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Investment Insights Monthly

From the Desk of Jack Kraft, CFA, Investment Strategist

September 2024

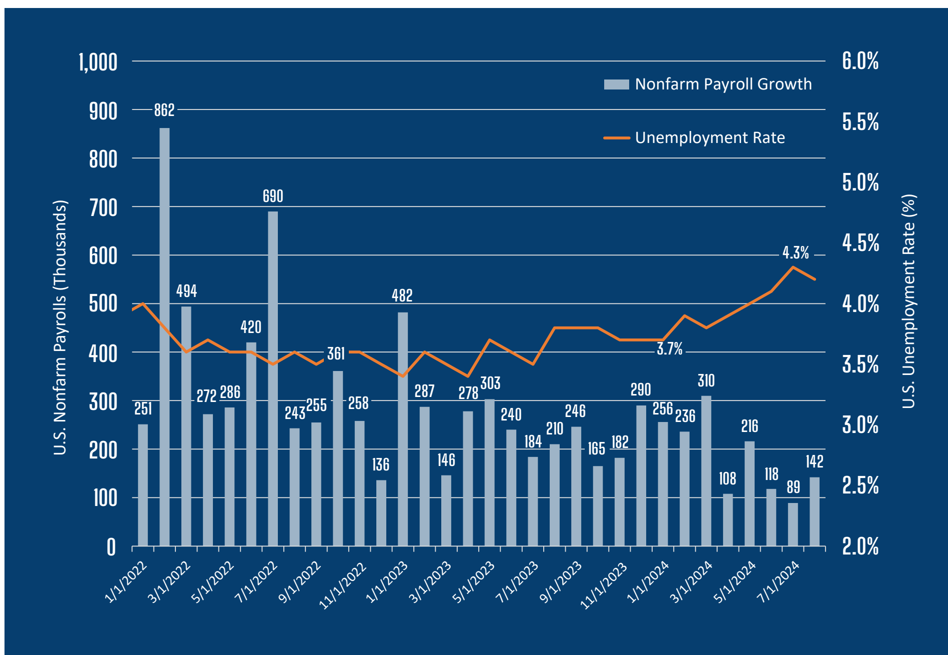
Don't Fight the Fed

September seems to be living up to its reputation for volatile equity performance, as seasonal factors often weigh on investor sentiment during this historically challenging month. Equities have been whipsawed in the first couple weeks of trading, with the S&P 500 drawing nearly 3.0% in the first three trading days and bouncing back to all-time highs by mid-month. Investors have been closely monitoring economic updates as they digest recent moves by the U.S. Federal Reserve (Fed) to lower the federal funds rate by 50 basis points for the first interest-rate cut since 2020. Following the decision, traders continued to price in an aggressive rate-cutting cycle into 2025, which has pushed equity valuations upward and bond yields lower, leaving investors asking if things are priced to perfection.

The most recent narrative that seems to be grabbing financial news headlines is recession fears. This started in early August following the nonfarm payrolls report that showed a fast rise in the unemployment rate, trigging the Sahm Rule. This rule has accurately predicted every recession since 1970 and is an economic indicator used to predict recessions in real time that states: When the three-month moving average of the national unemployment rate is a half percentage point or more above its low over the prior 12 months, we are in the early months of recession. Although the rule has been triggered, I'm not sure if it's time to be running for the hills.

The unemployment rate has risen from historically low levels of 3.7% at the start of 2024 to 4.3% in July, and most recently, ticking down to 4.2% in August. Additionally, part of the increase in the unemployment rate can be attributed to higher-than-normal immigration rates as it takes time for new immigrants to gradually integrate into the labor force. On top of this, there are other data points suggesting a cooling off in the labor market, such as a falling quit rate, declining hire rates and lower-than-average payroll growth data since April. These combined factors suggest less confidence in leaving current jobs by the quit rates and slowing demand for labor/fewer job openings by the hire rates, indicating caution from the workforce.

U.S. Nonfarm Payrolls and Unemployment Rate



As of September 18, 2024
Source: Haver Analytics Data

A cooling labor market is not all bad news. In fact, it has been the goal of the Fed since the central bank started restricting monetary policy in March 2022. Looking back to more than two years ago, there was a surplus of job openings—roughly three job postings for every one worker. This put upward pressure on labor costs and was one of the many contributing factors to abnormally high inflation. Currently, I believe this is a rebalancing to a healthier labor market rather than signs of an imminent recession. One supporting factor is that layoff rates remain at historically low levels, a metric that should be watched going forward.

