Monthly Market Update

August 2024

Madison INVESTMENTS

Highlights:

- July saw a shift in market dynamics, with large tech declining and small and mid-caps rising. The S&P 500 ended the month up 1.2%, while the Russell 2000 jumped 10.2%.
- Economic reports and Fed Chairman Powell's statements supported the expectation of rate cuts due to lower inflation and weak job reports.
- The flattening yield curve and expected rate cuts boosted interest rate-sensitive sectors like Real Estate, Utilities, and Financials.

July was a month of twists and turns -- and not just in presidential politics. Within the markets, the byword was rotation as large tech faltered and small and mid cap stocks revived. It took a final day rally to push the S&P 500 Index positive, rising 1.2% for the month, bringing the year-to-date return to a healthy 16.7%. After years of underperformance, small stocks leaped to the head of the class, with the Russell 2000 rising 10.2%, constituting the bulk of the index's 12.1% year-to-date advance. The fate of the "Magnificent 7" was revealed in the two trailing S&P sectors as Tech fell -2.1% and Communication Services dropped -4.0%. As would be expected given these statistics, large value was well ahead of large growth, a trend that held but was less pronounced in smaller stocks.

While the trends were clear, assigning causality or predicting staying power remains challenging. The bond market offered clues as the long-standing inverted yield curve flattened, particularly in the narrowing 2-year to 10-year spread. Longer yields dropped significantly as the market priced in expectations for Federal Reserve rate cuts, with a 100% probability projection for a quarter point in September and a measurable possibility of a half-point cut. The market was also optimistic regarding November and December cuts. One effect of lower rates is a boost to smaller stocks, which tend to be more leveraged to the cost of borrowing.

Another beneficiary of projected rate cuts tends to be interest rate-sensitive sectors, and these led the S&P 500 in July, with Real Estate up 7.2%, Utilities up 6.8%, and Financials advancing 6.5%. Giving confidence to the projections were economic reports in July and Federal Reserve Chairman Powell's reiterations in his late July presentation of the Board's data dependency. The July 11 inflation report showed June consumer prices unexpectedly lower. A shift in demand is being reported by numerous companies, from makers of recreational vehicles to fast-food purveyors. While the economy remained relatively strong, the latest jobs report showed enough signs of weakness to support the projected Fed rate cuts.

One of the most common questions we're receiving is how the presidential election is likely to affect portfolios. We looked at historic trends, and while the evidence is mixed, there is a tendency for markets to dip as the uncertainty of elections approaches and then rally after the results. This appears to be driven more by uncertainty than by election results in terms of party victories. While presidential policies can impact individual companies and industries, broad economic and geopolitical realities have been more important. Trying to adjust asset allocations based on election projections has been a losing game. One constant has been how a mixed government has been perceived as the best for markets since this reduces the probability of dramatic legislative changes. We prefer to think in longer terms than election cycles and believe that fundamentally sound companies can prosper despite the vagaries of campaign promises and the unavoidable concerns that accompany them.

Portfolio Manager Q&A - Haruki Toyama

This past month, we've seen a slight rotation from the mega caps to mid and small caps and just about everything in between. What do you think is driving this reversal, and does it have staying power?

It's challenging to predict when market trends will end or continue. Historically, we've seen expensive stocks become even more expensive in the short to medium term, while cheap stocks can continue to decline. Consider the tech bubble in the late 90s or the financial bubble in the 2000s—both lasted much longer than anticipated. Alan Greenspan spoke of irrational exuberance in 1996, yet that [bull] market lasted years longer than expected. There's no clear signal for these rotations, so it's crucial to focus on the intrinsic value of companies. This approach provides an anchor when deciding whether to buy or sell.

Haruki Toyama
Head of Mid Cap & Large Cap Equity,
Portfolio Manager

In your most recent letter, you acknowledge AI's potential to transform society but express skepticism about its short-term economic returns. Companies are already spending billions of dollars on AI. How do you evaluate whether these AI investments will translate to sustainable economic value for a company?

As you can imagine, we've dedicated a lot of time to this question over the past few years. The returns on many AI investments are difficult to gauge. For some companies, positive returns are possible, but it's challenging to form a strong opinion. Fortunately, we don't need a strong opinion on every potential investment. We only make a handful of investments in our portfolios each year, so we don't need an opinion on 95 out of 100 potential opportunities that come across our desk. Many questions, especially regarding AI and its economic returns, end up in what we call the "too hard" pile.

