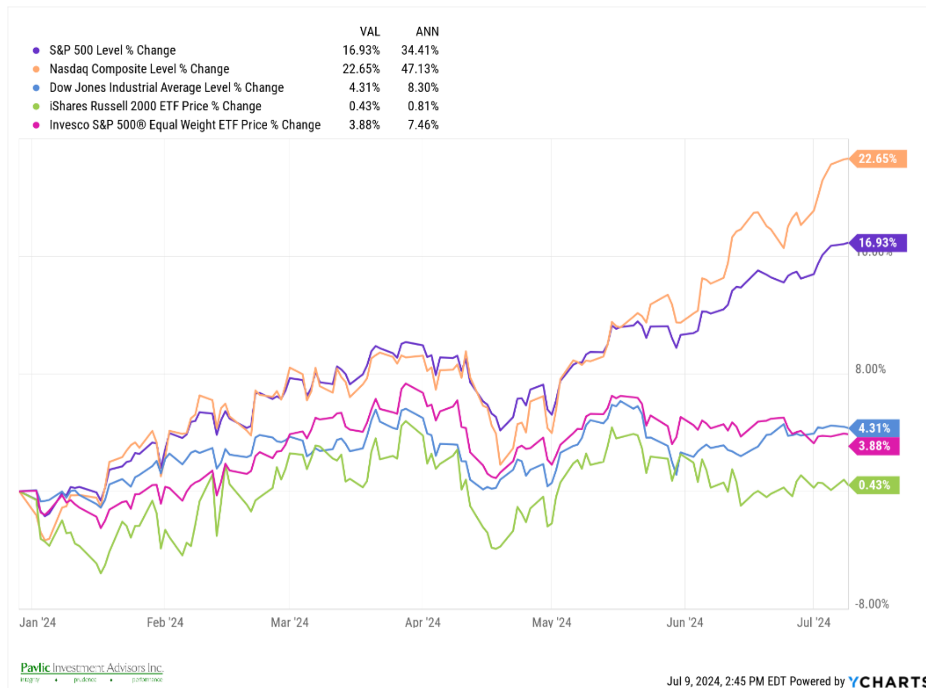
Pavlic Investment Advisors

Client Review & Outlook

2nd Quarter, 2024

Dear Client,

You may recall last quarter's newsletter ended with "enjoy stock market gains for now, but prepare for increased volatility ahead" given that during the first quarter of the year we only experienced a 2% market decline. What transpired during the 2nd quarter was a ~5% market decline in April, followed by continued strong gains in both May and June largely driven by the large cap technology companies. **The performance of our core portfolio of stocks* continued its strong performance in the second quarter significantly outperforming the Dow Jones Industrial Average, the equal weighted S&P 500, and the Russell 2000 on both a gross and net of fees basis, while falling just short of the heavier technology-weighted indexes such as the S&P 500 market cap weighted index and the all-technology NASDAQ index.** We continue to believe that we will see a broadening of the rally to other areas that have been left behind in the prior years in sectors like utilities, health care, real estate, energy, and materials and we are slowly repositioning our portfolios as such.



During the first half of the year we have been engaging with clients to demo our new financial planning software tool called Right Capital. The feedback thus far has been very positive, and we will continue using this software on an ongoing basis for financial planning. While life situations as well as market conditions change, to account for all the moving variables in real time we have implemented a holistic software-based approach to give the best advice to our clients not just on the investment portfolios under which we manage, but other financial decisions such as when to tap Social Security, retirement spending, and Roth IRA conversions, just to name a few. While investment performance will always be our number one priority, we believe clients have greatly benefited from this additional offering, which is all included as being a Pavlic Investment Advisors client. Within your financial plans, we will always have to make assumptions based on one's health as well as market conditions, but making safe and conservative assumptions within this new tool has given our clients additional comfort into what their future financial picture looks like. If you haven't yet sat down with us to review your financial plan, please don't hesitate to reach out and schedule either an in-person meeting or a video conference. We are excited to show you the new technology we have which is designed to give you a better wholistic picture of your financial health in real time.

