Madison
INVESTMENTS

Market and Economic Review

Client Communication for the Second Quarter 2024

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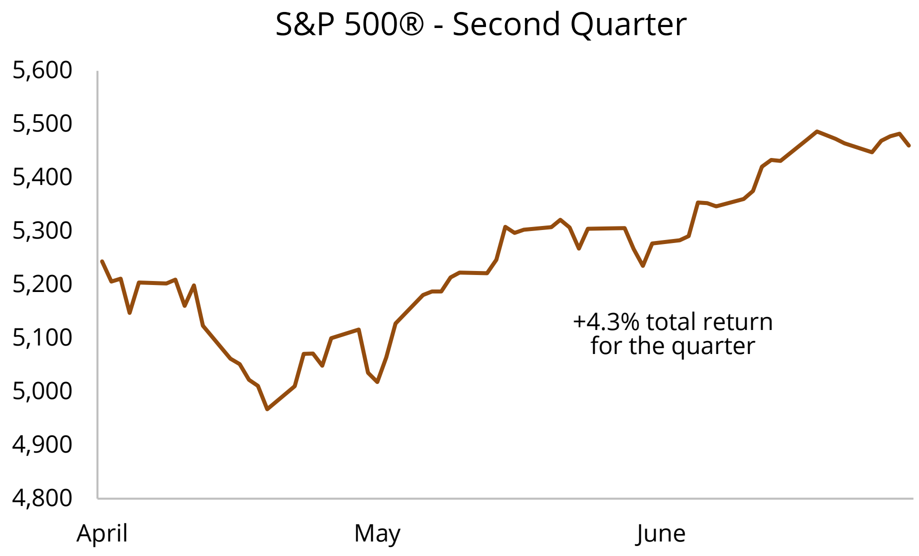
2Q 2024 - ANOTHER SOLID QUARTER

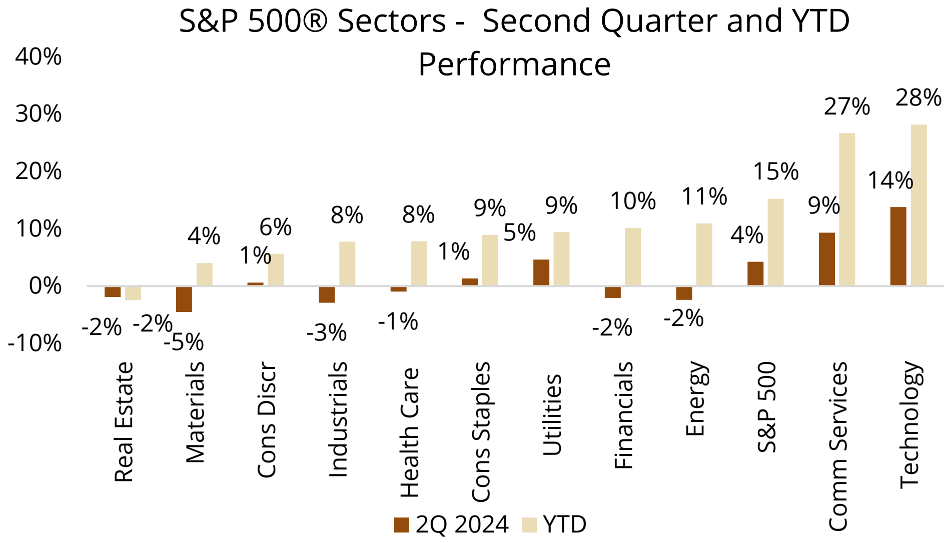
Second Quarter Highlights

Equity markets continued to move higher in the second quarter, with the S&P 500 returning 4.3% and bringing the year-to-date to 15.3%.

Inflation continues to moderate, albeit slowly, with the most recent Personal Consumption Expenditures Price Index reading at 2.6% compared to 2.7% in April. The market continues to expect the Federal Reserve (Fed) will begin cutting interest rates in 2024. We are watching inflation data closely as it will likely be the key determinant for when the Fed begins to lower rates.

First quarter GDP slowed to 1.3% after solid growth in the second half of 2023. GDP growth expectations for 2024 continue to moderate with 2.0% expected in the second quarter and more moderate growth of 1.6% anticipated for both the third and fourth quarter.





Sector Snapshot

After a solid first quarter, equities were more mixed during the second quarter with modest declines in a few sectors, modest increases in a handful of others, and then a continuation of strength in Communications Services and Technology.

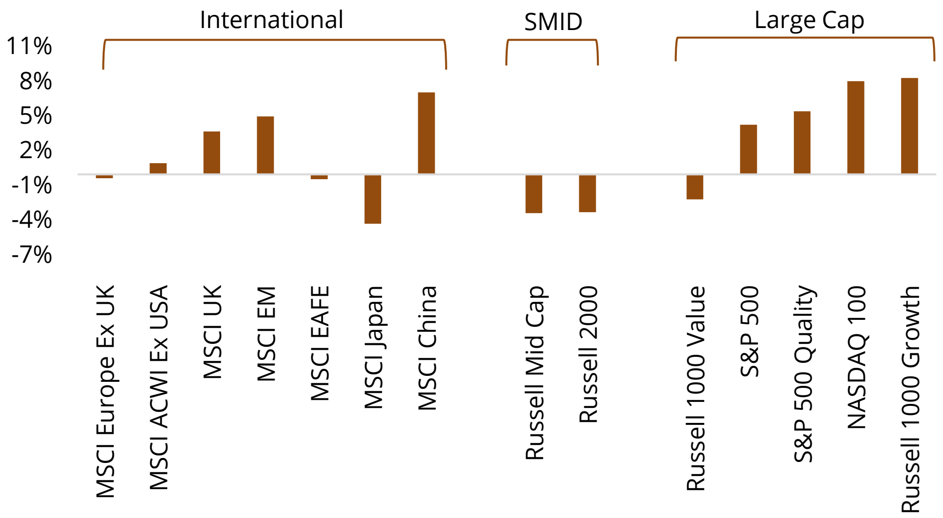
Communication Services and Technology were up 9% and 14%, respectively in the second quarter while Materials, Industrials, Real Estate, Energy, Financials and Healthcare were down modestly. Consumer Discretionary, Consumer Staples and Utilities were up modestly.

Once again, market returns are being driven by a few stocks. Five stocks account for over half of the return year-to-date.

Source: FactSet, Bloomberg

2024 - SECOND QUARTER CONTINUES HIGHER

Q2 2024 Equity Market Returns: Size and Geographies



Growth Leads Performance

Outside of large cap equities, markets were mixed during the second quarter. Large cap equities remained strong with the Russell 1000 Growth continuing to lead the market, up 8.3%. while Midcap and Small cap stocks were down -3.3% for the quarter.

