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Economic and Market Outlook

September 30th, 2024

Don't Get Spooked

October: this is one of the peculiarly dangerous months
to speculate in stocks. The others are July, January, September,
April, November, May, March, June, December,
August and February.

- Mark Twain

Section I. Introduction

Samuel Clemons, aka Mark Twain, points out the myth and reality of equity investments in one eloquent statement. Many believe that October is the worst month of the year for stocks. This myth is borne from the Panic of 1907, the market crash of October 1929 and Black Monday in October 1987. This has created the "October Effect" which is the perception that stock markets decline during the month.

The reality is that since 1928 the worst performing month on average is September (Chart #1) with a historical average decline of 1.17%. October on average is up 0.52% even with those occasional but rare major pull backs.

Unfortunately, there are always reasons stock market investments are risky and you might be tempted to sell your holdings. We manage risk through position size and sector allocation.

However, movements in the stock market, up or down, do not have a single cause and cannot be explained by a single narrative. Equity markets swing wildly from day to day on the smallest of news, rally and crash on sentiment, and celebrate or vilify

the most inane data points. In reality, market prices result from billions of shares being bought or sold in reaction to each investor's perception. It's important not to get caught up in the madness and instead to stay rational and patient.

Another example of irrational thinking is basing investment decisions on politics. Many clients are aware we keep politics, specifically presidential elections, out of investment decisions. The simple reason why is shown in Chart #2. If you invested $10,000 from 1961 to 2023 only when a republican was president you would have $102,293. Utilizing the same behavior only when a democrat was president would yield $500,476. But if you just stayed invested regardless of who occupied the White House, you would have $5,119,520.

Section II. The Bull Market

The most basic definition of a bull market is an upward move of 20%. Since the lows of October 2022 through September 24th, 2024, on a closing basis, the S&P was up 60.27%. In addition, the S&P has achieved all-time highs multiple times.

Bull markets do not die of old age. While we are approaching 2 years in this Bull run, the average Bull market is up 114.1% and lasts 1,011 days. Bull markets end because of Black Swan events or because of recessions in the economy. By definition, Black Swan events cannot be predicted. For reasons cited later in this report, we do not see a recession coming in the near future.

2024 is turning out to be a great year for equity markets. Moving forward, our own internal proprietary model confirmed the Bull market with one signal and gave us another signal we have only seen 10 times covering 65 years of data. This signal indicates a 14.1% return over the next 12 months with a 90% success rate. In addition, analysts at JP Morgan said that over the last 40 years the Fed has cut 50 basis points with the S&P within 1% of its high 12 times. The market was higher a year later all 12 times with an average return of around 15%.

To be clear, in the short term we fully expect some type of correction or consolidation for the market over the next few months. Corrections of less than 10% are part of normal volatility, and are healthy for the market. The S&P has already had a correction of 5.5% in the last few months. The Dow Jones Industrial Average had two, 5.2% and 4.7%.

The four quarter earnings estimates for 2025 for the S&P rose to $279.74. This is an almost $20 increase from June's $260.60. That equates to a 14.69% annualized return.

Despite recent market fluctuations and uncertainties, the momentum behind AI-driven technologies remains strong. As companies across industries continue to embrace AI to drive innovation and efficiency, investors are presented with unique opportunities to capitalize on the transformative power of artificial intelligence. The AI revolution is not just a fleeting trend but rather a fundamental shift that is poised to reshape industries and create new opportunities for growth and innovation. Besides the obvious technology names, we are also looking into energy opportunities because of the dramatic power requirements that AI demands.

Section III. Inflation

The readings for inflation continue to moderate. Currently the Consumer Price Index (CPI) is up 2.5% on an annual basis, and core CPI, which excludes food and energy, is up 3.2%. Both readings are for August 2024. CPI and core CPI continued their descent since our last report. The CPI reading has leveled off after peaking in June of last year at 9.1%. The core rate actually peaked in September at 6.6%. This is still above the Federal Reserve's 2% target. The problem with all these measures of inflation is that they are backward looking and lagging indicators.

