MARKET MOMENTUM CONTINUES

SOFT LANDING CREATES A MARKET TAILWIND

Let’s start with a summary of returns generated in the various corners of the capital markets:

Quarterly Market Performance Barometer %

Name	Category	Q3 2024	Q2 2024	1 Year
US Market	US Equity	6.06	3.48	35.60
Value	US Equity	8.95	−1.47	27.67
Growth	US Equity	4.63	2.42	33.34
Dividend Composite	US Equity	8.89	−0.05	29.13
Wide Moat Composite	US Equity	4.53	7.26	41.93
Developed Markets ex-US	Global Equity	8.19	−0.58	25.32
Emerging Markets	Global Equity	8.20	5.26	25.62
US Core Bond	Fixed Income	5.15	0.17	11.39
US Treasury Bond	Fixed Income	4.71	0.18	9.67
US High Yield Bond	Fixed Income	5.29	1.07	15.69
TIPS	Fixed Income	4.10	0.93	9.79
US 10+ Year Treasury Bond	Fixed Income	7.83	−1.65	15.49

Source: Morningstar Direct. Data as of Sep. 30, 2024. Performance in %.

CONFLUENCE OF FACTORS SOOTHE INVESTORS

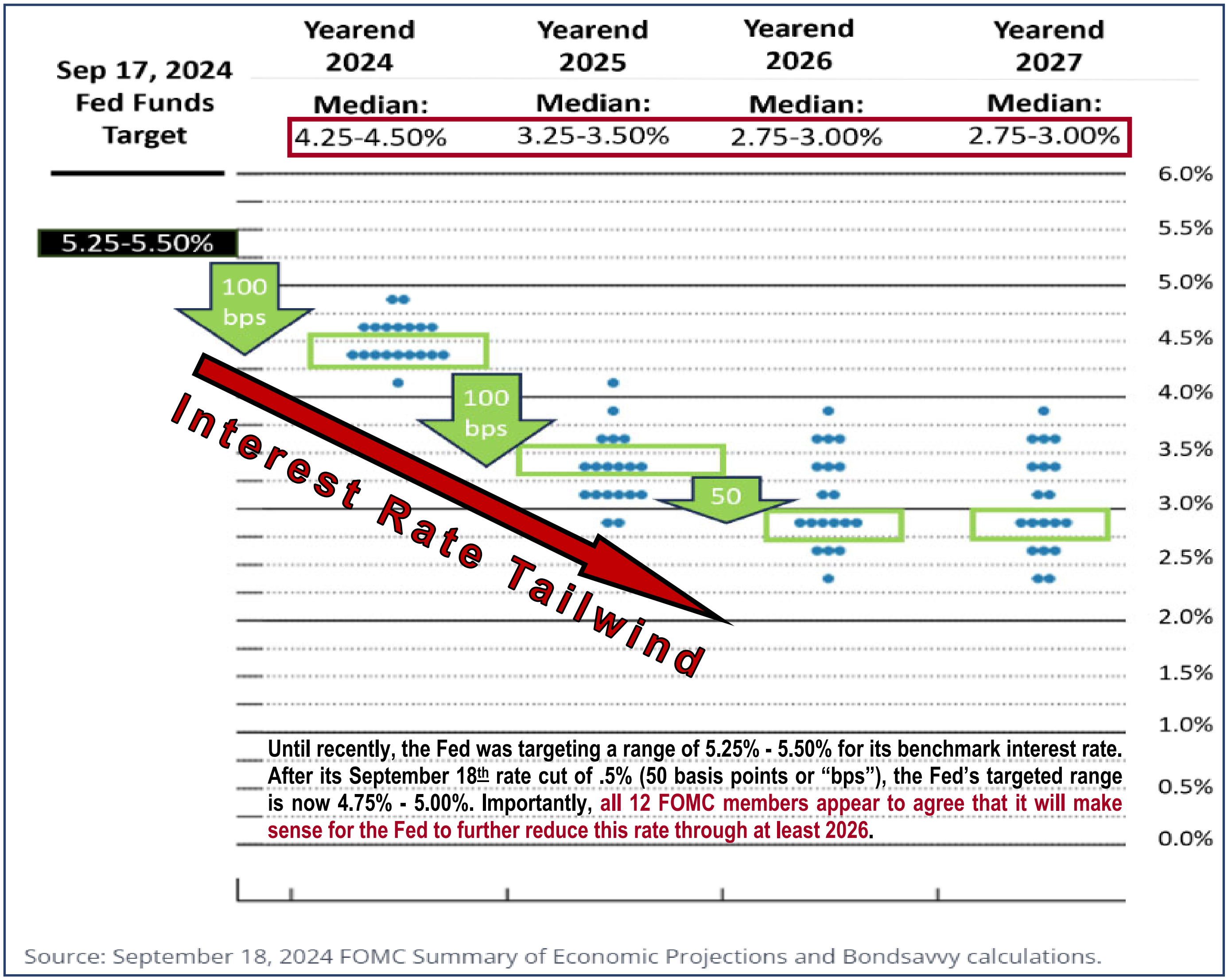
In my last note, I made the case that case equities were richly valued when viewed through a historical lens while also noting that asset class valuations are capable of deviating from their norms for extended periods. Asset class valuations are context sensitive and **the current environment of declining interest rates, continued economic growth, low unemployment, tame inflation and accelerating earnings growth is creating a backdrop that is very much to investors’ collective liking**.

