MARKET COMMENTARY

Passing the Baton

July 2024

- U.S. small cap stocks ended July up 10%, while U.S. large cap stocks ended the month up 1%, the widest relative performance spread since February 2000.
- After a prolonged period of favoring mega-cap technology stocks, investors turned their attention to small cap stocks due to a mild June inflation report, anticipation of expected interest rate cuts, and election developments.
- The Bank of Japan hiked interest rates on July 31, which, along with currency intervention, led to a strengthening of the yen. This has put carry traders in a difficult position, as they now face higher U.S. dollar repayment costs.
- Aside from the Olympics, several market and political races will compete for investors' attention—and likely contribute to market volatility—in the coming months.

Overview

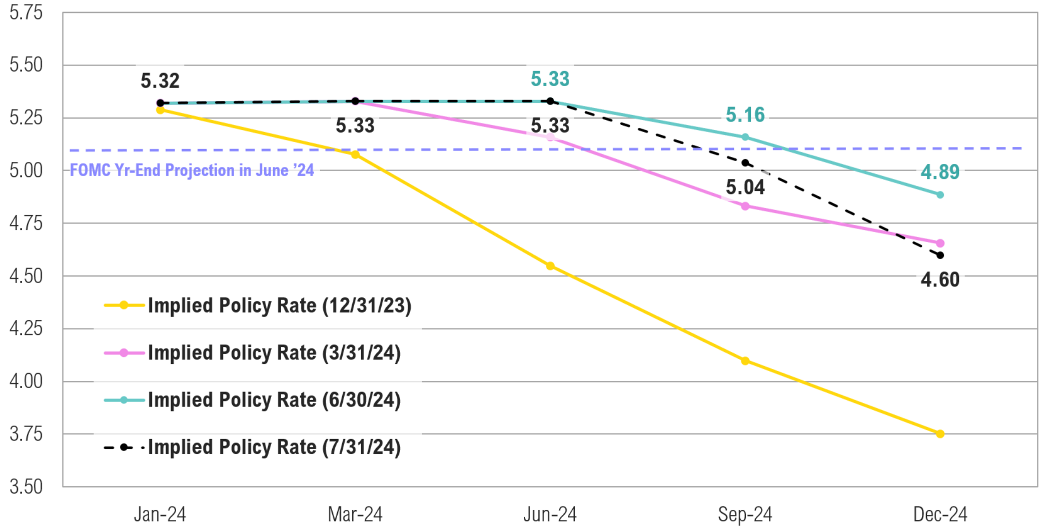
Much like an Olympic athlete in Paris, U.S. small cap stocks delivered a gold medal performance in July, ending the month up 10%. U.S. large cap stocks lagged, ending the month up 1%. At 9%, July was the third-widest monthly spread between U.S. small cap and U.S. large cap stocks since 1980, with only February 2000, 18%, and January 1992, 10%, exceeding it. Encouraged by the increasing likelihood of imminent interest rate cuts, U.S. intermediate-term bonds ended July up more than 2%.

The June inflation print showed prices reaching the lowest level since early 2021

The June inflation report showed prices rising at a slower-than-expected pace, reaching the lowest point since early 2021. Headline inflation eased from 3.3% year-over-year to 3.0%, with the monthly rate showing a 0.1% decline—the first month-over-month decrease in four years.[1] Core inflation also ticked lower in June, from 3.4% year-over-year to 3.3%.[2] Bolstered by the mild inflation report, markets started to price in the probability of a 50-basis point interest rate cut at the September Federal Open Market Committee (FOMC) meeting. As of the end of July, markets were pricing in the equivalent of three rate cuts for 2024, despite there being only three FOMC meetings remaining this year. At the July FOMC meeting, held on the last day of the month, Federal Reserve Chair Jerome Powell acknowledged the increasing likelihood of an imminent interest rate cut, saying, "A reduction in our policy rate could be on the table for as soon as the next meeting in September."[3] Powell also emphasized that any decision to cut rates in September would be apolitical, asserting that the Fed "would never try to make policy decisions based on the outcome of an election that hasn't happened yet."[3]

Mild June Inflation Report Bolstered Market Rate Cut Expectations

Implied Fed Funds Rate, %



Source: Bloomberg

Excluding the pandemic, the unemployment rate is now the highest it has been since September 2017

