PCM
Peak Capital Management

Sitting on their Hands

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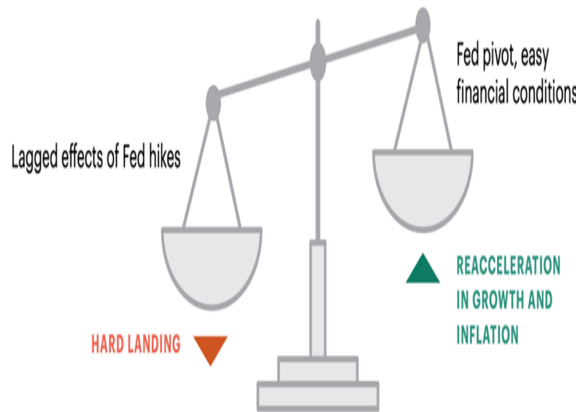
Brian Lockhart

I believe we are entering an economic crossroads this summer that will determine the next intermediate term trend for both the equity and debt markets. There has been a massive economic tug-of-war since the Fed pivoted in December 2023 to easier credit conditions when announcing that rate hikes were completed and they expected inflation to trend back towards their 2% target level.

Risk assets have risen dramatically since the Fed pivot. Dormant sectors like private equity, leveraged buy-outs (LBOs), mergers and acquisitions (M&A), and initial public offerings (IPO) rose dramatically in the first half of 2024 in expectations that rate hikes were coming to cure stagflation concerns. Public markets rallied with the S&P 500 increasing by $12.5 trillion and the Barclay Aggregate Bond Index rising by $3.2 trillion on the expectation of rate cuts. The problem, at least for the Fed, is that inflation paused in its declining trend line and appears to be moving sideways at the 3%-3.5% level, still well above the 2% target.

What we are learning is that the high interest rates resulting from 11 Fed rate hikes has only negatively impacted a relatively small slice of the economic pie in the US. Younger consumers, whose debt levels are higher and incomes more modest, have felt the brunt of the rate hikes while older, less leveraged consumers with stronger balance sheets have benefitted from the higher rates. This creates the economic contradiction where credit card and auto loan delinquencies are at levels not seen since the Great Financial Recession while consumer spending continues to rise at a strong pace. When you add in the $15.7 trillion of wealth added from stock and bond markets over the last 6 months, it is clear why spending remains robust and inflation has not fallen as much as expected.



Source: Apollo Chief Economist

The same is true in the corporate world. Companies that are highly leveraged are suffering with bankruptcies, restructurings, and debt defaults rising dramatically. In 2022, the default rate on corporate loans was below 2% and that figure is 6% today according to data out of Moody's. High yield bonds have doubled their default rate from 2% to 4%. However, companies with low leverage levels are thriving with strong earnings growth on the back of rising demand for products and services.

The struggles experienced by consumers with high debt levels and overleveraged companies have not been sufficient to cause a hard landing for the economy that many, me included, expected in 2023. It also means that inflation has remained persistently higher than the Fed and economists expected and forcing the expected rate hikes to be pushed further and further out. The Fed created a strong "risk-on" environment with the easing of financial conditions in December 2023 but the talk about lower rates may have run its course and the market is looking for action on the part of the Fed.

> **"When you add in the $15.7 trillion of wealth added from stock and bond markets over the last 6 months, it is clear why spending remains robust and inflation has not fallen as much as expected. "**

Credit spreads today suggest virtually no risk to continued economic growth. The yield on investment grade bonds is only 95 basis points (0.95%) higher than US Treasury debt and high yield trades at only 3.25% above Treasuries, both historically low. The Fed has created a paradox for themselves, the pivot to easier conditions has kept the economy resilient but also has prohibited inflation from continuing its downward trend to the target of 2%.

The parts of the economy that are interest rate sensitive are struggling while the wealth effect drives spending higher for those benefitting from higher yields. The resolution of many of the supply chain issues that plagued the world post-COVID has resulted in goods inflation falling but at the same time, services inflation continues to run hot (concert tickets, airline travel, overseas vacations, etc).

