Putting Recent Equity Weakness Into Perspective

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Summer volatility is not unusual, especially on summer Fridays that have major economic releases that challenge the market narrative. In this case, recent earnings and economic releases have questioned the soft landing, no recession outlook with fears of a recession becoming top of mind. Before we give you our perspective on the economy and equity market sell-off (down 6% from recent highs), we remind investors that the market narrative tends to fluctuate quite dramatically—remember in January when the market was pricing in seven Fed rate cuts this year, and then just a few months ago, many were wondering if the Fed would cut at all this year. The point: take the market narrative with a grain of salt and look at the fundamentals in determining your outlook for the economy and financial markets. We ultimately believe this soft patch of data will prove to a be a 'growth scare,' not a 'recession reality.' Below are our thoughts:

A 'Growth Scare' In The Making?

The soft payroll report (114k jobs created in July) on the back of weak manufacturing data yesterday has triggered a strong market reaction (in both stocks and bonds) as the market starts to worry that the Fed is behind the curve and that a recession will result. We would caution our readers to not overly react to any one number. Yes, the labor market has clearly decelerated in recent months and consumer spending is slowing, but we have been anticipating this weakness given the Fed's restrictive policy stance for some time. In fact, our economist has been forecasting a sharp deceleration in growth in 2H24 (Q3: 1.0%, Q4 0.8%) as the consumer slowdown and labor market normalization become a near-term drag on growth. However, we do not believe a recession is on the horizon because the job market, while weakening remains in good shape (the unemployment rate is rising because more workers are entering the labor force, not because of rising layoffs), corporate spending (i.e., tech-related spending) is healthy, and government spending (via the CHIPS/IRA Acts) should offset any slowdown we see from the consumer.

We have been calling for the Fed to start dialing back some of its policy restraint as overly restrictive policy was no longer warranted. While the Fed has been trying to thread the needle with the timing of its first rate cut and perhaps missed an opportunity to kick off its easing cycle this week, a rate cut is coming. The bond market is already doing the work for the Fed—Treasury yields are sharply lower (2Y and 10Y Treasurys are at 52-week lows) and this will drag mortgage rates and small business borrowing rates lower as well—providing much needed relief to the sectors of the economy that are hurting.

The market has quickly moved to pricing in over four rate cuts by year end, signaling to the Fed that they need to move policy rates lower or risk a recession. While the Fed does not like to surprise the market and policymakers have suggested it needs to see 'more good data', we still believe the Fed will do what it takes to avoid a recession (i.e., the 'Fed Put'). Our economist's base case is two cuts—in September and November, but he believes the Fed is flexible. Two other scenarios are: if next month's jobs numbers come in weak, it could cut 50 bps at the September meeting. If economic data deteriorates further sooner, it would not be unprecedented to see the Fed move intermeeting if the data warrants.

Putting the Recent Equity Weakness Into Perspective: Pullbacks in the market are never comfortable. But this current drawdown is part of a normal functioning market. As the S&P 500 moved above our year-end target of 5,400 we had turned more cautious. Our concerns were driven by five key factors:

1. ***Bad News Would Become Bad News* |** While 2Q GDP figures suggested that economic growth was healthy, forward-looking indicators (e.g., labor market softness, companies highlighting a slowing consumer, housing weakness) suggested that the economy was weakening. A slowing economy would likely lead to downside for earnings estimates and forward-looking guidance. We have seen that occur with earnings disappointments from McDonald's, Procter & Gamble, and Wayfair.
2. ***Valuations* |** A lot of good news was priced into the market, with the S&P 500's trailing P/E trading in the 93rd percentile. Any economic or earnings disappointment would likely lead to increased volatility. We have seen that with both economic and earnings releases, particularly this week.
3. ***Investor Over Optimism* |** Investors had gotten overly complacent. The % of bullish investors rose above 50%, a level that has historically led to negative short-term future performance.
4. ***Historical Precedent* |** The market typically experiences 3-4 5% pullbacks on average and a max intra-year drawdown of 13%. Up until this most recent pullback, the market had only experienced one pullback year-to-date with a max drawdown of ~5%. Greater volatility is not unusual.
5. ***Negative Seasonality* |** While the S&P 500 has been up each of the last 10 Julys, August and September have been the two worst-performing months on average. The open election (two non-incumbent candidates) provides an additional wrinkle to this, as the S&P 500 has been down on average in the 100 days leading up to election date.

What is the Equity Price Action Telling Us? Currently, the equity market is acting as expected with a 'growth scare' serving as the catalyst for the drawdown.

- Volatility has increased, but there has not been any panic-driven broad-based selling.
- At this juncture, defensive sectors (e.g., Consumer Staples, Health Care, Utilities) are outperforming whereas some of the more cyclical sectors are feeling more pressure.
- Consumer Discretionary, which is now negative year-to-date, has seen downward pressure which is consistent with the weakness seen in consumer-related economic data.
- Small-cap equities, which are levered to domestic economic growth have had a bigger decline than large-cap (S&P 500) stocks.
- Energy stocks have sold off as oil prices have fallen toward $73/barrel as growth concerns mount.

As a result, much of this market reaction is consistent with a slowing economy and it is not disorderly. That is why we view this pullback as a normal reaction and consistent with our economic forecast (i.e., weak 3Q & 4Q GDP) and year-end S&P 500 target (5,400).

So where do we go from here? We use our equity target as a guiding light for the direction of the market. When the market moved above our 5,400 price target, we turned more cautious. From a technical perspective, when the market is in an up-trend and breaks through its 50-day moving average to the downside, it tests its 100-day moving average 77% of the time (currently 5,308) and 200-day 44% of the time (currently 5,008). Interestingly, the S&P 500's 100-day moving average has been a key level of support in recent years and will be a level many technicians will focus on in the near term. Going forward, we expect the recent weakness to continue as the market digests the slowing economic activity and the impact on earnings. Keep in mind, the average max intra-year drawdown (13%) would bring the

S&P 500 down to around the 200-day moving average of ~5,000. While we may not get to that point, we do expect uncertainty around the economy, earnings, and the upcoming election to lead to further volatility—consistent with seasonal patterns exhibited over the last 50 years. However, we reiterate our year-end target of 5,400 and would get progressively more positive on the equity market if we see more downward pressure (Read: Buying opportunity). The reason: we do not expect a recession, just a soft patch in the economy. Assuming that is the case, earnings should continue to move higher into next year and this young bull market should continue its path higher.

For fixed income, with the 10-year Treasury yield below our 4.0% year-end target, we would be cautious to extend duration here given the sharp rally that we've seen in recent weeks (particularly with yields in overbought territory) and the exuberance priced into the Fed's expected interest rate path given this recent growth scare. We have been on this roller coaster ride before, and the market could be getting ahead of itself given the outsized moves we've seen this week with yields. However, we would look for opportunities to deploy cash and cash equivalents as the timing of the Fed's rate cut nears.

As market activity continues to develop, we will provide updates as warranted.

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