AEQUITAS INVESTMENT ADVISORS

QUARTERLY LETTER – SEPTEMBER 30, 2024

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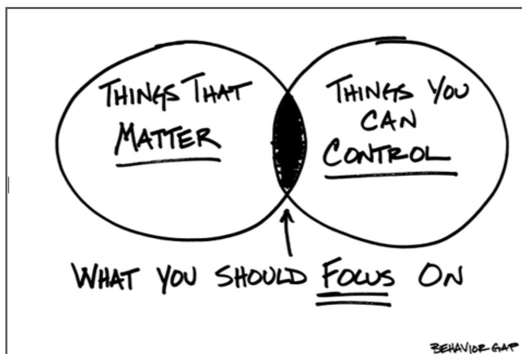
Re: Focusing on What We Can Control During Turbulent Times

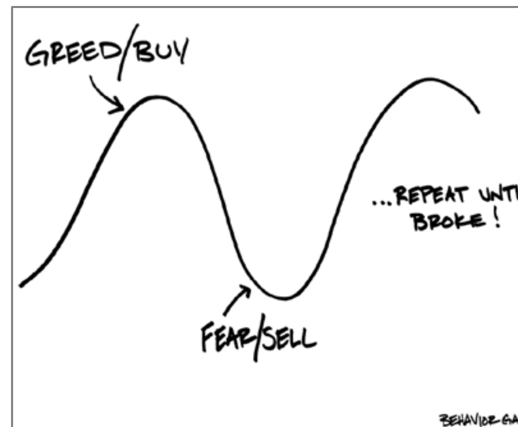
Warner & Your Team!

In these turbulent times, especially with the upcoming election and heightened geopolitical risks, there might be a natural tendency to allow our emotions and fears of the unknown to override our more rational thought process. While most of the global uncertainties and risks are beyond our direct control, there is an overlap between what we can control and what really matters. In this quarterly letter we will review some of the important factors we can control from an investment perspective, as well as provide updates on the four major concerns investors had at the beginning of 2024 (inflation and interest rates, the economy, geopolitical risks, and the U.S. election). First, we'll discuss why we believe it's important to not allow our emotions to drive our investment decisions.



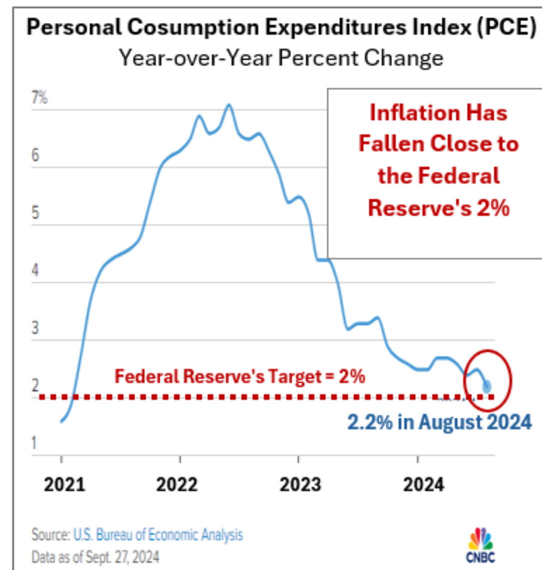
Avoid Letting Emotions Drive Investment Decisions

Warren Buffett, arguably one of the most successful investors of all time, is known for his rational and steady approach to investing. Perhaps his most practical piece of advice for investors is to be "fearful when others are greedy, and greedy when others are fearful." Or put another way, when stock prices reach unsustainably high price levels, such as during the irrational exuberance period during the Tech Stock Bubble of the late 1990s and, arguably, more recently with the Magnificent 7 stocks, investors should become more cautious and disciplined by trimming what may be over-valued stock positions, i.e., taking some profits off the table, and avoid the tendency to become greedy. Conversely, the time to be greedy is when stock prices fall significantly due to economic downturns or geopolitical shocks when investors tend to be fearful, but at a time when stocks might be trading at discounted prices. Many investors, if not guided by such a disciplined investment principle, might do just the opposite by riding a wave of greed and allowing certain stock positions or asset classes to appreciate beyond prudent portfolio allocation levels, or worse yet, buying expensive stocks when their prices might already be too high. As indicated in the illustration to the left, that's not a good formula for long-term success.

