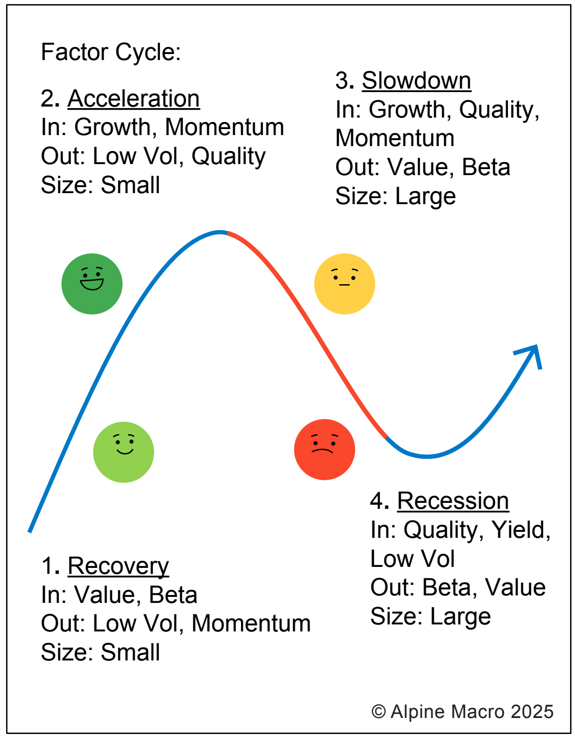
What's Working Across This Market?

It may seem as if Mega Tech has been the only consistent source of leadership in recent quarters, even as some members weather early year wobbles, but this resilience is a symptom of factor characteristics which have proven durable across other market segments.

Now is not the time to abandon leading exposures to Growth, Momentum, and Revisions given the start-and-stop macro backdrop but our outlook for eventual disinflation with easing financial conditions and resilient growth augur for a gradual rotation towards cyclicality.

Alternatively, more conservative exposures to Quality and Larger Size are not dead but feature as downside limiters as opposed to upside gatherers and will be less attractive as the cyclical rotation comes sharper into focus.

Chart 1 Mapping Out The Factor Cycle



Factor Performance Around Cycles

Stocks with shared characteristics often exhibit similar performance tendencies around points of the business cycle which enables the application of these insights to be transferable across sectors and industries. This is an important feature and especially useful for investors with a narrower mandate on particular sectors, sizes, or styles.

Expansionary periods historically begin with risky segments outperforming before giving way to more established growth leadership as cycles mature. When the economy overheats, forcing policymakers into action, or something "breaks" within the financial system, stocks exhibiting lower risk characteristics protect on the downside.

Chart 1 illustrates the business cycle and a simplified mapping of factors at each stage while Table 1 shows the correlation between certain factors and macro indicators and Exhibit 1 shows our "Factor Factory", which provides a primer of financial metrics to watch for assessing common factors.

Table 1 Certain Factors Are More Macro Sensitive

	S&P 500 Factor Correlation With:			
	10-Year Treasury	High-Yield Spread	10/2 Year Treasury	USD
Growth	0.01	-0.17	-0.03	-0.09
Momentum	-0.11	0.23	-0.24	0.02
Revisions	0.19	-0.29	-0.13	-0.11
Size (Large)	-0.28	0.65	0.02	0.14
Quality	-0.26	0.62	-0.15	0.06
Value	0.44	-0.53	0.09	-0.08

Note: S&P 500 Sector-Neutral Excess Returns, data since 2003

Exhibit 1 Factors To Watch

Factor Factory				
Quality	**Growth**	**Profitability**	**Leverage**	**Value**
ROE/ ROIC Variability Leverage	Sales EPS Actual/ Fwd	ROE/ROA/ ROIC Margins Asset Turnover	Debt/ Market Debt/Book Debt/ EBITDA	E/S/EBITDA/ FCF Price EV Yields
Volatility	**Size**	**Momentum**	**Revisions**	**Yield**
Implied Realized Beta	Market Cap Assets Sales EBITDA	1 Yr – 1 Mo 1 Yr – 2 Wk 6 Mo – 2 Wk LT Reversal	Sales Earnings Target Price	Dividend Shareholder Payout

