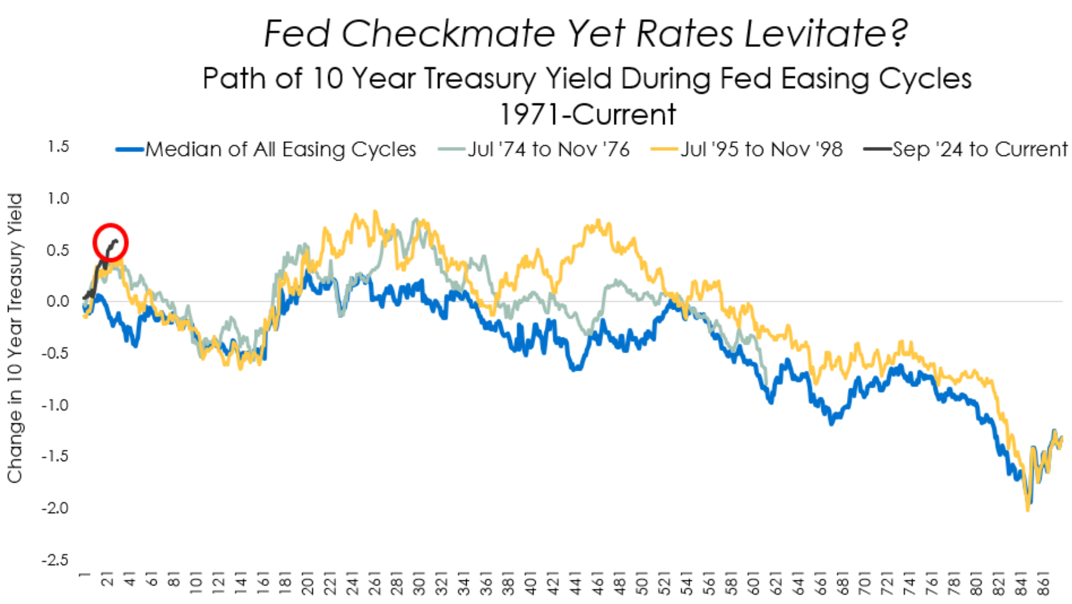
Fed Checkmate Yet Rates Levitate?

"Once you leave the ground, you fly. Some people fly longer than others."

– Michael Jordan (2005)

Different things may come to mind when thinking about the hyperbole of defying gravity. Perhaps it's the nostalgia of it, but the first thing this author thinks of is none other than Air Jordan himself. MJ was simply able to do things that others couldn't. Slam dunk competitions were as exciting as playoff runs because of the creativity that Jordan displayed in his ability to seemingly defy gravity.

Last month, the Fed declared victory on inflation by lowering short term interest rates 50 basis points (0.5%) – its first rate cut in more than four years. Curious to many an investor – since then – long-term interest rates have defied their own version of gravity as the 10 Year Treasury yield <u>rose</u> by 58 basis points (0.58%) through the end of October. <u>While counterintuitive, this behavior isn't as rare as one might think</u>. Of the nine major Fed easing cycles over the past half century, four of them witnessed rates initially rising on the long end. The chart below shows the two most similar paths ('74-76 and '95-98) as compared to what we've seen so far today. In both cases, the 10 Year Treasury yield fought the move lower in short rates (in fits and starts) for the better part of two years. The '07-08 period was less pronounced and faded more quickly while the '81-82 easing cycle was the most extreme example of longer dated yields rising



Source: Factset. Easing cycles include periods: Jul '74 to Nov '76, Apr '80 to Jun '80, Jun '81 to Dec '82, Sep '84 to Aug '86, Jun '89 to Sep '92, Jul '95 to Nov '98, Jan '01 to Jun '03, Sep '07 to Dec '08, Aug '19 to Mar '20, Sep '24 to Current. Median is calculated where observations are available.

almost 250 basis points (2.50%) in response to the Fed's most egregious rate cutting mistake (in the prior '80 easing cycle). As can be seen by the median path of all easing cycles, it intuitively makes sense that – ultimately – longer term interest rates get pulled down by the effect of the Fed cutting short-term interest rates. The magnitude of the pull down is largely dependent on the deflationary impulse often associated with recessions and /or hard landings (as two thirds of Fed easing cycles have witnessed).

<u>In summary – while the duration of each period varies, Fed easing cycles have lasted an average of about two years with every circumstance seeing the 10 Year Treasury yield finish lower than initial levels by the conclusion of the last Fed rate cut. The path, however, is never a one-way move as questions around being "early or late" seem to always be the narrative</u>.

