Market analysis | August 5, 2024

At a glance

The softer U.S. labor market, with the unemployment rate at its highest since October 2021 and in the wake of no change to the Fed's interest rate target, pressured equities last week. However, earnings remain resilient, with second quarter results exceeding consensus expectations.

Number of the week

4.3%

The unemployment rate in July, up from 4.1% in June.

Term of the week

Yield – The earnings generated and realized on an investment over a period of time, including the interest earned or dividends received from holding a particular security. It's expressed as a percentage based on the invested amount, current market value or face value of the security.

The U.S. labor market is finally softening. Just 114,000 new jobs were added to payrolls in July, the second-lowest monthly increase of 2024. The unemployment rate ticked up to 4.3% as the labor force grew by more than 400,000 individuals. Slower year-over-year average hourly earnings growth, up just 3.6% from 3.9% in June, is a constructive sign on dissipating inflation. While weaker momentum can breed concern, payrolls still gained an average of 202,000 per month in 2024.

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Global economy

Quick take: The U.S labor market is softening from robust levels, though business demand for labor remains elevated. Global manufacturing activity is weakening; demand remains soft for goods relative to services.
Our view: The global economy continues to see moderating growth, especially across manufacturing activity, and global inflation continues to decelerate. Despite higher interest rates, the U.S. Bank Economic team sees conditions consistent with a soft landing in the U.S.

- **The U.S. labor market is finally softening.** Just 114,000 new jobs were added to payrolls in July, the second-lowest monthly increase of 2024. The unemployment rate ticked up to 4.3% as the labor force grew by more than 400,000 individuals. Slower year-over-year average hourly earnings growth, up just 3.6% from 3.9% in June, is a constructive sign on dissipating inflation. While weaker momentum can breed concern, payrolls still gained an average of 202,000 per month in 2024. Meanwhile, businesses continue to seek labor; job openings remained above 8 million in June, though off the 2022 peak of more than 12 million, while the household surveys estimate just over 6 million unemployed individuals.
- **The Institute of Supply Management Manufacturing Purchasing Manager Index (PMI) hit an eight-month low in July, falling 1.7 points to 46.8.** Readings below 50 are indicative of contracting manufacturing activity. Deeper reductions in employment, production and new orders hurt the index, which has been below 50 for 20 of the past 21 months.
- **Global manufacturing surveys from S&P Global indicate a growth setback in July.** The Eurozone PMI indicated contraction for the 16th month in a row. After three months indicating expansion, Japan's PMI slipped back into contraction. Additionally, data for China indicated a slower rate of growth. New orders remain a challenge across the countries. However, India's manufacturing activity remains robust, with the survey indicating strong activity with buoyant demand translating into cost inflation.
- **Central banks remain focal points for global markets.** The Bank of England last week enacted its first interest rate cut of this cycle in a narrow 5-4 vote. In trimming the target rate by 0.25% to 5%, Governor Andrew Bailey said restrictive policy could be dialed back a bit; further decisions will be made meeting by meeting. In contrast, the Bank of Japan hiked its target interest rate to 0.25%, with Governor Kazuo Ueda noting they have some distance to reach their neutral rate. The BoJ also plans to cut its monthly asset purchases in half by early 2026 as it starts to wind down the era of easy monetary policy as inflation exceeds the 2% target.

Equity markets

Quick take: U.S. equities ended last week in retreat following downbeat economic data. While inflation, interest rates and earnings are consistent with higher equity prices, seasonal volatility, indications of accelerating economic weakness and technical price-trend deterioration are among near-term headwinds.
Our view: The fundamental backdrop remains favorable for U.S. equities. Inflation is falling, interest rate cuts are looming, earnings are trending higher and performance breadth is constructive. Near-term, valuations remain elevated.

