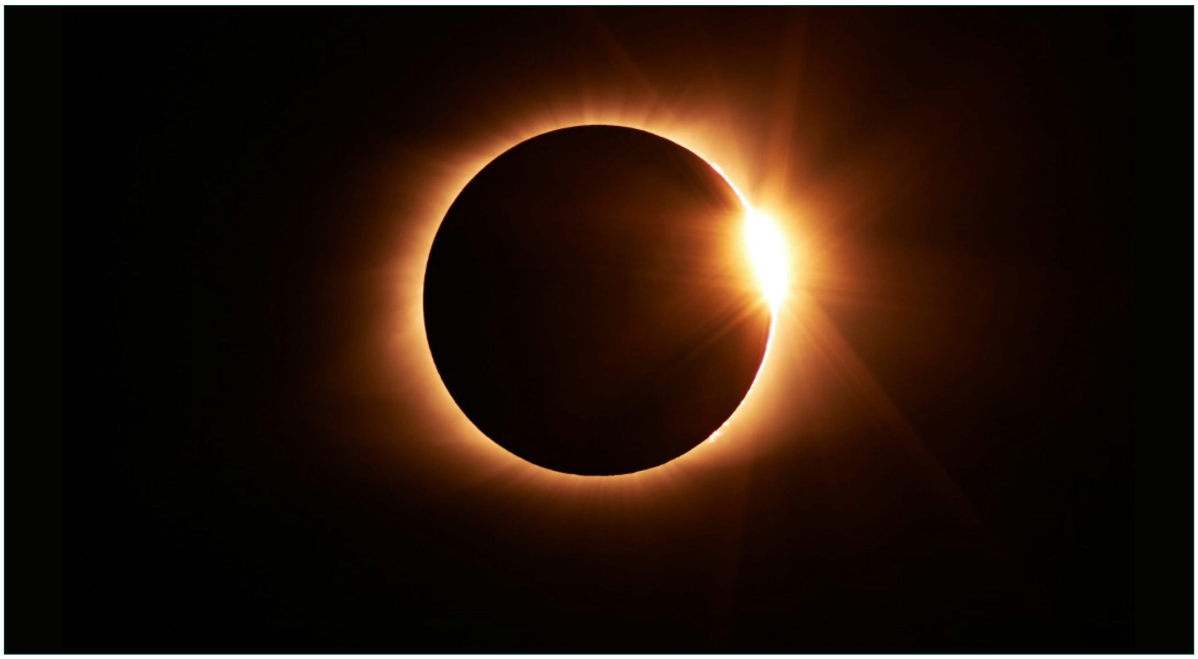
INVESTMENT OUTLOOK

A PEAPACK PRIVATE PUBLICATION

SECOND QUARTER 2024:
TOTAL ECLIPSE OF THE SUN, BLINDED BY THE LIGHT

The sun shall be turned into darkness, and the moon into blood,
before the great and terrible day of the Lord comes.
-Joel 2:31

The second quarter featured a number of newsworthy events, but perhaps the biggest media and cultural phenomenon was the solar eclipse in April that passed through a substantial swath of the US. Labeled 'the Great North American Eclipse,' it is estimated that 50 million people experienced this astronomical event directly, with many times that number viewing the eclipse on television, social media, and streaming platforms.



Total eclipses are rare phenomena. While they occur somewhere on earth every 18 months on average, they recur at any given place only once every 360 to 410 years. The next total solar eclipse that will be visible in the contiguous US will occur in 2044. In ancient cultures, solar eclipses were imbued with great significance, and were often viewed as fearful signs.

A solar eclipse occurs when the moon passes between the earth and the sun and, in doing so, obscures the sun. Because the moon is so much closer to the earth than to the sun, it can fully block all direct sunlight. Viewers in the path of a total eclipse experience darkened skies during the daytime. However, gazing at the sun during an eclipse without specialized eye protection is unsafe; it can cause permanent eye damage and even blindness. NASA warns, "It is never safe to look directly at the eclipse without proper eye protection." Casting our eyes down from the sky to earth, we see investors' eyesight at risk from the blinding light of the technological phenomenon of artificial intelligence (AI). While many people are uncertain what the use cases will be for AI, investors seem highly certain that it will be endlessly lucrative—brilliantly so, in fact—for a handful of companies.

Have investors failed to heed NASA's warning? Are they staring at the eclipse, damaging their vision?

