Newsletter

MCS Family Wealth Advisors

*Managing Risk to Increase Wealth®*

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# 2024 Third Quarter Newsletter and Outlook

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The US economy has remained strong despite a constant drumbeat that a recession is nigh. The Coming Soon Recession has been justification for market pundits' advice to brace for a recession and lower interest rates. The stock market never got the memo because it has mostly been on a tear the entire year.

Current economic conditions suggest that the stock market has more room to run despite market valuations that are consistent with poor long-term (decade) performance. The trouble is that no one knows when the poor performance period that drags down longer-term returns starts, or how it plays out. Will it be big losses over a short period of time that take years to recoup, or smaller, grinding, annual losses?

Contrary to what many market analysts promoted, bond yields have *increased* since the Fed *reduced* the overnight Fed Funds rate by half a percent. Intermediate and long-term bonds remain unattractive because their interest rates remain below short-term interest rates. However, intermediate and long-term bonds are on a path to normalize. Normalization means they offer higher yields than short term bonds (aka a 'term premium') to compensate for the extra risk of lending money for longer periods of time. (The extra risk includes higher future inflation and increased future borrowing / deficits.)

Through September 30, 2024 (if MCS clients' accounts were treated as one large portfolio), on average clients gained 3.4%, after fees. For comparison purposes, the Bloomberg Barclays Aggregate Bond Index gained 4.4%, and the S&P 500 Total Return Stock Index (S&P 500) gained 22.1%. The range of MCS individual client returns was from a gain of 9.4% to a gain of 1.4%[1]. The clients who fared the best and the worst were overweight in long held, low- cost basis stocks.

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## Do US Presidential Elections Matter to Investors?

As I wrote in a previous newsletter, the past 75 years of historical data support the observation that financial markets don't care much about US political outcomes. Investors will simply adjust their stock strategy to the industries favored by the party with the most political clout.

Abraham Lincoln's election in 1860, however, was an exception. This election had an immediate impact on financial markets, and the situation would only get worse. (see Figure 1).

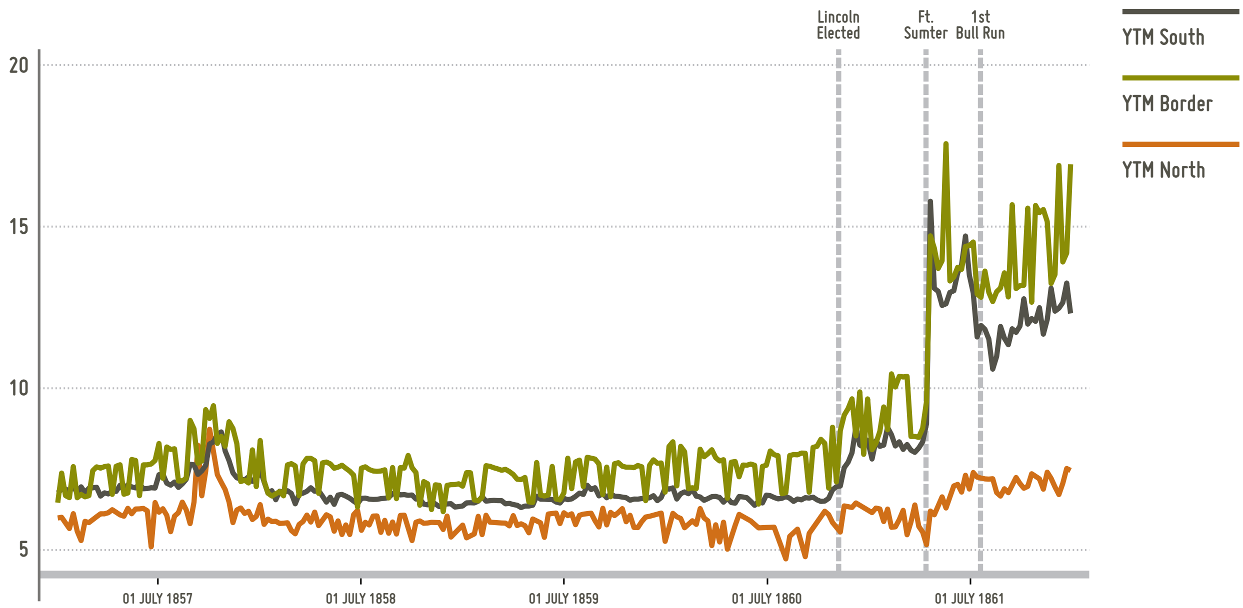
A 2023 research paper, *Dynamic Secessions: Evidence from the U.S. Civil War*[2], identifies how the municipal bonds of various states reacted to Lincoln's election and the events leading up to the start of the Civil War.

