LUTHER KING CAPITAL MANAGEMENT

SECOND QUARTER 2024 REVIEW

The U.S. economy's pace of growth is slowing. The first quarter's annualized real Gross Domestic Product (GDP) annualized growth of 1.4% was tempered by decreased federal government spending, lower production of inventory investment, and rising imports. The economy is cooling from a blistering 4.9% growth in the third quarter of 2023, followed by 3.4% in the fourth quarter of last year. Although we anticipate a slight rebound in second-quarter GDP, tepid growth will likely result over the balance of the year. There has been a sharp deterioration in economic data relative to expectations in recent months. Job creation has become mixed, decelerating in April and surging in May. Other labor market data – including job openings, the quits rate, and business sentiment surveys – have shown weakness. The open question is whether the current balancing of labor supply and demand is simply a reasonable normalization or the harbinger of more turbulent times ahead.

Strong corporate earnings helped propel equity market indices higher through the first half of 2024, but returns remain quite uneven beneath the surface. Despite a small handful of mega-cap stocks lifting the technology-heavy Nasdaq Composite Index to a gain of 18.6% over the first six months, the average stock in the index experienced a decline of 38.6% at some point in the first half of this year. Uneven returns were also evident within the Standard & Poor's 500 Index, which returned 15.3% for the first half of the year, while the average stock in the index only experienced a 5.1% gain. The largest ten companies in the Standard & Poor's 500 Index represent a record 37.0% of the index, making the headline index a less reliable indicator of the average stock return.

ECONOMY

The primary economic debate is whether the U.S. economy is on track for a soft landing or a recession. The economic data provide little clarity, as signs of a slowdown can be seen as either a healthy rebalancing that cools inflation without causing a growth contract or as a precursor to a mild recession starting in early 2025. In May, retail sales were significantly weaker than expected, especially when excluding autos, and housing starts dropped to a four-year low. However, industrial production rose 0.9% from a month earlier in May, after showing no growth in April. The economy's service sector expanded in June at a pace not seen for twenty-six months, as measured by the U.S. Services Business Activity Index. Services activity has risen for seventeen consecutive months after nearly stalling in late 2023. The strength of the service sector has created the greatest impediment to lowering inflation.

Supporters of a soft landing argue that this cycle is unique, making the usual rules inapplicable. The post-pandemic inflation surge was largely the result of demand rebounding and significant government stimulus. Moreover, unlike prior monetary tightening periods, many households and businesses have been more insulated from interest rate hikes by holding low fixed-rate mortgages and long-term corporate bonds with low borrowing costs. The combination of a surplus of consumer savings and lower interest rate sensitivity has helped mitigate the impact of the significant spike in interest rates this economic cycle. The result is a gradually slowing economy with disinflation that may avoid the recessionary outcomes that would typically be associated with a sharp tightening of monetary policy.

The soft-landing outlook may turn into a mild recession. The economy displays signs of late-cycle behavior, such as rising unemployment (3.4% to 4.1%), rising credit delinquencies, and tightening credit availability. These signposts typically emerge late in the business cycle when the economy is peaking and often strain the full utilization of resources. Other signposts include record corporate profits and profit margins, often at a time when the Federal Reserve is battling high inflation. The end of a business cycle is much more complicated and fraught than the beginning. With the benefit of hindsight, this dynamic is often reflected in the behavior of equities. Market tops are generally a process, while market bottoms usually are events.

The looming national elections will undoubtedly continue to receive attention. In addition to the Presidential race, one-third of the seats in the Senate (which Democrats control by two seats) and all seats in the House of Representatives (which Republicans control by seven seats) are also on ballots this fall. A small margin is also likely to determine leadership beginning in 2025. The election outcome could result in one party controlling both houses of Congress and the Presidency, often the setting for most significant policy shifts.

