Risk On Risk Off

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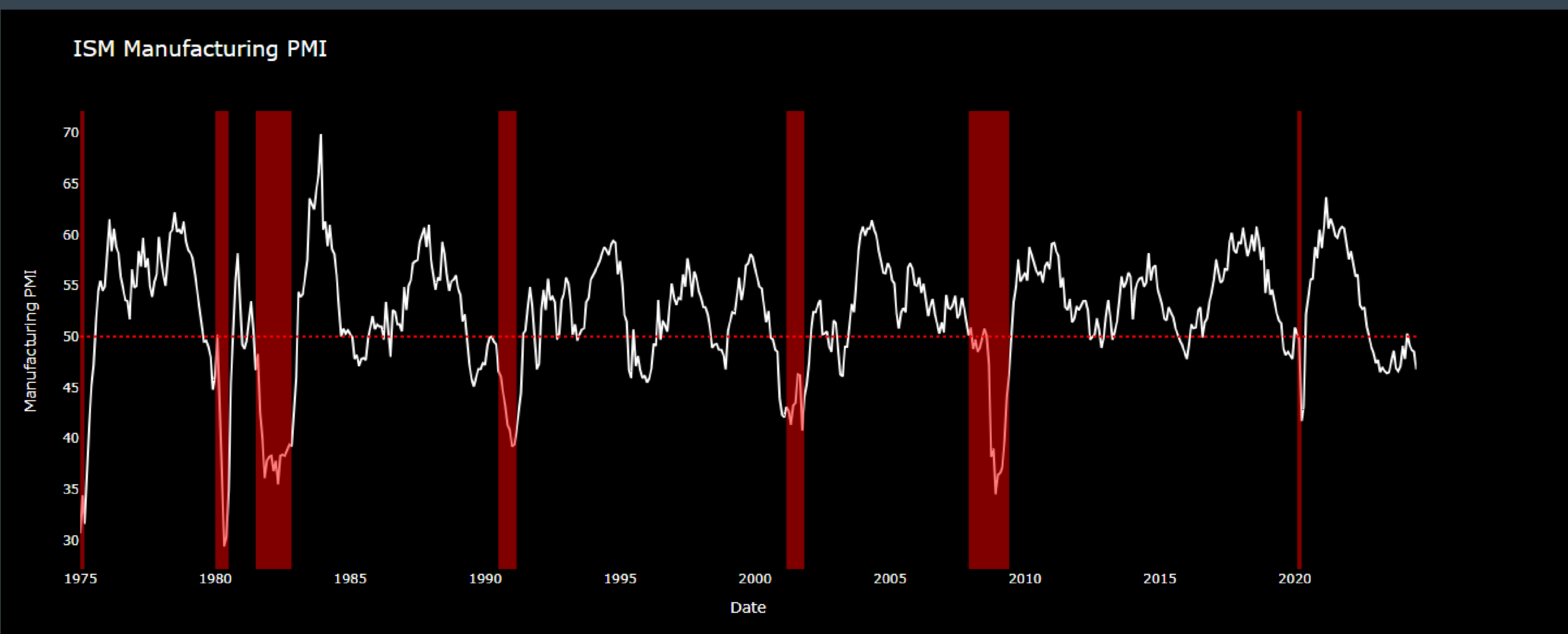
A soft landing remains a low-probability scenario in our opinion. However, the markets have priced in this scenario as the base case. To achieve a soft landing, we need further cooling in the economy to bring inflation down from 3% to 2%. This process will likely involve seeing mixed economic data, with some weak and some strong data spread across various sectors of the economy. Recently, market pricing has become more volatile as data has been released, with significant reactions to both positive and negative news. There have been overreactions in both directions, and the moves in the latter part of last week exemplify this overreaction. While nonfarm payrolls, which we will delve into deeper later on, came in soft, the markets reacted as if a recession was imminent. Yields have steadily trended lower over the last few months, but this trend accelerated to the downside this past week. Initially, this was perceived as a sign that the Fed might begin to cut rates, which would relieve pressure on companies with large debt burdens. However, this is only true to a point. As yields on the 10-year Treasury fell below 4% while the Fed Funds rate remains at 5.25%-5.50%, it starts to look more like a recessionary move, where investors are positioning for a risk-off scenario in stocks. The 10-year yield is now down to 3.8%. This is an area we would look to see some support.

