**Bracing For Turbulence**

# Q4 2024 Market Update

"An election is coming. Universal peace is declared, and the foxes have a sincere interest in prolonging the lives of the poultry."- George Eliot

Q3 is always a rocky one and it lived up to its name by producing more volatility than we have seen all year. As we turn the page to the final quarter of the year, questions abound about if the market can keep up the bull run or if it's been fatally wounded by a slowing economy and weakening labor market. The looming elections are causing anxiety levels to reach full panic mode for many investors; however, we temper that fear as elections matter much less to markets than they do to us personally. We argue the bull market is still alive and well, and we survived the weakest quarter of the year setting up for a year-end rally post-election.

The Fed is ushering in a new era in policy, moving from holding rates steady to rate cuts. This, combined with the yield curve un-inverting, both signal a new economic regime that historically has favored value stocks and small caps over large technology stocks. But our base case thesis remains: this is a similar market to 1994-1998 where we saw transformative technology (internet age) drive above average returns and market growth. Gradual cuts and continued economic growth can sustain market growth. We just need to stick the soft landing and have the consumer hold up.

**A Review Of The 1990's Shows A Soft Landing Is Possible**

| ANNUAL FED ACTION | YEAR | S&P 500 | NASDAQ | RUSSELL 1000 Value | RUSSELL 2000 | MSCI EAFE | MSCI EM | MSCI ACWI |
|---|---|---|---|---|---|---|---|---|
| 100bps hike | 2000 | -10.14% | -39.29% | 4.88% | -4.32% | -15.21% | -31.80% | -15.08% |
| 75bps hike | 1999 | 19.53% | 85.59% | 5.24% | 19.59% | 25.27% | 63.70% | 25.00% |
| 75bps cuts | 1998 | 26.67% | 39.63% | 13.23% | -3.83% | 18.23% | -27.52% | 19.93% |
| 25bps hike | 1997 | 31.01% | 21.64% | 32.01% | 20.69% | 0.24% | -13.41% | 12.93% |
| 50bps cuts | 1996 | 20.26% | 22.71% | 18.15% | 14.77% | 4.40% | 3.91% | 10.93% |
| hike and cut | 1995 | 34.11% | 39.92% | 33.66% | 26.47% | 9.42% | -6.95% | 16.90% |
| 250bps hike | 1994 | -1.54% | -3.20% | -5.46% | -3.26% | 6.24% | -8.67% | 2.86% |
| None | 1993 | 7.06% | 14.75% | 14.39% | 17.26% | 30.49% | 71.26% | 22.12% |
| 100bps cuts | 1992 | 4.46% | 15.45% | 9.43% | 16.52% | -13.89% | 9.05% | -6.70% |
| 300bps cuts | 1991 | 26.31% | 56.84% | 19.46% | 43.35% | 10.19% | 55.97% | 16.92% |
| 125bps cuts | 1990 | -6.56% | -17.80% | -12.37% | -21.30% | -24.71% | -13.76% | -18.64% |
| 10-Year Average | | 16.13% | 27.55% | 12.77% | 13.03% | 6.59% | 13.36% | 10.23% |

