Q2 2024 Commentary

July 2024

"Success is not about being the best, but about being better than you were yesterday."

Bernard Arnault

Q2 Market Recap

U.S. economic data continues to show signs of moderate growth. Investors are 'all-in' on stocks, sentiment is high and interest in hedging is low. Quarterly earnings should offer more guidance on the health of the consumer and corporate America, but overall, the trend looks positive. The S&P 500 was up over 4% in Q2, led by large caps and technology. Similar to last quarter, growth beat value and small caps underperformed. Foreign stocks were flat while emerging markets gained 5% for the quarter. Interest rates were volatile but ended the quarter largely unchanged. Bonds treaded water as the Federal Reserve patiently waits for inflation to moderate further before cutting interest rates. Private credit and junk bonds continued to outperform investment grade bonds as credit spreads narrowed.

Asset Class	Benchmark	Q2 2024	YTD
U.S. Large Cap Stocks	S&P 500 TR USD	4.3	15.3
U.S. Small & Micro Cap	Russell 2000 TR USD	-3.3	1.7
Intl Dev Stocks	MSCI EAFE NR USD	-0.4	5.3
Emerging Mkt Stocks	MSCI EM NR USD	5.0	7.5
Global Stocks	MSCI ACWI NR USD	2.9	11.3
U.S. Municipal Bonds	Bloomberg Municipal TR USD	0.0	-0.4
U.S. Taxable Bonds	BBgBarc US Agg Bond TR USD	0.1	-0.7
U.S. High Yield Bonds	BBgBarc US Corporate High Yield TR USD	1.1	2.6
Intl Dev Bonds	S&P International Sov Ex-US Bond TR USD	-3.1	-7.3
U.S. REITs	MSCI US REIT NR USD	-0.2	-0.8
Broad Commodity Futures	Bloomberg Commodity TR USD	2.9	5.1
Energy Partnerships	Alerian MLP TR USD	3.4	17.7
Gold	DJ Cmmdty Gold TR USD	4.9	12.7

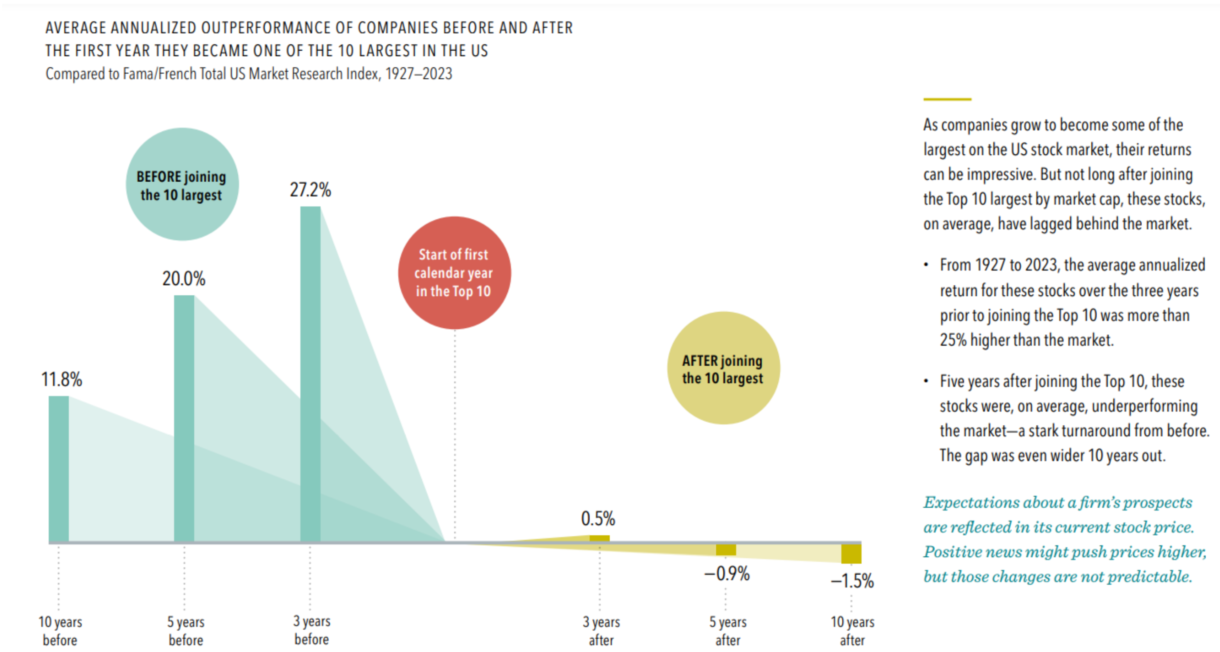
Source: Morningstar as of 6/30/2024

Corporate earnings are expected to rebound in the second half of 2024 and 2025, led by communication services, health care, information technology, and energy sectors. While there continues to be a disconnect between survey-based 'soft' economic data and 'hard' economic data, the positive trend continues to drive stock markets higher. Many companies are trading at premiums relative to their historical valuations. U.S. stocks either need positive earnings surprises to justify current valuations or investor sentiment needs to continue to support above-average valuations for outsized returns to continue. Both are possible given the unusual policy backdrop in the U.S. Meanwhile, risks are still on the horizon. Continued global geopolitical conflicts and shifting political preferences may create uncertainty and increased volatility for investors.

