GENTRUST

Q4 Investment Perspectives

2024

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Executive Summary

Q3 '24 Recap – Global equities (ACWI) are +18.5% YTD[1]. Inflation data continued to moderate as CPI dropped to 2.5% in August, causing rates to drop and fixed income (BND) to be +4.8% YTD. Estimates of GDP for Q2 '24 came in at 3.0%. Employment data began to weaken, with the latest data showing a 4.1% unemployment rate for September.

What's Priced In – Fixed income markets are pricing in an additional 150bps of Federal Reserve cuts before Dec 2025. This represents an unusually large amount of easing priced into markets. The S&P 500 forward P/E ratio is around 21, although much of that can be attributed to the 8 largest technology stocks[2], which have an average P/E of 28. Earnings estimates for the S&P 500 are expected to be 10% higher in 2024 than 2023 and 13% higher in 2025 than 2024.

Rate Cutting Cycles – In the past, almost every time the Federal Reserve cut rates, a recession ensued. Following the recent 50bps cut, the Fed is expected to cut another 150bps in the next 15 months which is the most rate cuts anticipated at the onset of a rate cutting cycle going back to 1995.

Election Analysis – There are sharp contrasts between the economic/tax proposals of the two US presidential candidates, although history tells us that implementation rarely matches the original proposals. The one thing that appears clear is that budget deficits will likely continue to be high. As levels of indebtedness continue to grow, we believe concerns will increase around the long-term sustainability of such policies.

Market Concentration – Global equity markets have become considerably more concentrated. The 10 largest constituents of the All Country World Index (ACWI), which is the equity index we use, have gone from 6.7% of the index to 21.1% over the last 15 years. This increased concentration has historically created increased volatility in markets which is a growing concern.

Positioning – We came into 2024 marginally overweight fixed income and underweight real assets. In Q2 we increased our overweight fixed income and reduced our exposure to equities. We have reduced the number of tactical tilts to keep our portfolios nimble and more focused on responding to the evolution of events.

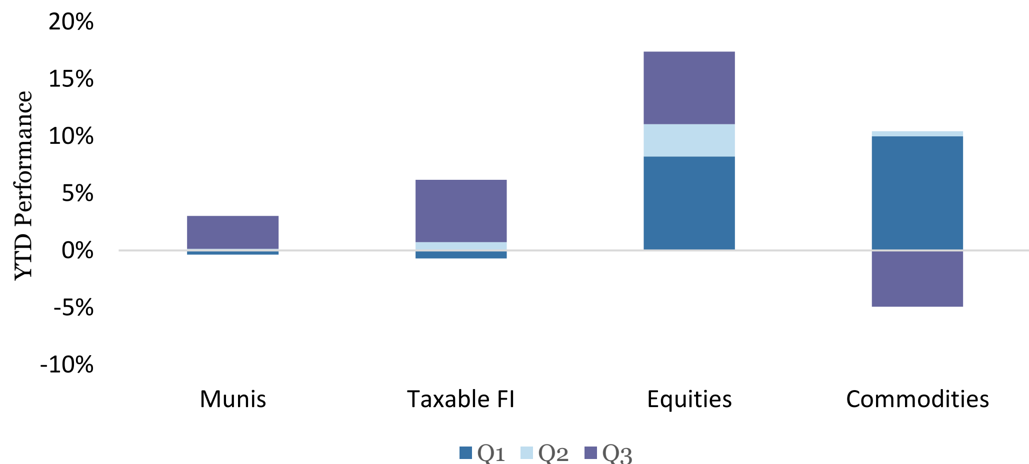
[1]YTD return numbers are from yCharts as of 09/28/2024. ACWI is the iShares MSCI ACWI ETFs and BND is the Vanguard Total Bond Market Index Fund ETF. All forecasts are expressions of opinion and subject to change without notice and are not intended to be a guarantee of future events. Past results do not guarantee future results. Real results may vary.
[2]The 8 largest technology stocks include Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA, and Tesla.

