Hutchinson
CAPITAL MANAGEMENT

July 2024

INVESTMENT PERSPECTIVES

Overcrowded?

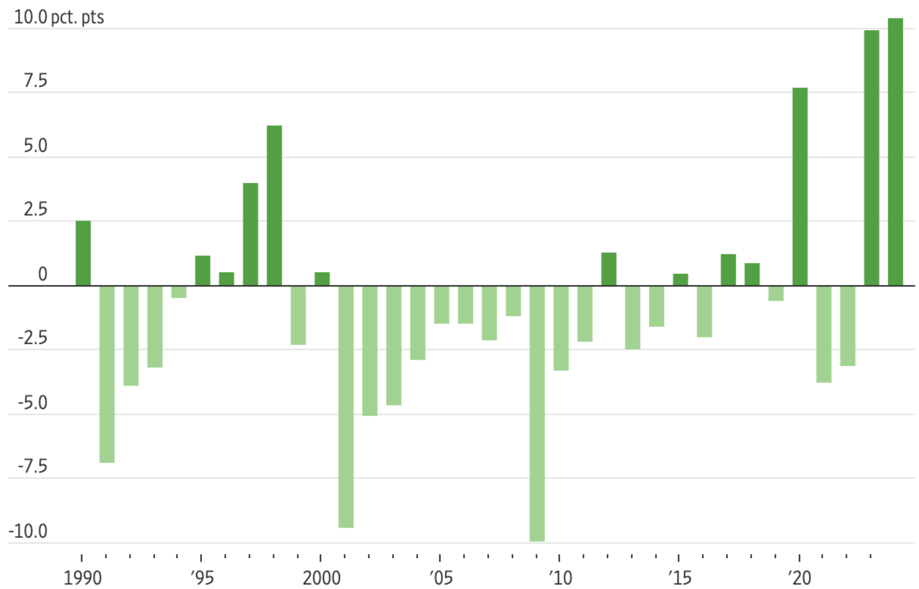
As the most recent quarter came to a close, the market continues to find itself in a “risk on” environment. As the major stock indexes continue to hit all-time highs, many investors have grown complacent, with the end of this bull market nowhere in sight--inflation and interest rates are trending down, a “business friendly” administration is leading in the polls, and artificial intelligence and obesity drugs carry the potential to fundamentally reshape how we live our lives. Over recent quarters, investing in the stock market has delivered on that optimism. While we are as pleased as the next investor, we must admit that many of the dynamics that are driving stocks higher give us pause. In this *Investment Perspectives* we highlight several of the dynamics drawing our concern and highlight how we are navigating this environment.

In the second quarter, major US equity indices continued their upward trajectory, with the S&P 500 and Nasdaq reaching new record highs. The S&P 500 gained 4.3% in Q2, bringing its year-to-date return to an impressive 15.3%. This performance was largely driven by the "Magnificent 7" tech stocks, which rose 16.9% during the quarter and continued to account for the majority of market gains. However, market breadth remained notably narrow, with only 24% of S&P 500 stocks outperforming the index year-to-date. This concentration of gains was further evidenced by the equal-weighted S&P 500 index actually declining during the second quarter, highlighting the outsized impact of the largest companies. Despite facing headwinds such as sticky inflation and a hawkish Federal Reserve, corporate earnings demonstrated overall resilience. The soft-landing narrative gained traction as economic data showed gradual disinflation alongside continued growth.

Narrow Breadth & High Concentration

The S&P 500 experienced a significant narrowing of market breadth, indicating that market gains were driven by a smaller number of stocks during the quarter. Specifically, the S&P 500 saw negative breadth, with more stocks declining (304) than advancing (199). Consequently, for the first half of 2024, only 24% of the stocks in the S&P 500 outperformed the index, marking the third narrowest 6-month period since 1986. The equal-weighted index is up just 4% so far this year, underperforming the S&P 500 by 11% - based on data going back to 1990- the widest gap in the first half of a year over that time span.

