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Expected Rate Cuts and Falling Inflation Push the S&P 500 to New Highs in Q2

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While the S&P 500 ultimately hit new highs in the second quarter, the month of April was decidedly negative for markets. The catalyst was the March Consumer Price Index (CPI), which rose 3.5% year over year, and came in higher than estimates. That hotter-than-expected reading reversed several months of declines in CPI and stoked fears that inflation could be “sticky.” Market participants pushed rate cut

expectations out from June to September in response. That adjustment in expectations in turn caused the 10-year Treasury yield to rise sharply, pressuring both stock and bond prices.[1]

At the May 1 FOMC decision, however, Fed Chair Powell essentially shut the proverbial door on the possibility of rate hikes. Powell stated that if the Fed was concerned about inflation, it would likely just keep interest rates at current levels for a longer period instead of raising them.[2] That comment provided immediate relief for investors and both stocks and bonds rallied. Then, later in the month, the April CPI report (released in mid-May) rose 3.4% year over year, slightly lower than the 3.5% in March. Confirmation that disinflation (the decline in inflation) had resumed further increased expectations for rate cuts in 2024. Additionally, employment data moderated in May, with the April jobs report coming in below expectations (but still at healthy levels).[3] The practical result of these developments was to increase September rate cut expectations and both stocks and bonds posted positive monthly returns in response.

The upward momentum continued in June thanks to more positive news on inflation and additional reassuring commentary from the Fed. The May CPI (released in mid-June) declined to 3.3% year over year, the lowest level since February. Core CPI, which excludes food and energy prices, dropped to the lowest level since April 2021, further confirming ongoing disinflation. Then, at the June FOMC meeting, Fed Chair Powell reassured markets that two rate cuts are entirely possible in 2024, reinforcing market expectations for a September rate cut.[4] Economic data, meanwhile, showed continued moderation of activity and that slowing growth and falling inflation helped to push the 10-year Treasury yield to a multi-month low. The combination of falling treasury yields and raising rate cut expectations sent the S&P 500 to new all-time highs in June.[5]

Stocks begin the third quarter of 2024 riding a wave of optimism and positive news as inflation is declining in earnest[6], the Fed may deliver the first interest rate cut in over four years this September, economic growth

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[1] https://finance.yahoo.com/news/inflation-comes-in-hotter-than-expected-in-march-123324666.html ; https://paralleladvisors.box.com/v/Q32024EconIndicatorsandReturns

[2] https://www.cnn.com/business/live-news/markets-federal-reserve-meeting-05-01-24#h_623e34be7953e26500a3818d35026b47

[3] https://paralleladvisors.box.com/v/Q32024EconIndicatorsandReturns

[4] https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20240612.pdf

[5] https://paralleladvisors.box.com/v/Q32024EconIndicatorsandReturns

[6] https://paralleladvisors.box.com/v/Q32024EconIndicatorsandReturns

remains generally solid and substantial earnings growth from Artificial Intelligence-linked tech companies has shown no signs of slowing down.[7]

If inflation continues to decline, economic growth stays solid and the Fed delivers on a September cut, absent any other major surprises, it's reasonable to expect this strong 2024 rally to continue in Q3.

However, while the outlook for stocks is undoubtedly positive right now, market history has shown us that nothing is guaranteed. As such, we must be constantly aware of events that can change the market dynamic to avoid getting blindsided by sudden volatility.

To that point, the market does face risks as we start the third quarter. Slowing economic growth, disappointment if the Fed doesn't cut rates in September, underwhelming Q2 earnings results (out in July), a rebound in inflation and geopolitical surprises are all potential negatives. And, given high levels of investor optimism and current market valuations, any of those events could cause a pullback in markets.

While any of those risks (either by themselves or in combination with one another) could pressure stock and bond prices, the risk of slowing economic growth is perhaps the most substantial threat to the current rally. To that point, for the first time in years, economic data is pointing to a clear loss of economic momentum.[8] So far, the market has welcomed that moderation in growth because it has increased the chances of a September rate cut. However, if growth begins to slow more than expected and concerns about an economic contraction increase, that would be a new, material negative for markets. Because of that risk, we will be monitoring economic data very closely in the coming months.

Bottom line, the outlook for stocks remains positive but that should not be confused with a risk-free environment. There are real risks to this market rally and we will continue to monitor them closely in the coming quarter. Please do not hesitate to contact your advisor with any questions, comments, or to schedule a portfolio review.

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[7] https://www.morningstar.com/markets/which-ai-stocks-are-turning-hype-into-revenue

[8] https://www.reuters.com/markets/us/us-weekly-jobless-claims-drift-lower-2024-06-27/

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