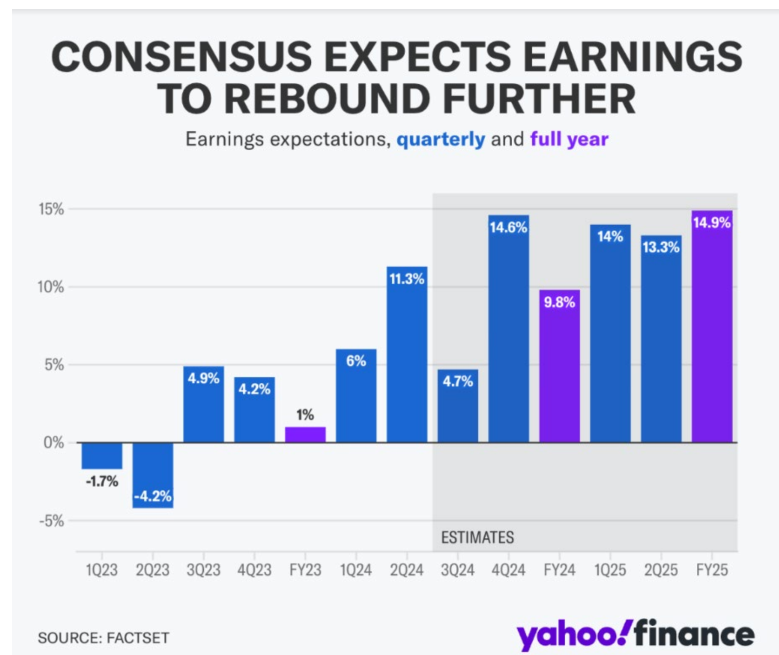
Pavlic Investment Advisors

Client Review & Outlook

3rd Quarter, 2024

Dear Client,

We ended the third quarter with continued positive stock returns up mid-double-digits for the year to date period and up mid-single digits for the third quarter alone. Our trailing one-year results for our core equity portfolio* is up over +25% on both a net and gross of fee basis. The stock market rally continues to be led by the combination of solid economic data (albeit with some warning signs), a more aggressive Federal Funds interest rate cut in September, and continued enthusiasm around Artificial Intelligence (AI). While this has benefited our portfolios, looking ahead our belief is that we will continue to see a broadening of outperformance to other sectors that have been left behind in this bull market such as utilities, health care, real estate, energy, and materials, especially as interest rates are expected to fall. While fundamentals of the "Magnificent Seven" stocks continue to be best in class, the growth of earnings is both broadening and accelerating to other parts of the market as shown in the chart right which is why we continue to maintain a well-balanced and diversified portfolio.



In addition to managing portfolios, we have been actively engaging with clients utilizing our new financial planning software tool called Right Capital. While life situations as well as market conditions will continue to change, to account for all the moving variables in real time we have implemented this holistic software-based approach to give the best advice to our clients as it relates not only to the investment portfolios we manage but other financial decisions such as when to tap Social Security, appropriate rates of retirement spending, and tax efficient Roth IRA conversions, to name a few examples. While investment performance and keeping excess fees low will always be our number one priority, many clients have appreciated this additional service offering we are providing. Clients now have a clear look at their entire financial picture which allows us to adjust investment risk and return goals if needed. Financial plans are not a "set it and forget it" as we will continue using this software on an ongoing basis with our clients. If you haven't yet sat down with us to get a demonstration of the tool, please let us know and we would be happy to set up an in-person meeting or a video conference.

