Q3 Market Review

The Broadening Continues

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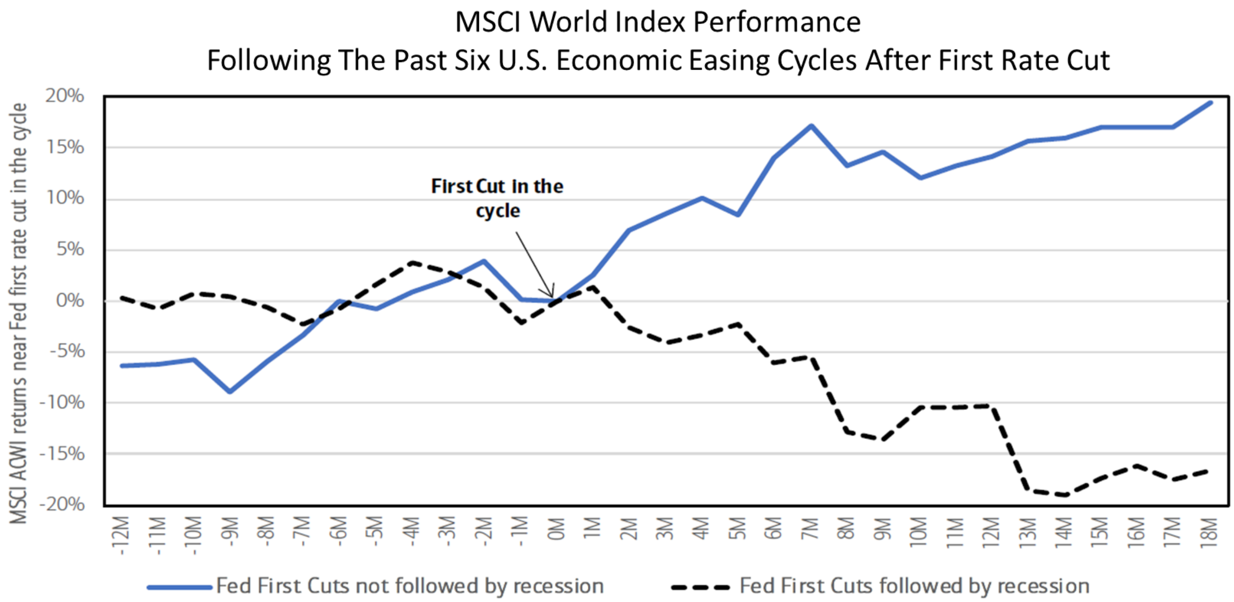
U.S. equities advanced to new highs during the third quarter. Despite the volatility in late summer, the market surged following the Fed's announcement of their long-anticipated rate cut and China's introduction of a new economic stimulus package. The S&P 500 closed out the third quarter with a total return of +5.9% and +22.1% year-to-date. This performance marks seven of the past eight quarters that the S&P 500 index has finished higher than anticipated which, thus far, has disproven many bearish investment strategists who were convinced that a 2024 recession was imminent. The 3rd quarter also saw a continued broadening of sector participation. Nasdaq reported that ten of the eleven large cap sectors finished with a total return that was higher than expected in Q3. Sector performance was led by Utilities, (+19.4%), REITs (+17.2%), Industrials (11.6%), Financials (+10.7%) and Materials (+9.7%). Energy (-23%) was the only sector in the red but still stands at +8.4% total return year-to-date. Lastly, the "10-2 treasury spread," as shown in *Figure 1,* turned positive for the first time since July 2022. Historically, this has signaled a healthy economic outlook for the coming months. For the fourth quarter, we believe the following themes will influence how we evaluate investment opportunities: 1) The effect that the first rate cut - and future rate cuts – will continue to have on capital markets, 2) Slowing inflation and its impact on U.S. consumer spending, 3) The continued broadening of sector participation beyond the Magnificent Seven, and 4) The outlook for corporate earnings for the remainder of 2024 and into 2025.

