QUARTERLY INVESTMENT NEWSLETTER

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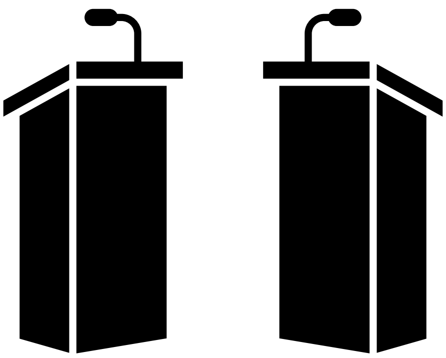
Welcome!

Every quarter the Investment Committee for Diversified puts together our thoughts on markets, the economy, and how it all pertains to our clients. We look to give our perspective on what it all means for investors and to share where our philosophy and processes are taking portfolios. Thanks for taking the time to give it a read...

Every four years we get the pleasure of coaching our clients, friends, and family through dealing with the emotional rollercoaster that comes with an American election cycle. To be crystal clear, that statement was 100% tongue in cheek. Managing emotions is one of the many day-to-day interactions we have with our clients and candidly we take great pride in helping be the calming voice during times of stress and concern. There is just something about political debate and election cycles that brings out irrationality in some individuals and, as the father of a 3-year-old, I've recently received a PHD in dealing with irrational behavior.

THE GREAT DEBATE(S)

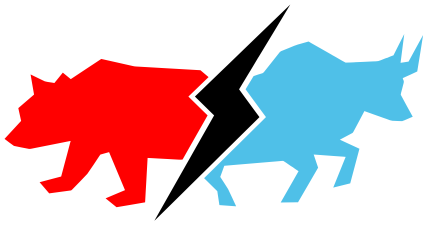
Just as the current Vice President and former President debated in Philadelphia on 9/10/2024, there are several debates happening in the financial markets around some really key issues.



While certainly not as tense, the outcome of these debates will have sizable impact on the path forward for markets. I thought it would be timely for us to dig into these debates in some detail and touch on historical market reactions during election years. So, let's check our emotions at the door and spend some time having our own debates...

MAJOR MARKET DEBATES

Red versus Blue. Democrat versus Republican. Conservative versus Liberal. Isn't it amazing how uncomfortable just saying these things can make us feel? The good news is that I'm not here to discuss political stances, and I'm not sure anyone would care to listen even if I were. As many of you know, there are several major economic debates happening right now that have a huge impact on financial markets and our daily lives. Let's go through a few of the really important ones, why they're important, the argument for each, and how we view the issue. We're going to try to go into this with an open mind, calm, and as rational as we can be...much like the typical political conversation, right?



