Blue Chip Partners: Quarterly Edge
Q2 2024

Market Outlook

U.S. equities continued their ascent in Q1 2024, notching fresh all-time highs for the first time in over two years. Optimism around the business impacts of artificial intelligence and healthy corporate earnings powered widespread returns. Looking forward, we see evidence that stocks can be higher over the 12 months to come.

The bond market has been volatile year-to-date, as expectations for the trajectory of interest rates seem to differ week-to-week. That said, key characteristics in fixed income have the asset class set up for a decade that we believe will look very different than the previous.

Within the domestic equity market, healthy corporate fundamentals and historical data point to potential for continued momentum.

In fixed income, elevated yields and supportive monetary policy provide a compelling backdrop for bonds.

Merits of momentum

The benefit of boring

Your Bottom Line

Healthy corporate fundamentals and historical data point to potential for continued momentum
Domestic revenue and earnings continue to grind higher, market returns have broadened, and history shows that stocks can maintain an upward trajectory after periods of strength.

Elevated yields and supportive monetary policy provide a compelling backdrop for bonds
Starting bond yields have a high degree of correlation with total forward-looking returns. Today, starting yields are near their highest levels in more than a decade. Should expectations come to fruition, declining interest rates over the next year would be a boon for returns across quality fixed income assets.

Source: Blue Chip Partners with data from Bloomberg Finance L.P. As of 31 March 2024. Additional detail in disclosures.

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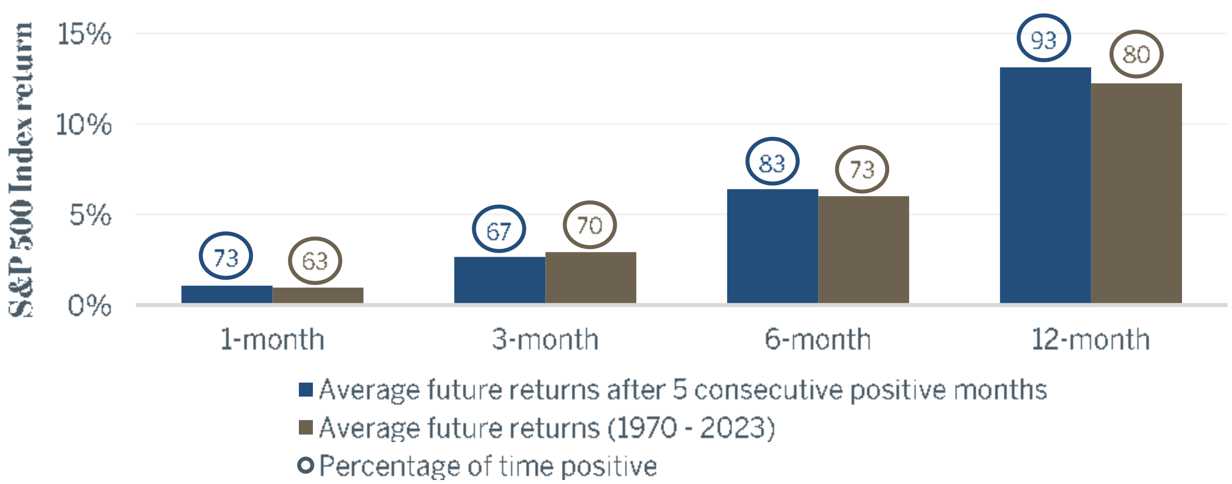
Merits of momentum

