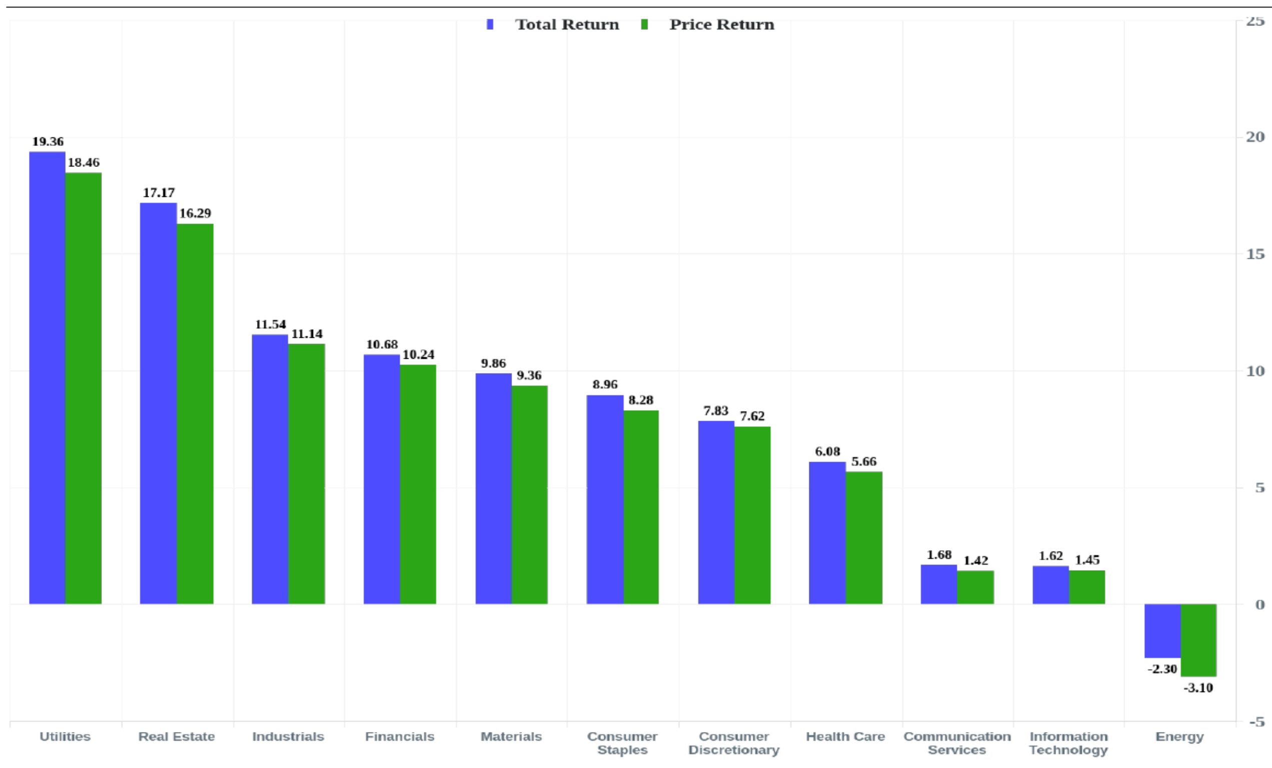
Chemung Canal Trust Company and Capital Bank, a division of Chemung Canal Trust Company

2024 Fourth Quarter Investment Outlook

Third Quarter Market Review

With only a brief pause from mid-July to early August, when the market narrowly avoided a technical correction of 10%, the S&P 500 charged ahead during the quarter, posting a gain of 5.89%. Even though an almost 6% quarterly return is impressive, it still was not the best quarter this year. The most notable factor in the third quarter was that, unlike previous quarters, the market's return was not primarily attributable to the performance of the Magnificent 7 stocks. Based on their average weight, the Mag 7 stocks contributed only 0.68% to the S&P 500's return, or just 12% of the Index's total return. This is in stark contrast to the second quarter, when those seven companies accounted for 5.36% of the index's 4.28% return, meaning that other 493 stocks, as a group, generated negative returns. The average stock during the third quarter, as measured by the S&P 500 Equal-Weighted Index, returned just over 9%. Since the mega-cap technology stocks did little to lift returns during the third quarter, the market found leadership in other areas.

Utilities and Real Estate were the best performing sectors during the quarter. The "easy" explanation for their performance was that investors migrated to these high yielding sectors as bond yields swiftly declined. It is also worth noting that prior to the third quarter, utilities and real estate had vastly underperformed the market since the start of 2023.

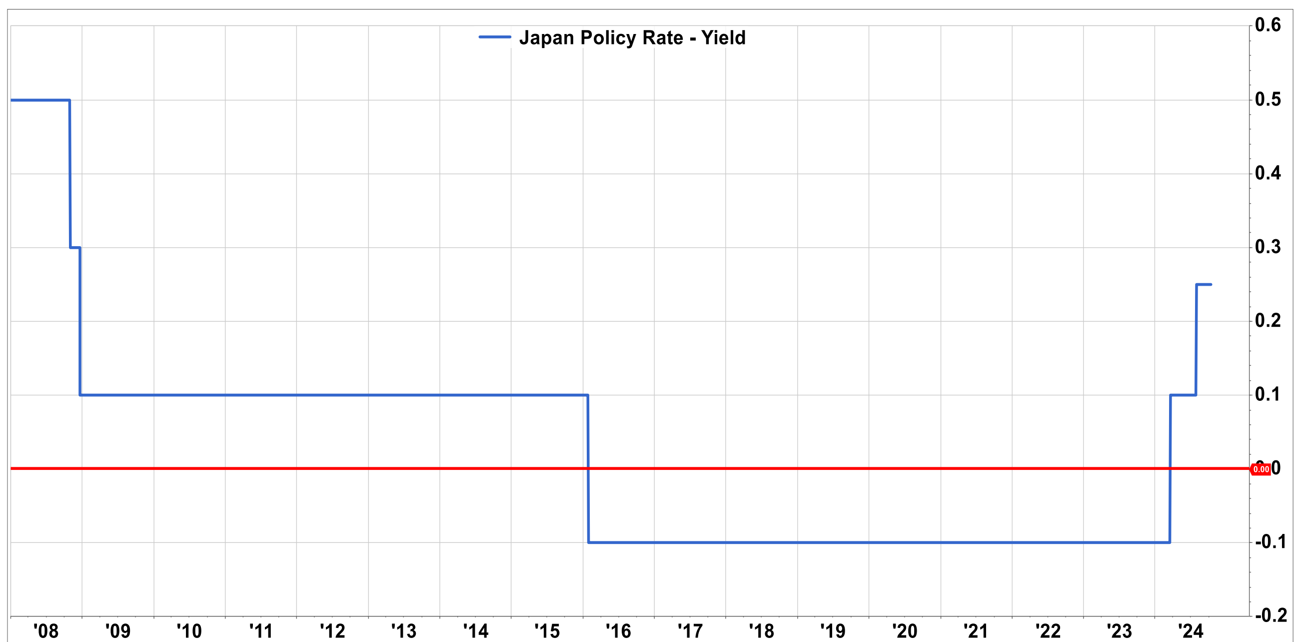


There is likely an element of normal market rotation occurring as well, as investors question the valuation and sustainability of the earnings growth of the mega-cap technology names. It was

encouraging to see that eight of the eleven S&P sectors outperformed the index during the quarter. The last time more than half of the sectors outperformed the index was the fourth quarter of 2022, demonstrating how concentrated the S&P 500's recent rally has been from a sector perspective.

