Chemung Canal Trust Company and Capital Bank, a division of Chemung Canal Trust Company

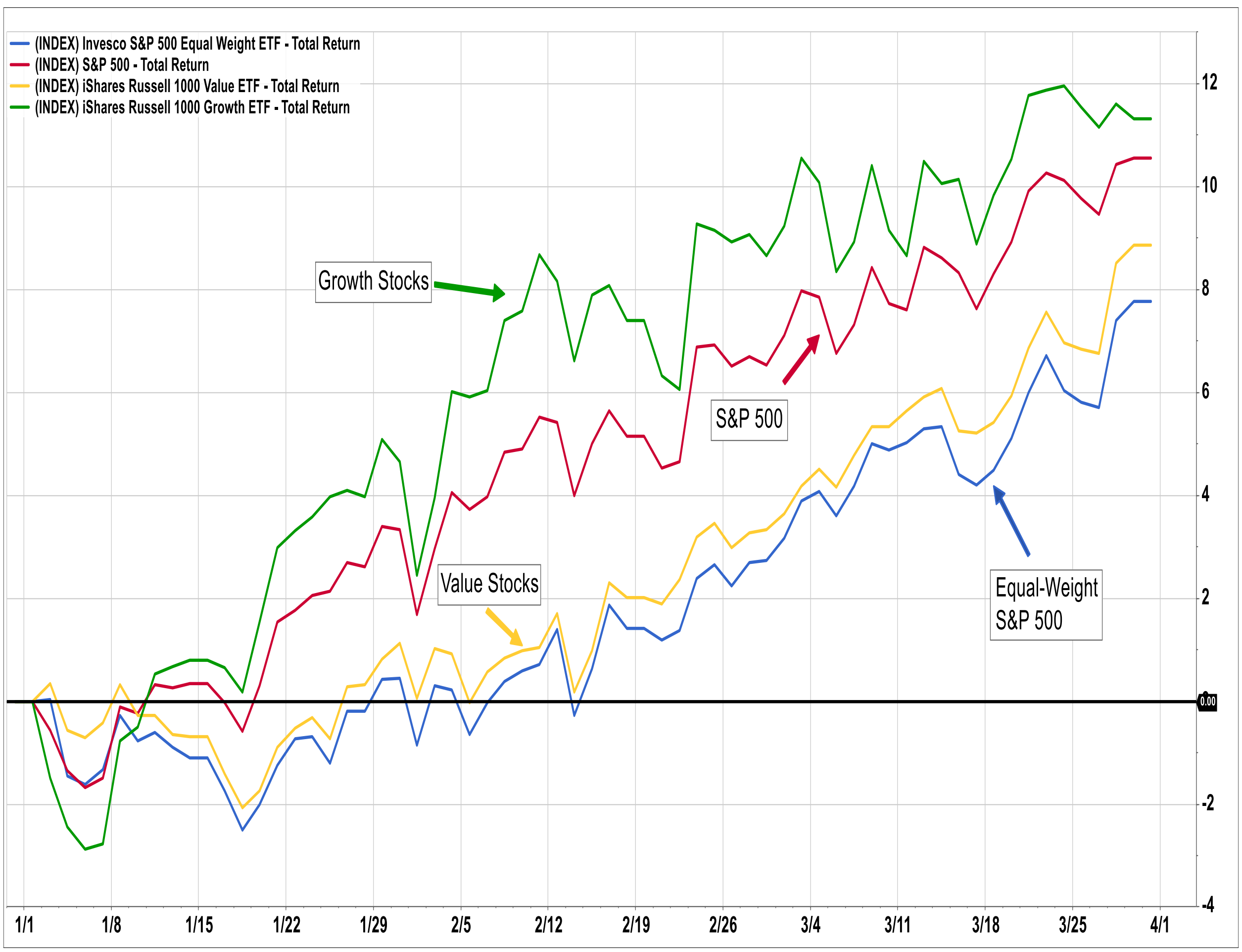
2024 Second Quarter Investment Outlook

Markets Review

Equities

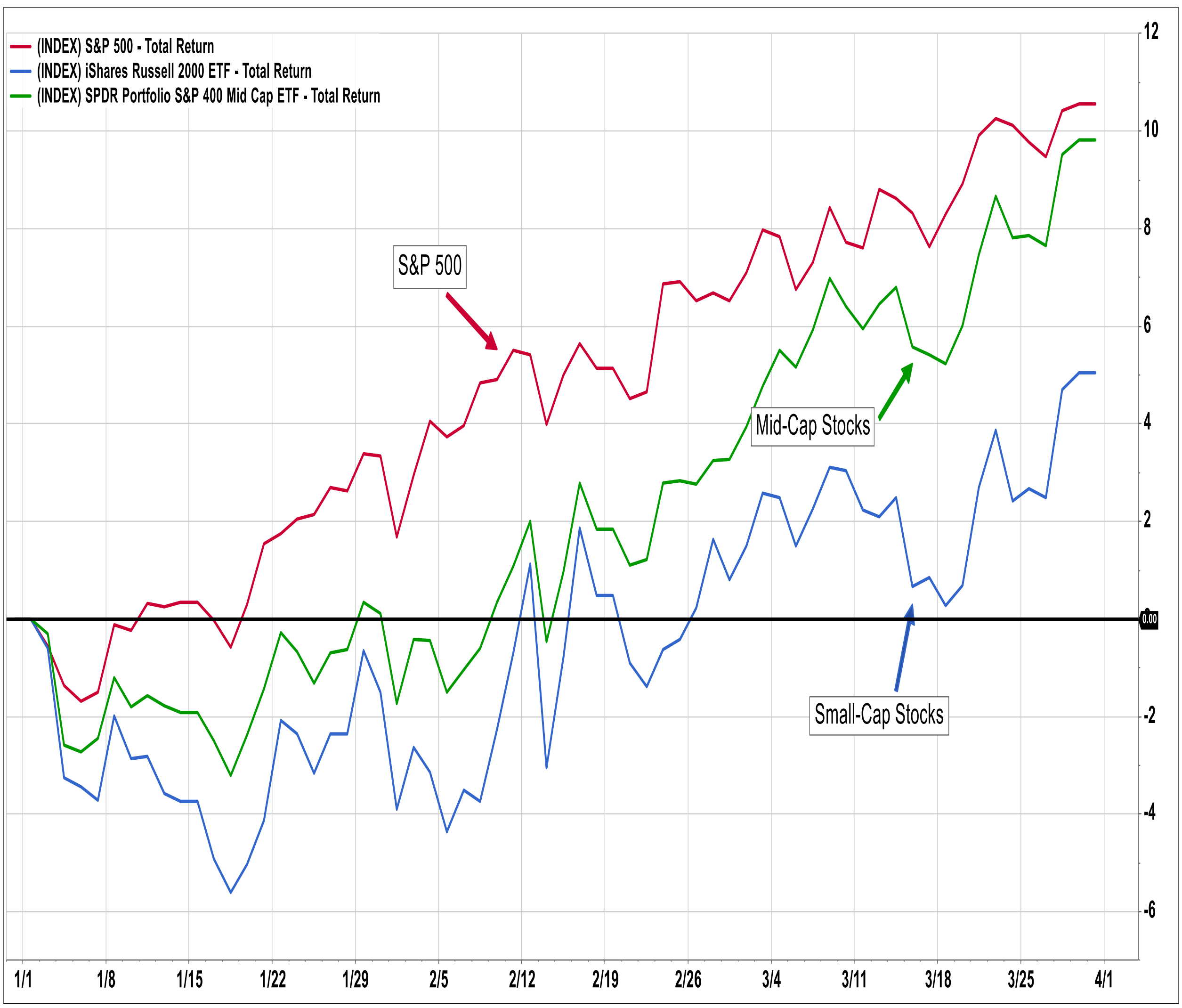
As investors entered the year with their outsized gains from 2023, it seemed reasonable that a pause in the market may have been in order. The list of potential risks seemed to be ever increasing. Geopolitical conflicts seemed to be heating up, the S&P 500 was trading at almost 20 times its forward earnings, the yield curve remained inverted, and leading economic indicators were consistent with levels associated with a slowing economy. In the face of this, equity markets charged ahead with the S&P 500 positing a 10.6% return for the quarter.

