

Quarter-In-Review – It was a mixed quarter for financial assets, with optimism about tech and AI driving some sectors, while poor earnings performance, election uncertainty, and sheer apathy weighing on other segments. Once again, the S&P 500 stands out as the best major index around the world. But even here you don’t have to look too far below the surface to find a far more nuanced picture. Mega-cap tech stocks shone, and NVIDIA on its own contributed to almost half the index return for the quarter. For the full year just six stocks (MSFT, NVDA, AAPL, GOOGL, AMZN, META) have made up 62% of the index’s return. But the chart below shows the percentage of stocks in the S&P 500 that have outperformed the index each year going back to 1973. This measure is at the lowest level ever!! It’s a similar story looking beyond the S&P 500 index. Small-cap U.S. stocks lost -3.3% in the second quarter while real estate stocks dipped -1.9%. The developed market EAFE index lost -0.2% after a relatively good first quarter. Election uncertainty in France played a large part in this result.

The table above also highlights that longer-term interest rates drifted higher in the second quarter despite a modest dip in core inflation. Intermediate-term Treasury bonds lost -0.2% in Q2, bringing the YTD loss to -1.5%, while longer-term government bonds lost -2.0% (-5.6% YTD). Within the government bond universe, only bonds with maturities of less than 2 years gained ground (+0.8% for the quarter, +1.1% YTD).

Needless to say, any diversified investor was left frustrated at the end of the second quarter. Few would think it prudent to concentrate their portfolio in six highly correlated stocks, and most other assets that investors hold to diversify their portfolios were flat to down during the quarter. Can we expect more of the same in the second half of the year? And where will the surprises likely come from?

Is There Fraying Around the Economic Edges? – For all the talk about how the election cycle or geopolitics could

Market Benchmarks			
Market Indices	2Q24	YTD	3-Yr An
Global Equities	+2.5%	+10.5%	+5.1%
S&P 500 Index	+4.3%	+15.2%	+9.9%
Russell 2000	-3.3%	+1.6%	-2.7%
Int'l Index (EAFE)	-0.2%	+5.8%	+3.0%
Emerging Mkts	+5.2%	+7.2%	-3.9%
Other Indicators			
	6/30/24	3/31/24	12/31/23
Fed Funds Rate	5.25%-5.5%	5.25%-5.5%	5.25%-5.5%
2-Year Treasury	4.73%	4.62%	4.25%
10-Year Treasury	4.35%	4.20%	3.88%
S&P 500 P/E Ratio*	21.0	21.0	19.5
Crude Oil	\$81.35	\$82.99	\$71.31
Core Inflation	2.6%	2.8%	3.2%

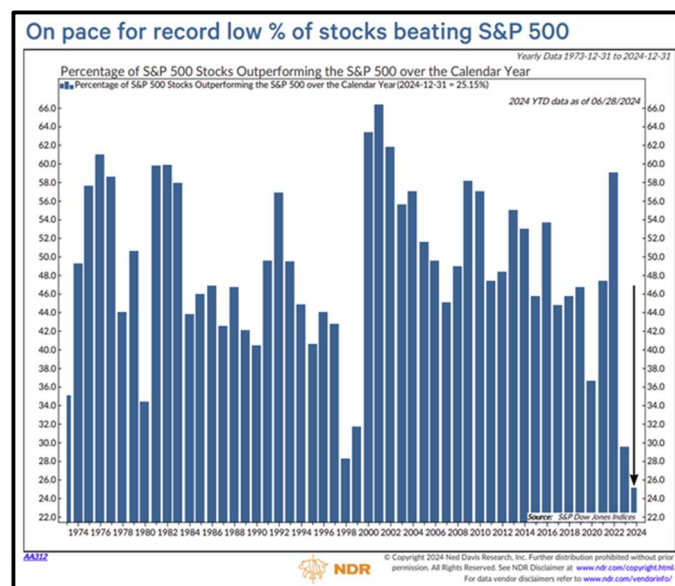
*Forward 12-month operating earnings per S&P

drive the markets in the second half of the year, the most important factor will remain the direction of the global economy. Certainly, elections can matter over the secular horizon, and the upcoming vote in the U.S. seems particularly important (more below), but at the end of the day it is hard to escape the fact that the economy drives earnings, and earnings drive stock prices.

