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Market Review and Outlook 3Q24

Highlights

Stocks continued to rally in the third quarter, with the S&P 500 Index posting a quarterly return of 5.9% (+22.1% YTD).

The Federal Reserve cut interest rates by a half-percentage point (0.5%) in September, an aggressive start to its first easing campaign in four years.

Rate-cutting cycles typically drive positive near-term market returns, but they have often been a precursor to recession (within one year) as well.

While economic expansion is likely to cool, it is expected to remain solidly positive through 2025. That should enable corporate earnings to continue to move higher.

With equities displaying historically rich valuations, investors should be prepared for more measured market returns and increased bouts of volatility moving forward.

After posting two consecutive quarters of losses in the first half of 2024, fixed income markets saw a strong third-quarter rally in bond prices—pushing the asset class's year-to-date performance back into solidly positive territory.

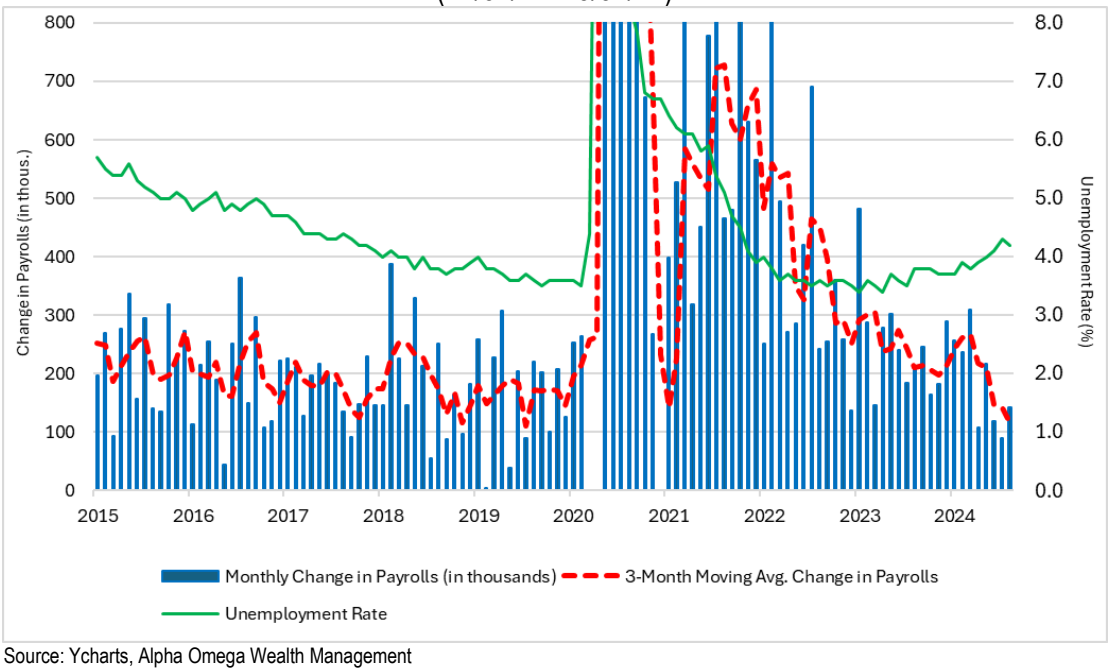
With interest rates slated to steadily decline through the balance of this year and next, the total return outlook for fixed income markets remains compelling.

Market Review and Outlook

Global equity markets extended their impressive year-to-date gains during third quarter. The move higher wasn't linear, however, as stocks encountered a temporary summer swoon in early August following the release of a disappointing July jobs report. The weaker than expected labor market figures renewed worries about deteriorating economic conditions and raised fears about whether the Fed waited too long to trim interest rates. Escalating scrutiny about the frenzy over artificial intelligence also contributed to the correction. After the brief early-August stumble though, equity markets regained their footing. The Fed's decision to reduce interest rates by a half percent in mid-September, its first rate cut since the 2020 COVID crisis, provided an added boost to the market. The S&P 500 Index closed the third quarter with total return of 5.9% (+22.1% YTD)—its seventh quarterly gain over the last eight quarters. International stocks also moved higher, with developed markets (EAFE) reporting a quarterly gain of 7.3% (+13.0% YTD) and emerging markets (EM) rising 8.7% (+16.9% YTD).

