Market commentary notes

Monthly call notes
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Key issues summary:

Anticipation and anxiety in the markets this week? A combination of anticipation and anxiety has taken hold. Anxiety that the weaker new payroll numbers and higher unemployment might mean we're headed for a recession, and anticipation that it means the Fed will definitely reduce interest rates in September. We see that anxiety in the bond markets as well. The yield on 10-year Treasuries fell to about 3.8% last week, which pretty clearly signals anxiety over a possible recession.

So what's the reality, as near as we can tell? First the ISM manufacturing survey came in at 46.8, which was down 2 points and weaker than expected. Adding to this July new payroll jobs came in at a weaker 114,000. The unemployment rate is 4.3% and 352,000 more people are listed as unemployed this month. On top of that the June payroll was revised down by 27,000 to 179,000. [https://www.bls.gov/news.release/empsit.nr0.htm].

Sounds bad, right? To put it in perspective, 366,000 more people said they wanted jobs and the labor force participation rate—the proportion of working age people working or looking for work—was unchanged at 62.7%. We have slightly more people working now than we did in July 2023. So the increase in unemployment isn't because people lost their jobs but rather because more people are looking for work. Also, hours worked has remained stable and average weekly earnings are up 3%. Finally, the services PMI, which encompasses about 80% of the economy, rose to a very robust 56.

My impression is that the economy is slowing, as I've said several times during the last 3 or 4 months. But so far, it doesn't show signs of recession. We'll get to what that means for businesses and profits in a minute.

Second, bear in mind that there are two manufacturing surveys. The one that fell dramatically is the ISM survey, which I don't follow. The reason is that it surveys mostly large companies and I don't think it represents the general situation in the economy completely. The PMI survey that I follow includes more, smaller companies. That's down as well, but at 49.6 it is just slightly under "stable."

So, in summary, there's definitely evidence of a slowdown but I would say it's far from dire for now. Things could get worse, but they could also improve.

Earnings—How do corporate earnings play into all of this? With 75% of the S&P 500 companies reporting, the blended earnings growth rate for Q2 S&P 500 EPS currently stands at 11.5%. This compares to the 8.9% expected at the end of the quarter. The blended revenue growth rate is +5.3%. So both

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earnings and revenues are up very nicely this quarter. [StreetAcount Scorecard, 2 August 2024]. However, there are some trouble spots. To my mind, not surprisingly, tech companies are showing relatively poorer earnings growth. Intel for instance came in well under expectations and the stock fell precipitously as a result. Amazon was also down in certain businesses compared to expectations. The Crowdstrike problem also weighed on the market this week. [StreetAccount Summary – U.S. Weekly Recap, 2 August 2024].

Overall, I would characterize the earnings reports as healthy with some conspicuous issues and misses, especially in the tech sector. That's important because it has been both a major component of the S&P and also the biggest driver in terms of S&P performance.

The Fed—in line with expectations—The FOMC met last week and made no changes to interest rates or to their purchases of longer-term bonds. As always, however, how they framed their views is important:

"Recent indicators suggest that economic activity has continued to expand at a solid pace. Job gains have moderated, and the unemployment rate has moved up but remains low. Inflation has eased over the past year but remains somewhat elevated. In recent months, there has been some further progress toward the Committee's 2 percent inflation objective. The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent." [https://www.federalreserve.gov/newsevents/pressreleases/monetary20240731a.htm, July 31, 2024].

This was released before the latest PMI and payrolls information. However, numbers from a single month aren't likely to sway the Fed to take action before the next meeting, which is in mid-September. I suspect the "expand at a solid pace" reflects the +2.8% GDP growth report from the last quarter.

Last month, I reviewed briefly what other central banks were doing and how their challenges differed from those of the U.S. Specifically, I observed that Japan was more likely to be on an interest rate hiking path than reductions, and indeed, last week the BoJ increased rates by 0.25%. I suspect they will do a little more and get rates to 1% over the next year. That should start to gently increase the value of the Yen, but probably won't change investment opportunities noticeably.

