JAG CAPITAL MANAGEMENT LLC

Quarterly Comments

Rising Rates Create Opportunities...And Risks

Market Overview

Stocks had a strong start to the third quarter before pulling back in August and September. Overall, the S&P 500 ended the quarter with modest losses, in part attributable to another spike higher in interest rates. In our opinion, the resilience in the US economy could be contributing to the recent market volatility. Although it may seem counterintuitive, good news on the economy sometimes translates into bad news for investment assets. This is because stronger-than-expected economic growth could make it harder for inflation to recede. Tamping down inflation has been the Fed's main priority since early 2022, and it appears to be more than willing to risk a mild-to-moderate recession if it supports its goal to bring the rate of inflation down to its target rate of 2%.

The July and August corporate earnings season was marked by broadly better-than-feared results and mostly favorable forward guidance, which supports consensus expectations for strong earnings growth into 2024-2025. Most companies we follow closely have navigated inflationary pressures relatively well over the past 24 months, largely by controlling discretionary labor-related expenses. The general tone of management teams continues to be cautiously optimistic, albeit with a noticeably tighter focus on cost management than was evident in 2020-2021. This has translated into some relatively large layoffs, especially within technology and adjacent industries. Although job cuts are unfortunate in many ways, investors are generally rewarding companies who can strike the right balance between expense growth and profitability. Despite industry-specific pockets of weakness, the overall labor market continues to be stable, with a low unemployment rate and high labor force participation. In our experience, labor market dynamics can change quickly. The growing friction between labor and management, combined with additional large strikes and layoffs could dampen consumer spending and stretch consumer wallets.

In a sign that markets are growing concerned about the long-term effect of higher rates on government interest expense, Fitch Ratings downgraded US sovereign debt in early August, from AAA to AA+. As one of the three larger US credit rating agencies, Fitch cited long-term risks of the current US fiscal trajectory as the main catalyst for the rating change. Looking back, the agency's downgrade amplified a rise in Treasury yields that lasted the entire month and extended through to the end of September. Other factors helped fuel the third quarter's "rate rumble," including the FOMC (Federal Open Market Committee) commentary following its September meeting that was less dovish on rates than many had expected, US dollar volatility, the agonizing ongoing war in Ukraine, the new war in Israel, and continued weakness in shares of many US regional banks. According to recent speeches and media appearances by voting FOMC members, even the Fed appears somewhat perplexed by this recent surge in rates.

"Whoops! There go those darned interest rates again!"

Source: Cartoonstock.com

Firm Highlights

Congratulations to our colleague **John Krueger** on successfully earning the Chartered Financial Analyst (CFA®) designation! John joined JAG in early 2021 and serves on our research team as an Equity Research Analyst.

In late September, two additional developments jolted the stock and bond markets. First, the United Auto Workers labor union began a general strike, a move that is likely to disrupt automobile production and weigh on economic growth. Second, the US careened towards another government shutdown as Republicans and Democrats failed to agree on a "Continuing Resolution" to fund the government. The shutdown was avoided at the last minute, but the 45-day funding extension expires on November 17th. This means there will likely be another budget battle in the coming months, a prospect that became even more unpleasant given the ouster of the GOP's Speaker of the House on October 2nd and the very recent spending demands to support Israel. History suggests that there will be a compromise deal reached next month as well, allowing both parties to claim some version of "victory" in the negotiations.

Following a dismal 2022 for both stocks and bonds, this year has provided a welcome respite for many investors. With a total return of 13% through 9/30/23, the S&P 500 is in contention to deliver solid double-digit gains for the calendar year. That said, far from all stocks are sharing in this year's bull market. For example, the Russell 2000 small-capitalization index return was only 2.5% through the end of the quarter. Value stocks, as tracked by the Russell 1000 Value Index, limped into the current quarter with a year-to-date return of only 1.8%. The FTSE World Ex-USA index has also lagged, returning 7.2% through 9/30/23. A substantial contributor to the S&P 500's strong returns has been its heavy representation of mega cap technology and adjacent companies. Sometimes referred to as the "Magnificent 7," these ubiquitous companies were worth a combined $10.4 trillion as of 9/30/23, representing 27.5% of the S&P 500.

