Wealthspire Advisors 2024 Q2 Review

Narrow Path: Different, But Not New

By the Wealthspire Advisors Investment Team

Recap

The consumer, economy, and markets all proved resilient in the recent quarter and year to date. In a new narrative, the larger corporations and wealthier households may benefit from the higher interest rates due to their liabilities largely being fixed when rates were lower and now earning substantially more on the cash they have on hand. Thus, higher rates actually benefit many and propel the economy, not universally stall it as traditional thinking goes. The long-anticipated recession has thus far failed to materialize, and the Fed has not begun to lower the rate they explicitly control, Fed Funds rate. At the beginning of the year, fixed income markets were factoring in more than six cuts by the Fed this calendar year; now the market anticipates less than two.

The stronger than expected economy has thus supported equities and the more risk-sensitive fixed income sectors. Equity markets were again led by a small group of U.S. large cap growth stocks as smaller cap and non-U.S. stocks lagged. Fixed income performance was bifurcated between the more interest rate-sensitive "core" vs. the riskier "satellite." Core was rangebound during the quarter while satellite continued to generate strong returns. With the yield curve inverted for two years now (longer-dated yields lower than shorter-dated yields), the fixed income market seems to be in a tug of war in resolving the inversion - will the economy soften and finally allow the Fed to lower short-term rates? Or will its continued robustness and the slowing progress on inflation result in bond holders demanding higher long-end yields?

Warning Signs?

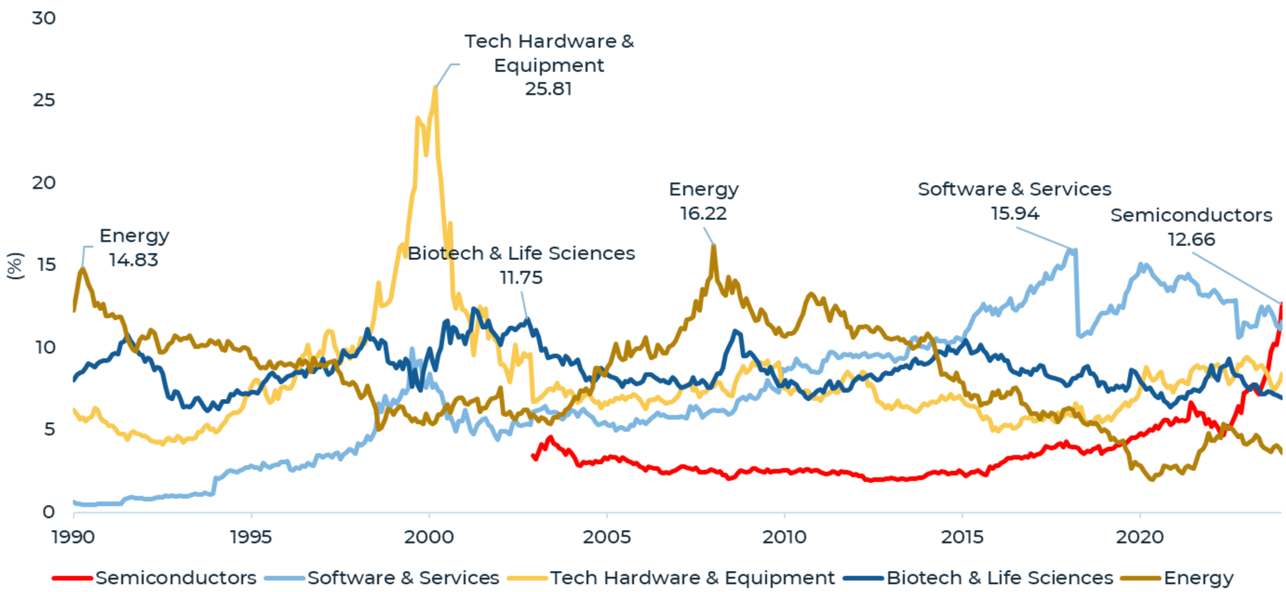
A prominent theme this quarter has been the continued outperformance of large cap growth stocks and in particular standout performer, NVIDIA Corporation (NVDA). The stock soared over 36% in the second quarter and now a jaw-dropping +150% YTD, driven by its leadership in artificial intelligence (AI) and data center markets. NVIDIA's cutting-edge graphics processing units (GPUs) have become essential for AI applications, positioning the company at the forefront of a transformative technology wave. Despite the overall strength in equity markets, the rally's narrow breadth has raised some concerns. A significant portion of the gains has been concentrated in a handful of large cap growth stocks, leading to questions about the sustainability of the current bull market. This narrow participation has led many to question whether the broader market may not be as healthy as headline indices suggest. Numerous representations of the narrowness of the market have been circulated, and they generally show today's narrowness only matched by prior periods also associated with equity market tops.

