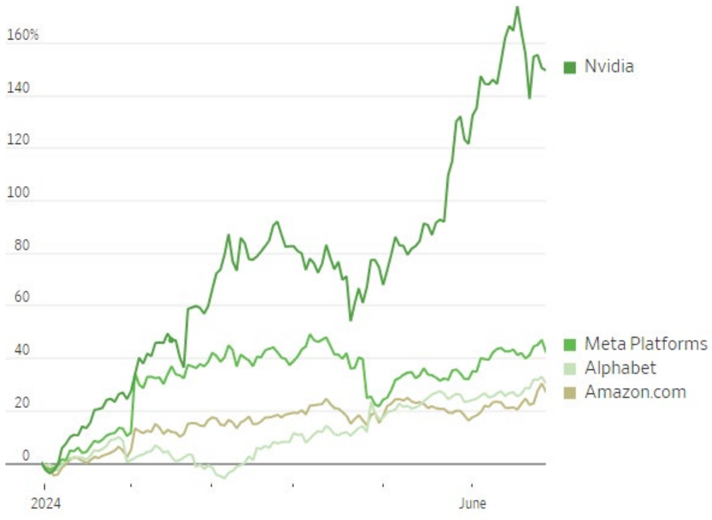
Two Diverging Paths

"Two Roads Diverged in a Wood, and I – I took the One less traveled by, and that has made all the Difference" – **Robert Frost**

The first half of the year is now in the books, and markets continued to perform well but were dominated by just a few names. For the first six months, the S&P 500 was up 14%, but 30% of that return was attributed to Nvidia **(Deep Dive Here)**, which rose by 149% as the AI hype continued. At one point, Nvidia was the most valuable company in the world. If we add Meta (Facebook), Microsoft, Alphabet (Google), and Amazon we can account for 50% of the market's return from just five stocks. The equal weighted S&P 500 was up 4.1%, underperforming by 10%. This gap is the biggest in the first half of the year going back to 1990.

Investors entered the year thinking the Fed would cut rates six times, but a series of hot inflation readings have left the Fed on pause. This pause has resulted in the 10-year Treasury rate increasing to 4.34% from 3.86% and resulted in a slight loss for the bond benchmark (US Aggregate Bonds). Below we discuss the narrow market leadership, what it means for the balance of the year, and everyone's favorite topic: the 2024 Election.



Source: FactSet

Q2 Recap

Narrow market leadership is not a new phenomenon in this market cycle. Although the nicknames and acronyms change quarter to quarter, it tends to be the giant technology companies leading the way. These companies have had the largest earnings and weightings in the various indices. We have written about the Magnificent 7 before, and since the beginning of 2023 these stocks have outperformed the other 493 stocks by 18%. In the 2nd quarter, the S&P 500 was up 3.9%, but within the S&P 500, companies related to AI (Artificial Intelligence) were up 14.7%. At the beginning of April, all stocks corrected because of higher inflation numbers and potentially higher for longer interest rates. Then something changed. The average stock generally declined into the end of the quarter, but the AI names shot higher than their earnings could justify. In other words, it wasn't earnings that raised the prices, it was the multiple on those earnings. No one truly knows what all of these large investments into AI will look like on a return basis or the time frame it will

