Q2 MARKET INSIGHTS

Summer 2024

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KEY TAKEAWAYS

The S&P 500® Index posted its strongest start for the first half of an election year since 1976, with a 15.29% gain. Since 1950, when the index has rallied by more than 10% in the first half of an election year, the second half has seen an average return of 7.7%.

S&P 500 returns continue to be driven by a handful of companies due to a divergence in earnings growth between those firms and the remaining members of the index. If economic growth continues to moderate or slow down, this phenomenon is likely to continue.

Federal Reserve (the "Fed") Policy: The economy is finally feeling the impact of the Fed's interest rate hikes. Consumer spending and the labor market have been resilient, but recent data suggests that they may be losing momentum. The Fed faces the challenging task of trying to avoid pushing the economy into a recession and taming inflation at the same time.

The S&P has posted 31 new all-time highs this year. While investors may be concerned about the sustainability of the upward trend, market participants must recognize that market highs are a natural part of market cycles and can persist for extended periods of time.

President Biden: Despite pressures to drop out of the race after the first debate, Biden will most likely be the Democratic nominee for President.

U.S. Election: The president has historically had little impact on investment returns.

It was a bumpy start to the second quarter for U.S. equities, as stubborn inflation readings forced investors to temper their expectations for interest rate cuts. However, resilience emerged as strong first quarter earnings from a select group of mega-cap companies bolstered market sentiment, propelling the S&P 500 to record highs with a 4.28% second quarter return. Year-to-date through June 30th, the S&P 500 is up 15.29%. Internationally, emerging markets outperformed the S&P 500 signaling a rebound in Chinese economic growth. The MSCI Emerging Markets Index finished the second quarter up 5.03%, marking a 7.60% gain for the year. In contrast, foreign developed markets, represented by the MSCI EAFE Index, faced headwinds—slipping 0.20% amid uncertainties surrounding central bank rate policies and apprehension over the outcome of the elections in France. For the year, the MSCI EAFE Index is now up 5.78%. Switching to fixed income markets, the Bloomberg Barclays U.S. Aggregate Bond Index, the leading benchmark for bonds, edged up 0.07% for the second quarter as the negative price impact from the shift in investor expectations for Fed rate cuts was offset by the income earned.

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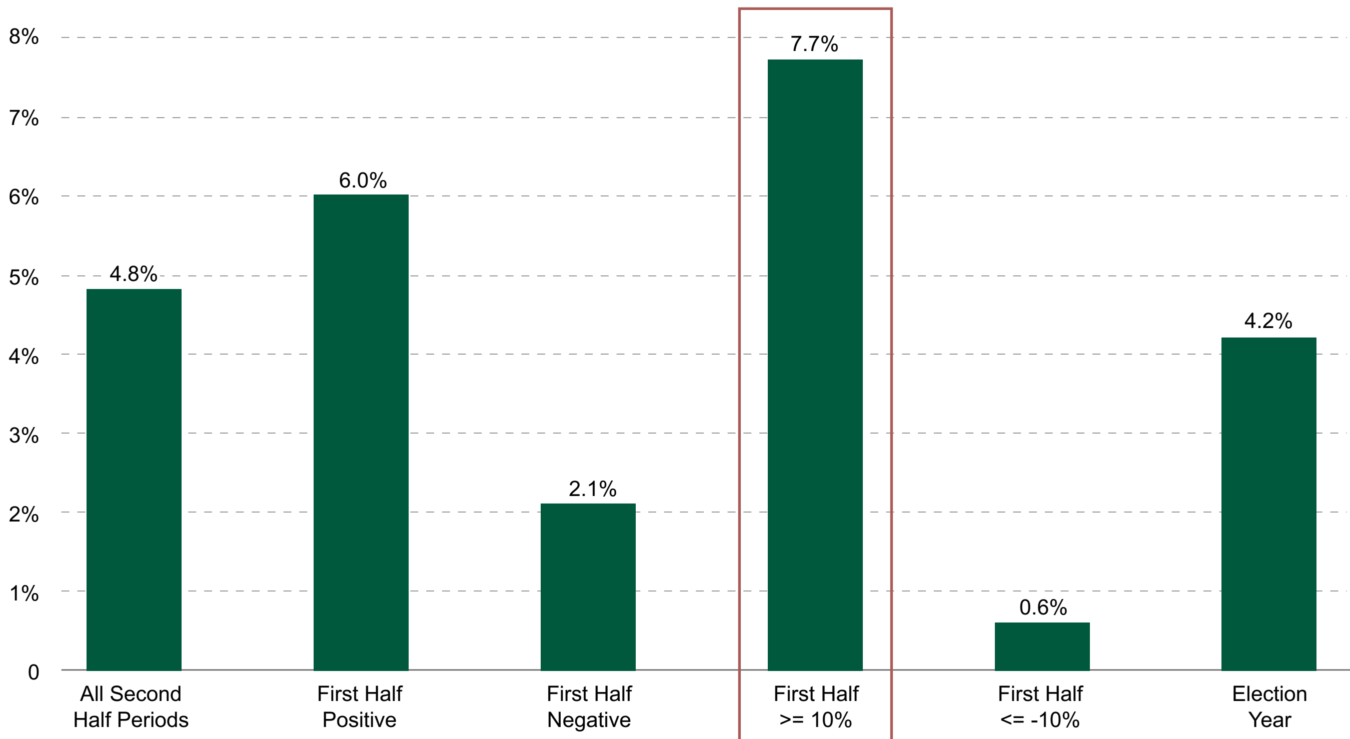
Second-Half Seasonality of the S&P 500 During Election Years (1950-YTD)