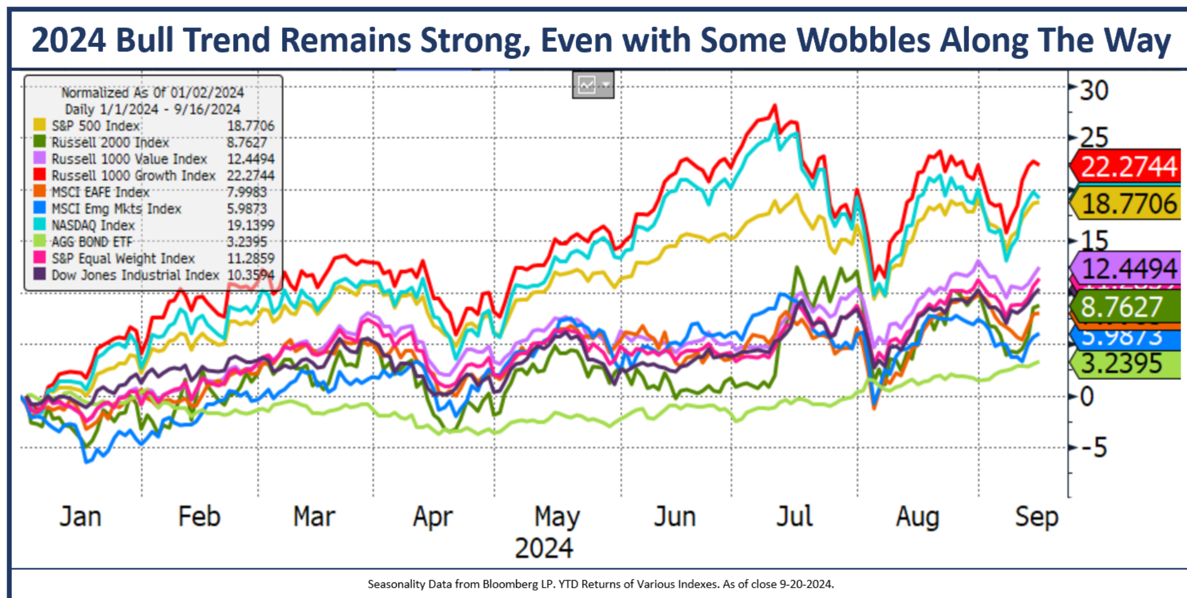
Seasonality Data from Bloomberg LP. S&P Annual Returns of Various Indexes in the 1990's. As of 9-15-2024.

In our opinion, the AI trade has not peaked, and its uptrend is still intact. While it's not universal (ORCL vs. ADBE) the growth of AI and AI supporting businesses continues to be strong. We believe select data centers, servers, computers, phones and chip makers remain attractive as AI continues to be implemented across business and personal lives. For example, ChatGPT (OpenAI's chatbot) launched in November 2022 and is now estimated to be used by more than 92% of Fortune 500 companies and has over 10mm paid subscribers and 1mm higher priced business subscribers. This implies more than $225mm revenue per month or $2.7B in annual revenue, generated by a technology less than 2 years old. While semiconductors have come under pressure in Q3, we believe that the trade is bending, but not broken. It is highly likely Generative AI, and all the supporting chips and servers, will continue to grow and expand and drive progress and efficiency across multiple businesses. It's a natural progression of innovation and not a flash in the pan fleeting trend.

This bull market is no longer young, but we continue to believe we could see further upside to close out the year. The current bull started in late September 2022, and we feel it could push up to the 5,800-6,000 levels assuming the bottom does not fall out on the economy. Inflation seems tamed for now, and labor and manufacturing weakness are now our greatest concerns. Investors also face a charged election to navigate through, along with the Fed pivoting to rate cuts. All of these factors raise the anxiety in the markets; however, it is not cause enough to derail the bull market which is being driven higher by expanding margins and earnings potential.

**Q3 Was a Consolidation, Not the Beginning of The End**

As of 9/20/2024, Indexes are struggling to finish out Q3. But this is a normal pattern. Both August and September have seen periods of increased volatility and sharp, but brief, drawdowns. Considering we have not had a full -10% correction, though came close in early August, this bull market has experienced limited downside volatility. While we are not back up to July peaks in all indexes, we feel that once we get through October, we could rally to finish out the year, assuming earnings growth and the consumer both hold up and continue to support growth.



Seasonality Data from Bloomberg LP. YTD Returns of Various Indexes. As of close 9-20-2024.

The 4th Quarter is historically the strongest period of the year. Per Bloomberg, the 10-year average return of the S&P 500 in the 4th quarter is 5.54%, well above all other quarters. Additionally, in 2022 and 2023 we saw a pullback in Q3 followed by a rebound quarter in Q4. In Q4, all three months average a positive return but for the last decade November has been the best month of the entire calendar year, averaging 3.81%. So, while it can be nerve wracking to stay the course with a contentious election looming, historical seasonal patterns point to market strength.