I’ll use the pages that follow to explore these forces and factors in greater detail.

DECLINING RATES—U.S. CENTRAL BANK STEPS ON THE GAS

The Federal Reserve's Open Market Committee (FOMC) made the interest rate tailwind official when it slashed its benchmark rate by .5% on September 18th. The Fed ordinarily adjusts interest rates in increments of .25%, so this .5% rate cut represents something of a fist pump.

The FOMC is comprised of 12 voting members who typically hold a range of views with respect to where to set the Fed's benchmark interest rate over the next few years. Their goal is to promote economic activity without creating an excessive level of inflation. For the sake of transparency, the Fed publishes a dot plot depicting its members' range of interest rate estimates for the next few years along with each member's longer-term view (below).

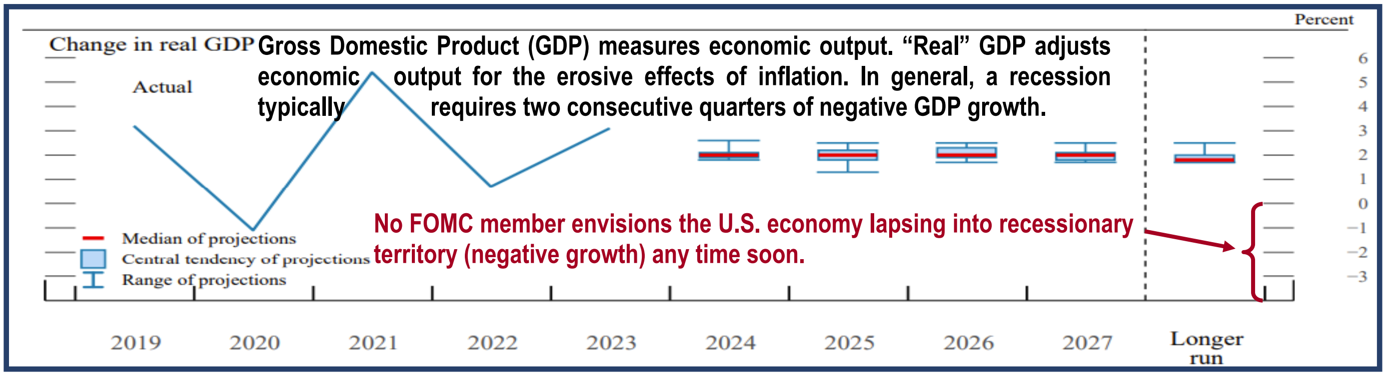


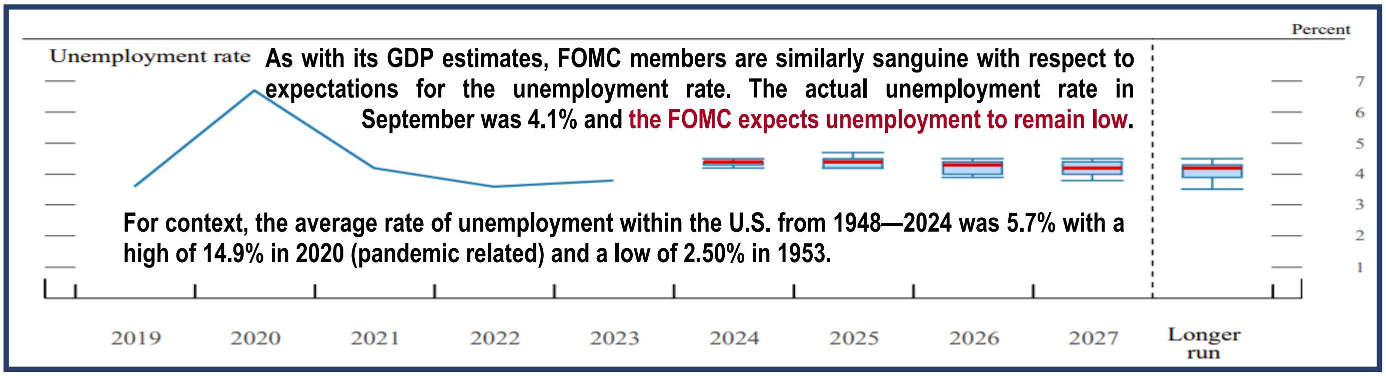
Source: September 18, 2024 FOMC Summary of Economic Projections and Bondsavvy calculations.