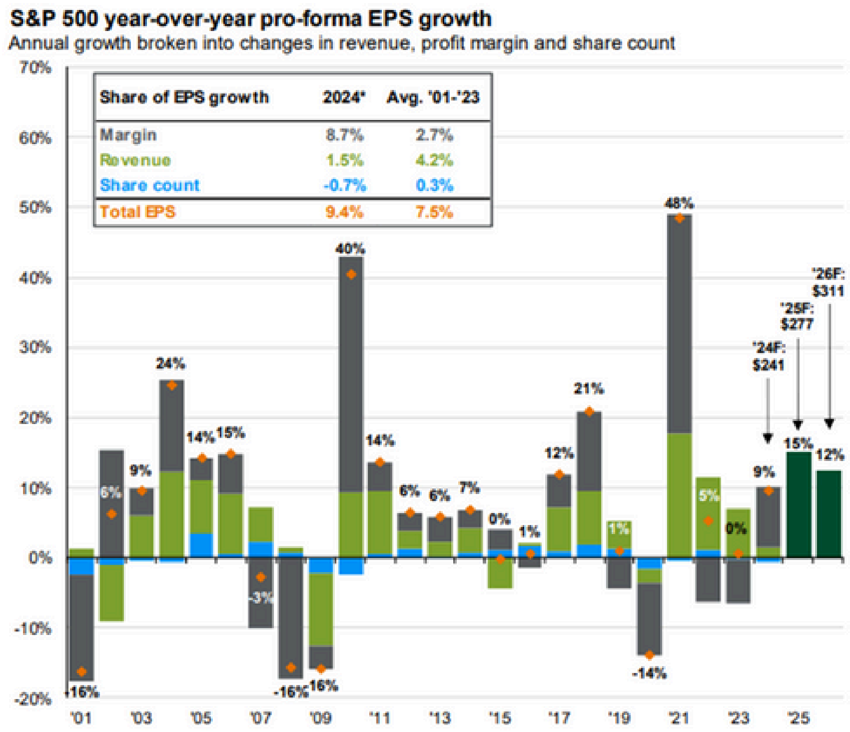
Bull versus Bear

This is always the big one that everyone wants to know. Is now a good time to invest? Does the market still have room to run? The answer will depend on which animal you're speaking with.

Bull Case: Inflation is fading. Earnings continue to grow. Consumer spending and leverage look reasonable. There is a lot to like when making the argument that markets can continue to perform well. Earnings for S&P 500 companies are expected to grow 9% in 2024, 15% in 2025, and 12% in 2026. Combine that with an index-level profit margin of nearly 13% and you have a recipe for potentially hitting all time market highs.

Bear Case: Markets are expensive. Stock performance has been concentrated. Some cracks are starting to form with unemployment ticking up. At over 21x forward earnings, the S&P 500 is trading quite a bit over the 17x earnings that it has historically traded at over the last 30 years. Those number simply mean that the average investor is willing to pay more and more in stock price for each dollar of earnings that the underlying companies produce. Price matters and when the top 10 companies in the index are driving nearly all of the growth, concerns are starting to build.

Rational Review: I'm going to grab the bull by the horns on this one. Earnings typically drive stock prices over the long term and right now the earnings picture looks very good. I think the earnings situation will put a floor on market corrections (yes, they can and will still happen) and provide opportunities to buy in at cheaper prices. Investors need to be cognizant of not overloading into the really expensive areas of the market and look for areas that will start to contribute to the earnings outlook described above.



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.

Forecasted figures are estimates only. Actual results may vary substantially.

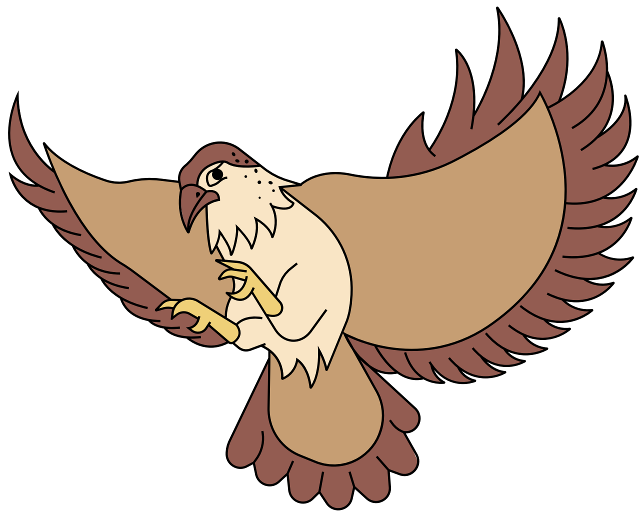
Dove versus Hawk

Look at me diving into the world of ornithology. That's the study of birds for those of you who don't know, and, yes, I 100% needed to Google that. Instead of mating habits and migrating patterns, we're actually going to discuss the role of the Federal Reserve (The Fed) and its voting members. In monetary policy, members are often referred to as either doves or hawks based on their priority of the dual mandate of the Fed (low positive inflation and low unemployment). Doves prioritize lower interest rates to stimulate the economy while hawks are protective of keeping inflation at bay and prefer to error on the side of higher rates. As you can imagine, the debate within economic circles has been quite public over the last couple of years and continues today. So which side makes more sense?

