

Q3 2024 MARKET COMMENTARY

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Introduction

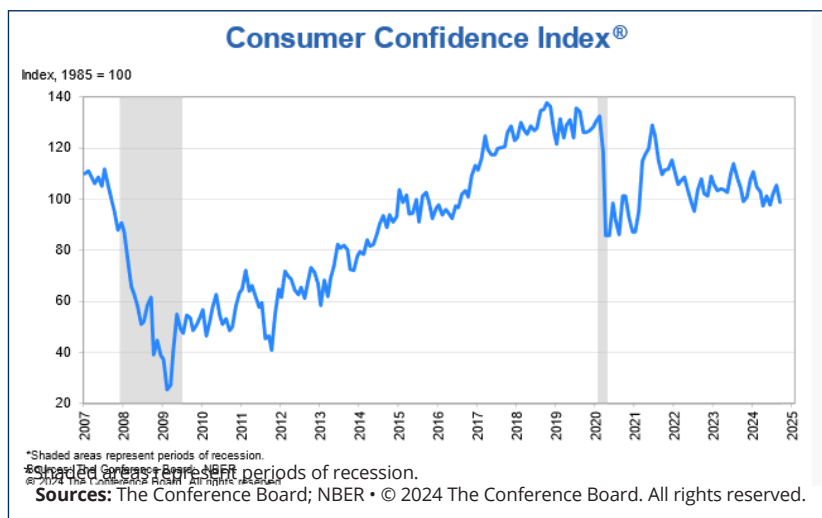
We reiterate our perspective from our previous commentary that near-term market risks are manageable and medium-term prospects remain attractive. The Federal Reserve's long-awaited reduction in interest rates played a key role in the solid returns on stocks and bonds. The broad market rose throughout July, despite the weakness in tech stocks. That cleared the way for value and small cap stocks to shine amid a long-awaited rotation, as investors shifted out of the rally's winners and into the laggards. However, a brutal selloff in August, sparked by renewed fears of a recession and the sudden unwinding of big bets in Japan, saw volatility spiked. Equities have since clawed their way back into the green and the S&P 500 ended the quarter up 5.90%, though

our concerns about overly stretched market valuations and the durability of an overly concentrated stock market persist.

Underpinning the equity market's rebound was the resolution of months of investor uncertainty over interest rates. With inflationary pressures easing, the Fed reduced its target rate by half a percentage point at its September meeting, and investors now expect the central bank to continue pushing rates lower. This additional clarity helped push bond markets further into positive territory during the quarter. Yields began falling in June and July as the outlook for rate cuts solidified. However, we remain skeptical over further upside for longer-term bonds, since stronger economic data has come in better than expected.

Current State of US Consumers

The third quarter 2024 proved to be yet another challenging three month stretch for the US consumer. Consumers' confidence tumbled in September, falling to the largest level in more than 3 years as fears about business conditions and jobs grew. The Conference Board reported that the consumer confidence index slid to 98.7, down from 105.6 in August, the biggest one month decline since August 2021. On a 6-month moving basis, the 35-54 age cohort has become the least confident while consumers under 35 remain optimistic. In terms of income, those making under \$50k are the least confident and those making over \$100k are the most confident about the future direction of the economy.