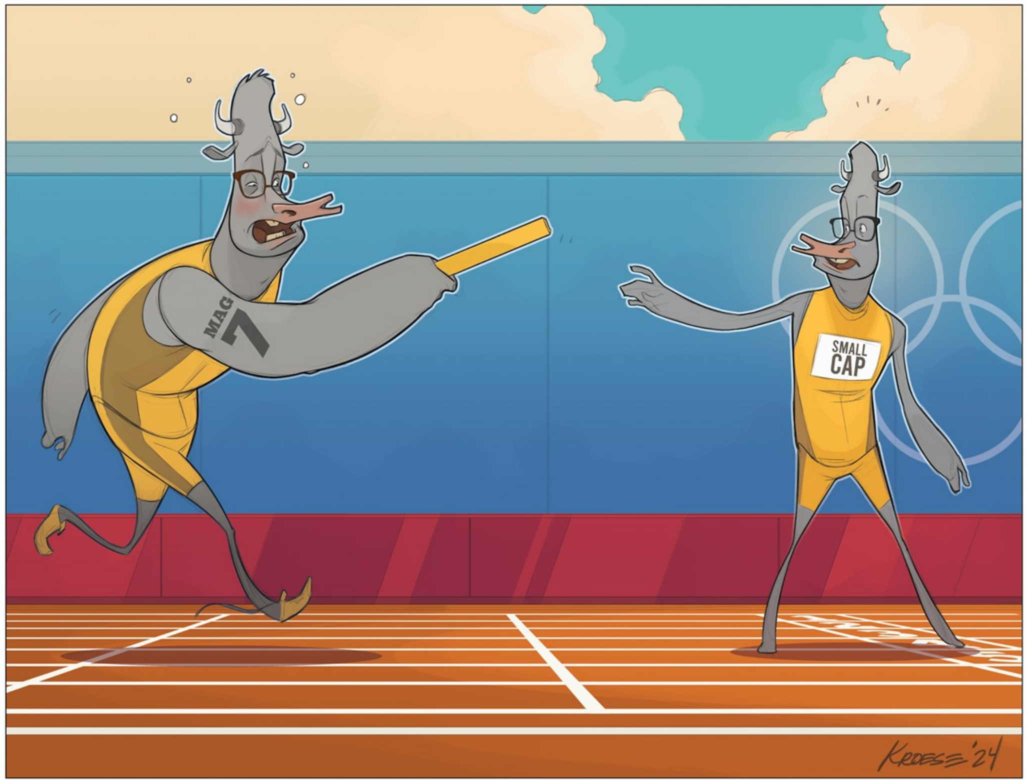
Continued signs of a cooling labor market are also clearing the way for the Fed to cut interest rates. Job openings dipped in June, from 8.23 to 8.18 million, and are now down over 30% from their peak of 12.18 million in March 2022.[4] The U.S. economy added only 114,000 new jobs in July, while the unemployment rate remained ticked up from 4.1% to 4.3%. Excluding the pandemic, this is the highest unemployment rate since September 2017.[5]

Treasury borrowing in 2024 is on track to be the second highest on record after 2020

Preliminary second-quarter gross domestic product (GDP) results indicated that the U.S. economy grew at a respectable annualized rate of 2.8% quarter over quarter.[6] This growth was largely driven by a reacceleration in government spending, which rose from 1.8% in the first quarter to 3.1% in the second quarter. However, while these preliminary results are subject to revision, government spending continues unchecked. With two months remaining in the 2024 fiscal year, which runs from October 1 to September 30, the fiscal deficit has surpassed $1.2 trillion.[7] This is a marginal improvement over the $1.4 trillion deficit recorded at the same time last year.[8] On July 29, Treasury announced its net marketable borrowing estimates for the third and fourth quarters. These estimates imply that borrowing in 2024 will exceed $2.2 trillion, the second largest on record after 2020. For context, during the COVID-19 year of 2020, the Treasury issued $4.3 trillion in net debt.[9]

