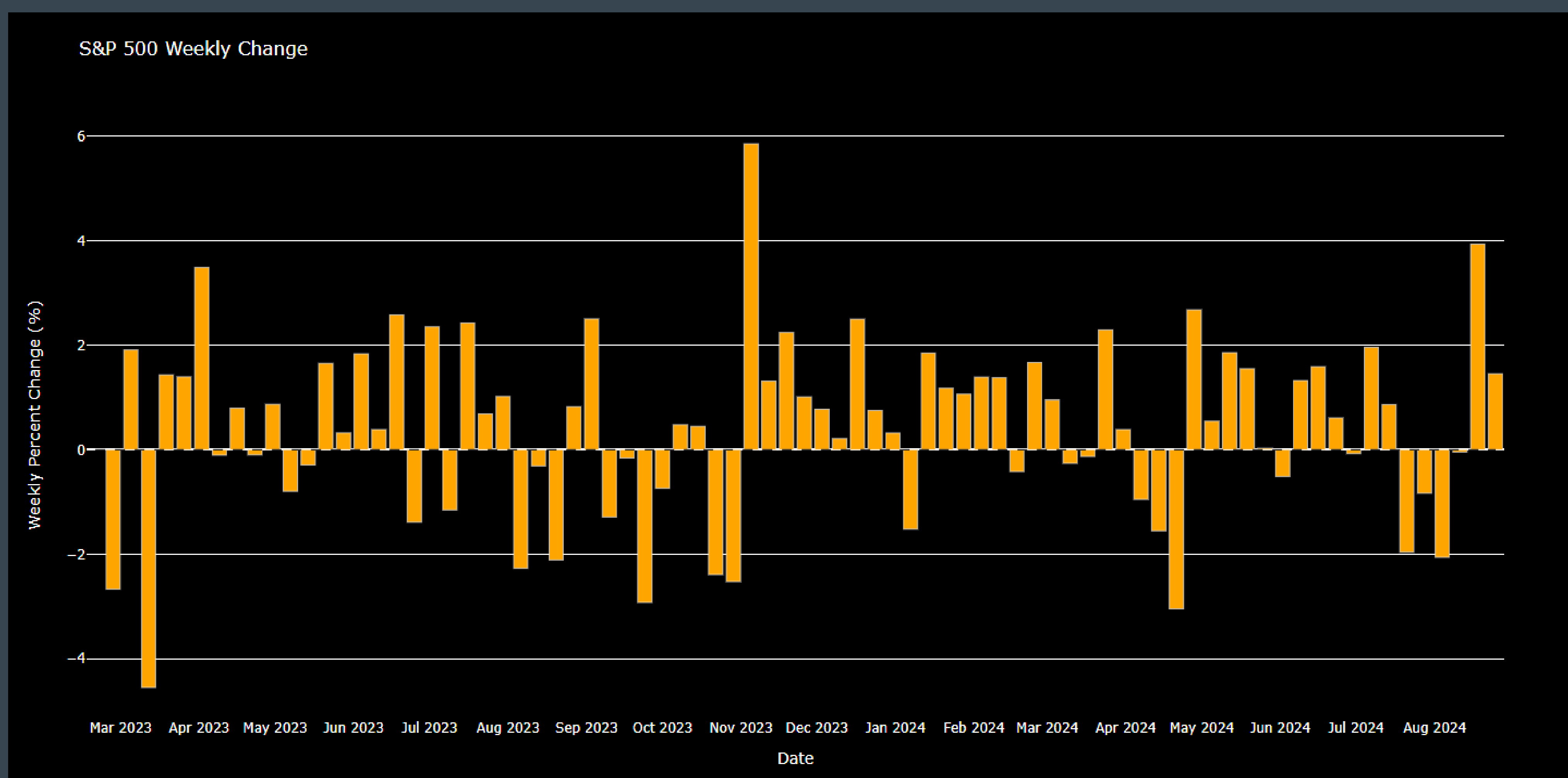
Danny Robushi, APEX MACRO Founder

# Rate Cuts Confirmed

August 24, 2024

The stock market has continued its pattern of strong recoveries after pullbacks, echoing previous V-shaped rebounds over the last year. Following a 9.5% decline, the market has surged back and is now hovering just below the all-time highs of 565 on the SPY. This resurgence has been fueled by multiple sectors breaking to new highs and contributions from the Mag 7 stocks, which experienced a larger pullback but found a bottom at 22% on an equally weighted basis. The rally has been further supported by investor optimism surrounding Jerome Powell's speech at the Jackson Hole symposium, where he confirmed the beginning of a rate-cutting cycle. The anticipation and subsequent confirmation provided a tailwind for the market's recovery.

Sectors like Tech and Communications, which make up a significant portion of the overall market, play a critical role in driving its movements. Recently, Tech endured the steepest selloff among the 11 sectors, while defensive sectors like Utilities, Consumer Staples, and Real Estate continued to advance. This rotation of capital into other parts of the market allowed the Tech sector time to find a bottom and rally back to its 50-day moving average. Notably, two weeks ago, the S&P 500 experienced its best week since November 2023, with a 3.9% gain and following it up with another 1.4% this past week. The previous rally in early November 2023 marked a market bottom and led to a 27% surge that extended into April this year before the next correction took place.



The highlight of the week was Jerome Powell's speech at Jackson Hole on Friday. The market was eagerly anticipating confirmation of rate cuts, and Powell delivered, signaling that cuts are likely in September. Now, the debate centers on whether the Fed will implement a 25 bps or 50 bps cut. With 100 bps in total cuts priced in by year-end and only three meetings left, the market expects one of them to deliver a 50 bps cut. However, without significant deterioration in the labor market, it's likely that the Fed will opt for one cut per meeting. Nick Timiraos of The Wall Street Journal highlighted key quotes from Powell's speech, which provide insight into the Fed's current stance amid the latest economic data:

"The cooling in labor market conditions is unmistakable."

