INVESTMENT PERSPECTIVES

OCTOBER 2024

Key Takeaways —

- China's rescue mission: Is it enough to stimulate growth?
- Potential changes to tax exemptions and what it means for munis.
- Taking stock: U.S. equity market and earnings expectations.

CHINA STIMULATES BUT NO "FLOOD IRRIGATION"

Mark Luschini, Chief Investment Strategist

The late Chinese Premier Li Keqiang, who once quipped that China's reported GDP growth was man-made, also uttered back in 2018 that the Middle Kingdom's economy does not require "flood irrigation" stimulus. He was referring to policymakers needing to take a more measured and precise approach in their efforts to reflate stalled economic activity as opposed to the precedent of an "all of the above" philosophy that led to malinvestment and unintended consequences.

A blitz of announcements recently from Chinese officials taking myriad steps to stabilize, if not reaccelerate, economic growth has received an inordinate amount of attention. Deservedly so, given that China's economy, the second largest in the world at an estimated $18 trillion but a distant second to the United States's $29 trillion, has been relatively weak over the past several years and dangerously close to missing its stated target of 5% annual growth.

China's central bank governor, alongside securities and financial regulators, unveiled a new package of supply-side measures intended to lift stagnant business and consumer spending. The stimulus package includes five key measures, such as cuts to the policy rate, mortgage rates, and bank's reserve requirement ratio, as well as providing liquidity to prop up the equity market. We believe these actions might bolster investor confidence and potentially stabilize or even boost Chinese equity prices. However, this new stimulus is unlikely to accelerate economic growth significantly. Instead, a substantial fiscal stimulus is likely needed for a meaningful recovery.

The announcement included the following:

- The People's Bank of China (PBOC), the equivalent of the U.S. Federal Reserve, cut the reserve requirement for Chinese banks, to be available for lending.
- The reverse repo rate was reduced, which is expected to lower the Prime Lending Rate, making borrowing less costly.
- Mortgage rates were cut, and the minimum downpayment for second home purchases was reduced to stimulate the beleaguered residential real estate market.
- The PBOC established a facility to allow eligible securities firms, mutual funds, and insurance companies to pledge assets to fund stock purchases and spur prices.
- The PBOC is providing financing to state-owned enterprises to purchase existing residential real estate to convert into affordable rental housing and reduce bloated inventories, hoping to steady falling property values.

These measures will likely improve sour consumer confidence and benefit the stock market. However, to effectively promote growth, the collective of these steps may still be too small to be a game changer. While consumer spending in China represents less than half of its GDP, as opposed to the U.S., where it is nearly 70%, it is still important, and consumer sentiment is critical for social stability. Therefore, as it is most everywhere, the key drivers for households are jobs and income. With soft employment conditions, the unemployment rate in China stands slightly above its stated target of 5%, youth unemployment tops 17%, and wages have stagnated; lower borrowing costs are unlikely to trigger a large or immediate upshift in spending.

In addition, the main constraint on credit growth, even if it is made cheaper and more accessible by these actions, is the lack of loan demand. First, with inflation running below 1%, real borrowing costs are still high. Second, falling house prices, where a disproportionate number of Chinese households have stored their wealth, exert downward pressure on consumer attitudes about spending. What might be most effective is fiscal stimulus in the form of transfers to households designed to boost confidence and spending, but that seems unlikely, at least for now.

The takeaway is that economic activity in China may stabilize, albeit at a somewhat subdued pace. Chinese stock prices could be primed for a more sustained advance, but much depends on the uptake by investors encouraged by these, and perhaps more formative efforts to come, delivered by Chinese officials. ■

MUNICIPAL TAX EXEMPTION

Guy LeBas, Chief Fixed Income Strategist

"The avoidance of taxes is the only intellectual pursuit that carries any reward." Frequent readers might notice that Janney ISG's economic philosophy is broadly Keynesian, and those words were from the founder of said philosophy, John Maynard Keynes. Keynes spent most of his life 3,000 miles on the other side of the Atlantic; however, he did witness the creation of the U.S. tax-exempt municipal bond market in 1913, if not its expansion in 1986. Keynes' tacit approval of the U.S. municipal bond markets clearly makes those of us who write about those markets the most prized of intellectuals.

Humor aside, the long-term value proposition offered by U.S. municipal bonds (munis) is that income generated by said bonds is exempt from federal and, in many circumstances, state and local taxation. For investors in a 32% or higher marginal tax bracket, the exemption (depending on market conditions) generally provides a net benefit. Said another way, while gross yields on munis may be lower than, say, yields on corporate bonds, the tax exemption makes the after-tax returns more attractive on munis so long as a single filer's adjusted income is $182,101 or higher ($364,201 for joint filers). The actual "breakeven" tax rate is more like 28% at present, but tax brackets jump from 24% to 32%.

