MARKET COMMENTARY

Status Quo

Q2, 2024

- U.S. markets delivered mixed results in the second quarter. Large cap stocks climbed 4.3% while small cap stocks declined by 3.3%. Bonds ended the quarter up 0.1%.
- Despite market and Fed expectations for at least one interest rate cut this year, U.S. inflation remains above the Federal Reserve's 2% target.
- A handful of mega-cap technology stocks have contributed to most of the S&P 500's year-to-date gains as market breadth remains narrow and tech sector valuations are at the high end of historical ranges.
- The fiscal situation remains precarious, as evidenced by a notable lack of fiscal responsibility in the recent presidential debate, which suggests a persistent lack of budgeting restraint.
- Despite these concerns, slowing growth and inflation appear enough to keep the bond market content, and yields remain relatively contained—at least for now.

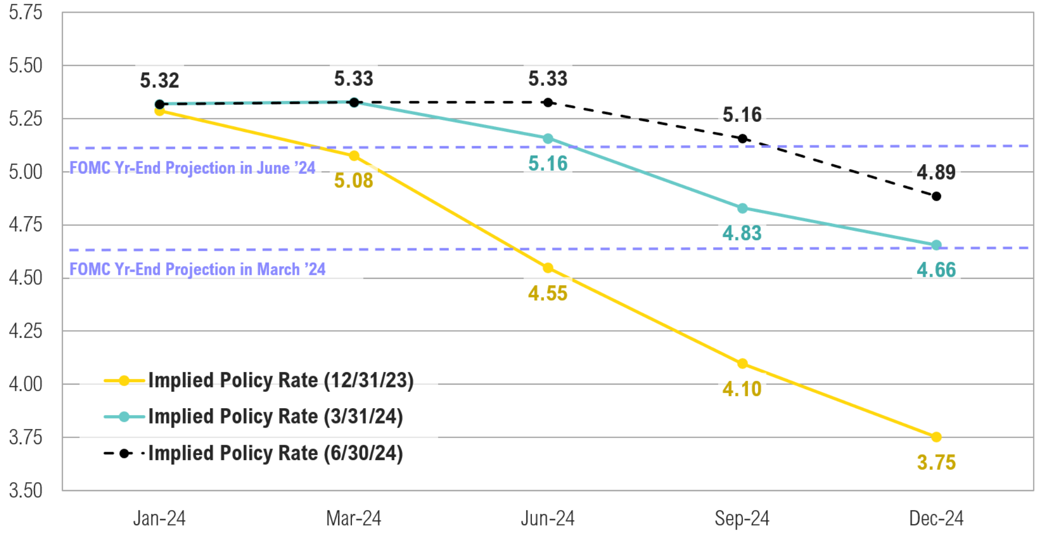
Overview

Equity markets delivered mixed results in the second quarter. U.S. large cap stocks climbed 4.3% over the quarter, bringing the S&P 500's year-to-date return up to 15.3%. In contrast, U.S. small cap stocks ended the quarter down 3.3%, and the Russell 2000 has gained only a modest 1.7% year to date. This is only the tenth time since 1990 that the quarterly spread between U.S. large caps and U.S. small caps has exceeded 7.0%, and most of those occurred in the lead-up to the tech bubble. The Bloomberg U.S. Aggregate Bond Index ended the quarter up 0.1% and finished the first six months of the year down 0.7%.

Inflation has been on a rocky road back down to the Fed's 2% target—which it has yet to reach

June marked the two-year anniversary since year-over-year U.S. inflation hit a four-decade high of 9.1%. Since then, inflation has been on a rocky road back down to the Fed's 2% target (which it has yet to reach), dropping to 3.0% in June 2023 and slightly rising at the end of May 2024 to 3.3%.[1] At the June Federal Open Market Committee (FOMC) meeting, the Federal Reserve opted to keep interest rates unchanged for the seventh consecutive meeting, and Fed chair Jerome Powell reiterated that the central bank did not yet have the necessary confidence to start cutting interest rates.[2] Market expectations for interest rate cuts dramatically shifted over the first half of 2024: In January, markets expected the equivalent of seven rate cuts in 2024, but by June, markets were expecting one to two cuts for this year.[3]

Market Expectations for Rate Cuts Have Notably Declined Since January
Implied Fed Funds Rate, %



Source: Bloomberg. FOMC projections are medians.

