James Investment Research, Inc.

Market Commentary

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JAMES
Investment Research, Inc.

Key Insights

- **Record Highs in U.S. Stock Markets:** The combination of easing inflation, a cooling labor market, and strong corporate earnings created a favorable environment for U.S. stocks, leading to increased investor confidence and a record-breaking rally in May 2024.

- **Inflation Moderation:** The April Consumer Price Index (CPI) report showed a slight decrease in headline inflation, with core inflation also slowing, indicating inflationary pressures are gradually easing. This development encouraged optimism among investors about the Federal Reserve's (FED) ability to manage inflation.

- **Cooling Labor Market:** Reports indicated a cooling labor market, with slower job growth and a slight increase in unemployment. This moderation suggested a more sustainable pace of economic growth, further contributing to the positive market sentiment.

- **Slowing Economy and Interest Rates:** Weaker retail sales and other economic data signaled a slowing economy, leading investors to adjust their expectations for potential interest rate cuts by the Federal Reserve. This anticipation of lower borrowing costs boosted stock market optimism.

- **Robust Corporate Earnings:** The first-quarter earnings season outperformed expectations, with a high percentage of companies reporting positive earnings and revenue surprises. This strong corporate performance helped drive the stock market rally.

- **Gold's Surge Amid Geopolitical Instability and China's Strategic Reserves Increase:** Gold prices surged 18% year-to-date driven by Middle East conflicts and China's strategic move to reduce its reliance on the U.S. dollar by increasing its gold reserves.

Monthly Recap

In May, U.S. stock markets experienced a significant rally, with major indices reaching record highs. The S&P 500 Index, representing larger stocks, increased by 4.96% in May and 11.30% year-to-date, while the Russell 2000 Index, representing smaller stocks, gained 5.01% and 2.68% for the same periods. The market rallied following NVIDIA Corporation's (NVDA) impressive earnings report, which surpassed already high expectations. The company also raised guidance for the upcoming quarter. This strong performance further reinforces the artificial intelligence (AI) secular growth narrative, which has been one of the most bullish themes driving market sentiment.

Markets were also buoyed by the decline in bond yields over the month. The yield on the 10-year Treasury note, a key benchmark for borrowing costs, retreated below 4.5% after briefly touching a six-month high of 4.7% earlier in the month. The Bloomberg U.S. Aggregate Bond Index, a widely followed benchmark for the overall bond market, rose by 1.66%.

In May, all the economic sectors posted positive returns, with the notable exceptions of the Consumer Discretionary and Energy sectors. Emerging as clear leaders, the Technology and Utilities sectors outpaced the rest of the market by a significant margin. Their outperformance can be largely attributed to the growing enthusiasm surrounding AI. Stock prices soared for some utility companies, such as Vistra Corp and Constellation Energy, with year-to-date returns of 158.09% and 86.52%, respectively. The remarkable performance of these utility companies can be attributed to the rapid expansion of AI data centers, which are driving a significant increase in electricity consumption. However, there is no guarantee these returns will be repeated.

Growth stocks outperformed value stocks by a wide margin in May.

Investors boosted their expectations for potential interest rate cuts and perceived a more stable economic outlook. This renewed optimism led to the record-breaking rally in stocks during the month.

Sticky but Moderating Inflation

One of the key factors was relief in inflationary pressures. After months of heightened inflation, a major concern for investors and policymakers alike, the latest data showed signs of easing inflation pressures.

The April Consumer Price Index (CPI) report indicated a decrease in headline inflation, falling to 0.31% from the previous month's 0.38%, with the year-over-year rate moderating to 3.4% from 3.5%. Core inflation also showed signs of slowing, dropping to 0.29%, with the annual rate falling to 3.6% from 3.8%. When examining core CPI on an annualized basis over one, three, and six months—metrics closely watched by Federal Reserve officials to gauge

inflation momentum—the figures increased by 3.6%, 4.1%, and 4.0%, respectively. These numbers reflect a slowing trend compared to March's readings of 4.4%, 4.5%, and 3.9%.

Arriving at a pivotal moment for financial markets and policymakers, the April CPI report follows three months marked by higher-than-expected inflation. The inflation numbers for Q1 2024 raised concerns about whether the Federal Reserve's current policy rate would be sufficient to balance supply and demand effectively, leading to increased speculation about the possibility of further rate hikes. The central bank will continue to monitor these metrics closely to determine the effectiveness of their monetary policy decisions.

Resilient but Slowing Labor Market

Another crucial factor contributing to the rally was the cooling of the labor market. Reports indicated job growth slowed down, often seen as a sign of a moderating economy.

In early May 2024, Federal Reserve Chair Jerome Powell noted although the labor market remained robust, it was showing indications of a gradual cooling trend. Powell stated, "The supply and demand of workers are coming back into a better balance, just as we would want."

