

# MARKET LETTER

## PACIFIC PORTFOLIO CONSULTING, LLC

Third Quarter 2024

### EXECUTIVE SUMMARY

- Markets seeing higher levels of volatility, as expectations whipsaw on a data-dependent Fed
- “Soft Landing” scenario retains the greatest support from the data and now from the crowd – despite having become broadly consensus, however, we still appear to be on the road to normal for inflation, monetary policy, unemployment, and economic growth
- Despite nice gains already this year and some lofty valuations out there, prospects of continued growth and lower interest rates have been driving robust and broad-based equity market strength
- The fate of the market remains primarily in the hands of the Fed’s monetary policy decisions in the coming quarters, leaving these as clear potential sources of investor worry and market volatility

### TRUE GRIT

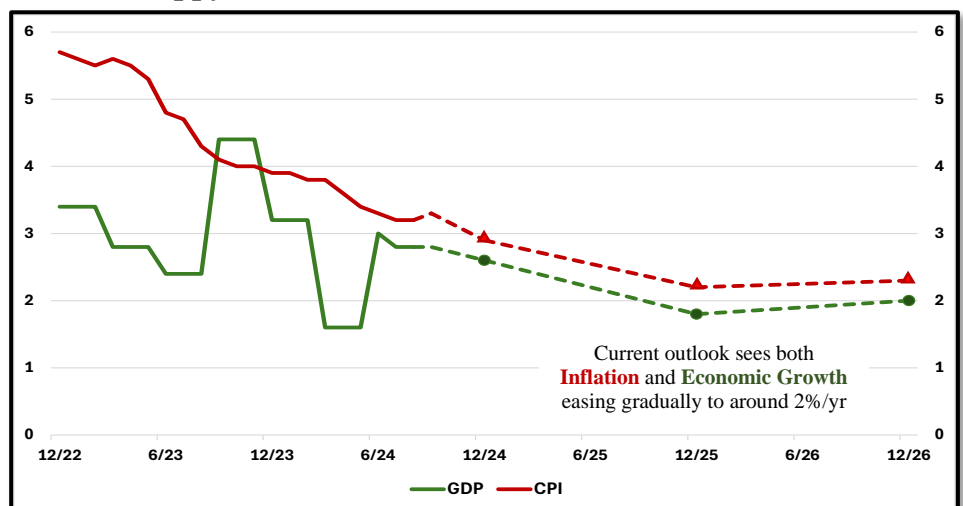
Some of you may already be familiar with the work of psychologist and popular TED talker Angela Duckworth on the concept of grit, which she refers to as “passion and perseverance for very long-term goals;” the dictionary, meanwhile, defines grit more broadly as an ability to display courage and resolve in the face of challenge.

From a pragmatic, “big picture” perspective, this could easily be making reference to the entire process of investing; certainly, this long-term practice we are pursuing together requires a healthy degree of grit from which to draw the courage, conviction, and discipline to prudently grow our clients’ wealth in pursuit of their – of your – most important long-term goals.

At the same time, on a much more micro level, I would also feel quite comfortable using the term “grit” to describe the recent character evident in both the economy and financial markets. Yes, volatility is up and there are any number of potential catalysts that could drive additional spikes; and, yes, day-to-day gyrations in the data have at times given both the Fed and the markets some serious whiplash. Nonetheless, the basic trend evident both on the economic and stock market fronts remains one of underlying strength and resilience.