In the first quarter, U.S. stocks as measured by the S&P 500 Index gained 10.55%. Seemingly picking up where 2023 left off, the U.S. market has returned ~26% over the previous 5 months – all of which displayed upward movement in the index. After a period of meaningful appreciation in the domestic equity market, it is common for investors to question the potential for further gains in the immediate term. While we are not in the business of predicting short-term price movements, we are encouraged by the healthy fundamentals across the corporate landscape. These include continued growth in both revenue and earnings as well as greater balance in the labor market. Further, performance of the U.S. equity market has been much more widespread in 2024 relative to 2023 (a component of our optimistic stance in the Q1 Quarterly Edge), which we would view as reflective of a healthy market. Finally, while we do not expect history to repeat itself, it certainly may rhyme with what is to come. Historical data indicates that 5 consecutive months of upward movement in the S&P 500 does not necessitate a pullback. In fact, future returns from the index have historically been ***higher*** than the long-term average after 5 consecutive months of positive performance, and have been more frequently positive over periods following a 5-month winning streak (full details found below). While we would not be surprised to experience periods of greater choppiness given lack thereof in recent months, both historical data and underlying fundamentals leave us optimistic on the trajectory of U.S. stocks.

The S&P 500 Index was up for 5 consecutive months – what happens next?

S&P 500 Index average future returns (1970 – 2023)

	1-month	3-month	6-month	12-month
After 5 consecutive positive months	1.07%	2.65%	6.39%	13.13%
% positive	73%	67%	83%	93%
Overall (1970 – 2023)	0.96%	2.92%	6.01%	12.24%
% positive	63%	70%	73%	80%



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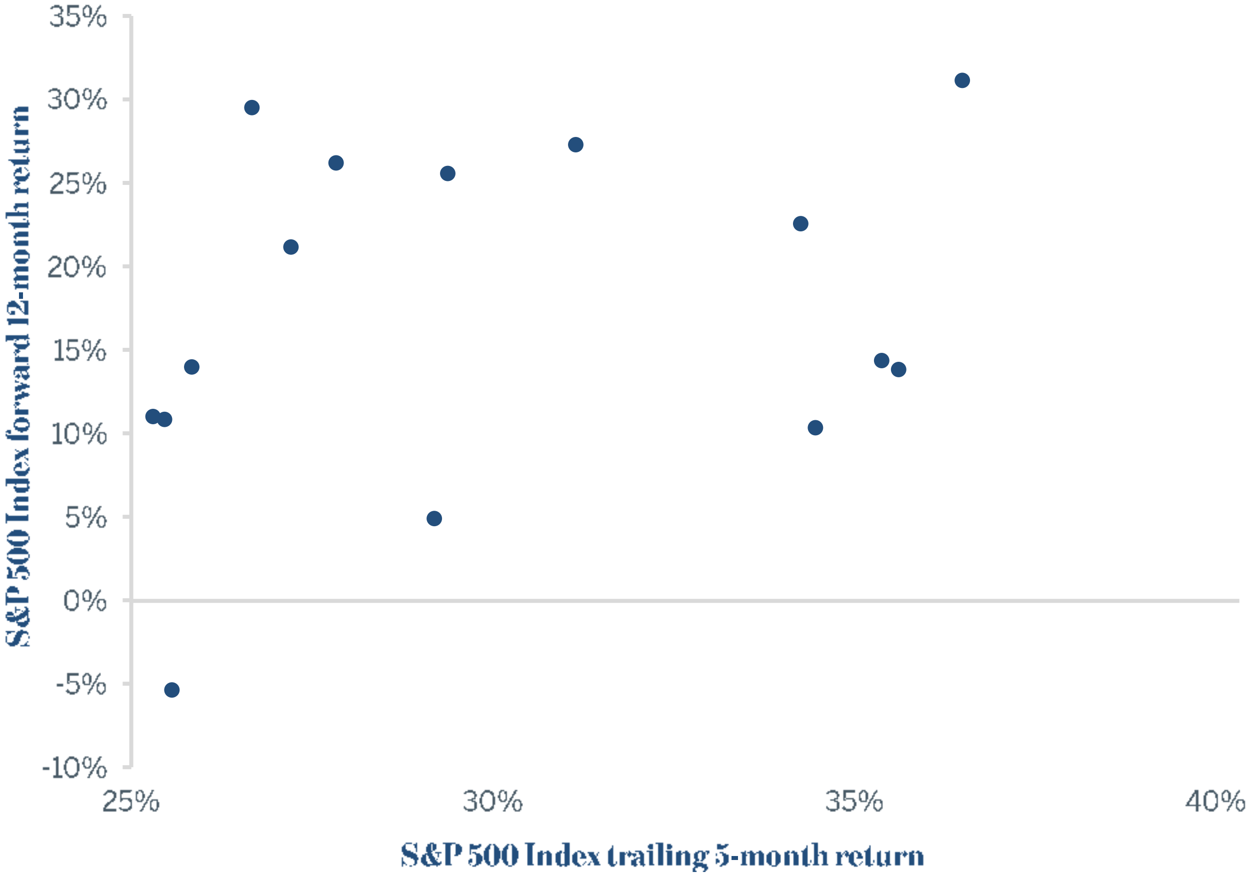
Merits of momentum