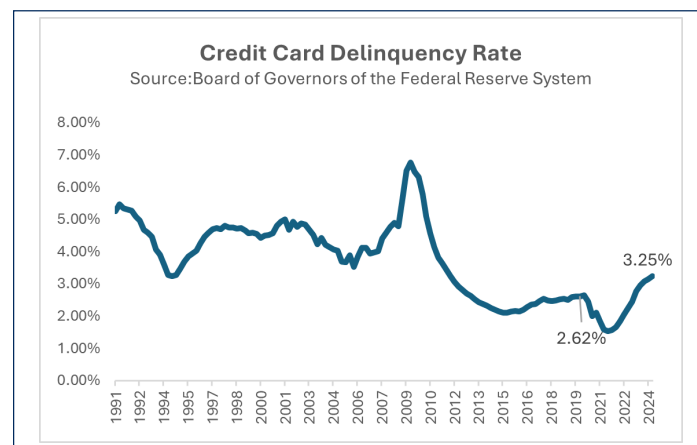
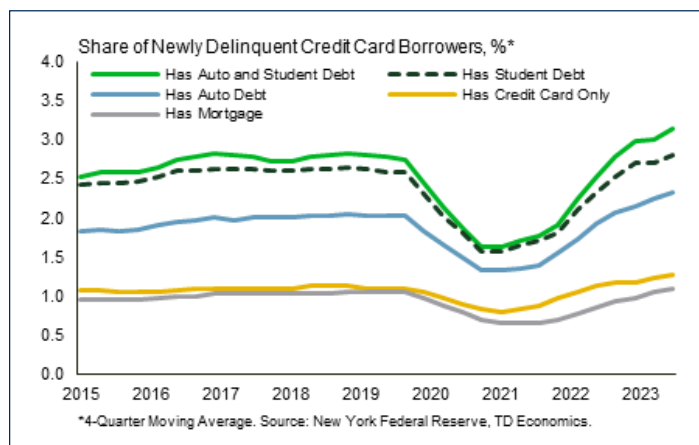
Despite the weaker consumer sentiment, retail sales surprisingly rose +2% this quarter and +2.1% over the past year. It is important to note that consumer spending is the biggest driver of the US economy, accounting for more than 66% of GDP. So, although the change in spending is relatively small, it is still a positive sign for the economy to see more spending from consumers. The biggest growth driver for the quarter was motor vehicle and part dealers which increased +7.56% in the quarter. Moreover, food service and drinking establishments saw sales increase by +2.9%

during the quarter and by +9.2% over the last 12 months, which leads all categories. Stronger-than-expected retail sales growth during the quarter signals that consumers are continuing to spend, especially in key areas of the economy. This indicates that consumer demand remains resilient, contributing positively to economic growth, amid inflationary and geopolitical pressures. Continued spending could ease concerns about an economic slowdown and demonstrates the significant role consumer behavior plays in driving U.S. GDP.

One of the main catalysts behind stronger than expected consumer spending is the result of increasing disposable income. Real disposable income which nets out inflationary effects grew 3.0% year over year and 0.07% month over month in September, driven by falling inflation and rising wages. With additional disposable income, households have more flexibility to increase their spending on goods and services, as well as helping to pay down existing debt.

The increase in consumer debt is another driving force behind higher consumer spending. However, that debt has been one of the biggest pain points for consumers, specifically mortgage, student loan, auto, and credit card debt. US consumers are experiencing a significant rise in credit card defaults, with delinquency rates reaching 3.25% (above pre-pandemic delinquency rate of 2.62%) and total outstanding credit balances of \$1.14 trillion. The increase in defaults indicates that more consumers, particularly those in the lower income cohort, are struggling to meet their

credit card obligations, reflecting growing financial distress. The surge in defaults is particularly pronounced among younger consumers. At the same time, total consumer debt levels have reached all-time highs with consumer debt hovering around \$17.9 trillion dollars. The high levels of debt are partly a result of rising costs in essential spending areas like housing, food, and transportation. The future path of consumer spending relies heavily on rising incomes and consumers' ability to take on more debt. While debt levels have reached all-time highs, the prospects of more interest rate cuts could provide more room for consumers to take on more debt without jeopardizing their debt service to income ratios. This could drive stronger consumption spending, particularly for spending on durable goods, which is starting to see a recovery. Nonetheless, if consumers still feel the price of essentials are rising too rapidly, they could potentially reduce their spending on discretionary goods and services, posing a threat to stronger consumer spending forecasts.



