Quarterly Market Letter

GENTER CAPITAL MANAGEMENT

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- Soft landing is still TBD

Introduction

The key term in this quarterly update is "soft landing." The question in the market is whether the Fed can engineer one for the economy. The very fact that "soft landings" are widely discussed speaks to the pervasiveness of macroeconomic reasoning in our country. Over the past several decades, the Federal Reserve's role in smoothing the sharp teeth of the business cycle has become so embedded that it is almost unnoticeable.

This was not always the case. We think of the Federal Reserve as an independent institution, and indeed, officials at the Fed cherish their independence as the source of their power. But Americans have a long history of distrusting central banks. Through the entire 19th century, from time of Lewis and Clark to our Second Industrial Revolution, most Americans were viscerally opposed to national banks. During the same period, the American economy was wracked by a high degree of financial instability. These instabilities were generally limited to local regions, but often spilled into the entire country. In either case, they harmed families and caused widespread hardship.

The Federal Reserve system came into existence in 1913. The near-death experience of the Knickerbocker Crisis in 1907, which followed the harrowing Wall Street crashes in 1873, 1884, 1890, 1893, 1899, and 1901, and which was followed by another crash in 1908, led to the formation of the National Monetary Commission. The Commission recommended, among other things, creating a set of regional banks which rolled up to a broader reserve system.

The Fed was a highly decentralized system during its first two decades. In keeping with our country's monetary practices since the 1830s, the fledgling System adhered to the gold standard. Most of its power was wielded on the district bank level, especially at the New York Bank, where Wall Street is located. To this day, the New York Bank has unique responsibilities and powers.

After the market crash of 1929, the Fed floundered as the economy underwent another existential crisis. When the Roosevelt Administration swept into office in 1933, it consolidated power at the Fed with the Board of Governors. It also began regulating gold, a singular event in our economic history. While the dollar would continue to be tied to gold (until President Nixon made the final break in 1971), constraints on gold ownership were handled by the White House, not the Federal Reserve. Despite the shift to a more national-based institutional framework, the Fed's operational leeway was limited during the 1930s.

With the onset of World War II, even that limited independence evaporated. Faced with the challenges of funding the war, the Roosevelt administration decided to borrow rather than massively increase taxes. Of the $340 billion that the United States government is estimated to have spent on World War II, $185 billion came from War Bond campaigns. Approximately 85 million of America's 135 million citizens (63%) owned War Bonds.

The Fed's role during the war was limited to "yield curve control." It was responsible for keeping longer-term Treasury rates pegged at 2.5% and short-term Treasury rates inside of 1%. This monetization of public debt enabled the federal government to focus on defeating the Axis powers without placing large burdens on taxpayers. It also led, when combined with the huge governmental outlays required to sustain the war effort, to soaring inflation.

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As the war ended, most Americans feared that the economy would recede back into a depression. Indeed, as government spending was dialed back, there *was* a recession in 1945. Still, inflation persisted, and the economy pulled out of the dumps in late 1945. Despite this, the now Truman Administration did not want the Fed to end the policy of yield curve control. Like many in his generation, Harry Truman believed that rates were determined by the banks, not by the market. He did not want the patriotic Americans who bought war bonds to be left holding illiquid investments with less yield than what the big shots could get from buying Treasuries.

As a result, yield curve control extended into the post-war period, with inflation averaging 10% per year from 1946 to 1948. Alarmed, Fed officials tried to convince the Truman administration to let the bond market determine Treasury rates. That conversation was stalled by the election of 1948 (which Truman won, to the surprise of almost everyone), and by the recession of 1949, which led to more than a year of *de*flation. But when the Korean War began, in June 1950, inflation reappeared with a vengeance.

At this point, Fed officials had had enough and took their complaints public. In March 1951, after months of negotiation, the "Treasury-Federal Reserve Accord" was signed, marking a watershed moment in the life of the Fed. While the Fed agreed to "assure the successful financing of the government's requirements," the Treasury agreed "to minimize the monetization of the public debt." The Fed could now return to stabilizing the purchasing power of the dollar, this time with authority in the hands of its governors in Washington D.C.

Since the Accord, the Fed has safeguarded monetary stability with varying degrees of success. Its independence remains at the pleasure of those who truly are accountable to the public: elected politicians. The Federal Reserve System was formed by an act of Congress, and an act of Congress can end it. Still, it is a small miracle that we are even discussing whether the Fed can engineer a "soft landing." It is a discussion which literally grows out of decades and even centuries of painful trial and error.

Review and Outlook

The third quarter of 2024 showcased the resilience of value-oriented stocks in a landscape of increasing change and volatility. Supported by full employment, the overall economy appears to remain on stable footing. Some of the more cyclically sensitive corners of the market are optimistic that the Fed will stick the soft landing and extend the current business cycle.

