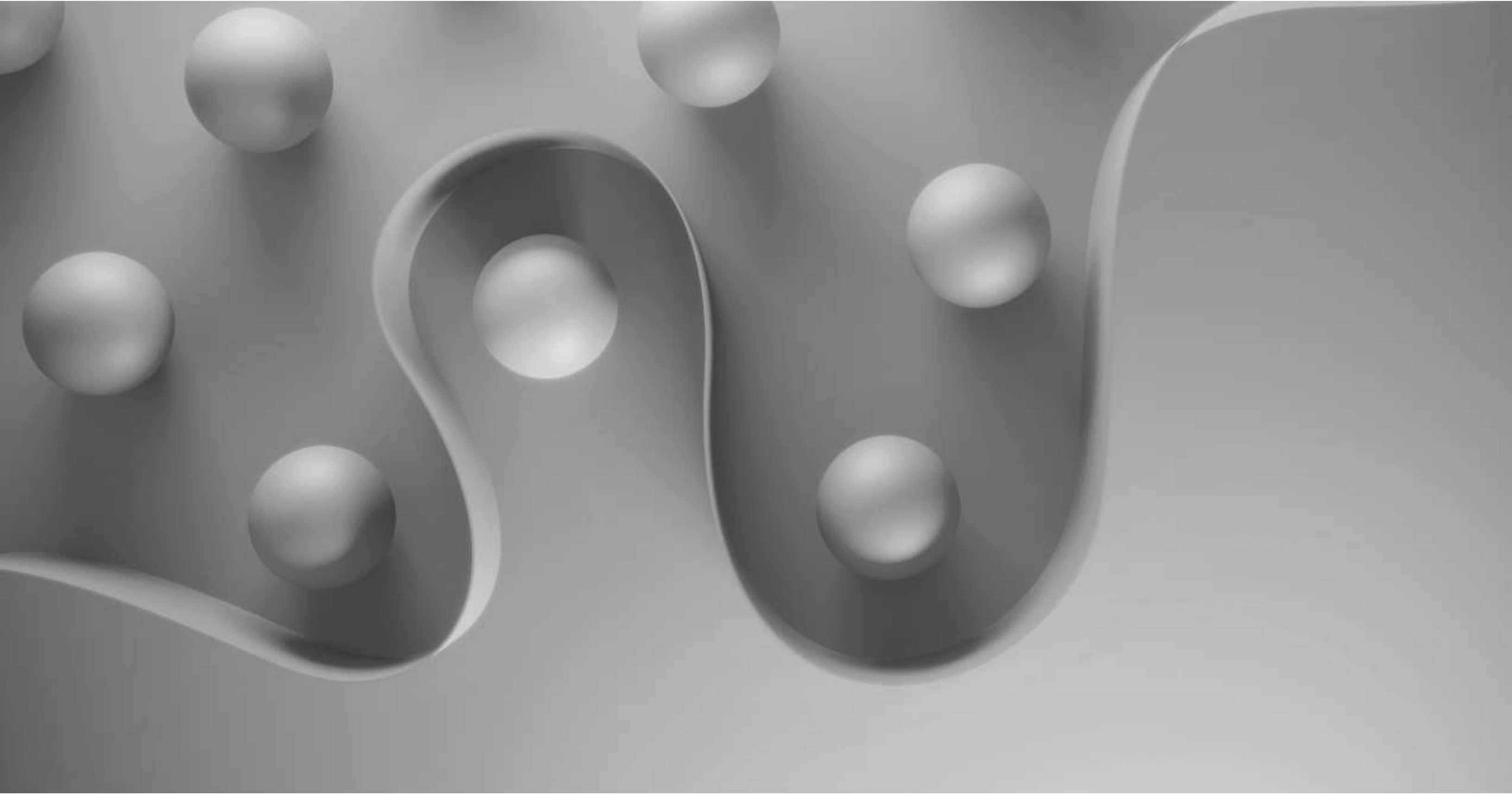

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NEUBERGER BERMAN

Equity Market Outlook 2Q 2024

Extreme Distortions Everywhere: A Moment for Active Management

Powerful investment themes, such as AI, can capture the market's collective imagination and we believe can create opportunities for tremendous wealth. Taken to an extreme, however, they can also trigger distortions across and within the markets.