We would remind readers that market concentration is not new. In the 1950s, when AT&T, GM, and DuPont reigned supreme, the top 10 names were a larger proportion of the S&P than any time during the Tech Bubble. In the mid-1960s, things got even more concentrated with the top 10 names at one point making up more than 30% of the S&P with AT&T, GM, and IBM in the top 3. Although more volatile, broad markets managed to generate robust returns over subsequent decades despite the concentration. And lest this be considered a U.S.-only phenomenon, smaller country markets often tend to be even more concentrated. France and Switzerland's top 10 respective names make up more than 50% of those markets. All this to say that concentration of the top 5 or 10 stocks alone, does not a top make.

More important are the fundamentals that back these companies and whether their size and price are disproportionate to their ability to earn money. The top 10 are trading at a 30x P/E multiple vs. 18x for the other 490 names in the S&P 500. Part of that is earned. These companies are generating 25% of the earnings of the S&P and even more of the earnings growth. The valuations are also better than what we saw during the Tech Bubble (top 10 north of 40x P/E). That said, one shouldn't measure reasonable valuations by previous peaks. This is where some concern is warranted, and diversification can help.

We would further remind readers that just as companies rise and fall, so do industries. With a continued focus on diversification, you will be more immune to today's hot sector falling out of favor and participate in tomorrow's riser.

S&P 500 Industry Group Weights



Source: Bloomberg Finance L.P. (data as of 6/20/24)

Fixed income markets are not without their own warning signs. While the absolute level investors can earn in many sectors has reached multi-year highs, these levels are a result of the rise in the base interest rates (Treasury). All other fixed income asset classes also consider a spread on top of Treasuries that investors demand for the incremental risk taken. These spreads are currently very low or "tight," suggesting investors are earning historically little for taking on the added risk.

Artificial Intelligence

While NVDA is the poster child for AI-influenced investing, we share two anecdotes to capture the potential breadth of AI's impact. Klarna, an online e-commerce platform, announced that AI was already 1) performing two-thirds of its customer service chats, 2) with similar customer service scores, 3) more accurately than humans, and that in aggregate, 4) their AI program was doing the work of 700 full-time employees.[i] Separately, JP Morgan announced it would begin charging for an AI tool that assisted 2,500 of its corporate clients around cash flow predictions, reducing the manual labor previously required by 90%.[ii] Even the oldest of old school industries - energy - has seen its prospects improve with AI as the amounts of power needed to drive the data centers at the heart of AI suggest a material increase is needed.

This is not to suggest you should be trying to pick AI winners. Rather, if you had been a long-term owner of the S&P 500 in a fund or ETF, you would've in fact benefited from its holding of say NVDA, rising from a miniscule weight of .10% in 2009 to its lofty 7% today. Similarly, staying diversified likely will allow you to capitalize on today's unknown company that becomes tomorrow's AI darling as well as those industry stalwarts that develop an AI angle that captures significant market share.

As we move into the second half of the year, we thus remind clients to resist the temptation to ask, "Why would I invest in anything but NVDA?" or "anything but U.S. large cap growth stocks?" We will always recommend staying diversified and point out that every time a stock or industry becomes the subject of such a question, a period of relative underperformance is likely ahead. In addition, our long-term Capital Market Assumptions continue to support equity diversification. Finally, the Presidential election will come further into focus, and we will be hosting sessions with Washington insiders over the coming months. We hope you have a good rest of the summer.

