"Dangerous Setup"
Market Commentary – July 2024

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The third estimate of Gross Domestic Product (GDP) shows that the output of goods and services produced by labor and property located in the U.S. grew at an annual rate of 1.4% in the first quarter of 2024. This is lower than the advance estimate of 1.6%, higher than the second estimate of 1.3%, and much lower than the 2023 Q4 reading of 3.4%. On June 12, the Federal Reserve revised its economic projections that were last released in March. It now sees GDP growth of 2.1% in 2024, 2.0% in 2025, 2.0% in 2026, and 1.8% in the "longer run" (beyond 2026). Each of these values is the same as in March, so the Fed's views seem to be stabilizing. Interestingly, it sees inflation at 2.6% in 2024 (vs. 2.4% as of March) and core inflation, which subtracts food and energy prices, at 2.8% (vs. 2.6% as of March). Given the slightly hotter inflation expectations, the Fed intends to keep interest rates higher for a bit longer.

On May 1, the Federal Open Market Committee (FOMC) kept its benchmark federal funds rate at a target range of 5.25% to 5.5%. The biggest change for the FOMC was regarding its projected interest rate cuts for 2024 and 2025. In March, the Fed projected the federal funds rate at 4.6% by the end of 2024 (implying 0.75% in cuts). As of June, it now sees the rate at 5.1% (implying one 0.25% cut). Similarly, the Fed raised its federal funds rate forecast for 2025 from 3.9% in March (1.5% in cuts) to 4.1% in June (1.25% in cuts). The "longer run" projection is also higher, increasing from 2.6% in March to 2.8% in June. The Fed's balance sheet had $7.231 trillion in assets on June 26, 2024, down from $7.284 trillion in assets on May 29 (slightly less than the Fed's new reduction commitment of $60 billion per month, which started effective June 1). The next FOMC announcement on monetary policy is scheduled for July 31.

Technical factors of the market are bullish (more demand than supply), while fundamentals are fairly priced – therefore, we are mildly bullish on the market. The Standard & Poor's forecast for S&P 500 operating earnings per share (EPS) through June 30, 2025 is $259.46, which implies a price-to-earnings (P/E) ratio of 21.0 with the S&P 500 at 5,460. The earnings yield (E/P) of 4.75% represents fair value relative to the 10-year U.S. Treasury note yield of 4.36%. The yield spread is 0.39%. Seven of the eight largest companies in the S&P 500 make up $16.0 trillion of the $48.2 trillion index market capitalization with a weighted P/E of 33.2. If 33.2% of the index has a P/E of 33.2, then 66.8% of the index has a P/E of 15.0 for the overall P/E to be 21.0. A P/E of 15.0 is an E/P of 6.67%, which is attractively priced compared to the 10-year Treasury note yield of 4.36% (a yield spread of 2.31%).

The S&P 500 motored higher in June, continuing its pattern of higher lows and higher highs (the definition of an uptrend). It hit an all-time closing high of 5,487 on June 18 and 5,483 on June 27. Over the past week or so, the highest trading volume occurred on down days (called "distribution days", which are a sign of internal weakness). Resistance appears to be around 5,500. Support should be found around 5,270 (50-day moving average), 4,970 (April 2024 low), 4,866 (200-day moving average), 4,800 (January 2022 high), and 4,600 (July 2023 high). Meanwhile, the trend is your friend, and the trend is up…for now.

There is much more weakness in the overall stock market than the S&P 500 would lead investors to believe, which is a dangerous setup for the summer and fall of 2024. In 2024, the market cap weighted S&P 500 is up 14.5%, while the equal weighted S&P 500 is up only 4.1% (both without dividends). Amazingly, both contain the same 500 companies! The dilemma is that in a market cap weighted index, bigger companies attract a higher percentage of incoming cash (thus pushing those stocks even higher). The opposite would happen for money flowing *out* of the index. The infatuation with technology stocks, especially those focused on Artificial Intelligence (AI), has reached euphoria. A whopping 32.4% of the S&P 500 is in the Information Technology sector. There will likely be some sort of black swan event that pops the bubble, although it is impossible to anticipate what, or when, that might be. The best we can do is identify the bubble and do our best to minimize our exposure to it. This means sitting out "exciting gains" that other investors are enjoying now. We believe that value investors' patience will be rewarded.