QUARTERLY MARKET INSIGHTS
3rd QUARTER 2024

RCB BANK
Trust & Wealth Management

Rate Cuts and Rotations

EXECUTIVE SUMMARY

- The labor market appears to be normalizing
- Expect a measured pace of Fed rate cuts into 2025
- Growth trajectory will dictate market leadership
- Quick increases in yields could pressure stocks

Global markets had an action-packed summer, headlined by a 13% drawdown in the technology-heavy Nasdaq Composite from mid-July through early August and a 50 basis-point (bp) Federal Reserve rate cut on September 18. Along the way, the S&P 500 recorded its 42nd new closing high of the year and large portions of U.S. Treasury yield curve dis-inverted after two years during which shorter-term yields were above their longer-term counterparts. Gold pushed well above $2,500 per ounce for the first time ever, while crude oil could not sustain upward momentum despite an escalation of tensions between Israel and Iran. In late September, Chinese authorities unveiled a long-anticipated batch of stimulus measures in attempt to support their economy and stock market.

The U.S. labor market experienced a brief bout of weakness in July that coincided with a surge in market volatility. But major U.S. equity averages stabilized in short order when jobs data showed improvement in August and September and the Japanese yen carry trade unwind seemed to run its course after a cathartic washout. Consumer inflation continued to gradually cool toward the Federal Reserve's 2% annual target, while consumer spending data, overall gross domestic product (GDP) growth and second quarter corporate profits all expanded at a solid pace. Finally, the U.S. presidential election heated up with Kamala Harris and Donald Trump trading places several times as the favored candidate based on polling aggregates and prediction markets.

We expect episodes of both equity and bond market volatility surrounding the upcoming election as market participants reprice securities in an environment of elevated policy uncertainty. Substantial market moves driven solely by the election outcome will likely prove to be overstated and short-lived as monetary policy, consumer spending, economic growth expectations, and corporate profits tend to be biggest drivers of investment markets over the long run.

Growth Scare

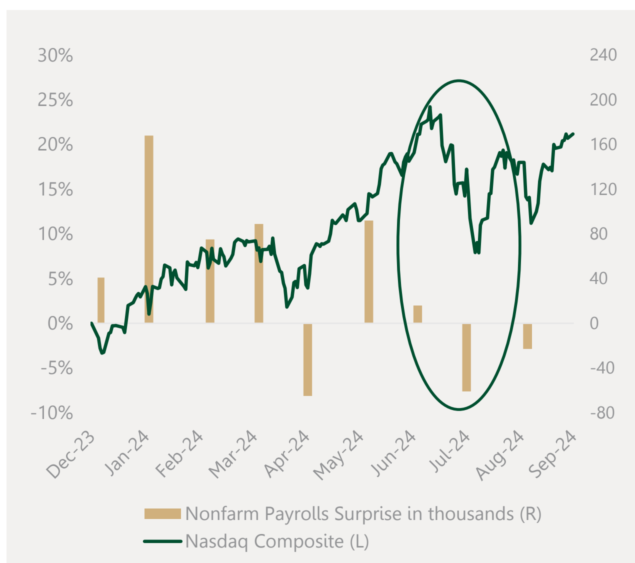
On August 2, a weaker-than-expected jobs report showed nonfarm payrolls increased by just 114,000 in July, well below the median forecast of 175,000 in a contemporaneous Bloomberg survey. As shown in Chart 1, the disappointing reading combined with a largely in-line June payrolls report for the weakest two-month period of job growth relative to expectations in 2024. Markets were particularly spooked by the increase in the unemployment rate to 4.3% in July from 4.1% in August. This triggered the so-called Sahm Rule, which stipulates recessions in the U.S are likely imminent when the 3-month moving average unemployment rate is 0.5% above its lowest level in the last 12 months. With the benefit of hindsight, we can say with some degree of confidence that for a few days in early August market participants probably over-interpreted the Sahm Rule as a nearly failsafe signal of a recession. The rule's inventor herself, former Fed economist Claudia Sahm, made it clear on multiple financial news networks, publications, and podcasts during the summer that she believes the U.S. economy is slowing but not currently in a recession.

