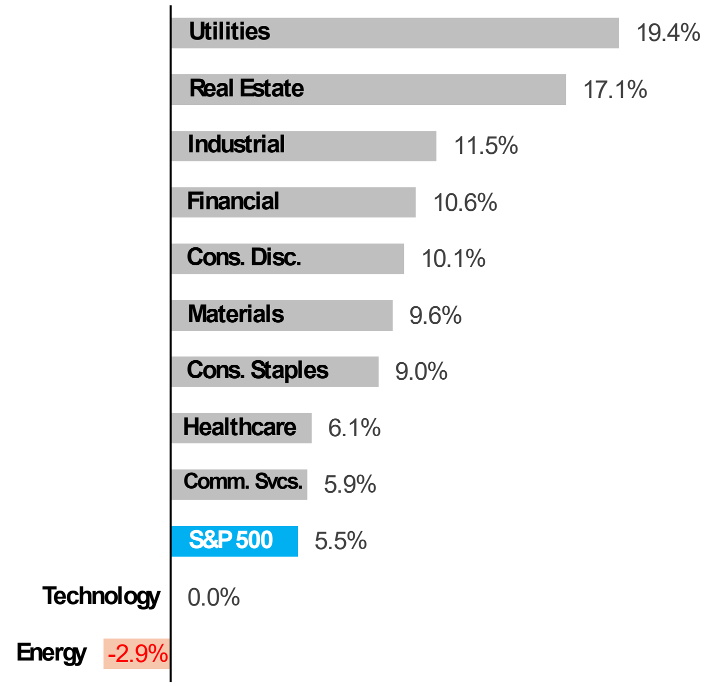
Investment Commentary

Broadening Market Strength, Fed Rate Cuts, and What Lies Ahead

U.S. equity markets saw broad gains in Q3, with all major indices posting positive returns. Notably, market leadership, which had been concentrated in large-cap tech, broadened as other sectors and asset classes joined the fun.

This is reflected in the impressive performance of the equal-weighted S&P 500, up 9.1% for the quarter, surpassing the market-cap weighted S&P 500's gain of 5.53%. Small cap companies also advanced, with the Russell 2000 rising 8.9%. The top-performing industries included asset managers, utilities, building products, REITs, property and casualty insurers, credit cards, and cruise lines. On the flip side, energy, semiconductors, software, money-center banks, department stores, steel, and autos lagged behind.

3rd Quarter 2024 Sector Returns



Source: FactSet

Interestingly, as the adjacent chart depicts, the artificial intelligence (AI) boom has spilled over into utilities, as the massive power demands of AI data centers have drawn investor attention to the sector. The industry anticipated some increase in demand with the advent of electric vehicles and the increase in onshoring of manufacturing, but it has only recently realized the extent to which demand will increase with the proliferation of AI data centers. After about two decades of flat demand growth, utilities now face the need to upgrade facilities. The enormous amounts of electricity needed could impact the pace at which the country moves toward cleaner energy. In addition, some nuclear power plants are being considered for reopening. The Biden administration recently officially backed the reopening of the Palisade Nuclear Plant in Michigan and is providing loan guarantees to facilitate the process. The supply/demand dynamic here could lead to higher electricity prices and eventually impact inflation if supply can not ramp up to meet demand both in the US and the rest of the world.

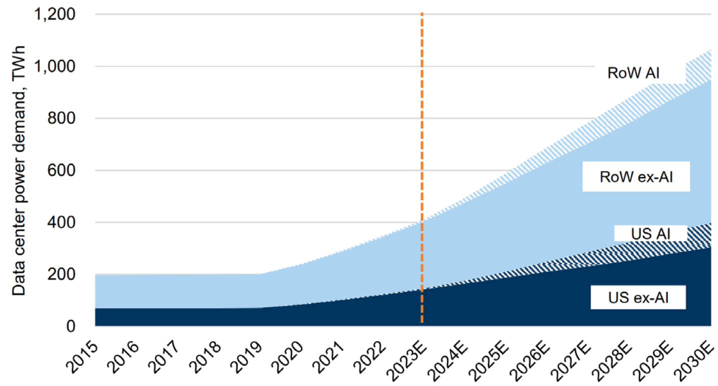
As the quarter progressed, expectations for a "soft landing" scenario gained traction. S&P 500 earnings for Q2 grew by a robust 11.3%, and the Fed cut rates by 50 bps, providing a favorable backdrop for growth (details below). According to Fundstrat, when the Fed cuts rates outside of a recession, the S&P 500 has been positive in seven out of seven cases, both three and six months after the initial cut. At the end of the quarter, China introduced measures to stimulate growth, which could have positive ripple effects across global markets. Additionally, the large pool of over $6 trillion in money market assets could eventually flow into equities, further supporting the market.

