Wealth Management Newsletter

Bangor WEALTH MANAGEMENT

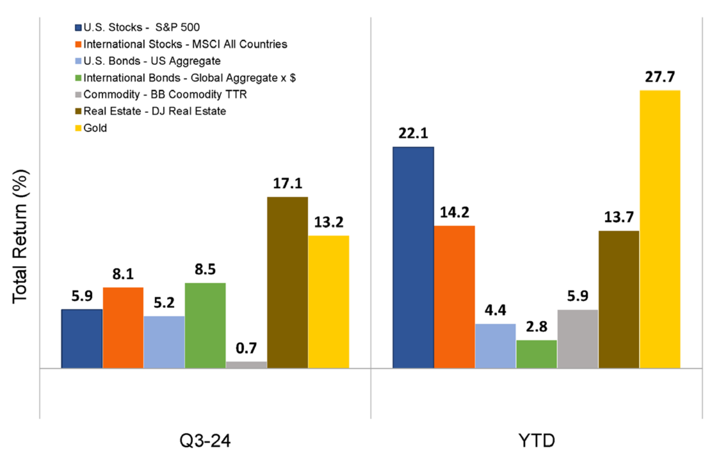
Fall Issue 2024

KEY POINTS

- Equity markets experienced another strong quarter, with a broadening rally driven by a shift away from the Technology sector and the Magnificent Seven stocks, toward interest rate-sensitive sectors such as Utilities, Real Estate, and Financials.
- Fixed income markets delivered strong returns in the third quarter as global central banks eased policy rates. However, the expectations for further rate cuts in the markets appear aggressive given the robust economic backdrop.
- Upcoming elections, geopolitical concerns, and the evolving economic landscape may contribute to near-term market volatility.
- Active investment management remains critical in the current market environment given the ever-growing concentration risk present in large capitalization equities.

2024 Q3 BY THE NUMBERS

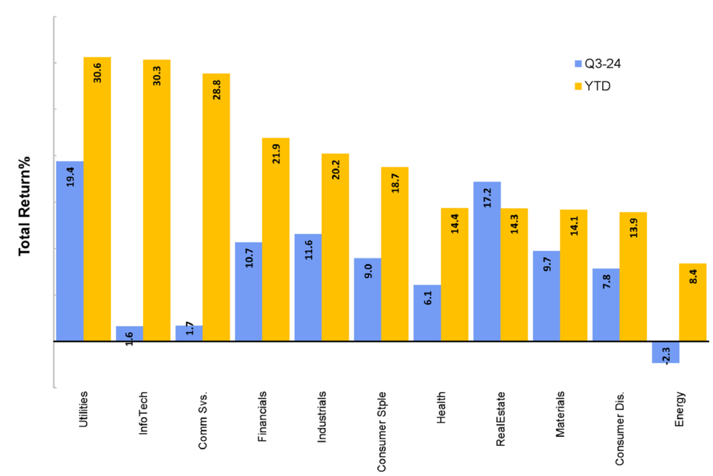
The third quarter of 2024 brought shifts in trends from the first half of the year, as investors moderated their optimism regarding the Magnificent Seven stocks and focused on the implications of anticipated Federal Reserve interest rate cuts. This shift broadened the rally into other areas of the financial markets (see Figure 1).



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

The S&P 500 rose by 5.9% in the third quarter, fueled by strong returns in interest-rate-sensitive sectors such as Utilities, Real Estate, Industrials, and Financials (see Figure 2). Mid- and small-cap stocks rallied 6.9% and 9.3%, respectively, outperforming their large-cap peers during the quarter. Value stocks outperformed growth stocks across the board during this period, although growth stocks continue to lead on a year-to-date basis. International markets experienced some volatility, partly due to a Japanese interest rate hike at the beginning of the quarter. However, these markets stabilized quickly, delivering positive returns of around 8.1% during the quarter. Developed international markets returned 7.3%, while emerging markets posted an 8.7% return, benefiting from a very strong September as China announced measures to stimulate its economy.

Bond markets were buoyed by the prospect of lower rates, with U.S. and international bond indices returning 5.2% and 8.5%, respectively. Commodity performance was much more muted, returning just 0.7% during the quarter. Also driven by the prospect of lower rates, the DJ Real Estate Index rose 17.1% during the quarter after being the worst performer in the first half of the year. Gold continued to rally to new all-time highs, returning 13.2% during the quarter and 27.7% year-to-date. Three quarters into the year, all major stock asset classes remain positive year-to-date, with the initial rise in equities—driven primarily by U.S. large-cap technology stocks—now expanding across all areas of the financial markets.



