Hoofbeats: Horses or Zebras?

Q3 2024 Market Outlook

“Look at market fluctuations as your friend rather than your enemy. Profit from folly rather than participate in it.”- Warren Buffett

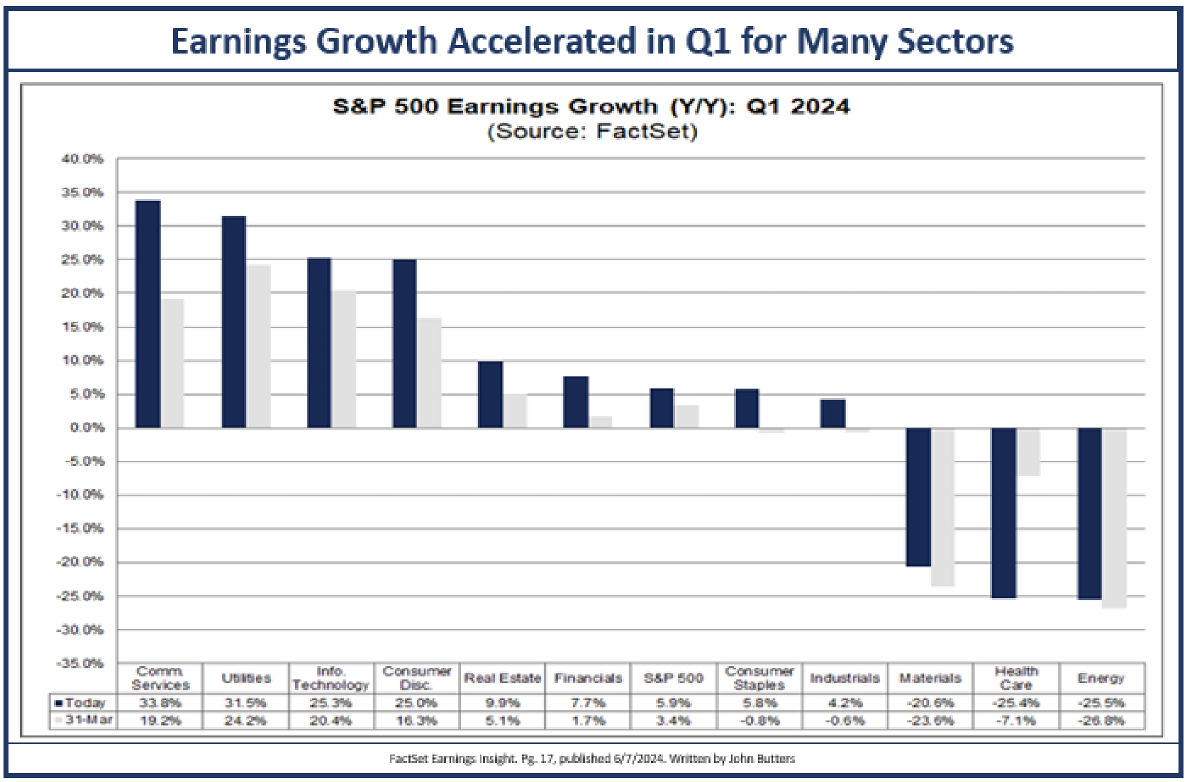
There is a wise adage, *if you hear hoofbeats think horses not zebras*. Meaning, consider common explanations rather than search for highly improbable ones. All signals point towards the bull market continuing, but we are stuck in an unfortunate period where it feels terrible to be a human existing in the United States right now. It can be hard for investors to see the positives that are driving the rally, and we find many people still extremely skeptical of the bull market or waiting for the other shoe to drop. As we hit the halfway point in the year it has been a solid, but unequal rally. To steal from Jay-Z, *I’ve got 99 problems, but the market’s not one*. We are also about to hit the apex of a hotly contested presidential election and the noise level is going to rise from a dull roar to earsplitting. Each candidate promising if you elect them, it’s all rainbows and puppy dogs, but if you don’t, we face economic ruin.

