

Quarter-In-Review – There was a lot for investors to like in the third quarter as almost every asset class we follow made money, with about the only exception being oil and oil related equities. And for once the big market cap companies didn't dominate everything else. The Magnificent Seven stocks performed fine (+5.7% for the quarter), but many other equity asset classes outperformed. As you can see from the table to the right, small-cap stocks jumped +9.3% for the quarter, and even the beleaguered international sectors beat domestic stocks. It was a good quarter for diversified equity portfolios.

The key driver for the markets lately has really been interest rates. The Federal Reserve cut their closely watched policy benchmark on September 18th by half a point, and both short-term and long-term rates declined meaningfully. This obviously helped bond investors, with intermediate-term Treasury bonds gaining +5.7% over the trailing three months while short-term Treasuries added +2.9% over the same period. But lower rates also feed through into the pricing for other asset classes, hence the sea of positive returns we saw for the quarter.

But uncertainty never ends, and as the fourth quarter starts there's a lot to ponder. The election in November could have implications for the capital markets, and turmoil in the Middle East is unnerving the oil market. And just as fundamental is the question about the economy and the Fed. Are they cutting rates because we are on the cusp of a recession, or have they made a policy mistake by easing rates? Or could we see the fabled soft landing that combines easing inflationary pressures and modestly lower rates with persistent growth? Let's start with the issue on most people's minds – the election.

Gauging What Won't Change

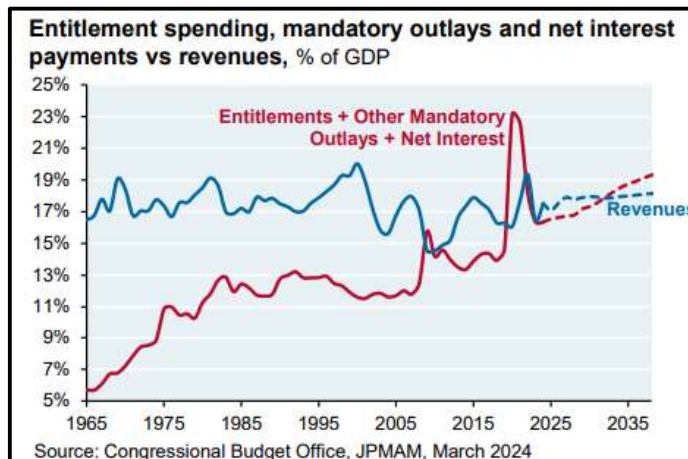
– We readily acknowledge that the last thing the world needs is another opinion about the upcoming election. But we'd be remiss if we didn't at least offer our thoughts on how the election could impact the markets in the coming months. We've said for some time now that the most likely outcome of November's election is gridlock, and we

Market Benchmarks			
Market Indices	3Q24	YTD	3-Yr An
Global Equities	+6.6%	+17.8%	+7.8%
S&P 500 Index	+5.9%	+22.0%	+11.7%
Russell 2000	+9.3%	+11.0%	+1.7%
Int'l Index (EAFE)	+6.8%	+13.0%	+5.6%
Emerging Mkts	+9.3%	+17.2%	+1.5%
Other Indicators	9/30/24	6/30/24	12/31/23
Fed Funds Rate	4.75%-5.0%	5.25%-5.5%	5.25%-5.5%
2-Year Treasury	3.64%	4.73%	4.25%
10-Year Treasury	3.79%	4.35%	3.88%
S&P 500 P/E Ratio*	21.5	21.0	19.5
Crude Oil	\$68.30	\$81.35	\$71.31
Core Inflation	2.6%	2.6%	3.2%

*Forward 12-month operating earnings per S&P

continue to be of this opinion. Current polling seems to indicate that whichever party wins the White House will not control both the House and Senate. It's certainly possible that we see a sweep, but at best this would enable the winner to pass a single headline-grabbing piece of legislation before the whole process bogs down in gridlock ahead of the mid-terms. While emotions are high going into November, an investor needs to assess what will change post inauguration day that impacts the investment backdrop. We suspect that when the dust settles four major political and economic trends will persist:

- 1) First, neither party is likely to have a popular mandate to do much beyond tinker around the edges of economic policy. Reagan won his second term with an +18.2% margin in the popular vote (58.8% to 40.6%), but ever since margins have thinned out. Obama carried reelection with just a +3.9% margin, while Biden managed +4.5%. Both Harris and Trump will



struggle to do much better which will make it tough to pass groundbreaking legislation. Certainly, executive actions play a bigger role today than they did twenty or thirty years ago, but even so, a President has limited tools to move the supertanker that is the U.S. economy.

- 2) A key driver of growth and inflation since 2020 has been the trend towards much larger fiscal expenditures.

