FINANCIAL MARKET
INSIGHT
VANN EQUITY MANAGEMENT

HIGHLIGHTS

- The Growth Scare Is Here (What It Means for Markets)
- **Weekly Market Preview**: How Far Can This Pullback Go?
- **Weekly Economic Cheat Sheet**: Important Growth Report Today
- What the Fed Decision Means

The week of August 5, 2024, begins with a major global market sell-off following the Bank of Japan's decision to tighten monetary policy for the first time in three decades. As investors brace for the volatility tsunami impacting a cross-section of risky assets (stocks, credit, commodities), greater uneasiness and a slowing U.S. economy could be enough to prompt the Federal Reserve to adopt a more aggressive schedule for cutting interest rates and loosening monetary policy. As such, we as investors may be given a narrow window to add on market risk if financial contagion does not spread or does the global economy fall into recession.

The interconnectedness of global financial markets means that Japan's financial turmoil could have ripple effects worldwide and exacerbate tightening financial conditions that would impact the funding sources of risk-on position-taking. The sell-off is not only impacting global equities, particularly markets with high-yielding currencies funded in the so-called carry trade. A carry trade is a **trading strategy that involves borrowing at a low interest rate and investing in an asset that provides a higher rate of return.** A carry trade is typically based on borrowing in a low-interest rate currency and converting the borrowed amount into another currency such as Australia, New Zealand, and Latin America, but also corporate credit risk and commodities.

Despite the recent pullback and selling pressures, the analyst community remains sanguine over earnings prospects, not just for U.S. companies, but for global markets as well. **Earnings are expected to grow over the next two years for the major markets (U.S., Japan, Europe, and Emerging Markets) even if that growth trajectory starts to slow down. Near-term liquidity-driven selling could eventually give way to long-term earnings growth reality.**

STOCKS

S&P 500

- Technical View: **The medium-term trend in the S&P 500 has shifted from bullish to neutral** as the uptrend line off the October 2023 lows was violated last week.
- Dow Theory: **Bullish (since the week of July 10, 2023)**
- Key Resistance Levels: 5399, 5479, 5537
- Key Support Levels: 5302, 5235, 5116

"The S&P 500 fell sharply last week thanks to disappointing economic data as the economic growth scare finally arrived and pushed the S&P 500 to multi-week lows."

SOURCE: Factset and Vann Equity Management Research Team

- ✓ **<u>What is Outperforming</u>**: Defensive sector, minimum volatility, and sectors linked to higher rates have relatively outperformed recently as markets have become more volatile.
- ✓ **<u>What is Underperforming</u>**: Tech/growth and high valuation stocks have lagged as yields have risen.

<u>Market Recap</u>

Domestic stocks attempted to stabilize into the middle of last week as tech earnings suggested AI-driven growth prospects were still intact; however, bad economic data Thursday and Friday led to a resurgence in recession concerns that saw the S&P 500 roll over to end the week down 2.06%. The index is now up 12.09% YTD.

<u>The Growth Scare is Here</u>

The growth scare that our investment team has been worried about finally appeared last week courtesy of the soft ISM Manufacturing PMI and jobs report and the result was a sharp drop in the S&P 500 and a collapse in Treasury yields (to nearly six-month lows). Additionally, on Friday we heard countless mentions across the financial media of recession risks and possibilities.

However, it is important to push back on the emotional anxiety that naturally occurs when stocks drop and the financial media screams trouble. Here is the reality from last week's data: First, for anyone paying attention (as we all have been) <u>last week's data was not a surprise.</u> There have been signs of a loss of economic momentum in various data points for months via economic reports and corporate commentary.

Second, last week's data really was not that bad in aggregate. Yes, the ISM Manufacturing PMI was ugly, but it has been weak for months and was not that much worse than before. Jobless claims and the jobs report, meanwhile, were worse than expected but on an absolute basis, 249k jobless claims is still very low and while July only added 114k jobs, the three- and six-month averages are still very healthy in the high-100k range.

