July 22, 2024

Cooling Inflation Helps Markets

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Mid-Year Review

The market had a great first half to 2024, with the S&P 500 up over 15% through the end of June. While market performance has largely been driven by Nvidia and the "Fabulous Three"—Amazon, Facebook/Meta, and Microsoft—we have also seen more broad-based positive performance from other areas of the market. More recently in July, we have seen the resurgence of performance from mid and small cap stocks as well as value stocks as we continue to see favorable data. Let's review some of the latest numbers:

1. **Inflation Continues to Fall –** The most notable news of late is the June Consumer Price Index (CPI) from the U.S. Bureau of Labor Statistics which surprised with a rate of 3.0%, the lowest in a year. Core CPI—less food and gas—was also below expectations at 3.3%. Lower inflation bodes well for interest rate cuts later this year by the Federal Reserve (Fed). Lower interest rates are more beneficial for smaller companies and value stocks and this was apparent in their outperformance after the inflation data was released.

2. **Broadening Corporate Earnings –** Earnings season is just kicking off but expectations for year-over-year growth for the S&P 500 are at 8.8% for the second quarter. This would mark the fastest pace since the start of 2022, but more importantly, eight out of the eleven sectors are projected to have positive growth. This is another sign that other areas of the market—outside of technology and communication services stocks—may see a favorable reversal.

3. **Labor Market Balancing –** The unemployment rate ticked up to 4.1%. While this is the highest rate since late 2021, it remains a historically low rate and not necessarily a bad sign as it supports a cooling, yet positive, economic growth. This is the scenario that the Fed is looking for to start cutting rates, a moderating inflation and balanced economic activity.

Lower inflation and a balanced economy enhance the chances of an interest rate cut later this year. This would be beneficial for most broad-based asset classes including stocks, bonds, and real estate. A rate cut, paired with strong corporate earnings, could be particularly beneficial for undervalued areas of the market such as small-cap and value stocks.

Diversification Math Lesson

As I discussed in my last market update, we are seeing concentration risk in certain areas of the market, particularly with a handful companies which have been driving a large portion of total market returns over the past year and a half. These companies are now trading at very high valuations and, given that markets are cyclical, there may be a reversal of fortunes coming up, while other companies catch up.

Over-concentrating to fewer areas of the market leaves your portfolio open to the risk of more severe drops, which may be hard to recover from. The chart below helps to illustrate how diversification can help alleviate some of these risks:

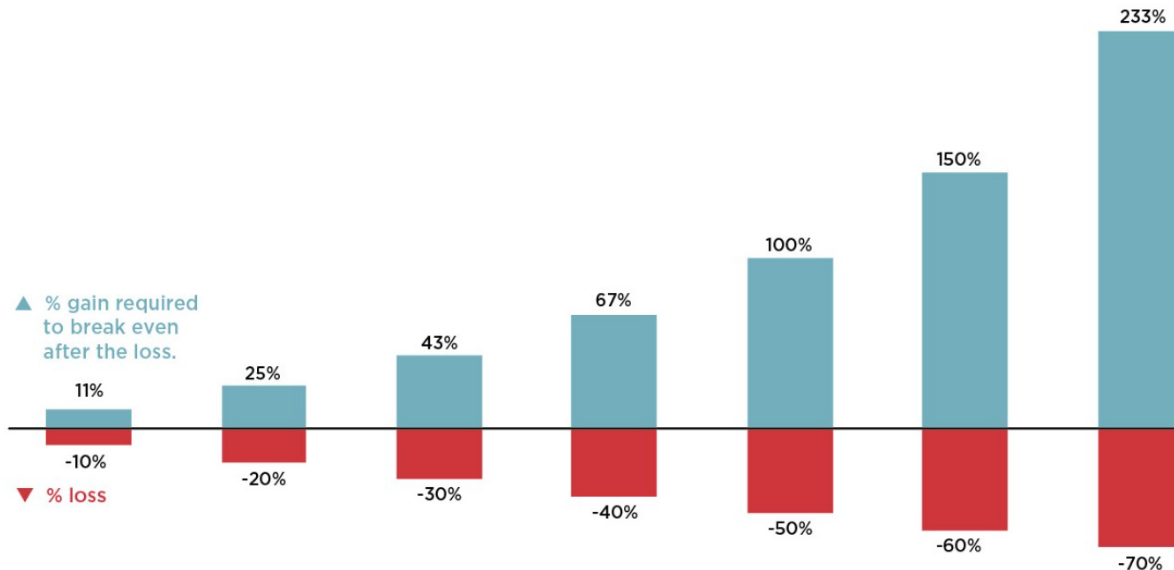
1. **The $100 Example** – Let's say you start with $100 and in year 1 your portfolio drops 10%, you are left with $90. In year 2, the market rebounds 10%, and you rejoice, until realizing you only have $99. You actually need an 11% rebound in year 2 to get back to your starting amount of $100. The balance between losses and gains needed to recover is not symmetric, and it gets harder to recover the more you lose.

2. **Win by Losing Less** – By allocating to various different asset classes which are less correlated with each other, you are able to dampen the losses in any period. If you lose less, then it becomes easier to recover when the rebound occurs. This is particularly true for more severe market drops. Notice that a 50% loss requires a 100% gain to recover but a slightly larger 60% drop needs a whopping 150% return to make it back.

3. **Diversification for the Long-Term** – A globally diversified and balanced portfolio approach helps support a smoother ride over the long-term, with less severe drawdowns. During the 2007-2009 Financial Crisis, the S&P 500 lost about 51%, which would have required close to a 105% return to recover. Meanwhile, a 60% global stock / 40% bond diversified portfolio would have lost about 35%, only requiring a 53% recovery to recoup losses.

Stay diversified, my friends.

Percentage Return Required to Fully Recover from a Loss



Source: Nationwide IMG Competitive Intelligence Team. https://blog.nationwidefinancial.com/markets-economy/capital-market-impact/break-even-math-how-much-gain-is-needed-to-recover-from-a-loss-fully/.

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As always, Dynamic recommends staying balanced, diversified and invested. Despite short-term market pullbacks, it's more important than ever to focus on the long-term, improving the chances for investors to reach their goals.

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