Navigating Recent Volatility in US Stocks

6 August 2024

The past two days have seen a notable decline in the US stock market, causing understandable concern among investors. It's important to remember that market volatility is a normal part of investing, and temporary dips can often present opportunities for long-term growth.

Why This Sell-Off is Happening

The recent sell-off in the US stock market can be attributed to several factors:

Poor Economic Data: Recent economic data showing signs of a slowing economy has led to concerns about a potential recession. The latest jobs report indicated that the US labour market has weakened further. The unemployment rate rose to 4.3% from 4.1%. Consensus was expecting 4.1%. The non-farm payrolls came in at 114,000, well below the previous 179,000 and the expected 175,000. Stocks sold off on concerns that recession risk in the US economy has risen considerably.

FED Behind the Curve Risk: There is growing concern that the Federal Reserve may be behind the curve in addressing economic conditions. Despite inflation showing signs of easing, the Fed's cautious approach to cutting interest rates raises fears that prolonged high rates could slow economic growth or induce a recession. This was evident in the end July meeting where there was no strong indication that rates will be cut at the next meeting. This perceived delay in rate adjustments has made investors anxious about the economic outlook.

Warren Buffett Sells Stock: It was announced on Friday that Warren Buffett's Berkshire Hathaway sold nearly 50% of its stake in Apple in Q2. This move has significantly impacted investor sentiment, leading to an 11% drop in Apple's stock price and contributing to the broader market sell-off. The sale is seen as a defensive manoeuvre, raising concerns about high market valuations and possibly economic uncertainty.

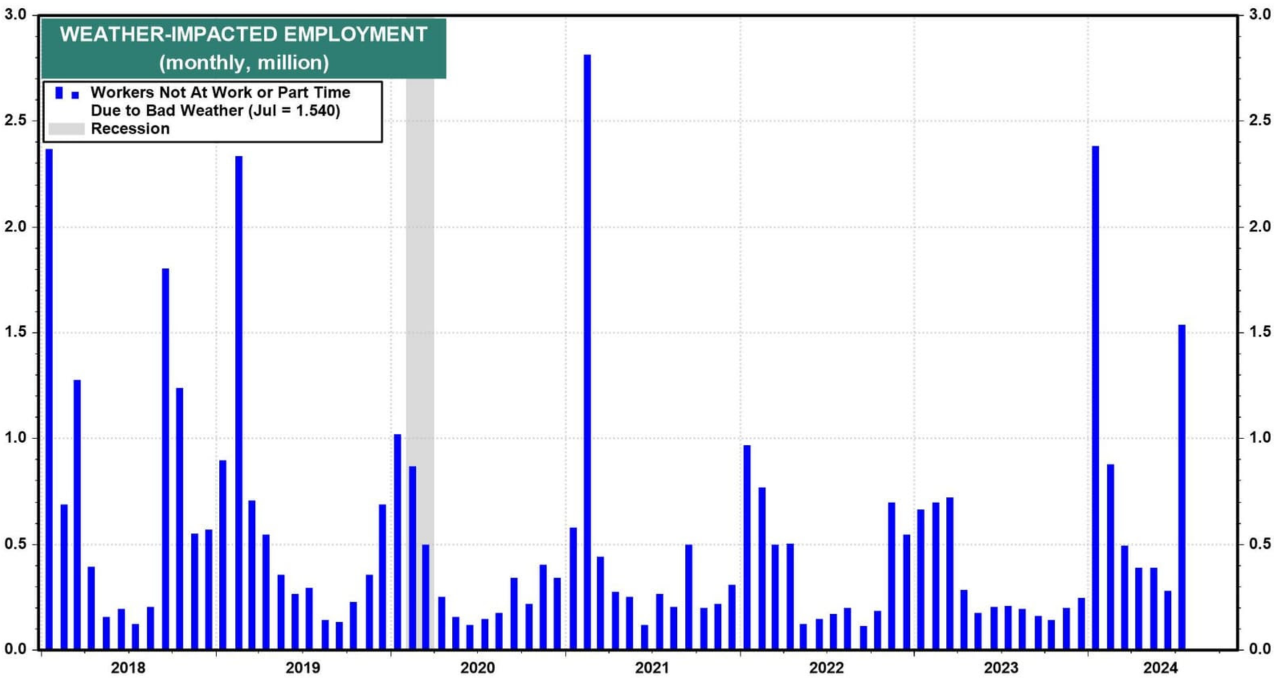
Unwinding of the Japanese Yen Carry Trade: The Bank of Japan's recent interest rate hike has triggered a significant unwinding of the yen carry trade. The Japanese Yen regained all its 2024 losses against the US Dollar in a matter of 17 trading days. Investors who had borrowed yen at low interest rates to invest in higher-yielding assets are now facing higher costs to repay those loans as the yen appreciates. This has led to widespread selling of assets, including stocks, to cover these margin calls, adding further pressure to the global markets.

Is the Sell-Off Justified?

While the market's reaction may seem severe, some level of caution is justified given the current economic environment. However, it's essential to consider the broader context:

Strong Corporate Fundamentals: Despite the recent sell-off, the underlying fundamentals of many US companies remain robust. The latest earnings reports show strong revenue and profit growth in key sectors such as technology and healthcare. According to Factset, three quarters of the S&P 500 companies have reported Q2 earnings, and 78% of them reported actual earnings above estimates, which is above the 5-year average of 77% and above the 10-year average of 74%. For instance, major tech companies have reported significant earnings growth due to high demand for their products and services. When companies fell short, they were largely due results that missed lofty investor expectations.

Impact of Hurricane Beryl on Jobs Report: The latest jobs report, which showed only 114,000 jobs created in July against expectations of 175,000, is likely impacted by bad weather, specifically Hurricane Beryl. According to government statistics, the household employment survey showed that 1.54 million workers were either not working or only part-time due to weather conditions, far above the historical average. This suggests that the weak jobs report may not be as bad as it appears and could reverse as recovery efforts begin and businesses resume operations.



Source: LSEG Datastream and © Yardeni Research.

Should Investors De-Risk?

Analysis of market breadth and cyclical sectors indicates that the current bullish cycle is not over. Prior to the recent sell-off, indicators suggest that many sectors remain strong and poised for continued growth. Small cap industrial stocks and retailer stocks have been on a uptrend despite the current high interest rate environment. This suggests that the overall market trend remains positive, and the recent dip may present a buying opportunity.

What Will Make It Stop?

Positive Economic Data: Strong economic indicators can boost investor confidence and support market recovery. Last night, the ISM services PMI was released and showed that the services sector was humming along, with activity, new orders, and employment all growing. As more data invalidate the recession risk, markets are able to bottom and resume its focus on corporate earnings, which continues to grow.

Staying the Course:

For now, we encourage investors to stay invested. While we are aware of risk of a recession, we do not see sufficient evidence to compel us to turn defensive in our asset allocation. We will continue to monitor for signs that a weakening trend is entrenched in the US economy and will update accordingly.