October 24, 2024

3Q 2024: A Broadening Rally with a Few Bumps Along the Way

The third quarter brought a noticeable shift in market dynamics. Where the first half of 2024 was defined by explosive gains in technology shares, 3Q was more subdued, with leadership broadening to a wider range of sectors. As interest rates were on the decline for most of the quarter, equity traders flocked to interest-rate-sensitive equities in the Utilities and REITs sectors, which posted total returns of 19.4% and 17.0% respectively. Technology, on the other hand, was the second-worst performing sector, eking out a 1.6% gain, while Energy was the only sector to post a negative return (-2.3%). Meanwhile, value stocks (as measured by the Russell 1000 Value Index) returned 9.4%, almost 3x as much as growth equities (as measured by the Russell 1000 Growth Index).

As far as the major indices, the Dow Jones Industrial Average led the pack with an 8.7% gain, followed by the S&P 500, which advanced by 5.9%, and the Nasdaq trailed with a modest 2.7% rise (although as of the end of 3Q 2024, it was up 21.8% for the year). Whether this is an actual change in leadership or just a temporary rotation out of mega cap technology shares remains to be seen. We remain skeptical but cautiously optimistic that the rotation has legs.

What's Behind the Gains?

It's impossible to pinpoint exactly what drives the stock market in any given quarter, but a few key factors seem to have been at play: cooling inflation, a dovish turn by the Fed, and a growing belief that maybe, just maybe, the economy can achieve a soft landing. A half-point Fed funds rate cut certainly helped, and with more reductions forecast before year end, investors welcomed the prospect of cheaper money.

However, this rally could be derailed quickly. Any one of a half-dozen factors—election-year surprises, lofty valuations, growing geopolitical tensions, or an unexpected shock (what former Defense Secretary Donald Rumsfeld referred to as "unknown unknowns")—could stop the market's upward trajectory. Keeping a small amount of cash on the sidelines might not be the worst idea, with the plan of purchasing stocks at more attractive valuations in the event of future market turbulence (not to mention that money market funds remain attractive with yields of up to 5%).

Not All About AI Anymore

If the first half of 2024 was dominated by the excitement surrounding AI, 3Q was a reality check, with investors asking, and rightly so, whether AI spending will actually translate into profits. Alphabet and Amazon were prime examples. Alphabet's capital expenditures nearly doubled, making some investors uneasy, and Amazon's sales forecast fell short even as it continued to ramp up AI spending. As a result, both stocks slid—Alphabet down 8.9% and Amazon off 3.6% for the quarter.

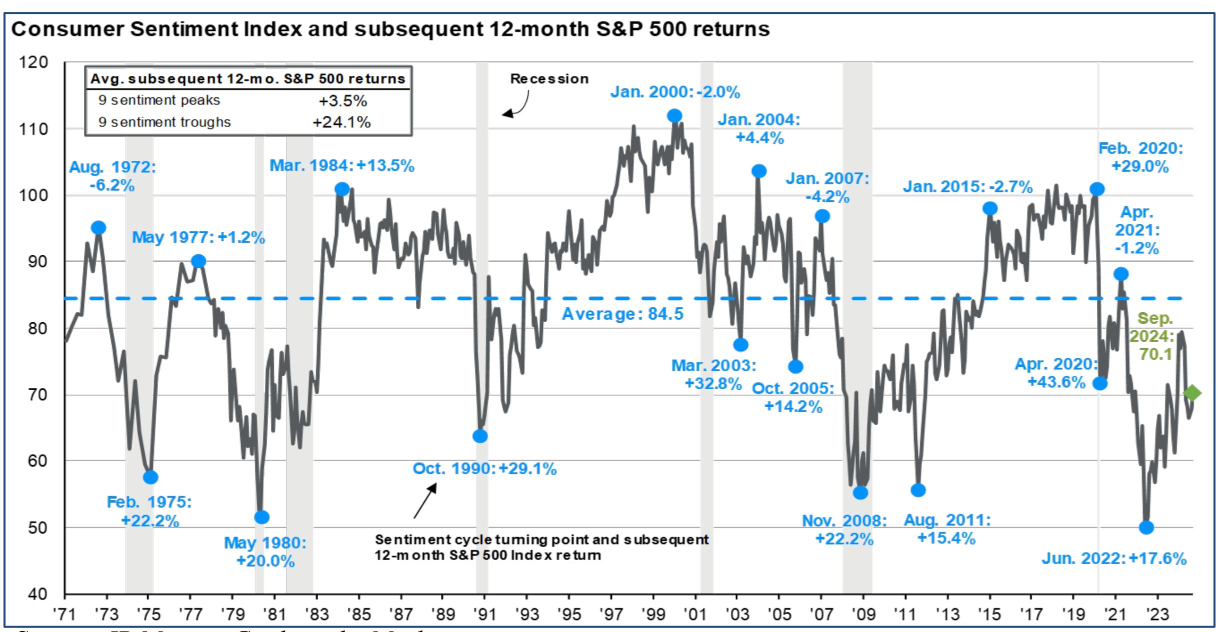
That's not to say that the market has lost faith in AI's potential. Far from it. But there is growing recognition that turning potential into profits will take time—and, likely, quite a bit more investment.