According to Bloomberg, the week ending May 4, 2024, saw a significant increase in initial U.S. unemployment benefit claims, reaching their highest level since August 2023. The Labor Department reporting first-time claims rose by 22,000 to a total of 231,000, surpassing the median forecast of 212,000 applications predicted by economists in a Bloomberg survey.

Slowing Economy

This month economic data releases painted a picture of a slowing U.S. economy, with several key indicators falling short of consensus expectations.

Retail sales, a crucial gauge of consumer spending, accounting for a substantial portion of the U.S. economy, came in below economists' forecasts. U.S. retail sales were unexpectedly flat in April, marking a slowdown from the previous month. This suggests consumers are becoming more cautious about their spending habits, possibly due to concerns about job security, rising prices, or a general sense of economic uncertainty.

The housing market and industrial sector also showed signs of cooling, with housing starts and industrial production falling short of expectations. Regional manufacturing surveys from the Philadelphia Federal Reserve and the Empire State Manufacturing Survey also came in below consensus, reinforcing the notion of a slowdown in the manufacturing sector. These weak readings suggest businesses are facing challenges in maintaining their production levels and the construction industry may be entering a slowdown, which could have spillover effects on employment, investment, and overall economic growth.

The U.S. economy is losing steam; indicated by weaker-than-expected economic data across multiple sectors and moderation in consumer spending. This slowdown could significantly impact businesses, consumers, and financial markets, leading companies to reassess growth strategies and consumers to become more cautious about spending. As economic growth cooled and inflation eased, investors anticipated that the Federal Reserve might consider cutting interest rates later in the year, which is generally seen as favorable for stock markets, as it reduces borrowing costs for companies and makes stocks more attractive compared to fixed-income investments.

Stellar Earnings Season

FactSet data reveals a generally positive trend in both earnings and revenue performance in the first quarter of 2024, with 96% of S&P 500 companies having reported actual results.

An impressive 78% of S&P 500 companies have reported a positive Earnings Per Share (EPS) surprise, indicating they have outperformed market expectations. This is a strong signal of the overall financial health and resilience of these companies, particularly in light of the challenges posed by the ongoing economic recovery. Similarly, 61% of S&P 500 companies reported a positive revenue surprise, suggesting they have been successful in generating sales and growing their top line.

According to FactSet, the blended year-over-year earnings growth rate for the S&P 500 in Q1 2024 is 6.0%. This marks the highest year-over-year earnings growth since Q2 2022, when the index reported a growth rate of 9.4%. This improvement in earnings growth is encouraging for investors, demonstrating the ability of these companies to expand their profitability despite the challenges posed by the current economic environment.

Interestingly, the estimated year-over-year earnings growth rate for the S&P 500 in Q1 2024 was initially pegged at 3.4% on March 31, 2024. However, due to the positive EPS surprises reported by companies across ten sectors, the earnings growth rate has been revised upward. This highlights the importance of monitoring actual results and adjusting projections accordingly, as

positive surprises can significantly impact the overall earnings picture.

From a valuation perspective, the S&P 500's forward 12-month Price/Earnings (P/E) ratio of 20.7 is above both the 5-year average (19.2) and the 10-year average (17.8). This indicates the market is currently trading at a premium compared to historical valuations. While this may raise concerns about the sustainability of current price levels, it is important to consider the broader context, including the low-interest-rate environment, the ongoing economic recovery, and the potential for further earnings growth.

Overall, the Q1 2024 earnings season presents a generally optimistic picture of the financial performance of S&P 500 companies. The high percentage of companies reporting positive EPS and revenue surprises, combined with the highest year-over-year earnings growth rate since Q1 2022, suggests the index is on solid footing.

Topic of the Month: Gold

The Shining Gold

"Two millennia ago, in the time of the Roman emperor Augustus, Roman centurions were paid a salary equivalent to 38.58 ounces of gold. Given the current price of gold, this works out to an annual salary of $86,342. Today, a U.S. Army Captain with six years of experience makes $85,594. This seemingly is an example of the golden constant."

Is There Still a Golden Dilemma? Academic Paper by: Claude B. Erb and Campbell R. Harvey, Duke University and National Bureau of Economic Research, May 7, 2024

Gold's Remarkable Surge Amid Challenging Conditions

This month gold surged to an all-time record high, with its price exceeding $2,400 an ounce. Remarkably, this rally occurred despite higher interest rates and a strong U.S. dollar, which are typically considered unfavorable for gold. Since gold is priced in U.S. dollars, an appreciating dollar generally results in a declining gold price. Additionally, gold does not generate interest, which is a disadvantage in a rising rate environment. However, various factors converged to boost the price of gold, including geopolitical risks, central bank purchases, and retail demand.

Gold's impressive performance this year has outshone stocks and bonds. The demand for gold continues to rise as uncertainty surrounding interest rates and geopolitical stability push more traders to seek refuge in safe-haven assets.

