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Second Quarter Review
Countdown to Rate Cuts

The second quarter ended much as it began with technology and artificial intelligence (AI) stocks leading the charge to the exclusion of most other shares. The S&P 500 gained 4.4% for the quarter while the Russell 2000 Index of small cap companies posted a loss of -3.3%. For the year through June 30th, the S&P 500 rose 14.5% while the Russell 2000 barely hung on to a slightly positive +1.6% return. Interest rates stayed high with short-term treasury bills and money market funds yielding a healthy +5%. The yield curve remained inverted, however, with long term treasury bond rates remaining below those on short-term T-bills.

To simplify, it was quarter of extremes and a continuing tale of two markets: the first being the "Magnificent 7" and the second being almost everything else. The 5 largest stocks in the S&P 500 Index accounted for almost 30% of the entire index, the highest level of concentration in at least 60 years, and most of the return. Through the second quarter, we have seen the largest outperformance by large-company stocks over small ones since 1998.

AI continued to generate excitement. We recognize the investment potential but are also aware of the risks, having managed investments through the collapse of the dot.com bubble in 2000. (Cisco Systems has yet to reach its peak price per share during the dot.com bubble in 2000, lo these 24 years later.) Even though the early examples of AI may be flawed and short-term exuberance may be excessive, it would still be perilous to underestimate its ultimate impact. We don't want to emulate Nobel Prize winning economist Paul Krugman who allegedly predicted in 1998 that "the Internet's impact on the economy [would be] no greater than the fax machine's." Critics can sound smart while being spectacularly wrong. As one of my colleagues recently wrote, "There are many shortcomings in today's iteration of the technology. Regardless, it SAVES TIME even as a simple, more efficient search tool, and it will get better quickly. There is no resource more valuable than time. Underestimate this technology at your own peril."

After the end of the second quarter, the preoccupation with AI stocks gave way quickly to increasing excitement over the prospect of the much anticipated but often postponed interest rate cuts by the Fed. As if someone threw a switch in early July, a massive reallocation of assets began to take place with money pouring out of high-flying technology stocks and into the badly lagging small-cap and high-dividend stocks. Suddenly, the script was flipped. In a matter of a few trading days, the small cap indexes gained over 11% while many technology stocks idled or declined. It was another extreme event to add to the list. Our patience with our investments in those small cap and dividend stocks has finally begun to pay off.

While interest rates have remained high, some inflation numbers appear to be moderating and employment numbers point to a cooling-off of a too-hot economy. These are exactly the signals that the Fed needs in order to begin cutting short-term interest rates. Rate cuts are generally good for stocks by reducing corporate borrowing costs (especially smaller company stocks) and increasing the value of a given dividend yield on a stock. A 3% dividend yield that the company can increase over time looks a lot better when Treasury bills are yielding 2% than when they're paying over 5%. That 5% yield may be a thing of the past by this time next year. That's why we believe our above-average-yielding dividend stocks will likely be more valuable to investors once interest rates decline.

Bullish investors point to several factors that may support a continued rally for at least the short term. Not only are investors salivating at the pending rate cuts (probably in September), but there is a reported $6 trillion held in money market funds that can also add fuel to the fire, especially when yields on those funds begin to decline from the lofty +5% currently. The Fed is planning to end its "quantitative tightening" just as the "soft landing" that the Fed has hoped for may arrive with moderating inflation and an economy that cools but doesn't stall.

However, a student of economic history would point out some counterintuitive correlations between stock market movement and interest rate cuts. The Fed often waits to cut rates so as not to "overheat" the economy and reignite inflation. There have been times where the much-anticipated rate cuts turned out to be the precursor to a significant *stock market decline*. In those cases, high interest rates had slowly weakened the economy and precipitated a recession rather than just a cooling of inflation. The recent excitement may be overshadowing increasing signs of a consumer-led slowdown in the economy. Some consumer stocks have been falling and restaurant revenues in general have been weakening. The recession that many (if not most) economists had called for this year (and/or last) may finally arrive just when it is no longer generally expected. The timeline below may remind us of how this played out once before:

- Sept 2007: Fed makes first cut to Fed Funds rate which stood at 5.25% - 5.5% at the time
- April 2008: Fed Funds rate is cut all the way down to 2% after Bear Stearns debacle
- Sept 2008: Disaster for market/economy hits after Lehman implosion – The Great Recession

So, while the recent advance may have more room to go, we should still be aware of the risks that things often don't go as planned, by the Fed or anyone else.

With the recent blizzard of economic data and political developments, we are preparing for the greater probability of a change in administrations in Washington come January. Along with a lower interest rate environment and possible tariff changes, this could have a noticeable effect on a number of industries including renewable energy, oil and gas, infrastructure, REITS, utilities, housing, and pipelines, to name a few. We will continue to adjust positions in our portfolios to account for these developments while attempting to keep the risks at a tolerable level. It is anything but a boring time to be an investor!

Enclosed you will find your second quarter reports and statements. Please review them at your leisure and contact us anytime you would like to discuss details or general strategy. We look forward to working with you as this drama unfolds.

Best regards,

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