With the third quarter in the rearview mirror, the S&P 500 is now approaching an entire year without a true market correction. However, the market did sell-off by 9.7% from the middle of July through the beginning of August. This was just 0.3% shy of an official correction occurring. The more volatile Nasdaq 100 index, driven by technology stocks, did enter into correction territory with a decline of 13.5%. Through the end of September, the Nasdaq 100 still has not reclaimed its previous high that was set in July. The element of this decline that was most painful though was that the market shed 7.5% in just three days. This decline was triggered primarily by the July non-farm payrolls report. The initial report showed that the US economy added just 114,000 jobs during the month, well below the consensus estimate for 175,000 jobs. Many investors began to question whether the economy was headed for a recession, instead of the soft-landing that so many had been forecasting.

If the lackluster payrolls report wasn't enough, the market was hit with a one-two punch when the Bank of Japan (BOJ) unexpectedly raised their policy rate to 0.25%. It is important to remember that Japan has operated under a period of extremely low and even negative policy rates following the financial crisis of 2008. Only in March did the BOJ end its negative policy rate which had been in place since 2016. The interest rate increase at the end of July marked the highest policy rate in Japan in more than 16 years.

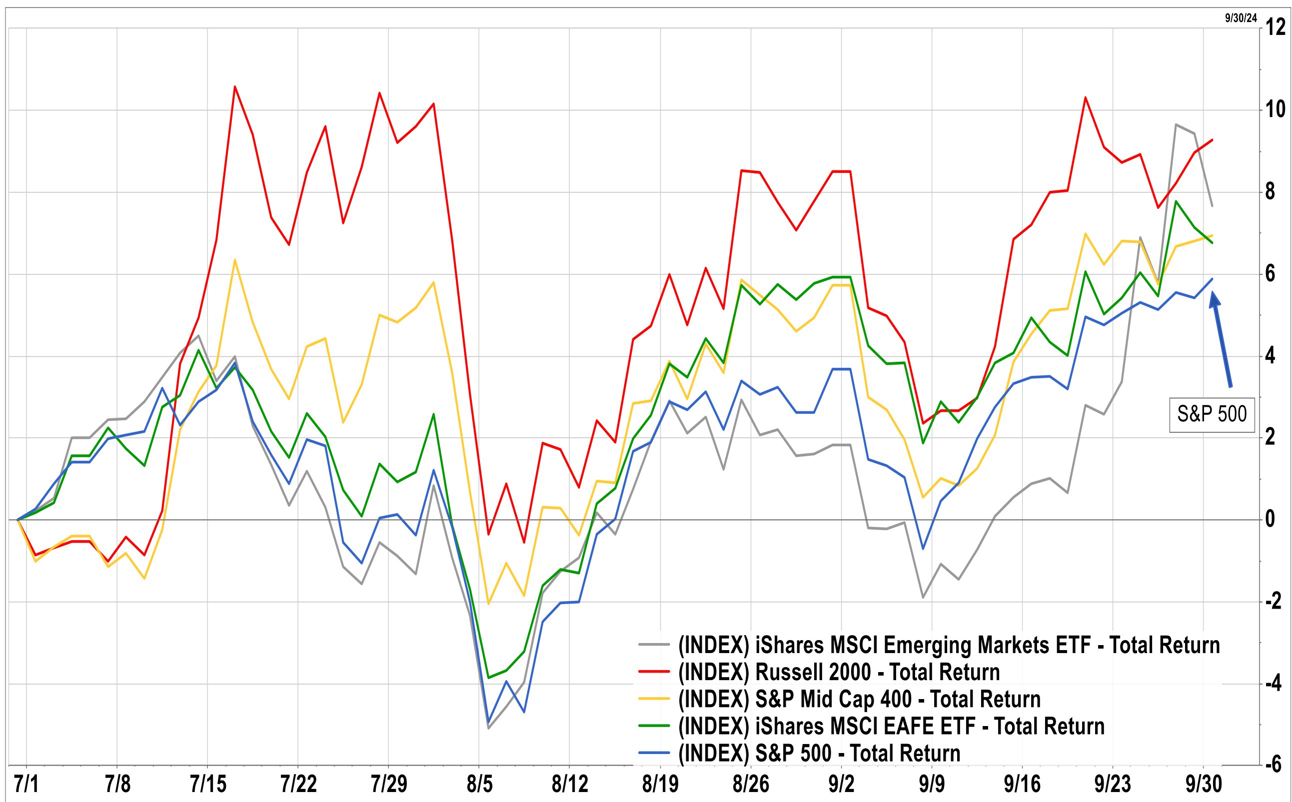


While a minor increase of the policy rate in Japan seems like a stretch to explain a sell-off in the S&P 500, it's important to understand the role of the Japanese currency in the global "carry trade."

In simple terms, a carry trade involves borrowing in a currency that has a low yield and is noted for its exchange rate stability. Those borrowed funds are then invested in a currency with a higher yield. The strategy is meant to earn a profit by exploiting the difference between the interest rates of the two currencies. In economic theory, this type of trade should not be profitable based on the

principle of uncovered interest rate parity (UIRP). UIRP states that any interest rate differential profit should be offset by an appreciation/depreciation of the currencies involved. In practice, however, this does not hold, and profits are able to be realized in undertaking a carry trade. Since the Japanese Yen is low yielding and quite stable, it was the ideal currency to fund a carry trade. The unexpected policy rate increase by the BOJ caused an unwinding in the carry trades involving the Japanese Yen and introduced a degree of instability into financial markets. The Yen appreciated by more than 10% against the US dollar in a period of just 3 weeks, causing stiff losses for investors utilizing carry trades. The appreciation became a self-fulfilling prophecy as investors had to buy Yen to exit their carry trades, causing even greater appreciation in the Yen. Actual figures are hazy, but UBS estimated that there was around $500 billion involved in the dollar-yen carry trade. Reuters cited analysts that believed the total yen carry trade could be worth as much as $4 trillion. Whatever the true size, it was apparent that the yen carry trade was able to disrupt financial markets, even with the catalyst of a minimal interest rate change in Japan.

In addition to the core U.S. large-cap equities that represent the majority of assets in most portfolios, small-cap, mid-cap, and international equities had a strong quarter. In fact, for the first time since the fourth quarter of 2020, U.S. large-cap stocks underperformed all other major equity asset classes, both domestic and international.

