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CIM Market Commentary & Outlook

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Uncertainty and Financial Market Outlook

- There are applications for the uncertainty principle in modern finance.

- Why would the Fed begin cutting interest rates aggressively if the economy was as strong as many have claimed? The answer to this question could be found in the election results themselves.

- Why would the Fed be cutting rates if the US job market was strong? Perhaps the job market is also not strong, as evidenced by the substantial downward revisions in new jobs created over the past year, over -800k according to the Bureau of Labor Statistics and -110k jobs, just in the past two months, according to the October nonfarm payroll report.

- Extending the Tax Cut and Jobs Act (TCJA) will be priority number one for the new administration. However, we also know that simply extending tax cuts, in their current form, will likely have very little economic impact, other than maintaining the status quo.

- Revenue from tariffs is unlikely to be large enough to offset the deficit that will likely result from extending the TCJA. For those who have suggested that tariffs could result in a significant rise in inflation, once again, we caution this view, as goods represent only a small fraction of the broader US economy.

- The S&P 500 now sits at record highs, at the second highest valuation in history, according to the CAPE ratio. It is also worth noting that both Vanguard and Goldman Sachs have recently published equity market research which concludes that returns for the S&P 500 are likely to be between 3% to 4%, per year, for the next decade. Perhaps this is why Warren Buffet, arguably the greatest investor in history, is now sitting on $325 billion in cash. That is the highest cash position Buffet has ever held in history, representing roughly a third of Berkshire Hathaway's market capitalization.

A German physicist formulated the uncertainty principle of quantum physics in 1927. According to Caltech, "the uncertainty principle states that we cannot know both the position and speed of a particle, such as a photon or electron, with perfect accuracy." That is to say, the more accurately we triangulate a particle's position, the less we know about its speed and vice versa. This means that we may know the speed or location of an electron, but not both at the same time.

There are applications for the uncertainty principle in modern finance as well. While strategists may state, with high conviction, they know both the specific destination and timing of market movements, history has demonstrated otherwise. A view expressed through speculation and hope is not the same as a position taken through understanding and knowledge. For example, just a few months ago, many in the investing community posited that the Federal Reserve (Fed) would need to raise interest rates further to arrest inflation. Yet, in September, the Fed embarked on its next easing cycle, cutting rates by a substantial 0.50% or 50 basis points. Therefore, as we consider the dizzying news cycle of the past six weeks, including the impact of Donald Trump's reelection, together with Republican control of Congress, we are reminded that political and business cycles are not the same thing. While we are extremely sensitive to a desire for certainty, following a contentious election cycle, we also know that the sausage making of governing often results in very different outcomes than one might expect. This is especially true when attempting to see months, if not years, beyond election night. While Republicans will control the executive and legislative branches of government, we do not yet know by what margin Republicans will control the House in particular. As of this moment, the balance of power in the House will likely continue to be narrow. Therefore, we need to consider a number of potential outcomes, from President-Elect Trump's policy initiatives and the Federal Reserve's actions, that may occur over the months and years ahead. We will do so with a healthy dose of modesty, given the highly uncertain nature of what may ultimately come to pass. We will also evaluate the essential diversifying role that fixed income plays in one's asset allocation, and the significant benefits of the tax-free cash flow that municipal bonds deliver.

Let's begin our discussion with a question. Why would the Fed begin cutting interest rates aggressively if the economy was as strong as many have claimed? The answer to this question could be found in the election results themselves. US exit polls clearly illustrated the primary issue that most influenced voting decisions on election night, was, in fact, the economy. Given the meaningful change in party control, across all three branches of government, one can presume that voters were extremely unhappy with the direction of the economy. The economy, therefore, may not be nearly as strong as the Fed and many in the financial services community would have us believe. Moreover, the Fed stated clearly, following its first rate cut in September, that it was pivoting away from focusing primarily on bringing down inflation, given inflation's steady decline over the past two years. The Fed, instead, is now more focused on supporting the US jobs market by lowering interest rates. This raises yet another question. Why would the Fed be cutting rates if the US job market was strong? Perhaps the job market is also not strong, as evidenced by the substantial downward revisions in new jobs created over the past year, over -800k according to the Bureau of Labor Statistics and -110k jobs, just in the past two months, according to the October nonfarm payroll report. Given these concerns, we must vigilantly follow the unemployment data to determine if job losses are accelerating, as this could result in slowing economic growth over time.

We will also be following closely the degree to which President-Elect Trump fulfills the policy initiatives he laid out on the campaign trail. What we currently know is that extending the Tax Cut and Jobs Act (TCJA) will be priority number one for the new administration. However, we also know that simply extending tax cuts, in their current form, will have very little economic impact, other than maintaining the status quo. While Republicans appear to be in firm control of the Senate, it appears they have only a narrow majority in the House. Without a Republican super majority in Congress, passing significant tax reform will require Republicans to pass tax laws via budget reconciliation. Budget reconciliation requires that new laws that reduce revenues and thereby increase the deficit, such as tax cuts, need to be paid for through offsetting revenue generators. Therefore, a fundamental question facing the new President and Congress will be where to find additional revenue to pay for the extension of the existing tax regime.