As was the case for most of 2023, a few of largest components of the equity market were once again driving the majority of the returns, making the index difficult to outpace.

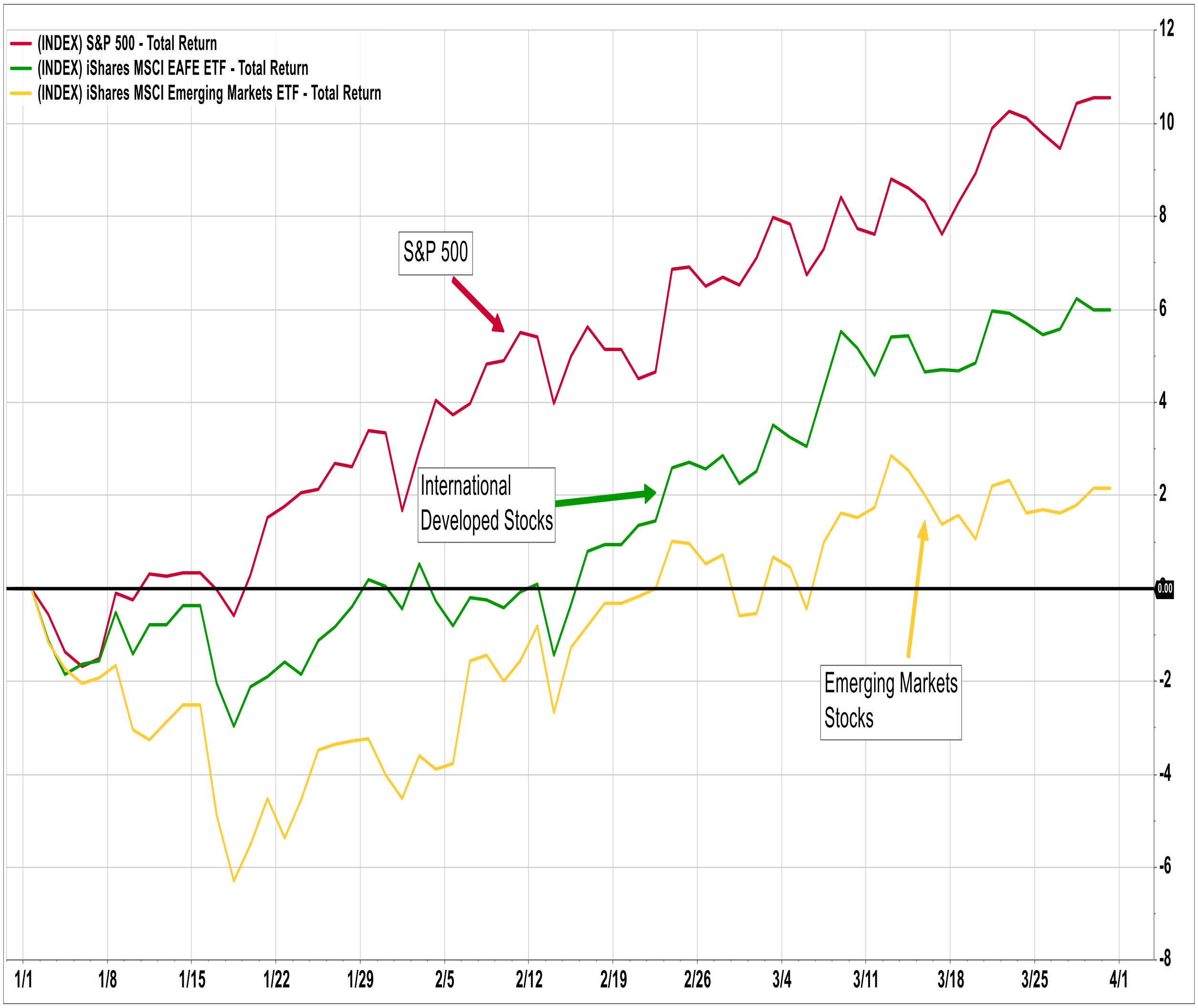


What changed during the last quarter was that the so-called "Magnificent 7" stocks, as a group, were no longer intact. Telsa's share price declined by almost 30%, and the once Magnificent 7 stocks turned into the "Super 6." Apple's stock also fell prey to negative returns during the quarter, although mildly in comparison to Tesla's decline. With Apple no longer contributing to the group, the rest of the once Magnificent 7 became the "Fantastic 5." The star of the group was undoubtably Nvidia, whose stock price rose by a staggering 82% for the quarter. On a weighted basis, the group (excluding Tesla) was up 20%, while the average stock in the S&P 500 was up *only* 7.8%. In most quarters, a 7.8% return would be well above expectations, but when compared to the mega-cap growth stocks, it felt less than impressive.

In keeping with a similar theme to 2023, neither small-cap or mid-cap stocks were able to outperform the S&P 500 for the quarter. Small-cap stocks generated a return that was essentially half of the S&P 500's results. Mid-cap stocks on the other hand were somewhat able to keep pace with their large-cap counterparts, generating a return of 9.95%. As we have previously mentioned, small-cap stocks tend to exhibit a higher degree of volatility and investors typically expect to earn a higher rate of return in small-cap stocks when compared to more stable large-cap companies. Small-cap stocks have now trailed the S&P 500 by more than half over the last decade, and the first quarter of 2024 only widened that margin.



