Birch Hill
INVESTMENT ADVISORS

Market View

October 2024

MARKETS GRIND HIGHER

US stocks pushed higher in the third quarter. Returns were led by interest-rate-sensitive sectors such as utilities, real estate, financials and consumer staples on expectations of lower interest rates. Technology stocks, which powered most of the market gains earlier this year, lagged. All US large capitalization indices have had strong year-to-date returns through September. The S&P 500 Index returned +22.1% over the period, still outperforming the S&P 500 Equal Weight Index (+15.2%) and the Dow Jones Industrial Average (+13.9%). However, the latter two indices narrowed some of their underperformance in the third quarter.

RISKS BUILDING IN THE EQUITY MARKET

Strong year-to-date performance has driven valuations of the S&P 500 Index above their long-term averages. At the end of September, the indexes' 12-month forward price-earnings ratio stood near 21, above its 30-year average of nearly 17. Valuations have expanded, partly due to higher expectations for corporate profit growth. Analysts are forecasting S&P 500 Index profits to grow approximately 13% per year between 2024 and 2026, roughly double the long-term average of 6% per year. A high concentration in very large, highly valued companies has also expanded the valuation of the index. The 10 largest stocks in the S&P 500 Index represented close to 35% of its market value at the end of September—near historical extremes—and they command much higher valuations than the rest of the companies in the index. High valuations, high expectations and high concentration could lead to disappointment at some point in the future. However, there is a case to be made that stocks can continue to grind higher if the Federal Reserve achieves its "soft economic landing."

THE NORMALIZING US ECONOMY

The current trajectory of the US economy appears headed toward a soft economic landing. Inflation growth has been receding toward the Federal Reserve's 2.0% target, with the Consumer Price Index growing 2.5% over the year-ago period in August, and employment statistics are normalizing.

Market Indicators		9/30/2024
TOTAL RETURN		
US Stock Markets	12 Mos	Year-to-Date
S&P 500 Index	36.3%	22.1%
S&P 500 Equal Weight Index	28.8%	15.2%
DJ Industrial Avg.	28.9%	13.9%
S&P 400 Mid Cap	26.8%	13.5%
Russell 2000 Small Cap	26.7%	11.2%
Int'l Stock Markets		
ETF Returns in US$		
EAFE Index (Europe, Australia, Asia, Far East)	25.1%	13.0%
Japan (MSCI Index)	21.2%	12.4%
China (FTSE 50)	23.4%	32.7%
Emerging Mkts Index	24.0%	14.8%
US Fixed Income Yields	12/31/2023	9/30/2024
6 Mo US T-Bill	5.26%	4.38%
2 Yr US T-Note	4.23%	3.66%
10 Yr US T-Note	3.88%	3.81%

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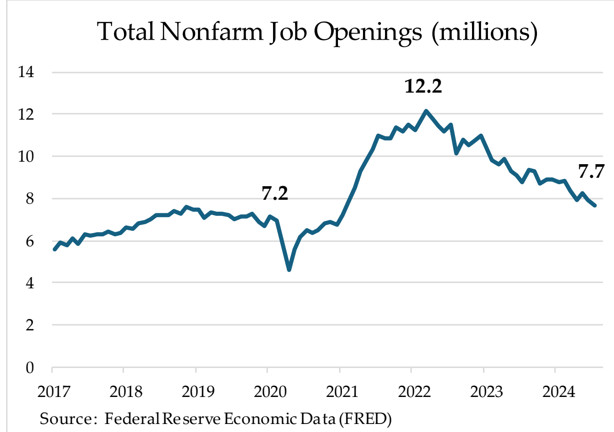
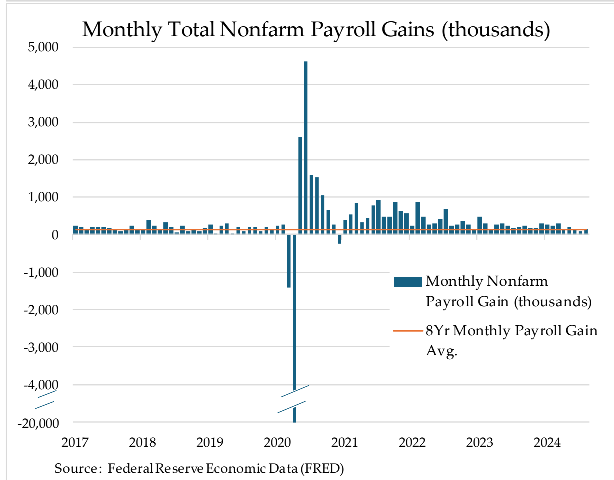
The unemployment rate crept up to 4.2% in August from its low of 3.4% in early 2023, but it is still well below its 6.2% long-term average. This labor market softening has spooked investors who worry the risk of a recession has increased. However, in our view, the labor market is more likely returning to a more normal supply/demand balance from the historically tight levels seen after the pandemic. Companies that hired frantically to meet abnormal demand during that period may no longer need the excess of labor they did back then. As seen in the chart to the right, demand for labor was extraordinarily high in March 2022, peaking at 12.2 million job openings, according to the Bureau of Labor Statistics Job Openings and Labor Turnover Survey. That has since declined to a more normal 7.7 million job openings in July, more consistent with pre-pandemic levels. Monthly job gains are also moderating closer to pre-pandemic levels, as seen in the second chart to the right. The gain of 142,000 jobs in August (blue bars) was below the torrid post-pandemic pace of gains but more consistent with the pre-pandemic pace.





A normalizing labor market may lead to softer consumer spending and slower US economic growth in the years ahead, but it doesn't necessarily mean the US economy will tip into a recession. Real gross domestic product (GDP) is forecast to grow a solid +2.0% in 2024, close to its long-term annual trend of +2.1%. Government spending should also support this growth. US federal deficit spending remains substantial, and neither presidential candidate has yet proposed balancing the budget. Therefore, US federal net debt levels are large (approximately 100% of GDP) and set to get larger.

FED CUTS RATES

Declining inflation, a softening labor market and a slowing US economy all mean there is less need for restrictive monetary policy. The Federal Reserve confirmed that view in September when it cut short-term rates by 0.50%. Further rate cuts likely lie ahead. Lower rates could help with affordability issues that consumers face today and lower borrowing costs for consumers as well as corporations. Both short-term and long-term bond yields have declined since the start of the year. Money market yields will decline further as the Fed continues to lower rates.

STRONG PERFORMANCE COULD PERSIST IF EXPECTATIONS ARE ACHIEVED

Stocks' performance has been strong in the first three quarters. The US economy appears to be slowing to a more normal rate of growth. Equity markets seem to be pricing in perfection. If high expectations are achieved, stocks could continue to move higher, but disappointments would likely soften prices. Investors should continue to hold high quality stocks in line with target asset allocation levels.

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