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2nd Quarter Commentary

2024

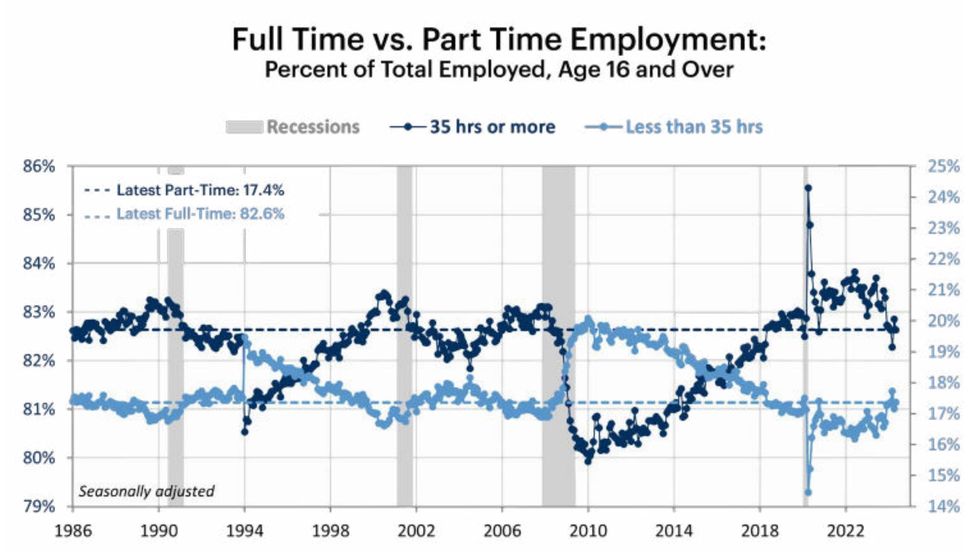
Economic Murkiness

Economic murkiness is how we can best describe the first two quarters of 2024. When a deep fog settles in and the waters are muddy, the only thing that can help us to navigate is a reliable compass. It is prudent to slow down and evaluate what the economic data is telling investors.

Jobs And Unemployment

Through May, the unemployment rate was 4%, which is historically low. Looking deeper into the sustainability of the jobs market, a critical indicator of its future is the relationship between the percentage of full-time and part-time employment.

This chart shows the challenges faced by the economy and markets during periods of declining full-time employment and increasing part-time work. Notably during the recessions of 1990, 2000-2002, and 2007-2009.