Market expectations for rate cuts have declined from seven in January to less than two

First-quarter earnings results showed that S&P 500 companies fared better than analysts expected. Year-over-year earnings growth for the quarter rose from an expected 3.4% at the end of March to 5.9% at the end of June.[4] For second-quarter earnings, the entire S&P 500 is expected to report year-over-year earnings growth of 8.8%, and full-year 2024 earnings growth estimates have now hit 11%.[5] Eight of the eleven S&P 500 sectors reported year-over-year earnings growth, led by communication services at 34%, utilities at 32%, and information technology at 25%.[5] A short list of companies, particularly in these sectors, continue to drive earnings growth and dominate market returns. For example, if Meta and Alphabet are excluded from results, earnings growth in the communication services sector falls from 34% to just 1.8%.[6]

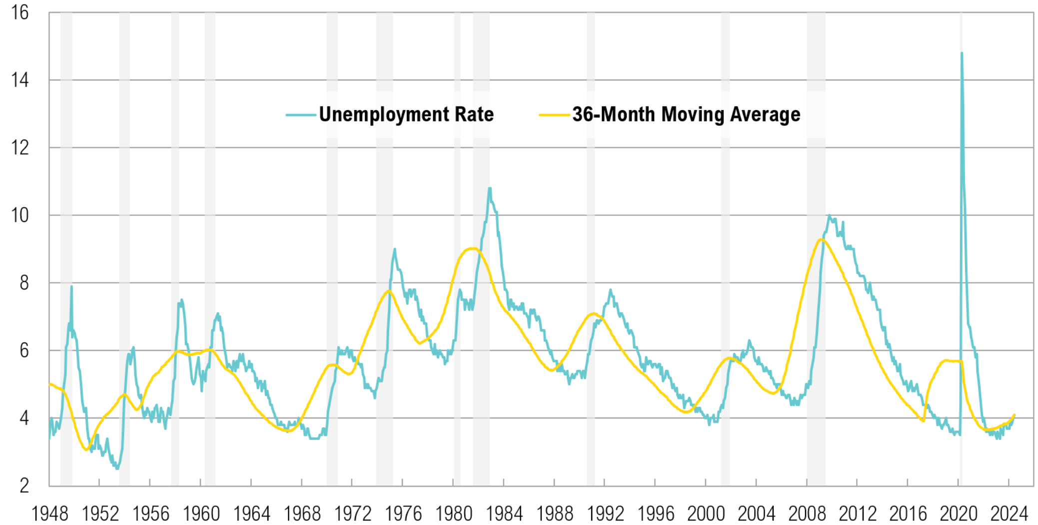
Overall, the U.S. consumer remained resilient throughout the first half of 2024. Personal income data remained stable, increasing at an average month-over-month rate of 0.5% for the first five months of 2024 (the most recent data available), compared to the 0.4% average monthly increase for the first five months of 2023.[7] This, along with consumer access to credit and buy-now-pay-later (BNPL) programs, suggests that consumer spending may be able to persist despite higher interest rates. However, consumer sentiment dropped notably over the past quarter. The University of Michigan's consumer sentiment index dropped from a two-year high of 79.4 at the end of March to 68.2 in June in its sharpest three-month fall since April 2022.[8]

Although the unemployment rate remains low, it has been trending higher

Consumers' willingness to spend appears intact given the solid labor market. Although the U.S. unemployment rate remains low, at 4.1%, it has slowly been trending higher, crossing above its 36-month moving average of 4.0% for the first time in four years—a trend that historically has been followed by a more noticeable increase in the jobless rate. Job openings climbed higher in May, to 8.1 million, from a downwardly revised 7.9 million in April.[9] The May JOLTS report highlighted a notable development in the U.S. labor market: For every job seeker, there were still 1.22 job openings, which suggests some persistent tightness in the labor market.[9] The quits rate has also held steady at 2.2% for seven consecutive months, slightly above the 20-year average of 2.0%.[10]

