Monday, August 5, 2024

SUMMARY-

I. NASDAQ enters correction territory as all equity averages sell off.

II. Fed indicates a September cut is possible, but weak jobs data spooks investors.

III. Bonds surge sending yields to lowest levels of the year.

IV. Numerous positive factors continue to support bull market and could keep correction short and shallow.

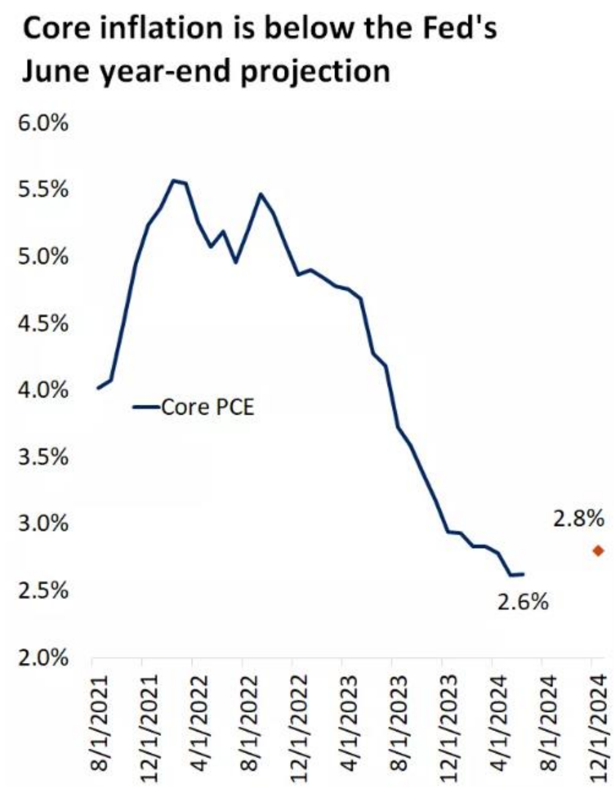
Good morning:

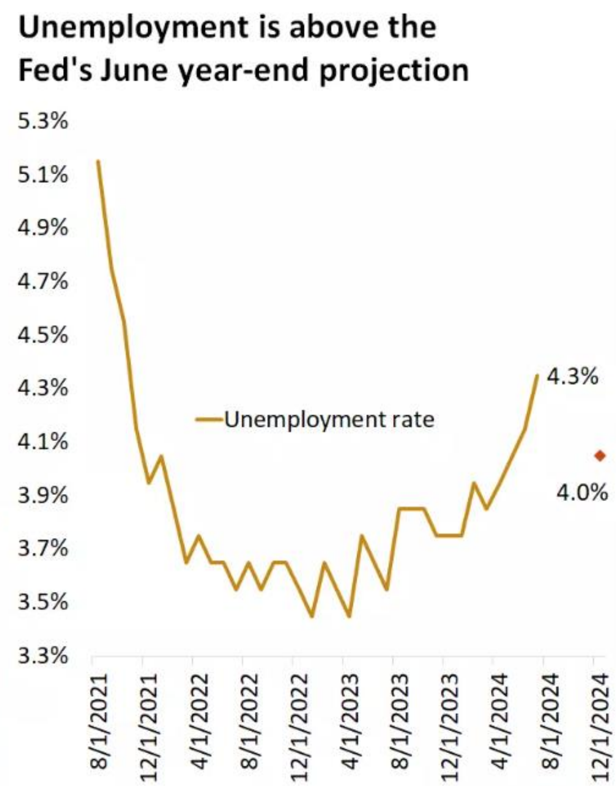
Noting the recent uptick in market volatility and suspecting it could persist or even expand, we concluded last week's *Monday Outlook* with a discussion and definition of the CBOE's VIX index, a mathematical measurement of equity market volatility. In response to weak labor market data, uneven earnings, and a loss of upward market momentum, the S&P 500 and NASDAQ fell in last week's trading for the third week in a row while the Dow snapped a four-week winning streak. Selling intensified into Friday's closing which recorded weekly results for S&P 500 of -2.0%, NASDAQ -3.3%, and Dow -2.1%. While each large-cap average is still up for the year, last week's losses now show the S&P 500 off 5.7% and the NASDAQ down 10.0% from last month's record high levels. Having touched the down 10% level, the NASDAQ now officially enters "correction" territory, although still up

12.2% for the year. As illustrated in the chart below, last week's market action caused the VIX index to spike to the highest level in more than a year.

