"Recalibrating to Neutral"

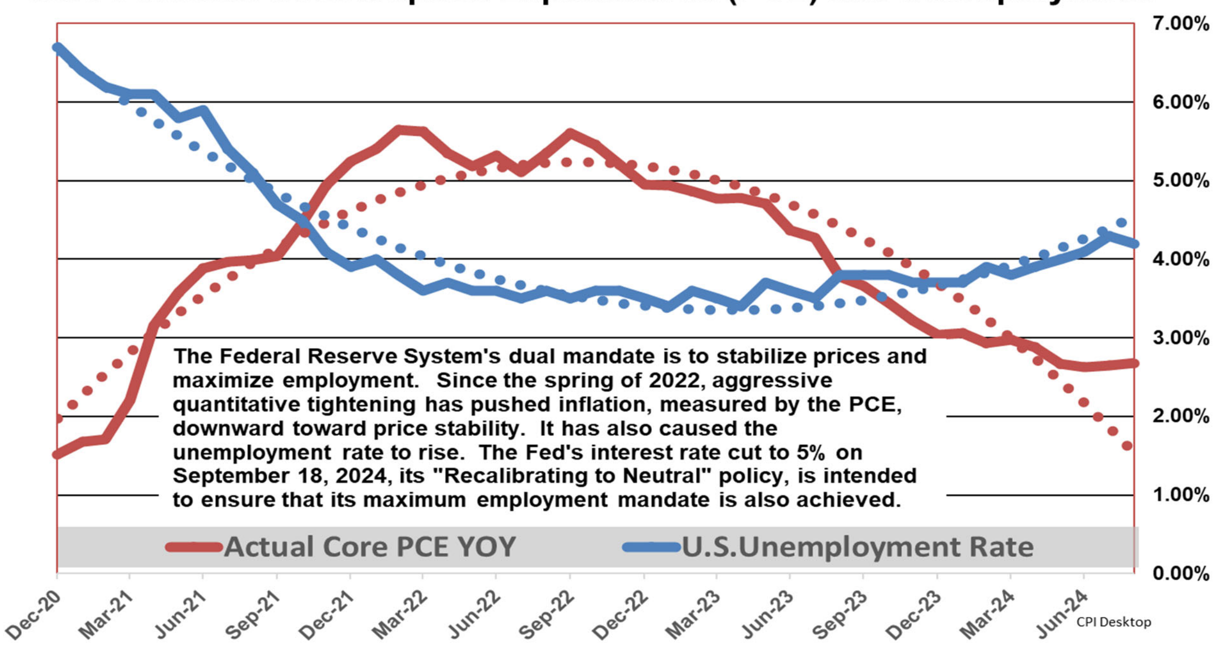
The Federal Reserve steadily increased the Fed Funds target rate from 0.25% in the spring of 2022 to a very restrictive 5.50% in July of 2023, where it remained until Jay Powell announced that Fed policy will be "Recalibrating to Neutral" and cut it to 5.00% on September 18th, 2024. The "neutral" Fed Funds rate is the rate that is neither restrictive nor stimulative, believed to be 2.50%-3.00%.

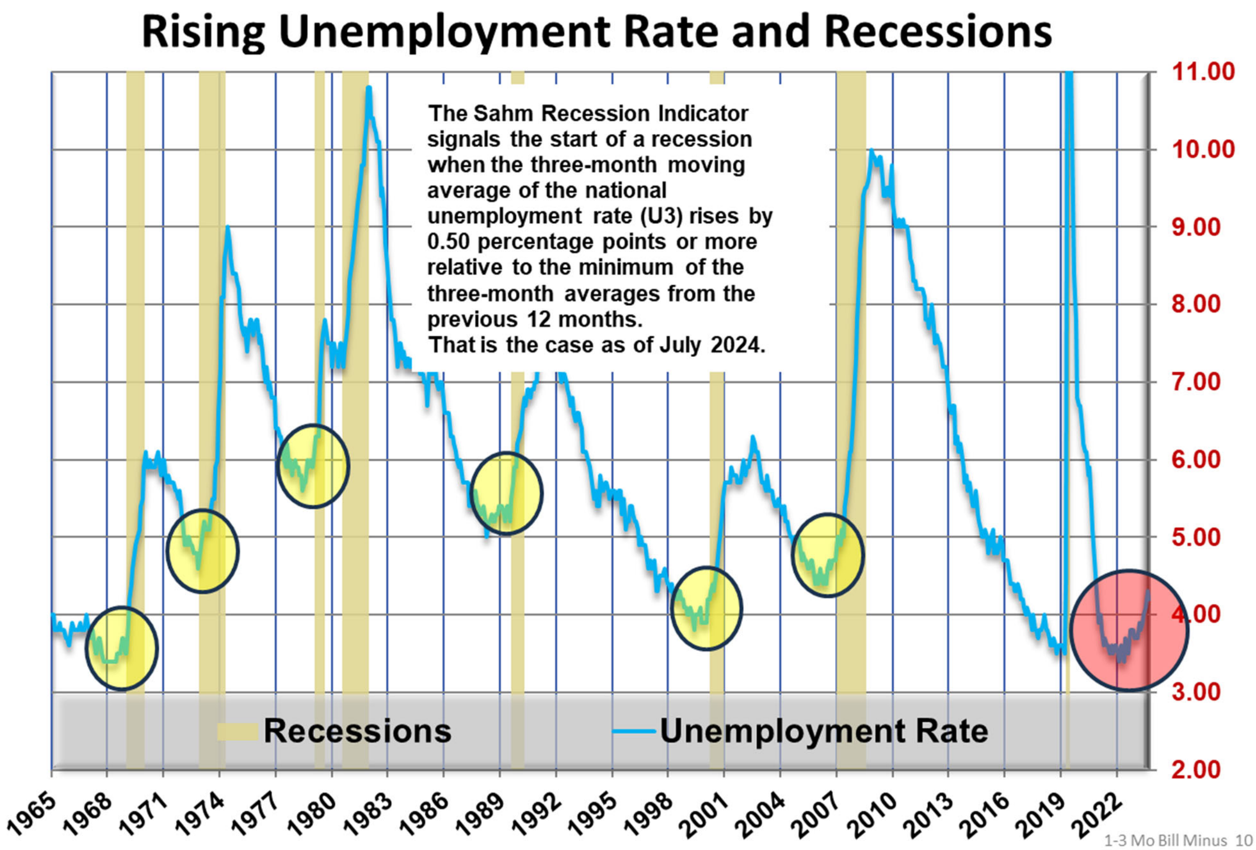
The Fed's dual mandate is to pursue stable prices and maximum employment. Inflation is falling in most developed economies and the Fed's favorite U.S. inflation gauge, the core PCE (Personal Consumption Expenditures), is nearing its target of 2%. Starting in the spring of 2022, the Fed aggressively raised interest rates in order to slash inflation from about 9.00% to about 2.50%. Higher interest rates discourage individuals and companies from borrowing and slow the level of economic activity. They also discourage hiring and tend to increase the unemployment rate. The unemployment rate is about 4.2%, up from a historical low of 3.4% in January of 2023.

The chart below, my real-world example of the "Phillips Curve," illustrates the inverse relationship between unemployment and inflation and how difficult it can be for the Fed to achieve both mandates. When the economy is strong and interest rates low, unstable prices can result. If the Fed raises interest rates to tighten economic conditions, unacceptably high unemployment can be the result.

