Choose Your Own Adventure

"Not all those who wander are lost."

– J.R.R. Tolkien (1892-1973)

Adventure is defined in the Oxford dictionary as an unusual and exciting, typically hazardous, experience or activity.

An adventurous spirit is the required psyche for today's investor especially as the Fed recently cut interest rates (by 50 bps or half a percent) for the first time in over four years. Such an event had us dust off the annals of history in examining other Fed easing periods in this "choose your own adventure" exercise.

For context, Fed rate cutting cycles are not terribly commonplace – happening on nine other occasions over the past half century. As can be seen in the table below, each episode has similarities and differences with no two instances quite alike.

- About two thirds of the time, Fed easing cycles have been associated with recessions coupled with sizeable draw downs in both earnings and the S&P 500.
- The other one third of the time, soft(ish) landings ensued despite all being different in terms of the magnitude of rate cuts (mid '90's saw the fewest while the '80's was among the highest on the list).

CHOOSE YOUR OWN ADVENTURE

No of Cycle	Start of Easing	End of Easing	Change in Fed Funds (%)	P/E at Start of Easing	Peak to Trough in EPS (%)	Date of EPS Trough	Peak to Trough in S&P 500	Date of S&P 500 Trough	Recession (Yes or No)
1	Sep-24	Dec-26	-2.50%	28.5	?	?	?	?	?
2	Aug-19	Mar-20	-2.25%	21.9	-33%	Dec-20	-20%	Feb-20	Yes
3	Sep-07	Dec-08	-5.00%	19.4	-92%	Mar-09	-53%	Feb-09	Yes
4	Jan-01	Jun-03	-5.50%	28.2	-51%	Dec-01	-40%	Sep-02	Yes
5	Jul-95	Nov-98	-1.25%	16.2	-3%	Dec-95	N/A	N/A	No
6	Jun-89	Sep-92	-6.75%	12.6	-37%	Dec-91	-16%	Oct-90	Yes
7	Sep-84	Aug-86	-5.75%	10.0	-13%	Dec-86	-2%	Nov-84	No
8	Jun-81	Dec-82	-11.50%	8.7	-19%	Mar-83	-20%	Jul-82	Yes
9	Apr-80	Jun-80	-11.00%	7.0	-3%	Jul-80	N/A	N/A	Yes
10	Jul-74	Nov-76	-8.25%	8.9	-15%	Sep-75	-25%	Dec-74	Yes

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 Fed Funds rate based on FOMC projection from the September dot plot and forecast exhibits and smoothed for intrayear reading; www.federalreserve.gov. Peak to trough EPS and S&P 500 defined as the period from when the Fed started easing to when the Fed started hiking rates.

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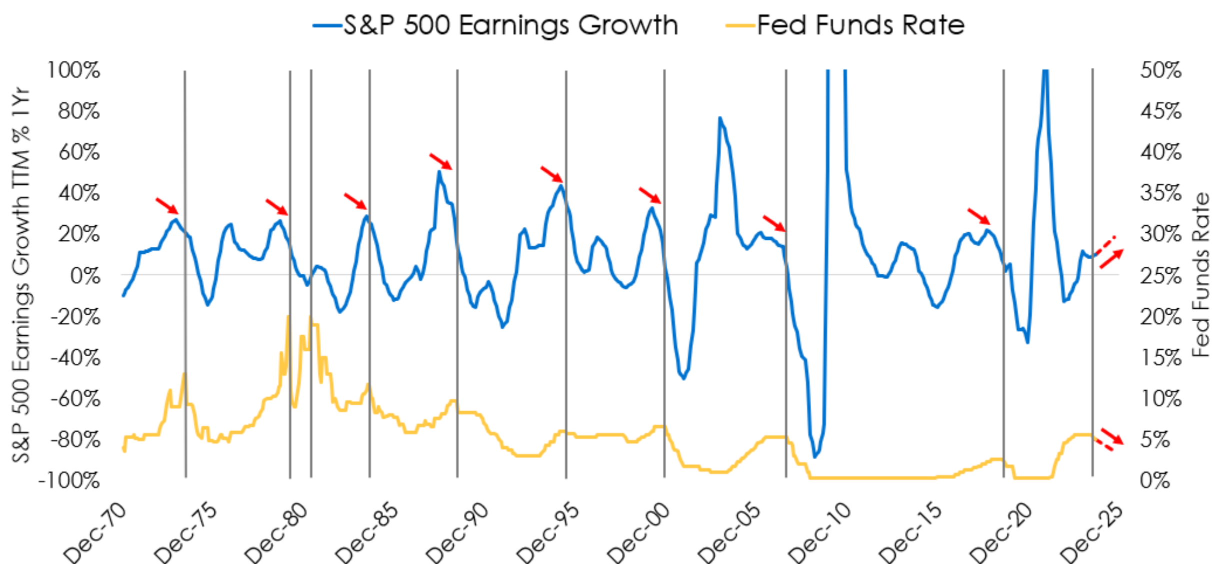
- The '80's easing cycle was the only soft landing with a recession though the starting P/E was the lowest on the list so inexpensive valuations were likely a buffer.
- The anticipated magnitude of this easing cycle looks most similar to '19-'20 with today's elevated valuations (based on S&P 500 trailing twelve month reported earnings) most analogous to the '01-'03 period.