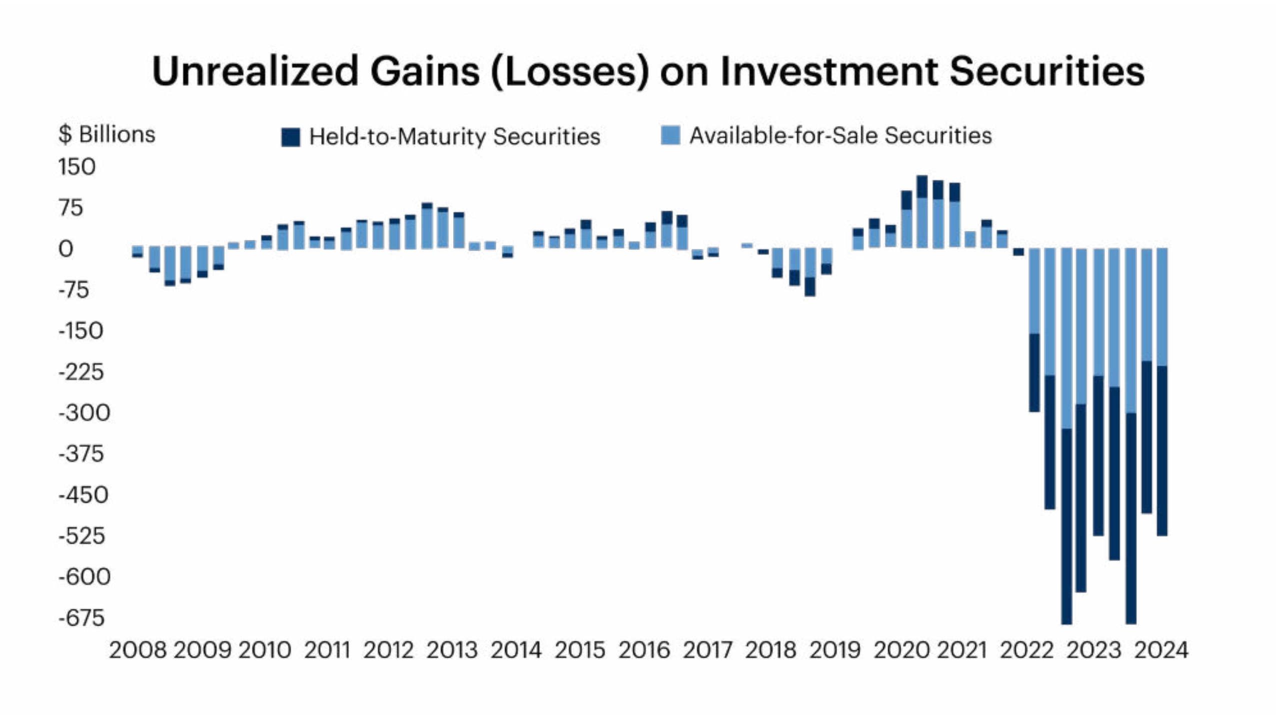
Source: Advisor Perspectives

Improvements in the job market could occur if the economy enters another growth phase, inflation is controlled, government spending is managed, and banks address their exposure to commercial real estate. These factors have the potential to lower the unemployment rate.

Current data indicates a weakening job market, with full-time positions continuing to soften and part-time positions strengthening.

Banking

The chart below illustrates U.S. banks have unrealized losses in the first quarter totaling $517 billion and are estimated to exceed $1 trillion in losses in 2024.



Source: FDIC

It's undeniable that U.S. banks are facing tremendous unrealized losses on their balance sheets with no end in sight. The housing market slowdown, the increase in mortgage costs moving from 3% to 7%, house prices remaining near all-time highs limiting new buyers, and significant losses in commercial real estate have all contributed to the challenges faced by the banking industry.

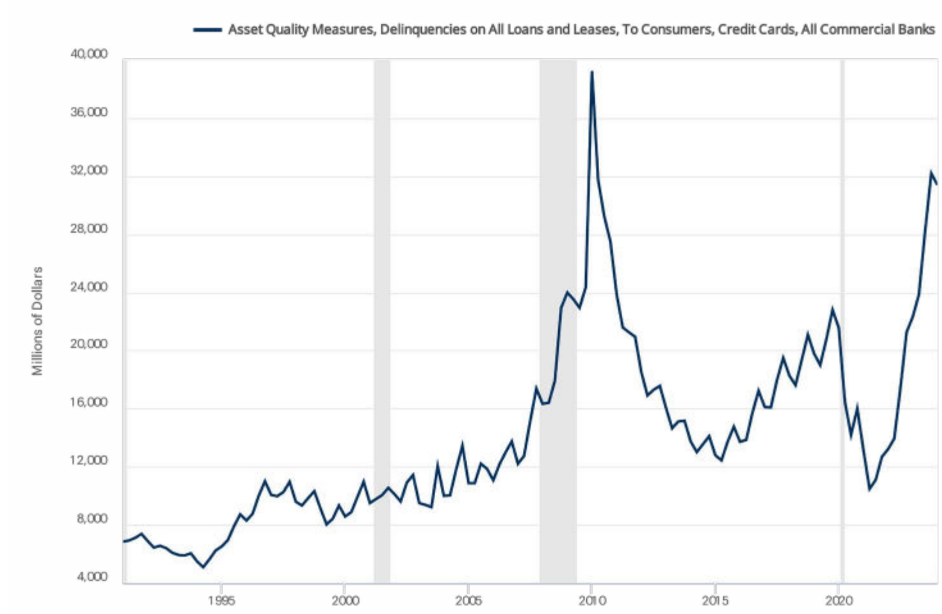
Delinquencies on All Loans and Leases

There is no hiding the fact that our banks are in a precarious position with delinquencies on a steep rise and deposits nearly a trillion dollars lower in the past few quarters. Delinquencies are a leading indicator of foreclosures and defaults.

