The strong first half of the year in markets continued in the third quarter, with the benchmark S&P 500 gaining another 5%. This leaves the stock market up nearly 21% through quarter end, the strongest nine month return to start a year since 1997. Most observers would likely be shocked by this performance, given that the rhetoric around the upcoming election, inflation and the economy has been, for the most part, extremely negative. While the stock market rally has continued, the way in which it rallied could not have been more different than for most of the last 18 months. The equity advance in the second quarter was extremely narrow, with most stocks falling or moving sideways while a small number of the largest technology companies associated with artificial intelligence rallied day after day after day. We wrote last quarter that the extreme divergence in the market would resolve in one of two ways: with recent winners falling or with the rest of the market starting to catch up. In the third quarter, we started to see a long awaited expansion in breadth. For example, the financials, industrials, and consumer discretionary sectors rallied 11%, 11%, and 9% in the third quarter, while the technology sector "only" gained 2%. We believe this trading action has been healthy, with many of the technology giants falling from record highs but not collapsing, while many other industries and companies have taken the baton of carrying the market higher.

The driver of the further gains seen in the quarter were solid corporate earnings reports and a fall in interest rates. The 10-year U.S. Treasury yield fell from 4.4% to 3.8% during the third quarter, driven in part by continued declining inflation. The August Labor Department report showed that the Consumer Price Index (CPI) grew 2.5% year-over-year, below estimates and at its lowest level since 2021. The continued disinflation trend seen over the past year has given the Federal Reserve the "green light" to begin cutting interest rates. At the September Federal Reserve meeting, they did just that, starting with a "jumbo" 50 basis point cut (0.5%) to signal to the market that they believe rates are restrictive and they will act fast should the economy deteriorate. From here, the pace in which the Fed cuts rates over the coming year will likely not be influenced primarily by the rate of inflation, but by the unemployment rate.

While inflation has been the primary macroeconomic factor that markets have obsessed over for the past 2 years, that is shifting to the labor market. The monthly non-farm payrolls report has become the new CPI report, one that the market awaits with bated breath. The job market is sending mixed signals at the moment, but weakness has become more and more hard to disguise. On the positive front, layoffs remain very low and unemployment claims data remains very benign. Layoffs remain lower than the average for the entire decade of the 2010s, and we are not seeing big upticks in workers filing for unemployment benefits. However, there are many other signals suggesting that the job market is not as healthy. The hiring rate and quits rate data in the recent August Job Openings and Labor Turnover Summary (JOLTS) report have continued to decline, suggesting that it is a tough time to find a new job. In addition, one of the biggest economic stories of the quarter was the release of the annual revisions to the non-farm payroll numbers that was released in August. This report showed that the U.S. economy had created over 800,000 fewer jobs than originally reported from March 2023 through March 2024. This report confirms the trend that job growth has been on a consistent decline, albeit not yet negative. This combination of low layoffs alongside slowing hiring

and job switching suggests that the job market is in a somewhat static state. While the slowing job market has some investors thinking that the economy is on the brink of recession, the Federal Reserve (and markets) believe that easing interest rates will help reinvigorate the job market and ensure a "soft landing" for the economy.

Despite the yearlong stock market rally that suggests that a soft landing is in the cards, we do expect that the volatility that has picked up in the third quarter will continue into the end of the year. October is often a dramatic month for markets, and even more so in election years. Historically, election year Octobers rank last in monthly stock market performance, as investor jitters often lead to increased selling. Outside of inflation and unemployment, geopolitics remains the top headline risk for markets. Tensions continue to increase in the Middle East, with Iran recently striking Israel with ballistic missiles in retaliation for Israeli strikes in Lebanon that resulted in the deaths of key Hezbollah officials. The Ukraine – Russia conflict continues to muddle on, with seemingly no end in sight. The potential for these conflicts to escalate will keep markets on edge for the foreseeable future, especially without clarity on who will be leading the country come 2025.

On the topic of leadership, the Presidential election continues to look like a coin flip at this juncture, with the occasional swing of momentum in each direction, while it appears Republicans have the advantage to win the Senate and the Democrats have the advantage to win the House of Representatives. Much can change between now and Election Day, and we will see if this year brings an "October Surprise" before November 5th. The ultimate election outcome will certainly produce some individual stock market winners and losers based on policy differences at the margin. However, we have always tried to look through the noise of election seasons and stay focused on the long run outlook for the companies that we are invested in specifically, and the U.S. economy more generally. In our estimation, it remains bright. Economic growth has remained steady, with real GDP up 3% over the last year. Unemployment, despite the aforementioned slowdown, remains consistent with a level near full employment. Inflation has been coming back down to the Fed's 2% target faster than almost every investor, economist, and policy maker expected. Headline credit card debt is at all-time highs, but household debt service as a percent of disposable personal income remains below almost every year of the last quarter of a century and the personal savings rate is above 5%. Most homeowners have significant equity in their homes after years of principal payments and gains. Corporate America continues to innovate faster than anywhere else in the world. The Federal Reserve has started to cut interest rates, and stands ready to aid the economy further should conditions deteriorate. There is no doubt that our country has its share of problems, including persistently high deficits, excess consumer debt and a shortage of affordable housing. Despite these problems and more, the next President will inherit the most dynamic economy in the world, one that we believe is positioned to thrive long into the future.

Please reach out to any of us in the office if you would like to discuss investment strategy or your own financial circumstances. We hope that you have a nice autumn and holiday season, and that we have a chance to talk again soon.