

Market outlook as of July 2024

“Politics is the art of looking for trouble, finding it everywhere, diagnosing it incorrectly and applying the wrong remedies.”

Julius Henry “Groucho” Marx (1890 – 1977), American comedian and actor.

Overview

Following robust gains in the first half of the year stocks seem to be set to go higher into the second half of the year with a strong tailwind supported by the AI frenzy and healthy corporate profits. Both the labor market and business fundamentals are still strong. According to Wall Street analysts, the S&P 500 Index businesses' earnings are expected to climb by over 10% this year and then increase again in 2025.

Risks

The markets are currently taking bad economic news as good news, as it makes for more certainty of a Federal Reserve rate cut. At some point “bad news” will be bad as it will mean the economy is deteriorating and we could be going into a recession. The danger is that growth slows down to the point that negative economic news turns into negative news for stocks.

As shown by the weakness of stocks such as Nike and Mc Donalds (down 30% and 13% respectively, year to date), consumers appear to be worn down by multiple years of inflation and high interest rates, especially from the middle class down. GDP growth has decelerated largely due to soft personal consumption expenditures (PCE), particularly for durable goods. Key indicators are starting to show softness. Labor market

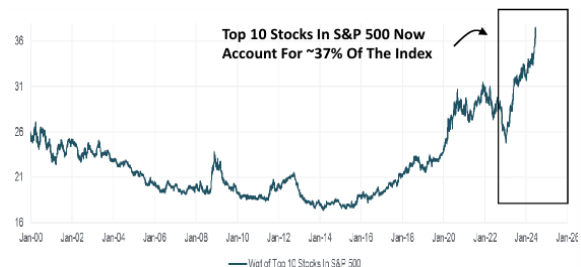
data – including job openings, quit rate and surveys of business sentiment – have been showing signs of weakness.

Although inflation is slowly receding it is still painfully high. It's unknown when the US Federal Reserve will lower interest rates. A trade war is still raging between China and the United States, and wars are still ongoing in the Middle East and Ukraine.

AI will at some point be influenced by the same economic rules and investor emotions similar to other product cycles. Longer term AI will have a significant impact on how we work and live. In the late 1990s, we observed comparable trends with the growth and burst of the telecom and technology bubble. Even though we don't think we're in a bubble right now, there's a strong probability some of these equities will experience painful declines. There is also a strong likelihood that strong competitors will emerge, making some existing companies vulnerable due to extended valuations.

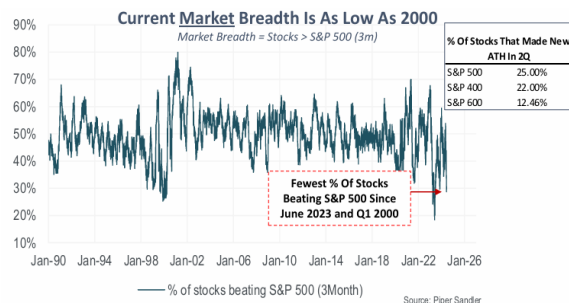
Bifurcation (Websters Definition: the point or area at which something divides into two branches or parts: the point at which bifurcating occurs)

The S&P 500 Index returns are being driven by a very narrow band of stocks (see below, source, Piper Sandler)

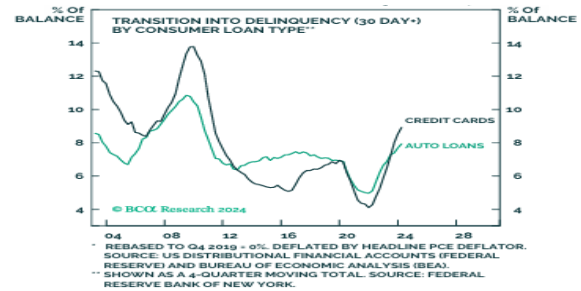
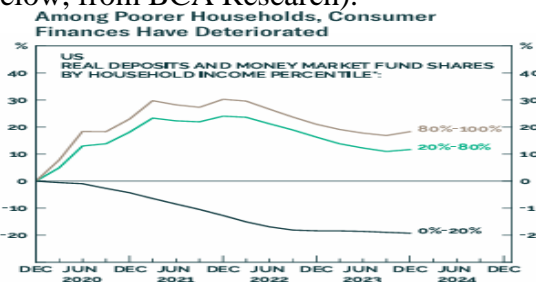


The difference between the returns of the S&P 500 (large caps) and the Russell 2000 index (small caps) is 13.6% for the six months ended June 2024 and a whopping 26.6% for the 18 months ended June 2024. This is unsustainable, especially when in the past small caps have outperformed large caps.

Market leadership (see below) has become extremely narrow and is unsustainable in the long term.



Not only is there a growing gap between the largest companies returns, certain sections of the economy but also between the population of “haves” and “have nots”. The middle class and below are feeling the inflationary effects in their household budgets and have run out of Covid savings. Credit card and Auto loan delinquencies have also started to rise. (see below, from BCA Research).



US Election

Stocks in 2024 have so far superseded the usual election-year returns. The election is heating up, which could cause market volatility in the second half. Market participants pay it a lot of attention when the polls change, and new policy considerations emerge.

Investors are interested in how various results will influence the markets' and the economy's trajectory. The significance of U.S. tax policy is especially noteworthy because the Trump administration's 2017 tax cuts are set to expire. Should the outcome be Republican (more than likely at this point), it's conceivable that the cuts will become permanent or prolonged.

Diversification

Most investors are placing too much confidence on a single segment of the market that has become extremely concentrated; this includes both index investors with a passive concentration (as shown in the graph on the second page) and active managers that favor the US and growth-oriented segments of the market. History shows that chasing the top performers after a run up is a losing strategy and that's why investors want to aim to include diversity in their portfolios.

With many questions still lingering over inflation, interest rates and global trade and tariffs, asset allocation will be more critical. We like our “bar bell” approach, where we are exposed to the market leaders, but also have other sectors that are currently out of favor but look very favorable longer term such as healthcare. We anticipate a strong profits recovery in this severely oversold industry, fueled by ongoing investments in cutting-edge medications, medical technologies, and treatments. The indication is that the demand for these now reasonably valued stocks has increased and that a catch-up phase is likely due soon.

U.S. large cap dividend growth stocks in particular have proved resilient during difficult economic environments, while offering potential for consistent income growth. Long regarded as the domain of mature industries with slowing growth prospects. Dividends are now gaining favor among information technology giants. Meta, Alphabet and Salesforce all of whom introduced dividends in the first half of 2024.