U.S. Banks at Risk

As of the first quarter 2024, the FDIC's Problem Bank List cites 63 banks. However, on June 6, 2024, the Social Science Research Network found 186 banks are at risk of failure or collapse. We won't go into all the ripple effects of bank failures, but it shines a spotlight on the significant difference between how government and independent third party researchers define what makes an "at risk" bank.

There is limited upside for banks unless the Fed reduces rates substantially in the coming quarters to help heal their balance sheets, and/or our economy enters a sustainable growth trajectory.



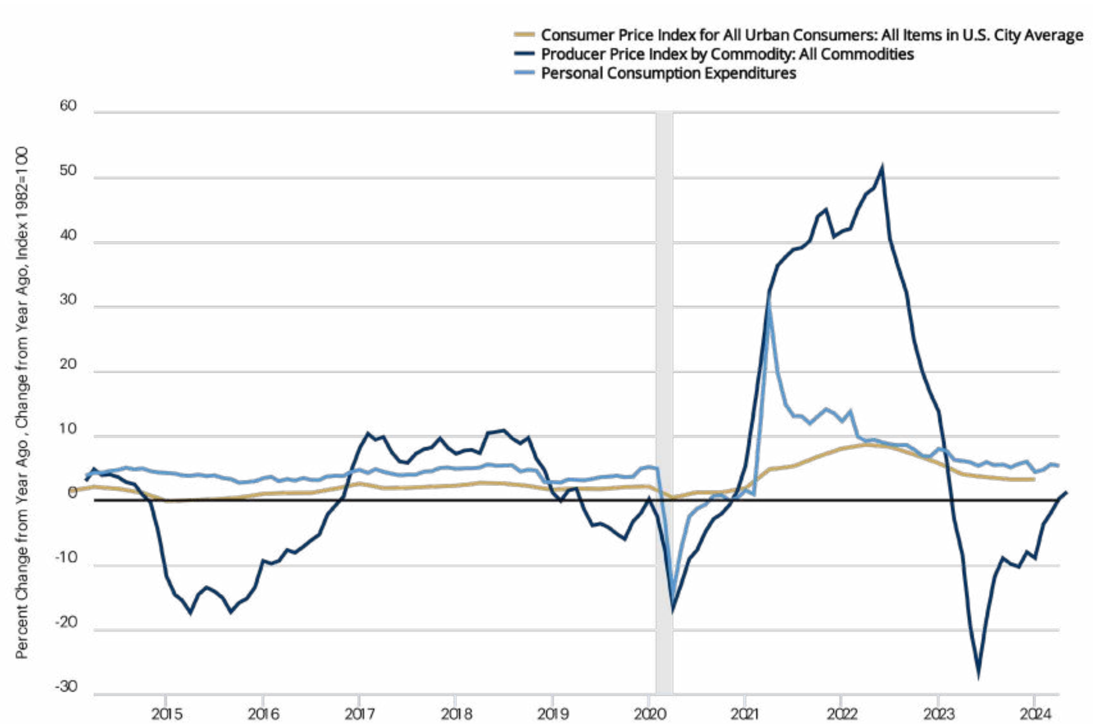
Source: Board of Governors of the Federal Reserve System (US)

The Fed

The Fed has stated repeatedly they are in a holding pattern to reduce rates until CPI, PPI, and PCE, all inflation indicators, calm down. When is the trillion-dollar question.

In portfolio management, historically, the most opportunistic time to own bonds is when the Fed reduces rates (historically 300 basis points from start to finish) combined with needs for income and overall risk reduction. It is reasonable to think we are close or already in the next cycle of the highest-quality bond market due in part to the fact that inflation has slowed down for the last two years.

