Market Commentary

June 30, 2024

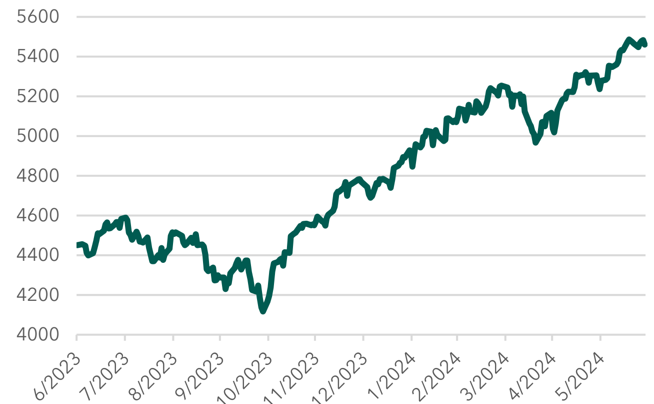
U.S. Equities Market

A Not-So-Balanced Diet

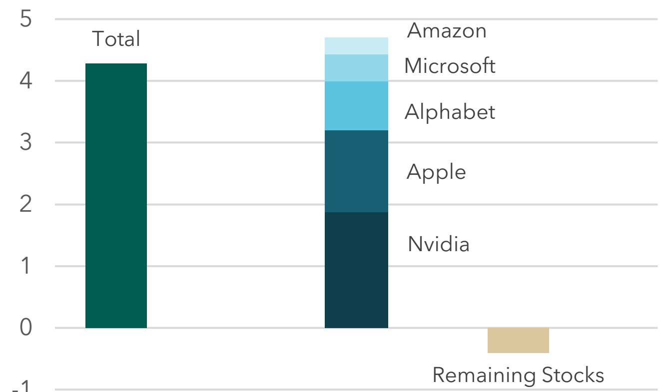
Equity markets continued to move into positive territory with the S&P 500® Index posting a 4.3% gain for the second quarter. Looking deeper, however, without just five stocks - Nvidia, Apple, Alphabet, Microsoft and Amazon - the index would have printed a negative return. Last quarter, we noted the narrowness of the rally, and though we saw signs of broadening in March, the market has narrowed even more significantly since. Value stocks, as represented by the Russell 1000® Value Index, had negative returns and underperformed their growth counterparts by nearly 10.5%. Similarly, small company stocks in the Russell 2000® Index returned -3.3%, underperforming those in the large company Russell 1000® Index by almost 7%. These trends of large outperforming small, and growth outperforming value, have been going on for some time and are at (or nearly at) historical extremes.

The outperformance of Technology sector stocks is centered around the excitement of Generative Artificial Intelligence ("Gen AI"), with some claiming it to be as significant of an event in human history as the Industrial Revolution. Vast sums of money are being spent on Gen AI by the largest companies in the world for fear of being left behind, though the return on these investments is highly uncertain. The underperformance of Financial and Industrial stocks may be attributed to interest rates being "higher for longer," as expectations for cuts by the Federal Reserve have been delayed. At the beginning of the year, markets were expecting five or six cuts, but current expectations have been whittled down to one or two. Higher rates slow the economy, which in turn may lower the profitability of economically-sensitive companies represented in these underperforming sectors. Explanations aside, a market where only a few gain when most tread water, or are beginning to sink, is less than ideal.

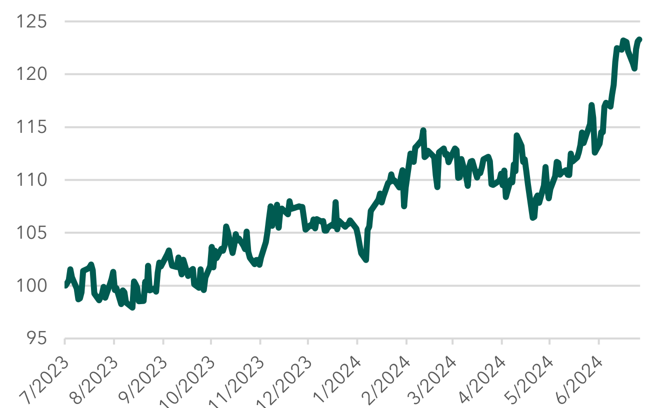
Markets in the second half of the year will be most concerned about two things: the upcoming Presidential election and the Federal Reserve (the "Fed"). With the Federal Funds Rate at 5.5%, inflation now below 3% and unemployment at 4% and rising, a rate cut would seem prudent. But will this non-partisan institution be nervous to lower rates before an election, for fear of playing politics? Speaking of politics, this election will be - and already has been - full of surprises, but some things won't change regardless of who wins. Deficit spending will likely move higher as entitlements crowd out discretionary spending on infrastructure and defense, and debt issued by the U.S. Treasury will continue to climb. Suffice to say that even children learn at an early age that to gorge on one thing - whether it be debt or candy - usually is not healthy if one wishes to grow long-term.