The Federal Reserve prefers to use a measure called the Personal Consumption Expenditures (PCE) Price Index to gauge inflation. The reading for PCE in July was 2.5% and the core rate was 2.6%. August data will be released September 27th. Inflation in the Euro Zone dropped to 2.2% on an annual basis in August.

Remember that containing inflation is not about lower prices, but about stable prices. It appears that the Fed's aggressive approach had its desired effect. The normal lag for the effect of rate hikes is 12 to 24 months or more. Our first hike was last March, 27 months ago. The resilient economy continues to mute the effects of restrictive Fed policy.

Wages are starting to moderate as job openings drop and adjustments for increases in the minimum wage start to moderate. Wage increases trail inflation so it is not the problem that many believe. Wages tend to increase in order to keep up with inflation, as opposed to causing inflation.

Section IV. The Federal Reserve and Interest Rates

Because of inflation, the financial media, the Fed and the equity markets have become more focused on interest rates. We were spoiled by ultra-low rates before and during the pandemic.

The Federal Reserve has begun to alter their previous monetary policy path. After holding rates steady at 9 of the last 10 meetings, Federal Reserve Chairman Jerome Powell and the committee cut rates 50 basis points at the September meeting. While we thought they would only cut 25 basis points, we believed they should have cut 50. They also continue to roll off $60 billion of bonds from the Fed balance sheet each month. Shrinking the Fed balance sheet will tighten money supply which once again means lessening consumer demand. This is reflected by the fact that growth in M2 money for August year over year is now -0.60% (Chart #3).

We do expect the Fed to continue cutting interest rates. This brings us to another study that found that after the first rate cut, if no recession materializes, the market is up 24% on average over the next year. Even if a recession comes the market rose 10% on average over the following year. Remember that cutting rates is usually a sign that the economy is slowing.

Some may feel that the Fed cutting by 50 basis points is a sign of concern on their part. We believe that they probably should have started in the July meeting. Also, there is no Fed meeting until November so the cut could be viewed as planning ahead, not panicking, about the economy in our view.

Rates in most European 10-year bonds are pulling back along with the U.S., because of a slowing global economy. The U.S. 10-year bond still remains more attractive to international investors for its yield and AA+ credit rating. The U.K. 10-year yields 3.94% (AA), German 10-year yields 2.14% (AAA), France 10-year yields 2.91% (AA), Italian 10-year yields 3.47% (BBB) and Swiss 10-year yields 0.49% (AAA). These compare to our 3.74% 10-year yield.

Section V. The Recession Model

As we have discussed in past reports, earnings and the economy are the true long term influences on the stock market. Recessions, or fear of recessions, are the

major reason we experience corrections of more than 10%. Corrections of less than 10% are just part of normal volatility and tend to happen multiple times each year.

The official arbiter of recessions in the U.S. is the National Bureau of Economic Research (NBER). They determine when our economy enters and exits recessions. The problem is that usually by the time they declare the official start date of the recession the economy is probably coming out or already done with that recession, in other words no predictive value.

At Clutinger, Williams & Verhoye we have developed what we view as a recession indicator which tracks 5 data sets on a monthly basis. If 3 of the 5 indicators are negative and the S&P 500 is below its 40 week moving average, it is a very strong indication that a recession is near or may already be underway.

Indicator number one compares the current monthly unemployment rate to its 12 month moving average. As of August, the unemployment rate was 4.2% and the 12 month moving average was 3.92%. By being above the moving average this indicator has stayed negative.

Indicator number two is represented in Chart #4. This represents the year over year percentage change of Advance Real Retail and Food Service Sales. This is one method to measure the strength of the consumer. Currently the reading is -0.45% for August, so this indicator remains negative. Any reading below 0 is negative.

Indicator number three is represented in Chart #5. This shows the year over year change in Industrial Production. This indicator has remained slightly positive. It currently sits at 0.04% for May 2024. This is not surprising given the still positive GDP number from the first quarter along with the GDP estimate for the second quarter.

