Stephens
Investment Management Group®

The following contains a brief discussion of the equity markets from Senior Quantitative Analyst, Charles Clavel, CFA.

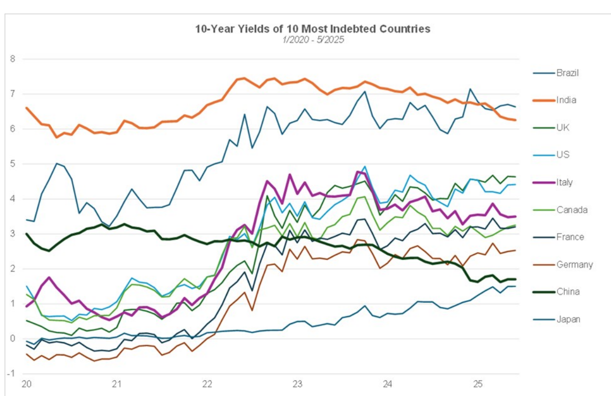
The Triumph of Experience

“A second marriage is the triumph of hope over experience.”
Samuel Johnson

The election of Donald Trump last November generated a lot of hope and enthusiasm among his supporters. Finally, the US had an opportunity to solve some long-standing issues, including rebuilding its manufacturing base, improving the standard of living of the middle class and rectifying the country’s chronic debt and deficits problem. With the Republicans controlling both chambers of Congress and the presidency, along with a president who doesn’t have to worry about re-election, the country finally had a real shot at implementing significant – and potentially painful in the short term – reforms. Surprisingly, unlike what happened 8 years ago, protests during and in the period following inauguration were rather tame. Besides the shock of defeat, maybe Trump’s opponents have come to realize that despite all the bluster, not much would actually change.

On the economic front, the administration’s agenda relies on three pillars: (1) **tariffs**, which aim to boost domestic manufacturing while providing some tax revenues that can help offset cuts in other taxes (2) **DOGE**, with the purpose of eliminating wasteful and fraudulent spending and (3) a “**Big Beautiful Bill**” that would implement a number of tax cuts and other stimulus measures that would boost the economy and help the country grow out of its debt problem. **Seven months later, it is becoming evident that the initial enthusiasm was a manifestation of the triumph of hope over experience, as all three pillars are getting seriously challenged**. Days after Liberation Day’s shock-and-awe announcements, Trump had to backpedal and announce a pause/rollbacks on tariffs after the very negative reaction from the equity, bond and currency markets. Trade deals typically take a long time to negotiate because of product or service specific considerations, so the tariff agenda may get lost in the sands of minutia and we’ll end up with rates that are not too far off from the pre-Liberation Day levels. DOGE looks more like a Chihuahua than a Dobermann, with ~ 180 Bn in savings compared to the 2 Tn promised during the campaign. As to the “Big Beautiful Bill”, its current version seems more like the latest ugly duckling of politicians’ propensity for fiscal largesse, with a litany of give aways to various constituencies. Elon Musk, who saw his hard work to cut fiscal spending being more than negated by the increase in spending from the bill, went on a public feud with Trump that would make a reality TV producer blush. Like other people before him who tried to tackle the debt and deficit issue, he is bumping against the fact that, in the words of Otto von Bismarck, politics is the art of the possible. Unfortunately, in a divided, democratic country, not much is possible.

Politicians pretending to enact reforms while the fiscal runaway train keeps going at an accelerating pace is nothing new, but **what is changing is that we are starting to see some signs that the bond market is calling the US to account**. The unprecedented fiscal stimulus in response to COVID and the ensuing inflation have led bond yields to rise across most of the world, creating fiscal challenges for highly indebted countries. As shown below, **the US is not the only country to have experienced rising yields, but bond investors seem to have taken notice of the (few) countries that have taken steps towards more fiscal responsibility and have been rewarding them with lower yields.** China has seen its long-term yield decline since 2021, as it has refrained from large fiscal stimulus in the face of a serious balance sheet recession. In addition, Italy’s 10-year yield has declined (unlike those in other major EU countries) since Georgia Meloni took office.



