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Quarterly Review and Outlook

Mission accomplished! Or so it appears. The Federal Reserve seems to have succeeded in taming inflation without causing the economy to enter a recession thereby giving investors the much hoped for soft landing. That prospect, along with a pivot in Fed monetary policy to lower interest rates, helped propel the stock market to a new high during the third quarter. As measured by the S&P 500 index, the stock market on a total return basis gained 6% in the third quarter and increased 22% year to date through September 30th.

At its meeting on September 17th, the Federal Open Market Committee decided to reduce the Fed funds rate by 50 basis points, which was at the high end of expectations. The decision was made as inflation has eased and the labor market has cooled. After raising the Fed funds rate by over five percentage points from near 0% in 2022 to a peak of 5.50% mid last year, the Fed held the rate steady for 14 months in its effort to quell inflation. They seem to have succeeded as reflected in the most recent CPI print which came in at +2.5% year over year. Fed Chairman Powell expressed the positive view that he and his fellow members had “greater confidence that inflation is moving down to the 2% target.” This positive view is held within the context of a healthy economy and slowing, but still decent employment growth. Clearly the Fed felt that cutting interest rates by 50 basis points would continue to sustain growth in both the economy and the employment market. With inflation declining and employment growing, the risks to both sides of the Fed’s dual mandate to promote price stability and maximum employment remain balanced.

With respect to the economy, Chairman Powell indicated that growth “continues to expand at a healthy pace” and is expected to continue to do so in the next few years. The Atlanta Fed estimates that third quarter GDP increased by ~3%. Consumer spending, which accounts for ~two thirds of the economy, has remained resilient and is estimated to have increased by 3.5% in the third quarter. A healthy job market and rising real wages have underpinned strength in consumer spending. Other supportive factors include increased corporate productivity which allows businesses to offer attractive wage rates and the wealth effect from gains in housing prices and the stock market. A healthy job market and growing economy have resulted in a positive outlook for corporate earnings. After posting flat growth last year, earnings for the S&P 500 index are projected to increase about 10% this year and 15% next year. This year’s earnings rise is expected to be led by the technology and healthcare sectors.

Interest rates in the third quarter declined, as fixed income investors anticipated the shift to Fed easing reflecting the decline in inflation and recent weakening in employment trends. The yield on the 10-year Treasury bond declined to ~3.75% by quarter end, down from about the 4.7% level in spring. Looking forward, Chairman Powell has indicated that there will be two more interest rate cuts this year with room to cut an additional 100 basis points next year. The Fed is attempting to return to a more neutral rate of 2.9% in 2026, but that will be dependent on inflation and other economic factors.

The Fed's focus has shifted away from inflation and more toward its employment mandate. Chairman Powell stated, "We will do everything we can to support a strong labor market as we make further progress toward price stability." He went on to say, "With an appropriate dialing back of policy restraint, there is good reason to think the economy will get back to 2% inflation while maintaining a strong labor market." Although the unemployment rate, currently 4.2%, has moved up from 3.5% in July 2023, it remains at an historically low level. As a result, the Fed chairman expressed confidence that with the current level of monetary policy, the Fed is in a position where it will be able to respond to any risks including the further weakening in the labor market. In determining the future direction of interest rates, the Fed will continue to rely heavily on the incoming data while also balancing the risks between inflation and employment.

Although the market has reached new highs, there are still concerns to worry investors. Geopolitical tensions are high and appear to be escalating. The war in Ukraine continues with no resolution in sight and the tensions in the Middle East are escalating as more countries are being drawn into the conflict. Economic trends in China are also a concern as the impact from the collapse in their real estate market is dampening consumer spending and an excess of goods produced in the country is leading to a decline in manufactured goods prices. With domestic consumption weak, China has turned to selling excess supplies abroad, in effect exporting deflation to other countries via their low-cost goods. The Chinese central bank, in an effort to boost the real estate market and bank lending, recently lowered interest rates and reduced bank reserve requirements. A fiscal stimulus program was also announced amounting to ~1.5% of GDP to support local governments and encourage consumer spending. Time will tell how effective these programs are.

In this country, the just announced longshoreman strike, depending on its duration, could once again wreak havoc with supply chains, disrupt holiday retail sales and increase prices for consumers. With the Presidential election just a few short weeks away, the media is filled with rhetoric from the candidates that can have a marked effect on market volatility. And there is always the lingering worry regarding the Federal budget deficit which on a 12-month basis rose to $2.07 trillion in August. The government's net interest outlays rose to a record $872 billion over the past 12 months. These factors result in a higher level of government issuance of Treasury securities which over time could lead to upward pressure on interest rates, although this does not seem to be the case currently.

Our investment approach in this market environment has been to remain equity focused. A healthy job market and growing economy, in conjunction with positive earnings growth and the Fed easing interest rates, presents a constructive backdrop for the stock market. With respect to our investment approach, we continually assess company fundamentals to assure that expectations with respect to revenue and earnings growth are likely to be met and competitive positioning maintained. New ideas are also sought that meet our investment parameters and offer the prospect of long-term capital appreciation. We invest in companies with sustainable competitive advantages, superior growth rates and strong management teams. In terms of investment focus, we continue to favor the technology, healthcare, industrials, specialty financial and select consumer sectors.

In the fixed income sector, we see our bond holdings as complementary to our equity holdings. In addition to generating income, fixed income securities help reduce portfolio volatility. Given the Fed's pivot to an easier monetary stance, we have taken steps to selectively purchase some longer dated securities to lock in higher interest rate returns. Our focus remains in higher quality securities as the risk/reward is not warranted reaching for yield in the riskier parts of the credit market. Municipal securities are also considered in taxable accounts if their yields are attractive vis-a-vis those offered on comparable taxable bonds.

As always, we are grateful for your support and encourage you to reach out to us with any questions or concerns you may have regarding your investments or portfolio structures.