Passing The Baton

July, 2024

Summary

- U.S. small cap stocks ended July up 10%, while U.S. large cap stocks ended the month up 1%, the widest relative performance spread since February 2000.
- After a prolonged period of favoring mega-cap technology stocks, investors turned their attention to small cap stocks due to a mild June inflation report, anticipation of expected interest rate cuts, and election developments.
- The Bank of Japan hiked interest rates on July 31, which led to a strengthening of the yen and higher repayment costs of carry trades.
- Aside from the Olympics, several market and political races will compete for investors' attention—and likely contribute to market volatility in the coming months.

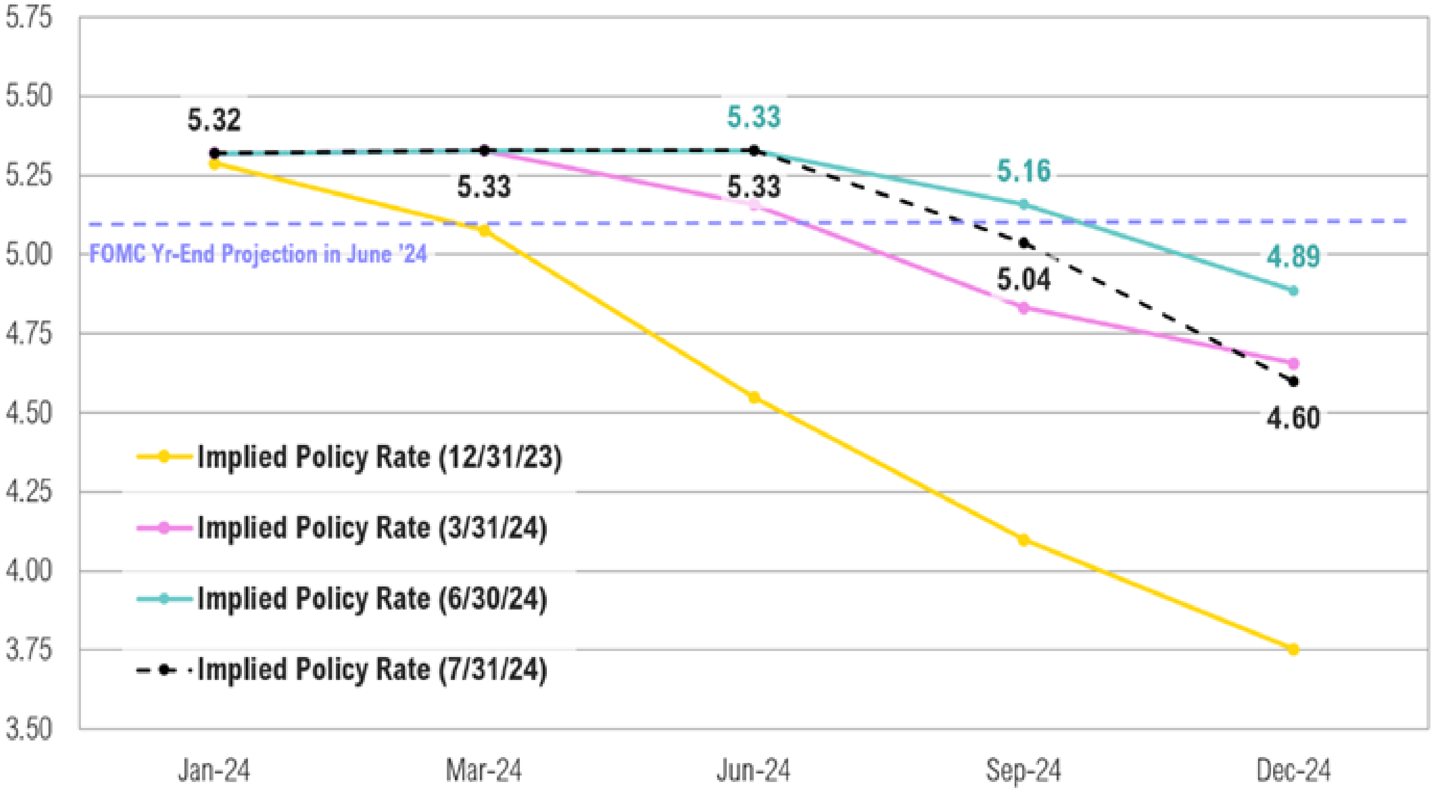
Overview

Much like an Olympic athlete in Paris, U.S. small cap stocks delivered a gold medal performance in July, ending the month up 10%, while U.S. large cap stocks took bronze, up approximately 1%. July was the third-widest monthly spread between U.S. small cap and U.S. large cap stocks since 1980, equaling an extraordinary 9% performance difference. Only February 2000 (+18%) and January 1992 (+10%) exceeded this rare occurrence.