Source: LPL Financial

The S&P 500 has just capped off its strongest first half of an election year since 1976 with a remarkable 15.29% gain. U.S. equities have historically posted positive returns during election years, with the S&P 500 posting an average return of 4.2% in each election year since 1950. If we use history as a guide, the current market rally may be poised to extend further. The chart above, courtesy of LPL Financial, outlines the seasonality of the returns of the S&P 500 during election years. As you can see, since 1950, the index has increased by 4.8% on average during the second half of an election year. However, when the index has rallied by 10% or more in the first half of the year, the second half typically sees an average return of 7.7% (highlighted by the red box).

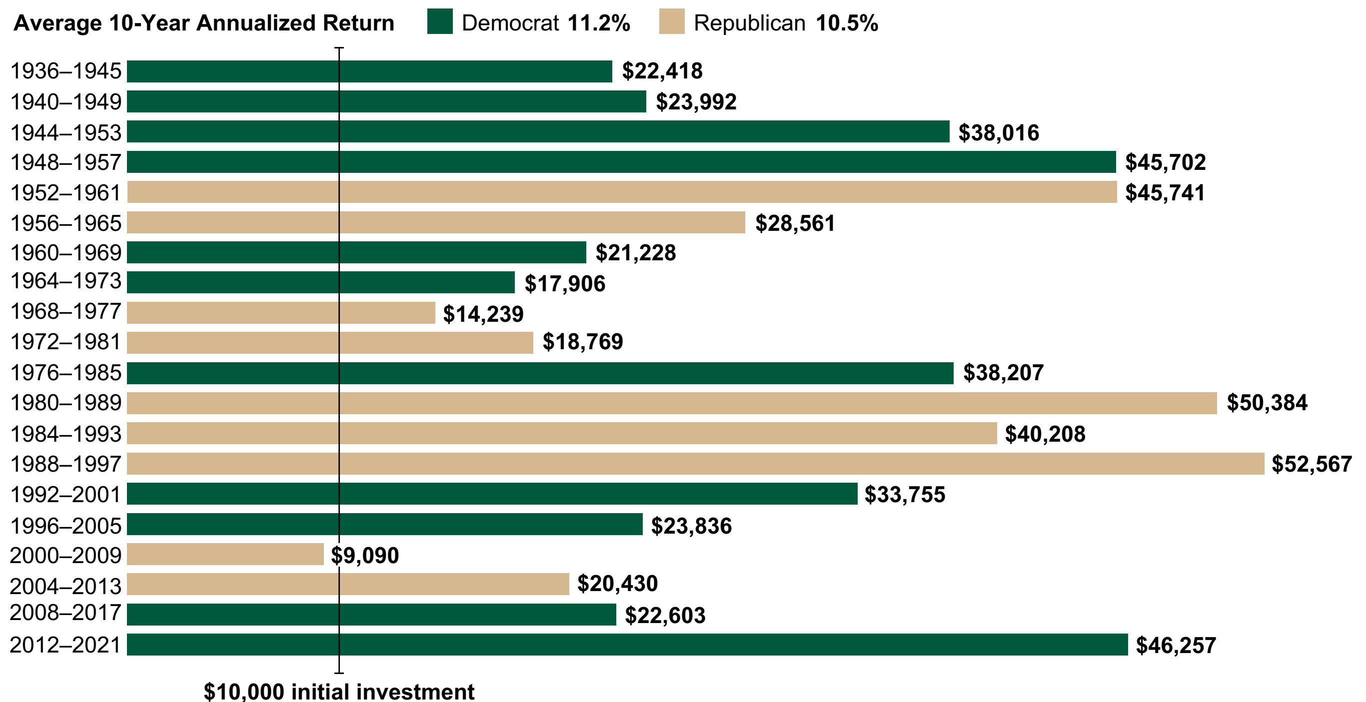
U.S. ELECTION: TRUMP VS. BIDEN…OR SOMEONE ELSE? DO FINANCIAL MARKETS CARE?

