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From the Helm

OCTOBER 2024

01

THIRD QUARTER 2024 MARKET REVIEW

While there were a few fireworks during the third quarter of 2024, equity markets remained in the upward trend that we have seen all year. The quarter ended with 83% of stocks in the S&P 500 index in technical uptrends, a robust ratio to be sure. The bond market was the big story of the quarter, rallying by 5.6% after a rather middling first half of 2024. Interest rates fell precipitously on moderate economic weakness and the promise of a fresh Fed cutting cycle. As inflation and inflation-adjusted interest rates fell, beneficiaries were gold (up 13.0% during the quarter) and rate-sensitive sectors like REITs (up 16.7% during the quarter) and Utilities (up 19.2% during the quarter).

In this Issue

01 THIRD QUARTER 2024 MARKET REVIEW

02 FED MANIA: A NEW RATE CUTTING CYCLE HAS BEGUN

03 BULL IN A CHINA SHOP

04 ROTATION NOT RECESSION: OUR NEAR-TERM OUTLOOK

05 TAX UPDATE HEADING INTO ELECTIONS

06 REQUIRED MINIMUM DISTRIBUTION CLARIFICATION CERTAIN INHERITED IRAS

07 WELCOME NASH!

For the year-to-date period, the S&P 500 finished Q3 having risen by 21.5%, while the equally weighted S&P 500 rose by 14.6%. The Nasdaq 100 was up by 19.4% and, on the other end of the spectrum, small-cap stocks rose 10.9%. International stocks have had a relatively strong year, up 13.6%, with a recent exciting catalyst from the Chinese government. The bond market as measured by the Bloomberg Aggregate Index is up 4.4%, while gold has risen by 27.1%.

02

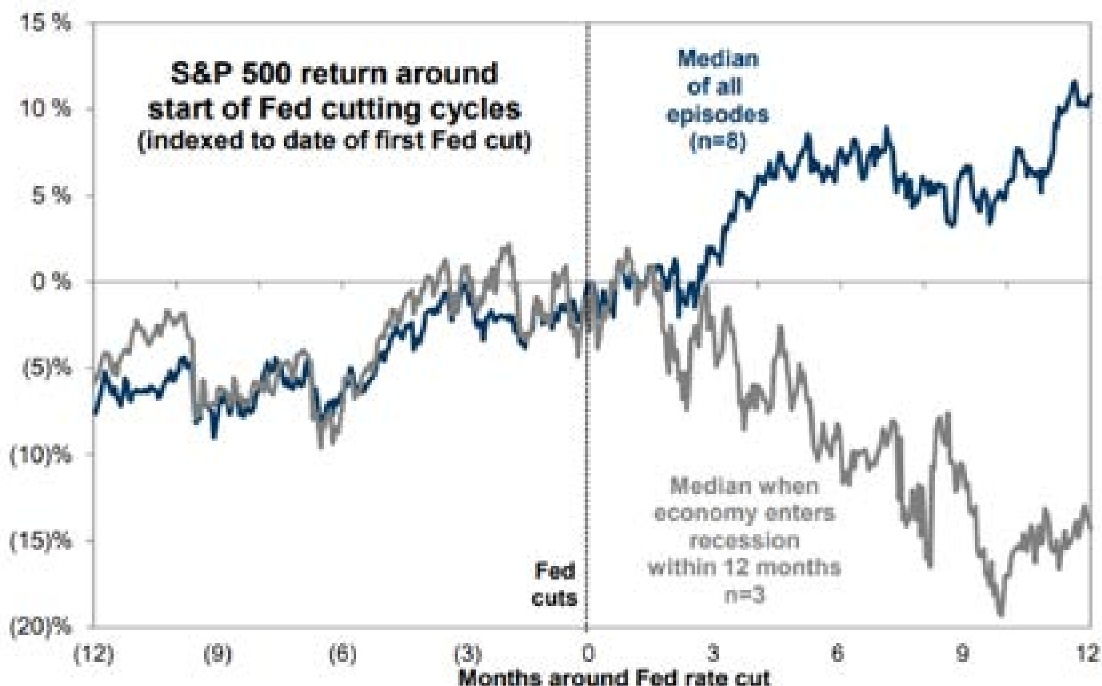
FED MANIA: A NEW RATE CUTTING CYCLE HAS BEGUN

"I don't see anything in the economy right now that suggests that the likelihood of a recession is elevated. You see growth at a solid rate, you see inflation coming down, and you see a labor market that is still at solid levels."
– Jerome Powell, Fed Chair, during September FOMC press conference.