The June inflation report showed prices rising at a slower-than-expected pace, reaching the lowest point since early 2021. Headline inflation eased from 3.3% year-over-year to 3.0%, with the monthly rate showing a -0.1% decline—the first month-over-month decrease in four years. Core inflation also ticked lower in June, from 3.4% year-over-year to 3.3%. Bolstered by the mild inflation report, markets started to price in the probability of a 50-basis point interest rate cut at the September Federal Open Market Committee (FOMC) meeting. As of the end of July, markets were pricing in the equivalent of three rate cuts for 2024, despite there being only three FOMC meetings remaining. At the July FOMC meeting, Federal Reserve Chair Jerome Powell acknowledged the increasing likelihood of an imminent interest rate cut, saying, "A reduction in our policy rate could be on the table for as soon as the next meeting in September." Powell also emphasized that any decision to cut rates in September would be apolitical, asserting that the Fed "would never try to make policy decisions based on the outcome of an election that hasn't happened yet."

Mild June Inflation Report Bolstered Market Rate Cut Expectations

Implied Fed Funds Rate, %



Source: Bloomberg

Continued signs of a cooling labor market are also clearing the way for the Fed to cut interest rates. Job openings dipped in June, from 8.23 to 8.18 million, and are now down over 30% from their peak of 12.18 million in March 2022. The U.S. economy added only 114,000 new jobs in July, while the unemployment rate ticked up from 4.1% to 4.3%. Excluding the pandemic, this is the highest unemployment rate since September 2017.

Preliminary second-quarter gross domestic product (GDP) results indicated that the U.S. economy grew at a respectable annualized rate of 2.8% quarter over quarter. This growth was largely driven by a reacceleration in government spending, which rose from 1.8% in the first quarter to 3.1% in the second quarter. However, while these preliminary results are subject to revision, government spending continues unchecked. With two months remaining in the 2024 fiscal year, which runs from October 1 to September 30, the fiscal deficit has surpassed $1.2 trillion. This is a marginal improvement over the $1.4 trillion deficit recorded at the same time last year. On July 29, the Treasury announced its net marketable borrowing estimates for the third and fourth quarters. These estimates imply that borrowing in 2024 will exceed $2.2 trillion, the second largest on record after 2020. For context, during the COVID-19 year of 2020, the Treasury issued $4.3 trillion in net debt.

By the end of July, over 70% of S&P 500 companies had reported earnings for the second quarter. Continuing a trend from the first quarter, four of the Magnificent Seven companies—Amazon, Google, Meta, and Nvidia—are expected to report year-over-year earnings growth of 56.4% for the second quarter. In contrast, the other 496 S&P 500 companies are expected to see earnings growth of 5.7% for the second quarter. Notably, these companies are forecast to reach double-digit earnings growth of 15.6% by the fourth quarter. Overall, the second-quarter earnings growth rate for the entire S&P 500 is anticipated to be 11.5%.

