Cetera® Investment Management

Fourth Quarter 2024

Quarterly Outlook

At-A-Glance

The Fed cut interest rates by 0.5% in September, front-loading its interest rate cuts for this year as they attempt to balance risks in the labor market with inflation seemingly under control.

The Fed's recent economic projections for year-end 2024 show real GDP growth at 2%, the unemployment rate at 4.4%, PCE inflation at 2.1% and the Fed funds rate at 4.4%.

Stocks have had a good year with large cap indexes up nearly 20% as of this writing. Large-cap stocks have outperformed small caps.

Bonds have been doing well, with the aggregate bond market up around 5.25% year-to-date, but more impressively, up nearly 15% since the 10-year Treasury Yield hit 4.99% in October 2023.

Election returns: Going back to 1948, in the 60 days before an election, the S&P 500 averaged -0.6%. From election day to inauguration day, the S&P 500 averaged 1.5%. Both were skewed heavily by the 2008 financial crisis, reminding us that there are larger economic forces at play than the presidential election.

With economic growth and the labor market slowing, there are risks in the markets. If companies miss earnings growth projections, stock prices will likely fall. However, the downside may be limited due to cash on the sidelines and Fed rate cuts acting as a stimulus for the economy.

Can Rate Cuts Stem the Labor Markets' Slowdown?

The third quarter officially marked the beginning of a new Federal Reserve (Fed) interest rate cycle. The Fed began raising rates in March 2022 to combat rising inflation. After pausing the rate hikes for more than a year, the Fed finally cut rates, signaling the start of a new cycle. This is important for a couple reasons.

First, investors no longer fear the Fed raising rates but can rely on the Fed to cut rates if economic data comes in weaker than expected. Lower rates act as a catalyst for the economy, because they make borrowing costs cheaper, so consumers and corporations can finance spending at a more affordable rate. For instance, if you're in the market for a car, auto loans will become more affordable. Mortgage rates will also decline, though not to the same extent, as they are more closely tied to longer-term rates.

Second, the Fed is signaling they are more concerned about the labor market than inflation. We will be monitoring the labor market very closely in the fourth quarter. This is important because America is a consumer-driven economy, and consumers don't spend as much money if they fear losing their job or they have lost their job. The labor market is indeed weakening, and rate cuts may be too late to stop the damage. This is a potential risk to markets.

Additionally, with the election in early November, there could be added volatility, which is already at a heightened risk due to high equity valuations. If corporate earnings growth misses their high expectations due to a softening economy, we would expect a market pullback. However, a pullback may be limited because there are a lot of investors in cash and money market accounts which will soon see their interest rates drop. As a result, they may look to enter the bond market or even the stock market if valuations become more attractive.

The bond market continues to offer decent yields. If bond prices fall, the yield could offset some of this price loss. Moreover, a weaker economy may support bond prices as investors turn to bonds when facing economic uncertainty.

It's possible the Fed could engineer a soft landing and avoid a recession by lowering rates. We will be following market risks closely in the fourth quarter. Though election year distractions may arise, staying focused on your own financial goals will help remove emotion from investing. Your Cetera financial professional can help keep you focused on your personal goals and objectives.

For a quicker look into what we are thinking and what is happening in the economy and markets, check out our 2024 Fourth Quarter Outlook Summary.

Economy

Going into the year, our three themes were that the Fed would go from foe to friend and finally cut interest rates, the economy would cool into a soft landing, and volatility would pick up. These three themes are playing out, apart from the increase in volatility. However, the potential drivers for volatility remain, and we would not be surprised to see some as we head into 2025.

Let's get started with the Fed, whose projections for 2024 were also positive. The Fed's projections going into the year seem to be materializing with one quarter to go. The Fed makes these projections each quarter during their Federal Open Market Committee (FOMC) meetings, which include a "dot plot" showing the committee members' projections for economic growth (inflation adjusted), the unemployment rate, inflation, and the Fed funds rate. In December 2023, the FOMC's median year-end 2024 estimate for real Gross Domestic Product (GDP) was 1.4%. Their preferred measure of inflation, the Core Personal Consumption Expenditure Price Index, was projected at 2.4%, and the unemployment rate at 4.1%. They also anticipated the Fed funds rate would end the year at 4.6%.

