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Market Overview

The Nasdaq[1] and S&P 500[2] indices experienced second quarter gains while the Dow Jones Industrial Average[3] was lower as yields stabilized. In addition, earnings came in stronger than expectations led by the mega caps, and inflation continued its course towards the downside. The Nasdaq Index led the second quarter stock gains finishing up 8.47%, with the S&P 500 Index and the Dow Jones Industrial Average Index trailing at 4.28% and -1.25%, respectively.

During the second quarter of 2024, technology was the best performing sector, gaining 8.62%, followed by communication services at 4.90%, and utilities by 3.79%. The 1Q24 earnings season delivered robust results, with pro-forma earnings increasing by more than 6% year-over-year, buoyed by margin expansion. While persistent dominance by the "Magnificent 7" has characterized earnings growth for a while, we anticipate a shift in this pattern. As 2024 unfolds, we expect broader sector leadership in profitability to foster a more inclusive rally across the equity market.

The Federal Reserve (the "Fed") kept interest rates unchanged throughout the quarter. Inflation stayed persistently high, surpassing 3% throughout the initial half of 2024, raising worries that it might persistently exceed the Fed's desired level.[4] Although the decline could be slower than anticipated, stable supply chains, slowing wage increases, and notable decreases in housing and car insurance costs are expected to help inflation gradually decrease again, with the goal of reaching the Fed's desired 2% target by mid-next year.

Bond yields (10-year) remained relatively range bound during the second quarter from a high 4.74% to a low of 4.19%. In June, Treasury yields fell, but for the quarter, they increased. The 10-year note closed June at 4.40%, marking a 19 basis point rise from March 31. The two-year Treasury yield also rose by 14 basis points to 4.77%, keeping the yield curve inverted. For the quarter, investment-grade credit spreads widened slightly, while corporate bonds saw a modest decline and underperformed Treasuries. Mortgage-backed securities (MBS) showed a slight underperformance compared to Treasuries overall, but outperformed in June specifically. High-yield corporate bonds made gains both for the month and the quarter.

Turning to international markets, emerging market equities outperformed developed market stocks during the quarter.[5] Chinese policymakers have accelerated monetary, fiscal, and regulatory easing measures to bolster economic growth. While these actions have helped stabilize the economy to some extent, it is uncertain whether they will lead to a complete resurgence in economic activity. The prospects for eurozone economies are improving with increased industrial activity, better bank lending growth, and inflation moving closer to the European Central Bank's (ECB) target range. In early June, the ECB implemented its initial 25-basis-point rate reduction, and market expectations suggest another 100 bps of easing could follow in the next year.

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U.S. Equity Returns Table
Source: Tamarac

Index	Q2 2024 Returns	2024 Returns
Dow Jones	-1.25%	4.79%
S&P 500	4.28%	15.29%
NASDAQ	8.47%	18.57%
Russell 2000	-3.28%	1.73%
MSCI World	1.17%	6.04%

U.S. Treasury Yield Table
Source: Treasury

	06/2024	06/2023	06/2022
3 month	5.48%	5.43%	1.72%
2 year	4.71%	4.87%	2.92%
5 year	4.33%	4.13%	3.01%
10 year	4.36%	3.81%	2.98%
30 year	4.51%	3.85%	3.14%

Other Indices Table
Source: Morningstar

	Q2 2024 Returns	2024 Returns
Gold (GLD)	4.52%	12.47%
Brent Oil (BNO)	0.75%	17.72%
U.S. Dollar Index (UUP)	2.68%	7.53%
Int'l Equity Markets (EFA)	-0.18%	5.79%
Emerging Equity Markets (EEM)	4.39%	6.65%

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Will the Market Finally Broaden in 2024?

Despite forecasts calling for a broader market rally in the quarter, the S&P 500 Index surged once again in Q2 2024, driven to a large extent by mega-cap technology stocks. In fact, the market narrowed during the quarter, with the S&P 500 Equal Weight Index[6] *declining* by 3.1% compared to the 3.9% *increase* in the market cap weighted version. With a growing performance divergence between mega-cap stocks and the rest of the market, what does the remainder of 2024 hold for stocks? For the answer to this question, we must turn once again to a discussion of recent macroeconomic trends.

Those of you who follow Chairman of the Federal Reserve (the "Fed") Jerome Powell know that he is fond of discussing the Fed's "dual mandate" of promoting maximum employment and stable prices. On the topic of employment, we note that in May 2024, the unemployment rate increased by 10 basis points to 4.0%.[7] The slight increase in the unemployment rate likely continues to signal that the labor market, while remaining resilient, has begun to show signs of slowing. In my view, this trend continues to represent the preferred "goldilocks" scenario in which unemployment remains historically low while beginning to increase slightly, indicating that the labor market, and by extension the economy, is beginning to slow down.

After several months of discouraging consumer pricing trends as inflation progress appeared to stall, the May reading from the Fed's preferred measure of inflation, the Personal Consumption Expenditures (PCE) Price Index, represented a welcome respite. The PCE Price Index was unchanged in May and was up 2.6% on a 12-month basis.[8] Both numbers were in line with consensus estimates and the 12-month figure represented a modest decline from the 2.7% number reported in April. The report also detailed that May consumer spending increased 0.2% on a nominal basis and 0.3% after factoring in inflation, indicating that the U.S. consumer remains relatively healthy in aggregate. While the PCE report was encouraging, the Federal Reserve's stated inflation target is 2.0% and it will likely want to see several months of persistent progress towards this goal before it initiates the rate cutting process.