**From the paper abstract:**

> *Using the canonical case of the secession of southern U.S. states in the 1860s and novel, hand-collected weekly state bond data from the NYSE, we first show that financial markets priced "secession risk" after the election of President Lincoln in the fall of 1860 – when Southern states' yields diverged and **long before war broke out** between the Confederacy and the Union. (Emphasis added.)*

Figure 1

## Average Yields to Maturity in the North, South, and Border States




**From the paper:**

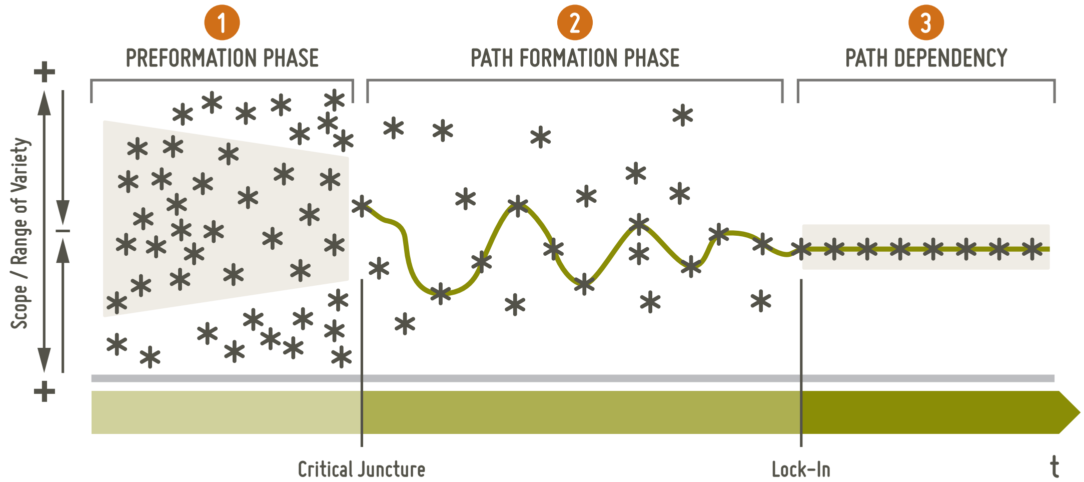
> *Even though a number of important political events related to states' rights and the issue of slavery took place between 1857-1860, Figure 1 suggests that none of these moved bond yields differentially. Divergence in YTM (Yield to Maturity) did not occur until the election of Abraham Lincoln for U.S. president in November 1860. Southern and border state bond yields jump by 1 to 2 percentage points on average in the weeks following the announcement that an "anti-slavery" Republican had won the Presidential election.*

Financial markets in other countries react negatively to destabilizing political changes. Yet, in the United States, there's an embedded assumption (based on roughly 100 years of market data) that destabilizing political changes won't happen here. Longer term data tells a different story for US markets; the US is not immune to ugly periods of political history and its negative financial consequences.

The best outcome for the 2024 election? The losing presidential party gets control of the Senate and / or the House resulting in political gridlock, which normally removes most of the risk of radical changes that may impact investors' wallets. This brings us to the topic of path dependency.

Figure 2

### The Three Stage Model of Path Dependence[3]




In the preformation phase, the future offers many potential outcomes, but as events transpire many potential outcomes disappear, narrowing the range of possible futures. Path Dependency describes a situation in which the outcome of an event (critical juncture) narrows the potential set of future outcomes until a single outcome is inevitable (lock-in).

> *"How did you go bankrupt?" Bill asked. "Two ways," Mike said. "Gradually and then suddenly"*
> *—"The Sun Also Rises" Ernest Hemingway, 1926.*

In the preformation (gradual) phase, Mike has many choices about how to spend his money. At the critical juncture, Mike's spending begins to exceed his income. In the path formation phase, Mike's excess spending continues as he borrows against assets for spending. At lock-in, Mike runs out of ways to get the money to support his spending and can't afford to pay back what he owes. He must file bankruptcy, and his 'potential futures' have 'quickly' collapsed.

