Q3 2024: Rate Cuts and Deficits and Elections—Oh My!

By Peak Trust Company's Chief Investment Officer, Lisa Russell, CFA. NOVEMBER | 2024

HIGHLIGHTS

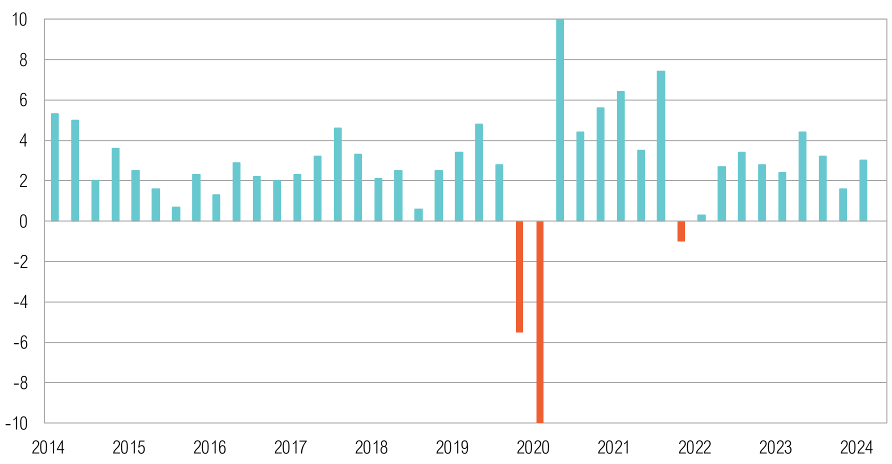
- U.S. large-cap stocks gained 5.9% during the third quarter, while U.S. small-cap stocks rose 9.3%. The Bloomberg U.S. Aggregate Bond Index had its best September since 2003.
- The Federal Reserve cut interest rates by 50 basis points, and it is expected to cut another 50 basis points before year-end.
- The U.S. Treasury's fiscal year ended in September with a $1.9 trillion deficit—the largest ever in a non-recession year.
- Investors face ambiguity about interest rates, the growing deficit, and upcoming elections, requiring nuanced vigilance in portfolio construction.

Overview

Markets performed well over the third quarter, and every major asset class is now positive for the year to date. In fact, this was the best first nine months of the year for U.S. large-cap stocks since 1997. These stocks, as represented by the S&P 500 Index, gained 5.9% over the third quarter and are up 22.1% year to date. The Russell 2000 Index of U.S. small cap stocks ended the quarter up 9.3% and are up 11.2% year to date. Notably, September was the best month for the Bloomberg U.S. Aggregate Bond Index since 2003. U.S. intermediate-term bonds gained 1.3% over the month, 5.2% for the quarter, and 4.4% year to date.

The U.S. Economy Grew By an Annualized 3.0% Quarter-over-Quarter in Q2

U.S. Gross Domestic Product, QoQ (Annualized), %



Source: Bloomberg

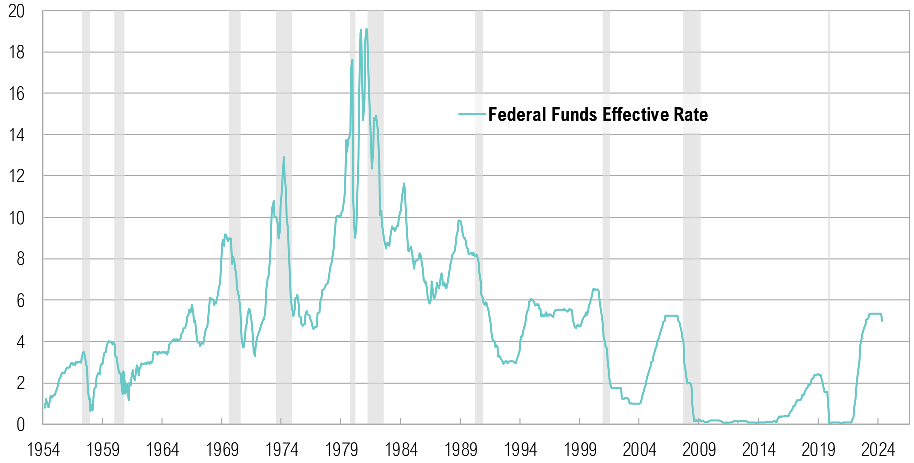
Final second-quarter gross domestic product (GDP) estimates indicated that annualized quarter-over-quarter growth rose from 1.6% in the first quarter to 3.0% in the second quarter. Compared to the first quarter, the acceleration in GDP was primarily driven by increased government spending (rising from 1.8% of GDP to 3.1% in the second quarter) and consumer spending (from 1.9% to 2.8%).

