

MARKET COMMENTARY

EQUITY ANALYSIS



A PIVOTAL POLICY MEETING

The Federal Reserve meets this week to determine the next steps for monetary policy. And while the Federal Open Market Committee appears divided as to the appropriate future course for policy, financial markets are positioned for significant rate cuts ahead.

As Chart A on page 3 shows, the futures market is betting on 5-6 rate cuts by the end of next year, ultimately lowering short-term policy rates to under 3% from today's rate near 4.5%. The committee meets under intense pressure to act as inflation remains well above target and amid signs of slippage in job growth.

SIGNS OF CURRENT AND ANTICIPATED INFLATION

Consumer prices are up 2.9% in a year through August, accelerating each of the past four months. Long-term inflation expectations priced into the bond market are also stuck near 2.4% as they have been ever since 2021. Perhaps more telling, however, is the surge in gold prices to a record \$3,600 per ounce from about \$1,750 an ounce in 2021. Year-to-date, gold is up 40% and the dollar index is off 11% in anticipation of aggressive monetary easing and efforts by some to hedge against such easing. Such large moves tell us that markets are ahead of the Federal Reserve in anticipating a significant monetary ease. However, accelerating consumer prices, a declining dollar, and surging gold all argues against a lowering of interest rates now.

JOB GROWTH STALLS, RAISING RECESSION ODDS

Confounding the policy choice is a darkening employment picture. Last month's puny 22,000 increase in non-farm payrolls was the fourth below-expectations monthly job report in a row. Further eroding the job picture was a major downward revision to previously estimated employment data wherein the Bureau of Labor Statistics revealed they overestimated the number of employed persons in the country by almost a million. The giant downward revision means that the employment situation is far closer to recessionary levels than previously thought. We also offer Chart B on page 4, which proves that growth in private

sector employment has now slipped below the "stall speed" that tended to precede recessions in previous cycles.

WHAT NEXT?

The contradictions of stubborn inflation with slipping job growth means that policymakers are likely to be of divergent views about what to do next. Arguments for and against a rate cut are both compelling based on the data above. For markets, the question of what comes next is just as vexing.

On Monday, Bloomberg News offered an analysis from Ned Davis Research which might shed some light (Chart C, page 4). The analysis studied the performance of various sectors following past rate cutting cycles. They found that when rates were cut significantly, the top performing sectors were defensive sectors like Healthcare and Consumer Staples, while the weakest performers were cyclical (Industrials) and Financials. Of course, it is important to note that the cause of the cuts is likely more relevant to the market's leadership than the cuts themselves. If rate cuts were prompted by gathering evidence of slowdown, it makes sense that defensive areas won out.

But this raises an even more interesting question. What would happen if the market only got two or fewer cuts? If cuts are deep, our preference for Quality should align with the historical tendency for defensives to lead. If cuts are shallow, cyclical leadership may emerge, but investors may also be forced to reassess stretched valuations.

This is a conundrum. If the Federal Reserve is forced to cut significantly, it will likely be motivated by further evidence of a slowing economy and job losses. This is not a good outcome for risky assets. On the other hand, if markets have run up in anticipation of rate cuts in the face of a growing economy, and then the rate cuts do not materialize, then market participants will likely ask "Why did we mark-up

asset values in the first place?” In either case, the delivered outcome will be disappointing — either the economy suffers an unexpected downturn, or financial markets realize that easing monetary conditions have been overestimated. It is hard to see an easy “out” to this dilemma.

PORTFOLIO POSITIONING

As we said earlier this year in a piece titled “Quality First: The Bedrock Principle,” we were in the midst of a low-quality rally where lower quality stocks were outperforming higher quality. We posited that this leadership was likely moving into its final stage as low quality stocks had led high quality for twenty-two months. The past year has seen the WCA Low Quality Index gain 25% versus the WCA High Quality Index as investors increasingly embraced risk (despite a brief tariff-induced reversal in early spring).

Further risk-on behavior by markets since the April lows only further pushes the quality pendulum toward low-quality. At some point this process will reverse. Investors will once again question whether they are being adequately compensated to take on risk or whether growth expectations priced into some high-flying areas are likely to be met. In either case, we believe that many will turn to the durability, flexibility, and predictability of currently overlooked, better valued, and higher quality issues.

There are more than a few puzzling contradictions confronting markets and policymakers alike this week as the Federal Reserve prepared to meet for what could be a pivotal meeting on policy. That is why we remain focused on high-quality companies whose durable cash flows can withstand shifting policy and economic crosscurrents.

