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4TH QUARTER | 2024

COLONIAL TRUST *Quarterly*

Q4 Expectations

In The Spotlight with Madeline

The Capital Markets

AS OUR TEAM WRITES THIS NEWSLETTER TO OUR CLIENTS AND FRIENDS, WE ARE DISTRACTED BY AND CONCERNED ABOUT THE VERY REAL CHALLENGES MANY OF US IN THE UPSTATE OF SOUTH CAROLINA AND WESTERN NORTH CAROLINA FACE AFTER TROPICAL STORM HELENE.

We know many of you have experienced power outages and property damage from wind and downed trees. This was a once-in-a-lifetime tragedy for many of us and it may take weeks or months for things to return to normal. Our thoughts and prayers are with those of you affected and we should all take this opportunity to care for our neighbors in need.

MARKET STRENGTH CONTINUED DURING THE THIRD QUARTER AND THE RALLY CONTINUED TO BROADEN.

The S&P 500 provided a total return of 5.9% for the quarter and is up 22.1% year-to-date. The horse race between domestic indices saw a reversal of leadership. The DJIA returned 8.7%, while the Nasdaq Composite was the laggard for the quarter, up 2.8%. In the third quarter, the market leadership changed dramatically from the second quarter. For the quarter ending June 28th, the technology and communications services sectors far outperformed the other nine sectors in the S&P 500. For the third quarter, those high growth sectors were barely positive, while utilities, real estate, and industrials led the market.

The best performing domestic index was the small-cap Russell 2000, which returned 9.3%. International markets outperformed the S&P 500 for the quarter, with developed markets returning 7.4%, while emerging markets returned 8.8%. The bond market, as measured by the Bloomberg Aggregate Bond Index, returned 5.2% for the quarter and is now positive 4.5% year-to-date.

The capital markets spent the first ten weeks of the quarter transfixed on the Federal Reserve in anticipation of the first interest rate cut. On September 18th, the market was greeted with a 0.5% reduction in the Fed Funds Rate and Fed guidance to expect another 0.5% cut before year end. This was after the Fed maintained a rate of 5.33% for 419 days. Longer term bond yields drifted lower for much of the quarter in anticipation of this change in policy.

THE ECONOMY

THE SLOWDOWN IN ECONOMIC ACTIVITY IN THE FIRST QUARTER WAS SHORT-LIVED, WITH SECOND QUARTER GDP REACCELERATING TO 3.0% GROWTH.

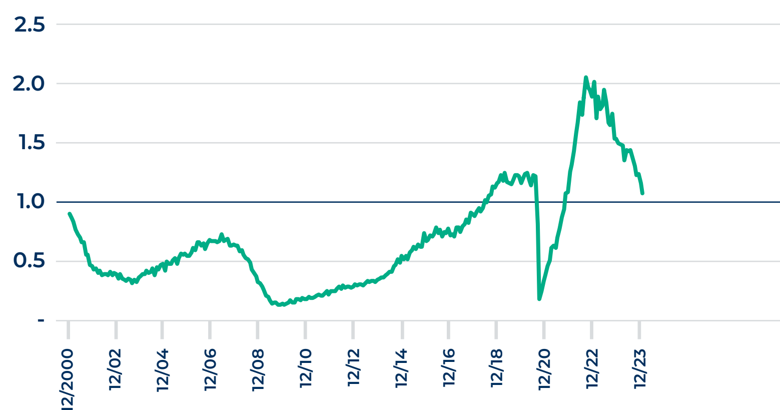
The pickup in growth was due to strong consumer spending, up 2.8%, government spending, up 3.1%, and a large build in inventories after inventory depletion in the first quarter. At quarter-end, the Atlanta Fed GDPNow Forecast for third quarter GDP growth was 3.1%. A survey of 68 Wall Street economists by Bloomberg has an average forecast of 2.0% growth for the third quarter, with these same economists increasing their estimates from just 30 days ago. While the first quarter saw more modest growth of 1.6%, growth has picked up heading into the fourth quarter.

