October 2024

Market Update

September has a reputation for being a difficult month for stocks, but this September every broad equity and asset class was positive save for the slightest decrease in oil/gas prices. Of course the Fed's first interest rate cut in years didn't hurt, but the market's reaction to the cut was fairly muted as it had already been expected and was largely priced in.

For the month the S&P 500 was up 2.1%, and that return was tilted to slightly favor large growth stocks (+2.8%) over large value stocks (+1.4%). Small cap stocks were up +0.7%. International developed stocks were up 0.9% and emerging markets were up 6.7%. Interest rates continued to fall, helping bonds (+1.3%) and real estate REITs (+3.2%). REITs are up 16.8% over the last quarter and are the best broad asset class over that time period. Commodities overall were up 1.7% even though oil and gas fell, but gold continued with its recent rise and gained another 5.7% (up 12.9% over the last quarter – second only to REITs).

While the mood for stock market investors has been celebratory since the start of 2023, the market has been whistling past valuation numbers that keep moving higher. The S&P 500 is now trading 45% above its long-term valuation average with large growth stocks trading nearly 60% above their average. The rest of the market is trading very close to average valuations. As we've noted, current price has been the dominant factor in determining future returns, and with the prices of so many companies at high levels we would expect the future returns of these companies to be much more muted compared to their returns over the last decade.

While not a perfect match, our current time has many similarities to what we saw in 2000. There had been a prior decade of outsized returns, a concentrated and expensive US large cap stock market, and the promise of the internet spurring new economic growth. The 2000s though became known as the "Lost Decade" when some of the most dominant companies saw their stock prices get cut by more than half and the S&P had a negative return over 10 plus years. During that same decade though REITs, US value, small, mid-cap, and international companies turned in positive returns.

Today's market is thankfully not as expensive as it was in 1999, but it is more concentrated and it assumes that AI will soon spur on much faster economic growth. While we may not see negative returns over the next decade, it wouldn't be a surprise for the market to rebalance as it did in the 2000s.

Our base case for 2024 is that GDP(Gross Domestic Product) will slow from 2023's level. While we didn't experience the recession many feared, higher interest rates and higher debt pressure on US households will have a slowing effect on spending and growth. Household net worth will remain bolstered by home values and investment accounts which have remained high. Inflation should continue receding but may not get to the 2% target. With both inflation and economic indicators slowing, the Fed will implement rate cuts in an attempt to manage a soft-landing for the economy.

Performance Summary

The S&P 500 is up 22.1% and small caps are up 11.2%. Developed international markets are up 13.0%. Growth stocks have outperformed but value stocks have narrowed the gap recently. With interest rates falling bonds are now up 4.5% and REITs are up 14.2%. MLPs are up 18.6%, gold is +27.2%, and commodities are +1.7%. High Yield, TIPs, short-term bonds, and floating rates are up 4.1% to 8.0%.

Fixed Income Strategy

Third quarter investment grade fixed income returns were among the strongest quarterly returns in recent years, as most rates along the Treasury curve hit year-to-date lows in anticipation for the Federal Reserve to begin the cutting phase of the interest rate cycle. The 2-year benchmark yield fell from 4.75% to 3.64%, and the 10-year benchmark yield fell from 4.40% to 3.78%. The 2s/10s Treasury curve steepened to a positive sloping curve in September after being inverted for over 2 full years. This flip, from inverted to a positively sloped curve is the market's interpretation that the Federal Open Market Committee (FOMC) will be aggressively cutting short term rates in the coming quarters.

The third quarter narrative was all about the FOMC's potential actions at their July and September meetings. At July's meeting, the Fed Funds rate was held steady at 5.50% as Chair Powell was looking for additional confidence inflation would continue to fall towards their 2% inflation target. However, at September's FOMC meeting, an unusually large 50bps cut initiated the next phase of the Federal Reserve's rate cycle. The Fed gained confidence inflation would continue to fall towards their 2% target, while shifting their focus to maintain labor market strength. To quote Chair Powell, "We will do everything we can to support a strong labor market as we make further progress toward price stability." The quarterly Summary of Economic Projections (SEP) gave additional forward guidance suggesting additional cuts were to be expected by year-end, which the market viewed as a green light to aggressively price-in a faster pace of cuts than Fed guidance.