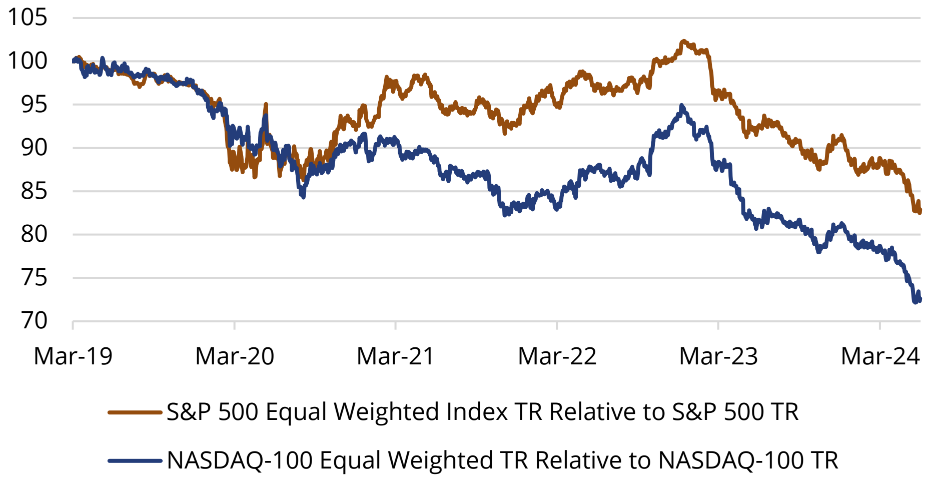
Geographically, we saw more varied returns. Chinese equities posted a strong quarter of 7.1%, while Japanese equities were down -4.3%, with Developed International equities ending slightly negative.

Breadth is Narrow

Although we saw some broadening away from the [1]Magnificent-7 late in the first quarter, the equity market continued to be dominated by a smaller and smaller number of stocks throughout the second quarter.

The S&P 500 equal-weighted was down -2.6% during the second quarter and is up 5.1% year-to-date which indicates a challenging environment for the average stock that has been masked by the continued strength of the Mag-7.

Returns Continue to be Concentrated



[1]The The Magnificent Seven stocks are a group of high-performing and influential companies in the U.S. stock market including Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, and Tesla.

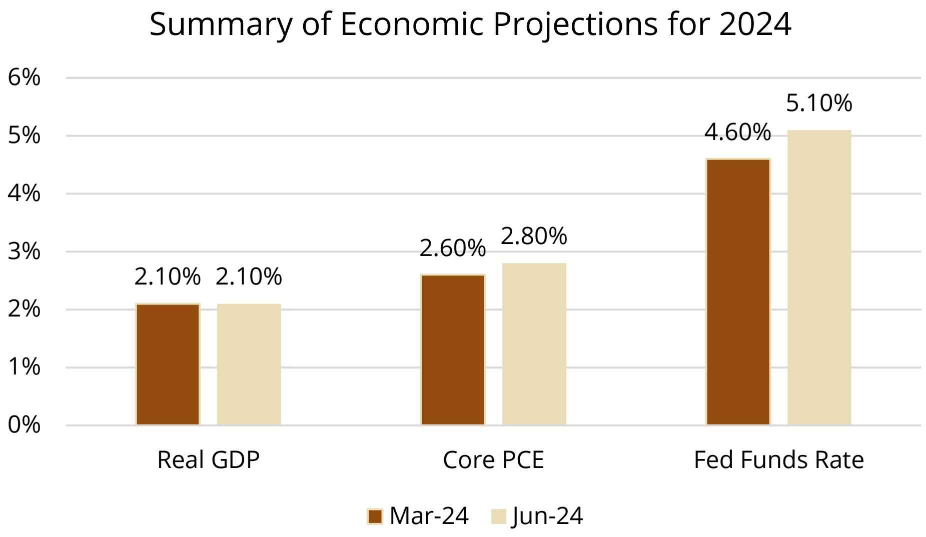
Source: Morningstar Direct, FactSet, Madison Investments

WILL RATES MOVE LOWER IN 2024?

Rates May Move Lower

The Federal Reserve projections seem to point to higher rates for longer. The most recent Series of Economic Projections (SEP) pushed Core PCE and Fed Funds Rates higher versus March forecasts.

We have seen some moderating inflation data recently but is it enough to position the Fed to lower rates? With markets reaching new highs, unemployment around 4% and a modestly growing economy, it would seem that the Fed could afford to wait before lowering rates.

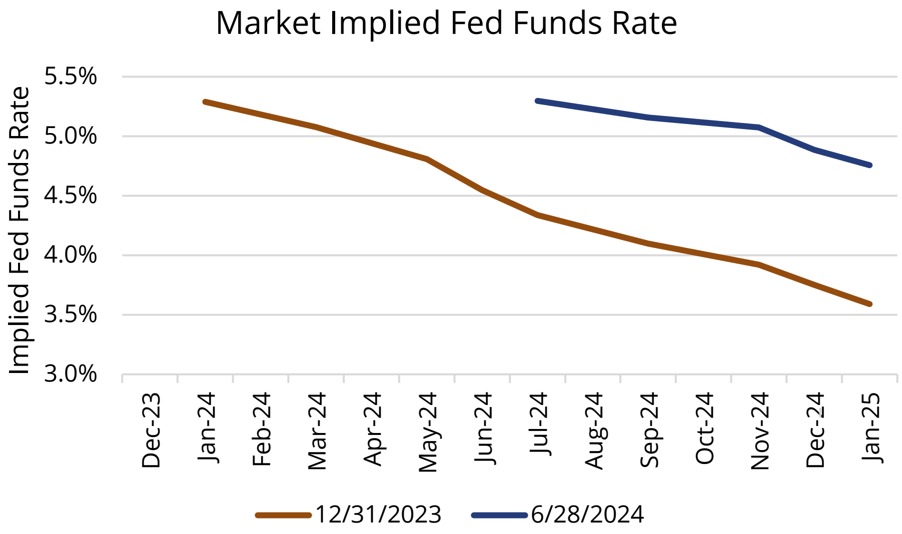


Interest Rate Expectations

Entering the year, interest rate markets were expecting the Fed to cut interest rates 6 times, beginning in March.

With no cut in March and slightly elevated inflation readings throughout the second quarter, interest rate markets are now anticipating only 2 interest rate cuts this year.