<u>While there appear to be just as many differences as similarities across Fed easing cycles, the one constant is the conceptual mission of the Fed to act as a counter stabilizer to the fundamental backdrop.</u> This independent policymaking body is intended to serve as the shock absorber to the business and economic cycle (by fulfilling its dual mandate focus on inflation and employment) – essentially putting the punch bowl out and taking it away when needed. <u>Logically, it makes sense then that the Fed would normally be cutting rates when earnings growth was slowing as a way to buffer the shock of a steepening decline.</u> As can be seen in the chart below, the fact that the Fed has almost always started its easing cycle after the point of peak earnings growth (except '81-'82 – back end of a double dip recession) is an important observation. While so far that remains the case today, earnings growth forecasts over the next twelve months have the Fed breaking that rule of thumb. Policymakers are forecasting as many as five (25 bps) rate cuts while bottom-up equity analysts are projecting S&P 500 earnings growth to accelerate from high single-digit to mid double-digit levels. <u>Can both be right?</u>

In our view, such a scenario requires quite an adventurous imagination and, if fulfilled, more than just a tip of the hat to Fed Chair Powell.

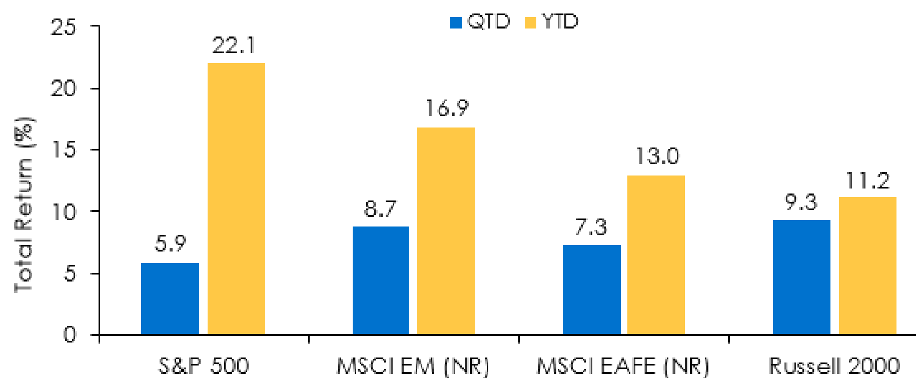
Fed Easing Cycles vs Earnings Growth



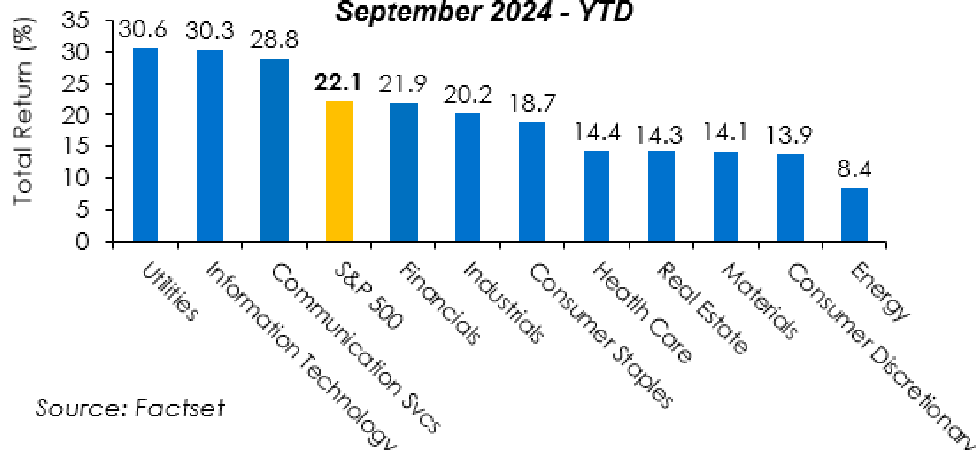
