CHOATE
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2024 Q2 REVIEW

Questions to Consider Ahead of the Elections

Choate Investment Advisors LLC
Two International Place
Boston, MA 02110
choateia.com

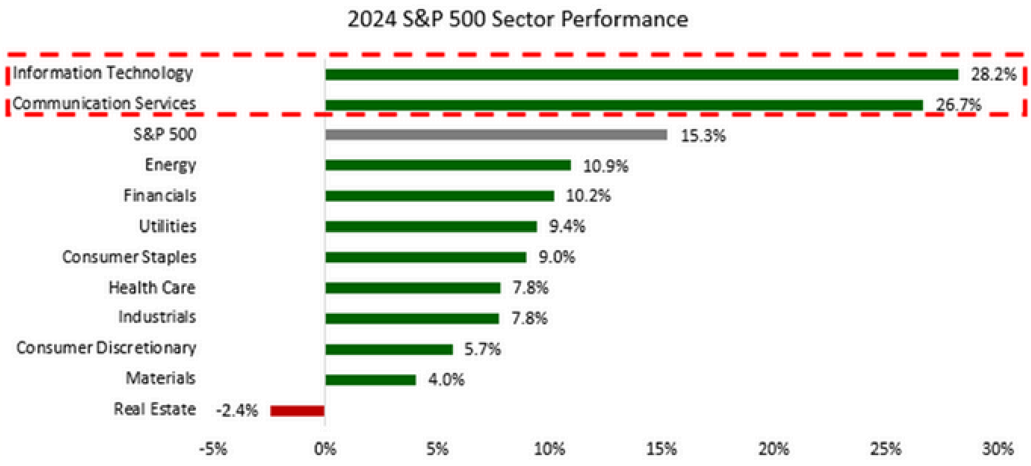
2024 Second Quarter Review

Questions to Consider Ahead of the Elections

The MSCI All Country World Index is up 11.4% and the S&P 500 is up 14.5% at mid-year. Mega-cap technology stocks continue to pace the market returns, led by NVIDIA. Meanwhile, the equal weighted S&P 500 Index is up 4.1% and the small cap Russell 2000 index is only up 1.6% year to date. Bond returns continue to struggle from lingering inflation expectations, as the Bloomberg aggregate bond index is down 0.7% year to date, despite current bond yields near 5.0%. Following the second quarter close, a surreal July has seen the US capital markets continue to hold steady, despite an assassination attempt on former president Donald Trump and the withdrawal of the current president, Joseph Biden, from seeking a second term.

The current economic expansion has been continuing for 4 years, although growth is clearly slowing. Trends that we have highlighted over the past several quarters remain in place for now. At a sector level, technology and communication services stocks continue to lead.

Chart 1: S&P 500 Sector Performance

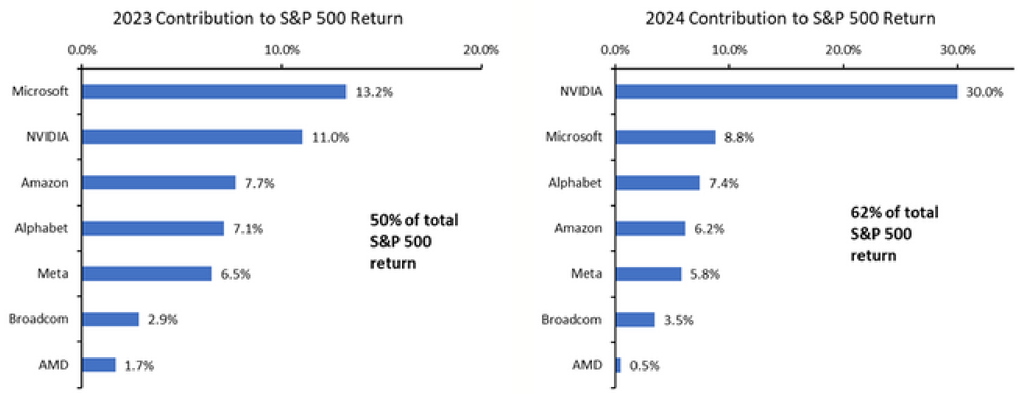


Source: FactSet as of 6/30/24

We continue to see the generative Artificial Intelligence (AI) theme resonate, including in the stock value of the semiconductor industry and NVIDIA, which is up 150% year to date. These are deemed the “picks and shovels” providers to support the AI processing infrastructure. In addition, AI computing uses a large amount of electricity to power all these data centers, and the utility grid suppliers are seen as beneficiaries of AI demand. The AI investment boom is a key support for the stock market. Microsoft, Alphabet, and Amazon dominate cloud computing and enjoy tremendous free cash flow to support more than $200 billion in annual capex spending on the promise of AI’s future profitability.

