PENOBSCOT
FINANCIAL ADVISORS

MARKET COMMENTARY

Q3 2024

MARKET REVIEW

Wall Street started the third quarter of 2024 with momentum, continuing a rally that lasted through much of the period. Investors remained focused on inflation and economic data, attempting to anticipate any potential interest rate moves by the Federal Reserve. The data was favorable, showing consistent declines in both the Consumer Price Index (CPI) and the Personal Consumption Expenditures (PCE) price index. By the end of the quarter, CPI had dropped to 2.5% and the PCE price index to 2.2%. These indicators of slowing inflation prompted the Federal Reserve to cut the Fed Funds rate by 0.5% —the first rate cut since the pandemic's onset in March 2020. The market responded favorably, with several major indices, including the S&P 500, reaching record highs. Among the sectors, utilities, real estate, industrials, and materials led the charge, while energy lagged. Bond yields also fell, with the 10-year Treasury yield dropping consistently throughout the quarter.

Gold prices surged in the third quarter, rising nearly 14% as expectations of further interest rate cuts boosted demand for precious metals. Central banks in Asia, particularly the People's Bank of China, also played a significant role in driving gold demand, propelling the price of gold to a record high of $2,685.15 per ounce. In contrast, crude oil prices dropped 16%, weighed down by concerns over China's economic struggles, increased supply, and weaker global demand. The U.S. dollar weakened, falling nearly 5% during the quarter, while mortgage rates trended down to 6.2%, offering some relief to homebuyers.

July was an intriguing month for the markets as small and mid-cap stocks took the lead after months of large tech stock dominance. Investors, encouraged by the possibility of rate cuts, shifted focus to these smaller stocks, which tend to benefit from lower borrowing costs. As a result, the Russell 2000 gained over 10%, outpacing other indices. The Dow and S&P 500 also rose, while the NASDAQ dipped. Interest-sensitive sectors like real estate and utilities outperformed, reflecting the broader market sentiment that lower interest rates were on the horizon. Bond yields continued to decline, with the 10-year Treasury yield narrowing its gap with the 2-year note as the yield curve flattened further.

In August, Wall Street started slow but regained strength by month-end. The S&P 500 gained 2.3%, while the Dow and NASDAQ posted smaller gains. The Russell 2000 was the only major index to retreat, losing 1.6%. Fed Chair Jerome Powell's hints at the possibility of interest rate cuts boosted investor optimism. However, concerns about slowing job growth and a cooling labor market, combined with uncertainties about industrial production and the shift in the presidential race, tempered enthusiasm. Bond yields fell once again, while inflation data continued to show improvement, further solidifying the case for a rate reduction in September.

September defied its reputation as a challenging month for stocks, with each of the major indices posting gains. The Fed's decision to cut rates by 50 basis points bolstered market confidence, and despite some sectors lagging, such as health care, real estate, and energy, investor sentiment remained positive. The month also saw continued volatility in the energy markets, with crude oil prices dropping further as demand weakened and supply outpaced consumption. Gold prices, however, hit new highs, maintaining their upward trajectory as uncertainty surrounding further rate cuts loomed. Despite some caution from Fed officials about future moves, the overall outlook for the markets remained upbeat heading into the final quarter of 2024.

