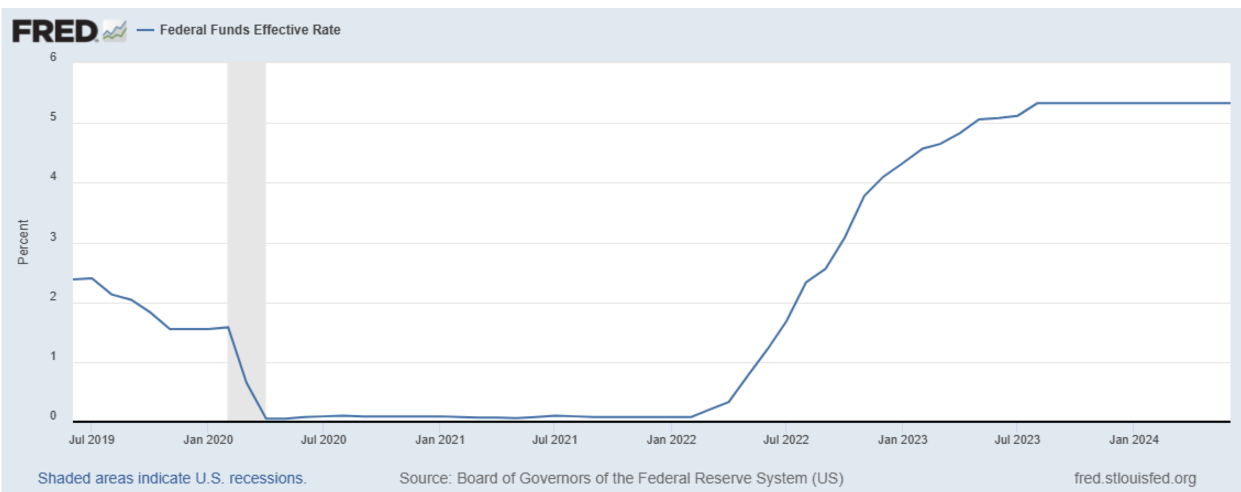
Capital Management, Inc.

Financial Markets Perspective

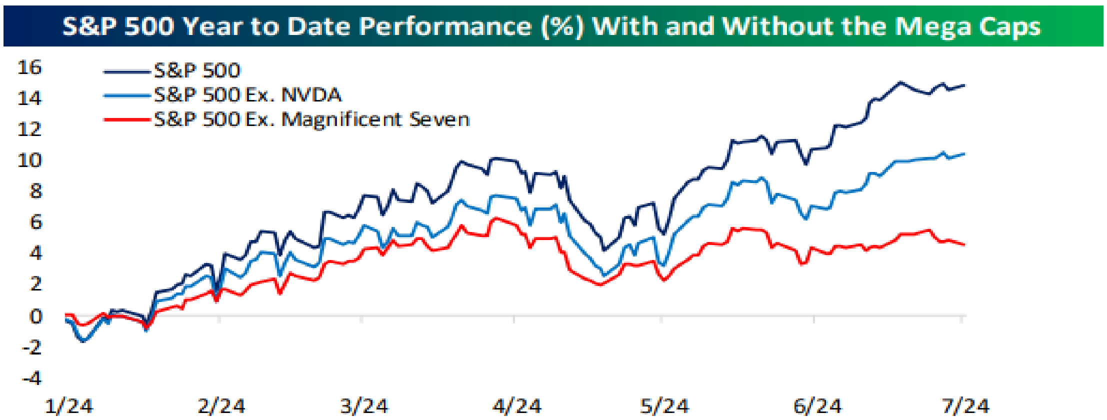
July 2024

The Outlook for Wealth Creation

The first half of 2024 was full of economic surprises that impacted financial markets. As the year began, most economists expected the Federal Reserve to embark on a strategy to reduce interest rates. This was a significant change in policy as the Fed raised rates historically in 2022 and 2023. Some forecasters said the Fed might cut the benchmark or Fed funds rate six times by the end of this year because inflation was receding toward the target of 2%! The bond market reacted by falling, and bond yields rallied, resulting in an inverted yield curve (when looking at the 2-year to 10-year spread). Then, the tables turned as inflation did not follow a trajectory lower. As a result, the Fed decided to wait on interest rate cuts, as seen in the chart below. As of this writing, there are only two potential rate reductions on the Fed's calendar – most likely in September and November. One advantage to this change of heart was that the outlook shifted to stable rather than falling interest rates. Consumers and businesses can plan in a stable interest rate environment. Stability is good for the equity markets. Also, high interest rates provide a higher income level to conservative investors and retirees, who are a growing component of the economy. As the second quarter ended, inflation was headed lower than interest rates, and the Fed continued to take a low profile.



