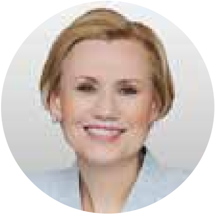
Reversal of fortune

Weekly Market Compass | August 20, 2024



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Strong stock rally

After a sharp decline bottoming on Aug. 5, new data drove a strong US stock rally last week — actually the best week this year.

Base case holds

We believe the US economy will avoid recession and re-accelerate later this year/early next year, as wages improve and monetary policy easing starts.

Eyes on Jackson Hole

Federal Reserve Chairman Jerome Powell is speaking at the Jackson Hole Economic Symposium and may provide color on easing plan.

A theme I keep coming back to this summer is "reversal of fortune." I think it accurately describes the last several weeks. Markets' perceived risk of a US recession has fallen almost as quickly as it rose thanks to recent data. US retail sales rose 1.0%, which was much higher than expected.[1] Walmart, a bellwether consumer retailer, reported better-than-expected results. Both the number of transactions and the average amount customers spent during those transactions was higher than it was during the same quarter last year. In addition, US initial jobless claims eased to 227,000 last week, which was below expectations, from 234,000 the previous week, which also was lower than expected.)[2] And consumer sentiment rose for the first time in five months in the University of Michigan Survey of Consumers. [3] It seems clear that continued progress on disinflation is helping.

Strong US and global rally

Markets are reflecting that with a very strong rally for US equities last week — actually their best week this year — as well as a strong global equity rally. The VIX has fallen dramatically from its August 5 peak. High yield spreads have tightened by more than 60 basis points since the August 5 market bottom.[4] Markets are clearly breathing a sigh of relief.

Some US cracks

But that doesn't mean that cracks aren't forming. One question asked in the monthly New York Fed Survey of Consumers is what the respondent believes is the probability they'll miss a minimum debt payment in the next three months. In the most recent survey released last week, the mean probability of missing a minimum debt payment over the next three months rose to 13.29%, the highest level since 16.15% in April 2020 in the face of pandemic shutdowns.[5] We've heard from countless companies that US consumers — especially lower income consumers — are under increasing pressure. Home Depot's CEO recently explained, "During the quarter, higher interest rates and greater macroeconomic uncertainty pressured consumer demand more broadly, resulting in weaker spend."[6] And Bank of America's CEO urged the Federal Reserve (Fed) to cut rates soon because of the pressure on consumers, "…in our consumer base of 60 million customers spending every week, what you're seeing is they're spending at a rate of growth of this year over last year, for July and August so far, about 3%. That is half the rate it was last year at this time. And so, the consumer has slowed down. They have money in their accounts, but they're depleting a little bit. They're employed, they're earning money, but if you look at — they've really slowed down…"[7]

Base case: Avoid US recession

In short, our base case from our mid-year outlook holds thus far. We think the US economy will be able to avoid recession and re-accelerate later this year/early next year, propelled by improving real (inflation-adjusted) wage growth and the start of easing monetary policy. But avoiding a more serious economic downturn is predicated on the Fed acting quickly enough. We already have improving real wage growth and now we're waiting for the start of rate cuts. We need rate cuts to start soon — that'll be key to our base case scenario playing out.

Japan reversal

It's not just the US. Japan is also experiencing a reversal of fortune of sorts. Japanese equities experienced a large sell-off in the aftermath of the Bank of Japan's (BOJ) decision to hike rates on July 31, which caused the Japanese yen to strengthen materially relative to the US dollar. But as I mentioned last week, on August 7, BOJ Deputy Governor Uchida pledged the BOJ would not hike rates again if markets are unstable. The Japanese yen (JPY) modestly weakened. Japanese equities also rallied, although I believe it was driven not just by a weakening yen but by strong economic data. For example, last week it was reported that Japan's gross domestic product (GDP) growth for the second quarter was higher than expected. It's important to note that private consumption items, especially durable goods, rose in the second quarter on higher wage increases. My colleague Tomo Kinoshita believes that with various policy supports, including tax cuts and revival of fuel subsidies, solid consumption growth is likely to be sustained in the short term. It's that pick up in consumption growth that appears to have helped domestic demand-related stocks after the early August stock market correction.

The Japanese yen carry trade, which unwound disruptively after the surprise BOJ hike, has rebounded in popularity in recent days. I anticipate, however, that the US dollar and other major currencies will weaken relative to the Japanese yen in the coming months as the Fed and other central banks ease. That doesn't mean Japanese equities will necessarily experience losses, given our expectation of sustainable economic growth. A strong JPY could provide a headwind for Japanese equities, but it's not insurmountable. Continued positive economic data could power Japanese equities higher, even in the face of political uncertainty, given the resignation of Japan's prime minister.

UK: Improved outlook

Then there's the UK. It was less than two years ago that Prime Minister Liz Truss and her Chancellor introduced a controversial budget that reflected the economic challenges facing the UK, and the UK experienced a gilt yield crisis. Today, the UK is enjoying its success in driving down inflation near the Bank of England's target, while unemployment for June clocked in lower than expected at 4.2%.[8] The outlook is positive. My colleague Paul Jackson has pointed out that UK real wage growth is higher than in the US, as is the UK household savings ratio (which is close to historical lows in the US) and that real retail spending is now recovering in the UK.[9] He argues that the UK consumer (and economy) may even be in better shape than in the US given the increased pressure on the US consumer. And the Bank of England has already begun to cut rates, which should provide a psychological boost. Markets have reflected an improved outlook for UK equities, with the MSCI UK Index up more than 3% last week.[10]

Looking ahead: A big week

This week, we'll get the minutes from the July Federal Open Market Committee (FOMC) meeting. That'll be important and could create short-term volatility as markets get a greater sense of what the Fed was thinking in late July. Its importance, however, will be short-lived as it's very backward-looking and we'll soon get some forward-looking guidance. Attention will turn to the start of the Jackson Hole Economic Symposium and Jay Powell's speech there at the end of the week. Historically, the Fed has taken advantage of Jackson Hole to introduce policy shifts (or even new policies), so I think we will get more color on the Fed's plan for easing. This will be "Must See TV" for market strategists and investment professionals, especially given the dramatic impact that monetary policy has had on markets in recent years.

