MALVERN CAPITAL MANAGEMENT

3rd Quarter 2024 Commentary and Market Outlook

October 2024

3rd Quarter 2024 Review

So much for the so-called September effect where September is usually a negative month for the equity markets. In September, the S&P 500 Index advanced 2.14% and 5.69% for the 3rd quarter. However, the better-performing markets were emerging markets, which powered forward by 8.20% in September and 11.02% for the 3rd quarter, and Real Estate Investment Trusts which climbed by 15.19% in the quarter. The technology-heavy NASDAQ 100 Index posted gains for the quarter of just 2.12% but with a lot of volatility.

We saw a shift toward value stocks away from growth stocks in the 3rd quarter. The Russell 1000 Value Index was up 9.27% versus the Russell 1000 Growth Index which was up 3.19% in the quarter. Growth stocks have been a leader for the past few years leaving value stocks far behind. The growth stock out-performance however, can be isolated to primarily seven stocks, often referred to as the "magnificent seven."

Another significant change in the 3rd quarter was realized by a surge in mid-capitalization and small-capitalization stocks. The Russell Mid Cap Index rose by 9.21% and the Russell 2000 Index (an index of small capitalization companies) jumped 9.27% for the quarter. These stocks have been laggards in recent years. Small-cap stocks in particular can be interest rate sensitive and the anticipation of falling interest rates may have led to their out-performance.

Not only did small-cap stocks benefit from a more accommodative Federal Reserve policy and falling interest rates, but the bond market also posted terrific gains in the 3rd quarter. The Bloomberg Barclays U.S. Aggregate Bond Index (an index of high-quality investment grade bonds) propelled ahead by 5.20% in the quarter. Lower quality junk bonds also did well with the Bloomberg Barclays U.S. Corporate High Yield Index rising by 5.28% in the quarter.

Indices Performance

Category	Representative Index	3rd Qtr 2024	Year-to Date	12 Months	3 yr*	5 Yr*	10 Yr*
Mature US Large Companies	DJ Industrial Average	8.72	13.93	28.85	9.97	11.78	12.03
Broad US Large Companies	S&P 500 Index	5.89	22.08	36.35	11.91	15.98	13.38
US Small Cap Companies	Russell 2000 Index	9.27	11.17	26.76	1.84	9.39	8.78
US Mid Cap Companies	Russell Mid Cap Index	9.21	14.63	29.33	5.75	11.30	10.19
Largest 100 NASDAQ Companies	NASDAQ 100 Index	2.12	19.97	37.48	11.88	21.97	18.53
Large Cap "Value" Stocks	Russell 1000 Value Index	9.43	16.68	27.76	9.03	10.69	9.23
Large Cap "Growth" Stocks	Russell 1000 Growth Index	3.19	24.55	42.19	12.02	19.74	16.52
Large Cap Stocks	Russell 1000 Index	6.08	21.18	35.68	10.83	15.64	13.10
Developed International	MSCI EAFE Index	7.26	12.99	24.77	5.48	8.20	5.71
Emerging Markets	FTSE All Emerging Markets	11.02	20.17	28.06	2.25	6.75	4.64
Broad US Bonds	Bloomberg Barclays US Aggregate Bond	5.20	4.45	11.57	-1.39	0.33	1.84
High Yield Bonds	Bloomberg Barclays US Corporate High Yld	5.28	8.00	15.74	3.10	4.72	5.04
Commodities	Bloomberg Commodity	0.68	5.86	0.96	3.66	7.79	0.03
Total US Market (all cap stocks)	Russell 3000 Index	6.23	20.63	35.19	10.29	15.26	12.83
Real Estate Investment Trusts	Wilshire US REIT Index	15.19	14.88	33.61	4.60	5.39	7.76
Cash	US T-Bill 90 Day	1.46	4.20	5.66	3.47	2.31	1.61

** 3 year, 5 year and 10 year returns are annualized. All periods ending September 30, 2024.*
All returns include the reinvestment of dividends.

Source: Morningstar Direct.

