Monthly Commentary

Sept 6th 2024

Air Pockets | Steve Henderly, CFA

One of the biggest thrills for roller coaster aficionados is the sensation of free-fall in their stomach as the train makes its way over the edge of the first drop. Perhaps you've experienced a similar sensation during a flight where there was turbulence or an air pocket. If it was unexpected, it probably caused brief anxiety. Earlier this year, a flight from London to Singapore was going smoothly until the plane experienced a sudden and dramatic change in altitude, dropping nearly 200 feet in less than 5 seconds. Panic probably best describes what passengers felt. A drop like that can throw anyone not securely in a seat belt into the ceiling and then quickly crash back down; more than half of the flight's passengers required medical treatment as a result of this unexpected air pocket.

Style	August	YTD
Foreign Stocks	+3.3%	+12.0%
S&P 500	*+2.4%*	*+19.5%*
Large-Cap Stocks	+2.2%	+17.2%
Bloomberg Bond Idx	+1.4%	+3.1%
Mid-Cap Stocks	+1.0%	+12.4%
Avg US Stock Fund	+0.9%	+14.7%
Small-Cap Stocks	-1.0%	+10.2%

Investors experienced an air pocket of their own last month as the S&P500 skidded roughly -6% in panicky trading over the first 3 days of the month. August carries a reputation for air pockets as much of the foreign investment community vacations during the month resulting in light trading volume compared to normal. Less trading volume means markets can react to new information in outsize ways relative to when trading volume (liquidity) is more normal.

August's "air pocket" was widely attributed to concurrence of a softer than expected monthly employment report (slower job growth) following communication from the Fed a day earlier on July 31st to keep short-term interest rates unchanged as further data is collected. Neither item was all that surprising, but there is an old saying: "Economic expansions do not die of old age; they're murdered by the Fed". If the Fed's interest rate policy is too restrictive for too long, economic pain can be expected; a "bumpy landing" as opposed to the desired "soft landing".

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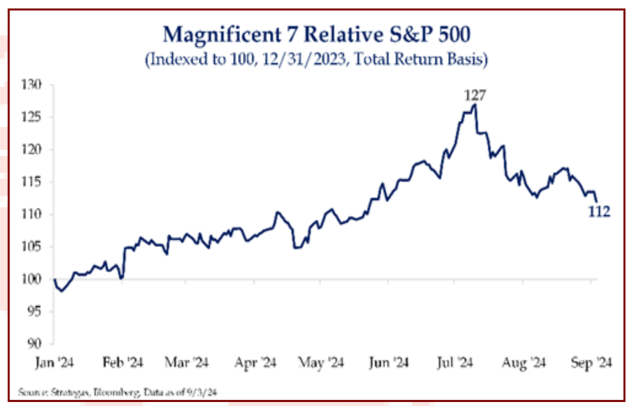
The softer unemployment report abruptly intensified worry that the Fed is already behind and the economy is weaker than previously believed. The additional straw on the camel's back was the Bank of Japan announcing it would raise its key borrowing rate causing a swift appreciation of the Yen and triggering unwind of leverage associated with some investors utilizing a "carry trade" strategy (borrow cheap in Yen; use proceeds to invest in other higher-return investments). This deleveraging rippled across seemingly unrelated areas of the market via selling of assets including US stocks to create liquidity.



While the S&P500, an index comprised of the 500 largest US companies, managed to fully ascend to conclude the month at a new high (the 36th fresh high of 2024, which is the most since 2021); smaller-size companies were unable to fully repair. It is interesting (and somewhat frustrating) that, while the S&P500 index remains a difficult bogey for a more diversified portfolio containing smaller-size and international companies to match, the performance of the Mag 7 companies is quietly softening since mid-July. On down days, high-flying tech is often suffering more and as a group not bouncing back as well. Is this an early signal that investors are taking some profits and/or performance may be set to broaden to other areas – including outside the S&P500?

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Looking ahead, the Fed's preferred inflation measure, the PCE index, is running at a 1.7% annual rate over the past three months - well within its target range. As a result, the Fed is shifting focus toward the employment side of its dual mandate, especially as some weaknesses emerge in U.S. employment data. Markets welcomed Fed Chair Powell's clear remarks at Jackson Hole in late August: "The time has come for policy to adjust. The direction of travel is clear... We will do everything we can to support a strong labor market as we make further progress toward price stability."