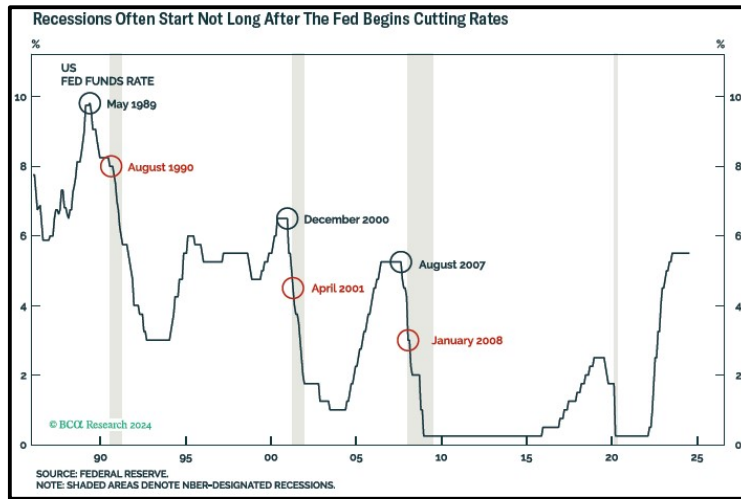
Little is likely to change in this regard. After the global financial crisis, there was a general push towards fiscal austerity around the world, and the U.S. was no exception. But today there's little popular support for fiscal retrenchment, and both the Harris and Trump economic plans want to spend more money than we do today.

Granted, the mix of spending and taxes will differ under each contender, but at the end of the day, neither wants to trim the size of the annual deficit.

- 3) A related, but more specific point, is that neither party will touch entitlement spending. Both parties agree that tinkering with Social Security or Medicare is the proverbial third rail. But to truly put spending on a more sustainable trajectory, mandatory expenditures have to be part of the discussion. The chart on page one shows that the combination of mandatory spending and interest on the debt is projected to exceed total revenues by roughly 2030. Certainly, the trajectory of revenues could change in the years to come, but again, there's little popular support for a higher tax burden economy-wide. The debate today only centers on who should pay more to fund someone else's tax cut.
- 4) Finally, both parties are likely to take an even more hawkish stance towards China. Trade protections became popular during Trump's first term, and Biden has largely continued his predecessor's policies. A Harris or second Trump administration is likely to continue, if not increase, the pressure on Chinese imports to 'bring the jobs home.'

This isn't to say policy choices won't differ under a Democratic or Republican administration in 2025, only that from a market perspective, the surprise could be how little really changes. The key trends of the post-COVID world are likely to persist:

- Fiscal spending remains the key driver at the margin for both growth and inflation. A Trump administration will probably spend more than a Harris administration, but red ink will persist.
- Fiscal spending, not monetary policy, will be the



efficiency and cost.

Sticking the (Economic) Landing – If you are sympathetic to the idea that the election ultimately won't have a big impact on the economy or the markets, you are left with the question of what sort of economy are we dealing with today. The bearish argument is relatively straightforward. History teaches us that every time the Fed has hiked rates aggressively, they ultimately tighten too much, and the economy falls into recession. Typically, the leading indicator of a pending recession is the labor market. Hence all the focus on the so-called Sahm rule, named after the former Fed economist Claudia Sahm. This rule stipulates that a recession is headed our way when the three-month average of the unemployment rate rises by 0.5% or more relative to the lowest level over the last twelve months. We broke through this level in August.

This is really what captured the Fed's attention last month and was the rationale they used to cut rates. Chairman Powell's comments over the last two to three months have gone from the typical two-sided view whereby controlling inflation and maintaining full employment are equally important goals, to one where maintaining full employment is job number one. The half-point cut last month was geared to be a surprise and send a signal that the Fed was taking its full employment mandate seriously. Furthermore, they outlined a path of significant rate cuts in 2025 to reinforce this view.



But what if the economy isn't as weak as many fear? The payrolls report on October 4th was surprisingly strong, and a report on services activity a few days before that was also robust. The most current estimate for third-quarter growth is running at roughly +2.5%, and the latest data indicates that the fourth quarter started with a decent head of steam. And we shouldn't forget that there's a feedback loop from