This is, to say the least, surprising. Were you to hop into your DeLorean (placing us, I suppose, squarely in Back To The Future III, given our theme this quarter) and travel back in time a couple of years, the conditions you would

Chart I: Happy Trails



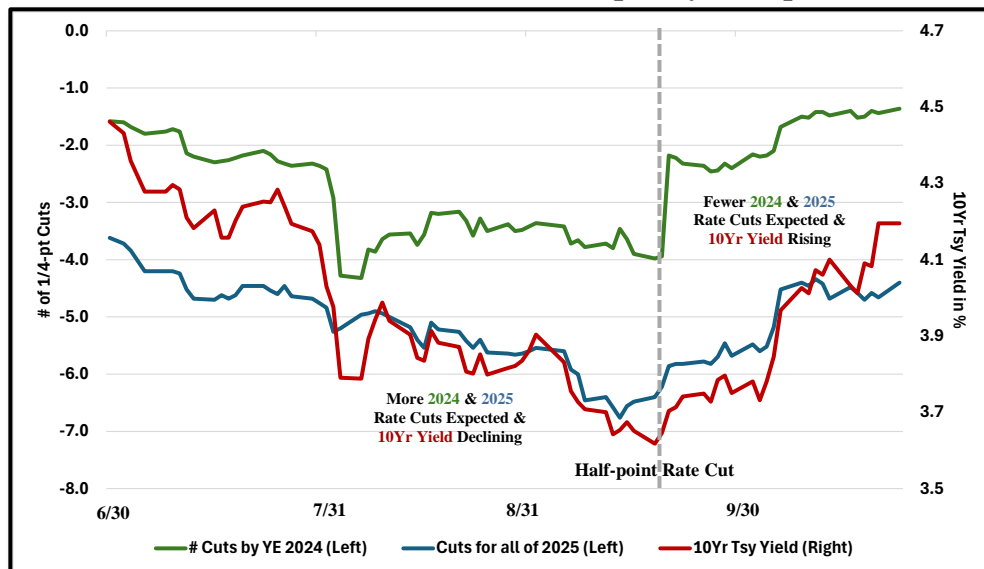
To the shock and disbelief of many, the economic scenario best supported by recent data is one of “Soft Landing,” whereby the Fed will have tightened monetary conditions sufficiently to bring inflation back under control without having overturned the appellation on growth. The widely accepted view among economists for the time being is for both of these variables to gradually drift lower towards their long-term trend levels. Of course, the actual trajectory will no doubt exhibit at least a bit more turbulence than implied by the forecasts, keeping both the Fed and the markets on their toes, looking for signs of any fundamental changes in the narrative.

observe would seem very much at odds with the present day you had just left behind. The Federal Reserve would have already tightened by a massive 300 basis points in roughly six months, inflation remained still nosebleed-worthy at nearly 8%, leading economic indicators were headed steadily lower, and the stock market was down a painful -25%, a broad-based decline that had sucked virtually every stock in every sector into its vortex. Signs warning of recession were everywhere. And yet here we are: the economy continues to chug along – sure, the pace is not terribly impressive (despite being well above long-term trend) but the very fact that growth is still positive is! Inflation, meanwhile, is down substantially and seemingly on track to reach the Fed’s 2% target ahead of schedule and the stock market has just celebrated the second anniversary of the ongoing bull market with cumulative gains over that time of a little over +60%. If anything, investors may be starting to wonder if things aren’t looking just a little bit too good these days (we have caught whiff of more than a few utterances of the term “melt-up”). As we always try to remind you, however, timing the markets is next to impossible and the only thing harder than that is trying to time the onset of a recession. What’s more, although it will not always be the case, conditions appear supportive of a continuation of this economic and market “grit” through year-end and into 2025 (provided the Fed doesn’t screw things up!)

## THE QUICK & THE FED

Looking for the hottest game in town? Put aside your tech stocks for just a moment and mosey on over with me to the Fed Funds futures market instead. Here we find the arena in which the “heavy hitters” – commercial banking institutions, hedge funds, pension plans, etc. – put their money where their mouth is and effectively hash out the market’s “consensus” view of where (and when) Fed policy is headed. While this has been a key area to watch for some time now – read “years and years” – it has not typically been as prone to the wild thrashing and gyrations so

