James Investment Research, Inc.

# Market Commentary

November 2024

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## Key Insights

- **Market Rally Broadens:** The S&P 500 Index has surged 68.23% since October 2022, marking a two-year bull market. The rally now extends beyond the “Magnificent Seven” tech stocks to broader market participation.
- **Monetary Policy Shifts:** Market expectations regarding the Federal Reserve’s rate cut trajectory have shifted, with traders now anticipating a slower and less aggressive easing cycle.
- **Corporate Earnings Excel:** The majority of S&P 500 Index companies reporting earnings beat analysts’ expectations, but market reaction was mixed due to elevated valuations, especially in tech stocks.
- **Treasury Yields Surge:** The 10-year Treasury yield climbed above 4% in October, reversing its September decline. This shift reflects growing concerns about inflation and uncertainty around the upcoming presidential election.
- **Gold Rally Accelerates:** Gold prices have surged to an unprecedented $2,789 per ounce, gaining 34.5% year-to-date. The rally reflects monetary easing expectations, geopolitical risks, and robust institutional buying.

## Monthly Recap

### US Equities Extend Rally on Broad Participation

The S&P 500 Index has soared approximately 68% since its October 12, 2022, bear market low, marking an impressive two-year bull market run. This sustained rally has been propelled by a convergence of favorable factors: moderation in inflation through early 2024, the Federal Reserve’s pivot toward monetary easing, and exceptional corporate earnings growth.

Since the stock market’s peak on July 10th, we’ve seen a notable shift in market dynamics. The market-weighted S&P 500 Index has gained 3.91%, while its equal-weighted counterpart, which assigns the same importance to giants like Amazon and smaller companies like Dollar General, has climbed 8.57%. During this period, the Magnificent Seven stocks (Apple, Microsoft, Google, Amazon, Meta, Tesla, and Nvidia) declined by 1.31%, while the remaining 493 stocks in the S&P 500 Index rose by 6.87%. Small-cap stocks, as measured by the Russell 2000 Index, showed an even stronger performance with a 9.47% gain. This broader market participation is further validated by the “S&P 493”, achieving positive earnings growth for the first time since 2022.

The year-to-date figures tell a different story, highlighting the dominance of large tech stocks earlier in the year. The market-weighted S&P 500 Index has risen 23.65%, driven largely by the Magnificent Seven’s remarkable 49.14% surge. The equal-weighted S&P 500 Index has gained a more modest 14.71%, while the 493 stocks excluding the Magnificent Seven are up 16.91%. Small-cap stocks have lagged behind with an 11.61% increase for the year.

These contrasting trends between recent months and the full year underscore a shifting market environment, where leadership has begun to broaden beyond the largest technology companies.

During this period, large-cap value stocks have notably outperformed their growth counterparts, with cyclical sectors gaining momentum since early July. This shift away from tech-centric leadership, combined with improved earnings across diverse sectors, signals a more balanced market rally with broader participation driving overall gains.

While the market’s performance in the first two years of this bull run aligns with historical averages, investors should temper their expectations for the third year. Analysis shows that the S&P 500 Index has typically averaged a more modest gain of 5.2% in the third year of a bull run. However, the current market environment’s unique characteristics, particularly its broad-based participation and strong corporate fundamentals, could provide support for continued growth, distinguishing this cycle from previous patterns.

### Gross Domestic Product Growth Driven by Consumer Spending

The economy has displayed remarkable resilience, defying earlier recession predictions, with the US economy expanding at a robust 2.8% annualized rate in the third quarter of 2024. This growth was primarily fueled by consumer spending, which rose 3.7% - its largest increase since early 2023, and continues to strengthen as evidenced by the Conference Board’s confidence index jumping 9.5 points to 108.7 in October 2024. The spending surge has been sustained by improved job market perceptions and robust expenditure

from higher-income consumers, particularly on services like entertainment, even as lower-income households show increased price sensitivity. In addition, the Federal Reserve's (Fed) balance sheet, which remains nearly twice its pre-pandemic size, continues to provide a supportive backdrop for economic activity.

### Inflation Concerns and the Fed's Balancing Act

Despite the positive momentum in equities, recent economic data has fueled uncertainty about the path of inflation and the Federal Reserve's monetary policy. The September Consumer Price Index (CPI) report, with core inflation exceeding expectations, has raised doubts about the pace of future rate cuts, particularly after the Fed initiated its easing campaign with a substantial half-point reduction in September. The market's current expectation leans towards a smaller, quarter-point cut in November. The Federal Reserve faces a complex balancing act as it aims to guide the economy towards a soft landing while keeping inflation in check. A soft landing scenario entails moderating inflation, easing monetary policy, and sustaining economic growth. However, the robust September jobs report, with accelerating wage growth, has made the Fed's task more challenging.

