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Trust and Wealth Management

QUARTERLY MARKET INSIGHTS – SECOND QUARTER 2024

To the Clients and Friends of Hilltop Bank Wealth Management:

When I last wrote to you, the prevailing concern in the economy was a reacceleration of inflation. Indeed, throughout the first quarter, and into the second, the data suggested progress in fighting inflation had at best, stalled. Now, as the second quarter passes by, we are beginning to see the early stages of the coin flipping once again. Whereas the debate in the first quarter was about inflation's persistence, and the Fed not applying the brakes hard enough, today's risk is that they will stay on them too long.

Cooler Inflation, Weaker Growth

Over the last two months, we have been pleased to see inflation once again moderating. This also coincides with a broader slowdown in the economy and a looser labor market. Collectively, these conditions are the predictable outcome of nearly two years of restrictive monetary policy. They are also the set of circumstances the Fed wanted to see continue before they began to cut interest rates. In fact, without yet another reversal in course, it is increasingly likely that before the next chance I have to write to you, rate cuts will have already begun.

To be somewhat technical, the argument for cutting rates is two-fold. First, there was essentially no inflation in May, and prices actually fell by 0.1% in June. Back in March, the year-to-date inflation rate was on pace to be 4.60% on an annualized basis. After these two readings, year-to-date inflation is now 2.81%. Core inflation (which backs out the more volatile prices of food and energy) has improved from 4.53% at the end of the first quarter, to 3.31% through June.

Second, the unemployment rate rose one-tenth of a percent in each of the past three months. It now sits at 4.1%, which is 0.1% higher than the Fed thinks is necessary for inflation stability. Much of this increase is due to growth in the labor force, which is of less concern than if it were the result of layoffs. To put it another way, the unemployment rate only reflects those Americans actually looking for jobs, and we want more folks to be active participants in the labor market. More reentering the market sends a different signal than an increase in jobs lost would. Regardless, when the unemployment rate starts moving, it often continues under its own momentum without some sort of intervention.

These two arguments are self-reinforcing. That is, slower inflation on the one hand, and slower growth on the other, can make us more confident that each is credible. The playbook for bringing down inflation is to cool the economy. It is what we expect to accomplish with restrictive monetary policy and indeed such policy's reason for being.

It is often said that monetary policy works with a long and variable lag. Historically, this lag has been about eighteen months but has varied between four and twenty-nine. Today we are about twenty-seven months from the first rate hike and fifteen months from the last. We must also acknowledge, however, that economic releases are published sometime after the activity they measure. For example, weak economic activity in April was already three months ago, and the lower May and June CPI reports are already two- and one-months old respectively. Some lag exists in both directions, so the Fed shouldn't wait until inflation is 2% to start moving in the other direction.

Now that we can be confident both inflation and economic activity are moving together, and have been for some time, we can have some confidence that we have begun the descent that will end in either the oft-discussed soft landing or perhaps something a bit rougher. The difference will require some luck in the timing of the cuts.

The committee of the Fed that sets interest rates, the FOMC, has been resolute in signaling its intentions well in advance under the Chairmanship of Jerome Powell. As of this writing, they have not yet done so for any date on which we might see the first rate cut. That signaling ought to come in the next weeks or months as delaying rate cuts risks weakening the economy too much and imperiling the possibility of that soft landing.

Markets in the First Half of 2024

At least to some extent, this next move by the Fed is priced into the market. Equity indices, which began the quarter with a 5.5% decline in the first few weeks, have made up all of that lost ground to end the quarter with a 3.9% increase. Bonds, which began the quarter with a drop of 2.69% ended the quarter more-or-less even, with a gain of 0.07%.

Market performance has once again been led by a small collection of mega-cap tech stocks. These "Magnificent Seven" now account for 33% of the total market capitalization of the entire S&P 500, after increasing in price by 36.9% year-to-date. As you will have heard, primary among these has been NVIDIA, the maker of graphical processing chips that are essential to the infrastructure required for further development of generative artificial intelligence.

As exemplified by NVIDIA, many of the winners so far this year are of the picks-and-shovels variety. That is, they reflect the idea that the best way to make money during a gold rush is to sell the miners their picks and shovels rather than mine oneself. In addition to the chips necessary to power generative AI, another example appears to be the provision of energy to power them. Utilities, which are usually a fairly low-risk, low-return, heavily regulated sector, are up 9.83% year-to-date.

In this newsletter exactly a year ago, I discussed the nature of hype cycles and how the crowds have a tendency to get ahead of themselves at the outset of a new, potentially transformative technology. At that point, I guessed that we had not yet reached peak excitement for this new shiny object, let alone delivery on its paradigm-shifting promise. The performance of the Magnificent Seven so far this year has certainly proven the accuracy of that assertion. It may be true that we have still not yet arrived at the first of these conditions, and certainly have not approached the second.

More and more, I think we will see reasonable minds question whether the roughly $1 trillion in capital expenditures currently budgeted for building out AI will provide sufficient returns. Surely, some of it will plant the seeds for the next, more promising phase of the technology. For today, it seems to me there is a gap in impact between being able to correctly predict the next word in a sentence or automating away some work tasks, versus creating the productivity gains associated with the creation of new, novel industries that has been the case with transformative technologies of the past.[1] If you want to keep selling picks-and-shovels, eventually someone has to find gold.

That being said, I would still hesitate to describe the markets, or even technology stocks specifically, as in a bubble. In contrast to past bubbles, price increases in the Magnificent Seven have been tied, at least loosely, to real revenues. That is, many of these companies are seeing real gains in income from others' investments in AI infrastructure. For example, NVIDIA has seen its earnings per share double in the last year. In fact, the price investors pay for those earnings is less (at a still eye-watering price of 74 times earnings) than it was a year ago (an even more astronomical 243 times earnings).

As we have also discussed in the past, most commentary you hear in the media, or online, is going to be prone to hyperbole. Something is either a bubble or a crash, rarely in between. I believe that it is not only possible but also prudent, not to fall into this trap. The most likely state of things is that while the trade around generative AI has become too expensive to justify at current prices, it may still be a productive development for the economy over the longer run.

As investors with Hilltop, you have the benefits of being well-diversified. One of these benefits is earning strong returns from equities, including the Magnificent Seven, in the past year. Another is that the Magnificent Seven do not make up our entire portfolios. The same is true for a slowing US economy, and interest rate cuts that potentially come too late. We can note the month-to-month, and quarter-to-quarter changes in our environment, and make adjustments as necessary to incorporate our views, but we ought to always keep one eye on the ends of our time horizons. On that day, it won't be the intermittent uncertainties we faced that will dictate our returns, but our patience and discipline in the face of them.

Best,

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[1] For example, the printing press surely replaced scriveners' jobs, but it also created the literary industry we still have today. Having AI automate your copyrighting may save you time, but it doesn't create a new field.