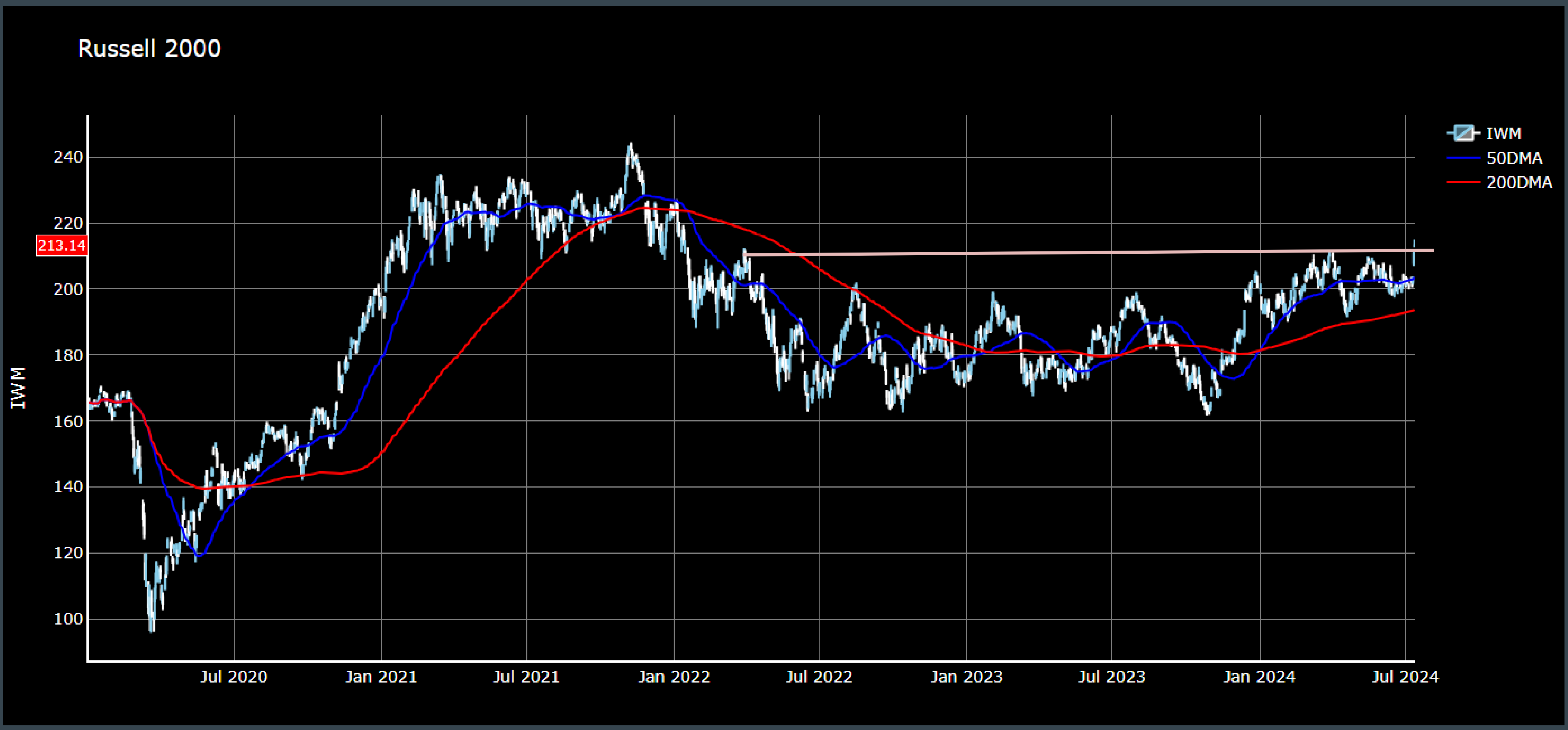
Danny Robushi, APEX MACRO Founder

Rotation or Head Fake?

