Market Commentary

Second Quarter 2024

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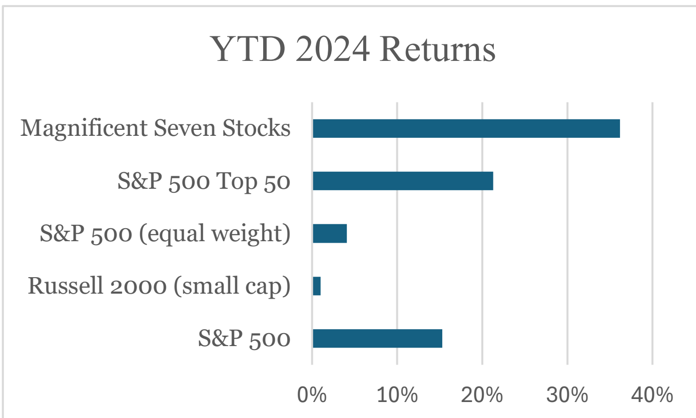
The second quarter of 2024 saw a continuation of the bifurcation in equities that began last fall. The benchmark S&P 500 index rose by 4.3% in the three-month period, bringing the year-to-date return to 15.3% and pushing the return from the end of October 2023 to an astonishing 31.5%. A few mega-cap companies have accounted for the bulk of the market returns over this period. Looking under the hood, we see there was a huge disparity in returns during the past six months. This can best be illustrated by the nearby chart. The seven mega-cap technology-related stocks, as well as the fifty largest stocks in the index far outpaced the returns of the overall benchmark. Smaller stocks were barely positive, eking out a gain of 1% in the first half of 2024. The average stock in the S&P 500 index rose by a scant 4% year-to-date. This disparity is concerning because it reveals a continuation of FOMO (Fear of missing out) on the part of investors, as they pour increasing sums of money into a dwindling number of stocks. Seven companies now account for 32% of the S&P 500 index. This is the most concentrated the benchmark has been in at least 40 years. We note the valuation disparity between the ten largest companies and the remaining 490 is around 55%. Although this is an enormous difference, it has not yet reached the whopping 95% achieved in the 2000 dot-com bubble. To paraphrase the 19th century sage Mark Twain, "history may not always repeat, but it usually rhymes." We do not know when this will end, but we are certain it will.



Turning to bonds, shorter-term yields increased modestly as the Fed continued pushing out the timing of the first rate cut. The 1-year Treasury bill rose to 5.11% from 5.03% on March 31. The 2-year Treasury note began the quarter yielding 4.59% and rose to 4.72% at the end of June. Longer-term maturities saw similar increases. The benchmark 10-year US Treasury note ended June with a yield of 4.34%, up modestly from the 4.21% rate at the end of March. Since late 2023, we have believed the Fed would keep rates higher for longer, as the path to its 2% inflation target seems challenging. In the past six months, Fed funds futures have moved from forecasting six or seven rates cuts in 2024 to currently estimating a single rate cut. We continue to believe that a slowing economy in coming months, rather than inflation reaching the Fed's 2% target, may be the impetus for the first rate cut.

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Economic and Market Outlook

The US economy continues to grow unevenly with some definite signs of slowing. Employment growth has moved lower in the past few months and the unemployment rate has reached 4% for the first time since January 2022 – a time when it was declining from the COVID effects. We expect this rate to continue to tick higher in the coming months. With inflationary pressures still evident in a few areas of the economy – namely housing, food, insurance, and autos – the final move from 3% to the Fed's 2% goal may be the most difficult. As we mentioned in our last commentary, the economic challenges are disproportionately hurting those on the lower end of the economic spectrum.

Earnings growth is the key to stock prices. After stalling for over a year, earnings growth resumed in the third quarter of 2023 and has modestly exceeded expectations since that time. With the economy now entering the third year of higher rates and higher inflation, the concern is the underlying consumer strength. A tapped-out consumer would be troublesome for future earnings growth. Earnings estimates for the S&P 500 in 2024 are currently about $246. Expectations are for a jump to $270-280 in 2025, with a further increase to $310 in 2026. Although we believe these estimates to be optimistic, any meaningful slowdown in economic growth would make these estimates far more challenging to achieve, and thus the market would be more expensive than it currently appears.

Oil prices moved in a tight range during the three-month period. The price for benchmark West Texas Intermediate (WTI) ended June at $81.57, down slightly from $83.11, three months prior. Gasoline prices moved along with crude prices and are virtually unchanged from a year ago as the summer driving season begins.

Despite the daily prognostications about when and if the Federal Reserve will cut interest rates, we believe there are far more crucial factors to analyze. The most important variables facing the US economy are the 2025 "tax cliff" and the soaring US deficits/ debt burden. These make the decision on Federal Reserve rate cuts pale in comparison.