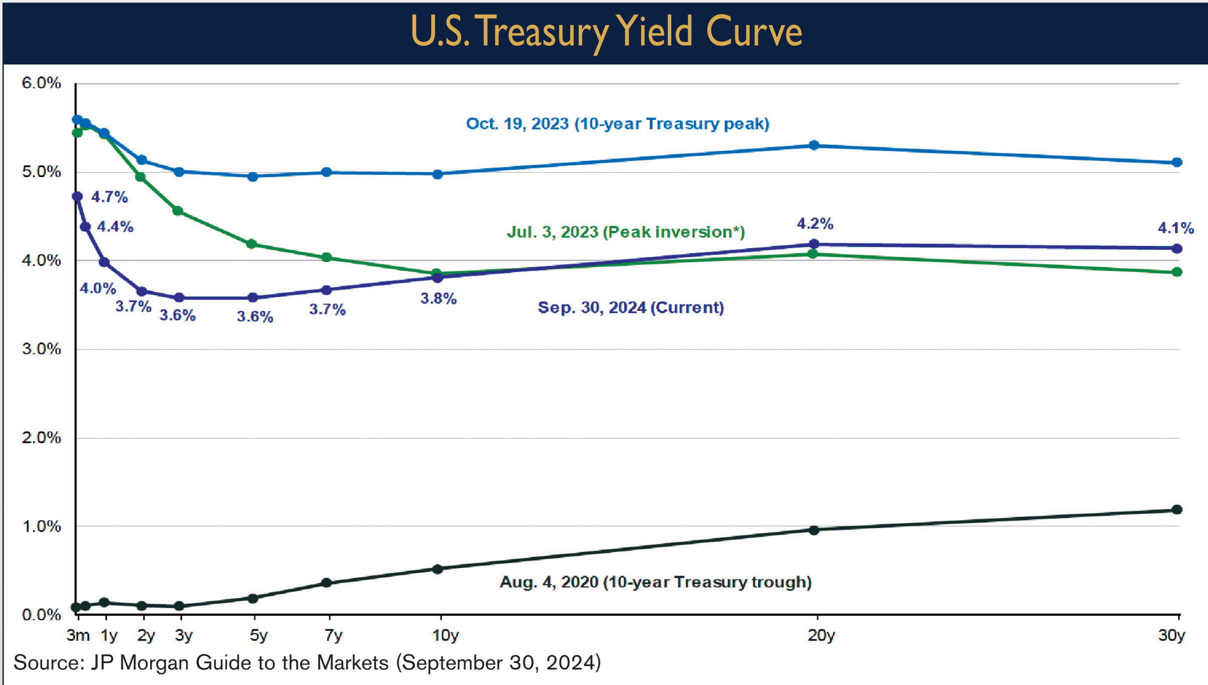
An observation for the quarter is that smaller was better and the more interest rate sensitive an investment is, the better it did. As we enter the final quarter of 2024 and the Federal Reserve embarks on a less restrictive interest rate policy, we will see if these interest-rate-sensitive investments continue to do well.

The Federal Reserve is Just Getting Started

At the September 2024 Federal Open Market Committee (FOMC) meeting, a cut of 0.50% in the Fed Funds rate was implemented. A cut of 0.50% was expected by only a few market observers while most investors and economists expected a cut of just 0.25%. The FOMC is expected to continue cutting interest rates as forecasted by the Fed Funds futures market. There are two more FOMC meetings in 2024, November and December, and it is widely anticipated that the Fed will cut by another 0.25% in each of these two meetings with some forecasts projecting another cut of 0.50% in November followed by a 0.25% cut in December. As we move into 2025, the Fed is expected to continue cutting the Fed Funds rate. How far will it go? The Fed will remain data-dependent and inflation and employment readings will drive its decision making.

Although the inflation rate remains above the Fed's 2% target rate, Fed Chair Jerome Powell said, "the upside risks to inflation have come down and the downside risks to employment have increased." There is some concern with the magnitude of the first rate cut in that it signaled to some that the Fed sees some weakening in the economy which is the reason for it to make such a significant cut. Market reactions after the rate cut were quite positive as the S&P 500 Index jumped 1.7% the day following the rate cut. Short-term treasury bill yields dropped a modest 0.12% and continued to fall in the days following the rate cut decision. Likewise, longer-term market-oriented rates as reflected by the 10-year U.S. Treasury Note yield rose the day of and days following the rate cut decision. We do not expect much upward movement in the 10-year U.S. Treasury Note yield but we do think we'll see further downward pressure on short-term treasury bill yields. We still have to keep in mind that longer-term U.S. Treasury Note yields are lower than short-term treasury yields giving us an "inverted yield curve."