S&P 500 performance lead over equal-weight index, first half



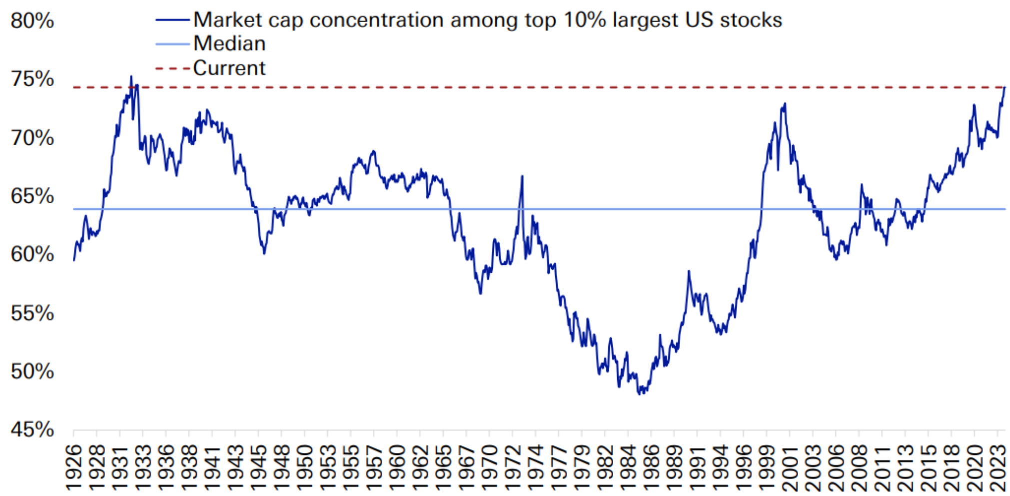
Note: Negative values mean the S&P 500 lagged behind the S&P 500 Equal Weight Index in the first half of a year. Data for 2024 is preliminary.
Source: Dow Jones Market Data

The first half of 2024 was also characterized by a highly concentrated market, particularly evident in the second quarter. This concentration manifested in a stark performance disparity between a small group of companies and the broader market. The impact was so significant that excluding the top 10 performing stocks, primarily large-cap tech companies, would have resulted in a near-zero market return prior to June.

The dominance of a few key players in driving market returns was particularly pronounced. Nvidia alone contributed to one-third of the S&P 500's 15.3% return in the first half of 2024, while the "Magnificent 7" (Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla) collectively make up 31% of the S&P 500 and contributed to ~60% of its year-to-date return. This level of concentration has pushed the US stock market close to its most concentrated state in history, raising questions about market dynamics and potential risks.

Historically, periods of extreme market concentration have tended to revert to the mean. This pattern of mean reversion suggests that such elevated levels of concentration are typically unsustainable in the long term. However, the current situation has prompted debate among market observers and analysts about whether this time might be different, given the unique factors driving the dominance of tech giants, including their strong fundamentals, the ongoing AI revolution, and their strategic importance in a world of increasing geopolitical competition. Despite these arguments, historical trends indicate that market leadership tends to broaden out over time, often coinciding with shifts in the business cycle or changes in regulatory environments.

Top 10% of stocks by size versus the entire US stock market



Source: Kenneth R. French database, Deutsche Bank.

Low Volatility

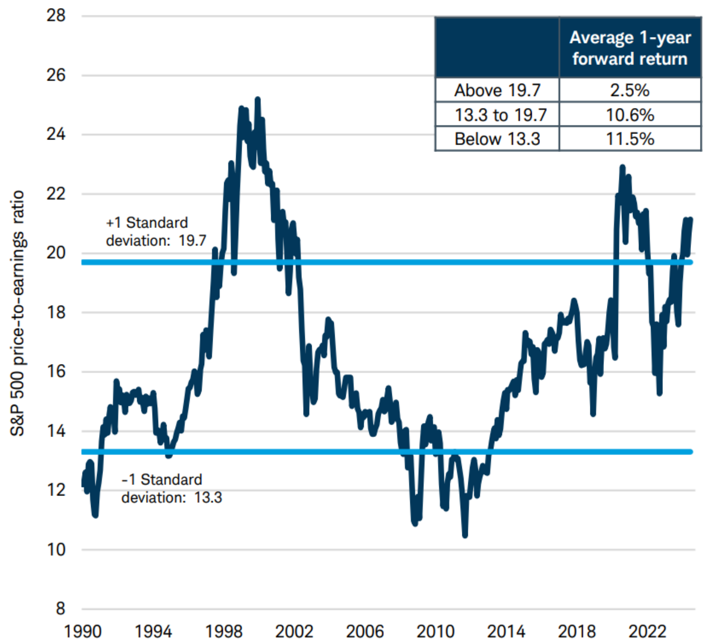
The current market environment, characterized by relatively low volatility as measured by the CBOE VIX index, may be lulling investors into a false sense of security. Historically, periods of low volatility have often preceded significant market corrections, as they tend to foster investor complacency. This complacency can lead to increased risk-taking and overvaluation of assets, setting the stage for potential market turbulence when unexpected events or shifts in economic conditions occur.

