Mid-Quarterly Market Commentary

Q3 August 2024

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Journey Wealth Investment Team

Pete Franz, CFA, CFP –
Chief Investment Officer

As the CIO of Journey Wealth, Pete is responsible for establishing, managing, and articulating the firm's investment platform and approach. He collaborates with the firm's investment partners, monitors markets, and conducts portfolio analysis to construct portfolios that align with client objectives.

As the Manager of Investments, Jack divides his time between developing solutions for clients and assisting with the curation of the firm's investment portfolios. Jack supports Pete in all facets of developing and monitoring the Journey Wealth investment platform, including working with key asset managers, our advisory team, and conducting ongoing research.

Jack LaLiberte, CFA, CPA -
Manager, Investments

Market Recap & Outlook

Market Recap

Recently, volatility has returned to markets as concerns have shifted from inflation to recession risk. Equity valuations, particularly in the US large cap growth segment, remain elevated relative to long-term averages. On the equity front, there are plenty of near-term risks to sustain continued volatility, including the path of the Fed's rate cuts, the upcoming election, as well as the possibility of a weakening consumer. For the long-term investor, these should be considered opportunities. There's still a substantial valuation discount in small-cap and international equities, which could benefit from interest rate cuts and a weaker dollar, respectively. On the fixed income front, the yield curve's inversion has minimized, reducing the yield consequences of extending duration.

Looking Ahead

Much of the discussion in the financial media has centered on the timing of the Fed's rate cuts. While rates are an important input, attempting to time the Fed is not a beneficial practice for long-term investors. Fixed income markets are likely to remain volatile while the Fed's path crystallizes, but higher yields help insulate bond investors from interest rate risk. The path for equities is less clear. Rate cuts are likely to provide short-term catalysts for stocks. However, equities seem to already be pricing in a soft landing. Historically, both fixed income and equities typically outperform cash over the long term, including during election years. We advocate building portfolios to achieve your long-term goals as opposed to trying to react to the latest Fed meeting, election news or geopolitical event. Please don't hesitate to reach out to your advisor to schedule time to discuss your financial plan, including your goals and planning assumptions.

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Leading Topics

Recession Risk

A recession is defined as a decline in GDP for two consecutive quarters. Although related, market movements and the unemployment rate don't determine when a recession occurs. Historically, capital markets lead economic indicators of a recession. The S&P 500 typically bottoms out approximately four months before the end of a recession. If a short, shallow recession occurs, it's likely to be over before we realize that it has occurred. US GDP growth for the second quarter of 2024 was 2.8% on an annualized basis. Even though this figure is likely inflated due to inventory purchasing and government spending, it remains above the 10-year average of 2.65%. The employment picture has shown signs of weakening, but the Fed also has plenty of room to stimulate. A slowing of the rapid growth we've seen over the past few years seems more likely than a recession in the near term.

Federal Reserve/Interest Rates

Although the Fed Funds rate has remained unchanged, the Fed has become significantly more restrictive over the past year as the real Fed Funds rate has steadily climbed. Futures markets are currently pricing in about 3 rate cuts by the end of the year, including nearly a 100% likelihood of a cut in September. While recent volatility sparked concerns that the Fed is being too slow to loosen fiscal policy, the Fed's language has shifted from inflationary concerns to a more dovish tone. Whereas much attention is focused on the short end of the yield curve, the longer end is more impactful for consumers and businesses considering debt for housing or other long-term investments.

Fixed Income

Yields across most fixed income categories are well above their ten-year averages, providing investors with an opportunity to lock in meaningful income for the long term. In either a soft-landing scenario or a recession, we believe the outlook for fixed income is bright. In both cases, interest rates, particularly short-term rates, are likely to decline. In addition to attractive yields, declining rates present an opportunity for capital appreciation in fixed income. When considering the reinvestment risk present in cash and somewhat elevated equity valuations, we believe fixed income offers an attractive risk-adjusted opportunity.