Some have suggested revenue will be found through the repeal of some, or all, of the Inflation Reduction and Chips Acts, as well as the rolling back of student loan forgiveness. The impact of this on the economy would likely be negative as government spending and additional discretionary spending from student loan forbearance contributed meaningfully to US GDP growth over the past four years. Some have even suggested that government spending was the primary factor keeping the US economy from slipping into recession during President Biden's term. Research indicates several Republican-controlled states have deeply benefited from both the Inflation Reduction and Chips Acts, making a full repeal potentially unlikely. Having said that, we see deep cuts of this nature as a limiting factor on GDP growth going forward. It has also been suggested that tariffs could create revenue that could offset tax cuts. While true, it is important to note that the President has the authority to raise tariffs on goods, not services. Goods represent roughly 6% of GDP, according to Rosenberg Research. Therefore, revenue from tariffs is unlikely to be large enough to offset the deficit that will likely result from extending the TCJA. For those who have suggested that tariffs could result in a significant rise in inflation, once again, we caution this view, as goods represent only a small fraction of the broader US economy.

Economic conditions are also very different now, compared to Trump's first term. First and foremost, we must recognize that when Trump took office in 2016, the economy was quite strong, the Fed was just beginning its rate hiking cycle, and tax rates had yet to be cut. This time, however, we are approaching the end of the business cycle, as evidenced by the sub 2.5% Atlanta Fed GDPNow estimate for Q4, while the Fed is just beginning to ease financial conditions by cutting interest rates.

We must also consider the degree to which risk markets have priced-in a significant degree of good news. The S&P 500 now sits at record highs, at the second highest valuation in history, according to the CAPE ratio. It is also worth noting that both Vanguard and Goldman Sachs have recently published equity market research which concludes that returns for the S&P 500 are likely to be between 3% to 4%, per year, for the next decade. Perhaps this is why Warren Buffet, arguably the greatest investor in history, is now sitting on $325 billion in cash. That is the highest cash position Buffet has ever held in history, representing roughly a third of Berkshire Hathaway's market capitalization. Clearly a significant degree of good news has been pulled forward in current equity market valuations, in our view. This is extremely important as investors seek to achieve strong risk-adjusted returns going forward.

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It is at moments like these, when outcomes are uncertain and risks are elevated, that we are reminded of the essential diversifying role that fixed income plays within one's asset allocation. Fixed income provides a fixed source of cash flow and confidence, assuming underlying credit quality remains stable, as investors await further confirmation of the direction of the economy. The additional challenge investors face is that the yields on cash instruments are declining rapidly. The Fed has already cut interest rates by 0.75% or 75 basis points. This cut is likely already reflected in the lower yields investors now receive on preferred savings and money market instruments. The good news is that yields on fixed income instruments are among the highest they have been in 10-15 years. For example, municipal bonds offer yields of 3.5%-4% tax-free, in the longer- intermediate and longer-term areas of the municipal bond yield curve. For those in the highest tax-brackets, these tax-free yields equate to roughly +6% to +7% on a taxable equivalent basis (TEY). If one shares Vanguard and Goldman outlooks for expected returns of the S&P 500, municipal bonds offer almost double the expected return, just from the cash flow alone, on a TEY basis. It is also worth noting that equities are almost four times more volatile than munis, based on their historical standard deviation of returns, according to Barclays Fixed Income Research. Given that municipal credit quality remains quite strong and will remain stable, broadly speaking, we firmly believe munis will continue to be one of the best performing fixed income segments on a risk-adjusted basis, going forward, in our view.

As we look out over the last quarter of 2024 and into 2025, what we know with certainty is that the direction of financial markets, the broader economy, and the geopolitical landscape will remain highly uncertain. We are also humble enough to accept that the uncertainty principle can be instructive, especially in environments like these. As investors consider the potential treacherous crosscurrents of political policy implementation and potential economic outcomes, we recommend a heavy dose of caution when assessing the statements of those who claim to know both the timing and destination of broader market movements. We also know that sentiment has been the primary driver of market movement over the past several weeks, rather than fundamental economic data. As professional managers, we do not invest based on sentiment. On the contrary, our investment philosophy and process is foundationally constructed on the basis of seeking to deeply understand risk and determine whether investors are being compensated for that risk. In this regard, interest rates have risen by over 80 basis points since the Fed cut rates the first time in September, largely on speculation. Therefore, we believe the current level of tax-exempt yields are attractive as they do not reflect the low risk associated with municipal bonds. As our clients know, we would never recommend investors make rash decisions with respect to their asset allocations based on a singular event or data point. On the contrary, we continue to advise investors to derive their asset allocation decisions based on their long-term investment objectives, risk tolerance, and the ultimate length of their investment horizons. While administrations come and go, we know that uncertainty is a constant presence in our lives. Fixed income allocations enable investors to remain calm and ride out periods of market volatility that otherwise may force financial decisions that are suboptimal at best or, at worst, detrimental to achieving their goals.

If you should have any questions regarding this commentary or the municipal bond market more broadly, please do not hesitate to contact us directly.

Best Regards,

Andrew Clinton
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