With the upcoming presidential election less than four months away, voters find themselves in a rare position where they can choose between two candidates who have both previously held the office of the president. This familiarity brings a unique dimension to the campaign, as voters can assess each candidate's track record and leadership style based on their previous terms. Therefore, voters (and investors) have a relatively clear understanding of what to expect—no matter who wins the election—having already lived through four years of President Trump and four years of President Biden. This dynamic suggests that voters are less likely to encounter major policy surprises and are instead poised to make their decisions based on nuanced assessments of each candidate's past record and proposed agenda. Do you know what would surprise us? We would be surprised if President Biden was not on the ballot in November. Despite many calls from political pundits, donors, and members of the Democratic party asking President Biden to drop out of the race after his performance in the first debate, we believe the odds are fairly low that President Biden will end his campaign. As we write this letter, President Biden seems steadfast in his commitment to running for re-election, and we see no indication that he is seriously contemplating stepping down. Biden currently holds 99% of the pledged delegates via winning the state primaries, and while these delegates are not obligated to vote for Biden as the nominee,

it is unlikely that they would abandon him. Democratic National Committee ("DNC") rules encourage, but don't specifically require, delegates to vote for the candidate they're pledged to support. Instead, the rules state: "All delegates to the National Convention pledged to a presidential candidate shall in all good conscience reflect the sentiments of those who elected them." In other words, delegates Biden won during the primary season are bound only by their consciences to actually cast their votes for Biden when it comes time to select a nominee, although mass defections would be unprecedented. Moreover, Democratic party rules also allow Democratic candidates to review and alter each state's slate of delegates pledged to them, ensuring that they are filled by loyal supporters. As such, we believe it is likely that Biden will remain the Democratic nominee for President. In addition to the fact that Biden does not appear to be stepping down from the race, there are a few other considerations. First, the Democratic party has planned its entire campaign around his candidacy, and the mechanics of putting forth a new candidate are incredibly complicated. If a change is to be made, it will have to happen soon. Even though the Democratic convention is not until August 19th, the DNC has scheduled a roll call vote for as early as mid-July, following the state of Ohio's odd requirement that a candidate be the official nominee for at least 90 days prior to the actual election on November 5th in order to qualify for the ballot in that state (which would be August 7th). While the Ohio state legislature recently waived this requirement, the DNC has nevertheless planned to call a virtual roll call vote before the actual convention in mid-August. In addition, there is no clear consensus on an alternative to Biden. Donors and pundits have suggested Kamala Harris, Gavin Newsom, Gretchen Whitmer, Hillary Clinton, and even former first lady Michelle Obama as possible replacements. However, none of them poll much better relative to President Biden in a matchup versus President Trump. Lastly, the Democrats are trying to be the party of stability, and a contested convention would undermine that image. The DNC is keen to avoid a repeat of the 1968 convention (which, coincidentally, also took place in Chicago), which was marred by violence across the city as well as venomous speeches and outrage amongst delegates. The sitting Vice President, Hubert Humphrey, won the party's nomination but ultimately lost the election.

No matter who ends up being the Democratic nominee, we believe it will have very little impact on the financial markets because the political party that wins the White House has, historically speaking, made essentially no difference when it comes to long-term investment returns. We highlighted this point in our year-end 2023 letter with a chart, courtesy of the Capital Group, that showed the 10-year annualized return of an investment made in the S&P 500 at the start of an election year (we included it again below).