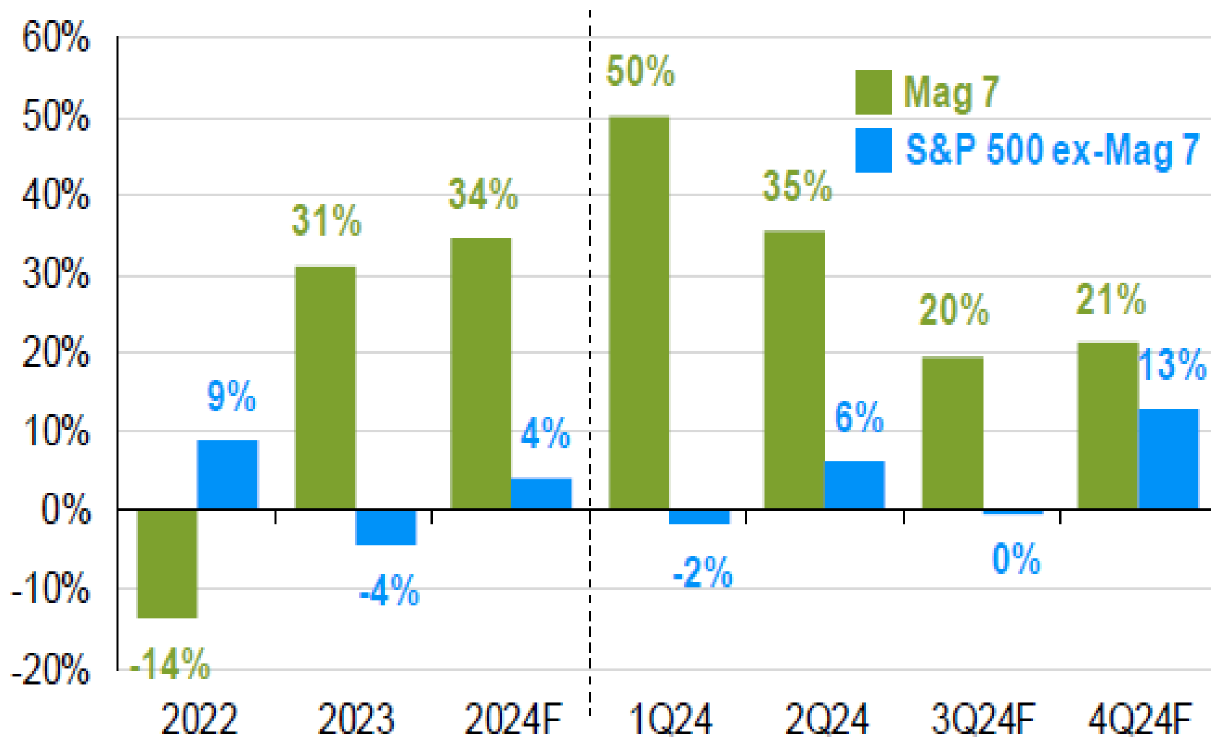


Even with the S&P 500's quarterly underperformance, it has now generated in excess of 36% on a year-over-year basis and is still the best performing asset class. The other "lagging" major equity asset classes have all generated more than 24% over the last 12 months.

Magnificent 7: Valuation Justified?

In previous *Outlooks*, we have spent a significant amount of time discussing the performance of the mega-cap technology stocks known as the Magnificent 7. The discussion of performance has largely been focused on their price performance and out-sized contribution to market returns. There's no argument to be made that their price performance has been anything short of magnificent, but their financial performance has been equally noteworthy.

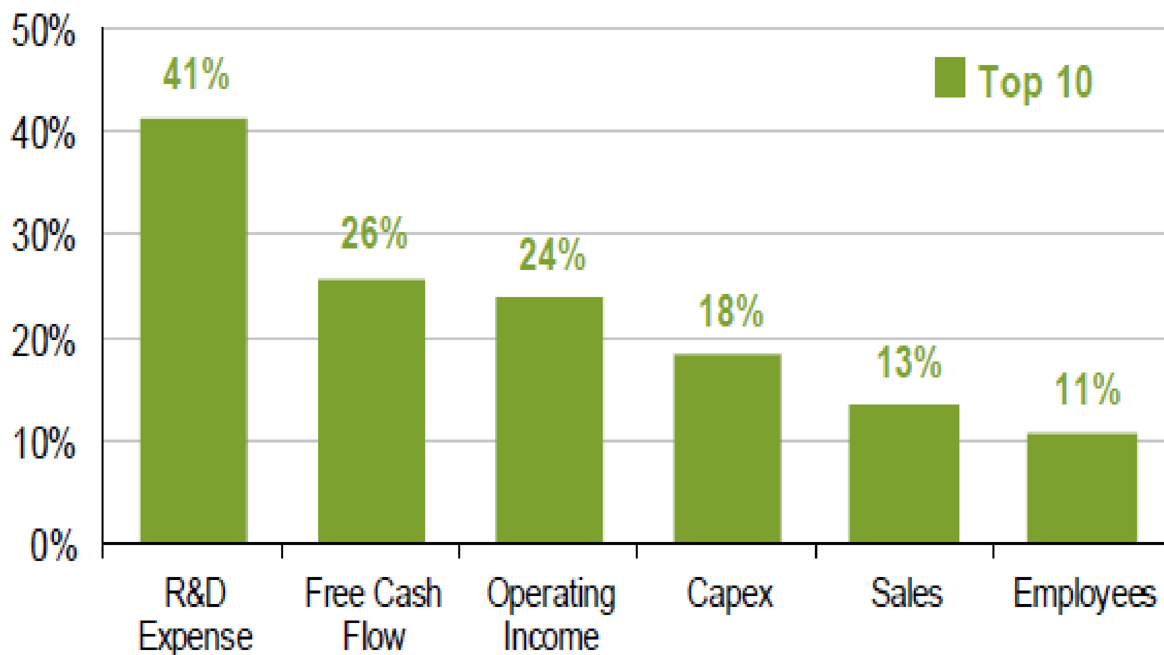
In 2023, the Mag 7 as a group generated 31% earnings growth on an annual basis. This is compared with the other 493 companies in the S&P 500 that saw their earnings decline by 4%. Based on forecasts for 2024, the Mag 7 are expected to grow their earnings in excess of 30% again, while the expectation for the rest of the market is that earnings growth will be in the low single digits.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

In addition to their astonishing revenue growth, another source for the significantly higher earnings growth rates for these stocks is their superior net-profit margins. The Mag 7 ended the second quarter of 2024 with a net-profit margin of 23.5%. The other stocks in the S&P 500 have an average net margin of just 8.5%. Since the start of 2021, the Mag 7's profit margins have outpaced the rest of the market by about 10-15%.

The real question in regards to these mega-cap technology stocks is whether this type of superior performance will continue into the future. Obviously, there is no single factor that can forecast their future prospects. One data point, however, that is the most astonishing is that the top 10 stocks in the S&P 500 account for 41% of the research and development spending in the entire S&P 500!



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.

