Monday, August 12, 2024

SUMMARY-

I. Selling hits crescendo before stocks stage big rebound.

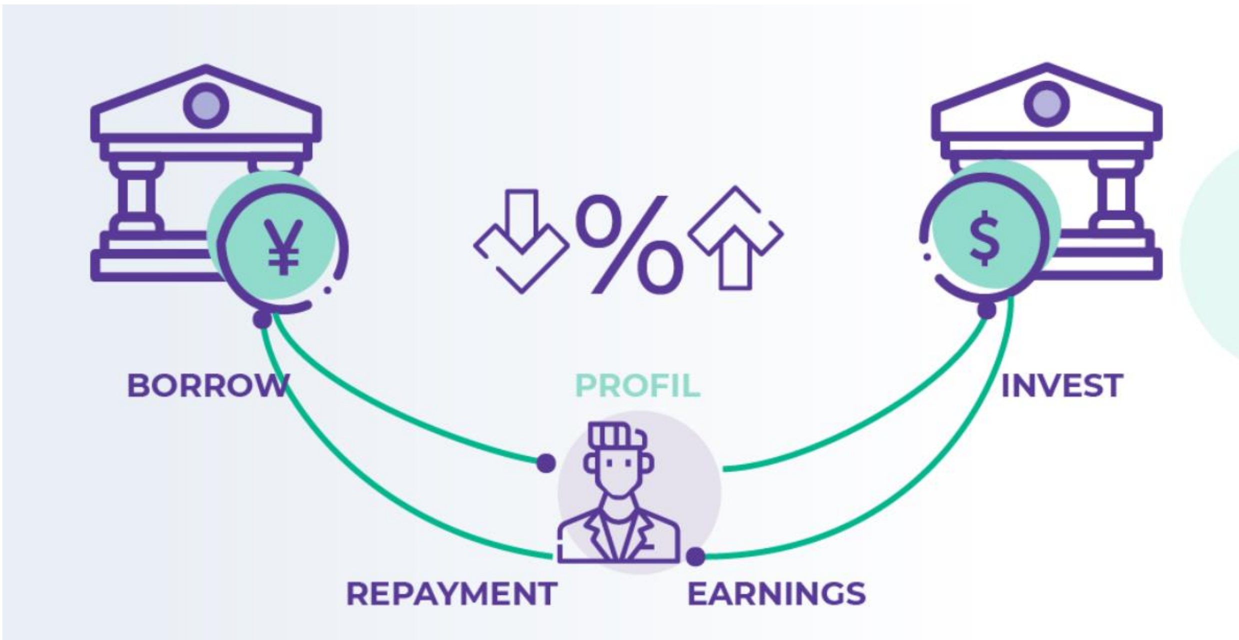
II. Japanese Yen “carry trade” unwinding partly at fault for last week’s selloff.

III. Prior such market dips are both common and usually short-lived.

IV. Forthcoming economic data and earnings could suggest whether recessions fears were overblown or justified.

Good morning:

Last week began with an aggressive acceleration of the prior week’s selling after July’s jobs report prompted some to fear an impending recession. Volatility was set to surge at the opening after Asian markets were rocked on major unwinding of the widely followed so-called Japanese Yen “carry trade.” With interest rates in Japan at or below zero for the past several years, the carry trade saw investors borrowing capital very inexpensively and then reinvesting the proceeds in other asset classes like equities, or even fixed-rate instruments at higher yields. However, when the Bank of Japan raised rates for the second time since March last week, the Yen strengthened versus the Dollar (making it more expensive to pay back a Yen-based loan), prompting some following this strategy to panic and begin unwinding their positions. Prior to U.S. markets opening on Monday, the Japanese stock market had plunged 12.4% overnight.