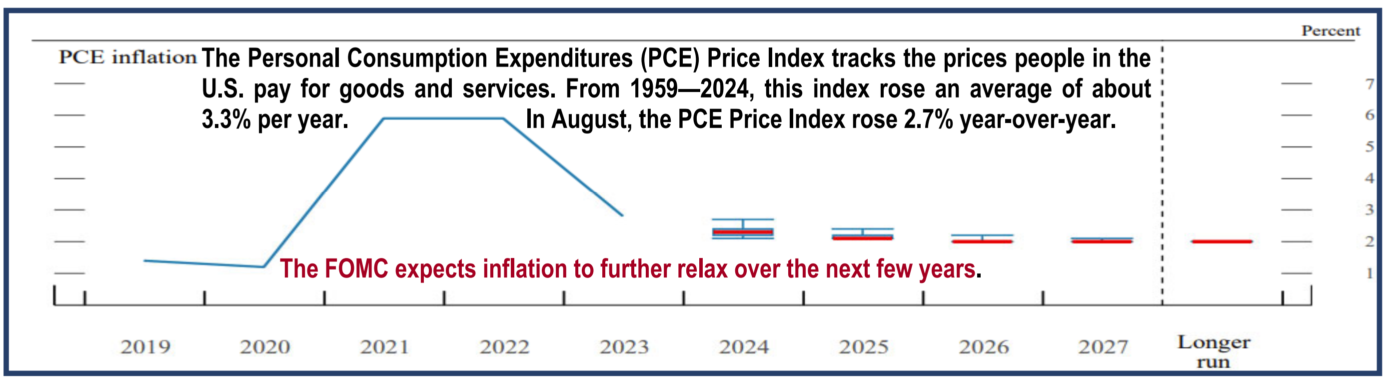
Declining interest rates tend to lift the valuations of equities and fixed income instruments along with the values of most other asset classes, and it appears that the U.S. is at the beginning stage of an interest rate tailwind that could last a while.

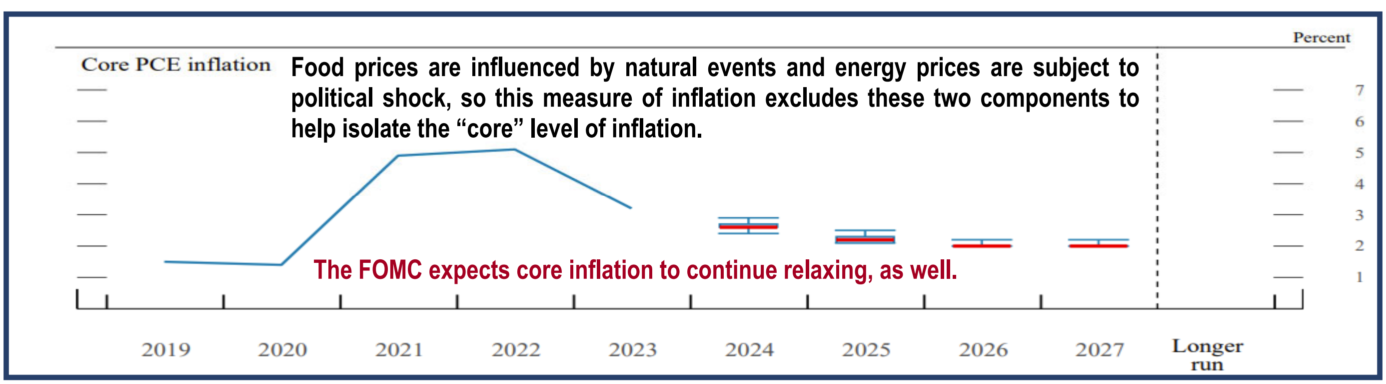
FAVORABLE GROWTH, UNEMPLOYMENT & INFLATION

When the Fed's interest rate dot plot was released, the Fed also released each FOMC member's future estimates for real gross domestic product (GDP) growth, the unemployment rate, and inflation for each year through 2027 and over the longer run (below).





