



# Where Do We Go From Here?

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## Where Do We Go From Here?

While we waited for last Friday's earnings reports to have a better sense of the landscape and begin writing about the second quarter earnings season, the markets appeared to have other plans for the weekend. Indeed, as we wrote this piece, we saw how the S&P 500 fell as much as 3.6%, the Nasdaq 100 dropped as much as 5.2%, and Bitcoin plummeted almost 15% in just a few hours. Meanwhile, on the other side of the world, Japan's Nikkei experienced its worst day since Black Monday in 1987, with the index declining by 12.4% in a single day. Although some of these indices and assets managed to recover part of the losses, these events clearly evidence the fragility of the current state of global markets. We have commented about this extensively in previous pieces [“Millimeters from Chaos”](#) and [“Is Nvidia the market’s Forrest Gump?”](#) and it is something that still concerns us.

So, what exactly happened? As we have mentioned throughout the year in our articles and calls, we could be reaching a point where bad news is simply that, bad news. Throughout the year, market participants have been treating bad news as good news, theorizing that bad news regarding the economy would push the Fed to cut rates sooner rather than later, potentially leading to buying opportunities. Despite signals of weakness in the labor market, cracks in consumer health, and lower household savings, markets continued to push the S&P 500 to record levels. However, Friday seemed to mark the breaking point for this trend of "bad news is good news", when the headline unemployment rate increased to 4.3% (up from 4.1% last month), its highest level since October 2021. This shift caused markets to refocus the discussion on whether the Federal Reserve will achieve a soft landing or inadvertently lead the United States into a recession. Investors are now concerned that the Fed has delayed cutting rates for too long and has over-constrained the country's

economy. In previous pieces we have talked about the difficulties of achieving a soft landing due to the overlooked importance of the impact of the labor market on the economy, [“Landing on an Aircraft Carrier”](#), [“The Fed is Important but so are other Variables”](#) and [“Balancing the Economy Between a Cold and a Heart Attack”](#). We continue to hold this belief.

In fact, looking at recession indicators such as the Sahm Rule, we could argue that last Friday marked the beginning of a new recession for the United States. The Sahm Rule is a widely used recession indicator, which has observed without fail that the initial phase of a recession begins when the three-month moving average of the U.S. unemployment rate is at least half a percentage point higher than the 12-month low. With July’s jobs report, this rule was officially triggered. While the creator of this indicator, Claudia Sahm, believes it is premature to declare that the economy has entered a recession, the data suggests momentum is heading in that direction.

However, it is difficult to attribute the market downturn solely to July’s unemployment rate. Interestingly, this correction can also be linked to several other dynamics, such as the overconcentration of the markets on a handful of stocks, Japan’s monetary policy, and the limited amount of cash on the sidelines currently observed in the markets. We have discussed the dangers of overconcentration in many of the pieces above. However, a new variable in the global market’s risk equation was Japan’s stock market, which as we mentioned earlier, dropped by 12% during Monday’s trading session. This decline was prompted by the Bank of Japan’s decision to meaningfully raise interest rates for the first time in eight years. While almost every country around the world was battling inflation, Japan had been attempting to stimulate economic growth and combat deflation using negative interest rates. After maintaining negative rates for eight years, Japan raised rates in March and then increased them again to 0.25% on July 31. During these eight years of negative

rates, investors took advantage of the opportunity to raise capital in JPY at nearly 0% to invest in USD assets. According to Japan’s Ministry of Finance, loans to foreign investors increased by USD 460 billion to USD 1.8 trillion between 2020 and 2023. Due to rising rates, investors had to unwind part of their carry trades in JPY, prompting them to sell portions of their assets denominated in US dollars.

Another aspect of the recent sell-off can be attributed to the limited amount of cash available for potential market investment. According to a report by BCA titled “Little Cash on the Sidelines,” aggregate investable funds are at a record low relative to the market value of U.S. equities and USD bonds. These investable funds include the sum of all money market funds, household time and savings deposits, and investment organizations’ time and savings deposits. The report highlights that today’s cash-to-U.S. equity market cap ratio is at record lows, comparable only to the peak of the 2000s tech bubble. This does not mean that investable funds have disappeared; rather, it indicates that the rising values of outstanding securities have outpaced the growth of these funds during the market rally. Although a low ratio of cash to market value does not necessarily imply an impending market sell-off, it can amplify a downturn once a sell-off begins, as seen during Monday’s market decline. The “Little Cash on the Sidelines” theory suggests that stocks may soon reach their peak due to insufficient cash reserves to sustain further stock market growth.

