Market Update
Q4 2024

TOMPKINS
Financial Advisors

PLANNING | TRUSTS | INVESTMENTS

With the Wind at Our Backs and a Weather Eye Forward
Maintaining a Steady Course Amidst Shifting Tides

Despite the numerous economic and geopolitical challenges encountered along the way, 2024 delivered a second consecutive year of double digit returns and financial successes for global equity investors – US GDP growth outpaced even the most bullish of analyst expectations, and central banks around the world changed direction, reducing policy interest rates for the first time in the post-pandemic era.

The S&P 500 ended 2024 up more than 20%. The strong performance was driven by the continued outperformance of large cap US Technology companies, like Nvidia, Amazon, Google and Apple. The US consumer also demonstrated continued resilience during 2024 amidst the ongoing stubborn inflation and higher unemployment challenges. As a result, the stocks of companies that provided customers with value-based pricing – such as Walmart, Costco, and TJX –demonstrated robust performance as consumers trimmed their spending on non-discretionary items at other retailers while continuing to frequent the stores that allowed them to stretch their spending as best they could.

Interest rates for longer-term bonds increased throughout 2024, even as the Federal Reserve started lowering interest rates on shorter-term treasury instruments. This alleviated some of the fiscal pressures from the interest expense they paid on an enormous federal debt. The diverging path of shorter-term and longer-term interest rates presents a challenge for the Federal Reserve as inflation, measured by the US Consumer Price Index (CPI), has remained stubbornly high even with the Fed having undergone the largest cycle of rate hikes in modern history.

While inflation, especially in housing, health care and insurance, is likely to remain entrenched, we seem to have avoided any prolonged broad-based deflation. Given this backdrop, along with a resilient US consumer and increased corporate earnings, economic growth appears fairly constructive as investors flip their calendars to 2025.

Higher bond yields typically coincide with higher net interest expenses for corporate borrowers. However, many corporations secured low-cost financing, some for a term of up to 30 years, during the recent era of historically low interest rates. Coupled with today's higher interest rates, this has actually resulted in higher profit growth for many corporations now earning a higher rate of return on their treasury deposits.

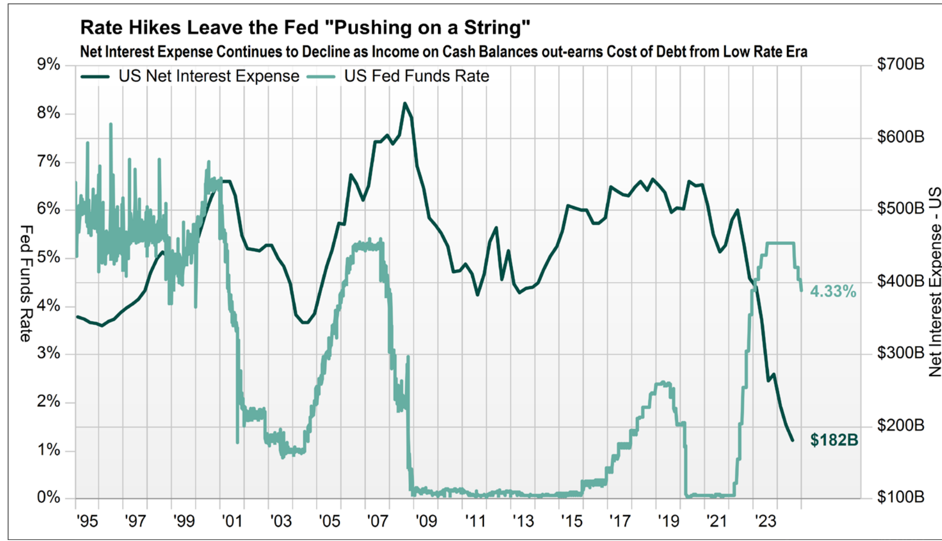

Exhibit 1: As the Federal Reserve began increasing interest rates in 2022, net interest expenses – which historically have increased as interest rates rise –decreased significantly. Companies that secured multi-year, low rate fixed financing before the Fed began hiking interest rates, were earning more in interest on their cash balances than they paid in financing costs. This resulted in higher profit margins for many companies throughout the US economy.