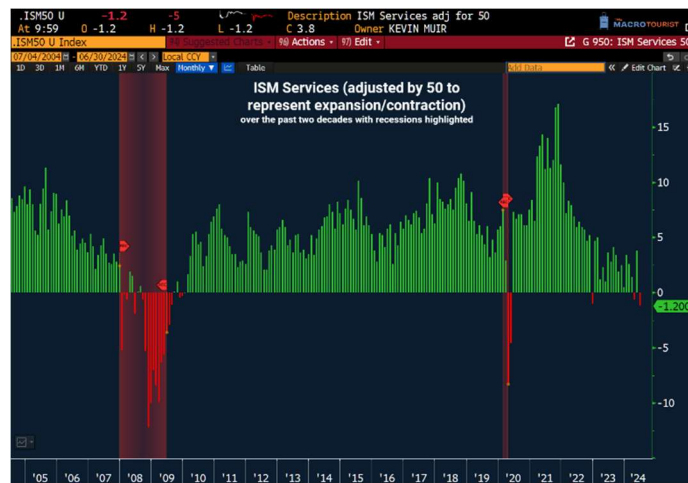
A number of pundits have achieved brief media attention over the last two years claiming a recession was just around the corner. The typical reasoning was that higher interest rates would do what they normally do – trigger a recession. This cycle has been different, though, and the U.S. economy has proved surprisingly resilient to the Fed’s monetary medicine. There are a number of reasons, most of which we’ve touched on in prior letters. Briefly, fiscal

spending is proving to be a huge tailwind, with much of the new marginal spending tied to infrastructure, green energy, and other capital-intensive sectors. Furthermore, higher rates have proved to be a boost for corporations and higher-income households due to rising earnings on cash balances. Additionally, the labor market has remained tight and income growth has been decent.

But jitters about the trajectory of the economy never really go away. Recent data from the



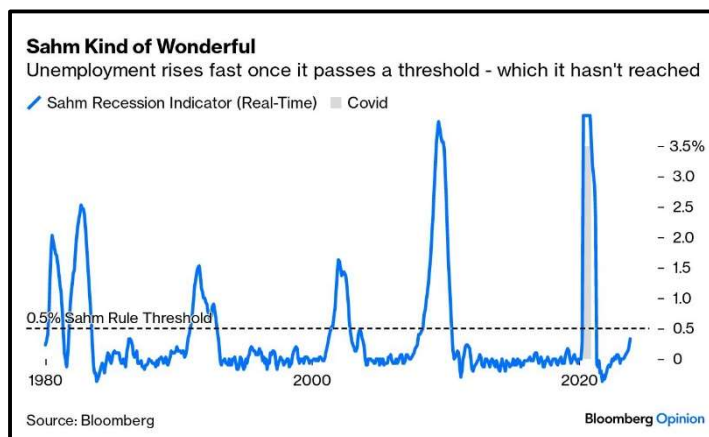
services sector shows a contraction in activity, something we really haven't seen since the COVID crisis. It's historically unusual for service activity to contract in the U.S., after all, consumption seems to be a national pastime. As you can tell from the chart to the right, there have been a couple of false signals over the last two years when activity briefly dipped. But this data point is worth watching.



Furthermore, the ever-resilient labor market is certainly slowing, and the trend in the unemployment rate is one of the few reliable predictors of recession, at least historically. There's even a rule for it – the Sahm Rule, named after the former Fed economist Claudia Sahm. This rule stipulates that a recession is headed our way when the three-month average of the unemployment rate rises by 0.5% or more relative to the lowest level over the last twelve months. Proponents of this indicator argue that rising unemployment can feed on itself as job losses lead to lower consumption, which feeds back into more job losses. The chart below shows this measure over time, and after the July 5th payrolls report, we are only 0.1% from hitting the required level (0.4% versus a threshold of 0.5%). Of course, every indicator works until it doesn't, but it is another data point worth watching.

