2024: SEMI-ANNUAL MARKET UPDATE

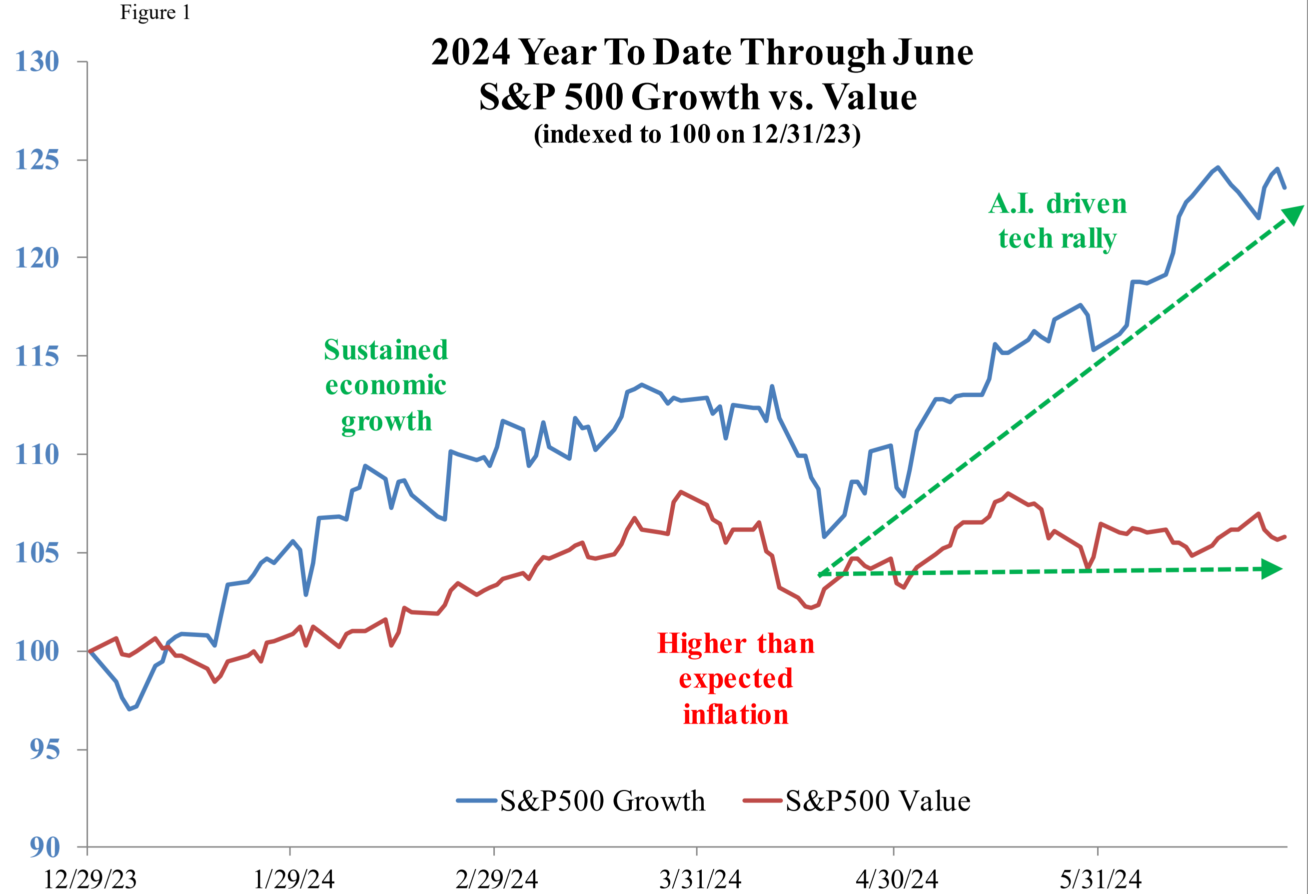
SUMMARY

Global equity markets rallied in the first half of 2024, powered by strong earnings of US mega-cap technology names seen as beneficiaries of the artificial intelligence revolution (figure 1). Persistent inflation forced investors to reassess prospects for interest rate cuts by Central Banks, keeping a lid on the performance of fixed income assets. Unexpectedly, commodities performed strongly across metal and energy markets.