In conclusion, we have seen a lot of reversals of fortune in the past several months, and we're likely to see more in the coming months. Taking a step back, I've been watching markets since 1995, and there has been no shortage of twists, turns, and surprises over the years. I've also learned that base case scenarios rarely, if ever, play out exactly as we anticipate. That's why I advocate for broad diversification in portfolios — including alternatives — for investors with long time horizons, with regularly scheduled rebalancing.

The week ahead

Date	Event	What it tells us
August 19	Bank of Canada Senior Loan Officer Survey	How economic or financial conditions are affecting business lending.
	People's Bank of China Loan Prime Rate	Benchmark lending rate.
	Reserve Bank of Australia Meeting Minutes	Gives further insight into the central bank's decision-making process.
	Korea Consumer Confidence	Tracks sentiment among consumers.
August 20	Eurozone Consumer Price Index	Tracks the path of inflation.
	Canada Consumer Price Index	
August 21	FOMC Meeting Minutes	Gives further insight into the central bank's decision-making process.
	Australia Purchasing Manufacturing Indexes	Provides an indication of the economic health of the manufacturing and services sectors.
	Japan Purchasing Manufacturing Indexes	
August 22	Jackson Hole Economic Symposium begins	Annual economic policy symposium hosted by the Federal Reserve Bank of Kansas City central bankers, policymakers, academics, and economists from around the world.
	Eurozone Purchasing Manufacturing Indexes	Provides an indication of the economic health of the manufacturing and services sectors.
	Germany Purchasing Manufacturing Indexes	
	India Purchasing Manufacturing Indexes	
	UK Purchasing Manufacturing Indexes	
	US Purchasing Manufacturing Indexes	
	Japan Consumer Price Index	Tracks the path of inflation.
	UK Consumer Confidence	Tracks sentiment among consumers.

Date	Event	What it tells us
August 23	Canada Retail Sales	Indicates the health of the retail industry.
	US New Home Sales	Indicates the health of the housing market.

Notes

[1]Source: US Census Bureau, Aug. 15, 2024.
[2]Source: Department of Labor, Aug. 13, 2024.
[3]Source: University of Michigan Survey of Consumers, Aug. 16, 2024.
[4]Source: St Louis Federal Reserve Economic Data, as of Aug. 16, 2024 reflected by the ICE BofA US High Yield Index Option-Adjusted Spread.
[5]Source: New York Fed Survey of Consumers, as of Aug. 12, 2024.
[6]Source: Home Depot earnings call, Aug. 14, 2024.
[7]Source: CBS News, "Face the Nation with Margaret Brennan," Interview with Bank of America CEO Brian Moynihan.
[8]Source: UK Office of National Statistics, Aug. 13, 2024.
[9]Source: LSEG Datastream and Invesco Global Market Strategy Office, as of July 31, 2024.
[10]Source: MSCI, as of Aug. 16, 2024.

Important information

All investing involves risk, including the risk of loss.

Past performance does not guarantee future results.

This does not constitute a recommendation of any investment strategy or product for a particular investor. Investors should consult a financial professional before making any investment decisions.

In general, stock values fluctuate, sometimes widely, in response to activities specific to the company as well as general market, economic and political conditions.

The risks of investing in securities of foreign issuers can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The ICE BofA Option-Adjusted Spreads (OASs) are the calculated spreads between a computed OAS index of all bonds in a given rating category and a spot Treasury curve. ICE BofA US High Yield Index value, tracks the performance of US dollar denominated below investment grade rated corporate debt publicly issued in the US domestic market.

Option-adjusted spread (OAS) is the yield spread that must be added to a benchmark yield curve to discount a security’s payments to match its market price, using a dynamic pricing model that accounts for embedded options.

The University of Michigan’s Consumer Inflation Expectations report is published monthly to assess US consumer expectations for inflation.

The CBOE Volatility Index® (VIX®) is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. VIX is the ticker symbol for the Chicago Board Options Exchange (CBOE) Volatility Index, which shows the market’s expectation of 30-day volatility.

Carry trade is a strategy in which traders borrow a currency that has a low interest rate and use the funds to buy a different currency paying a higher interest rate.

The MSCI United Kingdom Index is designed to measure the performance of the large- and mid-cap segments of the UK market.

Disinflation, a slowing in the rate of price inflation, describes instances when the inflation rate has reduced marginally over the short term.

A basis point is one-hundredth of a percentage point.

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

Diversification does not guarantee a profit or eliminate the risk of loss.

Alternative products typically hold more non-traditional investments and employ more complex trading strategies, including hedging and leveraging through derivatives, short selling and opportunistic strategies that change with market conditions. Investors considering alternatives should be aware of their unique characteristics and additional risks from the strategies they use. Like all investments, performance will fluctuate. You can lose money.

The opinions referenced above are those of the author as of **August 19, 2024**. These comments should not be construed as recommendations, but as an illustration of broader themes. Forward-looking statements are not guarantees of future results. They involve risks, uncertainties and assumptions; there can be no assurance that actual results will not differ materially from expectations.