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WEALTH MANAGEMENT

OUTLOOKS

July 2024

ECONOMIC OUTLOOK

Summary

Inflation metrics were among the most anticipated economic releases during June. This shouldn't come as a surprise since inflation impacts everyone and has arguably been the most closely followed economic data point since prices initially began accelerating in 2021. Those persistent price pressures caused the Federal Reserve to implement one of the most aggressive rate-hiking cycles in their history. The Fed increased the overnight rate to 5.5% which ultimately brought the headline Consumer Price Index (CPI) down from a peak of 9% to a low of 3% in June of 2023. Sadly, year-over-year CPI hasn't declined any further since then, even though the overnight rate has remained restrictive and untouched for nearly a year. Monthly CPI values accelerated for the first four months of the year until May's inflation data (released in June) finally provided some relief. During that time, inflation reestablished its ability to move markets, as market participants try to predict the Federal Reserve's next actions.

Those actions (or inactions) will be largely dependent on a combination of the level of inflation and growth within the economy. The renewed inflation to start the year hasn't provided Fed members with the necessary confidence the economy is on a sustainable path toward their 2% inflation target, which in turn decreases the expectations of future rate cuts. Economic growth in the form of GDP had been strong recently, but it weakened considerably during the first quarter. It is too early to tell if the economy is truly starting to slow, but each day that passes with a restrictive Fed Funds rate increases the likelihood we will experience negative economic consequences.

We have seen some warning signs of this recently. Retail sales, for example, have been weak for the past two months. ISM services has been in contractionary territory (<50) for two of the last three months and factory orders declined in May. The unemployment rate has also crept higher to start the year and now sits at 4.1%. After holding the overnight rate at restrictive levels for nearly one year, many market participants have been eagerly awaiting the Fed's next rate-cutting cycle. Despite the positive inflation data released in June, they likely won't be appeased until there are several more months of evidence inflation is heading back to 2%.

Positives

Headline CPI was flat for the month (it's lowest value in nearly two years)

Durable goods orders beat expectations by 0.6% (0.1% vs. -0.5% est.)

1Q24 GDP was revised higher by 0.1% to 1.4%

Negatives

1Q24 consumption was revised lower by 0.5%

Month-over-month new home sales declined by double digits (-11.3%)

ISM services was contractionary for the second time in three months (48.8)

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EQUITY OUTLOOK

Summary

The S&P 500 Index rose 3.6% in June, although the breadth of the advance was once again very narrow. The same handful of stocks in technology or tech adjacent sectors, which contributed meaningfully to returns in 2023 and for much of the first half of this year, were once again the catalysts.

The narrow market leadership was also evident in comparing June performance characteristics by style. The Russell 1000 Growth Index climbed 6.7% while the Russell 1000 Value Index shed 0.9%. Information technology and communication services were the best preforming economic sectors rallying 9.3% and 4.9% respectively. The 3.0% loss in the basic materials sector was trailed only by utility stocks which fell 5.5%. While the S&P 500 continues to trade at or near all-time highs, only 46% of the index's constituents are trading above their 50-day moving average.

Market rallies led by so few companies have not historically been indicative of a healthy market. For that reason, many market pundits have been hopeful of meaningfully wider participation from other industries and styles. Equity markets have made several attempts, in the last many months, to broaden out beyond the existing leaders, but each of these efforts to date have failed to maintain momentum.

The next major test for equity markets is likely to be second quarter earnings results, which unofficially kick off in the second week of July. Earnings estimates have been improving for the market as a whole and we expect results, in general, to be fairly strong and also to vary widely between different companies and industries. Results and the market's reaction is likely to be quite bifurcated. While equity valuations appear to be a bit stretched based on traditional measures, we believe proven investment selection of high-quality companies will benefit long-term investors over time.

Positives

Artificial intelligence and related technology ushering in a new innovation revolution

Weakening economic data improves Feds chance of cutting this year

Negatives

Labor market remains resilient in spite of other softer economic data

Geopolitical tensions remain elevated

Unknowns

First Presidential debate caused more uncertainty regarding the upcoming elections

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OUTLOOKS

July 2024

FIXED INCOME OUTLOOK

Summary

Bond yields kicked off June with the largest three-day rally since January for the 10-year Treasury note. Adding to the last couple of days of May, it was the biggest five-day decline since the bull run of last fall. The move was short lived and yields remained volatile as they bounced back up following a strong payroll report for May. They then turned lower again following favorable inflation data that should help the Fed gain confidence in the ability to cut rates this year. At the June 12 meeting of the Federal Reserve's Open Market Committee (FOMC), members removed expectations of rate cuts for 2024, but retained the same level of cumulative cuts through 2026. There were three moves of 20 basis points (bps) or more during the first half of the month. Including the first trading day of July, there were four sizable reversals. Even with this volatility, the high-low trading range of 25 bps was below the long-run average of 33 bps. By the end of the month, the 10-year was 10 bps lower in yield at 4.40% while the 2-year had declined 12 bps to end at 4.75%.

After steadily narrowing each month of this year, credit spreads reversed and moved modestly wider by 8 bps. For the first time this year, in July, Treasury bonds outperformed investment-grade corporate bonds of a similar maturity. At $104 billion, new investment-grade corporate bond issuance remained well above the recent yearly average for June at $88 billion. Year-to-date issuance of $1,172 billion make the first half of this year the most active since the flood of issuance during the COVID fueled 1H20. Overall, returns for the month were solidly positive for all of the broad market indexes and in the top 40% of monthly returns over the past 50 years. Year-to-date returns have turned positive for the broad intermediate-maturity indexes yet remain slightly negative for the full-duration benchmarks.

There is little difference in the Fed's new reduced outlook for rate cuts and the market's expectation as measured by the Fed Funds futures contract. The Fed is at one cut with the market expecting one or two. With favorable inflation reports, the impact of the difference should be of little importance to setting longer-maturity yields. When the rate cuts do eventually begin, we believe there is an opportunity for yields to decline from current levels. As such, since April we have recommended maintaining a portfolio duration slightly longer than that of the benchmarks (5%). With the increase in credit spreads, we also continue to favor a higher allocation to corporate bonds. In spite of the current volatility, we believe in the next six to 12 months investors will be rewarded for locking in today's market levels.

Positives

Retail investors continue to purchase bond funds and ETFs

With no discussion about rate increases, Fed rate cuts are only a matter of timing

Negatives

Year-over-year inflation comparisons are increasingly difficult as small increases roll off

Federal budget deficit and heavy Treasury debt issuance

Unknowns

Political uncertainties domestically and abroad

Middle East conflict in Israel. Domestic protests. Russia/Ukraine war

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