Q2 Market Review & Outlook

July 10, 2024

The S&P 500 Index is up 4.3% for the 2nd quarter and 15.3% for the year to date through 6/30/24. International stocks as measured by MSCI ACWI ex-US rose 1.2% and 6.0% for the corresponding three- and six-months periods, while high quality bonds were relatively flat and more credit sensitive fixed income rose modestly, up 1.1% for the quarter and 2.6% year to date.[1] Clearly, the capital markets are driven by inflation rates, productivity and economic growth, and valuations – and not by politics.

In the United States, the economy remains on solid footing, with continued low unemployment and easing inflation. The Federal Reserve has left the Fed Funds target rate at 5.25-5.5% but investors are reasonably confident that the Fed can cut if the economy weakens. In the interim, the U.S. consumer remains strong and household net worth, led by the mostly retired Baby Boomers, hit a new record in 2024.[2] Spending on services, notably for experiences, remains robust.

Significantly, spending on CapEx (capital expenditure) is also encouraging. Companies and governments are investing heavily on infrastructure to support the broadening application of artificial intelligence, green energy and onshore manufacturing, a development that we will be reviewing in depth in the next edition of *Independent Thinking*. In the interim, it's important to note that the robust CapEx cycle should support job growth and help to keep unemployment low, a key factor in keeping a recession at bay.

Market bears, who have been expecting a U.S. recession for three years, now point to rising credit delinquencies among the less affluent (who represent a relatively small proportion of the economy) and to some weakness in durable goods sales and some other forms of consumer spending. Longer-term, we are more concerned about record government debt levels, a structurally large budget deficit, and declining birthrates.

On balance, however, we have a positive view. While we wouldn't characterize ourselves as either bulls or bears, we do believe there are at present more positives for the U.S. economy than negatives.

CASH AND DEFENSIVE ASSETS

The 10-year Treasury yield ended the 2nd quarter yielding about 4.4%, which resulted in a slight negative total return for most high-quality bonds indices year-to-date. Municipal yields as a percentage of Treasuries rose during the quarter, making them relatively more attractive.

With the Fed likely to leave rates around the current level for the balance of the year, cash and very short-term bonds should continue to earn an annualized 5% plus return, far outpacing the return of longer dated Treasuries and other high-quality bonds.[3] We believe that a portfolio of high-quality bonds represents an attractive long-term investment, as current yields seem likely to beat inflation over the next decade across the curve. We continue to modestly extend the maturities in our client portfolios.

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[1] Bloomberg U.S. Corporate High Yield Index

[2] Federal Reserve Economic Data

[3] ICE BofA US Treasury Bill (3 Months), annualized

CREDIT ASSETS

Credit spreads, or the differential between Treasuries and credit risky corporate bonds, have compressed, leading to modestly positive total returns for both the 2nd quarter and the year to date. While credit spreads are lower than the long-term average, the absolute yields of nearly 8.0% we believe make high yield corporate credit a worthwhile investment, as are high quality business development corporations, which hold pools of private middle market corporate loans, and securitized credit, which provide exposure to pools of consumer loans and commercial and residential mortgages.[4]

GROWTH ASSETS

The top 10 companies in the United States by market capitalization now represent 37% of the S&P 500. As of June 30, Microsoft, Apple and Nvidia were each worth over $3 trillion and Google and Amazon both over $2 trillion. These 10 companies (as measured by the S&P 500 Top 10 Index) rose 14.4% for the 2nd quarter, and 28.9% for the first six months of the year. In contrast, the S&P 500 Index on an equal weighted (as opposed to market capitalization-weighted which is how the index is measured) basis declined 2.6% in the 2nd quarter and rose just 5.1% for the six months. This differential shows how the dominance of a narrow subset of companies has impacted the performance of the whole.

While these high valuations give us pause, the Big Tech companies are the first – and likely lasting – beneficiaries of what seems to us the beginning of an A.I.-driven productivity super cycle. A.I. productivity enhancements are likely to eventually flow through to other companies as well, big and small, in all sorts of industries, driving future earnings growth. While we invest in most of the Big Tech companies, we are also focused on the next beneficiaries of this cycle, including companies in the health care, consumer discretionary and financial services sectors.

International stock market indices are also generating positive, albeit more modest, returns, with the MSCI ACWI ex-US Index up 1.2% for the 2nd quarter and 6.0% year to date. After 15 years of relative stock market and corporate earnings growth underperformance, the valuation gap between domestic and international stocks sits near a record differential.[5] While we remain underweight international stocks, we are taking advantage of this valuation differential by adding to our international exposures, notably in Japan, which has a better earnings growth profile.

ILLIQUID ALTERNATIVE ASSETS

Private market fundraising remains low. The weak IPO market is making exits for private equity owned companies difficult; the high current cost of debt is making leveraged buyouts less profitable, and commercial real estate remains troubled. We believe, less capital entering the market should lead to more disciplined investing and to attractive investment opportunities in current vintages. But private markets are difficult to time; we believe that the best investment approach to this asset class is programmatic, investing across asset classes and vintages to build a diversified private market portfolio over the long-term.

CONCLUSION

We expect the narrow U.S. equity market to broaden if productivity continues to improve, which would allow earnings to grow into currently high valuations. Fixed income yields after inflation remain positive across maturities and asset classes. And private alternative assets can potentially add high returns and diversification to traditional liquid portfolios. We remain focused on helping ensure that each client's portfolio can withstand a

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[4] Bloomberg US Corporate - High Yield: Yield to Worst of 7.9% as of end of June

[5] Data from MSCI Index

range of market and economic outcomes while maintaining an appropriate level of liquidity and reflecting long-term financial goals.

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