LNW PERSONAL WEALTH ADVISORY BY Laird Norton Wetherby

Q4 2024 Commentary

The U.S. Experiment Gets Tested

> **"We are not afraid to entrust the American people with unpleasant facts, foreign ideas, alien philosophies, and competitive values."**
>
> ~ John F. Kennedy

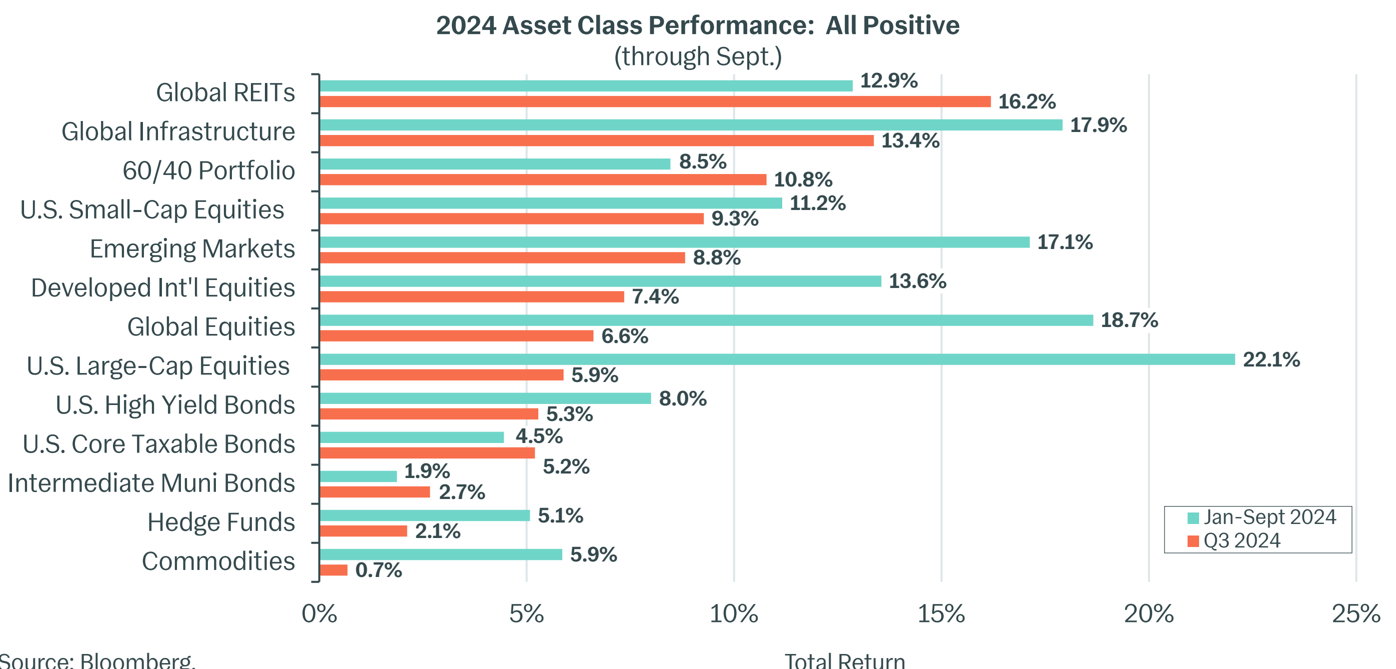
Is there an election coming up? While this may seem like a ridiculous question, it does get at the markets' insouciance to rising political and geopolitical risks (see chart below). The S&P 500 has gained just over 20% in 2024 through September; this high of a return for the first nine months of the year has not been seen since 1997.

And, heck, this happened amid the U.S. President dropping out of the election, two assassination attempts on the former President and Republican presidential candidate, a Japanese market meltdown (and rebound) and the wars in Ukraine and the Middle East both escalating to ominous new levels. While we cannot pretend to know how these seismic events will pan out, we have been wrestling with the implications.