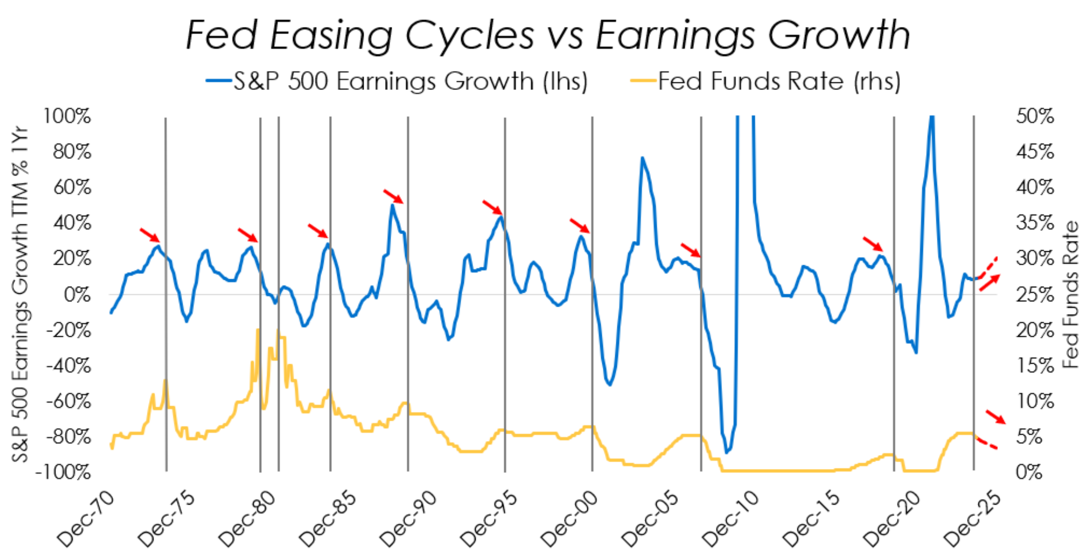
Is the Fed cutting too late and in response to already weakening fundamentals?

Is the Fed cutting too early and risking a resurgence of inflation?

Can the Fed proactively cut rates to engineer a soft landing and extend the business cycle?

As we stated last month and can be seen in the chart below, the uniqueness of this easing cycle stems from the fact that the Fed is doing something it rarely ever does – cutting rates <u>before</u> a presumed peak in earnings growth which isn't expected to occur until the back half of next year.

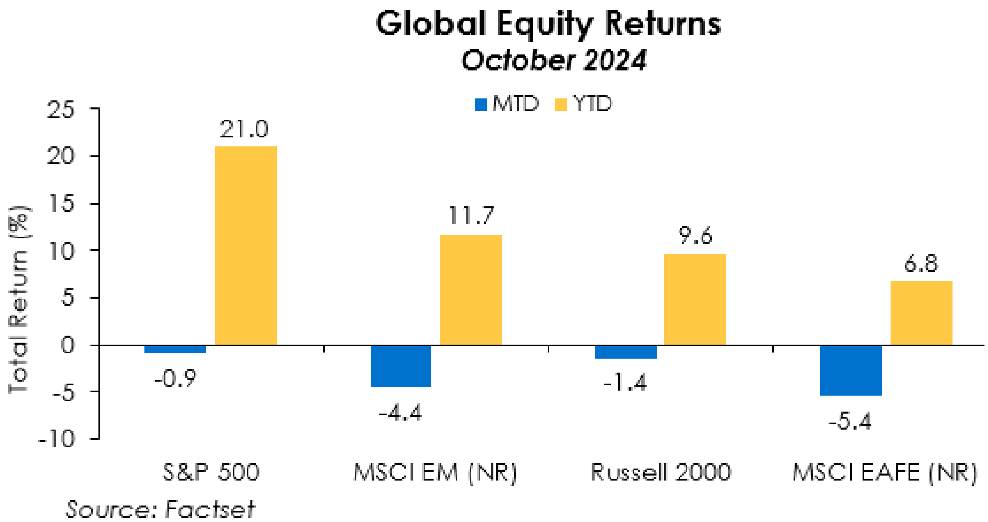
<u>The degree to which the long end of the curve can continue to defy gravity will likely have a lot to do with how growth and inflation respond to Fed rate cuts</u>. We're staying tuned in to the signaling it may provide.



