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July 20, 2024

2024 Q2 Investment Commentary

US markets continued marching upward to new highs through the second quarter following a short correction and investor sentiment reset in April. Data points have at times been choppy, driving volatility, but longer trends remain intact. Economic expansion, earnings growth, slowing inflation and improving breadth continue to support the case for the long-term uptrend in equities to continue. However, like last quarter end, sentiment had become extended and valuations stretched, so a digestion of recent gains is needed to keep exuberance in check.

Over the last two weeks, US markets reacted quickly to a material decline in inflation and the attempted assassination of former President Trump. An intense counter trend rotation occurred out of Mega Cap and Tech winners and into Small Caps, Cyclical Value and "Trump trades" (Financials, Energy, Industrials, and Materials). Further pressure was created due to the Biden administration threatening new semiconductor export restrictions to China and a major global software failure.

It is too early to tell how this counter trend move will play out. Are we seeing a short squeeze, a healthy correction or the start of a bigger secular shift? Several divergent characteristics under the hood include relative performance not yet breaking long term leadership trends (Chart 1), new all-time highs and breadth thrusts (both significant percentage of stocks rising with significant volume) preceding the selloff, and the lack of follow through by the bond market (Chart 2). We will look for confirmation before overcommitting.

The Atlanta Fed's GDPNow model estimate for real GDP growth in the first quarter of 2024 is now +2.7%. This estimate dynamically adjusts to new data points and thus provides a good visual of the choppiness we have seen (Chart 3). The US economy is growing moderately and remains solid.

Inflation data has trended lower since stumbling in the first quarter. The annual rate has fallen for the third straight month. June CPI data surprised markets by unexpectedly falling -0.10%, notably the first month-over-month decline since May 2020 (Chart 4).

The labor market and the consumer also continue to be encouraging though less convincingly so. The unemployment rate in the United States ticked up to 4% and has been variable month-to-month. Including revisions, unemployment claims exceed new jobs by a thin margin, but remain well below levels of concern. Wage growth continues to exceed inflation. Retail sales continue to come in above expectations showing that consumer spending remains resilient, despite high interest rates and signs of easing in labor market tightness.

The Federal Reserve is expected to announce in their July 31st meeting, the 1-year anniversary of their last hike, that they will begin to cut rates in September, following their August break. The risk of restrictive Federal Reserve policy weighing too heavily on the economy is nearing. In the face of recent inflation and employment data, a lack of action would undermine credibility. The CME futures market is confirming, currently pricing a 94% likelihood of a 25bps cut in September. However, recent equity market reaction looks to be overly expectant. To avoid a 1970s-like resurgence in inflation, cuts will need to occur slowly keeping Real Rates (adjusted for inflation) at a neutral or only marginally restrictive level. Empirically, cutting slowly has also resulted in the best performance from equity markets (Chart 5).

Valuations are stretched as price has led earnings growth. The current forward 12-month P/E ratio for the S&P 500 is 21.2, above the 5-year average of 19.3. However, we are entering a period of accelerating earnings which should keep valuations in check. The bottom-up target for the S&P 500 is now 6062, up from 5750 in April, and 9.3% above yesterday's closing level of 5544. Further, the index has become unusually concentrated. If we strip out the largest 10 stocks in the SP500, valuations look much more reasonable at 17.6, and these stocks are also expected to see a greater earnings acceleration into year end, having trailed since 2022 (Chart 6).

For Q2 2024, according to FactSet's July 19th *Earnings Insight*, the estimated year-over-year earnings growth rate for the S&P 500 is +9.7%, up from an estimated +8.9% at the end of the first quarter. If reported, this would mark the highest year-over-year earnings growth rate since Q4 2021 and mark the fourth straight quarter of growth. Revenue and profit margins also remain robust. Looking ahead, analysts have cautiously lowered estimates but still anticipate year-over-year earnings growth of +11.0% for 2024, accelerating and broadening though year end and into 2025, estimated +14.7% (Chart 7).