The presidential election is in the path formation phase. It MIGHT have serious implications for investors.

If you are interested in stepping back and analyzing the partisan fray, you might give Epsilon Theory's Ben Hunt some attention. I would also call your attention to Ground News, a Canadian based organization that, like Epsilon Theory, measures and reports the bias in news reporting on both the left and right.

## Epsilon Theory:

> *I think Kamala Harris is going to win the election this November.*
>
> *I think this for the same reason that I thought Trump would win in 2016: modern Presidential elections are turn-out elections … they're not about 'winning over' undecided voters but about turning out a supermajority of your core voters in your core districts … and I think Harris is beating Trump pretty handily in this regard, almost as badly as Trump was trouncing Biden a few months ago. There is authentic voter enthusiasm out there for Harris in Team Blue, a relief rally from Biden's 'retirement' that has somehow been transformed into a vibrant campaign. This enthusiasm for Harris is as incomprehensible to me personally as the remaining enthusiasm for Trump in Team Red, but so what? It's there, it's growing, and I think it's enough to get Harris to 270 electoral college votes.*

> *…Where the common knowledge game rears its ugly head is the day after the election: Wednesday, November 6th. That's the day where, if I'm right, Kamala Harris has claimed victory in the early AM hours and where some hours later Donald Trump has … umm … also claimed to be the winner. Or at least has stated publicly that he is not the loser, that there is 'evidence' of a terrible fraud perpetrated against him, that the election has been stolen. Again.*
>
> *Win or lose – and I think it's lose – that's what he's going to say. That he's the winner. You know it and I know it. We all know it. No one in a position of media prominence for Team Red or Team Blue – what we'd call a Missionary in common knowledge terms – is talking about it, because it's totally counterproductive for either side to talk about it before it happens, but we all know that it's going to happen. If he wins, he wins. If he loses … well, he didn't lose. Donald Trump is not going to concede this election, and he's going to call for 'patriotic Americans' to 'stand up' and 'get to the bottom' of it.*
>
> **THIS is our common knowledge about Donald Trump: we all know that we all know that he will not accept the election result if he loses.**

This assessment in bold, matches my own. What about you?

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## Bottom Line

Treasury bills (T-bills) remain a very attractive low risk investment. With yields below T-bills, intermediate and long-term treasury bonds are unattractive but improving. Stocks could move higher in the short run, given relatively favorable economic conditions; however, the market is very expensive from a historical valuation standpoint (which *implies* poor *long-term* returns).

The chance of post-election political volatility appears significant. Given the risks, I'm taking a wait-and-see approach.

If current circumstances leave you unperturbed or even bullish, and you'd like exposure to stocks, call me at 541-345-7023 or email me at michael@mcsfwa.com and we'll implement a strategy that provides stock exposure.

## Endnotes

[1] MCS Family Wealth Advisors (MCS) consolidated client returns are dollar-weighted, net of investment management fees unless stated otherwise, include reinvestment of dividends and capital gains and represent all clients with fully discretionary accounts under management for at least one full month in 2024. These accounts represent 99% of MCS's discretionary assets under management as of 09/30/2024 and were invested primarily in US stocks and bonds (?% of client assets on 09/30/2024 were invested in tax-exempt municipal bonds). The Stock Index values are based on the S&P 500 Total Return Index, which measures the large-capitalization US equity market. The Bond Index values are based on the Bloomberg Barclays US Aggregate Bond Index, which measures the US investment-grade bond market. Index values are for comparison purposes only. The report is for information purposes only and does not consider the specific investment objective, financial situation, or needs of any recipient, nor is it to be construed as an offer to sell or solicit investment management or any other services. Past performance is not indicative of future results.

[2] Lacroix, Jean; Mitchener, Kris James; Oosterlinck, Kim; Dynamic Secessions: Evidence from the U.S. Civil War; April 15, 2023

[3] Sydow, J., Schreyögg, G., & Koch, J.; 2009; Organizational path dependence: Opening the black box. ***Academy of Management Review***, 34(4): 689-709



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