Talk of a potential "Fed policy mistake" swept across markets as the weak July jobs report came just two days after the Federal Open Market Committee (FOMC) voted to keep its policy rate unchanged in a range of 5.25% - 5.50% on July 31. In the moment, concerns mounted that Fed Chair Jerome Powell and his colleagues were behind the curve and missed their opportunity to ease policy into a rapidly slowing economy in order to preserve an economic soft landing.

Nonfarm payrolls data released September 6 showed the U.S. economy added a net 142,000 jobs in August, which was below the consensus 165,000 estimate but a sequential improvement from the downwardly revised 89,000 reading from July. Jobs

CHART 1

Job Market Weakness Drove Summer Correction



Bloomberg. Data as of 9/30/24. Past performance does not guarantee future results.

gains then reaccelerated sharply in September with a net addition of 254,000 according to data released October 4. Importantly, July and August payrolls were upwardly revised by a combined 72,000 and the unemployment rate ticked down to 4.1% in September from 4.2% in August and a nearly three-year high of 4.3% in July.

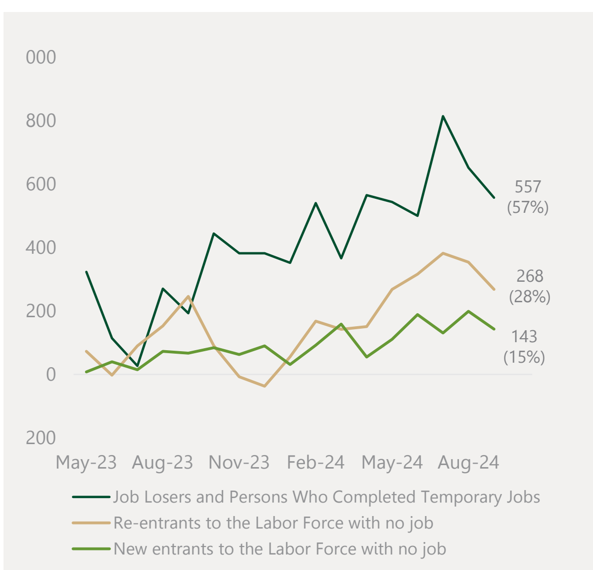
Labor Supply and Productivity

Overly pessimistic observers of the U.S. economy may have overlooked the affect that new entrants and reentrants to the labor force had on the increase in the unemployment rate from the cycle low of 3.4% in April 2023. As seen in Chart 2, about 43% of the net increase in unemployed persons actively looking for work in the U.S. from April 2023 through September 2024 was explained by individuals entering the labor force for the first time or re-entering after an extended absence. This is a significantly higher percentage than in periods leading up to recessions that began in 1990, 2000, and 2007, when 70% to 100% of the increase in the unemployment rate was due to workers who lost their jobs.

Leading up the Global Financial Crisis recession of 2007-2009, the U.S. unemployment rate bottomed at 4.4% in May 2007. Over the next 17 months, the total number of unemployed persons in the domestic labor force increased by 3.1 million as the unemployment rate climbed to 6.5%. Of this 3.1 million, about 2.34 million, or 76% were people who lost their jobs or temporary workers who completed their jobs. Over a similar 17-month stretch from April 2023 through September 2024, the unemployment rate climbed from 3.4% to 4.1% and total unemployed persons

CHART 2

Change in unemployed persons since April 2023



Bloomberg. Data as of 9/30/24. Past performance does not guarantee future results.

in the labor force rose by 968,000. Individuals losing their jobs accounted for just 57% of this increase compared to 76% from May 2007 through October 2008. If the economy is ultimately strong enough to soak up these new entrants and reentrants to the labor force, it would surprise us to see unemployment rate move much higher than the 4.3% reading in July absent an exogenous shock.