Claudia Sahm, the creator of the Sahm Rule, says that the rule relies on a powerful negative feedback loop where job losses cause laid-off workers to reduce spending, thus leading to further job losses and curbed spending until we ultimately find ourselves in a recession. This does not seem to be taking hold when looking at other pockets of the economy. For example, real income growth remains strong, GDP growth is progressing at a healthy rate and solid retail sales data indicate a strong consumer. All this put together suggests that job growth should remain strong and be able to absorb the increase in labor supply, keeping the unemployment rate from spiraling upward.

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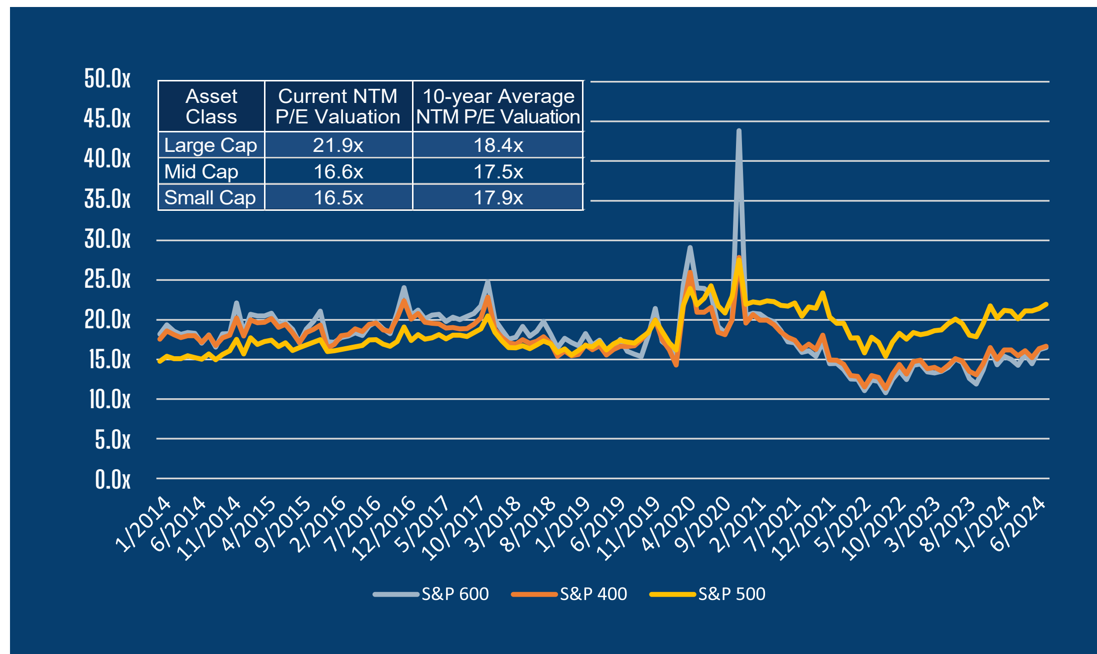
Turning to the equity markets, valuations remain top of mind here in the Benjamin F. Edwards office. Large-cap stocks, as measured by the S&P 500, are trading above 21 times forward price-to-earnings—much above the 30-year average of 16.7 times. Valuations for the S&P 500 are nearing the 90th percentile of most expensive relative to history and suggest further gains will need to come from an increase in earnings growth. For large-cap stocks as an index, I see the upside as limited by these stretched valuations. Equity returns are no longer skewed by the mega caps, with the gains broadening out across the S&P 500 in the most recent quarter. Investors have rotated out of the beloved Magnificent Seven stocks to more defensive sectors such as utilities, financials and health care, which have joined the rally.

Despite higher valuations in pockets of the market, I still think it is important to remember to **not fight the Fed.** In other words, equity prices should continue to be supported by central banks (U.S. and abroad) adopting more accommodative monetary policy. Additionally, if the economy remains in a disinflationary environment and the labor market continues to be robust, I think this bull market should continue to run. The easy gains likely have been made, with the stock market up nearly 47% since the start of 2023 at the time of this writing. This rally has been driven by both multiple expansion and above-average earnings growth by large and mega caps. Over the long-term, earnings growth drives the direction of the market, and supportive monetary and fiscal policy should help lead to modest gains in 2025.

Small-, Mid- and Large-Cap Valuations



Asset Class	Current NTM P/E Valuation	10-year Average NTM P/E Valuation
Large Cap	21.9x	18.4x
Mid Cap	16.6x	17.5x
Small Cap	16.5x	17.9x

As of September 16, 2024
Source: Haver Analytics Data
NTM refers to next 12 months. Large Cap measured by S&P 500, Mid Cap measured by S&P 400, and Small Cap measured by S&P 600.