Passing The Baton

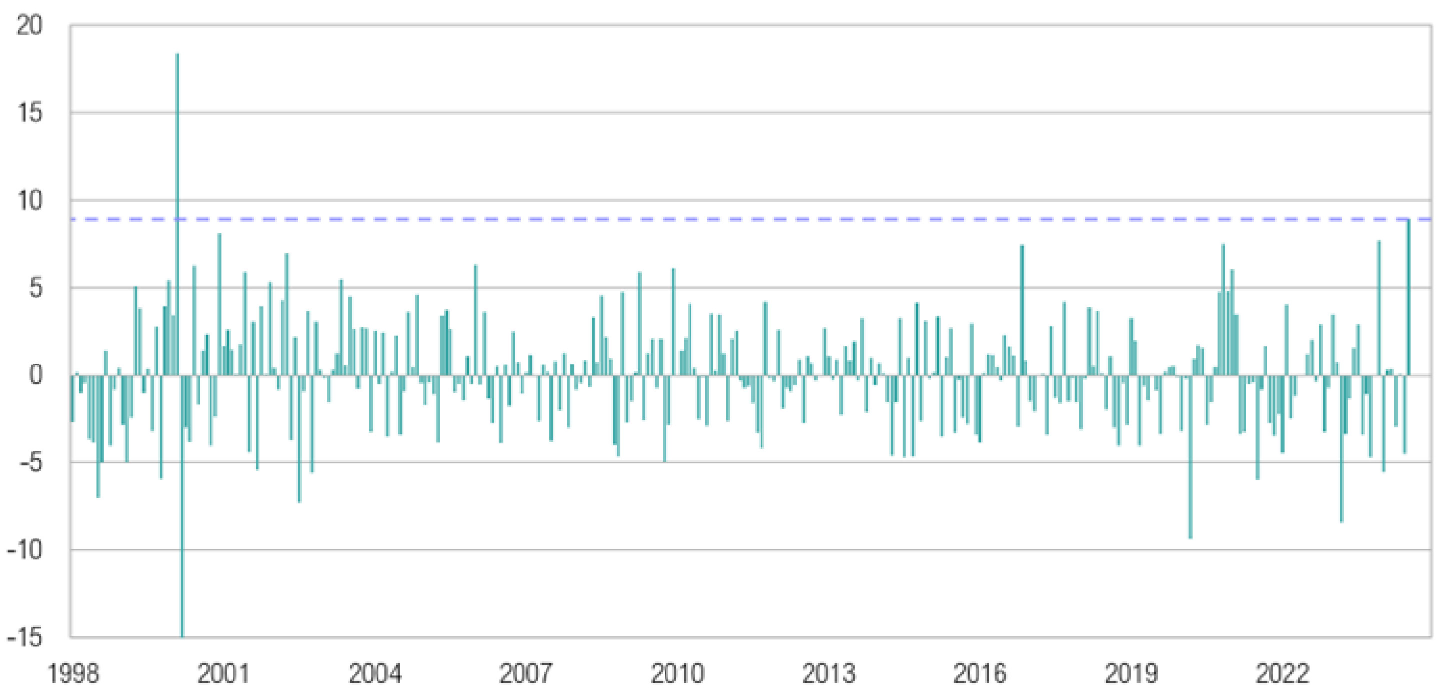
At the start of July, the Russell 2000 Index of U.S. small cap stocks was underperforming U.S. large cap stocks (proxied by the S&P 500) by 5.9% over the past decade—the fourth-worst decade for small caps relative to large caps in a century. Year-to-date, small cap stocks had gained only 1.7%, compared to the 15.3% gain made by large cap stocks. Then came July, when U.S. small cap stocks sprinted ahead to end the month up 10%, outperforming their large cap counterparts by 9% - the widest monthly spread since February 2000.

After months of mostly underweighting the asset class in favor of the mega-cap Magnificent Seven companies, investors surged into U.S. small cap stocks in July, and small cap funds experienced some of the strongest weekly inflows on record. Two key factors likely contributed to this rally: the mild June inflation report and recent election developments (including the June 25 presidential debate and President Biden's subsequent withdrawal from the presidential race on July 21).

Although the rally in small cap stocks evoked memories of 2000—a period when small caps continued to outperform for years—distinct differences raise questions about the sustainability of the recent rally. For one, heavily shorted securities rose dramatically, as indicated by the GS Most Shorted Index, which reached its highest level since September 2022. This suggests that much of the rally in small cap stocks was likely the result of short covering and investors' desire to rebalance away from extreme positions. The small cap rally also represented a de-risking event in which investors sought to reduce their exposure to large-cap positions. According to the Bank of America's Global Fund Manager Survey, owning the "Magnificent Seven" has been the most overcrowded trade for several quarters. However, mega-cap stocks are also less expensive than they were in 2000. The average price-to-earnings (PE) ratio of the S&P 500 Information Technology Index peaked at 32x on July 10, compared to a peak of 59x on March 24, 2000. Furthermore, smaller companies are less profitable today than they were then: 41% of companies in the Russell 2000 now have negative earnings, compared to 19% in March 2000.