Turning to economic growth, Q1 2024 GDP growth was recently revised up to a final estimate of 1.4%, up slightly from the second estimate of 1.3%. At first blush, this appears to represent a marked deceleration from Q4 2023 GDP growth of 3.4%. However, it is important to note that a sharp spike in imports resulted in net exports, a notoriously volatile category, acted as a 0.65% drag on Q1 2024 GDP.[9] By comparison, net exports *boosted* GDP by an average of 0.23% from Q1 2023 to Q4 2023. While the initial estimate for Q2 2024 GDP will not be released until July 25th, the Federal Reserve Bank of Atlanta's GDPNow forecasting model is currently calling for Q2 2024 GDP growth of 1.5%, which is consistent with a cooling but still growing economy.[10]

Putting all of these data points together provides us with a picture of a strong but slowing economy, a relatively healthy consumer, and slow progress in the inflation battle. I continue to believe these indicators point to interest rates staying higher for longer. In fact, I am inclined to concur with the most recent Federal Open Market Committee's projection for rate cuts, which implies one 25 basis point rate cut by the end of 2024. The earliest opportunity for a rate cut would occur at the next Federal Open Market Committee (FOMC) meeting, which will take place from 7/30/24 to 7/31/24. I view a July rate cut as being highly unlikely and believe the September FOMC meeting, which will occur from 9/17/24 to 9/18/24 to be a more realistic rate cutting opportunity, though that date may also prove to be premature.

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Will the Market Finally Broaden in 2024? (continued)

What provides me with the confidence that the Fed will hold off on rate cuts until at least September if not later? First, Chairman Powell has repeatedly indicated his desire to see sustained progress towards the Fed's 2% inflation target before he is comfortable cutting rates. A July rate cut does not provide the Fed with enough data points to make this evaluation and a September rate cut may also not provide the Fed with enough of a sample size. Second, with the economy still growing, a healthy overall consumer environment, and unemployment remaining relatively low, I see no reason for the Fed to rush into the rate cutting process. Third, with the "last mile" of the inflation battle proving to be relatively challenging, the worst mistake the Fed could possibly make in my view would be to declare a premature victory by cutting rates too soon, reigniting inflation in the process.

Circling back around to the stock market, what does all of this mean for equities? If the Fed is able to keep rates higher most of 2024 without triggering a recession, i.e. the "soft landing" scenario, I believe there is more room for the market to run. This does not mean that the pace set by large cap growth stocks in Q1 and Q2 2024 will prove to be sustainable as it almost certainly will not. While I believe large cap tech stocks with generative AI exposure will maintain market leadership, the ride will likely prove to be a bit bumpier as we have recently experienced with NVIDIA Corporation's (NVDA) late June price swings.

I also believe market breadth will expand as large cap stocks outside the generative AI ecosystem narrow the performance gap. In my view, this broadening will take place both within and outside of large cap equities traditionally classified as growth stocks. With regard to the former, I believe that the tech trade will broaden to include stocks in other technology industries such as enterprise software that have woefully underperformed their IT peers through Q2. In addition, while I continue to expect growth stocks to outperform value stocks in 2024, I believe the performance differential will close considerably as stocks from traditional value sectors such as Consumer Staples, Energy, Financials, and Industrials begin to benefit from a rotation back to value as multiples of growth stocks continue to climb. In addition, small cap stocks, after taking a breather for much Q1 and Q2, may begin to finally take off as the path to lower interest rates becomes clearer.[11]

In sum, while I continue to see the rest of the year being a bit choppier from a performance perspective, I continue to believe that a modest rate cutting environment in the absence of recessionary economic signals and/or resurgent inflation should propel the market higher, driven by a larger basket of stocks than the first half of the year. In addition, while the market in aggregate appears to be priced at a premium, I believe it there are pockets of the market that still appear attractive from a valuation perspective, and within these undervalued market segments, it is possible to find stocks that trade at a material discount relative to their near and long-term earnings power.

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Disclosures

Sources:

[1] The Nasdaq Composite is a stock market index that includes almost all stocks listed on the Nasdaq stock market and is heavily weighted towards companies in the information technology sector.
[2] The S&P 500 Index is designed to be a leading indicator of U.S. equities and is commonly used as a proxy for the U.S. stock market.
[3] The Dow Jones Industrial Average, Dow Jones, or simply the Dow, is a stock market index of 30 prominent companies listed on stock exchanges in the United States. The DJIA is one of the oldest and most commonly followed equity indexes.
[4] Source: U.S. Bureau of Labor Statistics. https://www.bls.gov/news.release/cpi.nr0.htm
[5] The MSCI World ex USA Index captures large and mid-cap representation across 22 of 23 Developed Markets countries (excluding the U.S.) and 24 Emerging Markets countries.
[6] The S&P 500 Equal Weight Index (EWI) is the equal-weight version of the S&P 500. The index includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight of 0.2% of the index total at each quarterly rebalance.
[7] Source: U.S. Bureau of Labor Statistics. https://www.bls.gov/news.release/pdf/empsit.pdf
[8] Source: Bureau of Economic Analysis. https://www.bea.gov/news/2024/personal-income-and-outlays-may-2024
[9] Swapping in this trailing four quarter average net exports boost in place of the 0.65% reported drag results in Q1 2024 adjusted GDP of 2.3%. We believe this adjusted Q1 2024 GDP figure of 2.3% represents a more accurate picture of the true health of the U.S. economy over the first three months of the year.
[10] Source: Atlanta Federal Reserve. The GDPNow model forecasts GDP growth by aggregating 13 subcomponents that make up GDP with the chain-weighting methodology used by the U.S. Bureau of Economic Analysis. https://www.atlantafed.org/cqer/research/gdpnow
[11] Small cap companies tend to carry higher relative levels of variable rate debt and tend to underperform large cap stocks in high interest rate environments due to their higher carrying costs of debt.

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