MVIA - MARKET COMMENTARY

Crazy Days of Summer

August, 2024

Summary

- Despite early declines, U.S. large-cap stocks ended August up 2.4%, while small-cap stocks were down -1.5%. U.S. intermediate-term bonds also increased by 1.4%.
- The Federal Reserve signaled a likely rate cut in September. Markets are expecting 1% in cuts by year end, implying one 0.5% cut, a move typically only seen in crises.
- The broader market rally since August 5 was led by interest rate-sensitive utilities and real estate sectors.
- Heading into year-end, we will continue to focus on interest rate cuts, inflation trends, and the upcoming election.

Overview

Capital markets in August certainly lived up to the moniker of the "crazy days of summer." Despite U.S. large cap stocks declining 6.0% early in the month, the S&P 500 ended August up 2.4%. U.S. small cap stocks fared less well, as the Russell 2000 small cap index ended August down -1.5%. As proxied by the Bloomberg U.S. Aggregate Bond Index, intermediate-term bonds rallied 1.4%, closing the month at a 52-week high. Intermediate-term bonds are now up 7.8% over the past year.

The July inflation report, released on August 14, showed headline inflation easing to 2.9% year over year—falling below 3.0% for the first time since March 2021. Core inflation also ticked slightly lower, dropping from 3.3% to 3.2%. The Federal Open Market Committee (FOMC) July 31 meeting minutes revealed a growing inclination to begin cutting interest rates, as labor market concerns increasingly overshadowed inflation worries. Several committee members expressed support for a 25-basis-point rate cut at the July meeting, and consensus increasingly formed around easing policy at the next meeting on September 17-18.

Along with cooling inflation, the labor market also showed continued signs of softening in August. Even though the unemployment rate ticked marginally lower, to 4.2% from 4.3%, the August jobs report showed the U.S. economy added 142,000 new jobs over the past month, below the expected 165,000. There were also notable downward revisions to new jobs added over June and July. On August 21, the Bureau of Labor Statistics released payroll revisions for the 12-month period through March 2024. The report showed that payrolls during that period had been revised downward by 818,000 jobs.

