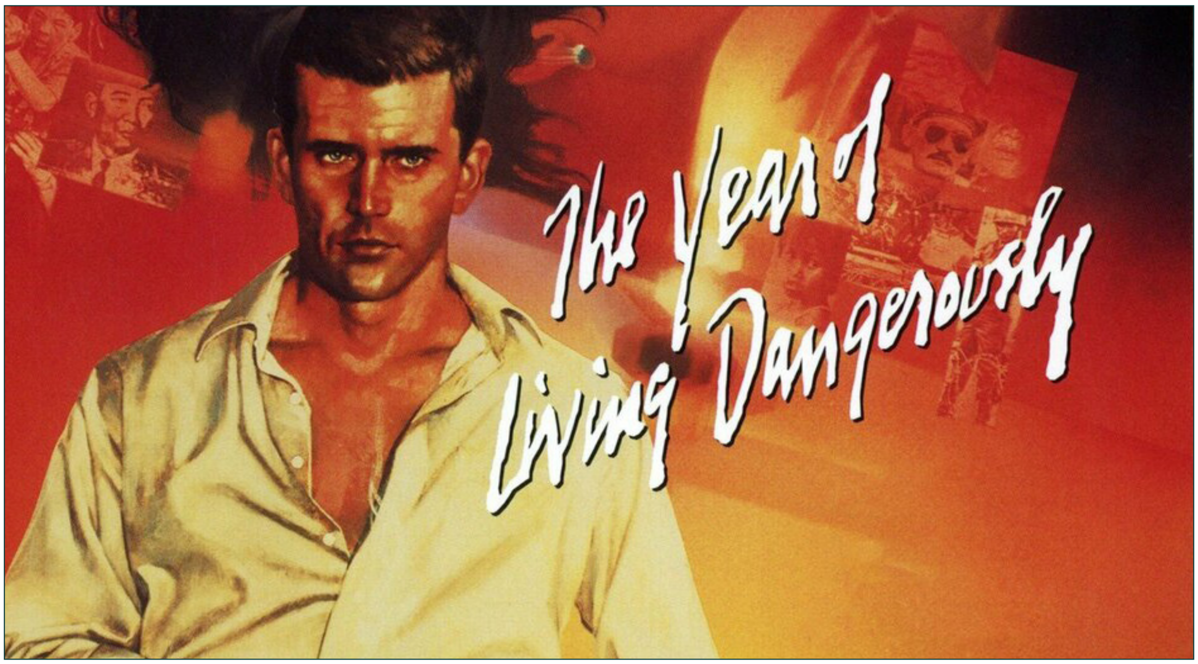
# INVESTMENT OUTLOOK

A PEAPACK PRIVATE PUBLICATION


## THIRD QUARTER 2024: THE (FED'S) YEAR OF LIVING DANGEROUSLY

*The biggest risk is to take no risk. Or to take crazy risks.*
*-John Marsden*

The Peter Weir-directed film, *The Year of Living Dangerously*, based on a novel by Australian Christopher Koch, presents a story in which the protagonists face difficult choices amidst political and economic turmoil. In the movie, a novice journalist (played by Mel Gibson) must choose between romance and the story that will make his career, against the backdrop of a political revolution.




The year was 1965, and the location was Jakarta, Indonesia. A far cry from the summer of 2024 in Washington, but protagonist Jerome Powell, chair of the Federal Reserve, found himself facing difficult choices amidst political and economic turmoil. Those choices involved a tension among the policy alternatives to meet the Fed's dual mandates of price stability and full employment.

On one side, inflation hawks advocated maintaining or even increasing interest rates, as inflation has remained above the Fed's target and the services economy reflects still-rising costs in areas such as insurance, shelter, and airline fares. With GDP growth running well above trend, these voices urged patience from the Fed to continue to allow higher interest rates to moderate inflation.