**Chart II: The Good, The Bad, and The Completely Unexpected**



Adding to the debate around the question “if the market is always right, how can it change so darn quickly?!” the outlook on the monetary policy front continues to see some pretty significant swings. For now, the consensus view is that we will see another cut or two by year-end 2024 – though there is an inordinate level of debate around the specifics of November, December, or both – leaving the mid-point of the fed funds rate range between 4 3/8 and 4 5/8 percent. For 2025, the market is currently looking for a total of 100 basis points in cuts (regardless of whether that comes as four quarter-point cuts or some variation in larger denominations), down from roughly 170 basis points expected just a month ago. Adding to the mix, long-term interest rates have actually been moving steadily higher over the month since the Fed’s first cut. On the one hand, this could be a result of the market having moved yields lower in anticipation of the Fed’s cut, though it could also be seen as an endorsement of the strength of the economy and acknowledgement that the Fed will not need to – or perhaps, as a result of inflation, will not be able to – cut as quickly as was previously believed.

reminiscent of a bucking bronco as it has recently in response to a surprisingly hot inflation print or an unexpectedly strong jobs number. Just in the months leading up to the Fed’s big 50 basis point cut in the policy rate of interest in mid-September, the market’s expectations swung from roughly 1 quarter-point rate cut to more than 4 by year-end. Following the September cut, meanwhile, more than one pundit exclaimed that we would see another half-point cut in November likely followed by another quarter-point in December. Such exuberance, however, looks increasingly as though it will prove to have been irrational.

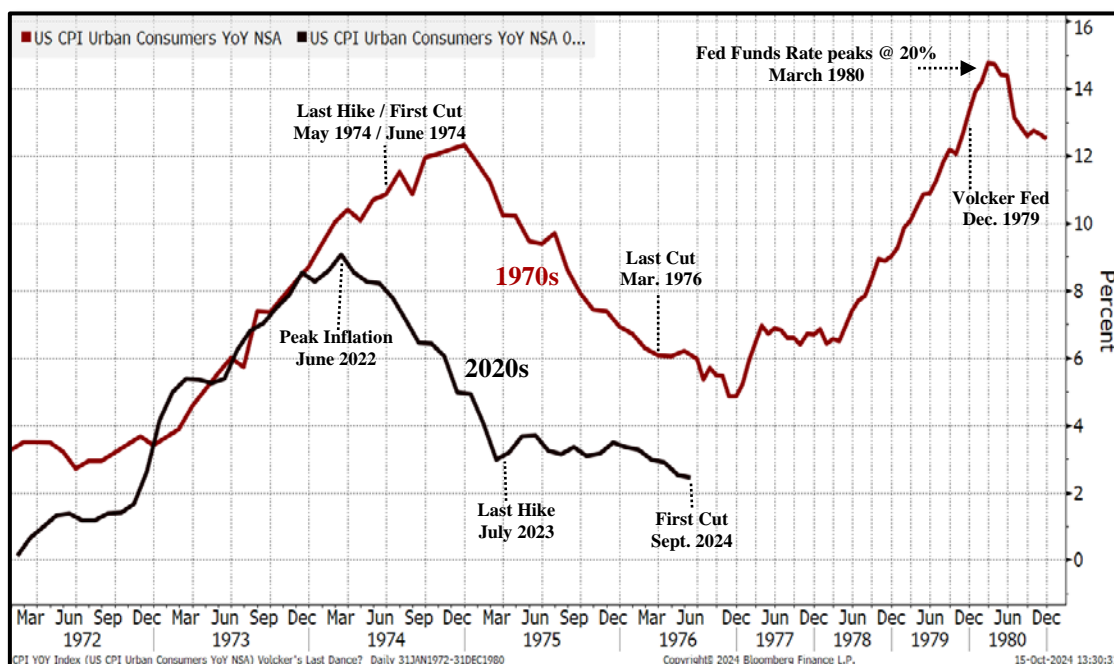
You see, over the past month, the labor market – the Fed’s “pet project” at the moment – has hinted that it might be holding up quite a bit better

than anyone dared to assume. Over the years of economic expansion since the 2020 COVID recession, job creation has followed a fairly steady stair-step lower, just as you would expect, from an extremely robust 500,000 jobs/month in 2021, to a still-impressive 400-odd thousand per month throughout 2022, to a healthy 250,000-300,000 last year, and now down to between 200k and 300k per month over the first nine months of 2024.