For indicator number four (Chart #6), we look at Total Nonfarm Payrolls divided by the Civilian Labor Force Level on a year over year percentage change basis. This indicator stands at 1.08%. A zero reading represents neutral therefore this indicator is positive.

Indicator number five (Chart #7) represents the Average Weekly Hours of Production and Nonsupervisory Employees-Manufacturing on a year over year percentage basis. Currently the reading is -0.25%, so this indicator is negative. This reflects the fact that inflation is easing.

Currently three of the five indicators are negative and the S&P 500 Index is 8.92% above its 40-week moving average as of September 20th. With the S&P 500 above its forty week moving average this model is not giving a recession warning sign. We will be closely monitoring these indicators in the coming months.

The above indicators are only updated on a monthly basis. To offset this situation we also track two other indicators. They are both indicators that are updated more frequently (on a weekly or daily basis) and we consider them as early recession indicators. Both are somewhat volatile so we track three month moving averages. These two indicators are separate and independent of the first five and either one can indicate the possibility of recession on its own.

The first one is the Aruoba-Diebold-Scotti Business Conditions Index which is updated on a daily basis and published by the Philadelphia Federal Reserve. The 91 day moving average is slightly positive and is at -0.21 currently. The divining line for entering and exiting recessions is -0.8.

The second indicator for recessions is the Chicago Fed Business Activity Index. It is reported weekly and the divining line for entering recessions is -0.7. The three month moving average remained relative steady at -0.17.

In summary, the two "early warning signs" are not predicting recession at this time. We still believe that in February 2023, when our indicators predicted recession, we may have already experienced the mild recession everyone keeps predicting.

Section VI. Market Psychology

For decades we have measured market psychology using price and volume data in the short and long term from the Dow Jones Industrial Average as well as a 17 week moving average of advancing and declining stocks on the New York Stock Exchange.

Currently, 10 out of 12 of our price/volume indicators are positive, which puts us in a good position. The S&P has reached 5733 and keeps making all-time highs. But that doesn't necessarily mean the end of the rally. The market needs corrections from time to time in the short term to stay healthy and growing over the long term.

Our advance/decline line has been positive for the last several weeks and sits at 56.0%, and is reflecting a positive bias but is not overheating with enthusiasm.

Our technical model measures the first and second derivative of price and volume for the market. We have developed this model to recognize patterns and spot buy and sell signals from reviewing years of historical data. This model is providing positive signs and our proprietary charting is reflecting a pattern seen during past Bull markets as previously sighted in this report.

Section VII. The Economy

Indexes that measure manufacturing data are mixed. The Philly Fed Manufacturing Index has turned positive unexpectedly. It rose from -7.0 the previous month to 1.7 in September of 2024. The Empire State Manufacturing Index increased to 11.5 in September, its best reading in seven months. The national ISM manufacturing index was 47.2% in August and the ISM services index was 51.5% (above 50 is considered growth, above 55 is considered exceptional growth). All these readings reflect a moderately strong economy and the fact that the Fed may just pull off the goldilocks soft landing scenario or even possibly no landing.

Multiple Wall Street and Federal Reserve predictions for GDP have stayed around 2%. GDPNow is estimating GDP for the third quarter of 2024 at 2.9%. This shows the economy is still resilient.

Section VIII. Conclusion

The third quarter has seen a continuation of the market rally that started last year. It has also highlighted short term market volatility. We have sighted many reasons why we believe it is wise to stay invested in the long run.

We continue to be optimistic moving forward. Over the short term, directional moves in the stock market are always going to be somewhat unpredictable. Though a crash remains within the realm of possibilities, given what history tells us about market valuations, the historic data on market returns and economic growth it is crystal clear that being an optimist and investing for the long haul is a winning formula.

