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Market Outlook & Strategy

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Executive Summary

- **Q3 2024**. Despite some volatility, it was another strong quarter for markets as Fed rate cuts and strong corporate earnings helped squash any uncertainty about future economic growth. The U.S. market rose by +6.2% and is now up +20.6% for the year.

- Value stocks (+9.4%) strongly outperformed growth stocks this quarter (+3.1%) as did small companies' stocks relative to large. The quarter also saw a healthy broadening of the market as investors continued to rotate away from technology and into smaller sectors such as utilities and industrials.

- International developed markets recorded quarterly gains of +7.8%, outperforming the U.S. market. This performance was driven by declining inflation and ongoing rate cuts in the Eurozone. Emerging markets also delivered strong returns in Q3 (+8.7%).

- As for fixed income, the leading benchmark for bonds (Barclays U.S. Aggregate Bond Index) realized a +5.2% return for the quarter. A Fed rate cut and indications of slower U.S. inflation led to falling yields and provided some appreciation for bonds.

- In this report, we take a closer look at the potential trajectory of bond returns and argue that bonds may do better in the years ahead. Changing supply and demand dynamics for bonds are the key drivers. On the supply side, the growing federal debt and private sector investment needs for AI and the energy transition will increase bond issuance and likely to force higher interest rates to ensure adequate demand. On the demand side, there is the impact of developed countries moving from aging to aged societies, which tends to lessen the demand for bonds as folks use up their savings in their later years. In addition, China has shown less appetite to purchase U.S. Treasuries of late.

- **Artemis Strategy**. We are currently taking a hard look at all of our clients' bond allocations, reviewing clients' current and prospective portfolio drawdown needs and, in some cases, reassessing risk tolerance and tax status. As for equities, we continue to favor the U.S. over international markets, although most of our underweight is in developed international markets (e.g., Europe) rather than emerging markets. We also remain very balanced between growth and value in the U.S. and have a healthy allocation to smaller company stocks, which are showing some nice signs of life of late.

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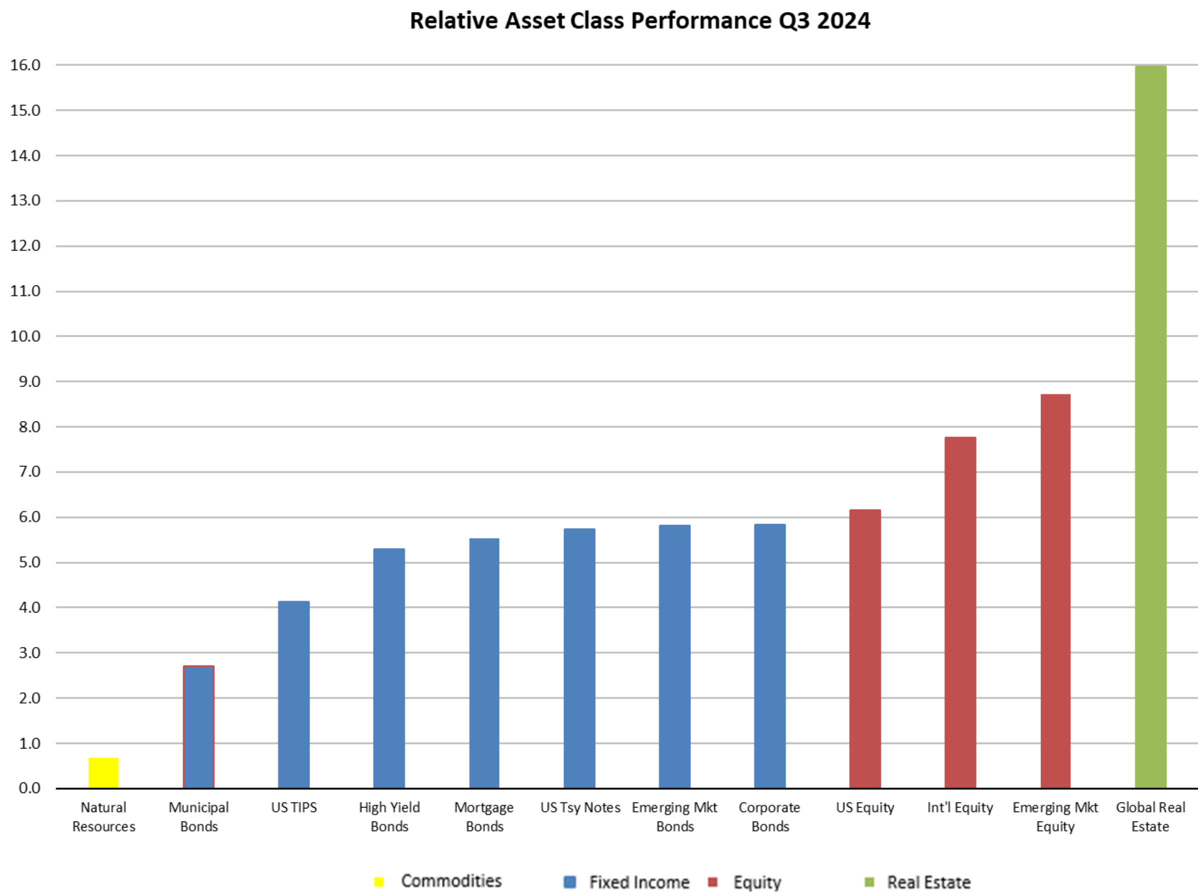
Markets in Review – Q3 2024

