

# BULLS & BEARS

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## Do Valuations Matter?

This inexorable climb in the market, with few interruptions and mild volatility, has led to increasing consensus among investors that valuations really don't matter any longer, especially given some of the unique characteristics of the Magnificent Seven. These companies could be considered in some cases to be quasi-monopolies, their large cash balances allow them to benefit from higher rates, and they generate almost shocking amounts of cash flow. Any discussion of valuation in client meetings these days is often met with signs of restless boredom. Their only potential weakness, some might concede, may come from the regulatory winds that come from Washington. For those of us of a certain age, one could be forgiven for being reminded of Irving Fischer's claim that the market has reached "a permanently high plateau."

Still, there are times, like 2022, when great companies can become bad stocks. Between now and the election, we would be loath to be underweight or short these companies under the threat of violence. Fiscal policy is easy and monetary policy is likely to become more accommodative. Still, we do not believe the laws of financial physics have been repealed. The significant decline in private equity exits (companies going public) is some testament to the fact that there are limits.

## Rate Cuts

With the first rate cut by the Fed likely to come in the next few months, we've been inundated with questions on how markets typically behave when the Fed starts cutting. Equity performance in rate cut cycles varies dramatically depending on what is going on with the economy. In easing cycles where the deterioration in employment is modest (i.e., soft landings), the market tends to be off to the races. In Fed easing cycles where employment continues to deteriorate sharply (i.e. recession) you tend to get market selloffs as claims rise.

When the Fed is cutting, we've seen consistent outperformance of quality factors over cyclical ones. This dynamic can be explained by the fact that the Fed is typically easing to support slowing growth. In periods of slowing growth, investors tend to reach for quality and risk-off factors.

Given the significant and persistent underperformance of small caps throughout the recent tightening cycle, many investors are anxious for the onset of an imminent easing cycle to be a boost for smaller cap stocks. We looked at historical performance of large and small caps in the 3,6- and 12-month

periods after the Fed's first cut. Every cycle has its nuances and there may be a small-cap cap catchup trade to be had, but history certainly doesn't indicate consistent small cap leadership when the Fed starts easing. In fact, more often than not, small caps underperform the first year after the Fed Eases.

## Dual Mandate

After years of persistent strength, the Fed's efforts to cool the economy are working. Inflation pressures are subsiding with most inflation readings below 3% on a year-over-year basis. The labor market has cooled, with job hiring and quit rates back to normal and the unemployment rate inching up. The interest-rate sensitive areas of the economy (e.g., housing, autos) are under pressure from elevated rates. And consumers, feeling the impact of price hikes, are slowing their spending. Case in point: car manufacturers and dealers have slashed prices and beefed-up incentives to counter softening demand.

Up until now, this has been good news for the Fed in its quest to tame inflation. But there is growing concern that the economy is cooling too quickly. Powell warned about the potential downside risks to growth from holding monetary policy too tight for too long, and former Fed Governor Dudley, one of the more vocal higher for longer hawks, is now openly calling for the Fed to start cutting rates. Hence, bad news may be turning into bad news, particularly if softer growth starts to weigh on earnings.

Please contact us at 1-855-829-7192 if we may be of assistance.

## Market Indicators

### 6/30/24 Year-to-Date Change

S&P 500	15.29%
NASDAQ	18.57%
Russell 2000	1.73%

### Interest Rates

	<u>12/31/23</u>	<u>6/30/24</u>
10-Year Treasury Note	3.88%	4.40%
3-Month Treasury Bill	5.35%	5.37%



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