AMI INVESTMENT MANAGEMENT
Registered Investment Advisor

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The Briefcase Indicator

In the mid-1990s, the financial news network CNBC introduced a morning program called *Squawk Box*. The show aimed to capture the appeal of a new generation of stock investors caught up in the dot-com craze, offering a witty alternative to programs like Louis Rukeyser's *Wall Street Week*. As some may recall, the *Squawk Box* of the 90's featured anchorman, Mark Haines along with two studio sidekicks, Joe Kernan and David Faber, with live trading floor reports from Maria Bartiromo. The program differed from today's version in that the reporting of financial news was often intertwined with ad-libbed wisecracks, practical jokes, and plenty of banter. One of the show's signature segments was the then Federal Reserve Chairman, Alan Greenspan, "briefcase indicator" report: an over-the-top analysis of Mr. Greenspan's briefcase as he made the unexciting walk from his car into important Fed meetings. At the time, Fed officials were tighter lipped, so the briefcase indicator was promoted as a forecasting tool for any change to Fed policy. The theory being, if the Fed Chairman's briefcase was bulging with papers, he needed to deliver important data and expect a change in interest rates. If the briefcase is flat, no change. The indicator became so popular that other media channels began picking it up and reporting on its accuracy. Years later when Mr. Greenspan was asked if the briefcase indicator was a true gauge, he said: "Not at all. Whether my briefcase was fat or thin depended on whether or not my wife made me lunch that day". [1]

Analysis used of Alan Greenspan's briefcase

Today, the steady stream of public comments from Fed officials through interviews, speeches, and symposiums offers greater insight into their thinking than the mythical, albeit entertaining briefcase indicator. In fact, the only mystery surrounding the most recent Federal Reserve meeting was not whether rates would be cut, but by how much. While the announcement of a 50-basis point (.005) reduction was less expected than the conventional 25-basis point (.0025) move, the markets absorbed the news without major disruption.

[1] Alan Greenspan Reflects on His Legacy' Jan. 7, 2020 Bloomberg Surveillance

CONTINUED ON PAGE 2

As the table below illustrates, over the past several months US Treasury yields have moved markedly lower, pricing-in the highly anticipated first rate cut since March 2020 while also factoring more to come. As we enter the early stages of this unusual easing cycle, markets are highly attentive to “what the Fed will do next.” At this point, it’s important for investors not to get caught up in the increments (25 or 50 basis points) but focus on the overall trend, why rates are being cut, and where’s the final destination.

Maturity	Yields % 5/31/2024	Yields % 9/17/2024*
US Treasury- 1 Year	5.18	3.99
US Treasury- 5 Year	4.51	3.44
US Treasury- 10 Year	4.50	3.65

* The date prior to the Fed's rate announcement

What makes this easing cycle so unusual is an aggressive interest rate cut is usually connected with deteriorating economic conditions or a crisis. As the economy hums along, inflation continues to cool, corporate earnings grow, while the labor market has weakened slightly but is still in pretty good shape—not typical conditions for a 50-basis point cut. The Fed is attempting to engineer a similar outcome to the mid-90s. During that time Fed Chairman Greenspan successfully navigated a minefield: raising interest rates, slowing economic growth, lowering inflation, then reducing rates, all while avoiding an all-out recession. This was the last time this less prevalent economic “soft landing” occurred.

The 50-basis point cut also suggests the Fed has turned the page on its fight against inflation and is now focused on supporting the broader economy. Its aim is to move away from the restrictive policies of the past couple of years and get closer to the elusive neutral rate—or the interest rate which neither stimulates nor restricts economic activity. The neutral rate is a theoretical level and is a moving target. Some experts argue that 2.5% is appropriate, others will say 3%, while others claim 3.5% is optimal. Whatever the rate, it’s likely much lower than the current effective level of 4.8%.

This journey leads to a destination and the prevailing economic conditions will determine how slowly or quickly we arrive at the neutral rate. Investors fully expect short-term rates to continue to decline, but what’s less expected are the risks and the wide range of outcomes that could occur. These span from the Fed achieving its soft-landing outcome, to lowering rates too aggressively which stokes inflation, to an unforeseen crisis which pushes for rates to go much lower. Unfortunately, there’s no briefcase indicator today to tell us what’s next. What we do know is borrowing rates will decline, which will assist in boosting spending and investment—a plus for the economy. For investors, the warm safety of 5% + money market and Treasury yields appears to be in the rear-view mirror for the time being. This is not all bad. The Fed has successfully navigated the unpredictable terrain so far, as we now enter the next phase of normalizing rates after years of distortions and high inflation.

Third Quarter Recap and Outlook

The third quarter was full of potential market-moving news: a sitting president drops out of the campaign, the vice president enters the election, two assassination attempts on a former president and candidate, the conflict in the Middle East escalates, and a major hurricane causes widespread destruction across the Southeast. Despite this series of profound events, the equity market’s strongest reaction came from Japan’s surprise decision to raise interest rates from 0 to 0.25%, their highest level in over 15 years. The rate hike made borrowing costs less attractive for those speculative investors that borrowed Japanese Yen and invested in other areas. The unwind of the Yen “carry trade” was the primary suspect behind the sharp sell-off in global equities in early August and is a prime example of these fringe risks lurking in the shadows.