In the first half of 2024, global equities rose +11.3% and U.S. fixed income declined slightly by -0.7% while broad commodities gained +5.1%. Volatility briefly spiked in April but ended the period unchanged. The U.S. Dollar rose by +4.5% against major foreign currencies.

THE TORTOISE AND THE HARE

Figure 1



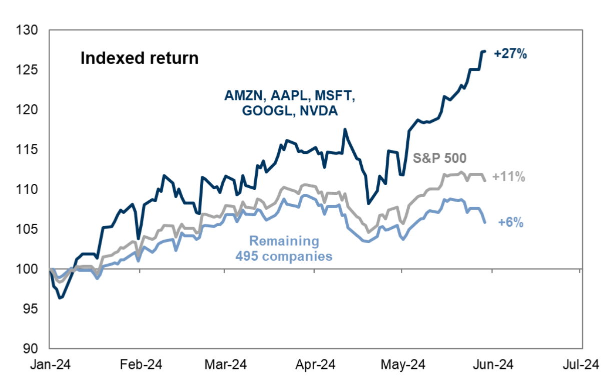
U.S. mega-cap technology companies drove performance across domestic and global indices during the quarter, due to strong results but also because of their enormous weight in market cap-weighted indices. As of now, the five largest companies in the S&P500 (Microsoft, Apple, Nvidia, Amazon and Meta) represent over a quarter of the entire index (figure 2)!

Figure 2

Source: Goldman Sachs, May 2024

Seen as beneficiaries of the artificial intelligence (A.I.) revolution, as evidenced by strong earnings growth, these stocks were bid up in the first half. The top five stocks ("Fab 5") represented almost 55% of the 15.3% increase in the value of the S&P 500 over the period. Nvidia alone represented almost 30% of the index upside. While the Fab 5 names increased about 35% in value during the period, the remaining 495 names in the index only grew about 9% (Figure 3, with numbers as of May 2024), highlighting the vast dispersion of outcomes in equity markets dominated by a single narrative: the A.I. hare vs. the rest of the market (tortoise).

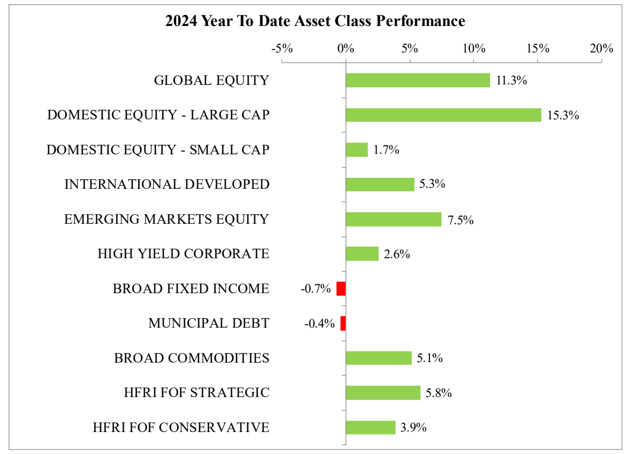
Figure 3



Source: Goldman Sachs, May 2024

Following these developments, all major asset classes recorded gains, except investment grade bonds. Small caps and foreign equities lagged U.S. large cap stocks, as did hedge funds and commodities (figure 4).

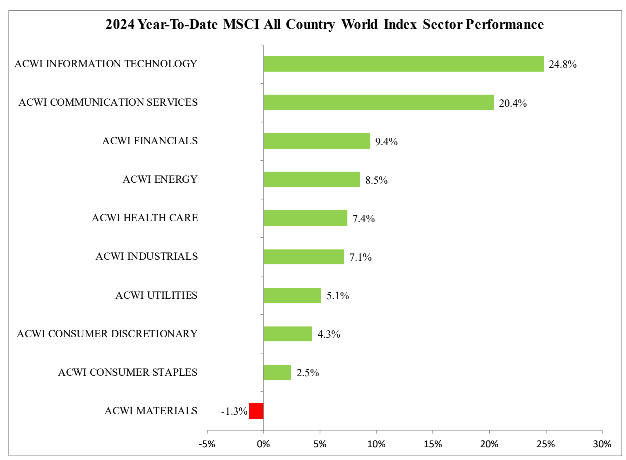
(Figure 4)



Source: Bloomberg

Year-to-date, all equity sectors are positive, except Materials. The best performing sectors are dominated by the Fab 5 stocks (figure 6).