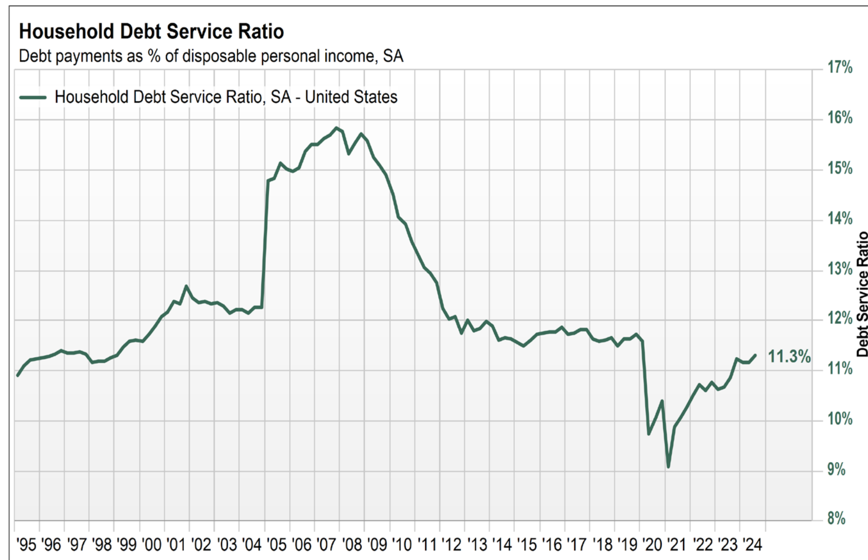

Exhibit 2: US consumers have had a similar experience to corporations in recent years. Even with interest rates having increased significantly since Q1 2022, higher borrowing costs haven't been felt by a large portion of the US consumer base who locked in low interest rates, especially on long-term debt, like mortgages.

Looking Ahead: Key Factors to Watch

As calendars turn to 2025, there are several factors that will continue to shape market dynamics in the year ahead:

Treasury Market Dynamics

- **Investor Appetite for Long-Term Treasuries:** The willingness of long-term investors to purchase Treasury bonds at yields below 5% will be a significant factor. Traditionally, these investors have tended to be a combination of foreign central banks, sovereign wealth, and other institutional funds, among others. If these large pools of investor capital remain reticent to purchase US Treasury bonds with maturities 10 years and longer, we'd anticipate that longer-term yields for US treasury bonds could continue to rise. As a reminder, prices and yields have an inverse relationship – when yields go up, prices go down (and vice versa).
- **Who is doing the tightening:** There have been a handful of instances in recent years where markets "helped" the Fed to either tighten or ease economic conditions. With the Fed recently initiating their tightening cycle, we're monitoring the markets to see whether they help combat inflationary pressures by keeping longer-term Treasuries sufficiently elevated, or if markets help ease economic conditions by enticing investment into longer-term Treasuries and put downward pressure on longer term interest rates.
- **Have we reached the tipping point:** As interest rates on the 10-year US Treasury Bond approach 5%, there becomes a point where equity market investors start to notice that longer-term bond yields have increased. With higher interest rates providing a positive contribution to corporate profits, we continue to monitor whether valuation multiples contract if/when the Fed's future rate reductions impact this new-found corporate profit center.