Treating returns as an outcome of the risks infused in portfolios is a cornerstone of our philosophy designed to shepherd clients through volatile times. As such, we have stayed grounded in our discipline: Calibrating portfolios to align with the risks clients can, need, should and/or want to take; tuning out the noise while trying to find the significant signals; and checking emotions at the door.

On the U.S. election, we find ourselves balancing two perspectives: (1) Historically, Presidential elections have not tended to matter to the markets; vs. (2) little today seems to resemble history, so this time *really* could be different (although writing the latter raises my hackles a bit as I have learned, sometimes painfully, to heed the lessons of history because it usually rhymes).

In this Commentary, we provide context for what is happening with the U.S. economy and the markets, the potential impact of U.S. elections, and ideas for positioning portfolios heading into 2025.



Source: Bloomberg.

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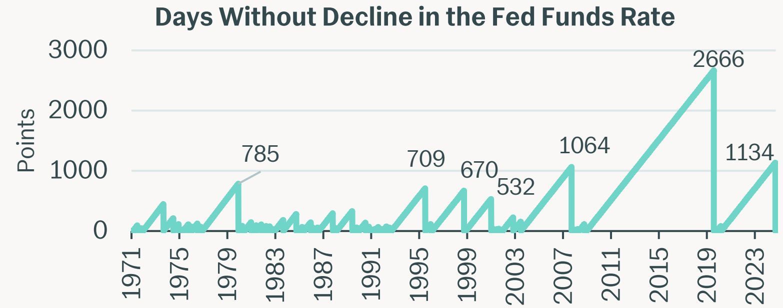
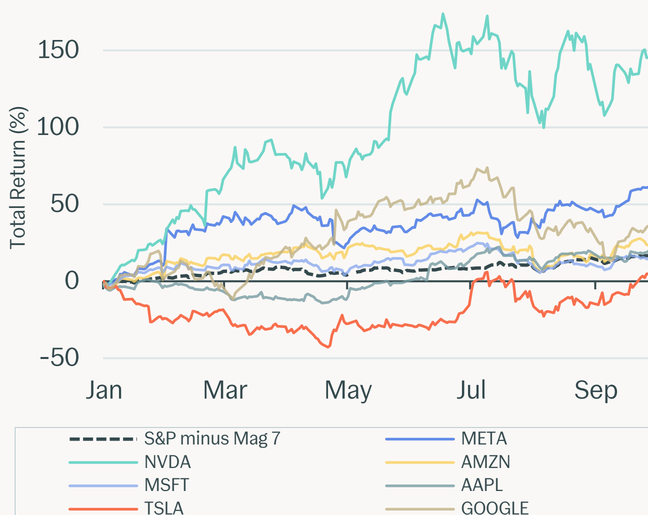
Third Quarter Wrap

September was a pivotal month. That's when the Federal Reserve started to lower interest rates, after the second-longest cycle of Fed interest rate hikes in history. Real assets and foreign stocks were the biggest beneficiaries although most markets were boosted by optimism that the U.S. economy has avoided a recession (or at least the worst-case scenarios). Here's a closer look:

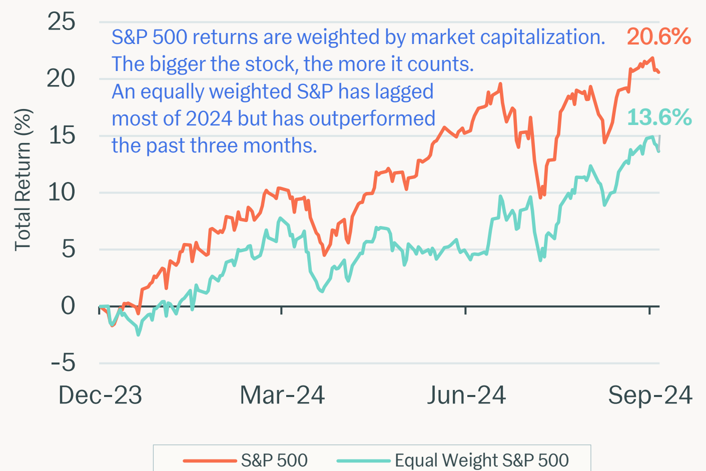


Source: Bloomberg.