**The 4th Quarter Is Historically The Strongest Of The Year**
**S&P 500 Quarterly Returns For The Last 10 Years**

| | Q1 | Q2 | Q3 | Q4 |
|---|---|---|---|---|
| 10 Yr Avg | .77 | 3.56 | .91 | 5.54 |
| 2024 | 10.16 | 3.92 | 2.88 | |
| 2023 | 7.03 | 8.30 | -3.65 | 11.24 |
| 2022 | -4.95 | -16.45 | -5.28 | 7.08 |
| 2021 | 5.77 | 8.17 | .23 | 10.65 |
| 2020 | -20.00 | 19.95 | 8.47 | 11.69 |
| 2019 | 13.07 | 3.79 | 1.19 | 8.53 |
| 2018 | -1.22 | 2.93 | 7.20 | -13.97 |
| 2017 | 5.53 | 2.57 | 3.96 | 6.12 |
| 2016 | .77 | 1.90 | 3.31 | 3.25 |
| 2015 | .44 | -.23 | -6.94 | 6.45 |
| 2014 | 1.30 | 4.69 | .62 | 4.39 |

Seasonality Data from Bloomberg LP. S&P Quarterly Returns for the last 10-years. As of 9-13-2024.

While the election this fall has many on edge, most strategists agree that the risks to the market are low but flag a sweep by either side as a risk to equities as it means either taxes go up or likely tariffs costs go up. In a recent research note, Citigroup Strategists Scott Chronert summarized it well: "We maintain our ongoing view that either candidate's policy platforms are U.S. equity negative, but notably in a sweep context. We mark the Harris platform as incrementally more negative (-4% to -6%) vs the Trump platform (0% to 4%). This is mostly a function of the direct implication of higher corporate tax rates in the Harris outcome. A split congress with either candidate mitigates most of the nearer term risk to fair values."

**Citi Research Points to Sweeps As the Main Risk**

**PROJECTED ELECTION IMPACT ON STOCKS**

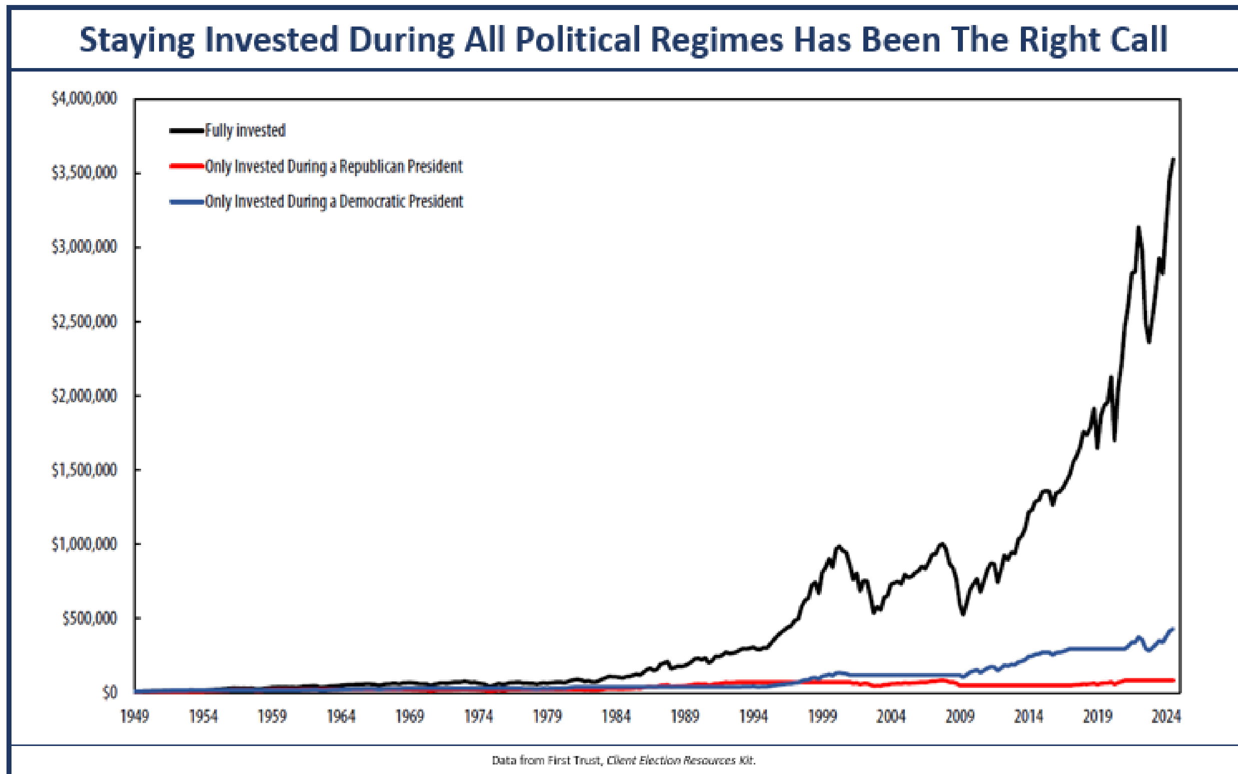
| ELECTION SCENARIO | DIRECT '26 EPS IMPACT | INDEX FAIR VALUE IMPACT |
|---|---|---|
| BLUE SWEEP | -7.2% | -6% to -3% |
| HARRIS + SPLIT CONGRESS | Unchanged | Unchanged |
| TRUMP + SPLIT CONGRESS | Unchanged | Unchanged |
| RED SWEEP | -1.4% | -4% to 0% |

