Janney

INVESTMENT PERSPECTIVES

JULY 2024

Key Takeaways —

- A look at the appetite for gold
- Measuring liquidity
- Summer stock performance

PROSPECTING FOR GOLD

Mark Luschini, Chief Investment Strategist

It is a rare circumstance that in presentations to a large group of investors, a question about the prospects for gold isn't raised. In this context, it centers on whether it is likely to move higher or lower or warrants a position in a portfolio. Historically, gold has had an intrinsic quality, namely its rarity, that has served the precious metal well for thousands of years as a currency or store of value and in art or jewelry. Today, we know it also has broad industrial applications for which it is employed in medical, aerospace, automotive, and electronics fields.

Gold has captured a lot of attention as it rallied to an all-time high in May, even generating a buying frenzy of gold bars that were being sold by a large, well-known hypermarket. Subsequently, its price advance has cooled a bit, which begs the question of what lies ahead. Are the catalysts for gold still in place, or have other variables intervened that might undermine its investment utility?

A contributing factor that explains the pullback in gold prices is a slowdown in purchases by China's central bank (People's Bank of China or PBoC)—a key source of increased demand over the past two years. At the same time, increased buying by central banks from other emerging market countries should limit its downside pressure. As an aside, real interest rates (nominal rates adjusted for inflation), which were rising and thus acting as Kryptonite for gold since it pays no interest or dividends, are generally falling, thus culling that as a headwind.

The amount of gold acquired by global central banks in just the past two years is over 25% more than what was bought in the past 15 years. China, Turkey, Poland, India, the Middle East, and Central Asia all contributed to strong central bank demand since 2022. In particular, the PBoC has been a key source of central bank gold demand growth. Its share of global central bank gold purchases increased from an average of 3.5% between 2017 and 2021 to roughly 22% since November 2022. Yet the tailwind from PBoC demand eased in recent months as its gold purchases tapered off. Notably, it did not buy any gold in May. The slowdown in the PBoC's gold purchases probably implies that its demand is sensitive to high gold prices.

Nevertheless, the increased PBoC appetite for gold likely represents a structural shift in demand. The motive behind the Chinese central bank's increased appetite for gold is a desire to diversify reserves away from U.S. dollars and possibly other Developed Market currencies. Given the probability that the Sino-American geopolitical rivalry will continue escalating in the coming years, we expect China and others to continue seeking to reduce their vulnerability to the global monetary systems where the U.S. dominates. Like China, Emerging Market central bank gold demand will probably persist even as purchases might waver over short-term horizons due to price fluctuations. Surveys conducted by the World Gold Council confirm that their stated intent is to increase their reserves denominated in gold over time.

Largely left out of the rally in gold is retail buying, leaving scope for lower real rates, often a catalyst to boost prices to spur increased demand for gold exchange-traded funds (ETFs). Interestingly, the U.S. and Europe are behind the drop in global gold ETF holdings. However, the start of the central bank easing cycle, already underway in Europe and by over 40% of those worldwide and expected to be followed by the Federal Reserve perhaps later this year, could stoke

gold ETF demand, albeit marginally, since ETF-related gold demand has accounted for less than 4% of the total over the last four years.

While our recently published Mid-Year Outlook does not forecast a recession in the second half of this year, we do acknowledge the budding risks of one, perhaps in 2025. Gold has historically delivered positive returns and outperformed its precious metal peers and other commodities during business cycle downturns. In addition, gold has often risen versus global equities in the lead-up to and during recessions. To sum, gold's longer-term prospects may shine because of significant strategic buyers (central banks) building reserves as source of demand, but it can also offer a tactical benefit to those seeking a haven from cyclical bouts of economic uncertainty. ■