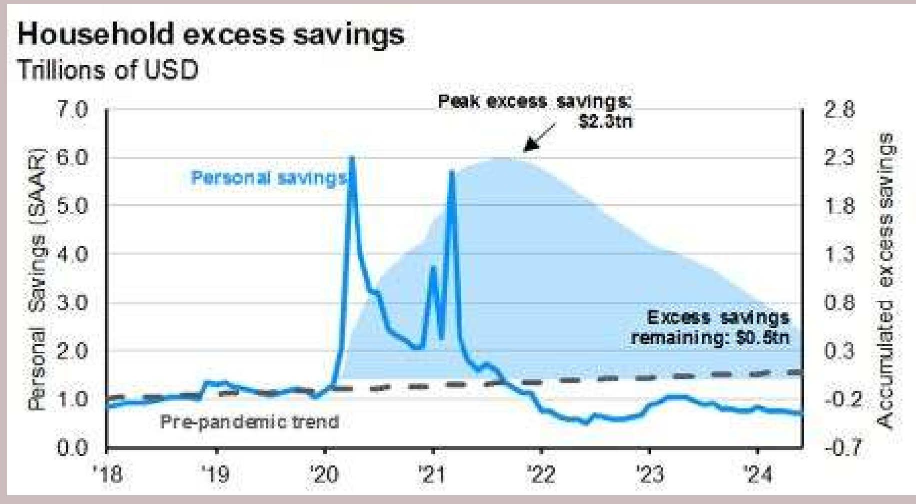
Elections

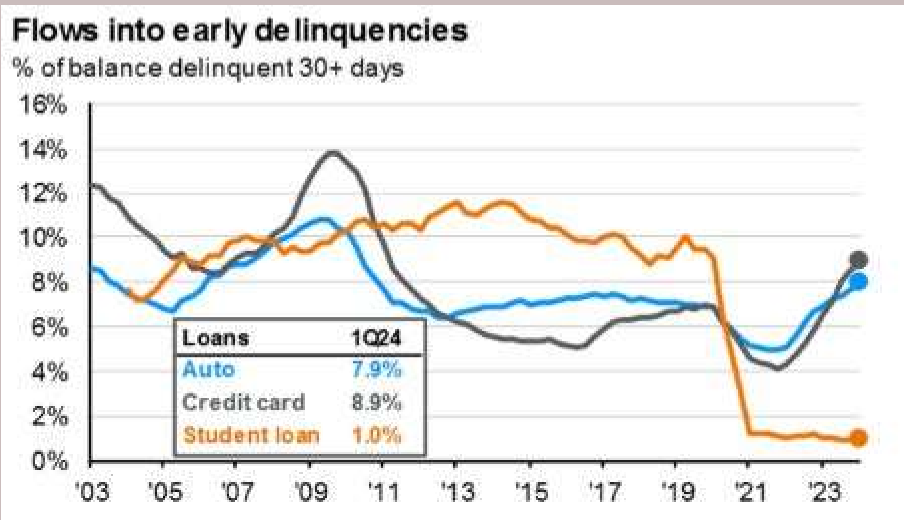
Historically, the party that controls the White House makes little difference for equity markets. Since 1937, the difference in returns under Democratic and Republican presidents is about 0.3% annually for US equities. The uncertainty over the Fed's rate path and the election outcome are likely to sustain elevated volatility in the near term. Although volatility can be uncomfortable, we know that equities and fixed income outperform cash over the long term. Reinvestment risk in cash instruments is particularly relevant when the most likely path for short-term rates appears to be downward. Markets are forward looking, and an uncertainty premium is likely built into asset prices. While we don't know what will occur, equities historically tend to perform well in the second half of election years as the outcome becomes clearer.

Recession Risk

Recent labor market data has refocused investors on the health of the US consumer and the risk of recession. JPMorgan recently upgraded their risk of a global recession in 2024 to 35%. The US consumer has certainly weakened since the COVID-era when interest rates were near zero and the stimulus was flowing. Excess savings have been largely depleted and delinquencies on consumer debt have increased notably over the past two years.

Recession is a scary word, but what does it really mean for your investments? Historically, recessions occur about every 6.5 years and generally last about 10 months. On average, the US stock market peaks about 5 months prior to a recession, although that figure varies widely. Of the 11 recessions since 1950, the stock market has typically bottomed out at about a 21% decline. That bottoming out process typically occurs about halfway through the recession. Recessions are defined as two quarters of negative GDP growth. If a recession takes the shape of the average recession, equity markets may bottom out before we can officially determine if a recession exists.