In this context, owning high-quality businesses becomes particularly important. High-quality companies are typically characterized by strong balance sheets, consistent earnings growth, and sustainable competitive advantages. These attributes provide a buffer against market volatility and economic uncertainty. During periods of market stress, such companies are often better positioned to weather downturns and may experience less severe stock price fluctuations compared to their lower-quality counterparts. Moreover, high-quality businesses tend to have more stable cash flows and are better equipped to maintain dividends or share buybacks, which can provide a measure of stability for investors during turbulent times.

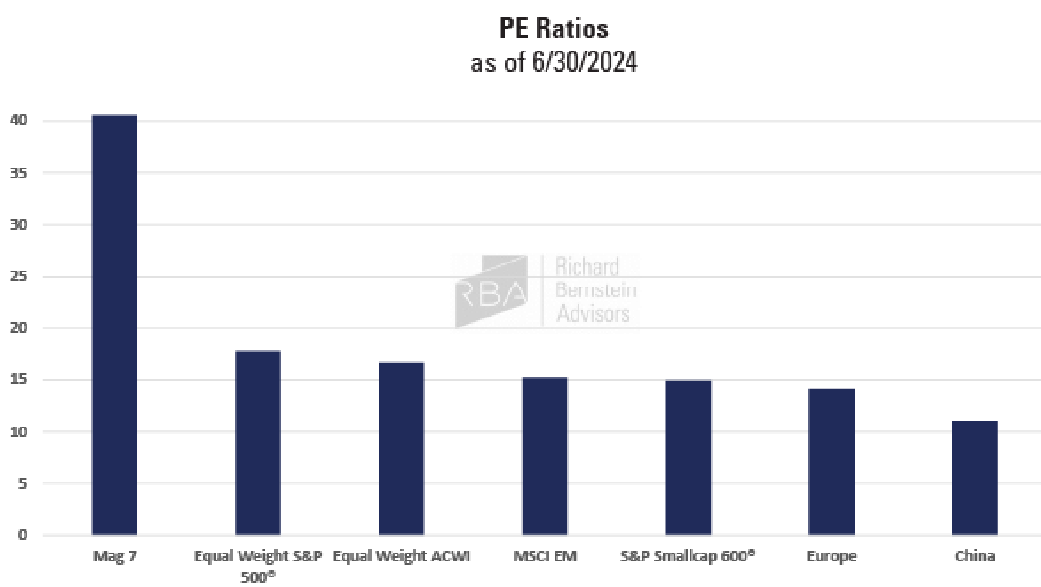
The current low volatility environment may not fully reflect potential risks on the horizon, including the hawkish shift in Federal Reserve policy expectations due to persistent inflation and robust job growth. This shift has already led to a repricing of rate cut expectations, indicating that the market may be underestimating the likelihood of future volatility spikes. In such an environment, high-quality businesses are likely to demonstrate greater resilience. Their strong fundamentals and financial flexibility allow them to adapt more effectively to changing economic conditions, whether it is rising interest rates, inflationary pressures, or supply chain disruptions. Furthermore, during periods of increased volatility, investors often flock to quality as a "flight to safety" move, which can provide relative outperformance for high-quality stocks. This tendency underscores the importance of maintaining a portfolio bias towards high-quality investments as a hedge against potential market turbulence and to capitalize on opportunities that may arise during volatile periods.

Investor Euphoria

Despite the strong market performance in the second quarter of 2024, several valuation metrics continue to suggest that stocks, in general, remain overvalued. The S&P 500's forward price-to-earnings ratio stands well above its long-term average, indicating stretched valuations by historical standards. However, the ongoing disinflation trend has helped alleviate some pressure on valuation multiples, as lower inflation expectations typically support higher valuations. Nevertheless, for valuations to become more attractive, companies will need to demonstrate sustainable earnings growth to justify current price levels. This is particularly important given the narrow market breadth, with gains concentrated in a small number of mega-cap stocks.

