Boston Trust Walden
Principled Investing.

# Investment Commentary

June 30, 2024

## Financial Markets

Stocks rose by 4.3% in the second quarter, as measured by the S&P 500 Index. But not all stocks participated in the quarter's ascent. Many segments of the domestic stock market, including middle and smaller capitalization indices, not only failed to keep up with the headline index but declined during the period. Even among large capitalization stocks, the average stock fell by 2.6%, as measured by the equal-weighted version of the S&P. International developed markets were also in the red, while emerging markets tallied a gain of 5.3% (a reversion from longer-term underperformance to developed markets).

| Total Returns through June 30, 2024 | | |
|---|---|---|
| **US Stocks** | **2nd Quarter** | **Year-to-Date** |
| Standard & Poor's 500 | 4.3% | 15.3% |
| Russell 2000® | -3.3% | 1.7% |
| **International Stocks** | | |
| MSCI World Ex-US | -0.5% | 5.1% |
| MSCI Emerging Markets | 5.3% | 7.8% |
| **US Fixed Income** | | |
| Bloomberg Gov't/Credit | 0.0% | -0.7% |
| 90-Day Treasury Bill | 1.3% | 2.7% |

The strong performance of the S&P 500 was again driven by a small number of mega-capitalization technology-oriented stocks. The Information Technology sector accounted for 95% of the Index's gain; NVIDIA led the charge, alone accounting for almost half of the S&P's return. The company is currently the clear leader in chip designs for Artificial Intelligence (AI) computing functions. The rise of this one stock is reflective of how AI has captured the imagination of society, the markets, and of course, the other companies placing orders for NVIDIA's chips — companies that believe developing AI capabilities will facilitate their own profit growth in the years ahead.

NVIDIA's stock performance has been hyperbolic. Averaging returns of over 90% per year for the last four years, its weight in the S&P 500 has grown from 0.9% to 6.6%, and now constitutes a larger portion of the Index than five of the eleven economic sectors. In fact, the chip designer briefly became the largest publicly traded company, surpassing Microsoft, in mid-June before the stock retraced its gains over the subsequent week. However, the contrast between the technology giants is striking. While NVIDIA has risen sharply and suddenly, Microsoft grew and evolved its business through multiple market, economic, and technology cycles to become the dominant company it is today. Whether NVIDIA can endure as a market leader remains to be seen, as competition in cutting-edge AI chips will certainly heat up, potentially challenging the company's dominance, business fundamentals, and stock valuation.

Meanwhile, in fixed income markets, broad domestic bond indices were largely unchanged as coupon payments compensated for the decline in bond prices (a result of a rise in interest rates during the quarter). As we discuss below, market participants yet again pushed out their expectations for the first interest rate cuts by the Federal Reserve as they interpreted the most recent batch of economic data.

## Investment Perspectives

Despite last year's widespread forecasts of a slowing US economy compelling the Federal Reserve to lower benchmark interest rates, neither has yet to pass. Rather, the economy continues to expand, albeit at a moderate pace, and the Federal Funds rate remains at the same 5.33% it has been since last July. The US economy's resilience has been broad-based, with everything from personal consumption expenditures to industrial production to labor market strength persisting despite higher financing costs.

Inflation indeed remains above the Fed's 2% target, but, unlike recent economic growth, its drivers are not so widespread. Shelter and auto insurance, which together account for just under 40% of the Consumer Price Index (CPI) basket, contributed almost 80% of the latest year-over-year inflation print. Importantly, however, these two inflationary forces appear idiosyncratic in nature, rather than an indication of elevated systemic pricing pressure. Shelter-related inflation readings, which alone count for over a third of the headline CPI, are notoriously lagging rather than reflective of current moves in housing prices, so their elevated levels are indicative of the rental statistics catching up with the reality of the real estate market. Meanwhile, auto insurance rates, which account for less than 3% of consumers' spending basket, have risen so abruptly—by 20% over the past year—that they contributed 0.6 percentage points to May's 3.3% CPI increase. The surging rates are being driven by several unique factors, including a higher incidence of collisions and more expensive car repairs (owing to an increasing preponderance of advanced technology in vehicles). With the recent elevated inflation numbers largely accounted for by these unique factors, we see sustained high levels of broad inflation as less of a risk to the economy than it has been in recent years.

