Market Commentary

First Affirmative
FINANCIAL NETWORK

Resilience and Sustainability

October 2024

Resilience and Sustainability

Overview

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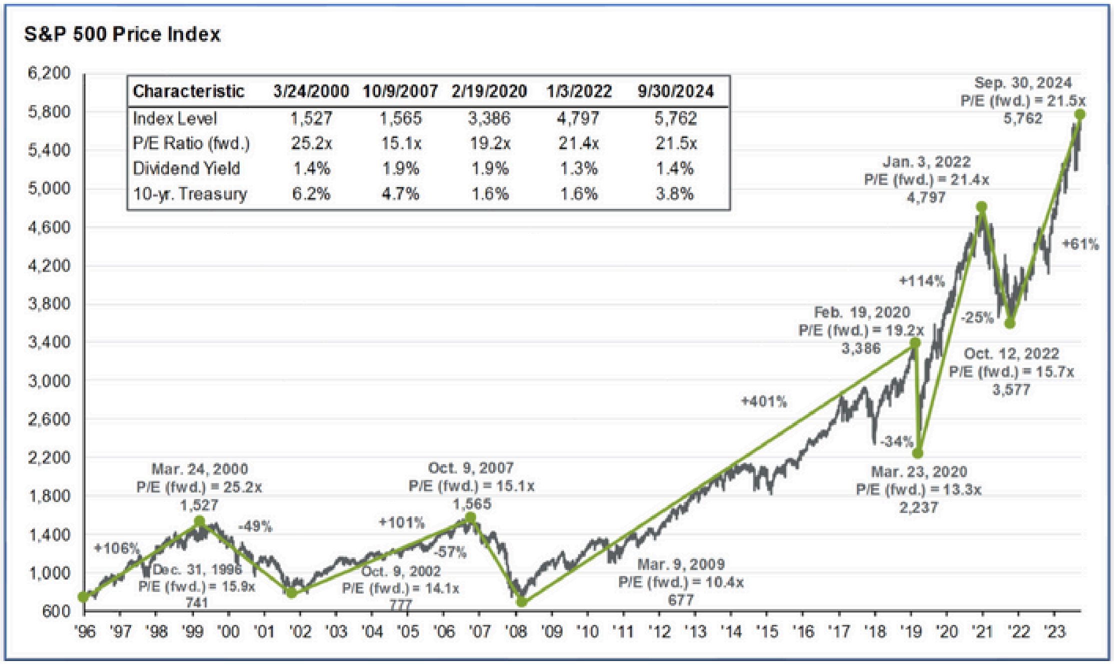
Following a 26% rise in 2023, the S&P 500 advanced by 22% in the nine months ended September 30, 2024. By third quarter end, the S&P 500 had reached another all-time high, exceeding the January 2022 peak by 20% and the March 2020 COVID low by a resounding 158% (see Figure 1). Equity market performance remained highly concentrated in the first half of 2024, with the Magnificent Seven surging 33%, compared with a 5% gain for the "Other 493" S&P 500 stocks.

The market demonstrated extraordinary resilience in the third quarter as the hyper-concentration of the past two years began to unwind. The market rose 6% in the third quarter as the Magnificent Seven faltered and the "Other 493" picked up the slack. For the first time in more than two years, the equally weighted S&P 500 outperformed the S&P 500. This expanded market breadth was good news for sustainability-themed strategies, which rebounded.

The US economy and corporate earnings have also been resilient as inflation has stabilized at a lower level (at least for now) and the Fed decisively pivoted toward lower interest rates. Unlike their impact on our psyches, US presidential elections have historically had little direct impact on stock market performance – and thus far, the current election cycle is no different. Geopolitical tensions, particularly the ongoing conflicts in Ukraine and the Middle East and strained US-China relations, continue to cast a shadow over the global outlook, and the US Federal budget deficit remains a key long-term risk.

Figure 1. S&P 500 at Inflection Points – Bull and Bear Markets, 1996 to Date



Characteristic	3/24/2000	10/9/2007	2/19/2020	1/3/2022	9/30/2024
Index Level	1,527	1,565	3,386	4,797	5,762
P/E Ratio (fwd.)	25.2x	15.1x	19.2x	21.4x	21.5x
Dividend Yield	1.4%	1.9%	1.9%	1.3%	1.4%
10-yr. Treasury	6.2%	4.7%	1.6%	1.6%	3.8%

Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of September 30, 2024

Third Quarter and Year-to-Date Performance – The Beginning of the End of Hyper-Concentration

Driven in part by the performance of the “Magnificent Seven” — Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla, and Meta — US equities surged 22% in the first nine months of 2024, far outpacing international markets (see Figure 2). In fact, as US earnings growth outpaced non-US growth over the past 15 years, US stocks returned 14.1% annually, on average, more than double the 6.5% annualized return of developed international markets (EAFE). The US now comprises 72% of the global developed markets index, the MSCI World index, and the “Magnificent Seven” represent 21% of the MSCI World. Nvidia’s market capitalization alone is equal to that of all 2,000 small-cap companies in the Russell 2000.