It is also election season at a time of historically high budget deficits. While no political party has a monopoly on deficit spending, expect no shortage of fiscal rhetoric and proposals before and after the election. Some of these proposals will probably involve higher tax rates for higher earners who, historically, have been some of the biggest owners of municipal bonds. Some of these proposals might even involve changes or limits to municipals' tax exemption, though the political will to do anything with that exemption is small at best. The bottom line is that there's a chance of higher tax rates for high-income earners in 2025. And while that's bad for disposable income, it's good for the performance of municipal bonds.

Table 1 presents an estimate of the potential impact on municipal bond market values from an increase in federal income tax brackets. Interestingly, the market value impact appears minimal; we project only a +0.3% outperformance for a 2% hike in top tax brackets. In contrast, when tax rates were reduced under the 2017 TCJA, we retrospectively observed a -1.0% underperformance from a change of the same magnitude.

Table 1: Municipal Bond Market Values

Top Tax Bracket (Excludes Medicare Tax)		10yr AA Rated Muni Bond Yield	Change in 10yr Bond's Value
+4%	41.0%	2.62%	2.0%
+2%	39.0%	2.71%	1.0%
Current	37.0%	2.80%	0.0%
-2%	35.0%	2.89%	-1.0%
25% Cap**	25.0%	3.33%	-5.9%

**Change in value estimated by holding TEY constant, changing yield, and recalculating market price.*

Source: Janney ISG

A much more significant, albeit less likely, risk to the municipal bond market could arise if tax reform alters the nature of the municipal tax exemption. Tax expenditures refer to items in the federal budget representing revenue the government forgoes. For taxpayers, these look like deductions or exemptions. For instance, the largest tax expenditure is the exclusion of employer-paid health insurance premiums from taxable income, accounting for $252 billion in lost revenue. Collectively, the top 10 tax expenditures amount to around $1.2 trillion in foregone revenue, with the municipal bond tax exemption contributing $40 billion. The foregone income from munis has actually declined in recent years while other tax expenditures have risen more-or-less in line with incomes.

Table 2: Federal Tax Expenditures

Federal Tax Expenditures	FY2024
Exclusion of employer contribution for healthcare	$252 bln
Reduced capital gains rate & exclusions	$233 bln
Defined contribution & benefot plans	$188 bln
Exclusion of certain rental income	$135 bln
Child tax credit	$110 bln
Charitible contributions	$82 bln
Earned income credit	$67 bln
Qualified business income deduction	$51 bln
Subsidies for insurance paid through health exchanges	$47 bln
Municipal bond tax exemption	$40 bln

Change is vs last qrtly refunding in May

Source: Janney ISG; Office of Mgmt & Burget; Tax Policy Foundation

What will the changes to the municipal bond tax exemption possibly entail? A full repeal of the exemption is highly unlikely, given its significant benefit to state and local governments. Instead, a potential reform might impose a cap on the amount of municipal bond income that is tax-exempt. For example, as shown in the first table, a hypothetical 10-year municipal bond could see its market value drop by approximately -6% if the exemption is capped at 25%. This table is based on cold arithmetic, but realistically, sentiment-driven selling could cause a larger move. That is a serious performance shortfall, but there is a very low probability in our estimate that such a policy will actually reach taxpayers.

The purpose of this tax discussion is not to alarm investors but to highlight that, while higher marginal tax rates could benefit the municipal bond market more than other markets, the effect of a cap on deductibility would not be fatal to the municipal bond markets. Moreover, as the federal cost of the tax exemption has been declining relative to incomes, it is a relatively unappealing target for significant changes in the near future. ■

IS IT THE FOMC OR FOMO THAT MATTERS?

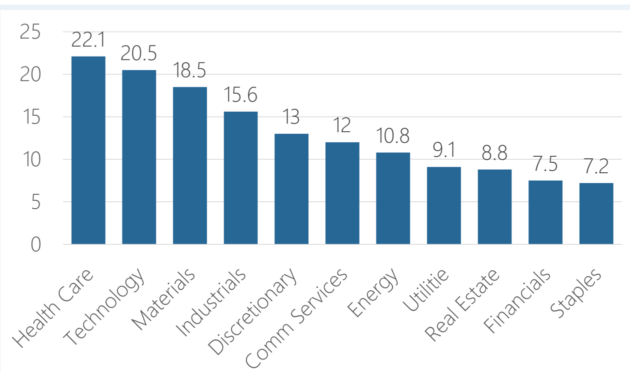
Gregory M. Drahuschak, Market Strategist

The November 5 election will dominant the news flow this month, but the last half of the month might contain more important news for investors.

In the long run, earnings expectations drive stock prices. Standard & Poor's began reporting 2025 earnings expectations 24 weeks ago. At that time, the expectation was for 2025 earnings to be more than 14% above 2024 earnings. Expectations for 2025 earnings continued rising through the next nine weeks before going sideways until the current high reached $276.45, 15.4% above the initial estimate. The upside in the estimate stalled until the first week of September and then fell for three consecutive weeks to a level only 0.4% above the initial 2025 estimate.

