Economic Overview

Steve Scranton, CFA, SVP, Economist

The economy continues to defy predictions of an imminent recession. After posting a 3% annualized growth rate in the 2nd quarter, the economy appears to have finished the 3rd quarter with a continued solid pace of growth.

- The New York Federal Reserve real-time model (Nowcast) is currently predicting economic growth continued at a 3.0% annualized rate in the 3rd quarter.
- The Atlanta Federal Reserve's real-time model (GDPNow) is currently predicting 3.1% growth.
- The median forecast from over 60 economists surveyed by Bloomberg shows a more cautious view with a forecast of 2.3% annualized growth.

The biggest news for many was the announcement by the Federal Reserve, at its September policy committee meeting, that it reduced its overnight borrowing rate by 0.50%. This signals that the period of rising interest rates has ended and a period of declining interest rates is beginning. How fast and how much are yet to be determined. That is good news for borrowers who have an interest rate tied to short-time benchmarks. It is bad news for savers who have their money in saving accounts or money market mutual funds.

As I have discussed in previous newsletters, economic growth starts with jobs creation, since wages and salaries make up 61% of total income. Jobs creation has clearly slowed this year compared to last year but remains positive. From January through August of last year, job growth averaged 266,000 per month. For the same period this year (August is the most recent data as of the creation of this article) jobs growth has slowed to 184,000 per month.

Growth in personal income slowed slightly compared to the same period last year. From January through August of last year, personal income averaged a 6.3% annualized growth rate. From January through August of this year the annualized rate slowed to 5.9%.

- Personal income after taxes and inflation slowed at a faster pace.
- From January through August of 2023, personal income after taxes and inflation averaged a 5.3% annualized rate while it grew at a 3.2% pace for the same period this year.

The pace of spending by the consumer also slowed compared to 2023 but not as much.

- From January through August of 2023, personal spending averaged a 6.7% annualized rate while it slowed to an average rate of 5.2% for the same period in 2024.
- Spending after inflation actually increased, as it averaged a 2.4% annualized rate from January through August of 2023 and a 2.6% pace for the same period in 2024.

The good news for the economy is that, as of August, income growth is growing faster than inflation and spending. This has allowed the consumer to continue spending.

- Real disposable personal income grew at a 3.1% year-over-year pace in August. This is income after inflation and taxes. Real personal spending grew at a 2.9% year-over-year pace.

Although we will not get the first official estimate of economic growth until the end of October, the available data indicates that the economy remained on solid footing through the 3rd quarter.

Strategy Review

Derrick Wilson, CIMA®, VP, Portfolio Manager

The 3rd quarter provided further gains overall. Equities continued their upward trajectory and bonds also provided strong returns. It was not all smooth sailing, however, as there was some volatility here and there, albeit short-lived. Federal Reserve monetary policy was a focus towards the end of the quarter with its September meeting. After initiating a 0.50% reduction in interest rates, the markets ultimately took this as a good signal.

A bit of change from recent quarters was that international equities outperformed US equities. A weakening US dollar aided in this dynamic, as the USD declined over 4.8% in the quarter. Within international equities, emerging markets outpaced developed countries. China was the main driver of EM outperformance, which really came in the last week of the quarter where an array of stimulus measures thrust upon the economy by the Chinese government provided the boost. To highlight, the MSCI China index gained 23.64% in the quarter, compared to the MSCI EM excluding China index that had a gain of 4.11%.

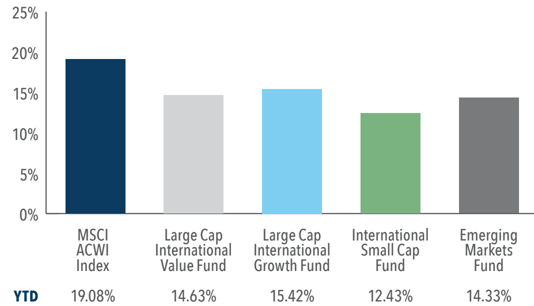
Within US equities, another shift, or flip, was small cap stocks outperforming large cap stocks. The reduction in interest rates provided the catalyst as this lowers the cost of financing operations. Investor sentiment also improved in more economically sensitive areas.