We should point out that few economists are making a recession call today. The post-COVID world is undoubtedly different, and there are still strong tailwinds for the U.S. economy. Personal income growth remains solid and household balance sheets are in fine shape, as are corporate finances. But activity is softening around the edges and the global economy is more vulnerable to an outside shock than before.

Inflation – The Goal Is In Sight – A few months ago many would have argued that the most likely shock would come from a resumption of inflation triggering the need for even higher policy rates. The odds of this scenario seem to be diminishing, though. Take the so-called 'supercore' inflation number which looks solely at inflation in the services sector. This indicator is back down to the Fed's goal of 2% (see chart at the top of the next page). It is a similar story in many other regions, and moderating inflation has led both the European Central Bank and the Bank of



high today. As you can see from the chart at the bottom of the next page, the real Fed Funds rate is as high as it's been in seventeen years. The Fed has been vocal about the fact they are sensitive to this situation and that the problems in the commercial real estate market are a possible early warning sign of too tight a policy setting. Of course, there is another school of thought that real rates before 2000 were consistently running between 4% and 5% and that in the post-COVID world, we need to get back to similar levels. But we suspect the Fed is going to err on the side of caution. If the unemployment rate continues to tick higher we think the Fed will use that as an excuse to cut a couple of times this year, possibly in September and November. Then they are likely to wait to see what the legislative fallout from the November election proves to be.

Election Wildcards Around the World – If there's a surprise in the second half it will probably be political. The U.K. just concluded a snap election that saw a change of power, while France went through two rounds of voting after a shock result in the European Parliamentary elections. Earlier in the quarter both Mexico and India held national referendums. While each election garnered justifiable attention in its own right, only the French election triggered a meaningful market reaction. The surprising resurgence of the Far Right unnerved the French bond market for a period of time, leading to lower prices and higher yields.

Of course, for those of us in the U.S. this is all but a prelude before November. Recently, the odds of a Trump victory in the upcoming U.S. election have risen sharply following President Biden's weak performance during the first presidential debate. The odds of a Republican sweep in November have risen, but it is too soon to bet on such an outcome given the chances of

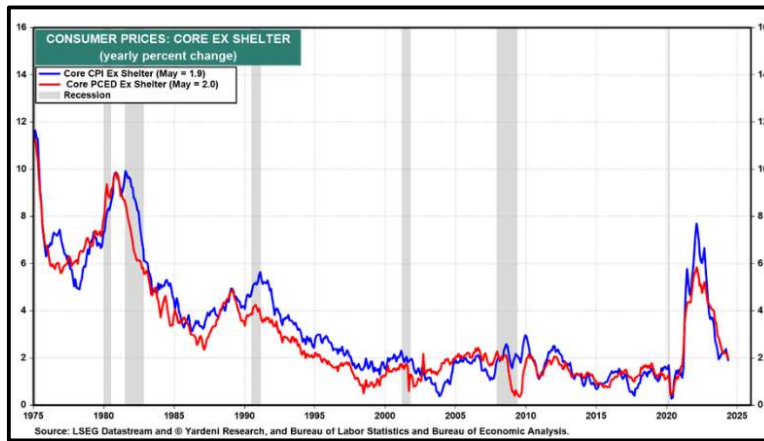
a possible democratic reshuffle before the convention in August. Bond yields did jump in the immediate aftermath of the debate, but the increase wasn't sustained for long.

While there is of course a lot of 'sound and fury' this election cycle, it is next to impossible to guess what Congress will be able to do after inauguration day, regardless of who wins. Even a clean sweep for one party does not guarantee a productive legislative agenda. In recent history, Congress has been particularly unproductive, and it would take a brave person to argue that we are going to see a flood of new legislation in 2025.

Two main economic issues loom large for investors. Former president Trump has promised a 10% across-the-board tariff if he returns to the White House, and he would pull out all the stops to extend the Tax Cuts and Jobs Act of 2017. A Democratic administration may differ in the details, but broadly speaking, they probably favor aggressive trade policy and an extension of the tax cuts as well. Both topics could be market-moving. Goldman Sachs estimates that Trump's 10% tariff would, if it provoked retaliation by America's trading partners, add 1.1% to American inflation while marginally reducing growth. Euro-area output could fall by 1%. It's a similar story, at least as it concerns inflation, if annual deficits continue to run at \$1.5 trillion a year or more. Higher inflation would force the Fed to raise interest rates—putting them on a collision course with former president Trump and other populist politicians. This scenario isn't our base case for the next two to three years, but it is something worth watching.