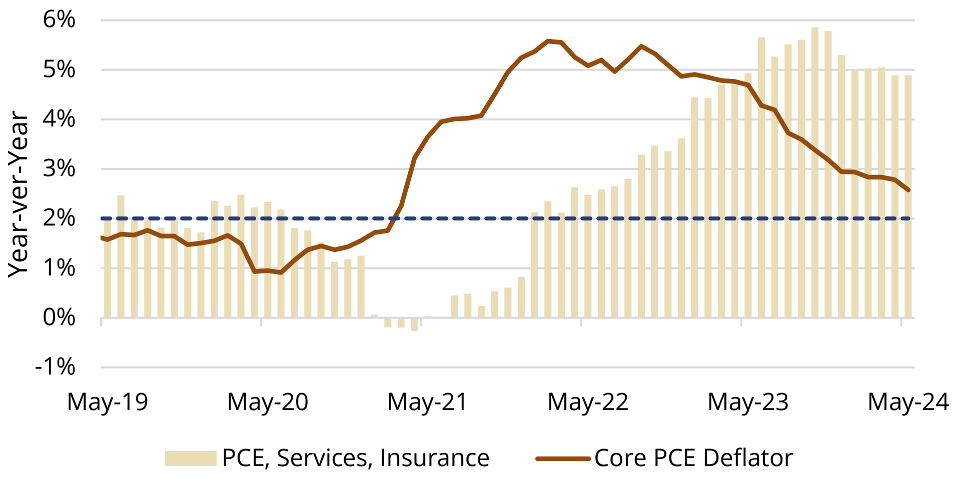
We don't expect the Fed to cut interest rates in July but ahead of the September 18th meeting they will have several more inflation and employment readings to consider.



Sources: FactSet, Federal Reserve

INFLATION HAS MODERATED BUT STILL ABOVE TARGET

Disinflation has Moderated



Disinflation has Slowed

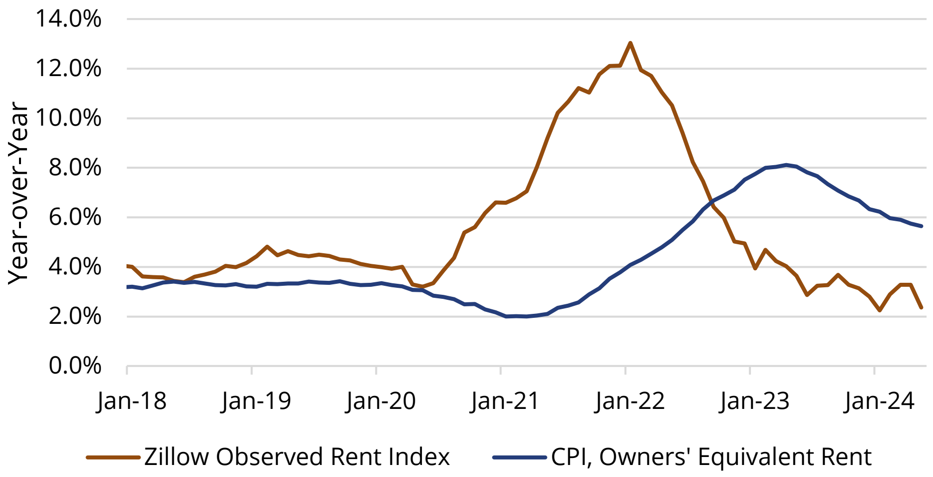
Inflation remains above the Federal Reserve's (Fed) price stability target of 2%.

While many components of inflation have moderated, others continue to increase at a relatively high rate.

Price increases in necessities, such as insurance, are causing service inflation to remain sticky.

As disinflation has slowed, the Fed has become more cautious with regard to reducing interest rates as the fear of cutting too soon and allowing prices to reaccelerate is unpalatable after such a large increase in prices over the last few years.

Shelter Components of Inflation Remain Sticky



Housing's Impact on Inflation

In addition to insurance, another essential need category that has seen sticky inflation is housing.

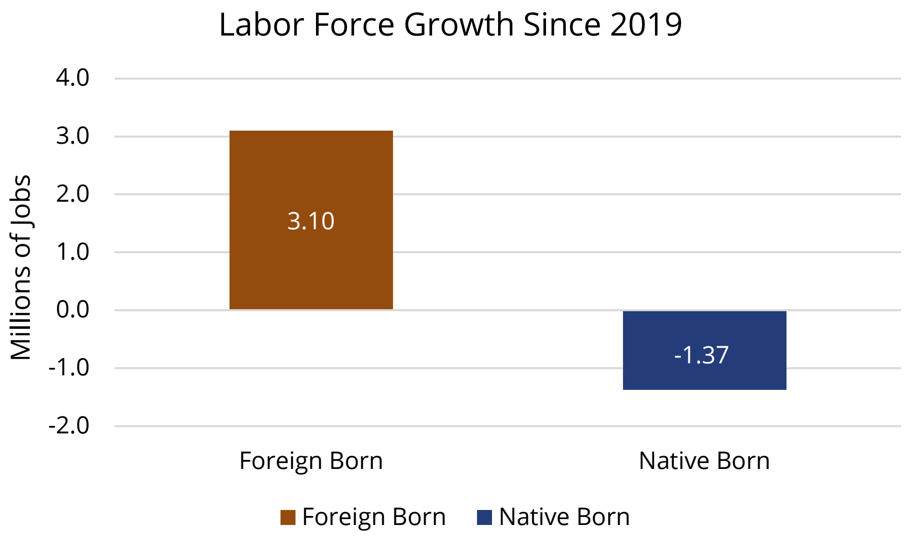
The Owners' Equivalent Rent component of the Consumer Price Index is well above its historical average as well as the Fed's target.

A structurally undersupplied housing market has led to sizeable increases in home prices and rents despite higher mortgage rates.

Should Owners’ Equivalent Rent move down to be more reflective of the real-time indices, it would provide a nice boost to disinflation and potentially provide the Fed with an opportunity to lower rates.

