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CEO/CIO

3Q24 Investment Update



Bob is a financial services industry veteran with over 40 years of experience managing large cap equity strategies as well as long and long-short equity strategies. His weekly, quarterly, and annual investment commentaries focus on key themes and risks driving equity markets, monetary policy, and the global economy. Bob is a regular guest and contributor to multiple media outlets such as CNBC, Bloomberg TV, Moneywise, and Fox Business News.

Introduction and summary



- We are in a high-risk, highly valued bull market driven by momentum.
- Predicting the end of a momentum run is a fool's game.
- Focus on earning predictability, earnings persistence and good cash flow generation in equity selection.

“Inflation is sticky; markets disagree or don't care.”

– Nancy Lazar, March 2024

“Prices reflect near perfection, yet today's world is particularly imperfect and dangerous.”

– Jeremy Grantham, March 2024

“The only function of economic forecasting is to make astrology look respectable.”

– Ezra Solomon, 1985

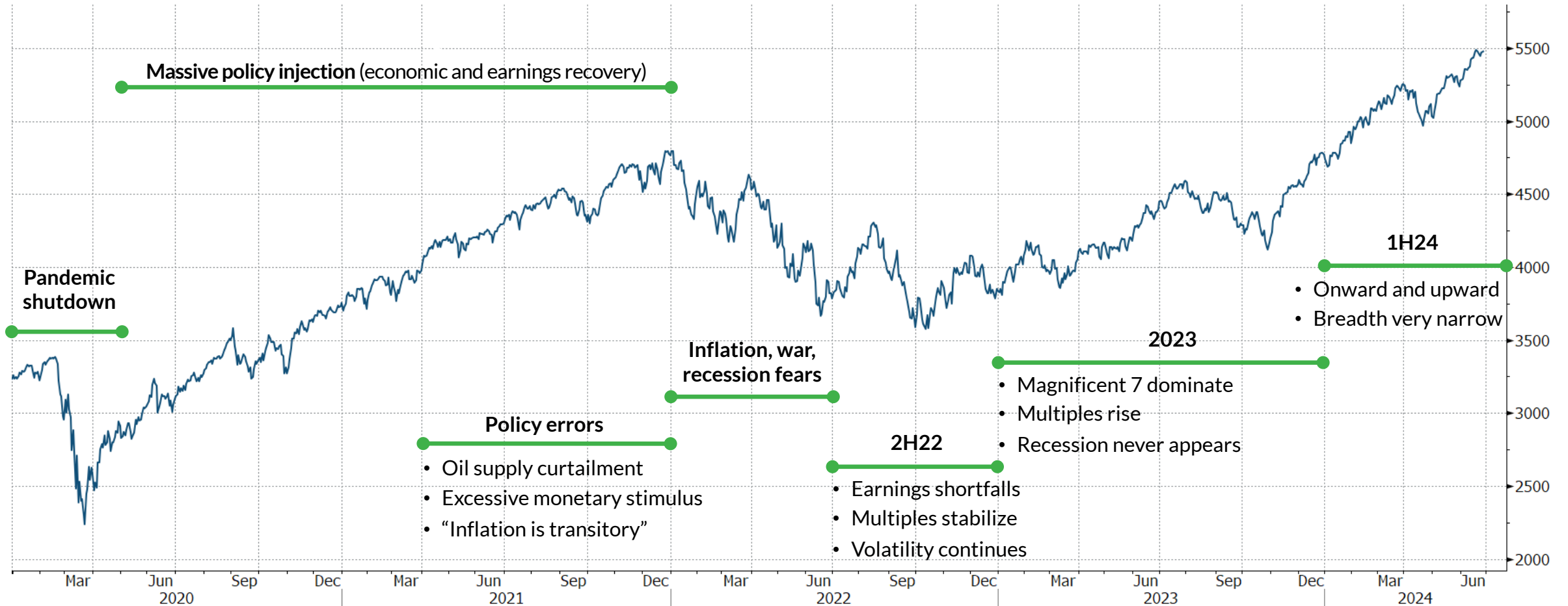
Recent returns



Index	2023 (%)	1H24 (%)
90-Day Treasury Bills (Bloomberg U.S. Treasury Bill 1-3 Month TR)	5.1	2.7
10-Year U.S. Treasury (Bloomberg U.S. Treasury 10+ Yr TR)	3.5	-2.0
U.S. Bonds (Bloomberg U.S. Agg Bond TR)	5.5	-0.7
High-Yield Corporate Bonds (Bloomberg U.S. Corp High Yield TR)	13.4	2.6
S&P 500 TR Index	26.3	15.3
S&P 500 Equally Weighted	13.9	5.1
MSCI World Ex. U.S. (MSCI World Ex USA NR)	17.9	5.0
MSCI Emerging Markets (MSCI EM NR)	9.8	7.5
Commodities (DJ Commodity TR)	-7.9	5.1

Source: Bloomberg as of June 30, 2024

S&P 500 4½-year history



Source: Bloomberg as of June 27, 2024

Intractable imbalances/problems



1. There are consequences to the Fed raising rates from 0% to 5.25% in 18 months.
2. 10+ years of quantitative easing (essentially zero interest rates) will go in history books as a major policy error.
3. The U.S. is running a high federal budget deficit at essentially full employment.

Key 1H24 developments



1. Economy stays strong (but begins to show signs of weakness).
2. Earnings progress still good.
3. “Recession” leaves most vocabularies.
4. Inflation turns sticky.
5. Fed cut expectations are reduced significantly.
6. Bond yields are up in Q1, down in Q2.
7. Tech continues to dominate (especially AI).
8. Stock market breadth narrows.
9. Ray of sunshine is non-U.S. economies and stock markets.
10. Race for U.S. president remains tight (with Trump narrowly ahead in Electoral College).

2H24 outlook



Bull case
Cutting cycle starts soon!
Sustained decline back to 2%
“Soft landing”
Double-digit growth ahead!
Sustained at high levels
Growth, growth, growth
“Fed put” is firmly in place
Advance continues: Target levels keep moving higher!

The Fed
Inflation
Growth outlook
Earnings
Valuations
Positioning
“Blow up” risks
Stock market

Bear case
“Higher for longer”
Core stickier than expected
Modest recession
Earnings growth disappoints
Falling into rising risk aversion
Defensives and high quality
Commercial real estate
Volatility picks up; tough to make money!

Key divergences



Large growth stocks
Mag 7
Cap-weighted
Big
DJIA
High-income consumers
Services

VS.

