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Market Newsletter
Second Quarter 2024

EXECUTIVE SUMMARY

- In the second quarter of 2024 large company stocks rose while smaller company stocks fell. Stocks of companies in Emerging Markets did better than those of developed markets. Bonds were flat.

- The Federal Reserve's interest rate campaign is beginning to impact the US economy as there are signs of slowdown, but not at an alarming rate.

- Inflation has cooled significantly since 2022, but low-income consumers are not feeling the benefits as prices of non-discretionary items remain high.

- Outside the US, economies are recovering but growing unevenly. As inflation has been cooling, the European Central Bank cut rates for the first time since 2019, as did the Bank of Canada.

- Despite the slowdown in the economy, analysts expect strong corporate earnings growth in the US and overseas. This should support stocks.

- Large company stocks have handily beaten smaller company stocks in recent times. However, over a longer period, small stocks have outperformed large stocks. This supports the need to invest in small company stocks to create resilient portfolios.

Table 1: Market indices

(*Returns include dividends reinvested*)	**Quarter to date**	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
S&P 500	4.28%	15.29%	24.56%	10.01%	15.05%
S&P Mid Cap 400	-3.45%	6.17%	13.57%	4.47%	10.27%
S&P Small Cap 600	-3.11%	-072%	8.66%	-0.26%	8.06%
MSCI Emerging Markets	5.12%	7.68%	12.97%	-4.68%	3.49%
MSCI EAFE	-0.17%	5.75%	12.09%	3.43%	6.98%
Vanguard Total Bond Market Index	0.14%	-0.68%	2.63%	-3.12%	-0.31%
Investment Grade Credit	0.12%	0.01%	5.02%	-2.82%	0.78%
Non-Investment Grade Credit	1.05%	2.60%	10.41%	1.63%	3.73%
Bloomberg Commodity Index	2.89%	5.24%	5.00%	5.65%	7.25%
Dollar Index	1.32%	4.47%	2.87%	4.63%	1.95%
10 Yr. Rate	4.34% 06/30/2024	3.87% 12/31/2023	3.82% 06/30/2023	1.44% 06/30/2021	2.00% 06/30/2019

Source: S&P Dow Jones, ml.com, MSCI.com, Morningstar, Bloomberg, Yahoo Finance

Table 2: Vanguard LifeStrategy (Asset Allocation) Funds

	Quarter to date	**Year to date**	**1 Year**	**3 Year Annualized**	**5 Year Annualized**
LifeStrategy Income	0.45%	1.46%	5.89%	-1.18%	1.97%
LifeStrategy Conservative Growth	0.90%	3.63%	9.28%	0.34%	4.23%
LifeStrategy Moderate Growth	1.33%	5.76%	12.67%	1.80%	6.41%
LifeStrategy Growth	1.79%	7.96%	16.19%	3.27%	8.57%

Source: Vanguard

Table 3: Recent Major US Economic Releases (These indicators have a significant impact on the stock market)

As of 07/05/2024			
	Latest Release	Recent Trend	Notes
Non-Farm Employment	206,000	Positive	Jobs growth is still very healthy, although the unemployment rate crept up to 4.1%, the highest level since December 2021, as more people are looking for jobs. Wage inflation moderated to the lowest level since 2021.
Weekly Claims for Unemployment Insurance	238,000	Positive	Initial claims for unemployment insurance are ticking up slightly but are still at a historically low level indicating a tight labor market.
ISM Manufacturing Index (over 50 indicates growth)	48.5	Negative	Manufacturing activity has been slowing in the last few months. While employment has remained strong, new orders and production are slowing. Overall, the index has been hovering just below 50 (Which means contraction) since late 2022.

