46 PEAKS
INVESTMENT ADVISORY GROUP

The Forest for the Trees.

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When you watch the markets every day, week, or even quarter, it's easy to lose perspective of the big picture – focusing too much on the forest for the trees so to speak. So, when something "big" happens, if we're too focused on the day to day, it can be easy to miss the significance. Zooming out to a distance from which to get a broader perspective, we think the third quarter of 2024 had several important developments that are likely to mark a major change in markets.

For one, there were some unusual patterns in the relative performance of different investment categories over the past few months. While the Large Cap S&P 500 index was up 5.9% for the quarter, it was – are you ready for this – **one of the worst performing categories** of stocks. Small Cap U.S. stocks were up over 9.3%. Non-U.S. stocks jumped almost 7.3% and Emerging Market stocks leaped 8.7%. We mentioned last quarter that it may be time for the rest of the U.S. stock market to catch up a little to the largest, most well-known and popular stocks. And what do you know…the "equal weight" S&P 500 index trounced the performance of the traditional capitalization-weighted index, advancing 9.5%. That's not to dunk on Large Cap stocks however – they are up almost 21% year-to-date, the best first nine months since 1997, and the best in an election year since 1928.

The bond market's performance was another big part of the story for the quarter. As bond yields fell sharply in July and August, bond prices rose, with the Core Bond index posting a 5.1% total return for the quarter. After several years of poor returns, this quarter's return for Core Bonds is a welcome contribution to diversified and conservative portfolios.

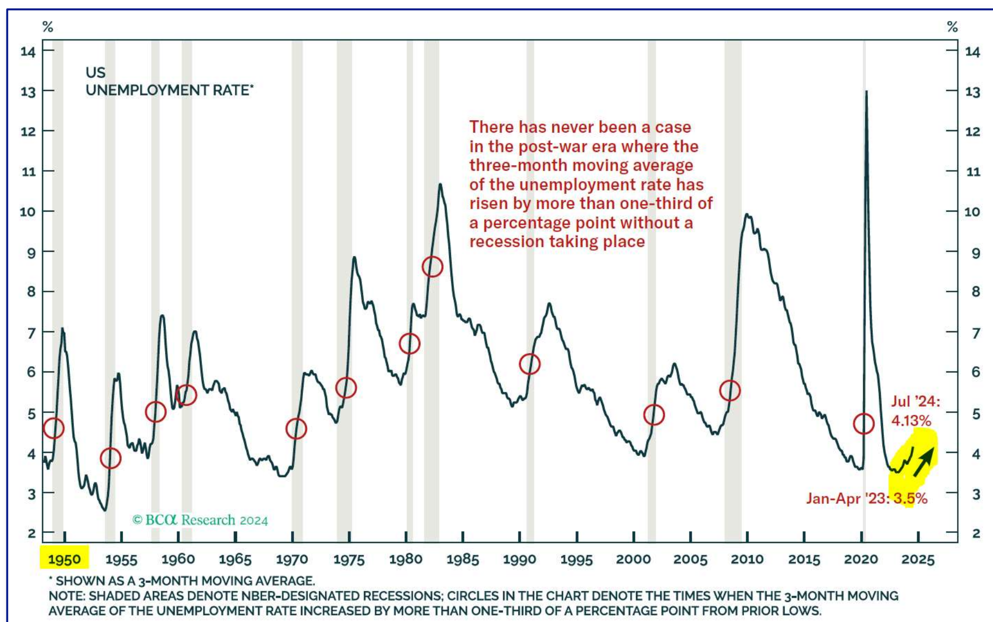
Within the Alternative investment universe, returns were mixed. Liquid publicly traded real estate like REITs were top performers across the investment landscape, but trend-following strategies like Managed Futures suffered as many markets weaved back and forth during the quarter without clearly defined trends. Private Equity has had a muted year so far while Venture Capital remains in a slumber, waiting for the IPO market to open again. Private Real Estate has not rallied along with their public REIT brothers yet. (But there is often a predictable lag between the two, in both directions.)

On the other hand, Private Credit continues to be **perhaps the best positioned** alternative or even non-alternative investment – positioned perfectly for a resilient economy and higher interest rates. Returns have been strong and barring a recession, are expected to continue. Overall, a well-diversified portfolios of alternative investments produced modest, positive total returns with little volatility, but as should be expected during a particularly strong period for stocks and bonds, trailed the total return of core assets.

