BIRLING CAPITAL ADVISORS, LLC

Think Strategically

The Good, the Bad, and the Ugly: Navigating the Metronome of Investor Temperament

December 23, 2024

The Metronome of Investor Temperament

Some years ago, I developed the concept of "The Metronome of Investor Temperament", A metronome is a tool that goes from left to right, producing a steady beat to help musicians play rhythms accurately. We refer to it when dealing with markets such as the US market's rhythm in the past 15 days, which began on December 5. These market sentiment changes often alter the investor temperament as typical greed transforms into fear. Being vigilant and understanding the excessive swings of any cycle is an essential requirement for any investor. Fear is the principal reason markets have moved down; in the specific case of the Dow Jones, it has lost 1,921.05 points.

The Ugly: The Five Key Index Returns fell

Let's examine the indexes we follow, comparing their performance from 12-5 to 12-20 and their YTD returns.

1. **Dow Jones** closed December 5 at 44,765.71 and fell 1,921.05 to close at 42,844.26, decreasing 4.30%. It also had a YTD Return of 13.67%, which is still quite good.
2. **S&P 500** closed December 5 at 6,075.11 and fell 144.26 to close at 5,930.85, decreasing 2.37%. It also had a YTD Return of 24.34%, which is excellent.
3. **Nasdaq Composite** closed December 5 at 19,700.72 and fell 128.22 to close at 19,572.50, decreasing 0.65%. It also had a YTD Return of 30.39%, which is outstanding.
4. **Birling Puerto Rico Stock Index** closed December 5 at 3,856.15 and fell 289.28 to close at 3,566.97, decreasing 7.00%. It also had a YTD Return of 6.69%, which is reasonable.
5. **Birling US Bank Index** closed December 5 at 6,516.74 and fell 303.43 to close at 6,214.31, decreasing 4.64%. It also had a YTD Return of 42.58%, which is outstanding and beats all indexes.

Dow Jones, S&P 500, Nasdaq Composite, Birling Puerto Rico Stock Index &. Birling US Bank Index YTD Returns YTD 12.20.24

As you can see, the five indexes have hit a pothole during the last 15 days, but as we examine their YTD returns, you can see that their performance ranges from a reasonable 6.69% for the Birling Puerto Rico Stock Index to 42.55% for the Birling US Bank Index.

As we see "The Metronome of Investor Temperament" in action, we note that investors generally are between optimism and pessimism, and they are all gathered in the corner of greed and fear.

Markets oscillate between greed and fear because investors and people oscillate between greed and fear; it is human nature. When we feel good about our prospects and the fundamentals of the markets are good, most investors get greedy and focused on making money. Greed and hubris cause markets to rise and most asset classes to increase in value. However, as soon as uncertainty or negativity dominates the markets, fear takes over, and investors begin performing asset rotations that would allow them to preserve money.

While the current market downturn began to unravel by December 5, it was on December 18 following the Federal Reserve Bank's 25 basis point decrease in interest rates. The fuel to the market's fire and fury came in the shape of the Fed's updated Economic projections showing a target rate of 3.9%, up from the 3.4% September projection, suggesting only two rate cuts in 2025, and projects a rate of 3.1% by the end of 2027, the mere indication of a prolonged period of elevated interest rates, has affected the investor sentiment.

The Bad: Market Reaction to Fed Policy

The Federal Reserve implemented a second consecutive quarter-point rate cut yesterday, bringing the target range for the federal funds rate to 4.25%-4.50%. Alongside the rate decision, the Fed unveiled updated economic projections. These include a revised median forecast for PCE at 2.50% and Core PCE at 2.5% by the end of 2025, up from 2.2% in September. The Fed now anticipates the fed funds rate will close 2025 at 3.9%, suggesting only two rate cuts in 2025, and projects a rate of 3.1% by the end of 2027, indicating a prolonged period of elevated interest rates. GDP is expected to be 2.1% for 2025, up from 2.0% in the September forecast and with an unemployment rate of 4.3%, down from 4.4% in the September forecast. The Federal Reserve highlighted two key factors driving its cautious stance on rate cuts: the future trajectory of inflation and the uncertainties surrounding tariff policies in the coming year.

