Dear O'Brien Client,

The second quarter of 2024 marked the third quarter in a row – and six of the last seven – of positive returns for investors. For the year, global stocks are up 12%, after jumping over 22% in 2023.

As long-term investors, we believe that maximizing time in the market is essential to helping individuals successfully achieve their financial goals. To that end, we must be comfortable with the volatility of performance – particularly in challenging markets. We therefore utilize diversification across and within markets to reduce that volatility of performance and rebalance our holdings when necessary to stay the course.

These concepts have been a hallmark of investing for decades and have worked well. We estimate that over the past 40 years, a global stock investor would have achieved a 10% return per annum with roughly 15% volatility.[1] Blending those stocks with a 40% allocation to investment-grade U.S. bonds reduced annual returns slightly to around 9% (there is no such thing as a free lunch), but also sharply reduced the volatility of that performance to below 10%.

But in shorter time periods markets move in cycles around those long-term trends. Sometimes the returns of stocks and bonds are very similar – implying less of a sacrifice of return is necessary to reduce volatility. Other times the difference in performance is wider, making the opportunity cost of that trade-off larger.

Since the Global Financial Crisis (GFC), we have been in a cycle that is moving in the latter direction. The low interest rate environment pre-COVID, coupled with the sharp increase in interest rates post-COVID have dramatically impacted the opportunity cost of diversification. While stocks have, on average, continued to generate the same 10%ish annual return with around 15% volatility since the summer of 2010, bonds have returned a much more modest 2% per annum. This 8% annual gap in average performance is roughly double the gap of the past 40 years.

The past half decade has witnessed an acceleration in that trend. Since the summer of 2019, global stock returns have been closer to 11%, but investment-grade U.S. bonds have been essentially unchanged. And through the first half of 2024 that performance gap widened to 13% (global stocks are up 12% and bonds are down -1% – see the table below).

	2Q 2024	2024	3 Years	5 Years		2Q 2024	2024	3 Years	5 Years
Emerging Market Stocks	5.0%	6.9%	-4.8%	2.8%	Mortgage-Backed Bonds	0.1%	-1.3%	-3.1%	-0.8%
Gold	4.9%	12.4%	8.8%	9.4%	**U.S. Aggregate Bond Index**	**0.1%**	**-1.0%**	**-3.1%**	**-0.3%**
U.S. Large Cap Stocks	4.3%	16.3%	9.9%	15.0%	Municipal Bonds	0.0%	-0.6%	-1.0%	1.1%
Commodities	2.9%	5.5%	5.6%	7.7%	Investment Grade Bonds	0.0%	-0.6%	-3.0%	0.5%
Global Stocks	**2.9%**	**12.0%**	**5.4%**	**10.7%**	Non-U.S. Developed Market Stocks	-0.4%	5.7%	2.9%	6.4%
High Yield Bonds	1.1%	2.5%	1.5%	3.7%	Real Estate Stocks	-0.9%	-2.7%	-2.1%	3.0%
Non-U.S. Stocks	1.0%	5.8%	0.5%	5.4%	U.S. Small Cap Stocks	-3.3%	1.1%	-2.7%	6.9%
Treasuries	0.1%	-1.2%	-3.4%	-0.7%	U.S. Mid Cap Stocks	-3.3%	4.4%	2.0%	9.2%

Past performance is no guarantee of future returns. You cannot invest in an index. 3-year & 5-year returns are annualized.
Source: Morningstar Direct, O'Brien Wealth Partners, as of 6/30/24.

At the same time, the drivers of stock market performance have become increasingly narrow. In 2010, the 10 largest companies in the 3,000 stock MSCI All-Country World Index (ACWI) accounted for roughly 8% of that index.[2] As of the end of the last quarter, that weight was north of 22%. Those 10 companies contributed a 4.2% return in 2Q, which was 145% higher than the 2.9% return of the ACWI noted in the table above. Put differently, the remaining stocks in the global stock universe experienced a net negative return in 2Q.

To be sure, there are fundamental reasons why these mega cap winners have so dramatically outperformed for so long and there is the potential for that outperformance to continue. But there is also the potential that other companies and markets could uncover other growth engines that are being overlooked today that would allow them to become the winners of tomorrow. Moreover, historically concentrated markets also magnify company-specific risks, for those few winners can have a greater impact on market-level performance and volatility than is typically the case.

[1] Source: Bloomberg Finance, LP, Violi, R, and Camerini, E. (2018) Emerging Market Portfolio Strategies, Investment Performance, Transaction Cost, and Liquidity Risk, O'Brien Wealth Partners calculations, as of 6/30/24.
[2] The top 10 companies are based on the 10 largest index constituents as of the end of the 1st half of each year. Source: Bloomberg Finance, LP, JPMorgan, O'Brien Wealth Partners, as of 6/30/24.

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Given all of this, we continue to believe the best course of action for long-term investors is to remain diversified both across and within asset markets. To quote the financial historian Peter Bernstein, we "view diversification not only as a survival strategy but as an aggressive strategy, because the next windfall might come from a surprising place…if you're comfortable with everything you own, you're not diversified.[3]"

Take, as an example, those lagging investment-grade U.S. bonds. A low starting yield combined with the rapid Fed tightening cycle has resulted in essentially no return over the past five years.

But going forward starting yields are now roughly 5%, the highest they have been since the GFC, which provides an income cushion that has historically correlated with better subsequent returns[4]. Since the early 1980s, when their starting yield has been around this level, investment-quality bonds have returned an average of roughly 5% per year over the next half decade.

Moreover, if a recession occurs that pushes rates lower (and prices higher), investment-grade bonds could provide an even greater return, which makes them an important diversifier in portfolios.

Taking a step back from asset market performance, global economic activity appears to have remained resilient in 2Q. While this resilience reduces the risk of imminent recession, it also may be contributing to inflation measures stabilizing at elevated levels relative to central bank targets. To the extent these dynamics persist, central banks will likely skew towards maintaining their current restrictive policy stances.

Against the globally resilient backdrop, the U.S. expansion continues, but underlying fundamentals are mature. Credit access has continued to tighten, monetary policy remains restrictive, profits are still soft for most companies, and hiring is slowing. Workers who lose their jobs are increasingly struggling to find new employment as 2024 progresses, which is typically an early-warning indicator of labor market weakness in the months ahead.

On a brighter note, while wage growth has slowed, it remains higher than inflation. This dynamic provides a boost to inflation-adjusted incomes and therefore spending – which is roughly 70% of the U.S. economy. To the extent wage growth continues to outstrip inflation, it reduces the probability that a recession occurs in the U.S. near-term.

We hope you are all taking care and enjoying the summer. If there are any changes in your personal or financial situation that might impact your investment objectives, or if you have any questions and would like to talk, please contact your Advisor.

Your O'Brien Team

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[3] Source: Jason Zweig. (2004). A (Long) Chat with Peter Bernstein. https://jasonzweig.com/a-long-chat-with-peter-l-bernstein/

[4] Past performance is no guarantee of future returns. You cannot invest in an index.

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