HIGH CONVICTION ACTIVE | HIGH QUALITY EQUITY | OUTLOOK

2024 Outlook: Atlanta Capital

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High Quality Stocks Offer Opportunity Amid a Sea of Market Noise and Volatility

KEY POINTS

1. Major equity indexes are at record levels of concentration, skewing index returns. This scenario provides an opportunity for active managers whose portfolios are differentiated from the benchmark to add value over the long term.

2. Inflation, interest rates, the Fed's balance sheet, credit issues and corporate earnings add to the sea of noise and volatility in the marketplace. Moreover, macro uncertainty is heightened by geopolitical wars.

3. We believe high quality[1] companies with proven pricing power, leadership in secularly growing markets, and disciplined expense management are well positioned to navigate these volatile environments.

What We Are Seeing

An extremely narrow market. The concentration of names and lack of breadth in the equity market is striking. Through the third quarter, the top five names in the Russell 1000® Growth Index accounted for almost 43% of market capitalization, while three sectors made up 96% of its gains. In the S&P 500, seven stocks accounted for 84% of that index's return for the same period.

Inflation and interest rates remain top of mind. Inflation is simply second-derivative math. Inflation may be slowing, but prices are still increasing. When a gallon of milk goes from $3.00 to $4.50 and then the price increase "slows," it's still problematic. In our view, the next leg of inflation will likely be wages. We have seen contract agreements with significant pay increases for workers in the airlines, automotive, health care and package delivery industries, among others. The economy remains far from the Federal Reserve's (the Fed) 2% inflation target.

The Fed's balance sheet is just starting to contract. We believe liquidity is just as important, or even more important, as interest rates. The Fed's balance sheet has exhibited a strong correlation to market performance over the last few years as the Fed's balance sheet has increased from approximately $900 million to over $8.9 trillion. Now the Fed is trying to withdraw that liquidity, which will likely have significant implications for markets in the U.S. and abroad.

What We Are Doing

Staying true to our philosophy and process. While noise and volatility permeate the markets, we are staying true to our bottom-up, high quality investment approach that focuses on consistent, dependable growers. We believe companies with a demonstrated history of consistent earnings growth and stability can provide attractive returns with moderate risk over the long term.

Displaying patience. We want to be long-term holders of a business. We look for companies with enduring competitive advantages. While the markets are volatile, our strategy and process are designed to sort through the noise and identify businesses that we believe will compound for our clients over time.

Deeply researching opportunities. With noise and volatility come opportunities. As market expectations and valuations reset, we think buying opportunities will expand — and we are ready to take advantage.

What We Are Watching

Corporate earnings. The significant increase in the equity market this year has been largely due to multiple expansion. What happens when companies increase wages materially and then see a decline in unit sales?

Credit. The second, third, and fourth largest bank failures in history occurred in 2023 and that was without any significant credit issues. The recent bank failures were solely related to interest rates but now credit issues are beginning to percolate. Credit delinquencies and late payments are increasing throughout the economy while availability has declined significantly as banks reassess creditworthiness and risk. And this is not just a consumer phenomenon. Commercial real estate, venture capital and biotech have all been hard hit by the ensuing credit crunch. The costs of moving away from a decade of 0% interest rates are beginning to be reflected throughout the economy.

The return of normalized markets. What happens in a normalized market without 0% interest rates? What happens without the Fed providing significant liquidity? What are normalized returns going forward?

Historically, Fed tightening cycles have had a strong correlation with high quality performance, beginning nine months after the first hike and remaining several years thereafter. Rising rates have a greater impact on lower quality companies (those companies with no or limited cash flow that must borrow money). High quality companies are impacted by rising rates, but the stability and durability of their business models provide advantages during high-rate environments, as their borrowing requirements are typically less.

Considering where we are in the economic cycle, and the high interest-rate environment, we believe high quality businesses are attractive now and for the foreseeable future. As compounders, we believe high quality businesses are poised to provide competitive, long-term results over a business cycle.

1. Higher quality companies typically have consistent earnings, strong balance sheets, significant free cash flow generation, growing revenues and meaningful competitive advantages, whereas the opposite is true for their lower quality counterparts.

Index definitions:

Russell 1000® Growth Index measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000® Index is an index of approximately 1,000 of the largest U.S. companies based on a combination of market capitalization and current index membership.

S&P 500® Indexis an unmanaged index of large cap stocks commonly used as a measure of U.S. stock market performance.

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