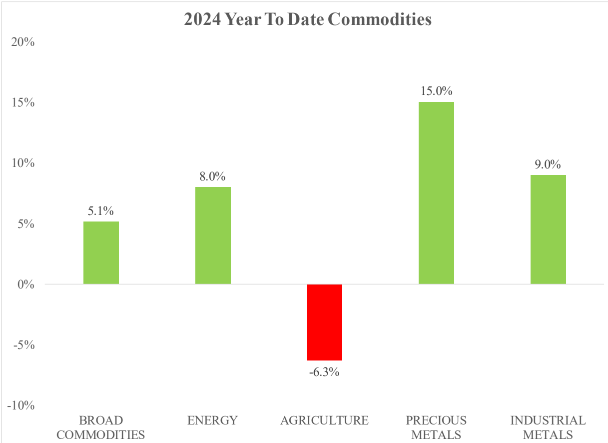
(Figure 5)



Source: Bloomberg

Commodity markets were broadly up, except agriculture, given oversupply conditions in grains. Shortage fears drove gains in copper, leading industrial metals higher. Gold purchases by Central Banks seeking a hedge to the U.S. Dollar drove gains in precious metals. Geopolitical volatility and OPEC cuts took oil prices higher during the period (figure 6).

Figure 6



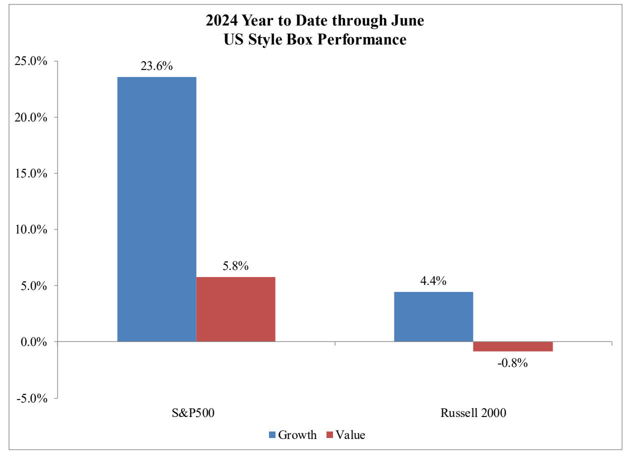
Source: Bloomberg

Equity volatility, as measured by the VIX index rose from 12.5 at the end of 2023 to a high of 19.2 in April, before settling back unchanged at 12.5 in June. The yield on the benchmark 10-year U.S. Treasury note rose from 3.88% at the end of 2023 and peaked at 4.71% in April, before dropping back to 4.40% by the end of June. The U.S. Dollar was supported by higher rates and rose against major currencies.

ONE FAST RABBIT!

With the dust now settling on the first half of the year, it is apparent that the artificial intelligence narrative drove the massive outperformance of large cap growth equities vs. value or small caps (figure 7), opening a relative value opportunity in small cap and value stocks for active equity investors. At an index level, the breakneck rally in the S&P 500 left the index at a forward Price/Earnings ratio of 22.6x by the end of June, or an earnings yield of 4.42%.

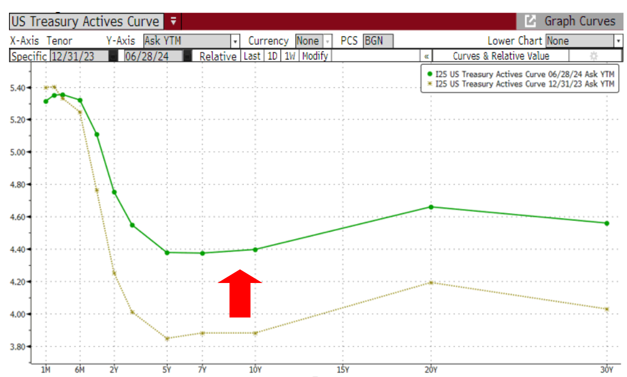
Figure 7



Source: Bloomberg

Meanwhile, bond investors cut back on their interest rate cut expectations in the face of persistent inflation, leading to a back-up in rates during the first half (figure 8). The 10-year U.S. Treasury yield rose, ending the period at 4.40%. The U.S. Aggregate Bond index offered a yield 5.00% at the end of June.