By the end of July, over 70% of the S&P 500 had reported earnings for the second quarter. Continuing a trend from the first quarter, four of the Magnificent Seven companies—Amazon, Google, Meta, and Nvidia—are expected to report year-over-year earnings growth of 56.4% for the second quarter.[10] Excluding these four, the other 496 S&P 500 companies are expected to see earnings growth of 5.7% for the second quarter.[10] Notably, these 496 companies are forecast to reach double-digit earnings growth of 15.6% by the fourth quarter.[10] Overall, the second-quarter earnings growth rate for the entire S&P 500 is anticipated to be 11.5%.[11]

U.S. small cap stocks outperformed U.S. large cap stocks by 9% in July



Source: SpringTide, Noah Kroese

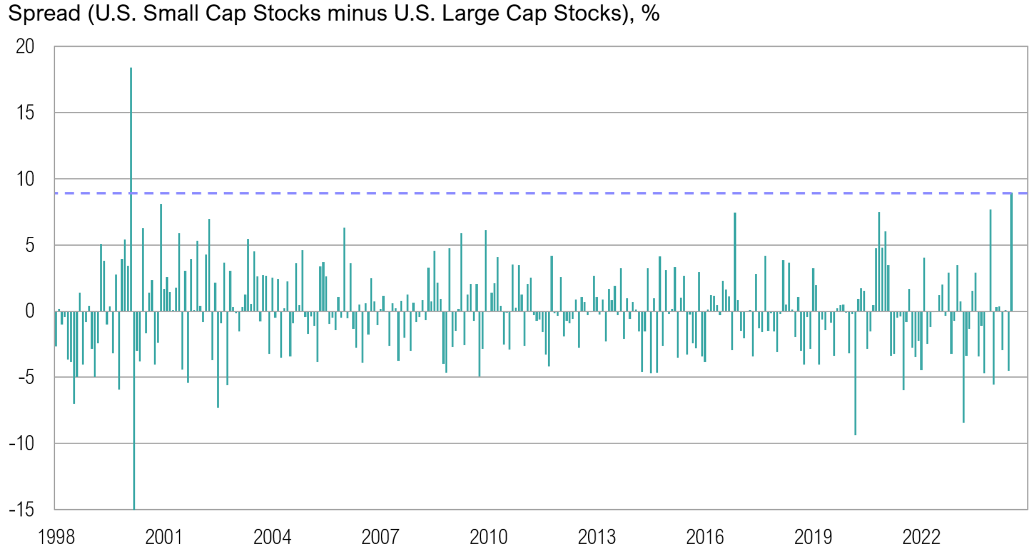
Passing the Baton

At the start of July, the Russell 2000 Index of U.S. small cap stocks was underperforming U.S. large cap stocks (proxied by the S&P 500) by 5.9% over the past decade—the fourth-worst decade for small caps relative to large caps in a century.[12] Year-to-date, small cap stocks had gained only 1.7%, compared to the 15.3% gain made by large cap stocks. Then came July when U.S. small cap stocks sprinted ahead to end the month up 10%, outperforming their large cap counterparts by 9%, the widest monthly spread since February 2000.

The July spread between U.S. small and large cap stocks was the widest since 2000

July Spread Between U.S. Small and Large Cap Stocks Was Widest Since 2000

Spread (U.S. Small Cap Stocks minus U.S. Large Cap Stocks), %



Source: Bloomberg. U.S. small cap stocks proxied by the Russell 2000; U.S. large cap stocks proxied by the S&P 500.

After months of mostly underweighting the asset class in favor of the mega-cap Magnificent Seven companies, investors surged into U.S. small cap stocks at a rapid pace, and small cap funds experienced some of the strongest weekly inflows on record over the past month.[12,13] Two key factors likely contributed to this rally: the mild June inflation report and recent election developments (including the June 25 Presidential debate and President Biden's subsequent withdrawal from the presidential race on July 21).

