R^2) is a statistical measure in a regression model that determines the proportion of variance in the dependent variable (e.g., GDP growth) that can be explained by the independent variable (e.g., change in 3-month T-Bill). The higher the r-squared, the better the independent variable is explaining variation in the dependent variable.

Plotting the data, we find a negative slope. But it's easy to see that the relationship is noisy. The pattern is more cloud-like than a clear trend. Further, the R-squared (R2) result is very low, telling us that prior changes in rates offer little explanatory power for the variation in GDP growth rates that follow.

A useful takeaway from these experiments is that far more than interest rates alone can impact economic outcomes. How companies and consumers plan for the potential of rising borrowing costs can play a role (e.g., many businesses refinanced debt when rates were low). Many other variables like net job creation, wage growth, consumer spending or saving, changes in inflation, or even things like extreme weather events can also have an effect. These are just a few examples, and each has uncertainty. We see this uncertainty manifest in our experiments' results, which helps explain why economic predictions can wind up far from reality.

What we believe remains paramount for investors is company valuations. In our view, ignoring valuations is ignoring expected returns. Valuation theory and empirical research shows that higher expected returns come from companies that offer higher levels of equity and cash flows for the price we pay. Taking this information from the market and company financials each day provides real-time insight into which companies offer higher or lower expected returns and can be used to seek better potential outcomes for investors.

5 Why now for U.S. equity income?

John Baldi
Portfolio Manager
ClearBridge Investments

ClearBridge Investments

John Baldi, Portfolio Manager at ClearBridge Investments, examines the evolving US equity income landscape and shares his strategies for generating income and growth, while also aiming to manage risk in uncertain economic and market conditions.

Key takeaways:

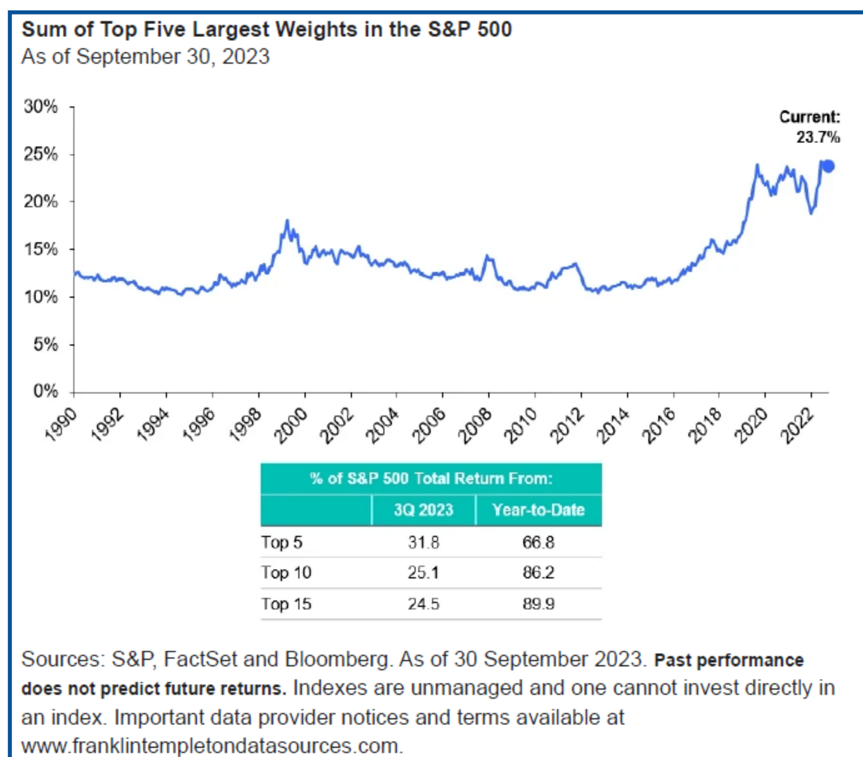
- Although US equities have performed well so far in 2023, there has been a narrow leadership from the so-called "Magnificent Seven" companies (Amazon, Apple, Alphabet, Meta, Microsoft, Nvidia and Tesla).
- In addition to strong participation in up markets, our strategy focuses on risk mitigation in uncertain markets, preferring stocks of companies that can withstand economic fluctuations.
- We do not aim to solely maximize upfront yield but focus on a balance of current yield and growth of yield. In an inflationary environment, income growth is crucial for protecting purchasing power.