Figure 8



Source: Bloomberg

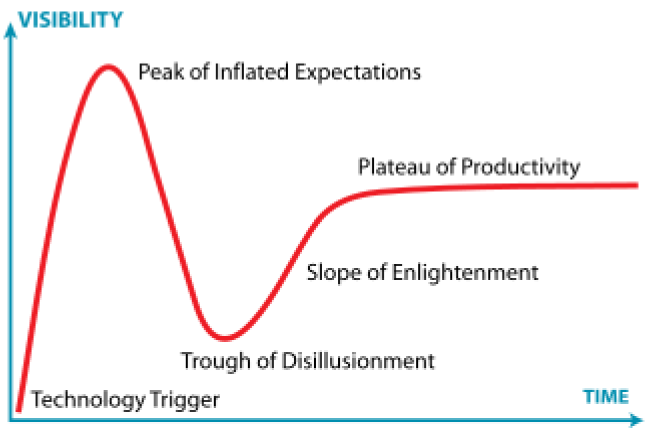
Thus, the first half ended with an expensive, high-momentum equity index trading at a forward earnings yield equivalent to no-default treasuries, offering another relative value opportunity for risk-averse investors.

TIME TO SLOW DOWN?

The success of U.S. mega-cap tech stocks has left them expensive and overbought. Is it time for the A.I. hare to take a nap?

Gartner, the technology consulting firm, developed the "Hype Cycle," a graphical representation of the five phases that new technologies typically experience as they mature (figure 9). This offers a valuable template to discuss how the market could evolve.

Figure 9



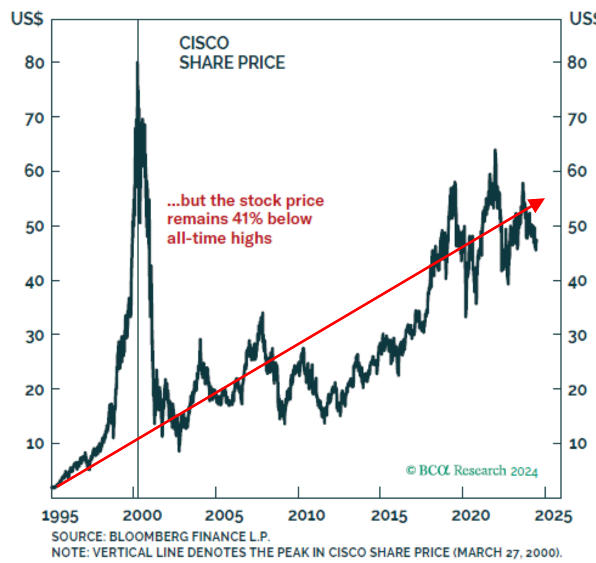
Source: Gartner, Wikipedia

The advent of generative A.I. provided the trigger for a new round of investment. Unless "things are different this time," a dangerous sentence in investing, we may be undergoing a phase of over-investment based on inflated expectations of future applications. A reset of expectations typically occurs once profitable applications become more visible, leading to more sustained long-term growth.

It's not that we doubt the long-term impact of new A.I. technology, but it is likely that overly optimistic near-term assumptions could lead to disappointment along of the path of intrinsic value growth.

On that note, it is worth remembering the example of Cisco, a darling stock of the dot.com bubble era: the stock reached a peak of $77.3/share in March 2000 and subsequently declined to $10.5 by September 2002, an 86% decline (figure 10).