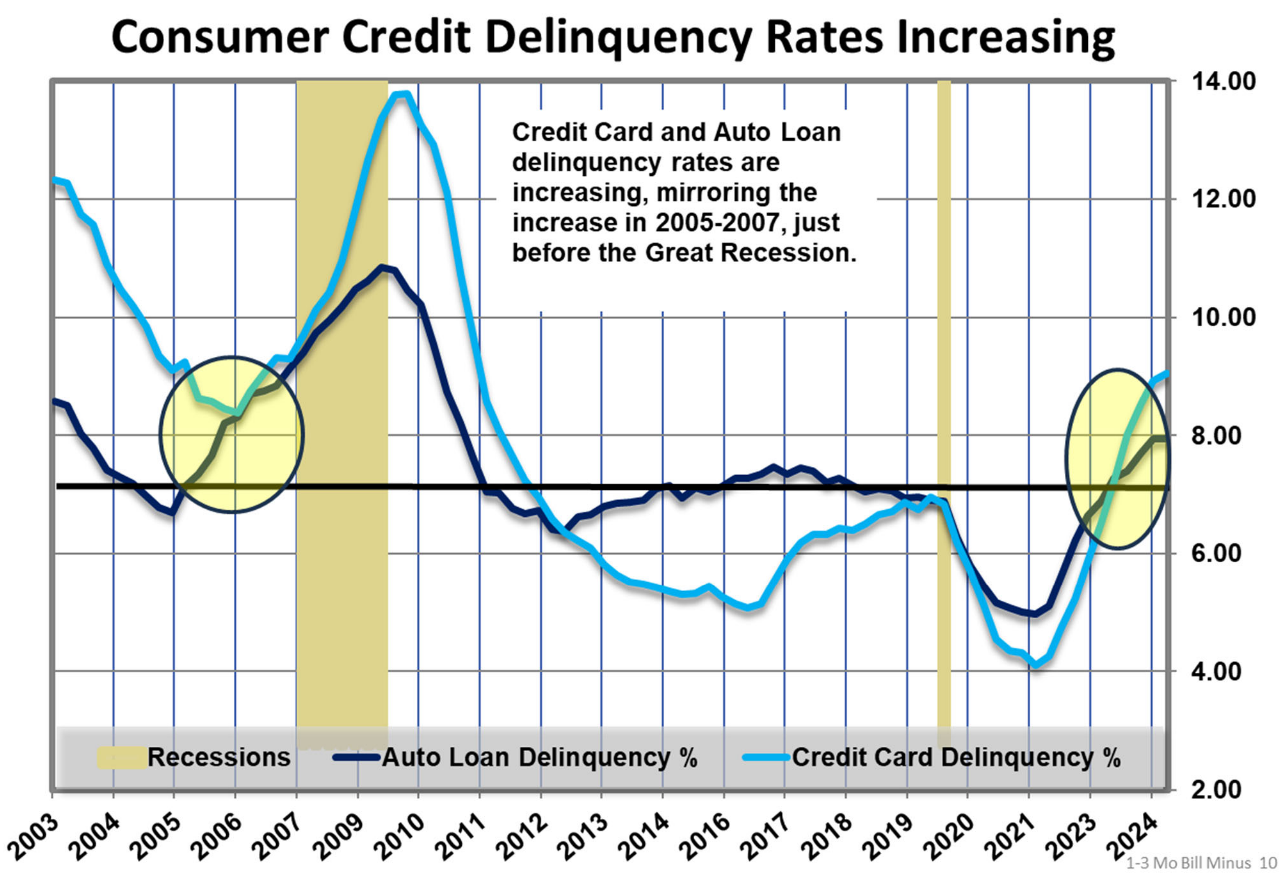
The U.S. economy is still strong, the Atlanta Federal Reserve bank predicts about 3.00% real GDP for the third quarter and S&P earnings are expected to grow at about 5.00% year-over-year. Having said that we also have some concerns. Leading indicators are falling, and the cost to carry our growing public debt is worrisome. The U.S. stock market is essentially at an all-time high, raising valuation concerns. Historically tight credit spreads are tempting investors to foolishly reach for yield in high-risk offerings like leveraged private credit. The potential U.S. East Coast ports strike could disrupt supply chains and increase inflation. There is some risk of a recession. Whatever direction the economy takes, we need to be prepared to deal with it.

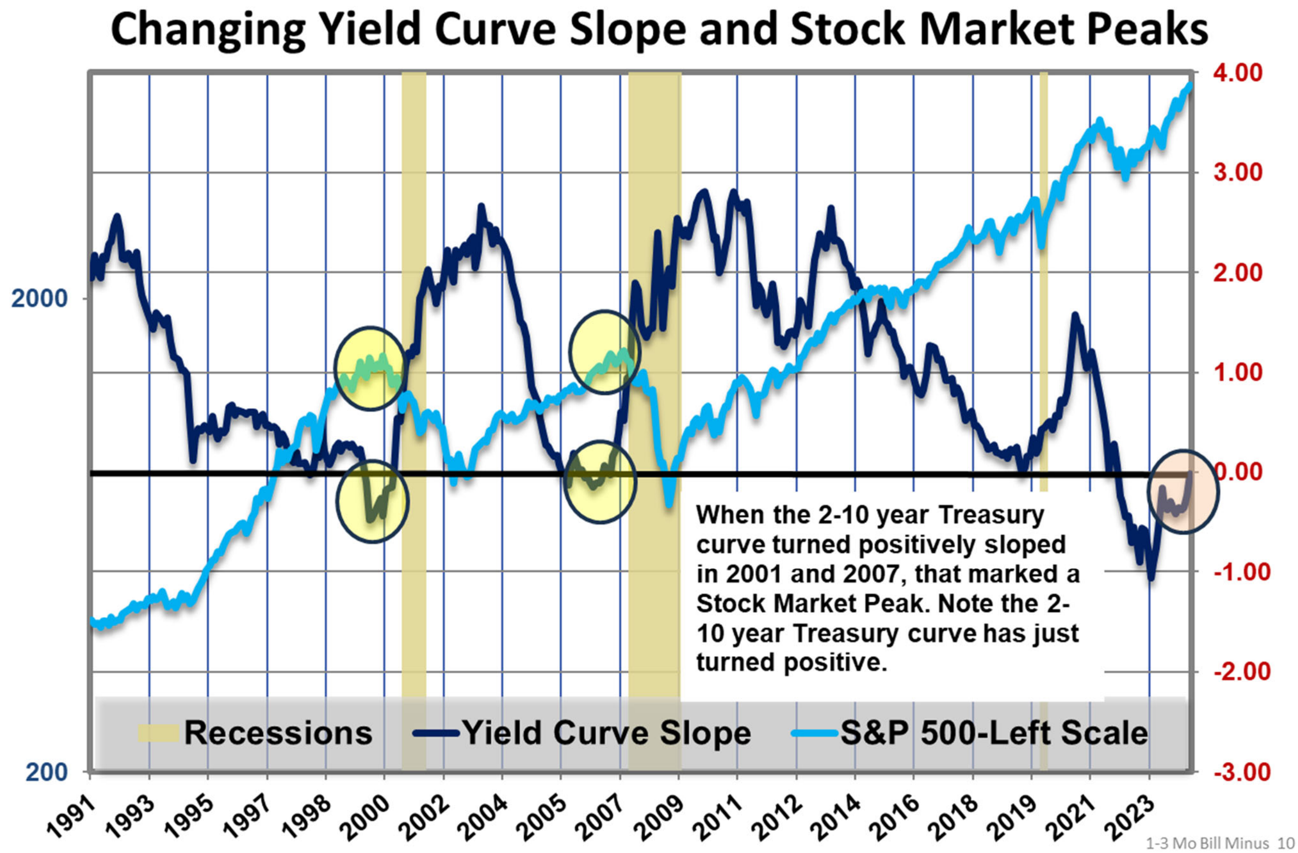
Core Personal Consumption Expenditures (PCE) and Unemployment