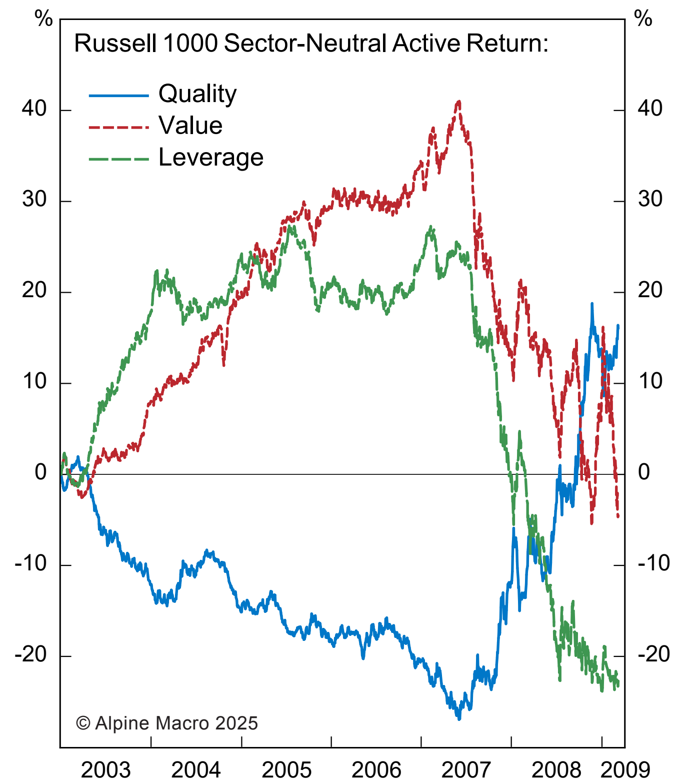
Impact Of Regimes And Sentiment

The business cycle is not the only consideration of factor investing as compositional elements matter alongside other determinants including investor sentiment.

Value stocks, for example, are vulnerable to bouts of underperformance under two scenarios: 1) furious growth rallies driven by positive sentiment, or 2) economic shocks. Growth factors, on the other hand, demonstrate less exposure to economic drivers but are more prone to speculative excesses or bubbles.

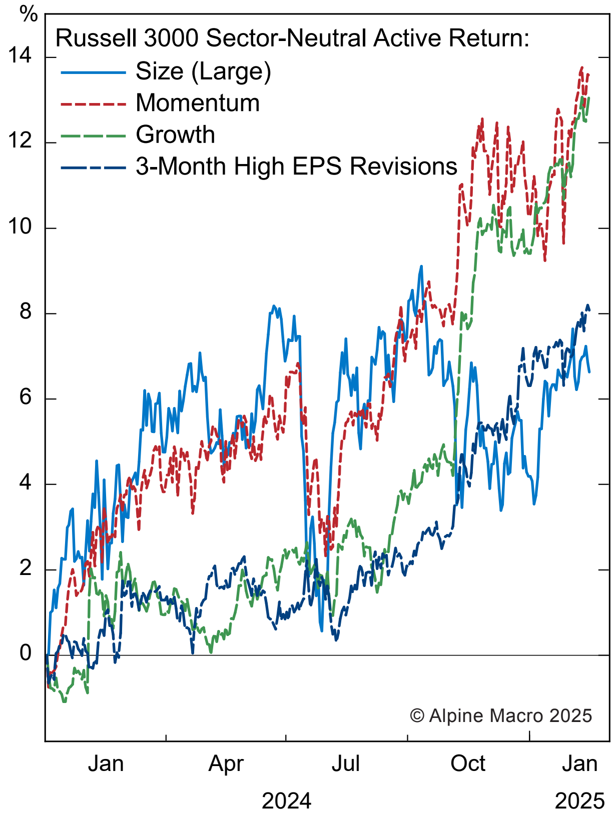
The boom-and-bust periods of the 2000s illustrate this example. The bull market Mania in lower Quality Growth stocks busted in 2000 and shifted toward Value and Leveraged leadership concentrated in financial and resource-adjacent sectors. These pockets were subsequently annihilated during the Global Financial Crisis (Chart 2).