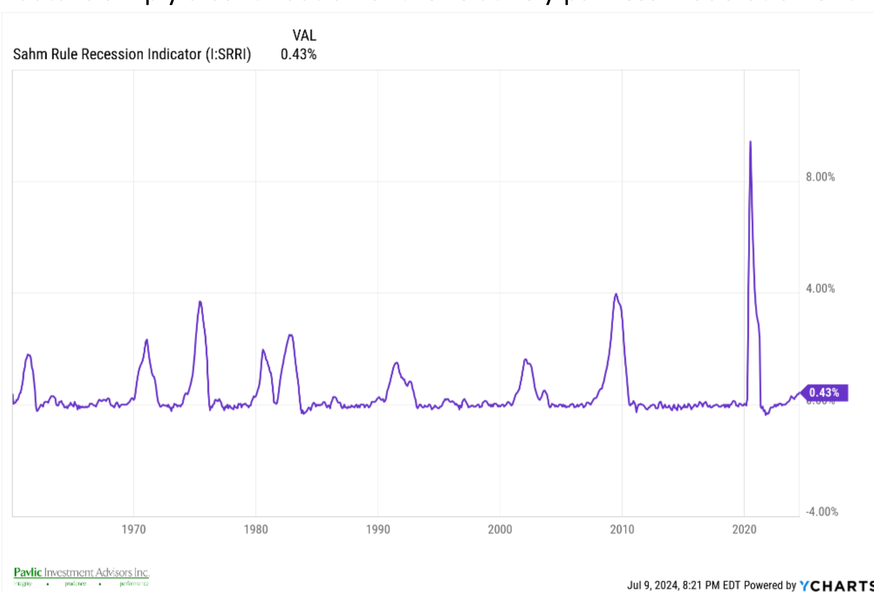
* This newsletter and the information presented herein are intended for informational purposes only. The views expressed herein are the author's alone and do not constitute an offer to sell, or a recommendation to purchase, or a solicitation of an offer to buy, any security, nor a recommendation for any investment product or service. While certain information contained herein has been obtained from sources believed to be reliable, neither the author nor any of his employers or their affiliates have independently verified this information, and its accuracy and completeness cannot be guaranteed. Accordingly, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, timeliness, or completeness of this information. The author and all employers and their affiliated persons assume no liability for this information and no obligation to update the information or analysis contained herein in the future. The performance of our core group of stocks is a good proxy for our equity performance but might vary widely between accounts. As always, past performance is not necessarily indicative of future results.

Stock Market Review

We focus our stock market review on the four largest drivers of the market: current macroeconomic conditions, mega-cap tech concentration, and how AI enthusiasm is driving performance of select technology stocks.

Current Economic Conditions—watching labor closely. An economic discussion usually starts with interest rates, which is a function of the reported inflation metrics. As a reminder, the Federal Reserve has a balancing act to achieve—maintaining low unemployment (stable jobs) while also keeping inflation in check (stable prices). Inflation has declined considerably from the highs of two years ago and that drop in inflation has increased expectations for Fed rate cuts, pressured Treasury yields, and helped stocks to continue to rally. The latest inflation data clearly showed that disinflation (the decline in inflation) has resumed with a most recent PCE report of +2.6% as of the end of June. To be clear, the level of prices is not falling, but instead the rate of price increases is slowing—which is all the Fed needs for a green light to cut rates. Currently, market expectations are ~75% for the Federal Reserve to begin cutting interest rates in September. Finally, wage growth continues to cool with average hourly earnings up +3.9% from the previous year now surpassing $35.00/hour for the average non-farm employee.