We envision a choppier 2nd half of the year, but still upward trending and bullish. The main drivers remain intact and while economic waters are muddy, fundamental earnings growth is shining brightly. Our bullish thesis is driven by 5 main themes:

1. Earnings expansion, and potentially margin expansion;
2. The strength of the Presidential Election Cycle & the technical strength of the bull run;
3. AI is still in early innings and likely continues to drive growth;
4. The Fed moving from hold to cut at some point in 2024 or early 2025; and
5. The consumer is bending, but not breaking.

1.) Earnings support further market gains

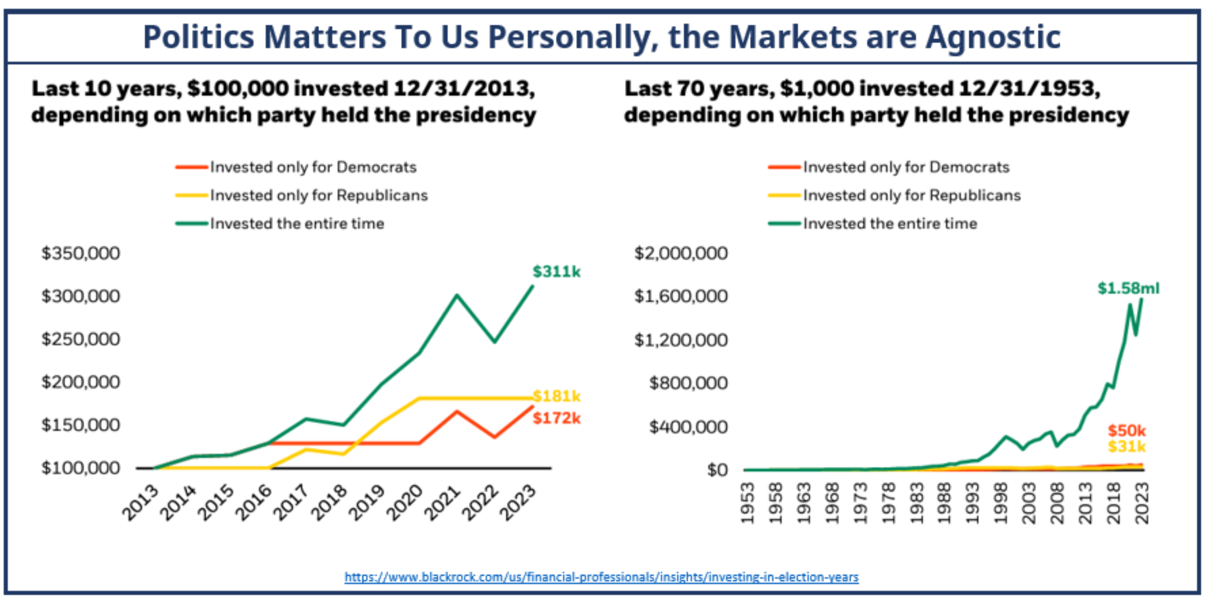
This rally has been built on the recovery in earnings, the end of the profit recession, and the continued ability of corporations to generate more revenue and begin to expand margins. Companies are also focusing on shareholder friendly policies such as buybacks, stock splits, and initiating or hiking their dividends. All of these activities return capital to the shareholder and continue to drive prices higher. Multiple matrices show that CEOs are more upbeat (even if some start to hedge against a consumer slowdown). According to FactSet, in Q1 2024 only 29 S&P 500 CEO's cited "recession" on their earnings call, down from 235 in Q2 2022. While 13 CEOs discussed the high potential of a "soft landing." With over 99% of S&P 500 companies having reported Q1 results, 79% beat their EPS numbers which is well above the 10-year average of 74%. The blended growth rate for Q1 earnings was 5.9%, higher than expected at the beginning of the year and the highest since 2022. Forward 12-month EPS estimates are also supportive of market's continuing to run, as Forward 12-month EPS now sits at 260.



