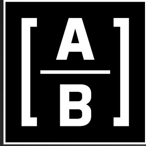


Everything Everywhere All at Once

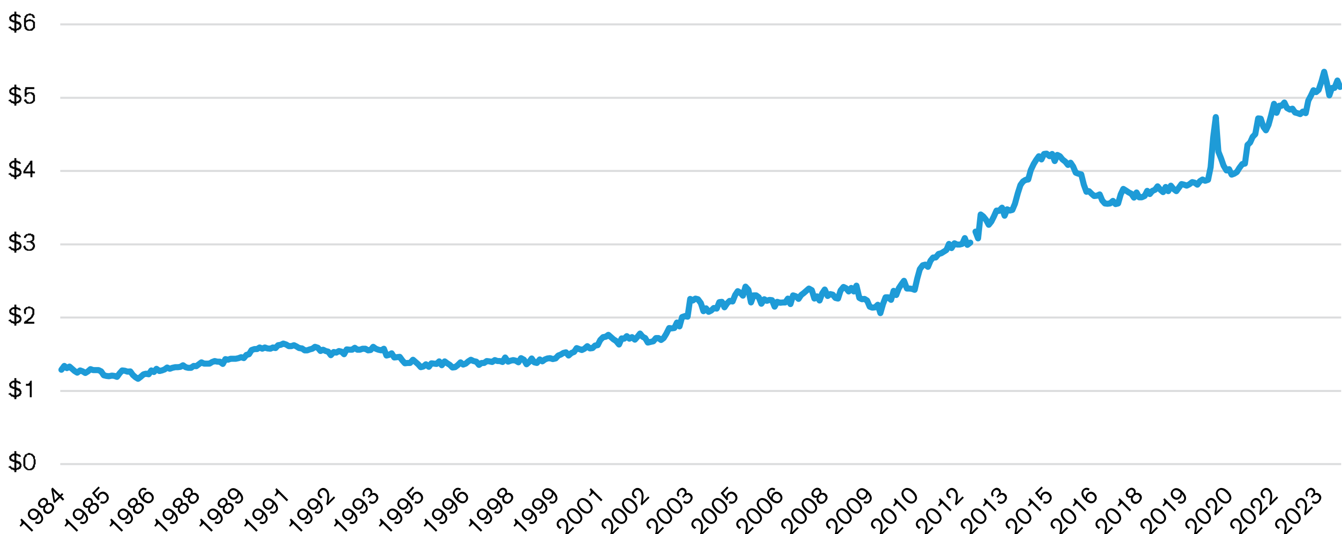
My letter this quarter starts with beef. Nothing tells you summer has arrived more than a 4th of July barbecue featuring one too many hamburgers. This may not seem to relate to the markets but stay with me here. I'll stick the landing (Olympic reference for end of letter).

Consider that a decade ago, a pound of ground beef would have cost $3.50. Today it's over $5—or even more depending on where you live and if you want the fancy versions. The point isn't that beef is expensive. It's that, assuming demand persists, beef will almost never be $3.50 again. It might not go to $6, but that doesn't mean it will hit $3.50.

So, while the Fed (and the markets) may say inflation is licked, that doesn't mean prices will fall from here. This disconnect feeds the narrative that there are problems in the economy. Even if the rate of change in prices (a.k.a. inflation) is declining—which is happening—it's natural to focus more on the price level relative to some distant memory of the past.

A large part of our country faces these higher prices without benefitting from the type of asset appreciation that everyone reading this letter has enjoyed. While over 60% of Americans now own stocks, the wealthiest 10% own 93% of them, and the rest own only 1%. Is it any wonder that people have different perceptions of how well the economy is working for them? And that these views come into conflict when asked about the economy and deciding how to spend, save, and invest their money?

PRICE OF GROUND BEEF: 100% BEEF (COST PER POUND USD) IN US CITY AVERAGE



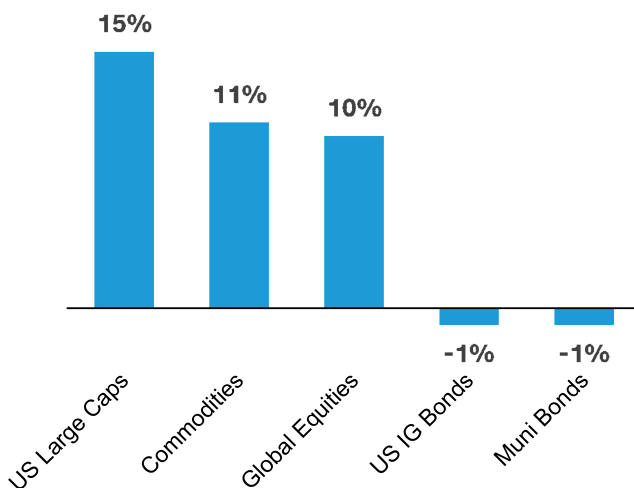
Source: US Bureau of Labor Statistics and Bernstein analysis

The Lay of the Land

The global economy and the markets maintained their impressive expansion in the second quarter. US large cap stocks continued to lead the way, both for the quarter and the year, and now sit 15% above their year-end levels. Global equities have tried to keep pace, returning 10% for the year. That puts them in line with commodities, which started out strong, then treaded water in the second quarter. Meanwhile, the environment has been more challenging for fixed income, which has been whipsawed by interest rate turbulence. Both investment grade taxable bonds and municipal bond indices are roughly flat halfway through 2024.

