JULY: A BIG SHIFT IN EQUITY LEADERSHIP

INFLATION UPDATE: MAJOR CONTRIBUTORS TO CPI

Figure 1: 7/31/2024 Returns (source: Bloomberg)

Conditional formatting: green (high) to red (low) for each time period

Bonds	ETF	Month	YTD	1YR	vs. 52-wk High	vs. 52-wk Low
US Aggregate Fixed Income	AGG	2.4%	1.7%	5.1%	-0.6%	8.2%
Investment Grade Corp Bonds	LQD	2.6%	1.2%	6.2%	-1.7%	11.5%
U.S. Treasury Bonds	GOVT	2.2%	1.4%	4.1%	-0.6%	6.6%
U.S. 20+ YR Treasuries	TLT	3.6%	-2.2%	-1.5%	-5.7%	15.0%
Muni Bonds	MUB	1.3%	0.8%	4.0%	-1.0%	6.8%
US High Yield	HYG	2.4%	4.7%	10.5%	-0.1%	9.6%
Non-US Corp Bonds	IBND	2.8%	-0.3%	4.8%	-2.8%	10.3%
Emerging Markets Bond LC	EMLC	2.3%	-1.6%	-0.6%	-5.8%	4.7%
Global Equity						
ACWI Global Equity	ACWI	1.5%	13.1%	16.9%	-2.3%	29.2%
ACWI Global Equity ex US	ACWX	2.2%	7.9%	9.2%	-2.3%	20.9%
International Developed	EFA	2.6%	8.5%	11.2%	-2.2%	22.4%
Emerging Markets	EEM	0.8%	7.6%	5.1%	-3.8%	18.1%
Global Equity by Region						
United States	VTI	1.9%	15.7%	21.2%	-2.4%	34.6%
Europe	IEUR	2.5%	8.3%	11.4%	-3.7%	23.9%
Asia ex-Japan	AAXJ	0.4%	9.0%	4.6%	-4.4%	18.6%
China	MCHI	-1.5%	2.4%	-14.1%	-15.4%	16.7%
Japan	BBJP	4.1%	11.9%	14.7%	-1.2%	23.2%
Latin America	ILF	0.2%	-12.4%	-7.8%	-16.9%	4.6%
US Equity						
US S&P 500	IVV	1.1%	16.6%	22.0%	-2.6%	34.6%
NASDAQ 100 QQQ	QQQ	-1.7%	15.4%	23.6%	-6.4%	37.7%
US Large Growth	IWF	-1.7%	18.4%	26.7%	-6.4%	40.0%
US Large Value	IWD	5.1%	11.9%	14.6%	-0.8%	27.9%
US Eqwt S&P 500	RSP	4.5%	9.6%	12.6%	-0.9%	28.7%
US Mid Cap	IJH	5.9%	12.4%	15.4%	-1.4%	33.9%
US Small Cap	VTWO	10.5%	12.3%	14.5%	-2.0%	38.5%

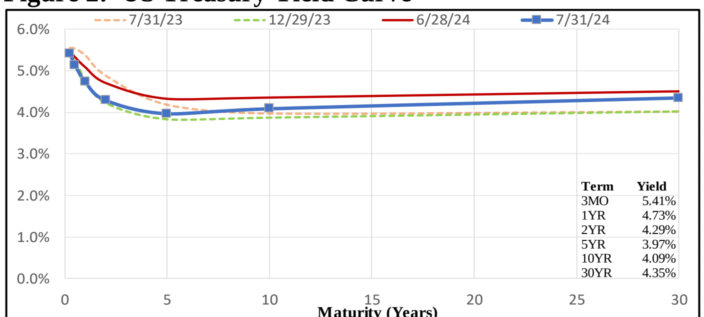
Softer employment and inflation data increased expectations for significant interest rate cuts this year and next, driving strong bond returns and a shift in equity leadership in July. Performance highlights for the month and year-to-date (YTD) are below.

- Bonds: The US Aggregate index (AGG) rose 2.4% this month (+1.7% YTD) as yields fell. Long-term Treasuries (TLT), which are very sensitive to interest rates, gained 3.6% (-2.2% YTD). Corporate bonds (LQD) rose 2.6% (+1.2% YTD), and high yield (HYG) rose 2.4% (+4.7% YTD). Non-US bonds were up this month but are down YTD on US dollar strength.
- Global equity (ACWI): +1.5% in July (+13.1% YTD).
- US Equity: The broad market (VTI) rose 1.9% (+15.7% YTD). The S&P 500 (IVV) gained 1.1% (+16.6% YTD). Small cap stocks (VTWO) logged spectacular gains of 10.5% (+12.3% YTD) but have still under-performed over the longer term. Falling bond yields fueled a sizeable rotation out of large growth stocks (QQQ and IWF) and sectors (technology and communications) into cyclical stocks (value and small caps) and rate-sensitive sectors (real estate, utilities and financials).
- Non-US Equity: Developed markets (EFA) gained 2.6% in July (+8.5% YTD), led by gains in Japan (BBJP +4.1%, +11.9% YTD) after the Bank of Japan finally raised interest rates above zero, rallying the Japanese stock market and currency. Emerging market stocks (EEM) rose 0.8% (+7.6% YTD) on continued gains in India (INDA +2.9%, +17.6% YTD) but weakness in China (MCHI -1.5%, +2.4% YTD).

