MARKET COMMENTARY

QUALITY: WHY IT STILL MATTERS

From last October's lows, the total value of stocks in the United States is up another $10 trillion. Sitting near $55 trillion, the U.S. stock market is now within a stone's throw of record high valuations. At the same time, profits and profit margins for the largest public companies in the S&P 500 index are also at levels not seen before. There are few signs of stress in financial markets, despite much handwringing over the Federal Reserve's (Fed) next move.

If there were real concerns that high interest rates were about to sink the economy, it is highly unlikely that investors would only demand a miniscule 1.40% additional yield for corporate bonds versus Treasuries. In fact, we have seen cases recently where high-grade corporate bonds traded with yields below the benchmark Treasury bond yield. There simply does not seem to be much fretting going on among investors in risk assets.

For some further perspective, we offer a simple table on page 3. As you can see, the value of stocks has been on an upward rise for most of the past twenty years. These gains were directionally consistent with growth in the economy and underlying corporate earnings power. The United States provided an excellent environment for wealth creation over this time, despite setbacks including a major financial crisis, pandemic, and unfolding geopolitical risks around the world.

A WEATHER EYE FOR RISK

But we would be wrong to assume that, just because the past has been generous to stock investors, that risk has been vanquished. The fact that good things have happened in the past does not guarantee that we will not suffer recessions and various unexpected crises in the future. Of course we will, and we need to prepare for that eventuality. This is why we focus heavily on "quality." Qualities like durability and flexibility go a long way when growth is challenged and clouds overtake the economy. So, yes, we will continue to place a higher premium on things like consistency and strength of a company's balance sheet, even at the expense of flashy growth or a high dividend yield.

Please look at the charts on page 4. They showcase two indices we have developed to track the performance of "High" versus "Low" quality stocks. Companies with more profitable assets, lower debt, consistent operating performance, and more predictable stock price movements are in the "High Quality" bucket, while companies with opposite traits inhabit the "Low Quality" bucket. You should know that the "Low Quality" companies *do offer* a higher dividend yield and are *cheaper* by some metrics. According to Bloomberg, the lower quality stocks are priced with a dividend yield over 3%, for example, while the "High Quality" stocks' dividend yield is only 1.6%. The lower quality stocks also trade at a lower multiple of "book value" or "book equity" than quality. The price-to-book ratio for low quality is 1.7x while the same ratio for high quality is 7.0x. If you are looking for cheaper, higher-yielding companies, you would be well advised to look at the low-quality group. Be warned, however, that doing so generally comes with higher risk.

Please also note that the two quality groups have been in a back-and-forth "horse race" over the past couple years. There has been no significant difference between the returns of the two groups over this period. However, one should also recognize the significant *difference in volatility* between the two indices in the bottom chart. The lower quality stocks exhibit far greater volatility, which can be something of a problem during more challenging times than what the market currently is pricing in today. Accordingly, we try to avoid the temptation of buying cheap, higher yielding, lower quality stocks, focusing exclusively on companies with greater stability and fundamental strength. In this way, we hope to benefit from the more defensive characteristics that tend to come with more profitable, less indebted, more predictable businesses when uncertainty arises in the markets.

WCA BAROMETER UPDATE

Although it is impossible to always accurately predict when markets will turn one way or another, it does not stop us from trying.

To this end, we offer the "WCA Barometer" as one way we seek to watch for changing tides. Originally a checklist of key data, we have spared our readers an exhaustive amount of reading by consolidating our findings from a wide range of indicators into a single chart. The chart on page 5 shows our barometer, and it continues to point in a generally positive direction. For the most part, growth around the world has been surprisingly strong of late, despite higher interest rates. Some of the more positive recent inputs to the "barometer" include a sense of overall optimism among investors, reasonably positive readings on corporate investment, rising earnings forecasts, low and consistent levels of job creation, and some signs of improvement in manufacturing.

With readings still forecast to track above 50, the growth outlook appears to be favorable for now. We offer a range of forecasts from good to bad (the dashed lines), but the "base case" forecast (solid projected line) remains on a constructive path (above 50).

Nonetheless, it still makes sense to us to keep focused on quality. At some point, there will be surprises and challenges that will call for a more defensive approach. We want to make sure we own the types of solid companies that other investors will seek out whenever that time comes.

