APPLETON
PARTNERS, INC.

Making Sense of a Magnificent Market Cycle:

A Look At How We Evaluate the Merits of High Growth Stocks

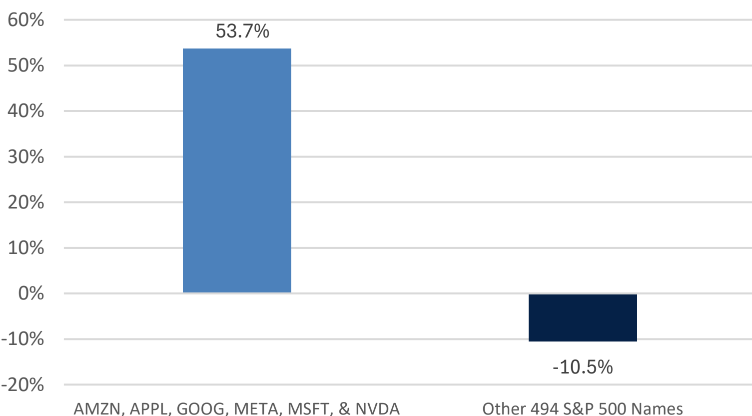
Big Tech Has Recently Dominated the Investment Landscape

Many years in the equity markets are characterized by a prevailing theme or development, at times something dramatic such as the dot com frenzy of 1999 or the subprime mortgage meltdown of 2007 and 2008 that launched the Great Financial Crisis. The dominance of the so called "Magnificent 7"[1], a group of high-flying mega cap growth stocks, is what stood out most this past year. Those seven stocks traded at a lofty average forward price-to-earnings ratio (P/E) of 30.8x as of 3/31/24, as compared to a far more modest 19.1x for the rest of the S&P 500 (ex-the "Magnificent 7")[2]. Additionally, they accounted for roughly a 29% weight in the S&P 500. Perhaps of greater importance to investors, JP Morgan recently calculated that 55% of the S&P 500's performance variance during 2023 was attributed to the weekly price movement of those seven names. In such an environment, an impetus to own market leading stocks is often evident among money managers.

Chasing performance can be dangerous, yet paying a premium to invest in great companies with powerful growth prospects can be highly rewarding. Quite frankly, we actively look for such opportunities. In fact, six of these stocks were collectively expected to post +53.7% earnings growth in Q4 '23 vs. -10.5% for the other 494 S&P names.[3]

By contrast, we view speculative momentum as problematic. Herding is a tendency among investors to follow the actions of others rather than relying on independent analysis when making investments. The financial media, our colleagues, and friends often place disproportionate emphasis on "what's working" as there is usually great interest in perceived winners. Throughout history this element of behavioral finance has contributed to periodic price surges in individual stocks or sectors, which often later reverses course as rallies lacking in substance ultimately fizzle out.

S&P 500 Earnings Growth (Y/Y): Q4 2023



Source: FactSet

Differentiating Between Sustainably High Growth and Overvalued Momentum

At Appleton, we seek to deliver attractive long-term returns for clients while carefully managing risk. With this in mind, how do we evaluate the merits of stocks exhibiting exciting price action?

Appleton's large cap growth strategy aims to buy high quality businesses at sustainable valuations. As an example, our research team often weighs a company's growth expectations relative to its stock price from several perspectives.

1. The price/earnings-to-growth ratio, or "PEG ratio" is a metric that calculates how much you are paying for anticipated earnings growth. A lower PEG ratio may indicate that a company's expected earnings growth is relatively cheaper than that of a similar company with a higher PEG ratio.
2. We also consider historical valuation as it offers useful context when looking at current stock prices. At times, buying a stock at a rich P/E relative to historical standards may be justified given the company's future growth prospects, although thoroughly understanding the business and the sustainability of earnings growth is essential.
3. Furthermore, we employ discounted cash flow ("DCF") analysis to project the unleveraged free cash flow a business is expected to generate over a 5 to 10-year period. Such modeling allows us to assess variables such as revenue growth, margin expansion, and risk when considering whether there is compelling value in the current price of a stock.

Darlings of the market may prove to be extraordinary investments, and lofty valuations often reflect exceptional future growth prospects. Nonetheless, jumping into a fashionable trade that is not grounded in fundamental analysis to us is imprudent. Through proprietary research we seek to uncover those important distinctions.