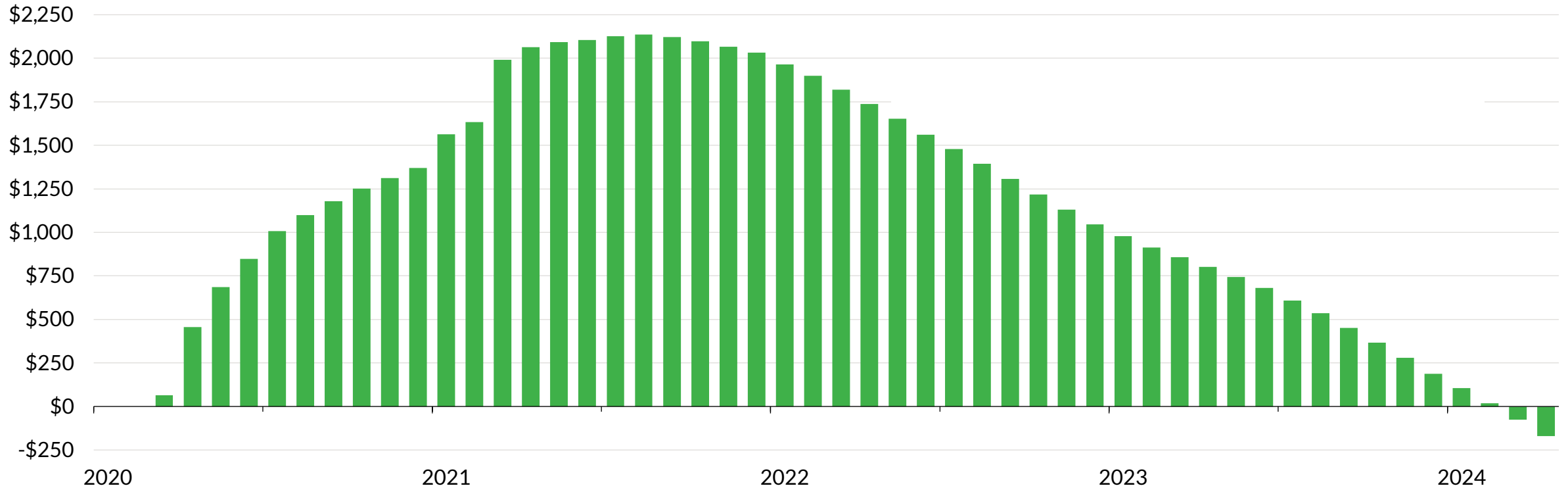
Everything else
Other 493
Equal-weighted
Small
DJTA
Low-income consumers
Manufacturing

Prediction 1



The U.S. economy experiences a mild recession as the unemployment rate rises above 4.5%

Cumulative excess savings held by U.S. households (\$B)



Source: Federal Reserve Bank of San Francisco (through April 2024)

Recession questions



Why has there been no recession?

- Excess savings from COVID
- Significant government spending
- Massive private credit borrowing

Why is a recession still likely?

- Lagged impact of massive Fed interest rate increases
- Inverted yield curve
- Leading economic indicators
- And now, increasing evidence of slowdown

The economy is slowing



- Long and variable lags of Fed policy are beginning to kick in.
- Ex Mag 7, revenue growth is slowing
 - Comp costs are two-thirds of compensation
 - Therefore, layoffs are beginning
 - Unemployment 3.4% → 4.0% (likely to go to at least 4.5%)
- Workweek ↓, Temporary Employment ↓, Inventories ↑
- Real incomes are beginning to deteriorate
 - Real retail sales flat YTD
 - Auto sales flat for 12 months
 - Delinquency rates rising
- Weakness in demand is causing pricing weakness (which is why inflation is slowing)

Likely consequences

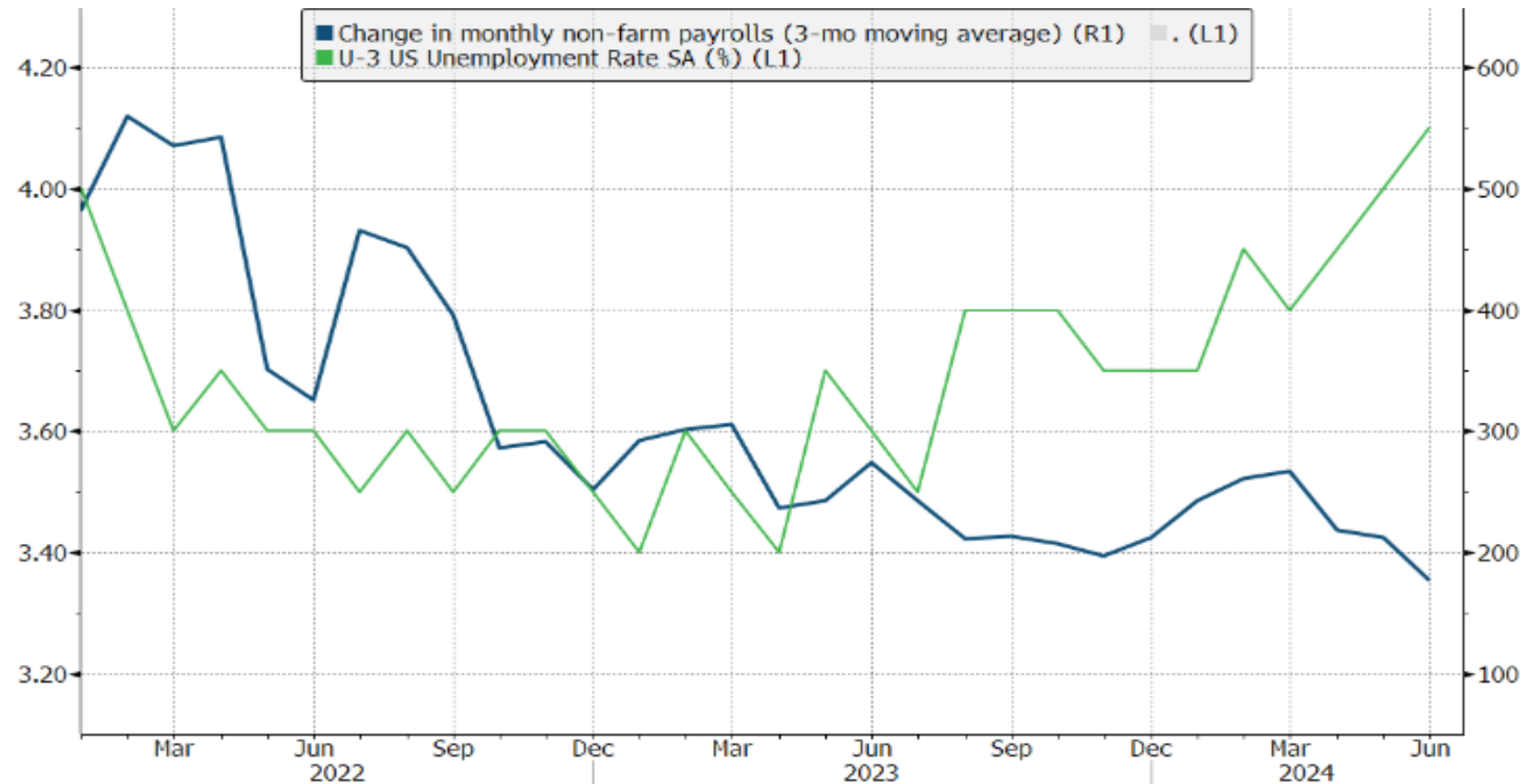
- Possible recession beginning in Q4 or Q1 2025
- Fed cuts this year: Best guess September and December
- Fed will be forced to shift focus from cooling inflation to fighting economic weakness