As it appears that the probability of a recession has increased (and markets are beginning to discount it as we predicted they would), it is essential for investors to understand that such downturns are a normal part of the market cycle. Maintaining a consistent investment strategy during these times is crucial. In previous articles, we have discussed portfolio rotation, but now we want to shift our focus to earnings and sectors to identify investment opportunities given current market conditions.

## Second Quarter Earnings Results to Date

	2Q24 Reporting Season					% Surprise				% of Companies Beating			
	So Far Reported					Revenue		Net Income		Revenue		Net Income	
	# Cos Rep	Total Cos	% Cos Rep	Sales Growth (YoY)	Earnings Growth	AVG (Last 4Qs)	2Q24	AVG (Last 4Qs)	2Q24	AVG (Last 4Qs)	2Q24	AVG (Last 4Qs)	2Q24
<b>S&amp;P 500</b>	375	500	75%	<b>5.0%</b>	<b>12.1%</b>	1.0%	<b>1.3%</b>	4.1%	<b>3.7%</b>	60%	<b>56%</b>	74%	<b>74%</b>
<b>Mag7</b>	6	7	86%	<b>10.9%</b>	<b>26.1%</b>	1.7%	<b>1.1%</b>	11.0%	<b>6.1%</b>	89%	<b>83%</b>	89%	<b>83%</b>
<b>S&amp;P 493</b>	369	493	75%	<b>4.2%</b>	<b>8.6%</b>	0.9%	<b>1.3%</b>	2.5%	<b>3.0%</b>	60%	<b>56%</b>	73%	<b>74%</b>
<b>Ex-Financials</b>	311	429	72%	<b>5.0%</b>	<b>10.7%</b>	0.7%	<b>0.8%</b>	4.5%	<b>2.0%</b>	60%	<b>57%</b>	75%	<b>74%</b>
<b>Ex-Energy</b>	356	477	75%	<b>4.7%</b>	<b>12.9%</b>	1.1%	<b>1.3%</b>	4.5%	<b>4.7%</b>	61%	<b>56%</b>	75%	<b>75%</b>
<b>Cyclicals</b>	201	251	80%	<b>4.7%</b>	<b>10.4%</b>	1.3%	<b>1.6%</b>	5.0%	<b>5.2%</b>	58%	<b>50%</b>	73%	<b>74%</b>
Energy	19	23	83%	<b>8.7%</b>	<b>2.0%</b>	0.1%	<b>0.6%</b>	-1.4%	<b>-8.5%</b>	50%	<b>58%</b>	54%	<b>53%</b>
Materials	21	28	75%	<b>-0.6%</b>	<b>-6.4%</b>	-1.2%	<b>0.7%</b>	2.4%	<b>4.8%</b>	39%	<b>52%</b>	67%	<b>81%</b>
Industrials	63	77	82%	<b>0.7%</b>	<b>-1.3%</b>	0.4%	<b>0.1%</b>	5.6%	<b>1.3%</b>	62%	<b>46%</b>	79%	<b>84%</b>
Discretionary	34	52	65%	<b>6.1%</b>	<b>18.7%</b>	1.5%	<b>1.0%</b>	16.8%	<b>8.8%</b>	64%	<b>47%</b>	84%	<b>62%</b>
Financials	64	71	90%	<b>5.2%</b>	<b>17.8%</b>	3.3%	<b>3.8%</b>	2.3%	<b>10.3%</b>	61%	<b>53%</b>	66%	<b>75%</b>
<b>Long Durat.   Secular Growth</b>	97	149	65%	<b>7.0%</b>	<b>17.2%</b>	1.6%	<b>1.5%</b>	2.7%	<b>1.9%</b>	71%	<b>74%</b>	82%	<b>86%</b>
Technology	43	67	64%	<b>6.1%</b>	<b>11.7%</b>	1.6%	<b>1.4%</b>	8.3%	<b>3.6%</b>	71%	<b>77%</b>	88%	<b>81%</b>
Communication	13	19	68%	<b>7.4%</b>	<b>24.6%</b>	0.8%	<b>0.3%</b>	7.8%	<b>5.2%</b>	58%	<b>62%</b>	71%	<b>85%</b>
Healthcare	41	63	65%	<b>7.3%</b>	<b>17.4%</b>	1.9%	<b>2.1%</b>	-8.3%	<b>-3.4%</b>	74%	<b>76%</b>	78%	<b>90%</b>
<b>Bond Proxy</b>	77	100	77%	<b>1.4%</b>	<b>1.4%</b>	-1.0%	<b>-0.8%</b>	5.7%	<b>3.9%</b>	50%	<b>48%</b>	65%	<b>61%</b>
Staples	24	38	63%	<b>0.4%</b>	<b>0.1%</b>	0.3%	<b>-1.0%</b>	6.9%	<b>2.3%</b>	52%	<b>33%</b>	80%	<b>71%</b>
REITs	30	31	97%	<b>7.2%</b>	<b>-10.0%</b>	1.0%	<b>0.6%</b>	8.0%	<b>5.4%</b>	66%	<b>57%</b>	58%	<b>50%</b>
Utilities	23	31	74%	<b>2.3%</b>	<b>14.5%</b>	-7.5%	<b>-1.1%</b>	1.9%	<b>6.9%</b>	32%	<b>52%</b>	53%	<b>65%</b>

