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Interest Rate Cuts Coming?

July 15, 2024

Dear Friends,

I hope this letter finds everyone in good health, enjoying their summer travel, and seeing their loved ones. To my surprise, the markets have remained tranquil and continue to perform well. As I write this in mid-July, the S&P 500 sits at an all-time high.

As I mentioned last quarter, the period between May and November is often volatile, especially in an election year. Markets do not like uncertainty, and as of now, there is some very real uncertainty surrounding President Biden's future as his party's nominee. I've enclosed an article that I think will assist readers with putting things in perspective. If you're viewing this online, you can check out that article ***here***.

Recently, I was reexamining previous newsletters I've sent out. On top of page 2 of the **Q2 April 2022** letter titled ***"Are Things Getting Better or Worse,"*** I referred to a conversation with a friend on the equity/stock research side of my business. (You can view previous letters on my website: antonemercurio.com.) We were discussing the potential for a recession since the Federal Reserve had just begun aggressively raising interest rates. His answer was, **"The lag time is between 2-3 years from the beginning of the rate hiking cycle to the beginning of a recession."** As I write, we're about 2.5 years into it.

I've had a lot of interesting discussions with some very smart people this past quarter. No one I'm talking to is warning of a recession, but most feel the economy is slowing and the labor market is weakening. All but one felt there would be interest rate cuts by 2025 at the latest. No one was preoccupied with the election outcome's effects on the economy. However, they do focus on what sectors of the market will do well if Republicans are in control vs. if Democrats are in control. The favored sectors if Republicans gain control seem to be: Energy (especially Oil/Gas), Banks, Insurance, and Defense companies. If Democrats come out on top: Green Energy, Telecom, Homebuilders, and Tech Manufacturing. I don't want to get too far off topic, but I always ask, "What should my clients know about that they aren't hearing about in the media"? One interesting answer was, *"The quiet revolution in healthcare that doesn't have to do with weight loss drugs."* The enclosed article summarizes that technology, or you can read it ***here*** if you're viewing this online.

By far, the most interesting discussion was with Sejal Penkar, Director of Fixed Income Markets at the esteemed Capital Group. She's impressively smart and has a knack for explaining complicated subjects to a guy like me. I don't get a chance to speak with her often, so it was good to hear her thoughts on things. In short, she sees an interest rate cut before the end of the year and continued cuts into 2026.

Enjoy the rest of the summer!

Sincerely,

Antone Mercurio CFP®

P.S. I finished writing this letter on Friday July 12th. The next day the big news broke: an attempt was made on former President Trump's life in Pennsylvania over the weekend. In times of crisis, we often see America at its best, coming together in the face of adversity. My hope is that this dreadful act will serve as a wake-up call, reminding us that above all, we are Americans, and that our shared humanity is stronger than any division. The markets have remained steady for now, but as we draw closer to the election, I urge you to be prepared for volatility. Above all, prioritize your safety. God bless America.

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MENU

The health care breakthrough that's not an obesity drug

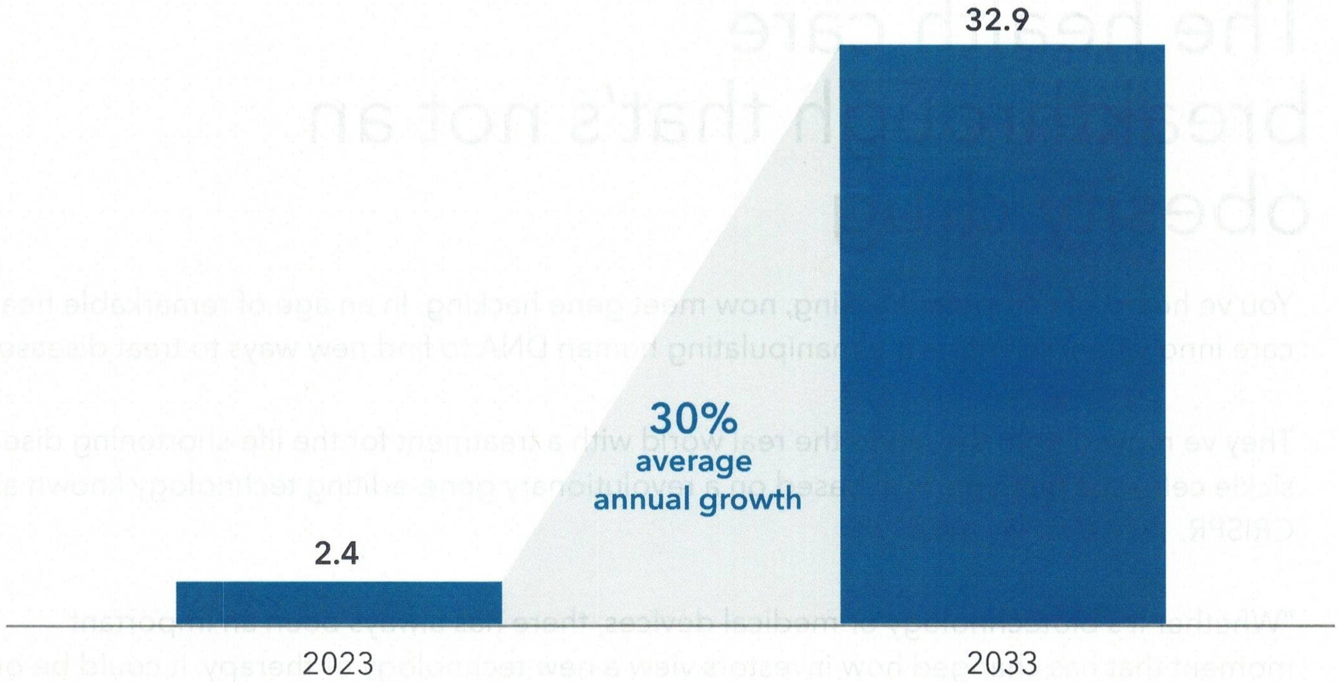
You've heard of computer hacking, now meet gene hacking. In an age of remarkable health care innovation, scientists are manipulating human DNA to find new ways to treat diseases.

