Market Update: Q3 2024

As one market observer keenly noted, *the third quarter was a difficult year.* Twists and turns in the data and a constant stream of disturbing headlines made the quarter drag on. Political turmoil dominated U.S. news, with one Presidential candidate stepping down and the other narrowly escaping two assassination attempts. Military conflicts escalated in the Middle East and Ukraine, and global shifts in currency and interest rates triggered a sharp drop in stocks. The stock rally was revived in September when the Federal Reserve cut interest rates a full half percent. After much turmoil, the stock market pushed higher, with the S&P 500 index ending the third quarter at an all-time high, and small-cap and international stocks joining the broad rally.

Key Takeaways

- **Uncertainty and volatility remain high**
- **Fed rate cut boosted markets in Q3**
- **Markets tend to struggle in lead-up to Presidential elections**
- **Herding and leverage pose market risks**
- **Proper asset allocation and perspective are key to long-term success.**

INDEX	Q3 2024	YTD	TRAILING 12 MO.
S&P 500	5.9%	22.1%	36.4%
Russell 2000 Small Cap	9.3%	11.2%	26.8%
MSCI EAFE - International	7.3%	13.0%	24.8%
MSCI Emerging Markets	8.7%	16.9%	26.1%
Bloomberg US Agg Bond	5.2%	4.5%	11.6%

SOURCE: BLOOMBERG

Fed Surprise 50

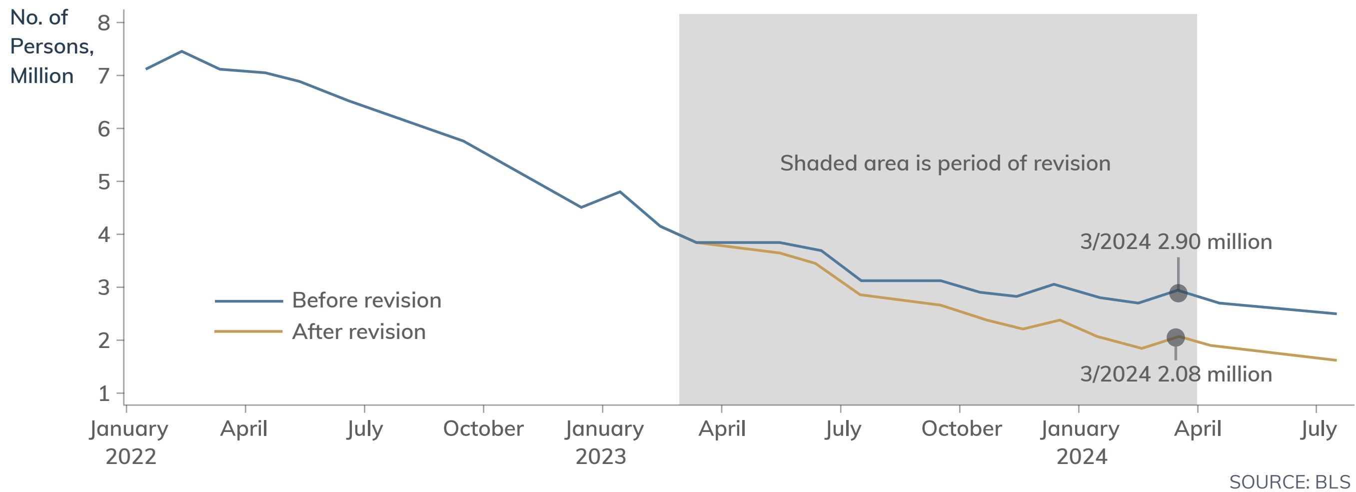
At its September meeting, the Federal Reserve acted decisively, lowering rates by 50 basis points when the market expected a 25-point cut. This rate cut, which signaled a shift in focus from fighting inflation to stimulating economic growth, boosted market sentiment and lifted stocks.

Financial news pundits hotly debated the Fed's aggressive action, with many questioning the committee's motives. Was the Fed politically motivated or trying to avoid criticism for acting too slowly? Chairman Jerome Powell maintains that the data justified the rate cut, with inflation treading toward the 2% target.

> *"Overall, the economy is in solid shape. We intend to use our tools to keep it there."*
>
> – Fed Chair Jerome Powell at the National Association for Business Economics, 9/30/24

The Fed has adopted the blanket defense of being 'data dependent.' However, when it comes to an economy as big and complex as the U.S., the data can be hard to wrangle. For example, the Bureau of Labor Statistics (BLS) can't count every single job added or lost. Instead, it uses survey-based mathematical models, which are later revised as more data comes in. In late August, the BLS announced it overestimated job growth by 800,000 for the 12 months ending March 30, 2023. This was the largest negative revision since the Great Recession in 2009, and no doubt played a role in the Fed's decision.

