Morgan Stanley

FOLLOWING THE FUNDAMENTALS

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A Quarterly Market Update from The Volrath Castle Group at Morgan Stanley

JOBS! JOBS! JOBS!

BY AARON CASTLE, *Financial Advisor & Portfolio Manager*

As the calendar turned from 2023 to 2024, we warned clients that the new year was likely to be filled with extreme news headlines being amplified by the 24/7 news cycle. We are nine months into the year and the headlines have not disappointed! Potential World War 3 stemming from conflicts in the Middle East, an immigration crisis in the US, and an ever-changing US presidential election just to name a few of the headlines. However, even with all those headlines, the stock market has been rather well behaved outside of a 2–4-week period this summer.

On July 16th, the S&P 500 hit an all-time high of 5,669 then quickly retreated 9.7%, registering a low of 5,119 on August 5th after the July BLS Employment report announced the unemployment rate in the US had risen to 4.3% the previous Friday. As jobs data stabilized and the unemployment rate retraced down to 4.2% in August, the S&P 500 rallied back to a new all-time high of 5,767 as of September 27th. (Source: ThomsonOne)

IN THIS ISSUE WE'RE COVERING

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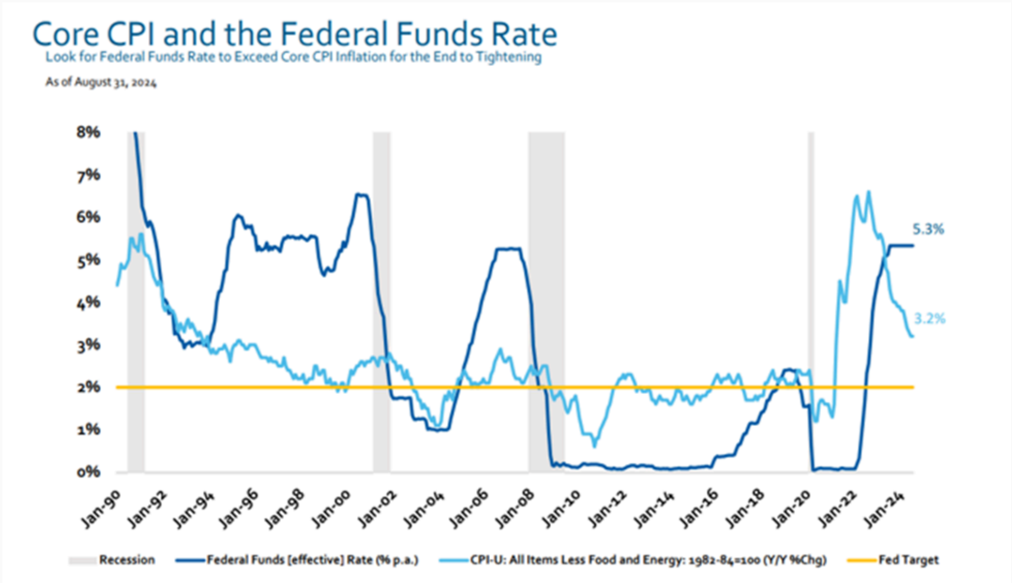
In this edition of our quarterly update, we will cover why the market was able to ignore headline risks most of the year until the jobs data started to deteriorate. We will also cover why we believe employment data readings will play an outsized role in stock market performance over the next 3-6 months.