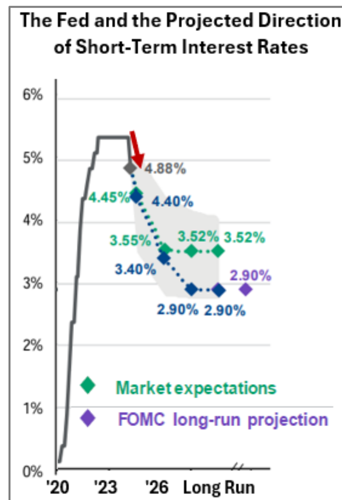


Good News on Inflation and Interest Rates

One of the four greatest concerns for investors at the beginning of 2024 was the direction of inflation and interest rates. The good news on both fronts is that inflation has continued its downward trajectory and is now remarkably close to the Federal Reserve's 2% inflation target for the Personal Consumption Expenditures Index (PCE). In fact, the most recent report through the end of August indicated that the PCE inflation rate had fallen to 2.2%. Given this progress, on September 19th the Federal Reserve lowered the Federal Funds Rate by 50 basis points (1/2 of 1%) from 5.33% to 4.83% (the first rate cut in four years). At this point, it appears that the Fed might accomplish its goal of a soft economic landing while achieving a "Goldilocks" economy, i.e., an economy which is stable, but not too hot to reignite inflationary pressures, but also not too cold to cause a recession and high unemployment.

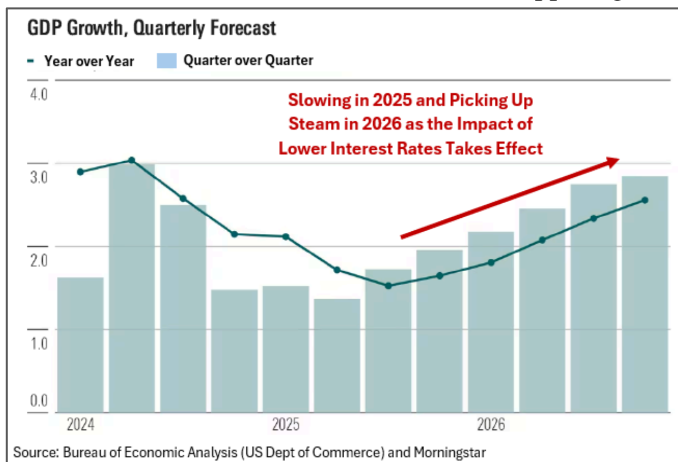


Accompanying the Fed's September rate cut announcement were indications that they might further reduce interest rates to a range of 4.25% to 4.5% by year-end, with further cuts throughout 2025. Their median long-term Fed Funds Rate target is currently 2.9% as illustrated in the downward trajectory line chart to the right. The blue dotted line is the consensus of the 19 voting members of the Federal Open Markets Committee (FOMC) as to the future direction of interest rates (assuming inflation continues downward). The green line is what the market is expecting which is slightly higher than the Fed's consensus forecast. In either case, the good news is that lower interest rates would provide a significant boost to economic growth for both consumers (e.g., lower rates for car loans and mortgages) and for small and mid-sized businesses which are highly dependent on bank financing to expand and grow their operations.



Good News on the Economy

Given the expectation that reduced borrowing costs will help stimulate economic growth, economists are generally upbeat about Gross Domestic Product (GDP) growth in the U.S. over the next few years. The risk of a recession in the near term appears quite low. As illustrated in the chart below, the rate of growth is expected to slow in 2025 before picking up steam once again in late 2025 and 2026 when the full impact of lower interest rates kicks in. Furthermore, economic activity remains largely favorable around the world as evidenced in the latest Global Economic Momentum table to the upper right (a score of 50 being neutral, a score above 50 indicates accelerating economic momentum, while a score under 50 indicates decelerating momentum, or contraction). Global economic activity is still expanding (top row), but at a slightly slower rate of growth than the month before (52.8 vs. 52.0). The Services component remains in expansion mode while Manufacturing activity is in contraction. India and the U.S. display the strongest levels of economic activity with the Euro Area being the weakest.



