

October 2024

Quarterly Market Strategy Report

October: A Liquidity Boom

The third quarter of 2024 included the long-anticipated September Federal Reserve meeting, and the first fed funds rate cut in four years. What was equally remarkable, was the dramatic shift in equity leadership, away from the popular large capitalization companies linked to growth from artificial intelligence (AI) to a much broader range of equities. This was a positive change for most investors and as a result, the Dow Jones Industrial Average gained 8.2% in the quarter, as compared to the Nasdaq Composite index with a 2.6% increase. The benchmark S&P 500 Composite index rose 5.5%, while the broader Russell 2000 index was the biggest winner with an 8.9% gain. Perhaps the most surprising point in terms of the quarter's performance was the spectacular 23% increase in the SPDR S&P Homebuilders ETF (XHB - \$124.56), a homebuilding exchange-traded fund. Clearly, this jump was in anticipation of the Fed's rate cut and the expectation that a shift to easy monetary policy would reignite the housing market.

50 BASIS POINTS

The 50-basis-point cut by the Federal Reserve was double the level expected only a month earlier. However, a larger cut may have been the Fed's insurance policy to reduce the risk of the US economy experiencing a recession or a hard landing. Equally important, at the end of September the Chinese government announced its biggest stimulus package since the pandemic. This package included more than \$326 billion in a variety of measures such as lower central bank rates, lower mortgage rates, minimum down payments on real estate transactions, and a 50 basis point decline in the RRR (reserve requirement ratio). The People's Bank of China Governor Pan Gongsheng said further easing is likely to be in the pipeline, and another reduction in bank reserve requirements should be expected before year-end. These additional actions may be necessary to reverse the slump in Chinese consumer consumption, a shaky property market and growing deflationary pressures.

Summary

The policy shift by the US, China, and a number of central banks to lower key interest rates increases liquidity in the global financial system. This should be a positive force for equities. The Wall Street adage "don't fight the Fed" has been good advice historically.

Global monetary policy currently supports equities, but what does not support equities is valuation. The S&P 500 trailing 4-quarter operating multiple is now 25.2 times earnings, and the 12-month forward PE multiple is 21.5 times.

Asian analysts believe it will take fiscal as well as monetary measures to revive China's economy, however China's move was greeted favorably and triggered equity and commodity rallies around the world.

Furthermore, this stimulus trend did not start in September. Many central banks — including those in Europe, England, Canada and some emerging markets — were already cutting their benchmark interest rates before the Fed pivoted in mid-September. This policy shift by a number of central banks to lower key interest rates increases liquidity in the global financial system and should be a positive force for equities. The Wall Street adage “don't fight the Fed” has been good advice historically.

While lowering the fed funds rate will support the US economy and a sluggish residential sector, it will also help the federal deficit. At present, 21% of outstanding marketable Treasury debt is held in short-term bills. September's rate cut and the cuts expected to follow, will lower the government's net interest expense in the months ahead. This factor should not go unnoticed since according to current White House data, in fiscal 2023, the government's net interest expense was 9.5% of total spending, and in fiscal 2024 it is expected to exceed the 9.9% of total outlays spent for defense and international expense.

RATE CUT HISTORY

Statistics on how the stock market reacts to an initial fed funds rate cut are quite mixed. History shows that the first rate cut typically occurs when the economy is already in a recession. But note, this fact may not have been known at the time since recessions — two consecutive quarters of negative GDP -- are only identified with a six-month lag. The one easing cycle that took place prior to a recession was in June 1989, however, this cut was also followed by a recession, but not until July 1990. Moreover, inflation of 6% or greater is typically followed by a recession, even though it may take years to materialize. In short, there are reasons to be cautious, yet the current Covid/post-Covid cycle has been unusual in many ways and the stock market clearly feels we are headed for a soft landing or no recession at all. And perhaps this is true and it will be different this time. But are not convinced that a normal economic cycle of expansion/recession has been eliminated entirely. It may simply have been postponed for another time.

EQUITY VALUATION IS HIGH AND AN ELECTION NEARS

Global monetary policy currently supports equities, but what does not support equities is valuation. The S&P 500 trailing 4-quarter operating multiple is now 25.2 times earnings, and the 12-month forward PE multiple is 21.5 times. By all measures, the US equity market remains richly valued and is at levels seen only during the 1997-2000 bubble, the

It may be too soon to worry about the market's current rich valuation. In prior cycles the 12-month trailing PE multiple reached a range of 27 to 31 before equity prices peaked.

November and December tend to be good months for stocks in most years, but they tend to be the best-performing months in a presidential election year.

The unemployment rate will be an important economic statistic in the months ahead. If the unemployment rate remains stable to lower, it would suggest a soft landing has indeed been achieved. This would be a good omen for both future corporate earnings and equity performance



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financial crisis of 2008, or the post-COVID-19 earnings slump. Still, it may be too soon to worry about current valuation. Even in these prior cycles, the 12-month trailing PE multiple reached a range of 27 to 31 before equity prices peaked. What is more, the current influx of liquidity has led some analysts to believe the US equity market could soon experience a “melt-up” in prices. In short, if the market is forming a bubble, or about to “melt up” valuation will not matter, at least in the short run.

2024 is a presidential election year, and while these years are rarely the best-performing years in the four-year cycle, there is a strong tendency for equity prices to rise at year end. November and December tend to be good months for stocks in most years, but they tend to be the best-performing months in a presidential election year.

In the months ahead, the unemployment rate may become more important to equity investors than Fed policy, inflation, or earnings. If the unemployment rate continues to rise, the odds of a recession will increase substantially, and the equity rally could come to an end. Conversely, if the unemployment rate remains stable to lower, it would suggest a soft landing has indeed been achieved. This would be a good omen for both future corporate earnings and equity performance.

*Stock prices are as of September 30, 2024



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