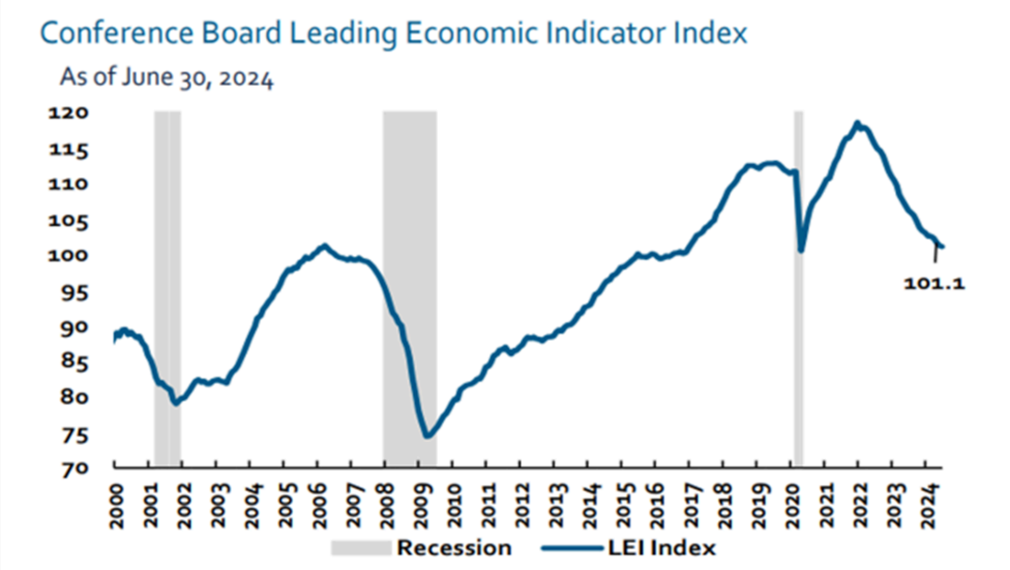
INTEREST RATES & ECONOMIC SLOW DOWNS

Over the past few years, we have continually covered the concurrent rise of inflation and interest rates in our quarterly updates. As a refresher, the Federal Reserve raised the Federal Funds Rate to the highest level in over 20 years to combat the historic rise in the Consumer Price Index. (inflation)



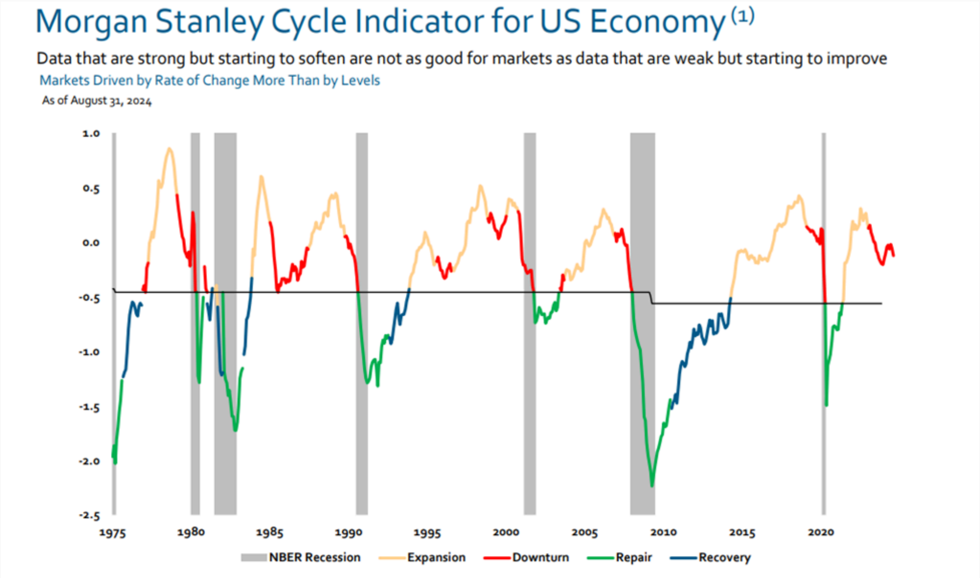
Source: Haver Analytics, Morgan Stanley Wealth Management GIO

We believe the Federal Reserve raising interest rates caused many of the economic indicators that we track to slow. As seen below, the Leading Economic Indicator Index peaked in late 2021 and has been moving downwards since the Federal Reserve started their rate hiking cycle. Historically, when this indicator has seen this level of deceleration, it has coincided with an economic recession.



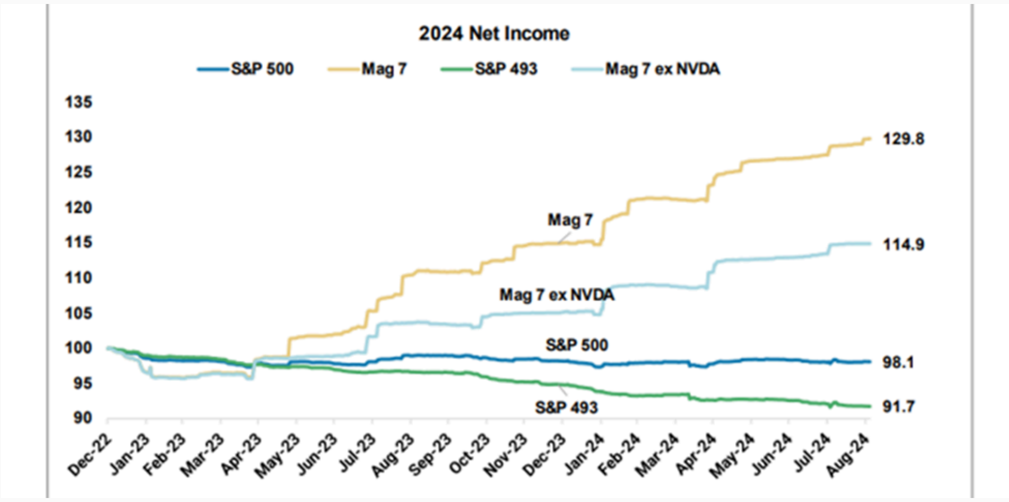
Source: Bloomberg, Morgan Stanley Wealth Management GIO. 8/31/24