Source: FactSet, Zillow, Federal Reserve Bank of St. Louis

LABOR MARKET SOLID ON THE SURFACE

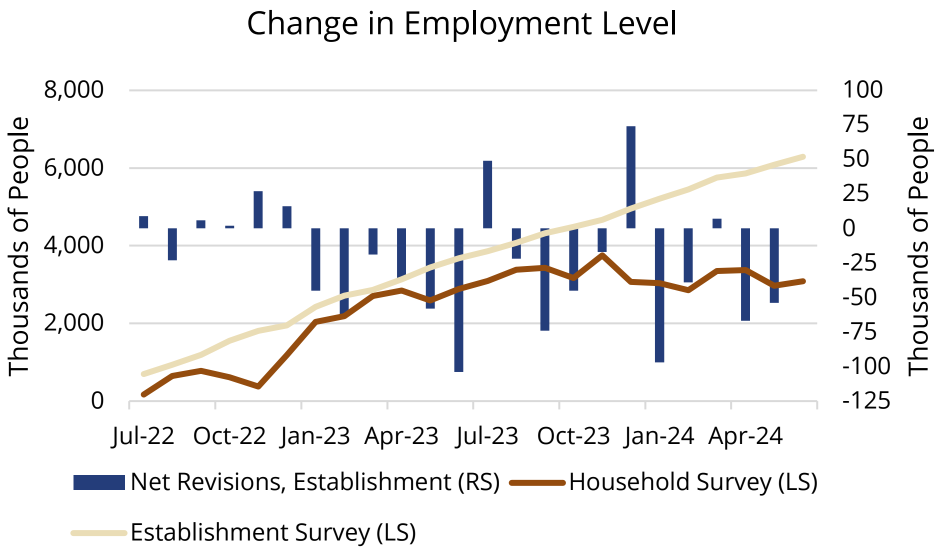


Immigration has Supported Growth

The large influx of immigrants over the last two years has had a positive impact on both economic growth and the labor market.

The number of foreign-born job holders has increased by 3.1 million, while the number of native-born job holders has contracted by nearly 1.4 million, providing for a net gain in the total level of the labor force over the last five years.

Should immigration continue as it has over the last couple of years, it has been estimated that the economy will need to create at least 250k new jobs each month for the labor market to maintain parity. While possible changes to immigration policy could have secondary impacts on both the labor market and economic growth.



Cracks Starting To Emerge?

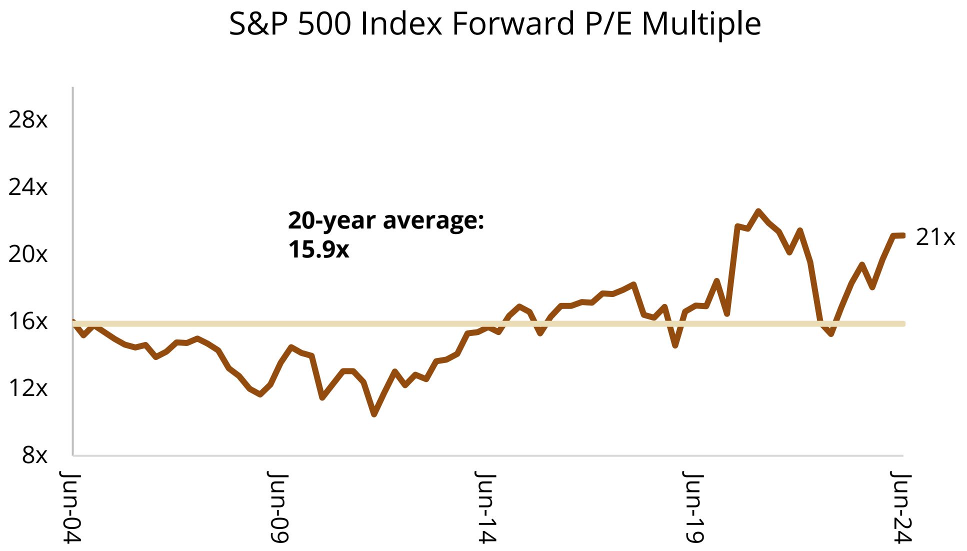
A bifurcation has emerged within the payrolls data between the Establishment survey which has been holding strong and the Household survey which has shown a much lower expansion in job growth.

The Establishment survey has also been subject to heavy downward revisions over the past couple of years, which is typically seen in late cycle environments.

Over two years into the monetary tightening cycle, and nearly a year since the last interest rate hike, it's not surprising to see weakness in the labor market begin to emerge.

Source: Factset, Federal Reserve Bank of St. Louis, Madison Investments

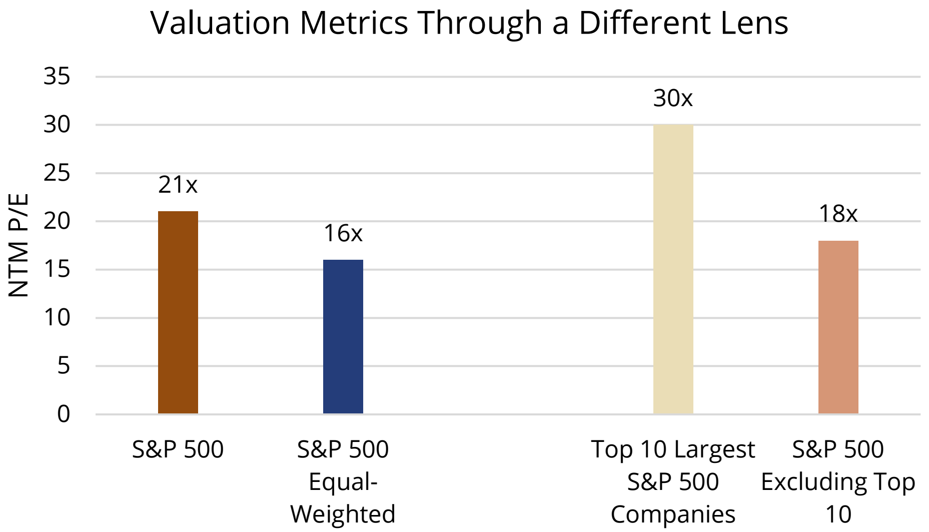
ANOTHER SOLID QUARTER FOR MARKETS, VALUATION REMAINS ABOVE AVERAGE

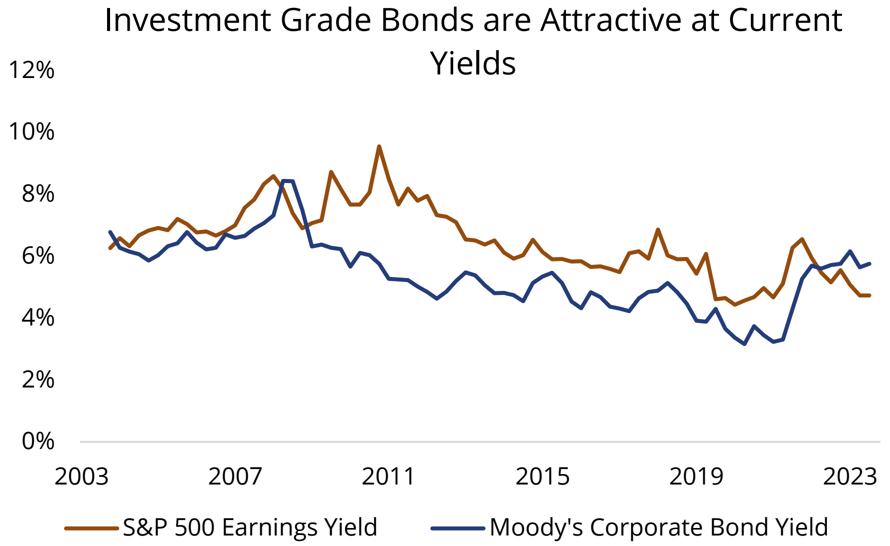


(Top Left) With a solid second quarter, valuations remain above historical averages at 21x forward earnings, above the 20-year average of 15.9x. However, the equal-weighted S&P 500 forward P/E multiple at 16x, is just above its long-term average, which implies that there is a small group of stocks trading at high earnings multiples.