- **Fixed Income: Strong Rebound.** Virtually all the gains in the U.S. bond market this year came in the third quarter on the Fed's 50 basis point cut in its key interest rate. Municipal bonds have lagged mainly due to a wave of new issuance as local governments rush to finance new infrastructure projects ahead of U.S. elections.
- **Global Equities: The Rally Broadens.** Another strong year so far for U.S. equities, with large-cap stocks continuing to lead the way. In the third quarter, the rally spread beyond big tech on the interest rate cut and the productivity boosting potential of AI across industries. Overseas, the standout was China, where stocks surged 23%, mostly in September, on rate cuts by the central bank and other government stimulus.
- **Real Assets: Ongoing Tailwinds.** A boost to portfolio diversification, this asset class was also a turnaround story. Publicly traded renewable energy equities (+14% in 2024 through September), infrastructure including utilities (+17%), and REITs (+13%) have been sought after for their relatively high yields, lower valuations and the surging demand for electricity to power AI.
- **Private Equity: Slow Recovery.** Investment activity has resumed but slowly as the high interest rates of the past few years have taken their toll. Wide bid-ask spreads underscore that the market will need some time to warm up. Transactions are occurring and there is no shortage of opportunities in AI and elsewhere, but investors need to be patient as that capital is more sporadically put to work.
- **Diversifiers (hedge funds and private credit):** Credit strategies, many of which do not carry interest rate risk, have benefited from higher base yields and wider spreads relative to Treasuries. Meanwhile, hedge fund strategies, such as equity long/short and relative value, are seeking to benefit from the pricing dispersion caused by interest rate volatility. Overall, the diversifiers category delivered according to expectations in context of strong equity markets.



Source: Y charts, M*, Bloomberg.