As part of its preliminary annual revisions to nonfarm payroll data, the Bureau of Labor Statistics estimated on August 21 that the U.S. economy added 818,000 (or 28%) fewer jobs from April 2023 through March 2024 than originally reported. The revisions (which will be finalized in February) imply average monthly job gains of 174,000 over this period compared to the original estimation of 242,000. Taken at face value, these downward revisions to job figures from the second quarter of 2023 to the first quarter of 2024 might suggest the economy was weaker during this period than the consensus view at the time. Yet, annualized GDP growth figures during these four quarters were 2.4%, 4.4%, 3.2%, and 1.6%. On average, the domestic economy expanded at annual clip of 2.9% over these 12 months, which is above the Federal Reserve's estimate of long-term potential GDP growth of 1.7% to 2.0%. The combination of above-trend growth and significantly fewer jobs gained than originally estimated points to a higher rate of productivity in the economy than was previously assumed. Improvements in productivity (producing more output with less resources) are generally seen as an important signal that an economy is capable of achieving a desirable growth rate without stoking excess inflation. The likely efficiency benefits of advancements in teleconferencing and hybrid work arrangements coming out of the pandemic across professional services industries in the U.S. is one of several theories that attempt to explain the trend of improving productivity.

The First Cut

On September 18, the Federal Open Market Committee (FOMC) voted 11-1 to reduce the federal funds rate by 0.5% to a range of 4.75%-5.00%. The long-awaited pivot to easing policy followed 14 months during which policymakers held their benchmark rate at a multi-decade high to combat elevated inflation. The size of the September move was not a complete surprise as market expectations were split between a 50-bps cut and a smaller-25 bps reduction. The lone dissent from Michell Bowman (who advocated for a more conservative quarter-point cut) was the first from a Federal Reserve Governor since 2005. Bowman, who was appointed by then-President Trump in 2018, has said repeatedly in recent months that she favors a cautious approach to rate cuts given she does not see clear signs of labor market weakness.

While Bowman may appear to be on an island with her dissent in September, it would not surprise us if there were additional FOMC voters who might be unsure about an accelerated pace of rate cuts given 1) the still-decent labor market and consumer spending backdrops and 2) annual core inflation has not yet reached the Fed's stated 2% target. Currently, pricing in fed funds futures markets indicate over 90% odds of a 0.25% rate cut on November 7 (two days after Election Day) and a 73% probability

0.25% reduction on December 18. If other FOMC voters are sympathetic with Bowman's view and economic data remain solid in coming weeks, then market expectations for an additional 50 bps of policy easing by the end of the year may prove too ambitious.

According to the FOMC's quarterly Summary of Economic Projections in September, the median participant now expects an additional 75 bps of rate cuts by the end of 2025 than was forecast in the June projections (see Chart 3). Setting aside Governor Bowman's dissent, we think its safe to say that Fed officials became more comfortable with a deeper trajectory of policy easing as both inflation and the labor market continued to normalize over the summer.

Yield Curve Normalization

As expectations of an initial Fed rate cut became reality, we saw a dis-inversion, or normalization, of the U.S. Treasury yield curve. This was brought to fruition by a so-called "bull-steepener" in which short-term U.S. Treasury yields declined at a faster pace than longer-term yields. As the summer progressed, bond market participants priced the beginning of a Fed easing cycle and a soft landing for the U.S. economy. For over two years from the first week of July 2022 through the first week of September 2024, yields on 2-year Treasury notes were above those on the 10-year maturity. Such an inversion is viewed as unnatural because bond investors are not being compensated for the additional risk associated with the extra time they need to hold a longer-term Treasury security until maturity.

Bull-steepener yield curve shifts are generally investors' preferred path for yield curve normalizations. The word "bull" refers to the positive returns for bondholders associated with lower yields, while "steepener" describes how the shape of the curve shifts. Bull-steepener moves tend to be market-friendly because lower yields ease financing pressure on the broad corporate sector. They also create a healthier operating environment for banks, which typically borrow short (deposit funding) and lend long (multi-year commercial, industrial, real estate loans). A more challenging route to a normalized yield curve would be a "bear steepener," a term describing an environment in which long-term yields increase at a faster rate than short-term yields. The yield curve normalizes, or re-steepens, but the move higher in yields creates a bearish return backdrop for bondholders. We saw a brief episode of yield curve bear-steepening in September and October of 2023 amid growing concerns of persistently high inflation and a surge in longer-dated Treasury issuance. This period coincided with double-digit peak-to-trough corrections in the S&P 500 (-10.3%), Nasdaq (-12.3%) and Russell 2000 (-18.3%).

