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The Heartland Group at Morgan Stanley Investment Insights

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Buckle Up, its Earning Season

As of writing this, the markets rolled over a bit since the middle of July. CPI numbers came out on July 11th and since then the Nasdaq peaked at 18647 and the S&P 500 peaked shortly thereafter at 5667 on 7/16.[1] All of this in the face of earnings that have come out. Which so far, of the 35% who have reported so far, 78% are still beating their expected earnings, and 60% of those are beating by a wider margin than the prior quarter.[2] In my prior newsletter I addressed where we thought the S&P 500 might go now that we broke thru the 5200-5400 range, and I said the next stop was about 5700 which would have given an additional 4-5% upside in this election year.[3] Well, we didn't quite get there, but I think we got pretty darn close enough to waive at it. And it appears there has been a rotation out of Mag 7 into small cap names and the rest of the 493 stocks in the S&P 500. You can see this by comparing the outperformance of the equal weighted index to the cap weighted we all know. S&P 500 equal weight is up 1.57% over the last month and the S&P 500 is down -0.128%. This is first time this year where on a monthly basis we have had out performance from the equal weighted index.[1] And to add-on to this thought, the Russell 2000 Small cap index is up 9.92% this month. That's a big out performance relative to the S&P 500 which is basically flat for the month. [1]

So why did this rotation start, well in my opinion its because investors are looking at the softening economic data and realizing that the Fed may cut interest rates soon. The current peak in the market was on 7/11 when the CPI number came out for June and was the softest yet, -0.1% Meaning prices went down for the month, not up. Gasoline was the biggest contributor, where gas prices are down 3.7% for the month.[4] This is the best number we have seen that Inflation is slowing, in fact this month, prices went down. So that means the fed can start to cut and remove the restrictive rates from the market.

CME tracker, which predicts the moves of the Fed, has priced a Sept 25 bps Fed cut at 89% chance, and a 88% chance that at least 2 cuts or more by December. It even shows a 57% chance of 3 cuts by December, better than a coin flip.[5]

So, if investors are now betting the fed will ease, why is the market going down? The market can be fickle sometimes. But I think it's also looking at the Unemployment numbers. For June, U-4 came in at 4.3% up again .1% since last month and the total unemployed U-6 number, stayed stable at 7.4%, same number for the last 3 months.[6] I think we are still far off from calling a recession, but I think the market may be worried the Fed is taking too long to cut, since inflation decreased this month but unemployment went up. Although I have said, these reports can be chunky and no one month can predict a trend, but that doesn't mean investors can't react or over-react to these chunky numbers. Which my guess is what is going on here, knee jerk reactions to data.

But if the Fed is going to start decreasing rates faster than what has been expected, than small caps should be a beneficiary of that, or more specifically, stocks that are not the high growth momentum names that have carried the S&P 500 all year. So that's why we are seeing some expansion of breadth in the market now.

So, what is next on the Horizon? Volatility. We haven't seen a pull back in the volatile tech heavy Nasdaq of 10% in a very long time. July 2023 with a -10.4% was the last time, and prior to that, it was Dec 2022 at -11.6%, and about every 6

1 Dow Jones/ Reuters news and Thompson One
2 Q2 earnings reports so far (factset.com)
3 June24 Heartland Group Newsletter(morganstanley.com)
4 Consumer Price Index Summary - 2024 M04 Results (bls.gov)
5 CME FedWatch Tool - CME Group
6 DOL July Unemployment data

months prior, we have had a 10% correction or more going back to the Covid pull back at -32.6% in Feb 2020. I believe this is the longest the Nasdaq has gone without a -10% or more correction since Sept 2018.[1] Additionally, we have yet to break the 10% downturn mark this month, but it got close. Suffice it to say, to see some volatility in these tech names is not surprising and may continue.

Despite expectations of the Fed soon lowering rates, and nervousness that they have taken too long to act, earnings have been strong so far. As I said up above nearly 35% of the S&P 500 reporting of those companies, 78% of them have beaten their consensus expectations.[2] So Q2 is another good quarter so far, but we need to listen for rest of year earnings guidance on conference calls. The market may be worried about a slowdown and the Fed reacting too slow to it. Our team are not necessarily in that camp, but it is a possibility.

I expect some strong swings from big names, and indices alike. So, if you don't like volatility, perhaps getting more cautious in the short run could be prudent. However, I believe momentum and growth are still intact and long-term we remain bullish on equities.

On the fixed income side, we still recommend a barbell approach, half of your fixed income allocation in higher quality and shorter term, money markets, CDs, Treasuries, and AAA CLOs. The other half in longer term maturities or debt with more credit risk., like high-yield bonds, and senior floating debt.

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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Duration, the most commonly used measure of bond risk, quantifies the effect of changes in interest rates on the price of a bond or bond portfolio. The longer the duration, the more sensitive the bond or portfolio would be to changes in interest rates. Generally, if interest rates rise, bond prices fall and vice versa. Longer-term bonds carry a longer or higher duration than shorter-term bonds; as such they, they would be affected by changing interest rates for a greater period of time if interest rates were to increase. Consequently, the price of a long-term bond would drop significantly as compared to the price of a short-term bond.

The value of fixed income securities will fluctuate and, upon a sale, may be worth more or less than their original cost or maturity value. Bonds are subject to interest rate risk, call risk, reinvestment risk,liquidity risk, and credit risk of the issuer. High yield bonds are subject to additional risks such as increased risk of default and greater volatility because of the lower credit quality of the issues.

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