Following a brief downturn in early April, the economy and markets have remained on solid footing in the second quarter, with the benchmark S&P 500 index gaining 4% while volatility within equity markets has been low and falling. The Chicago Board of Options Exchange Volatility Index (VIX), a measure of volatility within equity markets and widely used as a barometer for market sentiment, has recently hit multi-year lows, while the S&P 500 has gone more than 40 trading days without a decline of 0.75% or more. To contextualize that statistic, during the 2022 bear market, the S&P 500 had 77 daily drops of 0.75% or more. A rising VIX is generally associated with increased fear and declining stock prices, and we are currently experiencing the opposite. The recent low volatility market gains have been driven by a narrowing path for Federal Reserve action, resilient corporate earnings, and excitement around various "mega trend" themes such as artificial intelligence and industrial reshoring.

As we entered 2024, the economy seemed to have a much more uncertain path. Wall Street was debating the probabilities of a hard landing, soft landing, or no landing scenario, with each having plausible arguments. As the year has progressed, the soft-landing camp has been winning out, as growth has remained positive but trending lower, and inflation, after an early year pickup, has started to fall again. This dynamic of a strong but slowing economy has also removed the need for either aggressive interest rate cuts, or additional interest rate hikes from the Federal Reserve. The market is now pricing in somewhere between 1 and 2 cuts in 2024, with the first likely in September. The narrowing of economic outcomes over the near term likely explains much of the fall in volatility this year, as the market has come to accept the soft-landing outcome.

The "narrowing" of economic outcomes has been the result of an economy that has stayed solid, but not too strong, with weakness beginning to appear in many spots. The recent May Nonfarm payrolls report showed unemployment rising to 4%, the highest reading since January 2022. While the absolute rate of unemployment is not concerning, it has been rising recently, with the fear that it will begin to rise more rapidly. The "Sahm Rule", a metric that the Federal Reserve follows carefully, is triggered when the 3 month average of the national unemployment rate increases by at least 0.5% from its lowest point in the previous 12 months, and warns of a coming recession. On its current trajectory, the Sahm Rule is likely to be triggered in the coming months. In addition, there has been no pickup in hiring recently despite the stock market rally, which tends to provide confidence to corporate executives to continue to pursue expansion instead of retrenchment. Echoing these worries, San Francisco Fed President Mary Daly recently cautioned that the job market is nearing an "inflection point". While the labor market has slowly started to show some cracks, the most recent inflation reports show that inflation has cooled to its lowest rate in 3 years, with both the Consumer Price Index and the Core Personal Consumption Expenditures Index, the Federal Reserve's preferred measure, coming in lower than expected for May. On the housing front, pending US existing-home sales fell to the lowest level since at least 2001 in May, as high mortgage rates and low inventory have driven increasing unaffordability in housing markets. In addition to the aforementioned unemployment, inflation, and housing data, recent figures on consumer confidence, manufacturing sentiment, personal consumption, and other areas of the

economy are all suggesting weakening growth. All of this recent weakness may justify rate cuts from the Federal Reserve in the second half of the year.

Looking ahead, the trend in the market remains positive, however, it is concerning that the heavy lifting is being done almost entirely by growth stocks, while value stocks have been sitting on the sidelines this quarter. The cyclicals that had enjoyed a strong start to the year including financials, materials, industrials, and small caps have shown recent weakness that may be explained by the recent slowdown in economic growth that we described above. Despite this cyclical sector weakness, defensives such as utilities and healthcare have not started to outperform either, suggesting the market is not overly concerned about a serious economic decline. This has led to a "divergence", in which the broad indices continue to rise but the number of stocks going up has started to fall. For example, on June 14th, the % of S&P 500 stocks outperforming the index over a rolling 21-day period fell to 18% while closing at an all-time high, the second lowest reading in history and lowest since 1955. Leadership has once again narrowed to a small number of large cap winners, mostly within technology. While these businesses are truly remarkable combinations of strong growth prospects, high profitability, and pristine balance sheets, their valuations have also become more stretched. Microsoft and Apple, for example, now trade at their highest price-to-sales ratios in over 2 decades, and the aggregate technology sector is now trading at its lowest free cash flow yield, a common valuation metric, in over 20 years as well. The extreme divergence can resolve one of two ways, either with the recent winners faltering or the rest of the market starting to catch up. We expect that for the rest of the market to catch up over the coming quarters, it will need to be driven in part by weakening data leading to Fed cuts and a decline in interest rates. This scenario would need to be somewhat analogous to the last successful soft landing which occurred in 1995. Back then, the Fed was able to cut rates by 0.75% after seeing slowing inflation, resulting in an economy that avoided recession and provided the backdrop for a continuing bull market. However, if breadth cannot improve over the coming months, it may portend trouble in the fall and looking forward to 2025.

Of course, we would be remiss not to mention the coming November election, which the market has started to once again focus on following the first Presidential debate. While we expect the broader market to continue its trend through the election cycle, volatility may increase as positioning changes as markets assess potential candidate changes and election outcomes. More to come on this topic as we transition into the fall.

Please do not hesitate to reach out to any of us in the office if you would like to discuss investment strategy or your own financial circumstances. We hope that you enjoy a happy and healthy summer.