

Goldilocks and the Two Bears

"This one is just right."

– *Goldilocks and the Three Bears* (1837)

Most of us likely know the fabled story of *Goldilocks and the Three Bears*, which at times has been referenced in discussions of the Goldilocks Principle – where balance and equilibrium are a point of emphasis. This month, we channel our inner child as we analyze the challenging task that lies ahead for the Fed following its recent interest rate cut announcement – the first such action since last December.

The table at right lays out our version of Goldilocks and the Two Bears – a reference to the two bearish scenarios apart from the "Just Right" outcome. That latter outcome effectively describes the Fed threading the needle with regards to interest rate policy. Inflation moderating with growth and the labor market holding up would allow the Fed to gradually layer in interest rate cuts. The other two outcomes are less desirable and likely to trigger unwanted volatility.

Goldilocks and the Two Bears

Scenarios	"Just Right"	"Too Slow" / "Too Cold"	"Too Fast" / "Too Hot"
Fed Rate Path	Very gradual rate cuts get to the Fed's neutral rate in a "cut and pause" fashion.	Rates remain elevated for too long as inflation remains (initially) sticky with a delayed path to the neutral rate.	Aggressive rate cuts amid fears of labor market weakness lead to an overly loose policy.
Inflation	Inflation gradually trends lower and holds at the Fed's intended target around 2%.	Sticky inflation eventually succumbs to a more notable slowdown.	Inflation reaccelerates as financial conditions continue to loosen.
Economic Growth	Growth moderates along with inflation before productivity gives way to a sustainable growth trajectory.	Growth falters as the restrictive nature of rates impacts businesses' ability to maintain pricing power and grow.	Growth reaccelerates too quickly triggering a second wave of inflation.
Labor Market	The unemployment rate stabilizes near current levels as firing activity remains benign.	Elevated rates and moderating growth lead to more meaningful layoffs.	Job openings more meaningfully outpace unemployed workers leading to a material rise in wage inflation.
Key Risks	While rates moderate, it may not be meaningful enough to stimulate depressed housing activity.	As growth weakens and the labor market deteriorates, consumption declines leading to a slowdown and recession.	Accelerating growth eventually gives way to stagflation leading to a Fed that has to reverse course and tighten.