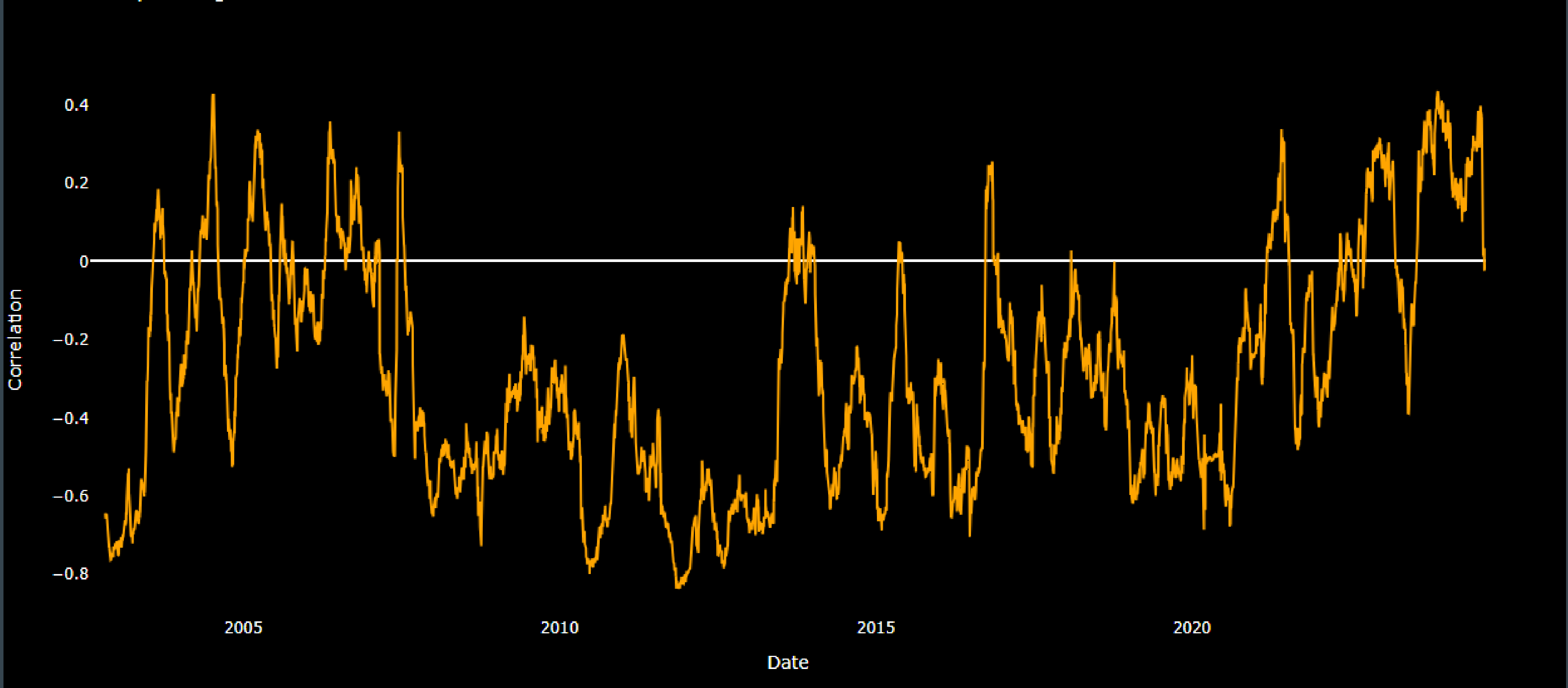
"It seems unlikely that the labor market will be a source of elevated inflationary pressures anytime soon."

"We do not seek or welcome further cooling in labor market conditions."

"The time has come for policy to adjust. The direction of travel is clear, and the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks."

"We will do everything we can to support a strong labor market as we make further progress toward price stability."