Source: Google

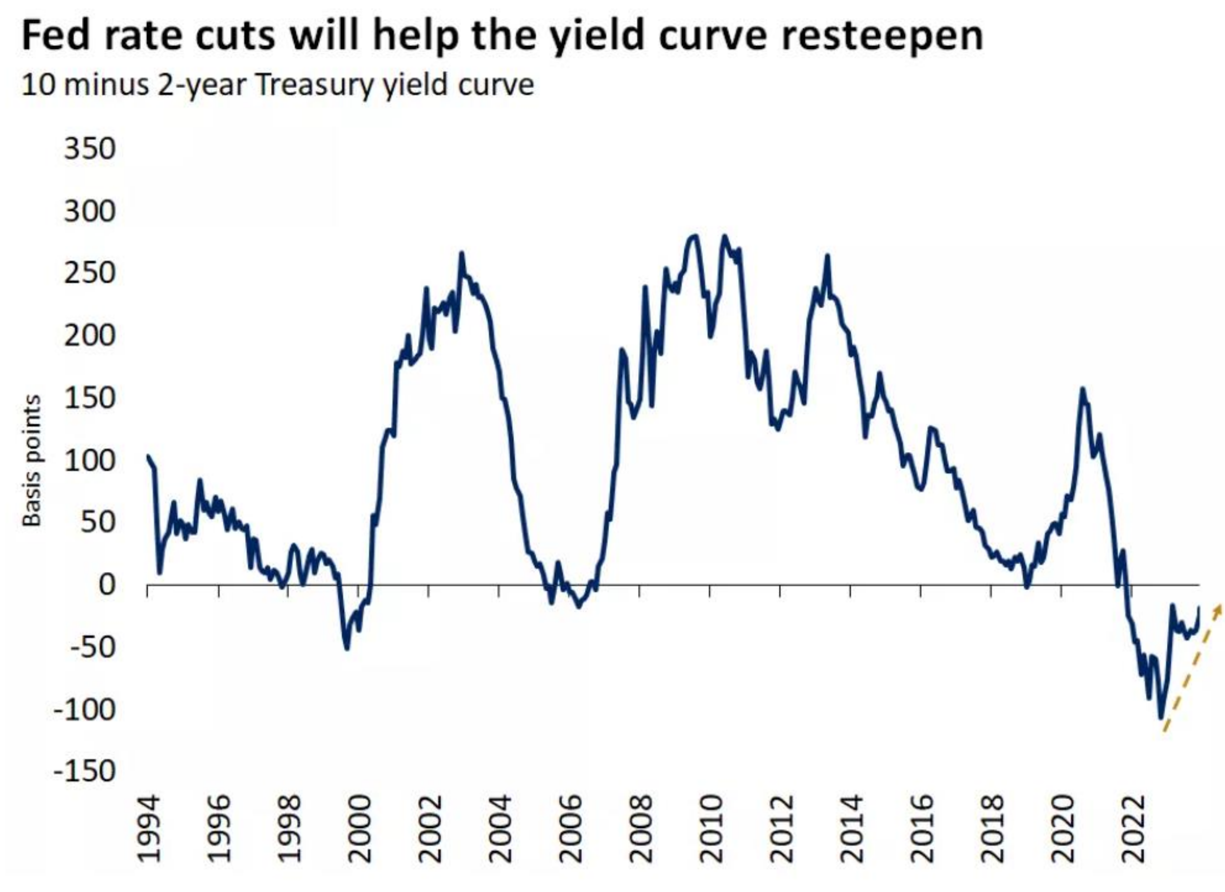
Among all the week's contributing factors, Friday's jobs report likely had the biggest impact. According to the Department of Labor, U.S. jobs growth slowed for the third month in a row and the unemployment rate rose to the highest level in nearly three years. July's gain of 114,000 jobs came in below expectations and was far short of the 12-month average of 215,000. The unemployment rate rose to 4.3% from 4.1% the previous month. This report coming two days after the Fed opted to leave interest rates unchanged sparked fears of an impending economic slowdown or potential recession due to the delayed effects of all the aggressive rate hikes over the past two years. Stocks rallied on Wednesday when the Fed said that an initial reduction could be on the table for its next meeting in mid-September if inflation continues to ease. However, the weaker labor data shifted sentiment to the idea that the Fed may have once again failed to act in a timely manner and may now be behind the curve.