LOOKING FORWARD

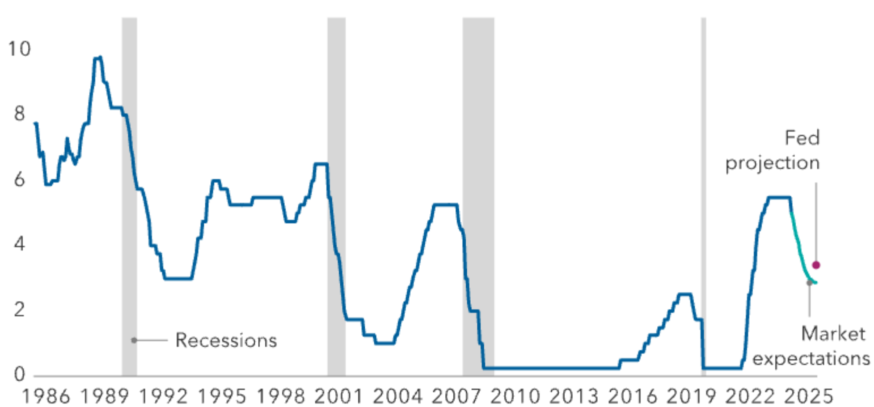
THE TRAJECTORY OF INTEREST RATES

The Federal Open Market Committee (FOMC) began what is anticipated to be the first in a series of reductions to the Fed Funds Rate in September. Markets adjusted quickly from an anticipated cut of 0.25% to the actual rate decision of 0.5%, reducing the target rate to 4.75%-5%. The larger cut indicated the reality that economic performance was becoming more uncertain, employment numbers were weakening, all while inflation risk had continued moderating. The Fed has been cautious to rebuff assumptions that rates would continue to come down in equally large increments, seemingly pushing a narrative of slow, gradual reductions on tap for the next 12-18 months, with pauses along the way if inflation were to re-ignite.

Markets, however, are pricing in more certainty that the Fed will continue to cut steadily and are discounting a lower Fed Funds Rate than the Fed itself is projecting, reflecting potential concerns around labor market trends, and geopolitical risks, any of which could potentially trigger a recession.

With short-term rates still elevated, it can be tempting to deploy more dollars into money market and high-yield savings vehicles, because their yields appear attractive relative to bonds. But this can be a short-sighted approach, since yields on these vehicles only lag the Federal Funds Rate by 90 days on average. Conversely, traditional bond yields are more durable because they lock in coupon payments until the bond matures. So, in a falling rate environment, it is typically prudent to select a lower yield for a longer period.

Additionally, unlike money market and high-yield savings accounts, falling yields cause existing bonds to appreciate in price, because older bonds with higher coupon payments become more attractive relative to new bonds with lower coupons. This is another reason why time-based fixed income instruments like corporate and municipal bonds have historically outperformed cash investments significantly during rate cutting cycles.

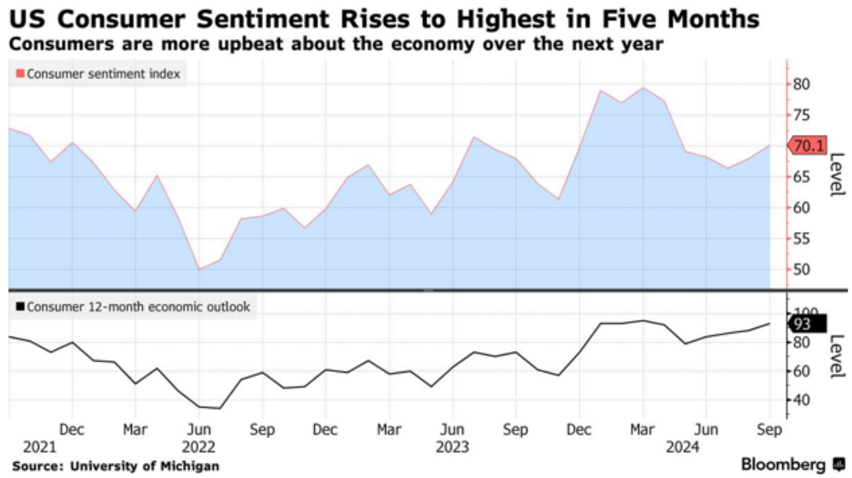


Sources: Capital Group, Bloomberg, Chicago Mercantile Exchange Group, Federal Reserve, National Bureau of Economic Research

Source: Blackrock, Bloomberg as of September 12, 2024.

ECONOMIC GROWTH AND RECESSION FEARS

While markets are discounting a lower rate structure, it isn't clear this is the result of widespread conviction of an impending recession. In fact, current consumer sentiment remains high, relative to historical norms.

