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FINANCIAL ADVISORY GROUP LLC

Third Quarter 2024 Economic and Market Outlook

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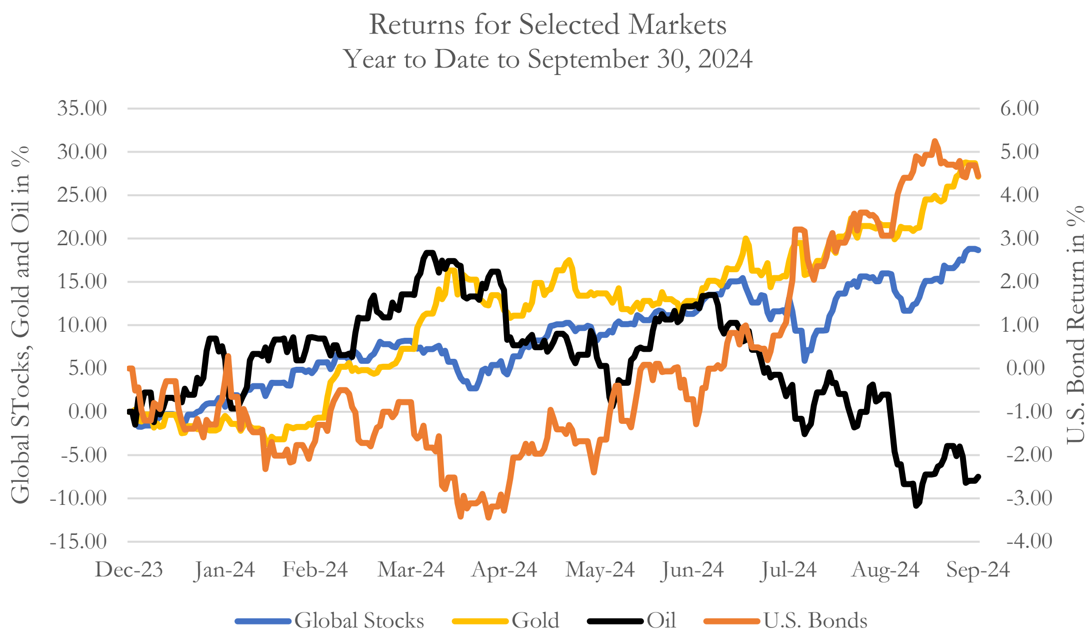
THIRD QUARTER 2024 ECONOMIC OUTLOOK

Economic conditions that surprised on the upside in the first half of the year have cooled modestly. While inflation continues to fall and the employment situation still looks healthy, the job openings and the quits rate have started to decline, wage growth has slowed, small businesses have indicated that they plan to hire less in the future. The unemployment rate has also ticked up above 4.0%. These are early signs of a slowing economy and could encourage the Federal Reserve to lower interest rates further in an effort to achieve a rare soft landing. The number and size of future cuts will depend on how the economy responds in the coming months.

Global markets have responded well to improving economic conditions and continued to recover. The traditional 60/40 balanced portfolio has posted strong results so far this year as interest rate headwinds have abated. Patient investors who remained committed to their strategy were rewarded, given portfolio values have recovered and are now above the levels reached during the last market peak. U.S. stock markets powered to record highs in the quarter, thanks again to excitement surrounding the latest advances in generative-AI technology and the broadening of the theme to include perceived winners outside of the technology sector. Bond markets got a boost from the first rate cut by the Federal Reserve in over four years.

Exhibit 1: Equity, Bond, Oil and Gold Price Returns in 2024



Source: Morningstar Direct. Market Indices include: MSCI AC World NR TR, SPDR Gold, Brent Crude Oil Price and Bloomberg U.S. Aggregate Index. Past Performance is Not a Guarantee of Future Performance

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However, rising geopolitical tensions in the Middle East have the potential to bring uncertainty, and therefore, volatility back into the markets. Israel's latest efforts to destroy Hamas and roll back Hezbollah's presence along the Lebanese/Israeli border has invited retaliatory strikes by Iran, increasing the likelihood of a broader and potentially more dangerous conflict in the region. We feel financial markets have not fully priced in this increased risk in our opinion. Oil prices actually declined on excess supply concerns in the quarter despite the increased military activity. Although gold, considered a safe-haven asset, has had a strong year and trades at record highs.

THE U.S. ELECTION AND THE MARKETS

For much of this year, investors were laser focused on the next move in interest rates. Now that the Fed has signaled their intention to ease monetary policy, attention is moving to the upcoming U.S. Presidential Election and its potential impact on markets. Economists surveyed in a recent (October 4-8) *Wall Street Journal* poll were asked about their expectations for inflation, interest rates and deficits given each candidate's stated economic policies. Respondents considered the potential impact of proposed tax policy, including changes in marginal tax rates, child and home buying tax credits and potential state and local tax adjustments.

In summary, the survey found that at the margin, higher tariffs and lower taxes would be more inflationary and potentially lead to higher interest rates and deficits in the future. Policies focused on tax cuts for middle income families, but higher marginal tax rates for the highest income earners and higher corporate taxes may be more fiscally balanced and have less inflationary impact. However, the survey also found that economists expected that both candidates' policies would lead to similar growth outcomes for the U.S.

Whether the proposed policies of the candidates are implemented depends largely on the makeup of Congress following the election. A divided government tends to limit change or dampen intended policy, while a majority increases the chances that it will be enacted. Historically, successful businesses respond and adjust to any new policy and ultimately find ways to generate earnings. As a result, we expect that financial markets will also adjust and that prices will quickly reflect any new information. Managing portfolios with a diversified strategy, rather than targeting them for a specific political outcome, has historically proven to be a reliable approach.