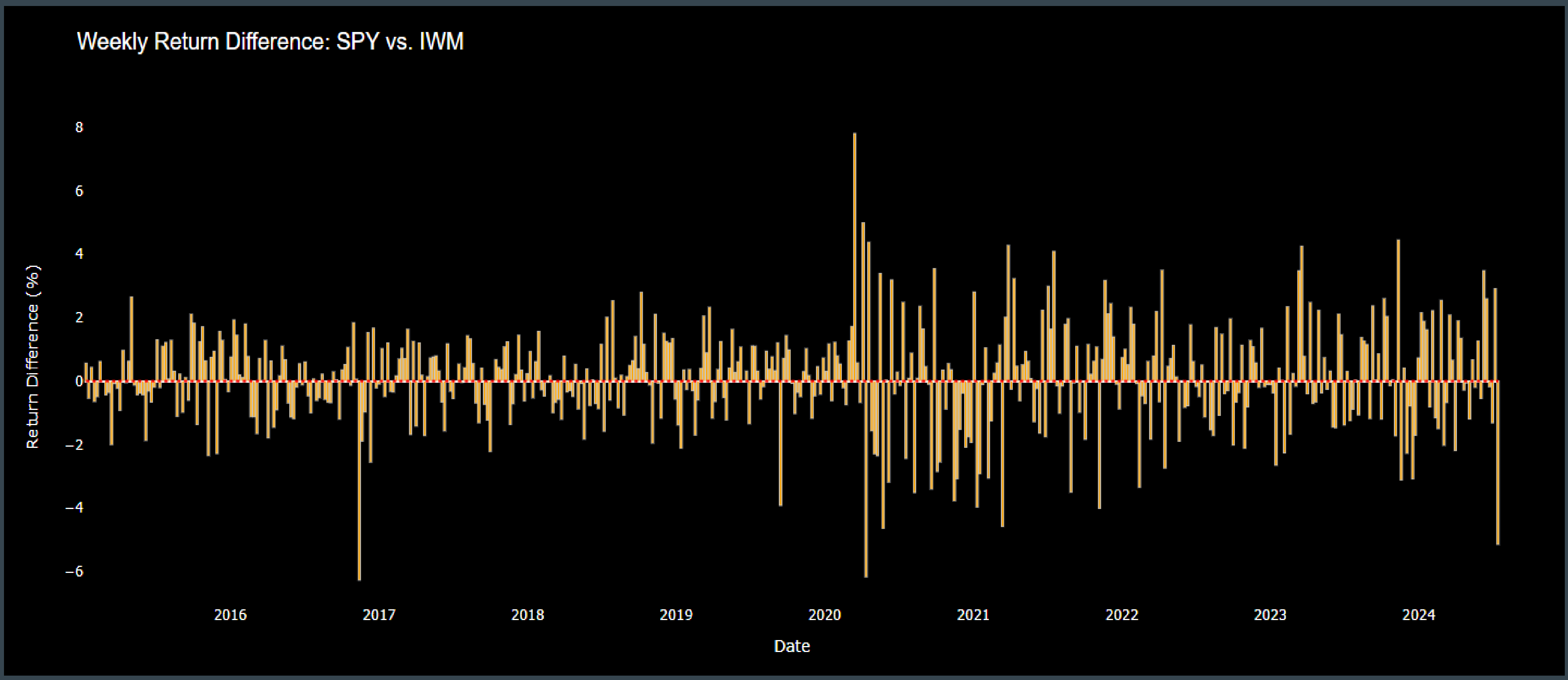
July 13, 2024

The Russell 2000 finished the week higher by over 5%, sparked by a rally that began on Thursday and continued through trading on Friday. The catalyst for this surge was the CPI report released Thursday morning, which showed our first negative month-over-month print since 2020. The CPI came in at -0.1% versus an expected 0.1%, bringing the year-over-year measure down to 3.0% from 3.3%. Core CPI, although positive at 0.1%, was still below expectations of 0.2%, setting this measure at 3.3% year-over-year. It was surprising to many that the Russell 2000, which remains about 12% off its late 2021 highs, responded the most. In an environment characterized by disinflation and, in this print, deflation with yields pulling back towards 4.2% on the 10-year Treasury one would expect growth stocks to further catch a bid. Lower nominal growth and yields create room for margin expansion, as higher growth rates and a lower discount rate come into play. Growth stocks can be viewed as zero-coupon bonds; they reinvest earnings to grow, meaning all embedded cash flows are realized in the future. Lower discount rates allow for higher current valuations, making these stocks more interest-rate sensitive. The logic behind the print and the subsequent asset price movements does not fully align, suggesting a possible short squeeze. Many funds have been shorting small caps while buying large caps with the proceeds. With depressed earnings growth and lesser pricing power, small caps have trended sideways for almost three years, making this a profitable trade. However, during a large rally, managers must sell mega-cap names to buy small caps and cover shorts. This was evident as the Russell 2000 surged while the Magnificent 7 lost over 2% just on Thursday.