The Election and the Bond Market

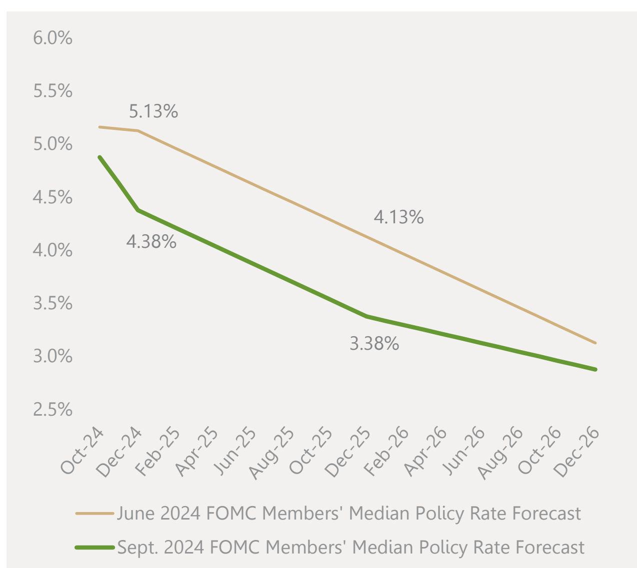
In recent weeks, some commentators and market participants have raised concerns about the increased likelihood of higher long-term Treasury yields under a prospective unified Republican government beginning in 2025. These voices describe the preferred policy mix of a Trump administration (deregulation, lower taxes, partial reductions in discretionary government spending, higher tariffs, tighter immigration controls) as likely to result in stronger short-term economic growth and higher inflation. Although the logic seems defensible, we would note legislation and trade policy-driven outcomes in 2025 and 2026 seem almost impossible to predict before Election Day.

Even if Republicans win the presidency and both chambers of Congress, many other political, economic, and market variables would likely have an impact on 1) the policies implemented and 2) the impact of those polices over time. We would note that consumer inflation was generally contained during the first Trump Administration as the year-over-year CPI ranged from 0.1% to 2.9%. Meanwhile, the 10- year Treasury yield was above 3% for a total of just 12 weeks in the four years spanning 2017 to 2020 (briefly in May 2018 and for most of 4Q18). For a more detailed analysis of how the preferred policy mix of both presidential candidates might impact the economy and markets in the short-term and long-term, please see our Election Commentary piece published on October 9.

No matter how the election unfolds, we would expect the major U.S. equity averages to struggle if long-term bond yields move much higher than 4.5% for an extended period. As noted above, stock market corrections in the fall of 2023 and spring of 2024 coincided with upside surprises in monthly inflation data and 10-year Treasury yields temporarily pushing above 4.5%. In the event of a sharp backup in yields, we would expect counteractions from the Treasury Department and Federal Reserve officials. Such

CHART 3

Fed Policy Rate Projections Moved Lower



Bloomberg, federalreserve.gov. Data as of 9/30/24. Past performance does not guarantee future results.

tactics could include an aggressive shift in Treasury issuance toward T-bills and the resumption of asset purchases (i.e., quantitative easing) by the Federal Reserve. Sharply higher bond yields could also become a politically sensitive topic in and of themselves, given the additional budgetary pressure they would create during a period of expanding federal deficits.

Gold

The precious metal has quietly registered one of the best year-to-date returns of all major commodity, equity, and fixed income segments, advancing 28% from $2,063 per ounce on December 31 to $2,634 on September 30. Gold probably benefited in the third quarter from a weaker U.S. dollar and lower Treasury yields given it most often trades in dollars and pays no interest. But there are clearly other variables at play if we consider gold prices surged 20% from mid-February through mid-April when the dollar was not weak and yields were moving higher. Other factors that seem to be supporting the gold price include elevated geopolitical risks currently focused in the Middle East and global central bank purchases led by China and various Persian Gulf states. Strong retail purchases in China amid extended slumps in both the property market and stock market have also been cited as tailwinds. Finally, concerns expressed by some market participants about potential monetary debasement in the U.S. to offset expanding federal budget deficits are another possible (though less discussed) catalyst for gold strength. Notably, shares of publicly-traded gold miners have not kept up with the price of the commodity as investors seem to have lingering concerns about elevated input costs for the capital-intensive business of gold exploration and extraction. Moving forward, we think an allocation to gold can continue to help the risk-adjusted returns of most portfolios given our assessment of the policy and geopolitical backdrops.