Figure 2. Global Equity Markets Performance, 9 Months to September 30, 2024

Returns	YTD 2024		2023		15-years	
	Local	USD	Local	USD	Ann.	Beta
Regions						
U.S. (S&P 500)	-	22.1	-	26.3	14.1	1.0
AC World ex-U.S.	14.7	14.7	14.7	16.2	6.0	1.0
EAFE	12.5	13.5	16.8	18.9	6.5	1.0
Europe ex-UK	12.1	12.8	17.3	22.7	6.9	1.1
Emerging markets	18.7	17.2	10.3	10.3	4.5	1.0

Returns	YTD 2024		2023		15-years	
	Local	USD	Local	USD	Ann.	Beta
Selected Countries						
Japan	14.4	12.7	29.0	20.8	6.4	0.7
United Kingdom	9.7	15.4	7.7	14.1	5.8	1.0
France	5.1	6.2	18.1	22.3	6.7	1.2
Canada	17.4	14.6	13.3	16.4	6.4	1.1
Germany	16.5	17.7	19.8	24.0	6.2	1.3
China	28.8	29.6	-10.6	-11.0	3.7	0.9
Taiwan	34.7	30.6	31.1	31.3	12.3	1.0
India	26.7	25.8	22.0	21.3	8.2	0.9
Brazil	-1.5	-12.6	22.7	33.4	-0.3	1.3

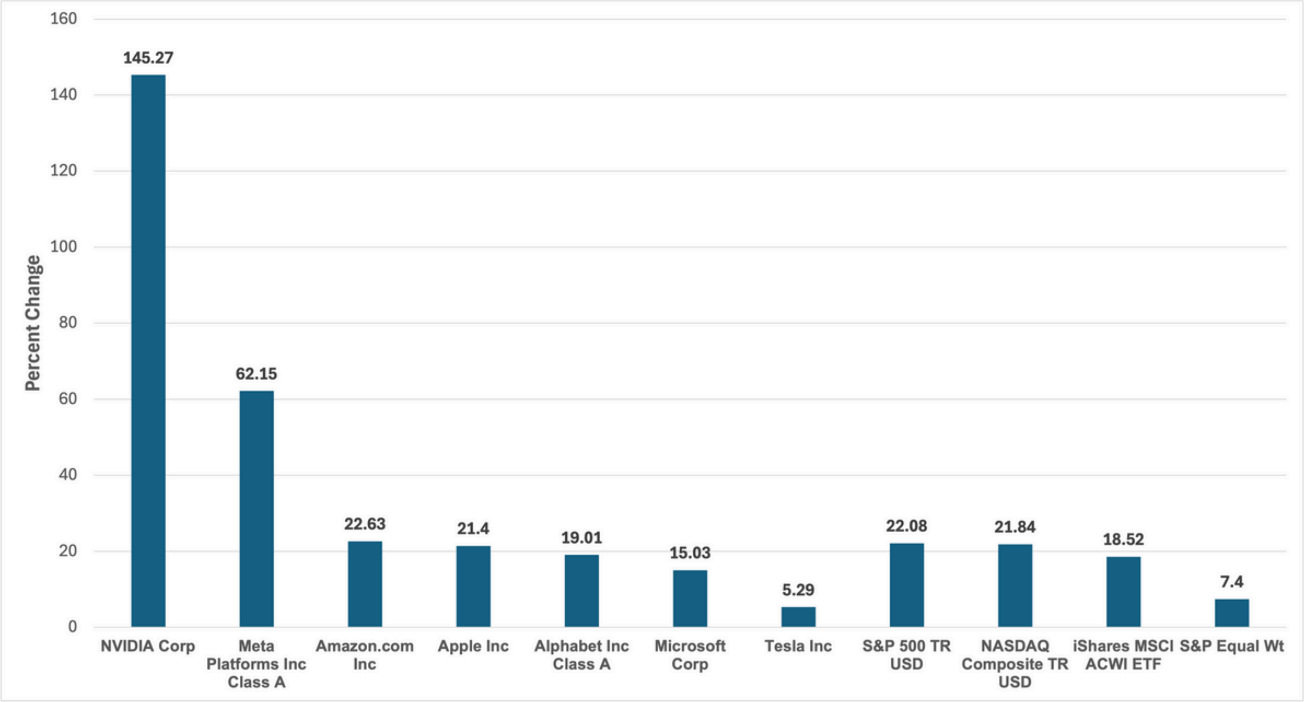
Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of September 30, 2024

US equities surged 22% in the first nine months of 2024, far outpacing international markets

The dominance of the Magnificent Seven began to fade in the third quarter. These stocks underperformed the broader market as (1) profit-taking emerged after strong gains, (2) rising bond yields dampened growth stock valuations early in the quarter, and (3) investors rotated into more cyclical areas as the sustainability of US economic growth became more widely accepted (see Figures 3 and 4). Despite the cooling in the third quarter, these mega-cap tech stocks accounted for 45% of market returns year-to-date, with the group up 35%, compared with 11% for the “Other 493” (see Figure 5).