The largest driver of the US economy is consumer spending, which continued to grow in the third quarter. The year-over-year inflation adjusted personal consumption expenditures increased between 2.6% and 2.7% for July and August. Retail sales for the same periods were up 2.9% and 2.1%. Both measures of consumer spending have slowed from 2023 but continue to show growth. The bifurcation we discussed in our last newsletter continues, with a worsening of the financial sentiment for lower income consumers. Deloitte's most recent State of the Consumer Survey showed that 77% of those with incomes of $100,000 or greater believe their financial situation is improving, compared to only 51% of those with incomes of $45,000 or lower. We saw this divergence in quarterly earnings reports, with retail and consumer facing companies commenting on the price sensitivity among many consumers. James Quincey, the CEO of Coke, said, "Definitely, there's a piece of the lower-income consumers which are either going out slightly less or, when they do go somewhere, looking for greater value through combo meals. Having said that, there are just as many consumers spending on more premium categories or more premium price points." As we enter the fourth quarter, we expect this divergence to continue, although slowing inflation and real wage growth should lessen the financial pressures for lower income consumers.

There was much angst over the last three months about the labor market. In fact, the moderating labor market is one reason the Fed cited in lowering interest rates. According to the Bureau of Labor Statistics (BLS) Establishment Survey, US employers added 1,765,000 jobs in the first eight months of 2024, with an average of 196 thousand per month. This compares to a monthly average of 251 thousand in 2023, although the last three months have averaged 116 thousand. Job openings have also fallen, with 7.67 million openings in July, down from 12.18 million in March 2022.

The number of job openings per unemployed person was 1.1 in July, down from 1.5 job openings per person a year ago. The unemployment rate has also increased in 2024, from 3.7% in December to 4.2% in August. We believe the labor market is normalizing and are not currently bothered by this uptick in the unemployment rate. This is partly because the labor force participation rate increased to 62.7% as people entered the labor market. Moreover, prime age workers' (25-54 years old) participation rate was 83.9% in August, a level last seen in 2001.

JOB OPENINGS PER UNEMPLOYED WORKER



WE WOULD BE CONCERNED IF WE NOTICED AN INCREASE IN INITIAL CLAIMS FOR UNEMPLOYMENT INSURANCE.

This measure trended down for the quarter, signaling companies have not increased layoff rates as hiring has slowed. Demand for labor is moderating while supply of labor is increasing, thereby reducing pricing pressures for wages. Average hourly earnings increased 3.8% in August, down from 4.3% in December. Compensation is an inflation driver and moderating compensation trends are good news for the Fed's inflation fight.

General inflation and wage inflation continued to moderate in the third quarter. Headline CPI fell to 2.5% in August, while inflation excluding food and energy was 3.2%. Inflation remains concentrated in the service sector, with goods prices continuing to fall. Shelter remains the key driver of services inflation, and the strange heuristic of owners' equivalent rents is the reason. This is where the BLS asks homeowners how much they would rent their own home for unfurnished and without utilities. This is an opinion and is slow to capture changes in pricing. Other measures of shelter, whether primary leases measured by the BLS or the measurements from Apartments.com and Zillow, show moderation in shelter prices. We agree with the Fed that inflation is on a trajectory towards the Fed's 2.0% target. Moderating inflation should improve consumer sentiment and allow the Fed to reduce interest rates further, both of which are positive for the economy.

With a solid consumer and falling inflation on the positive side of the ledger, the business sector is mixed. Manufacturing has not reaccelerated. The Institute for Supply Management (ISM) Purchasing Managers Index remains in contraction territory at 47.2. It trended lower over the last five months, after a brief uptick in the first quarter. Industrial production has flatlined, with year-over-year measures oscillating between slight contraction and expansion. Capacity utilization rebounded post-pandemic but fell from over 80% in 2022 to 78% at year-end 2023. It had bounced around 77%-78% for the first eight months of 2024. Further weakening is not evident in the manufacturing sector, but there is also no discernible improvement in the most recent data. It is possible that lower short-term interest rates will improve demand for big ticket manufacturing products, like autos. But that will take some time to play out. While the manufacturing sector is in neutral, the service sector continues to grow. The ISM Services PMI measure is 51.5 for August, signaling this part of the economy is expanding. Travel and dining provide insight into discretionary services spending. The post-pandemic rebound in TSA check-ins and OpenTable reservations continues to set records.

