# Are we Witnessing a Change in Market Sentiment?

**Richard Harris | July 2024**

After several brutal years of interest rate hikes to stem the COVID-induced inflation hangover afflicting economies worldwide, we can be almost certain that, with few exceptions, we are at the peak of the interest rate cycle. However, with the first signals and comments of easing by central banks, there are also signs of deteriorating macroeconomic data, leading us to question whether central banks have not taken this decision too late and question the delayed effects of the high interest rates over the last two years.

The June unemployment figures in the US spooked markets when the figure came in at 4.3% versus an expected 4.1%, triggering a sell-off in equities, while bond yields fell sharply as investors began to price in the higher potential of a US recession and more drastic action needed by the Federal Reserve to prevent this. The reason why this 0.2% increase is so significant is because it now means the Sahm Rule has been violated.

The Sahm Rule is a simple economic indicator designed to signal the onset of a recession and has proven to be a reliable early warning sign of economic downturns in the United States. It works by tracking the three-month average of the unemployment rate. When this average rises by at least half a percentage point from last year's low, the Sahm Rule indicates the onset of a recession. This has left investors questioning market commentary of a “soft landing”, something we have spoken about in earlier newsletters.

Due to the above concerns, central banks in the US, the UK and the Eurozone have illuded to further rate cuts in the near future. In contrast to this some countries, due to their own economic deterioration, are being forced to raise interest rates.

Japan is one of these countries, the Bank of Japan raised interest rates to 0.25% on 31 July in order to control the rapid depreciation of its currency. Whilst this may seem insignificant, the Japanese yen has long been seen as a funding currency for global trade as investors have borrowed in Yen at these low rates to invest in higher yielding bonds and equities around the world. This is known as the yen carry trade and estimates suggest that the size of this trade could be as high at $20Tn, with use of leverage and derivatives involved.

Panic broke out on Monday and Japan's Nikkei index plunged by up to 12% as investors scrambled to unwind the trade by selling offshore assets and repatriating the funds back to

Japan. Global markets followed suit and we saw some of the biggest falls in global indices since 2020, while the volatility index surged to COVID period highs.

Global markets have since recovered somewhat, but this development should not go unnoticed and highlights the fragility of the current system, and the potential systemic risks associated with various independent policy changes around the world.

Returning to the deteriorating macroeconomic conditions in the United States (which is being watched due to its significant role in the global economy), we are seeing signs of deterioration in employment, the housing market, consumer numbers and the ISM, all of which point to rate cuts in the near future. The UK and Europe have already started the rate-cutting cycle for similar reasons. The extent to which central banks will cut rates as global macroeconomic conditions deteriorate will be closely watched as they will be aware of the risks of a second round of inflation if too much liquidity flows into the system, as we saw in 2020.

Markets have already started pulling back based on these late cycle fears, as shown in the table below, which illustrates drawdowns of major sectors from their recent highs:

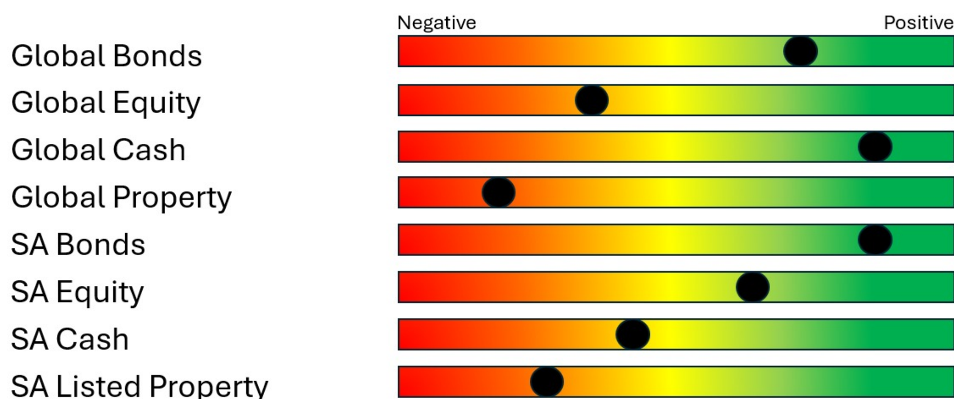
| SECTOR | Change from Recent Highs to 6 August |
|---|---|
| Technology | -14.15% |
| Energy | -11.20% |
| Consumer Discretionary | -9.95% |
| Financial | -4.86% |
| Materials | -4.44% |
| Communication Services | -4.21% |
| Industrial | -4.14% |
| Utilities | -2.49% |
| Healthcare | -1.58% |
| Real Estate | -0.87% |
| Consumer Staples | -0.85% |

Above all, capital is fleeing the “exuberant" areas of the market that have driven indices higher over the past two years: the Technology and Consumer Discretionary baskets are well below their recent highs and the energy sector is down due to fears of recession.