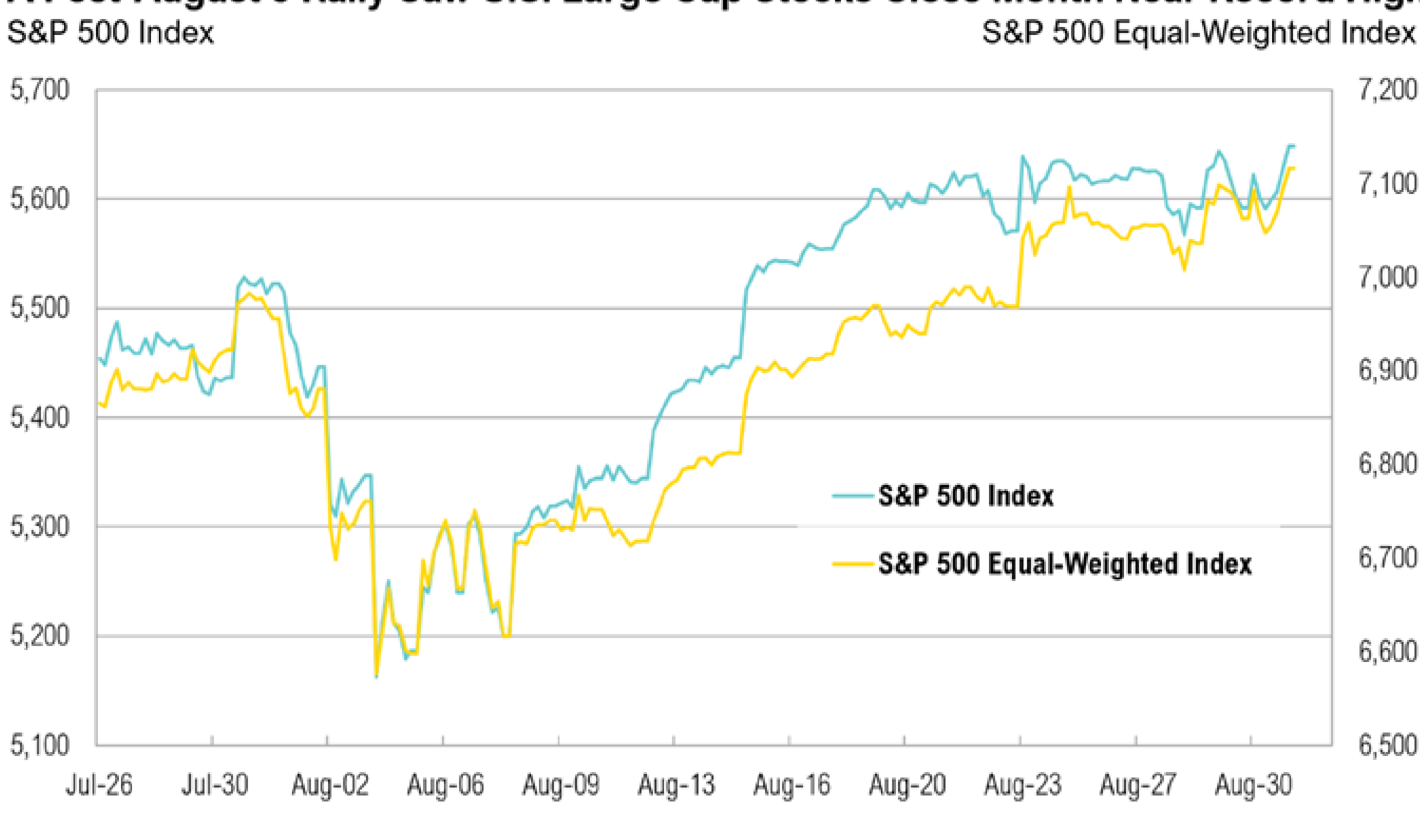
This equates to an average monthly downward revision of 68,000 jobs, reducing the estimate of new jobs added each month from 242,000 to 174,000. Notably, the majority of the revisions were concentrated in higher wage sectors, such as information and professional business services. Overall, these payroll revisions adjusted the labor market characterization from ‘very strong’ to ‘strong’. It’s important to note that these new estimates are still well above the 10-year average of 164,000.

Supported by steady inflation reports, ongoing labor market cooling, and Fed Chair Jerome Powell’s Jackson Hole comments on adjusting policy, investors are now expecting 100 basis points in rate cuts by year-end. With only three FOMC meetings left in 2024, this suggests a 50 basis-point cut before year-end, a move typically reserved for recessions or crises.

Crazy Days of Summer

The 'Summer Slowdown' is a seasonal phenomenon in which the stock market typically sees lower trading volumes and reduced price volatility during the summer months. However, while investors may have been hoping for more of these “lazy” days in August, the first week of the month turned out to be quite the opposite. Stock prices dropped rapidly in early August, while volatility spiked. A weaker-than-expected U.S. July jobs report and a slow-down in U.S. manufacturing activity triggered the rout. As a result, the S&P 500 declined by -6.0% between July 30 and August 5. At the intraday lows, the S&P 500 had dropped -9.7% from its all-time high on July 16. During the same period, U.S. small cap stocks experienced their largest three-day decline since the 2020 COVID-19 shock, falling nearly -10% and wiping out most of the gains made in July. Since August 5, a swift rally boosted broader markets, leading to positive returns by month’s end. The S&P 500 surged nearly 9.0%, bringing it just shy of a new record high. This rally also improved market breadth, with the equal-weight S&P 500 hitting a new record.