In our **2Q 2024 Equity Outlook**, we take stock of a few of these distortions and the potential opportunities they create for active management. Some highlights:

- We are constructive on equities in light of the global industrial rebound and believe the U.S. nominal economy is likely to remain surprisingly resilient.
- We expect stock market leadership to broaden away from Technology and into other sectors both cyclical and defensive, even though we believe the AI theme offers significant long-term potential.
- We find historically extreme distortions across sectors and styles, potentially both a risk to portfolios and an opportunity to take advantage of changing trends.
- **Portfolio Considerations:** We recommend overweighting the Energy, Materials, Financials, Consumer Staples, Health Care and Utilities sectors, while underweighting Information Technology, Communication Services, and Consumer Discretionary. We also advise portfolio factor shifts from growth to value, and large cap to small cap.

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Investment Themes and Views[1]

We have retooled the methodology behind our equity recommendations to provide more actionable guidance for active asset allocators and portfolio managers. Our updated methodology—based on return/risk ratio cycles, which this paper discusses in greater detail—is designed to assess developing risk and opportunity cycles at the index and subcomponent levels (countries, sectors, regions and styles) and be more responsive to changes in market sentiment. The targeted investment horizon for the these recommendations is approximately 12 months, but we expect more frequent adustments at the sub-index level.

U.S.	POSITIONING
S&P 500[2]	**Overweight**
Communication Services	Underweight
Consumer Discretionary	Underweight
Consumer Staples	Overweight
Energy	Overweight
Financials	Overweight
Health Care	Overweight
Industrials	Overweight
Information Technology	Underweight
Materials	Overweight
Utilities	Overweight

EQUITY STYLES	POSITIONING
Russell 1000[2]	**Overweight**
Russell 1000 Growth vs. Value	Underweight
Russell 1000 Growth	Underweight
Russell 1000 Value	Overweight
Russell 2000 Small Caps	Overweight
U.S. MLP	Underweight
U.S. Equity REIT	Neutral
Europe Small vs. Large Caps	Underweight

PORTFOLIO FACTORS (USA)	POSITIONING
MSCI USA[2]	**Overweight**
Beta	Underweight
Small Size	Overweight
Value	Overweight
Growth	Underweight
Momentum	Neutral
Quality (Sector-Neutral)	Underweight
Minimum Volatility	Neutral
High Dividend Yield	Overweight
Low Leverage	Overweight
Foreign vs. Domestic Sales	Underweight

KEY REGIONS & MARKETS	POSITIONING
MSCI ACWI[2]	**Overweight**
EAFE	Underweight
EM	Underweight
Europe	Underweight
U.S.	Overweight
Canada	Underweight
U.K.	Underweight
Japan	Overweight
China	Underweight
India	Overweight
Brazil	Neutral

[1] For illustrative and discussion purposes only. This material is general in nature and is not directed to any category of investors and should not be regarded as individualized, a recommendation, investment advice or a suggestion to engage in or refrain from any investment-related course of action. The firm and its portfolio managers may take positions contrary to any views and themes expressed.
[2] Benchmark

