JAMES
Investment Research, Inc.

ECONOMIC OUTLOOK 2024

4th Quarter Outlook

An Indepth Forecast
of the Year 2024

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In This Report

3rd Quarter Recap

The third quarter of 2024 was characterized by two pivotal developments: unprecedented market turbulence and a decisive turn in Federal Reserve (Fed) policy. Throughout August and September, the stock market experienced substantial fluctuations driven by various economic factors and corporate earnings reports, following an all-time high reached on July 10, 2024. The CBOE Volatility Index (VIX), a key measure of market volatility, saw dramatic swings. In early August, it logged its largest-ever intraday jump, spiking to nearly 66 before settling above 38. By mid-August, it had fallen back to around 15, illustrating the rapid shifts in market sentiment.

Nvidia, a bellwether for artificial Intelligence (AI) related stocks, exemplified the market's volatility. On September 3, Nvidia's market value plummeted by $279 billion in a single day, marking the largest one-day decline in a company's market value in U.S. history. This event highlighted the fragility of even the most robust tech stocks during this period.

The Federal Reserve initiated its rate-cutting cycle with a significant 50 basis-points (bps) reduction at the September Federal Open Market Committee (FOMC) meeting, bringing the new Fed Funds target range to 4.75%–5%. This marked the first non-COVID-19-related cut since 2019 and came from a 20-year high point in interest rates. The move signaled a pivotal shift in monetary policy and demonstrated the Fed's commitment to staying ahead of potential economic challenges.

The Fed's updated Summary of Economic Projections (SEP) dated September 18, 2024, indicates further cuts likely for the near future, with 50 bps more expected this year and 100 bps for 2025. This proactive approach enhances the probability of achieving a "soft landing," potentially reinvigorating economic growth in 2025. The Fed's dual mandate now prioritizes employment over inflation in driving decisions, making monthly jobs reports crucial. Despite this shift, inflation remains a concern, with the core Consumer Price Index (CPI) at its highest level to start a rate cut cycle since 1989.

By September 24, 2024, the S&P 500 Index had rocketed 21.43% year-to-date, notching its 41st record close of the year, while the NASDAQ Composite Index had paralleled this impressive performance with a 21.07% leap. In contrast, small-cap stocks, represented by the Russell 2000 Index, gained a more modest 10.80%.

The performance disparity was even more pronounced when comparing the "Magnificent Seven" tech giants to the broader market. Microsoft, Amazon, Meta, Apple, Alphabet, Nvidia, and Tesla collectively rose by 43.21%, according to the Bloomberg Magnificent Seven Index. Meanwhile, the remaining 493 stocks in the S&P 500 gained only 16.47%. Further illustrating this disparity, the S&P 500 equal-weighted index, which gives the same importance to each constituent regardless of market capitalization, rose by just 14.12%. This stark contrast highlights the outsized impact of large-cap tech stocks, particularly the "Magnificent Seven", on overall market performance and underscores the concentration of gains in a handful of mega-cap companies.

Year-to-date as of September 24, 2024, all sectors of the S&P 500 have posted gains, albeit with significant disparities in performance. The Utilities and Communication Services sectors led the broad market, surging by 28.8% and 23.9%, respectively. At the other end of the spectrum, the Materials and Energy sectors have lagged, posting more modest gains of 13.4% and 8.6%, respectively. The Utilities sector's exceptional performance can be attributed to two key factors: outsized returns from utilities providing electricity to AI data centers, and a favorable shift towards lower interest rates. Leading the Utilities run was Vistra Corp., whose 194% return year-to-date through September 24, 2024 dwarfs even Nvidia's 144% return. This divergence in sector performance underscores the uneven impact of technological advancements and monetary policy changes on different segments of the economy.

Fixed income investments showed improvement in the third quarter of 2024. As of September 24, 2024 the U.S. Aggregate Bond Index had gained 4.73% year-to-date, primarily due to lower interest rates. The 10-year U.S. Treasury note yield, a key benchmark for the bond market, demonstrated a significant downward trend throughout the year. It reached a year-to-date high of 4.705% on April 25, 2024, before declining to the year's low of 3.88% on September 16, 2024. This downward movement in yields, which moves inversely to bond prices, was the main driver behind the positive performance of the broader bond market.