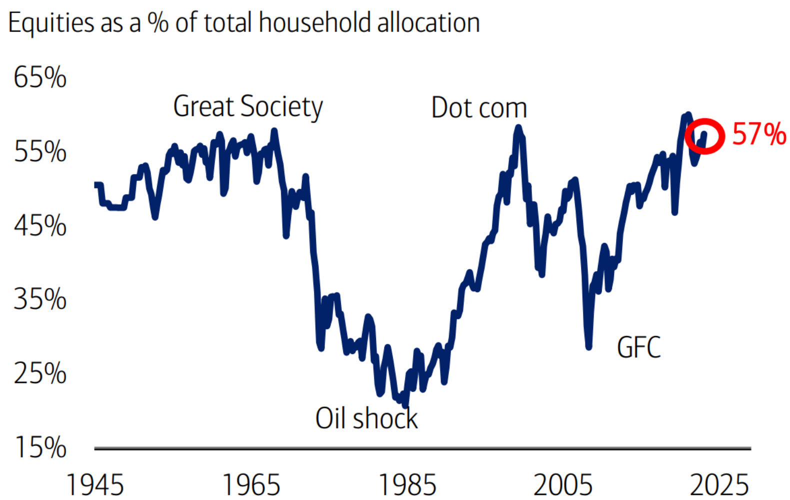


Source: Charles Schwab, the Schwab Center for Financial Research, Bloomberg, as of 6/30/2024

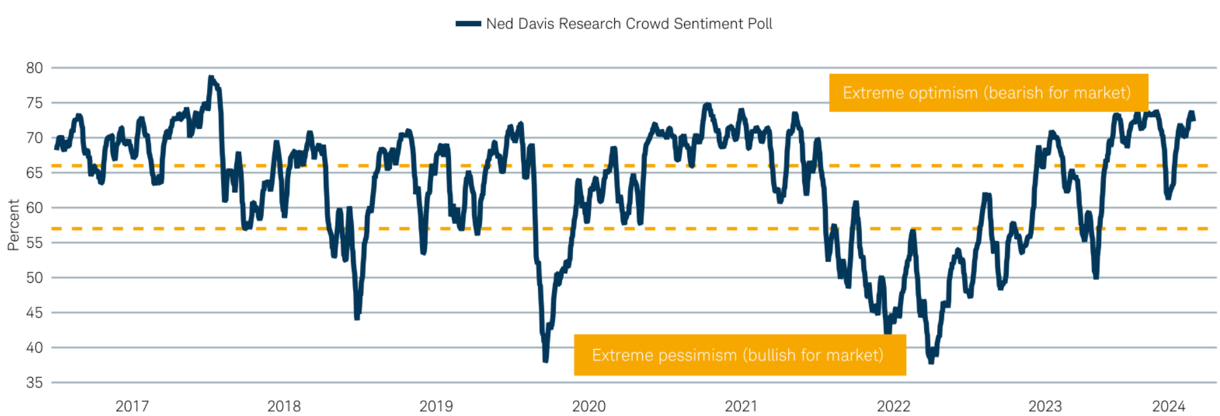


Source: Richard Bernstein Advisors, Bloomberg

Investor sentiment experienced a significant upturn in the second quarter, coinciding with major indexes reaching new all-time highs. The S&P 500 posted an impressive 31 record highs year-to-date, reflecting growing optimism among market participants. This bullish sentiment is further evidenced by US household equity allocation approaching all-time highs, indicating a high level of confidence in the stock market. The Crowd Sentiment Poll from Ned Davis Research remains in "extreme optimism" territory, a level that has historically been associated with weaker subsequent market performance. This elevated sentiment, coupled with the strong year-to-date gains of 15.3% for the S&P 500, suggests that much of the good news may already be priced into the market. Investors should exercise caution, as periods of extreme optimism and high equity allocations often precede market corrections or periods of consolidation. The combination of these factors - record highs, extreme optimism, and near-peak household equity allocations - underscores the potential vulnerability of the market to any negative surprises or shifts in sentiment.



Source: Bank of America Research Investment Committee, June 2024



Source: Charles Schwab, Ned Davis Research, Inc. as of 6/30/2024

Focus on Quality

At HCM, we focus our investment strategy on high-quality businesses at value prices that demonstrate exceptional financial performance and stability. These companies are characterized by strong earnings and free cash flow growth, coupled with high returns on invested capital. Such metrics are indicative of efficient operations and effective capital allocation, which are crucial for long-term success in competitive markets. By prioritizing these financial indicators, we aim to identify companies that can consistently generate value for shareholders across various economic conditions.

