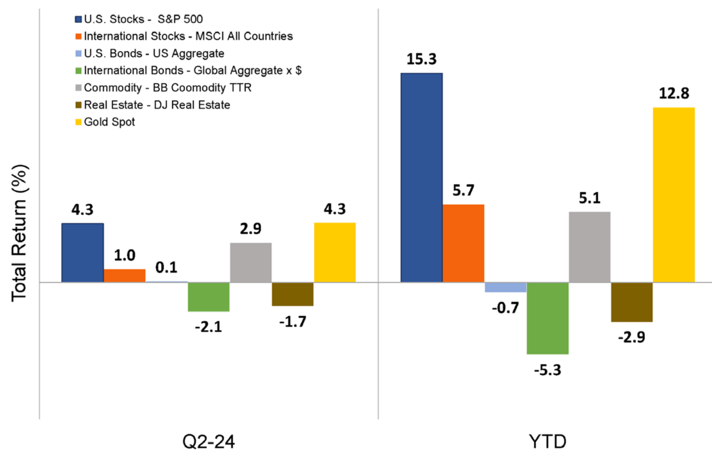
Wealth Management Newsletter

Summer Issue 2024

KEY POINTS

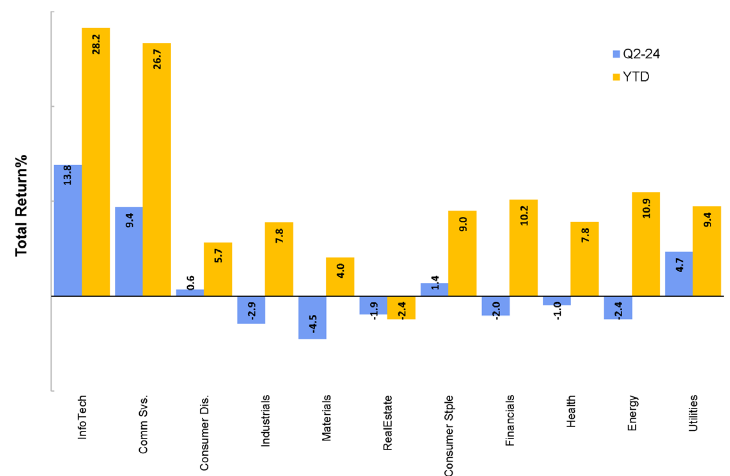
- The S&P 500 rose by 4.3% in Q2, driven once again by the Information Technology sector. However, mid, and small capitalization stocks struggled, and international equities remained stagnant
- The “Magnificent 7” (Mag 7) stocks have accounted for 61% of the S&P 500’s year-to-date return
- Expectations for rate cuts were pushed into late 2024, reflecting the Fed’s need for greater confidence in achieving their inflation objectives which has continued to weigh on fixed income returns
- Active investment management remains critical in the current market environment given the ever-growing concentration risk present in large capitalization equities

2024 Q2: BY THE NUMBERS



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

The first half of 2024 extended the divergent trends observed in 2023, marked by significant disparities in market performance amidst ongoing economic and geopolitical uncertainties (see Figure 1). The S&P 500 rose by 4.3% in the second quarter, primarily driven by a robust 13.8% return from the Information Technology sector (see Figure 2), prominently bolstered by NVDA contributing a substantial portion of this increase. Meanwhile, mid, and small cap stocks, alongside an equal-weighted version of the S&P 500, struggled, posting negative quarterly returns of -3.5%, -3.3%, and -2.6%, respectively. Internationally, developed markets remained stagnant, with flat returns as countries within the region navigated tentative recoveries amid political instability. Conversely, emerging markets experienced a modest upturn, recording a 5% increase during the quarter. Despite these divergent trends, all remain positive on a year-to-date basis. Investors continue to find comfort in U.S. large cap stocks, with the S&P 500’s 15.3% first half return more than doubling that of mid, small, and international equities.



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

Fixed income market returns remained muted during the quarter with U.S. Bonds essentially unchanged as investors grappled with conflicting economic indicators—including inflation, productivity, and employment data—as they sought to forecast potential Federal Reserve interest rate adjustments. Amidst that investing backdrop, the DJ Real Estate Index faced continued challenges, declining by an additional 1.7%. Conversely, gold sustained its robust performance from Q1, advancing by an additional 4.3% in Q2. The broader commodities index also showed resilience, returning 2.9% over the period. Overall, the investing markets in the first half of 2024 underscored the persistence of uneven performance trends across sectors and regions amidst a backdrop of global economic and geopolitical uncertainties.