Numerous critical issues are up for debate this election cycle, including taxes, energy, health care, and tariffs. A key point of contention will be the 2017 Tax Cuts and Jobs Act (TCJA), set to expire at the end of 2025. This legislation introduced significant changes to the tax code, such as expanding tax brackets, reducing the top tax rate, raising the standard deduction, and limiting mortgage interest and state and local tax (SALT) deductions for individuals. It also increased the federal gift and estate tax exemption. The legislation also lowered the corporate tax rate from 35% to 21% and changed deductions, depreciation, and other business tax items. Barring a potential extension, consumers and companies will face higher taxes in just over a year.

While election outcomes historically lead to policy changes, elections have minimal long-term impact on market performance. Economic cycles often move independently of who is in office, affecting administrations regardless of their policies. For example, Presidents George H.W. Bush and George W. Bush faced economic challenges such as high inflation, an inverted yield curve, and a recession. President Obama benefitted from a favorable low-interest-rate environment, while President Trump dealt with tighter monetary policy during his early years in office. The next President will likely inherit a tailwind of easing monetary policy to begin their term.

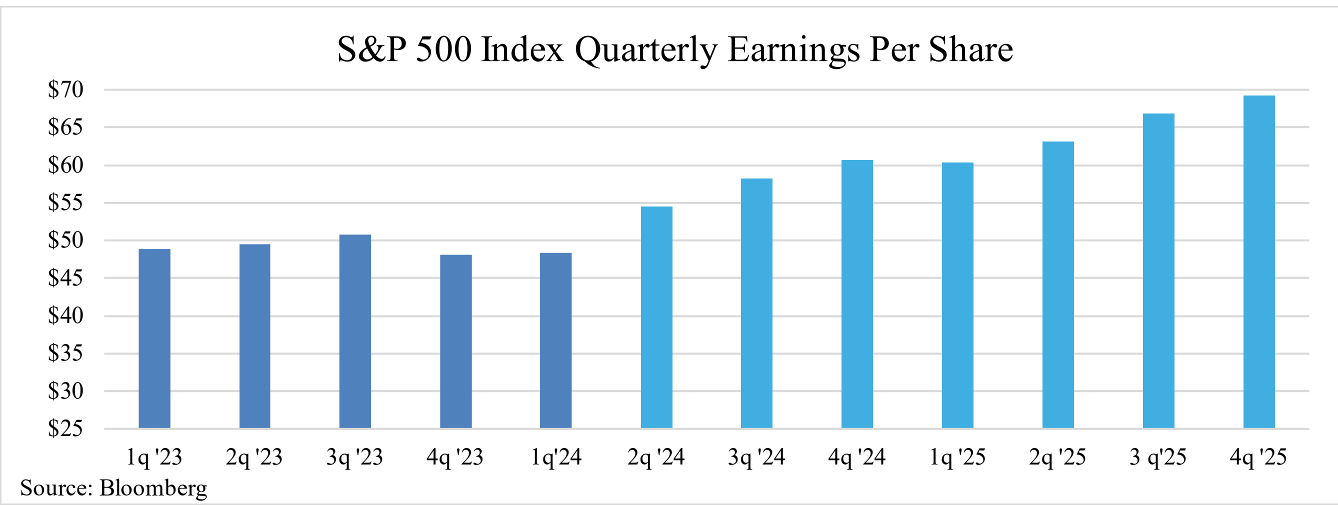
MARKETS

The bull market in U.S. equities continued in the second quarter following a wobble in April related to stronger-than-anticipated inflation reports. Higher inflation fears began easing by May, and the equity market quickly regained footing. The Standard & Poor’s 500 Index's strong performance year-to-date is reminiscent of the first half's returns in the late 1990s, another period of strong market concentration. Today, three companies individually have market capitalizations of over $3 trillion (NVIDIA, Microsoft, and Apple). These companies comprise over 20% of the Standard & Poor’s 500 Index. At the height of the dotcom era in 1999, the top three Standard & Poor’s 500 Index members had less than a 10% weighting. The top 25 members of the index currently have roughly the same market cap as the remaining 475 members.