They've moved from the lab to the real world with a treatment for the life-shortening disease sickle cell – the first approval based on a revolutionary gene-editing technology known as CRISPR.

"Whether it's biotechnology or medical devices, there has always been an important moment that has changed how investors view a new technology or therapy. It could be one major success or a series of successes, and we are seeing pockets of that now across health care," says Rich Wolf, portfolio manager for The New Economy Fund®.

Gene editing is set to expand over the next decade

Estimated global market size of CRISPR gene editing (USD billions)



Source: Statista. As of January 2023. CRISPR stands for "clustered regularly interspaced short palindromic repeats."

Novo Nordisk's and Eli Lilly's weight loss drugs, originally developed for the treatment of diabetes, are prime examples. The drugs, sold under the brand names Ozempic, Wegovy and Zepbound, could reshape industries beyond health care.

Meanwhile, cell and gene therapy companies are forging their own paths. These therapies can modify, replace, activate and disable genes. And rather than outright change human DNA, some companies are working on ways to moderate or fine-tune how they're expressed.

"Approvals for genetic disorders based on a single gene such as sickle cell are just the beginning for gene-editing therapies," Wolf says. "There will be more to come, but it won't be a linear progression. We need to see these technologies work for diseases that affect a wider patient population. There's a lot of wood to chop before that happens, but I believe we will get there."

