FROM THE DESK OF BOB CENTRELLA, CFA **July 8, 2024**

I hope you all had a bang of a 4th of July holiday. I'm also hoping patriotism is making a comeback! It was steamy hot back here in NJ for most of it but any of you in the path of Beryl we hope you stay safe. You'll be happy to hear that this quarter's letter will be a bit shorter than usual so it should be a quicker read but hopefully still insightful.

The 2nd quarter on the surface looked solid for stocks if you look at the 4.38% return of the S&P 500. For the year, the S&P has returned 15.23%, a great 6-months. But below the headline number was a different picture. It's all about A-I. Since last year, AI (Artificial Intelligence) stocks have been dominating the markets. The stock market continues to be driven by the mega cap stocks group of 6 stocks this year (Nvidia, Microsoft, Apple, Amazon, Meta & Google). In Q2 Nvidia market cap broke $3 trillion and it briefly was the largest company in the world. Those 6 stocks have accounted for 60% of the return of the S&P 500. Meanwhile, the Equal-Weight S&P 500 actually declined -2.6% in Q2 and is only up 4.96% YTD. Many other indexes were down in Q2 including small and midcaps and the Dow Industrials fell -1.25% in Q2. Bond yields rose during the quarter with the 10-yr UST yield rising from 4.2% to 4.34%, although during the quarter it rose as high as 4.7% as inflation figures early in the quarter were higher than expected.

Below is a table of price returns for various assets in Q2-24. There is a lot more negative than positive.

ASSET	% RTN	ASSET	% RTN	ASSET	% RTN
Nymex Nat Gas	47.5%	1-3 Yr US Treas	-.16%	Nikkei 225	-1.95%
Comex Silver	17.9	Stoxx Europe 600	-.24	Nymex Crude	-1.96
Taiwan	13.5	IShares High Yield Bond	-.76	SP 500 Equal Weight	-2.6
Copper	9.7	Euro	-.76	Ethereum	-3.3
Nasdaq Comp	8.3	Vang Total Bond Agg	-.80	SP Small Cap 600	-3.55
Hang Seng	7.3	Ishare Natl Muni	-.98	Russell 2000	-3.62
Comex Gold	4.97	7-10Yr US Treas	-1.07	SP Midcap 400	-3.82
S&P 500	3.92	IBEX 35 (Spain)	-1.18	CAC 40 (France)	-8.85
FTSE 100	2.66	DAX (Germany)	-1.39	BITCOIN	-10.3
WSJ Dollar Index	1.48	Dow Jones Avg	-1.73	Cocoa	-20.9

Nat Gas rose 47.5% and was the biggest gainer much to chagrin of homeowners. Precious metals also were strong in the quarter. The Nasdaq Composite rose 8.3% led by large cap tech stocks. Most international equities declined and were led down by France (-8.85%) due to the election results which were a surprise. Germany, -1.39%, Spain -1.18% and the Euro Stoxx 600 -.24% all lost ground. Bond prices declined as yields rose. The UST 7-10 year bond fell -1.07%. Cocoa, which was the big gainer in Q1 up 133%, declined 21% …now good news for us chocolate lovers!

Among cap sizes and styles, it was a very narrow market gain. Large Growth was the only group to provide a positive return in Q2 and it was a huge return of 9.65% while all other styles and cap sizes had negative returns. For the year Growth has outperformed and the large growth return of 23.47% is by far the leader.

Index	Q2 % Rtn	YTD %	Index	Q2 %	YTD %	Index	Q2 %	YTD %
S&P 500 Growth	9.65%	23.47%	S&P MC 400 Growth	-3.45%	11.51%	S&P SC 600 Growth	-1.65%	2.76%
S&P 500 Value	-2.15	5.68	S&P MC 400 Value	-3.56	.45	S&P SC 600 Value	-4.83	-4.92
S&P 500	4.38	15.23	S&P MC 400	-3.42	5.87	S&P SC 600	-3.24	-.99

On a sector basis, Technology again led with an 11.0% gain followed by Communication Service +9.47%, the same two winners as Q1. Utilities became a quasi-AI play and rose 3.07%. On the downside the cyclical stocks were weak with Basic Materials (-4.56%) , Industrials (-2.62) and Energy (-1.95) being the worst sectors.

Sector	% Rtn	Sector	% Rtn
Technology	11.0%	Cons Cyclical	-.74
Comm Svcs	9.47	Real Estate	-1.22
Utilities	3.07	Energy	-1.95
Cons Defensive	1.16	Industrials	-2.62
Healthcare	.41	Basic Materials	-.4.56
Financial	-.37		