Despite the recent volatility, markets remain in a secular bull market, supported by the weight of evidence. Moderate economic growth, strong balance sheets, an earnings tailwind, coupled with a more normalized rate environment and the election should support a continued broadening of equity market returns and positive performance. We favor high-quality growth at reasonable prices and businesses with stable free cash flow and healthy balance sheets. We will continue to balance growth and value and are prepared to shift defensively if necessary.

Our playbook continues to focus on significant secular, cyclical, and structural trends. A few important themes we are following are the reshoring of industry and reconfiguration of supply chains, datacenter and AI infrastructure, semiconductor cycles, underinvestment in energy and materials, beneficiaries of normalizing interest rates and the shifting Presidential election dynamics.

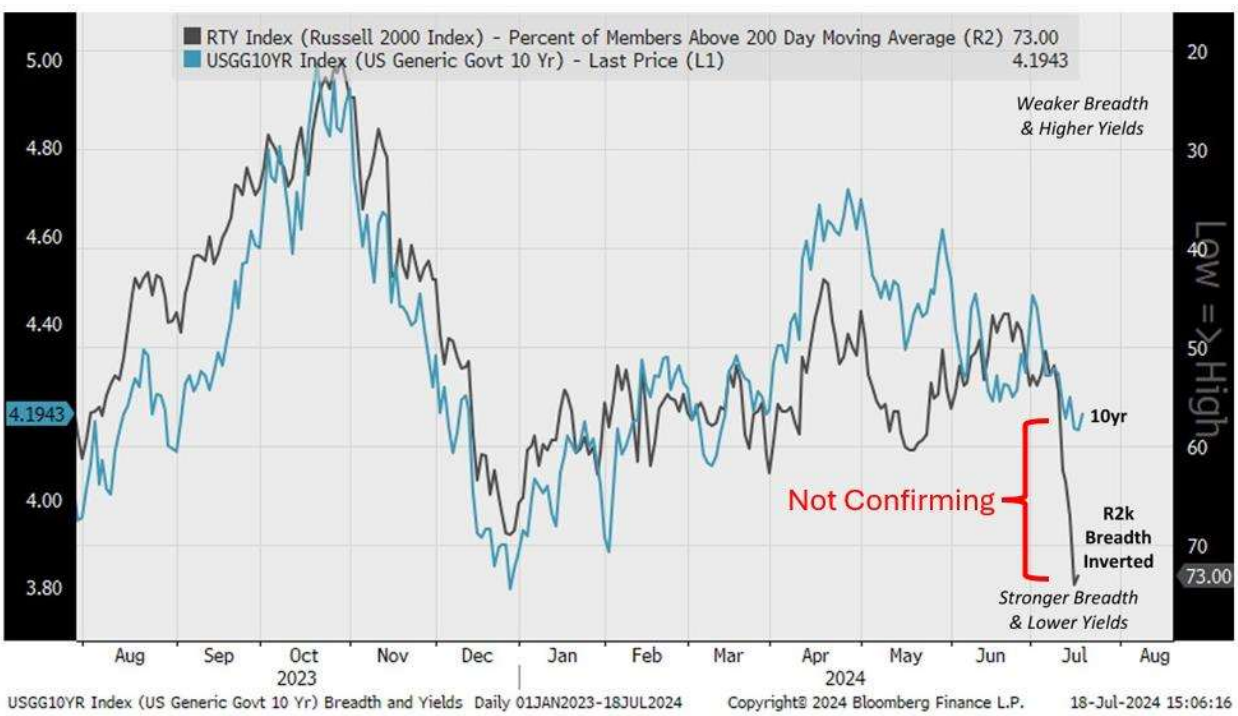
Election years bring positive change. Falling interest rates will be an added tailwind for markets. We are bullish but remain cautious in the near term as the market digests recent events.