The "Magnificent 7"			
Company	**Ticker**	**Cap ($B)**	**% S&P 500**
APPLE INC	AAPL	2,676	7.0%
MICROSOFT CORP	MSFT	2,345	6.5%
ALPHABET INC CL A (both share classes)	GOOGL	1,541	4.0%
AMAZON.COM INC	AMZN	1,304	3.2%
NVIDIA CORP	NVDA	1,074	3.0%
TESLA INC	TSLA	794	1.9%
META PLATFORMS INC CLASS A	META	667	1.9%
	Total	**10,401**	**27.5%**
All stocks listed in the table are held in one or more JAG strategies			

Source: FactSet, SPY holdings, JAG Capital Management

Collectively, the Magnificent 7 advanced 55% year-to-date through 9/30/23, contributing for approximately 86.4% of the S&P 500's total return. In other words, these seven stocks alone have powered most of the S&P 500's strong returns so far this year. This is an incredibly challenging environment for active equity managers, although we do own all the stocks noted above within our various strategies.

Some investment pundits are troubled with the fact that these seven companies account for almost one third the weight of the entire S&P 500. They conclude that because the Magnificent 7 have grown so large over the past several years, these companies might be more likely to produce disappointing relative or absolute returns in the future. While anything is possible, we would note history suggests the potential that some or all of these companies' leadership positions could persist for quite a long time. For example, companies like General Electric (GE), AT&T (T), Exxon Mobil (XOM), and General Motors (GM) were consistently among the biggest S&P 500 constituents throughout the1950s through1980s, with similar or even bigger market weights than the Magnificent 7 carry today. There were genuine fundamental reasons why these were the titans of their day. We think this shows that, given the right conditions and circumstances, large well-managed companies with strong competitive positions can defend their moats for decades before being successfully challenged.

As we have written extensively (**Insights AI Part 1**, **Insights AI Part 2**), we believe the rise of Artificial Intelligence (AI) is an extremely important development for investors and society. The ultimate winners and losers of AI will be determined in the coming months and years, but it is possible that much or most of the economic rewards of AI could eventually accrue to the technology leaders listed in the table to the left. If this proves to be the case, the Magnificent 7 could continue to command investors' attention for quite some time. Thankfully, prudent long-term investors need not make a binary choice. Our focused but diversified approach to managing client portfolios allows us to maintain meaningful exposure to the Magnificent 7 and other industry-leading companies, without sacrificing risk management.

Technological disruption is not limited to the Technology sector. In a previous **Insights piece**, we highlighted the unprecedented adoption of GLP-1 drugs including Ozempic, Wegovy, and Mounjaro. These treatments have been shown to be highly effective in treating Type 2 diabetes and obesity. More recently, results from a new study have further invigorated interest in these game-changing medicines and created ripple effects across the Health Care sector and the broader financial markets. On August 8th, Novo Nordisk announced preliminary results from their SELECT study, which demonstrated a 20% reduction in the risk of major cardiovascular events for patients taking their GLP-1 drugs, compared to a similar group of patients in the placebo group. These remarkable results are expected to drive broader coverage of GLP-1 drugs among payers and further accelerate the adoption curve among patients with Type 2 diabetes and obesity.

In the wake of the SELECT data being published, perceived "winners" including Novartis (NVO), Eli Lilly (LLY) and other companies involved in the supply and distribution of these drugs have seen their stock prices rise dramatically. Downstream beneficiaries may include clothing/textile companies that see higher demand from wardrobe adjustments. On the other hand, companies which are perceived to be at risk from more widespread use of GLP-1 drugs have experienced equally painful reactions to the recent developments. This cohort of perceived "losers" include companies which produce cardiovascular devices and tools for managing diabetes, and even fast-food restaurants and snack food manufacturers, and the packaged container companies that serve these markets.

Although the tangible effects on the revenue and earnings of these businesses are unlikely to be seen for months or even years, financial markets are a discounting mechanism. As such, short-term stock price movements are infused by human emotion and characterized by over- and under-reactions to long-term changes in fundamentals. Currently, the capital market clearly believes that the addressable market for certain types of medical devices, restaurants, and snack foods could shrink if GLP-1 treatments become widespread. While it is too early to tell how this will play out in the long term, we are closely monitoring the first- and second-order effects of anti-obesity treatments on companies in a variety of market segments across the Health Care, Consumer Discretionary, and Consumer Staples sectors.

Market Outlook

. . . "If I can be optimistic when I'm nearly dead, surely the rest of you can handle a little inflation."

–Charlie Munger
Comments during Berkshire Hathaway's May 2010 Annual Meeting

As Mr. Munger reminds us, it is important to maintain some perspective. This can be easier said than done, especially when we all have 24/7 access to all manner of news, newly minted expert opinions, and threats via the never-ending flood of online and social media. It is worth noting that Charlie made these comments in May 2010, when the wounds of the Great Financial Crisis were still all too fresh. Incidentally, his optimism was well-placed, as the S&P 500 has produced an annualized average return of 12.9% from 5/31/2010 through 9/30/23.

