the 9:05 Bailard's Quarterly Newsletter Q2 2024

Economic Brief: Tyranny of the Few

Jon Manchester, CFA, CFP® (Senior Vice President, Chief Strategist, Wealth Management, and Portfolio Manager, Sustainable, Responsible and Impact Investing) charismatically threads how high food prices and the AI boomlet have produced a "K-shaped" economy and stock market, creating the opposite impact on two populations.

Inside this edition:

Value Ingesting

Civility, alas, has its limits. This is perhaps nowhere more evident than in the cesspools of politics and social media, both playgrounds for the civility-challenged. The discourse devolution predates the pandemic, of course, but stressors have emerged in Covid's shadow. Some clearly fall in the life-or-death category, while others are decidedly less consequential: "Why does Zoom need to update now?" One old and nearly forgotten nemesis, inflation, made an entirely unwelcome return after roughly four decades of dormancy. At its recent peak in mid-2022, the Consumer Price Index (CPI) reached a 9.1% year-over-year (y/y) growth rate. Following rapid improvement over the next 12 months, CPI readings have since settled into the still elevated 3.0% to 3.7% range. This wearying bout with inflation has not been particularly well-received by consumers, nor policymakers. The University of Michigan's Consumer Sentiment Index plunged to an all-time low of 50 in June 2022, half of its pre-pandemic level. In releasing the survey results at that time, University of Michigan's Chief Economist Joanne Hsu noted that, "Inflation continued to be of paramount concern to consumers."[1]

> *The "Misery Index" simply adds the inflation and unemployment rate. The higher the number, the greater the misery felt by citizens. To the extent there is misery, it has come via inflation.*

While it is obviously a stretch to blame rising prices for the ongoing bear market in civility, they do seem to be a piece of the gloominess puzzle. In the 1970s, economist Arthur Okun created the "Misery Index," which simply adds together the inflation and unemployment rates. The higher the combined number, the greater the misery felt by citizens. To this point, the U.S. unemployment

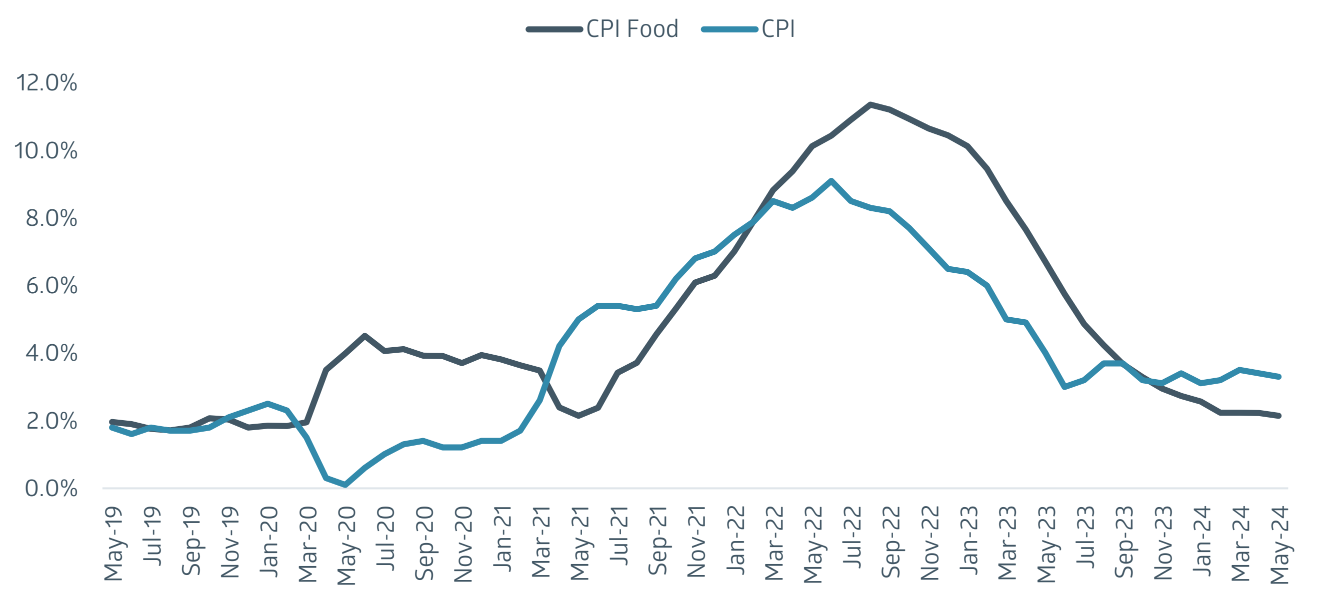
1 "Survey of Consumers," www.sca.isr.umich.edu, University of Michigan. 6/24/22

