GW&K MARKET INSIGHTS

Transcript of 2Q24 conversation with Harold Kotler & Bill Sterling

GW&K INVESTMENT MANAGEMENT

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We invite you to listen to our quarterly conversation with Harold Kotler, Bill Sterling, and moderator Dan Fasciano as they review events from the second quarter of 2024 and discuss:

- The potential effect the upcoming US presidential election could have on markets;
- When the Federal Reserve is likely to make its first rate cut, and how many cuts for 2024 the market is currently pricing into its expectations; and
- How Fed easing could reverse what has been a very restrictive force on the economy and potentially set the stage for better growth into 2025 and beyond.

Edited transcript

Dan Fasciano: Welcome to the Second Quarter Client Conference call for GW&K Investment Management. This call represents the views and opinions of GW&K Investment Management and does not constitute investment advice, nor should it be considered predictive of any future market performance.

My name is Dan Fasciano, Director of Private Wealth here at GW&K. Joining me on today's call is Harold Kotler, GW&K's Founder-Chairman and Chief Investment Officer, as well as Bill Sterling, our firm's Global Strategist.

Guys, presidential politics, CrowdStrike, the upcoming Olympics in France — it's hardly been a boring summer so far. Harold, I want to start with you. President Biden announced this past weekend that he's taking himself out of the 2024 presidential election. You were prescient enough last quarter to mention the potential similarities to the 1968 Democratic National Convention in Chicago. Are there any ramifications investors should be considering now leading up to the November election or beyond? And how much does this election matter in your mind, as it relates to the markets?

Harold Kotler: Why don't you ask a more difficult question? One of the reasons I think there won't be any other candidates to compete with Ms Harris is I don't think people think Trump can be defeated. No one's talked about that, but he's got a machine, and it's well oiled, and unless she is remarkably articulate and challenges him at the debates, she could be the fall person for the Biden administration.

As it works out, it is important that he did drop out, but I wish he had done it earlier, so there could have been a process. I think it, how it affects the markets, I think it's very hard to play that game. Yes, things will be different. Yes, there will be winners and losers, but to sit here and try to figure that out would be a fool's game.

I worry about the deficit under either administration. I worry about challenging this attitude of tariffs and competing in the world and not cooperating. We have a lot of issues that both parties will have to address. I will call your attention to JD Vance and his book (*Hillbilly Elegy*), that he wrote about 10 years ago. I'm reading it now, and I happen to think that this guy, even if the

Republicans don't win, he is the face of the Republican Party. He is in his 30s, he's brilliant, a Yale graduate, comes from Kentucky, a poor background. He is the real deal and I think people need to listen to him and watch him and try to understand because if it's not this time, maybe the next time.

Dan Fasciano: That's helpful perspective Harold. Particularly true given the number of announcements over the past two weeks and that the election is fewer than four months out. Bill, let's stay with the macro. When we started the year, consensus forecasters had the Fed easing five times in 2024. To your credit, you were not in that camp.

That said, Chair Powell's recent congressional testimony was balanced to dovish. What are your thoughts about inflation, monetary policy, and are there any pieces of data you're watching closely going into the second half of the year? Maybe start us out with what's currently priced in for rate cuts prior to year-end?

Bill Sterling: The market's currently pricing in about two and a half cuts, by the end of the year. So, either 2 or 3 cuts, with a pretty strong consensus that the first rate cut is going to occur in September. And I think the reason for that is the balanced and dovish tone of Chair Powell recently has basically reflected balanced data. You know, at the end of last year, the second half GDP in 2023 was running at a blistering 4% annual rate. It looks like in the first half of this year it's more like 2%. And the unemployment rate has ticked up from a low of 3.4% last year to 4.1% now and it looks like it could be ticking up a little bit higher. So, the fed is worried about both sides of its mandate now, inflation control, but also worrying about the employment side of things.