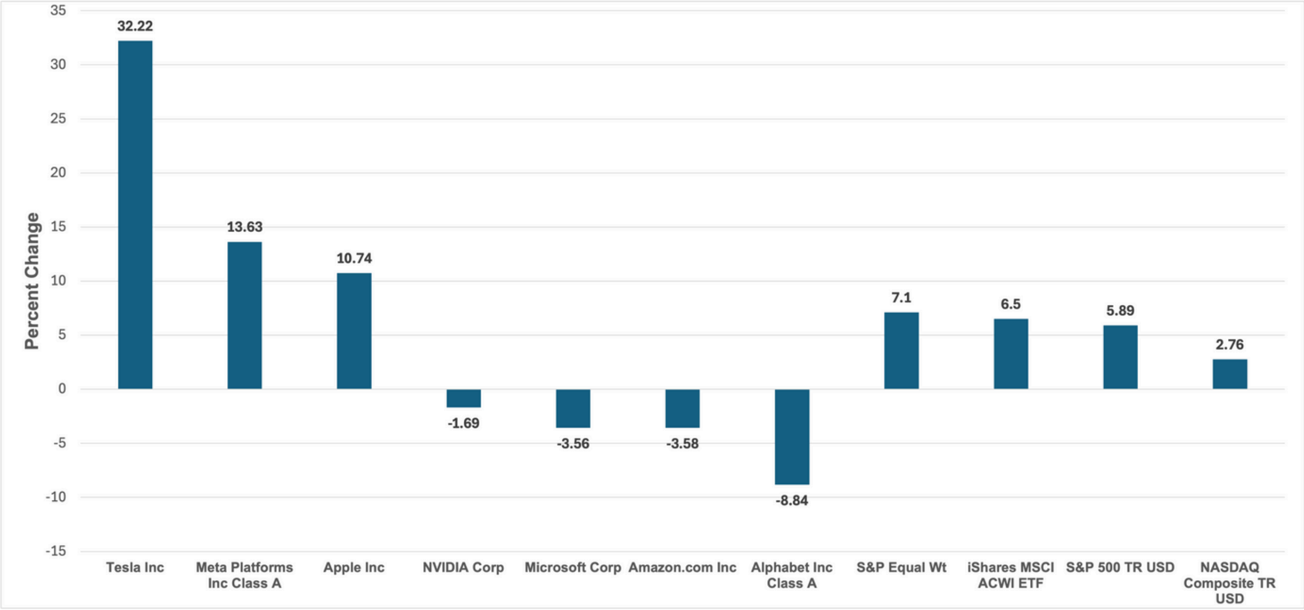
The concentration of companies within the US equity market and the United States in global indices has raised concerns among investors that a bubble has been inflated and is poised to burst. However, this is not the Dot-Com bubble of mid-1990s-2000 – a period during which investors were valuing companies based on “numbers of eyeballs”, rather than earnings (which were non-existent for most Dot-Com companies). In contrast, as the Magnificent Seven have surged higher, so have their earnings, particularly flag-bearer Nvidia’s.

Figure 3. Magnificent Seven Returns, Nine Months Ended September 30, 2024



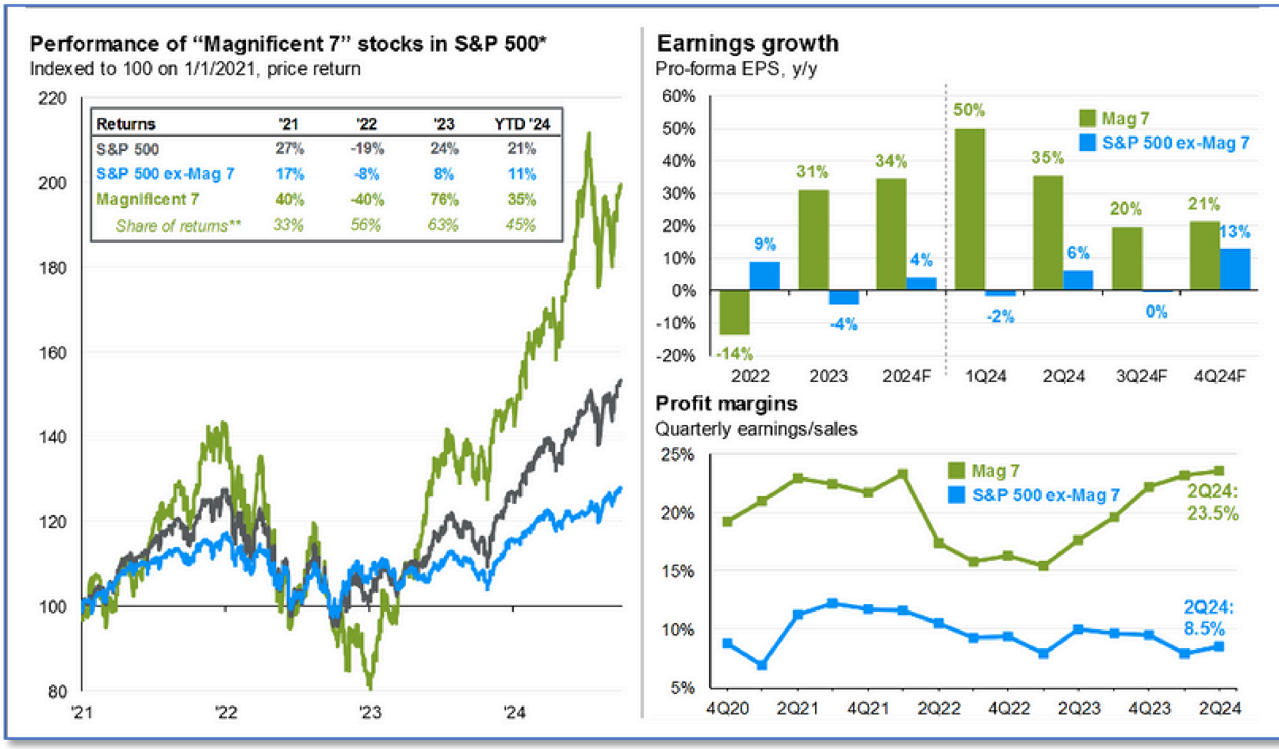
Source: First Affirmative, Data are as September 30, 2024

