Market update: the Good, the Bad and the Ugly

As we head into Jackson Hole's symposium by the end of the week, what's next for stocks? Below, we look at the good, the bad and the ugly sides of the current fundamental and technical backdrop.

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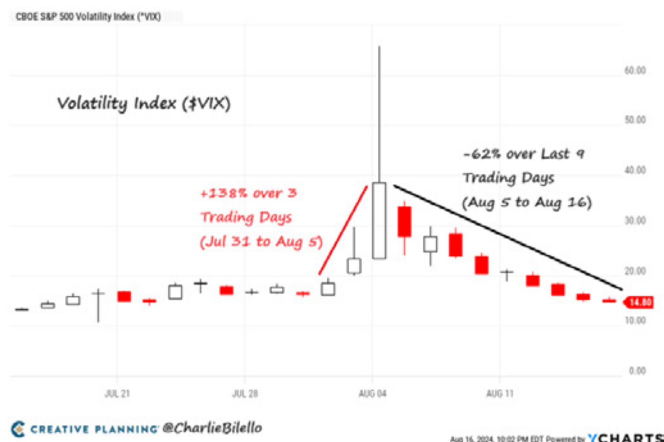
Markets over the past week continued to recover from the previous week's sharp pullback, with the S&P 500 up over 10% from the August 5 lows, and the technology-heavy Nasdaq up over 14%. The VIX is now LOWER than it was before August 1, declining 62% (from 38.57 to 14.80) over the last 9 trading days, making it the biggest volatility crash in history.



Indeed, it looks like the Yen Carry Trade – that blew up markets 2 weeks ago – is attracting Hedge Funds again. Japan's currency has weakened more than 5% against the dollar since August 5. Yen shorts have risen ~30-40% in the past week. Meanwhile, the "Mag 7" have rebounded strongly. As shown on the chart below, the $/Yen and Mega-caps tech continue to move together.

Meanwhile, the Dow Jones Industrial Average trades at the highest level in history while credit spreads are tightening again with the US junk bond yields trading at the lowest since December of last year.

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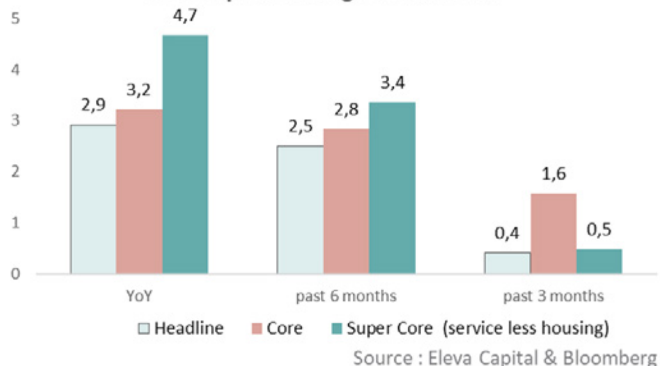
The Good

Macro factors

In the US, two macroeconomic themes seemed to have driven the positive sentiment over the past several days.

First, inflation data continues to moderate, with both consumer price index (CPI) and producer price index (PPI) inflation coming in softer than expected for the month of July. For the first time since March 2021, y-o-y headline inflation dropped below 3.0%. On a 3-month basis, the inflation trend is clearly decelerating and converging towards the Fed's 2% target.

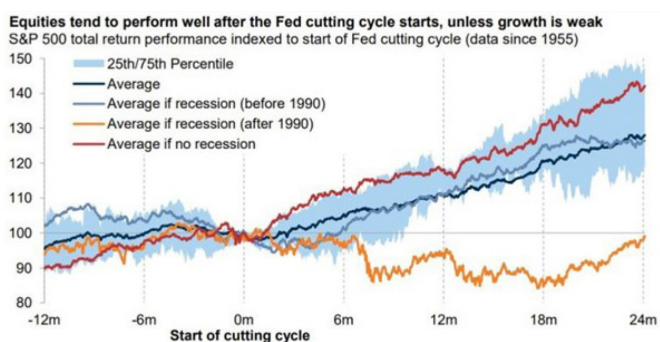


Another macro theme which is taken positively by markets is the fact that economic data continues to hold up well. Last week, both retail sales and jobless claims came in better than forecasted. Meanwhile, University of Michigan consumer expectations figure continue to improve. These measures point to a U.S. economy that may be cooling but certainly not on the precipice of a sharp downturn or recessionary environment.

