Second Quarter 2024 Key Takeaways:

In the second quarter of 2024, the U.S. economy stayed resilient in an environment where inflation and interest rates remained higher than expectations.

The S&P 500 Index was up nearly 4.5% in the quarter, reaching a new all-time high.

Overseas, results were mixed with developed international stocks (MSCI EAFE) falling 0.2%, while emerging markets stocks (MSCI EM Index) rose 5.0% for Q2 2024.

Overall, economic and corporate fundamentals remained relatively healthy in the quarter.

The prevailing consensus is that the next move for the Fed Funds rate is likely to be lower.

Lower rates benefit faster-growing companies more than slower-growing companies because fast-growing companies tend to use more debt to finance their growth.

As the economy and corporate earnings continue to grow, it's clear that the Fed's efforts to slow growth with higher rates is taking longer than expected to have an impact. Today, (real) economic growth remains stronger than expected in the 2% to 3% range

Looking ahead, my base case is for the economy to continue expanding but I suspect the pace of growth will slow over the remainder of the year. I also expect inflation to edge lower and labor markets to remain stable for at least the near-term.

The consumer has driven U.S. economic growth for the past three years, thanks to improvement in both employment and real wages.

While interest rates and mortgage rates have increased significantly, their impact on the economy has been softened by the fact that the share of homes without a mortgage has risen to roughly 40%, and that nearly half of all mortgages outstanding have fixed rates below 4%.

B R O A D W I N G
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Market Recap

In the second quarter of 2024, the U.S. economy stayed resilient in an environment where inflation and interest rates remained higher than expectations. Tighter monetary policy was offset by accommodative fiscal policy, and a still-strong U.S. consumer.

The S&P 500 Index was up nearly 4.5% in the quarter, reaching a new all-time high. The gains came with some volatility in the three-month period. The S&P fell 4.1% in April, pressured by a stronger-than-expected March inflation report and rising bond yields. In May and June, stocks rebounded led once again by technology stocks. Chip-maker Nvidia became the world's most valuable company in late-June after its share price climbed to an all-time high, making it worth $3.34 trillion, with its price nearly doubling since the start of this year. We also saw the continuing trend of large-cap stocks (Russell 1000 Index) outperforming small-cap stocks (Russell 2000 Index) and fast-growth stocks (Russell 1000 Growth) beating slow-growth stocks ("value") (Russell 1000 Value).

Benchmark Returns as of June 30, 2024

	MTD	QTD	YTD
EQUITY BENCHMARKS			
S&P 500 Index	3.59%	4.28%	15.29%
Russell 1000 Index	3.31%	3.57%	14.24%
Russell 1000 Value Index	-0.94%	-2.17%	6.62%
Russell 1000 Growth Index	6.74%	8.33%	20.70%
Russell 2000 Index	-0.93%	-3.28%	1.73%
NASDAQ Composite	6.03%	8.47%	18.57%
MSCI ACWI Index	2.23%	2.87%	11.30%
MSCI EAFE Index	-1.61%	-0.42%	5.34%
MSCI Japan Index	-0.71%	-4.27%	6.27%
MSCI Emerging Markets Index	3.94%	5.00%	7.49%
FIXED-INCOME BENCHMARKS			
Bloomberg U.S. Aggregate Bond Index	0.95%	0.07%	-0.71%
Bloomberg Municipal 1-15 Year Index	1.29%	-0.34%	-0.63%
Bloomberg U.S. Treasury TIPS Index	0.78%	0.79%	0.70%
ICE BofA Merrill Lynch U.S. High Yield Cash Pay Index	0.94%	1.02%	2.50%
Morningstar LSTA US Leveraged Loan index	0.35%	1.90%	4.40%
Morningstar Nontraditional Bond Category	0.37%	0.91%	2.67%
ALTERNATIVE BENCHMARKS			
Bloomberg Commodity Index	-1.54%	2.89%	5.14%
SG Trend Index	-2.68%	-3.16%	8.69%
3-Month LIBOR	0.47%	1.42%	2.86%
U.S. Dollar (DXY Index)	1.14%	1.26%	4.47%
Morningstar Multistrategy Category	-0.19%	-0.20%	4.44%

Source: Morningstar Direct. Data as of 6/30/2024.