As we continue to proceed through the next several months, the continued rate cutting by the Fed should cause short-term treasury yields to fall more and force money market yields to adjust lower. In addition, the Prime Rate should continue to fall making borrowing costs more attractive over the upcoming next several months.



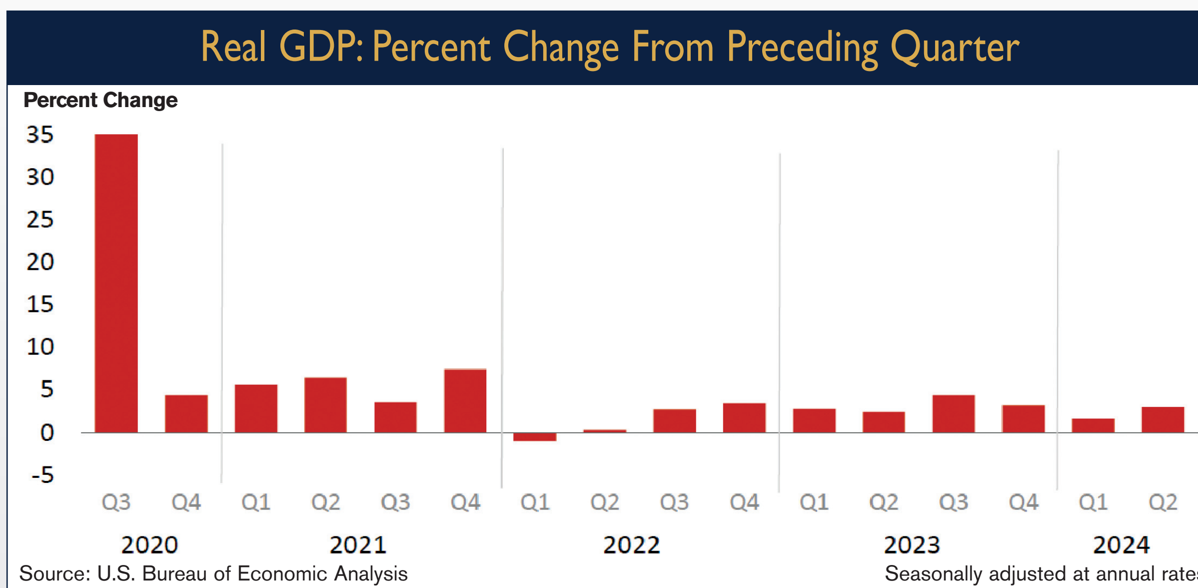
Source: JP Morgan Guide to the Markets (September 30, 2024)

The U.S. Economy

The economy in the United States is displaying a mixed picture. Inflation readings have shown that the rate of price increases has slowed, while prices remain elevated over where they were four years ago. Most likely the only way that we will see deflation is with a recession. Also, what effect will the short dockworker's strike have on inflation as they walked out on September 30th and returned to work on October 4th causing some disruption to the supply chain?

The monthly jobs reports have given a very positive read on the economy. We have shown an average of 203,000 jobs created over the past 12 months. Beyond the past 12 months, job growth has been strong for the past four years. One concerning reading is that the unemployment rate has ticked up by 0.60% over the past few months through August (but it did tick down by 0.1% to 4.1% in September). Also, many economists believe the job growth we have experienced over the past few years is largely due to the return of jobs that were halted during the pandemic and not new jobs created.

Real Gross Domestic Product (GDP) has been quite strong. As the measure of growth in the economy, it is comforting to see its strength. The reading in the 2nd quarter of 2024 was 3.0% (third revision). This is considered a healthy number. It is hard to argue that we are facing a recession with such growth.



Other readings portray the economy in a not-so-positive light. The Conference Board publishes a monthly consumer confidence reading. Consumer confidence fell in September to 98.7 from 105.6 in August. The consumer confidence report represents the current business environment and the outlook for future months. The September report was a disappointing number.

The Conference Board Leading Economic Index (LEI) showed a decline of 0.2% in August and a decline of 0.6% in July. The LEI has fallen 2.3% since February following a decline of 2.7% for the prior six months (August 2023 through February 2024). The LEI is intended to predict changes in the business cycle and show where the economy is heading over the short term.