The bond market also benefitted from the Fed's policy shift with strong gains across the curve with longer-dated maturities gaining a bit more than shorter maturities. Notably, after 26 months of inversion, the yield curve returned to more normal conditions with the 2-year yield moving lower than the 10-year yield. Credit outperformed government bonds, with both investment-grade and high yield corporate bonds ahead of Treasuries. Emerging market bonds outpaced all.

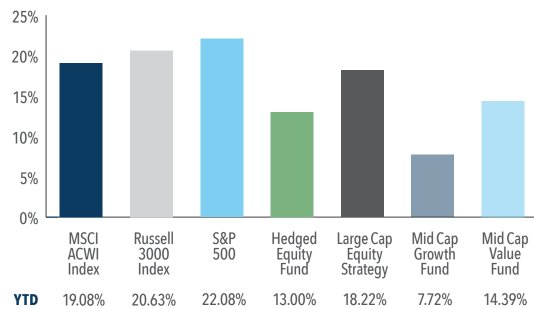
Real estate and global infrastructure greatly outperformed in the 3rd quarter, both with returns in the mid-teens. Commodities were a little choppy throughout, ending just barely positive. Within the broad basket, precious metals gained over 11% but was offset by energy declining nearly the same. Managed Futures trend-following strategies struggled with weaker trends and market chop. Global macro finished positive, but less so than other bond strategies.

Ultimately, the 3rd quarter was heavily influenced by the change in Fed policy. What may have initially been a concern for investors, quickly turned to a positive. Entering the final quarter, geopolitical risks have come more to the forefront, as well as the US presidential election. Volatility could pick up. While not knowing where this ends, markets have been through this before and will make it through again.

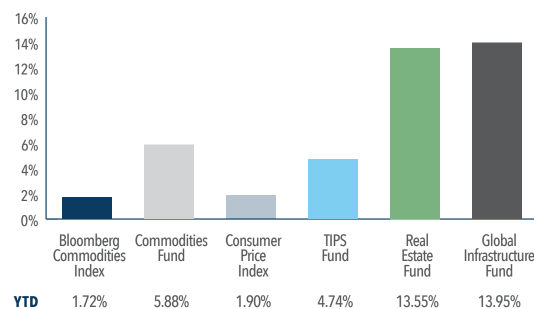
INTERNATIONAL DIVERSIFICATION
YEAR-TO-DATE PERFORMANCE



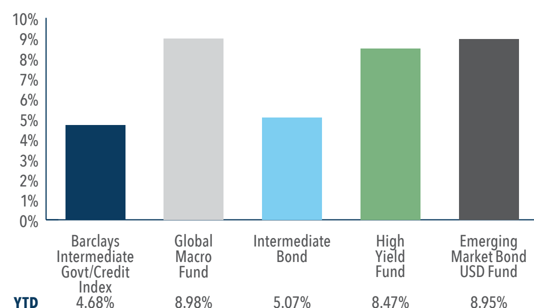
DOMESTIC DIVERSIFICATION
YEAR-TO-DATE PERFORMANCE



REAL RETURN (INFLATION PROTECTION) DIVERSIFICATION
YEAR-TO-DATE PERFORMANCE



INCOME DIVERSIFICATION
YEAR-TO-DATE PERFORMANCE



Domestic Equities

Gayle Sprute, VP, Senior Portfolio Manager

Domestic stocks delivered another installment of solid gains during the 3rd quarter, albeit with a couple of bumps along the way. At the end of July and again at the end of August, stocks staged sharp, but short, sell-offs. In both cases, a small handful of disappointing economic data sparked investor concern that, although disinflation is progressing, the economy and labor market might be slowing quickly — and that the Federal Reserve (Fed) could be falling behind the curve in lowering interest rates.