Amid rising tensions in the Middle East, oil prices have also collapsed, falling by 12% in July. This decline is a signal of slowing global growth. Oil is an input to everything we do, so decreasing demand is one of many indicators that economic activity is slowing. Currently, oil prices are down to $73 per barrel.

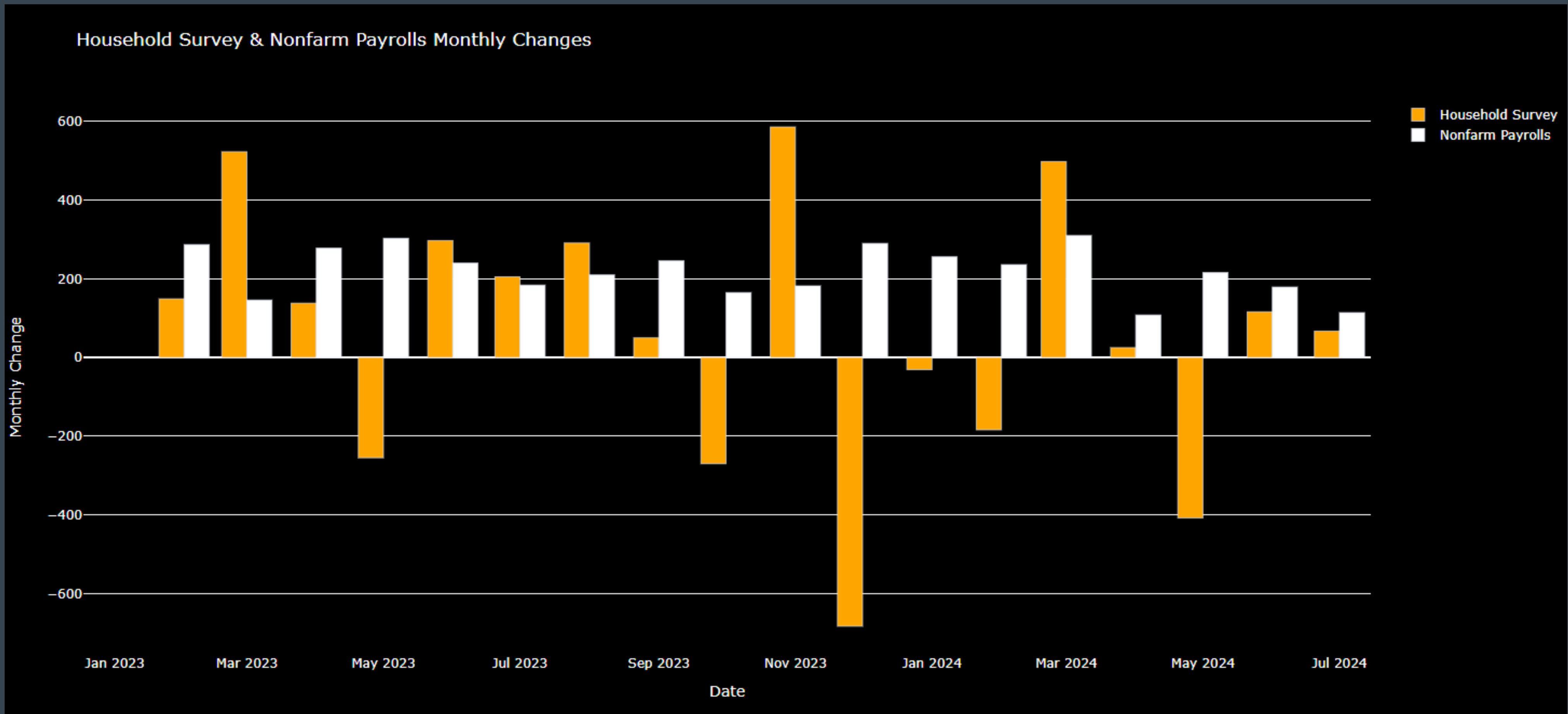
Copper is another commodity that can provide clues about where we are in the business cycle. The breakout higher that we saw in May gave many investors the impression that a growth slowdown was further out in the future than initially thought. However, copper has since fallen almost 20% and found support at its 200-day moving average. Much of the pricing we see in copper is heavily related to China's growth, and they are currently dealing with deflation. Consequently, the lack of demand from their economy is putting downward pressure on copper prices. Nonetheless, copper remains an important input to consider when trying to get an overview of what the market is pricing in.