What Are Bonds For? – It's certainly been a trying few years for bond investors. They suffered through losses in 2021 and 2022 and saw only a modest recovery in 2023. So far this year they are probably sitting on losses once again. While the inflation spike in 2022 was the immediate cause of the bond bear market, the fact that starting yields in late 2020 were so low was the precondition for subsequent returns. We shouldn't forget that the yield on the 10-year Treasury hit a low of roughly 0.5% in late July 2020!!

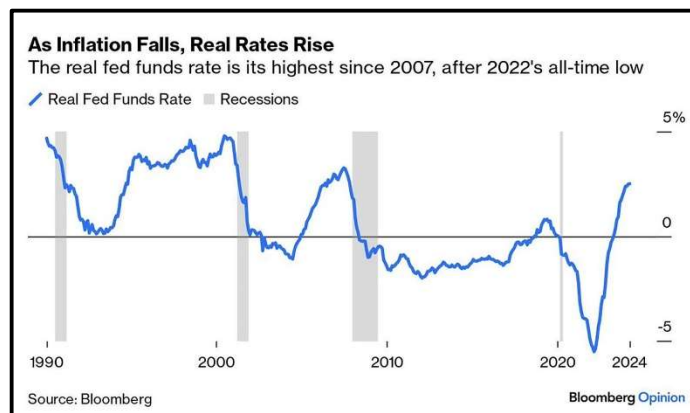
One feature of human psychology is that we all tend to be trend followers. There



are undoubtedly evolutionary reasons we developed this tendency (the last guy to eat the red berry died – avoid red berries!!!), but when it comes to investing we can be led astray. Looking at bonds again, the trend from 2018 to 2020 was very favorable for fixed-income investors. Yields did nothing but go down, and returns over this period were in the double digits. Money flooded into fixed income. But by late 2020 there was no value left in government bonds with yields so low, and almost any future scenario was going to lead to losses. Today, the valuation picture has fundamentally changed. You can once again earn income in fixed income, and while we wouldn't claim bonds are cheap at today's levels, they do provide two important roles for some investors:

- Income. Cash yields over 5% today, and bonds with a maturity of two years pay roughly 4.6%. Muni yields are also very attractive for investors in a high tax bracket.
- Recession hedge. No one knows what the future holds. We have noted above some economic indicators that are starting to flash yellow, but other indicators remain firmly in growth territory. But one thing we know with a high degree of certainty is that the economic cycle has not been consigned to the 'ash heap of history.' There will be another recession at some point in the future. Recessions are usually deflationary. A deflationary recession would mean higher quality bond yields would fall and prices would increase.

This last point is important for investors who want to hold diversified portfolios. What's going to zig when the rest of your portfolio zags? While this seems like a quaint question to ask when AI stocks are adding the equivalent of France's GDP to their market cap each week, we subconsciously know that trees don't grow to the sky. We'd argue that stocks will do what stocks typically do in a recessionary scenario, go down (historically it has been about -30% or so). We don't think this is imminent, but a portfolio with a time horizon beyond the next twelve to eighteen months would probably benefit from some fixed-income exposure.



As we did last quarter, we'd still argue the front part of the yield curve remains the most attractive. Look at the table at the top of the next page. You

can see that yields have increased in each maturity bucket, but only short-term bonds have made money this year due to their higher yield and lower sensitivity to rate changes. We are maintaining this position going into the second half of the year. While a recession might argue for extending maturities to benefit more from falling rates, we think this move is still premature. We'd subjectively assign less than a 1 in 3 chance of a recession starting before year-end. And depending on how the election unfolds and what policy path is chosen, inflation could still hurt long-maturity bonds.

