

July 2024 Market Commentary

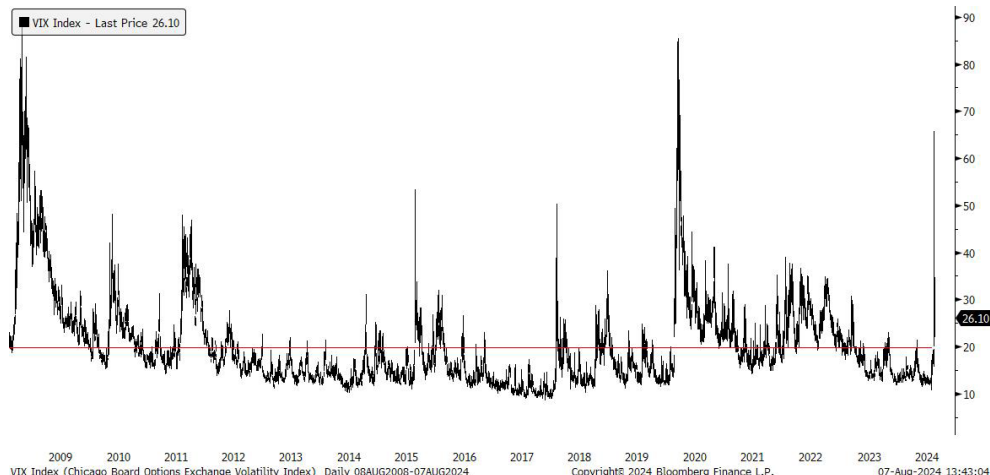
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Comeback for the average stock. July started off strong for the broad equity markets but ended mixed, as a cooler inflation reading (June CPI came in at 3%, the lowest level since June 2023) touched off a rotation into laggards, including smaller cap stocks and cyclicals that should benefit more from the approaching kickoff of a Fed interest rate cutting cycle. Mega caps and AI winners also generally stumbled after reporting second-quarter earnings results, failing to meet high expectations. With the stocks trading at arguably stretched valuations, there was little room for disappointment. While the S&P 500 (+1.2%) and the Dow Jones Industrial Average (+4.5%) managed to finish higher for the month, the NASDAQ fell (-0.7%). Yet, the average stock performed much better than the broader indexes, thanks to the rotation into laggards, highlighted by the equally weighted S&P 500's 4.5% gain and the small cap Russell 2000 index's 10.3% jump.

Volatility returns with a bang: Global markets have been rattled over the last few days. Japanese equities fell more than 12% overnight on Sunday—the worst day for the Nikkei since 1987. The NASDAQ quickly entered correction territory, dropping more than 10% from the recent peak hit only a few weeks ago, and the S&P 500 was recently off more than 8% from its recent peak. The short-lived rotation into small caps and cyclicals from last month reversed course. We cautioned last month that we were likely to see a pickup in volatility, given elevated valuations and a seemingly high degree of complacency. Still, we did not expect the VIX or “fear gauge” to spike to 60 – a number last seen during the depths of COVID and, before that, the 2008 financial crisis.

VIX Index – “fear gauge”



Source: Bloomberg

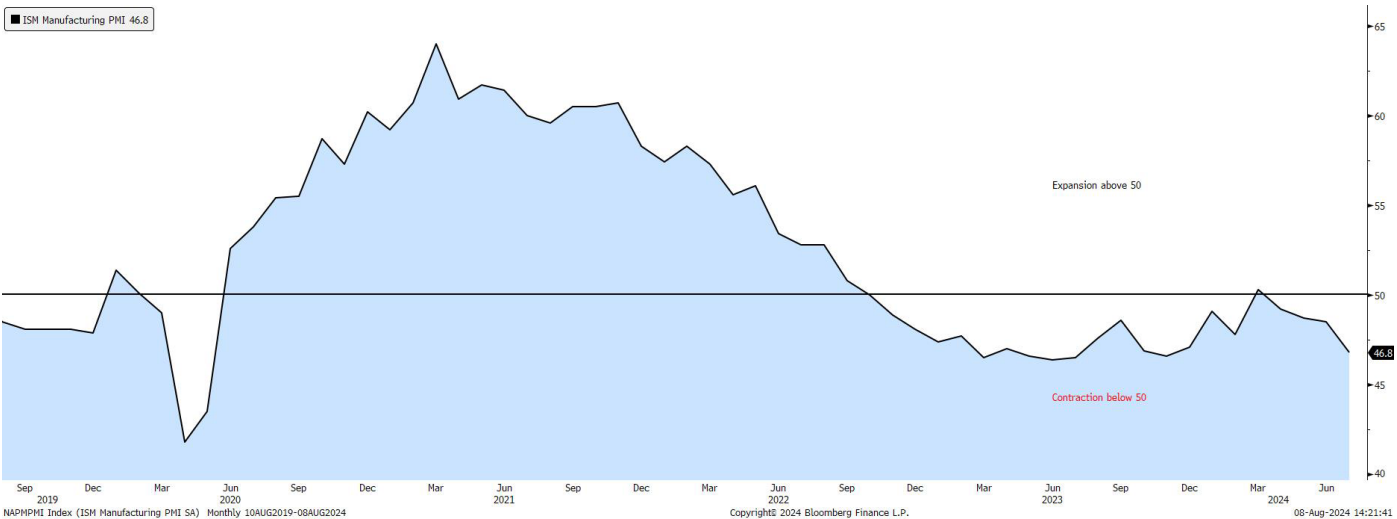
The surge in volatility seems mainly related to the unwind of the Japanese carry trade: in short, investors borrow money in Japan where interest rates are low and invest the borrowed money in places where returns are higher (e.g., US tech stocks, emerging market debt, etc.), eventually cash out, repay the loan, and pocket the difference. It works swimmingly as long as nothing disrupts the apple cart (i.e., interest rate/FX differentials hold steady and volatility is low). Yet on August 1, the central bank of Japan unexpectedly raised interest rates for the second time this year by a *whopping* 0.1% to 0.25% and announced plans for quantitative tightening, touching off an unwind of the trade, which had likely started a few weeks earlier. A weak US July labor report (+114k missing the +175k estimate) and US ISM manufacturing index reading (at 46.8, the lowest level in 8 months) seemingly added to investors' fears, sparking additional selling and prompting calls of an imminent recession. Yet, neither economic report should have been much of a surprise. The economy has been slowing for months, the labor market has also been moderating (note, Hurricane Beryl may have distorted the latest figures), and manufacturing has been in contraction territory for 20 of the last 21 months. Indeed, a few weeks ago, these numbers may have sparked a market rally, raising the probability that the Fed would cut interest rates, but in the midst of panic, they were simply another reason to sell. ([For more on the recent events from a cross asset class perspective please see our recent Seelaus Asset Management market update.](#))

