A Broadening Rally

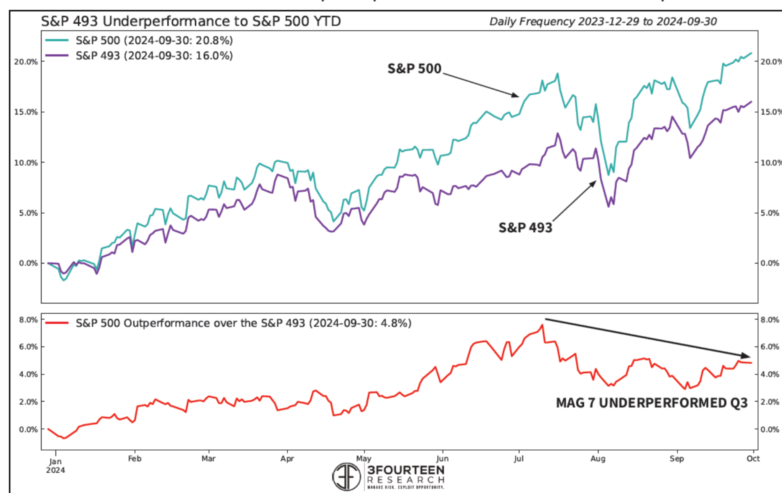
"A pessimist complains about the noise when opportunity knocks" – **Oscar Wilde**

Despite wars, hurricanes and a contentious election, the market continues its historic rise, consistently hovering around all-time highs. While technology and AI dominated the first half of the year, the third quarter saw a broadening rally with many of the other sectors outperforming Technology and the overall S&P 500. The broad market was up 5.5% in the 3rd quarter and is now up just over 20% for the year, marking the best performance through three quarters since 1997.

Perhaps the performance was in anticipation of the Fed finally cutting rates, exceeding expectations with a 0.50% cut in September. Bonds performed particularly well for the quarter and were up 5.87%. This was driven by a decline in overall rates as the 10 Year Treasury went from 4.5% to 3.66% at the low point for the quarter. The decline in rates is a big positive for all types of loans, particularly mortgages. In the sections below, we discuss the quarter in detail, provide a year-end outlook and explore projections for 2025 and beyond.

Q3 Recap

In our last newsletter we discussed the narrow market leadership, in particular Nvidia, and its implications for future market performance. Historically, narrow leadership is not necessarily a good thing and can often end in a bubble. We concluded the need for broader market participation to sustain the positive momentum.



For the quarter Nvidia was down slightly but dropped by 20% in August and the Magnificent 7 were essentially flat. Nevertheless, the rest of the market picked up the pace and the other 493 companies in the S&P 500

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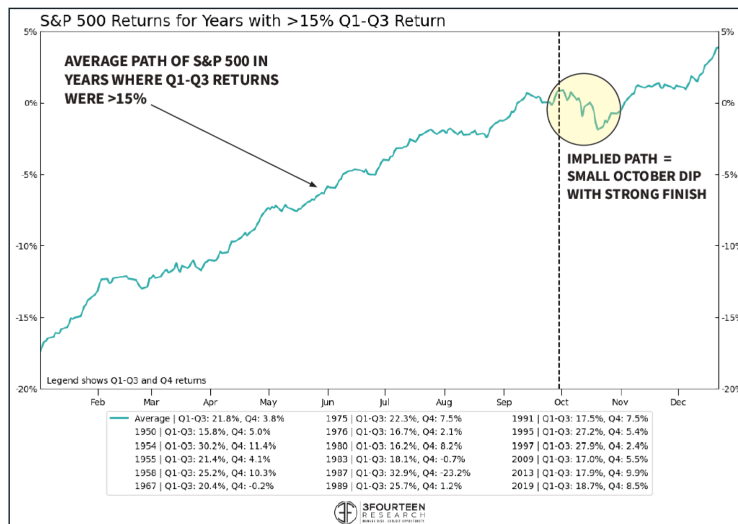
were up over 8%. This was a great outcome and paints a good picture for the remainder of the year and the next 12 months.