AI will eventually automate many manual functions, coding, and analytical processes, but it may take 3-5 years before we see the eventual returns on these initial investments. We notice that most IT departments are not increasing their total IT spend rates but are diverting expenditures away from other initiatives to support AI investment. Therefore, AI spending seems to be supporting the current market valuations and expected earnings growth.

Chart 2: A Few AI Stocks Account for Majority of Market Returns During Past Two Years



Source: FactSet as of 6/30/24

Halfway through 2024, we want to frame some potential concerns:

Can the markets continue to rise solely on expectations for these few companies?

Will the performance of the remaining S&P 500 stocks catch-up to the leaders (a positive outcome) or will these leaders come back down to earth (a negative outcome)? The economy continues to expand faster than consensus estimates. Most companies' profits are heavily affected by the economic backdrop, and general economic conditions remain favorable. Our job is to assess the weather ahead, and labor growth has been very resilient but is softening. The unemployment rate remains low but is slowly moving up, and wage growth is trending down. We are not seeing any layoffs yet or rising unemployment that would be warning signs for the economy.

Chart 3: US Wage Growth Trending Downwards While Unemployment May Be Trending Higher

Source: Bloomberg, Federal Reserve Bank of Atlanta, Bureau of Labor Statistics as of 6/30/24

The housing market remains tight with low inventory but also low turnover, while affordability continues to struggle from high mortgage rates. Housing affordability rapidly deteriorated in 2021-2022 with a surge in home prices and a steep rise in mortgage rates.

Chart 4: Housing Affordability for Median Households Deteriorate to Pre-GFC Levels

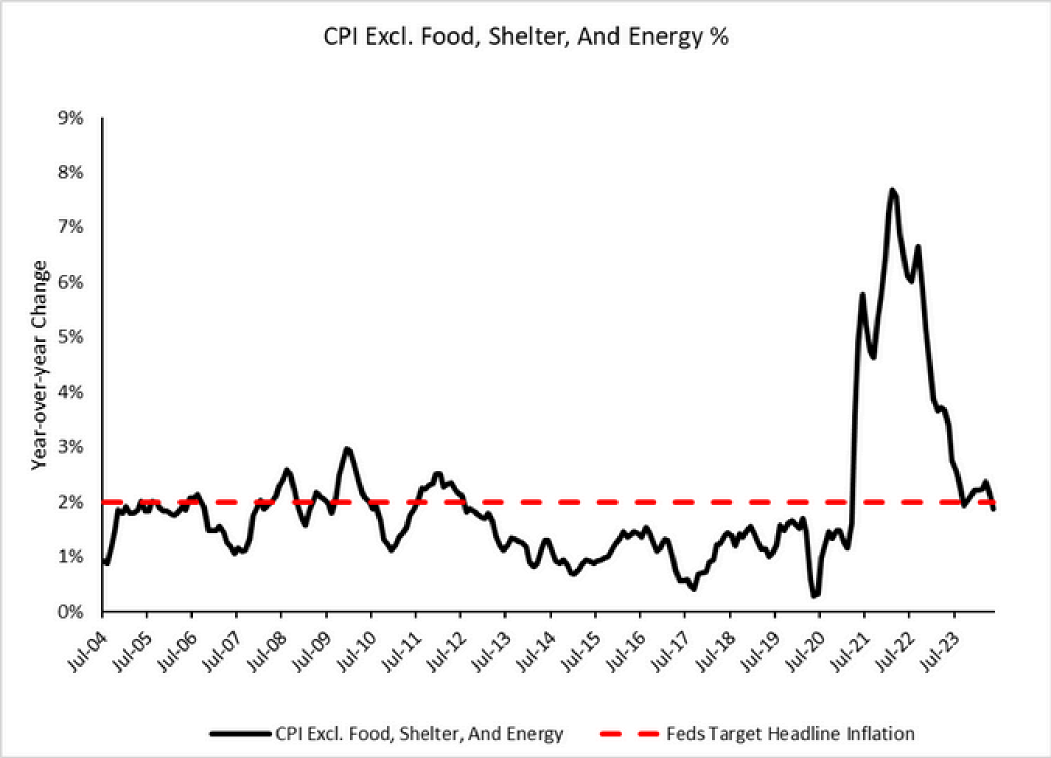
Source: Bloomberg as of 6/30/24

Geopolitics remain stressful.