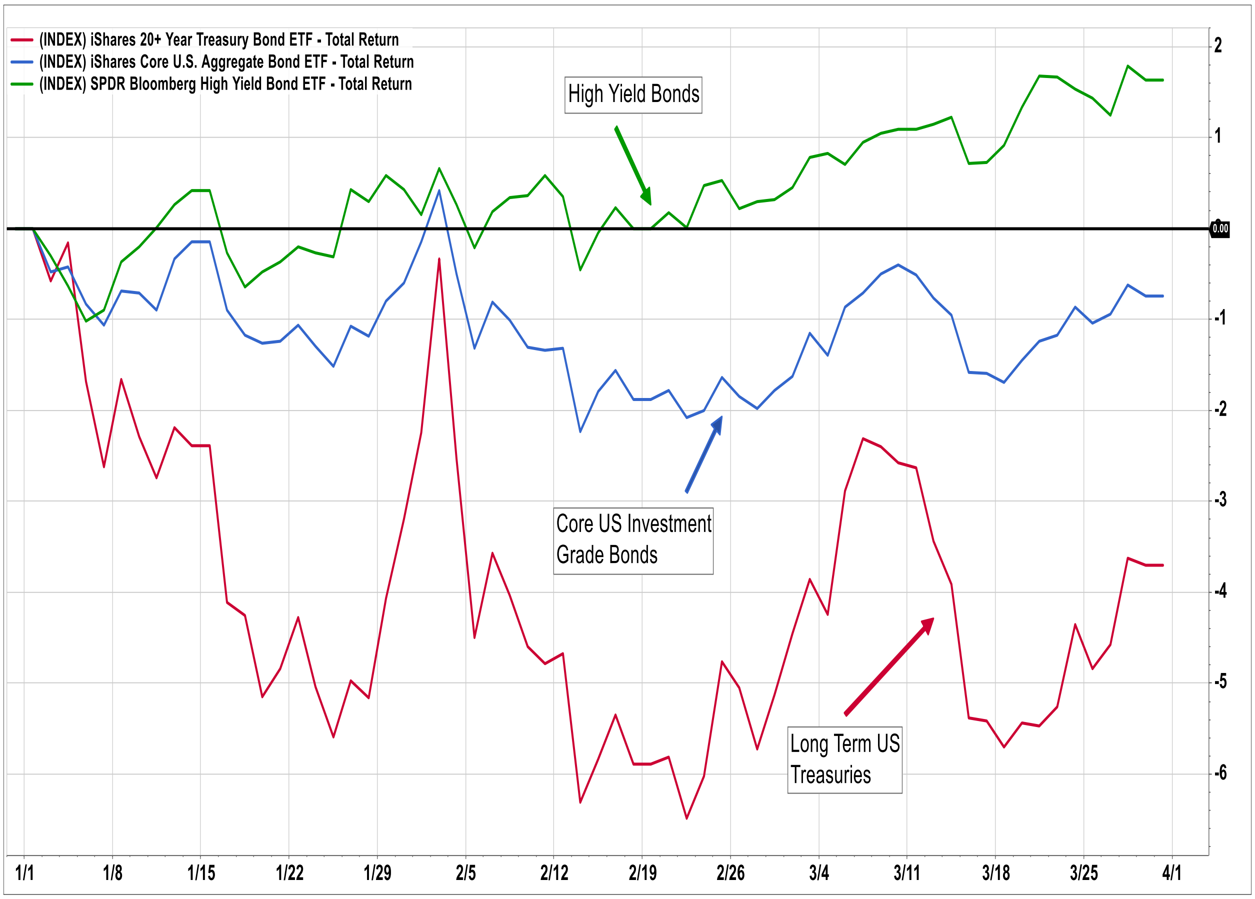
The S&P 500 outperformed international stocks during the first quarter by a healthy margin as well. The MSCI EAFE index of international developed stocks generated a 5.8% return. Emerging market stocks fared even worse with a 2.4% return for the quarter.



While it might seem that international stocks have not been beneficial to own over the last 15 months, it's important to remember that the international markets have a very different sector composition when compared to domestic markets. The MSCI EAFE index's largest sector weighting is financials, followed by healthcare and industrials. Technology companies only make up about 10% of the benchmark. In contrast, technology stocks represent almost 30% of the S&P 500. Even when combined, financials and healthcare stocks are not as large of a component of the S&P 500 as technology. In a market that has been driven by technology stocks, it's reasonable to see international markets underperforming. When the market tides change, as they always do, and technology is no longer in favor, the benefits of international diversification will be valuable.

Fixed Income

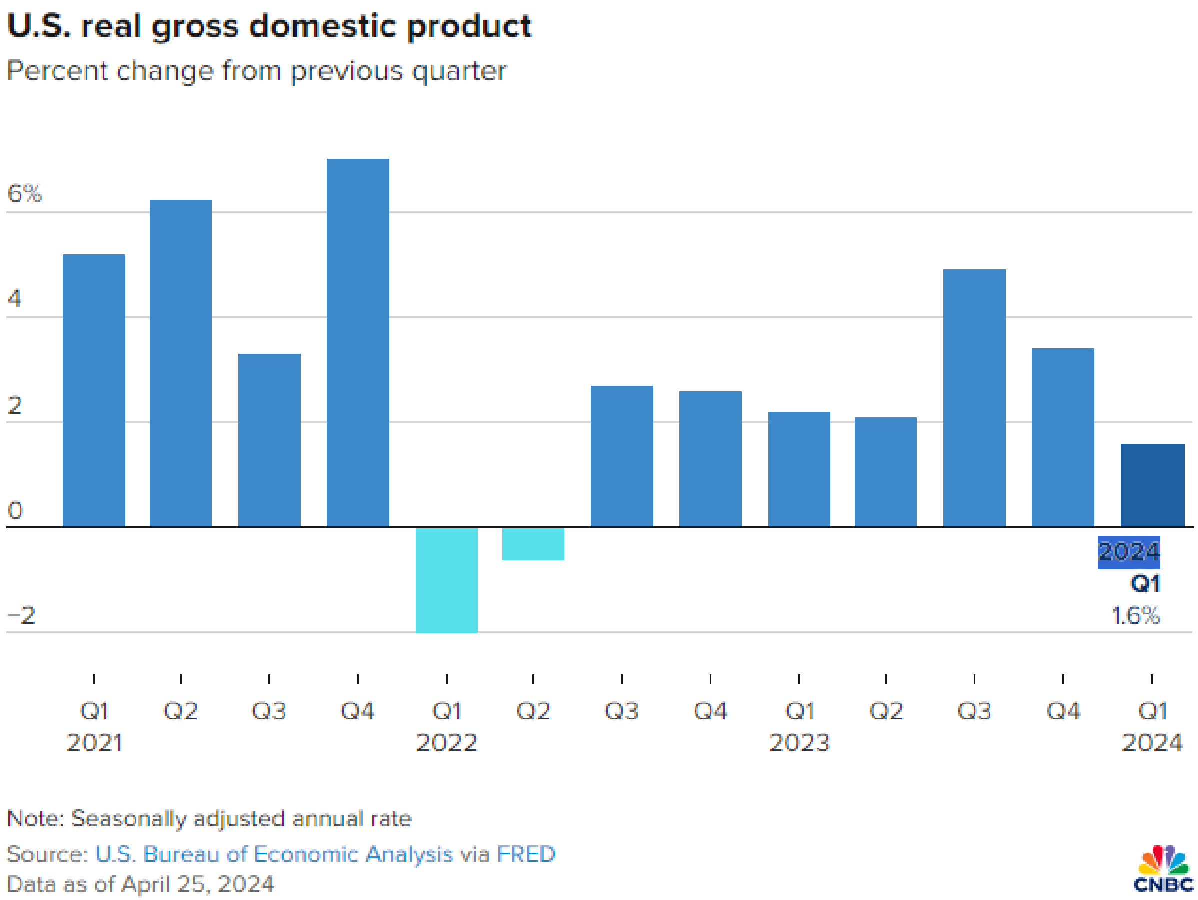
Despite the dispersion in returns among the various equity segments, each generated a positive return for the quarter. Fixed income did not enjoy the same outcome. Core US investment grade bonds, as measured by the Bloomberg US Aggregate index, declined by 0.78% during the quarter. High yield bonds, which share a higher return correlation with equities, generated a +1.5% return. The longer duration areas of the fixed income market suffered the most with long-term treasuries declining by about 3.7%.