How, then, did we suddenly get to the point where Jerome Powell uses his press conference following a fairly monumental rate-cut meeting to telegraph to markets that the Fed does not need nor want to see any further slackening take place in the labor market? If we chalk it up to the Fed's insistence on being data-dependent, I suppose it makes some sense: they would have been watching with some concern as monthly job growth began to fall short of expectations during Q3, at the same time that a massive revision in the past data showed that 800,000 fewer jobs had been created over much of 2023 and early 2024 than had initially been reported.

Powell's statement, frankly, has not aged terribly well in the...oh, 5 weeks (!) since the Fed's last meeting, as nonfarm payrolls came in at +250k in September, well ahead of the consensus expectations of +150k and a reading unlikely to raise any kind of economic "red flag." Quite the opposite, in fact: it would seem to signal that the labor market does not require any kind of emergency attention from the Fed and that the overall economy continues to do relatively well. This may also be the same message the US Treasury market has been trying to get across to us

### Chart III: Volcker's Last Stand?



lately: rather than moving lower after the Fed cut short-term rates – as one might have expected – the yield on the 10-year immediately began to move sharply higher, from just under 3.7% in mid-September to north of 4.2% by mid-October. The most benign explanation – but likely the least realistic, given the magnitude of the subsequent increase in yields – would be to say that the bond market simply anticipated the Fed's move and adjusted yields lower ahead of the actual rate cut. The more reasonable takeaway, however, is that the bond market believes that either economic growth will remain solid, inflation will

If anything is keeping Jay Powell up at night, it's the ghost of Paul Volcker pointing ominously to the above chart, which compares the U.S. economy's recent bout of high inflation to the raging inflation of the early 1970s, along with its subsequent rebound over the second half of that decade, when policy makers were too quick to declare victory. The Fed had raised its policy rate to a peak 13% by mid-1974 and – anticipating a peak in pricing pressures – began to move rates sharply lower over the next two years, reaching 4.75% by early 1976...just in time for inflation to begin moving sharply higher once again. It was not until Volcker took charge in late 1979 and jacked the policy rate of interest to 20% that the Fed was able to "break the back" of inflation, albeit at the cost of pushing the economy into deep double-dip recessions in 1980 and 1981. Granted, the current Fed has tried to be mindful not to repeat the mistakes of its predecessor and continued to hike interest rates until inflation was well past its peak, thereby reducing the risk that the beast was not truly tamed, though at greater risk to economic growth. This has left the Fed much more focused on growth and the "full employment" component of its mandate these days than on "price stability." Whether it is able to maintain such a sanguine and pro-cyclical attitude going forward will be critical to keeping the U.S. (and global) economy out of recession. Realistically, however, even though there will (likely) be further interest rate cuts this year and (certainly) next year, the size and pace of their policy path is subject to change and, already, is almost certainly going to be more gradual than was the consensus view just a few weeks ago.

be slower to come down than expected, or some combination of both. Either way, the implications are largely the same: bonds are saying the Fed either won't need or won't be able to cut as quickly as previously believed. Market expectations have begun to taper accordingly, with the revised outlook calling for a total of 25 to 50 basis points total by year-end 2024, with a possibility of the Fed even sitting on its hands entirely in November.

The Fed's attempt to navigate this monetary policy "razor's edge" will no doubt remain a key area of risk, as it has for some time now, as will the market's speculation surrounding whether they can actually thread the needle on a "Soft Landing" or if they have already waited too long – their typical M.O., in which case we are headed for recession – or have instead pulled the trigger too early, in which case your fistful of dollars may require a few dollars more, opening up the prospect of a 70's-style resurgence in inflationary pressures that forces the Fed to throw the current policy playbook out the window.