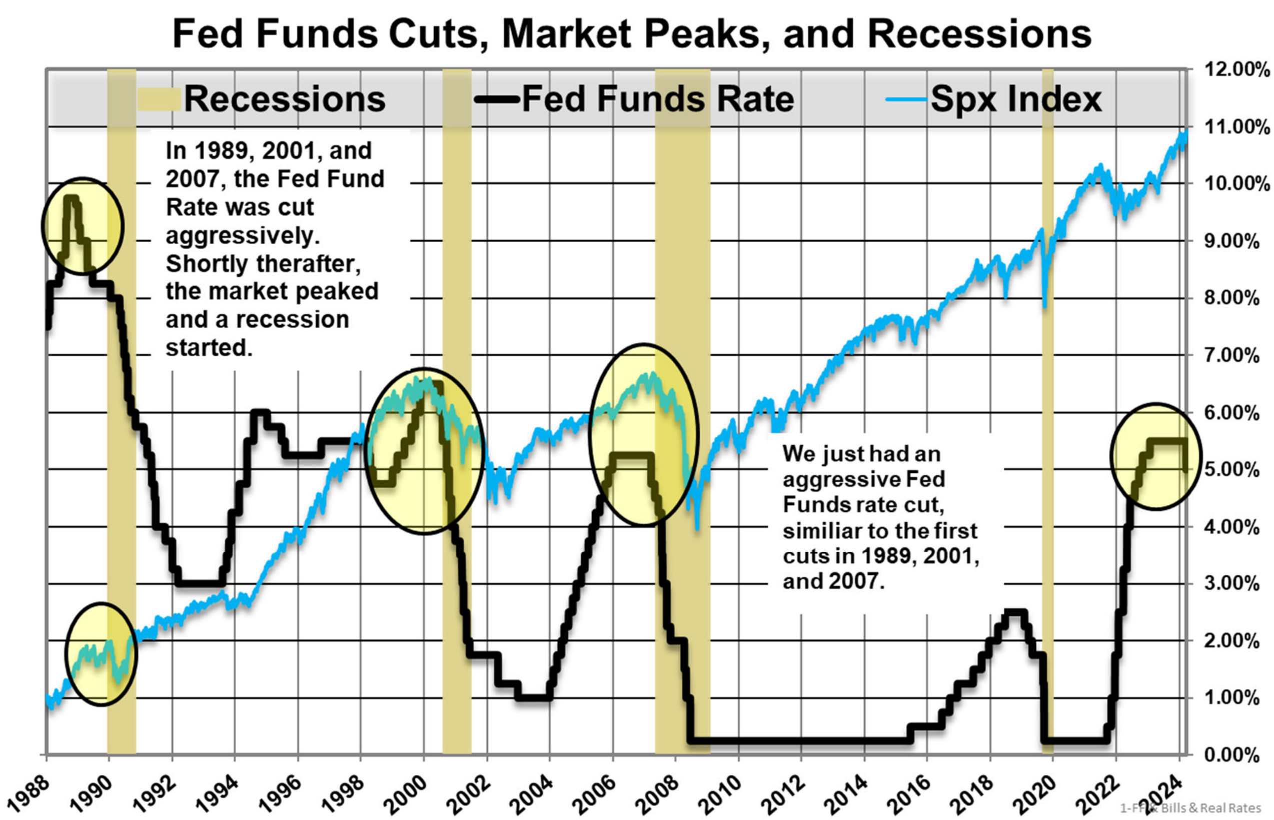


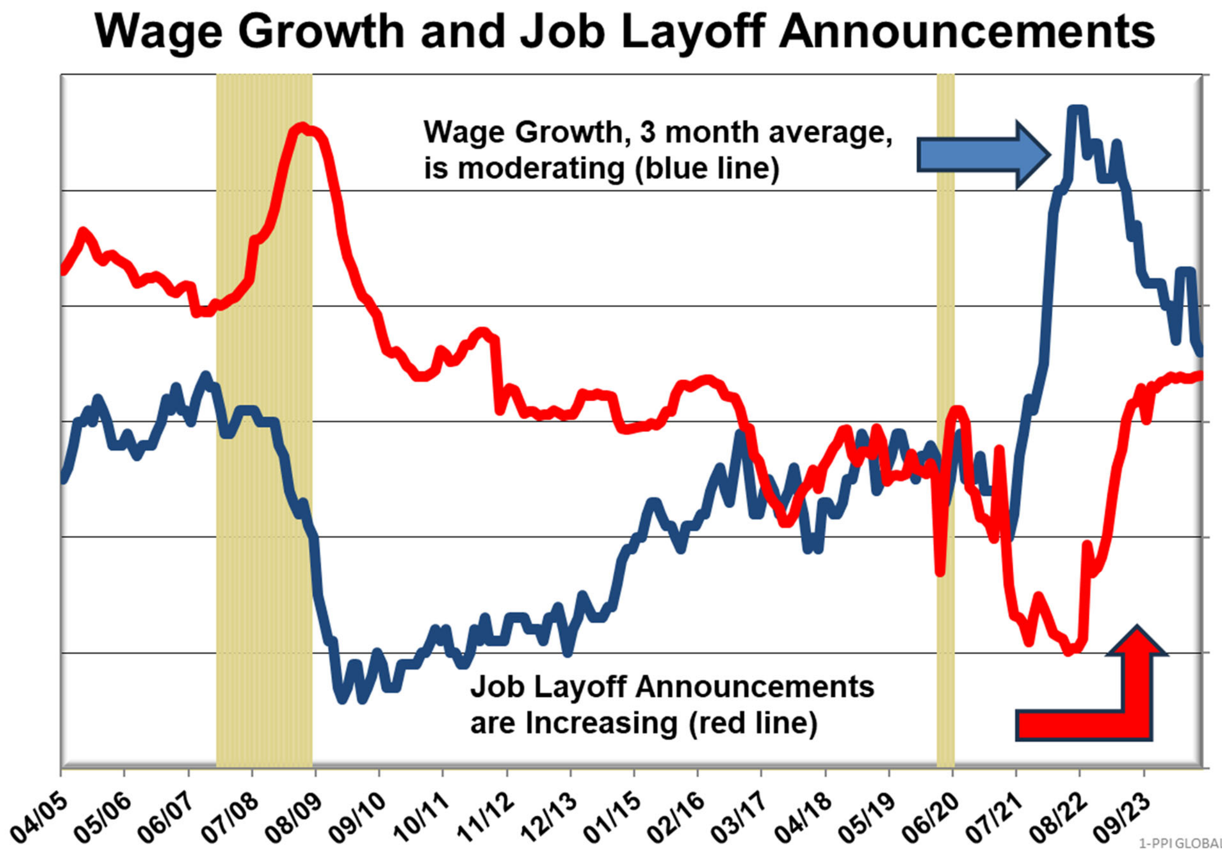
Concerning historical signals indicate that the U.S. economy may be months away from a recession. The “Sahm” indicator (see above) has a strong historical record of having forecasted a recession going back to 1965. Credit card and auto loan delinquencies are increasing, a sign of economic stress among consumers, and a precursor to a recession (see below).



