FROM THE DESK OF BOB CENTRELLA, CFA October 7, 2024

The summer is sadly behind us and Q3 is in the books, but it was a good one in the financial markets. More on that in a minute. I hope you all had a great summer. When not working, I spent a lot of the summer golfing, going to the beach and attending rock concerts. We were on an "old man" tour kick, seeing Neil Young, The Rolling Stones, and ELO among several others. I figured it was a possible last chance to see these classic rock bands. Last year we saw The Eagles twice and are scheduled to see them at the Sphere in January. IMHO, there are fewer good new rock bands anymore, so I keep listening to the stuff I grew up with. I also saw Hootie, Matchbox 20, The Outlaws, The Cranberries and even a few more. Shoot me an email if you saw any fun concerts this summer. Speaking of shooting, my wife will shoot me if I buy any more concert t-shirts!

As for Q3, the market also kept on rocking & rolling as stocks and bonds produced solid returns. The S&P 500 returned 5.75% as the much-anticipated September swoon never happened, and ended the quarter up 21.85% YTD. It looked like the market was going to correct in July and August as it fell -9.7% from mid-July to the beginning of August after 2 big down days had investors thinking the worst as stocks fell 5%. But a decent jobs report brought bargain hunters back and the market recovered in August and ended up having a good September contrary to historical seasonality. On the bond front, the Federal Reserve lowered the Fed Funds rate by .50% in September and bonds rallied. For the quarter, the Barclays Bond Aggregate returned 5.3% and the yield on the 10-Year UST fell from 4.34% to 3.80%, a decline of 90 basis points from its high for the year in April. Below is a table of asset price returns (not total return) for the quarter.

ASSET	% RTN	ASSET	% RTN	ASSET	% RTN
Hang Seng	19.27	Ishare 20+ yr UST	6.89%	Ishare Muni Bond	1.95%
Coffee	18.04	Comex Silver	6.59	FTSE 100 UK	0.89
Comex Gold	13.25	SP Midcap 400	6.55	Bitcoin	0.50
Shanghai Comp	12.44	DAX Germany	5.97	Cocoa	-.09
Nymex Nat Gas	12.38	S&P 500	5.53	Taiwan Weighted Index	-3.51
TSX Canada	9.71	Vang Tot Bond	4.25	Nikkei 225	-4.20
S&P 500 Equal Weight	9.48	Euro	3.93	WSJ Dollar Index	-4.83
SP Sm Cap 600	9.65	Euro Stoxx	2.93	Mexican Peso	-6.88
Russell 2000	8.90	MIB Italy	2.93	Lean Hogs	-8.18
IBEX 35 Spain	8.53	Nasdaq Comp	2.57	Nymex Gasoline	-22.42
Dow Jones Average	8.21	CAC-40 France	2.09	Ethereum	-24.79

The Hang Seng Hong Kong index was the best asset class rising 19.27%. Among commodities Gold continued its strong run climbing 13.25%. Other international stocks also climbed including Shanghai +12.44%, Canada +9.71%, Spain 8.5% being the strongest. Bitcoin (+0.50%) had a relatively benign quarter for a change although it's cousin Ethereum was the worst asset declining 24.79%.

Among cap sizes Small Cap stocks (+10.15%) had the best quarter followed by Midcaps (+6.95%) and then large caps (5.75%). Value stocks outperformed across all the cap sizes for the quarter although YTD Growth stocks still hold a sizeable lead. Small Cap Value was the best group, rising 11.12% in the quarter.

Index	Q2 % Rtn	YTD %	Index	Q2 %	YTD %	Index	Q2 %	YTD %
S&P 500 Value	9.03%	15.23%	S&P MC 400 Value	9.32%	9.81%	S&P SC 600 Value	11.12%	5.65%
S&P 500 Growth	3.68	28.01	S&P MC 400 Growth	4.65	16.70	S&P SC 600 Growth	9.0	12.01
S&P 500	5.75	21.85	S&P MC 400	6.98	13.22	S&P SC 600	10.15	9.06

On a sector basis, the Fed rate decrease helped rate sensitive stocks. Utilities were the top sector rising 19.38% and it also benefited as a quasi-AI power play. Real Estate jumped 17.36% due to the rate drop while Industrials climbed 10.0% and Basic Materials rose 9.95%. On the downside, communication serviced fell -0.65% and Energy was the worst sector, falling -3.79%.

