ARPG
INTELLIGENT INVESTMENT

INTELLIGENT INVESTMENT

Third Quarter 2024

S&P 500 YTD 20.81%[3]

MSCI ALL WORLD ex US YTD 9.96%[3]

"Don't Waste Your Time On Me You're Already the Voice Inside My Head"[1]…

The third quarter of 2024 is in the books. And what three months it was! We certainly weren't "Bored To Death"[1]. The voice of Fed Chair Powell certainly got in our heads by shocking markets with a 0.50% rate cut. Outside of the emergency rate reductions during Covid, the last time the FOMC cut by half a point was in 2008 during the global financial crisis.[5] Vladimir Lenin once wrote (and I am no fan of Lenin but his words ring very true these days) "There are decades where nothing happens; and there are weeks where decades happen." This seems apropos as we were all "Unsuspecting Victims"[1] of what can only be described as a once in many lifetimes' series of events. Beginning with an assassination attempt on a former President and current Presidential candidate, an eleventh-hour change in a major party's Presidential candidate, followed by another assassination attempt along with what appears to be a budding full-scale war in the Middle East. Maybe "We'll have Halloween on Christmas"[1] this year too?

Last quarter we wrote that 2024 has continued to defy the naysayers and bears and ARPG has remained in the bull camp for the better part of two years. To reiterate "One More Time"[1] we believe the market is on sound footing and doesn't appear to heading to the "Darkside"[1] anytime soon.

July through September is typically volatile and usually the weakest of the four quarters. Equity markets generally "Carousel"[1] this time of year, with a great deal of up and down movement but not really going anywhere. I found this September to peculiar after tumbling -4% (4th worst September start since 1928)[2], the S&P 500 clawed its way back to a 2% gain. This is a unique scenario to say the least. There have been twenty instances of the first four days of September being negative. In all twenty instances September proved to be an especially bad month and finished "Down"[1] all twenty times. Except this time. Why?... What is different about September 2024 and what, if anything does this late third quarter bounce tell us about the remainder of the year?

We think September's atypical performance speaks to the incredible resiliency of equities even amidst the seemingly decades of events that took place over the course of just eight weeks… "What My Age Again"[1]?... Markets are seeing through these short-term potential headwinds focusing on longer term metrics that are pointing in the right direction. Strong, growing earnings and guidance, interest rates contracting due to inflation cooling towards its historical range, healthy but not tight labor markets, consumer spending remaining strong as seen through retail sales and most importantly a Federal Reserve beginning to relax monetary policy. "We'll Wish this Never Ends."[1]

We won't "Waste Our Time" studying what ARPG believes to be the "Voice Inside the Head" of the markets, the Federal Reserve saying "Come Dance With Me"[1] and surprising markets with a double-sized cut by lowering policy rates 0.50% signaling they are now in an easing cycle… easing from a very restrictive to neutral position that is. For the first time in over thirty months, we have a Federal Reserve who isn't "The Angel from my Nightmare"[1] and trying to restrict the economy.

A dovish Federal Reserve will likely bring the probability for many sectors of the market to expand. However, relaxing monetary restriction can be an especially positive time for small cap stocks. In the two days directly following the Fed reducing policy rates markets were "Felling This"[1] and small-caps, whose performance have lagged for quite some time, rallied alongside the broader market. This is in large part due to the combination of small-caps sensitivity to interest rates and their attractive valuations. The median price multiple for small caps sits 36% below their large cap counterparts. 10.7X vs 16.7X. The last time small-caps traded at this relative discount to the S&P 500 was 1999 and coincided with the beginning of 12-years of relative outperformance of small-caps from 1999 to 2010 in which "All the Small Things"[1] outperformed by approximately 6.5% annually.[2]

Let's not write off the large caps just yet though. Large caps are well positioned to continue their juggernaut journey as earnings last quarter were much stronger than expected. Overall, 82% exceeded estimates, and those that exceeded did so by a median of 5%. Top line revenue results also exceeded estimates by a median of 5% and 60% of those reporting exceeded those estimates as well.[4]

While there are signs of stress for the consumer, the latest retail sales report surprised markets by expanding 0.1% over the prior month after consensus predicted a contraction of (-0.20%). Moreover, with the debt service ratio at 10% consumers aren't overly burdened with debt. During the last 2 recessions signs of consumer stress usually begins when this exceeds 13% [2]. The Fed reducing rates is delivering lower cost of money for credit cards, auto loans, adjustable-rate mortgages and even installment debt which will reduce consumer debt service ratio.

Have the markets fully priced in a 0.50% rate reduction by the Fed thus not leaving much gas in the tank for the remainder of the year? Unlikely, over the past 50 years data suggests stocks positively react to Fed cuts when the economy is not crashing or deteriorating into an eminent recession. Since 1971 the Federal Reserve has begun a rate reduction cycle seven times, "Always" the S&P 500 was higher six months later with an average period return of 12.8%.[2]

Elsewhere we are seeing China's economy positively inflect due to their recent stimulus measures. Chinese leadership is keenly aware they require strong consumer and real estate markets for their economy to fire on all cylinders. Although a healthy China is good for the global economy as a whole, the materials and industrial sectors will likely be the primary beneficiaries of the stimulus. Here at home the US posted second quarter GDP at 3.0% annualized much higher than the 1.9% initially forecasted. Moreover, in the final days of September Atlanta Federal Reserve tracker revised third quarter GDP from 2.9% to 3.1% annualized[4]. These are solid and sustainable numbers, coupled with interest rates coming down, via the 10 year Treasury Note contracting from 4.48% to start July to 3.79% to finish September[4]. One doesn't need to "Go Away to College"[1] to see the tailwinds coming together for equity markets.

Fall is finally here! Although in many parts of the country it's feeling a lot more like Hotumn than Autumn we're certainly glad the cool weather is coming around "I Miss You". "Let's live Like Jack and Sally"[1], carve pumpkins and get ready for Trick or Treaters, because before we know it the Holidays will be here and it will "The Party Song"[1] time of the year. In any season or market, the best investors always focus on the long term and ARPG will continue to practice our approach to value investing, "Intelligent Investment is Investment on Value, buying high quality companies in low quality times". This is what sets ARPG apart from the rest. As always, we thank you for your confidence and are humbled by your trust. Please feel free to contact us at any time.

INTELLIGENT INVESTMENT

Sincerely,
Matthew D. Dahl
Chief Investment Officer

1. Blink 182
2. Fundstrat
3. ARPG / Stockcharts.com
4. Factset
5. CNBC