Review & *Outlook*

THIRD QUARTER 2024

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Review and Outlook

This past quarter has been a bit of a roller coaster for the financial markets, particularly for the S&P 500 Index. While the index ended up 5.9% for the quarter, it was down 5% at the beginning of August. And for the first time since the onset of COVID in early 2020, the Federal Reserve lowered interest rates. On September 11th, the Fed cut rates by 0.5%, which was considered surprisingly large, as many anticipated a cut of only 0.25%. This follows a rapid rise in rates from effectively zero in January 2022 to 5.25% in August 2023, done in large part to mitigate surging inflation. The Fed has a dual mandate to both minimize unemployment and to keep inflation under control. Raising rates so rapidly was primarily driven by a desire to drive down inflation.

How the markets react to falling interest rates depends on the underlying part of the economy that the Fed is trying to address. If lowering rates is driven by a weakening economy and significantly rising unemployment, the markets may anticipate declining earnings growth, putting pressure on stock prices. Given the stress higher interest rates have put on certain segments of the economy, in particular the real estate sector, there has been ongoing concern of a potential recession. However, if the significant drop in inflation has created space for the Fed to lower rates, the idea of a "soft landing" can remain intact, and the markets are likely to remain positive.

Consistent with this, the Blue Chip Consensus forecast calls for slowing employment growth, but not a contraction. That lack of a contraction combined with lower inflation, good income growth, and some renewed activity in the housing market (with lower interest rates) points to a "no landing" scenario, or a very comfortable "soft landing" for the economy. This forecast bodes well for stocks. Stocks typically do well when interest rates fall and the economy continues to grow. But, as economists, we would be remiss not to point out our concerns about the forecast.

For those on the upper portion of the income spectrum, things have been very good. Yes, borrowing has been more expensive for the past couple years, but savings have been generating solid returns, providing additional cash on top of the COVID stimulus funds. And all that money has backstopped strong consumer spending. But those at the lower end of the income spectrum can be facing challenging circumstances, including the fact that any stimulus funds ran out long ago, they don't have the savings to benefit from high money market rates, and inflation has made balancing their household budgets very challenging. In short, the major metrics point to a slower, but still healthy economy. However, questions emerge when you dig deeper and think about the risks.

Index Performance Data
Total Return as of 9/30/2024

Indices[1]	Q3 2024	Trailing 12 Months
CRSP U.S. Total Market Index Total Return	6.18%	35.23%
iShares MSCI ACWI EX-US Total Return	7.70%	21.72%
Bloomberg U.S. Aggregate Bond Index	5.20%	11.57%

When we think of more obvious risks, we think of what is happening with commercial real estate or what the escalation of war could mean, especially in the Middle East, if it resulted in higher oil prices. We also wonder how to interpret increased unemployment rates within specific occupations. While it is hard to imagine a recession with unemployment below 5% at the national level, the rate of increase since the first quarter of 2024 has some people concerned. The most recent labor report showed essentially no increase in unemployment in August, suggesting no recession, but economic researchers Pascal Michaillat and Emmanuel Saez have said they aren't so sure. They think recent increases have been worrisome, and assign a probability that we are entering a recession at 40%.[2]

Nevertheless, we see many people doing well and spending a lot (as evidenced by continued strong consumer spending), while others live in a very different economy. A press release from the Federal Reserve Bank of New York last month offered that, "Household Debt Increased Moderately in Q2; Auto and Credit Card Delinquency Rates Remain Elevated".[3]

Data from the Federal Reserve Bank of St. Louis also shows that credit card loans are now well above pre-pandemic levels. Does that point to problems on the horizon? Perhaps not. Delinquency rates were moderately higher from 1994 through 2008 than they are right now. Our conclusion is that households deleveraged in the wake of the financial crisis of 2008, then had stimulus funds to help manage their debt, so we see a return to an economic state that was normal prior to 2008, rather than the approach to some kind of crash. That said, we will be watching labor market reports closely through the fall. If the unemployment rate resumes its upward march, we imagine the Federal Reserve will respond by lowering interest rates more than currently expected (50 basis points at their next meeting, and another 25 basis points later in the year).

We always need to remain mindful that the economy and markets can move on separate paths. While we have been experiencing steady, but low economic growth, the stock market has risen significantly over the past year, and prices measured by many metrics are at historically very high levels. Returns in the coming year may be muted simply because prices have run up so far and so quickly in recent months. Much of the market exuberance has been based on the anticipation of the interest rate cycle not just pausing, but fully shifting into reverse.

One area that we are watching (but not obsessing upon) is the upcoming election. There is simply too much that presidents and their administrations don't control when it comes to the economy and the financial markets, and there is virtually no correlation between one party's winning the election and the economy doing any better or worse. We also don't really know what either candidate would actually do, or be able to do, if elected. Further, a divided congress, which looks likely, may mean it will be difficult to move any particular agenda. So, no matter who is elected president, or how congress plays out, the many things could happen after the election are simply conjecture and speculation. So, while we do have concerns, it is clear the election is very close and the outcome highly uncertain. At this point in time, we don't feel there is any information coming out of the election cycle to have us make adjustments to our client portfolios.

With a relatively positive outlook for the economy, we expect stocks will be volatile through the election. The economic foundation is fine, but there will be shifting views about what might happen in the near future. Those changing views will mean ups and downs for stock prices. We would only see a drop in the stock market if the labor market weakens more than currently expected, or because of other external factors, such as a reset of pricing multiples from current highs.

Looking more globally, it appears that China is taking steps to shore up their economy, though we are skeptical about the effectiveness of those policy changes. We continue to face the risk of escalation in both Ukraine and the Middle East, with the latter having the potential to dramatically increase the price of oil. We expect bonds will continue to do well through the end of the year, though not as well as they have for the past several months.

