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AB Sustainable Global Thematic Equities Fund

Equity Rally Continued

The rally in equity markets continued into 2024 driven by artificial-intelligence (AI) proliferation, a resilient US macroeconomic backdrop and confidence that the easing cycle will start at some point during the year. The disinflation narrative is intact while corporate profits are recovering—an "immaculate disinflation"—for now. Meanwhile, the Fed is proactively shifting policy to protect the US expansion. All of this is consistent with a positive view on the market, reflected in fund flows and rich valuations.

Global markets, as measured by the MSCI All Country World Index (ACWI), increased 3.1% in March, bringing 1Q:24 returns to 8.2%, in US-dollar terms.

The Not-So Magnificent 7—Markets Returns Are Diversifying

Despite continued market concentration in 2024 with market-cap weighted indices outperforming their equal weighted counterparts, dynamics are shifting beneath the surface.

The performance of the "Mag 7" has started diverging after trading in unison for most of 2023. Prices of two of the seven stocks that drove last year's rally have fallen year to date (Apple and Tesla, neither of which is owned in our Portfolio).

In addition, while the breadth of the rally is still uninspiring, it has started to improve with a rising share of stocks trading above their 200-day moving average. This dynamic is also reflected in the performance of sectors. After having underperformed in prior months, energy and materials are now the top two performing sectors over the past month, while consumer discretionary and technology—home to Tesla and NVIDIA—have moved down in rank to the very bottom of the list.

According to Goldman Sachs, other concentrated markets in the past 100 years often ended in "catch-up" rallies as the market broadened. This suggests a further broadening in the coming months could lead to more gains overall.

Expect Broadening, but Still Modest Economic Growth

In aggregate, companies delivered another earnings beat in 4Q:23 and the consensus 2024 GDP forecast has risen, a reflection of the better-than-feared economic backdrop and optimism over a soft landing.

The narrowness of recent profit growth presents a potential cautionary note for markets. Excluding the "Mag 6" companies (the Mag 7 less Tesla, [NVIDIA, Meta Platforms, Amazon, Microsoft, Alphabet Inc. and Apple], which is struggling with more idiosyncratic issues), S&P 500 corporate earnings declined year over year in each of the final three quarters of 2023, or down 9% on a cumulative basis. In contrast, cumulative earnings rose 120% for the Mag 6.

We believe earnings growth can broaden in 2024, which bodes well for market returns beyond the largest technology stocks. In fact, consensus estimates are in for a catch up in terms of earnings growth for the rest of the market for the back end of 2024. Finally, we would note that despite recent positive GDP revisions, the economic outlook for the next several years is still fairly anemic. The consensus currently expects real GDP growth of just 1.5% for 2024 and 2025 for the Group of Eight countries. That's a constructive backdrop for stronger, more resilient, less macro-dependent themes like those we target in our strategies.

Post-COVID-19 Normalization—A Tailwind to Our Portfolios

Global supply chains were materially disrupted during COVID-19, leading to boom/bust cycles within certain industries including healthcare tools and instruments suppliers, which negatively impacted our Portfolio. However, with supply chain pressures moderating and healthcare utilization generally improving, many healthcare companies are pointing to stronger growth this year. Bioprocessing, for example, is showing clear signs of bottoming/rebounding, which bodes well for our Medical Innovation theme.

More broadly, aggregate inventory levels have just returned to normal and a restocking wave could spur growth in manufacturing in the quarters ahead.

Final Thoughts

Over many years of managing investors' money, we have seen clients lose patience and chase returns via recent winners. History shows investors get penalized when purchasing an asset expensively—even when fundamentals are positive. We believe many of today's largest technology firms fit this profile, while opportunities exist to find companies with similar growth rates at more attractive prices elsewhere.

Portfolio Performance

For the first quarter, the Sustainable Global Thematic Portfolio increased in absolute terms but underperformed its benchmark, the MSCI ACWI, both gross and net of fees. During the quarter, stock selection detracted from overall returns, while sector selection contributed. Stock selection within technology and financials detracted the most, while selection in industrials and an overweight to technology contributed.

Infineon Technology, from our Climate theme, engages in the provision of power and sensing solutions, as well as technologies for the electrification of the automotive industry. Shares detracted on concern that a slowing macroeconomic environment will have a negative impact on semiconductor end-users, especially in the automotive industry. We believe increasing demand for electric vehicles, renewables and auto safety will provide opportunities for growth over the long term.