The S&P 500 Index was up >25% in 5 months – what happens next?

> 12-month forward returns were positive in 93% of occurrences (14 / 15) since 1970

S&P 500 Index average 12-month returns (1970 – 2023)	
After >25% return in 5 months	17.15%
% positive	93%
Overall (1970 – 2023)	12.24%
% positive	80%



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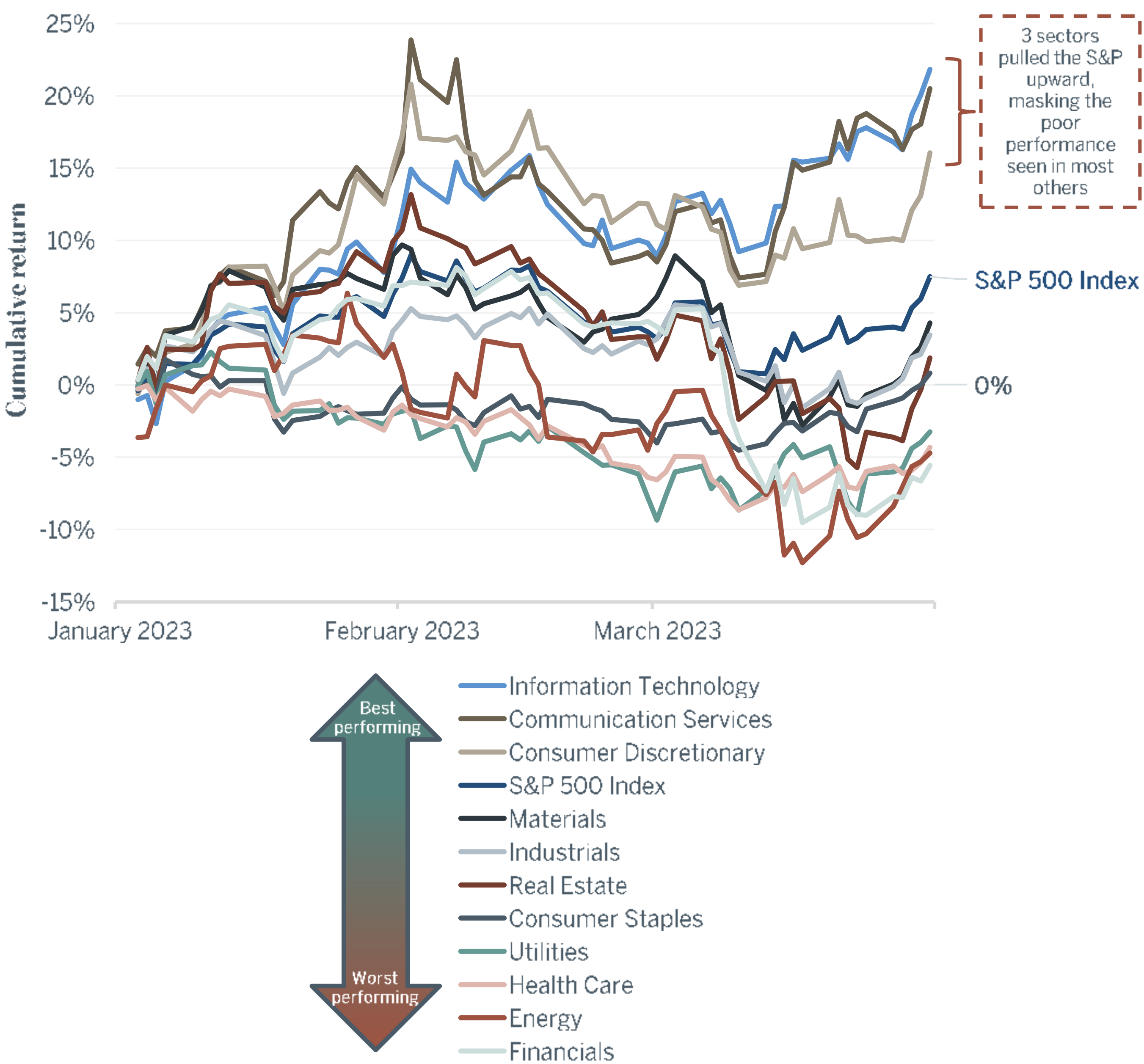
Merits of momentum

