



2024: All About (AI, Earnings, Fed Policy, and the Election)

Second Quarter 2024

The S&P 500 Index experienced its first real dose of volatility early in the second quarter, but expectations for interest rate cuts by the Federal Reserve, resilient economic growth, and continued strong financial performance from AI-related tech companies ultimately pushed the index to new all-time highs. The S&P 500 Index finished the quarter with strong year-to-date gains.

While the S&P 500 hit new highs in the second quarter, the month of April was decidedly negative for markets as fears of no rate cuts in 2024 pressured stocks. The catalyst for this concern was the higher than estimated March Consumer Price Index (CPI), which rose 3.5% year over year. That hotter-than-expected reading reversed several months of declines in the CPI and re-ignited fears that inflation could still be “sticky” and if so, could delay expected Fed rate cuts in 2024. Higher interest rate concerns were compounded by comments by New York Fed President John Williams, who stated rate hikes (which investors assumed were over) were possible if inflation showed signs of re-accelerating. The practical impact of the hot CPI report and William’s commentary was to push rate cut expectations out from June to September. This caused the 10-year Treasury yield to rise sharply, from 4.20% at the start of the 2nd quarter to a high of 4.72%. Those higher yields pressured the S&P 500 in April, causing it to fall 4.08% and finishing as the worst month since September 2023.

It wasn’t long before that trend reversed. On the first day of May, the Fed largely dispelled concerns about potential rate hikes and ignited a market rebound that ultimately carried the S&P 500 to new all-time highs. At the May 1st Federal Open Market Committee (FOMC) meeting, Fed Chair Powell essentially shut the proverbial door on the possibility of rate hikes, stating that if the Fed was concerned about inflation, it would likely just keep interest rates at current levels for a longer duration instead of raising rates. Later in the month, the April CPI report (released in mid-May) rose 3.4% year over year, slightly lower than the 3.5% in March. The resumption of disinflation (the decline in inflation) further increased expectations for rate cuts in 2024. In addition, employment data moderated in May, with the April jobs report coming in below expectations - but still at healthy levels. The practical result of the resumption of disinflation, the supportive Fed commentary, and moderating labor market data was to increase the expectations for a September rate cut, pushing the 10-year Treasury yield back down below 4.50% and sparking a 4.96% rally in the S&P 500 in May.

Upward momentum continued in June, thanks to yet more positive news on inflation, additional reassuring commentary from the Fed, and strong AI-linked tech earnings. To begin, the May CPI (released in mid-June) declined to 3.3%, the lowest level since February. Core CPI, which excludes food and energy prices, dropped to the lowest level since April 2021, further confirming ongoing disinflation. Then, at the June FOMC meeting, Fed Chair Powell reassured markets two rate cuts are entirely possible in 2024, reinforcing market expectations for a September rate cut. Meanwhile, economic data showed continued moderation and that combined with slowing growth and falling inflation helped to push the 10-year Treasury yield down to 4.20%, a multi-month low. Markets were further supported by investor excitement for AI which remained extreme in June. Strong AI-driven earnings from a host of technology companies along with news that Apple (AAPL) was integrating AI technology into future iPhones pushed stocks even higher. The S&P 500 hit another new all-time high above the 5,500 level.

Second Quarter Performance Review

On closer inspection however, overall market performance was not as broad based as one would expect. AI enthusiasm again powered the Nasdaq and S&P 500 higher but other broader-based major indices lagged. The Nasdaq was by far the best performing major index in the second quarter – while the S&P 500, where tech is the largest sector weighting at over 32% exposure, also logged a solidly positive gain. However, less tech-focused indices didn't fare as well. The Dow Jones Industrial Average and the small-cap focused Russell 2000 surprisingly posted *negative* quarterly returns. By capitalization, large caps outperformed small caps in the second quarter, as they did in the first quarter of 2024. In April, higher Treasury yields and economic growth concerns pressured the Russell 2000.