At the end of the third quarter, divergent views of how the economy will evolve were concentrated on the labor market. Unemployment is low at 4.2% but has moved higher throughout the year. The main concern is - will companies maintain profitability, or will cost cutting (a.k.a. layoffs) be necessary to defend profit margins? Historically, once layoffs begin, they happen en masse, which is an obvious risk.

Recent revisions to job creation and Gross Domestic Income (GDI) figures have not added clarity to the mosaic. Jobs created had a sizable negative revision, implying a weaker labor market. However, GDI was revised significantly higher, implying the economy is stronger and more resilient than earlier thought. In our view, the economy has remained surprisingly resilient YTD as legacy liquidity and continued fiscal stimulus continue to work through the system. Clarity on how the economy evolves from here is very low given offsetting economic data.

Investment grade corporate spreads were little changed during the quarter, ending the quarter slightly narrower at +89bps. The story was similar in high yield credit, with those spreads narrowing 14bps to +295bps. Strong demand from investors, in addition to a solid fundamental backdrop, have supported the corporate market even as issuance is on its strongest pace since 2020.

We have maintained a corporate sector focus in our strategies, but corporate spreads at historically tight levels currently present a less favorable risk/reward profile. As a result, we are maintaining our increased weighting in government bonds. We continue to position portfolios with an overweight to duration, and relatively balanced yield curve positioning.

Equity Income Strategy

The Equity Income strategy's primary goal is to provide reasonable income while also offering the potential for capital appreciation.

Strategy participated in the broadening of the markets and returned close to 8% for the quarter. Utility companies were notable outperformers as AI energy demand boosted the sector.

In the quarter we had no trades to report.

As always, we continue to look for opportunities to upgrade the quality of the portfolio while staying true to our disciplined valuation process.

Defensive Equity Strategy

The Defensive Equity strategy remains focused on identifying companies with stable operating results and reduced stock price volatility in the broader market.

As the market broadened beyond the Mag 7 companies that had driven most of the gains over the past year, the strategy outperformed many areas of the market in Q3, delivering a return of approximately 8%. However, it slightly lagged behind large value and small-cap stocks, which posted returns of around 10% for the quarter.

In terms of portfolio allocation, our strategy maintains an overweight position in high-quality stocks while deliberately underweighting sectors that are sensitive to economic cycles, such as financials and materials. This approach aims to mitigate risk and emphasize stability in uncertain market conditions.

Additionally, we continue to hold cash and have a small position in gold.

We added a new position in Q3 in Edward Lifesciences.

Core Equity Strategy

In the third quarter of 2024, equity markets saw a broadening of performance beyond the mega-cap tech stocks (often referred to as the "Mag7" — companies like Microsoft, Apple, Google, Amazon, Nvidia, Meta, and Tesla) that had dominated much of the market's growth in the first half of the year.

As such, Utilities, real estate, and industrials rose around 19%, 17%, and 12%, respectively, while other segments, such as technology, communication services, and energy, all posted near-flat returns in contrast to the S&P 500's gain of 6%

Additionally, the Federal Reserve started easing its restrictive rate policy, reflecting increased confidence that inflation is returning to its target level. Monetary tightening had a disproportionate impact on small-cap companies, which typically carry more floating-rate debt. As the Fed began to communicate easier financial conditions, this shift in policy became a key catalyst for the market's rotation from large-cap growth stocks into small-caps, cyclicals, and value sectors. The financial sector, particularly regional and community banks, has also gained momentum as the market anticipates further rate cuts.

From an economic standpoint, the U.S. economy remains relatively healthy. Household balance sheets are relatively stable, job growth continues at a moderate pace, and as inflation trends downward, the Fed has more room to continue lowering interest rates. However, at lower income levels, we are seeing a slowdown in discretionary spending and a rise in delinquencies on credit cards, auto loans, and other debts, as excess savings have diminished. Home sales and construction remain constrained by high mortgage rates. Should the Fed continue to ease policy, builders may respond with increased housing starts, given that home prices remain elevated, and supply is insufficient to meet population demand. These are some of the key indicators we're closely monitoring as we approach year-end.