Can a Lopsided Stock Market Get More So? – We noted at the beginning of the letter that the returns for the U.S. equity market have really been driven by a small handful of companies that are a play on the AI theme. The average stock in the S&P 500 is up just +5% this year while the index is up over +15%. Can this continue? You'll read firm views on either side of the argument, but we don't think anyone can really know with much certainty. Can the AI trend lead to once-in-a-generation growth opportunities and geometric earnings growth? It certainly could. But are investors overpaying for what's likely to be an underwhelming earnings stream (at least relative to expectations)? This is undoubtedly going to be true at the individual company level. But trying to time the transition from the former to the latter scenario is neigh on impossible. Our recommendation and portfolio positioning is to hold some of the growth segments of the market that are benefiting from the AI phenomena while at the same time diversifying into cheaper

U.S. Treasuries	Yield		Return	Avg. Maturity
	6/30/2024	12/31/2023	2024 YTD	
2-Year	4.71%	4.23%	1.10%	2 years
5-Year	4.33%	3.84%	-0.42%	5
10-Year	4.36%	3.88%	-2.03%	10
30-Year	4.51%	4.03%	-6.20%	30

Source: J.P. Morgan

sectors. It's worth noting, though, that we are maximum underweight in both small-cap and international stocks and hold no dedicated REIT exposure.

Finally, a quick word on market corrections. Simply put – we should expect them. As of July 2nd, the S&P 500 has not experienced a single-day

correction of over 2% in 351 days. You have to go back to February 2018 to find a similar period of calm, and before that 2007. The table at the bottom of the page shows S&P returns going back to 1976 and intra-year drawdowns. The average correction over this period is -16% (and the data is very similar if you go back to 1928). We are still in the camp that stocks will beat bonds as long as economic and earnings growth persists, but this view would not preclude a 5% to 15% correction in the second half of this year.

Final Thoughts –The second half of this year is shaping up to be one of big crosscurrents. Obviously, the election in the U.S. is on many people's minds, and there are a number of scenarios that could play out going into

November. Just as important will be the legislative agenda that emerges after inauguration day. Furthermore, there are some hints of economic softening, and while we think the odds favor continued growth, we have to be attuned to trends in service activity and employment going forward. Finally, the equity market has been a one-way bet for some time now, especially in the top market cap names. While we wouldn't be so bold as to bet against the trend, we do think it is prudent to pull in return expectations for the second half of the year and prepare mentally for a correction.

Charles Blankley, CFA
Chief Investment Officer

S&P 500 Annual Returns and Intra-year Drawdowns: 1976 to 2023					
Year	Return	Drawdown	Year	Return	Drawdown
1976	23.8%	-8.4%	2000	-9.0%	-17.2%
1977	-7.0%	-15.6%	2001	-11.9%	-29.7%
1978	6.5%	-13.6%	2002	-22.0%	-33.8%
1979	18.5%	-10.2%	2003	28.4%	-14.1%
1980	31.7%	-17.1%	2004	10.7%	-8.2%
1981	-4.7%	-18.4%	2005	4.8%	-7.2%
1982	20.4%	-16.6%	2006	15.6%	-7.7%
1983	22.3%	-6.9%	2007	5.5%	-10.1%
1984	6.2%	-12.7%	2008	-36.6%	-48.8%
1985	31.2%	-7.7%	2009	25.9%	-27.6%
1986	18.5%	-9.4%	2010	14.8%	-16.0%
1987	5.8%	-33.5%	2011	2.1%	-19.4%
1988	16.5%	-7.6%	2012	15.9%	-9.9%
1989	31.5%	-7.6%	2013	32.2%	-5.8%
1990	-3.1%	-19.9%	2014	13.5%	-7.4%
1991	30.2%	-5.7%	2015	1.4%	-12.4%
1992	7.5%	-6.2%	2016	11.8%	-10.5%
1993	10.0%	-5.0%	2017	21.6%	-2.8%
1994	1.3%	-8.9%	2018	-4.2%	-19.8%
1995	37.2%	-2.5%	2019	31.2%	-6.8%
1996	22.7%	-7.6%	2020	18.0%	-33.9%
1997	33.1%	-10.8%	2021	28.5%	-5.2%
1998	28.3%	-19.3%	2022	-18.0%	-25.4%
1999	20.9%	-12.1%	2023	26.1%	-10.3%

Data Sources: NYU, Bloomberg (My Calculations)

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