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What an astonishing turn of events. Less than 10 days ago, we were starting to enjoy a market with breadth. The Magnificent Seven tech stocks that were carrying much of the market had dropped but improvements in small-cap, mid-cap, real estate, and the other 493 companies in the S&P 500 made for a good month in our investment strategies. We're now basically experiencing a massive, indiscriminate global sell-off. This newsletter will be a direct effort to provide context to the sell-off and how we hope to navigate it.

Commentary Summary

1. The headlines say the market sell-off was caused by a weaker job market report on Friday along with downward revisions from prior month. The knee jerk reaction appears to be concern that the Federal Reserve has fallen behind on interest rate cuts and may cause a recession. However, by numerous measures, US companies and the US economy are currently doing fine, which doesn't align with the intensity of the selloff.
2. Japan's interest rate hike, and strengthening Yen probably aren't helping but extremely volatile Japanese stocks tells me that other factors may be in play.
3. This is the definition of a "panic sell", in my view. While initially scary, I expect cooler heads to prevail, plus market selloffs may create buying opportunities if the selloff continues.

Headlines say a weaker jobs report caused the selloff…but the US Economy is not currently suffering.

The jobs report on Friday conveyed some unexpected weakness as 114,000 jobs were added in July. [1] This was lower than expectations plus jobs data for prior months was also revised downward.[1] When comparing job growth rates over last year, July 2024 was 3.6% *higher* than July 2023 but lower than 3.8% in June, implying that a meager 0.2% was "lost". A soft jobs report implied that the Federal Reserve has made a mistake by not cutting rates sooner and recession is all but certain. At risk of sounding glib, this felt like sports commentators saying that Simone Bile's gold medal aspirations were in jeopardy because of a mild leg injury. Clearly that forecast didn't work, and in my view, connecting a slightly weaker trend in jobs to an imminent US recession and Fed mistakes is a pretty big leap. By several measures the US economy is hardly in dire straits at this time.

- Gross Domestic Product rose at an annual pace of 2.8% in the second quarter (from April – June) meaning the economy is expanding.[2]
- The unemployment rate rose from 4.3% but this is still fundamentally healthy and historically low.[1] Analysts correctly highlight that the unemployment rate that has risen 0.6% (3.7% in January to 4.3% in July) which is the fastest semi-annual increase since the pandemic.
- A measure called the Labor Force Participation Rate *increased* in July.[1]
- A measure called the Worker Productivity Rate *increased* 2.7% over July 2023.[1]
- Based on second quarter earnings season, 78% of the S&P 500 firms have beat analyst earnings estimates compared to a 74% 10-year average.[3]
- US PMI (Purchasing Manager's Index) *increased* from 48.8% in June to 51.40% in July.[4] A PMI index of 50% or greater indicates expansion. Again, some correctly point out that the PMI index was 52.70% a year ago, which does mean that the index has declined -2.5% in a year, but it is *still* in an expansionary trend.
- The ISM Service Sector Index rose to 51.4% in July. Like the PMI, anything above 50% is expansionary.[5]

We don't like seeing a weaker jobs report but that by itself should not merit a significant market sell-off, in my view. I cannot emphasize enough that in times like this, one must take everything with a grain of salt and avoid

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getting emotional because of scary headlines. Don't forget that as recently as March the markets sold off because inflation reports showed 3 consecutive months of broad-based price increases in nearly every category. Economists and analysts were shouting that the Fed was making a terrible mistake by cutting rates *too soon.* Inflation was stuck, consumers had to resign themselves to a "new normal" of high prices, companies would be motivated to keep prices high to boost revenues and profits because consumers had accepted a new reality, workers would continue to demand higher wages, and inflation would enter a difficult feedback cycle. From March 28 to July 31, S&P 500 alone increased 5.3% as fresh data proved that inflation was softening, and all was not as bad as feared. This time could be different, but March was a good lesson in patience and avoiding knee-jerk investment decisions and crowd sentiment.