July Spread Between U.S. Small and Large Cap Stocks Was Widest Since 2000

Spread (U.S. Small Cap Stocks minus U.S. Large Cap Stocks), %



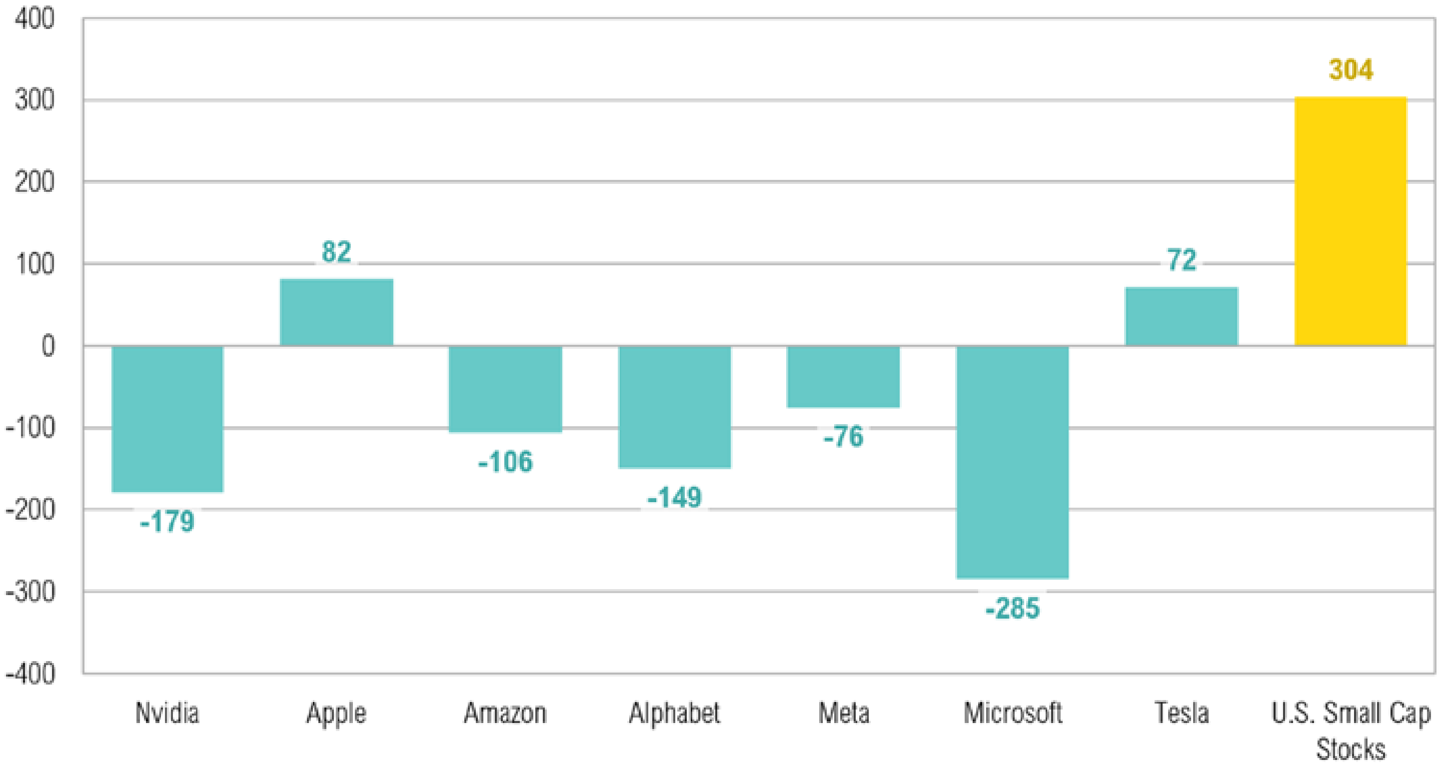
Source: Bloomberg. U.S. small cap stocks proxied by the Russell 2000; U.S. large cap stocks proxied by the S&P 500.

After gaining 37% in the first six months of the year, the Magnificent Seven ended July down -1.2%, erasing over $640 billion in market cap. Despite the rally in small caps, the entire Russell 2000 Index's market cap gain of $304 billion in July was little more than what Microsoft alone lost in terms of market cap over the same period.