KEY TAKEAWAYS AND LOOKING AHEAD

1. The market rally has been narrowing and needs to broaden for the rally to continue. As I mentioned earlier, the market rally was carried by a handful of stocks in Q2 and for the year. Tech stocks are strong because that is where the spending is taking place. Small and mid-caps pulled back in Q2 as did many sectors. A rotation from the leaders to the laggards would be healthy. For the market to move higher, the rest of the market needs to participate. Because…
2. Valuations are getting stretched. The S&P 500 now sells at 21x forward eps, above the 5-yr (19.3x) and 10-yr (17.9x) averages. Also, the PE on the S&P Tech sector is 33.5x forward eps. This can continue but multiple expansion is a dangerous game without EPS growth. Earnings need to increase too.
3. Corporate profit reports for Q2 are coming. The next few weeks will be influential on stocks as companies report Q2 earnings and give guidance. Expectations are for a strong Q2 thru Q4 earnings. Estimates call for 8.8% earnings gain overall in Q2, the highest in a few years. Revenues are expected to climb 4.6%. For Q3 eps are forecasted to grow 8.1% and then 17.3% in Q4 against a weak 2023. Overall, that is an 11% gain in 2024 and expectations are for a 14.5% gain in 2025.
4. Inflation was higher than expected early in the quarter but now seems to be easing a bit. Inflation numbers came in above 3% early in the quarter causing rates to rise and forecasters to lower the probability of a Fed rate cut. The expectation is now that the Fed might cut once before the election, but the Fed continues to state they need to see more progress first on lowering inflation.
5. Bond yields continue to remain above 5% out to a year and above 4.25% long term. **The yield curve has been inverted now a record 700+ days and counting**. Unless the Fed surprises (unlikely) and cuts rates this summer, bond yields should stay above 5% and the curve inverted. The 3-month to 10-Year inversion is about 1%. So, the inversion is likely to stick until next year when and if the Fed is more aggressive on cutting rates.
6. The economy is not strong and weakening in many areas. If inflation weren't high the Fed likely would have cut rates already to stimulate the economy. Q1 GDP growth was only 1.4%. Manufacturing is weakening, housing is stagnant due to high rates and non-manufacturing is in decline. Technology and AI spending are propping up otherwise declining fundamentals. The jobs market seems to be holding steady, but the unemployment rate has crept up to 4.1% from 3.6% a year ago.
7. Seasonally slow summer period for stocks is coming our way. August and September are two of the worst months seasonally. We did get a brief 5% correction in April, are we due for another correction?

8. Election will take center stage soon. The disastrous Joe Biden performance in the debate has put the election forefront. Rhetoric will increase and markets may become volatile as we move closer to November. To me the bigger issue may not be the President (markets seem to do well regardless of who is President) but the makeup of the House and Senate. Markets seem to prefer split houses as a check and balance.

BONDS

Not much has changed with bonds. Short yields above 5% and medium to long yields above 4% still offer some decent returns. Given the yield curve inversion, I don't see longer term bonds earning much more than their current yield. My strategy remains in place of a barbell and laddering approach coupling short and intermediate bonds (only out a few years) with a combined yield in the 4.5% range. There is a slight probability the Fed could lower rates once in September before the election, then pause. I still see a range of 25 basis points up or down from current levels in the 3- to 10-year yields until the Fed signals a cut. Preferred stocks and convertible bonds continue to offer a decent return opportunity if rates don't move much higher. US bonds out to 1 year and cash Money Market yields should stay near/above 5.0%.

EQUITIES

Large growth stocks continued leading the way breadth was weak as many other stocks lagged in Q2. The approach of Mega-cap plus diversification that I have preferred did not do as well in Q2 as the cap-weighted S&P 500 in total, but provided positive returns. I expect solid earnings from the mega-cap stocks but given high valuations any miss in earnings or weaker guidance may be penalized severely. We saw that in Q1 with some stocks. If earnings are as strong as anticipated, it is possible the rally can broaden out. But the seasonally slow summer could dampen that. Mid-cap stocks appear attractive to me while small-caps would need some rate cuts to do better. Large caps are the core of the portfolio but you could see some profit-taking in Mega Caps after earnings in the summer.

SUMMARY AND CONCLUSION

If the typical seasonal pattern plays out in the summer, stocks will post a gain in July as earnings come in but then be weak in August and September into October earnings. Uneasiness about the Fed, the election and the economy is likely to stay with us for the next few months at least. I see a higher probability of a 5-7% correction again during the summer but buying to come back into the market especially after the election regardless of who wins. The biggest surprise for markets would be a democratic sweep, since it is not expected. This could be met with some selling. Overall, I believe we could still finish the year up another 5-10% from the end of Q2. But I'd be a better buyer after September if the seasonal pattern holds true. My sector approach is to stay diversified, but I look for attractive valuations and stories among individual companies. Technology, Comm Services and Consumer Discretionary will have the best EPS growth among sectors.

On the international front, the surprise French election results hurt European stocks. I still like some exposure to international stocks and prefer developed markets. I'd continue to avoid China.

Coming into 2024 my base case forecast was for a nice up year for stocks and a collect-the-coupon year for bonds. I think Equities outperform bonds in the 2nd half, but ST bonds should be held for income and protection in balanced accounts and will produce positive returns of 2% to 2.5%. For equities, I continue to favor a diversified large cap equity portfolio with some exposure to mid, small, and international stocks as well. Stock-picking will be key.

Feel free to contact me with any comments. Enjoy the rest of the summer. Cheers!

Bob