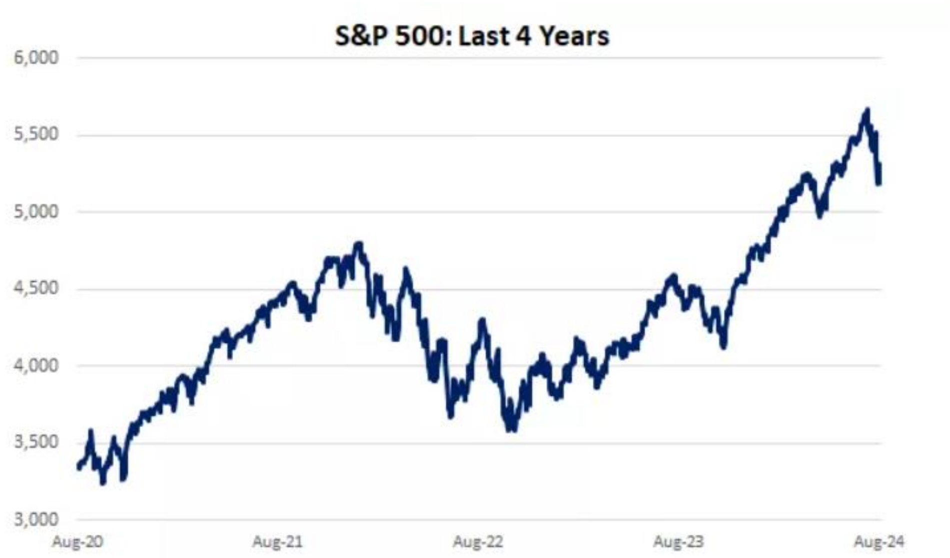
Within the first hour of equity trading on Monday, the VIX (volatility index) spiked to multi-year highs as equity averages faced heavy selling. At its low, the Dow was down more than 1,000 points with comparable declines in most other equity averages before bargain hunters emerged to reduce some of the day's losses. The days that followed saw additional sizable swings, though they included several sharp daily gains. All told, major large-cap stock averages finished with just a modest change on the week, not nearly in as rough a fashion as the headlines might have suggested. Small-caps in the Russell 2000 Index led the week's rebound with a gain of nearly 3%. As unpleasant as a sudden surge in market volatility can be, panic is *not* a strategy. On the contrary, those who took advantage of Monday's fear-driven selling to do a little bargain hunting were quickly rewarded as markets clawed their way back in the following days.

Let's not forget that this recent pullback was coming from a market at record high levels, with last week's lows only amounting to an 8% decline in the S&P 500 Index from an all-time high. Even with the recent drop, the stock market is still up nearly 20% over the last year, and 50% since the bull market began in October of 2022.

The stock market pullback was abrupt, but started from an all-time high...

Source: Bloomberg, S&P 500 index, indexes are unmanaged and cannot be invested in directly. Past performance is not a guarantee of future returns.

...And it looks much less significant in the bigger picture.



Source: Bloomberg, S&P 500 index, indexes are unmanaged and cannot be invested in directly. Past performance is not a guarantee of future returns.

We realize that each such market decline feels unique, or an indicator of a much worse drop to come, but 5% or more declines are actually rather common. Over the last 25 years, 5%+ drops occur on average three times per year. The velocity may be contributing to the anxiety as markets often take the escalator on the way up, but an elevator on the way down!

Dips in the market are common and are often a part of broader moves higher.

Source: Factset, S&P 500 performance, indexes are unmanaged and cannot be invested in directly. Past performance is not a guarantee of future returns.

Looking at 10% market corrections since 2010, the average length of such pullbacks was 63 days. Smaller 5%-10% pullbacks have had significantly shorter shelf lives. While the table below shows that the declines aren't erased immediately, they have not dragged on forever, with the market recovering each of the losses and returning to new highs in less than five months on average. It's this window within which we think investors can benefit from the temporary pullback in stock prices when quality companies are suddenly on sale.

	Duration of Correction	Time to Return to a New High
Mid '10	49 days	87 days
Late '11	108 days	96 days
Mid '12	42 days	68 days
Mid '15	66 days	219 days
Early '16	68 days	92 days
Early '18	44 days	102 days
Late '18	65 days	84 days
Late '23	64 days	28 days

Source: Bloomberg

Part of last week's sharp recovery stemmed from the belief that perhaps markets overreacted to July's jobs data and panic selling ensued. Sudden fears of an imminent recession were most likely overblown with an economy whose GDP growth rate is admittedly slowing but is by no means contracting at this time. Corporate profits are still rising, and the Fed is on the verge of a major easing cycle that is widely expected to start next month. Additional forthcoming earnings reports for this quarter, along with further economic data will be closely evaluated to see whether additional intelligence can be gleaned about the health and trajectory of our economy. Remember, a declining interest rate environment has historically been quite good for stocks and could serve as a fundamental support to our current bull market in the months ahead. As we navigate through these various developing issues during this seasonally weaker period for equities, it is important to expect further volatility (in both directions), and not let short-term market movements alter a long-term investment strategy.

Have a great week!

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