Monthly Market Commentary

A risk-off rally lifted global equity markets slightly in the second quarter. But behind the modest overall gains lay a market of extremes. Breadth was near the lows reached during the dot-com bubble. Only larger, growth companies and a few defensive sectors managed positive returns. Cracks appeared elsewhere – small caps and cyclicals suffered outright declines as the global economy grappled with the lagged impact of higher interest rates.

Extreme market bifurcation continued in the second quarter of 2024. The big kept getting bigger. The largest ten stocks in the S&P500 index accounted for nearly three quarters of first-half returns and their market cap now is an unprecedented 37% of the Index market cap. Market breadth – measured by the percentage of companies that achieve returns higher than index average – dropped to around 30%, a low reached months before the dot-com bubble burst in 2000.

Meanwhile, the real economy showed signs of weakness with earnings season for most economically sensitive stocks going poorly. Political risks came to the fore roiling markets in France and Mexico, while defensive sectors started to outperform cyclical ones. These are all classic signs of a late-stage cycle in markets.

The US equity market, driven by a handful of megacap tech stocks, was the only bright spot across major world indices. The broad-based S&P 500 and tech-heavy NASDAQ were up 3.9% and 8.3%, respectively. In Europe, the Stoxx 50 dropped -3.7% driven by weakness in France (the CAC index slid -8.9% on the back of political developments) and Germany (DAX down -1.4%). In Asia, the NIKKEI 225 was down -1.9% despite continued weakness in the yen while the Shanghai Composite was also down -2.4%.

The growth sectors - home to the megacap names - led performance in Q2. Tech (NVDA, AAPL, MSFT) and Communication Services (Google, Meta) were up +11.2% and +7.7%, respectively. Defensive sectors also did well as investors continued to digest the lagged effect of high interest rates on the economy – Utilities and Healthcare were up +2.2% and +0.2%, respectively. Cyclical sectors fell with materials leading the slide (-4.0%) followed by industrials (-2.6%) and energy (-2.0%).

Interest rates remained high with the US 10-year yield climbing by 20 basis points to 4.4%. Expectations for interest rate cuts in the US have been significantly reduced – the market now expects less than two by the end of 2024, down from three at the end of March.

The AUD gained against most major currencies as the reality of a more restrictive monetary policy in Australia relative to other regions bit. Oil prices were marginally lower (-2.0%) while the Bloomberg commodity Index edged up +1.5% with no apparent trend emerging. The VIX remained very low by historical standards, closing the quarter at 12.4, 0.6 points lower than at the end of the first quarter.

Pharmaceutical giant Roche was the top contributor to performance this quarter. The shares rebounded from a very low valuation reached in the first quarter and we see continued upside from here. Henkel, a German consumer products and adhesives manufacturer, was another top contributor. Strong Q1 result saw management upgrade FY24 guidance on the back of better margins and organic volume trends. Redeia, a Spanish electric utility company, also contributed positively to the quarter. Growth in the regulated asset base and improved odds of higher regulated return to be awarded next year, have led to upgrades in earnings expectations.

The largest detractor to performance this quarter was Mexican retailer Fomento Economico Mexicano (FMX). FMX shares declined in line with the local Mexican index on the back of what was viewed as market unfriendly presidential election outcome. However the fundamentals remain unchanged and we continue to see valuation upside in the shares. Japanese telco giant NTT was also a large detractor to performance. Its shares fell sharply on a disappointing FY24 result where the company missed guidance and gave underwhelming guidance for next year. The company also flagged spending more cash on M&A over the coming years, although an undemanding valuation keeps us invested for now.

The fund initiated a new position in Brenntag, the largest chemicals distributor in the world. The main attractions are a capital light business model, a growing top line and a stable margin regardless of economic outlook at an attractive valuation (see Stock in Focus). The fund exited three positions on valuation grounds after reaching our price targets – Wheaton Precious Metals (metals streaming), H&R Block (tax advisory) and Sandoz (generic and biosimilar drugs maker).

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