2H24 Update | Hold On Loosely, But Don't Let Go

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A Brief Look Back

The broader economy is finally showing signs of slowing. Monetary policy's unprecedented influence on the U.S. economy and capital markets during and following the COVID-19 pandemic remains evident today. While consumers and businesses strive to normalize behaviors, elevated price levels caused by generationally high inflation have only begun to decelerate meaningfully enough to impact consumer's wallets.

The Federal Reserve continues to struggle with messaging following one of history's most aggressive rate-tightening cycles. ***As a result, many economists and strategists find themselves in uncharted waters, with no historical context from which to compare and forecast. At the same time, investors are left in the cold, trying to discern signal from noise.***

Notwithstanding, equity indices have performed exceptionally well over the last 12 months, even with investors recalibrating expectations for interest rate cuts in 2024 to roughly two, from as many as six, dating back to 4Q23. ***However, the breadth of YTD returns is concentrated in a few names, continuing the narrative that began in October 2023.***

In addition, investment-grade bond spreads remain historically tight, and the yield curve has remained inverted for almost 600 days. In our opinion, this could be interpreted in one of two ways. Either as an omen forewarning of the potential for higher bond yields or a confirmation that the soft (or no) landing narrative will come to fruition, as corporate austerity and proactive balance sheet management will further support profit margins.

Still, global uncertainty prevails. The Russian/Ukraine War is over 850 days old. At the same time, no substantial peace accord is in the offing between Israel and Hamas, while an escalation between Israel and Hezbollah may be all but certain. Further, U.S. debt service has surpassed defense spending and Medicare, totaling over $34 trillion as of May 31, 2024. And let's not forget that 2024 is an election year when more Americans view both major party candidates unfavorably than at any time in the past ten elections. This concern is amplified by President Biden's challenging performance in last Thursday's debate, which has sent shockwaves through the Democratic Party and fueled rumors/obstacles of replacing him as the Party's nominee.

Through June 30, 2024, the S&P 500 is higher by 15.3%. However, an equal weight index of the S&P 500 is higher by only 5.1% during the same period. The NASDAQ is higher by 17.5% YTD, while the Dow is up only 4.8%. We observe that the Cyclical sector continues to outperform the Defensive sector, which is higher by 16.9% vs. 8.7% respectively. Further, Growth has outperformed Value, higher by 20.7% vs. 6.6%, respectively. Large Cap equities are up by 15.3% YTD, while Small Caps are up 1.7%. Technology and Communication Services have outperformed the broader equity market, driven specifically by names such as NVDA, AMZN, MSFT and META. Utilities recovered in 2024, up by 7.6% YTD, and higher by 3.9% over the trailing three months. The remaining equity sectors in the S&P 500 have averaged (simple) roughly a 7.0% return in 2024, with the exception being Real Estate, down over 4.1%.

Fixed Income, in general, has given back most of the early 2024 gains. Corporate Investment Grade bonds are down 0.7% for the year, while High Yield Bonds are higher by 2.6%. Short Duration Municipal Bonds are up roughly 0.7%, while longer-dated Municipal Bonds are down by roughly 0.8%. Short Duration Treasuries have outperformed, with 3-Month TBills up 2.7% and 1-3Yr Treasuries higher by roughly 4.2%. Longer Duration Treasuries have underperformed. An index of 10-year Treasuries is down about 2.0%, while Longer-Duration bonds are down as much as 5.0%.

Economic Update

We maintain the U.S. will enter (or is already in) a mild recession within the next 12 months. The recent employment trends (NFP, Household Survey, NIFB, Quits, Temp Employment, and Claims) are indisputable. We continue to reference our 2024 Outlook, which, based on the research of Kevin Kliesen, a business economist and researcher with the Federal Reserve of St. Louis, who introduced the notion that long expansions are typically followed by shorter and mild recessions.

