STREET SMARTS

CARY STREET PARTNERS

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3Q COMMENTARY & MARKET OUTLOOK

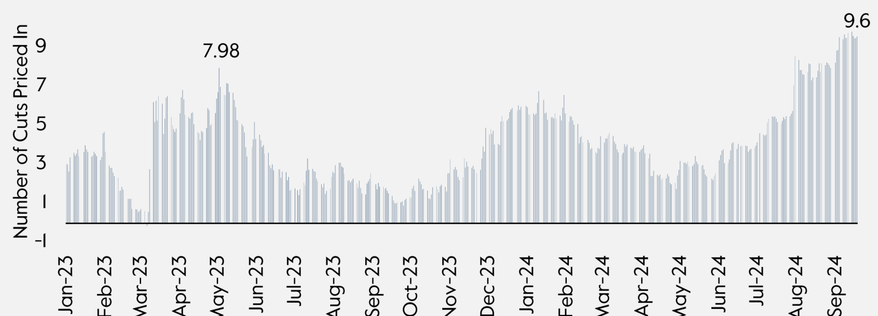
Rotation is the most important pivot going on in equities.

Market results for the third quarter were good. Despite a volatility spike induced by the unwinding of the Yen carry trade in early August, stocks and bonds have moved notably higher since the beginning of July. Breadth and participation have improved in equities since we commented on this dynamic in the 2Q Street SMARTS. During the third quarter through this writing, large-cap stocks defined as the Russell 1000 were higher by 5.02%. Small caps were outperformers for the period, with the Russell 2000 higher by 9.10%. All equity styles and market capitalizations were higher, although the value side of the market was better than the growth side. Mega cap tech stocks have caught a bid recently but longer term are losing momentum relative to other sectors. Given that technology comprises roughly one-third of the S&P 500 Index, this could portend an ongoing scenario in which the S&P struggles versus other market averages. This is all part and parcel of improved breadth and rotation within the equity market, which is the lifeblood of a sustainable uptrend. In fact, this scenario is essentially what we saw in Q3. Relative to the cap-weighted S&P, equal-weighted S&P outperformed. The opportunity set going forward is more favorable toward small caps, equal weight large cap strategies, and market sectors such as, but not limited to, financials. Rotation is the most important pivot going on in equities.

The macro update is clearly one that features Fed moves on short-term Fed funds rates which were lowered in the September meeting by 50 basis points. Much of this event was forecast and priced in ahead of the announcement. Bonds are higher in the quarter by 5.45%, as defined by the Bloomberg US Aggregate Index. Yields are much lower than back on May 2nd when we published "Another Chance to Bite into Bonds." The benchmark 10-year Treasury yield at that point was roughly 4.5% and is now roughly 3.75%. The policy-influenced 2-year Yield has fallen even more. While still generally constructive on bonds, easy money was made on entry points previously recommended back in late October 2023 and May of this year. Bond performance going forward is likely to be more incremental. Bond markets have anticipated a hefty series of rate cuts. A potential fallout of the recent sizable move may be the need for fewer cuts going into next year.

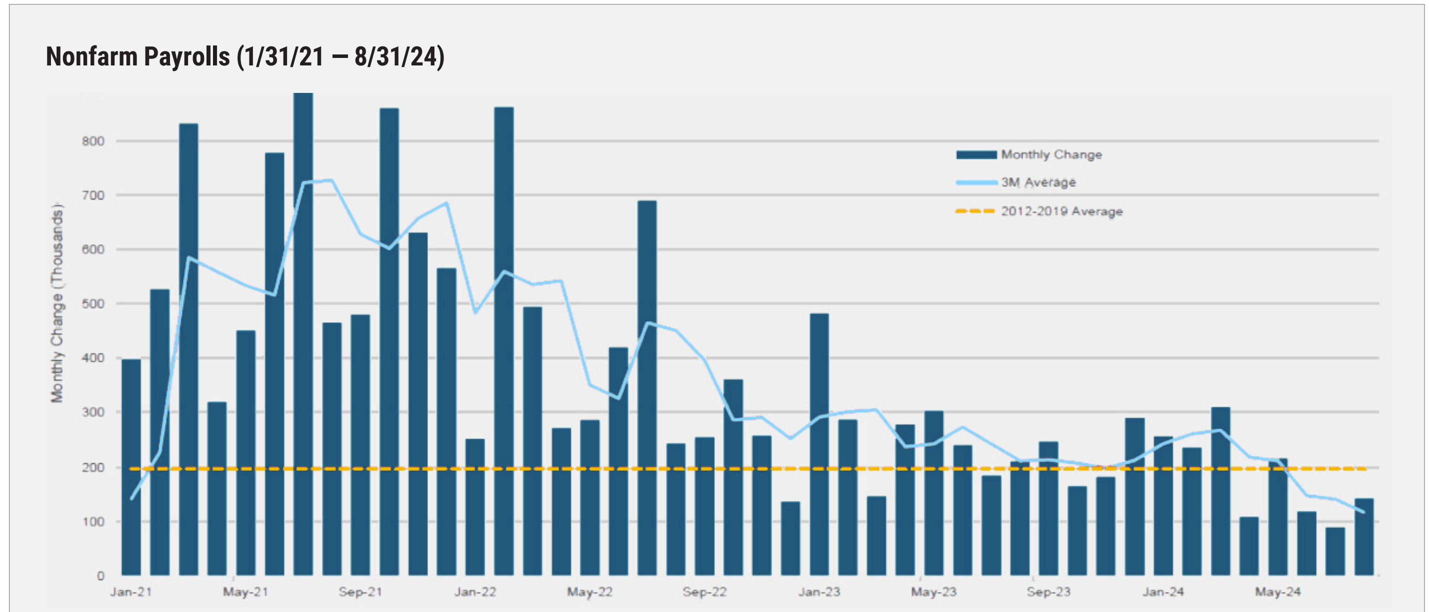
The Federal Reserve's move to cut Fed funds rates was unprecedented in one important respect. Every other instance in which the Fed has started a rate-cutting cycle by 50 basis points has been in reaction to a sharply weakening economy or emergency, think Great Financial Crisis. Consequently, one must throw out the historical impacts of this rate cut as this is very much a non-recessionary rate cut. The Fed is cutting rates first and foremost in reaction to much lower inflation data that has created a more restrictive policy each time we receive a lower inflation mark. Prior to the cut, the Fed was sitting at a 5.25 to 5.5% Fed funds rate target versus an inflation rate approaching 2.5%. In fact, both core CPI and PCE have annualized below 2% over the last three months. That creates a lot of room for Fed funds to go down and remain restrictive, albeit to a lesser degree. A rate of roughly 100 basis points over inflation is what we describe as close to neutral.