Earnings will likely play the deciding role in the sustainability of the small cap rally. As of the end of July, Bloomberg Consensus showed earnings growth for the Magnificent Seven rising by 46% in 2024, while slowing to a still-impressive 20% in 2025. In contrast, earnings growth expectations for the Russell 2000 in 2024 are more modest at 3% but are projected to jump to 36% in 2025. If the earnings growth for U.S. small cap stocks materializes, the rotation may turn out to be sustainable. A smooth pass of the baton from long-favored large cap stocks to their small cap counterparts would likely suggest a certain level of economic resiliency.

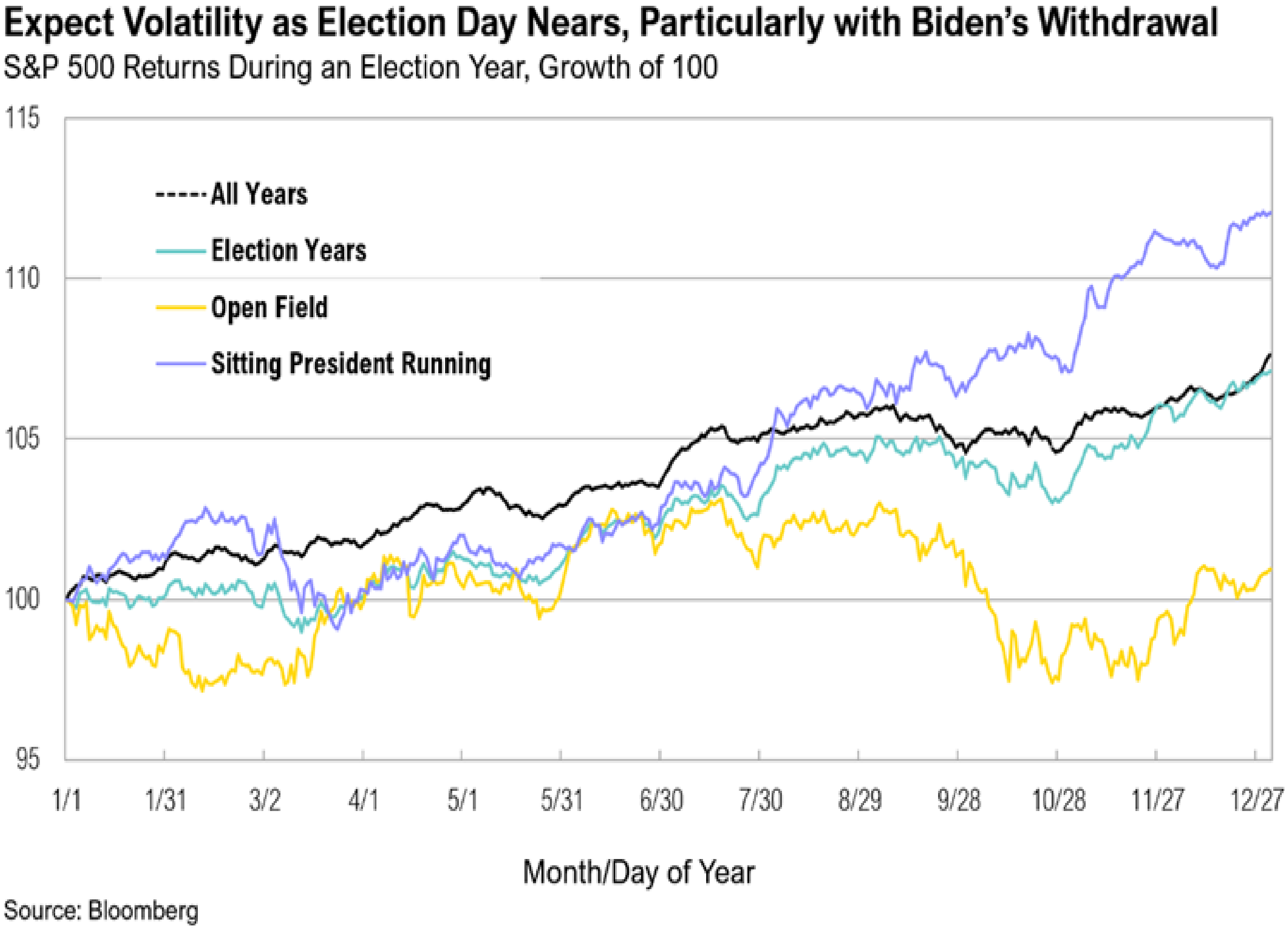
U.S. Small Caps Gained Only a Little More in Market Cap than Microsoft Lost

Market Cap Change (7/1/2024 – 7/31/2024), $Bn



Source: Bloomberg. U.S. small cap stocks as proxied by the Russell 2000 Index.