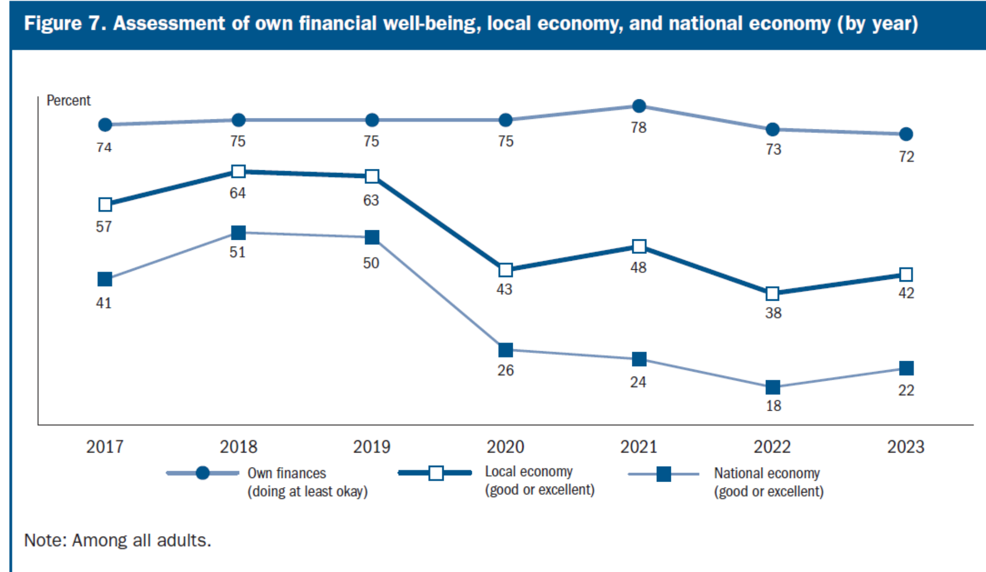
In Focus

This quarter we focus on public information and decision making. In theory, well-functioning markets require good information. The idea is that with solid information people won't regret the decisions they make. Especially big decisions, like making major purchases or investing in a new business.

Several years ago, we dedicated an "In Focus" to how in some southern states, particularly Florida, it appeared that lots of people who were not worried about climate change were buying real estate from folks who anticipated rougher times ahead. We expected companies providing property insurance to take a reality-based view, and that insurance rates would be pushed up in the coming years. This has proven true, with insurance rates increasing dramatically in recent years, and many insurers actually leaving the Florida market altogether.[4] The recent path of devastation from

Hurricane Helene, from Florida up through North Carolina, suggests this trend of shrinking property insurance coverage will continue and broaden. One consequence of this is that many people in Florida cannot afford to buy insurance, and are choosing to go uninsured. In general, banks require property insurance as a condition of obtaining a mortgage, yet despite this, Florida has seen a record number of people moving to the state in recent years. However, it seems that a growing number are expressing some regret due to rising insurance costs and seemingly more routine cleaning up from wind and flood damage.[5] We expect the cost of property insurance to continue to increase for many southern states, and are curious to see if residents will be successful in shifting those costs by increasing demands for the Federal Government to provide subsidies propping up the insurance and real estate markets.

Figure 1[6]



Another example of where perceptions may be different from reality, and perhaps with consequences, is how people view their own personal finances compared to that of the local and national economy. In a recent report by the Federal Reserve, a broad survey of adults asked how they view their own financial well-being, as well as that of the local economy, and the national economy. The results showed that, in the past four years, a remarkable chasm has opened up between how people view their own finances compared to the local and national economies.

For example, in 2023, 72% of adults responded that their own financial well-being was "good" or "excellent". At the same time, only 42% felt similarly about the local economy, and only 22% for the national economy. The remarkable result is that if 72% of respondents feel their finances are good, it seems highly implausible, if not impossible, that the overall national economy is a disaster. Presumably people are better informed about their own situation than that of everyone else around the country. While this dichotomy between a more positive view of one's own situation versus a more negative view of the local and national economy existed previously, the gap between the two increased dramatically starting in 2020, widening to over 20%. This difference between perception and reality probably has the most impact in the realm of politics, but could also impact how companies and investors think about deploying investment capital, where they hesitate, perhaps due to the constant doom and gloom.

1. Index performance data provided by ICE Data Services, and calculated by Black Diamond, an SS&C Advent company.
2. Michaillat, P., & Saez, E. (2024, September 16). Has the recession started?. Pascal Michaillat. https://pascalmichaillat.org/16/
3. Household debt increased moderately in Q2 2024; auto and credit card delinquency rates remain elevated. Household Debt Increased Moderately in Q2 2024; Auto and Credit Card Delinquency Rates Remain Elevated - FEDERAL RESERVE BANK of NEW YORK. (2024, August 6). https://www.newyorkfed.org/newsevents/news/research/2024/20240806
4. Pichee, A. (2024, September 27). Hurricane Helene hits Florida homeowners already facing soaring insurance costs. CBS News. https://www.cbsnews.com/news/hurricane-helene-homeowners-insurance-florida/
5. Marcof, B. (2024, July 24). Florida's population TOPS 23M for the first time due to people moving in from other states. Secret Miami. https://secretmiami.com/florida-record-breaking-population/
6. Overall financial well-being. The Fed - Overall Financial Well-Being. (2024, May). https://www.federalreserve.gov/publications/2024-economic-well-being-of-us-households-in-2023-overall-financial-well-being.htm

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