3Q 2024
Market Commentary

The third quarter of 2024 brought with it more than a few surprises. The Magnificent Seven stocks along with the NASDAQ and S&P 500 indexes experienced weakening momentum after strong first half returns. Although the excitement with developments in the Artificial Intelligence field haven't diminished, the perceived beneficiaries did take a tumble from their lofty July valuations. These growth indexes recovered by quarter end, but for the quarter as a whole, the NASDAQ gained a mere 2% while the S&P 500 rose by 6%. In contrast, our primary value benchmark posted returns above 9% for the quarter. It turned out that the Federal Reserve Board's 50 basis point (0.5%) cut in the Fed Funds Rate at their September 18th meeting proved more beneficial to economically-sensitive stocks than highly-valued stocks.

The Fed's big announcement that investors had been waiting for since Chairman Powell's original "pivot" statement in December 2023 finally fell into place. The "Pivot" to lower rates is on, and with a bang! Expect this change in policy and direction to eventually restore the yield curve to its long-missing-in-action normal positive slope. One of the biggest beneficiaries of having short-rates lower than longer-maturity bonds is expected to be banks and financial service companies. It further should restore the normal risk premiums in the bond market for taking credit and maturity risk. This is a positive development, not one to be feared.

The trick for Powell seemed to be to deliver the large 50 basis point cut without triggering marketplace concern that the Fed was signaling the economy was deteriorating rapidly. The Chairman clearly tried to allay these fears in his formal comments. However, massive government deficit spending fueled much of the economic growth in the last year, and at the same time, the significant downward revision in employment gains (-814,000 for the year ended March of 2024) and lower monthly gains since then suggests the post-presidential election economy might show signs of weakening regardless of who wins. Consensus expectations appear to reflect the belief the economy is headed for a soft landing. This by itself makes soft-landing a more-risky assumption, not less.

Alongside the emergence of AI as top economic and market themes came the surge in expectations for future power consumption growth. So guess what was the top performing sector in the S&P 500 in the quarter? Utilities! With planned data centers popping up everywhere, the rush has begun to secure reliable baseload power sources. Baseload power output requires the generation source to produce power non-stop, 24/7. Intermittent sources like wind and solar aren't useful without massive battery backup. But with the progressive closure of coal-generated power and the dearth of new nuclear power projects, the nation and state electric grids are already highly stressed, unable to add such projected loads. What irony then that Constellation Energy seeks to reopen at least one of the nuclear reactors at the infamous Three Mile Island plant. If Jimmy Buffett was still alive, he may have decided the verse in his famous song, "Volcano" needs to change. "Don't want to land on no Three Mile Island, I don't want to see my skin aglow." Nuclear power technology has come a long way since Three Mile Island, and technologies such

as the smaller-scale Molten Salt reactors appear promising. Existing plants scheduled to be wound down may reverse course to extend their lives. What is clear, however, is that utilities are undertaking massive investments to improve transmission and distribution systems and to increase baseload power output, mostly using what is called CCGT (combined cycle gas turbine technology) to generate power. The combination of a rising rate base and higher allowed ROE's presents a favorable environment for utilities not seen since the 1950s and 60s.

With all of the concern about China's intellectual property theft and its slowing economic growth (discussed a year ago in client newsletter, *China is Running Out of Rabbits!*), China just launched an all-out set of programs to stimulate flagging domestic growth and to pull the country out of its commercial and residential property slump. After an abysmal return over the prior year up to September, China's stock market has reacted with a massive rally. We're skeptical this will be sustained given the inherent problems we've previously identified but investors are enjoying a significant relief rally.

For the U.S., even with the growing set of restrictions on both China's exports and its ability to import advanced chips and equipment from the West, the overall contribution of net exports from the U.S. continues to worsen. Supply chains have already begun moving to other countries outside of China, but not necessarily back to the U.S.

While negative net exports restrain aggregate U.S. growth, the surge in the change in private inventories added over one percentage point to real GDP growth in the second quarter. Relative to the first quarter, the gain was even larger as inventories were liquidated in the first quarter. Separately, although the contribution of government to GDP amounted to 0.5%, the massive deficit spending from the CHIPS Act and the Inflation Reduction Act is partly felt in the growth in business investment as non-residential investment has been sustained at close to 0.5% contribution to GDP growth for the last three quarters. So much stimulus has already been added by deficit spending, the level of spending and the rate of change should level out in coming quarters rather than continuing to grow. On balance, ongoing U.S. economic growth is better represented by the less than 2% gain that excludes the inventory surge in the quarter.

One can't ignore the challenges posed by our current presidential election. Although there are significant differences in policies between parties, each have consequences for future economic growth. What's worse for the economy? One party wants to initiate a massive increase in corporate taxes, the capital gains tax, and possibly institute a tax on unrealized capital gains (which would be massively disruptive to stock markets but is unlikely to be supported by Congress). The other party wants to raise massive tariffs on China and nearly all country competitors. Both ideas are bad for U.S. corporate revenue growth and financial market returns. Fortunately, U.S. corporations have benefited from three trends over the last four decades which have contributed to the overall rise in S&P 500 company aggregate net profits:

1. The top marginal corporate tax rate fell from 46% at the beginning of the 1980s to 21% currently.
2. T-Bond yields have progressively trended lower since the peak of 15% in 1981, dramatically lowering net interest expense for corporations.
3. The growth in intellectual property rights from innovations in the U.S. that include semiconductors, software, and network effects (like Facebook and Google).

From our perspective it appears that the first two are likely to reverse direction and move higher, meaning more interest expense from refinancing bonds at significantly higher yields than during the last decade and higher tax payments. Between implementation of the 15% global minimum tax, the likely expiration of low U.S. corporate tax

rates at the end of 2025 and additional increases in post-election Congressional action, tax rates appear to be headed higher.

These risks are likely to produce more muted total market returns over the next five years than seen over the last decade, but taking such risks into account is the first step when structuring client portfolios that meet each client's needs and objectives and protect capital.

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