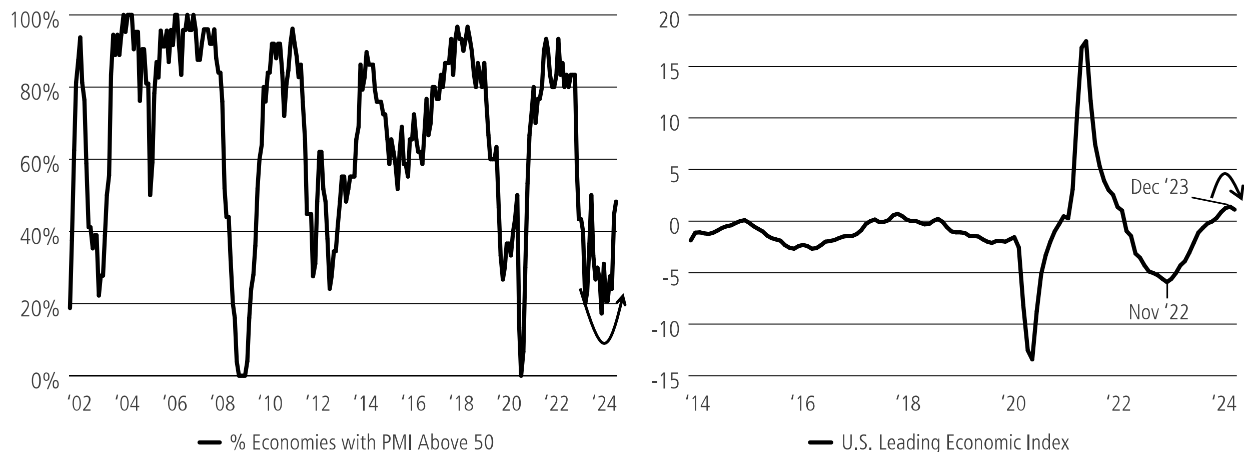
TABLE OF CONTENTS

MOVING BEYOND THE MAGNIFICENT SEVEN 1
SIGNIFICANT DISTORTIONS IN THE STOCK MARKET 3
MIND THE MEAN REVERSION 5
TIMELY PORTFOLIO MANEUVERS 9

Moving Beyond the Magnificent Seven

Even in the face of higher interest rates and slowing loan growth, U.S. economic growth has remained resilient and leads the world. We believe rising bond yields and tightening credit spreads are indicative of strength in nominal GDP growth. At the same time, we detect a cyclical upturn in global industrial production (see the left side of figure 1), a trend that has historically tended to last three to eight quarters.[1] These developments support our near-term constructive stance on equities in general, and the U.S. in particular.

FIGURE 1: GLOBAL INDUSTRIAL ACTIVITY IS PICKING UP WHILE THE U.S. IS SHOWING EARLY SIGNS OF MODERATING GROWTH



Source: Neuberger Berman Research and FactSet. Data as of March 31, 2024. Economies referenced are Australia, Austria, Brazil, Canada, China, Denmark, France, Germany, Greece, India, Indonesia, Ireland, Israel, Italy, Japan, Mexico, Netherlands, New Zealand, Poland, Russia, Singapore, South Korea, Spain, Switzerland, Taiwan, Turkey, U.K., U.S. and Vietnam.

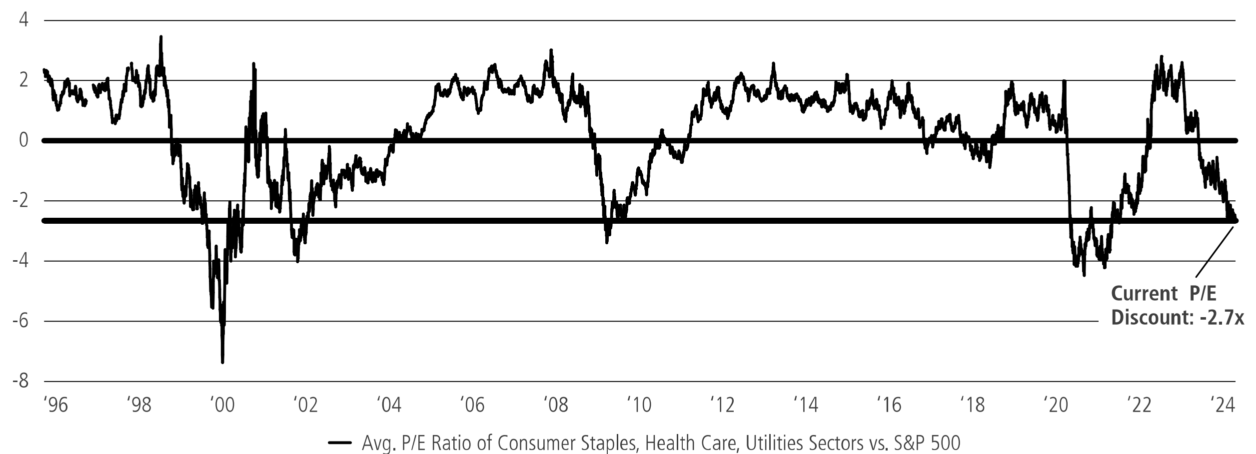
We believe a potential pickup in global industrial activity also argues for a broadening stock market away from the Magnificent Seven—including Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA and Tesla—and into sectors that are sensitive to global growth such as Energy, Materials and Industrials, which we are now overweight.