Source: Factset; historical monthly earnings data smoothed over each quarter from Robert J Shiller; www.shillerdata.com. Earnings growth is calculated based on trailing twelve month reported earnings figures. Next twelve month forecast for earnings based on bottom up analyst estimates for S&P 500 reported 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 and smoothed for intrayear reading; www.federalreserve.gov.

The third quarter ended with Stocks, Bonds, and REITs posting strong returns during the period. Year-to-date returns remain tiered with Stocks up the most while REITs contine to close the gap. Meanwhile, Bonds and Commodities are up low to mid-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 – though returns broadened out in the quarter helped by the anticipation and eventual start of Fed rate cuts.

Stocks

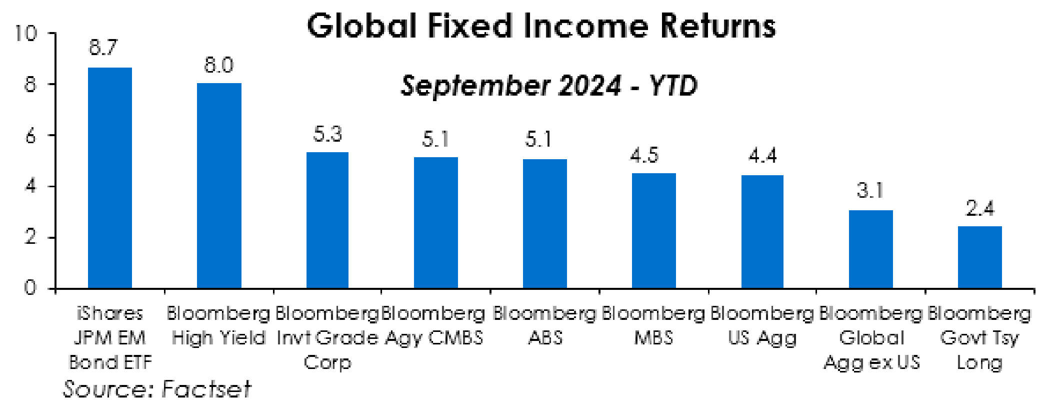


Stocks posted strong returns for the quarter with a broadening tone. Results were led by US Small Caps (Russell 2000) followed by Emerging Markets (MSCI EM), International Developed Markets (MSCI EAFE), and US Large Caps (S&P 500). The latter continues to lead year-to-date – though with improved participation as eight of eleven sectors outperformed this quarter compared to only two (Technology and Communication Services) in the first half of the year. US Small Caps (Russell 2000) were up modestly during the month but led for the quarter as they anticipated rate cuts and an economic soft landing. Overseas, International Developed Markets (MSCI EAFE) have been buoyed by the easing of foreign central banks and improving inflation. Meanwhile, Emerging Markets (MSCI EM) rallied sharply during September as China announced significant economic stimulus to encourage domestic demand.



