Market Strategy
by STRATEGAS A BAIRD COMPANY

BAIRD
Private Wealth Management

Quarterly Market Update

Third Quarter, 2024

BULLISH ‘TIL THE BILL COMES DUE

Big headlines. If a person had somehow been given, back in the first half of the year, newspapers for July, August, and September (with security prices redacted), the future might have looked dire for the markets. In Q3, there were two assassination attempts on a former president who is running for the White House. His opponent dropped out of the race on a lazy Sunday afternoon, leaving his relatively unknown vice president to pick up where he left off. And a sharp rise in the value of the Japanese yen led to an unwinding of leveraged trades that triggered a gut-wrenching (if brief) global sell-off. A person reading these future headlines couldn’t be blamed for betting on a big downturn in the market. And if they’d invested accordingly, they could easily have been broke by Labor Day because despite all the noise in Q3, markets marched ever higher.

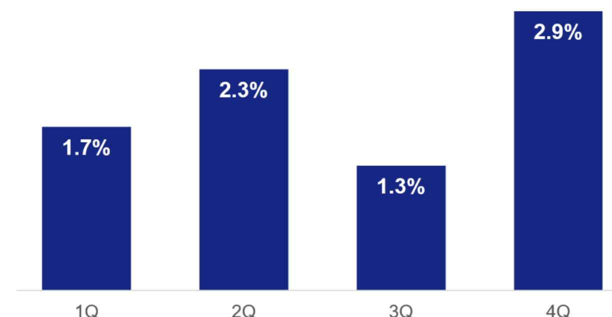
Changing dynamics. Perhaps the 24-hour news cycle and social media overload has numbed the average investor to events that might have hit markets harder in the past. Perhaps technology has sped up the time it takes for the collective wisdom of millions of investors to be reflected in asset prices. Or perhaps the advent of quantitative easing as a policy option—and the swelling of the Federal Reserve’s balance sheet since 2008—has simply made investing, like love, mean “never having to say you’re sorry.”

Tailwinds. In the end, all the Q3 drama came to naught. The Fed cut the benchmark fed funds rate by 50 basis points and signaled that more interest rate cuts lie ahead. China launched the biggest stimulus package seen since the 2008 financial crisis. Record U.S. oil production and weak energy demand from China led to a meaningful decline in energy prices despite the prospect of escalating hostilities in the Middle East—and those lower fuel prices are providing a boost for U.S. consumer spending (and thereby the U.S. economy as a whole).

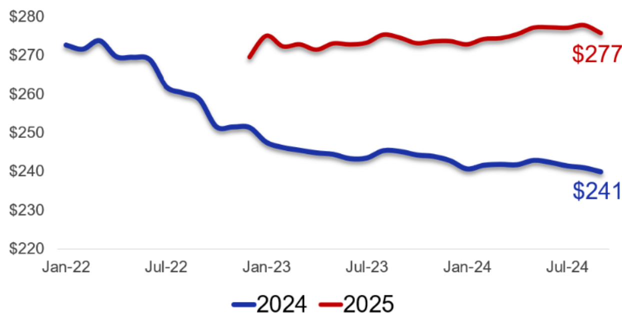
Bullish, still. With inflation cooling, central banks and investors alike are betting that monetary policy will become more accommodative. Thus, although few assets in the world today can be called cheap, it seems that few investors want to tempt fate by betting against the bull market. Economic and earnings growth remain respectable, long-term interest rates are low, and credit spreads remain historically tight. In Q3, stock market strength broadened beyond the Magnificent 7’s heavy influence and 10-year Treasury yields fell by nearly 60 basis points. As we have been saying all year, we will remain bullish until the bill comes due.

Asset Class	Representative Benchmark	Q3 Return
US Large Cap	S&P 500	5.9%
US Small Cap	Russell 2000	9.3%
International	MSCI AC World ex-USA (USD)	8.2%
Commodities	Bloomberg Commodity	0.7%
Gold	LBMA Gold PM ($/oz)	12.8%
Municipal Bonds	Bloomberg Municipal Bond	2.7%
Taxable Bonds	Bloomberg US Aggregate	5.2%
Cash	Bloomberg 3-Month T-Bill	1.4%

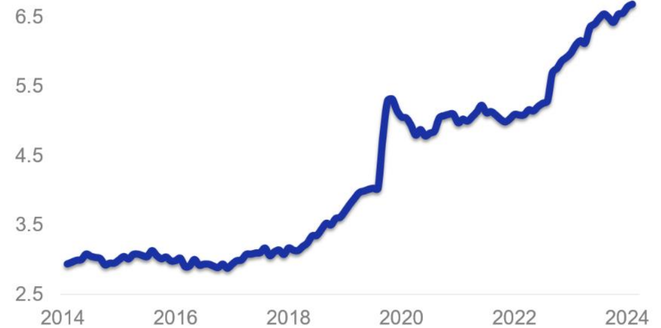
S&P 500 Average Quarterly Return (since 1928)