Source: Yellow Cardinal Research

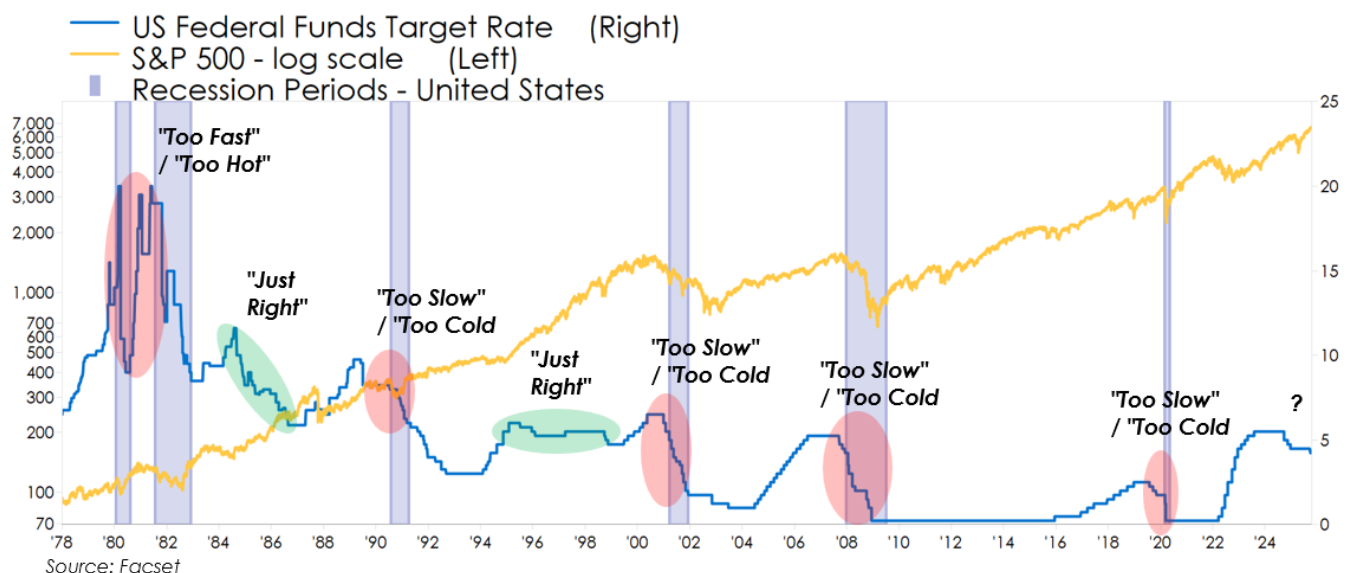


In the "Too Slow / "Too Cold" scenario, the Fed is slow to cut rates as the economy and labor markets eventually give way to overly restrictive policy that dampens growth to the point where businesses are forced to lay off workers in order to compensate for weakening demand prospects. In the "Too Fast / "Too Hot" scenario, an overly anticipatory Fed cuts rates prematurely resulting in a second wave of inflation that leads to a reversal of policy and eventual hiking of rates to protect against a further wage-price spiral.

As can be seen in the chart below, so-called soft landings are rare with the most successful one often cited being in the mid '90's, which helped to propel both the market and the economy. While "Too Fast / Too Hot" episodes are also rare, one of the more extreme observations included the double dip recessionary period in the early 1980's. An inflation fighting Fed led to the first recession, though political pressure resulted in notable easing that ultimately proved to be premature as inflation persisted. Perhaps not surprisingly, the "Too Slow / Too Cold" scenarios are more common as the Fed is generally seen as reactive – a function of being dependent on the data before a policy response occurs – which typically acts with a lag. Of course, one must also be careful not to assume that the Fed is the only factor in either causing or avoiding recessions. That is definitively not the case as numerous variables influence economic conditions and, in some cases, downturns become unavoidable with policy actions, at best, only helping to limit the magnitude and duration.

As for today's fabled chronicle, thus far it most closely resembles the "cut and pause" episode of the mid '90's though much will depend on the (in)actions that lie ahead with the full story yet to be written. We're staying tuned in.

Fed Funds Rate and Recessions

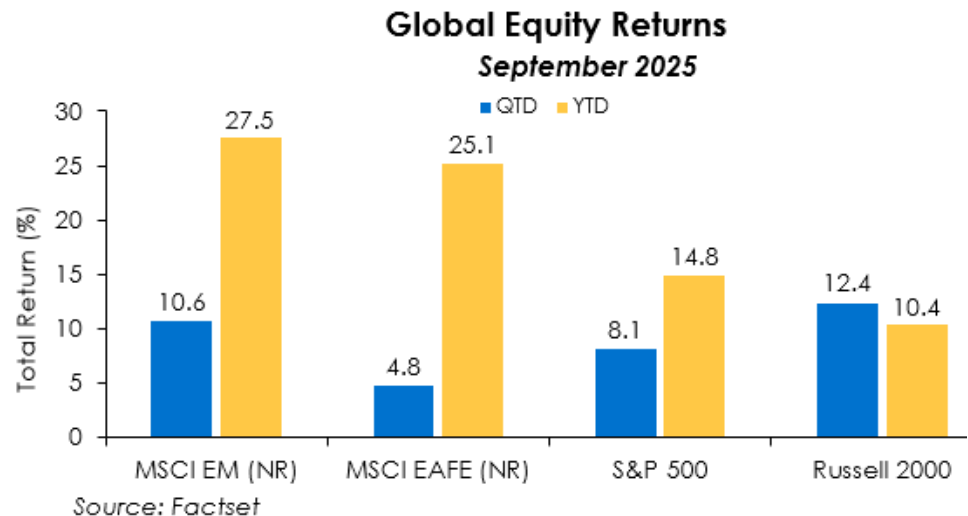


Third quarter results were strong with positive returns for Stocks, Bonds, REITs, and Commodities. Small Caps led Stocks higher for the quarter on expectations of additional interest rate cuts while Precious Metals led within Commodities. Bonds posted solid returns led by Emerging Market Debt and Credit while REITs were helped by the downward bias in interest rates as well.