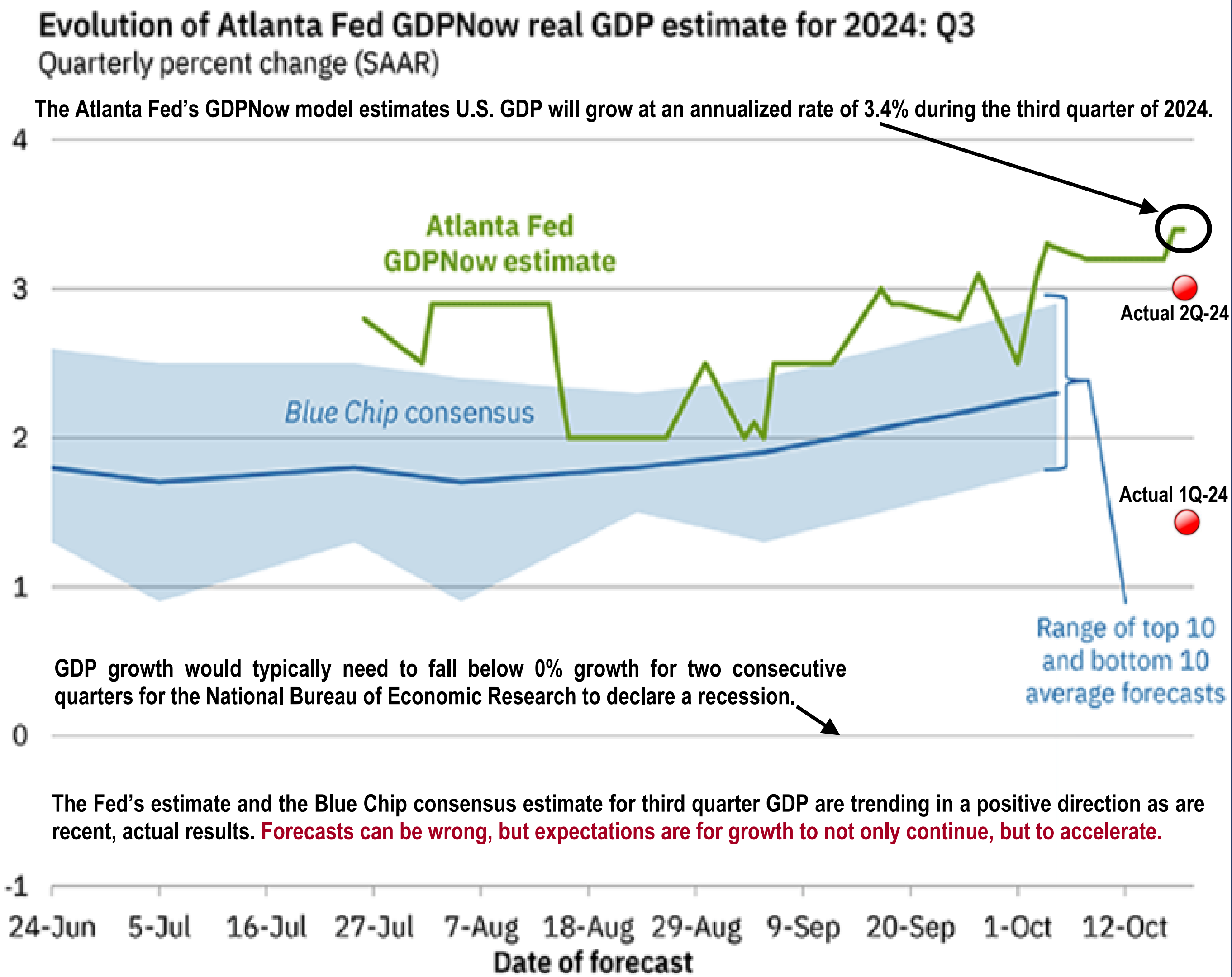




FED MODEL ALSO SIGNALS CONTINUED GROWTH

The growth rate of real gross domestic product (GDP) is a key indicator of economic output, but the official estimate is released with a delay which is a little like a weather forecaster predicting rain after you're already wet. To counteract the delay associated with the official release of GDP data, the Federal Reserve Bank of Atlanta has developed a model that provides periodic estimates of what the official GDP figure might be if it were calculated prematurely.

As of the October 18th estimate that appears below, GDP for the third quarter of this year looks pretty healthy.