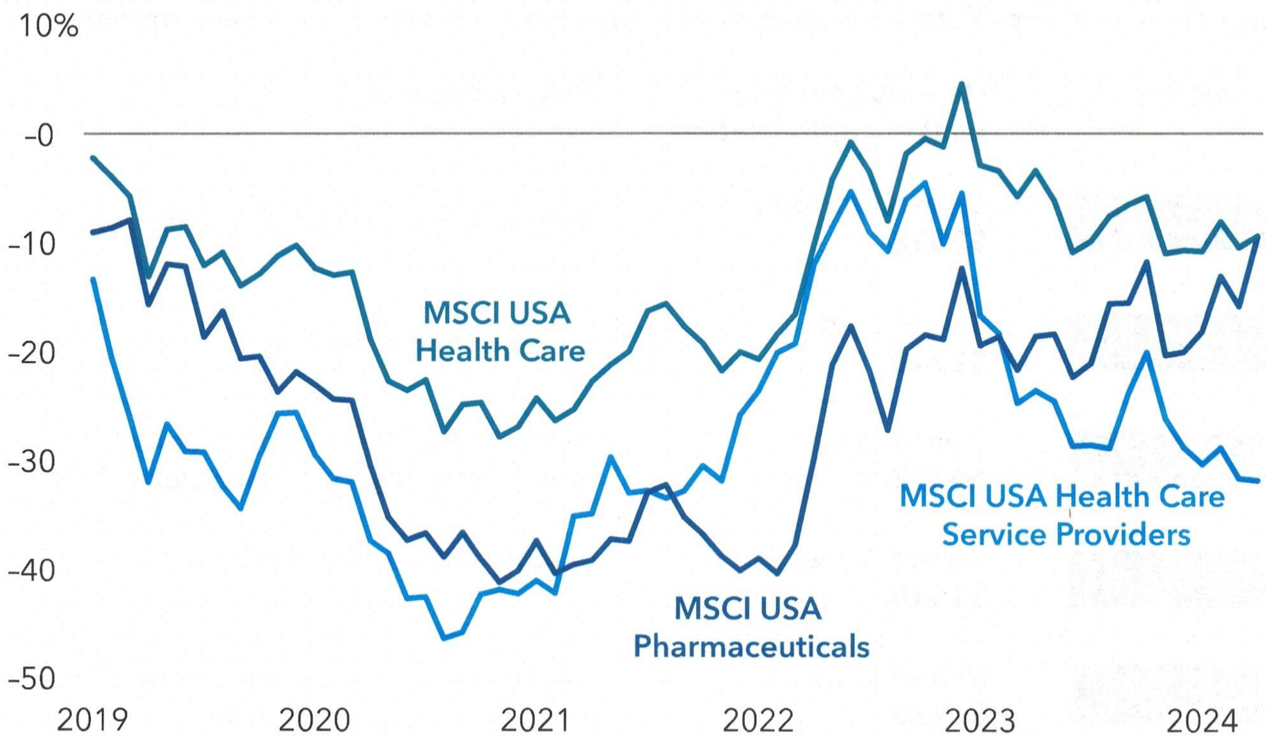
The science and the share price

Biotech investing is notorious for hype not quite meeting reality. More recently, the Federal Reserve's monetary tightening policy siphoned capital away from more speculative investments like biotech.

Many companies were also caught flat-footed as demand for pandemic-era innovations, such as vaccines, dropped faster than projected, adds Wolf. "There was tremendous excitement over anything that was going to treat the pandemic, and valuations spiked in a big way. The bubble has since burst, particularly for companies with their revenue potential tied to the pandemic."

Health care stocks appear undervalued relative to the broad market

Relative P/E valuations – MSCI USA Health Care and sub-sectors vs. MSCI USA



Sources: Capital Group, MSCI. Relative valuation is the ratio between the forward 12-month price-to-earnings (P/E) ratio of the health care-related sectors and the MSCI USA Index. P/E for a stock is computed by dividing the price of a stock by the company's annual earnings per share. A value below zero indicates that health care is relatively undervalued. As of April 24, 2024.

Nevertheless, it's an industry that long-term investors can't ignore. Health care spending in the United States reached $4.5 trillion in 2022, according to the Centers for Medicare and Medicaid Services, or 17.3% of U.S. GDP. Valuations have improved for industries within health care. Since the start of 2024, investors have returned to health care stocks. And if interest rates decline, that could support continued capital flows into the industry.

When you're on the cutting edge of science, there will always be failures. Significant hurdles remain for widespread adoption of cell and gene therapies, and health care investing is a decades-long endeavor. "The framework I follow considers the potential future earnings and the probability of success. In the case of biotech, I like to start with small allocations, which I'll add to once the technology passes the threshold of helping a larger patient population or disease," Wolf explains.

Biotech charges forward

Health care companies are racing to define how diseases are treated. Cell and gene therapy companies – including Vertex Pharmaceuticals, Gilead Sciences and Amgen – are going after the same diseases that weight loss drugs are targeting in the kidney, liver and heart, as well as cancers, autoimmune disorders and others.

Companies are developing cell and gene therapies for many diseases

Largest pharma and biotech companies with gene and cell therapies in development

Company	Headquarter and market capitalization	Target diseases
AstraZeneca	United Kingdom **$233B**	Rare diseases, metabolic disorders
Novartis	Switzerland **$224B**	Rare genetic diseases
Roche	Switzerland **$168B**	Hemophilia, Huntington's, spinal muscle atrophy, ophthalmology
Amgen	United States **$144B**	Oncology and rare diseases
Pfizer	United States **$143B**	Single-gene defects, neuromuscular and hematologic diseases
Vertex	United States **$102B**	Cystic fibrosis, sickle cell disease, beta thalassemia

Sources: Capital Group, MSCI, Drug Discovery & Development. Company examples include constituents of the MSCI All Country World Pharmaceuticals, Biotech and Life Sciences Index that fall within the top 15 largest companies by market capitalization and have gene editing and cell engineering candidates in current development as of March 10, 2023. Market capitalizations as of April 25, 2024.

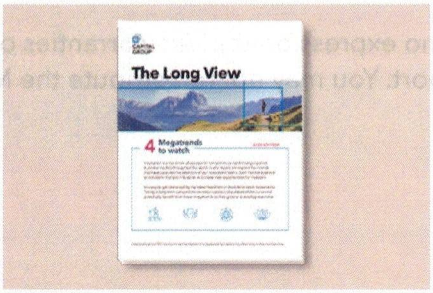
In the case of cell therapy, cells are modified outside the body and then infused into patients. One specific type is commonly known as CAR-T. It has gained approval to treat certain blood cancers. CAR-T stands for chimeric antigen receptor, with the T referring to a type of immune cell modified to find and destroy cancer cells.

Current CAR-T treatments use a patient's own cells and are limited by the long, complex journey involved for patients, manufacturing challenges and high costs. "Treatments may become more accessible and safer as scientists develop off-the-shelf techniques derived from unrelated donor cells," says biopharmaceuticals and biotechnology analyst

Christopher Lee. "Additionally, I believe companies will go beyond using T-cells and incorporate other types of cells over the next decade."

