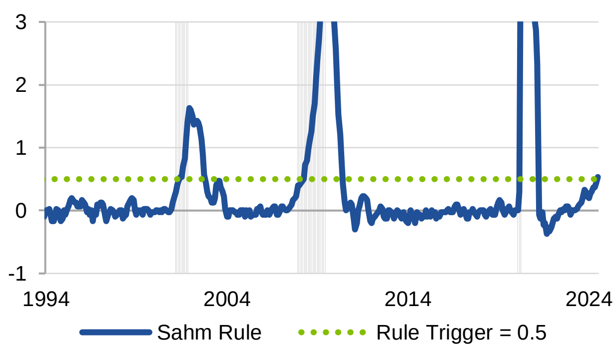

July 2024

# From gains to turmoil: July's gains turn into August's woes

Concerns over a weakening labor market and the U.S. potentially falling into recession triggered a market correction that began in mid-July and took a sharp downturn in early August, wiping out the strong gains from the earlier part of July. The increase in the unemployment rate in July triggered the Sahm Rule, which has historically been an effective indicator of an onset of a recession. This rattled investors, leading to a sharp selloff in equities and a rally in bond prices. As of end of day August 5, the S&P 500 fell 8.5% from mid-July, and the 10-year U.S. Treasury yield slid to 3.78% from 4.23% on July 15.

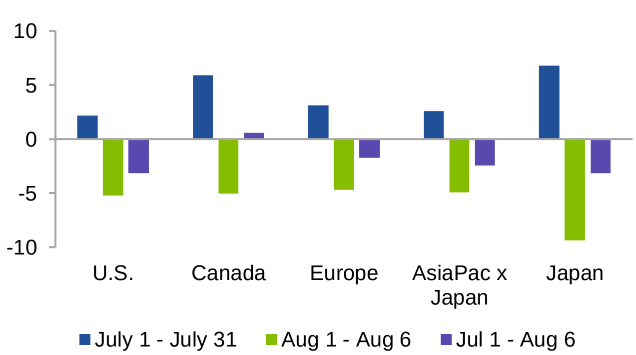
**The Sahm Rule has been triggered**




Source: Bloomberg.

Despite the pullback that started in mid-July, the S&P 500 and Dow Jones posted positive returns for July. August began, however, with a sharp sell-off in both domestic and international markets, in reaction to the Bank of Japan's (BoJ) surprise rate hike on July 31. The rate hike to 0.25% – the highest level in

**Significant correction in early August**



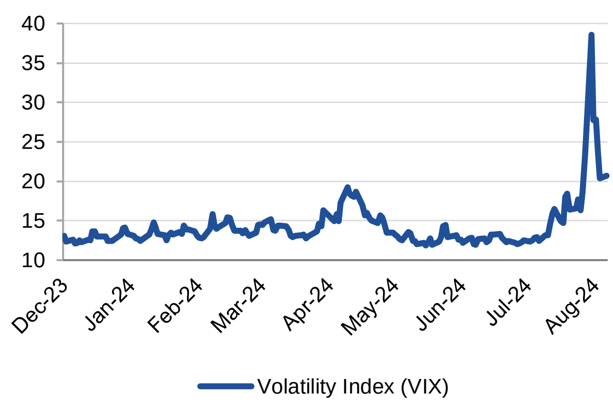

Source: Morningstar.

15 years – and BoJ's hawkish comments triggered the unwinding of carry trades (borrowing yen at lower interest rates to invest in foreign markets with higher returns), causing the soaring yen to send Japanese equities sharply lower. The TOPIX index dropped by 17.6% (JPY) in two trading sessions, marking the largest two-day decline since 1950. The yen rallied sharply by 10.8% from its lows in early July, back to levels seen in May.

## Panic selloff spiked volatility

Index volatility soared in the first three trading sessions in August, hitting an intraday high of 65. This in turn exacerbated market selloffs as it triggered the unwinding of "dispersion trades." Dispersion trades involve selling options on an index, which is typically relatively overpriced, to buy options on individual companies, which are typically underpriced. When index volatility soars, profitability on these trades sours, and the unwinding of these trades can exacerbate the selloff and volatility of the markets.