The increase in interest rates during the quarter was the culprit for the lackluster bond returns. The 10-year US Treasury Bond began the year with a 3.88% yield and ended the quarter at 4.20%. The monetary policy sensitive 2-year US Treasury yield moved up almost 40 basis points as market participants began to lower their expectations for Federal Reserve rate cuts. This pricing out of interest rate cuts came on the back of multiple hotter-than-expected inflation readings during the quarter. A once optimistic market began 2024 with an expectation for six interest rate cuts during the year. Current expectations are for two rate cuts and even that is questionable given the persistent inflation. The ultimate result though was a downward repricing of fixed income instruments during the quarter.

GDP Growth Slowed in Q1, But That's Not the Worst News

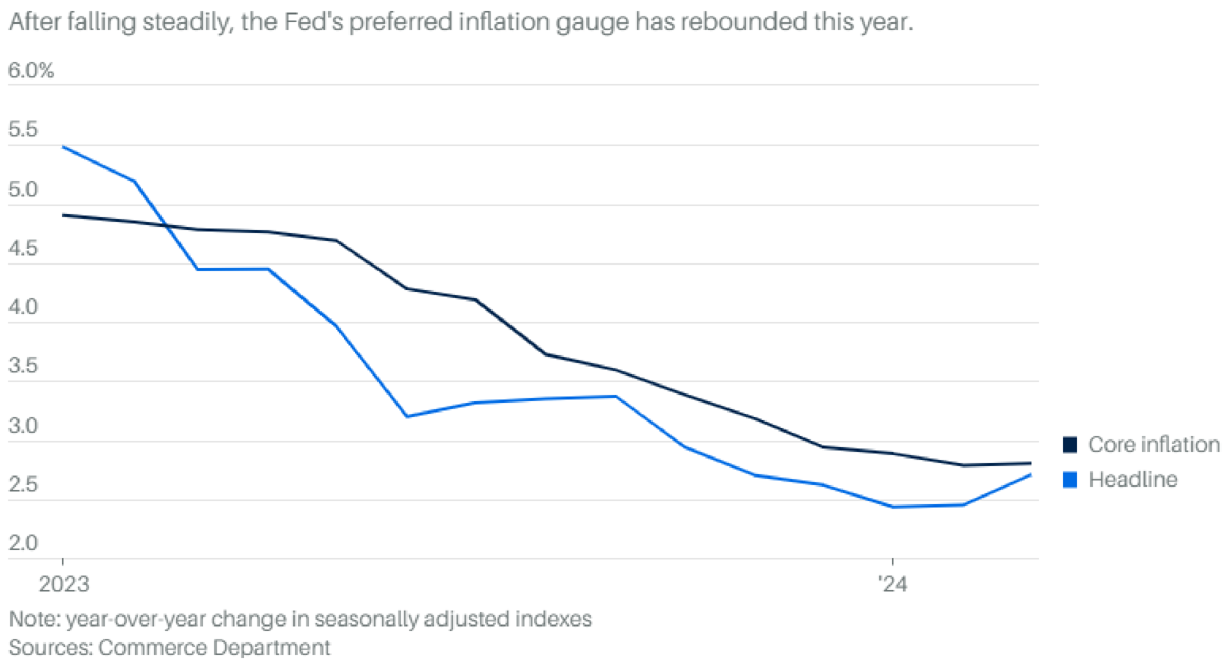
U.S. economic growth slid to an almost two-year low in the first quarter of 2024 while inflation rose, interrupting a run of strong demand and slowing price pressures that had fueled optimism for a soft landing.



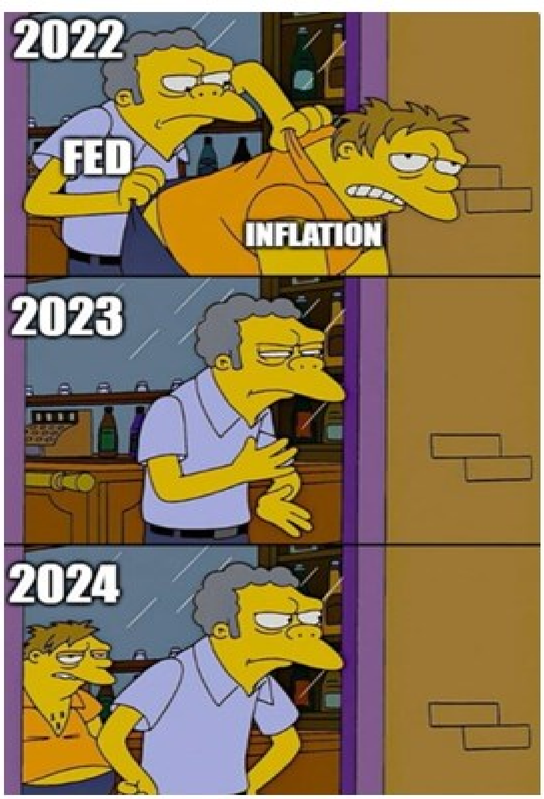
U.S. Gross Domestic Product (GDP) increased at an annual rate of just 1.6% in the first quarter, falling short of the 2.3% consensus estimate and slowing from the robust 3.4% recorded in the fourth quarter of 2023. The economy's main growth driver – consumer spending – slowed to a 2.5% pace in the quarter, down from a 3.3% gain in the fourth quarter and below the 3% consensus estimate.

There was bad news on the inflation front, as well.

The Personal Consumption Expenditures index (PCE) – the Fed's favored inflation gauge – accelerated to 2.7% in March, above economists' expectations for a 2.6% gain as well as February's reading of 2.5%. A single month or quarter is not a trend, and the reported numbers in themselves don't represent an alarming change from prior reports. Inflation has cooled considerably from the decades-high levels experienced in the summer of 2022, but the progress that was made last year is showing signs of being more elusive in 2024.



To be clear, it's not that the latest PCE report is evidence that inflation is accelerating so much as it is a confirmation that the Federal Reserve still has more work to do to reach its target rate of 2%. And several Fed officials have said in recent public statements that they're not convinced that inflation is trending sustainably toward the target rate.