Figure 1

The First Cut

"Overall, the economy is in solid shape, and we intend to use our tools to keep it there," an optimistic Jerome Powell stated at the National Association of Business Economics last month following the news of the Fed's first rate cut. Although global equities saw an immediate uptick after the announcement was made, it's difficult to predict how markets will behave over the next few quarters. However, Bank of America's recent analysis of equity performance following the last six U.S. easing cycles may give us some direction. In *Figure 2*, the solid blue line represents the three easing cycles where a recession was averted after the first rate cut. The dotted black line represents the three easing cycles where a recession took place after the first rate cut. In the three cycles where a recession followed the first rate cut, the MSCI World Index fell -10%, on average, over the next 12 months. In the three cycles where a recession was avoided after the first rate cut, the MSCI World Index gained +14%, on average, over the next 12 months. Global Quant Strategist, Nigel Tupper, believes that Bank of America's "indicators of the global cycle are positive, suggesting that the market's response to the most recent rate cut by the Fed could be interpreted as a bullish signal for equities in the coming months."



Moderating Inflation

Figure 3

Final Results for September 2024

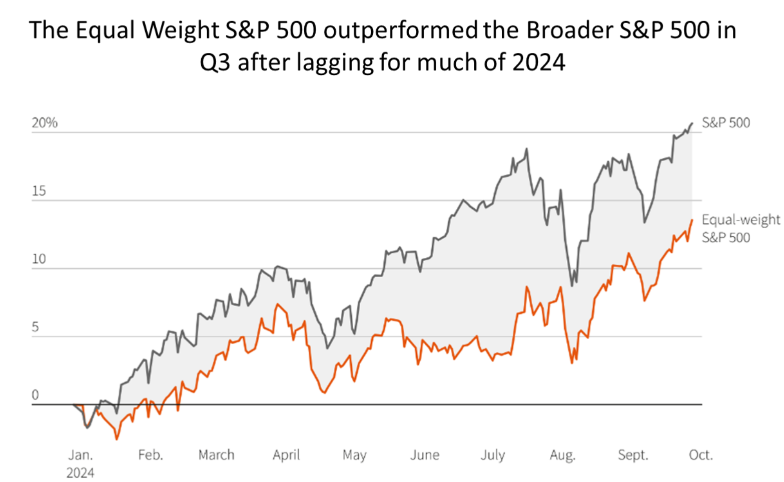
	Sep 2024	Aug 2024	Sep 2023	M-M Change	Y-Y Change
Index of Consumer Sentiment	**70.1**	67.9	67.8	+3.2%	+3.4%
Current Economic Conditions	**63.3**	61.3	71.1	+3.3%	-11.0%
Index of Consumer Expectations	**74.4**	72.1	65.7	+3.2%	+13.2%

Source: University of Michigan, Consumer Sentiment Survey – September 2024

According to the latest University of Michigan survey, positive economic signals are translating to the consumer as well. Per *Figure 3*, consumer sentiment is up +3.3% month-over-month and +3.2% year-over-year as of the publication of their September 2024 report. While the consumer's perception of economic conditions has decreased (-11%) since this time last year, the good news is that it has increased month-over-month (+3.3%) since August demonstrating that they are feeling more optimistic about the economy now than they did earlier in the quarter. Another promising data point is that the expectations index for September is up +13% year-over-year. This may reflect future optimism and that the average consumer is aware that inflation has continued to slow. "While there are some signs that consumers perceive a slight deterioration in labor market conditions, they do not expect it to have substantial effects on the economy," said Joanne Hsu, the survey's director. "Consumers recognize that labor markets have been relatively strong, and they expect that the Fed will step in to prevent unemployment rates from spinning out of control." According to the survey, consumers across all age, income and education groups voiced less concern this month over high prices for durables, vehicles and homes. Consumers also reported feeling optimistic about the outlook for employment.