The economy is slowing

The unemployment rate is rising, and payroll growth is slowing



U.S. unemployment rate vs. change in NFP (3-month moving average)



Source: Bloomberg

U.S. nominal activity measures running 5% or less make it difficult to hold policy rates close to 5.5% indefinitely



U.S. nominal data	Latest Y/Y %
Gross domestic product	5.4
Personal income	4.5
Gross domestic income	4.3
Manufacturing shipments	3.0
Nominal industrial prod. (IP x PPI)	2.8
Retail sales & food service	2.3
Wholesales sales	1.4

Prediction 1

The U.S. economy experiences a mild recession as the unemployment rate rises above 4.5%



We're just entering the timeframe when tightening triggers a downturn

Fed funds initial hike	First quarter of recession	Quarters from liftoff
3Q 1958	3Q 1960	8
4Q 1967	1Q 1970	9
2Q 1972	1Q 1974	7
2Q 1977	2Q 1980	12
4Q 1980	4Q 1981	4
4Q 1986	4Q 1990	16
2Q 1999	2Q 2021	8
3Q 2004	1Q 2008	14
Average	—	10
1Q 2022	?	11

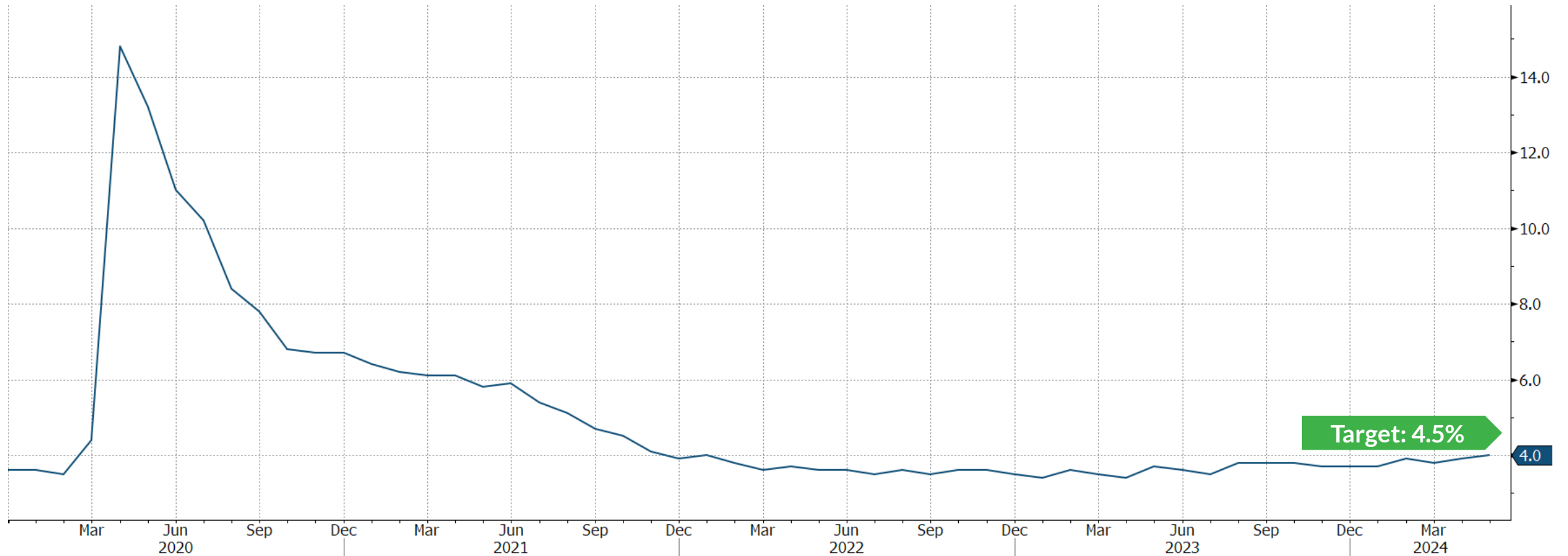
Source: Piper Sandler

Prediction 1

The U.S. economy experiences a mild recession as the unemployment rate rises above 4.5%



U.S. unemployment rate total in labor force (seasonally adjusted)



Source: Bloomberg

Prediction 2

The 2-3% inflation ceiling of the 2010s becomes the 2-3% inflation floor of the 2020s



U.S. CPI inflation year over year (%)



Source: Bloomberg

Why is inflation likely to remain sticky?



1. Huge and growing federal budget deficits
2. Two-thirds of federal budget is indexed to inflation.
3. Labor markets remain fairly tight.
4. Environmental regulators and geopolitics keep costs higher than otherwise.
5. Deglobalization—re-shoring and shorter supply chains.

Prediction 3



The Fed cuts rates fewer than the six times suggested by the Fed funds futures curve

Is mission accomplished?

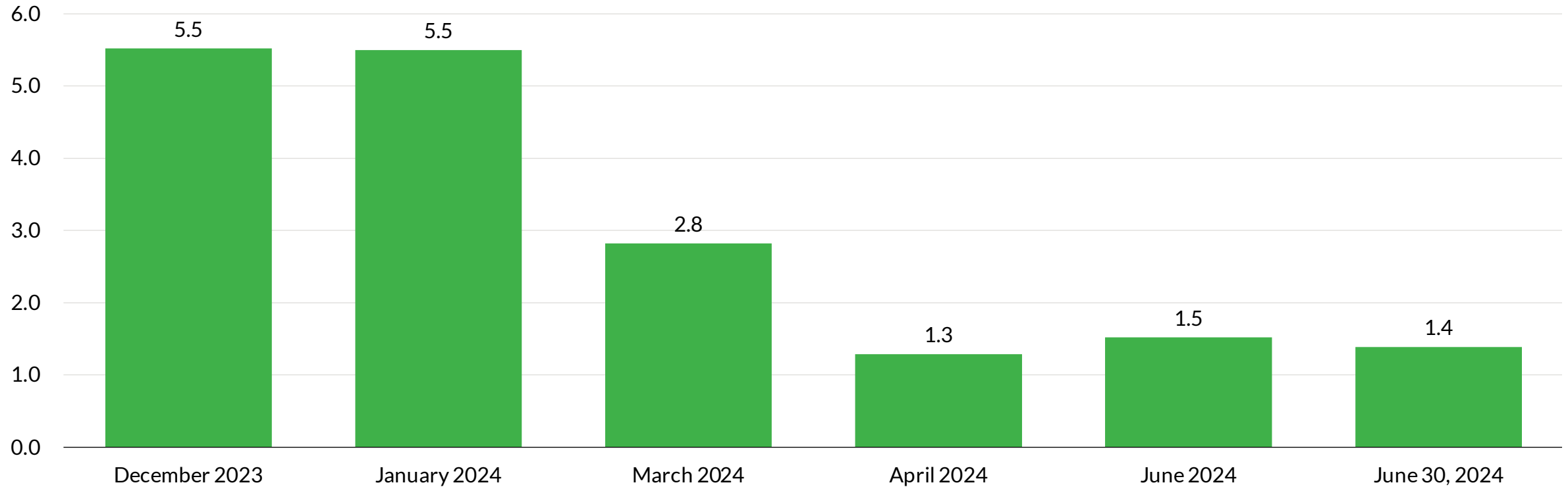
	CPI trailing 12 months	
	Headline	Core
May 2023	4.0%	5.3%
May 2024	3.3%	3.4%