Interest Rates and the Economy

The yield curve (Figure 2) plots the interest rates (vertical axis) for various US Treasury maturities (horizontal axis). Yields declined in July as benign employment and inflation data fueled hopes that the Federal Reserve will cut interest rates in September with more aggressive cuts through 2025. Headline CPI fell to 3.0% year-over-year, and the 2.6% reading on core Personal Consumption Expenditures, the Fed's favored inflation metric, rests just above their 2% target. An inverted yield curve (short-term > long-term yields) is usually a recession warning, but a "soft landing" now seems likely. US 10-year Treasuries now yield 4.09%.

Figure 2: US Treasury Yield Curve

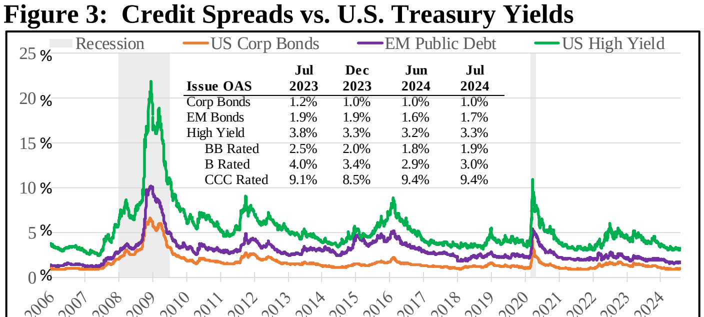


Source: Board of Governers of the Federal Reserve System via St. Louis Fed (FRED)

For bonds other than US Treasuries, we track the option-adjusted spread (OAS) between their yields and Treasuries of comparable maturities (Figure 3). Low or narrowing spreads signal optimism, while high or widening spreads signal fear. Spreads were stable again in July but remain very low by historical standards.

- Investment grade corporate bond spreads were steady at +1.0% this month and are slightly below the 1.2% spreads a year ago.
- High yield (non-investment grade) spreads have stabilized at +3.3% but are still down from +3.8% in the last year. Spreads of the riskiest bonds (rated CCC & below) were stable at +9.4% but have widened this year and over the past twelve months.
- Emerging market spreads widened to +1.7% but have tightened versus +1.9% a year ago; investors see low risk in EM debt.

Figure 3: Credit Spreads vs. U.S. Treasury Yields



Source: Ice Data Indices, LLC via St. Louis Fed (FRED)

Inflation Update: Contributors to CPI

The Federal Reserve (Fed) began hiking interest rates in March 2022 to combat the inflation spike that followed the massive supply chain disruptions during the COVID pandemic, the subsequent fiscal and monetary response, and further energy and commodity price shocks after Russia invaded Ukraine. Having raised rates aggressively from near zero to the current target range of 5.25-5.50%, the Fed seems poised to cut interest rates as headline CPI (Consumer Price Index) inflation has declined from a June 2022 peak of 9.1% to a 3.0% annual rate as of June 2024. (Note: The Fed's preferred inflation metric, core Personal Consumption Expenditures, is now 2.6% year-over-year excluding the volatile food and energy prices; this remains above their 2.0% target.)

Stock and bond markets in the US (and around the world) remain laser-focused on every new piece of economic data, extrapolating implications for the timing and magnitude of potential interest rate cuts. This week, the Fed reiterated their plan to begin cutting rates only when they "have greater confidence that inflation is moving sustainably toward 2%." Fed Chair Powell stated that they are "getting closer… but not quite there yet," hinting that a September rate cut could be appropriate. Investors cheered.

The graphic below provides a fascinating and thorough overview of inflation dynamics across multiple sub-components. The key drivers of inflation have clearly evolved. The initial spike was fueled by pandemic-related supply chain disruptions, causing sharp increases in energy (green bars in the figure below) and goods prices (orange bars). (Note: "Core goods" are the tangible things that we buy, like apparel, cars, furniture, etc.) The global economy basically shut down; ships could not get into ports to be unloaded, and store shelves were empty. Energy and food (purple bars) supplies were further disrupted after Russia invaded Ukraine in early 2022. The inflationary impact of these categories (energy, goods, food) subsided as the global economy reopened and supply chain disruptions were resolved. Prices have begun to decline more recently, with observable decreases in the price of gas, new and used cars, furniture, appliances, electronics, and other goods according to the Bureau of Labor Statistics.