Economy

Production and Manufacturing

The ISM Manufacturing Purchasing Managers' Index (PMI) survey remains weak, with key indicators like production, new orders, and employment showing noticeable weakness. This weakness is reflected in Industrial Production, which has grown just 0.7% annualized since 2022, compared to 2.9% historically, and has been trending sideways for nearly two years. Fortunately, regional Federal Reserve reports from New York, Philadelphia, Richmond, and Kansas City are showing signs of improvement in new orders, suggesting a soft landing for the economy is still possible.

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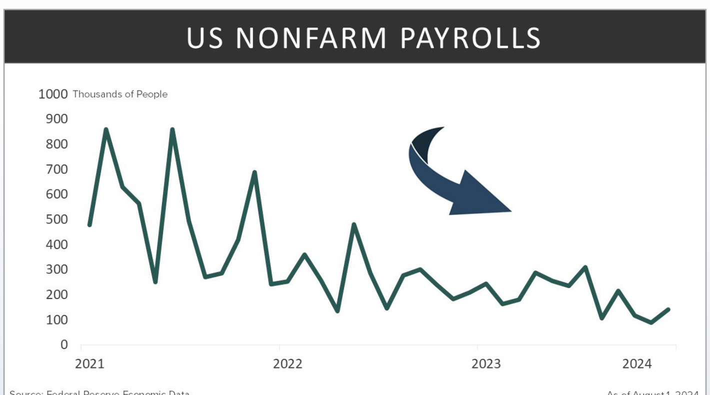
Despite the manufacturing weakness, broader economic data show some resilience. U.S. core inflation (CPI year-over-year less food and energy) has fallen over 3.4% from its 2022 peaks, while Gross Domestic Product (GDP) growth has accelerated. Real Personal Consumption grew at 1.2% for the three months ending in July, further supporting strong economic growth despite a sluggish manufacturing sector.

These factors suggest that while manufacturing remains soft, businesses are closely watching for potential shifts in monetary policy and anticipating more interest rate cuts in the coming quarters. Further interest rate cuts could help increase investment and economic growth. For now, most firms remain cautious as borrowing costs remain high, and political uncertainty, especially ahead of the U.S. elections, weighs on investment decisions.

Labor Market

The U.S. labor market continues to add jobs while simultaneously showing signs of softening. The recent jobs report revealed an increase of 142,000 jobs for the month of August, with the strongest growth in healthcare, leisure and hospitality, and construction sectors. Additionally, layoffs remain at low levels, and those in their prime working age of 25-54 years are seeing the employment-to-population ratio at a 23-year high.



However, there are growing concerns about the labor market softening and a steady decline in job openings. The unemployment rate has risen from 3.8% to 4.2% over the past 12 months, although most of this increase results from workers re-entering the labor market. Productivity gains have been strong, suggesting employers need fewer workers to meet demand, which may impact those looking for jobs. Earlier this year, our research highlighted the decline in temporary employment over the past year and how this can be a precursor to a recession. Unfortunately, this downward trend continues.

While there is no clear sign of a pending recession, the slower pace of job creation and weakening job market indicators suggest a cautious outlook. The Federal Reserve is using the cooling labor market as justification to continue their interest rate cuts, while keeping an eye on potential reversals in falling inflation data.

Retail and the Consumer

Consumer and retail trends continue to remain strong in the U.S. economy. August retail sales unexpectedly rose by 0.1%, following an upwardly revised gain of 1.1% in July. This strength highlights consumers' ability to maintain spending despite higher costs. Online sales rebounded, and gains were also seen in sectors like sporting goods and health-related purchases. Cheaper oil and gasoline prices have provided additional relief for households. Core retail sales, which exclude volatile sectors such as automobiles and gasoline, rose 0.3%, signaling steady consumer demand. Low layoffs and steady wage growth continue to support household finances and spending trends.

Our James Investment consumer indicators remain neutral, with consumption acting as a key factor in sustaining economic growth. While there has been a slight uptick in signals suggesting we may be nearing a recession, the overwhelming majority indicate a stable consumer base, and an economy entrenched in the late phase of the business cycle. Robust consumer spending, wage growth, and moderate inflation suggest the economy is not in a recession.