- **Dove Case:** Inflation isn't the threat that it was a short time ago and we're well on our way to the 2% target level. With unemployment starting to tick up off the very low levels of roughly 4%, the Fed should cut rates to prevent a weakening in the labor market and possible recession. With real interest rates (short term cash rates minus inflation) at pretty high levels, its time to reverse course and reduce the cost of borrowing.

- **Hawk Case:** The last mile in the battle against inflation is always the hardest, and we're not at the finish line yet. History has shown that if we cut too soon and inflation bounces back that its going to be very painful for the economy and markets. Given the strength of domestic GDP and the fact that the labor market has barely started to crack, we should be cautious in cutting rates. A slower pace of cutting is more prudent at this time.

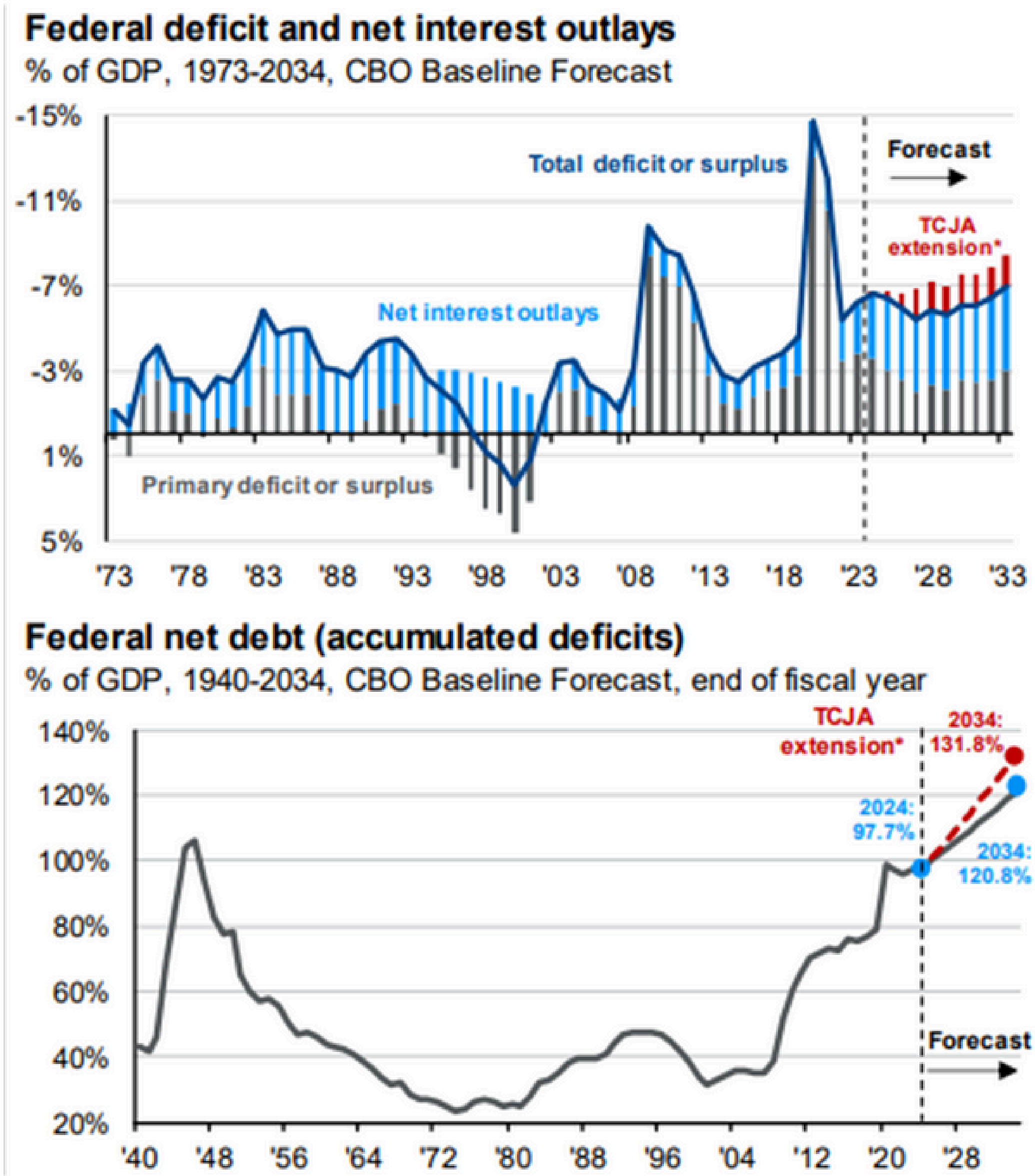
- **Rational Review:** The easy way out here is to say I have more of a pigeon view, which is said to be an individual with more of a centrist view than doves or hawks. You're welcome for all of the bird talk (maybe its time to start a bird newsletter). To take an actual side here, I tend to lean with the hawks on this and not feel the need to push rates down too quickly. The economy is hanging on rather well with GDP trending at 3% for Q3 2024, unemployment still near 4%, corporate earnings projected to keep growing year over year, and consumer spending hanging in there. Sure, rates can come down a bit and ease some parts of the market like real estate. Maybe it's the neurotic planner in me but I like to keep bullets in the metaphorical chamber in case the economy does start to unexpectedly show signs of weakness. If we cut too quickly, the options become minimal to stimulate the economy rather than taking our time and cutting quickly if things warrant. Once again, we can and should reduce rates over the next year but leaving ourselves some flexibility seems like the prudent move right now.