Despite these concerns, Fed Chair Powell emphasized the strength of the US economy, describing it as "in a good place". The economic fundamentals remain robust, and ongoing market volatility presents valuable opportunities for long-term investors.

These projections took the markets into a downward spiral that ultimately made the Dow Jones fall 1,123,03 points, followed by the Nasdaq Composite, which fell 716.37 points, and the S&P 500 fell 178.45 points; all indexes lost between 2.58% to 3.56% and registering the dubious record of the first ten-day losing period in 50 years.

Inflation has significantly declined over the past two years but remains above the Federal Reserve's 2.0% target. The Fed gradually projects core personal consumption expenditure (PCE) inflation to ease, reaching the 2.0% benchmark by 2027. However, moderation is expected to be slower than previously anticipated.

On the policy front, Fed Chair Powell briefly addressed potential shifts in trade and tariff policies, acknowledging their potential impact on inflation. Still, he emphasized that the evolving nature of these policies makes it challenging to draw firm conclusions about their influence on inflation forecasts.

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Federal Reserve Bank Economic Projections 2024-2027

Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, December 2024

Percent

Variable	Median[1]					Central Tendency[2]					Range[3]				
	2024	2025	2026	2027	Longer run	2024	2025	2026	2027	Longer run	2024	2025	2026	2027	Longer run
Change in real GDP	2.5	2.1	2.0	1.9	1.8	2.4–2.5	1.8–2.2	1.9–2.1	1.8–2.0	1.7–2.0	2.3–2.7	1.6–2.5	1.4–2.5	1.5–2.5	1.7–2.5
September projection	2.0	2.0	2.0	2.0	1.8	1.9–2.1	1.8–2.2	1.9–2.3	1.8–2.1	1.7–2.0	1.8–2.6	1.3–2.5	1.7–2.5	1.7–2.5	1.7–2.5
Unemployment rate	4.2	4.3	4.3	4.3	4.2	4.2	4.2–4.5	4.1–4.4	4.0–4.4	3.9–4.3	4.2	4.2–4.5	3.9–4.6	3.8–4.5	3.5–4.5
September projection	4.4	4.4	4.3	4.2	4.2	4.3–4.4	4.2–4.5	4.0–4.4	4.0–4.4	3.9–4.3	4.2–4.5	4.2–4.7	3.9–4.5	3.8–4.5	3.5–4.5
PCE inflation	2.4	2.5	2.1	2.0	2.0	2.4–2.5	2.3–2.6	2.0–2.2	2.0	2.0	2.4–2.7	2.1–2.9	2.0–2.6	2.0–2.4	2.0
September projection	2.3	2.1	2.0	2.0	2.0	2.2–2.4	2.1–2.2	2.0	2.0	2.0	2.1–2.7	2.1–2.4	2.0–2.2	2.0–2.1	2.0
Core PCE inflation[4]	2.8	2.5	2.2	2.0		2.8–2.9	2.5–2.7	2.0–2.3	2.0		2.8–2.9	2.1–3.2	2.0–2.7	2.0–2.6	
September projection	2.6	2.2	2.0	2.0		2.6–2.7	2.1–2.3	2.0	2.0		2.4–2.9	2.1–2.5	2.0–2.2	2.0–2.2	
Memo: Projected appropriate policy path															
Federal funds rate	4.4	3.9	3.4	3.1	3.0	4.4–4.6	3.6–4.1	3.1–3.6	2.9–3.6	2.8–3.6	4.4–4.6	3.1–4.4	2.4–3.9	2.4–3.9	2.4–3.9
September projection	4.4	3.4	2.9	2.9	2.9	4.4–4.6	3.1–3.6	2.6–3.6	2.6–3.6	2.5–3.5	4.1–4.9	2.9–4.1	2.4–3.9	2.4–3.9	2.4–3.8