Q3 '24 Recap

Performance

Risk assets continued their march higher in Q3 2024 against a backdrop of moderate but weakening economic data. Global equities (ACWI) were +6.4% on the quarter and US large cap equities (SPY) were +5.3%. The rally has started to broaden with equal weighted S&P500 (RSP) +9.4% during the quarter, while EM equities (VWO) were +10.6%, driven by stimulus measures in China. Fixed income markets have also rallied given the sharp decline in 10-year interest rates from a peak of 4.5% in July down to 3.8% near the end of the quarter. As a result, the US aggregate bond index (BND) was up +5.4% in Q3. Finally, commodities (GSG) were the worst performing major asset class this quarter given the decline in inflation expectations overall, and they returned -4.9%, while certain commodities such as gold (GLD) performed better at +14% during Q3.[3]

Performance YTD



Source: Bloomberg. Performance YTD for the asset classes in the chart above is from 1/1/24 through 09/27/24. The Vanguard Tax-Exempt Bond Index Fund ETF returns is used for Munis, the Vanguard Total Bond Market Index Fund ETF returns is used for Taxable FI, the iShares MSCI ACWI ETF returns is used for equities, the iShares S&P GSCI Commodity-Indexed Trust ETF returns is used for Commodities. Past performance is not indicative of future returns and returns do not account for fees. Real results may vary. The results shown are gross of all fees and expenses and include the reinvestment of all dividends and capital gains.

Macroeconomic Data

Inflation data continued to moderate following some higher-than-expected data points in the first quarter that were largely due to seasonal factors. Headline CPI for the month of August came in at 2.5% vs. 3.4% at the start of the year and core CPI, which excludes more volatile components like food and energy, came in at 3.2% vs. 3.9% at the start of the year. Estimates of Q2 '24 GDP came in at a robust 3.0%, roughly steady with 2.9% in Q1 '24 and 3.2% in Q4 '23. The various Fed trackers currently estimate Q3 GDP around 3%. There was some concern in the middle of the quarter as unemployment rates in the US ticked up to 4.3%, triggering the so-called "Sahm Rule" which is meant to be a predictor of recessions, although the unemployment rate retreated to 4.1% in September.

[3]All market data is from yCharts from 06-30-24 until 09-28-24. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary. ACWI is the iShares MSCI ACWI ETFs, BND is the Vanguard Total Bond Market Index Fund ETF GSG is the iShares S&P GSCI Commodity-Indexed Trust ETF,SPY is the SPDR S&P 500 ETF Trust, RSP is the Invesco S&P 500 equal weight ETF, VWO is the Vanguard Emerging Markets Stock Index Fund ETF, and GLD is the SPDR Gold Shares ETF.

Stepping Back: The Big Picture

In the years following the Great Financial Crisis, we were in an economic paradigm characterized by lower-than-expected growth and inflation, which enabled global central banks to stimulate the economy through low interest rates. Following the COVID-19 pandemic, governments responded with fiscal stimulus as well, which injected large amounts of money directly into the economy and the hands of consumers. As the world began to normalize, consumers flush with cash from government stimulus spent money at record levels, while at the same time supply chains were heavily strained. In addition, the commodities markets were upended following Russia's invasion of Ukraine. These dynamics ultimately led to the highest levels of inflation we have seen in 40 years, and resulted in central banks aggressively raising interest rates to slow demand and reduce pricing pressure.

As the economy has started to weaken, the Fed is trying to preemptively ease financial conditions and engineer a soft landing.

Higher rates flowed through the economy with long and variable lags, and while global growth slowed, it did so in a surprisingly measured fashion while inflation returned close to normal levels. During the current cycle, several forces have buoyed economic growth including large capital investments in AI and stronger than expected consumer spending. Those large investments in AI also masked the slowing real economy with strong equity performance, although that performance was largely concentrated in a small number of companies benefiting from the increased AI spending.

Labor markets that were extremely robust in 2023 started to weaken in 2024, and central banks have responded by lowering interest rates in Europe, Canada, and most recently in the US. Additionally, China has announced large stimulus programs. Normally lower rates with moderate growth and inflation is positive for financial assets, but bond markets are currently pricing in high levels of interest rate cuts. Equity markets are simultaneously pricing in strong earnings growth. Together, these market expectations point to a perfect landing where the Fed moves quickly back to a neutral base rate and equity markets benefit. The question going forward is whether reality will deliver those rosy expectations.