Figure 4. Magnificent Seven Returns, Quarter Ended September 30, 2024



Source: First Affirmative, Data are as September 30, 2024

Figure 5. S&P 500 Index: Concentration



Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of September 30, 2024

Inflation and Interest Rates – Proactive Fed Pivot

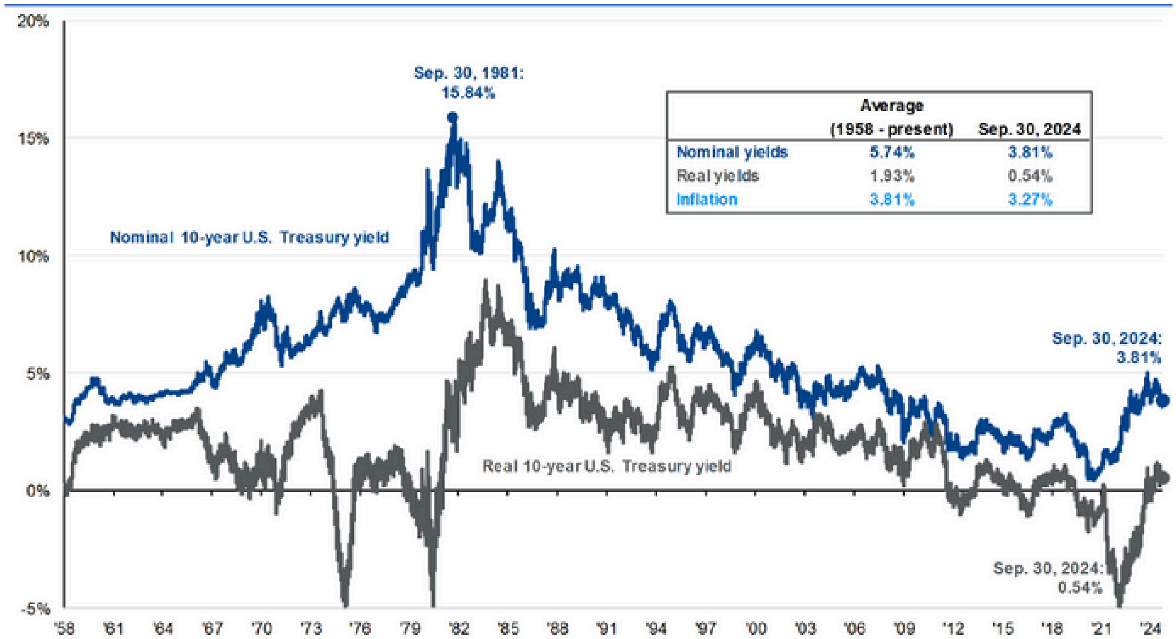
At its September meeting, the Federal Reserve lowered the federal funds rate by 50 basis points. This reduction in rates to 5.33% to 4.83% eased monetary policy for the first time in four years amid progress toward its dual inflation and unemployment mandates. Despite pressure to ease rates earlier in the year, the Fed maintained a "higher for longer" approach through September, emphasizing its commitment to fighting inflation. As inflation continued to cool in the third quarter, moving toward the Fed's long-term target of 2%, and unemployment remained steady, the Fed slashed interest rates.

Barring a US economic slowdown, which we view as unlikely, we believe the Fed could hold rates steady around current levels. Recent highly publicized worker demands for significant wage increases, the expanding conflict in the Middle East, which could lead to higher oil prices, and persistently low real yields (see Figure 6) suggest that inflation could re-accelerate as 2024 progresses.

The back-up in 10-year US Treasury yields from their low of 3.64% the day before the Fed announced its rate cut to 4.206% on October 22nd suggests market participants believe rates may stabilize at around current levels. Higher for longer interest rates will not only affect consumers and debt-laden businesses, but also the federal government (see Figure 7).