Monetary policy & financial conditions

During August 5 panic, investors started to discount a massive dovish turn by the Fed, even discounting an emerging rate cut. Two weeks after, better than expected macro data and the sharp recovery of equity markets sparked a "hawkish" drop in rate-cut expectations: markets now expect less than 100 basis points rate cuts by the end of the year. Odds of a 50-bps interest rate in September has plummeted to less than 25% as a 25bps rate cut at September FOMC is now the base case.

Still, the fact that real interest rates are above 2% at the time the job market is cooling down while the disinflation trend is firmly in place is opening the door to a normalisation of monetary policy. Market returns following rate cuts have been positive except for periods when the market is generally in crisis and/or economic growth is weak.



Source: Goldman Sachs

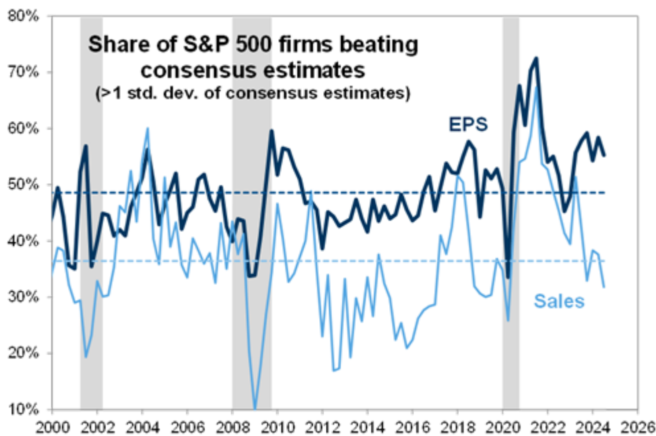
We also note that financial conditions remain quite supportive for equity markets as credit spreads continue to tighten. Indeed, credit markets rallied hard last week, alongside the drop of the VIX and effectively adjusting back from "hard landing" to "soft landing" scenarios.

Source: www.zerohedge.com, Bloomberg

Corporate earnings

The macro backdrop has distracted many investors from fully appreciating the strength of the 2Q earnings season. Earnings are largely behind us with over 90% of S&P market cap having now reported. Some key points:

1. 55% of S&P companies have beat EPS by more than 1 standard deviation (vs ~48% historic average) driven by margin beats, while 10% of companies have missed by 1 standard deviation (vs. 13% historic average).
2. Companies beating have outperformed the S&P by 244bps on T+1 (vs 101bps of historic outperformance), while companies missing have underperformed the S&P by 77bps on T+1 (vs 211bps of historic underperformance).

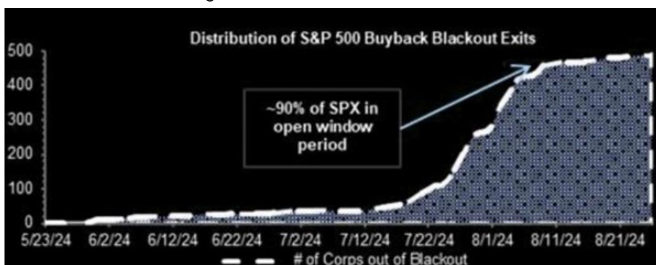


Source: Goldman Sachs

We also note that 2025e and 2026e operating EPS remain well oriented. Earnings momentum remain positive and is a tailwind for equity markets.

Share buy-backs

The majority of US companies are now OUT of their buyback blackout period with roughly 90% of the S&P 500 in open window period. Buybacks have been a major source of demand for equities during the last years and are expected to become a tailwind for stocks – especially mega-cap techs – in the coming weeks.



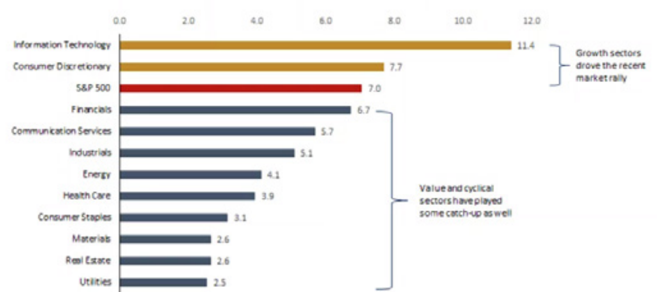
Source: Goldman Sachs

Market Dynamics

The market trend remains positive with the Nasdaq composite back above the 50 days moving average.

