David Hagee: Hello and welcome to Conversations with Commerce Trust, our show about the markets, investment themes, and economic insights that matter to you. I'm your host, David Hagee, Chief Investment Officer with Commerce Trust. Today, we're discussing the equity markets and our expectations across the equity spectrum for the rest of 2024 with KC Mathews, our Chief Market Strategist, and Don McArthur, our Senior Investment Strategist and Director of Equity Research here at Commerce Trust. Welcome back to the podcast, gentlemen.

KC Mathews: Hi, David.

Don McArthur: Good morning, David.

David: We've had a more eventful summer than I think any of us anticipated inside both the economy and the stock market. We've seen the stock market have a pretty significant pullback here, almost 8.5%, 9% where we're at right now in early August, and that we've also seen maybe some of the signs of weakening inside the U.S. economy. KC, what are your thoughts on the overall economy right now, of what we've seen, and where we're going?

KC: It's interesting, David, that we do expect economic activity to cool. In the past two weeks or so, we started to get some data confirming that and some of the data scared the equity markets. There are really three issues that caused some turbulence in the stock market recently. One was we received some manufacturing data that indicated that economic activity was cooling and at the same time, that inflation remained sticky. Secondly, we saw unemployment increase. That's concerning; that the economy is going to slow down, and consumption will be curbed. Then, lastly, there was some activity overseas. There are a number of things that caused this recent turbulence in the U.S. stock market.

David: We have some of these technical aspects happening and you also have maybe an undercurrent of weakness. I'm struck by the idea, though, that in the second quarter, GDP (gross domestic product) grew by 2.8% versus 1.4% inside the first quarter of 2024. Where is this weakness that we're seeing inside the markets right now or inside the economy, as well as what's the path for inflation right now?

KC: There appear to be some dislocations in the market, but you're spot on, GDP has been surprisingly strong. In the second quarter of this year, we saw 2.8% year-over-year GDP growth and then the Atlanta Fed (Federal Reserve Bank of Atlanta) expects 2.9% growth in the third quarter. Well, we anticipate a little bit more cooling for the calendar year 2024. We expect 2% GDP growth. That's not bad. That's good for business, and it's good for financial markets.

We will see some disinflation, and we have seen that already. Inflation was at a really high number, and that has come down significantly. When you look at the Fed's (Federal Reserve's) favorite guide, you would look at PCE, Personal Consumption Expenditures (Price Index), that inflation indicator is at 2.5% year-over-year and the core PCE, taking out the volatile food and energy variables, at 2.6%. The Fed's target is at 2%. We're getting closer and closer, and that has ramifications to interest rates and Fed activity.

David: As we have this economic backdrop of inflation cooling and that strong economic growth here, I think the question that everyone has been waiting on is, is the Fed too late? That's the narrative that we're currently experiencing right now. What is our outlook for rate cuts for the balance of 2024?

KC: You're going to see that narrative out in the marketplace, that once again, we're going to blame the Fed for the end of the economic cycle where they kept rates too high too long. The jury is still out on that, and we're not here to criticize the Fed. But clearly, the stage is set for the Fed's September meeting to cut interest rates. They meet in September, November, and December this year. It looks like you're going to see cuts in each of those meetings. Right now, Fed funds is at 5.5%. It could get down to 4.5%, a full 1% cut by the end of the year, and we expect more cuts into 2025, as long as we see that disinflation continuing.

David: Don, let's talk a little bit about corporate earnings as we transition into equities here. What's your outlook, and what have we experienced for 2024 on the corporate earnings' side?

Don: Even though you have a cooling economic landscape, it's still positive for S&P 500 (Index) earnings. We're just wrapping up second quarter earnings. Companies are telling us how they've done through June of this year. Earnings are coming in better than expected, up about 9% over the prior year. In the back half of the year, the estimates are coming down, but it's still going to be pretty robust. For the full year of 2024, earnings look like they're going to be up about 9%, 10% over the prior year.

As we look into 2025, the estimate across the street is that earnings are going to be up another 17%. Now, that seems a little high given this economic forecast we have. If you look at where revenue comes from for the S&P 500, it's economic growth. If the economy is going to grow 2%, maybe plus, inflation is maybe around 2.5%, that gives you 4% to 5% nominal GDP growth. That translates back into S&P 500 revenue. We get a little margin improvement from mixed shift to those better companies becoming bigger, and then there's a little bit of buyback. I would think you're probably closer to 8% to 10% in 2025. Still nice, still supportive of equity prices.