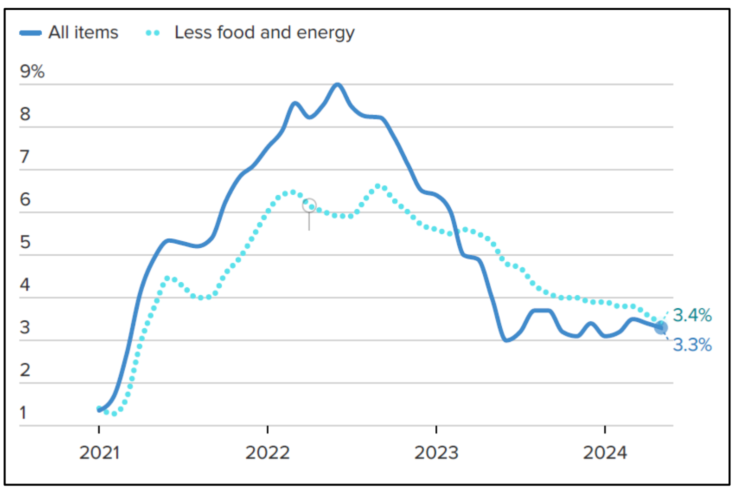
	Latest Release	Recent Trend	Notes
ISM Non Manufacturing Index (Over 50 indicates growth)	48.8	Negative	The services sector, which had been growing until recently, is now contracting. The index is at the lowest level since April 2020 impacted by several underlying components. Taken together with the manufacturing index, this means the economy is slowing.
Consumer Prices (Month over month change)	0%	Positive	Consumer price inflation slowed in May but increased 3.3% from a year ago. Excluding the volatile food and energy components, consumer inflation was 3.4% from a year ago.
Producer Prices (Month over month change)	-0.2%	Positive	Producer prices unexpectedly fell in May - the biggest decline in 7 months. Energy price was the biggest contributor but a drop in several underlying components points to moderating inflation.
Retail Sales (Month over month change)	0.1%	Negative	Relatively high inflation, high interest rates and a cooling jobs market are leading to lower spending by consumers than earlier in the year. Spending on services (Such as restaurants) which had held up well earlier in the year, are now slowing as well.
Consumer Confidence (Conference Board)	100.4	Negative	Consumer confidence has slipped in recent months weighed down by higher cost of living, elevated borrowing costs and, a softening in the labor market. Despite the recent drop, consumer confidence has been in a narrow range over the last 2 years.
Durable Goods Orders (Month over month change)	0.1%	Negative	Core capital goods orders, which excludes transportation and defense orders, fell 0.6% in May. This was the largest drop this year. Higher borrowing costs and softening demand is making companies cautious.
Industrial Production (Month over month change)	0.9%	Positive	Industrial production rose the most since last July. Surprisingly, manufacturing activity, which seems weak based on other indicators, helped industrial production notch a strong number.
Capacity Utilization	78.7%	Negative	Capacity utilization has consistently dropped from a level over 80 in 2022. This could indicate the slack in the economy developing because of slowing economic activity.
Housing Starts	1.277 Million	Negative	Housing starts fell to the lowest level since June 2020 and has dropped 19.3% from a year ago. High mortgage rates are dampening housing activity.
Home Prices (Case-Shiller Home Price Index- Year over Year)	7.2%	Positive	A dearth of sellers continues to support home prices, as the 20-city index rose to a record high in April.
GDP (Real, Annualized)	1.4%	Positive	In the first quarter of 2023, US GDP grew at the slowest rate since the spring of 2022, but has been surprisingly strong. Higher imports and a drop in inventories caused the decrease from the fourth quarter of 2023, when it rose by 3.4%

Source: Bloomberg, www.federalreserve.gov, www.bls.gov, www.ismword.org, www.nahb.org

Financial assets rose in the second quarter of 2024, although there were significant differences in performance under the surface. Stocks continued their ascent helped by the performance of the largest companies, but smaller company stocks fell. Outside the US, developed company stocks lost ground but stocks of emerging economies rose during the quarter. Bonds eked out a small gain, helped by non-investment grade credit, as the benchmark 10-year US Treasury rate was barely higher than where it was at the end of last quarter.