Productivity is an economic concept not often discussed in quarterly updates, likely because of its long-term implications and imperfect measurements. However, we may be on the cusp of improving productivity driven by a lack of available labor for several years, coupled with improvements in technology, particularly artificial intelligence. The BLS measures labor productivity by the output per hour in the nonfarm business sector. The most recent reading for the second quarter was 2.5% and has averaged 2.3% since the first quarter of 2022 – post-pandemic recovery. From 2011 through 2019, the financial crisis until the pandemic, this measure averaged 1.1%. Productivity improves everyone's situation – workers earn greater income for the same work and employers improve profit margin. It also reduces inflation by providing more output for the same amount of work. It is a magic economic elixir for the economy and markets. It may be too early to say we have seen a durable upshift in productivity. However, at the Barclays Global Financial Services Conference in September, the COO of JP Morgan estimated the value of AI to the firm was approaching $2bn, with much of that related to fraud prevention. This is a perfect example of improving productivity and saving costs from technology investments.

ON THE WHOLE, WE ARE OPTIMISTIC ABOUT THE ECONOMY.

The positives in the economy outweigh the negatives. Moderating inflation and lower interest rates increase the possibility that the negatives in the manufacturing sector will experience an upturn over the next several quarters. The impacts of improving productivity may take years to truly understand and measure, but if occurring, this shifts economic growth to a higher level.

THE CAPITAL MARKETS

CORPORATE EARNINGS FOR THE SECOND QUARTER WERE BETTER THAN FORECAST, WITH 78.6% OF S&P 500 CONSTITUENTS BEATING WALL STREET'S EXPECTATIONS.

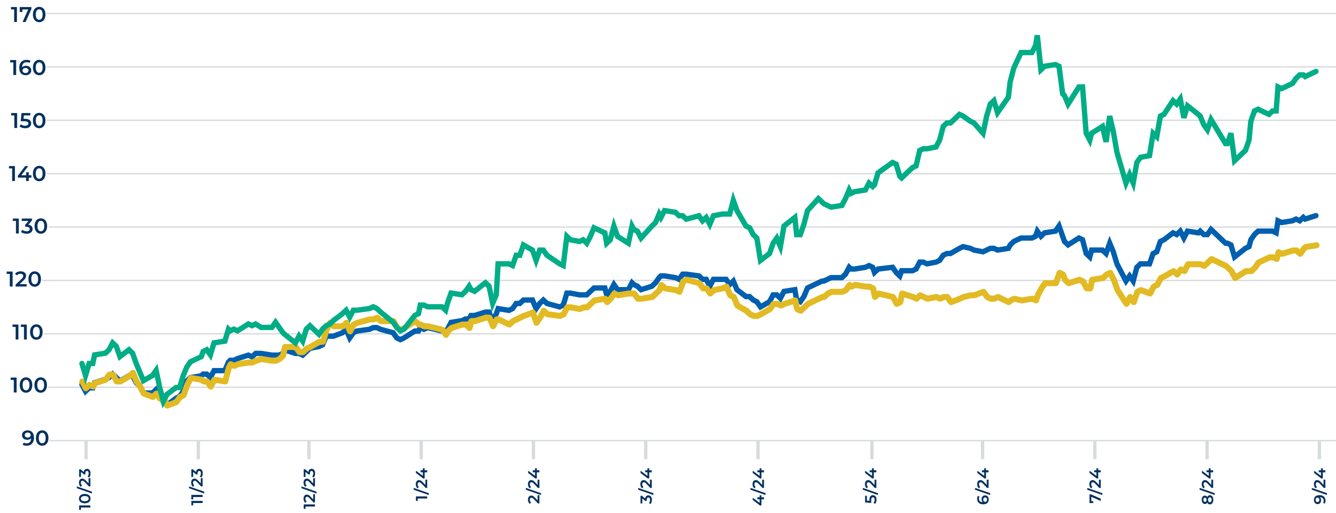
Earnings rose 6.4% for the index, while revenues rose 4.3%. Profit margins expanded as inflationary pressures moderated. These impressive earnings gave way to lower guidance for earnings growth for the third and fourth quarters. The estimates for both quarters were reduced by approximately 2.0%, with the projected growth rates in the third and fourth quarters now 16.3% and 17.8%. This puts expectations for full year earnings growth at 11.1% for 2024 and 2025 estimates are for 16.6% growth. Revenue estimates for full year 2024 and 2025 are 5.3% and 6.1% respectively. Wall Street analysts are projecting continued margin improvement, allowing earnings growth to outpace revenue growth.

