Alex Thompson

Lance Hollingsworth

John Laughlin

Sarah Haizlip

Leslie Drummond

"Swim at Your Own Risk"

Dear Clients and Friends: July 15, 2024

It's summer once again. The Memphis heat and humidity will quickly remind you of that. The remedy for the higher temperatures is often the annual family pilgrimage to the beach. While we bask in the same hot and sticky conditions, somehow gazing out over the calm ocean waters makes it feel so much more pleasant.

Recently, however, several reported shark encounters just off the tranquil shoreline have reminded us that the calmness on the surface sometimes can mask the turbulence below. From an investing perspective, in the first half of 2024, we continue to witness similar behavior. On the surface, the S&P 500 continues to drive to new all-time highs and the economy keeps chugging along. Below the surface, it is a bit more chaotic.

Stocks and Bonds

The S&P 500 has been setting one record close after another in 2024, but not every stock has been participating. Over the last few years, big tech stocks have been the driving force behind the stock market's increasing value. That trend accelerated recently as innovations among the biggest companies using artificial intelligence (AI) have pushed their stock prices even higher.

As we have explored in recent quarterly letters, the S&P 500 is a "cap weighted index" meaning that the bigger the company, the more influence it has on index performance. The top 10 companies in the United States by market capitalization now represent 37% of that index. Microsoft, Apple and Nvidia are each worth over $3 trillion and Google and Amazon both over $2 trillion. For some local perspective, with FedEx's value at $70 billion and Autozone's at $50 billion, Microsoft is 45 times and 65 times larger than two of the biggest companies in our backyard. The recent increases in the size and concentration of these companies are unprecedented.

Their influence on the performance of the index is also unprecedented. Collectively, these 10 stocks, including the AI theme, were up +14.4% for the quarter and almost +30% for the year. They are responsible for over 60% of the S&P 500's total return, which is up +4% for the quarter and almost +15% for the year. In contrast, the "equal weighted" version of the index was down -2.6% for the quarter and is up only +5% year-to-date. The pattern of divergence also shows up in sector performance where 6 of 11 sectors had negative performance for the quarter. Additionally, 80% of all stocks in the index, a record high percentage, are underperforming the index.

Smaller companies struggled during the quarter as well, finishing -3.5% and bringing year-to-date returns back down to only +1%. International stock markets generated positive, albeit more modest, returns being up +1% for the quarter and up +6% for the year. The differential in performance of these large cap tech stocks and pretty much everything else shows how the domination of a narrow subset of companies has impacted the performance of the whole and how the outlook on the surface is misrepresenting the market below.

Summit Asset Management LLC ~ 5100 Wheelis, Suite 107, Memphis, Tennessee 38117
Phone 901.729-8100 ~ Fax 901.729-8101 ~ www.summitassetmanagement.com

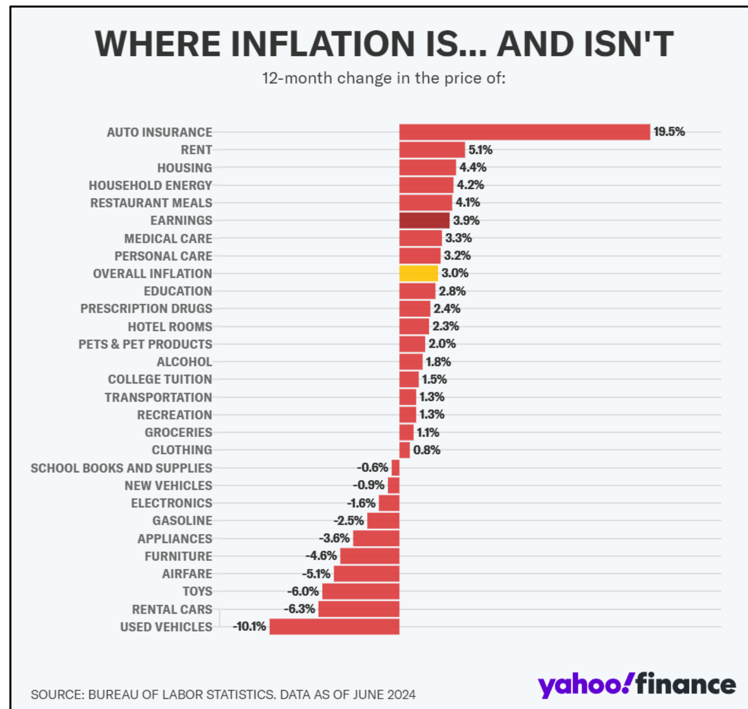
The bond market continues to have its own chaotic movements as it grapples with seemingly every inflation statistic and what it might imply for the Fed's next move. For the quarter, the Bloomberg Aggregate Bond Index was virtually flat. However, intra-quarter volatility tells a different story. Monthly returns of -2.5%, +1.7%, and +0.9% respectively were indicative of the choppiness seen in the market. Even after starting the year with the higher interest payments, bonds remain down about -1%.