Not to be forgotten is the second dual mandate of the Federal Reserve--to maintain full employment which is widely viewed as an unemployment rate less than 4.0%. The US economy continues to create jobs, however the trend shows job creation at a more subdued pace. According to the latest BLS data, 206,000 jobs were added in June, the 41st straight month of job gains. However, the unemployment rate, defined as the number of workers who identify as unemployed as a percentage of the civilian labor force, rose to 4.1%. While the rate continues to hover near 50-year lows, it is also at its highest level since November 2021. The unemployment rate is slowly creeping higher, begging the question if the recent run of data is simply a continuation of the relatively painless moderation of the past few years or if it marks the beginning of something more damaging to come. There is an economic rule called the **"Sahm Rule"** which warns that the US economy is in the beginning stages of recession if the unemployment rate's three-month average rises half a percentage point or more from the averages low over the prior twelve months (chart right). It's designed to detect an acceleration of job losses, and it successfully predicted the prior nine US recessions going back to 1970. As of June, this reading is at 0.43%, just 0.07% away from signaling a further weakening labor market.



"Let's Concentrate on Concentration". There have been many discussions in the financial world about the increased concentration of the largest technology companies. While high concentration hasn't historically signaled a market top, concentration of markets normally dissipates over time and shifts from one leading sector to another. Today, the top 10 stocks represent 37% of the S&P 500 market cap weighted index. Earnings contribution of these top 10 stocks equated to 27% of the index which we give full credit to—the big are getting bigger because they are making the most profit. However, valuation of these top 10 stocks is now 30.2x on a trailing P/E basis, compared to the S&P 500 at 21.0x., and 17.6x for the remaining stocks in the index (chart next page).

* This newsletter and the information presented herein are intended for informational purposes only. The views expressed herein are the author's alone and do not constitute an offer to sell, or a recommendation to purchase, or a solicitation of an offer to buy, any security, nor a recommendation for any investment product or service. While certain information contained herein has been obtained from sources believed to be reliable, neither the author nor any of his employers or their affiliates have independently verified this information, and its accuracy and completeness cannot be guaranteed. Accordingly, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, timeliness, or completeness of this information. The author and all employers and their affiliated persons assume no liability for this information and no obligation to update the information or analysis contained herein in the future. The performance of our core group of stocks is a good proxy for our equity performance but might vary widely between accounts. As always, past performance is not necessarily indicative of future results.

These predominantly large cap technology names have rapidly gained additional share as the market crowned them AI's biggest beneficiaries. While this could be true, paradigm shifts like the internet and AI make the future even more uncertain. Only one tech name from the 2000's top 10 remains in the list today—Microsoft (one of our key holdings). Conversely, today's tech sector is trading at a P/E of ~30x vs. a peak of ~70x in 2000. Based on this, we believe investors can get comfortable with owning technology stocks within an overall diversified portfolio, however, there is a valuation premium associated with owning these names as well that investors need to be aware of.

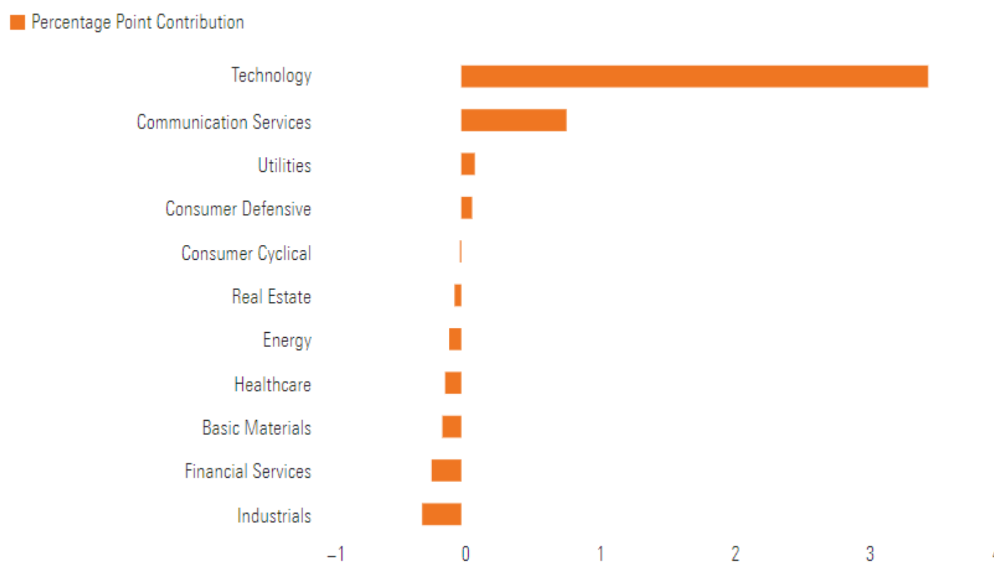
P/E ratio of the top 10 and remaining stocks in the S&P 500

