JOURNEY

Journey Wealth

Mid-Quarterly Market Commentary

Q4 November 2024

Explore the world
your wealth & health
make possible.

Overview

- Investment Team
- Market Recap & Outlook
- Leading Topics
- Equities: Valuation & Concentration
- The Fed & Interest Rates
- Fixed Income
- Housing Supply
- The Election & Markets
- What It All Means

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

Now that the election is in the rear-view mirror, market participants can focus on the longer-term economic outlook. Looking at the domestic economic picture, it's difficult to see many red flags. Unemployment, inflation and GDP trends indicate that the Fed is successfully executing a so-called soft landing. However, no economic cycle lasts forever. With lofty equity valuations and an elevated level of concentration in domestic equity markets, it's critical to ensure that your portfolio is built with the future in mind and doesn't simply reflect recent return trends. On the fixed income front, the Fed has control over the short end of the yield curve and has telegraphed its intention to move rates modestly lower. There is much more uncertainty at the longer end of the curve, which is more subject to market dynamics and expectations of future inflation.

Looking Ahead

Fixed income markets are likely to remain volatile while the Fed's path crystallizes, and the fiscal impacts of the incoming administration's policies become clearer. However, higher yields insulate bond investors from interest rate risk and elevated equity valuations make bonds more attractive on a relative basis. Rate cuts and the potential for deregulation are likely to provide short-term catalysts for stocks. However, domestic equities seem to be priced for perfection. Given the level of US equity concentration, international equities provide a critical element of diversification. We advocate building portfolios to achieve your long-term goals as opposed to trying to react to the latest Fed meeting or election result. Please don't hesitate to reach out to your advisor to schedule time to discuss your financial plan, including your goals and planning assumptions.

See disclosures on final page of this document

Leading Topics

Elections & Markets

Historically, the party that controls the White House makes little difference for market returns. However, markets tend to rally immediately after elections, simply due to a reduction in uncertainty. The Trump victory is likely to provide some near-term tailwinds for equities with the hope of tax cuts and a reduced regulatory burden. The drivers of long-term equity returns are complex. Long-term growth and demographic trends are likely to be far more influential on future returns than any election outcome. The Trump win generated a strong response in fixed income markets. Yields jumped across the board, with those at the longer end increasing by a larger magnitude, resulting in yield curve steepening. A steeper curve is likely driven by a combination of factors, including anticipated higher Treasury issuance as well as potential inflationary concerns. For bond investors, these higher yields could represent an opportunity to lock in higher rates. However, investors should be cautious about over-extending duration. The trend of larger Treasury issuance seems unlikely to change any time soon, as there is little impetus for austerity from either side of the aisle, likely supporting or continuing to drive up longer-term interest rates.

Federal Reserve/Interest Rates

The Fed announced another rate cut in early November, reducing short-term rates by an additional 25 bps. Futures markets are currently pricing in one additional rate cut before the end of the year. The impact on savers has been immediate, with rates on CDs and money market instruments decreasing accordingly. However, long-term rates remain relatively unchanged or higher than they were before the Fed began easing. This is most apparent in mortgage rates, which have increased substantially over the past few months. Higher, more stubborn long-term interest rates are likely to crowd out corporate investment and consumer spending, potentially slowing long-term GDP growth.

Fixed Income

The fixed income rally in the third quarter likely signals that rates have peaked for the cycle. However, substantial government borrowing is likely to maintain a floor on interest rates. Yields across most fixed income categories remain well above their ten-year averages. While there may be less near-term appreciation potential in fixed income, the yield incentive remains. When considering the reinvestment risk present in cash and elevated equity valuations, we believe fixed income offers an attractive risk-adjusted opportunity.

Equities: Valuation & Concentration

For the past two years, domestic equity markets have marched upwards without significant bumps in the road. Since October of 2022, the S&P 500 has returned over 50% and the PE ratio of the index has increased by over 40%. While we've seen some broadening of equity performance over the past few quarters, US equity markets remain remarkably concentrated in a handful of companies. At the end of October, ten companies represented over 35% of the weight of the S&P 500 Index. The valuation of those ten companies is about 50% higher (as measured by the PE ratio) than the remainder of the Index. Given the degree of concentration and valuation of domestic equities, market prognosticators have indicated that future US equity returns may be muted relative to the recent past. We recommend maintaining healthy weights in domestic small-cap as well as international equities, which sport more modest valuations than the S&P 500 Index.