The GDP print of 2.8% two weeks ago provided further tailwinds for the rotation into Small Caps and non-tech sectors of the S&P 500. However, this week's Manufacturing PMI print came in at 46.8, down from the previous month's 48.8. This exemplifies what I mentioned in the introduction about mixed data leaning towards both growth and recession. As this data comes in, the market is flip-flopping between which of the two to bet on.

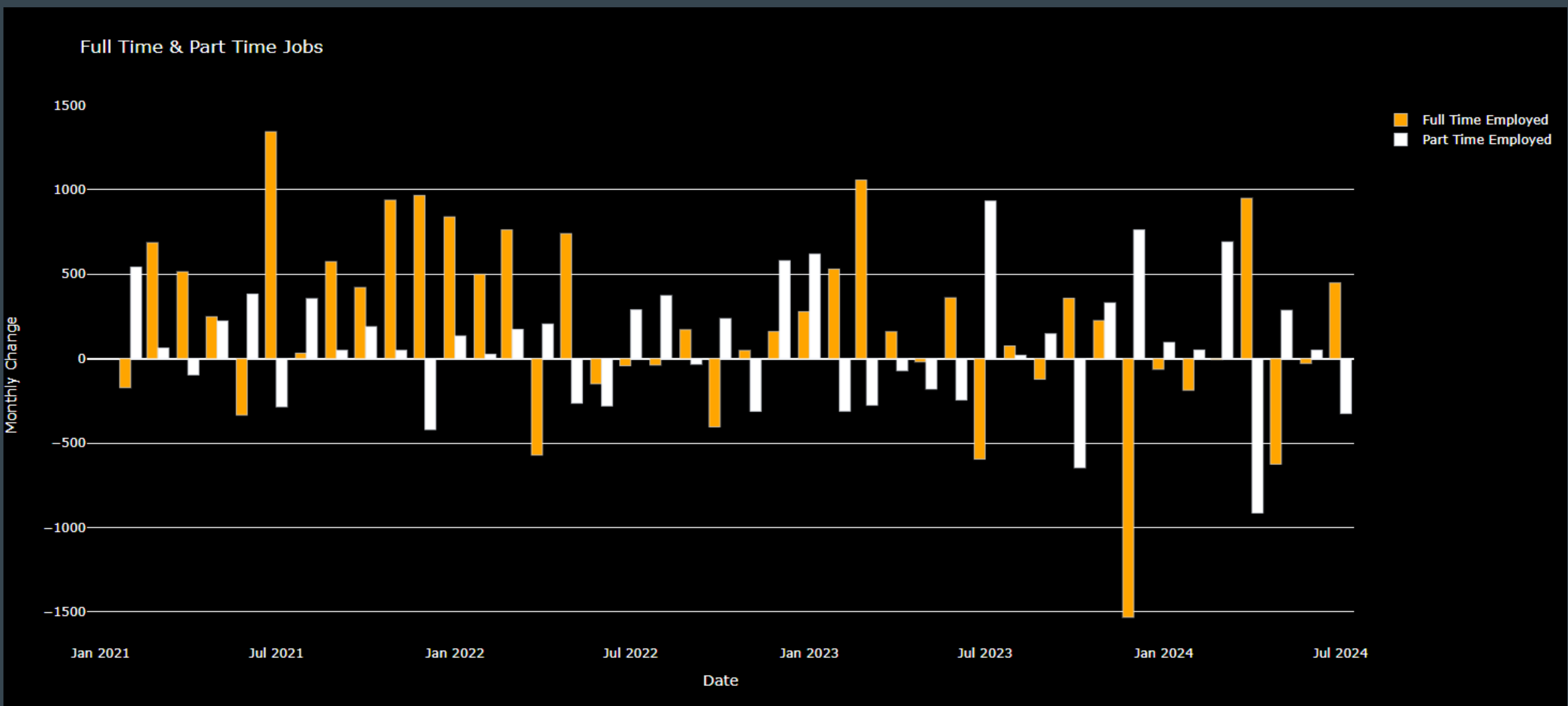


After a reversal of sentiment and drawdowns in both Tech and Semiconductors throughout the week, the all-important Nonfarm Payrolls number garnered all the attention on Friday. It came in at 114,000, below the expectations of 170,000, and the prior month was revised down to 179,000 