In addition, we have seen mega-cap companies in the technology sector sell off as many investors question how their massive investments in artificial intelligence (AI) will impact their profits when most of these AI technologies are freely available online. This has been confirmed by the recently reported earnings figures of most of “the magnificent 7” stocks that have been so in favor until now. There is no doubt that these are some of the best companies that have ever existed. However, valuations have spiraled out of control and unrealistic growth forecasts have been made for these companies over the next 5 years, leading to a market concentration not seen since the tech bubble in 2000.

We have been cautioning clients about the above scenarios for some time, as capital preservation remains paramount when markets get ahead of themselves. Especially when there are fixed income alternatives that should benefit from central banks cutting rates and yields being at current levels. Warren Buffet and his team at Berkshire Hathaway seem to be aware of this as they have recently announced that their cash holdings have grown to a whopping $277bn as they take a defensive stance to invest in equities as valuations normalise.

**The table below highlights our current Asset Class views:**




## Market Update

During July, investors holding small to mid-cap and value companies were finally rewarded: the Russell 2000 Index outperformed the Nasdaq100 Index by up to 12%. This performance was driven by the likelihood of interest rate cuts towards the end of the year and by money managers taking profits from a somewhat overvalued part of the market to position themselves in defensive companies that have been undervalued for so long. This is in stark contrast to the trading patterns of the last 18 months.

The MSCI World Index rose by almost 2% in July, while emerging markets (as measured by the MSCI EM Index) rose by around 0.5%. Chinese listed companies continue to struggle as China tries to recover from its property problems and as investors retreated due to the lack of policy response from the Chinese authorities, possibly too soon as China is likely to start stimulating the economy more aggressively as the yuan gains strength from a depreciating US dollar.

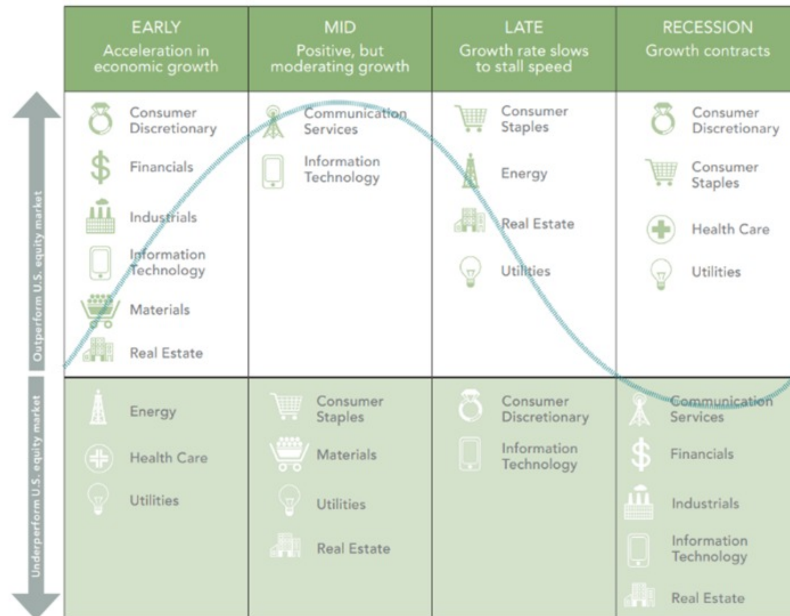
With the exception of gold and cocoa, commodity prices broadly fell in July, driven by weakening global macroeconomic conditions and a weakening Chinese economy. Brent Crude fell by 6.6%, closely followed by copper (-4.9%).

The local market, as measured by the Allshare Index, continued its post-election uptrend for obvious reasons, gaining 3.9% in July. This performance was led by construction and building materials, commodities, financials, and listed property, which rose 15.4%, 5.7%, 5.1% and 4.4% respectively. The rand treaded water, trading between R18.00 and R18.50 to the dollar, as foreign investors await further confirmation of the country's improving fundamentals before investing in South Africa. The political scene has been a little quieter in recent weeks as the parties involved in the GNU work hard to find solutions for an economy in desperate need of leadership and growth policies.

Our market outlook, both locally and abroad, remains cautious as we continue to monitor ongoing global developments and central bank commentary. We remain defensively positioned, with maximum offshore exposure and relatively high cash and defensive allocations in our portfolios. In the near term, we will seek to invest in assets that generate higher returns (alpha) and offer reasonable risk-adjusted returns at favourable entry points.

## Chart of the month

As we approach the later stages of the economic cycle, it is important to look at how certain asset classes perform in the different phases of the economic cycle so that we can effectively manage the allocation to these asset classes. The chart below illustrates this and highlights that sectors focused on consumer staples outperform sectors such as technology, property, financial services and industrials during periods of economic deterioration or recession. It is important to remain cognizant of signs of global volatility and take advantage of asset classes that are likely to outperform at different stages of the economic cycle.

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***"The skill to investing is not about reading what is in the news, it is about estimating what is priced in, and what the probabilities are with respect to future outcomes." - John Biccard***

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