Job openings show a steadily normalizing labor market



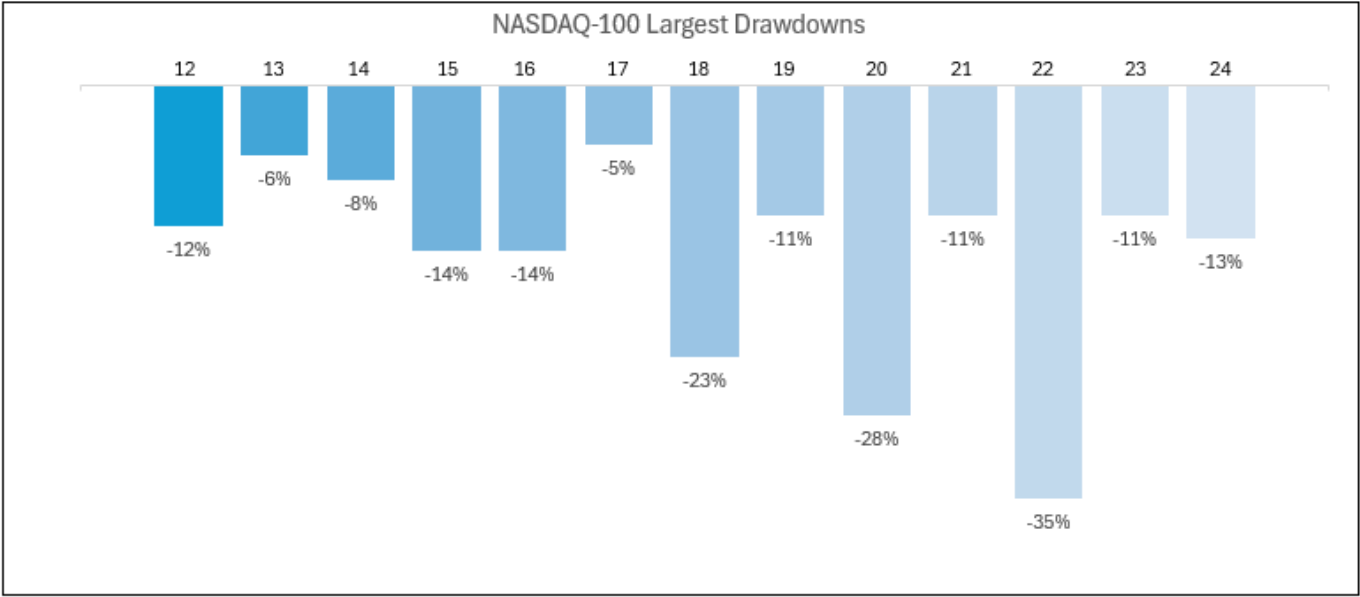
Source: Bloomberg

Manufacturing has been stuck in the doldrums for some time



Source: Bloomberg

Gut punch, but mostly technical/positioning related with longer-term constructive view unchanged: While the reasons are always different, this is a typical pullback for stocks, although the speed of the decline was disconcerting.



Source: Bloomberg

Volatility may remain elevated over the next few weeks. We could even revisit or break the lows from earlier in the week, particularly given we are in a seasonally weak period through September, and the ramping Presidential election cycle may contribute to skittishness. Yet, this pullback was mostly about technicals and the selling of leveraged positions, and once the unwind is complete, fundamentals will reassert themselves. Given that S&P 500 companies are on track to report the strongest earnings growth since the fourth quarter of 2021, according to FactSet data, we do not foresee an imminent recession or more significant drawdown in stocks. Risks remain, including simmering geopolitical tensions in the Middle East (one reason we continue to like energy stocks) and there are growing signs of consumer stress, including rising credit card and auto loan delinquencies (why we remain cautious on consumer-oriented issues). Yet, we expect that the Fed will cut interest rates in September, which will support a broader swath of stocks going forward, including small caps, cyclicals, and dividend payers, many of which have lagged the market rally.

As always, we would enjoy hearing from you. Please reach out with any comments or questions.

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