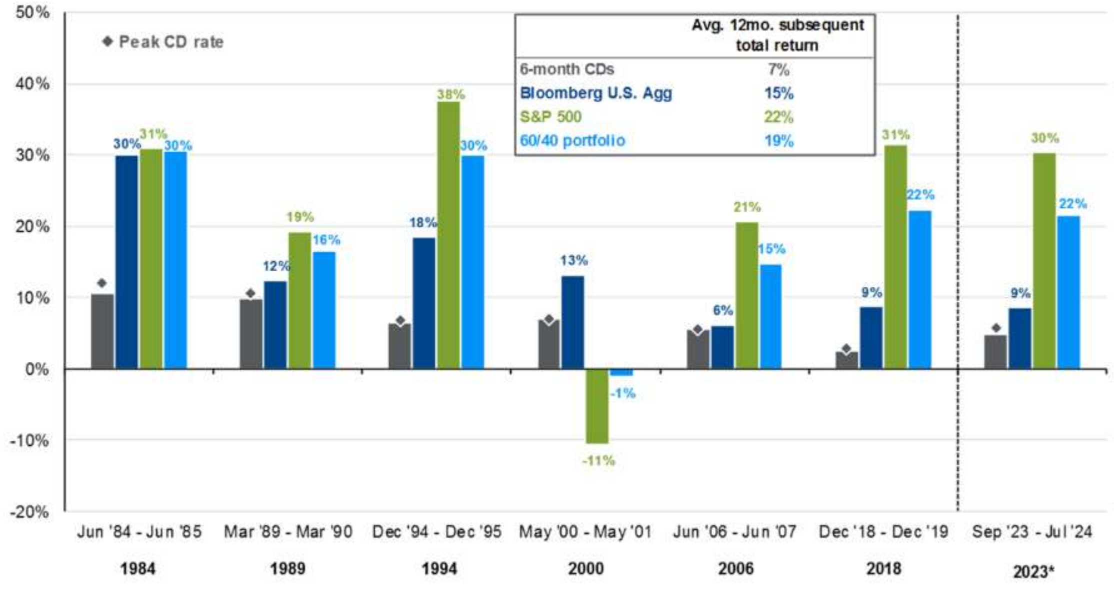
Source: JP Morgan

Recession Opportunities

A recession is far from certain in the near term, and we consider slower growth to be the most likely course for the economy. The performance of equities during recessions is predictable, although equity markets typically lead the real economy. For the long-term investor, attempting to time recessions isn't a worthwhile endeavor.

On the other side of the asset allocation coin, fixed income typically outperforms both cash and equities during recessions. Although cash seems like a safe harbor in choppy financial waters, the Fed typically reduces short-term interest rates rapidly during recessions. Though we can't control GDP growth, we can control our reactions. While we never advocate market timing, there are other ways to take advantage of declines in the equity markets, none of which include reducing exposure based on feelings of unease. A few options include rebalancing and tax loss harvesting. Loss harvesting allows investors to accrue tangible benefits from market volatility. One of the easiest ways to prepare for a recession or a soft landing is to get excess cash off the sidelines and into fixed income, while maintaining reasonable cash reserves. In either case, short-term rates will likely come down and fixed income can serve as both a risk dampener as well as an avenue for capital appreciation.

Investment opportunities outside of CDs
Peak 6-month certificate of deposit (CD) rate during previous rate hiking cycles and subsequent 12-month total returns



Source: JP Morgan

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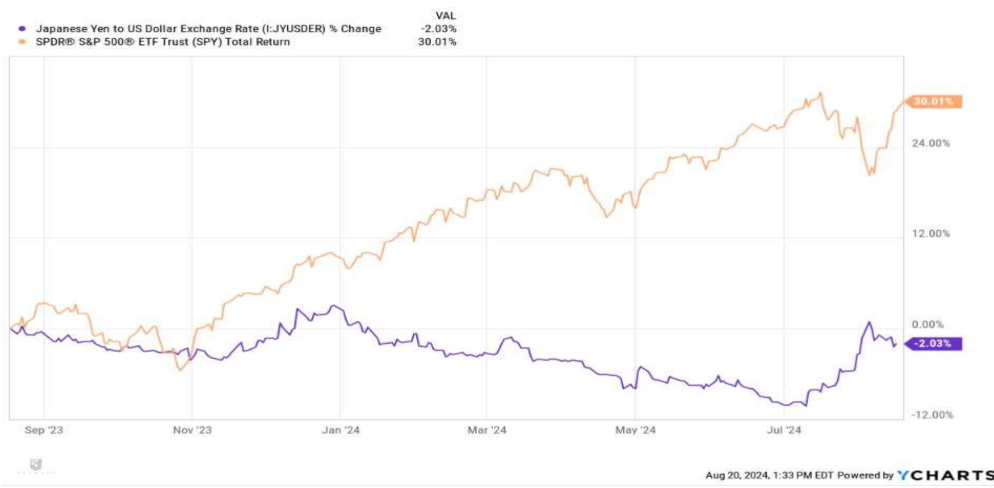
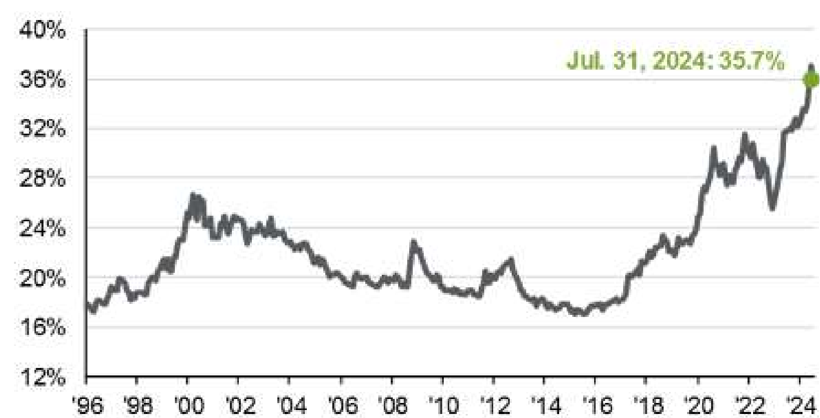
The Return of Volatility

Until the past few weeks, markets have seen well over a year of muted volatility. Earlier this month, volatility returned to the forefront as the BOJ unexpectedly raised rates, threatening traders who had exposure to the Japanese Yen carry trade. Institutional investors took advantage of low interest rates in Japan to borrow at advantageous rates to buy US equities. Japan's unexpected increase of borrowing rates caused a ripple effect whereby an increase in the strength of the Yen caused a decline in US equities as well as a spike in volatility as traders unwound leveraged positions.