Stocks

US Small Caps (Russell 2000) led Stocks higher for the quarter as markets anticipated another round of rate cuts by the Federal Reserve. US Large Caps (S&P 500) performed well on the back of strong corporate earnings and AI optimism. International Developed Markets (MSCI EAFE) and Emerging Markets (MSCI EM) continued to deliver strong results and lead all equity asset classes

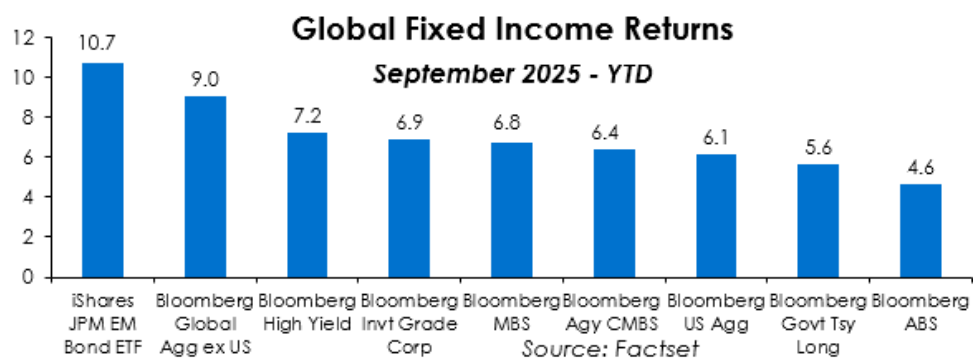
year-to-date. Foreign returns have benefited from dollar weakness while Emerging Markets have also benefited from rate cuts and fiscal stimulus. From a sector perspective, outperformance has been driven by AI influenced areas including Communication Services, Information Technology, Industrials and Utilities – though all sectors have delivered positive returns for the year.



Bonds

After pivoting to an easing bias in the back half of last year and then leaving rates unchanged at all previous 2025 meetings (January, March, May, June, and July), policymakers resumed their easing stance with a 25 basis point interest rate reduction in September. However, softening labor market readings juxtaposed against strong consumption data and sticky inflation have created uncertainty regarding the path of future rate cuts. The Fed is now forecasting three additional cuts (25 bps per) while the market is anticipating four to five cuts by the end of next year. Bonds have performed well with returns generally up mid to high single digits.

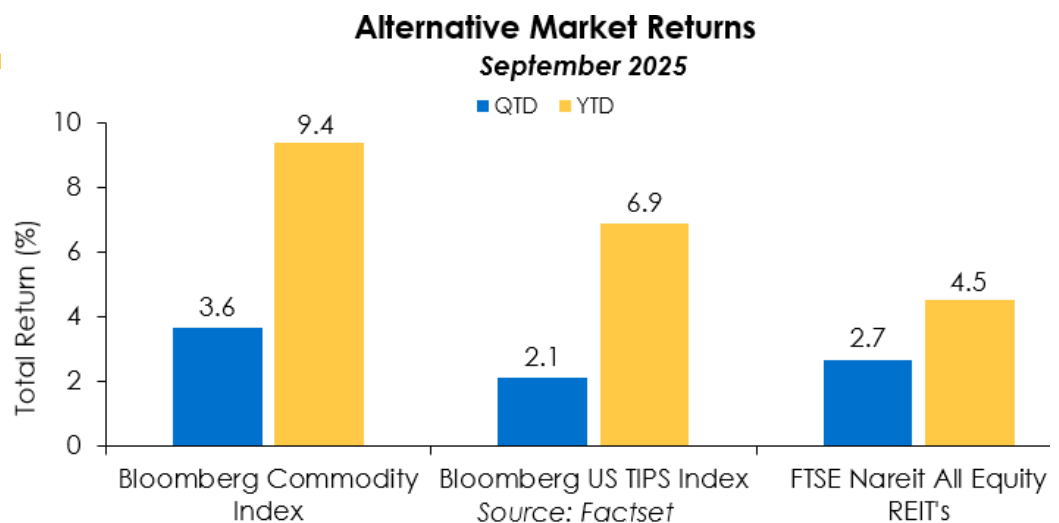
Emerging Markets (iShares JPM EM Bond ETF) and International Debt (Bloomberg Global Agg ex US) have been the standouts for the year due to dollar weakness while long duration Treasuries and Asset Backed Securities (Bloomberg ABS) have lagged.