There are several important market dynamics currently underway, which are worth examining in more detail. First, as we head into the first rate cutting cycle in years, there are already 150bps of rate cuts priced into the market between now and the end of 2025. Second, government debt levels and policy maker's willingness to continually run high deficits is becoming a growing concern. Finally, the increasing market concentration in the US and in the technology sector are approaching levels which are unsustainable, which increases risks to client portfolios. We will explore each of these dynamics in the following sections of this outlook.

What's Priced Into Markets?

Fixed income markets shifted meaningfully in the 3rd quarter following some weaker than expected macroeconomic data. This culminated with the Fed cutting interest rates by 50bps at their latest meeting in September, which were the first rate cuts since 2020. As of writing this letter, markets are currently pricing in 2 more rate cuts (50bps) in 2024 following the 50bps cut that was just delivered, and an additional 100bps of cuts through the end of 2025. If these cuts are delivered, it would bring the Fed Funds rate down to 3.50%.

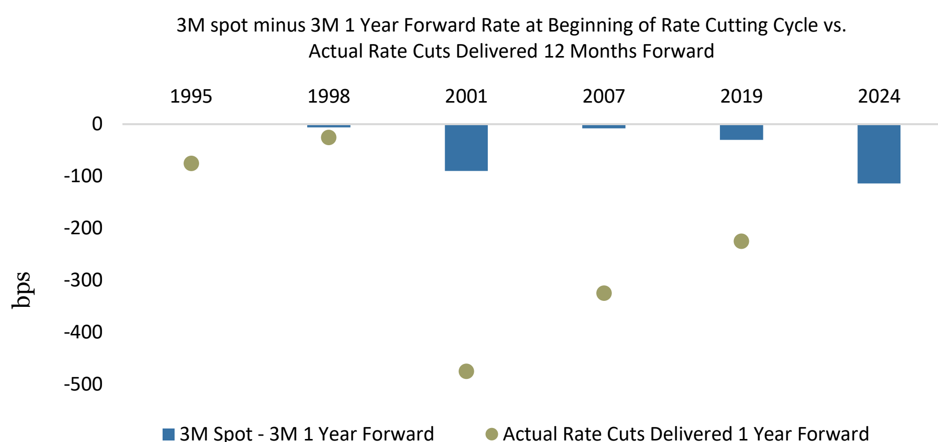
We believe successful investing requires comparing one's views to what is already priced into markets. Currently, lower interest rates and strong earnings growth levels are already reflected in market pricing.

Currently, there is an unusually high number of rate cuts already priced into the market. The current easing cycle has been better telegraphed than prior cycles, as the Fed looks to calibrate the front-end rate to the current economic conditions.

To illustrate this, we can look at what a 3-month Treasury bill currently yields and compare it to where the market thinks a 3-month Treasury bill will yield 1 year from now. On September 18th, 2024, the day the Fed cut rates, a 3-month T-bill yielded 4.76%. One year from now, the market expects a 3-month T-Bill to yield just 3.62%, for a difference of -114bps. Looking back at the 6 most recent Fed cutting cycles, this is the biggest difference between current and 1 year forward expected 3M T-bill rates we have observed.

That said, in cases where a recession followed (2001, 2007, 2019), more rate cuts were delivered than what was priced in at the time.

More aggressive rate cuts are priced in compared with history



Source: Bloomberg, GenTrust calculations. 3 Month Treasury Yield minus 3-month treasury 1 year forward rate. Actual rate cuts delivered are starting Fed Funds minus actual Fed Funds 12 months later.

Equities

The day after the Fed delivered its first rate cut this cycle the S&P 500 closed at an all time high of 5713. Currently, the S&P 500 forward P/E ratio is around 21, which is elevated relative to recent history. Much of the elevated valuation of equities at the index level can be attributed to the largest constituents of the index, which are currently at a P/E of 28. This might be understandable given that these companies have been the driving force behind earnings growth over the past couple of years. In 2023, the Magnificent 7 (Apple, Microsoft, Alphabet, Amazon, Nvidia, Meta, and Tesla) grew their earnings by 35% compared with -4% for the remaining 493. However, this level of growth outperformance is also priced to continue. Earnings estimates from Bloomberg for the S&P500 are expected to be 10% higher in 2024 than 2023 and 13% higher in 2025 than 2024. NVDA/AMZN/MSFT/GOOG are expected to grow EBITDA 115%/21%/18%/13% from 2024 to 2025, which are remarkable levels of growth for two trillion-dollar companies.

