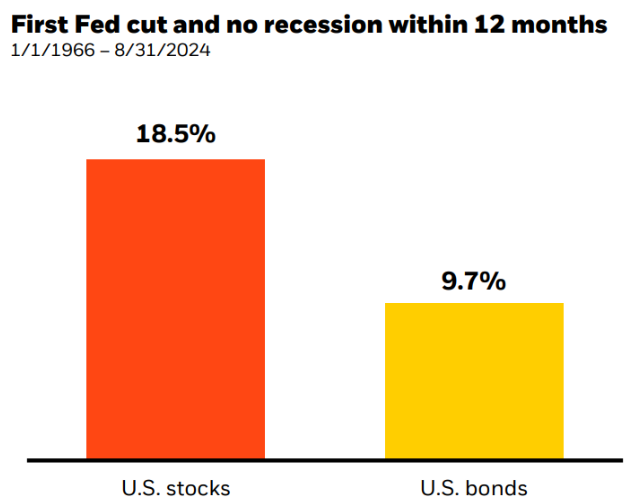
Good afternoon,

And Happy Autumn! It's not just the leaves that have started to fall. The Federal Reserve has begun to lower interest rates, and inflation continues to come down. Meanwhile, the economy continues to grow at a healthy clip, and earnings estimates for next year are for 13% growth. All of this creates a Goldilocks "not too hot, not to cold" climate that is positive for both stock and bond returns.

The S&P 500 notched its best 9 month start since 1997, gaining 21%. Bonds, too, are carrying their weight with the Barclays Aggregate Bond Index up 4.85%. All of this has occurred against a backdrop of low volatility. The pullbacks in the market we've experienced this year have been short and shallow. Also, with the Federal Reserve cutting rates, the outlook for both stock and bond returns over the next 12 months is positive – provided the economy manages to stay out of a recession. Looking at data going back to 1966, stocks have historically risen 18.5% and bonds 9.7% after the first rate cut.

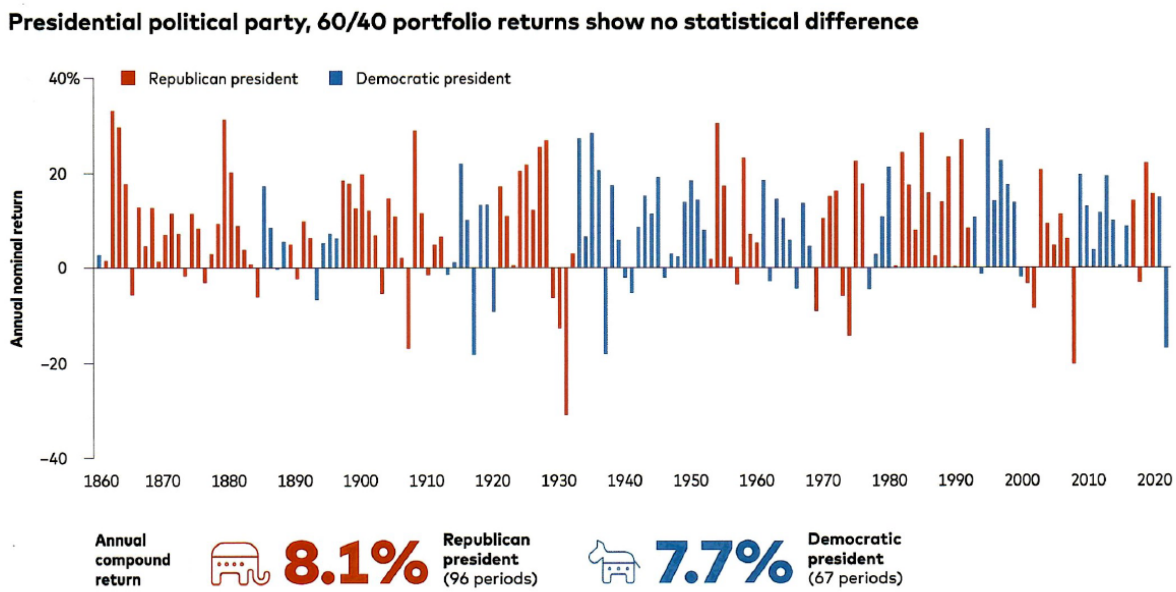


Source: Morningstar

However, as we all know from the fable, Goldilocks did not have too long to enjoy her perfect situation before the bears came home. I'd like to address some of the risks we are monitoring and describe the changes we're making and considering for our investments.

