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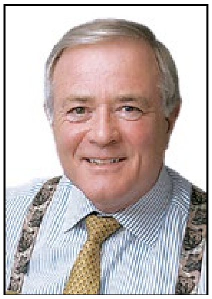

William Rutherford

AI frenzy and market euphoria propel stocks to record highs

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June closed a remarkable first half of 2024 for the U.S. stock market, driven by an unrelenting fervor for AI investments. The S&P 500 climbed an impressive 14 percent year-to-date, propelled by gains in technology giants and AI-related stocks. Nvidia has been at the forefront of this surge, with its shares skyrocketing 149 percent so far this year. Nvidia briefly became the most valuable public company globally, with a market cap surpassing $3 trillion. Other major tech players, including Alphabet, Apple, Microsoft, Meta, and Amazon have likewise seen substantial gains, and these six stocks now represent over 30 percent of the S&P 500 index. The outsize performance of these AI-driven stocks highlights a potential vulnerability in the current rally in that the overall market's strength is heavily reliant on a narrow group of top-performing companies.

Inflation remains a critical factor in market sentiment. The Federal Reserve's preferred inflation gauge, the Personal Consumption Expenditures (PCE) price index, rose by a modest 2.6 percent in May from 12 months previous, marking the lowest year-over-year increase since 2021. This encouraging data suggests that price pressures may be moderating, potentially paving the way for the Fed to ease interest rates later this year. Gross domestic product expanded at a 1.4 percent annualized rate in the first quarter of 2024, a slight uptick from the previous estimate.

According to the Consumer Confidence Index, consumer confidence dipped slightly in June, indicating that while consumers' assessments of the current business and labor market conditions improved, their outlooks weakened. This mixed sentiment highlights the delicate balance between the strength of the current economy and concerns about the future and an overstretched consumer.

Despite the slight dip in consumer confidence, the labor market remained robust. Total nonfarm payroll employment increased by 272,000 in May, with significant job gains in health care, government, leisure and hospitality, and professional and technical services. The unemployment rate remained steady at 4 percent. The latest JOLTS report from the Bureau of Labor Statistics indicated that the number of job openings decreased for the second consecutive month to 8.1 million, the lowest level in three years. This decline, coupled with steady numbers of hires and separations, indicates a potential cooling in the labor market.

Nevertheless, layoffs remain at a low level, suggesting that while hiring may slow, net job growth continues to be positive.

Due to the strength of the June reports, the data-dependent Federal Reserve's recent meeting minutes called for only one interest rate cut in 2024. The Fed's outlook reflects an ongoing debate about what level of rates are neither expansionary nor contractionary, with an economy at full employment (5 percent unemployment or lower) and inflation stability. In other words, what is the "neutral" interest rate? Current data indicates we may be close to that level where we are. The strong economic performance, coupled with low unemployment and a cooling inflation trajectory, has bolstered hopes for a so-called "soft landing" in the economy.

The steady GDP growth and substantial number of robust corporate profit reports have bolstered investor confidence. However, the overall economic strength has not translated into uniform gains across all market sectors. Market participants continue to predict growth spreading beyond the tech sector to others, but this has not happened. One notable trend in the current market is Wall Street's "prove it" mentality toward software stocks. Investors are demanding tangible evidence of how AI is enhancing business performance before committing to driving up stock prices. This cautious stance contrasts with the enthusiasm surrounding semiconductor and hardware companies, which have already reaped significant stock market rewards from AI advancements. The volatility in software stocks highlights the market's heightened sensitivity to earnings and forward guidance and to concerns about companies being able to monetize their AI investments. Companies that report solid quarterly results but fail to revise their estimates upward often face sharp sell-offs.

The remarkable growth in AI-related stocks underscores the importance of maintaining a diversified portfolio to participate in the market sectors currently in favor yet find cushion for the inevitable reversals in market sentiment. Index funds, referred to as passive investments, have outperformed many active stock pickers during this recent period. However, the concentration in six major stocks has introduced considerable overweight risk to these funds. Reflective of this concentration is the divergence between the capitalization weight S&P 500 and the equal weight S&P 500 to the largest disparity it has had in 30 years. Many fund investors believe they are diversifying by owning various funds, but they should periodically check the top 10 holdings of all their funds to assess their overall exposure to a few companies and sectors.

The AI revolution unfolding before our eyes has prompted comparisons to the dot-com boom of the late 1990s, with its promise of disruptive technologies and sky-high valuations. A key difference today is that the top-performing stocks are large companies with strong balance sheets, positive earnings and cash flow, and valuations that are, on a relative basis, not stratospheric. However, the lessons of the past remind us of the importance of maintaining a disciplined, diversified, long-term approach to investing. Diversification is the last free lunch. Investors must chart a course that balances growth and stability, always keeping an eye on the distant horizon.

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