Maclura Investments

3Q24 Review - Market Finally Starts To Broaden Out

Clay E. Brethour, CFA

Major US equity benchmarks were higher in the third quarter as the market performance broadened out from the "Magnificent 7" large cap technology stocks that have been driving most of the market mid-year. As illustrated in the table below (exhibit 1), the Morningstar style and market cap range benchmarks have all returned double-digit returns year-to-date with the exception of the Morningstar U.S. Small Cap Value benchmark. Bond benchmarks were also up meaningfully during the quarter (mid-single digits) as the prospects of the Federal Reserve lowering short-term interest rates became more certain as the quarter progressed.

Exhibit 1. Investment-Style Returns

	Morningstar Index Market Returns	2016	2017	2018	2019	2020	2021	2022	2023	2024 1st Qtr.	2024 2nd Qtr.	2024 3rd Qtr.	2024 YTD
Growth	U.S. Growth	3.16%	29.52%	0.78%	35.90%	44.65%	24.79%	-36.70%	38.48%	8.32%	2.42%	4.63%	16.08%
	Large Growth	1.79%	31.15%	2.94%	33.81%	38.86%	21.47%	-40.36%	47.26%	9.59%	4.73%	2.22%	17.31%
	Mid Growth	6.46%	25.67%	-3.16%	36.01%	46.17%	14.97%	-32.37%	25.38%	10.56%	-4.73%	5.98%	12.21%
	Small Growth	9.61%	23.77%	-5.67%	27.60%	43.52%	-1.00%	-33.13%	26.65%	5.29%	-1.57%	7.01%	10.90%
	US Market	12.44%	21.47%	-5.05%	31.22%	20.99%	25.78%	-19.43%	26.44%	10.24%	3.48%	6.06%	20.98%
Value	U.S. Value	20.79%	14.23%	-7.51%	25.09%	-1.31%	23.98%	-0.72%	11.98%	8.41%	-1.47%	8.95%	16.37%
	Large Value	18.91%	15.09%	-5.90%	25.70%	-0.62%	21.49%	0.26%	11.82%	8.89%	-0.59%	8.67%	17.64%
	Mid Value	25.21%	13.02%	-10.63%	24.81%	-3.76%	29.02%	-2.39%	10.94%	8.19%	-3.05%	9.59%	14.94%
	Small Value	27.96%	8.40%	-16.61%	19.96%	1.01%	31.79%	-6.60%	14.58%	4.64%	-5.17%	9.69%	8.83%

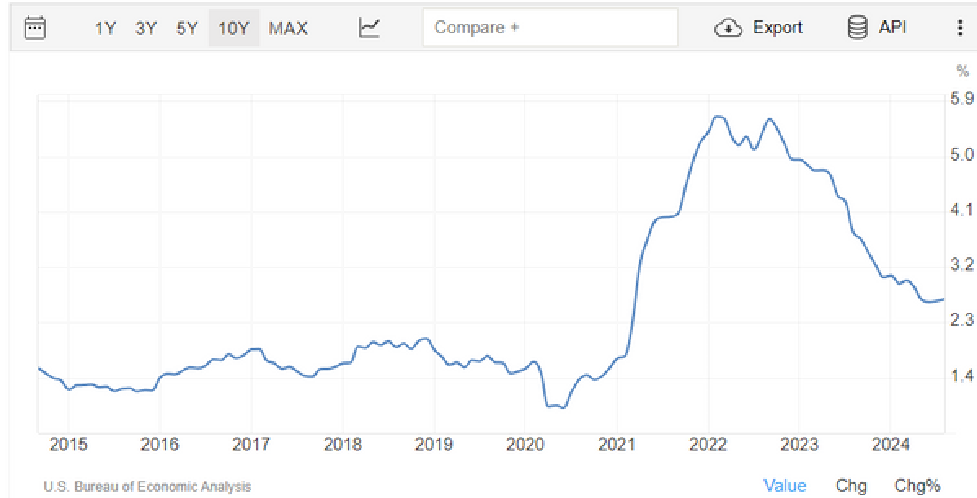
Source: Morningstar

While the market broadened out, volatility also increased during the quarter and nearly derailed the market in mid-July when a weak US jobs report raised recessionary fears and concern that the Federal Reserve had kept interest rates too high for too long. Amplifying the volatility was the surprising move by the Bank of Japan to raise its benchmark short-term interest rate to a range of "around 0.25%" on July 31st from its previous range of 0% to 0.1%. This was the second time that the Bank of Japan raised interest rates, the first being at its March meeting, its first time in raising its policy rate in over 17 years.

The reason that Japan's interest rates influenced the U.S. stock market is that it prompted an unwinding of the "yen carry trade," which is the practice of borrowing cheap Japanese yen to fund other assets. Often, when technical influences create trading decisions, selling can become indiscriminate and take the market on wild rides. Although the market bounced back to close at near record levels for the quarter, as a bull market ages, often traders are swayed by minor influences, and volatility will likely be at a heightened level going into the end of the year. These events might include: companies reporting financial quarterly results that don't measure up to expectations, geopolitical challenges, or the Federal Reserve moving too slowly to help keep the economy on a sustained path of growth.