What does this mean for an economic outlook? It is my opinion that the Fed is likely to sit on their hands and not cut rates as suggested by their pivot in December 2023. I do not expect any rate hikes in 2024 as inflation is likely to remain above 3% for the balance of 2024. There are four reasons for this forecast:

1. The labor market remains very tight and wage growth is likely to remain above 4%
2. The focus on energy transition will keep energy prices elevated without political change
3. Geopolitical concerns in multiple regions will keep spending on defense high that is less productive
4. Deficits: $2 trillion expected in 2024 will continue the binge borrowing of US government

The markets are likely to become concerned about the Fed's ability to deliver on rate cuts taming the animal spirits unleashed last December. A market pivot to risk-off could see equity prices give back much of the recent gains and potentially initiate a bear market even if there is no recession.

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Feeling Un-Confident

The rapid decline in Consumer Confidence continued in the latest reporting period with many surveys hitting new cycle lows. Particularly somber is consumers expectations for business conditions that has fallen to the lowest level since 2011. The Conference Board data is consistent with the NFIB Small Business Optimism index that has fallen from a high of almost 110 in 2019 to just 90 today. Surprising in the confidence surveys is the pessimism about the labor market from many workers. Labor remains tight with unemployment at a very low 4% nationally but at the same time, 1.84 million Americans are receiving unemployment benefits, the highest since November 2021. Whether a sanguine consumer will slow spending and lead to slower GDP growth is yet to be determined.

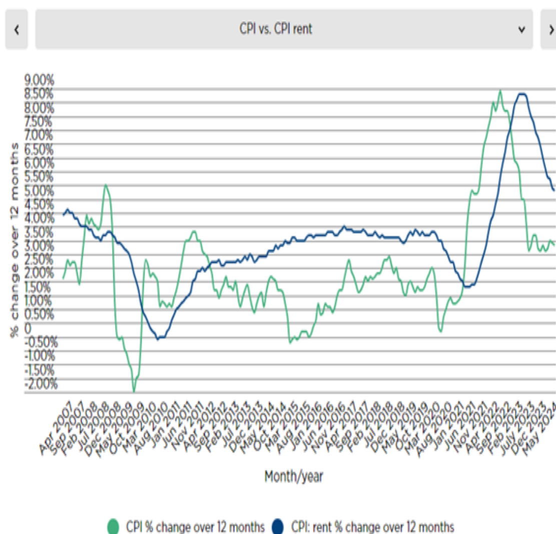
- Not all results from the Conference Board were negative as the Philly Fed Manufacturing index has risen from -10.0 to +10.0 in 2024 suggesting a resurgence in domestic manufacturing activity.
- Weighing on consumers has been the continued rise in home prices combined with high mortgage rates causing housing affordability to decline to 2022 levels and driving rents higher.
- Consumers in the bottom quintile of income have seen a dramatic decline in savings as government programs have ended. Bank deposits have fallen by 20% for this group since January 2020.

Market Breadth

The trend of mega-cap outperformance continues into 2024. The chart to the left illustrates the return of the capitalization-weighted S&P 500 Index and the Equal Weighted S&P 500 Index year-to-date. The capitalization weighted version of the index is higher by roughly 15% in 2024 compared to a more modest 5% for the equal-weighted version. The narrative to start the year was that market breadth was much improved compared to 2023, and for the most part, the equal-weighted version kept pace until mid-May. But since then, the two versions of the index have diverged as the technology sector continues to rally.

- Investors are not rotating out of technology (at least not yet) despite a 35% rally in the S&P Technology Sector over the past year. Technology not only represents roughly one-third of the capitalization weighted index, but also represents about one-third of the index's cash flow. There's little reason to expect a rotation out of technology unless the narrative changes.
- Investors pay roughly 30x forecasted earnings for the technology sector, which, considering how profitable the largest companies are and the cash flow they generate, doesn't seem too unreasonable from a valuation standpoint. We shouldn't be surprised to see a repeat of 2023 in terms of equal-weight underperformance.

