The Markets Lack Volatility

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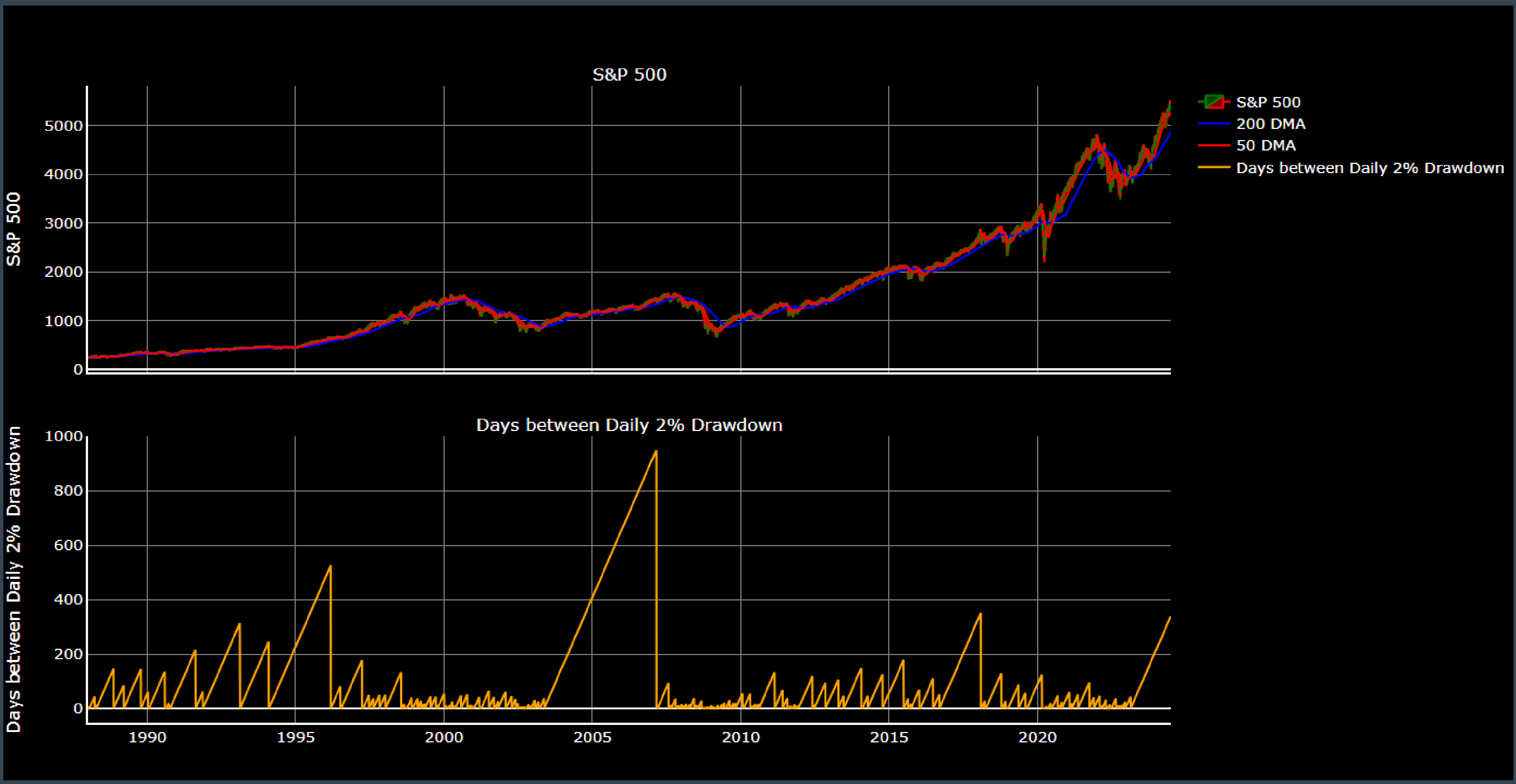
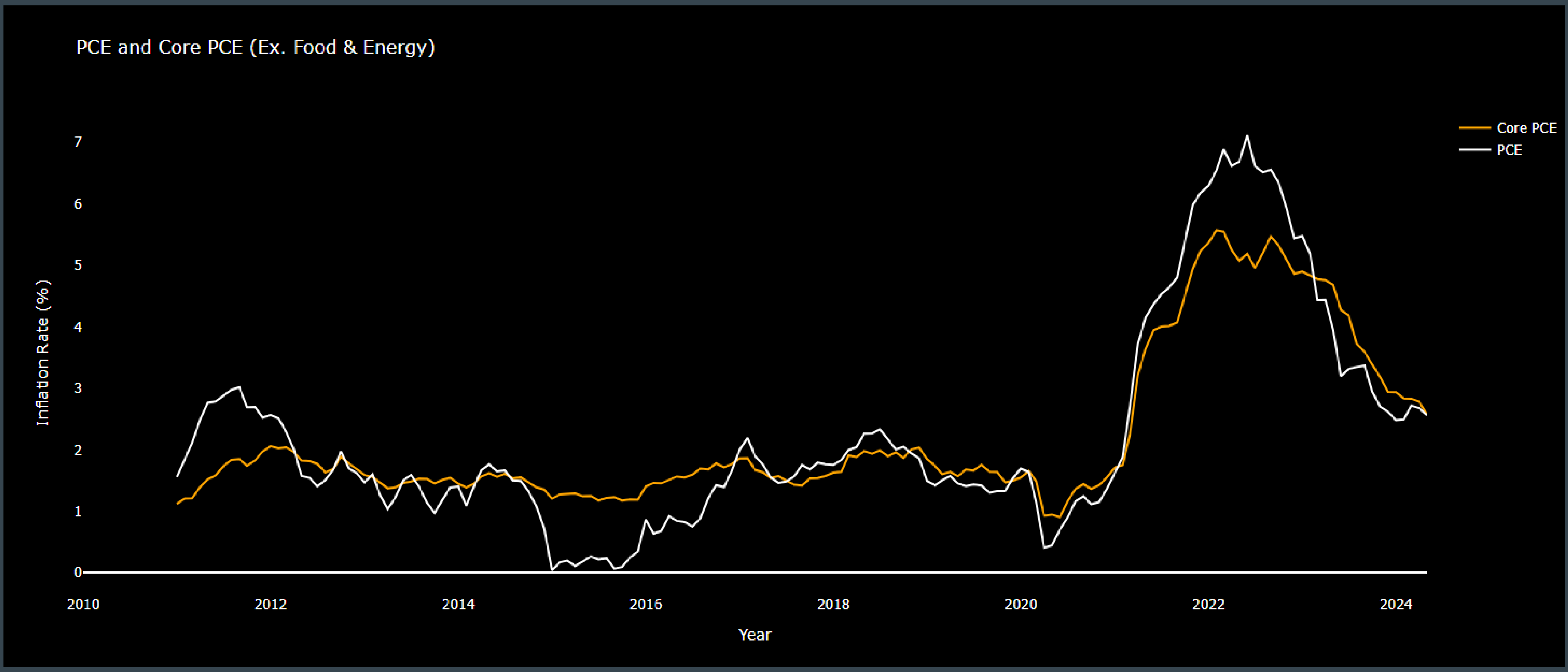
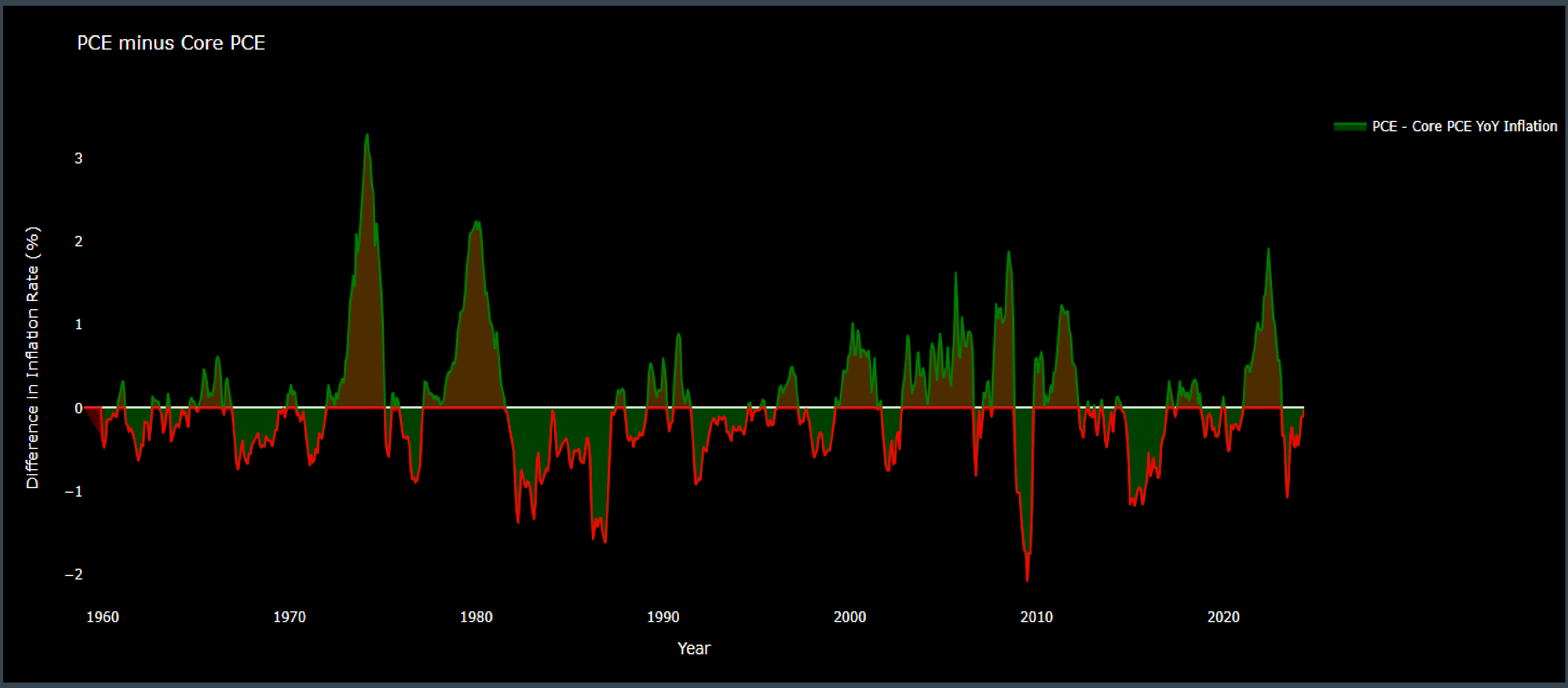
The S&P 500 has traded sideways for the past two weeks, struggling to breach 5,500. As noted last week, the majority of underlying sectors have pulled back and are in slight downtrends. The market has experienced a lack of volatility for some time, which initially guided us higher from the November 1st bottom. Recently, however, it has resulted in the market stagnating. Concentration has continued to build among the top 7 names, and their correlations have decreased over the past few months. As these stocks move in different directions, it resembles a swimmer swimming against the tide: a lot of effort without much progress. For instance, Nvidia has pulled back 12%, but the S&P 500 hasn't budged. During this period, Amazon made a new closing high, Google rallied, and Microsoft continued its upward trend. The Technology sector ETF recently underwent a shake-up, with Nvidia now holding a 20% weighting, replacing Apple as a top 2 holding. Apple now holds a 4% weighting, and this sector will broadly track where semiconductors go, as AMD and Broadcom are also top 10 holdings. As the market consolidation continues, there is speculation about whether this sets us up for another move higher or indicates a forming top. The S&P 500 has gone 340 days without a daily 2% drawdown, and the VIX has remained below 15 for months. This could be a setup for the latter.



