Morgan Stanley
INVESTMENT MANAGEMENT

Equity Market Commentary

SLIMMON'S TAKE | APPLIED EQUITY ADVISORS TEAM | July 2024

AUTHOR

ANDREW SLIMMON
Managing Director and Senior Portfolio Manager, Applied Equity Advisors

The following views and perspectives are formed by the work of the Applied Equity Advisors team in managing assets for investors.

On June 17th, we released a June Slimmon's TAKE. A few points I think are important to reiterate:

1

One of the best performing factors year-to-date is earnings revisions.[1] Simply put, the better the earnings revisions, the better a stock's performance. Likewise, the worse the revisions, the worse a stock has performed.

In our opinion, the current environment is symptomatic of an equity market acting extraordinarily rational.

Applied Equity has a bias towards good fundamentally performing companies and tends to avoid "bottom fishing" or purchasing stocks simply because their price has declined significantly. The correlation between strong fundamentals and good stock performance is a key reason for Applied Equity's overall positive results year-to-date.

To state the obvious, this is not my first investment cycle. The most powerful knowledge I have gained in this business is unquestionably from the many painful lessons I have learned along the way.

I have bought turnaround stocks in the past and have come to appreciate (the hard way) Warren Buffett's simple quote: "Turnarounds seldom turn."[2]

I have also bought poorly performing companies whose stock prices were so low they seemed irresistible. That reminds me of a second quote (which I struggle to ascribe to anyone), equally as simplistic, "stocks rarely go up for long if companies are not meeting Wall Street's expectations and rarely go down for long if exceeding."

In my younger years when I was more amenable to believing I could outsmart the market, I was less respectful of such simplistic ideas. One too many times the steamroller of reality has run me over, leaving

[1] Bloomberg. Current year earnings per share, three-month change.
[2] Quotefancy.

my “outsmarting ego” fully trampled for good.

2 ***Currently, it is difficult to find a company with better earnings revisions than Nvidia, a stock that we own.***

As much as Nvidia has captured most of the media attention, it is not the only company with excellent earnings revisions. Other companies simply do not get the coverage Nvidia does.

As Nvidia’s stock price has levitated relative to the rest of the market, so has its single stock risk. Let us not forget, Nvidia has had ten 50% stock price declines since going public in 1999.[3]

But with other companies also performing fundamentally well, there are plenty of opportunities to offset this single stock risk. We would highlight the Infrastructure Act beneficiaries as a straightforward theme.

Nvidia’s stock price peaked on June 18th, the day following our last Slimmon’s TAKE. At least for now. However, our infrastructure plays have rallied nicely since that date, as of this writing.[4]

I think the lesson is that even good fundamentally-driven stocks can get overbought and overly loved. It is a healthy reminder to control exposure, trim when position sizes get too big and work to ensure the stocks in the portfolio don’t zig and zag together.

Understanding AEA’s true risk exposures is a real advancement in our work, and portfolio manager Phillip Kim deserves a ton of credit.

As of this writing, we have seen a pretty sizable move into value and out of growth. However, I think it’s too late to chase the value names and too early to increase growth exposure.

3 What bothers me about this current rotation since July 11th is the best performers have been the riskiest stocks. Many of the biggest recent winners are companies that are *losing* money. They have the worst fundamentals, and they have the highest betas, or volatility in relation to the overall market.

This is a clear change from what we saw in 1H 2024. Beta is driving the market of late, not fundamentals. (In general, the higher the risk, the better they are doing.)

Currently, we are experiencing froth in risk, yet we are about to enter the two worst months for equities on average.[5] Allow me to state the obvious… this may not be a good set up.

The rotation into higher risk at this point in the year does not feel particularly healthy to me. I always want to tighten up the sails at this time of the year, not let them out.

4 Having said that, we are approaching earnings season. Given the index weightings of the mega-caps,[6] good earnings reports from them might cushion the blow at the index level. Especially if they are already weak going into their reports.

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[3] Bloomberg.

[4] Bloomberg.