However, there are headwinds to consider. Valuations remain elevated, with more than 80% of S&P 500 stocks trading above their 50-day moving averages at quarter's end. Furthermore, mixed signals from corporate earnings reports—some mentioning consumer strength, others consumer weakness—raise concerns about whether the U.S. consumer, a key economic driver, may be pulling back. Additionally, questions remain about the effectiveness of Fed rate cuts, especially if job growth slows further.

Another noteworthy development was the end of the Treasury yield curve inversion, where the 10-year yield was lower than the 2-year yield (known as "2s10s spread" in Wall Street parlance). According to Barron's, five of the last six recessions since 1980 were preceded by an inverted yield curve of at least 20 days. The recent inversion lasted a record-breaking 793 days but

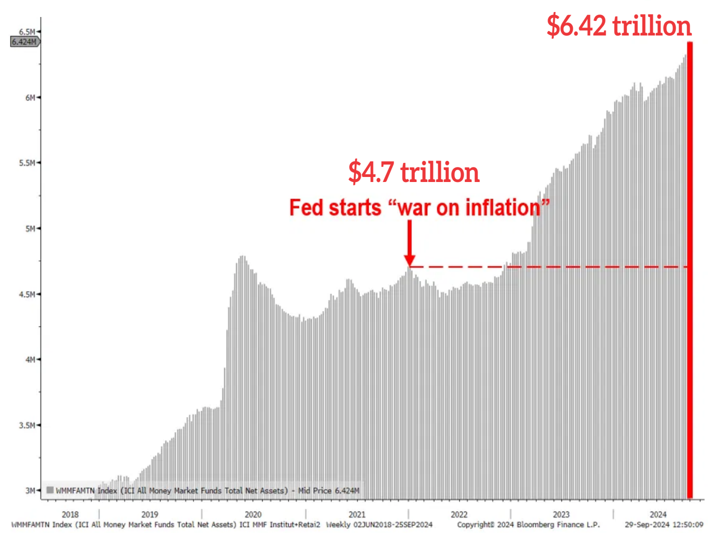
Global Data Center Electricity Consumption

TWh; Includes AI and Excludes Cryptocurrency



Source: Masanet et al. (2020), Cisco, IEA, Goldman Sachs Global Investment Research

ICI Total Money Market Balances



Source: Fundstrat, Bloomberg

has not yet been followed by a recession—though historically, recessions have begun after the yield curve normalizes. A more optimistic view is that yields fell in anticipation of Fed rate cuts, particularly at the short end of the curve, where borrowing rates are most directly affected. It remains to be seen what impact these cuts will have on the economy.

Election and Tax Policy Preview

The 2024 U.S. presidential election is rapidly approaching. Thus far, it has not been a major market driver, though this could change in the weeks ahead. Regardless of who wins the White House and Congress, the main policy focus in Washington next year will be dealing with the expiring individual tax cuts passed as part of the 2017 Trump Tax Cuts and Jobs Act ("TCJA") that expire at the end of 2025. Even though the tax cuts that expire next year are mainly on the individual side, the market will likely be subject to "headline risk" associated with provisions that do not expire, specifically the corporate tax rate (which was decreased to 21% from 35% in 2017 but does not expire) and the capital gains rate (which was unaffected by the TCJA and stands at 20% plus an additional 3.8% for those making more than $200K AGI).

What is even considered, let alone gets signed into law, will ultimately depend on both who wins the White House and, just as importantly, on the complexion of the House of Representatives and the Senate. Currently, the race for the White House still looks very much like a toss-up. Polling in battleground states and other indicators point to a tight race, with swing voters in those states likely to decide the outcome. In terms of Congress, a divided Congress (a narrow Republican Senate and a narrow Democratic House, with both chambers flipping) still looks like the most likely outcome. However, Republican or Democratic sweeps are entirely possible. In other words, whoever is in the White House may very well have to negotiate a divided Congress on the issue of tax reform (and everything else), which could make next year's tax fight transactional, last minute, and difficult to handicap.

Let's take a quick look at some of the high-level tax provisions that will be in play next year, along with some scenario analysis around what action we may see depending on the election outcome. Again, it's difficult to be too precise here, as much will depend not only on which party controls Congress but also on the margin of that majority.

- **Income tax rates:** Vice President Harris has advocated for extending all the TCJA income tax cuts for those making less than $400K and increasing the top tax rate back to 39.6% from the current 37% for those making more than ~$500K (indexed for inflation). Trump, on the other hand, has advocated for a straight-line exemption for the entire TCJA, including for those in the top tax bracket.

- **Standard deductions:** The standard deduction was increased significantly under the TCJA (currently at $14.6K from $6.5K), and it is assumed that both candidates would extend the increase.