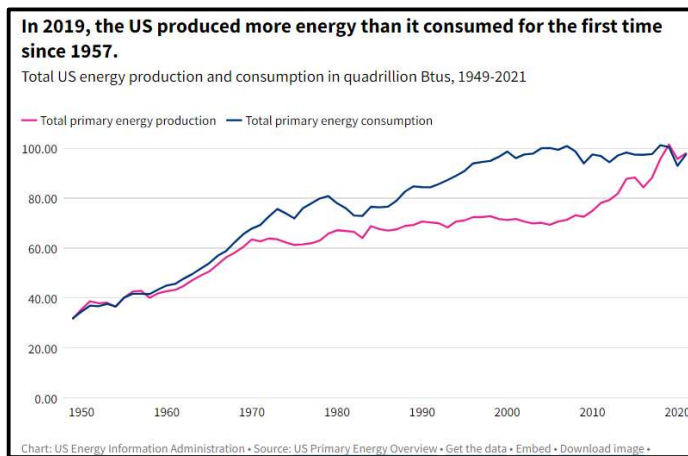
monetary easing into asset prices and the real economy. Just as tighter policy is designed to restrain growth, easing monetary policy can boost growth simply because stocks and bonds become more valuable. And as you can see from the chart at the bottom of the previous page, policy isn't just easing in the U.S. We are seeing rate cuts and stimulus measures around the world. Both the European Central Bank and the Bank of England have cut rates recently and signaled more to come. Furthermore, China is taking relatively dramatic steps to support their market through targeted lending schemes and monetary easing. On an individual country level it might not move the needle much, but a coordinated global easing cycle can make a big difference.

What's the most likely outcome? Of course, the answer is that no one really knows - the best we can do is talk about probabilities. In our mind the recession risks seem overdone at this point. Certainly, the labor market has softened from a few months ago, and hiring in the tech sector is downright weak. But overall, the recent increase in the unemployment rate appears more tied to an increase in immigration than mass layoffs. In general consumer spending continues to percolate and the financial condition of the corporate sector is robust. Furthermore, as we noted earlier, we do not appear to be on the cusp of a major fiscal retrenchment.

Not all Fed tightenings have resulted in a recession. Looking back at the chart at the top of page two, there are a couple examples in the 1990's of the economy avoiding a recession after a period of monetary restraint. We shouldn't discount a repeat of this scenario in the months to come. The fabled soft landing!!

What About an Oil Shock? – All the feel-good talk about the mid-1990s is all well and good, but watching the news headlines lately brings back memories of 1973 and the oil embargo. At the beginning of 2024 when the pundits were speculating about an 'October surprise', the discussion was largely centered around the domestic political scene. But it turns out the surprise is originating overseas.

As we write it appears that the odds of a direct conflict between Israel and Iran are increasing. While we have no great insights on the likely path of the

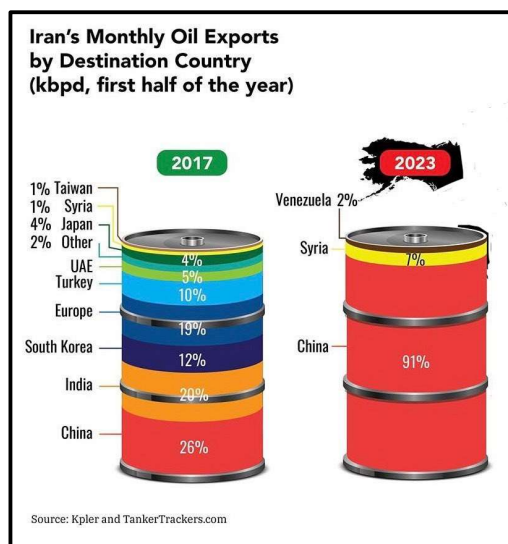


much of our energy needs. As you can see from the chart above, in the 1970s we consumed far more energy than we produced domestically. But this changed in 2019, and today we produce more than we consume. Now this statistic is a bit misleading because we do import certain grades of oil that refiners cannot find domestically. But our reliance on imports from the Middle East has fallen from 45% of imports in 2007 to 11% in 2021, and roughly three-quarters of our imports from the Middle East comes from Saudi Arabia.

It's also worth noting that almost all of Iran's production goes directly to China due to global trade sanctions (chart below). Clearly, Middle-Eastern tensions can lead to oil price volatility over the short term, but this isn't the 1970s where we are looking at an actual disruption of supply in the U.S. and the infamous gas lines. Oil is currently bouncing around \$76 a barrel as we write, still below the roughly \$80 average we've seen over the last three years. Prices could certainly spike if hostilities pick up, but the odds of a second oil shock seem reasonably low at this point.