At the sector level, performance was decidedly mixed as only four of the eleven S&P 500 sectors finished the second quarter with positive returns. The best performers were the AI-linked technology (+13.8%) and communications services (+9.4%) sectors. Utilities (+4.7%) also logged a positive quarterly return, as the higher dividend yields and resilient business models were attractive to investors, given rising concerns about future economic growth. Turning to the sector laggards, energy (-2.4%), industrials (-2.9%), and materials (-4.5%) sectors closed the quarter with modestly negative returns. Their declines reflected growing anxiety about future economic growth as those sectors, along with small-cap stocks, are more sensitive to changes in U.S. and global growth.

Internationally, emerging markets outperformed the S&P 500 during the quarter thanks to optimism towards a rebound in Chinese economic growth. Falling global bond yields late in the quarter also boosted the attractiveness of emerging market investments. Foreign developed markets, meanwhile, lagged both emerging markets and the S&P 500 and posted a fractionally negative quarterly return. The combined timing and number of Bank of England and European Central Bank interest rate cuts, along with French and German political concerns later in the quarter, acted as headwinds for foreign developed equities.

US Equity Indexes	Q2 2024	YTD
S&P 500	4.28%	15.29%
NASDAQ Composite	8.47%	18.57%
DJ Industrial Average	-1.27%	4.79%
S&P 500 Equal Weighted	-2.63%	5.07%
Russell 2000 (Small Cap. Stocks)	-3.28%	1.73%
MSCI EAFE (International Developed)	-0.09%	5.78%
MSCI Emerging Markets (International EM)	5.32%	7.60%

Source: Bloomberg Professional

06/30/2024

For fixed income markets, the leading benchmark for bonds (Bloomberg Barclays US Aggregate Bond Index) realized a slightly positive return for the second quarter, as rising expectations for a September Fed rate cut and moderating U.S. economic growth boosted bonds broadly. Shorter-duration bonds outperformed those with longer durations in the second quarter, as bond investors priced in sooner-than-later Fed rate cuts. Meanwhile, longer-dated bonds were in the red despite the return of disinflation and moderating U.S. economic growth.

Turning to the corporate bond market, lower-quality but higher-yielding “junk” bonds rose modestly in the quarter while higher-rated, investment-grade debt logged a slight decline. That performance gap reflected continued investor optimism towards corporate profits despite some disappointing economic reports, which led to bond investors taking more risk in exchange for a higher return.

US Bond Indexes	Q2 2024	YTD
Bloomberg US Aggregate Bond	0.07%	-0.71%
Bloomberg US T-Bill 1-3 Month	1.34%	2.68%
ICE US T-Bond 10-20 Year	-1.16%	-3.36%