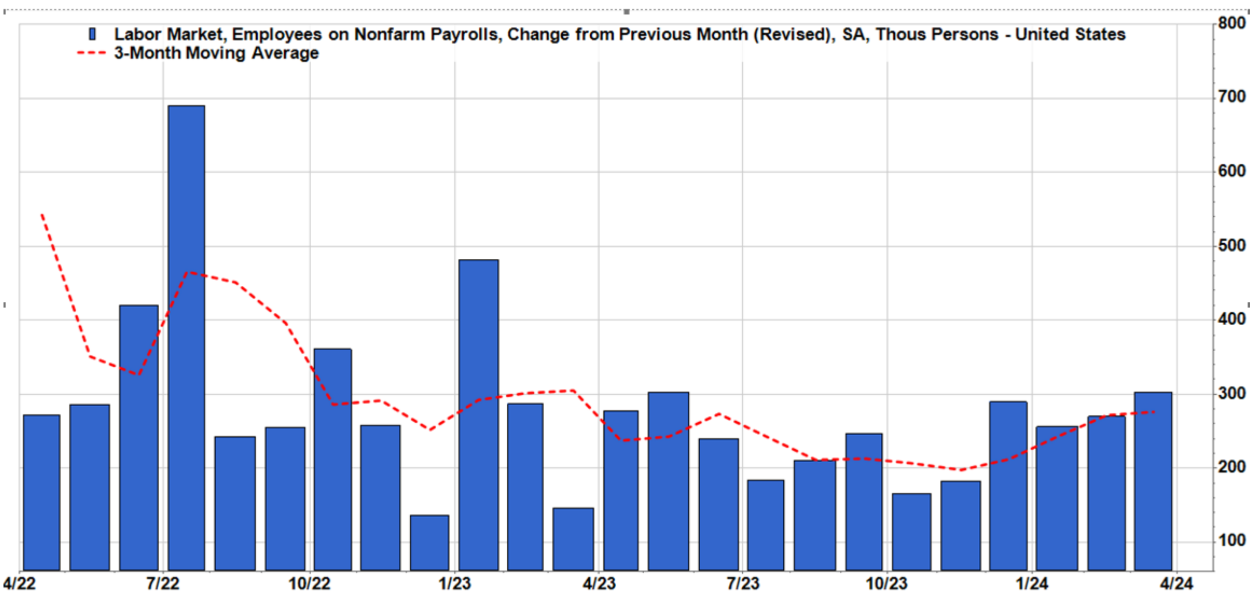
So every monthly inflation report is taking on elevated importance in the minds of investors. The 2.7% report is, of course, a year-over-year number. But recent reports have shown *monthly* increases in inflation consistently in the 0.3% area, including the March report. The fact is that the Fed needs to see monthly reports in the 0.15-0.2% range to get to its 2% target, which still seems to be far off in the minds of most analysts.

The recent reports on GDP and inflation represent the "worst of all worlds" for investors who began the year with expectations that strong growth and moderating price increases would give the Fed ample reason to begin cutting rates by mid-year, at the latest. But now that the "final mile" toward reaching the Fed's inflation target is showing signs of being the most difficult, rate cuts are almost surely off the table for the foreseeable future, even as the economy is expected to slow further over the next few quarters.

Jobs Market Remains Hot

According to most analysts' predictions, jobs growth was supposed to have slowed by now as the pandemic recovery ran its course and the pressures of 11 interest rate hikes began to be felt by employers. Instead, monthly new jobs reports continued to surprise on the upside.

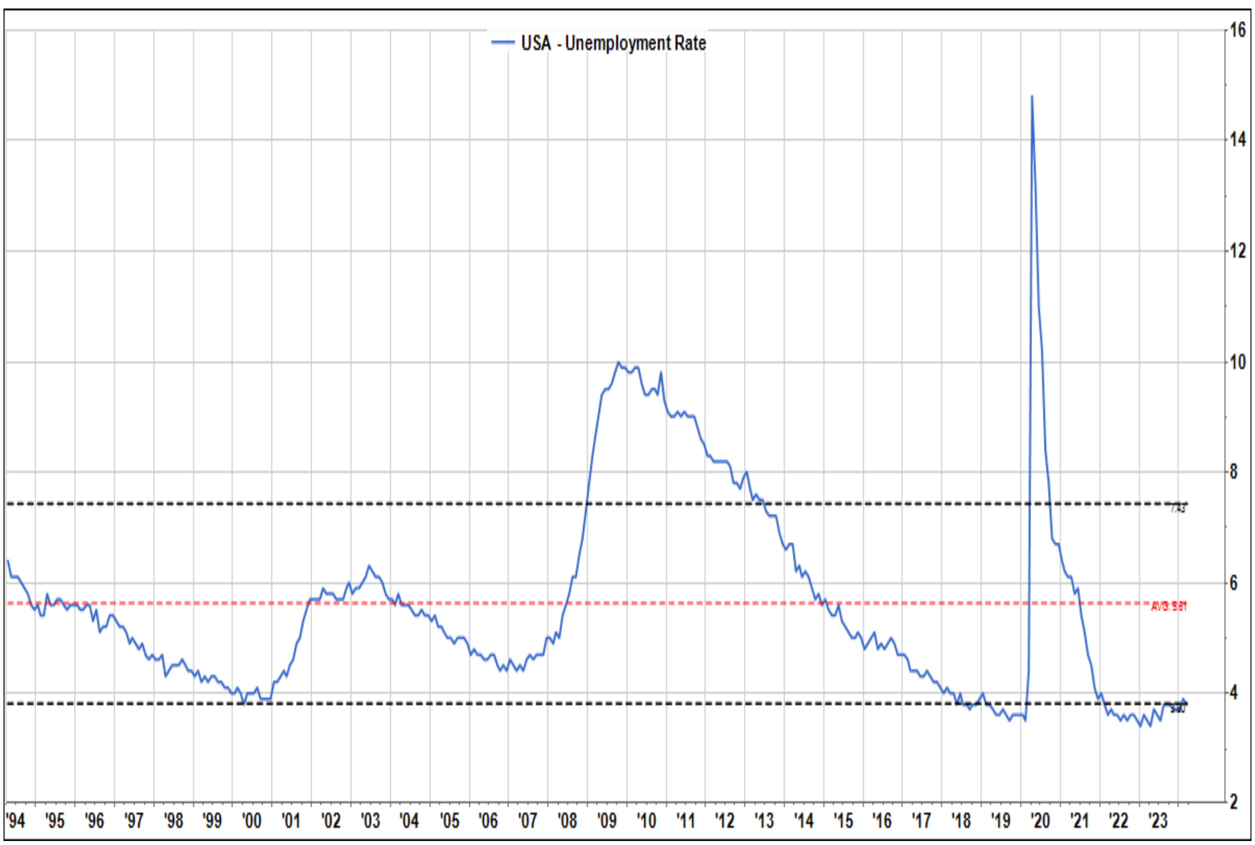
The U.S. labor market added 303,000 new jobs in March, far above the 212,000 new jobs that had been forecast. The March report represented the 2nd straight month of accelerating jobs gains, and the 3-month moving average of new jobs has remained in an uptrend since December. Employment gains were primarily concentrated in service-related areas such as health care and private education, and leisure and hospitality industries have now fully recovered to their pre-pandemic levels. New jobs in goods producing industries accounted for just 13% of the overall employment gains.



The unemployment rate has again fallen back to 3.8% from 3.9% in February, despite the fact that more people have begun looking for work, particularly in the 16-24 year old demographic. Not only is the labor market exceeding expectations, it is also one of the strongest the U.S. economy has produced historically. The unemployment rate has been below 4% for 26 months in a row, the longest streak since the 1960s, and 39 consecutive months of jobs gains marks the fifth longest period of job expansion in history.