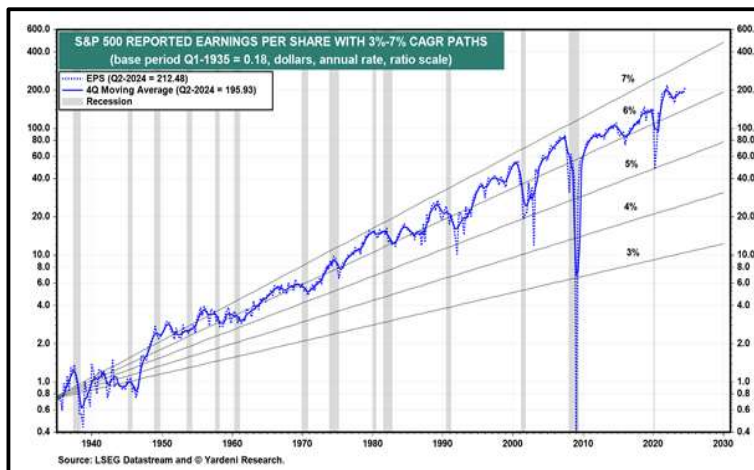
Pulling It All Together – So where does this leave us when it comes to our investment outlook? Let's talk about bonds first. Rates fell fairly dramatically across the yield curve in the third quarter as investors priced in a very dovish

Federal Reserve. We think this has gone too far. The latest jobs report paints a picture of an economy that is doing just fine, and while inflation is under control, it's unlikely to revisit the low levels we saw before COVID. Whoever wins the White House this fall is likely to continue spending, and even modest rate cuts from the Fed in the next few months are likely to lead to somewhat higher inflation expectations. Throw in possible new trade sanctions and we think we are living in a world where inflation averages 2.5% to 3.5% for the foreseeable future, not the sub-2% levels we experienced before CVOID.



Even as we write investors are reassessing just how many times the Fed can cut over the next twelve months, and we think it will be fewer times than the market expects barring an unforeseen shock. It doesn't mean 2-year and 10-year Treasury yields need to go up dramatically, only that bonds are likely to be vehicles to capture yield over the next year, not capital gains. But this isn't a bad thing at all. Yields in fixed income have moved noticeably higher in the last couple of years, and high-quality bonds remain the asset of choice to hedge against a recessionary scenario.

As for the global equity markets, we are still in the camp that stock returns are likely to beat bond returns in the months and quarters to come. When looking at the equity market it is so easy to get caught up in the quarter-to-quarter earnings game. Did the company beat earnings estimates or fall short? But most of our time horizons are multiple years if not decades. The chart above traces the earnings growth of the S&P 500 from the late 1930s to today. Note that the y-axis is logarithmic. Over this long timespan, earnings have grown from \$0.80 a share to \$200. But even over shorter periods, growth has been dramatic. An investor unlucky enough to buy into the S&P 500 at the peak of the dotcom bubble has still seen the underlying earnings on their investment grow from roughly \$60 a share to \$200. Over long periods of time earnings for U.S. corporations have grown at roughly 6% per year. Add on another couple of percent for dividends, and the resulting compound returns can lead

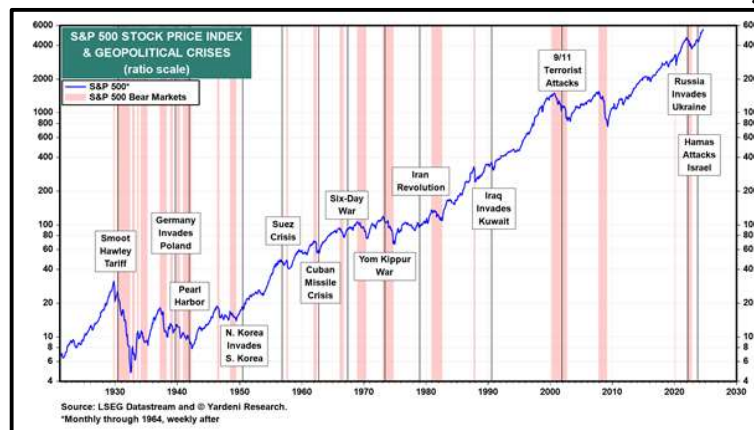


to a doubling in investment portfolios over roughly ten years. There's obviously no guarantee this can continue into the future, but we think it makes a lot of sense to focus on the long-term compounding dynamics for equities rather than the noisy headline-grabbing stories.

Final Thoughts – As the final quarter of 2024 kicks into gear it's easy to lose

sight of the fact that the markets have had a solid year despite all the crosscurrents that have materialized. Obviously, the election is front and center, but the turmoil in the Middle East and the ongoing war in Ukraine play a part. For investors, it is all too easy to extrapolate geopolitical uncertainty into their market positioning, often to their detriment. The chart at the bottom of the page overlays the S&P 500 on major geopolitical crises. The lesson, as always, is not to overact to the headlines.

The path for stocks and bonds going forward will be determined by the more prosaic factors that always drive the markets over the long term. Growth, inflation, interest rates, and earnings remain as important as ever, and the outlook for the next few months appears reasonably good to us at the moment. There's a decent chance that easing monetary policy around the world could bolster the growth outlook without destabilizing the inflation backdrop. If so,



earnings should continue to grow, supporting equity prices. Bonds have moved a long way to price in easier policy, and it wouldn't surprise us that bond returns going forward will be modest if we avoid recession, as we think we will.

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