When just a handful of stocks get all the media coverage, it can be difficult for investors to resist that fear of missing out and stay disciplined. How does your philosophy and process guide investment decisions, particularly during periods of market hype?

Our focus is on determining a company's intrinsic value, which is independent of news, opinions, or the stock market's mood on any given day. Internally, the most important thing for us is that we promote a culture that prioritizes the value of a company over daily news fluctuations. We constantly ask ourselves whether news or events actually impact a company's value. In other words, does it increase [or decrease] profits on a sustainable, long-term basis?

What opportunities has this concentrated market presented down the market cap spectrum or across industries?

While we don't necessarily see large pockets of opportunities, there is potential in less popular areas. We aim to understand significant trends like AI due to their potential impact on society and our investments. However, looking beyond these headline topics can reveal opportunities. Smaller caps tend to be cheaper than larger companies, and non-tech companies are often more affordable. Even within technology, the heavy focus on AI has weakened demand for other tech vendors, creating opportunities outside the AI domain.

U.S. Equities (%)

	July	YTD	1 Year	3 Year	5 Year	10 Year
DJ Industrial Average	4.5	9.5	17.2	7.5	11.1	12.0
S&P 500	1.2	16.7	22.1	9.6	15.0	13.2
Russell 1000	1.5	15.9	21.5	8.5	14.6	12.9
Russell 1000 Value	5.1	12.1	14.8	7.0	9.9	9.0
Russell 1000 Growth	-1.7	18.6	26.9	9.5	18.4	16.3
Russell Midcap	4.7	9.9	13.7	3.7	10.2	9.9
Russell 2000	10.2	12.1	14.3	1.9	8.9	8.7

U.S. Equity Characteristics - S&P 500

	July	2023
Price/Earnings Ratio (NTM)	21.1	19.7
Weighted Avg. Market Cap ($B)	961.0	721.7
Dividend Yield (%)	1.3	1.5

U.S. Equity Sectors - S&P 500 (%)

	July	YTD	Weight
Communication Services	-4.0	21.6	8.9
Consumer Discretionary	1.7	7.4	10.0
Consumer Staples	1.9	11.1	5.8
Energy	2.1	13.3	3.7
Financials	6.5	17.3	13.1
Health Care	2.7	10.7	11.9
Industrials	4.9	13.0	8.4
Information Technology	-2.1	25.6	31.4
Materials	4.4	8.6	2.3
Real Estate	7.2	4.6	2.3
Utilities	6.8	16.9	2.4

International Equities (%)

	July	YTD	1 Year	3 Year	5 Year	10 Year
ACWI	1.6	13.1	17.0	5.8	11.0	8.7
ACWI ex USA	2.3	8.1	9.7	1.8	6.3	4.2
MSCI EAFE	2.9	8.4	11.2	3.6	7.4	4.8
Emerging Markets	0.3	7.8	6.3	-2.7	3.4	2.6
China	-1.3	3.3	-12.4	-13.9	-4.4	0.5
Japan	5.8	12.4	16.2	4.7	7.8	6.1
Germany	1.9	7.6	8.9	-0.3	5.7	3.3
United Kingdom	4.2	11.4	13.3	8.1	7.0	3.2
India	4.0	21.5	35.6	14.6	15.7	9.7

Key Asset Prices

	July	2023
EUR/USD	1.08	1.11
USD/CAD	1.38	1.32
USD/JPY	150.38	140.92
GBP/USD	1.28	1.27
Bitcoin ($)	64,619.3	42,265.2
Gold ($/oz)	2,447.0	2,066.0
Crude Oil (WTI) ($/bbl)	77.3	75.8

Fixed Income (%)

	July	YTD	1 Year	3 Year	5 Year	10 Year
Government Bond	2.2	1.3	4.2	-2.9	-0.2	1.2
Municipal	0.9	0.5	3.7	-0.9	1.2	2.5
U.S. Aggregate Bond	2.3	1.6	5.1	-2.6	0.2	1.6
Investment Grade Corporate	2.3	1.9	6.5	-2.6	0.9	2.5
High Yield	1.9	4.6	11.1	2.2	4.2	4.6

U.S. Treasury Yields (%)

	July	2023
3-Month	5.4	5.4
6-Month	5.1	5.3
2-Year	4.3	4.2
5-Year	4.0	3.8
10-Year	4.1	3.9
30-Year	4.4	4.0

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Large Cap investing is based on the expectation of positive price performance due to continued earnings growth or anticipated changes in the market or within the company itself. However, if a company fails to meet that expectation or anticipated changes do not occur, its stock price may decline. Moreover, as with all equity investing, there is the risk that an unexpected change in the market or within the company itself may have an adverse effect on its stock. Investing in growth-oriented stocks involves potentially higher volatility and risk than investing in income-generating stocks. The biggest risk of equity investing is that returns can fluctuate and investors can lose money.

