Second Quarter 2024 Commentary

An Oxford Harriman & Company Market Commentary

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The topic of interest rate cuts continues to dominate the financial markets. Investors remain focused on when the Federal Reserve will lower rates, while keeping a close eye on corporate earnings and valuations. Economists are analyzing inflation and labor market data to determine their impact on the probability and timing of rate cuts. Speeches by Fed members and minutes of recent Fed meetings have received greater scrutiny as investors search for clarity about the central bank's next steps.

This commentary discusses investors' focus on the Federal Reserve, recaps second quarter performance and looks ahead to the remainder of 2024.

Global Central Banks are Starting to Cut Rates

While the Federal Reserve waits for more confirmation that U.S. inflation will return to its 2% target, the trend among global central banks has shifted decisively away from tightening. Central banks cut interest rates early in the pandemic to protect against unknown risks associated with shutting down the economy. When the economy reopened and inflation soared to multi-decade highs, they reversed course and raised interest rates with the goal of easing inflation. Interest rates were left at these high levels while waiting for inflation to slow, as evidenced in the rate plateau from 2022 into 2023.

Entering the third quarter, central banks are starting to cut interest rates as inflation slows around the world. More than 10 central banks have cut rates, including Canada, Switzerland, and the European Central Bank. The monetary policy environment is shifting from rate hikes to rate cuts, and investors expect this trend to continue in the coming quarters as more banks cut interest rates. However, this easing cycle is likely to be more staggered than previous cycles, with central banks cutting interest rates at varying speeds based on their unique inflation and economic growth conditions.

Analyzing Economic Trends & Surprises From 2Q24

A theme from the past few years has been the U.S. economy's strength compared to the rest of the world. U.S. homeowners locked in low mortgage rates during the pandemic, which has protected them from the immediate impact of higher rates. However, mortgage rates reset more frequently in some countries outside the U.S., with those borrowers feeling the impact of higher rates sooner.

The Citigroup Economic Surprise Index, which compares economic data releases against Wall Street's estimates is something we follow. A positive reading indicates economic data

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is stronger than anticipated (positive surprises), while a negative reading signals more negative surprises. In March 2022, the index turned negative as the Federal Reserve started to raise interest rates. The increase in negative surprises signaled a slowdown in response to early rate hikes. During the past two years, the index stayed mostly positive as the economy remained resilient, with most economic data points surpassing expectations.

During the second quarter, there was an increase in the number of negative economic surprises as the U.S. economy underperformed expectations. Job growth slowed in April, and the unemployment rate rose to 4% in May. Notably, the job growth figures for April and May have subsequently been revised down by a combined 111,000 jobs. Retail sales declined in April, raising concerns about the financial health of U.S. consumer and potential stress for lower-income households. If consumers cut back too much, employers may respond by lowering head count. May manufacturing survey data signaled a slowdown, and the U.S. Census Bureau reported the economy grew more slowly in the first quarter than initially estimated.

Investors are debating what the recent negative surprises indicate. However, there isn't a clear relationship between negative surprises and the rate of economic growth. Rather, the index is more of a reflection of how the economy is performing relative to investor (or more specifically, Wall Street analysts) expectations. The more appropriate question may be whether the U.S. economy is returning to its pre-pandemic trend after growing at an above-average rate since the pandemic's end. If so, investors may need to adjust their expectations to match the economy's new equilibrium.

Investors Remain Focused on the Federal Reserve's Next Interest Rate Decision

The market remained focused on the Fed's policy guidance in the second quarter as inflation eased and economic data softened. However, there was no major shift in expectations, and investors still expect a rate cut prior to the end of this year. While the market is closely monitoring the Fed, it's not receiving much actual guidance.

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On one hand, members of the Fed have advocated for patience. They want more confirmation that inflation is moving toward their 2% target. At the same time, those members, including Chairman Powell, have said there is a high bar for additional rate hikes.

Due to the unclear commentary, the market is left to speculate about the Fed's next step with many investors using monthly economic data to adjust their outlook. However, those data points can vary from month to month, as they are adjusted to account for seasonal economic effects like summer vacations and holiday shopping.