Source: Bloomberg, SIMG Analysis

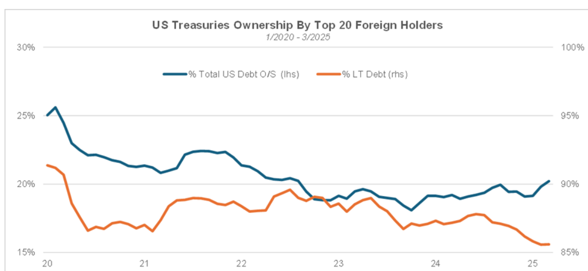
Long term government bond yields have historically been related to economic growth and inflation. The chart below shows the results of a simple, linear regression analysis of 10-year Treasury yields vs. YoY changes in the CPI and YoY growth in quarterly real GDP, over 3 sub-periods: a period of relatively high inflation and rising yields from Jan 1962 to Sep 1981, the "Great Moderation" period when bond yields and inflation have been on a declining trend, from Oct 1981 to Jul 2020, and the more recent period since Aug 2020. **In both the inflationary and disinflationary periods, this simple model exhibits substantial explanatory power regarding bond yields, with statistically significant coefficients to both the inflation and growth variables**. There is no doubt that one can build a far better model with better proxies for inflation and growth and a more complex relationship with bond yields, but the high explanatory power of this simple model shows how inflation and economic growth have historically been strongly related to bond yields. This makes the results of the regression on the most recent period even more surprising: **over the past 5 years, there has been no statistically significant relationship between either CPI inflation or GDP growth and 10-year yields.** Those results are consistent with the casual observation that yields have been steadily rising over the period while inflation has come down substantially since the summer of 2022 and GDP growth has been relatively stable post COVID. Granted, this model could be way too simplistic for the current environment, and it's easy to poke holes: the recent time period may be too short, the extreme growth numbers during COVID may distort the regression, there could be better variables representing inflation and growth, the relationship with yields may have become more complex, etc.... However, the analysis shows that **it's far from clear that the historical relationship between bond yields, growth and inflation still holds, and we can't exclude the possibility that the bond market is pricing in new risk factors that were not under consideration in decades prior, for example the risk that the fiscal situation may get out of control.**

10-Year Treasury Yield vs. CPI YoY and Real GDP Growth YoY

	8/2020 - 3/2025	10/1981 - 7/2020	1/1962 - 9/1981
# Observations	56	466	237
R-squared	1.5%	51.9%	77.0%
Inflation T-stat	-0.02	20.71	24.01
GDP Growth T-stat	-0.86	6.41	4.36

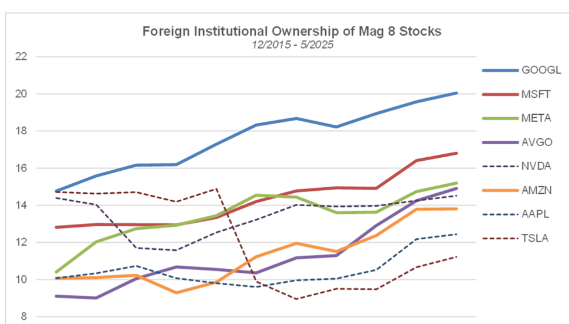
Source: Bloomberg, St Louis Fed's ALFRED database, SIMG analysis

According to the TIC (Treasury International Capital) data, **today's top 20 foreign holders (i.e. countries) share of total public debt outstanding has declined from ~25% at the beginning of 2020 to ~ 20% as of 3/2025.** To be clear, it's not that their holdings of Treasuries have declined. They did increase over the period, but at a lower rate than total public debt, suggesting that foreign investors have a hard time keeping up with the Treasury's pace of issuance. **In addition, the mix of their holdings has shifted from 91.4% in long term Treasuries to 85.6% over the same period**. While there could be many reasons for these changes, US politicians' cavalier attitude towards debt and deficits certainly doesn't boost foreign investors' confidence.