CONTINUED ON PAGE 3

Although the pullback was short-lived, it did open a window into areas of the market that are potentially more at-risk when we undergo a more prolonged correction. Sectors benefitting most from the Artificial Intelligence (AI) investment boom, like semiconductors and some of the large technology stocks, experienced much sharper price declines than the broader indexes during this period. Despite the temporary spike in volatility, the major stock indexes marched higher while continuing to hit record highs. Year-to-date, the S&P 500 and Dow Jones Industrial Average are up 22% and 14% respectively, while overseas stocks registered returns just over 14%.[2]

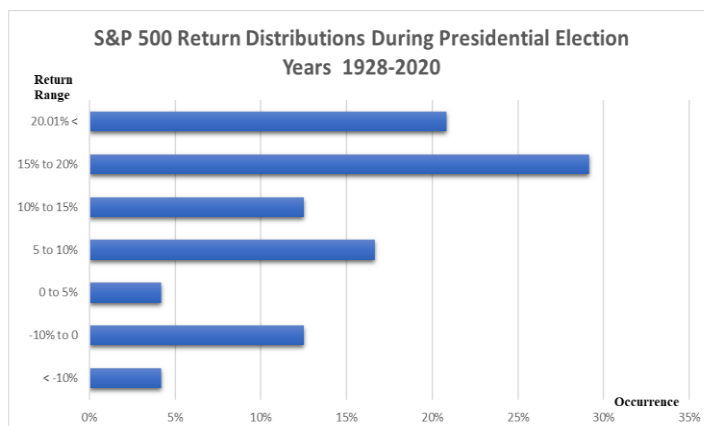
The third quarter also highlighted the benefits of owning high quality bonds in a diversified portfolio. After a turbulent period from 2021-2022, when the principles of diversification were not fully apparent, high-quality bonds once again provided stability and helped offset some of the volatility in portfolios during the early August choppiness. In addition, the shift lower in bond yields over the past several months has lifted bond prices, resulting in total returns (price appreciation + interest income) of 4.6%[3] for taxable fixed income so far this year.

As we've stated in past commentary, we're not overly pessimistic about the economic outlook or the future adoption of generative AI technology. However, given the run-up in prices, the lofty valuations of stock indices, and the growing risks (some known, some not) our preference has been to tilt portfolios slightly more cautious in this environment. Broad diversification and selectivity will become increasingly important as we navigate the path ahead. It's also important to remember that there is a world beyond the popular Magnificent Seven stocks. These include railroad operators, medical device manufacturers, banking institutions, and food/beverage producers—among others. Although some of these sectors are less glamorous than the technology leaders, many of them consist of durable businesses with competitive advantages that have survived and thrived through the peaks and valleys over time.

We believe exposure to these areas in addition to more reasonably valued international stocks will assist in building a more resilient stock portfolio. Lastly, despite bond yields declining over the past quarter, we believe the steady income and diversification benefits make them a valuable component to a balanced portfolio.

Presidential Elections and Stock Returns

As we enter the home stretch of what is likely to be a contentious presidential election, the question often arises of how the outcome will affect stock prices. As shown in the graph below, presidential election years, generally, had a positive impact on stock returns. Over 80% of presidential election years have delivered positive returns for stocks relative to the more modest 70-75% chance in any given year. Barring any unforeseen events in the fourth quarter, 2024 is on par with a pretty standard election year result.



While much attention will be given to the presidential race, it's the control of Congress that is perhaps more important to markets as a whole. The presidential candidates can promise the moon during the campaign process but it's ultimately Congress that has to turn these promises into law.

CONTINUED ON PAGE 4

[2] As measured by the MSCI ACWI ex USA index
[3] The Bloomberg Intermediate Govt/Credit bond index return through 9/30

As it currently stands, markets appear to be operating under the assumption that no matter who is in the White House, Congress will be either split or one party will have a very slim majority. While a balanced government is generally seen as good for markets, this election will be important in determining a path for some key tax policies. The sunsetting of provisions in the 2017 Tax Cuts and Jobs Act (TCJA) may have implications for individual income tax rates, capital gains rates, and estate plans. The threat being without the broad compromises needed to pass complex bills, many of these supportive policies will expire. While we think it's in the best interest of both parties to put together a plan forward or extend the TCJA until a clear plan can be delivered, the political "sausage making" is always unpredictable. What we do know is making drastic changes to portfolios based on the outcome of an election or under the assumption of future legislation is not a good investment strategy. It's important not to get distracted by short-term noise. We've always preferred gathering information, evaluating the options, and making careful decisions that takes into consideration the impact of returns and goals. There is always time to make adjustments to portfolios if needed, and we are here to assist with making informed decisions that align with your investment plan.

AMI Update

We're excited to announce the launch of AMI's newly updated website. The fresh design and improved navigation offer a more user-friendly experience. The updates will also make it easier to stay informed by accessing the client portal or our investment commentary. We invite you to check it out at www.amiinvestment.com.