A Post-August 5 Rally Saw U.S. Large Cap Stocks Close Month Near Record High



Source: Bloomberg

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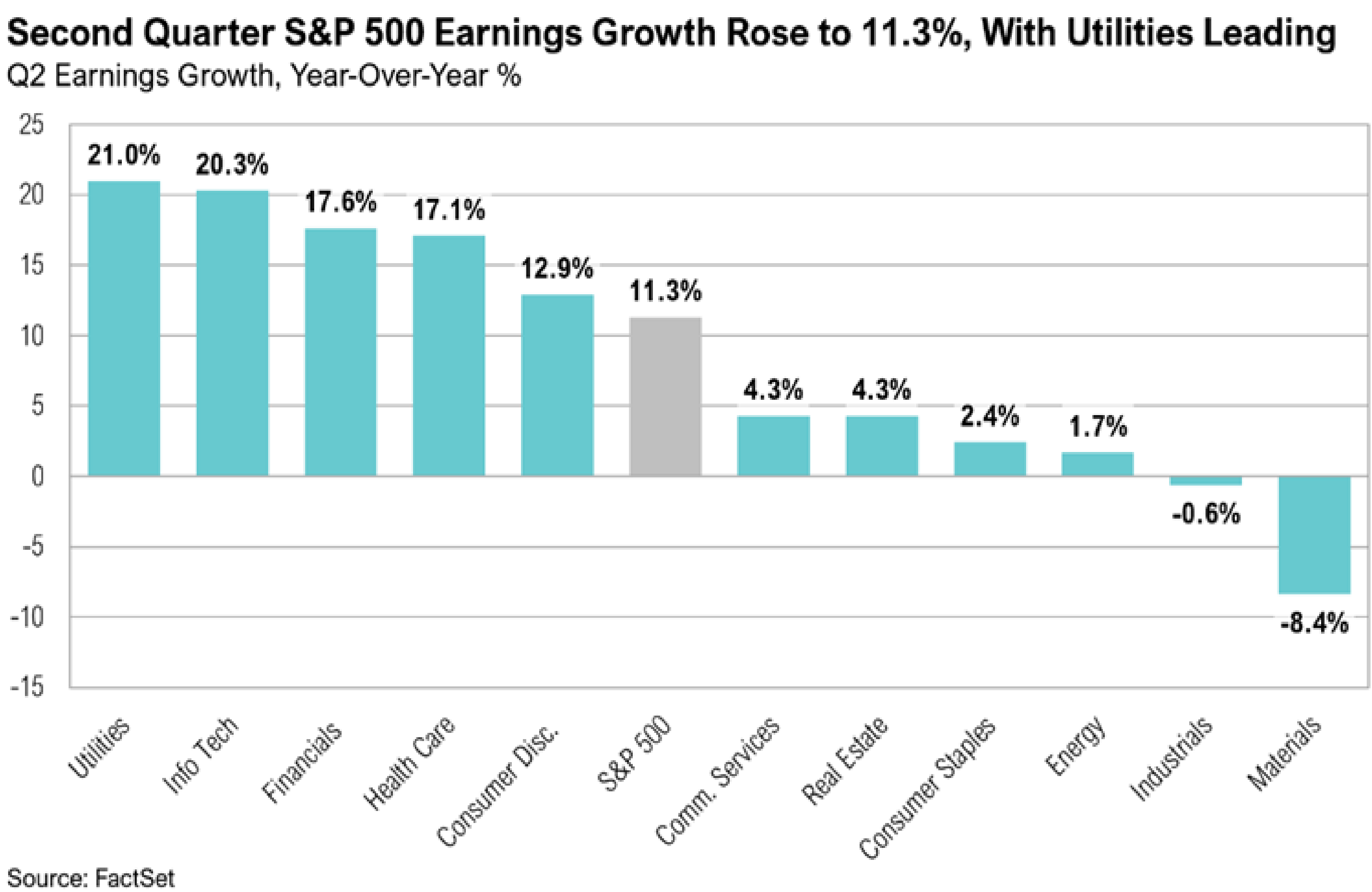
While the early August selloff was broad, some sectors rebounded more strongly. The utilities sector, up over 5% for the month and more than 18% year-to-date, benefited from a record-high power market auction. The auction came in at $269.9 per megawatt-day, an 800% increase from $28.9 a year earlier. This surge reflects supply and demand imbalances, mainly due to rising electricity demand from AI data centers and slow new-generation construction.

The high probability of a rate cut in September also helped lift the real estate sector, which gained 7.3% after August 5, finishing the month up more than 5%. Thirty-year fixed mortgage rates dropped back below 7% for the first time in over a year, as the potential for lower mortgage rates boosted homebuilder stocks, with a record 58% of U.S. homebuilders trading at all-time highs.

