HILLTOPBANK
Trust and Wealth Management

QUARTERLY MARKET INSIGHTS – THIRD QUARTER 2024

To the Clients and Friends of Hilltop Bank Wealth Management:

As we enter the final quarter of 2024, we have been treated to the third best start to a presidential election year for U.S. stocks, with the S&P up 22.1%, while U.S. aggregate bonds are up 4.5%. We now enter a new phase of the monetary policy cycle with the Fed commencing the descent stage of its attempted soft landing.

Thinking Like the Fed

When last I wrote to you in July, we speculated that the Fed might begin cutting rates at their September meeting. They did, in fact, take that opportunity and lowered the fed funds rate by half of a percent. The reasoning behind that move was twofold. First, inflation has drifted downward over the last few months at a pace the Fed is comfortable with. While it remains above their long-term goal of two percent, it is reasonably close enough that it has taken a back seat as a source of concern. The new primary concern is the job market, which has softened over the course of the year, and which they would prefer not to see soften much more.

As we know, along with price stability, the other side of the Fed's dual mandate is the goal of maximizing employment. Often, these two goals are at odds. In times of high inflation, the Fed will tighten monetary policy, which usually has the knock-on effect of increasing unemployment. When unemployment is high, they will loosen monetary policy, which can result in higher inflation. This cycle has been unique in that the inflation fight has not yet resulted in high unemployment.

For much of the post-pandemic period, we have seen ample job openings, with more than one job available for every person looking for work. While this remains true, the ratio has declined over the past few months to just about 1.1 vacancy for each job seeker. That suggests a labor market that is better in balance.

In addition to vacancies, we have also seen the percentage of jobholders quitting decline to pre-pandemic levels, as well as the percentage of job-seekers being hired. What was often called the "great resignation", where you could switch companies for an enticing pay bump, or to be allowed to work from home, looks well and truly over. On the other hand, what we have yet to see is significant layoffs, as firms are reluctant to let go of workers that they struggled to hire immediately post-lockdown. That would signal a much weaker jobs market, so the lack thereof is encouraging.

The unemployment rate has ticked up slightly in the last few months but remains historically in line with a level most would consider to be full-employment, 4.1%. As you may know, the unemployment rate is the result of not just how many jobs the economy adds, but also how quickly the labor force is growing. That is, if we add 150k jobs, but 200k new people begin looking for work, the unemployment rate will increase despite the growth in the overall number of people working. Rather than layoffs, it is this type of growth that has fueled much of the increase from post-pandemic unemployment lows below 3.5% to the current rate.

Taking all of this into consideration, the Fed likely sees a labor market that is cooling and is now lowering rates to try to arrest that cooling before it becomes too self-reinforcing.

The Fed, of course, is not the only actor in this play. In addition to the monetary policy lever, there is also a lever for fiscal policy, or how much the government spends to stimulate the economy. Since the pandemic, the US has been running substantial deficits to encourage growth, holding the fiscal policy lever wide open. The Congressional Budget Office, which are the folks in charge of projecting these things, believes the deficit will be $1.8 trillion in the year 2024.

I mention this mostly because the lack of any trend toward greater fiscal responsibility in the near term will impact the rate path the Fed embarks on. If the fiscal lever remains in a full-forward position, it tracks that the monetary lever will need to compensate by remaining more restrictive than it otherwise would. As of now, the average projections by the Fed show a Fed Funds rate at the end of next year between 3.25% and 3.5%. At the end of 2026, they expect a rate between 2.75% and 3.0%. Tax policy, spending policy, and regulatory policy could all change that path as well as the final destination. So too, could further weakness in the labor market or a resurgence of inflation. For now, economists expect the Fed to cut rates until employment growth is strong enough to absorb new entrants into the workforce, and once that has been accomplished turn its attention back to inflation if necessary.

Speaking of the fiscal lever, with the election a few short weeks away, I will reiterate the best advice I can give on trading around it, which is not to try. Most election experts (of which I am not) seem to think the race is a coin flip at this point. Even if we could accurately guess the winner, we have very little idea of which campaign promises they will be able to implement. Even if we could guess the winner and the policies, the consequences of those policies are unlikely to be known for quite some time after they are put in place. With all of those unknowns, my advice is simply to look through the noise of the election cycle. This is not to say that elections have no consequences, or that policy doesn't matter (more on this briefly). However, historically, the party in control of the lever has not been a good indicator for what the markets will do, which as always, is to fluctuate.

Notable Nobel Prize Winners

In addition to our immediate situation, I believe it's beneficial, from time to time, to consider our economy through a broader lens. For me, this exercise is not only valuable for providing context, but can help identify and challenge whatever priors I am consciously or unconsciously operating from. The recent award of the Nobel Prize for Economics provides just such an opportunity.

This year, the prize was presented to a trio of economists studying the importance of societal institutions for a country's prosperity. That is, they have attempted to explain why some countries have prospered, while others have not, and arrived at a theory that one of the factors is the political and economic systems that have been implemented. Societies that have developed inclusive systems, meaning they encourage participation by their citizens in economic activities that make the best use of their talents and skills, and enable individuals to make their own choices, have prospered. In contrast, countries that have tended to stay poor implement extractive systems, or systems that ignore human input, waste potential, and try to exploit resources like free labor.

Why is that of interest to us? First, in the modern world, we can place our investment capital in nearly any geographic location we like. For any major economy (and many minor ones) we could probably find an investment vehicle that specializes in it. Second, the vast majority of us are probably majority invested in vehicles focused on the United States.

While for many of us, this is just something we've always done, these economists' research suggests why that might have been a beneficial strategy over the past century or so. In addition to a strong rule of law and robust property rights, the United States has done a pretty good job at encouraging entrepreneurship and the development of human capital. While there will always be countervailing examples of exploitation and repression, the broad swath of this country's history has been one of innovation and participation. We don't get everything right, but the opportunities available to us by the happy accident of our being American, are immensely superior to those available to the majority of humanity. Therefore, we invest in the U.S. not just because it is home, but because it has provided an exceptional investment experience. An experience which it turns out may be due to the inclusive institutions we've inherited. Although we may not be the best performer in any given year, the overall track record is pretty strong.

Finally, as we enter the waning stages of this election year, and are inundated with messages about everything that is wrong with our country and our fellow Americans, I hope this note will encourage you to also increase the aperture of your lens, and appreciate everything this country has gotten right so far. Even if it has come by way of a quote we dubiously attribute to Winston Churchill: "Americans can always be trusted to do the right thing, once all other possibilities have been exhausted."

Best,

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