Sector	% Rtn	Sector	% Rtn
Utilities	19.38%	Cons Cyclical	7.62%
Real Estate	17.36	Health Care	5.64
Industrials	10.0	Technology	1.23
Basic Material	9.95	Communic Svcs	-.65
Cons Defensive	9.89	Energy	-3.79
Financial	9.60		

Key Takeaways from the Quarter and Looking Ahead

1. The narrow market rally finally broadened out. Starting in mid-July, the expectation the Fed would aggressively cut rates sparked a rotation out of the biggest tech stocks towards laggards and other sectors. The so-called Magnificent 7 stocks underperformed the "other 493" this quarter for the first time since Q1-22 as the market rally moved beyond the top stocks. The Mag-7 gained 3.2% as only 3 of the 7 increased and the outsize gain by Tesla of +24% kept the group from declining. As further proof, the equal-weight S&P 500 returned 9.5% compared to the 5.8% return for the cap-weighted S&P 500. Finally, the percentage of companies in the S&P 500 outperforming the benchmark in 2024 is 36% YTD compared to 24% for all of 2023 including 66% of companies which outperformed in Q3. The 36% is still below the average of last 30 years of 48% so this can continue.

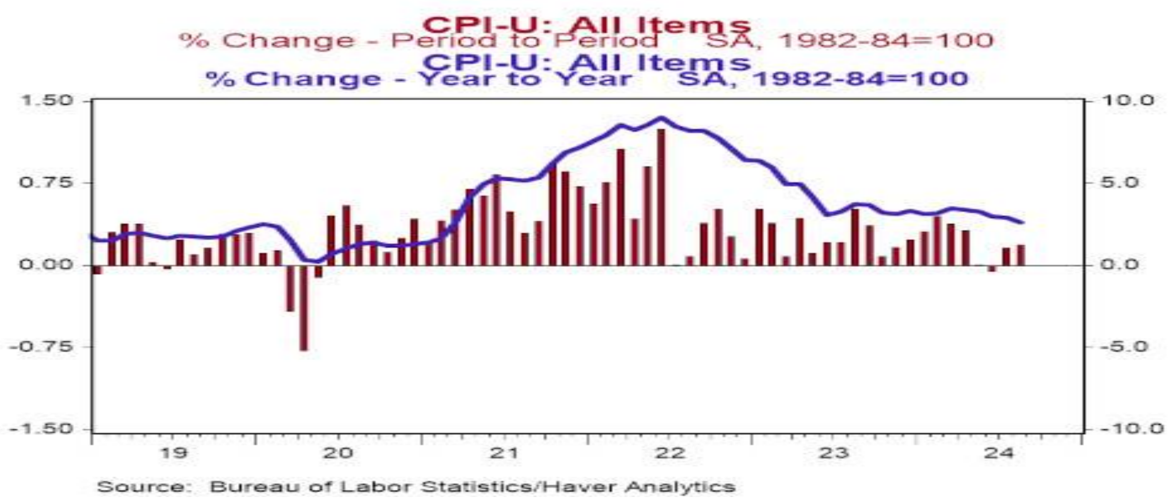
2. Valuation is still stretching but mostly because the rest of the market did better. The S&P 500 sells at 21.4x forward EPS, up slightly from 21x at the end of Q2 and above the 5-yr (19.5x) and 10-yr (18.0x) averages. But breaking that down, the Mag-7 sells for more than 35x expected earnings while the "other 493" is valued at just over 19x forward earnings.

3. Corporate profit reports for Q3 are coming in a few weeks. For Q3, growth overall is expected to be about 4% with a breakdown as follows:

Expected EPS Growth	Q3-24	Q4-24	Q1-25	Q2-25	Q3-25
The Mag 7	17.9%	16.3%	15.2%	14.5%	16.6%
Other 493	1.7%	13.9%	14.2%	13.0%	15.6%

As you see, after Q3, EPS growth for the 2 groups is expected to be closer. Given where the PE ratios are there are better values among the other 493 stocks. Along with the rate cuts, this is a primary reason why we are seeing investors rotate out of the big-caps into the other 493.

4. AI stocks took a breather in Q3. Artificial Intelligence stocks had been on a tear but took a breather in Q3 as the rally broadened. But AI spending is real, and the question is when or how will it translate to earnings growth for stocks other than the suppliers. Some suppliers, such as chip and software companies, are seeing tremendous growth. Obviously, Nvidia has led this growth. How AI will integrate into our lives and translate to higher profits for other companies is still forming.
5. In September the Fed lowered rates by .50% and indicated more is expected by year-end. After the Federal Reserve surprised markets with a 50 basis-point cut, they also said that rates could drop by another 100 basis-points (1%) by the end of the year. This had a positive effect on stocks and bond prices. The bond yield curve is still inverted from the short-end with yields up to 1-year higher than long-term yields. But the spread is now normalizing from the 2-year to 10-year bond yields. This may indicate that investors are lowering the odds of a recession happening. So far, they have been wrong for the last 2 years as there was not a recession.
6. Inflation has declined on a reported basis but obviously prices remain elevated, and we are paying much higher for same products than several years ago. But it appears that inflation has resumed its downward trend; consumer prices are up 2.5% in the last year – the lowest level since the inflation scare began in early 2021 – and have been slowing lately, up at 1.1% and 2.0% annualized rates in the last three and six months, respectively.