Prediction 3



Cuts implied by Fed fund futures 1-day **AFTER** recent Fed meetings

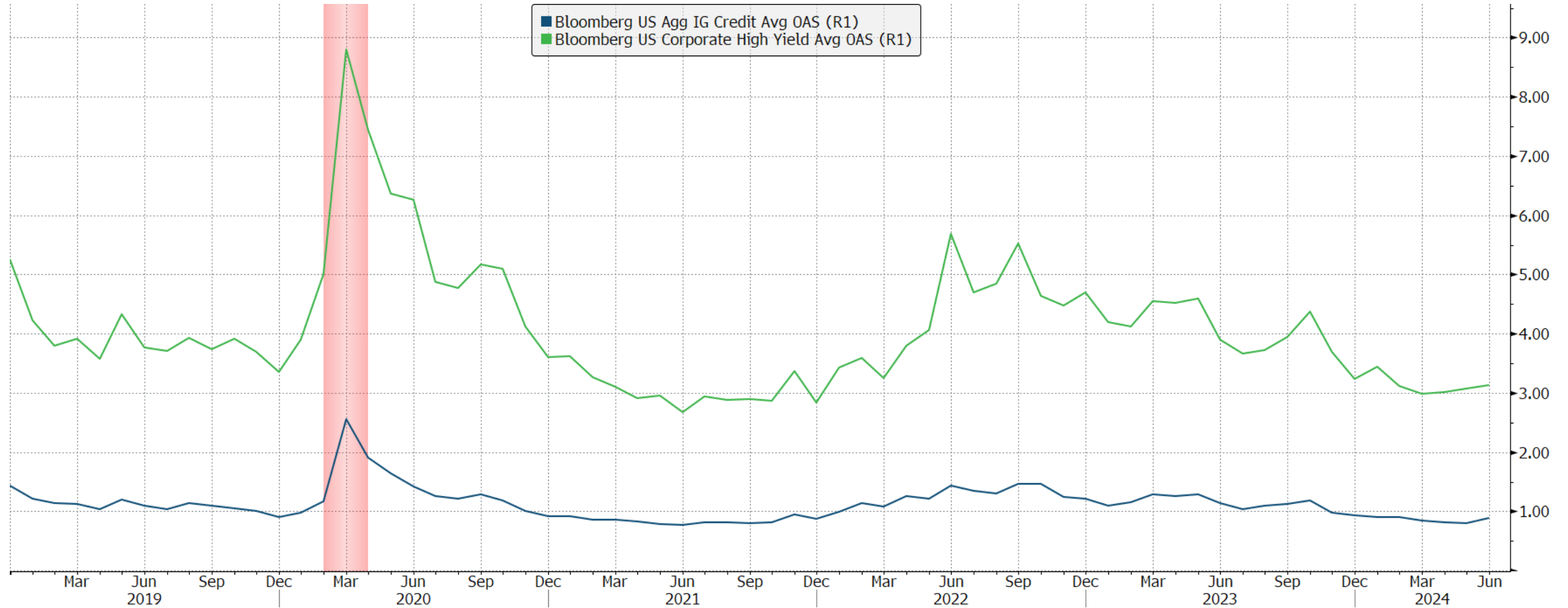
Implied cuts by year-end 2024



Source: Bloomberg as of June 30, 2024

Prediction 4

Credit spreads widen as interest rates decline



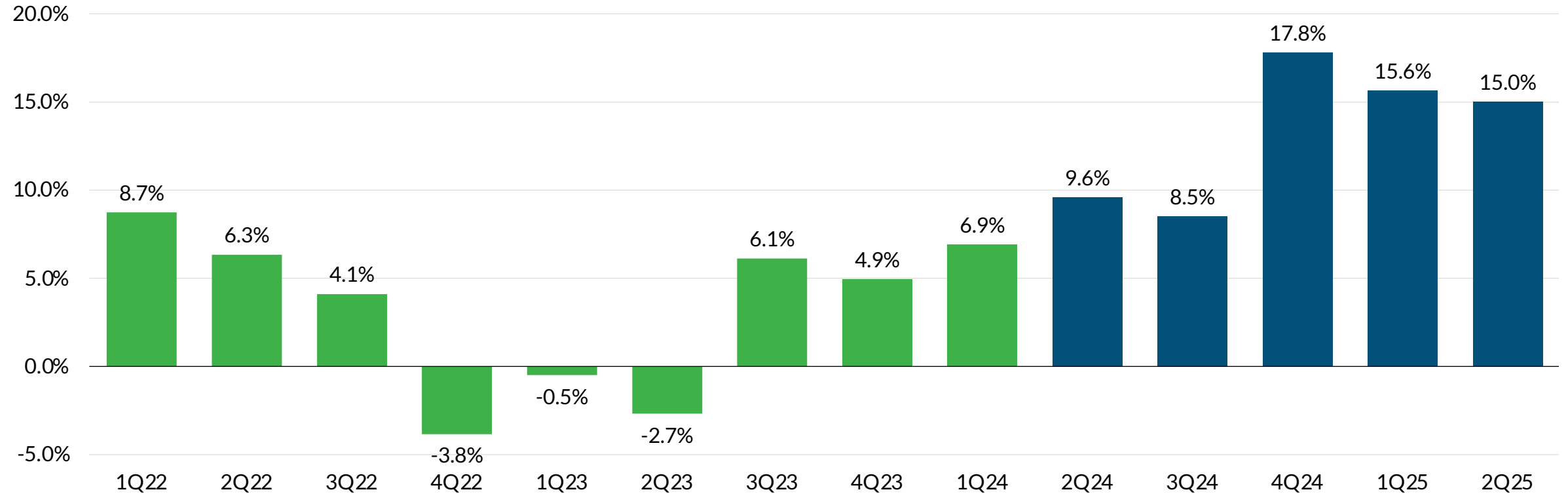
Source: Bloomberg as of June 27, 2024

Prediction 5



Earnings growth falls short of the double-digit percentage consensus expectation

Consensus: The earnings recession is likely over



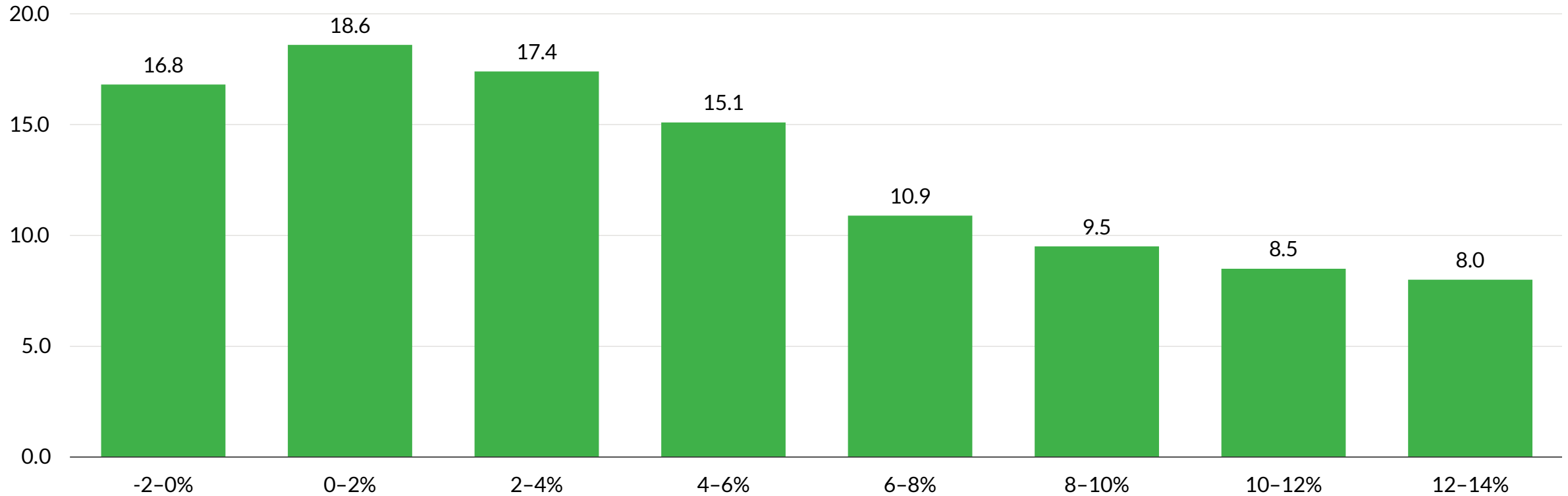
Source: FactSet as of June 30, 2024

Prediction 6



Stocks record a new all-time high early in the year, but then experience a fade

S&P 500 P/E vs. Inflation: Average S&P 500 TTM P/E by CPI Y/Y Tranche (1950–Current)



Source: Strategas

Prediction 6

Stocks record a new all-time high early in the year, but then experience a fade

