Market Update
August 5, 2024

TURTLE CREEK
WEALTH ADVISORS

OUR VIEW OF THE STOCK MARKET CORRECTION

The current rapid decline in the stock market has been very unnerving given how quickly it has occurred. However, the case can be made that it is normal and healthy. In fact, investors may be overreacting a bit to the recent economic data that has caused the decline.

Let's begin by discussing what is causing the current downturn. When the Federal Reserve began raising the Fed Funds rate in March of 2022, their goal was to bring down the inflation rate, which peaked at 9% in June of 2022. Their main objective was to reduce consumer spending, given that the consumer accounts for roughly 70% of US economic growth and is the key driver of inflation. In order to reduce spending, the Fed needed to raise the unemployment rate, because when there are ample jobs and wages are growing rapidly, US consumers spend aggressively. When the Fed began the rate hiking cycle, the unemployment rate was at 3.6% while wages were growing at almost 7% per year. Last Friday's July jobs report showed that unemployment had risen to 4.3% while wage growth had slowed to 3.8% per year. Certainly, a deterioration from two years ago, but both data points are still much better than historical averages (5.6% and 3.3%, respectively). Investors have reacted negatively to this data, but it is still representative of a healthy economy.

So why the sell off? Many investors have been anticipating a recession ever since the Fed began raising rates in 2022, because that is what normally happens in a rate hiking cycle. Importantly, recessions generally cause bear markets in stocks. However, this cycle, because it was precipitated by the Covid Pandemic, is much different than any ever seen before. So, let's evaluate the Bull case vs. the Bear case for what's happening today.

BEAR CASE

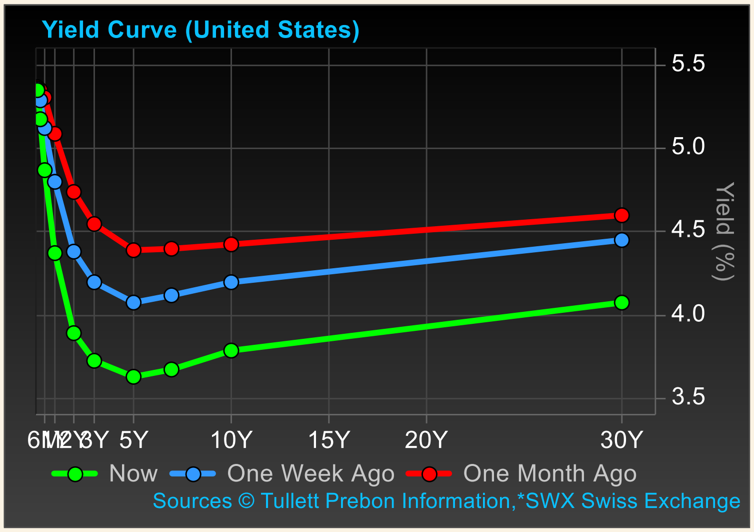
1. The Unemployment rate has risen by more than 0.5% since its most recent low, triggering the SAHM rule (a historic recession indicator).
2. The 10-year Treasury bond yield has plummeted from 4.43% one month ago to 3.8% today, the lowest level since December of 2023. This could be seen as a sign that economic growth will continue to weaken rapidly (see chart below).
3. The S&P 500 hasn't experienced a 10%+ correction since October of 2023. The market has normally seen at least one such correction each calendar year, so it appears to be due.
4. The S&P 500 is still trading at a lofty 21.5x forward earnings despite the selloff.
5. Other economic data, such as the Manufacturing ISM, has fallen recently.
6. Economic weakness is being exacerbated by Middle East tension and US Presidential election drama, which adds to the uncertainty investors are feeling.
7. There is now some concern over whether the growth in companies exposed to Artificial Intelligence, e.g. Nvidia and Microsoft, is slowing. This is a key factor given how impactful earnings growth and stock market gains from these companies (known as the Magnificent 7) has been this year.

BULL CASE

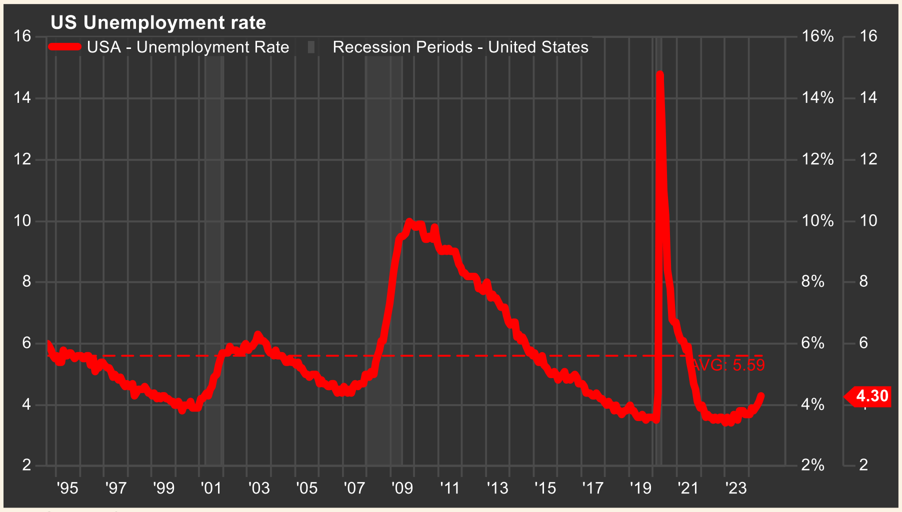
1. Employment and annual wage growth are still well above historical averages, indicative of an economy far from recession (see 30-year unemployment rate chart below).
2. As of this writing, the S&P 500 has declined by 8% from its recent high, which takes it back only to levels seen as recently as late May of this year.
3. 2nd Quarter corporate earnings have been reported to date at +11.5% year-over-year, a very strong rate of growth and a one that exceeds the expectation at the start of the quarter.
4. The Atlanta Fed is projecting US GDP growth of a healthy 2.5% for the 3rd quarter of this year, well above a recessionary growth rate.
5. A research firm that Turtle Creek follows has created a set of 9 indicators to determine whether a Bull Market has ended. As of today, only 2 of these indicators are flashing red.
6. Because inflation has fallen significantly and unemployment has risen above 4%, the Fed is now expected to cut the Fed Funds rate by as much as 0.5% at their mid-September meeting, while investors expect 1.25% in cuts by year end 2024, reducing the rate to 4.25% by year end 2024.
7. Lower interest rates, from Fed Funds to the 10-year Treasury, should support continued economic growth and stock market gains.

Ultimately, no one can accurately predict the stock market or whether a recession will occur. In fact, not counting the self-imposed recession of 2020, the US has not experienced a recession since 2008, so the economy could be overdue for one. Recessions are healthy in that they prune the economy of excesses that build up over time (e.g. high house and food prices) and allow the economy to regain a solid growth rate. To be clear, *the TCWA investment team does not expect a recession* at this point, but if one did occur over the next 6-12 months, we'd expect it to be relatively shallow and brief, and expect the Fed to act quickly to offset the impact of it.

Also, please note that well-diversified portfolios tend to fare much better in stock market downturns than does the broad equity market. In fact, the drop in interest rates has resulted in nice gains for bonds recently, as demonstrated by a gain in the Bloomberg US Aggregate Bond index of 4.2% over the past 30 days. This is precisely why we recommend balanced portfolios of stocks, bonds, and alternative investments.



FactSet as of 8/5/2024



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