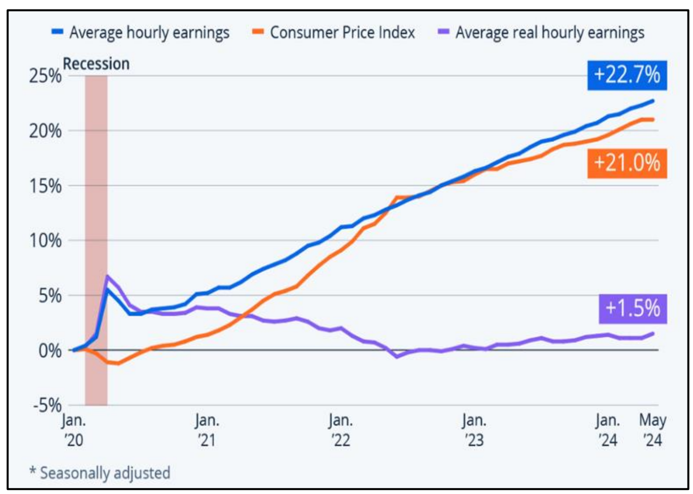
The US economy is continuing to grow even as there are clear signs that the Federal Reserve's (Fed) attempts to curtail the growth rate of the economy to bring down inflation are beginning to take effect, but not at an alarming rate. The employment situation is still robust with plenty of jobs being created but the unemployment rate is at the highest level since December 2021. Fortunately, this is not because people are losing their jobs but because more people are looking for employment. (The unemployment rate is the number of unemployed people divided by the number of people looking for jobs- a ratio that is affected both ways by the number of people actively looking for jobs). Job openings have come down significantly but are still higher than before the pandemic. Fewer people are moving jobs in search of higher pay, which augurs well for stable wages and overall inflation rate. As per data released in early July, wages grew by 3.9% from last year, the slowest rate since 2021. However, wages have been growing at a faster rate than inflation over the last year as the overall rate of inflation has come down significantly since 2022. (Fig 1 and 2). Resilient wages and falling inflation should benefit consumers, however those with relatively low income feel differently, as prices of

Fig 1: Inflation has come down significantly since 2022.



Source: US Bureau of Labor Statistics

Fig 2. Wage growth outpaced inflation last 1 year.

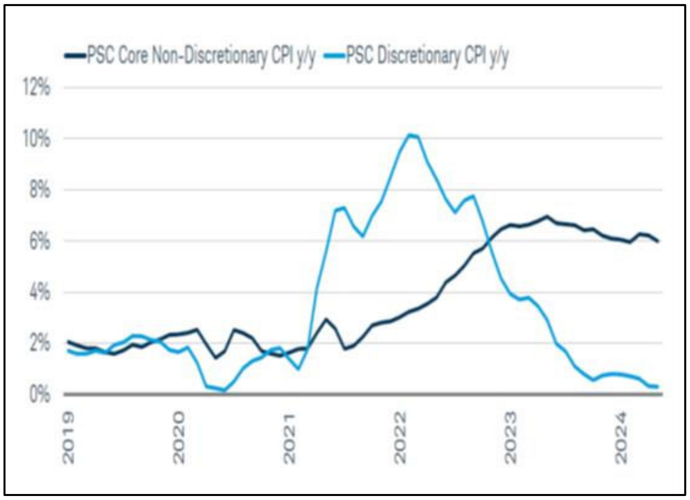


Source: Statista

non-discretionary items (Such as Medical Care Commodities, Rent, Hospital Services, Personal Care Products etc.) have remained stubbornly high as compared to those of discretionary items. (Fig 3). As a result, consumer confidence is well below its recent peak (Fig 4) and has settled in a range near 100. Apart from making the Fed's job of maintaining price stability with plenty of jobs in the economy harder, this could also have an impact on the Presidential elections in November. (However, as we discussed last quarter, historically the stock market and the economy have done well irrespective of politics). The Fed is now expected to cut rates just once in 2024 (From the current two decade high of 5.25%) as it believes there has been "modest" progress in lowering inflation closer to its target of 2%, but inflation "remains elevated."

