Palisade Capital Management | Private Wealth

Q3 2024 REVIEW AND OUTLOOK

Broad Market Indices	INDEX LEVEL	3Q 2024 RETURN (%)	YTD 2024 RETURN (%)
S&P 500® Index	5,762	5.89	22.08
Dow Jones Industrial Average	42,330	8.72	13.93
NASDAQ Composite Index	18,189	2.76	21.84
Russell 2000® Index	2,230	9.27	11.17
MSCI ACWI ex US Index	481	8.06	14.21
Barclays U.S. Aggregate Bond Index	94	5.20	4.45
VIX Volatility Index	17	34.49	-22.80
Baltic Dry Index – Spot (Ocean Cargo Shipping Rate)	2,084	1.66	37.56
Gold ($ per ounce) – NY Spot	2,636	13.25	27.72
Oil ($ per barrel – West Texas intermediate)	68	-17.74	-5.22
Bitcoin ($)	63,197	4.75	43.67

U.S. Treasury Yields	9/30/24	6/30/24	Change over Quarter
3-Month	4.61	5.36	(0.75)
2-Year	3.64	4.72	(1.08)
10-Year	3.79	4.37	(0.58)

Source: FactSet Research Systems, Inc.

What Just Happened? The U.S. equity market (S&P 500® Index) rose by 5.9% in the third quarter, its third back-to-back quarterly win this year. Stocks also defied warnings of a rocky September by *gaining* 2.1% in the month. More important than the collective win/loss record of the market is the recent shift in stock market leadership away from a handful of mega-cap technology shares (the "Magnificent Seven" or "Mag 7" stocks like Amazon and Microsoft, for example) to a broader, more inclusive cohort. An *equal weighted* S&P 500® index – a stock index in which each member has the *same weight* at the start of the period – rose by 9.6% in the third quarter, outpacing the "tech-heavy" NASDAQ index, which rose by just 2.8% in the period. This was only the first time in the last eight quarters that a proxy for the *entire* stock market outpaced the more narrowly focused NASDAQ index.

The Great Rotation. The broadening of the American stock market is a healthy development, and one we believe is likely to have legs. We say this for two reasons:

First, the stock market reflects the economy itself. Consumers are ready to exhale again after the strains of the COVID-19 pandemic and its inflationary aftermath. After many quarters of low and stable unemployment (~4%), falling inflation (~2-3%), and healthy economic growth (also ~2-3%), investors and consumers alike might see this setup as the new normal. As Federal Reserve Board chair Jerome Powell said recently, it's time for the central bank – and, by extension, the rest of us – to "recalibrate" how to think about inflation, interest rates, and the economy's health.

So, how could this setup be bad for technology shares? Paradoxically, the high-flying and richly valued mega-cap technology shares have come to be viewed by investors as "safe haven" investments because of their great financial strength and creation of growth businesses in areas like cloud computing and artificial intelligence (AI). But these characteristics, as attractive as they may be, could lose their luster as the *exclusive* domain of large technology companies. AI, for example, will come into its own as an accelerant of economic growth when its benefits are widely distributed throughout the economy, and not benefit big tech companies alone. And when that distribution occurs, the "Mag 7" stocks might come down a peg in investors' estimation *relative* to the rest of the equity market.

Second, falling bond yields might increase the relative appeal of value stocks. Financial theory tells us that high-growth stocks benefit when interest rates fall, and they suffer when rates rise. That's *generally* true, but practice sometimes clashes with theory. Here's where the wires get crossed: when bond yields fall, as they have been trending in recent months, yield-focused investors seek replacements for their maturing bills and bonds, and that search may cut a path to higher yielding common stocks like, for example, utility, energy, and pharmaceutical shares – classic valuation sensitive stocks. The 10-year Treasury bond now yields 3.9% (as of October 4), down from nearly 5% last October. Several high-quality oil and drug company shares offer higher yields than that *and* have raised their dividend payouts steadily for decades.

In addition, the valuation gap between growth and value stocks compels attention. At the end of the third quarter, the forward price/earnings ratio of the equal weighted S&P® 500 Index was 18x versus 27x for the NASDAQ index. That gap alone could tilt capital flows toward value shares.

Relatedly, there's another factor that could accelerate the Great Rotation: qualified dividends. Most companies' cash dividend payments are considered "qualified" for federal income taxes, meaning they are taxed at relatively low rates: 20% for high-income filers (married couples with incomes greater than $550,000/year) and as low as 0% for joint filers with annual income below $90,000/year. We have no idea how the House, Senate, and presidency will fall between the Republicans and Democrats next year, but change *will* occur. There is some chance, not insignificant, that personal tax rates will increase. In that case, the value of qualified dividends could jump, which could further raise investors' preference for higher yielding common stocks (value stocks). We believe this development would likely support the Great Rotation, as would some legislators' wish to raise the corporate tax rate on share repurchases; in that event, corporations might opt to return more of their financial surpluses to shareholders through dividends rather than share repurchases. We note that divided government (where neither party controls *all* the levers of policy) is both likely *and* a brake on implementation of extreme programs, like sharp jumps in tax rates.