Q1 2023 performance by S&P 500 sector

> **Unhealthy market:** returns were concentrated in 3 sectors and just a handful of stocks



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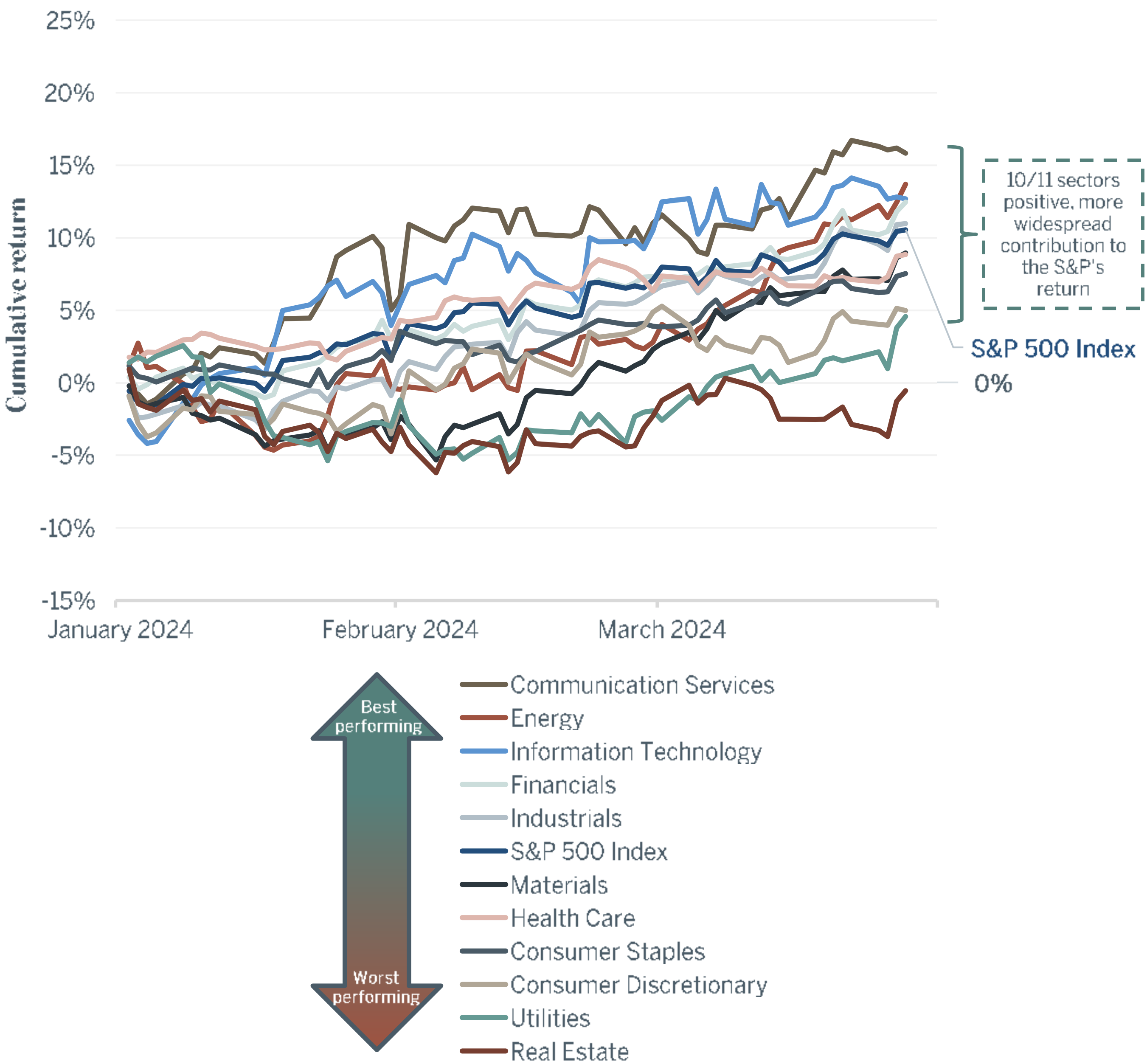
Merits of momentum