Volatility is likely to persist through the end of the year as the path of the Fed's rate cuts, the continued unwinding of the carry trade and election-related uncertainty continue to jostle markets. The S&P 500 remains historically concentrated in a handful of large growth equities. If your portfolio looks like the S&P 500, you may be more exposed to volatility than a more diversified portfolio that includes international, small-cap and value equities.



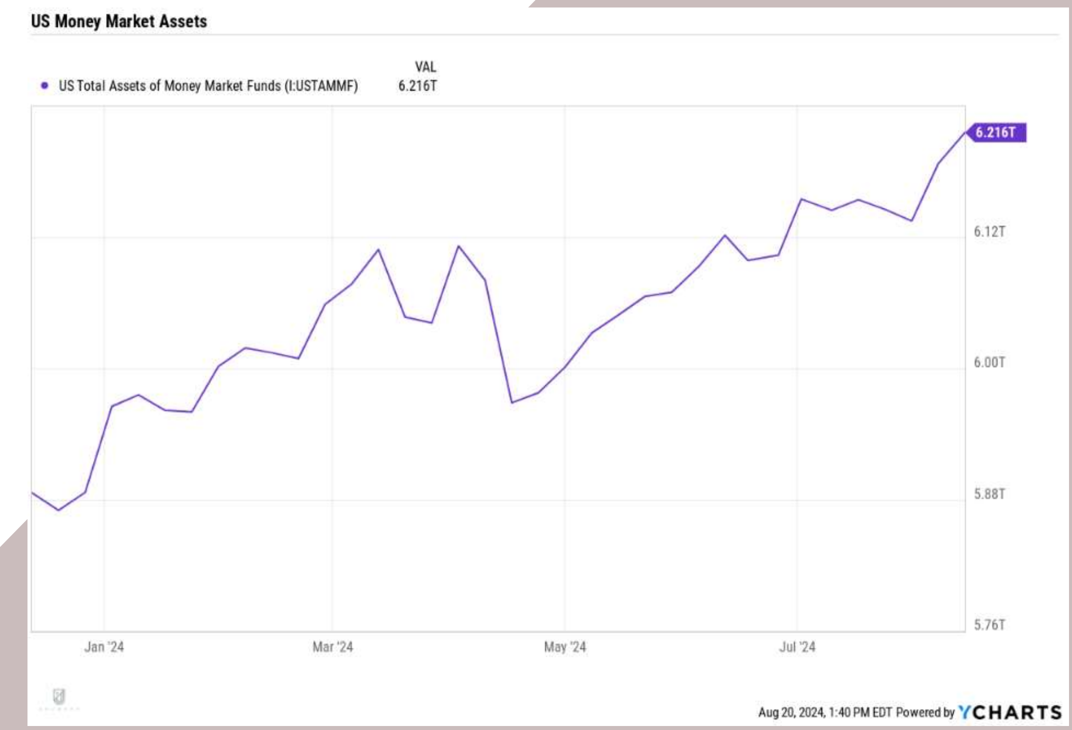


Source: JP Morgan

Inflation & The Fed

Inflation has down-shifted over the past few months, with CPI now below 3% YoY. Inflation remains nearly 50% above the Fed's target of 2% but the trajectory is encouraging. Shelter represented about 90% of the total inflation figure in July. However, shelter is one of the most lagging portions of CPI due to the measurement methodology. The outlook for housing affordability has a few bright spots. Zillow reported that in June, nearly 25% of home listings saw a price cut at some point in the listing cycle, the highest level since 2018. Mortgage rates are also at their lowest levels in over a year. However, inventories remain at about a third of the pre-COVID average and new housing starts sit at their lowest level since 2020. The constraints on supply will likely continue to pressure housing prices to the upside.