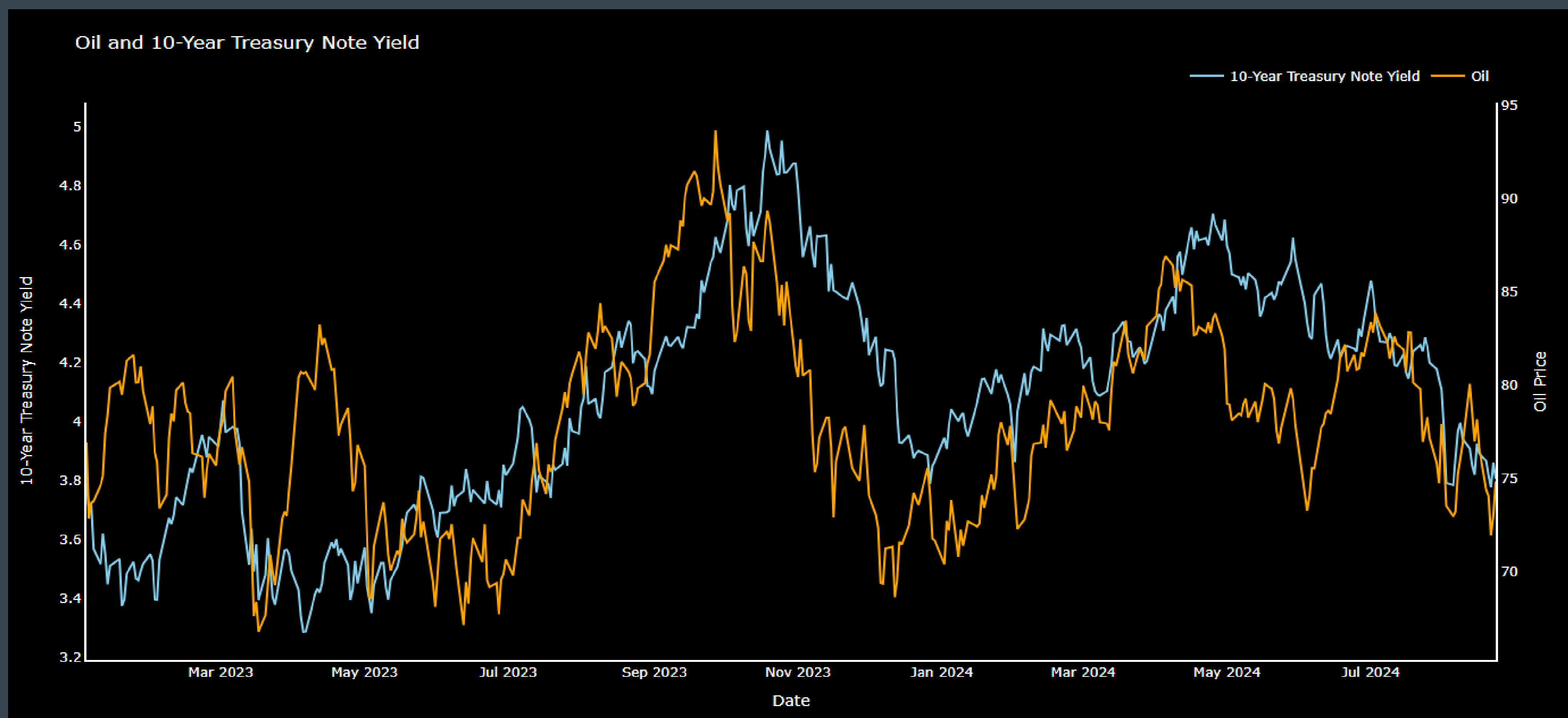
The focus has now shifted decisively to the labor market, as the Fed seems confident it has made significant progress in combating inflation. We've long suspected underlying weaknesses in the labor market, and the recent Quarterly Employment and Compensation (QECW) data confirmed this, showing a downward revision of payrolls by 818,000. The Fed is now recognizing these vulnerabilities, noting that the primary risk ahead is a potential slowdown in consumption if labor market conditions worsen. We believe that the stock market has also adopted this perspective, with a growing sensitivity to labor market data over inflation data. This shift is reflected in the return of the negative correlation between stocks and bonds, which had turned positive during periods of high inflation. Typically, when inflation exceeds 3%, stocks and bonds tend to move in tandem because the Fed maintains a restrictive stance on rates, causing both asset classes to fall as rates rise. However, with inflation now below 3% (CPI at 2.9%) and the Fed considering rate cuts, the market is becoming less sensitive to rate moves. Bonds are resuming their traditional role as a risk-off asset, pushing the correlation with stocks back into negative territory. As long as the trend in inflation continues downward, labor market data will increasingly influence market movements and the Fed's policy decisions, as emphasized by Jerome Powell.