[5] Factset since 1929, based on the Dow Jones Industrial Average from 1929 and the S&P 500 since 1957.

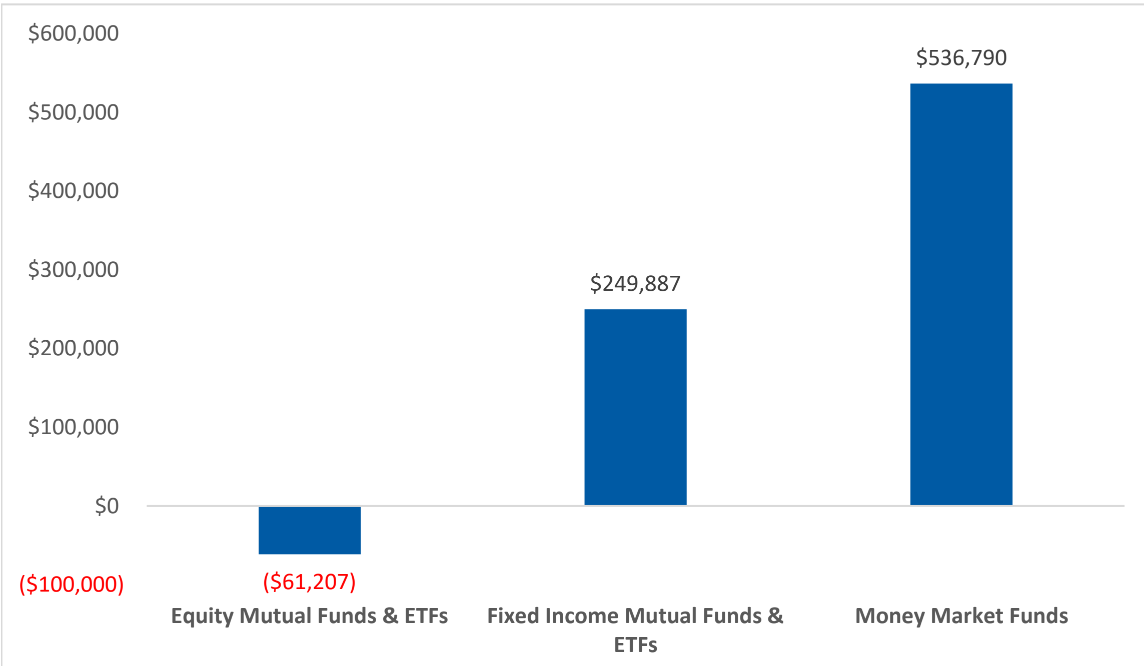
[6] The stocks with a market value greater than $200 billion.

5 To be clear, I still believe the S&P 500 will be higher by year-end.

One of my primary reasons remains behavioral. Simply put, money pours into relatively safe products in the early stages of a bull market because the “rear-view mirror” reminds investors of the past dangers. However, in the later stages of a bull market, the “rear view mirror” appears to be nothing but good times for risk assets. Therefore, money pours out of safety.

If “bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria,”[7] where do you think we are in the bull market cycle?

Trailing 1-year fund flows (MMs) as of June 2024



Source: Strategas.

As CEO Larry Fink said on Blackrock’s Q2 quarterly call: “There’s just too much investable dollars parked in cash that will need to re-risk into credit and equity assets.”[8]

6 The bottom line is stick with what has worked long-term. Growth or value, large or small…stick with companies that have solid fundamentals and be wary of this month’s equity leadership. When speculative stocks go down, they don’t wait for the elevator for a gentle ride.

Yet another lesson I learned…the hard way!

[7] Sir John Templeton.
[8] July 15, 2024.

7 Finally, and more specifically as it pertains to Applied Equity's holdings, while it's early into Q2 earnings season, we have experienced an excellent set of reports so far. This is coming on the heels of some recent stock weakness.

I will gladly take recent poor price action but upward earnings revisions off strong reports (buying opportunities) over fundamental misses, any day.

Andrew

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