Much of the rally in small caps was likely due to investors' desire to rebalance away from extreme positions

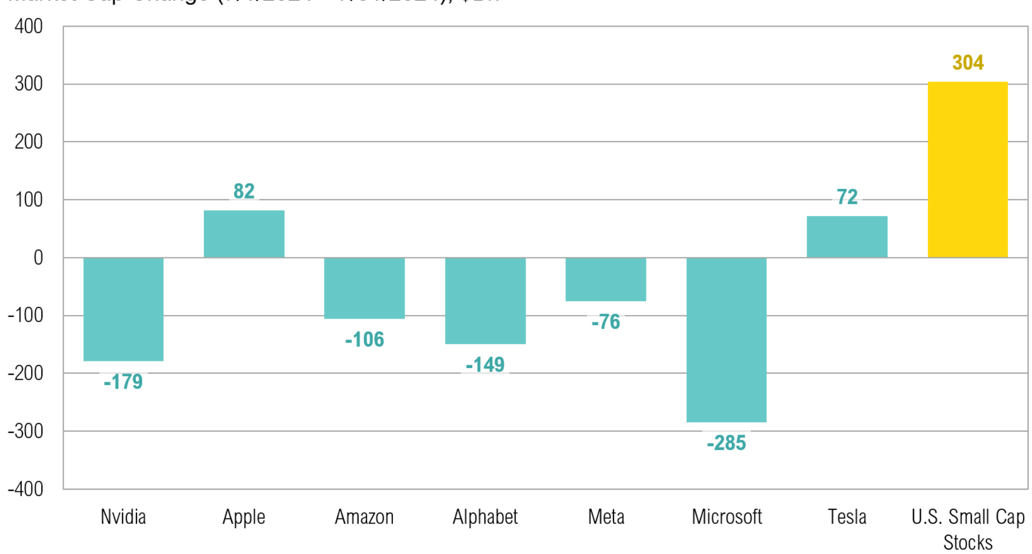
Although the rally in small cap stocks evoked memories of 2000—a period when small caps continued to outperform for years—distinct differences raise questions about the sustainability of the recent rally. One key difference is that, before this year's rally, there was a dramatic rise in heavily shorted securities, as indicated by the GS Most Shorted Index, which reached its highest level since September 2022. This suggests that much of the rally in small cap stocks was likely the result of short covering and investors' desire to rebalance away from extreme positions. Short covering occurs when investors who have sold stocks short buy them back to close their short positions, often to limit losses or lock in profits, and these purchases can push stock prices higher. The small cap rally likely also represented a de-risking event in which investors sought to reduce their exposure to large-cap positions. According to the Bank of America's Global Fund Manager Survey, the "long Magnificent Seven" has been the most overcrowded trade for several quarters.[14] However, mega-cap stocks are also less expensive than they were in 2000. The average price-to-earnings (PE) ratio of the S&P 500 Information Technology Index peaked at 32x on July 10, compared to a peak of 59x on March 24, 2000. Furthermore, smaller companies are less profitable today than they were then: 41% of companies in the Russell 2000 now have negative earnings, compared to 19% in March 2000.[15]

After gaining 37% in the first six months of the year, the Magnificent Seven ended July down 1.2%, erasing over $640 billion in market cap. Despite the rally in small caps, the entire Russell 2000 Index's market cap gain of $304 billion in July was little more than what Microsoft alone lost in terms of market cap over the same period.

The Magnificent Seven erased over $640 billion in market cap in July

U.S. Small Caps Gained Only a Little More in Market Cap than Microsoft Lost

Market Cap Change (7/1/2024 – 7/31/2024), $Bn



Source: Bloomberg. U.S. small cap stocks as proxied by the Russell 2000 Index.

Earnings will likely play the deciding role in the sustainability of the rally. As of the end of July, Bloomberg Consensus showed earnings growth for the Magnificent Seven rising by 46% in 2024, while slowing to a still-impressive 20% in 2025. In contrast, earnings growth expectations for the Russell 2000 in 2024 are more modest at 3% but are projected to jump to 36% in 2025. If the earnings growth for U.S. small cap stocks materializes, the rotation may turn out to be sustainable. A smooth pass of the baton from long-favored large cap stocks to their small cap counterparts would likely suggest a certain level of economic resiliency.

