2024 Continues its Solid Start

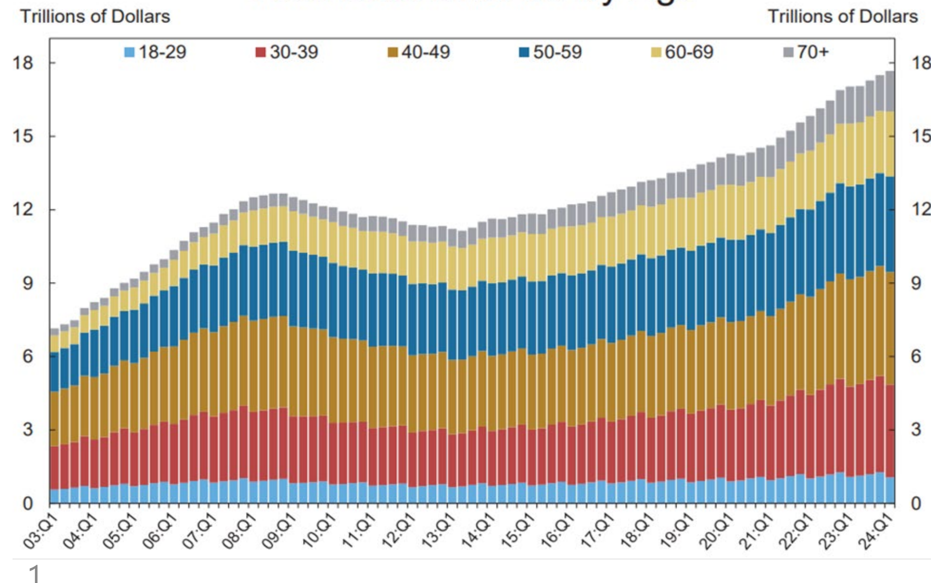
Despite macro headwinds, including a marked slowdown in consumer discretionary spending, the S&P finished the second quarter in positive territory, posting a return of +4.28% for the period and bringing the year-to-date return to 15.29%. Like Q1, large-cap technology drove the rally, with Info Tech (+2.95%) and Communications Services (+0.96%) representing the market-leading sectors; laggards included Consumer Staples, Consumer Discretionary, and Industrials. Similar to the S&P, the constituents of the Magnificent 7 were the primary drivers of the portfolio's performance for the period; Nvidia continued its YTD climb, surging 37% in Q2, followed by Apple (+23%), and Alphabet (+21%). We continue to believe that market leadership will broaden away from the Mag 7 as the year progresses. As a result, we have opportunistically taken profits in outperforming tech names and positioned the portfolio to capture the upside from companies likely to benefit from declining rates and a cyclical top-line re-acceleration.

Retail Headwinds

Retail sales stalled in the second quarter, driven by the collective weight of historically high consumer debt, inflation, and higher interest rates. The low end of the retail spectrum was especially hard hit, as consumers chose to shift spending from discretionary items to the basics such as groceries, energy, and healthcare. These fundamentals clearly impacted portfolio holdings as Target (TGT) guided down its July quarter same store sales (SSS) and Starbucks (SBUX) saw its SSS decline 4% in its March quarter, well below Street consensus of +1%. Both holdings finished down for Q2. TJX, which caters to value shoppers, bucked the trend, finishing +9.2% for the period, based on better-than-feared earnings and guidance. Going forward, we remain confident in the long-term prospects at TGT and SBUX. TGT has managed inventories well during the downturn and SBUX is tweaking its menu to appeal to a younger demographic, which should boost top line growth in the next upcycle.

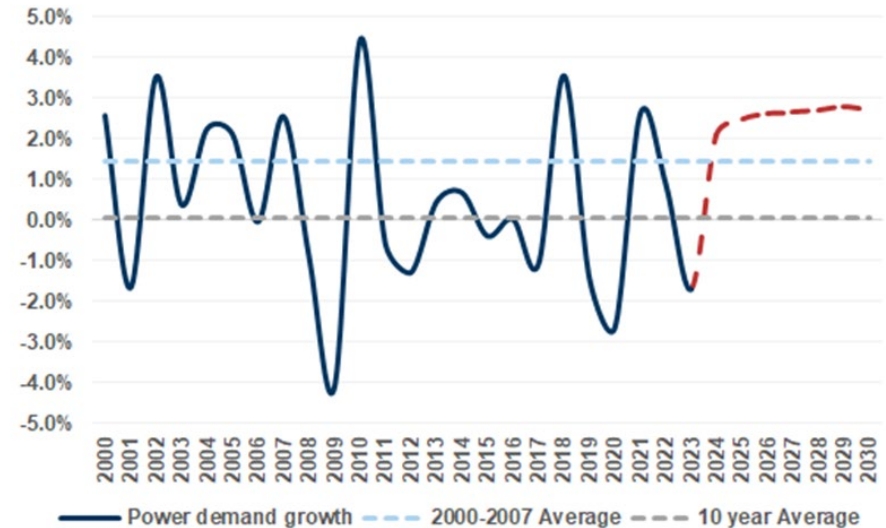
Medicare Advantage Creates Volatility in Healthcare

Medicare Advantage health insurers started the quarter off with unwelcome news. The Centers for Medicare and Medicaid Services left the final rate announcement unchanged at -0.16%, while the related healthcare companies had been expecting a meaningful increase. This decision made 2025 margin targets hard to achieve, which subsequently led to negative EPS revisions. In addition, the risk of a slowdown of new membership enrollments increased with the resulting benefit changes and higher pricing, negatively impacting portfolio holdings Humana and CVS in Q2. Going forward, the CMS plans to review their star ratings, which could lead to better reimbursements and helping margins offset the lower rate. With the stocks having re-rated lower after the rate decision, we see opportunities starting to show up with the risk now that plans and margins steadily improve from here.



AI Driving Power Consumption Growth

With the large push into AI by many of the large tech companies, global power demand is seeing a step change in its growth rate. This is due to the immense energy consumption of AI data centers and the surge in new data centers being constructed by the cloud service providers. In the US, Goldman Sachs estimates that electricity demand will increase by a CAGR of ~2.4% through 2030 (vs. flat growth over the last decade), driven by a ~15% CAGR in data center power demand. To meet this demand, close to 50 GW of incremental generation needs to be built, along with major improvements to the power grid. This buildout should provide an upside opportunity for the Utilities in those regions, and we would expect many to increase their growth rates, leading to outperformance by those companies. As such we have been adding exposure to the portfolio to capitalize on this new catalyst.



Outlook

As we came into 2024, we were expecting a change in market leadership away from the Magnificent 7 and towards cyclical and value stocks, with a broadening out of returns in the market. The signs are this has started to happen, and it remains our outlook for the rest of 2024. Several of the"7" are off to a strong start for 2024, but not all are as evidenced by the underperformance of Apple and Tesla. With the Fed still planning on three rate cuts, expectations of moderating inflation, and consumer confidence numbers in the sweet spot, the economy is likely to experience a soft landing, which should benefit most stocks. In addition, corporate profits are still expected to improve over 2023, with S&P 500 EPS growth estimates in the 11% range currently, driven by steady top line growth and improving margins as labor and transportation costs ease. These combined fundamentals should provide a tailwind for the overall market, and any weakness will likely prove to be short-lived.

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