In contrast, U.S. small-cap stocks underperformed large-caps in the post-August 5 recovery and saw more volatility throughout the month. Although the Russell 2000 Index rallied over 8.5% from August 5 to August 30, it ended the month down -1.5%.

By the end of August, all S&P 500 companies had reported their second-quarter earnings. The index's earnings growth improved from 8.9% at the start of the third quarter to 11.3% by month-end. The utilities sector led with a 21.0% year-over-year growth rate, followed by information technology at 20.3%. Financials also saw strong performance, with earnings growth estimates rising from 4.3% to 17.6% during the quarter



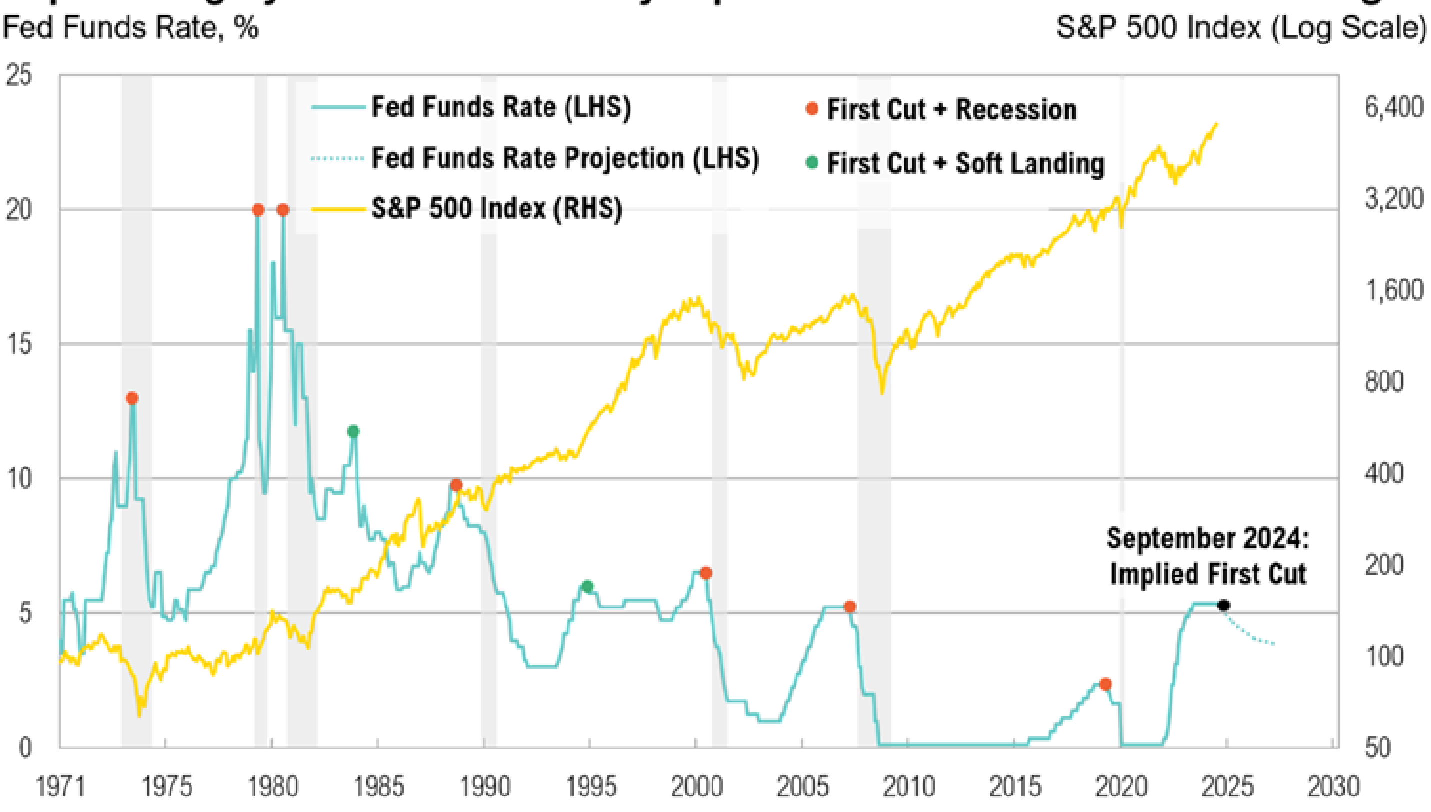
Small cap earnings for the second quarter revealed many challenges. However, small caps' full-year earnings growth is now expected to exceed large cap stocks' full-year earnings growth, coming in at 13.4% versus 11.3%. This shift could help small cap stocks shed the "value trap" label they have endured, which refers to stocks that appear cheap but continue to underperform.

