US Equities
Investment comment

June 30, 2024

For professional investors only

The facts: Like in previous months, economic indicators released in June were mixed to slightly soft, and companies' comments looked increasingly cautious. The first presidential debate revived concerns about Joe Biden's capabilities, and uncertainties kept growing on the international front.

Many different details brought more confirmations of the progressive slowdown in activity, in the USA and the rest of the world. There was nothing obvious but **a slow downtrend remained visible behind the mix of surprises on the upside and the downside**.

The ISM Services index, which was back to 53.8, its highest level since August 2023, was one of the few exceptions, but this seemed to conflict with the views expressed by retailers such as Walmart or Target. Many of these suggested that, after low-income customers, it was middle-income households' turn to restrict their spending. Most other indicators looked either soft or less strong than before. This was the case for the ISM Manufacturing index, which was back to 48.7 after a short-lived improvement, and for the NAHB index, which posted its lowest reading since the beginning of the year. Consumer confidence, as measured by the Conference Board, also continued to oscillate around the 100 bar, showing that sentiment had softened after its recent peaks of summer 2023 and early 2024. Meanwhile, according to the Census Bureau, both durable goods orders (ex-transportation) and retail sales (ex- auto) were down 0.1% in May. For the latter, lower gasoline prices appeared to have played a role in this second consecutive decline, but **the same source also pointed to a rebound in wholesale inventories**. Three of the last four readings were up, which contrasted with the long string of inventory reductions observed since 2022.

Employment data remained very strong, but contained some early signs of a deterioration. Both new and continuing jobless claims, which are published every Thursday by the US Department of Labor, have been rising gradually since the beginning of the year. Moreover, according to the Bureau of Labor Statistics, **unemployment was back to 4% in May, for the first time since the end of the Covid period.**

As regards prices, the May data was rather reassuring, and inflation appeared to be slowing gradually towards the Federal Reserve's targets. Production prices were down 0.2% month-over-month, and the core index remained flat. Consumer prices were stable over the same period, and up 0.2% excluding food and energy. Import prices were down 0.4%, which probably owed in part to the strength of the dollar in April, as well as the softening of oil prices in April and May. It was difficult to say if the central bank would eventually be moved by these trends, all the more as the dollar had been weaker in May before rebounding in June, while the barrel of WTI was back above $81 at the end of the month. In any case, **the FOMC meeting held just before mid-June kept rates unchanged, despite a surprise cut by the Bank of Canada a few days earlier**. The ECB's move to a more accommodative policy, with a 25 basis points cut, was not unexpected, but it came with cautious comments warning that it was not necessarily the beginning of a new rate cuts cycle.

Although June was not a busy period for earnings announcements, a few companies had yet to report their quarterly results, and many others used analyst days or broker conferences to update their outlook. Overall, **the mood was cautious and very few companies raised their guidance**. Even after reporting above expectations, most executive teams just kept full-year forecasts unchanged, which was viewed as negative. Besides Walmart, Target and Kohl's, the list of noteworthy disappointments also included companies traditionally considered resilient, like Nike or, among non-US companies, L'Oreal. The difficulties of retail pharmacies Walgreen Boots Alliance also made a lot of noise, although they came largely from execution issues. Moreover, the Federal Reserve published the results of the 2024 stress tests for major financial groups. All 31 banks passed, but the tests showed that they would be less resilient under the current assumptions of extreme circumstances than they were in last year's review.

The political landscape also involved lot of uncertainties. On the domestic side, **the first debate ahead of the presidential election turned into a nightmare for the Democratic Party**. It highlighted that, despite their relatively similar ages, Donald Trump and Joe Biden were not at all in the same shape, and observers from inside the President's camp started to say openly that it was time to think about a "plan B". Meanwhile, on the other side of the Atlantic, the results of the European elections showed a considerable drop in support to governing parties in several key countries. France was one of them, where Mr. Macron's decision to dissolve the Lower House of Parliament contributed to make things even more unpredictable.

These developments naturally contributed to undermine the credibility of both the US and European authorities in their foreign policies. There was no sign of improvement in Ukraine, where Moscow continued to regain disputed areas and threatened to retaliate directly against countries which authorized Kyiv to use weapons they had supplied against targets beyond the Russian border. Vladimir Putin also visited North-Korea and Vietnam, as part of his effort to develop foreign support. Things did not get better either in the Middle-East, where Iran continued to poor fuel on the fire. The conflict threatened to expand to Lebanon, and the Houthis managed to hit several ships in the Red Sea. Late in the month, social unrest developed in Kenya after the country proved to be on the brink of bankruptcy. **The World Bank said dozens of other countries were also in a stretched financial situation**, often as a result of the rise in major interest rates.