*Source: Citi Research*

https://www.cnbc.com/2024/09/16/citi-says-with-both-candidates-bad-for-stocks-hope-for-split-congress.html?__source=newsletter%7Cprocomm%7Cpropulse%7C20240916

**The Election May Be a Non-Event For the Markets**

While the election is vitally important to us personally and socioeconomically, data suggests trying to trade the election is a bad idea. If you are a Democrat, you likely feel nothing positive could happen in a second Trump administration. And if you are a Republican, you likely feel a Harris administration could spell doom to the markets and economy. Both are likely overreactions, at least in the stock market. History says the best scenario for the market is split power among the White House, Congress and the Senate. Markets love certainty and continuity, and the checks and balances of a split government prevent sweeping overhauls. Regardless of which side wins, it is very short sighted to trade your portfolio around who is in power. Per Vanguard[1], since the 1800's a balanced portfolio averages 8.7% in a Presidential election year (41 periods) while non-Presidential election years (122 periods) averages 7.7%. LPL expands on the case for staying invested even during "adversarial" years[2]. Since 1950, if you had $100,000 invested, but you only invested during Republican Presidents you would have $1.04mm. Investing only during Democratic presidents yielded $3.12mm, but both are dwarfed by staying invested all years regardless of Presidential policy, with that portfolio growing to $32.55mm. Politics is best left out of your investment strategy.




Elections matter to investors personally, but markets tend to take election uncertainty with a grain of salt for multiple reasons. First, there is *always* an upcoming election. Midterms, special elections, appointments, resignations; it's constantly in flux who is in charge and what the majority party's priorities are. Most publicly traded companies expect to exist through a myriad of political regimes, some more business friendly than others, but it's an ever-changing landscape. Every 2 years the composition of government shifts, not to mention international elections along with state and local.