A debate remains as to whether the Fed can pull off an economic "soft landing" (moderating inflation, declining interest rates, and sustained GDP growth) or if the more common "hard landing" (rising unemployment and slower/negative GDP) will ultimately ensue. While the soft-landing narrative has become the overwhelming expectation, which is responsible for extending the market rally over the last few quarters, any incoming data contradicting that outcome will rattle investor sentiment. The pronounced slowdown in the labor market trends of late, highlighted by weaker expansion of new jobs added during August and several downward revisions to the figures reported in prior months, is a prime example of data that could flip the economic outlook.

Labor Market Trends
Monthly Change in Payrolls and Unemployment
(12/31/14 – 8/31/24)



Source: Ycharts, Alpha Omega Wealth Management

Decelerating employment trends do not in of themselves point to an imminent downturn or recession, as the labor market may simply be normalizing from the post-pandemic recovery. However, when factoring in other cracks in the economic data (weak manufacturing metrics, falling commodity prices, etc.), some level of caution still seems warranted.

This is likely what prompted the Federal Reserve to slash interest rates by a half-percentage point (0.5%) in September, an aggressive start to its first easing campaign in four years. Outside of the emergency rate reductions during COVID, the last time the Fed cut rates by half a point was in 2008 during the global financial crisis. The question now is whether the Fed's policy pivot towards lower interest rates will provide adequate support to keep the economy growing at a rate sufficient to propel equity markets higher.

Conventional wisdom suggests that easing monetary policy cycles (rate cuts) are favorable for financial markets, as lower borrowing costs for consumers and businesses often drive increased economic activity and corporate earnings expansion. Historical market returns largely support that supposition. On average, the S&P 500 Index has risen 10% and 14%, respectively, over the 6- and 12-month periods following the first interest-rate reduction during Fed cutting cycles. That said, nearly 65% of the rate-cutting cycles were precursors to recession within 12 months of the first rate cut, as the Fed's efforts to arrest an economic downturn with monetary policy were unsuccessful. This proved to be the case for each of the last three rate-cutting cycles that preceded the 2001, 2007/08, and 2020 recessions.

Market Performance Following the Start of Rate-Cutting Cycles
(12/31/53 - 9/30/24)

First Fed Rate Cut	S&P 500 Price Change 6 mos. from First Rate Cut	S&P 500 Price Change 12 mos. from First Rate Cut	Recession Within 12 mos. After First Rate Cut?
February 5, 1954	17%	41%	Yes
November 15, 1957	7%	32%	Yes
June 10, 1960	-2%	15%	Yes
April 7, 1967	9%	4%	No
August 30, 1968	3%	-3%	No
November 13, 1970	23%	11%	Yes
November 19, 1971	19%	26%	No
December 9, 1974	39%	33%	Yes
May 30, 1980	22%	19%	Yes
November 2, 1981	-6%	11%	Yes
November 21, 1984	15%	22%	No
June 6, 1989	7%	13%	Yes
July 6, 1995	11%	19%	No
September 29, 1998	25%	21%	No
January 3, 2001	-8%	-14%	Yes
September 18, 2007	-12%	-21%	Yes
July 31, 2019	8%	10%	Yes
September 18, 2024	**?**	**?**	**?**
Average	*10%*	*14%*	
Median	*9%*	*15%*	
% Positive	*76%*	*82%*	