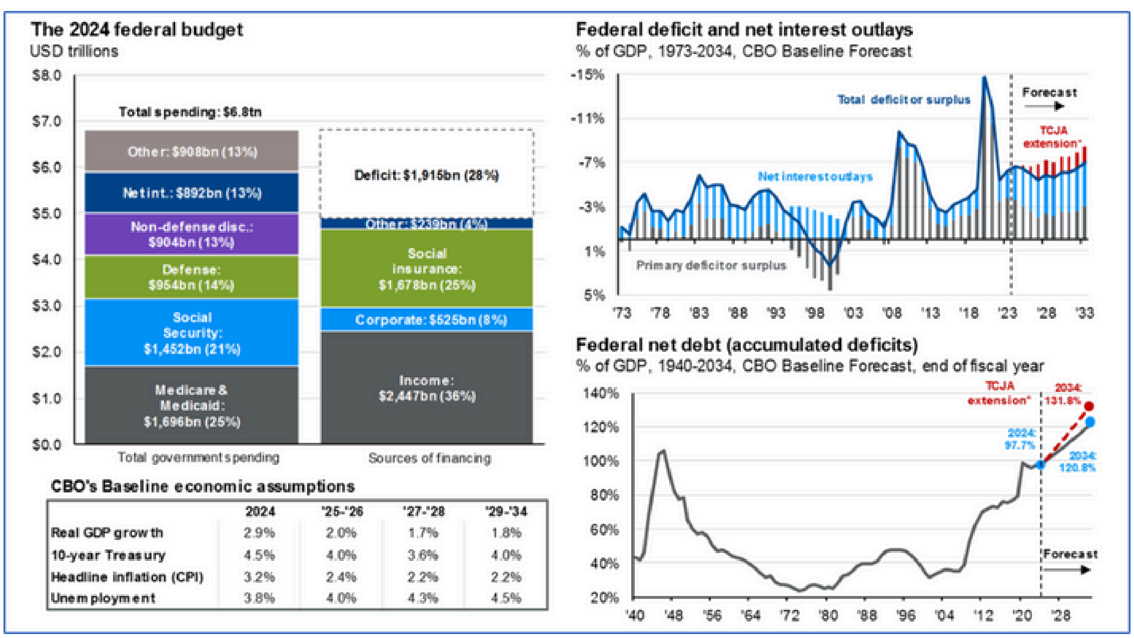
In 2024, the federal government is slated to spend $892 billion on Net Interest Expense, just 6% less than it spends on Defense and about in line with its spending on Non-Defense Discretionary spending (i.e., everything other than Social Security and Medicare/Medicaid). The Congressional Budget Office (CBO) is targeting 3.2% inflation this year, declining to 2.2% in fiscal 2027-28 and holding steady thereafter. According to the CBO, interest rates will follow a similar trajectory. Given the magnitude of federal borrowings, even marginally higher for longer inflation and interest rates could have a significant impact on the federal budget – and by extension US taxpayers and the economy.

Figure 6. Nominal and Real US 10-Year Treasury Yields



Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of September 30, 2024

Figure 6. US Government Federal Finances

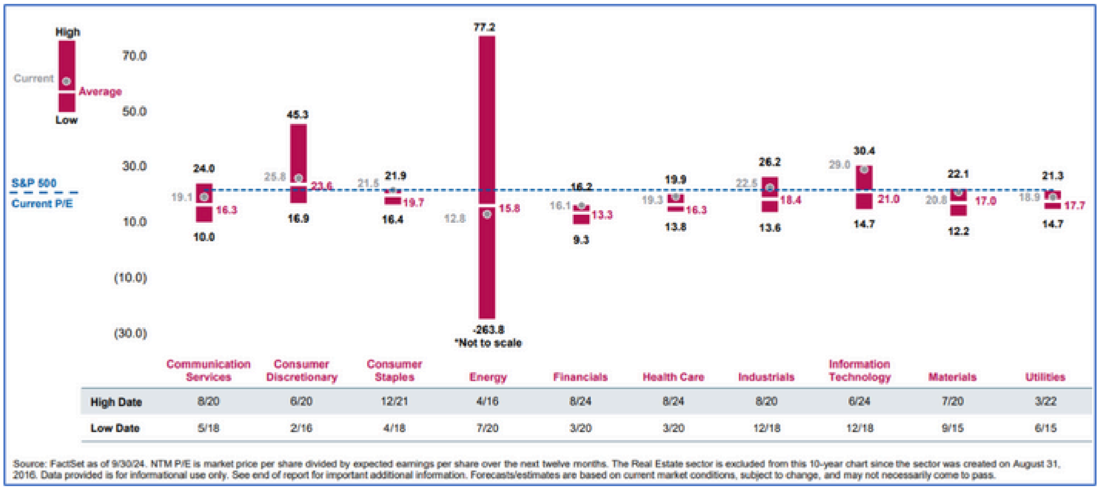


Source: J.P. Morgan Asset Management Guide to the Markets – U.S. Data are as of September 30, 2024

