Quarterly Recap – September 30th, 2024

The third quarter continued the upward trend in stock markets and jolted bond markets higher for the year. Economic data continues to be good, but not extraordinary, lifting investors' hopes for a soft landing. The major development is that the Federal Reserve has begun cutting rates, beginning with a half percent cut in September.

Equity markets seesawed during the quarter but ended at all-time highs. Encouragingly, the rally has broadened beyond just a few mega-cap technology companies. Valuations are high, but investors are betting that falling interest rates will be a tailwind in an economy that hasn't slowed down.

Bond markets have been expecting interest rate cuts, but they have been slow to materialize. As it became more apparent that the September meeting would finally deliver a rate cut, bonds have steadily increased in price during the quarter. Markets now anticipate short-term rates to be around 3% by the end of next year.

The change in interest rates comes as inflation remains around 3%, still above the Federal Reserve's target of 2%. There's been little further progress in subduing inflation for over twelve months, which had been enough to keep interest rates elevated. However, during the quarter the unemployment rate began moving higher, triggering the "Sahm Rule," which has historically been a recession indicator. While we're confident that we're not currently in a recession, this indicator as well as other marginally weak data points were enough to convince the Fed to start cutting. The Federal Reserve also released guidance indicating that they expect to continue lowering interest rates, though always with the caveat that they will remain data dependent.

We remain bullish for the stock market, as a solid economy with falling rates provides a great investing environment. For bonds generally, it's possible that upside remains limited as so much good news has already been priced in. For our income portfolio, though, we see myriad tailwinds.

The environment is not without risks. Geopolitical tensions continue to rise. Elections historically aren't important to markets, but this election season has been especially combative. And we are cautious about the timing of rate cuts; the Fed might unwittingly be re-stoking inflation by doing so. Stocks and bonds have celebrated that development by rising markedly. If investors feel wealthier, they're likely to spend more money, contributing to inflation. We will be watching data closely to see if the Fed acted prematurely.

INDEX	3rd Qtr	2024	2023
MSCI All Country World	6.5%	19.1%	22.8%
S&P 500	5.6%	22.1%	26.3%
Dow Jones Industrial	8.6%	13.9%	16.2%
Russell 2000	9.9%	11.2%	16.9%
EAFE	7.1%	13.6%	19.0%
MSCI Emerging Markets	8.7%	17.1%	10.2%
BC Aggregate Bond Index	5.8%	4.5%	5.5%

TREASURY RATES	9/30/24
Fed Funds	5.13%
3 Month	4.62%
2 Year	3.64%
5 Year	3.56%
10 Year	3.78%
20 Year	4.17%
30 Year	4.12%

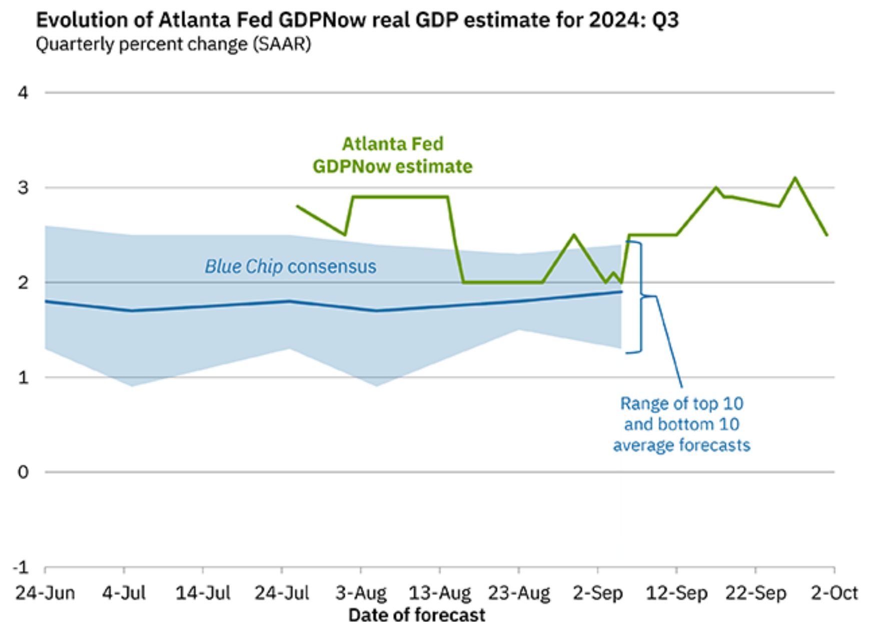
Greetings from Verismo Financial!

We are excited to announce that we've started our own company, Verismo Financial! While it's a big change in many ways, we anticipate returning to normal operations after a few short months. The entire team is still here, and our approach to investment planning and investment management will remain consistent. Thank you to all our clients who have already planned to join us in this transition. Your trust and friendship mean so much to the team.

We appreciate the patience of our clients as we work tirelessly to transition their accounts to our new platform. While it's a short-term inconvenience, we promise that the change will be beneficial as we strive to continue to provide the service to which you're accustomed. As always, give us a call if there's anything you need.

Economic Developments

Despite what you might hear on the news or social media, the economy remains strong. GDP growth for the second quarter was 3%. In a few weeks we will get our first look at data for the third quarter. The Atlanta Federal Reserve's GDPNow model currently projects another quarter of growth between 2.5% and 3%.[ii] With federal deficit spending at the level it currently sits – 40% of GDP when combined with state and local spending – if nothing changes it will be very difficult to push the economy into a recession. The current level of spending relative to GDP is surpassed by only the responses to the 2008 Great Financial Crisis and the 2020 Covid stimulus. While we would welcome a reevaluation of the budget, it's important to realize that government deficit spending is also extremely stimulative.



