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MARKETS IN FOCUS
Macro Insights

Catalysts in Focus
Investment implications of the election and November FOMC

By Matt Orton, CFA, and Joey Del Guercio

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FOMC takeaways: Confirming the status quo

The penultimate Federal Open Market Committee (FOMC) meeting of 2024 capped an incredibly busy week – and thankfully there were no surprises.

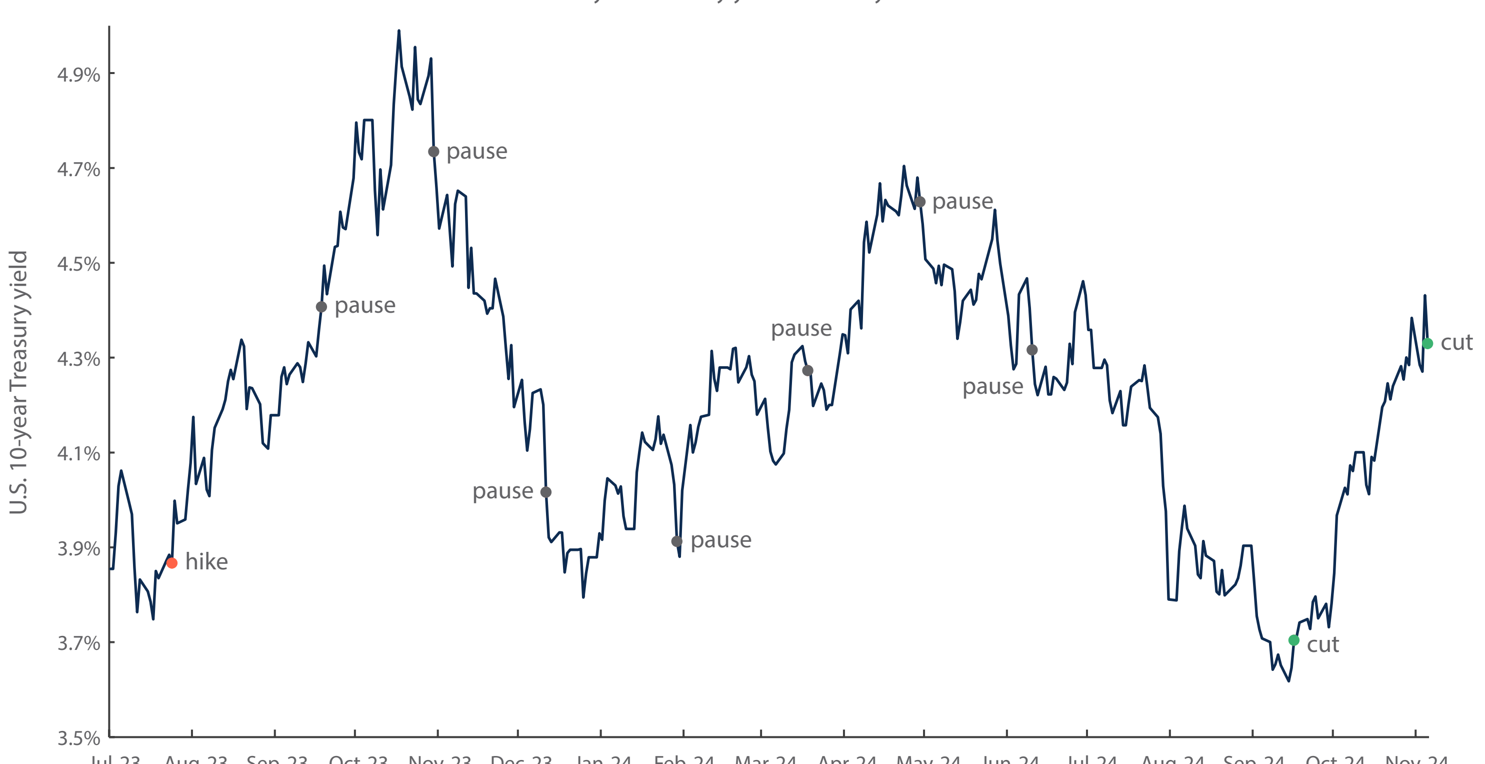
U.S. Federal Reserve (Fed) Chair Jerome Powell was purposeful in not offering much forward guidance on where interest rates could go from here, keeping the Fed's options open for the December meeting and beyond. While there might be a slightly lower bar to skip a December rate cut depending on economic data in the coming weeks, Powell did state that current economic conditions support further easing given the current state of the labor market, wages, and inflation. Specifically, he noted that the labor market has cooled, wages are no longer contributing to inflation, and inflation has moved close to the FOMC's 2% target.[1]