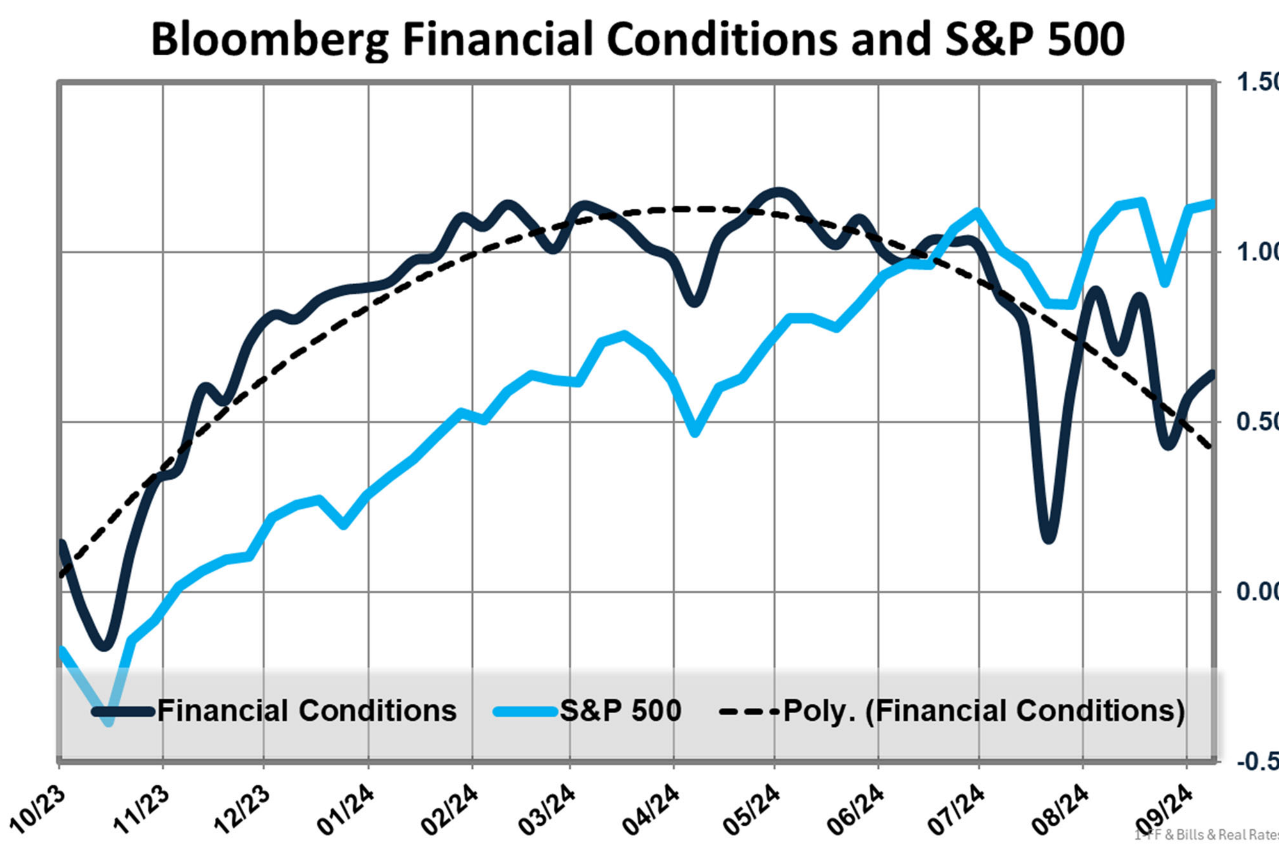


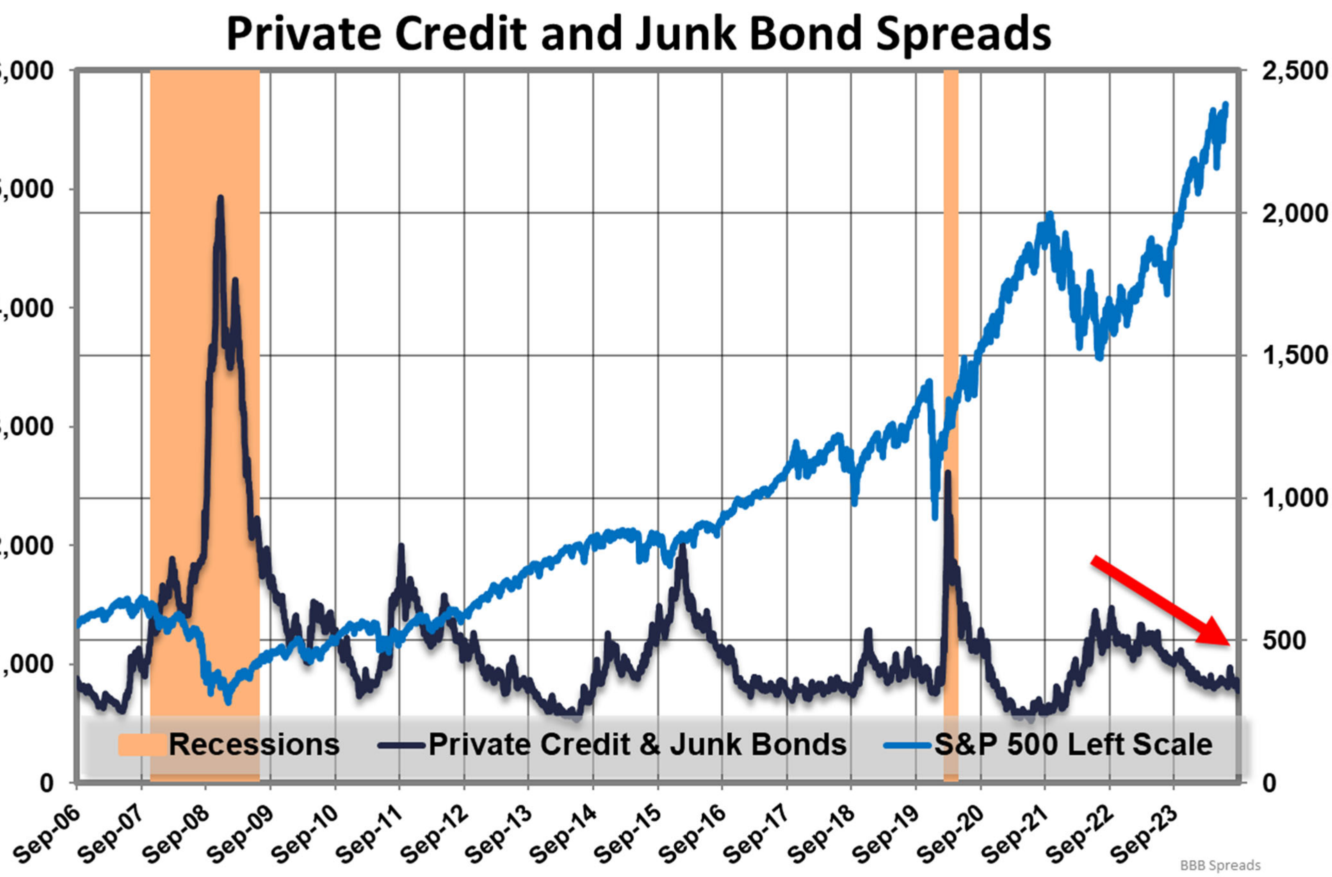
The U.S. economy is still growing at a healthy pace, with an estimated 3% real GDP for the third quarter. However, there are some concerning signs, such as the aggressive Fed rate cut (see below) and subsequent steepening of the yield curve (see above). **At the same time, it is important to note that** the triggers for the 2001 recession (dotcom bust) and the 2008 recession (junk mortgage defaults) are not present today.