Robert B. Morse

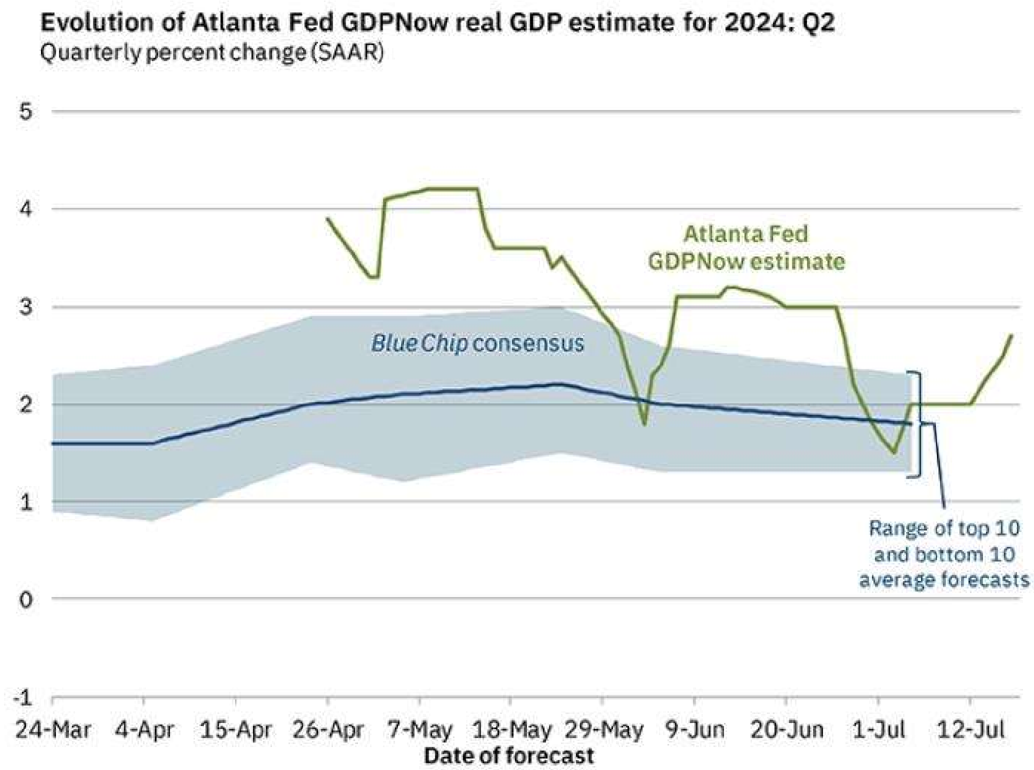
Chief Investment Officer

1. **Russell 2000 (Small Caps) relative to S&P 500 (Large Caps)**

2. **Interest Rates and Russell 2000 Inverse Correlation**

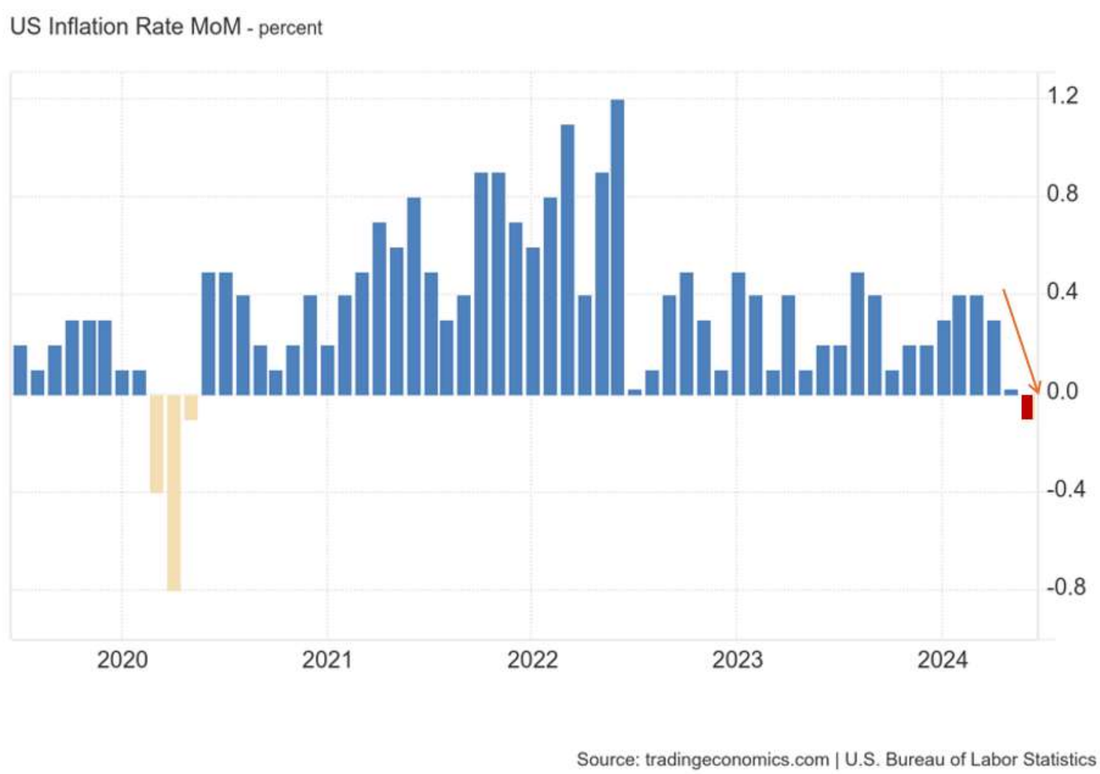


3.



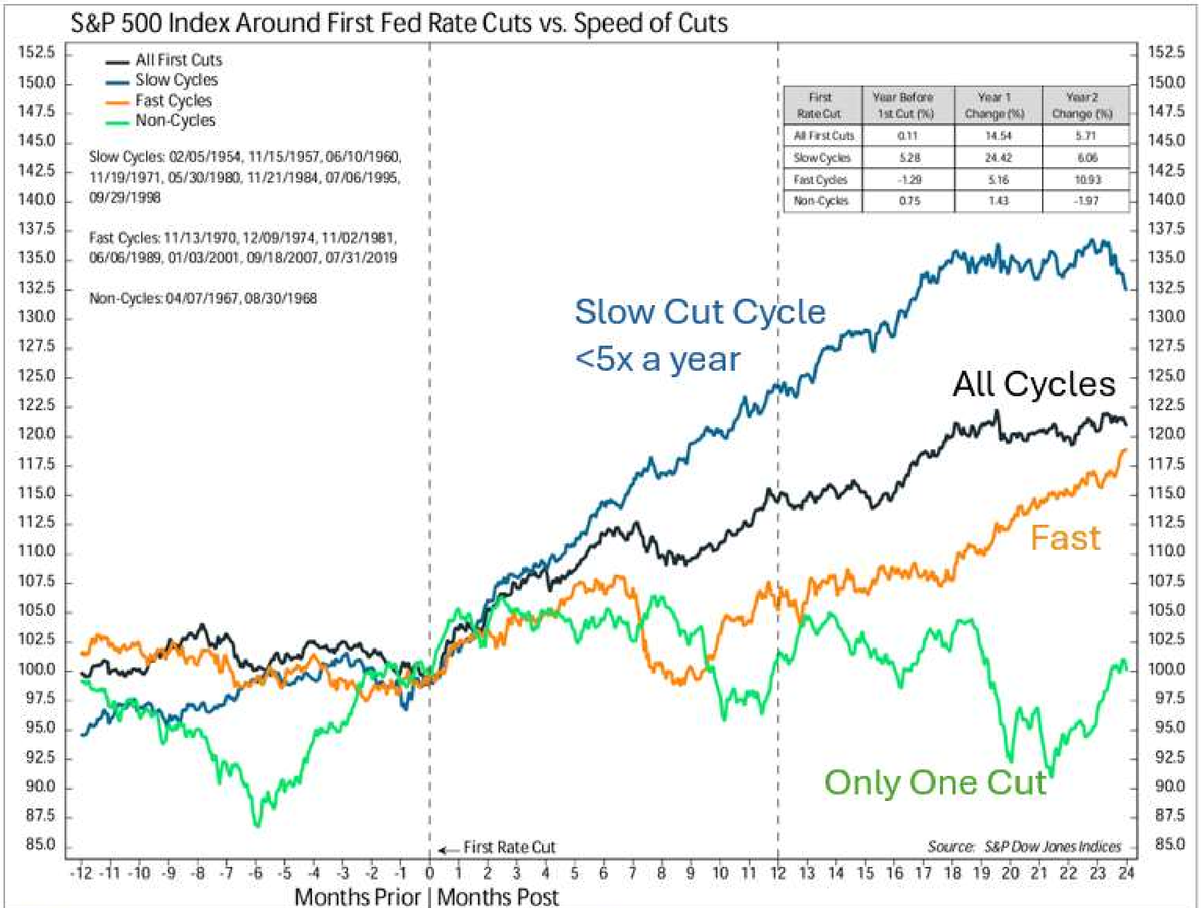
Evolution of Atlanta Fed GDPNow real GDP estimate for 2024: Q2
Quarterly percent change (SAAR)
5
4
3
2
1
0
-1
Atlanta Fed
GDPNow estimate
Blue Chip consensus
Range of top 10
and bottom 10
average forecasts
24-Mar
4-Apr
15-Apr
26-Apr
7-May
18-May
29-May
9-Jun
20-Jun
1-Jul
12-Jul
Date of forecast