Happy Halloween,

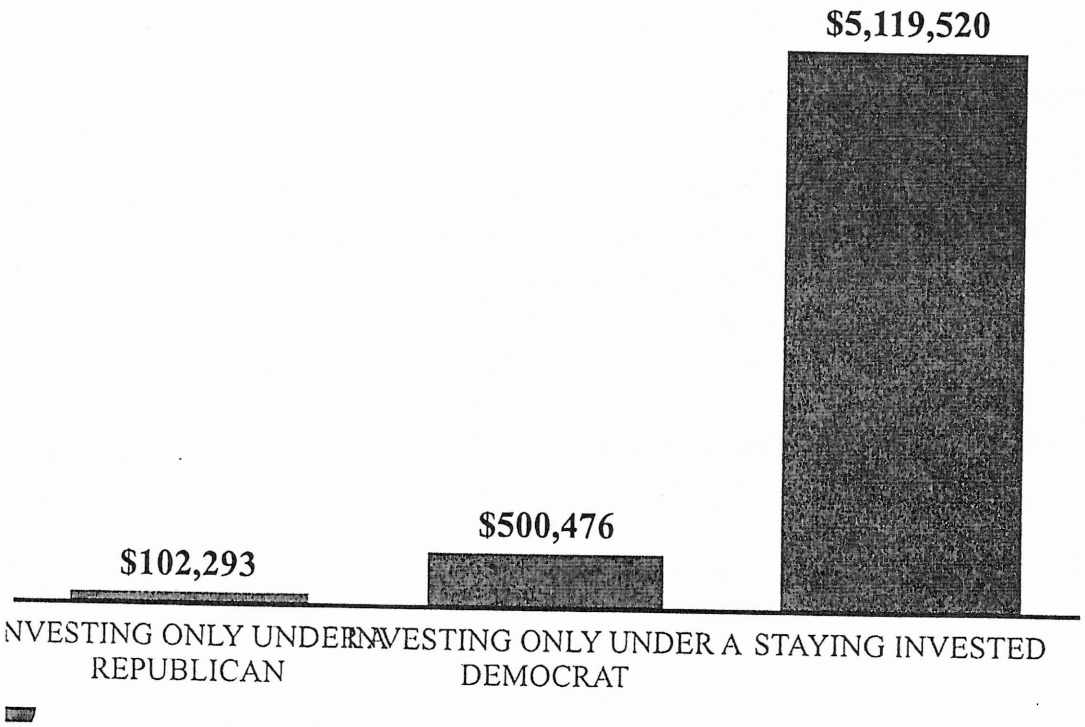
Scott B. Williams, CFA, CFP

Kent Edwin Stone

Chart 1

