Market Review & Outlook

July 2024

The market rally that kicked off in late October 2023 extended its gains during the second quarter, continuing a historical trend of stocks performing well during presidential election years. Indeed, the S&P 500 just posted the best first half performance during an election year since 1976 and the second-best first half during an election year since S&P 500 inception (1957). Although the S&P 500 experienced a 5.4% correction in April, the current rally has "left valuations stretched, sentiment optimistic, and the market overbought," according to analysts at Ned Davis Research. They further note that other factors leave the U.S. stock market vulnerable to a correction in the second half of the year, including corporate-earnings estimates, uncertainty around potential Fed rate cuts and November's presidential election, and the limited breadth of the market's rally.

Index	June 2024	2nd Quarter	Year-to-date	One Year	Description (what the index is comprised of)
S&P 500	3.59%	4.28%	15.29%	24.56%	Large Cap US Stocks
DJ Industrial Average	1.23%	-1.27%	4.79%	16.02%	Large Cap US Stocks
Nasdaq Composite	6.03%	8.47%	18.57%	29.61%	Large & Mid-Cap US Tech Stocks
Russell 1000 Growth	6.74%	8.33%	20.70%	33.48%	Large Cap US Growth Stocks
Russell 1000 Value	-0.94%	-2.17%	6.62%	13.06%	Large Cap US Value Stocks
Russell 2000 Growth	-0.17%	-2.92%	4.44%	9.14%	Small Cap US Growth Stocks
Russell 2000 Value	-1.69%	-3.64%	-0.85%	10.90%	Small Cap US Value Stocks
MSCI EAFE	-1.61%	-0.42%	5.34%	11.54%	Foreign Developed Market Stocks
MSCI Emerging Markets	3.94%	5.00%	7.49%	12.55%	Emerging Markets Stocks
S&P US High Yield	0.92%	1.21%	2.72%	10.27%	US High Yield Corporate Bonds
Bloomberg US Aggregate Bond Index	0.95%	0.07%	-0.71%	2.63%	US Treasuries, mortgage-backed, investment grade corporate bonds

Speaking of breadth, while the S&P 500 has made 31 new all-time highs this year, experts continue to voice concerns about the market gains being overly concentrated in a narrow group of large technology stocks. To be sure, market bears aired the same concerns throughout last year, when the AI frenzy led to outsized returns in Magnificent 7 stocks, especially Nvidia. Also, a 10%+ correction would be completely normal for a market that has enjoyed such a strong advance, with the S&P 500 up ~33% since October 27, the day the last 10% correction in the market came to an end. For a more detailed look at how various asset classes performed in recent periods, please refer to the table.

To begin 2024, the economy was coming off two straight quarters of robust growth, and the futures market was pricing in up to seven Fed interest rate cuts after Jay Powell's dovish December press conference. Fast forward six months later and the path forward is less clear for the Fed. While inflation has come down sharply since the Consumer Price Index (CPI) hit 9.1% in June 2022, it has inched higher to 3.3% in May from last June's cycle low of 3% and remains stubbornly above the Fed's 2% target rate. A 3.3% rate of inflation means prices would double in just under 22 years. At the same time, the unemployment rate has drifted higher to 4% from a low of 3.4%. In past cycles, a 0.6% percentage point rise in the unemployment rate off the cycle low has often marked the beginning of a recession, and the Fed itself projects the unemployment rate could rise to 4.1-4.2% this year.

Around the beginning of the year, many bears rescinded their recession forecasts on the back of 2023's strong second half. But perhaps that was the wrong call, and the recession was merely "delayed, not derailed" as economist David Rosenberg likes to say. To wit, economic growth was already slowing as 2024 began, as the 1st quarter GDP dipped to a 1.3% annualized rate, down from 3.2% during 4Q2023 and 4.9% in 3Q2023. In addition, the Atlanta Fed GDP nowcast currently predicts the economy grew 1.5% for the 2nd quarter, down from its own 4.2% forecast in mid-May. The St. Louis Fed model pegs Q2 growth at 0.75%. In addition, the manufacturing sector of the economy continues to struggle, The ISM Manufacturing PMI has been below 50 (in contraction) for 19 out of the last 20 months. With data going back to 1948, that's only happened two other times: 1989-91 (Recession in 1990-91) and 1981-83 (Recession in 1981-82).