7. The economy grew 3% in Q2 and is expected to grow 2.5% in Q3. Overall, news is mixed. Manufacturing remains soft and in decline while Services (non-manufacturing) is showing growth but also inflation. Unemployment news was actually better with the most recent jobs report surprising slightly on the upside and the unemployment rate fell to 4.1%, lowest since June. Government spending has been consistent and perhaps causing overall GDP numbers to seem higher than reality.
8. The election will take place on November 5th, and it can't come soon enough in most people's minds just to get away from the rhetoric from both sides. History has shown the market tends to rally initially regardless of who wins (relief rally). Just as important as the Presidential race are the House and Senate races for control. Markets have tended to do best with a split Congress as it acts as a check and balance on the White House. There are plusses and minuses for each side as far as markets are concerned, but neither side seems to care about the ballooning deficit and public debt. Regardless of how you vote, please go out and vote!

9. Seasonally strong Q4 period could spell good news for stocks in Q4 along with election relief. The period of late October to Mid-December has been one of the best for stocks. This coupled with the Fed possible lowering rates again should give stocks positive momentum.
10. Geopolitical Risk is high and remains a market risk. The Israel/Hamas/Hezbollah war is spreading, and a cease-fire does not seem likely anytime soon. The fighting there has taken attention away from Russia/Ukraine, which also still wages. These conflicts, especially in the Middle East, can pose a threat to financial markets if they broaden.

BOND OUTLOOK

Bond yields this past week have risen back to the 4% level for 2-Yr to 10-Yr US Bonds. At the short end, 3-Mo (4.65%) to 1-YR (4.25%) yields are still higher but expected to fall in coming months if the Fed continues its rate reduction effort. Assuming inflation remains in check and no recession occurs, we expect the Yield Curve to finally revert over the next 6-9 months and normalize around the 4% level. As such, we see returns at this level or somewhat higher on a total return basis through 2025. So, bond returns of 4%-6% are possible from here through 2025. Obviously, if the Fed must be more aggressive due to a weaker economy, bond total returns could be higher as prices rise and yields decline. We now favor lengthening maturities to lock-in 4% yields as money market yields decline.

EQUITIES OUTLOOK

As we've already talked about, stocks are somewhat expensive on a historical basis overall, but the broadening rally shows that there are many pockets of opportunities among the non-mega caps. Mid-caps and Small-caps appear to have a valuation advantage and may respond favorably to further rate cuts. On a sector basis, cyclical and rate-sensitive stocks tend to do better as the Fed cuts rates. In this rate-cutting cycle the Fed is walking the tightrope of keeping inflation inline while keeping the economy growing and not falling into recession (soft-landing). Earnings growth on a sector basis favors Technology, Health Care and Comm Services as the strongest with Energy, Materials and Financial the weakest in Q3. I continue to like a diversified portfolio favoring a combination both the Megacaps and other Large/Mid-caps with a higher weight to non-Mega cap stocks. Exposure to mid-cap and small-cap stocks during a rate reduction cycle is also recommended. On the international front, I still favor developed nations, but Emerging economy stocks tend to do well in a rate reduction cycle too.

SUMMARY AND CONCLUSION

The Q3 seasonal pattern threw us a bit of a curve ball as stocks rallied in September. Does that take away from some of the typical Q4 seasonal strength? I don't think so. The next few weeks of earnings season could be bumpy for stocks, especially among the higher-valued mega caps if they don't report solid numbers and give a decent outlook. *But overall, I still expect a positive return in Q4 especially after the election is past us*.

My 2024 base case forecast was for a nice up year for stocks and a collect-the-coupon year for bonds. Stocks have done better than expected while bonds have been about in-line after the nice run in Q3. I think Equities outperform bonds in the 4th quarter, but bonds should be held for income and protection in balanced accounts and will produce positive returns. For equities, I continue to favor a diversified equity portfolio with some exposure to mid, small, and international stocks as well. Stock-picking will be key. Look for non-mega caps to continue to do better as the breath in the market continues to expand.

Feel free to contact me with any comments. Have a great Fall and Winter.

Bob