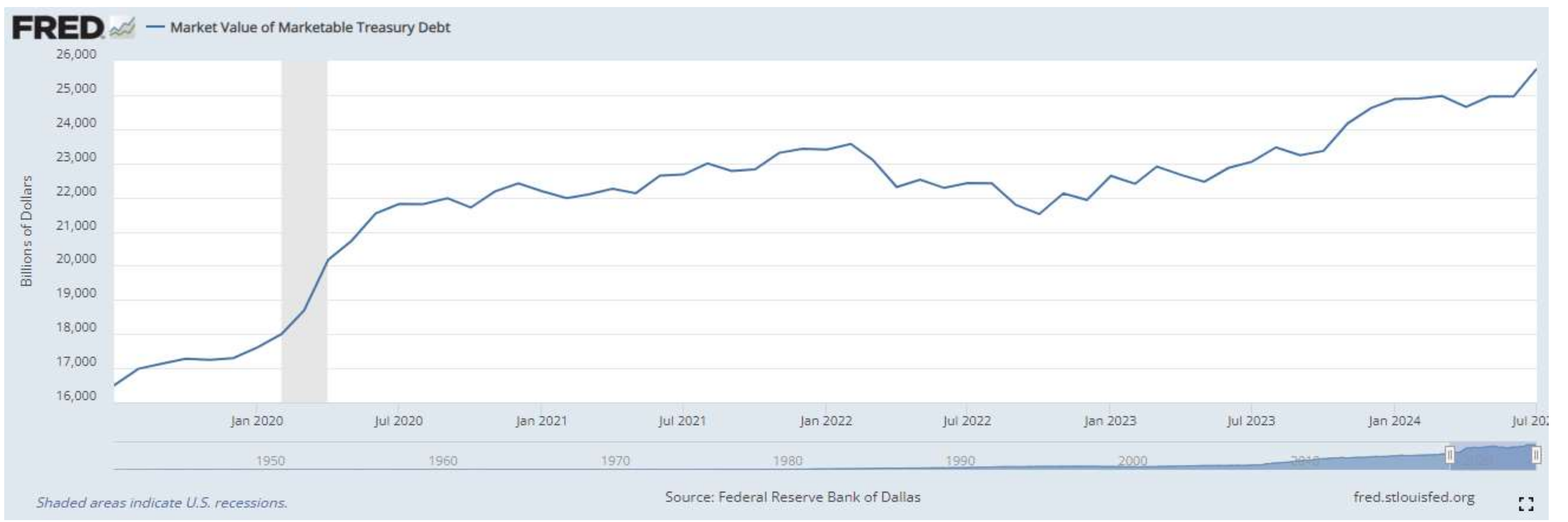
The Fed's tone has made a dovish shift over the past six months as inflationary concerns have lessened and employment has taken center stage. A rate cut at the September meeting is nearly assured based on the Fed Funds futures, with the market pricing in three 25 basis point rate cuts through the end of the year. When rate cuts begin, money market rates are likely to decline almost immediately, while the stimulative impacts (lower rates on loans) are likely to take a bit longer to impact borrowers. Money market funds in the US currently have assets of over $6 trillion.



While many investors are reactive, we encourage our clients to approach asset allocation proactively. Fixed income funds have seen substantial inflows this year as the possibility of rate cuts becomes more likely. Historically, there is a meaningful difference in returns if you extend duration before rate cuts occur as opposed to after the Fed begins to reduce rates.

The Deficit & Markets

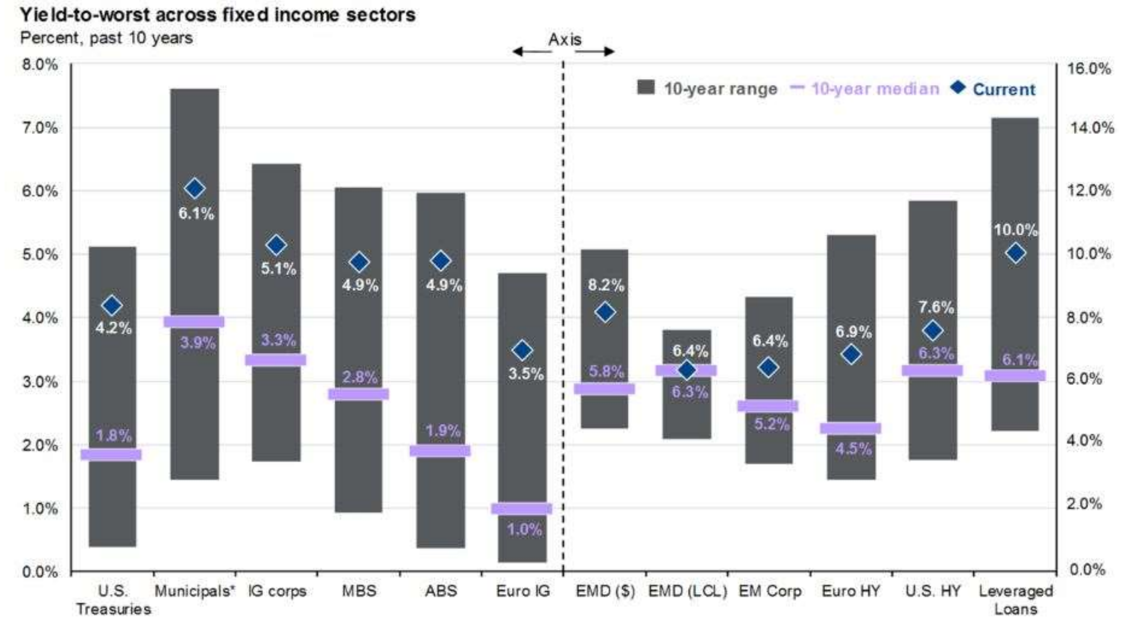
Market commentators have focused on the Fed's actions at the short end of the yield curve. The longer end of the curve is much more impactful for most borrowers. The current level of deficit spending is a unique experience in the US outside of wars and economic crises. The impact for investors and consumers could be substantial over time. One of the more significant impacts is that borrowing costs are unlikely to return to pre-COVID levels. While the Fed has significant control over the short end of the yield curve, Treasury issuance has a greater impact on long-term yields. These yields in turn influence long-term borrowing rates for consumers and businesses. While the possibility of default is remote, there are other consequences of larger deficits, including potentially slower long-term GDP growth and higher future taxes. On the current trajectory, the proportion of the Federal budget allocated to entitlement spending and debt service is expected to continue to expand. Those elements already represent about 60% of the Federal budget. That spending continues to pressure the portion of the budget allocated to items that bolster GDP growth such as innovation subsidies and infrastructure investment. High debt levels limit fiscal flexibility. While politicians have been averse to providing concrete solutions on debt reduction, one of the most probable is higher taxes. Though being tax-efficient should always play a role in portfolio construction, the importance of tax efficiency is likely to continue to expand. Higher long-term yields and slower growth may also shift the asset allocation requirements to meet your financial goals, with fixed income potentially playing a larger role in portfolio composition going forward.