As we have pointed out repeatedly in these Outlooks, the two main responsibilities of the Federal Reserve are to: 1) maintain stable prices; and 2) promote maximum employment, consistent with price stability. So, the current strength in the labor market presents somewhat of a puzzle for the Fed, in that the pace of new jobs being added is too rapid to allow inflation to come down to the

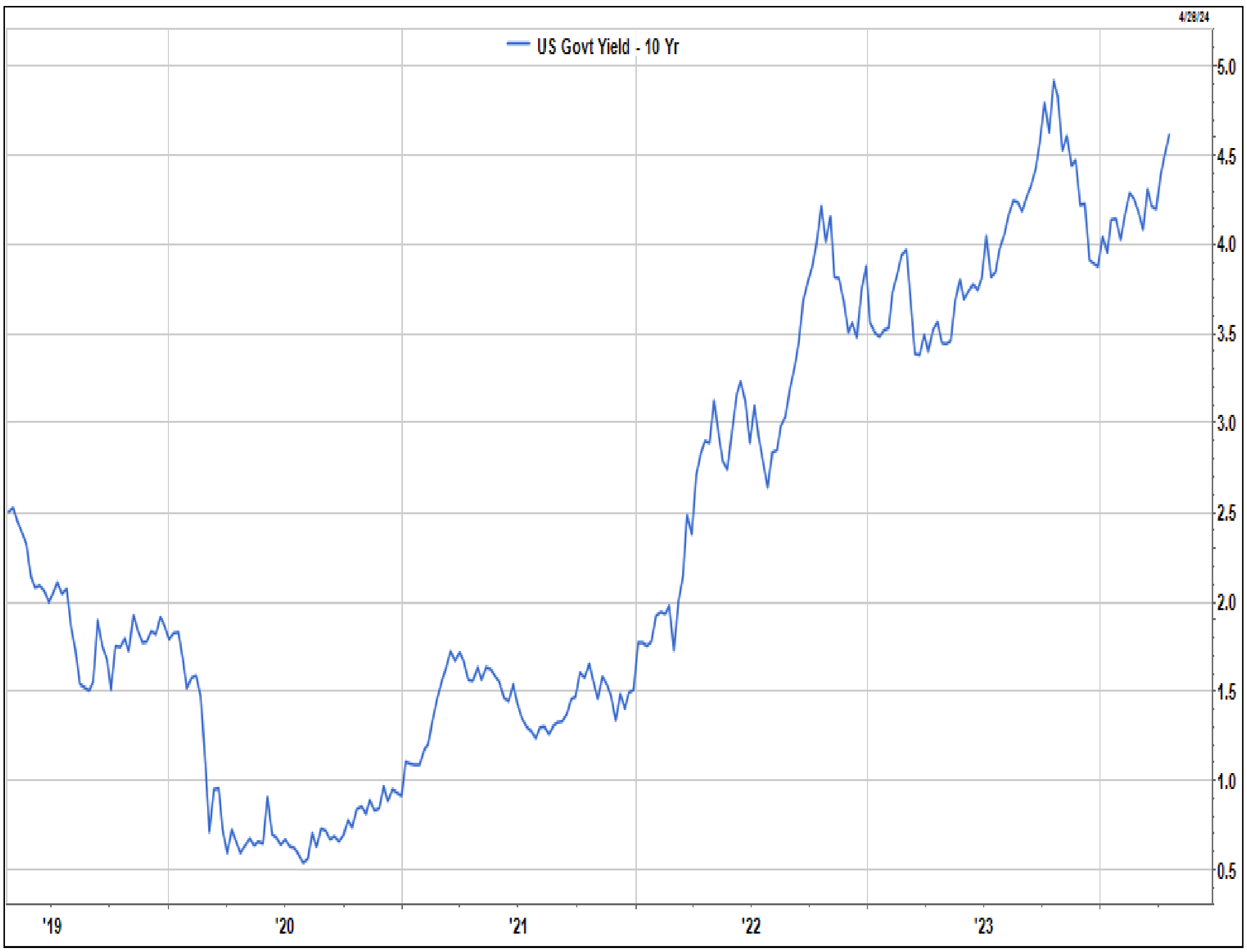
Fed's 2% target. On the other hand, this strength is enough to allow the Fed to focus solely on public enemy #1 – inflation. This is another argument against expecting interest rate cuts anytime soon.



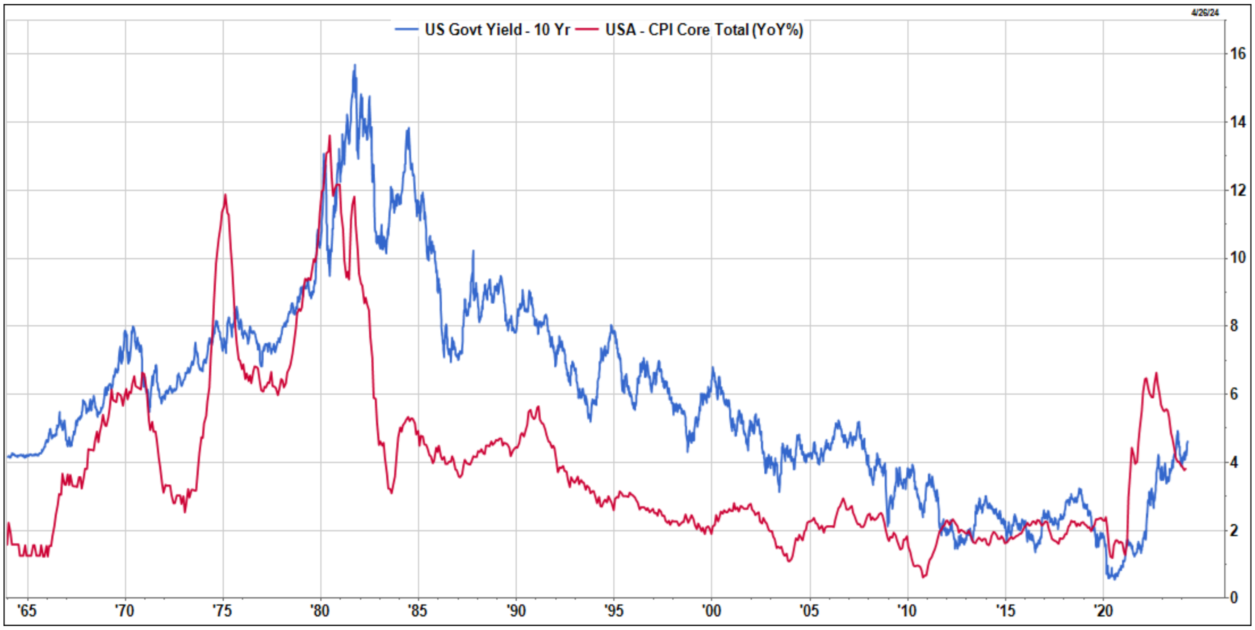
Interest Rates

As pointed out earlier, interest rates rose in the first quarter – and bond prices fell – continuing a trend that has persisted for most of the last 5 years. The 10-Year U.S. Treasury yield ended the quarter at 4.2%, up 32 basis points from year end, and has continued to rise in April to a level of 4.67%.

The Bloomberg U.S. Aggregate Bond Index has generated an annualized return of exactly 0.36% over the last five years and has shown a *minus* 2.46% annualized return over the last three years. Worse, if you had purchased a long-term bond in July 2020 – in the midst of the recession and at the bottom in interest rates – you would have lost 46% of your principal by now, while collecting less than 1% per year in interest.