Fed Rate Cuts Priced In Over Next 12 Months (Relative to 5.33% Peak)



Source: Carlyle Analysis; Bloomberg, September 2024. There is no guarantee any trends will continue.

At the same time, inflation has moved toward its target, and the Fed's other mandate, full employment, looks a little wobbly. We would describe this as normalization from the exceedingly tight labor market of two years ago and not something terrifying, but job growth has diminished, and labor supply is up. The bottom line is that the Fed policy has shifted as risks have shifted — the odds of higher inflation are less than the odds of higher unemployment.



Source: Natixis Portfolio Analysis & Consulting; Bloomberg.

The most significant economic consequence of rate cuts is likely to be in housing. Mortgage rates have already declined about 170 basis points from last year at this time. If rates get into the 5.5% to 5.75% zone, that should spur some significant pick-up in residential transaction volume. Housing starts are still about 25% below pre-rate hike cycle levels. A pick-up in housing has a huge economic multiplier effect, which, added to the productivity and capital investment dynamics we have previously commented on, portends a solid economy.

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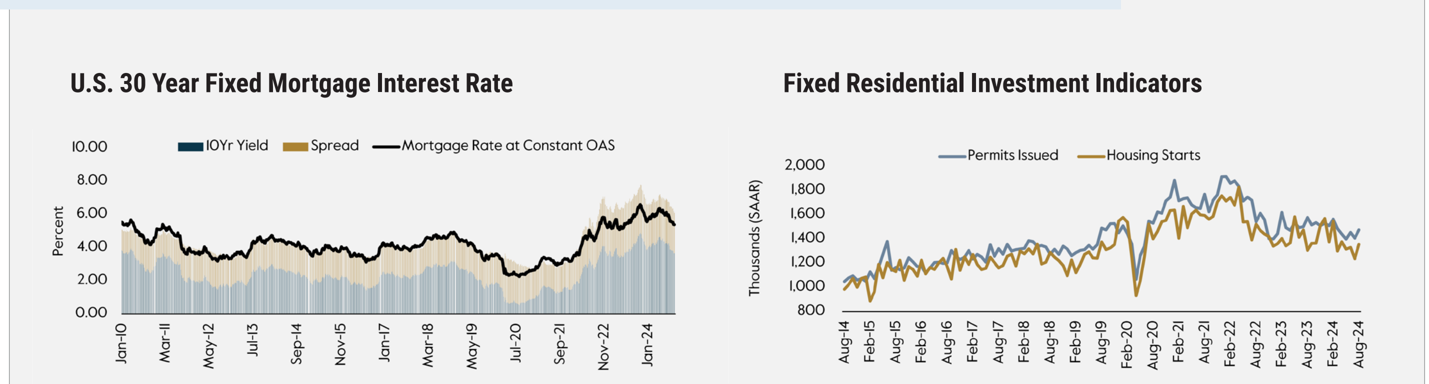

Source: Carlyle Analysis; Federal Reserve, September 2024. There is no guarantee any trends will continue.

All market performance figures are sourced from Bloomberg.

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The Russell 2000® Index is a capitalization-weighted index designed to measure the performance of a market consisting of the 2,000 smallest publicly traded U.S. companies (in terms of market capitalization) that are included in the Russell 3000® Index.

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