David: Strong corporate earnings coming through and anticipated for the balance of 2024 and maybe even into '25. As we start to dissect the market, we've had a strong market. Even with this pullback, we're up around 10% for the S&P 500, but the composition of that return has changed quite a bit. KC, maybe you could talk a little bit about how the market has morphed a little over the summer here.

KC: The leadership has changed in July. The driver of domestic markets was really seven large companies called the Magnificent Seven (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Telsa), or the Mag Seven. We still like those stocks. They still have great growth potential, but you're seeing a change in leadership, one due to the change in interest rate outlook. You're seeing more interest rate-sensitive sectors in domestic large caps, such as financials and utilities, perform extremely well over the past 30 days. In addition to that, certain sub-asset classes like mid-cap and small-cap that can be interest rate-sensitive also posted very strong numbers in the month of July. The question is, is it a fad or is it a start of a new trend?

David: With the stock market turbulence that we've seen over the course of the end of July and into August here, is this just a garden variety correction that you could argue is healthy for the market, or is this the start of a new bear market?

KC: We're in the camp of a correction. When you look at the data, when you study corrections, they're normal and healthy for cyclical bull markets. You see them every year. The last time we saw a 10% correction was late 2023. Then this year, 2024, the markets really went straight up. In April, you saw a 6% correction, and then here in July and August, you're seeing a correction of 8.5%. It hasn't changed our tune on the direction of the market that we expect to see positive rates of return for calendar year 2024, but we expect some type of correction every year.

David: Don, given that we're in the camp of this is more of a garden variety correction that is no fun to go through, but certainly something that is to be expected in stock market investing, what do we anticipate happens to equities when you start to have Fed rate cuts out there?

Don: When you look at the past rate cutting cycles, the S&P in average is up 5% 12 months after the first cut. We do have corrections from time to time.

KC: One of the things that we're watching, as you know very carefully, is why the Fed would be cutting (interest rates). Are they normalizing interest rates, or do they have to restimulate the economy? We're in the camp of normalizing interest rates, and that's where you see these positive rates of return after a Fed cut. That's just really important to distinguish why the Fed is cutting.

David: I think the headline here is the recession fears may be overstated, but they're not unfounded at this point. That's positive for equities longer term. KC, from a high-level on stocks, how are we positioning with regard to asset class at this time?

KC: One of the things that we feel strongly about is to remain disciplined and diversified and not get caught up in some of these short-term trades. You're seeing some of that right now, that other sub-asset classes in the equity space have performed very, very well in the month of July.

One example is small caps. Small caps underperformed large caps for a number of years and then, all of a sudden, in July, outperformed large caps because they are interest-rate sensitive. When you look at the Russell 2000 (Index), which is a small-cap index, it's really loaded up with real estate stocks called REITs (real estate investment trusts) or financial stocks, banks, insurance companies, all interest rate-sensitive type securities. So, they performed very, very well. What's interesting when you look at small caps is they're (still) more sensitive to economic activity than interest rates.

David: Given this environment, I think it's meaningful to talk about some of the risks that we see moving forward inside the stock market as well as the economy. Don, KC, where are you seeing the risks at right now?

KC: Yes, there's always a laundry list of risks out there in the market, but one of them is valuation. Don, you might want to just chime in on valuations, what you're seeing out there.

Don: Yes. Valuations are something we always watch. They mean more for the longer term than the shorter term. You can't really use valuations as a quarter-to-quarter indicator. We are at the high-end of valuations now. With the pullback in the markets, they have become more attractive, but we are at the upper end of the range.

KC: Yes. I would add, there's other issues out there. Corrections as we talked about are always present every year. This year, we see a presidential election year. There's always some uncertainty and volatility around the election, but that is short-term and short-lived. Sticky inflation, or perhaps reacceleration of inflation is a potential risk that we're watching. Consumers financial health, right now the consumer is in relatively good shape. We're starting to see unemployment numbers pick up. That would be a concern to us, which would indicate some slowing economic activity.

Then even changing investment themes. When you think about the Mag Seven stocks, where the leadership of the markets, well, over the decades, that changes from decade to decade. So, a number of things that we're watching that could change our forecast down the road.

David: Thank you for the interesting discussion today, gentlemen. If you've enjoyed what you've heard, you can subscribe to our show on Apple Podcasts, Spotify, Amazon Music, or wherever you get your podcasts. Thank you for joining us on *Conversations with Commerce Trust*. I'm David Hagee. We'll talk again soon.

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August 7, 2024
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