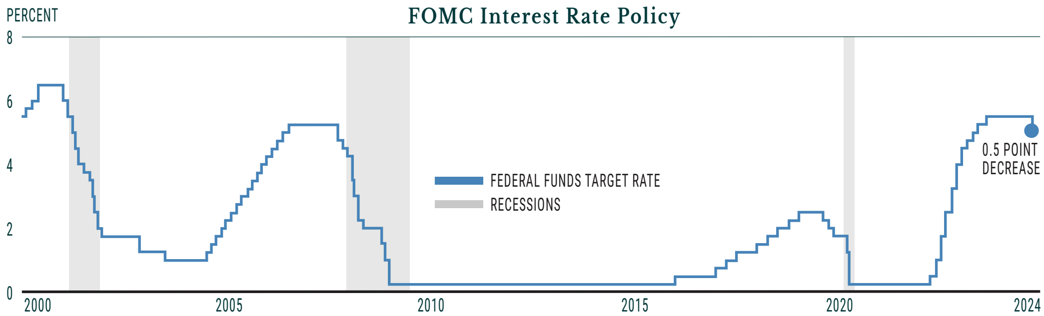
On the other side, dovish analysts cited datapoints indicating softening in the labor market as a strong argument to cut interest rates. The unemployment rate, currently 4.2%, may be low from a historical perspective but has risen considerably from its nadir of 3.4% in April 2023. Furthermore, the unemployment rate tends to gather momentum once it begins to rise. Given that, some pundits urged the Fed to begin cutting rates in earnest.

As the summer came to an end, the Fed was faced with two challenging interest rate decisions: to cut or not to cut? And, if to cut, by how much?

## THE FED DECIDES

*Life is filled with difficult decisions, and winners are those who make them.*
*– Dan Brown*

On September 18th, the Federal Open Market Committee (FOMC) reduced the Fed funds rate by 50 bps (0.5%). More than a year—419 days—passed from the last rate increase in July 2023 and this rate cut, the second longest time between a hike and a cut.



SOURCE: THE NEW YORK TIMES

The FOMC had raised its benchmark interest rate 11 times between March 2022 and July 2023, in response to a surge in inflation that the Fed had mistakenly perceived as transitory. The Fed's delayed response to higher prices in all likelihood contributed to the spike in inflation, which reached a high of 9.1% in June 2022.

Since that peak, the CPI has moderated substantially, clocking in at 2.5% in August. The Fed had resisted pressure to reverse its restrictive monetary policy stance and begin trimming interest rates, citing a need for greater 'confidence' that inflation was on a steady path back towards its 2% target. This September, it ditched any vestiges of indecisiveness and confidently axed the Fed Funds rate.

## MARKETS DECIDE

*The best decisions aren't made with your mind, but with your instincts.*
*-Lionel Messi*

Market participants had no trouble deciding on the direction of monetary policy in the third quarter. Front-running the FOMC, investors convinced themselves that interest rate cuts were coming, and coming in quantity at that. And, in turn, that lower rates support higher asset values.

| Asset Class | Index | 3rd Quarter Returns | Year to Date Returns |
|---|---|---|---|
| US Large Cap Stocks | S&P 500 Total Return | 5.9% | 22.1% |
| US Large Cap Stocks | S&P 500 Equal Weighted | 9.6% | 15.2% |
| US Small-Mid Cap Stocks | Russell 2500 | 8.7% | 11.3% |
| International Developed Markets Stocks | MSCI EAFE | 7.3% | 13.0% |
| Emerging Markets Stocks | MSCI EM | 8.7% | 16.9% |
| Real Estate Securities | MSCI US REIT | 16.1% | 15.8% |
| Commodities | Bloomberg Commodities Futures | 0.7% | 5.9% |
| Bonds | Bloomberg Barclays US Aggregate | 5.2% | 4.5% |
| Cash | FTSE USBIG 1-Month Treasury Bill | 1.4% | 4.1% |

SOURCES: THE WALL STREET JOURNAL, STANDARDANDPOORS.COM, FTSE, MSCI, BLOOMBERG

As a result, stock and bond markets rallied spectacularly. Notably, after dominating for six quarters, the Magnificent 7 megacap technology growth stocks ceded market leadership—to defensive sectors, to value stocks, to small cap stocks, and to international stocks. US large cap stocks posted an admirable 5.9% quarterly gain, but they were out-performed by all other equity asset classes. US small-mid cap stocks, viewed as having greater sensitivity to the cost of credit, were big beneficiaries of expectations of lower interest rates. Gaining most from such expectations? Real estate investment trusts (REITs), anticipating potential lower financing costs and valuations boosted by lower capitalization rates, soared more than 15% during the quarter.