Historically Tight Labor Market has Started to Soften

U.S. Unemployment Rate vs 36-Month Moving Average



Source: Bloomberg

ISM Services PMI contracted due to lower business activity and persistently high prices

Additional signs of softening economic data emerged over the second quarter. Final first-quarter GDP estimates showed that quarter-over-quarter annualized growth dropped from 3.4% to 1.4%, and the consumer spending portion of GDP was revised down from 2% to 1.5%.[11] Despite ongoing consumer spending, retail sales declined by 0.2% month-over-month in April and rebounded only slightly in May, rising by 0.1%. Moreover, the ISM Services PMI unexpectedly dropped back into contractionary territory in June, falling to 48.8 (less than 50 indicates contraction) while the ISM Manufacturing PMI remained in contractionary territory in June.[12] The services PMI declined primarily due to lower business activity, fewer new orders, and persistently high prices.[13]

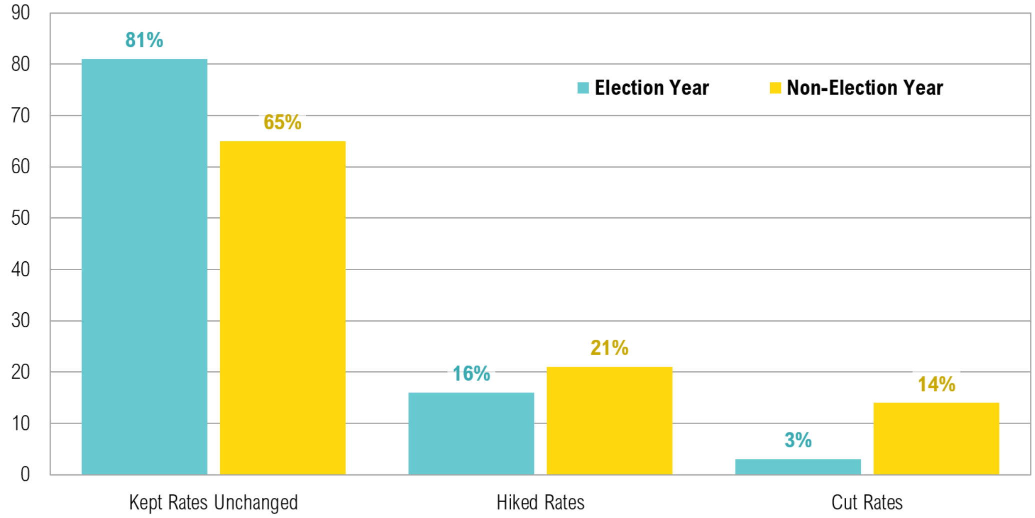
Status Quo

Despite a notable improvement from the four-decade high of 9.1% in June 2022, U.S. inflation remains well above the Fed's official 2% target, at 3.3%. While the Fed has maintained interest rates at 5.25% to 5.5% for nearly twelve months, other central banks worldwide have started to reduce rates. On April 3, the Swiss National Bank became the first G10 central bank to cut interest rates this cycle.[14] On June 5, the Bank of Canada lowered interest rates by 25 basis points, and on June 6, the European Central Bank followed suit, marking the first rate cut since 2019.[14,15] Over the quarter, many have appealed to the Fed to cut interest rates. Senator Elizabeth Warren on June 10 sent a letter to the Fed urging them to lower rates, and even President Biden in April stated, "Well, I do stand by my prediction that, before the year is out, there'll be a rate cut."[16,17]

For now, the Fed seems content with the status quo of elevated interest rates and inflation above 2%

Although the Fed's economic projections have been revised downwards from two cuts to one rate cut for this year (and the year-end inflation rate has been revised upwards from 2.6% to 2.8%), history shows that the Fed tends to prefer keeping rates unchanged as a presidential election day draws nearer. Between 1994 and 2023, the Fed kept interest rates unchanged 81% of the time in the six months leading up to election day and cut rates only 3% of the time—all during 2008.[18] However, in September 2012, the Fed announced open-ended quantitative easing, a form of policy easing, so anything is possible.[19] Also, at its May FOMC meeting, the Fed announced that it plans to taper quantitative tightening, which implies it will purchase approximately $500 billion in Treasuries over the next twelve months.[20] So, for now, it seems that the Fed is content with the status quo of elevated interest rates and inflation above 2%.