This becomes very relevant in the middle of this month when the third-quarter earnings season hits full stride. According to FactSet, the estimated third-quarter year-over-year earnings growth rate for the S&P 500 is 4.6%, which, if achieved, would be the fifth consecutive quarter of year-over-year earnings growth. Eight of the 11 sectors are projected to report year-over-year earnings growth with Information Technology, Health Care, and Communication Services expected to post double-digit growth. On the other hand, the Energy Sector is projected to report a double-digit decline in earnings. With the market currently trading at a relatively elevated 21 times earnings, not meeting expectations would not be well received.

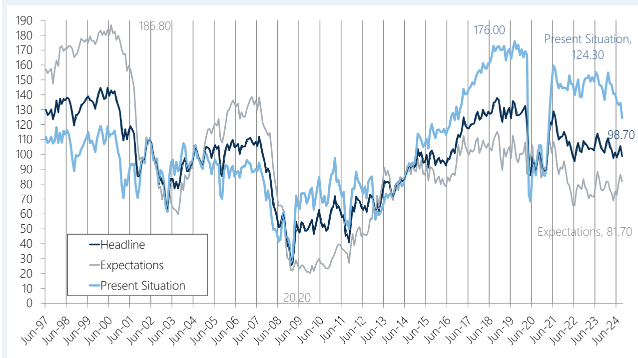
Chart 1: 2025 % Earnings Gain Expected



Source: Janney ISG

With the holiday shopping season in sight, consumer sentiment is important. The most recent report from the Conference Board of its Consumer Confidence Index showed the biggest sequential decline in more than three years. The Expectations component fell 4.6 points to 81.7. Remaining above 80 was notable as historically, a dip below 80 signifies an impending recession. However, this component has been below 80 eight times this year without an ensuing recession.

Chart 2: Consumer Confidence Index — Three Major Components

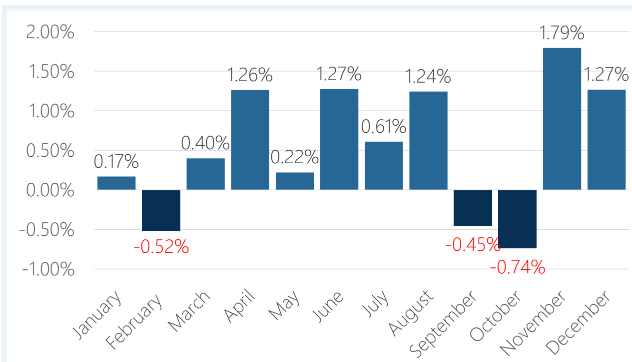


Source: Janney ISG

And then there is the election

Not a day this month is likely to pass without election items dominating the press and potentially the stock market. However, it is wise to ignore the election news except for one item.

Chart 3: Average S&P 500 Election Year Result 1952-2020



Source: Janney ISG

There has been an unusually tight corollary between what the S&P 500 does from the July 31 through the October 31 closing value. If the S&P 500 has a gain of any magnitude in this period, the incumbent, or his political party, will retain the White House. Conversely, an S&P 500 loss means White House control reverts to the other political party. According to this theory, if the S&P 500 on October

31 is at least 5522.31, Democrats will remain in control of the White House. As of September 30, 2024, the S&P 500 closed at 5762.48. More details on this are in the Janney Investment Strategy Group report, "91 Days that Matter," which is available from a Janney Financial Advisor.

October in election years, on average, has the worst market result, but with election uncertainty out of the way, this, on average, is followed by solid November and December gains. From the end of World War II, the equity market posted gains in 80% of all fourth quarters.

Table 3: Final Quarter of Election Years

	October	November	December
1952	0.16%	4.31%	3.47%
1956	1.97%	-3.1%	1.5%
1960	0.06%	2.97%	5.08%
1964	0.81%	-0.52%	0.39%
1968	0.72%	4.8%	-4.16%
1972	0.93%	4.56%	1.18%
1976	-2.22%	-0.78%	5.25%
1980	1.6%	10.24%	-3.39%
1984	-0.01%	-1.51%	2.24%
1988	2.6%	-1.89%	1.48%
1992	0.21%	3.03%	1.01%
1996	2.61%	7.34%	-2.15%
2000	-0.5%	-8.01%	0.41%
2004	1.4%	3.86%	3.25%
2008	-16.94%	-7.49%	0.78%
2012	-1.98%	0.28%	0.91%
2016	-1.94%	3.42%	1.82%
2020	-2.77%	10.75%	3.71%

Source: Janney ISG

As always, the market's technical posture will have a hand in the market's near-term movement. There are several relevant technical conditions this month.

With the 12.6% gain from the intraday low on August 5, 2024, to the intraday high on September 26, 2024, the S&P moved into an overbought status that could inhibit short-term upside. As the rally unfolded, the S&P surpassed several key resistance levels. The most notable of these was at 5650; however, should the market have to endure a pullback, this same level could provide intermediate-term support. ■

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