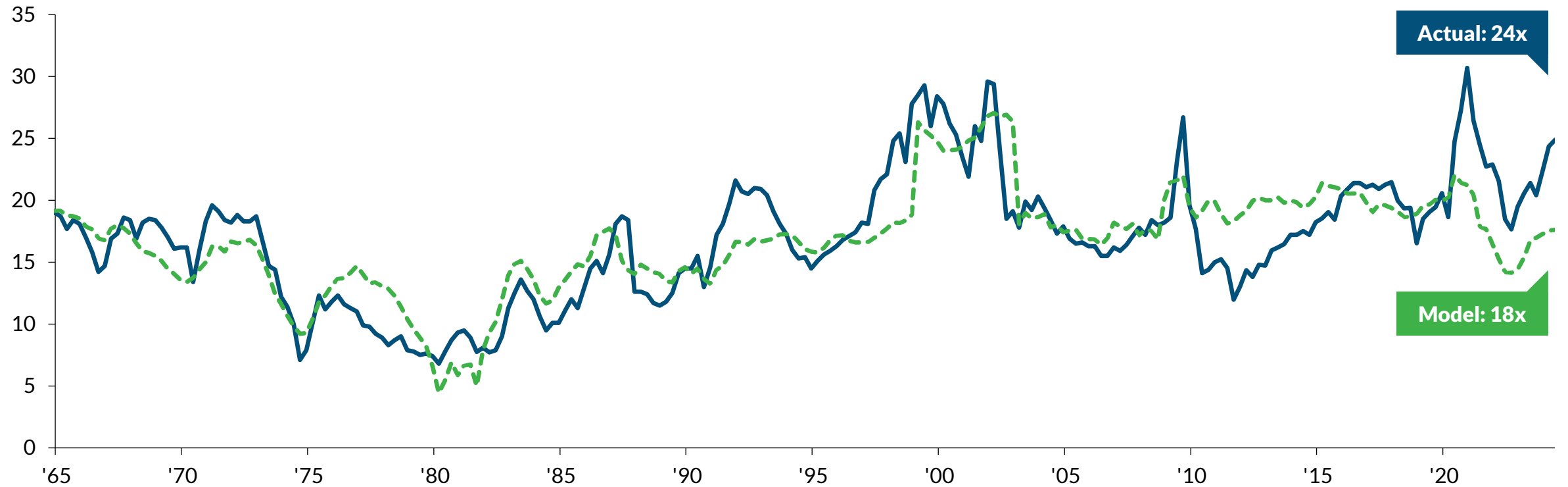


Valuation metric	S&P 500	
	Current	Historical percentile
Forward 12M P/E	21.2x	88
EV / T12M EBITDA	16.1x	96
EV / T12M Sales	3.2x	97
Free cash flow (T12M) yield	3.1%	81
Price/book	4.9x	98
U.S. market cap/GDP	202%	95

Wide gap between Strategas PE model and current levels



Strategas S&P 500 TTM P/E model



Source: Strategas as of June 30, 2024

Prediction 6

Stocks record a new all-time high early in the year, but then experience a fade



Starting P/E	S&P 500 average forward returns (%)				
	1-year	3-year	5-year	10-year	
< 10x	13.4	11.2	12.3	11.5	
10-12	14.9	13.0	10.4	10.5	
12-14	10.5	9.1	8.5	9.6	
14-16	12.4	10.9	9.8	9.3	
16-18	6.4	6.3	5.3	5.2	
18-20	7.4	6.0	5.5	4.4	
>20	3.9	4.4	5.5	3.0	



The Dow Jones will eclipse 100,000 on a 'turbo booster' combo of earnings growth and Fed rate cuts, Wall Street CIO says

