Alley Company Quarterly Letter
Constructive Landscape

July 12, 2024

As background, it was about a year ago at this time that the Federal Reserve increased interest rates for an eleventh consecutive time to the current range of 5.25 – 5.50 percent. This cumulative action was part of the most aggressive fight against inflation since the 1970s. Many Wall Street pundits and investors alike were pessimistic about the outlook for the economy and the stock market. But fundamentals have proven them wrong. The U.S. economy has in fact remained resilient and technology-led innovation and earnings growth have powered the S&P 500 Index to an advance of 25 percent for the one-year period ending June 30th, 2024.

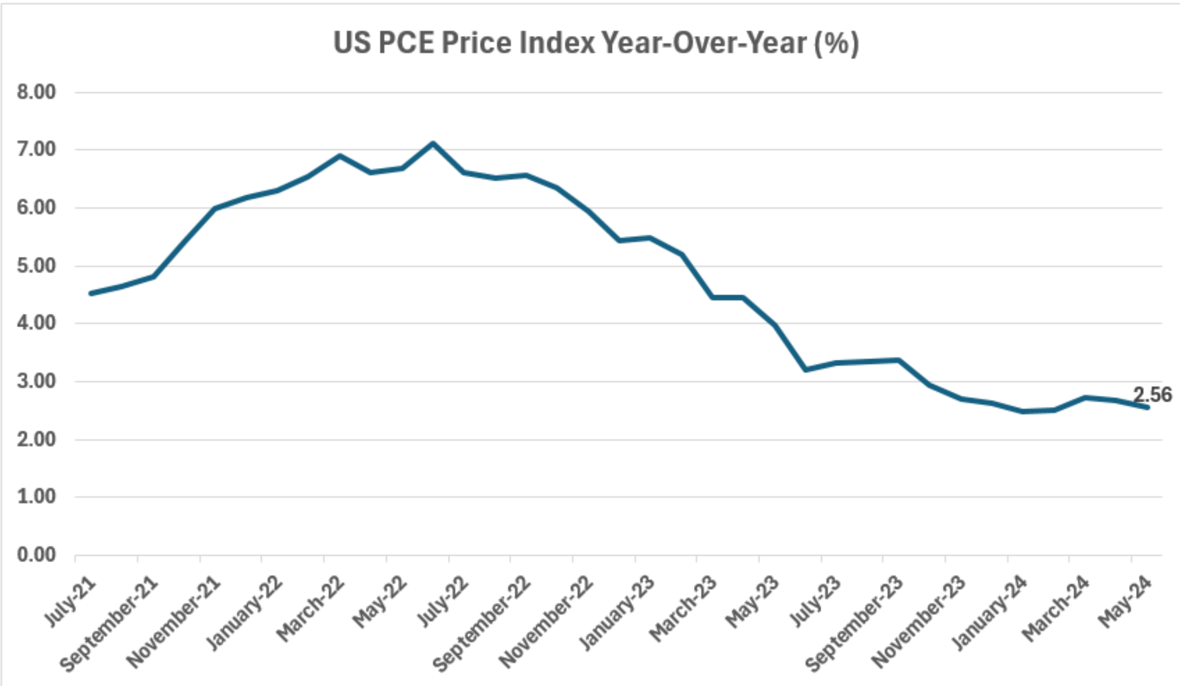
To be sure, the traditional business cycle has not been repealed. Economic recessions as well as market corrections will undoubtedly be a part of the future. However, it's important to note that placing undue emphasis on trying to time these occurrences can prove to be very costly for investors.

With that said, awareness of the current investment landscape is always important as investors manage life events and any potential changes in their asset allocation mix. As we look at the current landscape, a constructive set of key fundamentals appear to be in place as outlined in the sections below:

Inflation

The rate of inflation has declined significantly from the elevated levels that pandemic-induced supply/demand imbalances ushered in (see Exhibit 1). A lower rate of inflation is a major positive for both consumers and investors relative to the all-important purchasing power of assets. If the current disinflationary trend persists, it is highly likely that the Fed's next move would be to cut interest rates, which typically supports the expansion of gross domestic product (GDP). Meaningfully lower interest rates at the short end of the yield curve would have positive implications for the banking system, businesses with floating-rate debt, and, potentially, overall investor psychology.

Exhibit 1: Personal Consumption Expenditures (PCE) Index – the Fed's Preferred Measure of Inflation

