July 2024 | **Mullaney on Markets**

The Fed 'Cuts the Cuts'

The Federal Open Market Committee of the Federal Reserve sent a strong message at the conclusion of their June 12 meeting: By holding rates steady at the meeting—and more importantly by reducing their projected rate cuts this year from three down to one via their Summary of Economic Projections—the Committee signaled that it would take more than one or two favorable inflation reports for them to consider cutting the Fed Funds rate. Bond investors reacted favorably to the news of the Fed's resolve to fight inflation, sending yields lower and the bond market to a gain of 0.95% for the month, as measured by the Bloomberg U.S. Aggregate Bond Index. The favorable rate backdrop and the conclusion of a strong Q1 earnings season helped to lift the S&P 500 Index to a gain of 3.59% during June.

For the quarter the S&P 500 returned 4.28% and year-to-date 15.29%, while the Bloomberg U.S. Aggregate Index eked out a gain of just 0.07% for the quarter but remained "in the red" over the six-month period with a loss of 0.71%.

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Long duration sectors show strength driven by a handful of stocks

Given the favorable interest rate environment prevalent during June, sectors with the longest durations fared the best, led by Information Technology, which posted a gain of 9.32% and contributed 80% of the S&P 500's overall return. Three stocks (NVIDIA, Apple, and Microsoft) representing just 4% of the sector's 67 holdings contributed 24% of the sector's June return.

Next came the Consumer Discretionary sector with a gain of 4.89%, where two stocks, Amazon and Tesla, were responsible for 97% of the sector's gain.

The laggard for the month was the Utilities sector with a loss of 5.51%. The selling in the sector was broad based, with only two of the thirty-one stocks that make up the sector posting gains. The sector had been one of the better-performing sectors during the year based on prospects of a surge in electricity demand from AI-related applications.

The "top-heavy" nature of the stock market continued in June as the S&P 500 Equal Weighted Index gave ground, dropping by 0.45%.

Much the same for the quarter

For the quarter, Information Technology was once again the leading sector, with a gain of 13.81% representing 95% of the overall return of the S&P 500. The same three stocks (NVIDIA, Apple, and Microsoft) contributed 22% of the tech sector's return during the quarter.

Tech was followed by the Communication Services sector, which posted a gain of 9.38% over the three-month period. One company, Alphabet, was responsible for virtually the entire sector's gain, with an average return of 20.71% for the two classes of the company's stock.

The Materials sector pulled up the rear for the quarter, with a loss of 4.50% as cyclical stocks in general came under selling pressure during the period.

Tech continues its domination

Tech also won the trifecta of returns, outpacing all sectors on a year-to-date basis with a gain of 28.24%, which represented 52% of the S&P 500 overall return. NVIDIA, with a gain of 149.50%, was responsible for 57% of the sector's gain and 30% of the return of the entire S&P 500 Index.

Communication Services once again followed Tech, posting a YTD gain of 26.68%, with two stocks, Meta Platforms and Alphabet, responsible for 38% of the sector's return.

Real Estate is the lone sector failing to produce a positive return so far this year, dropping by 2.45%. The sector has been pressured by loan and principal losses in commercial real estate properties, most notably in the office space segment of the market.

Risk characteristics are mixed

While high-quality stocks within the S&P 1500® Index (those rated B+ or better by Standard & Poor's) beat low-quality stocks (B or lower) by 55 basis points and the Russell 1000 Index of large-cap stocks outperformed the Russell 2000 Index of small-cap stocks, +3.31% to -0.93%, the highest-beta quintile of the S&P 500 beat the lowest-beta quintile by over 5%, though that figure was influenced by the "Magnificent 7" stocks, which carry a beta of 1.42 versus the S&P 500 and returned +9.67% during June.

For the quarter the story was the same, with high-quality beating low-quality by 183 basis points and large caps outpacing small caps (+3.57% to -3.28%), but with the highest beta quintile of the S&P gaining 10.47% to just 0.38% for the lowest beta quintile.

The story differs on a year-to-date basis with high-quality stocks lagging low-quality stocks by 7.83%, but large-caps still beating small-caps (+14.24 to +1.73%) and high-beta shellacking low-beta by over 25%.

Value lags growth, but heavily skewed by large caps

In terms of style, large-cap value lagged large-cap growth during June, with the Russell 1000 Value Index dropping by 0.94% compared to a gain of 6.74% by the Russell 1000 Growth Index. The -7.68% return differential between the Russell 1000 Value Index and its growth counterpart was the sixth-widest monthly tally in history, dating back to 1979, and in the 99th percentile of the relative monthly return distribution.