The Atlanta Fed's model doesn't show evidence of a slowdown[i]

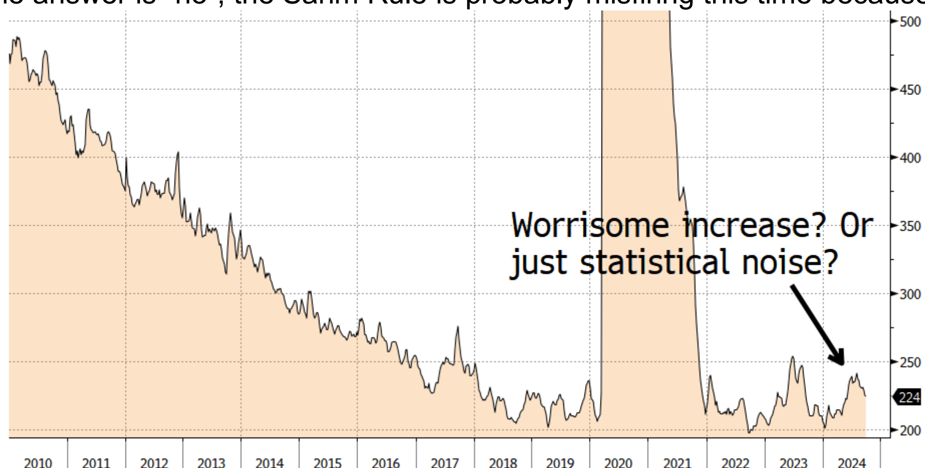
The Commerce Department recently revised GDP numbers for the past few years, based on more complete information.[iii] This data slightly raised GDP growth estimates during the entire period after the pandemic. 2021 was overall revised higher by .3%, 2022 by .6%, and 2023 by .4%. Higher growth is great, and if you look at the GDP figures since the pandemic you see an economy consistently growing at 2-3%, which historically indicates a healthy economy. Perhaps also of interest – these revisions revised the second quarter of 2022 from -0.6% to +0.3%. Do you remember the debate in 2022 about whether we were in a recession or not? The decision was ultimately that it was *not* a recession, according to the National Bureau of Economic Research, who subjectively look at the totality of data in order to decide what the history books will say. That would have been the first time that two negative GDP quarters in a row would not have indicated a recession; to some, it looked like a partisan decision. The GDP revision absolves them of that accusation.

The revision also raised Gross Domestic Income (GDI) estimates, data points which are rarely remarked upon since they tend to closely track GDP numbers. However, since the

pandemic the GDP and GDI numbers had deviated substantially, potentially indicating that GDP was not as high as measured, or an issue with how much laborers were being paid. The GDI figure is a key input to many models which predict the consumer's ability to spend. We've seen a lot of articles over the last eighteen months projecting a slowdown in the economy based on consumers running out of savings, using more credit cards, or because wages weren't keeping up with inflation. It's possible that many of these analyses were based on incorrect GDI data, and the US consumer is actually doing better than we thought.

Last quarter we mentioned the "Sahm Rule", an indicator which has historically indicated that a recession has already begun. The rule states that if the rolling three-month average of unemployment rises .5% above the lowest unemployment rate of the last twelve months, then the economy is in the early stages of a recession. The rule was devised by Claudia Sahm, who noticed that recessions often start with a gradual rise in unemployment which then accelerates. If the Federal Reserve realized early that a recession was underway, they could direct aid to the appropriate individuals and ultimately limit the damage to the economy. Since its invention, it has been accurate with each recession we've experienced.

We mentioned the Sahm Rule last quarter because we were on the verge of triggering it. Be careful, we cautioned, not to take the recession fears too seriously. Claudia Sahm agreed, saying that this time is different. Sure enough, the next unemployment figure triggered the Sahm Rule, and we've seen media reports discussing it, questioning if we are in the early stages of a recession. We believe the answer is "no"; the Sahm Rule is probably misfiring this time because of the historic levels of immigration, not from underlying weakness in the labor market. Fed Chairman Powell agrees with this interpretation, recently stating, "if you're having millions of people come into the labor force, and you're creating 100,000 jobs, you're going to see unemployment go up."[v]



The rolling four-week average of Initial Jobless Claims has ticked higher, but is it meaningful? We don't think so.[iv]

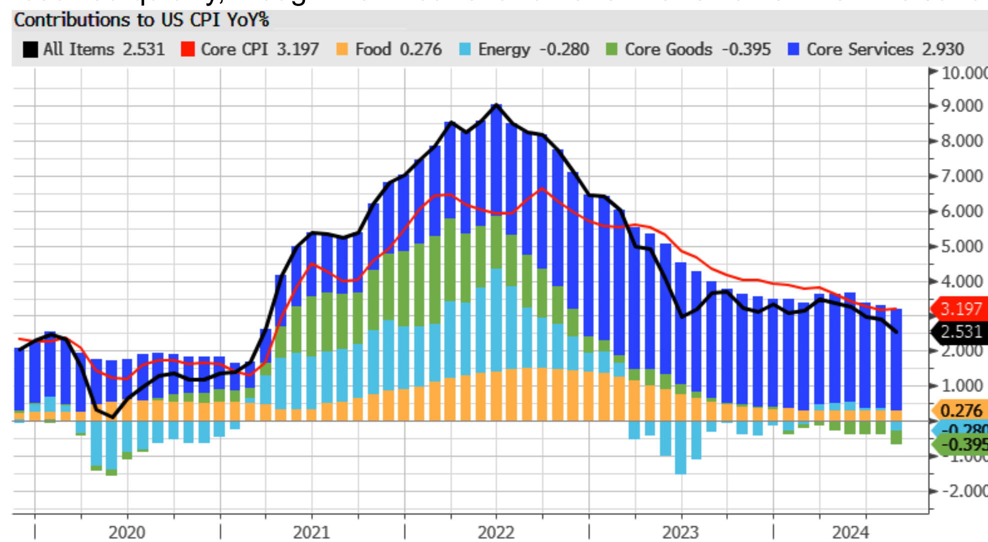
(It's interesting to note that the Sahm Rule has never been wrong about a recession. But the stock market has not reached an all-time high during a recession since at least World War 2. One of these indicators is going to "take the L" this time.)