Mr. Kliesen's research showed that **during the three post-WWII recessions that followed protracted expansions, GDP fell, on average, by only 0.9%, compared to a 2.6% contraction for the seven other recession periods.** In addition, **nonfarm payroll growth fell by only 1.5% during these three periods, versus negative 3.2%.** Further, the **unemployment rate increased by only 2.5% during these three periods versus the average increase of 3.5% during other recessions.** Also, we believe the true allegory to the current environment is the 2001 recession. As a reminder, the National Bureau of Economic Research (NBER) didn't even declare the U.S. entered the 2001 recession until it was over. **During the nine-month 2001 recession, real GDP growth declined by only 0.6%, nonfarm payrolls fell by 1.3%, and unemployment increased by 2.1%.**

Furthermore, we believe the current market sentiment is similar to 2001, when all donned rose-colored glasses. Kliesen found that in the six months leading into the 2001 recession, only 16% of professional forecasters surveyed expected a recession over the ensuing 12 months. Further, even the day before the 9/11 terrorist attacks, only 13% of a similar survey group indicated that they believed the U.S. had entered a recession. We believe the past is prologue here, and while many market participants are pushing the soft/no landing narrative, the U.S. will inexorably hard land into a recession. Still, we are hopeful that any potential recession may have similar characteristics to 2001.

Inflation And Interest Rate Update

We believe the current interest rate environment remains restrictive. No time in history has the FOMC increased interest rates so vigorously in such a short period. While we believe these actions were warranted post-pandemic, we also feel that modest cuts should have already been instituted, given the observed inflation trends over the last six months. Recent trends in core CPI and PPI, along with trends in wage growth, support this long-held view. Most recently, Friday's Core PCE Deflator print of 2.6% further supports our contention that the FOMC may be too conservative in its inflation forecast and interest rate projections.

In addition, commodities generally remain constrained, held back by weakness in the energy complex. Even copper has recently retraced from recent highs. Going forward into the second half of 2024, we would not be surprised to witness at least 50-75bps of rate cuts instituted by the FOMC, despite their recent SEP/dot-plot forecast of one (1) cut. **We believe the economic trend may surprise to the downside moving into 2H24, which may spark two (2) interest rate cuts, with one later in the year potentially amounting to 50bps**.

Valuation And Market Update

We believe equities may be modestly stretched at the index level, but individual value opportunities may still exist across the broader equity universe. **The driving force in market-cap-weighted indices remains the weight of large-cap technology companies**, specifically those with AI applications. As of June 30, 2024, **the combined market weight contribution to the S&P 500 Index from NVDA, AAPL, MSFT, AMZN, Google and META amounts to almost 30%, with the top three largest companies (MSFT, AAPL and NVDA) representing over 20% of the S&P 500.** These large-cap technology names continue to exhibit a combination of cost containment, solid balance sheets, and positive sales and/or cash flow growth. So, it should be no surprise why investors, especially those with mandatory equity allocations, continue to crowd into these names. **Further, the weighted average YTD total return among these six names amounts to 36%, contributing as much as 62% (or 9.5% out of 15.3%) to the S&P's aggregate return thus far in 2024. This also suggests that the other 494 individual companies in the S&P 500 have returned only 5.8% thus far in 2024.** So, in our view, the overall trajectory of the S&P through 2H24 will be heavily impacted by the vector of a concentrated set of companies.

We **continue to maintain the capital markets are moving from a Bull Flattener to a Bull Steepener environment**, where by long-duration fixed-income may further recover, and defensive growth equities should outperform the S&P 500, at large. We reiterate increased allocation to Staples and Healthcare. We believe Technology, which is a long-equity duration sector, may continue to benefit as rates get cut and as the AI boom extends out to other technology companies and the Communication sector. Utilities may continue to have a bid in the near-term, as AI will require increased electricity usage. We believe Real Estate will remain challenged in the near-term, but as more rate cuts unfold, funding costs will fall. However, the overhang associated with central business district (CBD) office demand will remain as companies struggle with return-to-office (RTO) trends. We also believe that Industrials, Energy, and Materials may benefit from any military restocking cycle and/or rebuilding efforts when/if various global conflicts draw to a close. However, this is a significant unknown, given the most recent headlines from the Middle East and Ukraine. As a result of our valuation and market analysis, **we are increasing our year-end target for the S&P 500 to a range of 5,200 to 5,300, which implies a 4-5% retracement over the next 6 months. We would not be surprised to see increased volatility and a larger pullback as the 2024 Presidential Election cycle continues and uncertainty surrounding President Biden increases. But once the election is done, we would not be surprised for a rebound in prices.**

In closing, we reiterate that every client situation is different and requires tailored analysis and recommendations. If you have any questions regarding this note or would like to discuss its implications for your portfolio, please connect.

We'd love to hear your thoughts.

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