Equity Markets: Valuation & Concentration

US Equity markets have become dramatically more concentrated over the past decade. From 2014 to 2024, the weight of the ten largest companies in the S&P 500 has approximately doubled. Presently, more than a third of the weight of the S&P 500 is concentrated in ten companies, many of which are involved in similar business segments. Additionally, over the past few years, valuations at the larger end of the US stock market have expanded as investors have built in higher growth expectations. This is reflected in the S&P 500's shrinking risk premium. This can be approximated as the S&P 500's earnings yield (inverse of PE) minus the yield on the 10-year treasury. Normally, this is a positive number, rewarding investors for the elevated risk of holding risky assets with higher returns. However, that figure is currently near zero, indicating little risk-adjusted benefit to holding the S&P 500.

Is concentration a bad thing? The answer is that it depends. Historically, the S&P 500 has delivered above average returns when concentration is increasing and the opposite has proven true when concentration is decreasing. The concern with concentrated equity markets is the increased risk, particularly as many of the largest US companies are in similar sectors.

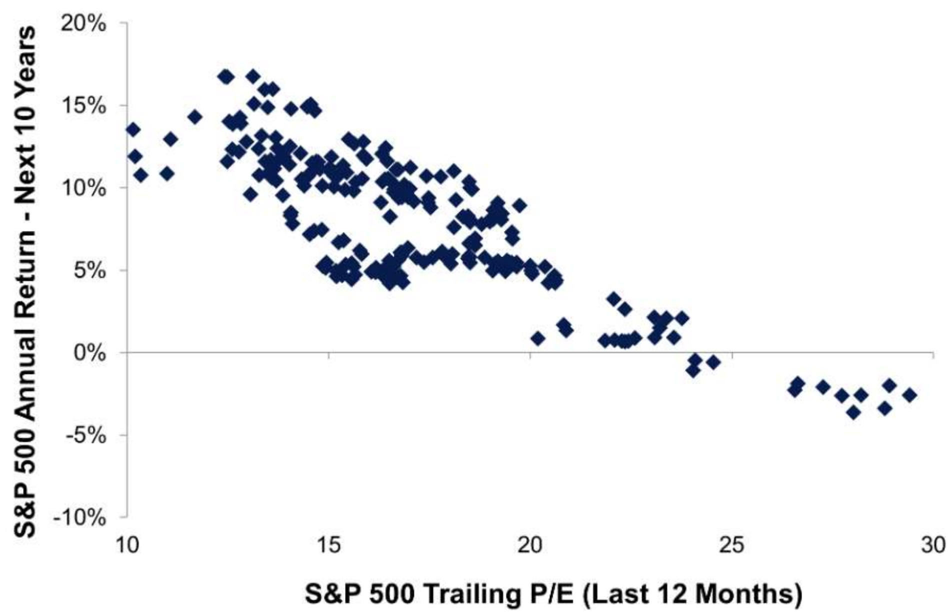
Source: JP Morgan

Equity Markets; Valuation & Concentration

There is not a strong correlation between the level of concentration in US equity markets and subsequent returns. Historically, current valuations are statistically significant predictors of long-term future performance. Presently, the trailing PE ratio of the S&P 500 sits just above 25. As the chart to the right indicates, 10-year subsequent returns with valuations that high have historically been negative, with a fairly strong correlation. Notably, there is essentially no predictive relationship between valuations and short-term (12 month) returns.

We aren't necessarily taking the position that US equities will experience negative returns over the next decade. However, we strongly believe in the prudence of diversification as well as the fact that valuations matter. In a world with higher equity valuations and elevated yields, the equity premium is likely to be smaller than in the past decade. As such, we anticipate that bonds will play a more substantial role in the composition of returns going forward. Furthermore, we believe that diversification within the equity sleeve is critical. There are several areas, including small cap US equities as well as international equities, where valuations are nearer to their historical averages.

