Markets Panic; Our Broad View Still Sees Calm Waters

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August 19, 2024

July ended with solid gains among the broad stock market indices amid signs of a long-awaited rotation in market leadership from Mega Cap Growth company stocks to Small and Mid-Cap company stocks.

Although the Federal Reserve stayed on hold at its July meeting there are many good reasons to believe that they will kick off a series of interest rate cuts beginning at the next meeting on September 18th. This belief that they will begin cutting rates was bolstered when the BLS Labor Report was released on the first Friday of August, showing a continued deceleration in creation, specifically with Private Sector jobs. The resulting rise in the unemployment rate to 4.30%, up from a cycle low of 3.60% triggered the Federal Reserve's "Sahm Rule" recession indicator. Federal Reserve Chairman Powell has stated on numerous occasions this year that the risks associated with its dual mandate of price stability (low inflation) and full employment are coming into balance. What this means is that at the current level of interest rates the Fed believes that the risk of inflation reaccelerating versus the risk of economic slowing creating rising unemployment are now about equal.

In 2022 and 2023 that balance between inflation pressures and rising unemployment was significantly skewed to the risk of rising inflation pressures. The key to the Federal Reserve engineering a "soft landing," which is defined as inflation coming back down to the Fed's 2% target level without the economic drag of high and restrictive levels of interest rates causing a recession, is to get the reading of the balance of risks right. We believe that the Fed should have cut rates at the July meeting, but Fed policy is more like playing Horseshoes than golf, close is good enough.

At the beginning of August, the weaker than expected BLS employment report and triggering of the Sahm Rule coincided with an interest rate increase by the Bank of Japan. The inflection of domestic economic data hinting at a material economic slowdown and a Bank of Japan triggered "Carry Trade" unwind resulted in a two-day violent drop in equities with the S&P 500 index dropping from an end of July level of 5,558 to 5,166 at the market close on August 2nd. This rapid sell-off of over 7% in the S&P 500 over two trading days temporarily changed the market narrative from looking forward to rate cuts in September and a successful economic "soft-landing" to "the Fed is behind the curve" and "hard-landing" recession fear.

We discussed all this new data internally. We concluded that the decelerating job creation and tick up in the unemployment rate was within the weakening trend that we had been expecting to unfold prior the Federal Reserve embarking on a series of interest rate cuts. We dismissed concerns over the highly historically accurate Sahm Rule being triggered because for most of the year we have been highly attuned to the possibility of the Salm Rule failing during this cycle, producing a false positive indication of a recession. I had several private message conversations with Claudia Salm over the first six months of 2024. I came to understand her rationale for believing that this economic cycle has certain unique post pandemic factors that she strongly believed could lead to a rare false positive recession indicator from her famous rule. Lastly, we understood that the Yen Carry Trade unwinding was inducing significant margin loan selling pressure among heavily owned areas of the stock market. Given that we are typically under exposed to the most popular large and mega cap stocks in the market and that this carry trade induced sell-off was essentially a very large margin call sell-off, which are inherently very short-term events that are only dangerous if you buy stocks using a margin loan.

August began with a lot of noise and panic. We saw a two-day 7% S&P 500 correction, a VIX volatility index spike over 50, and nearly a half of one percent drop in the yield on the 10-Year Treasury Note. Momentum investors and factor-based trading algorithms saw flashing red lights and that means these investors were motivated to sell. We have been expecting a slowing economy and a higher, more normal, unemployment rate. We expected the Salm Rule to trigger and the market narrative to react to that recession indicator with a short period of weakness, but I we understood that the Salm Rule was likely to show a rare false positive. Lastly, we did not anticipate a Japanese Yen carry-trade rapid unwind, but when we saw it, we knew that such an unwind is likely to be very short-lived and unimportant to long-term oriented investors.

I am going to keep this month's commentary short. Economically, we are looking ahead to the Federal Reserve Chairman's Jackson Hole Conference speech and the August BLS Employment Report on September 6th. In the meantime, we see bond yields firming up near current levels and the equity markets continuing to try to broaden out stock leadership beyond the so called Magnificent Seven mega cap technology stocks, which is an important development for Seven Summits Capital portfolios. Our equity process typically results in meaningful allocations to small and mid-sized company stocks at the expense of being overweight more familiar and widely held large and mega-cap stocks.

Enjoy the balance of your remaining summer!

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- The Standard & Poor's 500, or simply the S&P 500, is a stock market index tracking the performance of 500 large companies listed on stock exchanges in the United States. It represents the stock market's performance by reporting the risks and returns of the biggest companies. Investors use it as the benchmark of the overall market, to which all other investments are compared.
- The NASDAQ Composite Index is a large market-cap-weighted index of more than 2,500 stocks, American depositary receipts (ADRs), and real estate investment trusts (REITs), among others. Along with the Dow Jones Average and S&P 500, it is one of the three most-followed indices in US stock markets. The composition of the NASDAQ Composite is heavily weighted towards information technology companies.
- The Dow Jones Industrial Average (DJIA), also known as the Dow 30, is a stock market index that tracks 30 large, publicly owned blue-chip companies trading on the New York Stock Exchange (NYSE) and the Nasdaq.
- The Russell 2000 index is an index measuring the performance approximately 2,000 small-cap companies in the Russell 3000 Index, which is made up of 3,000 of the biggest US stocks. The Russell 2000 serves as a benchmark for small-cap stocks in the United States.

The Russell 2500 Index measures the performance of the 2,500 smallest companies in the Russell 3000 Index, with a weighted average market capitalization of approximately $4.3 billion, median capitalization of $1.2 billion and market capitalization of the largest company of $18.7 billion.