The Rotation Conversation

The extended stretch of U.S. mega cap growth style outperformance took a hiatus in the third quarter as investors rotated into other areas of the market that had been out of favor for most of the last 18 months. The threat of tighter U.S. export restraints of high-end semiconductors and related equipment to China pressured most of the large U.S. semiconductor-related stocks in July. Comments from Donald Trump questioning the implicit U.S. security guarantee for advanced chip-making hub Taiwan against a potential Chinese military incursion or naval blockade also weighed on shares of semiconductor firms. Finally, the broad technology sector was pressured by concerns about a possible slowdown in capital spending on generative AI chips and data center computing by the enterprise cloud hyper-scalers (Amazon AWS, Microsoft Azure, Google Cloud) due to uncertain returns on investment.

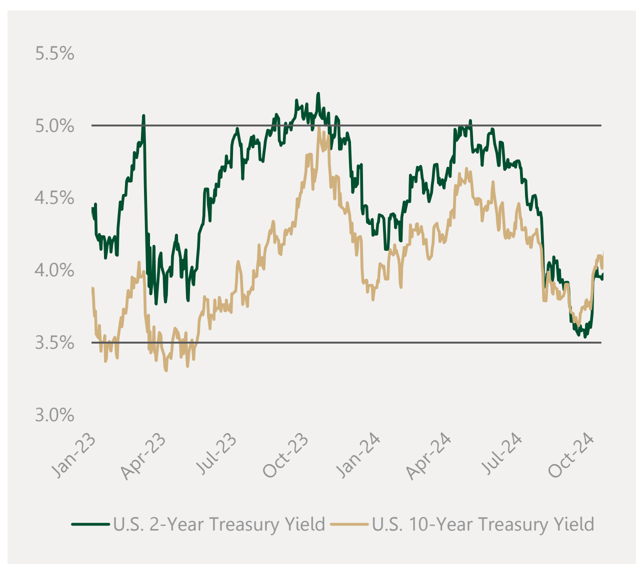
Over the period spanning June 28 through July 26, the small cap Russel 2000 (10.37%) outpaced the mega cap Nasdaq 100 (-3.35%) by nearly 14%, its widest margin of 4-week outperformance since May 2002. This followed a period of acute underperformance for U.S. small cap stocks dating back to regional banking industry turmoil in the late spring of 2023. From March 1, 2023 through June 30, 2024, the Nasdaq 100's 63.5% return dwarfed the Russell 2000's 10.2% gain. The former was boosted by enthusiasm for generative AI demand, while the latter was challenged by concerns about elevated interest rates on regional lenders and cyclical companies with higher degrees of financial leverage.

In addition to the semiconductor headwinds, a downside surprise in the June CPI report on July 10 seemed to be a primary catalyst driving this period of small cap relative strength. Investors appeared to get excited about the prospects of an accelerated pace of Fed rate cuts disproportionately helping small cap stocks by lowering their interest expense burden and turbo-boosting their operational leverage. We think an extended period of small cap relative strength would likely require a full-blown "soft landing," including continued disinflation, resilient economic growth, and Fed rate cuts. Although we believe investors should be constructive on the overall market backdrop heading into the final months of 2024, above-trend economic growth could limit the amount of policy easing Fed officials are comfortable with in 2025. In this scenario, we would not expect a durable stretch of meaningful outperformance from U.S. small cap stocks versus their large cap peers.

From July 16 to August 5, concerns about a deteriorating labor market, a Fed policy mistake, and overextend technology stocks drove an 8.5% correction in the S&P 500, the benchmark's steepest drawdown since last October. Selling was amplified

