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Investment Institute

Market Commentary

Weekly perspective on current market sentiment — **May 22, 2024**

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Last week's S&P 500 Index: +1.5%

Bifurcation, stocks and bonds

Key takeaways

- Federal Reserve data shows that 80% of American households have less cash available to spend now versus 2019.
- A similar type of bifurcation is appearing for companies in various sectors and different capitalization tiers.

Ok, regular readers know this strategist doesn't like to throw around terms without providing definitions that makes sense. "Bifurcation" is a term the financial media have been using for quite some time to describe what is going on in the U.S. economy. Officially, according to The Merriam-Webster Dictionary, bifurcation is "the state of being divided into two branches or parts."

And that is how we view the current state of the U.S. economy. Those at the top end of the income scale are doing well and spending a lot of money on discretionary items like vacations, cars, dining out, and other assorted luxuries. Those in the lower tiers of the income scale are struggling with inflation and wage growth that hasn't kept pace with prices on everything from food to energy to housing (just to name a few key items). Federal Reserve data shows that 80% of American households have less cash available to spend now versus 2019. We know that consumer spending accounts for 65% to 70% of economic activity in the U.S. This data suggests the economy and earnings growth are likely to slow in the quarters ahead as many consumers start to hold back or become more choosy in where and how they spend their money.

A similar type of bifurcation is appearing for companies in various sectors and different capitalization tiers. Small businesses tend to depend more on today's expensive bank funding than larger ones, which can tap equity and bond markets. And small service-oriented businesses struggle with rising labor costs. We have been quality-focused on the favored large-capitalization domestic companies and underweight small-cap domestics as represented by the Russell 2000 Index. The S&P 500 Index, made up of these high-quality companies, has dramatically outperformed the small-cap index over the last two years (+36.1% vs. +18.6%; data from May 20, 2022 – May 20, 2024).

Drilling down further to the sector level, long-cycle industrials such as the aerospace and electrical sub-industry groups remain in high-growth mode in response to a strong push for new factories and infrastructure. On the other hand, those so-called short-cycle industries more closely tied to consumer goods in general remain sluggish while households become more selective in their spending.

And finally, from a fixed-income standpoint, there is the bifurcation in the fixed-income markets. In our view, investors are not being adequately compensated for taking on the higher potential volatility of long-term bonds. Our strong current preference is for the short-term fixed-income segment, which offers higher rates than longer maturities, and, for now, serves as our parking spot for cash eventually intended for the equity market as we expect better opportunities to arise.

For now, the two-tiered economy and markets offer opportunities of varying degrees for investors in their efforts to position portfolios for the environment that lies ahead.

Risk considerations

Forecasts are not guaranteed and based on certain assumptions and on views of market and economic conditions which are subject to change.

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Small-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility.

Definitions

Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000® Index.

Russell 3000® Index measures the performance of the 3,000 largest U.S. companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

An index is unmanaged and not available for direct investment.

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