Next 12 months, 1996 - present

Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. The top 10 S&P 500

AI Enthusiasm continues to drive select technology stocks higher. Both the earnings growth and psychological enthusiasm of the advancements in artificial intelligence, which really began in earnest 18 months ago, has been an integral part of the rally in stocks. There is little debate that the market cap weighted indexes of the S&P500 and the NASDAQ are benefiting from the AI enthusiasm. As asset managers, the biggest question we ask ourselves every day is whether or not the enthusiasm is bubble forming and if so, how should we position portfolios. The root of the question stems from "is the relative risk, worth the potential reward?" Our answer is, recognizing it may be unsatisfactory, it depends. Playing Monday morning quarterback, owning companies in the semiconductor space such as Applied Materials (AMAT) and Teradyne (TER) have been our best calls in the last 18 months. Both have been net beneficiaries of the chip manufacturing process within AI. We also own large cap technology names that are purchasing the new AI chips and implementing it into their business models such as Microsoft (MSFT), Apple (AAPL) and to a lesser extent Accenture (ACN). **In short, we have owned what has worked historically, but we are growing increasingly more interested in what hasn't worked over the last 18 months**. The chart left shows just how concentrated the returns were in the second quarter. The bad news is that specific technology names have propelled the market cap weighted indices to levels that we would consider frothy. The good news is there are 10 other GICS sectors that look either fairly valued or undervalued, and we are wondering when we will see a rotation—either from technology underperforming or other sectors outperforming—start to occur.

Sector Contributions to Q2 Returns

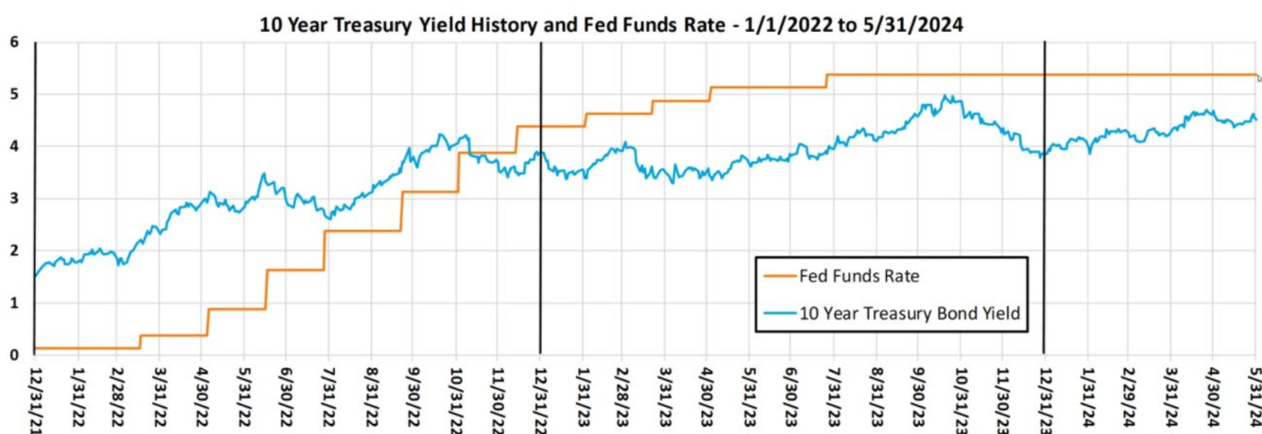


Source: Morningstar Direct. Data as of Jun 27, 2024.