Amid Economic Resiliency, Earnings Growth Remains Strong

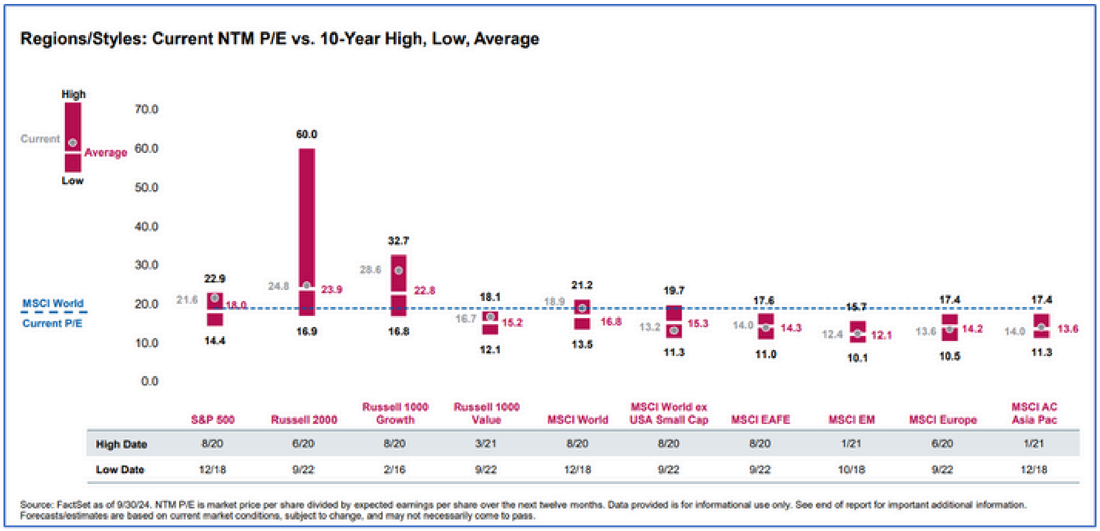
As shown in Figures 8 and 9, global equity markets are fairly valued. The valuations of growth-oriented categories (Russell 1000, S&P 500) and sectors (Information Technology) are above their 10-year averages, while global small cap stocks and value-oriented sectors (Energy, Utilities) are below their 10-year averages. According to FactSet, based on the average improvement in the earnings growth rate during the current earnings season, the index will likely report year-over-year growth in earnings of more than 7% for the third quarter. Fair valuations and 7% earnings growth underpin our expectation that markets will post trendline mid-to-high single digit returns in 2025.

Figure 8. Valuation Analysis – S&P 500 Sectors: Current NTM P/E v 10-year High, Low, Average



Source: Eaton Vance Monthly Market Monitor, March 2024

Figure 9. Valuation Analysis – Regions/Styles: Current NTM P/E v 10-year High, Low, Average



Source: Eaton Vance Monthly Market Monitor, March 2024

Values-Aligned Investments Rebound

The narrow tenor of the equity market in the first half of 2024 resulted in continued underperformance of selected sustainability-themed strategies (see Figure 10). As market breadth expanded in the third quarter, sustainability-themed strategies rebounded, outperforming the broader market (see Figure 11).

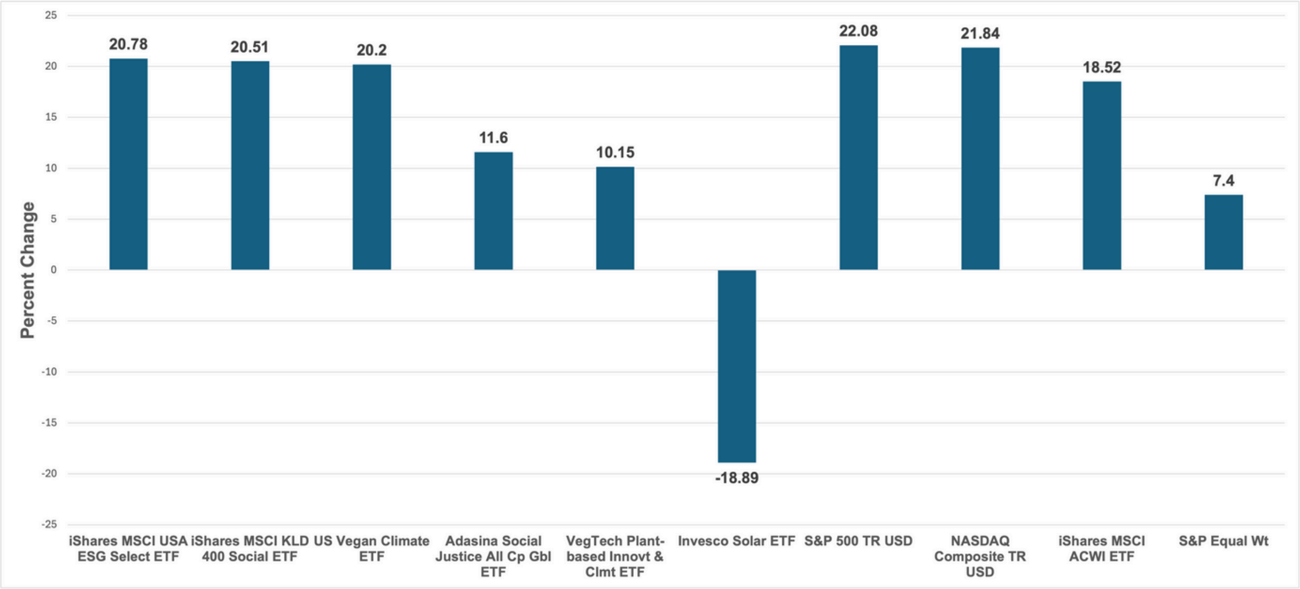
The Morgan Stanley Institute for Sustainable Investing recently published a report, which analyzes performance and flows of the 99,000-fund broad Morningstar global fund universe and nearly 8,000 sustainable funds over the January 1, 2024-June 30, 2024, period. According to Morgan Stanley, “sustainable fund assets under management (AUM) globally reached a new high of $3.5 trillion on June 30th, up by 3.9% from year end 2023. This is 7.0% of total AUM, down slightly from 7.2% at the end of 2023.” As shown in Figure 12, sustainable funds modestly outperformed traditional funds in the first half of 2024 (although according to data from Morningstar, most actively managed mutual funds underperformed the market in the first half of 2024).

