Investment Perspective

The S&P 500 (SPX) continued to advance to new all-time highs throughout the second quarter. This strength was primarily led by the advance of 10 mega-cap stocks. For the segments of the stock market beneath these mega-caps, the investment environment has been more challenging. For example, the SPX generated a return of 4.28% in the second quarter while the Russell 2500 was down 4.27%. We discuss these divergences at greater length in this edition of Investment Perspective and believe the coming shift in monetary policy may be the catalyst to produce a broadening out of the stock market. A summary of year-to-date index returns for the period ending June 30, 2024 is as follows:

The coming shift in monetary policy may be the catalyst to produce a broadening out of the stock market

Dow Jones Industrials	4.8%	Russell 2500	2.4%
MSCI EAFE	5.8%	S&P 500	15.3%
NASDAQ Composite	18.6%	Wilshire 5000	13.6%

GLOBAL ECONOMY

Global economic growth is moderate with recent data continuing to support a constructive outlook. World GDP growth is expected to increase 2.6% this year, and early estimates suggest 2.3% in 2025. European and Japanese growth is just under 1%, and China is muddling through a challenging environment with 4-5% growth, which is subpar by historical standards. The weak Chinese domestic economy means greater reliance on the country's exports. Recently, the U.S. and E.U. placed tariffs on Chinese electric vehicles to counteract the heavy government subsidies supporting Chinese auto manufacturers. These types of actions are likely to continue. On the monetary policy front, the Bank of Canada and European Central Bank (ECB) each reduced their official interest rates by 25 basis points in early June, and other central banks are easing or preparing to ease. Confidence is rising that inflation is sufficiently under control to reduce interest rates.

The U.S. is now on the cusp of a monetary easing cycle without having experienced a true recession

The U.S. economy is forecast to grow approximately 2.3% in 2024 with an expectation of slightly slower growth in 2025. Moderate contributions from the consumer sector, non-residential capex spending, technology spending and a recovering residential investment sector are helping to provide balanced growth. The only major detractor to GDP growth is strong import demand, although net imports often reflect a healthy domestic economy, which is the case today. Consumer spending is increasing at a moderate pace due to a strong job market and the wealth effects of a rising stock market. However, there are signs that spending will moderate ahead. For example, the pace of new auto sales slowed in the second quarter to approximately 1% from the first quarter's pace of 5%. In general, a low-to-moderate pace of consumption can be sustained for an extended period absent a credit crunch or a labor recession. The unemployment rate is historically low at 4.1%, albeit up from 3.4% in January 2023. The labor participation rate is gently increasing to 62.6% and

575 Lexington Avenue / 30th Floor
New York, NY 10022
P 212.344.3300 / F 212.344.2045
americancapitalmanagement.com

payroll growth is 1.1%. Collectively, these indicators reflect a stable labor market. Interestingly, the labor participation rate for prime-age workers (25-54 years old) is 83.7% -- the highest level since February 2002 -- which reflects the generational mix shift as baby boomers retire. The manufacturing sector continues to be in an extended downturn, as evidenced by the ISM purchasing managers index for manufacturing, which registered 48.5 in June, only slightly above the average reading for the last 12 months. Higher mortgage rates (7.1% for a 30-year fixed mortgage) have curtailed existing home sales and new home building, but the housing sector is demonstrating more resilience than expected because overall supply is tight. For example, the Case-Shiller National Home Price Index is up 6.2% y/y with the latest reading in April, which is higher than the pace of appreciation just prior to the pandemic in early 2020. The growth path remains moderate with balanced contributions from multiple sources. The U.S. is now on the cusp of a monetary easing cycle without having experienced a true recession during the tightening phase.

