PENOBSCOT
FINANCIAL ADVISORS

# MARKET COMMENTARY

Q2 2024

## MARKET REVIEW

In the second quarter of 2024, the U.S. economy continued to demonstrate resilience, achieving a stable GDP growth rate of approximately three percent.  This growth was primarily fueled by strong consumer spending and significant investments in technology and infrastructure.  Consumer confidence remained high, bolstered by a healthy job market and wage growth, which in turn supported retail and service sector performance.  Additionally, government initiatives aimed at modernizing infrastructure and promoting green energy further contributed to economic expansion.

Political uncertainty surrounding the upcoming presidential election in the United States significantly contributed to market volatility in the second quarter of 2024.  Concerns over potential shifts in economic policies, regulatory changes, and trade relations created a sense of caution among investors.  This uncertainty led to fluctuating stock prices, particularly in sectors such as healthcare, energy, and finance, which are highly sensitive to policy changes.  As candidates proposed divergent economic agendas, market participants remained wary, resulting in increased volatility and a cautious investment environment.

Inflation remained a central concern in the U.S. during this period.  Although there was a slight moderation compared to the previous quarter, inflation rates continued to exceed the Federal Reserve's target.  Key contributors to this persistent inflation included elevated energy prices and ongoing supply chain disruptions affecting various goods.  In response, the Federal Reserve maintained a cautious stance on monetary policy, balancing the need to curb inflation with the goal of sustaining economic growth.  This approach included gradual interest rate adjustments and continued monitoring of economic indicators.

The U.S. financial markets reflected the broader economic conditions, exhibiting notable volatility throughout the quarter.  The technology sector continued to perform exceptionally well, driven by strong earnings reports and investor optimism about future growth prospects.  Green energy stocks also experienced significant gains, buoyed by increased government support and rising demand for sustainable energy solutions.  Conversely, traditional sectors such as retail and hospitality faced pressures from inflation and changing consumer behaviors, leading to mixed performance in these areas.

On the global stage, the Asia-Pacific region stood out with robust economic growth.  China's economy expanded by six percent, fueled by a resurgence in manufacturing and increased consumer confidence.  India, too, demonstrated strong growth, with its GDP rising by over seven percent, driven by advancements in the services sector and substantial foreign direct investment.  Meanwhile, Europe experienced mixed results; Germany and France maintained steady growth due to strong industrial production and exports, while Southern European countries faced ongoing fiscal challenges and high unemployment rates.  Global financial markets experienced volatility, with U.S. stocks fluctuating and Asian markets, particularly in China and India, seeing substantial gains.  Commodity markets were marked by price swings, with oil prices rising due to production cuts by major producers and increased demand for precious metals as a hedge against inflation.

# LOOKING FORWARD

## ARE SMALL CAPS POISED TO CATCH UP?

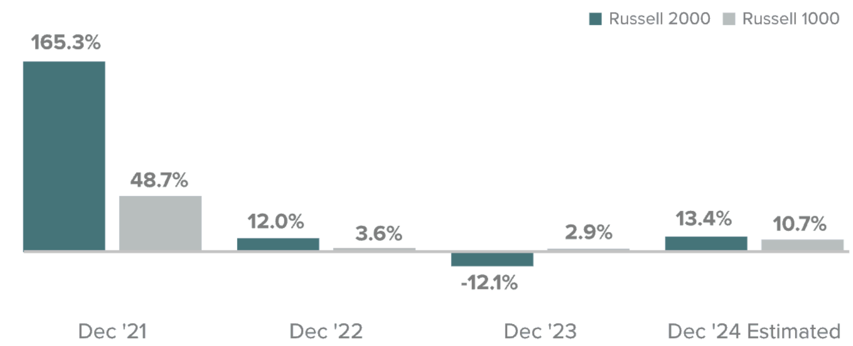
Second quarter performance in stocks was driven largely by some of the largest technology companies. This reflects a trend that has continued over the past 12-18 months. Outside of these few 'mega-cap' stocks, performance of the remaining stocks has been less impressive. This trend can be seen in action over the second quarter, both domestically and internationally. Market-capitalization-weighted indexes like the S&P 500 and the MSCI All-Country World Index turned in gains during the quarter, while the *average* stock making up those indexes (represented by the 'equal weighted' version of each index) had negative returns for the same period.