With the typically "lazy" days of the historical "Summer Slowdown" trend disrupted by the early August selloff and subsequent recovery, investors also faced some uncertain, 'hazy days'. As of August 31, markets were pricing in a near-certain interest rate cut at the September 17-18 FOMC meeting, with a 67% probability of a 25-basis-point cut and a 33% probability of a 50-basis-point cut. According to Bank of America's August credit investor survey, a record 76% of U.S. investors now expect a soft landing for the U.S. Economy.

However, history reminds us that the Fed cutting rates doesn't immediately stop the lingering effects of prior hikes. In fact, much of the stock market weakness often occurs after the final rate hike. For instance, in January 2001, after the Fed announced the first rate cut of the cycle, the S&P 500 fell by more than 40% over the next two years. Similarly, in September 2007, when the Fed began cutting rates before the Global Financial Crisis, the S&P 500 declined by over 50%. Stocks only began to recover in March 2009. Whether the Fed can achieve a soft landing this time around remains uncertain, particularly since inflation is still above its official 2% target.

While equity markets gradually shifted from chaos to calm over the past month, bond markets held steady as yields remained contained. Treasury yields dropped early in August and stayed at those lower levels for the remainder of the month. The 10-year Treasury yield ended August at 3.9%, a level last seen in early January. Notably, the 10-year minus 2-year Treasury yield spread, after briefly dis-inverting on August 28, ended the month flat at 0.0%. This marked the end of the longest inversion period on record—784 consecutive days.