Interest rates fell dramatically across the entire curve. The rally was especially pronounced on the shorter end. The "bull steepener" was mostly driven by the market perception that economic weakness would lead to a faster pace of cuts from the Federal Reserve and ended the 27-month inversion between the two-year and ten-year Treasury rates. Apart from the extreme short end, which is almost entirely Fed-dependent, the yield curve is back to being positively sloped.

Despite perceptions whipsawing with each new data release, the economy continues to exhibit solid fundamentals. The persistent and surprising economic strength cannot be ignored and has led us to increase our growth forecast from 1.25% at the start of the year to 2.5% now. We expect some small amount of slowing in 2025, as an overall upward drift in unemployment pressures consumption. Still, that should be partially offset by easier financial conditions.

GDP growth should also draw from the continued fiscal engagement of the federal government, although the manner of that engagement will vary significantly depending upon the result of the election next month. From an investment perspective, each candidate has a different policy focus, which can lead to different sector outcomes. Moreover, while each candidate leans towards a specific set of policies, it remains to be seen what can be implemented. We do not expect dramatic sector-level changes from either candidate, although we do acknowledge, of course, that elections have consequences, and that those consequences extend to the capital markets.

Inflation has shown signs of moderation, which bodes well for the purchasing power of consumers—and the profitability of stocks. While headline CPI continued its downward trend, Core PCE—the Fed's benchmark—increased during the quarter. Other

inflation metrics also remain elevated. These include the "supercore inflation" numbers and the Atlanta Fed's "Sticky Price CPI." Moreover, Owners' Equivalent Rent, which measures sheltering costs, has not declined as rapidly as expected.

As the Fed moves deeper into its "balanced" risk assessment and is no longer exclusive to the upside risk of inflation, unemployment numbers assume greater meaning. The U-3 unemployment rate is now at 4.1%, close to the Fed's long-run target. While this is still an economically healthy level, trends suggest that it will go higher.

Still, just as growth and inflation have been persistently higher than pundits expected, unemployment has been persistently lower. As Fed Governor Christopher Waller said: "It should be clear to everyone that many pre-pandemic economic relationships have not proven to be good policy guides post-pandemic. Reliance on old lessons from inverted yield curves to predict a recession, a Phillips curve to predict inflation, or a flat Beveridge curve to predict the movement in the unemployment rate, have all led to mistaken economic forecasts." We think these words should be remembered when evaluating the current investment landscape.

There were other factors impacting the market during the third quarter. The election is a source of risk, which has the effect of pushing rates lower. The unwinding of the yen carry trade in early August caused a degree of panic, with significant spread widening. Cooler heads prevailed and the widening reversed course, to the extent credit spreads ended up *tightening* by four basis points during the quarter. Finally, volatility in the Treasury markets continued to be high. These past three years have been very volatile for treasuries, especially when compared with the prior decade.

Going forward, we expect the Fed to continue to cut rates. The cadence of rate cuts will be data-dependent, just as the Powell Fed is data-dependent. Based on the evolving data picture, we could easily see the Fed cutting 50 basis points from its target rate in each of its final two meetings of 2024; we could just as easily see the Fed making no more cuts this year. Splitting the difference, we project two 25 basis point cuts, totaling 100 basis points for 2024. At the start of 2024, our projection was 75.

On the fixed income side, we think the prospect of chaos after, and even before, the November 5 election creates a degree of uncertainty making us hesitant to be short duration. Although we think that rates are a bit "rich," our baseline view is that rates will exit 2024 close to where they are today.

For 2025, the big question is: "does the Fed manage a soft landing?" A hard landing is the Fed cutting multiple times into the face of weakening growth and employment. Keeping in mind Governor Waller's comments, we are also intrigued at the prospect that the Fed has *already* stuck the landing, although it is way too early to run a victory lap. By a 70/30 margin, we see these "soft-landing or already landed" scenarios as more likely than the "hard landing" outcome.

On the equity side, S&P 500 earnings estimates for the balance of 2024 reflect the better-than-expected GDP, with aggregate earnings on pace to grow a solid 9-10% year-over-year. As we look forward to 2025, we are taking a bit more of a conservative view that earnings growth will be a very reasonable 6-8% compared to initial consensus estimates for 15%. While we still see plenty of risks in the market, if employment and economic activity continue to grind higher, equity markets—fueled by ample global liquidity and animal spirits moored to the soft-landing narrative—will remain well bid.

Fixed Income Report

The adage that "there is no such thing as a free lunch" has been confirmed yet again. For two years, the inverted curve created space to garner extra yield without taking on duration risk. For investors targeting intermediate durations, the barbell strategy made good sense. Buying short-term bonds and longer-term bonds while avoiding the "belly" of the curve was an intuitive way to earn extra income. We used the strategy ourselves.