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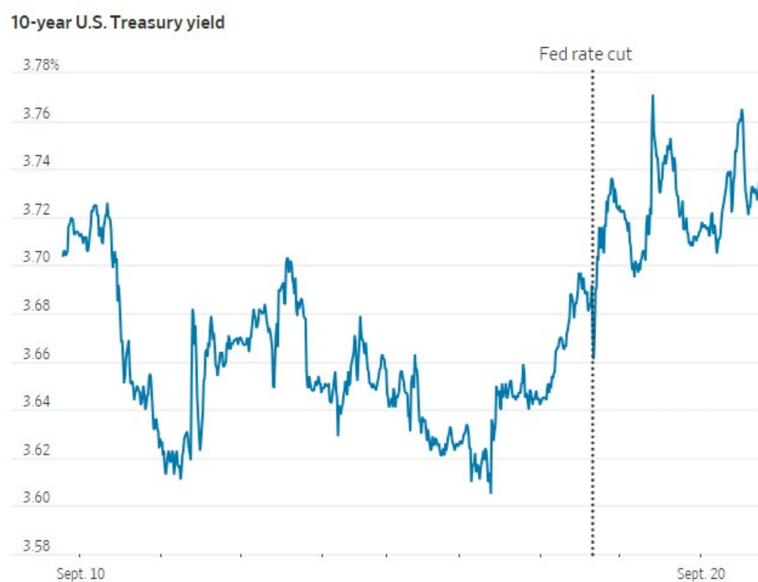
Stock Market Review

We focus our stock market review on three main topics: what the Federal Funds rate cut means for investors, looking beyond the "Magnificent Seven", and politics ahead of the U.S. Election next month.

Fed Rate cuts don't equate to lower borrowing costs. A common assumption we've heard in the financial media lately has been that the Federal Reserve interest rate cuts directly equates to an equidistant decline in common borrowing costs such as mortgage rates and auto loans. However, this isn't necessarily the case. In fact, in the week after the Federal Reserve cut interest rates by 0.50% in mid-September, the 10-year US treasury increased by 0.10% in the week following. This is a good reminder that the Fed doesn't have complete control over all borrowing costs in the economy. In fact, the central bank only manages short-term rates that banks charge each other for overnight loans, which shift costs on credit-card debt and other types of short-term floating-rate loans. Fixed rate loans such as mortgages and auto loans are driven primarily by movements in US treasury yields. For much of the last two years, we have had an inverted yield curve, where short term rates are higher than long term rates. The Fed lowering the overnight rate (the shortest rate on the yield curve) can simply get us back to a normal shaped yield curve where short term rates are lower than long term rates. Longer term rates don't necessarily have to decline, and as such, neither do mortgage and auto loan rates.



From the investor's perspective, a lower Federal Funds rate means a lower expected interest return on our money market fund position. For over the last twelve months, we have held a ~5.0% average position in the money market fund earning over 5.0% in annualized interest. Recognizing that this position hasn't earned as much as our core stock portfolio, on a risk adjusted basis the money market fund lowered our overall portfolio volatility while still earning a satisfactory return. For clients with bonds in their portfolios, we are having discussions on extending duration with investment grade bonds by locking in higher yields for a longer period as we expect the money market fund return to continue to come down to the low 3.0%'s by the end of 2025. Obviously predicting where long (and short) term interest rates are headed is a difficult endeavor and that is why we buy bonds with the intention of holding them until maturity, thereby locking in the yield to maturity. We are not buying and selling bonds with the intention to make excess alpha as we think this is a fool's errand largely due to the bid ask spreads and transactions costs associated with fixed income.

Another point to make is that stronger economic conditions generally equate to higher interest rates and vice versa. In our 2Q letter we focused on the Sahm rule. The latest unemployment reading as of early October was 4.1%--still viewed near a structurally full employment rate, however we are keeping close watch as we remain 0.60% higher than unemployment levels reached in the middle of 2023. Any faster rise in the unemployment rate in the future will likely result in the Federal Reserve lowering interest rates that much faster, which would drive both higher bond prices and a more positively sloped yield curve benefitting our variable rates bonds.