Source: Charles Schwab, Bloomberg data as of 7/1/2024

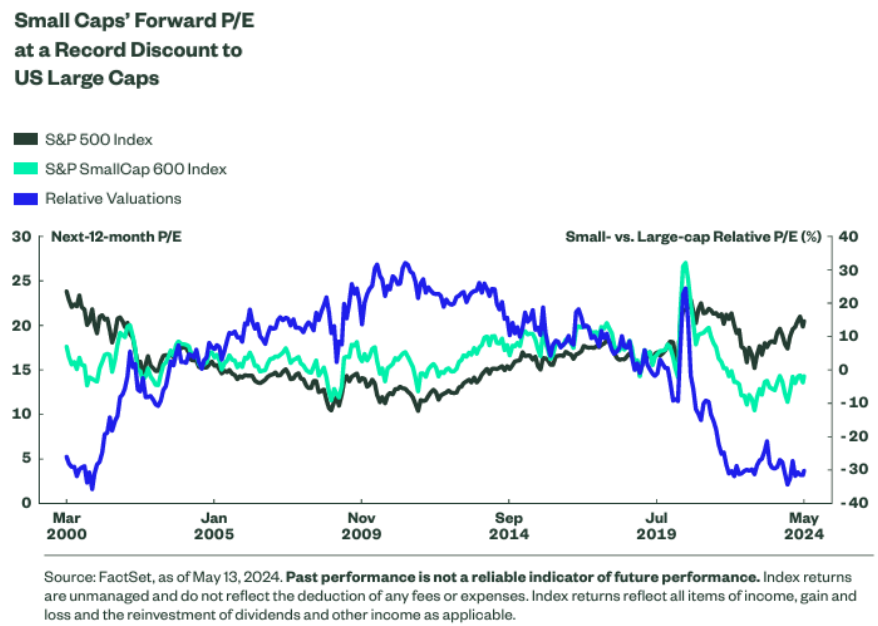
Market gains are more and more concentrated in these few huge companies, while the remaining components of the S&P 500 and the smaller companies that comprise the S&P 600 index continue to lag in price performance. Importantly, however, earnings on smaller companies are expected to rebound, resulting in a nearly unprecedented disparity in valuation. Price-to-earnings ratios on the S&P 600 are at a record discount relative to the larger-cap S&P 500.

Considering the higher long-term average returns on small-cap stocks, this kind of disparity in valuation levels may signal an opportunity for investors looking to diversify out of heavy concentration in large and mega-cap stocks.

**Small-Cap's Estimated Earnings Growth Is Expected to Be Higher in 2024 than Large-Cap's**
1-Year EPS Growth as of 6/30/24