Overseas, results were mixed with developed international stocks (MSCI EAFE) falling 0.2%, while emerging markets stocks (MSCI EM Index) rose 5.0% for Q2 2024.

Within the bond markets, returns were positive across most fixed-income segments. The benchmark 10-year Treasury yield ended the quarter close to where it started, but rates were

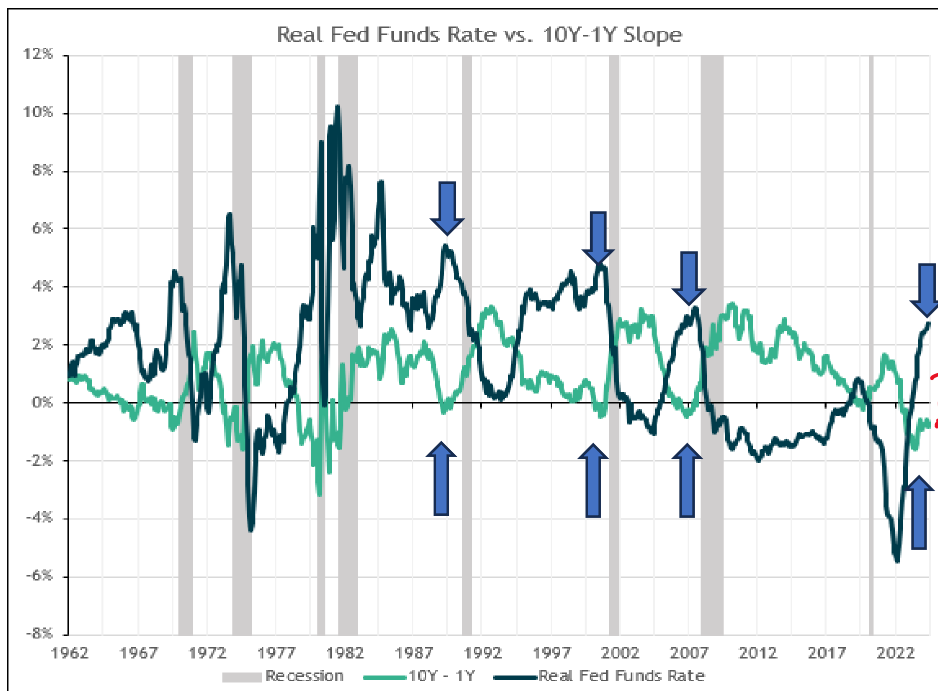
volatile in the period. The 10-Year Treasury started at 4.20%, rose to 4.70% before coming back to the mid-4.20% range. In this environment, the Bloomberg U.S. Aggregate Bond Index gained 0.3% and high-yield bonds (ICE BofA Merrill Lynch High Yield Index) were up 1.0% in the quarter.

Overall, economic and corporate fundamentals remained relatively healthy in the quarter. The prevailing consensus is that the next move for the Fed Funds rate is likely to be lower, even if the cuts are taking longer than expected. Lower rates benefit faster-growing companies more than slower-growing companies because fast-growing companies tend to use more debt to finance their growth. The expectation of cheaper financing partly explains the recent outperformance of fast-growing stocks.

Macroeconomic and Investment Outlook

During the second quarter, the U.S. economy began its fifth year of expansion after the brief pandemic-related recession in April 2020. Ongoing economic growth has defied widespread expectations of a recession that were present for most of 2023. Recession concerns were due to the Fed's rapid and meaningful increase in interest rates resulting in an inverted yield curve (historically a good predictor of recession), and the potential negative impact this would have on the economy. As I laid out in the fourth-quarter 2023 commentary, my view was that given the current level of inflation, Fed policy seemed to be on the fence about accommodating or restricting the economy.

My view on Fed policy is largely based on the level of the *real* Fed Funds rate (Fed Funds rate minus inflation, shown in blue in the chart below), and prior recessions (gray-shaded area in the chart below).



In the chart to the left, the green line shows the shape of the Treasury curve, with points above 0% indicating a normal (upward) sloped yield curve; and below 0% representing an inverted (downward) sloped yield curve. The vertical grey bars indicate a recession. The blue arrows are those points just before a recession.

