

2024 Third Quarter Update

Review: Most asset classes delivered strong returns in Q3, including the S&P 500, which has now returned 22.1% year to date. The S&P 500 continues to be ahead of international stocks for the year. However, both developed and emerging markets had a strong finish to the quarter, outpacing the gains for the S&P 500 in Q3. The long-awaited cut of the Fed Funds Rate last month was a key catalyst for both stocks and bonds. The US Aggregate Bond Index returned 5.2% in the quarter, as interest rates fell (driving up the prices of bonds).

	3Q24	2Q24	1Q24	2023
S&P 500	5.9%	4.3%	10.6%	26.3%
MSCI EAFE^{1,2}	7.3%	-0.1%	5.8%	18.9%
MSCI Emerging Markets²	8.9%	5.4%	2.2%	10.3%
Bloomberg U.S. Aggregate Bond	5.2%	0.1%	-0.8%	5.5%
Bloomberg Municipal Bond	2.7%	0.0%	-0.4%	6.4%

¹Europe, Australasia, Far East

²MSCI returns are in U.S. Dollars

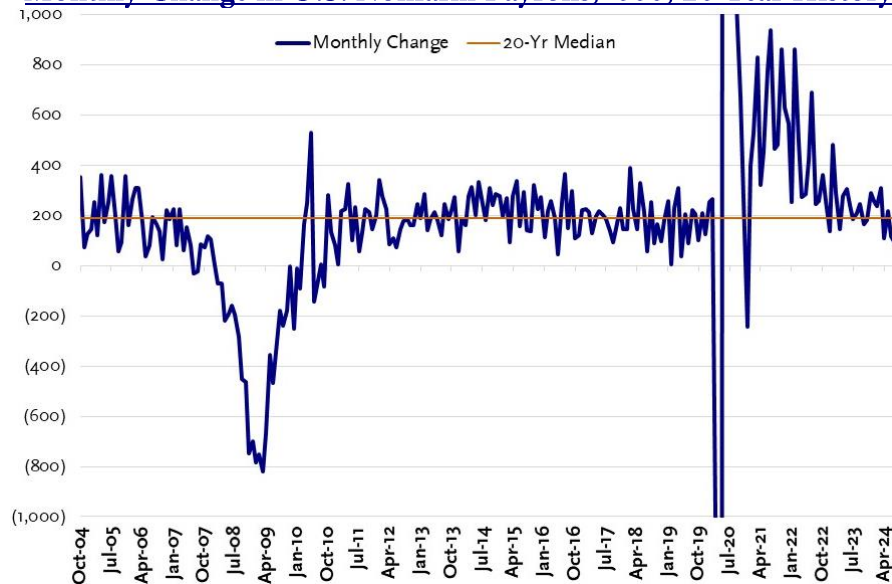
Rate Cut? Check... Soft Landing? TBD

With inflation heading toward the Fed's target, attention shifted to the labor market, which has been slowing in recent months. As a result, the Fed announced a 0.50% cut to the Fed Funds Rate at their September meeting. Markets rallied on the news, with the consensus opinion being that by going with a larger initial cut rather than 0.25%, the Fed increased the likelihood that a soft economic landing could be achieved.

All else being equal, the larger initial rate cut *may have* slightly improved the probability of a soft landing. However, we have seen in previous cycles that monetary policy typically has a lagged effect on the economy. A key factor that led to the larger rate cut was the slower than expected jobs growth in July, and it is not yet clear whether the extra 0.25% cut is sufficient to arrest the slowdown in jobs growth. If it is not, then the stock market is not likely to continue to view rate cuts as positively as they have. The following chart shows the change in monthly nonfarm payrolls over the past 20 years. The readings in recent months have been slightly below the long-term median level, so to have increased confidence in a soft landing, one would like to see a stabilizing trend in the coming months.



Monthly Change in U.S. Nonfarm Payrolls, '000, 20-Year History



Source: U.S. Bureau of Labor Statistics; data through August 2024

Outlook: US real GDP growth is expected to slow over the next year. The current consensus estimate for 2025 GDP growth is 1.8%, compared to an estimated 2.5% for 2024. Despite this expected deceleration in economic growth, US corporate earnings growth is expected to accelerate in 2025, with S&P 500 estimates implying 16.1% growth next year compared to the 10.8% expected in 2024. The underlying assumption behind the expected acceleration in earnings growth next year is that even though the growth of the “Magnificent 7” stocks might decelerate, the growth of the other 493 stocks of the S&P 500 would accelerate (meaningfully). While we often point out that the economy and stock market are not the same, this expected divergence in growth trends seems overly optimistic to us. Even if the U.S. is able to realize a soft economic landing, is it reasonable to expect an acceleration in US corporate earnings growth?

One possible explanation for the apparent divergence in expected growth trends could be an expectation of accelerating international economic growth, coupled with a weaker US dollar. However, estimates for major international economies do not reflect the strong rebound in GDP growth that would likely be required to boost US corporate earnings growth. China recently announced a number of stimulus measures to attempt to reinvigorate growth, but it remains to be seen whether they will be successful. Additionally, rising geopolitical tensions represent a significant wildcard for growth.

Strategy: The Price-to-Earnings (P/E) ratio of the S&P 500 remains around 21x, well above the trailing 30-year average of 16.7x. If earnings growth does indeed accelerate next year, it is possible that this seemingly elevated valuation metric will not be a meaningful headwind to stock returns next year. However, as evidenced by our comments in the earlier sections, we believe that investors might be overly optimistic in their outlook and subsequent willingness to pay up for stocks. Therefore, we remain biased towards higher quality growth stocks where valuations are reasonable, and we continue to view opportunities in higher quality bonds as attractive ways to improve the overall risk-reward of investment portfolios in the current market environment.