Broadening Sector Participation

Figure 4



Source: LSEG Datastream

For much of 2024, we have been concerned that market returns were too heavily concentrated in ten, mostly technology, companies. The third quarter, however, saw more stocks meaningfully participate in the S&P 500's run to record highs. According to Reuters, eight of the S&P 500's eleven sectors outperformed the broader index in the third quarter. The Fed rate cut, and potential for future rate cuts, has helped to stimulate investors' interest in Financials (+10.2%), Industrials (+11.1%), and other sectors that often benefit from a healthy economy and low rates. Per *Figure 4*, and more to the point, the equal-weight version of the S&P 500 gained roughly 9.5% during the quarter, relative to the broader S&P 500, which returned a little more than 5.5%. At the same time, the influence of the “Magnificent Seven” on the overall market performance declined from 34% in July to 31% in September (according to LSEG Datastream). "I find it to be quite healthy that tech has kind of consolidated," said King Lip, chief strategist at Baker Avenue Wealth Management. "We're not in a bear market for tech by any means, but we've definitely seen some evidence of a rotation." Heading into Q4, we anticipate seeing a continuation of this trend as we believe that long-term investors may have an opportunity to invest in high-quality stocks across multiple sectors.

Earnings Outlook

Ed Yardeni, President of Yardeni Research, remains bullish on earnings but has waived a caution flag. Yardeni continues to see inflation as an issue and feels that continued steep rate cuts by the Fed could potentially lead to an unsustainable market melt-up. "I think that by cutting rates by 50 basis points and by indicating they want to do more – based on some of their recent comments – they risk overheating a warm economy. The economy's doing quite well." Although Yardeni has raised the risk of a melt-up from 20% to 30%, his earnings outlook remains positive. Per *Figure 5*, Yardeni is estimating that Q4 year-over-year earnings growth for the S&P 500 to be at +15.5% versus the

Figure 5

S&P 500 EARNINGS FORECASTS: YRI VS ANALYSTS' CONSENSUS (10/4/24)

Year / Quarter	a / e *	Yardeni Research - Level	y/y%	Analysts' Consensus - Level	y/y%
2021	a	208.1	49.0	208.1	49.0
Q1	a	49.1	48.3	49.1	48.3
Q2	a	52.6	87.9	52.6	87.9
Q3	a	53.7	38.8	53.7	38.8
Q4	a	54.0	26.7	54.0	26.7
2022	a	218.1	4.8	218.1	4.8
Q1	a	54.8	11.5	54.8	11.5
Q2	a	57.6	9.6	57.6	9.6
Q3	a	56.0	4.3	56.0	4.3
Q4	a	53.2	-1.5	53.2	-1.5
2023	a	221.4	1.5	221.4	1.5
Q1	a	53.1	-3.1	53.1	-3.1
Q2	a	54.3	-5.8	54.3	-5.8
Q3	a	58.4	4.3	58.4	4.3
Q4	a	57.2	7.5	57.2	7.5
2024	e	250.0	12.1	241.3	9.0
Q1	a	56.6	6.6	56.6	6.6
Q2	a	60.4	11.3	60.4	11.3
Q3	e	63.0	7.9	61.0	4.1
Q4	e	66.0	15.5	63.9	11.3
2025	e	275.0	10.0	277.3	14.6
2026	e	300.0	9.1	312.9	13.1