4.



US Inflation Rate MoM - percent
1.2
0.8
0.4
0.0
-0.4
-0.8
2020
2021
2022
2023
2024
Source: tradingeconomics.com | U.S. Bureau of Labor Statistics

5.



First Rate Cut	Year Before 1st Cut (%)	Year 1 Change (%)	Year 2 Change (%)
All First Cuts	0.11	14.54	5.71
Slow Cycles	5.28	24.42	6.06
Fast Cycles	-1.29	5.16	10.93
Non-Cycles	0.75	1.43	-1.97

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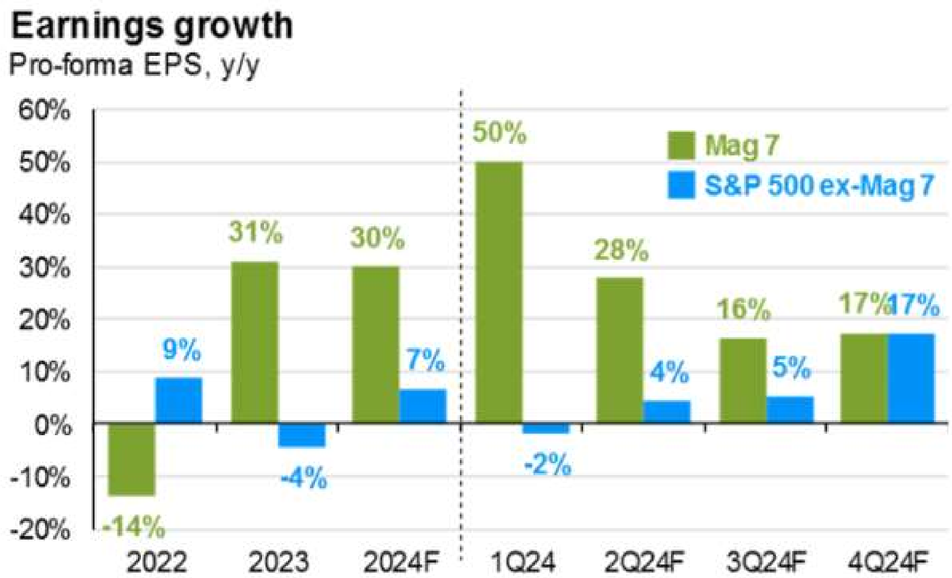
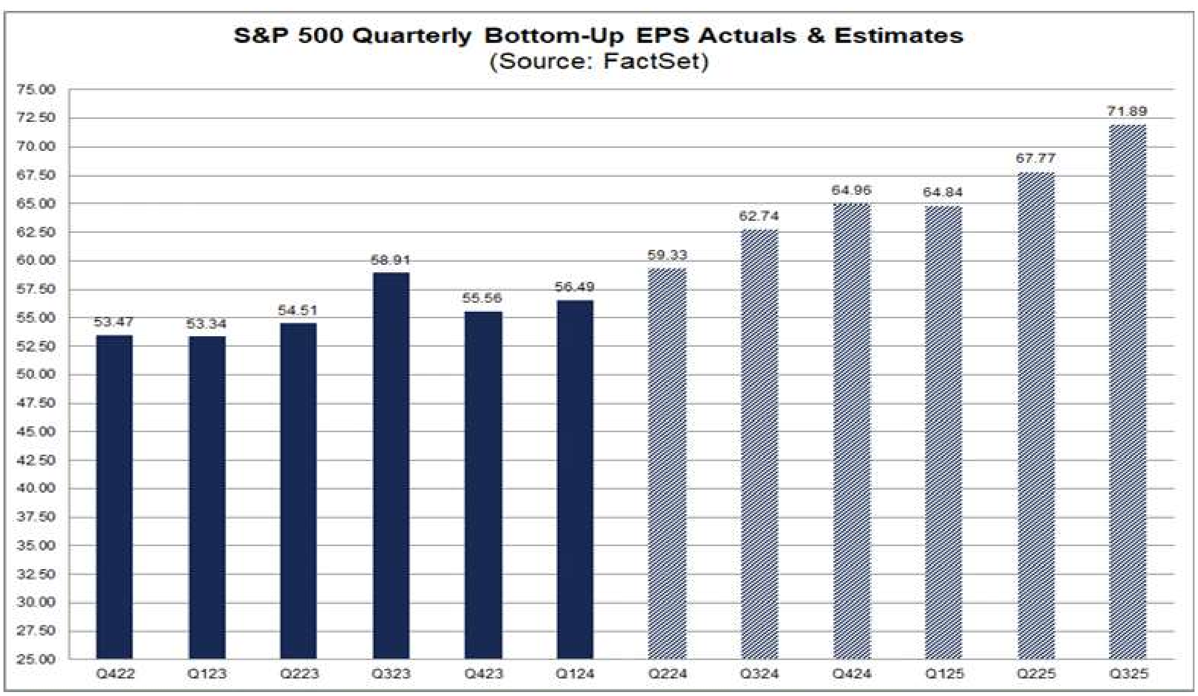

Earnings growth
Pro-forma EPS, y/y
Mag 7
S&P 500 ex-Mag 7
60%
50%
40%
30%
20%
10%
0%
-10%
-20%
-14%
9%
31%
-4%
30%
7%
50%
-2%
28%
4%
16%
5%
17%
17%
2022
2023
2024F
1Q24
2Q24F
3Q24F
4Q24F

7.


S&P 500 Quarterly Bottom-Up EPS Actuals & Estimates
(Source: FactSet)
75.00
72.50
70.00
67.50
65.00
62.50
60.00
57.50
55.00
52.50
50.00
47.50
45.00
42.50
40.00
37.50
35.00
32.50
30.00
27.50
25.00
53.47
53.34
54.51
58.91
55.56
56.49
59.33
62.74
64.96
64.84
67.77
71.89
Q422
Q123
Q223
Q323
Q423
Q124
Q224
Q324
Q424
Q125
Q225
Q325