YEAR-TO-DATE RETURNS OF MAJOR ASSET CLASSES

Percent



As of June 30, 2024.
Past performance does not guarantee future results.
Source: Bloomberg and Bernstein analysis

As large cap tech continues to outperform, some are questioning how far this tech and AI dominance can go. The "Magnificent Seven," which includes Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla stocks, along with Broadcom, now make up 34% of the S&P 500. Nvidia alone has contributed two trillion dollars to the six trillion-dollar market rise in 2024. This statistic is even more remarkable when you consider that the stock started the year with a $1.2 trillion market cap and was worth only $360 billion just a year before.

At first blush, this may sound alarming. But it's not entirely unwarranted. In the same period, net income has grown from around $5-10 billion per year to an expected $67 billion this year. Put another way, investors who bought Nvidia in late 2022 paid less than six times what the company would earn two years later. How's that for a value stock multiple? Pulling back the lens, 80% of the increase in the S&P 500 so far this year has come from Nvidia, Microsoft, Apple, Amazon, Meta, Alphabet, Broadcom, and Lilly.

As we cast our eyes on the markets, we're guided by the economic backdrop. Once the Fed has a few consecutive months of encouraging economic data, we believe they'll have the green light to start cutting rates. Currently, we foresee that happening at the end of this year. The core PCE index—their preferred inflation measure—has been within 0.8 percentage points of the Fed's target for the past six months and is expected to continue falling. Meanwhile, some labor market measures (like job openings and the quits rate[1]) are returning to more normal levels, and the unemployment rate is now 0.7 percentage points higher than its lowest level in early 2023. As price stability becomes more attainable, we'll be looking alongside the Fed at the labor market to determine whether rate cuts should take place gradually or aggressively to ensure the Fed continues to meet the "full employment" arm of their dual mandate.

Everything is Awful, Everything is Awesome

It's been around two years since the word "vibecession" first entered the popular lexicon. For those not familiar with the term, it's the idea that even in an otherwise expanding economy, public sentiment (a.k.a. "vibes") remains extremely negative.

In recent months, countless polls and surveys have been released that are, frankly, almost unfathomable to those of us working in the investment industry who pay constant attention to the economic data in the US and around the world.

The most striking figures came in May, from a Harris Guardian poll that found:

- 56% of Americans think we're in a recession (in actuality, GDP growth has been outpacing potential GDP growth and economists have been forced to raise forecasts)
- 49% think stocks are down for the year (we're actually at all-time highs)
- 49% think unemployment is at a 50-year high (in fact, it's near its all-time lowest level, which was hit just last year)

Those figures are so staggering, you might think them misprints. But they merely confirm data from other recent surveys. For instance, 74% of Americans think the economy is only fair or poor, according to a New York Times poll in March. Two-thirds say inflation is heading the wrong direction (May's inflation report was the lowest since April 2021). Three-quarters say price increases are outpacing wage gains

1 Featured in the monthly Job Openings and Labor Turnover (JOLTS) data: https://www.bls.gov/jlt/home.htm

(post-inflation wages have been rising since April 2023 and are currently running at a very normal ~1% real growth rate).

This is why I started this letter pointing out the linkage between hamburger prices and the lack of stock holdings among the bottom 50%. It's hard to feel good when everything you buy is more expensive and your asset base hasn't budged.

This "vibecession" might also stem from people believing that they are doing well when everyone else isn't, just as many people have extremely negative views of Congress while holding their own representative in high regard. A Wall Street Journal poll found that in swing states, there is a 30-percentage point difference between the number of people who believe the economy has worsened in the past two years and those who think it has improved. Meanwhile, roughly 20 percentage points more people in those states believe ***their state's*** economy has been on the upswing during that same period.

Revisiting our questions from the outset, we trace a lot of the answer to individual experiences with prices post-pandemic. Depending on who you are, where you live, and what you spend your money on, you may have faced very divergent realities of late. Did you buy or furnish a house recently? Have you purchased a new or used car? Do you cook at home with beef or chicken or tend to eat out or order in more often?