Alternatives

Commodities have delivered solid year-to-date returns helped by significant performance in Precious Metals while Energy and Agriculture prices have lagged. Meanwhile, publicly traded Real Estate

(REITs) has benefited from the more recent downward bias in rates. Finally, year-to-date returns on Treasury inflation protected securities (TIPs) have performed better than nominal Treasuries amid volatile inflation expectations that have been biased higher since April.



Market Outlook

*"It's Tricky to rock a rhyme, to rock a rhyme that's right on time.
It's Tricky."*

– Run DMC, *It's Tricky* (1986)

As the page turns further into 2025, we remain focused on the ever evolving Tricky "Tri-Cycle" – the "three cycle" framework we're using to assess the landscape. An ever fluctuating (and late) Economic Cycle, gradually maturing Profit Cycle and wildly reversing Policy Cycle – makes for the continuation of a Tricky backdrop that requires investors to keep their proverbial eyes up and "Head on a Swivel". Let's explain.

Tricky "Tri-Cycle"

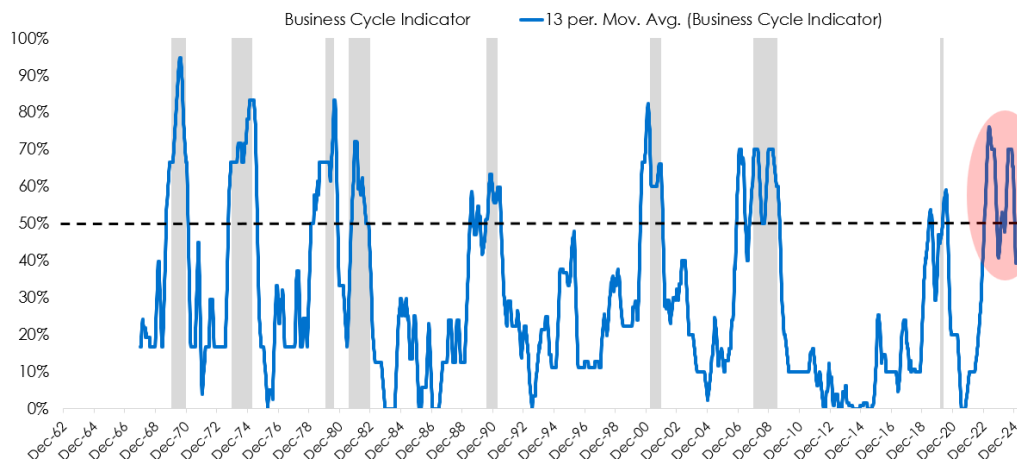
Cycle	Stage
Economic Cycle	Fluctuating (and Late)
Profit Cycle	Maturing
Policy Cycle	Reversing

Economic growth remains choppy with a stagnating impulse, in part, due to trade and fiscal policy. In isolation, the sizeable increase in the deficit would have made the budget bill virtually impassable. However, when viewed within the context of tariff revenue as an offset,

the GOP was able to successfully pass the fiscal measure. Still, tariffs raise the question of stagflation for the Fed which has meant they've been reluctant to meaningfully act citing their recent lowering of rates as a "risk-management cut" in response to some weakness in the labor market. Policymakers are also aware of the budget bill stimulus in the form of lower corporate tax rates (100% expensing) and targeted consumer aid (increased SALT deductions and child tax credit measures) that becomes sizeable as we head into next year. This leaves investors wondering how much the Fed will

be able to cut rates. Stepping back a bit further, we still believe there's fundamental evidence – including yield curve dynamics, leading economic indicator composites, certain survey relationships and especially