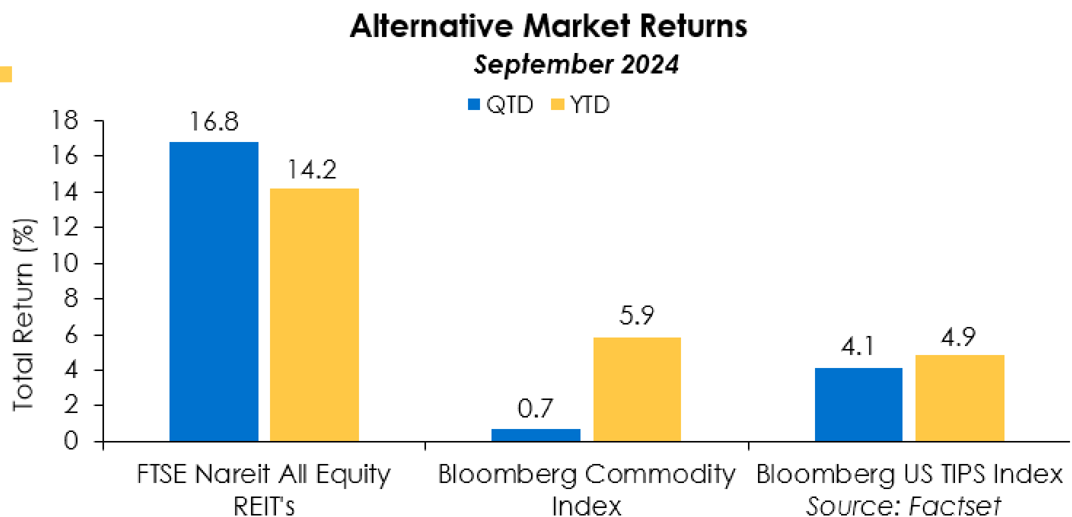
Bonds

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 reductions (25 basis points per) through the end of 2025. While year-to-date returns have been more modest compared to Stocks – generally in the mid-single digits – Bond returns were robust in the third quarter. Credit (High Yield) and Emerging Markets (JPM EM) have been among the best performing areas for the year, though Long Dated Treasuries and the Global Agg ex US have seen the best momentum of late amid lower rates and a falling dollar.



Alternatives

Commodities rallied in September after China announced stimulus plans to boost domestic demand and are now solidly positive for the year. Meanwhile, publicly traded Real Estate (REITs) posted strong returns in the quarter amid falling rates. Finally, returns on Treasury inflation protected securities (TIPs) have recently started to underperform nominal Treasuries as concerns about sticky inflation have begun to recede.



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Market Outlook

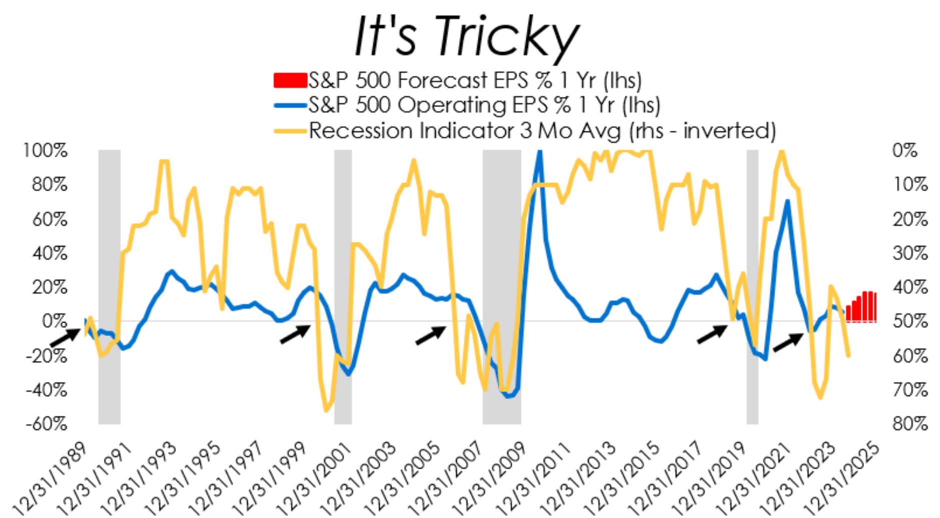
"It's Tricky to rock a rhyme, to rock a rhyme that's right on time. It's Tricky."