Powell also talked about adjusting the pace or destination of easing only when plausibly close to the neutral rate, and current policy is not plausibly close to the neutral rate by any means. As such, we continue to expect another 25-basis point cut in December followed by a more gradual pace in 2025, likely following an every-other-meeting cadence, which would lead to an additional 100 basis points of cuts.

We also think it's worth highlighting that Powell noted that the run-up in bond rates over the past month is "not principally about higher inflation expectations." Rather, he said, "they're really about a sense of the likelihood of stronger growth, and perhaps less in the way of downside risks." Given this supportive growth environment, many investors have questioned whether the Fed should continue cutting rates, especially if there are concerns that fiscal policy could be inflationary. Powell tried to address this concern directly by noting that the job of the FOMC is to react to, rather than to preempt, the passage of any such fiscal measures. The Fed is carefully balancing its dual mandate, and we expect future monetary policy to hinge on the evolution of economic data, which will certainly be influenced by fiscal policy. For now, it's up to the market to bet on how things will play out.

The Fed's rate-cutting cycle continues

U.S. 10-year Treasury yield since July 2023



Source: Bloomberg, as of 11/7/24.

[1] Unless otherwise indicated, all data cited is sourced from Bloomberg as of Nov. 7, 2024.

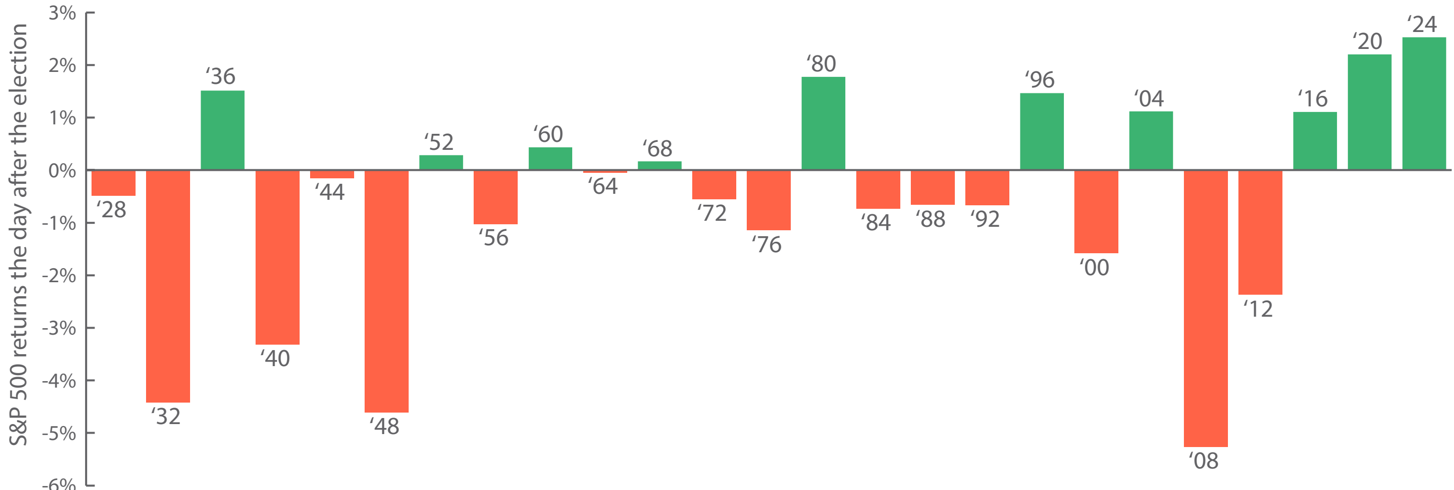
U.S. election takeaways: Back to the future?