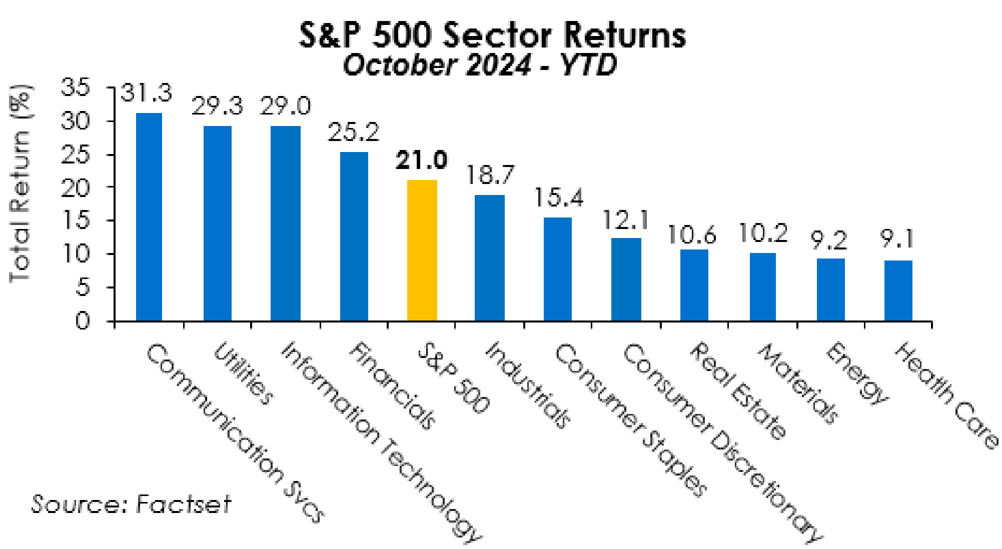
Source: Factset; historical monthly earnings data smoothed over each quarter from Robert J Shiller; www.shillerdata.com. Earnings growth is calculated based on trailing twelve month reported earnings figures. Next twelve month forecast for earnings based on bottom up analyst estimates for S&P 500 reported earnings using the S&P Dow Jones Indices datasets; www.wpglobal.com. Next twelve month forecast for Fed Funds rate based on FOMC projection from the September dot plot and forecast exhibits; www.federalreserve.gov.

After strong third quarter returns, Stocks, Bonds, and REITs retreated in October with the back up in longer dated yields. Year-to-date returns remain tiered with Stocks and REITs up the most while Bonds and Commodities are generally up low single digits. The S&P 500 continues to lead global equity markets for the year given its growth oriented bias influenced by AI related enthusiasm.

Stocks

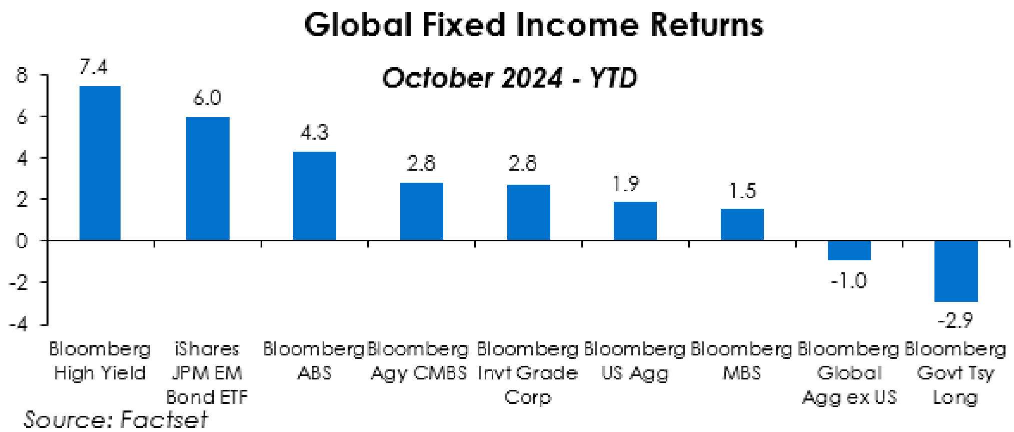


Stocks posted negative returns for the month with weaker results in international markets as the U.S. dollar rallied. U.S. Large Caps (S&P 500) continue to lead year-to-date – with some resumed narrowing of the market in October after improved participation in the third quarter. US Small Caps (Russell 2000) were down modestly in the month following strong thrid quarter momentum in anticipation of continued rate cuts and a soft landing. Overseas, International Developed Markets (MSCI EAFE) relinquished some of the third quarters's strong performance as interest rates and the dollar rose. Emerging Markets (MSCI EM) also retreated, after surging almost 7% in September, on questions about the effectiveness of China's recently announced stimulus program.



