KAR | Kayne Anderson Rudnick Investment Management

# Market Review Commentary

2Q 2024

## Market Review

The U.S. equity market had a positive return in the second quarter with the S&P 500 Index advancing 4.28%, bringing the year-to-date return to 15.29%. Large cap growth stocks, as measured by the Russell 1000 Growth Index, were the best performers in the quarter gaining 8.33% and 20.70% for the first half of the year. Value stocks, as measured by the Russell 1000 Value Index, lagged growth stocks declining 2.17% in the second quarter, bringing the year-to-date return to a positive 6.62% for the year. Small capitalization stocks underperformed their larger cap counterparts with the Russell 2000 Index declining 3.28% in the quarter and advancing 1.73% for the year. International developed markets continued to lag U.S. large-cap markets with the MSCI EAFE Index declining 0.42% in the quarter and up 5.34% for the year. Emerging markets performed better than developed international markets with the MSCI Emerging Markets Index increasing 5.00% in the quarter and 7.49% for the year-to-date.

The Bloomberg U.S. Aggregate Bond Index was flat for the quarter returning 0.07% and declining 0.71% for the year. High yield, as measured by the ICE BofA U.S. High Yield Index, advanced 1.09% in the quarter and 2.62% for the year-to-date. Municipal bonds, as measured by the Bloomberg Municipal Bond Index, declined 0.02% for the quarter and returned -0.40% for the year.

In this commentary, we focus on four key questions we believe are on investors' minds as we enter the third quarter.

## 1. When will the stock market begin to broaden out beyond the biggest technology companies?

No one can predict with any certainty when the market will broaden. The combination of strong earnings in technology combined with macroeconomic data that continues to be mixed and oftentimes conflicting helps explain why investors have concentrated their positioning in technology. The boom in Artificial Intelligence ("AI") has created a clear narrative of growth that contrasts with other, more uncertain parts of the market.

**FIGURE 1: S&P 500® INDEX SECTOR PERFORMANCE ENDING JUNE 30, 2024**

| | Info. Tech. | Comm. Svcs. | Utilities | S&P 500® Index | Cons. Staples | Cons. Discr. | Health Care | Real Estate | Finan-cials | Energy | Industri-als | Materials |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2Q | 13.8% | 9.4% | 4.7% | 4.3% | 1.4% | 0.6% | -1.0% | -1.9% | -2.0% | -2.4% | -2.9% | -4.5% |
| 1 Year | 41.8% | 44.9% | 7.8% | 24.6% | 8.2% | 13.1% | 11.7% | 5.6% | 24.2% | 15.9% | 15.5% | 8.7% |

*Source: Strategas. Data is assumed to be reliable. This information is being provided by Kayne Anderson Rudnick Investment Management, LLC ("KAR") for illustrative purposes only.* ***Past performance is no guarantee of future results.*** *Returns could be reduced, or losses incurred, due to currency fluctuations.*

If we look at the macroeconomic picture broadly, we see a mixed picture. Many sectors have been hurt by higher interest rates, manufacturing output has been bumpy, and the energy and materials sectors have seen steep earnings declines. Consumer spending has been surprisingly resilient, first in goods and now in services. Given the U.S. market is consumer-driven, this has been a key component of investor optimism. However, a strong labor market can cut both ways. On the one hand, healthy labor markets support solid consumer demand. On the other, too strong of a labor market can drive wage growth and prevent the Fed from beginning to cut interest rates.

The recent softening of the labor market could be the Goldilocks scenario to unlocking a soft landing for the economy. We would note however that consumers are feeling the cumulative impact of persistent inflation, not the rate of year-over-year change. We see that fatigue throughout the economy, such as the broader adoption of private label products from name brands and weakness in consumer discretionary businesses, particularly those targeting the low-end consumer versus the relative strength in off-price, close-out retailers. Consumers are reaching for value and there is some concern that if the labor market weakens more materially, we could see a much swifter step down in consumer spending.

If we look at S&P earnings expectations by sector for 2024, we can clearly see growth in the technology sector as well as communication services, which is benefitting from election ad spending. Utilities are also seeing earnings growth on the back of higher spend for AI.

