Q3 24

WEALTH MANAGEMENT QUARTERLY INVESTMENT LETTER

The Season of Change

Quick Look

» While the election dominated headlines, the past quarter also brought about its share of meaningful, non-political events, much of which can be viewed favorably by investors.

» At the September meeting, the Fed opted for the larger 0.50% cut to kick off what appears, by their projections, to be a two-year easing cycle of a cumulative 2.5% in rate cuts.

» The U.S. Treasury yield curve is once again upward sloping, thus ending one of the longer inversion periods in market history.

» Bonds returned more than 5% this quarter, and nearly 12% over the past one year, the highest rolling one-year return for the asset class since 2009.

» U.S. stocks ended the quarter at all-time highs, with expanding market breadth and easing Fed policy.

» The August CPI report showed that year-over-year headline inflation had fallen to 2.5%, its lowest level since February 2021.

» The labor market picture has become murky enough that its risks now appear to be on par with price stability concerns.

» Markets have shifted their focus evenly towards economic growth rather than just inflation, which, in turn, has diminished the correlations between stocks and bonds, a welcome development for balanced portfolios.

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Quarterly Investment Letter, Q3 2024

Election Day is right around the corner, and with one month to go, the race appears as close as any in recent memory. The seven swing states that will decide the election – PA, MI, WI, NC, GA, AZ, and NV - are within two percentage points, according to Nate Silver's polling data. The extraordinary events over the summer – two assassination attempts, Biden's withdrawal and Harris's subsequent appointment, the spectacle of the two debates, etc., have fully consumed the daily headlines.

But during our collective preoccupation with election coverage, there have been material market events afoot, many of which are not election related at all. In the investment realm, this quarter has brought about "meaningful change" that is not just candidate-speak gobbledygook. Let's discuss some of the recent investment-related headlines you may have missed, and their impact on portfolios.

The Fed Cuts Rates: At the September meeting, the Fed opted for the larger 0.50% cut to kick off what appears, by their projections, to be a two-year easing cycle of a cumulative 2.5% in rate cuts. As you may recall, in 2022, the Fed launched an aggressive rate hiking program that raised rates 5.25% in short order to slow the economy enough to stem inflation. Defying their own expectations, inflation has slowed without requiring a concurrent recession. Now, the Fed will attempt to unwind its restrictive policy without reigniting inflation. Metaphorically speaking, the plane is now descending.

U.S. Federal Funds Rate: Easing Cycle Has Begun

Source: Factset

While the hardest part of the Fed's mission appears behind them, it is worth noting that out of the 15 rate-cut cycles that have occurred over the last 50 years, only six did not experience a recession within 12 months of the initial cut. Often, this was because the Fed was too late to take action, as Fed stimulus often has a delayed impact. Fed Chair Jay Powell acknowledged this as their rationale for opting for the half-point cut, saying "You can take this as a sign of our commitment not to get behind."

In terms of impact, borrowers that have home equity or variable interest loans tied to the prime rate should immediately benefit, while rates for auto loans and credit cards should begin to fall from their 20-year highs. For savers, however, it means the days of 5% rates on money market funds and short-term CDs are almost certainly over. It appears closing time for the "T-Bill and Chill" crowd, as investors relaxing on large cash amounts will need to seek other investment alternatives to avoid lower returns.

The Yield Curve Reverts: The yield curve, which plots the interest rates of different maturity U.S. Treasurys, has spent the last two years in a downward sloping shape in which longer-dated bonds yield less than their shorter-dated counterparts. This is known as an inversion and often precedes economic recessions. In September, anticipation of Fed rate cuts helped to push 2-year yields below the 10-year Treasury yields, normalizing, or uninverting, the yield curve.

This is noteworthy as an upward-sloping yield curve suggests an economy returning to normal, thus ending one of the longer inversion periods in market history. Alternatively, the last four recessions all saw the 2s/10s curve turn positive between two to six months before the recession arrived (seen in the chart at the top of the next page in which the gray bars signal recessions). We will see if the curve reversion event becomes yet another previously tried-and-true recession indicator that gets debunked by the resilience of this current economy.

U.S. EQUITY RETURNS (%)

As of 9/30/2024	Q3 2024	YTD Return	1-Year	3-Year	5-Year	10-Year
S&P 500	5.9	22.1	36.4	11.9	16.0	13.4
Russell 1000 (Large Cap) Growth	3.2	24.6	42.3	12.0	19.8	16.5
Russell 1000 (Large Cap) Value	9.4	16.7	27.8	9.0	10.7	9.2
Russell 2000	9.3	11.2	26.8	1.8	9.4	8.8
Russell 2000 (Small Cap) Growth	8.4	13.2	27.7	-0.4	8.8	9.0
Russell 2000 (Small Cap) Value	10.2	9.2	25.9	3.8	9.3	8.2