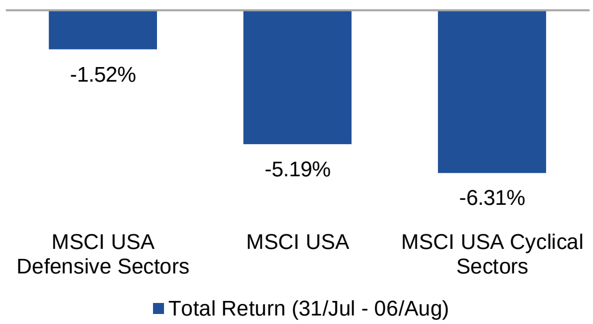
**VIX soared to highest level since March 2020**




Source: Bloomberg.

In this panic selloff, the magnitude of the drawdowns varied greatly by sectors and factors. Defensive sectors stood out as safe havens relative to the cyclical sectors. Low valuation held up better than companies that are rich on valuation, and large-cap companies outperformed small-cap companies. Importantly, bonds fulfilled their traditional risk mitigating role as higher bond prices offset stock price weakness during this period. We expect this relationship to be the norm going forward, unlike the past few years where higher interest rates caused both bonds and stocks to fall at the same time.

**Defensive sectors saw limited downside**




Source: Bloomberg.

## Multiple sources of volatility

### U.S. economic deceleration

U.S. economic data has been weak since May, but the latest data concerning the labour market and manufacturing activities rattled investors as a potential signal that the U.S. economy has weakened past the tipping point and may fall into a recession. The thinner liquidity in the summer months also exacerbated the market drawdown.

The payrolls report showed a sluggish labor market. Job creation disappointed as it expanded by a modest 114,000 workers, falling significantly short of the expected 175,000 and marking a sharp slowdown from June’s report. While partially impacted by a growing labour force, the unemployment rate rose by 0.2% to 4.3%, continuing its upward trend for the fourth consecutive month.

The ISM Manufacturing Index also fell below 50, into contractionary territory, with falling new orders and employment. Although manufacturing weakness is worsening, it is still not at a level consistent with the economy falling into a recession.

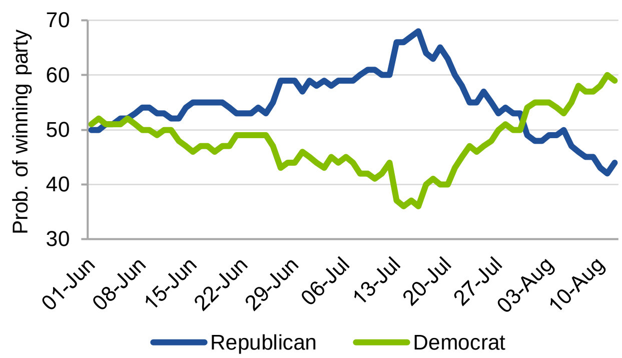
### Dovish BOJ and strong yen rattle the markets

On July 31, the Bank of Japan hiked its policy rate and announced further quantitative tightening, reducing its pace of monthly bond buying from JPY 6 trillion to JPY 3 trillion. While the central bank had previously telegraphed its intention of tapering asset purchases further, the rate hike took market participants by surprise. The Japanese yen rallied sharply, while the Japanese equity markets plummeted. The rally in the yen drove the unwinding of the yen carry trade, a strategy where investors borrow in yen at low interest rates and invest in higher-yielding assets elsewhere.

### Gamechanger in U.S. politics sent shockwaves

Politics in the U.S. continued to create shocks and swings, including President Biden's poor debate performance and a failed assassination attempt on former President Donald Trump, which first increased the likelihood of a Trump win and a Republican sweep. However, Biden's subsequent withdrawal from the race and Kamala Harris stepping in caused a sea change in this election, reinvigorating Democratic voters and shifting the dynamics dramatically. Harris also raised a record-breaking $310 million for her campaign in July, while her VP choice Tim Walz helped to pull poll results ahead of Trump, resulting in a tight race once again.