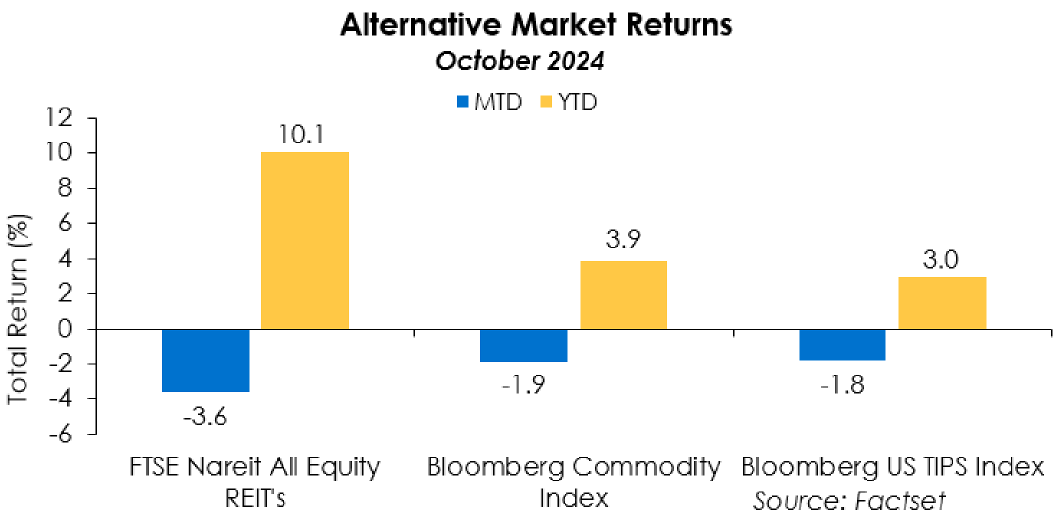
Bonds

Following aggressive moves by the Fed amid ongoing (albeit slowing) balance sheet reduction – policymakers reduced the Fed funds rate by fifty basis points at their September meeting (Fed Funds at 4.75-5.0%). The Fed's pivot to an easing bias was the first in over four years as they emphasized balanced risks to both sides of their dual mandate (price stability & full employment). Policymakers are now forecasting as many as six additional rate cuts (25 basis points per) through the end of 2025. Bond returns were negative in October as longer dated yields rose post the Fed's first round of rate cuts – counterintuitive but not necessarily uncommon as noted above. Year-to-date returns have been modest compared to Stocks – generally in the low-single digits. Credit (High Yield) and Emerging Markets (JPM EM) have been among the best performing areas for the year. Long duration Treasuries and the Global Agg ex US continue to lag year-to-date and for the month as rates backed up and the dollar rallied.



Alternatives

While posting positive returns for the year, Commodities retreated in October as geopolitical risk ebbed and flowed. Meanwhile, publicly traded Real Estate (REITs) pulled back after very strong third quarter returns as rates rose in the month. Finally, returns on Treasury inflation protected securities (TIPs) outperformed nominal Treasuries as inflation expectations rallied in October in response to economic growth conditions that surprised to the upside.



Market Outlook

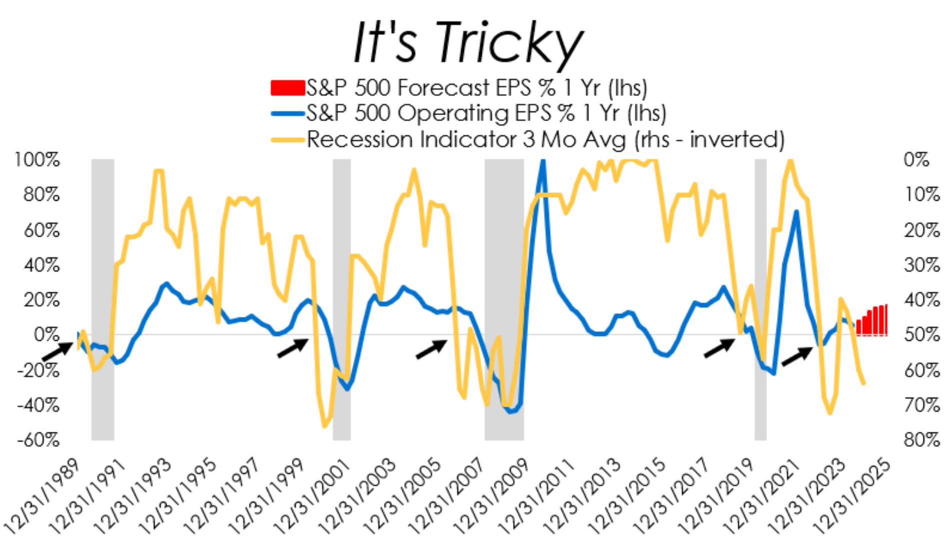
"It's Tricky to rock a rhyme, to rock a rhyme that's right on time. It's Tricky."