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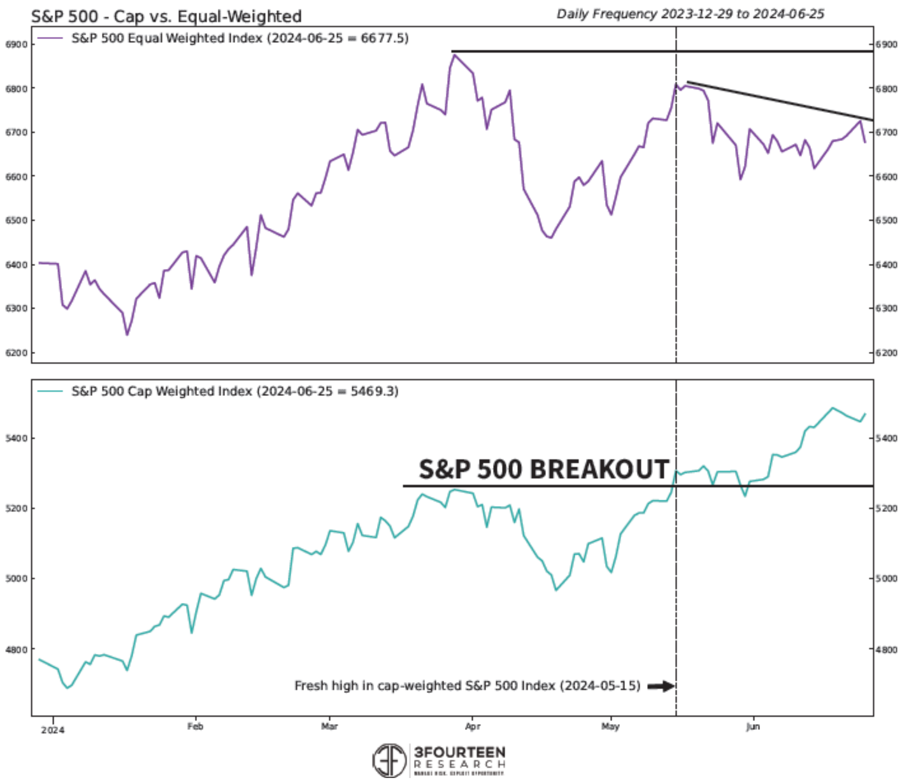
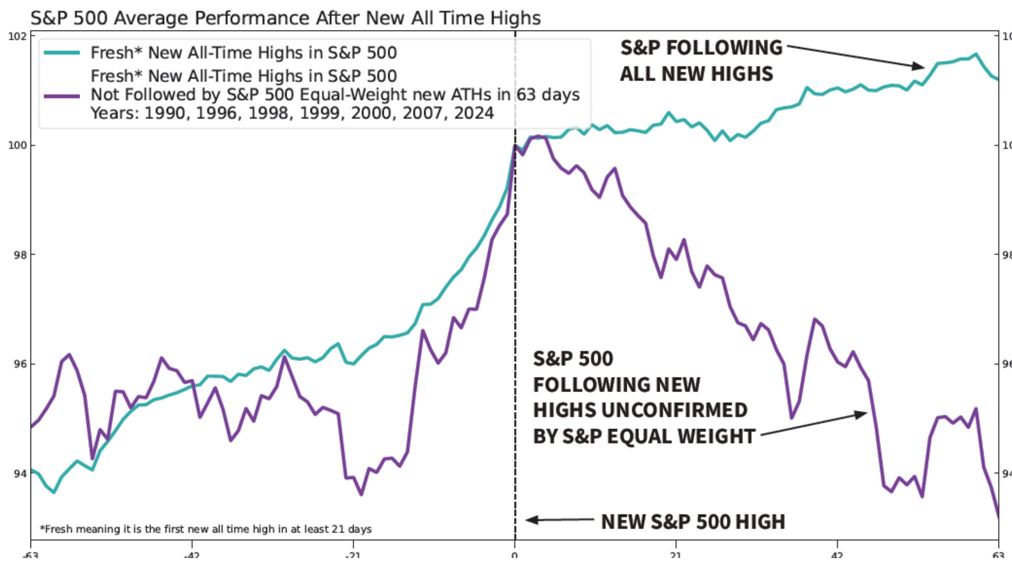
take to realize those returns A few years ago, Meta invested tens of billions of dollars into the Metaverse. Unfortunately, the Metaverse didn't produce any significant revenues or profits and the stock came crashing down. There are certainly some similarities with this AI spending binge.



In the short term, we are more concerned with the average stock vs the market index. In the accompanying chart, we can see the overall market breaking out to new highs in mid-May (bottom chart), however the equal weighted S&P 500 has continued to decline since its highs at the end of March (top chart). In stock terminology this phenomenon is called breadth, and most bull markets need strong breadth and many companies performing well to continue.

2nd Half Outlook

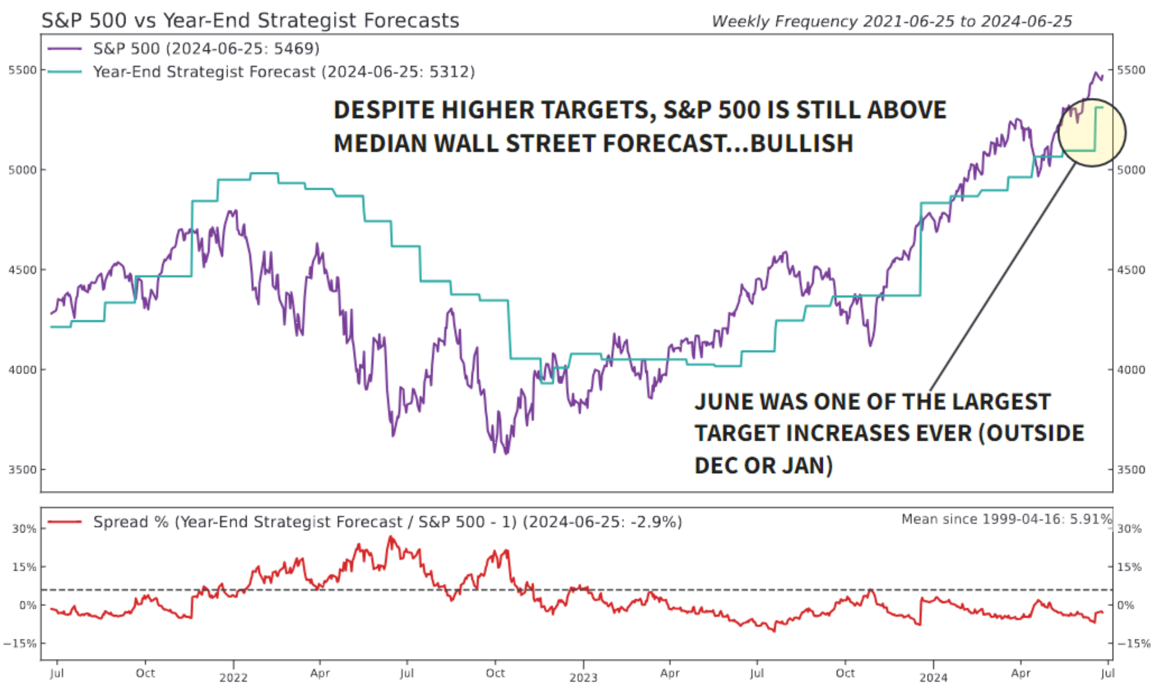
Over the next few months, breadth will be one of the key variables driving stocks. If we look at history, it tells us that the average stock really needs to pick up the pace and the equal weighted indexes need to confirm the breakout sometime this summer. Otherwise, we could be looking at consolidation going into the fall. This chart shows the other instances in which the new highs were not confirmed, and it generally leads to a correction. Although



