Monday, July 29, 2024

SUMMARY-

I. Tech stocks correct as value and small-caps continue to benefit from rotation trade.

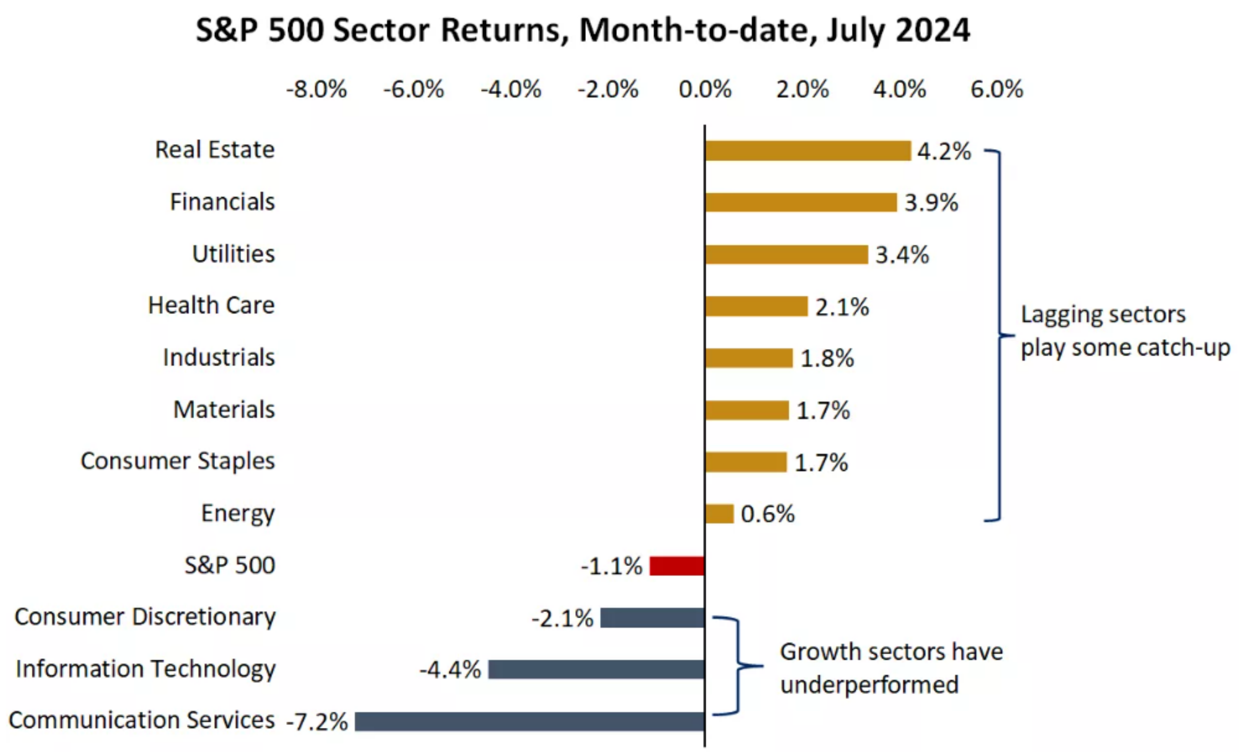
II. Upside earnings surprises continue to favor cyclicals.

III. Historical political developments have tightened race.

IV. Political uncertainty and broadening market participation is prompting heightened volatility for investors.

Good morning:

The S&P 500 and the NASDAQ retreated for the second week in a row amid choppy trading while the Dow again moved in the opposite direction, recording its fourth consecutive weekly gain. For the S&P 500 and the NASDAQ, modest rallies on Monday and Friday weren't enough to offset a sell-off on Wednesday. By week's end, the NASDAQ posted a -2.1% loss, the S&P 500 declined -0.8%, while the Dow gained 0.8%. However, it was the small-cap Russell 2000 index that continued its comeback adding 3.2% to lead equity averages. This marks the third straight week of the relatively sudden sector rotation into value and small-cap stocks following the July 11th cooler than expected CPI report and the impending rate cuts that it portends.