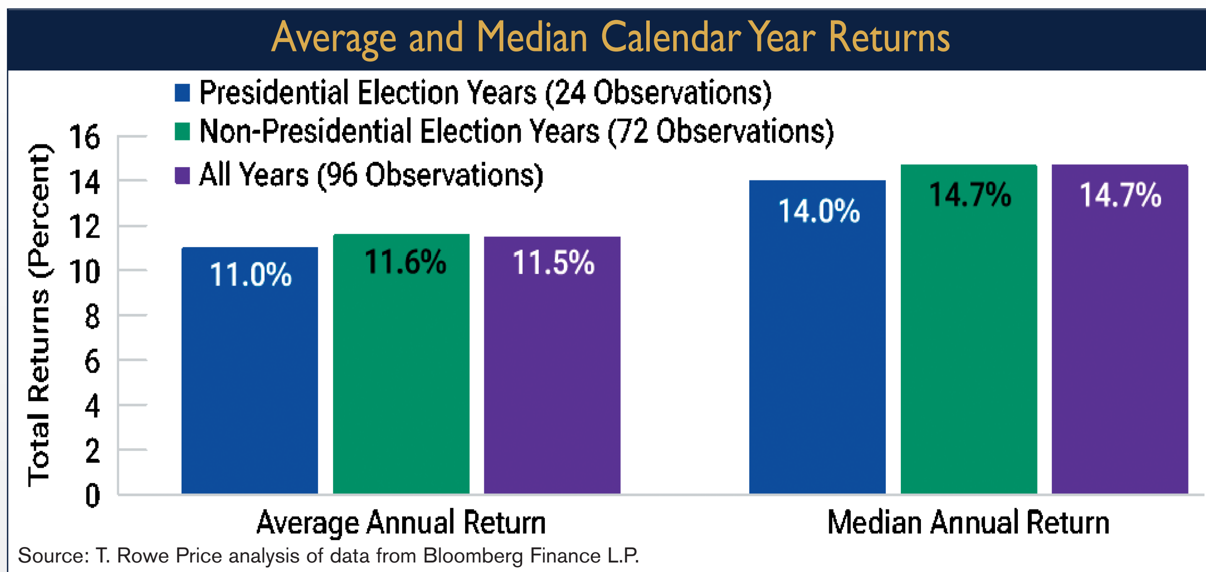
The Institute for Supply Management's (ISM) Manufacturing report showed a reading of 47.2 in August. Any reading under 50.0 is considered recessionary. The ISM Services report had a reading of 51.5 for August which is a positive number.

What is the outlook for a recession? Many economists are forecasting a recession to begin soon with some claiming we are already in a recession. It is our long-standing opinion that we will avoid a recession and we

do not see a recession at least over the next six months. The strong GDP data and healthy jobs reports give us confidence that we can avoid falling into a recession. We do realize the unemployment rate has ticked up by over a 1/2% and this is a concern, but the monthly jobs growth is still very healthy.

Elections Getting Close

As an election year, 2024 should be a positive year if history repeats itself. The 4th year of an election cycle which we are in now is usually good for the markets. In Presidential election years, the S&P 500 Index has an average annual return of 11.0% based on the average of the last 24 presidential election years. Pretty impressive gains but not as good as the non-Presidential election years which average 11.6%. But comparing the presidential election years to non-presidential election years there does not seem to be much significance to the returns' differential, 11.0% versus 11.6%.



Source: T. Rowe Price analysis of data from Bloomberg Finance L.P.

It is difficult to see the direct implication of a presidential election year to a non-presidential election year. Ultimately the market moves higher based on corporate earnings and the outlook for future corporate earnings. Tax, trade, economic, and fiscal policy all impact corporate earnings and are specific to the specific candidate and president. Also, the makeup of the House and Senate has a bearing on the ability of a president to make changes to public policy.

As for this year, both candidates offer quite a difference in policy proposals. Both candidates have policy proposals that will be good for corporate earnings and ultimately benefit the stock market. Each candidate will benefit the markets in different ways. Recent polls show that it is a very close race and it is very difficult to predict a winner. It is also not our place to endorse one candidate over the other. Our role is to manage client's portfolios in whatever political environment that presents itself.

Corporate Earnings

Analysts at the Standard & Poor's Corporation project the Standard & Poor's 500 Index earnings per share of $227.34 for the quarter ending September 30, 2024. The analysts have trimmed their estimates for the third quarter from their projection in June 2024 where they had projected earnings of $229.09. This continues a trend of analysts' downward revision of earnings we have seen all year. Nonetheless, these analysts project earnings on the S&P 500 Index of $265.11 per share 12 months from now or growth of 16.6% over the next year. For Fiscal year 2024, the estimated earnings growth of the S&P 500 Index is 10.7%. However, a lot of this earnings growth may be coming from the so-called magnificent seven stocks

(Apple, Google, Nvidia, Tesla, Meta, Microsoft, and Amazon). The year-over-year earnings growth expectation for the magnificent seven for fiscal year 2024 is 34% versus the S&P 500 ex-magnificent seven of 4%.

