ECONOMIC OUTLOOK & MARKET REVIEW | 3Q24

KEY TAKEAWAYS:

1. **Artificial Intelligence (AI) dominated investor psyche and drove market performance during the quarter. Market sentiment was also supported by the expectation of a continued expansion, a rebound in corporate earnings, and Fed interest rate cuts.**
2. **We believe the transition to lower interest rates will be slow and longer-term rates are likely to remain elevated, which will have significant investing implications.**
3. **The US economy's underpinnings remain constructive, fortified by continued strength in the labor market, a healthy consumer, and strong corporate balance sheets.**
4. **Despite anticipated volatility, domestic markets remain attractive. Stocks should benefit from continued spending and, for those seeking current income, short and intermediate bonds offer attractive yields.**

Artificial Intelligence (AI) stocks dominated investor psyche during the second quarter. The S&P 500 was up 4% in the quarter, led by Nvidia Corporation and supported by generally constructive economic reports and stable interest rates. While AI, which has been under development since the 1950s, has been the dominant theme of market performance for the last several quarters, up until recently it was largely an afterthought for the public. The November 2022 release of ChatGPT proved a seminal moment and immediately changed the calculus for investors, businesses, government, and consumers.

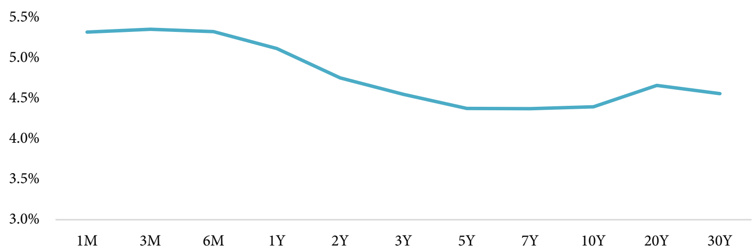
Nvidia designs and sells the computer chips necessary to keep AI humming and is the foremost example of both the acceptance of, and the potential for, general AI. Sales of Nvidia's chips rose over 400% to $22.5B in its latest quarter, supporting the stock's 150% increase year to date. In late June, Nvidia supplanted Microsoft as the U.S.'s most valuable company. Further exhibiting the "power of AI", Apple stock rallied after announcing an enhanced AI engine, propelling it to record highs. While the companies that make the chips and software for AI have received much of the attention, a rising tide lifts several boats. For example, AI's insatiable appetite for data storage and energy, both for processing and cooling, presents opportunities for companies that are involved in constructing the necessary backbone of data centers.

In addition to the AI phenomenon, positive market sentiment is driven by the expectation of continued expansion, a rebound in corporate earnings, and Federal Reserve (Fed) interest rate cuts. For now, the market seems mostly unconcerned about the economy, the wars in Ukraine and the Middle East, or the domestic political climate.

The Fed is in a difficult position. At over 5%, near-term interest rates are considered restrictive to economic activity, and many believe that the Federal Reserve will (and should) lower short-term rates. Whether they lower rates or not, the economy continues to expand coincident with inflation trending down, closer to the Fed's preferred 2% rate. Housing-related inflation remains too high but leading indicators suggest that shelter costs should moderate later this year. This has created a conundrum for the Fed: lower interest rates too soon and inflation's path may reverse, wait too long and higher short-term interest rates could force a broad economic pullback.

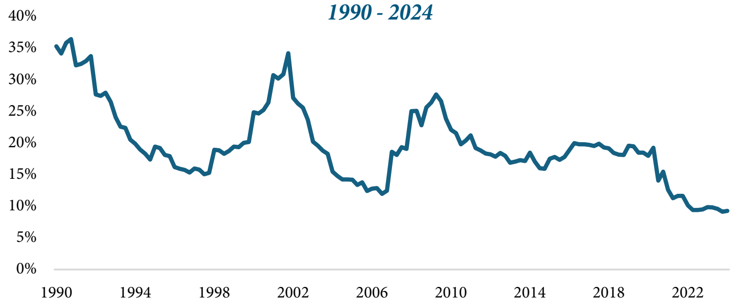
The yield curve remains inverted with short term rates higher than longer ones, a condition that has historically preceded a recession. But after two years of inversion, the economy has settled into a moderate expansion. Many consumers and businesses have been sheltered from the higher short term interest rates because of enhanced pandemic-era savings. In addition, fixed-rate debt accumulated in that era, be it mortgages or corporate bonds, carry lower interest rates. While the absolute level of debt has risen, consumers and business are less burdened by interest payments.

