SIGMA
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Q3 2024 MARKET REVIEW AND OUTLOOK

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MARKET REVIEW & OUTLOOK

In moves that somewhat mimicked the summer of 2023, the third quarter experienced a fresh bout of volatility after a strong start to the year. Global equity markets faced a turbulent summer, dropping ~8% from mid-July to early August before staging a powerful rally to recover those losses. New all-time highs were briefly reached before markets pulled back sharply at the start of September on renewed recession fears as the S&P 500 had its worst week since the regional banking scare of early 2023.

The quarter closed out with the MSCI World Index up 6.2% in Q3 and 19.3% year to date, trading at new all-time highs. Despite the spotlight shining on the state of the US economy, US equity markets continued to outperform their European counterparts with the S&P 500 up 20.81% year to date vs the Euro Stoxx 600 which is up 9.17% year to date in local currency terms.

The July sell-off was largely caused by the sudden appreciation of the Japanese Yen, on the back of a policy shift by the Bank of Japan. This led to the unwinding of popular 'carry trades', in which investors had borrowed at lower rates in Japan to fund purchases of higher-yielding assets abroad, notably the US. Simultaneously, US economic data releases for July highlighted a weakening labour market with the unemployment rate rising to 4.3%, triggering the 'Sahm rule' (identifies signals related to the start of a recession when the three-month moving average of the unemployment rate rises by 0.50% or more relative to its low during the previous 12 months), a closely watched recession indicator. This flurry of events resulted in a drastic repricing of risk assets as markets adjusted their expectations for an increased number of rate cuts by the Federal Reserve.

As is typical in corrections, sharp moves lower that are sentiment driven, quickly reverse on the realisation that it may not be as bad as initially feared. For one, the 'Sahm Rule' historically has only reliably signaled a recession when other economic indicators such as GDP growth, industrial production and retail sales have also been weak. Today, a closer look at the US economy still paints a picture of resilience. US GDP grew at an annualised rate of 3% in the second quarter as consumer spending remained solid and corporate profitability expanded. US retail sales over the summer surprised to the upside and industrial production continued to trend flattish, which isn't all too alarming given manufacturing only accounts for 11% of US GDP. Importantly, the services sector, which is the engine of the US economy, remains solid.

Admittedly, July and August data has highlighted the US labour market is potentially slightly weaker than thought. The unemployment rate has risen as shown in Chart 1, but it remains historically low, and the recent increases largely reflect strong labour supply from immigration rather than a substantial increase in layoffs as highlighted in Chart 2. However, the hiring rate, which is an indication of demand for labour, has slowed notably from its 2023 peak as shown by the light blue line in Chart 2.

CHART 1
THE UNEMPLOYMENT RATE REMAINS HISTORICALLY LOW AND AT LEVELS CONSISTENT WITH FULL EMPLOYMENT

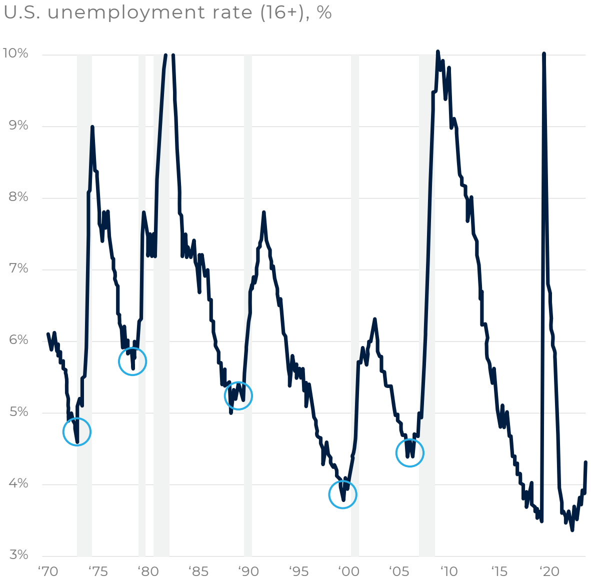
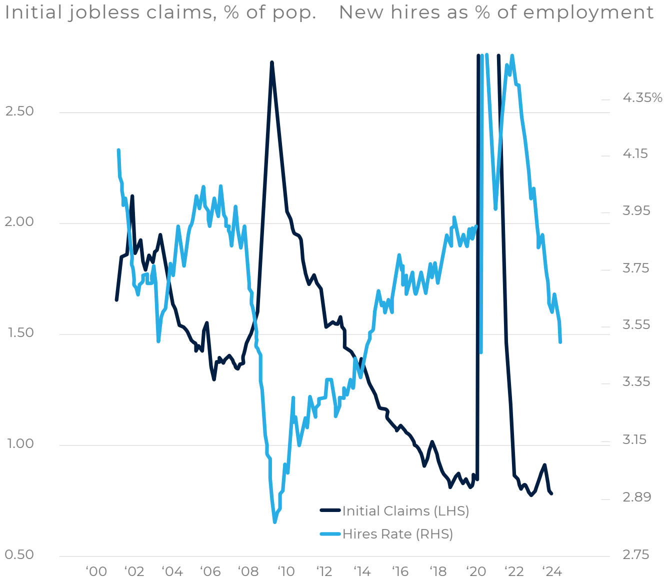


