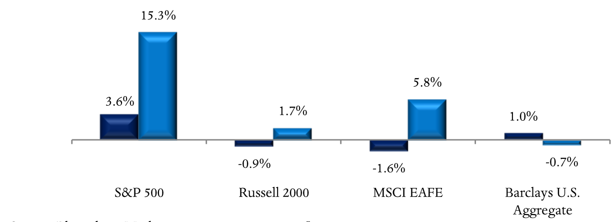
PAPAMARKOU
WELLNER PERKIN

June - July 2024 Issue # 254

Markets

US equities were bifurcated in the second quarter, featuring poor market breadth and negative performance for most indices. Yet a small group of large-cap growth stocks, with outsized index weightings, produced robust gains. The S&P 500 added +3.6% in June, its seventh consecutive monthly gain, powering to a record high (+4.3% in Q2; +15.3% ytd). Conversely, the Russell 2000 index of small capitalization stocks dropped -0.9% in June (-3.3% in Q2; +1.7% ytd). From an economic perspective, the market narrative remained volatile but leaned towards a Soft-Landing/Goldilocks scenario. Overseas equities in the MSCI EAFE index declined -1.6% in June (-0.2% in Q2; +5.8% ytd). The Euro Stoxx 600 index suffered a monthly pull-back of -1.1% in June on the back of political jitters (+1.6% in Q2; +9.5% yd). In Asia, Chinese stocks in the Shanghai composite continued to produce lackluster performance (-2.9% in June; -0.3% in Q2; +0.9% ytd) due to economic concerns. In Japan, local stocks encountered some upward resistance after a strong +20.9% Q1 run to all-time highs (+3.0% in June; -1.3% in Q2; +19.3% ytd) driven by corporate reforms and a weakening Yen.

Interest rates peaked in early Q2 and have since been in a downward trend, but remain higher, across the curve, in 2024. Since the start of the year, the US 2-year Treasury Note yield has increased +50bps to 4.75% and the 10yr yield +52bps to 4.40%. The 10s, 2s spread has been inverted since July 2022, which is its longest inversion on record. While this indicator has historically been an early warning signal of an oncoming recession, one has not yet materialized in this cycle and US economic activity continues to impress with its resilience. As a result, the Barclays US aggregate bond index has chalked-up a two month win-streak with June +0.9% (Q2 +0.1%; -0.7% ytd).



Source: Bloomberg Markets

In commodity markets, WTI crude oil prices fell -2.6% in the second quarter (to $81.54/bbl) but have posted gains of +13.8% so far in 2024, driven by geopolitical concerns in the Middle East, and steady global economic advances. Gold, which investors often use as a hedge against geopolitical or economic uncertainty, gained +4.1% in Q2 (+12.8% ytd), trading at $2,325.71/oz, after reaching record highs in March. Meanwhile, copper prices climbed higher early in the quarter, achieving gains of more than +25%, before paring back and ending the quarter up +8.5%. The orange metal is widely used in industrial processes and products, including many electronics, and its performance is seen as a leading indicator of the global economy's health.

Geopolitics

President Joe Biden and former President Donald Trump participated in their first debate of the 2024 election season. President Biden's biggest political weakness, his age (81) and perceived frailty, became a clear liability on the stage. Trump (age 78), meanwhile, began the night with a calmer demeanor than in the past, being largely respectful of the debate rules around time limits and interruptions. Tackling one of his biggest perceived weaknesses, Trump took the more moderate conservative stance that abortion policy should be left up to the states. Subsequent fact-checking showed that Trump falsely represented the January 6 attack on the US Capitol and misstated the strength of the economy during his administration. Biden, who tends to lean more on exaggerations and embellishments rather than outright lies, misrepresented the cost of insulin and overstated what Trump said about using disinfectants to address Covid. In all, it was a heated debate in which the candidates sparred over various policy issues that showed they are far apart on many points. Biden's performance cast some doubt about his ability to govern for another four years, leading to some speculation of his withdrawal from the race. Who Trump will choose to be his vice presidential running mate should be known within the next two weeks, in advance of the Republican National Convention scheduled for July 15-18. The Democratic convention is set to be held from August 19-22.

In European Parliament elections, which occur every five years, far-right parties made significant gains and the Greens lost many of their seats. While European center right, center left and liberal parties will likely remain a ruling majority, there will be more pressure to address some of the policy issues pertinent to parties further to the right, including immigration, the Green Deal and the environment. As part of the ensuing fall-out President Emmanuel Macron was forced to call for snap elections for France's own national parliament.

United States

While US economic activity has been stronger than anticipated, versus the start of the year, second quarter data came in below expectations in several instances. To the upside, job growth has recently exceeded consensus and the unemployment rate, which bottomed in January 2023 at 3.4%, has risen to 4.0%. On the inflation front, the Federal Reserve's preferred measure (PCE) came in at 2.6%, in-line with forecasts and down from 2.7% in April. While the Fed is unlikely to cut rates at its next open market committee meeting on July 31, its messaging could be more dovish. Given the continued disinflation trend and the increasingly below consensus economic data (as per Citigroup's Economic Surprise Index) the Fed may have cover to signal a rate cut at the ensuing FOMC in September. The Federal Reserve's most recent Summary of Economic Projections (SEP) shifted hawkishly to one rate cut this year rather than the three forecasted as recently as March. Investors are more dovish and are expecting two rate cuts (totaling 45bps) from the Fed by year-end.