Fixed Income

While interest rate volatility is likely to continue as the Fed's actions and political uncertainty buffet the yield curve, the opportunities available in fixed income appear attractive on a risk-adjusted basis. The opportunity set in fixed income should be evaluated relative to other asset classes. Although yields on cash-equivalents are enticing, the Fed could single-handedly reduce those yields, exposing investors to reinvestment risk. Higher rates have shifted the asset allocation dynamic. A few years ago, bonds provided little yield and served primarily to mute volatility, whereas they now offer real yields as well as an avenue for capital appreciation. This shift, in conjunction with lofty US equity valuations, has compressed the equity risk premium.

The two most frequently discussed outlooks for the US economy are a soft-landing or a recession. In a soft-landing scenario, the Fed would gradually reduce short-term rates, normalizing the yield curve over time. In a recession, the Fed may reduce rates more rapidly. In either scenario, investors would likely be drawn to fixed income for different reasons. In a soft landing, cash-heavy investors would be searching for yield and in a period of economic weakness, investors would be searching for a safe harbor. Either scenario would likely see fixed income yields decline and prices rise. While there will likely be volatility around the election and upcoming Fed meetings, current yields present an attractive opportunity on a risk adjusted basis. Furthermore, fixed income is likely to perform well under a variety of economic conditions.



Source: J.P. Morgan Asset Management. Data as of 7/31/2024.

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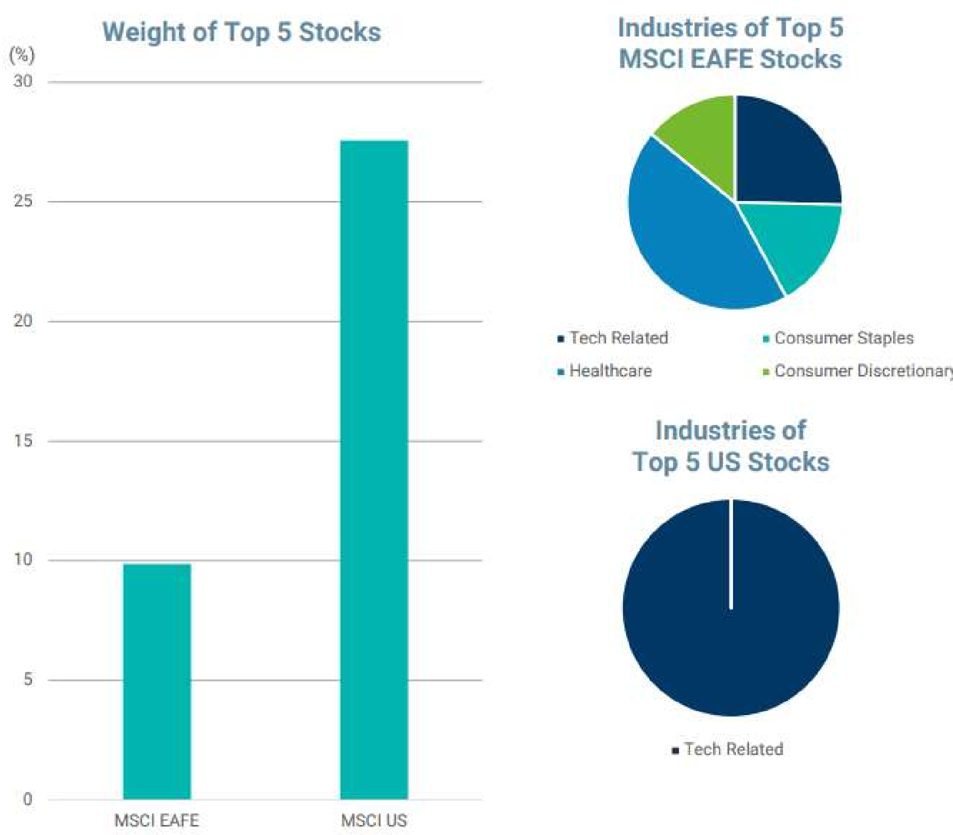
International Equities: Diversification & Growth