Despite some volatility, it was another strong quarter for markets as Fed rate cuts and strong corporate earnings helped squash any uncertainty about future economic growth. The U.S. market rose by +6.2% and is now up +20.6% for the year. See Figure 1. Value stocks (+9.4%) strongly outperformed growth stocks (+3.1%) this quarter as did small companies' stocks relative to large. This quarter also saw a healthy broadening of the market as investors continued to rotate away from tech and into smaller sectors such as utilities and industrials. The rotation was driven by profit-taking after the significant AI-fueled rally and a sharper-than-expected drop in inflation.

Figure 1. Asset Class Returns in USD for Q3 2024(%)



International developed markets recorded impressive quarterly gains of +7.8%, outperforming the U.S. market. This performance was driven by declining inflation and ongoing rate cuts in the Eurozone. However, economic indicators are signaling a potential slowdown in future growth. Similar to the U.S., a sector rotation away from technology stocks occurred globally. Emerging markets also delivered strong positive returns in Q3 (+8.7%) and solidly outperformed the U.S., largely due to monetary stimulus measures announced in China, which investors expect to spur stronger growth.

In terms of real assets, commodities were mixed as metals and agriculture gained while energy had a sharp decline as global demand weakened. Real estate had a strong quarter, largely due to rate cuts as this asset class tends to outperform when bond yields are falling.