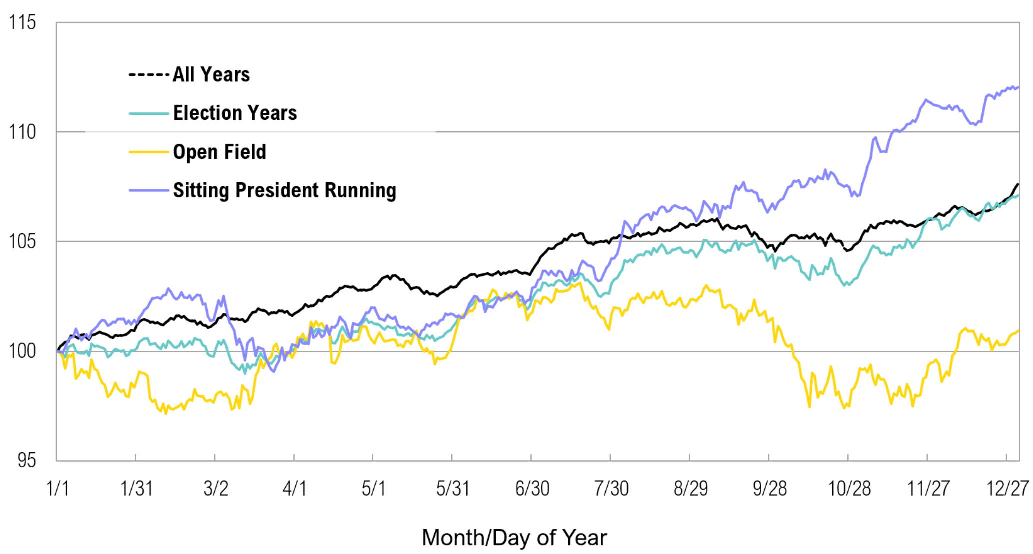
The spread between Trump and Harris had narrowed to a roughly 50/50 split by the end of July

On July 21, President Joe Biden officially announced his withdrawal from the race and endorsed current Vice President Kamala Harris as the new Democratic presidential nominee. Up until President Biden's decision to withdraw from the 2024 presidential race, former President Donald Trump had been leading in the polls, and betting markets favored a 64% probability of a Trump win over a 36% probability of a Biden win.[16,17,18] With this historic spread, which endured for most of July, and based on recent performance of several sectors, it seems that markets were looking back to 2016 for a possible repeat of history, as U.S. small cap stocks increased by 18.3% in the two months following the Trump election in 2016. As of the end of July, the spread between Trump and the now-Democratic nominee Harris had narrowed to roughly a 50/50 split.[16,17,18]

Now that the political baton has been passed to a new Democratic candidate, markets are dealing with the inevitable volatility that typically characterizes a closely contested election. History suggests that the seasonal trends of U.S. large cap stocks tend to be influenced by whether the incumbent president runs for re-election or not.

Volatility in U.S. large cap stocks tends to increase as a closely contested election nears

Expect Volatility as Election Day Nears, Particularly with Biden's Withdrawal
S&P 500 Returns During an Election Year, Growth of 100



Source: Bloomberg

In scenarios where the incumbent is running, summer trading has generally been subdued, and the S&P 500 has shown a gradual upward trend, followed by a slight decline towards the end of August. Conversely, in years when the incumbent does not seek re-election, trading during the summer months has tended to exhibit greater choppiness and volatility has extended from August through November. Thus, volatility at this point in the election cycle is quite normal and to be expected. In more ways than one, the race is on.