Housing

In October 2023, the average 30-year mortgage rate peaked at 7.8%, the highest since 2000. Since then, rates have fallen by roughly 1.5%. While consumers have expressed greater optimism regarding mortgage rates, overall homebuying sentiment remains unchanged as housing affordability remains low. The Housing Affordability Index from the National Association of Realtors was 94.3 for the second quarter of 2024, indicating limited affordable buying opportunities. Additionally, the Housing Market Index from the National Association of Home Builders (NAHB) has been declining since April.

Housing starts have been decreasing since 2022, indicating lower consumer confidence. Furthermore, permits are trending lower than in 2022, although at a diminishing rate. These indicators could reduce supply, ultimately leading to less affordable homes. In fact, home prices have not fallen for most of the country, despite higher interest rates. The most recent Case-Shiller National Home Price Index reports home prices rising almost 5% year-over-year through September 24, 2024.

As mortgage rates continue to fall, there is a possibility of an influx of consumers beginning to buy after waiting on the sidelines. Moreover, one area that could also benefit is homeowners with high mortgage rates, as they look to refinance to lower their mortgage payments. However, we are concerned this could be short-lived as it may put additional upward pressure on home prices and ultimately force buyers back to the sidelines.

Equity

Federal Reserve Policy Shift: Pivotal Rate Cut

The Federal Reserve's decisive step implementing a substantial 50 bps reduction at the September FOMC meeting demonstrates the Fed's proactive stance to engineer a "soft landing" for the economy. By gradually easing monetary policy, the Fed aims to stimulate economic activity and potentially reinvigorate growth as we move into 2025, which typically helps companies grow their earnings, and hence, stocks rise. As we saw, the S&P 500 is hitting all-time highs following the recent Fed move.

Inflation Concerns Remain

Despite the increased focus on employment, inflation remains a significant concern for policymakers. The current economic landscape presents a unique challenge, with the CPI at its highest level to start a rate cut cycle since 1989. This elevated inflation rate adds a layer of complexity to the Fed's decision-making process, requiring a delicate balance between stimulating growth and managing inflationary pressures.

Market Expectations vs. Fed Plans

A potential disconnect has emerged between market expectations and the Federal Reserve's projected plans. Financial markets are currently pricing in a more aggressive rate-cutting cycle, anticipating 100 bps of cuts for 2024 and a total of 10 cuts by the fourth quarter of 2025. This outlook may prove overly optimistic, especially if the labor market remains robust and the economy avoids a significant downturn. The disparity between market expectations and the Fed's actual intentions could lead to volatility as investors adjust their positions based on evolving economic data and policy decisions. We should also note that the market has been overly optimistic in calling for rate cuts for the last couple of years – at least.

Corporate Earnings and Market Valuation

Stellar Earnings Season

The second quarter of 2024 has witnessed exceptional corporate earnings performance. According to FactSet, 79% of S&P 500 companies reported positive earnings per share (EPS) surprises, while 60% exceeded revenue expectations. The blended year-over-year earnings growth rate for the S&P 500 reached an impressive 11.3%, marking the highest growth rate since the fourth quarter of 2021. Nine sectors reported higher earnings compared to initial estimates, driven by upward revisions and positive surprises. This strong earnings season reflects the resilience and adaptability of American corporations in the face of changing economic conditions.

Elevated Market Valuation

Current market valuations remain elevated, presenting both opportunities and challenges for investors. According to FactSet, the forward 12-month price-to-earnings (P/E) ratio for the S&P 500 stands at 20.6, surpassing both the 5-year average of 19.4 and the 10-year average of 18.0. These high valuations suggest that much of the positive economic outlook may already be priced into the market. As a result, the near-term upside for equities may be more limited compared to previous soft-landing scenarios, requiring investors to be more selective in their approach.