The Fed Tends to Keep Interest Rates Unchanged as Election Day Nears
Average FOMC Rate Decision Between May and November (1994 – 2023), %



Source: Federal Reserve, Bespoke Investment Group. Analysis between 1/1/1994 and 8/31/2023.

Only 17% of S&P 500 stocks outperformed the index in June

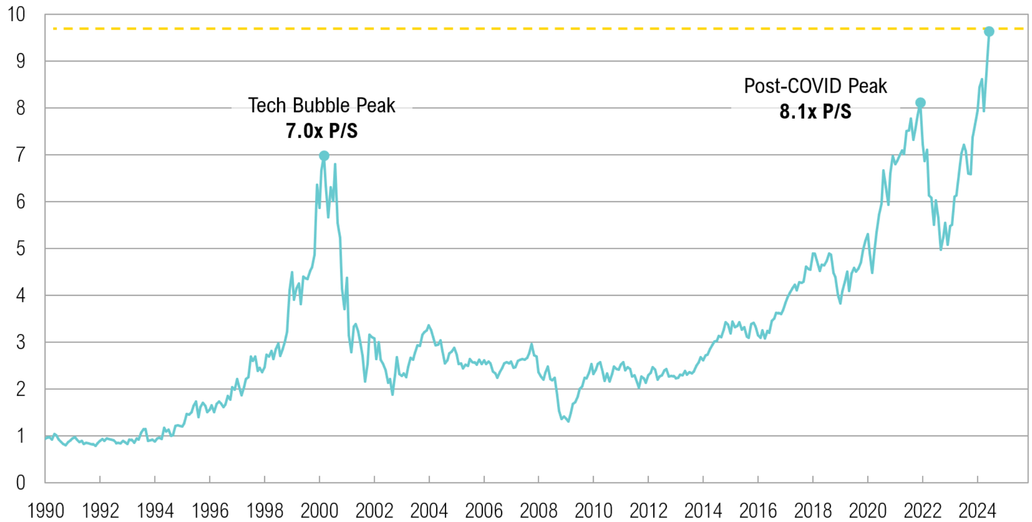
Bolstered by mega-cap technology companies and continued enthusiasm surrounding artificial intelligence, the S&P 500 ended the second quarter up 4.3%. The technology sector fared best, gaining 14% over the quarter, followed by communication services, which gained 9%, and utilities companies, which ended the quarter up 5%. The Magnificent Seven—Apple, Microsoft, Meta, Alphabet, Amazon, Tesla, and Nvidia—have gained more than 35% year to date, compared to the 8% gain that the other 493 stocks in the S&P 500 have made. The narrowness is extreme. Only 17% of S&P 500 stocks outperformed the index in June, compared to the historical average of 49%, marking the lowest participation rate in at least a decade.[21] Further, the correlation between the S&P 500 market cap and equal-weighted indices is among the lowest in 25 years. As unusual as the narrowness is, it is hard to argue that it isn't at least partially justified by earnings growth trends. In 2023, the Magnificent Seven enjoyed year-over-year earnings growth of 19.3% while the rest of the S&P 500 (or the S&P 493) saw earnings decline by 1.4%. The status quo divergence in earnings growth is expected to continue in 2024, as full-year earnings for the Magnificent Seven are expected to rise by 53.5% while earnings for the rest of the 493 S&P 500 companies are expected to rise by only 4.2%.

The S&P 500 has experienced its longest period without a daily decline of 2% since the GFC

This mega-cap tech rally has been accompanied by historically low levels of volatility. The S&P 500 has now experienced its longest period since the Global Financial Crisis without a daily decline of 2% or more, and the ongoing rise in tech stocks has pushed valuations higher.[22] The S&P 500 technology sector ended June at a 9.8x price-to-sales (P/S) ratio, which was 40% higher than the tech bubble peak of 7.0x. Similarly, the median S&P 500 technology stock ended June with a 6.6x P/S compared to 5.5x at the peak of the tech bubble. This market exuberance was further captured in investor sentiment: The Bank of America's Fund Manager Survey showed its most bullish sentiment since November 2021.[23] Meanwhile, expectations for a global "hard landing" made new lows, and household stock allocations hit 70-year highs of 34.5%.[23,24]