TABLE A | U.S. ECONOMY AND STOCK MARKET

Source: WCA, Bloomberg

Year (Quarter)	Stock Market Value ($Trillions)	Economic Output (GDP, $Trillions)	Stock Market Value / GDP	S&P 500 Earnings Per Share	S&P 500 Profit Margin
2024Q1	$55.3	$28.3	1.95x	$250	11.0%
2019Q1	$30.6	$21.1	1.45x	$170	10.5%
2014Q1	$22.7	$17.2	1.31x	$121	9.4%
2009Q1	$9.4	$14.4	0.65x	$65	5.6%
2004Q1	$13.9	$11.9	1.17x	$66	7.2%

CHART A | A HORSE RACE: WCA HIGH QUALITY VS. WCA LOW QUALITY INDEX Source: WCA, Bloomberg

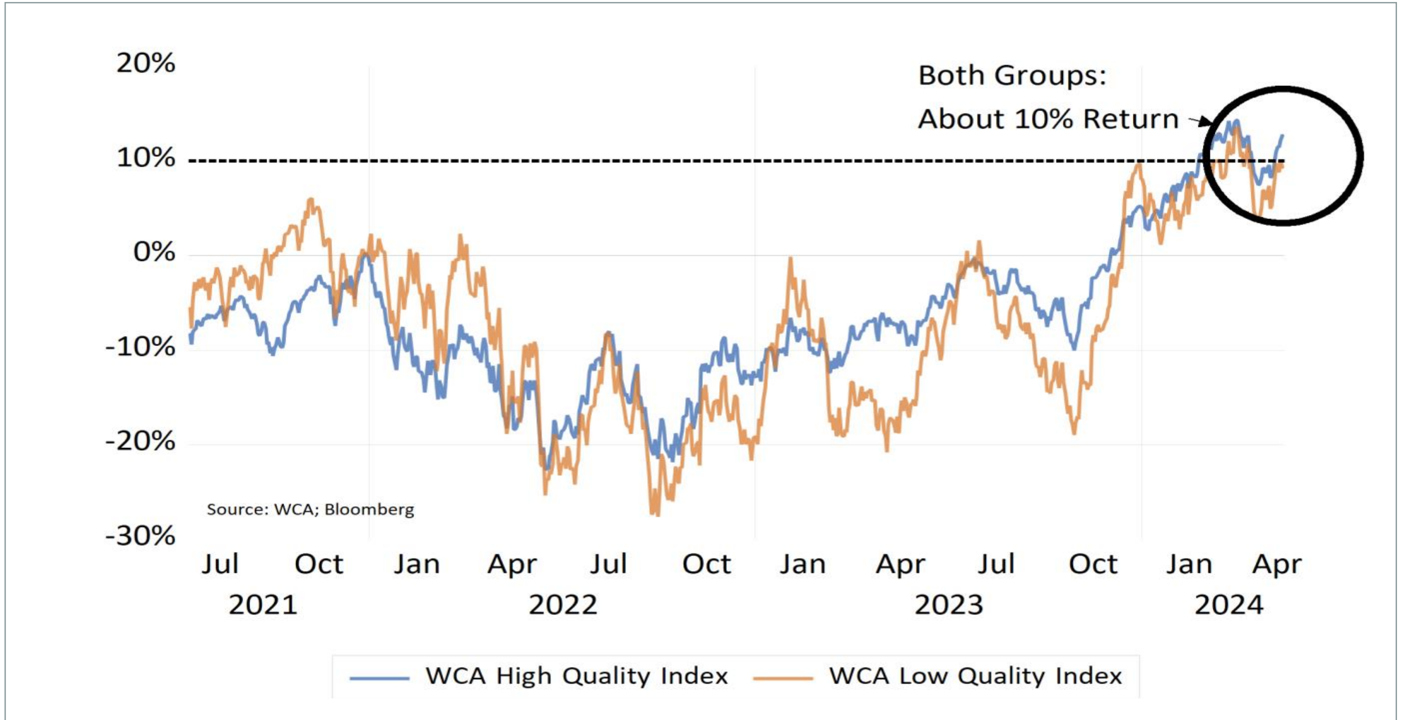


CHART B | VOLATILITY MEASURES BY WCA QUALITY CATEGORY 1999-2024 Source: WCA, Bloomberg