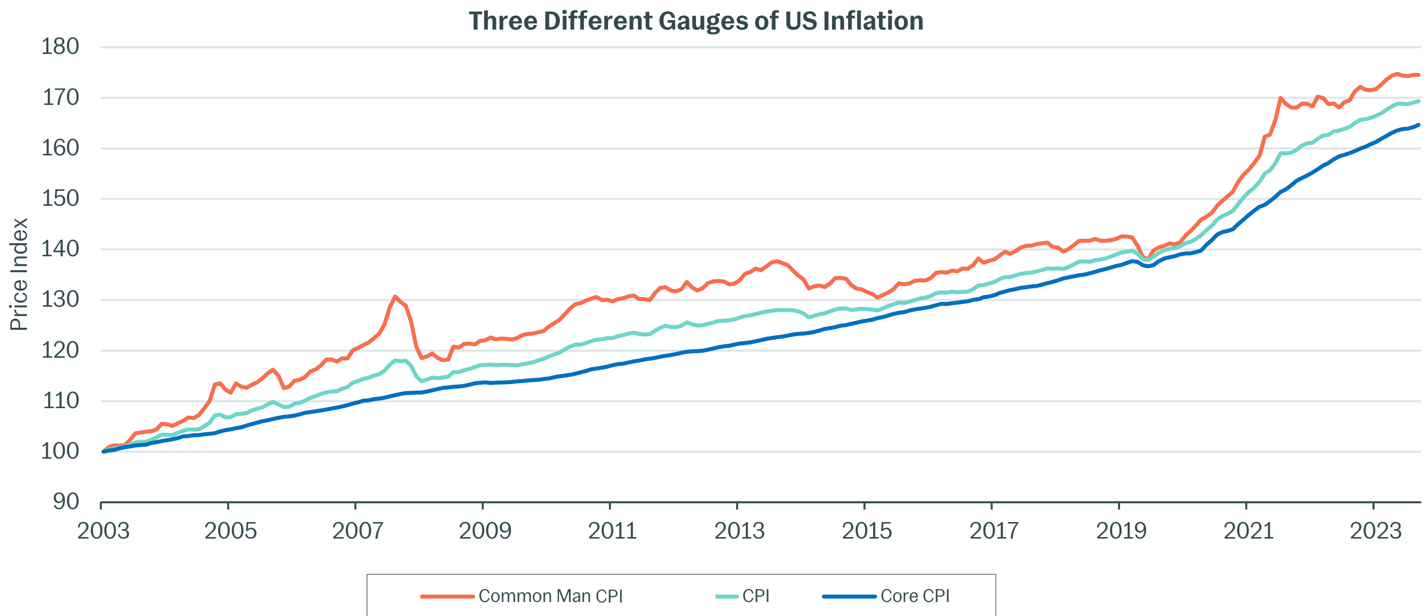


Source: Ycharts & Morningstar, S&P 500 as measured by SPY and Equal Weight as measured by RSP through 10/3/2024.

The U.S. Economy & Markets from 30,000 Feet

The 2024 rally in U.S. stocks is grounded in three major expectations: lower interest rates; tame inflation; and ongoing economic growth, which has continued to surprise on the upside. Inflation is indeed trending down toward the Federal Reserve's 2% target by virtually all measures. The last few months even showed inflation below 2%.

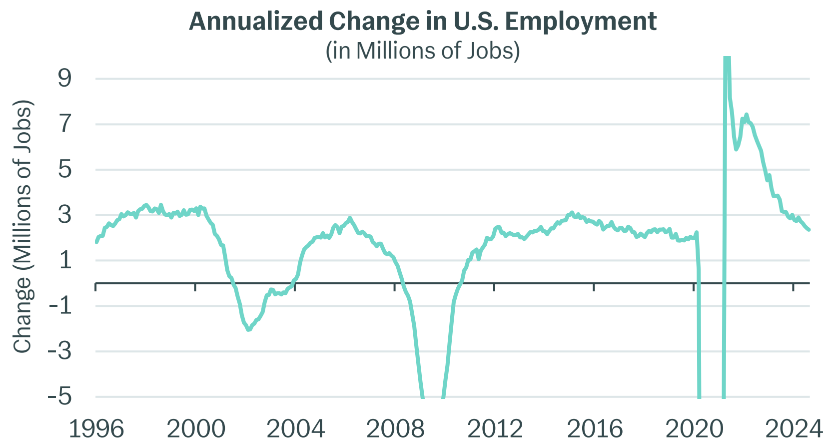
However, the impact of inflation depends on whom you ask. "The Common Man CPI" which reflects essential expenses (housing, food, energy, insurance, etc.) is up about 25% since 2022. (See top chart at right.) This steep increase has impacted consumer confidence and is why inflation and the economy are top issues in U.S. elections.



CPI = Consumer Price Index. Core CPI = CPI minus food and energy.
Source: Federal Reserve Bank of St. Louis.

Meanwhile, the U.S. economy is growing albeit with pockets of weakness. The September jobs report showed solid job creation, lower unemployment (back down to 4.1% from 4.2%) and wage increases. Looking below the surface, however, most new jobs were in government, leisure/hospitality, education and healthcare; most sectors sensitive to the economy actually shed workers.

Given the backdrop of slowing inflation, the Fed pivoted to lowering interest rates to address the second part of their mandate: supporting full employment. Clouding the picture shortly thereafter, the Bureau of Economic Analysis (the agency that officially calls recessions) released strong upward revisions to real (inflation-adjusted) economic growth for 2022-2023. This raises the odds that the U.S. is further away from recession than previously thought.



Source: Bloomberg.