Chart 2 2000s Boom/Bust Of Value And Leverage



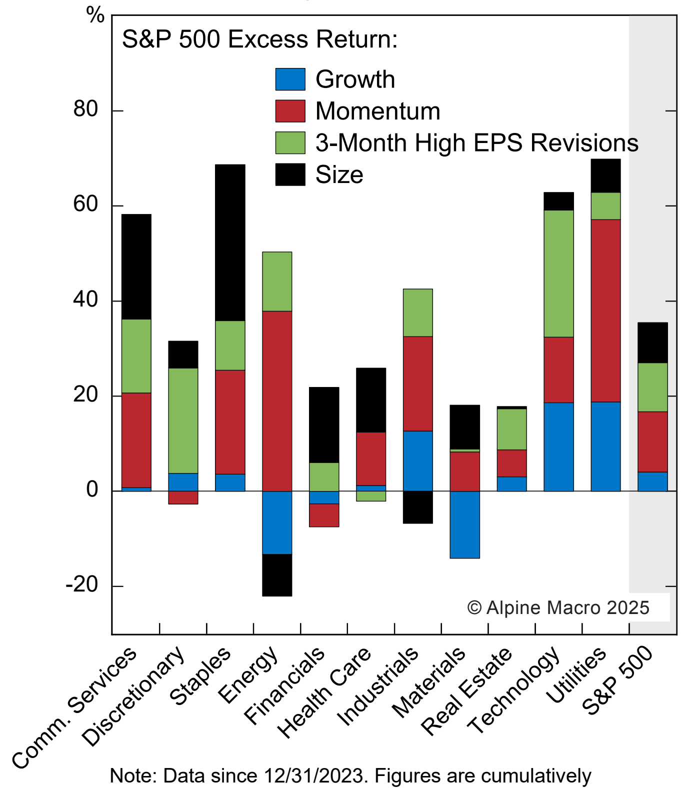
Source: Bloomberg Finance L.P.

Chart 3 Durable Leadership Of Select Factors



Source: Bloomberg Finance L.P.

Chart 4 Strong Hit Rate For Large, Grow, Mo', And Revs



Note: Data since 12/31/2023. Figures are cumulatively stacked and do not represent sector return

What's Working Now?

Even as overall market leadership is heavily swayed by Mega Tech, certain factors have posted consistent excess returns on a sector-neutral basis across styles and market cap (Chart 3):

1) Growth 2) Momentum 3) Revisions 4) Size (Large)

Why Are These Factors Working?

The success of this factor mix reflects lukewarm investor sentiment regarding an uneven growth backdrop and wobbly financial conditions. Importantly, the U.S. is not the only consideration as large exposures to international supply chains and revenue streams require a global purview.

This factor leadership suggests a market driven more by "FOBO" (Fear of a Better Option) than "FOMO" (Fear of Missing Out). Investors are net bullish but unwilling to fully commit to a complete risk-on stance. Instead, there is a sense of "survive and advance" in leaning into what has worked in the recent past and should continue barring shifting circumstances.

In this context, it's understandable why a premium develops for faster organic growth and strong revisions while the overall profit backdrop is mixed, and financial conditions churn. Larger companies with better financial and operational wherewithal to withstand uncertainties are also attractive, for now.

Chart 4 shows how the value-add of these factors have been incredibly consistent across sectors.

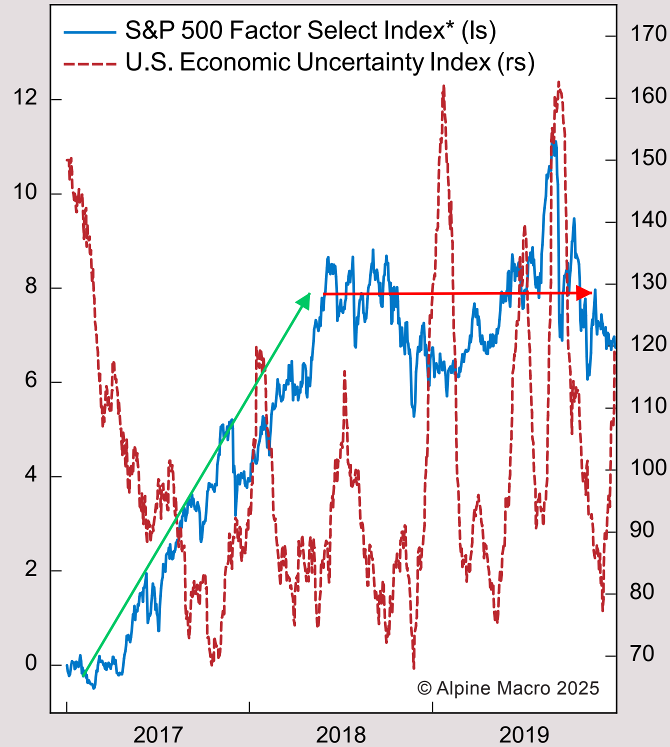
The Trump Paradigm

Factor leadership experienced strikingly similar trends in the early period of Trump 1.0 with Growth, Momentum, Revisions, and Large Size outperforming in 2017 through autumn of 2018 even as economic uncertainty intensified (Chart 5).

