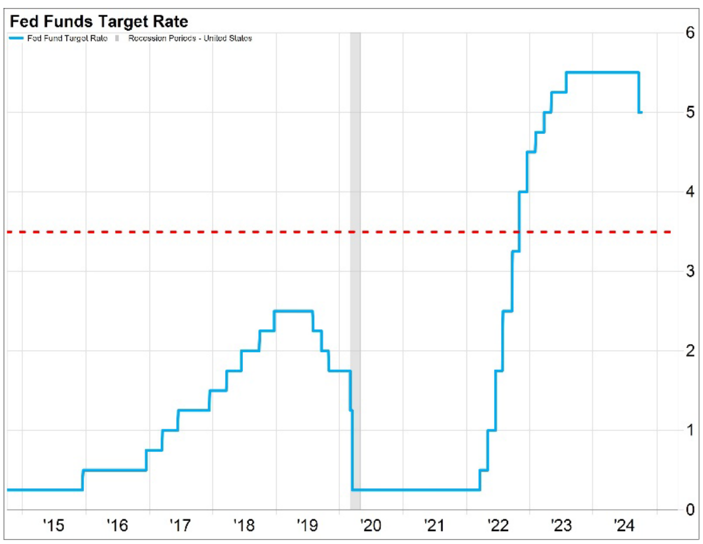
STOKES CAPITAL ADVISORS, LLC

Market Commentary
September 30, 2024

Quarterly Market Review

Risk on! exclaimed investors during Q3 as U.S. equity markets rallied to record highs on accommodative monetary policy, double digit earnings growth and healthy macro-economic trends all pointing toward a soft landing for the U.S. economy.

The Federal Reserve surprised markets with a ½ point or .50% rate cut and gave a very dovish outlook for additional rate cuts as well. Markets are now projecting two more ¼ point or .25% rate reductions which would bring the Federal Funds rate to 4.50% by year end. Longer term, markets are projecting a terminal Fed Fund rate of 3.50%. This is what some refer to as R Star which is the theoretical neutral interest rate that is neither restrictive nor accommodative.



In terms of earnings, U.S. companies delivered better than expected results for the second consecutive quarter. The S&P 500 recorded earnings growth of 11.4% for Q2 driven primarily by the Technology sector. Analysts are projecting a slow-down in earnings for Q3 but Technology and the MAG7 is expected to lead the way.

Quarter	Estimate	Actual
S&P 500 Q1 2024	5.5%	6.1%
S&P 500 Q2 2024	8.8%	11.4%
S&P 500 Q3 2024	7.7%	-

Data Source: FactSet, S&P 500 earnings growth year over year.

Looking at the macro-economic data for the quarter, job gains have slowed, and the inflation data continues to trend toward the Fed's 2.0% target. These data have now turned the Fed's attention from inflation to employment. In their most recent FOMC policy statement, the Fed acknowledged that "the risks to achieving its employment and inflation goals are roughly in balance" and it was time to shift monetary policy. In addition, the U.S. economy continues to expand at above trend growth rates and the consumer data show no signs of deteriorating with retail sales, wages, and household balance sheets improving.

Turning to the bond market, bond prices rallied sharply during the quarter with the Barclays Aggregate Bond Index recording a 5.2% total return, the second-best quarterly result in a decade for the bond market. High yield or "junk" bonds continue to outperform investment grade bonds and spreads between junk and investment grade have narrowed to multi-decade lows; More confirmation that the soft-landing narrative remains intact.

While the inflation concerns are in the rear-view mirror, according to the Federal Reserve, the precious metals markets do not share their confidence. Gold reached an all-time high during the quarter to close at 2,659 $/ozt. Silver is at a multi-decade high, and copper has rallied 15% from the August low. Consumers did get a reprieve from the energy complex during the quarter only to reverse course at quarter end as the conflict in the Middle East continued to escalate. Possible sanctions on Iran, the third largest oil producer, could remove over 3 million barrels/day from the global market. Brent crude oil finished the quarter at $72/barrel but rallied to $78 in early October.

Investment Strategy & Outlook

Markets climb a wall of worry……2024 certainly fits the popular adage. Rising geopolitical uncertainty, recession fears, runaway deficits and debt, polarized political parties, and unprecedented monetary policy actions, but equity markets are at record highs.