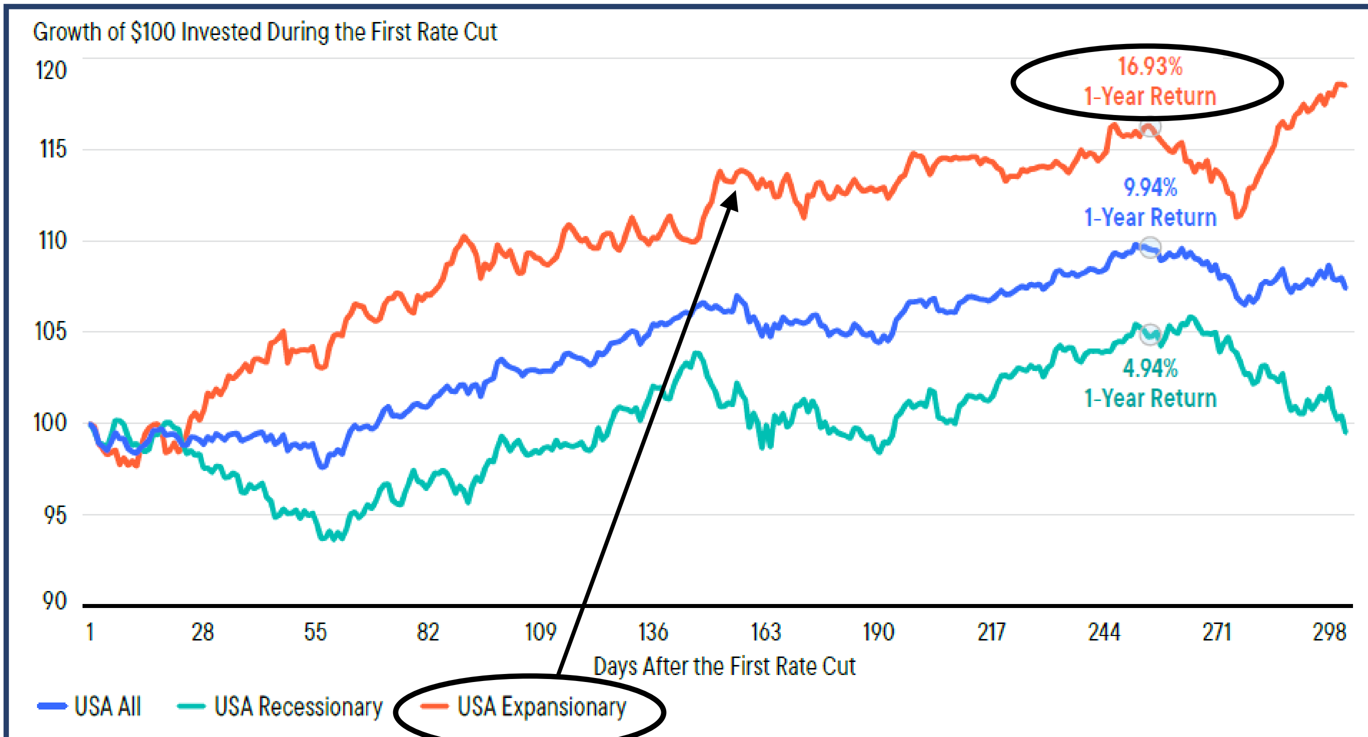


Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

RATE CUTS HAVE DRIVEN EQUITY PERFORMANCE

Since the Fed's Dot-Plot suggests that it intends to implement a series of rate reductions over the next few years, the following image is instructive because it isolates the performance of U.S. stocks over the one-year period *after* the Fed implements an initial rate cut. The following curves were developed by aggregating stock market performance after rate reductions from 1974 through 2019.

I suspect the researchers who assembled this data excluded the rate cuts the Fed implemented in 2020 to eliminate distortions caused by the pandemic. I also note that these researchers used the MSCI USA Index as a proxy for the U.S. stock market. This index may be somewhat less familiar than the S&P 500 I typically favor, but the MSCI USA Index is similar to the S&P 500.