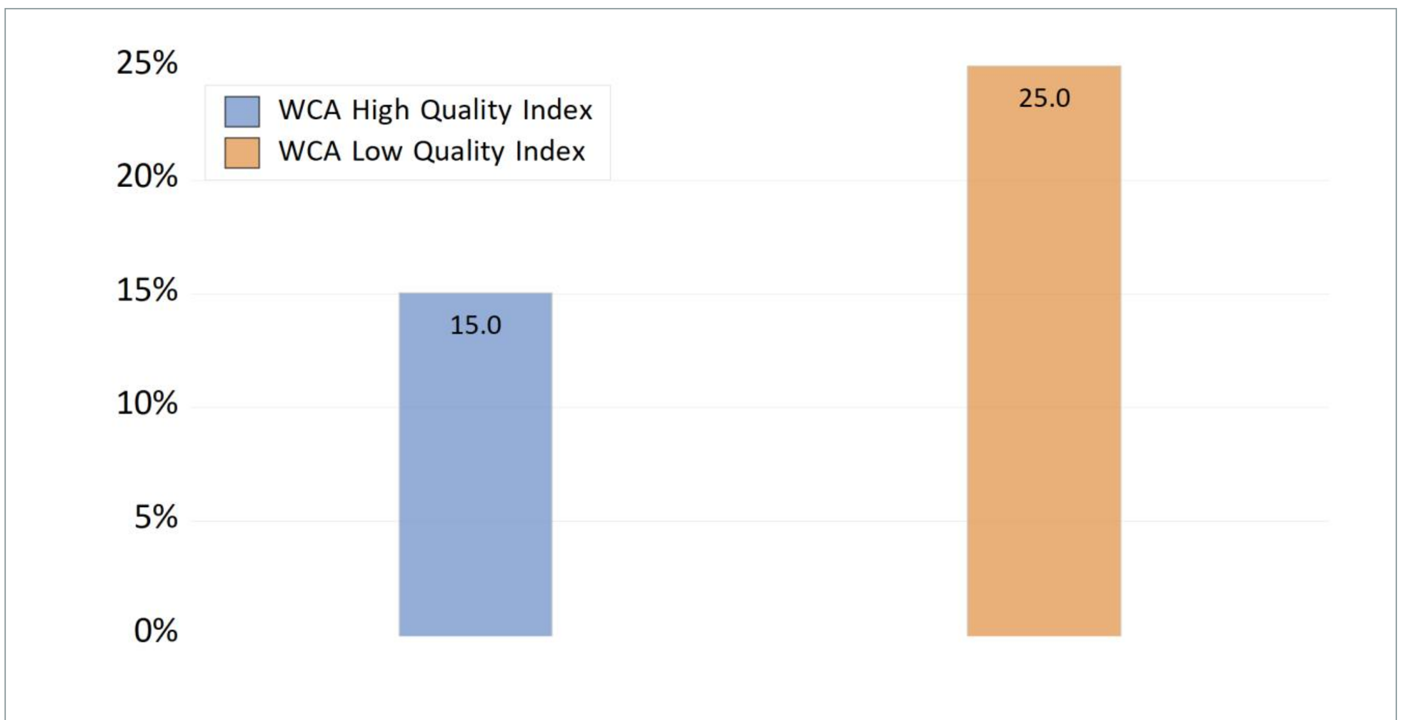
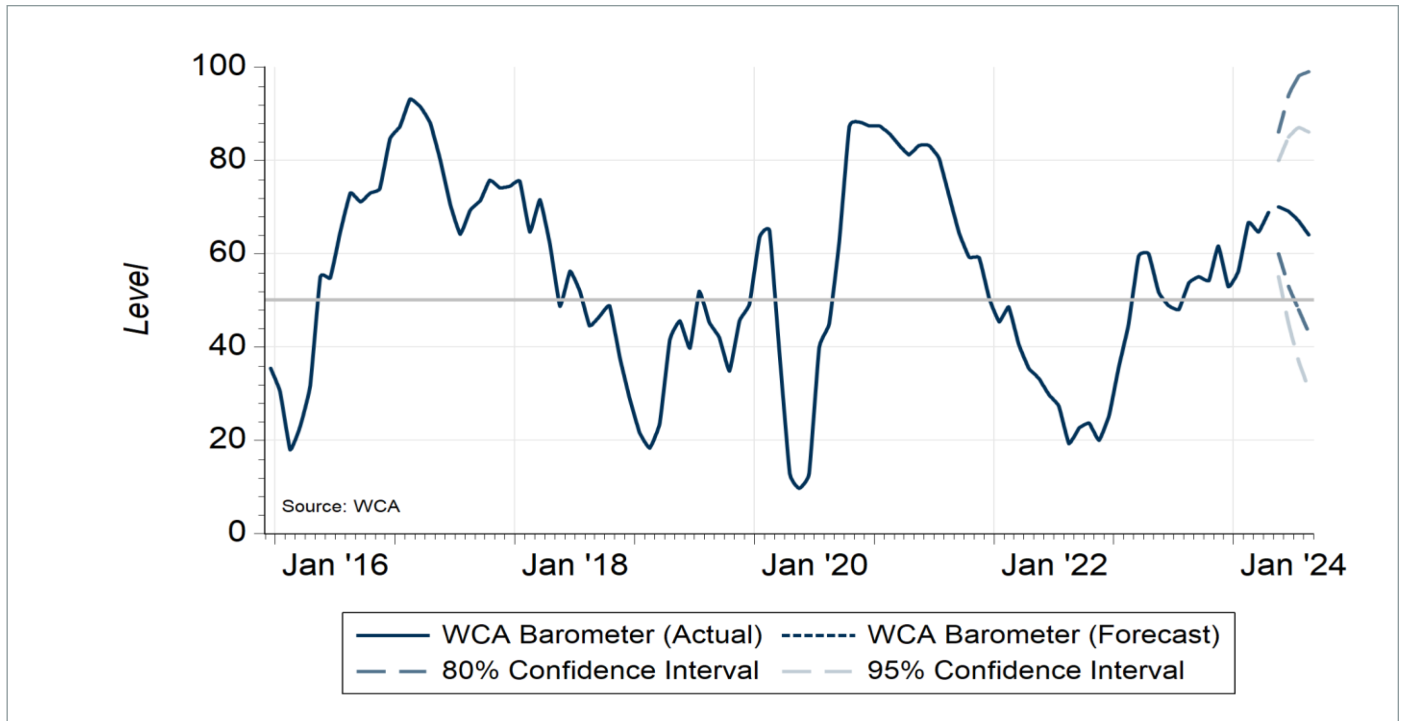