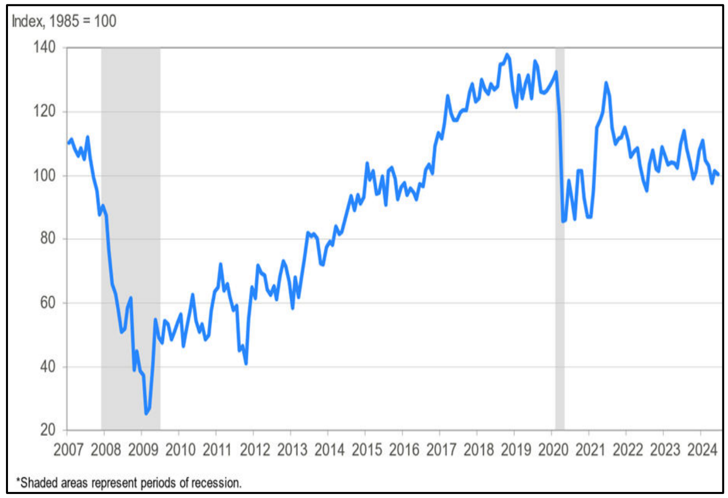
In other signs that the economy is slowing, both the US manufacturing and services sectors are now contracting as indicated by the two ISM indexes. These indexes tend to be volatile but there has been a clear downward trend in both the indexes over the last 2 years. Until recently, the services sector was growing, helped by spending in areas such as restaurants and travel, but as of June this sector is also contracting.