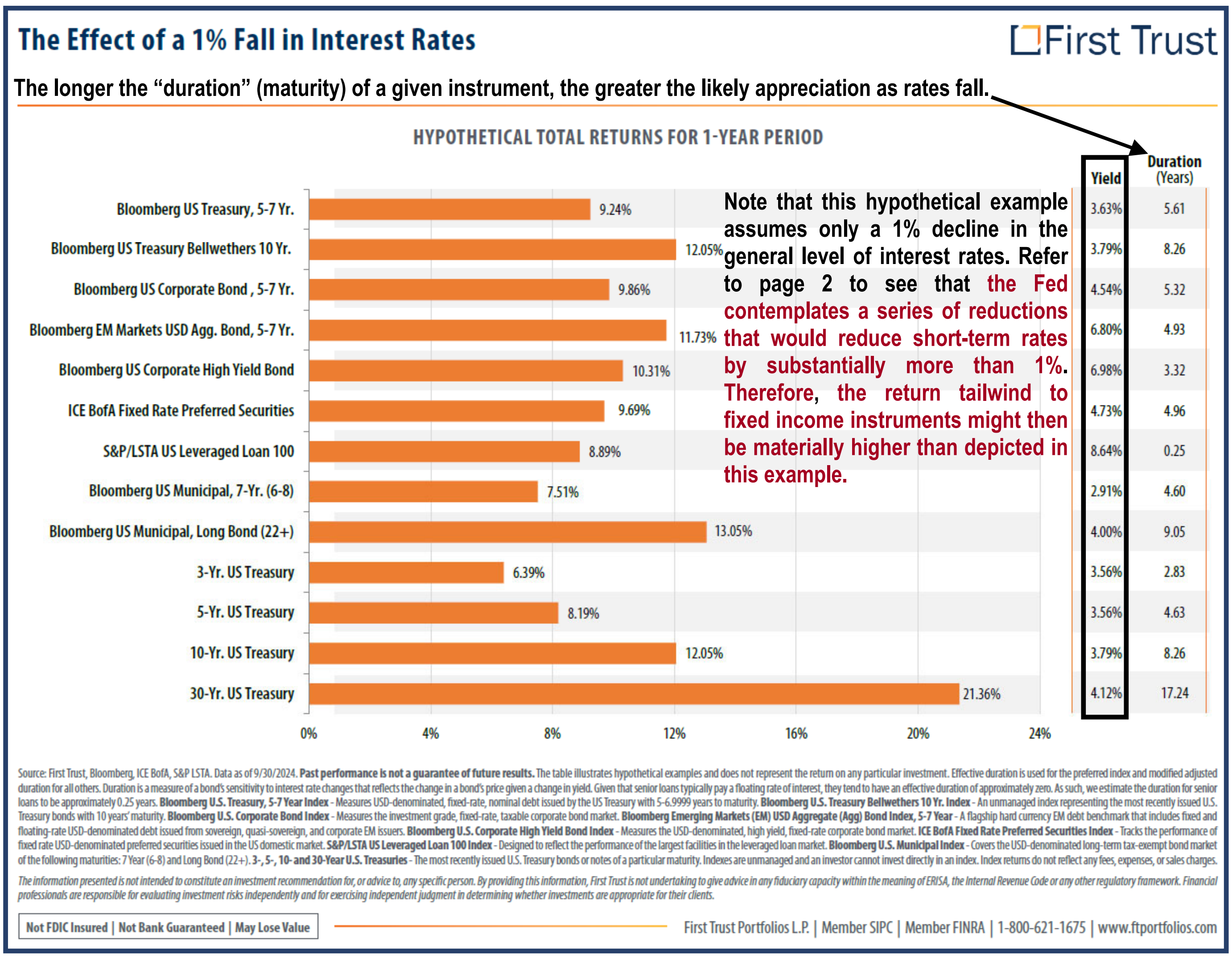
Sources: MSCI, Macrobond. Analysis by Franklin Templeton Institute. Performance is calculated using daily price returns of the MSCI USA Index since December 31, 1969. Performance represents average returns for the periods. Rate cut periods begin July 15, 1974 (R), April 1, 1980 (R), June 15, 1981 (R), April 15, 1982 (R), September 20, 1984 (E), November 4, 1987 (E), June 6, 1989 (E), July 6, 1995 (E), September 29, 1998 (E), January 3, 2001 (R), September 18, 2007 (R) and August 1, 2019 (R), where R represents recessionary cuts and E represents expansionary cuts. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. Important data provider notices and terms are available at www.franklintempletondatasources.com. **Past performance is not an indicator or a guarantee of future results.**

When all rate cuts are considered, U.S. equities posted an average one-year return of 9.94% (blue line). However, when rate reductions are separated according to whether they occurred during a recessionary environment or during an expansionary environment, the difference in the average one-year **return data is far more positive for rate reductions that have occurred against a backdrop of economic growth which is the backdrop that currently applies.**