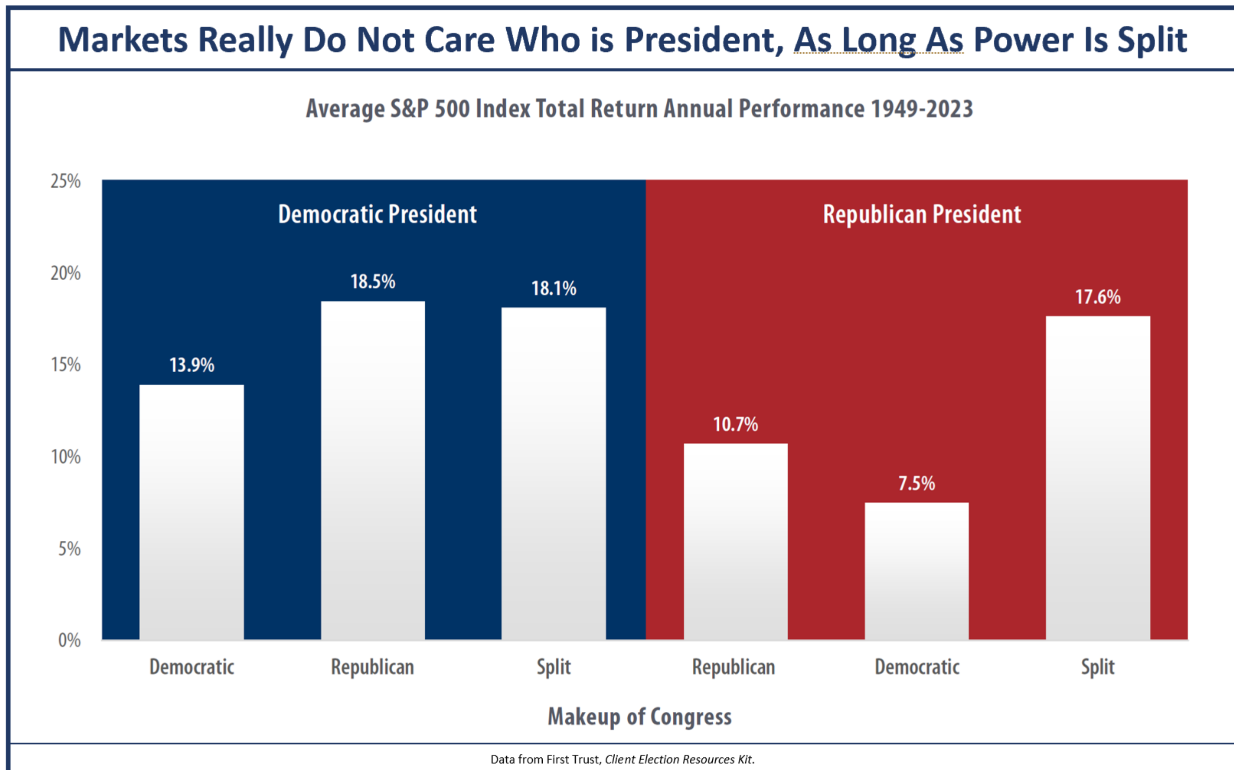
[1] https://investor.vanguard.com/investor-resources-education/article/presidential-elections-matter-but-not-so-much-when-it-comes-to-your-investments



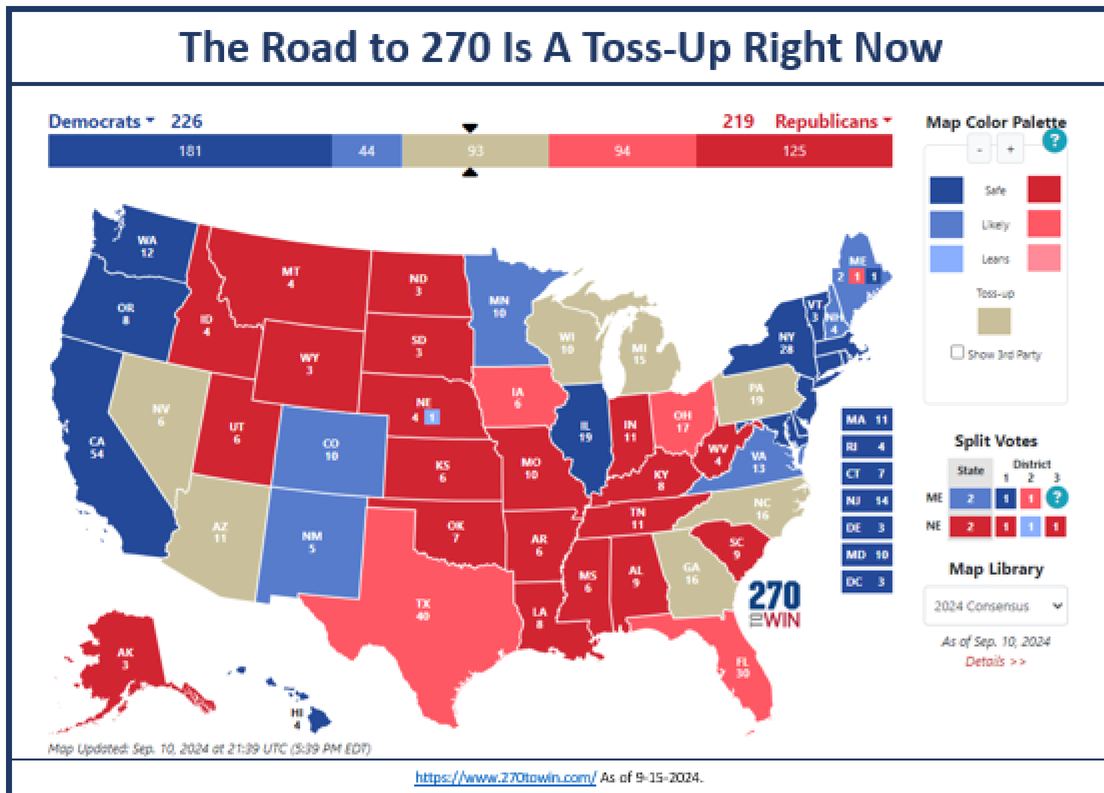
[2] https://www.lpl.com/research/blog/for-the-stock-market-its-about-policy-not-politics.html

