The second quarter of 2024 was yet another extension of the recent narrative: equity market returns positive, policy rates elevated, economic numbers resilient and myriad opinions on the direction forward. Yet again, the S&P 500 closed near all-time highs, despite a 5%+ pullback to begin the quarter and once more the technology and communications sectors (read: Nvidia, Apple, Microsoft and Alphabet), led the way. The market capitalization-weighted index outperformed the equal-weighted index by roughly 7% for the quarter, with Nvidia alone contributing nearly a third of the overall index's performance. The AI theme continued to drive the market and entice investors to allocate capital to the sector, despite the hype and extremely lofty expectations.

The Fed remained an omnipresent focus for market participants, with ever-shifting economic data reflected in the roller coaster of implied expectations for forward policy rates. The pendulum swing in Q1 that we saw, from the market pricing in roughly six cuts down to less than two, moderated somewhat in Q2. Currently the implied year-end Fed Funds level is around 4.75%, a modest decrease from three months ago, as much of the recent economic data has come in at, or below expectations. Similarly, the 10-year Treasury yield remained range bound, beginning the quarter at 4.21%, while presently sitting at 4.29%. The rates markets should continue to be driven by several factors: Fed policy outlook, long-term growth expectations and the US fiscal situation. This last point is one to watch, as the Federal deficit is currently 7% of GDP, with 16% of the total Federal budget spent on interest expense alone and the average interest rate on debt outstanding having nearly doubled from its 2021 low. If rates moderate from here, this could serve to contain the ballooning deficit, however the longer they stay elevated, the more this lower yielding debt will be rolled over into higher yielding issuance, potentially creating a snowball effect on government spending.

Economically speaking, the US remains remarkably resilient and seemingly well-positioned to engineer the much-discussed soft landing scenario. Real GDP grew at a 1.4% annual rate in the most recent quarter, a slowdown from the brisk 3.4% rate in Q4 of 2023; much of the deceleration was attributed to a drop in business inventories and increases in imports, both volatile numbers. Likewise, the reduction in inventories could be read as businesses attempting to position themselves for an upcoming slowdown, which, given the other confluence of factors, may not actually materialize. Similarly, the unemployment situation continued to soften modestly, while remaining well below historical averages. Job openings dropped in Q2, along with wage growth and the labor force participation rate ticked up (notably to a 22 year high among prime-age workers), all serving to reinforce the disinflationary forces that the Fed is aiming for. The most recent CPI numbers showed a 3.3% year-over-year increase in price levels while core PCE readings have more than halved since their 2022 peak. While inflation is still below the Fed's 2% target rate, most of the economic data is trending in the right direction, further bolstering the case for Fed rate cuts sometime this year.

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The effect of rate cuts on market returns most likely depends on the reason for said cuts. If the Fed is cutting because they feel they have achieved a sufficiently restrictive policy level, then cuts should almost certainly be a catalyst for further gains. However, if rates are lowered due to substantial impending, or realized economic weakness, then the outcome is less definitive. As it stands now, the latter seems less likely, as S&P 500 earnings are forecast to grow 11.3% in 2024 and already 78% of reporting companies have beaten expectations. Additionally, all but two sectors (materials and energy) are expected to report positive earnings growth this year. The outlook for 2025 is even stronger, with expectations for 14.4% growth and all sectors reporting positive earnings.

Nonetheless, asset class diversification, coupled with prudent risk management and a sufficiently long-term approach are still the key drivers of overall success. Given the uncertainty of outcomes with which we are operating, hewing closely to our established goals, plans and compass remains paramount. If you have any further questions or concerns, please feel free to reach out. We're here to provide you with the support and guidance needed to navigate the markets with confidence. As always, thank you for your continued trust in our services.

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