A complete picture of the labor market is somewhat of a Rorschach Test. You can find marginal weakness if that's what you're looking for. Or you can find a historically strong labor market if that's more your style. It's telling that each economist's or investor's opinion falls almost entirely along partisan lines.

While the unemployment rate has risen, it's rising off levels that would be considered extraordinarily low in any other era. Initial jobless claims data provides a weekly report regarding job losses. These have also shown marginal weakness, but still well within a normal range. The Job Openings Labor Turnover Survey (JOLTS) is less well-known. It reports the number of job openings on a monthly basis, and has been steadily moving lower. The number of jobs per

unemployed person is still well above 1.0, though. Again, we are seeing incremental weakness, but mostly because the labor market was historically strong after the pandemic.

Our belief is that the labor market is still performing well, and that's perhaps proven most by the recent strike by the longshoremen along the east coast, which threatened to disrupt supply chains and cost the economy dearly. The strike was disruptive, and also audacious, as the workers were demanding a 77% rise in wages over the next six years, citing grievances about how they were treated during the pandemic. Such demands are rare in a poor labor market, and also bode poorly for inflation for two reasons. First, if such wage gains, or even substantially lower ones, are common across multiple industries, that's potentially a big contributor to inflation. And second, supply chain disruptions can cause inflation, which we experienced just a few years ago when Covid roiled the economy. Supply-side inflation is uniquely difficult for the Federal Reserve to respond to, because factories don't care if interest rates are at 0% or 10% if they don't have the parts that they need. Fortunately, the strike was resolved quickly, though the threat of another strike remains when the January deadline arrives.



CPI data shows that inflation has come down in goods but not services[vi]

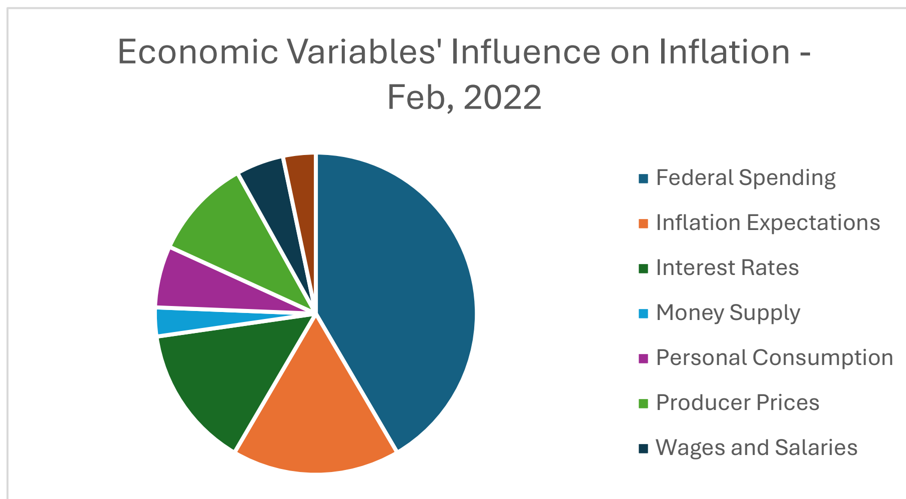
In the meantime, inflation has remained subdued, stuck around 3%. It's still above the Federal Reserve's 2% target but has stayed consistent in a relatively tight range. Goods inflation and energy have returned to normal levels and barely contribute to the overall number. Services inflation is most of what remains, especially when excluding energy prices, and is known to be slower to change – "stickier". And in the services component, over 60% of the price increases come from shelter inflation.

Shelter is measured through "owners' equivalent rent", which is a proxy for housing costs. They conduct a survey and ask homeowners what they would have to pay in rent if they wanted a similar property. As we know, home prices have remained elevated despite rising mortgage rates. Homeowners are simply keeping their existing mortgages, and it doesn't look like this will change soon. In fact, we are actively making the housing cost situation worse through various policies. Instead of creating new supply of houses through construction, we are adding demand from immigration. And now there's discussion of a $25k credit for new homebuyers. We did some advanced calculations and estimate that this will add roughly $25k to the price of any home on the market.

The college MIT recently published a study called "The Determinants of Inflation".[vii] They found that in the post-pandemic period "federal spending" was responsible for 42% of inflation. The next closest contributor was "inflation expectations" at 17%. This conflicts with the traditional explanation for inflation, which is growth in the money supply, also referred to as "M2". Their analysis attributed just 3% of contribution to M2. If this analysis is true, with federal

spending remaining high it's difficult to see inflation improving much more, and there is risk to the upside from supply chain disruptions or rising energy prices.

We remain optimistic about the economy, and see an environment that's likely to persist. But it's worth questioning what it would take for the economy to stumble. So far it's made it through high interest rates, multiple foreign conflicts, and a banking crisis. The localized geopolitical conflicts could intensify or expand. It's also possible that a dramatic stock market correction could cause economic hardship. Federal spending could get reduced, either through cost-cutting or out of necessity, if interest rates were to turn significantly higher. Finally, we don't expect any immediate economic impacts from the election, but a protracted legal battle debating the outcome could induce enough uncertainty to affect the economy.



A recent study at MIT analyzed the contributors to 2022's bout of inflation[viii]

Speaking of the election, it's currently projected to be a coin flip. That probably means that the outcome will be a divided government one way or the other, which is historically better for markets, because it leads to more conflict and fewer changes. Our economy tends to work best when we aren't constantly changing the laws. Trump and Harris differ in significant ways, but we don't see a big difference in how they will affect markets or the economy. They are likely to both continue spending money. Remember that Trump's victory in 2016 ushered in an impressive stock market rally. And the current administration presides over a market at all-time highs. Both administrations would likely be friendly enough to markets. Perhaps the one obvious exception would be the proposed tax on billionaires' unrealized gains, which has been floated by the Harris campaign. We believe this could have negative consequences for markets and the economy, which is a major reason why we don't think it will ultimately be seriously considered.