Lastly, while the President wields enormous power, he or she is limited in some regards. For instance, tax policy and budgeting is set by Congress and not the White House. Neither candidate seems to have a plan for how to tackle the ballooning deficit, though both have floated tax policy changes. The current highly partisan divide and slim majority margins are likely to prevail and keep status quo though multiple economic and finance experts are warning on the National debt becoming an unavoidable issue. At some point we will face another ratings downgrade and less demand for Treasuries if we cannot work to tackle the expanding deficit and debt burden.

Article 1, Section 8 of the US Constitution states: "The Congress shall have power to lay and collect taxes, duties, imposts and excises." So, while the President can certainly set priorities and use their considerable sway to try and convince constituents and legislatures, it will be up to Congress to pass a budget, keep the lights on, and set tax rates. One area the President can directly affect the economy is via tariffs, as the 1974 Trade Act allows the president to impose a tariff for National Security reasons for up to 150 days without congressional approval. This unilateral tariff power was bolstered by the 1977 International Emergency Economic Powers Act (IEEPA) which allows the President to regulate international commerce under multiple scenarios. International trade, tariffs and executive orders are the 3 directly controlled executive branch powers that could dictate economic trajectory. And all may be challenged. For example, student loan forgiveness is currently tied up in the courts. But the President is not a dictator and is not able to unilaterally change the budget, taxes, or many laws.



The election will come down to 5 main states and 68 electoral college votes that are still a toss-up: Pennsylvania (19), North Carolina (16), Georgia (16), Arizona (11) and Nevada (6). There are some others that may be more competitive (such as Michigan, Wisconsin and Virginia) but in my opinion, PA, NC and GA will decide the presidential election. California is going to California (Harris) and Texas will go Trump as there are many states where the polling and population leans strongly one way or another. The race to 270 likely will come down to those toss up states. Additionally, we are not expecting the election to be called the night of November 5th, we advise to be prepared for delays for recounts and mail in ballots to be counted completely.



https://www.270towin.com/ As of 9-15-2024.

## The Fed Understands The Risks

The Fed is attempting a difficult feat in orchestrating a soft landing and avoiding a recession. Goldilocks scenarios are needed where the economy is not too hot, nor too cold and inflation not too high, nor too low, and the labor market not out of balance with too many job openings or too few. This has been done in the past circa 1995 by Alan Greenspan, but the Fed faces risks of doing too much or doing too little too slowly. For now, the measured approach is helping provide stability to equity and bond markets. Clear communication and a steady hand are needed. At the recent 9/18 meeting, the Fed decided to be proactive by cutting rates 50bps vs. 25bps, which the markets approved of and rallied sharply. The Fed seems forward looking and focused on preventing disaster vs. reacting to data on a month-to-month basis. This more aggressive support of economic growth may allow the economy to stick the soft landing and avoid recession and a complete disaster in the labor markets.

The biggest issue driving inflation at this point is housing and rent equivalent costs. Housing has been stuck not just because of high rates but also high prices and lack of supply. In our opinion, the

housing market experienced a fundamental shift post-2008 financial crisis that makes this harder to solve. Pre-2008, AirBnb was not a thing, and the number of single-family homes owned by banks and investment companies was low. Most private equity was focused on multifamily apartment complexes and not on owning portfolios of single-family homes. This shifted post 2008 as companies like Blackstone realized how profitable owning a portfolio of single-family homes could be. Combined with individuals and investors running portfolios of AirBnb long- and short-term rentals, suddenly supply was taken off the market well above trend. This supply is not coming back, and the individual buyer faces bidding against institutions and businesses that can provide a cash closing making it even harder for a first-time home buyer. Additionally, post 2008 there was a multi-year period where housing development was significantly slower than trend, and we are still working our way back to normal supply of new homes. Shelter is about 36% of CPI which has an outsized effect on monthly fluctuations. The National Association of Realtors (NAR) tracks affordability of housing, which has hit a new low as home prices soared and mortgage rates remain high.