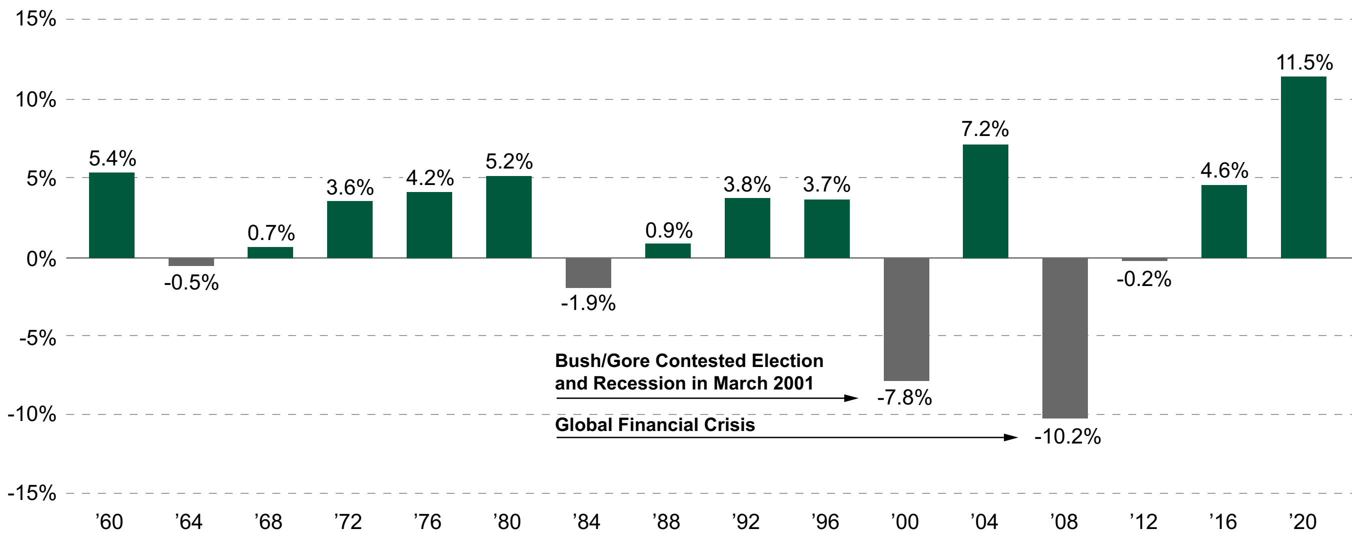
10-Year Growth of Hypothetical $10K Investment Made at the Start of Election Year (USD)



Source: Capital Group, Standard & Poor's. Each 10-year period begins on January 1 of the first year shown and ends on December 31 of the tenth year. For example, the first period covers January 1, 1936 through December 31, 1945. Figures shown are past results and are not predictive of results in future periods.

The Stock Market Reacts To Economics Rather Than Elections

S&P 500 return between election day and yearend, %



Source: Bloomberg Finance L.P., and J.P. Morgan. Data as of December 31, 2020. Past performance is no guarantee of future results. It is not possible to invest directly in an index.

"Over the decades, long-term performance of the market has shown almost no correlation to one party's policies."

As you can see, the average 10-year annualized return of an investment made at the beginning of an election year when a Democrat won was 11.2%, and the return when a Republican prevailed was 10.5%. Over the decades, long-term performance of the market has shown almost no correlation to one party's policies. We acknowledge that the chart on the previous page examines longer-term timeframes; however, if we look shorter-term, we can see that the economic backdrop at election time still appears to matter more than who is the victor. It's true that some election years have seen bigger price swings than others, but the reasons for that were largely macroeconomic. For instance, in 2020, COVID lockdowns impacted broad markets much more than the opposing candidates' ideologies. Likewise, consider 2008, when Democrat Barack Obama ran against Republican John McCain: the unfolding global financial crisis was the predominant driver, not each candidate's view on the Iraq War or healthcare. When the market has fallen post-election, it has almost always been because a recession was imminent or because (as in 2008) the economy had already been in recession (see graph above courtesy of J.P. Morgan which shows the return of the S&P 500 between election day and year end in each election year going back to 1960).

