

Q3 - 2024

Capital Market Outlook

The stock market, as defined by the S&P 500, rose 5.9% in Q3, and is now up more than 22% for 2024 through September 30. The dynamic in Q3 was a bit different vs. the first half of the year and we are encouraged to see better participation from non-“Magnificent 7” stocks, as well as better breadth driving this quarter’s rally. The quarter was volatile with the market reacting to signs of a weakening labor market in both August and September. The long-awaited Fed cut did come in September, propelling a strong rally into the end of the quarter. We remain somewhat cautious on the economy, which has shown areas of both weakness and strength. Thus, we do see risk to the stock market, which continues to make new highs and trades at a historically high valuation. That said, we also see opportunities in areas outside of companies involved in AI infrastructure and continue to like stocks for the long-term.

The market reacted negatively to both the July and August employment reports, which both saw total jobs miss estimates by relatively wide margins while the unemployment rate ticked higher. The data from July, where unemployment increased to 4.3%, triggered the Sahm Rule, developed by former Fed economist Claudia Sahm, an indicator of a recession start that measures the increase in unemployment relative to its low during the prior year. It is important to note that the Sahm rule has a perfect track record but has generally been around three months late confirming recessions. In addition, the Bureau of Labor Statistics in its annual revision lowered the number of jobs added in the twelve months prior to March 2024 by an astounding 818K, or approximately 68K fewer jobs per month. This sizable change highlights the increasing unreliability of the BLS jobs survey, as well as a labor market that is not as strong as it would seem on the surface. However, the September employment report came in much stronger than expected, with the economy adding 254K jobs vs. the 150K estimate. This report has put a lid on some of the recession calls for now, but it is important to note that there were several negatives in the report that are not typically discussed, namely a new low survey response rate, which adds to the unreliability of the data. There were also a high number of part-time jobs added while full-time jobs were lost. Lastly, there were also many government jobs added, not necessarily a hallmark of a strong underlying job market.

The downward path of inflation throughout the course of this year, as well as signaling from the Fed, made an interest rate cut an inevitability throughout the course of the summer. Beginning in August, the debate centered on whether the Fed would cut 25 or 50bps. Following the August jobs report, Fed Chair Powell began to advocate privately for a larger cut, which is what ultimately came to be at the Fed meeting on September 18th. While positive that the Fed recognized the restrictive nature of its prior policy, a 50bps cut with rates still around 5% will likely have little impact on the areas of the economy under the most strain and will take several months to fully filter through the economy.

Taking a broader view of the economy, there are pockets of strength; namely August retail sales that came in above estimates at +0.1% when a decline was anticipated. There had been some rumors that retail sales would miss badly, and this data in mid-September helped drive the end-of-quarter rally.

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It is important to keep in mind that retail sales are growing well below the rate of inflation, and consumer companies have been increasingly negative about spending, especially around the key back-to-school season. The Conference Board index of consumer confidence in September fell the most since August 2021, with views of the current business environment turning negative and respondents' assessment of the labor market deteriorating further from August. Recent increases in oil prices could also have a negative impact on spending as we head into the holidays. Manufacturing, which accounts for about 1/3rd of the economy, has been contracting for the past two years. Services continue to grow, but generally the economic picture is mixed.

Looking forward, we believe equities remain the best place to invest for long-term capital appreciation. We are concerned by the combination of elevated equity valuations and a somewhat deteriorating economic outlook, as well as ongoing geopolitical tensions globally, and have positioned the portfolio to not be overly aggressive. Current estimates call for the S&P 500 to grow earnings in the low teens in 2025, accelerating from the current year, a number we see as challenging to achieve, especially in a soft-landing scenario. We also view the excitement around artificial intelligence and huge gains in companies like Nvidia as posing risks to the overall market, given the potential for one small indication of slowing growth to affect the entire Tech sector. We continue to prefer areas of the market that we believe are more durable, specifically Healthcare, Consumer Staples, and certain areas within Software. While these areas have been out of favor with investors as of late, these businesses can quickly become very exciting in a challenging economy. At AMI, we continue to invest for the long-term, actively managing risks and staying disciplined, with a focus on companies that can perform well regardless of the macroeconomic picture.

Sincerely,

Your AMI Investment Management Team

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Point of Contact: Matthew Humiston · 424-320-4002 · matt@amiassetmanagement.com

10866 Wilshire Blvd, Ste. 770, Los Angeles, CA 90024 · 424-320-4000 · www.amiassetmanagement.com