Presidential Election Years

With less than a month to go until the presidential election, I'd like to share the study below, showing annual returns for either a Republican or Democratic president using a 60% stock/ 40% bond portfolio. This study goes back to 1860, so it truly provides a long-term perspective. Of note, the big down years have been the result of economic data, not the election. This includes the Great Depression, the Dot Com bust and the Great Recession of 2008-09. The conclusion: it doesn't matter to the markets – at least initially - which party wins the election.



Source: Vanguard

Risks

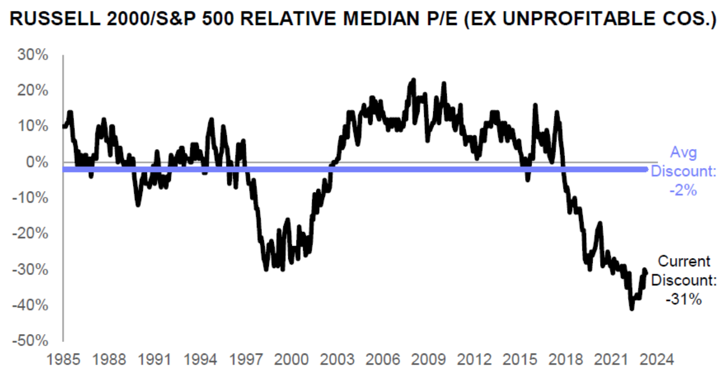
The biggest risks to the markets as we see it are as follows:

1. The economy falls into a recession. Current data is not showing this as a high probability in the next 12 months, but there are a few noteworthy trends. In particular, the unemployment rate, while still historically low at 4.1% has moved up from 3.5%.
2. A broader war erupts in the Middle East. As tensions escalate, the chance of a bigger war in the region increase. This could result in a spike in oil prices, which could be inflationary.
3. Inflation could stop falling and even head back up. Barring the aforementioned geopolitical risks, inflation could rise as a result of a strong economy and declining short-term interest rates. The job numbers remain strong and wages are growing faster than the current rate of inflation.

Investment Updates

Small Cap stocks as measured by the Russell 2000 index are up 7.6% year-to-date. They are looking attractive from a valuation perspective. As the chart below shows, they are trading at a 31% discount to the S&P 500, which is close to an all-time low.

In addition, when interest rates are falling, Small Cap stocks have historically outperformed their large cap brethren by a significant margin.



Source: Factset

Another asset class that is looking increasingly attractive from a valuation perspective are **international stocks**, especially when compared to the S&P 500. As the following chart illustrates, international equities are trading at an extreme discount to those in the U.S. However, it should be noted that the conditions that favor domestic stocks such as higher economic growth and a strong dollar, are still prevalent. As such, it makes sense at this juncture to maintain an investment in international stocks, but not to increase their weight in a portfolio just yet.

Source: JP Morgan

Lower interest rates and inflation have resulted in a favorable backdrop for **intermediate-term bonds**. Current projections show the Fed Funds rate dropping from 5.25% to 3% by the end of 2025/ start of 2026. As interest rates fall, bond prices rise and given the expected magnitude of the interest rate drop I am continuing to move out of short-term bonds and into the intermediate-term maturities.

Buffered Exchange Traded Funds (ETFs) have been rising in popularity amongst investors. Also known as "Armored" ETFs, they are investments in an index (such as the S&P 500) with a degree of downside protection built in. However, they also have an upside limit, typically 10-12% for the ensuing 12 months. With market performance having been higher than expectations this year, coupled with valuation measures that are starting to get stretched, I am exploring the best way to integrate them into certain portfolios.

We will be hosting a Zoom call in the near future to bring in an expert in Buffered ETFs if you'd like to learn more about this particular investment. The date is still TBD and we'll send you an invitation when it is set.

In summary, the outlook for both stock and bond returns remains positive given the firm economic backdrop and the onset of interest rate cuts. As before, I view any declines as an opportunity to rebalance portfolios and do tax-loss harvesting.

Please feel free to call or email me directly if you'd like to discuss any of the above items or your investments in greater detail.

Very Truly Yours,

Jim

James Herrell, CFA / Sr. Portfolio Manager
Generate Wealth LLC / generatewealthllc.com
jamesherrell@generatewealthllc.com
P:626-345-5830 / **M:** 805.451.5960
A: 155 N. Lake Avenue Suite 800 Pasadena, CA 91101