## ECONOMIC GROWTH: STRONG AND DECELERATING

*The important question is not whether conditions are good or bad,*
*but whether they are changing for better or worse.*
*-Arthur Zeikel*

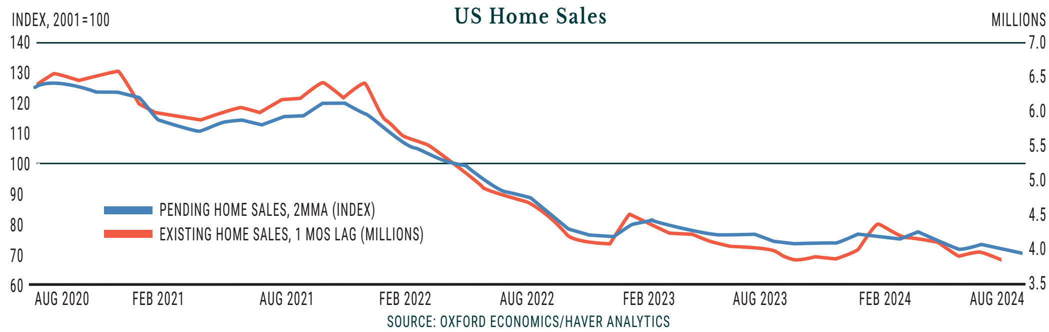
The economy has been growing at an above average pace, after a soft patch in the first quarter of the year. Most economists believe US GDP growth potential is about 1.8% annually—thus 3% growth recorded in the second quarter suggests considerable economic momentum. It was also in line with the 3.1% growth rate recorded for all of 2023, and stronger than 2022's 2.5% advance. This robust economic expansion is at least in part the result of highly accommodative fiscal and monetary policies adopted in response to the Covid pandemic.


The just-ended third quarter, according to the Atlanta Fed's GDPNow estimate, grew at a healthy 2.9% clip, in line with the second quarter.

However, some forward-looking estimates of GDP growth suggest a significant slowdown. The Conference Board estimates that third quarter GDP growth decelerated to 0.8%, and forecasts the fourth quarter GDP growth rate to come in at a tepid 1.0% rate. It predicts growth will moderate to a 1.7% rate in 2025, somewhat below the Fed's 2.0% forecast in its most recent Summary of Economic Projections.

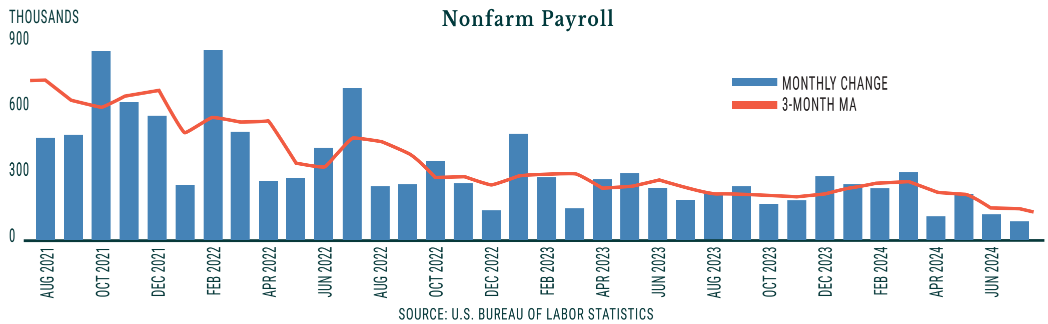
Among the data points supporting the suggestion of economic deceleration is slipping automobile sales, down 1.1% versus August 2023. The NFIB's Small Business Optimism Index also fell in August, recording its 32nd consecutive month below its 50-year average. The Fed's most recent Beige Book (a qualitative review of current economic conditions in the Federal Reserve's districts) was replete with anecdotes of economic weakness.

