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FINANCIAL MARKET SNAPSHOT

Mid-Year Market Review: Insights and Outlook for the rest of 2024

July 29, 2024

In this edition of the Market Snapshot, we are providing a review of the second quarter and a brief outlook on market conditions as we head towards the back half of 2024.

In the second quarter of 2024, major market indexes moved higher despite slowing economic conditions and delayed Fed rate cut expectations. The market's resilience was supported by a soft-landing narrative that gained traction during the quarter, driven by continued disinflation, solid GDP growth, reduced recession expectations, improving corporate earnings, buoyant consumer spending, and a stable, more balanced labor market – all of which appeared to support the notion of a gradual economic slowdown rather than a hard landing scenario.

Current Economic Conditions

During the second quarter, the US economy demonstrated notable resilience. Real GDP increased at a 2.8% annualized pace in Q2, beating the consensus estimate of 2.1%. Growth was supported by robust consumer spending and a stable labor market.

Recent data shows that consumers continue to spend. In fact, retail sales in June were nearly unchanged month-over-month but showed a 2.3% increase year-over-year. However, while consumers are still spending, they are doing so more selectively, likely influenced by ongoing concerns about inflation and some economic uncertainty. Despite these concerns, consumer spending has highlighted the underlying strength of the US economy.

Additionally, while the labor market has shown some signs of cooling, it remains relatively strong. In June, employers added 206,000 jobs, slightly above economists' expectations. However, the unemployment rate ticked up to 4.1% as slightly more people (re)entered the labor force, marking the first time it has been above 4% since November 2021.

Despite this increase, the labor market still remains historically tight, with a labor force participation rate of just 62.6%. Recent data also showed wage growth – while still strong – continues to cool, with average hourly earnings up 3.9% year-over-year in June, according to the Bureau of Labor Statistics. These factors collectively underscore the underlying strength of the US economy and appeared to support the soft landing narrative.

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Federal Reserve Policy

The quarter began with heightened concerns about inflation remaining stubbornly high. This led to a more cautious outlook among economists and investors, as the Federal Reserve's stance on interest rates continued to dominate market sentiment. As a result, expectations for multiple rate cuts held by investors at the beginning of the year continued to be scaled back during the quarter due to more persistent inflationary pressures. However, as the quarter progressed, inflation data began to show signs of moderation, which helped to improve consumer sentiment and provided additional support to financial markets.

Specifically, the Fed's preferred measure of inflation – the Personal Consumption Expenditures (PCE) Index excluding food and energy – declined to an annualized rate of 2.6% in May, down from 2.8% in April. We believe there is the potential for additional declines in the inflation rate during the back half of the year as some of the more stubborn components – such as shelter and labor costs – continue to cool.

Consequently, the Federal Reserve's stance on interest rates will likely continue to be a critical factor impacting market sentiment over the foreseeable future. During their June meeting, the Federal Reserve continued to hold rates at 5.25-5.5%, a position it has held since July 2023. Despite improving conditions, Federal Reserve officials have indicated that any rate cuts will be dependent on continued progress in reducing inflation so as to ensure it is on a sustained path towards their 2% long-term target.

However, as of July 22nd, the CME Group indicates that traders are currently pricing in nearly a 100% chance that the Federal Reserve will cut its benchmark interest rate in September, while the year-end market median fed funds rate of 4.82% suggests ~55 basis points of cuts from the current midpoint. That implies market pricing in more than two cuts (of 25 basis points each) by December 2024, with almost seven cuts by December 2025.

Second Quarter Stock Market Performance & Narrow Market Breadth

US equity indices delivered mixed results in the second quarter. Large-cap stocks, particularly those in the technology sector, continued to perform well, driven by strong earnings growth and ongoing enthusiasm around artificial intelligence (AI). The S&P 500 index rose by 4.3% during the quarter, registering gains in six of the last seven quarters. Year-to-date, through the end of Q2, the index has risen 14.5%. In contrast, small-cap stocks faced significant challenges, declining by 3.3% during the quarter and only up 1.0% on a YTD basis.

As a result, concerns about market breadth – or the total number of stocks that are increasing in prices as opposed to the number of stocks that are undergoing a decline in their prices – were frequently aired throughout the quarter, with a nearly seven percentage point performance gap opening between the official market-cap weighted S&P 500 Index and its equal-weight variant, RSP (-3.0%).