Additionally, we expect inflation to pick up globally by mid-year, further boosting earnings. It also supports our overweight stance on inflation-sensitive sectors—Energy, Materials and Industrial—and underweight on Consumer Discretionary, Information Technology and Communication Services. And from a style standpoint, we are now overweight value vs. growth, which is consistent with our sector allocation.

[1] Source: Neuberger Berman Research and FactSet. Data as of March 31, 2024.

Rising equity risk appetite has been a key driver of Technology's run over the last year. We expect risk-seeking to diminish as U.S. growth, still stronger than the rest of the world, begins to moderate, as shown on the right side of figure 1. This dynamic supports our constructive view on U.S. equities overall, while underweighting Technology and overweighting the low beta and unloved Utilities, Consumer Staples and Health Care sectors, which are now trading at historically notable P/E discount to the S&P 500 (see figure 2).

FIGURE 2: UTILITIES, CONSUMER STAPLES AND HEALTHCARE SECTORS ARE TRADING AT A NOTABLE DISCOUNT TO THE S&P 500



Source: Neuberger Berman and FactSet. Data as of March 31, 2024.

In the following sections, we take a closer look at a few of the distortions in the equity market—wrought primarily by the Mag 7's recent bull run—and what they could portend for equity investors over the next 12 months.

Significant Distortions in the Stock Market

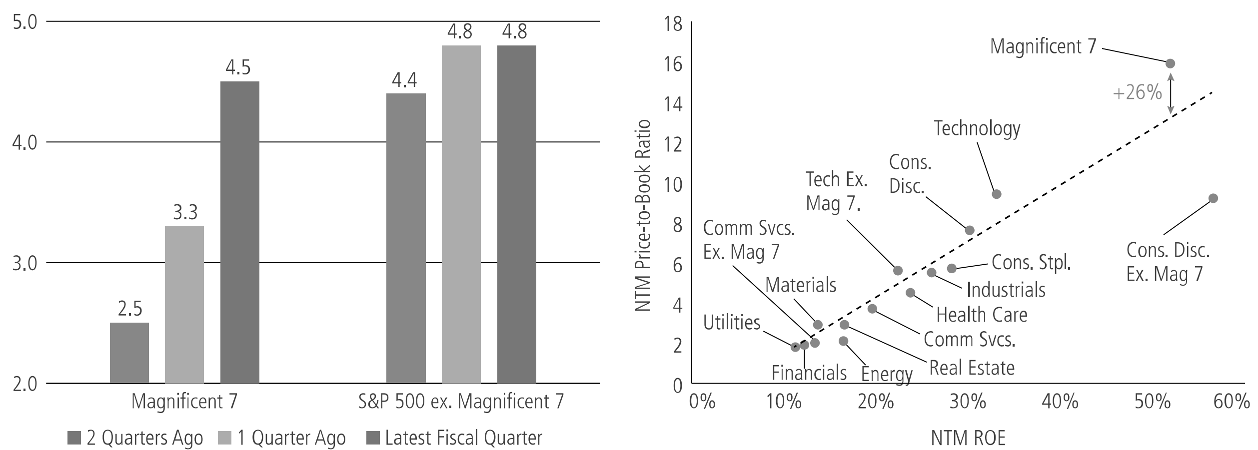
A confluence of factors—including surprisingly strong economic growth, robust corporate earnings, a net dovish Federal Reserve, healthy market liquidity and bullish sentiment in the largest corner of the stock market—has propelled a spectacular 40% rise in the S&P 500 since the start of 2023. With that run, however, came an even more spectacular polarization at the sector level.

Two tech-dominated sectors—Communication Services and Information Technology—have collectively outperformed the S&P 500 by 40% since the start of 2023; meanwhile, seven other sectors—Utilities, Energy, Consumer Staples, Real Estate, Health Care, Materials, and Financials—trailed the S&P 500 by an average 27%. Utilities fared worst, declining 4% during this period and lagging the broader index by 44%.[2]

While AI exuberance remains elevated, the risks to the continued outperformance of the Technology and Communication Services sectors, in our view, have steadily risen.