Source: Bloomberg Professional

06/30/2024

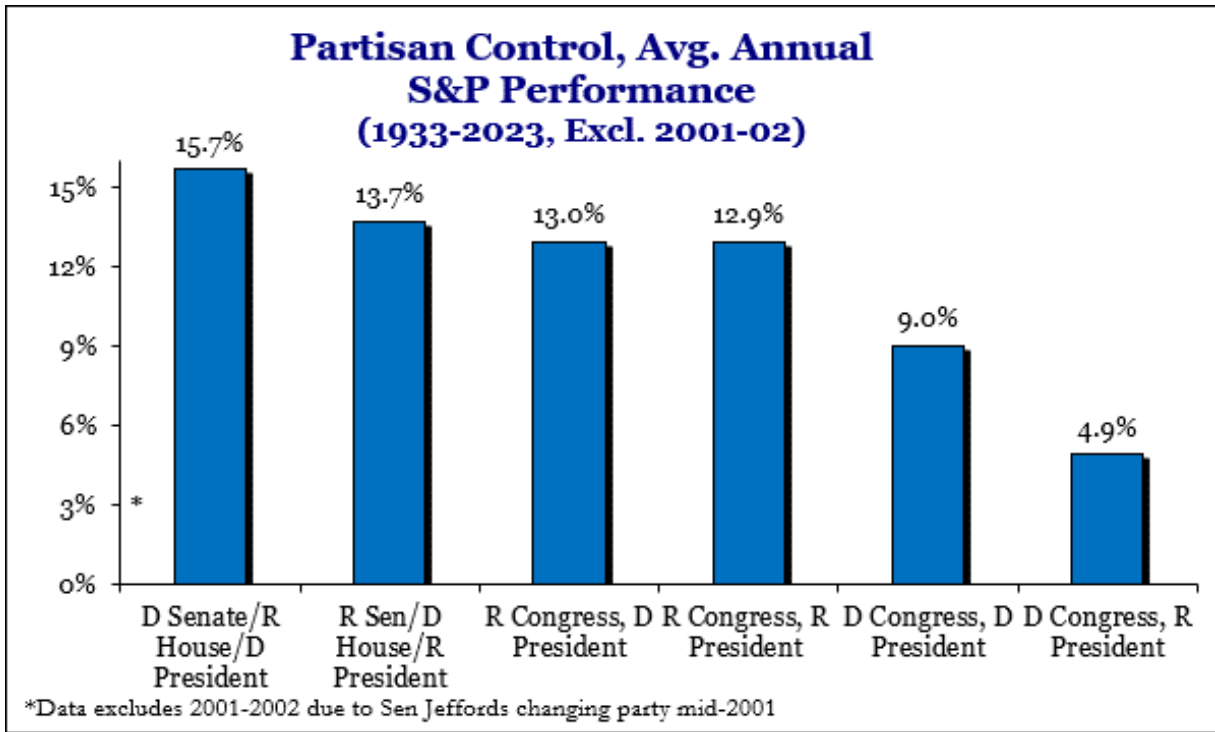
What Lies Ahead

Stocks begin the third quarter of 2024 riding a wave of optimism and positive news. Inflation is declining in earnest, the Fed may deliver the first rate cut in over four years this September, economic growth remains generally solid, and earnings growth from AI-linked tech companies has shown no signs of slowing down. This optimism is reflected in the fact that the S&P 500 has made more than 30 new highs so far in 2024 and is trading at valuation levels that, historically speaking, are not “cheap.” That said, if inflation continues to decline, economic growth stays solid, and the Fed delivers on a September cut, it is reasonable to expect this strong 2024 rally to continue. While the outlook for stocks is undoubtedly positive right now, market history has shown us that nothing is guaranteed. As such, we must be constantly aware of events that can change the market dynamic, as we do not want to get blindsided by sudden volatility. To that point, the market does face risks as we start the third quarter. Slowing economic growth, Fed disappointment, underwhelming Q2 corporate earnings results, a rebound in inflation and geopolitical surprises (including the looming U.S. elections, European elections, possible China/Taiwan conflict) are all potential negatives. Given current levels of investor optimism and market valuations, any of these events could cause a pullback in markets similar to what was experienced in April (or worse).

While any of those risks could result in a drop in stocks or bond prices, the risk of slowing economic growth is perhaps the most substantial threat to the markets. To that point, recent economic data is pointing to a clear loss of sustained momentum. As of now, the market has welcomed that moderation in growth because it has increased the chances of a September rate cut. However, if growth begins to slow more than expected and concerns about an economic contraction increase, that would be a new, material negative outcome. Because of that risk, we will be monitoring economic data very closely in coming months.

While politics do not price stocks in the long term, they can create short term angst and volatility. The Presidential debate that occurred on June 27th is just one more example of the potential chaos that could come to the U.S. elections this fall. Comments following the debate remain concerning and divisive for a whole host of reasons and could surely prove to be a catalyst for market volatility as we approach both the conventions and the election. Other than in the 1860's, the country has rarely been more divided, and recent events only serve to divide us more. Be assured that we do not manage money based on these headlines. However, we do remain vigilant by continually analyzing the potential impacts of either a Democratic or Republican sweep or any

combination. History suggests a divided Congress serves us best as a nation and as investors (see below chart). We remain patient during this time but will respond as needed as more clarity emerges.



Source: Strategas Research Partners

In closing the outlook for capital markets remains positive, but that should not be confused with a risk-free environment. There are real potential risks that are looming, and we will continue to monitor them closely in the coming quarter. We remain focused on both opportunities and threats to the markets. We thank you for your ongoing confidence and trust. Your SlateStone team will remain dedicated to helping you successfully navigate this market environment. Please do not hesitate to contact us with any questions, comments, or to schedule a portfolio review.

Sincerely,

SlateStone Wealth Investment Committee

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