As we head into September, a rate cut from the Fed on September 18th is virtually certain, with more cuts likely to follow. The yield curve may finally un-invert[1] for the first time in two years(!). While this might seem like positive news for the markets, a cut (perhaps as large as 0.50%) is already factored into market prices. In fact, markets are now pricing in a total of four rate cuts (1% total) before the end of 2024 - surprising how quick the expectation for multiple cuts returned. We feel this magnitude of cuts also creates potential for market disappointment or global financial crosscurrents. Japan for example must proceed cautiously to avoid moves that are too divergent relative to other major central banks, which could cause further global market stress.

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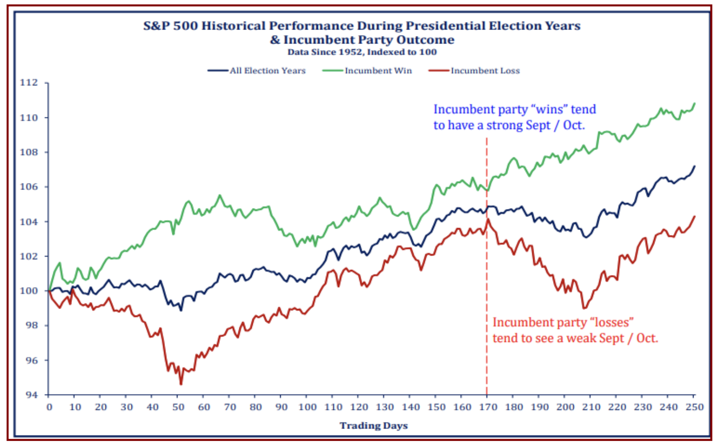
September is known for volatile market conditions, with each of the past four Septembers ending in the red. Geopolitical tensions and election-year uncertainty are high as we approach the outcome of the Presidential race, just two months away (hopefully). Don't be surprised if we hit more "air pockets" or market-shaking surprises – perhaps already underway in these early days of a new month. Data now suggests a safe yet "bumpy" landing instead of the desired goldilocks "soft landing". With the crosswinds of an election year and the Fed's difficult task, a safe landing (bumpy or soft), with no recession, would be a success.

(1) The US yield curve first inverted, meaning rates on shortest term borrowing are more expensive than longer-term borrowing rates, back in early 2022. This is an abnormal borrowing environment, and one which historically signals economic weakness lies ahead due to lending market dysfunction.

Market Trivia: Does the stock market predict the outcome of the election? Historically the stock market tends to deliver positive performance in September and October when the incumbent party won; and negative when the incumbent party lost. Is the market truly predictive, or are voter attitudes shaped by recent market performance? What will the next two months bring, and will it align with the election outcome?



Following the election, performance is historically positive regardless of which party wins as the uncertainty fades. No particular outcome is necessarily more bullish or bearish than the other for the next four years. However, the least favorable political environment for markets tends to be when a single party controls all branches of government. If you care about financial stability, it's worth noting that a balance of power is usually a benefit to the economy.

Fund Spotlight: Diamond Hill Core Bond: In mid-July, we initiated replacement of one of our traditional, core -bond funds (American Funds Bond fund of America) with Diamond-Hill's Core Bond Fund (DHRIX). Both funds sport a disciplined process, attractive long-term performance relative to applicable benchmark and peers; are free of transaction fees/commissions; and competitive expense ratios. Investing in fixed income has presented challenges in recent years (particularly amid swiftly rising interest rates in 2022); however, bonds remain a key to risk management and portfolio diversification. We find the fund from Diamond-Hill compelling in that the fund company is significantly smaller than the counterpart it replaces. Fixed income markets, unlike equity markets, are highly nuanced and the ability for a fund to pursue owning smaller issues is an advantage and opportunity to enhance returns over time. It's track record supports this perspective and we believe this is an upgrade to the fixed income allocation in portfolios.

Nvest Engagement: Delivering financial peace of mind is our ultimate goal. A quick summary below of the content our team shared over the past month via LinkedIn and Facebook. We hope you find these updates useful and informative. Please take a moment to follow us to receive on-going updates:

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- A good reminder of why we encourage a diversified portfolio and set allocation to stocks & bonds based on a "buckets of time" concept. LINK
- We're hiring! Seeking to fill the position of Client Advisor. Please share our position profile with anyone you believe might be a good fit at Nvest as we seek to deliver financial peace of mind to our wonderful clients. LINK
- Thank you to all of our wonderful clients who were able to join our Happy Hour at Getaway Brewing in Dublin's beautiful Bridge Park! For those unable to join, here is the document we briefly reviewed. LINK

- Back to school for the Ranly and Henderly kids! Wishing everyone a fun, safe, and productive school year!

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