

**A Shot Across the Bow – Market Commentary**

South Africa outperformed in July as SA Inc shares continued to benefit from improved sentiment. The ALSI returned +4.3% in USD terms, outperforming Emerging Markets (“EM”) and the MSCI World which covers Developed Markets.

EMs were poor at +0.3%, underperforming the MSCI World which was at +1.8%. The US underperformed the MSCI World with Tech negative, driving the Nasdaq and the S&P 500 lower. The Nasdaq itself was negative at -1.6%, while the S&P was positive but with a more subdued +1.2%.

With Tech under pressure, Value outperformed strongly at +4.8%.

The market movements were somewhat unusual in a month when inflation measured by US CPI fell below 3% p.a. for the first time in more than 3 years. Both nominal and real yields declined, maintaining 10-year breakeven inflation at 2.2%. Yields should have been supportive of stocks in general (they were) and Growth stocks in particular (they weren’t).

The various market returns are summarised in Table 1 below.

**Table 1. South African and global equity returns (USD) for July 2024\***

	Jul-24	YTD 2024
FTSE/JSE ALSI (ZAR)	3.9%	9.9%
FTSE/JSE ALSI (USD)	4.3%	10.5%
MSCI World	1.8%	13.7%
MSCI EM	0.3%	7.8%
MSCI Value	4.8%	11.3%
MSCI Growth	-1.0%	16.1%
S&P 500	1.2%	16.4%
Nasdaq 100	-1.6%	15.6%

\*Total return indices, Source: Factset

Early August’s volatility has come and gone, and the narrative and the market have supposedly settled back into their pre-volatility mode. We are told it was a “scare”. We note that

1. prior to the episode, expectations appeared to have shifted in favour of a soft landing
2. once the volatility began the narrative quickly shifted to the dangers of recession, while the markets spoke for themselves in real time
3. now that this particular episode has passed, the narrative has reversed to “no recession” and “all clear”

We are not so sure about any of this. An obvious first conclusion from the above points is that media coverage and commentary moves with the market and is no guide to portfolio positioning – one should follow one’s own thinking on investment strategy.

### **Why is the debate important?**

The issue of recession is not without importance. Should a recession materialise this could lead to a de-rating of the S&P 500 from the current 25x to 15x, or a price decline of -40% from current levels. As importantly, recovery afterwards could take the better part of 2 to 3 years.

### **What's it going to be?**

The problem is that there are prominent voices in the market arguing multiple sides. An argument in favour of no recession and subdued inflation (and declining Treasury yields) appears to be that the policy rate has not exceeded the nominal growth rate, therefore monetary policy has not been restrictive. Another argument in favour of a forthcoming recession focusses on labour market developments, therefore declining growth, inflation and Treasury yields. Yet a third (equally credible) position suggests no recession plus resurgent inflation, therefore expect Treasury yields to rise.

An additional twist in the tale of macro uncertainty could yet arrive via the US election itself, with one candidate intending to raise corporate taxes, sure to be negative for prices, and the other looking to do the opposite, therefore sure to be good for prices.

Our own view is that we would not be surprised to see economic and market turbulence and likely soon. This is based on a variety of indicators e.g. composite leading indicators and the ongoing yield curve inversion (which, incidentally, we expect to reverse before any trouble starts i.e. the Fed rate will decline first), etc.

As a matter of investment philosophy however we do not employ macro views in our portfolio strategy. The current debates and uncertainties are a good example of why this is so. Macro views are seldom consistently correct even when formulated by prominent professionals. In taking a macro position, one side will inevitably be correct over a given period of time and the others will likely pay a price in performance terms. We have instead positioned the M1 Capital Global Equity Prescient Fund on the assumption that we do not know what the macro outcome will be.

### **What is the Fed's record on soft landings?**

The established track record of the Fed in managing soft landings is not good, with no successes to report this century. Out of 11 episodes of monetary tightening since 1965, the tightening by Alan Greenspan in 1994-95 is the only one acknowledged to have been successful in achieving a soft landing. The criteria for soft landings can be relaxed however, and the objectives of monetary policy can be examined on a per case basis, to make a case for a greater success rate<sup>1</sup>.

### **The market decline originated in July**

As for early August's episode we suggest that this had its origins in July and August was a culmination rather than the event itself. The episode also ultimately originated in Japan.

We do not delve into the details of the carry trade or that its unwinding caused the Japanese market to decline sharply – this has been covered extensively in the media. What we do point to is that the Japanese stock market began to decline, and the USDJPY rate began to strengthen in early July, possibly in anticipation of the second rate hike on 31 July by the Bank of Japan. The latter, incidentally, appears to have a good track record of hiking into a recession, and perhaps that is also an indicator to watch.

We set out the movement of the Topix and the policy rate in Chart 1, and the USDJPY rate in Chart 2 below.

**Chart 1. Topix and the Japan policy rate**



Source: Factset

**Chart 2. The USDJPY rate**



Source: Factset

The US market itself appeared to have been hit by a double whammy – Japan on the one hand, and unfavourable US labour market data coming out in early August, on the other.

As an additional comment it also now appears that labour data has been revised downwards, suggesting greater than expected labour market weakness.

### Did Value protect you?

Chart 3 below presents the relative movements of the MSCI Large Cap Value and Growth Indices for the year to date.

Per Chart 3 below, both Value and Growth declined sharply in early August. Value however declined relatively less during this short episode. The decline in Growth also began earlier in July. This is no doubt due to the movement of the large Tech shares.

Tech remains the high risk high reward segment in the US market – if there is no recession Tech shares can be expected to continue to outperform. If there is a recession however, they are likely to experience the sharpest declines. Perhaps not unlike the Resources sector in South Africa in terms of market beta.

### Chart 3. Year-to-date relative movements of the MSCI World Large Cap Value and Growth Indices



Source: Factset

### Summary

We suspect the market declines in early August were a warning of further developments rather than an isolated incident. We would not be surprised to see more sustained volatility in the months to come, likely after the first US interest rate cut(s). We suggest caution.

### References

1. "Landings, Soft and Hard: The Federal Reserve, 1965-2022", Blinder, A., Journal of Economic Perspectives, vol. 37, no. 1, Winter 2023, (pp. 101-20)