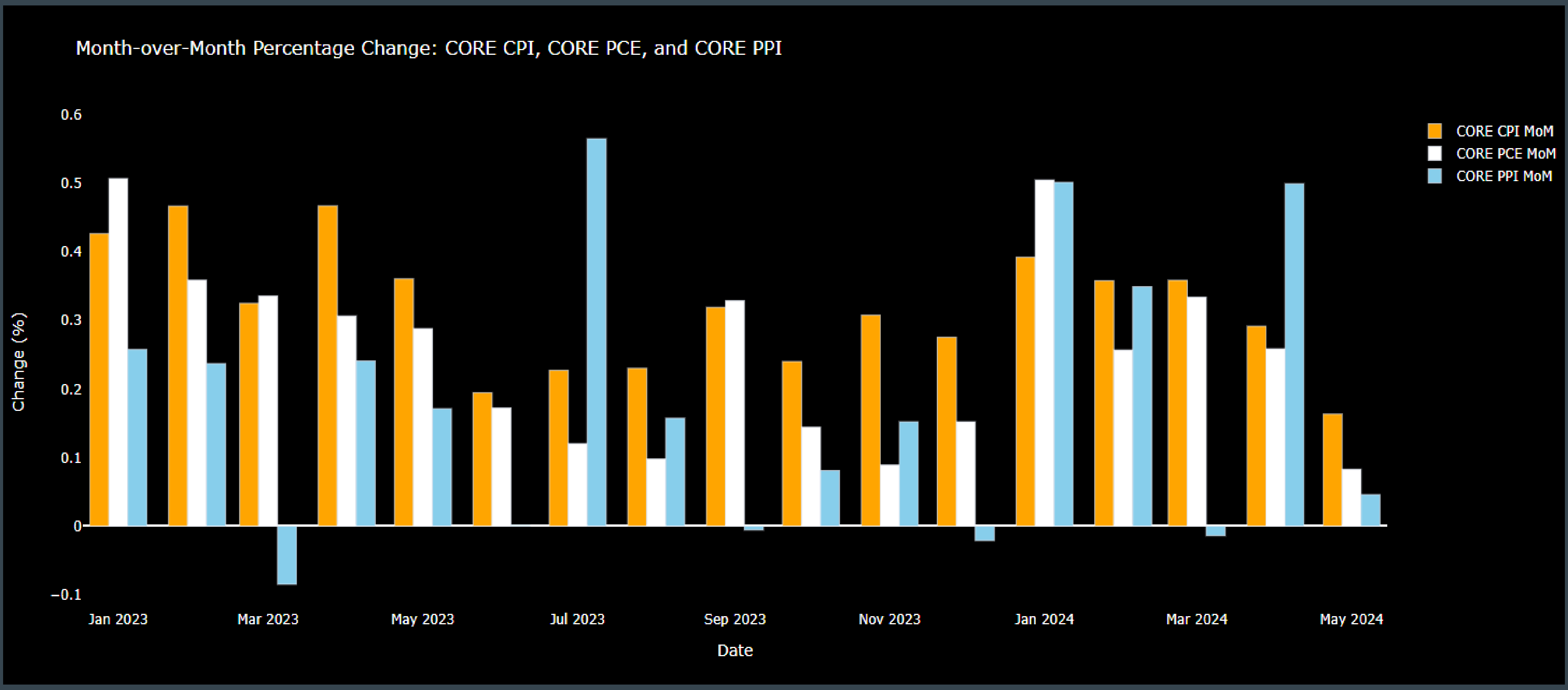
Personal Consumption Expenditures (PCE) on Friday showed the same deceleration of inflation in May as the CPI report. PCE was 0.0% month-over-month, while Core PCE was 0.1%. Both measures now stand at 2.6% year-over-year. The Fed's Summary of Economic Projections estimates Core PCE to be 2.8% by the end of the year, indicating they anticipate higher inflation in the coming months. We tend to agree due to the influence of base effects. Lower inflation rates in the summer and fall months of last year will create an upward bias on year-over-year comparisons for this year. Our analysis found that if PCE is reported at 0.15% for the rest of the year, the annual rate would only decrease to 2.4%. If PCE comes in at 0.20% monthly, it would trend higher towards 3.0% by year-end. This week's report marked the first time this year that the month-over-month PCE was lower than 0.20%.