Positive Economic Indicators

Recent economic data paints a nuanced picture of the U.S. economy. Retail sales have exceeded expectations, indicating robust consumer spending. The manufacturing sector shows signs of improvement, with key indices trending positively. The labor market remains resilient, as evidenced by consistently low jobless claims. Additionally, the housing sector is exhibiting positive trends, suggesting a recovery in this crucial area of the economy. These indicators collectively point to underlying economic strength, which may influence the pace and extent of future rate cuts.

Market Implications and Sector Performance

Historically, the commencement of a rate-cutting cycle during non-recessionary periods has often led to robust equity market performance. This pattern suggests that the current economic environment could be conducive to continued market strength, albeit with some caveats given the elevated valuations.

Sector Rotation

The shift in monetary policy is likely to catalyze a rebalancing in market performance across various sectors. Cyclical and interest rate-sensitive sectors may see increased investor interest as lower rates typically boost economic activity. Small and mid-cap stocks could benefit from improved liquidity conditions and economic growth prospects. High dividend-paying stocks and preferred stocks may also attract investors seeking yield in a lower interest rate environment.

Cash on the Sidelines

A significant amount of capital, $6.3 trillion, currently resides in money market funds, representing a potential source of future market support. As interest rates decrease, some of this sidelined cash may flow into riskier assets like equities, potentially providing additional fuel for market growth.

Certain sectors, particularly technology and communications, are sitting on substantial cash reserves. This accumulation of capital could drive increased mergers and acquisitions activity, as companies seek to deploy their resources strategically. Such corporate actions have the potential to further propel market growth and reshape industry landscapes.

Risks to Our Scenario

While the economic outlook appears cautiously optimistic, several factors could disrupt the current trajectory. A resurgence of inflation could force the Fed to pause or reverse its rate-cutting cycle, potentially shocking the markets. Any significant deterioration in the labor market could increase the odds of a recession, altering the economic landscape dramatically. Geopolitical risks, particularly ongoing tensions in the Middle East and Ukraine, continue to pose threats to global stability and economic growth. Domestically, the potential for contested election results in November 2024 introduces an element of political uncertainty that could impact market sentiment and economic policy.

Fixed Income

Inflation

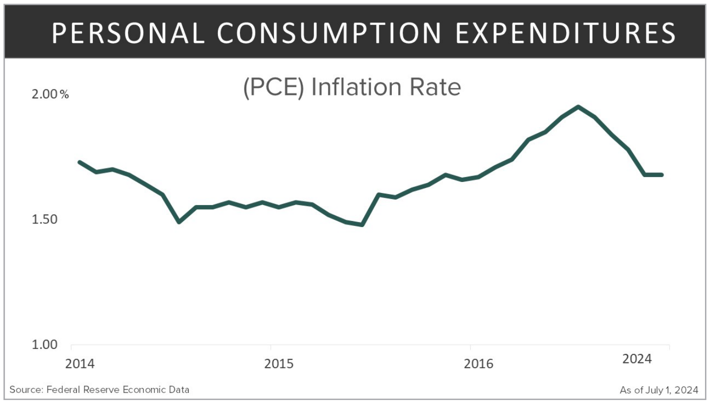
The Federal Reserve's recent rate cut didn't catch anyone off guard, as rates on 2-Year and 10-Year Treasuries had already declined by 50 and 40 bps, respectively. Investors, reading the tea leaves, bought ahead of this recent move.

When examining the rationale behind the decision, we must remember that the Fed operates under a dual mandate: maximizing employment while maintaining price stability. A weaker labor market helped pave the way for the cuts as the unemployment rate rose to 4.3% – not an exorbitant number, but certainly moving higher. Some argue the rate cut was a preemptive move to prevent the job market from worsening further, while others suggest the Federal Reserve waited too long amid a cooling labor market. Throughout, the Fed maintained they are "strongly committed to supporting maximum employment."

Inflation data also trended lower, allowing Fed Chair Jay Powell and his colleagues to act. The CPI readings increased by 2.6% from a year ago. While this is still slightly above the Fed's 2.0% target, it's drastically lower than the 9.0% rate seen just a couple of years

ago. The Fed cited the trend to lower inflation rather than change its inflation target, giving them room to change the focus to employment.