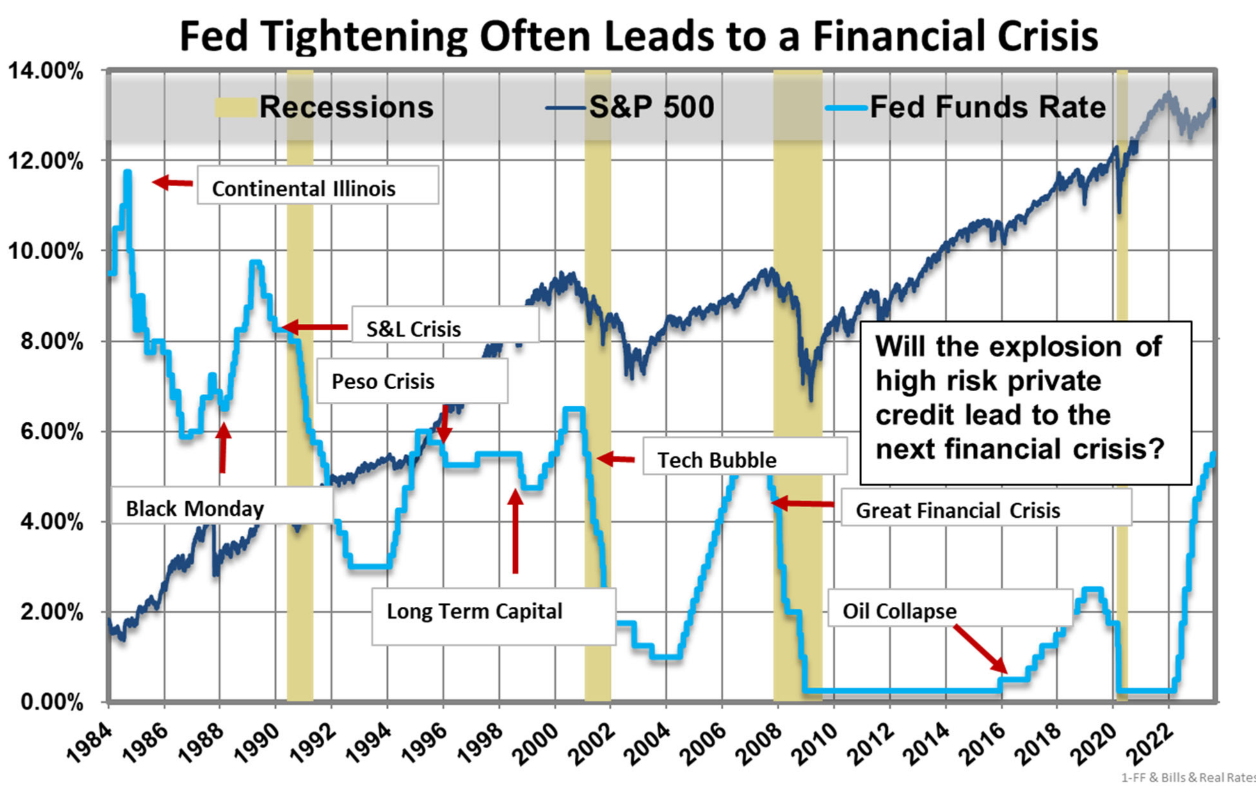


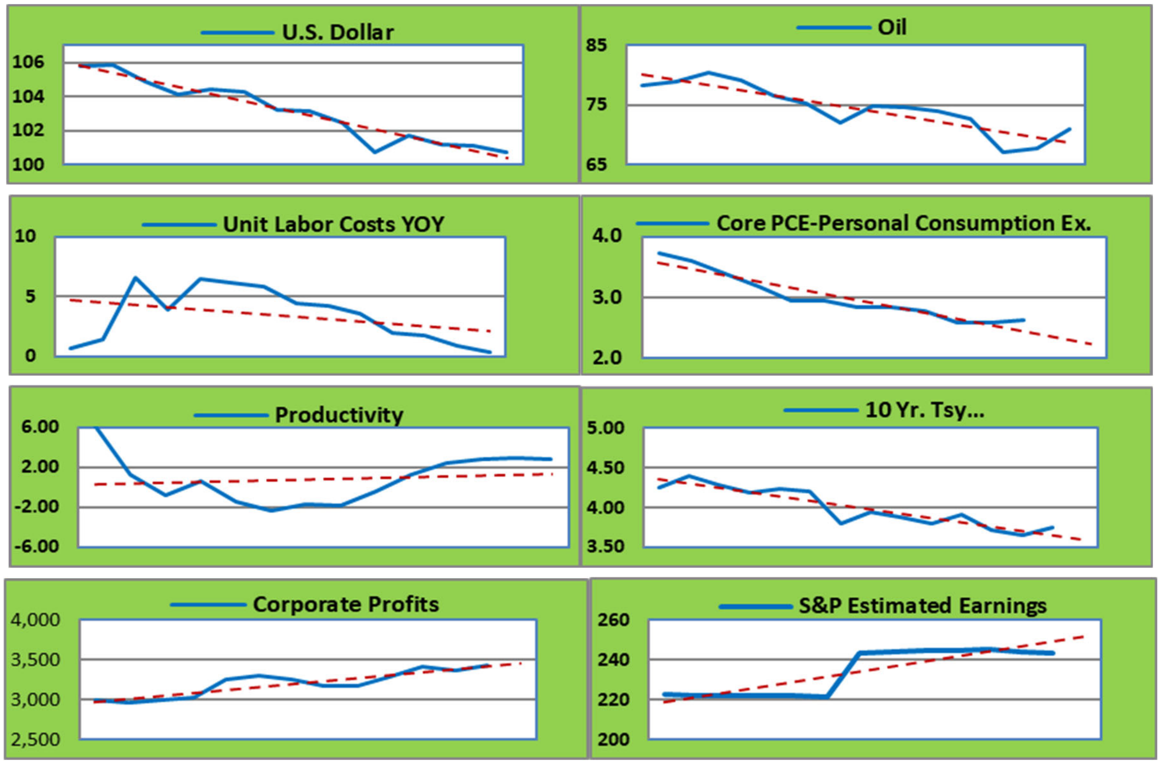
Wage growth has slowed, job layoff announcements have increased (see above), and the Bloomberg Financial Conditions index, which tracks the overall level of financial stress in the U.S. economy, is rolling over (see below). All of these are signs of a slowing U.S. economy and provide additional reasons for the Fed's aggressive 50 basis point cut to the Fed Funds rate.