International equities offer appealing growth prospects, particularly in emerging markets. Emerging markets are forecast to have more rapid GDP growth than the US over the next five years and nearly all the global middle-class growth over the same period is expected to occur in Asia. While the AI boom has captured the imaginations of many investors, the AI revolution will likely be built upon a foundation of semiconductor production. Currently, only about 12% of semiconductor production occurs in the US, while over half occurs in China, Taiwan and Korea. One of the headwinds facing emerging markets has been the dominance of China over most indices and its recent economic stumbles. However, China's weight in the MSCI Emerging Markets Index has been reduced from around 40% a few years ago to closer to about 25%. India's weight in the same index has doubled over the past four years.

While US equities have become more concentrated in a handful of large companies over the past few years, international markets are more diversified on several levels. For example, the top 10 names in the MSCI ex. US Index represent only about 13% of the total index while the S&P 500 is more top-heavy. Ten names make up 36% of the S&P 500's market capitalization, many of which are in the same industry, a staggering level of concentration. We view international equities as a critical element of portfolio construction both due to diversification of risk as well as a broadening of the growth opportunity set.



Source: Lazard, FactSet, MSCI. Data as of 6/30/2024.

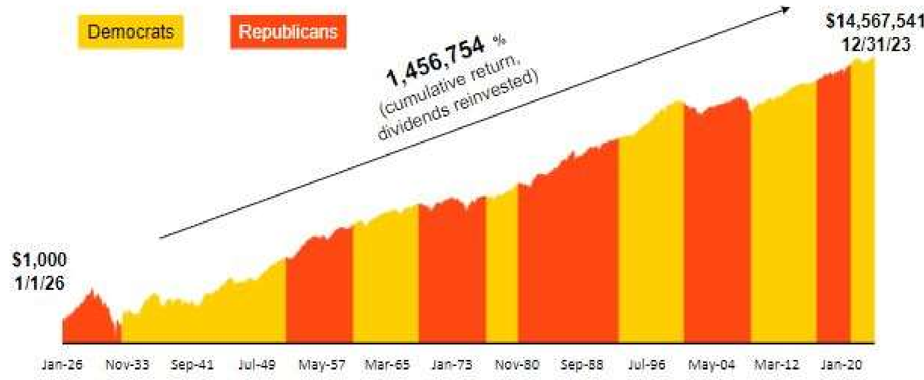
The Election & Markets

Elections can generate volatility, which can make otherwise rational market participants question their exposures. Which party is in the White House is historically irrelevant for US equity returns. Since 1937, the difference in US equity returns under Democratic and Republican Presidents is 0.3% annually. On the other hand, US equities perform notably better under divided government than under unified government. Perhaps the lack of action under a divided government reduces legislative risk in the market's eyes. From an investment perspective, returns over the next four years are unlikely to be driven by which party holds the White House.

The difficult part about trying to decipher the market impact of elections is in discerning which positions represent political posturing and which represent policies that will come to fruition in some form. Additional restrictions on trade and immigration would likely dampen growth prospects while potentially increasing inflationary risks. Tax hikes and worker-friendly policies such as a higher minimum wage and stronger union protections could squeeze profitability. Additionally, the pass-through effect of these policies also includes some inflationary risk. At the end of the day, the next few months are likely to test investor resolve as volatility re-emerges. When it does, it's critical to remember the long game and invest accordingly. US equity markets have been a consistent engine of returns regardless of political leadership. If you have cash sitting on the sidelines, volatility may present an opportunity.