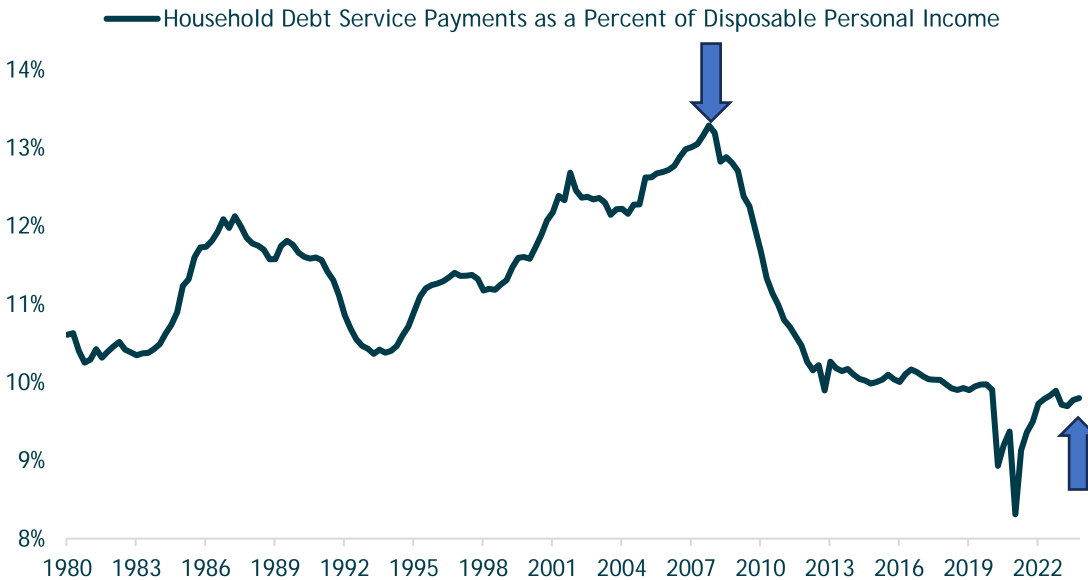
One can see that while the yield curve has been inverted since July 2022, Fed policy was accommodative for most of that time, i.e., interest rates were still low. It's only been more recently that Fed policy moved toward restrictive levels. In prior cycles, real Fed Funds proved restrictive at the 3.5% (or higher) level. To the extent that inflation continues declining (a prospect for which there is increasing evidence), and the Fed keeps rates unchanged, Fed policy will become proportionately tighter, an event that could begin to choke the economy. This is one reason that could support the Fed's decision to start cutting rates in the second half of the year.

As the economy and corporate earnings continue to grow, it's clear that the Fed's efforts to slow growth with higher rates is taking longer than expected to have an impact. Today, (real) economic growth remains stronger than expected in the 2% to 3% range, a level that is above the Fed's long-run growth estimate for the U.S. This robust activity seems to have been driven by strong consumer spending despite an erosion of pandemic savings.

Looking ahead, my base case is for the economy to continue expanding but I suspect the pace of growth will slow over the remainder of the year. I also expect inflation to edge lower and labor markets to remain stable for at least the near-term. This backdrop supports investing in stocks and other risk assets. Despite significantly elevated valuations for certain parts of the stock market, earnings growth from these companies has continued to surprise to the upside, thanks to the "AI revolution" and spurred capital investment. But what about the consumer? Will their spending continue even after the pandemic bonus fades?

The Consumer

The consumer has driven U.S. economic growth for the past three years, thanks to improvement in both employment and real wages. The strong consumer has surprised many, given the headwinds of higher interest rates and inflation. However, it's worth pointing out that U.S. consumers are not highly levered like they were prior to the Financial Crisis (see Debt Service chart on next page). When less of the consumer's budget goes to paying a mortgage, there's more left to purchase other things and that's what the consumer has been doing: purchasing other things! The percentage of the average consumer's budget remains below 10%, compared to 13% before the financial crisis (see arrows on chart). Moreover, while interest rates and mortgage rates have increased significantly, their impact on the economy has been softened by the fact that the share of homes without a mortgage has risen to roughly 40%, and that nearly half of all mortgages outstanding have fixed rates below 4%.



Source: Board of Governors of the Federal Reserve System. Data as of 12/31/2023.