In addition to the Leading Economic Indicator Index declining, the Morgan Stanley Cycle Indicator for the US Economy transitioned from a reading of “Expansion” to a reading of “Downturn” shortly after the Federal Reserve started raising interest rates. Historically, a “Downturn” reading from this indicator has coincided with a material economic slowdown or recession in the US.



Source: Morgan Stanley & Co., Bloomberg, Haver Analytics, NBER. Grey bars indicate periods of recession. (1) The Morgan Stanley US Cycle Indicator measures the deviation from historical norms for macro factors including employment, credit conditions, corporate behavior and the yield curve. The repair phase occurs due to the time lag between when these factors are beginning to improve and when they turn positive. The Morgan Stanley US Cycle Indicator was revised as of December 31, 2018, by MS & Co. Research.

As economic indicators were deteriorating, broad measures of corporate earnings in the US also struggled to grow. Outside of a few mega-cap companies that have exposure to artificial intelligence, many S&P 500 companies experienced earnings contractions from December of 2022 through August of 2024. As seen below, the “Mag 7” saw earnings growth of 29.8%, while the other 493 companies that comprise the S&P 500 Index saw earnings decline by 8.3%.



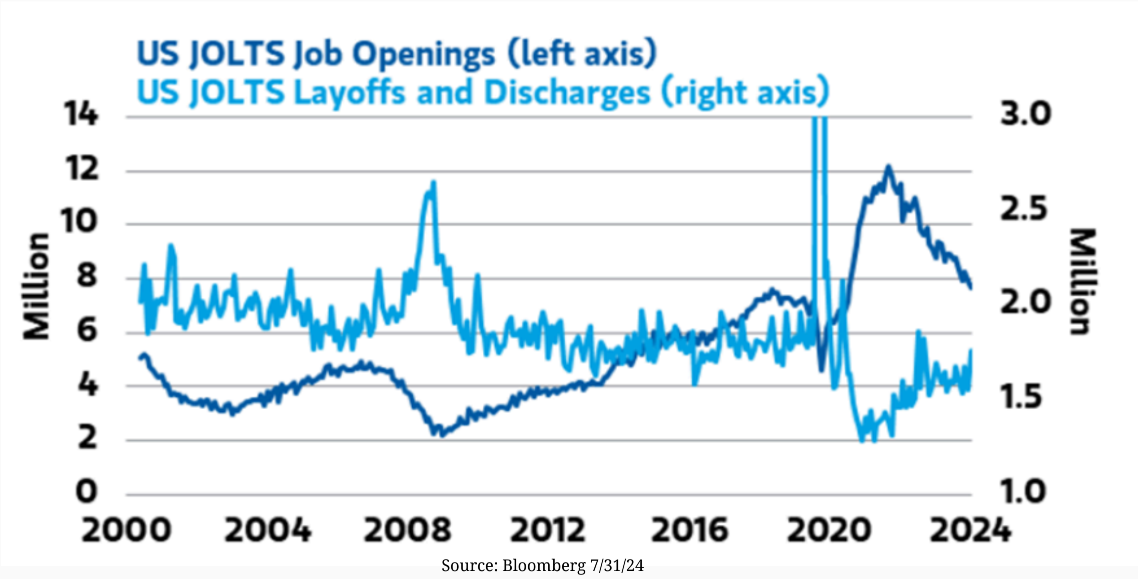
Source: Factset. Bloomberg, Morgan Stanley Research 8/31/24

JOBS! JOBS! JOBS!

Historically, when companies struggle to grow their profit levels, one of their first reactions is to slowdown or stop their plans to hire employees. Recent NFIB Small Business surveys confirm that small businesses are taking that action. As seen below, Small Business Hiring Plans have decreased significantly as economic indicators and broad earnings have deteriorated.

Source: Bloomberg, Morgan Stanley Wealth Management GIO. 8/31/24

Recent JOLTS data, or the job openings index, has also confirmed that companies are slowing their hiring plans and removing job postings for new employment. However, while companies have slowed their hiring, we have yet to see companies start laying off employees in a material fashion. The below chart shows a steady decline in job postings while layoffs have yet to see a material change the past two years.