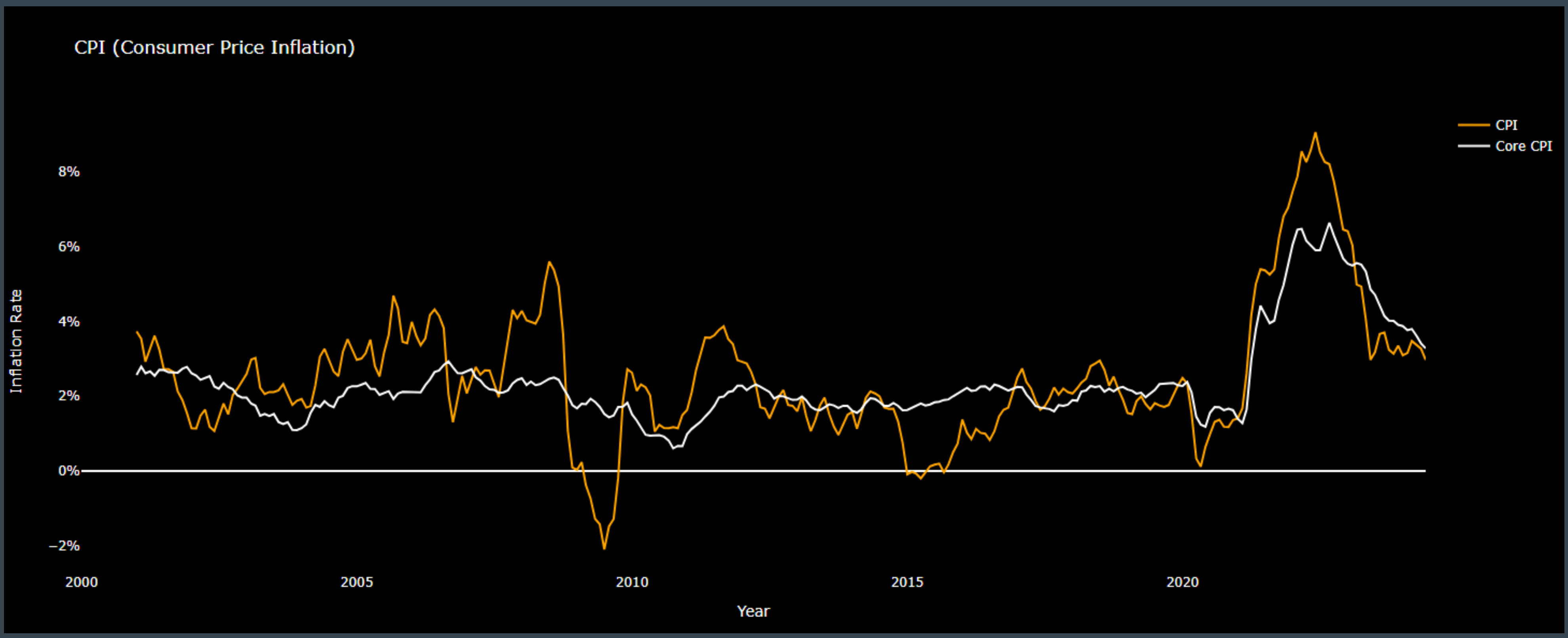
The Russell 2000 is now trading above $213, breaking through resistance at $211 which has held since 2022. We do not think this will spark a larger rally to new all-time highs, as the same conditions that existed a week ago and months before that still exist today. Even if we get two rate cuts due to moderating inflation this year, compared to the Fed's projection of one, it does not change the underlying conditions for small caps. A 25 basis point cut will impact market psychology more significantly than the financial health of these companies. Russell 2000 companies have substantial amounts of floating-rate debt, meaning rates would need to be materially lower to meaningfully improve their interest coverage ratios and margins.



