Q3 Review & Outlook

October 2024

ELEMENT	TREND	COMMENTS
VALUATION	Negative	Stock prices are high again, most especially the largest companies.
INTEREST RATES	Positive	Markets are now expecting two 25-basis-point rate cuts this year.
INFLATION	Positive	Inflation continues to drift lower.
VOLATILITY	Neutral	Price volatility has climbed, though this often boosts future returns.
MONETARY POLICY	Positive	The Fed has begun cutting short-term interest rates.
DOMESTIC POLICY	Neutral	U.S. presidential election imminent.
GEOPOLITICAL	Negative	Middle East on the brink of war; China economy reeling.

Storms

This has been a difficult stretch here in North Carolina. Less than two weeks ago, Hurricane Helene and other storms produced up to 31 inches of rain in some parts of Western North Carolina, resulting in flooding that claimed the lives of dozens of people in this state, leaving behind damage to property and infrastructure that can truly be described as Biblical. Entire communities were washed away by forces not witnessed in that region for generations.

The damage was truly catastrophic. However, it has been quite inspiring to see the response from people not just from around the state but from across the continent who have donated time, goods, skills and other resources as a part of the relief effort. Even so, please consider making monetary gifts in the coming weeks and even months to organizations that are in a position to provide targeted, boots-on-the-ground relief to those who need assistance—and there will be thousands—after the storm surge of benevolence inevitably begins to subside.

Blue Ridge Public Radio has published the following list of WNC relief organizations:

List: Ways To Donate and Help Flood Victims in WNC

Please take a moment to review the list and perhaps find an organization whose mission aligns with your interest in giving. Thank you!

Market Performance

Financial market performance was strong during the third quarter. The most notable change during the quarter was the outperformance of small-cap stocks and value stocks. After a benign CPI report in July, traders became convinced that the Fed would begin cutting short-term interest rates in September. They were right. The Russell 2000 Index, a widely followed small-cap index, returned 9.3% for the quarter. The Russell 2000 Value Index returned 10.1%. While all major U.S. indices posted enviable returns, the value factor certainly had a star turn. Large-cap value, as measured by the Russell 3000 Value Index, returned 9.5%. Growth and large-cap indices posted solid returns also, but nonetheless trailed value and small caps for a change.

Global Equity Index Performance

	2022	2023	1Q24	2Q24	July	Aug	Sept	3Q24	YTD
S&P 500	-18.1	26.3	10.6	4.3	1.2	2.4	2.1	5.9	22.1
DJIA	-6.9	16.2	6.1	-1.3	4.5	2.0	2.0	8.7	13.9
NASDAQ	-32.5	44.7	9.3	8.5	-0.7	0.7	2.8	2.8	21.8
Russell 2000	-20.5	16.9	5.2	-3.3	10.2	-1.5	0.7	9.3	11.2
Russell 2000 Value	-14.8	14.6	2.6	-3.7	12.4	-2.0	0.0	10.1	8.8
Russell 2000 Growth	10.0	18.5	7.5	-2.9	8.2	-1.1	1.3	8.4	13.1
Russell 3000	-19.2	25.9	10.0	3.2	1.9	2.2	2.1	6.2	20.6
Russell 3000 Value	-8.0	11.6	8.6	-2.3	5.5	2.4	1.3	9.5	16.2
Russell 3000 Growth	-29.0	41.2	11.2	7.8	-1.3	1.9	2.8	3.4	24.0
International	21.0	17.9	5.6	-0.6	2.3	1.4	1.3	7.8	13.1

Source: Bloomberg, Trust Company of the South

Two factors contributed to this change in market leadership. First, smaller companies tend to benefit more from an accommodative Fed than larger ones. That's because they tend to be more levered and thus benefit more from lower interest expense and incrementally easier business conditions. Second, valuations had become so stretched among the megacap tech names that anything other than blowout earnings would be punished.

Mixed earnings results from AI darlings NVIDIA, Microsoft and Google raised questions about the timing and returns on the massive investments these companies are making, and with the prices of those stocks at nosebleed levels, there was absolutely no room for anything other than promises of extraordinary earnings growth. Those are tough bets to make. When stocks have perfection priced in, and the future brings even the tiniest cloud, repricing can be swift and severe.

It's not as if the Magnificent Seven have crashed—they haven't. They merely underperformed the broader indices during the quarter. But they did underperform meaningfully—the S&P 500, excluding the Magnificent Seven, returned 8% for the quarter vs. 1.7% for the group. The quarter may have been a turning point.

New Market Leadership?

What are we to make of a market in which the performance leaders are not technology shares but... utilities? Yes, the best performing sector during the third quarter was utilities, up 19.4%. Next best was real estate, up 17%, and industrials, returning 11.5%. It's curious that this particular combination of defensive stocks (utilities) and expansionary stocks (industrials) would each be among the leaders unless one considers the fairly unusual set of circumstances in the economy. While it's certainly true that the economy has cooled, fears that a recession is just around the corner have all but vanished. The labor market continues to hold up well and while the absolute level of consumer prices is still uncomfortably high, the year-over-year inflation rate has returned to basically normal levels. So, we have a Fed that is cutting rates amid an expansionary backdrop, and therefore, we witness sectors such as utilities and real estate, which benefit the most from lower rates, leading the way along with industrials, which typically lead into an accelerating economy. It's a highly unusual set-up and one that would seem to support asset prices.