Source: Morningstar

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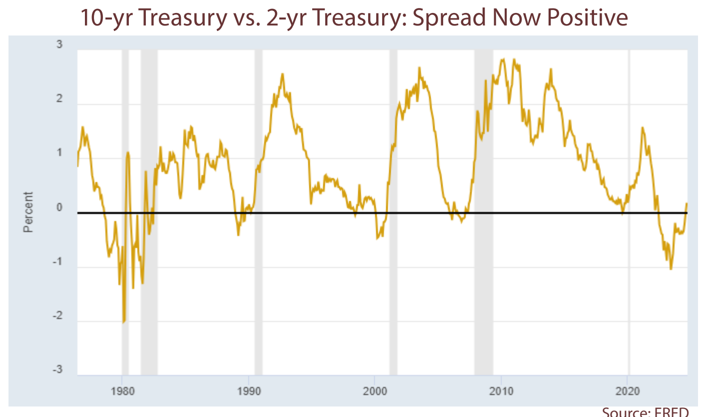
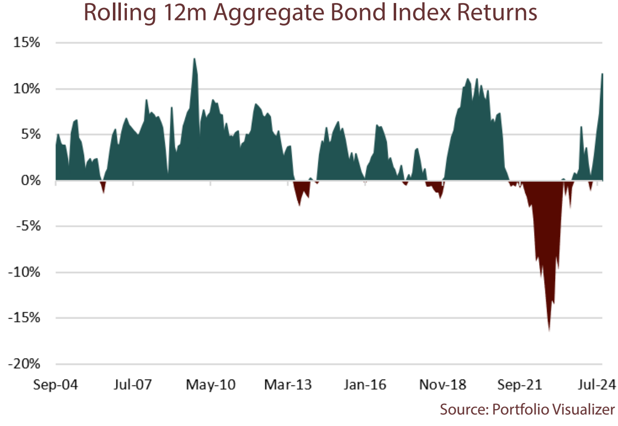
10-yr Treasury vs. 2-yr Treasury: Spread Now Positive



Source: FRED

Bond Returns are Good: It has been a tough couple of years for bond investors; the Aggregate Bond Index ended last quarter with negative annualized returns over the last five years. But this quarter, the fortunes of bond investors turned for the better, as yields fell sharply in anticipation of the Fed's easing cycle. This compression in yields, coupled with already healthy coupons, helped the Agg Bond return more than 5% this quarter, and nearly 12% over the past one year, the highest rolling one-year return for the asset class since 2009.

Rolling 12m Aggregate Bond Index Returns



Source: Portfolio Visualizer

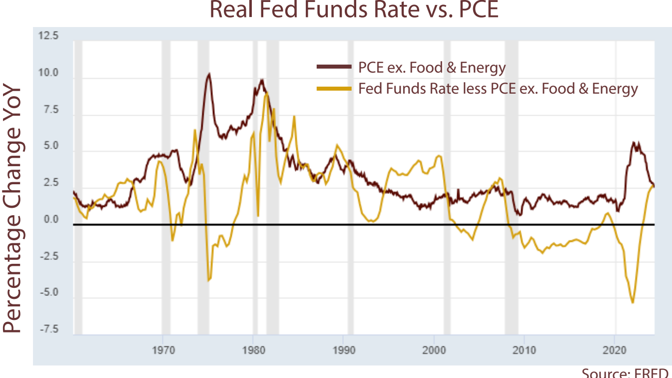
Additional compression in bond yields is far from a given; yields have now already priced in the Fed's expected rate cuts. But with a current yield on the 10-Year at 3.7%, investors can reasonably assume that the next decade of annualized returns should outpace the paucity of the last decade by nearly 2%, which is a welcome development for less risky investors.

Stock Market Gains Become Widespread: U.S. stocks keep humming along, with 43 new all-time highs for the S&P 500 Index year-to-date. Recent quarters saw market gains that were powered almost entirely by a handful of Mega-Cap Tech stocks, but this quarter's gains were made following a different playbook, as expected rate cuts propelled the recent underperformers. Value led Growth, Small-Caps outperformed Large-Caps, and an equal-weighted S&P 500 portfolio outpaced the Magnificent-7.

At quarter-end, nearly 80% of S&P 500 Index members closed above their 200-day moving average. Fundamentally, this coincides with earnings growth coming not just from the Mag-7 stocks, but from the rest of the Index as well. This increased market breadth seems indicative of a healthier and more sustainable bull market.

Inflation Falls Below 3%: The August CPI report showed that year-over-year headline inflation had fallen to 2.5%, its lowest level since February 2021. Food price inflation, which has been a talking point for both parties (via either its cumulative effect or alleged price-gouging), increased just 0.9% in the past year, well down from a peak of 13.5% in August 2022. Core inflation has slowed to 3.2% over the past year, with its firmer number being held up by shelter, an inflation component with a widely known lag. U.S. asking rent prices, which are more timely data, have been declining for 15 straight months, a clear indicator that shelter inflation is poised to continue to fall and likely provide continued support for further disinflation.