Source: Bureau of Economic Analysis (US Dept of Commerce) and Morningstar

Global Economic Momentum

Purchasing Managers' Index (PMI)

	Aug	Sep
Global	52.8	52.0
Global Manufacturing	49.8	48.8
Global Services	53.8	52.9
U.S.	54.6	54.0
Euro Area	51.0	49.6
Japan	52.9	52.0
China	51.2	50.3
India	60.7	58.3
Emerging Markets	52.1	51.1

Green = Accelerating Momentum

50 = Neutral, >50 = Accelerating,

Geopolitical Risks

Geopolitical risks have only worsened over the recent months given the expanding conflict in the Middle East, the continuing war between Russia and Ukraine, and tensions between the U.S. and China. In our last quarterly letter, we looked back over the past 75 years at 17 of the most significant geopolitical events to learn of their impact on the economy and the stock market. We found that geopolitical events generally led to increased stock market volatility immediately following most of the events, however, the impact on the economy and the stock market was generally short lived. In fact, the average two-year annualized return for the stock market was 6.8% following the 17 geopolitical events, and in only two instances was the return negative after two years (the September 11th attack in 2001 and the Arab-Israel War in 1973). However, even in those two instances, the returns were positive after just an additional four months (28 months until the stock market fully recovered). The lesson is that while volatility did heighten in the immediate aftermath of the most significant geopolitical events over the past 75 years, for long-term investors the downturn represented a buying or rebalancing opportunity rather than a time to panic and sell. One other point, we generally advise our clients to maintain 8 to 10 years' worth of future cash flow needs in high quality bonds and cash reserves so that whenever there is an economic downturn, as there surely will be numerous times in the future, there would be no need to sell stocks or stock funds at depressed prices to meet cash flow requirements. By having such a safe-haven allocation within the portfolio, we can allow time for stocks to recover as they did in 28 months, or less, following all of the 17 major geopolitical events over the past 75 years.

The U.S. Election: Examining a Controversial Issue

In our last quarterly letter, we reviewed in depth many of the important proposed policy differences between Kamala Harris and Donald Trump (readers can review our Q2 2024 comments at Aequitas-com/helm). Rather than repeating ourselves, in this quarterly letter we will focus on one highly controversial economic issue, i.e., tariffs on imported goods, which might have a significant impact upon U.S. economic growth both in the short and long-term depending upon the outcome of

the election. Unlike most other major policy initiatives being proposed, a president might be able to impose sweeping new tariffs using executive action alone without the consent of Congress. In brief, the following is where the candidates stand on the use of tariffs:

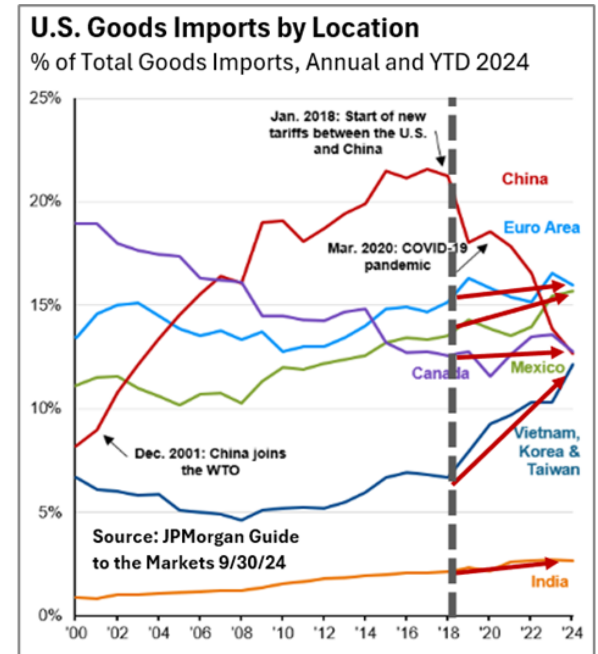
- Kamala Harris would likely maintain the current "tough on China" status quo with a continuation of existing targeted tariffs to help protect American workers and companies from China's unfair trade practices. These include targeted tariffs on steel, aluminum, semiconductors, electric vehicles, lithium-ion batteries and solar cells. (Harris has not proposed utilizing tariffs to raise revenue for her policy initiatives, instead, she has proposed increasing the corporate tax rate from 21% to 28% [it was 35% in 2017] and increasing tax rates on high income earners.)
- At the very center of his economic plan, Donald Trump has promised to impose a universal tariff of 10% (or possibly 20%) on all US imports as well as a 60% tariff on imports from China. He has claimed at various times over the past few months that the revenue raised from these tariffs would replace the income tax, finance unspecified childcare benefits, create a U.S. sovereign wealth fund, eliminate the federal budget deficit, and even begin paying down the national debt. (Trump draws inspiration from former U.S. President William McKinley's promotion of high tariffs in the 1890s.)

  Reality check: the total value of all goods imported into the U.S. in 2023 was $3.1 trillion compared to $4.2 trillion collected in income and payroll taxes. To replace income and payroll taxes, the tariff rate would need to be at least 135% on average across the board. However, with tariffs at such a high rate, imports would plummet as would the revenue from tariffs, thus negating their benefit and requiring that income taxes in some form or another be reinstituted.

Some History and Comments on Tariffs

In a September 24th *Forbes* article entitled, *Trump on Tariffs: Can We Replace Income Taxes,* Joseph J. Thorndike, director of the Tax History Project at the non-profit Tax Analysts organization, stated that Trump has revived the idea of tariffs "…against all logic and available evidence – that tariffs, …can be the foundation of federal finance, just like they were in the 19th century." Before becoming president, as an Ohio congressman William McKinley championed the Tariff Act of 1890 which increased the *average* rate of tariffs up to 49.5%, but not across the board as certain goods were taxed at higher rates than others. The tariffs were not well received by the average American who suffered steep price increases (as would be the case today). On the positive side, tariffs did stimulate some U.S. manufacturing development, but in the final analysis, the net economic benefit of the tariffs was insignificant. McKinley later in his presidency became more forward looking and essentially reversed his view on tariffs. In his second inaugural address, McKinley said, "Reciprocal trade arrangements with other nations should in liberal spirit be carefully cultivated and promoted." Later in an address in Buffalo New York, McKinley stated that, "Commercial wars are unprofitable. A policy of good will and friendly trade relations will prevent reprisals."

Putting aside the preposterous claims that tariffs could replace the income tax system and eliminate the federal deficit, among other claims, most economists believe that imposing heavy tariffs on imported goods would increase costs for US consumers (as they did in the 19th century) and create slower economic growth. In addition, any portion of the tariff costs not passed on to consumers would need to be absorbed by U.S. corporations which would negatively impact their earnings. Retaliatory tariffs from our trading partners might negate any short-term benefits. Furthermore, foreign trade patterns are highly adaptive. As an example, the tariffs imposed on China by the Trump administration in January of 2018 did effectively reduce Chinese imports as represented by the red line in the graph below. However, imports from our other trading partners increased across the board leading to an even larger trade imbalance. Tariffs might be akin to "Whack-A-Mole" economics where when one trading partner's imports are whacked down via tariffs, another trading partner might benefit. Or if tariffs are applied to certain imported goods, or across the board, U.S. manufacturers of those goods would have an incentive to increase their prices to take advantage of the higher imported prices.



