

2Q 2024 Commentary

July 9, 2024

THE BIG THING: Artificial Intelligence Powered Tech Stocks

- 🌿 Artificial Intelligence (AI) continued to be the focal point for investors.
- 🌿 Large Cap Growth stocks led all other areas of the market.
- 🌿 US stock indices not exposed to large cap growth stocks were down in the quarter.

EQUITIES

Quarterly Returns: “Magnificent 7” Or Else

- 🌿 **Best:** Large Growth +8%, NASDAQ +8.4%, S&P 500 +4.3%¹
 - NVIDIA +37%; Apple +23%
- 🌿 **Worst:** Small Value (-3.6%), Mid Value (-3%), Mid Core & Small Core (-3%)
- 🌿 International: developed markets (-0.2%) and emerging markets +4.1%.
- 🌿 Gold +5%; Bitcoin (-15%); the dollar rose vs Euro and Yen.
- 🌿 Hedge funds and other alternative funds were mostly positive.

YTD Returns: Most Indices Up; Large Cap Led Mid and Small Cap

- 🌿 **Best:** NASDAQ +25%, Large Growth +21%, S&P 500 +15%; Large Value +6%
 - NVIDIA +150%
- 🌿 **Worst:** Small Value (-1%), Small Core +2%, Mid Value +4%
- 🌿 International: developed markets +6% and emerging markets +8%.
- 🌿 Gold +13%; Bitcoin +45%
- 🌿 Distressed hedge funds are performing well.

FIXED INCOME

Quarterly and YTD Returns: Lower Prices and Higher Yields

- 🌿 In the second quarter, US Treasury interest rates rose slightly across the entire interest rate curve.
 - This trend continued from the start of the year.
- 🌿 Municipal and corporate bond prices ended the second quarter down as interest rates rose. (**Table 1** below).
 - Corporate bond interest rates rose less than Treasuries (spreads narrowed).
- 🌿 The Federal Reserve (The Fed) held rates steady throughout the quarter and YTD.
 - Economic growth slowed to 1.4% but remained healthy.

¹ Large cap growth = Russell 1000 Growth Index; Large cap core = S&P 500; Large cap value = Russell 1000 Value Index; Mid cap growth = Russell Mid Cap Growth Index; Mid Cap Core = Russell Mid Cap Index; Mid cap value = Russell Mid Cap Value Index; Small cap growth = Russell 2000 Growth Index; Small cap core = Russell 2000 Index; Small cap value = Russell 2000 Value Index; Developed international = MSCI EAFE Index; Emerging markets = MSCI Emerging Market Index. These terms will be used throughout the commentary. Source: FactSet & PSG.

Strong S&P 500 returns in 2Q belie the churn for non “tech” stocks.

- Inflation stabilized the last few months but remains above the Fed’s 2% target.

- 🌿 The Fed continued to shrink its balance sheet, but slowed the rate of the decline:²
 - -\$178 billion in Q2.
 - -\$1,311 billion since the April 2022 peak.

Treasury yields rose in the quarter and YTD.

Table 1
US Treasury Yields

Maturity*	12/31/23	3/31/24	6/30/24	2Q24 Yield Change	1H 2024 Change
3 Month	5.4%	5.3%	5.4%	+0.0%	+0.0%
2 Year	4.3%	4.6%	4.7%	+0.1%	+0.4%
5 Year	3.8%	4.2%	4.3%	+0.1%	+0.5%
10 Year	3.9%	4.2%	4.4%	+0.2%	+0.5%
30 Year	4.0%	4.3%	4.5%	+0.2%	+0.5%

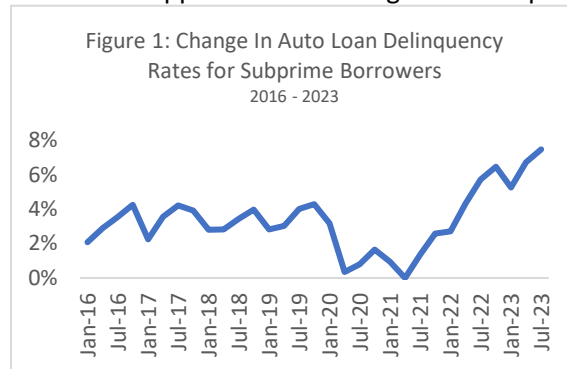
*Source: FactSet

ECONOMIC AND MARKET ENVIRONMENTS

Economic Growth Continues but Signs of Strain Appearing

- 🌿 US economic growth slowed in the first quarter to 1.4% from 3.9% in 4Q 2023.
- 🌿 Second quarter growth is expected to be under 2% as well.⁴
- 🌿 The job market continues to be strong, but less so than the last few quarters.
 - Unemployment has drifted higher to 4.0% (May).
 - 4% unemployment is still extremely low by historical standards.
- 🌿 55% of Americans believe inflation and the cost of buying/renting a home are the most important problems.⁵
- 🌿 Auto loan delinquency rates have accelerated for lower end borrowers.⁶ (Figure 1)
 - 🌿 Homebuilders and auto suppliers were among the worst performers in 2Q.

Subprime borrowers are struggling; homeowners still not particularly stressed from interest payments.



² Source: Federal Reserve and PSG; the Fed owned \$3.9 trillion of Treasury Notes and Bonds as of 3/26/2024.