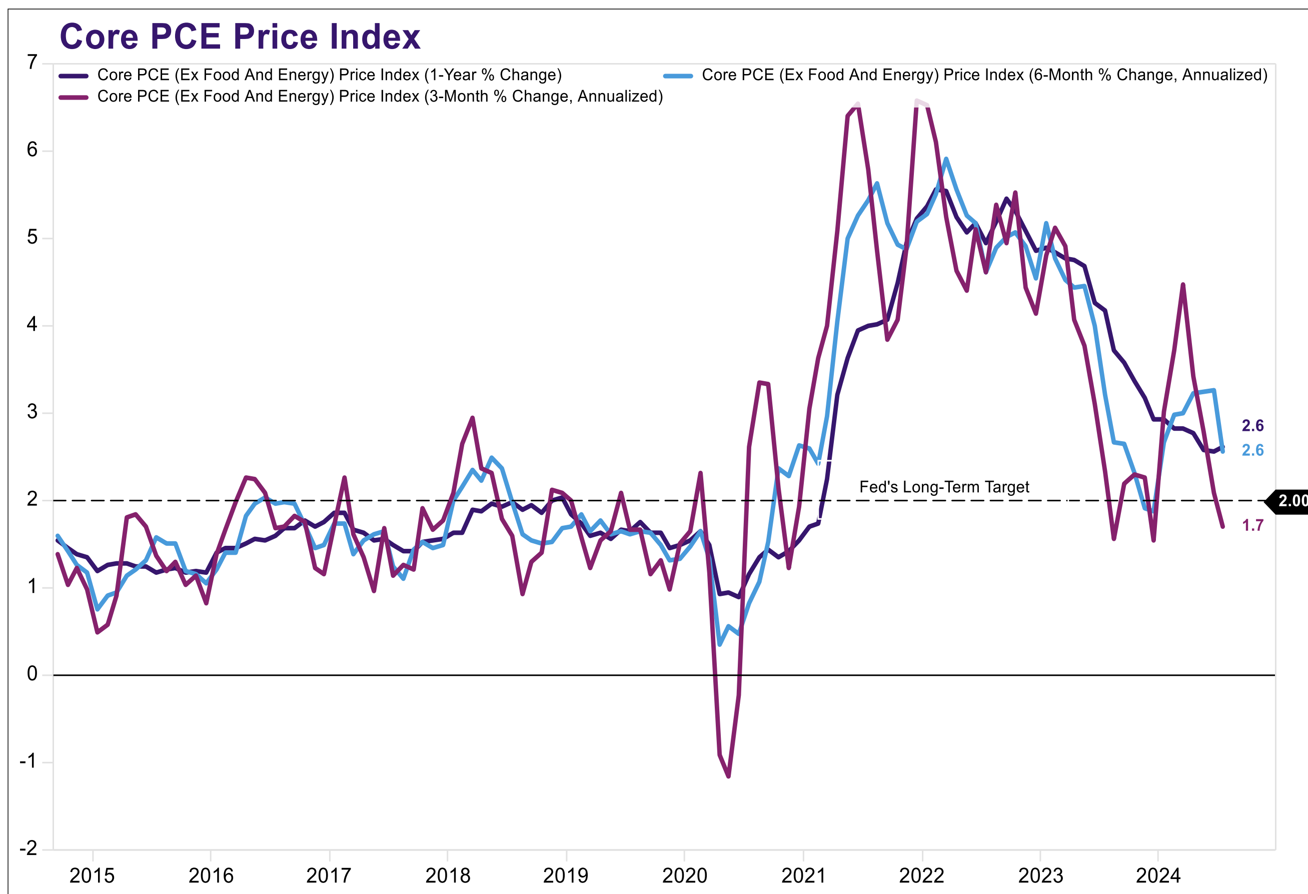
The current Fed funds rate is in a target range of 4.75% - 5%, and the Fed is expected to cut another 0.5% by year-end. We will discuss this further in the outlook.