(Bottom Left) Looking at a variety of valuation metrics, you can see that the 21x P/E multiple is being driven by the largest companies in the S&P 500 index. The largest 10 companies by market capitalization are trading at 30x. As mentioned above, the equal-weighted is at 16x and if you remove the top 10, the remaining companies are trading at 18x. When screening for ideas for your portfolio, we continue to look for attractively valued companies with strong growth prospects.

(Bottom Right) Comparing the S&P 500 Earnings Yield with the Moody's Corporate Bond Yield, fixed income looks marginally more attractive, warranting a positive outlook for investment grade fixed income.





Source: FactSet, Bloomberg, Moody's, Goldman Sachs, Madison Investments

FIXED INCOME EXECUTIVE SUMMARY

Market Summary (2Q24)

- The Federal Reserve maintained its patient policy approach, leaving rates unchanged while awaiting confirmation that inflation is indeed slowing towards its 2% long-term target. Recently, inflation unexpectedly rose in Canada and Europe.
- First quarter GDP slowed to a 1.4% annual growth rate, down from 3.4% in the fourth quarter 2023. Economic activity was weighed down as consumers purchased fewer goods and spent less on food service and accommodations. Also, businesses expended less on replenishing inventories.
- Inflation reports during the quarter were mixed as the price of goods deflated while the price of services remained above 3%. Housing continues to exert upward pressure on inflation.
- After peaking in April, Treasury yields receded to levels about 20 basis points higher than March 31st. On June 30th, 3-month, 2-year, and 10-year Treasuries yielded 5.36%, 4.75%, and 4.40%, respectively.
- High-quality corporate bond risk premiums widened 3 basis points (bps) during the quarter to an average spread of 86 bps.

Matters Madison Fixed Income is Monitoring

- The catalyst for an eventual Fed rate cut remained murky as tamer inflation data was offset by labor market stability and steady economic growth. Although the jobs market appears to be cooling, wage gains near 4% and an increase in the number of jobs available has buoyed consumer confidence and supported overall spending. Although recession fears have subsided, mistiming by the Fed (in terms of its first rate cut) could jeopardize prospects for a soft landing.
- Some consumers are facing hard times as evidenced by accelerating delinquency rates on credit card, auto loans, and housing debt. Housing affordability remains a challenge given high rental costs, lofty home prices and mortgage rates over 7%. Economic growth could be hampered should spending diminish within financially stable households.
- Fixed income valuations seem stretched within the corporate market, although absolute yields appear attractive within the financial sector. Mortgage-backed securities trading at slight discounts continue to offer convincing long-term value.

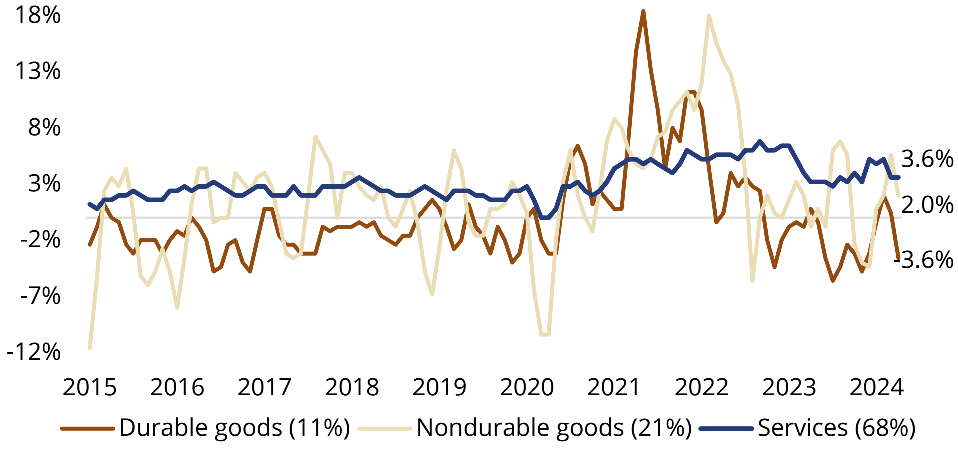
Source: Bloomberg, ICE Global Indices

Inflation Continues to Trend Downward

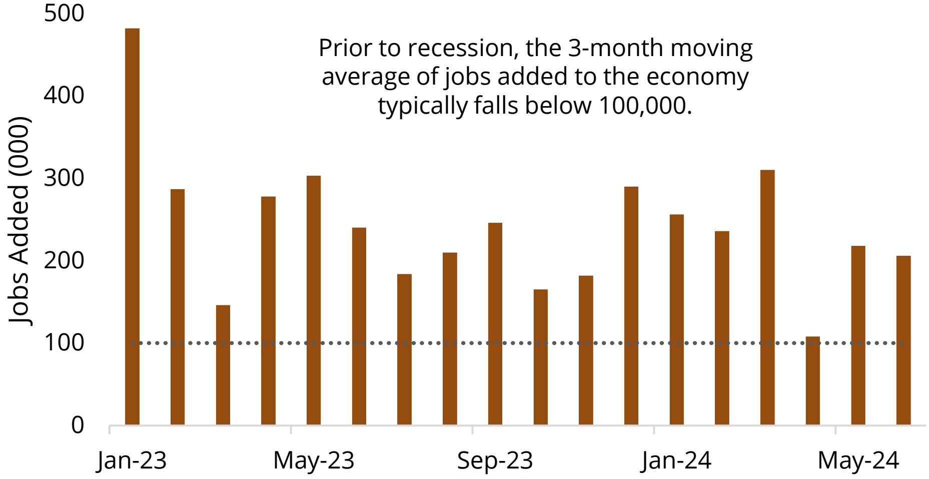
Price trends for both durable and non-durable goods have helped lower the rate of inflation. Although goods are displaying a disinflationary trend, the price of services lingers above 3%.

As shown in the chart at right, inflation tends to be less volatile for the much larger services sector in comparison to goods, implying it may take a few quarters for the overall rate of inflation to near the Fed's 2% target.