Another area of cell engineering is focused on modifying stem cells to replace missing or defective cells. For example, Vertex aims to cure Type-1 diabetes by transplanting insulin-producing cells into the pancreas, a program currently in human clinical trials.

Yet another promising innovation is RNA-interference (RNAi). This technology allows companies to create highly specific therapies that turn off the production of proteins that cause disease. Biotech company Alnylam is currently developing programs in areas such as heart failure, hypertension and Alzheimer's.



The Long View: 4 megatrends to watch

"The idea that you're not irreversibly changing the DNA is compelling, but like most health care innovation, safety is paramount," says equity analyst Judith Finegold, who focuses on U.S.-based biopharmaceuticals.

Every patient population has a different risk profile. "There are programs underway to irreversibly gene edit your liver to treat high cholesterol, and in 15 years that could be the answer, but we need to really understand the safety profiles for drugs because having high cholesterol is not a death sentence," she adds.

Richmond Wolf *is an equity portfolio manager with 27 years of investment experience (as of 12/31/2023). He also covers U.S. medical technology companies and REITs as an equity investment analyst. He holds a PhD from the California Institute of Technology and a bachelor's from Princeton.*

Christopher Lee *is an investment analyst with research responsibility for U.S. pharmaceuticals and biotechnology. He has 16 years of investment industry experience (as of 12/31/2023). He holds a medical degree from Columbia University and a bachelor's degree in molecular biophysics and biochemistry from Yale.*

Judith Finegold *is an equity investment analyst with eight years of industry experience (as of 12/31/2023). She holds a PhD from Imperial College London, an MBA from INSEAD and a degree in medicine from the University of Cambridge and University College London.*

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The **MSCI USA Health Care Index** is designed to capture the large- and mid-cap segments of the U.S. equity universe. All securities in the index are classified in the health care industry.

The **MSCI USA Pharmaceuticals and MSCI USA Health Care Service Providers Indexes** are subcomponents of the MSCI USA Health Care Index and only contain companies within each respective industry.

The **MSCI All Country World Pharmaceuticals, Biotech and Life Sciences Index** is composed of large- and mid-cap stocks across 23 Developed Markets countries. All securities in the index are classified in the Pharmaceuticals, Biotechnology and Life Sciences industry group (within the Health Care sector) according to the Global Industry Classification Standard (GICS®).

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Market Bulletin

Investing in an election year

Published: 01/22/2024

Meera Pandit
Global Market Strategist

In brief

- Don't let how you feel about politics overrule how you think about investing.
- Markets don't like uncertainty; elections almost always reduce it.
- Market timing is just as difficult around elections as it is at any other time.
- Past performance during elections and presidencies indicates little about future results.
- The economy and markets tend to fare well under all configurations of government.

Presidential elections always add an extra element of uncertainty to investing, and after a halcyon 2023 in equity markets, could come as a shock to investors. On top of assessing the path of the Federal Reserve, the stability of profits and the consumer, and navigating economic resilience vs. recession, investors will have to grapple with the barrage of headlines about the 2024 election. Although uncertainty can create opportunity, investors often make their worst mistakes during uncertain times, which can sometimes take years for portfolios to recover from. Therefore, maintaining a disciplined approach to investing is critical to achieving one's long-term investment goals. In that light, we have compiled five key principles for investing in an election year.

Don't let how you feel about politics overrule how you think about investing.

