Q3 2024 Stock Market Update

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Climbing the Wall

The third quarter brought more gains to equity investors. The S&P 500® Index returned 5.9% and the Russell 2000® Index advanced 9.3%. Notably, gains broadened to corners of the market other than large cap technology stocks. Year-to-date (YTD) returns are somewhat staggering in light of persistent calls for economic weakness and market malaise. Incredibly, both the S&P and Dow Jones Industrial Average have been positive for 10 of the last 11 months. The S&P 500 is now up a whopping 22.1% for 2024. Other notable indices are also up nicely, albeit a bit more subdued than the tech-heavy S&P.

There were a couple sharp pullbacks during the quarter. Signs of consumer duress, rising unemployment (although still low by historical standards) and slowing economic growth gave way to recession fears. In fact, it seemed the sky was falling just a few weeks ago. The Nasdaq Composite was down 13% in a month, the Russell 2000 had declined over 3% three days in a row and the S&P was about 10% off its highs. Ultimately, stocks managed to shrug off fears and charge to new highs. There's an old saying that stocks "climb a wall of worry". This has certainly proven to be the case in 2024.

It hasn't all been sunshine and roses for the market. As discussed in recent letters, large technology stocks tethered to the artificial intelligence (AI) theme have dramatically outperformed in 2024. However, many more cyclical areas such as industrials, transports, energy and consumer discretionary have struggled due to broader economic fears. Smaller cap stocks, which are generally more economically sensitive, have also lagged significantly (the Russell is up 11.2% YTD). We saw some of these areas perform better in the last quarter, but they could have more recovery potential if we are indeed headed for a soft landing.

Did someone say soft landing? Enter the Federal Reserve. After tremendous buildup and speculation, the Fed cut its benchmark interest rate 50 basis points on September 18th. This was the first rate cut since Covid in March 2020 and followed a long string of raising interest rates in an effort to tame high inflation. The Fed has a dual mandate of subdued inflation and full employment. With inflation down to 2.5% year-over-year, the focus now shifts to the employment side of the equation and avoiding a recession. Rate cuts are currently expected to continue through next year.

It may seem unusual to start lowering interest rates in the absence of any crisis and with economic conditions still okay. Indeed, gross domestic product (GDP) growth clocked in at 3% in the second quarter. However, the Fed wants to stay ahead of any potential weakness and views rate cuts as "recalibrating" policy to a more neutral level following a period of more restrictive policy. For sure, the likelihood of an economic "soft landing" has improved alongside the commencement of easier monetary policy. This is a good thing for stocks.

Now for the obligatory mention of politics. Sigh. The presidential election is quickly approaching. In coming weeks, we will be inundated with political advertising and extreme rhetoric. It's a tight race that has been a source of anxiety for investors on both sides of the aisle. Different sectors/stocks could fare differently under different administrations, but it seems futile at this juncture to speculate on potential outcomes. That said, we think some of the more extreme scenarios/business impacts associated with either candidate are often overstated. This would be especially true if a divided Congress brings gridlock. Perhaps the best thing will just be getting the election over with so we can move on.

With politics out of the way, investors' focus will likely return to economic growth and the Fed. Easier monetary policy and a "Goldilocks" economy (i.e. not too hot and not too cold) could be supportive of stocks going forward. It is worth noting, however, that the S&P 500's valuation already looks pretty full at roughly 21x earnings estimates for next year. Justifiably, this may lead one to conclude the market's price levels are relatively fair and its risk/reward profile balanced.

As touched upon previously, there are still many stocks (especially more cyclical names) that are far from their highs and trading at sharp discounts to the large cap technology leaders that dominate the S&P (5 stocks alone comprise 26% of the index). To wit, the equal-weighted S&P 500 trades at 16.7x next year's earnings estimate. This is not to say that we don't like the large tech leaders. We just point out that risk/reward profiles may be more favorable elsewhere in a backdrop of lower interest rates with decent growth.

Sincerely,

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