AI: MORE HEAT THAN LIGHT?

Turn your face to the sun, and the shadows fall behind you.
-Unknown

The momentum driving investor enthusiasm for stocks imbued with an AI halo continued unabated in the second quarter, with megacap US technology stocks ascendant, the bright sun on which investors' gaze was fixed.

Asset Class	Index	2nd Quarter Returns	Year to Date Returns
US Large Cap Stocks	S&P 500 Total Return	4.3%	15.3%
US Large Cap Stocks	S&P 500 Equal Weighted	-3.1%	4.1%
US Small-Mid Cap Stocks	Russell 2500	-4.3%	2.4%
International Developed Markets Stocks	MSCI EAFE	-0.4%	5.3%
Emerging Markets Stocks	MSCI EM	5.0%	7.5%
Real Estate Securities	MSCI US REIT	0.1%	-0.2%
Commodities	Bloomberg Commodities Futures	2.9%	5.1%
Bonds	Bloomberg Barclays US Aggregate	0.1%	-0.7%
Cash	FTSE USBIG 1-Month Treasury Bill	1.4%	2.7%

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

US large cap stocks powered ahead again this quarter, driven by the Magnificent 7 AI powerhouses. However, the rally was narrow, as smaller US companies did not participate and fell back in the quarter. Also left behind in the shadows of US technology darlings were international developed markets, laggards with far fewer AI-themed stocks to push them higher. It was a good quarter for emerging markets, which perhaps benefited from low expectations. Fixed income markets eked out a slightly positive return, in the face of better inflation data and stable monetary policy. Yields on cash were healthy, as short-term interest rates held steady. What is clear is that the moon dimmed a number of asset classes even as the sun dazzled a few.

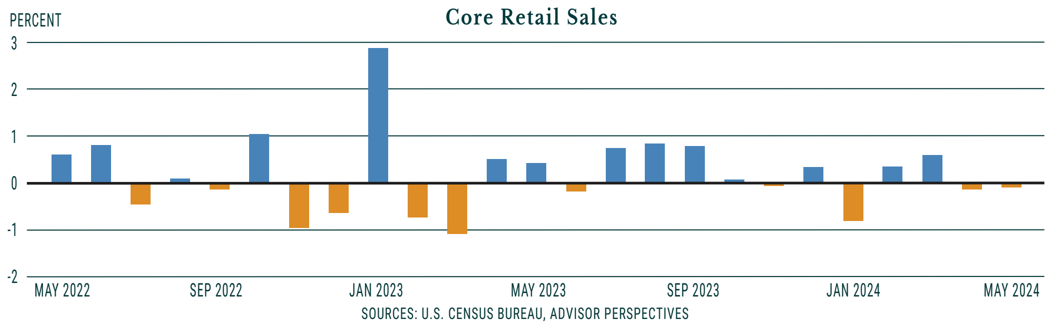
THE MIDYEAR ECONOMY: BRIGHT LIGHT, OR THE HARSH LIGHT OF DAY?

Light breaks where no sun shines
-Dylan Thomas

The best fuel for markets to rocket higher is a robust economy which, in turn, lifts earnings up. Arguably, we are in a Goldilocks moment in the economy. After a pause, inflation has resumed progressing toward the Fed's 2% target. The labor market is no longer over-heated and while the unemployment rate has risen, it is at an historically low level.

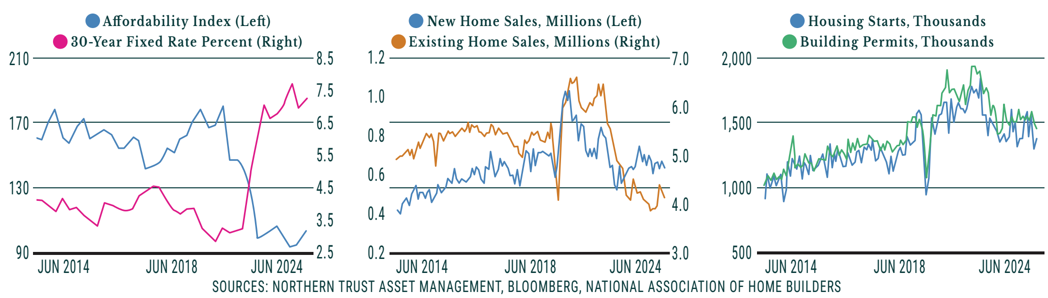
The economy picked up in the second quarter, following an underwhelming 1.4% advance for US GDP in the first quarter. The Atlanta Fed's GDPNow estimates that the economy grew at a trend-like 2.2% annual rate. That said, that's a deceleration from readings hovering around 4% earlier in the quarter, and a number of datapoints suggests that cumulative, if lagged, effects of higher interest rates are reducing inflation by slowing down economic growth.

