

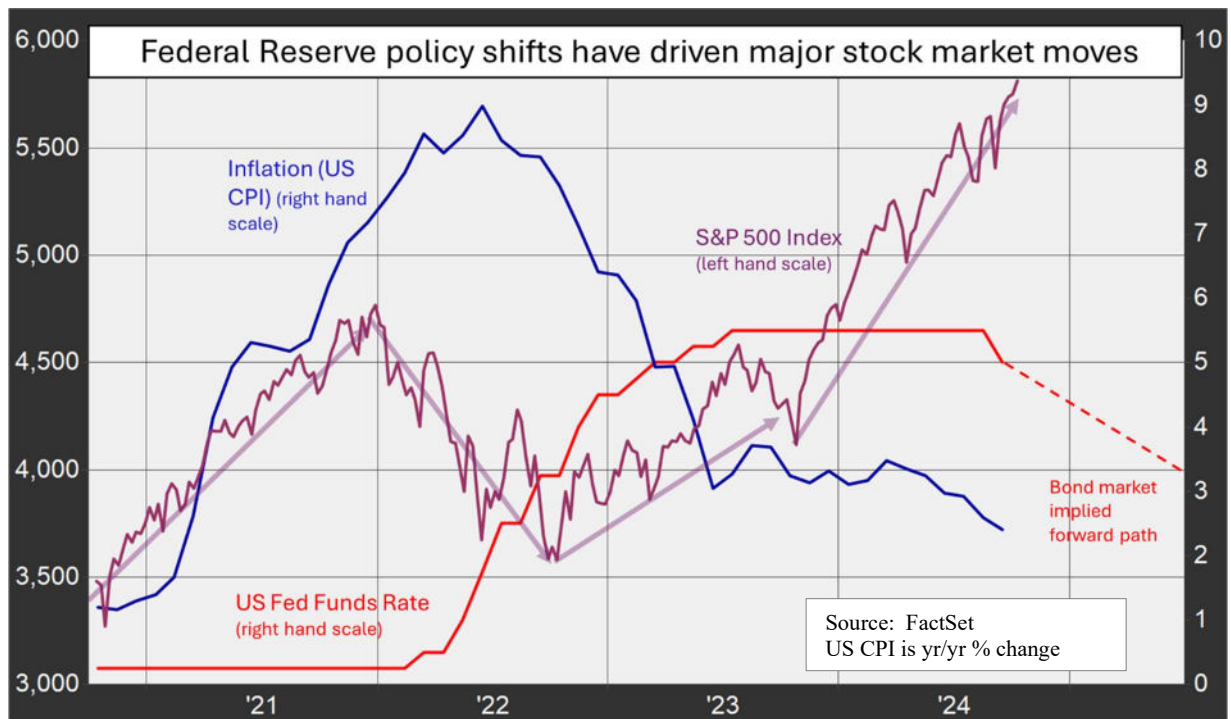
## Investment Commentary—October 2024

As the third quarter progressed, all eyes were on the U.S. Federal Reserve. Prior to its September 18<sup>th</sup> meeting, the Fed signaled that it would reduce the Fed Funds rate for the first time in over four years. The only question was how much--would it be a typical 0.25% (referred to as 25 “basis points”) reduction, or a larger 50-basis point cut? The stock market, which always prefers lower interest rates, hoped for and got the bigger reduction, pushing stocks to all-time market highs.

With the September rate cut, the Fed has come full circle since it slashed interest rates in the early days of the Covid pandemic. In retrospect, the course of the U.S. stock market since that time can largely be explained as a response to changes (and anticipated changes) in Fed interest rate policy. As we consider what may lie ahead, it may be useful to review that history.

\*\*\*

The near complete Covid lockdown in March of 2020 shuttered much of the global economy. With stock and bond markets dropping precipitously, the Fed took dramatic action. It offered banks unlimited funds on extremely generous terms. It announced that it was prepared to intervene in bond markets as a buyer of last resort. And it slashed short-term rates to near zero, committing to keep them there as long as necessary.



The Fed's "whatever it takes" response, combined with trillions of dollars of federal spending, triggered a huge and sustained stock market rally off the Covid bottom.

By early 2021 storm clouds had appeared on the horizon in the form of huge supply chain disruptions. Covid lockdowns, especially those resulting from China's zero-Covid strategy, revealed the fragility of complex global manufacturing networks. Too many products depended on one or two sources for key components or sub-components, causing shortages to cascade through the entire system. Consumers, flush with cash from federal stimulus programs and unable to spend on travel and restaurants, tried to load up on physical goods, causing demand to spike just as production was disrupted. (Remember what it was like to order furniture or appliances in the spring or summer of 2020?) Economics 101 dictates that too much demand and too little supply causes prices to surge, and that is exactly what happened (illustrated by the blue line in the chart on the previous page).

For most of 2021 policymakers believed that the imbalance of supply and demand would work itself out, and inflation would prove to be "transitory." By the end of 2021 however, it was clear that inflation had become persistent and widespread, and that the Fed would have to push interest rates sharply higher. The stock market, which had been buoyed by low rates, retreated. From early 2022 to mid-October, the Fed pushed the Fed Funds rate (the red line in the chart) up 250 basis points, the steepest series of rate hikes in decades, triggering a 25% stock market decline.

