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The Heartland Group at Morgan Stanley Investment Insights

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Is the Recession finally coming?

Lots of relevant economic news to report so far this month of August. But before I get into the details, we have been fielding calls from clients about the political climate and how that may affect the stock and bond market, and more specifically their portfolios. In short, I would say that typically, stock markets are not significantly impacted by whom is elected. Sometimes there are trends when an incumbent party wins or if there is a change to leadership. There can be knee jerk reactions, but the outcome has less impact than most people think, and company performance is still the best statistic to gauge stock prices. We do have research reports on market expectations based on election outcomes, feel free to reach out if you want more information.

Now on to the economic news at hand. As of writing this, the S&P 500 is at 5625, up about 1.874% mtd (month to date) and the Nasdaq is at 17754 up .883% mtd, and the S&P 500 equal weight index is up 1.425% mtd, hitting an all-time high at 7055.[1]

As noted in our last Newsletter, we were expecting increased volatility into this earnings season.[2] Investors were weighing many factors: slowing economic news, CPI reports, unemployment reports, and continued earnings announcements from companies. The S&P 500 started to drop in mid-July but by Aug 1st it accelerated to the downside. And what I believe was the cause can be explained in 2 factors. One, the unemployment data that came out on Aug 2nd. U-4 Unemployment number was up .2% for the month of July and went to 4.5% annualized. The U-6 number was up .4% monthly to 7.8% annualized total unemployed.[3] A bit more than expected. These numbers, even though still well below the healthy norm, made investors think that perhaps the FED had waited too long to ease interest rates. Which in turn increased fears of a recession. Two, the Bank of Japan raised their interest rates to the highest it has been in a long time and causing the Yen to drop vs the US dollar, which in turn caused the Asia markets plummeted.[4] This was adding skepticism to US investors psychology that the markets have rallied up so much and valuations were getting far too stretched. Many investors started to take some money off the table. And the selling persisted for four more days.

The VIX (Volatility Index) spiked to the highest we have seen since Covid, from 16.81 on Aug 1st, to 65.73 on Aug 5th.[1] Now the VIX is back down to 15.43 as of today[1]. That type of spike and recovery is typically savead for truly extreme corrections. From July 17 to Aug 5th, we had a peak to trough correction in the S&P 500 of -7.19% and the Nasdaq had a peak to trough correction from July 10th to Aug 5th which was down -13.12%.[1] We have already recovered much of that drop just in the last 16 trading days, and in my opinion the fear index (VIX) spiked exceptionally high, which to me means investors are jittery.

So here we are now, the S&P at 5625, still knocking at the door of our 5700-price target. Most of the earnings numbers are in and 79% of the companies in the S&P 500 surprised to the upside, beating their expectations, and with a 10.9% earnings growth, the highest earnings growth we have seen since Q1 2021, companies are still very

1 Dow Jones/ Reuters news and Thompson One
2 June24 Heartland Group Newsletter(morganstanley.com)
3 DOL July Unemployment data
4 MS Research Bank of Japn rate hike
5 factset.com Aug 16 earnings insight
6 CME FedWatch Tool - CME Group
7 Consumer Price Index Summary - 2024 M04 Results (bls.gov)
8 ECI Home : U.S. Bureau of Labor Statistics (bls.gov)
9 Nonfarm payroll growth revised down by 818,000, Labor Department says (cnbc.com)

profitable.[5] However, P/E ratios are still stretched at 21, which is above the 5-year average (19.4) which tells me the market is still a little expensive.[5] But considering that the FED is now about to start an easing cycle, making it cheaper for companies to borrow and expand, a higher P/E ratio seems reasonable.

In fact, the CME tracker now has a 65.5% chance of a 25 basis point cut in rates for September and a 34.5% chance of a 50 basis point cut. Furthermore, December fed Funds futures are pointing to a very high probability of 100 basis points cut or more at 75% chance.[6] What does that mean, the market is baking in a very aggressive easing cycle by the FED.

CPI inflation numbers came in on Aug 14th at up .2% for the month vs -.1% last month, and year-over-year number is at 2.9%.[7] These numbers can be a bit chunky but the trend still points to inflation being reduced to manageable levels.

So, if corporate earnings are the strongest, we have seen in nearly 4 years, and inflation is in check, employment and job growth is still robust, the FED is easing monetary policy, why is there still fears of a recession. Honestly, I don't know, I think some investors just like to be fearful. It's one thing to be cautious, but fear can cause investors to make bad mistakes, even if that mistake is inaction. Some pundits are still worried about a recession, but I don't see one on the near horizon.

Of course, something from left field could always occur, but you can't plan for Black Swan events. The only stats that we see to be cautious of, is wage growth and employment numbers. As I stated above, I think investors sold off in fear of the unemployment number coming in a too cool, perhaps a sign that the FED waited too long to cut rates. I have also heard a fear that the FED may need to tighten again. Wage growth, specifically total compensation is up 4.1% year-over-year.[8] So maybe if people are fully employed and their income is growing, inflation will show up again, and cause the FED to start hiking rates once more. I don't see that as a real possibility, and the FED has been cautious to wait as long as they did to help ensure they won't need to turn around and start hiking rates up. Pundits and worriers can't have it both ways. Its time to stop second guessing the FED and just admit they probably nailed this soft landing about as good as anyone could have thought possible.

The only other interesting stat this past month is a revision to total job creation from the Dept of Labor. The annual nonfarm payroll revision found 818,000 less jobs were created. Originally the March 2023- to March 2024 job creation was at 2.9 million, but numbers are refined and there was a huge change.[9] The economy still created over 2 million jobs. But we thought that revision stat may be of interest to readers. Of course, if there is a significant hit to job growth, that could affect the chances of a recession. But as of right now, I don't think that one-off correction stat nor the employment number is remotely in recession territory. In fact, its in a growth territory.

Where does that leave us this month? We don't think a recession is coming, and although markets have made significant gains this year, we probably have a bit more to go. However, it is unlikely we keep up the current pace. We will probably have a bit of a hard time breaking thru the 5700 mark on the S&P 500 while seeing some rotation to more defensive sectors. Especially given that these next few months can historically be difficult for bull markets. Nevertheless, I would stay fully invested. Get cash off the sidelines as money market rates and short-term investments will be paying less soon. Look for modest returns in the markets from now to year end, but probably more volatility (both up and down) until November elections are finished.

The greatest compliment one can give us is a referral to their friends and family.
As always, please call or email us with any questions or concerns about the management of your family's wealth.

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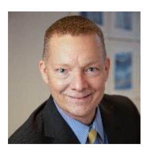

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