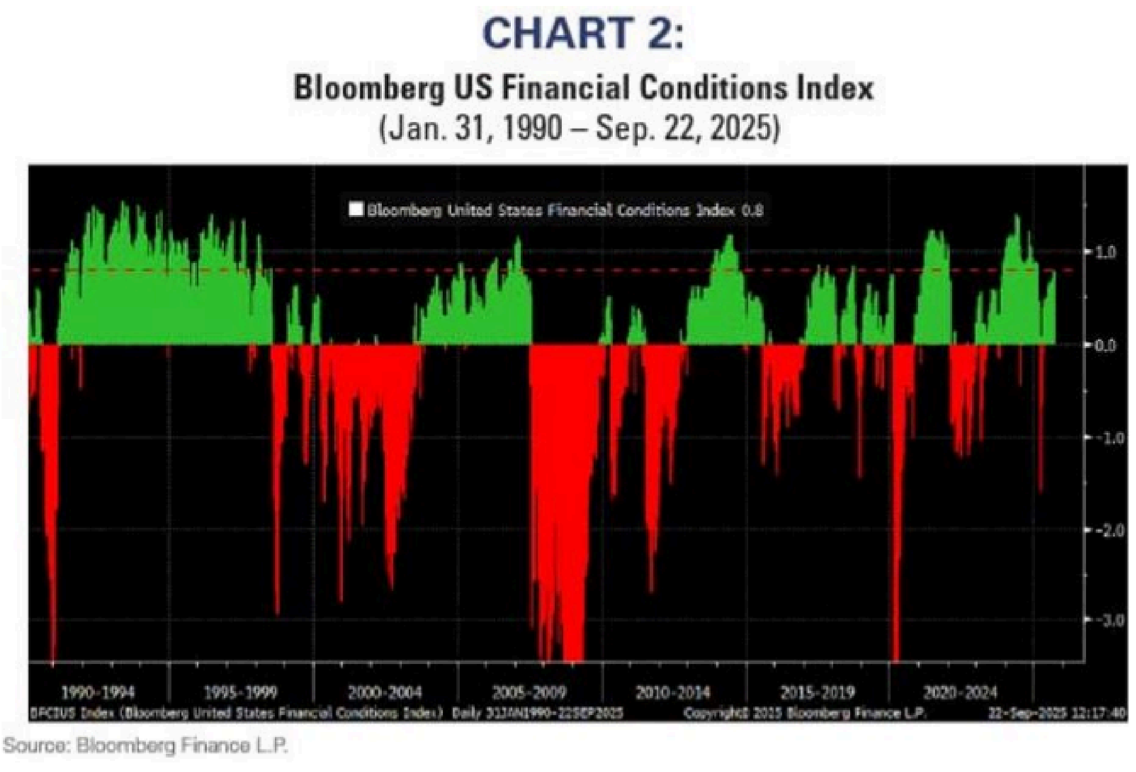
Our apologies for the delay in getting this month's e-mail out. We wrote this on Monday the 6h of October, but the approval process took longer than normal this month.

As you likely noticed when you received your September statement or checked your balance online, September produced robust returns for both stocks and bonds. As the markets became more certain the Fed was resuming rate cuts, returns increased in concert. The S&P 500, Dow Jones Industrial Average and NASDAQ Composite indices rose 3.6 percent, 2.0 percent and 5.7 percent respectively. Small and mid-cap stocks also rallied with the Russell Midcap up 0.9 percent and the Russell 2000 gaining 3.1 percent. The US bond markets rose as well with the Bloomberg US Aggregate Bond index increasing 1.1 percent for the month and the Bloomberg US Municipal Index gaining 2.3 percent.

Our team is getting more concerned about valuations– especially on the big tech stocks. It's also true that the Fed is cutting when inflation is above their target and financial conditions are already relatively loose.



Source

As Morgan Stanley pointed out in this month's On The Markets, "as has been the case for much of the year, valuations have not been an impediment. They continue to be stretched, with an S&P 500 forward price/earnings ratio of 23 and the "Buffet indicator" (total market cap relative to GDP) at 232%."

Here's a good article explaining the Buffett Indicator. It's never been a good sign it gets as high as it is today. That said, like Richard Bernstein at RBA advisors who released an excellent piece called "Watch the Fed" on September 29th, we see 4 potential paths forward from here. In fact, we think it's fair to say these four bullets approximately summarize the full range of views currently in the financial press.

1. The possibility that inflation isn't dead and employment isn't waning. The Fed might have to go on hold or even reverse course and raise rates. This is the worst-case scenario for financial markets fueled by liquidity and speculation, but might be good for the relative performance of value, dividends, non-technology quality, and more broadly diversified portfolios.
2. The possibility that employment is much worse than expected and a series of large rate cuts ensue. This isn't a particularly good scenario either because it implies the economy and earnings are demonstrably weaker than consensus forecasts. Defensive sectors would likely outperform in this environment.
3. The Fed's rate cuts are very timely, and the economy reaccelerates without much inflation. This would result in a broadening of the market in a very healthy way.
4. The Fed adds unnecessary liquidity to the financial markets and speculation runs rampant. This might be fun for some investors in the short-term, but it could create serious misallocations within the economy and add to significant future inflation

So which camp are we in on our team? Option 3 is our preferred narrative. While we predicted August and September CPI would be high in these notes, there's already evidence it will cool in Ocotober. We still believe the bump in CPI was more of a one-time tariff pop than a move to a persistently higher inflation regime. The Cleveland Fed's Inflation Nowcast Indicator for October is back down to 0.24 percent, something like a 2.8 percent annualized rate (September annualized was 4.6 percent). Conversely, The Atlanta Fed's GDP nowcast for the 3rd quarter rests now at just shy of 4 percent – very robust growth. If the Atlanta Fed is correct, markets will be surprised by the robust 3rd quarter growth and likely by a positive earnings season.

What do we fear? Option 4 – but not because it will produce immediately bad returns for clients so much as cause our diversified approach to relatively underperform the speculators for a time. There a non-zero chance that the Fed cutting rates exacerbates speculative behavior and distorts capital allocations. To be fair, Morgan Stanley's GIC is more concerned about possibility 1 than we are on our team. The financial press has focused mostly on possibility 2, especially this last week or two, as the government shut-down furloughed about 750,000 employees; but we see very little evidence of possibility 2 save some indications that consumer credit is rolling over partly as a consequence of the resumption of student loan payments and the corresponding hit to credit scores.

While we do think the AI Capex boom may be a bubble in some sense, we are not persuaded it's over yet either. We think the underlying economy is sound and that the median stock – or average stock on a per capita basis – remains reasonably priced. Opportunities in small and mid-stocks as well as international and emerging market stocks abound. It's easy find fast-growing companies at much cheaper prices than the market-cap weighted indices overall or the US tech sector particularly. Furthermore, to the degree that an AI bubble were to burst, most of the speculation is taking place in a very narrow group of stocks and cryptocurrencies – so diversified portfolios may provide a better than average buffer against volatility during a market correction just as they did earlier this year during the Liberation Day sell off.

Succinctly said, out team remains cautiously optimistic we can continue to deliver good risk-adjusted returns on diversified portfolios. Bonds still look attractive to us at current yields. Stock indices look very expensive, but the average stock does not. We plan to continue to hedge against a weakening dollar and to bet that the Fed will continue rate cuts as the economy provides decent growth and moderating – but higher than would be preferred – inflation.

As always, if you have any questions or concerns, please don't hesitate to let any member of the team know.

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