Among the indicators that are flashing yellow: a slowdown in consumer spending, a moribund housing market, cracks in the labor market, and weakness in commercial real estate.



As the chart above indicates, in three of the past five months core retail sales have back-tracked. While this is a volatile data series, a trend of a weakening consumer appears to be taking shape.

The housing market is plagued by limited inventory, high mortgage rates, and elevated prices. The National Association of Home Builders estimates that 77% of US households are unable to afford a median-priced home. As a result, sales of both existing and new homes have fallen precipitously as can be seen in the middle chart, below. And despite a shortage of housing supply, housing starts and building permits have fallen below pre-pandemic levels.

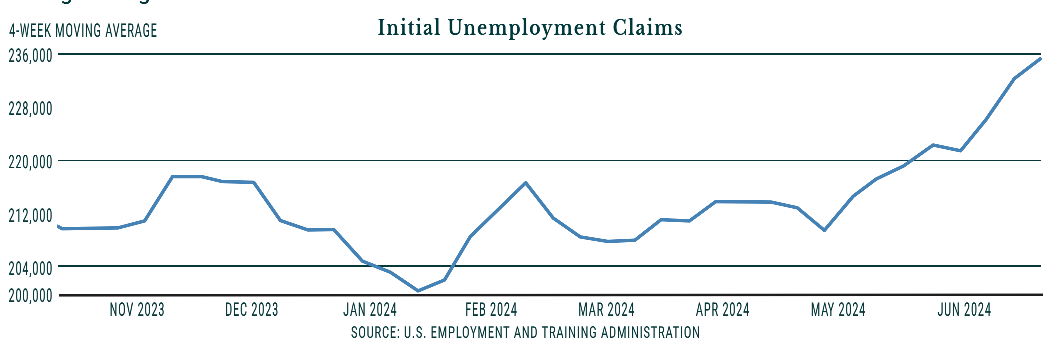


Housing turnover generates substantial follow-on economic activity for appliance makers, furniture and home improvement retailers, construction trades, and so on. Interest rates do not appear to be poised to fall sufficiently to reinvigorate the housing market and therefore generate related economic activity.

Additionally, the affordability issue has sustained demand for rental housing, keeping rents elevated.

There is mounting evidence that the labor market is beginning to show some signs of stress. Unfilled positions, according to the Census Bureau's Job Openings and Labor Turnover Survey, are down by one-third from their peak two years ago. Unemployment has risen from a cyclical low of 3.4% to 4.0%. Challenger, Gray & Christmas reports that corporate layoff announcements year to date in 2024 are the third-highest in the last fifteen years.

New initial unemployment claims have also begun to rise, as is apparent in the chart below reflecting the four-week moving average for such claims.



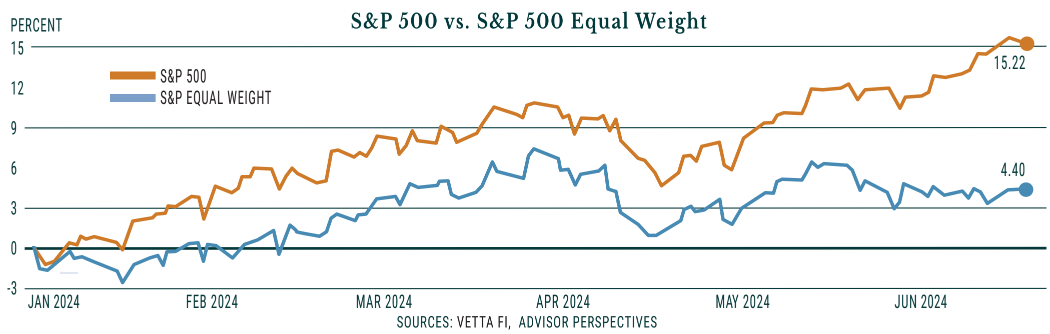
Consumption accounts for approximately 70% of US GDP activity, and consumer spending in turn depends on a fully employed and well-paid labor force. Thus, indicators of a weakening labor market and more muted wage gains are concerning. It is also worth noting that labor market data tend to be coincident or lagging indicators—which is to say, by the time problems are apparent in the labor market, a dimming economic growth environment is usually fairly well-established.