An offset to these worries came as the Fed delivered increasingly dovish communication throughout the quarter. Some further easing in inflation data amidst slowing employment data strengthened the idea that the Fed would shift its focus from the mandate of stable prices and toward that of maximum employment — thus increasing the likelihood of a start to an interest rate easing cycle. In late August, Fed Chair Powell telegraphed that "the time has come for policy to adjust." And indeed, in mid-September, a 50 basis point cut to rates (the first cut since 2020) kicked off the long-awaited rate cutting cycle — music to the equity market's ears.

Anticipation about falling interest rates, amidst stable overall economic data, contributed to across-the-board gains for the major domestic indices during the 3rd quarter: Russell 2000 +9.3%, Russell Mid-Cap +9.2%, Dow Jones Industrial Average +8.7%, S&P 500 +5.9%, and Nasdaq Composite +2.8%. Notably, all of the indices are up double digits year-to-date, with the S&P 500 providing leadership, +22.1%, followed closely by the Nasdaq Composite, +21.8%.

With the prospect of rates moving lower, it is not surprising that rate sensitive sectors provided leadership. During the quarter, the best-performing sector was utilities, +19.4%, followed by real estate, +17.0%. The laggard was energy, -2.3% (owing to a drop in WTI crude from $83/barrel to $68/barrel during the quarter) and, SURPRISINGLY, technology, +1.6%. Another surprise occurred as value, +9.0%, beat growth, +3.7%.

Focal topics leading into year-end include: 1) economic "data watch," particularly as it pertains to inflation, the labor market, and the economy; 2) the Fed's pace of rate cuts; 3) election outcomes for the White House, Senate, and House; and 4) 3rd quarter earnings results and management outlooks for 2025.

Fixed Income

Callen Young, VP, Portfolio Manager

The 3rd quarter of 2024 saw significant moves in both the Treasury and municipal bond markets. The 5-year U.S. Treasury yield began the quarter at 4.42% and dropped to 3.55% by September 30. A similar but more gradual decline was seen in 5-year AAA municipal bonds, with yields falling from 2.98% to 2.37%. These shifts were driven by a combination of softer economic data, cooling inflation, and the Federal Reserve's monetary policy decisions.

As the quarter progressed, market participants increasingly expected rate cuts from the Federal Reserve in response to data that suggested a slowing economy. By mid-September, the Fed had cut the federal funds rate by 50 basis points, bringing it down to 4.75%–5.00%. Fed Chair Jerome Powell indicated that if July's economic data had been available earlier, the Fed might have acted sooner. This dovish stance and the actual rate cut contributed to the sharp decline in Treasury yields. The drop in the 5-year Treasury reflected these market expectations, as investors priced in a more accommodative monetary policy.

In contrast, muni yields declined more modestly, with the heavy supply of new municipal bonds dampening the effect of the Fed's easing. Issuance of munis was up 35% year-over-year as issuers sought to lock in lower borrowing costs ahead of potential volatility related to the 2024 elections. This influx of supply kept muni yields from falling as steeply as Treasuries, leading to attractive relative values for munis at times through the quarter. The 2-year/10-year Treasury yield curve, which had been inverted since July 2022, returned to normal in early September, a typical signal of monetary easing. The muni curve, typically steeper than the Treasury curve due to tax exemptions, and credit and liquidity risks, also began to steepen, although heavy issuance flattened it at times during the quarter.

The labor market showed signs of a gradual cooling. Nonfarm payroll gains slowed sharply, with just 89,000 new jobs added in July, followed by 142,000 in August. The unemployment rate edged up to 4.3% in July before falling slightly to 4.2% in August. Despite these weaker labor market figures, weekly unemployment claims remained low through September, signaling that the slowdown is gradual and not yet a significant downturn.