## Housing Continues To Be A Problem

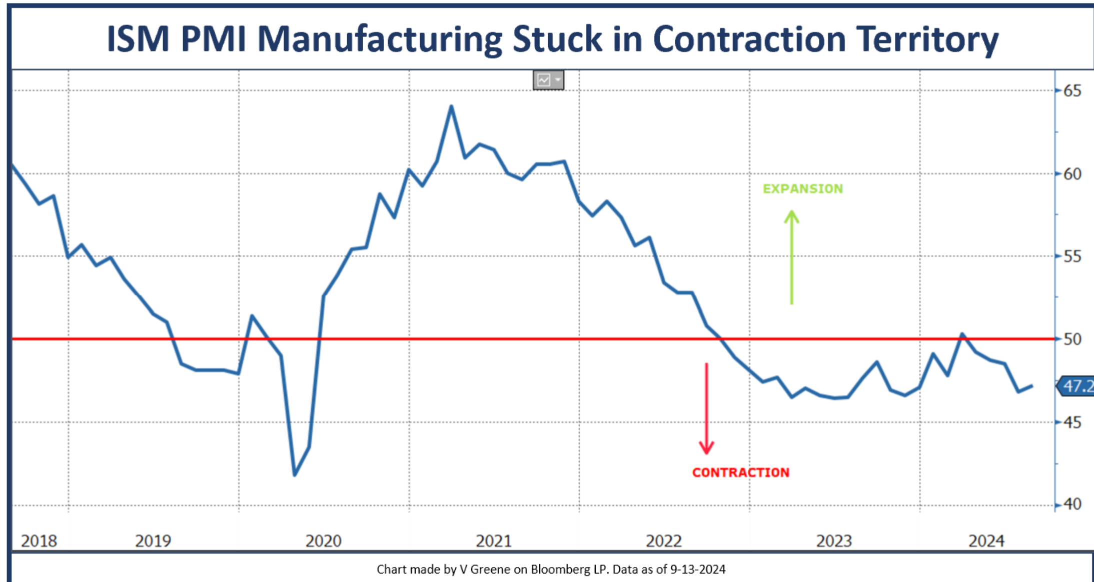
**NATIONAL ASSOCIATION OF REALTORS: HOUSING AFFORDABILITY INDEX**

| Year | | Median Priced Existing Single Family Home | Mortgage Rate* | Monthly P & I Payment | Payment as a % of Income | Median Family Income | Qualifying Income** | Affordability Indexes Fixed | | |
|---|---|---|---|---|---|---|---|---|---|---|
| 2021 | | 357,100 | 3.01 | 1206 | 16.9 | 85,806 | 57,888 | 148.2 | | |
| 2022 | | 392,800 | 5.40 | 1765 | 23.0 | 92,148 | 84,720 | 108.8 | | |
| 2023 | | 394,100 | 6.88 | 2072 | 25.4 | 97,699 | 99,456 | 98.2 | | |
| 2023 | Jul | 411,200 | 6.92 | 2,171 | 26.6 | 97,865 | 104,208 | 93.9 | | |
| 2023 | Aug | 410,200 | 7.15 | 2,216 | 27.1 | 98,291 | 106,368 | 92.4 | | |
| 2023 | Sep | 397,400 | 7.28 | 2,175 | 26.4 | 98,705 | 104,400 | 94.5 | | |
| 2023 | Oct | 396,000 | 7.70 | 2,259 | 27.4 | 99,109 | 108,432 | 91.4 | | |
| 2023 | Nov | 392,200 | 7.52 | 2,198 | 26.5 | 99,432 | 105,504 | 94.2 | | |
| 2023 | Dec | 385,800 | 6.90 | 2,033 | 24.5 | 99,767 | 97,584 | 102.2 | | |
| 2024 | Jan | 382,900 | 6.72 | 1,981 | 23.7 | 100,472 | 95,088 | 105.7 | | |
| 2024 | Feb | 388,000 | 6.86 | 2,036 | 24.2 | 100,876 | 97,728 | 103.2 | | |
| 2024 | Mar | 396,600 | 6.90 | 2,090 | 24.7 | 101,556 | 100,320 | 101.2 | | |
| 2024 | Apr | 411,100 | 7.07 | 2,204 | 26.0 | 101,663 | 105,792 | 96.1 | | |
| 2024 | May | 422,400 | 7.14 | 2,280 | 26.7 | 102,364 | 109,440 | 93.5 | | |
| 2024 | Jun r | 432,900 | 7.00 | 2,304 | 26.8 | 103,172 | 110,592 | 93.3 | | |
| 2024 | Jul p | 428,500 | 6.93 | 2,265 | 26.3 | 103,278 | 108,720 | 95.0 | | |
| | | | | | | | | This Month | Month Ago | Year Ago |
| | Northeast | 518,300 | 6.93 | 2,739 | 28.5 | 115,528 | 131,472 | 87.9 | 84.3 | 91.4 |
| | Midwest | 324,400 | 6.93 | 1,714 | 20.4 | 100,642 | 82,272 | 122.3 | 119.3 | 121.1 |
| | South | 379,400 | 6.93 | 2,005 | 25.3 | 95,114 | 96,240 | 98.8 | 97.8 | 95.5 |
| | West | 643,300 | 6.93 | 3,400 | 36.2 | 112,725 | 163,200 | 69.1 | 68.6 | 67.3 |

