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WEALTH MANAGEMENT

OUTLOOKS

August 2024

ECONOMIC OUTLOOK

Summary

July's employment report appears to cement a September rate cut from the Fed, only two days after Federal Reserve's Open Market Committee (FOMC) Chairman Jerome Powell officially put the prospective cut "on the table." The nonfarm payrolls data missed expectations by 90,000 jobs (including two-month net revisions), but the biggest surprise was a 0.2% jump in the unemployment rate, bringing it up to 4.3%. While a sub-4% unemployment rate has been somewhat normalized during the past six years, it's important to note that it is historically low.

Still, the increasing unemployment rate raised some alarm bells as it triggered the "Sahm Rule," which is named after Claudia Sahm, the macroeconomist who created the economic indicator. The Rule states that any time the three-month moving average of the U.S. unemployment rate is at least a half percentage point higher than the 12-month low, the economy is in the initial stages of a recession. Though the indicator has proven accurate for more than 50 years, even the creator herself believes it may not be accurate this time, stating "a recession is not inevitable and there is substantial scope to reduce interest rates."

There are certainly several reasons to believe this time could be different. First and foremost, the economy is still solid. Yes, we have seen some weakness in the data of late, but nothing that would indicate an immediate recession. GDP for the second quarter was 2.8% and consumption remains strong. Additionally, some of the weaker data might be explainable. Hurricane Beryl in Texas may have had a direct impact on the employment report as 461,000 people reported they were employed but unable to work due to the weather and temporary layoffs increased by 249,000. Both of those are much higher than is typical.

Additionally, the unemployment rate appears to be increasing due to more people joining the labor force rather than employees being laid off. Also, the employment-to-population ratio (EPOP) for prime-age workers (ages 25 to 54) increased to its highest level since the pandemic recovery (80.9%). It would be uncommon for these data points to be increasing during a recession.

Positives

Inflation data in June was lower than expected (CPI -0.1% vs. 0.1% est.)

Second quarter GDP surprised to the upside by 0.8% (2.8% vs. 2.0% est.)

Retail sales (ex-Autos) for June were stronger than expected (0.4% vs. 0.1% est.)

Negatives

Factory orders for June were worse than expected (-3.3% vs. -3.2% est.)

Average Weekly Hours of All Employees fell to its lowest level in four years (34.2)

Initial jobless claims is approaching its highest values in a year at 249k

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EQUITY OUTLOOK

Summary

The S&P 500 Index rose 1.2% in July. At first glance, it would seem like a fairly quiet month by recent standards but there was much more to it when you look under the hood. As we mentioned last month, equity markets have made several attempts to broaden beyond the narrow leadership over the last couple of years. The great rotation of July 2024, however, seemed more meaningful and coincided with other impactful events.

One significant rotation was out of growth stocks and into value. The Russell 1000 Growth Index lost 1.7% in July while the Russell 1000 Value Index climbed 5.1%. Small-cap investors have felt left behind, with the Russell 2000 Index underperforming large-cap pears in each of the last three calendar years as well of six of the last seven years. Last month, however, the Russell 2000 Index surged 10.2% marking the index's best monthly performance relative to the S&P 500 Index in over 20 years.

While market conditions were poised for a rotation given the recent outperformance of a handful of growth stocks, there were additional catalysts for the change in July. Softening economic data along with a benign June inflation reading added to the likelihood of a September Fed rate cut. Political uncertainty also weighed on markets. President Joe Biden's poor debate performance ultimately led to his decision to drop out of the 2024 race, clearing the path for Vice President Kamala Harris to take the reins. An assassination attempt on former President Trump added to the uncertainty in July.

We are now mid-way through the release of second-quarter corporate earnings and results have generally been positive. Even with expectations elevated, 78% of companies have exceeded estimated earnings. The stock market's reaction to earnings has been somewhat mixed in spite of generally positive results.

As the end of summer nears, equity markets are likely to continue dealing with various uncertainties. Several corporations have hinted at challenged lower-income consumers and cautious consumers in general. Stock markets have also shown some seasonal challenges in early fall, which could once again ring true. A highly divisive election with razor close polling margins is unlikely to inspire confidence in equity markets. The bottom line: volatility remains likely over the coming months.

Positives

Inflation and economic data clear path for Fed rate cut in September

Artificial intelligence and related technology ushering in a new innovation revolution

Negatives

Economic data continues to soften

Geopolitical tensions remain elevated

Unknowns

Presidential election polls are extremely close

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FIXED INCOME OUTLOOK

Summary

Bond yields began to decline early in July following a payroll report that was as expected in terms of job growth but included substantial downward revisions to previous months. The three-month average payroll gain was now the lowest since the pandemic. The unemployment rate bumped to 4.3% from 3.8% three months ago and a low of 3.4% just over a year ago. The rally continued into mid month as favorable inflation reports further eased concerns about reemerging inflationary pressures. The first negative inflation print in four years was thought to bring the Fed one step closer to the first rate cut of a prolonged easing cycle. But to the contrary, at the conclusion of the Federal Reserve's Open Market Committee (FOMC) meeting on the last day of July where they choose to leave the overnight rate unchanged, they issued a slightly more hawkish statement since there was no reference to considering a September rate cut. Investors gave little consideration to this statement or Fed Chairman Powell's cautionary tone at the subsequent press conference. Yields across the curve moved about 10 basis points (bps) lower on the day and the futures market began to fully price-in three rate cuts by year's end.

For the month, the 2-year Treasury note declined by 50 bps to end at 4.26%. The 10-year dropped to 4.03% which was 37 bps lower. The 30-year ended at 4.30%, down 26 bps from June's month end. Corporate bonds delivered slightly better returns than Treasury notes as credit spreads ended little changed for the month. Overall, the investment-grade bond market delivered strong returns with the Bloomberg Intermediate Government/Credit Index up 1.88% and the Bloomberg U.S. Aggregate Bond Index returning 2.34%. These returns were the third consecutive positive monthly returns since the devastating decline in April and near the top 10% of monthly observations since the indexes were created.

Holding steady at 5.50% (upper band), the Fed Funds rate has now crossed over one full year since it was last changed. While it seems like an interminably long period to hold at the top restrictive policy rate, at 255 trading days it is only slightly longer than the average of 246 days for the previous four rate peaks since 1998. We were and are optimistic rate cuts will ensue in September. Obviously, the very weak payroll report released on August 2 adds to our confidence. Historical analysis shows regardless of how much rates move in advance of Fed cuts, the 10-year is always lower at the end of the easing cycle if greater than three cuts. Additionally, short rates decline to an even greater degree and the yield curve steepens. This could be more pronounced this year as the market contends with an election cycle and unprecedented government deficits. While we remain optimist for bond investors, given the sizable drop in yields during the first few days of August, we are removing long duration policy and now recommendation maintaining a duration equivalent to the benchmarks.

Positives

Economic data showing more signs of stress

Fed rate cuts likely soon. May be larger or more frequent than previously thought

Negatives

Federal budget deficit and heavy Treasury debt issuance

Yields have already moved sharply lower

Unknowns

Political uncertainties and future domestic policy

Middle East conflict in Israel. Domestic protests. Russia/ Ukraine war

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