Maclura Investments

2Q24 Review - Concentrated Momentum Continues To Drive Large Cap

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The market continued its upward momentum as measured by the Morningstar U.S. Market Index returning 14.07% for the first six months of the year. Though there are 1,310 stocks in the benchmark, the bulk of the positive returns are in the top 10 stocks that account for 33% of the weight of the Index. Excluding those ten stocks, the market would have been down for the year, and excluding the largest attributor to this year's performance to date (Nvidia – NVDA), the U.S. Market Index would be up 5.5% year-to-date, which is similar to 4.96% YTD performance of the equally-weighted performance of the S&P 500.

Exhibit 1. Investment-Style Returns

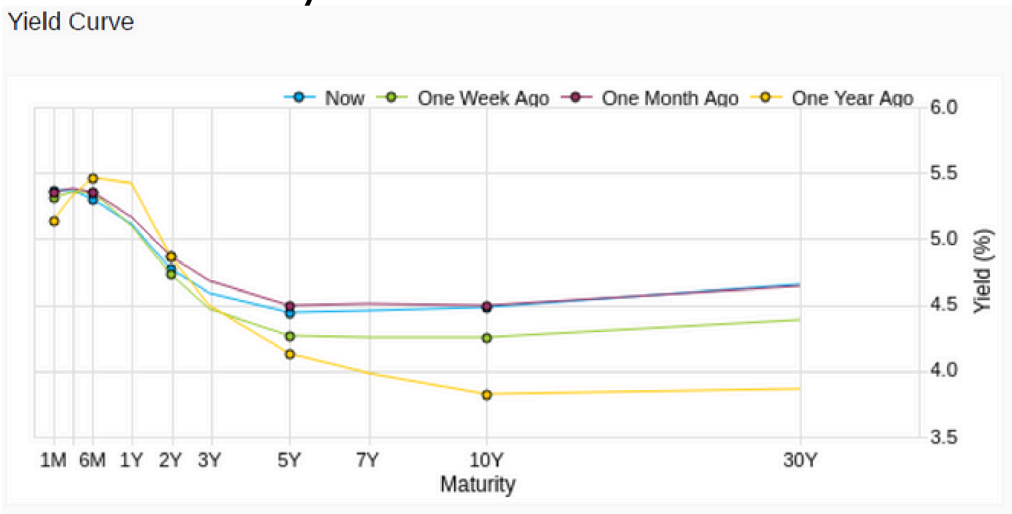
	Morningstar Index Market Returns	2016	2017	2018	2019	2020	2021	2022	2023	2024 1st Qtr.	2024 2nd Qtr.	2024 YTD
Growth	U.S. Growth	3.16%	29.52%	0.78%	35.90%	44.65%	24.79%	-36.70%	38.48%	8.32%	2.42%	10.95%
	Large Growth	1.79%	31.15%	2.94%	33.81%	38.86%	21.47%	-40.36%	47.26%	9.59%	4.73%	14.77%
	Mid Growth	6.46%	25.67%	-3.16%	36.01%	46.17%	14.97%	-32.37%	25.38%	10.56%	-4.73%	5.88%
	Small Growth	9.61%	23.77%	-5.67%	27.60%	43.52%	-1.00%	-33.13%	26.65%	5.29%	-1.57%	3.64%
	US Market	12.44%	21.47%	-5.05%	31.22%	20.99%	25.78%	-19.43%	26.44%	10.24%	3.48%	14.07%
Value	U.S. Value	20.79%	14.23%	-7.51%	25.09%	-1.31%	23.98%	-0.72%	11.98%	8.41%	-1.47%	6.81%
	Large Value	18.91%	15.09%	-5.90%	25.70%	-0.62%	21.49%	0.26%	11.82%	8.89%	-0.59%	8.25%
	Mid Value	25.21%	13.02%	-10.63%	24.81%	-3.76%	29.02%	-2.39%	10.94%	8.19%	-3.05%	4.88%
	Small Value	27.96%	8.40%	-16.61%	19.96%	1.01%	31.79%	-6.60%	14.58%	4.64%	-5.17%	-0.78%

Source: Morningstar

The insatiable demand for a handful of the large cap technology stocks tied to artificial intelligence (A.I.) can also been seen in the YTD returns for the U.S. Growth and Large Growth benchmarks, where Nvidia's 149.5% performance year-to-date accounted for 86% and 70%, respectively of the indexes' performances. Without the large technology companies' outsized performance in the quarter benefiting the U.S. Growth and Large Growth benchmarks, along with the general US Market benchmark, those benchmarks would have been inline with the other benchmarks for the quarter.