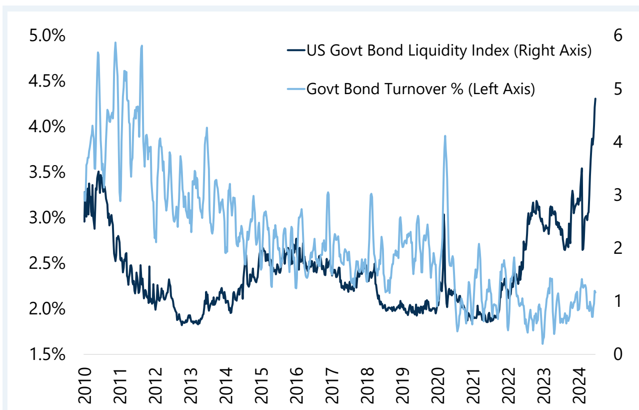
OVERBLOWN LIQUIDITY CONCERNS

Guy LeBas, Chief Fixed Income Strategist

Violent market moves—such as the +0.15% no-news selloff in interest rates on the final day of June 2024—are often chalked up to "liquidity." There's some truth to that statement. In the last several weeks, a few headlines have emerged on deteriorating bond market liquidity. Specifically, one measure of liquidity based on a Bloomberg index (albeit flawed) seems to be weakening. The broader issue, however, is that bond markets have grown, intermediaries have shrunk, and popular trades have become ever more crowded. Nowhere is that more evident than on quarter-end dates in which rebalancing billions of dollars gets jammed into a single hour of activity.

First, it's important to define the type of liquidity under consideration. When it comes to the financial sector, there are two major types of liquidity: internal liquidity, which concerns firms' abilities to fund their operating activity and external liquidity, which concerns the ability and ease of investors to sell investments reasonably quickly and without accepting a large haircut below market value. Internal liquidity is excellent. By and large, firms are generating strong profits, and market-based financing is readily available to nearly any investment grade or high-yield-rated issuer. As a final liquidity backstop, private lenders are available to provide capital to even stressed borrowers.

Chart 1: Higher "Error" and Lower Turnover Hint at Weaker Treasury Liquidity



Source: Janney ISG: Bloomberg; Federal Reserve Bank of NY

By contrast, external or market liquidity in bonds is on the poor side. Measuring this concept is tricky. One way to measure liquidity is to assess the "error" between expected and actual trading prices, which the Bloomberg index (mentioned above) uses. Today, this measure of error is the highest since the Global Financial Crisis era.

Another way to measure liquidity is in trading volume relative to bond market size. Percentagewise, trading is very low, again, suggesting weaker liquidity. The ideal way to measure bond market liquidity is by understanding how much a large buy or sell order affects prices. Only big intermediaries that participate in billions of trades per day can estimate that effect, and those same intermediaries restrict the re-publication of that valuable information. Qualitatively, however, we can say that these more robust measures of liquidity are quite good and much better today than the full-year average in 2023.

Similar stories emerge in other non-Treasury bond markets, particularly corporates. While nominal investment-grade rated corporate bond trading volumes average around $45 billion per day compared to $12 billion ten years ago, the corporate bond market has grown, so volume as a portion of the overall market is only two-thirds of what it once was. Moreover, though the data are too complex to detail here, corporate trading is heavily concentrated in a relatively small number of issues from large debt-issuing companies, suggesting that broader liquidity for corporates is poorer than these percentage measures imply.

The concept of lower liquidity is concerning, especially given the problems liquidity created in 2008-2009 and its resurgence in 2020. However, the current issue involves external liquidity rather than internal liquidity. Today, with external liquidity somewhat weaker, the risks do not involve corporate failures but rather higher frictional costs. We observe several outcomes:

- Institutional investors may struggle to buy or sell large quantities of bonds efficiently.
- Bond market price movements may become more volatile, particularly to the downside.
- Over time, borrowing costs for governments and corporations may increase in small but significant ways.

On the first count, large investors face a higher probability of moving the market against themselves if they sell a position. For individual investors or even small to midsize institutional investors, lower liquidity poses less of a problem. On the second count, sharper moves in the bond markets present both opportunities and challenges. What long-term investor wouldn't want prices to fall temporarily and returns to rise temporarily for liquidity reasons? Some of the best market entry points in the last two decades have resulted from liquidity-exacerbated bond selloffs.