Preserve – Interest Rate Commentary

For the last nine months investors have been expecting a rate cut cycle to begin. This started in November of last year, when the Federal Reserve neglected to raise rates one final time. In the final two months of 2023, ten-year yields fell 1.25% as investors quickly adjusted for imminent rate cuts. This mentality took its most extreme form near at the end of December; investors expected six rate cuts by the end of 2024, including as early as March.

The story of 2024 has been the expectation of rate cuts in two to three months, but never arriving. Like the riddle "What's always coming but never arrives? Tomorrow," the Fed has consistently teased investors with the prospect of cutting rates, only to defer to the future due to economic strength and resilience in inflation. We are on the record saying that this would continue at least until at least November, as economic conditions stayed strong. We didn't think

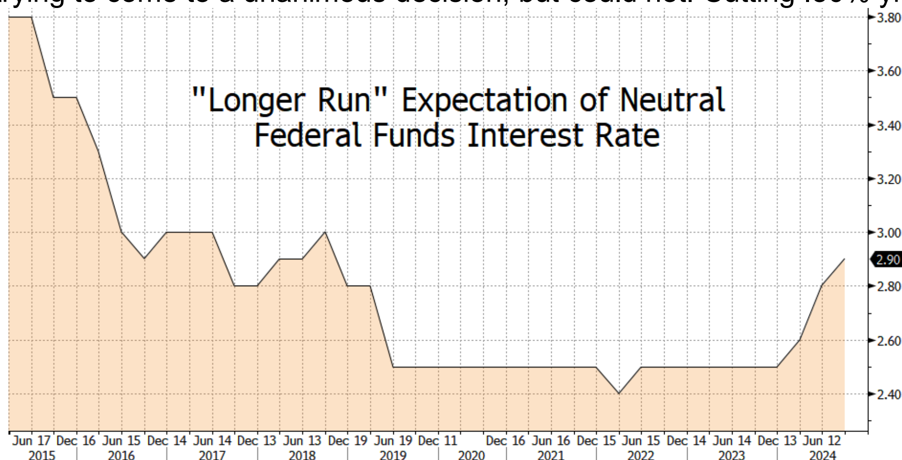
that the Fed would want to be seen as partisan by changing their policy shortly before the election, especially if the data continued to be relatively strong.

That prediction turned out to be wrong. Once the first rate cut got pushed out to September, it never got pushed out further. That's for a variety of reasons. The Sahm Rule getting triggered certainly drew some attention to the labor market. Marginal weakness in a variety of economic indicators gave the Fed some additional cover. A spike in stock volatility in August led to calls for a potential emergency rate cut. Complaints from politicians potentially made an impact – Elizabeth Warren was calling for as many as .75% in cuts leading up to September's meeting. But changes in the political climate might have actually been the reason. Stated simply, the Fed's decision either way wasn't going to be the story of the election season. That story is some combination of "Trump found guilty," "Supreme Court rules Trump can't be found guilty," "Biden bombs the debate," "Trump nearly assassinated," "Biden backs out of nomination, backs Harris," "Trump nearly assassinated again," and then likely something about the abrupt acceleration of hurricane season. In this world where truth is stranger than fiction, there was no room for something innocuous like interest rates.

(We write this as North Carolina and the surrounding area struggles in the wake of Hurricane Helene, and Florida braces for Hurricane Milton. We hope you and your families are safe and out of the path of these historic storms.)

So with the freedom to move interest rates if they wanted, the Federal Reserve decided to go with a .50% cut, taking rates down to 4.75%. It's notable that they started with a "jumbo" cut. Back in 2022 when they started raising rates, they started with an increase of .25% before eventually moving .75% at a time. Why did they feel the need to start big this time? The day before the decision, markets were still 50/50 about how large the cut would be. That's the most uncertainty that we have ever seen before a Fed decision. Usually the Fed will guide the markets in the weeks beforehand, or release the information through a surrogate such as the Wall Street Journal to avoid surprising markets. They didn't do it this time, and the only explanation is that they were still figuring it out – maybe just hours beforehand.

Last quarter we highlighted the level of agreement at the Fed. Specifically, that votes had been unanimous at 12-0 for years. This seemed strange, because when Fed members gave speeches they typically had very different outlooks for the economy and interest rates. This was the meeting where that tension was finally revealed. Our guess is that Powell was trying to come to a unanimous decision, but could not. Cutting .50% yielded one dissenting vote – the first since 2008. It's likely that a .25% cut would have yielded more than one dissent. So Powell went in whichever direction that would present the Fed members as more united.



The Fed's expectation for "longer run" interest rates has gradually increased[ix]

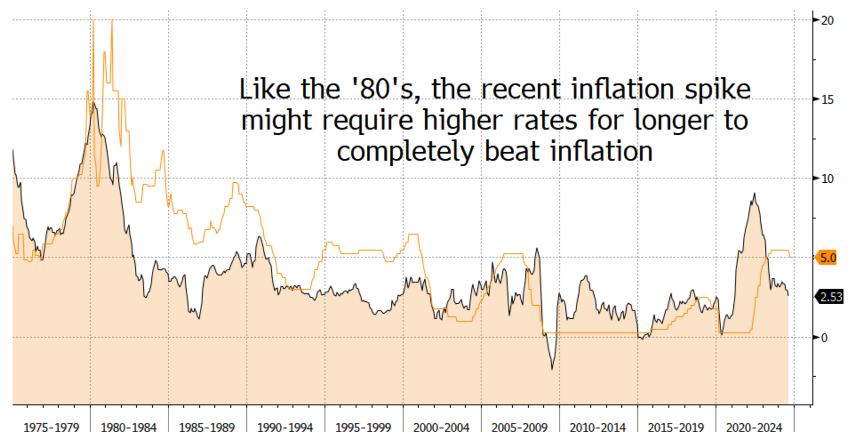
The Fed's "Summary of Economic Projections" (SEP) always receives a lot of attention. It shows the different Fed

members' projections for a variety of different economic measures. Specifically, we generally highlight the "Dot Plot," which shows where they expect interest rates to be at the end of each calendar year and in the "longer-run." While it's supposed to be treated as a prediction, and has a poor track record of being correct, the market typically treats it as gospel, a promise of what's to come. This is like trying to build a house using blueprints that aren't to scale – directionally probably pretty close, but not enough to be confident in the final product.