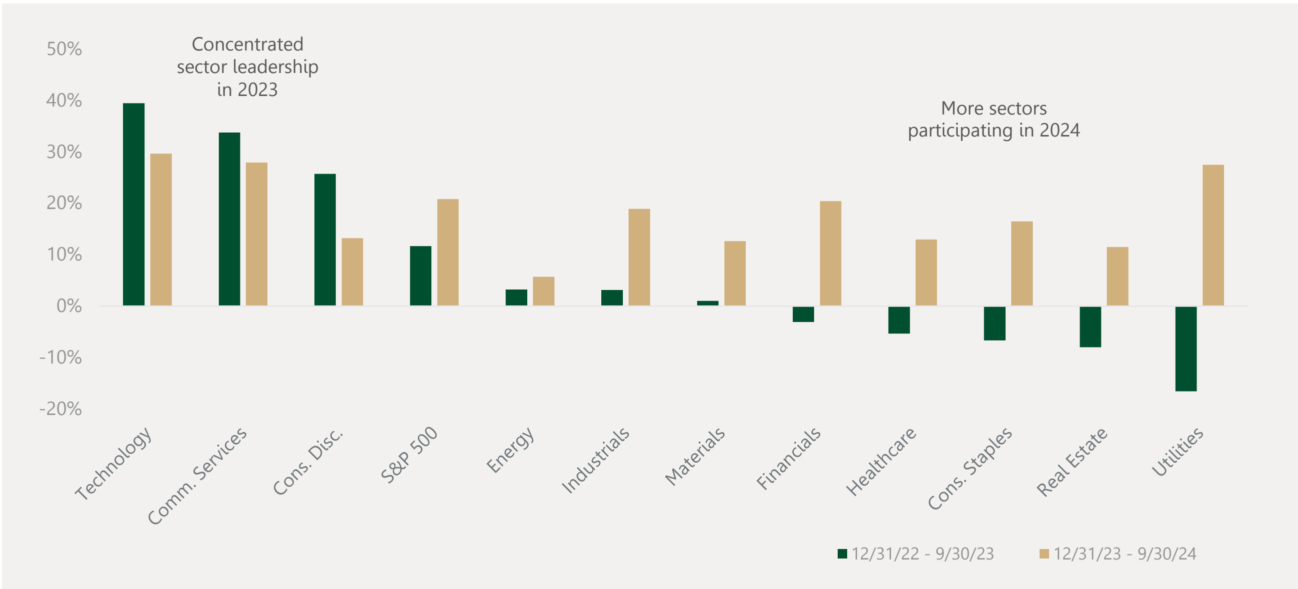
CHART 4

The Extended Range of U.S. Treasury Yields



Bloomberg. Data as of 10/18. Past performance does not guarantee future results.

CHART 5
Year-to-Date S&P 500 Sector Returns



Bloomberg. Data as of 9/30/24. Past performance does not guarantee future results.

during this period due to an unwind of the Japanese yen carry trade. This is a speculative strategy favored by hedge funds in which money is borrowed in low-yielding currencies to fund leveraged positions in markets with high-yielding currencies. The U.S. stock market quickly rebounded, however, as investors seemed to be comforted by solid second quarter corporate earnings and expectations, improving labor market data, and growing expectations for a Fed rate cut in September.

Chart 5 shows the returns of every S&P 500 sector through the first three quarters of 2023 and 2024. As we all remember, market leadership was very concentrated last year in the three sectors dominated by the Magnificent 7 stocks – technology, communication services, and consumer discretionary. Sector returns in the first three quarters of this year have been somewhat of different story. The technology and communication services sectors are the strongest performers once gain. But industrials, financials, consumer staples, and utilities have either kept up with the S&P 500 or outperformed the broad index in the first nine months of the year. Historically, a broadening of sector returns has signified a solid economic backdrop and been positive for the underlying durability of an equity bull market.

Corporate Earnings: No issues here

The S&P 500's second quarter earnings were stronger than expected with 14% year-over-year growth, which topped analysts' forecast for 8.3% growth. The index is becoming less dependent on the Magnificent Seven stocks as the vaunted group's earnings growth moderates from high levels and other areas of the index rebound. The annual growth rate in the operating earnings per share (EPS) of the S&P 500 excluding the Magnificent Seven stocks (S&P 493) in the second quarter was 9.3%, more than double the 4.0% analyst projection. This was the first quarter of year-over-year profit growth for the S&P 493 since 4Q22. Cost cuts and lower inflation helped the S&P 500 operating margin grow 0.53% year over year to 15.01%. This was the second consecutive quarter with positive growth following six quarters of margin contraction largely due to inflation pressures. S&P 500 revenue growth is also on pace to exceed analysts' projection with 5.83% growth versus the 4.56% analyst forecast. Sales growth is being led by the technology, energy, and health care sectors, with each posting growth around 8% or more in the period. Materials was the only sector with a sales decline. Index-level operating EPS are projected to grow 9% in 2024 to $242 from $223 last year. Index-level profit growth is projected to accelerate in 2025 to 14% driven to a large extent by the technology and healthcare sectors. The communication services, industrials, and materials sectors are also projected to generate strong earnings growth next year. Profit growth expectations have been relatively steady for both 2024 and 2025, although we have noticed 2025 estimates moving modestly lower in recent weeks.