"Magnificent 7" and S&P 500 Returns
2021 – present

Total Return	2021	2022	2023	2024 YTD (as of 3/31)
"Magnificent 7"	+40%	-40%	+76%	+13%
S&P 500 ex-Mag. 7	+17%	-8%	+8%	+6%

Source: FactSet, S&P, JP Morgan Asset Management

1. Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla
2. Source: Bloomberg
3. FactSet

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MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- Tax-exempt yields began the year in an overbought position, which coupled with sustained economic strength, drove rates higher in line with USTs. The spread between 2s and 10s widened significantly during Q1.

	12/31/23	3/31/24	QTD change
2-yr AAA Muni	2.52%	2.97%	+45bps
10-yr AAA Muni	2.28%	2.51%	+23bps
30-yr AAA Muni	3.42%	3.68%	+26bps

- The Fed remained on hold while a debate raged over when cuts might begin. We have been calling for only 2 or 3 cuts in 2024 despite what had been a 5 to 6 cut market consensus. The market is now only pricing in 3 cuts, and July is more likely than June as a starting point.
- After hitting 75.5% at the start of Q3 '23, 10-year Muni/UST ratios plummeted below 60% throughout Q1. A likely longer-term range lies between 60-70%, well off of prior averages.
- Municipal fund buyers returned in earnest in Q1 with +$8.8B of net fund inflows into all municipal categories, while ETFs garnered an additional $640M.
- Despite a bump in yields, AAA-AA spreads were unchanged at 7bps, while AAA-A spreads widened modestly from 27bps to 31bps. With spreads trading through their 5 and 15-year averages and credit quality likely beyond its peak, we are emphasizing high credit quality.
- Municipal issuance rebounded in Q1 at $99.1B (Bond Buyer), up 24% vs. the same period of 2023. A 39% increase in revenue bond issuance led the way. New money only increased by 2%, although current refundings rose 54% vs. 2023.
- Higher yields caused longer duration bonds to underperform in Q1. The 1-year index remained positive at +0.11% in an otherwise challenging quarter. Credit outperformed as the "BBB" rated segment was up +0.60% vs. -0.81% for the AAA component of the broad index.
- We expect the municipal curve to begin to normalize in Q4 with the front end coming down and stability in the longer end. As such, we see value in 1 to 4-year maturities while also focusing purchases on the steeper 9 to 12-year portion of the curve.
- Our UST trading range for 2024 is 3.75%-4.50%. In Intermediate portfolios, we are working to maintain a 4.65 to 4.75-year duration target.

Investment Grade Corporates & Treasuries

- A surprisingly resilient labor market and overall economy pushed UST yields up during Q1 with the 10Yr rising 32bps to 4.20% and then another 19bps to 4.39% as of 4/5.
- Sustained demand has kept IG credit spreads tight as the OAS on the Bloomberg Corporate Bond Index closed Q1 at 89bps, only 2bps wider than the YTD low reached on 3/21.
- IG Corporate issuance has been exceptionally high with a record $520B coming to market in Q1. This reflects robust demand, attractive borrowing costs, and lingering forward economic uncertainty.
- Fund flows into short and intermediate Investment Grade funds has been robust in 2024. There hasn't been a single week of outflows this year which has extended consecutive positive inflow weeks to 21, helping to absorb a rapid pace of issuance.
- Ratings agencies have taken action on 94 individual credits in the Investment Grade Credit space during Q1. Of those, 35 were upgraded and 48 were downgraded leaving the upgrade/downgrade ratio at 0.73. This is slightly higher than last year's 0.57 during Q1 but well below the 1.52 first quarter average over the last 10 years.

Equities

- Stocks rose each of the first 3 months of the year leaving the S&P 500 with a +10.2% Q1 return. Nasdaq followed suit at +9.1%, with the DJIA posting +5.6% performance, and the small cap Russell 2000 lagging, albeit at a healthy +4.8%.
- Ten of eleven S&P sectors closed higher with only interest rate sensitive REITs declining (-1.4%). Growth oriented sectors and cyclicals outperformed.
- Stocks gained ground despite an increase in UST yields as markets hawkishly repriced expectations for Fed rate cuts in 2024. Fed Fund futures now imply only 2.7 cuts this year, down from 5-6 at the beginning of January.
- GDP grow at +3.4% in Q4 on the back of a resilient consumer and labor markets that show few signs of cracking, an environment conducive to Federal Reserve patience.
- Leadership from mega cap technology names persisted through January and February before losing some steam. Small caps and the equal-weighted S&P 500 outperformed in March, an expansion of breadth we see as healthy.
- Volatility has largely been absent of late as the VIX averaged 13.7 over the first 3 months of the year, as compared to a full year average of 19.5 dating back to 1990. There were also no meaningful drawdowns, a calm that is unlikely to persist.

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