During the quarter, the Bureau of Economic Analysis released its annual data revisions, notably upping second-quarter 2022 GDP from a previously reported decline of 0.6% to growth of 0.4%, quarter over quarter. This revision means that the economy did not, in fact, contract for two consecutive quarters, which would have met the informal definition of a technical recession.

Although inflation has fallen significantly since it reached its four-decade high of 9.1% in June 2022, it has remained above the Federal Reserve's official 2.0% target for over three-and-a-half years. The August inflation report, released in September, showed headline inflation at a 41-month low of 2.6% on a year-over-year basis. The labor market remains resilient, and the U.S. economy continues to add new jobs. In September, the economy added 254,000 new jobs, far surpassing the expected 150,000. Furthermore, the unemployment rate ticked marginally lower over the quarter, from 4.3% in July to 4.1% in September.

In September, the Fed Cut Rates by 50Bps Despite CPI Still Above 2% Target

Fed Funds Effective Rate, %



Source: Bloomberg

Following one of the most aggressive interest rate hiking cycles in history, it's easy to forget that interest rates were near 0% as recently as March 2022. Between March 2022 and July 2023, the Fed raised rates by 5.0%, maintaining a target range of 5.25% to 5.50% for 14 months until September. At the September Federal Open Market Committee (FOMC) meeting, the Federal Reserve cut interest rates by 50 basis points. This cut occurred even with both core and headline inflation above the target, a robust labor market, and no signs of stress in financial markets.

Rate Cuts and Deficits and Elections—Oh My!

August 2024 marked the 85th anniversary of The Wizard of Oz. Throughout the third quarter, investors followed their own yellow brick road, navigating a forest of election unpredictability, a unique rate cut, and an ever-growing U.S. fiscal deficit—hoping their journey will ultimately lead to the economic equivalent of the Emerald City: a soft landing.

In September, the Fed cut interest rates and signaled the start of a new rate-cutting cycle. Although largely anticipated (markets were pricing in a 65% probability of a 50-basis-point cut two days before the announcement), such a significant cut—especially the first in a cycle—is unusual, typically occurring only in times of crisis. Similar 50-basis-point cuts occurred before the start of the recession in January 2001, before the Global Financial Crisis in September 2007, and during the pandemic in March 2020. A 50-basis-point cut in the current benign economic environment is unprecedented.

At the post-FOMC meeting press conference on September 18, even Chair Jerome Powell noted the strength in the labor market:

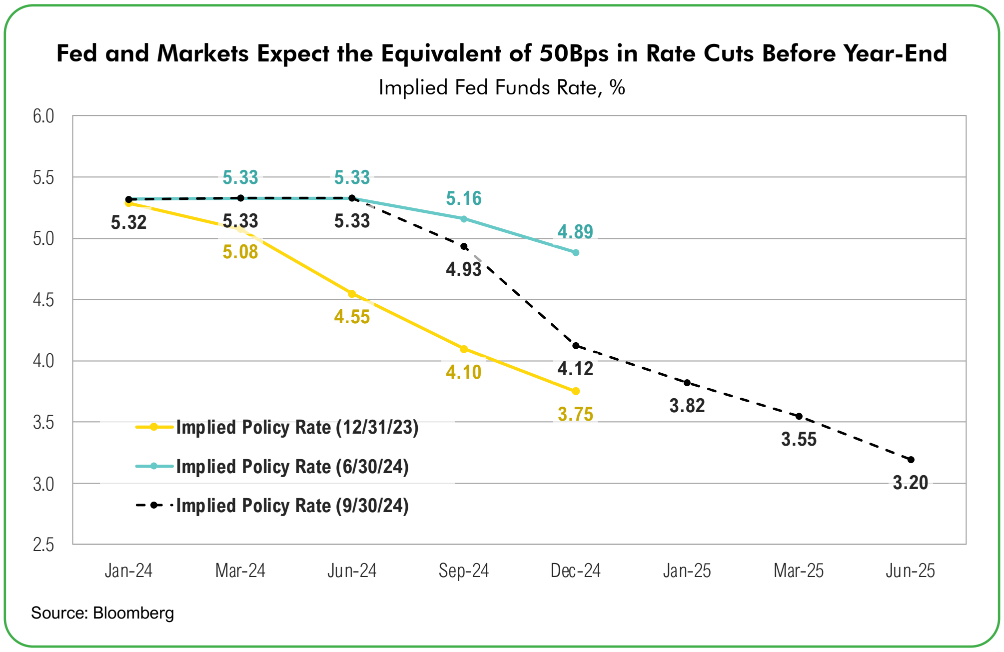
> "This recalibration of our policy stance will help maintain the strength of the economy and the labor market and will continue to enable further progress on inflation as we begin the process of moving toward a more neutral stance."

With both core and headline inflation above the official 2.0% target, financial conditions at their loosest since May 2022, and the labor market not showing signs of significant cooling, it's debatable whether the Fed's recent 50 basis point rate cut was justified. Indeed, addressing this very concern, Powell expanded on the FOMC's decision in the press conference:

> "There is thinking that the time to support the labor market is when it's strong and not when you begin to see the layoffs…. We don't think we need to see further loosening in labor market conditions to get inflation down to 2.0%."

Initial jobless claims, for example, are nearly 60% lower at this rate cut than at the time of the January 2001 initial rate cut and 40% lower than at the time of the September 2007 initial cut. The Fed's recent 50-basis-point cut may be overcompensating for past mistakes by acting more aggressively now, perhaps trying to avoid the error of moving too slowly ahead of prior recessions. However, the Fed's more lenient approach to monetary policy could re-accelverate growth and cause inflation to reverse course from its current cooling trend. The move could also encourage risk-taking behavior and push up asset prices. The forward price-to-earnings ratio for the S&P 500 is currently elevated at 21.5, but it is still below the Tech Bubble peak of 25.1, indicating that valuations could become even more stretched.

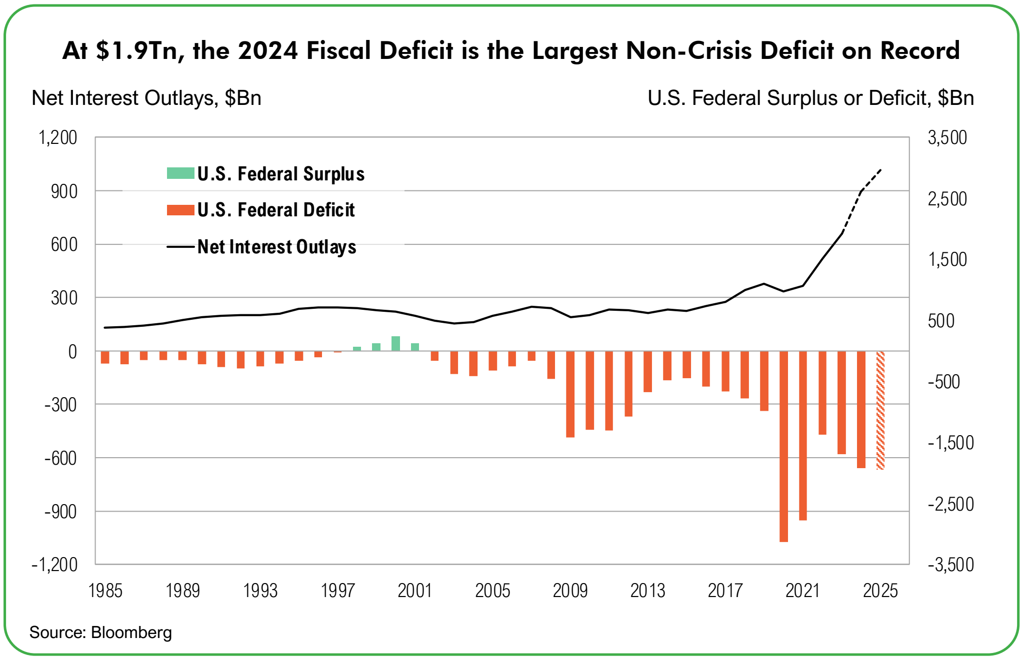
Whether the Fed will ultimately be willing—or able—to defeat the Wicked Witch of inflation remains to be seen. Both the Fed and the markets are expecting the equivalent of another 50-basis-point reduction by year-end, implying a 25-basis-point cut at each of the remaining FOMC meetings in 2024, bringing interest rates down to a range of 4.25% to 4.50%.