BONDS ALSO RECEIVE A TAILWIND AS RATES DECLINE

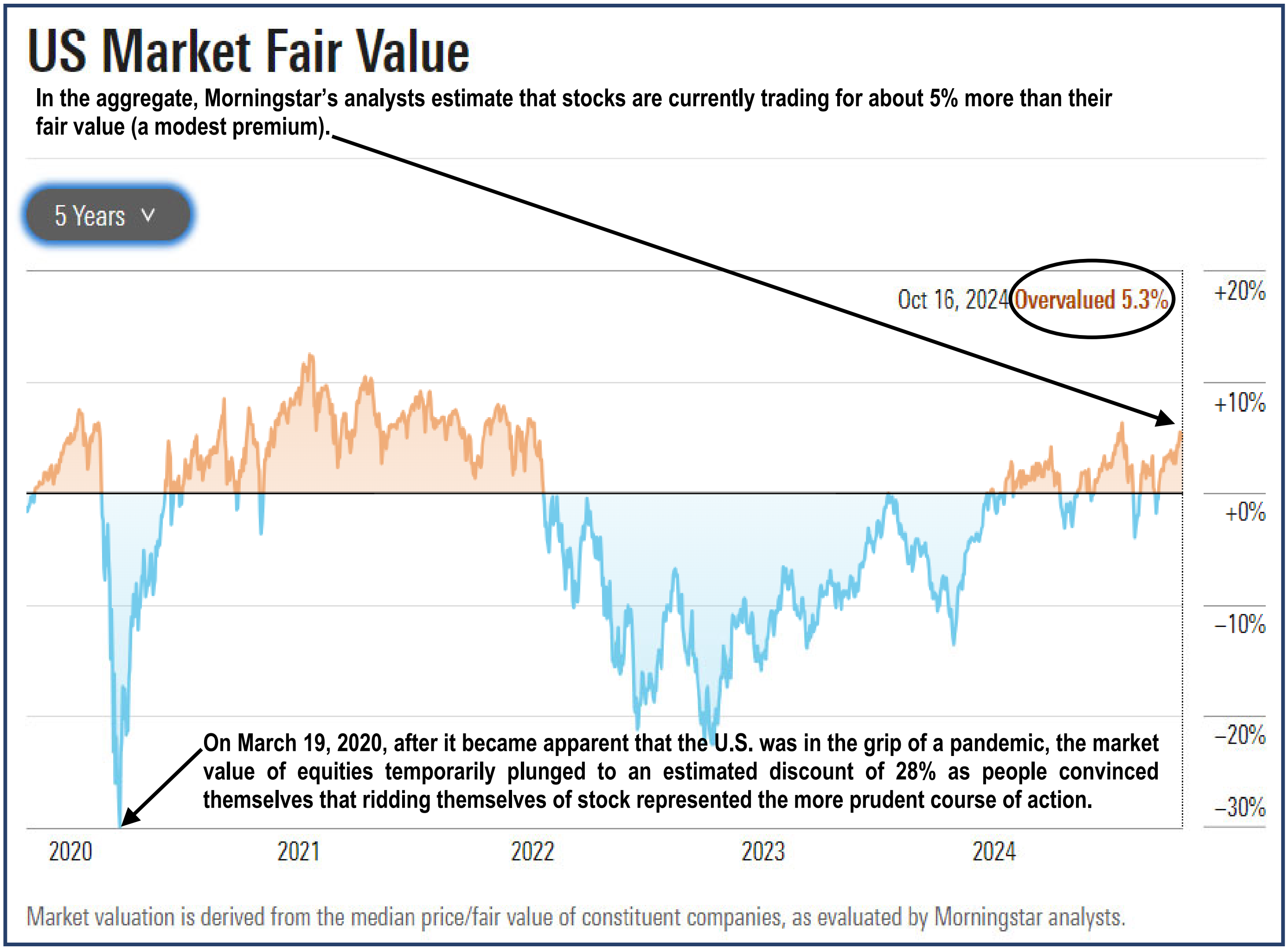
Since the yields available from these instruments will decline in sympathy with the overall economy, one might assume that an environment of declining interest rates will necessarily stymie the returns available from various types of bonds. However, that's not necessarily the case. While the interest paid on interest-bearing securities will typically decline in an environment of declining rates, **interest income represents only one component of investor return**. Although the one-year returns shown below are only hypothetical, returns from fixed income instruments are mostly governed by mathematical relationships, so hypothetical results still offer valid points of comparison.

To start, note the disconnect between the interest income generated by the "yield" of a given instrument (boxed), and the "total return" generated by that instrument over the course of one year. **The difference between the two figures represents return available to the investor as a result of <u>appreciation</u> of the instrument.**



