NORTH STAR
ASSET MANAGEMENT, INC.

July 2024

# INVESTMENT UPDATE

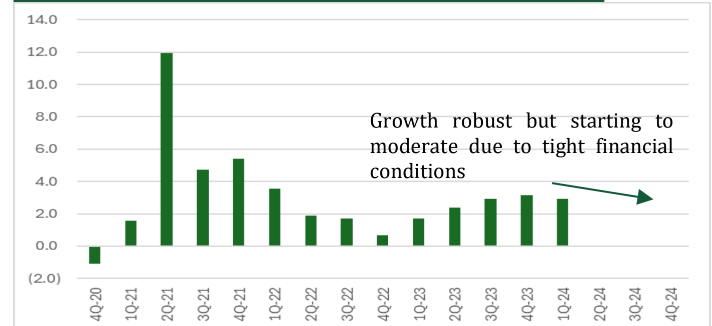
## Executive Summary

- Stock market returns diverged materially with a handful of mega-cap technology stocks driving substantially all incremental returns in the quarter.
- The Fed maintained the Fed Funds rate at 5.25-5.50% for the 4th consecutive quarter and financial conditions are back into balance, with the money supply back to historical averages relative to GDP, and "real-time" inflation remaining under control around the Fed's target of 2.0%.
- The U.S. economy remains robust and growing but the effects of high rates are now starting to impact growth.
- The Fed should start lowering rates now as overtightening remains one of the main risks to future economic growth.
- Market cap concentration reached new highs as the divergence in earnings growth and investor sentiment around a handful of mega-cap technology companies increased during the quarter.
- Excluding these handful of companies, stock and bond market returns were subdued in the quarter, but underlying fundamentals for earnings growth continue to improve.
- We believe stock market returns will broaden as earnings growth accelerates during the 2nd half of the year and beyond, while broad market valuations remain fair.
- Return prospects remain attractive and long-term investors should remain invested at the mid-to-high end of the range in equities and the low-to-mid end of the range in bonds relative to their long-range targets.

## High Rates are Increasingly Showing Their Effect with Inflation Remaining Low and Growth Moderating

Interest rates remained high during the quarter as the Fed maintained the Fed Funds rate at 5.25-5.50%. Hence, monetary policy remains tight and broad financial conditions have come back into balance. "Real-time" inflation (excluding lagging shelter costs) remains low around the Fed's long-term target of 2.0% and the money supply (M2), a key leading indicator of future inflation, has normalized back to its historical levels relative to the size of the economy, providing further evidence that inflation is back under control. However, given the lagging effects from monetary policy action to economic impact, high interest rates have now started show their impact on the U.S. economy. Growth remains resilient, with real GDP (nominal minus inflation) growing close to +3.0% year-over-year through the 1st quarter 2024, as shown in graph 1 in the next column, but growth is expected to slow going forward as the normalization in conditions is evidenced broadly. This includes the continued narrowing of the gap between the demand and supply of labor, growth in incomes moderating, and continued subdued demand in the most interest rate sensitive areas of the economy such as real estate and other discretionary categories.

**Graph 1: U.S. Real GDP Year-over-Year Percentage Change**




Source: U.S. Bureau of Economic Analysis, North Star Asset Management

Despite the expected moderation in growth, we continue to be constructive on the underlying fundamentals in the economy. The consumer, which makes up two-thirds of the economy, continues to be in good shape, albeit with some financial pressures for lower income households, as net worths remain at all-time highs, employment levels remain close to record levels, and aggregate debt and debt-service costs remain low. Additionally, the banking system remains healthy with plenty of liquidity and good loan quality despite slower loan growth. Overall, when combining these solid fundamentals along with lower future interest rates as the Fed starts easing, we believe economic growth will be sustained going forward.

## The Fed Should be Lowering Rates as Overtightening Remains a Main Risk to the Economy

Having successfully met its two mandates of getting inflation back under control while sustaining economic growth, the Fed has signaled over the last six months that they will be lowering rates going forward, gradually easing towards a more balanced monetary policy-stance over the coming 12 to 24 months. At the beginning of the year, expectations were for four to six interest rate cuts by year-end and continuing into 2025. However, due to the resilience of the economy, expectations have gradually fallen to one or two cuts for the year. While there are concerns that inflation could reaccelerate due to continued economic growth as interest rates come down, these worries are misplaced as inflation is caused by an imbalance in money supply relative to the size of the economy. Due to the very restrictive financial conditions, including historically high real yields currently above 3.0% as shown in graph 2 on the next page, the balance between the money supply relative to the size of the economy has rapidly normalized back to historical levels.