Historically, the key drivers of equity market performance have been macroeconomic factors like corporate earnings, economic growth, and interest rates. Other dynamics, like the decisions made by the Fed, have had a much greater impact on market sentiment than any soundbite we have heard from politicians. Therefore, investors must be cautious before making investment decisions based on who is occupying the White House. While politics can evoke strong emotions, investors should not lose sight of their long-term investment goals.

LAGGED EFFECT OF INTEREST RATES STARTING TO TAKE HOLD

Turning to the macro environment, the fervent pace of economic growth that was driven by the recovery from the pandemic is continuing to show signs of slowing down.

Incoming data indicates that the economy is finally feeling the full impact of the Fed's interest rate hikes. While some data points like the inverted yield curve, negative readings of

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the Leading Economic Indicators, contracting manufacturing activity, and tighter bank lending standards have been indicating an economic slowdown for many months, consumer spending and employment have remained resilient until recently. Consumer spending, which has buoyed much of the economic activity here in the U.S., is beginning to show signs of fatigue, as excess savings accumulated via fiscal stimulus in response to the pandemic appear to finally be depleted (something we highlighted in last quarter’s update). Recent retail spending data—credit card delinquency statistics coupled with weak commentary from companies such as Starbucks, Yum Brands, Nike, and General Mills—suggest that the consumer is losing momentum. Similarly, the labor market, once a pillar of strength, is displaying early signs of deceleration, with job growth tapering off. These developments underscore a pivotal moment for the Fed, which faces the challenging task of trying to avoid pushing the economy into a recession while taming inflation at the same time. This delicate tightrope walk necessitates careful navigation of monetary policy. On one hand, keeping interest rates at current levels risks weakening economic activity further. While on the other hand, cutting rates too soon may re-ignite inflationary pressures. Much to Chairman Powell’s chagrin, inflation remains somewhat sticky. While the Consumer Price Index (“CPI”) has fallen from it’s high of 9.1% in June of 2022, the last few months have seen inflation stabilize rather than fall further. The CPI has averaged 3.3% so far this year, as disinflation in the prices for goods has moderated and inflation for services remains stubbornly high. This is still well above the Fed’s target of 2%. There are other dynamics involved as well. The principal one being the ever-increasing budget deficit. In our opinion, one key takeaway from the first presidential debate was that there was no mention of deficit reduction or serious talk of entitlement reform. Although Biden did indicate that he would support an increase in the payroll tax for those making more than $400,000 per year, neither candidate, nor either party, appears inclined to propose any major spending overhauls. Therefore, our view is that no matter who wins the election, the deficit is likely to rise. As a reminder, the "deficit" refers to the budget deficit, which is the annual mismatch between what the U.S. government generates in revenues (via taxes) versus what it spends on entitlements, defense, and interest expense. As deficits increase, the government needs to borrow more, leading to higher levels of national debt. With the Fed having raised its benchmark interest rate by 5.25% since March of 2022, the cost of servicing this debt has become increasingly burdensome. As these interest payments rise, they consume a larger portion of the federal budget, straining fiscal sustainability and limiting the government's ability to invest in long-term growth initiatives. As a result, the Fed will also likely feel pressure from Congress to cut interest rates. It will be interesting to see what the Fed will do given its mandate to promote maximum employment and stable prices. Currently, investors (based on the Fed Funds futures market) are pricing in two 0.25% rate cuts for the year. While we also expect the Fed to cut maybe one or two times this year, we believe the Fed will endeavor to keep rates as high as necessary until inflationary pressures subside.

Given that we don’t expect the Fed to be too aggressive with the pace at which it will cut rates, economic growth will likely remain muted. Against this backdrop, we would expect corporate earnings growth to remain subdued as well. Therefore, we believe the handful of companies that have been propelling the S&P 500 Index higher this year will likely continue to lead equities over the near-term. The S&P 500’s advance this year has remained heavily dependent upon a relatively narrow basket of stocks. Of the 15.29% total return of the S&P 500 year-to-date, the top 10 stocks in the index (as measured by market capitalization) have contributed 11.13%, or nearly 73%, of the return. The main reason for this outperformance is due to the divergence in earnings growth between these 10 companies and the remaining 490