When the economy experiences a seismic shift, as it did in the Great Recession and the COVID pandemic, the mathematical models take time to calibrate. Expectations for further rate cuts remain mixed, but their timing and pace will largely depend on labor market strength. For now, the trend appears to favor lower rates, which would support stock and bond prices. However, as stewards of our clients' capital, we need to avoid over-relying



on single data points or becoming too confident in projections. Economic models change from year to year and are better used as a compass than a map.

Volatility Returns

For years, we have chronicled the dominance of U.S. large cap technology stocks relative to other asset classes. In the third quarter, however, the tables were turned slightly as U.S. small-cap and international stocks outpaced the S&P 500. Several factors drove this shift, including the market's anticipation of and reaction to Fed rate cuts and a falling dollar. It may also have been a classic 'reversion to the mean,' as the valuation gap between relatively expensive large-cap U.S. stocks and other less expensive asset classes was stretched to the extreme. All of these are valid, rational reasons for the third-quarter performance difference. However, there was also a violent market correction driven by less traditional forces.

In late July and early August, investors learned a lesson in the 'carry trade.' With technology eliminating many geographic and regulatory boundaries, professional traders can easily access other markets to deploy complex trading strategies. The latest version of the carry trade involved borrowing at extremely low rates in Japan, then converting Yen to other currencies to buy assets in other markets. Those assets might be technology stocks, gold, real estate, treasuries... essentially anything that would eclipse the cost of borrowing in Yen.

Suffice to say, the carry trade became very, very popular. Japan had held rates effectively at zero for 15 years. When the Bank of Japan finally raised rates, borrowing costs rose and the Yen appreciated, making the 'cost of carry' higher. These higher costs, combined with other factors, caused a sudden unwinding of the carry trade. Volatility spiked and stock prices plunged, including those of large-cap U.S. technology companies.

Although stock markets stabilized within days of this episode, and eventually erased losses, the event was a clear reminder that 'herding' remains an ever-present risk. In modern markets, herding becomes more dangerous when investors use leverage to express bets. Leveraged, cross-border trades can introduce extreme volatility. Maintaining appropriate asset allocation and avoiding complacency are critical, even if that means realizing sizable capital gains.

Election Fatigue

With less than a month until the Presidential election, polls are effectively tied. Anxiety over election uncertainty is amplified by the 24-hour new cycle and barrage of doomsday political ads. Understandably, clients may worry about how the election will impact their portfolios. While we are not political science experts, we are students of the market. As such, we can look to history for patterns

S&P 500 VS VIX, 2024 YEAR TO DATE

SOURCE: YCHARTS

that might offer insights. Here are three observations:

1. In tight election cycles, the market tends to struggle leading up to election day and then recover afterward. Intuitively, it makes sense that a relief rally would occur once uncertainty resolves.
2. The immediate post-election period tends to be positive for the stock market, whether the incumbent or the challenger wins. The market has, however, struggled when someone other than the incumbent or challenger – a relative unknown – has taken office, though this rare outcome lacks strong statistical support.
3. Historically, markets have performed better under a divided government, with the two houses of Congress held by different parties. This is true regardless of whether the President is a Democrat or Republican.

Elections are only one of many social and economic factors that have impact the market over the past 70 years and there is no reset button with a change in the Oval Office. Economic policies matter only to the extent that Congress enacts them. In a divided government, competing ideas and compromise are necessary for productive outcomes. These same principles apply to business and markets.

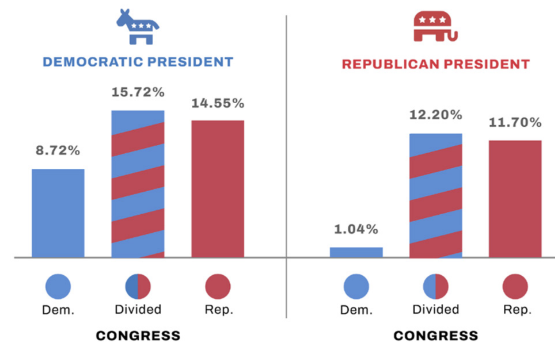
Summary

We expect that stock market volatility will stay elevated in the months ahead. That said, we will not shy away from it. The market tends to overreact to external shocks, and such periods tend to precede strong stock performance. Our focus remains on being a consistent steward of client portfolios: insulating them to meet near-term cash flow needs, while capitalizing on opportunities to add quality growth stocks.

CHALLENGERS BEING ELECTED
DAY AFTER ELECTION THROUGH INAUGURATION DAY (SINCE 1952)

	REPUBLICAN	DEMOCRAT	EITHER PARTY
Incumbent	+1.07%	+4.82%	+2.68%
Challenger	+2.02%	+5.80%	+4.86%
Neither	+1.80%	-5.57%	-0.31%

AVERAGE ANNUALIZED S&P 500 PERFORMANCE, 1950-2023



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