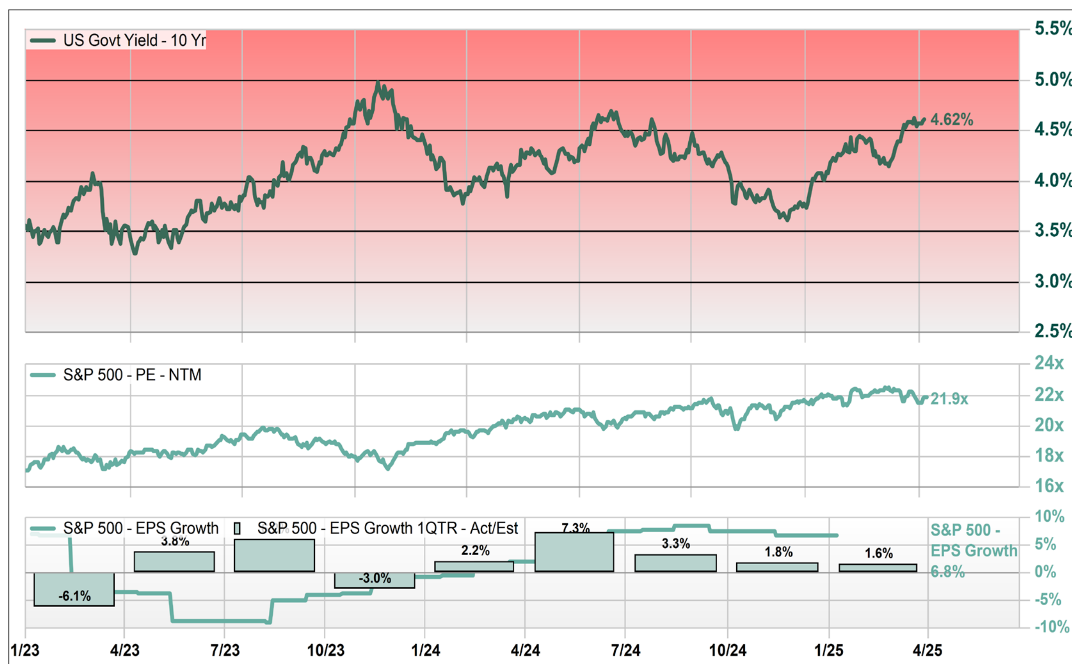

Exhibit 3: In recent years, valuation multiples (price to earnings) contract as interest rates for 10yr US Treasury Bonds approach 5% (corporate profits contract as financing costs expand). Currently, corporate earnings continue to exceed expectations as cash balances earn higher rates of interest than the financing costs secured in low-rate years.

The Fed's Dual Mandate

- **The Mandate's Newest Sibling:** By Congressional directive (The Federal Reserve Act of 1977), the US Federal Reserve operates under a "dual mandate" to promote maximum employment and maintain stable prices. Recent rate cuts by the Fed have had a more direct and immediate impact on lowering the government's national debt service than they have on lowering inflation. That said, a primary goal of the interest rate cuts is to combat inflation. Lowering interest rates can stimulate economic activity, potentially leading to job growth and increased consumer spending. Though the current optics may put the Fed in poor light, the impact on inflation from their rate cuts is less direct and can take time to materialize. If inflation remains persistent and doesn't return to the Fed's target range of 2%, future Fed actions, like additional cuts, may be tempered as they work to cool the economy.

- **Monetary Policy Changes to Address Fiscal Challenges:** Recent precedent has shown a willingness of the Federal Reserve to step in and resume purchasing longer term bonds if there are not enough interested investors to purchase them from US Treasury auctions. If market participants continue to demand higher rates of interest in order to be enticed to purchase US Treasury Bonds with maturities 10yrs and greater, the Fed may eventually be forced to step back in to buying bonds on the open market. This will expand their balance sheet, reverse their recent course and help relieve the upward pressure on longer-term bond yields and the resulting principal erosion.