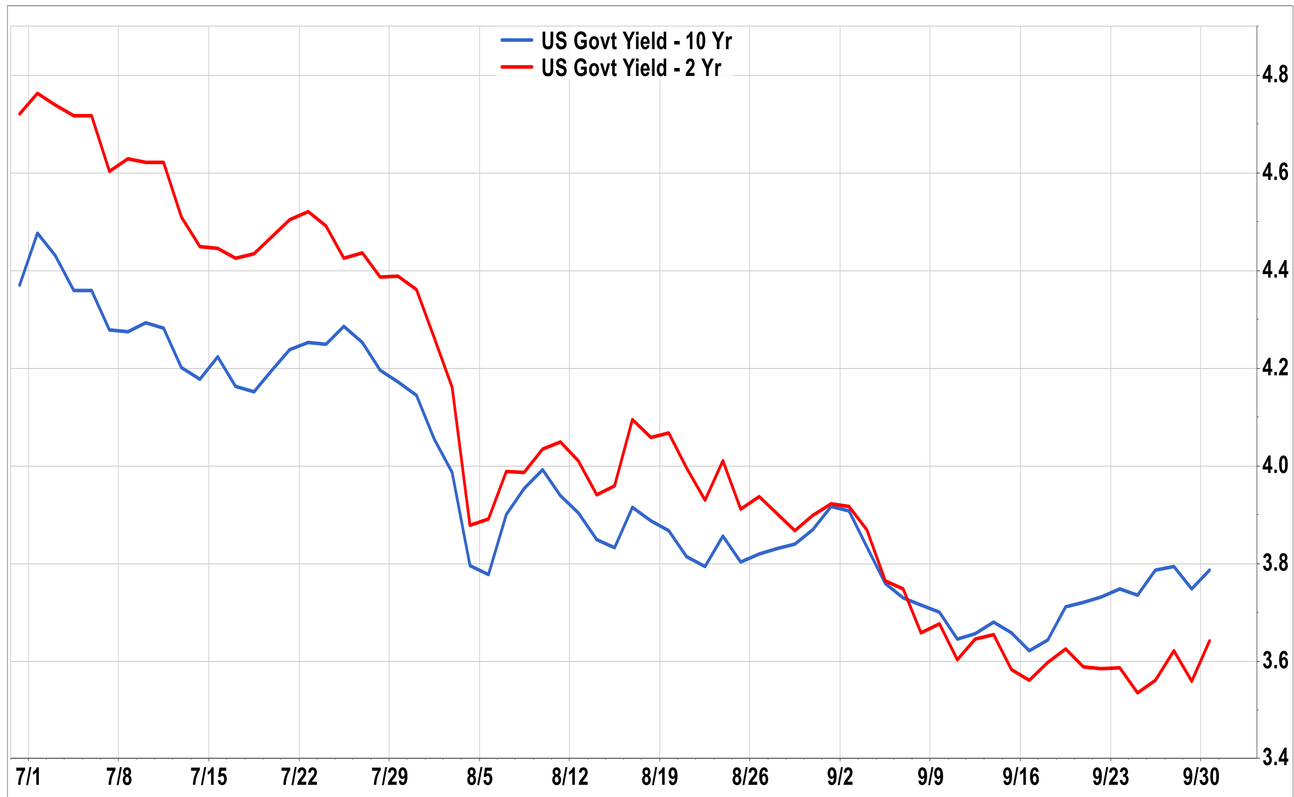
R&D spending is not a guarantee of future performance, but it signifies how committed these companies are to maintaining their competitive advantage. Does this justify their current valuations? History suggests that stocks do not tend to trade at 30 times their forward earnings estimates for a long period of time. This is especially true when the average stock trades at almost half of the Mag 7's forward P/E ratio. However, their financial results suggest that a valuation premium of some degree can be justified.

Fixed Income

The Bloomberg US Aggregate bond index performed almost as well as the S&P 500 during the 3rd quarter, generating total return of 5.2%. On a year-over-year basis, the index has now posted double-digit returns at 11.57%. Over the last 3 years, however, bonds have still generated a -1.39% annualized return, due to the severity of the historic bond market decline that was experienced in 2022.

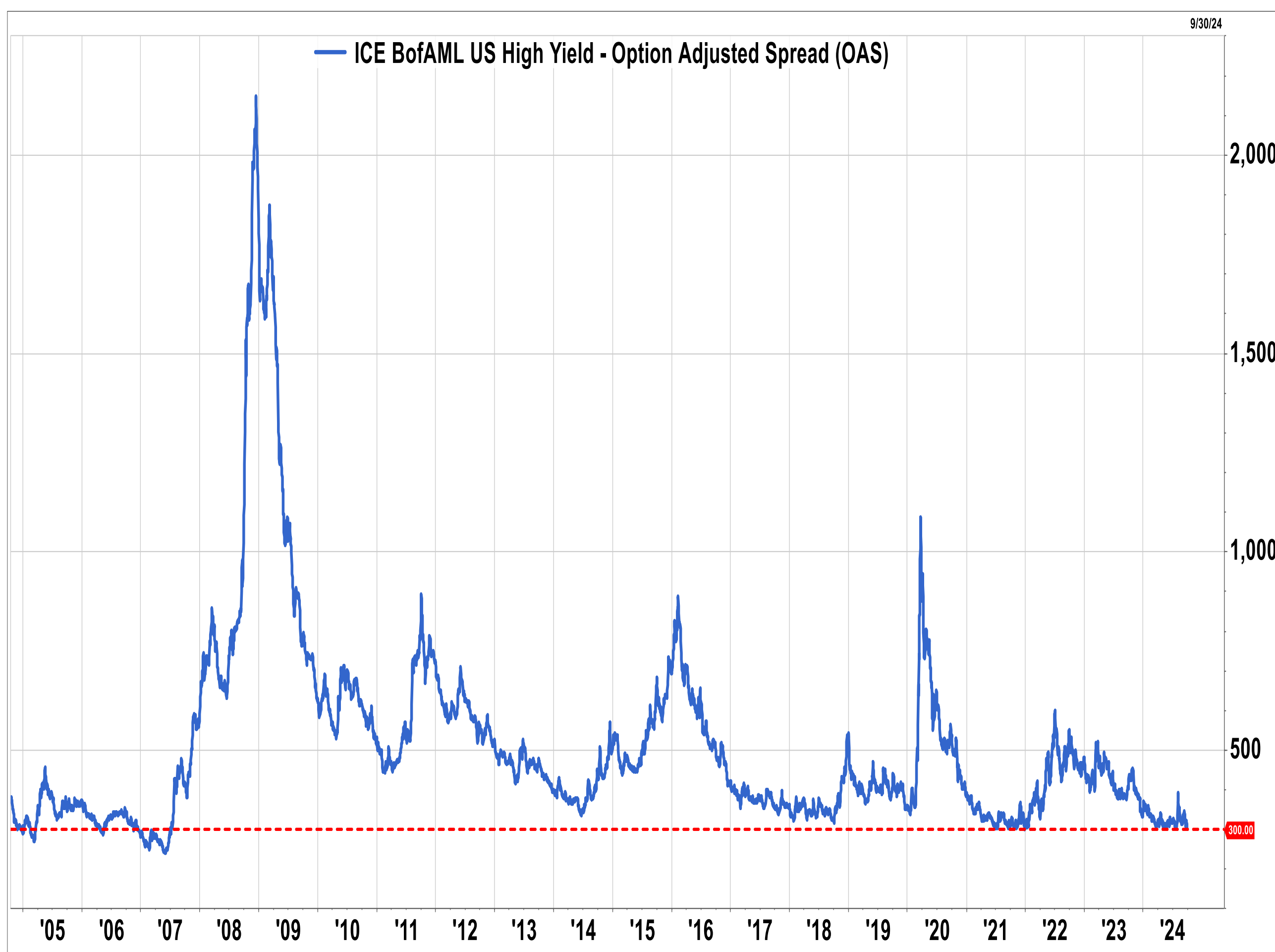
The bulk of the fixed income return for the quarter came through price appreciation, as opposed to income generation, as yields declined. The 10-year US Treasury yield began the quarter at 4.48%

and ended at 3.79%, a decline of just under 70 basis points. The policy-sensitive 2-year Treasury yield declined by 1.12%, to end the quarter at 3.64%.



It's important to point out that while the 2-year and 10-year Treasury yields both materially declined during the quarter, the rationale for the decline of each is very different. The 2-year Treasury, as was previously noted, is very sensitive to the interest rate policy that is set by the Federal Reserve. As was widely anticipated, the Federal Reserve began cutting interest rates by 0.50% in September. Since financial markets are forward-looking mechanisms, the 2-year Treasury yield began declining well in advance of the actual interest rate policy decision. On the other hand, the long end of the yield curve is far more sensitive to expectations for future economic growth and inflation. This is not to say that there is no relationship between Fed policy and long-term interest rates, but to acknowledge that the two are not as directly linked as are shorter-term yields. The 10-year Treasury yield declined following two disappointing non-farm payrolls reports that potentially indicated the soft economic landing might not materialize. The compounding factor was the steady decline in inflation expectations. Using the pricing on a 5-year Treasury Inflation Protected Security (TIPS), the market now anticipates that the Fed may undershoot their 2% inflation target.