Current US Treasury Yield Curve



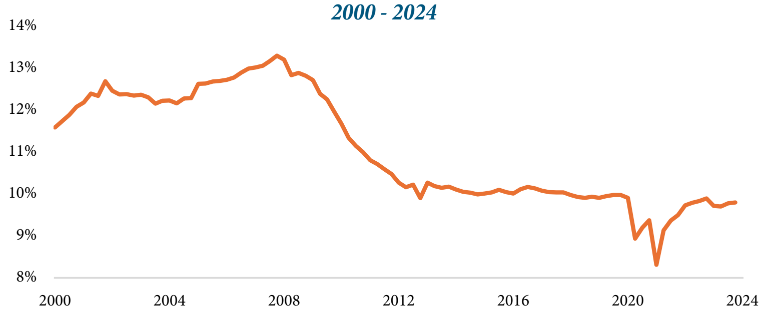
Source: Bloomberg

Corporate Net Interest Paid as a % of Operating Surplus 1990 - 2024



Source: US Federal Reserve

Household Debt Service Payments as a % of Disposable Personal Income 2000 - 2024



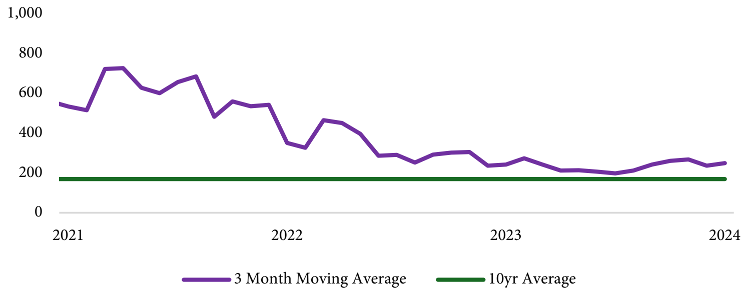
Source: Board of Governors of the Federal Reserve System

We believe the transition to a lower interest rate era will be slow, more a waltz than a tango. It will likely leave many unsatisfied as five- and ten-year interest rates are unlikely to retreat to the levels we experienced in the 2010's and will stay near current levels for the foreseeable future. This potential return to the pre-Great Financial Crisis norm and a more "normal" yield curve will have more investing implications as we approach the late 2020's.

The economy's underpinnings remain constructive. For the consumer, employment opportunities, while not as robust as 2 years ago, are still solid. The labor market is still adding over 200,000 jobs per month, on average. Wage growth has slowed but continues to outpace inflation.

Change in Non-Farm Payrolls (Thousands of Persons)

2021 - 2024

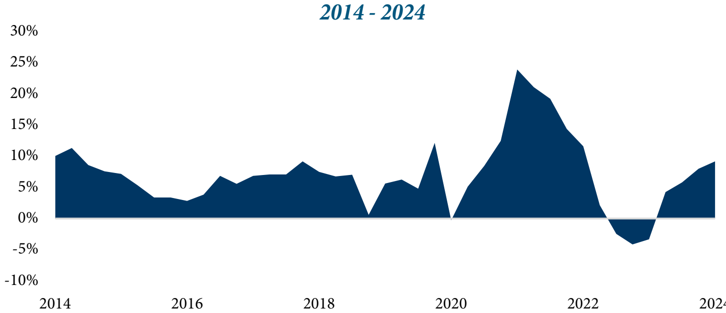


Source: US Bureau of Labor Statistics

Consumer net worth, which incorporates asset prices, is up 9% over the past year, which helps explain the solid consumer spending trends. While many readings of consumer sentiment are far less positive than the financial metrics would suggest, we attribute this odd contrast to broader geopolitical concerns, some social unrest and an uninspiring domestic political climate. The overall consumer remains broadly healthy, although lower income earners are feeling the pinch. That was evident last quarter as companies that focus on cheaper goods and services noted strains in their customer bases.

Household Net Worth (% Change from a Year Ago)

2014 - 2024

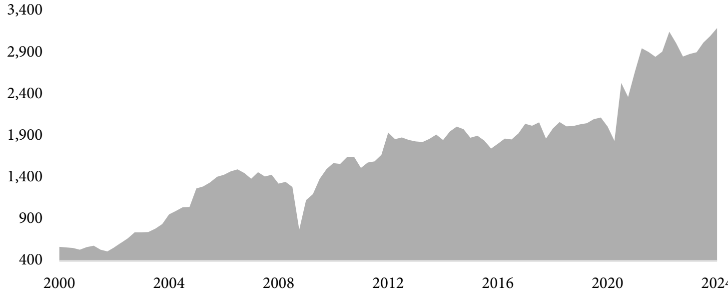


Source: Board of Governors of the Federal Reserve System

Similar to the consumer, American companies are generally in good shape. Earnings growth took a breather in 2023 but financial strength did not. Profit margins remain near record highs and the pandemic-era disruptions are in the past. Corporate earnings grew over 5% in the first quarter and are expected to be up 9% in the second. However, with less ability to increase prices going forward, companies will need to remain efficient to support current valuations.

Corporate Profits After Tax (Billions of Dollars)

2000 - 2024



Source: US Bureau of Economic Analysis

We expect more volatility this year and into next driven by domestic and global events. Domestically, presidential elections frequently come with political talking points and promises, that in most cases will never be realized. However, they can impact interest rates and stock prices as investors attempt to gauge longer-term impacts. Stock market performance continues to be largely driven by a handful of stocks, and a return of market breadth could create issues for portfolios that are not appropriately diversified.

Globally, geopolitical tensions remain heightened, and we would not be surprised to see certain nations testing U.S. resolve, especially as it pertains to the current conflicts in Ukraine, the Middle East, and Taiwan. Most economies are also navigating their own tricky paths. China faces domestic growth challenges, Japan is tackling its own inflation fight after raising its short-term interest rate for the first time in 17 years, and Europe continues to struggle with productivity.

Anticipated volatility aside, the domestic markets remain attractive. Stock investors should benefit as corporate earnings rebound and job creation supports spending. Pandemic era fiscal stimulus packages continue to prop up government spending and companies will continue to invest in AI initiatives. For those seeking current income, short- and intermediate-term bonds offer attractive yields. Those yields may be with us longer than many anticipate.

Investment Oversight Committee

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