After the Great Recession, caused by a lack of lending regulations for low-quality mortgage issuance, bank capital requirements were tightened. This forced low-quality borrowers to seek loans elsewhere, leading to the burgeoning private credit business. Junk bond and private credit spreads are tightening (see above), reminiscent of conditions in 2007, just before the Great Recession. Fed tightening cycles often culminate in a financial crisis (see below), there is a risk that high-risk private credit loans could trigger the next crisis.



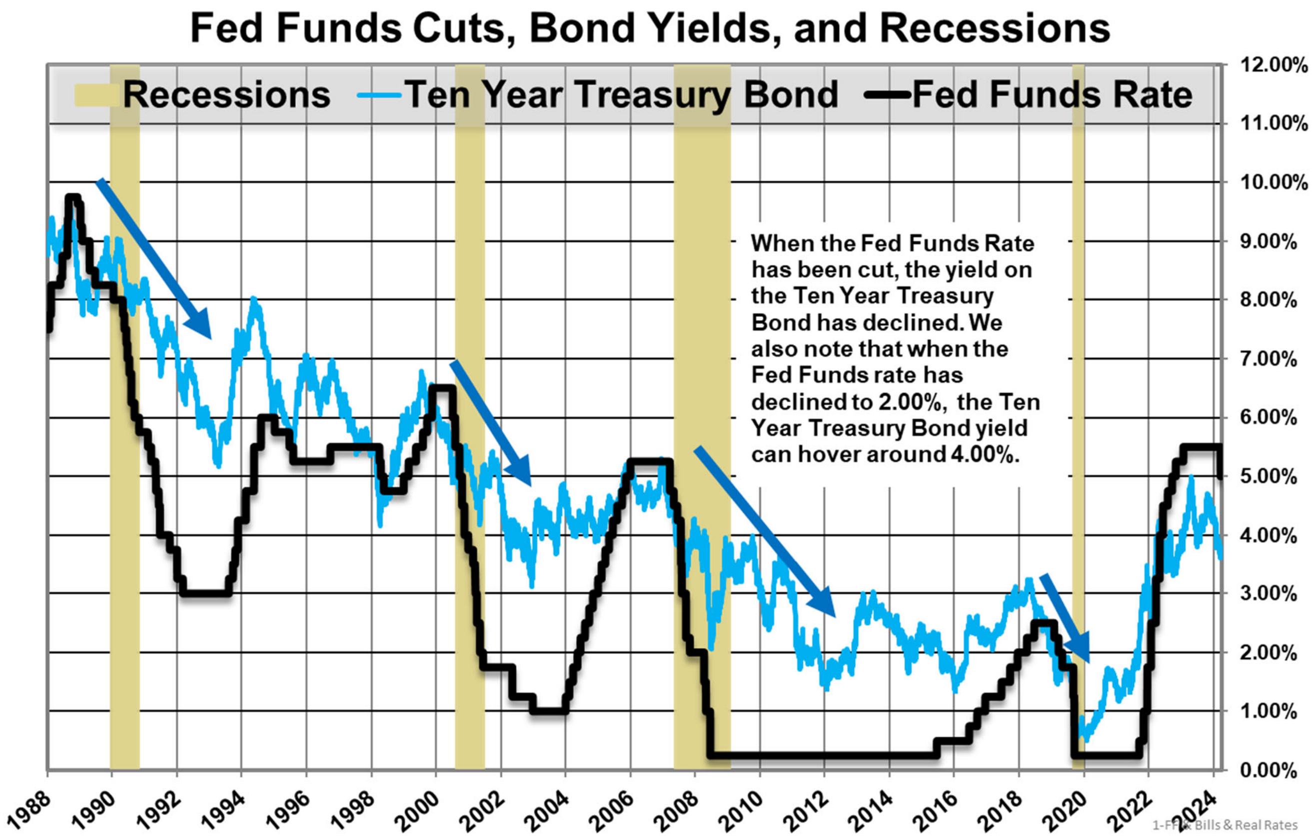


We have had a great stock market run over the last twelve months and the mainstays of that run, a weakening dollar, falling oil price, decreasing real labor costs, decreasing inflation, robust productivity increases, declining bond yields, upward revised increasing corporate profits, and earnings estimates, are all still in place (see above).

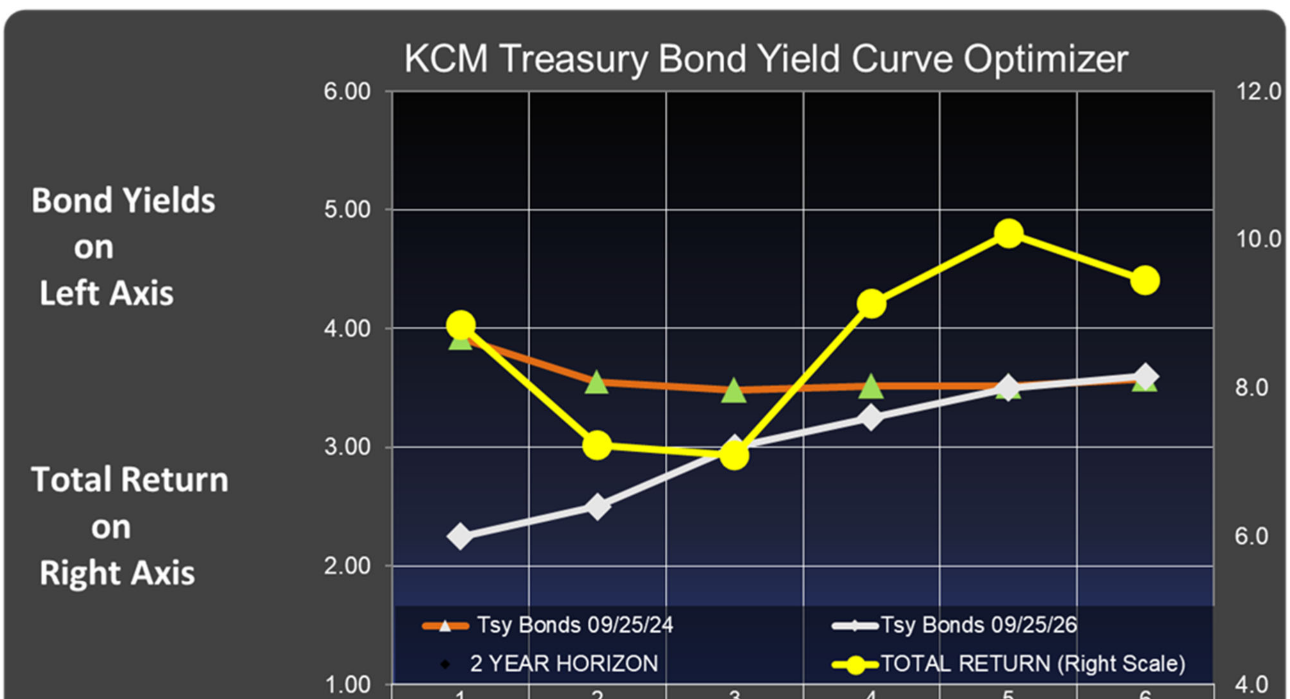
Stocks ultimately trade based on earnings, which are projected to grow by approximately 5% in 2024. With a P/E ratio of 22.88x on the 2024 earnings estimate of $250 for the S&P 500, the market is not necessarily in bubble territory compared to historical market peaks of around 29x in 2000 and 26x in 2021 (see below). While the forward P/E ratio is approaching these peaks, it has not reached them yet. Therefore, the market is not in bubble territory. Although the economy may be slowing, the current and anticipated rate cuts (the adage 'don't fight the Fed' holds true), the trillions of dollars parked in money market funds with declining yields, and expansionary fiscal policies could support further increases in stock prices.