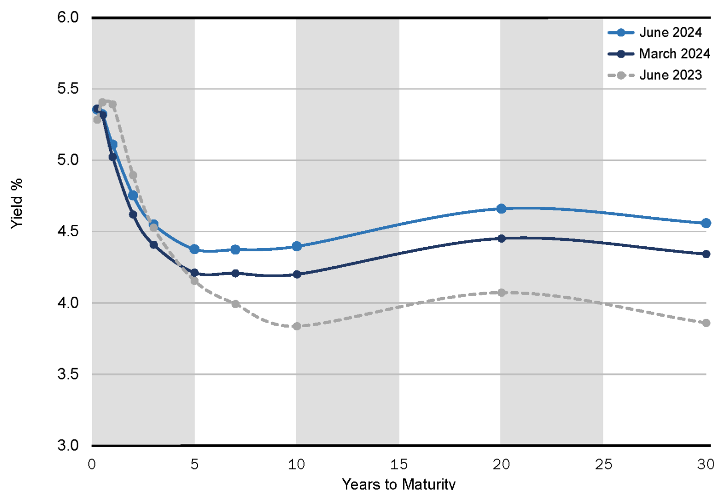
THE ECONOMY

In Q1 of 2024, the U.S. economy continued its growth trajectory, albeit at a slower pace of 1.4% compared to last year’s 3.1% annual pace. Meanwhile, inflation remains a significant concern, with recent readings still well above the Fed’s 2% target, adding uncertainty to economic forecasts. Fixed income market sentiment has shifted to align with the Federal Reserve’s updated guidance of a single rate cut this year, diverging sharply from the initial expectation of three cuts at the beginning of the year. Unemployment remains under 4%, yet ongoing jobless claims have gradually increased, marking the highest

level since late 2021. A sustained increase in these claims could potentially alleviate labor cost pressures and eventually lead to higher unemployment rates. Additionally, consumers have depleted the $2 trillion in excess savings accumulated during the pandemic, reducing their capacity to absorb further price increases for goods and services. While this spending slowdown could help mitigate inflationary pressures, the strength of the consumer has been a crucial factor in preventing a recession thus far. Going forward, global capital markets face the critical question as to whether the economic "soft" landing that has been priced into equity markets will come to fruition.

FIXED INCOME MARKETS — MORE CONFIDENCE NEEDED FOR RATE CUTS

In the second quarter of 2024, influenced by interest rate cuts in Canada and Europe, fixed income markets were relatively stable (see Figure 3) despite ongoing inflation concerns. After initially rising, yields reversed course later in the quarter due to modestly weaker economic data, and continued disinflationary progress. The Fed's economic projections and communications have continued to suggest a future rate cut, although expectations for the start of cuts were pushed into late 2024 because of the Fed's need for greater confidence in achieving its inflation objectives.



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

Assuming disinflationary pressures persist, potential fixed income returns appear skewed towards lower yields and higher bond prices. The yield curve has remained inverted for an unprecedented duration, prompting a view that shorter-dated bonds are the most appealing segment on the yield curve. However, short-dated U.S. Treasury supply continues to be issued at record levels, a trend that has impacted the overall shape of the yield curve and its historic economic forecast signaling prowess. Investment grade bonds do not currently offer very much incremental yield relative to the credit risk involved, particularly in the event of an economic downturn. Meanwhile, mortgage-backed securities continue to offer significant yield enhancement with limited exposure to refinancing risks given current market yields.

MARKET VIEW AND PORTFOLIO CHANGES

While cautiously optimistic heading into 2024, we anticipated that absent an economic recession or collapse in corporate profits, equities would produce positive but more modest investment returns than we experienced in 2023. As we reach the midpoint of the year, the S&P 500 has surged over 15%, building on a 26% gain from the previous year. Despite concerns about stubborn inflation and reduced expectations for Fed rate cuts slowing the pace of ascent compared to Q1, large-cap stocks have maintained gains due to resilient economic activity, rising profit margins, and solid earnings growth.

Market performance continues to be dominated by the largest stocks in the index. For instance, the "Magnificent 7" (Mag 7) have accounted for 61% of the S&P 500's year-to-date return, down slightly from their 63% contribution in 2023. As a result, this mega-cap group is currently priced at thirty-four times earnings, elevating the overall S&P 500 index price-to-earnings multiple to twenty-one times forward earnings. Meanwhile, the remaining 493 companies in the S&P 500 trade at a more reasonable seventeen times forward earnings. We expect profit growth to broaden across sectors as we progress through 2024, potentially supporting a more inclusive equity market rally. Looking ahead, bottom-up EPS forecasts for the S&P 500 still suggest more than 11% year-over-year earnings growth in 2024, followed by 14% in 2025. We believe that expanding participation in profit growth beyond the Mag 7 and current AI beneficiaries will create compelling opportunities for active management during this period of heightened index concentration.

While the broader environment for risk assets remains favorable, we believe that artificial intelligence enthusiasm, a resilient economy, disinflationary progress, and Fed rate cuts are already reflected in the elevated valuations and record-high asset prices. Looking ahead, a contentious U.S. presidential election, elevated geopolitical tensions, stubborn inflation, and potential for earnings disappointments pose risks to the rally. That said, assuming no policy mistakes or economic stumbles, capital markets are likely to deliver solid investment returns for 2024. Especially given that Presidential election years have historically been accompanied by strong capital market returns. To that end, despite entering 2024 near record highs, the S&P 500 has already reached more than thirty new all-time highs this year.

The BWM Investment Team remains vigilant with respect to the current market risks, maintaining a slightly defensive portfolio construction with additional cash reserves for opportunistic deployment in case of a market pullback. Managing high-quality, broadly diversified portfolios allows for ongoing participation in the current bull market while providing downside protection should volatility rise given the very highly concentrated nature of recent investment market returns.

As always, please feel free to reach out to our wealth management team to review your financial goals and ensure that your investment portfolio aligns properly with your risk tolerance and time horizon.

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