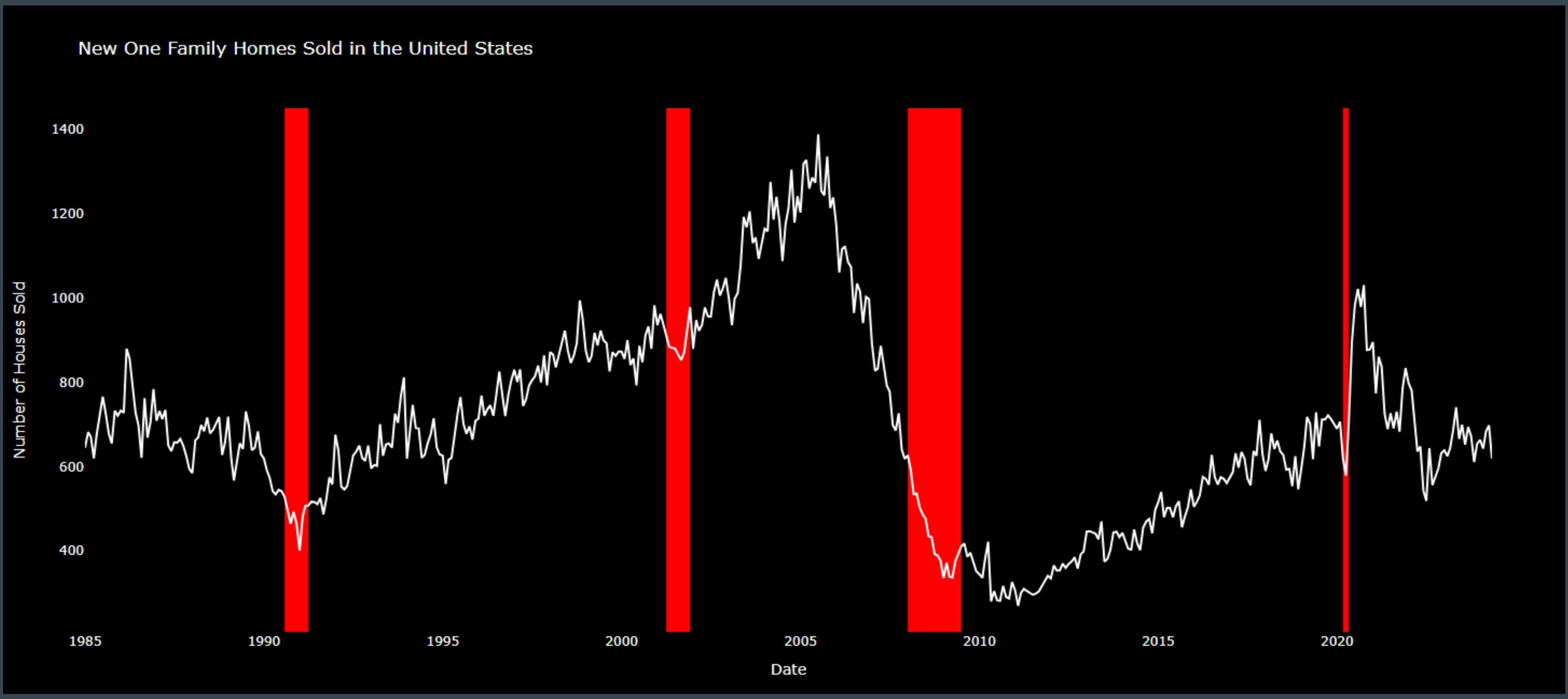
This month's PCE report also brings Core PCE back down to the same level as PCE for the first time since February 2023. Core PCE has been higher during this period due to the impacts of food and energy prices. With these volatile inputs to inflation now reduced, we can expect less tailwinds from them going forward, assuming no oil price shocks. When examining the impact that goods and services are having on PCE, it is clear that goods are not rising in price at all. Services remain the main contributor to the elevated rate of inflation.



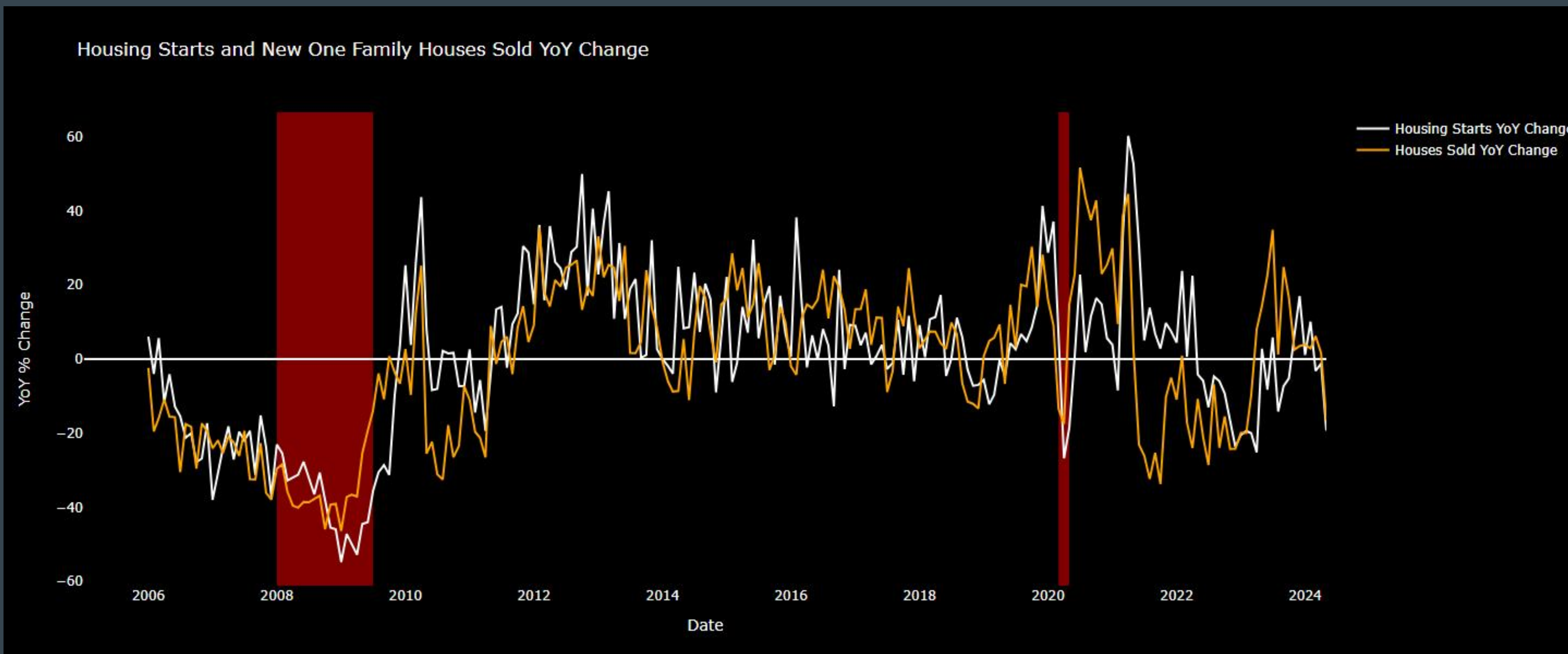
It was a positive month overall for inflation metrics across the board. Core CPI, Core PCE, and Core PPI all came in below 0.20% for the first time in over 18 months. While this trend may not necessarily continue due to potential shocks in the coming months, it has positively impacted market pricing for now. Yields rebounded on Friday but have generally come down. As noted at the beginning of the article, the market has not had anything significant to overreact to within the recent economic data.