Q1 2024 performance by S&P 500 sector

> **Healthy market:** returns were widespread across sectors and stocks



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The benefit of boring

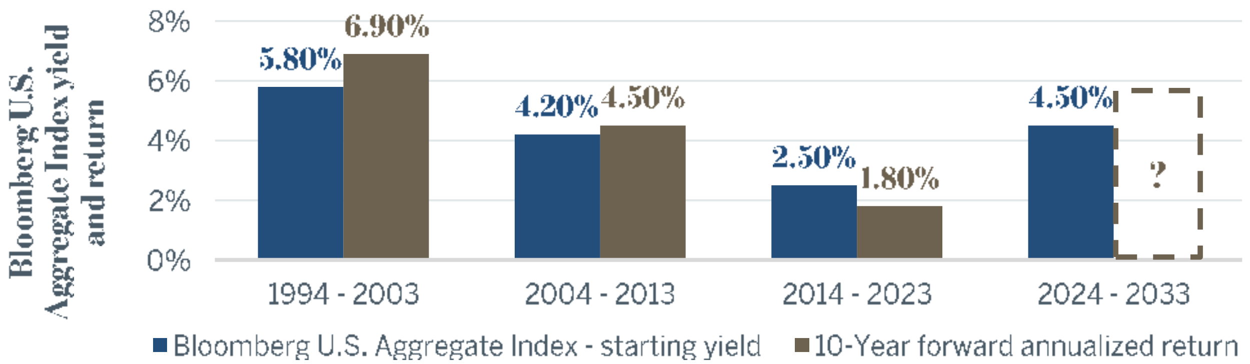
For the better part of the last year, we have been vocal with regards to why we view the bond market as ripe for investment. Now more than ever, our constructive thesis holds. Our optimism can be distilled into two primary points:

1. **Starting yields are near their highest levels in more than a decade, and**
2. **The Federal Reserve is expected to start reducing interest rates this year**

On the first point, it is imperative to understand that the initial yield of an investment in the bond market has historically been the best predictor of total return. If an investor purchases a 10-year Treasury bond at par yielding 4.00%, when held to maturity, the return experienced will be 4.00%. Prices can fluctuate in the secondary market based on interest rate movements throughout the life of a bond (bond prices and interest rates are inversely correlated), but income will be the primary driver of return – especially when the level of income generated is more sizable.
In 2023, for example, higher starting yields played a pivotal role in driving return. The 10-year Treasury touched 5% in October, and despite meaningful interest rate volatility throughout the year, the 10-year yield ended the year precisely where it began – 3.88%. Even though rates moved higher through October, returns in most subsets of the fixed income market remained positive or only modestly dipped into negative territory as income distributions served to offset price declines. 2022 was a different story, as meaningfully lower starting yields were unable to buffer against hefty upward movements in interest rates. In fact, the combination of low starting yields and severe price declines had a significant negative impact on a decades' worth of return, as you can see in the chart that follows. Thus, with starting yields close to multidecade highs, today's bond market should be viewed as compelling.