Source: Royce Investment Partners 2Q24 Small Cap Recap

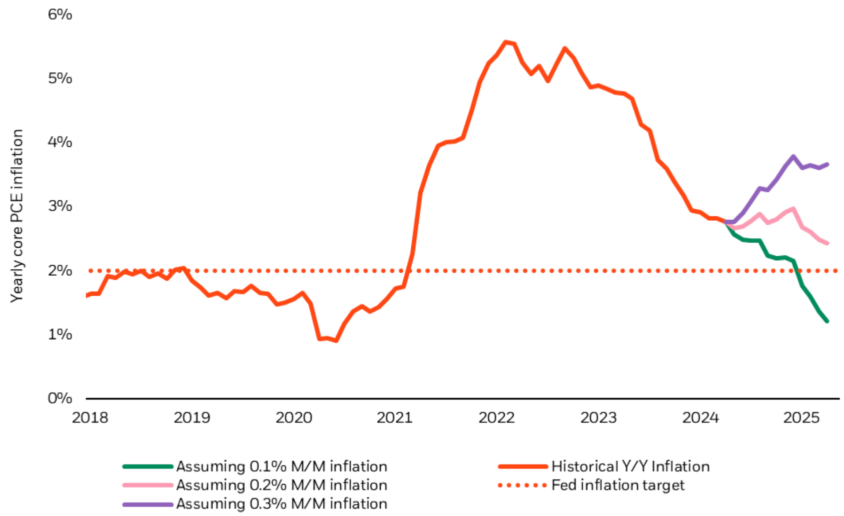



Source: Charles Schwab, Bloomberg data as of 7/1/2024

## INFLATION: THE LAST MILE

The past two years have marked good progress being made on the inflation front. While Fed governors will typically remind us that inflation can flare up again at any time, there is growing consensus that much of the fuel for hyper-inflation has dried up.

We'll be watching this closely. Core PCE inflation is the measure preferred by the Federal Reserve. Looking forward, month-over-month movements of 0.1% could push yearly inflation below the Fed's target 2% in the upcoming year. However, higher month-over-month movements could substantially lengthen the time we have to wait to reach the Fed's goal (or even begin to drive inflation up once again).



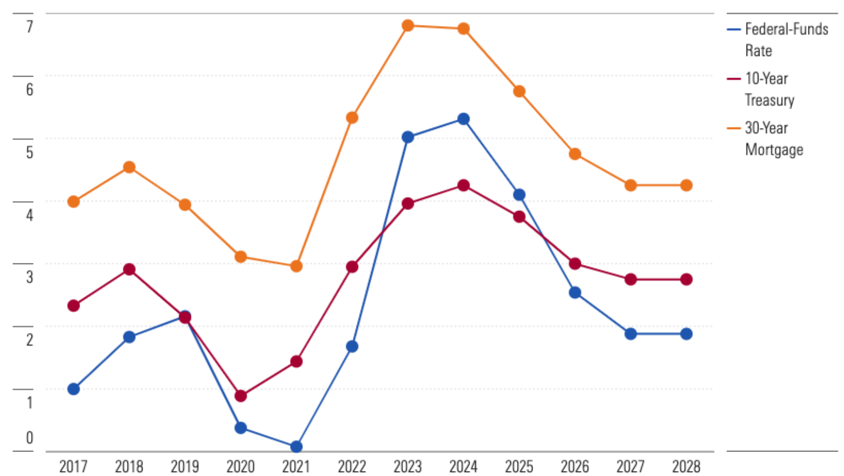

Given their data dependency, it is likely that the Fed will be cautious with rate 'normalization'. Expectations in late 2023 were up to six rate cuts during 2024. Now, only about two such cuts are priced into market expectations. Outside the need to rescue the economy from a recession, we see little likelihood that the FOMC is in any rush to 'normalize' rates. In fact, looking through the lens of the 21st century, interest rates, while certainly higher than recent trends, are not even near historical levels.

**US Interest Rates**


Federal Reserve, Morningstar Data as of Jul 11, 2024.

Still, following guidance from the FOMC, it would not be unreasonable for home buyers to hope to see 30-year mortgage rates in the 5's next year and the 4's by late 2026. A combination of aggressive home-building, normalizing housing inflation AND more affordable mortgage rates could be tremendous news for would-be homebuyers.

**Interest-Rate Forecasts (Annual Averages)**




Federal Reserve, Morningstar Data as of Jun 27, 2024.