That said, there are signs the U.S. consumer may be slowing. Recent data have pointed to declining consumer sentiment as a warning sign of slower spending ahead. The University of Michigan Consumer Sentiment Index fell to a seven-month low in June, indicating a pessimistic view of personal finances. In the May retail sales report, growth was positive but slower than expected. This recent data point suggests consumers are exercising more caution amid tighter budgets.

In my view, consumption growth is slowing as high borrowing costs, high prices, and depleted savings are starting to bite into the budgets of low- to moderate-income consumers. While the headlines tell us inflation has slowed since its 2022 peak, prices remain more than 20% higher than they were in 2020. Consumers are finding it difficult to get excited about prices rising at a slower pace. This is especially true for lower-income consumers, who feel the impact of inflation when buying essentials such as rent, food, and gas.

So far, any concerns around the consumer have not seemed to scare investors. Investors have pushed the S&P 500 to more than 30 new highs this year as the economy has grown at nearly 3% (in real terms) over the past four quarters. But as excess savings shrink, the impact of inflation is more painful. I would characterize this process as a normalizing of spending after a period of splurging, rather than something more ominous in the near term. Therefore, I am currently viewing this as a yellow light, not red, one that merits monitoring the labor market and the consumer for signs of further deterioration, which could impact positioning in portfolios.

Investment Outlook and Portfolio Positioning

After falling 4% in April, global stocks (U.S. plus foreign stocks) rebounded in May and June with the MSCI ACWI Index gaining nearly 3% for the quarter. U.S. stocks again led the charge with all three major indexes – the Dow Jones, Nasdaq, and S&P 500 all making new all-time highs in the quarter.

Domestic Equities

Continuing the theme from 2023, an even smaller handful of U.S. mega-cap technology stocks continue to lead way higher for the domestic equity market (S&P 500 Index). Last year just 30% of stocks within the S&P 500 outperformed the index. This was a historically low figure -- a level not seen since the late-1990s. Yet, so far in 2024, the concentration of returns moved even higher. Through late June 2024, only 27% of stocks are outperforming the S&P 500. This is lowest reading on record going back more than 50 years. As shown in the table below, the top 10 contributors in 2024 have accounted for 70% of the S&P 500's 15% year-to-date return, and a single stock, Nvidia, accounted for nearly 1/3 of the year-to-date return of the index. I should note that growth indexes have become even more concentrated. The 10 largest stocks in the Russell 1000 Growth Index now account for more than 50% of index. This is highest level of concentration since inception in the late 1970s.

Top 10 Contributors to S&P 500's 15% YTD Return

Company	Ticker	GICS Sector	Portfolio Weight	YTD Return	Contribution to Index Return	% Contribution to Index Return
NVIDIA	NVDA	Information Technology	6.3%	138.5%	4.2%	28%
Microsoft	MSFT	Information Technology	7.3%	19.5%	1.4%	9%
Alphabet	GOOGL/GOOG	Communication Services	4.2%	28.4%	1.1%	7%
Meta Platforms	META	Communication Services	2.4%	41.2%	0.8%	5%
Amazon.com	AMZN	Consumer Discretionary	3.7%	22.1%	0.8%	5%
Eli Lilly and Co	LLY	Health Care	1.6%	53.2%	0.6%	4%
Apple	AAPL	Information Technology	6.5%	8.4%	0.6%	4%
Broadcom	AVGO	Information Technology	1.5%	43.7%	0.5%	4%
Berkshire Hathaway	BRK.B	Financials	1.6%	16.1%	0.3%	2%
JPMorgan Chase & Co	JPM	Financials	1.2%	18.3%	0.2%	1%
Top 5 Contributors			23.9%		8.3%	55%
Top 10 Contributors			36.4%		10.5%	70%

Source: Morningstar Direct. S&P 500 Index proxied as iShares Core S&P 500 ETF. Data as of 6/24/2024.

While the concentration levels in the index are noteworthy, it's possible that this trend can continue for some time. Afterall, the strong run for Artificial Intelligence (AI) stocks has been supported by companies such as Nvidia which continue to deliver and beat earnings estimates.

Our growth portfolios have meaningful exposure to many of these strong-performing mega-cap stocks, which has benefitted portfolio performance. But our portfolios remain balanced, also owning

larger-cap slower-growing ("value") stocks and smaller-cap U.S. stocks that are trading at more attractive valuations and offer important diversification benefits. Smaller-cap U.S. stocks, for example, are trading at valuations relative to large-cap stocks that have not been seen in years, dating back to the late 1990's, but there's no question owning anything other than fast-growing large-cap stocks has been a handicap in this market. But that's so far. Going forward, I think it's quite possible that areas of the equity market which have lagged and have lower valuations—small-cap companies and value stocks—could benefit from an ongoing expansion and a broadening out of the market rally.

