Financial Markets Perspective

October 2024

Global Monetary Policy and Financial Markets

The third quarter surprised financial markets in that both bonds and stocks bucked the seasonal trend and finished higher. Most notably, September will be remembered as a turning point in monetary policy as the Federal Reserve reversed course and lowered the target fed funds rate by 50 basis points down to a range of 4.75-5.00%. This change to "easy" money was broadly expected in financial markets as the Fed's strategy to use interest rates to lower inflation appeared effective. The broad measures of inflation, the CPI, PPI, and PCE all fell into the 2-3% range for the most recent reporting period in September. The U.S. Aggregate Bond index finished up 5.2% -- its best quarter since December 2023 and the 5th consecutive month of gains. While credit markets experienced some volatility in early August after the unwinding of the yen carry trade, investment grade and high-yield bonds quickly recovered, returning 5.7% and 5.1%, respectively. While the third quarter was strong in the fixed-income market, gains are unlikely to be repeatable given how much Fed easing is already expected in the months ahead.

History tells us that equity markets advance when the Fed lowers the fed funds rate. So far, that expectation is being fulfilled as major market indices such as the Dow Jones Industrial Average and the S&P 500 index hit record highs in the third quarter, with the S&P 500 up 6%, scoring four record highs during the quarter and marking its fourth consecutive quarter of gains. The S&P 500 has achieved 42 record highs so far this year and has returned 21.7%. The powerful stock market rally has been underpinned by strong earnings growth, with second-quarter earnings rising at the fastest pace since the fourth quarter of 2021. More importantly, the third quarter brought a change in market leadership, significantly widening returns beyond the mega-cap tech leaders. Tech underperformed the S&P 500 by its widest margin since the second quarter of 2016. The best performers were more defensive and interest-rate sensitive stocks, such as Utilities and Real Estate.

Across the pond, the European Central Bank (ECB) lowered the deposit rate in September by a quarter of a percentage point to 3.50% after inflation fell to 2.2% in August. As a result, equities declined slightly during September but have been up double-digits over the last twelve months, with the S&P Europe 350 index up almost 20%. Key gainers up more than 10% this year include equities trading on exchanges in Belgium, Denmark, Germany, Italy, the Netherlands, Spain and Sweden. Meanwhile, the Bank of England cut interest rates from 5.25% to 5.00% in August for the first time in four years, sending equities in London down and lowering year-to-date returns to around 5%.

Economic prospects are brightening in Europe and the United Kingdom after both regions experienced near-recession conditions during 2023. More robust bank lending and rising incomes are boosting Europe, but Germany continues to struggle due to its auto sector's reliance on China. The UK economy is finally showing signs of life after being stagnant since the end of COVID lockdowns, with consumer and business confidence rising and inflation easing.

In the Asia-Pacific region, Japan's economy is touch-and-go as gross domestic product (GDP) growth is weak, and household spending is under pressure from rising prices. The Bank of Japan seems determined

to swim against the global central bank trend by raising interest rates further. As a result, Japan's equity market remained volatile (also due to mixed election results), with the S&P Japan 500 index up and down by 4% in the last days of September, closing the month lower. Yet, the year-to-date return for the index is a gain of almost 15%. China's economy remained pressured by weak property-market problems, slowing credit growth, and near-record-low consumer confidence. As a result, China's central bank unveiled the most aggressive stimulus package since the pandemic to boost the country's economy. Chinese and Hong Kong stocks rocketed, with the S&P China 500 index and the S&P Hong Kong Broad Market index (BMI) closing the quarter up 18% and 21%, respectively.

Financial markets are barometers for the health of the overall domestic economy. We have seen better-than-expected economic data, and the sensitive measure of short-term economic conditions, as measured by the GDPNow forecast from the Federal Reserve Bank of Atlanta, indicates that third-quarter real GDP growth could come in at 3.1% -- up from a previous estimate of 2.9%. However, the continuing strike at Boeing is a factor that could have a major negative impact on bonds and stocks in the fourth quarter of this year. We also remained concerned about the uncertainty surrounding Russia's continued war on Ukraine and the immeasurable impact of an expanding war in the Middle East.

Conclusion

Last quarter, we concluded: "New highs in the equity market may be forecasting continued better economic times. Investors are celebrating rising corporate profits and expecting lower inflation and interest rates. The short-term roadblocks include the wars in Gaza and Ukraine and the inability to forecast their outcomes. The commercial real estate markets are in turmoil, with one or more large bankruptcies possible. Lastly, the result of our national election may permanently change how the government relates to the private sector. We sense some increased market volatility and uncertainty as we approach election day. Yet, as we enter the year's third quarter, the outlook remains bright despite these pending uncertainties."

For the most part, we were fortunate that our last quarterly forecast came to fruition with bond and stock markets rallying around the globe. As we pointed out in our October Market Musings earlier this month, financial markets tend to do well over a complete presidential cycle as measured from the beginning of a new president's inauguration. So, our conclusion for the fourth quarter is: "Steady as she goes."