*Effective rate on loans closed on existing homes - Federal Housing Finance Agency. Adjustable mortgage rates are not available since 2010.*

https://www.nar.realtor/research-and-statistics/housing-statistics/housing-affordability-index

Manufacturing is also a risk to the Fed, as both manufacturing production as well as employment have been mired in a slump for over a year. While wages have gone up, the number of employed people and hours worked have continued to fall. Services have kept the economy running, but the industrial, manufacturing and energy sectors are signaling more stress and headwinds. August was the 5th straight month of US manufacturing contracting as the ISM manufacturing gauge sits at 47.2. Any reading below 50 denotes contraction. New orders are also shrinking, dropping to a 15-month low, backlogs shrunk, and inventories rose. These declines are bringing drops in manufacturing employment levels, which may further pressure the US labor market and limit opportunities.




While we flag these 2 areas (housing and manufacturing) as potential risks, along with the concern that the labor market deteriorates further, for now the base case remains bullish. There continues to be secular drivers of earnings growth and profit margin, and the consumer continues to defy bearish expectations. This is not a new bull market by any means – we are likely middle-innings – and there are certainly events and economic trends that could derail the uptrend if they deteriorate. But in terms of probability and likelihood, we believe it's more likely than not that we will end the year higher than where we are today, and that the election will end up being a non-event to the equity market. This is no longer just a rally of 7 technology stocks, it's a broad-based rally lifting many stocks to new highs.

Investing always involves risk. And there will always be some reason to fear the future and justify the desire to sell equities. For instance, China is extremely weak, or the Middle East could escalate from skirmish to full out war between Israel and Iran. Or market valuations are not cheap, and the market is expensive, and Warren Buffett keeps selling stock. Every bull market comes with naysayers and risks of short-term loss. Per research by the Capital Group[3], over a 1-year period, you have a 27% risk of negative returns. Extending to a 5-year period, the risk of a negative return drops to 12%, and over 10 years it's only 6% likely you will see a negative return in the S&P 500.

This year has felt on the edge of disaster since day one. But most of the jitters are social and political, not economic or market based. There is no doubt this is a highly charged, highly partisan period in US history, but we advise not to let those feelings drive your investment policy. Investors should continue to focus on long term trends and look to data and facts to drive portfolio positioning, and not feelings and emotions. This remains a bull market, driven by technological innovation and supported by economic growth. Until the labor market turns negative, or economic growth slows to zero, it's likely we will see the bull continue to run though Q4. October and November will likely be extremely noisy; so, investors need to tune out the bulk of the discourse to find underlying facts.

[3] https://www.capitalgroup.com/individual/planning/investing-fundamentals/time-not-timing-is-what-matters.html

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