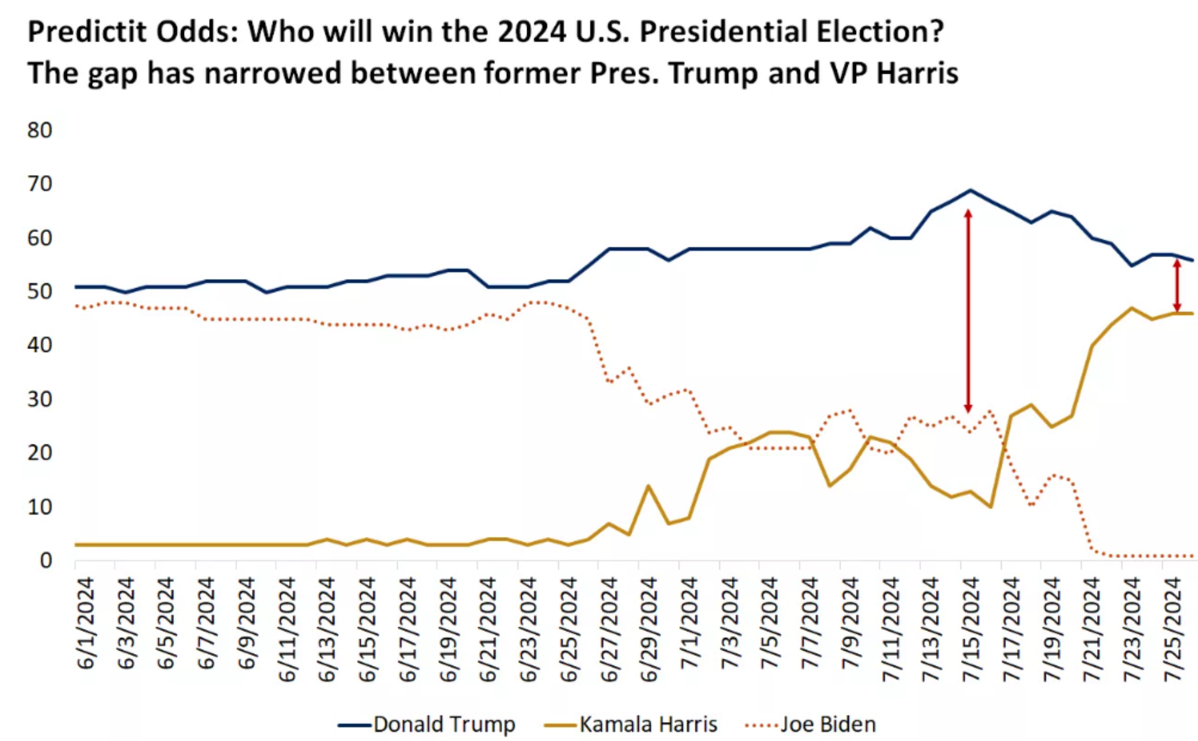


Source: FactSet, as of July 25, 2024

The clear disparity in sector returns this month illustrated in the above chart has been seen as overdue by many market historians. It has been understandably frustrating to watch the stellar recent returns in much of the tech and communications services sectors while so many other sectors lagged. The outsized weighting the mega-cap tech stocks like the Magnificent Seven represent in the S&P 500 have skewed the index's return to closely align with that sector, causing more properly diversified portfolios to appear as underperforming. This month's volatility and start of a correction in many Mag 7 names illustrates how the S&P 500 index is not only far from fully diversified, but perhaps riskier than perceived. Our SMART Portfolio strategies have fairly equal exposure to growth and value styles, as well as large, mid, and small-cap equity categories. As such, this month's market results have enabled this allocation strategy, in addition to our Dividend Growth and Equity Income strategies, to outperform the tech-heavy market-cap-weighted averages.