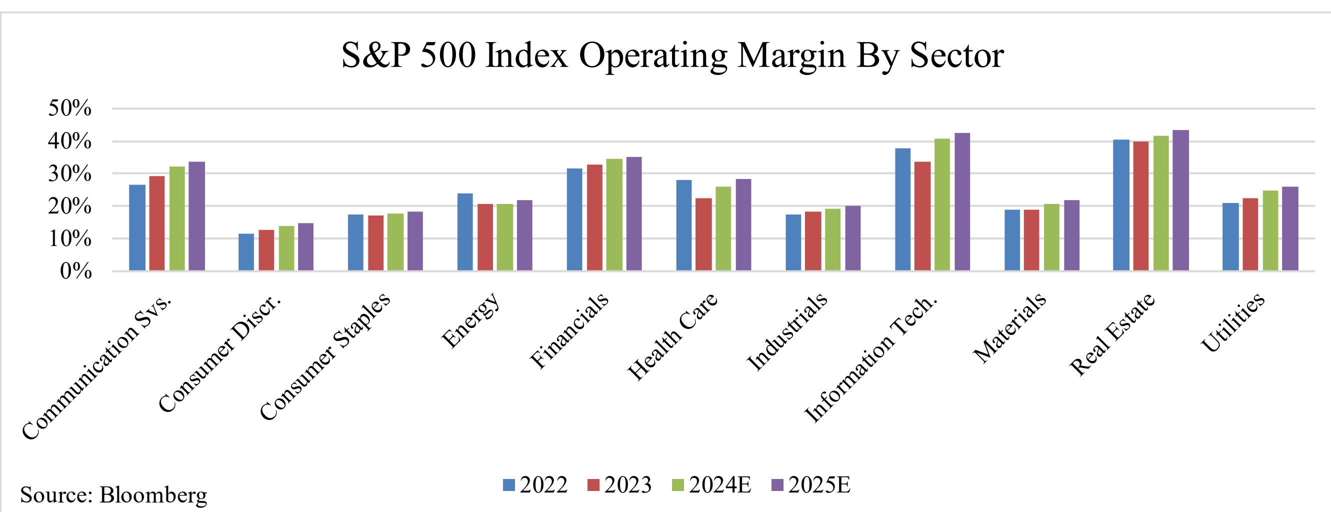
Interestingly, nearly 60% of the Standard & Poor’s 500 Index return during the first two quarters of the year was driven by just five mega-cap stocks: NVIDIA, Microsoft, Meta Platforms, Amazon, and Apple. The concentration of returns was most pronounced in the second quarter, with NVIDIA, Apple, and Microsoft alone powering 90% of the gains during the quarter.

The outperformance of the Standard & Poor's 500 capitalization-weighted index relative to its equal-weighted counterpart was striking in the second quarter, with a spread of 6.9% - the third widest since the inception of the equal-weight index in 1990. Larger spreads were only seen in the fourth quarter of 1999 (8.0%) and the first quarter of 2020 (7.1%). Over the past six quarters, the capitalization-weighted index has outperformed the average stock by 26.0% due to the outsized impact of a few large technology-related companies.

Examining consensus forecasts is often helpful because the equity market is the collective expression of investors' future expectations. After all, the best short-term indicator of equity market behavior can often be how the future materializes relative to expectations. This is particularly true as we progress through the market cycle. Whether it is economist projections or corporate earnings forecasts, growth expectations for the second half of 2024 and into 2025 are very high compared with recent reality. The chart below illustrates Wall Street analysts' expected earnings acceleration over the next seven quarters.



Much of the future earnings growth reflected above results from elevated operating margin expectations, as shown below.