– 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.



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 un-inversion of the (10-2 year) yield curve and limited incremental economic capacity suggests that we remain closer to the end than the beginning of the business cycle. However, the earnings recession that

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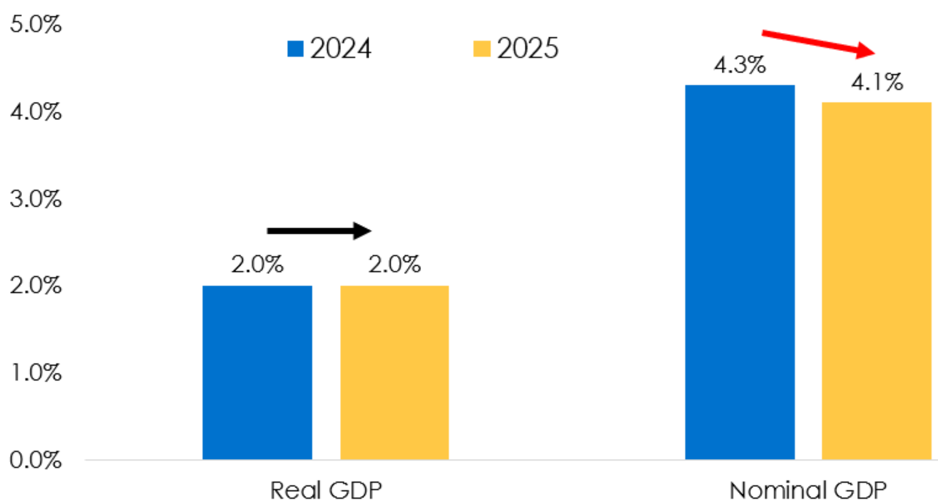
occurred last year has been resolved with an upturn in profit growth expected throughout this year and next. The chart above evidences both of these conditions. Our recession indicator continues to register comparable late cycle levels while the consensus forecast for S&P 500 earnings growth shows a re-acceleration into next year. We believe this setup requires investors to keep their proverbial "Head on a Swivel" in recognizing the cyclical earnings improvement while also understanding that its sustainability remains up for debate.

In further examining this disconnect, let's start by reviewing the chart at right which highlights the Fed's US economic growth forecast for 2024 and 2025 in both real (excluding inflation) and nominal (including inflation) terms.



Despite real GDP growth that's averaged 2.3% in the 1H24 and 3Q GDP growth estimated at 2.5% (per the Atlanta Fed's nowCast tracker), the Fed expects US economic growth of only 2.0% for the full year 2024. This implies an expected step back in the final quarter of this year. Also of note, policymakers kept real GDP growth unchanged at 2.0% for next year as well. Finally, as a result of the Fed forecasting a moderating inflation backdrop, the FOMC forecast for nominal GDP in 2025 highlights a deceleration. The bottom line is that economic prognisticators are projecting slowing growth to come.

This expected decleration in top line growth appears to be at odds with what investors are forecasting for the corporate profit cycle. The chart on the next page highlights historical figures for S&P 500 revenue and earnings growth along with the aggregate annual operating margin (operating earnings divided by revenues). Note that next year's estimates are forecasting an acceleration in both revenue and earnings growth combined with positive operating leverage leading to new highs in the operating margin. The previous high water mark for the margin was back in 2021 when a post COVID bounce resulted in an exceptionally high double digit revenue growth environment.

It would seem that economic and corporate profit cycle forecasts are inconsistent. In short, either investors' growth projections are too rosy or the Fed's expected number of rate cuts (another 150 basis points by YE25) are too aggressive.