STAY INVESTED NO MATTER THE POTUS

Growth of $10,000: 1961 to 2023

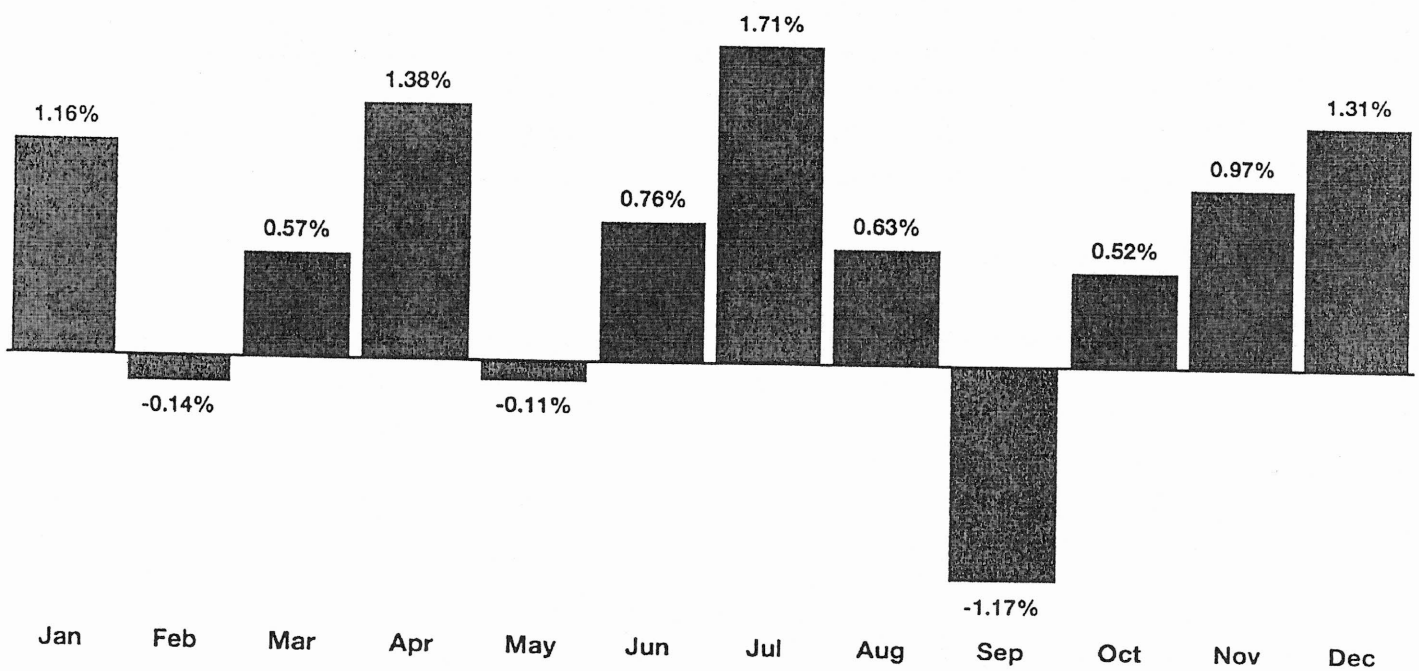


SOURCE: SCHWAB CENTER FOR