level has remained rather subdued, at 4% or below since late 2021. To the extent there is misery, it has come via inflation. From a populist perspective, a key source of the inflation angst seems to be elevated food costs. The CPI Food Index crested north of 11% y/y growth in summer 2022 (see chart below), and despite its y/y growth rate decelerating to 2% by May 2024, consumers remain troubled by the unrelenting price hikes.

Although consumer spending has held up in aggregate —Personal Consumption Expenditures (PCE) rose 2.4% y/y, inflation-adjusted in May 2024—companies are sounding cautious, particularly regarding less affluent customers. When Dine Brands Global, the parent company of Applebee's and IHOP, reported earnings in early May, chief executive John Peyton said that lower-income consumers are, "more aggressively managing their check, finding our value-oriented items."[2] That mentality is very familiar to McDonald's, long embroiled in the Burger Wars. Chris Kempczinski, CEO of the Golden Arches, noted in late April that its customers were being, "more discriminating with every dollar" they spent. According to the company, the average price of all of its menu items increased 40% over the last five years, matching the rise in the cost of labor, paper, and food.[3] In June, McDonald's announced their "Summer of Value" campaign, including a $5 meal deal. Joe Erlinger, President of McDonald's USA, acknowledged, "We heard our fans loud and clear—they're looking for even more great value from us..."[4]

These are not isolated price rollbacks. Target announced they would cut prices on approximately 5,000 frequently shopped items, and Walgreens said they would slash prices on 1,300 items. Even upscale Whole Foods lowered prices. This has some analysts convinced a "K-shaped" economy persists, in which the higher-income cohort is on an upwards trajectory, while the lower-income segment struggles to absorb higher costs. Per U.S. Department of Agriculture (USDA) data, consumers spent more than 11% of their disposable income on food in 2022, the highest percentage since 1991.[5] The tide is now turning, and it has impacted certain pockets of the equity markets. Over the first half of 2024, the Standard & Poor's 500 (S&P 500) Food, Beverage & Tobacco industry group returned just 0.1% on a price-only basis.[6]

Consumer Price Index vs. Consumer Price Food Index: Year-Over-Year Changes



Source: Bloomberg. Data through May 2019 - May 2024.

2 "Why Companies Are Nervous About the Consumer," www.nytimes.com, 5/10/24
3 "McDonald's says $18 Big Mac meal was an 'exception' and news reports overstated its price increases," www.apnews.com, 5/29/24
4 "McDonald's Kicks Off Summer of Value Across the US," www.mcdonalds.com, 6/20/24
5 "It's Been 30 Years Since Food Ate Up This Much of Your Income," www.wsj.com, 2/21/24
6 Price-only returns do not include dividend income, only the price changes.

A more cautious consumer is apparent in other areas as well. The S&P 500 Consumer Durables & Apparel group posted a -14.4% price-only return, dragged down by subpar results from retailers Lululemon and Nike.