Consider that, over the past six months, the *market beta* of the Mag 7 has held steady at an elevated 1.42, similar to a cyclical stock.[3] (That figure implies in our view that for every 1% movement in the broader index, the Mag 7 would move 1.42% in the same direction.) However, the *earnings sensitivity* of the Mag 7 to the broader economy has increased dramatically: As shown on the left side of figure 3, six months ago the earnings sensitivity of the Mag 7 to nominal GDP was about half of the rest of the S&P 500; since then, the Mag 7's earnings sensitivity has *nearly doubled*. In other words, Mag 7 earnings are now about as cyclical as the rest of the S&P 500.

FIGURE 3: THE MAGNIFICENT 7'S EARNINGS ARE MORE CYCLICAL TODAY THAN SIX MONTHS AGO



Source: Neuberger Berman Research and FactSet. Data as of February 29, 2024. **Past performance is not indicative of future results.**

[2] Source: FactSet. Data as of March 27, 2024.
[3] Source: Neuberger Berman Research and FactSet. Data as of March 20, 2024.

A primary justification for the high valuations among the Mag 7 has been the predictability and dependability of the group's earnings relative to the rest of the S&P 500. In our view, however, that argument has gotten harder to make.

To see why, consider the right side of figure 3, which plots the relationship between price-to-book value and return on equity for various industries over the next 12 months. (The chart suggests to us that industries lying above the dotted line are trading at a relative premium to what is justified by their current profitability, while those below the line are trading at a relative discount.) Given that it appears the Mag 7's business fundamentals are now nearly as cyclical as the rest of the market, we believe that the group's 26% valuation premium relative to profitability-adjusted fair value is harder to justify—which makes them potentially vulnerable to underperformance. Meanwhile, at the sector level, Communication Services and Information Technology now boast the lowest accumulation of short interest within the Russell 3000.

In our view, these are signs of significant and perhaps unsustainable bullishness that, when combined with related intra-index and sectoral distortions, prompt us to ask: *Are these recent trends more likely to extend—or reverse—over the next 12 months?*

We attempt to answer this crucial question in the next section by examining the market through various lenses, including *sector positioning, sector weights and return-risk ratio cycles.*

Mind the Mean Reversion

Sector positioning is extreme

"Positioning" measures how much of a portfolio is allocated to a certain asset class or sector. Not long ago, in the fall of 2022, Tech positioning among discretionary investors (e.g. mutual funds and hedge funds) had *plummeted to the 0th percentile* of all periods since 2010, while Utilities positioning had risen *above the 90th percentile.*[4]

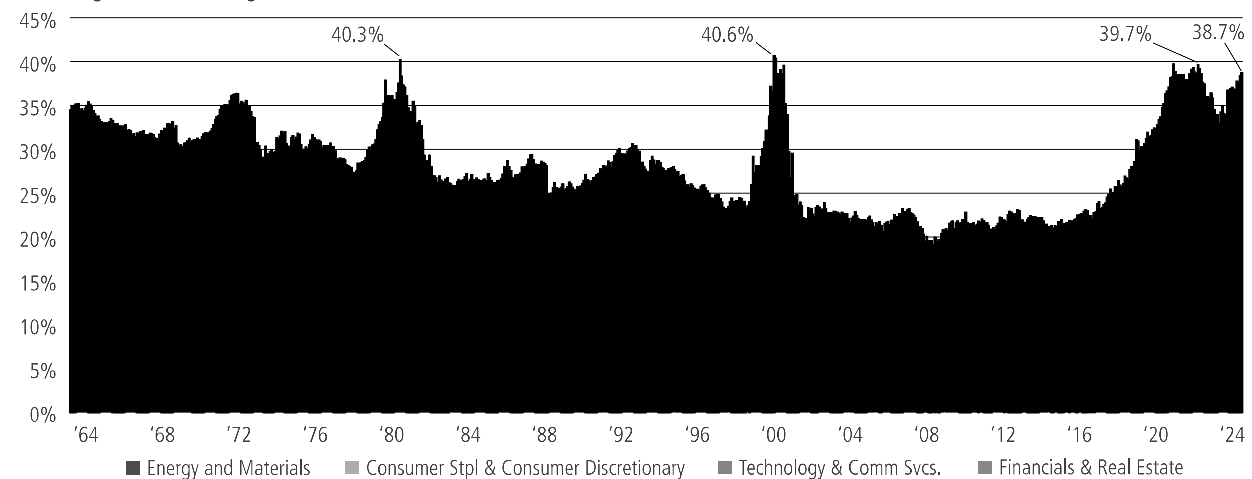
Six quarters later, the script has flipped: Tech positioning now stands at the 94th percentile, while Utilities positioning has dropped to 3rd percentile.[5] By historical standards, there simply isn't much more room to push that gap—thereby, in our view, increasing the risk of a trend reversal should AI-linked tech earnings growth begin to fall short of elevated investor expectations.