"Profits are the mother's milk of stocks, and for that matter business and the entire economy" This was a Larry Kudlow comment from 2011 but is an accurate description of a key driver for the record U.S. equity market rally this year. Additionally, if you believe the Federal Reserve will continue to lower interest rates (the bond market is projecting another 1.00% of cuts) then you essentially have added a turbo charger to the earnings engine.

However, one push back to this bullish narrative would be the valuation argument. No question there are segments of the equity market that are trading at lofty valuations. The MAG7 are certainly suspects. The elite group of stocks is valued at an average forward PE multiple of 31.2 times compared to the 20-year average forward PE multiple of 16 times for the S&P 500. In addition, the MAG7 generates almost no income with an average dividend yield of 0.29%. So, investors who need income will have to eventually monetize these gains, i.e. figure out when to sell…. possibly the hardest investment decision of them all.

Company	Ticker	Fwd PE	YTD %	Yield
Apple, Inc	AAPL	34.9	21.5%	.40%
Microsoft Corp	MSFT	31.5	15.1%	.80%
NVIDIA Corp	NVDA	44.0	145.3%	.03%
Alphabet Inc	GOOGL	21.8	19.0%	.50%
Amazon Inc	AMZN	39.4	22.6%	.00%
Meta Platforms	META	28.0	62.2%	.30%
Tesla Inc	TSLA	112.6	5.3%	.00%
Average		***31.2***	***41.6%***	***.29%***
S&P 500 Index		***20.9***	***22.1%***	***1.30%***

Source: FactSet, YTD total return as of 09.30.2024

Clearly Investors who leaned into the tech trade over the last two years have been rewarded with outsized returns reminiscent of the dotcom boom of the late 1990s. If you recall, the NASDAQ collapsed in early 2000 and did not recover until 2015. Former Fed Chair Alan Greenspan warned investors in 1996 of "Irrational Exuberance" but of course greed never listens to sound advice. Indeed, it was a lost decade for equity investors which suffered from a market bubble and twin negative tail risk events, the 9/11 Terrorists Attacks and the Great Financial Crisis 08-09.

However, one important difference between the two eras is that the current tech boom (Artificial Intelligence) is primarily driven by gigantic companies with solid balance sheets, strong free cash flows and impressive earnings growth while many of the 1999 dotcom names were never truly going concerns.

As the Fed begins to normalize monetary policy, investors should prepare for more than just lower short-term interest rates. Historically, a shift in monetary policy brings with it elevated levels of market volatility and signals an inflection point for investors. Say goodbye to the juicy 5% yields in the cash markets and portfolios holding bonds will see declines in income as well as bonds either get called or mature and reinvestment rates decline.

Investors should not "fight the Fed" but instead consider strategic portfolio realignments. In terms of the equity market, stock pickers or active management should have an advantage given the valuation discussion earlier. Investing in a company that pays little or no dividend, and trades at market premium (30 times earnings) does not seem like a sound investment decision to us. Instead, consider investing in a company that trades at a discount to the market, pays a dividend and increases the dividend every year at a rate greater than inflation.

In addition, lower yields in the bond market will serve as a tailwind for dividend payers as the quest for yield heats up. Dividend growers tend to trade at a discount to non-dividend payers and have provided attractive risk adjusted returns over the long run as well.

Finally, all investors should be asking this question: How should I invest my capital to earn a positive real return? That is a return net of taxes, and net of inflation. The last decade was a wakeup call for investors with bonds and cash finishing the decade with negative real returns. With almost 4 years into this decade, equities remain the only asset class with a positive real return.

Capital Markets Scorecard

Benchmark Description	Q3	YTD
U.S. Treasury 3 Month T-Bill	1.38%	4.06%
Barclays Aggregate Bond Index	5.20%	4.45%
Bloomberg US High Yield Bond	5.28%	8.00%
S&P 500 Index Total Return	5.89%	22.08%
S&P 500 Equal Weight Index Total Return	9.60%	15.16%
NASDAQ Composite Total Return	2.76%	21.84%
S&P U.S. Dividend Growers Total Return	8.97%	17.86%
Russell 2000 Index Total Return	9.27%	11.17%
Alerian MLP Index Total Return	0.72%	18.56%
MSCI Emerging Markets Index	6.77%	18.73%
China SCI 300 Index Local Currency	17.87%	20.3%
U.K. FTSE 100 Index Local Currency	1.83%	9.85%
Japan Nikkei 225 Index Local Currency	-3.50%	15.16%