Our unwavering commitment to investing in high-quality companies is designed to provide you with a resilient and stable portfolio, especially during times of market volatility. By focusing on businesses with robust financial health, consistent earnings growth, and sustainable competitive advantages, we aim to mitigate the long-term risks associated with market turbulence. These companies not only offer the potential for steady returns but also serve as a safeguard against economic uncertainties. As the market landscape continues to evolve, we believe that our strategy of prioritizing quality will enable us to navigate challenges effectively and capitalize on opportunities, ensuring long-term value creation in your portfolios.

In Conclusion

The human mind is fascinating. We crave to be part of groups. We tend to think linearly, so we assume if things are getting better, they will go on getting better. On the opposite end of pendulum, when things look bleak, we tend to assume it will go on being bleak. Unfortunately, this does not work well in the world of investing since markets are inherently cyclical and oscillate between recession and expansion. Right now, investors see a bright future especially in companies tied to nascent technologies. While we too are excited about the future, we have learned that we cannot pay too much for lofty expectations that run the risk for falling short.

Our job is to remind clients that upward trending markets invariably end, just as bear markets do. We must train ourselves that strong markets are not inherently good, and neither are down markets bad; they just ARE. Such is the life of an investor. Investing in the stock market is a journey and we need to acclimate to the long ride. Most importantly, by taking advantage of the market and economic cycles as they come. Trimming stock positions where we are being paid a full price and reallocating money to quality stocks that have been left by the wayside and present a good, if not great, long-term opportunity. We have no idea how long this current bull market will last, no one does, but we are mindful that we are likely closer to the end, than the beginning.

PLEASE SEE IMPORTANT DISCLOSURES BELOW:

As of June 30th, 2024, Hutchinson Capital Management (HCM) held:
158,309.2512 shares of Apple Inc (AAPL)
5,770.08 shares of Amazon.com Inc (AMZN)
71,918.84320 shares of Microsoft (MSFT)
67 shares of Tesla Inc (TSLA)
1,863 shares of NVIDIA Corp (NVDA)
388.0182 shares of Meta Platforms Inc (META)
145,454 shares of Alphabet Inc Class A (GOOGL)

As of June 30th, 2024 (Prices in USD unless noted otherwise)
Apple Inc (AAPL) closed at $210.62
Amazon.com Inc (AMZN) closed at $193.25
Microsoft (MSFT) closed at $446.95
Tesla Inc (TSLA) closed at $197.88
NVIDIA Corp (NVDA) closed at $123.54
Meta Platforms Inc (META) closed at $504.22
Alphabet Inc Class A (GOOGL) closed at $182.15

As of June 30th, 2024, the following were the ten largest holdings of HCM:

Name of Issuer	% of Equity Portfolio	6/30/2024 Closing Price
Berkshire Hathaway Inc Class B	6.67%	$445.61
Microsoft Corp	6.34%	$443.52
Apple Inc	5.96%	$228.88
Alphabet Inc Class A	5.23%	$181.02
Novo Nordisk ADR	4.73%	$135.42
Bank of America Corp	4.63%	$43.98
Progressive Corp	4.52%	$221.35
Jacobs Solutions Inc	4.44%	$149.55
United Health Group Inc	3.81%	$573.28
Exxon Mobil Corporation	3.2%	$117.64

For a complete list of holdings, please see our most recent 13F filing on the following SEC website: http://www.sec.gov/edgar/searchedgar/companysearch.html

HCM's investment decision making process involves a number of different factors, not just those discussed in this document. The views expressed in this material are subject to ongoing evaluation and could change at any time.

Past performance is not indicative of future results, which may vary. The value of investments and the income derived from investments can go down as well as up. It shall not be assumed that recommendations made in the future will be profitable or will equal the performance of the securities mentioned here. While HCM seeks to design a portfolio which reflects appropriate risk and return features, portfolio characteristics may deviate from those of the benchmark.

Although HCM follows the same investment strategy for each advisory client with similar investment objectives and financial condition, differences in client holdings are dictated by variations in clients' investment guidelines and risk tolerances. HCM may continue to hold a certain security in one client account while selling it for another client account when client guidelines or risk tolerances mandate a sale for a particular client. In some cases, consistent with client objectives and risk, HCM may purchase a security for one client while selling it for another. Consistent with specific client objectives and risk tolerance, clients' trades may be executed at different times and at different prices. Each of these factors influence the overall performance of the investment strategies followed by the Firm.

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