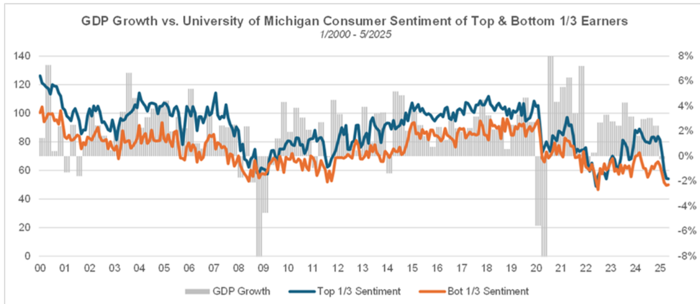
Source: U.S. Department of the Treasury, SIMG analysis

Concurrently, foreign investors have been increasing their share of ownership in the largest market cap stocks, and more specifically the magnificent 8 (the original "Mag 7" + Broadcom). As shown below, the trend in rising foreign ownership since 2015 has been especially evident for Google, Microsoft, Meta, Amazon and Broadcom. **As large, steady growers, those companies may be perceived as sufficiently safe to represent a viable alternative to long term government bonds.**



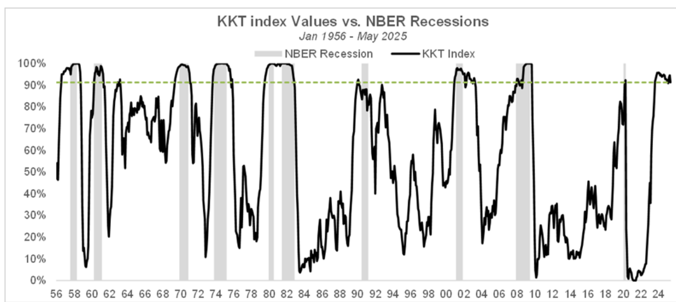
Source: FactSet, SIMG Analysis

During the Biden administration, the high amounts of fiscal spending supported economic growth, so far helping to avoid an "official" recession. With that stimulus now gone, and the "Big Beautiful Bill" still going through Congress, one may wonder what could help sustain economic growth in the months ahead. The high levels of economic policy uncertainty – notably related to tariffs – also contribute to businesses and households postponing investment decisions, resulting in lower-than-otherwise growth. Among the various signs that the economy is in a period of slow growth or recession is the observation that the gap in sentiment (according to the University of Michigan's measure) between the top 1/3 and the bottom 1/3 of income earners has narrowed considerably (to the downside) over the past few months, from 22 points as of 10/31 to only 4 points as of 5/31. Over the past 25 years, the sentiment gap has been wide during economic expansions and has narrowed (often to the point of closing completely) as the economy was decelerating.



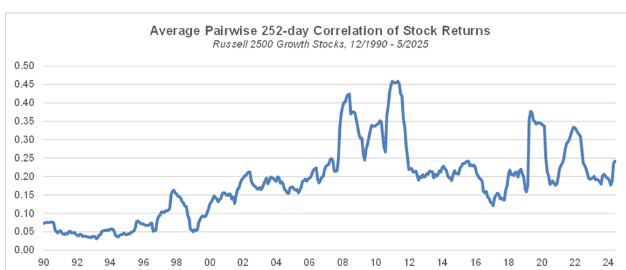
Source: Bloomberg, SIMG Analysis

The KKT model also continues to indicate that we are closer to a recession than to a period of robust growth but has reversed the uptick observed over the past two months. As a result, an exit of recessionary/slow growth conditions may come sooner than one might think. At 91.3%, the current reading is only in the 14th percentile of values reached during recessions since 1956. The passage of the "Big Beautiful Bill" could be the trigger for a shift in economic conditions.



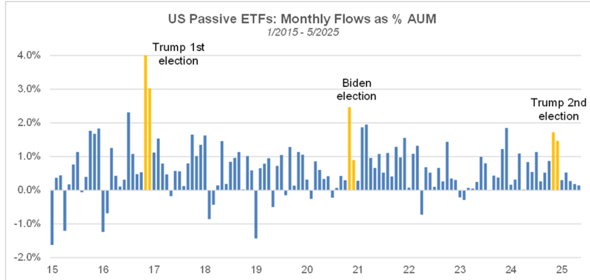
Source: St Louis Fed's ALFRED database, Robert Shiller's data (http://www.econ.yale.edu/~shiller/data.htm), Bloomberg, SIMG Analysis. The methodology behind the KKT model is explained in the research paper below: A NEW INDEX OF THE BUSINESS CYCLE by William Kinlaw, Mark Kritzman, and David Turkington

Our long-term measure of investor sentiment, **the average pairwise correlation of stock returns, has continued to rise sharply in May, consistent with a spike in risk aversion**. However, risk aversion remains far from historical extremes. The market seems unfazed by concerns about tariffs, deficits and the recent escalation in geopolitical tensions, and is within a hair's breadth of all-time highs.