CHART 2
THE HIRING RATE IS FALLING BUT LAYOFFS REMAIN LOW



Source: Bureau of Labour Statistics, Haver Analytics, J.P. Morgan. Data as of June 30, 2024.

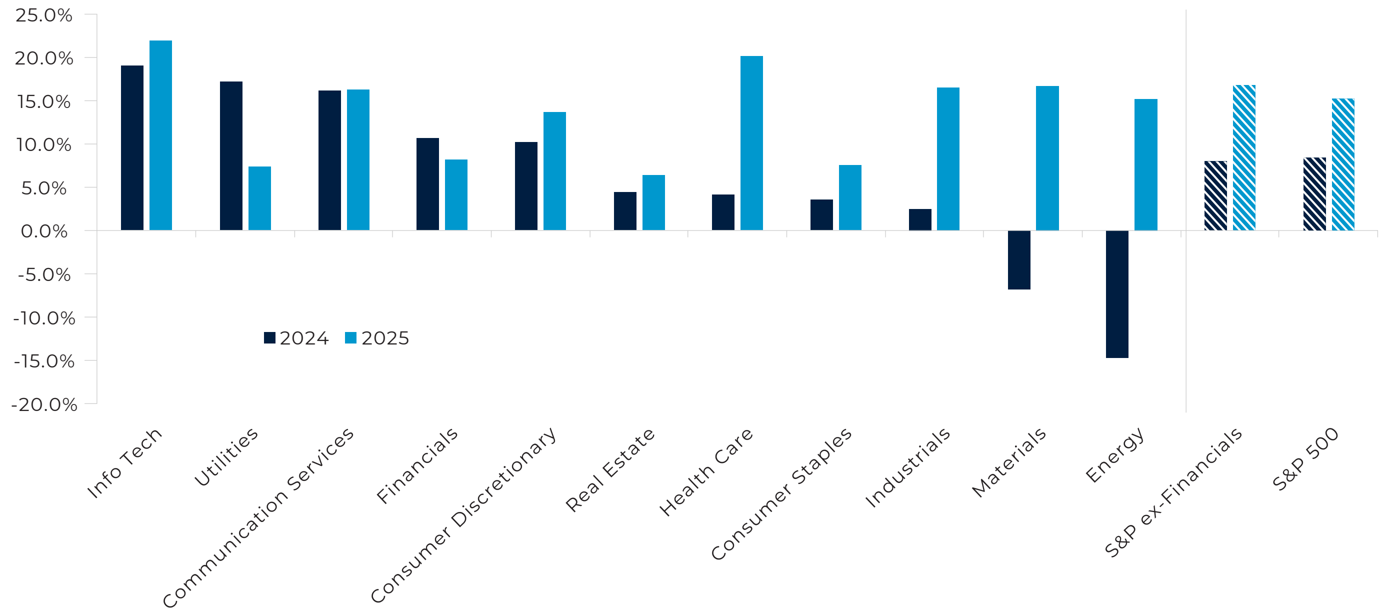
It is this cooling in the labour market that resulted in the recent shift by the Fed away from their focus on combatting inflation, which is now trending close to target levels, towards supporting economic growth and preventing an unwanted decline in employment. As a result, the Fed opted for a more aggressive 50 basis points cut to the federal funds rate at their September 18th FOMC meeting.