On Repeat

In theory, the first two quarters of 2024 should have been challenging for growth stocks. The Federal Reserve ("the Fed"), contrary to expectations, did not reduce its Fed Funds target range. At the outset of the year, holding rates steady was assigned a 0% probability for the June 2024 meeting, according to the CME FedWatch Tool. Instead, the futures market expected 75 basis points of rate cuts by now, which would have taken the upper end of the target range down to 4.75%. In addition, the 10-year U.S. Treasury Note yield rose 52 basis points to 4.40%, although it did ease from an April high of 4.70%. Lacking support from lower rates, the sharply higher valuations for growth stocks could have proved problematic. Investors shrugged off these headwinds, however, and continued to bid up any equities deemed a direct or indirect beneficiary of the artificial intelligence (AI) boomlet.

Within the tech-heavy S&P 500 Index, the song remains the same. After comfortably leading the Index last year, the Technology and Communication Services sectors assumed the same positions over the first half of 2024. Similar to last year, a relatively small group of Tech oligarchs are running the show. Chipmaker Nvidia, the current AI kingpin, saw its stock price soar 149%, accounting for approximately 30% of the S&P 500 Index's return alone. The market-cap weighted S&P 500's other five largest stocks (Microsoft, Apple, Amazon, Alphabet, and Meta) contributed another 32%, meaning the top six names generated ~62% of the Index's total first half of the 2024 return. This is a concentrated market, with a K-shaped element of its own—a widening gap between the haves (Tech/AI) and the have-nots (nearly everything else). The S&P 500 Equal Weighted Index returned just 4.1% price-only over the first half of 2024, far in the rearview mirror compared to the S&P 500's arguably artificially inflated 14.5% price increase. According to *Bloomberg*, that is the widest underperformance margin ever for the first six months of the year.[7]

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One of the most famous *Saturday Night Live* skits, More Cowbell, aired in April 2000. The actor Christopher Walken played a fictional music producer, directing a band that included actor Will Ferrell on the cowbell. Walken's character insists the band's song needs one thing: "I've got a fever, and the only prescription is more cowbell!" The market's fixation on AI feels a bit the same, where the intensifying ring of the AI cowbell drowns out nearly all other sound. It has, however, provided a growth story for the equity markets, and investors continue to funnel capital into the theme. By the end of Q2, the S&P 500 hadn't experienced a 2% or worse down day in 340 trading sessions, dating back to February 2023. Expected volatility, as measured by the Chicago Board Options Exchange (CBOE) Volatility Index, continued to drift at a low level in the second quarter. The main complaint might be that more stocks aren't enjoying index-type returns. Equality, admittedly, has never been a strength of the stock market, and probably not a fair aspiration. Yet, with the S&P 600 SmallCap Index down 1.6% price-only year to date, there is a sense that not all engines are firing.

Tea Leaves

In the waning days of the second quarter, the Bureau of Economic Analysis (BEA) reported encouraging inflation data. The core PCE price index, which excludes food and energy prices, increased just 2.6% y/y, its slowest growth rate since March 2021. This may provide some fuel for stocks in the coming months, as traders impatiently await Fed rate cuts. The degree to which this is already reflected in the stock market's overall valuation remains a concern. The so-called (Warren) Buffett indicator tracks