Investments in midsize companies may entail greater risks than investments in larger, more established companies. Midsize companies tend to have narrower product lines, fewer financial resources, and a more limited trading market for their securities, as compared to larger companies. They may also experience greater price volatility than securities of larger capitalization companies because growth prospects for these companies may be less certain and the market for such securities may be smaller. Some midsize companies may not have established financial histories; may have limited product lines, markets, or financial resources; may depend on a few key personnel for management; and may be susceptible to losses and risks of bankruptcy.

The Dow Jones Industrial Average® (The Dow®), is a price-weighted measure of 30 U.S. blue-chip companies. The index covers all industries except transportation and utilities.

The S&P 500® Index is an unmanaged index of large companies and is widely regarded as a standard for measuring large-cap and mid-cap U.S. stock-market performance. Results assume the reinvestment of all capital gain and dividend distributions. An investment cannot be made directly into an index.

The Russell 1000® Index measures the performance of the 1,000 largest companies in the Russell 3000® Index, which represents approximately 89% of the total market capitalization of the Russell 3000 Index.

The Russell 1000® Growth Index is designed to track those securities within the broader Russell 1000 Index that FTSE Russell has determined exhibit growth characteristics.

The Russell 1000® Value Index is designed to track those securities within the broader Russell 1000 Index that FTSE Russell has determined exhibit value characteristics.

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 11% of the total market capitalization of the Russell 3000® Index.

The Russell Midcap® Index measures the performance of the mid-cap segment of the U.S. equity universe. The Russell Midcap® Index is a subset of the Russell 1000® Index. It includes approximately 800 of the smallest securities based on a combination of their market cap and current index membership.

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The MSCI ACWI ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets countries (excluding the US) and 23 Emerging Markets countries. With 1,843 constituents, the index covers approximately 85% of the global equity opportunity set outside the US.

The MSCI EAFE (Europe, Australasia & Far East) Index is a free-float adjusted market capitalization index that is designed to measure developed market equity performance, excluding the U.S. and Canada.

Emerging Markets - MSCI Emerging Market Index captures large and mid cap representation across 24 Emerging Markets (EM) countries. With 1,138 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

China - MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs).

Japan - MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market.

Germany - MSCI Germany Index is designed to measure the performance of the large and mid cap segments of the German market.

United Kingdom - MSCI United Kingdom Index is designed to measure the performance of the large and mid cap segments of the UK market.

India - MSCI India Index is designed to measure the performance of the large and mid cap segments of the Indian market.

Government Bond - Bloomberg US Government Index measures the performance of the U.S. Treasury and U.S. Agency Indices, including Treasuries and U.S. agency debentures. It is a component of the U.S. Government/Credit Index and the U.S. Aggregate Index.

Municipal - Bloomberg U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prerefunded bonds.

U.S. Aggregate Bond - Bloomberg U.S. Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, mortgage backed securities, asset-backed securities and corporate securities, with maturities greater than one year.

Investment Grade Corporate - Bloomberg U.S. Credit Index measures the investment grade, US dollar-denominated, fixed-rate, taxable corporate and government related bond markets. It is composed of the US Corporate Index and a non-corporate component that includes foreign agencies, sovereigns, supranationals and local authorities.

High Yield - Bloomberg U.S. Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Bloomberg EM country definition, are excluded.

Weighted Avg. Market Cap: measures the size of the companies in which the portfolio invests. Market capitalization is calculated by multiplying the number of a company's shares outstanding by its price per share.

Price-to-Earnings (P/E) Ratio: measures how expensive a stock is. It is calculated by the weighted average of a stock's current price divided by the company's earnings per share of stock in a portfolio.

Dividend Yield: the portfolio's weighted average of the underlying portfolio holdings and not the yield of the portfolio.

Yield Curve: a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. There are three main types of yield curve shapes: normal (upward-sloping curve), inverted (downward-sloping curve), and flat.

The Magnificent Seven stocks are a group of high-performing and influential companies in the U.S. stock market: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

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