Regardless, let's take a look at what the Dot Plot says. The Fed thinks two more cuts are due before year end. With two meetings left, that's likely one .25% cut at each one. For 2025 they see another four cuts, then another two in 2026, bringing us down to 2.75%, which is also where they see rates remaining in the "longer run." 2.75% is where the Fed thinks we are not restrictive or stimulative – slightly higher than 2.4% where they projected it in 2021, but lower than 3.6% where they projected it in 2015. The important part is that it's 2.5% lower than 5.25% – the level where we've spent more than a year.

Investors can only come away with one interpretation: we're cutting rates, and we've got a long way to go. And bond markets have taken notice. The two-year yield fell from 4% to 3.5%. The ten-year yield fell from 4.4% to 3.6% during the quarter. This accounts for three more cuts before year-end (as opposed to two projected by the Fed) and eight more before the end of 2025 (as opposed to six projected by the Fed).

The average spread between the ten-year yield and two-year yield is 1%. The two-year and ten-year yield are currently at 4% - so the ten-year actually needs to go higher, to 5%, to get back to average. If we expect to go back to a typical yield curve, the two-year yield has already adjusted for nearly all of the rate cuts, and the ten-year yield has overshot to the downside and needs to move fairly substantially higher. And this is despite the fact that the Fed has only just begun cutting rates. The current level of the ten-year yield really doesn't make a lot of sense unless you expect a recession, which would force the Fed to cut substantially more than predicted. In a world of 3% inflation, a ten-year yield at 4% doesn't look attractive at all.



The Federal Funds Rate (orange) vs. Year-over-Year CPI (black)[x]

We have often compared today's response to high inflation to the story from the 80's. Forty years ago, inflation was way too high and the Federal Reserve Chairman Paul Volcker took dramatic actions that led to rates of 20%. Seeing inflation begin to relent, he soon lowered rates. This led to a resurgence of inflation that required rates to remain high for even longer. Eventually inflation was beaten down and the Federal Funds Rate was normalized, but not without significant economic damage. However Volcker is remembered fondly for taking action that was necessary, as the alternative potential damage from runaway inflation was mitigated.

Current Federal Reserve Chairman Jerome Powell invoked Volcker's name when he was asked if he would do what is needed to fight inflation, replying "I hope that history will record that the answer to your question is yes."[xi] Nevertheless, we are cautious about Powell's

current approach. Inflation has not gotten back to target, and he's now creating a wealth effect by lifting the values of stocks and bonds.

If inflation starts to move higher, there's a risk that higher rates will be required once again. But by signaling a path of rate cuts, it will require several data points for him to justify flipping his outlook. This could cause the Fed to fall behind, replaying the mistake from 2021 of calling inflation "transitory."

It's too early to make the call right now, but we are cautious about trusting the current trajectory of Fed policy. It's worth noting that gold has started rallying. It didn't rally during the Ukraine War or when the Middle East heated up. It's had just two periods of intense movement – one after the Fed signaled rate hikes were done, and another when it became apparent that rate cuts were coming soon. It's possible that gold is indicating that the Fed is making a mistake.

Earn – Bond Market Commentary

The bond market performed well in the third quarter. Bonds had disappointed investors leading up to the summer, as rate cuts kept getting pushed farther into the future. Patience has been rewarded, as interest rates finally moved meaningfully lower throughout the third quarter and the Federal Reserve finally delivered the first rate cuts.

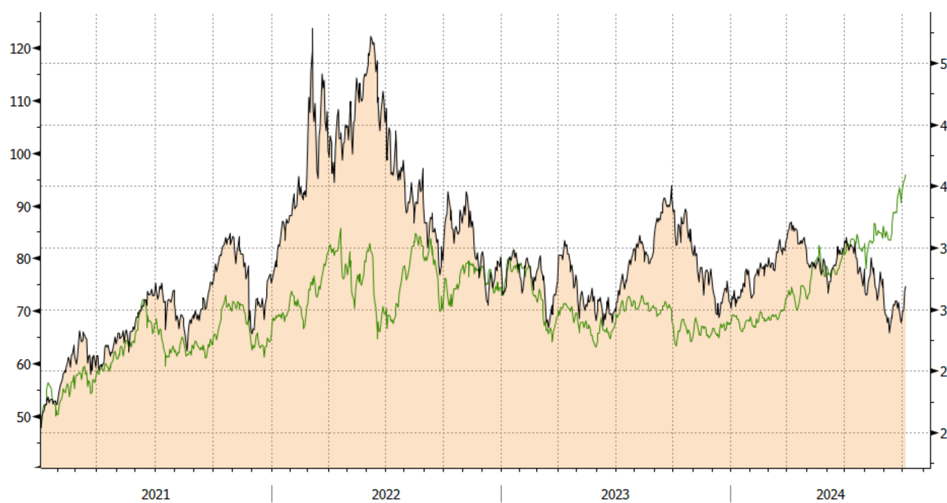
During the quarter bonds benefited from duration as interest rates fell, and also from credit risk. The spread between high yield bonds and similar bonds with no credit risk continues to narrow as investors pour in new money. The troubled sectors are well known, such as commercial real estate, while others are benefiting from a strong economy and the prospect of falling rates. This will allow them to borrow money at a lower price.