THE OPPORTUNITIES AND RISKS AHEAD

The global economy continues to normalize in the post-pandemic era. Inflation is easing and interest rate policy is settling at moderately higher rates in the U.S. and abroad. For years, the bond market was offering very little in terms of income, and bond returns were driven mainly by price increases

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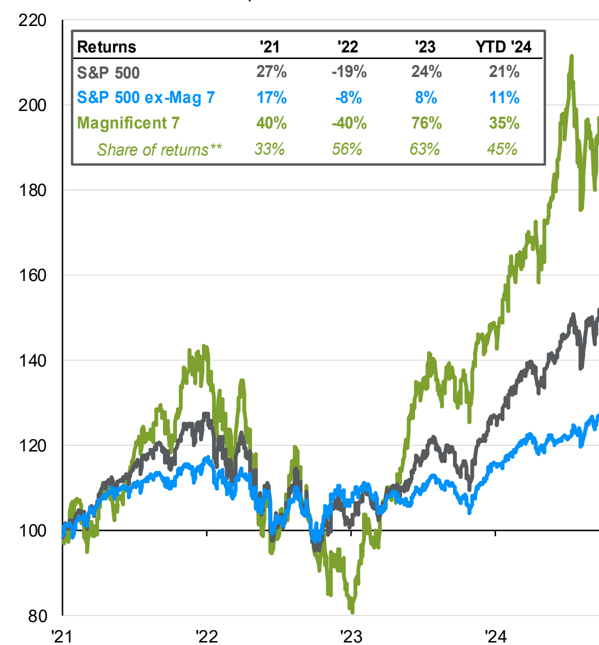
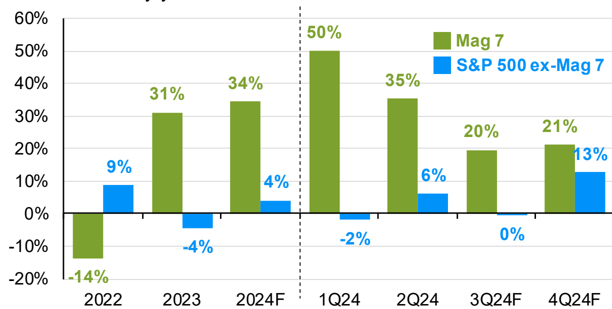
rather than yield. The situation is different today. Fixed Income markets, particularly high-quality, investment-grade bonds, offer an attractive alternative to stocks.

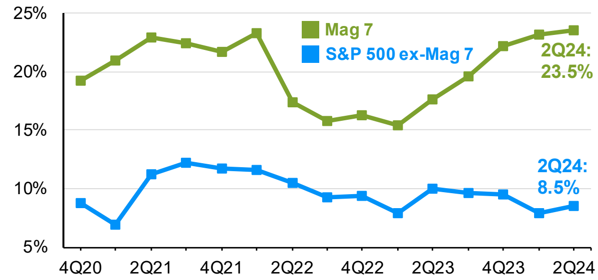
The concentration of the U.S. market and its narrow leadership over the last several years leaves the U.S. stock market vulnerable to a potential correction in our view. In **Figure 2** we show the latest JP Morgan Guide to the Markets analysis of the drivers of the S&P 500 Index over the last few years. What stands out is how bifurcated the market has been. Stock performance and earnings growth of the so-called "Magnificent 7" have far outpaced the other 493 companies in the index. Stock prices have been supported by the outsized profit margins of the group.

Figure 2: A Tale of Two Markets



Returns	'21	'22	'23	YTD '24
S&P 500	27%	-19%	24%	21%
S&P 500 ex-Mag 7	17%	-8%	8%	11%
Magnificent 7	40%	-40%	76%	35%
*Share of returns***	*33%*	*56%*	*63%*	*45%*





Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management. *Magnificent 7 includes AAPL, AMZN, GOOG, GOOGL, META, MSFT, NVDA and TSLA. Earnings estimates for 2024 are forecasts based on consensus analyst expectations. **Share of returns represent how much each group contributed to the overall return.. *Guide to the Markets – U.S.* Data are as of September 30, 2024.

Portfolios tend to be structured to include significant allocations to the Magnificent 7 stocks due to their importance in the market and overall economy. However, taking a more balanced approach by diversifying with U.S. mid-size and small-capitalization stocks, as well as international investments, can help to mitigate concentration risk.

While portfolios have clearly benefited from the success of these large technology companies, the performance and characteristics of the market ex-Mag 7 indicate that the real economy is not as strong as the headline number suggests. The higher borrowing rates that many businesses and households have been subject to over the last few years has slowed pockets of the economy. More specifically, these pockets include the housing market, segments of the commercial property market

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and funding for venture capital and growth equity, all of which tend to rely on debt financing. Although growth has remained resilient thus far, any slowdown has the potential to tip the economy into recession.

With short-term bonds offering nominal yields in excess of 4.0% as of September 30, 2024, and inflation expected to fall toward 2.0%, there is now an opportunity to capture positive inflation-adjusted returns with low volatility. Intermediate-term bonds with more interest rate sensitivity offer the potential for higher total returns if economic conditions slow since rates tend to fall in this scenario.

In addition to fixed income, alternative investments designed to either hedge risk or generate uncorrelated income can be valuable portfolio components when equity markets decline. While these allocations have not been fully appreciated by investors in the last several years, given the strength in the U.S. stock market, their role in the portfolio remains critical. Equity markets are notoriously difficult to predict and they can turn quickly.

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Past Performance is No Guarantee of Future Performance.

Reminder: The returns for your accounts are affected by the timing of new investments, cash flow patterns (deposits, withdrawals and transfers), client-specific asset allocation policies and retained individual securities. All of these variables may cause dispersion among returns, as compared to our Models.

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