- Headline, June 2024

Five stocks account for 60% of S&P 500 return YTD



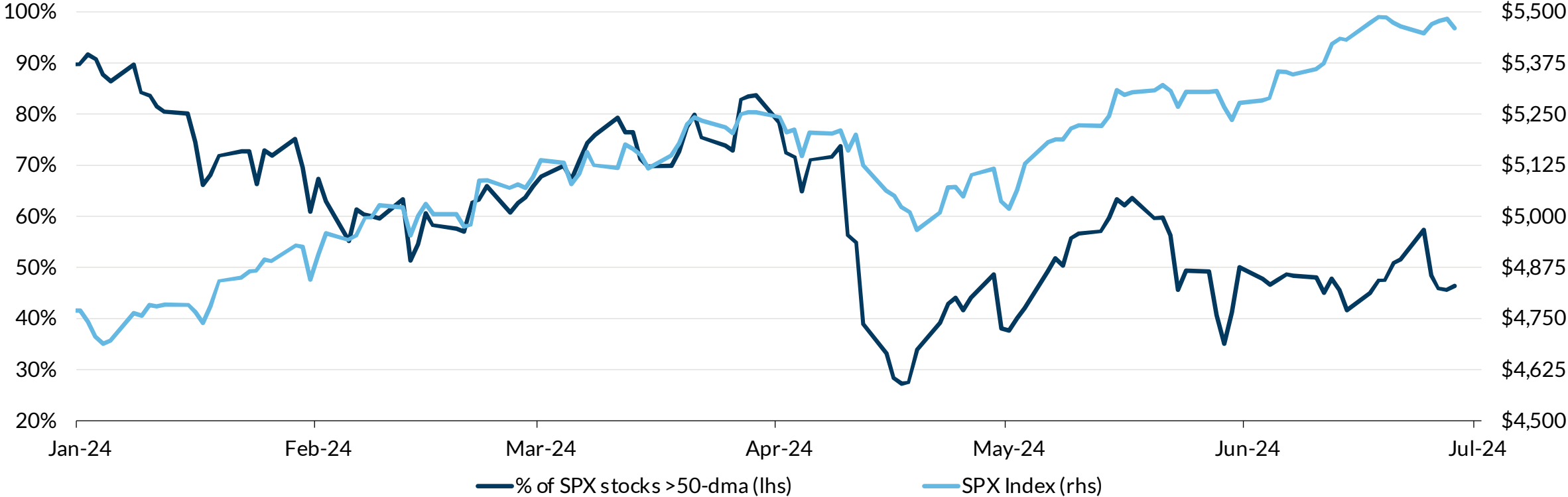
Top five contributors to YTD S&P 500 return of 15.3%

Ticker	Company	YTD total return (%)	Contribution to index return (bps)
NVDA	NVIDIA Corp.	150	458
MSFT	Microsoft Corp.	19	135
GOOG/GOOGL	Alphabet Inc.	30	113
AMZN	Amazon.com, Inc.	27	95
META	Meta Platforms Inc.	43	88
Top five contributors		45	889

Internals weakening



S&P 500 vs. percent of stocks above 50-day moving average



Source: Bloomberg as of June 30, 2024

Prediction 7

Energy, financials, and consumer staples outperform utilities, healthcare, and real estate



Overweights	1H24 return ¹	Underweights	1H24 return ¹
Energy <ul style="list-style-type: none"> • Cheap; strong earnings generation • Strong and growing cash flow • Global energy security concerns Risk: World peace	+9.1%	Utilities <ul style="list-style-type: none"> • Dividend yield less attractive • Payouts high • Not cheap vs. bonds Risk: Late cycle outperformance track record	+7.6%
Financials <ul style="list-style-type: none"> • High quality/low leverage vs. history • Historically inexpensive • Eventually positive yield curve Risk: Regulatory risk; commercial real estate	+9.3%	Healthcare <ul style="list-style-type: none"> • Typical election year underperformance • Poor drug pipeline • Not particularly cheap Risk: Good defensive characteristics	+6.9%
Consumer staples <ul style="list-style-type: none"> • Defensive characteristics if recession • Weakening dollar beneficiary • Valuations have de-rated Risk: Will lag in economy and market recovery	+7.6%	Real estate <ul style="list-style-type: none"> • Commercial/office space risk • Tough to secure investment capital • Patience required given headwinds Risk: Dividends strong	-4.1%

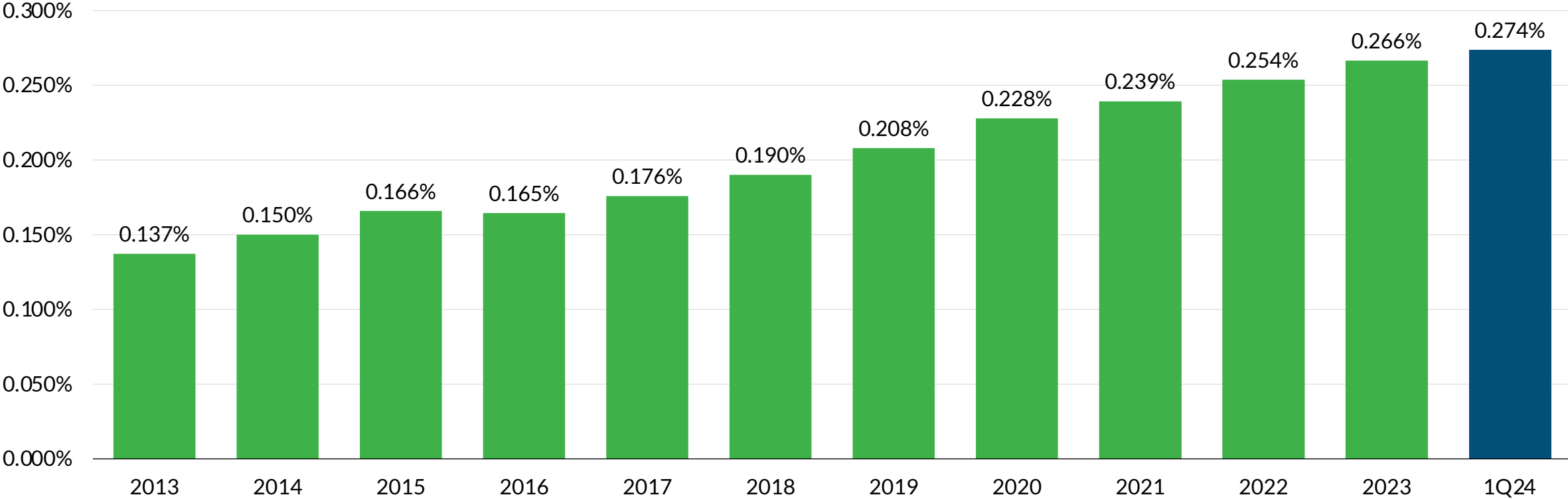
¹ Source: Bloomberg as of June 30, 2024

Prediction 8



Faith-based share of industry AUM rises for eighth year in a row

Faith-based market share (percentage of total industry AUM)



Sources: Morningstar and Crossmark as of March 31, 2024

Prediction 9

Geopolitical crosscurrents multiply but have little impact on markets



Geopolitical issues

1. Extreme polarization within U.S. (on lots of issues, especially wars)
2. Two highly unpopular leaders running for president
3. Ukraine-Russia war
4. Middle East war
5. Iran nuclear threat
6. China cold war
7. Global political uncertainty: 40% of countries, 41% of population, nearly 60% of global GDP and nearly 80% of stock market capitalization experiencing national elections in 2024