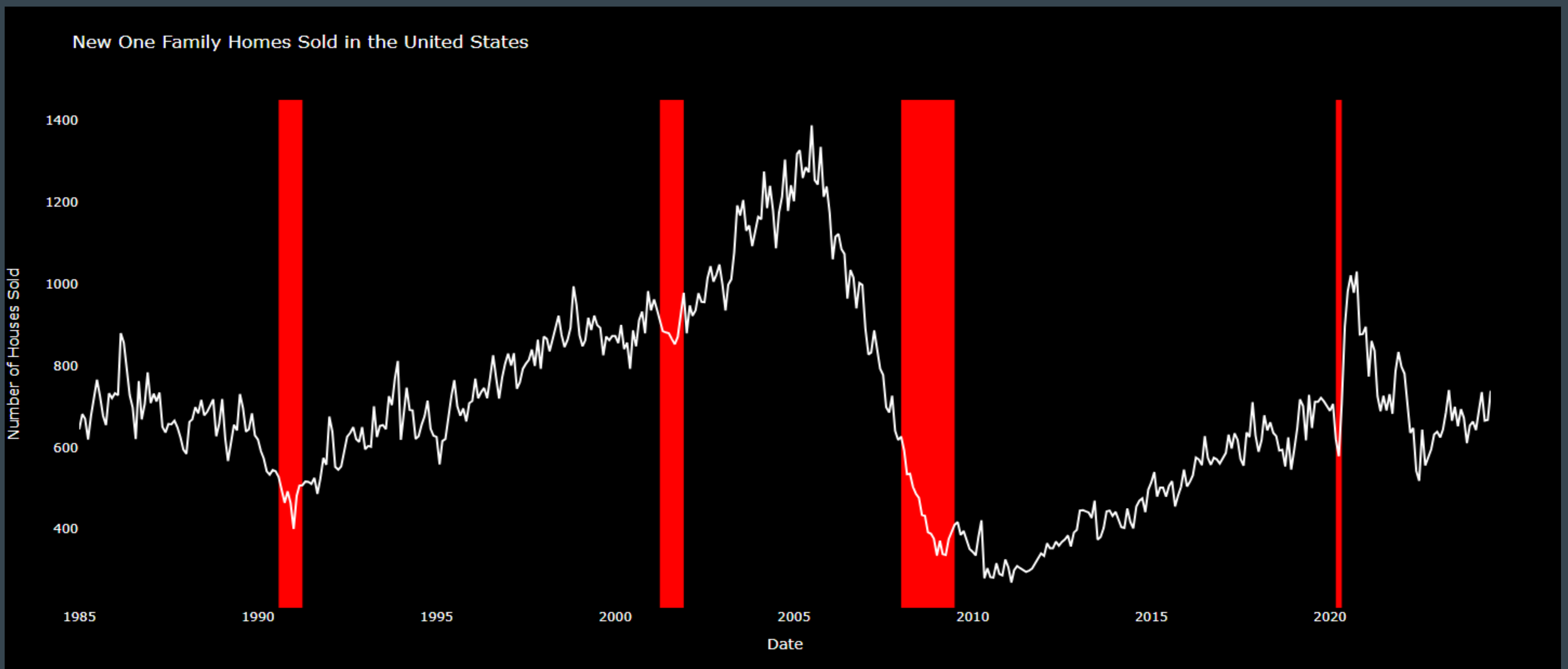

We are edging closer to the long-debated outcome of either a soft or hard landing for the economy. Currently, key assets like the 10-Year Treasury Yield are crucial indicators of investor sentiment. The 10-Year Yield has recently dropped to 3.81%, a level it has tested multiple times over the past few weeks. The weaker-than-expected Nonfarm Payrolls report contributed to this decline, as investors moved into safer assets, signaling concerns about economic growth. A sustained break below this level, especially without any movements at the short end of the curve from the Fed, would suggest a more recessionary outlook. This part of the yield curve

is heavily influenced by nominal GDP, and with CPI at 2.9%, yields dropping further would indicate that real GDP is heading below 1%, reflecting significant economic slowing.