### Earnings Season Supports Market but Valuation Concerns Linger

The third quarter 2024 earnings season has emerged as a compelling testament to corporate America's resilience and adaptability. With 51% of S&P 500 Index companies having reported their actual results, the data reveals impressive performance that exceeds market expectations. The proportion of companies reporting positive earnings per share surprises has reached 74%, while those posting revenue surprises above expectations stands at 51%, demonstrating robust corporate execution despite ongoing macroeconomic uncertainties.

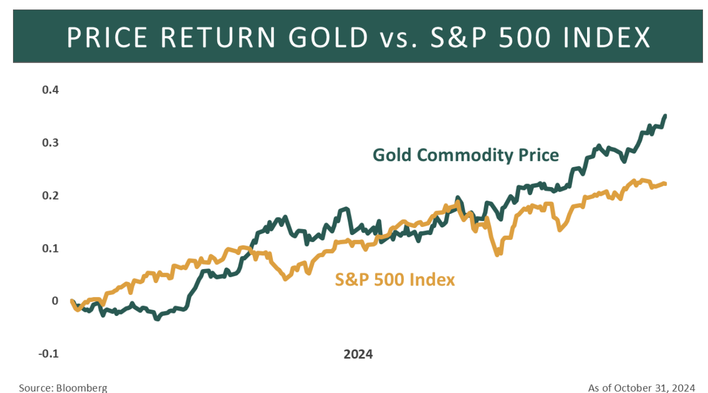
The blended year-over-year earnings growth rate has reached 8.7%, marking one of the highest levels observed since the fourth quarter of 2021. This achievement is particularly noteworthy in the communications, financial and healthcare sectors, where companies have consistently outperformed analyst expectations. The positive earnings momentum has extended beyond the largest companies, as evidenced by the encouraging growth trends displayed by the "S&P 493" for the first time since 2022.

Market reaction to these strong results has been notably measured, primarily due to persistent valuation concerns. The forward 12-month price-to-earnings ratio for the S&P 500 Index continues to trade above both its 5-year and 10-year averages, suggesting potential vulnerability should earnings growth disappoint, or interest rates rise more than anticipated. This dynamic valuation is particularly pronounced in the technology sector, where strong year-to-date performance has resulted in historically elevated multiples.

Investors are carefully evaluating whether current earnings justify the significant valuation increases witnessed over the past six months, especially for highly valued technology companies. While the Magnificent Seven tech giants have driven a substantial portion of the S&P 500 Index's gains in the first half of 2024, the broader market's earnings growth, though more modest, continues to show encouraging signs of improvement.

### Gold Outshines Global Assets

Gold has achieved unprecedented heights in the financial markets, recently setting a new all-time high of $2,789 per ounce. This remarkable performance represents a 34.5% gain year-to-date, establishing gold as one of the best-performing assets of 2024.




Three key factors have driven this exceptional rally. First, the Federal Reserve's monetary policy shift, marked by a recent 50-basis-point rate cut, has created a favorable environment for gold. Markets are anticipating an additional 75 basis points in rate reductions by year-end, which typically benefits non-interest-bearing assets like precious metals.

Second, heightened geopolitical tensions, particularly the ongoing conflicts in the Middle East and Ukraine, have reinforced gold's traditional role as a safe-haven asset. This increased global uncertainty has prompted investors to seek secure stores of value.

Third, sustained demand from both investors and central banks has provided fundamental support for gold prices. Looking ahead, the sustainability of gold's rally may depend on the Federal Reserve's policy decisions. Should economic indicators—particularly labor market strength

and inflation levels—remain robust, the Fed might adopt a more conservative approach to rate cuts than markets currently expect, potentially moderating gold's upward trajectory.

### China's Global Stimulus Impact

China's comprehensive stimulus measures, aimed at reviving its economy and supporting the struggling property sector, are expected to have ripple effects across global markets. Analysts anticipate that these efforts will boost demand for commodities, particularly in the industrial metals and materials sectors. Emerging markets and international stocks, particularly those with exposure to the Chinese economy, are also likely to benefit from this stimulus.

## Topic of the Month: Bond Market Yields Surge Despite Fed Rate Cuts

Typically, when the Federal Reserve cuts interest rates, bond yields decrease. However, in a seemingly paradoxical turn of events, market yields have surged higher despite the Fed's recent decision to increase the size of its interest rate cuts from 25 to 50 basis points. This unexpected development has raised concerns in financial markets.

October 2024 witnessed a significant and historically unusual surge in bond yields. Both 2-year and 10-year Treasury yields rose by approximately 50 basis points, marking the first such occurrence since September 2022. Bloomberg data shows that such simultaneous yield increases of this magnitude are rare, occurring only six times this century.

### Driving Forces Behind the Surge

The surge in yields reflects a fundamental reassessment of economic conditions and monetary policy expectations. Economic data has consistently outperformed expectations, particularly in the labor market, where September's job gains were the strongest in six months. Robust retail sales growth has further improved the outlook, with the GDP for the third quarter reaching 2.8%. These positive indicators have significantly reduced recession fears.