The breakup was prompted by fears of a policy mistake coinciding with a sharp decline in growth expectations which preceded a curve inversion. Large Size continued to maintain leadership but was joined by Low-Volatility and Quality in a risk-off lurch.

Since 2023, a similar regime of factor leadership has asserted itself and has shown little sign of abating following U.S. elections.

Chart 5 Factor Mix Unperturbed By Trump 1.0 Uncertainty



*Equal-weight index of Growth, Momentum, 3-Month High EPS Revisions & Size (Large)
Source: Baker, Bloom & Davis, Bloomberg Finance L.P.

Leading Factors

Fast Growth

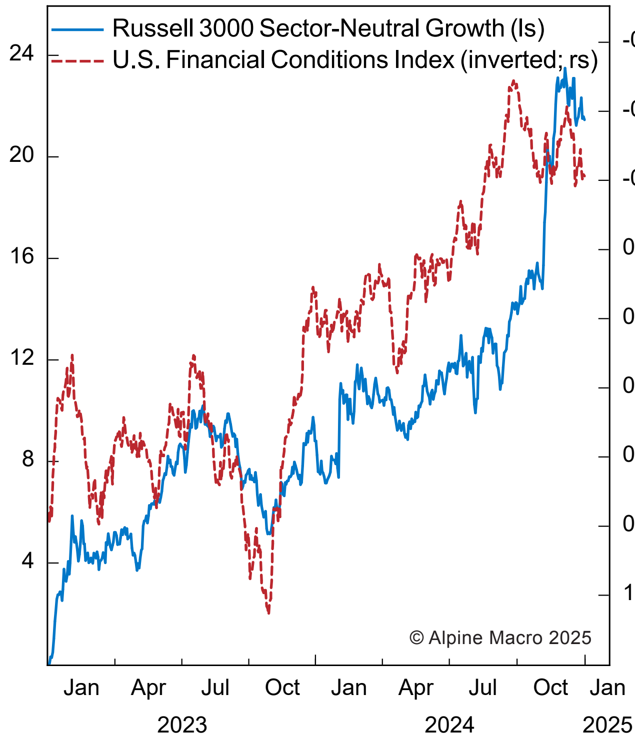
Companies that have exhibited faster earnings and revenue growth are outperforming at a convincing pace, regardless of size. This is a proof point to our view that the leadership of the Magnificent 7 is due primarily to the uniqueness of those companies.

The two conditions during which growth stocks perform best have been in place for several quarters: A) scarce revenues and/or profits for the broader market, and B) a build-up and blow-off topping process of Manias.

The results are irrefutable. Since 2023, companies in the top quintile of Growth have added 12% of excess performance in U.S. Large Caps and 27% in Small Caps. Moreover, higher growth companies within the Russell 1000 Value Index have outperformed by 18% while the "growthiest" companies in the Russell 1000 Growth Index have added 32% (Chart 6).

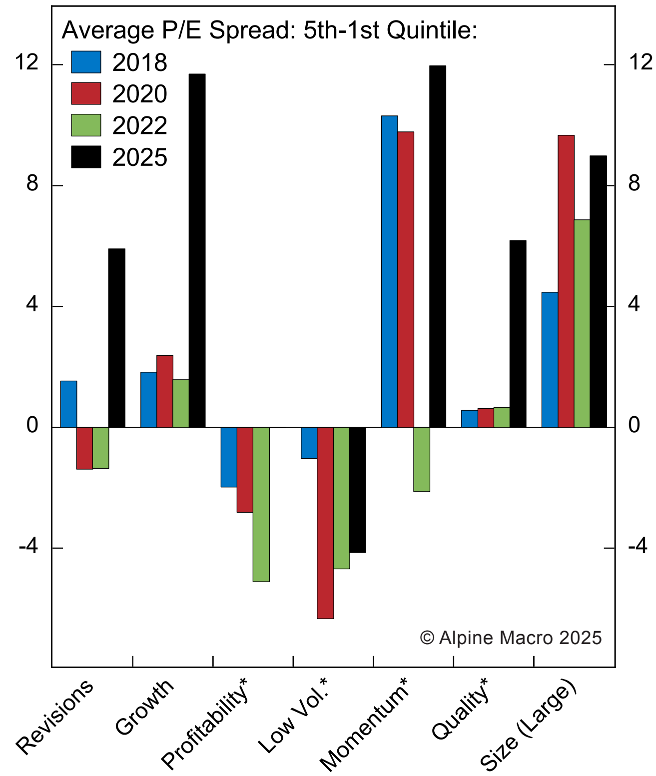
The risk for Growth is that it's priced at a premium, even standing out amongst a sea of other expensive factors (Chart 7).