The current sources of inflation are shelter (rent and home prices), leisure services (dining out, recreation, travel, etc.) and episodic spikes in other areas, such as the recent jump in car insurance premiums. The most painful and difficult to resolve is "sticky" shelter inflation. High mortgage rates caused a shortage of houses for sale as homeowners chose to stay put rather than buy a new home with a much higher mortgage rate. This increased demand and prices for new homes and apartments. While shelter prices remain high, the rate of increase has begun to decline. Interest rate cuts could help reduce shelter inflation further as lower mortgage rates could help rebuild the existing home sales inventory.

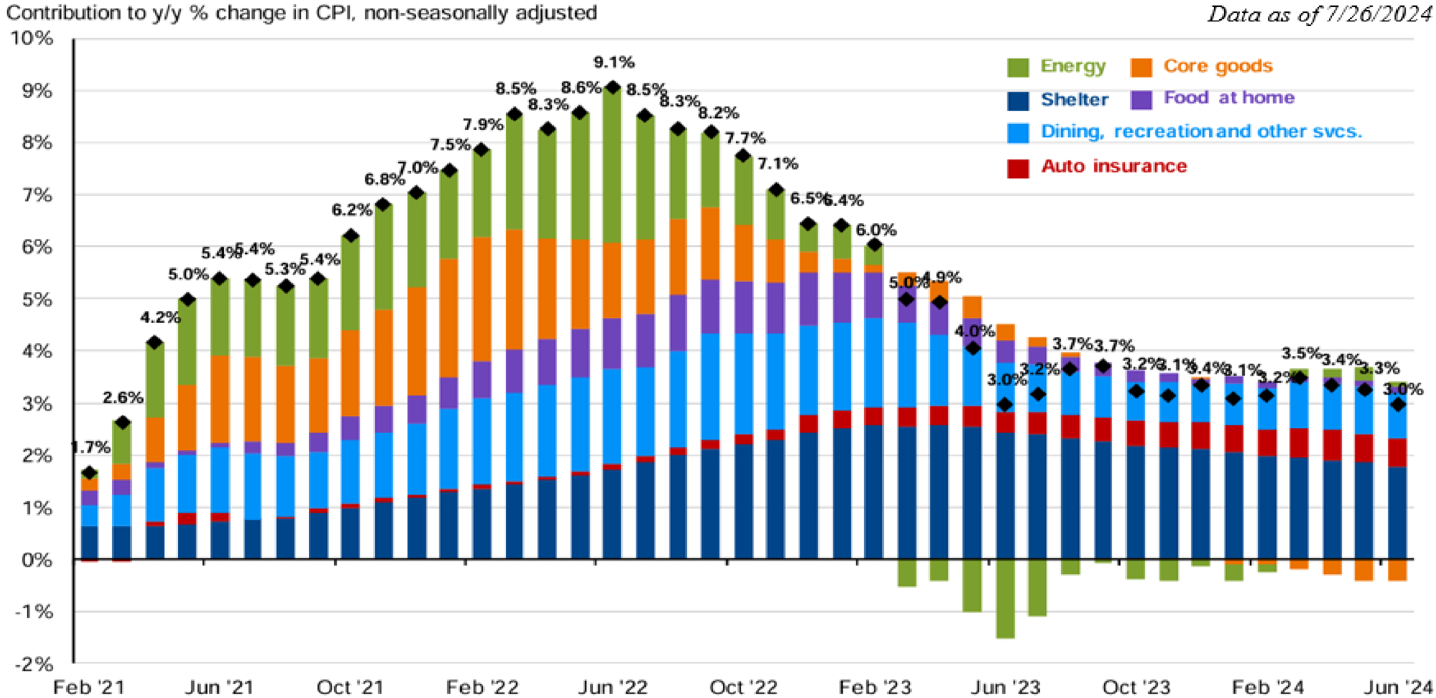
Bottom Line

Investors remain hyper-focused on interest rates, analyzing each new economic data point to assess when the Fed will begin cutting interest rates and by how much. Stocks and bonds lost value in April as stronger-than-expected employment and inflation data pushed expectations for Fed rate cuts further out into the future. Softer economic data in May and June renewed investors' hope for Fed rate cuts this year, causing stock and bond prices to rebound. Investors were further encouraged by lower-than-expected employment and inflation data released in July and now expect the Fed to cut rates to 3.50-3.75% by the end of 2025, according to the Fed Funds Futures market pricing. These expectations continue to fuel gains in stocks and bonds and have led to a significant rotation into more economically-sensitive segments, most notably into smaller stocks, which tend to be highly cyclical. Whether this rotation continues will depend on incoming data, including the monthly jobs report due out this week and inflation updates due out later this month. Diversification continues to be critical to offset further market volatility, which will likely remain elevated through the end of the contentious US elections.

Contributors to headline CPI inflation

Contribution to y/y % change in CPI, non-seasonally adjusted

Source: JP Morgan "Guide to the Markets"
Data as of 7/26/2024



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