Monday, July 1, 2024

SUMMARY-

I. First half registers strong gains for growth stocks.

II. Unusually low volatility YTD due to improving inflation data.

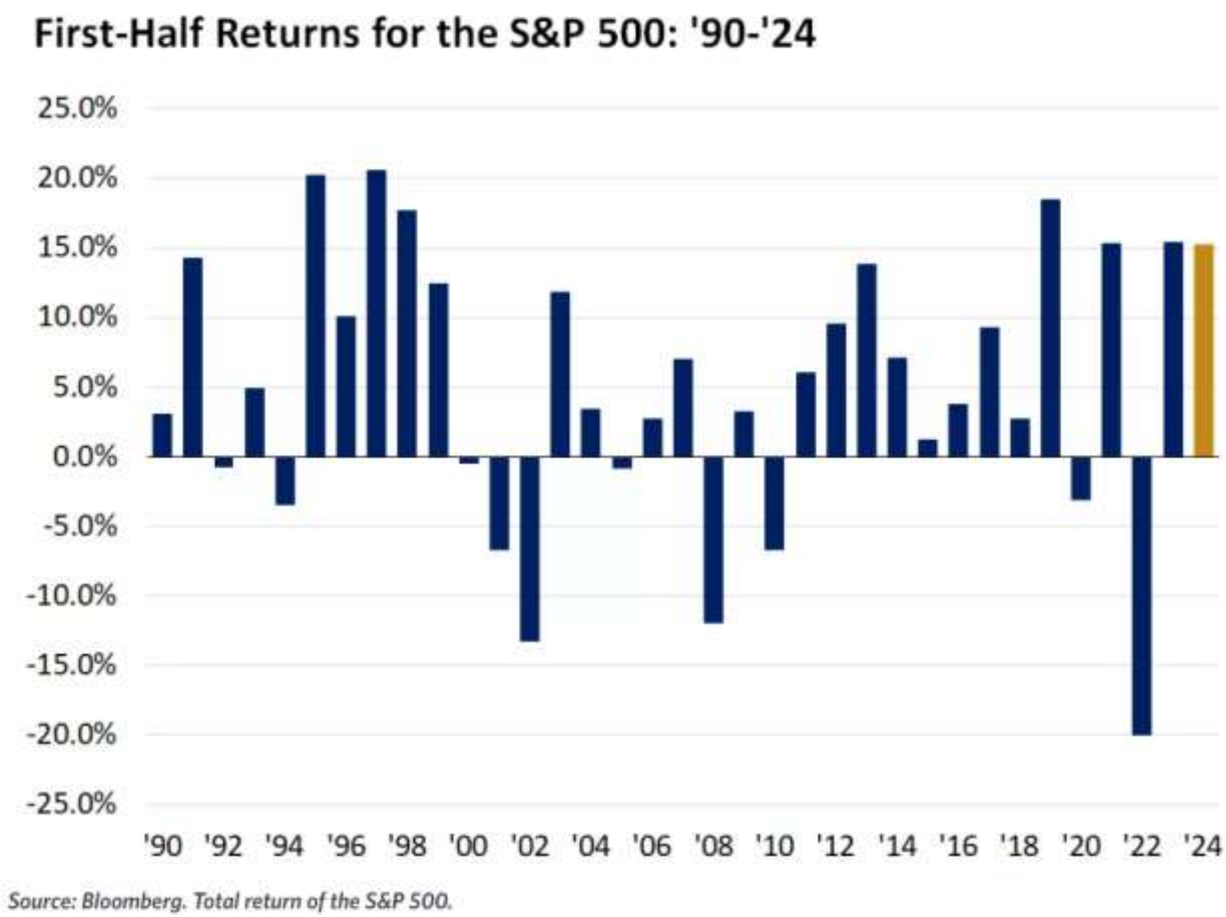
III. Some signs of broadening but AI excitement still leads market charge higher.