After much hype, intrigue and a few leaks to a certain Wall Street Journal reporter, the Federal Reserve finally began a new interest rate cutting cycle. On September 18, Jay Powell announced a 50bps or 0.50% cut to a new range of 4.75%-5%, citing policy that was far too restrictive given the most recent inflation reading of 2.5% and a relatively significant move up in the unemployment rate, from a bottom of 3.6% to 4.2%.

There was little logic in the Fed keeping the Fed Funds rate (referred to as FFR) more than 2% higher than inflation. We believe that the economy's neutral rate is about 1% higher than the smoothed rate of inflation; in this case about 3.75%-4.25%. Today, the investment community appears to be pricing in too many cuts, which suggests that much of the move in bonds is behind us.

Historically, rate cuts precede recessions by six months. Cycles that kick off with larger, more unorthodox cuts, have always led to recession on a 12-month basis. Is it true that this time could be different? The answer hangs on whether the rise in the unemployment rate slows or stops, as supply and demand for labor finally finds a post-pandemic equilibrium, or if unemployment follows its usual, non-linear pattern higher after a cycle bottom.



When the Fed cuts interest rates and no recession materializes within 12 months, stocks rise by 21% on average. Today, based on economic data, it is likely that there is no recession ahead. U.S. GDP growth remains robust. While there is momentum behind the unemployment rate, at 4.2%, this is well within a historical, steady state median called NAIRU (non-accelerating inflation rate of unemployment).

According to famed Wall Street strategist Ed Yardeni, "The latest Fed policy decision lifted the odds of an outright melt-up in equity prices, ala 1999."

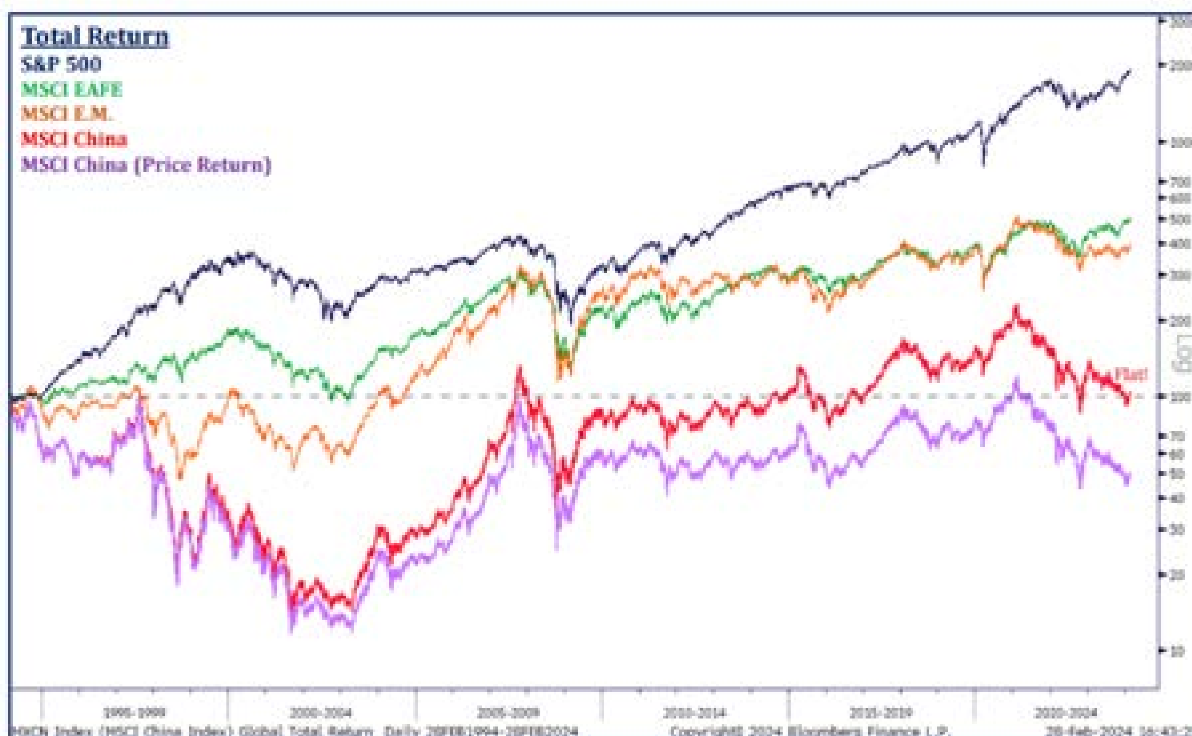
03

BULL IN A CHINA SHOP

The Chinese economy and markets have been mired in deflation and weakness for years. Covid hit China hard, and the country stayed "closed" for far longer than other large economies, driving a scarcity mentally amongst most of its citizens. The government famously grabbed power and data from the country's large technology companies in 2021, days before the heralded Ant Financial IPO. China is a country emerging from its own housing crisis and in desperate need of economic reform.