Data Sources: Bloomberg Financial LP, Bangor Savings Bank

THE ECONOMY

The US economy maintained its modest strength in the third quarter of 2024, alleviating recession fears. To wit, Q2 GDP growth was an impressive 3%, with Q3 tracking in the mid-3% range. Although the unemployment rate reached 4.3% in July which was the highest reading since October 2021, thereby rekindling fears of an economic slowdown, most economists attributed the rise to an increase in labor supply as opposed to layoffs. The rate subsequently declined to 4.1%, while wage growth remained robust. Inflation data continued to moderate, edging closer to the Fed's elusive 2% target, although the pace of disinflation has slowed. Despite the economic strength, the Fed surprised markets by cutting interest rates by 50 basis points in September and signaled that further policy easing may be on the horizon.

FIXED INCOME MARKETS

Bond markets saw strong returns in the third quarter as global central banks embarked on rate-cutting cycles and bond yields declined. The Fed lowered overnight interest rates by 50 basis points in September, signaling that easing would continue—albeit at a more measured pace—as they gained confidence that pricing pressures would ease. U.S. Treasuries returned nearly 5% for the quarter, with riskier credit and high-yield markets outperforming, as credit spreads remained resilient. Shorter-dated bonds led the rally as the yield curve began to dis-invert.

Looking ahead, while bond yields have declined as expected in a rate-cutting cycle, they may have overshot potential future Fed cuts. Markets are currently pricing in another 50 basis points of cuts in 2024, with a terminal rate projected around 3% by the end of 2025. Strength in the labor market and robust consumer activity suggest that the Fed is unlikely to ease too quickly, as doing so could risk a return to elevated inflationary pressures like the experience of the past few years. Credit spreads remain historically tight, offering investors only marginal incremental yields for taking on additional risk.

MARKET VIEW AND PORTFOLIO CHANGES

The U.S. economy has passed its first soft-landing test, as most economic data has proven resilient, and inflation has cooled markedly. This has allowed the Fed to shift its focus to signs of a weakening labor market. Despite several bouts of market volatility late in the summer, risk assets continued to rally, leading to solid third-quarter gains as investors grew increasingly confident that the Fed can cut monetary policy rates back to more normal levels in support of its dual mandate and the economy.

While the first half of the year was characterized by the dominant performance of the Magnificent 7, Q3 showed signs of a more broad-based rally. More specifically, during the quarter, the equal weighted S&P 500 rallied by 9.6% while the market capitalization weighted S&P 500 which is dominated by the Magnificent 7, rallied by 5.9%. We are encouraged by this broadening participation and expect it to continue, as profit growth for the S&P 493 is accelerating, while the Magnificent 7's profit growth has been decelerating. While overall valuations remain stretched on a historical basis, they continue to be supported by strong fundamentals and solid earnings growth expectations.

The upcoming U.S. presidential election and continued global geopolitical tensions may introduce elevated volatility in the quarter ahead. However, we expect election-related volatility to subside once the results are finalized. Additionally, defensively positioning portfolios in the months leading up to elections has historically caused investors to miss strong subsequent equity market returns. According to Goldman Sachs data, the S&P 500 has provided an average return of 14.4% in the month leading up to, and the eleven months following past elections since 1992, while short-dated Treasury Bills have delivered an average return of just 2.1%. While this year's election may have a short-term market impact, our research suggests that economic and inflation trends have a stronger relationship with market performance over time.

The BWM team remains cautiously optimistic about financial markets as we approach year-end, as the elusive soft-landing narrative remains intact. We are carefully monitoring risks as developed economies slow and potential trade and geopolitical conflicts loom. We continue to favor caution and maintain flexibility in portfolio positioning while still participating in the recent strength of financial markets. Diversification is critical in the current environment. For equities, we remain focused on investing in high-quality companies with reasonable valuations, clear earnings visibility, and durable cash flows. We also continue to maintain a domestic bias relative to developed and emerging markets, given the U.S.'s economic resilience, stronger earnings, and greater exposure to near-term technological advancements such as AI. Regarding fixed income, high-quality bond yields are reasonably priced and offer potential for capital appreciation as the Federal Reserve reduces monetary policy rates.

Importantly, bonds have also recently resumed their traditional inverse relationship with equities, providing valuable diversification benefits. The interest burden on U.S. government debt is a growing concern, and neither political party has demonstrated a clear commitment to addressing the deficit problem, which could drive long-term bond yields higher over time. We expect gold to continue to perform well due to rising fiscal deficits, continued central bank buying, geopolitical tensions, Fed interest rate normalization, and a weaker dollar. Cash rates of return are set to decline alongside monetary policy rates.

In closing, history has shown repeatedly that the best defense against an uncertain investing landscape is having—and sticking with—a long-term financial plan. Therefore, please don't hesitate to reach out to our wealth management team to review your investment goals and ensure that your portfolio is properly aligned with your risk tolerance and time horizon.