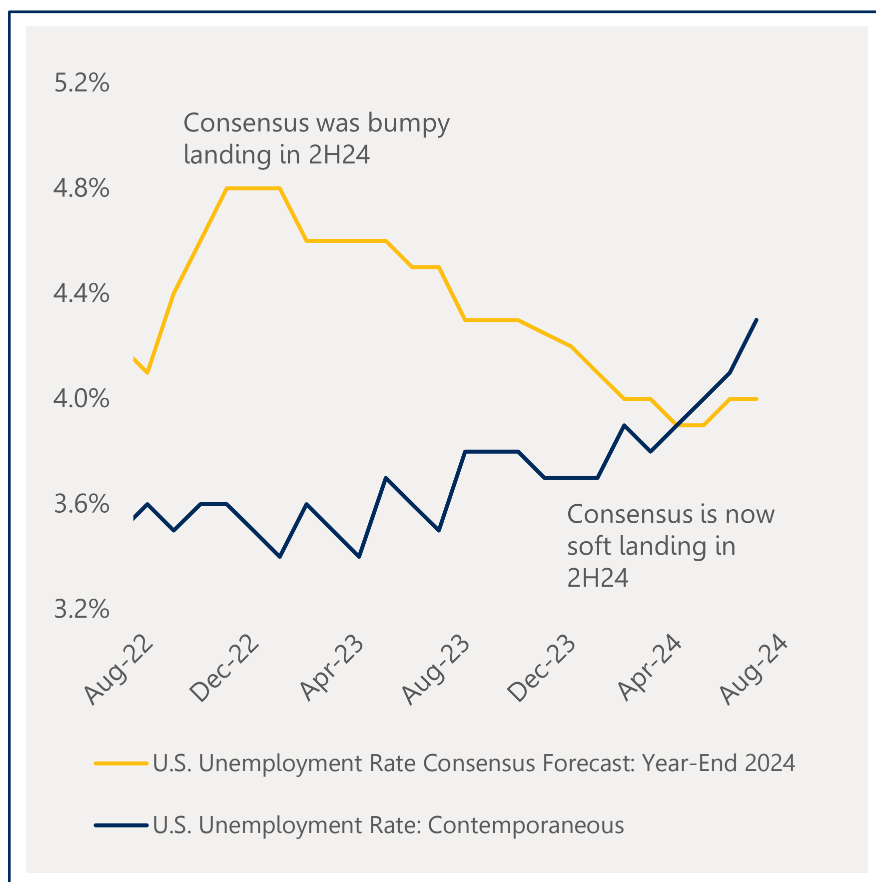
SMB Trust Services

August 2024

Market Review

Softening Labor Market

Unemployment Rate vs. Consensus for Year-end 2024



Source: Bloomberg. Past Performance does not guarantee future results.

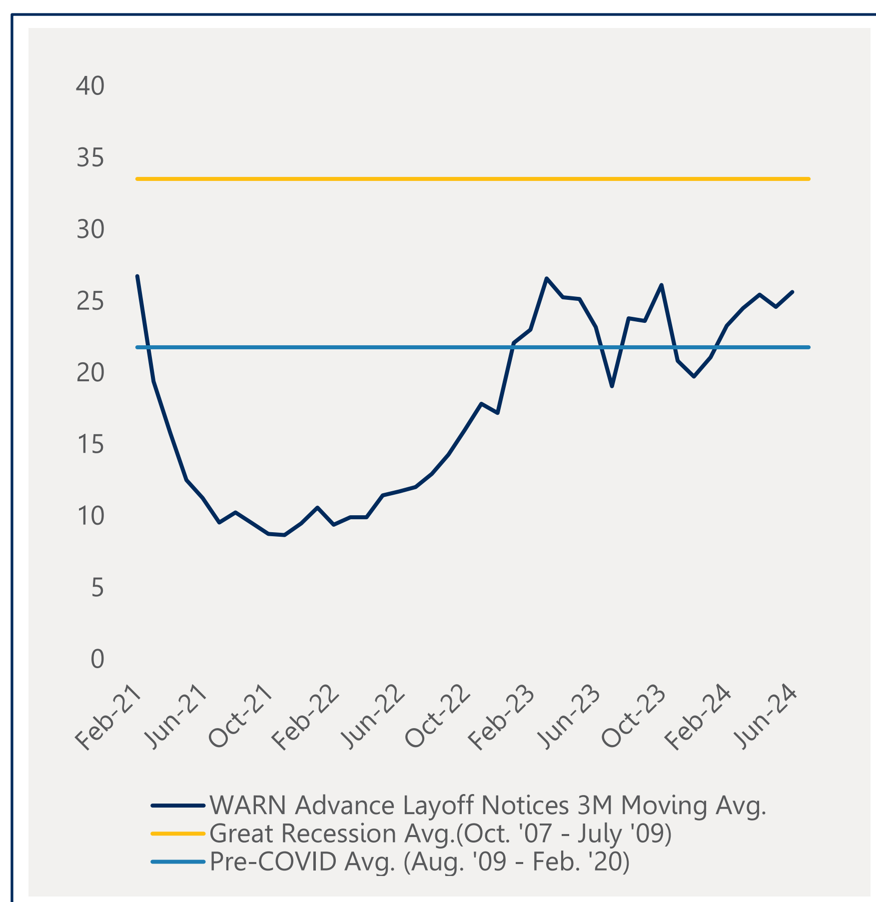
U.S. nonfarm payrolls increased by 114,000 in July, well below expectations of a 175,000 gain. The disappointing reading was in stark contrast with the majority of monthly payrolls figures this year that exceeded expectations. While jobs growth was disappointing, the market was particularly spooked by the increase in the unemployment rate from 4.1% to 4.3%.