Global tensions are rising in Europe, Asia, and the Middle East, and overseas economies remain relatively weak. Tariffs and trade policy are shifting from economic tailwinds to headwinds. For almost two decades, the world economy remained reliant on growth and innovation in the US, but Covid supply chain problems are leading many companies to shift their offshore strategies and rebuild plants in the US. China's push to exports products is adding to trade tensions and will likely lead to higher tariffs and other restrictions from the US and Europe, impacting regional frictions, immigration, and energy policies.

Inflation continues trending down, with the core measure (excluding food, energy, and shelter) back near the 2.0% Federal Reserve target. The risks facing the economy are now balanced between inflation and unemployment, and many central banks are already cutting interest rates. However, economic factors have a momentum of their own, and once unemployment begins to rise, a recession becomes increasingly likely. Thus, there is growing pressure for the Federal Reserve to lower interest rates in September.

Chart 5: Inflation Still Trending Lower



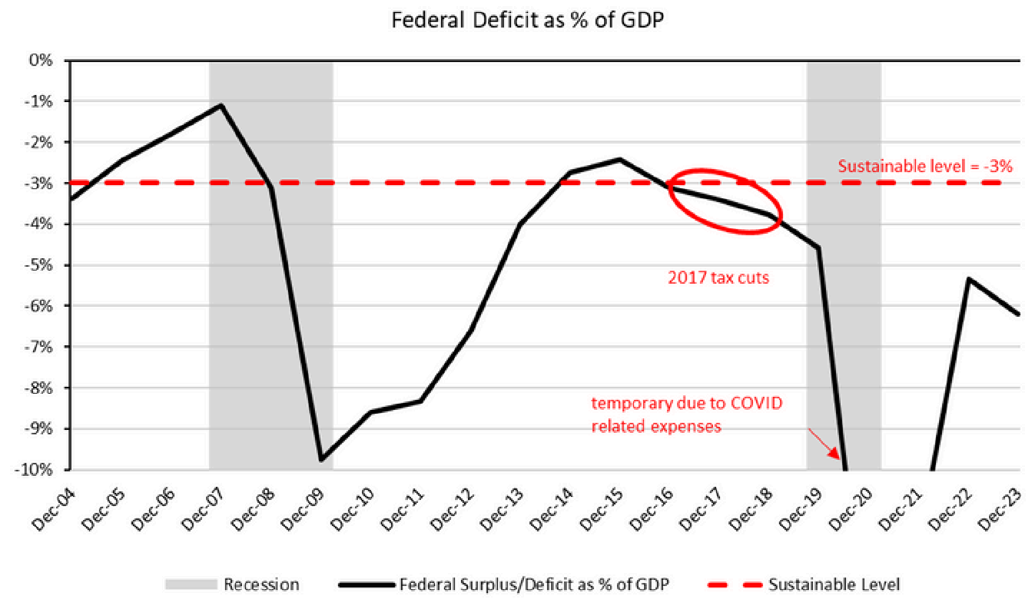
Source: FactSet as of 6/30/24

Political turmoil everywhere?

We are seeing dramatic changes from 2024 elections in the UK, France, and probably the US. Immigration concerns remain very high in Europe and North America, with political parties divided on policies and cultural challenges. Geopolitical tensions are also dividing into rival East versus West positions, with the Ukraine war entering its third year and China pressuring the Philippines and Taiwan in the South China Sea, which may exacerbate trade tensions or lead to more direct conflict between the US, Russia, China, Iran, and North Korea.

From a policy perspective, if former President Trump returns, this will likely lead to a more isolationist US Foreign Policy and higher trade/tariff tensions, while extending the tax cuts set to expire in 2026. It is especially hard to forecast this election's impact on the economy and potential legislative initiatives next year. We have highlighted in past discussions that current budget deficits as a % of GDP are very elevated. Our Federal debt is financed by overseas investors and their confidence in the US dollar currency value. Future administrations will have to wrestle with both spending cuts and likely tax increases to bridge a more sustainable federal spending budget, while the chart below illustrates that a sustainable federal deficit is about 3% of GDP. This leads to declining debt to GDP ratio when nominal GDP growth exceeds 3%, which is considered an appropriate long term target for the United States (nominal GDP growth was 5.4% for Q1, 2024). You can also see the impact of the 2017 tax cuts altering the fiscal stability in the chart below. At present, neither candidate has outlined a real path to achieving a more sustainable budget picture. We anticipate that this challenge may be more of a focal point in 2028 and beyond.