from 206,000. This makes it 11 of the last 16 months with downward revisions. This print sent yields across the curve lower, and everything sold off except for Utilities, Staples, and Bonds. It was a risk-off day that you would normally see in a recession. While 114,000 is a weak payroll print, it is not an indicator that the economy is heading into a recession. Traditionally, we need to see negative payroll prints for such a warning. Additionally, cyclical sectors such as construction added

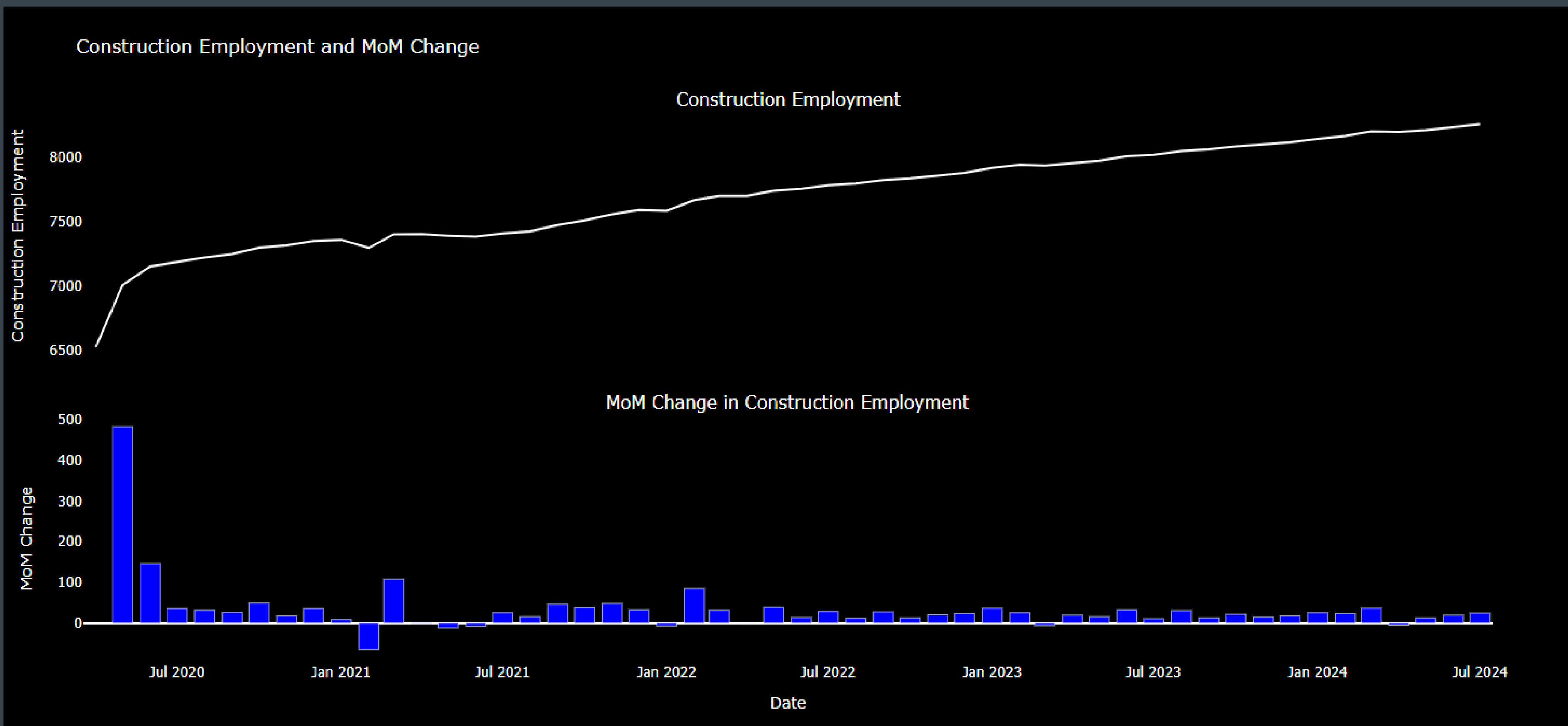
25,000 jobs. For those who regularly read our work, we believe construction jobs will be the indicator to signal a recession. While the Nonfarm payroll report showed 114,000 jobs, the household survey reported 67,000 jobs.