The good news for those who avoided the temptation to seek "safety" in bonds is that the dramatic rise in rates has made bonds relatively more attractive. At the very least, the yield on the 10-Year U.S. Treasury is once again above the inflation rate, which is the normal state of affairs that has existed for much of the last 40 years. The less good news is that the 10-Year



Treasury yield is *barely* above the inflation rate as measured by the core Consumer Price Index (CPI), and both nominal rates and real (inflation-adjusted) rates are still below the levels that the economy has experienced historically. So whether *real* interest rates return to their historical norms very much depends on whether nominal rates continue to rise or progress on lowering inflation returns to base course.

<u>Corporate Earnings – Better than Expected (Again)</u>

We are at the midpoint of the first quarter earnings season, and S&P 500 companies continue to perform well relative to expectations. Almost half of the companies in the index have reported earnings, and 77% have reported actual earnings above estimates. The average positive earnings surprise for the companies that have reported has been 8.4%.

There is undoubtedly a fair amount of manipulation that occurs around earnings reporting season. According to FactSet, 112 companies issued guidance in advance of their Q1 earnings release, and 71% of them guided estimates lower. Positive earnings surprises have been a characteristic of every season since the dark days of the pandemic recession, as pervasive negative guidance has lowered the bar for producing positive surprises. This earnings season will likely be no different.

Eight of the eleven S&P sectors are reporting earnings above Q1 2023 levels, led by the Communications Services, Information Technology and Consumer Discretionary sectors. Not surprisingly, all of the Magnificent 7 companies (or 6, depending on whether Tesla is ousted or just on probation) reside in one of those 3 sectors. The only sectors reporting year-over-year declines are the Health Care, Energy and Materials sectors.

At this point, 264 companies in the index have issued guidance for the remainder of this fiscal year. Of these companies, 52% have guided estimates lower than the current mean estimate, not a meaningful indicator in the larger scheme of things. Consensus estimates among Wall Street analysts for 2024 have come down less than 1% since the end of last year, and the full year's earnings are still expected to be 11% above 2023's level. We will be interested to see what effect the most recent disappointing GDP report has on estimates for the remainder of 2024 and 2025.

We've often commented on the disproportionate impact of the Magnificent 7 stocks on the S&P 500's price performance, but what effect does this group have on the S&P's earnings?

Analysts expect that 5 of those 7 companies will be the top 5 contributors to year-over-year earnings growth for the index in the first quarter. Nvidia, Amazon, Meta, Alphabet and Microsoft are expected to report earnings gains of 64% (combined) above the same quarter last year. The blended year-over-year earnings gains (reported plus remaining estimated) for the index in Q1 are expected to be 3.5%. However, if you exclude the results of the 5 companies just cited, the earnings *decline* for the remaining 495 companies would be -6%, according to analysts at FactSet.

As we mentioned at the beginning of this piece, one of the members of the Magnificent 7 was seriously wounded during the quarter. Tesla's stock price is down 32% this year – and 60% from its high – after reporting worse than expected earnings and revenues for the quarter. The company also announced the departure of key executives as well as plans to lay off 10% of its global workforce, moves that CEO Elon Musk characterized as part of the company's next "phase of growth." Musk also announced that the company has switched its focus from its next generation autos to prioritize efforts on its robotaxi program, which will be unveiled in August. So, stand by.

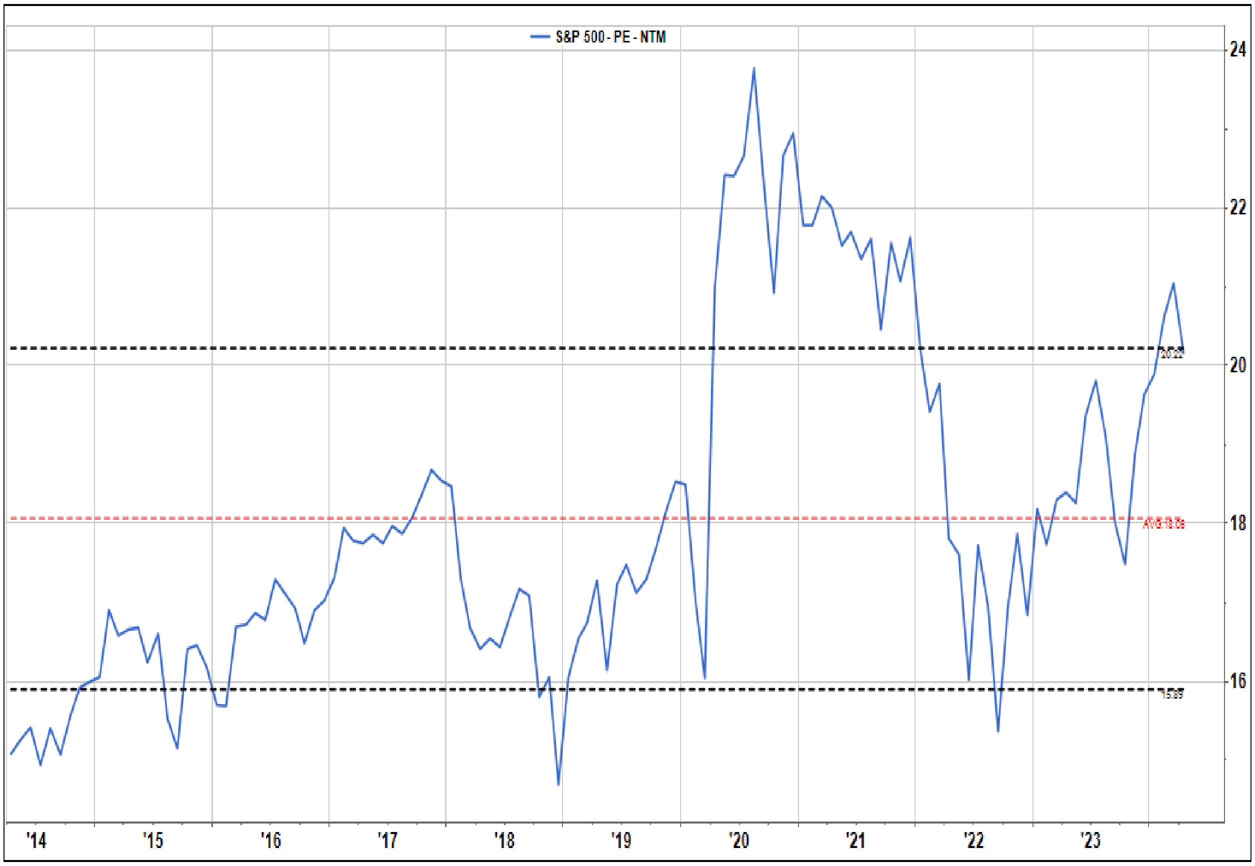
Valuations Still Extended, but Not Really

Despite the recent sell-off, the S&P 500 still trades at more than 20 times the next 12 months' earnings estimates, well above its mean multiple of 18 times forward earnings over the last 10 years. This is a source of concern for many, but we would make two observations that may temper such anxieties.