The housing industry, with its sensitivity to interest rate levels, has been particularly moribund. As the chart below makes clear, pending and existing home sales have been depressed for almost three years, reflecting elevated mortgage rates, low inventory, and challenging affordability.

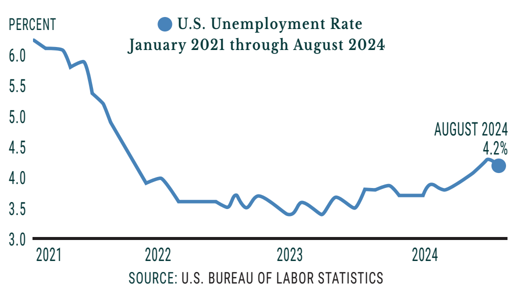


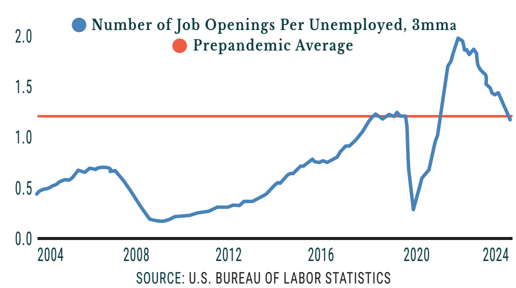

Also weak: manufacturing. One example: falling agricultural commodities prices are suppressing demand for farm equipment; tractor and harvester sales were down 12% and 29%, respectively, from a year ago.

Underlying these signs of economic slowing are indications that the labor market is softening.




As the chart above shows, the three-month moving average of nonfarm job additions is clearly in a downtrend, as employers curtail new hiring. Other labor market data tell the same story: unemployment has been rising over the last year and a half, and the number of job openings compared to the number of unemployed persons has fallen by half.

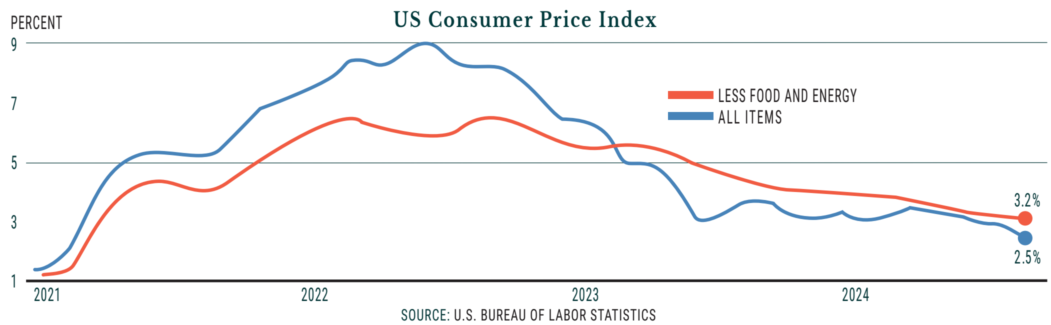



Concern about these trends under-pinned the Fed's decision to cut interest rates in September. One labor market indicator that has not yet evidenced weakness is weekly new unemployment claims. The data here suggest that while companies have slowed hiring, they have not begun to lay off employees. As economic growth slows, it will be important to monitor whether businesses resort to reductions in force to protect profit margins. Over coming months, all eyes will be focused on the health of the labor market—the Fed will respond to signs of weakness in the labor market, as such weakness tends to worsen quickly.

It's also important to remember that a fully employed workforce underlies consumer spending—which, in turn, constitutes almost 70% of US economic activity. Any deterioration in the labor market is likely to both reflect and reinforce economic softness. As it is, consumers have taken on substantial debt. Credit card balances, totaling $1.14 trillion according to the Federal Reserve Bank of New York, are the highest level on record. Home equity loan balances, totaling $380 billion, rose almost 12% over the past year. Automobile loans outstanding total $1.6 trillion. Across consumer debt categories, defaults are rising.