One of the reasons that Stocks and Bonds performed well was because the U.S. economy continued to **grow at a slow and steady pace**, about 3.0% in inflation-adjusted terms - Neither overly strong nor weak. And very recent data is encouraging. We've mentioned in the past that when looking at the economy and markets, "surprises" and "direction" are often more important than level. If the economy is good but getting worse, that's often viewed as more dangerous than if things are bad but getting better. Over the summer, the vast majority of economic indicators were surprising to the downside and thus, recession risks were increasing. That trend has since reversed. The Citi

Economic Surprise index is now positive again – the first time since May. Good news on the economic front.

Overall, the unemployment rate, which is really the truest indication of a recession, is still relatively low at around 4.1%. But it climbed off of its lowest point and in September, unemployment claims surged more than expected to their highest level in a year. Some of this may be a result of Hurricane Helene. And Hurricane Milton is likely to have an impact as well this month, making interpretation of the data more difficult. With the unemployment rate climbing from a low of 3.5% to 4.1%, some researchers argue that a recession is around the corner. This chart, from the very well-respected BCA Research, illustrates the U.S. unemployment rate (green line) and recessions (vertical grey shaded bars). BCA points out that since World War II, there has **never once** been a case where unemployment has risen like it has recently without being followed by a recession.



Everyone knows that the four most dangerous words in finance are "this time is different." Yet, that hasn't stopped many analysts from trying to explain why this indicator may not be useful today. One argument is that the labor market has changed so much in the last few years. Following the pandemic, many over the age of 55 elected to retire and not return to work. Over the last couple of years, the slack has gradually been picked up by a few different groups – Millennials, minorities, and working-aged woman. As a result, the prime-age (25 – 55 years old) labor force participation rate has climbed steadily and is now at its **highest rate in over 20 years** – since 2001.

Besides workers returning to the labor force, there may be another contributing factor – immigration. Thus, it can be argued that the recent rise in unemployment is not due to a loss of business confidence and a corresponding pick-up in layoffs – it's more due to an increase in supply of workers via both a growth in population and those returning to the job market. This is **an important distinction** – an increase in unemployment due to firings and layoffs is a much more negative and recessionary development than an increase in unemployment due to an increase in the supply of workers.

Besides a broadening out of strong investment performance and the reversal of economic surprises from negative to positive, the other big news this quarter was the Federal Reserve, which **delivered on its promises**. And then some. While many were expecting the Fed to lower rates by 0.25%, they elected to go big with a 0.50% cut in September, lowering the Fed Funds rate from a range of 5.25%-5.50% to a range of 4.75%-5.00%.

Among analysts, there remain strong, divergent opinions on Fed policy. On one side, some analysts say the economy and the labor market are fine, and there's no need for aggressive Fed cuts. Yet, there are other credible views that the damage from higher rates has already been done, we just have not seen its effects yet, that we're heading toward a recession and sharply higher unemployment, and the Fed is too late in cutting rates.

In their messaging, the Fed emphasized that their short-term rates are simply too high for current economic and inflation conditions, and that risks are now balanced between employment and inflation. Their main message was that, with inflation under 3% and trending back toward 2%, that short-term rates at 5% needed to be "recalibrated" closer to a level near the inflation rate. Thus, they were beginning a **multi-year process of lowering rates** down from above 5.0% to levels more appropriate for lower inflation, closer to 3.0%. The market's expectation and the Fed's own forecasts are close to being in agreement – that the Fed will have two more 0.25% cuts this year, to finish the year around 4.40%, and then four more next year to get rates near 3.40% by the end of 2025.

The Fed felt comfortable lowering rates because, in their eyes, they had seen enough proof that inflation was under control and that risks of another inflation flare up are low.

The September inflation figures, released just recently in October, **may have them reconsidering**. While the CPI increased 0.2% in September, this was double market expectations. Food prices increased 0.4% in September, the most since January. Some versions of CPI are showing higher inflation – "Core CPI" is still at 3.3% and rising for the first time in 18 months. Overall, we won't make too much out of the September figures, but we harbor some concerns that inflation may not be fully slayed yet.

If we're trying to assess whether inflation risks are behind us, it's a good idea to see if the market is telling us anything. Well, after the Fed lowered short-term interest rates 0.50% and indicated that they are embarking on a series of interest rate cuts, naturally, the yield on the 10-year U.S. Treasury ~~declined~~ **rose**. Wait. What? Yes. The Fed cut short-term interest rates and the yield on the benchmark 10-year Treasury *increased* 0.41% from its low on September 16 to mid-October, climbing back to over 4.0%! What to make of this? Well, the obvious interpretation is that the market is not concerned at all about a recession and thinks that a more accommodative Fed will stimulate the economy, risking higher or at least more stubborn inflation.