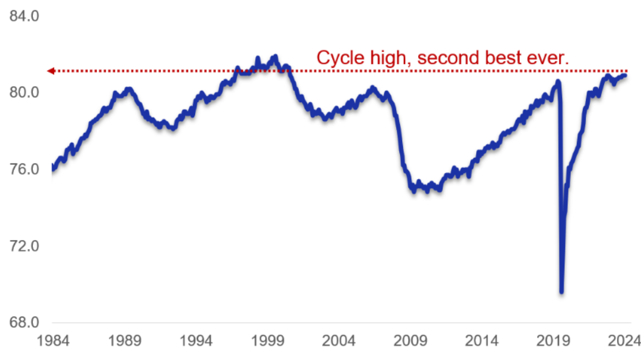
All of the data shown above is from FactSet



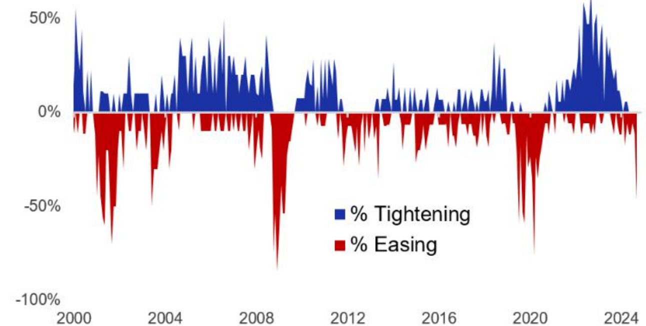
Despite recent downward revisions to 2024 earnings estimates, the consensus estimate for 2025 continues to hold strong at $277 per share. That would amount to a robust +15% growth rate in corporate earnings, which would require record-breaking profit margins to achieve. It would also be unusual for Fed cuts of more than 100 basis points to coincide with double-digit earnings growth—a combination that has not been seen since 1984. Still, things are looking up—the percent of sub-industries delivering profit growth is moving higher, and non-Magnificent 7 companies are increasingly expected to grow earnings. We estimate 2025 earnings of $265 per share.



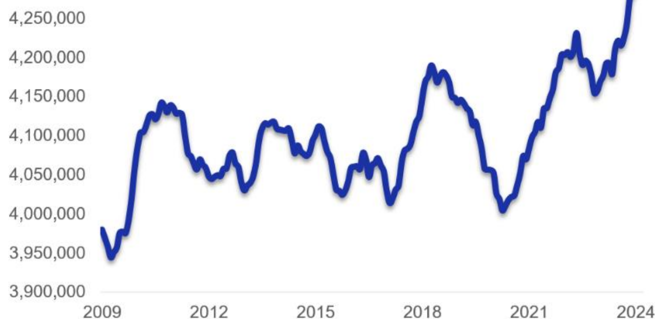
Going from a zero percent interest rate policy to yields of 5.5% helped produce this cycle-defining chart—more than $1.5 trillion has flowed into money market funds since mid-2022. But with the Fed beginning to cut rates, we will start to see money market yields dip below 5%, setting up a fascinating psychological test: how low do the yields on money markets have to get before investors start to look elsewhere? Historically, a 3% fed funds rate seems to be when flows reverse. Some of that outflow will go to stocks but given the higher risk profile of equities, we could see more of those dollars going into bonds instead.



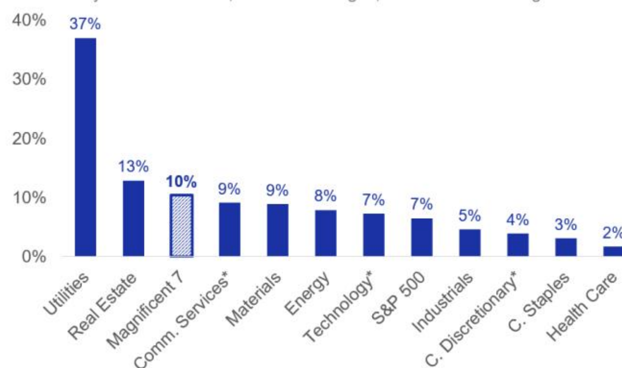
Recent cracks in U.S. employment helped to spur the Fed to start cutting rates. The Sahm rule, which signals recession when the unemployment rate rises too quickly, was triggered in July. However, there is some debate as to whether the rule will be accurate if an increase in labor supply drives unemployment up (the unemployment rate can rise if the number of people looking for work rises—via immigration, for example). Our work suggests the Sahm rule should be confirmed by a drop in the employment-to-population ratio—and for now, there is no such drop. The ratio is at a cycle high and claims for unemployment insurance are low. All good so far.