Fig 3: Discretionary vs non-discretionary prices



Source: Charles Schwab

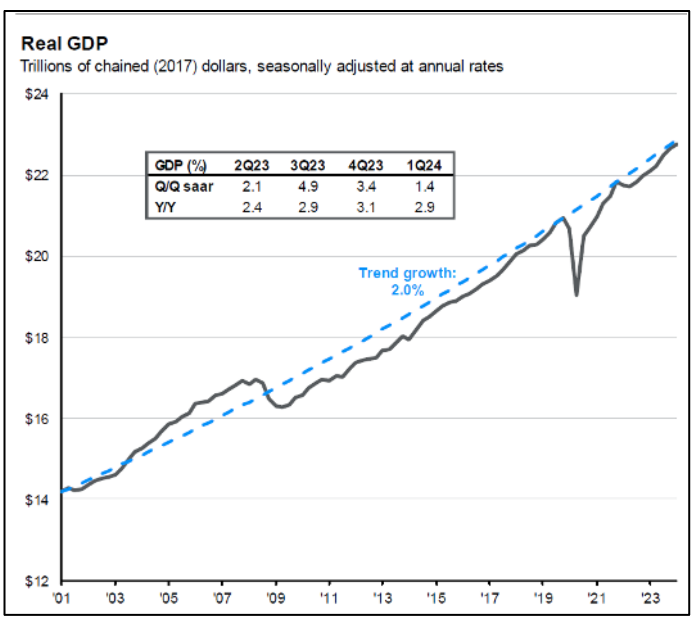
Fig 4: Consumer Confidence



Source: Conference Board

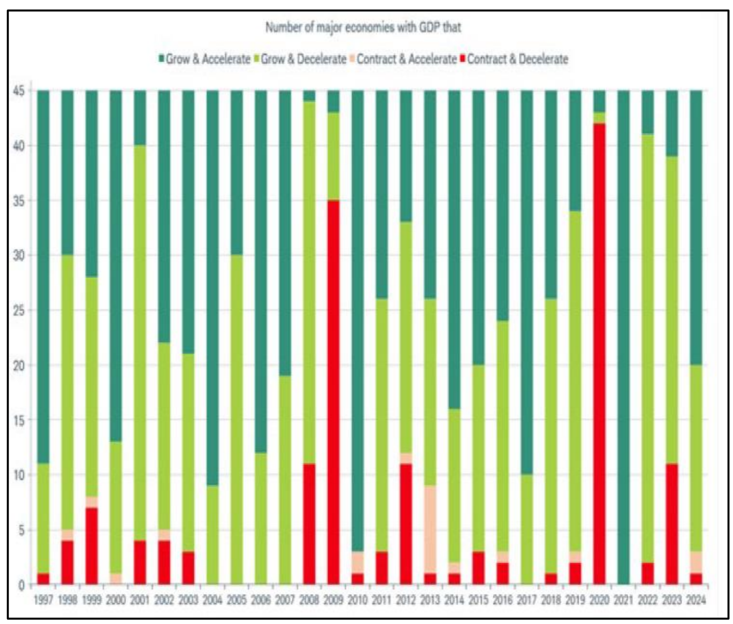
Overall, the US GDP grew at an annual rate of 1.4% in the first quarter of 2024 and is expected to grow by a similar rate in the second quarter, according to the Federal Reserve of Atlanta. This is down from a growth rate of 2.5% for 2023 and 3.4% in the fourth quarter of 2023. Despite the recent slowdown, the US economy is growing at a rate much faster than previously expected and in line with the long-term trend rate of 2%. (Fig 5)

Fig 5: Long term US GDP growth rate



Source: JP Morgan

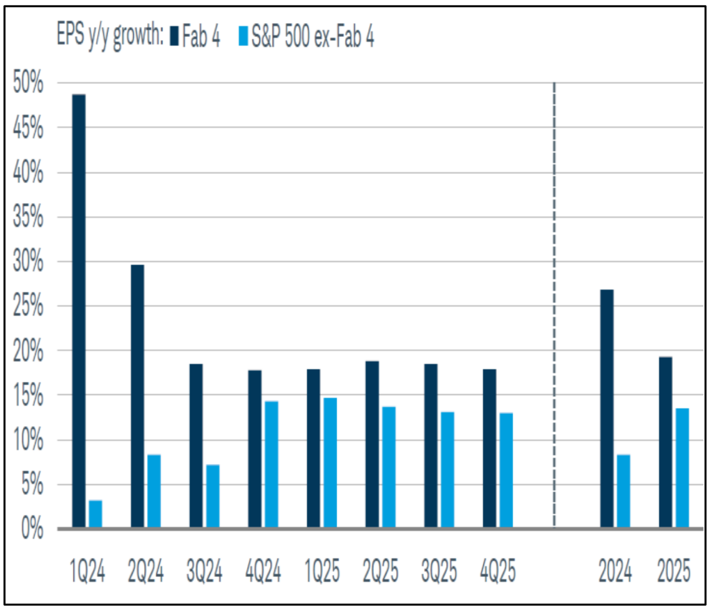
Fig 6: Growth (Shades of green) in world economies



Source: Charles Schwab

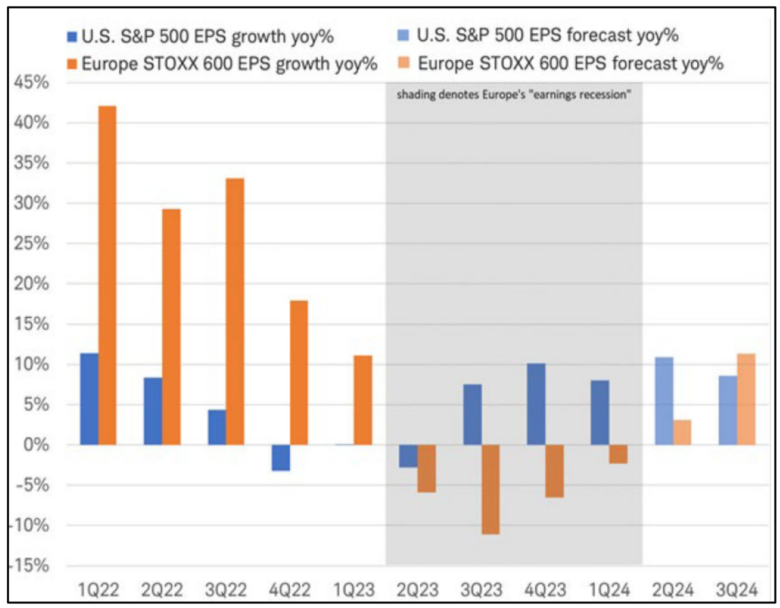
Outside the US, economies are recovering but growing unevenly. As seen in Fig 6 a greater number of economies are growing this year as compared to last year. The World Bank expects the world economy to stabilize for the first time in three years but at a lower rate than recent history. Global growth is projected to be 2.6% in 2024 before hitting 2.7% in the next two years. That is lower than the 3.1% average in the previous decade. As inflation has been cooling, the European Central Bank cut rates for the first time since 2019, as did the Bank of Canada.