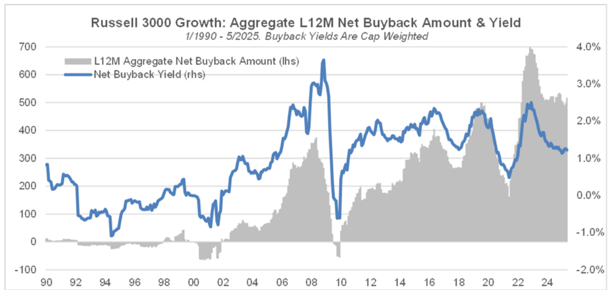
Source: FactSet, SIMG Analysis

As I have argued in prior monthly notes, the market is more driven by factors impacting liquidity than by the state of the economy. One source of liquidity that has benefited equity markets over the past 15 years has been the rise in passive investing. As shown below, passive ETFs have experienced steady inflows with only occasional and mostly shallow drawdowns over the past 15 years. **Following Liberation Day, passive inflows have slowed down but have not turned into outflows, confirming the resilience of such flows in the face of macroeconomic stress that was observed in 2022.**



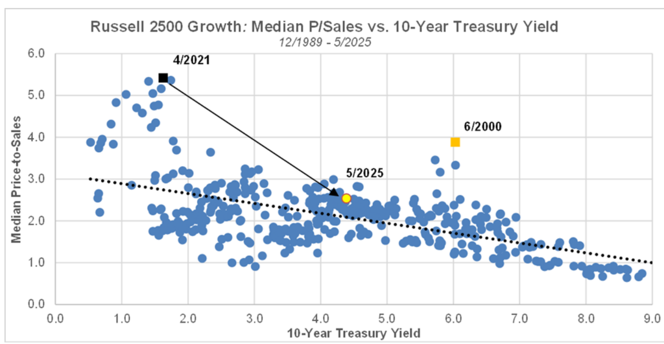
Source: FactSet, SIMG Analysis

Corporate buybacks have also benefited the stocks of large cap companies, thus contributing to the overall market's rise given large caps' weights in cap weighted indices**. So far, share repurchase programs have remained robust despite the uncertain macro environment.**



Source: FactSet, SIMG Analysis

As of the end of May, the median price-to-sales multiple of small & mid cap growth stocks remains at a level that is broadly consistent with the 10-year Treasury yield, suggesting that **SMID growth stocks are not over-valued.**



Source: FactSet, SIMG Analysis

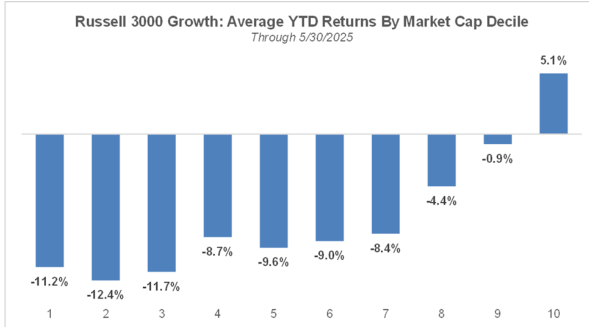
Regarding styles, **the best performing cohorts year-to-date continue to be large caps, low volatility and high-quality stocks,** even though high (low) volatility stocks have strongly out-(under-) performed last month. Large caps have been the best performing style year-to-date, while small caps have struggled.