Meanwhile, the FOMC's 'greater confidence' that inflation is headed on a path down to its 2% target is supported by recent data. Its preferred gauge, core personal consumption expenditures (PCE), generated a dovish reading this month. August PCE rose only 0.1% in August, as did core PCE (excluding food and energy prices). The PCE index rose 2.2% over the past year, and core PCE rose 2.7%—approaching the Fed's 2% target.




Other measures are similarly encouraging. Inflation expectations, from both survey and market measures, generally remain well anchored. The most recent reading of the Consumer Price Index came in at 2.5% year over year increase, and core CPI (excluding food and energy) rose 3.2% year over year. (The shelter component has been sticky but should decline over the next several months.) There are no indications of pipeline inflation pressures from the Producer Price Index. Import prices were lower in August, and industrial commodity prices have declined.

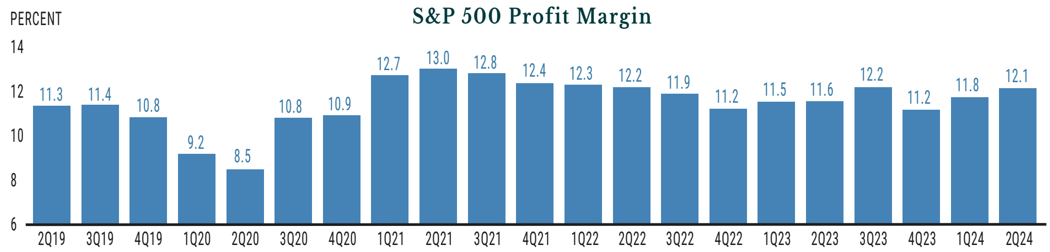
Nonetheless, there are reasons to remain vigilant about inflation. Against a backdrop of deglobalization, high deficits, curtailed immigration, and decarbonization, it's not inconceivable that inflation could boomerang.

## EARNINGS GROWTH: STRONG AND STRONGER

*Too much, too young, too fast*
*I'm gonna drink it up while it lasts*
*Too much, too young, too fast*
*I'm gonna tear it up so fill my glass*
*-Airbourne*

US equity markets have advanced smartly this year, up 22%—following a 26% rise in 2023. The S&P 500 has notched 41 record highs. As noted, the prospect of lower interest rates has helped boost valuations. Stocks also were boosted by strong earnings growth—according to S&P Global, second quarter normalized earnings per share rose 12.9%. For the third quarter, FactSet reports that earnings are estimated to rise a more modest 4.6%. Looking further out, analysts are forecasting 14.9% earnings in the fourth quarter, and 15.1% for all of 2025.

These are lofty expectations. Research firm Strategas estimates that companies will need to generate record profit margins of 13.9% to achieve next year's earnings estimates. For reference, the net profit margin for the S&P 500 in the second quarter was 12.1%.



SOURCE: FACTSET

The only higher readings on net profit margin occurred during the pandemic, when companies took advantage of supply chain shortages, raising prices and maximizing margins. Technology companies in particular sport high profit margins, so continued strong growth from the sector will be necessary to reach analysts' optimistic projections. The Magnificent Seven are projected to contribute 24% of the S&P 500's 2025 earnings, in line with their 2024 contribution.

Some skepticism is being expressed about the ability of technology companies to achieve meaningful returns from the artificial intelligence (AI) boom. A partner at the venture-capital firm Sequoia Capital recently calculated that to justify this year's investment in data centers and chips alone, AI businesses will ultimately need to generate $600 billion in revenues. Mark Zuckerberg, CEO of Meta Platforms (the company formerly known as Facebook), has acknowledged that it may be years until AI apps are monetized. And Google's CEO, Sundar Pichai, has stated that there is a 'time curve' before underlying AI technology can be developed into meaningful solutions.