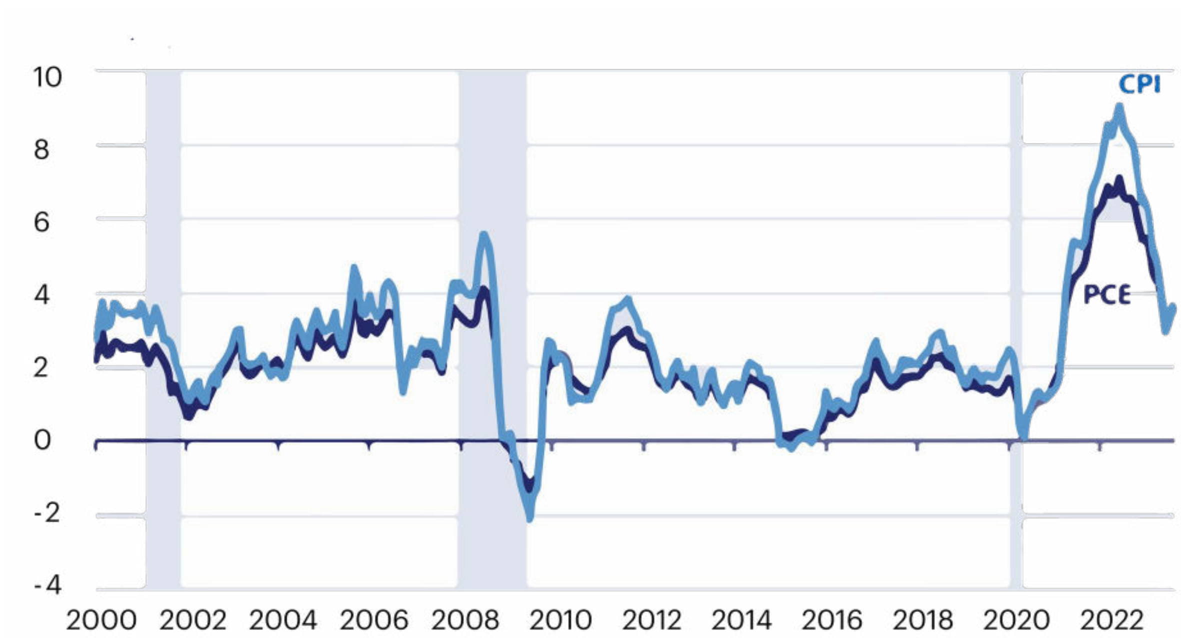
Inflations Top Indicators: CPI, PPI, and PCE



Source: BLS, BEA

CPI PCE Inflation Since 2000

Year-on-year percent



Source: Bureau of Economic Analysis, CEA calculations

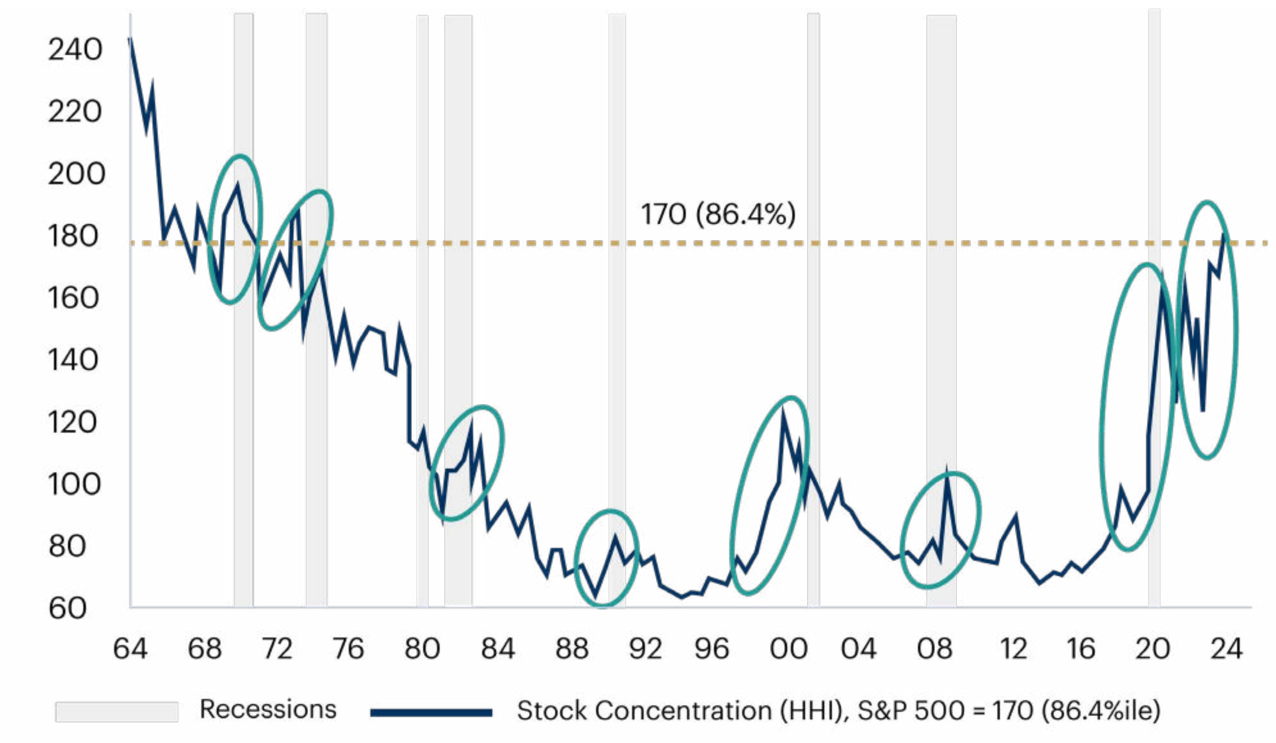
As we look closely at pre-pandemic data, it is interesting to note current inflation measures are back to where they were at the end of 2019. So, what is the Fed waiting for? The Fed states they need to have several months of data indicating that inflation is easing before they cut rates. Note that the following sectors all show a decline since 2022/23: car and truck rentals, used cars and trucks, gasoline, airline fares, appliances, televisions, health insurance costs, household furniture, eggs, lettuce, tomatoes, cheese and related products, butter, potatoes, beef, fresh fish, and seafood.

