CIO Memo

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Authors:
Christian Nolting
Global Chief Investment Officer

Dr. Ulrich Stephan
Chief Investment Officer Germany

Michael Blumenroth
Senior Investment Strategist

When Wall Street coughs…

Key takeaways

- Weaker economic (especially labor) data fuel concerns about U.S. economy.
- Some market discussions about future Fed rate cuts potentially being too late.
- Markets were due a correction after strong gains, but this is not a bear market.

1. What happened?

Are we now witnessing the end of a bull market? The S&P 500 had gained 38% from end-October 2023 to mid-July 2024, the Nasdaq 100 47% and the so-called Magnificent 7 some 67%. The market had priced in a robust economy with declining inflation. Expectations for the Q2 earnings reporting season were also ambitious. However, when the reporting season started in mid-July, market volatility increased significantly. The reasons are to be found in both the economic data and the reporting season.

The U.S. Federal Reserve had opened the door for an interest rate cut in September at the end-July FOMC meeting, but made the decision dependent on further inflation and labor market data. However, the subsequent publication of data on initial jobless claims and the ISM sentiment index for the manufacturing sector gave rise to market discussions as to whether the Fed might have waited too long to cut interest rates and whether the U.S. economy could still slide into a recession. In the last week in July as many people registered as newly unemployed as in November 2021. The labor market component of the ISM fell to its lowest level since June 2020. The July labor market report, published today, confirms the subdued picture. Only 114,000 new jobs were created vs. 185,000 expected. The unemployment rate rose to 4.3%.

The Q2 reporting season is going well overall, but some prominent and highly-capitalized companies have been unable to fully meet expectations. Of the 342 companies which have reported so far, 79% have beaten analysts' expectations. Profits have increased 5% more than expected and are currently up 13% (blended) in aggregate. But technology stocks, which are particularly under observation, have only beaten earnings estimates by 2.8%.

Unsettling news outside of the U.S. is also not helping to calm the market mood at the moment. Middle East conflict is affecting oil prices. The Bank of Japan's decision to raise interest rates has led to a sharp appreciation of the JPY against the USD. Furthermore, Chinese data suggests that, following the weakness of the domestic economy induced by the real estate market, exports are now also being negatively affected. And, finally, Europe's largest economy, Germany, is still affected by weak growth.

2. How did markets react?

Markets have moved from seeing opportunities to seeing reasons for caution. The CBOE volatility index VIX has jumped to over 20 and the MOVE index for the bond markets is shifting too. The stock markets have fallen since their highs in July: the S&P 500 by around 6%, the Nasdaq 100 by 11% and the Magnificent 7 by around 15%. Against trend, the smaller companies in the Russell 2000, which benefit more from interest rate cuts, are still up almost 4% on a monthly basis, although the index has recently not been able to decouple completely. On the other hand, the bond markets have seen strong gains with yields on two-year U.S. Treasuries falling to 3.93% percent – the lowest level in 14 months – and their ten-year counterparts to 3.83%. Other assets considered as safe havens, such as gold and the Swiss franc, have also risen.

3. What does it mean for investors?

We think our more cautious assessment of the market situation over the summer has been confirmed. After very positive stock market development, a correction was overdue and this could continue until the Fed delivers its first interest rate cut. An opportunity to prepare the markets for this step could be the central bankers' Jackson Hole meeting on August 22-24. The reporting season will also continue to provide impetus.

Against this background, we believe further volatility is possible in the coming weeks but we see no fundamental reasons for a bear market. On the one hand, future central bank interest rate cuts are undoubtedly on the table and, on the other, companies are showing solid results on average. We therefore continue to suggest a so-called barbell strategy of blue chips, including U.S. big tech, and smaller companies that should gain when interest rates are cut and the economy recovers. Investors may consider price corrections as a buying opportunity.

Glossary

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

The ISM manufacturing index is produced by the Institute for Supply Management and is based on surveys of supply management professionals.

Jackson Hole is the location (and common name) of an annual economic symposium of the Kansas City Fed.

JPY is the currency code for the Japanese yen, the Japanese currency.

The Magnificent 7 stocks are a group of high-performing and influential companies in the U.S. stock market.

The MOVE (Merrill Lynch Option Volatility Estimate) Index is a yield curve-weighted index of the normalized implied volatility on 1-month treasury options.

The Nasdaq 100 Index includes the 100 largest companies by modified market capitalization trading on Nasdaq exchanges.

The Russell 2000 Index is a U.S. Small Cap Index that includes around 2,000 companies, the bottom two-thirds of the Russell 3000 Index.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries are bonds issued by the U.S. government.

USD is the currency code for the US dollar.

The VIX Index (CBOE Volatility Index) is a measurement of volatility implied by S&P 500 Index options.

Volatility is the degree of variation of a trading-price series over time.

Historical performance

Performance	2.8.2019 - 2.8.2020	2.8.2020 - 2.8.2021	2.8.2021 - 2.8.2022	2.8.2022 - 2.8.2023	2.8.2023 - 2.8.2024
2-year U.S. Treasuries	4.0%	0.2%	-3.6%	0.4%	5.6%
10-year U.S. Treasuries	12.3%	-2.9%	-10.7%	-6.5%	5.2%
S&P 500	11.6%	34.1%	-6.7%	10.3%	19.1%
NASDAQ 100	41.8%	37.2%	-13.8%	19.1%	20.4%
Magnificent 7	117.4%	64.4%	-8.4%	36.9%	41.8%
Russel 2000	-3.5%	49.7%	-15.0%	4.5%	7.4%
Gold	37.1%	-8.2%	-2.9%	9.9%	27.6%
USDJPY	-0.7%	3.3%	21.8%	7.6%	2.6%
CHFUSD	7.5%	0.9%	-5.4%	9.1%	1.7%

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