Style Performance, Top or Bottom Quintile vs Market
Russell 3000 Growth Universe, Through 5/30/2025

	High Volatility	Low Volatility	Most Shorted	Least Shorted	Large Caps	Small Caps	Quality	Junk	High Rate Sensitivity	Low Rate Sensitivity	High Passive Ownership	Low Passive Ownership
Jan 2025	(2.6%)	(0.2%)	0.1%	(0.6%)	3.1%	(3.0%)	0.3%	(2.4%)	0.3%	0.6%	(0.1%)	(1.7%)
Feb 2025	(3.5%)	5.0%	(3.8%)	4.7%	2.6%	0.8%	4.3%	(2.6%)	0.3%	1.2%	(0.8%)	(1.8%)
Mar 2025	(5.8%)	4.7%	(1.9%)	2.1%	1.9%	(4.4%)	4.3%	(5.0%)	(1.5%)	2.8%	2.4%	(2.3%)
Apr 2025	5.7%	(1.9%)	2.0%	(1.2%)	1.2%	2.1%	(1.6%)	3.7%	(1.8%)	0.9%	(3.1%)	1.9%
May 2025	2.8%	(3.2%)	0.5%	(0.5%)	(0.1%)	1.1%	(1.4%)	(1.6%)	0.9%	(3.1%)	(0.1%)	(0.6%)
2025	(3.4%)	4.4%	(3.1%)	4.5%	8.8%	(3.4%)	5.8%	(8.0%)	(1.8%)	2.3%	(1.7%)	(4.5%)

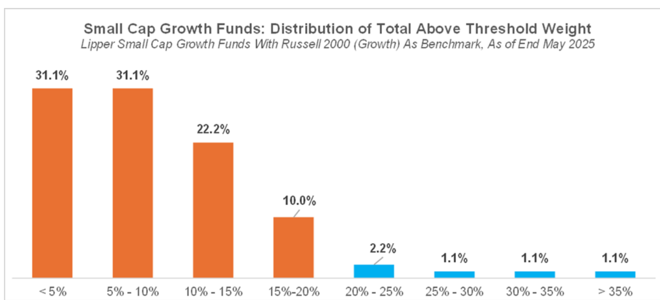
Source: FactSet, SIMG Analysis

Note that through the end of May, **only the top decile in terms of market cap has generated a positive return on average so far this year**.



Source: FactSet, SIMG Analysis

The market volatility in recent months has been accompanied by a widening of return dispersion in the cross section of stocks. As a result, a small cap manager who owns what used to be small caps a few months ago may now have a meaningful exposure to large caps and could be at risk of violating the Names Rule, which states that at least 80% of assets should be invested in the type of investments implied by the fund's name (in this case, small caps). If enough funds find themselves in this situation, it could create significant selling pressure on larger caps and buying pressure on smaller caps as managers rearrange their portfolios to still be in compliance when their benchmark's rebalancing occurs. Within the Lipper Small Cap Growth fund universe, there are ~90 funds (per FactSet) that have the Russell 2000® or the Russell 2000® Growth as benchmark. Based on those funds' latest reported holdings, and assuming holdings have not changed between the report date and May 31st, it is possible to estimate what percentage of each fund's holdings would be invested in stocks whose market cap is above the highest cap in the preliminary list for the Russell 2000® Growth (which seems to be HIMS, with a market cap of 12.7 Bn as of the end of May). Russell typically publishes preliminary lists in the weeks ahead of the actual rebalance, which occurs at the end of June. The chart below shows the distribution of the Lipper universe's small cap growth funds that have the Russell 2000® or 2000 Growth® as benchmark by percentage of assets that is above the market cap threshold**. ~5.5% of those funds would have more than 20% of their holdings in "larger than small" caps and another 10% of funds would have an above-the-threshold percentage of their assets that is between 15% and 20%** (which would be in compliance but may cause the manager to adjust out of caution).



Source: FactSet, SIMG Analysis

Per the discussions above, the US's deteriorating fiscal position may have been a key driver of the rise in long term rates, which could continue in the absence of significant fiscal tightening measures. Consequently, it may be advantageous for investors to identify stocks with a positive rate sensitivity (i.e. that tend to out-perform when rates rise) and avoid those with negative sensitivity. A popular heuristic among investors is that value stocks tend to have a positive rate sensitivity while growth stocks tend to have a negative sensitivity. However, at least in the growth universe, the reality is much more nuanced. The tables below show the percentages of stocks with significant positive or negative rate sensitivities on a 5*5 grid in terms of value and growth quintiles, as of the end of May. I used price-to-sales as the valuation measure and FY2 vs. FY1 expected revenue growth as the growth measure. I also measured rate sensitivities using bivariate regressions of weekly stock returns vs. weekly market returns and weekly changes in 10-year Treasury yields and used +/- 1.5 as significance thresholds for the T-statistic on the change in 10-year yield's coefficient. Stocks with positive rate sensitivities are a bit all over the place on the growth-value map – but there seems to be relatively few of them in the most expensive quintile. By contrast, **negative rate sensitivity stocks tend to concentrate in the upper left corner, i.e., expensive, low expected growth stocks.**