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

U.S. Taxable Fixed Income Market

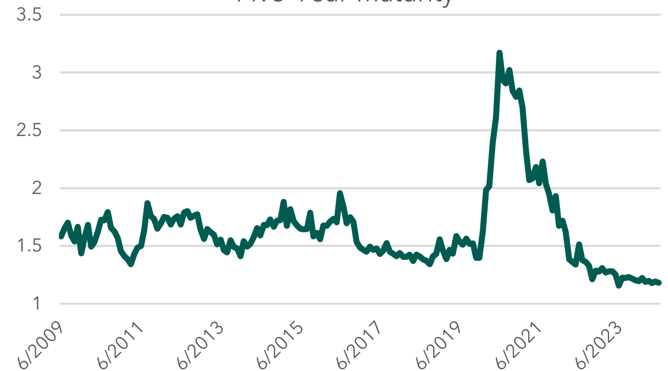
In the Eye of the Bondholder

The Bloomberg Intermediate Government/Credit Index gained 0.6% in the second quarter, driving 2024's year-to-date performance up to 0.5%. Much of the return came from the market pricing out a Fed rate hike as rates fell. It seems to us that the Fed cutting rates is no longer a matter of if, but when. That, combined with a solid economic backdrop, aided a decline in rates and supported risk assets.

The bond market is no exception to the rally in risk assets, as many areas of the credit market offer very little spread relative to history. Using broad bond market indices from Bloomberg, a typical five-year BB-rated corporate bond now only yields 1.18 times the yield of a typical BBB-rated five-year corporate. Examining data going back fifteen years (180 months), U.S. investors have only seen that ratio lower on two other occasions. On average over that time, BB-rated paper has carried yields that are about 1.65 times that of BBB-rated paper. Additionally, on average over the last twenty years, an investor in a typical investment grade bond could expect to add 22.1 basis points of spread for each year they lent money to a company. In other words, a four-year corporate bond would offer a spread of 88.4 basis points to a U.S. Treasury, while a five-year corporate bond would offer 110.5 basis points. Now, however, an investor is only receiving 13.4 basis points of spread for each year they lend money to a company, or in our example, 53.6 and 65.5 basis points, respectively.

One area of the market where the risk-adjusted yield is quite attractive is the U.S. Treasury market. Currently, the Bloomberg U.S. Treasury: Intermediate Index offers a relatively attractive yield compared to its duration. Right now, the yield-per-unit-of-duration of that index is at a ratio of about 1.25, which is attractive compared to its twenty-year median of 0.43. In other words, for the same level of risk, this index currently offers nearly three times the yield than it typically had over the last twenty years. You would have to go back to July 2007 to find such an attractive risk/reward in intermediate U.S. Treasuries. Generally, the predominant ways to increase yield in a portfolio are by taking either more credit risk or more interest rate risk. Today, relative to history, investors are being compensated to take interest rate risk while they are getting next to nothing for accepting credit risk.

Source: Bloomberg



Source: Bloomberg

Source: Bloomberg

Market Commentary

June 30, 2024

U.S. Municipal Fixed Income Market

Bumpy Yield as the Market Hangs on Every Data Point

Entering the second quarter of 2024, the Treasury market was still pricing in several Fed Funds rate cuts for the year. As data came in, 10-year Treasury yields rose, peaking at 4.61% on May 15th and ending the quarter back at 4.40%. Repricing the market from several cuts to perhaps one or two cuts for the year was consistent with the message that the Fed would keep interest rates higher for longer. The municipal market yields rose as well, but not in lockstep. We saw yields rise across the curve, but primarily in the 4-10 year tenors, with rates higher from 35–46 basis points (a flattening of the U-shaped yield curve). June's very positive performance helped to make quarter to date and year to date municipal returns nearly positive.