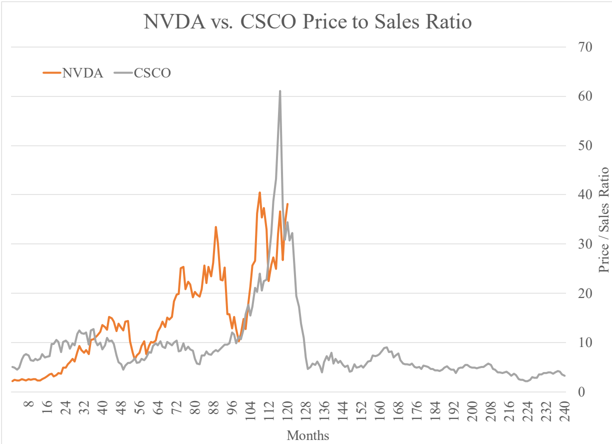
Figure 10



Source: BCA Research

Yet, the company was profitable and has endured. The issue was not the business model but the valuation (the Price/Sales ratio reached a high of 63.2x in March 2000) assigned by optimistic investors. Many commentators today compare current markets to the dot.com era and conclude that valuations are not as excessive as they were back then. However, we may still be on a similar path. The following graph (figure 11) shows the price to sales ratio of Cisco 10 years before and 10 years after peak. This is overlayed with the price to sales ratio of Nvidia over the past 10 years. While Nvidia has not yet reached the short-term peak of over 60x achieved by Cisco, it is still trading around 40x, expensive by any standard. Consider that the S&P 500 index currently trades around 3x and has averaged 1.6x since 1991.

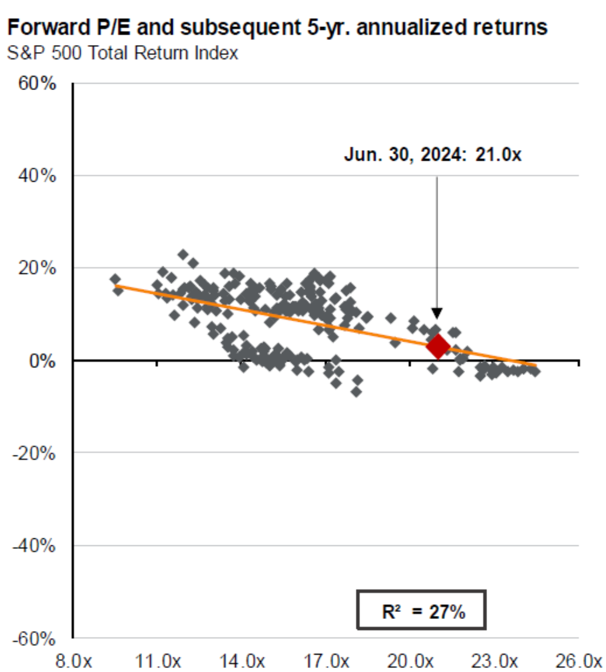
Figure 11



Source: Bloomberg

Thus, a great company may not always yield a great investment, depending on the price at which it is trading. Could Nvidia be the rare company that grows into its extreme assumptions? It's possible, but we doubt this would apply to the entire market. Meanwhile, valuations may not be a great predictor of short-term market movements, but they have a great track record of predicting returns over a market cycle (figure 12). And at today's valuations, forward return expectations at the index level are decidedly low.

Figure 12



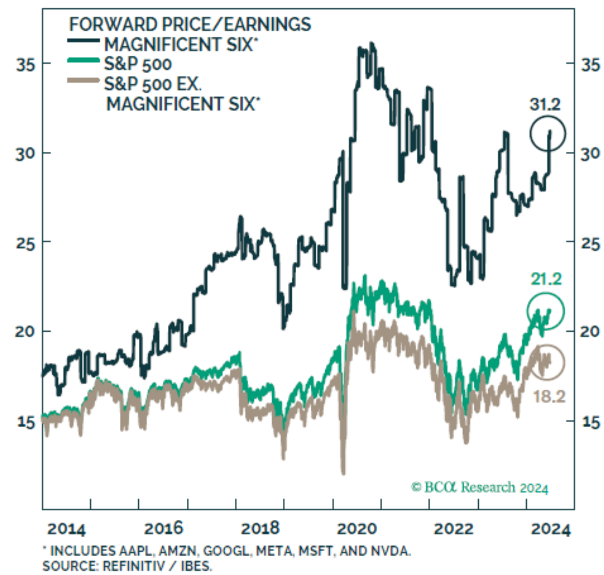
Source: JP Morgan, Guide to Markets, June 2024

CAN THE TORTOISE CATCH UP?

By definition, a diversified portfolio will place less emphasis on current market winners and build positions into either areas that offer greater return expectations or that can diversify away some of the risks.