From a portfolio standpoint, we added a few new names: Edward Lifesciences, Advanced Micro Devices, Broadcom, Nike, Airbnb, and Canadian Pacific. We exited positions in IFF, Fortinet, and Accenture in the quarter.

International Equity Strategy

During the third quarter, the MSCI EAFE international stock index increased roughly 7%. The real estate, utilities, and communication services sectors drove the increase for the quarter, increasing around 17%, 15%, and 12%, respectively. The information technology and energy sectors were the two underperforming sectors as they were in negative territory.

The third quarter ended with healthy returns across most asset classes despite stocks being hit hard in early August from the combination of an interest rate hike in Japan and weaker US economic data. The less hawkish tone from Japanese policymakers and new stimulus in China helped support equities late in the quarter. Developed market equities returned nearly 7% over the period while parts of the market that previously suffered the most outperformed. Small caps delivered over 9% while growth stocks gave up their recent outperformance. We began to see a rotation out of growth into emerging markets and international markets, which we did not see in previous quarters.

The real estate sector outperformed as the European real estate markets are showing signs of recovery as the European Central Bank cuts rates and gradually cooling inflation supporting valuations. With bond yields falling, we saw the most negatively impacted sectors, utilities and real estate perform the best in the market in the third quarter.

In the quarter, we added new positions in Deutsche Post, BNP Paribas, Tokyo Electron, Canadian Pacific, and SMC Corp.

We exited positions in IFF, Telus Corp, Bank of Nova Scotia, BMW, and Accenture in the qtr.

Our goal is to have a portfolio of high-quality businesses with competitive advantages that can withstand changes in economic conditions and thrive through a business cycle. Companies with established moats often expand market share and strengthen their business during a downturn. These are the types of companies that we continue to look for in the International Equity strategy.
While we cannot predict near-term risk factors, we can control the companies we invest in. Our disciplined approach of owning high quality, financially viable and intrinsically cheap companies form the International Equity portfolio.

Value Strategy

In the third quarter, the Russell 1000 Value benchmark increased nearly 10%.

The utility sector led the benchmark, with an 18% gain. Close behind was the real estate sector, with a roughly 17% gain for the quarter. Energy was the only sector in negative territory.

Utilities have lagged the broad market as elevated bond yields have increased the sector financing costs due to its capital-intensive business. But utilities earnings growth continues to show resilience in the current high-interest rate environment. Over the long term, the market forecasts increased data center power consumption, electrification of the transportation sector, and manufacturing reshoring to provide secular tailwinds to the utility sector. With long-term treasury yields near their peak, this may indicate the worst is behind this sector, which explains part of the outperformance.

Real estate did well in Q3 as the real estate market is showing signs of change. As bond yields fell this quarter, the spread between cap rates and bond yields widened. This provides a more favorable environment for real estate investments. The market's expectation of further rate decreases provided a tailwind to the real estate sector as these businesses will experience an increase in demand for construction and new home sales to close the housing deficit.

Earnings for U.S. large value stocks in the energy sector encountered difficulties in Q3 due to soft demand and inventory buildup of oil. The strong growth in US shale production caught the energy markets off guard.

As always, valuation opportunities drive the over and underweight positioning. Currently, we see value in consumer discretionary and some areas of technology and industrials.

In the quarter, we added new positions in Airbnb, Capri Holdings, Micron Technology, Lululemon, LGI Homes, Norfolk Southern, Advanced Drainage Systems, Applied Materials, and Estee Lauder.

We exited positions in Comcast, Lamb Weston, RTX, Starbucks, and Expedia in the quarter.

Thematic Equity Strategy

Thematic is by far our most aggressive growth strategy with over 40% in Technology and 10% in Biotech –to this extent Thematic had a great quarter as investors increased their risk spectrum.

As ever, we remain vigilant in our efforts to identify new themes of secular growth that would benefit the strategy.

Covered Call Strategy

The primary goal of the Big Covered Call strategy is to obtain exposure to equities, with greater income potential at the cost of reduced upside participation. Should the broad US equity market continue to rise, but at a slower pace, or become range-bound, constrained by high valuations on the upside but buoyed by strong earnings on the downside, this may continue to be a fruitful period for the Covered Call strategy.