FINANCIAL RESEARCH; MORNINGSTAR; TKER VIA SAM RO

Chart 2

S&P 500 Monthly Returns

1928 - 2023



Data source: Yardeni Research

Chart 3

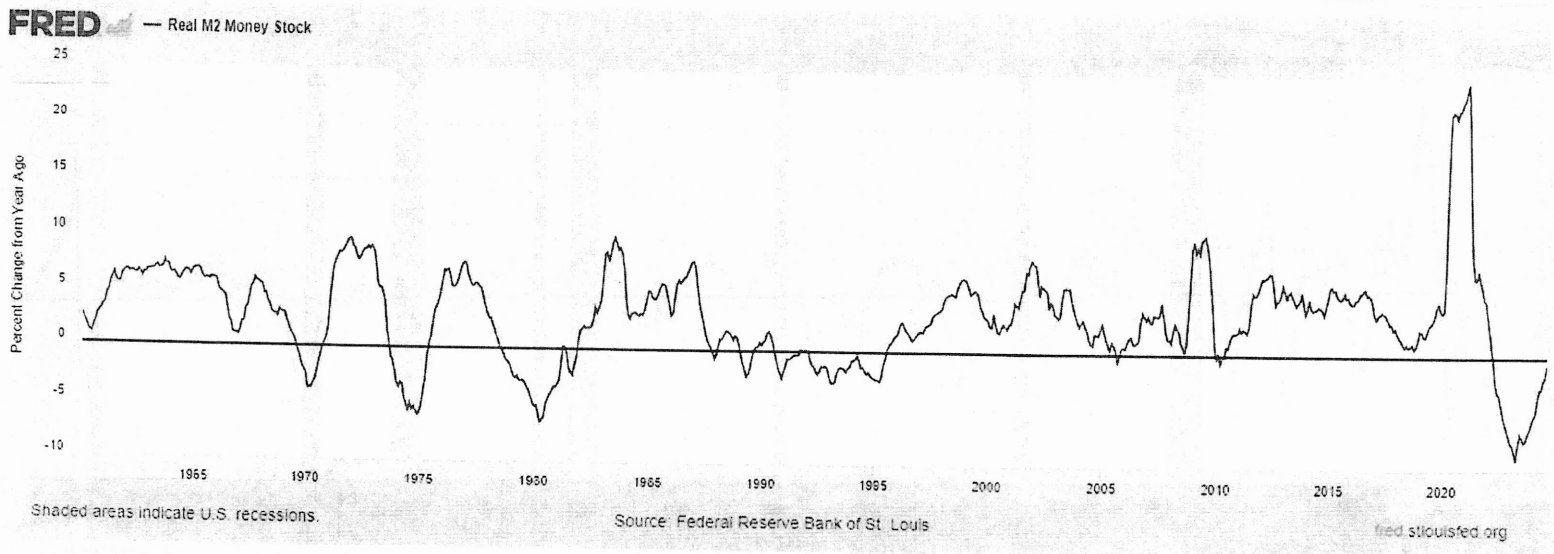


Chart 4

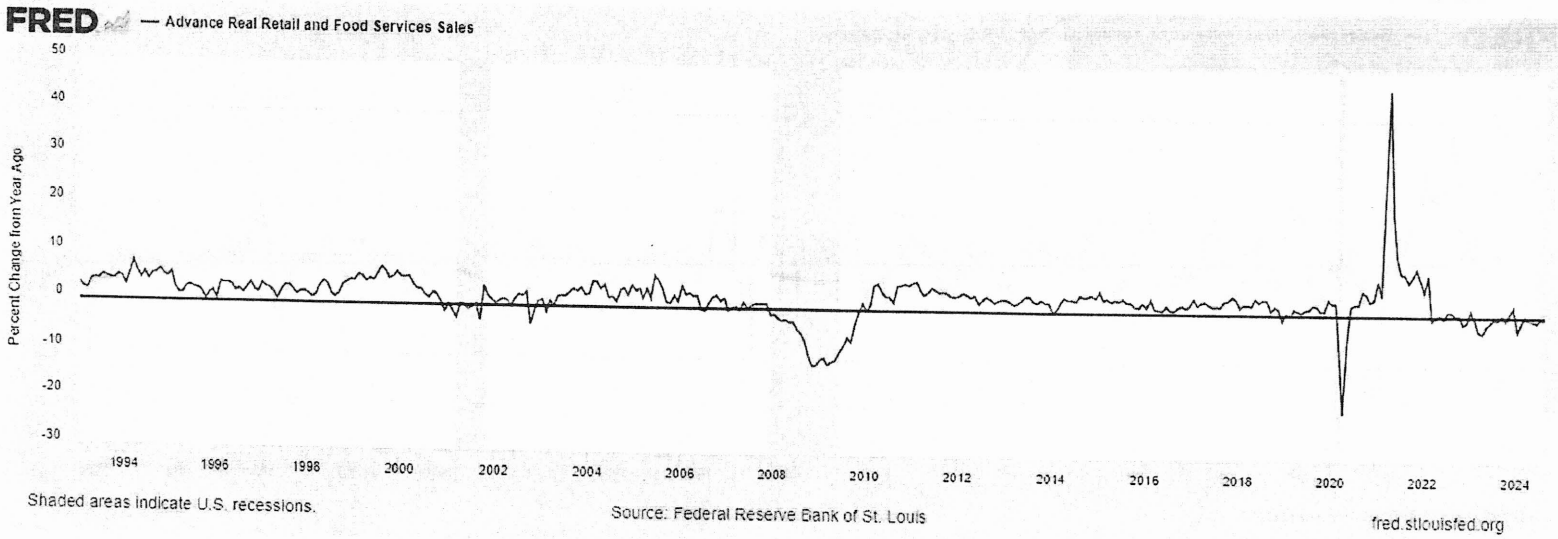


Chart 5