Tech Sector Price to Sales Ratio Ended June 40% Higher Than Tech Bubble Peak

S&P 500 Information Technology Sector, Price to Sales Ratio



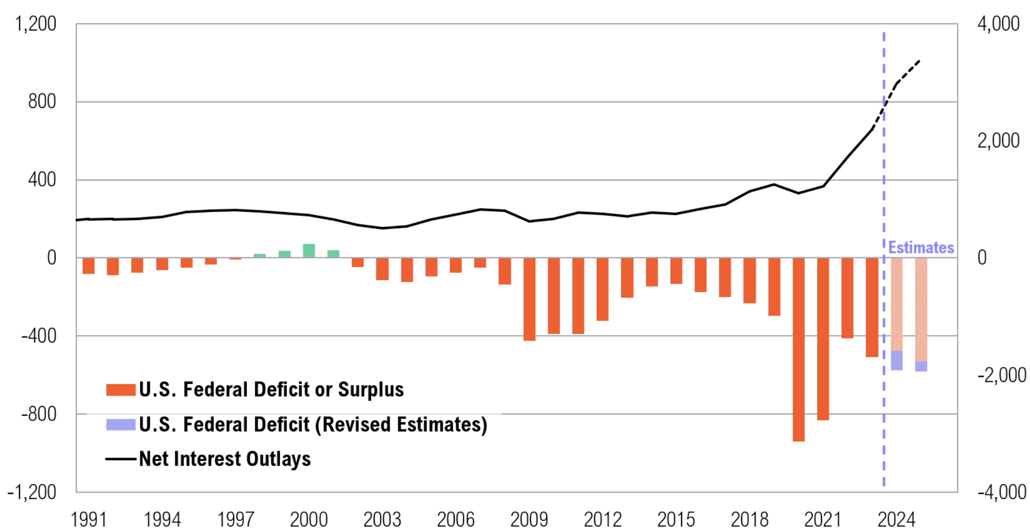
Source: Bloomberg

A key takeaway from the recent presidential debate was a lack of focus on fiscal responsibility

The precarious fiscal situation in the U.S. continues. The fiscal year-to-date budget deficit has reached $1.2 trillion.[25] On June 18, the Congressional Budget Office (CBO) revised the expected fiscal budget deficit upwards to $1.9 trillion (or 6.7% of GDP)—a 27% increase from its original February estimate of $1.5 trillion.[26] This level of deficit spending is more akin to an economy in recession or one dealing with a global pandemic. Net interest outlays, which are projected to increase significantly, are expected to constitute a growing share of the deficit—rising from $650 billion in 2023 to $892 billion in 2024—and they are expected to increase to $1.7 trillion by 2034.[26] Unadjusted for inflation, the U.S. is expected to add as much debt in the next decade as it did from 1789 to 2021.[26] A key takeaway from the recent presidential debate, held on June 27 between President Biden and former President Trump, was a lack of focus on fiscal responsibility. Neither candidate proposed measures for budget restraint, likely reinforcing the recent CBO projections for an escalating fiscal budget deficit.

CBO Revised 2024 Fiscal Budget Deficit Projections Upwards by 27%, to $1.9Tn

Net Interest Outlays, $Bn U.S. Federal Deficit or Surplus, $Bn



Source: Bloomberg

Bond markets have remained stable despite higher inflation and continued fiscal spending

Bond markets have remained stable despite higher inflation and continued fiscal spending. Throughout the quarter, yields were relatively contained. The yield curve shifted higher in April on hotter-than-expected inflation data, but it flattened again following a series of softer economic data prints over the last two months of the quarter, specifically when lower first-quarter GDP revisions and ISM PMIs dropped into contractionary territory. The 10-year Treasury yield ended the quarter at 4.4%, and the 2-year Treasury yield ended the quarter at 4.7%.