The highly anticipated start of the Fed cutting cycle inevitably brought plenty of Wall Street commentary with it, which can be difficult to muddle through. Some market participants feared the “supersized” cut may be a sign the Fed sees trouble ahead, noting historic times the Fed started loosening cycles with larger cuts, such as the early period of the Covid-19 pandemic and preceding the Global Financial Crisis. However, the consensus this time around is bullish, amid confidence a soft-landing is on track. Historically, cutting cycles have been positive for equities; Goldman Sachs noted that during the five cutting cycles since 1984 where the economy did not quickly enter a recession, the S&P 500 typically returned +6% during the three months, +9% during the six months, and +17% during the 12 months after the first Fed cut.

Our view is largely in line with consensus, but we believe it’s crucial to highlight that the Fed is not the dominant driver behind long-term market returns, nor does it possess any unique foresight into the economy's future. While Fed Chair Jerome Powell positioned the recent rate cut as a precautionary move rather than a response to imminent trouble, we see more value in focusing on the core fundamentals driving markets today, specifically, the continued strength in corporate earnings growth as shown in Chart 3. Businesses are emerging from an earnings recession with momentum, lending conditions are improving, and capital investment is picking up after two years of cutbacks. These factors, combined with resilient, if slightly slowing, economic growth, should be supportive for equities over the next 12 months, regardless of the Fed’s short-term policy actions.

CHART 3
EARNINGS GROWTH IS WIDESPREAD AND ACCELERATING

S&P 500 2024 EPS consensus growth, %



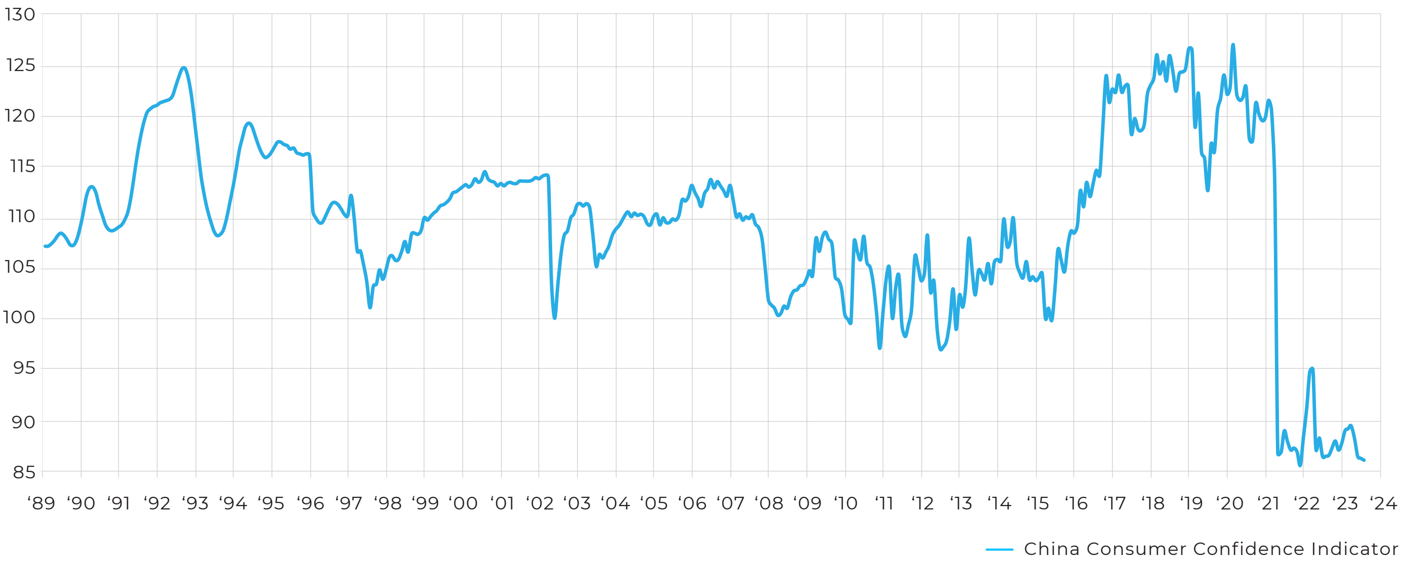
Source: Morgan Stanley. Data as of August 31, 2024.