The U.S. economy's resilience is partly attributed to a notable increase in productivity, a trend not observed in other major economies. Technological advancements and innovations like artificial intelligence hold the potential to boost long-term growth without necessarily fueling inflation. This prospect could justify a higher steady state for interest rates.

However, mounting inflation concerns have complicated the outlook. The 10-year break-even rate—the difference between nominal Treasury yields and Treasury Inflation-Protected Securities (TIPS) yields—is testing its July highs, indicating rising inflation expectations. The yield curve's bear steepening pattern, where short-term yields rise more steeply than long-term yields, suggests investors anticipate both persistent inflation and a slower pace of Fed rate cuts.

The strong economic data and inflation concerns have prompted markets to reassess the Fed's rate-cutting cycle, now expecting a more gradual and shallower path of monetary easing through September 2025. The bond market's behavior reveals growing skepticism about the Federal Reserve's ability to achieve a soft landing - controlling inflation while maintaining economic growth.

### Political and Market Structure Challenges

The upcoming presidential election has intensified fiscal concerns, as both candidates' proposals are projected to further elevate the national debt. The potential for increased government spending and bond issuance to finance the growing debt could exert upward pressure on long-term Treasury yields. Additionally, the close race and the possibility of additional trade tariffs, particularly under a Republican victory, have introduced uncertainty and fueled inflationary concerns.

Liquidity in the Treasury market faces challenges due to constrained dealer balance sheets. The prolonged inverted yield curve has discouraged carry traders, leading dealers to hold more inventory acquired in government auctions. This situation, coupled with rising yield volatility, hampers dealers' ability to intermediate Treasury securities effectively.

The recent bond market dynamics have resulted in increased volatility, with the MOVE index - which measures expected Treasury yield volatility through options pricing - reaching its highest point for the year. This volatility reflects uncertainty surrounding future Fed actions, the potential impact of the election, and liquidity constraints in the Treasury market.

The rising yields could potentially slow economic growth as borrowing costs increase. However, if the yield surge is primarily fueled by positive factors like increased productivity, the economic impact might be less severe. The bond market faces the risk of further sell-offs, particularly if inflation remains persistent or if the election outcome triggers concerns about increased debt and fiscal expansion. For the stock market, rising bond yields can pose a challenge by making bonds a more attractive investment alternative, potentially limiting stock market growth.

### Investment Implications and Strategies

Investors can consider several strategies in response. Higher yields present an opportunity to lock in attractive rates by extending the duration of fixed-income portfolios. With traditional Treasury hedging capabilities diminishing, investors may seek alternative hedges like gold. Active portfolio management becomes crucial, involving careful monitoring of economic data, Fed policy pronouncements, election developments, and market sentiment.

The outlook for the bond market remains uncertain, with investors grappling with shifting Fed expectations, election uncertainty, and persistent inflation risks. While some analysts see the potential for yields to stabilize or even decline in the short term, the longer-term trajectory is likely to depend on the outcome of the election, the Fed's policy decisions, and the strength of the US economy.

## Conclusion:

As we assess the October 2024 market environment, several interconnected themes emerge across different market segments. The equity market's strength has evolved beyond its initial tech-focused rally, with the S&P 500 Index's 68.23% gain since October 2022 now reflecting broader participation. This market breadth is evidenced by the outperformance of the Equal Weight Index and the meaningful momentum gained by small-cap stocks and cyclical sectors, suggesting a more sustainable market advance.

Corporate earnings have demonstrated remarkable resilience, with 74% reporting S&P 500 Index companies exceeding expectations and achieving an 8.7% blended year-over-year growth rate, one of the highest since Q4 2021. However, this strength is tempered by valuation concerns, as the S&P 500 Index's forward P/E ratio remains above historical averages, particularly in the technology sector.

The Federal Reserve's monetary policy stance has become increasingly complex. While the initial 50-basis-point rate cut in September signaled the beginning of an easing cycle, stronger-than-expected economic data and persistent inflation have led markets to price in a more gradual path of rate reductions. Economic data remains robust, with 2.8% GDP growth in Q3 driven by strong consumer spending and improving confidence.

The bond market's reaction to these developments has been significant, with the 10-year Treasury yield climbing above 4% as investors reassess inflation risks and monetary policy expectations. This shift reflects growing skepticism about the Fed's ability to achieve a soft landing and concerns about potential political implications of the upcoming presidential election.

Gold hit record highs at $2,789/oz amid geopolitical risks and Fed easing, while China's stimulus efforts are expected to boost global commodities and emerging markets demand.

Looking ahead, investors face a market environment that requires careful navigation of multiple crosscurrents. While broad market participation and strong corporate fundamentals provide support for continued growth, elevated valuations and persistent inflation concerns create notable headwinds. The interaction between equity markets, fixed income, and global economic factors suggests maintaining a diversified approach while remaining attentive to evolving risks and opportunities. Professional guidance becomes increasingly valuable as investors seek to balance these competing forces in their portfolio strategies.

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