Certain sustainable investment themes, particularly those focused on carbon reduction, green technology, and social governance, have maintained resilience as part of long-term investment strategies

Performance within the sustainable fund universe was also divergent in recent periods. For example, renewable energy strategies faced significant headwinds due to rising interest rates, NIMBY (not in my backyard) and environmental impact push-back, and persistent uncertainty surrounding government policies and subsidies. Higher borrowing costs have also had a significant impact on capital-intensive wind, solar energy, and water projects. Additionally, the global energy transition has faced delays as governments adjust subsidies and policies and consumers reject government mandates to move quickly to electric vehicles, particularly in the US. Nonetheless, certain sustainable investment themes, particularly those focused on carbon reduction, green technology, and social governance, have maintained resilience as part of long-term investment strategies.

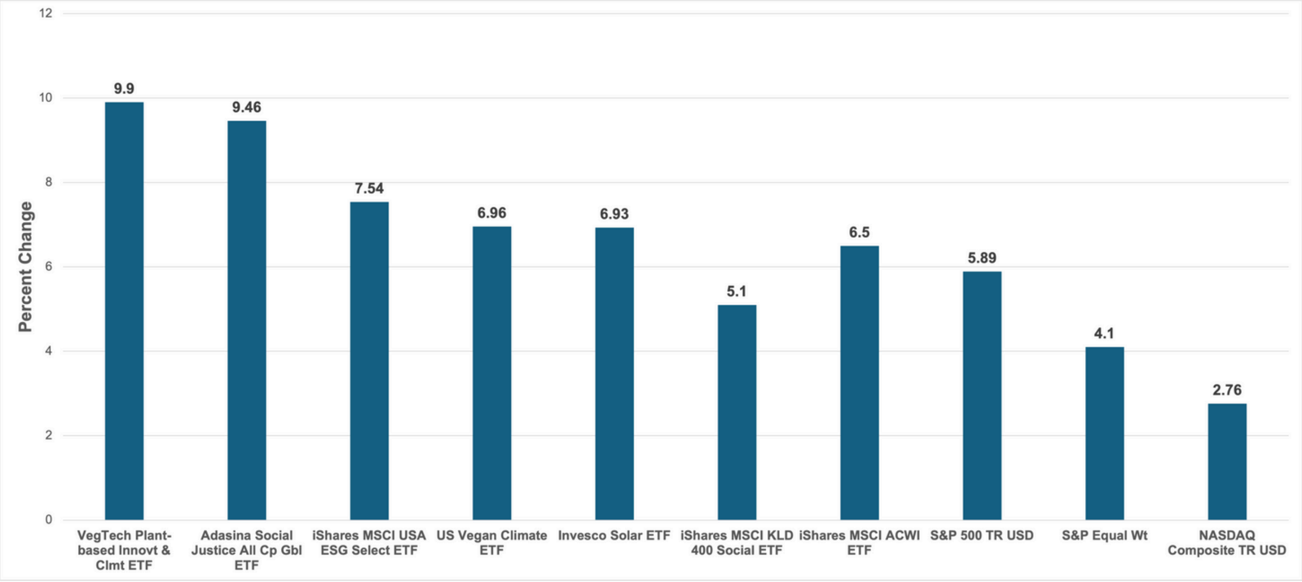
As we know, the market reflects the world as it is today. Values-aligned investors invest in the world as they want it to be and look to achieve long term financial and impact goals aligned with their values. At First Affirmative, we remain convinced investors must take responsibility for the impact their money has in the world. Since 1988, we have served individuals and institutions seeking to achieve financial returns and align their portfolios with their values to meet both their financial and impact objectives. For the future, our Values-Aligned Direct Index Solution (VADIS) represents the future of hyper-customized portfolio management and enables clients to invest in the world as they want it to be. By combining trusted personal financial advice, leading sustainable and responsible investment expertise, and scalable technology, VADIS enables advisors to provide personalized portfolios aligned to each client's financial goals and values.

