

Third Quarter Summary

The S&P 500 increased 2.3% in Q3, but there was a significant variation beneath the surface. The Magnificent 7 and several other technology stocks came roaring back, after a somewhat subdued first half of the year, substantially outpacing traditional Value, Small-Cap, and international stocks. The equal weighted S&P 500 lost 1.9% in Q3 and is perhaps better reflective of the performance of the typical large cap stock. Smaller companies generally fared the worst, with the Russell 2000 Small-Cap Index declining 7.2% in Q3. International stocks, as represented by the MSCI EAFE Index were approximately flat in Q3, since the stock market of most countries that comprise this index continue to grapple with sluggish economies and heightened levels of inflation. The Russell 1000 Value Index had a more nuanced performance. The headline number for the Russell 1000 Value Index increased a respectable 2.6%, but performance was largely driven by a few of the Magnificent 7 names. Specifically, Apple, Meta, and Microsoft increased 15.2%, 28.8%, and 37.7%, respectively, in Q3.

Continued investor enthusiasm for the proliferation of artificial intelligence (AI) stocks was one factor in the market rally. SpaceX, a play on a broad range of technological innovations, made its public market debut at a valuation close to \$2 trillion, briefly making Elon Musk the first trillionaire in history. Anthropic is poised to launch their own IPO by year end, also valuing the firm at roughly \$2 trillion. GDP figures for Q3 is expected to be solid, with most estimates ranging for growth between 2.5% and 4.0%.

However, notable increases in interest rates negatively impacted the returns of most bonds and financial stocks. The Federal Reserve increased short-term interest rates for the first time this year at its September meeting. Perhaps more impactful, long-term interest rates increased sharply. The yield on the benchmark 10-Year U.S. Treasury Note increased from 4.4% to 5.3% during Q3. This rise occurred despite the best efforts of U.S. Treasury Secretary, Scott Bessent, who announced his department planned to purchase billions of dollars of U.S. Treasury securities in an effort to dampen long-term interest rates. The 30-year mortgage rate now averages 7.5%, a multi-year high. The Bloomberg Barclays Aggregate Bond Index fell 3.5% in Q3, a sizeable drop for a “safe haven” asset class.

Inflation has remained well above the Fed’s 2% target, with both the Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE) Index showing roughly 3.5% increases on a year-over-year basis. The ongoing military conflict in Iran does not appear close to a near-term resolution, despite some optimism earlier in the year. Accordingly, oil prices increased approximately 40% in Q3 and were one of the main contributors to heightened levels of inflation. Surging diesel prices continue to be a major sticking point since they impact virtually the entire supply chain of physical goods delivered around the world.

Market Outlook

With less than one month until the midterm elections, there is not a shortage of prognostications, not to mention the torrent of political advertisements. Mindful of the expression “putting your money where your mouth is,” prediction markets, such as Kalshi and Polymarket, find that investors believe there is roughly a 90% chance that Democrats regain control of the House of Representatives and more than 60% chance that they control the Senate. Republican Senator Thom Tillis and other analysts have raised the possibility that President Trump may contest the election results if he views them as unfair or unfavorable.

Although we expect stock market volatility to increase around the election date, any dislocations are usually short-term in nature. Short-term meaningful declines in the stock market are usually counterbalanced by increases in the value of investment grade bonds. Hence, a diversified portfolio may be the best way to mitigate political risk. We choose to focus on the fundamentals of the economy, which are fairly good, as noted earlier in this report.

Accordingly, we do not encourage investors to make radical changes to their portfolios simply based on election outcomes.

In our view, portfolio changes should primarily occur at the industry or sector level, since Congress controls the U.S. budget. For example, areas related to Healthcare may positively benefit from a Democratic sweep of Congress, while traditional Energy and Defense firms may perform well if there is a split congressional outcome. In the event of stock market volatility surrounding the election, it may represent a buying opportunity for long-term investors. The third year of the Presidential term is historically the best for the stock market. It may be unlikely for the stock market to have a fourth consecutive year of extremely strong returns, but our point is that indiscriminately selling stocks simply due to political reasons may not be the best course of action for long-term investors.

Overall, we have a moderately optimistic outlook on equities and still expect them to outperform bonds for the year ahead. However, the sharp rise in bond yields has made them somewhat attractive for investors putting new money to work. Inflationary pressures and a relatively low unemployment rate will likely force the Fed's hand to continue to raise short-term interest rates. The main question for market participants is, "How far and how fast?" Federal Funds futures prices show a wide variation in market expectations for interest rate hikes over the next year. The median forecast is for an additional 75 basis points in rate hikes from its current range of 3.75%-4.00%.

In our view, hikes of this magnitude may be a bit too aggressive for a few reasons. We believe Jay Powell is likely to step down from his position as Fed Governor within the next year due to his exoneration of fraud in the investigation related to building renovations of the Federal Reserve. Powell's likely exit will provide President Trump with the opportunity to add another "dovish" governor to the Board. The sharp rise in long-term interest rates has resulted in mortgage rates reaching a 3-year high. Housing prices are the largest component of the Consumer Price Index (CPI). The "double whammy" of elevated home prices and high mortgage rates create a backdrop for subdued increases in real estate prices. Of course, Fed Chair Kevin Warsh was appointed by President Trump who has vociferously called for lower interest rates. Although Warsh has stressed the Fed's independence, we believe he will lean towards a dovish posture regarding future interest rate hikes. A shorter than expected resolution to the military conflicts related to Iran and Russia would put downward pressure on energy prices and hence inflation.

Geopolitical risks are ever present and always have the possibility of worsening. A further rise in long-term interest rates may place increased pressure on an already strained U.S. federal budget deficit. As we enter earnings season, the risk of a weaker than expected outlook by AI related firms may shake one of the pillars of the current bull market. Lastly, just when we think we have put global pandemics in the rearview mirror, news emanated from Russia about a possible lab leak of the pneumonic plague. At present this incident appears to be contained, but we continue to watch this story closely.

John M. Longo, PhD, CFA

Chief Investment Officer, Portfolio Manager



Beacon Trust 163 Madison Avenue, Suite 600 | Morristown, NJ 07960 | 973.377.8090 | BeaconTrust.com

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