Source: Bespoke

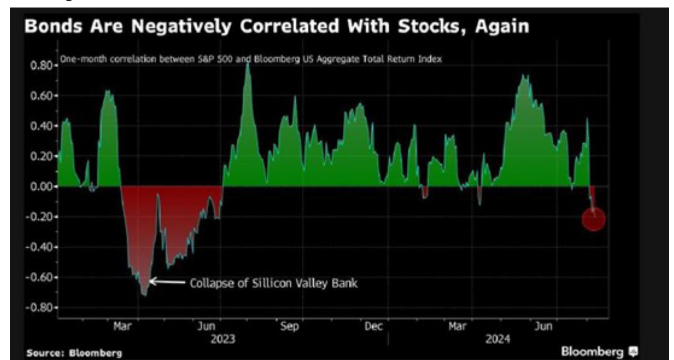
We also note that the recent market recovery has been led by a broad number of stocks. Indeed, the rally has been by the technology and growth sectors, which had also been down the most during the recent pullback. Additionally, value and cyclical sectors have also played some catch-up during the last 2 weeks as shown on the chart below.



Source: Edward Jones/FactSet

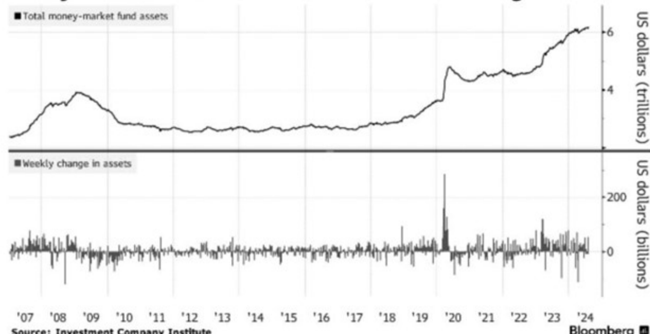
Cross-assets

A major development has been taking place recently: equities and bonds are not positively correlated anymore: this is very important from a portfolio construction perspective as it implies that adding long duration bonds to multi-assets portfolios enables to decrease the overall risk through diversification.



Source: Bloomberg

Another positive from a cross-assets perspective is the fact there is lots of cash on the sideline. Last week, Money Market funds hit all-time high of $6.19 Trillion. About $52.7 billion flowed into US money-market funds in the week through August 7, the largest weekly inflows since the period ended April 3, according to Investment Company Institute data.



Source: Bloomberg

With Fed Fund futures pricing in 150-175 basis points of rate cuts before the end of 2025, there is a chance that some of this cash will move into risk assets in the coming months.

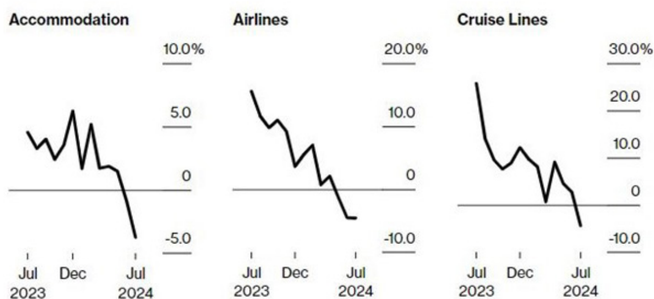
The Bad

Macro factors

While recent macro data have been downplaying the risk of hard landing, it remains difficult to assess how the current shape of the US consumer, which is roughly 80% of the US economy. While July retail sales (+2.6% y-o-y) were above expectations, there are few caveats:

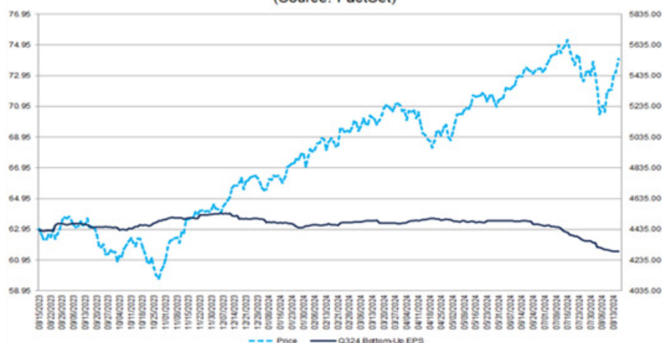
3. After adjusting for higher prices, retail sales were down 0.4% y-o-y;
4. Both the nominal and real numbers are well below the historical averages of +4.6% nominal and +2.0% real;
5. Previous numbers were revised downward.

There is also some tangible evidence that the consumer outlook is very uncertain. One example: the tourism industry. As shown below, flights, hotels and parks are all flashing travel warning signs.