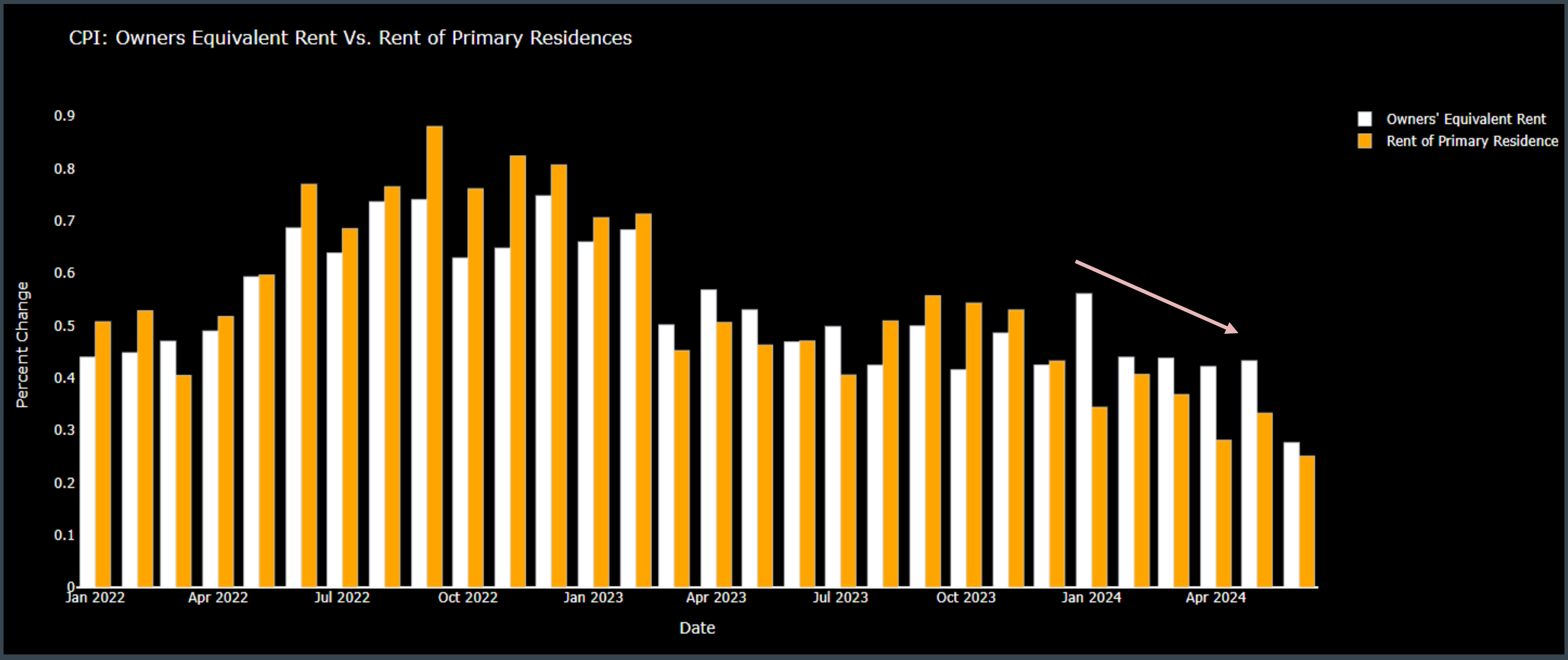
Even with the doubts we have about the start of a rally in the Russell 2000, the move this week was notable. It was the largest outperformance of small cap stocks versus the S&P 500 since April of 2020.