With the election behind us, we believe investors can re-focus on the strong underlying fundamentals of the market. Overall, we're encouraged by the constructive market backdrop, particularly given the strong returns over the past few days. Following the U.S. election, investors have been reducing hedges that were focused on the outcome and have effectively been buying back into the market by re-adding to positions in risk assets. While the animal spirits might temper a bit in the short term, we believe the fundamental backdrop is quite strong and supportive of additional upside.

We just witnessed the best post-election S&P 500 reaction on record, and historically this move has predicted the direction of returns through the rest of November 71% of the time going back to 1928 (17 out of 24 instances). Even more importantly, there has only been one time (1936) when the market was green on the day after the election and then went on to post a negative return through the rest of November. That is a very strong precedent to support expecting additional upside heading into the end of the year.

Going forward, we believe selectivity will be essential since the rising tide isn't going to lift all boats. Looking back to 2016, it's worth noting that the defensive sectors that fell post-election subsequently traded sideways for several months. The cyclicals that outperformed immediately post-election continued to trend higher. We have favored thinking about leaning into cyclicality in the second half of this year, and we think the trade in financials, especially in regional banks and capital markets companies, could have scope to keep moving higher on a less restrictive Federal Trade Commission (FTC) regime and an increased likelihood of industry consolidation. Industrials also is a sector we continue to favor. We have advocated playing offense with defense, and we still like aerospace and defense areas, especially those with software elements or security solutions for domestic law enforcement. We also like companies exposed to construction spending, potential beneficiaries of the massive capital expenditure spending planned for the buildout of artificial intelligence, and electric equipment companies.

We discuss below why we do not think that President-elect Donald Trump's policies in his second administration will necessarily be inflationary and lead to higher interest rates. Rather, we expect rates to move lower into the end of the year, and after approaching 4.5% in the 10-year Treasury yield we're already seeing a bit of a top. It's tough to go out on a limb and to think about adding meaningfully to duration right now given the elevated level of interest rate volatility, but for long-term investors still sitting in cash or for pension funds or insurance companies, we believe there's a



Source: Bloomberg, as of 11/7/24.

very attractive opportunity right now to consider locking in some of the highest yields we've seen in the past 15 years.

Even though the moves on Wednesday were significant, earnings have been quite strong, recent economic data remains supportive, and a big risk event has now been removed. We expect all of this to support continued strength in equities going forward. Some of the "Trump trade" winners had big days in the wake of the election. Below we outline some key trends to consider as we head into the final stretch of the year and whether we think these one-day reactions are durable or should be faded:

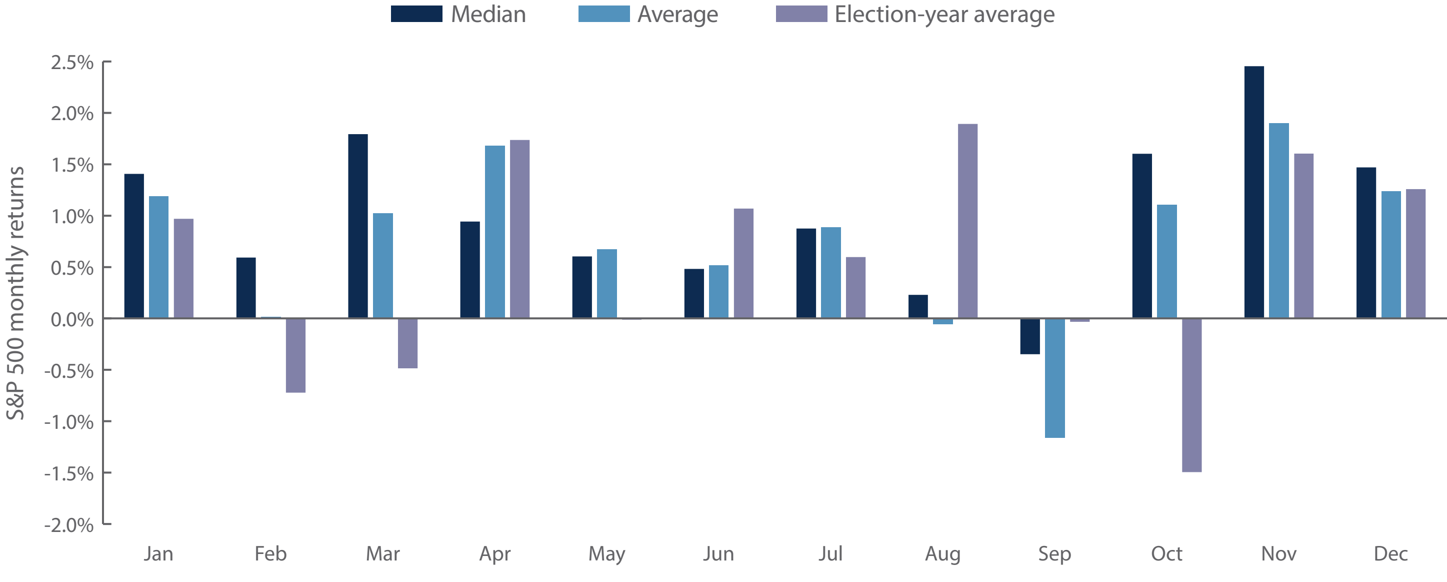
- Meaningful outperformers: financials, industrials, and energy. The story here is underscored by the prospect of deregulation and expected policies aimed at fostering a more business-friendly environment. Financials are the most notable beneficiary with expectations for Trump to install a less restrictive Federal Trade Commission (FTC) regime, allowing for more mergers and acquisitions (M&A) activity, of which investment banks will get a piece of every deal. There's plenty of pent-up demand from the last four years, and we believe financials could continue to outperform as deal flow finally manifests. Regional banks are also due for consolidation, and a Trump administration likely allows this to play out. Outside of financials, industrials and energy both can benefit from less regulation coinciding with more projects. Industrials have the potential benefit of Trump being an outspoken proponent of reigniting American manufacturing and touting onshoring efforts. Cyclicals continue to look attractive going forward as Trump's pro-growth agenda comes to fruition.
- Yields are higher, but for how long? The jump in yields was a response to investor concerns over fiscal deficits as well as potential second-order effects of Trump's pro-growth agenda – higher growth leads to higher inflation, which could change the course of the Fed and lead to higher yields. We continue to believe that the worst of inflation is behind us, even with tariffs or a larger deficit. Yields look overextended, but we would tread very carefully in the short term.
- Meaningful underperformers: real estate, consumer staples, and utilities. Two concepts that work somewhat in tandem are at play here: the growth outlook and yields. These sectors have been anything but a monolith with select sub-industries leveraged to secular growth themes such as artificial intelligence posting strong performance, and especially so as rates fell during the spring and summer. Given the context of trailing outperformance in recent months, and paired with expeditiously rising yields, this sell-off makes a lot more sense. Other than the rate backdrop and the expectation for a stronger economy that benefits cyclicals going forward, nothing fundamental has changed within defensives. We wouldn't fade these sectors entirely, but instead would practice extra selectivity within them.
- Small caps on the cusp of breaking out? Small caps were one of the most touted Trump trades ahead of the election, and their follow-through has been solid. Specifically, the Russell 2000® Index posted its strongest one-day gain in two years as investors bet that small firms will be big beneficiaries of Trump's growth-oriented policies. Additionally, small- and mid-caps stand to benefit from a more favorable M&A environment and de-regulation. Despite a nearly 15% gain over the past month or so, the Russell 2000 is still below its last all-time high from November 2021 and we could see continued strength given an exceptional technical setup, positive macroeconomic tailwinds, and a reacceleration in earnings. That said, mind the increase in yields: If we continue to see yields moving higher, this could eventually pressure smaller companies just as it did earlier in the year.
- Divergence in international performance. International equities were mostly down following the election, which was mainly the result of a rising U.S. dollar (higher Treasury yields fuel demand for the dollar). We expect the Trump administration to enhance the importance of nuance in investing in international equities – selectivity will be key here. We think that U.S.-allied Asian nations such as India, Taiwan, and Vietnam can benefit from Trump's presidency as the United States and China continue their decoupling and the U.S. moves key supply chains toward friendlier destinations.