- **SALT deduction:** The TCJA eliminated the full state and local tax (SALT) deduction, instead imposing a $10K limit on the state and local taxes, including property taxes that a tax filer can deduct from their federal tax burden. This meant that for many (mostly wealthy) folks living in high income states, the TCJA represented a tax increase. While Harris has been silent on what she would do, it is assumed that under a Democratic sweep, the entire SALT deduction could be reinstated, or at the very least, the current cap of $10K would be raised significantly (e.g., to $80K). In order to deflect concerns that this only benefits the top taxpayers (which it does), we could see it coupled with a reinstatement of the lower pre-TCJA AMT threshold. For his part, Trump recently said he would also reinstate the entire SALT deduction, which Republican members of Congress seem unlikely to do. However, Trump's statements may mean we could see some compromise on the cap (i.e., an increase to $40K or $50K). Regardless, the current $10K cap is likely to increase under almost all scenarios or possibly get eliminated altogether under a Democratic sweep.

- **Estate tax exemption:** While the TCJA did not change the top rate at which estates are taxed (40%), it doubled the amount individuals and married couples could exempt from the estate tax. While there is undoubtedly a risk that under a Democratic sweep, the exemption reverts to its pre-TCJA levels, Democrats would likely only control the Senate by about one vote in that scenario. As such, an exemption extension is more likely than not, regardless of the election result.

- **Corporate tax rate:** The cut in the corporate tax rate from 35% to 21% was made permanent under the TCJA, so Congress does not need to necessarily do anything about it. However, Harris has proposed increasing the corporate rate to 28%, while Trump has proposed cutting it to 15%. In reality, neither of these outcomes appears likely, with Republicans unlikely to cut below 20% due to fiscal concerns and Democrats more likely to land somewhere below 28% (e.g., 25%).

- **Capital gains tax rate:** The TCJA preserved the capital gains tax rate, which currently stands at 20% for those making less than $200K and 23.8% for those making more than that. Harris has proposed a rate of 28% for those making less than $200K and 33% for everyone else. While the capital gains tax rate could increase under Harris, it would unlikely be to the full 33%. It is also doubtful that taxes on unrealized gains – for those making $100M or at any level – will get any real traction. The same can be said for any form of wealth tax.

- **Everything Else:** the Child Tax Credit, housing tax credits, eliminating taxes on tips, and reducing taxes on Social Security income may all be in the mix, but due to the mounting deficit (~6.5% of GDP for 2025), Congress will likely balk at significantly on adding too many additional "freebies."

Tax reform will likely dominate Washington next year, regardless of who wins the White House or controls Congress. From an economic perspective, whatever gets passed will primarily be an extension of existing policy rather than a whole host of new tax cuts. This means that while a tax bill could be stimulative at the margins, it is likely to be broadly neutral. Regardless, we should expect the market to contend with significant headline risk next year as tax reform is once again on the front burner, and much, if not all, of the final bill will be deficit-financed.

Possible Tax Outcomes Under Different Election Scenarios

Tax Provision	Pre-2017 Tax Rates	Post-2017 Tax Rates; expire 2025	Republican Congress	Split Congress	Democratic Congress	Split Congress
Top Rate	39.6%	37%	37%	37% to 38%	39.6%	38% to 39.6%
Individual Tax Rates / Brackets	10%: $0; 15%: $39K; 25%: $94K; 28%: 196K; 33%: $425K; 35%: $427K; 39.6%: All above	10%: $0; 12%: $39K; 22%: $83K; 24%: 157K; 32%: $200K; 35%: $500K; 37%: All above	Extend	Extend	Extend for <$400K	Extend for <$400K
State & Local Taxes (SALT) & AMT	Full deduction	SALT deduction capped at $10K	SALT cap raised (e.g., to ~$40K+)	SALT cap raised (e.g., to ~$40K+)	SALT cap raised (e.g., to $80K) / fully reinstated	SALT cap raised (e.g., to ~$60K+)
Estate Tax Exemption	$5.5mm/person	$13.6 mm/person*	Extend	Extend	TBD (Extend most likely)	Extend
Child Tax Credit	$1K/child	$2K/child, refundable up to $1.6K*	Extend with work requirements	Extend with some work requirements	Expand (e.g., $3K; proposed $6K will be difficult)	Extend / expand
Standard Deduction	$6.5K single/ $13K married	$14.6K single/ $29.2K married*	Extend / Increase**	Extend	Extend	Extend
Capital Gains	20% / 23.8% ($200K+)	20% / 23.8% ($200K+)	20% / 23.8% ($200K+)	20% / 23.8% ($200K+)	Likely increase (e.g., ~25% to ~28%)	TBD (e.g., stay at 23.8%, raise to ~25%)
Corporate Tax Rate	35%	21%***	Likely to stay at 21%	Likely to stay at 21%	Likely increase (e.g., to ~25%)	TBD (e.g., stay at 21%, up to ~25% increase)

Source: Joint Committee on Taxation; Congressional Budget Office; Tax Policy Center; PIMCO

*Indexed for inflation since passage of TCJA; **Ways and Means Chair Smith (R-MO) has proposed an additional $4K deduction on top of standard deduction; ***Corporate tax rate does not expire in 2025. For illustrative purposes only.