## **HIGH NOON FOR THE MAGNIFICENT SEVEN?**

No need for a showdown, as stocks across the board posted strength once again in Q3, capping their best 9-month start to the year in nearly 30 years. Even so, some challengers did emerge to call out the market's reigning gunslingers, as we've seen play out a few times already over the past couple of years, without ever getting the necessary follow-through. Once again, we saw the makings of a pronounced rotation in leadership from the outset this past quarter, as high-flying tech stocks corrected sharply from mid-July through early-August, reflecting concerns around their seemingly lofty valuations and the potential for faltering economic growth (which would be expected to flow straight through to stocks' bottom line). The broad market pulled back as well, though other – less magnificent – segments of the market showed considerable relative (if not absolute) strength. As the quarter – and earnings season – progressed, continued strength in both the economy and corporate profits – as well as growing expectations for the start of an easing cycle by the Federal Reserve – helped to turn market sentiment bullish once again and produced a significant rebound, particularly in the more beaten down names, many of which quickly resumed their uptrends and went on to set new all-time highs shortly after quarter-end.

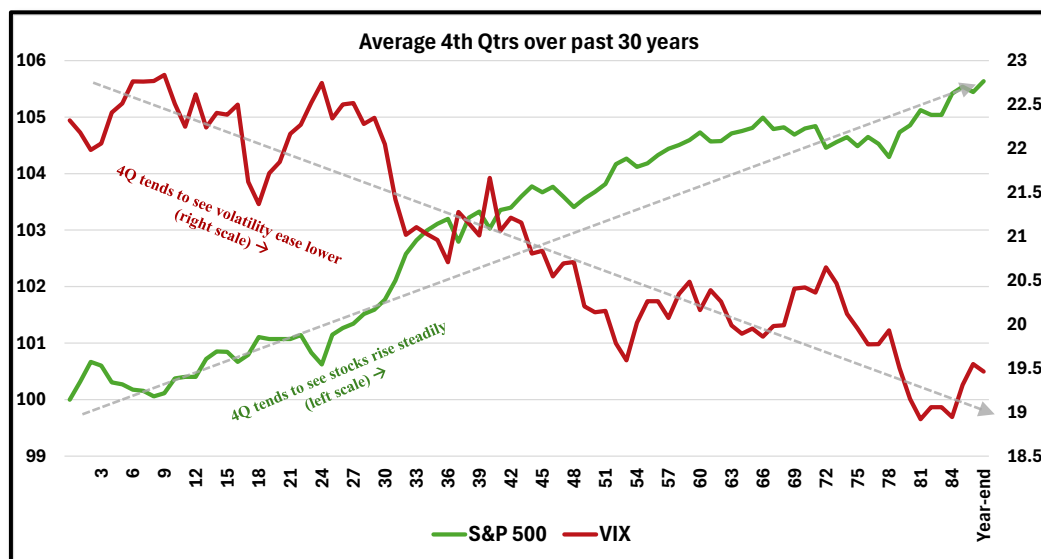
We would not be surprised to see the rotation dig in its heels this time. Don't get me wrong: tech stocks are not being put out to pasture! As we have reiterated for some time now, you will certainly want to keep owning them – we don't time markets, we believe in diversification, and, frankly, it could easily be a long-term mistake to miss out on the innovation and growth taking place at many of these companies – but you will want to be mindful not to over-own tech. Sure, tech was up once again this quarter, but the strongest sector this period? UTILITIES of all things!! Meanwhile, cyclical segments like Financials and Industrials were also areas of leadership during the quarter. Need more convincing? How about this: the *equal-weighted* S&P 500 index soundly outperformed the cap-weighted version (the one dominated by the handful of mega-cap growth stocks), while the 493 remaining S&P stocks similarly outperformed the (seemingly) Magnificent Seven stocks by a sizable margin. Last, but not least, small-caps – long left for dead – benefited from their greater sensitivity to interest rates to come charging in like the cavalry. Overall, this points to a welcome and necessary broadening of the market, away from simply a handful of expensive, fast-growing, and high momentum names to encompass much broader swathes of the market that have been neglected for some time and which are better positioned to benefit from continued economic growth.

