Third Quarter 2024 Market Commentary

An Oxford Harriman & Company Market Commentary

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The major development in the third quarter was the Federal Reserve's decision to cut interest rates by 0.50%, the first rate cut of this cycle. This occurred as the Fed shifted its focus, with unemployment rising to a 33-month high and inflation receding. In the equity market, stocks ended the quarter higher despite some volatility, including a brief but sharp sell-off in early August. The S&P 500 posted its fourth consecutive quarterly gain and ended September near an all-time high. This commentary discusses the Fed's first rate cut, examines the increase in market volatility, recaps third quarter market performance, and looks ahead to the final quarter of 2024.

The Federal Reserve Cuts Interest Rates

During the third quarter, the Fed began the process of normalizing interest rates after a volatile five years. To recap, the Fed cut interest rates a total of 1.5% to near-zero during the COVID pandemic to support the economy. It kept rates near 0% until March 2022, when it began raising interest rates in response to soaring inflation. From March 2022 to July 2023, the central bank raised rates by 5.25%, one of the largest and fastest rate-hiking cycles in decades. The Fed held interest rates steady for over a year as it waited for inflation to return to its 2% target, and after 14 months, it started the rate-cutting cycle with a 0.50% reduction at its September meeting.

The Fed's transition to cutting interest rates comes as its focus shifts from lowering inflation to supporting the labor market. Since the last rate hike in July 2023, annual inflation has dropped from 3.3% to 2.6%. However, over the same period, unemployment has risen from 3.5% to 4.2%, the highest level since October 2021. The Fed appears confident that inflation will return to its 2% target but has expressed concerns about the health of the U.S. labor market. The Fed and investors are trying to understand the reasons behind, and impact of, the labor market softening over the past year. This could be the labor market simply normalizing after experiencing significant disruption during the pandemic. However, it may also be an early sign of weakening labor demand. This uncertainty is one reason the Fed moved to cut interest rates.

Investors expect the Fed to cut interest rates at its two remaining meetings this year, with further reductions expected throughout 2025. The market expects an additional 0.50% rate cuts by the end of this year, followed by another 1.50% by the end of 2025. Investors are betting that the combination of falling inflation and rising unemployment will cause the Fed to implement these significant rate cuts. However, the actual timing and amount of rate cuts will depend on the economy's path. A weaker economy will justify more rate cuts, while a stronger economy will require fewer rate cuts.

Impact of Rate Hikes on the U.S. Economy

There are four key economic indicators that offer insight into the current state of the U.S. economy: manufacturing PMI, housing starts, consumer credit, and retail sales.

Manufacturing PMI (Purchasing Managers' Index) is a key gauge of manufacturing activity. Values above 50 indicate expansion, while those below 50 signal contraction. The pandemic triggered a sharp decline in manufacturing, followed by a strong recovery in 2021. However, since the Fed began raising interest rates, the PMI has steadily declined and remained below 50. This may suggest the manufacturing sector is contracting, with higher interest rates likely putting downward pressure on the industry.

After dropping early in the pandemic, housing starts rebounded through early 2022. However, as the Fed raised interest rates, the number of housing starts declined. This downward trend reflects the impact of higher mortgage rates, which has reduced affordability and dampened construction activity.

The number of new residential construction projects is an important leading indicator and a key measure of housing market health. After dropping early in the pandemic, housing starts rebounded through early 2022. However, as the Fed raised interest rates, the number of housing starts declined. This downward trend reflects the impact of higher mortgage rates, which has reduced affordability and dampened construction activity.

Year-over-year changes in consumer credit outstanding provides insight into the willingness of consumers to take on new debt. Loan growth surged during the pandemic, fueled by fiscal stimulus and low interest rates. However, since the Fed began raising rates, loan growth has leveled. Slowing loan growth can be a sign that consumers are less willing or able to borrow due to higher interest rates, which can curb purchases of interest-rate-sensitive goods like homes, autos, and boats.

Consumer spending is a key driver of economic growth since it makes up a large portion of GDP. Retail sales plummeted as the economy shut down in the pandemic, but spending rebounded sharply in late 2020 and 2021. While retail sales growth has slowed with rising interest rates, it remains positive, indicating that consumer spending is holding up relatively well despite higher rates. The consumer's willingness to keep spending has been a source of strength and economic resilience.

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Together, these data points reveal the impact of rate hikes on the economy. Higher interest rates appear to be weighing on manufacturing, housing, and loan growth. However, the main engine of the economy, the consumer, continues to spend. Economic data may indicate that the current level of interest rates is restrictive, and the Fed's goal in lowering rates is to stimulate interest-rate-sensitive sectors and prevent a deeper slowdown. Economists and investors will monitor these data points in the coming months to gauge the impact of the Fed's interest rate cuts on the economy.

Financial Markets Experience Increased Volatility

In early August, the stock and bond markets experienced significant volatility. Signs of investor stress started to appear during the earnings season in July, when investors raised concerns about the high costs of developing artificial intelligence (AI) and whether future revenues would justify the expensive investments. A few weeks later, investors were spooked as unemployment rose from 4.1% to 4.3%. Investors worried the Fed had waited too long to cut rates and risked tipping the U.S. economy into a recession that could be hard to reverse.

Collectively, these concerns caused investors to sell stocks and buy bonds, leading to a significant deleveraging event across global financial markets. The S&P 500 declined more than 8% from mid-July through the first week of August. This slide was punctuated by a 3% drop in this index on August 5th as concerns about global currency moves led to panic selling. Indeed, the CBOE Volatility Index spiked to 65 in early trading that day (from a mid-teens level the week before).