Resilient US economy with narrow leadership in equities

Throughout 2023, investors expected that the United States would be in a recession and the US Federal Reserve (Fed) would begin to cut interest rates in the back half of the year. Yet, not only did the Fed not cut rates, it also raised them. Third-quarter 2023 economic growth was the strongest on record. Thus, macroeconomic conditions have evolved and remain fluid.

US equities, as measured by the S&P 500 Index, have performed strongly so far in 2023. However, there has been a narrow leadership by the so-called Magnificent Seven stocks: Amazon, Apple, Alphabet, Meta, Microsoft, Nvidia and Tesla.

As of September 30, 2023, the Magnificent Seven represented around 25% of the market capitalization of the S&P 500.[1] Only two out of these seven, Apple and Microsoft, pay dividends.[2]



% of S&P 500 Total Return From:		
	3Q 2023	Year-to-Date
Top 5	31.8	66.8
Top 10	25.1	86.2
Top 15	24.5	89.9

Sources: S&P, FactSet and Bloomberg. As of 30 September 2023. **Past performance does not predict future returns.** Indexes are unmanaged and one cannot invest directly in an index. Important data provider notices and terms available at www.franklintempletondatasources.com.

In our analysis, there will likely be a mild US recession in 2024 and the Fed will keep rates elevated for a longer period of time than the market expects. We also believe that US equity valuations are still too high and will likely

decline as the Fed continues to battle inflation.

Risk mitigation in uncertain markets

We do not concentrate on macroeconomic data, however, and instead design our portfolio to do well in different environments, which can include unanticipated inflation, deflation, economic growth, recession, and high and low interest rates. We prefer stocks of companies we believe can ride out economic storms.

Among other things, our strategy aims to provide risk mitigation in bearish and more volatile markets. Our approach is to invest in companies with strong balance sheets, low levels of leverage, durable revenue streams, high returns on invested capital and wide competitive moats that we believe can weather challenging market conditions.

While periods of rising markets lift returns for all assets, the underlying conservatism of our strategy means it will tend to lag in very hot markets like the one we have seen in 2023.

On the flip side, the deeper the correction in equity markets, the more risk mitigation we believe we can offer. In short, our strategy is not as growth-oriented as the S&P 500, but not as value-oriented as our peers.

A focus on income and growth of income

Another hallmark of our strategy is that we don't design our portfolio solely around maximizing upfront yield; instead, we seek a balance of upfront yield and growth of yield. We believe it is important to discover how companies translate their earnings and cash flow growth into income growth for their shareholders.

Recent high inflation has served as a stark reminder of how important income growth is in protecting purchasing power in an inflationary environment. We focus on income growth partly because we don't know how inflation will evolve in the future.

The current yield and growth of yield combination we seek can also include variable dividends. In addition to paying a base dividend, for example, a company might pay an additional variable dividend when times are especially good.

In 2022 when prices rose for commodities like oil and gas, some energy companies rewarded shareholders with a higher level of variable income because the cash flows of companies in this space were greater. As commodity prices fluctuate, these companies can reduce the variable dividend without impairing the base dividend they pay.

Even without these variable dividends, and even if a recession happens in the United States, it is our view that companies' payout ratios won't be severely impacted and could still grow.

1. Sources: S&P, FactSet and Bloomberg. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator of future results.** See www.franklintempletondatasources.com for additional data provider information.
2. Nvidia pays a very small nominal dividend, yielding 0.03%.

Glossary:

Standard & Poor's 500® Composite Stock Price Index ("S&P 500® Index") is a weighted index of common stocks of 500 leading companies in leading industries of the U.S. economy, capturing 75% coverage of U.S. equities. The index is capitalization weighted, thereby giving greater weight to companies with the largest market capitalizations.

Gross Domestic Product (GDP): A measure of the total economic output in goods and services for an economy.

Treasury Securities: Debt securities issued by the U.S. Treasury and backed by the direct "full faith and credit" pledge of the U.S. government. Treasury securities include bills (maturing in one year or less), notes (maturing in two to 10 years) and bonds (maturing in more than 10 years). They are generally considered among the highest quality and most liquid securities in the world.

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