Chart 6 Growth Gains Coinciding With Easing Financial Conditions



Source: Federal Reserve, Bloomberg Finance L.P.

Chart 7 Factors Are Expensive, Growth Stands Out



*Sector-Neutral
Source: Bloomberg Finance L.P.

Mo' Money Mo' mentum

In normal times Momentum can be a potent driver of excess returns but as we've documented in past reports, when momentum cracks it often craters, scarring investors who don't rotate away quickly enough.

Yet Momentum has proven to be more durable than often realized with strong historical performance during periods of growth acceleration and slow-downs, which are the longest phases of the business cycle, as it's a less macro-sensitive factor.

During the current regime there have been a few stop-and-start instances in which a wobble in leadership threatened to unwind the Momentum advance but it's scaled the wall of worry on each occasion.

Since 2023, companies in the top quintile of Momentum have added 11% of active return in Large Caps and 15% in Small Cap. This confirms earlier observations that Momentum is even more potent within Small Cap.

Earnings Momentum Also Surging

The Momentum factor measures the strength of *price changes* but the Revision factor measures *fundamental changes*. Analyst expectations for company earnings generally track well with actual realized earnings, especially on a directional basis, so upward revisions are considered a positive indicator of fundamental improvement.

The Revision factor, which measures the breadth and magnitude of estimate changes in recent weeks, is especially attractive during periods of economic uncertainty as it's a faster moving and more micro-based characteristic. The exception to this is during periods of idiosyncratic shock or recession which are often unforeseen.

Since 2023, companies in the top quintile of earnings revisions (3-Month) have added 8% of excess performance in U.S. Large Caps and 13% in Small Cap. The added returns have been even more pronounced in the Growth style (+28%) than Value (+14%).

Bigger Is Better, For Now

Size has mattered on a cross-sectional basis within market cap, sectors, and styles. Larger companies have handily outperformed across most segments (Chart 8).

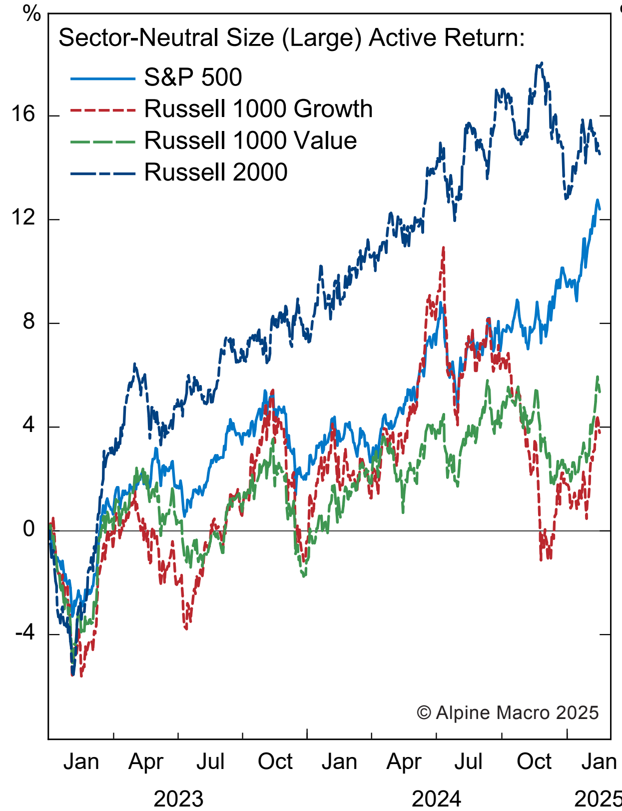
Larger size is usually associated with higher quality and lower risk but also slower growth over time given more mature businesses and the law of large numbers.

Since 2023, the top quintile of companies by market cap have added 13% of excess performance in U.S. Large Caps and 15% in Small Cap. Larger size has also outperformed across both Growth and Value Indexes. The durability across these strata confirms that *leadership of larger companies is not only a Mega Tech phenomenon.*

Will These Factors Still Work?

It's unlikely that factor leadership will dramatically shift unprovoked but expect there to be rotation as our view towards broadening profits, gradually lower inflation, and easing financial conditions comes sharper into focus.