Corporate earnings

As mentioned earlier, Q2 earnings season was strong. However, we note some negative revisions to Q3 numbers. The fact that Q3 EPS estimates are going down while stock prices are going up is not what we like to see.



Source: FactSet

Market Dynamics

While the trend for the main US equity indices remains positive and market breadth (i.e participation to the upside) being supportive, defensive stocks have been leading the market since the peak of the S&P 500 on July 16. For instance, higher dividend paying stocks have been outperforming stocks that pay no dividends. As shown below, there are exactly 100 stocks in the S&P that pay no dividend, and those stocks were down 5.6% on average from July 16 through last Friday's close. Conversely, the 100 stocks in the index with the highest dividend yields were up slightly over the same time frame.

Source: Bespoke

While this market rotation is a development we have been expecting, defensive leadership is not necessarily a good sign for the direction of the broad market.

Sentiment

The surge of the VIX on August 5 was a clear sign of market panic. We note, however, that the sentiment remains euphoric. As the S&P 500 was plunging earlier this month, retail investors were buying the dip. They remain aggressively invested into stocks.

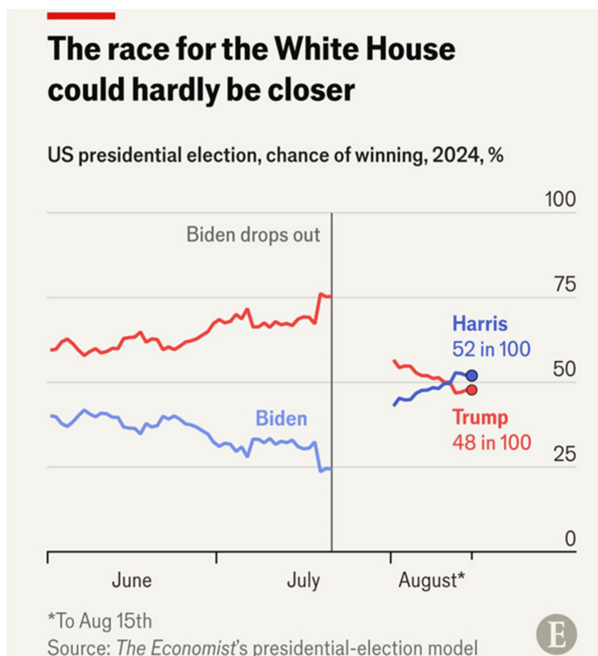
Source: Vanda Research

The risk with too positive market sentiment is that any negative macro or geopolitical development could lead to an unwinding of crowded trades at the same time, precisely what happened on August 5.

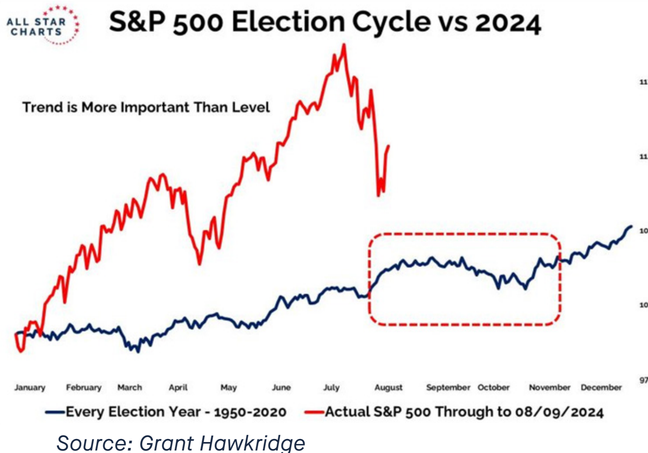
Geopolitics

The upcoming US election outcome remains highly uncertain – and markets hate uncertainty. As shown below, The Economist revised forecast shows the presidential election race between Kamala Harris and Donald Trump is, in effect, a toss-up.

Meanwhile, prediction markets are now showing a 53% chance of Kamala Harris winning the 2024 election, according to Polymarket. These markets are different than polls in that the probabilities are based on real money wagers. In 2016, polls put odds of Hillary Clinton beating Trump at 70%, with some as high as 98%. Trump's victory in 2016 ended up resulting in one of the largest polling and election forecaster failures in history. Will prediction markets prove to be more or less accurate?



History shows that markets tend to be volatile during the months ahead of the elections. On average, the 4-year cycle shows that the next few months are sideways at best.