Looking forward, we see the outlook for equities and risk assets as accommodative, backed by a myriad of tailwinds:

- This bull market remains grounded by fundamentals with the S&P 500 exhibiting robust earnings growth, strong margins, and positive guidance.
- Earnings breadth continues to expand, spelling positively for breadth of performance to continue its expansion across sectors and down the market cap spectrum.
- We expect election-induced volatility across asset classes to continue to ease absent any exogenous shocks.

- Traders likely will continue to unwind their election hedges, effectively buying back into the market, while falling implied volatility would permit systematic strategies to take on more risk.
- Seasonality is on our side with November and December historically being two of the best months of the year in the S&P 500. It's also typical for equities to rally in the months following an election as uncertainties fade away.

We believe the path of least resistance for the stock market is up.



Source: Bloomberg, as of 12/29/2023.

About the authors

Matt Orton, CFA, is Senior Vice President, Head of Advisory Solutions and Market Strategy at Raymond James Investment Management.

Joey Del Guercio is a Research Associate for Market Strategy at Raymond James Investment Management.

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Sector investments are companies engaged in business related to a specific sector. They are subject to fierce competition and their products and services may be subject to rapid obsolescence. There are additional risks associated with investing in an individual sector, including limited diversification.

Investing in small cap stocks generally involves greater risks, and therefore, may not be appropriate for every investor. The prices of small company stocks may be subject to more volatility than those of large company stocks.

International investing presents specific risks, such as currency fluctuations, differences in financial accounting standards, and potential political and economic instability. These risks are further accentuated in emerging market countries where risks can also include possible economic dependency on revenues from particular commodities or on international aid or development assistance, currency transfer restrictions, and liquidity risks related to lower trading volumes.

Definitions

Animal spirits is a phrase used to describe how human emotion, irrational thinking, and a herd mentality among market participants can drive financial decision-making and investing in uncertain environments and volatile times. British economist John Maynard Keynes coined the phrase in his 1936 book, "The General Theory of Employment, Interest, and Money."

Basis points (bps) are measurements used in discussions of interest rates and other percentages in finance. One basis point is equal to 1/100th of 1%, or 0.01%.

Breadth describes the relationship between the median and the mean of a market index. When a few data outliers result in a mean that is substantially larger (or smaller) than the median of the full data set, then the performance of the entire index is being driven by a "narrow" selection of companies. An index supported by "broad" market movements is one where the median is closer to the mean.

Capital expenditures, or capex, are monies used by a company to buy, improve, or maintain physical assets such as real estate, facilities, technology, or equipment, and may include new projects or investments.

Cyclical stocks have prices influenced by macroeconomic changes in the economy and are known for following the economy as it cycles through expansion, peak, recession, and recovery.

Defensive sectors include companies that tend to have a constant demand for their products or services, making their operations more stable during different phases of the business cycle.