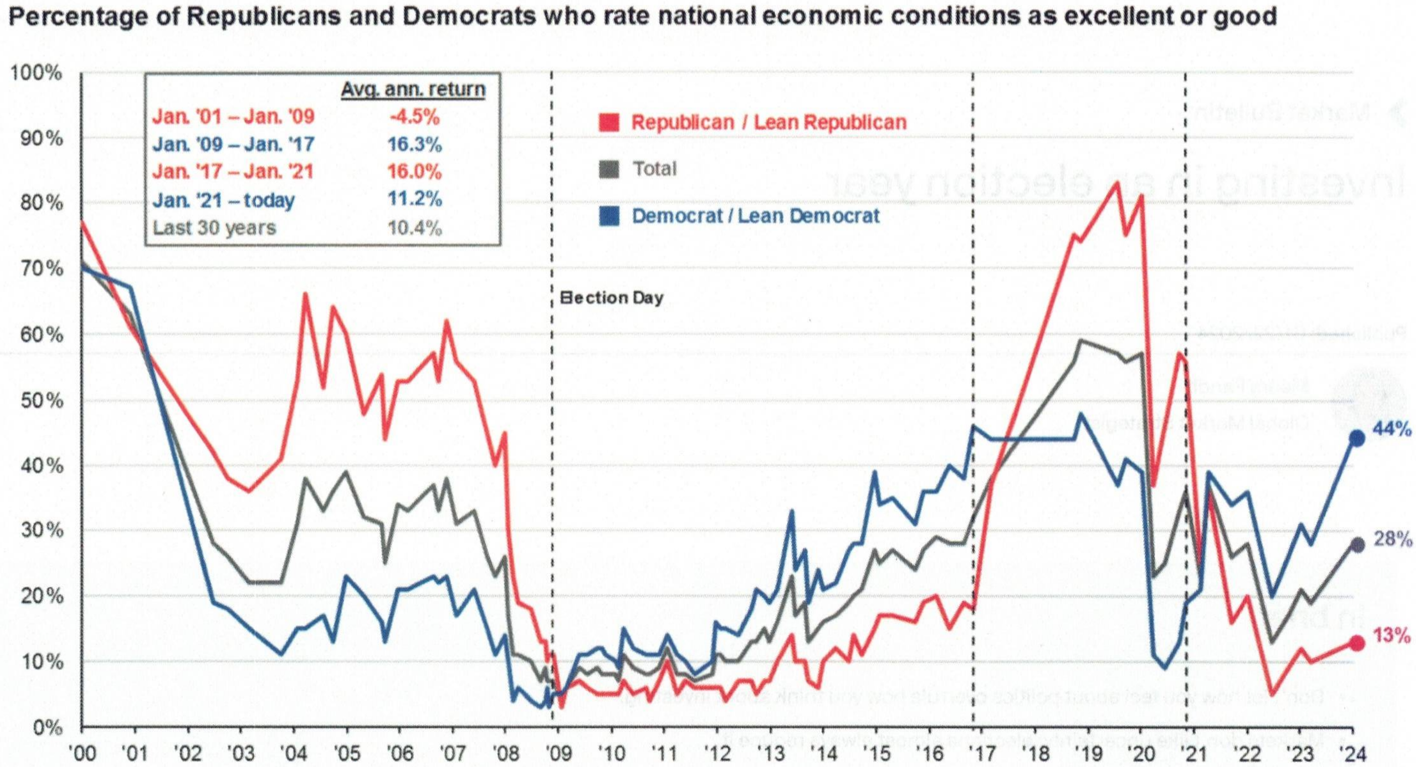
Political opinions are best expressed at the polls, not in a portfolio. One cardinal rule investors ought to follow: Don't let how you feel about politics overrule how you think about investing.

Exhibit 1 shows a survey from the Pew Research Center asking Americans how they feel about economic conditions. The results show that Republicans often feel better about the economy under a Republican president, while similarly Democrats often feel better about the economy under a Democratic president. Investors often make portfolio decisions based on their economic outlook.

Yet, average annual returns on the S&P 500 during the Obama administration of 16.3% and during the Trump administration of 16.0% were almost identical and higher than the average return over the last 30 years of 10.4%. It is likely the macro conditions, like ultra-low interest rates enjoyed during both Obama and Trump administrations, were a more influential driver of above-average returns during those periods, rather than the policy prescriptions each president espoused.

Investors who allowed their political opinions to overrule their investing discipline may have missed out on above-average returns during political administrations they didn't like.

Exhibit 1



Source: Pew Research Center, J.P. Morgan Asset Management. Pew Research Center, "Republicans, Democrats Move Even Further Apart in Coronavirus Concerns." Question: Thinking about the nation's economy, How would you rate economic conditions in this country today... as excellent, good, only fair, or poor? The survey was last conducted in January 2024.

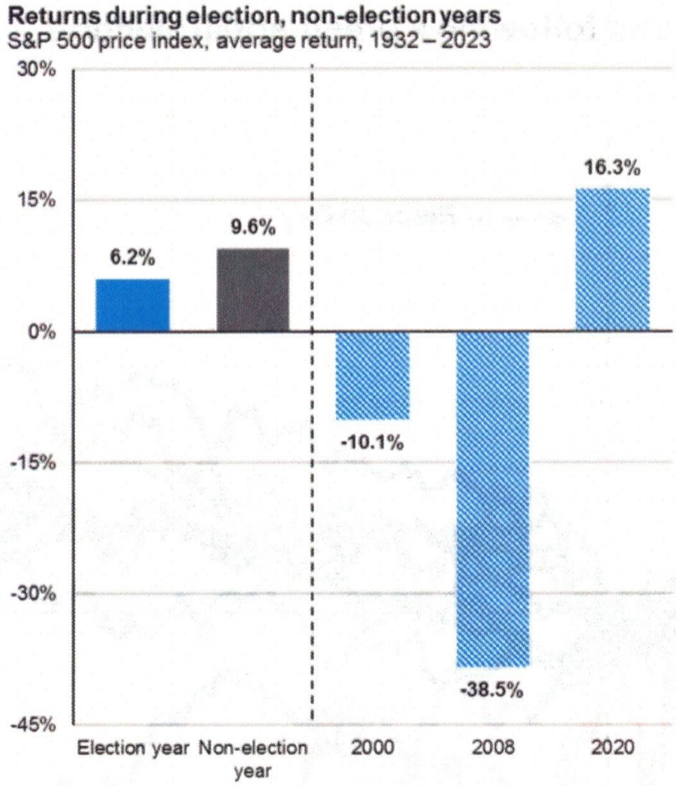
Guide to the Markets – U.S. Data are as of February 29, 2024.