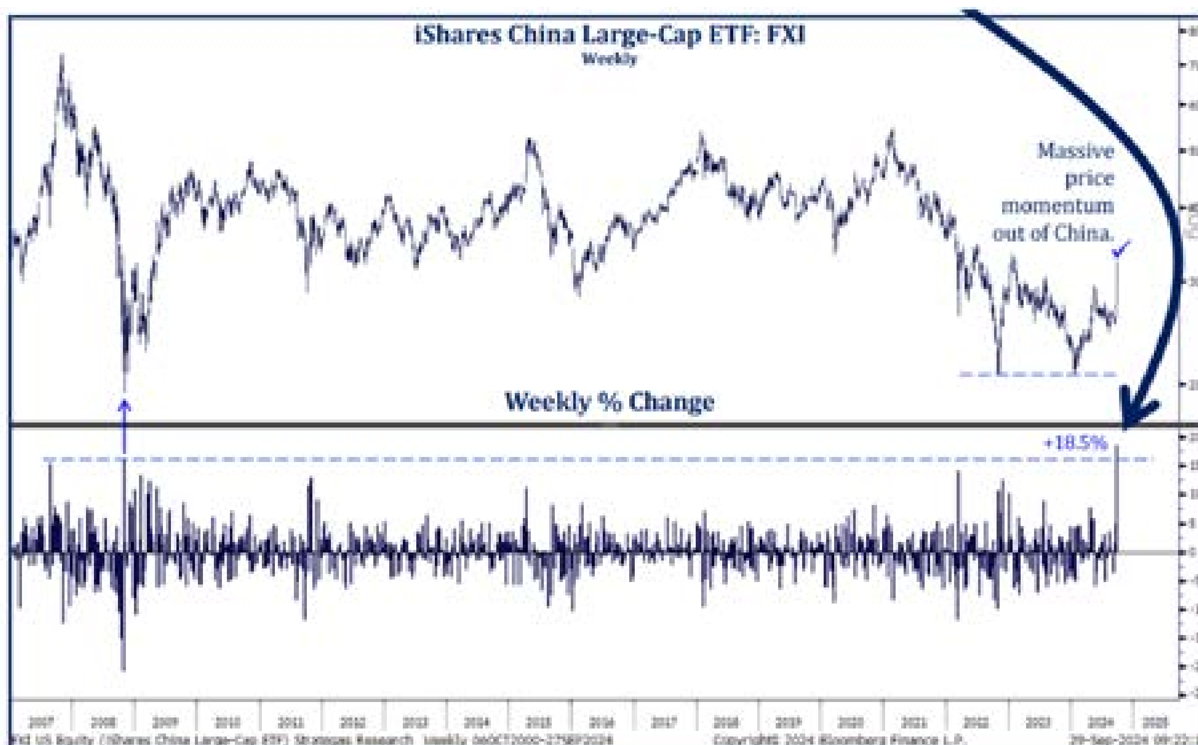
Close followers of the Chinese government guessed that some stimulus was likely to be delivered before 2024 was out, as economic metrics worsened month after month and youth unemployment recently surged to nearly 19%. Local governments had run out of money as land sales dried up and tax collections wilted away.

The bazooka that was delivered a few weeks ago surpassed all expectations and is reminiscent of the stimulus delivered during the Global Financial Crisis, underscoring mounting alarm over slowing growth and investor confidence. The stated commitment to stimulus equates to 3% of GDP. The market gave its approval, driving the best week of Chinese equity market performance in history.



Many of the easing measures target direct equity market intervention for the first time, providing at least $113bn of liquidity support. These loans include $71bn to help investors buy shares, and nearly $43bn to fund corporate share buy-backs. Interest rates were cut, and the PBOC supplied an injection of tier-1 capital for state banks. The amount of money that banks must hold in reserve was reduced to the lowest level since 2018. For the mortgage market, the PBOC effectively reduced the average mortgage rate by 0.50% and reduced the required downpayment to 15% from 25%. Further, the central bank will provide 100% financing for local governments to buy unsold homes.

Clearly the Chinese government recognized the need to jump-start the economy, and addressing the property crisis is a good first step. The stated stimulus measures also emphasized boosting employment. If the PBOC can restore confidence in the property market, which represents a significant portion of consumer wealth, and improve job security, consumers may begin to tap into their pandemic savings.