The first quarter spike in inflation has dissuaded the Fed from moving quickly on cutting interest rates at the pace initially anticipated at the beginning of the year by investors, and it had a negative impact on those stocks outside of the A.I. orbit. However, on the last day of the quarter, the May PCE Price Index Excluding Food and Energy, also known as the core PCE price index and the Federal Reserve's preferred measure of inflation, increased 2.6% from one year ago, inline with expectations. While the first couple months of the year inflation ticked higher, the overall trend remains downward with core PCE inflation sliding to 2.6% on a year-over-year basis, down from 2.9% at the start of 2024. It remains doubtful that the Federal Reserve will initiate cuts to its short-term interest rate range at the July meeting (July 30 -31), the odds have increased for the September meeting (September 17-18) for the Fed to announce the first 25 basis point reduction in federal funds rate.

Exhibit 2. US Treasury Yield Curve



Source: *Factset*

Currently, there is a significant amount of cash invested in money market funds ($6.12 trillion) because, as illustrated in the U.S. Treasury yield curve, the highest yields are at the shortest duration securities (Treasury Bills). This is because the Federal Funds rate target range is currently 5.25% to 5.50%, but as cuts are initiated, this yield will adjust accordingly. As more inflation data is released and it confirms the successful subduing of inflation by the Federal Reserve and the economy continues towards a "soft-landing," the likely alternative for the cash currently parked in money market funds could be the stock market.

Market outlook

ChatGPT changed the world in November 2022 when it introduced the concept of generative A.I. to the public. Though it has been over a year and a half, in my opinion, we aren't even through with the first inning of this dramatic change that is coming to the economy. A.I. will reshape work processes and everyday life perhaps more than the introduction of the personal computer decades ago.

While Nvidia has gotten most of the limelight as the market leader of graphic processing units (GPUs), which are imperative in teaching A.I. models, there are many facets in which to participate in the coming A.I. ecosystem. I monitor a diverse list of over 45 companies that have important roles in developing and monetizing A.I. services and products. This list of companies has a total market capitalization of over $20 trillion dollars. As a reference of how large that is, the total market capitalization of Europe's six market exchanges is just over $17 trillion!

Perhaps the most significant change to society will be that it will move into an environment where users have a conversation with data and documents. In a corporate setting, A.I. will do most of the grunt work while more seasoned professionals will put the finishing touches on the A.I. generated answer, whether it be source code, graphic design, or the summary of minutes from a transcript meeting. From a consumer perspective, A.I. will be a personal assistant and allow individuals to not have to seek answers on their phone but rather have the phone "speak" to them. Perhaps society can return to looking outward instead of being glued to a tiny screen in their palm. Regardless, all this technology requires software, significant memory in devices, more power generation, more power efficiencies, upgrade of personal electronics (PC and phones), edge A.I. infrastructure buildout to limit latency (time to receive answers to inquiries), IT hardware, and IT consulting. All this will take time, and as I said before, the A.I. transition in the economy is still in the first inning of what could be a double header.

The broad market has been languishing more so than reflected in the large benchmarks (Morningstar US Market, Large Cap Growth, and S&P 500). When one of the largest weights in the benchmark is up nearly 150% in the first six months, it has an outsized impact on the benchmark's performance, as mentioned previously.

Not taking anything away from Nvidia's performance, but as a semiconductor, having one of the largest companies in the benchmark whose industry is the highly cyclical semiconductor industry, the probability that it will remain one of the largest companies alongside Microsoft and Apple is slim over the long-term. Being on the front-end of the A.I. buildout, as the market broadens out, other companies will start to outperform Nvidia, particularly in the relatively inexpensive small to mid-cap stocks, which have underperformed so far this year.

In these months before the November Presidential election, it remains uncertain who will actually be on the Democratic ticket after President Biden's dismal performance in the first debate. Regardless of who or what party wins the election, tax policy will be front and center with the expiration of the household tax cuts that were passed under President Trump's term in office. It would be doubtful that Congress would let those tax cuts lapse and expire without some form of tax reform. Additional high-tech tariffs could be a factor to diminish China's ability to advance its A.I. ambitions. With the Biden administration keeping most of the Trump administration tariffs in place and adding additional tariffs in May 2024, it would appear that both parties won't be changing their tune about tariffs in the short-term, and I'm sure it will be a potential headwind for years ahead.

As I have previously mentioned in my market commentary, the fiscal stimulus will continue to provide a positive tailwind to certain industries for years, through the previously passed bills: the Infrastructure Investments and Jobs Act of 2021, the Inflation Reduction Act of 2022, and the CHIPS and Science Act of 2022. But nothing can measure up to the positive boost that the A.I. spending boom has had on the economy, and it will continue to provide a strong tailwind for many years for both the market and economy.

There will be a significant amount of news impacting the market during the third quarter, particularly the high probability of the first, long awaited interest rate cut in September. In my previous quarterly market commentary, the outlook included that the market would likely achieve double-digit returns for the year. While this has been achieved with some of the larger cap benchmarks, I believe that as the market broadens, all market cap benchmarks have a strong probability of finishing the year up double-digits.