Source: JPM as of August 5, 2024

## Earnings highlights for the quarter:

Despite Monday’s market downturn, companies have been delivering healthier results than expected. According to FactSet, as of August 2, 75% of S&P 500 companies had reported their results, with 78% of them announcing positive earnings per share (EPS) surprise and 59% reporting a positive revenue surprise. So far, year-over-year earnings growth stands at 11.5%, which is the highest since the fourth quarter of 2021.

During the quarter, the Financials sector managed to achieve positive results despite weakness in consumer

spending and high interest rates. Banks focused on controlling deposit costs, which had been squeezing margins over recent quarters. This cost-control measure helped offset weak loan growth, primarily driven by further deterioration in auto loans and commercial real estate (CRE) loans. While credit cards remained the only growth driver for loan portfolios, consumer card spending slowed during the quarter, with discretionary spending reflecting inflationary pressures. Residential mortgage rates have been declining, with the 30-year rate falling to 6.73%, which is expected to increase mortgage origination volumes. Credit quality is stabilizing, though there is concern

about the impact of continued deterioration in employment on credit card delinquencies. Guidance for banks anticipates improved Net Interest Income due to cost-control measures, offset by lower loan growth and weaker discretionary spending.

Within the healthcare sector, while "obesity" stocks have yet to report, Goldman Sachs noted that all large pharmaceutical companies that have reported have exceeded estimates. China has been a common headwind for healthcare companies due to lower demand and the government's ongoing anti-corruption campaign, which has disrupted normal market order volumes. On a positive note, managements indicated that companies are recovering the normal flow of elderly customers lost due to premature deaths from COVID-19, which has improved volumes and utilization rates of generic medicines. Healthcare stocks have outperformed the rest of the index, primarily due to a rotation from cyclical to defensive sectors in an environment of disappointing mega-tech earnings.

In the Consumer Staples sector, rising unemployment is a concern due to the sector's nature; however, earnings guidance from companies already appears to account for consumer weakness for the rest of the year. Companies have experienced pricing deceleration, increased product promotions, and slower volume recovery. Overall, revenues have been weaker, but cost-efficiency measures and lower commodity prices have improved margins, leading to earnings beats for the quarter. However, as promotions are increasing, private labels are gaining more traction, and U.S. consumers are showing increased value-seeking behaviors, such as a preference for "combo meals" and discounts. Overseas consumers have proven more resilient than domestic ones, which could explain why multinational companies have provided better guidance than U.S.-centric names.

