

Market Review and Outlook Second Quarter 2024

Equity markets made further gains during the second quarter of 2024 with the S&P 500® index up 4.28% as large tech companies continued to lead the market. In terms of size and style, large-cap growth stocks performed well as companies like NVIDIA continued to report strong earnings. Among domestic equities, small-cap value lagged other styles with the sentiment for regional banks remaining challenged. Developed international equities continued to lag behind domestic stocks, although emerging markets fared relatively well during the quarter despite persistent hurdles in China. Positive growth in Taiwan and India helped offset the slowdown in China.

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Within fixed income, short-duration bonds outperformed their longer-duration counterparts as the yield on the 10-year Treasury bounced higher during the quarter. Among credit spread sectors, bank loans, emerging-markets debt, and high-yield all performed relatively well versus core bonds.

Outlook

While inflation in the U.S. continues to decelerate slowly toward the Federal Reserve's (Fed's) target rate of 2%, its sluggish progress (despite a cooling labor market) has delayed interest-rate cuts. Heading into the year, markets had predicted the Fed would have begun cutting rates by now, but fear of reigniting inflation has convinced the Fed not to make changes during the first half of 2024.

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As anticipated, Consumer Price Index (CPI)–Shelter (which represents about a third of overall CPI) continues to decelerate—albeit remaining relatively high. Given the method the Bureau of Labor Statistics uses to calculate shelter inflation, this official data tends to lag market data by several quarters. This trailing effect is illustrated by the following chart, which compares CPI shelter and Zillow’s rent index.



Source: FactSet

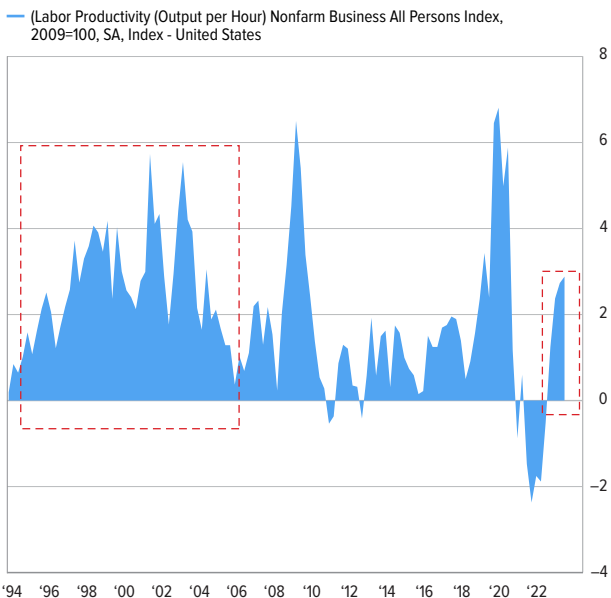
Given that actual market rent prices have stabilized, we expect inflation as determined by CPI will continue to head toward normalization within the next few quarters. Unless there is some unforeseen catalyst that sparks inflation, the Fed may feel more comfortable to initiate a series of rate cuts starting later this year.

Nevertheless, we recognize that high interest rates have not only slowed the economy, but also added pressure to corporate profits. This has been especially challenging for smaller companies that tend to be more leveraged than larger ones, which has compelled us to underweight small-cap stocks and overweight domestic large-cap companies (especially large-cap growth). Although only a handful of companies have benefited from the ongoing AI rally, we do not believe the current market has peaked. For instance, the price-to-earnings ratio of the S&P 500® index remains well below bubble levels seen during the dot-com boom era of the late 1990s.



Source: FactSet

With the adaptation of AI, businesses should begin to experience improvements in profitability, which should further alleviate pressures of high valuations. As history shows, advancements in technology can lead to several years of productivity gains. The following chart suggests that we could be in the infant stage of this AI productivity cycle. This has the potential to provide fuel for future economic growth, allowing risk assets to perform well.



Source: FactSet

In terms of sectors and styles, we continue to favor technology and growth over financials and value. We still believe the environment is challenging for the banking industry, as many institutions continue to report dismal

earnings due to weak loan growth. Despite the wide dispersion between valuations associated with growth and value sectors, we remain cautious about the sector rotation that will eventually occur. Nonetheless, we believe the interest-rate and yield-curve environment will continue to present challenges for some value sectors. Bank profits are unlikely to improve until the yield curve starts to steepen, which may take some time. Additionally, while we expect the long-term bull trend to remain intact, the market will likely experience some correction along the way.

Although we expect a modest slowdown in the U.S. economy due to a cooling labor market and rising credit card delinquencies, the prospect of a near-term recession has fallen to a point that justifies our modest overweight to domestic equities. We are aware of the risk of high

valuations in large-cap growth and are evaluating emerging opportunities elsewhere. However, we need to be patient for more clarity in the market before making any significant movements. While conditions are steadily improving, we realize much will depend on how the Fed addresses the various risks on the horizon. As always, we will continue to monitor these risks and adjust our allocations accordingly.

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4 of 4



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