Source: Bloomberg

In response to the week's developments, bonds rallied causing yields to drop to the year's lowest levels. Although still inverted, the yield curve is poised to normalize and even steepen when the Fed begins to lower short-term rates. Futures markets now have a September cut a near certainty with one or two more cuts likely by year end. Such cuts are expected to cause short-term interest rates on both adjustable-rate loans, as well as savings vehicles to fall in-synch. The decline in the all-important 10-year treasury bond is meanwhile expected to ease mortgage rates which could stimulate real estate transactions and economic activity.

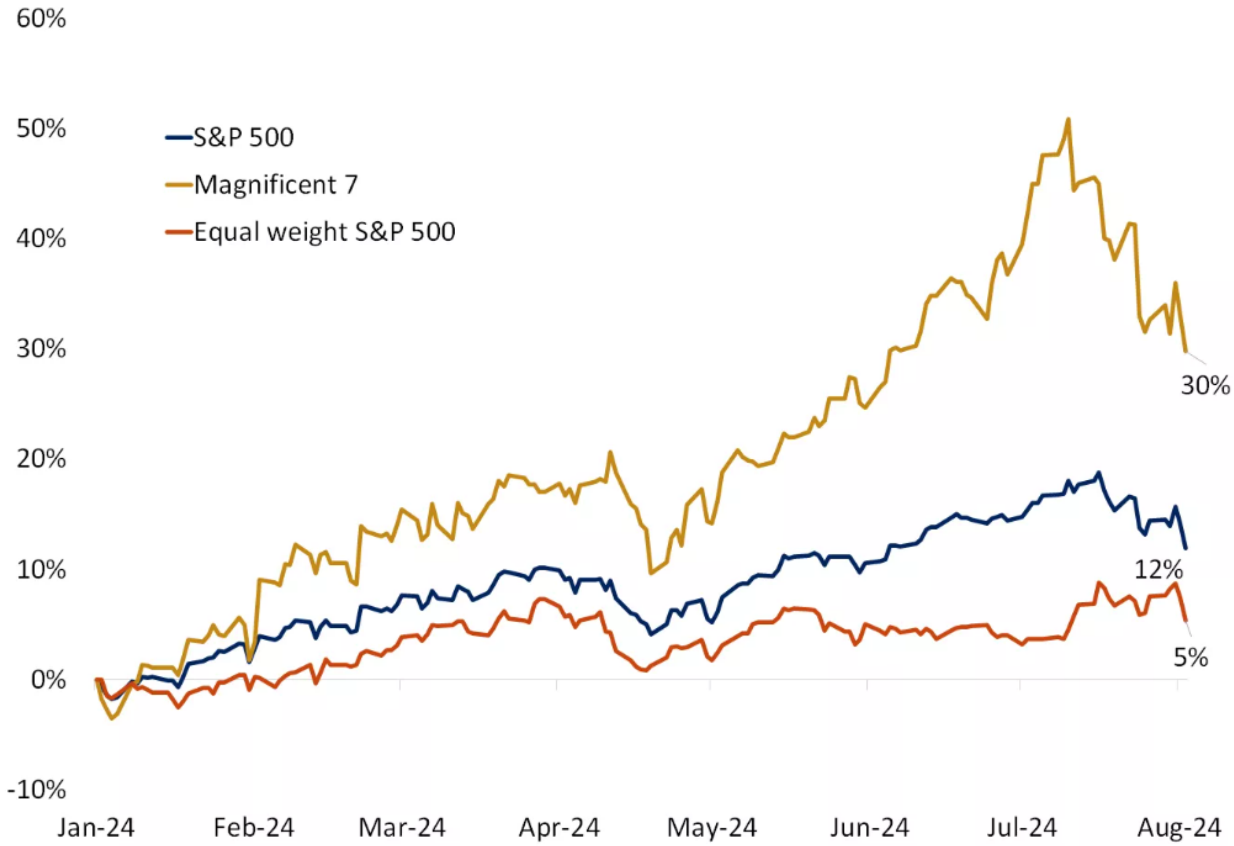


Source: Bloomberg

Sharp pullbacks in the tech sector harken back to so-called “bubbles” in recent history. Most notable among them was the “Dot Com” market bubble in the late 1990’s. However, in that case, newly minted internet-related companies soared to stratospheric valuations without much of any sales, let alone earnings. Such a market was truly a frenzy not all that different from the famous Dutch tulip bulb mania of 1636-37 where prices soared far beyond any reasonable level. Today’s artificial intelligence (A.I.) phenomenon is far different primarily because the principal benefactors have been well-established companies that have actual revenue and profits. In fact, due to the tremendous level of real profits, several of the A.I. players have grown to be among the largest public companies in the world. As the current sector rotation continues, recent weakness among the Magnificent Seven mega-cap tech stocks seems to be more of a validation of other opportunities in the market more than a signal that A.I. is a bust. On the contrary, we think that A.I. is poised for rapid growth over the next 5-10 years and can continue to drive earnings for the companies that are spending heavily today to enable its development. However, there will likely be a timing gap between when the costs occur and when companies might reap the benefits of their investments. The