Wespath

Investment Services Driven by Your Mission

A Message from Chief Investment Officer

Johara Farhadieh

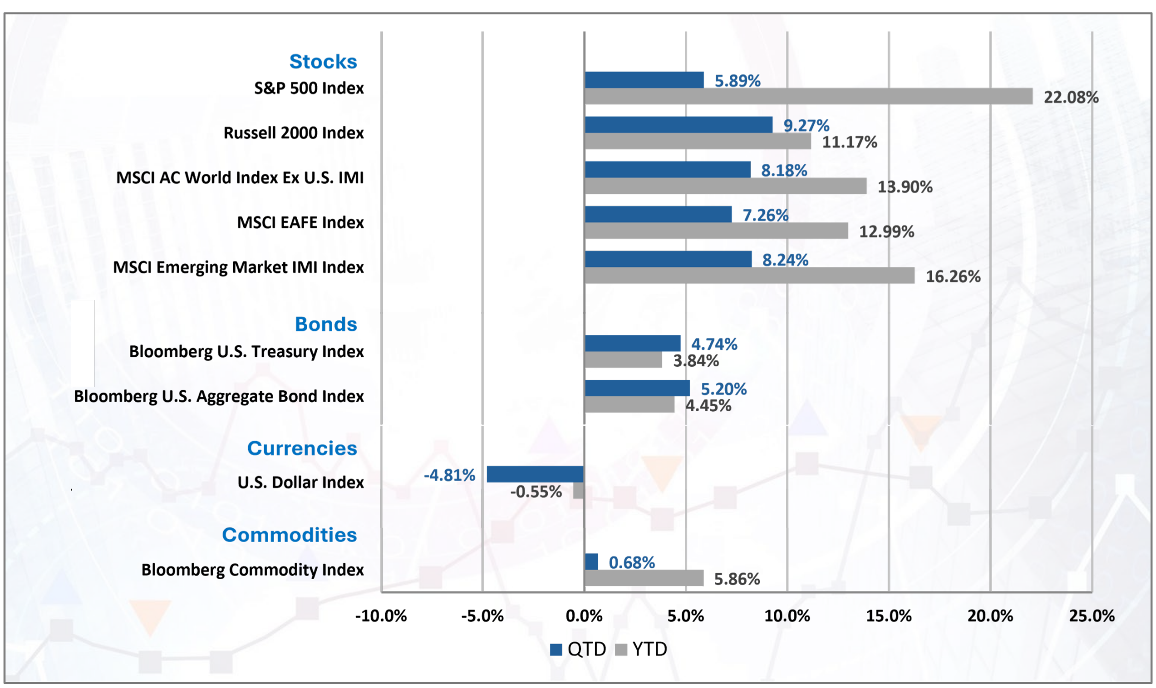
Welcome!

Thank you so much for checking out Wespath's inaugural quarterly letter for institutional investors. Since stepping into the CIO role in August, I have emphasized our dedication to meeting your needs—not just through our fund offerings, but also through more comprehensive and informative communication. These new letters will provide our investors with relevant market and fund information, along with valuable perspectives from our great investment management, sustainable investing and institutional services teams.

We hope you find it engaging and useful!

Key Takeaways from Q3

- **GDP**—U.S. GDP growth for the third quarter is estimated at 2.5%, per the Atlanta Fed's GDPNow forecast. U.S. GDP grew at 3.0% in Q2, slightly stronger than the 2.5% growth seen in 2023.
- **Inflation**—U.S. inflation continues to cool, with the Consumer Price Index (CPI) rising 2.5% year over year in August. This is down from 2.9% in July and represents the lowest CPI reading since February 2021.
- **Jobs**—The unemployment rate in the U.S. dropped to 4.2% in August from 4.3% in July. However, this rate is higher than the 50-year low of 3.4% witnessed in 2023, and there have been some downward revisions to 2024 data so far this year.
- **The Fed**—On September 18, the Federal Reserve (Fed) cut its benchmark rate by 50 basis points. The Fed's post-meeting statement indicated this move was motivated by softer inflation and economic growth expectations.
- **Stocks**—The S&P 500 gained 5.9% for the quarter and is now up 22.1% year to date. In international stock markets, both the MSCI ACWI ex-U.S. IMI and MSCI Emerging Markets IMI indexes rallied 8.2% in Q3.
- **Bonds**—Yields fell following the Fed's rate cut, and bond prices moved higher. The Bloomberg Aggregate U.S. Bond Index gained 5.2% for the quarter and is now 4.5% higher for the year.
- **China**—Chinese stocks surged at the end of September following news that China's government would soon launch its most aggressive economic stimulus efforts since the pandemic. The stimulus includes both rate cuts and fiscal support measures aimed at supporting China's cooling economy. The Shanghai Composite Index gained more than 21% in the five days following the stimulus announcement.