This summer's moves highlighted the forward-looking nature of bonds markets, moving on expectations for an outlook of slowing growth and moderating inflation rather than waiting for official policy changes. The US 10-year Treasury yield peaked at 4.70% in late April, then dropped over 1% to 3.62% by mid-September, bottoming out ahead of the Fed's rate cut decision on the 18th. Ultimately, the markets move first, with declining yields fuelling a 7% rally in the Bloomberg Global Aggregate Bond Index (USD) over the quarter.

Turning our attention to the rest of the world, the summer months have been eventful to say the least. The unwind of the Japanese Yen carry trade had significant effects on the Japanese equity market with the Nikkei 225 declining over 25% in local currency terms in just under a month before rebounding circa 20% in the following weeks. However, the final trading day of the quarter saw the index down close to 5% on news Liberal Democratic Party leader Shigeru Ishiba, known for his hawkish stance on monetary policy, would be appointed as the country's next prime minister. Despite the Nikkei's volatile resurgence, it still trades roughly 10% below its July peak as the sharp appreciation in the Japanese Yen, on the back of further monetary policy tightening by the Bank of Japan, weighs on the export heavy index constituents.

Meanwhile in China, the PBoC (People's Bank of China) continues to fight its deflationary battle as the property sector downturn hampers economic growth. While there are signs the Chinese economy is stabilising and trending close to their target 5% annualised GDP growth rate, it has largely been buoyed by robust exports and masks growing discontent with the domestic economy. Economic weakness has spurred outright deflation and consumer confidence remains extremely depressed as shown in Chart 4. Until recently, officials had only made small moves to try stimulating the economy, failing to provide the confidence boost markets were seeking.

CHART 4
CHINA CONSUMER CONFIDENCE INDICATOR



Source: China NBS, Haver Analytics, J.P. Morgan. Data as of July 31, 2024.

However, weaker than expected August data spurred officials to finally announce surprise rate cuts to multiple policy rates over the last week of the quarter. Furthermore, an official readout from a meeting of China's politburo pledged they would deploy necessary fiscal stimulus to meet their annual growth target and stabilise the beleaguered property sector, sending Chinese equities soaring; with the Hang Seng closing the quarter up 20%. While it is still early days and no specifics on fiscal spending have been announced yet, it marks a clear shift in their approach and a comprehensive and targeted stimulus package is welcomed. China's economic malaise warrants close attention and further deteriorations in the Chinese economy could cause concern for spillovers to the rest of the world but for now, despite all their woes, China continues to positively contribute to global economic growth.

As for Europe, a slight divergence between the UK and mainland Europe is beginning to emerge. The quarter started with a landslide victory for the Labour Party in the UK General Election, with Keir Starmer taking office as the new Prime Minister with a large Labour majority. Turning to economic data, the recent Purchasing Managers Index data points to improving growth momentum in the UK in both the manufacturing and services sectors, whilst inflation continues to trend in the right direction, allowing the Bank of England to hold off on consecutive rate cuts at their September meeting.

