Boston Trust Walden
Principled Investing.

Investment Commentary
September 30, 2024

Financial Markets

Total Returns through September 30, 2024		
US Stocks	**3rd Quarter**	**Year-to-Date**
Standard & Poor's 500	5.9%	22.1%
Russell 2000®	9.3%	11.2%
International Stocks		
MSCI World Ex-US	7.7%	13.1%
MSCI Emerging Markets	8.7%	17.2%
US Fixed Income		
Bloomberg Gov't/Credit	5.1%	4.4%
90-Day Treasury Bill	1.4%	4.1%

US stocks maintained their upward trajectory in the third quarter. Large capitalization stocks, as measured by the S&P 500 Index, returned 5.9% during the period, bringing year-to-date gains to over 20%. The S&P is now up by 54% since the end of 2022 when the current bull market began. As we've reported previously, the first 18 months of the rally were disproportionately led by a group of technology-related mega-cap stocks dubbed the Magnificent 7. But this quarter saw a rotation in market leadership. In fact, only three of the Magnificent 7 beat the Index return, while the other four were in negative territory for the quarter. Conversely, the average stock, as measured by the equal-weight version of the S&P 500, gained 9.1% for the period. Mid and small-cap indices also beat the S&P 500 during the quarter after trailing for the prior year and a half.

The broad-based nature of stock gains may be tied to two things. Most prominently, the Federal Reserve's change in tone and policy provided an extra lift to more rate-sensitive pockets of the market like the utility, real estate, and financial sectors, as well as smaller cap stocks. Secondly, after the hype around artificial intelligence and the sharp rally in a small number of AI-related stocks since 2022, it was only a matter of time before rising valuation levels of many of these stocks would prompt investors to begin questioning when the technology's promise would translate to earnings and cash flows. This happened, to at least some extent, in the third quarter and shares of the high-flying group faltered.

Evolving interest rate policy by central banks around the world was a significant factor in global markets as well. Both developed and emerging international markets registered healthy gains for the quarter, but there were some hiccups in certain regions. Japan's equity market fell 11% in one day in early August on concern over how its central bank would manage interest rates, and how their actions might affect the Yen's exchange rate against the US dollar and other currencies. China's market was down for most of the quarter until the government announced significant stimulus measures designed to boost the economy, propelling its equity market higher.

Even more directly tied to the Fed's shift, lower interest rates helped the fixed income market as yields fell and bond prices rose across maturities. Coupled with falling yields in the final quarter of 2023, most primary bond indices now sport double-digit returns for the trailing twelve months.

Investment Perspectives

A Long-Awaited Rate Cut

At the Federal Reserve's recent September meeting, the US central bank lowered its policy interest rate. After reaching a peak target Fed Funds rate of 5.33% in August 2023, the market had originally expected the Fed to begin cutting rates around March of this year. Although the Fed repeatedly stated that they needed to see more tangible evidence of inflation coming down, the wait was longer than many expected. Nonetheless, the reduction represents a significant turning point for the Fed as it tries to fulfill its dual mandate of stable prices and full employment.

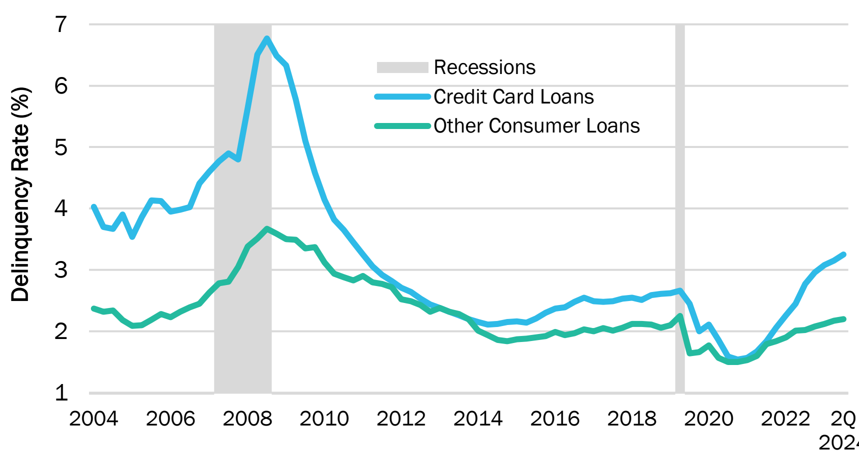
Inflation data now indicates that the post-pandemic spate of decades-high pricing pressure is all but over. Notwithstanding some lagging data points and relatively idiosyncratic pockets of the economy that we've previously highlighted, namely housing and auto insurance, the aggregate inflation rate seems well on its way to returning to the Fed's 2% target.

The labor market is also beginning to show signs of moderating from a very strong starting point. It is coming back to earth from an exceptionally robust period that included rapidly rising wages, an abundance of companies trying to hire, and historically low unemployment rates. Wages continue to rise at a healthy clip (in excess of inflation), while the unemployment rate, at just over 4%, remains in the vicinity of what most economists consider full employment.

If rising prices are no longer buffeting consumers and the labor market is still intact, why does the Fed feel compelled to cut interest rates — and by 0.50% (rather than the typical 0.25%) to boot? We view the change in policy as an acknowledgment that consumers are facing other challenges. A primary one, by monetary policy design, is the cost of financing. The same higher borrowing rates that helped to slow the economy and tame inflation are becoming an increasing burden on consumers. Though homeowners have not struggled to make their mortgage payments on time (most likely due to the low-rate financing they locked in a couple of years ago), data shows delinquencies are creeping up in other areas of consumer financing. Late credit card payments are taking place at rates not seen for over a decade, while delinquencies for other consumer loans (e.g., auto loans) are also moving higher.