Meanwhile the ECB and Bank of Canada both reduced rates by a quarter of a percent in June and July respectively. The BoC is now at 4.5%. That was the BoC's second reduction of the summer. [https://www.bankofcanada.ca/core-functions/monetary-policy/key-interest-rate/, August 2, 2024].

Employment – July's payroll report was a somewhat disappointing +114,000. My sense was that it would be nearer to 150,000. However, weekly wages were still up 3% from a year ago and hours worked were stable. [https://www.bls.gov/news.release/empsit.nr0.htm, August 2, 2024].

July was okay, but then a big downdraft—In July, we saw more volatility in domestic equities but still, the S&P 500 was up 1.2%. Small caps were up an astonishing 10.5%—though not quite enough to catch up with large caps on a YTD basis. REITs and international indexes were also up.

On the bond side, intermediate bonds went up another 2.1% while commodities fell 3.5%.

That changed somewhat in the beginning of August as stock markets, especially tech, tumbled as described previously.

Global stock indexes

Total Index	July %	YTD %	1 yr %	2023 Est PE Trailing/ Projected
S&P 500	1.22	16.70	22.15	23.27/21.76
S&P Mid Cap	5.81	12.33	15.41	18.25/16.49
S&P Small Cap	10.80	9.99	14.10	26.69/16.44
FTSE All REIT	7.18	4.83	11.14	
MSCI All Country xU.S.	2.32	8.14	9.75	
MSCI Emerg Mkt	0.30	7.81	6.27	

Source: Morningstar as of July 31, 2024. Estimated PE's are 12 month values from S&P Dow Jones Indices. Trailing PE's are as of September 29, 2023. Projected PE's are as of December 29, 2023. Figures are provided for comparisons over time.

Fixed income and alternatives

Total Return Index	July %	YTD %	1 yr %
Bloom Agg Intermed	2.12	2.16	5.58
ICE BofA U.S. Convertibles	1.88	4.18	5.25
S&P GSCI	-3.52	7.17	0.20
Bloom U.S. Corp HY	1.94	4.58	11.05

Source: Morningstar as of July 31, 2024.

Sector performance—In July, the best sectors were real estate and utilities—both typically debt-heavy. The worst were communications and IT. However, on a YTD basis, communications and IT are still at the top, along with financials. Real estate, consumer discretionary and materials brought up the rear. Same as last month. [https://www.spglobal.com/spdji/en/documents/performance-reports/dashboard-us.pdf, August 2, 2024]. [https://digital.fidelity.com/prgw/digital/research/sector, August 2, 2024].

Commodities

Commodity and food price changes, current month and YoY

Total Index	June%	YoY %
Copper	-9.5%	5.2%
Lumber	11.0%	-1.2%
Cotton	0.7%	-21.3%
Sugar	-11.5%	-23.3%
Coffee	2.9%	39.6%
Wheat	-6.1%	-17.7%
Corn	-3.9%	-18.3%
Oil	-11.6%	-9.3%
NatGas	-19.5%	-26.3%

Source: https://tradingeconomics.com/commodities, August 2, 2024.

Six of these nine major commodities saw prices decline in July. For these nine, the average one-year price change was a decline of 8.1%, which points to both a decline on average in commodity prices and reflects their extreme recent volatility. On a YoY basis of these 9 commodities, 6 saw price changes of more than 10% from a year ago. Five were declines and one (coffee) was a substantial increase.

Looking more broadly at commodities, when we look at 22 categories of agricultural commodities and 26 categories of industrial commodities, 29 of the 48 saw price declines in July, compared to 34 last month. Twenty-three saw lower prices than a year ago versus 18 last month. So there's still evidence of declining commodity prices that will feed into the supply chain going forward. The declines in oil, natural gas and copper prices should help both consumer and wholesale inflation numbers.

U.S. economy

The U.S. economy at a crossroads ...