An encouraging sign for future earnings is the operating margin of the S&P 500 Index or earnings divided by sales. The estimated operating margin of the S&P 500 Index for the 2nd quarter of 2024 is 11.94%. The average operating margin since the 1st quarter of 1993 is 8.83%. Again, however, the operating margins may be a little distorted given that the operating margin for the magnificent seven as of the 2nd quarter of 2024 is 23.5%. The rest of the S&P 500 Index has an operating margin of 8.5%, a little below the 31-year average operating margin for the total S&P 500 Index.

Nonetheless, earnings will continue to be the driver of stock prices.

Market Valuation

Based on the current estimated earnings per share of $227.34 for the 3rd quarter of 2024, the trailing Price-to-Earnings (P/E) ratio of the Standard & Poor's 500 Index is 25.35 times. The 30-year average trailing P/E ratio is 19.96 times (the average of quarter-ending P/E ratios for the past 30 years). The current forward P/E ratio on the S&P 500 Index is 21.74 times. According to JP Morgan, the 30-year average forward P/E ratio is 16.73 times. These current P/E ratios define an over-valued market.

Other valuation measures also point to an over-valued market. The current Cyclically Adjusted P/E Ratio or CAPE ratio is currently 35.24 times with a 30-year average of 27.94 times. This form of the Price-to-Earnings ratio takes into consideration inflation. The current dividend yield on the S&P 500 Index is 1.35% with a 30-year average of 1.99%. The Price-to-Book value is 4.47 times versus a 30-year average of 3.17 times.

Over-valued markets can continue to get more over-valued especially when taking into consideration the effect of falling interest rates. If we look at other periods when the Federal Reserve began cutting the Fed Funds rate, we mostly see very positive returns 24 months out from when the Fed started cutting rates. From February 1994 to February 1995, the Fed raised interest rates by three full percentage points. In July of 1995, the Fed began cutting interest rates and the market rose. The S&P 500 Index rose 11.32% in the six months following the Fed's beginning of interest rate cuts. Large-cap stocks outperformed small-cap stocks. Value stocks outperformed growth stocks. Health care was the best performing sector rising over 26% in the six months after the Fed's easing. 24 months after the Fed began cutting interest rates, the S&P 500 had a cumulative return of 70%.

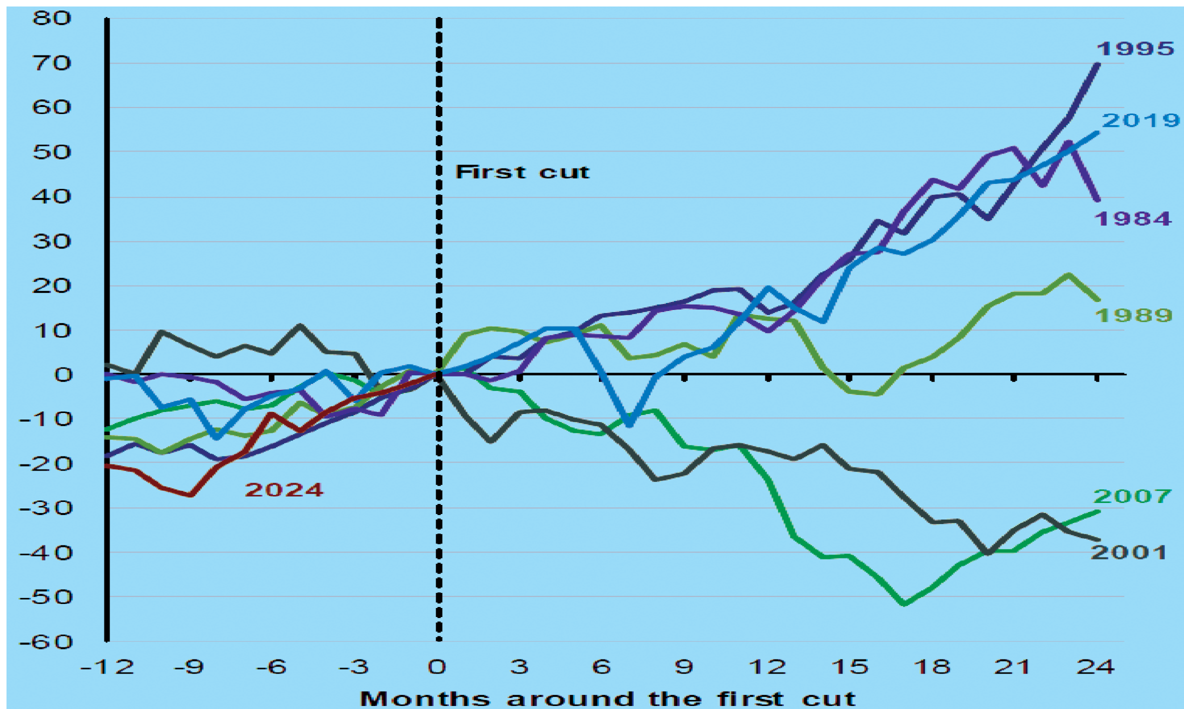
In other easing cycles, we see a similar move in the direction of the market but perhaps not as robust a move as the 1995 interest rate-cutting cycle. In 1984, 1989, and 2019 we saw positive markets 24 months out after the Fed began to cut interest rates.