Bonds, meanwhile, remain an unloved and widely disrespected asset class among most investors, unfairly so in our opinion. Core investment-grade bonds were up nearly double-digits over the twelve months ending in September, while those segments of the bond market subject to any degree of credit risk did even better. Even though rates may have peaked, high grade short- and intermediate-term fixed income securities are still kicking off their highest levels of income since 2007, while a decrease in the market rate of interest – as the Fed cuts and/or economic growth slows – would drive bond prices up, offering the potential for some capital appreciation as well. Meanwhile, as we often note, there is an extremely high degree of correlation of between the starting level of yield – as proxied by the 10-year US Treasury – and the subsequent total return on a fixed income portfolio over the next 5-10 years, implying that investors should expect their core bond exposures to return somewhere in excess of +4% over that timeframe, providing a solid base for a diversified "60/40" portfolio, while adding stability to dampen the volatility we are likely to continue seeing from stocks.

## COOL HEAD LUKE

As we head into what is traditionally the best quarter of the year for stocks (particularly when the market has shown strength throughout its first three quarters) you will want to keep a cool hand, sure, but more important still will be keeping a cool head about you. Things are good; the economy is healthy, stocks are up – heck, everything is up! – so enjoy it, but don't let yourself be swayed, especially at times when market sentiment or market volatility might also be up. For the time being, neither a recession nor a bear market is apparent anywhere on the horizon, but that doesn't mean they're not still out there somewhere, lurking around just the bend to ambush unwary investors who stray too far from the well-marked trail of long-term strategy.

### Chart IV: Heading To Even Greener Pastures



The fourth quarter has a reputation – historically well-deserved – of being kind to stock market investors. Over the nearly 100 years since 1926, Q4 has come in positive 80% of the time, compared with 60%-70% for the other three quarters. Similarly, the average return has been better in 4<sup>th</sup> quarters as well: nearly +4% compared with +2% to +3% for quarters 1 through 3. What about when we look at years in which the first three quarters were all positive, as has been the case this year? In those cases, Q4 was positive 90% of the time with an average return of over +6%. Of course, they can't all be winners: the crashes of 1929 and 1987, as well as the worst of the GFC bear market all took place in October. Meanwhile, it's hard to overlook the fact that presidential elections are invariably a fourth quarter phenomenon; even so, 4Q readings have been positive in over 80% of elections years over this timeframe. Market volatility has also tended to drift lower as a year draws to a close – both in general and in election years (excluding 2008, of course), as markets seem to like having election uncertainty resolved more than holding a preference for one particular election outcome over another.

You'll likely have become accustomed by now to a world in which a narrow slice of the market dominates everything else and where you struggle to keep pace unless you have loaded up on those names. If that is, indeed, what market action has taught you in recent years, do your best to unlearn it – fast! The history of the stock market makes a very solid case for the leaders of the last cycle being the laggards of the next, an inevitable side-effect of investor enthusiasm taken to the extreme. This isn't to say they won't go up, they're just unlikely to go up as much as the broader market. Stocks trading at an elevated valuation today have – at best – pulled forward return from a future period,

effectively decreasing their potential attractiveness going forward. This is not to say that magnificent stocks are not worth owning, merely that they are highly unlikely to be quite as magnificent going forward precisely because they have been so absurdly magnificent in the past!

As the market cap-weighted indexes, by their very nature, skew further and further towards these positive outliers, diversification between and within asset classes – into different segments, sectors, styles, market capitalizations, and geographies – helps to alleviate the risk that can come from an overconcentration in recent winners. There hadn't been a whole lot of near-term benefit to these risk management aspects of investing over the past couple of years, at least until recently; their long-term merit, however, has never been put in doubt. Don't have a hair trigger and, instead, stick with a long-term, diversified approach and a strategy that has been put in place with your specific risk tolerance and goals in mind. If you've got yourself a hankerin' for a change, don't hesitate to circle the wagons with your advisor, our CEO, Larry Hood, or myself.