We understand it may not feel as though inflation hasn't eased, yet CPI, PPI, and PCE have all come down in the past two years.

U.S. Stock Market Concentration

Could it be a new normal where tech stocks lead us into an era of advancement, growth, and sustainability? Wall Street would say anything is possible, especially a bull market (their continuous narrative).

Concentration within the S&P 500



Source: JP Morgan

However, if you look at the Magnificent Seven or the top ten stock holdings of the S&P 500, they show a massive concentration of very few stocks, similar to 1929, 1963, 2000, and 2019. Currently, the top ten S&P 500 holdings represent 35% of its market cap.

Largest U.S. Companies by Market Cap by Year

1980	1990	2000	2010	2020	Feb 2024
1. IBM	IBM	GE	ExxonMobil	Apple	Microsoft
2. AT&T	Exxon	ExxonMobil	Apple	Microsoft	Apple
3. ExxonMobil	GE	Pfizer	Microsoft	Amazon	Alphabet
4. Amoco	Altria	Cisco	GE	Alphabet	Nvidia
5. Schlumberger	RD Shell	Citigroup	Chevron	Facebook	Amazon
6. Shell	Bristol-Myers	Wal-Mart	IBM	Tesla	Meta
7. Mobil	Merck	Microsoft	P&G	Berkshire	Berkshire
8. Chevron	Wal-Mart	AIG	AT&T	J&J	Eli Lilly
9. Arco	AT&T	Merck	J&J	JPMorgan	Broadcom
10. GE	Coca-Cola	Intel	JPMorgan	Visa	Tesla

Source: S&P, Russell Investments

Markets evolve and innovation prevails as the future of stock markets has identified who the next great corporation will be along with who has fallen out of favor.

How high stocks can go is anyone's guess. Historically, investors flock to a very limited number of stocks when near a market cycle peak. The top three stocks now represent 20% of the S&P 500 the prior high in concentration was 8% for the top three stocks.

When stock concentration levels are extremely elevated in their current market cycle, the historical norm is an economic slowdown, market correction, and recession to follow.

The Bond Market

The typical trigger for an inverted yield curve is when long-term expectations for the economy sour and look very weak, if not negative. In the fall of 2022, the inversion of interest rates began, and nearly two years later short-term bonds still have higher rates than long-term bonds.

Historically, recessions begin approximately 18 months after the Fed begins raising interest rates. In April 2022 the Fed began raising rates and, to date, a recession has not hit our economy.