Now that the Federal Reserve has moved into a cutting cycle, we think the barbell structure is less optimal. For our accounts owning taxable bonds, we have started shifting strategies to a more neutral or even a slight "bullet" orientation. For our accounts

owning tax-exempt securities, the process of transitioning is slower, as the municipal bond portfolios are characteristic-based and not a set of specific securities. Still, we are dismantling the barbells as advantageously as possible. We also expect to exploit the "roll," which occurs in a normal rate environment.

In the third quarter, there was a major decrease in Treasury yields as the market priced an aggressive easing cycle from the Fed. This development occurred in the aftermath of the false inflation signal during the first quarter. Once again, our taxable strategies held strong, with three strategies slightly underperforming and four strategies slightly outperforming their respective benchmarks.

Credit spreads remained narrow (85-105 basis points) during the third quarter. We think that spreads will have a hard time compressing from these levels with Treasury yields this low. The lack of significant upside cautions against taking additional risk. At the same time, given our outlook for moderating inflation and slow (but positive) growth, we are comfortable maintaining our overweight allocation to corporate bonds. While we still see relative value in individual credits and sectors, we also recognize that the corporate bond market is no longer "cheap" and may look for opportunities to reduce our exposure.

A middling economy is not bad for carry strategies. We continue to interrogate the market for extra yield, recognizing that the search for yield can backfire when the positioning gets lopsided. And with the Fed cutting rates, increased merger and acquisition (M&A) activity, which tends to benefit shareholders, marks an increased risk to creditors. We have found, however, that companies which recently underwent M&A will sometimes focus on balance sheet repair, making them attractive investments. The banking sector should perform well in a more normalized rate environment. We also see energy infrastructure as a sector which continues to have value.

Cash on the sideline is estimated at $7 trillion. With money market rates still well above the zero-bound torpor of the not-too-distant past, the economy has interest income to reinvest and maintain positive economic growth. The sidelined cash can also be used to invest in other asset classes and could move into stocks and bonds as the curve normalizes. Fundamentals tend to drive capital allocation decisions, but this factor could help provide a ceiling on interest rates and a floor to stock prices, at least temporarily.

We continue to avoid TIPS, which are expensive relative to our inflation outlook. In short, we look for incremental investments and continue to review credits from businesses with wide moats. While always on the lookout for relative value, we balance this search to the reality that credit is not particularly cheap these days.

Like Treasuries, municipal bonds rallied in the third quarter. After two outperforming quarters, our flagship intermediate strategy gave back some performance in the third quarter. The most significant moves came on the short end, with the market reorienting its expectations concerning the pace of Fed rate cuts. This led to an outperforming five-year bullet index, which is the benchmark to our intermediate products. Still, in terms of absolute returns, the third quarter brought meaningful price appreciation to our client portfolios.

We have repeatedly stressed that the new issue market for municipal bonds provides an excellent opportunity to capture additional tax-free income. Year in and year out, primary market deals are priced at a discount to secondary market offers. This year, municipal bond issuance has finally picked up after a two-year slump. In the first three quarters of this year, the volume has nearly matched the entire output of 2023 and 2022 combined. For our part, we have taken full advantage of the deluge of supply, doubling our participation levels from last year (and the year still has three months to go). We expect to see a seasonal slowdown to close out the year, but we will continue to be an active player in the primary market.

It is a highly concentrated market, with three states (CA, TX, and NY) accounting for 40% of the new issuance in 2024. The surge in primary market supply is not surprising. State and local governments have long underinvested in infrastructure. The upswelling of new issuance can partially be attributed to the end of the COVID-19 federal assistance, prompting municipalities to seek alternative funding sources.

The increased supply has helped normalize Muni-to-Treasury ratios. The 10-year ratio has expanded from 58% at the close of 2023 to around 70% now, making munis more attractive on a tax equivalent basis. Investors may be willing to pay up for the convenience and satisfaction of tax exemption, but in the third quarter, that premium was reduced.

Despite the uncertainties posed by the impending election, and its implications for tax policy, we are comfortable with our level of AMT (alternative minimum tax) holdings. These bonds provide excess return to our clients and have proven a tactical success. While do not expect to be adding to our AMT positions, we *do* expect to add more pre-paid gas bonds. These provide attractive carry from a rapidly growing sector and will generally be in the belly of the curve.

Now that the curve is normalizing and is expected to continue along that path, we think the barbell trade will be far less effective in producing excess returns. The "free lunch" may be over, but we knew it was never entirely "free." More importantly, new market horizons mean new market opportunities, and those are our focus.