Markets can be driven by 3 main catalysts: expanding earnings, increasing profit margins, and multiple expansion. The average P/E is sitting at 20.7, which is above both the 5-year average (19.2) and 10-year average (17.8). Markets aren't cheap, but we are also well below bubble territory and there is room for that to expand to 23-25x if momentum continues. Profit margins for Q1 came in at 11.8%, with 8 sectors seeing solid profit margin expansion, and we could see that push back up to the 12% levels with more efficiency and AI driving better returns and/or lowering costs. For now, the market isn't cheap, there are no buy-one-get-one free discounts, but there is also historical precedence for the market to be able to rally further given the fundamental growth backdrop.

2.) The Presidential Election Cycle Favors Equity Markets

Another driver of the bull market is 2024 is a Presidential Election year, which historically has been a strong year, and even more so when an incumbent in running. Per T Rowe Price, the stock market tends to run up in the 12-months and 6-months before the presidential election and is stronger if the incumbent party wins. Since 1949, the Dow has been up 10.1% during election years with an incumbent running vs. 5.3% in all election years and 1.6% with an open field. The Election Cycle Theory dates to the *Stock Trader's Almanac* written by Yale Hirsch, with data going back to 1833. The almanac states the reason markets rise before an election is, "incumbent administrations shamelessly attempt to massage the economy so voters will keep them in power." The election year tends to be a strong year, even if it's hotly contested such as 2000 or 2020. But regardless of who wins in November, it's likely not going to change all that much for the overall stock market. Data tells us it's best to stay invested though all US political regimes vs. trading in or out depending on which party holds the White House. Politics matters deeply to us personally, but the market tends to be focused on a much longer time horizon. Politics will constantly be in flux among the White House, House of Representatives, and the Senate, meaning turnover and power shifts are inevitable. Some industries could be more sensitive, such as solar or oil & gas, but the vast majority will not see a tremendous shift in how they operate their companies depending on who is in power.

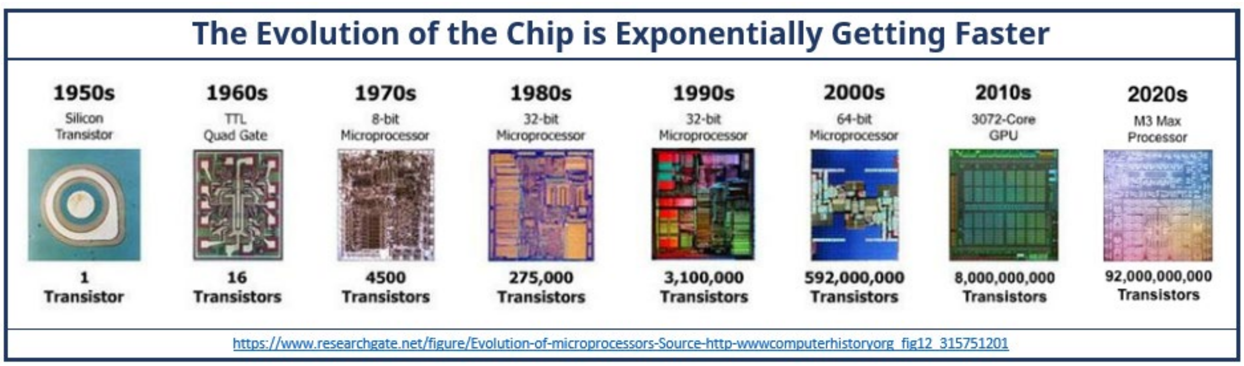


History may not always repeat itself, but it tends to rhyme and follow a pattern. While patterns can be invalidated and black swan events can occur, probability is on the side of a strong upcycle continuing. The S&P 500 is trading well above its 200-day moving average and there is a strong up-channel trend supporting further upside. And while concentration is concerning, the fact that the top-10 stocks represent 37% of the market cap of the S&P 500 are leading it higher as those stocks are currently extremely strong. AAPL, MSFT and NVDA are now each more than 6% of the S&P 500, and these technology stocks have shown their ability to grow earnings and revenues to justify some of the obscene multiples they trade at currently. The strong momentum rally, we feel, will continue to propel the winners higher and returns may continue to be dominated by technology and communications.