**Kamala pulling ahead of Trump in polls**



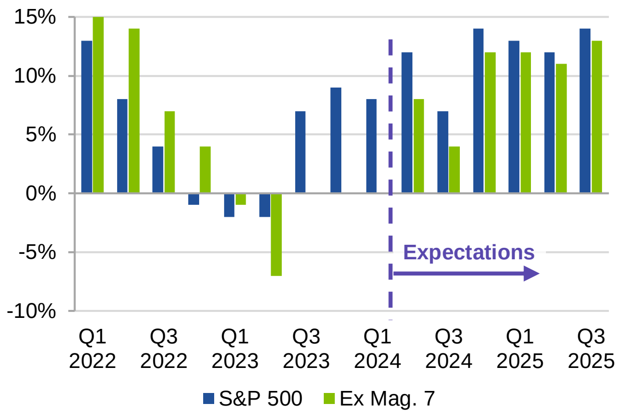

Source: Bloomberg.

**Bottom line**: As the U.S. election is shaping up to be a tight race, the uncertainty around policies might lead to higher market volatility. Markets tend to rise once this uncertainty is alleviated, which means staying invested is as important as not making huge bets based on political outcomes. Investment opportunities are unlikely to change significantly regardless of who wins the election.

## Double digit growth in U.S. earnings in Q2

91% of the companies in the S&P 500 have reported earnings so far, and 78% are reporting EPS higher than estimates. Although the percentage of S&P 500 companies reporting positive earnings surprises is above average levels, the market’s high expectations are rewarding positive EPS surprises less than average and punishing negative EPS surprises more than average. Overall, the index is reporting its highest year-over-year earnings growth rate at 10.8% since Q4 2021, the fourth consecutive quarter of year-over-year earnings growth. It also marks the first quarter since 2022 where the other 493 companies reported positive quarterly earnings growth.

**S&P 500 ex Mag 7 had positive earnings growth**




Source: Factset.

Looking ahead, consensus estimates for earnings growth in Q3 and Q4 of 2024 stand currently at 5.4% and 15.7%, which translates to earnings growth of 10.2% for the calendar year 2024, suggesting a resilient U.S. economy. Following the Q2 reporting season, estimates for FY2025 earnings have held steady and resilient, at almost 14% growth, making the U.S. the strongest country among developed markets.

**Bottom line:** The U.S. equity market continues to be concentrated not only on price returns but also earnings contribution. A small number of companies are contributing a significant portion of earnings, increasing volatility and vulnerability on the index. Notwithstanding the latest drawdown, the premium on U.S. valuations reflect a soft-landing scenario with high expected earnings growth. Companies require material upside catalysts to get further upside or valuation gain, while companies that deliver negative surprises get punished. We expect the U.S. market to be rangebound until year-end, and investors need to be selective and stay disciplined with regular rebalancing to mitigate concentration risk.

## Moderating inflation supports September rate cut

### Weakening U.S. labour market makes a strong case

Second quarter GDP growth beat expectations at +2.8% in the U.S. This was boosted by strong consumers, private investment, and softening employment and inflation numbers. This has shifted the question about the U.S. Federal Reserve (Fed) rate cuts from "when" to "how much" with the first cut widely expected in September.

Although the Fed kept the policy rate unchanged for the eighth meeting, the policy statement and press conference leaned dovish, signaling the first cut as soon as September, on increased concerns regarding the labour market, and continued progress towards the inflation target of 2%.

Subsequently, the July jobs report painted a picture of a rapidly cooling labor market, potentially signaling a shift in the economic landscape. However, the role of strong labor force growth in suppressing the unemployment rate complicates the interpretation of traditional recession signals. As a result, economists are closely watching for further signs of weakness in activity data and labor market indicators to fine-tune their forecasts.