GDP estimates

[https://www.bea.gov/data/gdp/gross-domestic-product, Aug. 2, 2024]. [https://www.atlantafed.org/cqer/research/gdpnow, Aug. 2, 2024]. The advance estimate for the 2Q2024 GDP growth rate came in at an unexpectedly high +2.8%. The main drivers were consumer spending and inventory rebuilding. Personal incomes were up $238 billion during the quarter. The current estimate for the quarter that we're currently in is +2.5%. [https://www.atlantafed.org/cqer/research/gdpnow, August 2, 2024].

U.S. PMI statistics

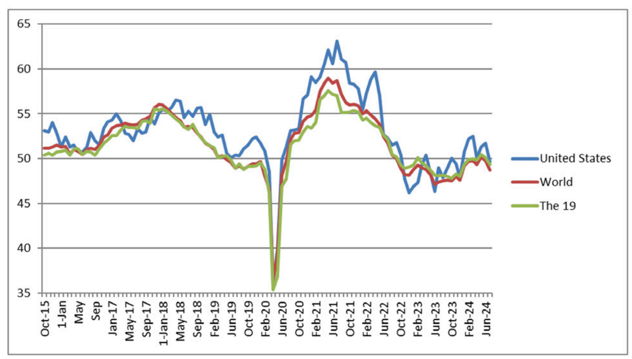
The July PMI Manufacturing number dipped to 49.6—below the 50 indicating stability, but just barely. This is the first time since 2023 that the number has been below 50. The Services PMI came in at a very strong 56. A couple of months ago it was 51.3. Together, I'd interpret these to indicate there's a little slowdown on the manufacturing side but the rest of the economy continues to grow. [Trading Economics, PMI statistics August 2, 2024.] [Trading Economics, https://tradingeconomics.com/country-list/services-pmi, August 2, 2024].

International

Manufacturing PMI

Every month I look at global Purchasing Managers Index (PMI) statistics. The July numbers indicate that manufacturing expanded in 15 of our 38 countries. It was 21 last month and 22 before that. The Eurozone was about stable though under 50 at 45.8. Germany, France and Spain were down a bit while Italy was up. Our GDP-weighted average manufacturing PMI dipped slightly more to 48.7, while our measure of the 19 major economies was at 49.3. Both are down from last month. EU's Services PMI stayed solid at 51.9 and Germany, France, Italy and Spain all had service PMIs above 50. [https://tradingeconomics.com/country-list/services-pmi, August 2, 2024].

Here's our updated graph of Manufacturing PMIs



Source: Author's calculations based on published PMI statistics, as of August 2, 2024.

Table summary

Region	Manu PMI	Last month	12 mo. Ago
U.S.	49.6	51.7	49
19 majors	49.3	50.1	48.1
38 world	48.7	49.8	47.4
EU	45.8	45.6	42.7
China	49.8	51.7	49.2

Source: Author's calculations based on published PMI statistics, August 2, 2024.

We're seeing that the recent trend in PMIs in the U.S. and abroad has been gently downward. That said, comparing the figures of today to a year ago, all of the recent figures are higher than they were 12 months ago, even if they are a little lower compared to a month ago.

So while this news isn't bad, it will probably cause the major central banks to start thinking about cuts sooner and perhaps more than they would otherwise.

Investment strategy

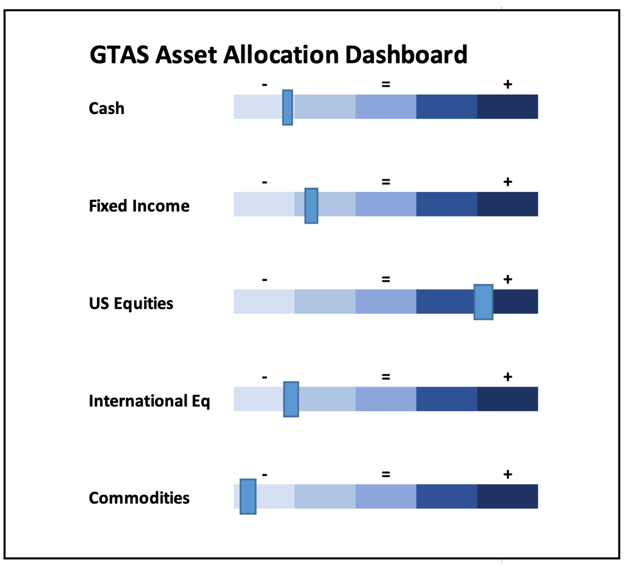
Last week and Monday we saw a hiccup in the global equity markets. There were likely several causes including economic weakness, rising rates in Japan and general anxiety over recession risk. However, these hiccups are common and typically occur a couple of times each year.