While economic growth, as measured by GDP, has cooled off since the end of last year, it has surprised both the Fed and many others with stronger-than-expected performance so far this year. Capital Economics, an economic research firm, anticipates real GDP growth to be 2.7% in 2024, which is well above the Fed's December median economic projection.

Inflation seems to be running in line with the median projection, though. If we take Core PCE data through July and use the last three months as a gauge for the rest of the year, Core PCE would come in at 1.7% (The August PCE report will be released at the end of September). Currently, the six-month annualized Core PCE inflation rate is 2.6%, as seen in **Figure 1**.

This relatively low inflation rate might perplex many consumers, who feel inflation is high, but inflation refers to the rate at which prices are rising, not the overall price level. As Fed Chair Jerome Powell mentioned in his last press conference, prices are high, not inflation. The overall price level from the end of 2019 to present rose by over 21%, as measured by the consumer price index. That is a significant jump in a relatively short amount of time, so it's difficult to adjust. Prices are still rising but at a slower pace now. Unfortunately, we likely won't be returning to 2019 price levels. Positively, average hourly earnings have outpaced inflation over this time frame.

Figure 1: Inflation Cooling



Source: Cetera Investment Management, FactSet, U.S. Bureau of Economic Analysis (BEA). Data as of 7/31/2024.

Perhaps another reason for rate-cut optimism is the softening labor market. The unemployment rate is already at 4.2%, and the trend seems to be pointing upward. Typically, the unemployment rate bottoms out and then spikes higher. It isn't a gradual climb, so this is something we are watching very closely, as is the Federal Reserve.

With inflation largely in line with the Fed's forecasts from the end of last year, they finally felt comfortable cutting rates, reducing them by 0.5% in September. They also have a meeting in November, which was postponed until after the election, and the last meeting is in December. The Fed could always implement an emergency intra-meeting cut, but this is less likely and typically done only in emergency situations.

Markets are forward looking, anticipating what the Fed will do next. One way to gauge what the market participants' expectations is through CME Group's FedWatch tool, which tracks probabilities for the Fed Funds rate based on implied 30-Day Fed Funds futures prices. Based on these probabilities, participants expect the range to be 4% to 4.25% by year-end, implying two more 0.25% cuts. If we don't see these cuts, we could experience the volatility we will discuss further in the equity section. The number of rate cuts in the fourth quarter will largely depend on how much the labor market softens. If the labor market holds up, we will probably see two more 0.25% cuts. Investors hoping for steep rate cuts should also be mindful of the reasons for such cuts.

While a soft landing with no recession is our best-case scenario, there are some warning signs we will be watching closely. We have already mentioned the unemployment rate starting to tick up, but consumer spending is also beginning to moderate, with rising credit card delinquencies. The forward-looking component of manufacturing surveys, new orders, is in contraction and trending lower. The good news is that rates would act as a tailwind for the manufacturing and housing sectors, which are also struggling. There are some lingering questions, though. Are the Fed rate cuts too late? Has the damage to the economy already been done? We will learn the answer to these question in the coming months. A recession seems unlikely in the fourth quarter, but it remains more uncertain for 2025.

Equity Markets

Through mid-September, the S&P 500 is up nearly 20% year-to-date. We were cautiously optimistic about stocks in 2024 due to increased earnings expectations and the Fed expected to transition from foe to friend by lowering interest rates. However, stocks have largely outperformed expectations because corporate earnings have also more than kept pace with their projections.

We were cautiously optimistic about stocks because they were arguably a little expensive relative to their companies' earnings potential. Price-to-earnings ratios on large-cap stocks were elevated entering the year and have remained so, with future earnings growth expected to be in double digits in the fourth quarter and beyond. Expectations for the third quarter are more moderate, though. P/E ratios can remain above long-term averages for extended periods, but this could be a source of future volatility if companies start to miss their high earnings expectations. While lower rates will benefit companies by allowing them to finance their debt at lower interest rates, a weakening economy could reduce demand and sales, negatively impacting companies. Investors will weigh the effects of rate cuts vs. a weakening economy in the coming months, which could lead to volatility as market sentiment shifts based on economic data and the Fed signaling.