Rental Relief



High inflation has placed an immense burden on lower and middle-class Americans who rent their homes. As prices for everyday goods and services skyrocket, these households face escalating rental costs that outpace their income growth. For many, this means a significant portion of their earnings goes toward rent, leaving little for savings or other essential expenses. The strain is compounded by stagnant wages, exacerbating financial insecurity and making it increasingly challenging to make ends meet. As landlords adjust rents to keep pace with inflation, tenants often find themselves grappling with tough choices: cutting back on necessities, taking on additional jobs, or even facing the prospect of eviction. As interest rates are expected to be cut by the Federal Reserve over the coming months, many renters are optimistic that the demand for rental units will decrease as more individuals and families opt to buy, resulting in lower prices.

- According to data from various sources, including the U.S. Census Bureau and real estate analytics firms, the median rent has steadily climbed year after year, often outpacing inflation and wage growth. This trend has been particularly challenging for lower and middle-income households, who typically allocate a larger proportion of their earnings to housing costs.
- Rent prices are now 32.1% higher than they were before the pandemic, but rental growth seems to have slowed from the major spikes of 2022. In May, rents are 3.4% higher than at the same time last year. The average annual growth was 4% in May 2018 and 4.2% in May 2019.

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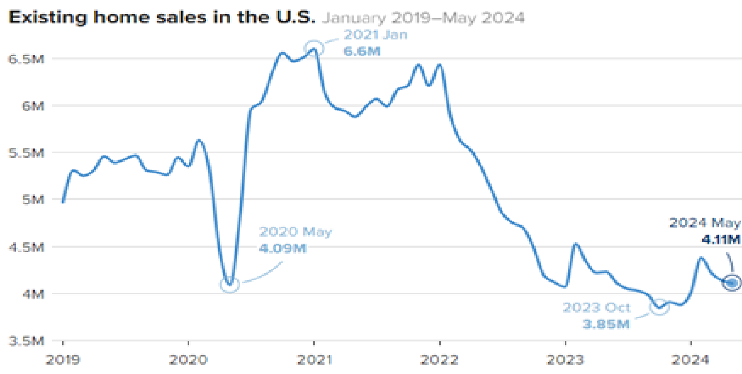
Quinn VandeKoppel

Macro View – "Stuck" Home Sales

In a rather pessimistic report produced by Bank of America last week, their economists believe that the housing market in the U.S. is "unlikely to recover for several years and affordability won't get any better unless a recession hits". Since the spike in buyers in 2020 and 2021, sales have largely been on a downward trend as many are sitting on the sidelines waiting for the Federal Reserve to lower interest rates from their highest levels since the turn of the 21st century. Not only are mortgage rates too high for those looking to buy a home, but existing homeowners are also stuck as they cannot afford to sell into a market where their monthly payment might be double what they are currently paying unless they are forced. However, the firm also noted that as interest rates begin to fall, you will see an uptick in sales, but "could take between 6 to 8 years" before getting back to the levels we saw just a few years ago.