We remain convinced that perhaps too much attention is being paid to the Fed. If sharply higher interest rates did not stop inflation, then why would somewhat lower interest rates fuel it? That doesn't make much sense.

Looking beyond the Fed…We don't invest or live on an island, and there were important developments around the world as well this quarter. Not only have other Central Banks been lowering interest rates, but in late September, China announced their most aggressive stimulus measures in years – lowering interest rates, mortgage rates, and the deposit requirements to purchase a house, all in an effort to boost consumer confidence and their real estate market. This "bazooka" stimulus package sparked a quick **25% rally in Chinese stocks**.

Refocusing on the U.S.A. – we are mindful of the upcoming election. First, to point out the obvious – While many Americans are likely anxious about the upcoming election, **the stock market is not**. After all, many stock market indices are up double digits, and volatility has been below average for an election year. The reason, we think, is that the odds of either party having a clean trifecta sweep of the White House and both houses of Congress are very low. Markets want checks and balances to keep policies on either side from getting too extreme. Nearly all of the political analysts that we've checked in on predict Republicans will take the Senate and the House will be a close call, but likely flipping to the Democrats, so a sweep is unlikely for either party.

We'd also caution you not to worry too much if the results of the Presidential election are still unknown on Wednesday November 6th. In fact, we think it's quite possible that the outcome will not be clear the day after election day. If that occurs, it will be the third time in recent memory and markets did not panic the last two times.

In spite of what feels like unusual uncertainty, as we head into the end of the year, **there are good reasons for optimism**. The next 6-7 months are historically a good seasonal period for stocks. Stocks have risen for five straight months, a rare sequence and sign of strength that since 1945 has almost always been followed by more gains over the next twelve months. The Fed and other central banks have embarked on a new cycle of interest rate reductions, and we believe in the investing mantra of "**Don't Fight the Fed**". The uncertainty of the election will soon pass. Productivity is up, profit margins are strong, and economic indicators are once again surprising to the upside.

As portfolio designers and asset allocators, we're encouraged by the broadening out of strong performance beyond the largest, most well-known American technology companies. If this phenomenon persists, there **could be a passing of the torch** to fuel the next leg of strong gains in diversified portfolios. We also see an opportunity for private markets to "catch up" in the next 12-18 months, as Private Equity, Venture Capital, and Private Real Estate have all been fairly benign during this year's bull run in the public markets. These categories could also help fuel overall portfolio gains if public markets take a breather.

But **our enthusiasm is tempered** somewhat by several factors. To us, the Fed cutting 0.50% and likely another 0.50% before year end does inject some risk to the outlook. With stock prices soaring, interest rates declining, real estate prices firming up, trade tariffs on the agenda for both parties, and geopolitical risks at elevated levels, the **conditions for an inflation revival are clear and present**. We also think that contrary to their historical

tendencies to err on the side of supporting the economy over fighting inflation, this Fed will be once-burned-twice-shy with inflation and will be keenly sensitive to any hints that inflation is reigniting. An acknowledgement that inflation is not yet slayed and a pause in the Fed's rate cutting plans anytime in the next 6-9 months would likely trigger a quick and meaningful sell off in both stocks and bonds.

On the other hand, can we really rule out recession yet? To do so means embracing "this time is different" in the labor market and dismissing the recent rise in unemployment as **a false signal for the first time in almost 80 years**. And with the economy plodding along at only modest growth, any shock to the global or U.S. economy has an increased chance of triggering an economic contraction. One such shock could be sharply higher oil prices if war in the Middle East escalates further.

So, this quarter saw some big changes – a broadening of investment performance beyond big U.S. Tech stocks, the Fed beginning its multi-year process of lowering interest rates, U.S. short-term economic surprises flipping from negative to positive, unemployment rising enough to trigger a historically infallible recession warning, and China taking dramatic measures to jump start its economy. That's **a lot to digest**. While the next 6-9 months could be either bullish or bearish for stocks, we think the weight of the evidence continues to argue for continued strength. But to us, that's not a slam dunk and we have **strived to design portfolios for either outcome**. With exposure to core stocks and bonds, both U.S. and International, and a healthy dose of alternative investments to manage both inflation and recession risks, we think our portfolios are like a strong forest with a diverse mix of trees – resilient, stronger together than individually, and able to shrug off short-term events while growing steadily over the long-term.

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