– Run DMC, *It's Tricky* (1986)

We continue to believe that it's important to maintain two frameworks for managing portfolios – the cyclical (shorter-term) and the secular (longer-term). The cyclical perspective is an attempt to assess where we are in this particular business cycle while the secular perspective evaluates where the structural tendencies might be over multiple business cycles.

While the secular view remains up for debate, we remain sympathetic to the notion that the paradigm is changing to one that ushers in the potential for more persistent and volatile inflation. Such a backdrop might set the stage for a higher cost of capital environment acting as a weight on stock valuations along with changes in market leadership. We find historical parallels today to the higher and more volatile inflation regime that existed back in the '60's-80's and we think the Fed is re-learning the painful lesson of falling behind inflation – one that it hopes not to repeat any time soon. Additionally, we believe there are structural considerations that exist today that might also support this changing paradigm including changes to both aggregate demand (money aggregates) and supply (de-globalization, labor markets, energy complex) not to mention building pressures on the federal deficit.

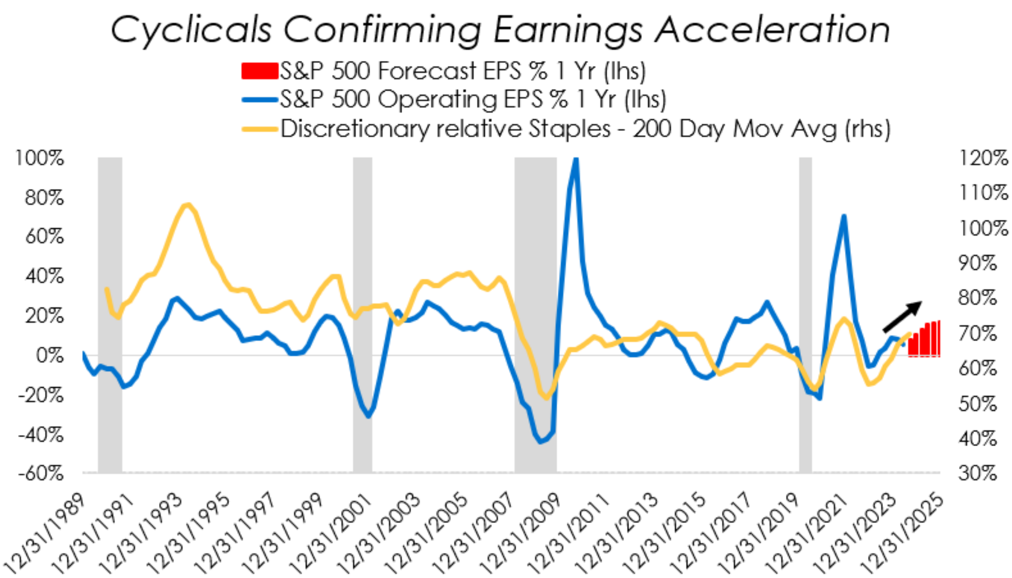
For now, those secular thoughts are taking a back seat to the cyclical view which remains in "Tricky" territory. That's partly because the fundamental data has, for now, evidenced a late cycle economic frame but earlier profit cycle picture. Just as investors might be asking if the Fed is cutting rates too late or too early, one might also be asking if we're early or late in the cycle.



Source: Factset; S&P Dow Jones Indices with operating EPS defined on a trailing twelve month basis. Yellow Cardinal Research; the Recession Indicator is a proprietary dashboard of financial conditions that historically have provided some lead time on recessionary events. When more than half of the weighted average signals were triggered, this often precluded a recession. The Recessionary Indicator is a weekly signal with the 13 week moving average smoothing the volatility.