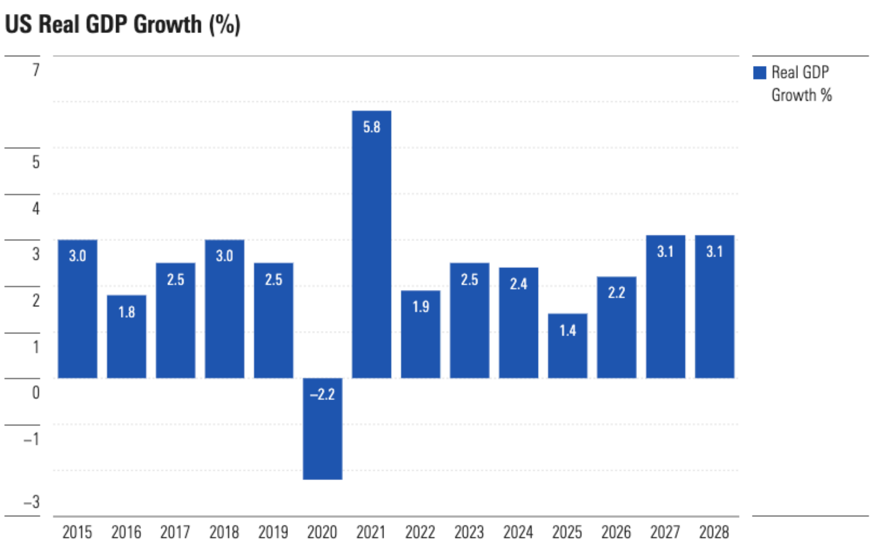
## SOFT LANDING: MISSION ACCOMPLISHED?

Importantly, the FOMC is not solely charged with the task of keeping inflation low. Price stability and full employment are competing forces the Fed must navigate.

Past Feds have used monetary policy to prop up floundering economies and to quell overheating inflation. Both dynamics have played out clearly over the past four years. Slashing interest rates and easing monetary policy helped to end the COVID-era recession – but combining with the supply chain issues also caused by the pandemic, these policies were complicit in the inflation spike that followed.

Fighting that inflation with higher interest rates and tighter monetary policy has seemingly worked as well. Now, the Fed looks back to plenty of examples where overtightening has led to recessions, while letting off the 'brake' too quickly has allowed inflation to re-ignite. There is a very little, if any, space to both bring inflation under control and not tank the economy.

So, which will it be this time? It's still early to say, but more economists are climbing aboard the narrative that the Fed may be successful in achieving the elusive 'Soft Landing' – where inflation is brought under control, but the economy continues to grow and does not fall into a major recession because of tightening measures being held in place for too long.



Bureau of Economic Analysis, Morningstar Data as of Jul 10, 2024.

## OUR TAKE

For most of the market, the second quarter reflected geopolitical and financial uncertainty. Still, market indexes clawed their way forward to end the quarter at or near record highs. This leaves an environment where valuation concerns start to take center stage and the probability of a correction increases. Long-term investors should always be positioned to ride out the occasional correction, especially when it comes about in the context of a broader economic expansion, and we feel that the current climate favors continued growth, both domestically and abroad.

While valuations in parts of the market are higher than normal, there are arguably large pockets of value that remain. Concentrating on areas where valuations have become widely dispersed has proven to be prudent during periods like this.

As such, we continue to favor a focus on companies and sectors, both domestically and abroad, where earnings are increasing, and valuations have not been blown out of proportion.

Three themes attracting our attention right now are:

1. The likelihood of rate cuts on the back side of 2024
2. Weakening pressure on the US dollar
3. Near-record dispersion in valuations, with a small number of large companies enjoying nearly all the price action in recent quarters

Considering these factors, we continue to underscore the importance of maintaining a diversified approach that has the potential to benefit from all three themes. This includes a focus on value and quality, diversification into small and mid-cap equities, and areas of the market most likely to benefit from a 'Fed Pivot', such as traditional and high-yield fixed income and private equity. Continued global diversification is also a key focus, in light of relatively low valuations outside the US, and continuing soft-dollar rhetoric coming from both sides of the political divide.