Source: St. Louis Federal Reserve, FactSet

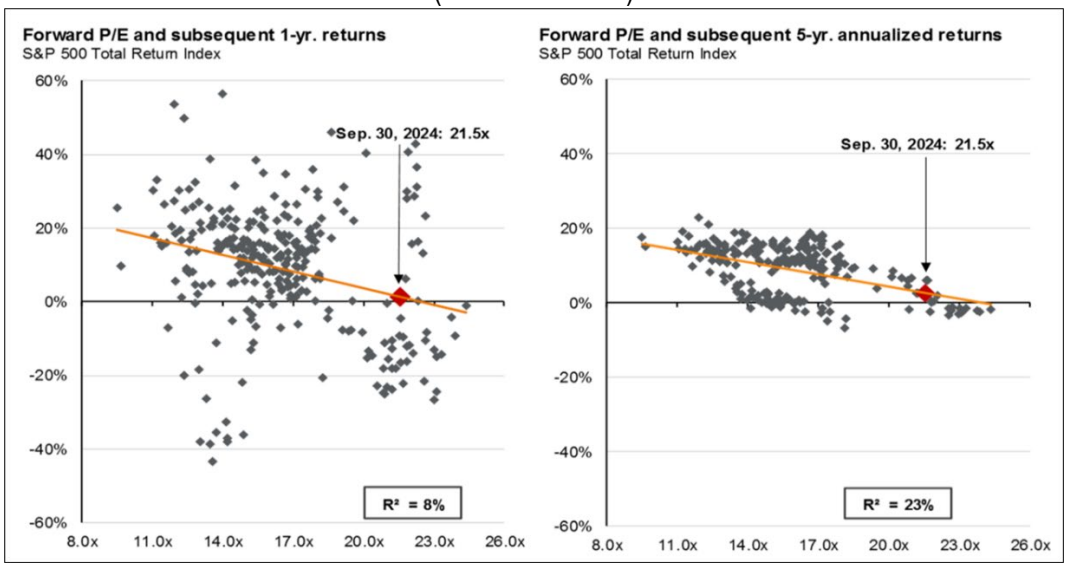
Current Fed rate cuts aren't intended to stimulate economic growth, but rather to move interest rates back to a neutral level—which neither stimulates nor restrains growth—so the economy can remain at a normal expansion rate. That should provide investors some comfort, as gradual rate-cutting cycles typically offer better equity returns (especially within the first year after the initial rate cut) than aggressive cutting cycles intended to stave off a recession or financial crisis. The Fed committee's latest "dot plot" projections predict that the federal funds rate will be reduced another half-point by year end (implying a quarter-point cut at each of its two remaining 2024 meetings), followed by four additional quarter-point rate cuts next year. That would push the benchmark federal funds rate down to a range of 3.25%-3.50% by the end of 2025—in line with a "neutral" monetary policy. A glide path more aggressive than that may indicate the Fed thinks the economy is in trouble.

While economic expansion is likely to cool from the second quarter's above-trend clip of 2.8%, it is expected to remain solidly positive for full-year 2024 (+2.5%) and 2025 (+1.8%). Even moderate GDP growth should enable corporate earnings—the most important near-term support for the stock market—to continue to move higher. That said, the consensus double-digit EPS growth expectations for 2024 (+10%) and 2025 (+15%) look elevated relative to the 7% long-term average, particularly at this later stage in the cycle, raising questions about the sustainability of equity valuations.

The S&P 500 closed the third quarter trading at a P/E multiple of 21.5 times forward 12-month earnings, marking a 30% premium to its long-term average of 16.5 times. This puts current equity index prices in the top decile of valuation history. As illustrated below, elevated valuation multiples tend to result in lower future returns—particularly over a multi-year investment horizon.

P/E Ratios and Equity Returns

(9/30/99-9/30/24)



Source: J.P. Morgan Asset Management, FactSet, Refinitiv Datastream, Standard & Poor's, Thomson Reuters

One of the primary contributors to the rise in equity valuations (at the index level), as well as the market's implied profit growth expectations, has been investor enthusiasm over artificial intelligence (AI). Reminiscent of the 1920s, 1950/60s, and late 1990s technology-led productivity booms, the consensus view is that AI technology will significantly transform companies, industries, and societies. That said, history shows the market often prices in the potential value creation of technological advances well before they materialize, raising the risk investors overpay for the cash flows those innovations ultimately deliver.