To be sure, there are fundamental reasons for the recent polarization: Relative to any S&P 500 sector, Tech is the most exposed to the growth factor, Utilities the least; Tech is relatively insensitive to higher policy rates (due to its ample cash reserves), while highly levered Utilities are much more rate-sensitive; Tech provides exposure to currently favorable factors—including high beta, large size, and quality—while Utilities do not; finally, Tech is riding the massive AI tide, whereas Utilities—while integral to powering the AI transformation—have failed to attract a commensurate degree of investor attention. That said, current extreme positioning suggests to us that many of these considerations could be fully priced in, and then some.

Meanwhile, the current degree of sector concentration within the S&P 500 has reached near-historic proportions. As shown in figure 4, the two largest sectors by market cap—Information Technology and Communication Services—now represent nearly 39% of the S&P 500, *a level temporarily breached on only three other occasions in the past 60 years*, during the Iranian Oil Shock of 1978 – 79, the peak of the Dotcom bubble in 2000, and the mid-2021 COVID Tech boom.[6]

FIGURE 4: TWO TECH-HEAVY SECTORS DOMINATE THE S&P 500—AT POTENTIALLY UNSUSTAINABLE LEVELS

Index Weight of the Two Largest Sectors



Source: Neuberger Berman Research and FactSet. Data as of February 29, 2024.

[4] Source: Deutsche Bank. Data as of March 23, 2024.
[5] Ibid.
[6] Source: Neuberger Berman Research. Data as of March 31, 2024.

History tells us that sector concentration extremes tend to be rare and short-lived. We find that eventual reversions to the mean often mark the peaks or troughs in cycles of investor optimism, foreshadowing the end of a trend and the beginning of the underperformance of the largest two sectors, which can be accompanied by an uncomfortable degree of volatility.

Return/Risk ratio cycles may augur swift reversals

We believe attempting to time the precise peaks and troughs in risk assets remains a fool's errand. However, our research suggests a potentially powerful approach—using return/risk (RR) ratio cycles—that we believe can help decipher when an investment theme (or sector) has potentially reached a positive or negative performance extreme.

The Sharpe ratio is a common tool for comparing the risk-adjusted performance of different portfolios. Yet we find a modified version of this concept can also help investors get a better statistical handle on when potentially perilous and unsustainable "groupthink" has set in.

We observe that stocks associated with an enduring investment theme tend to rise or fall alongside an active debate among bulls and bears. This debate introduces natural volatility in the market—hence the saying, "Nothing goes up or down in a straight line." When an investment theme continues to trend but its volatility collapses, that's roughly the time, we believe, that *thesis* has morphed into *consensus*, the debate has fizzled and groupthink has set in. When this happens, stock prices often hurtle without much volatility, pushing the absolute value of their RR ratio higher.

Based on our research, groupthink tends to be self-correcting, often quickly. Extended RR ratios, we find, are often a prelude to trend reversals, and as debate and volatility come back to life, RR ratios begin to retreat. This dynamic creates an RR ratio cycle—one that, we believe, can be very helpful in assessing turning points of both deeply loved and deeply out-of-favor investment themes and sectors.