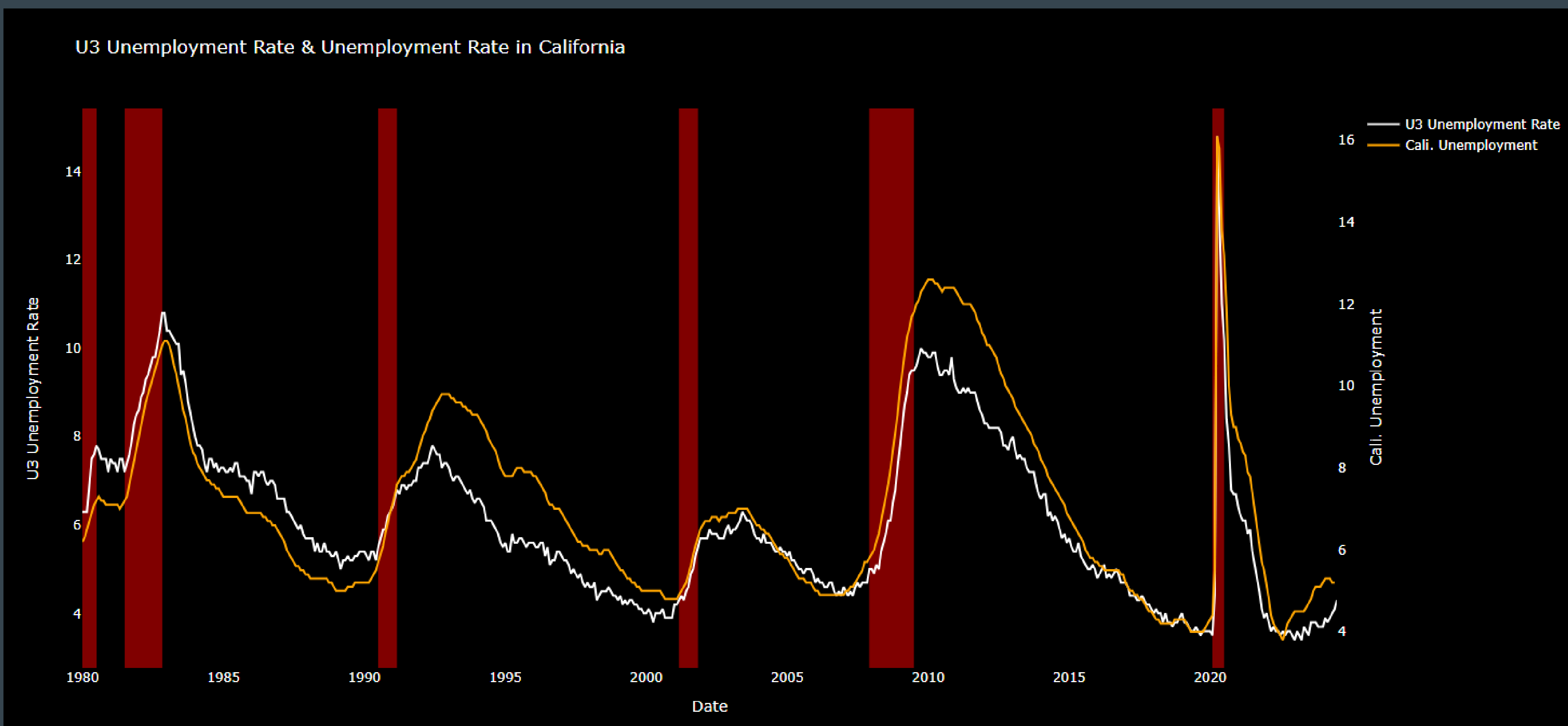
We have noted in the past, the discrepancy between Full Time Jobs and Part Time Jobs added over the past year. Full Time jobs have fallen by over 1 million, while Part Time jobs have risen by a million. This latest report, however, showed the opposite. We saw a gain of 448,000 Full Time jobs and a loss of 325,000 Part Time jobs.