CHART A | MARKETS PRICED FOR BIG CUTS

Source: Bloomberg

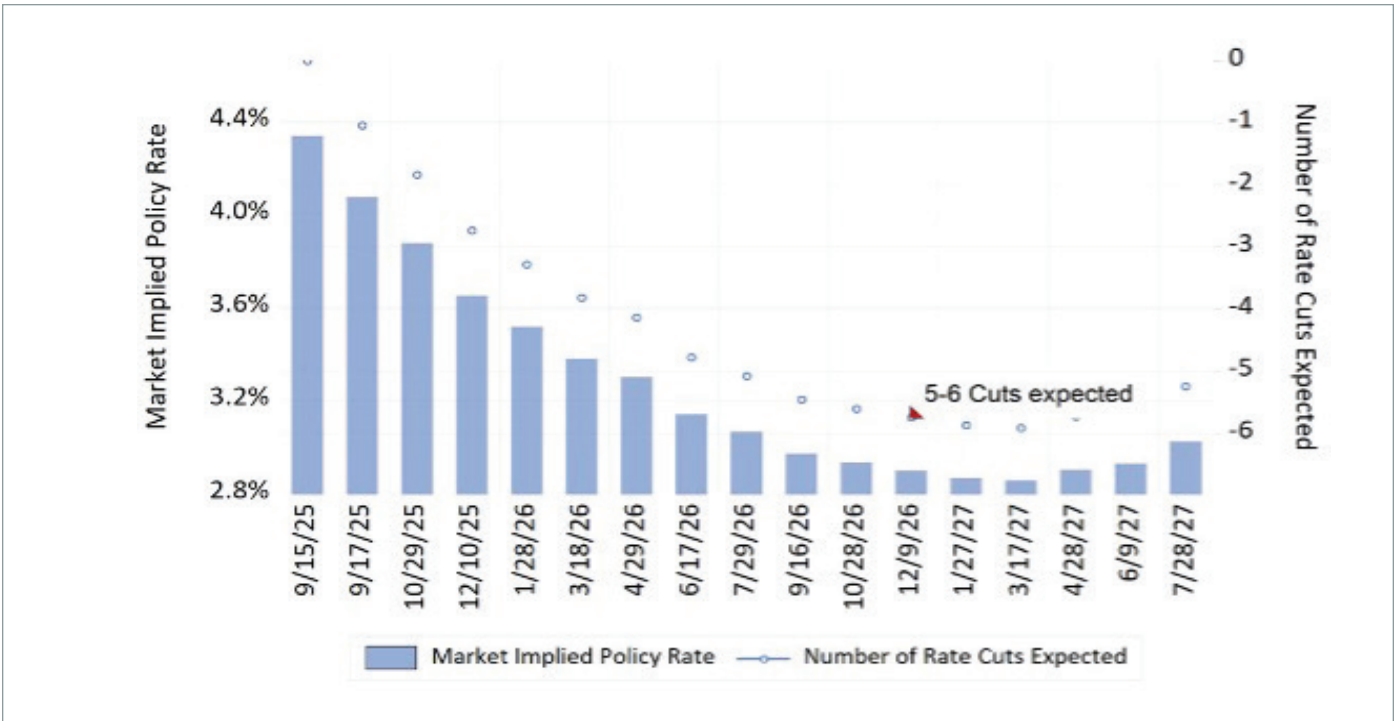
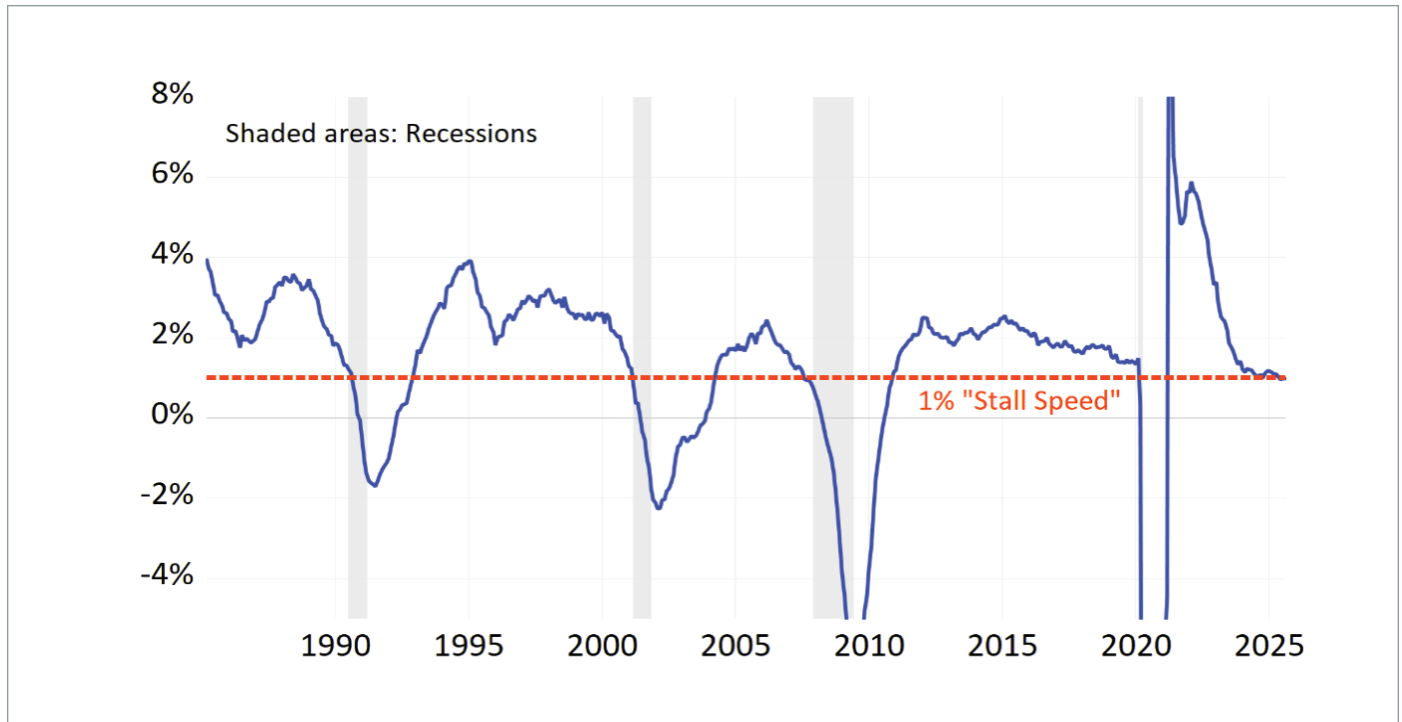