Fiscal Expansion versus Monetary Tightness

I can't say that this debate rolls off the tongue like the other two, but it's equally important. In all honesty, I tend to get most questions in this specific area. Concerns over government spending and Fed policy weigh on investors' minds, and it makes sense given US fiscal deficits and the ballooning of the Fed's balance sheet. Which is a bigger issue?

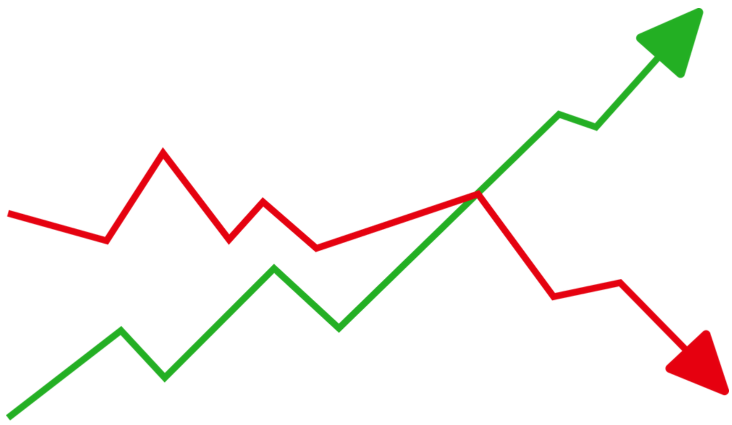
Fiscal Expansion Case: It should come as no surprise to anyone that the US has been running fiscal deficits for over 20 years. It should come as no surprise to anyone that there is a crossover point in the 2030's where entitlement spending plus interest will exceed Federal revenues. Neither party has fully addressed fixing the deficit issue nor how to sustain social security beyond its projected "problem" date. While the remedies to fix these issues won't be overly popular to get elected, investors have a hard time ignoring it. Running budget deficits and printing money to cover them will devalue the currency over time, potentially ramp up inflation, and make it harder to fix in the future.



