2Q 2024
Market Commentary

With three Trillion here and three Trillion there, you easily have a large proportion of the stock market's capitalization. Apple, Microsoft and Nvidia each rose above $3 trillion in market value in the quarter, with Nvidia's stellar $1.9 trillion gain since the beginning of the year setting a record for the magnitude and speed at which its rise occurred (to its June peak).

The quarter's price action in the S&P 500 also sets (or is close to) an all-time record for broad market concentration of return. Just going beyond the *Magnificent Seven* to the *Top Ten* stocks by market value (which adds Eli Lilly, Walmart and JP Morgan to the list, all of which have market values above $500 billion), the group accounted for over one third of the overall S&P capitalization in June and over two thirds of the market's nearly $6 trillion gain in total value during the second quarter. Wow!

A further indication of this lack of market breadth is the fact that nearly 59% of the stocks in the broad market index, the S&P 500, had negative returns in the quarter. Value benchmarks posted negative returns for the quarter while the overall index recorded low single-digit positive returns. Returns were pretty mediocre overall except for mega-cap stock gains.

Credit investors' hunger for AI and GLP-1 weight control investment themes for much of this concentration that began in earnest last year. AI is revolutionary, but the pace at which successful applications, revenues and earnings advance may be more evolutionary. We think nearly every aspect of business will eventually be impacted by AI, but right now, every info tech and media company needs to purchase hardware and new chips to learn how to use them in new products and services. This action is likely to add more in costs before it adds revenues and earnings (Nvidia excepted). Furthermore, just as both tech and ordinary companies wanted to have some form of "internet" or "dot com" in their names and business plans in the late 1990s, so too does each company today want to announce that it will benefit from AI. Those who failed to get this "memo" generally fell behind the market's recent performance, yet by no fault of their own if they are sticking to successful business plans. Financial markets have yet to sort out which companies will have lasting success in their AI investments.

For the *Mag 7*, price earnings ratios on Wall Street's "next twelve months" earnings expectations have risen since the beginning of the year, meaning price gains have outpaced earnings expectations. This increases downside vulnerability should any hiccups in current optimistic growth forecasts occur. Furthermore, this action occurred in the face of a continued modest rise in Treasury yields during the quarter; yet the rise had very little impact on valuations of these mega-cap names.

“Higher for longer” has prevailed over the beginning-year expectation of 5-6 Fed rate cuts, and now there is increasing evidence that economic growth, particularly consumer spending on goods and housing, is indeed slowing. The usual interest-rate and economically suspect sectors in our primary large-cap value benchmark were hurt the most in the second quarter, including negative returns among consumer discretionary, energy, materials, real estate and financial stocks, despite offering some of the most attractive valuations in the overall market. So when the Federal Reserve Board finally turns to cutting the Fed Funds Rate, we believe these sectors are likely to be the primary beneficiaries of lower interest rates, rather than the already highly-valued tech stocks.

Why hasn’t the economy already headed into recession?

The amount of federal government stimulus spending from the IRA and Chips Acts (as an example) clearly has sustained aggregate demand above what it might otherwise have been. The economy has yet to “pay the piper” for the massive federal deficits that require nearly a $1 trillion of additional annual funding. In addition, the huge cumulative number of migrants that have crossed our borders have undoubtedly become part of the U.S. labor pool, earning income and consuming goods. Without these impacts, we might have already gone into recession.

At the same time, our view is that the economy is experiencing something more like stagflation, meaning subpar economic growth below 2% and sticky price inflation at or above 3%. This was certainly true in the first quarter during which real GDP grew by only 1.4% (annualized quarterly rate) while PCE price inflation gained 3.4%. The weakening in retail sales growth in the second quarter suggests we are likely to have another quarter of real GDP growth below 2%, with price inflation hovering close to 3%. Such conditions are neither beneficial to overall corporate profit growth nor to the stock market’s overall Price/Earnings ratio.

While the stock and bond markets await the Fed’s first decision to cut rates (with market probabilities suggesting it will be September), the Presidential election has finally taken center stage after the market’s long period of ignoring the potential outcomes. As pointed out in our first quarter commentary, the electorate doesn’t seem to like either candidate. President Biden’s recent unfavorable ratings (per FiveThirtyEight polls) stands at 55% compared to a nearly equal 54% unfavorable rating for former President Trump. At the same time, President Biden’s weak performance at the debate on June 27th has significantly damaged his reelection chances. The betting markets often offer a more accurate reflection of a candidate’s probability of winning than election polls. Following the debate, both election polls and betting market probabilities moved meaningfully in Trump’s favor and reflected a plunge in Biden’s probability of winning re-election. None of change, however, in these polls and betting odds reflect certainty.

President Biden’s policies (like the IRA spending on renewable energy) are already in place, and his re-election would imply that none of these current policies would change.

If former President Trump is re-elected, changes would be far more significant, but the initial impact on the economy might be more negative if he reigns in the deficit spending that has propped up current real economic growth or pursues a strategy of massively raising tariffs. His ability to make significant changes would be dependent upon having the House and Senate controlled by his party, and there is no certainty this will occur. Current polls suggest that Republicans may capture control of the Senate but might lose the House (the latter being close to a 50/50 toss up), in which case there won’t be a constituency to support a permanent extension of the current income tax structure.

If the current income tax regime is allowed to expire in 2026, personal and corporate tax rates and tax brackets would revert back to the higher levels of 2016, hurting economic growth, perhaps causing or extending a period of recession. Regardless, however, of which party wins the White House, boosting defense spending will have to be a high priority. With the risk of conflicts growing on multiple geographic fronts with Russia, Iran, and China, the world is unlikely to be a peaceful place in the next four years no matter who is elected President.

We remain cautious about the outlook for financial markets and at the same time believe there's a wide range of investment opportunities that already sell at depressed valuations and provide upside opportunity. We continue to believe there is both more downside protection and upside opportunity in implementing a thoughtful value-based approach to investing.

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