Durable and Nondurable Goods vs Services (annualized 3-month rolling average)



Monthly Change in Nonfarm Payrolls



Prior to recession, the 3-month moving average of jobs added to the economy typically falls below 100,000.

Employment Conditions Are Favorable

The monthly change in non-farm payrolls reflects a promising jobs market despite rising weekly jobless claims and a 4.1% unemployment rate. Persistent wage gains near 4% and reduced bank balances have lured some detached workers back to the jobs market.

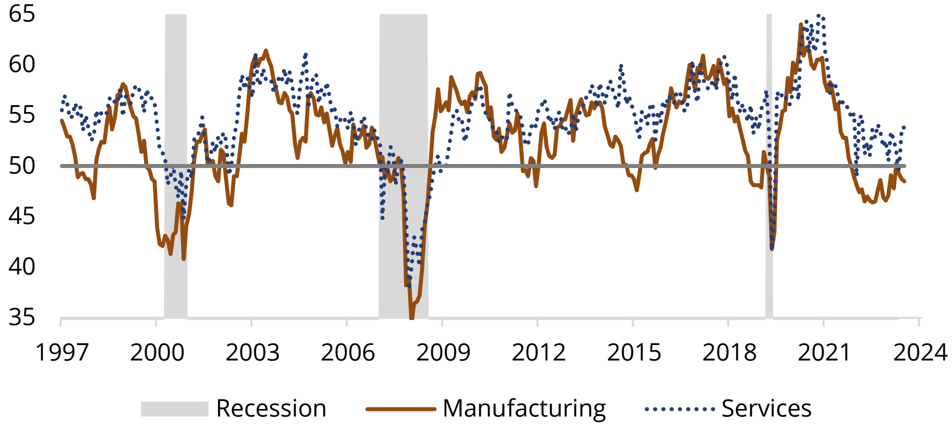
In May, over 8 million jobs were available for the 6.8 million unemployed persons, some of whom may be unqualified to fill the open positions. We believe wage gains will decelerate in the coming quarters should the unemployment rate edge higher. Assuming this occurs, inflation is apt to fall as consumption declines.

Source: Bloomberg

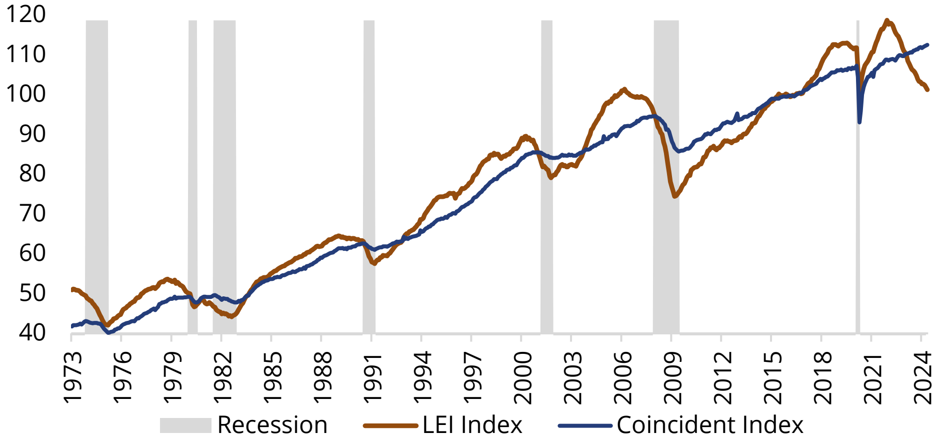
Economic Growth Appears to Be Slowing

The manufacturing sector has been contracting since late 2022 as reported by the Institute for Supply Management (ISM). *[A reading above/below 50 indicates expansion/contraction.]* In contrast, the Services sector has prolonged its expansionary state, although at a slower pace. When combined, the manufacturing and services ISM indicates an expanding economy. This supports our thesis that GDP may slow in the coming quarters to a level near 2%.

ISM Manufacturing and Services Sectors (Institute of Supply Management)



Leading Economic Indicators vs Coincident Indicators



Leading Indicators Also Suggest a Slowing Economy

The Conference Board's Leading Economic Index (LEI) has maintained a descending trajectory which began in early 2022. The most recent report revealed drops in six of the ten LEI components, the most significant being new orders, expectations for business conditions, building permits, and the inverted yield curve (e.g. 10-year Treasury minus the federal funds rate).

In comparison, upward movement in coincident indicators suggest the economy has yet to reach its pinnacle during the current cycle. This bodes well for economic growth and reduces the risk of a near term recession.

Source: Bloomberg

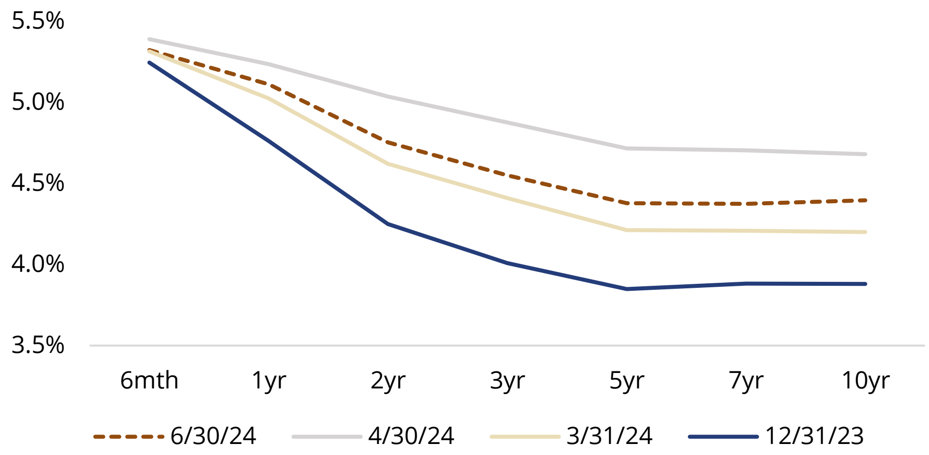
ASSET CLASS (GOVERNMENTS)

Interest Rates May Have Peaked

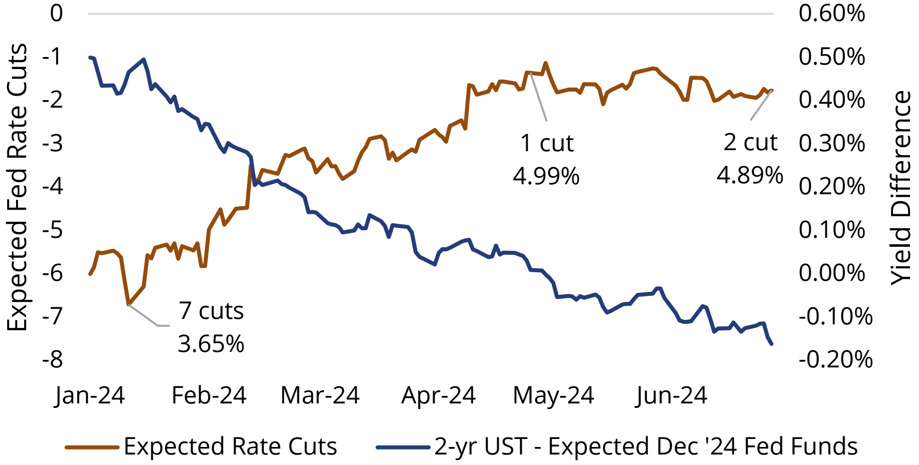
The Federal Reserve upheld its data dependent approach and left its policy rate unchanged at the central bank's June meeting. Steady economic growth and constructive employment conditions have kept the Fed on guard against a possible inflation resurgence.