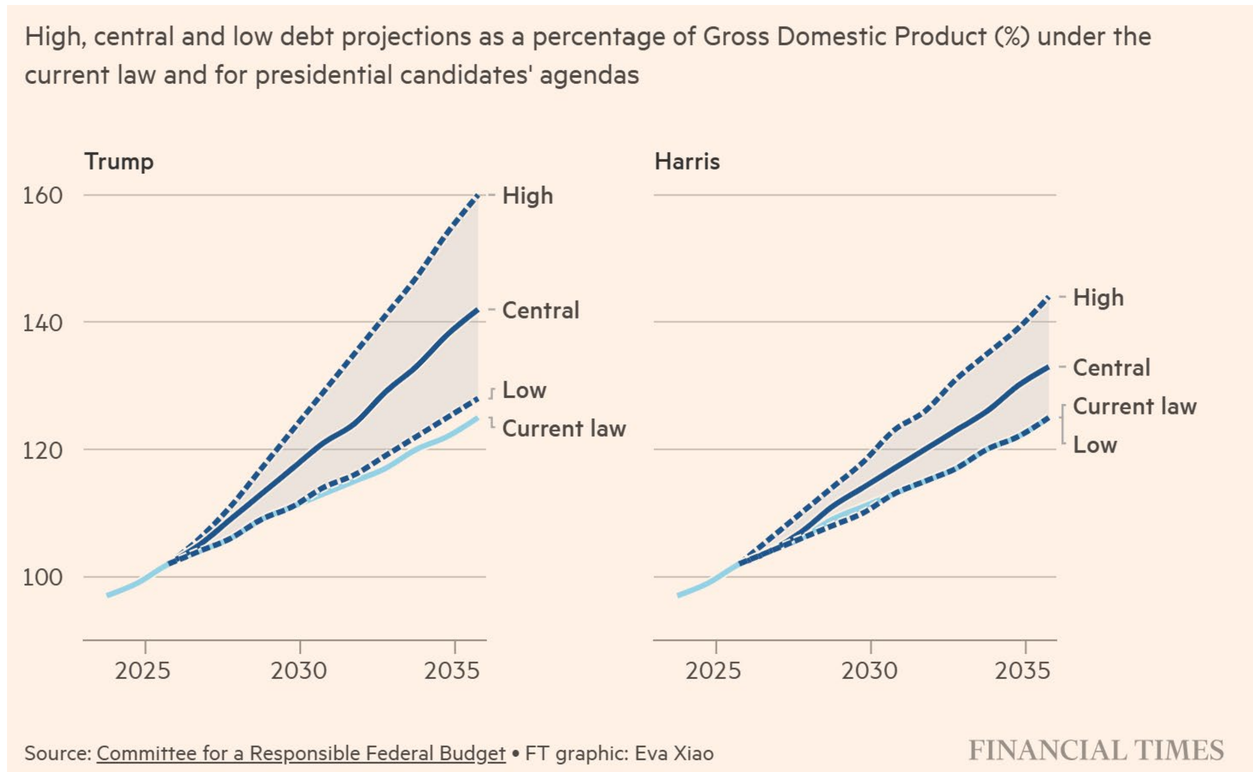
As for fixed income, the leading benchmark for bonds (Barclays U.S. Aggregate Bond Index) realized a positive return (+5.2%) for the quarter. A Fed rate cut and indications of slower U.S. inflation led to falling yields and provided some appreciation for bonds.

Rethinking Bond Allocations

With the Presidential election just around the corner, we are getting a lot of questions as to the economic and market consequences of Donald Trump or Kamala Harris winning the White House. This is a tough question because we also don't know which party, if any, is going to control Congress. However, based on what both candidates are saying, experts are estimating that the U.S. federal debt is destined to increase over the next decade, much more so under a Trump presidency according to recent estimates. See Figure 2.

Why does this matter for markets? As investment managers, one of our most fundamental tasks is helping clients decide what mix of stocks and bonds is appropriate for them. As such, we need to take a view on prospective equity and bond returns to help set an appropriate mix. There are several reasons why we think bond returns (best estimated by their current yield), will offer better value for the lower risks associated with owning them in the coming years, and the level of the U.S. federal debt is one of them.

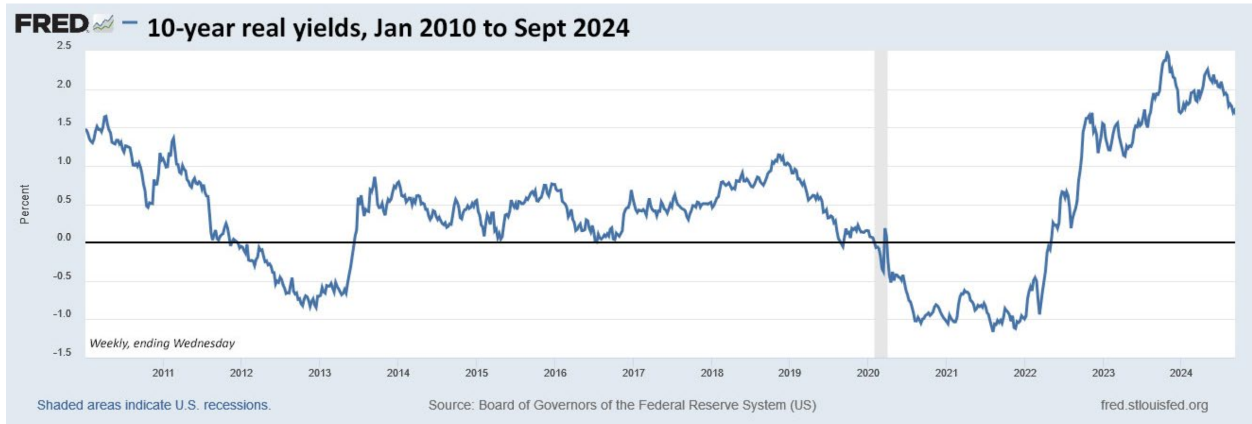
Figure 2. Projected Debt as a Percentage of U.S. GDP by Candidate