It's important to avoid exaggerating their importance or their predictive power, but at the same time we're always watchful for major changes in economic conditions and sentiment. So far we aren't seeing these.

My sense is still that the U.S. economy has more to offer investors on the stocks side and the bonds side than any other major economy. It is possible that we'll see a longer-term rotation from IT stocks into other sectors and into small- and mid-cap. However, so far, with the exception of Intel, IT earnings have been okay though not stellar.

We're of a mind to stick to our positions but not add to IT at this time. If you are a bond investor, this may be a good time to extend maturities out a few years to lock in rates before the Fed gets serious about reducing short-term rates. I wouldn't do it this week, but I would start gearing up for longer maturities.

GTAS Allocation chart



(+/=/-) represents our group's views over a 6- to 18-month time horizon concerning tilts relative to our strategic positions.

+ implies an overweight in that asset class.

= implies a weighting similar to our strategic weight.

- implies an underweight.

Index definitions

Past performance is no guarantee of future results. You cannot invest directly in an index.

Bar Agg Intermed — Bloomberg Barclays U.S. Aggregate Intermediate Total Return index is composed of the BarCap Government/Credit Index, the Mortgage-Backed Securities Index, and the Asset-Backed Securities Index. The returns for the index are total returns, which includes the daily reinvestment of dividends.

Bar U.S. Corp HY — Bloomberg Barclays U.S. Corporate High Yield Total Return index includes all fixed income securities having a maximum quality rating from Moody's Investor Service of Ba1, a minimum amount outstanding of $100 million, and at least one year to maturity.

FTSE All REIT — FTSE Nareit All Equity REITs Total Return index is an index of publicly traded Real Estate Investment Trusts (REITs) that own commercial property. All tax-qualified REITs with common shares traded on the NYSE, AMSE or NASDAQ National Market List are eligible. Additionally, each company must be valued at more than $100MM USD at the date of the annual review.

ICE BofA U.S. Convertibles — ICE BofA U.S. Convertible Bonds Total Return index tracks the returns of U.S.-traded convertible debt issued by companies with a significant presence in the United States. The index is composed of various combinations of convertible structure and credit quality (e.g., it includes investment-grade, speculative-grade, and non-rated issues). The returns for the index are total returns, which include reinvestment of dividends.

MSCI All Country xU.S. — MSCI All Country World Index Ex USA NR is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global developed and emerging markets. The index consists of 48 developed and emerging market country indices. The returns for the index are total returns, which include reinvestment of dividends.

MSCI Emerg Mkt — MSCI Emerging Markets NR index consists of 26 developing economies including Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Pakistan, Peru, Philippines, Poland, Qatar, Russia, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey and the United Arab Emirates.

S&P 500 — S&P 500 Total Return index is a market capitalization-weighted index composed of the 500 most widely held stocks whose assets and/or revenues are based in the U.S.; it's often used as a proxy for the U.S. stock market. Total Return (TR) indexes include daily reinvestment of dividends.

S&P GSCI — S&P GSCI Total Return index is a composite index of the commodity futures. It represents unleveraged, long only investments in commodity futures that are broadly diversified.

S&P Mid Cap — S&P MidCap 400 Total Return index is comprised of stocks in the middle-capitalization range, and includes approximately 10% of the capitalization of U.S. equity securities. Total Return (TR) indexes include daily reinvestment of dividends.

S&P Small Cap — S&P SmallCap 600 Total Return index consists of 600 domestic stocks chosen for market size, liquidity, and industry group representation. Total Return (TR) indexes include daily reinvestment of dividends.

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