In terms of data, I think it's still pretty much inflation, inflation, inflation. We had a bit of an inflation scare in the first three months of the year where some numbers like core CPI were annualizing north of 4%. The latest three months have been pretty positive. So, the latest three months of annualized for core at only 2.1%, which was pretty much a mission accomplished type of number from the Fed's point of view. So as long as those inflation data remain benign, I think this path of the fed, cutting rates, maybe once every meeting or every other meeting over the course of the next year, makes a lot of sense to me.

Dan Fasciano: It's helpful to know — it really kind of sets expectations from a macro standpoint. Harold, if you don't mind, let me steer your attention towards the equity markets. I mean, we're just a few weeks into the second half of the year, and US stocks, depending on cap weightings, are up between 7% and 17% already. Not surprisingly, for everything we've seen, large caps are again leading the charge. The 10-year Treasury yield has been moving lower for most of the summer and is now at around 4.25%. You've noted recently at some of our internal meetings that there are things going on, particularly on the equity side, that are changing. What are you seeing and how would you recommend clients think about opportunities going out over the next 12 months or so?

Harold Kotler: I think the next 12 months will be a wonderful period for investors. Interest rates will come down, the stock market will go up, small caps that have been lagging finally got in gear and have much further to go. And the large companies when they report earnings will still be incredibly powerful. It's not going to be either or, I think it's going to be a very broad market. If

you want a window of opportunity, it's right this second because yes, rates will come down. The economy will slow, it won't go into a deep recession, it may have two quarters in a row negative GDP, but that's technical, and companies are doing well. And we're going to have a different administration in Washington. Whichever party wins, there will be much more energy and it could be a really sweet spot. The drag of high short-term rates on people's decision making probably will be a Venus flytrap, and you're going to walk away from that cash and you get yourself invested.

Dan Fasciano: Bill, Harold's talking about market breadth here, and you just wrote a piece on the narrowness of the market, and you put specific attention in that piece on The Magnificent Seven, maybe touching or building off of what Harold just said about broad markets, can you put the current situation into some sort of historical context? And in your mind, what should investors make of this as they think about the market going forward?

Bill Sterling: There are different ways to look at market concentration, or in this case, narrowness of the market advances, for example, the top 10 stocks by market cap in the S&P are now 37% of that entire Index, and you have to go back many, many, many decades to see that much concentration of market cap in a few large names. You can also look at measures like the, gap between the S&P 500, or capital-weighted index, the one that's normally quoted to the market, that's up something like, 18% this year versus the S&P 500 Equal Weight Index, which doesn't give as much weight to those large caps, and that's up only about 8%. Last year that gap was 13%, which, going back to 1990, that's a second percentile reading. In other words, it's been extremely rare to see that big of a gap between the cap-weighted index and the equally weighted index. And what I found in my historical research was when the market has been that narrow in the past, then over the subsequent one-, three-, and five-year periods, small caps have had a very significant outperformance of large caps — on the order of 500 to 800 basis points, per annum, and with a hit rate that typically is around 70% or better.

So I think that it's certainly the case that looking back, it makes sense why the market has been so narrow. You know, the Mag Seven stocks, those Magnificent Seven tech stocks are themselves 30% of the S&P 500, but they've accounted for almost 90% of the earnings gain so it's been a rational sort of assessment of where the earnings have been that have resulted in that concentration. But particularly as Harold mentioned, if we have a Fed that's going to be easing, we could easily see a broadening out of the market, particularly as the market looks forward to better growth, next year and beyond, thanks to an easier Fed.

Dan Fasciano: You both are really making an important case about not being complacent, while at the same time, remaining vigilant, leaning towards stock selection that, particularly as we approach next year, there's lots to pay attention to, so I appreciate the context there.

You know, Harold, back to you and sticking a little bit more to the overall theme here. As many listeners know, we're celebrating our 50th anniversary this year. It's a biggie. And I'll say, selfishly, one of the perks to sitting close to you is the conversations we have putting current times into some historical context. Now I'm going to kind of pivot on you here. You wrote your most recent economic commentary with the lead off of saying that capitalism, innovation, technology, defy the notion that the more things change, the more they stay the same. You really challenged us to say that things are evolving here and that you've seen this. You know, so here's the question. There's

no shortage of opinions on AI (artificial intelligence). I mean, I don't even want to Google the term AI, but you had some specific ideas around how investors should think about it. Would you be willing to share some of those ideas here?