Finally, the conservative think tank Peterson Institute for International Economics has published several research reports on the impact of Trump's proposed tariffs. In an October 10th article entitled, *Trump's high tariffs would*

create an administrative nightmare while disrupting the US economy, they asserted that "It is not possible to pay for all government expenditures with tariffs he has proposed or for that matter at any level." In an August 21st article, *Election 2024,* their research found that "The median household would expect to see its after-tax income fall by about 4.1 percent, more than $2,600, because of tariffs. Still, the top 1 percent would experience net gains in income because their losses from tariffs are more than offset by Trump's proposed tax cuts." As was learned in the 19th century, tariffs are essentially a regressive tax which disproportionately affects lower-income households.

How Might the Election Results Impact the Stock Market?

In September, the global financial services company UBS published a joint analysis from their senior economists and investment strategists which modeled the impact on the economy and stock market of various outcomes of the November election, including the tariffs proposed by Donald Trump. Under the Trump tariff scenario, they forecast that the U.S. stock market, represented by the S&P 500 Index, might decline by close to 12% by the end of 2025 before beginning to recover in 2026. Their best-case scenario is for the continuation of divided government (i.e., neither party in control of the White House and the two houses of Congress). The next best scenario, according to UBS, would be a Republican sweep, with a Democrat sweep in third place. Their analysis indicates that the extreme tariff scenario would constrain competitiveness and cause global economic output growth to slow to 2.7% in 2025 and slow further to 2.0% in 2026 which is weaker than the 2.9% growth in both years under their baseline scenario. Ironically, while the Republican Sweep scenario appears favorable for the stock market's performance over the next few years according to UBS, the extreme tariff scenario would appear to offset the stimulative benefits of the Republican's tax cuts (essentially, shooting themselves in the foot).

S&P 500 Performance Forecast for Four Election Scenarios

Scenario	End of 2025	End of 2026	Cumulative
Baseline: Divided Gov't	8.5%	7.0%	16.1%
Republican Sweep	8.1%	6.3%	14.8%
Democrat Sweep	1.7%	7.9%	9.7%
Trump Tariffs	-11.9%	8.7%	-4.2%

Source: Forbes, UBS Investment Bank

While we believe the UBS forecast is based on logical assumptions, no one really knows how the stock market might react to an extreme tariff scenario, although there is no doubt there would be heightened uncertainty which would probably roil the markets. However, there is a lot of daylight between Trump's campaign promises and the realities of actually implementing such an extreme tariff plan (there is already pushback being voiced by some Republicans in Congress, key business groups, and some of Trump's own economic advisors). Nonetheless, we believe that the most practical strategy for dealing with such uncertainty, as well as potential geopolitical risks, is to maintain a highly diversified balanced portfolio, including safe-haven fixed assets combined with globally allocated equities.

While the UBS report was focused on election's impact on the stock market, another concern which will require close monitoring is the impact on U.S. Treasury bonds and our government's ability to pay for future deficits and the growing national debt. In our last quarterly letter, we mentioned that neither candidate has addressed the U.S. debt problem. However, Harris's policy proposals appear to be significantly less costly than Trump's. According to the bipartisan Committee for a Responsible Federal Budget, Harris's proposals would increase the national debt by $3.5 trillion through 2035, while Trump's proposals would increase the debt by $7.5 trillion. Given this more dire national debt outlook resulting from Trump's proposals, interest rates on U.S. government bonds have jumped recently as the odds of a Trump victory and Republican sweep have increased.

Future Portfolio Returns Expectations Update

One of the most effective and reliable ways to deal with short-term uncertainties is to focus on reasonable long-term investment rate of return assumptions and to periodically make adjustments as economic conditions and asset prices warrant. In the table to the right, we have updated the future expected rates of return and risk levels for various asset classes and balanced portfolios based upon the latest data from Research Affiliates (researchaffiliates.com). Research Affiliates utilizes the Cyclically Adjusted Price-to-Earnings Ratio (CAPE Ratio) as a key element in their future return estimates for the various asset classes within equities. (The CAPE Ratio was introduced by

