MARKET OBSERVATIONS
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Divergence

Divergence of opinion in the political arena is on the rise, particularly as U.S. presidential candidates vie for the votes of the undecided. The heightened focus on political divergence tends to come and go with election cycles. Divergence of opinion among investors over economic trends and financial market outcomes is ever-present. Uncertainty is elevated especially if trends among closely watched indicators diverge from historical norms and relationships. Investor divergence of opinion lasts only so long as expectations are replaced by realities. A review of some important recent trends can provide perspective for assessing market return and risk expectations in the period ahead.

PERSPECTIVE

The Federal Reserve seeks to achieve maximum employment and inflation at the rate of 2% over the longer run. One could expect to see divergent trends in these key economic measures. Chart I shows employment and inflation trends over the past year and the divergence that has occurred. While inflation has not yet reached the Fed's 2% goal, the rate has declined significantly from the 9.1% TTM level posted in June 2022 to a level that requires a less restrictive monetary policy. However, employment gains have slowed notably and have included a major downward revision to prior reported employment gains.

The most direct expression of Federal Reserve policy is the level it sets for the Federal Funds ("FF") rate. Chart II shows the policy path as reflected in the FF rate. The last two major cycles of rising rates brought the FF rate to the same 5.3% peak. While the cycle patterns appear similar, there are material differences. The cycle uptrend that began in March 2022 resulted in a greater overall increase over a shorter period of time than the cycle that began in June 2004. The consensus path forward for the FF rate from here is a relatively gradual decline. The decline shown here over the next 13 months occurred in only 4 months of the prior cycle. Each economic cycle has its own dynamics that shape policy responses. In any event, the current consensus FF path forward may prove to be a bit too gradual.

Stock market and bond market price trends often diverge. Such divergence underlies the principle of portfolio diversification. Chart III shows divergent market trends over the past year, and they have been notable. Keeping in mind that when yields decline, bond prices rise, there have been two extended stretches when prices have risen for both assets. The first two months and the last four months capture this convergence. Divergence captured the remaining six months in between. Stock market price levels have backed off from recent all-time highs. Recent bond market price gains reflect in part an expectation of lower Fed policy rates ahead. From convergence to divergence, a full range of potential outcomes for stock and bond price trends awaits.

CHART I

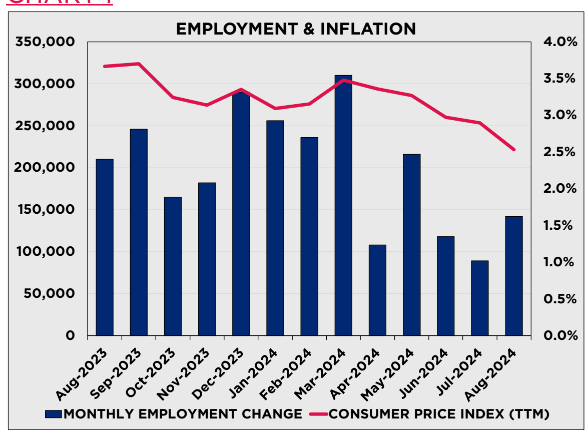


CHART II

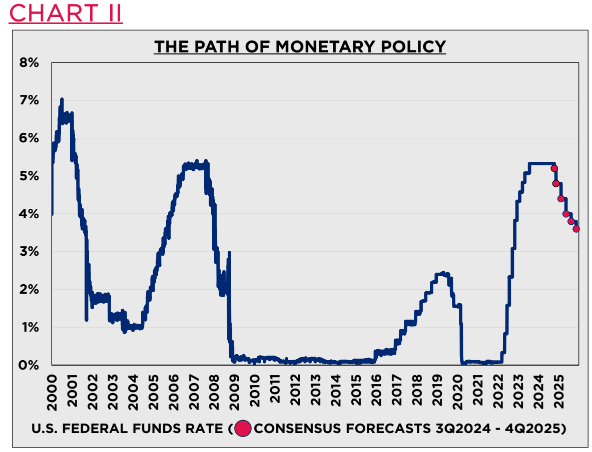
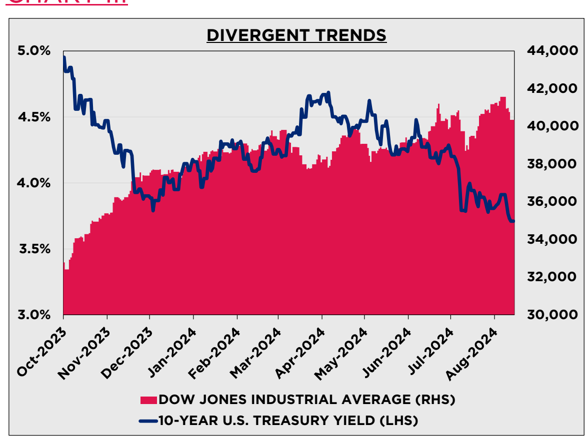


CHART III



INVESTMENT IMPLICATIONS

Investors are well-advised to keep in mind the old precaution that past market patterns do not guarantee future outcomes. At the same time, divergent patterns often reflect market dynamics that do repeat over time and within cycles. Less certain is the timing and magnitude of any such divergencies. A now-expected trend toward lower Fed policy rates generally would suggest lower bond yields (higher prices) and higher stock market price levels. Of some certainty is the potential for market risks ahead. These must be weighed relative to hoped-for returns.