Chart 8 Large Outperformance Not Exclusive To Mega Tech



Source: Bloomberg Finance L.P.

Momentum, Revisions, and Growth—to a slightly lesser extent—have shown their ability to outperform through those circumstances in the past and we'd be less inclined to doubt their efficacy until given reason to suggest otherwise.

Larger Size, however, has a history of not keeping pace as macro conditions improve and breaks with the other leading factors as it is one of the most sensitive to credit spreads and economic output. In 2013, for example, U.S. Manufacturing PMIs surged alongside Momentum, Revisions, and Growth while Larger Size sank. A similar divergence occurred in 2003-2007, too.

Chart 9 shows that Larger Size, like Quality, can become overwhelmed when the growth conditions improve.

The risks to our outlook come in the case of a reacceleration of inflation which would prompt further tightening of policy, or a significant deterioration of sentiment. The former would risk a deterioration in profits which could imperil the confidence in Revisions while the latter would threaten Mania-adjacent Growth and Momentum.

Is Quality Dead?

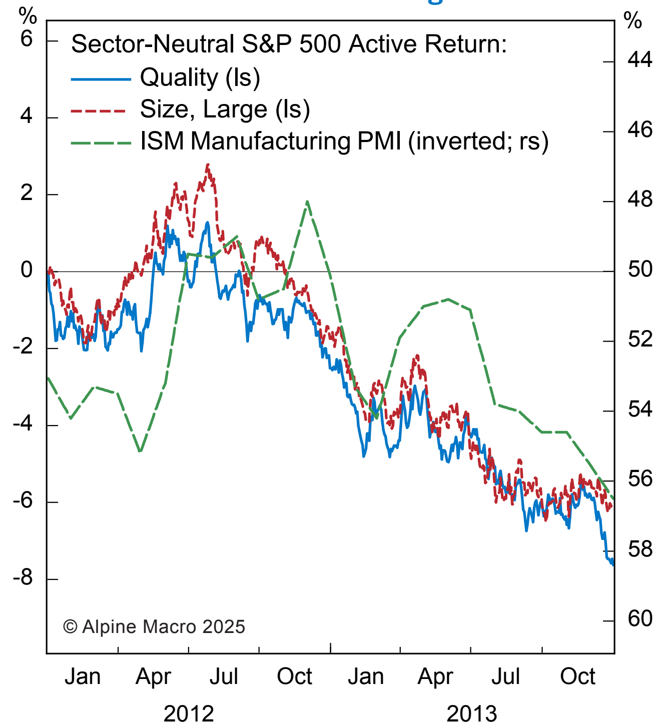
Quality hasn't generated consistent alpha in recent quarters even as it shares some similarities with Larger Size. As a risk-off factor, Quality usually outperforms in waning expansions and through contraction. It also tends to react inversely to financial conditions. These attributes have contributed to underperformance this cycle as profits have been concentrated but solid, and financial conditions have followed an uneven downtrend since October 2023.

Our expectation for broadening profit growth and a flat-to-easing bias for financial conditions will limit the upside for Quality. If financial conditions tighten or the economy slips Quality will come back into vogue.

Conclusion

Our central view is that a solid nominal growth environment with gradual disinflation will combine with margin expansion to drive broadening profit growth. This will allow for the main ingredients powering current factor leadership to remain largely in place, however we'd expect some rotation towards risk-on cyclicality.

Chart 9 Size & Quality Sank As PMIs Moved Higher



Source: Bloomberg Finance L.P.

At a minimum this should promote a shift away from larger size exposures in favor of smaller size. An improving growth backdrop with stable financial conditions would also provide a window of opportunity for Value, especially within the Small Cap space, although we advocate for a barbell with Large Growth to retain exposure to the Mania potential of Mega Tech.

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Investment Recommendations

Strategic Recommendations (6 - 12 months)

Recommendations	Open Date	Performance: Vehicle	Performance: S&P 500	Active Return
Long S&P Industrials	5/29/2024	14.54%	16.12%	-1.58%
Long S&P Utilities	6/12/2024	14.51%	12.85%	1.66%
Long S&P 600	6/24/2024	10.77%	12.30%	-1.53%
Short S&P Materials	7/24/2024	1.03%	12.70%	11.67%
Long Regional Banks (KRX)	8/21/2024	15.43%	8.83%	6.60%
Long U.S. Home Construction ETF: ITB	01/15/2025	-5.93%	2.83%	-8.76%

A Unique Mind On The Markets