3.) AI has room to run

Modern economies have experienced multiple watershed technological innovations that changed the course of history. From the inventions of fire, the wheel, the industrial revolution, the car surpassing the horse and buggy, the telegraph to telephone transition, and most recently the internet boom, technological innovations have fundamentally shifted the trajectory of the global economy. Even within the recent internet era, we have seen a massive shift in how we communicate and work with texting and TikTok rapidly replacing phone calls and Facebook. AI is the next frontier, and we should see an uptick in productivity as AI driven chips become more mainstream driving exponentially faster phones and computers. There is also likely a faster replacement cycle for computers, phones, and tablets as old devices rapidly become obsolete. We saw that recently in the markets with AAPL's WWDC (WorldWide Developers Conference) where their new AI driven iOS will only work on 2 current iPhone models, or you can upgrade to the new 16 this fall.

While it feels like the technology market is moving too fast, we feel this is a normal trend that is following a tried-and-true playbook for adoption and new revenue creation. The world is constantly changing, and technology tends to move exponentially faster. Gordon Moore, the co-founder of Intel, came up with Moore's Law in 1965. Simply put, Moore's Law states that the number of components on a single chip doubles every 2 years at minimal cost. In 1965 he predicted there would be 65,000 transistors per chip by 1975, and here in 2024 we are putting 50 **billion** transistors on a chip basically the size of a peanut. Chips aren't just getting marginally better; they have radically transformed over the last 2 years and are likely to continue to evolve just as fast over the next 2.



NVDA is leading the way, but there are plenty of other chip makers also succeeding such as TSMC, AMD, QCOM, and INTC. NVDA is focused on a new chip every year – a significant acceleration from its prior 2-year rhythm. It's up and coming full system Blackwell platform is expected to again be an exponential leap forward with an inference capability 20x its current Hopper AI platform and it will consume less energy. It's estimated that NVDA is bringing computer power 1000x faster than even 8 years ago. Blackwell is expected to enable real-time AI on a trillion-parameter large language model and multiple companies are lined up to adopt this new Data center platform including AMZN, GOOGL, MSFT and ORCL. Even its current H200 chip is 45% faster than its H100 chip just released in 2023. Exponential expansion of technology should have an exponential effect on productivity and earnings, driving further market gains.

4.) A Fed Cut is not the end of a Bull Market

The Fed continues to be a wild card. Already this year expectations have ratcheted down from 6 expected cuts down to 1. But a Fed rate cut does not necessarily mean the death of a bull market. Often, it depends if the US is in a recession, or if a recession comes within 12 months of the first rate cut. Per an in-depth review of Fed policy by Schroders[1], there have been 22 rate cutting cycles since 1928. In 16 of the 22 cycles (72.7%), the US economy was either in a recession or entered one within 12-months of the initial cuts. Even with a recession headwind, over the 12-month period after the initial cuts, the average return is 11% for stocks. If you analyze the periods of no-recession, the average return jumps to 17%. There are some notable exceptions to the positive returns post-cutting, including recently 2000 and 2007 cuts which both saw drawdowns of over -10% in the 12-month period after the first cut. But if this plays out like 1995 or 1998 markets might repeat both 1995's (+23%) and 1998's (+25%) were strong bull market runs. We have been arguing that it might repeat the mid 1990's with a soft landing and coming technology boom supporting the markets.