**FIGURE 2: GICS SECTOR CONTRIBUTION TO S&P 500® INDEX EARNINGS**

| | Cons. Discr. | Cons. Staples | Energy | Finan-cials | Health Care | Industri-als | Info. Tech. | Materials | Comm. Svcs. | Utilities | Real Estate | Full Year |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2020 | $10.60 | $12.68 | ($7.33) | $29.12 | $23.69 | $7.23 | $32.73 | $4.24 | $19.68 | $6.24 | $3.50 | $142.38 |
| 2021 | $16.85 | $12.31 | $9.40 | $46.96 | $29.94 | $13.47 | $42.57 | $6.62 | $22.91 | $5.06 | $3.29 | $209.38 |
| 2022 | $14.95 | $13.27 | $26.08 | $29.96 | $31.64 | $18.01 | $42.93 | $7.74 | $25.47 | $6.51 | $5.01 | $221.59 |
| 2023P | $18.86 | $15.10 | $17.22 | $44.14 | $25.88 | $20.31 | $41.33 | $5.47 | $23.95 | $6.99 | $3.69 | $222.94 |
| 2024E | $21.25 | $18.50 | $16.25 | $46.50 | $27.75 | $21.50 | $46.75 | $5.00 | $25.75 | $8.25 | $3.25 | $240.75 |

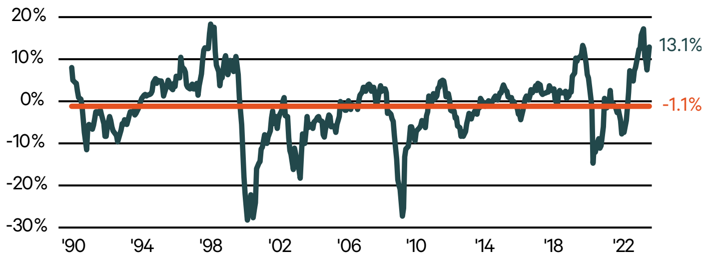
*Source: Strategas. Data is based on Strategas estimates per share and is assumed to be reliable. Figures above are in billions. This information is being provided by Kayne Anderson Rudnick Investment Management, LLC ("KAR") for illustrative purposes only.* ***Past performance is no guarantee of future results.*** *Returns could be reduced, or losses incurred, due to currency fluctuations.*

We can argue that most sectors in the S&P 500 saw earnings bottom in 2023. That has not been the case for small and mid-cap companies. Small and mid cap companies are expected to report earnings growth in the upcoming second quarter earnings season. However, we would note that more mid-cap sectors have already reached their bottom than in small-cap. Seven of 11 mid-cap sectors reported improved earnings in the first quarter of 2024. Only two sectors in small cap (health care and utilities) delivered earnings per share (EPS) improvement in the first quarter. An additional four sectors are expected to show growth this upcoming earnings season. It is our expectation that without more substantial earnings improvement, the small cap index could continue to lag large cap. That is not to say we would avoid small cap, but rather focus on quality businesses that have more resilient earnings. We believe these durable businesses have performed better than the benchmarks would suggest.

## 2. Have there been other periods historically in which stock market performance has been driven by so few names?

From a historical perspective, we have seen two periods where the gap between the market-cap weighted versus equal weighted indices has been this wide (the late 1990s and the late 2010s) and would note that while the gap can persist for some time, the reversals can be sudden.

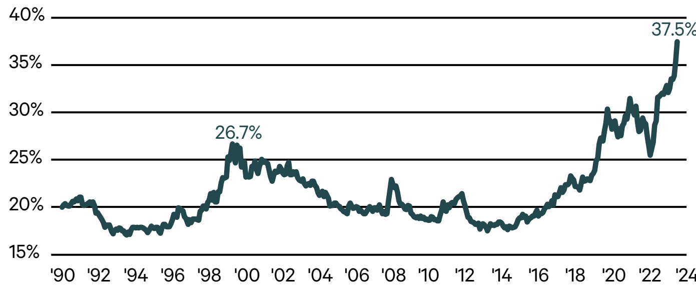
**FIGURE 3: S&P 500® VS. S&P 500® EQUAL-WEIGHTED INDEX**
Rolling 12-Month Return Differential




*Data as of June 30, 2024. Data is obtained from Strategas and Bloomberg and is assumed to be reliable. The information provided in this chart is for illustrative purposes only.* ***Past performance is no guarantee of future results.***

Currently, investors continue to seek out safety from secular growth leaders in technology given that there is less relief from interest rates. And, indeed, the market got even narrower during the second quarter with the top 10 S&P constituents accounting for nearly 38% of the benchmark. However, on an earnings basis, this group accounts for only 31% of all net income.