The Federal Reserve has two simple mandates: to achieve maximum employment and keep prices stable. The Fed's preferred gauge on inflation is the Core Personal Consumption Expenditures Price Index (PCE), which is released by the Bureau of Economic Analysis every month.

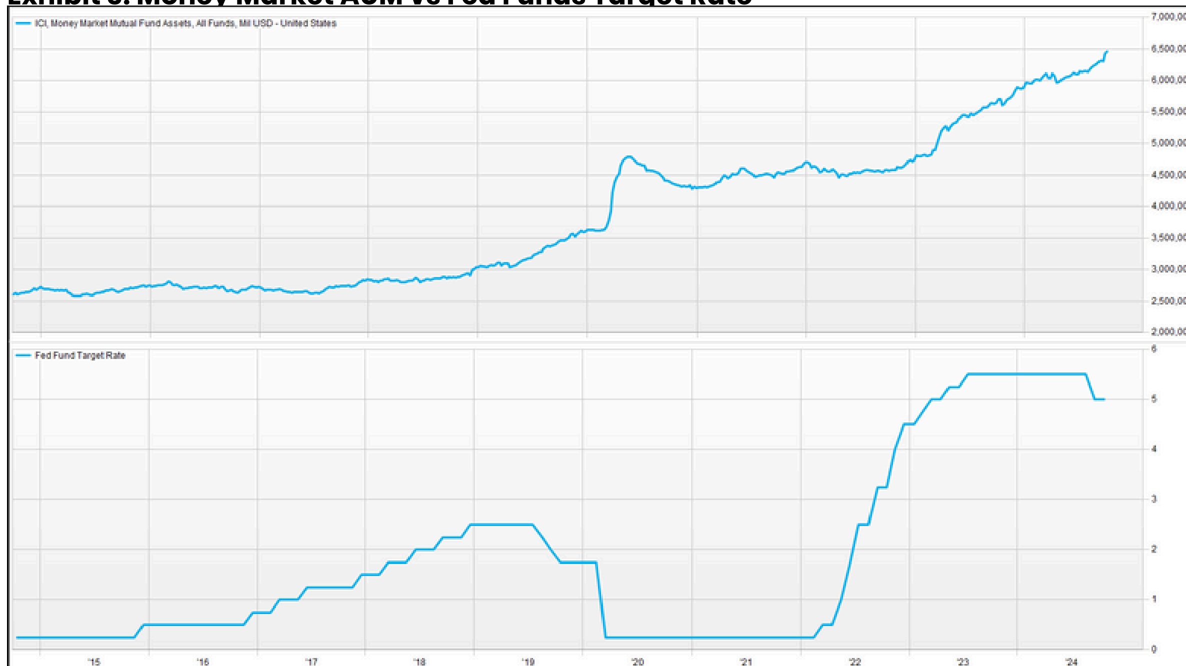
Exhibit 2. US Core Personal Consumption Expenditures Price Index (PCE)



The latest figure released in August showed that inflation continues to be trending downward (2.7%) to the Federal Reserve's annual inflation target of 2%. (exhibit 2). While it is tempting to wish that inflation would return to the low levels achieved 2015 through 2020, the central banks throughout the world struggled with making monetary policies effective in spurring inflation to achieve that 2% goal. Even with the most aggressive quantitative easing (QE) policies implemented at nearly all of the world central banks to achieve the goal, it took shutting down the world's supply chain via the Covid pandemic to increase inflation. Pending another global economic shock that shuts down the world's economy again, I don't believe that inflation will be an issue in the foreseeable future. During the September meeting, Federal Reserve Chairman Powell stated that unemployment has become a greater problem than inflation and that the Federal Open Markets Committee had decided to take decisive action by lowering the target range of the Federal Reserve Rate by 50 basis points to a range of 4.75 to 5.00%.

With this pivot in the Fed's policy regarding short-term rates, the question with which market watchers struggle is at what cadence and length is the Fed likely to reduce interest rates and its likely impact to the stock market. The upper chart below (exhibit 3) shows the amount of capital in money market funds and the bottom chart shows the Federal Funds rate (the rate that the Federal Funds manipulates to influence the economy).