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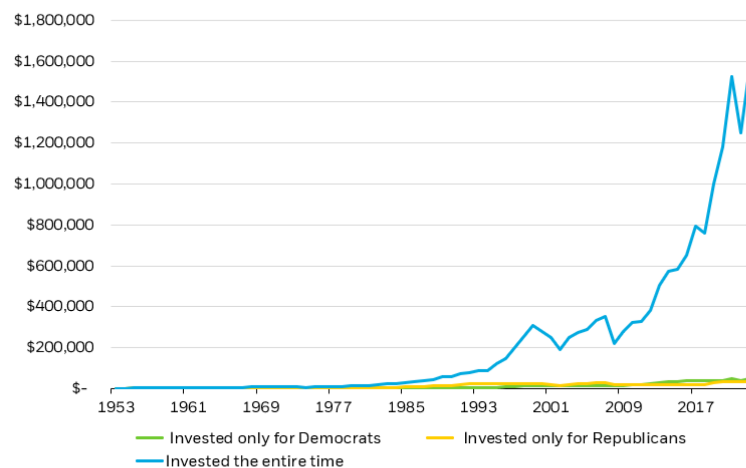
Looking beyond the "Magnificent Seven" for our future stock growth drivers. The Federal Reserve's more aggressive 0.5% interest-rate cut helped fuel a new push in the stock market to record highs, but we believe the next leg of the rally is likely going look quite different from the tech-driven push of the last two years in which the "Magnificent Seven," a group of mega-cap stocks concentrated in the tech sector have dominated US stock market returns. Nvidia (NVDA), Tesla (TSLA), Microsoft (MSFT), Alphabet (GOOGL), Meta Platforms (META), Apple (AAPL), and Amazon (AMZN)) now make up more than 33% of the S&P 500 Index. We believe rate cuts open the door for a wider dispersion of winners, particularly in sectors that have been left behind in this most recent bull market run such as utilities, energy, and real estate. A good example of this has been one of our best performing holdings year-to-date (purple line below) called **NextEra Energy (NEE)**. NextEra is America's largest regulated electric utility, selling electricity to over 6.0 million customer accounts in the U.S. Revenue expectations for this year are 6.0% above consensus estimates and EBITDA (a measure of cash flow) have come in 17% above consensus estimates so far this year. We don't doubt that the "Mag Seven" are still going to put up impressive growth numbers, which is why we still own several of them, but the rate of growth is decelerating, while the rate of growth of the names outside the Mag Seven we see accelerating at a faster rate.

Another area of the market we find interesting is software. With the persistent rising price of employee talent, particularly highly skilled talent, we expect companies to continue to look to technology to increase productivity within their organizations. While tech stocks have been rising, much of that has been due to semiconductor chip manufacturers within the sector and other AI related names. We have been taking advantage of this trend by owning names like Applied Materials and Teradyne. Software names have largely not taken part of the AI boom, and while fundamentals remain strong with several software companies, we are keeping an eye on valuations for an entry point as we potentially look to continue to capitalize on AI productivity and technological innovation.

The Election. While the election is top of mind for many investors, we want to remind our clients that regardless of who is in the White House, corporations have an uncanny ability to grow earnings over the long run. Stock prices are highly correlated to stock earnings. Blackrock published a recent white paper that shows tight elections are usually associated with increased market volatility in the near term, broad market performance is unaffected by which party wins the White House. Data shows that the ability to stay invested has been significantly more important than investing based on which party wins the presidency. Those who stayed the course as political winds changed earned nearly double those who shifted their strategy based on the election in the last decade, and significantly more multiples of increased performance looking across multiple decades as evident in the chart right (blue line).