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that make up the index. According to FactSet, analysts are projecting earnings for the S&P 500 to grow 11.2% for 2024. However, when you look at the top 10 stocks in the S&P, earnings for those companies are expected to contribute 12.6% earnings growth. In other words, the remaining 490 companies in the index are expected to contribute negative earnings growth of 1.4%. Equity prices generally reflect expectations of future earnings growth. When the profits cycle decelerates, investors gravitate to the fewer and fewer companies that can maintain growth during an increasingly adverse backdrop. These 10 names are especially popular, in part, because they are perceived to have the structural fundamentals to achieve sustained earnings growth during periods of slow growth. In addition, these companies have strong market shares in many of the economy's most important sectors (artificial intelligence/computing power, data storage, eCommerce, finance, software, social media, smartphones, healthcare, and media streaming). We believe that in order to see a reversal towards broader market participation, we would need to see evidence of improving economic growth.

IN CLOSING

As we look ahead to the remainder of 2024, we anticipate daily market volatility will continue to be driven by investor expectations for changes in Fed policy. In addition, any surprises regarding the election (i.e. should Biden decide not to run) could lead to market instability. That being said, we must remember not to overreact to daily market gyrations. Let's not forget that equity markets have recently been posting strong returns, finishing the second quarter near all-time highs. Many investors tend to get nervous when markets hit new highs, as they grow concerned about the sustainability of the upward trend. It is essential that investors recognize that market highs are a natural part of market cycles and can persist for extended periods of time. During the first half of 2024, the S&P 500 achieved an impressive milestone by closing at an all-time high on 31 separate occasions. Over the past 50 years, historical data reveals that just over 7.5% of trading days have marked new all-time highs for the S&P 500. Interestingly, during many of these instances, market observers speculated that stocks had reached a definitive "top," suggesting potential downturns ahead. However, hindsight provides a sobering perspective: less than 1% of these trading days were followed by a significant 20% drawdown in the subsequent year. This historical context highlights the challenges of market timing and the unpredictability of short-term market movements. This is why maintaining a long-term perspective when investing is paramount for achieving financial goals and navigating market volatility effectively. A well-designed and diversified asset allocation strategy tailored to individual factors such as financial position, risk tolerance, and investment timeline helps mitigate risks and capitalize on opportunities over time. By aligning investments with specific goals and timelines, investors are well positioned to withstand short-term market fluctuations and benefit from compounding returns and asset appreciation over the long term.

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We thank you for your ongoing confidence and trust. Please rest assured that our entire team remains dedicated to helping you successfully navigate these financial markets.

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The MSCI EAFE Index is a stock market index that is designed to measure the equity market performance of developed markets (Europe, Australasia, Far East), excluding the U.S. & Canada. The MSCI EAFE Index is an equity index which captures large and mid-cap representation across Developed Markets countries around the world, excluding the U.S. and Canada. With 913 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Indices are not managed and do not incur fees or expenses. Performance numbers for the index are total return with dividends reinvested in the index.

The MSCI Emerging Markets Index captures large and mid-cap representation across 24 Emerging Markets (EM) countries*. With 838 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Performance numbers for the index are total return with dividends reinvested in the index.

The Bloomberg Barclays U.S. Aggregate Bond Index provides a measure of the total return performance of the U.S. dollar denominated investment grade bond market, which includes investment grade government bonds, investment grade corpo¬rate bonds, mortgage pass through securities, commercial mortgage backed securities and asset backed securities that are publicly for sale in the United States.

The Consumer Price Index (CPI) is issued by the U.S. Bureau of Labor Statistics and is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services. Indexes are available for the U.S. and various geographic areas.

Leading Economic Indicators (LEI), a composite of economic data points put together by The Conference Board designed to signal peaks and troughs in the business cycle. The Conference Board is a global independent business membership and research association working in the public interest.

Artificial intelligence (AI) is a wide-ranging branch of computer science concerned with building smart machines capable of performing tasks that typically require human intelligence. While AI is an interdisciplinary science with multiple approaches, advancements in machine learning and deep learning, in particular, are creating a paradigm shift in virtually every sector of the tech industry. Artificial intelligence allows machines to model, or even improve upon, the capabilities of the human mind. And from the development of self-driving cars to the proliferation of generative AI tools like ChatGPT and Google's Bard, AI is increasingly becoming part of everyday life — and an area companies across every industry are investing in.

Please contact us for more information on how we can assist you with your financial needs.

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