FORECASTED FIGURES ARE ESTIMATES ONLY. ACTUAL RESULTS MAY VARY SUBSTANTIALLY. *TCJA IS TACX CUTS AND JOBS ACT

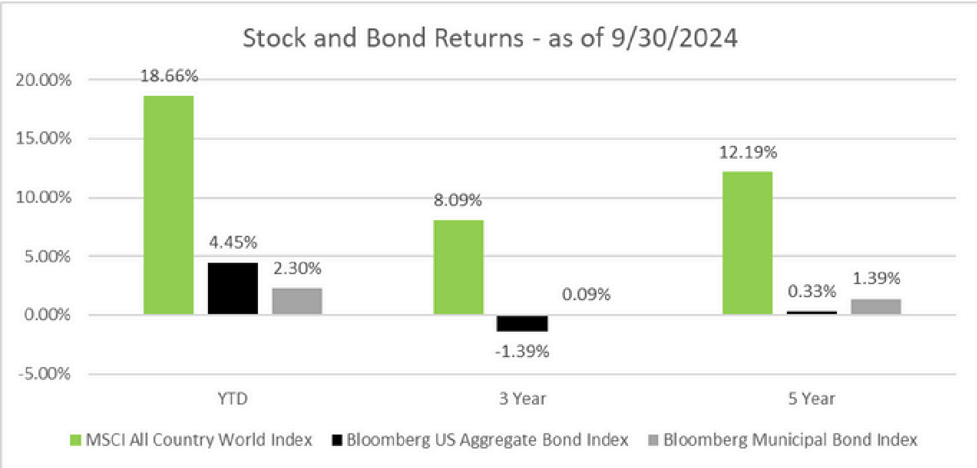
Monetary Tightness Case: The case here is that the U.S. being the world's currency and GDP increasing over time, we're overstating the issue of government debt. The bigger issue is tight monetary policy where the Fed has increased rates too much too quickly, and now lending costs have become prohibitive to maintain economic growth. On top of that, real estate markets around the country have come to a standstill as owners sitting on appreciated homes with sub-3% mortgages are stuck. The time has come to cut rates quicker and become more accommodative on the monetary side.

Rational Review: My bigger concerns continue to stand on the fiscal side. I think the economy and consumers can deal with rates at current levels or at least slowly reducing them, but the fiscal issues to me need to be sorted out at some point. There are levels of debt that studies show can become crippling (although Japan would like to have a conversation on that) and so many Americans rely on social security to sustain themselves in retirement. Ignoring these issues may not have direct market impact, but indirectly will potentially affect consumer sentiment, interest rates, and foreign investment. The interest part here is that very few political candidates want to throw out realistic solutions here, while so many Americans are clearly concerned over their, and their children's, future.



Q3 2024 – Bulls, Doves & Politics

If we're keeping score for the first nine months of the year, the bulls and doves are likely winning. As you can see in the chart, global equity markets were up over 18% through September in what has been a continuation of the recent bull market.



SOURCE: YCHARTS; DATA AS OF 9/30/2024; PERIODS OVER 1 YEAR ARE ANNUALIZED RETURNS, PAST PERFORMANCE DOES NOT GUARANTEE FUTURE RESULTS. SOURCE: CME GROUP

As we think about what's dominating market headlines and what we all need to be prepared to discuss at the Thanksgiving table, I'd say the major topics include a strong stock market, rates coming down, and (…gulp) politics.