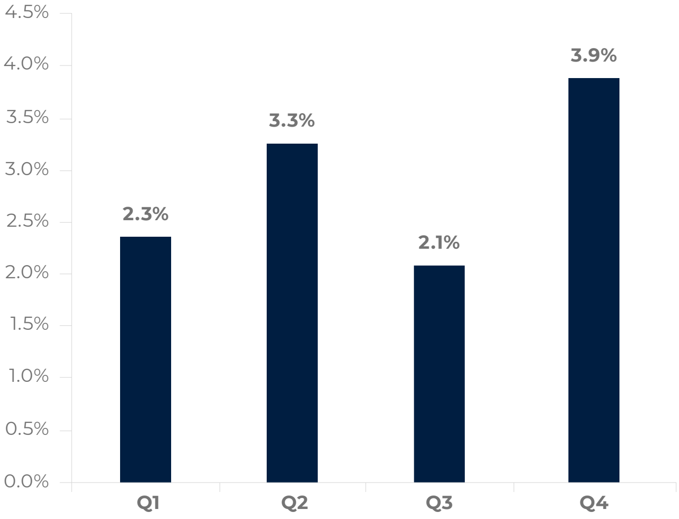
In mainland Europe, the French election resulted in a hung parliament and more uncertainty. After 11 weeks of political instability Michel Barnier was appointed Prime Minister and formed a right-ward leaning government he hopes will not fall. Ultimately, political gridlock is likely to persist in France and the bloc. Moreover, reaccelerating weakness in manufacturing and benign growth has increased expectations for an accelerated rate cutting cycle by the ECB.

Looking at the quarter ahead, upcoming Q3 earnings releases will likely be the directional driver for stocks with S&P 500 earnings growth forecasted at +4.6% in Q3. AI should continue to receive outsized attention as the secular growth theme of the moment, but we will be paying close attention to underlying demand conditions and the health of the global consumer. The US Presidential Election in November will take centre stage in the headlines and volatility is likely to increase in the lead up to it. However, a look back through history suggests elections have limited impact on markets and political gridlock tends to persist irrespective of the outcome. As the elections round to a close, markets typically welcome falling uncertainty and as a result returns tend to be highest in the fourth quarter of election years, as shown in Chart 5.

CHART 5

S&P 500 RETURNS IN ELECTION YEARS TEND TO BE HIGHEST IN THE FOURTH QUARTER

S&P 500 average quarterly price returns in election years, 1927-2024, %



Source: Bloomberg Finance L.P., J.P. Morgan. Data as of August 29, 2024

While no one can predict with certainty how markets will evolve in the short term, given the many variables at play, we remain vigilant, monitoring developments closely on behalf of our clients.

Our parting thought is this: markets are highly efficient, already pricing in widely known information and expectations, which makes them notoriously difficult to time. Historically, the triggers for bear markets are rarely the issues dominating headlines. Instead of reacting to short-term noise, it's far more prudent to ride out volatility and stay focused on the long term. More wealth is often lost by trying to avoid corrections or bear markets that never happen than by enduring the natural ups and downs of the market.

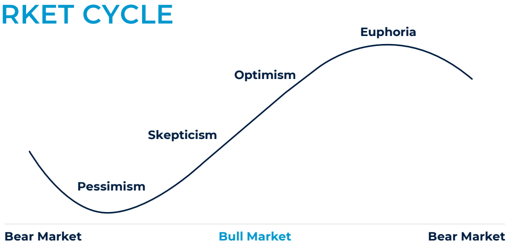
As the late Charlie Munger, former Vice Chairman of Berkshire Hathaway, once said:

"The big money is not in the buying or selling, but in the waiting."

THE SENTIMENT LIFECYCLE” – A CHECK IN ON WHERE SENTIMENT STANDS TODAY

Sir John Templeton’s wisdom that “bull markets are born on pessimism, grow on scepticism, mature on optimism, and die on euphoria,” offers a valuable framework for understanding the development of market cycles.

CHART 6
THE EVOLUTION OF SENTIMENT THROUGHOUT A MARKET CYCLE



> ***“Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria.”***
>
> *- SIr John Templeton*

In the depths of the 2022 bear market, fears of high inflation, aggressive rate hikes and geopolitical tensions sent investor sentiment to some of the lowest levels on record. Extreme pessimism peaked in the summer and depressed equity markets and valuations laid the foundations for this new bull market. As equity markets rebounded sharply in early 2023, many investors remained on the sidelines, fearful of another downturn and sceptical the recovery was real. Markets climbed the “wall of worry” higher while those on the sidelines awaited the recession that never happened.