LAZY, HAZY, AND SOMETIMES CRAZY

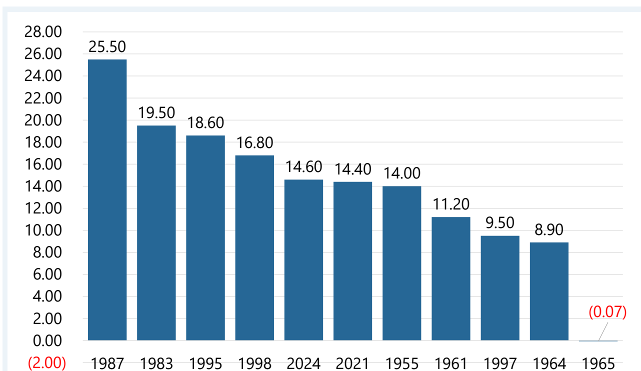
Gregory M. Drahuschak, Market Strategist

The second half of the year typically kicks off with golf courses and beaches occupying investors' minds more than the performance of the S&P 500. The diversion away from the market, however, can be costly.

On average, July is by far the best summer month for stocks and the fourth-best month of the year overall. The S&P 500 in July posted a gain in 44 of the previous 74 possible months, with an average gain of 1.21%. The 9.11% gain in July 2022 was the best gain for the month.

The S&P 500 ended July higher in the last nine consecutive years. Most interesting, however, is that the best gains often happen in the first half of the month, with the first 15 days of July being the best two-week trading period of the year over the last 95 years.

Chart 2: Best First Half % Since 1955 with S&P Setting New All-Time Highs



Source: Janney ISG

Election years bring their own unique element with the national political party conventions in mid-summer. The Republican National Convention takes place this year from July 15 through July 18 in Milwaukee, Wisconsin, and the Democratic National Convention will be in Chicago, Illinois, from August 19 through August 22.

By almost any measure, the first half of 2024 treated investors well. The S&P 500 produced the second-best first-half gain in an election year since 1945. Among the years setting all-time highs, the first half of 2024 was the sixth best. First-half performance like this has had a strong tendency to lead to gains in the second half, too.

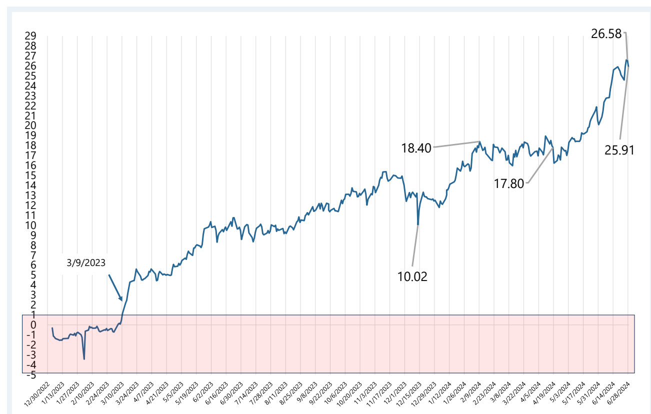
Election-year chatter will be present throughout the balance of 2024, but starting on Friday, July 12, second-quarter earnings will command the most attention. That day, BNY Mellon, Citigroup, JP Morgan Chase, and Wells Fargo kick off earnings season, followed by six more large banks reporting the next week. Earnings season, however, does not hit full stride until the week of July 22.

Earnings are always important, but lofty expectations for 2025 set a fairly high bar, especially for the high-profile stocks that have paced the market's run to new highs.

As the second quarter ended, 10 of the 11 S&P 500 sectors were estimated to post double-digit earnings in 2025 versus this year. The height of the earnings bar is most obvious considering that the Technology Sector is expected to post a year-over-year gain of 19.7%, followed by an 18.6% gain in the Health Care Sector, a 17.1% increase in the Materials Sector, and 15.0% in the Discretionary sector. The heavy weightings of the Technology (32.6%), Health Care (11.8%), and Discretionary (9.8%) sectors add increased importance to their results in a market that already is capitalizing 2025 earnings at a price-earnings ratio of nearly 20.

The wide performance disparity between the capitalization-weighted S&P 500 and the equally weighted version is a worrisome aspect of the market. This did not improve last month. In fact, it became worse and is currently as wide as we can find going back when the equally weighted Invesco S&P 500 Equal Weight ETF began.

Chart 3: SPX vs RSP % Performance Gap—January 1, 2023 to Now



Source: Janney ISG

This does not mean the widely followed cap-weighed S&P 500 must drop, but the dominance of a handful of stocks that have created the performance gap does add an element of risk worth considering.

Keep in touch with your Janney Financial Advisor, who is updated on this factor each day.

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