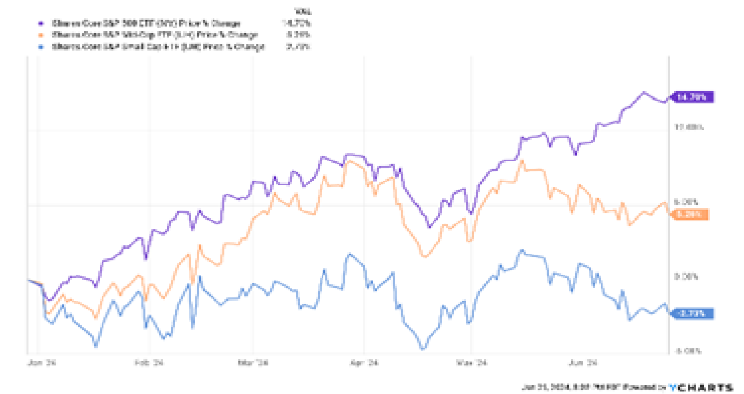


Fixed Income – Poor Performance

If you've been invested in traditional fixed income over the past five years, you're likely disappointed with your returns. The iShares Core US Aggregate Bond ETF (AGG) has delivered an annualized loss of 0.10% during this period. While these results are understandably frustrating, it doesn't necessarily mean that fixed income should no longer be part of your portfolio. However, in the current economic environment, investors may want to reassess their bond holdings, considering the potential for persistent inflation and prolonged higher interest rates. As we've previously discussed, one alternative worth considering is investing in short-term U.S. Treasury bills, which currently offer yields around 5.3%. This option could appeal to investors seeking income without assuming additional credit risk for higher yield. Additionally, when the Federal Reserve eventually begins cutting interest rates, fixed income investors could potentially experience a boost to their portfolios due to the inverse relationship between the two.

Taking Stock – Large Cap Dominance

If you've been following the markets this year, it's no surprise that large-cap stocks, represented by the iShares Core S&P 500 ETF (IVV) in the chart to the right, have outperformed mid- and small-cap peers. As of June 24th, the large-cap ETF has risen nearly 15% year-to-date, driven largely by a few prominent names, while mid- and small-caps have lagged behind despite strong Q4 performance last year. Heading into the second half of the year, many are wondering if large-cap stocks, especially in the technology sector, can sustain their impressive performance of the past year. With the Federal Reserve expected to lower interest rates by at least 25 basis points before year-end, there's optimism that this move could broaden market participation, benefiting stocks across all market capitalizations rather than just the largest ones.



Technical – Price Target Increases

Last month, Goldman Sachs raised its 2024 year-end price target for the S&P 500 Index (.SPX), from 5,200 to 5,600, citing strong earnings growth by five mega-cap U.S. tech stocks and a higher fair value price-to-earnings ratio multiple. However, the upgraded target only reflects an upside of about 2.4% to the index's last close of 5,469.29. Currently, the relative strength index (RSI), is sitting at 69, a signal indicating that large-cap markets are at or near overbought territory. As we head into the second half of the year, the election in November remains a key risk to the S&P 500. Historically, index volatility increases before the election during election years, but following the election, volatility typically subsides and the large cap index rebounds to an even higher level. With the likelihood of increased volatility and investors focused on when the Fed might cut interest rates, the remainder of the year could be a bumpy ride.

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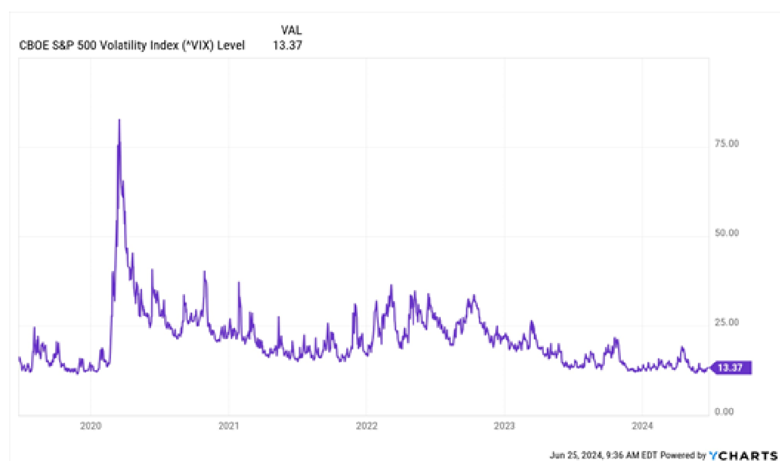
Market Volatility

Clint Pekrul, CFA

We often talk about market volatility and the CBOE VIX Index with respect to investor sentiment. It's noteworthy when major stock indexes, such as the S&P 500, exhibit prolonged periods of below-average volatility. Investors can become complacent and consequently might overreact to the first sign of stress.

The CBOE VIX Index is a common measure of investor expectations about short-term volatility. It represents the premium that investors pay for options (puts and calls) on the S&P 500 Index over the next 30 days. Historically, the VIX has averaged roughly 17 since its inception.