What Now

How well the U.S. labor market holds up will likely be a strong indicator regarding the speed and magnitude of future Fed moves. Historically, the U.S. economy is sometimes already in or will soon be in a recession once the Fed starts cutting rates. Conversely, there have been many occasions of "no landing" -- the economy continues to grow well. The table below shows S&P 500 returns for periods when the Fed started to cut interest rates under two scenarios: when a recession was underway vs. when a recession did not materialize.

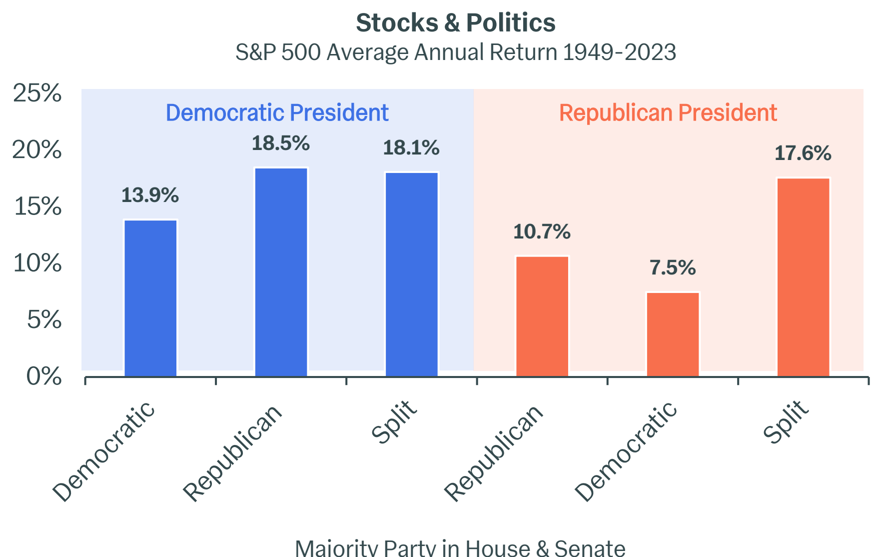
	Fed Cut + Recession* (1970 - Aug. 2020)		Fed Cut + No Recession^ (1970 - Aug. 2020)	
	Average Return (%)	% of Time with Positive Return	Average Return (%)	% of Time with Positive Return
Previous 12 Months	1.6%	60%	7.9%	71%
1 Week Forward	-0.3%	20%	-0.8%	57%
2-4 Weeks Forward	0.1%	60%	3.0%	71%
1 Month Forward	0.5%	60%	2.9%	71%
3 Months Forward	-7.5%	20%	8.4%	100%
6 Months Forward	-3.5%	20%	12.8%	100%
9 Months Forward	-4.0%	40%	13.1%	86%
12 Months Forward	-2.3%	40%	15.8%	100%

*Fed Cut + Recession: July '74, April '80, June '81, January '01, September '07.
^Fed Cut + "No Recession": January '71, October '84, October '87, June '89, July '95, September '98, July '19.
Source: Fundstrat Global Advisors.

Bonds have tended to deliver stronger-than-average total returns in the year following the first cut in a cycle. Stock market performance has been mixed, depending on broader economic conditions. This is yet another reason to infuse portfolios with ingredients that can help take advantage of or protect against various outcomes.

U.S. Elections: Seeking Normalcy

We are in a highly charged, polarized political environment. The most desirable outcome from a capital markets perspective would be (1) Presidential election results that are not contested; and (2) neither party ends up with a big enough majority in Congress to enact radical policy changes impacting the economic landscape.



Harris vs. Trump 2024

GLOBAL TRADE. **Both seem to favor tariffs but differ in scope radically.**

HARRIS

Likely to retain current tariffs on China and may apply a surgical approach to broaden tariff policy.

TRUMP

10%-20% tariffs globally (impacting $3 trillion in goods). On Chinese imports, 60% tariffs, which may be rhetoric to create bargaining leverage.