On July 21, President Joe Biden officially announced his withdrawal from the race and endorsed current Vice President Kamala Harris as the new Democratic presidential nominee. Up until President Biden's decision to withdraw from the 2024 presidential race, former President Donald Trump had been leading in the polls, and betting markets favored a 64% probability of a Trump win over a 36% probability of a Biden win. With this historic spread, which endured for most of July, it seems that markets were looking back to 2016 for a possible repeat of history, as U.S. small cap stocks increased by 18.3% in the two months following the Trump election in 2016. As of the end of July, the spread between Trump and the now-Democratic nominee Harris had narrowed to roughly a 50/50 split.



Now that the political baton has been passed to a new Democratic candidate, markets are dealing with the inevitable volatility that typically characterizes a closely contested election. History suggests that the seasonal trends of U.S. large cap stocks tend to be influenced by whether the incumbent president runs for re-election or not.

In scenarios where the incumbent is running, summer trading has generally been subdued, and the S&P 500 has shown a gradual upward trend, followed by a slight decline towards the end of August. Conversely, in years when the incumbent does not seek re-election, trading during the summer months has tended to exhibit greater choppiness and volatility has extended from August through November. Thus, volatility at this point in the election cycle is quite normal and to be expected. In more ways than one, the race is on.

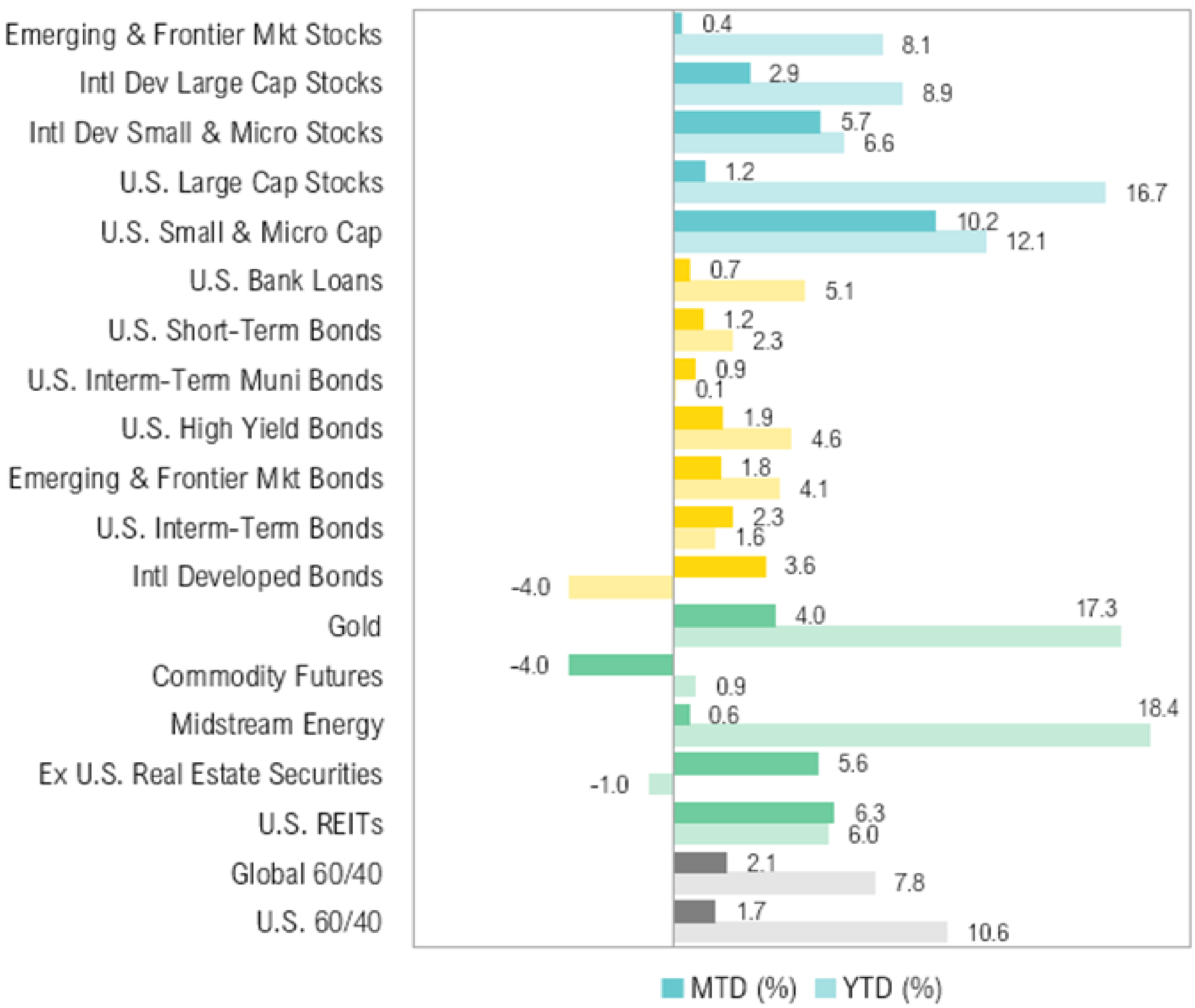
Markets

In addition to the strong returns for U.S. small cap stocks, U.S. REITs gained 6.3%, as interest rate-sensitive areas of the market celebrated the milder inflation report and increasing likelihood of rate cuts. U.S. intermediate-term bonds gained 2.3% on similar sentiment. International small cap stocks outperformed their large cap counterparts. The former ended July up 5.7%, and the latter ended the month up 2.9%. Gold ended the month up 4.0%, reaching a new high of $2,471 per ounce on July 18. Commodity futures were the worst-performing sector, ending the month down -4.0%, followed by emerging and frontier market stocks, which gained only 0.4%.

The 10-year minus 2-year Treasury yield, a common indicator of economic growth and general representation of the Treasury yield curve, reached -0.09% on July 24, the nearest point of dislocation since it inverted on July 6, 2022. As of the end of July, the yield curve had been inverted for 523 consecutive trading days—the longest on record, with or without a recession.