There were two easing cycles in which stocks fell, in 2001 and 2007. Both of these times there was some exogenous event coinciding with the rate easing cycle's beginning. In 2001 we had the 9/11 attacks and in 2007 we saw the mortgage market meltdown and bank crisis. Although it is hard to predict some event taking place, we believe that the current market most parallels the 1995 easing cycle.

Further, the yield level of the 10-year U.S. Treasury Note may have a bearing on which investment style outperforms. It appears that the lower the 10-year U.S. Treasury Note yield the more growth stocks will be in favor and out-perform. A higher yield tends to favor value stocks. At the beginning of 1995, the 10-year U.S. Treasury Note yield was 7.877%. When the Fed began cutting rates value stocks outperformed growth stocks. On September 30, 2024, the 10-year U.S. Treasury Note yield was 3.802% suggesting that growth stocks may outperform value stocks during this rate-cutting cycle (unless the 10-year Treasury Note yield would rise further).

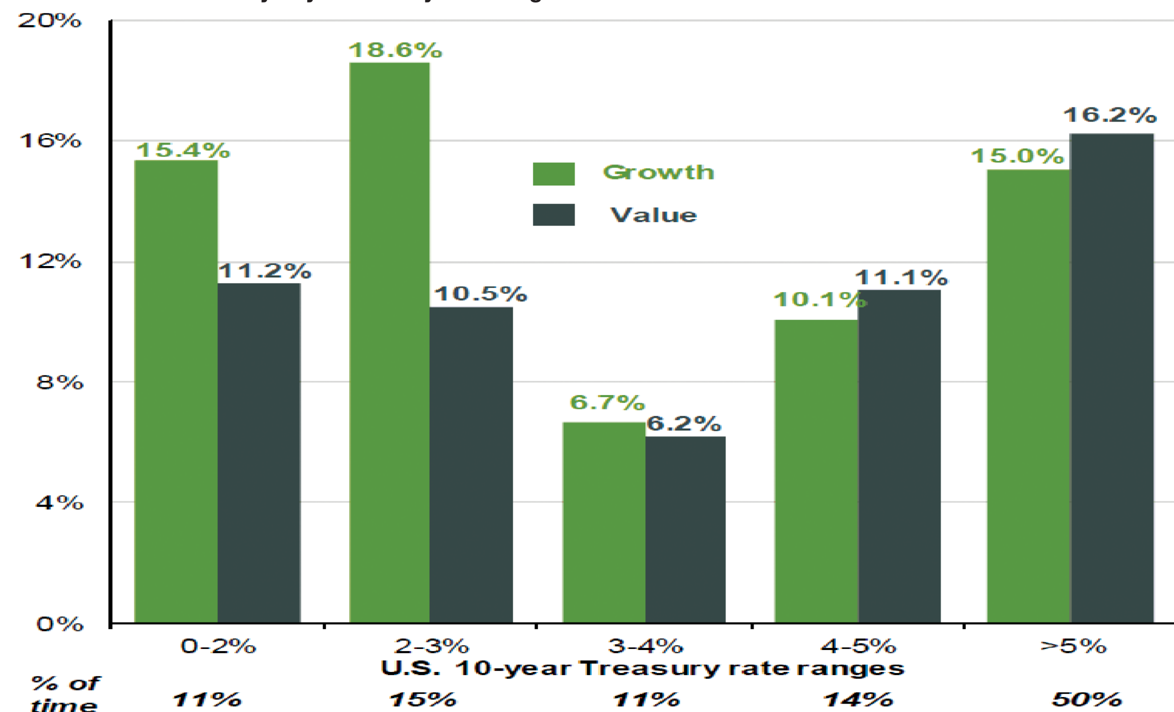
Regardless of which style does better, we believe that stocks will do well during the current rate-cutting cycle.