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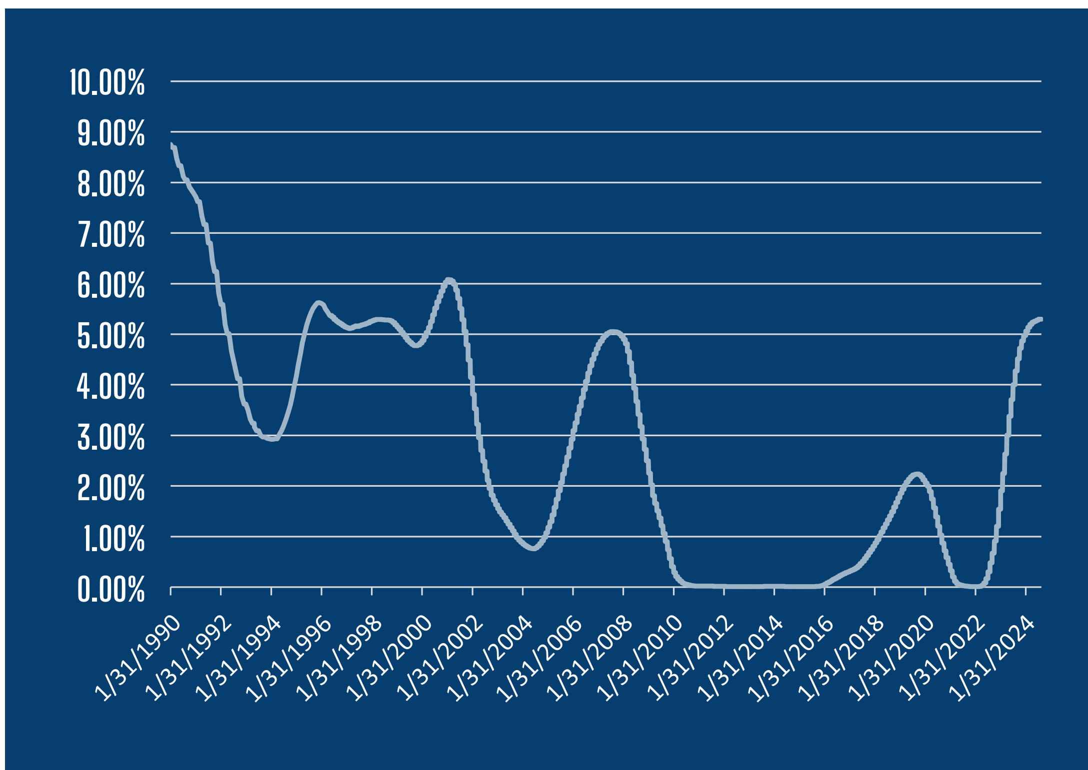
One area of the market that looks attractive on a valuations basis is the mid-cap asset class, which is trading at a much more reasonable 16 times forward earnings. The S&P 400, which is used to measure mid-cap stocks, includes companies ranging from $1 billion to $20 billion in market cap. Historically, starting valuation has been a solid predictor of forward returns for the space. The forward price/earnings multiple mentioned above suggests the space is trading in the 25th percentile since 1995, according to Goldman Sachs. Companies in the space also tend to be profitable, with only 9% of the index constituents having negative net income. Compare this with the S&P 500, which runs at about 5%, while the small-cap universe, as measured by the Russell 2000, has roughly 35% of unprofitable companies.

Conversely, a spot of the market that will soon look less and less attractive with each Fed rate cut is money market funds. Investors have been enjoying the risk-free 5% annual gain on cash in this higher interest-rate environment, but those days look to be numbered. Since 1990, yields in money market funds have fluctuated between roughly 9.0% to nearly 0.0%, proving that these vehicles shouldn't be used for long-term investments, but rather short-term vehicles to park cash that will be needed in the next 12 to 24 months. Currently, investors (institutional and retail) have a record amount of money ($6 trillion+) in these short-term yielding securities, which may sound nice given their risk-free attributes, but in reality, a lot of wealth creation has been missed by being out of the market. As rates come down, demand for money market securities should fall out of favor and could provide a tailwind to equity valuations and longer-duration fixed-income securities.

Vangaurd Money Market Yield



As of September 16, 2024
Source: Ycharts
Money market yield measured by Vanguard Federal Money Market Investor Fund.

