

Q2 - 2024

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## Capital Market Outlook

The stock market, as defined by the S&P 500, rose 4.3% in Q2 driven by similar factors to Q1, moderating inflation driving hopes of interest rate cuts, and no end to the fervor over stocks levered to growth in artificial intelligence. However, in our view, the underlying economy and labor market continue to weaken, posing a risk to stocks in the second half of the year, especially if the Fed continues to waver on rate cuts. We also see risk in how concentrated returns are in the market and believe investors are too focused on semiconductors as the sole beneficiaries of artificial intelligence. That said, we do see areas of opportunity in sectors left behind by the current rally and continue to like equities for the long-term.

Inflation continues to moderate, largely as expected, but remains above the Fed's long-term goal of 2%. May Core PCE, the Fed's preferred inflation gauge, was in-line with estimates at 2.6% when announced on June 28, decelerating from 2.8% in April. June Core CPI, released in early July, rose 3.3% year/year, better than the 3.4% expectation and down slightly from May. Two areas are keeping the inflation data higher; auto insurance, which has increased significantly over the past few years and is likely sticky, and rent, which should trend lower as the economy moderates over the coming months and as apartment supply grows. The key outstanding question is whether the Fed will be willing to get ahead of a weakening economy, if it's not already too late, and cut rates with inflation still above its 2% target.

Messaging from the Fed stayed relatively consistent in Q2, highlighting progress on inflation and the likelihood that an interest rate cut could be appropriate, although not guaranteed, at some point in 2024. This has supported equity valuations throughout the year, however, there has also been a cautious tone about moving too quickly with inflation still running above target, despite a clear weakening in the labor market recently. The Fed kept rates unchanged at the June FOMC meeting, as expected. Notably, the Fed also revised its inflation forecast for 2024 upward, and lowered its forecast for rate cuts this year from three to one. Swap markets are now pricing in a slim 9% chance of a cut in July, but a 91% chance of a rate cut in September.

Taking a broader view of the economy paints a picture that appears inconsistent with a stock market hitting all-time highs. May retail sales missed estimates, and companies were far more cautious on the health of the consumer in Q2 relative to earlier in the year. The most recent ISM Services reading in early July contracted at the fastest rate in four years and the ISM Manufacturing index has been contracting since October 2022, apart from one positive reading in March 2024. June non-farm payrolls came in ahead of estimates (206k vs. 190k estimate) but both April and May were revised lower by a combined 111k jobs. Full-time employment fell in June, as many of the jobs that have been added in recent months are part-time, which is not indicative of a booming economy. In addition, 2023 continues to be quietly revised lower as actual numbers from employers are reported with a nine-month lag. Layoffs at large employers have also been accelerating and the unemployment rate ticked up to 4.1%. This is very close to triggering the Sahm Rule, which is an indicator of a recession start that looks at the increase in unemployment relative to its low during the prior year. It is important to note

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that the Sahn rule has a perfect track record but has generally been around three months late confirming recessions.

The top 10 companies in the S&P; Nvidia, Microsoft, Apple, Amazon, Alphabet A/C, Meta, Berkshire Hathaway, Eli Lilly, and Broadcom accounted for close to 75% of the gains this year. There was some hope at the end of Q1 that breadth was improving, i.e. more stocks participating in the rally, but breadth actually worsened in Q2 as the top 10 returned more than 5%, meaning the other 493 companies produced negative returns in aggregate. In addition, these 10 largest companies accounted for almost 37% of the index's market cap at the end of Q2, the highest level of concentration since 1972. The extreme momentum in a small set of companies has created a narrow and expensive overall market heading into the second half of 2024.

Much of the S&P 500's gain so far this year, as well as last year, was driven by one company, Nvidia. There are many reasons to be impressed with Nvidia's growth, but we question how long the market can be supported by just one company. Nvidia is enjoying the first mover advantage in artificial intelligence semiconductors, much like Cisco was in the 1990s. However, competition is coming as some of Nvidia's largest customers are working on their own chips as replacements. Given the lack of recurring revenue and the boom/bust nature of Nvidia's business model, we have avoided owning the name. While it has been a drag on performance this year, we continue to believe there is significant downside risk as semiconductor demand wanes and/or competition heats up.

Semiconductor companies, such as Nvidia, and cloud computing providers, Microsoft, Google, and Amazon, have been the clear early beneficiaries of the AI boom. However, most companies are still trying to figure out how to monetize AI. In every big investment cycle the infrastructure needs to come first, think cell towers before cell phones, but ultimately an application that people will pay for needs to be developed and that usually comes from the software companies who capitalize on the infrastructure. We believe those companies will generate long-term returns from AI, which is why AMI focuses on recurring revenue software models.

Looking forward, we believe equities remain the best place to invest for long-term capital appreciation. However, we recognize that nuanced challenges lie ahead. The economic picture has worsened over the past few months as high rates begin to impact the economy and equity valuations are stretched. However, certain areas of the market are appealing, specifically Healthcare, Consumer Staples, and certain areas within Software that have been left behind by the frenzy for AI hardware stocks. While these areas have been out of favor with investors, these businesses can quickly become very exciting in a challenging economy, especially given the durability of demand for these companies' products. At AMI, we continue to invest for the long-term, actively managing risks and staying disciplined, with a focus on companies that can perform well regardless of the macroeconomic picture.

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