Although investors and consumers often focus on CPI, it's worth noting that the Fed's preferred inflation gauge remains the Personal Consumption Expenditures (PCE) index. The Fed believes that if they remain on this path, the rate should fall to 2.3% by the end of this year and 2.1% next year, just a hair above their desired rate of 2.0%.



Rather than implying the rate cuts were a necessary move to keep the economy afloat, Fed Chair Powell used the term "recalibration" to soften the tone. The intent was perhaps to suggest the move was simply to put rates in a range where they are no longer restrictive, but rather at their chosen neutral level. As a result, many Wall Street prognosticators now anticipate two more rate cuts in the remainder of 2024, at each of the November and December meetings. Unsurprisingly, the Fed declared the process would take place over time, indicating the committee is not in a rush. Should those two cuts occur as anticipated, that would bring the total decline in interest rates to 1% for the year 2024.

Dot Plot

While the remaining portion of 2024 has some clarity, the path of rates in 2025 could be the true driving force for bond markets. If we are to believe the Fed's Dot Plot – a visual representation of where they think rates will be at the end of each year – another 100 bps in cuts would occur in the next calendar year, putting the rate at 3.4% at the end of 2025. While the exact amount and timing of these moves is murky, one thing is clear: rates are on a downward trajectory.

This rate cut by the Federal Reserve was relatively early compared to the current position in the economic cycle. Often, the Fed waits too long, sometimes until the U.S. economy is already in a recession. Due to the timing of these actions, we will continue to hear more about a "soft landing" or the possibility of avoiding a recession. While lower rates generally equate to higher prices for Treasuries, lower rates combined with a strong economy could lead to even higher prices for corporate bonds. The stronger the economy remains, the better the scenario for high-yield bonds. A thriving economy with low borrowing rates allows often-indebted companies to issue bonds at lower rates, thereby improving their debt servicing and ultimately their bottom lines.

Fixed Income Sectors

Spreads on corporate bonds have been tightening over the past year, now at 125 bps as shown by the Bloomberg BVAL US Corp BBB index. If the Fed is able to achieve a soft landing, corporate bonds, with their slightly higher coupons, could be the biggest winner among fixed income investments. Even as spreads have narrowed, supply remains healthy as borrowers look to issue new bonds, taking advantage of now-lower interest rates.

If there is evidence of more than a minor slowdown in employment, we believe higher quality bonds like Treasury bonds and high-rated corporate bonds may perform well.

In either scenario, a higher duration level would be acceptable with the expectation of lower rates. Locking in higher coupon payments with rates headed south would benefit both those looking for income and those seeking capital appreciation in the price of their holdings.

Conclusion

As we reflect on the third quarter of 2024, we find ourselves navigating a complex economic landscape characterized by significant market volatility and a pivotal shift in Federal Reserve policy.

The stock market's performance tells a tale of two realities. On one hand, the S&P 500 and NASDAQ have posted impressive year-to-date gains exceeding 21%, painting a picture of robust market health. However, this broad-brush view obscures a more nuanced reality. The lion's share of these gains can be attributed to the stellar performance of the "Magnificent Seven" tech giants, which have far outpaced their peers. This concentration of growth in a handful of mega-cap companies has created a significant disparity with smaller cap stocks and other sectors, highlighting the uneven nature of the current market rally.