% Stocks With Significant Positive & Negative Rate Sensitivities By Valuation & Growth Quintiles

Russell 3000 Growth Universe, as of End May 2025

POSITIVE RATE SENSITVITY

P/Sales		*Low* Q1	FY2/FY1 Exp. Sales Growth Q2	Q3	Q4	*High* Q1
Expensive	Q1	**3.3%**	**0.0%**	**0.0%**	**1.7%**	**6.3%**
	Q2	12.0%	4.8%	6.9%	11.0%	1.6%
	Q3	6.1%	0.0%	7.9%	5.6%	0.0%
	Q4	12.2%	5.2%	3.1%	2.4%	5.3%
Cheap	Q1	8.8%	3.0%	4.3%	12.9%	12.5%

NEGATIVE RATE SENSITVITY

P/Sales		*Low* Q1	FY2/FY1 Exp. Sales Growth Q2	Q3	Q4	*High* Q1
Expensive	Q1	**13.3%**	**35.7%**	**17.2%**	8.5%	7.6%
	Q2	**28.0%**	**21.4%**	**15.3%**	4.1%	7.8%
	Q3	**21.2%**	**17.1%**	6.3%	13.9%	12.5%
	Q4	10.8%	10.4%	9.2%	12.2%	0.0%
Cheap	Q1	10.5%	10.4%	17.0%	9.7%	12.5%

Source: FactSet, SIMG Analysis

Within the factor space, top ranked stocks in terms of sales growth and price momentum were the best performers last month. Year-to-date, high ROE, gross profitability and trailing sales growth stocks have fared best.

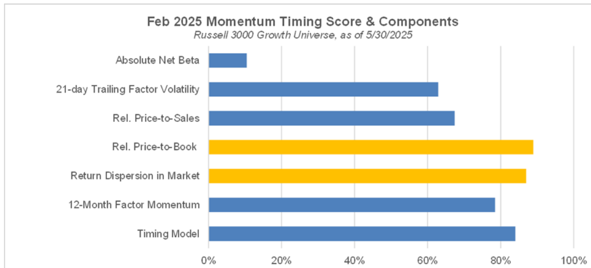
Alpha Factor Performance, Top Quintile vs Market

Russell 3000 Growth Universe, Through 5/30/2025

	Fwd P/E	Price/Sales	FCF Yield	ROE	Gross Profit	Total Yield	Sales Growth (T12M)	Sales Growth (FY2/FY1)	12-M Price Mom.	1-M. Mom. Reversal	Earnings Revisions
Jan 2025	0.7%	1.4%	0.7%	0.1%	1.8%	(0.6%)	2.2%	(1.3%)	1.0%	0.1%	(0.3%)
Feb 2025	0.7%	2.0%	2.0%	2.7%	1.6%	1.2%	(1.1%)	(4.0%)	(1.5%)	0.4%	0.9%
Mar 2025	2.3%	(0.3%)	1.6%	2.0%	0.6%	2.4%	(0.1%)	(2.7%)	(0.5%)	(4.2%)	(0.4%)
Apr 2025	(2.7%)	(3.7%)	(2.9%)	(0.4%)	0.4%	(2.8%)	1.6%	0.8%	2.4%	2.6%	3.8%
May 2025	(2.1%)	1.7%	(0.6%)	1.2%	0.5%	(2.3%)	2.3%	4.6%	2.7%	(0.1%)	(0.3%)
2025	(1.1%)	1.1%	0.8%	5.7%	5.0%	(2.0%)	5.0%	(2.7%)	4.1%	(1.2%)	3.7%