expectation for increased volatility should again be part of any equity market, tech-sector, and particularly A.I. sector investing for the coming months as we navigate these turbulent waters. Additionally, the fear of expanded military conflict in the Middle East is also adding to the market’s anxiety as we start the trading week.

After outsized gains earlier in the year, mega-cap tech stocks drive broader pullback. Diversified portfolios are holding up better during this risk-off phase

Year-to-date price returns



Source: Bloomberg

Despite this month's pullback for the broader market and correction for the NASDAQ, numerous positive fundamentals still could serve as underpinnings for the bull market. Inflation continues to decline towards the Fed's 2.0% target, likely providing the green light for near-term rate cuts. The economy continues to expand, albeit at a slower pace. Productivity is on the upswing, with the expectation of further gains due to A.I. And corporate earnings are still rising with many previously lagging sectors now garnering renewed investor interest.

Additionally, the roughly $6.4 Trillion on the sidelines in money market funds is more than double the average for the past 30 years and could prove important should a portion find its way into equities as rates savings rates fall when the Fed starts to ease.

Source: Bloomberg

With momentum clearly to the downside, this week is likely to start with further weakness. However, markets will be closely watching additional economic reports and other key earnings reports as the week unfolds to either confirm or contradict the current palate of concerns. Should the equity market pullback persist, it should not be met with panic or any major change in long-term strategy. A peak-to-trough correction of at least 10% while unpleasant, is actually a very common thing occurring at least once in nearly every year. Like a smart consumer, wise investors should look to buy quality merchandise when it is on sale!

Have a great week!

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