Additionally, the top ten stocks of the S&P 500 Index – having a combined weight comprising approximately one-third of the index on a cap-weighted basis – returned an average of 14.3%, besting the broader index return by roughly 10 percentage points. And while more than 78% of S&P constituents traded above their 50-day moving averages at the end of Q1, that proportion shrank to ~46% near the end of Q2. However, as we entered the third quarter, the market's strength has become notably more broad-based, with multiple sectors contributing to gains, which could indicate a healthier and more sustainable rally.

Bond Market Dynamics

The bond market also experienced fluctuations. Early in the quarter, bonds faced downward pressure due to persistent inflation concerns. However, as inflation data improved, bonds regained some ground, ending the quarter with a modest gain of 0.1% as measured by the Bloomberg Aggregate Bond Index. Investors remained focused on the Federal Reserve's signals regarding future rate cuts, which are now anticipated to begin in September.

The U.S. Presidential Election

With the US Presidential election roughly 100 days away, we all have to deal with a barrage of never-ending news coverage, ubiquitous social media comments, and political advertising that will last through election day. We understand that it's only natural for many investors to be concerned about the impact that changing political conditions might have on the economy, the broader market, and their portfolios. However, historical data suggests that overly focusing on the political leadership rather than on fundamentals might be imprudent. We note that the stock market is influenced by a myriad of factors – such as macroeconomic data, corporate earnings, geopolitical events, and investor sentiment.

While political decisions and fiscal policies can have an impact, they are just a couple of pieces of a much larger puzzle. Also, keep in mind that a well-diversified portfolio is already designed to withstand a variety of market conditions, including changes in political leadership. As such, overreliance on political speculation could lead to concentrated portfolio risks that might result in missed market opportunities.

So, while it's important to be aware of how political developments can affect the markets, we believe that maintaining a disciplined investment approach that prioritizes bottom-up, fundamental research coupled with top-down, macroeconomic analysis is likely to be a more reliable method in helping to achieve long-term financial goals.

Q2 Earnings Expectations

Market fundamentals – particularly earnings – have been integral in supporting market valuations so far this year. A number of the companies in the "Magnificent 7" saw their stock prices increase during the second quarter, which helped to drive the level of the S&P 500 higher during this period. However, are companies in the "Magnificent 7" also expected to drive earnings higher for the S&P 500 for the second quarter? The answer is yes.

According to recent data from FactSet, four of the companies in the "Magnificent 7" are projected to be among the top five contributors to year-over-year earnings growth for the S&P 500 during Q2. These four companies (in order of highest to lowest contribution) are NVIDIA, Amazon.com, Meta Platforms, and Alphabet. In aggregate, these four companies are expected to report year-over-year earnings growth of 56.4% for the second quarter. Excluding these four companies, the blended (combines actual and estimated results) earnings growth rate for the remaining 496 companies in the S&P 500 would be 5.7% for Q2 2024. Overall, the blended earnings growth rate for the entire S&P 500 for Q2 2024 is 9.7%. This is an increase from the estimated 8.9% growth rate as of June 30. If the actual growth rate reaches 9.7%, it will mark the highest year-over-year earnings growth rate reported by the index since Q4 2021, which saw a remarkable pandemic rebound growth rate of 31.4%.

Looking Ahead

The second quarter of 2024 was characterized by cautious optimism as inflation concerns began to ease and the outlook for Federal Reserve rate cuts improved. As we move into the third quarter, the focus will likely remain on continuing disinflation traction, approaching Fed rate cuts, ongoing AI optimism, solid Q2 earnings results, and firming expectations for the soft-landing scenario to play out. However, we remain mindful regarding the health of the consumer, the potential for rising unemployment, worries about bumpy disinflation and a sluggish Fed rate response, and extremely narrow market breadth. As a result, we caution investors that we could experience increased market volatility as we move into the back half of the year.

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The fast price swings in commodities and currencies will result in significant volatility in an investor's holdings.

Precious metal investing involves greater fluctuation and potential for losses.

Government bonds and Treasury bills are guaranteed by the US government as to the timely payment of principal and interest and, if held to maturity, offer a fixed rate of return and fixed principal value.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price.

High yield/junk bonds (grade BB or below) are not investment grade securities and are subject to higher interest rate, credit, and illiquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

The MSCI EAFE Index is a free float –adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

The MSCI EM (Emerging Markets) Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of the emerging market countries of the Americas, Europe, the Middle East, Africa and Asia.

The S&P 500 Index is a capitalization weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing the major sectors of the U.S. economy.

The Bloomberg Barclays U.S. Aggregate Bond Index is an index of the U.S. investment grade fixed-rate bond market, including both government and corporate bonds.

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