Adobe, from our Empowerment theme, detracted after reporting a strong first quarter but providing a lighter-than-expected outlook for the company's second quarter, where expectations for further uplift from monetization of Adobe's newer generative AI products released last year was higher. The company highlighted a number of positives in the quarter, including operating margin expansion even in the face of continued new product releases, strength from its research and development organization, and a four-year $25 billion share buyback program. We expect the second half of the year to demonstrate strength, and we remain confident in Adobe's growth trajectory, supported by several recent and upcoming product launches and the prospects for AI monetization.

Calix, a provider of internet access equipment for network buildouts in the US, from our Empowerment theme, detracted as customers shifted planning resources to applying for a massive funding program from the US government, the Broadband Equity, Access, and Deployment (BEAD) Program. While deployments have slowed in 2024, it creates an even bigger potential setup for growth in 2025, when disbursements from BEAD flow in earnest and Calix's customers race to deploy. We think investors will get excited about the company as we get closer to this reality.

Flex, an outsourced manufacturer of products including communication devices and autonomous driving systems for electric cars, from our Climate theme, contributed after posting strong performance during the period. The company is seen as a beneficiary of AI-related data center spend as it produces servers and full rack systems for customers. Additionally, operating margins have been stronger than expected, which supports earnings in the face of macroeconomic-related headwinds in the consumer and industrial segments.

ASML, a provider of advanced lithography technology for the semiconductor industry, also from our Empowerment theme, contributed after it beat earnings expectations amid record bookings; it also had some positive commentary surrounding installed base and margin tailwind. The massive order figure suggests increasing confidence for growth reaccelerating in 2025.

Taiwan Semiconductor Manufacturing, the world's largest chipmaker, from our Climate theme, contributed following growing need for semiconductors driven by AI demand.

Thematic Check—Steady Progress

Amid all the noise, our themes continue to move forward as broad shifts in the global economy run their course. Global challenges such as access to healthcare and infrastructure needs are not solved overnight. Although having less exposure to the mega-cap technology cohort has not helped, our core thematic exposures continue to offer robust growth potential.

We believe a portfolio with high-quality companies on the right side of change, trading at reasonable valuations, provides a strong combination for the current market environment. Resilient fundamentals and narrow leadership in the market has created a powerful setup for a group of companies that fit this profile.

Within our Information, Communication and Technologies theme, the latest earnings results from a number of leaders like NVIDIA, AMD (unheld) and the cloud providers demonstrates that society's move toward intelligent digital economies is leading to increased demand for bigger networks, more powerful and energy efficient data centers and new consumption models. We continue to expect the key AI enablers (the companies that facilitate the training and running of AI models in an energy efficient way), along with the AI adopters (those that successfully integrate AI in their applications) will enjoy strong tailwinds near-term.

We are also excited about infrastructure opportunities in the quarters and years ahead. Many roads, bridges, sewer systems and buildings in this country are aging and requires updating. The need for significant Federal funding will be partially met with the bi-partisan Infrastructure Investment and Jobs Act, the CHIPs Act and the Inflation Reduction Act that together should lead to the deployment of over $1 trillion in new funding over the next decade. The goal of this legislation is to return the US to a position of industrial and technological leadership in the world. This, in our view, will provide a durable investment backdrop for many of our Portfolio companies. Some of our areas of investment focus include water infrastructure and equipment, grid resilience, and the renewable energy ecosystem.

In our Health theme, the underlying growth in medical innovation remains robust. In 2023, we saw the second highest number of new novel drug approvals by the FDA (55) in the past 10+ years. This growth hasn't translated into earnings for the suppliers in this ecosystem because of excess inventory, but it is finally being worked through. The year 2024 should see a recovery in earnings as a result, despite ongoing headwinds in China. The market enthusiasm around GLP-1 weight loss drugs continues to be high, although we've seen some evidence that the cost of these treatments born by payors will limit adoption below what bullish estimates assume. Our preferred stance continues to be via exposure to the enablers that develop instruments for drug discovery, clinical trial management and packaging, rather than through the end product vendor. This allows us to participate in the underlying market growth without assuming the concentrated risk of owning the GLP-1 providers themselves.

Our thematic research effort remains robust and we are excited to dive deeper into several topics this year including China's domestic semiconductor supply efforts, AI and energy implications, and the effect of climate disasters on the availability of insurance. We look forward to sharing our conclusions with you in the quarters ahead. Our Portfolios continue to harness powerful thematic drivers through companies that in our view are best positioned to capitalize on these opportunities. This approach has delivered strong results for our clients over time and we're highly confident in its ability to do so in the future.

As always, thank you for your continued support.

Dan Roarty

Please refer to the following legal disclosures.

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