A Broader Rally Takes Shape

As the AI frenzy moderated, investors went hunting for value in more traditional areas, leading to a broader rally. Utilities stole the show, jumping 18% as falling bond yields made their dividends look more appealing and an expected increase in energy demand from AI data centers fueling higher earnings expectations. Real estate followed closely, up 16%, and Industrials joined the party with an 11% gain. Even regional banks, which had been struggling, perked up after a challenging 2023, with the KBW Bank Index climbing over 16% for the 3rd quarter.

Consumer Confidence and Market Cycles

Historically, high levels of consumer sentiment have tended to precede weaker stock market returns, with the average 12-month S&P 500 gain after sentiment peaks just +3.5%. Undue optimism among investors often leads to overvaluation or complacency, setting the stage for corrections. On the flip side, low sentiment (which in turn leads to the undervaluation of stocks creating fertile opportunity for future outsized gains) has historically marked excellent buying opportunities, with 12-month returns averaging +24.1% after sentiment troughs. As of September 2024, the Consumer Sentiment Index stands at 70.1—below the long-term average of 84.5 but well off the June 2022 lows of 50. We're in the early to middle stages (we hope) of a sentiment recovery: sentiment isn't euphoric, but neither is it deeply pessimistic. Even if the easy gains resulting from extreme fear are behind us, the current environment can still present select opportunities, especially if sentiment continues to improve (supporting near-term equity inflows) and economic conditions stabilize.



Source: JP Morgan Guide to the Markets

A Small-Cap Rally

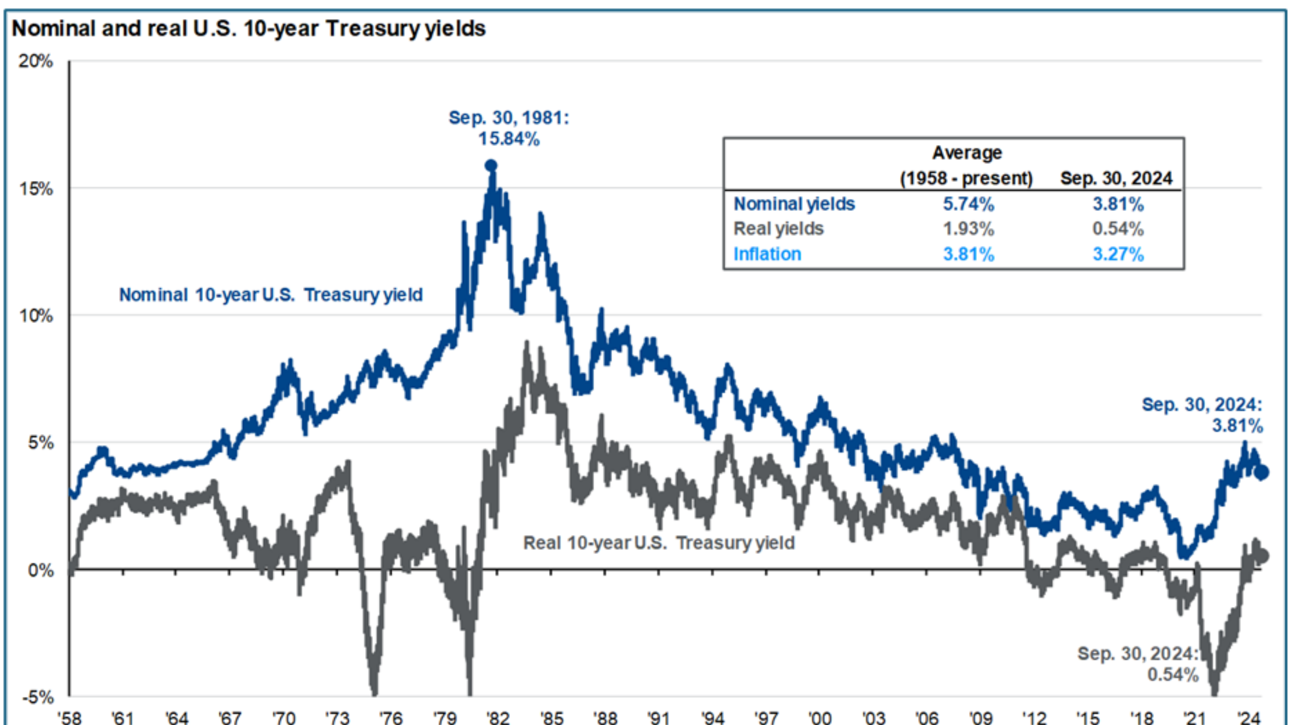
The Russell 2000 started the year out slow (up just 1.7% through 2Q) but then advanced 9.3% for 3Q. Notably small-cap stocks, as measured by the Russell 2000, would have been negative for the first half of 2024 had they not been buoyed by the staggering 188% gain in Super Micro Computer. However, Super Micro (no longer a small-cap company after the massive increase in its market capitalization) fell back to earth this quarter (down almost 50%) right after leaving the Russell 2000! (Even so, the stock is still up ~46% for the year through Q3.) Despite the stronger showing in 3Q, small-caps are still ~7% below their all-time highs.