The market peak in 2000 was the result of excessive valuations in the tech sector (we do not have a tech bubble today), the dotcom bust, rising inflation, and the Fed's tightening monetary policy. In contrast, today's market conditions are significantly different. The P/E ratio is nearly six points lower than its 2000 peak, inflation is on a downward trajectory, and the Fed has embarked on an easing path. The 2021 market peak was a result of aggressive easing measures implemented in response to the COVID-19 recession of 2020. Although the Fed Funds rate was at a historic low of 0.25% in 2021, it began rising in March 2022, eventually reaching 5.50%. Inflation, as measured by the CPI, had surged to 7.00% and peaked at 9.10% in June 2022. Today, the Fed Funds rate is 4.75% and is expected to decrease further. Additionally, CPI inflation has declined to approximately 2.50%.

	Peak 3/31/2000	Peak 12/31/2021	EST. 2024 9/30/2024	Compared to 2000 Peak	Compared to 2021 Peak
S&P 500 Forward PE Ratio	28.82	25.84	22.88	-5.94	-2.96
Dividend Yield	1.10	1.27	1.42	0.33	0.15
Fed Funds	**6.00**	**0.25**	**5.00**	**-1.00**	**4.75**
3 Month T-Bill Yield	5.87	0.03	4.49	-1.38	4.46
Ten Year Treasury Bond Yield	6.00	1.51	3.74	-2.26	2.23
Consumer Price Index YOY	**3.80**	**7.00**	**2.50**	**-1.30**	**-4.50**

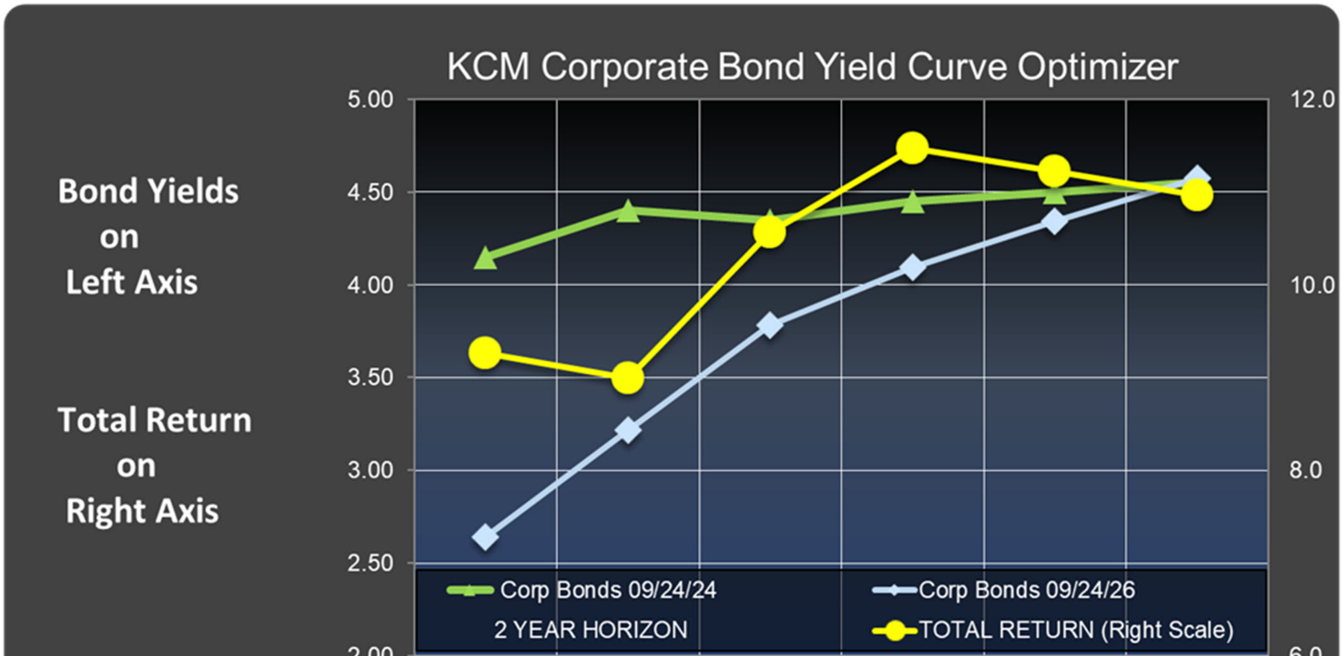


Historically when the Fed cuts the Fed Funds rate, the yield curve steepens and the yield on the ten-year Treasury bond declines. We also note the term premium on the ten-year bond versus Fed Funds hovers around 2.00%. So, as Fed Funds continue to decline, the yield on the ten-year Treasury bond is likely to drift around 4.00% (see above). The chart below illustrates where Treasury bond yields are today, where we believe they will be in two years and where to invest today to maximize your total return over the next two years.



	1	2	3	4	5	6
Tsy Bonds 09/25/24	3.92	3.55	3.48	3.52	3.52	3.58
Tsy Bonds 09/25/26	2.25	2.50	3.00	3.25	3.50	3.60
2 YEAR HORIZON						
TOTAL RETURN (Right Scale)	8.8	7.2	7.1	9.1	10.1	9.5