Figure 8: Last 70 years, $1,000 invested in 1953 depending on which party held presidency



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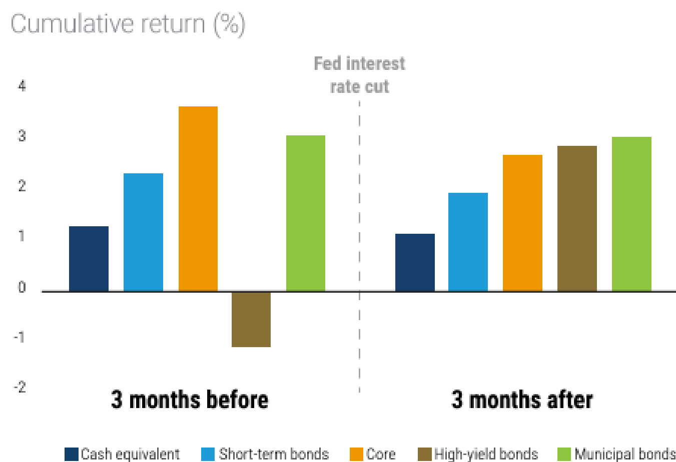
Bond Market Review

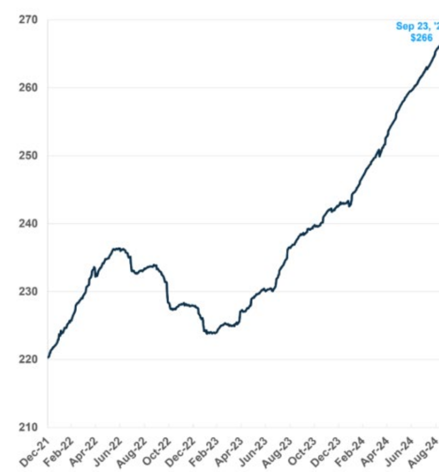
A welcome reversion to a normal shaped yield curve. As mentioned in our stock market outlook on the previous page, the 0.50% rate cut from the Federal Reserve has many implications for bonds, arguably even more so than on stocks. This is because the decrease of the federal funds rate directly lowers the shortest end of the yield curve—the rate banks lend overnight to each other. This has started to relieve pressure of higher rates across the yield curve, but secondly, and more importantly, it has started to give us a normal shaped yield curve with longer dated bonds further out to maturity presenting higher yields than shorter dated bonds. We have had an inverted yield curve for much of the last 18 months and the lowering of the Federal Funds rate should help to erase that inversion. This will be particularly beneficial to our variable rate spread bonds that pay based on the steepness of the yield curve.



What should we expect from bond performance before and after Fed rate cuts? Looking at the past performance of fixed income before and after the Fed cuts rates, we can see that most bonds posted positive returns in the period preceding a rate cut and continued to post positive returns after rate cuts began (chart above). For low risk-tolerance volatility-wary investors who may still be sitting on cash, short-term bonds could be a good way to get back into the market. For investors who want to lock in higher starting yields and total returns, there may be opportunities with high-quality bonds further out on the curve in the 5 to 10 year duration span. Currently, we are locking in ~5.0% yields to maturity for some clients further out on the yield curve as we believe that the money market fund yield will come down in tandem with the Federal Reserve lowering the federal funds rates.

Market Outlook and Commentary

Earnings and the jobs market remain key. While inflation is still ever present in people's lives, the pace of increases in prices is coming down (said differently, prices are still going up but at a slower pace). This gives the Federal Reserve the ability (and need) to cut rates, especially given the recent increase in unemployment we have seen. To use an analogy, we compare the current economic backdrop to a car going down a steep hill--steep from fiscal and monetary stimulus post-COVID. The Federal Reserve has ridden the brakes going down the hill to stop inflation and make sure the car doesn't get out of control. But now the economy is back on a flat road (normal) and the Fed is still riding the brakes (high rates). If they don't let off, the car will stop (recession). That we believe was the motivation behind the aggressive cuts in September and it reinforces that while the market has convinced itself the Fed isn't behind the curve, the risk of that may be greater than the market currently anticipates. We continue to balance return and risk in our equity portfolios while overlaying our strategy with each client's individual asset allocation policy directive mix between stocks, bonds, and cash.



"If past history was all that is needed to play the game of money, the richest people would be librarians."
- Warren Buffet

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