That said—and despite the "vibecession"—consumers' actions are much more indicative of a strong economy. Consumer spending remains robust. And importantly for the markets, risk appetite appears high. You can see it in the historically low incremental return which investors are demanding from stocks versus bonds. Professional investors are fully invested, with cash levels at 4% ticking near the lowest they historically seem to reach. And households have more of their wealth invested in stocks than at any point in history—though as mentioned, that buoys some much more than others.

We keep a close eye on the data. Both anecdotes and feelings matter in terms of anticipating behavior. But hard national datasets on types of consumer spending, the labor market and wages, investor positioning, corporate profits, and investment in growth matter more.

With these robust fundamentals in mind, we're keeping an eye out for signs of an economic downturn. They remain scarce. And lofty stock market valuations make us somewhat cautious, though they're not so high as to lead us to believe that bonds will outperform over the medium- to long-term. All in all, the US economy and the US markets are healthy. Right now, our greatest concern is whether they're ***too*** good. In the meantime, public market worries abound, and as the old saying goes, "Markets climb a wall of worry."

Skeletons in the Closet?

The rise of private credit as an asset class in the past few years has been remarkable. For our part, we've been banging the drum in support quite loudly since the pandemic. We cited "private corporate loans" and "real estate loans" as two of our most actionable ideas going into 2022 and our conviction has only strengthened in the subsequent two years. While we still hold that conviction—they remain among the most attractive opportunities in the broader investment universe—we are starting to see some ripples below the surface.

Before unpacking that, let's first pinpoint where we do not see changes. Take commercial real estate debt. We continue to find the asset class extremely appealing due to market stresses, particularly the unbalanced capital structures that were designed for a low interest rate world. These now need to be reworked. That has put significant bargaining power in the hands of lenders with fresh capital, especially as banks have retrenched. Where faulty capital structures sit on top of high-quality assets, we see potential. In addition, we have started to notice more opportunities in the equity side of the private real estate market since earlier this year. Although it's still in its early stages, we anticipate more assets coming to the market and more capital structures requiring additional equity injections over the next few years. That should provide a great opportunity for fresh capital in the space.

So, where ***are*** the changes we're seeing in the private credit markets? In direct lending to companies. A lot of money flooded into this market at the same time the surge in interest rates shut the deal market down. Some of the transactions completed by others today are more about financial engineering than about fostering growth. However, having a strong origination pipeline, clear lending standards, and a history of solid underwriting with a process to ensure its continuation is still crucial. Fortunately, we have all of these in place.

Even so, passing the peak is not the same as becoming unattractive. Yields in the first quarter still stand over four percentage points higher than those of high-yield bonds and a little under three percentage points higher than those of levered loans. We maintain a high degree of conviction in private credit, as the risk-adjusted returns remain more attractive than those of other asset classes. In short, it's still one of our top ideas. But the tide may finally be turning, and that's an important inflection point we wish to highlight. As that trend unfolds, it may also set up more attractive opportunities in the coming years to deploy cash as less-experienced players find themselves in trouble thanks to deals they're striking today.

Enjoy the Summer

As I put the finishing touches on this letter from beside a lake in New Hampshire, I hope that you and your families are able to enjoy the fresh air and warm weather that summer brings. While there are always undercurrents of concern and stress in the world and the markets, conditions remain healthy and robust overall. Take some time to enjoy life this summer.

With all due respect to our international clients and friends, I will be cheering for Team USA in the Olympics. If you're fortunate enough to find yourself in Paris, I hope you enjoy the city. My brother lives there and it truly is one of the world's gems.

Among other things, I'd recommend you skip the Louvre and head to the Rodin sculpture garden instead. Take a stroll in the Tuileries Gardens or a river boat cruise during the day. Don't waste a meal on a dinner cruise—the food options in Paris are much too good for that. If you're near Sacré Cœure, there are some top Michelin star quality lunch places (try the sweetbreads). And for those of you who enjoy wine, consider bringing a hard-sided wine suitcase to bring a case home. French wine in Paris wine shops is remarkably reasonably priced. Best of all, enjoy the world's top athletes competing in one of the world's top cities!

Remember, we have our eyes on the market so that you can enjoy life, knowing that your finances are in sound hands. As ever, thank you for trusting us as the stewards of your capital.

Best regards,

Alex Chaloff
Chief Investment Officer

Alex Chaloff is the Chief Investment Officer and Head of Investment and Wealth Strategies at Bernstein. In this role, he leads a national team of strategists across investments and wealth planning—including asset allocation advice, investment platform oversight, model portfolio construction, new product development, manager research, tax planning and solutions, and estate planning research—while remaining continuously focused on moving our clients forward with strong after-tax risk-adjusted returns. Alex has spent his Bernstein career refining our investment platform, listening to clients, and conducting deep research into investment and wealth planning topics that are critical to achieving clients' goals.

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