Furthermore, the Conference Board's index of leading economic indicators (LEI) fell again in May, has now declined 26 out of the past 27 months and sits 14.7%

below its recent high, a decline consistent with past recessions. As with other economic indicators, some experts believe government/central bank intervention into the economy during Covid may have distorted the predictive ability of the LEI, as the companion coincident indicators continue to make new highs and diverge from the leading indicators.

Ever since the Fed's dovish rate pivot at its December meeting, its public pronouncements have been increasingly hawkish, with various FOMC members suggesting rates should remain at current levels or even higher. For now, markets seem to accept the "higher for longer" narrative on interest rates, and Fed funds futures currently forecast only one rate cut over the remainder of 2024. At the same time, this is curious since early this year, stock market cheerleaders rationalized the strength of the rally in part by saying: "the Fed is going to cut rates a bunch of times this year and you know how stocks love rate cuts!"

However, this isn't always true. For example, the Fed aggressively slashed rates to zero from September to December 2008, but that didn't stop the S&P 500 from declining 37% that year and not bottoming until the following March. From November of 2007 through March of 2009, the S&P 500 experienced a 57% drawdown peak-to-trough. During the 2000-2002 bear market, the Fed slashed rates from 6% immediately prior to the 9/11 terrorist attacks to 1% by December 2001. That didn't stop stocks from continuing their descent into the October 2022 market low, with stocks failing to display any broad strength until the spring 2003 US invasion of Iraq. From March 2000 to October 2022, the S&P 500 experienced a 49% drawdown.

Notwithstanding some recent reports surprising to the downside, it's true that headline employment, growth, and inflation data in the US and other developed markets has been positive at the margin. While economic growth in the US may have slowed relative to expectations, coupled with sticky inflation, it's been strong enough to derail the idea of multiple 2024 Fed rate cuts. For its part, the Fed's most recent (June 12, 2024) statement remained upbeat, to wit, "Recent indicators suggest that economic activity has continued to expand at a solid pace. Job gains have remained strong, and the unemployment rate has remained low. Inflation has eased over the past year but remains elevated. In recent months, there has been modest further progress toward the Committee's 2 percent inflation objective."

The conundrum facing investors is whether the AI craze can continue to push the market higher in the face of increasingly elevated sentiment and valuations. Stock markets are strongest when participation is broad, and weakest when participation is narrow. According to Bank of America, only 24% of the S&P 500 stocks beat the index over the first 6 months of 2024, marking the third narrowest 6-month period in history since 1986 (was narrower in Jul 2023 at 23% and in Feb 2020 at 21%). Nvidia alone accounted for 30% of the S&P 500's 15.3% return, while the top 10 largest stocks in the index accounted for 77.2% of the return. The only year that percentage has been higher? 2007. Small cap stocks as represented by the Russell 2000 were up only 1.73% YTD and are still down almost 17% from their late 2021 high. Relative to the S&P 500, it was the worst showing for small caps since 1998. Growth stocks continue to outperform value stocks, a trend in place since the Great Financial Crisis.

Of course, if the economy remains on solid footing and corporate earnings continue to grow, market participation could broaden out. However, if the lagged effects of aggressive Fed rate hikes continue to pressure business activity, economic growth and earnings could deteriorate and force an adjustment in market valuations. Currently, the S&P 500 trades at ~22.3 times estimated forward 12-month earnings, compared to an average of 15.6x over the trailing 20 years. While the market may not be spectacularly overvalued, nearly every market valuation metric falls into the top decile of all historical observations.

Retirement investors generally do best when they maintain a consistent strategy and avoid overreacting to day-to-day events in the market, especially if you have time on your side until retirement age. For those close to retirement, being mindful of the risk level in your portfolio becomes a more pressing concern. For example, does your level of stock exposure leave you vulnerable to a big drawdown in the market? We would be happy to review questions like this with you.

Investing involves the risk of loss that clients should be prepared to bear. If you have a general administrative question about your account, please contact our customer service at 800-535-4253 option 1. If you would like to set up an investment consultation, please contact our customer service line or send us an email at advisors@wespac.net. We would be happy to schedule a call or Zoom meeting to discuss your portfolio.