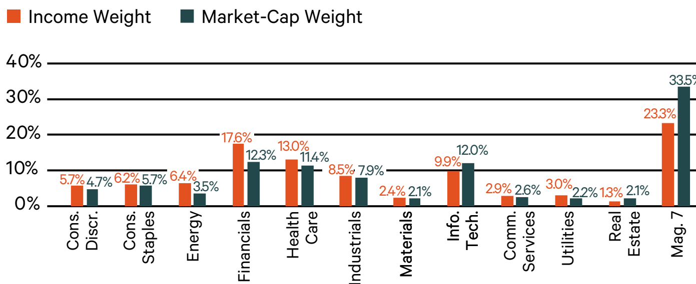
**FIGURE 4: TOP 10 AS A % WEIGHTING OF THE S&P 500® INDEX**




*Data as of June 30, 2024. Data is obtained from Strategas and Bloomberg and is assumed to be reliable. The information provided in this chart is for illustrative purposes only.* ***Past performance is no guarantee of future results.***

If we drill down to the Magnificent 7 more specifically, this group has seen multiple expansion. The Mag 7 accounts for 32% of the S&P by composite weight but only 23% by earnings. So while we understand investor positioning to go where there is growth, valuations could be a bit full here.

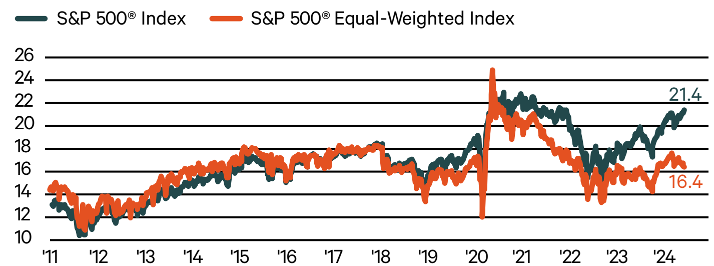
**FIGURE 5: S&P 500® NET INCOME WEIGHT VS. SECTOR WEIGHT**




*Data as of June 30, 2024. Data is obtained from Strategas and Factset and is assumed to be reliable. The Magnificent 7 is its own sector and is excluded from the other sectors. The information provided in this chart is for illustrative purposes only.* ***Past performance is no guarantee of future results.***

We do believe much of the gap in valuations is justified. The Magnificent 7 are businesses with durable competitive protections and strong cash flows. However, no asset is so unassailable that valuation does not matter. Should there be any hiccup in spending from just a handful of companies, it could have a profound impact on earnings and valuations. While many investors seek index investing as a way to diversify, there is less safety in that diversification than in previous periods.

**FIGURE 6: S&P 500® VS. S&P 500® EQUAL-WEIGHTED INDEX**
Next 12-Month Price to Earnings Ratio




*Data as of June 30, 2024. Data is obtained from Strategas and Bloomberg and is assumed to be reliable. The information provided in this chart is for illustrative purposes only.* ***Past performance is no guarantee of future results.***

## 3. How is KAR thinking about AI within its investment decision making?

In most technology transitions, there are three phases described and abbreviated as IPA: Infrastructure, Platform, Applications. Currently, we are in the Infrastructure phase with AI and that is leading to strong demand for the hardware used to run these AI programs.

In most of these transitions, we expect capital expenditure demand to often move in fits and starts as the hardware investment is not always optimized. We saw this during the telecom boom, with overbuilt capacity that took time to digest. It is unclear if that will be the case with AI now, but we caution that we could see more volatility rather than just seemingly endless demand.

The advent of true platforms and applications (i.e., more traditional software use cases) is still on the horizon.

**Julie Biel, CFA**
*Chief Market Strategist*

Julie Biel, CFA is Chief Market Strategist, Portfolio Manager, and Senior Research Analyst with primary research responsibilities for the small and mid-capitalization information technology and health-care sectors. Ms. Biel began her equity research career in 2004.