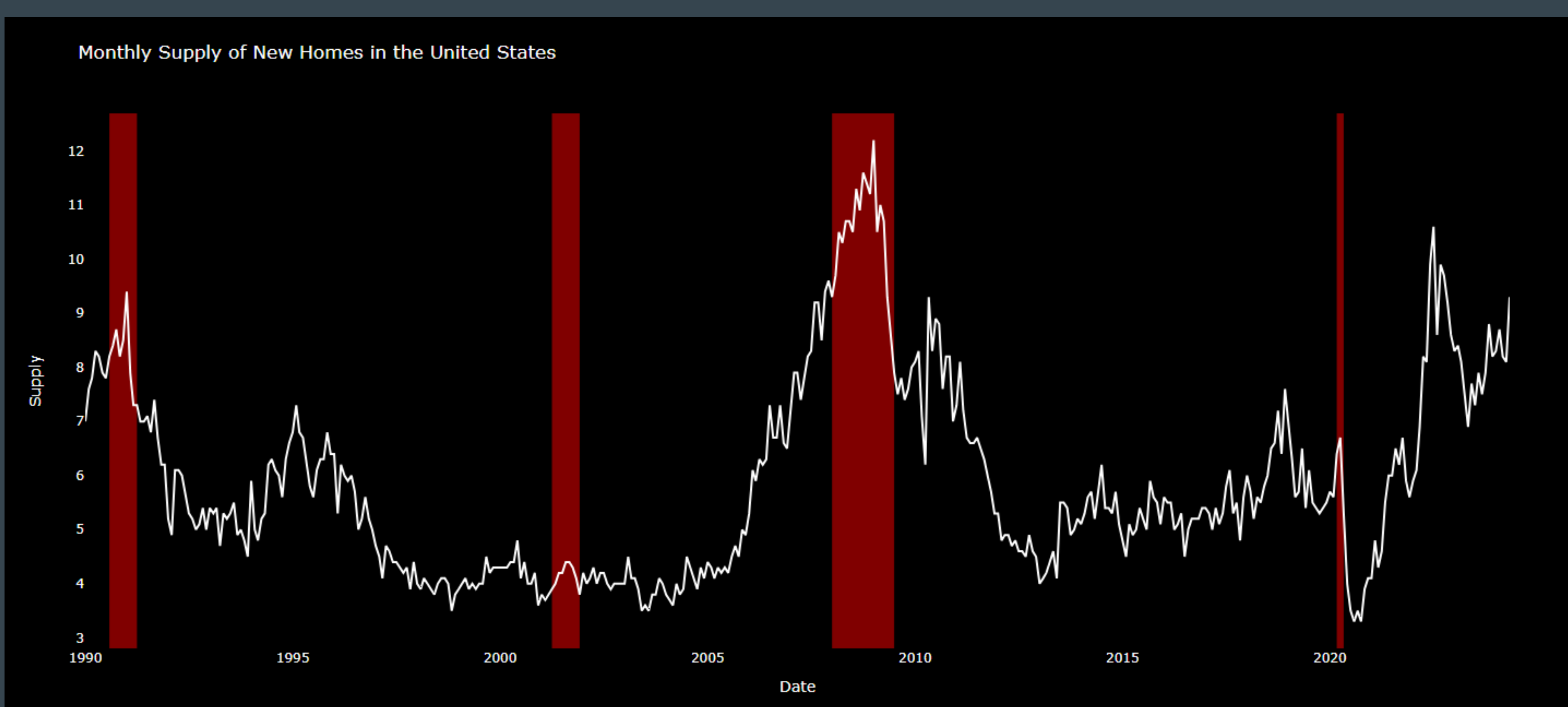
There was more housing data on the docket this week, and it continues the negative trend from last week. New home sales fell sharply from 698K to 619K this month, an 11% month-over-month drop. Home prices are also up 7% year-over-year. For someone looking to buy a home, an estimated household income of over $100,000 is now needed, while the median household income in the country is around $75,000. Pending home sales also fell and are now at their lowest point this century. The housing market is essentially frozen. The average mortgage rate locked in by homeowners is around 4%, while current rates are above 7%. Home prices have increased cumulatively by 45%-50% over a four-year period. With such high rates, nobody wants to give up their lower-rate mortgage to buy at higher rates, resulting in low transaction volumes and prices continuing to grind higher.