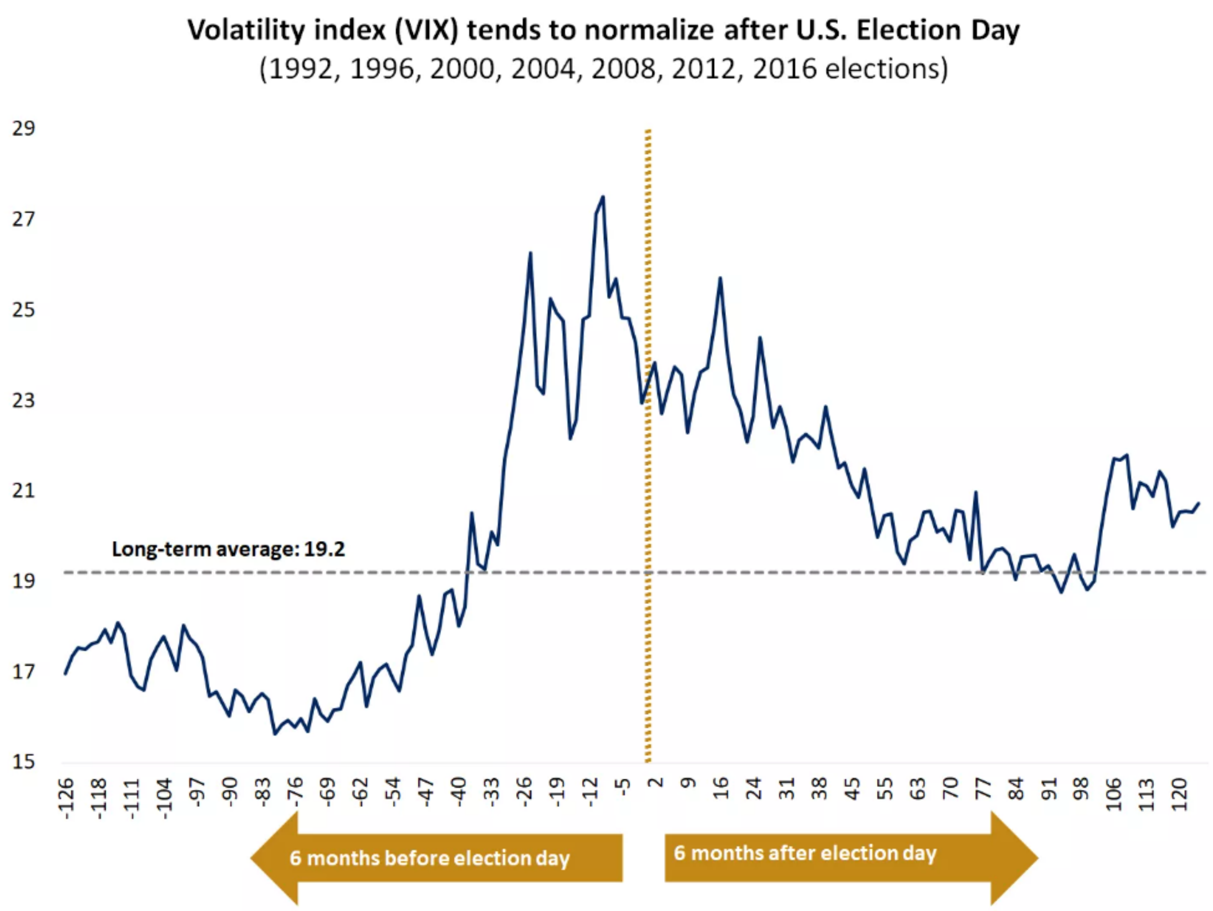
As we near the midpoint of second-quarter earnings season with about 41% of S&P 500 companies having reported thus far, earnings are on track to grow 9.7% year-over-year, above expectations for 9% growth at the end of the first quarter. The largest upside earnings surprises are coming from sectors like financials, energy, and health care, more so than technology and growth sectors. In addition, looking ahead toward fourth-quarter earnings, not only is earnings growth expected to be above 16%, but also the value and cyclical sectors are expected to contribute more to this growth than the artificial intelligence (AI) and technology sectors. This broadening of earnings growth is supportive of the market rotation and the broadening of market leadership, a healthy component to any bull market.

Increased market volatility has also accompanied several weeks of political volatility in the wake of an attempted assassination of one candidate and the forced removal of the other. After President Biden ended his reelection bid and endorsed Vice President Harris last week, markets and political strategists alike have had to reassess the current election season and its potential outcome. With Kamala Harris appearing to now have the support from the majority of Democrat party delegates to receive the nomination, she will soon name her running mate. Although many of these developments have just occurred, current polling and betting odds have already indicated a far closer race. Markets will be watching to see if former President Trump's lead narrows further as we approach next month's Democratic National Convention. Of course, any major legislative changes may require the presidency in addition to both houses of Congress. For this reason, markets generally favor divided government where significant and potentially disruptive policy changes are less likely.