P/E Ratios Have Historically Been Excellent Predictors of Ten-Year Performance

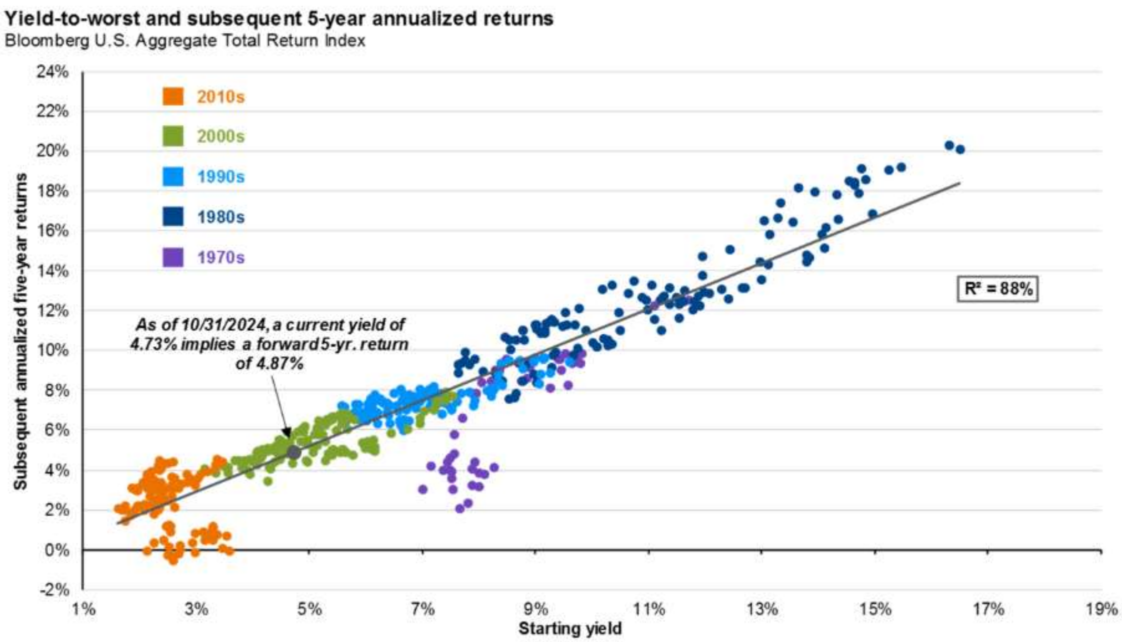


Source: LPL Financial

The Fed & Interest Rates

Whether due to the Fed's maneuvering or other macroeconomic factors, substantial progress has been made in the fight against inflation. Deflationary pressures in the goods & energy spaces have cooled inflation to levels near the Fed's 2% target (2.6% as of October). The Fed's messaging points to further easing. Futures markets are baking in somewhere around 0.25% to 0.50% of Fed Funds rate cuts between now and the end of the first quarter of 2025. What does that mean for investors?

The Fed's dovish actions are likely to have a near instant impact on deposit and money market rates. The impact on the remainder of the yield curve is harder to determine. The pace of Federal debt issuance is unlikely to slow in the near-term, likely placing a floor on longer-term interest rates. Not only are longer-term rates likely to remain elevated, they're also likely to continue the recent trend of volatility. Interest rate volatility is influenced by supply/demand dynamics as well as investors' future inflation expectations.