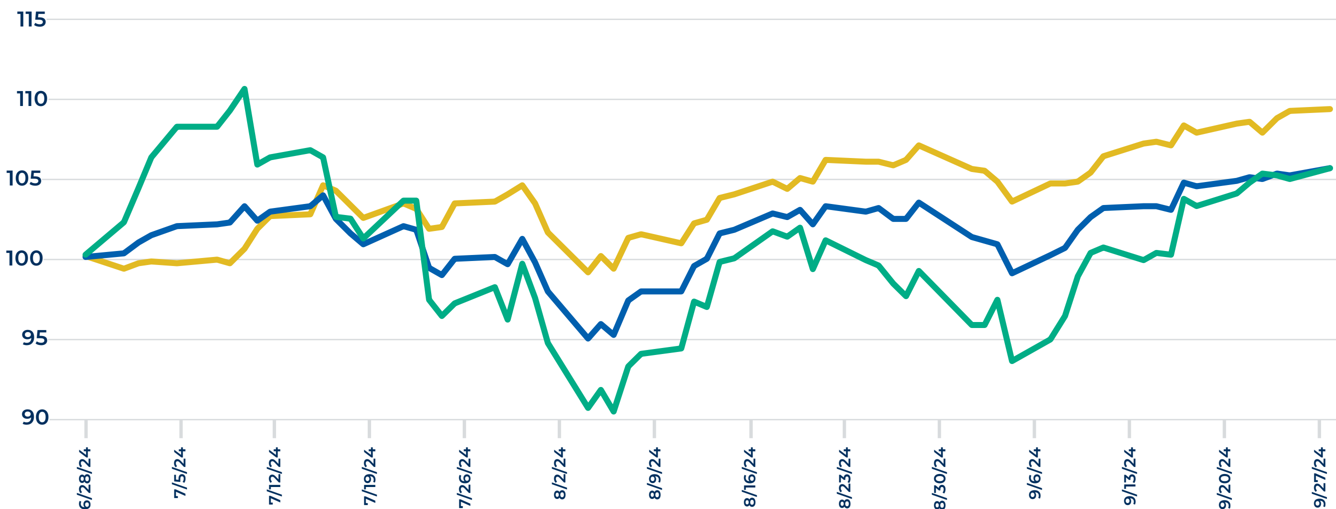
THIS ATTRACTIVE EARNINGS BACKDROP IS REFLECTED IN MARKET VALUATIONS.

The price-to-earnings ratio of the S&P 500 is 24.6x trailing earnings. The market is a forward-looking mechanism and the price to expected earnings for the next twelve months is 21.4x. When considered in isolation, a forward P/E ratio of 21.4x is rich. This is near the high level of valuation in 2021, although below the 25x forward earnings of the tech bubble in 1999. However, in the equity market, it is important to consider many factors and not look at single data points in isolation. As we have written many times in the last few quarters, a handful of stocks are having an outsized impact on returns and valuations. The trailing P/E ratio of the Magnificent Seven stocks (Apple, Alphabet, Meta, Nvidia, Tesla, Microsoft, and Amazon) is 38.9x and the forward P/E is 34.9x. The valuation of many of the other 493 stocks in the S&P 500 is considerably more reasonable than that of the Magnificent Seven. Another interesting valuation metric is the PEG ratio, or P/E to Growth ratio. This metric examines the price-to-earnings ratio in the context of projected earnings growth, with a lower PEG ratio signaling more attractive valuations. The PEG ratio for the S&P 500 is 1.25, compared to over 2.0 during 2021. This ratio has trended lower over the last year, as growth expectations have increased.

When examined by market sectors, growth estimates are greatest for the high growth technology sector, with FY24 and FY25 estimates of 24.7% and 28.9% growth. Consistent with the broadening out of market returns, FY25 growth is projected to also be strong in healthcare (29.7%), materials (24.7%), real estate (16.4%), and industrials (14.3%). The market is recognizing the positive economic backdrop for sectors and companies beyond a handful of large tech stocks, and we are seeing a change in leadership. Over the last year, the Magnificent Seven has offered tremendous returns; however, the equal weighted S&P 500 index outperformed the S&P 500 and the Magnificent Seven in the third quarter.

With improving prospects for earnings growth and more reasonable equity valuations, we expect the many of "other 493" to offer investors attractive returns. We believe this leadership change is quite healthy as many of these large tech stocks digest their impressive returns.