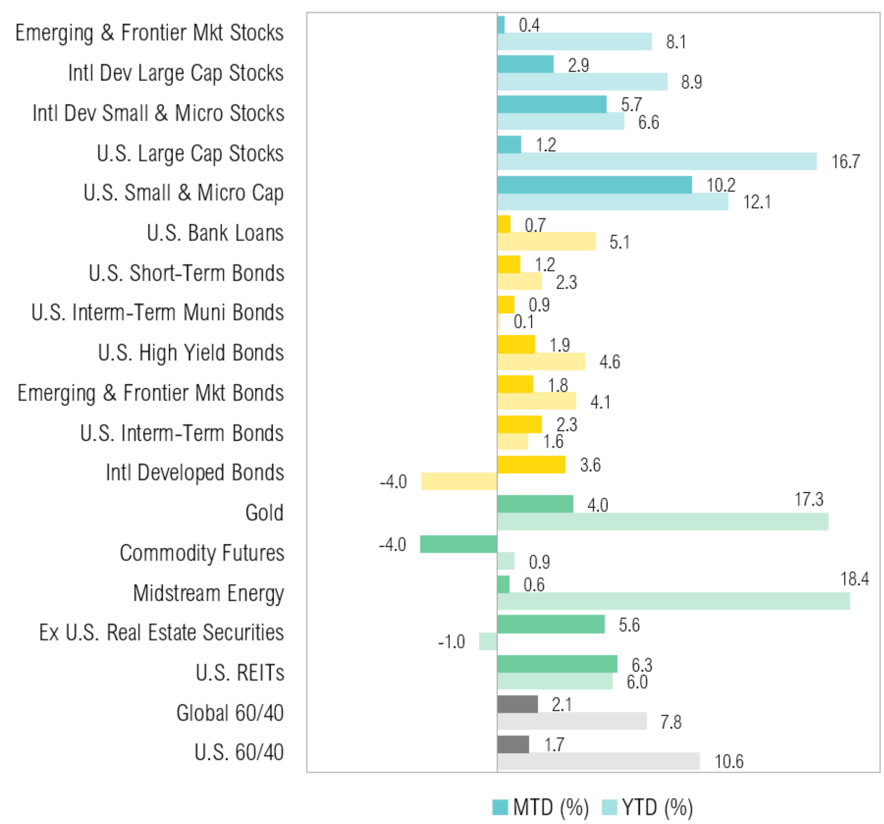
Markets

In addition to the strong returns for U.S. small cap stocks, U.S. REITs gained 6.3%, as interest rate-sensitive areas of the market celebrated the milder inflation report and increasing likelihood of rate cuts. U.S. intermediate-term bonds gained 2.3% on similar sentiment. International small cap stocks outperformed their large cap counterparts. The former ended July up 5.7%, and the latter ended the month up 2.9%. Gold ended the month up 4.0%, reaching a new high of $2,471 per ounce on July 18. Commodity futures were the worst-performing sector, ending the month down 4.0%, followed by emerging and frontier market stocks, which gained only 0.4%.

The 10-year minus 2-year Treasury yield neared the point of dis-inversion

The 10-year minus 2-year Treasury yield, a common indicator of economic growth and general representation of the Treasury yield curve, reached -0.09 basis points on July 24, the nearest point of dis-inverting since it inverted on July 6, 2022.[19] As of the end of July, the yield curve had been inverted for 523 consecutive trading days—the longest on record, with or without a recession.

July 2024 Key Market Total Returns



Source: Bloomberg

The Bank of Japan's recent rate hike and currency intervention led to a rapid strengthening of the yen

The Japanese yen reached its lowest level in four decades against the dollar, sinking to ¥161. However, it rallied 11% in the last week of July, strengthening to ¥142. The rebound was largely driven by currency intervention from the Bank of Japan. An official report showed Japanese authorities spent nearly $37 billion in July to shore up the weak yen.[20] Amid currency weakness earlier in the month, the Bank of Japan hiked interest rates from 0.1% to "around 0.25%" on July 31, raising Japanese rates to their highest level since 2008.[20,21] The Bank of Japan's decision to hike interest rates to 0.25% and the

Yen carry traders have found themselves in a precarious position

rapid strengthening of the yen have left carry traders finding themselves in a precarious position as they now face increased loan repayment costs in U.S. dollars due to the yen's appreciation. This unexpected shift has forced some traders to liquidate assets to repay their yen-denominated loans, reflecting a widespread miscalculation that Japan's interest rates would remain at zero indefinitely.

Looking Forward

Aside from the Olympics, several other market and political races will compete for investors' attention—and likely contribute to market volatility—in the coming months. This includes volatility in interest rates as bond investors balance the competing forces of slowing growth, the start of an imminent rate-cutting cycle, and fiscal spending that continues at crisis-era levels.

Several market and political races will compete for investors' attention in the coming months

Although lower asset prices would be a welcome development and an opportunity to put additional capital to work, typical election year seasonals—coupled with still-high equity valuations—suggest that there is no rush. That said, like the Olympics, only time will tell who the ultimate winners in several of these races will be. Until then, we believe clients are best served reminding themselves of the timeless principles of patience and diversification, especially with uncertainty around an extremely contentious presidential election.

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DEFINITIONS

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Intermediate-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Intermediate-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

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