Markets were somewhat more volatile in the third quarter, with brief selloffs in early Aug and Sep. Nonetheless, the market managed to eke out another strong gain with the rally finally broadening. The Nasdaq 100, dominated by megacap tech, lagged while small caps, international, and the equally weighted version of the S&P500 regained some ground. Nonetheless value/cyclical/small/international stocks remain at cheap to average valuation levels while high-quality growth stocks remain in the 90+ percentile on valuation measures such as forward price-to-earnings (P/E), Shiller CAPE, or market cap to GDP. Despite their high valuations, investors seem to perceive the megacap tech stocks as a safe harbor while storm clouds continue to gather on the horizon.

These storm clouds remain about the same as in 2022; they have neither dissipated nor delivered rain. Since the peak of growth and inflation in 2021, we've seen a steady decline in both, but not enough to tip us over the neutral level into recession. Notwithstanding a hot jobs report this week, the labor market appears to be exhibiting the same pattern we've seen heading into prior recessions. Similarly, leading economic indicators continue to suggest slowing growth. The official data such as GDP/GDI do not yet reflect this weakness but have no track record of reliably warning investors of upcoming issues in the past. In fact, they often paint a highly misleading picture at economic inflection points, and the numbers are subsequently revised, sometimes by huge margins. As a result, we remain mired in the same status quo without a clear sign that we will have a recession, or that we will not. In this environment, investors seem willing to (over)pay for quality and predictability while remaining wary of investments with a strong dependence on the broader economy.

With markets in fear of a potential recession and huddling for safety in large/quality/growth stocks, these may struggle to deliver future returns. In a recession, they could perform more poorly than has been the case historically because they are so richly valued and heavily weighted in investors' portfolios. Such stocks are consensus long crowded bets, and in a storm, ships in a crowded harbor may suffer! In a recovery, they do not offer much upside from a rise in overall economic activity. In contrast, small/value/cyclical and international stocks have a higher gearing to economic growth and thus more upside potential if we sidestep a recession. They may well suffer if we do enter recession, as is normal, but their relative cheapness and investors' underweighting offer a better margin of safety.

The Fed are certainly trying their best to nail the soft landing. Powell has noted the deterioration in the labor market and last month moved to cut rates a larger-than-normal 50 basis points, to better reflect that we are now entering a regime where downside growth risks have begun to equal or exceed upside inflation risk. While this was a controversial move, it may prove prescient. Unfortunately, this transition from the hiking cycle into the cutting phase was telegraphed so far in advance (late Oct 2023) that the market has already priced in the potential gains! From the point where Powell first pivoted to the end of the third quarter, the S&P500 rose almost 40% and the 10yr interest rate fell around 130 basis points. This means that a significant portion of the rate cutting cycle is already baked into today's prices of stocks and bonds. The Fed will have to cut more than expected (in the event of recession) or cut less than expected (in a recovery) for financial prices to react. Simply delivering the cuts that are baked in will not move markets. We saw a limited reaction in asset prices following the recent 50bps cut, and this seems likely to continue until we get a clearer picture of the next stage in the post-Covid economy.

With about a month left until the election, bringing with it possible changes in tax rates and economic policy, there's high potential for volatility. Predicting the outcome is near impossible, much less guessing the eventual winners and losers in markets, as should be clear from the shocking fallout of the first debate (or the counter-consensus rally following Trump's victory in 2016). Far from a guaranteed soft landing and easy path to strong second half gains, the remaining 2 quarters of 2024 look rife with potential problems. It's possible that all will be peaceably resolved and the market will continue to climb the proverbial wall of worry, but with short interest declining rapidly to zero, fund managers underweight cash, equity market volatility at cycle lows, investors of all classes far overweight equities, and tech valuations stretched while their weighting in major indices is extreme, it's difficult to see what drivers of marginal demand will extend this narrow rally. In 2022, recession was viewed as a near certainty and widespread derisking by investors helped to cushion markets and provide a launchpad for gains in 2023-24 as hedges were removed and full risk weights re-upped. Now, the consensus and positioning are the opposite, and that suggests the risk of a decline is now much higher given that any catalyst could easily spark a rush to derisk or hedge portfolios. Even without a sudden correction, over the medium term, the outlook for buy-and-hold investors who do not actively diversify away from the market-cap-weighted S&P500 and especially the Nasdaq 100 is arguably poor. Options premia in the major indices remained well below the average levels of the post-Covid period for most of the quarter. There are a myriad of strategies that have become very popular with investors, most of which sell options on a monthly, weekly, or even daily basis. As a result, it has become more important than ever to monitor options prices and ensure that the level of risk premium remains appropriate. If options prices fall too far, then I may choose to sell fewer options than normal, covering only half or even a quarter of our shares. If simultaneously leaning bearish, I'd also raise our cash level to maintain the net beta and volatility of the portfolio somewhere close to the normal range. If leaning more bullish, then simply holding uncovered stock would be the appropriate approach. Should options prices fall so far that I judge the risk premium to have turned negative, then I might hold stock and purchase some protective puts or cheap calls at discounted prices. This type of flexible approach is crucial now that so many assets much capital has flowed into options-selling strategies. Any strategy that is deliberately price-insensitive and mechanically repeats the same trades regardless of valuation is doomed to failure in the long-term, a fact which investors in "passive" funds may be wise to ponder.