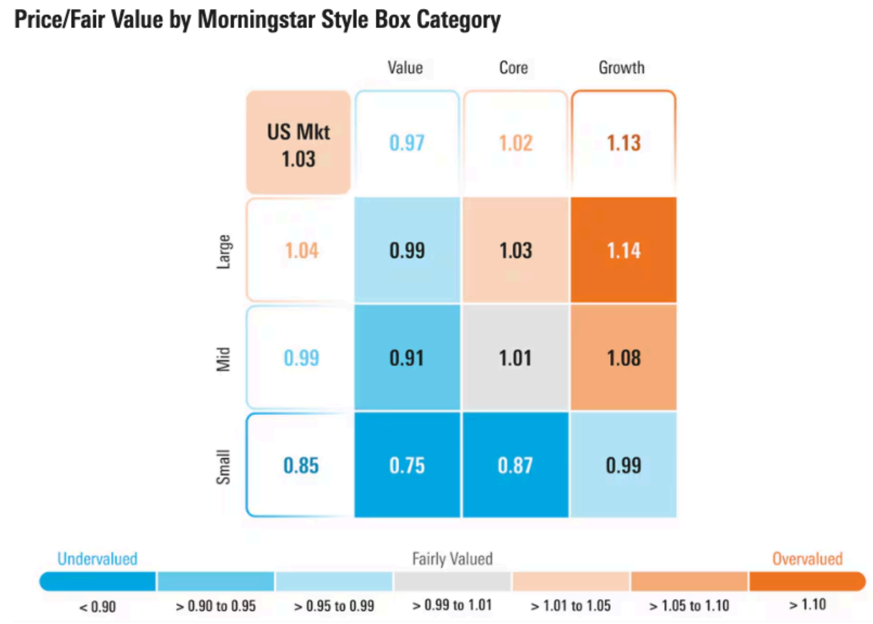


IS THIS A ROTATION TO VALUE?

It's no secret that a small number of mega-sized companies have been driving market performance for some time. Over the past twelve months, seven of the largest companies in the US have delivered returns that have significantly outpaced the rest of the market. No company is a more significant poster child for this growth than Nvidia has been, returning almost 200% over that period.

While Artificial Intelligence is garnering well-deserved attention and hard-earned investor dollars, it will be challenging to determine when this exuberance has exceeded rational levels. All the while, plenty of companies are delivering fine earnings and projecting continued growth – without having shot up nearly as much in market value.

While Morningstar sees the US stock market as being 'slightly overvalued', by approximately 3 percent, it's worth noting this isn't a consistent phenomenon. In fact, while the large-cap growth category is now seen as significantly overvalued, smaller companies and 'value stocks' (those whose prices are lower relative to their earnings) are largely seen by Morningstar as still priced at levels below their fair value.



Source: Morningstar. Data as of September 23, 2024.

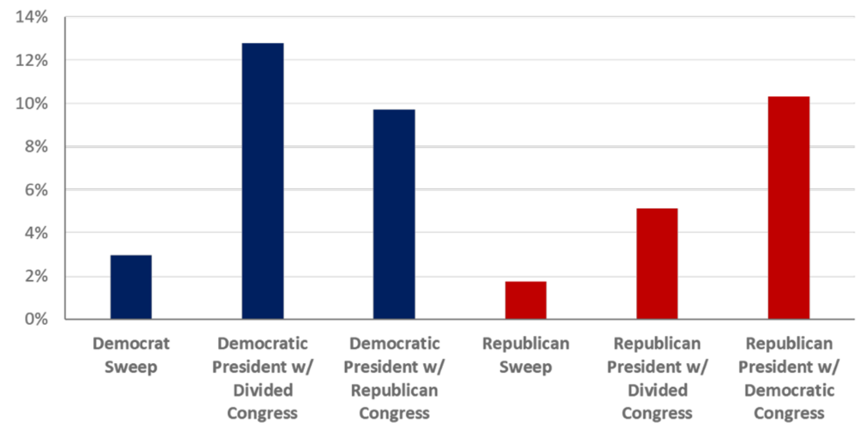
This dichotomy is a head-scratcher…. And historically, when one part of the market becomes overpriced, there is often rotation in performance to areas where the more justifiable valuations exist.