First, current valuations are useful in comparing the long term expected returns of various assets or asset classes; but they are poor predictors of changes in the market's direction in the short term, as markets can often remain over-valued (or under-valued) for long periods. Of course, if the market does change direction, the downturn (or upturn) will likely be more violent if the market is at an extreme valuation level.

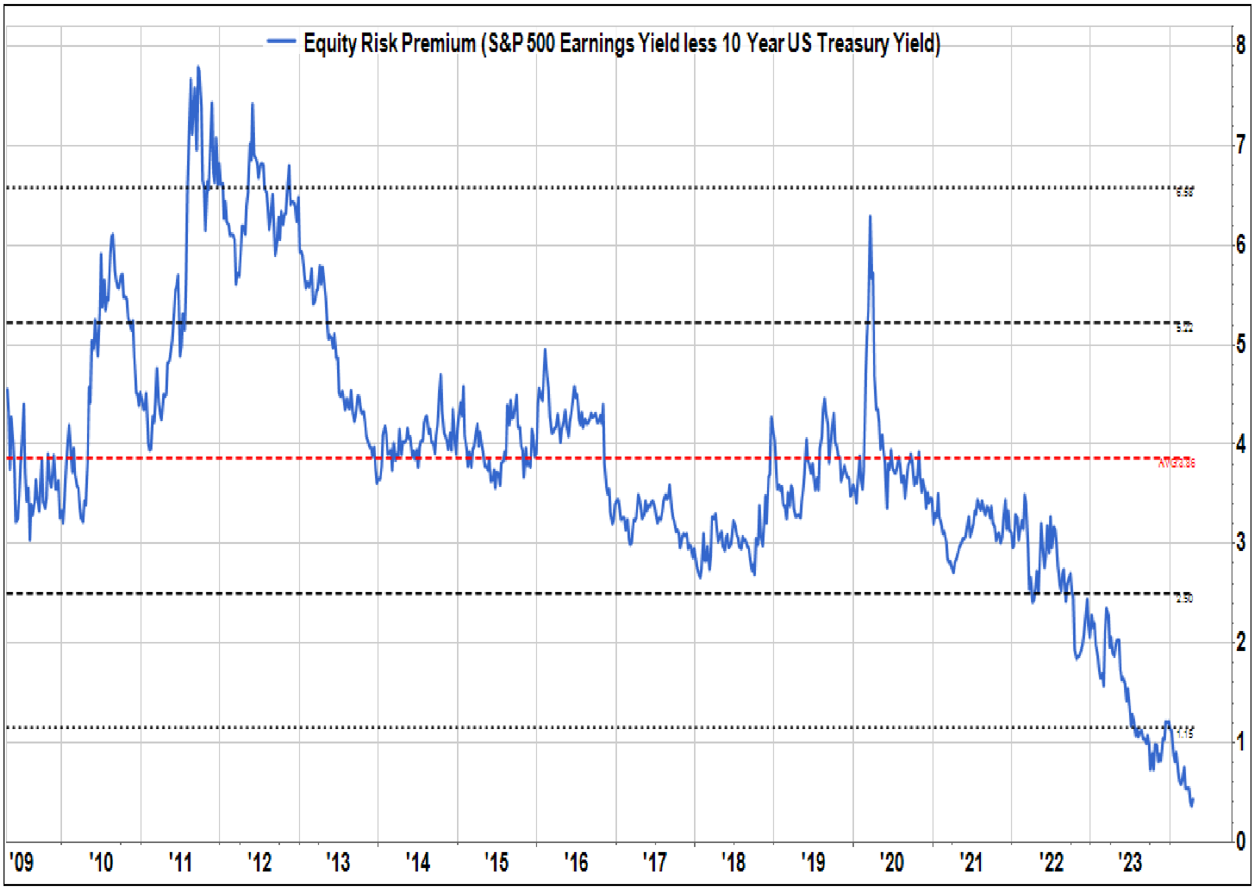
Second, if the Magnificent 7 stocks have a disproportionate effect on the S&P 500's price performance and earnings growth, they also have a disproportionate effect on market valuations. Truly, we are getting weary of having to write separate analyses for the Magnificent 7 and the Less Than Magnificent 493, but the index has become concentrated as never before due to the rapid price increases of this handful of companies, and it is thus less representative of the "market" than it has ever been.

According to FactSet, the Mag 7 trades at a weighted multiple or 30.8 times forward 12 months' earnings estimates, roughly 50% more than the S&P 500 index, itself. So again, if we remove the effect of the large relative capitalizations of these few companies and create an equal-weighted index, we'd find that the S&P 500 stocks trade at an average multiple of just 16.1 times earnings, which is roughly equal to the average multiple of the S&P 500 over the last 10 years.



However, the stock market does appear to be over-valued by one measure – interest rates.

The market's mean Price/Earnings multiple of 18 times over the last decade occurred during a period when interest rates were much lower than they are today. Inverting the current P/E multiple of 20 gives us an "earnings yield" of 5%, a level barely above the current yield on the 10-Year U.S. Treasury Bond of 4.67%. Equity investors have generally looked for an "equity risk premium" of 3-4% relative to bond yields to compensate them for the additional risk of owning stocks. But as the chart, below, shows, the run-up in bond yields and the expansion of the market's P/E multiple have driven the equity risk premium to essentially zero. A negative equity risk premium indicates that investors are not being compensated for the additional risks of owning stocks. This will loom large for investors if future reports on GDP and inflation continue to disappoint.



Conclusions

So far, the stock market has shrugged off disappointing news on GDP growth and inflation with barely a ripple. Even during the late-March early-April selloff, the index never declined as much as 6% from its high, and the percent of stocks trading above their 200-day moving average never fell below 50%.

It is remarkable that the S&P 500 has been able to generate a total return of almost 40% (including dividends) over the last 5 quarters, during which time the yield curve has remained deeply inverted, leading economic indicators have continued to point to an economic downturn, long-term interest rates have been rising, and the Federal Reserve has been either raising short-term rates or promising to keep rates ”higher for longer.”

Rather than pausing or consolidating gains following a 24% rise in 2023, U.S. stocks have instead accelerated their gains in the first quarter, rising 7.8%, which equates to a roughly 35% annualized return – even after excluding the outsized contributions of the Magnificent 7.

The message of this *Outlook* is that after such an incredible run in 2023 and into 2024, investors should keep their longer-term expectations in check. Recession indicators are still flashing yellow, and the inflation war has not yet been won. Wars in eastern Europe and the Middle East still pose potential threats to food and oil prices, and a stormy election season is about to descend on us with full throttle. And even if the market remains unaffected by these concerns, gravitation to the mean, by itself, is always a powerful force. Do not be surprised if the road ahead is bumpier than the road just traveled.

Joseph J. Tascone
Senior Vice President &
Chief Investment Officer
JTascone@chemungcanal.com

Michael D. Blatt, CFA, CMT
Vice President &
Senior Investment Officer
MBlatt@Chemungcanal.com

Peter M. Capozzola, CFA
Vice President &
Senior Investment Officer
PCapozzola@capitalbank.com

Kevin W. Brimmer
Assistant Vice President &
Investment Officer
KBrimmer@chemungcanal.com

Shelby M. Fay, CFA, CFP®
Vice President &
Investment Officer
SFay@chemungcanal.com

Chemung Canal Trust Company

CAPITAL BANK