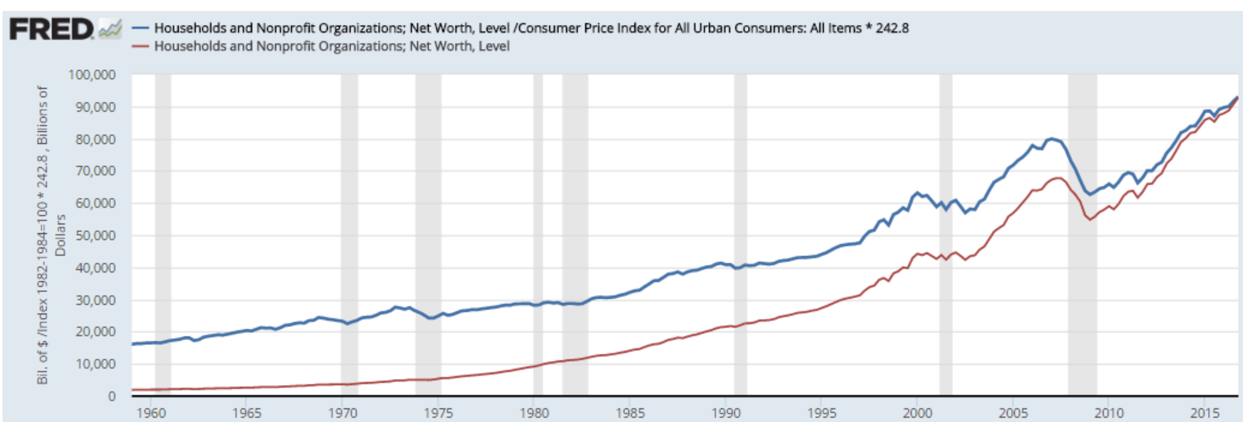
Another surprise was that the economy remained strong despite higher interest rates. Corporate profits remained above expectations, and analyst estimates were well below reported earnings. Unemployment remained low, i.e., below 4%, even though the Fed had pushed interest rates higher. The stock market was dominated by large-capitalization growth stocks where expectations about the potential benefits of artificial intelligence engrossed investors. Only the "Magnificent Seven" outperformed for the second quarter while the rest of the market eked out a small gain, as shown in the chart on the next page. Although major stock indices hit new highs during the quarter, only the mega-cap stocks pulled the total market higher. History tells us that advances in large-cap stocks initially characterize bull markets; the end of bull markets is characterized by strength in small-cap equities. Given the current relative performance of all indices, we could be a long way from a major market downturn. Also, monetary policy is on the side of the stock market. Equities go down when interest rates go up; they flourish when rates go down. The outlook continues to be for lower rates, either sooner or later. As long as inflation doesn't surprise the forecasters, we should be in for continued market gains.



** Magnificent Seven includes: Apple (AAPL), Amazon (AMZN), Alphabet (GOOGL), Meta Platforms (META), Microsoft (MSFT), NVIDIA (NVDA), & Tesla (TSLA)*

The Status of Wealth

Many economists point to the growth in wealth inequality between rich and poor. They never say wealth is rising for both groups as they only focus on the supposedly widening gap. Considering wealth is growing across the board, consumers should be more confident of late. Measures of consumer confidence are not at record levels, but they have been improving. One important indicator of consumer health is how often people eat out, an expensive option relative to eating at home, as the costs of restaurants and tipping have been accelerating. Overall, consumer wealth is at record levels (as is corporate wealth), as seen in the chart below.



The expected decline in inflation resumed in May as the consumer price index was unchanged for the month, and the producer price index declined slightly by 0.2%. Only the commercial real estate business is suffering from the impact of the pandemic as real estate occupancy rates continue to decline. Without sufficient rental income, these entities may suffer from foreclosures. One example that provides some perspective on how the commercial real estate market is suffering is the offering price for a 42-story office building in downtown St. Louis. According to a story in the Wall Street Journal, the asking price is approximately $3 million! On the residential side, home prices remain dubious as current homeowners stay put in the face of high interest rates. Additionally, new buyers are priced out of the market since they cannot afford to buy.

A few politicians have railed against the concentration of wealth among the "ultra-rich." They plan to implement a wealth tax and levy taxes on unrealized capital gains. This proposal is not good because we know wealth creates more wealth. For example, consider the weekend Mansion section of the Wall Street Journal, where multi-million-dollar homes are listed. These millionaires employ hundreds of people to design and build these homes. Additionally, most hire people to maintain their homes (cleaners, gardeners, pool cleaners, etc.). How many jobs are created because of this wealth? We do not have the answer, but we are sure many more people would be unemployed if these wealthy "employers" were not there. Stripping the wealthy of their savings will boomerang on the poor, who supposedly would benefit from this suggested wealth transfer.

Artificial intelligence is giving us the opportunity for another significant leap in productivity and standards of living. All those graduating engineering students will do something to make our lives easier and our ability to experience more time for our private lives. These advances gradually became essential to our lives, just as we experienced with the personal computer and the Internet. Similarly, AI could have an even more significant impact on how we live. This assumption may be brash, but our experience has been that technological breakthroughs have given Americans the highest standard of living in the world.

Conclusion

New highs in the equity market may be forecasting continued better economic times. Investors are celebrating rising corporate profits and expecting lower inflation and interest rates. The short-term roadblocks include the wars in Gaza and Ukraine and the inability to forecast their outcomes. The commercial real estate markets are in turmoil, with one or more large bankruptcies possible. Lastly, the result of our national election may permanently change how the government relates to the private sector. We sense some increased market volatility and uncertainty as we approach election day. Yet, as we enter the year's third quarter, the outlook remains bright despite these pending uncertainties.