The Utility sector (Philadelphia Utility Index) had a great quarter as investors price future AI demand[xii]

Infrastructure such as real estate, pipelines, and utilities have rallied throughout the quarter for three main reasons. Falling rates are beneficial to them, not so much because they necessarily need to borrow money. Rather, investors compare the yield from infrastructure investments to the other alternatives out there. When rates are generally higher, these investments aren't as attractive. Separately, the Artificial Intelligence (AI) speculative boom has expanded outside of technology. The intense power demands of AI are becoming well known, and infrastructure investments will need to deliver those energy needs. Finally, existing infrastructure has become better appreciated because of the difficulty and cost of building it new. This is due to regulations as well as inflation. Ironically, if Vice President Harris were to win the election, we could see pipelines and similar infrastructure rise in price, even though she is expected to be comparatively harsher with

regulations. But under her administration it would also continue to be nearly impossible to get approvals for new projects, raising the value of existing infrastructure. It's noteworthy that infrastructure has had an outstanding quarter while oil has fallen in price for much of the summer when historically the two have been tightly correlated. For the past few years, pipelines have specifically focused on paying down debt to make themselves less exposed to the whims of the price of oil. That good choice is now paying off for investors.

Closed-end funds (CEFs) have performed excellently all year, but especially over the last few months as measured by the ISE High Income Index. In previous newsletters we highlighted activism, which continues to be a tailwind for funds priced at large discounts. The recent positive performance is caused more by the Goldilocks-type environment that we predicted earlier this year. The value of the funds has generally risen along with the bond market, and many of these funds benefit disproportionately due to leverage. Leverage costs are projected to fall along with interest rates. And money market funds are yielding less as they follow the path of interest rates; yield-hungry investors will be looking for alternatives, and CEFs have historically been a popular choice for them.



Pipeline CEFs (green) (TYG pictured here) have gradually stopped following the price of oil (black)[xiii]

Discounts for CEFs have closed by several percentage points during the quarter. As a reminder, discount tightening is essentially free performance. If a CEF's investments don't change in value, but the discount tightens, an investor will likely still see positive performance compared to their investment amount. The converse is also true – a widening discount is a penalty to the investor, unrelated to the underlying investments. Some CEFs have seen positive moves of 5% or more over the last three months – and that's not even considering the value gained from their investments! An index of CEFs shows a total return of 16.8% so far this year (ISE High Income Index), far above the Bloomberg Aggregate's return of 4.5%, and more than double the return of high yield bonds of 7.9% (iBoxx Liquid High Yield Index).

Flexible Income Portfolio (FIP)

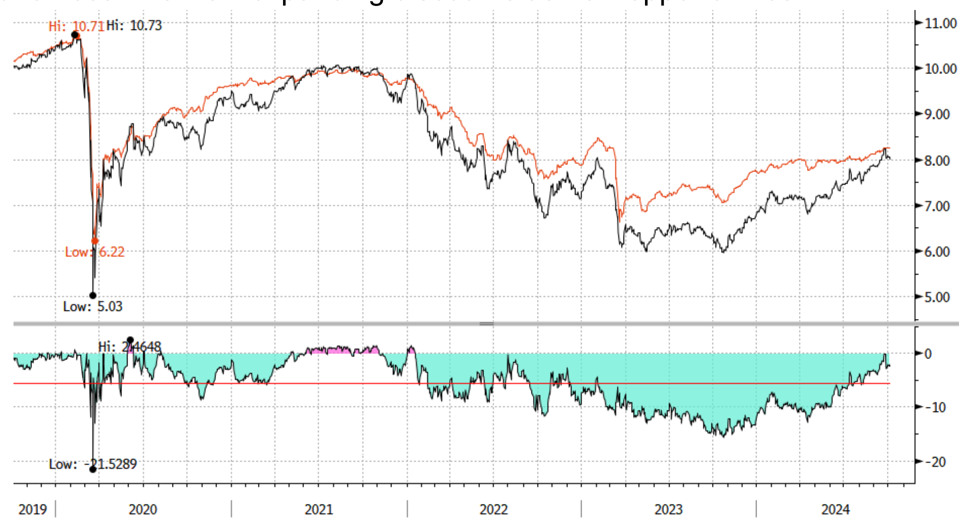
The Flexible Income Portfolio had an excellent quarter of performance. Contributions came from virtually every part of the portfolio as falling interest rates acted as a common tailwind.

Our generous allocation to infrastructure was the biggest contributor to performance. Activism has been especially active in this space. \We believe the double-digit discounts are attractive and increasingly rare. And as we discussed, infastructure investments have performed well in this environment.

Last year we increased our allocation to preferred stock, most of which is issued by banks. This sector got beaten up during the bank turbulence in March of 2023 as investors wondered whether other banks would fail. We increased our allocation after becoming comfortable with the fact that we believed the Federal Reserve had offered enough assistance to stabilize the situation. Preferred stock has been the best performer of bond-like investments following the crisis.

Our many investments in CEFs have fared well. While many CEFs have rallied and seen their discounts tighten, we screen and research individual funds to find opportunities which have uniquely high potential reward compared to the risk of the discount widening further. We tend to buy funds when their discounts are wider than average, exposing us to less risk from further losses from discounts. And we attempt to sell funds when their discounts are tighter than average, seeking to "lock in" the gains and move onto other opportunities. Because of this process, when discounts tighten, we typically benefit disproportionately. And when discounts expand, we typically suffer less. We view expanding discounts as new opportunities.