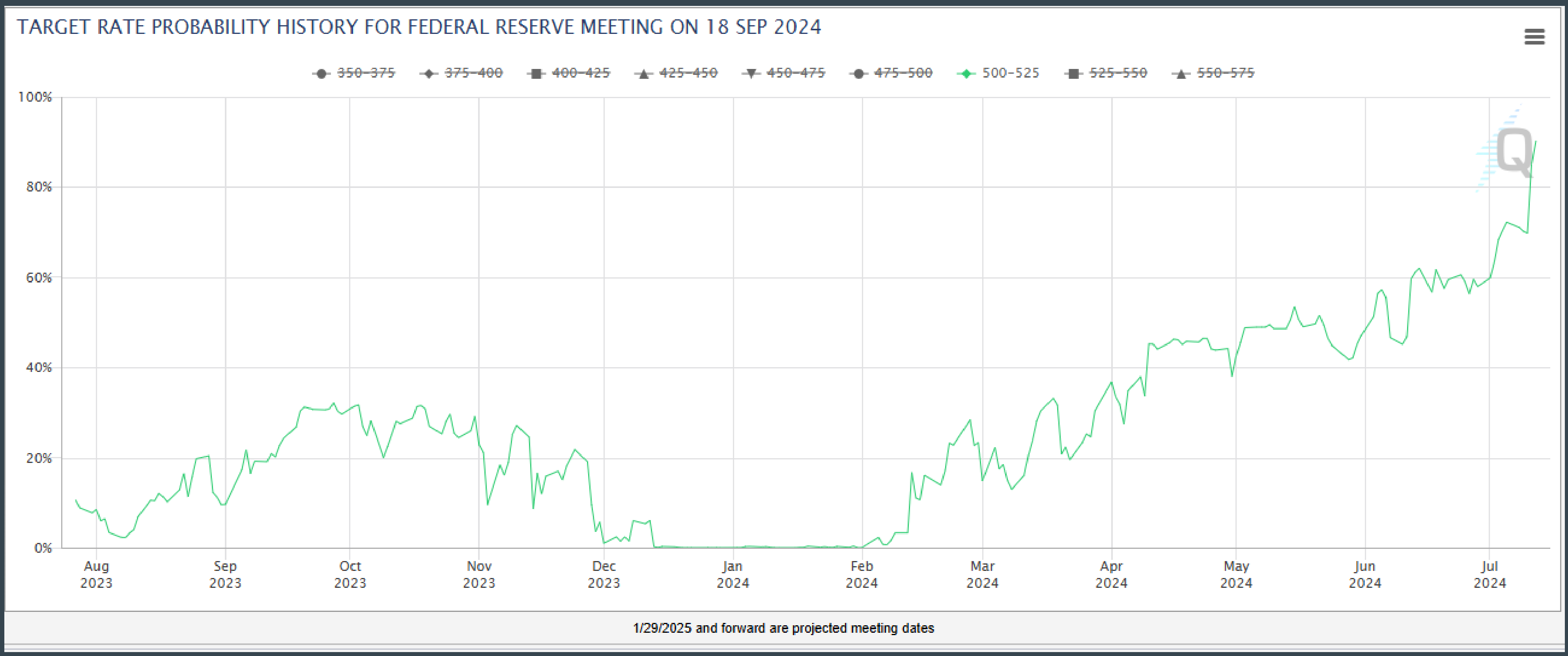
The inflation print this week drove both CPI and Core CPI lower to 3.0% and 3.3%



One of the main drivers of the lower print was Owners Equivalent Rent and Rent of Primary Residence which make up over 35% of CPI and both measures saw disinflation. OER came in at 0.27% and Rent of Primary Residence came in at 0.25%, both the lowest they have been on a month-over-month basis in over 2 years. There are still base effects over the coming months that will put an upward bias on the year-over-year inflation numbers however, so we think that there needs to be more data prior to the Fed making a move on rates.