International Equities

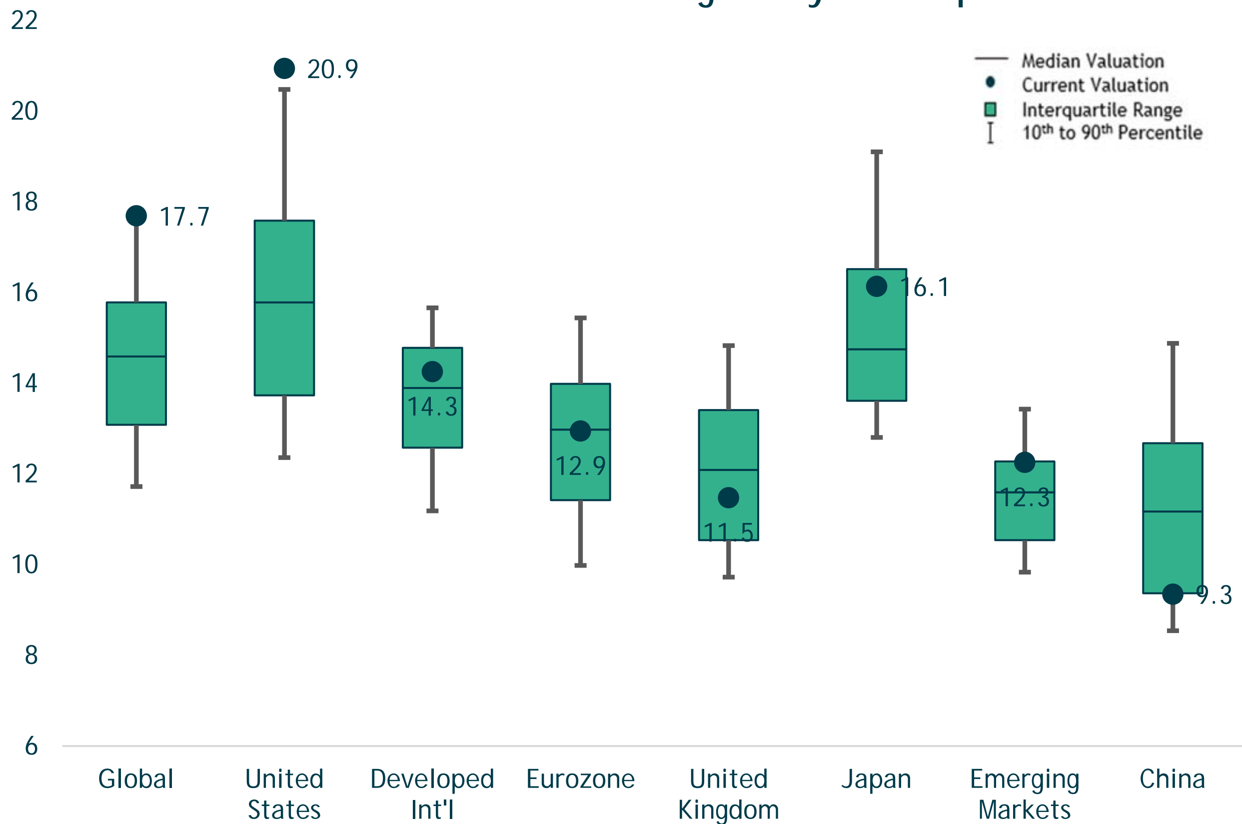
Outside of the U.S., there are some compelling opportunities in developed international (MSCI EAFE) and emerging-market stocks (MSCI EM). Europe, for example, is home to several leading businesses in a range of growing and attractive sectors. For instance, Novo Nordisk has seen its stock price double over the past two years following the successes of its type-two diabetes drug Ozempic, and its weight-loss drug, Wegovy, becoming Europe's largest company. Within the consumer discretionary sector there are world-leading European luxury brand companies such as LVMH, which have benefited from growing consumption of a rising population of those considered middle-class in emerging economies.