Although there were many headlines in the quarter, the most important was the Fed's first rate cut. Going into September, there was uncertainty about whether the Fed would cut rates by 0.25% or 0.50%. Although inflation numbers have generally trended lower, rising unemployment influenced the Fed's decision. In the end, they went with the larger cut and most financial assets responded favorably.

After two years, the inverted yield curve has finally normalized, and longer-term yields are now back above shorter-term yields. Although the normalization of the yield curve is often associated with a recession, this time appears to be different, and the majority of professionals don't see a recession in the next 18 months. Goldman Sachs recently lowered the recession probability to 15%, which is in line with the historical average. So, it seems like the most likely outcome may indeed be a "soft landing."

2nd Half Outlook

Although there are many potential exogenous events that could occur, such as an all-out war in the Middle East, current conditions generally look solid. Historically when returns have been greater than 15% through the first 3 quarters of the year, there tends to be follow through. However, some choppiness is to be expected and when looking at similar years, that choppiness tends to occur in October *(see below)*. These tendencies also line up well with election years, which also experience heightened volatility before the outcome of the elections are known and then stabilize as there is more certainty around the results.



We've discussed analysts' price targets several times this year. In January, the average expected return for 2024 was just 1%. Now, three quarters into the year, those targets have still not caught up to current market pricing. This suggests that the targets will continue to be revised higher and a chase into year-end is very possible. Once again, analysts have missed the mark, highlighting the importance of a well-defined investment game plan.

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2025 and Beyond

Economic cycles have been studied throughout modern history and the boom-and-bust cycles tend to repeat themselves. However, coming out of the financial crisis (2007-2009), something changed dramatically and that was interest rates, which stayed historically low for a decade, despite a good economic backdrop. With COVID in 2020, rates were pushed down to zero and the government poured massive amounts of money into the pandemic. The uncharacteristically low interest rates and the massive stimulus have completely distorted the normal economic cycle.

A couple of years ago, we highlighted the potential for rolling recessions and that seems to have played out across the various sectors of the economy. Initially, massive labor and supply shortages drove the highest inflation in decades. The inflation led to historic interest rate increases and caused stock and bond market declines in 2022, led by deep drops in Technology stocks (Recession 1). Prolonged higher interest rates have now caused mini recessions throughout the real estate market (residential and commercial). In fact, residential home sales are lower than any point, including the financial crisis (Recession 2). In addition, the lower end consumer is now pinched as can be seen through rising credit card delinquencies and anemic sales in both new cars and many other durable goods (Recession 3). Moving forward, we expect diversification to be as important as ever.

Stocks

With interest rates normalizing, stock valuations and earnings may become more important. Over the past 18 months, markets have discounted the importance of earnings in the technology sector as companies spent massively on AI. However, in the 3rd quarter, companies such as Google were scrutinized as the AI spending has not yet connected to the bottom line.

Overall earnings have been relatively flat over the past 3 years, but they are projected to rise by 15% in 2025, which is part of the reason stocks have performed so well this year. This level of earnings growth is significant, so markets could be disappointed if it doesn't materialize.

Currently, the market is valued at 21.5x 2025 earnings, compared to a 30-year average of 16.7x. This suggests the market might be overvalued. However, the 493 companies we mentioned earlier have a slightly more reasonable valuation of 19.6x. While valuations aren't very predictive of short-term returns, they become more reliable over time. A chart illustrating market peaks and troughs shows that January 2022 had a valuation strikingly similar to today's levels. Again, valuations are important, but not necessarily predictive. The key difference between 2022 and now is that we were at the beginning of the rate hike cycle vs. the end and the overall economy looks to be very stable as evidenced by the soft-landing forecasts.