-Jim Ayres, CIO



### 3<sup>RD</sup> QUARTER 2024 CAPITAL MARKET PERFORMANCE

<i>Index (as of 9/30/2024)<sup>1</sup></i>	<b>1 Qtr</b>	<b>YTD</b>	<b>1 Year</b>	<b>3 Year</b>	<b>5 Year</b>	<b>10 Years</b>
FTSE 3-month T-Bills	1.37%	4.17%	5.63%	3.63%	2.38%	1.67%
Bloomberg Gov't/Credit Intermed.	4.17%	4.68%	9.45%	0.17%	1.26%	1.96%
ICE BofA US High Yield	5.27%	7.90%	15.55%	3.08%	4.53%	4.94%
Bloomberg Multiverse	6.97%	3.81%	12.25%	-2.81%	-0.63%	0.74%
S&P 500	5.89%	22.08%	36.35%	11.91%	15.98%	13.38%
Russell 1000 Value	9.43%	16.68%	27.76%	9.03%	10.69%	9.23%
Russell 1000 Growth	3.19%	24.55%	42.19%	12.02%	19.74%	16.52%
Russell Mid Cap	9.21%	14.63%	29.33%	5.75%	11.30%	10.19%
Russell 2000	9.27%	11.17%	26.76%	1.84%	9.39%	8.78%
Russell 2000 Value	10.15%	9.22%	25.88%	3.77%	9.29%	8.22%
Russell 2000 Growth	8.41%	13.22%	27.66%	-0.35%	8.82%	8.95%
MSCI EAFE	7.33%	13.50%	25.38%	6.02%	8.72%	6.22%
MSCI EAFE Small Cap	10.65%	11.59%	24.08%	0.12%	6.85%	6.63%
MSCI Emerging Markets	8.88%	17.24%	26.54%	0.82%	6.15%	4.41%
MSCI Frontier Markets	4.63%	11.15%	15.63%	-2.43%	3.72%	1.37%
Wilshire US REIT	15.19%	14.88%	33.61%	4.60%	5.39%	7.76%
DJ Global Select RESI	15.90%	12.02%	29.97%	1.85%	2.52%	4.96%
Bloomberg Commodity Index	0.68%	5.86%	0.96%	3.66%	7.79%	0.03%
IQ Hedge Multi-Strategy	3.60%	7.07%	11.63%	3.04%	3.74%	2.98%
Domestic Balanced	5.20%	14.90%	25.06%	7.35%	10.22%	8.95%
Global Balanced	5.70%	13.16%	22.81%	5.38%	8.31%	6.93%

<sup>1</sup> The Bloomberg U.S. Government Credit Intermediate and Multiverse indices are registered service marks of Bloomberg Finance LP. The ICE BofA US High Yield index is a registered service mark of Intercontinental Exchange; the S&P 500 Index is a registered trademark of the McGraw-Hill Companies, Inc.; the Russell 1000, Russell 1000 Value, Russell 1000 Growth, Russell Mid Cap, Russell 2000, Russell 2000 Value, and Russell 2000 Growth indices are registered trademarks of the Frank Russell Company; the MSCI EAFE and MSCI Emerging Markets indices are registered trademarks of MSCI or its subsidiaries; the Wilshire REIT index is a registered trademark of Wilshire Associates Incorporated; the DJ Global Select RESI index is a registered trademark of Dow Jones Trademark Holdings LLC; the Bloomberg Commodity Index is a service mark of Bloomberg Finance L.P.; the IQ Hedge Multi-Strategy index is a trademark of New York Life Investment Management LLC. The Domestic Balanced benchmark represents a blend of 60% S&P 500 and 40% Bloomberg US Intermediate Government/Credit, rebalanced monthly, while the Global Balanced benchmark depicts a blend of 60% MSCI ACWI and 40% Bloomberg US Intermediate Government/Credit, also rebalanced monthly.