The 2017 tax cuts are set to sunset at the end of 2025. Lines in the sand are already being drawn by some in Washington who see this as a chance to rewrite substantial portions of the tax code. President Biden has vowed not to raise taxes on anybody earning under $400,000 per year. In return for extending some tax cuts on the middle class, many are demanding higher taxes on corporations and the wealthy. A few have also floated a version of a wealth tax which we believe is not only unconstitutional but would also face a significant challenge to get through a divided congress. As is its norm, it is likely congress will debate these issues well into the second half of 2025 before anything meaningful gets enacted. Investors and consumers will spend much of next year wondering what their tax rates will be in 2026 and beyond.

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The tax debate ties into the second variable - budget deficits and the US debt. Tandem believes the US does not have a revenue (tax) problem, but rather is spending far too much. Currently, the US brings in about 17.2% of GDP in revenues. This is in line with the 50-year average of 17.3%. However, the US is spending 24.2% of GDP this year compared to a 50-year average of 21%. In fact, the Congressional Budget Office projects spending to average 24% of GDP for the next decade. Since the end of World War II, spending exceeded 24% only once – in the 2009 recovery from the financial panic amid massive stimulus spending. Since COVID, it has regularly exceeded the 24% threshold. Without bringing spending under control, the federal debt will continue to spiral higher. Higher interest rates mean the government will need to spend an increasing amount on interest payments to finance the debt.

We believe volatility in financial markets will increase as we get closer to the November elections. Our concern regarding the elections is less due to who the eventual victor will be, but on how the process plays out. We recall the election limbo we endured in 2000, where the winner was not decided for several weeks. As the election drama wound through court challenges, financial markets declined due to the uncertainty. Looking at the markets' muted reaction following the first debate in late June, we perceive that institutional investors are largely indifferent to who the next President will be. We have long believed US Presidents have a far more limited influence on the domestic economy than many think. They can state their wishes and cajole congress to enact certain legislation and tax policy, but the US economy is a behemoth and not easily moved based on most changes. Rather, significant changes in regulatory burdens can and do influence businesses. From our perspective, this is the most meaningful contrast between the two candidates.

Portfolio Positioning

We have written for the past few months that the US equity market is modestly above its fair value. We have also stated that there are several industries and sectors selling at discount valuations. History tells us that this disparity can remain for several quarters or even years. The challenge for investors is to not give up on a tried-and-true investment strategy and chase the stocks that have the best momentum. We saw this end poorly in 1999-2000, in 2007-2008 and for those with a longer-term perspective, the Nifty Fifty era in the early 1970s. At some point, valuations become important again. As Benjamin Graham - famed investor and mentor to Warren Buffett - once said, "In the short run, the market is a voting machine but in the long run, it is a weighing machine." Incidents like Roaring Kitty and the meme stocks with their hyper volatile trading provide evidence that speculation is prevalent in many areas of the market today. In 2021 we saw SPACs raise $160 billion from investors with nary a business plan in place. Little has changed in the economy and the interest rate outlook in the past eight months, yet stocks are now almost 32% higher. That alone is disconcerting. There will always be frothy times in markets, and we counsel clients to be cautious when there is. It is easy to envy others as their speculative stocks are rising by 100% or more in a few months, but it is extremely rare for those same stocks to see their fundamentals improving as rapidly.

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We are not counseling you to sell stocks, but rather to be sure your portfolio asset allocation is one you are comfortable with, especially when the ability to earn 5% in money market funds or low-risk credit instruments is an option.

Conclusion

Stocks have enjoyed a sharp rally over the past eight months. We think it is partially due to the increasing influence on a small number of stocks on the indices along with a bit of speculative euphoria in a few companies. Economic growth is modest but declining, with GDP forecast to slow to below trend growth in 2024. Equities have risen faster than earnings forecasts, making stocks more expensive than they were at the start of 2024. We step back from this landscape and look at the continuing wars in Ukraine and Gaza, the third year of higher interest rates continuing to affect consumers, slowing employment growth, and an uncertain Presidential election in four months as reasons to be cautious. This means being vigilant on what one owns, taking profits in those holdings that are meaningfully above fair value, and understanding that slightly lagging a market that has gone parabolic is far better than fully participating in the sharp rise as well as the future declines when market valuations adjust. We cannot judge the timing of these events, but we must guard against potential negative factors affecting portfolios.

We end this market commentary by wishing you and your families a happy, healthy, and safe summer season. We invite your questions on all things financial and enjoy speaking with clients on a regular basis. As always, we request you inform us of any significant changes in your financial situation or if you have any specific questions or concerns about your investments.

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