The chart below captures the VIX Index going back over the last five years, which includes the onset of COVID in 2020. As the chart reveals, the VIX has not only converged to its long-run average (the VIX is mean reverting) but has now broken below to a current level of 13.



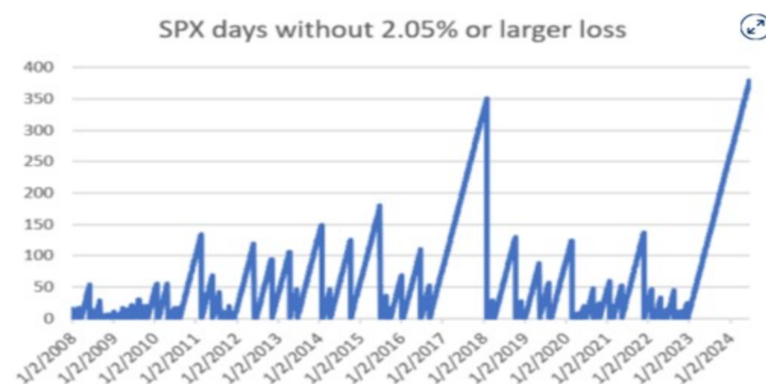
It's been somewhat of a relief over the past year for investors considering the roller coaster we have been through with the pandemic (a -30% rapid drawdown) and the interest rate reset of 2022 (a -16% decline for the S&P 500).

Despite the ups and downs of the past five years, the S&P 500 Index is higher by roughly 100% on a cumulative basis, including dividends. The market actually delivered an 18% return in 2020 amidst a global economic shutdown, thanks in large part to the Federal Reserve cutting interest rates to zero and the federal government providing trillions in stimulus.

The markets continued to move higher in 2021, but by 2022, a dose of reality set in as the Federal Reserve began to reverse its interest rate policy by raising rates to their highest level since the financial crisis. Generationally high inflation necessitated higher rates. Still, despite the move, the S&P 500 fell only -16% for the year, which historically isn't too onerous.

In fact, we've already recovered from the drawdown and have established multiple new highs in 2024 on the back of stocks like Nvidia and Microsoft.

The chart below illustrates the number of days since the S&P 500 has experienced a drawdown of -2% or more:



The S&P 500 has gone 377 days without a selloff of 2.05% or more, which is the longest period since the Great Financial Crisis.

CNBC

The current streak of consecutive trading days is noteworthy and is reflected in the previous VIX chart. *The volatility of the VIX index itself is compressed relative to history.*

Think about a rubber band that is being stretched. We don't know how much further the current streak can continue, but if history tells us anything, when a streak with this duration snaps, it won't likely be a one-day event but a prolonged period of heightened volatility.

The most recent example was 2017-2018. In the first year of Trump's presidency the S&P 500 delivered very attractive risk-adjusted performance. Volatility, as measured by the VIX, traded well below its average for the entire year. The market finished 2017 higher by 21%.

Then, in 2018, the Fed hinted that they might need to raise interest rates and investors sounded the alarm. The S&P 500 subsequently dipped -20% and the VIX, which had been dormant, suddenly exploded. The Fed eventually pivoted and the S&P 500 surged into 2019.

The point we're making is that it seems we're currently in a period of complacency and it won't last. We don't know when it will end but when it does, investors will have an opportunity to take advantage of a possible dip in the broader market. Stocks that fundamentally look attractive but seem expensive (e.g., they trade at elevated P/Es relative to expected earnings growth) could suddenly be on sale. That's when long-term investors can take advantage of a buying opportunity.

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Q: Are small cap stocks poised for a breakout?