Business Cycle Indicator



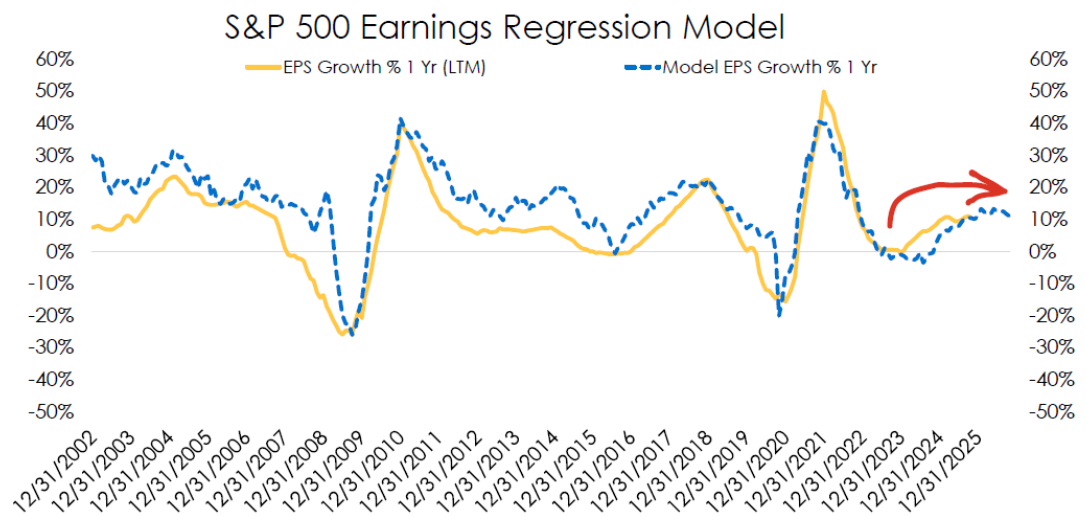
Source: Factset and Yellow Cardinal Research; the Business Cycle Indicator is a proprietary dashboard of financial conditions that historically have provided some context of business cycle duration and lead time on recessionary events. When more than half of the weighted average signals were triggered, this often preceded a recession. The Business Cycle Indicator is a weekly signal with the 13 week moving average smoothing the volatility.



labor market measures – that point to being on the later side of the economic cycle. As can be seen in our business cycle indicator on the prior page, an increased percentage of measures being triggered is a good illustration that we remain at comparable late cycle levels in the economy (with recessions designated by shaded regions – chart on prior page).

At this point, the profit cycle doesn't look as late as the economic cycle but the fundamental trends suggest a gradually maturing backdrop. As can be seen in the chart below, our proprietary top-down earnings regression model

suggests a healthy but gradual leveling off of earnings growth ahead. This is corroborated by bottom-up earnings growth expectations that peaked back in January. However, recent revisions have been more positive – perhaps helped by the earnings benefit of a



weaker dollar, the expected limited fallout from tariffs and assistance from the previously cited budget stimulus. The AI CAPEX spend is also a tailwind for growth though with one caveat. Should its current pace be sustained for a prolonged period, we've found it would be comparable to some of the other most significant examples of overbuilds in history (Railway Boom – mid 1800's, Internet – late 1990's, Housing – mid 2000's). For now, we see a solidly positive – albeit leveling off – earnings growth trajectory denoting a gradually maturing profit cycle. The bottom line is that we think its important to monitor the late economic cycle and maturing profit cycle in such a fluid fundamental backdrop.