Pulse on US Businesses/Corporations

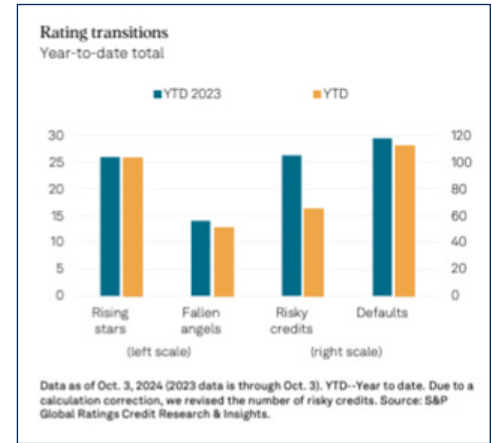
US businesses and corporations find themselves in a stronger financial position than US consumers do. While the debt held by nonfinancial corporations have increased from \$10.8T pre-pandemic to \$13.9T in Q2 2024, debt occupies a lower percentage of their overall capital structure. The current debt to equity ratio for US corporations is 91.2%, while pre-pandemic levels were higher at 99.5%, and the average over the previous decade was 101.7%. Debt to equity ratios have likely declined due to increased equity values and strategic moves by corporations to avoid higher interest payments

and de-risk their balance sheets. As a result, businesses have more room to take on more debt in the future for increased capital expenditure and investments.

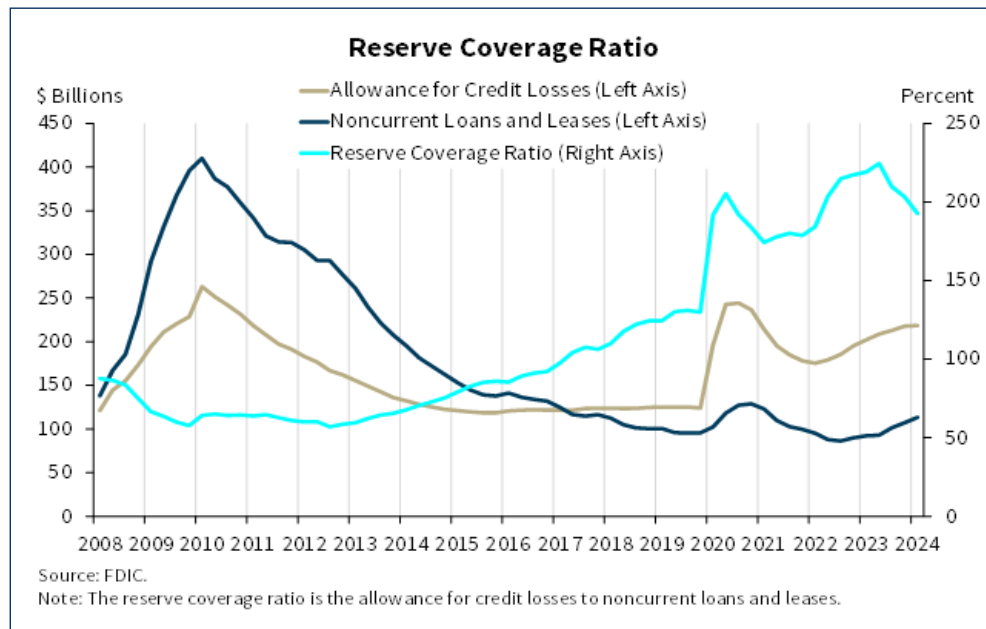
The stronger capital positioning of businesses has also been reflected in the rating agencies' view on corporate debt. This year, Standard & Poor's has made more positive than negative changes regarding their credit outlook and ratings, a reversal from last year which saw more negative rating changes.



Within financial institutions, net charge-off rates (NCO) have been increasing amongst banks' balance sheets. The total charge-off rate of all loans has increased to 0.65% from a low of 0.19% in Q3 2021. This rate is also higher than Q4 2019 at 0.52%. However, when compared to its historical long-term average, NCO is still trending below its last 10-year average of 0.83%. This suggests increasing financial distress



when compared to the post-pandemic recovery period, but still falling in line within its historical expectations. Finally, upcoming corporate debt maturities have been pushed out as new loans continue to be extended. Consequently, allowance for loan losses is growing at a slower pace than loan growth, indicating that near-term overall default risks are lower, despite some fears around specific lending like commercial real estate.