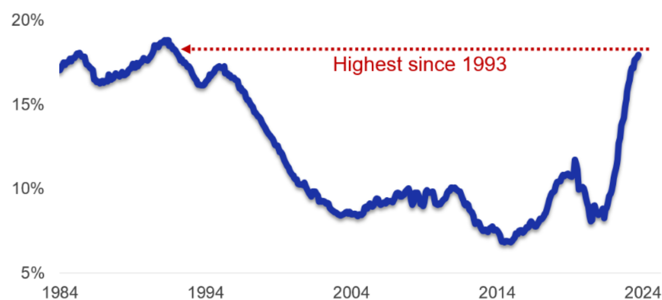
The percent of G20 central banks cutting interest rates is now at its highest since 2020 (and its highest non-recession level in decades). There are plenty of risks to the global economy, including the lagged effects of such aggressive rates hikes just a few years back. But the bottom line is that a continuation of the U.S. soft landing is still the base case, and there is a real possibility that lower Treasury yields and a weaker U.S. dollar can spur a global manufacturing rebound. With other central banks cutting alongside the Fed, China announcing serious fiscal stimulus, and OPEC again pumping oil (led by Saudi Arabia), a synchronized global upswing could be in the cards.



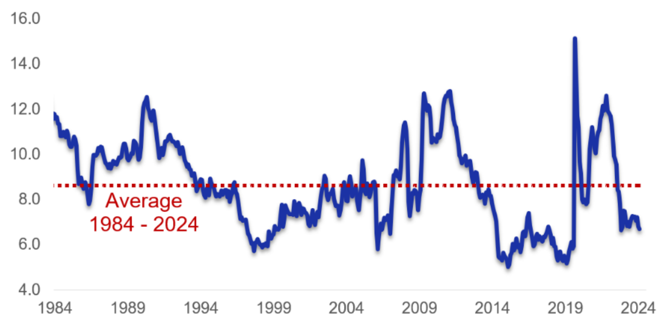
Artificial intelligence requirements, the push for electric vehicles, and new manufacturing and data centers have all created a surge in demand for power—particularly electricity—creating additional strain on aging utility infrastructure. We believe that all-encompassing, power-related securities (consisting of those directly involved in creating sources of power) are set up to thrive in such an environment. In addition, we are also bullish on securities tied to businesses that will be secondary beneficiaries of the add-on impacts of increased power generation and usage.



There are many reasons to own the Magnificent 7 companies (Meta, Amazon, Alphabet, Tesla, Nvidia, Apple, Microsoft) even at today's relatively lofty valuations—they generate a ton of cash, they have the potential to benefit from first-mover advantages of A.I., they are growing their earnings faster than the rest of the market is, and, generally speaking, they have little debt at higher long-term interest rates. These companies formerly tended to be "capital light." That appears to have changed, as investments in A.I. have made the Magnificent 7 some of the biggest spenders in the market.



U.S. debt-servicing costs are near all-time highs and net interest costs will soon exceed Defense spending for the first time in history. The best way to stem this spiral is to cut rates, as the Fed began to do in September, but this will be a slow process. That means that next year, both parties will be thinking about how to raise revenue to pay for any extensions of the 2017 Tax Cuts and Jobs Act provisions (many of which expire in 2025). Directionally, the U.S. fiscal situation is actually improving, but the next president will have his or her hands full with $4 trillion of expiring tax cuts and ACA subsidies, rising geopolitical tensions, and limited fiscal capacity.



Inflation remains critically important for this presidential election. We have found that the Misery Index (inflation + unemployment) has predicted 15 of the past 16 presidential election results and every election since 1980. We like this indicator for its relative simplicity: if the 3-month average is higher year over year, the incumbent party has lost, and if it is lower, the incumbent party has won. For the Misery Index to be lower in October, the combination of unemployment and inflation cannot exceed 7.3%. Today, that index is below 7.0%, but it has hovered near 7.3% all year. Inflation (especially in gas prices) and the labor market both remain very important.

S&P 500 Index (Large Cap / U.S. Stocks): A representative sample of 500 leading companies in leading industries of the U.S. economy. These are equity securities of large capitalization (generally $7 billion plus market cap) companies having growth and value characteristics. ● **Russell 2000® Index (Small Cap / Small Core):** Measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represent approximately 10% of the total market capitalization of the Russell 3000® Index. These are equities of small capitalization. ● **MSCI EAFE Index Net (International / Developed Markets):** A free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US and Canada. As of May 27, 2010 the MSCI EAFE Index consisted of the following 22 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom. ● **BBgBarc Aggregate Bond Index (Taxable Bonds / Bonds):** Composed of approximately 6,000 publicly traded bonds, including U.S. Government, mortgage-backed, corporate, and Yankee bonds with an average maturity of approximately 10 years. ● **BBgBarc Muni Bond Index (Municipal Bonds):** Bonds must have a minimum credit rating of at least Baa, an outstanding par value of at least $3 million, part of a transaction of at least $50 million, issued after December 31, 1990, and have a year or longer remaining maturity ● **FTSE 3-month T-bill Index (Cash):** This index measures monthly return equivalents of yield averages that are not marked to market. It consists of the last one-month and three-month Treasury bill issues, respectively. ● **Bloomberg Commodity Index (Commodities):** Composed of commodities traded on U.S. exchanges, with the exception of aluminum, nickel and zinc, which trade on the London Metal Exchange (LME). Subindices include Petroleum, Grains, Industrial Metals, Livestock, Precious Metals, and Softs.

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