The Energy and Materials sectors were more of a mixed bag, where subsectors in Energy like Renewables and

Oil & Gas posted higher than expected earnings growth propelled by increased oil prices. At the same time, the Materials sector saw some companies in the industrial commodities complex report lower than expected earnings growth based on lower demand, mostly from China. It is important to note that quarter-to-quarter volatility in these sectors is fairly normal.

So far, the Consumer Discretionary sector has shown a degree of general weakness, especially when it comes to products and services. Companies in the Leisure and Apparel industries saw slower sales growth; however, companies in the automotive industry like General Motors were able to post improving sales and earnings. The elephant in the room, Amazon, beat Wall Street's expectations but saw its stock lower after it reported earnings, based on increasing margin pressures.

— "In our view, what **we see ahead is more volatility.**

Earnings season is not over yet, and market leader Nvidia has yet to report. Geopolitical risks abound, from the Middle East to Europe, Asia, and even Venezuela in our back yard, as uncertainty is high around the world."

The Technology and Communications sectors have seen a bit of a dichotomy. On one hand, Communications beat Wall Street's expectations and posted higher than expected growth metrics, led by Netflix, Alphabet, and Meta. Netflix experienced solid gains in subscriber growth, while Alphabet's cloud and search businesses

remained strong. At the same time, Meta’s increased use of AI led to higher margins. In the Technology sector, particularly in the Technology Hardware industry, things were different. Apple continued to experience sales pressures, mainly from China, while Intel reported lower sales and margin guidance, relative to expectations that appeared to be too high. This was, in fact, a theme across many of the Semiconductor companies as well, where many companies reported earnings which were good, but did not meet the loftiest of expectations from the Street. The bar was set high by Wall Street, where good was not good enough. This was evident in AI bellwether Super Micro’s report. The stock jumped 18% after hours, after the company reported better than expected sales. However, the stock then dropped close to 15% after the company gave 2025 profit and sales guidance that did not meet Wall Street’s high expectations. That is close to a 35% swing in price, all after hours, before most investors could even trade the stock.

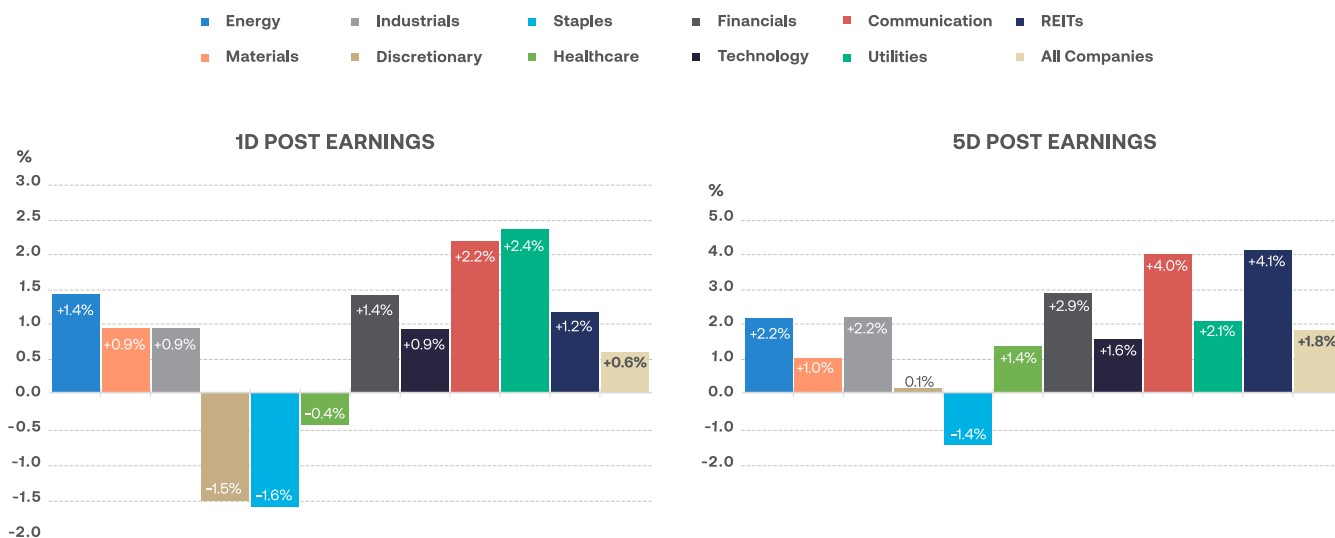
Volatility in the markets is clearly high and likely to remain so in the foreseeable future. In last week’s publication we wrote that the CBOE Volatility Index, or VIX, which