Inflation continued to moderate, with the core personal consumption expenditures (PCE) index – the Federal Reserve's preferred inflation measure – rising by 2.7% year-over-year in August. While this remains above the Fed's 2% target, the marked progress in inflationary trends, along with the slowing labor market, helped justify the Fed's rate cut and reinforced market expectations of further easing.

Looking ahead, we expect both the Treasury and muni yield curves to steepen further as the Fed continues its rate-cutting cycle. Whether this steepening comes from falling short-term rates, rising long-term rates, or a combination of both will depend on inflation data, labor market performance, and political developments ahead of the 2024 election. The muni market, in particular, may experience ongoing volatility due to heavy issuance and political uncertainty, though as supply pressures ease, muni yields should follow Treasuries lower.

International

Matthew Clarke, CIMA®, VP, Senior Client Portfolio Manager

The 3rd quarter of this year was another positive one but wasn't without volatility. **Central bank policy continued to make headlines** with additional interest rate cuts from the Eurozone, Canada, Switzerland, Sweden, a cut from the UK, New Zealand **and of course a jumbo 50 basis point (bps) cut from the United States in September**. Notably, Japan continued to be an outlier, moving in the opposite direction by hiking rates in July for the second time this year. Japan's move strengthened the yen (most since 2008) and sparked an early August unraveling of the Yen Carry Trade, which involves investors borrowing the yen to buy other currencies offering higher yields.

Potential for more accommodative central bank policy helped to offset the short bout of volatility induced by Japan, and ongoing concerns about escalations in Ukraine and the Middle East. As a result, global stocks and bonds closed out the quarter higher. Over the quarter, **emerging markets stocks continued to outpace their developed international peers. At the same time, developed international stocks outpaced domestic stocks**. Emerging markets (MSCI emerging markets index) returned 8.82% on the quarter and 17.02% year to date (YTD), while developed international (MSCI EAFE) gained 7.35% on the quarter and 13.55% YTD. For the sake of comparison, the S&P 500 returned 5.89% on the quarter, but is still leading international on a YTD basis at 22.08%.

China drove returns in the emerging markets space fueled by significant stimulus including a combination of rate cuts and support for China's struggling real estate sector. Putting things into perspective, the Shanghai Composite ended the quarter up an impressive 14.28%, which brought its YTD return up to 15.33%.

With so many central banks moving in an accommodative direction, global bonds benefited. The Bloomberg Global Aggregate ended the quarter higher by 6.98%. Notably, emerging debt (JPMorgan EMBI) closed out the quarter higher by 6.15% followed by US Treasuries (Bloomberg US Treasury TR Index) at 4.74%.

As we consider the final quarter of the year, we believe it's appropriate to revive a term we used at the onset of the year – "cautiously optimistic". China's massive stimulus should be positive over the near-term for the global economy while US economic data and monetary policy continue to move in favorable directions — providing the framework for a sustained tailwind. At the same time, we cannot ignore rising geopolitical tensions, upcoming US elections and the potential of economic surprises.

Additional and expanded information to this newsletter discussion may be obtained by contacting your relationship manager. We will be happy to expand our discussion with you to meet your individual requirements as a client of Wealth Management & Advisory Services.

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Third Quarter 2024 – Highlights

Economic Outlook

Steve Scranton, CFA, SVP, Economist

As discussed in the Economic Outlook section of this newsletter, the economy continues to grow at a solid pace. The next twelve months' growth may well be determined by the Federal Reserve's monetary policy actions. The Federal Reserve has a dual mandate for determining its monetary policy. The dual mandate is to achieve stable inflation and full employment.

Let us examine both of those criteria to try to understand the future path of interest rates.