S&P 500 Returns Around the Start of Fed Cutting Cycles



Source: JP Morgan Guide to the Markets, September 30, 2024.

Value vs. Growth in Different Interest Rate Environments



Source: JP Morgan Guide to the Markets, September 30, 2024.

Finding Value in an Overvalued Market

Although the Standard & Poor's 500 Index companies look expensive with a forward P/E ratio of 21.74, there may be value found within components of the S&P 500 Index or elsewhere around the globe. Within the S&P 500 Index, we have both the "value" style and "growth" style of investments. Growth stocks have a current forward P/E ratio of 28.6 times while value stocks have a forward P/E ratio of 16.7 times. Value stocks are still trading at a higher P/E ratio than the long-term average of 14.1 times (the monthly average since December of 1997) but are much cheaper than growth stocks. Growth stocks' long-term average forward P/E ratio is 21.1 times (since December 1997).

Real Estate Investment Trusts (REITs) are a sector within the S&P 500 Index. REITs tend to do well in falling or a lower interest rate environment. They also offer diversification benefits to an investment portfolio with an average correlation to the S&P 500 Index of 0.6 (average from the 4th quarter of 1980 to the 1st quarter of 2024).

Looking beyond the U.S. we find other markets that appear to be inexpensive relative to the United States. The emerging markets have a current forward P/E ratio of 12.7 times. A specific emerging markets country, China, is also cheaper than the U.S. with a forward P/E ratio of 10.5 times. Within the developed markets, Europe (ex-United Kingdom) is trading at a forward P/E ratio of 14.5 times. Lastly, Japan has a current forward P/E ratio of 14.7 times. It was trading at a P/E ratio of 15.1 times at the beginning of this year.

With interest rates declining, interest rate-sensitive investments such as utility stocks and bonds make a lot of sense as well.

Conclusion

September is often thought of as a negative month for stocks, which is referred to as the "September effect," but not this year. The S&P 500 Index advanced by 2.14% for the month and 5.89% in the 3rd quarter. However, even more, outstanding performance in the quarter was registered by the emerging markets, REITs, mid-cap stocks, and small-cap stocks.

The Federal Reserve began cutting interest rates in September. We believe that this is just the beginning of a cycle of interest rate cutting. The Fed has been pretty transparent with what it plans to do. It is attempting to uphold its dual mandate of maximum employment and stable inflation. The economy is strong, growing by 3% in the 2nd quarter of 2024. Inflation is getting under control. Although the rate of increase has slowed, prices remain elevated from where they were just four years ago.

We are currently in an election year and Americans will select a new president in just a few weeks. Both presidential candidates have diametrically opposed views of where they would like to take this country. Current polling says the race is too close to call and hopefully, the results will be known soon after election day.

Corporate earnings on the S&P 500 Index are solid and projected to grow steadily over the next year. Operating margins on the Index component companies are historically high but the margins may be distorted by the magnificent seven companies. Valuations on the S&P 500 Index are quite elevated historically but the interest rate-cutting cycle we are in may offer a valid reason to expect stocks to go higher. At least such stock strength is supported by the results seen in past interest rate-cutting cycles.

Although the U.S. Stock market as a whole may be over-valued, certain components of the S&P 500 Index may be more reasonable such as value stocks and REITs. Also, some overseas markets seem quite reasonable such as the emerging markets, China within the emerging markets, Europe (ex-United Kingdom), and Japan. All offer reasonable comparable valuations. Lastly, bonds and interest rate-sensitive stocks such as utilities also seem attractive in a falling rate environment.

As such, we are here to listen, counsel, and provide direction to all of our clients.

James L. Olsen, CFA, CFP®
President & Chief Investment Officer

Michael P. Czajka
Chief Executive Officer

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