Nearly two years after the AI-fueled market rally started, the commercialization of a truly transformative—let alone profitable—application of the technology has yet to emerge. It's likely that significant technological breakthroughs from AI are on the horizon, but the return-on-investment path ahead will probably be a long and complicated one—consisting of ups/downs and winners/losers. In the interim, if AI technology ends up having fewer use cases and lower adoption than the market currently expects, a valuation correction could be coming for the high-flying, mega-cap technology stocks. Given the disproportionate percentage AI-related stocks now comprise of the capitalization-weighted benchmarks, this could limit the return prospects for headline indices. Nonetheless, it's plausible that the market could enter a cycle where most stocks continue to go up (powered by the strength of the economy and easing monetary policy), but the broader index fails to participate—enhancing the opportunities for active management strategies.

Equity market performance (as measured by the S&P 500 Index) over the last 24 months has been extraordinary, marked by a cumulative total return of 66% for the S&P 500 Index over the period. With interest rates projected to gradually descend from previously restrictive levels towards a more normalized range over the coming quarters, investors will have a bullish catalyst at their backs that could extend those gains further. This assumes, however, that the labor market and inflation achieve equilibrium to keep economic expansion intact. An overwhelming consensus of investors now expect the economy to sustain its positive trajectory, but with roughly two thirds of post-WWII rate-cutting cycles (including each of the last three) ending in recession within one year of the first rate cut in those cycles, an elevated measure of caution is warranted over the near to medium term. At a minimum, with equities displaying historically rich valuations at the index level, investors should be prepared for more measured market returns and increased bouts of volatility moving forward.

Core Portfolio

No new portfolio positions were initiated during the quarter, but we exited our holding in Bunge Global (BG).

Bunge is an agribusiness and food company, which operates as a middleman in the farm-to-consumer food chain. The company was a significant beneficiary from the spike in crop prices following the supply-and-demand imbalances created during COVID, which was further exasperated during the onset of the Ukraine/Russia war in 2022. Over the last few years, Bunge saw its operating margins more than double and earnings more than triple from its average pre-pandemic levels. With global agricultural fundamentals now having largely moved back into balance, pushing crop prices significantly below their post-pandemic highs, Bunge's earnings are poised to reset at a lower baseline. While the stock's reasonable valuation could still offer additional upside, we sold our position in the company and reallocated the proceeds to securities where we have more confidence in the near-term profit expansion opportunities.

Tactical Portfolio

In the Tactical portfolio, we made several position changes in the quarter. We liquidated our holdings in two sector-specific ETF holdings: the VanEck Agribusiness ETF (MOO) and the Invesco Energy E&P ETF (PXE). Those exits helped to fund the purchase of two new ETF positions during the third quarter. We bought the Fidelity Enhanced Mid Cap ETF, as the mid-cap equity space provides attractive diversified sector exposure relative to the broader market at more compelling valuations than large cap equities. We also purchased the Simplify Volatility Premium ETF, which is an income-producing fund structured to capitalize on temporary spikes in market volatility, as we believe more frequent and substantial swings in investor sentiment could ensue over the coming quarters.

