BRAVE BOAT
Capital Advisors

The Brave Report

Q3 2024

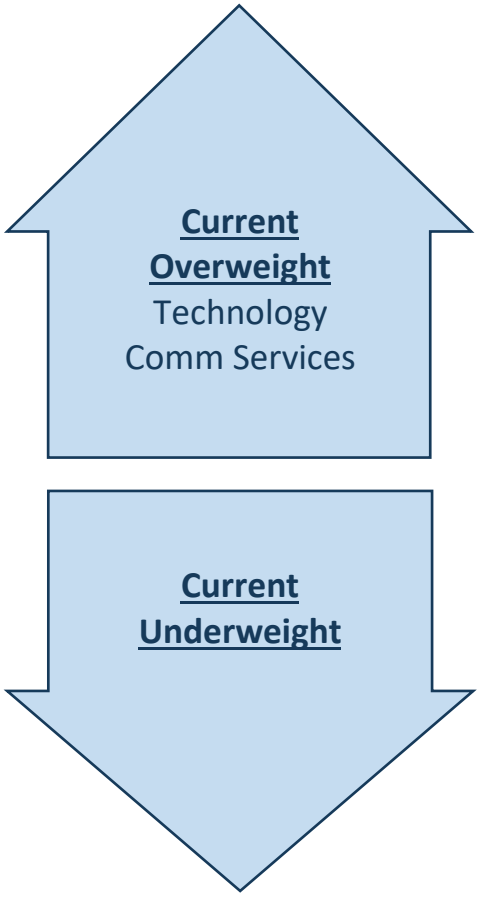
All eyes on the Fed… The Federal Reserve finally ended its cycle of rate increases, cutting rates by half a percent. While a 50-basis point cut isn't going to do a lot to stimulate growth, it sends a signal to investors that the Fed feels it has inflation under control. We now have the debate of what the pace of future cuts will be. The Fed was forced to raise rates rapidly starting in early 2022 and now they must unwind those cuts while still preventing inflation from roaring back.

The chances of avoiding a recession continue to rise but external factors could still force a change in strategy for the Fed as they try to thread the needle of a soft landing.

Market Overview

The markets again powered higher during the third quarter as investors shrugged off concerns of weakened guidance and stretched valuations. The Dow was the big winner during the quarter, surging 8.2%. The S&P 500 and Nasdaq trailed the Dow's returns but still added 5.5% and 2.5% respectively. We did see an uptick in volatility this quarter, which saw all three indices sell-off near the end of July and early August. The Nasdaq was hit the hardest, dropping more than 11% from mid-July to early August. However, markets jumped back quickly, finishing the quarter near all-time highs.

On the rates side, we also saw a jump in volatility as the Fed finally started to cut rates. The yield on the 10-year treasury dropped almost 75 basis points during the quarter to finish the quarter yielding around 3.75%. We saw similar volatility across the entire curve as speculation around the speed at which the Fed will continue to cut rates has been debated. We have seen a tampering of expectations over the past few weeks as fewer rate cuts over the next few months are now the consensus. As has been the case over the past two years, inflation and employment data will continue to drive these decisions.



The Federal Reserve finally changed course at its most recent meeting, cutting rates for the first time since the pandemic. This cut represented an end to the rapid rate increases that started in the Spring of 2022 to help combat inflation. Starting in March of 2022 we saw the Fed raise rates from close to zero to over 5% in a year and a half. While this initial rate cut still keeps rates above 5%, it signals a change in course for the Fed. They now feel like they have some control over inflation and, so far, have done so without a major negative impact on employment. We have seen a slowdown in employment data, but this was an expected outcome to get inflation under control and closer to the long-term targets.

This one cut will not have a major impact on the economy in the short term, but the speed and size of future cuts will be the hotly debated topic

moving forward. One 50 basis point cut in rates does not impact borrowing costs to a point that stimulates borrowing but a series of cuts would have an impact that spills over to many parts of the economy. The big questions are whether the economy has enough strength to withstand a slow and steady cutting cycle, or will more aggressive cuts be needed to prevent the economy from spiraling into recession.