Asset Class	Forward P/E[4]
US Mega Cap	28.8
US Large Cap	21.3
US Small/Mid Cap	15.8
Canada	14.6
Japan	13.6
Europe	13.6
EM	11.7
China	8.8

On the other hand, small and mid-cap stocks are trading near their historical average of 15-16. International equities are also valued much more modestly than US equities and in many cases are at or below historical averages.

[4]Source: LSEG Datastream, Yardeni Research, and Standard and Poor's. The US Mega Cap 8 Forward PE includes: Amazon, Apple, Meta, Microsoft, Netflix, NVIDIA, and Tesla. Both classes of Alphabet are included. Canada, Japan, Europe, EM and China prices are divided by 12-month forward consensus expected operating earnings per share.

Rate Cutting Cycles

To understand what has happened in past rate cutting cycles, we examined 7 cycles going back to 1984. Below is a summary of our findings:

	Rates			Market Movements						Economics			
First Cut	Starting Rate	First Cut	Total Rate Cuts 12M After First Cut	S&P 500 P/E @ First Cut	S&P 500 Drawdown @ First Cut	Max S&P 500 Drawdown over Next 12M	S&P 500 6m After Rate Cut	S&P 500 12m After Rate Cut	Treasuries 12m After Rate Cut	Gross Domestic Product (GDP) @ First Cut	Personal Consumption Expenditure (PCE) @ First Cut	Unemploy-ment @ First Cut	Institute for Supply Management (ISM) Manufacturing @ First Cut
Oct-84	11.75%	-1.75%	-3.75%	10.1	-2.8%	-7.0%	12.9%	17.5%	20.6%	3.9%	3.7%	7.3%	50.0
Jun-89	9.75%	-0.12%	-1.50%	12.7	-1.1%	-10.0%	10.6%	17.8%	8.7%	4.1%	4.4%	5.2%	49.3
Jul-95	6.00%	-0.25%	-0.75%	14.1	0.0%	-4.2%	13.3%	21.4%	2.0%	1.2%	2.1%	5.6%	45.9
Sep-98	5.50%	-0.25%	-0.25%	19.3	-11.3%	-9.7%	23.1%	22.5%	-1.7%	3.8%	1.4%	4.5%	49.3
Jan-01	6.50%	-0.50%	-4.75%	21.6	-11.1%	-27.7%	-7.7%	-12.4%	6.1%	2.4%	1.9%	3.9%	43.9
Sep-07	5.25%	-0.50%	-3.25%	14.4	-1.8%	-22.2%	-14.3%	-22.2%	10.6%	2.5%	2.0%	4.6%	52.2
Jul-19	2.50%	-0.25%	-2.25%	17.0	-1.5%	-33.8%	9.9%	11.1%	11.8%	3.4%	1.7%	3.6%	51.5
Sep-24	5.50%	-0.50%		21.5	-0.6%					3.0%	2.6%	4.2%	47.2
Mean	6.8%	-0.5%	-2.4%	15.6	-4.2%	-16.4%	6.8%	8.0%	8.3%	3.0%	2.5%	5.0%	48.9
Median	6.0%	-0.3%	-2.3%	14.4	-1.8%	-10.0%	10.6%	17.5%	8.7%	3.4%	2.0%	4.6%	49.3
Standard Deviation	2.8%	0.5%	1.5%	3.9	4.5%	10.6%	12.1%	16.5%	6.7%	1.0%	1.0%	1.1%	2.8

Source: Federal Reserve Economic Data and GenTrust Calculations. Real-world data often exhibits non-linear relationships, which may require more complex models. Past performance is no guarantee of future results. Real results may vary. 12M forward calculations include the period 12 months following the first cut date. The S&P 500 drawdown refers to the decline in the value of the index from its peak to its lowest point before a new peak is reached. It's expressed as a percentage and is utilized as a measure of risk, showing how much an investor could potentially lose during a downturn.

All rate cutting cycles since 1995 began with either a 25bps or 50bps cut and the Fed Funds rate was usually around 6% when the cutting began, except for 2019. This is consistent with the current cycle. Twelve months after the first cut, Fed funds were on average 2.4% lower which is approximately what's priced into the current interest rate curve.