Equity markets cheered the Fed's announcement, and the S&P 500 rose 2.6% between September 18 and September 30. Market breadth also improved as rate-sensitive areas of the market rallied throughout the third quarter, both in anticipation of and following the Fed's first rate cut. Notably, 45% of S&P 500 constituents outperformed the broader index over the past three months, a significant improvement from just 26% six months ago. The technology and communication services sectors both climbed over 4.0% between September 18 and September 30. The utilities sector also saw strong gains, rising 3.6% between September 18 and the end of the month, finishing the quarter up 19.4%. After a robust third quarter, utilities have now surpassed the technology sector to become the S&P 500's top-performing sector in 2024, up 30.6%. The real estate sector closed the quarter with a gain of over 17%, and U.S. small-cap stocks advanced 9.3%. Small-cap stocks are particularly sensitive to interest rates due to relatively high debt levels and the high ratio (approximately 42%) of unprofitable companies in the Russell 2000 Index.

In contrast to risky assets, the Treasury market appeared to play the role of the Scarecrow as it digested the rate cut. Notably, the 10-year Treasury yield, which reached a one-year low of 3.6% on September 16—just two days before the Fed's rate cut—ended the month 20 basis points higher, at 3.8%, while reaching nearly 4.0% just after the jobs report was announced in early October. The rise in yields could be signaling the bond market's recognition that the Fed may tolerate higher inflation or could reflect underlying concerns about the precarious U.S. fiscal situation, especially the weight of rising debt and the structural deficit burden, which threaten to drive up long-term borrowing costs, regardless of the Fed's actions.

Despite the pandemic having ended several years ago, the U.S. economy continues to be driven by crisis-era government spending that is producing multi-trillion-dollar deficits with no end in sight. The close of the third quarter marked the end of the U.S. Treasury's fiscal year, and the most recent Treasury monthly budget statement shows that the budget deficit has ballooned to $1.9 trillion, making the 2024 deficit the largest ever in a non-crisis or non-recession year. Net interest outlays have surged to $843 billion, surpassing both defense spending ($798 billion) and health expenditures ($824 billion). The U.S. government is currently paying an average of $3.0 billion in interest expenses each day, including weekends. A further 50-basis-point decline in interest rates, as expected by year-end, is estimated to reduce these daily interest payments to $2.5 billion.



