MARKET COMMENTARY

2ND QUARTER 2024

Rick D. Moulton, CFA
Managing Director of Equities

On the surface, the first six months of 2024 were a utopia for investors. The S&P 500 returned more than 15% with very little volatility. This advance occurred despite the Fed not cutting interest rates and with inflation remaining stubbornly elevated. These impressive returns, however, mask some underlying warning signs. Despite the overall index posting strong returns, the majority of stocks in the S&P 500 actually declined in the second quarter. The market's gains were driven almost exclusively by the six largest stocks, which have been fueled by enthusiasm about artificial intelligence. Several measures of investment risk are elevated, including valuation levels and market breadth. To generate a repeat performance in the second half of the year, the market will likely need to broaden beyond its current narrow leadership and traverse potentially formidable obstacles.

The first six months of 2024 represent the best start on record to a presidential election year. Excitement about generative AI catalyzed some well-known large companies to drive the broader indices higher. The six largest companies accounted for over half of the return of the S&P 500. In fact, Nvidia, which momentarily became the world's most highly valued company, accounted for nearly 1/3 of the gain in the S&P 500. Non-large-cap areas of the market did not fare nearly as well. In fact, indices containing small and mid-cap stocks posted losses in the second quarter.

In the second quarter, more speculative investments did well. Bitcoin and other cryptocurrencies surged as several crypto funds received regulatory approval. So-called meme stock investing returned after a three-year hiatus. Junk bonds performed well, signaling investors have minimal concerns about default risk or economic growth slowing. This investor optimism is also reflected in market valuation levels. The S&P 500 is now trading more than one standard deviation above its 25-year average. These lofty valuation levels have historically occurred only during periods of excessive optimism.

As we look ahead, bullish investors are confident that the second half of the year can build on the momentum of the first half. History is on their side. Looking back, when the market has risen 10% or more in the first half of a year, the second half rises more than 80% of the time with an average gain of eight percent. Bulls are banking on continued strong corporate profit growth to legitimatize current elevated valuation levels. Additionally, should inflation continue to trend down toward the Fed's target rate of 2%, we could see interest rate cuts in the back half of the year.

Despite these reasons for optimism, investors have several warning signs to suggest that future returns will not be as robust and future volatility will not be as placid as what they enjoyed in the first half of the year. To advance further, the market will likely need to broaden beyond the six largest companies, as they possess both lofty valuations and lofty expectations. Should their results merely be good as opposed to exceptional, investor sentiment could sour. If history is any guide, narrow, speculative markets tend not to persist for more than a few quarters.

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The November election also injects uncertainty into the markets. The election results will impact many elements of the economy that influence investor expectations, including the regulatory climate, monetary policy, and trading policies.

Regardless of the factors that promise to shape market returns in the second half of 2024, the Riverbridge Investment Team remains steadfast in its investment philosophy, which is centered on investing in companies possessing high degrees of recurring revenue while internally financing their growth. More importantly, we seek management teams that are prioritizing long-term earnings power over short-term reported earnings. Our portfolio companies continue to invest to strengthen their strategic market positions. We believe this focus on earnings power creates the foundation for compelling returns over a full market cycle.