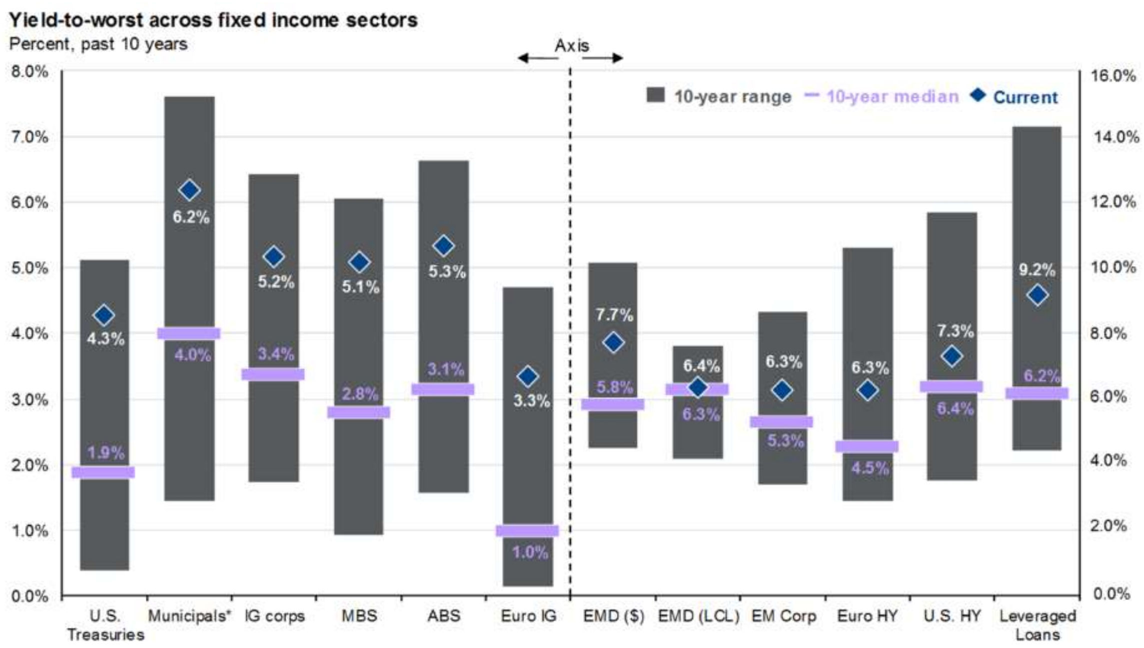
Source: JP Morgan

While many investors are reactive, we encourage our clients to approach asset allocation proactively. While there may not be as much of a capital gain opportunity present from extending duration as there was earlier this year, the case for locking in higher rates with excess cash is compelling. While we don't know where longer-term rates will go, we have a reasonable indication of the Fed's intentions at the far more controllable short end of the yield curve.

Fixed Income

While interest rate volatility is likely to continue as the market digests the Fed's actions and the interest rate implications of the incoming administration's policies, the opportunities available in fixed income appear attractive on a relative basis.
Although yields on cash-equivalents are enticing, excess cash holdings expose investors to reinvestment risk. Additionally, since the Fed has begun cutting rates, there is no longer a yield trade-down to holding core fixed income relative to money market instruments. 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 meaningful yields as well as an avenue for capital appreciation. This shift, in conjunction with lofty US equity valuations, has meaningfully compressed the domestic equity risk premium.

The two most discussed outlooks for the US economy are a soft-landing or a recession, although recessionary concerns have recently taken a back seat. In a soft-landing scenario, the Fed would likely continue to gradually reduce short-term rates, normalizing the yield curve over time. In a recession, the Fed would likely reduce rates 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 recession, investors would be searching for a safe harbor. Either scenario would likely see fixed income yields decline and prices rise. All said, fixed income is positioned to perform well under a variety of economic conditions. Risks to the fixed income outlook include an inflationary spike or a jump in Federal deficit spending.