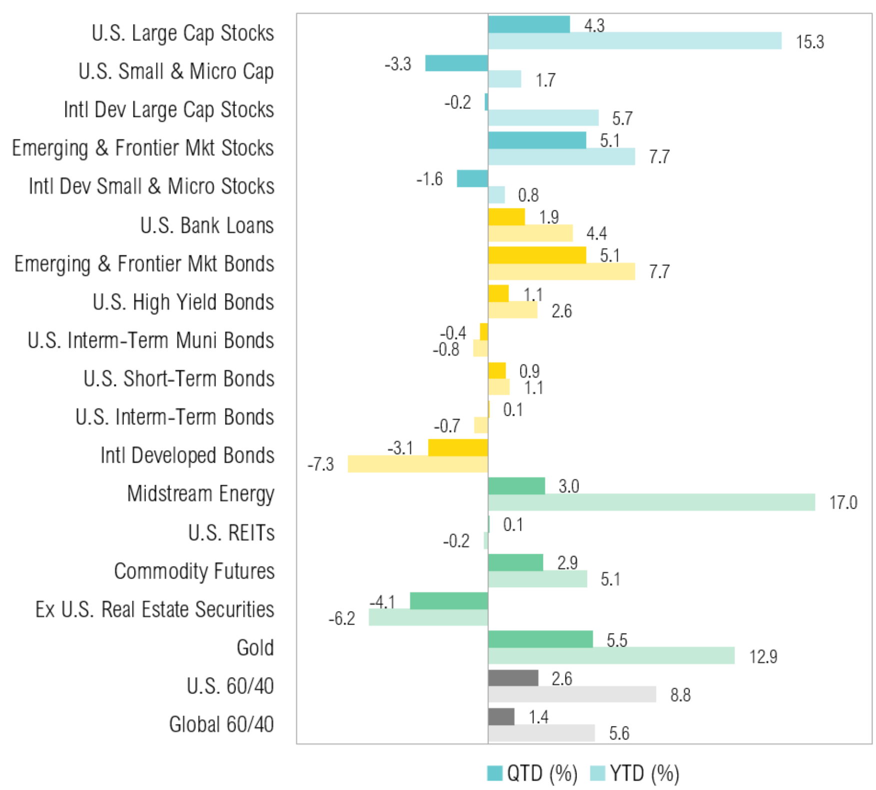
Treasury yields jumped higher in the closing days of the quarter, likely due to concerns over the fiscal implications of a possible Republican sweep in November.[27] History shows that budget deficits tend to expand when one party controls both Congress and the White House.[27] Increased deficits (which seem inevitable, at least in the shorter term) could lead to an increased supply of bonds and may put downward pressure on Treasury prices. Despite these concerns, slowing growth and inflation appear to be enough to keep the bond market content, and yields remain relatively contained.

Markets

Performance in several emerging markets was largely determined by election outcomes

In equity markets, emerging and frontier market stocks were the top performers, gaining 5.1% over the quarter. Performance in several emerging markets was largely determined by election outcomes, including notable elections in South Africa, Mexico, and India over the past three months. The MSCI South Africa Index ended the quarter up 12.3%, the MSCI Mexico Index ended the quarter down 16.1%, and the MSCI India Index ended the quarter up 10.2%. Bolstered by a handful of mega-cap tech companies, U.S. large cap stocks ended the quarter up 4.3%. U.S. small cap stocks were the worst-performing equities, ending the quarter down 3.3%. U.S. intermediate-term bonds ended the quarter up 0.1% and are down 0.7% year-to-date.

Q2 2024 Key Market Total Returns



Source: Bloomberg

Gold ended the second quarter up 5.5%, reaching a new record high of $2,446 per ounce on May 20. After dropping to $73.2 per barrel on June 4, West Texas Intermediate (WTI) crude ended the quarter at $81.5 per barrel. Gas prices, which had been slowly declining after peaking at $3.8 per gallon on April 22, ticked higher as oil surpassed $80 per barrel, and the national average price per gallon of regular unleaded gas ended June at $3.6 per gallon.[28]