However, the volatility was short-lived, and the S&P 500 rebounded to end August with a modest gain. There was some continued volatility in early September as investors returned from summer break, but the S&P 500 again recovered quickly and set a new all-time high later in the month. The rise in market volatility marks a significant shift from the past 12 months of steady S&P 500 gains, but so far, investors have brushed it aside.

Equity Market Recap – Stocks Trade Higher as Investors Rotate Within the Market

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Despite the volatility, the S&P 500 set multiple new all-time highs during the third quarter, adding to its list of new highs from earlier in the year. However, it was the change in stock market leadership that made headlines. The Equal-Weighted S&P 500, the Russell 2000, and the Value factor all outperformed the S&P 500, while the Growth factor underperformed. A similar pattern occurred at the sector level, with underperformers from the first half of 2024 outperforming in the third quarter. Interest-rate-sensitive sectors outperformed in anticipation of rate cuts, with the Utility and Real Estate sectors both gaining over 17%. Cyclical sectors, including Industrials, Financials, Consumer Discretionary, and Materials, also outperformed the S&P 500. In contrast, the Technology sector lagged the market rally, ending the quarter flat after outperforming in the first half of the year.

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Two key events, the Fed's first interest rate cut in September and growing concerns about AI's profitability, led to the change in market leadership in the third quarter. In the first half of 2024, uncertainty around Fed policy and concerns about the economy pushed investors toward large-cap and AI stocks. Meanwhile, smaller companies underperformed due to worries about their sensitivity to higher interest rates. With the Fed now officially cutting interest rates and doubts emerging about AI's monetization potential, investors sought out new investment opportunities.

International stocks outperformed U.S. stocks in the third quarter for the first time since the fourth quarter of 2022. The MSCI Emerging Market Index gained 7.7%, outperforming the S&P 500 by almost 2%. The MSCI EAFE Index of developed market stocks also outperformed the S&P 500, returning 6.8%. International stocks benefited from two themes: a weaker U.S. dollar and AI companies' underperformance during the stock market rotation. However, despite outperforming in the third quarter, the two major international indices are still underperforming US equities year-to-date due to their lack of exposure to AI stocks.

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Bond Market Recap – Bonds Trade Higher in Anticipation of Interest Rate Cuts

In the third quarter, bonds traded higher as investors prepared for the start of the Fed's rate-cutting cycle. The 10-year Treasury yield fell from 4.37% at the end of June to 3.79% at the end of September. The 2-year yield, which is a proxy for investors' rate cut expectations, fell from 4.72% to 3.64% over the same period.

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On one end, CCC-rated bonds, the lowest-rated and most sensitive to economic conditions, produced a total return of over 11% as corporate credit spreads tightened. The group's outperformance suggests that investors expect interest rate cuts to stimulate economic growth and make refinancing easier.

On the other end, AAA-rated bonds, the highest quality and most sensitive to interest rate changes, gained over 6% as the market priced in the first rate cut and yields fell.

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Together, the two groups' outperformance may indicate that investors expect rate cuts to boost economic growth and relieve pressure on highly leveraged companies. It appears that corporate bond investors are receiving less yield compensation for taking on corporate credit risk compared to the past 20 years. We believe credit spreads are often used to gauge financial conditions and investor sentiment toward the economy. Today's tight spreads signal economic stability, strong market liquidity, investor willingness to buy risky assets, and low perceived default risk.

Fourth Quarter Outlook

With the Fed beginning to lower interest rates, investors are focused on what happens next. The two key questions are how much the Fed will cut interest rates and how the economy will respond to those rate cuts. The next six months will be critical in providing answers to these questions, and investors will analyze each economic data point for clues about the economy's trajectory. This intense focus on economic data may have the unintended consequence of keeping market volatility elevated as investors flip between optimism and pessimism.

We researched the S&P 500's performance in the 12 months before and after the first interest rate cut. Historically, the S&P 500 has performed very differently depending on whether the economy falls into a recession after the first rate cut. When rate cuts stimulate economic growth, the S&P 500 gains an average of 23% over the next 12 months. However, if a recession follows, the S&P 500 declines, on average, 4%. Our team will review economic data in the coming months to see what impact interest rate cuts have on the economy.

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Many economists believe that the unemployment rate will remain relatively steady over the next twelve months. At the same time, they do expect a cooling in wage increases and a more stable and less mobile workforce. In other words, job seekers are more likely to stay in the roles that they currently occupy versus leaving their current employment to find higher wages elsewhere. As a result, there is growing confidence among economists that inflation will continue to ease in the year ahead giving the Fed room to continue to lower rates. We remain cautious about such views; however, recognizing that inflation is comprised of many components, not just wage growth.

Political views can stir strong emotions, but we believe making investment choices based on those feelings can lead to poor portfolio decisions.

As we conclude this quarterly commentary, we want to briefly touch on the upcoming presidential election. With the election quickly approaching, you may be wondering how the outcome will affect financial markets and whether you should change your investment strategy. Political views can stir strong emotions, but we believe making investment choices based on those feelings can lead to poor portfolio decisions. As we mentioned in one of our recent commentaries, data suggests that whichever party occupies the White House has little to no impact on investment performance, with fundamental factors like corporate earnings growth and valuations impacting the stock market far more than political headlines. The U.S. economy's success, growth, and resiliency don't change with each new election, and neither should your long-term investment strategy.

We remain committed to monitoring the many factors that could impact the markets and will keep you updated accordingly.

Sources:

Standard & Poor's

WhiteHouse.gov

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Russell 2000® Index: The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

S&P 500 Index: The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.

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