PARTNERS IN FINANCIAL PLANNING

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Second Quarter Investment Commentary

The U.S. and (to a lesser extent) global equity markets continue to generate positive returns for investors, the bond market is settling down and the long-predicted recession keeps being moved back by the market pundits. It's almost easy to forget that bear markets ever happen, given the returns of last year and this year's first two quarters.

The gains have slowed down from the red-hot first quarter, but they are still historically robust. The Wilshire 5000 Total Market Index—the broadest measure of U.S. stocks—gained 3.31% for the year's second quarter and stands at a 13.58% gain since January 1. The Russell 3000 index has gained 13.56% so far this year.

Looking at large cap stocks, the Wilshire U.S. 2500 Large Cap index was up 3.43% for the second quarter, with a 13.79% gain so far in 2024. The Russell 1000 large-cap index is up 14.25% so far this year, while the widely quoted S&P 500 index of large company stocks gained 3.92% during the year's second quarter, and is now sitting on a 14.48% gain for the year so far.

Meanwhile, the Russell Midcap Index is up 4.96% in the first half of 2024.

As measured by the Russell 2000 Small-Cap Index, smaller companies posted a 1.73% gain in the year's first six months. The technology-heavy Nasdaq Composite Index has gained 18.13% so far this year.

Foreign markets are up for the year as well. The broad-based EAFE index of companies in developed foreign economies has gained 3.51% in the first half of 2024. Emerging market stocks of less developed countries, as represented by the EAFE EM index, have gained 6.11% in dollar terms so far this year.

Real estate securities posted an essentially flat quarter, with the Wilshire U.S. REIT index down 0.25% for the quarter and down 0.26% for the year so far. The S&P GSCI index, which measures commodities returns, lost 0.70% in the second quarter, but still holds a 7.98% gain in 2024 so far. Gold prices are booming, up 12.83% for the quarter to a near-record $2,327 an ounce.

The S&P 500 utilities index, a broad measure of the performance of utility stocks, is churning along with a 3.85% return for the most recent quarter, now delivering 7.58% for the year.

The bond markets seem to have settled into stability, though we are still experiencing an inverted yield curve. Yields on 10-year Treasury bonds rose slightly from 4.32% at the start of the quarter to 4.40% currently. 30-year government bond yields have risen incrementally from 4.46% in the first quarter to 4.56% today.

But with the inverted yield investors can get higher returns on, respectively, 12-month Treasuries (5.11% rate, 6-month government (5.32%) and 3-month Treasury bills (5.35%). Five-year municipal bonds have risen from a 2.44% aggregate yield to 2.96%, while 30-year municipal bonds moved from roughly 3.75% in the first quarter to 3.79% today.

The markets seem to be testing new highs every week or so, but the first thing you notice, if you look closely at the numbers, is the more modest returns experienced in the second quarter compared with the first. The commentators and pundits interpret that as the markets 'running out of steam,' as if daily and monthly price movements are produced by some kind of mechanical engine. They're not. The early part of the year might be fairly described as a period of overenthusiasm, while today investors seem to be more relaxed about the possibility of 'missing out.'

The chief worry as we enter the third quarter is that much of the equity returns are coming from small handful of AI-related companies. The companies that are most closely associated with AI developments—Nvidia, Apple, Amazon, Meta and Microsoft—are soaring even as the rest of the market is taking a pause. As a result, the S&P 500 is also soaring, on a very thin number of big winners. Microsoft has seen its shares soar nearly 75% since the beginning of last year, after announcing its OpenAI initiative. NVIDIA's share price has increased 149.48% in the first two quarters of this year. Amazon, which provides extensive server farms, is up more than 27% this year.

Analysts and investors with long memories are telling us that they've seen this movie before: new technology promises to change our economic landscape, creating vast efficiency improvements, and permeating every aspect of our lives. The new technology does that, but in the process, investors in the new technology lose billions. The market reminiscence is the Tech boom of the 1990s and the massive collapse of stock prices—known as the tech wreck—that ushered in the new millennium.

Will companies find a way to use AI technology in a way that benefits their bottom line? Eventually, yes. But currently, the new technology is a cost rather than a source of revenue for all but a small handful of companies. Yes, Nvidia, the chip maker, is generating record profits—and gains. Apple Computer plans to harvest AI in its iPhones, but does that mean it will sell more phones than it has in the past? Microsoft, which pioneered ChatGPT, hasn't yet seen the investment generate a boost to the bottom line, and, well, other than writing college essays and maybe having computers man the phone lines to handle FAQs that are also posted on the website, what's the use case? A recent study found that, as of today, fewer than 6% of large firms are using AI-related technologies in a meaningful way.

A secondary worry is how AI models are straining our energy systems—which, of course, are also the utilities that run our air conditioners in the summer. Several reports have suggested that our electrical systems are groaning under the weight of this new AI-driven demand; a generative AI system uses 33 times more energy than computers running task-specific software, and the computations rely on giant data centers that suck up energy.

In 2022, the last year we have statistics, data centers used 450 terawatt hours of electricity, and that is expected to double in the next two years. At that time, the demand consumption will be roughly equivalent to the electricity consumption of Japan.

We are starting to hear ordinary people talking about their investment portfolios, and the AI sector of the stock market, in cabs, hair salons and dinner conversations. Whenever that happens, you can suspect that there's a bubble forming in whatever they're talking about. There is no question that AI will change our business and personal lives, perhaps dramatically, the way software and information technology have done. But history has shown that investing in transformative technologies can be tricky at best. The bigger question, that will be answered in the next 12 months, is whether the rest of the market will hold up if there is a (perhaps temporary) pullback in the highest-performing tech stocks in our investment indices.

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