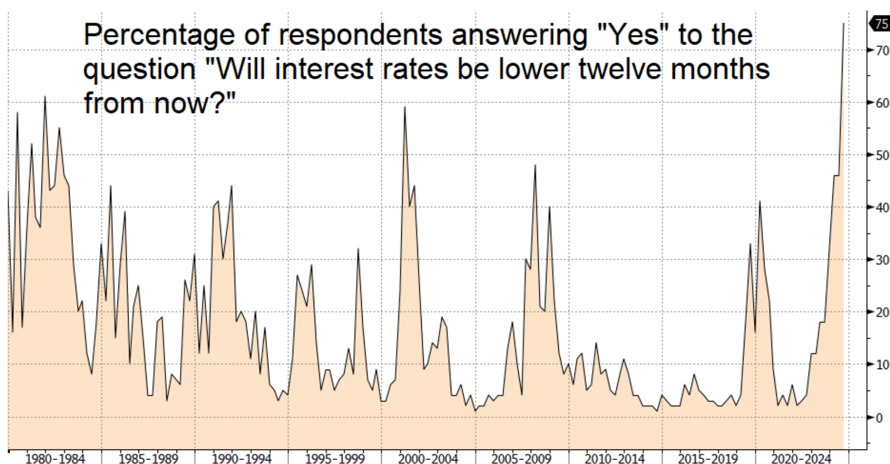
CEFs remain a niche part of the market where these idiosyncrasies and pseudo-arbitrage still exist, even though they are well known. The universe of CEFs is small enough that larger investment managers can't realize enough of a benefit to make a difference to their enormous amount of assets. At the same time, smaller investment managers are reticent to invest in personnel and other resources to track these unique investments on a full-time basis. We seek to position the portfolio so our research makes a noticeable difference to our performance, while also having enough assets under management to justify the significant investment in the strategy.



The difference (bottom, black) between a CEF's price (top, black) and its net asset value (top, orange) creates opportunities in FIP to buy or sell specific funds[xiv]

It's important to note that FIP is a constantly changing strategy because of this dynamic. The positive performance could continue in the short term if it's simply treated as a buy-and-hold portfolio. But over the long term the CEFs it holds potentially need to be rotated in order to realize the potential benefits of discount widening and tightening.

Looking forward, we intend to gradually reduce our allocation to the CEF structure for the time being. This isn't because we dislike the funds, but rather because we believe that better entry points will become available when the CEFs aren't trading at such narrow discounts. We are again reducing duration, as we expect that the ten-year yield is likely to move higher. Even though we expect the Fed will continue cutting the Federal Funds Rate, that doesn't mean that prevailing interest rates must follow them lower. Right now, 75% of the population think rates will move lower, higher than ever found before by this survey from the University of Michigan.[xv]



75% of the public thinks interest rates will do down in the next twelve months – higher than ever before measured by this survey[xvi]

Grow – Stock Market Commentary

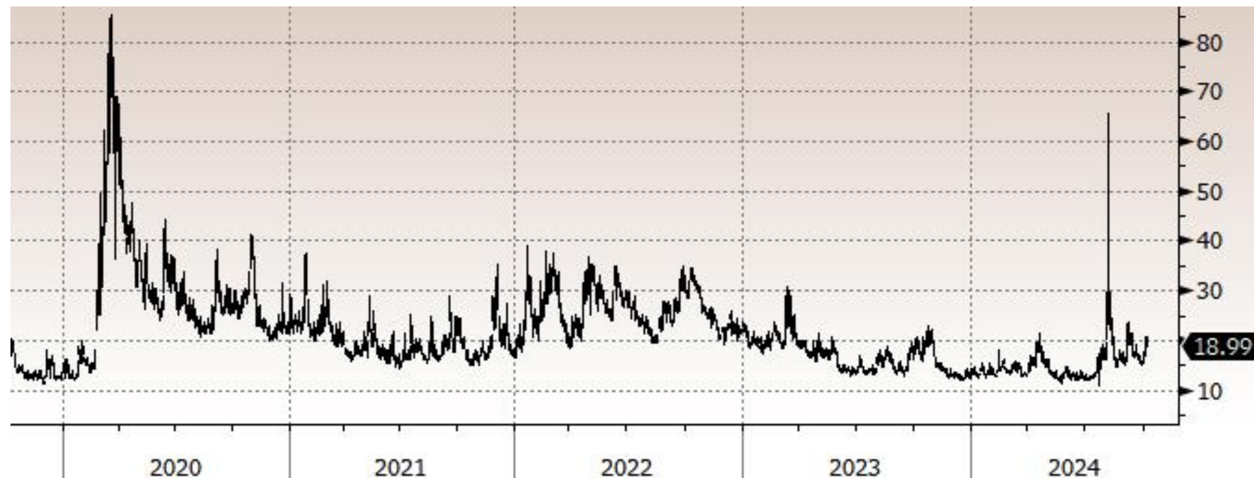
The stock market enjoyed another positive quarter. Mercifully, this time the gains were driven by more than just a few technology stocks. But the quarter was not without its drama. Stocks faced a situation in August which threatened Covid-like volatility. Unrelated to that, near the end of the quarter, China made some announcements which sent their market flying higher.

The "Yen Carry Trade" is the wonkiest event to threaten financial markets in recent memory. In many ways it's reminiscent of the events of Long-Term Capital Management (LTCM), a hedge fund filled with brilliant academics which blew up in 1998, requiring a bailout to avoid contagion to the rest of the financial system.

