



2024 SUMMER INVESTMENT OUTLOOK

The second quarter of 2024 has seen an extension of many of the same trends that were in place during the year's first three months. Economic growth continues to be satisfactory which has provided the foundation for ongoing strength in the job market. This, in turn, has underpinned consumer spending which is holding up better than many expected as the year began. Inflation continues to moderate while still remaining well above the Federal Reserve's target. As such, the central bank has not been able to reduce interest rates yet this year as anticipated. The market is currently pricing in approximately two twenty-five basis point cuts this year, down from an expectation of six twenty-five basis point cuts six months ago.

Thus far in 2024, the economy and capital markets have managed to make forward progress despite the fact that interest rates have not declined as expected. In fact, while the fed funds rate has remained constant this year, market based interest rates across most of the yield curve have actually moved higher year to date. Yields on two, five and ten year U.S. treasury notes are up 48, 43 and 36 basis points, respectively. This has been welcome news for fixed income investors who can now earn respectable rates of return on relatively short term, high quality securities.

Equity markets have been volatile with an upward bias over the past three months. The S&P 500 fell over 4% in April, rose nearly 5% in May and is up another 3.2% plus so far in June, notable monthly fluctuations for the index. As is often the case, as the market has moved higher, Wall Street analysts and investors have become more bullish. Buy recommendations are increasing on many of the most popular stocks while market prognosticators are increasing their year end price targets. Both Goldman Sachs and Deutsche Bank recently noted that their sentiment indicators suggest that stock market positioning is stretched. Similarly, Bank of America observed that their clients are increasingly constructive on the stock market outlook while cash levels are at multi-year lows.

While equity markets have made progress so far this year, those gains have been uneven. A very narrow group of technology stocks have accounted for the lion's share of the stock market advance in 2024. This explains the unusually wide disparity among the indices as noted below.

Equity Markets – 6/24/2024

	<u>Index Price Level</u>	<u>2024 YTD Total Return</u>
Dow 30 Industrials	39,411	+5.6%
S&P 500	5,448	+15.0%
NASDAQ Composite	17,497	+17.0%
MSCI All Country World Index ex-USA	330	+5.9%

Outlook

The U.S. economy advanced 1.3% in the first three months of 2024 and the Bloomberg consensus forecast calls for 2.1% growth in the current quarter. Projections call for this rate of progress to moderate in the second half of the year to a 1.7% rate and move only modestly higher next year with a full year 2025 estimate of 1.8% growth. Market participants, who had priced in a meaningful chance of recession one year ago, have clearly moved on from that gloomy forecast and now expect the expansion to continue, albeit at rates below the long term trend line for U.S. economic activity. Tempering this confidence in the outlook is the fact that both the Citigroup and Bloomberg economic surprise indices have been trending lower for much of the past year. These indicators measure whether broad based economic metrics are coming in better or worse than expected, so the recent string of disappointments may suggest that the market's optimism is overdone.

Growth has been sufficient to support an ongoing healthy job market. The latest employment report revealed that 272,000 new jobs were created in May, above the average gain of 232,000 over the past twelve months. Meanwhile, the unemployment rate came in at 4.0%. This was the thirtieth consecutive month that figure has been 4% or lower, the longest such streak since the late 1960s. Some observers have suggested that companies are loathe to shed workers as hiring during the height of the COVID era was incredibly difficult, a memory that has led corporate managers to err on the side of retaining talent. Consensus forecasts call for employment gains to continue with an average of approximately 136,000 monthly jobs created over the balance of 2024 and only a slightly lower average rate than that for the full year 2025. Meanwhile, the unemployment rate is not expected to move north of 4.1% during the time frame. Other job market indicators tell a similar story. The latest monthly report noted that there are currently 8.06 million job openings while 6.50 million people are seeking employment. This ratio of 1.2x has been steadily declining but still suggests that those seeking work have some bargaining power with employers. This is evident in wage growth which has advanced at a 4.1% rate over the past twelve months.

Job market strength, coupled with rising household net worth, has been supportive of consumer spending. Outlays on services (roughly 2/3 of the total) have been strong as post-pandemic pent up demand remains robust. The goods economy, which enjoyed outsized gains during the pandemic, has been relatively weak for some time though it is showing signs of stabilizing. Spending remains bifurcated with upper income Americans in an ideal position. This demographic typically owns their own home, which is either debt free or has a mortgage at a very favorable rate. With house values and stock prices at or near all-time high levels, these consumers have benefited from the wealth effect as they spend more as their net worth rises. The Federal Reserve reported that U.S. household net worth reached \$160.8 trillion at the end of the first quarter, a record high. On the other hand, many less fortunate Americans are feeling anxious about their financial position. The cumulative effect of inflation in recent years has eroded their standard of living. At the same time, the rapid rise in interest rates over the past eighteen months has saddled this group with higher payments on auto loans, credit cards and other borrowings, a challenge for those with debt levels at record highs.

Inflation, while moderating in recent months, remains stubbornly high and above the level targeted by monetary officials. The latest consumer price index (CPI) report revealed that headline prices were up 3.3% versus one year ago, while core CPI, which excludes food and energy, advanced 3.4%. Both of these figures are notably above the Federal Reserve's 2% objective. Meanwhile, the Fed's preferred inflation gauge, the personal consumption expenditures index (PCE), rose 2.7% year over year in April and was up 2.8% on a core basis. While the goods economy has experienced some deflation in recent quarters due to weak demand, service inflation (excluding energy) was up 5.3% in the latest report. This impacts consumer psychology as big ticket goods (e.g., cars, appliances, furniture) are purchased infrequently while many services (e.g., restaurants, streaming services, airline fees, auto/home/health

insurance) are bought on a regular basis and therefore are more visible to consumers. This may account for some of the disconnect between the strength of the economy and job market versus how people feel about their overall financial situation.