Much of the benefits of AI or traditional machine learning are evident in household software names, particularly those focused on simulation or automation. However, generative AI, where brand new information is created, is still working through growing pains. The well-publicized problems of hallucinations or data inaccuracy could limit how quickly it will be adopted. However, we expect these problems to eventually be overcome and believe that generative AI will profoundly impact the way we do business over the long-term.

Immediate use cases include software developers, leveraging the technology to help write new code more quickly. This is an ideal early use case where the user is already comfortable with new technology languages and the risk of errors from the generated code is low because they should be quickly found. There are reports that some engineers have become 30% to 50% more efficient using generative AI, which should enable both small and large companies to move more quickly on their software development roadmaps. Beyond some of these types of unique edge cases, we believe the opportunity set (while large) is still very undefined.

## 4. Over the past 10 to 15 years, fiscal stimulus and quantitative easing helped to support investment returns. Given a different macroeconomic environment now, what should investors be considering moving forward?

Until this most recent hiking cycle, the U.S. economy enjoyed 13 years of rates averaging 0.5%. This supported asset prices and made it easier for businesses, regardless of quality, to be successful. While we do expect the Fed to eventually cut interest rates, we do not expect interest rates to return to 0%. The last 13 years are the anomaly, not the current 5.25-5.50%, which is less than 100 basis points above the long-run average.

Assuming a more normalized or neutral rate of 3-4% could have a profound impact on how companies operate and how assets are priced. We are not sure this is appreciated by the market. We do believe, however, that it will allow for quality companies with low leverage to better differentiate themselves to investors. From our perspective, competitively-advantaged businesses should be better-positioned to weather a more capital-constrained environment by generating all their capital needs internally and finding opportunities to reinvest without relying on free outside financing to do so.

It is always important to remember that no one can predict the macroeconomic environment with any regular accuracy and that is especially true right now. The market consensus in 2022 was that technology was invincible, while in 2023, the consensus believed a recession was around the corner, and at the start of 2024, the consensus assumed that we would see six rate cuts in 2024. If an investor had positioned his/her portfolio for this outcome, he/she would have lagged dramatically every year. Considering the level of uncertainty both geopolitically and domestically, we believe you are much better off not positioning a portfolio for any one specific event, but rather owning great businesses that have a strong Darwinian instinct to adapt to compete. In our view, that fundamental understanding is much more attainable than knowing where the economy will be in 12 months.

*Large-capitalization stocks are represented by the S&P 500® Index which is a market capitalization weighted index which includes 500 of the largest companies in leading industries of the U.S. economy. Growth stocks are represented by the Russell 1000® Growth Index which is a market capitalization-weighted index of growth-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. Value stocks are represented by the Russell 1000® Value Index which is a market capitalization-weighted index of value-oriented stocks of the 1,000 largest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. Small-capitalization stocks are represented by the Russell 2000® Index which is a market capitalization-weighted index of the 2,000 smallest companies in the Russell Universe, which comprises the 3,000 largest U.S. companies. The MSCI® EAFE Index is a free float-adjusted market capitalization index that measures developed foreign market equity performance, excluding the U.S. and Canada. Emerging markets are represented by the MSCI® Emerging Markets (EM) Index which is a free float-adjusted market capitalization index tracking the equity performance of global emerging markets. The Bloomberg U.S. Aggregate Bond Index is a market value weighted index that tracks the daily price, coupon, pay downs and total return performance of fixed-rate, publicly placed, dollar-denominated and non-convertible investment grade debt issues with at least $250 million par amount outstanding with at least one year to final maturity. Performance is calculated on a total return basis with dividends reinvested. The ICE BofAML U.S. High Yield Index tracks the performance of U.S. dollar denominated below-investment-grade corporate debt publicly issued in the U.S. domestic market. The Bloomberg U.S. Municipal Index covers the USD-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and prefunded bonds. This report is based on the assumptions and analysis made and believed to be reasonable by Advisor. However, no assurance can be given that Advisor's opinions or expectations will be correct. This report is intended for informational purposes only and should not be considered a recommendation or solicitation to purchase securities.* ***Past performance is no guarantee of future results.***



kayne.com
800.231.7414