Investment Perspective

The Federal Reserve cut interest rates on September 18th for the first time since early 2020. This cut signals the beginning of an accommodative monetary cycle that will lower interest rates to a more moderate level and relieve the economy of the restrictive impact of tight monetary policy. With looser policy on the horizon, the S&P 500 (SPX) advanced to new all-time highs throughout the third quarter. Investors have begun to see a slight increase in stock market breadth across all capitalization ranges, but overall market psychology remains dominated by the Magnificent 7 mega-cap stocks. A summary of year-to-date index returns for the period ending September 30, 2024, is as follows:

Dow Jones Industrials	13.9%	Russell 2500	11.3%
MSCI EAFE	13.5%	S&P 500	22.1%
NASDAQ Composite	21.8%	Wilshire 5000	20.6%

We are entering a period of global monetary easing, which should support financial markets with increased underwriting, M&A activity and a greater appetite for risk-taking

GLOBAL ECONOMY

Global GDP growth is expected to increase 2.7% this year, and early estimates suggest 2.5% in 2025. On balance, the global growth outlook has been modestly improving. Growth in Europe and Japan is forecast to be under 1%, and China faces a difficult economy with 4.5-5% growth. Chinese authorities are responding to the challenging environment with a series of stimulus efforts aimed at reinvigorating growth and stabilizing the sectors overly reliant on financing, particularly the property market. On the monetary policy front, nearly every major central bank excluding the Bank of Japan has reduced interest rates in the past three months. Confidence is building that inflation is sufficiently under control to reduce interest rates. It is important to note that Japanese policies are not in sync with the rest of the world due to its long battle with deflation, which finally appears to be over. The Bank of Japan will be raising interest rates for the foreseeable future. Putting that aside, we are entering a period of global monetary easing, which should support financial markets with increased underwriting, M&A activity and a greater appetite for risk-taking.

U.S. economic growth is firming more than previously expected. Forecasts are rising as the labor market and consumer spending prove healthier than expected. The consumer continues to provide a solid backbone for the economy. U.S. GDP is expected to grow approximately 2.8% in 2024 with a moderate deceleration in 2025. Growth is coming from the consumer sector, non-residential capex spending, technology spending and the government sector. Even the residential housing sector is improving despite subdued activity for new and existing home sales. The only major detractor to the economy is import demand, which outweighs export activity. The September retail sales report showed sales, excluding autos and gas, increased at a 6.3% q/q annualized pace in the third quarter.

575 Lexington Avenue / 30th Floor
New York, NY 10022
P 212.344.3300 / F 212.344.2045
americancapitalmanagement.com

The manufacturing sector continues to be in an extended downturn, as evidenced by the ISM purchasing managers index for manufacturing, which registered 47.2 in September, slightly below the average level for the last 12 months

This represents the fastest pace since the first quarter of 2023. The September employment report showed payrolls increased 254,000 – higher than the average monthly gain of 203,000 over the last 12 months. The unemployment rate is 4.1%, the labor participation rate is gently increasing to 62.7%, and payroll growth is 1.6%. The October report was muddied by the hurricanes, and we will have to wait until the next report to gain a clearer employment picture. In sum, these indicators reflect a stable labor market, which is sufficient to support broad-based economic growth. Mortgage applications for new purchases and refinancings are also showing early signs of accelerating from historically depressed levels, but mortgage rates will need to come down to truly invigorate housing. Home affordability remains a headwind for faster home turnover and will not improve until mortgage rates decline further or homes prices decline. The manufacturing sector continues to be in an extended downturn, as evidenced by the ISM purchasing managers index for manufacturing, which registered 47.2 in September, slightly below the average level for the last 12 months. Industries reporting production growth are tied to the computer and electronics industry and the food and beverage industry. Conversely, weakness was reported in the following industry verticals: minerals, metals, chemicals, wood products, and plastics. Overall, recent trends in economic activity suggest that domestic demand is healthy with balanced contributions from multiple sources. A recovery in housing and manufacturing will provide further confirmation of an expansionary environment.

MONETARY POLICY: THE FED EASES

The Federal Reserve cut the federal funds rate by 50 basis points to 5.0% on September 18. This was the first accommodative move since early 2020 when the pandemic started. This signals that the central bank is satisfied with the downtrend in inflation and marks a constructive development after several years of restrictive monetary policy. Additional interest rate cuts are likely during the final two months of the year. In total, the market expects approximately 150 basis points of cuts over the next 12 – 18 months, but this will be data dependent.

The market expects approximately 150 basis points of cuts over the next 12 – 18 months, but this will be data dependent

The consumer price index (CPI) in September increased 2.4% y/y – the smallest year-over-year change since February 2021 and down from 3.7% in September 2023. Core inflation (CPI excluding food and energy) rose 3.3% y/y and the Fed's preferred measure of inflation, the core personal consumption expenditure (PCE) price index, which excludes the impact of food and energy prices, rose 2.7% y/y in August. We expect a further downtrend trend in inflation over the next year, but it may be challenging to meet the Fed's 2% policy target. Interestingly, the yield on 10-year Treasury bonds has increased 55 basis points to 4.28% since the September 18 interest rate cut. Long-term bond yields have bounced around in a volatile manner over the past two years as the debate around hard landing vs. soft landing has battled out in the financial markets. Currently, the soft-landing scenario is the most likely. In addition, bond investors are concerned about the growth of the federal deficit and demanding a higher term premium.

INVESTMENT OUTLOOK

The extreme stock market concentration in the 10 largest companies creates an attractive set-up for small and mid-cap stocks to begin a period of outperformance

The key ingredients are in place to earn double-digits returns in small and mid-cap growth stocks over the intermediate term. These ingredients include a positive outlook on corporate earnings growth, accommodative monetary policy, an improving inflationary outlook and constructive investor sentiment. In addition, the extreme stock market concentration in the 10 largest companies creates an attractive set-up for small and mid-cap stocks to begin a period of outperformance. It is not easy to say when this may occur, but the stage is set.

We expect S&P 500 (SPX) operating earnings per share to grow 9% this year to $240 with 13% growth in 2025 to $270. These forecasts include mid-single-digit revenue growth combined with margin expansion. Currently, the SPX is valued at 21.5x the projected earnings over the next twelve months versus its long-term average of 16.6x. The Magnificent 7 companies in the SPX are trading at 37.4x forward earnings, which is 74% above the average of the index. Excluding these seven companies, the average SPX stock is more moderately valued at approximately 16x forward earnings. The S&P 500 has become more concentrated than ever. Over the last 35 years, the average weight of the top 10 stocks in the S&P 500 index has been 20%. During the dot-com bubble in 2000, the combined weight of the top 10 stocks peaked at 25%. At present, the figure stands at approximately 32%. We expect the narrowness of the stock market to eventually broaden out with a positive impact on small and mid-cap stocks.

Recession risks are low, and credit conditions are stable

The risks to the outlook include a sharp rise in Treasury yields associated with a combination of a stronger economy, higher levels of Federal deficit spending and the reemergence of inflationary pressures. At this juncture, recession risks are low, and credit conditions are stable. If the job market grows slowly, as it has been, consumer spending will remain moderate. But if payroll growth deteriorates significantly, there is risk to the outlook via the consumer feedback loop. The key additional risks include China's slowdown, cyber-attacks, disappointing earnings, the Iran/Israel conflict escalating, and an unexpected credit crisis. In our opinion, with lower short-term interest rates, investor risk appetites will increase, refinancing risks will diminish, M&A activity will pick-up, and a positively sloped yield curve will signal fewer recessionary risks which will work collectively to the benefit of small and mid-cap stocks.