One other often overlooked point on dividends: Over many decades, dividends have accounted for the majority of stocks' returns. According to the research firm Strategas, dividends have constituted 59% of stocks' total return in the 93 years between 1930 and 2024. An outlier decade like the 2020s (dividends were just 15% of stocks' total return then) might have fooled a casual observer into believing that dividends are not so important to stock returns.

Dividend Contribution to Total Return

Decade	Price Pct. Change	Dividend Contribution	Total Return	Dividends Pct of TR	Avg Payout Ratio
1930s	-41.9%	56.0%	14.1%	100.0	90.1
1940s	34.5%	100.1%	134.6%	74.4	59.4
1950s	257.3%	180.3%	437.7%	41.2	54.6
1960s	53.7%	54.2%	107.9%	50.2	56.0
1970s	17.2%	59.1%	76.4%	77.4	45.5
1980s	227.4%	143.1%	370.5%	38.6	48.6
1990s	315.7%	115.7%	431.5%	26.8	47.6
2000s	-24.1%	15.0%	-9.1%	100.0	35.3
2010s	189.7%	66.9%	256.7%	26.1	35.2
2020s	74.8%	13.5%	88.4%	15.3	35.4
Average	**114.4%**	**87.8%**	**202.2%**	**59.4**	**52.5**

Source: Strategas; Data as of 8/31/2024.

What We Expect Ahead. The economy has a head of steam, and we expect shares to trend upward at least in the next few months. But U.S. shares are expensive by most historical yardsticks, and there are challenges ahead. As we look to 2025, we need clarity on some policy questions with regard to both monetary (interest rate) and fiscal (taxation) issues. Kicking the can down the road on our national debt may not be a luxury we can afford forever. Our gross national debt is now about 120% of GDP, and interest on the debt will soon exceed what the country spends annually on defense. Both presidential candidates have promised tax cuts that will exacerbate the debt problem. It seems to us the only realistic way out of our current debt dilemma will come with embracing policies that encourage growth. The proliferation of AI processes throughout the economy may be just one way of achieving a stair-step increase in productivity – and thus growth. We will monitor the situation carefully.

Thank you for allowing us to manage your investments. We aim to reward your faith in us for years to come.

Sincerely,
Palisade Capital Management

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The S&P 500® Index is an unmanaged index that is widely recognized as an indicator of general market performance, based on the market capitalizations of 500 large companies having common stocks listed on the NYSE or NASDAQ. The S&P 500® Index does not have a defined investment objective, nor does it charge fees and expenses.

The Dow Jones Industrial Average (The Dow), is a price-weighted measure of 30 U.S. blue-chip companies. The index covers all industries except transportation and utilities.

The NASDAQ Composite Index measures all NASDAQ domestic and international based common type stocks listed on The NASDAQ Stock market.

The Russell 2000® Index (the "Index") measures the performance of the small-cap segment of the U.S. equity universe. It consists of approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. Source: London Stock Exchange Group plc and its group undertakings (collectively, the “LSE Group”). © LSE Group 2024. FTSE Russell is a trading name of certain of the LSE Group companies. Russell® is a trade mark(s) of the relevant LSE Group companies and is used by any other LSE Group company under license. All rights in the FTSE Russell indexes or data vest in the relevant LSE Group company which owns the index or the data. Neither LSE Group, nor its licensors, accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company's express written consent. The LSE Group does not promote, sponsor, or endorse the content of this communication.

The MSCI ACWI Ex-U.S. is a stock market index comprising of non-U.S. stocks from developed and emerging markets. The Index is made up of constituents which make up approximately 85% of the global equity market aside from the U.S.

VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market's expectation of 30-day volatility. It is constructed using the implied volatilities of a wide range of S&P 500® Index options.

The Bloomberg Barclays U.S. Aggregate Bond Index covers the USD-denominated, investment-grade, fixed-rate, taxable bond market of SEC-registered securities.

The Baltic Dry Index (BDI), is issued daily by the London-based Baltic Exchange. The BDI is a composite of the Capesize, Panamax, and Supramax Timecharter Averages. It is reported around the world as a proxy for dry bulk shipping stocks, as well as a general shipping market bellwether.

West Texas Intermediate (WTI) is a grade of crude oil used as a benchmark in oil pricing and is the underlying commodity of the New York Mercantile Exchange’s oil futures contracts.

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