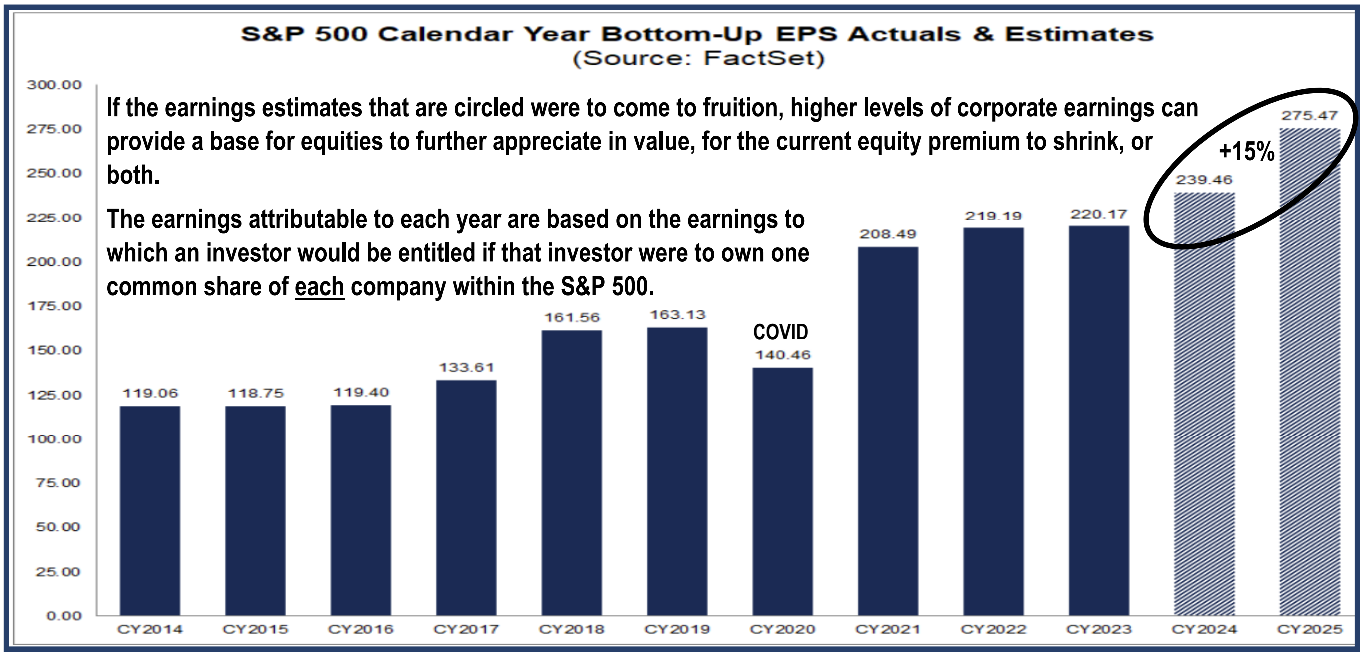
EQUITIES STILL COMMAND A PREMIUM …

Depending upon the valuation metric applied, equities could fall almost anywhere along the valuation spectrum, but I would mostly expect a given valuation metric to suggest that equities are at least modestly overvalued. As an example, Morningstar compiles the fair value estimates of the common stock under the purview of its analysts to the actual values of those shares in the marketplace to reveal the degree to which the market values of those stocks deviate from its analysts' estimates of fair value (below).



… BUT CONTINUED EARNINGS GROWTH WOULD ERASE IT

In general, the estimated, 5% valuation premium shown above could be erased if corporations were able to increase their earnings power by approximately that much or if analysts felt that the future earnings generated by these companies were to grow at some increased rate. If you refer to the image on the next page, you'll see that **analysts collectively expect corporate earnings to increase 15% next year**. If this earnings growth were to come to fruition, it could erase that 5% valuation premium in a few months.



HEDGING EQUITY EXPOSURE

The overwhelming majority of our clients have either already retired or are near it, and most of the folks within this group are at least somewhat sensitive to downside market volatility. I've written about this topic before, but I wanted to again mention that I have replaced in many (not all) portfolios at least some portion of traditional, *unhedged* equity exposure with a range of exchange-traded funds that are designed to provide some protection against market drawdowns.

In exchange for receiving this downside protection (known as a "buffer"), some portion of the market's upside appreciation potential must be foregone. For example, I often opt for a 15% downside buffer and the cost of that buffer comes primarily in the form of a) upside appreciation potential that is capped to some maximum (e.g., 16%) over some defined period and b) the loss of whatever dividend the stock index tracked by that fund would have paid such as the 1.3% dividend offered by the S&P 500. I do this because volatility can leave deep wounds.

— Glenn Wessel

Losing Less Matters More

Investing in the market with a built-in buffer can be powerful. Without a buffer, if your portfolio declines, it subsequently needs to gain more than it lost to get back to even. However, the portfolio with a buffer (of 9%, 15%, or 30%) needs far less of a gain to get back to even after experiencing loss.

IF YOUR PORTFOLIO LOSES:	5%	10%	20%	30%	40%	50%
YOU WOULD NEED THIS SUBSEQUENT RETURN TO BREAK EVEN	▼	▼	▼	▼	▼	▼
NO BUFFER	**5%**	**11%**	**25%**	**43%**	**67%**	**100%**
9% BUFFER	0%	1%	12%	27%	45%	69%
15% BUFFER	0%	0%	5%	18%	33%	54%
30% BUFFER (-5 TO -35%)	5%	5%	5%	5%	11%	25%
100% BUFFER	0%	0%	0%	0%	0%	0%

For illustrative purposes only. Does not represent an actual investment. There is no guarantee a fund will achieve its buffer objective.