Rates may have summitted in April when a series of economic reports along with Fed rhetoric convinced investors the Fed would delay potential rates cuts until later this year. Recently, rates have drifted lower in response to inflation declines and signs the economy may be waning.

Recent Treasury Yields



Market Expectations for Fed Funds at Yearend 2024 versus 2-year Treasury Yield



The Fed Is Likely to Cut Rates Once or Twice in 2024

Investors have overwhelmingly discounted prospects for aggressive Fed rates cuts this year. In contrast to early 2024 when market participants expected 7 rates cuts (e.g. from 5.50% to 3.75%), investors now believe the Fed will lower rates a maximum of twice (e.g. from 5.50% to 5.00%) by year end.

Investors also anticipated a positively sloped yield curve by year end with yield estimates of 4.32% for the 2-year Treasury and 3.83% for the effective federal funds rate. Market sentiment has shifted since the beginning of the year and investors expect the curve will remain inverted at year end.

Source: Bloomberg

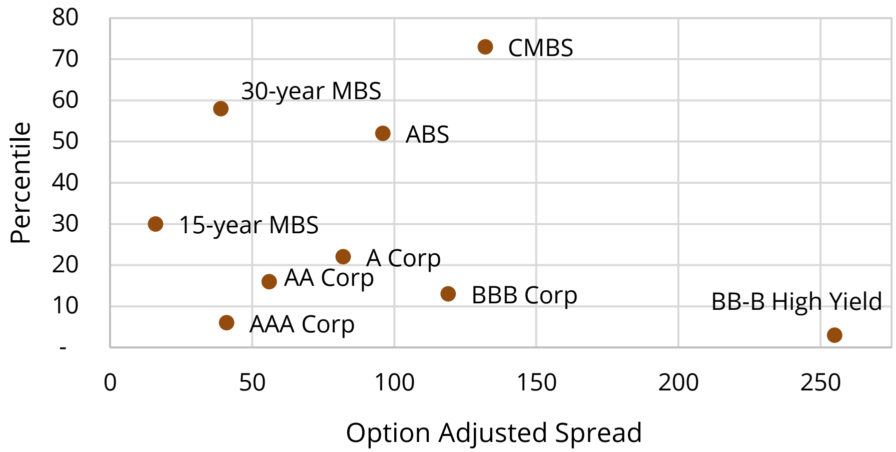
ASSET CLASS (CORPORATES)

Corporate Risk Premiums Remain Stretched

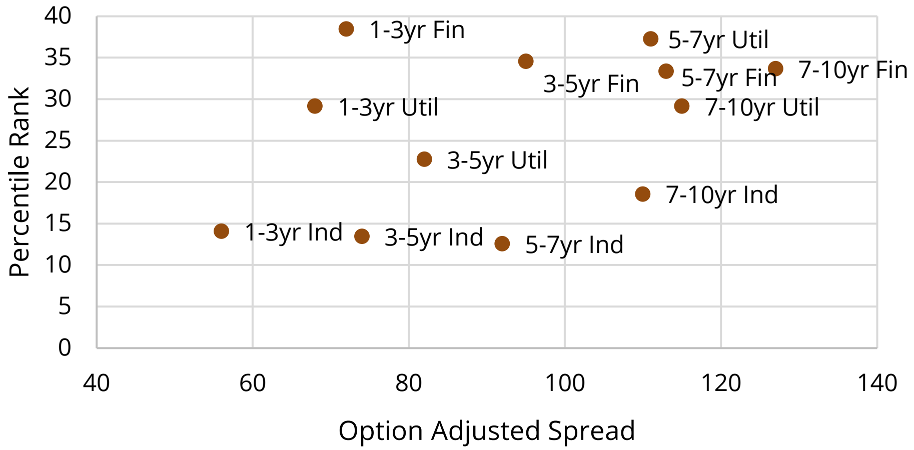
Corporate bonds appear richly valued as measured by the percentile ranking of option-adjusted spreads[1] (OAS). At the end of June, investment grade (IG) corporate bonds had an average OAS of 96 and fell into the 19th percentile. This means spreads have historically been wider 81% of the time. A similar evaluation of other fixed income sectors suggests mortgage-backed and asset-backed securities currently offer more attractive relative value.

[1] – An option-adjusted spread represents the spread (risk premium) after adjusting for an embedded option (e.g. an issuer's ability to call a bond issue prior to maturity).

Sector Valuations
(based on OAS data from 1997 thru 6-30-24)



Industry Valuations
(based on OAS data from 1997 thru 6-30-24)



Corporate Bond Yields are Attractive

Despite low corporate OAS, a case can be made for positioning corporate bonds on the basis of yield. At quarter end, the average yield on IG corporate bonds was over 5% with a percentile rank near 65% . Today's yield level provides an inherent performance cushion should rates rise or spreads widen.

In part, we assess corporate bond valuations by sector. Currently, we believe bonds within the financial sector offer decent risk/return characteristics. However, we caution investors to carefully appraise issuer creditworthiness as a precursor to locking in yield.