Figure 10. Selected Sustainability-Themed ETFs – Returns, 12/31/2023-9/30/2024



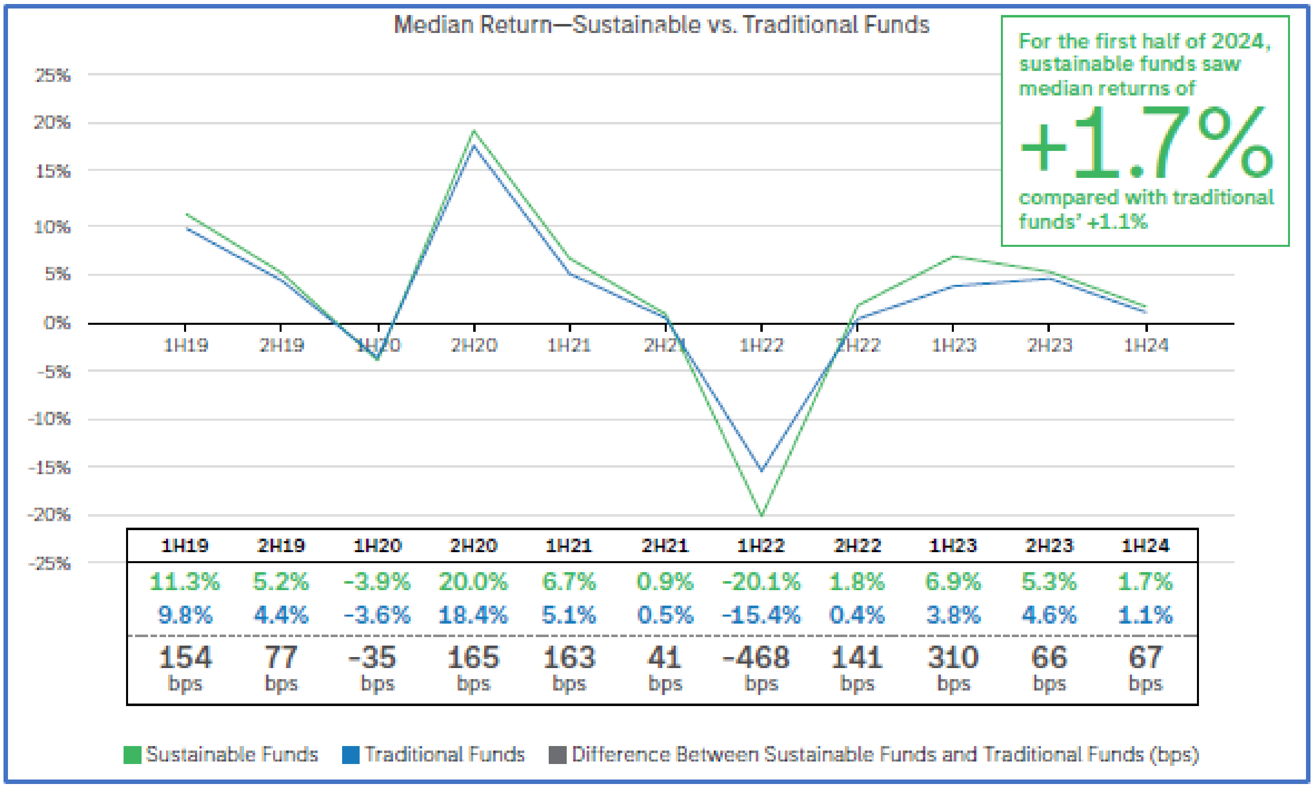
Source: First Affirmative, Data are as September 30, 2024

Figure 11. Selected Sustainability-Themed ETFs – Returns, 12/31/2023-9/30/2024



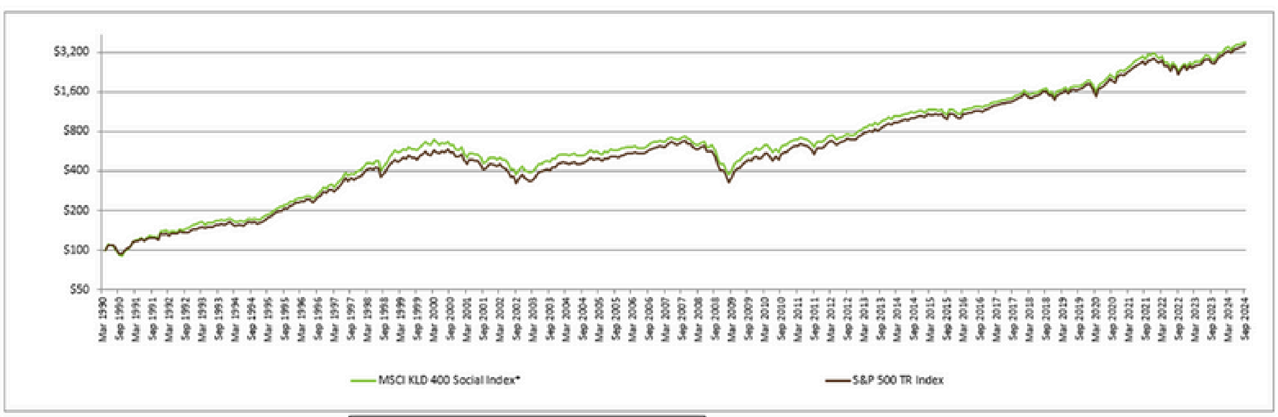
Source: First Affirmative, Data are as September 30, 2024

Figure 12. Performance – Sustainable Funds v Traditional Funds



Source: Morgan Stanley Institute for Sustainable Investing analysis of Morningstar data as of August 1, 2024. Table shows data in basis points (bps), 10 bps = 0.1%.

Figure 13. MSCI KLD 400 vs S&P 500 Indices, September 30, 2024



	MSCI KLD 400 Social Index*	S&P 500 TR Index
Annualized Return Since 5/1/90:	12.78%	10.90%

Source: Morningstar. *Data prior to 9/1/2010 is that of the MSCI KLD 400 Social Index GR, while data since 9/1/2010 is that of the MSCI KLD 400 Social Index NR. Indices are unmanaged groups of securities. Index performance does not include the impact of cash, fees, or transaction costs. Investors cannot invest directly in indices but may purchase mutual funds or other investment products designed to track the performance of various indices.

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