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October 8, 2024

Third Quarter Review
Elections and Soft Landings

On September 18th, the Federal Reserve Board (the "Fed") lowered interest rates for the first time in 4½ years. This comes after one of the most dramatic series of rate increases in history, from almost 0% in March of 2022 to 5¼% in August of 2023. That peak rate was held for over a year before the Fed decided that inflation was coming down and a reduction in rates wouldn't add fuel to the inflationary fire. Stocks responded by going to new highs. This time it was not just the artificial-intelligence-related stocks that gained ground. In fact, the "Magnificent Seven" cooled off for a while, and the more value and dividend-oriented equities began to move higher. All three major stock market indexes rose, with the S&P 500 gaining over 5% for the quarter, posting the best year-to-date performance since 1997. Even bonds rose with the Barclays Aggregate index gaining 5%. Year-to-date, the top performing asset classes remained Bitcoin, Gold, and large cap stocks.

In a development that has been a surprise to some investors, the rates on bonds with maturities of 2 years to 30 years have actually increased since the day the Fed lowered short-term rates. This should serve as a reminder that the Fed controls only short-term rates while the market sets rates for longer maturities. This "twisting" of the yield curve is one reason we did not pile into longer-term maturities in anticipation of Fed rate cuts. Current expectations are that there will be two more ¼% rate cuts before year-end, bringing the total 2024 rate cuts to a full 1%. Therefore, we will likely end the year with Fed funds at about 4¼%. Long term rates such as those on bonds and mortgages will likely be determined by two things: inflation and recession (or lack of one).

Interest rate changes affect the economy with a time lag. Many economists believed that the dramatic rise in rates from March of 2022 might help to battle inflation, but that it was also likely to lead to an economic recession as business slowed due to the burden of higher interest expenses. An interest-rate-induced recession is often referred to as a "hard landing." Inflation and interest rates may come down, but the cure causes much economic pain. However, no recession has materialized, and the economy appears to have weathered that storm fairly well so far. Consequently, Fed Chairman Jay Powell recently made the statement that a "soft landing" was in sight. Certainly, that is what stock investors are betting on as the market holds well in the face of many uncertainties.

It is often said that "the market does not like uncertainty." This always struck me as odd since I have never seen a market where the future was certain. We currently have at least three uncertainties that loom before us. The first is "geopolitical conflict" or what we used to call war. Just a whiff of major conflict in the Middle East used to trigger a knee-jerk sell-off in the stock market as the fear of constricted oil supplies panicked investors. Although the potential for escalation is still very much present, the markets have so far reacted calmly to the turmoil and destruction that has already had such a traumatic impact on so many lives. It may be that the U.S. is no longer as reliant on middle eastern oil supplies since we are currently the largest producer in the world and supplies appear to be adequate. (Also, alternative energy sources are growing as a source of electrical power.) While we hope for a peaceful resolution, or at least a de-escalation of hostilities, we should be prepared for the market impact of possible increased conflict.

The second uncertainty is the upcoming elections for president and congress. While a victory for either presidential candidate may have immediate impact on certain sectors (e.g., alternative energy, imports, oil exploration, and pipeline businesses), the general market appears not to be overly vulnerable to a crash caused by the election outcome (as touted by some grandstanding prognosticators). One possibility that we should be prepared for is the uncomfortable position of not being able to determine the winner in the election's immediate aftermath. A contested election result might prove to be a drag on investor sentiment, at least in the short run, and will likely be more so if the "contesting" is protracted or violent.

One certainty is that neither party has serious plans to reduce the federal budget deficit. This has been a ticking time bomb during my entire career in the investment business, and it may continue to tick without incident for some time to come. However, we should be aware that the U.S. debt is now 7% of GDP, up from 3.4% in 2017. The interest on the debt is taking more and more of the federal budget, which may lead to a "tipping point" where expenditures spiral out of control. The timing is uncertain, but the math is hard to ignore, and it calls for continued diversification of assets in order to maintain purchasing power. This is one of the main reasons cited by cryptocurrency investors (Bitcoin) when justifying their investment in a "currency" that can't be "printed into oblivion."

The third uncertainty is whether or not we will face a recession as a delayed consequence of the high interest rates that are just now being eased. A similar scenario played out in 2007 when a recession followed the first round of rate cuts. A recession would likely hurt stock prices but would probably benefit long-term bonds as demand for borrowing would decline, pushing longer rates lower and bond prices higher. Some market participants believe that we are in for a spate of "slugflation" with sluggish economic growth (no recessionary "hard landing") but persistently high inflation. Rising unemployment coupled with increased inflation would be a real problem for the Fed and the markets. When all these factors are taken into account, it may still be the "easing" of monetary conditions by the Fed that would provide the fuel for higher stock prices in a continuation of the bull market.

At least some of these uncertainties will be resolved in the near future, and we will endeavor to react accordingly. With year end approaching, let us know if you would like to discuss realized gains and losses for tax planning purposes. At your request, we can provide an estimated year-to-date realized gain/loss report for your review. We would be happy to discuss your current third quarter reports along with any questions or suggestions you might have for your portfolio of investments.

Best regards,

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