Bond yield movements show the data's volatility and the market's indecisiveness. Examining the weekly changes in the 10-year Treasury bond yield over the past eight years shows some interesting data. From 2016 to 2022, the 10-year yield's movements were relatively small,

except for a few large drops at the onset of the COVID pandemic and the Fed's decision to slash interest rates to near zero. However, yields have been more volatile in both directions since the Fed began raising interest rates in March 2022. Today, Treasury yields are the most volatile they have been in eight years as the market navigates a complex transition from rate hikes to rate cuts.

Equity Market Recap – Stocks Rebound After April Sell Off

The second quarter was a series of ups and downs for equity prices. In April, stocks traded lower, reversing some of the earlier gains from the first quarter. In May, stocks rebounded, and the S&P 500 finished the quarter by setting multiple new all-time highs. Four S&P 500 sectors traded higher in the second quarter, while the remaining seven traded lower. Technology's 8.8% gain made it the top-performing sector, with Communication Services gaining 5.2% and Utilities returning 4.6%. In contrast, cyclical sectors underperformed, with Materials, Industrials, Energy, and Financials being the four biggest underperformers. During the second quarter, the S&P 500 Index gained 4.4%, increasing its first half 2024 return to more than 15%. In contrast, the Russell 2000 Index of small cap companies fell by 3.3%, reducing its first half 2024 return to 1.6%.

A notable theme we have discussed in prior commentaries has been the outperformance of the largest market-cap companies. The Magnificent 7, which is a group that includes Amazon, Apple, Facebook-parent Meta, Google-parent Alphabet, Microsoft, Nvidia, and Tesla, has returned 34.9% this year.

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International stocks underperformed U.S. stocks in the second quarter, but performance varied. The MSCI Emerging Market Index gained 4.4%, comparable to the S&P 500's return. However, the MSCI EAFE Index of developed market stocks declined 0.2%. The two main international stock market indices have underperformed U.S. stocks by almost 10 percentage points year-to-date, despite mid-single-digit gains. The difference in returns continues to be a lack of exposure to companies in the artificial intelligence industry outside the U.S.

Bond Market Recap – Bonds Experience a Volatile Quarter

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Above we highlighted the increased volatility of Treasury yields that occurred during the second quarter. Yields ended the quarter marginally higher, but it was a bumpy ride. The 10-year Treasury yield started the quarter at 4.20%, rose to 4.70% by late April, and dropped back to 4.37% by the end of June. Despite the intra-quarter yield volatility, bonds posted relatively flat returns. Corporate investment grade generated a -0.5% total return, lowering its first half 2024 return to -1.4%. High yield gained 0.7%, increasing its first half 2024 return to 2.2%.

Third Quarter Thoughts

The stock market had a strong first half of 2024. As previously discussed, these gains have been driven by a small number of companies.

The stock market had a strong first half of 2024. As previously discussed, these gains have been driven by a small number of companies. Currently, the top 10 companies in the S&P 500 account for 37% of the index's market cap while they contribute 24% of its earnings. This is the widest gap of that measure since 1990. With earnings season upon us, the stakes are high to deliver on expectations of 8.8% growth from last year's second quarter. This would mark the fourth straight quarter of earnings growth and the largest increase since the first quarter of 2022. Profits for the full year 2024 are expected to rise 11%. While the overall earnings numbers are important, investors are also hopeful that the earnings picture will broaden beyond the current market leaders.

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As we have mentioned in prior commentaries, investors began 2024 expecting the Federal Reserve to cut interest rates multiple times. However, the first rate cut has yet to occur. Interest rate futures indicate an expected rate cut before year-end; however, we remain unconvinced that a rate cut in 2024 is certain. The upcoming earnings season and labor trends could provide clarity on the need for a rate cut. The Fed is mandated to keep the jobs market as strong as possible without fueling inflation. The voting members are keenly aware that when the labor market falters it is not a simple task to get it back on track. We will continue to keep an eye on the unemployment rate. If it keeps moving higher, it will be a sign that the labor market is out of balance. This will raise the prospects of a rate cut before year end.

Investors are correct to focus on corporate earnings growth and the status of the labor market and U.S. consumer, but there is also the upcoming presidential election and continued geopolitical unrest to consider. We will continue to monitor how these items impact the financial markets and provide you with timely updates.

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