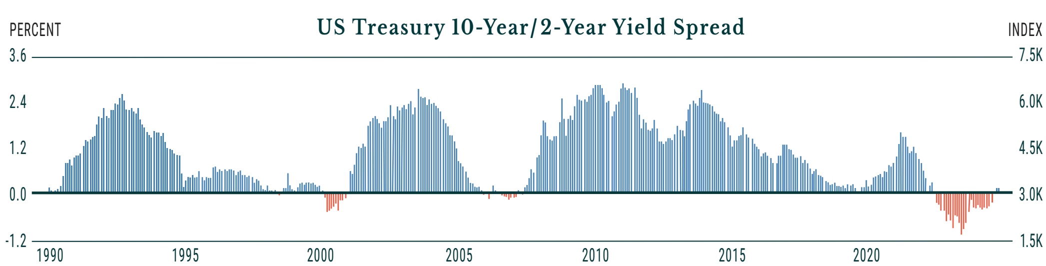
Nonetheless, expectations are high. From a valuation perspective, the S&P 500 continues to trade at a lofty level—21.6 times estimated earnings for the next 12 months. (For reference, the 10-year average forward price/earnings ratio is 18.0 times.) The foundation for such a valuation is lower rates and rapid earnings growth. In turn, the Fed will need to engineer a soft landing, without reigniting inflation.

## THE BOND MARKET: YIELDS DOWN, PRICES UP

*What goes up must come down*
*Spinning Wheel got to go 'round*
*-Blood, Sweat & Tears*

In his stated remarks, reinforced at the press conference following the last FOMC meeting, Chair Powell was unwavering in justifying the 50 bps rate cut and in suggesting this was just the beginning of a downward cycle in interest rates. The bond market, looking at the same data the Fed was observing, reached the conclusion ahead of the Fed, and brought market rates down by approximately 100 basis points over the course of the summer.

Shorter rates fell by a greater magnitude than long rates. This bond market action served to unwind the inverted yield curve. As of this writing 2-year Treasurys yield 18 basis points (bps) less than 10-year Treasurys.



SOURCE: MACRO/MICRO

This market action is consistent with prior initial rate cutting cycles—three months before the first cut, fixed income markets rally in anticipation of FOMC action, and rates continue to fall following the first rate cut. The explanation for this is that when the FOMC cuts rates, it is usually because economic growth is slowing, and the FOMC is forced to take a more aggressive policy stance as the economy slides towards or into recession. Only when the Fed achieves a soft landing have interest rates risen after the first cut.

The Fed's Summary of Economic Projections indicates that the FOMC anticipates two more rate cuts in 2024 and four rate cuts in 2025. Such moves, if they were to occur, would bring the Fed Funds rate down to 3.25-3.50%, effectively a neutral interest rate policy—one designed to neither stimulate nor slow economic growth.

## 2025: THE YEAR OF LIVING/INVESTING PRUDENTLY

*However well organized the foundations of life may be, life must always be full of risks.*
*-Havelock Ellis*

Life may at times bring us into situations in which we are forced to live with danger. Investing, too, can be a dangerous undertaking. Take too much risk and potential losses could mount up. Avert all risk and perhaps fail to achieve one's financial goals.

Investors, like the Fed, face some challenging decisions. Position portfolios for a possible recession or for a soft landing? For a Red Wave, a Blue Wave, or no wave? For disinflation or reflation?


In times of heightened uncertainty, it can be helpful to return to sound core investing principles. Among them: diversification, long-term perspective, valuation sensitivity, and high quality.

In the US Large Cap equity space, the broadening out of the market from the Magnificent Seven technology stocks to value, defensive and cyclical stocks is an encouraging sign. That said, our enthusiasm for US large cap stocks is tempered by elevated valuations. More modest valuations in smaller cap US stocks and international stocks suggest potentially better appreciation potential at lower risk.

In fixed income, yields are down from peak levels several months back, but are still attractive from levels seen in the last fifteen years. Reasonable expectations of lower interest rates justify some duration extension to intermediate term bonds. Still-tight credit spreads and the potential for an economic slowdown suggest focusing on higher quality credits.

The characters in *The Year of Living Dangerously* found themselves living and working in the midst of a revolution. Investors, too, find themselves making portfolio decisions amidst a number of technological and social revolutions: artificial intelligence, streaming media, electric and autonomous vehicles, the green energy transition. Prudent portfolio management isn't revolutionary—but it does take discipline and focus. Fundamentals—thoughtful analysis, industry insight, risk management—are timeless. They will serve, in a year that promises both danger and opportunity.

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