04

ROTATION NOT RECESSION: OUR NEAR-TERM OUTLOOK

After a 14-year, secular bull market, it is tempting to call the current market environment "late cycle," especially since the unemployment rate has risen from a cycle low of 3.6%. However, our team is considering the idea that the market might be in a mid-cycle environment.

We base this idea on the HOPE framework developed by Michael Kantrowitz at Piper Sandler. Various parts of the world and sectors have been in their own, mini recessions over the last few years. This has led

to desynchronized global growth. The current situation is more coordinated thanks to global central bank interest rate cuts (except for Japan), and the massive Chinese stimulus detailed above which is positive for Asia and Europe broadly.

Reasons why this market has more room to run:

- GDP growth for the second quarter of 2024 was 3%, and the Atlanta Fed's GDP estimate for the third quarter is for 3.1% growth.
- We have an easing Fed that is likely to end quantitative tightening in early 2025.
- This interest rate cycle should be positive for housing market transactions and mortgage refinancings.
- The global manufacturing cycle (as measured by ISM PMIs and LEIs) has been down in the dumps for years and currently sits at levels consistent with the manufacturing recession that we have been in. It is likely that these metrics improve from here, not worsen. Chinese stimulus magnifies the manufacturing cycle.
- We saw earnings contract in 2022 but expand since that period. Absent a major shock, it seems likely that corporate earnings will grind higher, achieving expanding profit margins. Much of this depends upon the trajectory for "Big Tech" and AI.
- The employment picture is amid a post-Covid normalization with job postings and demand coming down, labor participation rates improving, and unemployment rising modestly from unsustainable levels. Weekly unemployment claims, historically the best leading indicator, are relatively low.
- Absent a spike in geopolitical tension, oil prices are likely capped by OPEC's recent decision to increase production to gain back market share.
- No matter the outcome of the presidential election in November, our country's aggressive fiscal spending is likely here to stay.
- Lastly, we know that global liquidity should continue to rise for at least the next two quarters. This measure encompasses central bank liquidity, global IPO markets, debt issuance, etc. This is quite positive. On January 1st, the U.S. government will hit the debt ceiling and, if unresolved, the Treasury will have $700bn to inject directly via the TGA.

If a cyclical upswing is, indeed, more likely than the markets expect, the way to play this is via a market "broadening" playbook, i.e. buy everything that is not Big Tech.

We present this idea with a massive dose of humility as it represents the Wall Street consensus and, as Mark Twain famously said, "whenever you find yourself on the side of the majority, it is time to pause and reflect." Everything we've learned about business cycles was upended by the Covid pandemic, and the investing community is flying blind without relevant historical parallels.

05

TAX UPDATE HEADING INTO ELECTIONS

We are facing uncertainty in the tax area, based not only on the upcoming election this fall and the two presidential candidates' various tax proposals, but also due to certain provisions in the Tax Cuts and Jobs Act (TCJA) expiring at the end of 2025.Unless the expiring provisions are extended, there will be some changes in store. As a firm, we are closely watching and planning for the various scenarios of tax policy change so that we can continue to offer timely advice and planning. Once the results of the election are in, not only for the office of the President but also for the majorities in the House and Senate, they will determine the balance of power and affect tax policy and make the road forward much clearer. We will continue to assist you as developments unfold. Please feel free to contact us with any questions.

06

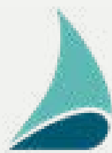
REQUIRED MINIMUM DISTRIBUTION CLARIFICATION CERTAIN INHERITED IRAS

Many had been waiting for IRS clarification to the earlier released IRS proposed regulations related to the SECURE ACT of 2019. The awaited clarification was specific to non-spousal inherited IRA accounts subject to the 10-year rule whose original owners died on or after January 1, 2020. Under the proposed regulations, with some exceptions, the RMDs from these inherited IRA accounts were required to be taken annually each year during a 10-year period after the original owner's death. The IRS has previously granted relief and waived the 10-year rule for annual RMDs for 2021, 2022, 2023, and 2024. Starting in 2025, the final regulations released in July require that annual RMDs are a requirement each year over the 10-year period. The account needs to be totally depleted by the end of the 10th year. Starting in 2025, if a required RMD was supposed to be taken and is not, penalties will be assessed.

07

WELCOME NASH!

Nash Davies recently joined the Fiduciary Tax group as a Tax Associate. He was previously a staff accountant at a local accounting firm, preparing tax returns and performing audits. Nash lives in Fairfield with his wife and daughter.



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