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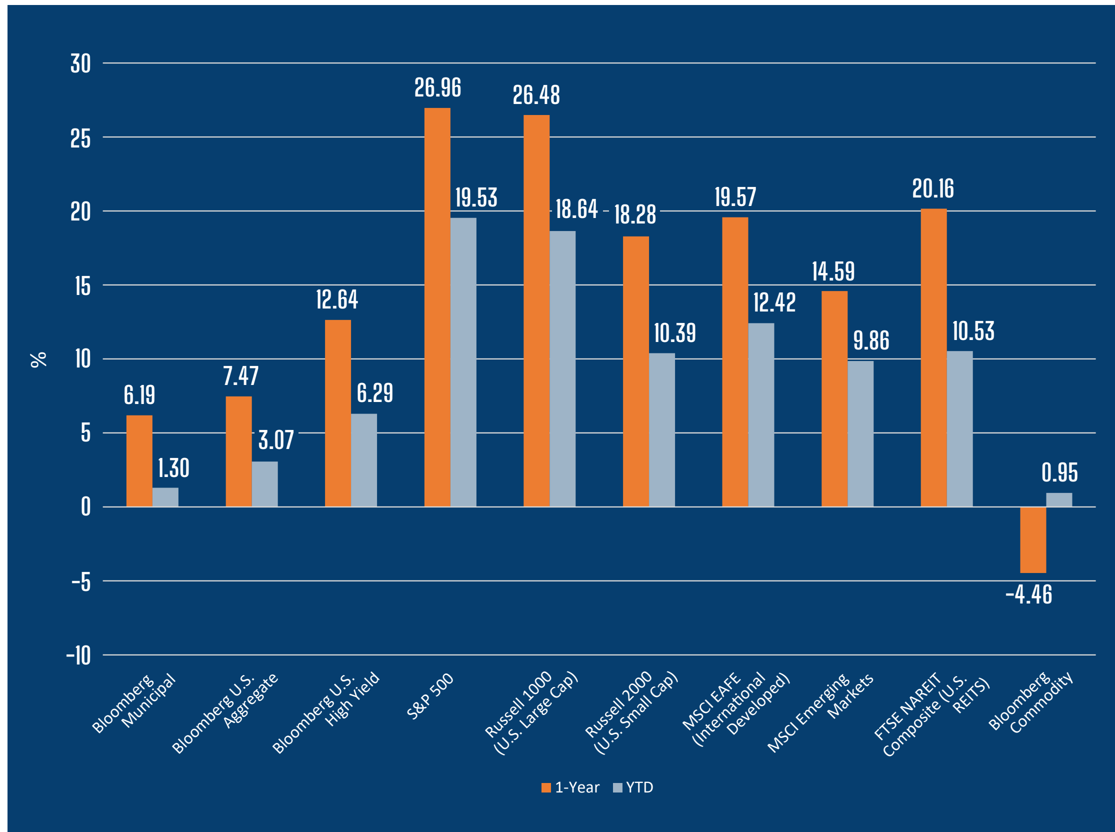
Asset Class Returns
Comparing Recent 1-Year and Year-to-Date Total Returns



As of August 31, 2024
Source: Conway Investment Research

Fixed Income

- The decline in Treasury and other sovereign debt yields provided another strong month of performance for fixed income across the globe.
- Core fixed income and municipals generated very solid performance, while most areas of credit benefited from higher carry/starting yields.
- After being negative for most of the year, the Bloomberg Aggregate Bond Index is now up over 3%.
- Bonds outside the United States also received a boost from the weaker U.S. dollar.

Equities

- U.S. equities were a mixed bag in August, with gains in large caps and weakness across small caps.
- Value beat growth within large caps, but the opposite occurred within small caps.
- The S&P 500 has gained 19.5% in 2024, and the Russell 2000 is up 10.4%.
- Equities outside the United States generally gained ground and outperformed U.S. equities last month. U.S. dollar weakness provided an added tailwind to non-U.S. assets.
- Unlike what occurred in the United States, growth beat value across EAFE (Europe, Australasia and Far East) equities.
- Emerging markets lagged developed markets in August, driven mainly by ongoing weakness and poor sentiment in Chinese equities.

Alternatives

- REITs posted another strong month as rates fell.
- Commodity prices were flat, with gas and oil noticeably weaker.