As noted, Construction Employment held up, gaining 25,000 jobs in July. This continues to trend upwards, and we are looking for a 5%-10% drawdown to signal a legitimate growth slowdown. While construction spending fell last month, Housing Starts and Permits rose. So, while we are seeing some shaky data, it has not yet filtered through to employment in this sector.



The unemployment rate rose to 4.3%, up from a trough of 3.4% a little over a year ago. This increase also triggered the Sahm rule, which occurs when the 3-month moving average of the U-3 unemployment rate rises 50 basis points above its 12-month low. Claudia Sahm, in discussing this indicator, stated that it is not a recession indicator per se, but rather a signal to policymakers that the economy is slowing and that they need to be accommodative with rate cuts or stimulus to avoid entering a recession. Historically, when this rule has triggered, it has often preceded a recession due to the nature of unemployment, which typically rises by 300+ basis points after a trough. In our previous article, we highlighted that the Sahm rule would trigger in July if the unemployment rate rose to at least 4.2%. However, we did not view this as an immediate indicator of a recession, and we still do not foresee a recession in the near term. The unemployment rate also has a high correlation with the unemployment rate of California. California's unemployment rate, which tends to lead, is at 5.2% as of July which leads us to believe the national unemployment rate has not yet peaked.



The FOMC meeting took place this week, but market action seemed to overshadow it. It was described by the media as a "snooze fest" because not much changed outside of a few words in Jerome Powell's usual statement. Rates were kept at 5.25%-5.50%, despite the growing calls for cuts. However, an important quote I wanted to highlight from the meeting is:

"Downside risk to employment is real now. The time is coming when it will be appropriate to dial back that level of restriction so we can address both mandates."

This has been hinted at in previous meetings this year, but Powell is explicitly saying that inflation is no longer the number one priority of the Fed. The Fed believes it is at a place where they have made enough progress on inflation to act if employment shows weakness. After the payroll print on Friday, the market's expectations shifted from a 100% chance of one rate cut in September to a 65% chance of two cuts. We don't think that the 114,000 figure was weak enough to warrant two cuts, but we have a few more prints to go before the September meeting.