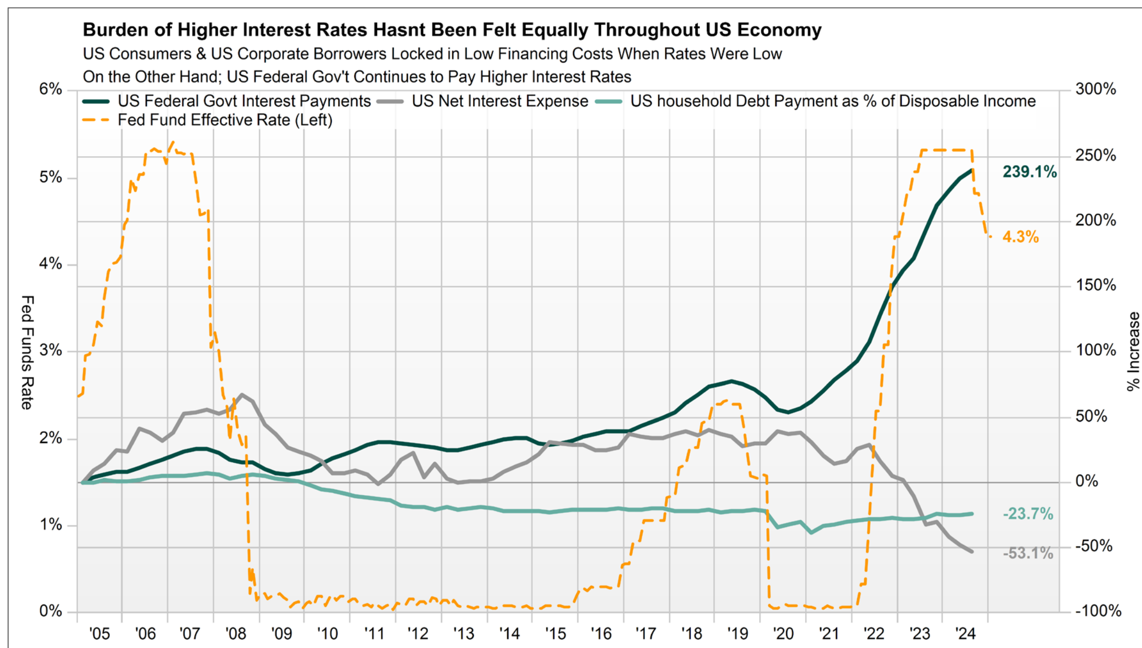

Exhibit 4: While higher interest rates have had a muted impact on corporations and consumers who have seen their debt financing expenses decrease since the early 2000s by 53% and 23% respectively, the burden of rapidly increasing interest expense has been front and center for the US federal government. Expanding deficits having become significantly more expensive in the recent rate-hiking environment. This asymmetric impact has likely been a factor in the Federal Reserve's decision to begin lowering interest rates amidst the backdrop of high and entrenched consumer inflation.

- **Keeping Our Eye on "The Punch Bowl":** In his famed speech in 1955, Fed Chair William McChesney Marting Jr. initially referenced the analogy that "removing the punch bowl" before things get out of hand is a prudent policy measure to control inflation during periods of economic expansion. As we move further into 2025, markets may begin to consider whether corporate profits could be impacted should the Fed continue reducing the Fed funds rate and negatively impact the yield on corporate cash balances and, by extension, the growth of the US economy. We will continue to monitor how companies are able to grow profits organically over the coming years as their earnings growth is paramount for sustaining continued market appreciation.

Investment Committee:

Geoff Blyth
Chief Investment Officer
585.419.8387
GBlyth@TompkinsFinancial.com

Michael Lawhead
Senior Portfolio Manager
585.419.8361
MLawhead@TompkinsFinancial.com

John Shea
Senior Portfolio Manager
607.273.0037
JShea@TompkinsFinancial.com

Victor Hugo Marin
Senior Investment Analyst
607.273.0037
VMarin@TompkinsFinancial.com

Eric Fitzpatrick
Investment Analyst
607.273.0037
EFitzpatrick@TompkinsFinancial.com

Investments and insurance products are not insured by the FDIC, nor deposits of, obligations of, or guaranteed by the bank or its affiliates, and are subject to investment risk including possible loss of principal.