The good news is that while a corner of the U.S. market is expensive, most other stocks trade at more reasonable valuations (figure 13).

Figure 13



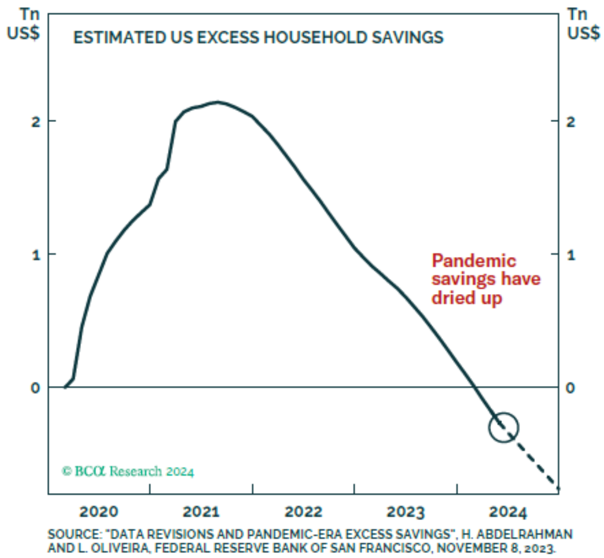
Source: BCA Research

Some of the valuation discount is justified by less impressive earnings growth but this also reflects overly pessimistic assumptions for some profitable, well managed and enduring companies, offering opportunities for active management as well as better downside protection in a potential downturn.

Should investors worry about a downturn given the strength of the stock market? Despite the prevalent soft-landing narrative (assuming no recession and no return of inflation), we believe that the U.S. economy is slowly weakening under the lagged effects of higher interest rates.

A key reason for the resilience of the U.S. economy recently was accumulated savings from the pandemic-era (reduced spending and government support). Economists now estimate that these excess savings have been depleted (figure 14), removing a pillar of support for consumption.

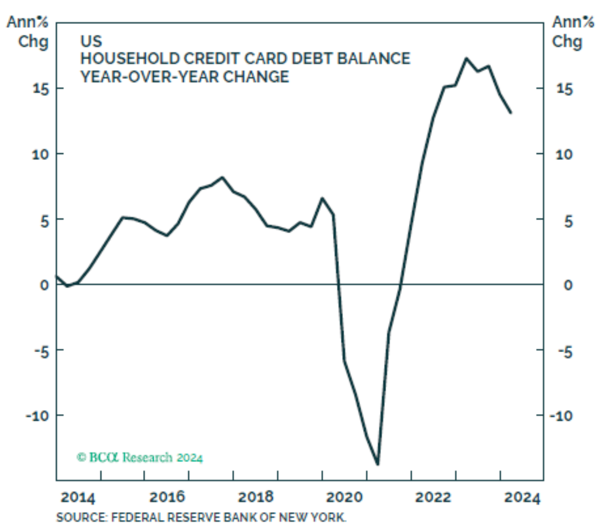
Figure 14



Source: BCA Research

To sustain consumption, households have moved from lower savings to higher credit card balances (figure 15).

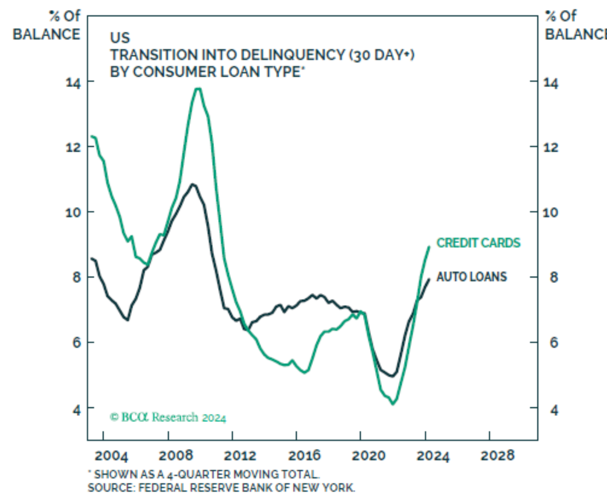
Figure 15



Source: BCA Research

These higher credit card balances are now experiencing rising delinquencies (figure 16). Hence the consumer appears stretched and in need of a higher savings rate (i.e. reduced spending). And any extension of current tax cuts would prevent adding to the burden of consumers but would not add to their savings.