Lower interest rates and a normalizing yield curve should boost investor confidence and risk appetite

FED POLICY & INFLATION

Recent messaging from Federal Reserve officials suggests interest rate cuts are near. Recall that the Fed has been on hold since July 2023 as it monitors the progress of decelerating inflation. The two most recent inflation reports (May and June) prove that inflation is under control and on a decelerating path to 2%. The consumer price index (CPI) in June was 3.0% y/y and core inflation (CPI excluding food and energy) rose 3.3% y/y. The Fed's preferred measure of inflation, the core personal consumption expenditure (PCE) price index, which excludes the impact of food and energy prices, rose 2.6% y/y in May. This compares to the 5.6% peak in February 2022. We expect further relief on the inflation front over the intermediate term that will support Fed easing and see two interest rate cuts this year. Bond investors have a similarly constructive view that inflation will ease as the 10-year Treasury yield has declined to 4.16% from 4.70% in April. Lower interest rates and a normalizing yield curve should boost investor confidence and the risk appetite to potentially support a broader rally in the stock market.

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STOCK MARKET DIVERGENCES

The U.S. equity markets are experiencing historically significant levels of concentration in the largest capitalization stocks. This has occurred for a variety of reasons, but principally because mega-caps benefit from artificial intelligence, grow faster than the average company and are perceived as a safe haven during a period of higher interest rates due to strong balance sheets and cash flow. The short-term consequence of this concentration is extremely wide performance divergences between the top 10 stocks and nearly all other benchmark measures. Investors crowding into a narrow selection of popular stocks results in attractive prices for large segments of the equity market. This creates a significant opportunity in small and mid-cap stocks. Specifically, the Russell 1000 and Russell 1000 Growth indices are the most concentrated in their histories with the weight of the top 10 stocks 32% and 61%, respectively. Additionally, small caps stocks are only 4% of the total U.S. market cap, which is historically low based upon CRSP data going back to the 1930s. Furthermore, the cumulative market cap of the top five stocks in the Russell 1000 is 5x greater than the entire Russell 2000, another historical extreme. Other periods of significant divergences (including the late-1990s, mid-1980s and early-1970s) have been followed by a sustained period of outperformance by smaller cap stocks. The current situation begs the question, is it sustainable? What are the catalysts to create a change? Significant divergences can persist longer than expected but eventually there is mean reversion. In this case, a reduction in short-term interest rates by the Fed and a transition to more accommodative monetary policy could be the catalyst. With lower short-term interest rates, investor risk appetites will increase, refinancing risks will diminish, M&A activity will pick-up and a positively sloped yield curve will signal fewer recessionary risks. These factors would aid in broadening out the market to the benefit of small and mid-cap stocks.

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INVESTMENT OUTLOOK

Investor confidence has increased that the Federal Reserve will cut interest rates in September due to progress on the inflationary front. Despite the narrowness in the stock market, the major equity indices have advanced, reflecting an outlook of low-to-moderate GDP growth, improving inflation, monetary easing and double-digit earnings growth. We expect SPX operating earnings per share to grow 10% this year to $244 with 11% growth in 2025 to $270. These forecasts are based upon single-digit revenue growth coupled with margin expansion. Currently, the SPX is valued at 21.8x next-twelve-month earnings versus its long-term average of 16.6x. The top 10 stocks in the SPX are trading at 32.2x forward earnings, which is 47% above the average of the index. This leaves the average SPX stock more moderately valued at 17.5x. The current environment supporting above-average valuations remains dependent upon moderating inflation and long-term interest rates in the 3.50-5.00% range. These issues warrant close attention.

The S&P 500 is more concentrated than it has ever been. Over the last 35 years, the average weight of the top 10 stocks in the S&P 500 index has been 20%. During the dot-com bubble, the combined weight of the top 10 stocks peaked at 25%. At present, the figure stands at 32%. We expect the narrowness of the stock market to eventually broaden and benefit small and mid-cap stocks. Recession risks are low and credit conditions are stable but deteriorating slightly. The stock market may consolidate as we await the monetary easing cycle. The key risks include China's slowdown, cyber-attacks, disappointing earnings, geo-political conflicts, higher inflation, Iran/Israel, recession, and an unexpected credit crisis. In our opinion, quality small and medium-sized growth companies are likely to achieve above-average annual returns over the next few years, especially if the market experiences a rotation away from the mega-caps.