To finance the current and rising federal debt, the U.S. Treasury has to borrow the money and does so by issuing bonds. The more bonds it issues, the higher the yield it must offer to entice investors to purchase them. An increase in demand can lessen the need to increase yield.) Over the last 20 or so years, there has been plenty of demand for U.S. Treasuries from China and other countries that run large trade surpluses. The massive amount of dollars these countries have earned from exporting to the U.S. have needed to be put somewhere, and U.S. Treasuries filled the void. So much so that since at least the Great Financial Crisis, the U.S. Treasury has not had to offer much in the way of yield to entice these buyers. See Figure 3. This is why most investment managers have been underweight U.S. Treasuries in their clients' portfolios until very recently.

Figure 3 also shows us that real yields have been on the rise of late, largely due to declining inflation and central banks favoring higher interest rates. This is only now starting to change, but even in the face of steadily declining inflation and the Fed's recent action of reducing short-term interest rates, longer term interest rates are staying high. Indeed, following the Fed's action in September of reducing short-term rates by 0.5%, the yield on 10-year Treasuries actually increased from ~3.7% to just over 4%.

Figure 3. Real Interest Rates on U.S. 10-year Treasuries: 2010-2024



Note: Real interest rates equal nominal interest rates less inflation.

There are several additional factors that may be driving this increase and reasons why nominal (and real) interest rates on longer-dated bonds may stay high or even go higher. One is the big investment needs for AI and for energy transition, which companies are going to need to borrow in part to finance. Global turmoil and regional wars are also going to need to be funded, as well as the social safety net needs (e.g., Social Security and Medicare in the U.S.) of an increasing aged population.

On the demand side, many developed countries are moving from aging to aged societies, which tends to lessen the demand for bonds as folks use up their savings in their later years. And finally, the preference of exporters to the U.S. to hold a lot of their earnings in U.S. bonds, which depressed Treasury yields over the last decade, may be waning. A worrying trend is that foreign holdings of U.S. Treasuries have decreased as a percentage of U.S. GDP in the past few years. See Figure 4.

Figure 4: Foreign Holdings of U.S. Treasuries Relative to U.S. GDP

Investment Implications

With bonds now sporting yields of 4-5% (and real yields of 1-2%), they are starting to offer greater value to portfolios than they have in some time, both in their typical role as a diversifier but also as a source of returns. To back this up, Vanguard's chief economist recently published some research that examines historical equity and bond market returns in the U.S. in different interest rate regimes since 1984.[1] As Figure 5 shows, in what is classified as high interest rate environments, they discover that 10-year ahead actual returns for global stocks and bonds were similar at just over 7% annualized. But stock returns were four times more volatile than those of bonds during these periods. Because bonds offered the same returns for lower risk, their performance relative to equities was particularly attractive on a risk-adjusted basis. In contrast, only in low interest rate environments did equities notably outperform bonds.