In the 22 Rate Cutting Cycles since 1928, 73% Saw Positive Equity Returns

Figure 1: Stocks have outperformed bonds which have outperformed cash when the Fed has started cutting rates, on average

Schroders

12-month real returns from the date of the first cut

Date of first cut	Cut to rates in each cycle, %	US stock market	Government bonds	Corporate bonds	Cash
Average		11%	5%	6%	2%
Average: no-recession		17%	2%	4%	3%
Average: recession		8%	7%	7%	2%

Past performance is not necessarily a guide to the future and may not be repeated.
[1]Indicates recession occurred within 12-months. Source for return data: CFA Institute Stocks, Bonds, Bills, and Inflation (SBBI®) database, and Schroders. Source for Fed Funds data: Post-1954 is direct from FRED. Earlier data is based on the Federal Funds rate published in the New York Tribune and Wall Street Journal, also sourced from FRED. I follow an approach consistent with that outlined in A New Daily Federal Funds Rate Series and History of the Federal Funds Market, 1928-1954, St Louis Fed. For that earlier data, a 7-day average has been taken to remove daily volatility i.e. the month-end figure is the average in the 7 days leading up to month-end. 611505

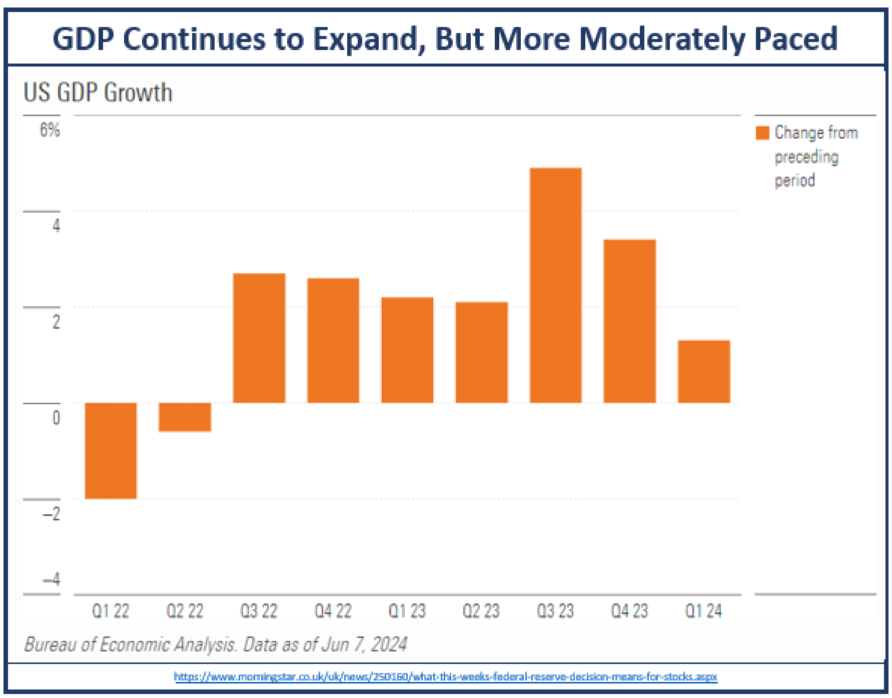
https://www.schroders.com/en/global/individual/insights/how-do-stocks-bonds-and-cash-perform-when-the-fed-starts-cutting-rates-/

Jay Powell was appointed to the helm of the Fed in 2018 and has faced both praise (COVID response) and criticism for mistakes on inflation in 2020-2023 (who could ever forget "transitory"). He has job security through May 2026, but will be defined by his ability to decisively tame inflation and avoid the re-acceleration of the late 1970's. One of the highest correlating periods in Fed history would be the mid-1990's Fed led by Alan Greenspan. In 1994, there were 6 hikes taking rates from 3.25% to 5.50% followed by one more hike of 0.50% to take rate to 6.00% in early 1995. the Fed added a full 300bps move up, before holding them there until a very slow gradual easing over 1995-1996. During the hiking cycle of 1994 through 1995, GPD growth slowed from 3.4% to 2.25% before recovering swiftly in 1996. While the S&P was down marginally -1.54% in 1994, it then ripped off 5 straight years of 20-30% annual growth per year. Markets showed that even during a hiking cycle, slowing GDP, and a gradual easing cycle, secular tailwinds such as rapid technology innovation can drive markets higher and the economy to a soft landing avoiding a recession. The 1990's tech and internet driven rally lasted well past "irrational exuberance," but did eventually come crashing down 2000-2002. If the current cycle follows a similar blueprint, we have more upside to come.