The Past Four Recessions

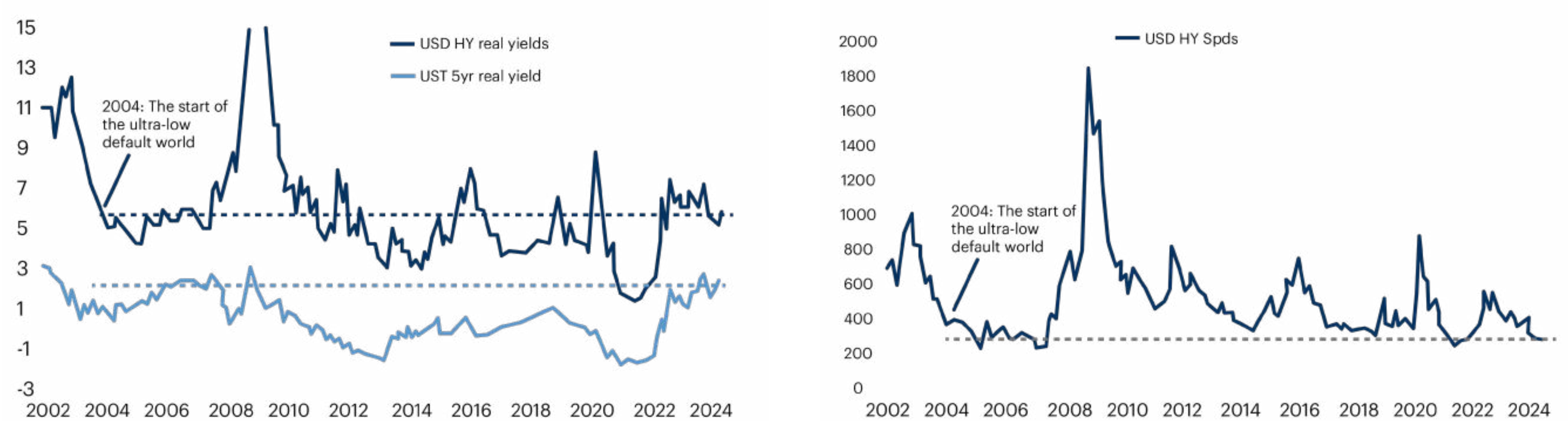
Year	S&P 500 Performance	Fed Rate Cuts (bps)
1980	-4.91%	645
1990	-3.10%	233
2000-2002	-42.99%	376
2008	-37.00%	408
Total	**-87.28%**	**1662**
Average	**-21.82%**	**415**

Source: Bloomberg Finance L.P. Data

As the Fed has postured themselves to reduce rates, history shows us once the Fed starts cutting, they are fairly consistent in lowering rates an average of 300 bps since 1957 in 9 of the last 10 recessions and 415 bps since 1981.

U.S. High Yield Spread near 20-year lows

Figure 1: UST (Syr) and HY Real Yields (left) and US HY Spreads (right). With Govt RYs around their post GFC highs but with HY spreads around their 20yr lows, HY RYs are above their 20yr average but not breaking out of the range for now.



Add Source: Deutsche Bank, S&P, Bloomberg Finance L..P.

A conundrum is at hand. Over the past few quarters, delinquencies on all loans and leases have spiked. The discrepancy between high real yields compared to government real yields, alongside an extremely low default environment, doesn't add up. Government real yields are near their highest levels since before the global financial crisis in 2008. At the same time, U.S. high-yield spreads have reached historic levels, leading to a situation where the pressure on credit real yields tests the likelihood of a rise in the structural default rate in the coming years.

If the bond market responds to the Fed cutting rates, as it has over the past 40 years, then U.S. government bonds have the real potential for significant outperformance in the coming quarters.

The bond market has experienced over three standard deviation plus events in the past few years. As the pendulum swings from one extreme to another, it does not stop in the middle but instead goes to the opposite extreme. No one knows for sure if this time is different, yet history does point in a more bullish direction for the highest-quality bonds.

Summary

There are cases for both positive and negative outcomes for jobs, banks, the Fed, U.S. stocks, and U.S. bonds. Asset management and Wall Street firms continuously lean heavily on the bullish side.

We see these economic facts as a time to revisit your financial plan with your Financial Advisor, consider reallocating your portfolio, and focus on opportunistic investments that have been out of favor. Now is the time for engaging in the ways of wisdom, not behavioral finance.

Love life,

Todd M. Schwartz, CFP®
Founding Partner

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