Chart 6: US Federal Deficit Remains Above Its Sustainable Level



Source: FactSet, Federal Reserve Bank of St Louis as of 12/31/23

This election season is especially contentious, but so far, investment results do not reflect these concerns. Generally, stocks do well in an election year as uncertainty is removed in early November.

Chart 7: S&P 500 Election Year Returns

Election Year	Winner	Party	Incumbent Party?	Return (%)
1960	Kennedy	Democratic	Challenger	0.5%
1964	Johnson	Democratic	Incumbent	16.4%
1968	Nixon	Republican	Challenger	11.0%
1972	Nixon	Republican	Incumbent	19.0%
1976	Carter	Democratic	Challenger	23.8%
1980	Reagan	Republican	Challenger	32.4%
1984	Reagan	Republican	Incumbent	6.2%
1988	Bush I	Republican	Incumbent	16.6%
1992	Clinton	Democratic	Challenger	7.6%
1996	Clinton	Democratic	Incumbent	23.0%
2000	Bush II	Republican	Challenger	-9.1%
2004	Bush II	Republican	Incumbent	10.9%
2008	Obama	Democratic	Challenger	-37.0%
2012	Obama	Democratic	Incumbent	16.0%
2016	Trump	Republican	Challenger	12.0%
2020	Biden	Democratic	Challenger	18.4%

Source: Cetera Investment Management, FactSet, Standard & Poor's as of 12/21/23

We remain cautious optimists, but the economy is slowing, and the shifting presidential election dynamics are entering uncharted waters. Given the current conditions, we still think owning stocks in line with your strategic target is an appropriate baseline. However, we will be monitoring unemployment, inflation, and key leading economic indicators, while waiting for the bumpy election outcome.

We look forward to hearing from you, and please reach out with any questions. We look forward to updating you on your portfolio and on our outlook for the next year.

Best regards,
The ChoateIA Investment Team

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If you have any questions, please contact your Choate Investment Advisors team.

Lanny Thorndike	617-248-4062	lthorndike@choateia.com
Tamer Alamuddin, CFA	617-248-4822	talamuddin@choateia.com
Henry Dormitzer	617-248-2123	hdormitzer@choateia.com
Diana B. Malcom	617-248-4778	dmalcom@choateia.com
Erin Kerr, CFA	617-248-4716	ekerr@choateia.com
Jake Kidder CFA	617-248-4038	jkidder@choateia.com
Alison Svizzero	617-248-4882	asvizzero@choateia.com
Jessica C. Welch, CFP	617-248-4875	jwelch@choateia.com
Christine Wright, CFP®	617-248-2125	cwright@choateia.com
Harrison Odaniell, CFA	617-248-4901	hodaniell@choateia.com
Jonathan M. Bentley, CFA	617-248-4925	jbentley@chaoteia.com
Benjamin P. Lewis, CFA	617-248-4808	blewis@choateia.com
Dennis Maier	617-248-4033	dmaier@choateia.com
Louis Marchant	617-248-5105	lmarchant@choateia.com
Kelsey Sullivan	617-248-4707	ksullivan@choateia.com
Malik Daley	617-248-4841	mdaley@choateia.com
Hideyoshi Watanabe	617-248-2112	hwatanabe@choateia.com
Deven Swim	617-248-4842	dswim@choateia.com
Joseph M. Sicilian	617-248-4063	jsicilian@choateia.com
Nicole F. Gagliardi	617-248-5120	ngagliardi@choateia.com
Courtney King	617-248-5258	cking@choateia.com
Max Sands	617-248-5038	msands@choateia.com
Andrew Burnside	617-248-4016	aburnside@chaoteia.com
Brian Suitor	617-248-2119	bsuitor@choateia.com
Kara Hayhurst	617-248-4070	khayhurst@choateia.com

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The S&P 500 is the Standard & Poor's Composite Index of 500 stocks and is a widely recognized unmanaged index of common stock prices.

The Bloomberg US Aggregate Bond Index is an unmanaged index that covers the investment grade fixed rate bond market index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities.