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MARKET SIGHT LINES

Reprise: Get Ready for Market Volatility, In One Direction or the Other

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Positive forces have been driving equity markets higher in 2024, including optimism around artificial intelligence (AI), better-than-expected economic results in the first half of the year, positive earnings growth in the second quarter, and the prospects of a Federal Reserve (Fed) rate cut. Recently we've seen an increase in market volatility, triggered by elevated valuations, election uncertainty, a slowdown in manufacturing, a weaker jobs market, geopolitical unrest, an increased focus on when AI capital spending will translate to AI earnings, and worries about Fed policy error. In this Sight|Lines, we revisit the topics of increasing market volatility and the prospect of a breakout market, in one direction or the other.

THE TAKEAWAY: THE MANY MARKET FORCES AT WORK LEAN NEGATIVE

Many market forces at work may mean increased volatility, once again setting up the potential for a breakout market, positive or negative. Recently, market forces seem to lean negative. In summary:

- AI optimism has driven markets higher, but the focus is turning to how AI capital spending will translate to earnings.
- In the first half of 2024, the economy grew at a brisk pace that was better than expected, but we're seeing evidence of a slowdown, especially in the manufacturing sector.
- A recently strong labor market has fueled consumer spending, but we're seeing evidence of a weakening jobs market.
- Geopolitical unrest can fuel investor nerves and dampen animal spirits, but hotspots can turn more negative … or positive, influencing animal spirits further.
- On average, market volatility increases as we head into an election, and a decisive victory, in one direction or the other, may lead to calmer markets.
- Fed officials have signaled the start of rate cuts in September, but investors worry about Fed policy error … too early, and inflation can heat up…too late, then possibly a recession.
- Positive earnings growth has been supportive of elevated market valuations, but valuations may be stretched in the face of a slowdown.

IN-DEPTH: THERE ARE MANY MARKET FORCES AT WORK CURRENTLY, BOTH POSITVE AND NEGATIVE. IN THE BALANCE, THEY APPEAR TO LEAN MORE NEGATIVE

The many market forces at work may well lead to increased volatility for the balance of the year and into 2025, setting up for a possible breakout market that can be positive or negative. Recently, these forces appear to lean more negative. Going deeper:

- AI optimism drove markets higher, but investors are questioning when investment will translate to earnings:
  - The Bloomberg Magnificent Seven Index is up 31% year to date.
  - As mentioned in our last Sight|Lines, four of these stocks – Alphabet, Amazon, Meta Platforms, and Microsoft – deployed about $58.5 billion in capital expenditures in the second quarter, much toward data centers and artificial intelligence, increasing focus on when earnings will benefit.
- Economic growth in the first half of 2024 was better than expected, but we're seeing evidence of a slowdown:
  - Annualized U.S. GDP was 1.4% in the first quarter and 3% in the second quarter, but consensus estimates are for 1.7% and 1.4% in the third and fourth quarters, respectively.
  - S&P Global and the Institute for Supply Management Purchasing Managers' Index (PMI) manufacturing levels were 47.9 and 47.2, respectively, signaling contraction in manufacturing.
- A recently strong labor market has fueled consumer spending, but the jobs market is softening:
  - The Job Openings and Labor Turnover Survey (JOLTS) report shows the number of job openings falling to 7.7 million in July, the lowest level since January 2021 and below the market forecast of 8.1 million.
  - The ratio of number of people looking for work compared to job openings fell to 1.07.
  - Note, however, that the unemployment rate fell modestly to 4.2% in August.
- Geopolitical unrest and local wars can fuel investor nerves and dampen animal spirits:
  - Both the Russia-Ukraine and the Israel-Hamas wars have investors worried about escalation.
  - That said, the prospect of eventual peace, most likely through negotiations, would provide relief.
- Market volatility increases as we head into an election, on average, and a clear outcome can calm markets:
  - In October and November, the VIX Index has run about 20% higher in presidential election years compared to years without a presidential election, on average.
  - Investors may experience relief If we avoid a contested presidential election.
- Fed officials have signaled the start of rate cuts in September:
  - Fed funds futures are signaling a 0.25% cut this month, with a 43% probability of a 0.5% cut.
  - Investors still worry about Fed policy error, with the possibility of continued inflation or a recession.
- Positive earnings growth has been supportive of elevated market valuations:
  - Earnings are forecasted to grow 10.8% this year and 15.3% next year.
  - The cap-weighted S&P 500 price-earnings ratio (P/E) sits 25.1, 18% higher than the 10-year average P/E ratio 21.2
  - Notably, the equal-weighted S&P 500 P/E ratio sits at 20.2, in line with its 10-year average.

CONCLUSION

Positive forces have been driving equity markets higher in 2024, but negative forces appear to be at work as well. As we do from time to time, it is helpful to anticipate the strong possibility of increasing market volatility and the prospect of a breakout market, in one direction or the other.

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