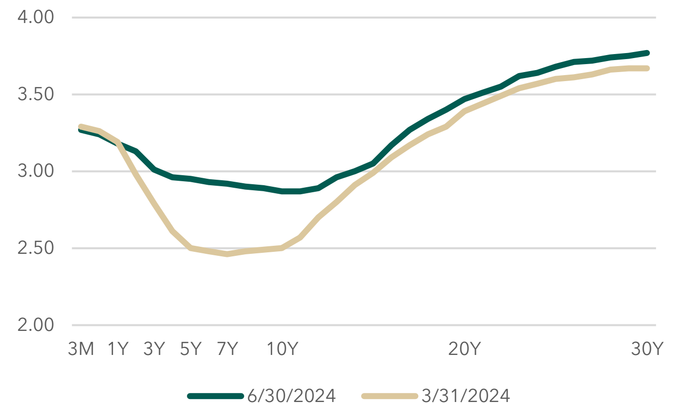
The impetus for June's performance was the announcement of May data for inflation, which generally measured lower again and therefore, interest rate cut speculation once again began to price into the markets. The unemployment rate also continued to rise toward an estimated 4% for June, a notable increase from the low of 3.5% in March 2023, but not yet above a more consistent level of "full employment." These two data measures are the ones the Fed is held accountable for; other data of importance is the unaffordability and low turnover of housing, wage pressures, and the wavering strength of the consumer.

Say what you will about the municipal bond market, but adjectives like "resiliency" and "tenacity" may be top of mind. New issues notably picked up this quarter, besting our expectations and rivaling historical levels. Issuance in the first half of 2024 of $239 billion compares most closely with new issuance in 2015 and 2016, the first years that new issuance broke $400 billion for the year.

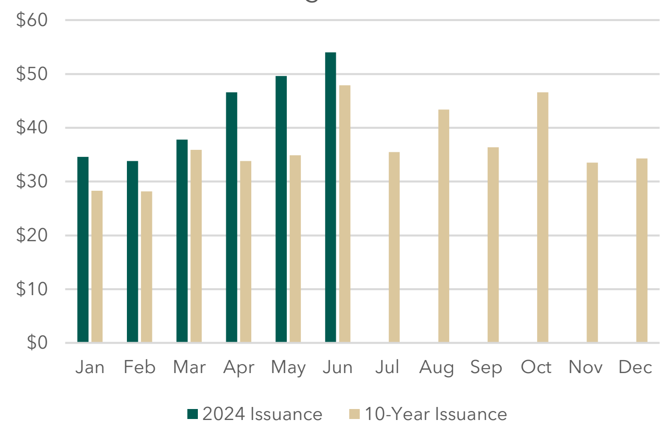
Fortunately, the new issuance supply met increasing demand. Not only are rates higher than the average of the past 10 years, it appears that taxes are more likely to go higher than lower as we grapple with rising federal government deficits. Municipal bonds are one significant way to try to reduce required tax payments to the IRS.

Looking forward into the second half of 2024, inflation and the Fed will be closely watched. Additionally, we will start being bombarded with presidential election campaign rhetoric, and continuing wars in Gaza and Ukraine, as well as tensions in China will likely impact our interest rate environment.

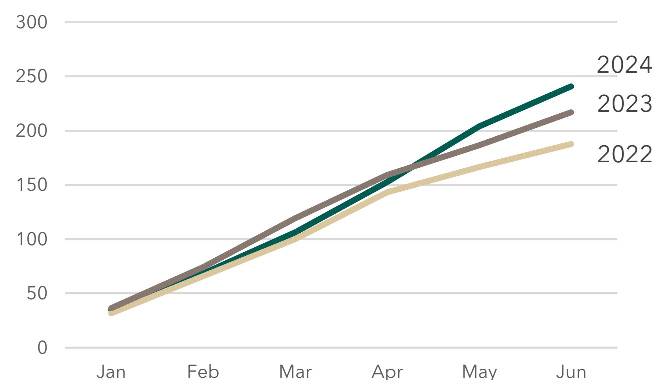
Municipal credit issues may surface, generally reporting that revenues will meet or exceed expectations, but outlooks may be declining. Political news along with data dependency may continue to whipsaw the market. Hold on and remember to invest for the longer-term, as we continue to bump down the road.



Source: Bloomberg



Source: Bloomberg



Source: Bloomberg

Market Commentary

June 30, 2024

DAVIDSON
INVESTMENT ADVISORS

International Equities Market

Rates & Elections – A Global Phenomena

Developed international markets fell slightly this quarter, with the MSCI EAFE Index dropping 0.2%. Emerging international markets outperformed, with the MSCI Emerging Markets Index returning 5.0%. The U.S. dollar appreciated 1.94%, making it a modest headwind to investment performance.

Although the Fed has yet to, central banks – most notably the European Central Bank and the Bank of Canada – have begun lowering interest rates by around 25 basis points, as inflation levels experience a promising cooling. For Europe, with the external risks of Ukraine's ongoing war and conflict in the Middle East, this cut poses possible inflationary shocks and leaves future cuts a question mark. However, paired with a strong resurgence in European banks' returns on equity, these rate cuts create a favorable outlook for investors. It remains to be seen what effects elections in France and the UK election will have on the markets as results play out in the upcoming weeks. Japan continues to face a depreciating yen, despite its rate hike back in March. This has led to a host of outcomes, including increased tourism, low consumer spending, and high import costs for Japanese companies.