By late 2022, inflation, while still quite elevated, had significantly receded. Capital markets correctly anticipated that the pace of rate hikes would slow. The stock market rebounded over twenty percent in the ensuing twelve months, but in halting fashion. While the pace of rate hikes did slow, inflation remained above the Fed's 2% target, and there wasn't a clear consensus among market watchers on when rate hikes would end. From August through October 2023, the S&P 500 Index declined by nearly ten percent as investors worried about "higher for longer," the idea that defeating inflation would require that the Fed Funds rate go higher than anticipated and stay high longer than expected.

Early in the fourth quarter of 2023, the Fed, confident that inflation had been subdued, began signaling that hikes in the Fed Funds rate had come to an end. The higher-for-longer worries faded and the stock market shot up. It hasn't looked back, and the S&P 500 is now up over 40% from last October's lows.

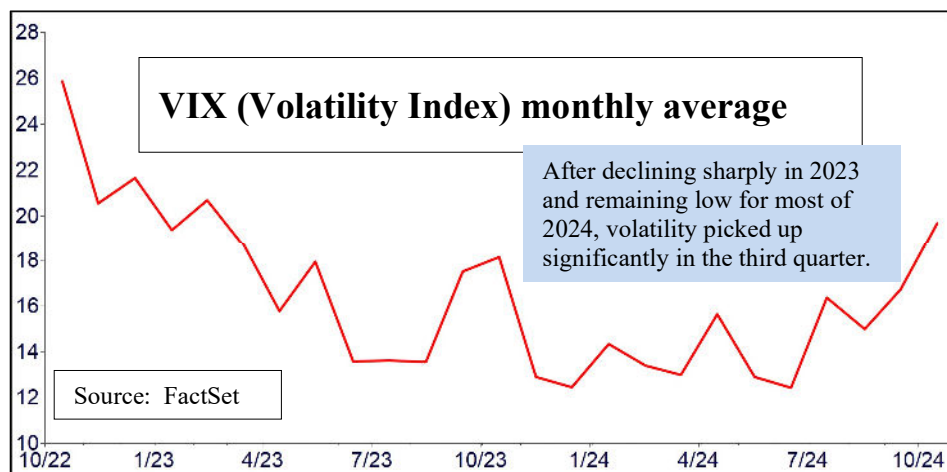
As the chart on the first page illustrates, bond markets expect the Fed to push short-term rates down another 150 basis points or so by the middle of 2025. The continued broad-based gains in the U.S. stock market suggest that investors are banking on lower interest rates, which decrease bond yields and make stocks look more attractive by comparison. In fact, the stock market seems to be anticipating that the U.S. is settling into a "Goldilocks economy," which is neither too hot (in which case inflation might perk up again) or too cold (in which case corporate profit growth would stall).

Even if a Goldilocks economy is the appropriate baseline scenario, other outcomes are plausible. A small jump in inflation could force the Fed to postpone further interest rate cuts. Although recession worries have waned, some unforeseen event, or the accumulated impact of higher rates

over the last two years, could tip the economy into a downturn. Judging by the level of the U.S. stock market, these less pleasant scenarios don't seem to be on most investors' radar screens.

\*\*\*

One of the most notable aspects of the stock market climb in 2023 and the first six months of 2024 was low volatility. Since 2004, in an average year the S&P 500 Index has suffered a 2%+ drop on ten trading days and a more painful 3%+ drop on four days. Heading into the third quarter, the S&P 500 Index had recorded a seventeen-month stretch in which it failed to decline by 2% a single time. Even by the standards of bull markets, when big declines are less common, that is very unusual. While the S&P 500 Index did climb by 5.8% in the third quarter, there were three trading days with 2%+ declines. The VIX Index, which measures volatility and is considered a gauge of fear and uncertainty, rose significantly and is back to historical levels after declining for most of 2023 and the first half of 2024.



It's not hard to think of reasons for increased stock market volatility. The Middle East conflict threatens to escalate into a major regional conflict. The war in Ukraine grinds on, with consequences for the stability of Eastern Europe. The results of the U.S. election seem certain to sorely disappoint half of the country. We are not by any means sounding an alarm on any of this. We have reminded readers many times over the years that the stock market is capable of ignoring grim political and geopolitical headlines provided that corporate profits continue to rise. Still, with the U.S. economy slowing (by design), lackluster profit growth is a possibility and economic shocks from events in the world at large can't be dismissed. A period of significant choppiness or even a significant pullback would not be altogether surprising.

The good news is that choppy markets and market pullbacks offer the best opportunities for actively managed portfolios to shine. When the stock market goes up in a straight line, stock selection becomes less important, and stocks may trade on momentum and not on fundamentals. Similarly, when the economy is strong and very few companies default, bond selection is less important. Bear this in mind if market volatility continues to increase in the months ahead.

*Boston, MA  
October 16, 2024*