High yield bond spreads have now declined to about 3.0% at the end of the third quarter, a level that is rarely seen in the fixed income markets. A spread in the bond market is a measure of the additional return that can be earned in a risky bond, that is in excess of the return on a default-free bond, like a US Treasury. This means that investors are being compensated less than usual for taking on additional risk in the bond market. For reference, over the last 20 years, the average high yield spread has been about 5.1%.

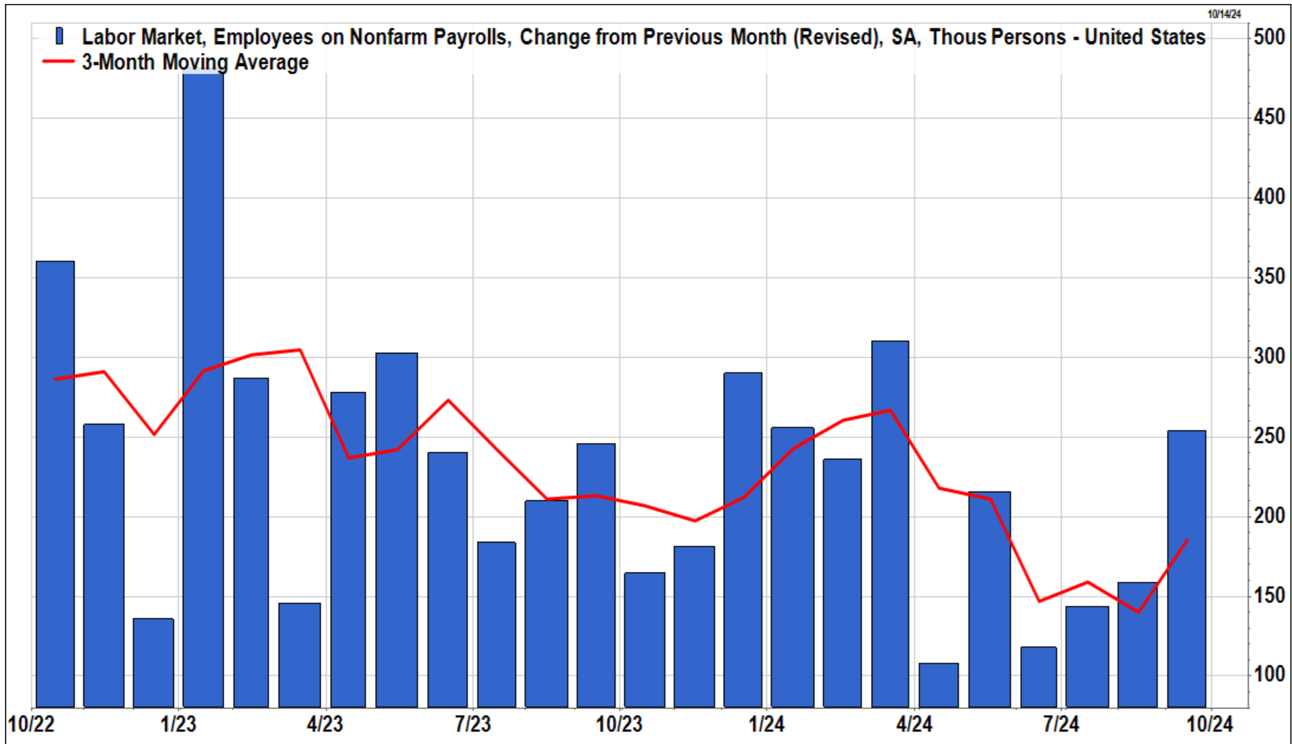


The high yield spread flirted with the 3.0% range in 2021, but the last time that level was significantly breached was in 2007. This low level of spread indicates that investors are confident that future economic growth will be strong, and bankruptcies will be low, otherwise they would not be willing to accept such a low level of additional return to take on more risk. Outside of the insight that high yield spreads provide for investor expectations, it is also a gauge for valuation levels in the bond market. This low degree of spread means that high-yield bonds are richly valued, at least on a historical basis.

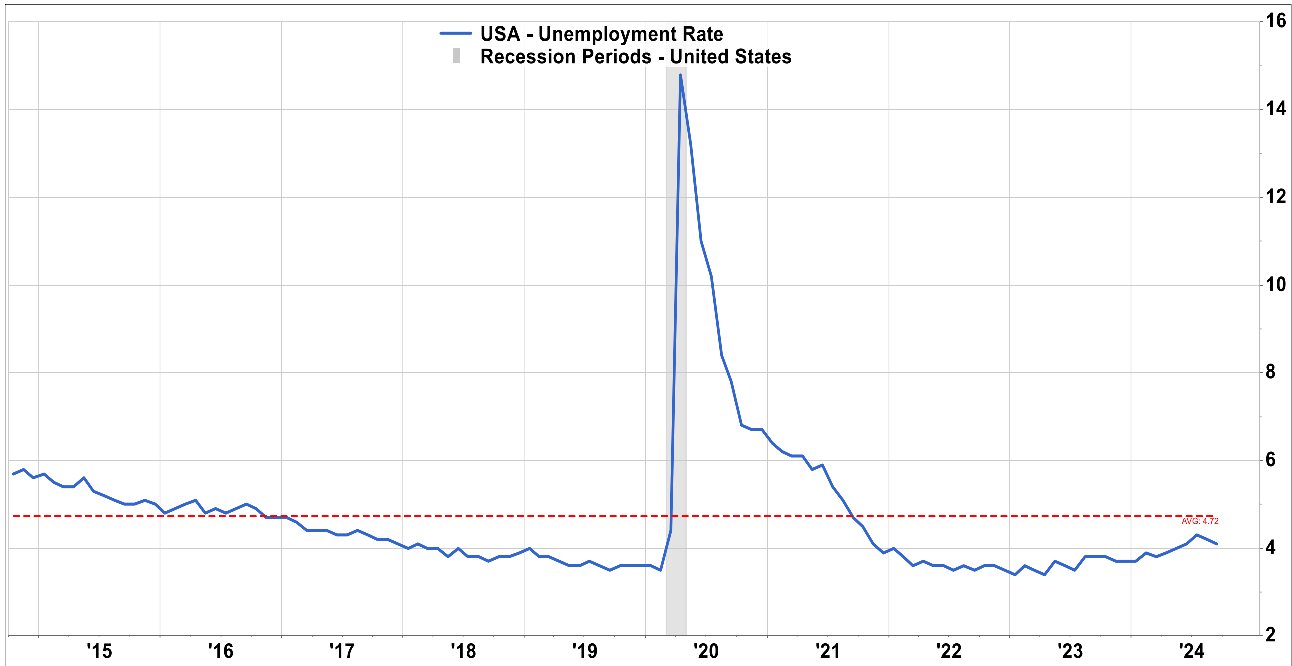
September Jobs Report, Another Mood Swing

Following disappointing jobs reports in July and August, the U.S. economy added far more jobs than expected in September and the unemployment rate edged lower. Nonfarm payrolls grew by 254,000, well above the consensus forecast of 150,000, and both the July and August reports were revised upward. September's report marked the third straight month of increasing jobs growth.

