October 2024 – The Fed Cut, Now What?

"Taking risks today for tomorrow's reward is both the most challenging and difficult of tasks. Unbridled optimism must be tempered with reality."
Sam Zell, Real Estate Magnate and Philanthropist

Tempering Expectations

The market had another excellent quarter, adding to what has already been an exceptional year. Through the end of September, the market has set 43 new all-time highs and has had the best returns through three quarters since 1997. Nothing, not wars, inflation, or heated politics has slowed this stock market.

This year is also coming on the heels of what has already been an incredible decade. Over the last 100 years, the U.S. stock market has averaged a return of approximately 10.6% per year with dividends included, but for the last 10 years, the S&P 500 has averaged over 12.7%! An extra 2% a year may not sound like much, but it adds up to more than 20% over ten years. This has truly been an exceptional period for the U.S. stock market. While we as investors have enjoyed the fruits of these returns, we always find new market highs a good time to pause and reflect not on what has happened, but where to go from here.

The law of averages, current market valuations, government debt loads, plus a host of other economic uncertainties would imply that returns for the next decade may not be as attractive as they have been for the last decade. The questions are what to do about it, and what should we all consider in such a decision?

The End of 5% For Free?

The simplest and most common way to diversify risk from stocks is to add bonds and fixed income to a portfolio. However, while we have recently been enjoying the highest interest rates in over a decade, rates are likely to be less attractive going forward. On September 19th, the Federal Reserve lowered the Fed funds rate by 0.50% and has signaled more cuts are coming. For over a year, the Fed had maintained its policy rate at over 5%, the highest since 2001 and up from near zero in early 2022. The market now expects the Fed to ease policy by another 0.25% before year end and to be at or near 4.0% through 2025.

Since 2022, the rapid Fed interest rate increases have been beneficial for savers and bond holders who, after a very long wait, were getting a 5% or more yield on short-term Treasury bonds, money market funds, and Certificates of Deposit. The world of earning 5% plus is over for now, but it is important to note that while we expect rates to be lower than last year, we are not heading back to zero.

This does not mean that clients with lower risk tolerance will not be able to earn a reasonable return on their investments. Typically, when the Fed lowers short-term rates, the intermediate and long-term maturities tend to yield higher rates. Therefore, intermediate government bonds, corporate bonds, and municipal bonds should offer decent returns and clients can continue to maintain a portfolio allocation.

While rate cuts will likely result in lower returns on short-term instruments, it is important to note that current rates will still be significantly higher than they were a few years ago and can still provide an acceptable rate of return to investors. We remain actively exploring higher yielding quality investments for clients in this changing interest rate environment.

Economic Storm Clouds

The United States remains a beacon for investors as global conflicts have made the U.S. a destination for investors from around the world. However, domestic politics have also cast aspersions on whether the United States will remain a country of free trade and free market economics. In a recent Financial Times survey found that global investors, policy makers, and business leaders are making peace with a world in which the U.S. is not an anchor of stability, but rather a risk to be hedged against.

The following issues are at the top of the list of concerns when allocating capital:

1) US-China Relations: The ongoing rivalry between the two economic powerhouses continues to pose significant concern for global trade and security;
2) Russia-Ukraine Conflict: Now entering its third year, the war between these two nations continues to impact energy security and commodity markets;
3) Middle East Stability: The broadening war between Israel, Iran and its proxies poses risks to global stability and could ensnare major powers into a conflict; and
4) Trade Politics: The shift in the U.S. towards onshoring, regionalization of supply chains, and the growing use of tariffs has impacted global trade. Both political parties in the U.S. have voiced continued support for additional tariffs, and despite their claims to the contrary, tariffs are an additional tax on the American consumer that will further increase costs and inflation.

What To Do

While serious, the risks of war, trade conflict, and inflation have been around since times immemorial. On some occasions they had devastating consequences, but all these dark periods have been overcome and the world has emerged with more prosperity than before. Human ingenuity, innovation, and perseverance have always overcome.

As we have said many times before, we should remain focused on the long-term horizon. Stocks may seem expensive now but are still the best asset class for long-term growth. Bonds are a great risk hedge, but they will provide less return going forward than we have recently enjoyed. Our politics are a mess, but as Winston Churchill remarked *"Americans can always be trusted to do the right thing, once all other possibilities have been exhausted."* We encourage everyone to take stock during these new market highs and wonderful decade we have had to reflect on your current goals and if your current portfolio allocation matches your tolerance for risk going forward. We look forward to further discussions with you all and please let us know if you have any questions, comments, or concerns. Thank you as always.

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