Context: The U.S. President can impose tariffs on specific products or countries but needs the approval of Congress for across-the board tariffs, which historically have hurt U.S. growth.

ANTI-TRUST, COMPETITION. **Differences may not be as big as they seem.**

HARRIS

Could continue the Biden administration's aggressive anti-trust policies of the current Federal Trade Commission.

TRUMP

Seemingly favors less regulation, especially in the financial sector and energy. But may still target certain companies or industries, especially Big Tech, with more regulation.

Context: Regardless of who is President, the focus of anti-trust enforcement has likely shifted to encouraging competition within industries instead of doing what's best for consumers (lower prices, etc.).

BUDGET & TAXES. **Major differences.**

HARRIS

Tax increases focused on corporations and higher-income filers, including: long-term capital gains rate of 28% for households with more than $1 million in taxable income; taxing unrealized gains above a certain amount at death and annually for those with $100 million or more in income. No change in taxes for households with income under $400,000. Tax credits for people with children, first-time homebuyers, starting a small business; no taxes on tips in certain industries.

TRUMP

Extend the provisions in 2017 Tax Cuts & Jobs Act (TCJA) due to expire at the end of 2025; restore the full state and local tax deduction; lower corporate taxes to 15% for companies producing in the U.S.; exempt tips, overtime pay, and Social Security benefits from taxes.

Context: Dominant control of Congress and the White House by one party could result in significant changes but if majorities are small or no majority, the status quo is likely to prevail.

THE ENVIRONMENT & ENERGY. **Major differences.**

HARRIS

Continue policies of the Biden administration supporting the transition to clean energy.

TRUMP

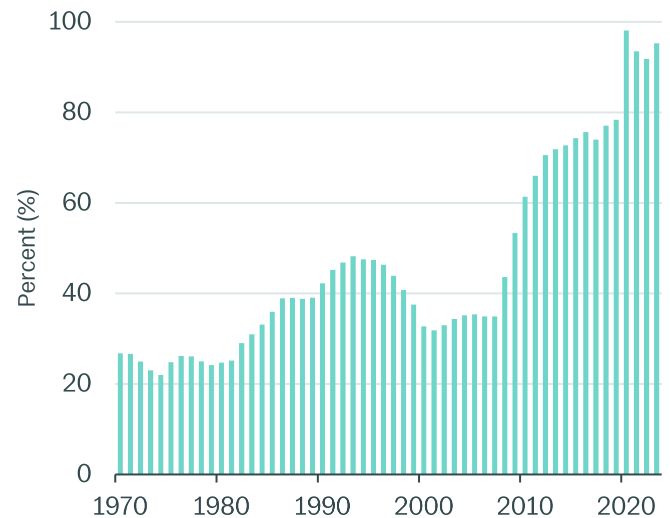
Undo or rewrite EPA regulations on powerplant and auto emissions, withdraw again from Paris climate agreement, make oil & gas drilling permitting easier, restart approval of liquified natural gas (LNG) export projects, undo parts of the Inflation Reduction Act (IRA), which supports renewable energy, or slow its implementation.

Context: Much of the spending under the Inflation Reduction Act (RIA) is going to Republican states and/or districts, making a complete repeal highly unlikely even given a Republican sweep of Congress. A sweep would more likely result in some changes at the margins on the EV tax credit and the methane emissions fee.