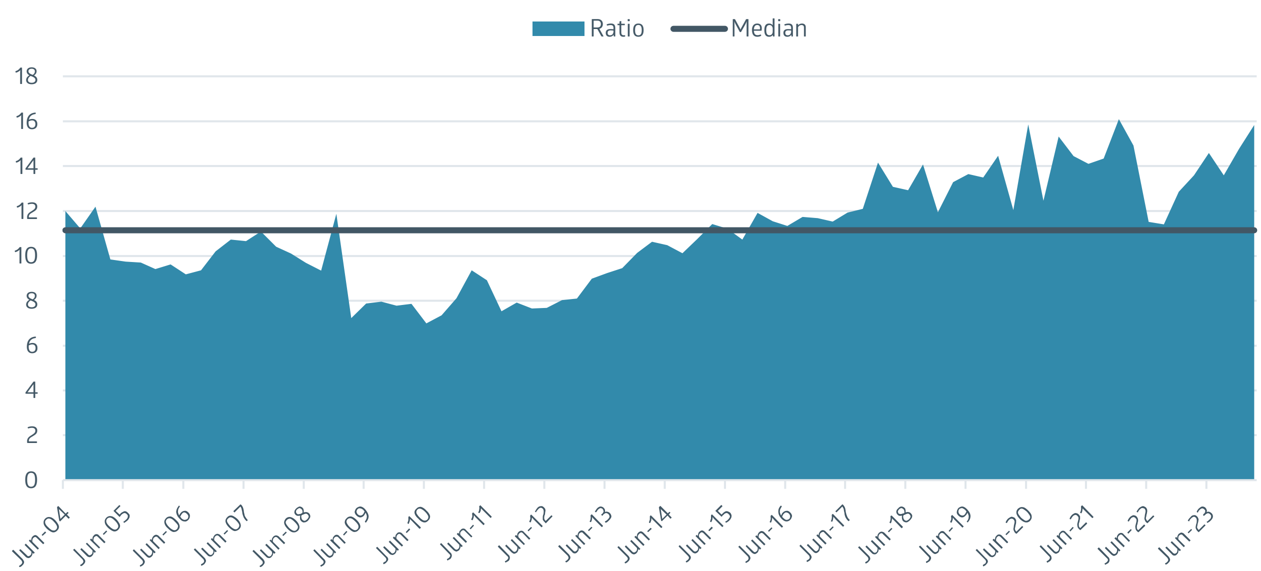
7 *"Where Stock Market Is Headed After Wild First Half: Five Charts," www.bloomberg.com, 6/29/24*

the ratio of the market's total capitalization to Gross Domestic Product (GDP). As a variation on that, the chart below looks at the S&P 1500 Index's total capitalization relative to the Corporate Profits After Tax series.[8] Over the last 20 years, this ratio has averaged roughly 11x, but reached nearly 16x at the end of Q1 2024—very close to its high for this timeframe.

This suggests stocks, in aggregate, remain richly-priced, but obscures underlying pockets of value. Indeed, it could be time for the long-awaited rotation into lower-valued industry groups. One such area, Banks, returned 15% price-only over the first half of 2024—one of just five S&P 500 industry groups (out of 25 total) to outperform the overall Index. Near quarter-end, the Fed announced a passing grade for all 31 large banks included in their annual "stress test" meant to assess how the banks are likely to perform in a severe recession scenario. The scenario assumed a 10% unemployment rate, a 36% drop in home prices, and a 55% decline in equity prices, among other variables. Despite those challenging conditions, the Fed concluded the 31 banks could absorb approximately $685 billion in losses and continue lending to households and businesses.[9] With more than enough capital to survive adverse economic conditions, the banks can return more capital to shareholders via increased buybacks and dividends. JPMorgan Chase immediately announced their third dividend hike within the past year, a cumulative 25% increase, and said the Board also authorized a new $30 billion share repurchase program.

Savita Subramanian, Bank of America equity and quant strategist, published a piece in mid-June titled, "How do bull markets end?"[10] Her research identified 10 indicators that have typically preceded market peaks, and produced few false positives during bull markets. They include valuation metrics, an inverted yield curve, lofty sentiment readings, tighter lending, and what she categorized as "late cycle hubris" indicators. As of May 2024, only four of the 10 indicators suggested a market peak—compared to an average of seven ahead of prior bull market peaks. Not surprisingly, Subramanian notes there is no single holy grail. As for what to do, she reminds us that remaining invested is generally superior to emotional selling, so trying to sell early or late around market peaks is not advised.