CHART C | WCA "BAROMETER" Source: WCA



Important Disclosures

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.

The Washington Crossing Advisors' High Quality Index and Low Quality Index are objective, quantitative measures designed to identify quality in the top 1,000 U.S. companies. Ranked by fundamental factors, WCA grades companies from "A" (top quintile) to "F" (bottom quintile). Factors include debt relative to equity, asset profitability, and consistency in performance. Companies with lower debt, higher profitability, and greater consistency earn higher grades. These indices are reconstituted annually and rebalanced daily. For informational purposes only, and WCA Quality Grade indices do not reflect the performance of any WCA investment strategy.

The Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 Index, which measures the performance of the 3,000 largest U.S. companies based on total market capitalization. The average market capitalization is approximately $11 billion, and the median market capitalization is approximately $3.5 billion.

The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by us and is not a complete summary or statement of all available data, nor is it considered an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. There is no guarantee that the figures or opinions forecasted in this report will be realized or achieved. Employees of Stifel, Nicolaus & Company, Incorporated or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed within. Past performance is no guarantee of future results. Indices are unmanaged, and you cannot invest directly in an index.

All investments involve risk, including loss of principal, and there is no guarantee that investment objectives will be met. It is important to review your investment objectives, risk tolerance and liquidity needs before choosing an investment style or manager.

Beta is a measure of the volatility, or systematic risk, of a security or a portfolio relative to the market as a whole. A beta of one is considered as risky as the benchmark and is therefore likely to provide expected returns approximate to those of the benchmark during both up and down periods. A portfolio with a beta of two would move approximately twice as much as the benchmark.

This commentary often expresses opinions about the direction of market, investment sector and other trends. The opinions should not be considered predictions of future results. The information contained in this report is based on sources believed to be reliable, but is not guaranteed and not necessarily complete.

Washington Crossing Advisors LLC is a wholly owned subsidiary and affiliated SEC Registered Investment Adviser of Stifel Financial Corp (NYSE: SF). Registration with the SEC does not imply a certain level of skill or training.

FOR MORE INFORMATION, PLEASE CONTACT US:

Washington Crossing Advisors

- **Kevin R. Caron, CFA,** Senior Portfolio Manager | (973) 549-4051
- **Chad Morganlander,** Senior Portfolio Manager | (973) 549-4052
- **Matthew Battipaglia,** Portfolio Manager | (973) 549-4047
- **Steve Lerit, CFA,** Senior Risk Manager | (973) 549-4028
- **Thomas J. Serzan,** Senior Equity Analyst | (973) 549-4335
- **Suzanne Ashley,** Internal Relationship Manager | (973) 549-4168

Sales and Marketing

- **Eric Needham, Director,** External Sales and Marketing | (312) 771-6010
- **Jeffrey Battipaglia,** External Sales and Marketing | (973) 549-4031

About Washington Crossing Advisors | Washington Crossing Advisors a wholly owned subsidiary of Stifel Financial Corp. (NYSE-SF). The WCA team has been helping individual and institutional investors build wealth for more than 25 years.

www.washingtoncrossingadvisors.com

© 2024 Washington Crossing Advisors, LLC. All rights reserved.

WASHINGTON CROSSING ADVISORS