Today we appear to be in the early stages of optimism, and this is being reflected in equity fund flows. Confidence in a soft landing seems to be much more widespread and investors are coming to terms with improving fundamentals. Good news is back to being “good” after almost two years of “good news is bad news”. Market breadth has also improved significantly, and gains are being seen beyond just the tech sector and the AI heavyweights.

The growing optimism continues to be supported by the resilience of corporate earnings and stronger than expected economic data which gives us confidence. A healthy amount of caution still exists and is well demonstrated by the frequent comparisons of companies like Nvidia to the tech bubble. But the reality is that if we truly were in a euphoric state, no one would be talking about the impending bubble bursting because everyone would be piling into equities on the fear of missing out.

A deeper look at the fundamentals further confirms the stark differences between the tech sector today and in the late 90s. We’ll stick with the example of Nvidia, the AI posterchild up over 1000% since its June 2022 bear market low and compare it with Cisco in the late 90s. Chart 7, on the left, highlights Cisco’s insane price return was driven solely by margin expansion (increase in Price/Earnings multiples as expectations for growth skyrocketed) whilst their earnings barely expanded. Naturally when the cloud lifted and earnings fell short, the stock price collapsed to levels more consistent with the company’s actual earnings potential. Nvidia on the other hand, has seen earnings growth outpace their stock market return, resulting in a contracting forward P/E ratio. Chart 8 on the right paints a very different picture to the one on the left. In other words, it’s not hype today, its earnings growth on the back of huge increases in demand for their AI chips.

CHART 7
CISCO’S SHARE PRICE IN THE LATE 90’S WAS DISCONNECTED FROM ITS EARNINGS

Price per share and earnings, indexed, 100 = 1/1/1995

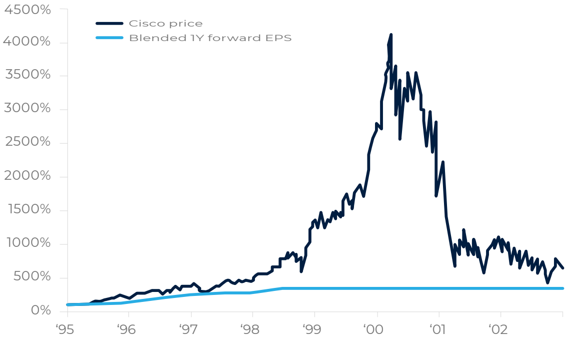
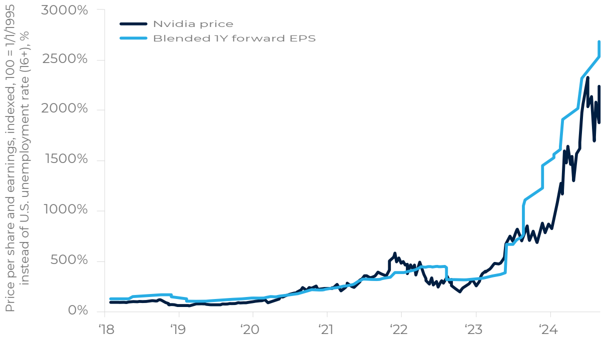


CHART 8
WHILE NVIDIA’S EARNINGS GROWTH TODAY HAS OUTPACED ITS SHARE PRICE RETURN

Price per share and earnings, indexed, 100 = 1/1/1995



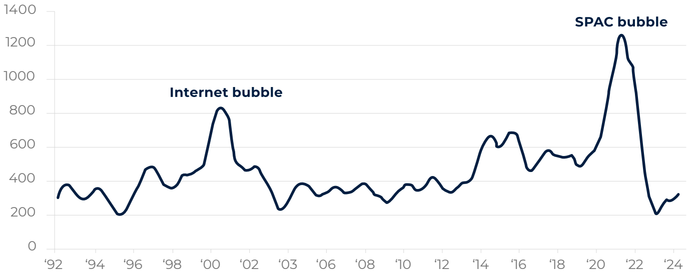
Source: Bloomberg Finance L.P., J.P. Morgan. (LHS) data January 1, 1995, to December 31, 2002. (RHS) data January 1, 2018, to S

Yet as we navigate this phase of growing optimism, we must be much more aware of signs of euphoria brewing. Some of the things we are keeping an eye out on include:

1. IPO Activity: a spike in IPO activity can be a sign of euphoria, especially if we are seeing a big increase in speculative or low-quality companies choosing to go public. So far in 2024, we have seen an uptick in IPO activity, particularly in the tech sector, as companies chose to take advantage of favourable market conditions. However, activity has remained muted as compared to previous bubbles as shown in Chart 9, and it has predominantly been by late stage, high quality companies.