Markets

Higher Return ↑ / Lower Return ↓

Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD 2024
US LC 1.68	US SM 5.44	US SM 4.13	ALTS 0.88	US LC 4.96	EM MKTS 3.83							US LC 15.29
ALTS 0.98	US LC 5.34	US LC 3.22	EM MKTS 0.67	US SM 4.16	US LC 3.59							EM MKTS 7.41
HEDGE EQ 0.66	EM MKTS 4.46	INTL 3.09	HEDGE EQ -0.80	INTL 2.95	STOCK/BOND 1.58							STOCK/BOND 5.86
STOCK/BOND 0.00	INTL 2.32	EM MKTS 2.12	MUNI -0.87	STOCK/BOND 2.23	HEDGE EQ 1.21							INTL 5.28
FIXED INC -0.27	STOCK/BOND 2.54	STOCK/BOND 1.89	INTL -1.75	FIXED INC 1.70	MUNI 1.13							HEDGE EQ 5.12
MUNI -0.34	HEDGE EQ 1.36	HEDGE EQ 1.35	STOCK/BOND -2.43	HEDGE EQ 1.25	FIXED INC 0.95							ALTS 4.85
INTL -1.09	ALTS 1.36	ALTS 1.48	FIXED INC -2.53	ALTS 1.18	ALTS 0.07							US SM 2.35
US SM -2.62	MUNI 0.07	FIXED INC 0.92	US LC -4.08	EM MKTS 0.58	INTL -0.23							FIXED INC -0.71
EM MKTS -4.23	FIXED INC -1.41	MUNI -0.11	US SM -6.70	MUNI -0.66	US SM -1.50							MUNI -0.77

LEGEND

US LC	Domestic Large Cap
US SM	Domestic Small-Mid Cap
INTL	International
EM MKTS	Emerging Markets
ALTS	Alternatives
FIXED INC	Taxable Fixed Income
MUNI	Tax-Exempt Fixed Income
STOCK/BOND	60% Global Stock/40% Muni
HEDGE EQ	Hedged Equity

Source: Morningstar and Bloomberg Finance L.P. (data as of 6/30/2024)

- A broad benchmark of U.S. equity performance, the Russell 3000 index, rose nearly 3% in Q2 and is now +13% YTD. The narrower S&P 500 index rose by even more (+4% in Q2), continuing the momentum seen earlier in the year (+15% YTD). Technology stocks in particular played a significant role in driving the market higher. The NASDAQ Composite is now up over 18% YTD. However, this rally was not broad-based, as gains were concentrated in a few mega-cap stocks. International stocks trailed U.S. with the MSCI ACWI ex U.S. index up a more pedestrian +6% YTD.
- In fixed income, the Bloomberg Aggregate index rebounded from its YTD lows in late April but still sits negative on the year (-.70%). The U.S. Treasury yields were relatively stable, with the 10-year Treasury yield ending the quarter near where it began at approximately 4.30%. After rising 70 basis points (.70%) through the first four months of the year, the 10-year yield fell 40 basis points, providing a tailwind to these fixed income returns. Satellite fixed income's high yield bonds (+2.5%) and leveraged loans (+4.4%) have both outpaced core fixed income YTD.
- Elsewhere, commodities were positive in Q2 but with mixed drivers. Grains fell, oil was flat, while metals (precious and industrial) closed higher. Private credit continued to chug alongside liquid satellite fixed income thanks to high coupons and tightening spreads. Private real estate held up slightly better than public REITs, though both are lagging equities year to date as the industry copes with higher borrowing costs and reduced transaction volume. Private equity market dynamics are idiosyncratic by manager, stage, and industry. That said, fund closure and exit activity has slowed over the past few quarters, resulting in dry powder now approaching $1 trillion.

[i] Source: https://x.com/kukreja_abhinav/status/1762710837565764060
[ii] Source: https://www.bloomberg.com/news/articles/2024-03-04/jpmorgan-s-ai-aided-cashflow-model-can-cut-manual-work-by-90