Prediction 10

The White House, Senate, and House all switch parties in November



Key issues

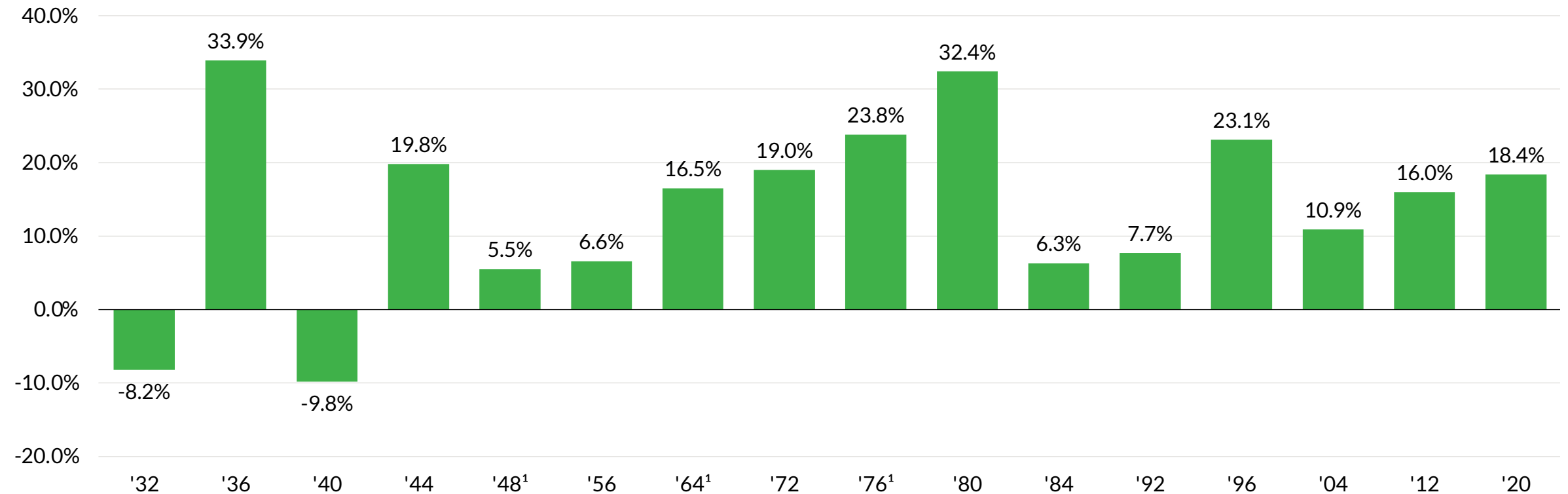
1. Tax policy (extension of Trump tax cuts)
2. Massive fiscal deficits/increased interest expense/entitlements
3. Relationship with China (trade, technology, Taiwan)
4. NATO commitment/Ukraine funding
5. Middle East war funding/Middle East relationship
6. Possible tariffs (more nationalism)
7. Southern border/drug traffic/cities and crime

Will the Supreme Court play a significant role in the election?

S&P 500 has increased in 13 straight presidential re-election years



S&P 500 total return in election years with incumbent president running for re-election



¹ In 1948, Truman assumed office after FDR's death and sought another term; in 1964, Johnson assumed office after JFK's death and sought another term; in 1974, Ford assumed office after Nixon's resignation and in 1976 sought another term.