Add to that, the third leg of the stool – a policy cycle that's abruptly reversing from looser fiscal and tighter monetary to one that suggests the opposite – (relatively) tighter fiscal and (relatively) looser monetary. We say relatively because, while the deficit remains unchanged in aggregate, the recognition of its unhealthy status is leading to some reductions in government spending and the need to find more government revenue (tighter fiscal). As referenced above, the Fed has recently cut interest rates with additional easing up for debate. This reversal in policy is causing investors, consumers and companies to re-think the backdrop resulting in persistently elevated uncertainty. The good news is that the sharp rally in risk assets since mid April (from



The Certainty of Uncertainty

Past Policy	Future Policy
Looser Fiscal	(Relatively) Tighter Fiscal - Less government spending / More government revenue
Tighter Monetary	(Relatively) Looser Monetary - Higher tariff rates likely lead to lower interest rates though not initially.

backing off of the worst case tariff rates) was a constructive move that flipped the technical script from bearish to bullish. This suggests that the market hasn't deemed anything a foregone conclusion. The bottom line is that we continue to live in an environment that

suggests an increasingly large number of potential scenarios still on the table. It's no wonder that the only certainty might be a high degree of uncertainty.

So what are the implications and key takeaways for portfolios?

From a portfolio positioning perspective, we continue to emphasize the importance of diversification and balance as a way to mitigate the high uncertainty as referenced above. While diversification has previously been an uncontroversial concept, the concentration present in passive indices today – by virtue of the price action over the last couple of years – suggests this notion remains a relic of the past. We respectfully disagree and think today represents a unique – though not unprecedented – opportunity in that diversification offers a “twofer” or two for one benefit – risk reduction and upside optionality. Most of us understand the concept of diversification as singularly beneficial in reducing risk and not putting all one’s eggs in that proverbial basket. In short, uncertainty is what compels diversification. But today’s concentration in the largest companies has now made the S&P 500 quite top heavy with the top 10 holdings representing twice the exposure it averaged during the period from 1990-2010. For investors, this mean reversion potential offers upside which is likely to come when investors have deemed that the pendulum has swung too far. The timing of such an episode is a notoriously difficult question to answer with any kind of certainty. But perhaps investors should take comfort knowing that they generally don’t need to. That’s because staying diversified still allows one to participate in the solid absolute returns that help one achieve plan success. And at the same time, not overly exposing one to the extreme risks that may ultimately come in the form of exceedingly depressed returns when the bill comes due. In our opinion, that’s what prudent investing is all about.

We continue to look for opportunities to rebalance portfolios to maintain that degree of balance – and have done so a couple of times this year. As a result, we’ve remained UW the most expensive and concentrated areas where we’ve viewed the long-term risk reward less favorably.



Within equities, our positioning incorporates balance geographically (tilt toward International) and within our US Large Cap exposure especially (away from the top of the market). Our bias has generally been to have more exposure to less expensive areas (down market cap). As such, we've maintained a larger OW in Cyclical Value and Defensive sectors combined with a smaller sized cap bias. We remain UW the most concentrated and expensive Cyclical Growth areas and think that if AI is as transformative as advertised its benefits will need to accrue to more than just the select few.

Within fixed income, we remain biased toward the higher quality US Core Fixed Income segment – where we're slightly longer in duration for diversification purposes. We've also previously added to International Fixed Income (EW), where the end of negative interest rate conditions has led to more attractive opportunities. Maintaining a higher quality bias means that we still remain UW the most expensive part of the bond market (High Yield) where extremely tight spreads have made this unattractive in our view.

Within alternatives, we remain fairly balanced across the board with neutral positions in Diversified Alternatives, Real Estate and Commodities. Earlier this year, we adjusted our mix of Diversified Alternative managers in order to provide greater insurance against market volatility by emphasizing income and short exposure – areas that can benefit from choppy market conditions, thus, enhancing diversification.

From a broader perspective, we also think that investors should keep in mind the following:

- Stay focused on the things you can control like ensuring you have adequate 6-12 month liquidity needs which should allow your long-term investment monies to stay invested.
- Has the structural integrity of your plan changed (purpose of money, time horizon, liquidity needs, risk tolerance)? If the answer is no, then recognize that the economy and the market run in cycles that diversified portfolios are there to help mitigate.
- Short term volatility is often the price one pays for the benefit of higher long-term returns.

Thanks for giving this a read.

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