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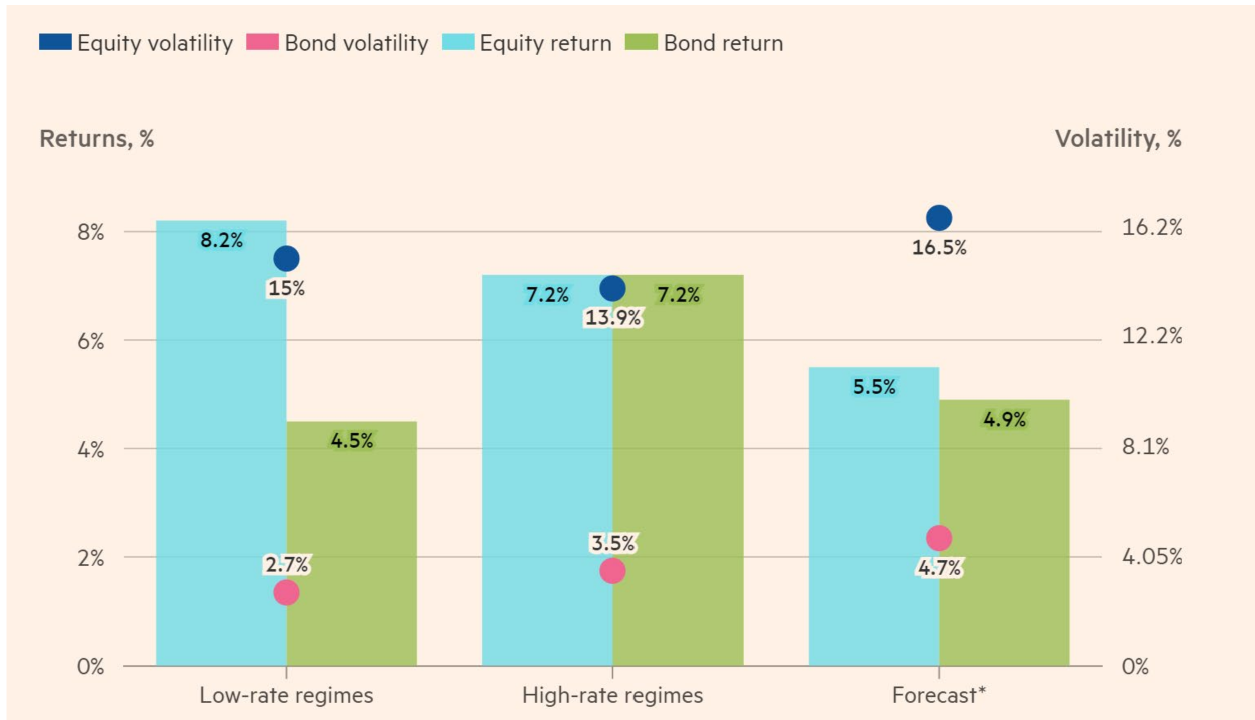
[1] Saleheen, Jumana. "It's Time to Tilt Portfolios More Into Bonds." *Financial Times*. August 30, 2024

Figure 5. 10-year Ahead Historical and Forecasted Returns Under Different Interest Rate Regimes



Source: Vanguard

The same chart also shows Vanguard's current 10-year projection for stock and bond returns, which incorporates their view (and the views of many others) that not only will bonds deliver higher returns than they have in the last 15 years, but that U.S. equities are currently expensive relative to fundamentals and so unlikely to provide the same returns going forward.

This is not to say that one should hold an all-bond portfolio, even one that is inflation-protected (via the use of Treasury inflation-protected bonds). But what is does say is that for those who chafe at excess equity volatility, or who think that the U.S. equity market is very expensive, this is a good time to be tilting one's portfolio toward more bonds. Said differently, if this view proves correct, investors are finally going to be rewarded for bearing interest rate risk in good times, and for the ballast value of bonds when the economy weakens as interest rates will then have more room to fall and for bond prices to rise.

Artemis Strategy

We are currently taking a hard look at all of our clients' bond allocations, reviewing their current and prospective portfolio drawdown needs and, in some cases, reassessing risk tolerance and tax status. The latter is important because we have historically favored the use of tax-free municipal bonds for high tax bracket portfolios, but given recent municipal bond market dynamics, only those in the very highest tax brackets are coming out ahead. We expect to be adjusting allocations on a case-specific basis starting very soon.

As for equities, we continue to favor the U.S. over international markets, although most of our underweight is in developed international markets (e.g., Europe) rather than emerging markets. We also remain very balanced between growth and value in the U.S. and have a healthy allocation to smaller company stocks, which are showing some nice signs of life of late.