The answer likely depends on one's point of view. Many an economist would cite the un-inversion of the (10-2 year) yield curve and limited incremental economic capacity as signals that would suggest that we remain closer to the end than the beginning of the business cycle. However, the fundamental investor is astute to point out that we're on the upswing of earnings growth – which is expected to continue throughout this year and next. The chart above evidences both of these conditions. Our recession indicator continues to register comparable late cycle levels while the consensus forecast for S&P 500 earnings growth shows a re-acceleration into the back half of next year. History tells us these disconnects tend to be uni-directional. An earnings recession can occur without an economic recession ('15-16) but generally not vice versa. This implies that the economic state can remain in an extended late cycle position until earnings materially weaken. In summary, we believe this setup requires investors to keep their proverbial "Head on a Swivel" in recognizing the cyclical earnings improvement while also understanding the extended economic frame.

The price action in the equity market is, in fact, confirming this cyclical improvement. As can be seen in the chart at right, when comparing the Consumer Discretionary sector against the Consumer Staples sector (both on an equal weighted basis using the relative 200 day moving average), the pro-Discretionary tilt implies a cyclical bias with limited concern for the economy at this point. It's also noteworthy that this relationship tends to directionally coincide with S&P 500 earnings growth. Growth acceleration favors the cyclical (Discretionary) tilt while deceleration the defensive (Staples) tilt. The bottom line is that investors continue to favor stocks that benefit consumer wants over consumer needs which seems to be consistent with a broadening growth backdrop as earnings accelerate. One might consider that a Fed in easing mode might further accentuate this set of conditions and benefit companies with more operating and financial leverage that tend to be smaller in size.



Source: Factset; S&P Dow Jones Indices with operating EPS defined on a trailing twelve month basis. Discretionary relative Staples is defined as the relative 200 day moving average using the S&P 500 equal weighted sectors indexed back to inception.

One might also argue that the opportunity tends to further align when looking at valuations where the top of the market still carries with it a much higher price to earnings ratio than the majority of its members. According to Factset data, consider that since the end of 2009, the "average" stock (as defined by the equal weighted S&P 500) is trading at a 21% discount to the market (as defined by the cap weighted S&P 500 index) versus its historical discount of about 5%. Similarly, the valuation difference between the S&P 500 Growth and Value indices are still rather extreme – not far off from their disparate readings witnessed back in late 2021 and before that, the Tech Bubble peak. The bottom line is that the highest valuations still remain concentrated in the hands of the largest and growthier weights in the index. A key takeaway for us is that this kind of market action has conditioned investors to become accustomed to succeeding with much less diversifcation than in the past – regardless of the building valuation (and mean reversion) risk and at a time when growth might be becoming more balanced.

As we look ahead, we think investors might have to think differently or "Open the Aperture" from both a cyclical and secular lens. Alternative scenarios to pre-existing leadership trends might be beneficial to consider. Given the (still) narrow set of market conditions, expanding one's investment field of view might lead to the realization that the future opportunity is now in the diversity of the investment universe rather than in the concentrated focus of a few select investments. Earnings growth accelerating as the Fed is easing might be a catalyst to consider.

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, consistent with the above view, we continue to emphasize a degree of balance across asset classes and market segments while remaining UW to the most expensive and concentrated areas. We also continue to believe that it's important to be cognizant of the potential changing paradigm (i.e. Secular) while also recognizing the earlier profit cycle setup – albeit within a late-cycle economic frame (i.e. Cyclical).

Within equities, in acknowledging the more constructive profit cycle year-to-date, our positioning incorporates more balance geographically and within our US Large Cap exposure. While having taken some profits in the latter, our bias has generally been to have more exposure to less expensive areas (broader vs top). As such, we've maintained a larger OW in Cyclical Value and a lesser OW in Defensive sectors combined with a smaller sized cap bias. We remain UW the most concentrated and expensive Cyclical Growth areas.

Within fixed income, we remain biased toward the higher quality US Core Fixed Income segment – where we are longer in duration and have actively repositioned our Treasury exposure in acknowledging the steepening yield curve. This exposure remains our biggest OW in portfolios for diversification purposes though we've also added to International Fixed Income, where the end of negative interest rate conditions has led to more attractive opportunities. Maintaining a higher quality bias means that we still remain UW the most expensive part of the bond market (High Yield) where spreads remain tight. High Yield corporate bonds tend to benefit from cyclicality though their incredibly tight credit spreads suggests this might already be fully recognized.

Within alternatives, we remain fairly balanced having previously reduced our UW to Real Estate and our OW to Diversified Alternatives as we think valuations in the former have come down to reflect the challenges of this interest rate senstive area and are now bottoming consistent with the Fed easing cycle.