Beyond the Headlines

Not Too Hot, Not Too Cold?

Many investors have been expecting a much slower U.S. economy, or even a recession, since early 2023. Yet here we are, 20 months later, and GDP growth remains just under 3%. Many of our clients are understandably curious: Why have so many economists and market pundits gotten it wrong?

For starters, forecasting has always been and will always be hard. And in recent years, it's only gotten harder. Since early 2020, we've had COVID, massive COVID-related responses (from widespread shutdowns to major economic stimulus), the normalization of hybrid work, changes to global supply chains, and countless other seismic events and trends.

Remember when inflation was ripping higher in 2021, and the Fed was confident it was "transitory"…? Looking back, we see the Fed and other economists couldn't accurately model the impact of COVID relief funds and easy monetary policy. The same appears to be true today estimating the path of growth and inflation—there's nothing in history quite like the last four years, and existing forecasting models have their limitations.

Today, some have speculated that we may experience some period of the "Goldilocks" scenario we've written about before, where the economy is neither too hot nor too cold. Growth has remained strong. Employment is solid but slowing. Inflation is cooling, and the Fed is starting to lower interest rates in response to the few pockets of weakness we have seen. It's still too early for victory laps, but some characteristics of that Goldilocks scenario have emerged.

Rotation Into Small Caps

While stocks were largely up in Q3, it wasn't a completely uneventful quarter for equity markets. An unwinding of the "Japanese yen carry trade" caused some volatility in early August. We explained its impact [in a recent blog](). The ripple effects into U.S. stocks ended up being minor, but it was a good reminder on the interconnectedness of certain markets.

In other news, U.S. stock markets witnessed some apparent renewed interest in smaller companies. Indeed, the Russell 2000 Index of small-cap stocks gained 9.2%, outpacing the S&P 500. Small-cap companies often have more debt and can benefit from lower borrowing costs, so with the Fed starting to cut rates, these stocks have started to see some impact. We've talked a lot about the longstanding dominance of the "Magnificent 7" and other mega-cap names, so this potentially emerging trend will be crucial to watch going forward.

Update from the Institutional Investment Services Team

Hello! It was a busy summer, and we are grateful to have seen many of you in person at various meetings and conferences. If it's been a while, we hope to see you soon!

If one theme has emerged in our recent conversations with clients, it's been change. Wespath experienced change recently with our CIO transition. And many of you have welcomed new staff, board members and committee chairs. Turnover can be intimidating, but it's made easier by strong governance and organizational policies. We recommend our **Fiduciary Focus educational series** for resources focused on non-profit governance. Plus, we're always here to help with your unique challenges! If you're experiencing change, let us know and we can organize materials and resources that can support your organization.

Sincerely,


Joe Halwax


Karen Manczko


Evan Witkowski


Neil Sobczak


Alicia Marriot

Insights from the Wespath Team

Why "Matching the Market" Isn't Always What It Seems

Amid the dominance of the Magnificent 7, many investors have understandably raised questions about the role of active management in their U.S. equity portfolios. Most active managers have struggled to outpace broad U.S. stock indexes, while passive strategies delivering their respective index's weight of the large-cap tech names have done well.

But as with many market trends, there's more here than meets the eye. Let's say, for example, an investor correctly identified that large-cap, growth-oriented stocks would lead the way in 2023. They may have pursued a passive, large-cap, growth-focused index fund to seek to "match" that market. And in 2023 alone, their actual returns could have varied as much as 25% based *solely* on which U.S. large-cap growth index they picked.