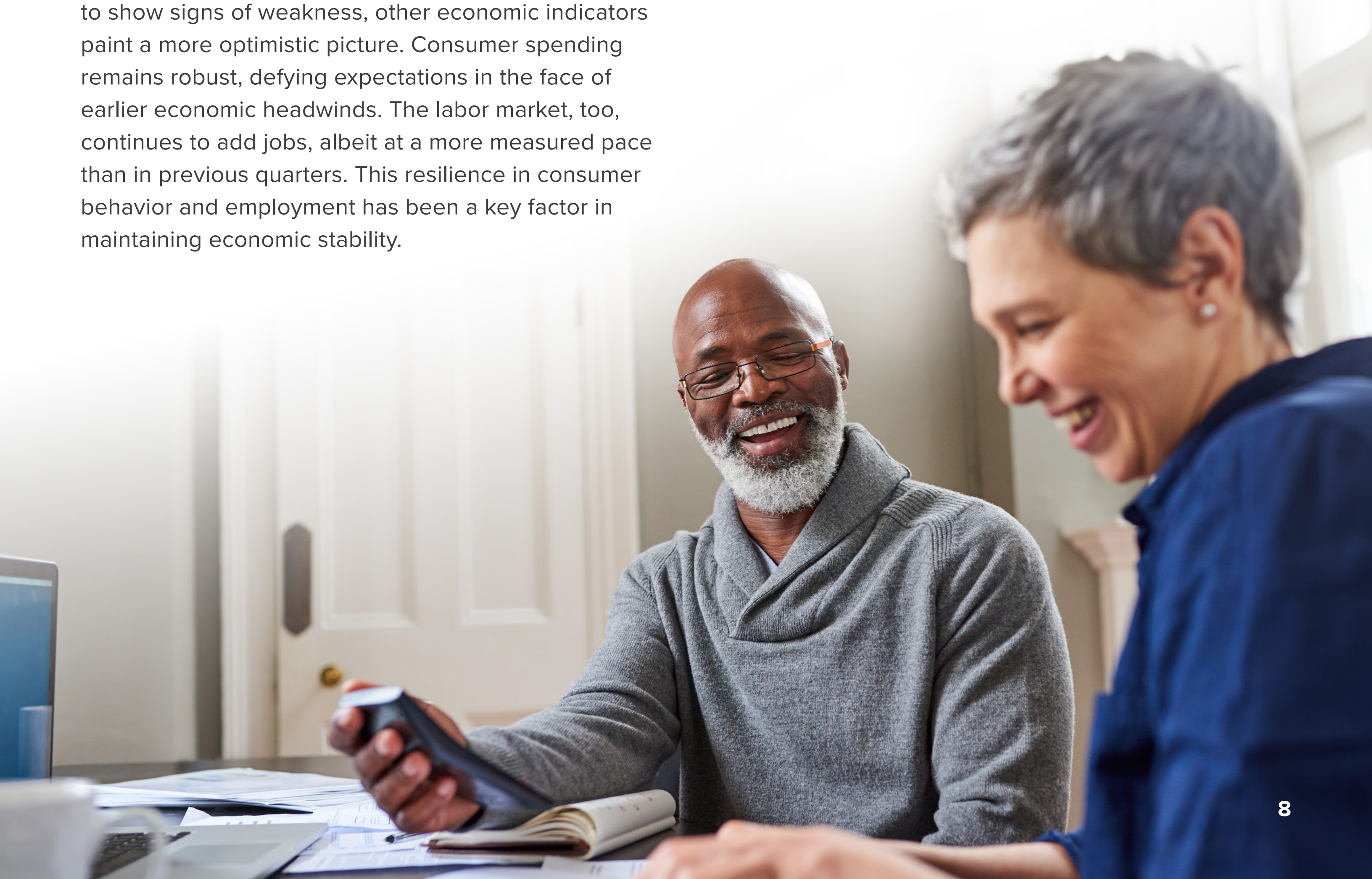
Against this backdrop of market performance, the Federal Reserve has taken center stage with a dramatic shift in monetary policy. The initiation of a rate-cutting cycle, marked by a substantial 50 basis-points reduction, signals a new chapter in the Fed's approach to managing the economy. This move, coupled with indications of further cuts on the horizon, demonstrates the Fed's commitment to engineering a "soft landing" – a delicate balance between curbing inflation and sustaining economic growth.

The broader economic picture presents a study in contrasts. While the manufacturing sector continues to show signs of weakness, other economic indicators paint a more optimistic picture. Consumer spending remains robust, defying expectations in the face of earlier economic headwinds. The labor market, too, continues to add jobs, albeit at a more measured pace than in previous quarters. This resilience in consumer behavior and employment has been a key factor in maintaining economic stability.

Inflation, once the primary concern of policymakers and investors alike, has shown signs of moderation. Core inflation has retreated from its 2022 peaks, yet it remains elevated enough to warrant continued attention from the Federal Reserve. This delicate inflation picture has been a crucial factor in shaping the Fed's recent policy decisions and will likely continue to influence its actions in the coming months.