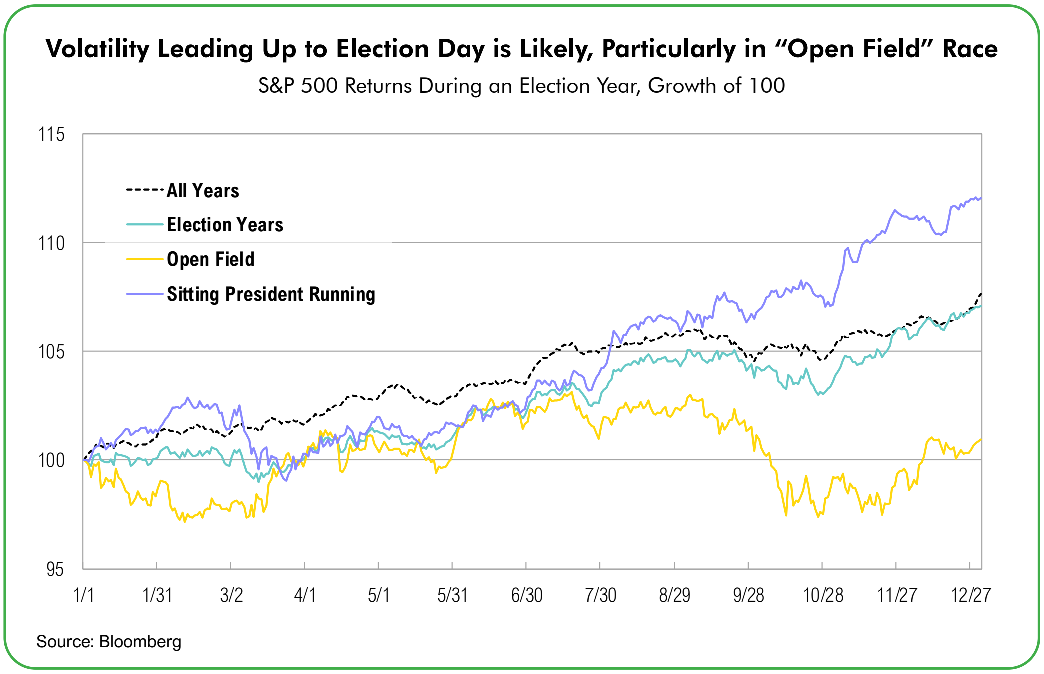
As Election Day approaches, neither presidential candidate has provided a detailed plan to address the deficit. Both candidates have avoided discussing the necessary policies to tackle the issue, and the deficit was only mentioned twice during the September 10 presidential debate. Current estimates suggest that both former President Trump and Vice President Harris's spending policies would add at least $6.0 trillion to the deficit over the next decade.

An additional risk is the potential for inflation to rise again if the growing deficit pressures the Fed to print more money to help the government manage its debt. Despite these unsustainable spending trends, longer-term Treasury yields have remained relatively stable. Regardless of individual opinions of the sustainability of deficits and how and when they should be addressed, the bond market will likely be the final arbiter of the sustainability of the U.S. fiscal strategy—or lack thereof. Investors should take notice if and when bond markets reach their limit and begin to push back against excessive government spending.

While it is too close to predict the election outcome, it would not be unusual for volatility to rise as Election Day approaches, especially given the incumbent president is not seeking re-election. However, markets typically rally once the uncertainty surrounding the election is resolved.

Markets

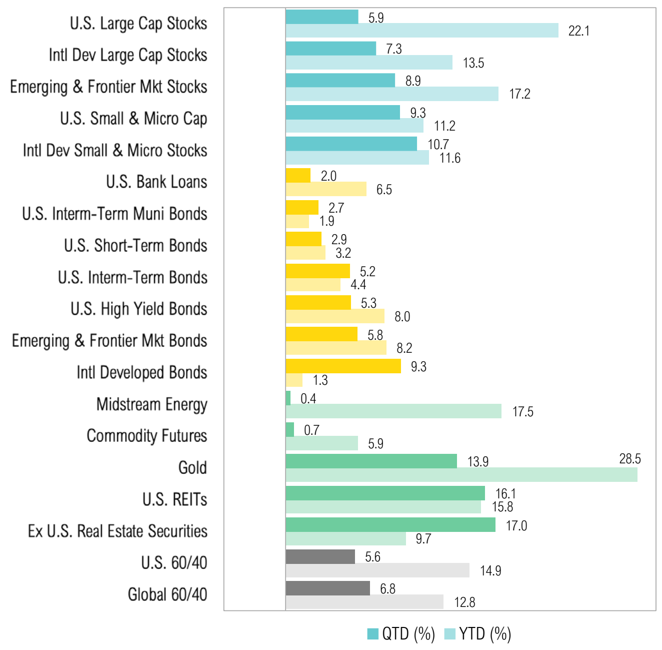
International equities slightly outperformed their U.S. counterparts in the third quarter. International developed market stocks, as represented by the MSCI EAFE Index, outpaced U.S. large-cap stocks, which ended the quarter up 5.9%, by 1.4%. Similarly, international developed market small- and micro-cap stocks rose 10.7% for the quarter, compared to a 9.3% gain for U.S. small-cap stocks. Emerging markets also performed well, finishing the third quarter up 8.9% to be the second-best performing equity asset class year to date, behind U.S. large-cap stocks. Emerging market gains were driven by the MSCI China



Index, which surged 23.5% on news of economic stimulus, and the MSCI South Africa Index, which gained 16.1%, continuing the positive momentum from the second quarter following a favorable election outcome. Meanwhile, U.S. intermediate-term bonds gained 5.2% in the third quarter and are up 4.4% year to date.