- The Federal Reserve's stated goal for inflation is 2.0%. Currently the two indices that it follows as their guide are not yet at 2.0%. Core CPI is currently at a 2.1% year-to-date level through August. If it grows 0.1% for the next four months, it will be at 2.5% at year-end. Core PCE is currently at 1.9% year-to-date through August. If it grows 0.1% for the remaining four months, it will reach 2.3%. Although not at its 2.0% target, Federal Reserve members have stated their confidence that inflation will continue to decline even if it does not hit its 2.0% target this year.
- A way to measure "full employment" is to examine the number of job openings that exist compared to the number of unemployed. When there are more job openings than unemployed people, that indicates a "fully employed" labor market. When there are more unemployed than job openings, that indicates a labor market that is not fully employed. Currently there are 1.13 job openings for each unemployed person as of August. That indicates an economy that is at or close to full employment.

Based on the above information, the Federal Reserve determined that its mandates were close enough to being met that it was time to begin lowering its overnight borrowing rate back to a "neutral" level. The neutral level of interest rates is a level that lets the economy grow without triggering higher inflation. The challenge is that this "neutral" rate cannot be mathematically calculated. It can only be observed by the economy's reaction to the level of interest rates. This is why the Federal Reserve states that it is data dependent.

Why this focus on interest rates for this quarter's Economic Outlook? Because interest rates are clearly a factor in determining future economic growth. Borrowers are affected if they have loans that have a variable rate of interest that is tied to a short-term benchmark. As interest rates rise, their monthly payment rises and less income is available for spending or investing. The reverse is true when interest rates are falling. This type of borrower is typically a business with operating lines or lines of credit and consumers with credit cards. Savers benefit when interest rates are rising as it provides more income that they can use to spend. When interest rates fall, savers receive less income and, all else being equal, have less money to spend.

Currently, the Federal Reserve is indicating that it anticipates continuing to lower its overnight borrowing rate until it finds the "neutral" rate. Economic growth will be impacted by whether it succeeds.

Amidst this uncertainty, my message remains the same:

- Focus on your business or job and keep doing what has made you successful.
- Have your game plan prepared so that when economic conditions change for you, you can respond objectively.
- If you are not a borrower and don't rely on interest income for spending, then ignore the "noise" over interest rates and continue to focus on strategies for future success.

Third Quarter 2024 – Market Overview

Cumulative Periods as of September 30, 2024

	Year-to-Date	1 Year	3 Years (Annualized)	5 Years (Annualized)	10 Years (Annualized)
Russell 3000 Index	**20.63**	**35.19**	**10.29**	**15.26**	**12.83**
S&P 500 Index	22.08	36.35	11.91	15.98	13.38
Russell Mid Cap Index	14.63	29.33	5.75	11.30	10.19
Russell 2000 Index	11.17	26.76	1.84	9.39	8.78
FTSE NAREIT All Equity REITs Index	**14.23**	**34.77**	**3.51**	**5.09**	**8.04**
Bloomberg Commodity Index	**5.86**	**0.96**	**3.66**	**7.79**	**0.03**
MSCI ACWI All World Index	**19.08**	**32.35**	**8.60**	**12.72**	**9.94**
MSCI EAFE Index	**13.50**	**25.38**	**6.02**	**8.72**	**6.22**
MSCI EAFE Small Cap Index	11.59	24.08	0.12	6.85	6.63
MSCI EM Index	17.24	26.54	0.82	6.15	4.41
Bloomberg Govt/Credit 1-5 Yr. Index	**4.50**	**8.10**	**0.94**	**1.54**	**1.77**
Bloomberg US Treasury TIPS Index	4.90	7.93	2.11	3.49	2.38
BofAML US High Yield Master II Index	8.03	15.66	3.08	4.55	4.95
JPM EMBI Global Diversified Index	8.59	18.54	-0.42	0.86	3.27
Bloomberg Municipal 1 Yr. Index	**2.59**	**4.97**	**1.60**	**1.49**	**1.29**
Bloomberg Municipal 3 Yr. Index	**2.47**	**6.17**	**0.77**	**1.33**	**1.38**
Bloomberg US Treasury Bill 1-3 Month TR USD	**4.08**	**5.52**	**3.57**	**2.33**	**1.63**

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