J.P. Morgan CEO, Jamie Dimon, recently opined that he believes that inflation will have an upward bias in the coming years and suggested that interest rates will likely have to stay higher for much longer than many anticipate. Among the trends that he thinks will contribute to ongoing price pressures include the costs associated with the shift to clean energy, spending on other necessary infrastructure improvements, the additional military expense needed as a result of the rising geopolitical conflicts, higher prices that will arise from ongoing trade tensions, and the price pressures that will be caused by seemingly never ending federal budget deficits.

Regarding this last point, the Congressional Budget Office (CBO) projects that the deficit this year will be \$2 trillion, up \$300 billion versus last year. This would equal nearly 7% of gross domestic product (GDP), an unprecedented figure during an expansion phase of the economy. Moreover, the CBO estimates that cumulative deficits over the coming decade will total nearly \$22 trillion. This would push the U.S. debt-to-GDP ratio to a level of 122% in ten years, up from a current level of 97%, with annual deficits over that span averaging over 6%. Looked at another way, federal revenue is projected to be 17.2% of GDP this year, in line with its fifty year average. Meanwhile, federal spending is expected to approximate 24.2% of GDP and average 24% of GDP every year from now until 2034. To put this into perspective, prior to the pandemic, the only other time in the post WWII era that federal spending equaled 24% of GDP was in 2009 in response to the Global Financial Crisis (GFC).

The upcoming November elections are not likely to do much to alter the budget math. Both candidates for president are advocating policies that do little to bridge the gap between revenue and spending. Additionally, the majority of government outlays are on autopilot tied to spending on things like Medicare, Medicaid, Social Security, interest payments and defense where politicians of either party have shown little willingness to exhibit fiscal discipline. It will be interesting to see how this plays out in the coming years. At the same time the U.S. government will need the global capital markets to fund its deficit spending, foreign ownership of U.S. debt is decreasing and the Federal Reserve is attempting to shrink its balance sheet. It is reasonable to assume that higher rates will be needed to entice investors to purchase U.S. government bonds in the coming decade as the supply/demand imbalance shifts power to borrowers on the margin.

The elections may have some implications for investors as each candidate is promoting ideas that are either inflationary or less stock market friendly. President Biden has proposed raising taxes on both corporate America and upper income Americans. Former President Trump has suggested imposing wide ranging tariffs which act as a tax on consumption and ultimately result in higher prices. He has also indicated a willingness to exert his influence on monetary policy. This would be a troubling development as politicized monetary policy would have an inflationary bias and would likely lead to even less fiscal discipline.

As noted at the outset, the stock market has moved higher in the opening half of 2024. Gains have been driven by a small subset of the market, potentially signaling that the current rally is not as healthy as the headline numbers suggest. The top ten stocks in the S&P 500 currently account for over 34% of the index. This is the highest percentage going back to at least 1980. In another sign of the lack of market breadth, the S&P 500 equal weight index (where all 500 stocks are weighed equally as opposed to the market capitalization weighting of the S&P 500) is up only 6.0% this year, nine percentage points behind the S&P 500. This index has not underperformed the S&P 500 by this much since 2008, just prior to the market meltdown of 2008-2009. Other signs of concern exist. S&P Global reports that more U.S. companies filed for bankruptcy in 2023 than in any year since 2010. Meanwhile, the percentage of

Russel 2000 companies (i.e., small cap stocks) that are expected to have negative net income over the coming twelve months is at 31%. This is close to a record high and well above the 25% levels that preceded the dot.com crash of 2000-2002 and the GFC of 2008-2009.

Market participants currently expect S&P 500 profit growth of over 11% for 2024. With Q1 growth of 5.9% and a projection for a 9% advance in the second quarter, this implies a strong rebound in the back half of the year. Anecdotally, this aligns with the expectations from corporate leaders who express similar optimism regarding their own business prospects. With stock market valuations well above the historical trend line, there is little room for error in this outlook or investors risk being disappointed. The equity risk premium, a measure of the attractiveness of stocks relative to safe U.S. government treasury bills, is at a twenty-three year low. On the plus side, corporate profit margins remain near record highs though the majority of the stock market's return in recent years have come from price/earnings ratio expansion, not from higher profits.

Investment Conclusions

As is often the case, today's investment climate offers reasons for optimism tempered by potential headwinds that could disrupt the status quo. Growth has continued at a pace sufficient to sustain a healthy job market and rising corporate profits. Despite the higher interest rate environment, overall financial conditions remain favorable as stocks and home values remain high, the value of the U.S. dollar is strong and credit spreads are historically tight. On the other hand, persistent inflation has made the financial lives for many Americans more challenging and has prevented the Federal Reserve from cutting interest rates as expected. This will make the record high debt levels for consumers and governments more expensive to finance as time goes on. In part, due to the ten plus year period when short term interest rates were close to zero, valuations for most asset classes are well above historical norms. On the margin, this will make meaningful additional appreciation more difficult to achieve in the intermediate term.

Most actively managed equity portfolios have underperformed the S&P 500 in recent years as that index has been dominated by a small group of technology stocks. Over the full market cycle, clients will be well served to maintain diversified, long term investment portfolios of high quality stocks selling at reasonable valuations. These investments can be paired with a short-to-intermediate term list of investment grade bonds that are currently offering yields near their highest levels in over a decade. Such portfolios have historically met clients' ongoing needs while smoothing out the volatility experienced by the major market indices.

June 25, 2024