



2024 FALL INVESTMENT OUTLOOK

The global economy and financial markets finally received the long-awaited Federal Reserve interest rate cut on September 18th with the central bank lowering its benchmark federal funds rate by 50 bps to a new range of 4.75%-5.00%. It has been a while coming, the second longest period in 70 years in between Fed rate cuts and the first reduction since March 2020.

Equity markets experienced the most acute bouts of volatility of 2024 in the third quarter leading up to this policy shift. The headline S&P 500 declined 8.5% from mid-July to early August as it became more evident that the labor market was slowing, shifting the balance of risks between the central bank's dual mandate of stable prices and maximum employment. Recent inflation readings have been accommodating as have forward-looking, market-based measures such as commodity prices. The core PCE price index is up 2.6% y/y (a multi-year low) and has risen just 1.7% on a 3-month annualized basis, nearing the Fed's 2% target. Broad commodity prices declined 6% over the summer months with crude oil and copper prices exhibiting particular weakness, until recently. Thus, with the risk to growth rising and the risk to inflation receding, it was time for the Fed to shift its policy regime in its eyes.

The third quarter saw investors front-running the Fed rate cut with broad Treasuries rallying 5.0% and the aggregate bond market appreciating 5.5%. Two-year Treasury yields declined 114 bps to a current 3.61% and the benchmark 10-year yield fell 61 bps to 3.79% since July 1st. Equity investors seemed to be a little more discerning throughout the summer as defensive sectors such as utilities and consumer staples outperformed technology and communication services, which are modestly in the red quarter-to-date. Such a sector rotation could be reflective of weaker economic growth prospects in the near term.

However, slowing growth is not the same as a recession and some equity market internals reflect the growing optimism of a potential soft landing should the Federal Reserve deliver an additional 150 bps of interest rate cuts by the end of next year and before the economy gets off-track. The average stock (per the S&P 500 Equal Weight Index) has returned +8.1% in the third quarter compared to the +5.1% return of the top-heavy headline index and the +1.4% return of the FANG+ index of megacap tech stocks. This improvement in so-called breadth could reflect investor hopes that fundamental strength can re-emerge across the broader economy aside from a narrow industry group like AI-related equities.

2024 YTD Total Return

	<u>9/25/24</u>	<u>% Change</u>
Dow 30 Industrials	41,915	+12.8%
S&P 500	5,722	+21.2%
NASDAQ Composite	18,082	+21.1%
MSCI ACWI ex-USA	348	+12.8%

Outlook

As the fourth quarter of the year soon commences, both bulls and bears have some narratives to hang their hats on. From the bull's perspective, the US macro backdrop remains generally supportive. Although payroll growth and consumption are slowing and excess pandemic savings is dwindling, real wages are rising once again as prices disinflate. Energy prices are lower than a year ago and the wealth effect from rising asset prices continues, putting the consumer on relatively solid footing overall. Recession risks remain low in the very short run, especially with the Fed initiating its rate cutting cycle. Excess liquidity (defined as money growth that is greater than GDP growth) is ample and still rising, supported by the recent interest rate cuts and a weaker dollar (down 5.1% since mid-April). Although mega cap tech stocks have taken a breather in the third quarter, the stock market rally seems to be broadening to other sectors/industries where earnings are generally fine, which is a healthy shift.

From the bear's perspective, one could argue that valuations are historically stretched and only higher in the late 90s bubble. The thesis on AI stocks has been tested more vigorously recently, with some related equities falling sharply as growth slows sequentially and investors question the timing of an economic payoff from the new technology. Employment is softening and inflation may not continue to fall at the same trend as the middle of the year. The Treasury curve has disinverted across many maturities, a signal that has historically meant the economy is weaker than it seems. Other parts of the globe remain lackluster. Eurozone GDP is expected to expand at just a 0.3% rate in the back half of the year and China is struggling to emerge from its post-Covid doldrums. Geopolitics seem less stable with wars on multiple fronts and adversaries challenging U.S. hegemony. Policy uncertainty is likely to persist until the conclusion of what is likely to be a very tight US general election.

The Federal Reserve is embarking on an interest rate cutting mission at a time when the unemployment rate of 4.2% has rarely been lower and broad financial conditions have almost never been looser (as proxied by an index of bond yields, credit spreads, stock prices, etc.). The Fed's so-called dot-plot projects an additional 150 bps of cuts at the moment, potentially reaching a range of 3.25%-3.50% by the end of 2025. Derivative markets are assuming even more aggressive cuts by the end of next year with fed fund futures pricing more than 200 bps of downside in the policy rate to 2.8%. Such easing is normally only seen in hard landing/recession occasions. Perhaps the biggest risk is that the Fed now stimulates an economy that is not yet sufficiently cooled since the previous rate hikes have had a remarkably dull impact to date for various reasons, risking a re-stoking of inflation that has yet to officially hit the Fed's 2.0% threshold.

While the labor market has definitely cooled, layoffs remain quite low and payroll growth is essentially reaching an equilibrium point between supply/demand and accommodating population growth at a forecasted average of 125k monthly additions over the next year or so. According to Deutsche Bank, most of the progress made on inflation over the past year has come from the supply side of the economy; demand-driven contribution to core prices has actually increased in 2024 by its calculation. Should the labor market stay where it is, aggregate demand could remain steady and further progress on disinflation may be hard to come by, leading the Fed to not cut rates as deeply as priced by markets (which would probably negatively impact risk asset prices). This could happen at a time when the so-called base effects in the fourth quarter become more challenging to statistically show the same progress on inflation that has been made over the past two quarters.