Another risk is that euphoria might overtake investors at a time when valuations are already at extremely high levels. The impetus for this rate cut cycle is that inflation is normalizing, and the labor market is cooling but not collapsing. It is not because a recession is imminent, as in 2001 or 2008.

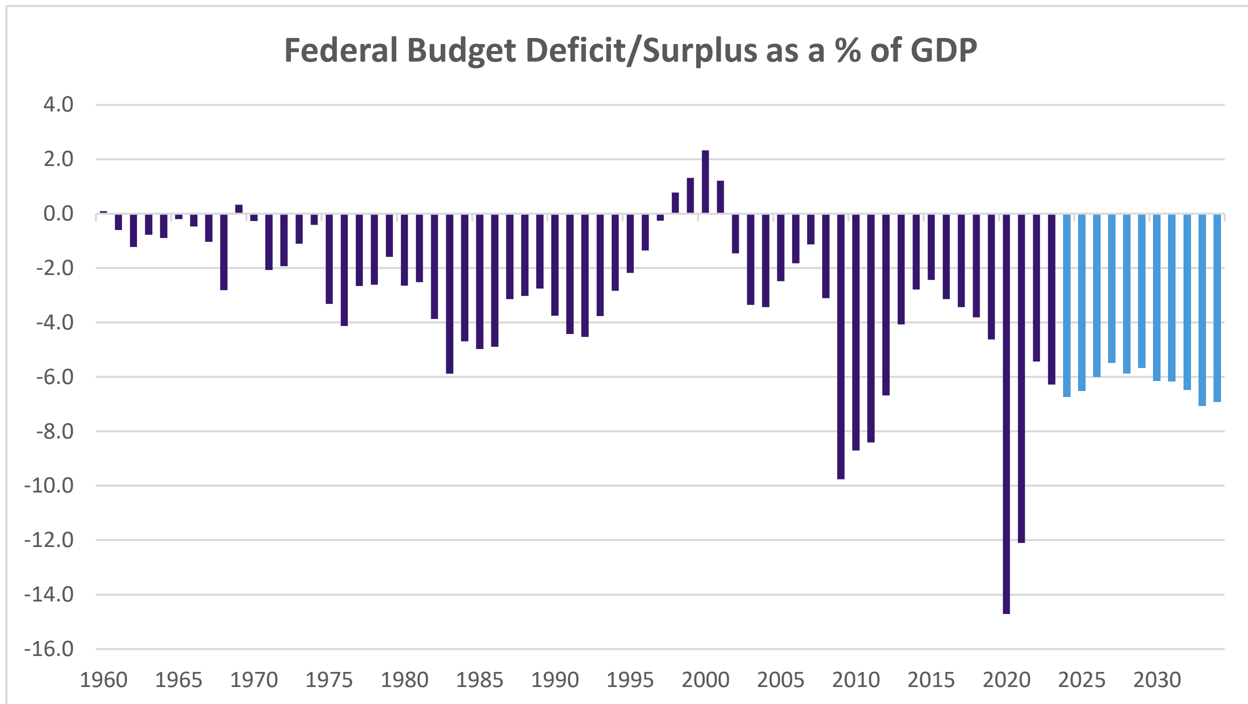
Another potential for volatility is the election in early November. We noted in past commentaries that stock returns in past election years have generally been positive. Going back to 1960, the average S&P 500 return in election years was 10.5%. Regardless of whether the incumbent party, the challenger party, a Democrat, or a Republican won, stocks were up on average. Differences in returns can largely be explained by outliers unrelated to the election, such as the tech bubble and financial crisis. We recently wrote a commentary on the election, diving deeper into historical election returns and examining the 60 days prior to the election and from election day to inauguration day. Returns leading up to the election were slightly negative but skewed by events such as the financial crisis and pandemic. Returns after the election were positive. With that in mind, we could still see short-term volatility around this election.

The biggest risk would be if there were no clear winner after the election, like the "hanging chads" dispute that occurred in 2000 when it was unclear if Al Gore or George W. Bush won the election in Florida. The U.S. Supreme Court ultimately had to intervene to settle the recount dispute. Even if a similar situation arises, we have a precedent, and while there was market volatility around the uncertainty of that election, the markets quickly rebounded after clarity was achieved.