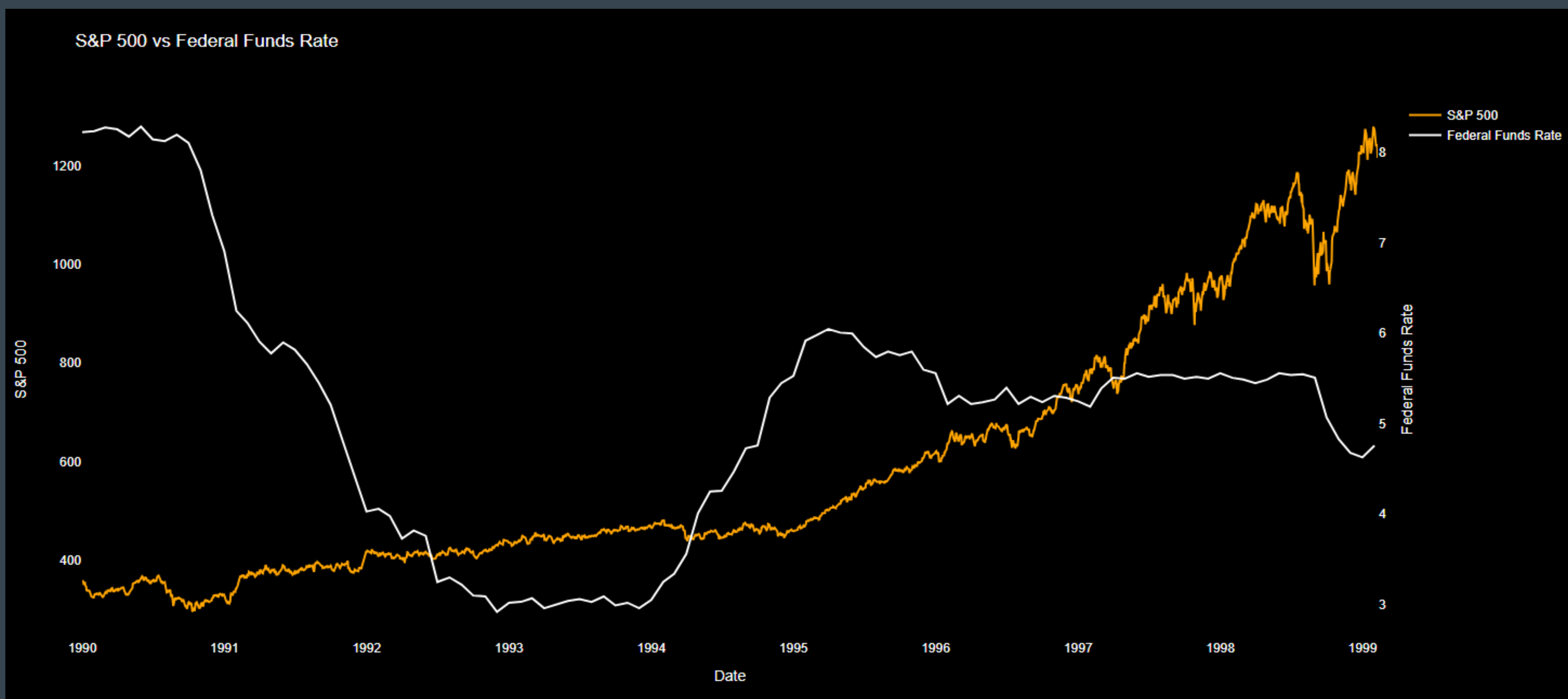
Another key asset we're closely monitoring is Oil, which has been moving in tandem with the 10-Year Treasury Yield. Interestingly, Oil prices have been leading this trend, with lower prices indicating a potential slowdown in global growth. The critical level to watch for Oil is $70. If Oil falls below $70 and yields drop below 3.8%, it would signal a slowdown in Oil demand, defensive positioning by investors, and weaker nominal U.S. growth.