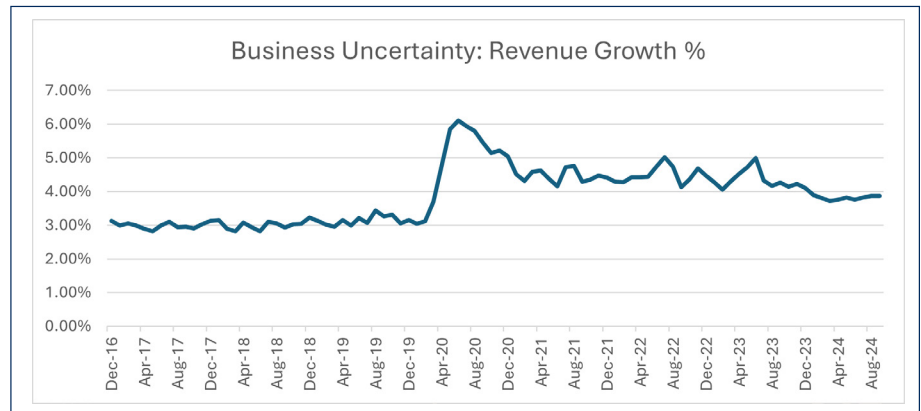


Turning to growth expectations, the Business Uncertainty Survey from the Atlanta Federal Reserve highlighted that businesses expect their revenues to increase by 4.1% over the next 12 months, stronger than their 2019 growth projections that came in at 3.7%. However, the uncertainty of that revenue forecast is also a lot higher than pre-pandemic levels, showing a 4% degree of uncertainty which could bring revenue growth

next year to flat or no growth. This greater level of uncertainty could be a result of more volatile economic conditions, lack of policy clarity with the upcoming presidential election, and still stubborn inflation. However, a 4% degree of uncertainty in the current environment is relatively stable, showing that businesses are not expecting significant disruptions or challenges that could lead to large forecasting errors.

The Bulls Keep Charging Forward

Despite the market's wall of worry, bullish investors have kept the market charging forward. Several headwinds have threatened to end the bull run but to no avail. Pessimistic consumer sentiment driven by higher cost of living, debt levels, and recessionary fears have not stopped them from spending. On the contrary, a survey conducted by McKinsey and Company showed that most consumers intend to spend more across most spending categories.



Source: Federal Reserve Bank of Atlanta, Survey of Business Uncertainty 2024.

Consumers reported higher intent to spend across most categories.

Expected spending per category over the next 3 months compared with usual,¹ % of respondents

■ Intend to spend less ■ Intend to spend the same ■ Will spend more on this category ■ Above 3% ■ Below -3%

| Group | Category | Expected spending | Net intent, percentage points | Net intent, Q3 2024 vs Q2 2024, percentage points |
|--------------------|--|---------------------------------|-------------------------------|---|
| Essentials | Fresh produce | 9 (less), 68 (same), 23 (more) | 13 | -2 |
| | Gasoline | 12 (less), 64 (same), 25 (more) | 13 | -8 |
| | Baby supplies | 18 (less), 51 (same), 31 (more) | 12 | 7 |
| | Meat and dairy | 12 (less), 67 (same), 20 (more) | 8 | 1 |
| | Pet food and supplies | 10 (less), 72 (same), 17 (more) | 7 | -1 |
| | Center-store/shelf-stable groceries | 12 (less), 70 (same), 18 (more) | 6 | 1 |
| | Nonalcoholic beverages | 16 (less), 72 (same), 12 (more) | -4 | 4 |
| Semi-discretionary | Personal-care products | 13 (less), 71 (same), 15 (more) | 2 | 2 |
| | Household supplies | 14 (less), 71 (same), 15 (more) | 1 | 1 |
| | Vitamins, supplements, and over-the-counter medicine | 15 (less), 70 (same), 15 (more) | 0 | 3 |
| | Fitness and wellness services in person or online | 20 (less), 62 (same), 18 (more) | -1 | 2 |
| | Toys | 30 (less), 48 (same), 22 (more) | -8 | 9 |
| | Skin care and makeup | 25 (less), 60 (same), 15 (more) | -9 | 7 |
| | Vehicles | 30 (less), 51 (same), 19 (more) | -10 | 5 |

Source: McKinsey & Company, "An update on US consumer sentiment - consumer sentiment rebounds but for how long?", August 2024.