Equity Market

The equity market continued to build on its solid returns from the first half of the year, with the S&P 500 achieving a new all-time high of 5,762 at the close of the quarter. Unlike the first half of 2024, the market broadened on renewed optimism for the soft-landing outcome. Investors believe that the Fed will be sufficiently aggressive to normalize rate policy, which should provide support for consumption and benefit a wider swath of stocks. The S&P 500 total return increased 5.9% in the third quarter, bringing year-to-date returns to +22.1%.

The performance of value stocks this past quarter was particularly noteworthy. Companies which offer solid dividends, stable earnings, and attractive valuations have captured investor interest as market participants seek to mitigate risk and capitalize on long-term capital appreciation potential. The Value index returned +9.4% during the quarter; the Growth index returned +3.0%. Year-to-date, Growth at +23.9% continues to outpace Value at +16.7% but the gap narrowed for the first time in several quarters. Further evidence of market broadening was observed in the Equal-Weighted S&P 500 gaining 9.1% during the quarter, versus the market-cap weighted index increasing 5.9%. In prior quarters, we noted the narrowness of market strength. This was not the case in the third quarter.

Persistently low equity risk premiums for the broad market should be a reminder that new capital investments need to be thoughtfully selective as we look for good relative value in the market. This dynamic is likely to continue until there is an actual break in the economy. Since equity risk premiums and future market returns are highly correlated, the current low premium suggests, in our view, that market returns over the near and medium term could become increasingly gated by earnings growth.

The historically low volatility we experienced in the first half of 2024 was finally punctuated by bursts of concern. As noted above, capital markets were gripped in early August by an unwinding dollar/yen trade, which reverberated across the global equity markets. And again, in early September, the economic data (and revised data) seemed to call into question the soft-landing scenario, with the Fed appearing too far behind the curve. While the market consternation was short-lived in both cases, it was a stark reminder that the equity market is not priced for any kind of negative surprises. It was also a reminder that the United States capital markets are intertwined with the global capital markets and remain highly susceptible to global events.

We continue to view the increasing trend towards deglobalization, near-shoring of manufacturing, protectionist tariffs, and the hostile geopolitical environment as headwinds to the broad disinflation which characterized the three decades prior to COVID-19. And while a slightly more elevated inflation environment is manageable, we remain focused on above-average equity market multiples. We think that equities can grow into these multiples if the soft landing is achieved. We would expect equities to track well with earnings growth from here and do not expect meaningful multiple expansion, like those of the past 18 months, to drive outsized returns. In fact, meaningful multiple expansion would be a

reason for us to become incrementally cautious in the near term.

Despite solid returns this year we still see opportunities to deploy new long-term capital. Interestingly, more than 40% of all stocks in the S&P remain below their highs reached in 2021, 30% are in correction territory (down over 10% from that prior peak), and more than 20% are still stuck in bear-market territory (down more than 20% since the prior peak).

As we move into the fourth quarter and look toward next year, we advise investors to stay agile. Market conditions are likely to remain fluid, influenced by economic data releases, corporate earnings, and geopolitical developments. Diversification and a long-term perspective will be key to navigating these uncertainties. The outlook for value stocks seems promising and we anticipate continued investor interest in these companies as the market shifts to a more balanced stance. This would be a sharp contrast to the old playbook of narrowly concentrating on the Magnificent-7 stocks or the Tech and Artificial Intelligence trade. By focusing on long-term fundamentals and relative valuations, we believe that value-oriented investments will play a crucial, and profitable, role in our portfolio performance.

Conclusion

When the Federal Reserve eased its target Fed Funds range by 50 basis points in September, it marked the first time since late 2000 that the Fed embarked on a new rate cycle with some amount other than 25 basis points. As a rule, the Fed prefers to start slowly when it is changing direction. Even with the last rate cycle in 2022, when the Fed was clearly behind the galloping inflation, the initial hike was only 25 basis points.

Until last month, one had to go back to 2000 to find a rate cycle which began with 50 basis points. The easing cycle which began in 2019, the tightening cycle which began in 2016, the easing cycle which began in 2007, and the tightening cycle which began in 2004, all started with 25 basis points.

The 50 basis point cut in 2000? *That* easing cycle began in the aftermath of the presidential election, with the Fed trying to make up for lost time. It did not want to interfere in the contest between George W. Bush and Al Gore. The recession we endured in 2001 is partly attributable to the Fed's unwillingness to preemptively ease in 2000. And this leads, perhaps, to the most important reason why the Fed has maintained its institutional independence in the decades since the Treasury-Federal Reserve Accord: *it tries to learn from its mistakes*.

The Fed has a checkered past and it is *not* the venue for bold new experiments (much less bold *old* experiments which have already failed). But if the dominant narrative is true and the Fed is managing a "soft landing," then we should acknowledge the magnitude of that achievement. After all, hard macroeconomic landings have caused untold suffering over the centuries. As chronically flawed creatures, our "living and learning" never seems to end, but occasionally, the results of that process are magnificent.

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