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I N V E S T M E N T   C O U N S E L

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STATEMENT OF INVESTMENT POLICY

BACKGROUND

Economic data released late this Summer tell a largely positive story: The economy grew more rapidly than expected earlier in the year despite the most aggressive Federal Reserve tightening in 40 years, increasing the likelihood of Fed's hoped for "soft landing." While hiring has slowed and unemployment has ticked-up slightly, to a 3.8% rate in August, consumers, whose outlays account for close to 80% of real GDP, continued to spend, underpinning the expansion. Meanwhile, manufacturing remains in a mild slump after having led the economic recovery from COVID-19. The Personal Consumption Expenditures price index (PCE), the Fed's preferred measure of inflation, rose to 3.3% in July from a year earlier, down notably from a peak last summer of 7%, though still well above the Fed's 2% target. Recall, the Fed pays even closer attention to the "core" PCE which strips out food and fuel costs, and that gauge climbed 4.2% in July, the latest month for which data is available. Fed officials expect the core PCE to finish the year at 3.76%, suggesting a further marked slowdown in inflation is coming.

Despite the generally favorable data flow, showing the economy's resilience, there are several uncertainties which point to sizable near-term risks to future economic growth. With a lagged effect, higher interest rates continue to work their way through the economy, taking their toll on interest rate sensitive sectors. Resumption of federal student loan payments will be a drag on consumer spending. The ripple effect of prolonged strikes at major automakers could put further downward pressure on manufacturing. And the uncertainties stemming from a possible government shutdown could rattle consumer confidence, slowing the economy in coming months.

Last week, Fed officials signaled they expect to leave interest rates higher for longer. However, their forecasts are anything but certain, not a set-in-stone plan. The uncertain outlook casts some doubt on the sustainability of current positive business trends. Largely overlooked, the M2 money supply has contracted 3.7% in the past year and bank credit at commercial banks as well as their commercial and industrial loans are both down. Following above-trend GDP growth last quarter, hard economic data and the results of recent surveys we monitor send a mixed message, pointing toward slower growth. Most recently, the S&P Global flash composite index fell 0.1 point to 50.1 showing business

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flat lined in early September, driven by a decline in demand at service providers. Labor markets have shown some signs of softening as the share of workers who are quitting their jobs, often a sign of bargaining power as employees leave their jobs for higher pay elsewhere, eased in July and is returning to pre-pandemic levels. Rising oil prices and freight transportation costs could lead recent declines in inflation to stall or even reverse, requiring higher rates. Consumer confidence remains depressed as many Americans are taking little comfort from the inflation slowdown since the cost of everything from transportation to restaurant meals to housing since 2021 has been abnormally large. Housing starts declined 11.3% in August, 14.8% below a year ago, and are at the lowest level since 2020. Homebuilders' confidence fell again in September as rising mortgage rates weighed on demand for homes. While the August retail sales report was stronger than expected, there were significant downward revisions to both the June and July data. And the forward-looking ISM Manufacturing index for August remained below 50 signaling contraction ahead in that sector, while the ISM Non-Manufacturing index rose to 54.5 portending expansion in services.

Looking ahead, the debate within the Fed over whether to raise rates one final time this year or to stand pat will depend upon incoming economic data the FOMC will review prior to their early November and mid-December meetings. How long rates need to remain high next year to bring down sticky inflation remains an open question. Readings of our firm's proprietary Economic Model, designed to signal a change in the direction of the economy six to nine months ahead of an inflection point, have been marginally above trend for the past three months leading us to increase the odds of "soft landing" to better than even. Along with the Fed, we await further data to conclude we have seen the end of the current rate tightening cycle and the beginning of a sustainable economic expansion.

INVESTMENT POLICY

The US equity market, as measured by the S&P500, has pulled back about 5% since its late July recovery high, just over 4% this month. The tech heavy NASDAQ has declined almost 6% this month and small cap stocks have fallen about 6.5% in September. Upward pressure on interest rates and dampened 2024 Fed easing expectations, coupled with higher energy prices and negative seasonality has soured investor sentiment, outweighing for the moment the peak rate narrative, positive earnings revisions, sanguine corporate commentary, pickup in IPO activity, better Chinese macro data and further policy support from Beijing. Adding to negative sentiment, the S&P500 has fallen below its 100-day moving average for the first time since March, a negative sign for traders. Our view has been the market was overbought earlier this Summer, ripe for the 5-10% sentiment-driven pullback which has occurred.

Year-to-date, the S&P500 has returned 12.5% largely driven by seven mega cap tech stocks which are up 90% this year and have contributed over 70% of the S&P500's year-to-date returns. For comparison, the equal-weighted S&P500 index is up only 5% this year, and the equal-weighted All Country World Index (ACWI) has gained only 3.3%. In our view, investment opportunities in these seven high priced stocks seems limited to market-like returns as investors have chased the equity market's narrow leadership, shunning diversified portfolios to gain greater exposure to these seven mega cap stocks. Beyond the "magnificent seven," the menu of attractive investment opportunities is likely to be historically broad and historically attractive.

The reversal of last year's out-performance of *value* shares by *growth* continues. Year-to-date S&P *growth* is higher by 17.8% outpacing the S&P *value* index which is ahead 7.8%. The broadening out of the market we noted in earlier client letters favoring *value,* has given way to a slightly smaller drawdown this quarter in *growth* when compared with *value*. Equity portfolios under our supervision remain fully invested, broadly diversified and balanced between *growth* and *value* with a slight tilt toward growth stocks, which is our bias. *There has been no change to investment policy.*

From a valuation perspective, the US stock market has gone from being undervalued at the start of this year to being fairly valued at 17.6x next year's consensus earnings estimate of $246 and 15.6x the consensus for 2025. It's worth noting that the S&P500's multiple would be only about 15x 2024 earnings if we exclude the "magnificent seven."

As long-term investors, we prefer to look beyond the near-term uncertainties to the coming business expansion, spurred by easing credit conditions and sound underlying business and consumer fundamentals, to the investment opportunities it will inevitably present.

The sharp rise in interest rates to more normal levels has made bonds investable once again. Accordingly, we are extending bond portfolio durations in clients' accounts toward a 2.5-year target. Maturing bonds are being replaced in clients' laddered portfolios by high quality, marketable corporate obligations maturing in three to four years where yields of 5.25% - 5.50% are available. We have limited the duration increase expecting rates on intermediate term debt to drift higher, eventually presenting a more attractive entry point.

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