The service sector led in the creation of new jobs. The hospitality industry added 69,000 positions in September after averaging just 14,000 over the previous 12 months. New hires in bars and restaurants grew as well. Gains in health care, government and social service remained strong. While manufacturing continues to lag, construction jobs grew by 25,000 in the month.



The household survey, which is used to calculate the unemployment rate, showed an even stronger picture with a gain of 430,000 jobs. The unemployment rate fell for the second straight month to 4.1%, measurably above year ago levels but still comfortably below what would be considered "full employment."



Strength in job creation spilled over into wages, as average hourly earnings increased 0.4% for the month and were up 4.0% from a year ago. While both figures were above estimates, they still represent a significant cooling of year-over-year wage gains of 5.5% or more that persisted in early 2022.

The share of the workforce either working or looking for work held steady at 62.7%, while the number of discouraged workers and those holding part-time jobs for economic reasons dropped to 7.7%.

Partially offsetting the strength evidenced in the September report is the fact that initial unemployment claims rose to their highest level in more than a year in the first week of October, with 258,000 claims reported. The 4-week moving average of initial claims has declined from July-August levels, but remains elevated compared to the number of claims reported a year ago.

All in, the September jobs data should alleviate concerns that the U.S. labor market is heading into recession or, at the very least, push any recession fears further into the future. Together with the upward revisions for July and August, the three-month moving average rate of new job creation has increased to 186,000, which is more than enough to provide jobs for new workers as they enter the workforce.

Prior to the September report, investors had been gaming whether the Federal Reserve would cut interest rates by another half percentage point in November, following September's aggressive 50 basis-point reduction. The strong September jobs report gives the Fed more maneuverability moving forward, and futures market pricing has shifted with traders now assigning a strong probability of slower 0.25% cuts in November and December. Fed Chairman Powell all but confirmed these expectations in a recent interview, stating that he expects the Fed to move in quarter-point increments through the end of the year.

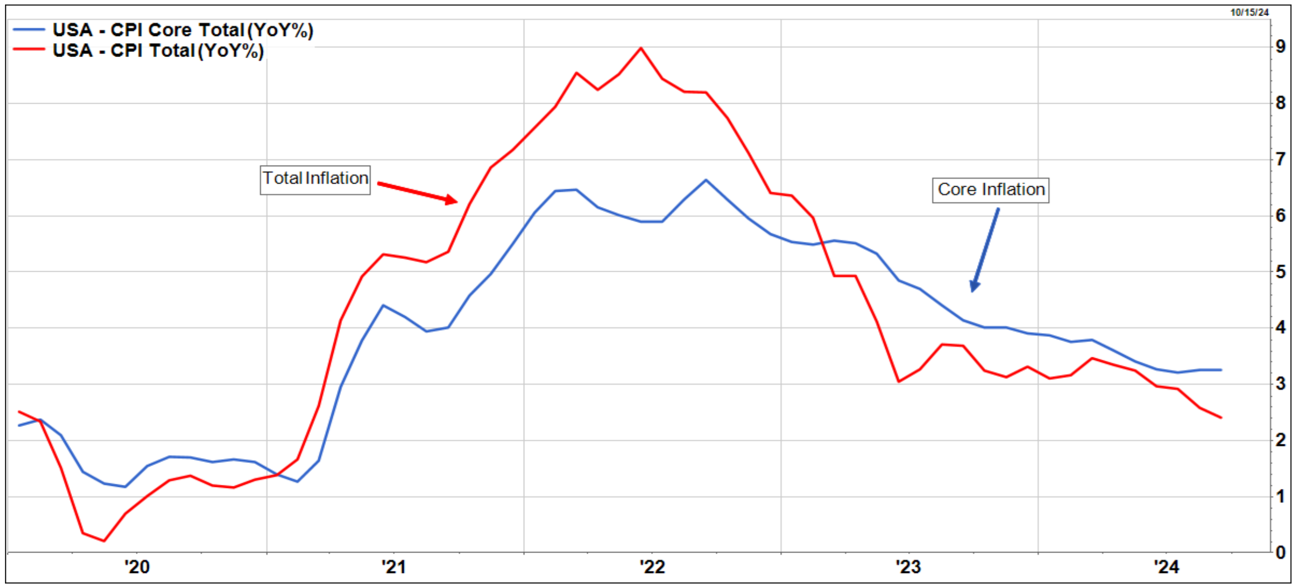
The destination is to move the federal-funds rate to the so-called "neutral" rate, a level which neither stimulates nor restricts economic activity. It's a worthy goal, but highly theoretical and impossible to achieve in real time. Economists' consensus put their estimate of the post-pandemic neutral interest rate in the high 2% or low 3% range. The median for the fed-funds rate over the long term is 2.9%, compared to the current fed-funds target range of 4.75% to 5%. Of course, neither the economic outlook nor fed-fund rate expectations remain static for long. If GDP growth and jobs gains remain stronger than expected, the consensus forecast for the fed-funds rate will likely move higher.

In reality, the Fed probably won't read too much into a single month's data, and neither should investors. Yes, the September jobs report was a "blowout" and upward revisions for July and August are evidence of a strong labor market. But prior to July, revisions to previous months' reports were mostly downward, and September's report is subject to revision as well. Analysts note that the response rate in the September survey was extremely low, with just 62% of businesses in the sample responding in time to be included in the Bureau's first estimate. That is down from 68% a year ago and the September average of 77% over the last decade. And the October data is probably going to be weaker due to labor strikes and the disruptions caused by hurricanes Helene and Milton.

