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THIRD QUARTER 2024 REVIEW

Investors entered the third quarter anticipating signs that inflation would sufficiently cool to allow the Federal Reserve Bank to begin cutting interest rates. Economic data soon supported this outlook, with softer employment figures and easing inflation pressures. The surprise jump in the unemployment rate reported in early August persuaded investors that the central bank risked labor market instability unless it began easing policy. On cue, the Federal Reserve delivered a half percent cut at its September meeting. The futures market expects the central bank to provide additional interest rate cuts in November and December. This environment has fueled optimism that the Federal Reserve pivot exemplifies exquisite timing; with inflation slowing, the economy and equity market now have interest rate cuts as a valuable tailwind.

The broad equity market saw a steady climb through July despite a loss of momentum in technology stocks, which turned lower. This change allowed value stocks and small-cap shares to gain ground, marking a long-anticipated market rotation. However, a sharp downturn in August, driven by renewed recession concerns and the rapid unwinding of large positions in Japan, caused the market to drop by 8.5% before recovering. Despite this setback, equities rebounded and closed the quarter with a 5.9% gain in the Standard & Poor’s 500 Index, showcasing the resilience and adaptability of the market.

While it's too early to determine if the central bank will achieve an economic soft landing, the odds have improved. However, the economic landscape is not without its challenges. Select economic data, such as consumer spending and wage growth, are mixed. Moreover, rising global risks could affect the U.S. market, including geopolitical tensions and slowing growth in major economies like China. Finally, if inflation proves more stubborn than expected, the Fed may be forced to reconsider its rate-cutting trajectory, potentially disappointing equity investors.

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ECONOMY

Overwhelming fiscal and monetary stimuli have supercharged the normal business cycle. Excess pandemic savings, historically low average mortgage rates, and massive government transfers aided the consumer in deflecting the full brunt of the rate-tightening cycle. The largely supply-driven inflation has moderated, with shelter remaining the primary culprit of upward price pressure. The Federal Reserve is now in an advantageous position, with the war on inflation presumptively won in the near term; the central bank has ample room to support the economy through easing monetary policy. However, cracks are evident in lower-income households. With rent and food prices up 20% to 25% from three years ago, it is unsurprising that a recent consumer survey by Affirm indicated three in five consumers believe the U.S. is currently experiencing a recession.

At its July meeting, the Federal Reserve left interest rates unchanged at a 23-year high. However, weaker jobs data in August and a rise in the unemployment rate from 4.1% to 4.3% sparked concern that the Fed may already be behind the curve in reducing interest rates. September marked the first time since the 1980s that the central bank delivered a half a percentage point cut outside of a recession or crisis. The supersized interest rate cut signals that the Federal Reserve recognized the risk of weakening labor demand. Members of the Federal Open Market Committee also sharply lowered their forecast for interest rates next year, signaling aggressive monetary easing is on the horizon.

Liquidity in the form of expanding money supply and lower borrowing costs are easing monetary conditions beyond the Fed's initial interest rate cut. Market interest rates have moved in anticipation of the Fed's long-expected rate cut in September. The 2-Year Treasury rate has fallen by roughly 1.5% since peaking at 5.0% in April. While credit card rates remain incredibly high, the mortgage rate is the most important interest rate for consumers. Thirty-year mortgage rates can be thought of as the yield on the 10-Year Treasury rate plus a risk premium. The risk premium is considerably larger when interest rates are rising and narrows when interest rates are falling. Therefore, mortgage rates could fall much faster than the corresponding decline in the risk-free rate. It is unsurprising to see mortgage refinance activity triple in recent months, albeit from very low levels.

Aggressive monetary easing will make it easier for companies, including many so-called "zombie" firms that cannot generate enough income to cover their debt payments, to continue borrowing. These firms remain afloat due to the historically low risk premiums and continued access to credit, but they pose a

threat to the market if economic conditions worsen. Over 30% of Russell 3000 companies are classified as zombie firms, representing $1.26 trillion in debt.

There is a low probability of a U.S. recession occurring in the next few months, but predicting beyond that time horizon is highly challenging. Recessions are often thought to evolve smoothly, but history teaches us that they result from abrupt events, which compound long-term forecasts. Recessions tend to shift suddenly between low and high probabilities.

There is anecdotal evidence that some businesses are pausing important decisions until after the November elections. Regardless of who wins the 2024 presidential election, we remain concerned over the level of deficit spending in the economy. If the Republican candidate wins, increased military spending and proposals to cut taxes could significantly add to the national debt, particularly if economic growth does not rise enough to offset the loss in revenue. On the other hand, a Democratic victory could also inflate the deficit through expanded social programs like health care, infrastructure, or education, which may require additional government borrowing. Both parties appear intent on relying on fiscal policy for specific initiatives, straining the federal budget. Furthermore, bipartisan interest in maintaining entitlement programs like Social Security and Medicare, especially as the population ages, is another factor likely to pressure the deficit regardless of the election outcome.