Contrast that with the Russell 2000 Value Index, which also lagged the Russell 2000 Growth Index but by a much lesser amount, -1.69% to -0.17%, which fell into the 76th percentile relative return distribution for the two indices.

One sector was responsible for 25% of the return differential between the Russell 1000 Value Index and the Russell 1000 Growth Index, once again Technology, with the Tech sector of the Russell 1000 Growth Index generating a return of 10.24% to the 2.87% return of Tech within the Russell 1000 Value Index, but with Tech representing 46.44% of the 1000 Growth index to just 9.04% of the 1000 Value index.

Midcaps fell between the two, with the Russell Midcap Value Index returning -1.60% to the 1.67% gain of the Russell Midcap Growth Index during the month.

The story was very much the same for the quarter, with the Russell 1000 Value Index falling by 2.17% and the Russell 1000 Growth Index gaining 8.33%. The -10.50% return differential between the two benchmarks over the quarter was also the sixth-widest in history and fell in the 97% percentile of the relative quarterly return distribution.

The Russell 2000 Value Index fared somewhat better, dropping by 3.64% to the 2.92% loss of the Russell 2000 Growth Index, while the Russell Midcap Value Index had the smallest performance gap, returning -3.40% to the -3.21% loss of the Russell Midcap Growth Index.

One-trick ponies?

The performance gap between the Russell 1000 Value Index and the Rusell 1000 Growth Index is also abnormally wide on a year-to-date basis, with the 1000 Value index gaining 6.62% to the 20.70% return of the 1000 Growth index. The gap can largely be traced to the tech sector of the Russell 1000 Growth Index, which has gained north of 30% and is responsible for 62% of the benchmark's overall return, with NVIDIA alone accounting for 36% of the overall gain.

The performance of midcaps was tighter with the Russell Midcap Value Index advancing by 4.54% versus the Russell Midcap Growth Index return of 5.98%.

The Russell 2000 Value Index failed to generate a positive year-to-date return, dropping by 0.85% versus a 4.44% gain by the Russell 2000 Growth Index. The performance gap between the two indices, like that in the large-cap space, was primarily due to the Technology sector, with the 2000 Growth Tech sector returning 71.34% and accounting for 47% of the return differential. Again, one stock, Super Micro Computer, was responsible for 36% of the overall performance differential.

Non-U.S. stocks show mixed results

Returns for developed market international stocks trailed the S&P 500 in June, with the MSCI EAFE Index dropping by 0.53% in local currency terms and by -1.59% in U.S. dollars. Fifty-five percent of the benchmark's loss in dollars can be attributed to France, which dropped by 7.45% as Marine Le Pen's National Rally party and her allies won a resounding victory in the first round of voting during the last weekend of the month and are targeting an absolute majority that could put France's government in the hands of a far-right party for the first time since World War II. President Emmanuel Macron's ruling coalition placed third, as the incumbent's gamble with a snap election backfired miserably.

For the quarter, the EAFE Index also lagged the U.S., returning 1.26 in local currencies and -0.17% in U.S. dollars—likewise on a year-to-date basis, with returns of 11.49% (local) and 5.75% ($USD).

Developed-market returns in dollar terms were lower due to the greenback's gain of 4.47% versus a currency basket comprising the Euro, Swiss franc, Japanese yen, Canadian dollar, British pound, and Swedish krona over the first six months of the year.

Emerging-market stocks fared better than developed-market stocks during both June and the second quarter, with the MSCI Emerging Markets Index returning 4.32% and 6.34% for the two periods in local currencies, and 4.01% and 5.12% in U.S. dollar terms.

Year-to-date, the MSCI EM Index has trailed the S&P 500, returning 11.20% in local currencies and 7.68% in dollar terms. One country, Brazil, has had a major negative impact on the YTD return as it represents over 5% of the index makeup and has dropped by 26.34% this year. Fiscal discipline uncertainty, high interest rates, and government meddling in the affairs of domestic companies are the most common reasons cited for the country's underperformance.

Let the good times roll

For what is now a protracted period of time, the S&P 500 and stocks in general have been the beneficiary of a series of supportive U.S. macro factors: a strong economy, a strong currency, ample internal and external liquidity, fiscal stimulus, and low political risk. While economic momentum has begun to decelerate, so has inflation, which supports the likelihood of the Fed initiating an easing cycle sometime in the not-so-distant future. Whether the Fed cuts rates twice between now and year end (as is expected by investors) or just once as they have signaled, that should be somewhat immaterial, as the S&P has easily handled the decrease in expected rate cuts from seven at the start of the year to two today. No cuts could be a temporary issue, as could volatility surrounding the November election. But with positive revisions and upside surprises continuing, earnings for the S&P 500 are now forecast to grow by nearly 11% in 2024, and with interest rates largely stable at what could be lower levels, positive returns are likely to continue over the near term.