Outlook

We continue to encourage investors with long-term time horizons to look through any short-term volatility surrounding the upcoming election and embrace a "glass half full" view. The most important components of the economic landscape are generally positive. We have a Federal Reserve that has pivoted toward easing as annual inflation has cooled near policymakers' 2% target. Energy price inflation has been muted for over a year despite two active wars near oil-producing regions. We think it's hard to overstate the beneficial psychological and financial impacts of steady or declining gas prices on U.S. consumer spending. This may change in years to come with the potential for increased adoption of electric and hybrid vehicles. But for now, steady or lower prices at the pump are a clear tailwind for aggregate consumer purchases - which account for roughly 70% of U.S. GDP.

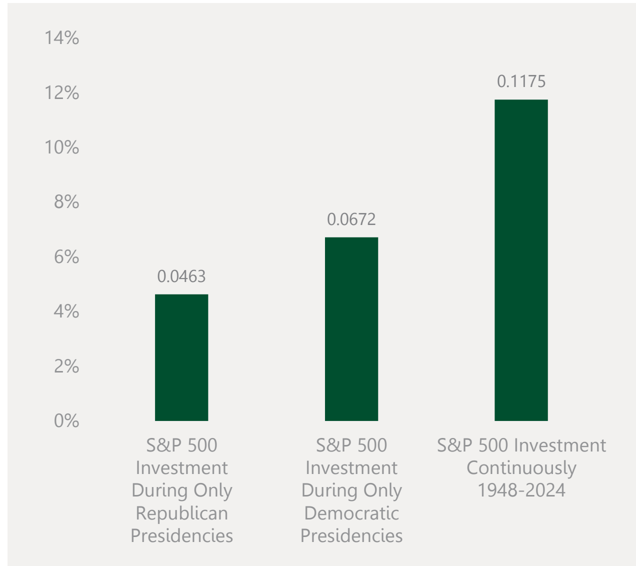
Even though we've seen recent volatility in the data, the U.S. labor market and consumer spending remain solid. Productivity has improved across the economy over the past several years coming out of the pandemic. Consumer confidence and small business confidence are admittedly low, but these types of sentiment surveys have become less useful as a leading gauge of economic activity in an era of elevated political polarization. Services sector strength has more than offset weakness in the global manufacturing sector.

We think it's difficult to argue that the combination of cooling inflation, a normalizing jobs market, strong corporate profit growth expectations, and a Federal Reserve with an easing bias can create the conditions for a recession in the U.S. This is important because periods of prolonged U.S. equity market weakness almost always overlap with recessions. Valuations at the index-level in large cap domestic stocks are extended but not at the extremes seen in bubble environments like the late 1990s. Modestly lower interest rates and an upturn in global cyclical industries could extend the broadening of market leadership we have seen in recent months.

Investors should probably expect an episode or two of market volatility in the days leading up to or immediately following Election Day on November 5. Although this particular election may feel uniquely intense, volatility around elections is quite normal as market pricing adjusts to the likelihood of policy changes. All other things equal, this could provide an opportunity to increase exposure to equity and credit allocations in client portfolios given the constructive fundamental backdrop and historical pattern of a strong final two months of the year for U.S. stocks during presidential election years. Although we think there could be a bit of upside risk to bond yields in coming weeks and months, we would likely recommend adding to duration at slightly higher levels. We expect short-to-intermediate-term U.S. government bonds and high-quality corporate bonds will play an increasingly important role in dampening the volatility of diversified portfolios due to the improved coupon cushion they offer after a two-and-a-half-year period of interest rate normalization.

CHART 6

Staying Invested = Best Long-term Strategy



Bloomberg. Data as of 9/30/24. Past performance does not guarantee future results. Returns shown are annualized and include every presidential administration from 1948 through 2024.

