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Quarterly Review and Outlook

With inflation moderating, corporate earnings rising and the Fed prospectively lowering rates later this year, the stock market advanced to a record high in June. Other factors supporting the advance have been a strong labor market and healthy economy. The rally, which started last fall, was sparked when the Federal Reserve pivoted from a restrictive monetary policy to one of prospective easing based on moderating inflation trends. On a total return basis, the S&P 500 index registered a gain of 4.3% in the second quarter and 15.3% for the first half of the year. Performance has been concentrated in the larger capitalization stocks of the index. The top ten stocks of the S&P 500 by market cap - Microsoft, NVIDIA, Apple, Amazon, Google (includes both share classes), Meta, Berkshire Hathaway, Eli Lilly and Broadcom - accounted for ~77% of the market's year to date return. This implies that the remaining 490 stocks in the S&P 500 index generated a year-to-date return of ~3.5% on average.

A solid job market, healthy economy and growing corporate earnings have been supportive factors for the market's rise. Strength in the job market is reflected in the unemployment rate which has remained below 4%, an historically low level, for the last three years. The U.S. economy, which grew at a 1.3% annualized rate in the first quarter, is expected to pick up to a growth rate of ~2.5% in the second quarter. The combination of these two factors has resulted in a positive outlook for corporate earnings. After posting flat growth last year, earnings for the S&P 500 index are projected to increase about 11% this year and 14% next year. This year's earnings rise is expected to be led by the technology and healthcare sectors.

Another supportive factor for the market has been the continued moderation in the rate of inflation. The Consumer Price Index (CPI) has decelerated from a peak of 9% year over year in June 2022 to a current rate of 3.3% on a reported basis and 3.4% on a core basis (excluding food and energy). While the current level is still above the Federal Reserve target of 2%, the downward trend is favorable. Another measure of inflation, which is preferred by the Fed, is the Personal Consumption Expenditures Deflator (PCED). This index grew at a 2.6% year over year rate in May, the lowest rate of increase since March 2021. Of note, the rate of inflation associated with goods (vs. services) is already running below 2%... the recent reading was 1.9%. The sub-component that is keeping the overall rate of CPI inflation higher than the Fed's target is a measure called homeowner's equivalent rent which captures the rental value of one's home. It comprises about one third of the CPI index. Homeowner's equivalent rent is currently running at a 5.4% year over year rate, which while high, is at its lowest level in two years. This inflation measure is expected to continue to decelerate as housing and rental prices cool. Helping to keep overall inflation on a downward trajectory has been a rise in productivity - higher output per worker. The use of technology, including newly developed artificial intelligence (AI) applications, has helped boost productivity by making companies more cost efficient. Given these factors, we believe the overall rate of inflation will continue to moderate and possibly approach the Fed's target level sometime next year.

Interest rates in the second quarter were in a holding pattern as the Federal Reserve maintained status quo in its monetary policy, keeping the Federal funds rate at its 5.25-5.50% target level. The yield on 10-year US Treasury securities traded in a range between 4.25-4.75%. The Fed has indicated that before lowering rates it would like to see more data to gain sufficient confidence that the improved trends in inflation are sustainable. Following the most recent FOMC meeting, Fed Chairman Jerome Powell acknowledged that modest progress had been made toward moving closer to the Committee's 2% inflation objective." However, he also made it very clear that they do not want to cut rates too soon and risk reigniting inflation.

In terms of future prospective rate reductions, the Fed's "dot plot" (Fed members assessment of future interest rates) has a median forecast calling for one interest rate cut later this year. This compares to forecasts at the beginning of the year which called for up to six to seven rate cuts. Current strength in the job market and the economy has allowed the Fed to take its time in reducing rates. Meanwhile, in Europe, both the Swiss National Bank and the European Central Bank have already cut interest rates reflecting the region's weak economic conditions.

A strong job market and healthy economy, in conjunction with positive earnings growth, moderating inflation and the prospect of the Fed cutting interest rates, presents a constructive backdrop for the stock market, so we continue to favor equities in the current environment. Within this positive outlook, we are also keenly aware that the Presidential election cycle and its associated rhetoric could cause some market volatility. We are also cognizant of the high level of investor bullishness, which sometimes is a negative contrary indicator. That said, the longer-term outlook remains positive. Within that constructive market framework, we continually assess our equity holdings to assure that fundamental expectations are being met. We also keep our eyes out for new ideas that meet our investment parameters and offer the prospect of long-term capital appreciation. Our approach is to invest in companies with competitive advantages, superior growth rates and strong management teams. In terms of investment focus, we favor the technology, healthcare, industrials, specialty financial and select consumer sectors.

With respect to the fixed income sector, we see our bond holdings as complementary to our equity holdings given their income generation and volatility dampening attributes. We continue to find attractive yields in the short-term market and have selectively extended maturities to lock in interest income streams for longer duration. Our focus remains in higher quality securities as the risk/reward is not warranted reaching for yield in the riskier parts of the credit market. Municipal securities are also considered in taxable accounts if their yields are attractive vis-a-vis those offered on comparable taxable bonds.

As always, we are grateful for your support and encourage you to reach out to us with any questions or concerns you may have regarding your investments or portfolio structures.