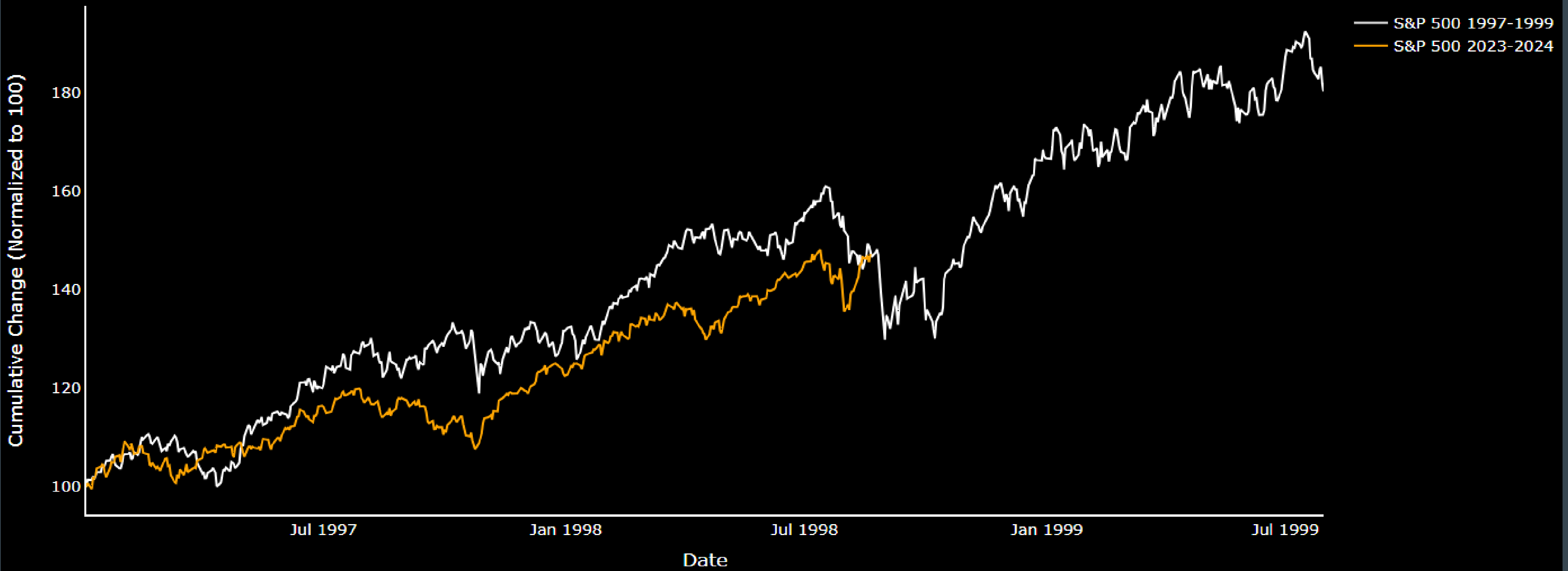

Key economic data points we wanted to highlight this week were the reports on new and existing home sales. With yields having declined over the past month, the expectation was that home sales might see a rebound if the soft landing narrative holds true. The idea behind a soft landing is that lower yields could help revitalize growth in sectors sensitive to interest rates, like housing. Indeed, existing home sales rose from 3.9 million to 3.95 million, and new home sales increased to 739,000 from 628,000 last month. While this is just one data point and shouldn't be overemphasized, it is the kind of positive sign you'd want to see if you're in the soft landing camp.




Reflecting on the current soft landing discussions and potential rate cuts, it's worth revisiting the Fed's success in engineering a soft landing in the 1990s. Back then, the Fed initiated a rate hiking cycle in 1994, followed by rate cuts in 1995. The economy managed to avoid a recession, and those cuts helped propel the S&P 500 up by approximately 200% over the next five years. Today, we see parallels with the current environment, marked by enthusiasm surrounding AI and retail investors eager to buy every dip. If the labor market remains stable and the Fed begins cutting rates without signs of a slowdown, we could see a similar scenario unfold, with the market potentially moving much higher. This is why it might be prudent to hedge for that outcome and maintain exposure to Tech.