The general strategy LTCM employed was identifying historical relationships between prices. When these relationships got out of whack, they'd make a bet that the relationship would normalize. They used leverage to take small advantages and make them worthwhile trading strategies. This strategy broke down during the 1998 Russian financial crisis. The historical relationships did not normalize fast enough, and LTCM was forced to liquidate losses due to their leverage.[xvii]

The Yen Carry Trade is a leveraged trade that has been popular with hedge funds since 2013, but especially so in recent years. Hedge funds short (sell something they do not own, essentially creating a negative asset) the Japanese Yen and use the proceeds to buy something else. This is attractive because Japan's bonds yield very little due to government interventions. The proceeds can be used to buy currencies of other countries, which can then be used to buy those countries' bonds; Mexican bonds have been popular because their version of the Fed Funds Rate is over 10%. Since 2000 the Yen Carry Trade invested in Mexican Pesos has had better performance than the S&P 500.[xviii] Though it's been popular and well-known, no one knows the exact amount of money involved in the Yen Carry Trade overall because it's divided between many different parties.[xix]

The reason that the Yen is a popular target is that the Japanese central bank has been trying to keep interest rates low in order to spur inflation. Also, historically the Japanese central bank is extremely slow to change monetary policy. They'll tell you months ahead of time if they're going to make a change. But as Mark Twain is quoted as saying, "It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."



The CBOE Volatility Index spiked to levels last seen during Covid when the Bank of Japan raised interest rates[xx]

Things changed in August when the Japanese central bank raised interest rates by .25% to the great surprise of markets. All of a sudden the central bank which always telegraphed its every move was suddenly an unknown, and the price of the Japanese Yen rose quickly because of the decision. Many investors were suddenly looking at an unexpected large loss and needed to raise money elsewhere in order to get out of the trade. They also wanted to do so quickly because everyone expected it to get worse before it got better. Nearly every asset that portfolio managers owned was now considered for sale in order to raise cash.

As we began trading the morning of August fifth, there was concern that we might hit a market-wide circuit-breaker. These are rules for halting trading in extreme circumstances and begin at a 15-minute halt when stocks are down 7%. (March of 2020 was the first and last time these new circuit-breakers were triggered. The most notable "trading halt" was probably following 9/11 when exchanges closed for a week.) The VIX Index – also known as the Fear Index – spiked to levels we haven't seen since Covid.

Fortunately, fears of contagion were overblown. Undoubtedly some funds took major losses, but within a week the damage to stocks had been undone. Within two weeks the VIX Index had returned to normal. It is now two months later, and it was debatable whether it was even worth including in our newsletter.

This event serves as a good reminder of the risks of Black Swans. Risks can sometimes appear out of nowhere. While everyone's been sweating about Ukraine and the Middle East – and justifiably so – the most volatile day since mid-2020 was caused by a .25% hike in interest rates by a country on the other side of the world.

Separately, but also in Asia, China has made some big announcements. China's economy has suffered ever since emerging from lockdowns. Youth unemployment is at 19%. Real estate has been in a persistent crisis. And the economy is flagging enough to impact the price of oil worldwide. There's also the persistent headwind that other countries are trying to do less business there. Due to these and other factors, their stock market has been going the wrong direction since early 2021.

To give the economy a boost, in late September China announced details of a massive stimulus deal. It includes lowering interest rates, lowering bank reserve requirements, lowering mortgage rates for existing loans, and policy tools to support the stock market.[xxi] It's unclear what the effects on the economy will be. In the short-term it could obviously spur demand, but it's hard to know if it's anything more than a sugar high.

China (purple) has rallied a lot recently, but has a long way to go to catch up to the post-Covid performance of the United States (black) or the rest of the world (blue)[xxii]

For the stock market, which is supposed to forecast economic conditions for the next months or years, the effects were immediate. The Chinese stock market rose the most in the following week than it has over any other week in over a decade. Though the gains are impressive, there is still a lot of ground to make up to catch up to other indexes from the last few years. This current stock market performance probably shouldn't be seen as a guarantee of success, but instead as putting some probability on the outcome. If the stimulus is enough to reverse the problematic economic trends, the rally will likely continue. But if it turns out to be an ineffective strategy, the recent gains could easily disappear.

ETF Portfolio

It was a positive quarter for the ETF portfolio, similar to broad markets. The portfolio has performed favorably in this very bullish environment. The broadening of the rally is encouraging and helpful for the portfolio. While not a huge portion of the portfolio, our emerging markets holdings benefited from the rally in China.

Our holdings in nuclear-related stocks got a boost from recent news that the shuttered power plant at Three Mile Island will be reopened at the behest of Microsoft to fuel their data centers. This is another development from Artificial Intelligence, whose demands for electricity could require the country to more seriously look at alternative sources of energy.[xxiii]

We remain bullish for the time being as falling rates, a humming economy, and deficit spending serve as tailwinds. We are entering a seasonally difficult time of year, though in recent years the start of winter has actually seen excellent gains. It's possible that the election creates some volatility. But even with the drama in 2020 the market shrugged it off. (Though it would be dishonest to overlook the fact that the Covid vaccines were announced just days after the election.)

We see three likely paths forward for the economy and will watch the data closely to determine if one is playing out. The most bullish is the current path, where inflation stays low and rates can be lowered without incident. Alternatively, rates are lowered but inflation picks back up, to the point where the Fed has to reverse course. It's unclear where stocks might trade

in such a scenario. Finally, there’s a chance that the economic data weakens and the Fed must cut aggressively to mitigate damage from a recession. Even with rates falling, this would likely be the most bearish outcome.

Best regards,

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[i] Federal Reserve Bank of Atlanta
[ii] Federal Reserve Bank of Atlanta
[iii] https://www.whitehouse.gov/cea/written-materials/2024/09/26/revisions-show-us-economy-grew-faster-2021-23-boosting-real-incomes/
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[viii] Data from https://mitsloan.mit.edu/ideas-made-to-matter/federal-spending-was-responsible-2022-spike-inflation-research-shows
[ix] Data from Bloomberg
[x] Data from Bloomberg
[xi] https://www.nytimes.com/2022/03/14/business/economy/powell-fed-inflation-volcker.html
[xii] Data from Bloomberg
[xiii] Data from Bloomberg
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[xvi] Data from Bloomberg
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