Third, and most importantly, last week's declines are more about the complacency we and others have warned about, not about a sudden, serious deterioration in the data. Two weeks ago, the S&P 500 was trading near **5,600** on a **2024 EPS of $245ish** and **2025 EPS of $270ish**. That is a **22.8X multiple** and a **20.8X multiple**, respectively. Those are multiples for perfect environments, i.e., solid (and not slowing growth), explosive earnings growth, and no existential risks (geopolitics, etc.). **That is not the environment the market has been in for months and last week the data was bad enough to make the market finally admit it and that is why stocks dropped hard, not because the actual fundamentals turned materially worse (they just were not as good as hoped for and investors finally had to admit it Friday).**

Our investment team can confidently say this: If the data were as worrisome as the market implied on Friday, nothing would have been up last week; but plenty in the market was in energy and utilities. **If the data were screaming recession, those sectors would not be positive, they would just be down a lot less than everything else.**

Looking forward, is a recession that hits stocks hard possible? Absolutely, and that is a risk we are <u>continuing</u> to look at closely. However, suddenly saying a recession is a real risk is about as appropriate as previously thinking one was not possible at all.

<u>Bottom line</u>: The growth scare is here. We are reducing volatility in our equity portfolios via defensive sectors and lower volatile names because we doubt it is over yet. Last week's data just told us, unequivocally, that growth is slowing, and the market finally had to listen. That does not mean a contraction or recession is imminent and as such we do not think de-risking via raising cash is appropriate unless you are sure you can get back in appropriately, because the outlook for this market has not significantly changed as much as the price action implies.

Economic Data (What You Need to Know in Plain English)

Economic data was almost universally disappointing last week, and two of the three major monthly economic reports pointed to an economy now losing momentum and those weak readings spiked economic growth concerns and sent stocks lower and Treasuries higher. The big report last week was on July jobs, and it was the weakest report in a long time. Job adds were 114k, far below the 170k estimate and the lowest number in several years. The unemployment rate, meanwhile, rose to 4.3%, above the 4.1% expectation and the highest reading since October 2021. Perhaps most disconcertingly, the U-6 under-employment rate rose to 7.8% from 7.4%, the highest level in several years.

Bottom line: Labor market indicators have been consistently, albeit slowly, softening for months and it finally showed up in the monthly labor market data as the labor market is clearly slowing in the U.S.

Looking at other data last week, there was only one notable growth report, but it was one of the biggest disappointments of the week, as the ISM Manufacturing PMI declined to 46.8 vs. (E) 48.8, the lowest level since last August. That drop caused a slowdown in concerns to pop and majorly contributed to Thursday's steep selloff. What made the ISM Manufacturing PMI such a bad number was not just the headline, but also the details of the report (which were equally as bad as the headline, if not worse). New Orders, the leading indicator in the report, fell to 47.4 vs. 49.3 previously while the Employment Index declined to 43.4 vs. (E) 49.3.

In sum, this was the worst week for economic data in a long time. To be clear, these numbers do not point to a recession. 4.3% unemployment is hardly awful and jobless claims of 249k would, historically, still be considered good. But the trend in this data is concerning from a growth standpoint and because the market has priced in virtually zero chance of a slower-than-expected economy, the data did spike slowdown worries and hit stocks and boosted Treasuries.

Bottom line: The Fed is clearly telling us they are going to cut in September. Powell also hinted at several rate cuts in 2024. Why? It is not because inflation is so low they can cut aggressively. It is because they are getting worried about growth and this just reinforces what is the key question for markets for the second half of 2024: We know that the Fed is going to cut rates, but will they cut rates in time to avoid a slowdown?

The answer to that question will ultimately determine which direction the next 15% (or more) lies in the S&P 500. From a tactical standpoint, in the short term (meaning the next few weeks) the economy remains in a Goldilocks state of solid growth and looming Fed rate cuts and that should support a milder, but ongoing rotation to Large Cap Value, the "rest" of the market (RSP) and cyclical sectors (small caps, industrials, energy, financials). So, this rotation from tech to the value/cyclical/small caps/RSP can continue given the Fed news.

However, looking beyond the next several weeks, the Fed's increased urgency regarding rate cuts just reinforces our preference for reducing volatility in portfolios via lowering beta. To be clear, the Fed could still stick the soft landing and that is why our investment team does not advocate raising cash.

The Fed is going to cut more because they are worried about growth. The market is not worried about growth at all. That setup does not usually end well in our estimation and as such, we do think it is best to continue to gradually and systematically reduce volatility in our tactical holdings while maintaining long exposure because if we get a growth scare, Fed rate cuts will not be able to stop the correction and high-beta and cyclical will get hit hard.