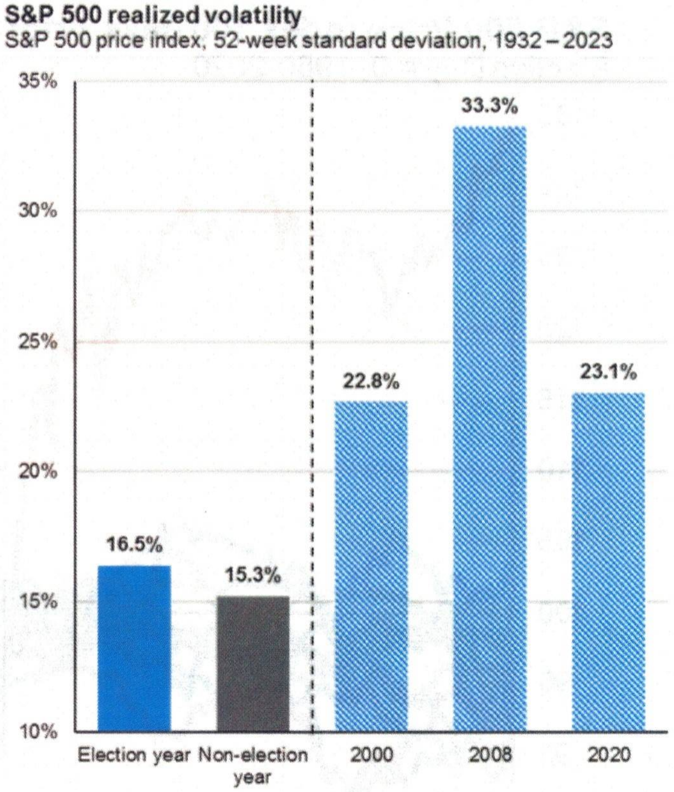
Markets don't like uncertainty; elections almost always reduce it.

During election years, returns tend to be lower and volatility tends to be higher because markets do not like uncertainty and elections breed uncertainty. Since 1932, S&P 500 returns on average were 6.2% during election years vs. 9.6% during non-election years. Realized volatility was 16.5% during election years and 15.3% during non-election years **(Exhibit 2)**. The average market drawdown in a given calendar year since 1980 was 14.2%, but 16.3% in election years vs. 13.5% in non-election years.

However, averages don't tell the full story as recent presidential election years have been particularly volatile with historic market drawdowns. For example, the 2000 sell-off was related to the bursting of the tech bubble, 2008 was the onset of the financial crisis, and 2020 was the onset of the pandemic. 2020 experienced a sharp correction and then a strong rebound, both completely unrelated to the election.

Exhibit 2





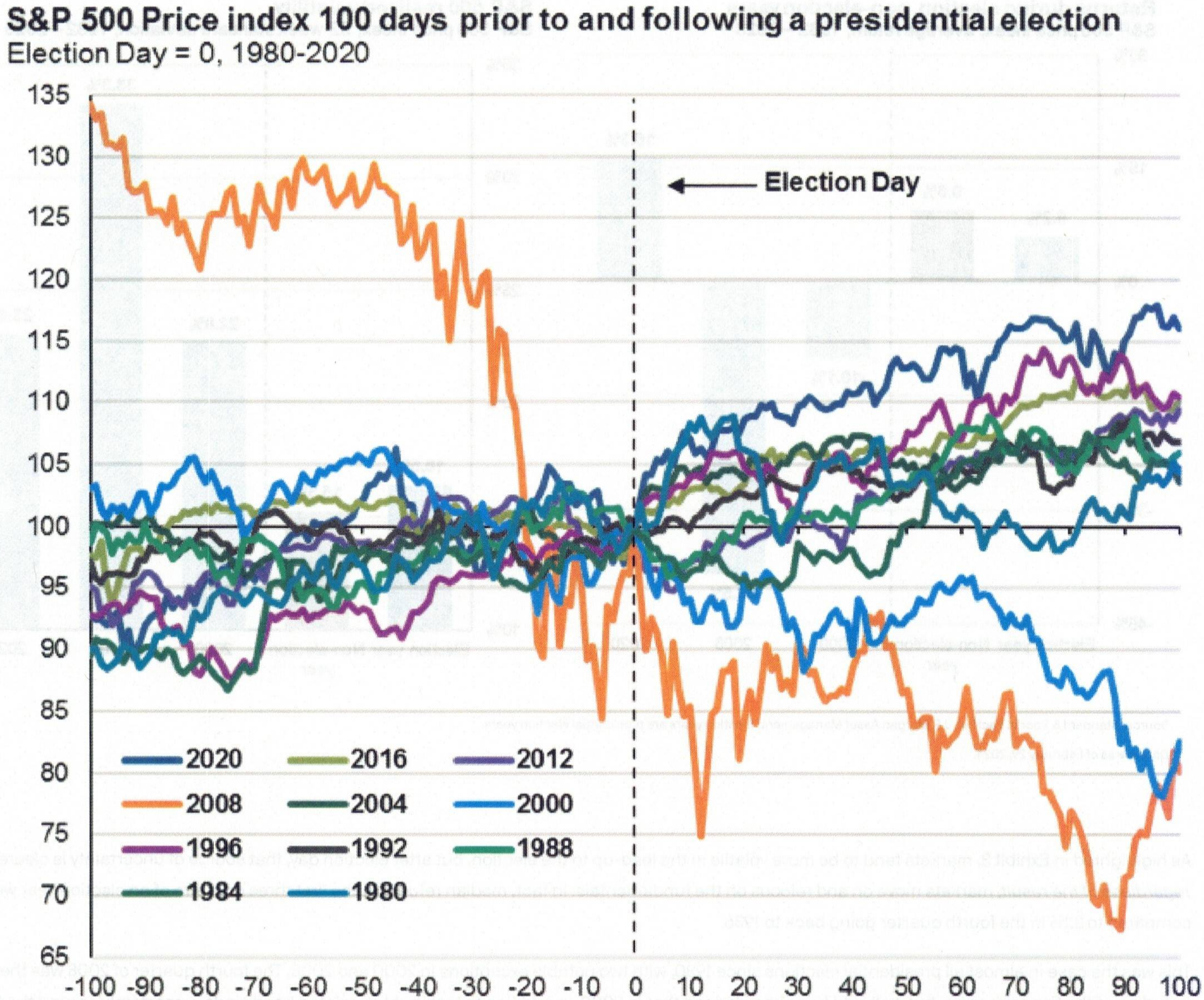
Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management. Election years are presidential election years.