CHART B | U.S. PRIVATE SECTOR EMPLOYMENT (1-YEAR PERCENT CHANGE)

Source: Bloomberg

**CHART C | S&P 500 RETURNS AFTER FED INTEREST RATE CUTS RESUME**

Source: Ned Davis Research

Following a pause of six months or more

S&P 500 Sectors	Median Gain Two or Fewer Cuts	Median Gain Four or More Cuts
Healthcare	0.1%	20.3%
Consumer Staples	-2.7	19.9
Energy	6.4	18.0
Utilities	4.2	14.6
Communication Services	4.8	14.2
Materials	3.4	11.4
Real Estate	6.2	9.6
Consumer Discretionary	1.8	6.4
Information Technology	6.4	1.6
Industrials	9.4	1.5
Financials	6.4	-0.2

Source: Ned Davis Research

Note: Cases with four or more cuts after pause: 7/20/82, 3/7/86 and 7/13/90.

Cases with two or fewer cuts after pause 1/19/76, 11/22/76, 11/6/02, and 6/25/03

IMPORTANT DISCLOSURES

Standard & Poor's 500 Index (S&P 500) is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market.

The Washington Crossing Advisors' High Quality Index and Low Quality Index are objective, quantitative measures designed to identify quality in the top 1,000 U.S. companies. Ranked by fundamental factors, WCA grades companies from "A" (top quintile) to "F" (bottom quintile). Factors include debt relative to equity, asset profitability, and consistency in performance. Companies with lower debt, higher profitability, and greater consistency earn higher grades. These indices are reconstituted annually and rebalanced daily. For informational purposes only, and WCA Quality Grade indices do not reflect the performance of any WCA investment strategy.

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Beta is a measure of the volatility, or systematic risk, of a security or a portfolio relative to the market as a whole. A beta of one is considered as risky as the benchmark and is therefore likely to provide expected returns approximate to those of the benchmark during both up and down periods. A portfolio with a beta of two would move approximately twice as much as the benchmark.

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