Real Fed Funds Rate vs. PCE



Source: FRED

The chart above, which we have discussed in detail in past investment letters, tracks core inflation as the maroon line and the real Fed Funds rate via the gold line. While inflation remains above the Fed's stated 2% target, the real Fed Funds rate ascent from a negative 5.4% at the start of their hiking regime to a positive 2.7% made a case that policy had become too restrictive. Two years ago, we speculated that restrictive policy might be required until the gold line crossed above the maroon line, a point of which has finally been reached.

Cracks in the Labor Market: The once-scorching labor market is showing signs of cooling. Job openings, hiring, and quits rates as a share of employment have all fallen below pre-pandemic levels. The three-month change in the unemployment rate climbed enough this quarter to trigger the Sahm Rule recession indicator, a metric that likely pushed the Fed to pull the trigger on fiscal stimulus (see chart on the next page).

Sahm Rule Historically Procedes Recession

Source: FRED

Other employment measures fare better; the layoff rate remains at record lows, prime-age labor force participation is at a 20-year high, and four-week average initial jobless claims declined over the quarter. But the labor market picture has become murky enough that its risks now appear to be on par with price stability concerns.

The Yen Carry Unwind: For more than a decade, the U.S. Dollar has been strengthening versus a basket of major currencies, fueled in recent years by interest rate differentials, particularly versus Japanese Yen. Ultralow rates in Japan made it attractive for investment strategies to borrow in yen, and then capture the carry by converting into higher yielding currencies or other risk assets, often using leverage.

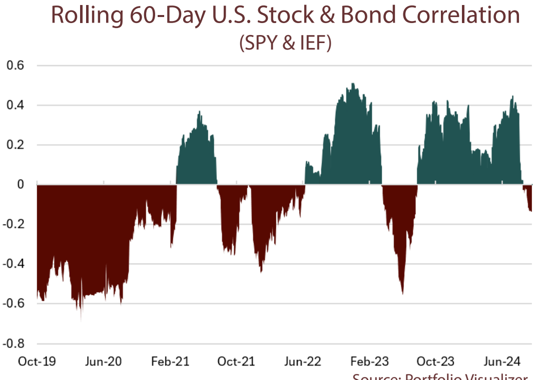
Japanese Yen to U.S. Dollar

Source: FRED

The fortunes of this strategy changed abruptly when the Bank of Japan made a surprise rate hike in front of imminent Fed rate cuts and a weak payrolls report, causing a major rally in yen against the U.S. Dollar. Investors who had borrowed yen were suddenly hit with margin calls, forced to buy yen, which begat more margin calls. The unwind sent major ripples throughout financial markets, including an 8% drawdown in U.S. stocks in August. Markets quickly recovered once trades were closed and leverage removed, even as the yen continued to strengthen throughout the quarter. Time will tell if the event was just a blip, or a meaningful trend towards a weaker dollar.

In summary, while all have been engrossed by the twists and turns of the political theatre, the past quarter also brought about its share of meaningful, non-political events, much of which can be viewed favorably by investors. U.S. stocks ended the quarter at all-time highs, with expanding market breadth and easing Fed policy. Markets have shifted their focus evenly towards economic growth rather than just inflation, which, in turn, has diminished the correlations between stocks and bonds, a welcome development for balanced portfolios (see chart below). The economy continues to remain remarkably resilient, even if recession concerns have not completely abated. COVID-era shockwaves continue to dissipate, resulting in economic data that is starting to look and feel more normal.

Rolling 60-Day U.S. Stock & Bond Correlation
(SPY & IEF)



Source: Portfolio Visualizer

And, yes, the outcome of the election and the resulting composition of Executive Office and Congress will likely have market implications. Tax policy, in particular, will be front and center in 2025, while a gameplan for deficit reduction, incredulously, has been punted to the 2028 election. This matter will finally, without question, reveal itself on November 5, or shortly thereafter. Probably. Possibly. Lets all hope.

INTERNATIONAL RETURNS (%)

As of 9/30/2024	Q3 2024	1-Year	3-Year	5-Year	10-Year
Int'l Developed ex US	7.3	24.8	5.5	8.2	5.7
Emerging Markets	8.7	26.1	0.4	5.8	4.0

Source: Morningstar

FIXED INCOME RETURNS (%)

As of 9/30/2024	Q3 2024	1-Year	3-Year	5-Year	10-Year
Aggregate Bond	5.2	11.6	-1.4	0.3	1.8
Muni	2.5	9.4	0.1	1.2	2.0
Int'l Bonds	6.4	11.8	-1.9	-0.1	0.8
High-Yield	4.4	13.9	2.6	3.8	3.9
Short-Term	3.2	8.7	1.6	1.9	1.8
90-Day T-Bill	1.3	5.5	3.9	2.5	1.8

Source: Morningstar

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