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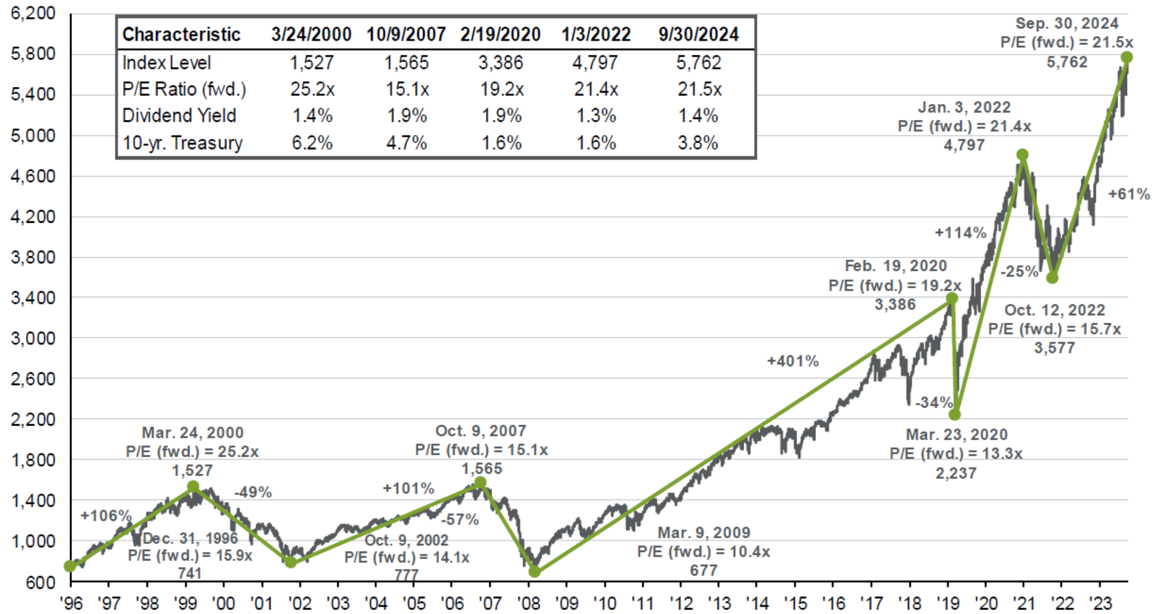


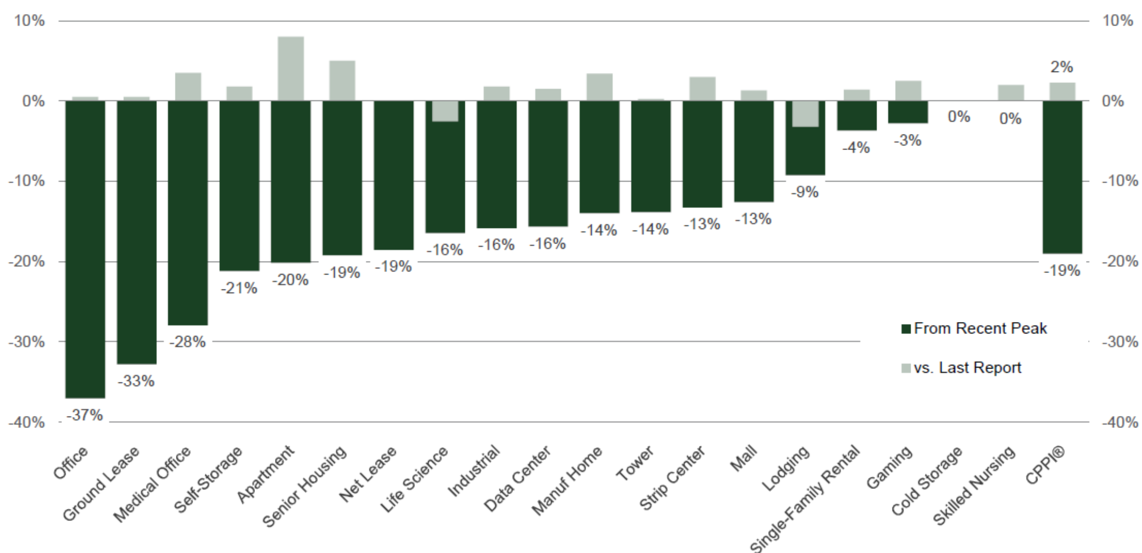
Characteristic	3/24/2000	10/9/2007	2/19/2020	1/3/2022	9/30/2024
Index Level	1,527	1,565	3,386	4,797	5,762
P/E Ratio (fwd.)	25.2x	15.1x	19.2x	21.4x	21.5x
Dividend Yield	1.4%	1.9%	1.9%	1.3%	1.4%
10-yr. Treasury	6.2%	4.7%	1.6%	1.6%	3.8%