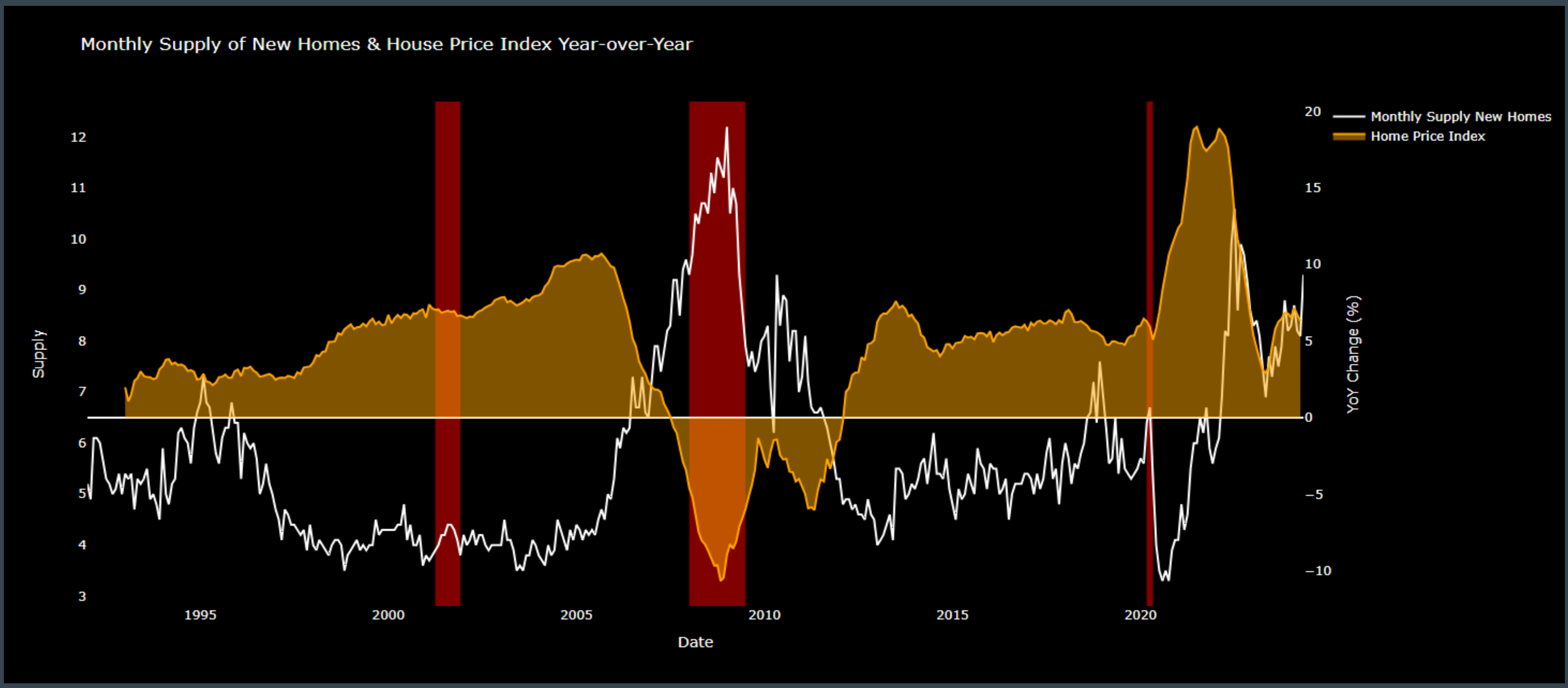
The falling number of transactions makes it harder for homebuilders to justify new construction. Prices being propped up may be the only factor allowing the numbers to work, especially given the high cost of capital required for construction loans. New one-family homes sold are now down 16% year-over-year, and the correlation to Housing Starts is high. As fewer homes sell, fewer homes will be built, exacerbating the existing supply problem.