Fig 7: Earnings growth of the ‘Fab 4” and others



Source: Charles Schwab

Fig 8: European earnings are expected to recover



Source: Charles Schwab

Despite the slowdown in the economy, analysts have not cut their earnings estimates for companies in the S&P 500 (A proxy for US stocks), according to FactSet. Following earnings growth of 1% in 2023, earnings are expected to grow by 11.3% in 2024 and 14.4% in 2025. If this were to happen, it will mark the third time in the past 15 years that the S&P 500 has reported two consecutive years of double-digit earnings growth. A seen in Fig 7, while a significant part of the earnings growth currently is because of the “Fab 4” (Amazon, Microsoft, Nvidia and Meta), over the next two years the rest of the stocks in the S&P 500 are expected to contribute a larger portion of the earnings growth than they currently do. Outside the US, European companies are expected to significantly improve their earnings growth between 2024 and 2025 as seen in Fig 8. Strong earnings growth should support stock prices.

Are large company stocks the only game in town?

Large company stocks have handily beaten smaller company stocks in recent times. Large stocks have been helped by the relative outperformance of the ‘mega cap’ stocks such as Apple, Microsoft and Amazon. On the other hand, high interest rates have adversely impacted the profitability of smaller companies. If you look at recent performance, it may seem like the best strategy is to invest exclusively in large company stocks with strong fundamentals such as those in the S&P 500. Table 1 shows the returns of the S&P 500 (Large company stocks) and the Dimensional US Small Cap Index since the financial crisis in 2009 and over the last 5 and 10 years. During these periods large company stocks have handily beaten smaller stocks, especially in the last 5 and 10 years.

Table 1: Performance comparison of large stocks (S&P 500) and small stocks

(Annualized returns)

Period	S&P 500	Small Stocks
2018-2023	12.10%	8.20%
2014-2023	12.0%	8.6%
2009-2023	14.0%	13.6%
2000-2023	7.0%	10.3%
1995-2023	10.5%	11.9%
1990-2023	10.2%	11.9%

Small stocks represented by the Dimensional US Small Cap Index

Source: Standards and Poor's, Dimensional Fund Advisors

However, if you look at performance since 2000, a different picture emerges, as small stocks have done better than large stocks in the period between 2000 to 2023. Readers may remember that 2000 was the beginning of the end of the 'internet bubble', when large company stocks (Such as Microsoft, GE, Nortel, Cisco etc) fell significantly over the next 3 years. However, even if you go back 5 years before 2000 to 1995, or even 10 years back to 1990, you can see small company stocks have outperformed large company stock, despite recent underperformance.

Of course, this does not mean you should only invest in small stocks, but it supports the need for an appropriate amount of smaller company stocks to diversify your portfolio and make it resilient over the long term. As discussed in a previous newsletter (CLICK HERE), "Diversification is primarily a risk management tool and is often called the only free lunch in the investment world. This is because it reduces the risk of a portfolio of investments without a commensurate reduction in expected returns. A diversified portfolio gives investors the confidence to tolerate the volatility of the portfolio so that they can benefit by staying invested over time, even if it comes at a cost of lower returns as compared to any specific market index."