IV. Lagging small-caps could turn quickly when rate cuts lower their borrowing costs.

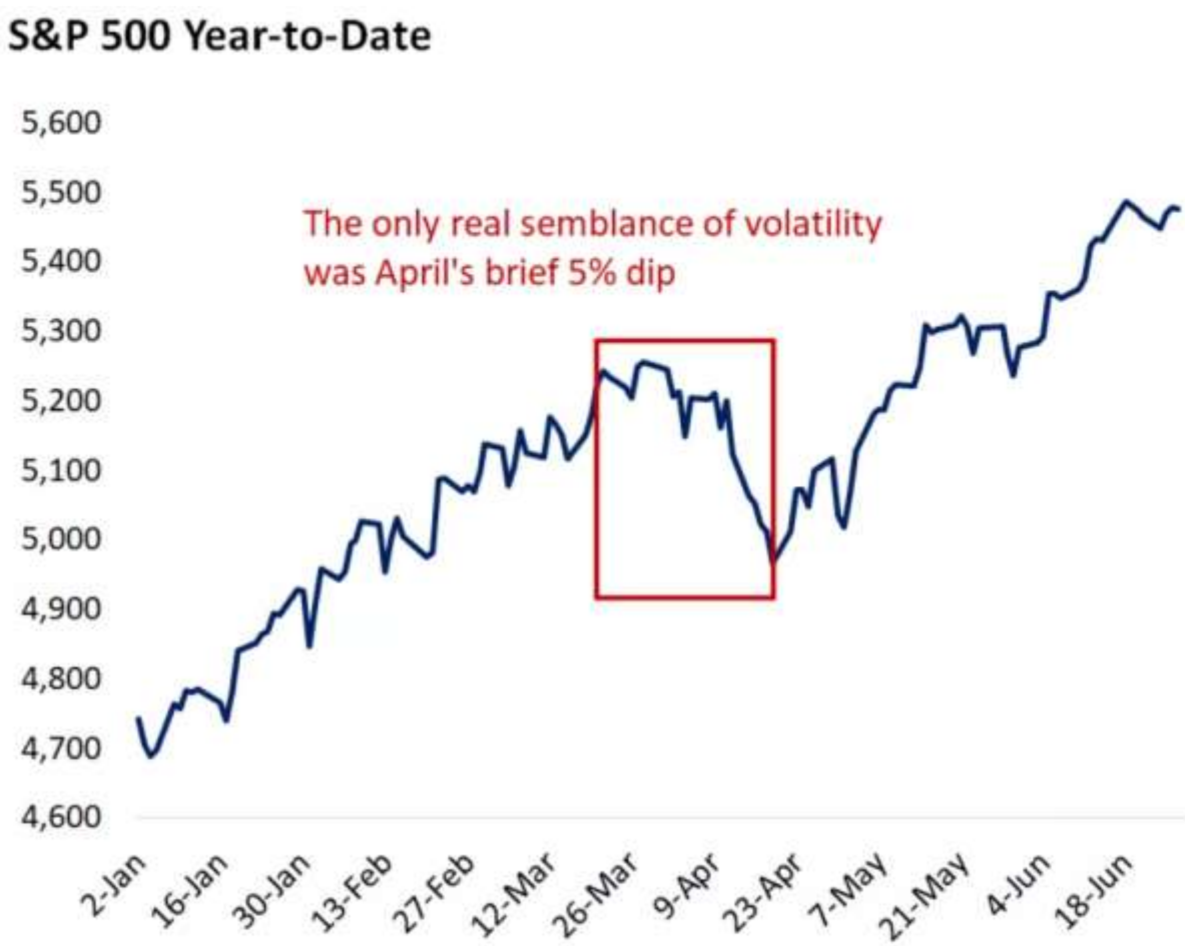
Good afternoon:

The S&P 500 and Dow Jones Industrial Average each closed out the first half of the year last week with tiny one tenth of one percent weekly declines, while the NASDAQ posted a two tenths of a percent gain by Friday's close. Equities continued to outperform other asset classes in the first two quarters of 2024 as strong earnings and economic news encouraged investors against a backdrop of improving inflation data. Although it has not materialized yet, as was widely anticipated at the start of the year, the commencement of a protracted Fed easing cycle has many believing that stocks can continue to provide solid returns for the foreseeable future.

The 15% gain YTD for the S&P 500 was certainly aided by the nature of how the index is calculated on a market-cap weighted basis. Large-cap technology companies like those in the Magnificent 7 that have been riding a wave of AI excitement all year are each given an index weighting relative to their size. And although it may not seem prudent, the bigger (or even more overvalued) a company gets, the larger its weighting in a market-cap weighted index. This year's first half S&P 500 return is among the top-seven in the past 35 years. Fortunately, strong first halves have not generally portended a weaker back half to the year. In fact, in the 11 years in which the index gained 10% or more by the end of June, the average full-year return went on to be 29%.



Also noteworthy is the lack of more typical equity market volatility so far this year. The largest stock market pullback in the first half was just a bit over 5%, benign in size and frequency when compared with historical yearly market declines. The drawdown emerged in April as a string of higher-than-anticipated inflation reports pushed interest rates higher and stoked worries of a persistent restrictive policy from the Fed. Markets rebounded quickly under the assumption that rate cuts were merely a matter of *when*, not *if*.



Source: Bloomberg, S&P 500 index as of 6/27/24.