* a = actual / e = estimate

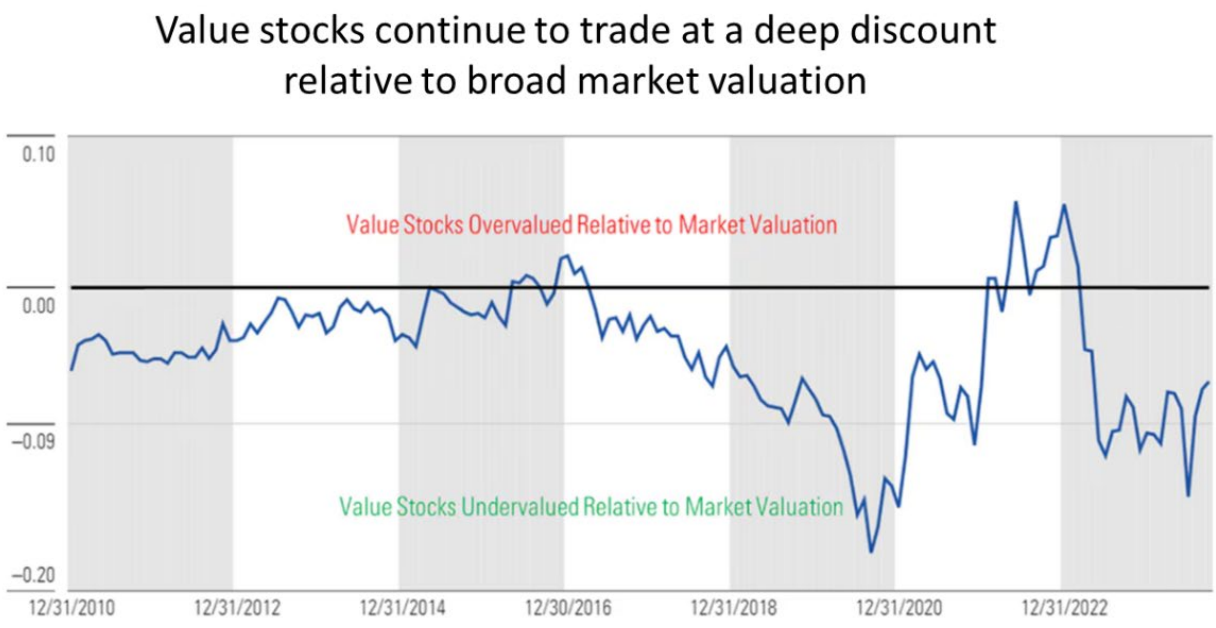
Source: Yardeni Research

analysts’ consensus of +11.3%. His earnings forecasts for 2025, however, are lower than the analysts’ forecasts – at +10% and +14.6%, respectively – as they likely factor in the melt-up risk he’s described. Like Yardeni, many financial commentators also believe that while inflation has slowed, it has not been eliminated as a risk. The combination of a strong job market, low unemployment, rising debt levels, and increased geo-political tensions could all contribute to inflation’s resurgence. Since the Fed has not reached its target goal of 2% inflation yet, central bankers will need to be measured with future rate decisions. As investors, it is important that we do not assume low inflation is inevitable at this point. True, the first rate cut boosted markets in the near term, but risks remain, and we need to be mindful of how this may play out over the long term.

Healthy Volatility

The popular Wall Street narrative for the moment is that a steady U.S. economy, consumer optimism, moderating inflation, and continued rate cuts will serve to provide market tailwinds for investors in Q4. The reality is that this is an election year and timing rate cuts has never been an exact science. Geo-political tensions are growing, and inflation continues to be a risk factor. While we're hopeful that U.S. equities will benefit from the positive economic forces at play, we must anticipate some volatility as well. In our opinion, a continued rotation out of highly valued large cap growth stocks into undervalued large cap stocks would be favorable for diversified investors and the overall health of the equity market. Analysts at Morningstar believe that this scenario has room to run in the fourth quarter and beyond. *Figure 6* represents the deep discount at which value stocks are currently trading (as of September 30, 2024) relative to broad market valuation.

Figure 6



Source: Morningstar, data as of September 23, 2024

As we approach the end of 2024, it is important to remember the resilience of the U.S. stock market. Over the past 50 years, it has endured a lot – including multiple wars, presidential resignations, market crashes, soaring inflation, and deadly pandemics. According to Blackrock, "had you invested $5,000 in the S&P 500 Index in 1974, it would have grown to be worth $1.3 million today." A simple reminder of the benefits of staying invested and the power of compounding returns.

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*GIPS Composite Data and Verification Information Available Upon Request