S&P 1500 Index Market Capitalization and Corporate Profits After Tax

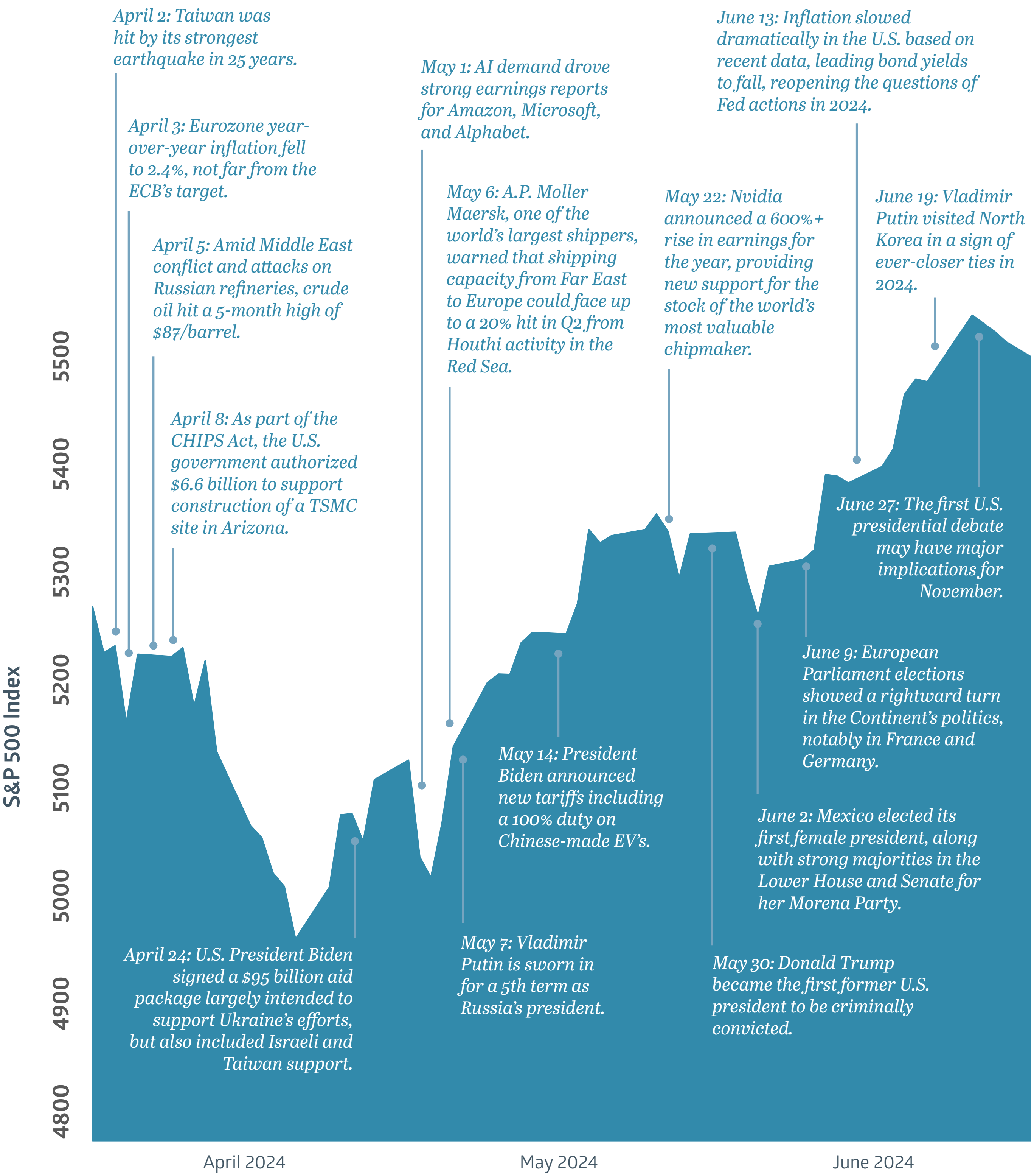


Source: Bloomberg. Data through Q2 2004 - Q1 2024.

8 Corporate Profits After Tax (without IVA and CCAdj), www.fred.stlouisfed.org
9 "2024 Federal Reserve Stress Test Results," www.federalreserve.gov, June 2024
10 "2024 Federal Reserve Stress Test Results," www.federalreserve.gov, June 2024

Q2 2024 World Events

WITH THE S&P 500 INDEX AS THE BACKDROP



Source: Bloomberg, Bailard. ***Past performance is no indication of future results.*** *All investments involve the risk of loss.*