Harold Kotler: I think unfortunately, people just keep on trying to define it and how it could be used, and it really takes away from the overall importance that we don't know, we can't know the extent of AI on our economy. But my intuition tells me that it's going to help productivity, earnings, and efficiency, and be a game changer for America and the world's industries allowing better profit, better growth at a time where the economy and population growth is low, and there's really not a lot of obvious ways to grow since there's so much world competition and everybody wants to stay close to their own home base, which sounds like it's, a poor economy. But AI turned the clock and makes it even with the restrictions and tariffs and competition and all the verbiage that's coming out, I think productivity growth is a key to an economy's success. And if we get productivity growth of 1% or 2%, it makes a huge difference in the lives of everybody. And everybody's going to worry about what job can be lost and who gets hurt, who doesn't, and it'll be a rat-tat-tat discussion. But like every other cycle, everybody will find their way and it will be a win-win for the world. And it's pretty exciting. So just don't get caught up in the debate of what this will do and what that will do, because we just don't know. But we need productivity growth and again, in a world where there's not population growth and obvious ways to really accelerate the world economies.

Dan Fasciano: Harold, for all the commentary by pundits around AI, you really summed up, the way I think investors should think about it from this perspective; it's really great context. Bill, assuming the Fed does start to lower its target for fed funds going into the year end, what would be some of the macro or market dynamics that you're going to be looking for and are there any segments or sectors you see as stretched or mispriced at this stage?

Bill Sterling: Well, I think in terms of macro dynamics, you know, we've been two years now into an inverted yield curve, which creates problems. The high rates obviously keep mortgage rates high; they keep consumer credit card borrowing rates higher, they keep interest margins for financial institutions squeezed. So basically, if the Fed starts to ease and then continues that ease for a while, that reverses a lot of that very restrictive force on the economy, and I think could set the stage for better growth into 2025 and beyond. I think, in particular for groups like small caps, which we think are much more favorably valued now than large caps, that's great news because small caps tend to have a much higher percent of their corporate debt as floating rate debt, which will benefit as those rates come down than, say, their large cap counterparts do.

So I think that, when we look at it right now, the, Russell 2000 has a forward price earnings ratio of about 17 times compared to 23 times for the cap weighted S&P 500 Index so that gap alone looks pretty intriguing to us in terms of signaling the potential for small caps to outperform.

In terms of sectors, our analysts are finding lots of interesting ideas in areas outside of technology like health care, like industrials, and like financials that could benefit from that yield curve finally steepening or uninverting. Those are just a few of the things we're looking at.

Harold Kotler: I agree with you completely, Bill. There are times in the cycles that are inflection points. It's like, okay, "When rates were going up, how far will they go, and when will they stop?" You get into that. But now we're in that other cycle. Rates will come down. How fast, and when? Well, that's not important. What's important is, they're coming down. What's important is, the market, to your point, will celebrate short rates declining and the long rate may come down a little bit. They still worry about inflation because the debt keeps on rising, but certainly the yield curve will straighten itself out and short rates will come down, and it makes a lot of businesses much more profitable. The shift from the investor who's keeping 5.5% cash flow in a money market will go to 3%. The same event will make the corporation not have to pay 6% or 7% but can pay a 3% or 4%. This is a game changer, and it's happening right now. So don't get distracted by the politics. I know there's a lot going on in the world, believe me I know, but this is economics and that's not going to change.

Dan Fasciano: So, guys, another content-rich call as always. And I want to thank both of you for sharing your thoughts. Should anyone listening in have any follow up questions or comments, please feel free to get in touch with your GW&K contact. And to all of the clients and friends listening in, we hope you enjoy the remainder of your summer, and we look forward to reconvening in October. Enjoy!

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