SUNSHINE, LOLLIPOPS, AND RAINBOWS

…and the expensive delicate ship that must have seen
Something amazing, a boy falling out of the sky,
Had somewhere to go and sailed calmly on
-W. H. Auden

Financial markets do not see such caution signs. It is high noon on a bright and sunny summer's day. Nothing can dim the sun's rays. Equity indices have notched 31 new all-time highs so far this year, boosted by surging semiconductor and tech megacap stocks. The anticipated power demands of an AI-dominated economy also gave a lift to utility stocks.

Beneath the surface, however, the picture is murkier. While the capitalization weighted S&P 500, dominated by megacap technology companies, has risen 15.2% this year, a different measure of the index—one that gives equal weight to all 500 stocks—is up only 4.4%, as can be seen in the chart below. This is an unprecedented divergence.



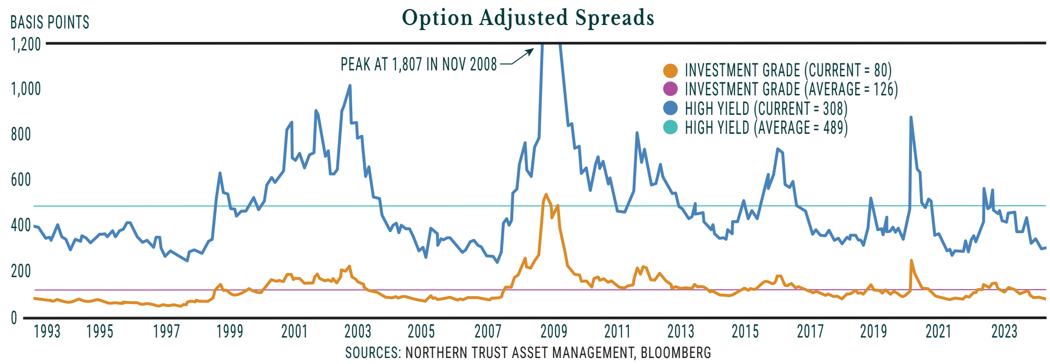
In the second quarter, the capitalization-weighted S&P 500 rose by 4.3% while the equal weighted S&P 500 actually fell 3.1%. Midcap and small cap stocks fell even more in the second quarter.

How do we understand this divergence?

To be fair, the market's advance was not just a story about investors' willingness to pay a higher multiple of earnings to purchase shares of perceived AI winners. Underlying earnings rose 5.8% in the first quarter, and net profit margins (already at lofty levels) inched up versus year-ago levels to 11.8%. Sales and earnings growth for some technology and AI-themed companies were up substantially more than that.

Still, the question needs to be asked: could it be that investors, brimming with over-confidence, are—Icarus-like—in danger of flying too close to the sun? Or, sticking with our opening metaphor, might investors no longer be seeing too well, staring into the AI-bright sun?

In the bond market, investors exhibit a similar what-me-worry attitude. After topping 5% a few weeks ago, the 2-year US Treasury yield has dropped back to 4.7% as market participants embrace a backdrop of slowly cooling inflation and an easing of the Fed's restrictive monetary policy. Buyers of corporate bonds exhibit nonchalance as they demand historically little premium for taking on company credit risk.



The chart above shows the incremental yield ('spread') investors demand on corporate bonds versus the safety of Treasury bonds. Those spreads are now one-third (or more) less than historical averages, indicating little concern about a possible recession and borrower default.