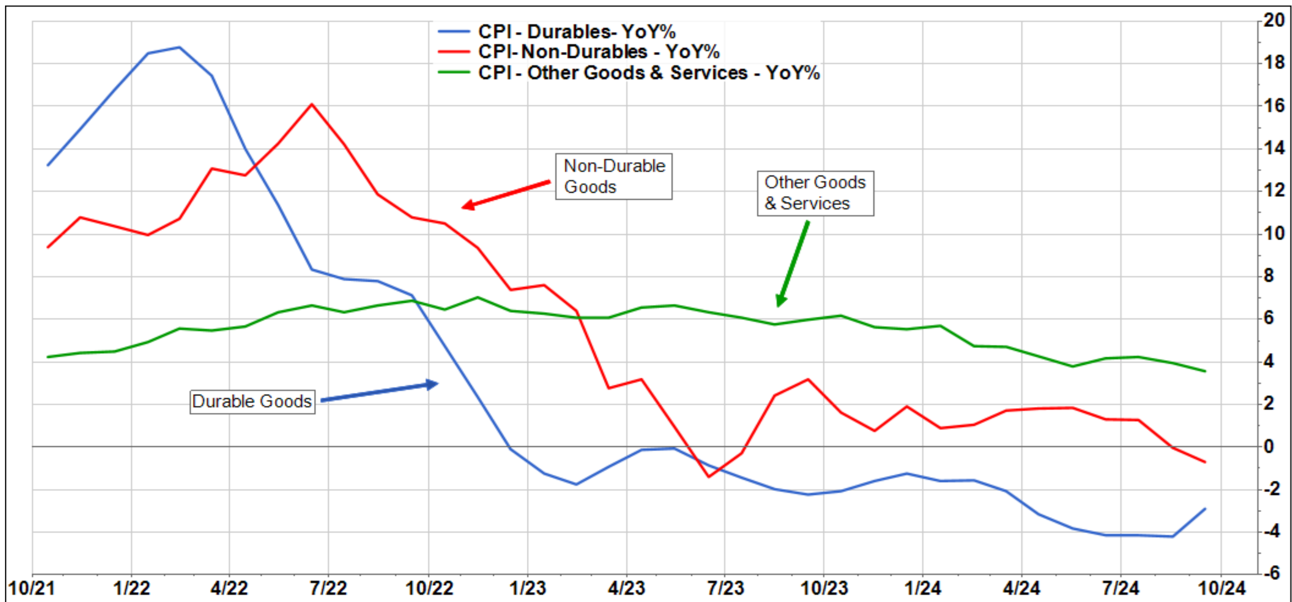
Inflation Down, but Not Out

The consumer price index (CPI) rose 2.4% in September on a year-over-year basis, slightly higher than the 2.3% expected but lower than August's reading of 2.5%. Month-over-month prices rose 0.3%, higher than the consensus 0.2% but in line with August's reading. Food and shelter contributed 75% of the monthly increase, but shelter inflation decelerated noticeably from prior months' reports. Gasoline prices fell during the month and are now at their lowest level since early 2022.

Excluding volatile food and energy prices, the *core* CPI rose 3.3% above year ago levels, the second straight month that measure has risen. The fact that core inflation remains above the so-called



headline number is due largely to service sector inflation remaining resistant to the Fed's interest rate hikes over the last 2+ years. While goods inflation can be sensitive to changes in interest rates – among other things, services inflation is mostly driven by wage increases which the Fed can not directly control. In fact, both durable and non-durable goods prices, which were increasing at double digit rates when the Fed began its series of interest rate hikes, have actually declined year-over-year. Durable goods inflation has been negative since early 2023. Meanwhile, service sector inflation has barely budged since the Fed began raising rates in early 2022.



Also, remember that the Federal Reserve looks at the broader Personal Consumption Expenditures (PCE) index to measure inflation, not the CPI, and September's PCE results won't be released until October 31. Through August, the core PCE price index was up 2.7%, and has stubbornly remained in the range of 2.6%-2.8% since February. The bottom line is that the "last mile" in the inflation fight appears to be the most difficult.

Still, for whatever it means, the September CPI report represented the smallest increase in headline inflation since February 2021, and inflation by this measure is barely above the Fed's 2% target and well below the 9.1% peak reached in June 2022. There is no consensus that the uptick in the core number is a signal that inflation is accelerating, nor do most analysts expect that the data will deter the Fed from cutting its interest rate another quarter percentage point. But another half percentage point cut is likely "off the table."

GDP Growth Expected to Be Solid

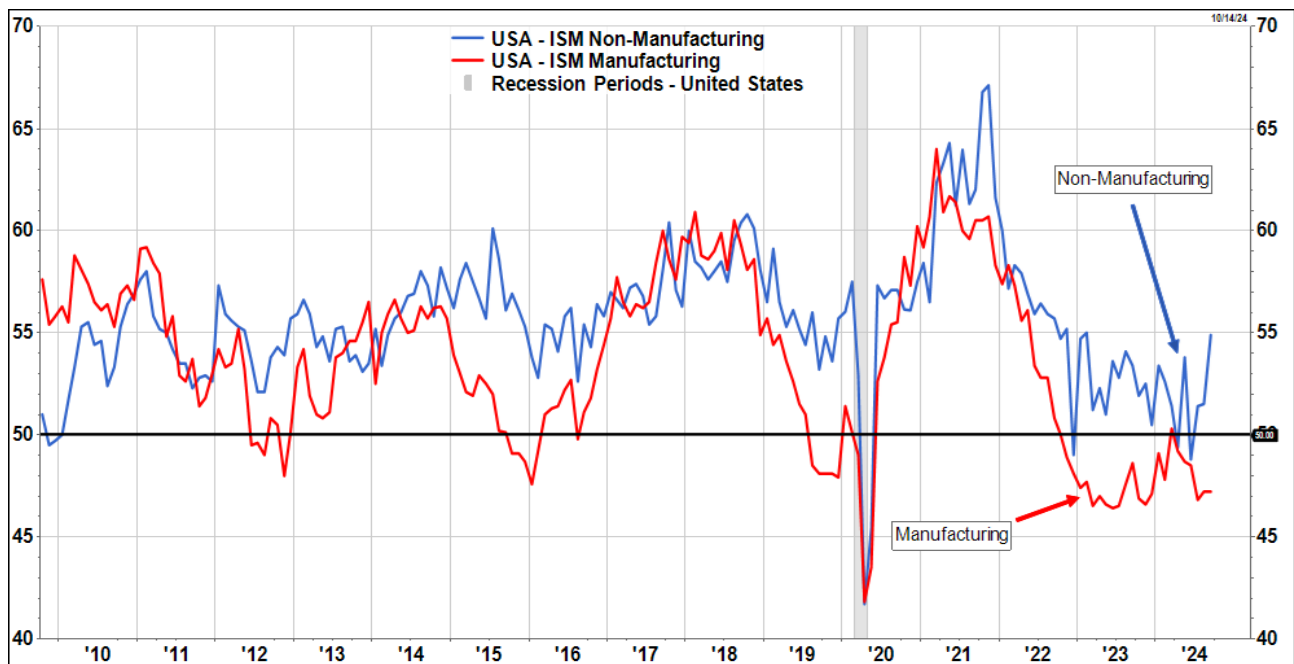
The release of the U.S. Gross Domestic Product in the 3rd quarter will be on October 30th, but the Federal Reserve Bank of Atlanta's GDPNow model estimates that the economy grew at an annualized real rate (after inflation) of 3.2% from the prior quarter. This follows 1st and 2nd quarter gains of 1.6% and 3.0%, respectively. Whatever the actual number ends up being, the U.S. economy remains fundamentally strong, and all evidence suggests that policymakers are on course to bring inflation under control without causing a recession.

Still, as is the case when discussing jobs and inflation, this is also a tale of two economies: a goods economy and a services economy.

The Institute for Supply Management (ISM) Manufacturing Index contracted in September for the 6th consecutive month, and for the 22nd time in the last 23 months. A reading below 50 (chart, below) indicates that a sector is contracting, while a reading above 50 indicates expansion. The production component of the manufacturing index improved during the month, but the more forward-looking new orders, backlog and employment indicators declined.

On the other hand, the services sector expanded for the 3rd straight month in September. The services index has been in expansion territory 49 times in the last 52 months, and September's reading of 54.9 represented its highest level since February 2023.