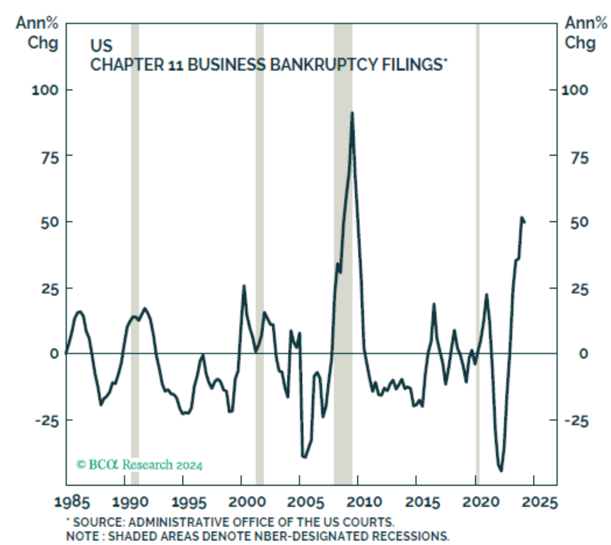
Figure 16



Source: BCA Research

Besides a slowing consumer, corporations are not in great shape either. Many of them borrowed heavily using floating rate loans in the period of ultra-low interest rates during the pandemic and now find themselves unable to cover interest payments. The recent sharp increase in Chapter 11 bankruptcy filings is already more consistent with recessionary periods (figure 17). This does not bode well for employment.

Figure 17

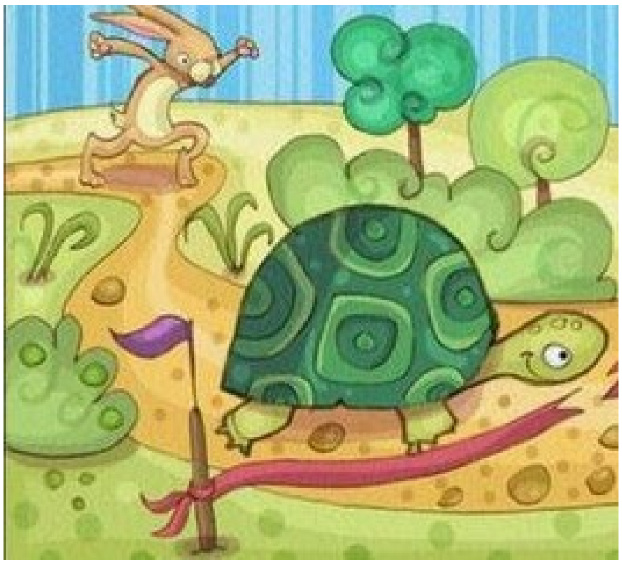


Source: BCA Research

This won't be solved easily. The Federal Reserve raised its target rate from 0.25% to 5.50% between 2022 and 2023. Short of reversing that entire move and risking inflation, many corporate borrowers will remain stuck with unsustainable capital structures.

More than ever, we think that portfolios need to evaluate adverse scenarios, including the risk of recession.

SLOW AND STEADY WINS THE RACE



At Windrose Advisors, our main concern remains achieving satisfying rates of returns over full market cycles, while avoiding painful drawdowns that threaten clients' spending power.

Achieving this goal entails building a highly diversified portfolio, seeking to protect assets against multiple potential adverse scenarios. Diversification means less concentration into single drivers of market performance. During these times of narrow market performance, our tortoise/ diversified portfolio may lag the hare.

However, narrow markets often signal late cycle dynamics, reinforcing our perception of risks. Taken to extremes, these narrow markets engender "FOMO," or the "Fear Of Missing Out," luring investors into the wrong position at the wrong time. During these times, a day-trading mentality sets in, wherein one buys high and hopes to sell even higher before the music stops. The path of the tortoise can be frustrating when the hare is taking a sprint. But we prefer to stick to our knitting and buy low with the knowledge that markets will eventually reward intrinsic value. As in the fable, "slow and steady wins the race."

"In the short run, the market is a voting machine but in the long run, it is a weighing machine." Benjamin Graham.

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