These same charts can be run with the S&P 500 versus the S&P Mid Cap 400 and S&P Small Cap 600. Or with the S&P 500 versus the MSCI EAFE index of developed international markets and the MSCI Emerging Markets index. In both cases, the S&P 500 trounces these other indices on a one-year basis, but each of these indices outperformed the S&P 500 in the third quarter. Unlike the S&P 500, which is trading at higher ends of historical ranges, each of these indices is trading at or below their historical ranges.

We don't think the end is near for the Magnificent Seven and large cap growth stocks, but we do believe there are attractive risk and return opportunities in other parts of the global equity markets.

The Bloomberg Aggregate Bond Index posted strong returns during the quarter amid a rally in the equity markets, which is an unusual occurrence. Interest rates fell across the yield curve; however, short-term yields fell much more than long-term rates during the quarter. The 2yr Treasury yield fell 1.15% to 3.61%, while the benchmark 10yr yield fell 0.63% to 3.77%. Falling yields drive bond prices and returns higher.

THE MARKET EXPECTS THE SHORT-TERM YIELDS TO CONTINUE TO FALL AS THE FED REDUCES THE FED FUNDS RATE.

The futures market is pricing in another 1.0% of cuts by January 29th and a Fed Funds rate of less than 3% by September 2025. As Fed Chair Powell has said on numerous occasions, future interest rate cuts will depend on the path of inflation and the labor markets. We believe the most likely path will be a lower Fed Funds rate. Oddly, longer term interest rates have increased since the Fed began reducing the Fed Funds rate on September 18th. The 10yr and 30yr treasury yields have increased by 13.3 and 16.1 basis points over that period. The Treasury yield curve appears to be moving to a normal, upward sloping yield curve.

This has several implications for investors. First and foremost, the higher yields on money market funds and short-term bonds will become a thing of the past. Money market yields have fallen by 0.37% since the Fed meeting and will price in the full 0.5% cut over the next few weeks. Money market yields will follow the Fed Funds rate down with further rate cuts. We expect the Fed to move the Fed Funds rates towards its long-term target of 2.75% over the next several years. The second implication is a normal and upward sloping yield curve will offer bond investors a fair return for taking interest rate and credit risk. The fact that longer term rates have not fallen with the cut in the Fed Funds rate illustrates the market is returning to a normal stance. We expect investors will be able to earn mid-single digit returns in fixed income investments with maturities in the five-to-seven-year range. It seems odd to comment about “normal” yield curves and “mid-single-digit” returns, but we have been through 15 years of an abnormal bond market. And the process of returning to normal has been a painful one.

As we finish drafting this report, we want to note that wider events outside of economic data can affect the market. As we noted last quarter, the market is pricing in a divided government. It appears that control of the House is a tossup, along with the Presidential race. The Senate will likely flip to Republican control. The market is pricing in gridlock, regardless of who wins the White House. There are hostilities in the Middle East and all the ports on the East and Gulf Coasts are closed due to a labor strike. Yet, the market is currently taking all of this in stride, and Fed guidance seems to trump all negative news for now.

IN SUMMARY

We believe economic growth will be in the 2%-3% range for the balance of 2024. We expect a lower Fed Funds rate will be additive to cyclical parts of the economy, where credit is a driver. The consumer will remain employed and spending. This is a positive backdrop for the economy and corporate earnings. We believe earnings growth will be strong in the third and fourth quarters of 2024 and into 2025. This strength has been recognized and priced into many companies’ share prices, particularly large cap technology names. However, there are other parts of the market that offer value, which now include small-cap and international equities.

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Client Service Representative

IN THE SPOTLIGHT

Madeline Smith joined the Colonial Trust Company in May 2024 as a Client Service Representative working alongside Jordan Taylor in our Family Services Division. Before joining Colonial Trust, she spent most of her career in cost accounting for construction and development. Recently, she worked as a property manager for Gateway House, a private non-profit organization. Madeline is grateful for the role of providing personalized service and care to our clients.

Originally from Miami, FL, a University of Central Florida graduate, she spent 25 years in Ponte Vedra Beach raising two children before relocating to the Upstate in 2014. Madeline's passions are spending quality time with her family and dogs and in worship and prayer. She volunteers for the Tom Coughlin Jay Fund Foundation and other local charity organizations. Madeline enjoys staying active, living a healthy lifestyle, cooking, boating, flying, and visiting the coast.

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