



News or events that may affect your investments

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Paul Christopher, CFA

Head of Global Investment Strategy

Understanding recent market volatility

Key takeaways

- After a mostly quiet summer, equity markets, interest rates, and commodity markets recently have turned sharply lower.
- We believe that the economy's slowdown and escalating Middle East tensions lead a set of factors likely to trigger further volatility during the coming months.

What it may mean for investors

- Considering these potential disruptors in the coming months, we reiterate our current guidance to focus on quality — asset classes, world regions, and companies with strong balance sheets, cash flow, and profit margins.

After a mostly quiet summer, equity markets, interest rates, and commodity markets have turned sharply lower in recent weeks. Through August 2, the S&P 500 Index posted its first three-week decline since mid-April, the technology-oriented NASDAQ Composite Index declined by 10% from its all-time high on July 10, and the Bloomberg Commodity Price Index fell by 11.2% between May 29 and August 2.

A number of factors are swirling around markets — earnings disappointments among some tech and consumer (airlines, autos, retail) companies, sudden and dramatic shifts in the presidential election campaign, and escalating geopolitical tensions in the Middle East — and we believe these risks will persist. On the earnings front, technology companies highlighted the week of July 29 but posted mixed results and downbeat outlooks. In general, slower-than-expected growth in artificial intelligence segments contributed, but most of the disappointments centered around slowing tech sales and, in one case, layoffs and a suspended dividend.

However, in our view, the main factor that has staying power is the economy's slowdown. The economic data, in aggregate, point clearly to a broadening weakness. Investors have been watching household financial stress build for the past two years, but during that time, job growth remained above its December 2009 – December 2019 average of 180,000 new jobs per month. The July employment report, released on August 2, showed only 114,000 new jobs created, far fewer than the 175,000 gain that the Bloomberg survey of analysts expected.

Falling interest rates reflect these rising economic concerns. The two-year U.S. Treasury yield, a proxy for short-term interest rates, fell from 4.97% to 3.88% between May 29 and August 2, the sharpest decline this year. Meanwhile, 10-year Treasury yields fell from 4.61% to 3.79%, which signals increased buying. Historically, a large

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decline in the shorter-term yield signals market expectations of coming deep cuts in Federal Reserve (Fed) policy rates. The immediate implication is that investors fear that the economy may weaken rapidly and want the Fed to cut rates aggressively to maintain economic growth.

Balancing market and economic signals

We do expect the Fed to cut rates as a way to shift its attention from inflation to stimulating the economy and new hiring. Market pricing portrays a rate cut in September as close to certain, and we agree. However, we think the three rate cuts we expect between now and the end of 2025 are many, or a lot fewer than the eight now priced into the interest-rate futures market. An important reason for this difference is that our labor market outlook anticipates an economic slowdown — not a recession.

Two points about the employment data in particular and about the data in general. First, jobs and other data still are in the early stages of weakening. Initial and continuing jobless claims have been rising, but they both are well below any readings in the year before or the year after the mild 2001 recession. Likewise, permanent layoffs are well short of those recorded in that downturn.

The Sahm rule, named for economist Claudia Sahm, predicts a recession when the 3-month average unemployment rate rises 0.5 percentage points or more in a 12-month period. That level was breached in July, but we believe some caution applies. The rule has worked best ahead of recessions that created large layoffs. But there is a post-COVID way to increase unemployment that has little to do with layoffs. As people come back to the labor force, there are not jobs for all, so some will register as unemployed. As of July, the rate of workers being laid off is similar to where it was a year ago.

Second, the drivers of spending, especially income growth after inflation, give a sense of where spending is headed. Inflation typically peaks during a recession, as incomes are falling. Past recessions began, in part, because prices were rising faster than worker pay and stifling purchasing power. But this time, incomes are outpacing inflation, which peaked over two years ago. Household purchasing power is still improving, and consumers could lead the economy to pivot later this year from slowdown to acceleration, especially if falling interest rates bring more credit availability and lower mortgages.

In short, we try to approach market and economic signals with some balance. We see a labor market that is still in the early stages of weakening and still some distance away from even the most moderate, modern recession (2001). We weigh indicators already at recession levels for whether their signal means what it did in prior cycles, and we see important differences. And most importantly, we consider the drivers of incomes and inflation and see the potential for consumer spending to grow.

Investment Implications

The economy is slowing, and the data are deteriorating faster, as the long-standing tightness of Fed interest-rate policy slows the economy. But we believe rate cuts are coming and will help stimulate cheaper and more available credit that, in turn, should help the economy pivot later this year, or early in 2025, to stronger growth through 2025. But we also see other reasons to maintain our current, selective approach to portfolio allocation. As September approaches, a number of known risks — call them “known unknowns” — are developing:

1. **Liquidity risk:** Liquidity refers to the availability of cash and particularly credit. High lending rates have constrained households and businesses, but cash flow and credit have been more available to many businesses. September brings quarterly federal corporate tax deadlines, and cash will transfer to the government. The Treasury is likely to conserve cash in the coming months because a coming debt ceiling in

2025 should limit the Treasury's borrowing capacity. Lower liquidity encourages some investors to take investment profits, and this should trigger some additional market volatility.

2. **Elections:** The campaign season has brought a cluster of political shocks. The presidential race remains close, and surprises have the potential to move markets unexpectedly. The Democratic Party's convention runs August 19 – 22, which means the final two months of the campaign could bring news about the policy positions of today's presumptive nominee, Vice President Kamala Harris.
3. **Geopolitical strains:** Over the course of the past month, several Hamas and Hezbollah officials have died violent deaths. Israel has not claimed responsibility in all cases, but based on the history of the Middle East, we have high conviction that Iran and its regional proxy forces, especially Hezbollah in Lebanon, intend a coordinated retaliatory strike. As happened in April, the strike may take one or two weeks to develop, but investors should consider that significant casualties or damage from such a strike may provoke retaliation from Israel, and the risk of a broader war could affect financial and commodity markets by more than it did in April.

As we weigh market and economic signals, we see the growing prospect for strongly positive and negative surprises. We have been tracking the slowdown and these other factors all year, and we once more reiterate our guidance to favor quality in allocation decisions — in other words, a focus on asset classes, world regions, and companies that appear to us to have better balance sheets, cash flow, and profit margins. We see this approach not as defensive, but as attending to the best mix of reward and risk available in markets.

Risks Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility.

Definitions

Bloomberg Commodity Index is comprised of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity.

NASDAQ Composite Index measures the market value of all domestic and foreign common stocks, representing a wide array of more than 5,000 companies, listed on the NASDAQ Stock Market.

S&P 500 Index is a market capitalization-weighted index composed of 500 widely held common stocks that is generally considered representative of the US stock market.

An index is unmanaged and not available for direct investment.

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