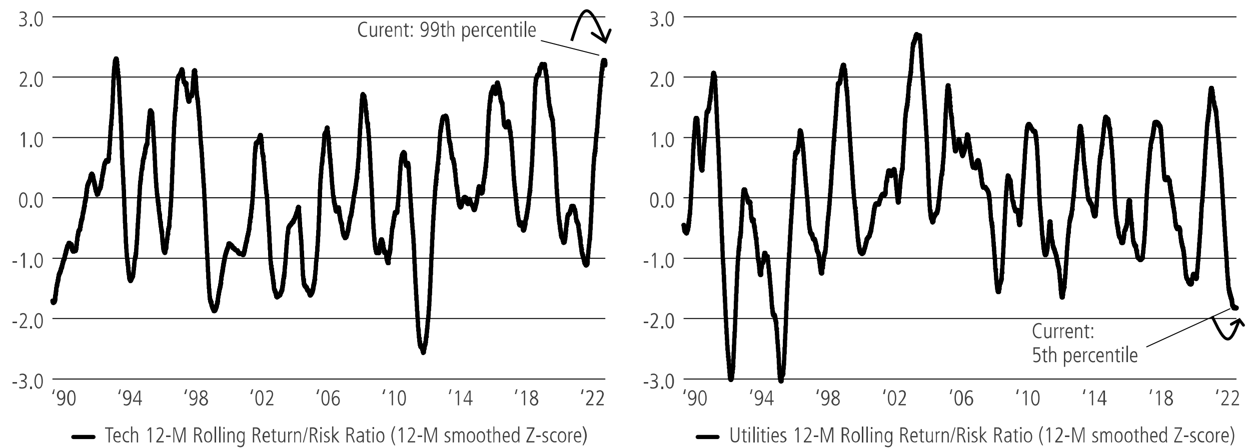
Our analysis shows that rolling 1-year trailing RR ratio captures this dynamic well and tends to cycle through peaks and troughs along with investor optimism or pessimism. (We calculate a sector's RR ratio is calculated as a sector's 1-year return *relative to the broader index*, divided by the standard deviation of that relative return.)

Sector Rotations

Consider the RR ratio cycles of two currently polarized sectors: Information Technology and Utilities. As shown in figure 5, the Information Technology sector's RR ratio ranks in the 98th percentile of data going back more than three decades, while the Utilities sector's ratio ranks in only the 5th percentile over the same period.

Now it appears that the pendulum is beginning to swing back from extremes; debate and volatility have returned to these sectors as groupthink has ebbed. Similarly, we have noticed other sectors' reversions as well, including in Communication Services (98th percentile), Healthcare (in the 3rd percentile), Consumer Staples (3rd percentile), Materials (7th percentile), Industrials (8th percentile), and Financials (11th percentile).

FIGURE 5: RETURN/RISK RATIO CYCLES CAN SPOT MARKET "GROUPTHINK" AND SIGNAL POTENTIAL REVERSALS IN SENTIMENT



Source: Neuberger Berman Research and FactSet. Data as of April 2, 2024. **Past performance is not indicative of future results.**

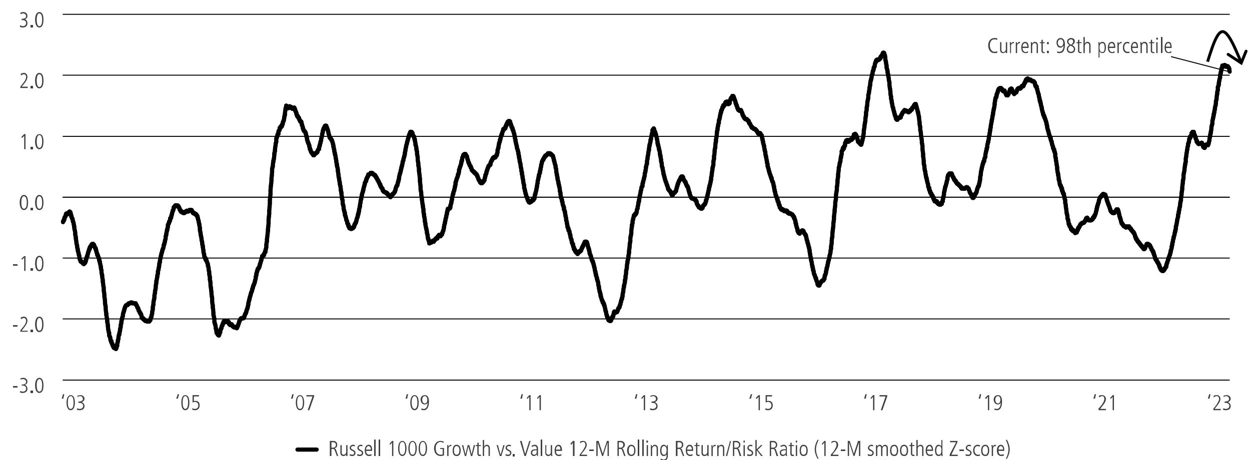
Instances of such extreme groupthink across this many sectors in the S&P 500 are historically rare. In fact, our observed groupthink across sectors *now ranks in the 99th percentile of data going back over three decades—on par with the sector polarization last seen during the dot-com frenzy in 2000*. We believe reversions across this many sectors are a potential risk to portfolios and an opportunity to take advantage of changing trends.