Though income drives the bulk of bond returns, price movement remains a factor as well, and history suggests that today's bond market is still in the early going of a lengthier rally. Persistent upward movement in the fixed income market has been visible following the end of Fed rate hiking cycles using data since 1978, while cash returns falter given the rate cuts that follow soon after. Today's yields have only fallen by a fraction of the average historical decline, and returns since the end of the Fed's hiking cycle (July) have not kept pace with what has previously been observed. This reinforces our stance that the time to begin a shift away from cash assets and towards bonds is now.

Expected bond returns should be higher in the next decade than the previous



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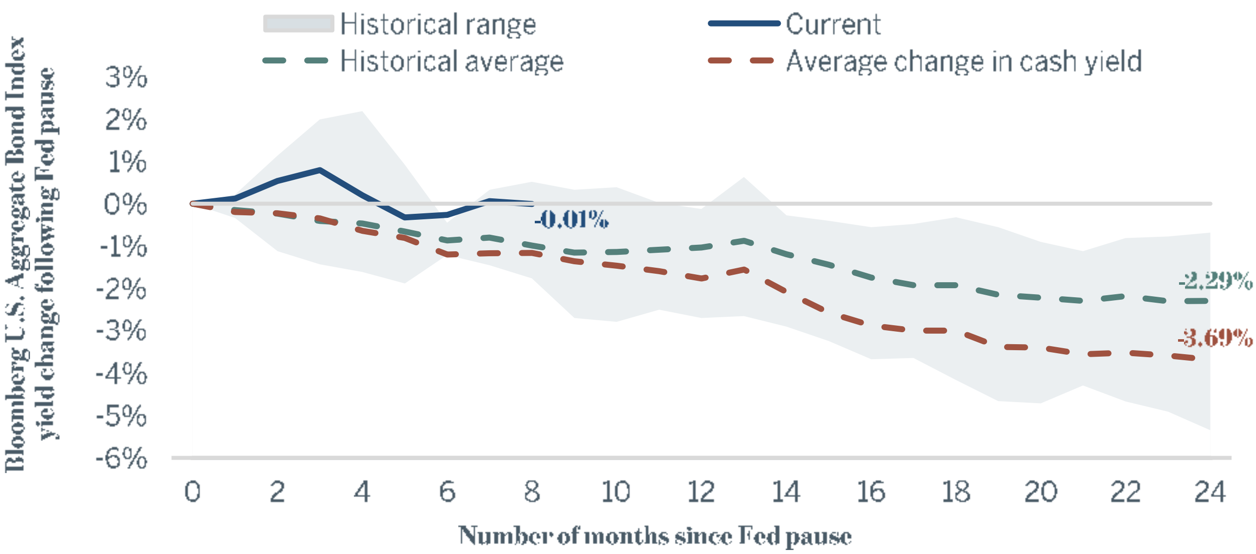
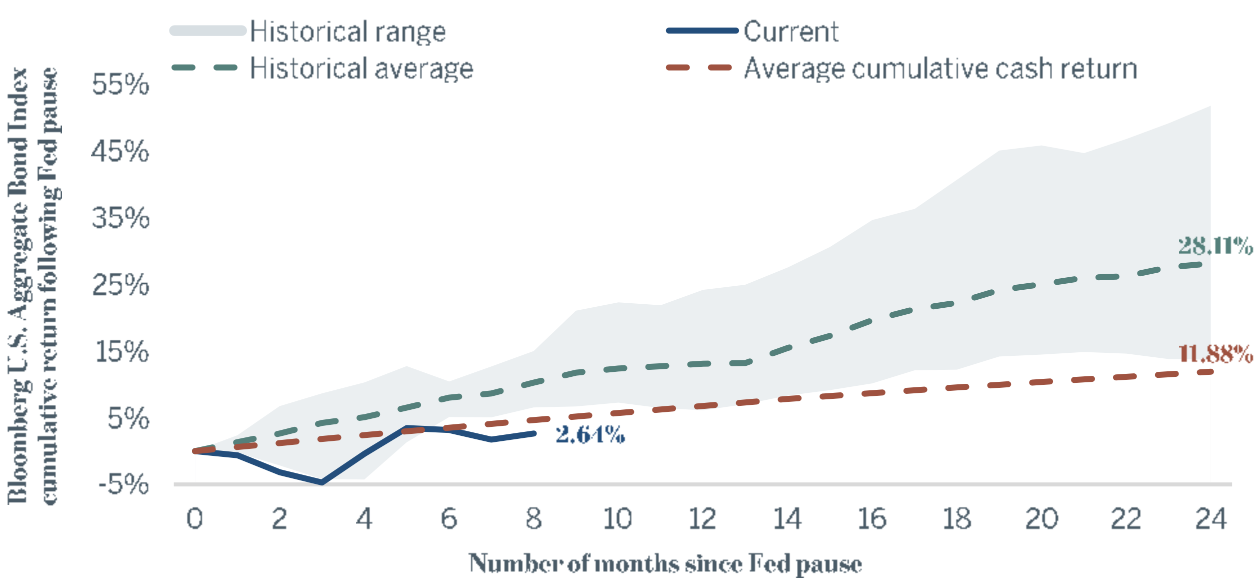
The benefit of boring