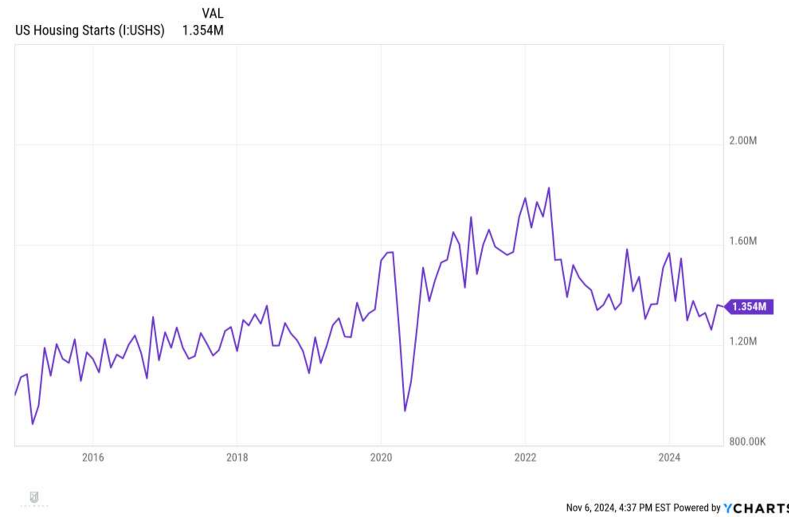


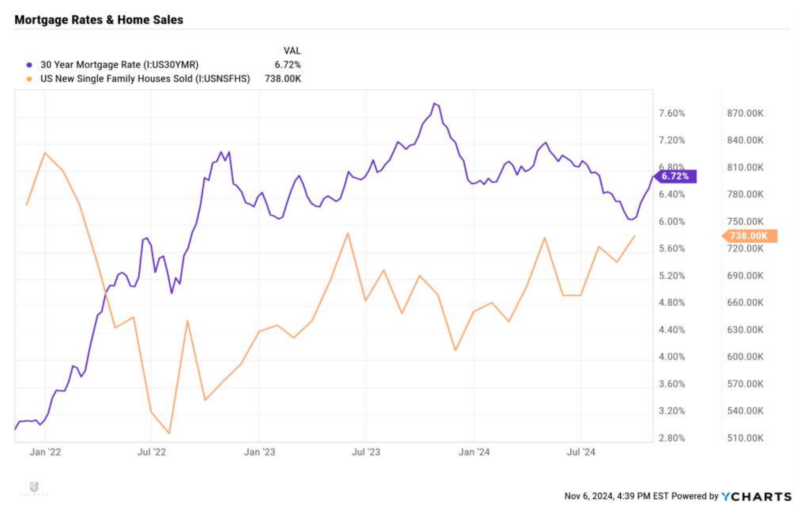
Source: J.P. Morgan Asset Management. Data as of 10/31/2024.
*Municipal yields are on a tax-equivalent basis assuming the highest US Federal tax bracket.

Housing: Supply Issues To Continue

A few months removed from the Fed's first rate cut, the myth that rate cuts will directly translate to lower mortgage rates appears to have been disproven. Mortgage rates have trended meaningfully higher over the past few months while short-term rates have fallen. Lately, mortgage rates have had little impact on housing market activity. Mortgage rates fell dramatically from their peak late last year through the end of the third quarter (from nearly 8% to close to 6%) and US existing home sales have remained essentially flat during that period. Lower short-term rates are unlikely to be a silver bullet to unlock housing supply.

The other issue driving the housing supply shortage is simple: new home construction isn't keeping pace with demand. On the supply side, the issue began long before COVID but was exacerbated by it's second order effects. Higher materials costs and labor shortages impacted homebuilders' ability to keep up with demand, while record low levels of home affordability tempered builders' appetite to over-commit to new supply. From a demographic perspective, longer life expectancies are also contributing to the housing supply problem. Baby Boomers own a larger portion of the US housing supply than any other generation. Boomers are currently between the ages of 60 and 78. The life expectancy of someone who is 60 in the US is currently 82 for men and 85 for women. As such, that demographic is holding onto their homes longer. Millennials, currently the second largest generation in the US, are in their prime home-buying years. These demographic trends, in conjunction with sustained higher mortgage rates and low levels of housing starts, are likely to sustain tightness in the housing market for the foreseeable future.