In an arguably overextended market, we believe that some of the best bargains can still be found in this segment. What's more, any further lowering of interest rates should be a tailwind for smaller companies, which often have higher levels of floating-rate debt.

Bonds and Yields: A Turning Point?

The 10-year Treasury yield dipped to 3.8%, down from 4.3% at the end of June—a sharp reversal after two consecutive quarters of rising yields. In even bigger news, the yield curve, which had been inverted since mid-2022, finally turned positive in September.

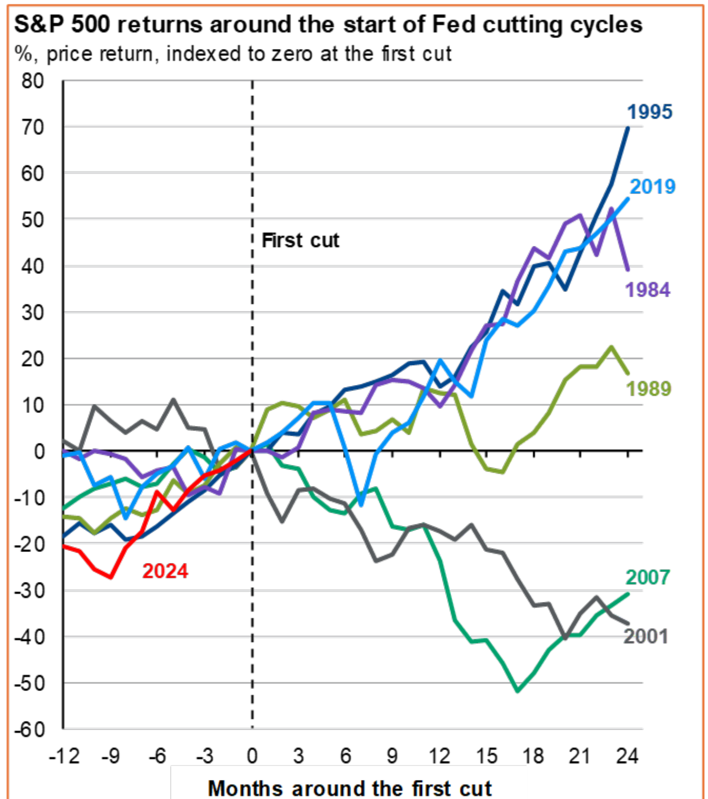
As we have repeatedly noted, regardless of whether the Fed reduces interest rates twice this year or just once (or not at all), historical context is essential. At 3.8% and 0.5% (as of September 30, 2024), nominal and real yields are still low by historical standards. The economy can function—and has done so before—with rates at these levels or even higher. If today's figures seem elevated, they seem so only relative to recent history.