Stock Market Leadership

Nvidia remains the stock market's darling with nearly 100% of Wall Street analysts assigning a buy rating to the company. Nvidia's remarkable earnings growth and stock price performance has vaulted the company to be one of the most valuable publicly traded stocks in the world. Many investors who missed this run up are eager to invest and enjoy continued growth. However, history tells us new investors should temper their enthusiasm.

The largest companies have historically been unable to sustain outsized stock returns at scale. As seen on the chart below, stock performance for companies who eventually became one of the 10 largest in the U.S. was impressive and significantly higher than the market. Subsequent 3-, 5-, and 10-year performance underwhelmed investors and underperformed the market.



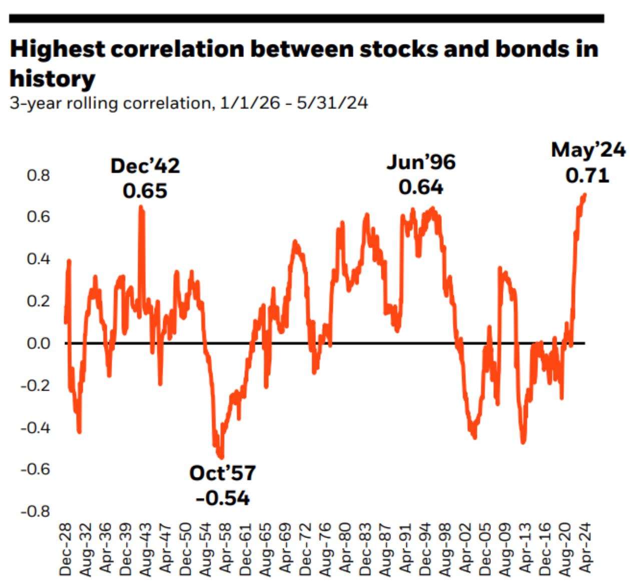
Source: Dimensional Fund Advisors

Why is this? Largely because expectations about a company's growth rate is already reflected in the current stock price. On the way up, positive earnings surprises help push prices higher, but this becomes difficult to sustain at scale. That said, current market leaders such as Apple, Microsoft, Nvidia, Google, and Meta continue to reinvent themselves and are challenging this performance trend.

Record Stock and Bond Correlation

Over the past few decades, investors built portfolios based on the premise that stocks and bonds largely moved in different directions – which they did. However, this trend has reversed in our higher interest rate environment as stocks and bonds no longer show a negative correlation. In fact, stocks and bonds are at their highest 3-year rolling correlation in history.

What does this mean for today's investors? Investing in assets that provide different return and risk profiles is essential. Liquid alternative strategies such as equity long/short and managed futures can help diversify portfolios. Private market assets including private equity, private credit, and private real estate may be able to help as well.



Source: Blackrock Student of the Market June 2024

Confusing Economic Signals

Many popular economic signals appear to be losing predictive power. One of the most popular, the Conference Board's Leading Economic Index, has been signaling a potential economic contraction for almost two years. Encouragingly, this index recently emerged from a recession warning signal. Predictably, economists and market strategists' accuracy rates have declined which may be confusing investors.

Economic data can be contradictory. Take for example, the NFIB Small Business Optimism index which remains far below long-term averages while CEO confidence is high and rising. Or look at the bleak housing starts data from last month relative to robust and growing fixed infrastructure investment. For every negative economic datapoint, there seems to be offsetting data pointing towards continued growth.

Growing or slowing?

Negative Signal	Comments	Positive Signal	Comments
NFIB Small Business Optimism Index	5-month high but below long-term average	CEO Confidence	Optimism following 2 years of pessimism
The Conference Board Leading Economic Index	Negative six-month growth rate	Coincident Economic Indicators	New records since July 2021 (The Conference Board)
Citi US Economic Surprise Index	Negative, lowest level since Q3 2022	Philadelphia Fed's Coincident Index Rising	Continued growth post pandemic
US GDP Growth	Lowest quarterly growth (+1.4%) since Q2 2022; level of spending remains robust	US GDP Growth Estimates	2024 and 2025 estimates increased YTD
Regional PMIs	4 of 5 regional manufacturing indexes are in contraction territory	Global Manufacturing & Services PMI	Manufacturing growth rebounding
Housing starts	-19.3% year over year decline	Fixed Investment	Strong infrastructure investment with large backlog of new projects planned
Tech sector employment	Approaching >500,000 cumulative layoffs	U.S. Unemployment Rate	Low @ 4% nationally, vacant jobs > job seekers

Source: Various • Get the data • Created with Datawrapper

Consistent with earlier Private Capital Management commentary, we've observed pockets of weakness in various industries within a moderately growing economy. Certain stocks and sectors remain firmly in a bear market, yet diversified investors will hardly notice as megacap technology companies continue to lead major stock indices higher. It has become increasingly important to tune out the day-to-day noise and instead focus on longer term trends when investing.

How to Invest Today

While it is tempting to chase returns, we strongly recommend investors stay diversified to preserve and thoughtfully grow their wealth while avoiding unnecessary risks. Markets often overreact and while AI enhanced productivity is here to stay, excess returns for AI themed stocks may not. Please reach out to your Private Capital Management team with any questions specific to your financial situation. Thank you for your continued trust.

Sincerely,
The Private Capital Management Team

Important Disclosure Information