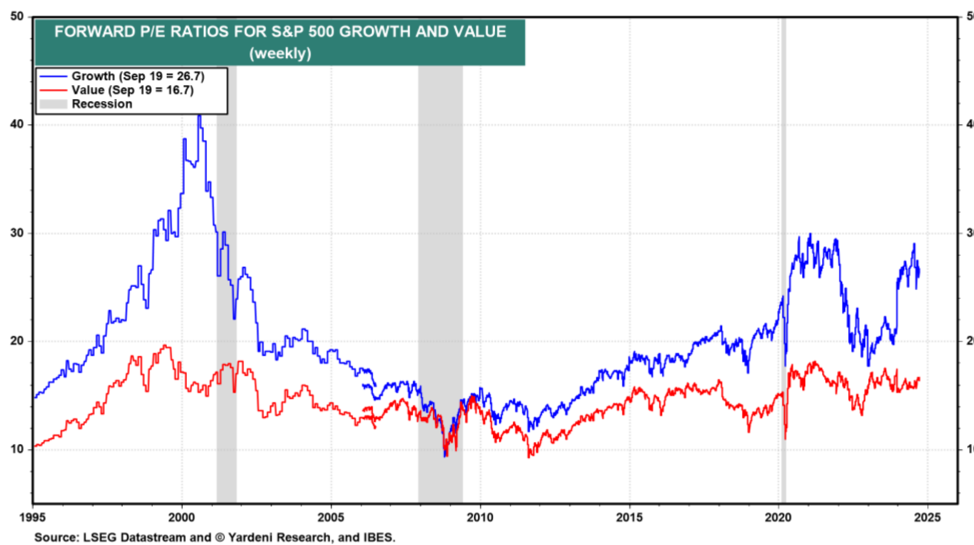
Third Quarter 2024
Investor Letter

Market Review

Financial markets performed well in the third quarter, with the S&P 500 Total Return Index rising 5.9%. The Bloomberg Aggregate Bond Index rose 5.2%. The quarter saw medium sized corrections in both August and September. Both were primarily in response to slightly disappointing economic numbers. In each case, the market recovered quickly. The most important issues for the market during the period were the possible economic slowdown and the Fed rate cut, both of which are discussed below.

Valuation Update

With the run up in equity valuations this year, it is worth reviewing where the market stands in terms of valuation. The short answer is that the market is probably modestly overvalued at current levels. The slightly longer answer is that valuations differ significantly among different parts of the market. The chart below illustrates how fast-growing companies are selling at a substantial premium to the rest of the market.



Federal Reserve Rate Cut

The September 19 decision by the Federal Reserve to lower the discount rate by 50 basis points marks a significant change in the trajectory of monetary policy. Directional changes by the Fed are quite rare, and generally stay in place for several years after they start. The decision, which lowered rates for the first time since March 2020, was larger than many analysts (including us) were expecting. It reflects the Fed's

view that the inflationary period of recent years is nearing an end, and that the Fed can now better balance its focus on price stability with its other major objective, which is full employment.

The decision to lower rates substantially (and to telegraph more rate cuts to come) was curious because by most metrics, the US economy is performing well. Recent economic data has been mixed, with some good figures and some more concerning ones. Overall, the US economy is expected to grow 2.0-2.5% this year, which is reasonably strong.

A risk of cutting rates while the economy is strong is that it will either re-ignite inflation or cause a market bubble. A tremendous amount of money has gone into short-term investments in recent years, driven in part by attractive rates of over 5%. As money flows out of these instruments, it is very possible that it will go into stocks, low quality debt and other more speculative investments. While this may be good for some period of time, history shows it could end badly.