Regardless of who wins the election, the winner will likely face a split Congress, making significant legislation such as tax cuts or tax increases difficult. Even if the future president is fortunate enough to have his or her party control both chambers of Congress, big spending initiatives will be constrained by budgetary

limits. Currently, the United States is running large budget deficits and is projected to continue doing so far into the future, as seen in **Figure 2**. The most ambitious plans will require significant funding, and both candidates would be reluctant to add substantially to this deficit.

Figure 2: Winners Curse?



Source: Cetera Investment Management, FactSet, U.S. Congressional Budget Office (CBO). Above zero indicates a budget surplus and below zero indicates a deficit. The blue bars are CBO projections for 2024-2034.

Another risk factor related to budget deficits is the economy. While we do not anticipate a recession that would require fiscal stimulus, the government may be less likely to come to the rescue and aid in economic recovery, as we saw during the financial crisis and pandemic.

We remain cautiously optimistic about the rest of 2024, but the aforementioned risks could create volatility and a pullback at any time. Some of the volatility can be mitigated by diversification within equities and an allocation to fixed income, if this aligns with risk and return objectives. While large-cap stocks have elevated valuations, small-cap stocks and international stocks are more attractive on a relative basis, with P/E ratios closer to their long-term averages. We are seeing signs of increased market breadth, and diversification is starting to benefit portfolios again. For a while, huge mega-cap companies, which make up much of the index, were driving the vast majority of market returns. Investors who did not overweight these companies, which were already such a large part of indexes, underperformed. Money market and savings account assets are also relatively high and could provide support if investors move this money into the stock market, especially if they are earning less interest after the Fed cuts rates or decide to buy at more attractive P/E multiples.

Fixed Income

Stocks have been having a good year, but bonds have quietly performed well too. Through mid-September, the Bloomberg U.S. Aggregate Bond Index, which measures the broad U.S. investment-grade bond market,

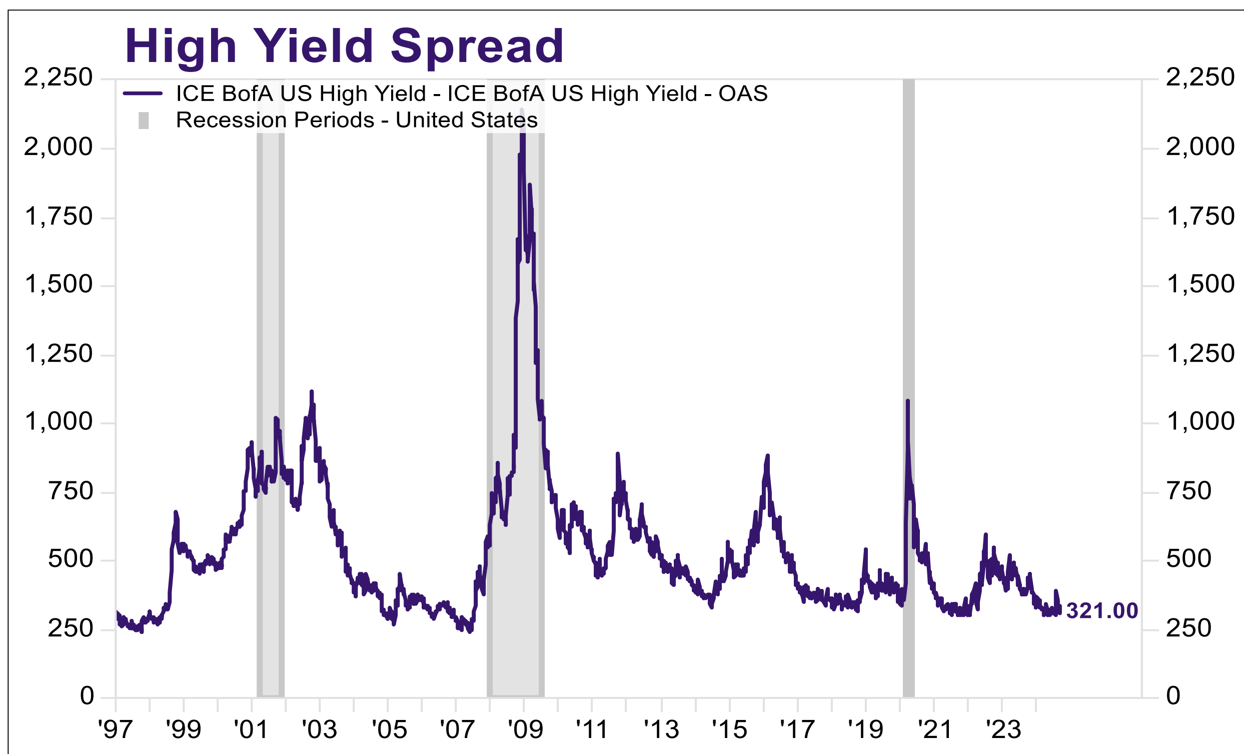
is up 5.25% year-to-date, and even more impressively, it is up almost 15% since the 10-year Treasury yield hit 4.99% on October 19 last year.