Defensive stocks provide consistent dividends and stable earnings regardless of whether the overall stock market is rising or falling. Companies with shares considered to be defensive tend to have a constant demand for their products or services and thus their operations are more stable during different phases of the business cycle.

The dual mandate consists of two over-arching goals that influence the course of monetary policy set by the U.S. Federal Reserve. Those goals are maximum employment and stable prices. Maximum employment is defined as the highest level of employment or lowest level of unemployment that the economy can sustain while maintaining a stable inflation rate.

Duration incorporates a bond's yield, coupon, final maturity, and call features into one number, expressed in years, that indicates how price-sensitive a bond or portfolio is to changes in interest rates. Bonds with higher durations carry more risk and have higher price volatility than bonds with lower durations.

Earnings per share (EPS) is calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability.

An exogenous shock is an unexpected event that takes place outside an industry, sector, or even an economy and that results in sudden negative changes on countries, their populations, their economies, and their capital markets.

Fade describes an investment strategy of trading against a prevailing trend in the market.

The federal funds rate is the target interest rate set by the Federal Open Market Committee of the U.S. Federal Reserve. The target is the Fed's suggested rate for commercial banks to borrow and lend their excess reserves to each other overnight.

The Federal Open Market Committee (FOMC) consists of 12 members: the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining 11 Reserve Bank presidents, who serve one-year terms on a rotating basis. The FOMC holds eight regularly scheduled meetings per year at which it reviews economic and financial conditions, determines the appropriate stance of monetary policy, and assesses the risks to its long-run goals of price stability and sustainable economic growth.

Fiscal policy refers to the tax collection and spending a government uses to influence its country's economy.

Growth investing is a stock-buying strategy that focuses on companies expected to grow at an above-average rate compared to their industry or the market.

Guidance refers statements from the managers of publicly traded companies that indicate whether they expect to realize near-term profits or losses and why.

A hedge is an investment or investment strategy that is designed to lessen the potential for losses in other investments. The price of an investment considered to be a hedge often moves in the opposite direction of the prices of the investments being hedged.

Implied volatility is a measure of volatility levels based on the market's assessment of likely future volatility. It is thus different from realized volatility, also known as historical volatility, which measures levels of volatility that took place in the past.

The inflation target of the U.S. Federal Reserve (Fed) is the rate of price increases that the Fed prefers to see to ensure the economy will remain stable. Generally, the Fed's target rate is 2%, as measured by the Personal Consumption Expenditures (PCE) Price Index.

Market capitalization, or market cap, refers to the total dollar market value of a company's outstanding shares of stock.

The neutral rate is the theoretical federal funds rate at which the stance of U.S. Federal Reserve monetary policy is neither accommodative nor restrictive. It is the short-term real interest rate consistent with the economy maintaining full employment with associated price stability.

Onshoring, also described as reshoring, describes an effort to bring manufacturing and other services back to the United States from overseas operations.

Seasonality refers to predictable changes that occur over a one-year period in a business, market, market sector, or economy based on the season, including calendar or commercial seasons.

Secular trends are large-scale and ongoing changes in economies and societies that have the potential to drive broad and lasting economic, technological, social or other kinds of changes.

Tailwind is a term used to describe events or market forces that exert a positive influence on an investment's performance.

Technicals refers to technical indicators of historic market data, including price and volume statistics, to which analysts apply a wide variety of mathematical formulas in their study of larger market patterns.

Trump trade refers to the idea that President-elect Donald Trump's return to the White House could bring policies that benefit certain industries.

Unwinding describes the process of closing out what is often a large or complicated trading position.

Indices

The S&P 500 Index measures change in stock market conditions based on the average performance of 500 widely held common stocks. It is a market-weighted index calculated on a total return basis with dividend reinvested. The S&P 500 represents approximately 80% of the investable U.S. equity market.

The Russell 2000® Index measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 7% of the total market capitalization of the Russell 3000® Index.

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