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August 30, 2024	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Bloomberg U.S. Treasury Bill 1-3 Month	0.48%	0.94%	3.64%	5.55%	3.43%	2.28%	1.59%
Bloomberg Municipal	0.79%	1.71%	1.30%	6.19%	-0.47%	1.02%	2.43%
Bloomberg U.S. Aggregate	1.44%	3.81%	3.07%	7.47%	-2.15%	-0.04%	1.64%
Bloomberg U.S. High Yield	1.63%	3.61%	6.29%	12.64%	2.57%	4.46%	4.65%
Bloomberg Global Aggregate	2.37%	5.19%	1.86%	6.95%	-4.20%	-1.37%	0.12%
U.S. Equity Indices							
DJ Industrial Average	2.03%	6.64%	11.75%	21.50%	7.69%	11.80%	11.79%
S&P 500	2.43%	3.67%	19.53%	26.96%	9.33%	15.91%	12.98%
NASDAQ Composite (Price)	0.65%	-0.11%	18.00%	26.35%	5.08%	17.33%	14.48%
Russell 1000	2.37%	3.86%	18.64%	26.48%	8.27%	15.54%	12.66%
Russell 1000 Growth	2.08%	0.35%	21.12%	30.93%	8.77%	19.07%	16.03%
Russell 1000 Value	2.68%	7.93%	15.08%	20.74%	7.23%	11.16%	8.85%
Russell Mid Cap	2.03%	6.83%	12.14%	20.01%	3.47%	11.24%	9.58%
Russell 2500	-0.26%	7.15%	9.67%	17.33%	1.89%	10.49%	8.76%
Russell 2000	-1.49%	8.51%	10.39%	18.28%	0.72%	9.68%	8.03%
Russell 2000 Growth	-1.11%	6.99%	11.74%	17.49%	-1.98%	8.35%	8.21%
Russell 2000 Value	-1.88%	10.08%	9.15%	19.05%	3.19%	10.37%	7.46%
Non-U.S. Equity Indices							
MSCI World	2.68%	4.51%	17.09%	24.81%	7.36%	13.65%	10.15%
MSCI ACWI	2.57%	4.26%	16.33%	23.72%	6.30%	12.67%	9.33%
MSCI ACWI Ex-U.S.	2.87%	5.28%	11.64%	18.25%	2.78%	8.07%	4.92%
MSCI EAFE	3.26%	6.30%	12.42%	19.57%	4.65%	9.14%	5.70%
MSCI EAFE Growth	3.95%	5.24%	12.05%	18.16%	0.77%	8.23%	6.55%
MSCI EAFE Value	2.57%	7.40%	12.86%	21.04%	8.47%	9.69%	4.62%
MSCI Europe	3.95%	6.20%	12.96%	19.47%	5.35%	10.05%	5.78%
MSCI Japan	0.51%	6.34%	13.20%	21.33%	4.41%	8.52%	6.73%
MSCI AC Asia	1.43%	3.53%	12.50%	17.80%	-0.02%	6.58%	5.23%
MSCI EAFE Small Cap	2.00%	7.83%	8.74%	15.68%	-1.89%	6.90%	5.76%
MSCI ACWI Ex-U.S. Small Cap	1.87%	5.79%	9.05%	15.71%	-0.03%	8.56%	5.57%
MSCI Emerging Markets	1.65%	2.02%	9.86%	14.59%	-2.07%	5.18%	2.94%
MSCI EM Asia	1.66%	1.46%	12.86%	16.91%	-2.11%	6.37%	4.57%
MSCI China	1.01%	-0.23%	4.58%	-2.98%	-12.68%	-3.24%	0.72%
MSCI EM Eastern Europe	2.19%	-0.07%	9.08%	25.39%	-34.46%	-18.46%	-7.74%
MSCI EM Latin America	2.64%	3.72%	-12.33%	-1.93%	4.16%	3.03%	-0.42%
MSCI EM Small Cap	1.83%	1.85%	9.24%	16.69%	4.05%	12.34%	5.41%
MSCI Frontier Markets	2.04%	4.00%	10.48%	10.98%	-2.39%	3.19%	1.38%
Hedge Fund Indices							
IQ Hedge Multi-Strategy	0.79%	2.02%	5.44%	9.04%	2.07%	3.52%	2.67%
Real Assets Indices							
FTSE NAREIT Composite	5.50%	13.01%	10.53%	20.16%	0.33%	4.56%	6.83%
Alerian MLP	0.00	0.01	0.19	0.29	0.27	0.14	0.02
Bloomberg Commodity	0.05%	-3.99%	0.95%	-4.46%	3.63%	7.02%	-1.08%
S&P Global Infrastructure	4.64%	9.26%	13.68%	18.89%	7.80%	6.53%	5.50%
Other							
Oil Price Brent Crude	-0.01	-0.09	0.02	-0.08	0.02	0.05	-0.03
CBOE Market Volitility (VIX)	-8.31%	20.58%	20.48%	8.07%	-2.51%	-4.60%	2.27%

Source: Morningstar

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