- **Year-to-date returns are positive, but August performance reflects angst.** The S&P 500 is up year-to-date 12.1%, as of Friday's close, with 10 of 11 sectors in positive territory, six of which are up 10% or more, supportive of a risk-on (more aggressive) bias. Conversely, the popular broad base indices are off between 2.7% and 6.4% in the first two days of August, with only four sectors posting gains.
- **Seasonality and technical price trends suggest near-term downside bias.** Historically, August and September are among the two worst-performing months of the year, following July as the best-performing month, according to FactSet.
- **Second quarter corporate results are trending above expectations, providing valuation support.** As of Friday's close, 75% of S&P 500 companies have provided results; sales are up 5.0% and earnings gained 11%, exceeding pre-quarter consensus expectations of 4.4% and 8.6%, respectively. Eight of 11 sectors are posting positive year-over-year earnings growth, supportive of a longer-term risk-on bias.
- **Key takeaways from second quarter releases reflect solid consumer and business spending amid weakening trends.** Consumer spending is resilient but with signs of slowing, particularly among lower-income groups. Industrial demand remains weak and business technology spending remains robust, particularly around artificial intelligence-related products, with competition becoming more pronounced.
- **Consensus earnings projections for 2024 and 2025 remain largely unchanged.** Analysts forecast earnings of roughly $242 per share for 2024 and $277 in 2025, according to Bloomberg, FactSet and S&P Cap IQ, reflecting respective robust 10% and 14% year-over-year growth. At present, the S&P 500 trades at 22.1 times the 2024 estimate and 19.2 times 2025 projections, at the high side of fair.

Bond markets

Quick take: The rapid decline in Treasury yields in response to disappointing employment data propelled strong gains across most segments of the bond market last week. High yield corporate bonds were an exception, posting mild losses as investors shied away from riskier assets.

Our view: Fixed income portfolios primarily allocated to high-quality bonds generate stable income while supplementary exposures to riskier high yield bonds and esoteric bond categories like non-agency mortgages and reinsurance can bolster long-run return potential.

- **The Federal Reserve (Fed) set the stage for a September interest rate cut at its meeting last Wednesday.** The Fed edited its statement to recognize a better balance between its price stability and full employment goals. In the post-meeting press conference, Fed Chairman Jerome Powell repeatedly emphasized balancing the inflation and employment mandates as justification for holding rates steady right now and as the primary consideration for determining rate policy going forward. This marked a clear shift to a more balanced tone than recent communication, which has emphasized problematic inflation. Slowing job growth in Friday's employment data provided additional evidence in favor of reducing interest rates. By Friday, bond yields reflected 80% odds the Fed delivers a 0.50% rate cut in September and 1.00%-1.25% in total rate cuts before year-end. Odds are even higher as of Monday morning. This material shift from the week prior, when markets priced 0.50%-0.75% in cuts by year-end, caused a dramatic decline in the 10-year Treasury yield of around 0.50%. Long-term Treasury bonds, which are most sensitive to interest rates, performed best. The aggressive repricing of Fed policy in interest rates highlights the importance of managing yield sensitivity in bond portfolios.
- **Riskier bond prices held up well compared to volatile swings in stock prices last week.** High yield corporate bond prices typically move in similar fashion to stocks, with swings in investor sentiment driving price changes in both investments. High yield corporate bonds lagged high-quality bonds last week, but prices only dropped a small amount. The resilience of high yield bond prices relative to stocks suggests investors retain a glass half-full outlook for riskier companies' ability to service their debts. We favor normal allocations to high yield bonds, recognizing the risk of slowing growth weighing on bond prices, but the extra income can improve return potential over time.

Real assets

Quick take: Interest rate-sensitive real assets continued their recent outperformance last week while growth fears continued to weigh on commodity prices. Real Estate and Infrastructure, particularly Utilities, outperformed the broader market handily. Commodity markets were the laggards, led lower by energy. Only the precious metals market posted positive results across all commodities

Our view: Diversified publicly traded real estate trusts remain inexpensive relative to private real estate. Tangible assets with stable cash flows present relative value opportunities as recession fears increase. Weaker growth expectations are pressuring commodities.

- **Real Estate outperformed the S&P 500 by 4.5% last week**. Cell towers and data centers posted the strongest returns while office and industrial companies fared the worst. Public real estate continues to trade at a discount to private markets (individual properties).
- **Infrastructure stocks outperformed the broader market by 4.6% last week.** Utilities and toll roads led gains while airports and midstream energy were the worst performers. Utilities are outperforming the S&P 500 by more than 6% year-to-date and the sector is 2024's second-best in the S&P 500 (19.2%), trailing only Communication Services (20.3%).
- **Crude oil prices fell 4.6% last week,** with increasing concerns about growth outweighing heightened geopolitical risk. Over a longer-term horizon, the crude market appears undersupplied, which should act as a tailwind to prices. Renewed fears of a global recession are driving prices lower for most industrial commodities.