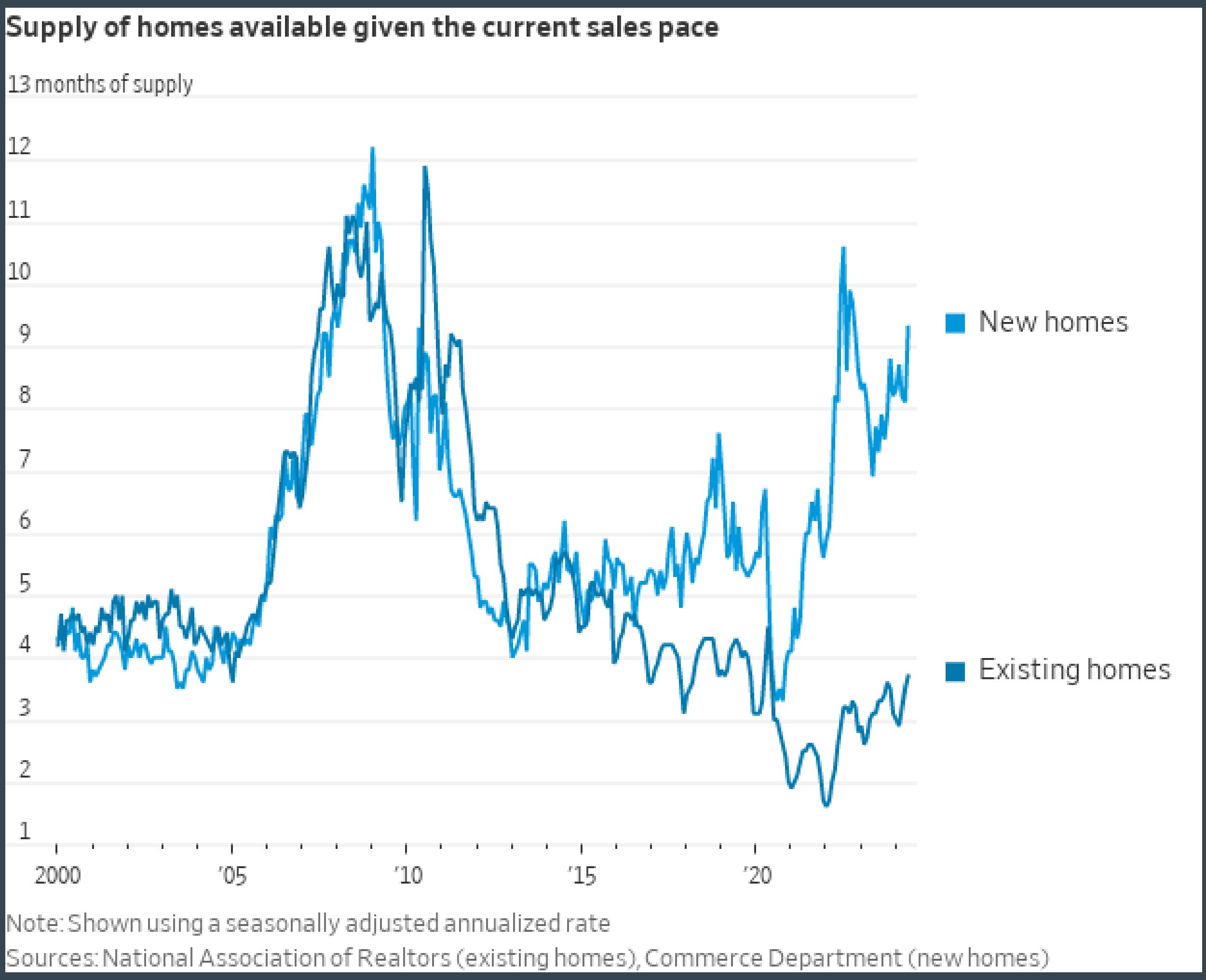
The month's supply of new homes has risen to 9.3, historically a negative indicator for prices. A rising supply would logically push prices lower. However, the market for new homes represents only 15% of the total housing market. With the existing home market not functioning efficiently, the new home supply coming online has not been enough to increase total supply and relieve the upward pressure on prices.



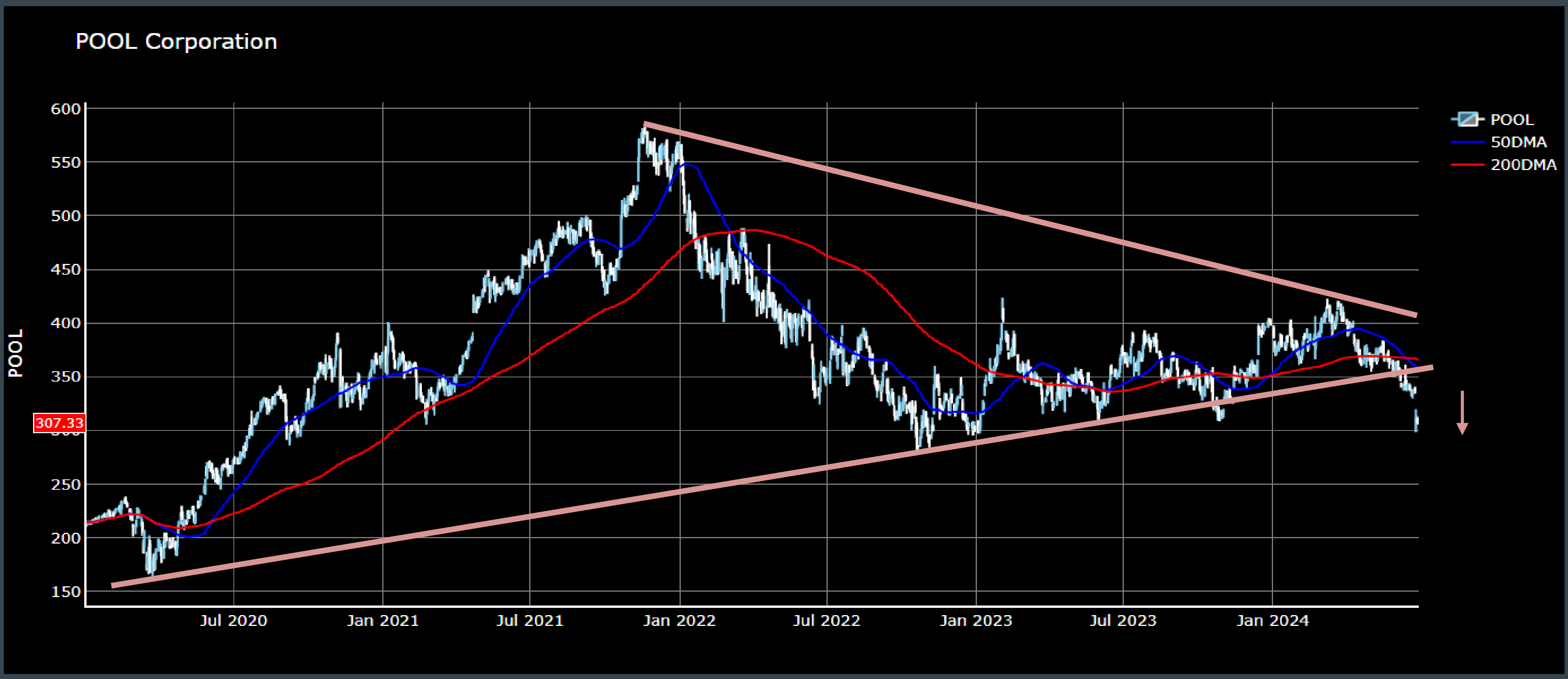
Looking back to 1992, the months of supply in new homes reaching 9 has been more than enough to not prices down year-over-year.