From our perspective, the biggest known risks for investors center on the future paths of interest rates, the shape of the yield curve in terms of short-term versus long-term yields, and inflation expectations. Of course, these risks are somewhat interdependent. While inflation has been moderating at a steady if uneven pace this year, any sign that it is re-heating could compel the Fed to raise rates more than currently expected. Similarly, with 30-year mortgage rates breaching 8%, pockets of the residential housing market are paralyzed.

As of August 2023, Existing Home Sales were at nearly 13-year lows. Homeowners who were lucky enough to lock in mortgages at less than 4% between 2019 and 2021 are now generally uninterested in selling—because the costs of financing another home are prohibitive. Single-family home prices remain firm in many geographies, reflecting the limited supply of homes for sale. But firm real estate prices do little to unfreeze the market because many first-time home buyers simply cannot afford the current cost of financing. If these conditions persist into late 2024 or 2025, they could eventually drive rents higher. Ironically, since rents are a significant input into government inflation data, higher-for-longer mortgage rates could themselves contribute to stickier inflation.

The investment implications of higher interest rates are playing out in real time. Part of the challenge here is a gap in our collective memory. Interest rates have not been "normal" since 2007. Although 16 years is but a blink in the long march of history, it is

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long enough that many industries and individuals have seemingly forgotten what it is like to live, work, and invest in a world in which very low-cost capital is not abundantly available.

Within our investment teams, we are avoiding investing in businesses that might have a particularly difficult time navigating a more normalized rate environment. As discussed in our **Q2 Commentary**, we continue to be cautious about the banking industry. Higher rates have run-on effects for banks and stress their balance sheets. Remember that bank profitability stems from the ability to "borrow short" (from depositors) and "lend long" (to borrowers), thereby capturing a spread. Additionally, although there are notable exceptions, the broader commercial real estate industry is under obvious and likely long-term pressure, especially within office buildings. In our view, banking remains exceptionally challenging, and we are generally avoiding investing in the shares or bonds of banks for now.

Much has been written since early 2022 discussing the implications of the so-called "inverted yield curve." This is a complicated way of saying that shorter-term interest rates have been higher than long-term interest rates, which is a relatively rare occurrence over the past 100+ years. Normally, investors demand higher rates of interest to lend their capital to borrowers for longer periods of time. This was caused in large part by the Fed's all-out assault on inflation, which led to it raising the Fed Funds rate from 0.25% to 5.50% in the span of roughly 18 months. However, in recent weeks, longer-rates have risen faster than short-term rates. This means that the yield curve is de-inverting, which is contributing to more volatility and pain in asset prices in recent months. We expect to see this volatility continue in the near term, given the current geopolitical turmoil and fluctuations in economic statistics, interest rates, and FOMC policy.

The biggest unquantifiable risks remain as they have for many decades, simmering for years in the background before occasionally storming into the foreground. Geopolitical, economic, and social tensions exist in many parts of the developed and developing world, but prudent and flexible governments will continue to make great advances over time. Similarly, environmental impact from natural geological forces and humanity continue to place strain on resources, but creative and determined societies, corporations, and individuals will work to create solutions in the coming decades. Within this context of uncertainty, we continue to invest with a focus on managing risks and capitalizing on attractive investment opportunities.

We are genuinely optimistic about the future but we are also realistic that the path forward is not simple, calm or obvious.

Thank you for your ongoing confidence and trust.

Warm regards,

Norm Conley
CEO, Chief Investment Officer &
Portfolio Manager

Disclosures

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Ownership: Fifty-one percent ownership by a Veteran or Veterans. The applicant must share in all risk and profits commensurate with their ownership interest.

Control and Management: Proof of active management of the business. Veteran must possess the power to direct or cause to direct the management and policies of the business.

Contribution of Expertise and Capital: Contribution of capital and/or expertise by Veteran owner(s) to acquire their ownership interest shall be real and substantial and be in proportion of the interest acquired.

Independence: The Veteran owner(s) shall have the ability to perform in their area of specialty/expertise without substantial reliance on non-Veteran-owned businesses.

About JAG

JAG Capital Management (JAG) actively invests for institutions and individuals in highly selective, customizable, and nimble equity and fixed income strategies. JAG is a boutique, independent, employee-owned investment management firm with offices in St. Louis and Chicago.

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