* This newsletter and the information presented herein are intended for informational purposes only. The views expressed herein are the author's alone and do not constitute an offer to sell, or a recommendation to purchase, or a solicitation of an offer to buy, any security, nor a recommendation for any investment product or service. While certain information contained herein has been obtained from sources believed to be reliable, neither the author nor any of his employers or their affiliates have independently verified this information, and its accuracy and completeness cannot be guaranteed. Accordingly, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, timeliness, or completeness of this information. The author and all employers and their affiliated persons assume no liability for this information and no obligation to update the information or analysis contained herein in the future. The performance of our core group of stocks is a good proxy for our equity performance but might vary widely between accounts. As always, past performance is not necessarily indicative of future results.

Bond Market Review

"Higher for Longer" Continues to Hold True. With another quarter in the books, the 10-year US treasury rate once again ended the quarter roughly where it started—around ~4.25%. The "higher for longer" interest rate environment has certainly been playing out (chart below). For our clients with a bond allocation, we continue to purchase bonds at a discount to their par value while also simultaneously collecting the interest payments that are owed to us until the bond matures. While longer dated bond prices fell as rates rose in 2021 and 2022, that pressure has abated simply due to the passage of time as opposed to a decline in rates. This benefit in this particular interest rate environment is instrumental to our bond strategy of holding bonds until maturity at which point we receive $100/bond par value along with the final coupon payment. Finally, it is important to note our investment grade bond strategy by design does not attempt to predict the path of interest rates—we simply take the expected rates of return when a bond is purchased with the plan to hold them to maturity.



2024 Market Outlook and Commentary

Keeping a close eye on the Sahn Rule. We have begun the third quarter with a stable yet noticeably slowing macroeconomic backdrop, with particularly worrying signs in the labor market. We hope this gets the Fed's attention -- as inflation has continued to fall the risk of increasing job losses should garner more of the Fed's attention. We see the risks between inflation and rising unemployment as more balanced today, and as such we believe the Fed should start cutting interest rates this fall. If unemployment were to rise to 4.2% or higher, violating the Sahn rule, we would expect more volatility with potentially a 5 to 10% pullback in the stock market, especially considering how far we've already come this year and with increased uncertainty surrounding the US presidential election. That said, on balance we still don't think a recession is just around the corner.

Finally, investor enthusiasm towards the potential for artificial intelligence (AI) remains a critical part of the bull market and continued strong earnings from Nvidia last quarter furthered investors' hopes that AI integration will lead to profitability and earnings, not just for tech companies, but for many businesses that utilize AI. However, as we see it today, AI integration has produced a lot of flashy headlines but not a lot of profit maximization for non-tech industries (at least not yet). If AI fails to broadly boost profits, and demand declines, that would be a significant negative for the market cap weighted indices that have been heavily driven by AI enthusiasm. In summary, this rally is currently supported by positive fundamentals, but we are aware of the increasing risks and that's why we are focused on managing both risk and return in a diversified approach. Please do not hesitate to contact us with any questions, comments, or to schedule a review meeting.

"Know both what you own, and why you own it." – Peter Lynch

* This newsletter and the information presented herein are intended for informational purposes only. The views expressed herein are the author's alone and do not constitute an offer to sell, or a recommendation to purchase, or a solicitation of an offer to buy, any security, nor a recommendation for any investment product or service. While certain information contained herein has been obtained from sources believed to be reliable, neither the author nor any of his employers or their affiliates have independently verified this information, and its accuracy and completeness cannot be guaranteed. Accordingly, no representation or warranty, express or implied, is made as to, and no reliance should be placed on, the fairness, accuracy, timeliness, or completeness of this information. The author and all employers and their affiliated persons assume no liability for this information and no obligation to update the information or analysis contained herein in the future. The performance of our core group of stocks is a good proxy for our equity performance but might vary widely between accounts. As always, past performance is not necessarily indicative of future results.