The Japanese yen reached its lowest level in four decades against the dollar, sinking to ¥161. However, it rallied 11% in the last week of July, strengthening to ¥142. The rebound was largely driven by currency intervention from the Bank of Japan. An official report showed Japanese authorities spent nearly $37 billion in July to shore up the weak yen. Amid currency weakness earlier in the month, the Bank of Japan hiked interest rates from 0.1% to "around 0.25%" on July 31, raising Japanese rates to their highest level since 2008. The Bank of Japan's decision to hike interest rates to 0.25% and the rapid strengthening of the yen have left Yen carry traders in a precarious position, as they now face increased loan repayment costs in U.S. dollars due to the yen's appreciation. This unexpected shift has forced some traders to liquidate assets to repay their yen-denominated loans, reflecting a widespread miscalculation that Japan's interest rates would remain at zero indefinitely.

July 2024 Key Market Total Returns



Source: Bloomberg

Looking Forward

Aside from the Olympics, several other market and political races will compete for investors' attention in the coming months. This environment could contribute to increased market volatility. This includes volatility in interest rates, as bond investors balance the competing forces of slowing growth, the start of an imminent rate-cutting cycle, and fiscal spending that continues at crisis-era levels.

Although lower asset prices would be a welcome development and an opportunity to put additional capital to work, typical election year dynamics suggest that there is no rush to do so. That said, only time will tell who the ultimate winners in several of these races will be. Until then, we believe clients are best served to exhibit patience and diversification, especially with uncertainty around an extremely contentious presidential election.

As always, if you have any questions or would like to schedule a meeting with one of our investment professionals, please don't hesitate to call us at 508-693-8850.

Sincerely,

Luke Murphy
Managing Director,
Martha's Vineyard Investment Advisors

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Learn more: Visit www.mvinvestmentadvisors.com

Martha's Vineyard Investment Advisors

496 State Road
West Tisbury, MA 02575
(508) 693-8850
www.mvinvestmentadvisors.com

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Citations

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