Beyond the Election: Risks & Opportunities

We see two ongoing risks, regardless of U.S. election results:

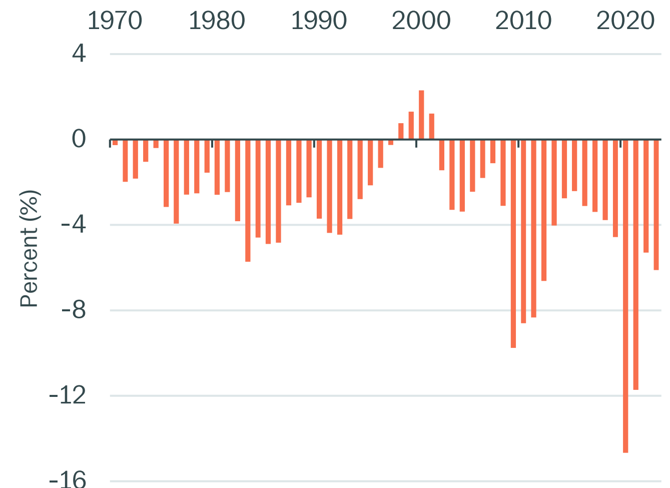
1. **Higher U.S. deficits requiring more Treasury debt issuance.** An aging population plus a ballooning national debt is not a good combination for long-term economic growth. These dynamics, coupled with more protectionist trade policies, can put pressure on inflation and interest rates settling in at a higher steady state, a thesis we put forth nearly three years ago.
2. **An adversarial relationship with China** in an increasingly multi-polar world. As a result, more U.S. companies are manufacturing in the U.S. (onshoring), in North America (near-shoring) or in neutral foreign countries (friend-shoring). We have mentioned a few beneficiaries in the past, such as India with one of the world's youngest populations shifting away from back office work to becoming a manufacturing hub as well as Vietnam, Indonesia and possibly Mexico.



*Public = U.S. individuals, companies, state and local governments, the Federal Reserve, foreigners. Source: MRB Partners, FRED.

Positive ongoing trends for the U.S. economy and markets:

- **Industrials/Infrastructure.** Earnings of U.S. industrial and infrastructure companies grew soundly in the third quarter and have gained momentum given three major government programs to support U.S. infrastructure, semiconductor production (CHIPS) and renewable energy (IRA). These programs could turbocharge onshoring independent of government actions. The world spent 40 years integrating globalized supply chains, which means we could see the reshoring trend endure for years.



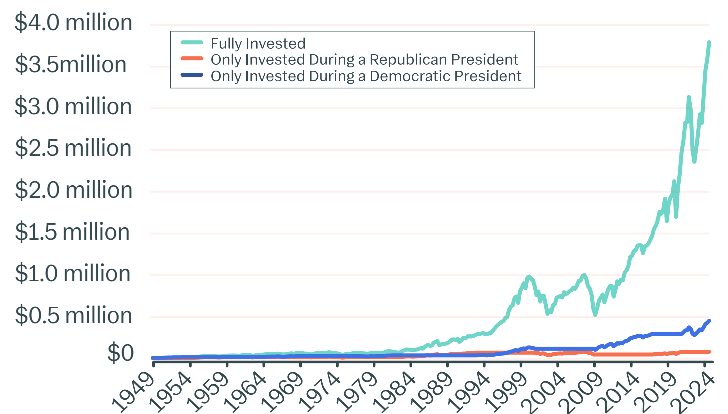
Source: MRB Partners, FRED.

- **Tech Independence.** The rollout of artificial intelligence by U.S. companies has cemented the U.S. as world leader in tech. In an increasingly digitized world, the benefits to the U.S. should transcend the political environment.
- **U.S. Economy is Dynamic, Nimble, Innovative, Multi-Faceted.** The U.S. economy has not slipped into recession in recent times without a push (major policy mistake or an external shock such as COVID). While we know there are countless unknown unknowns lurking, the Fed is easing, inflation is falling and the election uncertainty is set to be removed. All of this could be a powerful cocktail for fundamentals.

Portfolio Positioning

We recognize the upcoming U.S. election can be a source of anxiety. As stated earlier, this time may not be any different given the historic probability that elections have not impacted U.S. capital markets in the years that follow. And it is actually quite possible that another event – yet unknown – will surpass the election in creating
downward volatility.