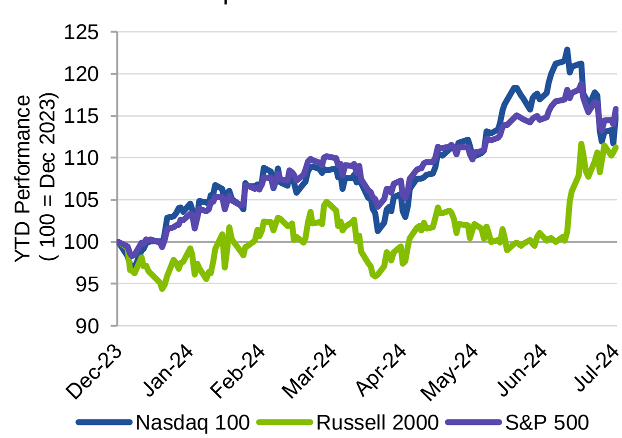
### Canada

Unlike our southern neighbor, Canada's domestic economic outlook is not as rosy and the trajectory continues to deteriorate. We believe this is reason for the Bank of Canada (BoC) to continue to cut rates in September, after its second consecutive 25bps cut in July.

Canada's inflation update in July was largely positive, with nearly all measures released at or below consensus forecasts. Core year-over-year price growth was essentially unchanged, remaining at 3% for the third consecutive month. Inflationary pressure at this point seems almost entirely related to shelter and housing. Removing the mortgage interest portion, the headline inflation rate would be at just 1.9%, in line with the Bank's target of 2%.

## July rotation to small cap in historic proportions

One of this year's laggards played catch up in July, as investors shifted towards small-cap equity stocks, which are more sensitive to interest rate cuts. The increased likelihood for rate cuts, following the soft U.S. inflation print and weaker U.S. labour market data, likely triggered the largest one-month outperformance in over 20 years of the Russell 2000 versus the Nasdaq 100 Index of 13.34%.




Source: Bloomberg.

**Bottom line:** The rotation was surprisingly sooner and bigger in magnitude than expected, as small cap rotation typically happens when economic growth begins to accelerate, not when it's decelerating, and forward-looking earnings growth in the small-cap companies typically needs to be accelerating as well. It is not the case at this point. While we continue to believe that the high-quality segment within the small-cap space is attractive, we believe this rebound could be short-lived, and the more sustainable recovery could still be ahead.

**NEI Investment Team**

## Asset class outlook

| Asset class | View | Changes from last month | Rational |
|---|---|---|---|
| **Equities** | OW | – | Pullback created better entry point, strong corporate earnings growth provide support, besides rate cuts as upside catalyst. |
| Canada Equity | OW | ↑ | Earnings back to positive growth rates in Q2, better clarity on path of rate cuts provide relief. |
| U.S. Equity | Neutral | ↓ | Earnings growth still high but investor expectations set too high. Elevated valuation limits upside. |
| International Equity | Neutral | ↓ | UK and Europe attractive at half the valuation of U.S. but face rising risks from international trade. |
| EM Equity | UW | – | Divergent growth trajectories by country. Selective opportunities but downside surprise on China GDP growth weighs. |
| **Fixed Income** | UW | – | Yields already reflecting disinflation in soft landing scenario, few catalysts to move lower in the near term, making equities more attractive. |
| Govt Bonds | OW | – | Yields fell to price in increased likelihood of rate cut in September, corporate credit more attractive in the short term. |
| IG Bonds | Neutral | ↑ | Spreads widened moderately in the pullback. Absolute yield levels remain attractive. |
| HY Bonds | UW | – | Fundamentals remain strong, spreads widened from historically levels. Keep quality bias for good absolute yields. |
| **Cash** | Neutral | – | High opportunity cost when macro environment remains supportive for risk assets. |

This table illustrates the short-term outlook of NEI's Asset Allocation Team on various equity and fixed income asset classes as of July 17, 2024. "UW" refers to an Underweight position, "OW" refers to an Overweight position. Symbols indicate the change in outlook from the prior month's outlook. The arrows indicate the change in outlook from last month. An upward arrow indicates a positive change on outlook, a downward arrow indicates a negative change on outlook and a dash indicates unchanged outlook.

