ICON Insights

Market Commentary - September 2024

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Equities

Since June of 2023, the Federal Funds rate, as set by the Federal Reserve (Fed), has been greater than trailing one year inflation, as measured by the Consumer Price Index (CPI). For example, the CPI was up 2.9% year-over-year in July of this year and the Federal Funds rate was 5.33% creating what is known as "real" (above and beyond inflation) interest rates. This meets ICON's definition of "tight" monetary policy. We believe this has affected investor behavior and given the stock market a certain personality or theme. Tight monetary policy always has the potential to cause a recession. Given that potential, investors have not embraced economically sensitive, cyclical companies. Many of those companies have had impressive growth in earnings but it is not reflected in the stock prices. Generally avoiding those stocks, investors have flocked to companies with unique growth situations such as artificial intelligence or weight loss drugs. The result has been a market with very narrow leadership and participation. In addition, there is a common belief among hedge fund managers that high real interest rates pose more problems for small companies than larger companies. As a result, stocks of small-cap companies were very sluggish. Also with high real interest rates, investors used debt instruments for yield rather than dividend paying stocks, making those stocks very sluggish. That was then. This is now.

The last three month-over-month CPI changes have been May 0.0%, June -0.1% and July 0.2% and many Fed officials have stated that they believe it is time to start lowing the Federal Funds rate. We believe the stock market is in transition from investors pricing stocks in a setting of high real interest rates to pricing stocks in anticipation of neutral interest rates. ICON defines neutral to be when the Federal Funds rate equals inflation. In this new setting, of approaching a neutral Federal Funds rate, we expect the stock market leadership to be broader. We expect small-caps and dividend paying stocks to participate and perhaps even lead. In other words, we expect a transitioning stock market with a very different personality, or theme, than we saw in 2023 and the first half of 2024, because investors behave differently when monetary policy is tight versus when it is easing.

A stock market transition is rarely smooth or quick. It usually involves tug-of-war, or turbulence, as the old and new themes come and go daily or weekly. It is too early to tell for sure, but when the new theme emerges potential leaders could be Financials, Industrials and a couple of industries in Utilities.

Bonds

The yield on the 10-year Treasury note began August of 2024 by dropping below 4.00%. After that it spent August in the 3.80% to 4.00% range. It seems comfortable in that range, and it appears investors need proof that inflation will drop further before taking longer term yields lower. While we believe the Fed's inflation target of 2.00% is attainable, we suspect most investors are skeptical. If so, bond rates will be slow to drop.

Summary

Not only has a new market theme appeared since early July of this year, but we saw some conditions and behaviors that occur when an old theme is about to end. One of those is how the eleven sectors correlated with the broad market. Correlation hit an extreme low, mostly due to the narrow leadership and participation and further adds support to the notion that the old theme has run its course and we are transitioning to a new market theme.

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ICON's value-based investing model is an analytical, quantitative approach to investing that employs various factors, including projected earnings growth estimates and bond yields, in an effort to determine whether securities are over- or underpriced relative to ICON's estimates of their intrinsic value. ICON's value approach involves forward-looking statements and assumptions based on judgments and projections that are neither predictive nor guarantees of future results. Value readings are contingent on several variables including, without limitation, earnings, growth estimates, interest rates and overall market conditions. Although valuation readings serve as guidelines for our investment decisions, we retain the discretion to buy and sell securities that fall beyond these guidelines as needed. Value investing involves risks and uncertainties and does not guarantee better performance or lower costs than other investment methodologies.

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The Federal Funds rate is the interest rate at which private depository institutions (mostly banks) lend (federal funds) at the Federal Reserve to other depository institutions, usually overnight. Changing the target rate is one form of open market operations that the Chairman of the Federal Reserve uses to regulate the supply of money in the U.S. economy.

The Consumer Price Index (CPI) is a measure of the average change in prices over time of goods and services purchased by households. The CPIs are based on prices of food, clothing, shelter, fuels, transportation fares, charges for doctors' and dentists' services, drugs, and other goods and services that people buy for day-to-day living.

The 10-year yield is the benchmark 10-year yield to maturity reflected by the current issue 10 year U.S. Treasury note.

Sources: Bloomberg

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