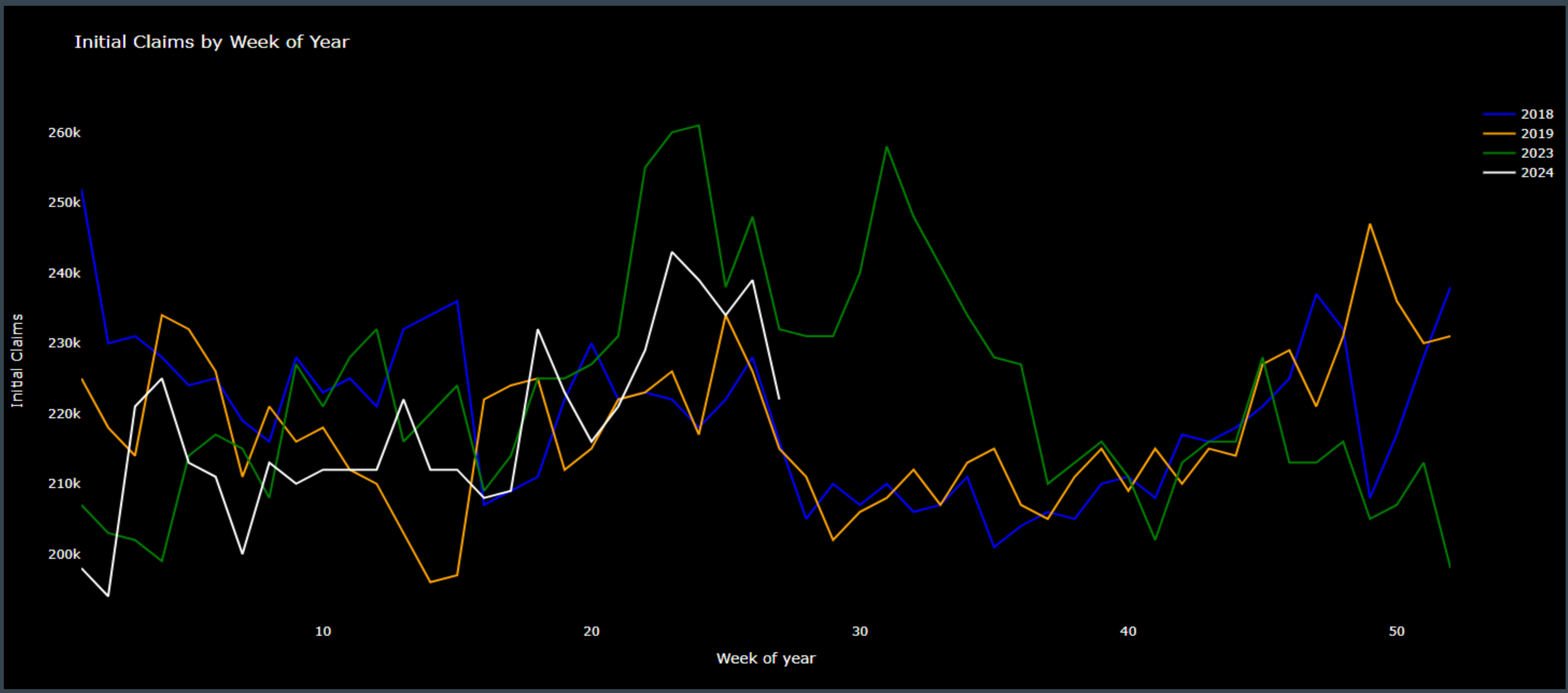
The upcoming Fed meeting in July now has a 10% chance of a rate cut priced in, and we are not expecting that to change significantly. However, with the data this week, the probability of a September cut has increased to 90%, up from 0% in February and 50% in May. Considering there is an election this year, the Fed may opt to proceed with this cut in September to avoid making a cut in November, which could appear politically motivated. Regardless of their decision, it is likely to draw criticism from one side or the other. We believe the key determinant will be the employment numbers over the next few months. If the labor market deteriorates further, a 25-basis point cut in September is likely. We delve deeper into the labor market implications later in this piece.