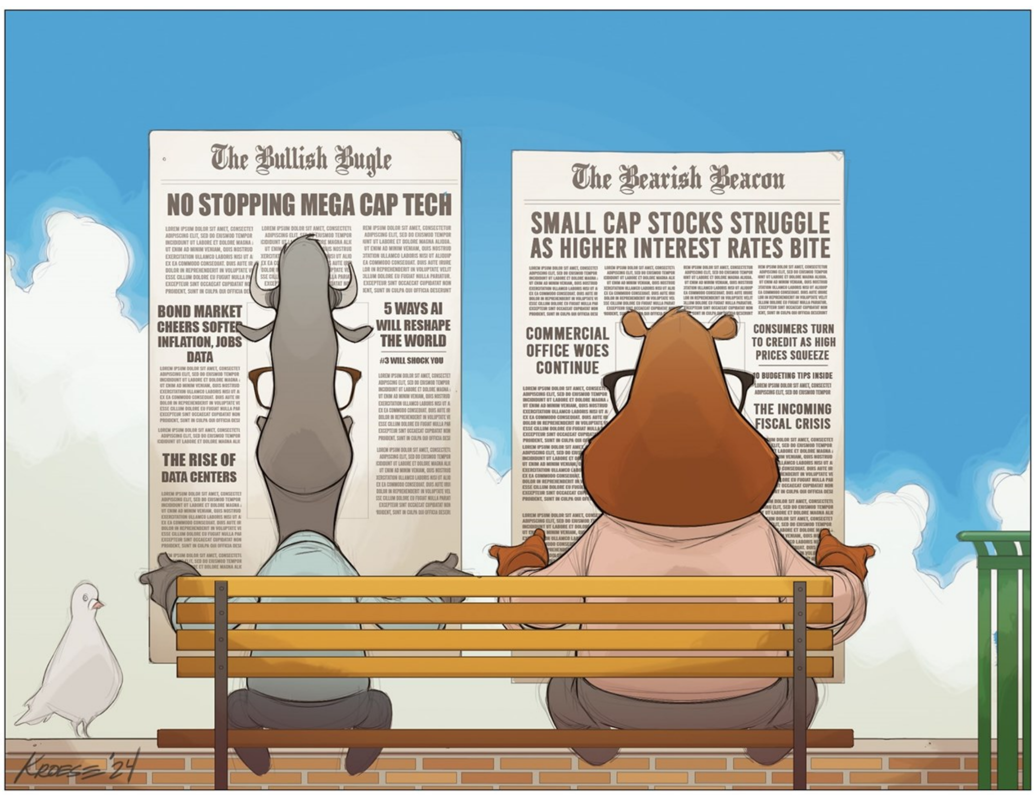
The Japanese yen dropped to the lowest levels in nearly four decades

The Japanese yen reached the lowest levels in nearly four decades on June 28, declining to ¥161 against the U.S. dollar. Over 60 countries will hold general elections over the course of 2024, and more than two billion people are registered to vote this year.[29] In France, the first round of snap elections, held on June 30, led to protests, and the final outcome will be determined in the first week of July. The MSCI France Index ended the quarter down 7.5%, in part due to election uncertainty.

Looking Forward

Capital markets have been in risk-on mode since the Fed's pivot in December 2023. Since then, U.S. large cap stocks have gained 19.1%, and U.S. intermediate-term bonds have seen only a 2.1% increase, highlighting the trade-offs associated with a looser approach to inflation. Although elements of this market environment seem unsustainable, there is no reason the current unusual dynamics cannot continue as long as the underlying conditions—such as crisis-level fiscal spending, an implicitly higher inflation target, the tapering of quantitative tightening, a stable labor market, and decent economic growth—continue. As long as these factors are maintained and longer-term bond yields remain stable, the economy and markets will have sufficient liquidity to function, and investors may continue to favor mega-cap growth companies, regardless of their valuations, at the expense of other areas of the market.

The current unusual dynamics may continue as long as supportive underlying conditions continue



Source: SpringTide, Noah Kroese

The bond market may serve as the final arbiter in determining when this slow-motion crisis reaches a critical point

With limited political will from both the Democratic and Republican parties to cut spending, looser fiscal policy could continue to impede the Fed's efforts to bring inflation back to 2% while also increasing the U.S. debt burden. Ultimately, the bond market may serve as the final arbiter in determining when this slow-motion crisis reaches a critical point. While a rotation to broader equity market breadth would be welcome, as there are attractive opportunities around the world, predicting the exact timing of such a rotation is impossible. For now, the status quo may continue—that is, until it doesn't.

Citations

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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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