PROTECTING EYES AND PORTFOLIOS

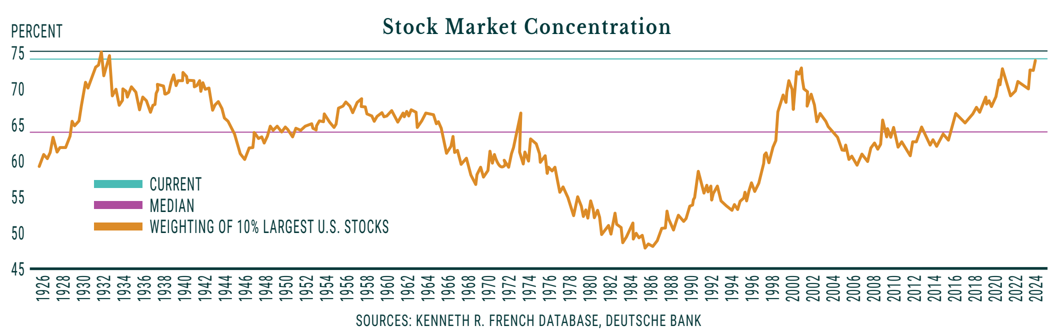
I try hard to keep detached
But I get carried away
Try to act less booby-hatched
But I get carried away
Carried away, carried away
I get carried away!
-Betty Comden and Adolph Green

My life is sunshine, lollipops, and rainbows
That's how this refrain goes
So come on, join in everybody!
-Howard Liebling

As investment advisors and portfolio managers, we are not focused only on earning satisfactory returns on capital that has been entrusted to us. We are also risk managers, mindful of averting potholes when we can spot them.

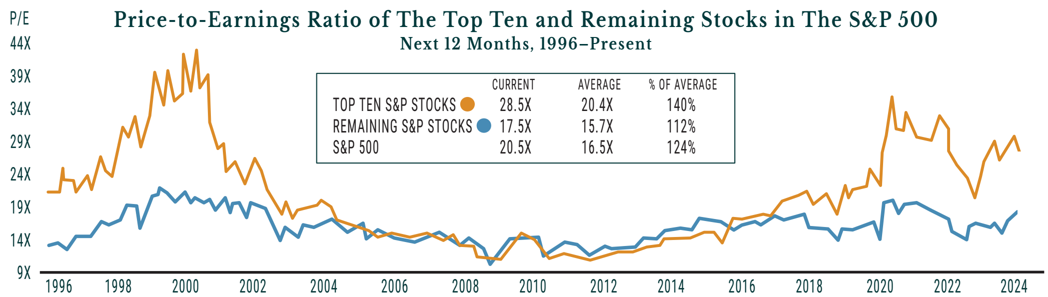
It's a challenging assignment, but there are moments in time when some risks appear abundantly clear.

The current market concentration is such a moment. The S&P 500's three largest stocks (Microsoft, Apple, and Nvidia) constitute more than 20% of the index. The ten largest stocks constitute more than 36% of the index. And, as the chart below shows, the top 50 stocks constitute 75% of the index.

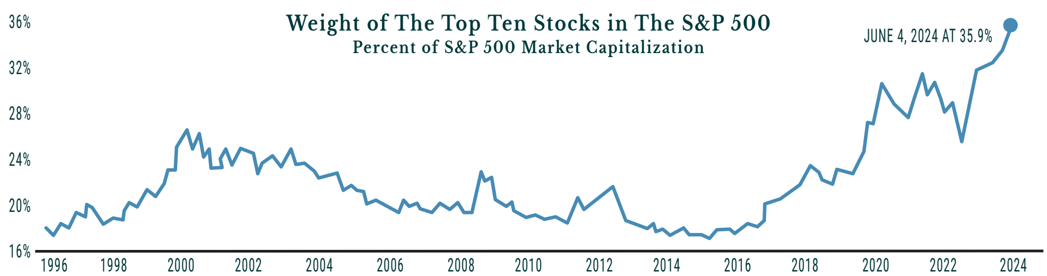


The market today is more concentrated than it was in the Internet boom of the late 1990s. The only time in market history that it has reached the current degree of concentration was at the end of the Roaring Twenties. And we know how that ended.

When markets are highly concentrated, they rise or fall on the outcomes for a small number of companies. Those risks are magnified when valuations are high and, relatedly, when expectations are high.



