

Why the recent market correction may have been an overreaction

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Bank of Japan

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Federal Reserve

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Economic data

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The massive stock market sell-off that occurred last Monday was significantly reversed by the end of the week. The happiest investors may have been the ones who turned off the financial news for two weeks to binge-watch sports from modern pentathlon to breaking, and are just now tuning back in. I did wonder last week if "Fed Guessing" might be considered an official sport since so many people participate in it (and I am guilty as charged).

But seriously, as I said last week, I would characterize the recent global market sell-off as an overreaction. Here are a few reasons why stocks have likely stabilized.

The Bank of Japan promises caution about rate hikes

The Bank of Japan (BOJ), which helped trigger the international sell-off by hiking rates two weeks ago, has calmed nerves by saying they would be very cautious about hiking rates again in the near term.

The BOJ's relatively surprising rate hike disrupted the carry trade — when investors borrow money in a low-yielding currency to invest in a higher-yielding currency. The Japanese yen has often been used as a carry trade funding currency because yen rates have been lower than elsewhere, especially the US, because of the BOJ's ultra-low monetary policy for so many years. The interest rate spread between US dollar and Japanese yen had been particularly wide since the US Federal Reserve (Fed) started tightening in 2022, increasing the potential profit from borrowing in yen to invest in dollars. However, that profitability was reduced by the BOJ's recent hawkishness.

But last week, Bank of Japan Deputy Governor Shinichi Uchida offered some reassurance: "As we're seeing sharp volatility in domestic and overseas financial markets, it's necessary to maintain current levels of monetary easing for the time being."¹

US jobless claims came in lower than expected

It was labor data — specifically the July US jobs report — that helped send markets into a tailspin by triggering concerns about a potential US recession. So it makes sense that it was labor data — specifically a lower-than-expected initial jobless claims number last week — that helped soothe markets.

Of course, underlying concerns about a recession involve more than just one labor market report, so we will want to monitor all economic data closely for signs of more cracks in the US economy that would suggest an increased likelihood of recession.

A key technical indicator signaled stocks may be oversold

The Relative Strength Indicator (RSI) is a momentum indicator that measures the speed and magnitude of recent price changes of a security or an index to evaluate whether investors may have overbought or oversold that investment. An RSI reading of 70 or above indicates an overbought situation. A reading of 30 or below indicates an oversold condition.

The RSI for the S&P 500 rose above 81 on July 10, suggesting overbought conditions. That quickly changed; the RSI for the S&P 500 Index fell to 30 on Aug. 5, suggesting an oversold condition.² Similarly, the RSI for the MSCI All Country World Index rose above 80 on July 16 but then fell to 27 on Aug. 5, suggesting an oversold condition.² RSIs for both indexes have normalized since then, currently hovering around 44-45.²

Bearish sentiment increased significantly last week

Individual investor bearish sentiment has historically been viewed as a contrarian indicator, potentially signaling an attractive buying opportunity.

The American Association of Individual Investors (AAII) tracks market sentiment on a weekly basis via polling. Bearish sentiment, which is defined as expectations that stock prices will fall over the next six months, increased a whopping 12.3 percentage points to 37.5% last week.³ That's well above its historical average of 31.0% and is its highest level in 2024.³

The corporate earnings outlook is solid, in our view

We have had a solid earnings season — 91% of S&P 500 companies have reported their second quarter results, and 78% of those companies beat earnings expectations.⁴ And the earnings outlook is fairly positive. The S&P 500 is expected to deliver year-over-year earnings growth of 10.8% for calendar year 2024.⁴ We are likely to see a softer third quarter, with 5.4% year-over-year earnings growth expected, but that is forecast to increase substantially in the fourth quarter.⁴ Earnings growth is projected to be strong in calendar year 2025 as well, at 15.2% year over year.⁴ And, as I have said before, more companies are expected to contribute to earnings growth, which should be supportive of stock prices.