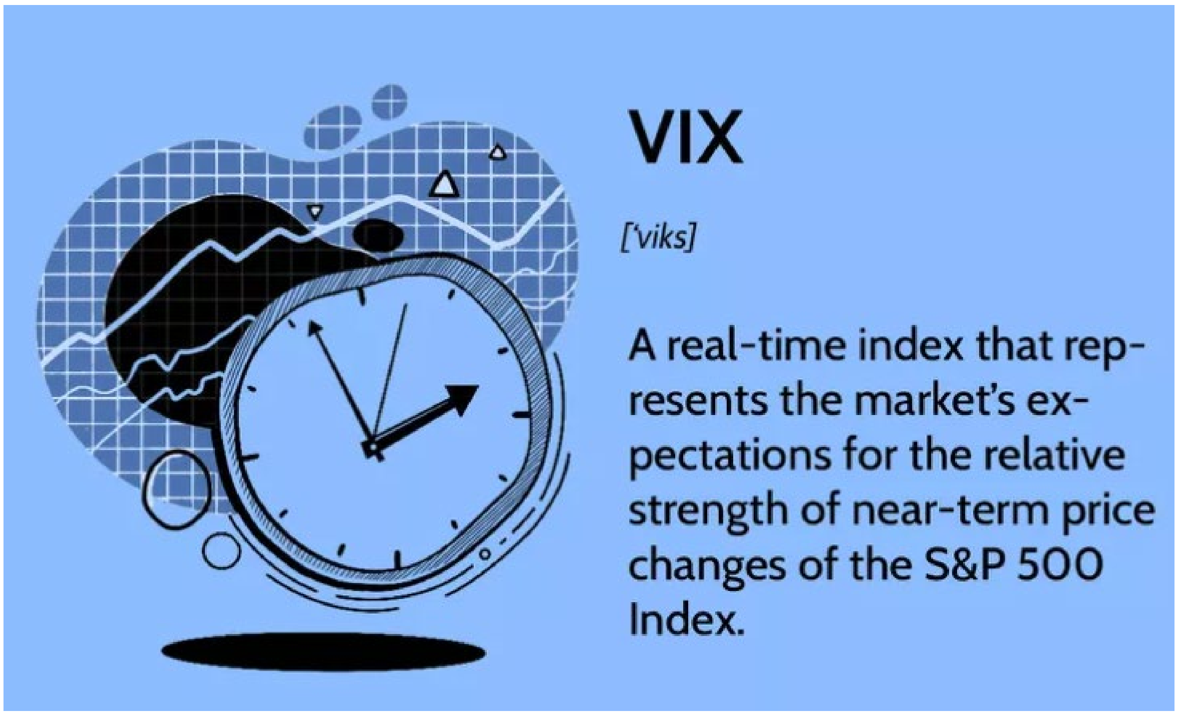
Source: Bloomberg, Predictit.

As we continue to point out, markets do not like uncertainty in general. With a new injection of political uncertainty now having been administered with only 100 or so days left until election day, investors should prepare for increased levels of volatility. However, election year volatility is not uncommon. In fact, history shows us that market volatility (as measured by the CBOE's VIX index) tends to increase ahead of election day, and then subside afterwards, regardless of who is in power. This could be in part because some uncertainty is lifted after the election is over, and markets can again focus on opportunities ahead.



Source: Bloomberg

In addition to more quarterly earnings reports, this week will bring a U.S. Federal Reserve policy meeting that concludes on Wednesday and a jobs report on Friday. The Fed is widely expected to keep interest rates unchanged at this meeting but may hint at future cuts. The jobs report will show how July's jobs growth compared with June's bigger-than-expected gain of 206,000 jobs. It's these key positive economic fundamentals on the eve of a Fed easing cycle that should serve to steady and propel our current bull market despite all the other noise and increasing volatility.



Have a great week!

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