NOTE: Projections of change in real gross domestic product (GDP) and projections for both measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. PCE inflation and core PCE inflation are the percentage rates of change in, respectively, the price index for personal consumption expenditures (PCE) and the price index for PCE excluding food and energy. Projections for the unemployment rate are for the average civilian unemployment rate in the fourth quarter of the year indicated. Each participant's projections are based on his or her assessment of appropriate monetary policy. Longer-run projections represent each participant's assessment of the rate to which each variable would be expected to converge under appropriate monetary policy and in the absence of further shocks to the economy. The projections for the federal funds rate are the value of the midpoint of the projected appropriate target range for the federal funds rate or the projected appropriate target level for the federal funds rate at the end of the specified calendar year or over the longer run. The September projections were made in conjunction with the meeting of the Federal Open Market Committee on September 17–18, 2024.

1. For each period, the median is the middle projection when the projections are arranged from lowest to highest. When the number of projections is even, the median is the average of the two middle projections.
2. The central tendency excludes the three highest and three lowest projections for each variable in each year.
3. The range for a variable in a given year includes all participants' projections, from lowest to highest, for that variable in that year.
4. Longer-run projections for core PCE inflation are not collected.

Our Perspective:

Given persistent inflationary pressures above the Fed's 2.0% target and the ongoing uncertainties surrounding the new administration's new tariff policy, we view the Fed's cautious approach to rate cuts as reasonable. However, we expect interest rates to trend lower over the next year, which should provide tailwinds for consumer spending and ease borrowing costs for households and businesses alike.

Interestingly, market expectations had already adjusted to the likelihood of two rate cuts in 2025. The Fed's updated dot plot aligns with this view, though current pricing suggests just one cut, according to the CME FedWatch tool. With this recalibration in market sentiment, the Fed now has an opportunity to exceed expectations with additional rate cuts, potentially bolstering market confidence and encouraging investment.

The Good: Key Drivers for Optimism

1. **Sustained Economic Growth:** The US economy continues to demonstrate resilience, with real GDP growing at an annualized 3.1% in the third quarter. Consumer spending, which accounts for nearly 70% of GDP, expanded by 3.7%, while nonresidential investment grew by 4%, indicating robust business activity despite higher borrowing costs. The Fed has revised its GDP growth estimate for this year to 2.5%, up from 2%. Additionally, the NFIB Small Business Optimism Index reached its highest level since 2021, signaling renewed confidence among small businesses.
2. **Strong Labor Market:** A solid labor market has underpinned economic resilience over the past two years. The unemployment rate remains low at 4.2% in November, well below the long-term median of 5.1%. November's substantial nonfarm payroll gain brought the 2024 monthly average to 190,000 jobs, surpassing the 10-year average of 160,000 jobs per month. While this marks a slowdown from 2023's average of 251,000, the pace of job creation remains robust.
3. **Rising Corporate Profits:** After flat earnings growth in 2023, S&P 500 earnings per share are projected to grow by 9% in 2024, the most substantial rate since 2021. Analysts forecast nearly 15% EPS growth for 2025, supported by a healthy economic backdrop that provides a solid foundation for corporate profitability.
4. **Global Central Bank Dynamics:** Central bank policies are in the spotlight, with the Bank of England holding rates steady at 4.75% amid sluggish economic growth and persistent inflation. In Japan, the Bank of Japan also maintained its policy rate at 0.25% while signaling readiness to raise rates as the country continues efforts to escape decades of deflationary pressures.

The combination of strong economic growth, a resilient labor market, rising corporate earnings, and central bank policy adjustments sets the stage for potential equity market gains in 2025.

The Final Word: Resilient Economic Fundamentals

The key takeaway from this week's FOMC meeting is the Federal Reserve's confidence in the strength of the US economy and labor market, reflected in its updated projections. Fed Chair Powell expressed his optimism, stating he was "very optimistic about the economy" during the press conference.