The housing market presents its own set of challenges and opportunities. Despite a significant drop in mortgage rates from their recent peaks, housing affordability remains a pressing issue for many Americans. The market sends mixed signals, with housing starts showing some weakness while falling rates create potential for increased buyer activity. This sector will be one to watch closely as it often serves as a bellwether for broader economic trends.

In the fixed income arena, bond markets have shown improvement, benefiting from the downward trend in interest rates. This shift has created opportunities for both income-seeking investors and those looking for capital appreciation in their bond holdings.



As we look to the future, the economic landscape is best described as cautiously optimistic. The Federal Reserve's proactive approach to monetary policy, combined with robust corporate earnings and several positive economic indicators, provides a foundation for continued growth. However, this optimism is tempered by several factors that demand vigilance.

Key among these is the potential disconnect between market expectations and the Federal Reserve's plans for rate cuts. If this gap widens, it could lead to increased market volatility as investors adjust their positions. Additionally, the changing monetary policy environment is likely to drive sector rotation within the equity markets, creating both opportunities and challenges for investors.

The impact of lower rates on corporate bonds and high-yield investments is another area of focus. In a scenario where the Fed achieves its desired "soft landing," these sectors could see significant benefits. However, this outcome is far from guaranteed, and investors must remain alert to signs of economic weakness that could alter this trajectory.

Geopolitical risks and domestic political uncertainty, particularly with the approaching U.S. elections, add another layer of complexity to the economic outlook. These factors have the potential to significantly impact market sentiment and economic policy in the coming months.

In conclusion, while the economy has demonstrated remarkable resilience and adaptability in the face of numerous challenges, the path forward requires careful navigation.

For investors, policymakers, and business leaders alike, the coming months will likely bring both challenges and opportunities. Success will hinge on the ability to stay informed, remain flexible, and respond strategically to rapidly changing conditions. By carefully monitoring employment data, inflation trends, and geopolitical developments, stakeholders can position themselves to help navigate the complexities of the current economic climate successfully.

For Investors:

Equities

- Brace for Heightened Volatility Amid U.S. and Global Election Uncertainties
- Explore Opportunities in Cyclical and Interest Rate-Sensitive Sectors
- Prioritize Small and Mid-Cap Stocks
- Emphasize High Dividend Stocks
- Selectively Add Emerging Market Stocks
- Favor Healthcare, Consumer Staples, and Real Estate Sectors

Fixed Income

- Prioritize Corporate Bonds
- Favor Treasury Bonds If Labor Market Conditions Deteriorate Further
- Emphasize Long-Dated Bonds
- Gradually Decrease Cash Holdings
- Anticipate Labor Market Dynamics to Outweigh Inflation in Shaping Fed Policy

Potential Risks to Our Outlook

- Cautiously Optimistic Economic Outlook, But Potential Disruptions Exist
- Inflation Resurgence Could Impact Fed Policy and Shock Markets
- Labor Market Deterioration May Increase Recession Risk
- Geopolitical Tensions in Middle East and Ukraine Threaten Global Stability
- Potential Contested 2024 U.S. Election Results Introduce Political Uncertainty

Disclosure

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Investing involves risks, including loss of principal. Past performance is no guarantee of future results.

Definitions

Federal (FED) Funds Rate: The target interest rate set by the Federal Open Market Committee (FOMC) at which commercial banks borrow and lend their excess reserves to each other overnight.

*Consumer Price Index (CPI): An index of the variation in prices paid by typical consumers for retail goods and other items.

*Ten Year U.S. Treasury Yield: a debt obligation issued by the U.S. government with a maturity of 10 years upon initial issuance.

*U.S. Aggregate Bond Index: Designed to measure the performance of publicly issued US dollar denominated investment-grade debt.

*S&P 500 Index: S&P (Standard & Poor's) 500 Index: is a market-capitalization-weighted index of the 500 largest US publicly traded companies.

*NASDAQ: is a global electronic marketplace for buying and selling securities.

*Russell 2000 Index: a stock market index that measures the performance of the 2,000 smaller companies included in the Russell 3000 Index.

***Indexes are not managed. One cannot invest directly in an index.**

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