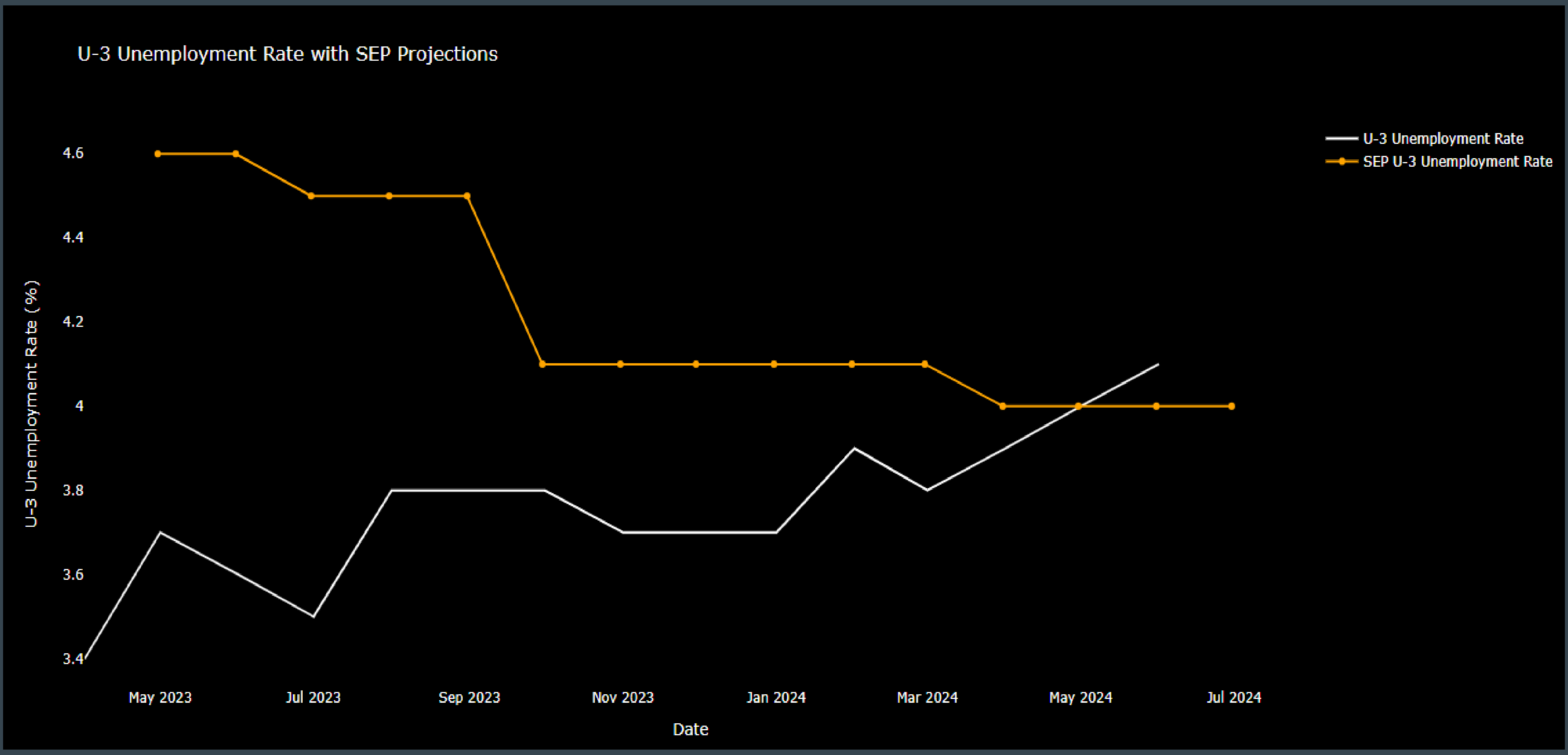
The Producer Price Index (PPI) was released on Friday of this week and largely flew under the radar, with many news outlets not giving it much coverage. However, the year-over-year measure has increased to 2.6%, after having bottomed out below 1% last year. The combination of CPI going negative and PPI rising has significant implications for the economy that many have overlooked. We have highlighted many times in previous pieces that companies have been struggling to pass through costs to customers, who have been pushing back. If this trend continues or worsens while input costs rise, we could see a scenario of margin compression, which is contrary to analysts' earnings expectations for the next year. Earnings are projected to rise by over 10%, driven mostly by margin expansion. If the opposite occurs, companies may respond by cutting labor, posing a headwind to the soft-landing narrative.

In breaking down PPI between Goods and Services, the rise this month was from the Services side not the Goods side which is less impactful to business margins overall, but this trend is one to monitor.

The exact scenario described above regarding margin compression among businesses, filtering down to the labor market, seemed to begin playing out in many people's minds with the uptick in Initial Jobless Claims. Claims increased from a low of 208,000 about two months ago to 239,000 just two weeks ago. They have since come down to 220,000 this week, but it prompted us to dig deeper and examine the seasonality of claims over the past few years. We found that the summer months consistently show higher claims, and this would only raise red flags if persistent. We have also previously pointed out in our piece titled "2 Sides of Inflation" that Initial Jobless Claims have averaged 381,000 at the start of a recession, based on an analysis of eight recessions dating back to the 1960s.



To get back to the discussion of the labor market and Fed cuts, the last Fed SEP released revised Core PCE higher for 2024 to 2.8% and kept unemployment flat at expectations of 4%. By revising up inflation and leaving the unemployment rate just 60 bps above where it bottomed out, they set up a scenario where it would be easier for them to justify cuts. Core PCE sits at 2.6% and now must rise to meet their projections. Meanwhile, the unemployment rate is currently at 4.1%, as pointed out last week, which is above their year-end target. With base effects likely to at least hold Core PCE where it is for the rest of the year, they are set up to cut later in the year with a justification from the labor market amid above-target inflation.


U-3 Unemployment Rate with SEP Projections
U-3 Unemployment Rate
SEP U-3 Unemployment Rate
U-3 Unemployment Rate (%)
4.6
4.4
4.2
4
3.8
3.6
3.4
May 2023
Jul 2023
Sep 2023
Nov 2023
Jan 2024
Mar 2024
May 2024
Jul 2024
Date

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