On average, when the Fed begins cutting interest rates, the S&P 500 is in a modest drawdown of -4.2% (-1.8% median) vs the current cycle where the market was not in drawdown and in fact set new highs the next day. This is because the Fed typically cuts interest rates in reaction to a weakening economy, which is reflected in declining equity prices. The path forward for equity markets in a rate cutting cycle is generally more volatile given the weakening macroeconomic conditions that usually accompany the rate cuts.

In 3 of the 7 rate cutting cycles, the S&P500 had drawdowns of over 20% in the subsequent 12 months, with a mean drawdown of -16.4% in the following year. However, longer term equity returns look more compelling. The S&P500 return 12 months after a rate cut was only negative 2 out of 7 times, with a median return of +17.5%. Returns on intermediate fixed income were also strong, with positive returns in 6 out of 7 cycles and a median return of 8.7%.

Lastly, when we consider key macroeconomic variables relative to prior cutting cycles, the environment today is not particularly unusual. In the previous 7 cutting cycles, gross domestic product (GDP) was on average 3% (vs current 3%), personal consumption expenditure (PCE) averaged 2.5% (vs current 2.2%), unemployment was 5% (vs current 4.1%) and the Institute for Supply Management (ISM) manufacturing gauge was 48.9 on average (vs current 47.2).

Current economic conditions and rate levels are all fairly consistent with past cutting cycles. If markets follow this history, in our view we are in store for a decent drawdown at some point, although history shows us that returns over the next 12 months are consistent with long run market returns.

US Election Analysis

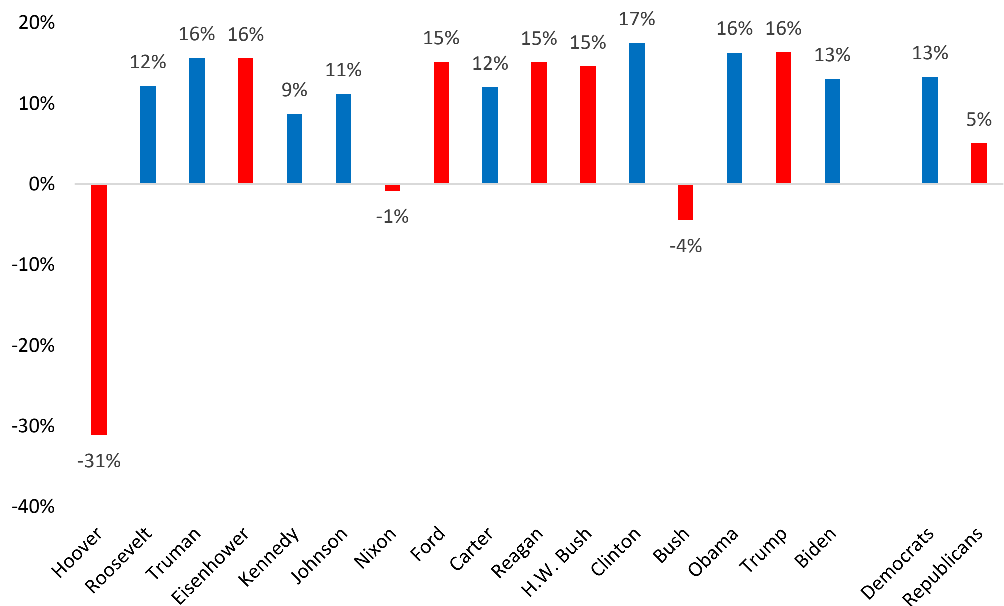
> While understanding the political landscape is a relevant input into the investment process, we find little evidence to suggest that the composition of government has a meaningful long-term impact on markets.

With less than 2 months before the election in the United States, most major polls show the race is too close to call. With this in mind, we think it's important to reiterate two important principles before going into more detail.

- Markets are very efficient so positioning for things that might happen after the news comes out is very unlikely to be a fruitful investment strategy, as markets most likely reflect your sentiment as well. As with all things, we want to focus on situations where our view is different than the consensus.
- Over the long term, we believe politics tend to have less impact on markets than people think, unless they rise to the level of being revolutionary – for example, if we saw an overwhelming majority in all branches of government and strong public backing for sweeping changes.