While there are many reasons to answer "yes" that I will elaborate on, I would still be surprised if small cap stocks see a surge in performance over the next 12 months. Small cap stocks are attractive from a valuation standpoint, trading at a significant discount to their large cap peers after 13 years of relative underperformance. Small caps representation in indices is at historically low levels suggesting they should rise relative to large caps. However, as noted in the Introduction of this report, my expectation is that rates are going to remain elevated longer than most economists are predicting, and small cap stocks are historically more susceptible to rising rates. Small companies carry higher debt to revenue levels on average and have a more difficult time accessing public market debt to refinance maturing debt. Many small cap companies have to rely on bank loans and private credit to finance their operations at a significantly higher borrowing costs compared to large companies who can issue investment grade bonds. Higher borrowing costs elevate overall risk for small caps and reduce earnings. Even though small cap stocks are flat for the year compared to large caps being up 15%, I do not expect them to materially narrow that gap in the foreseeable future. Small cap stocks are also generally viewed as riskier so the expectation of a "risk-off" period does not bode well for them.

It's understandable why investors are generally frustrated with small capitalization stocks. The S&P 600 Index, which measures the performance of companies with a market capitalization of less than $10 billion, has underperformed the mega-cap S&P 500 Index by roughly -35% over the past three years on a cumulative basis. Furthermore, small capitalization stocks generally exhibit higher volatility than their larger size counterparts. As a result, investors have realized greater volatility with lower returns by allocating to smaller sized companies. Recent performance has been discouraging, but investors should consider the market forces that influence the long-term performance of small capitalization stocks.

In general, smaller sized companies are more susceptible to the business cycle than larger capitalization stocks. Higher interest rates are a particular headwind for smaller companies. Conversely, when economic conditions are more favorable, small capitalization stocks can deliver outsized returns. Consider 2003 through 2007, the period between the dot.com and sub-prime recessions. The S&P 600 Index outpaced the S&P 500 Index by roughly 20%. Likewise, from 2009 through 2019, the period between the financial crisis and COVID, the S&P 600 Index outpaced the S&P 500 Index by roughly 120% on a cumulative basis. Investors should be patient with their small capitalization allocations. It might pay off in the long run.

Q: What are the market implications of a Biden vs Trump rematch?

While millions of Americans very much care about who the next President is, I do not believe the markets give a rip. The naysayers in 2016 that suggested the economy and markets would implode if Trump was elected were soundly discredited as both the economy and stock market performed exceptionally well until COVID. If anything, I think a majority of people dread the fact that the next generation of political leaders, on the left and right, have not assumed greater levels of responsibility and leadership.

If I were to venture a guess, I would say Trump is likely to win in November. The reasons are many but focus on how well Trump seems to have growth his base of support from 4 years ago. Trump is polling among minority voters at levels not seen before. A recent poll showed 22% of black voters favoring Trump compared to just 9% of black votes received in 2020. Biden's support from black voters dropped from 89% in 2020 to just 69% in the poll. The data with Hispanic voters shows similar increases in support for Trump. The political left is more divided this year than in prior years, highlighted by the differences of opinion regarding the Israel-Hamas conflict. Democrats have also historically relied upon young voters in elections and that group has been hardest hit by higher rates and inflation making them dissatisfied with the status quo.

This election cycle is somewhat unique in that we know how the market performed under both Trump and Biden. Looking at the S&P 500 Index from 2017 through 2020, stocks gained a cumulative 80% including dividends. The period covered rallies in 2019 and 2017 and the drawdowns of 2018 and 2020. Likewise, the S&P 500 Index has gained roughly 53% from 2021 through today under the Biden administration, which includes the rally of 2021 and the pullback of 2022. The market continues to reach new highs this year. So, combined, the S&P 500 Index is up about 170% compounded since 2017, or about 14% annualized.

The results are impressive considering everything we've been through since Trump was first elected. We've been through a roller coaster of sorts with periods of relative calm (e.g., 2017 and 2024 to-date) and periods of instability (e.g., 2020 and 2022). These opposing scenarios have occurred equally under both administrations, so I'm not sure that having a rematch between Trump and Biden really matters much for the overall market. It's not clear to me that investors favor one candidate over the other with respect to return expectations for their portfolios. A Trump election won't change Nvidia's or Microsoft's profitability, just as a Biden administration won't dictate Federal Reserve policy concerning interest rates.

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