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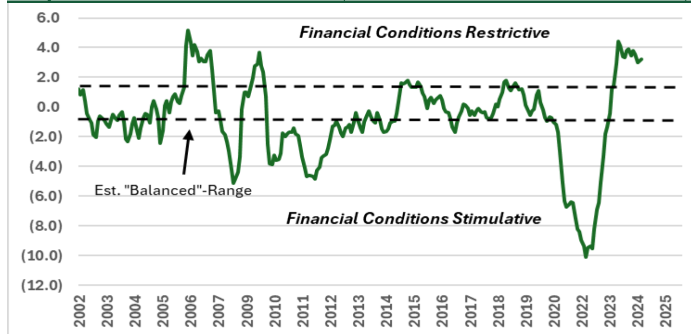
**Graph 2: Real Fed Funds Rate % (Fed Funds minus CPI excl. Shelter)**




Source: St. Louis Fed, Bureau of Labor Statistics, North Star Asset Management

We believe the Fed should start to lower rates now to continue to support sustained growth, as it will take time for rate cuts to impact the economy. The prolonging of keeping rates high continues to increase the risk of temporarily causing an economic slowdown in 2025. It also increases the likelihood of the Fed having to cut rates faster and to a greater degree, in order to stimulate the economy, leading to continued magnification of the business cycle and increased market volatility.

## Market Cap and Return Concentration Reached Historical Highs While Broad Market Returns Were Subdued

After very strong, broad-based market performance for stocks and bonds in the six months leading up to the 2nd quarter, market returns have since diverged significantly. For the quarter, large cap stocks (S&P 500) continued to perform and were up +4.3% and up +15.3% year-to-date, small cap stocks (Russell 2000) were down -3.3% in the quarter and up +1.7% year-to-date, international stocks (MSCI EAFE) were down -0.3% and up +5.3% year-to-date, and bonds (USBIG) were up +0.1% and down -0.7% year-to-date. Going into the quarter, broad valuations were slightly above historical averages, due to the strong outlook for above-average earnings growth, and it was anticipated that the market would enter a short period of lower returns as companies "grew into their valuations". This largely took place in the broad market but is not apparent when looking at the S&P 500, as the total index performance did not reflect the average return of the 500 companies. Performance was mainly driven by a handful of mega-cap technology companies (up over +30% year-to-date combined) that have contributed more than half of the entire index return year-to-date. Specifically, one technology company, which has more than doubled in value year-to-date, has contributed over one-third (or more than 5 percentage points) of the index return year-to-date, and close to half of returns for the index in the 2nd quarter. The stark contrast in return dispersion can also be shown by comparing the S&P 500 (market cap-weighted) versus the S&P 500 equal-weighted index which was down -2.6% in the quarter and is only up +5.1% year-to-date. Subsequently, market concentration in the S&P has reached record highs with the top 3 companies making up over 20% of the total index value, and the top 10 stocks now making up 37%, as shown in graph 3 in the next column.

While the current market concentration and divergence in performance could continue near-term, we ultimately believe it will reverse and that the contribution to earnings growth and market returns will broaden over time.

**Graph 3: Weight of Top 10 Stocks by Market Capitalization in S&P 500**

Source: JP Morgan Asset Management

## Broad-Based Earnings Growth Fundamentals Improving and Long-Term Return Prospects Remain Attractive

Stepping back, we maintain our view that the fundamentals for sustained long-term economic growth underpinned by technological innovation, driving broad productivity growth in the economy, remain firmly in place. However, it is relatively early in the current innovation cycle. In the current phase, the pace and magnitude of capital investments to develop the technology and build capacity is extremely high, in fact much higher than anticipated only a few quarters ago, and largely independent of broader financial conditions. The mega-cap technology companies that have driven stock performance year-to-date are at the heart of the current phase, which has driven exceptional earnings growth and led to tremendous investor optimism, resulting in valuation-multiple expansions, further amplifying stock returns. When combining these dynamics with the expectations for fewer rate cuts in 2024, which affects stocks in the broader market more short-term, this has led to the recent deviation in stock returns and subsequent market concentration.

Despite a temporary pause in broad market returns during the 2nd quarter, the underlying fundamentals for sustained long-term earnings growth and stock returns continued to improve and we expect earnings growth to accelerate as we move into the 2nd half of the year and beyond. We believe growth will be driven by the combination of the continued normalization of business conditions post-pandemic, cyclical tailwinds as the Fed starts lowering interest rates, and broadened productivity benefits from technological innovation and digital transformation. Consequently, we believe this leads to a convergence in earnings growth as the broader market accelerates, while growth for the mega-cap technology companies remains high but slows, as earnings comparisons get tougher going forward. At the same time, while valuations are higher for these select companies, broad market valuations are roughly in line with historical averages. Overall, given that we expect earnings growth to be higher than average over the next several years, return prospects remain attractive for long-term equity investors. For bond investors, return prospects remain some of the most attractive in the last 15 years. Overall, we believe long-term investors should remain invested at the mid-to-high end of the range in equites and the low-to-mid end of the range in bonds relative to their long-range targets.

*In accordance with SEC Rule 204-3(b), our Form ADV is available upon request. Please call or write to Susan C. Beaver, North Star Asset Management, Inc., 134 E Wisconsin Ave, One Neenah Center, Suite 300, Neenah, WI 54956.*