Additionally, the economic conflict with China that started during the Trump administration and continued with the Biden administration (including blocking China's ability to purchase advanced semiconductor chips) has failed to stymie the strong advance of semiconductor stocks- which collectively as a group account for 12% of the S&P 500. Lastly, increased political polarization and concerns about the federal debt levels have not led to a surge in longer term rates nor decreased demand for Treasury bonds. We believe that the market's ability to scale "the wall of worry" and continue its' march upwards is predicated on three major themes. 1) Innovation continues to drive profits. 2) Monetary policy is easing. 3) The current bull market is still relatively young.

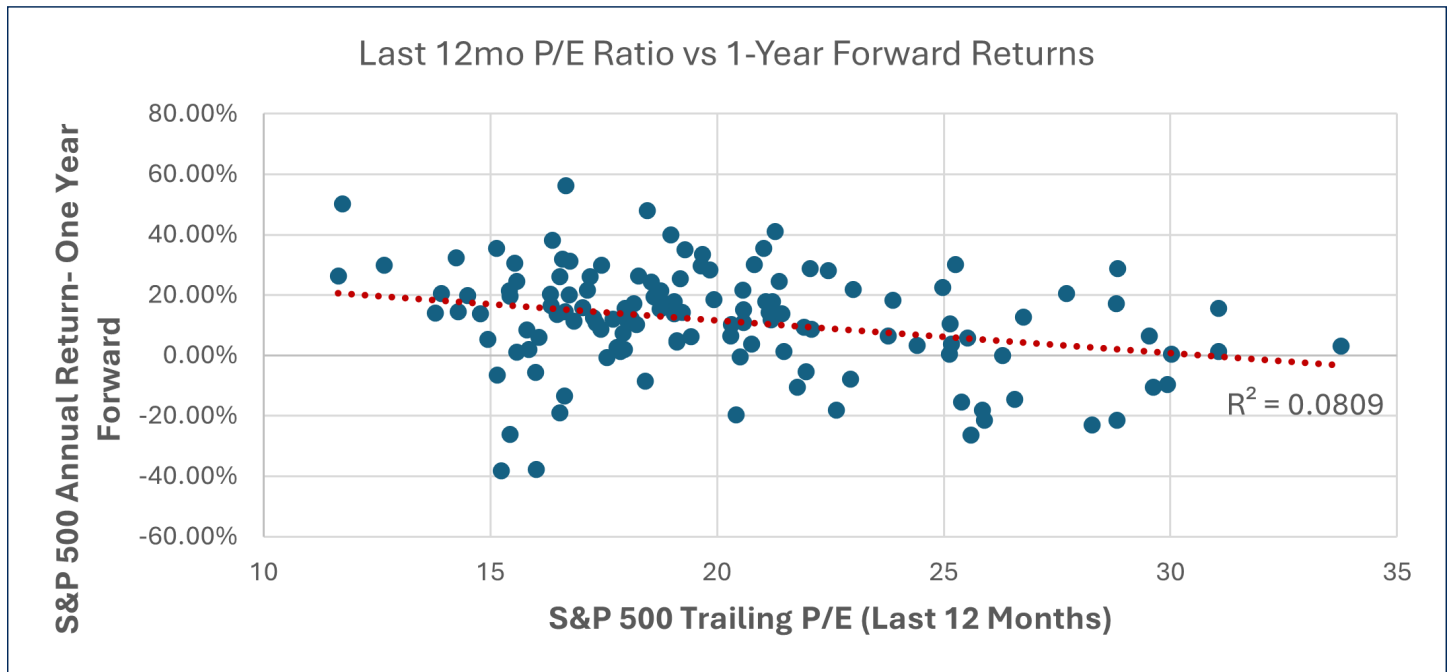
Innovation continues to drive earnings and market valuations higher. While the first leg of the market/AI rally has involved mostly hyper-scalers (AMZN, META, MSFT, GOOGL) and semiconductor manufacturers (NVDA), an increasing number of other AI winners are emerging. Companies dedicated to infrastructure buildout, such as data center REITs, energy storage, electrification, and utilities have posted strong profits. Consequently, we have witnessed the market rally broadening out to other sectors, as evident in the rotation into small caps and value stocks in the last quarter. Given that less than 5% of U.S. companies are actively using AI (according to Census Bureau data), the runway for both AI native and non-native companies could last for years to come. As for the monetary environment, since 1985, five of the best ten years for the S&P 500 came when the Fed lowered rates outside of a recession. The most pertinent historical analog to the current environment might be 1995. Then, the Fed achieved a soft landing just as the market was beginning to appreciate the new wave of excitement around the personal computer and the internet (Netscape IPO'd in August 1995). Although a reflation in prices driven by a stronger economy and consumer spending pose a risk to the monetary easing cycle, we view that the current Fed Funds rate is still between 100 to 175 basis points higher than its real long-term neutral rate, providing the Central Bank some wiggle room to ease financial conditions further.