Bonds

As mentioned earlier, bonds had a strong 3rd quarter. The accompanying chart shows that rates, particularly for 10-year Treasuries, have been quite volatile and the most recent decline was a massive move. Treasuries are forward-looking and reflect expectations of potential interest rates cuts from the Fed. This latest movement not only mirrors the recent 0.50% cut but also aligns with the series of rate reductions the Fed is forecasting for next year. As a result, bond performance for the rest of the year will most likely continue to be muted with the majority of returns expected to come from income and not capital appreciation. The one thing that could change this view is a recession, in which bonds would be a great diversifying asset, but again, this seems like a lower likelihood at this point. Declining rates are also negative for savers who have parked money in Treasury Bills and Money Markets.

Real Estate and Other Alternatives

Real Estate pricing is driven by cap rates, which are calculated by dividing a property's income (NOI) by its market value. Cap rates are influenced by interest rates. In general, lower interest rates result in lower loan payments, which ultimately increases values. Each specific sector of real estate and each geographic region have somewhat different cap rates, but in general falling cap rates are good and mean that valuations are increasing. As an example, cap rates for high quality apartment buildings were as low as 3.5% in 2021 and rose to 6% at the end of 2023. The change in cap rates was a result of large valuation declines, caused by higher rates on refinances and a general freezing of much of the real estate market. Today, cap rates are declining and multifamily is projected to be back in the low 5s by 2026. We believe that real estate looks attractive moving forward, especially as the debt side of the ledger becomes more affordable. Not all real estate is created equal and moving forward, we like affordable housing, industrial and data centers. We also like special situations in other sectors, especially where an owner becomes a forced seller for reasons that are out of his/her control.



Private Equity and Venture also look attractive. Similar to the stock market, returns and valuations for Private Equity peaked at the end of 2021. Valuations have come down significantly and new money being invested into the sector has also seen dramatic declines. The private companies that have survived this downturn should come out on the other side stronger and more focused.

As many Private Equity deals rely on debt financing, lower interest rates should improve the outlook for new deals and create more liquidity as deal flow continues to increase. The world of investing is complex and there are many opportunities outside of traditional investments for a diversified investor. We believe those areas look very attractive compared to both stocks and bonds.

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Resources

<u>What We Are Reading/Watching</u>:

True State of Social Security: We recently wrote a blog outlining the current state of social security: Blog Post

John Mearsheimer and Jeffrey Sachs Discussion: One of our team members attended the All-In Summit where John Mearsheimer and Jeffrey Sachs, two of the country's foremost foreign policy experts, were on-stage discussing the state of geopolitics. See below for a link to this fascinating and insightful discussion: https://www.youtube.com/watch?v=uvFtyDy_Bt0

Coatue's 2024 EMW Conference: Mid-Year state of the market update from one of the most successful public and private technology focused investment firms: https://drive.google.com/file/d/184tgms_70fL5P0b1l83qSXk8vpFr4kfl/view

Update & Conclusion

Thank you for taking the time to read this letter. As always, please let us know if you have any questions related to your investments, taxes, or general planning or if there have been any changes to your overall plan or risk tolerance. This is a great time for year-end tax planning, so please let us know if you would like to set up a review meeting.

Sincerely,

Canal Capital Management

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