



Wealth Advisory Market Update

August 7, 2024



Market Update

Equities:

The equity market, as measured by the S&P 500, rose by 1.13% for the month of July. That brings the total return for the index to 15.78% for the year. During the month, a rotation began to take place into companies other than mega cap tech. Small caps, mid-caps, and large value all saw significant gains relative to the market weighted index. However, the gap remains large. This is evident when comparing the S&P 500 Equal-weight index and the Market Cap weighted index. There is currently a 1,000bps difference so far this year, as the broader market has struggled. A rotation into a broader market rally would be a positive sign going forward.

Earnings season is in full swing. And as we have mentioned before, the narrow leadership at the top which has driven the market for the better part of the past two years was closely watched. Earnings reports from the mega cap technology names have disappointed thus far. The companies remain expensive and are trading well above their current intrinsic value. Their earnings reports do not support the premiums at which they continue to trade. Much of the technology sector continues to show big spending for AI, but so far revenues have not followed. So far, there have been no AI applications that will generate revenue streams that match current spend rates. We believe that, unless this changes, large Capex spending without significant cash flow will be punished.

Recent earnings reports have painted a grim picture of the state of the consumer. McDonald's missed on both revenue and earnings as its same store sales fell for the first time since 2020. They warn consumers will "continue to feel the pinch of the economy and a higher cost of living" for the next several quarters. Wayfair's CEO said the current slowdown in the home goods category is similar to the 2008 financial crisis. Amazon and Costco both traded down on weak guidance going forward as consumer spending continues to taper.

Our outlook for the equity markets has not changed since the beginning of the year. We still believe a conservative approach is prudent given the state of the economy and current valuations. As we mentioned last month, we did not expect a \$1 trillion deficit every 100 days to continue and keep the economy afloat. We are also in the midst of turmoil overseas that could lead to volatility going forward. Also, our biggest fear going into the end of 2023 was the carry trade in Japanese Yen. We wrote about it for six months and the impact it could have on our markets should this trade begin to unwind. It seems we were just a bit early. Since August 1st, the S&P 500 has shed six percent as the yen strengthened against the dollar. If this continues, we expect more downside coming from the massive trade unwind. However, the probability of the BOJ capitulating is very high.

Economic Indicators and Monetary Policy:

The FOMC met in July where it was widely expected they would keep the federal funds rate unchanged. Fed Chairman Jerome Powell's press conference remained the same as he continued to stress the importance of assessing incoming data. His comments on the labor market have changed from "being hot" to being in "better balance". He then went on to say they were watching "really carefully" in the event of a sharper labor market downturn. That seemed to be an omen for the jobs report that was released two days after the meeting.

The jobs report for the month of July sent the market tumbling, as recession fears have come back to the forefront. Forecasts expected to see one hundred and eighty-five thousand new jobs; only one hundred and fourteen thousand were added. This is the lowest since December 2020. On top of that, five of the past six months of data was revised lower. Full time employment continues to decline compared to the same period last

year with most job gains being part time jobs, not indicative of a strong labor market. But what really sent the markets lower was the unemployment rate ticking up to 4.3% when it was expected to remain at 4.1%. This triggered the “Sahm rule” which implies the economy is currently in a recession. This adds to the growing list of recession indicators over the past two years.

The Bank of Japan (BOJ) raised interest rates even though economic growth is slowing. This was the expected move but could not have occurred at a worse time. The BOJ move was a reaction to their weakening currency relative to the dollar over the last year. As a result, the carry trade has started to unwind. Monday, the Nikkei (Japanese Stock Exchange) had its worst day since October 1987, down over 12%. This sent markets down across the globe as trades are being covered. A strengthening Yen and weakening asset prices in the US are not a good mix.

On top of the economic worries, geopolitical risks remain extremely high. Israel conducted a strike in Tehran in which they eliminated a political leader of Hamas while he was in the Iranian capital. Iran has vowed “severe punishment” as a result of this attack. Israel does not appear to be backing down, as Prime Minister Netanyahu stated, “whoever seeks to harm us will pay a very heavy price.” Peace talks seem unlikely at the moment. As tensions continue to ramp up, we can also expect volatility to pick up, especially in the oil markets.

Strategy:

The latest developments emphasize the importance of a more conservative approach. We will continue with our diversified equity positioning, consisting of quality companies trading at a discount to intrinsic value. Companies that possess market dominance, pricing power, and steady demand historically perform better in this type of environment. Interest rates have rallied hard over the last few weeks, with the 10-year Treasury hitting 3.6% yield on Monday. We continue to look towards the intermediate segment of the yield curve with our duration. High quality credits remain favorable over high yielding paper. The Mortgage-Backed Securities (MBS) space continues to offer appealing yield spreads in this present climate. We are not buying longer dated maturities after the recent rally. We think it is a bit overdone and expect a backup in rates in the near future.

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