2024 Mid-Year Update: Navigating the Messy Middle

July 2024

Building a Lifelong Partnership

In our 2024 outlook, titled "Prepare, Don't Predict," we outlined three broad themes that we believed would influence markets in 2024—inflation stuck in the "messy middle," consequences of a concentrated market, and preparation for a possible recession. With the first half of the year behind us, these stories have each played out in different ways, and we believe that each will continue to be important for the rest of the year and beyond.

2024 Themes Revisited

1. The Messy Middle

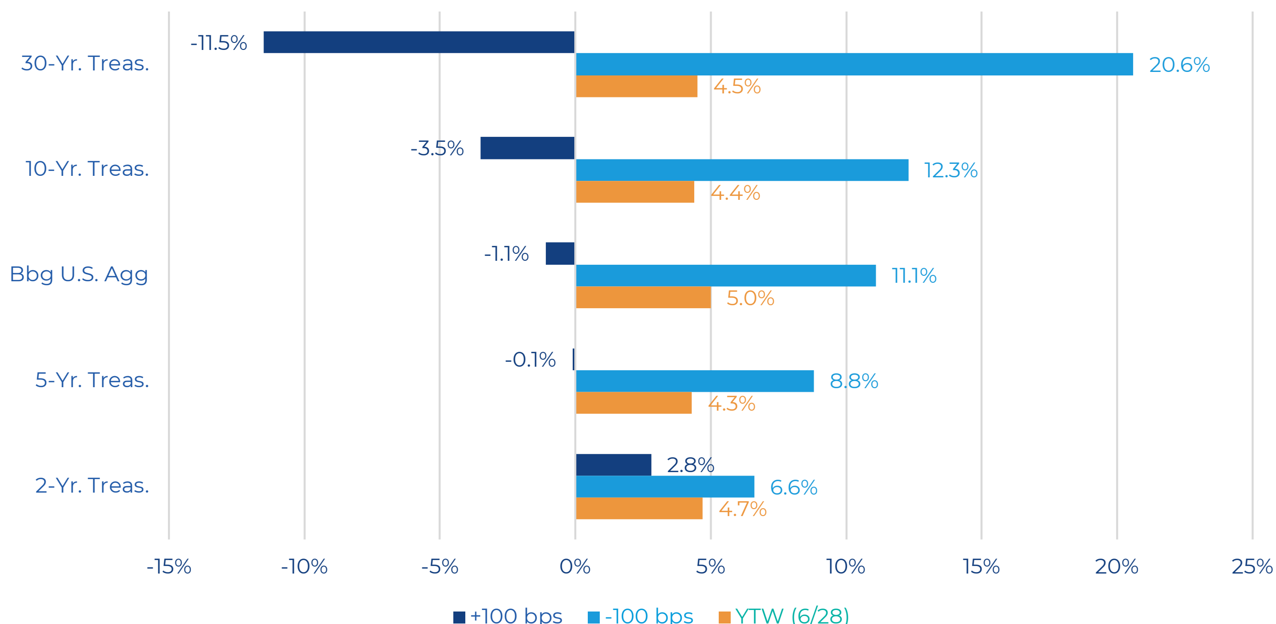
At the beginning of the year, we believed that inflation would remain on a downward trend, but that the journey back to the Federal Reserve's 2% target would be a bumpy one. This has been the case so far. Amid alternating months of optimism and pessimism, inflation numbers have broadly decelerated, with year-over-year CPI reaching 3.0% in June for the first time since March 2021. However, while inflation has declined significantly from its peak of 9.0% two years ago, its downward path stalled in recent months—June's 3.0% reading is barely below January's 3.1% rate. There have also been bumps along the road. Year-over-year CPI declined almost every month from June 2022 to June 2023, then bounced from 3.1% back up to 3.6% and remained stuck between 3.4-3.6% for nearly a year before trending down again.

The path forward for inflation is unclear. Energy prices have played a significant role in decreasing headline numbers but are always volatile. Insurance costs continue to skyrocket, with auto insurance up more than 20% over the past year. The shelter component of CPI has grown more slowly in recent months but is still more than 5% higher than a year ago. This last factor will likely be the biggest determinant of where inflation goes from here—shelter is the largest component of CPI at 36%, so it will be nearly impossible to get index growth back to 2% so long as shelter remains elevated. Conversely, if rental rates begin to dip, it could provide the final leg down to the Fed's target.

PORTFOLIO CONSIDERATIONS

A structurally higher inflation rate near 3% may force investors to change their thinking around markets but may not necessarily be detrimental. Investors have made money in far more inflationary periods in the past. Moreover, we maintain our belief that steady inflation between 2.5% and 3% may allow the Fed to cut interest rates, despite their insistence that they will target 2%. Such an environment may create an attractive opportunity in longer-duration bonds, which tend to appreciate more than their shorter-duration peers when rates decline.

While skews remain favorable for long duration investing, however, we acknowledge that risks remain, since the Fed is not the only factor that determines bond prices. The Treasury is currently issuing tens or hundreds of billions in new debt every month, with no sign that deficit spending will slow. As federal debt continues to swell, investors may demand higher returns to continue to purchase it. This would place supply-driven upward pressure on Treasury yields, and downward pressure on bond prices, with greater impact on longer-duration bonds.