Data are as of February 29, 2024.

As highlighted in **Exhibit 3**, markets tend to be more volatile in the lead-up to the election, but after election day, that source of uncertainty is cleared, and, *regardless of the result*, markets move on and refocus on the fundamentals. In fact, median returns in the first three quarters of an election year were 1.9% compared to 3.1% in the fourth quarter going back to 1936.

This was the case in almost all presidential elections since 1980, with two notable exceptions in 2000 and 2008. The fourth quarter of 2008 was the unfurling of the financial crisis, but it should be acknowledged that in 2000, in addition to tech bubble-related headwinds, uncertainty around the fate of the election did cause market jitters. In the presidential election of 2000, we did not get official election results until a Supreme Court ruling on December 12, 2000. The S&P 500 fell by 4.2% between the election and that ruling. In contrast, markets were up 4.2% between election day 2020 and the following Saturday when the official result was declared.

Exhibit 3



Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management.

Data are as of February 29, 2024.

Market timing is just as difficult around elections as it is at any other time.

That is why market timing can be a dangerous strategy around elections. The two most recent presidential elections in 2016 and 2020 are prime examples of this. In the early hours of November 9, 2016, futures plummeted as election results were coming in, but markets closed 1.1% higher after that day's regular trading session when the results were finalized, and as mentioned, markets rallied strongly after the 2020 election. In fact, in both cases there was a pre-election rally of 3% between the prior Friday and election day itself, so markets turned before many ballots were even cast. Some investors are eager to sit on the sidelines until election uncertainty passes, but risk missing subsequent rebounds which typically occur faster than investors can get back into the market.

Past performance during elections and presidencies indicates little about future results.

Investors always want to know how markets performed under different configurations of government or different years of a presidency. How do markets perform under a Republican sweep or Democrat sweep? What if a Republican wins the White House but loses both chambers of Congress? How do returns look in the first year of a presidency?

This information is relatively easy to compute but these returns tell investors very little about why markets performed the way they did and how markets are likely to perform in the future. Monetary policy, fiscal policy, economic growth, labor markets, corporate profits, and valuations are much better indications of future returns. Fiscal policy is driven by the government of course, but the configuration of the government matters and a sweep by one party doesn't guarantee that it will accomplish all its campaign promises. In fact, due to growing political polarization, garnering consensus within a party is becoming increasingly difficult. For example, when the Democrats controlled Congress, President Biden had an ambitious Build Back Better proposal, which was later scaled down to a more moderate Inflation Reduction Act as a compromise between members of his own party.

Furthermore, just as calendar years are arbitrary markers when considering economic and market cycles, they also seldom align with actions of presidential administrations.

The economic context, not the political context, tends to be much more relevant to understanding historical market environments and returns.

The economy and markets tend to fare well under all configurations of government.