Historically, the central bank has needed a recession (if even a modest one) to complete the final mile.

A few of the more reputable names in finance remain skeptical of a so-called soft landing for the economy. Speaking at an event on September 20th in Washington, Jamie Dimon of JPMorgan Chase said, "...I wouldn't count my eggs on that outcome. I am a little more skeptical than other people. I give it lower odds. I hope it's true, but I'm also more skeptical that inflation is going to go away so easily," citing drivers including deficit spending and the remilitarization of the world.

Former Treasury Secretary Larry Summers opined on September 19th on Bloomberg that "the risks of actually going as far with monetary policy as the Fed seems to think that it will are pretty significant in terms of having an increase in inflation. Should inflation pressures reemerge, then you won't see interest rates go down as much as officials predicted in their so-called dot plot." He also cautioned that the Fed is underestimating the neutral rate, which is the long run rate at which the central bank sees its benchmark as consistent with maintaining 2% inflation. Summers said higher fiscal borrowing and major investments in areas like renewable energy indicate a higher neutral rate of at least 4% compared to the Fed's latest projection of 2.9%. This has implications for the longer end of the Treasury yield curve, too, and hence mortgage rates.

While commodities declined over the summer months and gave the Fed a pass to start cutting interest rates, that trend reversed sharply once it was leaked in the media that policymakers intended to cut by 50 bps at their September 18th meeting. The Bloomberg Commodity Index is up nearly 8% the past two weeks driven by broad gains in crude oil, copper, and gold. Such a trend bears watching and could be a sign of investor concerns around further gains on inflation. A weaker dollar makes commodities less expensive in foreign currencies and has historically led to an uptick in demand outside of a recession.

Gold in particular has done well in 2024, rising 26% since the end of February and 12% since its late July low in anticipation of interest rate cuts (and alongside a declining US dollar where its correlation over the past four months has been highly negative at -0.91). Since 2000, gold prices tend to rise 6.3% for every 25 bps reduction in the fed funds rate, according to Bloomberg data. While the metal could take a near term breather as the market discerns the Fed's ultimate path on rates, it has a history of faring well when the economy is most in distress.

Chinese authorities unleashed the most substantial stimulus to date this week to address its beleaguered economy, which has experienced five straight quarters of declining prices per its GDP deflator and the longest streak of deflation dating back to 1993. The PBOC cut its main policy rate, lowered the required reserve ratio for banks, and increased liquidity support for a variety of investors and consumers in the troubled property sector and local stock market. Fiscal leaders also intend to issue \$284 billion in government bonds, which will be evenly split between stimulating consumption and helping local governments tackle debt problems, per a Reuters report. Delivery of such stimulus all at once is highly unusual compared to the recent piecemeal approach and the magnitude of measures are likely the greatest since 2015 when the country experienced a slowdown in its trend growth rate as well as a stock market crash.

With most major central banks now cutting rates in unison, Bloomberg measures of both global financial conditions and excess liquidity are rising sharply and portend a potential pickup in global economic activity and further stock market gains based on their historical 6-9 month leads. As well-known Wall Street strategist Ed Yardeni noted following last week's Fed rate cut, the latest

policy decision lifted the odds of an “outright melt-up” in equity prices. “If they overheat the economy and create a bubble in the stock market, they’re creating some issues,” he noted. That is because the stock market is more expensive now than it has ever been at the start of an easing cycle during the modern Fed era. The Goldman Sachs Financial Conditions Index is already back to April 2022 levels and easier than anything observed between 2000-2016, according to the Bloomberg macro team. That makes it seem unlikely that the full array of interest rate cuts forecasted by the Fed and currently priced by derivative markets will be necessary, which raises questions about the sustainability of equity valuations.

Aside from accommodative financial conditions and rate cuts, the market could pause at some point ahead of the upcoming 2024 general election given the policy uncertainty that exists around the outcome. The Electoral College map makes it a very narrow contest with the states of Pennsylvania, North Carolina, and Georgia likely determining the outcome, where the difference between the candidates in 2020 was an average of 55,000 votes.

The federal government has the greatest need for lower interest rates given the burgeoning budget deficit. Interest payments on the U.S. debt have already surged to 15% of revenue from 10% in just two years, but both candidates are proposing policies that could trigger inflation and increase the deficit. As Simon White from the Bloomberg macro team succinctly notes, “Policy tightening is supposed to re-install some discipline to markets and the economy. Yet there is an irony that the most flagrant transgressor of fiscal rectitude — and the one being given a free pass by the Fed to continue in its free-spending ways — is also the greatest danger to a resurfacing of inflation.” The most likely outcome of the election at the moment based upon recent polls seems to be a continuation of split government, which may be best for investors as to ensure the fight over federal finances remains vigorous.

Investment Conclusion

As always, we remain committed to the prudent decision-making that drives our long term results. Sometimes that means trimming or exiting investments when the market offers a great price for capital protection, as we have done in some cases recently. With many stock indices achieving new all-time highs there is a dearth of new stock investments at the moment in the high quality universe in which we participate. Nonetheless, our steady and regular due diligence prepares us should opportunities present themselves during the upcoming third quarter earnings season, when stock prices can often be volatile and longer run fundamentals quickly mis-priced based on short term results. While Treasury yields have moved sharply lower into the 3.5%-3.6% range, we are still finding attractive yields and spreads in investment grade corporate bonds where we can widen the maturity of our bond portfolio to lock-in solid income over multiple years ahead of the Fed’s interest rate cuts.

September 26, 2024