



## Investment Newsletter

Second Quarter 2024

The S&P 500 continued its unrelenting climb higher, posting a total return of +4.18% that culminated in a total return of +15.05% for the first half with 31 new record highs. International markets were also positive, with the MSCI All-Country World ex-U.S. Index posting a total return of +0.96% for the quarter and +5.69% for the first half.

This performance can be attributed to a steady continuation of the same key drivers:

- Stronger-than-expected earnings growth. Nearly 79% of companies in the S&P 500 beat consensus earnings expectations for the first quarter – and by an average of +7% – with the Information Technology, Health Care, and Consumer Staples Sectors leading the outperformance. The S&P 500's annual earnings growth is forecasted to accelerate to +10.8% this year versus just +0.5% last year.
- Receding inflation. The Personal Consumption Expenditures (PCE) Index, the Federal Reserve's preferred inflation gauge, has fallen steadily to +2.6% in May 2024 from its peak of +7.0% in June 2022. Furthermore, on a month-over-month basis, the PCE in May was flat – the first time this year.
- Expectations for interest rate cuts later this year. Investors came into the year expecting six interest rate cuts but now expect only two. The Federal Reserve publicly conceded it envisions one rate cut this year but needs to first see inflation moving sustainably toward its long-term annual target of +2.0%.
- Overall sturdy labor market with good new job creation of 248,000 jobs per month this year, low unemployment of 4.0%, and solid wage growth of +4.7%.
- Strong growth in Generative Artificial Intelligence (GenAI). In fact, the only three sectors that beat the S&P 500 this quarter were the ones most closely tied to the build-out of GenAI: Information Technology, Communication Services, and Utilities.
- Revenge of the 'Magnificent 7.' Just when stock market breadth had been improving, the so-called 'Mag 7' contributed an astounding 116% of the S&P 500's total return in the quarter. Just two stocks – NVIDIA (44%) and Apple (31%) – contributed a combined 75% of the S&P 500's total return in the quarter.

For fixed income, bond yields continued to rise as higher-than-expected inflation pushed out the Federal Reserve's interest rate cuts this year. However, yields moderated in June as inflation renewed its decline.

The Bloomberg U.S. Intermediate Government/Credit Index posted a total return of +0.64% for the quarter and +0.49% for the first half, while the Bloomberg Barclays Municipal Bond 1-5 Year Blend Index returned just +0.16% for the quarter and -0.06% for the first half.

While bond yields on short maturities remain higher than on long maturities, we expect this to unwind if the economic data continue to show softness and expectations increase for interest rate cuts. In addition, a rising federal budget deficit could put upward pressure on long-maturity bond yields.

In a period of economic and geopolitical uncertainty, we remain committed to purchasing high-quality, intermediate-maturity bonds. This is a key component of our capital preservation strategy for clients.

The stock market's unflappable performance belies a number of developing concerns:

- First quarter U.S. real GDP growth was the slowest since the second quarter of 2022. Growth of +1.4% was below expectations of +2.2% because of consumer spending that was revised lower. The low-end consumer in particular is struggling, a topic raised by multiple consumer-facing companies on their quarterly conference calls. The Consumer Discretionary Sector posted the third-highest negative earnings surprises in the first quarter.
- U.S. aggregate household debt has increased +25% to \$17.7 trillion from December 2019 to March 2024. In the first quarter, the Federal Reserve reported 'serious delinquency' rates (90 days or more past due) rose +36% for mortgages, +30% for credit cards, and +13% for auto loans – all on a year-over-year basis. The rates for credit cards and auto loans are now above their 10-year average levels.
- Extreme lack of stock market breadth. Ten stocks contributed 73% of the S&P 500's year-to-date total return. If these 10 stocks were excluded from the S&P 500, its year-to-date total return would be +4.16%. In addition, the 10 largest stocks in the S&P 500 now make up 37.5% of its market capitalization versus 26.7% at the previous peak in 1999.
- Tech stocks have set an all-time performance record on GenAI growth. The Information Technology Sector recently surpassed its 'Internet Bubble' peak in March 2000 for relative total return outperformance versus the S&P 500 and is now 32.5% of the S&P 500's total market capitalization.
- GenAI is spawning an energy crisis. A GenAI search consumes 4-5x more electricity than a Google search. Moreover, global electricity usage from data centers is projected to increase by up to 590 terawatts from 2022 to 2026 – more than the annual electricity usage of Brazil or Germany.
- The stock market is expensive. Relative to its all-time high valuation set in March 2000, the S&P 500 trades at a -14% discount on a price-to-earnings (P/E) ratio basis, but at an +8% premium on a price-to-sales basis – a metric that is less easily manipulated by lower tax rates, cost cutting, or stock buybacks.
- Federal budget deficit spending is out of control. The deficit forecast for 2024 was recently increased by +27% to \$1.9 trillion, and the cumulative deficit forecast over the 2025–2034 period was increased by +10% to \$22.1 trillion. Annual net interest expense on the federal debt (currently \$34.8 trillion) is now higher than annual defense spending.

Despite these concerns, the core drivers powering the favorable investment backdrop for equities – declining inflation, expectations for lower interest rates, accelerating corporate earnings growth, and GenAI – are still intact, although largely factored into the stock market's valuation. Going forward, further stock market gains will have to be driven mostly by earnings growth.

In an encouraging sign, the gap in earnings growth between the 'Mag 7' and the other 493 stocks in the S&P 500 is set to narrow significantly over the balance of the year, with near parity expected by the fourth quarter. Specifically, in the first quarter, the 'Mag 7' grew earnings +80% versus -16% for the 493 stocks. However, by the fourth quarter, the 'Mag 7' is forecasted to grow earnings +18% versus +17% for the 493 stocks. In addition, the earnings growth gap for the two groups is forecasted to narrow by more than 50% in 2025 over 2024.

This should finally help catalyze more sustainable stock market breadth and create a 'stock picker's market' that plays into the strengths of our investment strategy and disciplined stock selection criteria – especially given the vast disparity in P/E valuation between the 'Mag 7' (32.9x) and the 493 stocks (18.2x).

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*Sources: Bureau of Economic Analysis (BEA), Congressional Budget Office (CBO), Federal Reserve Economic Data (FRED), BlackRock Fundamental Equities, International Energy Agency (IEA), Federal Reserve Bank of New York, Strategas, Nature and FactSet.*