The appeal of gold is often questioned because, unlike equities, bonds, and real estate, it pays no dividends, coupons, or rent. However, as a financial asset, gold is benefiting from increasing fundamental economic and geopolitical risks, especially in these troubled times.

Its diverse sources of demand give gold particular resilience. According to the World Gold Council, the average annual sources of gold demand are jewelry (35%), technology (7%), investment (39%), and central banks and other institutions (19%). This multifaceted nature of gold contributes to its stability and potential for solid returns in various market conditions.

Geopolitical Risk

Gold prices surged around 33%, rising from a yearly low of $1,820 on October 5, 2023, to $2,426 as of May 21, 2024. This increase is largely attributed to the Middle East conflict that began with Hamas attacks on Israel on October 7, 2023. Historically, gold performs well during economic uncertainty and market volatility, making it an attractive option for investors seeking to diversify risk and maintain portfolio stability.

The unexpected death of Iran's president and reports of the Saudi Arabian king's declining health are additional sources of rising political instability in the Middle East. Concerns are mounting that the conflict between Hamas and Israel will further escalate, particularly affecting crucial transport routes such as the Red Sea and the Strait of Hormuz. Meanwhile, the Russia-Ukraine war continues with no diplomatic resolution in sight. All of these boost gold's appeal as a safe haven for wealth.

China's Strategic Move to De-Dollarize by Increasing its Gold Reserves

From 2022 to 2024, a significant trend in global foreign exchange (FX) reserves has been the increased gold purchases by central banks, particularly China. According to the World Gold Council, the People's Bank of China (PBoC) has reported 18 consecutive months of rising gold reserves. In April 2024 alone, China added an additional 2 tons of gold, bringing its total reserve holdings of gold to 2,264 tons—the highest level ever. This accounts for 4.9% of China's total FX reserves. In 2024 alone, China accumulated 29 tons of gold, and over the past 18 months added 316 tons, or 16%.

Gold is generally considered a politically neutral safe asset, protected from sanctions or seizure, making it an attractive option for countries looking to mitigate geopolitical risks. Over the past two years, foreign central banks have significantly increased their purchases, likely influenced in part by the decision of the U.S. and

its Western allies to seize a portion of Russia's foreign reserves following its invasion of Ukraine.

Retail Investors Fuel Gold Rush Amid Price Surges

The recent surge in gold prices has ignited a wave of speculation and excitement among retail investors, echoing the gold rushes of the late 1970s, early 1980s, and the financial crisis of 2008. This time, the trend is fueled by the convenience of purchasing gold bars online, particularly through retail giant, Costco.

Costco has entered the gold market, selling up to $200 million worth of gold and silver each month, according to Wells Fargo. The retailer's online store offers one-ounce, 24-karat gold bars exclusively to members. Each membership is limited to one transaction, with a maximum of five units per purchase, and the demand is so high that the gold bars are frequently sold out.

The convenience of online purchasing, coupled with the perceived potential for substantial gains, has attracted a new generation of retail investors to the gold market. This accessibility has made it easier than ever for retail investors to get involved, driving a significant increase in the demand for bars and coins, creating a speculative rush. The CME Group's Micro Gold futures contract reflects this buying frenzy. In Q1 2024, the average daily volume (ADV) reached 64,949 contracts. In April alone, the ADV for Micro Gold futures surged 119% month-over-month, marking the second-highest monthly ADV since the product's launch. This surge in trading activity for smaller-sized gold futures contracts further underscores the growing participation of retail investors in the gold market.

However, experts caution that the speculative nature of this retail investing may lead to increased volatility in the gold market. The heightened trading activity in smaller-sized futures contracts, such as Micro Gold futures, may amplify short-term price fluctuations. As with any investment, it is essential for retail investors to conduct thorough research and consider their risk tolerance before making significant investments in gold or other precious metals.

Conclusion

In conclusion, the significant rally in U.S. stock markets and the remarkable surge in gold prices in May 2024 reflect a complex yet optimistic economic landscape. The stock market's record highs were driven by positive economic indicators, better-than-expected corporate earnings, easing inflation, a cooling labor market, and slower economic growth. These all contributed to increased market optimism and expectations of potential interest rate cuts. Similarly, gold's rise to over $2,400 an ounce, fueled by geopolitical risks, central bank purchases, and heightened retail demand, underscores its enduring appeal as a safe-haven asset. Despite typically unfavorable conditions such as higher interest rates and a strong U.S. dollar, gold's diverse demand—from investment to jewelry and technology—has bolstered its value.

However, broader economic data indicates ongoing challenges, including a slowing economy, softer retail sales, and persistent inflation in certain sectors. As the Federal Reserve continues to monitor these trends, the potential for further monetary policy adjustments remains a key focus for investors. Both the positive earnings season for stocks and the strategic moves by countries like China to increase their gold reserves highlight the importance of vigilance and adaptability. A balanced approach is advisable for navigating the evolving economic conditions, crucial for maintaining market stability and protecting wealth amidst global challenges.

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