Growth-to-Value Rotation

We believe RR ratio cycles also offer valuable perspective on the potential rotation from growth stocks into value stocks.

As shown in figure 6, the 1-year trailing RR ratio for the Russell 1000 Growth Index versus the Russell 1000 Value Index performance peaked at the 99th percentile in mid-January and has since been falling. *This suggests to us that the year-long rotation from value to growth may have reached its cyclical peak, implying that growth stocks may be poised to underperform value stocks over the next 12 months.*

FIGURE 6: RETURN-RISK RATIO CYCLES IMPLY THAT DEMAND FOR GROWTH STOCKS MAY HAVE PEAKED



Source: Neuberger Berman Research and FactSet. Data as of March 22, 2024. **Past performance is not indicative of future results.**

Over the past seven years, we find that the peaks and troughs in the RR ratio cycle have effectively delineated periods of outperformance among growth and value stocks. Given the market's highly polarized sector sentiment, extremes in sector positioning and abiding enthusiasm for AI, we think an eventual rotation from growth into value could be more intense than usual, *and thereby suggest underweighting growth versus value over the next 12 months.*

We think current conditions present a significant opportunity for skilled active managers who can potentially take advantage of value and sentiment dislocations and capitalize on rotations away from groupthink. In our view, sector rotation and prudent stock selection are more critical than ever in order to manage the elevated risk within themes and sectors.

Timely Portfolio Maneuvers

History shows that compelling investment themes can invite groupthink among market participants, which in turn can produce unsustainable distortions across various sectors. Thanks to Tech and AI, here we may be again.

Given the extreme distortions in the market, we believe this is a moment tailor-made for skilled active managers able to steer away from consensus and offer prudent stock selection and risk management within themes and sectors—crucial maneuvers that passive investment vehicles are not built to make.

In light of the various distortions we have examined above, we believe investors should consider making some timely portfolio adjustments.

In our assessment, underweighting the Tech sector and focusing on thoughtful security selection may prove a better way to capitalize on the AI theme while managing potentially rising risks in a sector dominated by extreme sentiment and momentum. Additional thoughts on where we see opportunities in the market, informed by our RR ratio cycle methodology, include:

Sectors (U.S.)
Overweight: Energy, Financials, Industrials, Materials, Consumer Staples, Healthcare, Utilities
Underweight: Information Technology, Communication Services, Consumer Discretionary

Equity Styles
Overweight: Value vs. Growth; Small vs. Large

Portfolio Factors (U.S.)
Overweight: Small Size, Value, High Dividend Yield, Low Leverage
Underweight: Beta, Growth, Quality, Foreign Sales Exposure

Key Regions and Markets
Overweight: U.S., Japan, India
Underweight: EAFE, EM, Europe, Canada, U.K., China

The targeted investment horizon for these recommendations is 12 months, but we expect more frequent changes at the sub-index level in response to changing market dynamics.

We acknowledge that strong investment themes, such as AI, can capture investors' imaginations for longer than history might suggest. However, we fear that the excesses of groupthink present a far greater threat to the future performance of equity portfolios.

For detailed recommendations across sectors, factors, style and geographies, see the section titled "Investment Themes and Views."

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Index Definitions

The **Russell 1000® Growth Index** measures the performance of the large-cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2 year) growth and higher sales per share historical growth (5 years).

The **Russell 1000 Value Index** measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values

The **Russell 3000 Index** measures the performance of 3,000 stocks and includes all large-cap, mid-cap and small-cap U.S. equities, along with some microcap stocks. The index is designed to represent approximately 98% of investable U.S. equities by market capitalization.

The **S&P 500 Index** consists of 500 U.S. stocks chosen for market size, liquidity and industry group representation. It is a market value-weighted index (stock price times number of shares outstanding), with each stock's weight in the Index proportionate to its market value.

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