The Carl / Timpone Group
at
Morgan Stanley

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The Serious Investor's Guide

Market Trends and Interest Rates

In our annual "Serious Investors Guides" from 2018 through 2020, we talked about the difficulties of dealing with the enormous debt we have built up as a nation, especially with the $8 trillion bailout during the pandemic. It appeared obvious to us that inflation was going to grow significantly and that interest rates would ultimately have to rise considerably in the future. In our eyes, there was no way this huge fiscal stimulus that was instituted during the global pandemic was going to end without the world experiencing some renewed levels of inflation.

Most of this above average inflation would be temporary or transient, as Fed Chairperson Jerome Powell had said back in 2020. This was due to the bottlenecks and supply chain shocks coming from the severe shut down of the world economies, the fast recovery from all this stimulus around the world and the corresponding demand for products and services from people getting back to work. But unfortunately, some of the inflation may linger because of the amount of unproductive fiscal spending going on around the world for renewed remilitarization, cleaning the environment and potential shortages in certain commodities.

Thomas A. Carl
Managing Director-Wealth Management
Senior Portfolio Management Director
Financial Advisor
Tel: (201) 967-6323
Toll Free: (800) 526-0829
Fax: (201) 262-3761
thomas.a.carl@ms.com

The Carl / Timpone Group
61 South Paramus Road
3rd Floor
Paramus NJ 07652

Edward C. Timpone
Executive Director
Senior Portfolio Management Director
Family Wealth Director
Financial Advisor
Tel: (201) 967-6349
Toll Free: (800) 526-0829
Fax: (201) 262-3761
edward.timpone@ms.com

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In light of all the inflation that we have been living through, the Federal Reserve Board has raised interest rates dramatically at a record pace—going from the federal funds rate of .25% to 5.5% in 16 months (from March of 2022 to July of 2023). These higher short-term interest rates caused banks to raise mortgage rates from as low as 2.6% to 8% by October 2023. Since then, the Fed has seen a big drop in inflation from a peak of 9% to a current rate of 2.5% and hence*, they have signaled that they are done raising rates and they would ultimately focus on lowering the federal funds rate.

On September 18, 2024, the Fed lowered the federal funds rate down .5% to 5% from 5.5% to help offset the somewhat fragile job market outlook. For now, the Fed seems much more focused on getting short-term interest rates back down to the neutral rate of around 3% because the unemployment rate has risen quite a bit (from 3.4% to 4.2%)*, which could indicate an economic slowdown or recession may be brewing in the next year or so.

Total U.S. job openings has decreased from a peak of 12.18 million jobs to the current level of 7.67 million jobs (or a 37% drop since March of 2022)*. This, combined with the lower level of inflation has caused the Fed to be more concerned about the economy and jobs, and they therefore feel the need to reduce lending rates for consumers and businesses alike. At the end of this easing cycle, the Fed wants to de-invert the yield curve which makes short-term rates lower than long-term rates, as is normally the case. This will help the overall economy, and our banks become more profitable, which will free up some additional capital to lend to businesses and individuals. The Fed's official dual mandate is to have stable prices and maximum employment, and since it now appears that price stability has been achieved at least for the moment, the Fed can now attempt to strengthen the job market.

* Source: Bloomberg

The Carl / Timpone Group

Thomas A. Carl
Managing Director- Wealth Management
Senior Portfolio Management Director
Financial Advisor

Edward C. Timpone
Executive Director
Senior Portfolio Management Director
Family Wealth Director
Financial Advisor

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The stock market has benefited by all the fiscal spending and excess liquidity that has arisen from this enormous stimulus. The residential real estate market has also benefitted from employees now being able to work from home, and since most homeowners do not want to give up their 3% mortgages to now pay 6.5 or 7% rates on a higher priced new home. This has led to a temporary decrease in supply and higher values in most homes across the country. The wealth effect has been keeping the U.S. economy moving forward, and since the pandemic has ended, people have shifted their spending from mostly goods, to travel and other services. This spending may be beginning to slow down as excess savings have been exhausted, and credit card debt has risen significantly with much higher interest rates (in some cases over 30%).

The higher inflation, higher interest rates, lower excess savings and higher personal credit card debt is hurting the middle and working-class consumers to a large degree. However, higher stock prices and real estate values have offset these to some extent. Our hope is that inflation stays subdued now, and that the Fed can engineer a soft landing for the U.S. economy. If not, things could get very difficult for the job market and stock market in the months and years ahead.

The U.S. Presidential election, the wars in Ukraine and Israel, and our tenuous relationship with China are all big potential problems for the world economy and international stock markets. Although the S&P 500 index has been hitting all-time highs recently, this index is still so heavily dominated by the mega-cap tech stocks or magnificent seven companies, which currently account for 31% of the S&P 500 stock index and a large portion of the performance this year. The other 493 stocks account for 69% of this index*. These tech stocks, due to the exciting components of Artificial Intelligence (AI), have led to another speculative burst of momentum causing a little too much exuberance that we feel will ultimately die down and hurt these holdings. As money flows out of these expensive stocks, we believe those investors that hold companies that are undervalued and make good financial sense to own, will benefit in a substantial way. Our focus is investing in a diversified portfolio of companies that are priced incorrectly, selling at a discount to their private market values, and holding them until the value gets recognized through some future catalyst. We are patient long-term investors, and we believe strongly that value investing over the next 5 to 7 years should outperform growth or momentum investing. Although the road may not always be smooth, we look forward to a good period ahead for our approach.

* Source: Bloomberg

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Family Wealth Director
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