August 2024

MONTHLY MARKET INSIGHTS

Key takeaways:

- US equities underwent a dramatic rotation as investors sold big tech while the small-cap Russell 2000 index surged.
- Bond yields resumed their downward trend as June's Consumer Price Index ("CPI") report came in softer than expected, and the Federal Reserve ("Fed") set the stage for rate cuts in September.
- Politics were in focus as Republican Presidential nominee Donald Trump survived an assassination attempt on July 13, and eight days later, President Biden dropped out of the race, succumbing to pressure from the Democratic Party after his disastrous debate performance on June 27.

July was particularly volatile for US equities, with the S&P 500 and the Russell 2000 showing positive returns while the tech-heavy Nasdaq declined. After making a new all-time closing high of 5,667 on July 16, the S&P 500 index pulled back 2.56% in the second half of the month to close at 5,552, representing a monthly gain of 1.13%. The reversal in the Nasdaq was more severe. It peaked on July 10 at 18,647 before pulling back 5.62% the remainder of the month to close at 17,599, down -0.75% for the month. The star of the month was the Russell 2000, which gained 10.10% after severely lagging in the first half of the year.[1] The spread between the performance of the S&P 500 and Russell 2000 during the month was one of the largest ever on record.

July's market action is being dubbed the "great rotation" as it represents a complete reversal from the trends witnessed during the first half of the year. The catalyst for the rotation came on July 11 when June's CPI report came in much softer than expected. June's CPI report significantly raised the odds that the Fed would start cutting rates in September, and it sparked a bond market rally that lowered yields to levels last seen in early February. By month end, the Fed-sensitive 2-year yield had dropped 49 basis points ("bps") to 4.26%, and the 10-year yield had declined 37 bps to 4.03%.[2] At the conclusion of the Fed's July meeting on July 31, Chairman Powell set the stage for a September rate cut, and after Friday's soft employment report, investors are now pricing in a high probability that it may be a 50-basis-point cut.

Lower yields sparked renewed investors' interest in small caps and other rate-sensitive equities, much like we saw late last year. Some of the areas of the market that had been hit the hardest by the Fed's rate-hiking campaign, like regional banks, real estate investment trusts ("REITS"), and homebuilders, led July's surge. However, unlike the fourth quarter of last year, when most stocks benefitted from the drop in yields, July's rally in small caps and other interest-rate sensitive names came at the expense of big tech and other leading large-cap equities. This market behavior calls into question whether July's small-cap surge was simply an unwind of extended positioning by momentum and other short-term investors or the start of a more sustainable advance for small caps.

We believe this surge in small-cap outperformance is unsustainable. Investors have understandably cheered the imminent return of Fed cuts as a positive for interest-rate-sensitive equities. However, these same companies also tend to be the least diversified and most economically sensitive companies, which makes them the most vulnerable during an economic downturn. While disinflation drives rate-cutting optimism, the broader economy also shows signs of vulnerability. The lagged effects of higher interest rates continue to weigh on housing activity and commercial real estate prices while the low-end consumer is showing signs of stress. Most importantly, the employment market is trending in the wrong direction, as evidenced by July's non-farm payroll report (released on Aug 2) that showed less-than-expected job gains of

1. Factset.
2. Bloomberg.

114,000 and the unemployment rate ticking up to 4.3%.[3] Average monthly job gains have slowed significantly this year, while the unemployment rate is well off last year's low of 3.4% and continues to tick higher.

The July jobs report ignited a huge rally in government bonds, taking the Fed-sensitive 2-year yield to a level not seen since early 2023 and the 10-year yield well below 4%. Rather than being a catalyst for further stock gains, the shocking drop in yields sparked renewed recession talk and a broad-based equity selloff that saw the Nasdaq hit correction territory. Not surprisingly, small caps have underperformed to start the month of August as investor attention has turned to economic weakness concerns.

As we discussed a few weeks ago in our mid-year outlook video, we think the odds of a recession in 2024 remain low, but investors are significantly underestimating recession risks for 2025. With elevated valuations and extended investor positioning, we were cautious coming into the second half of the year and warned about the likelihood of a profit-taking selloff ahead of the election. As the calendar turns to August, our concerns look prescient. A bout of weak economic data along with uninspiring earnings reports from the Magnificent 7 and some leading semiconductor companies catalyzed a market selloff. Looking ahead, we expect elevated volatility in August, but we expect the S&P 500 index will find good support in the 5,000 – 5,200 range.

While July's equity market activity was clearly eventful, the month's biggest headlines came from the political sphere. On July 13, former President and Republican nominee, Donald Trump, survived an assassination attempt at a campaign rally in Butler, Pennsylvania. The bullets fired by 20-year-old Thomas Matthew Crooks killed one attendee, severely wounded two others, and grazed Trump's right ear, coming inches away from killing him. The assassination attempt casts a troubling eye on the Secret Service, which failed to fully secure the rally's perimeter and allowed Crooks to fire unobstructed shots at Trump from a rooftop approximately 400 feet away. Trump's iconic reaction and resolve in the face of such adversity drove up his odds of winning the election in the following days.

On the Democratic side, President Biden dropped out of the race on July 21, finally succumbing to enormous pressure from big donors and the Democratic Party after his disastrous performance in the June 27 Presidential debate. Polls suggested Trump would win convincingly as President Biden was unsuccessful in allaying fears about his cognitive decline and ability to lead. After Biden's announcement, the Democratic party quickly rallied behind Vice President Kamala Harris as their nominee, avoiding a potentially contentious and crippling nomination process. Instead, the Democratic base appears re-energized, the Harris campaign raised record amounts in its first week, and recent polls suggest the election outcome is too close to call.

3. Bloomberg.

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