The effects: Once again, the S&P 500 index rose significantly (+3.55%) thanks to a handful of very large stocks, but a vast majority of its components were down. Once again, our strong stock picking against our investment universe could not offset the biases resulting from this situation, and we underperformed.

Only three of the eleven GICS sectors did better than the S&P 500 Index in June, and they happened to be the only three groups containing at least one of the so-called "Magnificent Seven". For the second consecutive month, Technology was the strongest category, and rose about 9.3%. **Nvidia continued to ride the AI wave and gained 12.7%, to such an extent that it briefly became the largest listed company in the US and the world**, ahead of Microsoft and Apple, which were well above the index too. The other two outperforming sectors were Consumer Discretionary and Communication Services, with very similar returns in the 4.7-4.9% range. Amazon (+9.5%) was one of the main contributors to the former's return, while Tesla's smaller weight mitigated the impact of its even higher return (+11.1%). In Communication, Alphabet gained 5.6% and Meta Platforms about 8%. In most of the above cases, **the performance driver was some sort of exposure to AI**. This had been obvious for some time at Nvidia, but also at the

main cloud service providers, and hopes of seeing Apple catch up after the introduction of "Apple Intelligence" supported the stock. Tesla was the only exception with no direct AI exposure at all, but the EV-maker benefited from its announcement of new, lower-priced versions to compete with Chinese makes. With their cumulative weight now reaching 33% of the S&P 500 index, these seven giants had a strong influence on our benchmark's return. To make things worse, another two very large companies, which are not considered part of the Mag7 but represent more than 1.5% of the index each, also performed strongly. One of them, Broadcom, also belonged to Technology. It gained almost 21% when its strong results and guidance update made investors realize its exposure to the AI theme. The other one was Eli Lilly, which regularly appears among the largest ten companies in the US, following its strong performance in the last few years (and again in June, with a healthy 10.4%).

At the other end of the performance ranking were Utilities (-5.7%) and Materials (-3.2%), which probably reflected the declining probability of seeing the Federal Reserve cut rates more than once before the end of the year. Four other sectors posted smaller negative returns.

As a result of this very strong large cap bias, the S&P 500's 3.55% was not representative of the market's real performance, and the equal-weighted average of its components' returns was negative, at -0.5%, i.e. about 400 basis points behind the official index! **The bias also impacted style indices, and gave the Growth versions an advantage amounting to 600 bps or more, which did not seem to reflect the real behavior of the market**. The bulk of smaller, faster-growing stocks actually was weaker than style indices suggest. This was the case for many retailers (which suffered from concerns about consumers), but also solar energy plays (hit by Solaredge Technologies' issuance of convertible debt) and even semiconductor or other technology stocks, whose growth is not questionable, but which happened to specialize in market segments that are currently untrendy.

Once again, our performance was far behind that of our benchmark, since our strategy's gross return was 1.37% vs 3.55% for the S&P 500 index (with net dividends reinvested). However, **it was also the twelfth time since the beginning of 2023 that our portfolio did better than the equal-weighted version of our benchmark**. In other words, in two thirds of monthly periods, we outperformed the "level 0" of value-added in stock selection.

Our portfolio's performance distribution reflected the effects of the above size bias. Only twelve of our 45 holdings outperformed the S&P 500 index, and many of them were the "Mag7s" we hold (often in an underweight position) or one of the other very large companies we discussed above. **Our best performer outside this list only came seventh in the return ranking … and it was Pure Storage, another beneficiary of AI**. A few others also did well, like Pinterest which, in the absence of any important news, only mimicked part of other social networks' strength. A handful of other "normal" companies also outperformed, including Stericycle, which we had bought just a few months ago, and which was boosted by the announcement of its takeover by Waste Management.

At the other end, **none of our weakest returns was due to company-specific issues**, but caution about the macroeconomic outlook was often involved, despite the relatively defensive nature of our worst performers. This was the case, for example, for Bath & Body Works, whose guidance was softer than expected and which, like many in the body care business, blamed consumers' reluctance to spend more than necessary. The stock, which had been resilient so far this year, was down more than 24%. Nextracker lost about 15% in sympathy with other photovoltaic players, despite having a very different profile, with exposure to utility-scale projects rather than households. The company however announced an interesting acquisition, and later received a new positive recommendation from a brokerage firm.