Looking at almost 100 years of data, Democratic Presidents have presided over greater stock market gains on average than Republicans. However, if we take the median performance across the two parties, which is less influenced by outliers, we find that Republican Presidents outperform Democratic Presidents 14.8% vs. 12.6%. For this reason, we find no clear indication that the political affiliation of any President will influence market returns.

S&P 500 Annualized Returns By President



Source: Bloomberg. For illustrative purpose only. The S&P 500 is an unmanaged weighted index of common stocks. An investment cannot be made directly in an index. The results shown are gross of all fees and expenses and include the reinvestment of all dividends and capital gains. Past performance is no guarantee of future results. Inherent in any investment is the potential for loss.

Fiscal Policy Comparison

With respect to fiscal policy, both candidates have put forward a wide range of ideas, with the key differences being centered on taxes and tariffs. Former President Trump's plan calls for making the individual income tax cuts from the 2017 Tax Cuts and Jobs act permanent, as well as lowering corporate income tax rates from 21% to 15% for companies that make their products in the US.

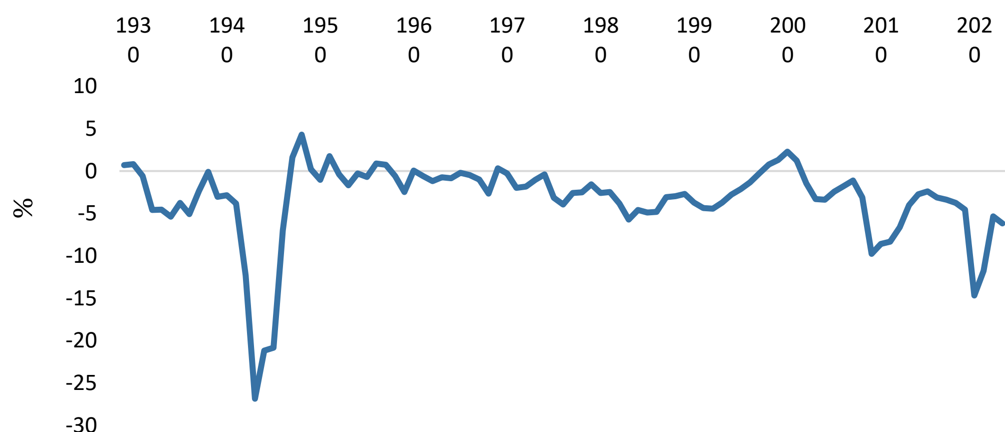
Additionally, former President Trump has proposed a variety of tariffs, most notably a universal baseline tariff of 10-20% and a 60% tariff on all imports from China. On the other hand, Vice President Kamala Harris has proposed raising both corporate tax rates and the top personal tax rate on long term capital gains to 28%. With respect to personal tax rates, she has proposed increasing the net investment income tax to 5% on income over $400k and expanding the child tax credit, earned income tax credit, premium tax credits and housing tax credits. She has also proposed increasing the deduction for startup costs from $5k to $50k. Vice President Harris does not currently have any plan to increase tariffs.

Ultimately, no one knows what changes to the tax code will be implemented 12-24 months from now. If history is any guide, they are not likely to resemble what is being proposed today. To underscore this point, consider both candidate's proposals for changing the corporate tax rate. President Trump also proposed reducing the corporate tax rate to 15% in 2017, which was ultimately never implemented despite having control of Congress at the time. Similarly, President Joe Biden proposed raising the corporate tax rate to 28% in both 2022 and 2023 just as Vice President Harris is proposing today, but was also unable to do so. The reality is, absent a supermajority in the Senate which is highly unlikely—Real Clear Politics (RCP) currently has 47 Republican Senate seats classified as "safe or not up for election" —history has shown us that sweeping changes are unlikely to pass.

Budget Deficit

While each candidate has proposed different mechanisms for generating tax revenues, both proposals are projected to increase the deficit. According to the Penn-Wharton budget model, the Harris campaign tax and spending proposal will increase the deficit by $2T over the next decade, while the Trump campaign proposal will increase the deficit by $4.1T . This comes at a time when the US fiscal outlook is already strained, given that our current deficit is over 6% of GDP.

Federal Surplus or Deficit as Percent of Gross Domestic Product



Source: Federal Reserve Economic Data https://fred.stlouisfed.org.

