



## U.S. Economy and the Federal Reserve

Despite increased volatility during the third quarter, U.S. equity markets ended September near record highs. The anticipation of the Fed cutting interest rates pushed rates lower and equities higher leading up to the September FOMC meeting, where the targeted rate was reduced by 50 basis points (bps). While economic growth shows signs of moderating, we remain confident the U.S. economy will be able to avoid a recession in the short term. We still expect the economy to grow above its historical trend growth of 2.0% for Real Gross Domestic Product (GDP) this year. The job market remains our key determinant for when and if significant economic weakness arises.

Job gains accelerated in the third quarter as the economy added 557K nonfarm jobs compared to 442K in the second quarter. The unemployment rate ended the quarter at 4.1%, unchanged from June, and up from 3.8% in September of 2023. Wage inflation rose by 4.0% year-over-year in September, slightly up from the 3.9% level in June. Disinflationary trends continued in the third quarter as the September Consumer Price Index (CPI) was up 2.4% year-over-year, which compares to a 3.0% increase in June. The September gain was the smallest 12-month increase since February 2021.

The U.S. Federal Reserve lowered its target federal funds rate by 50 bps at their September meeting to a range of 4.75% to 5.00%. The Committee cited inflation moving towards their 2.0% target and a slowing job market as the rationale for a less restrictive monetary policy. Fed guidance was updated to reflect two more 25 bps cuts this year and four 25 bps cuts in 2025. A market risk remains should Fed policy diverge from market expectations.

## Capital Markets Performance

Interest rates moved lower during the third quarter as the market priced in the Federal Reserve, beginning their rate-cutting campaign. The two-year Treasury ended the quarter down 105 bps at 3.66%, while the 10-year Treasury ended the quarter down 55 bps at 3.81%. After two years of being inverted, the yield curve steepened and was positively sloped between the two and the 10-year treasury at quarter end. The Bloomberg Barclays U.S. Aggregate Index was up 5.2% in the quarter, with all six sectors recording solid gains. Higher rated bonds and longer duration bonds were relative outperformers in the third quarter.

Despite volatility during the quarter, U.S. equities added to year-to-date gains. The S&P 500 ended the third quarter up 5.9% and near a record high. In a reversal of recent trends, small and mid-caps outperformed large caps in the quarter, with value leading growth across market capitalizations. Small-Cap Value (+10.2%) was the best relative performer in the third quarter. Ten of the eleven S&P 500 sectors were positive performers, led by Utilities

(+19.4%) and Real Estate (+17.0%). The Energy sector was the only negative performer (-2.3%).

International stocks were relative outperformers versus the U.S. in the third quarter. The MSCI ACWI ex USA Index gained 8.1%, while the MSCI Emerging Markets Index was up 8.7%. MSCI Europe was the weakest relative performer but gained 6.6% in the quarter.

Most central banks globally have begun to lower interest rates as inflation moderates globally. The Bank of England (BOE) cut rates for the first time in four years, lowering its bank rate by 25 bps to 5.0% at their July meeting, while the European Central Bank (ECB) cut rates again in September, lowering its main refinancing rate by 25 bps to 3.50%. The Bank of Japan (BOJ) kept rates unchanged at 0.25% at their September meeting, citing global economic growth uncertainty. Late in the quarter, the People's Bank of China announced new stimulus to boost their economy, including cuts to mortgage rates for existing housing and a reduction in the reserve requirement ratio by 50 bps. The U.S. dollar (DXY) weakened by 4.8% in the third quarter and depreciated by 5.1% year-over-year. A weaker dollar tends to be a tailwind for international equity returns.

## Outlook and Portfolio Positioning

While we still anticipate a moderating U.S. economy through the remainder of the year, we expect solid consumer spending to support above-trend economic growth. Stubborn inflation, central bank interest rate policy, election uncertainty and geopolitical tensions around the globe remain key market risks.

We remain balanced in our equity positioning between growth and value, as we believe market performance will continue to broaden across sectors. Valuations for both mid and small-cap stocks remain attractive compared to large-caps, in our view. A weaker U.S. dollar, increased Chinese economic stimulus and attractive relative valuations remain potential catalysts for international markets, especially emerging markets. We believe valuation and quality remain the key factors driving global equity performance. During the third quarter, we replaced our international value manager with a new manager that we believe will generate more consistent absolute and relative performance.

Our fixed income portfolio remains positioned toward intermediate duration and a tilt toward quality, consistent with our expectations for economic data to moderate over the near term. Despite continued interest rate volatility year to date, we continue to believe rates for this economic cycle peaked in mid-October of last year. Investors should continue to focus on the "income" component of fixed income returns in 2024, as we expect interest rates to remain range-bound through the end of the year.

Despite market volatility, it is important to stay diversified and invested for the long term. History shows that time in the markets produces better outcomes than attempting to time the markets.

As always, we thank you for your continued support and trust in Newport Capital Group.

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