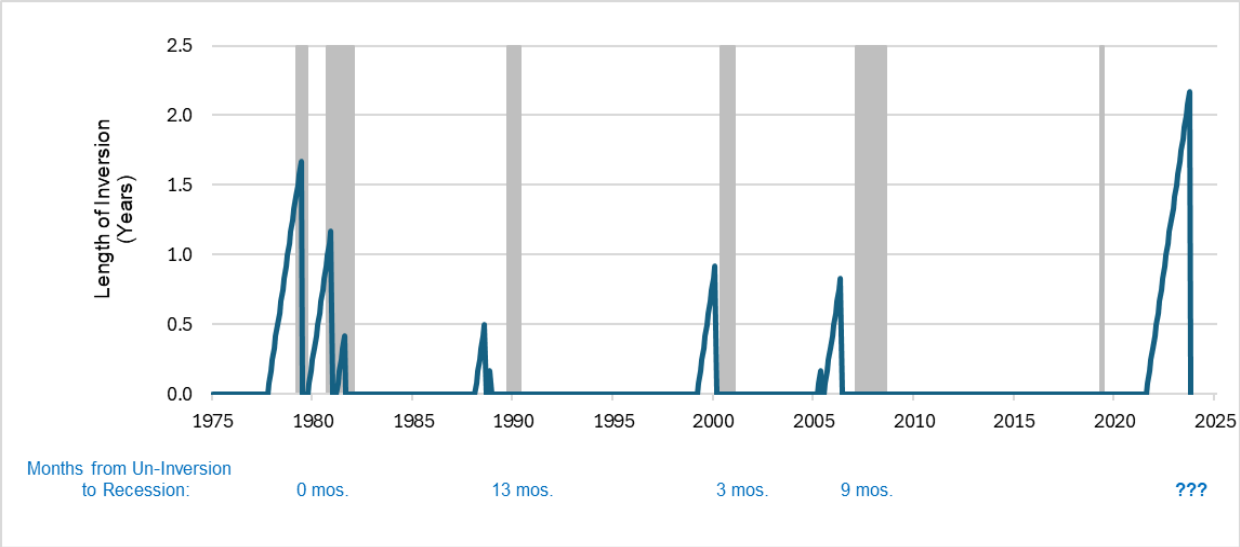
Fixed Income

Fixed income markets posted their second-strongest quarterly gain of the last 25 years during the third quarter, pushing the asset class's year-to-date performance back into positive territory. The benchmark U.S. aggregate bond index returned 5.2% during the quarter (+4.5% YTD), as bond prices rallied with yield decline across all treasury curve maturity intervals. The biggest yield declines occurred in shorter duration treasuries, which tend to be more sensitive to monetary policy moves. The 2-year yield fell below 4.0% for the first time since May 2023, closing the quarter at 3.66%, while the 10-year dipped to 3.81% by quarter end. Those rate moves during the quarter flipped the 2-year/10-year yield curve from being "inverted" to "un-inverted"— returning to its normal shape in which shorter-term rates are lower than longer-term rates— for the first time in more than two years.

Inverted yield curves have been regarded as one of the most reliable barometers of recession, given that all six U.S. recessions since 1980 have been preceded by at least a brief inversion of the yield curve. Many

investors interpret the absence of a recession during the most recent inversion period (the longest on record), and subsequent yield curve un-inversion, as an indication that a feared economic downturn is now off the table. However, while inverted yield curves signal a recession watch, the yield curve's reversion back to an un-inverted state has historically functioned as a more imminent recession warning (with a lead time of 0-13 months). Thus, the risk of a recession still developing over the coming year shouldn't be dismissed.

Length of Yield Curve Inversion
2-year Treasury Yield > 10-year Treasury Yield
(12/31/75 – 9/30/24)



Source: Ycharts, Alpha Omega Wealth Management

Irrespective of where the economy trends in the near term, interest rates are likely to move lower from here. That should continue to provide a supportive backdrop for fixed income assets moving forward. While the initial rebound in bonds from oversold conditions has already materialized as investors have front-run policy rate cuts, continued normalization of the yield curve is expected—with short-term yields poised to keep falling faster than long-term yields. Thus, the intermediate-term belly of the yield curve currently looks to be the sweet spot for bonds, providing a balance of attractive income and duration protection.

Final Thoughts

The market twists experienced during the third quarter offered another reminder that it's often best for investors to stay the course through bouts of volatility, as this patience is often rewarded on the other side. The current quarter could have its own market swings, as political uncertainties come to the forefront ahead of the November election.

While both political parties have espoused ill-advised policy ideas that could have unintended consequences, history shows that destructive policies typically fail to garner political support—especially if there is a divided Congress, as is expected. For this reason, elections tend to have a fleeting impact on equity returns, as broad economic trends and market fundamentals are what ultimately drive longer-run stock performance. That is likely to hold true this cycle, regardless of which party wins in November.

As always, thank you for the continued trust you place in us to manage your assets. If you have any questions or needs, please reach out at any time.

Parkside Investments, LLC

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