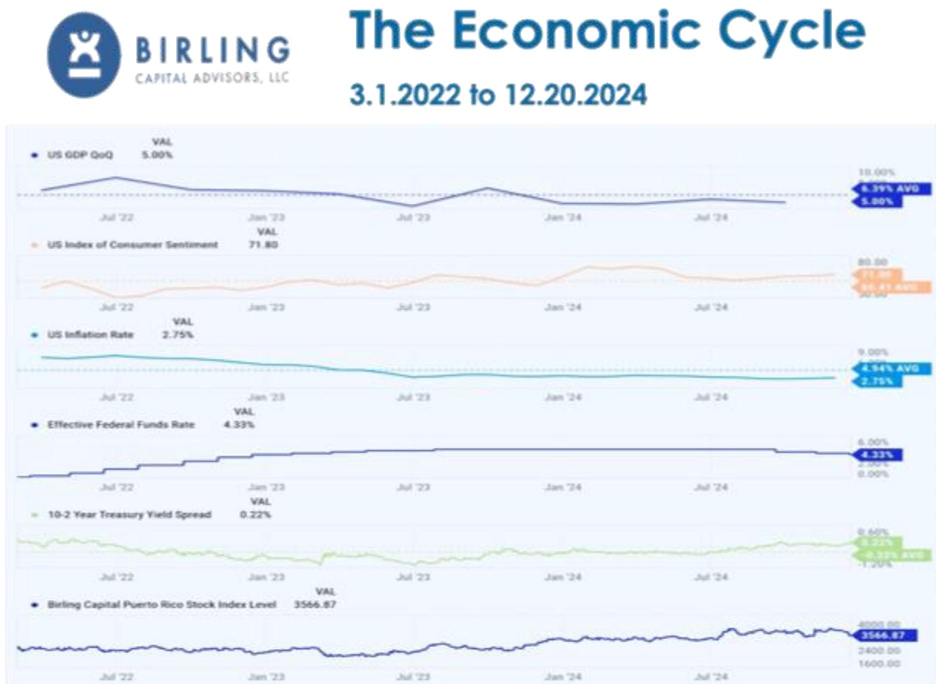
The Fed's revised forecasts highlighted improved economic growth and a lower unemployment rate than September estimates. US GDP is now expected to grow by 2.1% in 2025, up from the prior estimate of 2.0%, while the unemployment rate is projected to decline to 4.3%, slightly better than the 4.4% projected earlier. This resilience in economic indicators suggests that consumers and businesses have adapted and performed well despite restrictive monetary policy.

The ongoing bull market continues to be fueled by robust economic performance, solid corporate earnings, and a resilient consumer base, even amid higher interest rates and elevated inflation. Last week's Fed meeting reinforced this narrative, affirming that inflation is under control and signaling a gradual path toward lower interest rates.

Recent data releases further underscore the strength of the US economy. Third-quarter GDP growth came in at an annualized 3.1%, exceeding expectations of 2.8%, driven by robust consumer spending of 3.7%. The Fed's GDP-Now forecast also projects fourth-quarter growth at an annualized 3.2%. These figures confirm that US economic growth is set to end the year above the long-term trend, typically in the 1.5%–2.0% range.

With solid fundamentals in place, the Fed's measured approach to rate adjustments and the economy's continued resilience should provide a favorable backdrop for investors, even as the pace of policy easing remains cautious.

The best advice for investors is to stay steadfast in the face of external noise, remain focused on your long-term financial objectives, and prioritize maintaining a well-diversified portfolio. Avoid reacting to short-term market fluctuations or external influences that can cloud judgment. Instead, ensure your portfolio reflects your risk tolerance, time horizon, and overall financial goals. Regularly reviewing and rebalancing your investments to stay aligned with these goals is key to navigating market uncertainties and building sustainable wealth over time.



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