Source: JP Morgan Guide to the Markets

How Markets Have Historically Responded to Fed Rate-Cutting Cycles

Historically, S&P 500 performance around Fed rate cuts has followed two distinct patterns: either markets rally sharply in response to easier monetary policy, or they struggle if cuts are seen as a response to an impending slowdown. Cycles like those of 1984 and 1995 saw the market gain 40%-70% over 24 months as rate cuts extended economic expansions. By contrast, 2001 and 2007 brought downturns when rate cuts weren't enough to offset wider economic problems like the dot-com crash and the global financial crisis.



Source: JP Morgan Guide to the Markets

In 2024, the market's trajectory leading into potential Fed cuts has been stronger than in cycles such as 2007, reflecting resilient economic data and cautious optimism. However, investors are still weighing the possibility that rate cuts could signal economic trouble on the horizon, much as it did in 2001. The question now is whether this cutting cycle will resemble 2019 or 1995—when Fed easing stabilized markets—or whether further economic weakness could derail gains.

The takeaway? If history is any guide, the 12-24 months after a first cut can be volatile but can also be rewarding if the economy stays intact. Investors should be prepared for near-term uncertainty while staying alert to opportunities if sentiment improves and rate cuts extend the market rally into 2025.

Can the Rally Continue?

The S&P 500's 22.0% year-to-date gain in 2024 marks its best first three quarters since 1997, when the fervor for technology stocks seemed to move in only one direction: up. For those skeptical of today's rally, it's worth remembering that from 1998 to March 24, 2000 (the peak of the dot-com bubble), the S&P 500 gained another ~62%. However, following that run-up, the market lost ~49% from the peak and pretty much came back to 1997 levels in 2002.

While bearish investors who were skeptical of the rally in 1997 and anticipated a reversal were *eventually* proven correct, timing the market proved to be an immense challenge, especially for professional investors. Retail investors can sit out market exuberance if they can get over their fear of missing out (easier said than done!), but professional money managers have no such luxury, with clients demanding short-term results (and to be fully invested) even during speculative bubbles.

Take Jean-Marie Eveillard, a legendary value-focused investor who ran a mutual fund during that period: when his strategy underperformed during the dot-com boom, he suffered a 70% loss in assets from client redemptions. As Eveillard put it, "After one year, your shareholders are upset. After two years, they're furious. After three years, they're gone." His experience highlights the pressures faced by professional investors who attempt to remain cautious while markets soar on speculative enthusiasm.

This historical perspective serves as a reminder that staying disciplined is crucial but that navigating a market driven by momentum and hype can be just as challenging for professionals as for individual investors, if not more so.

Dot-Com Era or Nifty Fifty Déjà Vu?

How should today's market, with its high valuations and concentrated gains in a handful of large-cap stocks, be interpreted through the lens of stock market history? It shares some similarities with the tech boom of the 1990s (though valuations today remain lower than those seen at the height of the dot-com bubble), but there are also meaningful parallels between today's market and the late 1960s and early 1970s, when the "Nifty Fifty" stocks dominated. These companies considered "one-decision stocks," were viewed as so high-quality, with such potential for growth, that investors were encouraged to buy and hold them indefinitely, regardless of price. Similarly, today's market leaders, such as Meta and Amazon, are high-quality businesses with strong growth prospects. But as we often stress, a great company is not always a great investment—valuation is just as important (perhaps even more important) when selecting investments.

There are also key differences between today's market and the Nifty Fifty era. According to Andrew Bary of *Barron's*, companies like Eastman Kodak, Avon Products, and Polaroid boasted P/E ratios as high as 95x earnings—far richer valuations than those of today's tech leaders. This historical comparison highlights the importance of being valuation-sensitive, even when business quality is exceptional. While today's tech giants may seem like the safest bets, history shows that valuation discipline matters—even with the best companies. What's more, the Nifty Fifty did not dominate market indices as today's mega-cap stocks do. In the 1970s, major indexes were still weighted toward industrials and old-line businesses like General Motors and oil companies, providing more diversification than the tech-heavy indices we see today.

Patience Pays Off

We've said it before, and we'll say it again: staying the course is one of the best ways to tilt the odds of long-term investment success in your favor. According to JP Morgan's research, since 1950, there has never been a 20-year period in U.S. stock market history during which investors averaged less than 6% annual returns. While past performance isn't a guarantee of future results, history shows that the longer you stay invested, the better your chances of earning satisfactory returns.

In times of volatility, it's easy to get caught up in the noise and second-guess decisions. But the market rewards patience. Even during challenging periods, those who hold tight and focus on the long-term horizon are often in the best position to benefit when markets rebound. The lesson? Time is your ally in investing—give it enough, and the odds shift in your favor.

Best regards,

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