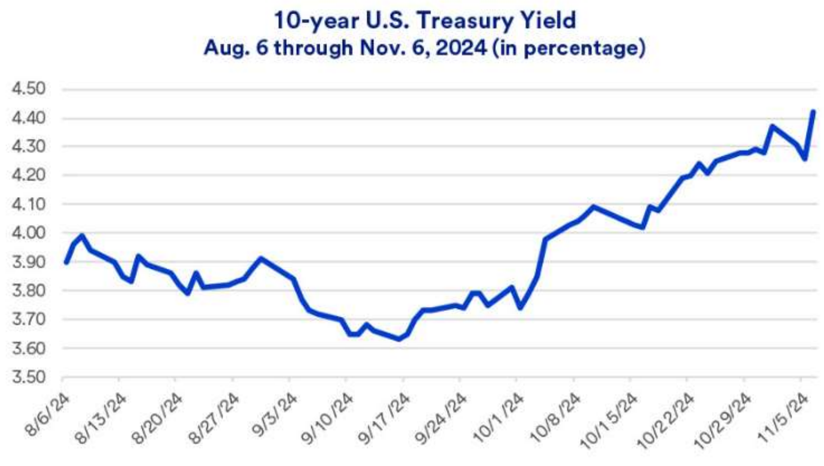




The Election & Markets: Part 1

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 average US equity returns under Democratic and Republican Presidents is about 0.3% annually. However, there are real market implications in the short term. The fact that the election was decided quickly and without a protracted period of uncertainty is a tailwind for equities. Equity markets dislike uncertainty and now the largest variable markets have faced this year is behind us.

The longer-term impact on equity markets is complex. While the prospect of lower taxes and a reduced regulatory burden are favorable for most businesses, a portion of that benefit is likely baked into elevated asset prices. At a sector level, the story is more nuanced. For example, de-regulation in the energy space could boost oil & gas stocks. However, if an increase in drilling reduces oil prices substantially, that could prove to be a double-edged sword. Some market segments that stand to benefit from the election outcome include financials and small-cap equities. Financials stand to benefit in two ways: deregulation and a steeper yield curve. The incoming administration has been light on specifics when it comes to financial deregulation. However, investors can be confident that with a Republican legislature and White House, there will be little impetus for additional restrictions on financial institutions. The steepening yield curve is likely to provide a tangible benefit to banking institutions. The curve had been steepening for about a year before the Fed began to cut rates. What's interesting is the Trump victory's impact on the longer end of the curve. The bond market's reaction to the election outcome indicates that market participants believe the incoming administration's policy agenda could prove inflationary as well as increase the pace of Treasury issuance. If rates remain higher for longer, while the Fed reduces short-term rates, that could prove to be a catalyst for banks. These institutions borrow based on short-term rates (the rates they pay depositors) and lend at long-term rates. A widening gap between the two is likely to be constructive for net interest income. Small-cap equities rallied substantially after the election results were known. While small-cap valuations are more reasonable than their larger counterparts, an environment with elevated rates may place a ceiling on more interest-rate sensitive equities. A business-friendly political environment could spur M&A activity, which is generally favorable for small-cap equities.