Exhibit 3. Money Market AUM vs Fed Funds Target Rate

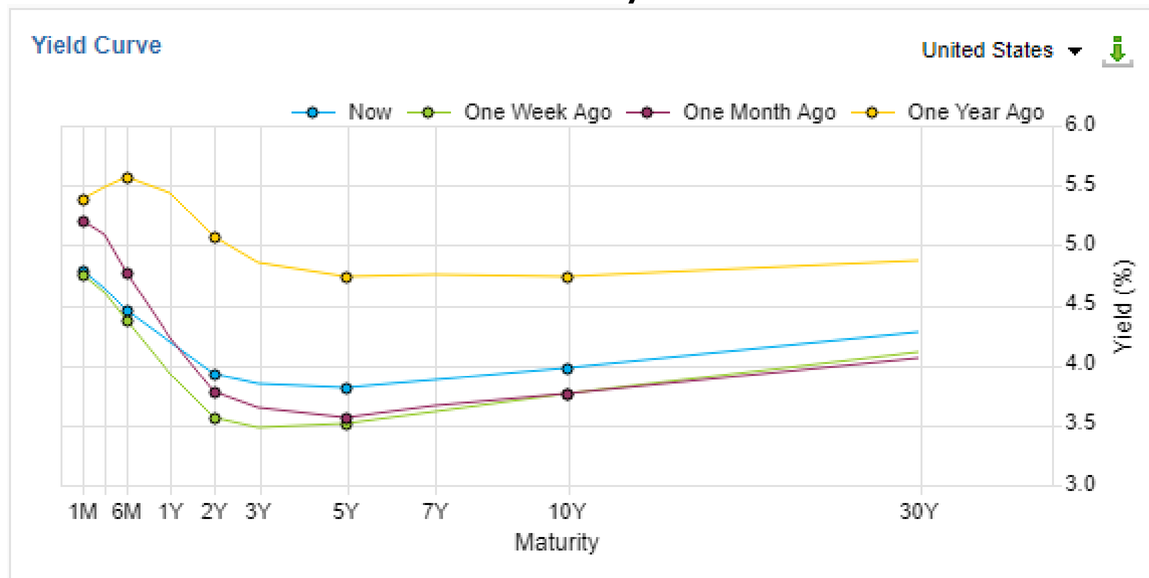


Source: Factset

When the short-term interest rates were near zero, the interest return on money market funds was essentially non-existent and provided minimal incentive to attract capital.

Though the Federal Funds were cut to near zero at the onset of the Covid pandemic to provide support for the economy, capital gravitated to the safe havens that money markets provided when the stock market collapsed during the early days of the pandemic. As the Federal Reserve raised rates to over 5%, money market funds were paying at interest levels not seen for nearly 15 years and recently accounted for $6.5 trillion in assets under management. As interest rates begin to be lowered by the Federal Reserve and interest yields drop in the securities in which money market funds invest, the attractiveness of holding money market funds will diminish. The likely beneficiary of this trend will be riskier assets (stocks) as investors seek to achieve acceptable returns and could provide a boost for the market, particularly dividend paying stocks.

Exhibit 4. Present and Historical US Treasury Bond Yield Curve



There is a high probability that the Federal Reserve will cut another 50 basis points before the end of the year. That will take the Federal Funds rate to a range of 4.25% – 4.50%. Bond yields have already reflected the move as illustrated with the blue line in the current US Treasury yield curve above (exhibit 4). As inflation continues to trend to the Federal Reserve's target of 2%, the one-month yield should trend to the 3.50% to 4.00% range next year, taking money market yields down with it. It is highly unlikely that the Fed Funds rate ever nears zero percent as during the years of experimenting with QE after the Great Financial Recession of 2008.

The investment being made in the artificial intelligence (AI) industry continues to be the most significant economic stimulus catalyst for the US economy. I've mentioned numerous times in my market commentaries that ChatGPT changed the world in November 2022 when it introduced the concept of generative AI to the public. Its impact to the US economy is more widespread than most realize, and without it, the market's outcome over the past two years would have looked extremely different. Stocks with AI exposure are entering greater scrutiny on their quarterly financial results and increased volatility around the perceived success or failure of these three-month results. However, the AI tailwind is far from over, particularly when most of the investment has been around laying the foundation of training the AI models, and the investment to put the power of AI into the hands of the user has yet to be made. I still believe that it will take a number of years to implement widespread usage of AI in the economy and investors with a long-term focus should not be overly focused and swayed by the quarterly results; as per my opinion, we aren't even through with the first inning of this dramatic change that is coming to the economy due to the implementation of AI.

While I haven't mentioned the "elephant in the room," the US Presidential election, I don't put too much credibility in the ability of politicians to have lasting influence on the flow of capital. Whichever party resides in the White House will have limited power to influence a divided Congress and its ability to implement the rhetoric spewed on the campaign trail. For now, the most influential currents on the market will continue to be the Federal Reserve and the massive AI investment cycle; so much so, that the next "market crash" will likely come as the AI investment cycle slows or starts to validate that users have no desire to implement it into their daily lives.

There are plenty of other issues to keep on the radar, such as the geopolitical unrest in the Middle East and the continuation of the Ukraine war, but I've learned over the years that the ingenuity of Corporate America to adjust and adapt to unforeseen circumstances is remarkable in ways that only the most capitalistic economy in the world can achieve. As I've mentioned previously in my market commentary, the market was set up to have a high probability of broadening out and achieving double-digit returns for the year in all market cap benchmarks. Pending any "left field" surprises during the last three months of the year, this should be achieved and continue to reward investors that have a long-term perspective on their investment goals.

Maclura Investments, LLC is a registered investment advisor. Maclura Investments utilizes direct investing to build customized equity portfolios for individuals. For more info, go to www.MacluraInvestments.com

Disclosure: This material is intended for information purposes only and does not constitute investment advice, a recommendation, or an offer or solicitation to purchase or sell any securities to any person in any jurisdiction. The opinions expressed are as of October 7, 2024, and are subject to change without notice. Investing in equities involves risk and past performance is not indicative of future results.