We analyzed the performance of five U.S. large-cap growth indexes from five major index providers—S&P, Russell, MSCI, CRSP and Dow Jones—over the past decade. The results showed that discrepancies are common:

Difference between highest and lowest return, select U.S. large-cap growth indexes

2023	2022	2021	2020	2019	2018	2017	2016	2015	2014	2013
25.2%	3.8%	4.4%	10.2%	7.7%	3.8%	3.6%	2.1%	3.7%	2.2%	2.8%

On average, over the past 10 years, the difference between the best-performing U.S. large-growth index and the worst-performing one in a given year is *6.3%*. This is a stark reminder that investors may still be making *active* decisions when pursuing passive investments.

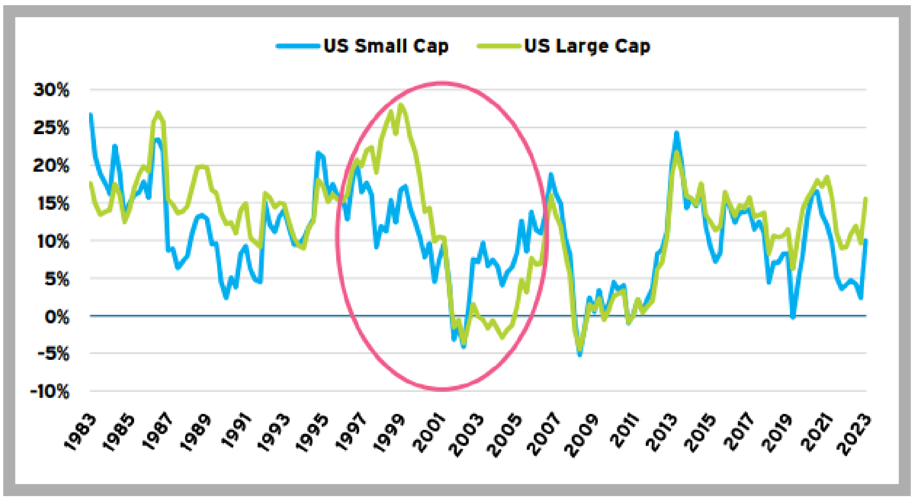
Source: Wespath and FactSet

Insights from the Wespath Team (continued)

For Investors, Patience Is Crucial

Active management is also an example of something that goes through cycles. There have been historical periods where 60% - 80%+ of active funds were outperforming the S&P 500, including the early 1980s, the late 1990s and the mid-2000s/early-2010s. There are similar periods where most active funds underperformed. This is similar to how small- and large-cap stocks move in and out of favor:

Rolling Five-Year Annualized Returns



(Source: Meketa Investment Group, Benchmarks used: Russell 1000 for U.S. Large Cap & Russell 2000 for U.S. Small)

As the chart illustrates, the last big reversal in large-cap leadership happened after the dot-com bubble burst in the early 2000s. We can't predict whether small caps' outperformance is the beginning of another such reversal. But, as CIO Johara Farhadieh likes to remind us, we can emphasize the importance of patience. Markets move in cycles. Underperforming asset classes tend to rebound. Trends tend to reverse, and as we noted earlier, forecasting exactly when they will reverse is very difficult. That's why sometimes the best move is no move at all.

Looking ahead

Going into the fourth quarter, the focus for investors is very likely *not* inflation, for the first time in years. Instead, all eyes will be on growth—both economic growth and corporate earnings growth. Despite continued positivity in GDP forecasts, there are enough anecdotal indicators the economy is cooling to raise some angst. The market *does* expect the Fed to continue to ease rates at a steady pace in Q4.

Meanwhile, corporate earnings will be crucial. Wall Street analysts expect earnings growth from the Mag 7 to ease back to levels similar to the S&P 493, which would support a "catch up" from the rest of the market to the giant technology names.

Of course, the November 5 U.S. elections will also capture investors' attention. While most research generally indicates that, while election years might be more volatile, there is very little long-term market impact based on the party in office, we expect a noisy October (we'll cover this more in-depth in our upcoming institutional investor webinar, **which you can keep an eye out for here**).

As always, we are striving to offer funds and support client portfolios that deliver long-term to our clients' missions. Patient investing means aligning our strategies with a focus on intrinsic value rather than popularity contests or short-term trends. Your mission and your organization are very important to Wespath. Thank you for the partnership and trust to steward your assets.