From a valuation perspective, the discount for developed international stocks versus the U.S. is the widest it's been in decades. Translation: international stocks are cheap compared to U.S. stocks.

From 2006 through 2016, the U.S. and developed markets traded within one multiple point of each other. So, an investor could buy one dollar of U.S. earnings (S&P 500 earnings) for $14, and they could buy one dollar of international earnings (MSCI EAFE earnings) for $13. Since 2016, the valuation gap has widened substantially. It now costs that same investor $21 for a dollar of U.S. earnings and $14 for a dollar of international earnings

The story can be seen in the chart on the next page. U.S. stocks trade at peak valuations, while other regions offer better relative values as their valuations are not as extended. All else equal, lower starting valuations imply better long-term returns and should provide more of a valuation cushion in case there's a selloff in stock markets.

So, back up the truck to the international stock store and load up on international stocks, right? Not so fast, Mr. Buffet. Sometimes there's a good reason for a stock, or in this case, a group of stocks from a particular economic region, to be discounted. Recent economic growth statistics coming out of the Eurozone tell a story of an economic region stuck in first gear, or even idling in a growth range between 0% and 2%. Which is to say, "barely growing." In my experience, investors find it hard to get excited about investing in a barely growing economy, especially when the politics of the day are resistant to changes that would promote more robust economic growth.



In looking at the above chart, an astute observer might intuit that the *absolute* valuations of most regions of the global economy -- the exceptions being the U.K. and China -- are still not cheap relative to the historic valuation norm for the region. While cheap *relative to U.S. stocks,* international stock valuations have failed to entice investors away from what is becoming ground zero for the AI revolution: the United States. Besides slow economic growth and limited exposure to the AI revolution, what else might be dissuading investors from "backing up the truck" to buy international stocks?

Investors may also be looking at the significant number of elections in the Eurozone in 2024, which brings political uncertainty and will likely bring volatility to these markets. For example, in mid-June, we saw volatility jump in France, a response to the decision by French President Macron to call a snap election after his party had disappointing results in the European Parliamentary elections. The markets were taken by surprise by the announcement of an early election and the reaction focused on the Eurozone markets and more particularly French securities. French government bonds tumbled, driving yields spreads over safer German bonds to the highest level in seven years. European stocks also declined though the drop was more pronounced in France, with Eurozone bank stocks getting hit the hardest, particularly French banks.

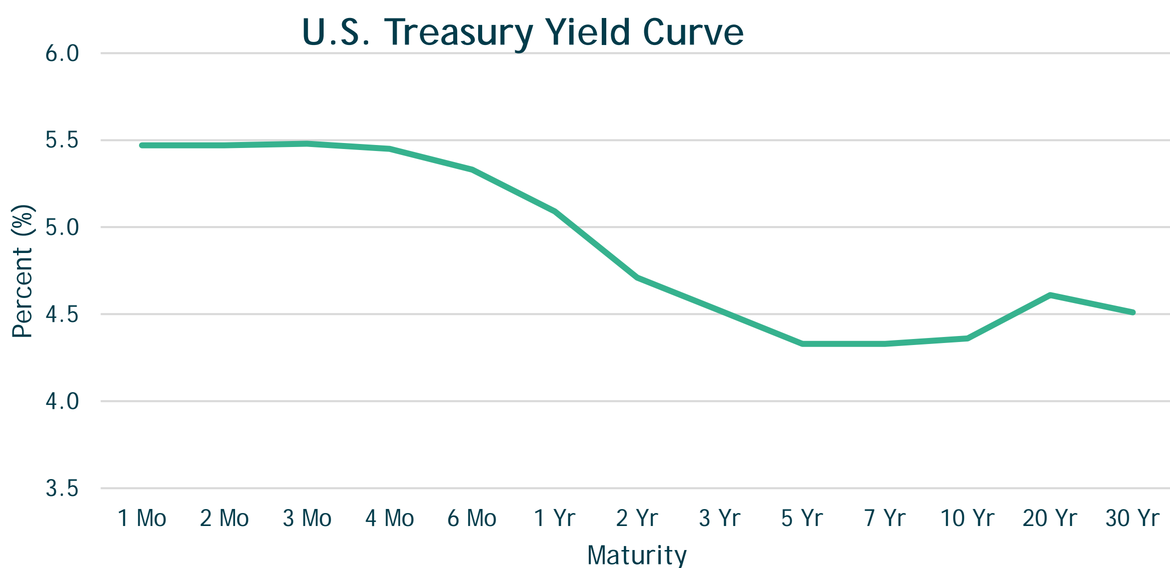
Of course, here in the U.S., you should expect pockets of volatility as the drumbeat around the November election gets lounder, particularly given today's polarized political environment.