Our decisions: The news from our holdings confirmed the compared strength of their fundamentals and their strategic execution. We thus sold only one line in June: Stericycle, whose price jumped following a takeover bid. We used the proceeds in a risk-mitigation purchase on one of the Magnificent Seven.

After rumors of a takeover by Waste Management were confirmed in early June, we decided to re-sell Stericycle, although it had been bought hardly two months earlier. **The medical waste management specialist's stock price had risen close to the level offered (in cash) by the acquirer**, and the holding looked likely to remain "dead money" until the deal would close. We thus assumed that it would be better to shift towards another more useful position.

The proceeds were used to adjust our exposure to an existing position, as part of our risk control process, which provides that no holding can remain more than three percentage points below its index weight.

For more details about our recent stock picks, please refer to the fund's detailed report or contact us.

Unfortunately, **this transaction, which was imposed by risk control, obliged us to further reduce our portfolio's active share,** which is now down to about 72%. This obviously remains well above the commonly accepted minimum to be recognized as a truly active approach. However, we were closer to 82% a few years ago, and we do not particularly enjoy having a significant part of our investments imposed by risk control against a distorted benchmark, rather than more logical risk/reward considerations.

We however remain confident in our stock selection, which admittedly offers sector weights less different from those of the index than usual, but continues to display a much stronger growth for a much more attractive valuation, on the basis of P/Es.

The outlook: While we do not see how the current uncertainties could be durably compatible with a strong economy, we do not expect the Federal Reserve to act immediately, unless it sees a risk of sharp slowdown. We maintain our moderate-risk strategy, and wait for fundamentals to prevail.

For a long time, our central scenario has assumed that both the economy and inflation were too strong for the Federal Reserve to cut rates as early as the market expected. **We continue to believe that, if things remain the way they are, US central bankers will probably not be inclined to use dry powder too early.** What has changed is, investors probably agree with this view now, as Jay Powell's message was finally received.

However, we note early signs of the economic slowdown that we have long been expecting, and the way things develop will determine whether a shift to a more accommodative monetary policy has become more likely. There is a limited possibility that the current trends may just be misleading, and revert to something more resilient, as already happened several times in the last few years. However, judging from corporations' comments, **it seems to us that activity is more likely to keep slowing, and, at some stage, cause an acceleration in unemployment**. It is important to keep in mind that, when US companies start feeling that tougher times are coming, they usually react

swiftly, cut costs and proceed with layoffs. **Unemployment may thus rise fast, all the more as there will be little room to play on wages**, after all the promises that were made in the last few years. It is interesting to note that, after banning extra service fees from restaurants and setting a minimum hourly wage of $20 (against the $7.25 officially imposed by Federal regulations) for "quick service restaurants", California had to cancel the restriction on service fees late in June, to try and curb the fast rise in restaurant closures.

We are therefore maintaining our current strategy despite its poor results over the last 18 months. We obviously could have been more aggressive, but nothing could be worse than changing our stance too late and "taking a saloon door in the face". Big Techs enjoyed a performance that we did not expect, but we remain convinced that many of them discount more than the good news that can realistically be anticipated. We already discussed our thoughts about AI above, and **many of the Magnificent Seven may cross a soft patch if adoption proves less steady than expected**. We also believe that the market's reaction to Apple's announcements was overdone, and that, while Tesla's weak performance in recent quarters probably warranted a technical rebound, its outlook remains tough, with continuing quality problems and aggressive competition. Moreover, **regulators all over the world are circling around US megacaps, and we would be surprised if they did not increase their pressure**.

This is why we remain comfortable holding more "normal" growth stocks and waiting until the market realizes their potential and their more attractive growth-adjusted valuation. **We believe that our strategy's continuing strength against the equal-weighted version of the benchmark is very encouraging news**. The most important advantage of our approach has always been its ability to add value through stock selection. As long as we manage to maintain this advantage, and however self-confident it may look, we know that we will be back ahead of our benchmark sooner of later. The equal-weighted version of the benchmark is poised to outperform its official, size-weighted version, as it always did in the long-term, because growth and valuation are much more logical drivers than size.

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Graphene Investments

AMF license #GP-16000022
10 rue La Boétie 75008 Paris (France)
T: +33.1.70.82.44.50
F: +33.1.70.82.44.49
E: contact@graphene-investments.com
W: www.graphene-investments.com