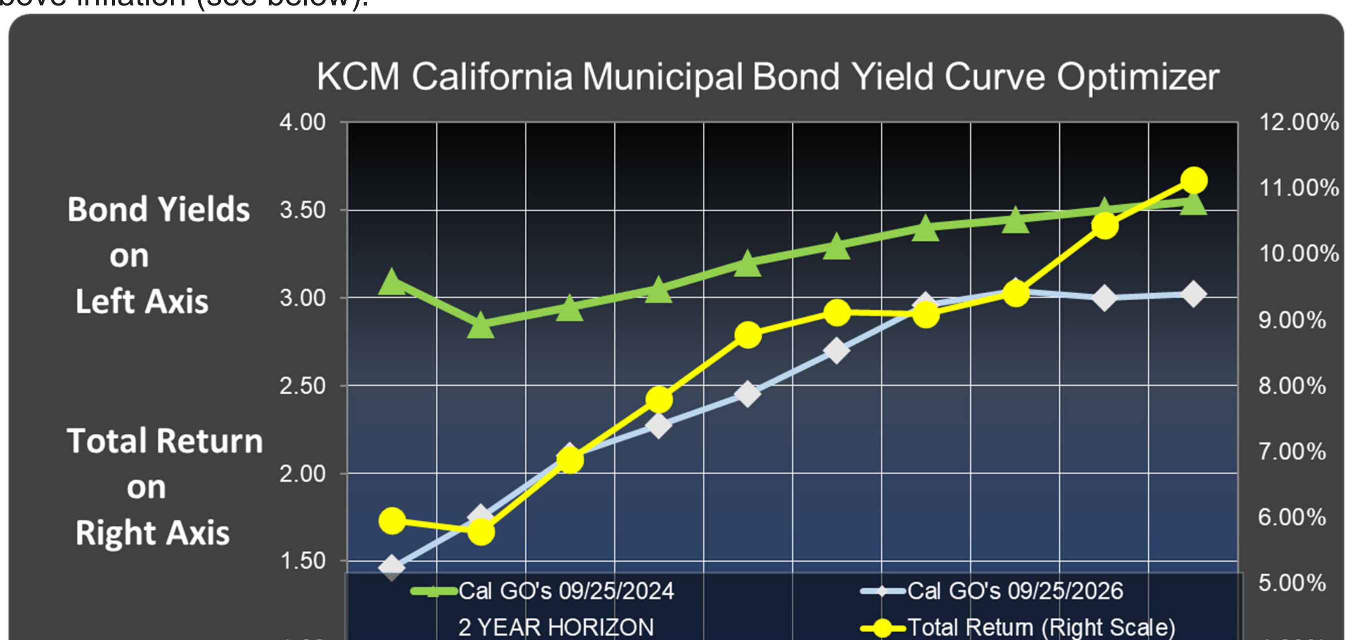
5-Tsy Return 2



	1	2	3	4	5	6
Corp Bonds 09/24/24	4.15	4.40	4.35	4.45	4.50	4.55
Corp Bonds 09/24/26	2.64	3.22	3.78	4.10	4.35	4.58
2 YEAR HORIZON						
TOTAL RETURN (Right Scale)	9.3	9.0	10.6	11.5	11.2	11.0

5-SHORT CORP RETURN

Investment-grade corporate bonds are trading at historically narrow spreads to government bonds, so we need to carefully analyze individual names to minimize volatility in a potential economic slowdown (see above). High-quality municipal bonds remain attractive, especially with a high coupon ten-year call date. They yield about 3.55% giving the investor an acceptable after-tax return above inflation (see below).



	1	2	3	4	5	6	7	8	9	10
Cal GO's 09/25/2024	3.10	2.85	2.95	3.05	3.20	3.30	3.40	3.45	3.50	3.55
Cal GO's 09/25/2026	1.46	1.75	2.10	2.28	2.45	2.70	2.96	3.04	3.00	3.02
2 YEAR HORIZON										
Total Return (Right Scale)	6.0%	5.8%	6.9%	7.8%	8.8%	9.1%	9.1%	9.4%	10.4%	11.1%

5 - California Muni

Wrapping up:

The Federal Reserve steadily increased the Fed Funds target rate from 0.25% in the spring of 2022 to a very restrictive 5.50% in July of 2023, where it remained until Jay Powell announced that Fed policy will be “Recalibrating to Neutral” and cut it to 5.00% on September 18th, 2024. The “neutral” Fed Funds rate is the rate that is neither restrictive nor stimulative, believed to be 2.50%-3.00%.

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The chart on page one, my real-world example of the “Phillips Curve,” illustrates the inverse relationship between unemployment and inflation and how difficult it can be for the Fed to achieve both mandates. When the economy is strong and interest rates low, unstable prices can result. If the Fed raises interest rates to tighten economic conditions, unacceptably high unemployment can be the result.

The U.S. economy is still strong, the Atlanta Federal Reserve bank predicts about 3.00% real GDP for the third quarter and S&P earnings are expected to grow at about 5.00% year-over-year. Having said that we also have some concerns. Leading indicators are falling, and the cost to carry our growing public debt is worrisome. The U.S. stock market is essentially at an all-time high, raising valuation concerns. Historically tight credit spreads are tempting investors to foolishly reach for yield in high-risk offerings like leveraged private credit. The potential U.S. East Coast ports strike could disrupt supply chains and increase inflation.

A positive stimulus surprise came from China’s Politburo meeting where they pledged to make the real estate market “stop declining” by calling for a “forceful” implementation of rate cuts. The Shanghai Stock Exchange index is up about 10% since Mid-September.

Recession Concerns

Despite continued healthy economic growth, several troubling indicators suggest that a recession may be looming. The historical accuracy of the Sahm Rule in predicting economic downturns, coupled with rising credit card and auto loan delinquencies signaling consumer financial strain, are cause for concern. Aggressive Federal Reserve interest rate cuts in the past, followed by a steepening of the yield curve, have historically been precursors to broader economic contractions. Additionally, wage growth has slowed, job layoff announcements have increased, and the Bloomberg Financial Conditions index, which tracks overall financial stress in the U.S. economy, is on an upward trajectory. All of these factors point to a potentially slowing U.S. economy.

Past Recession Triggers Are Currently Not Present

It is important to note that the specific triggers of past recessions are not currently present. The 2001 recession was triggered by the excessive pricing of 'dotcom' stocks and the subsequent collapse of the tech bubble. The 2008 recession was caused by the collapse of the housing market due to poorly underwritten mortgage bonds that defaulted, putting tremendous strain on the banks. We do not see a similar overvaluation of technology stocks, and the housing market, likely overpriced due to a lack of supply, remains relatively stable.

Fed Tightening Cycles Often Lead To A Financial Crisis

After the Great Recession, caused by a lack of lending regulations for low-quality mortgage issuance, bank capital requirements were tightened. The stricter regulations forced low-quality borrowers to seek alternative sources of financing, making the private credit business mighty attractive for lenders. Junk bond and private credit spreads are currently tight, reminiscent of conditions in 2007, just before the Great Recession. Given the historical relationship between Fed tightening cycles and financial crises, we believe there is a substantial risk that defaulting private credit loans could trigger the next crisis.

Investors Should Stick With Quality

Low-quality credit products, like junk bonds and leveraged private credit offerings, do not perform well in an economic slowdown. Defaults rise, spreads widen and prices plummet. Spreads to Treasury bond yields can easily widen five hundred basis points, which equates to a 30% or more decline in price. Stick with quality in uncertain times.

Are Stocks Still Attractively Priced?

We have had a great stock market run over the last twelve months and the mainstays of that run, a weakening dollar, falling oil price, decreasing real labor costs, decreasing inflation, robust productivity increases, declining bond yields, increasing corporate profits and earnings estimates, are all still in place.

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Where We See the Sweet Spot for Bonds

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By our calculations, the sweet spot on the curve for Treasury and corporate bonds is 4-5 years and 10 years for municipal bonds.

…And Stay Flexible!

As the election progresses, we must carefully observe, evaluate, and adjust to the potential and actual outcomes. A significant increase in the capital gains tax or the (unlikely) taxing of unrealized gains would likely have a negative impact on the market.

The Tax Cut and Jobs Act of 2017 raised the estate tax exemption (imposed on the transfer of property upon death) to its current level of $13.61 million. However, without further action from Congress and the executive branch, this exemption will decrease to $5 million on January 1, 2026. For estates valued above the exemption amount, a tax of approximately 40% is applied. For instance, an estate worth $13.61 million can currently be passed on entirely without federal estate tax. Beginning in 2026, however, a tax of roughly 40% would be due on the difference between $13.61 million, or greater, and $5 million if the current exemption is not extended.

Staying informed and adapting our strategies can help us navigate the uncertainties and hopefully thrive in the always evolving and uncertain economic landscape.

As always, we are glad to meet with you to address your questions or concerns, and we thank you for investing with KCM. It is our constant goal to exceed your expectations.

Jay Kellett - Founder and CEO

Note: All graphs were produced by KCM using data from Bloomberg. Bloomberg is also the source of the stated economic data.