Rapid Hiking Cycles Have Historically Impacted Markets With a Substantial Lag



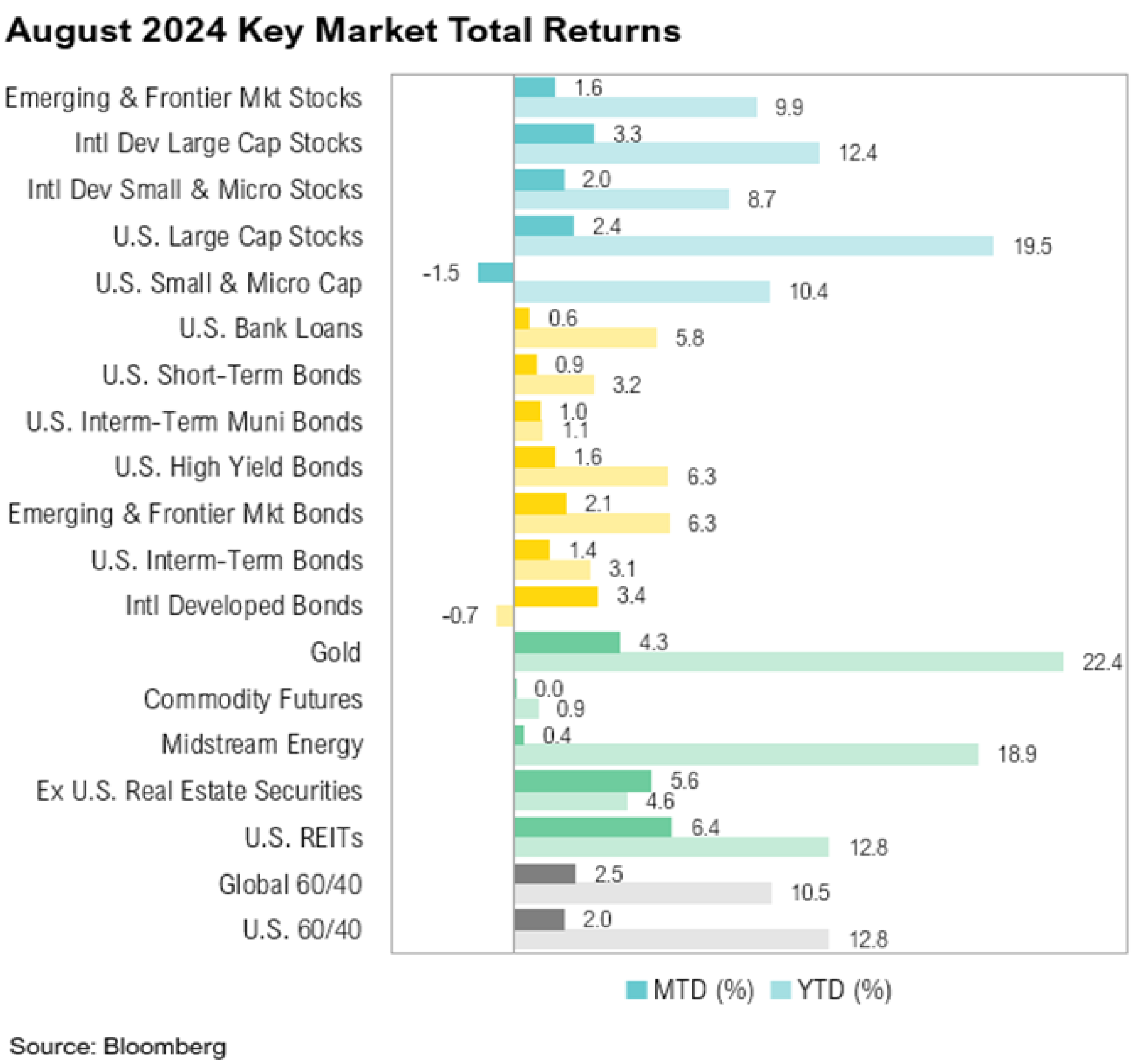
Source: Bloomberg

Markets

U.S. small cap stocks were the only major asset class to finish August with negative returns. In contrast, international equity markets outperformed their U.S. counterparts, led by gains in European markets. While U.S. large cap stocks ended the month up 2.4%, international developed market large cap stocks rose 3.3%, and international developed market small-cap stocks gained 2.0%, outperforming U.S. small caps by 3.5%. Among European markets, the MSCI Switzerland Index and MSCI Germany Index both posted gains of 4.8%, while the MSCI France Index rose 3.8% and the MSCI United Kingdom Index increased by 3.3%.

Boosted by the high probability of an interest rate cut at the September FOMC meeting, U.S. intermediate-term bonds ended the month up 1.4%, Gold also performed well during the month, rising 4.3% and reaching a new high of $2,511 per ounce on August 27. Year-to-date, gold is up 22.4%, making it the best-performing asset class so far this year.

In international news, the Japanese yen continued to strengthen against the dollar throughout August, closing the month at ¥146. During a parliamentary session on August 22, Bank of Japan Governor Ueda reaffirmed his stance on policy normalization, signaling a willingness to further raise interest rates if Japan's economic growth and inflation stay on track. In contrast to Japan's rate-hiking trajectory, other central banks around the world have begun—or signaled that they plan to begin—cutting interest rates in the coming weeks and months. The European Central Bank, the Bank of England, the Swiss National Bank, and the Bank of Canada have all initiated rate cuts.



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Looking Forward

As we head into year-end, we will continue to focus on potential interest rate cuts, future inflation trends, and the upcoming presidential election. The effects of interest rate cuts are still widely unknown, particularly as the Fed appears poised to cut rates amid above-target numbers and near full employment. Whether inflation continues to ease and when (or if) it will return to its 2% target remains to be seen. Additionally, the upcoming election brings significant uncertainty not only regarding the outcome but also concerning the policies that will be implemented by the winner. Given all these variables, we encourage investors to stay diversified and patient.

As always, if you have any questions or would like to schedule a meeting with one of our investment professionals, please don't hesitate to call us at 508-693-8850.

Sincerely,

Luke Murphy
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