While the budget deficit problem is not new, if the fiscal outlook continues to deteriorate eventually it will present challenges to investors. The most obvious consequence will be a rise in Treasury yields, most likely in the longer end of the yield curve, as investors will start to question the "risk free" nature of the US Government.

While we think it's extraordinarily unlikely that the US Government would ever default, investors will likely demand a higher yield to compensate for some long-term credit risk.

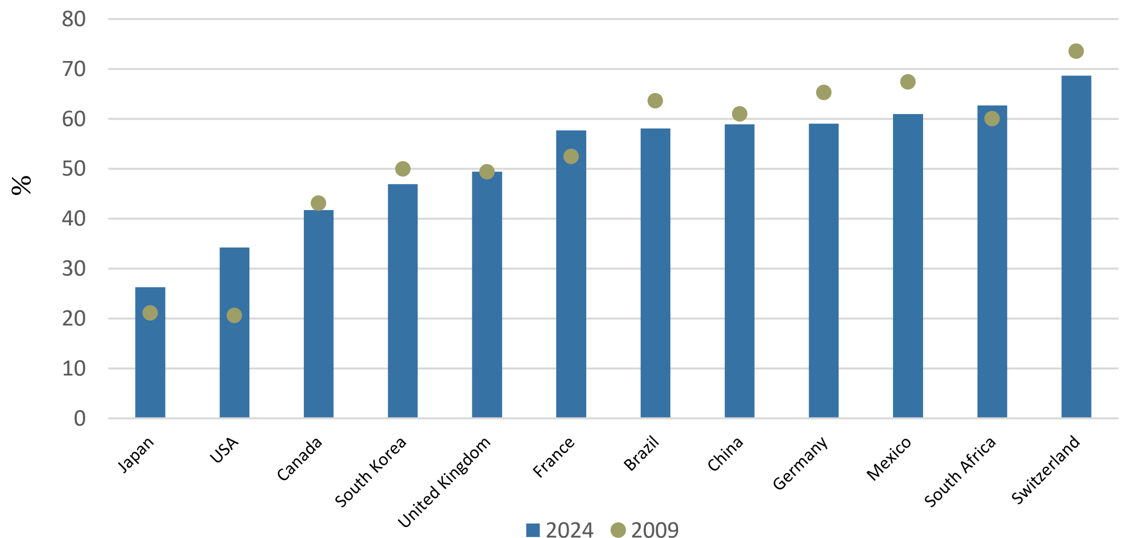
Along the same lines, credit spreads are near their all-time tights, despite a weakening economy. This is likely driven by a confluence of factors including: overall high yield levels, a central bank that is now moving toward easier monetary policy, and the relative preference of high-grade credit over US government debt given the worsening fiscal outlook.

In August of 2023, Fitch downgraded the US to AA+ from AAA, joining S&P which has held a AA+ rating since 2011. Following this downgrade, the United States' composite credit rating—defined as the average rating of Fitch, S&P and Moody's—is now AA+, which is below corporations such as Microsoft and Johnson & Johnson. If the US fiscal situation continues to deteriorate, we could see highly rated corporate bonds such as these continue to trade at incredibly tight levels. Currently, the Bloomberg AAA Corporate Bond Index option adjusted spread is 31bps, just 3bps off the tights going back to 1990.

Market Concentration

Global equity markets have become considerably more concentrated over the last 15 years. In 2009, the 10 largest constituents of the ACWI were just 6.73% of the index. Today, the top 10 names are 21.16%. A lot of attention has been paid to the market concentration in the United States, where the top 10 constituents in the S&P 500 have grown their market share of the index by over 65%, which is the largest increase across 12 major equity markets we examined. However, on a relative basis, the S&P 500 is much less concentrated than other country specific indices, many of which have over 50% of their respective equity index in the top 10 names. That said, the United States' stock market is also considerably larger than other countries, which means that its growing concentration risk has an outsized influence on global equity markets.