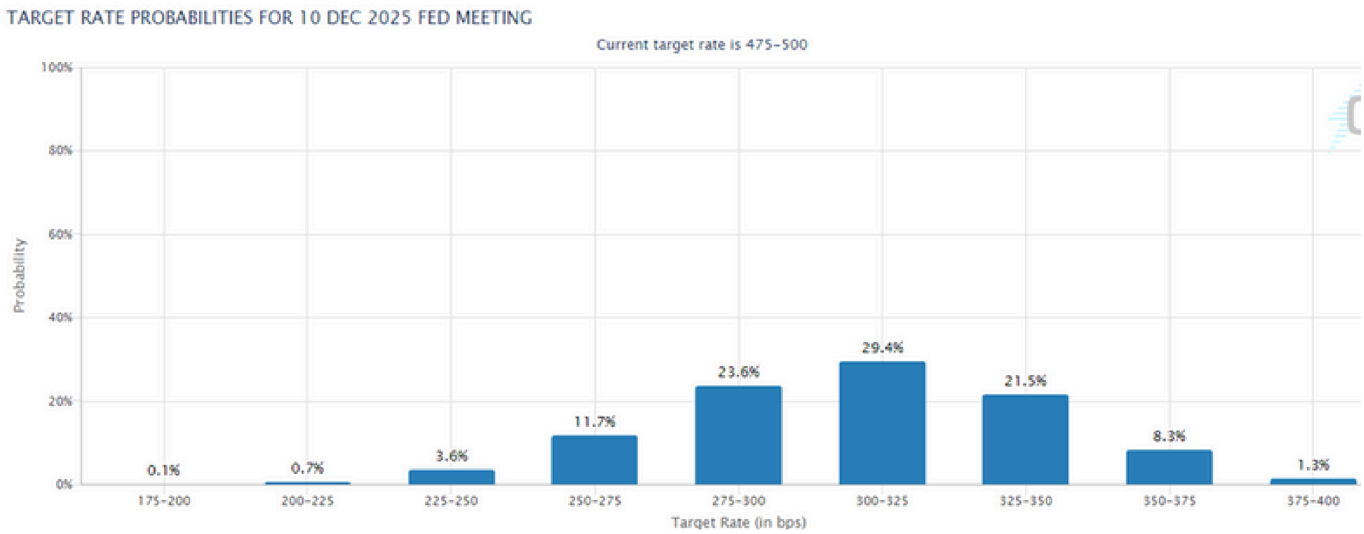
Equity Market Strength

The bulls have been running for most of 2024. Through the end of the quarter, global equity markets have rallied a total of over 18%. At a more granular level, the S&P 500 ended the quarter up 5.9%, continuing its bullish trend from late 2022. Small caps, represented by the Russell 2000, soared by over 9% in the quarter, reflecting a broadening market rally. The combination of consumer spending, healthy profit margins, and growing earnings give us an optimistic backdrop for equities moving forward.

The question we often get is it time to fade the rally? First, market timing rarely works, and we strongly advise against it. One interesting historical point to consider…the S&P 500 has been positive in 8 out of 9 months this year. That has happened in 8 calendar years historically, and in all 8 of those years the index was positive in Q4. You know the deal, past performance is no indication of future results, but the point is that running from a strong equity market isn't always the best reaction. We continue to be optimistic around equity markets for many reasons presented in the newsletter.

The Fed Pivots

The Fed raised interest rates to up over 5% as of July 2023 and remained there for well over a year. We finally saw the pivot in September when short-term rates got cut by 0.50%. On the bond side, yields fell significantly across the credit spectrum and returns ended above 4% for the year through the end of Q3. The Fed's move signaled a shift toward a more accommodative policy, and markets are now expecting rates to approach neutral by 2025. The doves have been pushing for rates to start getting cut before higher rates put stress on the economy. As we look forward, the focus will be on how much, and how quickly, rates get cut. As you can see below, this illustrates market expectations are quite wide for where rates will land by the end of 2025. It should be an interesting debate for hawks and doves.