It's too early to determine whether such a 'rotation' is already in play, but since the end of the second quarter of 2024, the 'Magnificent Seven' have performed at a level behind their smaller value counterparts. This has resulted in the market-cap-weighted S&P 500 index underperforming the 'Equal-weighted' index since the beginning of the 3rd quarter, with value stocks outperforming growth stocks recently.

OH, YES, AND THE ELECTION…

As of the publication date, we have no idea how the election of 2024 is going to work out. The only thing we can say with near certainty is that it is going to be close.

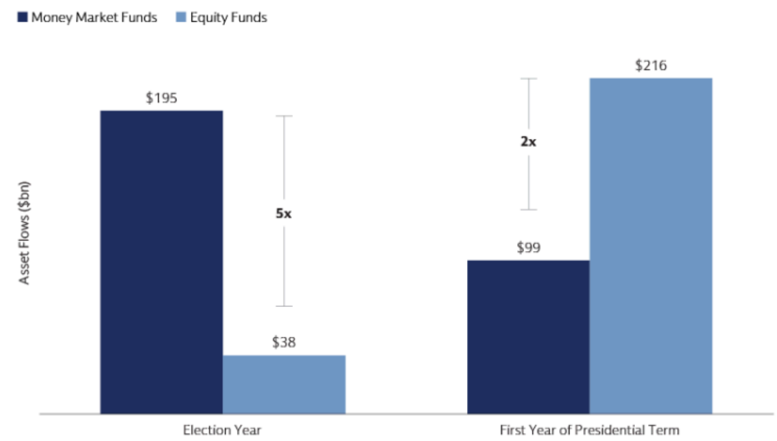
One direction that seems to be developing credibility is that regardless of who takes the White House in November, we have a high probability of seeing 'split government' where no single party ends up with the presidency and control of both houses of Congress. Although it may seem counterintuitive, that's something markets might find solace in. Historical returns during periods where our government is divided have proven better, on average, than those where one party has swept the executive and legislative branches.



Source: Schwab Center for Financial Research with data provided by Morningstar, Inc.

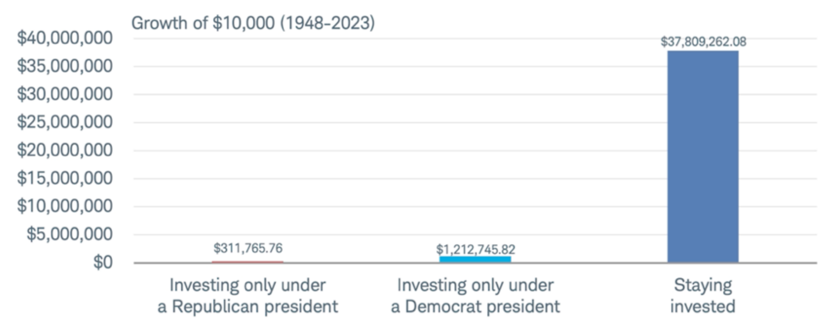
One thing we tend to do as investors is to shy away from deploying capital when we're uncertain about what the future holds. And no time seems to resonate with uncertainty like a hotly contested presidential election. During election years, investors tend to favor safer money market funds over equity funds by a factor of around 5 to 1. That is doubtlessly the case here in 2024, with a close election and attractive returns on safe-haven assets like money market funds and high-yield savings accounts.

In the first year of a presidential term, however, that trend tends to reverse, and investors move into equity funds at twice the rate of the safe havens. This could be an encouraging source of tailwinds to the equity markets even after the election.



Source: Morningstar and Goldman Sachs Asset Management.

Regardless, it's prudent to avoid trying to game the politics with your investments. Investors who have remained steadily invested regardless the politicians in charge, have outperformed in the long term. BY A LOT!



Source: Schwab Center for Financial Research with data provided by Morningstar, Inc.

OUR TAKE

We are gifted with a strong consumer, lowering interest rates, areas of the market that are objectively still cheap, and a high level of positive sentiment. Geopolitical events could very well shake things up in the near term, so prepare for volatility. But remaining prudently allocated and staying the course, both in good times and bad, still emerges as the winning strategy time and again. Don't forget to VOTE!!