Source: FactSet as of June 28, 2024. Total potential return based on a parallel move in interest rates up or down by 100 basis points. Data based on respective Bloomberg Bellwether Treasury Indices & Bloomberg US Agg Bond Index. YTW = yield to worst.

2. Concentrated Consequences

At the beginning of the year, we noted that investor equity returns in 2023 may have been excellent or modest depending on their allocation to just a few stocks. Despite many predictions of a broader market in 2024, reality has been quite the opposite. The "Magnificent 7" stocks generated more than half of the S&P 500's total returns in 2023, as each rose more than 50% for the year, and three (Tesla, Meta, NVIDIA) rose more than 100%.[1] Many of those same names carried their momentum into 2024 and have been joined by surging stocks like Eli Lilly and Broadcom. Through the first half of the year, NVIDIA alone contributed more than one-quarter of the S&P 500's 15.3% advance, while the nine biggest contributors together made up more than two-thirds of the index's return. As a result, the ten largest companies in the S&P 500 comprised 37% of the index at the end of June, the highest level in the index's history.[2]

To some degree, this rally can be justified. NVIDIA's earnings per share over its past four fiscal quarters have been more than five times greater than the year prior, while net income has been more than eight times higher. According to JPMorgan, the "Mag 7" grew earnings 31% in 2023, compared to -4% for the other 493 companies in the S&P 500.[3] In 2024, those numbers are projected to be 30% and 7%, respectively. Even with such growth, however, these behemoths sport lofty valuations. The S&P 500 index is pricey by historical standards, carrying a forward P/E ratio of 21x on June 30, above its 30-year average of 17x. But this valuation is largely a consequence of concentration—the weighted average P/E for the index's ten largest names was 30.3x, while the other 490 averaged 17.6x, closer to historical norms.

PORTFOLIO CONSIDERATIONS

We reiterate our view from the beginning of the year—the tech titans may very well continue their market dominance, but we must acknowledge that concentration may contribute to market fragility and allow other assets to outperform if any of the big names falter. Valuations in U.S. small caps and many non-U.S. stocks are below the S&P 500, opening the door to a reversal in fortunes if big tech earnings growth slows and puts their valuations under pressure. This uncertainty prompts prudent diversification—we maintain exposure to all of these asset classes, preferring to benefit from the market's broad uptrend rather than trying to correctly predict which particular sectors or styles will be in favor at any given time.

3. Don't Predict Recession—Prepare

Our outlook at the beginning of the year noted that, while the widely predicted recession of 2023 did not materialize, it was too early to declare victory and shelve all fears. To some degree, it appears that equity markets have done just that, pushing higher due to a combination of good corporate earnings, decent economic data, and rate cut hopes.

Still, the past few years have not been without difficulty. The economy as a whole never tilted into a recession (no, those two quarters of negative GDP at the beginning of 2022 do not count), but various sectors have faced "rolling recessions" at different times as the highest inflation and interest rates in over a decade altered the financial landscape. Technology firms executed significant layoffs in 2022 as higher interest costs challenged their growth trajectories. An ongoing collapse in the value of office buildings played a role in the failure of several regional banks. The residential housing market remains mired in a transaction slump as homebuyers balk at high prices and homeowners stand pat with low mortgage rates. Manufacturing businesses have seen slower activity as consumer spending shifted from goods to services after the pandemic.

Yet there have been many positives as well. Though the unemployment rate has risen, job creation remains resilient, with more than 200,000 jobs added in 13 of the last 18 months, and an average of 240,000 per month over that period. Average wages have recently outpaced inflation, slowly recovering lost purchasing power. Specifically, CPI was higher than wage growth over every rolling 6-month period from March 2021 until December 2022, when wage growth bumped higher and has stayed ahead ever since. Lastly, GDP has continued to grow, albeit at slower rates. This year's first two quarters saw 1.4% and 2.8% (estimated) growth rates, slower than the 4.9% and 3.4% rates at the end of 2023. But such moderation was expected as the economy fully recovered from the pandemic and returned to a more normal trajectory.

PORTFOLIO CONSIDERATIONS

We believe that the last 18 months of market returns serve as a reminder of the futility of market timing—just ask any of the recession doomsayers who pulled their money in late 2022 or 2023. We remain aware that recessions will occur again in the future and will seek to adjust portfolios as necessary in response to their arrival, but we reject the idea of complete portfolio overhauls in an attempt to predict the tops and bottoms of the economic cycle.

As we look forward to the remainder of this year, markets seem to be anticipating a “soft landing,” in which gradually easing inflation and labor market data allow the Fed to cut interest rates while GDP grows at modest rates. But plenty of threats to this rosy projection exist—slower consumer spending due to higher interest rates and/or elevated inflation, rising unemployment as hiring slows, fallout from slumping commercial real estate values, and many more. With our eyes always on the road ahead, we continue to emphasize the importance of properly constructed, diversified portfolios that allow investors to stay fully invested across market cycles.

As always, we are here to help you navigate the potential risks and opportunities along the road. Feel free to contact your Octavia representative with any questions or concerns.

[1]Morningstar Direct, as of 6/30/2024.
[2]J.P. Morgan Asset Management, as of 6/30/2024.
[3]J.P. Morgan Asset Management, as of 6/30/2024.
All economic data (CPI, earnings, payrolls, GDP, etc.) retrieved from Fred as of 7/24/2024.

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