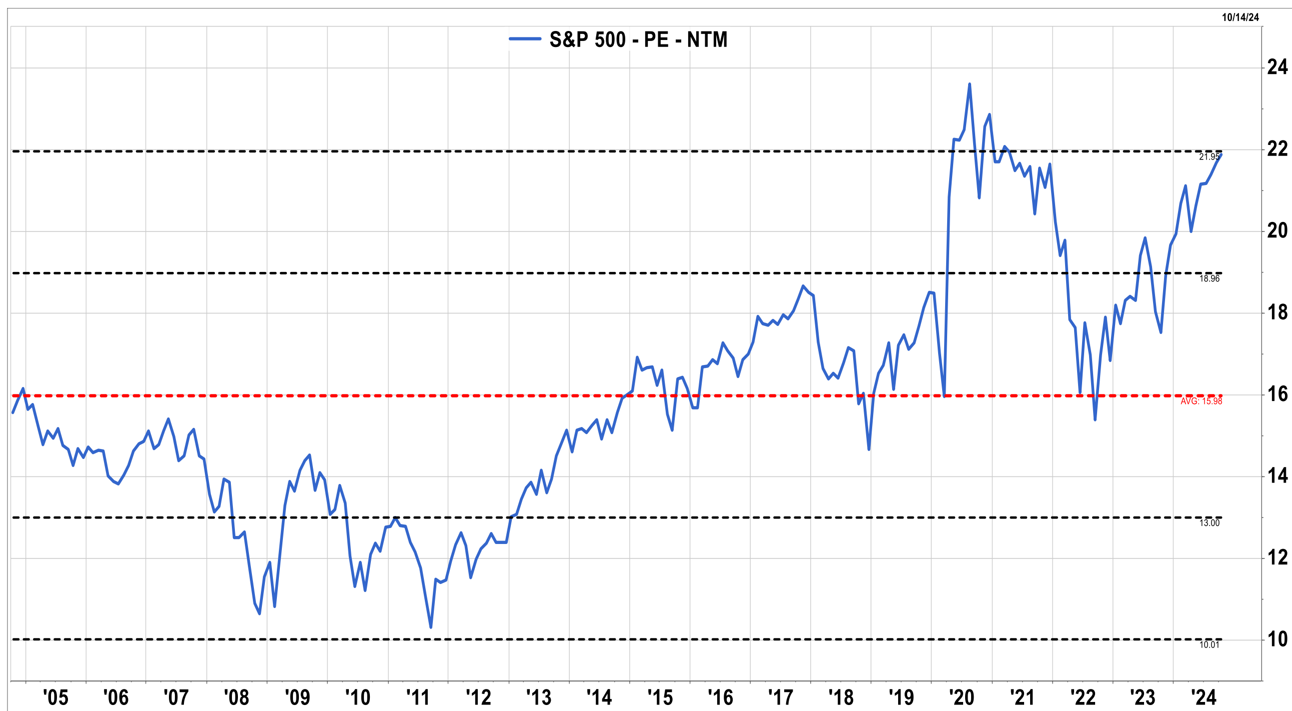
As far as what this means for inflation and jobs growth going forward, it is instructive to note that the main concerns expressed by survey respondents in the services sector were labor costs and availability.



Equity Valuations Reflect the Goldilocks Economy

A healthy labor market, lower interest rates, continuing – if choppy- progress in the inflation fight, and an economy that is neither too hot nor too cold might suggest that investors have the "all clear" to continue to add risk to their portfolios. After all, a soft landing that entailed all of those conditions has long been viewed as the best of all possible outcomes, as well as the least likely if one looks at history. Unfortunately, it is clear that the improved outlook is also abundantly reflected in the stock market's current valuations.

Even as the Magnificent 7 stocks under-performed the market in the recent quarter, the S&P 500's price/earnings multiple has expanded to 21.9 times consensus forward 12 months earnings estimates, almost 2 standard deviations above its 20-year average. It could be argued that such a lofty multiple is justified in view of the improving odds of a soft landing as well as the Federal Reserve's recent move to begin lowering interest rates. However, there have been 3 prior instances of Fed tightening in which no recession has occurred, and we are at the highest S&P 500 valuations that have ever existed at the inception of Fed monetary easing.



Where We Stand

An oft-cited adage of equity investing is, "Don't fight the Fed." Yet the S&P 500 has risen 53% since the end of 2022 even as the Federal Reserve continued its restrictive policies. The index has set 46 new highs this year, without a single 10% decline from any of them. We are overdue for a correction.

Another adage states that the most expensive words an investor can utter are, "This time is different." But this cycle has clearly been "different" in so many respects, and it may continue to defy expectations and history going forward.

Climbing a "wall of worry," is an often-used metaphor for the idea that stock prices can rise despite economic uncertainty or negative news. Among the many worries that the current market optimism is ignoring are these:

- The federal debt and deficit are at record levels and are rising unchecked. Interest expense on the accumulated debt at $950-billion, now exceeds our annual expenditures for defense ($826-billion) or Medicare ($869-billion).

- Geopolitical risks, and their potential impact on energy supplies and global supply chains are growing. The Russia/Ukraine war is in its 3rd year with no end in sight, Israel is fighting a two-front war with military organizations funded by Iran, and China/Taiwan tensions could boil over at any time.

- Earnings growth, particularly for the Magnificent 7 stocks will be slowing as quarterly comparisons begin to be measured against unsustainable prior levels and lofty expectations. Mag 7 earnings growth reached 60% year-over-year in last year's 4th quarter, slowed to 50% in the 1st quarter, 33% in the 2nd quarter, and an estimated 17% in the 3rd quarter. Overall, S&P earnings are expected to be up just 3.2% in the 3rd quarter, down from 7.8% expected at the beginning of the quarter and 11.6% in the 2nd quarter. For the full year, 2024 earnings are expected to be 9.7% above 2023 levels, and estimates for 2025 are 15% above this year's level.

- Service sector inflation has barely budged since the Fed began its war on inflation, Core PCE is stuck in a range that is still well above the Fed's target, so the risk remains that the Fed may still decide to slow – or halt – future interest rate cuts. Devastation from hurricanes Helene and Milton could also have a negative impact on growth and inflation numbers, at least in the short term.

- The labor news is not *all* good, with initial unemployment claims elevated from earlier in the year and the unemployment rate 0.7% above its low achieved last year, more than enough to trigger concerns about the Sahm Rule. That rule states that if there is a 0.5% rise in unemployment on a rolling 3-month basis above the year earlier level, the economy has typically slowed into a recession. This, along with a yield curve that is still (slightly) inverted, and consumer sentiment that is still negative could mean that the remaining few analysts still calling for a recession might still be right (finally).

Whether any or all of these concerns continue to be merely bricks in the wall of worry or become catalysts for a market downturn depend on where we are in the market cycle. Mutual fund pioneer John Templeton once said that bull markets are born on pessimism, grow on skepticism, mature on optimism, and die on euphoria. Although valuations might suggest otherwise, sentiment and other market indicators don't support the idea that we're at the euphoric stage – yet.

Along with the 46 new highs in the S&P 500, market breadth has greatly improved. The equal-weighted S&P is close to a new high and has outperformed its cap-weighted counterpart over the last quarter. More than 85% of all stocks are now up year-over-year. This is a dramatic change from the beginning of the year when more than 50% of stocks in the index were down, and 75% of all stocks were under-performing the index.

Currently, 77% of S&P stocks are trading above their 200-day moving average, up from just 25% in October 2023.

As mentioned earlier, 8 of the 11 S&P sectors outperformed the index in the 3rd quarter, in contrast to the first half of the year in which 9 of the 11 sectors under-performed.

Historically, when the Fed begins to cut rates and we're not in recession, the S&P 500 has been up three and six months after the first cut seven out of seven times. Those are pretty good odds unless – again – this time is different.

Sentiment is bullish, but not so bullish as to be a contra-indicator, and there is a healthy $6.4-trillion in money-market funds to serve as fuel for further advances or to "buy the dips."

Valuations will matter eventually, and the current market price/earnings multiple will likely be unforgiving of earnings disappointments. Since 1980, market corrections of 10% or more have occurred every 1.2 years, so we are clearly due for a downturn at some point in the near future, but this market cycle has defied history in so many other ways that the past is not necessarily a useful guide. So, having acknowledged the risks of high valuations and other worries, the adage that we choose to follow for now is, "In a bull market, be bullish."

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