Technology companies are characterized by relatively large profit margins – the ability to convert a significant portion of their sales into profits. NVIDIA, Microsoft, Alphabet (Google), and Meta Platforms represent 20.6% of the Standard & Poor's 500 Index with an average operating margin nearly sixfold greater than the index. The prominence of these companies within the Standard & Poor's 500 Index lifted the operating margin of the index to near-record levels; however, the margin story is more broad-based. As the chart on the prior page reflects, the energy sector is the only sector not forecast to achieve a multi-year high in 2025.

Nominal economic growth has been exceedingly strong, rising 5.4% year-on-year in the first quarter, primarily driven by inflation. This dynamic has allowed many companies to raise prices faster than employee wages. Record forecasted operating margins aided the resulting market environment that anticipates accelerating earnings growth in 2025. This backdrop is characteristic of a late market cycle when growth persists longer than most expect, and begrudgingly, growth expectations get reset to ever higher levels. We have witnessed market strategists repeatedly having to mark their yearend market estimates higher throughout the first half of the year.

Based on economic and earnings expectations, the market is unquestionably pricing in a soft landing. The market risk is that future growth lands shy of lofty expectations. In that case, investors will have to mark down expectations against a market that currently trades for 21.5X forward earnings. In essence, investors are currently paying peak-type multiples for record earnings, leaving little room for recasting future expectations.

Following the Presidential debate in late June, long-end U.S. Treasury yields surged, and prices dropped, indicating investors are starting to price in a Trump victory. The market reflects the potential mix of protectionism, which could be inflationary, more robust economic growth, and a greater Treasury supply to finance further deficit spending. The federal government is running its largest budget deficit during a peacetime economic expansion. Eight quarters into the current economic expansion would be an ideal time to attempt right-sizing the budget. Successful fiscal reform will likely prove elusive as "mandatory" programs and interest payments dominate federal outlays. Compounding the challenge, these spending programs – primarily Social Security, Medicare, Medicaid, and other health-related spending – are driven almost entirely by the aging U.S. population. While the next President may inherit a more favorable monetary policy environment, the large budget deficit could restrict the scope of the policy agenda, which could include a larger military budget.

CONCLUSION

Although historically low, the unemployment rate is rising and should be closely watched. Once it begins to move upwards, it typically accelerates higher. With excess savings drained and borrowing rates high on credit, lower-income consumers are now experiencing reduced buying power, which should weigh on total consumption. On the positive side, household and business finances are strong due to the deleveraging during the recovery of the pandemic, creating some cushion in an economic downturn.

Expected corporate profit growth of around 12% this year has lifted the average stock price during the first half of the year. However, there remains a significant divergence in headline market indices and the experience of the average stock, as investors remain enamored with mega-cap technology companies. The strong start to the year has historically heralded good news for the year's second half. Since 1950, the Standard & Poor's 500 Index has risen more than 10% through the first half of the year twenty-two times. On eighteen of those occasions, the market has continued to advance in the second half of the year, with the average annual gain topping 25%.

*FINANCIAL MARKET TOTAL RETURN**

	Second Quarter 2024	**Six Months Ending 06/30/24**	**One Year Ending 06/30/24**	**Annualized Return Two Years Ending 06/30/24**	**Annualized Return Three Years Ending 06/30/24**	**Annualized Return Five Years Ending 06/30/24**
Standard & Poor's 500 Index	4.28%	15.29%	24.56%	22.05%	10.01%	15.05%
Russell 2000 Index	(3.28%)	1.73%	10.06%	11.18%	(2.58%)	6.94%
Value Line Composite Index	(4.61%)	(0.60%)	4.14%	7.67%	(2.71%)	3.91%
Dow Jones Industrial Average	(1.27%)	4.79%	16.02%	15.12%	6.42%	10.33%
Nasdaq (OTC) Composite	8.47%	18.57%	29.66%	27.95%	7.82%	18.24%
Bloomberg Gov't/Credit Intermediate Bond Index	0.64%	0.49%	4.19%	2.03%	(1.18%)	0.71%

* *Total Return Includes Income*

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