Seasonal and technical patterns also support a positive outlook

During the past 50 years, July has been a less-than-mediocre month for stock returns, with the S&P 500 producing a positive return just 52% of the time, the second-lowest percentage of any month of the year. Over the past 20 years, the returns for July have been starkly different, with the S&P 500 producing a positive return 75% of the time and tied for the second-best month of the year.

Since WWII, when the S&P 500 has produced a positive return over the first six months of the year, it has gone on to produce a positive return for the remainder of the year 77% of the time. When the return over the first six months has exceeded 10%, a positive return for the remainder of the year has occurred 83% of the time.

This year the S&P 500 has hit a record high 31 times. Since 1954, when the S&P has hit 25 or more record highs in the first half of the year, the median performance in the second half of the year has been 9.6%.

While valuations, market-cap concentrations, deficits, and debt levels remain worrisome, they appear to be issues that will be addressed at another time.

Bond credit ratings are measured on a scale that generally ranges from AAA (highest) to D (lowest).

Terms and Definitions:

Beta: A measure of a portfolio's market-related risk or its price movement in relation to a benchmark. Securities with betas higher than 1.0 have been, and are expected to be, more volatile than the benchmark; securities with betas lower than 1.0 have been, and are expected to be less volatile than the benchmark.

Earnings Per Share (EPS)

The Magnificent Seven stocks are a group of high-performing and influential companies in the U.S. stock market: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

S&P 500 Index: The S&P 500 Index is a registered trademark of the McGraw-Hill Companies, Inc. and is an unmanaged Index of the common stocks of 500 widely held U.S. companies.

The S&P 1500, or S&P Composite 1500 Index, is a stock market index of US stocks made by Standard & Poor's. It includes all stocks in the S&P 500, S&P 400, and S&P 600. This index covers approximately 90% of the market capitalization of U.S. stocks and is a broad measure of the U.S. equity market.

MSCI EAFE Index: International markets are represented by the MSCI EAFE (Europe, Australasia, Far East) Index. The MSCI EAFE Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada.

MSCI EM (Emerging Markets) Index: Captures large and mid cap representation across emerging markets countries covering approximately 85% of the free float-adjusted market capitalization in each country.

Russell 2000 Value Index: The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index. The Russell 2000 Value Index contains stocks included in the Russell 2000 Index displaying low price-to-book ratios and low forecasted growth values.

Russell 2000 Growth Index: Russell 2000 Growth Index measures the performance of stocks in the Russell 2000 Index that display higher price-to-book ratios, higher earnings forecasts, and higher sales-per-share growth.

Russell 2000 Index: The Russell 2000 Index measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

Russell 1000 Value Index: Measures the performance of those Russell 1000 companies with lower price-to-book ratios and lower forecasted growth values.

Russell 1000 Value Index: The Russell 1000 Value Index contains stocks included in the Russell 1000® Index displaying low price-to-book ratios and low forecasted growth values.

Russell 1000 Growth Index: Measures the performance of the large cap growth segment of the U.S. equity universe. It includes those Russell 1000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2 year) growth and higher sales per share historical growth (5 years).

The Russell Midcap Value Index: The Russell Midcap Value Index measures the performance of stocks included among the 800 smallest companies in the Russell 1000 Index that display low price-to-book ratios and low forecasted growth values.

The Russell Midcap Growth Index: The Russell Midcap Growth Index measures the performance of stocks included among the 800 smallest companies in the Russell 1000 Index that display higher price-to-book ratios, higher earnings forecasts, and higher sales-per-share growth.

Bloomberg US Aggregate Bond: The Bloomberg USAgg Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond.

U.S. Dollar Index (DXY): The U.S. Dollar Index is used to measure the value of the dollar against a basket of six foreign currencies. The value of the index is a fair indication of the dollar's value in global markets.

Core Personal Consumption Expenditures Price Index (Core PCE): A measure of prices that people living in the United States, or those buying on their behalf, pay for goods and services. It's sometimes called the core PCE price index, because two categories that can have price swings – food and energy – are left out to make underlying inflation easier to see.

CPI (Consumer Price Index): The CPI 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. Average price data for select utility, automotive fuel, and food items are also available.

Beta: A measure of a portfolio's market-related risk or its price movement in relation to a benchmark. Securities with betas higher than 1.0 have been, and are expected to be, more volatile than the benchmark; securities with betas lower than 1.0 have been, and are expected to be less volatile than the benchmark.