The world, including both developed and emerging nations, has to grapple with China's actions, as Xi Jinping, China's president, continues to export goods at unnaturally cheap prices in an attempt to assuage the economic impact of its floundering real estate market. More global companies are exiting China's territory as the nation's nationalist focus poses threats to business; over one hundred international actions have been put in place to limit the harm that Chinese imports have on nations' domestic economies. Adding to the uncertainty in emerging markets are two notable elections during the second quarter. In India, while BJP-backed incumbent Narendra Modi secured a third term, he secured far less than projected seats in Parliament, representative of a country that is unsatisfied with his false promises of social reform and strong identity-centered politics. The uncertainty of this election's outcome leaves markets dubious of India's economic outlook. On the other side of politics, left-wing Claudia Sheinbaum was elected president of Mexico, creating a fear of possible constitutional changes and a deterioration of checks and balances. This election further heightened market uncertainty and volatility.

From an emerging markets state, it looks as though countries other than China will lead the way in investment performance, especially as post-election reactions wind down. There continues to be investor interest in global equities which is increased by foreign interest rate cuts, despite the political uncertainty that weighs on investors' minds.

MSCI EAFE Index

Source: Bloomberg

MSCI Emerging Markets Index

Source: Bloomberg

Bloomberg Dollar Spot Index

Source: Bloomberg

Disclosures

Davidson Investment Advisors, Inc. is a SEC registered investment advisor. The opinions expressed herein are those of Davidson Investment Advisors and are subject to change.

The information contained in this presentation has been taken from trade and statistical services and other sources, which we believe to be reliable. We do not guarantee that this information is accurate or complete and it should not be relied upon as such.

This presentation is for informational and illustrative purposes only, and is not intended to meet the objectives or requirements of any specific individual or account. Past performance is not an indicator of future results. Indices provide a general source of information on how various market segments and types of investments have performed in the past. An investor should assess his/her own investment needs based on his/her own financial circumstances and investment objectives.

The information on indices is presented for illustrative purposes only and is not intended to imply the potential performance of any fund or investment. Index performance assumes the reinvestment of all distributions, but does not assume any transaction costs, taxes, management fees, or other expenses. Indices are not available for direct investment.

The S&P 500® Index is a gauge of large-cap U.S. equities and serves as the foundation for a wide range of investment products. The index includes 500 leading companies and captures approximately 80% coverage of available market capitalization.

The Russell 1000® Growth Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with higher price-to-book ratios and higher forecasted growth values. The Russell 1000 Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

The Russell 1000® Value Index measures the performance of the large-cap value segment of the U.S. equity universe. It includes those Russell 1000 companies with lower price-to-book ratios and lower expected growth values. The Russell 1000 Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics.

The Russell 3000® Index measures the performance of the largest 3,000 U.S. companies representing approximately 98% of the investable U.S. equity market. The Russell 3000 Index is constructed to provide a comprehensive, unbiased and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are reflected.

The Russell 2000® Index measures the performance of the small-cap to mid-cap segment of the U.S. equity universe. It includes the bottom two-thirds in terms of company size of the Russell 3000® Index.

The Bloomberg U.S. Treasury: Intermediate Index measures U.S. dollar-denominated, fixed-rate, nominal debt issued by the U.S. Treasury with maturities of 1 to 9.9999 years to maturity.

The BVAL AAA Callable Yield Curve is a standard market scale with non-call yields up to year 10 and callable yields thereafter. This curve assumes a normalized 5% coupon and is plotted as an offer side yield to worst.

The MSCI EAFE Index is broadly recognized as the pre-eminent benchmark for U.S. investors to measure international equity performance. It comprises the MSCI country indexes capturing large and mid-cap equities across developed markets in Europe, Australasia and the Far East, excluding the U.S. and Canada. Numerous exchange-traded funds are based on the MSCI EAFE Index, and the Chicago Mercantile Exchange, NYSE Liffe U.S. and the Bclear platform of Liffe are licensed to list futures contracts on this index as well.

Disclosures

The MSCI Emerging Markets Index is a free-float weighted equity index that captures large and mid-cap representation across Emerging Market countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

The Bloomberg Dollar Spot Index tracks the performance of a basket of 10 leading global currencies versus the U.S. Dollar. It has a dynamically updated composition and represents a diverse set of currencies that are important from trade and liquidity perspectives.