I used air quotes on the term “passive” because there really is no such thing as a passive investment strategy- the decision-making is simply outsourced to other parties or done by obscure committees behind closed doors; the term “passive” is really a misnomer.

This quarter, I kept approximately 25% of our capital invested in the Russell 2000 via the IWM ETF. While small caps are more vulnerable during recession, the relative price of the Russell compared to the S&P500 remains attractive. A recession would cause the position pain, but for now, the upside still looks more favorable. Additionally, allocating a portion of assets to the Russell 2000 helps to lower the concentration risk in megacap tech that remains a concern in the S&P. Finally, option prices in IWM are higher, offering greater return potential. I maintained a high cash level (above 10% on average across accounts) thus far in 2024, which was a drag but provides flexibility in the event of a market dislocation. Managing volatility via cash level and strike price selection for our call sales has outperformed put option purchases so far and remains the risk-management plan. However, I am weighing the potential benefits of adding some longer-dated protection on the downside given the cheap prices of 6m-1yr protective put options.

Investors in the growth and accumulation phase of their investing life cycle or those with a strong bullish outlook may wish to look at other strategies while those in the distribution phase or with a more neutral market outlook may find Covered Call an attractive complement to their traditional portfolios.

Disclosures

All earnings data comes from Standard and Poors' S&P 500 Earnings and Estimates Report as of 9/30/2024. Asset class performance numbers come from Morningstar as of 9/30/2024.

The S&P 500® is widely regarded as the best single gauge of large-cap U.S. equities. There is over USD 9.9 trillion indexed or benchmarked to the index, with indexed assets comprising approximately USD 3.4 trillion of this total. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

The 10-year Treasury note is a debt obligation issued by the United States government with a maturity of 10 years upon initial issuance. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.

REITs, or real estate investment trusts, are companies that own or finance income-producing real estate across a range of property sectors.

A master limited partnership (MLP) is a business venture in the form of a publicly traded limited partnership. It combines the tax benefits of a private partnership with the liquidity of a publicly traded company.

The Russell 2000 Index® measures the performance of the 2,000 smallest companies in the Russell 3000 Index.

The iShares Russell 2000 ETF (the IWM ETF) seeks to track the investment results of an index composed of small-capitalization U.S. equities.

The Russell 1000 Index® measures the performance of the large-cap segment of the US equity securities. It is a subset of the Russell 3000 index and includes approximately 1000 of the largest securities based on a combination of their market cap and current index membership.

The MSCI EAFE International Stock Index measures the performance of the large and mid-cap segments of developed markets, excluding the US & Canada equity securities. It is free float-adjusted market-capitalization weighted.

The MSCI ACWI Index measures the performance of the large and mid-cap segments of the particular regions, excluding USA equity securities, including developed and emerging market. It is free float-adjusted market-capitalization weighted.

Market Beta (Beta) is a measure of a stock's volatility in relation to the overall market. By definition, the market has a beta of 1.0, and individual stocks are ranked according to how much they deviate from the market.

The Nasdaq-100 Index (NDX®) defines today's modern-day industrials—comprised of 100 of the largest and most innovative non-financial companies listed on the Nasdaq Stock Market based on market capitalization.

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