

Quarterly Market Commentary

Second Quarter 2024

Maintaining Equilibrium



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“Peace is an unstable equilibrium, which can be preserved only by acknowledged supremacy or equal power.”

- Will Durant, *The Story of Civilization*

Will Durant was an American historian and philosopher best known for his 11-volume series “The Story of Civilization”. He and his wife, Ariel, spent the better part of forty years publishing the chronicles of Eastern and Western civilization, and through their work, the Durants were awarded both the Pulitzer Prize for General Nonfiction and The Presidential Medal of Freedom.

Economies, like peace, are typically in a state of unstable equilibrium. While there are periods of boom and bust, just as there are periods of prosperity and war, these extremes have usually been shorter-lived. Following the pandemic, the U.S. economy has maintained an unsteady equilibrium for far longer than most investors expected. Despite high inflation, rapidly rising interest rates, several wars beginning around the globe, and a contentious election cycle, the US economy has steadily grown.

The Young and the Restless

The Federal Reserve’s interest rate hikes have continued to rein in the rate of economic growth. Higher borrowing costs are disproportionately impacting stretched consumers and businesses leading to rising consumer delinquencies, rising corporate bankruptcies, and a falling consumer savings rate not seen since the Great Financial Crisis.

When the Fed began raising interest rates in March of 2022, certain pockets of the economy were immediately squeezed. Younger households, whose incomes are relatively

lower, and debt is relatively higher, have felt the most pronounced effect. As a result, credit card and auto delinquencies amongst the youngest consumers are at levels not seen since 2008. The reason this is a concern, beyond the long-term social impact, is that these levels have been reached despite a very strong labor market. The unemployment rate has remained near 4.0% during the post-pandemic period, far below the long-term average of 5.7%. Although employment is high, an increasing number of people are falling behind on paying their bills.

Another look into the health of the consumer is to measure the level of deposits on household balance sheets today versus their balances prior to the pandemic. When comparing the two periods, only the top quintile of household incomes has larger balances in their checking and savings accounts than they did four years ago. Said another way, 80% of American households have depleted their savings as a result of the inflationary environment over the past few years.

Lifestyles of the Rich and Famous

Economic growth has powered ahead despite the figures above. Part of the explanation lies in the fact that the top quintile of income earners represents almost 40% of the total consumption in the US. This cohort continues to fill airports, sports stadiums and concert venues with leftover pandemic stimulus and increased household net worth from higher financial asset prices over the past few years.

Since the famous Fed “pivot” in November 2023, the market capitalization of the S&P 500 has risen roughly \$12.5 trillion, and the bond market has increased about \$3.2 trillion. For context, US consumer spending in all of 2023 was \$19 trillion. In just the past 7 months, we have created total household wealth nearly equal to consumer spending in all of 2023.

Quarter To Date as of June 30, 2024 ¹	
S&P 500 Total Return Index	4.3%
Dow Jones Industrial Average	-1.3%
Nasdaq Composite Index	8.3%
Russell 2000 Index	-3.3%
MSCI EAFE Index	-0.2%
MSCI Emerging Markets Index	5.0%
Bloomberg Aggregate Bond Index	0.1%

The “K Economy” Persists

While an income and wealth divide has always been present in America, monetary policy of the past 27 months has exacerbated the issue. For those who owe money, the Fed’s interest rate increase has been extraordinarily painful. However, for those who own assets, the environment may have never been better.

The stock market and home prices are at all-time highs, cash flows from fixed income investments are the highest they’ve been in 20 years, and those with low-rate debt or have no debt at all have largely been impervious to the rate hikes affecting younger and more highly levered families. Interestingly, many homeowners who purchased or refinanced homes and mortgages during the 2010-2020 period are now “trapped” in their houses, unwilling to trade a 3% mortgage for a new 7-8% loan. Further, they have borrowed money at

a lower rate than the yield of their investments and are actually earning a healthy spread.

The bifurcation of the consumer base has a parallel in Corporate America. Generally speaking, smaller and younger firms have borrowed or raised money to fuel operations and growth. These firms tend to have higher debt as a percentage of enterprise value. Default rates have nearly tripled over the past 2 years for these smaller and highly indebted companies as they have struggled to absorb higher borrowing costs. Since these companies employ fewer people and the overall default rate remains modest, the impact on the broader economy has been small.

Like the top end of the consumer K, large firms such as those in the S&P 500, have been mostly insulated from a higher cost of capital. Many issued low-rate debt during the pandemic tend to be less indebted overall, and generate more cash flow, enabling them to self-fund growth.

This trend can clearly be seen in market performance, as larger companies outperformed their smaller counterparts in the 2nd quarter. The performance gap between the Large-Cap and Small-Cap indexes (as measured by the S&P 500 and Russell 2000) was an astonishing 760 basis points over the last 3 months and 1,500 basis points in the year-to-date².

Stronger for Longer

In recent months, there has been some evidence that the consumer is pushing back against inflationary price increases. Despite slowdowns in retail sales and discretionary spending, there has been no subsequent slowdown in earnings expectations out of Wall Street. Analysts are estimating +9-10% EPS

¹ Black Diamond

² FactSet

growth in the most recent quarter – largely driven by the secular growth story of artificial intelligence (AI).

For their part, CEO's are the most bullish they have been on the economy since late 2021. They have put their money where their optimism is, as they have maintained their workforce in the face of a restrictive rate environment.

Further, given the wealth effect of rising asset prices over the past 18 months, consumer spending may very well hold up well into the future.

There are risks, of course. The Fed cannot yet declare victory on inflation as the Consumer Price Index has been stuck around 3%. Well north of their 2% target. The risk to the economy and risk asset rally has been and continues to be the Fed's commitment to getting inflation back to 2%. The lagged effects of policy and the economic damage that may evolve alongside remains unknown. Keeping interest rates higher for longer seems a blunt tool, but it is the only one at their disposal to ultimately win that fight.

Nevertheless, the economy and markets have been able to withstand the restrictive rate environment to date, and we believe that this resiliency can persist.

As always, we thank you for your partnership and stand ready to answer any and all questions that you may have. Enjoy the remaining months of summer!

Respectfully,

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The impact of the outbreak of COVID-19 on the economy is highly uncertain. Valuations and economic data may change more rapidly and significantly than under standard market conditions. COVID-19 has and will continue based on economic forecasts to have a material impact on the US and global economy for an unknown period.