Though this headwind has yet to slow the US economy, let alone tip it into recession, such a development is an early sign of potential consumer stress. With many of these shorter-term loans keying off the Fed's overnight interest rate, policymakers can provide some relief.

US consumers are beginning to show signs of stress



Note: Other consumer loans excludes credit cards and mortgages (as well as commercial, agricultural, and industrial loans)

The Fed's commentary and updated summary of economic projections provide a broader context for their actions. Their collective forecasts for the labor market were downgraded relative to previous views, implying that current weakening could continue, yet expectations for real economic growth in the coming years remain at effectively the same 2% they foresaw in their June projections. Perhaps the latter is owed to their own more aggressive expected rate-cutting pace over the coming years, relative to what was previously anticipated. Such forecasts are interesting for Fed watchers and may offer some insight into the Fed's current collective thinking. Perhaps most significantly, the changes inherent in the Fed's aggregate view, as well as the wide range of forecasts among the survey respondents, provide us with evidence that the Fed is indeed following the highly data-driven approach Chairman Powell has been preaching for the last several years.

Pulling further on the historical thread, the recent past may provide a backdrop for a psychological impulse that could also be at play for policymakers. As inflation began ramping during the COVID recovery, the Fed's stance, repeated ad nauseam, was that pricing pressure was due to transitory factors. In following such a position, the Fed was decidedly late with the pace and magnitude of their eventual maneuvers to tamp down on inflationary forces that had become more entrenched than expected. Accordingly, it is only natural that policymakers wouldn't want to be behind the curve again. This provides some rationalization for the "double" cut to interest rates in September, along with the fact that the current lowered rate remains at a level that is considered restrictive, rather than stimulatory, to the economy. Regardless of interpretations of the Fed's motivations, we view the domestic economy on solid footing for continued expansion in the quarters ahead.

The Election and More

Though it seems as if we have been in this presidential election cycle for the last four years, we have at last made it to the homestretch. History shows that stock market volatility increases in the months immediately preceding and following presidential elections. Such a phenomenon is not surprising given the impact fiscal and other policy positions can have on the economy, corporate profits, and investor behavior. We don't expect this cycle to be any different.

We will leave the prognostications of who might occupy the White House for the next four years to the political pundits, but polls indicate that the election will be close. Undoubtedly, who emerges victorious is important on many fronts, but the markets' focus, and ours here, is on the financial and economic implications. Tax policy is a primary issue at play for investors. The 2017 Tax Cuts and Jobs Act has several personal income tax provisions that are set to expire at the end of 2025, including lowered income tax rates, higher standard deductions and Federal estate tax exclusions, and the cap on state and local tax (SALT) deductions, among others. It will require an act of Congress for any or all of these to continue past 2025; thus, control of the legislature, from the perspective of tax policy, is just as important as the White House. Importantly, one tax provision that won't be expiring is the corporate rate, which was lowered to 21% in the same law. Such relative permanence provides a measure of stability within the outlook for corporate profits. Any significant changes to tax policy and federal budgeting broadly will likely hinge on whether either party is able to sweep the House, Senate, and White House.

Though fiscal policy requires cooperation from two branches of government, the Executive branch does have more, if not unilateral, sway over trade relations — including the institution/continuation of tariffs or trade deals — as well as broader matters of global cooperation. From that perspective, the two leading candidates offer decidedly different approaches. We continue to monitor election-related developments and prospective policy proposals that would have implications for portfolio positioning and securities.

Though the elections will be a significant event in our country and the markets, we recognize that there are plenty of other factors and risks affecting investors today as well. That is to say, we expect higher levels of market volatility to continue up to, and likely beyond, November's election. The recent labor disputes and resulting strikes in East Coast ports, as well as at Boeing, are just two high-profile examples of a labor trend that has gained steam in the past couple of years and can threaten to disrupt portions of the economy. Recent escalation of the conflict in the Middle East, as well as the ongoing war in Ukraine, and tension between China and Taiwan, also suggest the era of global cooperation may be waning. In addition to the humanitarian crises involved, any shift away from globalization has implications for supply chain efficiency and corporate profit margins.

Outlook and Positioning

As we enter the fourth quarter facing higher-than-usual elements of uncertainty, continued elevated market volatility should be expected. Furthermore, the US stock market remains highly concentrated among a small group of mega-capitalization stocks, with index returns heavily influenced by that group's fate. But such risks also provide opportunities. The market continues to offer shares of many companies with high quality and sustainable businesses that can succeed in varying economic climates, and whose shares are trading at reasonable valuations. Thus, we continue to favor well-diversified portfolios of stocks in multi-asset accounts. At the same time, bonds offer such portfolios ballast should economic and/or market conditions deteriorate. And, despite the Fed's actions and the resulting changes in available yields, such investments continue to offer an ample level of income and are an attractive repository for near-term cash needs.

Sources: Factset, Bloomberg, Standard & Poor's, US Treasury, US Bureau of Labor Statistics, Board of Governors of the Federal Reserve System, Federal Reserve Bank of Atlanta
Chart Source: Federal Reserve Bank of St. Louis