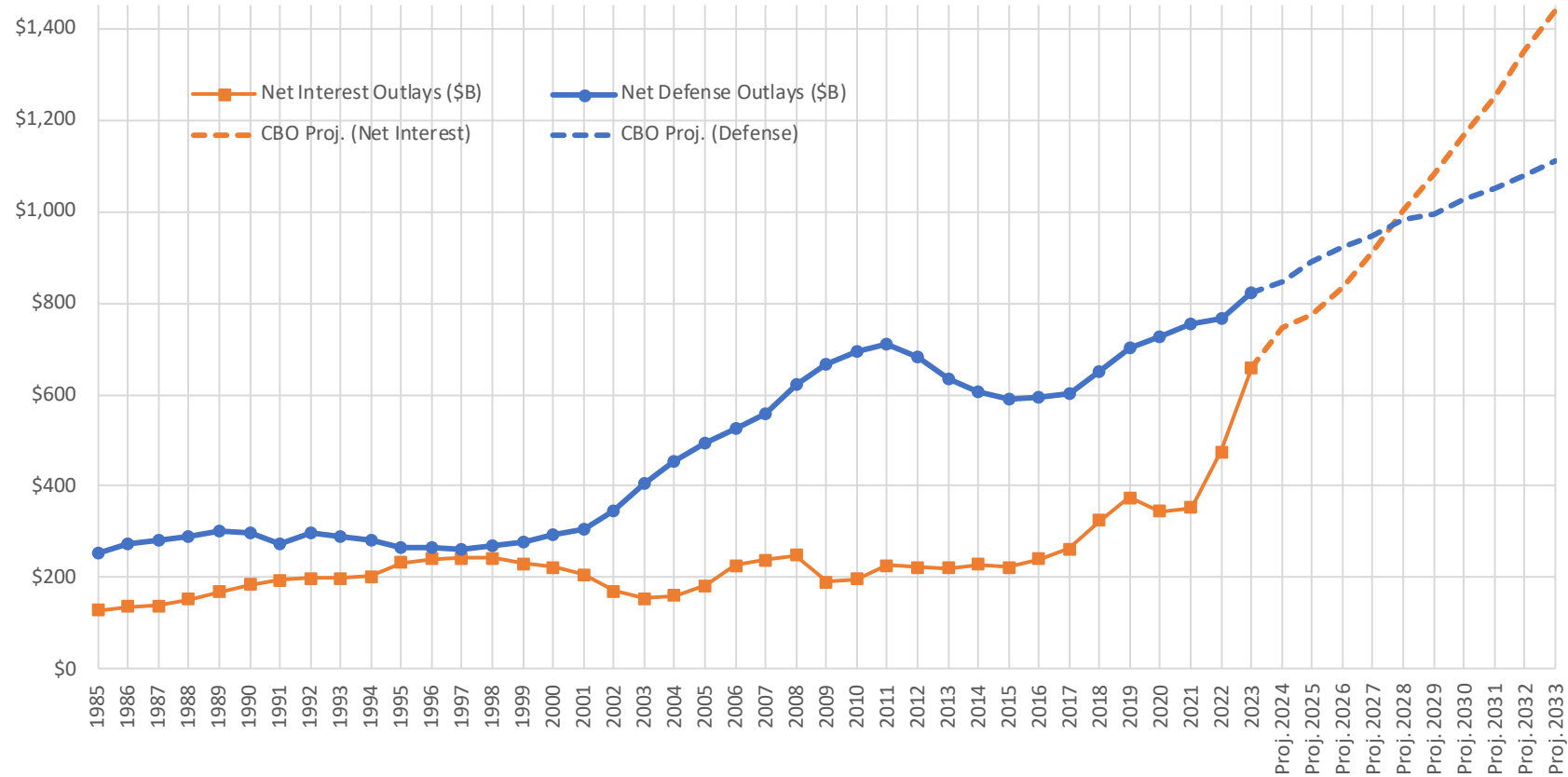
Source: Strategas

Prediction 10

The White House, Senate, and House all switch parties in November



Major components of Federal spending

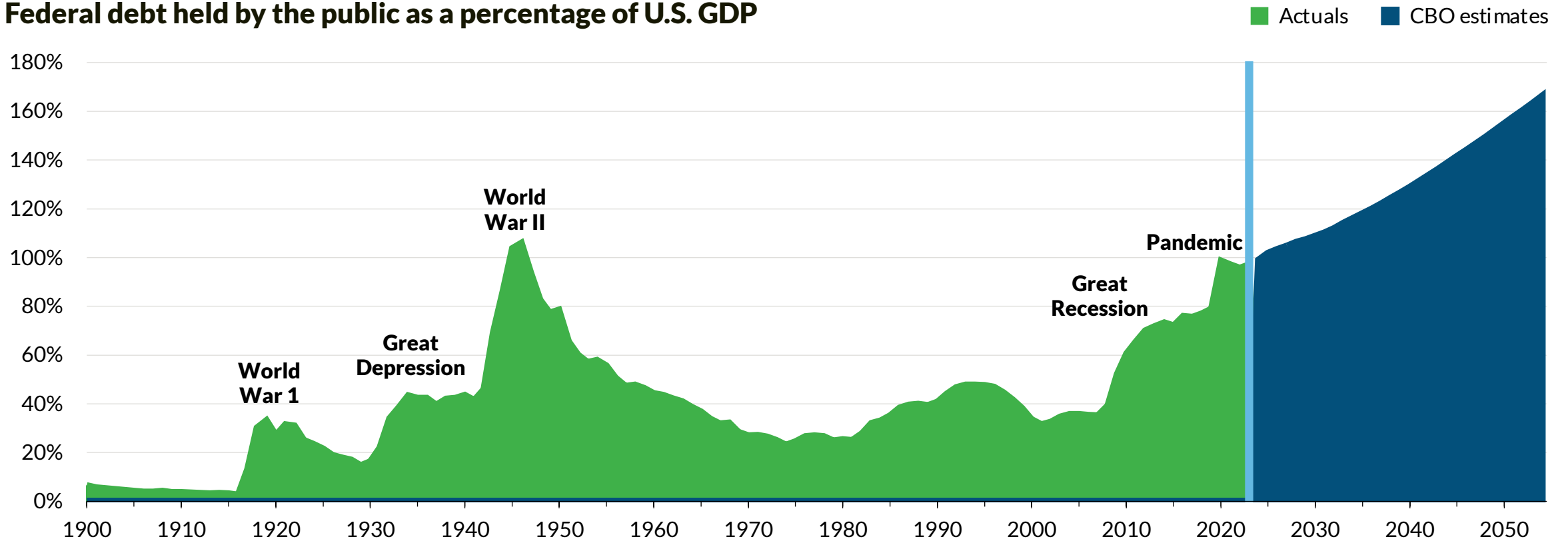


Source: Congressional Budget Office (CBO)

The big long-term risk



Federal debt held by the public as a percentage of U.S. GDP



Source: Congressional Budget Office (CBO)

Summary observations



- 1 The bid under U.S. stocks will persist for as long as the economy/earnings are okay and bond yields don't rise in a disorderly manner. Having said that, high valuations are increasing risk levels.
- 2 High valuation and narrow corporate bond spreads suggest that monetary policy is not restrictive.
- 3 Earnings growth should broaden (as should the market), but growth expectations are full/excessive.
- 4 Inflation will remain sticky.
- 5 Globally, economies are picking up from recessionary or near-recessionary levels.
- 6 Global trade will pick up cyclically, even as the secular decline continues.
- 7 Dollar is likely to weaken as U.S. slows some and non-U.S. economies recover.

What could go wrong?



- 1 Economy weakens noticeably

- 2 Fed stays tight for too long

- 3 Mideast war worsens

- 4 Commercial real estate collapse

- 5 Election crisis

- 6 Domestic disaster

Conclusions



- 1 The delayed recession shows up in 2024.
- 2 Inflation continues to fall but central bank targets (2%) remain elusive.
- 3 The Fed lowers rates, but less than expected.
- 4 Earnings fall short of expectations, even without a recession.
- 5 Stocks are expensive on most all measures.
- 6 Own stocks with good earnings predictability and persistence, and strong cash flow.
- 7 Do some dollar-cost averaging into international.
- 8 Expect dollar weakness.
- 9 Geopolitical threats continue to create uneasiness.
- 10 Election crosscurrents continue to accentuate polarization.

What to do?



- 1 Expect choppy markets (buy dips/trim rallies).
- 2 Focus on earnings growth and free cash flow (not P/E expansion).
- 3 Own some quality fixed income.
- 4 Diversify across asset classes and geographies (more non-U.S.).
- 5 Own high-quality value and less expensive growth.
- 6 Consider an absolute return strategy to complement market exposures.
- 7 Be prepared to step up if significant weakness.

Equity investors



Receive:

≈ 8% annual return

Tolerate:

3 corrections of 5% per year

1 correction of 10% per year

1 correction of > 15% once every 3 years

1 correction of > 20% once every 6 years

S&P 500 “batting average” (i.e., % of positive calendar years) since 1926: 75%

What to expect over the next 10 years



- 1 More modest investment market returns

- 2 Another recession

- 3 Population: older, with more grandparents than grandchildren
 - World population growth nearly 100% in 65 and older citizens
 - Obese children now outnumber underweight children for the first time ever

- 4 Technological innovation: information, healthcare, energy, and manufacturing

- 5 Robots and automation threaten jobs

- 6 Smart phone turns into smart everything

- 7 Space tourism

- 8 Globalization replaced by more isolationism/protectionism/populism

- 9 U.S./China cold war

- 10 Cyber warfare, possible biological warfare

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All investments are subject to risks, including the possible loss of principal. Past performance does not guarantee future results.

Equity investments generally involve two principal risks—market risk and selection risk. The value of equity securities will rise and fall in response to general market and/or economic conditions (equity market risk). The value of any individual equity security will rise and fall in response to the market's perception of the issuer's revenues, earnings, balance sheet, credit worthiness, business plan, and overall perception of the viability of the issuer's business (selection risk).

Fixed income investments generally involve three principal risks—interest rate risk, credit risk, and liquidity risk. Prices of fixed-income securities rise and fall in response to interest rate changes (interest rate risk). Generally, when interest rates rise, prices of fixed-income securities fall. The longer the duration of the security, the more sensitive the security is to this risk. There is also a risk that the issuer of a note or bond will be unable to pay agreed interest payments and may be unable to repay the principal upon maturity (credit risk). Lower-rated bonds, and bonds with longer final maturities, generally have higher credit risks. As interest rates rise and/or the credit risk associated with a particular issuer changes, bonds held within a portfolio may become difficult to liquidate without realizing a loss (liquidity risk).

Many municipal bonds also include call features that allow the issuer to call the bonds—repaying the principal before maturity—usually done in the context of a refinancing transaction if/when interest rates fall. When a bond is called, the holder does not incur a loss, but cash received from the call must be re-deployed, generally in a less favorable interest rate environment (call risk).

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Q&A



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