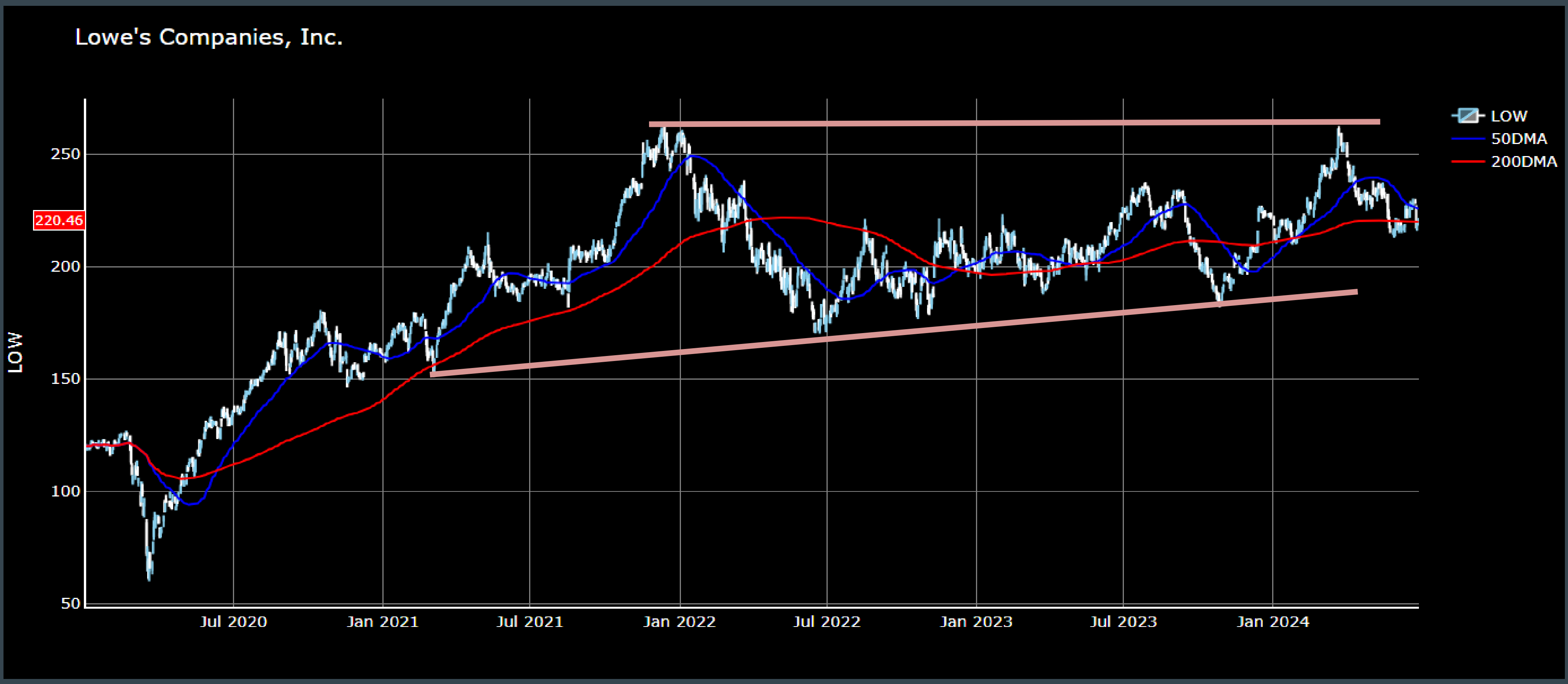
However, as noted above the scenario we are currently facing is highlighted by the dislocation between the supply of new homes and existing homes. New homes constitute only 15% of the market, while existing homes make up 85%. With mortgage rates locked in at historically low levels for the majority of Americans, the supply of existing homes remains at around 3 months. This creates a market where lower mortgage rates could also mean lower prices if it unlocks the pent-up supply of existing homes.



The knock-on effects of this situation have been felt across the broader economy. Along with the market being frozen, discretionary spending among consumers for big-ticket items or home improvement has pulled back. Pool Corporation reported this past week that installations are down 17% year-over-year, sales of materials are also down 11%, and revenue is expected to decline by 7%. This news sent the stock price down 8% on the day after the report.



The largest beneficiaries of home improvement, Home Depot and Lowe's, saw tremendous gains during the pandemic as everyone stuck at home began updating appliances, making repairs, and building home offices. Both stocks peaked in January 2022 and remain in a drawdown two and a half years later. Housing activity and related spending contribute 15%-20% to GDP in the country. With the frozen market and pullbacks in discretionary spending, headwinds are created for economic growth.



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