At LNW, we strive to build resilient portfolios able to navigate through market cycles. As we head into peak election uncertainty, let's consider the impact of various exposures.



Source: First Trust, Standard & Poor's. Data is quarterly from 1949 – 9/30/2024.

- **Fixed income.** U.S. Treasuries may come under pressure if there is a contested U.S. election. However, owning a mix of bonds, including municipals and corporates, should help diffuse risk as we wait for any turmoil to end.
- **U.S. equities** could also be dragged down by turmoil in U.S. elections, making international equity exposure a winning strategy (relatively speaking) longer term if U.S. political institutions and society go through a protracted recovery period.
- **Diversifiers** should continue to play an extremely important role in portfolios to mitigate risk and take advantage of the dislocations that could ensue.
- **Real assets** (vs. financial assets), including commodities, can further enhance diversification and serve as a long-term store of value.
- **Private markets** in credit, equity or real assets could seize up in a prolonged contested election until the dust settles. Because of relatively long holding periods, managers have the ability to be patient and take advantage of opportunities once a steady state is apparent and private markets start to function again.

In addition, here are some precautionary measures LNW clients may want to discuss with their advisory team:

- **Stress test equity holdings** for a significant drawdown in dollar terms related to your goals (this is just an exercise not an expectation). Doing so can help determine whether you can tolerate that kind of risk emotionally and financially. If you can sleep at night and you can still accomplish your goals by recalibrating the risk of your portfolio (i.e. targeting a more conservative strategic allocation), you may want to consider doing so.
- **Review your cash allocation to determine if it is at your "sleep-at-night" level.** Keep in mind, if you and your advisor decide to raise cash, this will be a significant drag on returns if the negative scenarios do not play out and a rally materializes. We do not advise being tactical in this way as most anticipated left tail events have not happened as expected. It is the UNEXPECTED -- the unknown unknowns -- that cause significant drawdowns.

Closing Thoughts

What I have found in my more than 34 years of experience investing client capital is that virtually all market turbulence is manageable IF you have in place: (1) An asset allocation built around realistic levels of risk (what you can handle emotionally and should take on to achieve your goals); (2) adherence, with discipline and without emotion, to a long-term investment plan; and (3) well-diversified exposures.

Unless you envision a dystopian future, the U.S. has seen far worse than what we are experiencing today. Realize that it is also possible that investors may be overestimating the risks to the global economy, and the risks could even be to the upside barring continued escalation of the two major wars.

Uncertainty about extreme (left tail) outcomes could be dampening economic activity before the election. People and companies considering major investments, sales or purchases may think to wait until after Election Day on November 5. As long as there is a decisive outcome (at some point post-election), we could see pent-up activity resume. On top of that, central bankers in the world's major economies are lowering interest rates, corporate profit growth is accelerating across the globe, and companies continue to enjoy historically wide profit margins.

ABOUT THE AUTHOR

Ronald G. Albahary, CFA® is Chief Investment Officer at LNW. As head of the investment team (see below), Ron determines the firm's investment strategy, directs the investment selection process, and works in tandem with client advisory teams to deliver investment solutions structured to attain each client's unique goals. Prior to joining LNW, Ron served as CIO or CEO at regional investment firms focused on ultra-high-net-worth families and foundations. Earlier in his career, he held leadership positions in the private client business of major global financial institutions, including Merrill Lynch and Northern Trust Private Bank. Ron has a degree in economics from the Wharton School at the University of Pennsylvania and currently serves as advisor to the Center for High Impact Philanthropy at the University of Pennsylvania.

The LNW investment team is comprised of 12 analysts and strategists working together to design and implement investment solutions for client portfolios. Six analysts at the firm hold the Chartered Financial Analyst® designation, with expertise spanning macroeconomics, public and private asset classes across the global capital markets, and impact investing. Collaborating with each other and with client advisors, the investment team's overarching goal is to help clients and their families preserve and grow their wealth over many generations.

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