CHART 9
IPO ISSUANCE HAS BEEN MUTED

Rolling 12m equity IPO issuance, Thousands USD

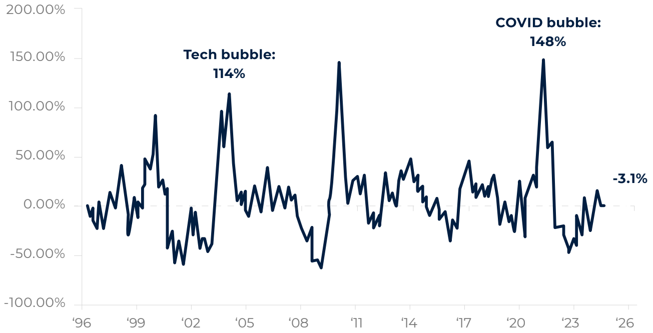


Source: Haver Analytics, J.P. Morgan. Data as of June 30, 2024.

2. Unprofitable Companies' Returns: when markets become euphoric, investors are willing to take on more risk amidst the belief they can only stand to gain. In past periods this has meant even unprofitable companies have been rewarded, a clear sign the market may be overheating. Chart 10 shows that contrary to the late 90s, today's rally has not been propped up by unprofitable companies as investors steer clear, suggesting we are still some way off from the onset of euphoria.

CHART 10
INVESTORS HAVE NOT REWARDED UNPROFITABLE COMPANIES IN THIS RALLY

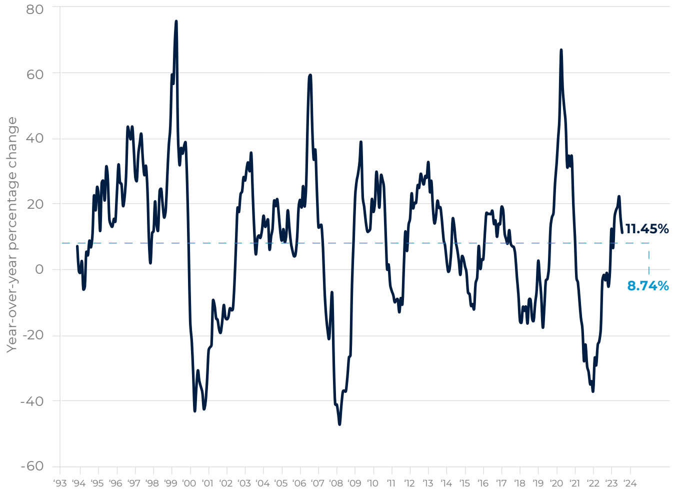
Unprofitable companies in Russell 3000, rolling 12-month total return, %



Source: FactSet, Bloomberg, J.P. Morgan. Data as of June 30, 2024.

3. Margin Debt Balances: are another indication of how much risk investors are willing to take, choosing to increase leverage as their risk appetite rises. Chart 11 indicates that while margin debt balances at brokers and dealers have increased notably since 2022 as investors have become more confident, we have not seen it spike well above long-term averages as we would expect in a full state of euphoria.

CHART 11
DEBIT BALANCES IN MARGIN ACCOUNTS AT BROKERS/DEALERS



Source: FactSet. Data as of July 31, 2024.

Currently, the various indicators we track to gauge sentiment remain in check. A combined analysis of sentiment with deep fundamental research of the macroeconomic and corporate environment gives a more rounded view of where we are in the market cycle. All three elements suggest this bull market still has some legs to run so enjoy it while it lasts. A time will eventually come to be more cautious but for now let the power of compounding work its magic.

Thank you for taking the time to read our Market Review and we look forward to updating you again next quarter.

Sigma Investment Committee

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