Source: Grant Hawkridge

The Ugly

Geopolitics

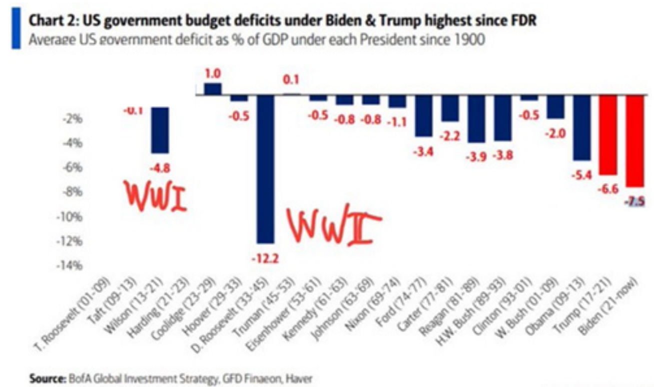
The risk of a deterioration in the Middle Eastern situation and/or a worsening Russia-Ukraine conflict remain high. The U.S. Defense Department said a week ago that it will send a guided missile submarine to the Middle East as the region braces for possible attacks on Israel by Iran and allies. Iran and Hezbollah have vowed to retaliate for the assassinations of Hamas leader Ismail Haniyeh and Hezbollah military commander Fuad Shukr. An attack could widen the Middle Eastern conflict, while tightening access to global crude supplies and boosting prices.

When it comes to Russia-Ukraine, the advance of Ukraine in Russia's Kursk region could lead to retaliation by Moscow leading to further escalation.

We note that recent market action by crude oil shows there is no geopolitical risk premium actually being priced in.

Macro factors

The resilience of the US economy despite restrictive monetary policy can be partly explained by fiscal stimulus which has been injected over the past years. This has led to ballooning budget deficits and record levels of debt. While the outcome of the US elections remains unknown, the only certainty is that both candidates will continue to keep record high budget deficits.



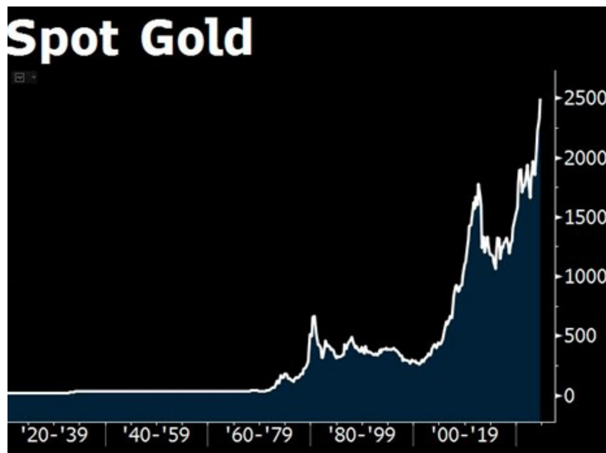
Source: BofA

The risk of a fiscal crisis leading to a surge in bond yields is quite elevated, and could lead to market dislocations similar to what we observed in the UK during the Summer of 2023.

In Europe, the risk of a fiscal crisis is elevated a swell, specifically in the second largest economy,France. Indeed, now that the Olympics are behind us, President Macron still needs to pick a new PM to lead a new government. Given the massive level of debt and the uncertain political outlook, markets will listen very carefully to the new French political agenda.

We live in a world of fiscal dominance, an economic condition that occurs when a country has a large government debt and deficit such that monetary policy targets keeping the government from bankruptcy as opposed to economic targets such as inflation, growth and employment.

The way financial markets are reflecting this new paradigm is most likely best reflected in the gold price, which just hit a new all-time-high at $2,500 an ounce. Year-to-date, Gold is up 20.7%, setting the stage for its strongest annual performance since 2020 when it gained 25.1%.



Source: Bloomberg

Final words

We believe that the market correction which took place early August was driven by technical factors rather than macro and fundamentals. The unwinding of the yen carry trade was an accident waiting to happen (see our June 2022 FOCUS note "Has Japan's central bank created a monster?"). The heavy net long positioning by CTAs, the traditional low liquidity of August and the high valuation ratios of some crowded trades (e.g. Mag 7) created the perfect "summer cocktail" for pullbacks of major global equity indices and a spectacular spike of the VIX.

As explained in our August Asset Allocation Insights, there was no reason to panic as macro and fundamental conditions remain favourable to equity markets.

Still, history shows that stock markets remain bumpy in the 4 to 6 weeks which follow a spike in the VIX. As such, we're keeping the current equity allocation unchanged (neutral vs. SAA), and adding some long duration bonds to portfolios as a diversifier. We also keep our exposure to gold and hedge funds.

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