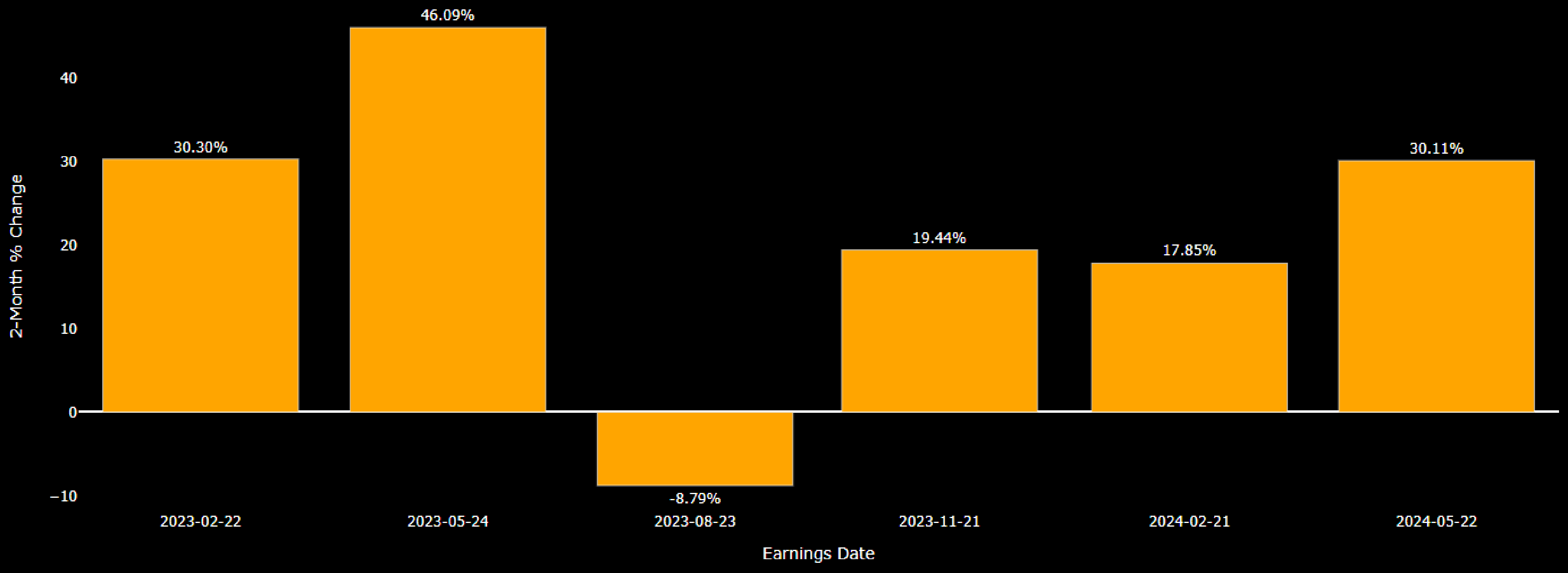

When comparing the S&P 500's performance from the beginning of 2023 through Friday with the market from 1997 to 1999, a strikingly similar pattern emerges. Both periods exhibit a choppy market through October, followed by a rally into the end of the year. This observation aligns with historical seasonality trends, suggesting that while short-term volatility may persist, there could be significant gains as we approach year-end.




The major event on the horizon next week is NVIDIA's earnings announcement on August 28th. As a company that represents over 6% of the S&P 500, NVIDIA's performance is closely watched. Over the past three years, NVIDIA has achieved an impressive 3 year compound annual growth rate of 60% in revenue. In the last two earnings reports, strong results sparked significant rallies in the stock, which also contributed to broader market gains. While past quarters' results are important, the market will be particularly focused on NVIDIA's forward guidance and commentary around AI demand, especially regarding their chips' role in the ongoing AI buildout.

Earnings days denoted in red:

In 5 of the last 6 earnings announcements for Nvidia the stock was higher by at least 17% 2 months after


2-Month Percent Change in NVIDIA Stock After Earnings
2-Month % Change
40
30
20
10
0
−10
30.30%
46.09%
-8.79%
19.44%
17.85%
30.11%
2023-02-22
2023-05-24
2023-08-23
2023-11-21
2024-02-21
2024-05-22
Earnings Date

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