2024 Mid-Year Stock Market Update

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The Fed, AI, and a Narrow Market

We are halfway through 2024. So far, results for equity markets have been mixed and the lead stories have been the Federal Reserve, artificial intelligence (AI) and "narrow" returns. Many large cap technology leaders have produced stellar returns while other areas of the market have languished a bit. The S&P 500® Index is up an impressive 15.3% while the Dow Jones Industrial Average® Index is well behind with a 4.8% gain and the small cap-oriented Russell 2000® Index is up only 1.7%. What's more, "growth stocks" have outperformed "value" stocks by an extraordinary margin of 14.1 percentage points. The Russell 1000 Growth® Index is up 20.7% while the Russell 1000 Value® Index is up 6.6%.

"FedWatch" is in full force. Investors continue to anxiously follow Federal Reserve commentary with hopes that more accommodative policy (i.e. lower interest rates) will support the economy and stocks. Expectations for rate cuts were too optimistic as we started the year and were quickly subdued by stubbornly high inflation data. More recently, however, tamer inflation data and evidence of decelerating economic growth have brought potential rate cuts back into play. Indeed, consumer spending across many areas seems to be slowing as excess savings from the pandemic era has largely been exhausted.

Then there's artificial intelligence (AI), which continues to captivate investors with the promise of significant innovation and value creation. The allure of AI has only been exacerbated by slowing growth elsewhere in the economy. Put differently, investors seem even more willing to pay a premium for growth as it is becoming scarcer, and have become more complacent about holding stocks with recent outsized gains. In fact, it sometimes feels as though we have two stock markets – the AI market and the "everything else" market. While leading AI plays continue to post astounding growth and attract investors' dollars, many other areas are struggling with post pandemic hangovers that could persist for a bit. Numerous industries (especially consumer facing businesses) that experienced spending booms have entered a period of normalization that entails slowing growth.

Consequently, market returns have dramatically narrowed. That is, gains have largely come from a handful of stocks. Within the S&P, the Information Technology sector has generated a whopping 28.2% return while the other sectors have averaged 8.9%. More cyclical areas like Consumer Discretionary and Materials are up 5.7% and 4.0%, respectively. Concurrent with more narrow returns, the S&P 500 has become increasingly concentrated. The top 10 names in the S&P are dominated by AI-related stories and now account for 37.0% of the index, which is the highest level of concentration since 1963 according to FactSet. The threesome of Nvidia (NVDA), Apple (AAPL) and Microsoft (MSFT) now account for 20.5% of the S&P 500 and have contributed 42.4% of the index's YTD gains. NVDA alone is up an astonishing 149.5% this year as it has become the official AI darling. Incredibly, NVDA's market capitalization surpassed $3 trillion in the quarter just a few months after reaching $2 trillion.

Investors' focus on relatively few things has sucked the life out of many other areas of the market, including value and small cap stocks. It has also created a conundrum for money managers benchmarked to the S&P 500. Striving solely to keep up with this particular benchmark would have necessitated holding a full helping of the aforementioned tech behemoths, while surpassing the S&P would have required seconds! We certainly understand the appeal of these stocks and own many of the AI leaders where appropriate (primarily in our Core Leaders strategy), but feel holding such massive weightings would entail taking on too much risk regardless of the promise of this new technology. This is especially true following the meteoric runs that many of these leaders have experienced. At the risk of sounding like we are whining or making excuses, we argue that diversification and risk management still matter.

From here, it seems to make sense for the market to become less bifurcated. We would not be surprised to see some of the biggest winners cool off a bit. Along those lines, we think gains could broaden to other areas of the market that have been more neglected. It's difficult to time when this will happen, and our thesis assumes Fed policy will start to ease and support the economy. However, we are willing to be patient and don't feel pressured to pander to recent market trends. Please refer to our strategy letters for specific ideas and we look forward to reporting back to you in three months.

Sincerely,

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