10-Year Future Annual Rate of Return Forecasts as of 9/30/24

Equities	10 Year "Expected" Return	Risk Level (Standard Deviation)
US Small Cap Value	8.7%	19.3%
Emerging Markets	8.6%	20.0%
Non-US Developed Markets	8.3%	16.4%
Global Equities Mix	**5.9%**	**15.3%**
US Large Cap Value	5.5%	15.3%
US Small Cap Growth	5.0%	22.4%
US Large Cap Growth	2.1%	17.2%
Fixed Assets		
Diversified Bonds	**4.7%**	**3.3%**
Cash (Money Market Funds)	3.5%	0.8%
Balanced Portfolios		
20% Fixed - 80% Equities	5.8%	12.5%
40% Fixed - 60% Equities	5.7%	9.7%
50% Fixed - 50% Equities	5.6%	8.4%
60% Fixed - 40% Equities	5.4%	7.1%
Inflation	2.4%	NA

Nobel laureate Robert Shiller and has proven to be one of the most accurate tools for forecasting long-term future returns for stocks.)

Most of the future rate of return estimates have been lowered slightly since our last update in reflection of the strong recent performance for bonds and stocks. Underpinning the future return estimates for equities is the financial theory that asset prices over time revert to their long-term average valuation levels relative to estimated future corporate earnings. Simply put, when stock prices rise significantly above their long-term average valuation levels, their future returns are likely to be lower as their valuations eventually revert to their long-term average levels. Conversely, when stock prices fall below their long-term valuation levels, their future returns are likely to be higher. The asset classes with the highest expected future returns in the table on the prior page are U.S. Small Value stocks, and stocks in the Emerging Markets and Developed Non-U.S. Markets (our model portfolio currently has an overweight to U.S. Small Value and to a lesser extent Emerging Markets). The lowest rate of return estimate is for U.S. Large Cap Growth stocks which are currently priced well-above their long-term average valuation levels. This asset class includes the largest stocks in the U.S. based upon market capitalization, including the Magnificent 7, i.e., Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla. The Magnificent 7 stocks currently comprise 31% of the market-cap weight of the S&P 500 Index and 19.5% of the MSCI ACWI Index. Our model portfolio's weight to the Magnificent 7 is currently 11% representing a significant underweight which we believe is appropriate given their lower future rate of return expectations.

One important aspect of utilizing the more reliable long-term economic forecasts is that what happens in the short term is of less importance in planning for the future. Ten-year forecasts can also help smooth out the impact of political and geopolitical events in the interim. For example, while there may be cause for concern as to the outcome of this November's election, we know that over the next 10 years we will have two additional presidential election cycles and five additional opportunities to change the composition of the House of Representatives and Senate (plus similar opportunities in our state and local elections). So, while the occupant of the White House and the members of Congress can impact the economy in the short run (for better or for worse), over the long run more powerful forces, including human ingenuity and technological developments, play a much larger role in powering economic growth and determining the future returns on stocks and bonds.

Focusing on Things We Can Control

In the opening paragraph of this quarterly letter, we utilized an artist's illustration to indicate that while there are many things in life over which we have no control, there are things we can control, and that our focus should be on things that matter and where we have control. In the world of investing, here are six important things we can control to improve the odds of a more successful outcome over the long term:

- Manage Portfolio Risk: One of the most important decisions an investor can make is in determining an appropriate allocation between bonds and stocks, or between Fixed Assets and Equities as we refer to them in our practice (Fixed Assets would include money market funds). The determination of the proper balance between the two is based upon various personal factors, including one's risk tolerance, time horizon and future cash flow requirements.
- Maintain Diversification: Beyond allocating between bonds and stocks, diversifying one's stock holdings can help avoid extreme investment outcomes and provide more reliable returns. This is one reason we recommend investing in thousands of the most profitable companies in the U.S. and abroad, and not allowing portfolios to become overconcentrated in just a handful of stocks (such as our recommendation to underweight to the Magnificent 7 stocks).
- Rebalance: Keeping portfolio risk aligned with one's personal risk tolerance requires regular rebalancing by trimming stocks when they have appreciated significantly beyond their targets and vice versa.
- Allocate Assets for Tax-Efficiency: For taxable investors, maximizing after-tax returns by allocating one's portfolio strategically among taxable brokerage accounts, traditional IRA and 401K retirement accounts, Roth IRA accounts and tax-deferred annuities to take advantage of each account's unique tax characteristics.
- Control Costs: Minimizing investment management costs enables one to keep more of the portfolio's total return. This is why we recommend low-cost and tax-efficient mutual funds (and ETFs) and are committed to providing our investment advisory services at a fee level which is generally lower than 80% of our peer group.
- Establish and Monitor a Long-Term Investment Plan: Establishing a prudent investment plan and updating it regularly helps avoid emotional traps and improves the likelihood of achieving one's goals.