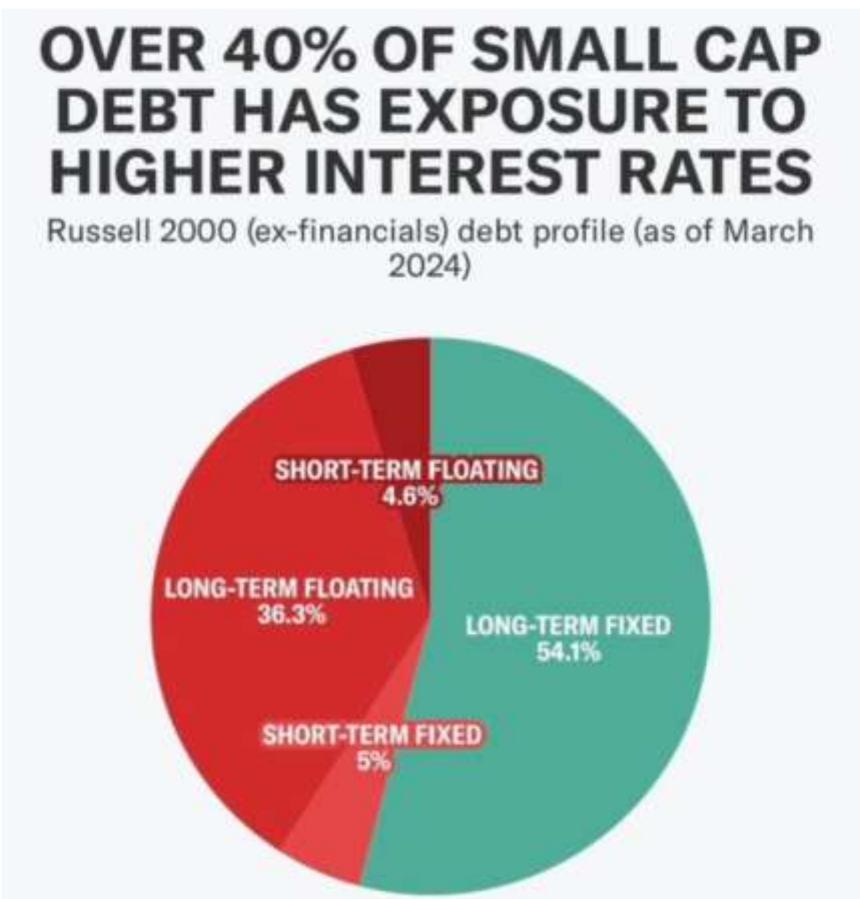
The VIX index (an index measuring market volatility, often referred to as the "Fear Index") recently fell to its lowest daily reading since 2019. Looking at a broader annual average for the VIX index, 2024's average level of 13.8 is the lowest since 2017 and would be the second-lowest yearly average in more than two decades.

Source: Bloomberg. CBOE Volatility Index.

Although AI-related companies continued to keep the information technology and communication services sectors in the lead and far outpacing all others, markets did start to broaden out in the first half the year. Energy, financials, and utilities sectors each showed strength while materials, consumer discretionary, and real estate stocks notably lagged. Also continuing their underperformance were small-cap stocks. Although small-caps have posted a respectable return of more than 11% over the past 12 months, most of that occurred in the fourth quarter of 2023. The mega-cap tech surge may also have pulled more speculative growth capital away from small-caps. Generally more sensitive to borrowing and labor costs, in addition to domestic demand, elevated interest rates, a tight job market and slowing economic growth are also likely keeping small-caps in check so far this year.

Source: Bloomberg, Russell 2000 Index.

However, if institutions begin to rotate back into small-caps in a more meaningful way, the gains could be both quick and sizable. This is partly due to the relatively small size of these company's values relative to large and mega-cap stocks. The combined market cap of ALL 2,000 companies in the Russell 2000 small-cap index is about $2.3 trillion, whereas Microsoft, Apple, and Nvidia have a market cap over $3 trillion EACH! For this reason, we still believe some exposure to small-caps in a diversified portfolio seeking long-term capital appreciation makes sense, particularly as we sit on the cusp of declining interest rates in the coming few years.



Source: FactSet

As we start the second half of 2024, we remain cautiously optimistic in the short-term and fairly bullish longer-term. We still believe a normal 10% correction is always a possibility, perhaps triggered by anxiety over the presidential election in November. We see technology firms and AI remaining popular as the possibilities for artificial intelligence continue to develop across all segments of the economy. Sector participation should continue broadening as many under-loved areas still offer good value. Long-awaited rate cuts are also likely to commence by year end, but then come gradually over the next two years as the Fed takes a cut-and-watch approach to ensure inflation does not reignite. Barring any unforeseen exogenous events, it should be a very fundamentally bullish environment for stocks to continue their march higher.

As a reminder, the markets and our office will be closing at 12:00 p.m. CT on Wednesday, July 3rd and reopening with normal hours on Friday, July 5th in honor of Independence Day.

Have a great week and a happy and safe holiday!!

Mark and Jeff

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The NASDAQ composite is an unmanaged index of securities traded on the NASDAQ system.

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The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index, which represent approximately 8% of the total market capitalization of the Russell 3000 Index.

Investing in small cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor.

Market return and statistical data obtained from: https://am.jpmorgan.com/blob-gim/1383452890099/83456/weekly_market_recap.pdf?segment=AMERICAS_US_ADV&locale=en_US

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