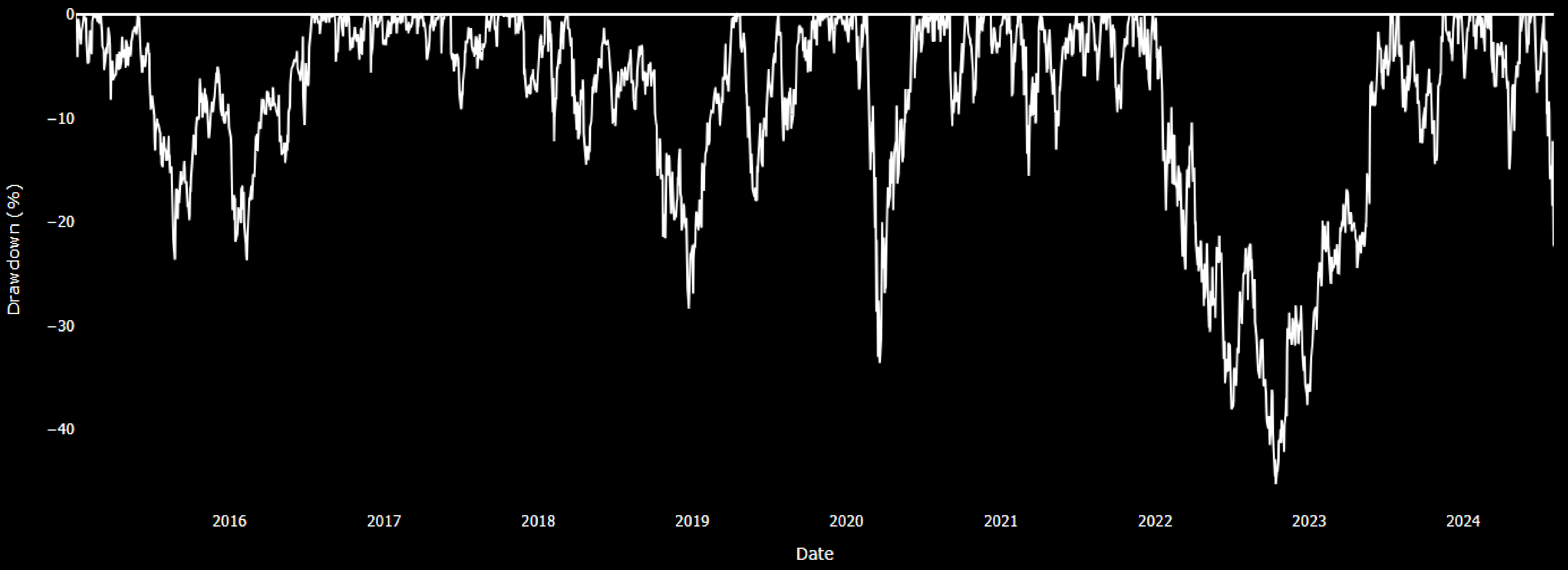
Something we highlighted a few weeks ago was the seasonality of the VIX. After July, we tend to see heightened volatility until the end of October, which is the most common period of the year for the market to predict increased turbulence. It did not take long for the VIX to head into the 20s, and it even reached 30 mid-day.

For a big picture view on where we are in equities:

- Tech is down 15% and sits at its 200-day moving average
- Semiconductors are in a bear market, down 24%
- The Nasdaq is correction territory down over 10%
- The S&P 500 through all of this is only down 6%
- The Russell 2000 erased all of its rally and is back to $207

Due to the concentration and valuations within the market, most of the stocks driving returns were priced for perfection. As they have reported earnings, they have been punished for any slip-ups or negative comments about guidance. The market is also beginning to worry about capex spend on AI due to the fact it has not resulted in significant revenue growth. The misses in economic data to the downside have also shifted positioning. However, we do not think we are entering a recession yet, and much of this move has been overdone to the downside. We expect a bounce in yields from the 3.8% level and broadening within the S&P 500 sectors. Tech and Semiconductors could also see a bounce after selling off, but I would be wary about where valuations stand for many of these names.

Semiconductors are in their largest drawdown since 2022



The Russell 2000 is back into its consolidation range, and we continue to believe in fading rallies in Small Caps until we see confirmation economic growth has troughed.

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