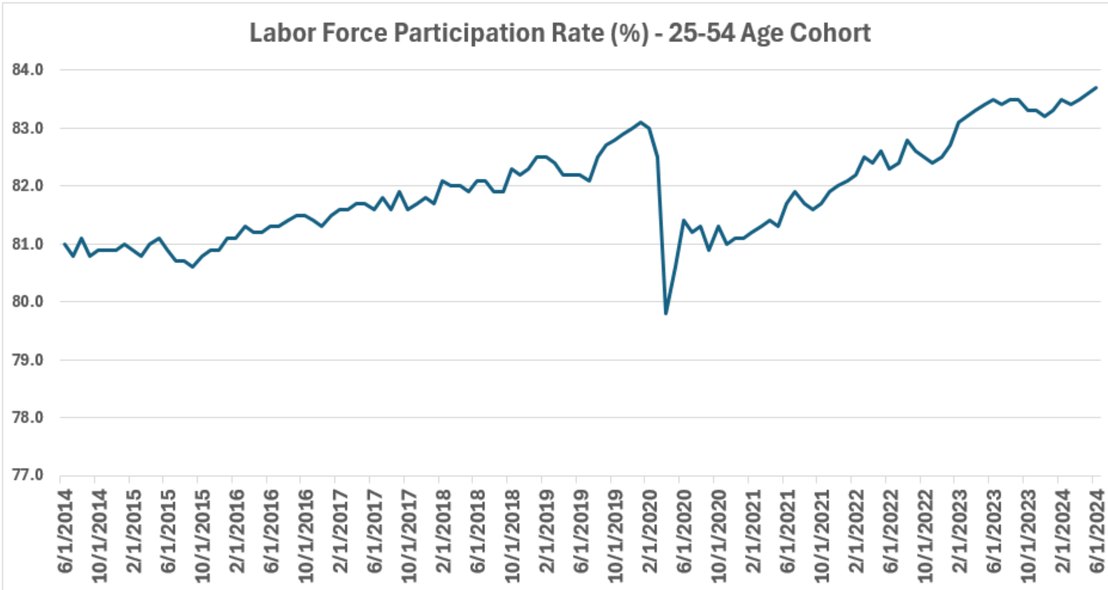


Source: YCharts, U.S. Bureau of Labor Statistics

Labor Market

While the labor market has cooled recently, at 4.1 percent, the unemployment rate is still near 50-year lows and well below the average rate of 6.2 percent. With consumption in the U.S. driving about two-thirds of GDP, the health of the labor market, and in turn the consumer, is of obvious importance. The chart below notes further strength, as the labor force participation rate among prime-age workers (e.g., age 25 – 54 cohort) has eclipsed pre-pandemic levels and now stands at a healthy 83.7 percent.

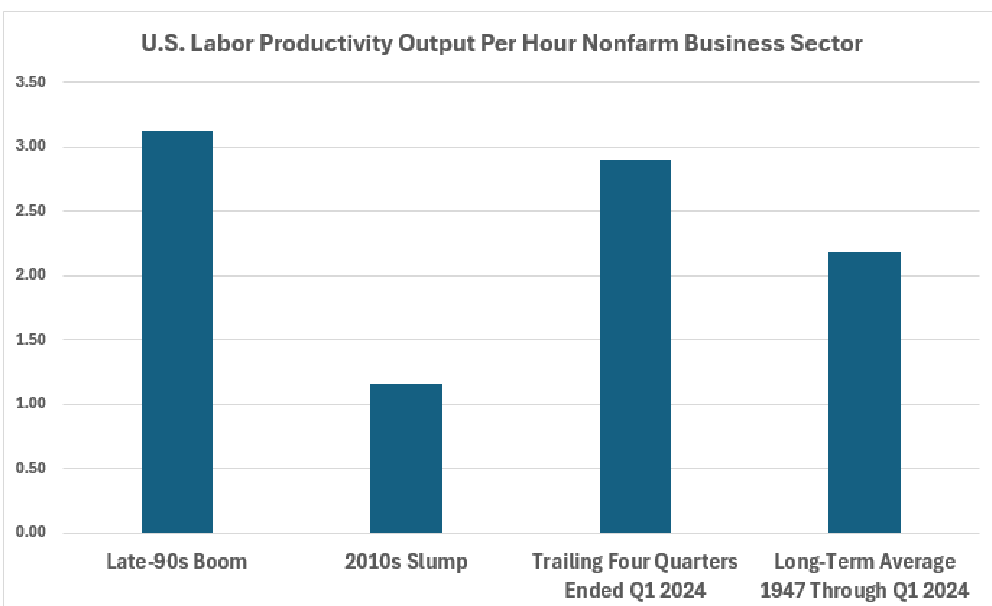
Exhibit 2: Prime-Age Labor Force Participation – Employed or Seeking Employment



Source: U.S. Bureau of Labor Statistics

Productivity

Productivity growth has experienced an uptick over the past year, as the third bar in the below chart depicts, and continued innovation and dynamism across Corporate America could fuel a sustained rally in this important economic metric. Productivity is the measurement of output per hour worked and is a key mechanism through which the economy can grow without consuming more resources and stoking inflation. Recent new-business creation and technological advancements are believed to be drivers of better productivity and sustained improvement would help economic growth and benefit Americans' standards of living.



Source: U.S. Bureau of Labor Statistics, Average Quarter-over-Quarter % Change (Annual Rate)

Market Narrowness

A narrow group of stocks, highlighted by the "Magnificent Seven," have driven recent market performance, which provides the opportunity for other areas of the market to play catch up and gain investor attention. For example, for the 3-year period ending June 30th, 2024, the market-capitalization-weighted S&P 500 Index advanced 10.0 percent annually while the average stock (equally weighted) in the index only advanced 4.8 percent. Further, small capitalization stocks produced *negative* returns over this time frame. These data suggest that the financial markets broadly speaking are not stretched or ahead of themselves. From a valuation perspective, while the S&P 500 Index trades at 21.0 times next 12-months earnings estimates, the median price-to-earnings ratio is lower at 17.8x and the value segment of the marketplace trades at 15.3x. [1]

Risks and Conclusion

Risks to a constructive outlook should always be thought of as omnipresent and today is no exception. The economy and the earnings outlook for corporations could falter more than expected; or inflation could reaccelerate. The upcoming presidential election is likely to create volatility at a minimum and U.S. fiscal policy will be under a microscope. Global geopolitics also look set to remain uncertain for the foreseeable future.

Notwithstanding the risks, the landscape for the U.S. economy and financial markets is constructive. While volatility is always part of the equation, trying to time the markets is not advised. Staying the course with a diversified portfolio of high-quality businesses is a recipe for achieving the primary objective of increasing the purchasing power of assets over time. For investors with lower tolerance for risk and volatility, implementing fixed income investments into their strategic asset allocation mix is the right course of action.

[1] Represented by the 12-month forward P/E ratio of the Russell 1000 Value Index