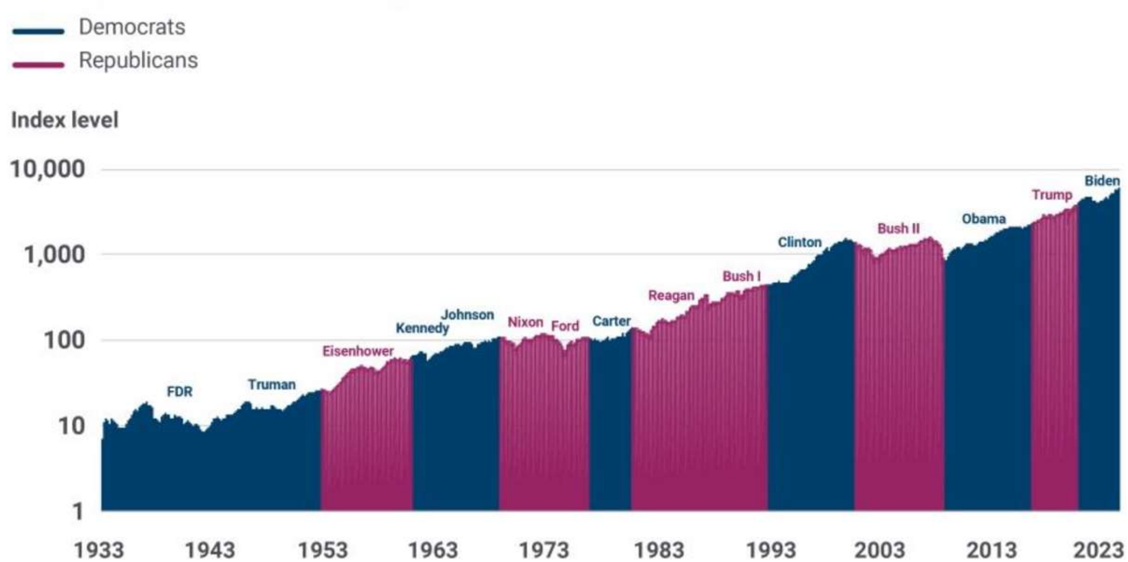


Source: U.S. Department of the Treasury, as of November 6, 2024.

The Election & Markets: Part 2

At the end of the day, politics are just one of many factors that drive markets. There are many other dynamics that will impact market performance over the next four years, many of which are unforeseeable. A recent example is the energy sector. Based solely on policy, you'd expect the energy sector to have performed better in Trump's first term than during the Biden presidency. However, you'd be incorrect. The S&P 500's Energy sector performed significantly better under Biden than Trump. This was not necessarily due to policy choices, but because of unforeseeable events, namely the COVID pandemic, which crushed energy demand at the end of the first Trump term. This isn't meant to lambaste the policies of either of our last two presidents, but rather an exercise in illustrating how difficult it is to forecast market performance based on the composition of our elected institutions. Markets are machines that process a vast amount of data. It's a foolish exercise to read too deeply into the future implications of one data point when making investment decisions. What is of critical importance for our clients is the financial planning consequences of the election, which are likely to be substantial. If the 2017 tax cuts are extended, there are far reaching estate planning consequences. The best advisors don't add value by predicting the next hot asset class or picking the next best mutual fund, but by developing an understanding of each client's unique goals and financial situation and providing tailored solutions to bring those two closer together.

The S&P 500 Index and presidencies



Sources: Bloomberg and American Enterprise Investment Services. Data through Nov. 6, 2024. These figures are shown for illustrative purposes only, are not guaranteed and do not reflect any actual investment or investment strategy. **Past performance is not a guarantee of future results**. An index is a statistical composite that is not managed. It is not possible to invest directly in an index.

What's It All Mean

Equity Valuations

US equity valuations and concentration have increased dramatically in recent years. While no one has a crystal ball, investors shouldn't plan on future returns that mirror those of the past decade. If your portfolio looks like the S&P 500, you may be more exposed to volatility than a more diversified portfolio that includes international and small-cap equities. These segments also sport valuations that are nearer to their historical averages than those of US large cap equities.

The Fed & Fixed Income

Inflation is very close to the Fed's target and the easing cycle has officially begun. The market now expects one additional rate cut this year as well as one in the first quarter of 2025. Long-term rates are partially driven by dynamics in the Treasury market as well as inflation expectations, 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.

Housing Supply

While many anticipated that rate cuts would prove to be a silver bullet for unlocking housing supply, that hasn't been the case. Mortgage rates have been driven more by future Treasury issuance expectations than by the Fed's actions. Elevated mortgage rates, in conjunction with higher construction costs, have restricted new housing starts. The other factor at play is demographic trends. With Baby Boomers holding onto their homes longer and Millennials in their peak homebuying years, housing supply is likely to remain tight for the foreseeable future, regardless of the Fed's actions.

The Election & Markets

The political party that holds the White House has little predictive power over equity returns. In the near term, reduced uncertainty and a business-friendly incoming administration are likely to be tailwinds for equities. However, markets are machines that process a vast amount of data. It's a foolish exercise to read too deeply into the future implications of one data point when making investment decisions. What is of critical importance are the financial planning consequences of the election (tax & estate planning), which are likely to be substantial.

See disclosures on final page of this document

JOURNEY

Relevant Disclosures