ECONOMIC FACTORS	CURRENT OUTLOOK
U.S. GDP Growth	We expect domestic economic growth to hold steady at an above-trend annualized rate of 2.0% - 2.5% in 4Q24 and 1Q25.
Federal Funds Rate	The Fed seems ready to cut its policy rate by another 0.25% in both November and December. The pace of easing may slow down in 2025.
Inflation	Disinflationary forces in the economy should push measures of core annual inflation from 3.0% to near 2.5% by the end of the year.
Employment	Monthly payroll gains around 150,000 and an unemployment rate under 4.5% in coming months would suggest a soft landing is underway.
Consumer Confidence	Still-elevated price levels and policy uncertainty following the election could weigh on sentiment in coming months.
Oil	Expectations of weak demand in China and Europe have offset escalating tensions between Israel and Iran to keep WTI around $70/barrel.
Housing	Housing market activity will probably remain suppressed until 30-year fixed mortgage rates drop another 100 basis points to near 6%.
International Economies	Above-trend GDP growth in India and Indonesia in 2024 is likely to be offset by weakness in China, the euro zone, and the UK.

	MINIMUM		NEUTRAL		MAXIMUM
FIXED INCOME			●		
Core Bonds				●	
TIPS	●				
Non-Investment Grade			●		
International	●				

CURRENT OUTLOOK

We prefer to hold short to intermediate-term US government bonds and investment-grade corporate bonds, which we expect will benefit from a de-inversion of the yield curve (when short rates decline while long rates stay anchored). We believe high quality bonds will play a key role in dampening the volatility of diversified portfolios in 2025 and beyond due to the improved coupon cushion they provide compared to most of the last 15 years.

If longer-term Treasury yields climb closer to 5%, we would consider extending the duration in client portfolios. We would expect Treasury and Fed officials to take various actions to stem increases in longer-term yields much above 5%.

U.S. high yield corporate bond spreads have narrowed by about 250 basis points since the regional banking turmoil in the spring of 2023, supported by resilient economic data and favorable supply-demand dynamics. Further spread tightening and declining yields would make high yield bonds less appealing.

	MINIMUM		NEUTRAL		MAXIMUM
EQUITIES			●		
Large Cap			●		
Mid Cap				●	
Small Cap		●			
Developed International			●		
Emerging Markets		●			

CURRENT OUTLOOK

The most important underlying components of the U.S. economy (aggregate job growth, wages, consumer spending) do not appear on the cusp of an imminent contraction. This is important because most extended periods of U.S. equity market declines over the last 70 years coincided with recessions. Now that the Fed has begun easing policy, the bar is even higher to be stategically underweight equities, even if valuations are extended relative to history.

Signs of an expansion of corporate earnings growth to more sectors and industries outside of the top 10 S&P 500 stocks so far in 3Q24 is a welcomed development. This could create the conditions for another leg of the current bull market that would likely prove more durable than the narrow leadership of 2023 and 1H24.

Given the balance of risks and opportunities, we think it makes sense to keep equity allocations focused on areas of the market that exhibit quality characteristics in terms of leverage, earnings volatility, and return on capital. If we see a cyclical reacceleration in the economy accompanied by lower interest rates, small cap, international, and value style stocks could become more appealing.

	MINIMUM		NEUTRAL		MAXIMUM
ALTERNATIVES*			●		
	Cap Pres	IWSG	Balanced	GWSI	Growth
Gold		●	●	●	
Hedged Equity					
Arbitrage					

CURRENT OUTLOOK

We recommend most portfolios maintain a moderate allocation to gold given our assessment that the economic, policy, and geopolitical backdrops remain well suited for the precious metal. The beginning of a Fed rate cut cycle, two active wars, and strong global central bank demand outside the U.S. should position gold to improve the risk-adjusted returns of portfolios in coming quarters. Our alternatives allocations, as seen in the table to the left, are designed to decrease the overall risk profile of our five investment objective-based portfolios (CAP PRES, IWSG, BAL, GWSI, and GROWTH.)

The above minimum/neutral/maximum recommendations represent RCB Bank Trust & Wealth Management's current positions relative to our Strategic Asset Allocation ranges. Views expressed have a six- to twelve-month horizon and are those of the RCB Bank Trust & Wealth Management.

*Cap Pres: Capital preservation; IWSG: Income with some growth; Bal: Balanced; GWSI: Growth with some income

RCB BANK
Trust & Wealth Management