we can't predict this outcome, we are optimistic heading into the 2nd half.

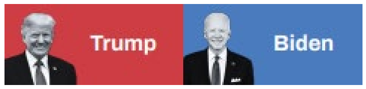
Again, looking at history, there have been 23 years since 1950 when the S&P 500 was up by more than 10% in the first half. Only four of those years produced negative returns in the 2nd half, but 10 led to returns greater than 10% over the next 6 months. Although this is not enough data on which to make a decision, we should not dismiss some of these calendar tendencies. A common theme in this type of year is that not everyone is fully invested, including both retail and institutional investors. Especially in the case of institutional investors, many are lagging their benchmarks significantly and could be forced to invest more aggressively heading into year-end carrying markets higher.

Forecasters, the so-called market experts, have done an especially poor job of predicting markets over the past several years, missing the 2022 drop and doubting this entire rally. In June (chart below), the strategists once again raised their forecasts, but the average is still below current prices. Typically, markets don't peak until the strategists have finally raised their expectations above current prices, thus this does not signal the end of the road to us.



More positives include the recent inflation readings which continue to come down. We are seeing discounts emerge throughout the retail world including the McDonald's $5 menu and at retailers including top brands like Lululemon. The new supply of housing and apartments coming online is low because of the higher interest rates and limited new construction over the last two years, and that should continue to put pressure on rents. Lower inflation is the key for the Fed to start their easing of rates, which might happen as early as September. Lower rates could drive investors that have been accumulating cash savings in Treasury Bills and Money Market funds earning 5% to reinvest those dollars back into equity markets when faced with lower yields. If mortgage rates get back to the 5-6% range the residential housing market would be unleashed, and this cycle could continue moving forward. As always, there are many risks out there, but based on what we know, the outlook remains favorable.

2024 Election



And now for everyone's favorite subject: the Election. Four months out, we are already having conversations about portfolios becoming more conservative if "X" wins. This is interesting because one day "X" is Biden and one day "X" is Trump. The polarization of the nation is at an extreme, and we want to take this opportunity to remind all clients that regardless of the outcome, your investments will be OK. The outcome of the presidential election is not the sole driver of investment returns and generally its impact is overrated. We have put together a short presentation of the markets and the economy under both Biden and Trump. You can find it HERE (Election Guide). This is important, because these are the actual numbers which aren't necessarily reflected in what we hear from either candidate. A few highlights:

- Markets did not tank post-election or after two months for either candidate when they previously took office, they were positive for both.
- Different sectors and asset classes could benefit or be hurt by either candidate, but that is tough to predict.
- As a result of inflation, stocks and bonds both had significant declines in 2022. Although there is a lot of blame to go around, COVID-19, both presidents, and the Fed ultimately put too much money into the system.
- Perhaps more important than the presidency, is the result of the Senate and Congressional races. A divided government has historically produced the highest returns.

Resources

What We Are Reading:

AI Capital Investment: As we alluded to earlier, this piece from Sequoia tries to quantify how much revenue needs to be produced from the investments being made in AI:
https://www.sequoiacap.com/article/ais-600b-question/

KKR Mid-Year Outlook: Always a good read with valuable insight from one of the top Private Equity firms in the world.
https://www.kkr.com/insights/mid-year-update-2024

Roger Federer Dartmouth Commencement Address: Great read and watch from one of the best tennis players and athletes of all time. His advice transcends sports and is especially important to those making investment decisions. *"The best in the world are not the best because they win every point…it's because they know they'll lose…again and again…and have learned how to deal with it."*
https://home.dartmouth.edu/news/2024/06/2024-commencement-address-roger-federer

Update & Conclusion

We would like to introduce Rob Solomson (BIO HERE), our newest hire. Rob will focus on the real estate side of our business and previously worked for Lingerfelt Commonwealth Commercial in Richmond and Hines Real Estate in DC.

Thank you for taking the time to read this letter As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance. This is a great time of year to set up a review meeting.

Sincerely,

Canal Capital Management

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Footnotes:

Charts – Pies, "H2 Outlook: Time to Double Down"?, 3Fourteen Research, 2024