We previously noted the backdrop for bonds in 2024 was favorable because yields were higher, as were durations. Bond prices rise when yields fall and that is what has occurred this year. The 10-year U.S. Treasury yield started at 3.88%, and as of this writing, it is at 3.65%. In addition to the price appreciation of the bonds, bond investors are receiving a decent yield. The yield on the Bloomberg U.S. Aggregate Bond index is currently around 4%. Yields are near their 2024 lows, so it's possible we may see a reversal at some point this quarter. Lower yields also bring the possibility of an inflation resurgence, but we believe inflation is currently under control.

Below-investment-grade bonds, otherwise known as high-yield bonds, have outperformed investment grade bonds due to their additional yield, which compensates for the increased risk of default or downgrade. However, these bonds are not as sensitive to interest rates and thus have not benefited as much from falling yields. As a result, the ICE BofA High Yield Index is up around 7.5% year-to-date and almost 14% over the last 12-months.

This high-yield spread over risk-free Treasury bonds remains relatively tight. Bond investors are not being rewarded as much for taking on this extra risk. This is good news for the economy, as bond investors are signaling that they view recession risk as low, though this can change quickly. We are currently cautious about high-yield bonds. We still recommend owning them as part of a diversified bond portfolio but are mindful of the risk-and-return relationship in this asset class. **Figure 3** shows high-yield spreads relative to their average. The average is skewed by recessions, which are highlighted using gray bands, but you can still see that spreads are low relative to history.

Figure 3: Risks in High Yield Bonds



Source: Cetera Investment Management, FactSet, Bank of American Merrill Lynch. Data as of 9/16/2024.

With elevated P/E ratios in large-cap stocks, bonds can serve as a good diversifier. Since the pandemic, bond yields have risen, offering more yield, or cushion, which could act as a buffer even if bond prices fall. We prefer investment-grade bonds over lower-credit, high-yield bonds. Bonds could also benefit from a lower Fed Funds rate. Investors in CDs or savings accounts will earn less interest, and those investors might shift money to bonds, looking to recoup some of the yield that they will be losing. This could act as a price support for bonds and potentially drive prices higher due to increased demand.

The Bottom Line

The big news for the third quarter was that the Fed finally cut interest rates. Investors had widely anticipated this entering the year, but the rate cuts came into question in the spring when inflation data proved to be hotter than expected in the early part of the year. After that initial scare, inflation moderated, and investors got what they wanted.

While a 0.5% cut in interest rates may not be a huge jolt to markets in the long run, it is significant in that we have officially entered a new interest rate cycle. Rather than wondering when the Fed would start to cut rates or even raise rates, the conversations now focus on how much they will cut rates in the coming meetings. There will be winners and losers both in equities and in fixed income. While each sector will have winners and losers within them, sectors that could potentially benefit from lower rates include financials, REITs, utilities, and technology. However, if the Fed does not meet investor expectations, these sectors could be hurt if the Fed does not cut as much as expected.

Other sectors hold up better in a weakening economy. Sectors such as consumer staples, utilities, and health care can be more recession resistant. Those looking to invest around the election should be cautious. As we discussed, markets tend to be resilient and not significantly impacted by elections in the long run. Focusing on one’s own risk and return objectives is paramount to being a successful investor. These are the factors we can control. Regardless of who becomes president, there are larger economic forces at play than which political party controls the presidency.