Stocks have continued higher regardless of party holding the presidency

Growth of $1k, 1/1/26 – 12/31/23

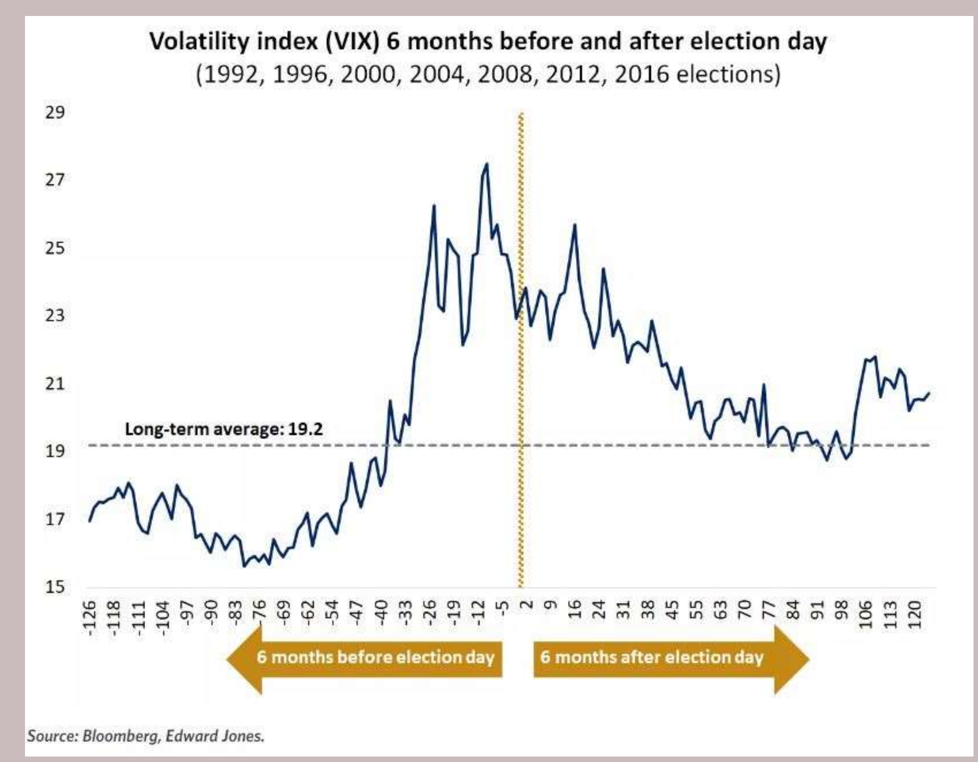


Source: Morningstar as of 12/31/23. Stock market represented by the S&P 500 Index from 1/1/70 to 9/30/23 and IA SBBI U.S. large cap stocks index from 1/1/26 to 1/1/70. **Past performance does not guarantee or indicate future results.** Index performance is for illustrative purposes only. You cannot invest directly in the index.

The Election

The long-term impact of election outcomes on fixed income markets is murky. While both candidates have relatively clear positions on most issues, it's important to focus on what's not being discussed: the Federal deficit. The trajectory of the deficit is unlikely to change drastically regardless of who sits in the White House. Treasury issuance is one of the more significant drivers of long-term yields.
Interest rate volatility is likely to continue through election day as market participants express their views on how the election outcome may impact the Federal fiscal situation. The largest near-term driver of rate volatility is likely to remain uncertainty surrounding the Fed's interest rate path.

In past election cycles, there has been a distinct trend where the VIX, a measure of expected US equity market volatility, tends to be elevated in the month prior to as well as the month after elections. In periods of elevated uncertainty, fixed income tends to outperform relative to equities. In the past three Presidential election years, fixed income has also healthily outperformed cash as an asset class. While it may feel comfortable to hold excess cash due to the expectation of volatility, history teaches us that cash underperforms fixed income and equities over long time horizons as well as in election years.



What's It All Mean

Recession Risk

The US consumer has weakened as the labor market has loosened and COVID-era stimulus reserves have dried up. While recessions have a negative connotation, they are insignificant from a long-term investment perspective. To reduce risk, ensure that you have adequate cash reserves and that your portfolio is sufficiently diversified. If your portfolio looks like the S&P 500, you may be more exposed to volatility than a more diversified portfolio that includes international, small-cap and value equities.

The Fed & Fixed Income

Progress on inflation has re-commenced after a period of stagnation. Housing remains the key to the residual above-target inflation. The Fed's tone has shifted in a more dovish direction. Markets anticipate three rate cuts from the Fed this year, beginning in September. Long-term rates are partially driven by dynamics in the Treasury market as well as the Fed's actions, with larger Treasury issuance likely to support higher long-term rates than we've seen in the recent past. Be conscious of the reinvestment risk in cash as the Fed reduces the Fed Funds rate.

International Equities

US equities have driven markets over the past decade, but we believe there are opportunities outside of this narrow neighborhood. In addition to more favorable valuations and a compelling growth narrative, international equities offer better diversification prospects than their more concentrated US counterparts.

The Election & Markets

The political party that holds the White House has little predictive power over equity returns. The predictable part of elections is that volatility is typically elevated in the months around election day. Volatility isn't a bad thing unless you anticipate drawing from your portfolio in the near-term. Maintaining adequate cash reserves is the best defense against over-reacting to volatility.

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Relevant Disclosures

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