Consensus third-quarter earnings growth estimates for the S&P 500 are in the low single digits, a modest target that seems quite achievable. With such a low average bar, look for many companies to beat estimates and for positive stock price performance. On the other hand, earnings growth estimates for the Magnificent Seven and the overall AI set are much higher. Should they fail to beat lofty expectations, they will continue to underperform.

Which Way for The Fed?

Continued strength in the labor market has given the Fed additional flexibility regarding its rate-cutting campaign. The central bank's 50-basis-point (bp) rate cut was an aggressive start to the campaign (the futures curve seemed to predict a 25-bp cut up until just shortly before the announcement last month), and subsequently, employment data likely has put the lid on additional 50-bp cuts. The futures market, which seems to have been especially fickle this year, is now pricing in two 25-bp cuts before the end of the year.

Interest rates fell throughout the curve during the third quarter, helping support strong performance in both equity and fixed income markets, though interestingly, they began to creep up again within the last week. Some of this movement was due to the strong September jobs report, and some is likely attributable to higher risk premiums owing to rising geopolitical uncertainty.

Rising Geopolitical Risks

The October 7 attacks on Israel are now, amazingly, a full year in the past, and the conflict has done nothing but spread during that time. Israeli ground incursions into Lebanon and Iranian air strikes into Israel are significant escalations, and energy markets have taken notice. Crude oil prices jumped 17% from their mid-September lows.

China has also contributed to bullishness in the energy complex. In late September, the Chinese government announced a new round of stimulus aimed at reviving the country's teetering economy. China's stimulus package includes deep interest-rate cuts, about $70 billion in financing for equity investors, additional support to fund share buybacks and multiple measures to try and prop up the country's ailing real estate market. Chinese stocks have soared, although fears that government measures are not enough have contributed to both energy and Chinese stocks giving back much of the gains in recent days.

While there are always geopolitical risks, this particular moment does feel a little murkier than some.

The Election

If you live in the battleground state of North Carolina, then you know what we're going through. We receive mail every single day, and we receive texts every single day from both sides, claiming that the country is going to go to hell in a handbasket if the other side wins. Does this mean we should all liquidate our portfolios and go try to find a cabin in the woods that was not washed away two weeks ago? Markets are likely to be volatile for the next few weeks as the election nears, but if history is any guide, the markets will eventually just incorporate the new information and price assets accordingly. In the end, businesses, employees and business owners will wake up and go to work in January and try to figure out how to make money. That will be true no matter who is in the White House or Congress.

Yes, politics has an impact on markets, but it is only one of many, many factors that influence markets, and investors have a terrible tendency to overestimate the effect of politicians on markets. Predicting markets solely based on the occupant of the White House is a mistake—other factors just matter far more. Consider the case of George W. Bush, a pro-business Republican. The S&P 500 lost value during his two administrations. Was it all Bush's doing that the dotcom bubble burst as he took office and that the Great Financial Crisis was in full force when he left? Or consider Democrats Harry Truman, Bill Clinton and Barack Obama. Markets effectively tripled or better under their administrations. Were they each amazing architects of economic expansion, or were they, at least in part, beneficiaries of fortunate timing?

Storms Redux

Every single day, investors face risks. On the one hand, there is purchasing power risk, the risk of having one's capital inflated away. Adjacent to that is the so-called "risk-free rate," the rate of return on U.S. government bonds. Corporate bonds are slightly more risky than sovereigns, and stocks are riskier than bonds. Conversely, the expected rate of return on these instruments increases as the risk increases. That's how investors earn returns—by taking measured risks. The trick is not to avoid risk; it's to make sure you are being adequately compensated for the risks you take.

Geopolitical risks are a fact of life. So are economic risks. Coupled with the magic of compounding, they're why equity investors are compensated more over the long haul than other investors.

Financial market storms, while potentially painful, can be more easily managed than real-world storms. Through diversification and maintaining a margin of safety, an investor can fairly well protect himself from catastrophic risk. In the real world, while we can take steps to avoid catastrophic risk, sometimes calamity happens anyway. Sometimes the non-smoker receives a grim diagnosis. Sometimes the hurricane comes to Appalachia.

In investing, risk management means different things to different people, but we keep coming back to Warren Buffett's description of it: *Risk comes from not knowing what you're doing*. No one is omniscient, and not all risk can be avoided, but investors can take measures to mitigate many bad outcomes by maintaining situational awareness, having a disciplined approach and being prepared. We underwrite our portfolios that way every day.

Since we've invoked Buffett, it only seems appropriate to also invoke Charlie Munger, who was fond of the following poem and recited it during at least one commencement address:

"The thoughts of others
Were light and fleeting,
Of lovers' meeting
Or luck or fame.
Mine were of trouble,
And mine were steady,
So I was ready
When trouble came."
– A.E. Houseman

We thank you for your continued confidence and we ask that you keep our WNC neighbors in your thoughts and prayers.

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