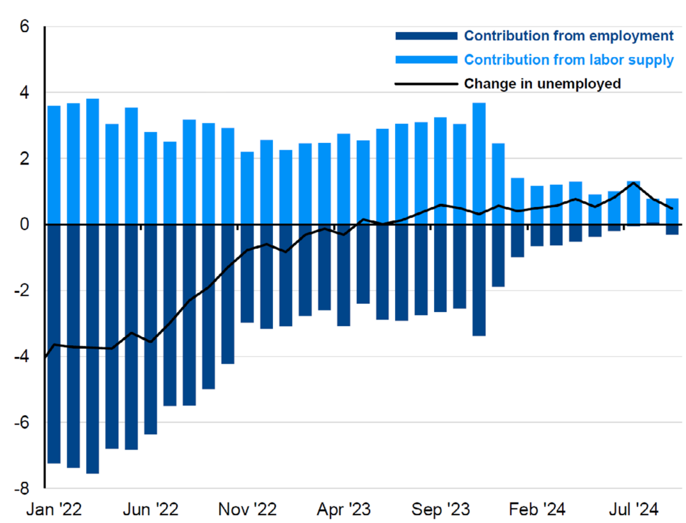
Tax reform is likely to be a key focus in Washington next year, regardless of the outcome of the presidential race or the balance of power in Congress. Economically, any legislation that passes is expected to largely continue current policies rather than introduce sweeping new tax cuts. As a result, while there may be some minor economic stimulus, the overall impact is expected to be relatively neutral. Nevertheless, the debate over tax changes is likely to generate headline risk for the market, especially since many of the proposed changes may increase the federal deficit.

Fed, Wall Street at Odds Over Rate Trajectory

In our most recent Withum Wealth Minute, we discussed the Fed's 0.50% September rate cut in its historical context. While both Wall Street and the Fed agree that this cut is the first of many, there's disagreement about the pace of further reductions. The Fed's "dot plot" reflects a slow, steady decline in rates, consistent with a still-healthy economy, balanced labor market, and easing inflation. Markets, on the other hand, are pricing in faster cuts, betting that worsening economic conditions will force the Fed's hand.

Breakdown of Unemployment

Millions, Change Over Previous 12 Months



Source: JP Morgan Asset Management

At the Jackson Hole summit in August, Fed Chair Powell cited a softening labor market and inflation nearing the 2% target as justification for the rate cut. Powell later referred to the move as a "recalibration" rather than a reactive measure in response to economic deterioration. Despite steady growth, with the Atlanta Fed's GDPNow model forecasting 2.9% annualized growth for Q3, the labor market has cooled, with unemployment rising to 4.2% from a 50-year low of 3.4%. This increase triggered the "Sahm Rule", a historically reliable recession indicator, adding weight to Wall Street's concerns. However, economist Claudia Sahm herself has attributed this instance to issues with labor supply (more people entering the workforce) rather than a weakening in labor demand (excessive quits or layoffs).

On the inflation front, Fed officials remain cautious. Michelle Bowman dissented at the September FOMC meeting, advocating for a smaller 25 bp cut, warning that inflation risks persist due to global supply chain vulnerabilities and geopolitical tensions. Bowman also highlighted risks from expansionary fiscal policy and housing demand pressures, suggesting that the Fed may need to move slowly on rate cuts absent a clear recession.

Even so, questions remain about how effective these cuts will be. Lower rates typically boost investment and spending, but the stimulative effect may be muted with many businesses and households already locked into lower-rate debt. In sectors like housing, for example, affordability remains a challenge despite falling mortgage rates. As a result, the anticipated boost to economic growth from rate cuts could be more limited than in past cycles, particularly if the Fed moves cautiously.

Closing Thoughts

The Fed's actions and macroeconomic trends will continue to shape the markets. We continue to anticipate elevated volatility as the election approaches and will share our thoughts and any changes to our outlook as they arise.

Our focus remains on managing risk and ensuring that your portfolio is well-positioned for long-term growth. As always, we're here to answer any questions you may have. Have a lovely fall! ▪

Withum Wealth Management will be hosting its live, **Fall 2024 Market Update Webinar** on November 5th at 12PM ET. **Click here** or scan QR code to register - and be sure to send in your questions ahead of time for our Q&A session at the end of the presentation.

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Need More Information? Please do not hesitate to contact a member of the Withum Wealth Management team with any questions or concerns:

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