Japan may offer a better explanation to the sell-off.

Japan has had a decades-long policy of ultra-low interest rates. A profitable (albeit risky) trading strategy unfolded called the "Yen Carry Trade". Traders borrowed Japanese Yen at very low rates and invested that cash into US mega-cap tech companies (i.e. the Magnificent Seven) following the Artificial Intelligence phenomenon. Last week the Bank of Japan (Japan's version of the Federal Reserve) decided to raise interest rates by 0.25% which contradicts a global trend by other central banks to lower interest rates. What appears to be happening is that borrowing Japanese Yen is now more costly, eating into the profits of the Yen Carry Trade, and causing traders to sell stocks to shore up the difference.

The Japanese Yen has also been weaker recently relative to the US dollar. A weaker Yen helped Japanese companies convert overseas sales (in US Dollars for example) into more Yen, which boosts profits. The Bank of Japan hiking rates has strengthened the Japanese Yen which hurts that conversion and may hurt corporate profits in Japanese companies.

It makes sense that Bank of Japan interest rate hike and stronger yen would be a headwind to the Japanese and global stock markets, but the Nikkei Index (Japan's version of the S&P 500) sold off 12% in a single day on top of sell-offs last week! This extremely volatile activity tells me that something else is at work, and it may have more to do with the Yen Carry Trade and less to do with fundamentals that really matter in the long run, in my view.

I believe this is a "Panic-Sell", not a doomsday scenario. It may also create opportunities.

Ironically, the breakneck speed in which both stocks have tumbled and bond yields have risen, are a reason not to act, in my view. History has taught me that sudden market selloffs with little concrete explanation are less dangerous than those that unfold gradually. Pricing bad economic or corporate data into stocks and bonds usually happens slowly as the mosaic of information sinks in. Flash crashes happen because bad news or negative surprises cause speculative bets (Stay-At-Home Stocks, Meme Stocks, AI stock frenzy, Yen Carry Trade) to go awry that triggers a broader cascade, which triggers automated algorithms, which triggers stop losses, which triggers a "sell and ask questions later" situation. This isn't fun and the headlines are scary, but I also don't see a reason to act at this time. Excluding the Nasdaq Index, we haven't even hit correction territory, let alone a bear market. If the sell-off intensifies, it may create opportunities to buy, but not at this time. Fortunately, as of now, bond spreads are normal, stock bid/ask spreads aren't particularly wide, liquidity is normal, and trading is generally orderly.

Summary

I'm reading headlines that investors are declaring that The Fed should have cut rates sooner and that the US is heading for a recession. The Fed has stayed silent, and I'm glad. The Fed's job isn't to respond to every

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catastrophe du-jour or rescue the markets when investors are fussy. Investors should remember a great phrase, "Never Fight the Fed". The Fed may be cool and collected, but once the Fed makes up its mind to move, its firepower is extraordinary.

The AI trade supporting the Magnificent Seven stocks has caused euphoria and now it's causing significant pain. If you truly believe in the transformative power of AI, then a re-pricing of these stocks is a good thing. If you think the market is too concentrated in AI stocks, remember that as soon as 10 days ago, breadth in other "non-AI, non-tech" areas of the markets were materializing, and that trend too will hopefully return.

Big selloffs are part of investing, just like recent multi-month run-ups. Remember that there is *always* something to worry about in the markets, bumpy times are stressful, good times are blissful, and the best client outcomes arise from having a plan, sticking to a plan, and never making investment decisions based on emotion.

Questions and comments are welcome.

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Sources & Disclosures
[1] *US Department of Labor*
[2] *Federal Reserve, Factset*
[3] *Factset, Wall Street Journal.*
[4] *US Purchasing Manager's Index, August 1, 2024 and July 1, 2024.*
[5] *Wells Fargo Economics, ISM. August 5, 2024.*

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