Diversification is prudent, and your Cetera financial professional can help you navigate any uncertainty to keep you focused on your personal goals and objectives.

This report is created by Cetera Investment Management LLC. For more insights and information from the team, follow @CeteraIM on X.

About Cetera® Investment Management

Cetera Investment Management LLC is an SEC registered investment adviser owned by Cetera Financial Group®. Cetera Investment Management provides market perspectives, portfolio guidance, model management, and other investment advice to its affiliated broker-dealers, dually registered broker-dealers and registered investment advisers.

About Cetera Financial Group

"Cetera Financial Group" refers to the network of independent retail firms encompassing, among others, Cetera Advisors LLC, Cetera Advisor Networks LLC, Cetera Investment Services LLC (marketed as Cetera Financial Institutions or Cetera Investors), and Cetera Financial Specialists LLC. All firms are members FINRA / SIPC. Located at 655 W. Broadway, 11th Floor, San Diego, CA 92101.

About Avantax

Avantax, Inc. (Avantax) is a wholly owned subsidiary of Aretec Group, Inc. (dba Cetera Holdings). Avantax is a unique community within Cetera Holdings. Avantax Investment Services, Inc., a subsidiary of Avantax, Member FINRA / SIPC. Located at 3200 Olympus Blvd, Suite 100, Dallas, TX, 75019. Avantax and Cetera Financial Group are under common ownership.

Disclosures

Individuals affiliated with Cetera firms are either Registered Representatives who offer only brokerage services and receive transaction-based compensation (commissions), Investment Adviser Representatives who offer only investment advisory services and receive fees based on assets, or both Registered Representatives and Investment Adviser Representatives, who can offer both types of services.

The material contained in this document was authored by and is the property of Cetera Investment Management LLC. Cetera Investment Management provides investment management and advisory services to a number of programs sponsored by affiliated and non-affiliated registered investment advisers. Your registered representative or investment adviser representative is not registered with Cetera Investment Management and did not take part in the creation of this material. He or she may not be able to offer Cetera Investment Management portfolio management services.

Nothing in this presentation should be construed as offering or disseminating specific investment, tax, or legal advice to any individual without the benefit of direct and specific consultation with an investment adviser representative authorized to offer Cetera Investment Management services. Information contained herein shall not constitute an offer or a solicitation of any services. Past performance is not a guarantee of future results.

For more information about Cetera Investment Management, please reference the Cetera Investment Management LLC Form ADV disclosure brochure and the disclosure brochure for the registered investment adviser your adviser is registered with. Please consult with your adviser for his or her specific firm registrations and programs available.

No independent analysis has been performed and the material should not be construed as investment advice. Investment decisions should not be based on this material since the information contained here is a singular update, and prudent investment decisions require the analysis of a much broader collection of facts and context. All information is believed to be from reliable sources; however, we make no representation as to its completeness or accuracy. The opinions expressed are as of the date published and may change without notice. Any forward-looking statements are based on assumptions, may not materialize, and are subject to revision.

All economic and performance information is historical and not indicative of future results. The market indices discussed are not actively managed. Investors cannot directly invest in unmanaged indices. Please consult your financial advisor for more information.

Additional risks are associated with international investing, such as currency fluctuations, political and economic instability, and differences in accounting standards.
A diversified portfolio does not assure a profit or protect against loss in a declining market.

The S&P 500 is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Bloomberg US Aggregate Bond Index is a broad based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. Eligible bonds must have at least one year until final maturity, but the index holdings have a fluctuating average life or around 8.25 years. This total return index is unhedged and rebalances monthly.

The ICE BofA US High Yield Index tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the U.S. domestic market. Securities must have a below investment grade rating (average of Moody's, S&P, and Fitch) and an investment grade rated country of risk (average of Moody's, S&P, and Fitch foreign currency long term sovereign debt ratings). Each security must have greater than 1 year of remaining maturity, a fixed coupon schedule, and a minimum amount outstanding of $100 million.