June 2024 Economic Statistics

	Jun-24	Dec-22	Dec-21
Federal Funds Target Rate	*5.25 - 5.50%*	*4.25 - 4.50%*	0 - 0.25%
Consumer Confidence Index	*100.4*	*108.3*	115.8
Manufacturing PMI Index	*48.5%*	*48.4%*	58.7%
Unemployment Rate	*4.0% (est.)*	*3.5%*	3.9%
JPY/USD	*160.83*	*131.11*	115.08
USD/EUR	*1.0713*	*1.0702*	1.1368
Gold/oz.	*$2,325.71*	*$1,824.40*	$1,828.39
Oil (WTI)/bbl	*$81.54*	*$80.26*	$75.21

Sources: see disclosure *

Europe

European economic momentum remained positive as the effects of the cost-of-living shock continued to abate. S&P expects the EU's GDP growth to accelerate from 0.7% this year to 1.4% in 2025. This is supported by Euro area inflation decelerating to 2.5% in June from 2.6% in May. Member states of the bloc with the highest annual inflation rates were Belgium (5.5%) and Spain (3.5%), while the lowest rates were recorded in Finland (0.6%) and Italy (0.9%). In Germany and France, consumer prices rose by 2.5%. Lower commodity prices, especially energy, have been supportive. Inflation is expected to further recede to 2.2% in 2025.

The European Central Bank (ECB) became the latest developed market central bank to cut interest rates (to 3.75%). This move was heavily signaled prior to its June meeting, but imbalances among countries and stickier-than-expected services inflation meant that the ECB was keen to stress that the path to any further policy normalization is heavily data dependent. Markets currently expect the ECB to periodically cut interest rates until the deposit rate bottoms out at 2.5% in the third quarter of 2025.

The UK's Bank of England hesitated to cut interest rates even though headline inflation tumbled to its

2.0% target. Strong wage growth is supporting services inflation, which grew 5.7%, leading to fears of a reacceleration in the headline figure. Erring on the side of caution, the central bank held rates at 5.25% for the seventh time, at the highest level in 16 years.

Asia

Moves by the Chinese authorities to support the real estate sector provided a boost to the local economy, which is forecast to grow by 5% in 2024. China's expanding clean energy sector accounted for an estimated 40% of the country's economic expansion in 2023. In an effort to mitigate China's growth from increased exports, and buttress their lead in EV's, batteries and solar panels, the European Commission said it will impose duties on imported Chinese electric cars ranging from 17.4% to 38.1%, on top of the standard 10% car duty, citing excessive subsidies. This comes less than a month after Washington announced plans to quadruple duties for Chinese EVs to 100%. The IMF has warned that severe global trade restrictions, and other economic fragmentation, could cost the global economy $7.4 trillion, over the long-term, cutting global economic output by as much as 7%.

Outlook

Global GDP growth is tracking towards 2.7% in 2024, 0.3% higher than previously expected, according to Fitch Ratings. Meanwhile, inflation is decelerating across many regions. Investors have thus come to expect future dovish behavior from central banks. Including the recent interest rate cut by the ECB, half of the G10 central banks have enacted reductions. The Federal Reserve is expected to follow in due course. These positive liquidity actions should reinforce bullish equity market expectations.

Upcoming second quarter earnings for the S&P 500 index are estimated to grow at +8.8% year-over-year, with associated revenue growth of +4.6%, according to FactSet. Eight of the 11 sectors are expected to report higher EPS growth in Q2. For CY 2024, analysts are projecting S&P 500 EPS growth of 11.3%, and revenue growth of 5.0%. For CY 2025, analysts are forecasting S&P 500 EPS growth of 14.4%, and revenue growth of 6.0%. This represents an impressive acceleration heading into year-end and continuing into 2025, as the effect of inflationary pressures on corporate margins fade and price increases drive revenues. The S&P 500 now commands a forward P/E ratio of 21.2, which is a 16% premium to its 10-year average, driven by the index's high growth constituents (the top 3 stocks, Microsoft, Apple, Nvidia, now sport market capitalizations over $3T and represent 20% of the index weighting). Therefore, a focus on quality and a long-term investment horizon is paramount.

With regard to fixed income, the worries that economies may overheat appear to have subsided and markets are confident the next move for the major developed market central banks is that of policy-easing on the back of lower inflation. As a result, the medium-term outlook for fixed income looks attractive. The benign macro-economic environment also appears supportive of credit markets calling for default rates and spreads to remain contained. Further, should a "higher for longer" interest rate scenario come to pass, it would allow investors to continue receiving strong coupon payments.

History tells us that the current low volatility regime will eventually be followed by a healthy bout of fear, when one of the myriad of potential risks comes to pass. Eventually, a broadening of equity market participation is to be expected and will be welcomed by most investors. Active hedge funds and non-market correlated investments stand to benefit in these scenarios, given their value-added research and ability to produce risk-adjusted returns. Underperforming small capitalization stocks should also benefit from a rotation of capital by investors seeking value. Noble alloy and other specialty metal commodities are increasingly being used in military and technology applications, while offering a hedge should inflation unexpectedly resurface. We are also seeing specific opportunities in software focused investments, with an activist element. For longer-term investors we have identified compelling private equity investments, revolving around European growth, healthcare, and education-technology.

*Sources: Reuters, Bloomberg, Bureau of Labor Statistics, Conference Board, Federal Reserve, Institute for Supply Management, MSCI, Russell, Standard & Poor's, Financial Times and the Wall Street Journal.