Closing Comments

Washington Post guest columnist Curtis Craig, consulting professor at the Duke Divinity School, wrote a timely article in the October 22nd *Inspired Life* section, entitled, *Anxious about the nail-biter election? Here's how to survive it*. Craig

acknowledged that "Democrats and Republicans are divided politically more than ever, but they fully share a common emotional reality: election anxiety." Psychological studies from the 2020 election found that anxiety rose by a remarkable 73 percent in the days leading up to and following the election. There was a 29% increase in visits to mental health providers and prescription drug usage. Craig wrote that anxiety is nonpartisan and impacts both Democrats and Republicans. Anxiety is also a common human condition when confronting uncertainty and is especially true in an election where one side inevitably loses.

Craig offered three mental shifts for dealing with election anxiety. First, remember that we've lived through and survived periods of time in the past which were portrayed as intolerable. Second, monitor our addiction to political news and set limits on election news consumption. Third, explore spiritual literature on how to deal with uncertainty. Craig wrote, "Every great spiritual tradition — such as Hinduism, Buddhism, Judaism, Islam and [Craig's] own tradition of Christianity — equips its followers to tolerate uncertainty and loss. [We have found that spiritual and self-help authors such as Eckart Tolle have offered helpful guidance as well.] Each of those traditions has demonstrated its historical capacity to help people withstand political catastrophes far more disruptive than what we face today." He went on, "The very nature of democracy requires all sides to tolerate loss and therefore endure anxiety….The healthier habits we adopt in the face of political loss will sustain us when we inevitably face our own personal financial, relational and health losses. No matter the outcome of the election, we all can choose to win our long game."

Finally, regardless of which candidate or which party wins or loses in the upcoming election, the fundamental laws of economics and principles of investing will not change. The volatility of the markets might be heightened, but as Warren Buffet reminds us, the emotional ups and downs of the stock market provide rebalancing opportunities for long-term investors. Furthermore, having a significant portion of our portfolios invested in safe-haven assets enables us to weather the potential storms while we carefully review our assumptions and make adjustments to our long-term investment plans.

Asset Class Performance Review
(Some Good News Not to Be Overlooked!)

In reviewing the Asset Class Performance Summary (below), the returns for the last 12 months and calendar quarter were remarkably positive across the board. The Global Stock Market surged by 31% over the past twelve months, driven largely by continuing strength in the global economy and the Federal Reserve's pivot toward lowering interest rates. The leading stock asset classes, including selected sectors, in order were Global Information Technology (+48.4%), US Large Caps (+36.4%), Global Environmental Markets (+30.6%) and Global Real Estate (+30.1%). The positive returns were broad-based, ranging from 25% to 26.8% for the other stock asset classes. Benefiting from falling interest rates, bonds generated excellent gains as well. U.S. Aggregate Bonds gained 11.6%, 1-5 Year Gov't/Credit Bonds gained 8.1%, and T-Bills gained 5.5%.

For the latest calendar quarter, all the asset classes and selected sectors were in positive territory as well. Leading the way was Global Real Estate (+17.1%) followed by U.S. Small Cap stocks (+9.3%). The range of returns for the other stock assets classes was between 1.1% and 8.7%. For the first time in a while, Global Information Technology was in last place (+1.1%), possibly reflecting concern about stretched valuations in this sector. The Global Stock Market advanced by 6.8%. Within Fixed Assets, U.S. Aggregate Bonds gained 5.2% followed by 1-5 Year Gov't/Credit Bonds (+3.5%) and U.S. T-Bills (1.4%).