### *Half Full or Half Empty?*

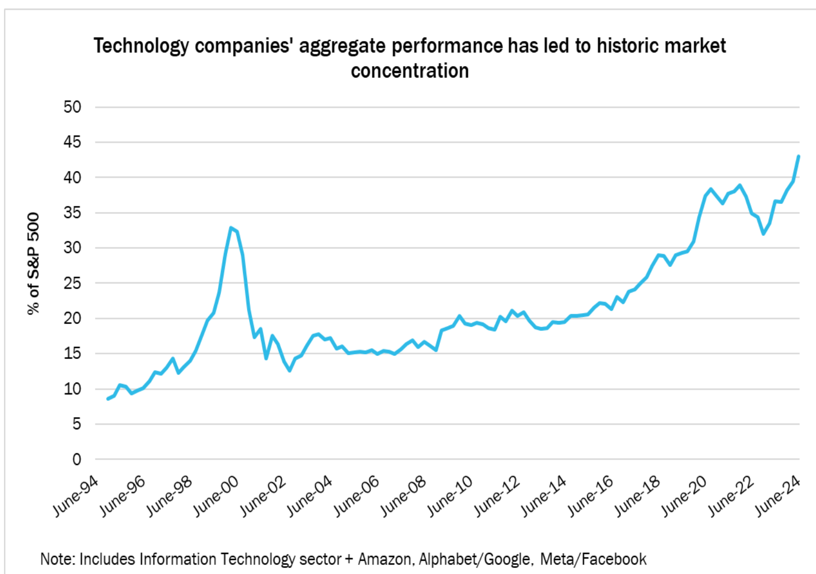
Further indicating the abatement of widespread inflationary pressure is moderating wage growth. As we have noted in prior quarters, markedly rising hourly wages helped to support consumer spending as pandemic-related savings were exhausted. At the same time, such rising labor costs were a catalyst for businesses to raise their prices. Though wage growth remains elevated, it continues to recede ever closer to the ~3% annual increases that were typical in the pre-COVID economy. Moderating wage growth can be viewed as both positive and negative for consumers, as it means slower growing incomes, but also suggests that price inflation will also be less going forward.

With the economy in reasonably good shape, and a "soft landing" seemingly the most likely outcome, the Fed has stated it will continue to hold policy rates where they are until inflation is closer to its long-term 2% target. Accordingly, investors have continued to push out their forecasts for when the Fed might begin to cut rates. Going into the year, Federal Funds futures implied expectations of six reductions throughout 2024; investors now call for one or two cuts by the end of the year. The delay not only contrasts with initial market expectations but also with other central banks around the world. Some, including the European Central Bank, have already started easing their benchmark interest rates as they combat flagging growth and other economic risks.

### *A Disconnect: The Economy and the Stock Market*

Clients often ask why the stock market continues to move markedly higher when the economy is only growing at a slow and steady pace. There are several answers to this question. First, it's important to note that though economic readings account for the recent past, the stock market is forward-looking — whether it be in anticipation of monetary actions from the Federal Reserve, expected future corporate profits (the long-term driver of stock returns), or other economic, financial, and geopolitical factors. Perhaps even more significantly, it's appropriate to acknowledge that the US stock market is not representative of the US economy. For example, US GDP statistics do not include foreign earnings of US companies, and the stock market does not include government entities (a significant spender and employer within the US economy), nor does it include over 30 million American small businesses. Other compositional mismatches are evident and becoming even more pronounced given the leadership of the recent market rally. For example, Information Technology (the formal sector plus technology-related companies like Alphabet/Google, Meta/Facebook, and Amazon.com, which are classified into other sectors) now represents over 43% of the S&P 500 Index, and, as noted above, have been the driving force for recent stock market gains. Meanwhile, technology-related products and services contributed only 9% of US GDP in 2023 and 7% of private sector jobs.

The recent success of technology companies has been profound. While US economic growth has remained in the low single digits, the aggregate technology cohort has grown its profits rapidly — by double digits annually — over the last five years. Such earnings growth has fueled the astronomical rise in the share prices of many in the group and even justifies some of the companies' current valuations. However, as noted, investors should be forward-looking. From that perspective, many of the cohort's valuations appear stretched, as they imply rosy expectations of continued extraordinary growth.




### *Outlook and Positioning*

Expensive valuation and industry concentration in the S&P 500 Index present risks for prospective stock returns. The S&P 500 is increasingly reflective of a small group of companies with differing prospects that have undue influence on the market's aggregate valuation. The Index is trading at ~22 times anticipated earnings (over the next twelve months) — a substantial premium relative to its long-term average of 17x. The rich valuations are especially evident when it comes to those companies participating in the AI revolution. If we think back to the internet bubble 25 years ago, we can recall that the pundits were decisively right about the technological revolution of that day: the internet had a profound impact in reshaping our society in the ensuing decades. That could, and is perhaps likely to, be the case with AI today. However, it is also worth recalling that not all companies (nor shareholders) emerged from the internet bubble as winners. In fact, many were not. And this is why we remain especially disciplined regarding companies with exuberant valuations that imply overly optimistic projections of future profits. Conversely, many other companies, including many high quality companies with sustainable business models, continue to trade at reasonable valuations; the valuation of the equal-weighted S&P 500, at 17x earnings and in line with historical averages, is demonstrative of this dynamic. Such stocks, which comprise the core of the diversified portfolios we manage, underlie our continued preference for equities in multi-asset portfolios.

Beyond equity market dynamics, economic and other risks continue to threaten equity values. This includes the continued lagged effect of higher interest rates, especially their influence on the commercial real estate market and consumer balance sheets. Neither of those segments has shown significant visible cracks, but the latent risks are notable as either could have widespread impacts on the economy by weakening the financial sector or consumer spending. The geopolitical landscape also provides plenty of potential disruptors to global economic conditions. Among them include the ongoing conflicts in Ukraine and the Middle East, China's posturing, and significant elections in the US, France, United Kingdom, and elsewhere. Such macroeconomic and geopolitical risks continue to highlight the prudence of holding an ample helping of bonds in multi-asset portfolios. Such instruments currently offer healthy income yields, while also providing protection should economic momentum be disrupted.

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