- Sharp declines in yields and attractive bond returns have historically followed Fed hiking cycles
- The current cycle appears as a large outlier, which implies the bond market has a significant runway for growth

Yields have not fallen in a manner consistent with history...



...which implies the bond market has extraordinary catch-up potential



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Disclosures
Q2 2024

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<u>S&P 500 Index average future returns (1970 – 2023):</u> Source: Bloomberg Finance L.P. Returns are shown for the S&P 500 Index from 31 January 1970 – 31 December 2023. The S&P 500 Index is a market capitalization weighted index that tracks the performance of 500 of the largest companies that are listed on stock exchanges in the United States. It is not possible to invest directly in an index.

<u>S&P 500 Index average 12-month returns (1970 – 2023):</u> Source: Bloomberg Finance L.P. Returns are shown for the S&P 500 Index from 31 January 1970 – 31 December 2023. Data included is representative of periods in which the index returned a value greater than 25% over a 5-month period. The S&P 500 Index is a market capitalization weighted index that tracks the performance of 500 of the largest companies that are listed on stock exchanges in the United States. It is not possible to invest directly in an index.

<u>Q1 2023 / Q1 2024 performance by S&P 500 sector:</u> Source: Bloomberg Finance L.P. Returns are shown for the various sector indices that underlie the S&P 500 Index from 31 December 2022 – 31 March 2023. The S&P 500 Index is a market capitalization weighted index that tracks the performance of 500 of the largest companies that are listed on stock exchanges in the United States. It is not possible to invest directly in an index.

<u>Expected bond returns should be higher in the next decade than the previous:</u> Source: Bloomberg Finance L.P. Yields are representative of yield to worst. Returns and yields are shown for the Bloomberg U.S. Aggregate Bond Index, and are representative of the 10-year periods between 31 December 1993 – 31 December 2023. The Bloomberg U.S. Aggregate Index is a broad-based fixed income benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. It is not possible to invest directly in an index.

<u>Yields have not fallen in a manner consistent with history…which implies the bond market has extraordinary catch-up potential:</u> Source: Bloomberg Finance L.P. Yields are representative of the yield to worst for the Bloomberg U.S. Aggregate Bond Index and the current yield of the U.S. Generic Government 3-Month Index. Returns and yields for the two aforementioned indices are calculated from the end of the month in which the Federal Reserve stopped raising rates in 1981, 1984, 1989, 1995, 2000, 2006, and 2018. The Bloomberg U.S. Aggregate Index is a broad-based fixed income benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The U.S. Generic Government 3-Month Index is a fixed income benchmark that tracks 3-month Treasury bills offered by the U.S. government. It is not possible to invest directly in an index.

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