SOURCES: FACTSET, STANDARD & POOR'S, J. P. MORGAN ASSET MANAGEMENT



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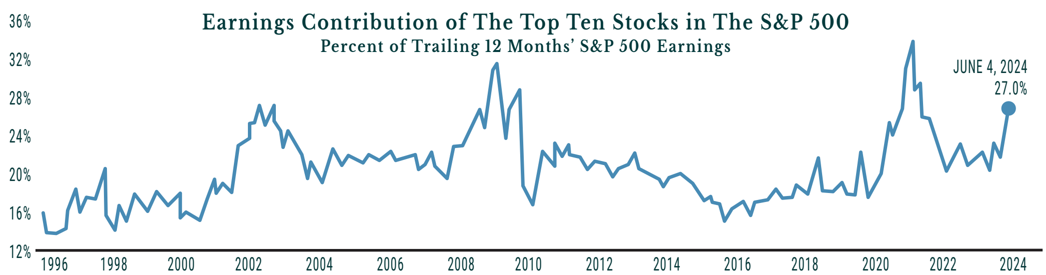


SOURCES: FACTSET, STANDARD & POOR'S, J. P. MORGAN ASSET MANAGEMENT

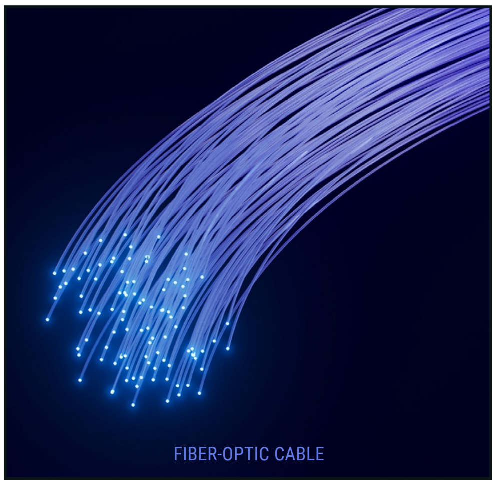
On the valuations front, the S&P 500 trades for 21 times forward expected returns, versus a 30-year average multiple of 16.6 times. Even more concerning, the top ten stocks are 63% more expensive than the S&P 490, from a price/earnings ratio perspective.

On the expectations front, investors are expecting earnings growth of 11.3% in 2024 and an additional 14.4% in 2025. The information technology sector is expected to grow earnings 18.8% this year and an additional 19.5% next year. These are indeed lofty expectations—and stock prices suffer mightily for those companies that fail to meet them.

In addition to capitalization weighted concentration, returns have been concentrated, too. Chip maker Nvidia alone, with its high index weight and remarkable return, contributed more than 33% of the entire S&P 500's appreciation thus far this year. The stock was up 36% in the second quarter and up 149% year to date. How often does one company account for such a large portion of the index's return? Almost never.

Some investors justify the astonishing run-up and stratospheric valuations of AI stocks like Nvidia, Supermicro (up 188% this year to date alone) and others by insisting that artificial intelligence, particularly generative AI, is totally revolutionary and paradigm-shifting. Such arguments are not new.

During the Internet 1.0 era, similar claims—that the Internet was revolutionary and would change the world—proved to be true. However, that didn't help Cisco, and Intel, and Corning, the big winners of the late 1990s whose fortunes—and stock prices—have floundered ever since. Everything did get networked, PCs became ubiquitous, and millions of miles of fiber-optic cable were laid. But networking technologies evolved, the domination of PCs was supplanted by mobile devices, and miles and miles of fiber-optic cable remained unlit for many years.



So pardon us if we are concerned when we hear insistent voices declare that this time is different. US large cap growth stocks may continue their advance, but they're performing a dangerous high-wire act without a safety net. With valuations already stretched, yet higher multiples are unlikely, so further appreciation depends on rapid earnings growth. Valuations and earnings expectations make such stocks highly vulnerable to sharp corrections should they disappointment. And the day will come when simply declaring an AI partnership will not propel a stock up double digits.

In this environment, smaller cap and international stocks present more attractive valuations and, therefore, a better-balanced risk-reward ratio. Some US large cap stocks outside the technology sector that will be beneficiaries of artificial intelligence are also attractive. In the bond market, prospects for a more slowly growing economy, which will push the FOMC to begin to bring down interest rates, provide good support to extend duration in bond portfolios. Maintaining a focus on high quality companies in both equity and bond markets is appropriate in the face of decelerating growth.

In other words, we are focused on protecting our eyes. It is tempting to stare at the eclipse, to forget about or abandon our protective eyewear. To be carried away by the glowing narrative of AI as completely game-changing and worth paying up for, at any price. But trees do not grow to the sky, and explosive growth will slow. It's not all sunshine and lollipops. Even as, awestruck, we behold the enormous potential of AI, this is a moment to don protective gear and avert our eyes from the blinding light. Safety first.

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