The Economy

The overwhelming consensus today is that the U.S. economy remains on firm ground with a soft landing increasingly in sight. For over two years, the Federal Reserve pushed rates higher, seeking to bring down inflation by slowing down growth, but avoiding recession. Inflation has continued to fall, unemployment remains low, and GDP growth is hovering around a solid 2.5%. With the help and support of strong consumer and governmental incentivized corporate capital spending, the economy has been surprising resilient.

Like the stock market, on the surface, all is well. Under the surface, things are a bit choppier. Recently, signs of consumer fatigue have emerged. Spending appears to have slowed in the second quarter to an annualized 1.3%, down from 2.0% in the first quarter and 3.3% in last year's fourth quarter. Two concerning areas are vehicle sales and housing starts. Both are stagnating. Soaring prices in recent years followed by surges in interest rates and insurance costs have reduced the pool of potential buyers. Meanwhile, for the one-third of U.S. households that rent their accommodations, rents continue to absorb a greater share of disposable income. Because of this, it isn't surprising to see some softening in consumer spending on the basics.

While inflation has cooled overall, some areas, like auto insurance, are proving to be exceptionally sticky. There is also evidence consumers are finally starting to push back against higher prices and corporate America is taking notice. Value meals at McDonald's are back!



The unemployment rate has also started to tick up. Despite slightly higher-than-expected payroll job gains, the June employment report was on the soft side. We also saw downward revisions in job gains in prior months. After hitting a 54-year low of 3.4% last April, the unemployment rate now stands at 4.1%. While trending in the wrong direction, today's rate is significantly below the 50-year average of 6.2%. Many employers may have over hired during the post-pandemic labor shortages and are now starting to rightsize their workforces.

Outlook

As investment advisors, who practice asset allocation and diversification in client portfolios, we prefer markets not be this narrow where only a few stocks or sectors provide the bulk of the available returns. The intensifying concentration of investor flows into large cap tech stocks that are heavily weighted in one of the most influential indexes can make it difficult for clients and us to focus on the longer-term benefits of a more disciplined investment strategy. Of course, our portfolios do have exposure to the AI theme, just in weights that we believe are appropriate for each client. However, we own other areas of the market as well. In times like now, these other investments can dilute performance.

In hindsight, the large outperformance of this handful of stocks can be rationalized. According to Goldman Sachs, companies both in tech and elsewhere in the economy are set to spend more than $1 trillion on AI in the next several years seeking to automate work, improve productivity, and reallocate labor into other tasks that will create new opportunities. This enormous spend is being reflected in earnings and revenue growth for the companies involved at a time where other companies are struggling to show growth.

We believe that in the next couple of quarters, we could start to see a reversal of fortunes. As growth for the AI sector becomes more difficult in year-over-year comparisons, those same comparisons should really start to ease for other sectors of the economy. The upcoming second quarter earnings period should mark the end of what's been a stealth earnings recession for the 493 non-Magnificent Seven stocks. Earnings growth is forecast to clock in at 6%, 7%, and 13% annually over the next three quarters.

We also believe that the consumer will remain relatively robust. There has been strong growth in real wages leading to solid gains in real disposable income since the start of last year. With the rise in the stock market, U.S. household wealth has increased by a huge $18.6 trillion over the last 18 months. Lastly, existing fixed-rate mortgages continue to insulate most consumers from the impact of higher borrowing costs while benefiting from the higher interest income.

Finally, it appears that the Fed may really be getting the soft landing it has been seeking. With inflation down and the competition for labor easing, they are free to start lowering rates at the first sign of economic need. Or even before. The first rate cut could come as early as September with a cut in December seen as almost a given.

For investors, this is a generally positive outlook. Milder but continued economic growth should allow for a continued gentle decline in inflation and, particularly when the Fed finally begins to ease, some fall in long-term interest rates. Hopefully, the currents under the surface will ease as well.

Thank you again for your continued confidence and trust as we work through these extraordinary times. We welcome your comments, questions, and referrals. Please don't hesitate to contact us. Stay safe and well.

Summit Asset Management LLC