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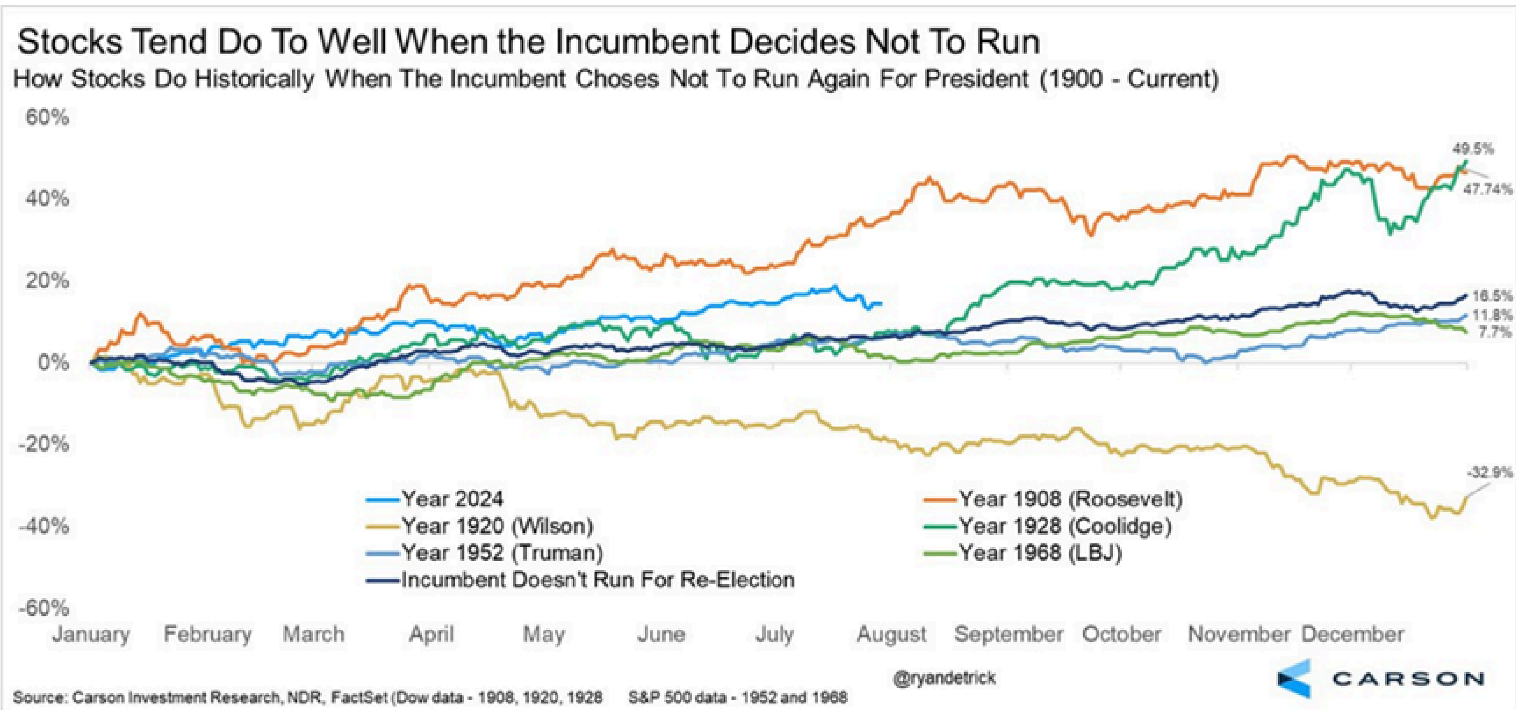
The Election in Focus

We couldn't have a newsletter about debates and not at least acknowledge that we have an election coming up in about a month. Every four years we have conversations with clients concerned about a variety of things related to the presidential election. Naturally, this is an emotional subject and it's easy to let feelings about specific candidates and policies affect our views about financial planning and portfolio positioning. As we always do, our first piece of advice is to do your best to separate those emotions from your plan and portfolio.

As markets come to grips with the likely winner, and their respective policy preferences, there will be gyrations in leadership and performance. Markets hate uncertainty and this is exactly what an election brings to the table.

From a historical perspective, we've been working to share previous market returns and scenarios given our situation. With President Biden dropping out and VP Harris stepping in, the narrative now changes from historical returns with an incumbent to what happens when they decide not to run. As you can see, there have only been a few instances and several were a long time ago, but overall returns have historically been solid when incumbents decide not to run. Take that for what it's worth. The debates will rage on but our focus will continue to be on economic conditions, consumer health, and changes to current policy.