The Fed is expected to be measured in its approach to rate cuts

The Fed will not, in my opinion, execute an emergency cut between now and the September meeting — there is no emergency so there is no justification for it. In fact, if they did cut rates before September, I think it would cause major market jitters. While I think it was a mistake for the Fed to forego a cut in July, I don't believe it will cause irreparable damage – it just puts the Fed behind the curve.

I believe Fed rate cuts will be measured at first. I don't expect the Fed to cut more than 25 basis points at its September meeting (I also believe cutting more than 25 basis points in September would cause market jitters as it suggests the Fed has become far more concerned about the health of the economy). My rationale for an "easing into easing" scenario: Just look at the Fed's modus operandi when it began to hike rates in 2022. It knew it was late to begin hiking but started in March with only a 25 basis

point rate hike. While that soon accelerated to 50 basis points in May and 75 basis points by the June meeting, the Fed seemed to want to “save face” when it started tightening. I think we will see a similar situation play out when the Fed finally begins cutting this September. I expect they will likely start with just 25 basis points.

Now there is fear that the July Consumer Price Index (CPI) print, which comes out this week, could derail the near certainty that the Fed will cut in September. I highly doubt that given the totality of recent data that indicates a continued disinflationary trend, most notably wage growth in July’s US jobs report, which was just 3.6% year-over-year. Recall the Fed is “data driven, not data point driven.”

Looking ahead

Most eyes will be fixated on the US CPI print for July, but I believe the University of Michigan’s consumer inflation expectations report is equally important because it matters to the Fed. There are other important data releases including some key economic data for the eurozone, UK and China. We will also get some other important US data which should give us insight into the health of the US consumer: retail sales.

While stocks seem to have stabilized, I do believe there is nervousness in the air, which is likely to lead to higher volatility and the potential for outsized reactions to data and developments. I believe investors with long time horizons could benefit from viewing their investment journey as a marathon rather than a sprint.

Dates to watch

Date	Event	What it tells us
August 12	Japan Producer Price Index	Measures the change in prices paid to producers of goods and services
August 13	UK Unemployment Rate	Indicates the health of the job market.
	China New Loans	Measures the change in the total value of outstanding bank loans issued to consumers and businesses.
	US Producer Price Index	Measures the change in prices paid to producers of goods and services
August 14	UK Consumer Price Index	Tracks the path of inflation.
	UK Producer Price Index	Measures the change in prices paid to producers of goods and services
	Eurozone Employment	Indicates the health of the job market.
	Eurozone Gross Domestic Product	Measures a region’s economic activity
	Eurozone Industrial Production	Indicates the economic health of the industrial sector.
	US Consumer Price Index	Tracks the path of inflation.
	Japan Gross Domestic Product	Measures a region’s economic activity
	China Industrial Production	Indicates the economic health of the industrial sector.
	China Retail Sales	Indicates the health of the retail sector.
	China Unemployment	Indicates the health of the job market.

Date	Event	What it tells us
August 15	UK Gross Domestic Product	Measures a region's economic activity
	US Retail Sales	Indicates the health of the retail sector.
	US Industrial Production	Indicates the economic health of the industrial sector.
August 16	UK Retail Sales	Indicates the health of the retail sector.
	University of Michigan US Inflation Expectations	Assesses US consumers' expectations for the path of inflation.

Notes

¹Source: Reuters, "BOJ deputy governor plays down chance of near-term rate hike, yen slumps," Aug. 7, 2024

²Source: Bloomberg, as of Aug. 12, 2024

³Source: American Association of Individual Investors, as of Aug. 7, 2024

⁴Source: FactSet Earnings Insight, Aug. 9, 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 S&P 500® Index is an unmanaged index considered representative of the US stock market.

The MSCI All Country World Index is an unmanaged index considered representative of large- and mid-cap stocks across developed and emerging markets.

The Consumer Price Index (CPI) measures changes in consumer prices. Core CPI excludes food and energy prices, while headline CPI includes them.

Tightening monetary policy includes actions by a central bank to curb inflation.

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

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

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

The opinions referenced above are those of the author as of **August 12, 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.