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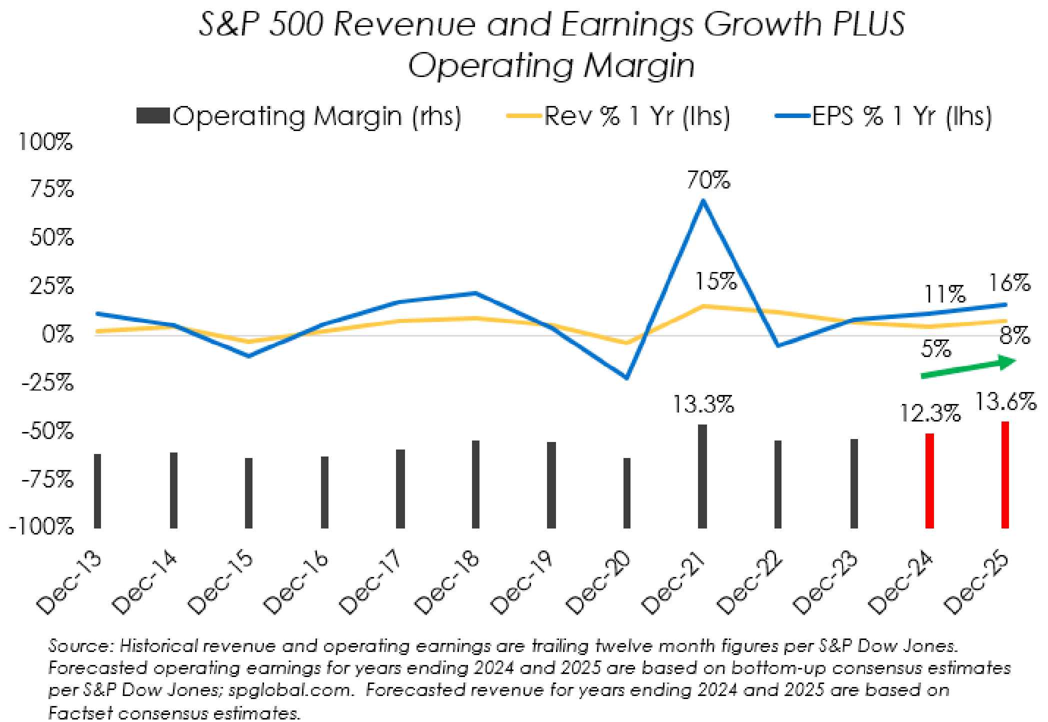

Source: Historical revenue and operating earnings are trailing twelve month figures per S&P Dow Jones. Forecasted operating earnings for years ending 2024 and 2025 are based on bottom-up consensus estimates per S&P Dow Jones; spglobal.com. Forecasted revenue for years ending 2024 and 2025 are based on Factset consensus estimates.

<u>We'll be watching both the bond market as well as our leading profit cycle indicators to gauge how this disconnect resolves.</u> To that point, the recent stronger and hotter September employment report pushed bond yields back up and dampened the number of Fed rate cuts bond investors are expecting (now more in line with Fed forecasts for this year and next). On the earnings front, we've started to observe a leveling off in some of our top-down measures as well as in bottom-up earnings estimate revision trends. This leveling off, while not disasterous, does indicate a maturation in the profit cycle with the debate over how quickly that's occurring and the degree to which it indicates a more evenly balanced growth composition.

Meanwhile, in regards to valuations, 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 20% 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. <u>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.</u>

As we look ahead, we think investors might have to think differently or <u>"Open the Aperture"</u> from both a cyclical and secular lens. Alternative scenarios to pre-existing leadership trends might be beneficial to consider. <u>Given the (still) narrow set of market conditions, expanding one's investment field of view might lead to the realization</u>

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<u>that the future opportunity is now in the diversity of the investment universe rather than in the concentrated focus of a few select investments. In addition to the profit cycle evolution, we think the shift in market rotation might be the beginning of this recognition.</u>

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, consistent with the above view, we continue to emphasize 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 frame (i.e. Cyclical).

<u>Within equities,</u> in acknowledging the more constructive profit cycle year-to-date, our positioning incorporates more balance geographically and within our US Large Cap exposure. While taking 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 slightly 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.

<u>Within fixed income,</u> 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 to take advantage of the steepening yield curve. This exposure remains our biggest OW in portfolios for diversification purposes though we've also recently 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 cyclical and expensive part of the bond market (High Yield) where spreads remain tight.

<u>Within alternatives,</u> 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 lower trend in rates.

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