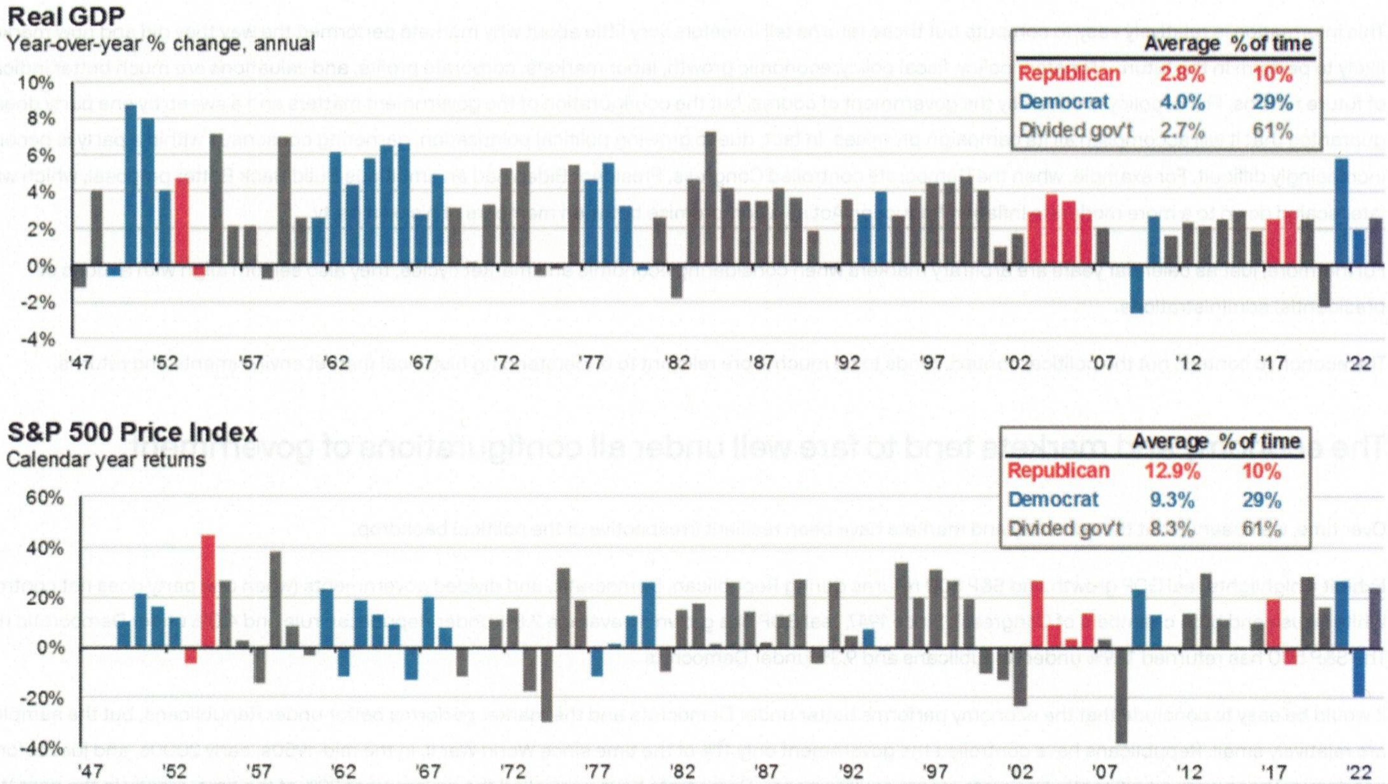
Over time, we observe that the economy and markets have been resilient irrespective of the political backdrop.

Exhibit 4 highlights real GDP growth and S&P 500 returns during Republican, Democratic, and divided governments (when one party does not control the White House and both chambers of Congress). Since 1947, real GDP has grown on average 2.8% under Republican rule and 4.0% under Democratic rule. The S&P 500 has returned 12.9% under Republicans and 9.3% under Democrats.

It would be easy to conclude that the economy performs better under Democrats and the market performs better under Republicans, but the sample sizes are relatively small. Republicans have controlled the government only 11% of the time since World War II, in the mid-1950s, early 2000s, and just before the pandemic. These were significantly disparate macro environments. Democrats have controlled the government 29% of the time, mostly in the post-WWII period and in the 1960s, but only in six years over the past three decades. Instead, the most common configuration of government is divided, which has produced 2.7% annualized real GDP growth since World War II, and 8.3% annualized returns on the S&P 500.

Ultimately, both the economy and markets tend to fare well under most government configurations.

Exhibit 4



Source: BEA, Standard & Poor's, FactSet, J.P. Morgan Asset Management. Data is calendar year.

Guide to the Markets – U.S. Data are as of February 29, 2024.

The outcomes of elections of course are incredibly consequential, but the impacts to the economy and markets may not always be direct, immediate, or apparent. It is therefore nearly impossible to design an effective and repeatable investment strategy around an election cycle or anticipated political outcome. Instead, investors should let their long-term goals, time horizon, and risk tolerance dictate their portfolios, not the political cycle.

The information presented is not intended to be making value judgments on the preferred outcome of any government decision or political election.

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