had been in an average range between 12 and 13 points for most of the past year, was starting to trend up, reaching 16 points as of last Thursday. Well, it climbed to a staggering 66 points on Monday, before settling back near 27 on Tuesday. That is a more than a 500% move in the volatility index in one week, after it had remained relatively stable over the previous 52 weeks. This increased volatility has clearly been reflected in the stock market over the past week. The adage stating that the stock market takes the escalator up and the elevator down is proving true.

So, the logical question now, is “where do we go from here?” In our view, what we see ahead is more volatility. Earnings season is not over yet, and market leader Nvidia has yet to report. Geopolitical risks abound, from the Middle East to Europe, Asia, and even Venezuela in our back yard, as uncertainty is high around the world. In the United States, the uncertainty surrounding the elections, coupled with uncertainty surrounding monetary policy are going to keep markets volatile. Most importantly though, we are potentially at the end of a business, and market, cycle. This is a reality that

### Average Sector Performance One and Five Days After Earnings Reports S&P 500 Earnings Beats + Misses

Source: JPM as of August 5, 2024



tends to get overlooked by the markets. As humans, we tend to focus on what is right in front of us; however, sometimes it is good to zoom out a little.

In 2023, the market was already nearing the top of the cycle, which at the time, was starting to get priced in by investors. However, the onset of the AI revolution that year clouded the picture, elongating the end of the cycle. This could explain why so many managers on Wall Street were caught off guard by the surging markets. Wall Street then might have over-reacted, building in expectations that priced the AI industry as if most productivity gains would be immediate. We believe that the AI revolution will be a game changer, as impactful as the internet, possibly more. Successful companies will abound. However, this will take time. Maybe not 10 or even 5 years, but not immediate either.

Now, as the fog of the AI revolution dissipates, the market is starting to realize that we are still at the end of the cycle, which was just prolonged, not eliminated by the AI euphoria. Much like the tides in the ocean can sometimes change faster or slower than others, so the business cycle can sometimes be shortened or prolonged. However, neither the tide nor the business cycle can be naturally stopped from changing. Given this backdrop, we believe that the best way to navigate this part of the cycle is shifting exposure to more defensive sectors, such as Consumer Staples, Utilities, and Healthcare, as well as economically insensitive industries such as Defense. In time, the storm will pass, the sun will shine, volatility will subside, and the cycle will reemerge anew, led by cyclical industries and small caps. For now, we just have to ride out the storm. ■

# House Views Matrix

	TACTICAL (UP TO 3 MONTHS)	CYCLICAL (UP TO 12 MONTHS)
<b>Global Asset Allocation</b>		
Equities	UNDERWEIGHT	NEUTRAL
Fixed Income	OVERWEIGHT	OVERWEIGHT
Cash	OVERWEIGHT	UNDERWEIGHT
<b>Regional Breakdown</b>		
US Equities <sup>1</sup>	OVERWEIGHT	NEUTRAL
European Equities	OVERWEIGHT	NEUTRAL
Japanese Equities	OVERWEIGHT	NEUTRAL
Emerging Market Equities	UNDERWEIGHT	NEUTRAL
Chinese Equities	NEUTRAL	NEUTRAL
US Treasuries <sup>2</sup>	OVERWEIGHT	OVERWEIGHT
Investment Grade Fixed Income	NEUTRAL	UNDERWEIGHT
High Yield Fixed Income	NEUTRAL	UNDERWEIGHT
Emerging Market Sovereign	NEUTRAL	NEUTRAL
US Dollar	NEUTRAL	OVERWEIGHT
Energy <sup>3</sup>	UNDERWEIGHT	UNDERWEIGHT
Precious Metals	NEUTRAL	OVERWEIGHT

<sup>1</sup>Relative to global equities in USD

<sup>2</sup>Relative to aggregate fixed income markets in USD

<sup>3</sup>Relative to an overall commodity allocation

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