Gold ended the third quarter up 13.9%, reaching a new record high of $2,675 per ounce in September. Since the start of the year, gold has set 35 new record highs and is up 28.5%. West Texas Intermediate (WTI) crude oil hit a one-year low of $65.8 per barrel on September 10, but it ended the quarter at $68.2. Then in early October, it spiked above $75 per barrel on news of escalating conflict in the Middle East and the strong U.S. jobs report.

Q3 2024 Key Market Total Returns



Source: Bloomberg

It was a busy quarter in Japan. In response to currency weakness in June, the Bank of Japan raised interest rates from 0.10% to 0.25% in July, pushing Japanese rates to their highest level since 2008. This decision, along with the rapid strengthening of the yen, placed carry traders in a precarious position as they faced increased loan repayment costs in U.S. dollars due to the yen's appreciation. The unexpected shift forced some traders to liquidate assets to repay yen-denominated loans, reflecting a widespread miscalculation that Japan's interest rates would remain at zero indefinitely. This dynamic coincided with a weaker-than-expected U.S. July jobs report and a slowdown in U.S. manufacturing activity, triggering a market rout in early August, which was followed by a swift recovery in stock markets in both the U.S. and Japan. The Bank of Japan has since signaled its commitment to further rate hikes, in contrast to other major global central banks, most of which have begun cutting rates. Japanese stocks ended the quarter up 5.8% and are up 12.4% for the year.

On September 24, the People's Bank of China announced a series of economic stimulus measures, including interest rate cuts, increased government spending, and eased property market restrictions to boost sluggish growth amid a weak real estate sector and declining consumer confidence. These measures are estimated to raise China's GDP by 40 basis points. Chinese stocks surged following the policy announcements, and the CSI 300 Index experienced its best 10-day rolling returns on record by climbing over 20% through the end of the quarter.

Looking Forward

"We're not in Kansas anymore" seems fitting as we look at the unusual policy mix of crisis-level deficits and a Federal Reserve that is taking a historically lenient approach to inflation, even as the economy seems to be humming along. Over the last four years, core inflation has run at an average annual rate of 4.8%, and the U.S. is spending more than $1.43 for every $1.00 it collects in taxes.

When The Wizard of Oz was released in 1939, it served as a story of hope and escape amid economic and geopolitical turmoil. The U.S., still emerging from the Great Depression, was running a 3.0% fiscal deficit—considered aggressive but necessary with unemployment at 17.2%. Today, while unemployment is a much lower at 4.1%, our deficit is more than double that of 1939.

Like Dorothy's uncertain journey, investors must face ambiguity around interest rates, the deficit, and the upcoming election. Policymakers seem content with decisions that prioritize the here and now at the expense of long-term fiscal stability, thereby limiting their ability to respond to future crises and threatening the role of the U.S. dollar in global trade. Given this landscape, we maintain that diversification should include healthy exposures to risk, average to below average durations on fixed income, and exposure to diversifiers such as gold.

About Lisa

Lisa Russell started with Peak Trust Company in 2003 and currently serves as Chief Investment Officer. Lisa brings over 25 years of investment experience to the Peak team. She specializes in designing unique investment programs for high-net-worth clients and trust accounts. She is highly attuned to the tax consequences of investment actions.

Lisa holds a Master of Business Administration in Finance from Emory University and a Bachelor of Science in Business Administration from the University of Southern California. Lisa holds the designation of Chartered Financial Analyst (CFA), and is a member of the CFA Institute and the CFA Society of Seattle.

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Chief Investment Officer

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