Finally, the current bull market is alive and well, entering its 24th month as it recovers from the market bottom established on October 11th, 2022. On average, the median bull market lasts for 46 months (three times longer than the median bear market) and the median total return for a bull market is approximately 110%. As of September 30th, the current bull market is 23 months young and has returned approximately 60%, suggesting plenty of upside left if this bull market merely matches its historical median. However, given the strength of the market over the last 12 months, we are not surprised to see that some investors are feeling the "rally fatigue" or think that the market is due for a correction. While we'd expect investor hesitation, upcoming presidential election, and geopolitical conflicts with Russia/ Ukraine and Israel/ Hamas to create above average volatility in the near term, we do not anticipate the type of bear market drawdown like one experienced in 2022 anytime soon without a significant external shock.

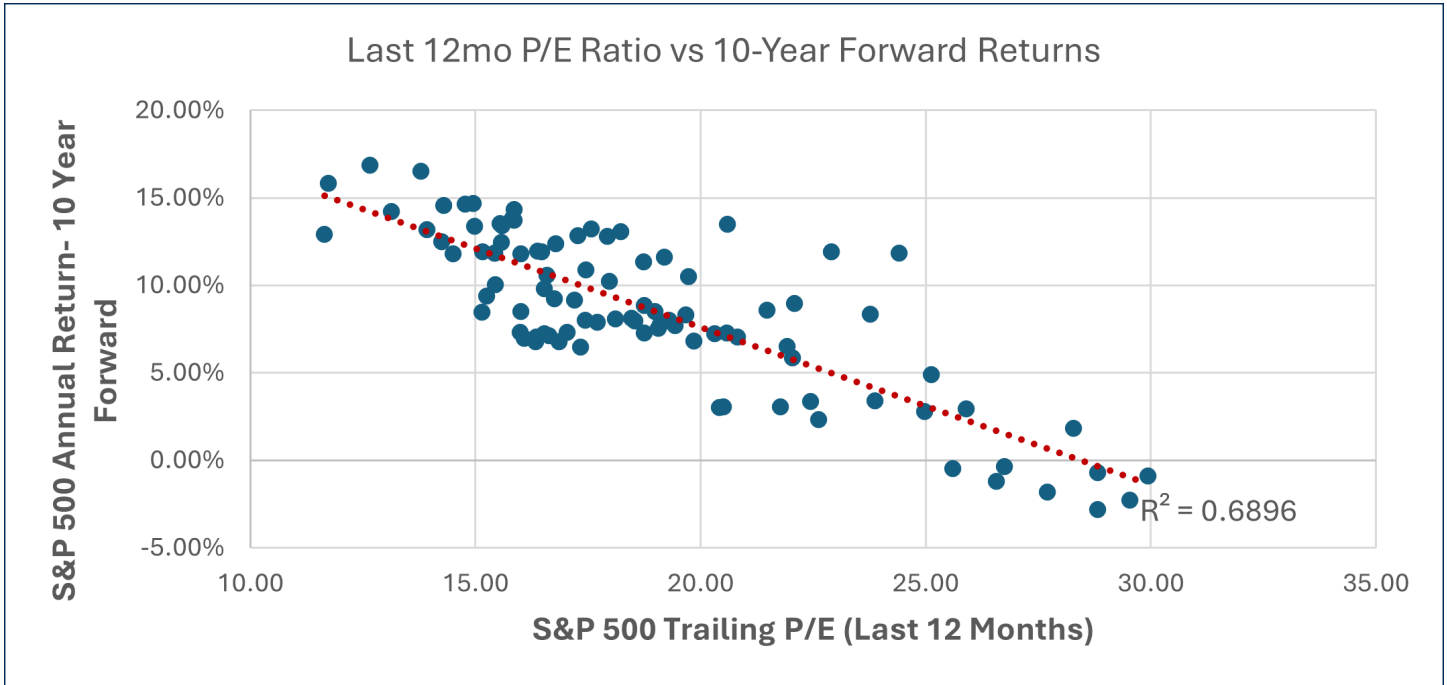
Case of resetting client expectations

Despite our strong underlying bullish tone, we have less confidence that the current bull market will achieve the same level of strong returns in the next decade as it did in the last 15 years (averaging +15% return per year). Central to our argument is that US stock valuations today are in their 90th percentile for both trailing 12 months price to earnings (P/E) and cyclically adjusted price to earnings (CAPE). In other words, today's market is in the top 10% of the most expensive markets in history. Nonetheless, market valuations do little in predicting short-term market performances, as expensive markets can always become more expensive in the near term. In looking at S&P 500 stock

returns since 1990, we can see the trailing 12-month P/E ratio has a very weak relationship in predicting annual returns 1 year out. However, if we extended the period to 10 years, the relationship between the trailing 12-month P/E ratio and subsequent average market annual returns would become much stronger. Statistically speaking, the R-squared, which measures how well the P/E ratio does in explaining market returns, improves from 8% to 69% when we move from a one year to a ten-year period. Additionally, valuations and market returns have an inverse relationship (downward sloping), indicating that the higher valuation levels are, the lower the expected future returns would be.



Source: Bloomberg, Liberty One Investment Management. September 2024.