MARKET

The Standard & Poor's 500 Index ended the third quarter at a record high. Encouragingly, the market broadened as it reached new heights. More than 60% of companies in the Standard & Poor's 500 Index outperformed the benchmark in the third quarter, compared to around 25% in the year's first half. As measured by the equal-weight Standard & Poor's 500 Index, the average stock outperformed the Standard & Poor's 500 Index by 3.7% during the quarter.

Combining the most compelling investment narrative of the past quarter century, AI, with the singularly unique business cycle, has produced some very peculiar equity market dynamics. For example, from the beginning of 2023 through the first quarter of 2024, the Standard & Poor's 500 Index returned 40% with a mere 6% earnings growth. However, if you exclude the "Magnificent Seven," the market return was only 19%, but more importantly, the earnings of the remaining "Other 493" fell by 2% (Magnificent Seven: Alphabet, Amazon, Apple, Meta Platforms, Microsoft, NVIDIA, Tesla).

The more cyclical portions of the Standard & Poor's 500 Index, such as Consumer Discretion, Industrials, and Materials, are forecast to see earnings growth accelerate into the mid-teens next year. More cyclical areas of the economy should also benefit disproportionately from falling interest rates. Earnings growth for the Other 493 is expected to accelerate from 4% this year to 12% in 2025. Closing the earnings growth rate gap between the Magnificent Seven and the Other 493 should allow the market to continue to broaden.

The equity and bond markets are currently painting diverging pictures of the economic outlook. Federal funds futures are signaling that the Federal Reserve will further cut interest rates by 2% by next September, implying that bond investors expect a significant economic slowdown or recession that would necessitate aggressive monetary easing. This contrasts starkly with the equity market's optimism, where expectations for 2025 earnings growth remain a robust 14%. This suggests that stock investors anticipate resilient corporate profits driven by brighter economic conditions. The disconnect between these two markets underscores the uncertainty in forecasting economic growth, inflation, and monetary policy, as equities expect a continued expansion while bonds seem to brace for an economic downturn.

Perhaps the most significant risk to the current bull market is complacency. The conditions that currently underpin the bull run - lofty earnings multiples on accelerating earnings growth, record operating margins, and Gross Domestic Product (GDP) growth above potential - are a very strong hand for investors to hold. The natural assumption is that the status quo remains in place, and increasing equity allocations are the best path for wealth accumulation. However, there is reason to dampen equity market return expectations. The current bull market will turn two years old on Columbus Day, and the third year of bull markets has historically seen enthusiasm wane. Since 1949, the median return for the twelve bull markets in their third year is 4.4%. Five of the twelve bull markets did not see their third anniversary. Of the casualties, four of the five bull markets that did not survive fell victim to monetary tightening, while the European sovereign wealth crisis and U.S. credit downgrade in mid-2011 claimed the fifth bull market. With the Federal Reserve easing monetary policy, the most significant risk to the economy is likely an exogenous shock, such as the price of oil jumping well above $100 or resurgent inflation.

CONCLUSION

A credit crunch has historically brought about the end of economic expansions amid a period of monetary tightening that escalates into a full credit crunch and eventual recession. With the Federal Reserve moving in September to ease monetary conditions, the odds of a near-term downturn have declined significantly, especially as key economic data, including GDP, personal income, Gross Domestic Income, and personal

savings, were recently revised meaningfully higher. In addition to these positive revisions, continuing solid economic data will likely bring into question the amount of interest rate cuts reflected in the forward curve.

The Standard & Poor's 500 Index's year-to-date return of 22.1% has been driven by roughly equal parts earnings growth and Price/Earnings expansion. The Standard & Poor's 500 Index trades for 21.4X earnings with high yield credit spreads—a key determinant of earnings multiples—at historically tight levels. In our view, it would be unlikely to see the earnings multiple expand further, thus bringing earnings growth into sharp focus. Based on our conversations with corporate management teams, the current expectation of 14% earnings growth for 2025 appears high. Any shortfall from this lofty growth expectation could be a headwind for the equity market.

*FINANCIAL MARKET TOTAL RETURN**

	Third Quarter 2024	**Nine Months Ending 09/30/24**	**One Year Ending 09/30/24**	**Annualized Return Two Years Ending 09/30/24**	**Annualized Return Three Years Ending 09/30/24**	**Annualized Return Five Years Ending 09/30/24**
Standard & Poor's 500 Index	5.89%	22.08%	36.35%	28.77%	11.91%	15.98%
Russell 2000 Index	9.27%	11.17%	26.76%	17.51%	1.84%	9.39%
Value Line Composite Index	7.05%	6.40%	17.82%	14.79%	0.81%	5.73%
Dow Jones Industrial Average	8.72%	13.93%	28.85%	23.92%	9.97%	11.78%
Nasdaq (OTC) Composite	2.76%	21.84%	38.70%	32.22%	8.87%	18.84%
Bloomberg Gov't/Credit Intermediate Bond Index	4.17%	4.68%	9.45%	5.76%	0.17%	1.26%

* *Total Return Includes Income*

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