Stock Market Concentration (%) of Top 10 Names (2009 – 2024)

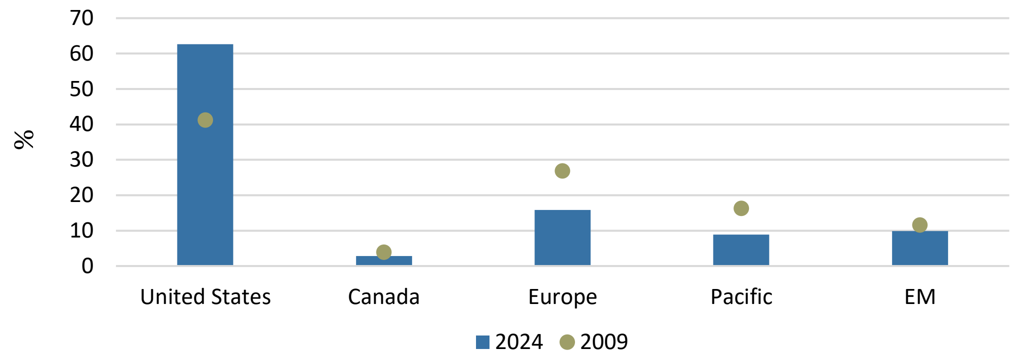


Source: Bloomberg. ACWI Top 10 names as of 10/4/2024: Apple, NVIDIA, Microsoft, Amazon, Meta, Alphabet A, Alphabet C, Broadcom, Taiwan Semiconductor, Eli Lilly & Co.

To illustrate this, consider the compositional change of the MSCI All Country World Index, which is the equity benchmark we track. Over the last 15 years, the United States has grown from 41% of the index to almost 63%.

In our view we are approaching a natural limit to how concentrated the ACWI can become, as the US will either become too rich relative to global peers, or other countries will aggressively seek to regain market share.

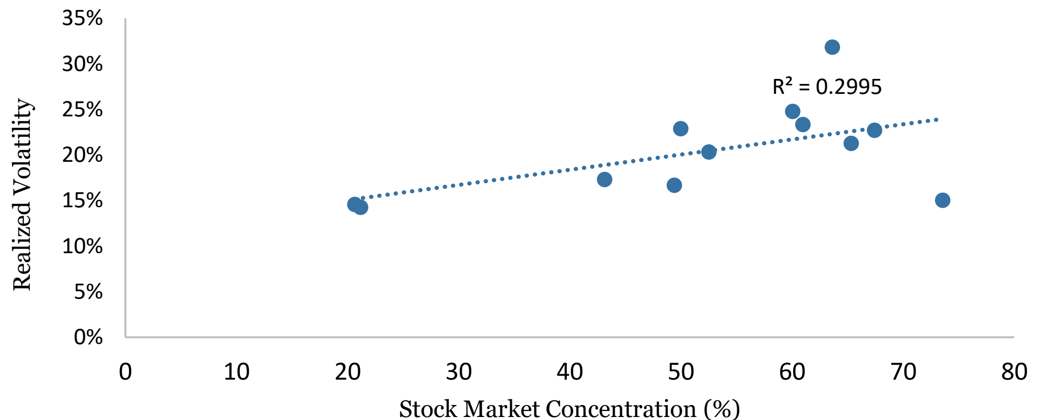
Change in Regional Composition of ACWI (2009 – 2024)



Source: Bloomberg. Regional composition of ACWI ETF as of 07/22/09 and 09/30/2024.

Market concentration creates two issues. First, there is a limit to how big any small set of companies will be allowed to get before a whole set of constraints ranging from anti-trust to more nimble competition start to impinge on growth. It's hard to know where that upper bound is, but it's there and we believe markets have been getting closer to it. Second, a more concentrated market reduces an investor's ability to diversify, likely amplifying risk in the form of increased volatility. As shown in the plot below, there is some correlation between market concentration and volatility.

Starting Market Concentration (%) vs. Realized Volatility



Source: Bloomberg and GenTrust Calculations. R^2 refers to the coefficient of determination for the simple linear regression model with realized volatility from 2009-2024 as the dependent variable and stock market concentration in 2009 as independent variable.

Positioning

We came into 2024 marginally overweight fixed income and underweight real assets, with positioning much closer to neutral than usual. We shifted to a more cautious stance in Q2 by increasing our overweight to fixed income and reducing our exposure to equities. Rates rallied significantly in Q3 although consistent with what a recession usually brings, which makes us less bullish on fixed income. We are still cautious on equities, especially given the increased concentration risks in major indices. We have reduced the number of tactical tilts we are taking to keep our portfolios more nimble and focused on responding to the evolution of events.

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