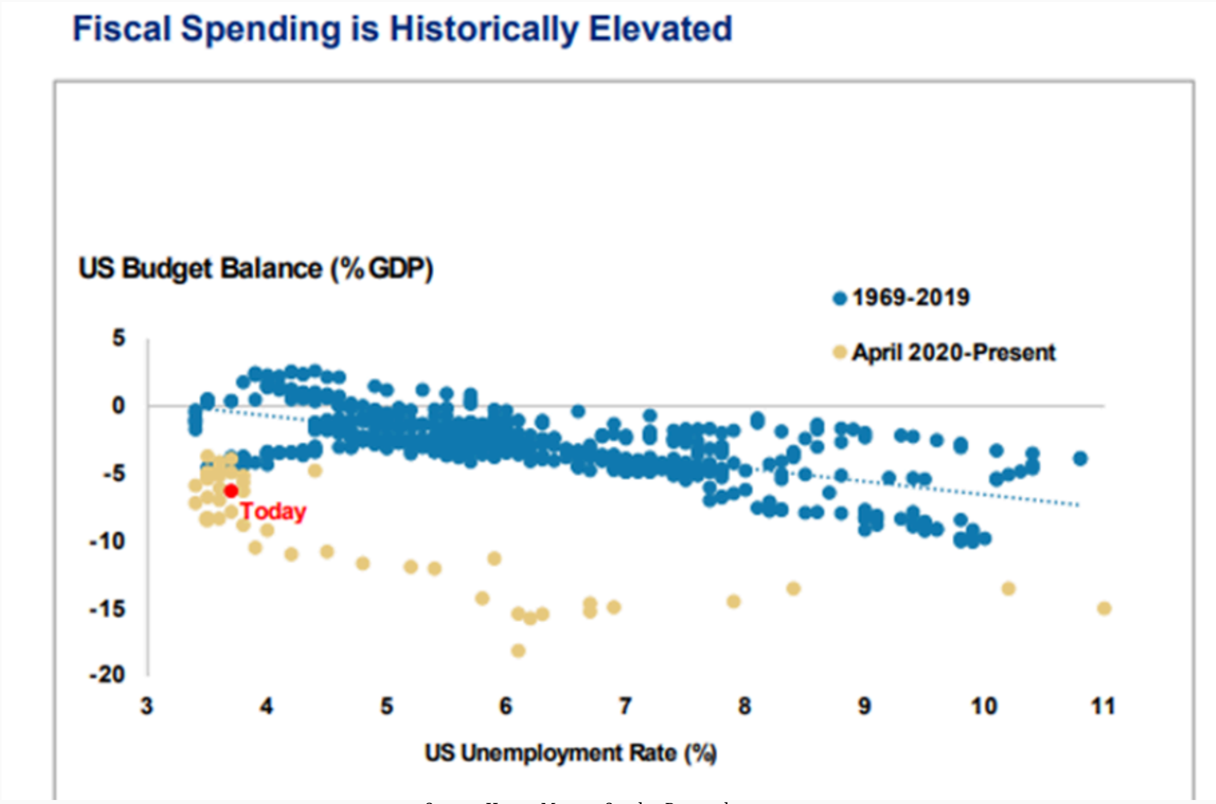
Source: Bloomberg 7/31/24

CONCLUSION

In recent updates, we expressed that our concern for an imminent economic downturn has decreased due to the high levels of deficit spending by the US Government. As seen in the chart below, the US Government has never employed such large deficits while the unemployment rate is at these levels. In our view, the large level of deficit spending is currently supporting the US Economy and until that spending dissipates, an economic recession will likely be avoided.

While our concern for an imminent downturn in the economy has lessened, we are still holding a cautious stance in the portfolios that we manage due to the narrowness of corporate profits and the decline in the leading economic and employment indicators previously discussed. Historically, after corporate profits have contracted, hiring plans are frozen, and companies eventually start reducing their work force.

In the weeks before and after the upcoming election, we expect news headlines to be just as startling as they have been the first nine months of the year. While we will be monitoring the election closely, we will also be focused on upcoming employment data and government spending levels as we believe those two factors will play a outsized role in the direction of the stock market.



Source: Haver, Morgan Stanley Research

JOIN OUR WEBINAR

Enjoy this content? We'll be hosting our quarterly webinar on Tuesday October 15th at 6:00PM CST. We won't ask you to turn your camera on, but you'll be able to see us! Your name will also be hidden for complete client confidentiality.

Email allie.girardin@morganstanley.com for the Invitation and Registration Link

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