Undoubtedly, headlines will influence short-term market fluctuations but longer-term, fundamentals are what drive market performance. My focus will continue to be on factors such as Fed policy, economic growth, inflation, fiscal imbalances, valuations, etc. My intention is not to minimize the gravity of the U.S. election, but to point out that the gears of the economy are not overhauled based on an election outcome. For example, the U.S. economy is consumer driven and that's not going to change. Ultimately, the fundamentals of the economy don't change overnight, and I don't think an investment strategy should either. As always, my approach is to be prepared to take advantage of opportunities that may arise with significant market fluctuations.

Fixed-Income/Bond Markets

Bonds. Boring, right? Bonds came into 2024 on a high note after ending 2023 with strong performance, and it seemed that the days of losses were behind us. After all, the economy was growing, inflation had declined meaningfully and consistently since mid-2022, the Fed was discussing rate cuts, and unemployment remained low. But then inflation and job growth came in higher than expected causing a dramatic reduction in the number of expected rate cuts. This created an unusual level of interest-rate volatility and questions mounted around Fed policy, pushing yields higher. This resulted in more attractive income for most fixed-income sectors, and this higher income will serve as a buffer against a move higher in rates.

In the meantime, the yield curve (shown below) remains inverted, meaning short-term bonds yield more than longer-term bonds. In time, we will return to a normal shaped yield curve, where investors receive higher yields for longer maturities. As shown in the chart below, investors are receiving



Source: U.S. Department of The Treasury. Data as of 6/30/24.

slightly more than 1% additional yield for investing in short-term bonds compared to the 10-year Treasury, with less interest-rate sensitivity.

At the end of June, a 3-month Treasury bond was yielding 5.48% compared to 4.36% for the 10-year Treasury. If one considers potential changes to the yield curve over the next two years, one possible outcome is that the Fed funds rate is 225 bps lower, an estimate based on the Fed's projection of nine rates cuts by the end of 2026. This would put the 3-month Treasury yield in the 3.0% to 3.25% range. If one assumes a normal term-yield premium, it's likely the 10-year Treasury would be in the mid to upper 3% range. From current yield levels of 4.36%, this limits the upside price potential as longer-term bond yields only have so much room to decline.

This outlook, combined with my view that inflation is under control, and that short-term interest rates have peaked and are likely to move lower explains my fixed-income portfolio positioning. In an upcoming portfolio change, I intend to re-position some of the fixed income portfolio into 5-year high-quality corporate bonds (5.25% overall portfolio yield-to-maturity) and AAA collateralized loan obligations, which offer rates that float with prevailing rates. Both are on the short end of the yield curve where there's less risk and where I can take advantage of the current inverted yield curve.

Conclusion

The U.S. economy looks set to benefit from a continuing gradual moderation in growth, inflation, and jobs, creating a backdrop that could support risk assets. As was the case last quarter, the stock market continues to hit new highs as economic growth continues to benefit corporate earnings. U.S concentration remains high with the Magnificent Seven representing over 25% of the S&P 500. There's no doubt that the other 493 stocks of the S&P 500 have struggled on a relative basis, but they could be set to move higher if the key economic drivers outlined above continue to fuel the economy. That said, fears of a recession haven't completely abated. Looking out to the end of the year and into next year, the question remains whether a recession will be avoided or delayed. As such, I am keeping a close eye on the typical drivers of recession, including the labor market, consumer spending, and corporate earnings, where a deterioration in these variables could influence portfolio positioning.

Heading into the second half of the year, I continue to anticipate pockets of volatility given headline risks related to Fed policy, geopolitical events, and the upcoming U.S. presidential election. In the event of volatility, I will look to be opportunistic, taking advantage of any attractive risk/reward opportunities that arise.

Thank you for your continued trust and confidence.

Best,
Kelly D. Kane, ChFC, CFP©

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