Source: FactSet, Bloomberg, ICE Global Indices

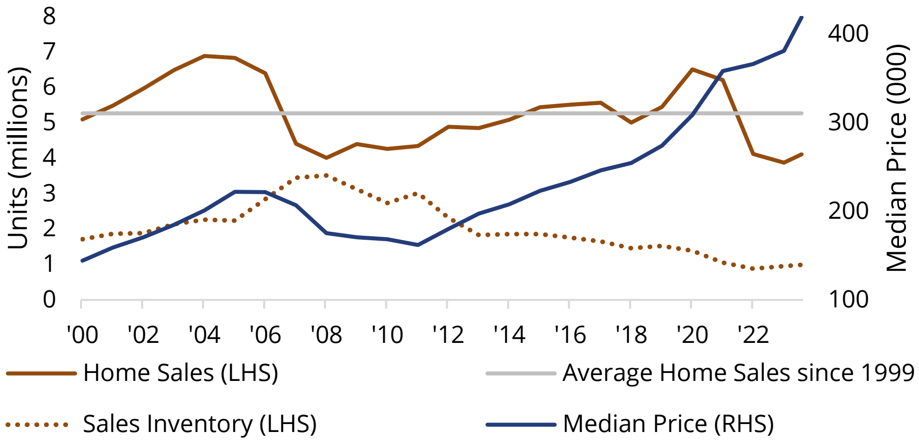
ASSET CLASS (ABS/MBS & HIGH YIELD)

Limited Housing Inventory is Supporting Home Prices

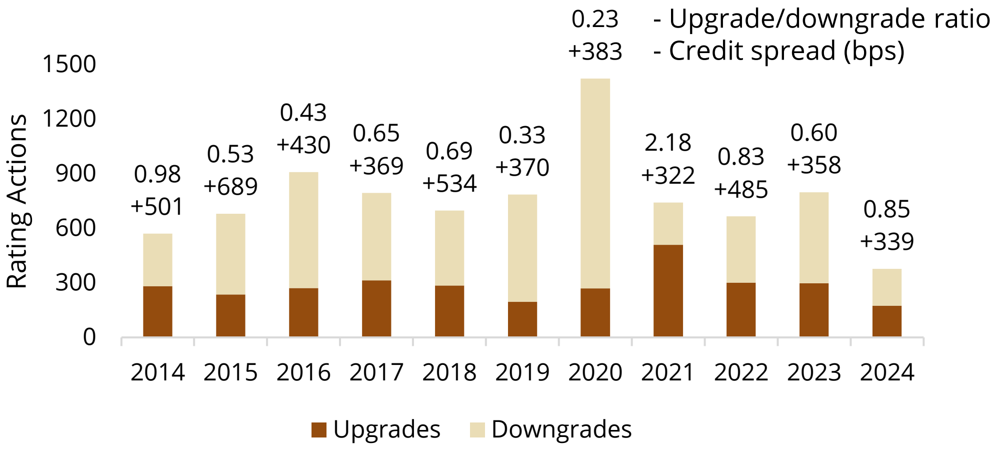
In May, the median sales price of an existing home set a record level of $419,000, a jump of nearly 10% since 2023. During the past three years, existing homes available for sale have been sparse, most recently due to higher mortgage rates. Over 60% of mortgage loans have rates at or below 4% and many of these homeowners are unwilling to sell and/or unable to afford the purchase of a more expensive home.

From an investor's perspective, lower coupon mortgages are prone to maturity extension and do not provide ample compensation for risk. We prefer near current coupon mortgages trading at slight discounts.

Existing Homes - Sales and Inventory vs Median Sales Price



S&P High Yield Rating Upgrades/Downgrades & Yearend Credit Spreads



Creditworthiness of High Yield Issuers is Holding Up

Expected defaults have ticked up this year, although the average level of financial wherewithal for non-investment grade issuers remains positive. Revenue growth and free cash flow has enabled most issuers to service outstanding debt. In addition, many issuers have not been exposed to refinancing risk because they termed out their debt maturities during the past few years.

Our immediate concern is the historically low risk premiums available on high yield debt. In today's market, we intend to maintain a higher quality focus as the economy and market adjusts to monetary policy.

Source: Bloomberg, ICE Global Indices

FIXED INCOME SCORECARD

Potential Impact on Bond Returns

	-			-0-			+
U.S. Macroeconomics							
Economic Growth				n/c			
Employment				n/c			
Inflation				n/c			
U.S. Policy							
Monetary (Fed)				n/c			
Fiscal (Congress)				n/c			
Regulatory			n/c				
Global							
Foreign Economics			n/c				
Geopolitical Tensions			n/c				
Central Bank Policies			n/c				
U.S. Corporates							
Credit Fundamentals				n/c			
Risk Premiums			n/c				
Liquidity				n/c			
U.S. Treasury Market							
Interest Rates			n/c				
Sentiment			n/c				

– Negative for Bonds	🟫 Current	n/c No Change
+ Positive for Bonds	🟦 Prior	

Annualized GDP growth is expected to be 1.5% to 2.0% in the coming quarters as consumers and businesses recalibrate spending patterns in response to the potential for weaker employment conditions and pockets of persistent inflation.

The Fed's monetary policy stance is likely to change later this year, assuming inflation maintains its downward trajectory. We believe the Fed will make one 0.25% rate cut this year. Election-related vola-tility is likely to surface in the coming months with a renewed focus on the government debt ceiling and 2025 expiration of tax cuts.

The central banks of Canada and the European Union lowered rates by 0.25% during the second quarter. Subsequently, both geographic areas reported higher than expected inflation. This may foreshadow the state of U.S. inflation. Geopolitical tensions are ever present with renewed concern over post election U.S. trade policies.

The financial health of most corporate credits remains encouraging as revenue growth, decent profit margins, and ample free cash flow support issuers' ability to service outstanding debt. Liquidity remains favorable as indicated by tight bid/ask spreads. Low risk premiums could become a concern should the economy stumble.

Interest rate volatility began moving higher in May due to conflicting economic reports (specific to inflation and employment) and differing comments by Federal Reserve officials. Rates for maturities inside of five years are apt to experience the most fluctuation once Fed policy becomes clearer.

DISCLOSURES

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This report is for informational purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of any security.

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Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only, and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance.

All investments contain risk and may lose value. Equities may decline in value due to both real and perceived general market, economic and industry conditions. Investing in foreign-denominated and/or -domiciled securities may involve heightened risk due to currency fluctuations, and economic and political risks, which may be enhanced in emerging markets.

In addition to the ongoing market risk applicable to portfolio securities, bonds are subject to interest rate risk, credit risk and inflation risk. When interest rates rise, bond prices fall; generally, the longer a bond’s maturity, the more sensitive it is to this risk. Credit risk is the possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. Bonds may also be subject to call risk, which allows the issuer to retain the right to redeem the debt, fully or partially, before the scheduled maturity date. Proceeds from sales prior to maturity may be more or less than originally invested due to changes in market conditions or changes in the credit quality of the issuer.

Upon request, Madison may furnish to the client or institution a list of all security recommendations made within the past year.

A basis point is one hundredth of a percent.

Yield Curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The slope of the yield curve gives an idea of future interest rate changes and economic activity. There are three main types of yield curve shapes: normal (upward sloping curve), inverted (downward sloping curve) and flat.