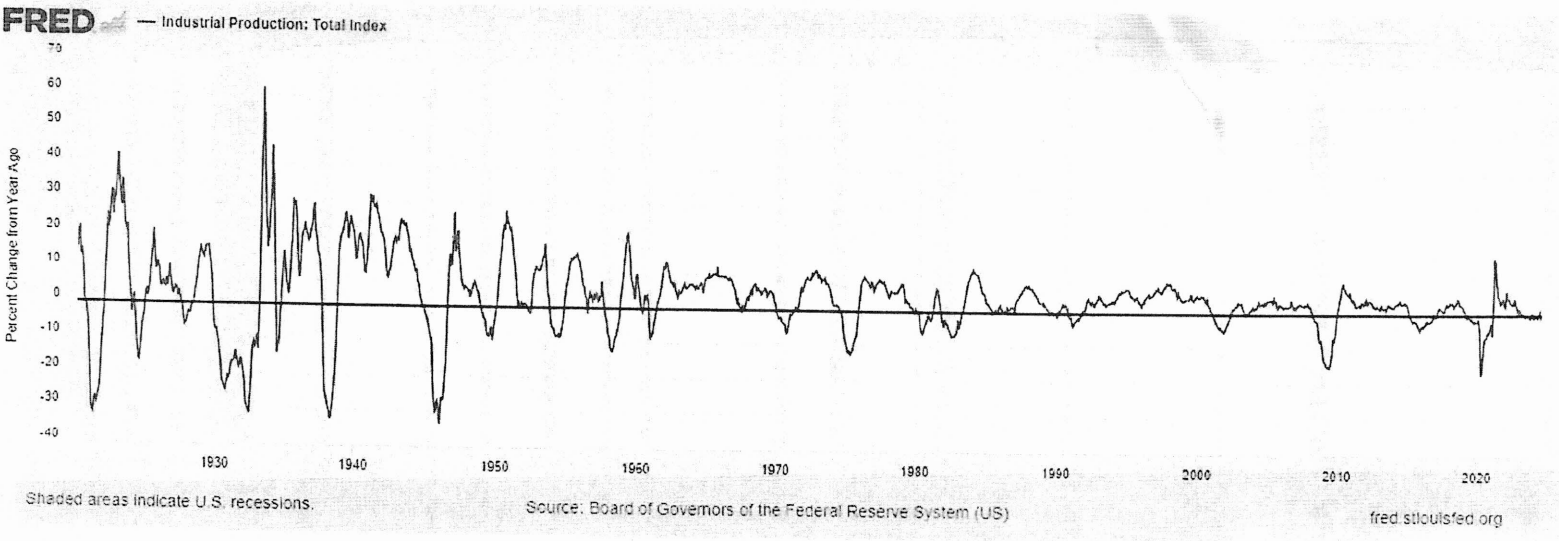


Chart 6

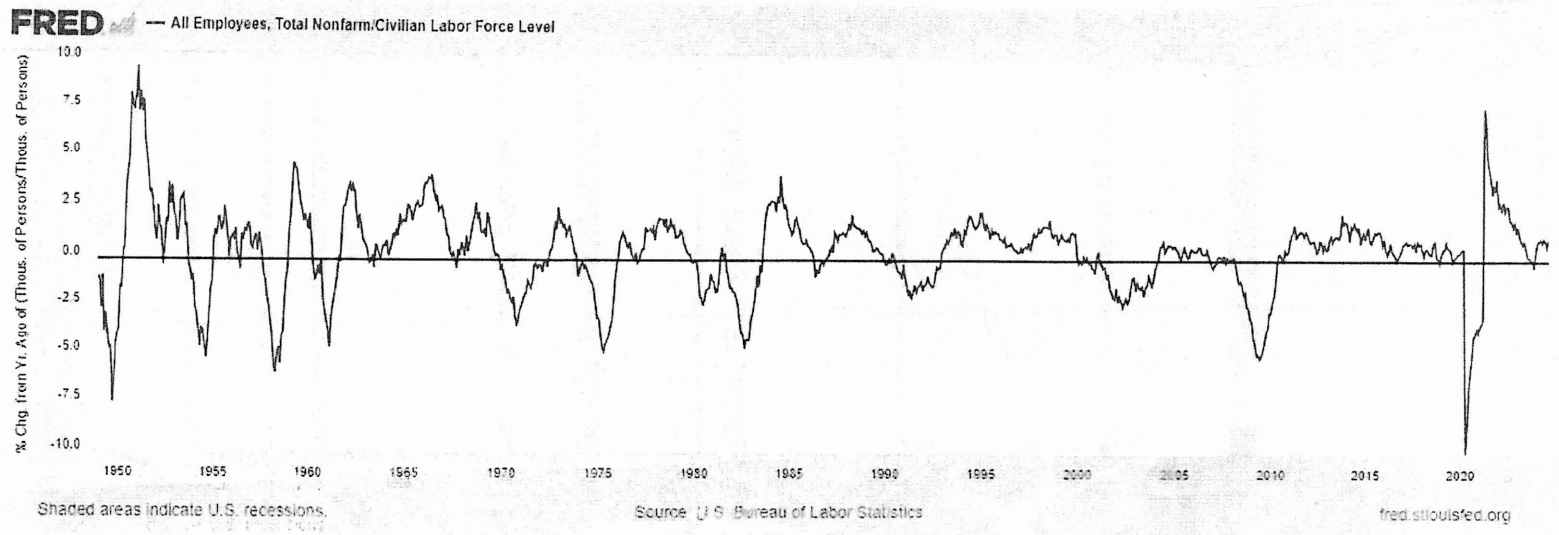
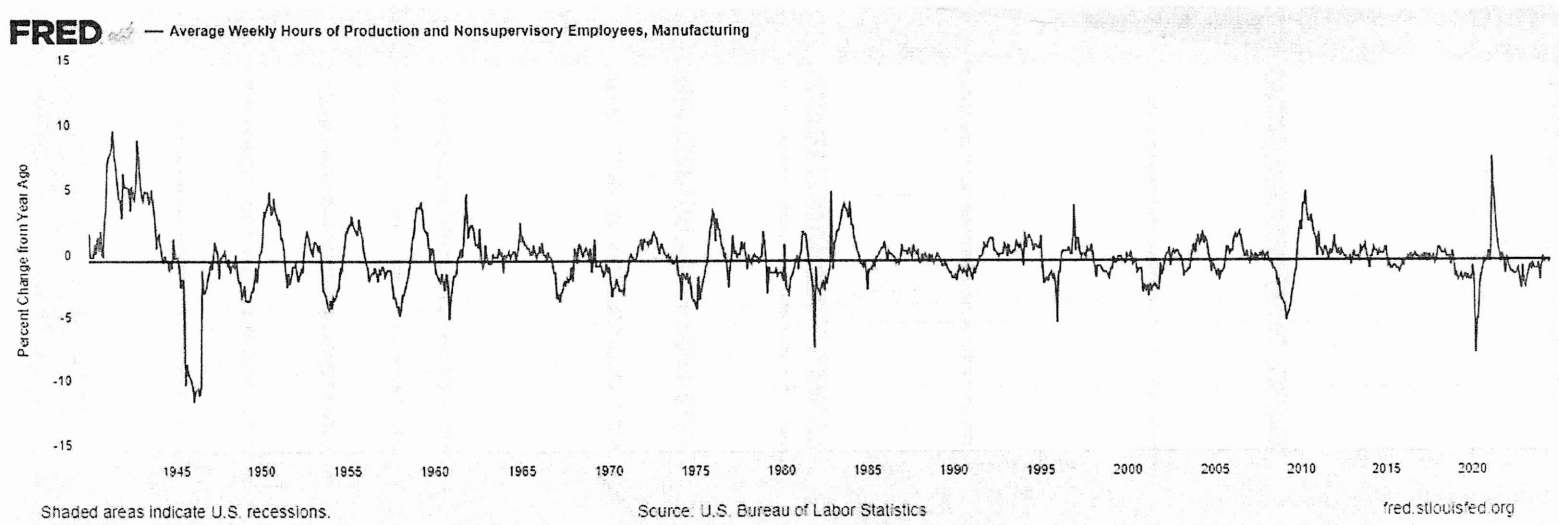



Chart 7