## Market performance

### Percent return in Canadian Dollars

| Returns less than 1 year are not annualized | 1 Mo | 3 Mo | 6 Mo | YTD | 1 Yr | 3 Yrs | 5 Yrs | 10 Yrs |
|---|---|---|---|---|---|---|---|---|
| **Fixed Income** | | | | | | | | |
| Bloomberg Canada Aggregate Index | 2.23 | 5.38 | 3.32 | 1.79 | 7.20 | -1.29 | 0.35 | 2.04 |
| Bloomberg Global Aggregate Index | 1.88 | 3.56 | 1.93 | 1.67 | 5.34 | -1.83 | 0.09 | 1.90 |
| Bloomberg US High Yield Index | 1.89 | 3.87 | 4.25 | 4.19 | 10.14 | 1.52 | 3.46 | 4.03 |
| **Equities** | | | | | | | | |
| MSCI World Index | 2.74 | 9.07 | 16.18 | 19.14 | 24.20 | 10.52 | 13.20 | 12.17 |
| MSCI World Growth Index | -0.01 | 10.33 | 17.56 | 21.64 | 27.63 | 9.69 | 15.96 | 14.91 |
| MSCI World Value Index | 5.78 | 7.75 | 14.75 | 16.57 | 20.61 | 10.69 | 9.70 | 9.03 |
| MSCI Canada Index | 5.88 | 6.84 | 11.21 | 11.80 | 15.79 | 7.50 | 9.69 | 6.65 |
| MSCI USA Index | 2.20 | 10.38 | 18.18 | 21.58 | 27.50 | 11.96 | 15.52 | 15.16 |
| MSCI EAFE Index | 3.92 | 5.78 | 11.47 | 13.60 | 16.72 | 7.19 | 8.45 | 7.37 |
| MSCI Europe Index | 3.13 | 5.27 | 11.88 | 13.23 | 16.16 | 7.55 | 9.11 | 7.31 |
| MSCI Japan Index | 6.81 | 7.04 | 11.12 | 17.79 | 21.96 | 8.27 | 8.89 | 8.63 |
| MSCI Pacific Ex Japan Index | 2.60 | 5.99 | 9.63 | 7.21 | 9.18 | 3.21 | 3.96 | 5.51 |
| MSCI EM Index | 1.26 | 5.42 | 16.90 | 12.94 | 11.53 | 0.60 | 4.47 | 5.10 |
| **World Currencies** | | | | | | | | |
| US Dollar | 0.96 | 0.55 | 3.40 | 4.77 | 4.95 | 3.43 | 1.02 | 2.41 |
| Euro | 1.93 | 1.76 | 3.00 | 2.63 | 3.01 | 0.33 | 0.44 | 0.26 |
| Pound Sterling | 2.58 | 3.15 | 4.29 | 5.56 | 4.77 | 0.74 | 1.99 | -0.35 |
| Yen | 7.94 | 5.17 | 0.45 | -1.83 | -0.89 | -6.89 | -5.36 | -1.41 |
| **Commodities** | | | | | | | | |
| Bloomberg Sub WTI Crude Oil Index | -1.99 | -1.27 | 12.66 | 21.11 | 13.62 | 17.82 | 4.69 | -6.06 |
| Bloomberg Sub Brent Crude Index | -2.39 | -2.24 | 11.08 | 18.61 | 12.69 | 24.23 | 15.49 | 0.87 |
| S&P GSCI Gold Spot Index | 6.71 | 7.98 | 23.68 | 25.05 | 29.18 | 14.62 | 12.59 | 9.36 |
| Bloomberg Sub Copper Index | -3.52 | -6.66 | 12.34 | 14.83 | 11.98 | 3.18 | 11.41 | 4.98 |

Source: Morningstar data as of July 31, 2024.



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