³ Data is seasonally adjusted; Source: Bureau of Labor Statistics

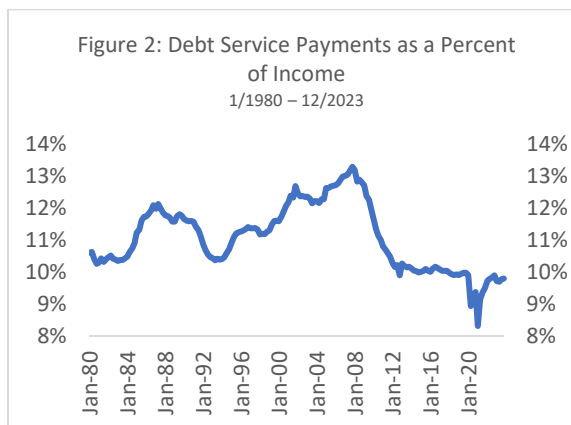
⁴ <https://www.atlantafed.org/cqer/research/gdpnow> (as of July 1, 2024)

⁵ <https://news.gallup.com/poll/644690/americans-continue-name-inflation-top-financial-problem.aspx#:~:text=Forty%2Done%20percent%20of%20U.S.,with%20most%20readings%20under%2010%25>

⁶ <https://www.federalreserve.gov/econres/notes/feds-notes/the-effects-of-credit-score-migration-on-subprime-auto-loan-and-credit-card-delinquencies-accessible-20240112.htm#fig2>

Lower Mortgage Rates Have Insulated Existing Homeowners

- Despite higher interest rates, debt service as a percentage of income is still at the low end of the last 40 years, shielding the average consumer from additional stress. (Figure 2)
- Older mortgages issued at rates of 3.5% or less have locked in borrowers at rates below today's money market returns.
 - We do not encourage clients to pay off low rate, amortizing mortgages.



Market Leadership Narrowed as Markets Digest Impacts from Artificial Intelligence

“There is something structural here.” – A growth manager on a call with PSG clients regarding AI.

- During the second quarter, markets tried to sort out the winners and losers.
- In last week's webinar with one of our large cap growth portfolio managers, she told us, “*There is something structural here,*” when asked about AI.
- There are a few known winners (as of now), which are generally outperforming for the quarter.
 - NVIDIA (+38%) announced another strong quarter of earnings and orders.
 - Apple (+23%) announced it would monetize AI similar to how it monetizes search. (Apple receives over \$20 billion per year from Google alone.)
 - Amazon (+21%) is planning to spend over \$100 billion on data centers over the next ten years to serve AI customers.⁷
- There are many questions about which business models will survive in a new AI world.
- In the meantime, the average S&P 500 stock generated a -2% return in the quarter.

Artificial Intelligence's Impact is Very Uncertain

AI's impact on the markets and economy are unknown, but active management should have opportunities to add value.

- The long-term winners from AI are unknowable at this time.
- AI could be in the stage of infrastructure buildout that enabled the internet.
 - Many “can't miss” stocks from the internet buildout did not turn out to offer solid, risk adjusted returns.
 - Cisco is still 42% below the 2000 high of \$82.
 - NVIDIA is trading at roughly 25x 2024 estimated sales and 12x 2029 estimated sales; both are extremely high valuations.
- It may be easier to identify the losers.
 - If true, active managers have opportunities to add value.
- Many of the internet's winners did not exist in 2000 (Facebook) or were in very early stages of formation (Google was founded in September 1998, went public in 2004).

⁷ The Wall Street Journal- “Amazon, Built By Retail, Invests in Its AI Future” – June 30, 2024

- Venture capital may own or be able to invest in the long term winners.

CONCLUSIONS

Stocks:

- 🌿 Year-to-date returns narrowed again as economic growth slowed and AI dominated the scene.
 - NVIDIA (+150%) is responsible for ~30% of the S&P 500's 15% year-to-date return.
 - So far NVIDIA has been able to grow into high expectations, but we suspect anything less than stellar numbers could cause a sharp decline in its price.
- 🌿 Leadership is as narrow as any time since the 1960s "Nifty Fifty" with 37% of the S&P 500 in the top 10 companies.⁸ This may be cause for concern.
- 🌿 Narrow leadership does not portend a crash.⁹
 - It has historically meant large cap outperformed small cap.
 - Active managers tend to outperform when the largest stocks (top 10 in the S&P 500) underperform small cap.¹⁰
 - Markets are cyclical, so while we have low confidence on the timing of a leadership change, we are highly confident it will happen.
 - We expect small cap stocks to outperform when it does.

Bonds:

- 🌿 Bond yields are attractive. It is becoming apparent that bond returns will exceed inflation.
- 🌿 Municipal bond rates were higher in the second quarter than the fourth quarter of 2023, and we took advantage of the higher yields.
- 🌿 The Fed's declining ownership of Treasuries put upward pressure on interest rates, while the inflation and lower growth expectations are keeping rates from rising significantly.

Private Investments:

- 🌿 Most of our distressed investments had a good first half and we continue to deploy capital where appropriate.
- 🌿 Diversified private equity investments with exposure to prominent Silicon Valley venture capital funds are our preferred way to invest in Artificial Intelligence.

PSG'S NEWEST ADDITION

We are excited to announce the addition of Jayndee Castro (Jayn) to the PSG family as a Client Services Coordinator. Jayn is a recent graduate of Iona College with an eagerness to learn and take on new responsibilities. We are excited to support her development and provide opportunities for her to grow and thrive in her new role.

⁸ JPMorgan Equity Strategy- "Market Update – Narrowing Momentum, Elevated Crowding, Concentrated Earnings, US Elections" June 27, 2024.

⁹ Empirical Research- "Market Concentration: Does It Tell Us Anything Useful?" June 24, 2024

¹⁰ Morgan Stanley- "Stock Market Concentration How Much Is Too Much?" June 4, 2024

Narrow leadership of this magnitude does not last forever; diversification will be critical when it ends.

DISCLOSURE

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