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With the existing P/E ratio of the S&P 500 measuring at 27x, history has not been kind to the expected future long term annual returns based on today's valuation levels. In setting future client expectations and what it would take to achieve their financial goals, it may be wise to err on the side of conservatism and forecast an equity return range of 5% to 7% versus a historical average of approximately 10%, and a far cry from the +15% experienced over the last decade. The true fair value of stocks greatly depends on what the prevailing macroeconomic environment is like- including

interest rates, inflation, and market volatility. Higher stock market valuations can be justified during periods of low interest rates, low inflation, and low volatility. The low rates push down the discount rate and the cost of a stake today in a company's future earnings. However, equity prices have continued to climb to new highs despite the transition towards a higher interest rate, inflation, and volatility environment over the last few years. This could suggest that investors may be complacent towards overpaying for equity risk premium and it is a substantial risk worth monitoring.

Outlook

Bad news used to be good news, but bad news has now become bad news again. Merely six months ago, investors were celebrating bad economic data as an indication that inflation would come down, and that would allow the Fed to lower interest rates as a result. A further cooling of the labor market and inflationary pressures have led the Fed to embark on its first rate cut since the Covid-19 pandemic, removing the cloud of uncertainty surrounding the path of interest rates. Investors have since pivoted their attention to the health of the economy, and more importantly, its earnings impact on corporate America. Any negative economic surprises could create a bout of volatility given the existing vulnerable state of financial markets. This vulnerability stems from both the equity and bond markets' pricing of a soft landing or no landing at all, with a lack of discounting for economic weaknesses.

Nonetheless, there remain plenty of investment opportunities within financial markets, each comprising their own unique set of characteristics-with different growth, earnings, and valuation profiles that can still generate a positive return for investors. Additionally, we are encouraged to see the broadening out of the market rally beyond the Magnificent 7 stocks and are excited about the opportunities that presents. As the "wall of worry" confronts investors, it is advisable for investors to remain invested and employ diversification techniques to help them navigate through any turbulence. A well-constructed diversified portfolio does not often look like the S&P 500, nor does it need to be for investors to achieve their long-term financial goals. We remain cautiously optimistic about the global economic future- supported by human ingenuity, population growth, and improving standards of living.

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