Some external factors will contribute to this path as energy and other commodity prices, driving factors in recent inflation data, have become much more volatile. War in the Middle East along with domestic weather disruptions in the oil markets have put upward pressure on energy prices which in turn have put upward pressure on inflation. Another jump in inflation would prevent the Fed from cutting rates as rapidly as once expected. We have seen a recent short-term spike in treasury rates as upward inflationary pressures have forced many investors to reconsider the speed at which the Fed will act. The Fed's dual mandate of stable prices and full employment may be at odds if inflation remains sticky, and the Fed is forced to be more patient with its cuts. This would, in turn, put negative pressure on risk assets.

If we continue to look at performance over the last quarter, we saw a healthy rotation out of the high-flying technology stocks and into other sectors. As I mentioned last quarter this kind of rotation will be needed for this rally to continue. I do think technology will be the leader moving forward but we need to continue to see broader participation both in contribution to earnings growth and stock market performance. As an example, if you were to remove NVIDIA from the Information Technology sector, earnings growth for the sector would drop from 15.2% to 7.9%. This reliance on one or a few big names paints an inaccurate picture of overall earnings performance.

Upcoming earnings releases will also hold quite a bit of information in terms of the strength of the economy. We saw some interesting trends in the second quarter results as earnings were strong but sales and future guidance remained muted. S&P 500 earnings were up 11% year over year, but sales growth was only 5.2%. We also saw weaker guidance across the board and downward earnings revisions for nine sectors. Third-quarter results should help to provide some additional color into whether this guidance was just companies being conservative or if there are some concerns over future growth.

With equities sitting near all-time highs, we have also seen some concerns of stretched valuations. The forward 12-month PE ratio for the S&P 500 currently sits at 21.4 which is above the 5-year average of 19.5 and the 10-year average of 18. Additionally, the 12-month forward price-to-sales ratio is sitting at its highest level since 2000. Third-quarter results will help to tell us if these valuations are justified or if growth has slowed enough to see some multiple compression.

Lastly, the election is only a few weeks away and with it comes a wide range of speculation about the expected outcome and its impacts. I mentioned last quarter that I do not feel the executive branch has much short-term impact on the economy, especially if Congress remains split. However, with that said, I also understand that markets often move on short-term sentiment and emotion. I think we could see some increased volatility over the next few months as economists and investors weigh the pros and cons of each party's agendas. More importantly, which agenda items are real ambitions, and which are simply campaign rhetoric.

Strategy Commentary

I have trimmed my overall equity exposure slightly as all-time highs gave me a chance to right-size some allocation percentages and mid-quarter volatility triggered some stop-losses. Most of this trimming has been on the margins

but I will continue to remain cautious until we get some confirmation from the Fed or earnings results. My larger adjustments over the last quarter have been mainly on the fixed-income side.

Domestically, I trimmed some of my large growth allocations. This is not a reflection of a change in my outlook but simply some profit-taking due to the runup in the large growth names year to date. I continue to be overweight to technology and communication services and I think the growth potential in these sectors will continue to be strong as AI spend is monetized in the coming years.

Internationally, I continue to be cautious. Geopolitical uncertainty continues to cloud the ability to invest in several regions. We have seen a recent jump in Chinese equities as the government has announced plans to inject capital into the markets. This seems to have created a bottom in the Chinese equities. I am not putting any new capital to work yet but it does make emerging markets, especially in Asia a bit more palatable. I will continue to monitor the situation in China moving forward.

On the fixed income side, I have started to make some adjustments. In the past year, I have been overweight short-duration treasuries as I have been happy with the risk-free yield of over 5%. Over the past two quarters, I have started to buy longer-dated treasuries as these durations will perform well if rates continue to come down. I am still maintaining a large number of short-dated treasuries as dry powder but will look to continue to add to longer-dated bonds if the drop in rates continues.

Please reach out to us directly if you have any additional questions or would like to arrange a free initial consultation to assess your needs and understand more about our services.

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