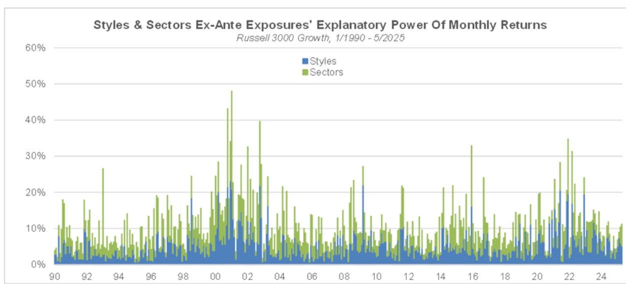
Source: FactSet, SIMG Analysis

At the end of May, our momentum timing model continues to indicate a high risk of under-performance for high momentum stocks in June. The timing model's current indication is primarily driven by the high relative price-to-book multiple of high momentum stocks and the high cross-sectional dispersion of stock returns in the growth universe.



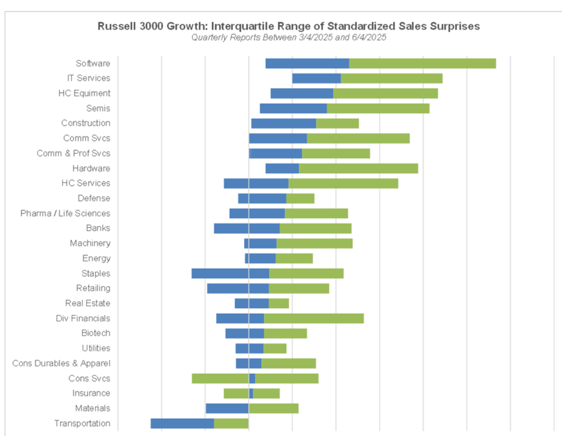
Source: FactSet, SIMG Analysis

The percentage of cross-sectional monthly return dispersion (within Russell 3000® Growth stocks) that is explained by exposures to styles and sectors has risen in May into the 67th percentile relative to the last 35 years. This percentage tends to spike during periods of macroeconomic stress or high market volatility.



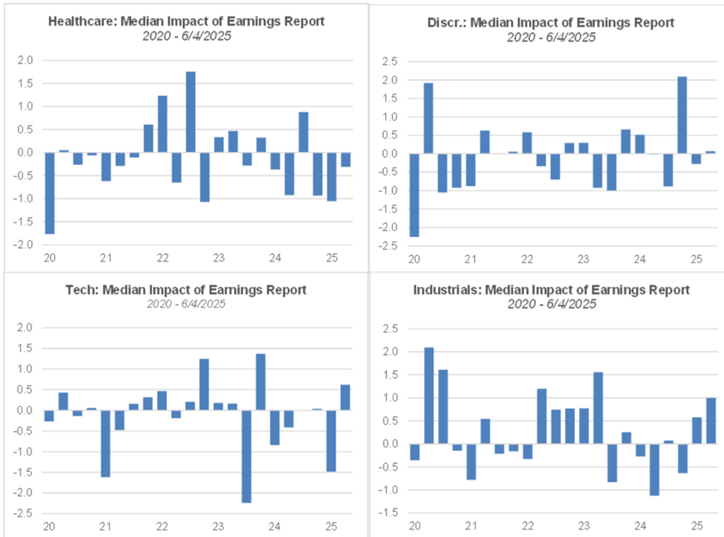
Source: FactSet, SIMG Analysis

The Q1 2025 earnings season is now in the rear-view mirror, and it reveals that companies in the growth universe have for the most part still been able to exceed expectations. **Despite skepticism regarding future growth in AI related themes following the release of DeepSeek models, a large majority of companies in software, semis and hardware have beaten revenue expectations**. By contrast, companies in the materials and transportation industries have struggled in the uncertain current macro environment.



Source: FactSet, SIMG Analysis

The price impact of earnings reports during the Q1 2025 earnings season has varied materially across sectors. Investors have expressed disappointment for the 3rd quarter in a row in healthcare and have had a neutral reaction to consumer discretionary companies' reports. By contrast, **they have reacted favorably to earnings announcements by tech and industrial companies.**



Source: FactSet, SIMG Analysis