[1] https://www.schroders.com/en/global/individual/insights/how-do-stocks-bonds-and-cash-perform-when-the-fed-starts-cutting-rates-/

5.) The Consumer is Bending not Breaking

The health of the US economy depends on the US consumer. The consumer is the biggest question mark, that in my opinion, has the highest potential to upset the market rally. Recent economic data has painted a mixed picture of US consumer health. The consumer discretionary sector, dominated by AMZN and TSLA, is one of the lagging sectors this year, up only about 2.61% through 6/14/2024. It is the 2nd weakest sector YTD, only trailed by real estate, and is about 10% behind the S&P 500. The sector is lagging due to concern that multiple consumer profiles are hurting and beginning to change spending behavior. Oxford Economics' Michale Pearce stated, "low-income households are already bearing the brunt of high inflation in addition to cooling labor markets. Delinquency and defaults are ticking up for these vulnerable consumers." We have seen companies like DG and MCD flag the consumer as a risk to growth but are also seeing "trading down" from moderate to high income earners looking to get a discount and becoming more price conscious. The trillion-dollar question is if all the COVID liquidity and excess cash and savings have been fully exhausted, and if the consumer really cannot spend any more, or if it is status quo and spending continues. The flip side to the price crunches of inflation is that wage growth has been rising steadily, helping offset the pain of higher prices. The health of the consumer is one area we are watching closely as it is a risk to our bull thesis. For now, we feel the consumer continues to make enough and spend heartily to support a US economic expansion. While GDP growth may continue to moderate, it is still expanding.



May's softer CPI reading gives hope that inflation will potentially be less of a pain point going forward for the consumer. Payroll growth remains solid, even as JOLTs falls, and it shows the labor market is moving more into balance. Inflation moderated in May in some key areas such as gasoline prices down 36% and the first decline in motor vehicle insurance costs since 2021 (though still up an eye watering 20% from a year prior). If we can see continued moderation in inflation, robust jobs growth, and wage growth, the consumer is likely to continue spending and keep our economy growing.

We are in a new chapter of the stock market driven by AI. Markets are not cheap, especially growth markets, the technology sector, and the bulk of the Magnificent 7. All those areas are trading at multiples above the 5-year and 10-year averages. But Alan Greenspan noted “irrational exuberance” on December 5, 1996, and the markets remained exuberant for a further 2 years. As bull markets go, this rally off the October 2023 lows is extremely normal. This rally lags the rallies in 1982, 2009, and 2020, with all of those persisting much longer before succumbing to valuations. Bulls last significantly longer than bear markets, and with a new technological innovation driving potential profits higher, for now we feel the bull will keep charging up.

There are plenty of risks lurking, and we remain vigilant watching leading indicators, consumer health, credit delinquencies and other potential canaries in the coal mine that would alarm us that the bull market may be coming to an end. But doom and gloom is often the incorrect outlook. Doom sells so we see the media focus more on terrifying *what-ifs* from the great cicada double brood event, to hyping up the potential fall of democracy in November. It is unlikely to derail the USA, though with continued focus on horrible possible outlooks, it’s Chinese water torture dripping away at investors and convincing us the world is lost. There are plenty of perma-bears calling for a crash and eventually they will be right. But so is a stopped clock twice a day, and that does not make it worth paying attention to.

Complaining Everything is Terrible is a National Past Time of Sorts

Graphic made by V Greene

But if you remember Y2K, or the 2012 potential Mayan apocalypse, it’s more probable that horrible events do not occur. And if they do, such as 9/11, our country has shown great resilience and togetherness in building back stronger. We continue our mantra of “keep calm and rally on,” and believe that this is a bull market and not a faux bear about to bring ruin to portfolios. The market rally is the hoofbeat of horses, not zebras, even if it is hard to believe. As Roman historian Tacitus opined, “the desire for safety stands against every great and noble enterprise.” Or more succinctly stated by Babe Ruth, “never let the fear of striking out get in your way.”

6 DEGREES
WEALTH

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