MIKE'S QUARTERLY TANGENT: DECISION FATIGUE

Someone I respect recently wrote the line "investing is hard, don't make it harder." So simple yet so perfect in what we often try to emphasize. As an investor, you're faced with an infinite number of decisions that you could theoretically make. From what asset allocation makes most sense all the way down to security selection and implementation. The concept related to this is something that we keep top of mind…decision fatigue.

Decision fatigue is the tendency for peoples' decision making to become impaired as a result of having recently taken multiple decisions. In the words of John Tierney: "Decision fatigue helps explain why ordinarily sensible people get angry at colleagues and families, splurge on clothes, buy junk food at the supermarket and can't resist the dealer's offer to rustproof their new car. No matter how rational and high-minded you try to be, you can't make decision after decision without paying a biological price."
Think about various points in your life when you potentially had young kids, a demanding job, and a million responsibilities in your day. Making good, rational decisions in the midst of chaos often leads to:

- Feeling tired
- Brain fog
- Anxiety
- Stress
- Difficulty making the right decisions
- Impulse buying
- Procrastination
- Indecision
- Making rash decisions based on little evidence
- Battling back and forth between various choices

Why do I bring this up and what in the world does it have to do with investing and portfolio management? I think this is something that investors need to take seriously and consider in their management of portfolios. The amount of information we have at our fingertips is incredible. There is a lot of noise in our daily lives around domestic politics, economics, and geopolitics. Not for nothing, I just debated myself across several of these noisy areas (I think I won the debate to be honest). How do we make decisions when our minds are thrown in so many directions and given so many items to consider?

To me, the answer is to first be aware enough to acknowledge this is a challenge. Second, build your process and philosophy to reduce the potential for decision fatigue. This is something we've worked towards internally, which is focusing on a fewer number of really important, impactful decisions within portfolios rather than hundreds of small, less impactful decisions. The result, in my opinion, is greater conviction and better decision-making. Sometimes less is more, especially when those fewer decisions have a bigger impact.

Information and debate are vital to the decision-making process. But, as you saw at the beginning of this newsletter, debates often involve rational arguments on both sides and tough decisions must be made regardless. As you think about your process, I suggest you consider the number of decisions you're requiring of yourself and whether or not you feel like each decision is being made with the same level of focus/attention/care. Just a little something to consider during election season when debates are plentiful.

Keep Perspective

Just remember that your team here at Diversified is always working on your behalf to adjust portfolios in a quickly changing landscape. We strive to always remain unemotional, proactive, and transparent as to what we're seeing, thinking, and ultimately doing. We sincerely appreciate our partnership and just know that we're always here if you have any questions on your financial plan, portfolios, or just would like to talk. Thank you for the trust you put in the Diversified team.

Connect With Us

Mike Horwath, CFA®

Mike is the chief investment officer at Diversified LLC, where he heads the Investment Committee and is responsible for the investment direction of he firm. He works closely with financial planners to support the investment side of the financial planning process. Mike oversees the ever-changing global investment landscape and evaluates the impact on each of our client's strategies. He's a proud father and husband and loves spending time with his dog.

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S&P 500: The Standard & Poor's 500 Composite Stock Price Index is a capitalization-weighted index of 500 stocks intended to be a representative sample of leading companies in leading industries within the U.S. economy. Stocks in the Index are chosen for market size, liquidity, and industry group representation.

Russell 2000: The Russell 2000® Index is a capitalization-weighted index designed to measure the performance of the 2,000 smallest publicly traded U.S. companies based on in market capitalization. The Index is a subset of the larger Russell 3000® Index.
MSCI All Country World Index: The MSCI ACWI captures large and mid-cap representation across 23 Developed Markets (DM) and 24 Emerging Markets

(EM) countries. With 2,937 constituents, the index covers approximately 85% of the global investable equity opportunity set.
GDP: Gross domestic product (GDP) is the total monetary or market value of all the finished goods and services produced within a country's borders in a specific time period.

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