How the Fed Cuts will Impact Your Investments

As noted, the most obvious impact of Fed easing will be on short-term holdings such as US Treasury bills, money market funds and CDs. The return on all of these instruments will fall as the Fed lowers rates. This includes the Treasury securities and money market funds held in client portfolios. Longer term bond yields may also be impacted by the Fed, but these rates are also impacted by factors over which the Fed has less control, such as expected inflation and the economic outlook. Equity prices would also be expected to rise with lower rates. Of course, equity prices have risen substantially in expectation of the Fed's move, and we believe the equity market as a whole is modestly overvalued, so it is hard to be sure how much impact this news will have. Also, equity prices (like long-term bonds) are impacted by factors such as economic growth and inflation. For now, we don't anticipate making substantial changes in our equity holdings as a result of the September news.

For clients who hold Treasury bills, we may make some modest adjustments to portfolios. What we won't do, however, is to materially lower the quality of our clients' holdings to compensate for falling interest rates. This practice, often referred to as "reaching for yield" is dangerous strategy which almost inevitably leads to disappointing results. The portion of client portfolios held in US Treasuries is invested to provide a modest return, while doing as much as possible to preserve principle. It is designed to balance equity holdings which have a higher expected return over the long term but may be highly volatile in the short term.

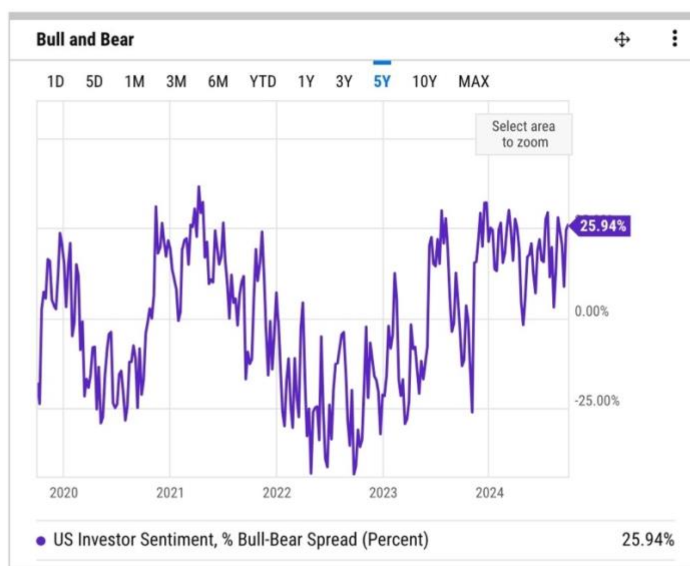
As we noted last quarter, the stock market historically sees above average volatility in the period prior to a presidential election, and this could very possibly be the case this year. Our goal is to use such volatility to our benefit, by looking to take advantage of emotionally driven selloffs which present opportunities to purchase shares at attractive values.

Sentiment Indicators Flash Warning Signs

Warren Buffett famously said that in the long term the market is a weighing machine, but in the short term it is a voting machine. His point was that while markets do a great job of valuing companies over the long term, in the short term markets are subject to emotion, over-reaction to news events, and all types of irrational factors. This is what creates periods in which markets become substantially over or under valued.

One way of measuring how the market is "voting" in the short term is to look at measures of investor sentiment. The American Association of Individual Investors conducts a weekly survey where they ask

investors whether the outlook for the market is positive or negative. The results are then tracked over time to show how sentiment ebbs between negative and positive. The chart below shows the results of one of these surveys over the past 5 years. The first thing to notice is that investor sentiment is generally completely wrong at major turning points. Note the high readings (indicating bullishness) in 2021 prior to the market correction the following year, and the low readings right at the market low in October 2022. Note also that since then, market sentiment has returned to reading similar to those at the 2021 peak. Does this mean a major correction is coming? Not necessarily, but it could at least mean that the market is vulnerable to a selloff due to an unexpected event or crisis such as a war scare or election uncertainty.



Source: American Association of Individual Investors

Anecdotally, we note that a number of market pundits have turned more positive after years of steadfastly maintaining that a recession or bear market was imminent. (It should be remembered that professional investors are human too and subject to the same human influences as everyone else.). This could also be a concerning sign.

Thank you as always for being a client. Please feel free to reach out to Roger or me to discuss your investments.

Best regards,

William R. Andersen, CFA
Principal and Chief Investment Officer