The current 4.3% unemployment rate is now noticeably above the year-end forecast of 4%. This is contrary to how the market was pricing the labor market at the beginning of 2023, when consensus called for unemployment to rise to 4.8% by the end of 2024, well above the rate of 3.4% at that time. The increase triggered the Sahm Rule, which stipulates a recession could start when the 3-month moving average unemployment rate is 0.5% above its lowest level in the last 12 months.

The change in market expectations shows how the consensus view has moved from expecting a recession by year end to now pricing in the Fed successfully orchestrating a soft landing. This shift could cause spikes in market volatility when disappointing economic data is released, whereas “bad news was good news” was the dominant view during the bulk of the Fed’s war against inflation.

Advanced Layoffs

WARN Act Layoff Notices, Thousands



Source: Bloomberg. Past Performance does not guarantee future results.

Advanced layoff notices by U.S. companies have been trending higher since the beginning of the year but are still slightly below levels seen in the first several months of 2023 amid widespread technology sector job cuts.

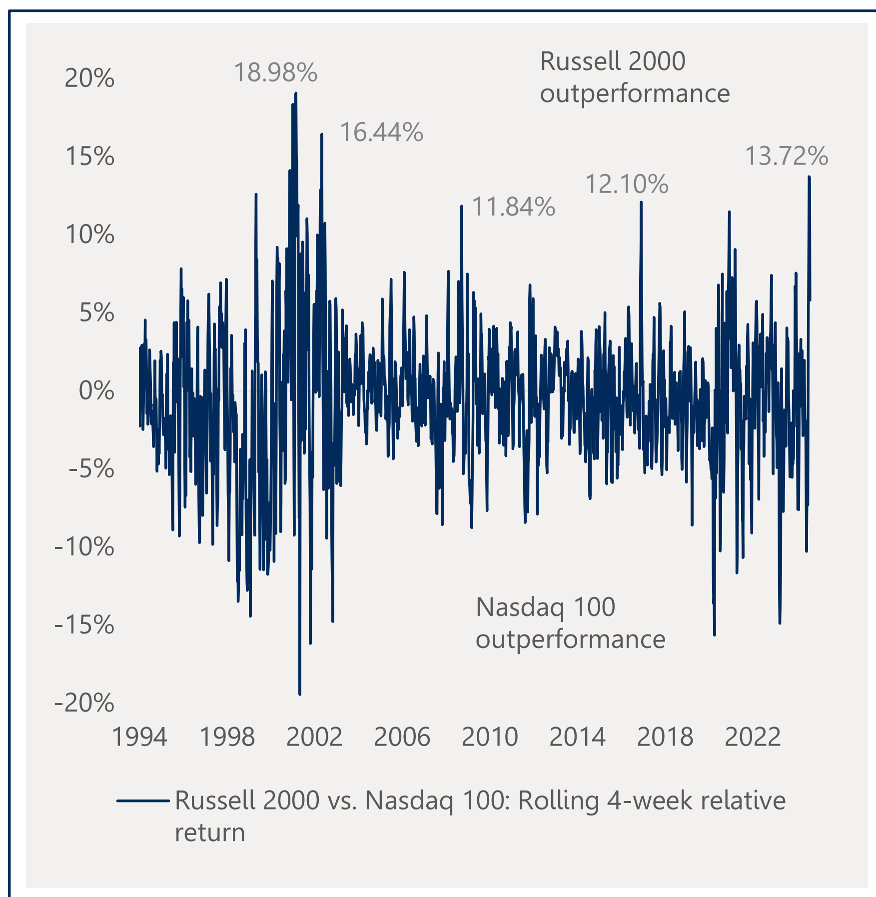
The Worker Adjustment and Retraining Notification (WARN) Act requires employers with 100 or more employees to provide notification to workers and state labor departments 60 days in advance of large planned layoffs. Recent analysis by the Bloomberg Economics team suggests layoffs have most notably been on the rise in California and Sun Belt states in sectors outside of technology.

According to research by Cleveland Fed economists, WARN data has historically been a leading indicator of state-level unemployment claims and the national unemployment rate. The national unemployment rate has risen to 4.3% in July from a low of 3.4% in April 2023. Over that 15-month span, about 60% of the 1.33 million-increase in unemployed persons in the labor force has come from layoffs, while about 40% have been new entrants and reentrants to the labor force.

Equity

Small Cap Rotation

Russell 2000 vs. Nasdaq 100: Rolling 4-week Returns



Source: Bloomberg. Past Performance does not guarantee future results.

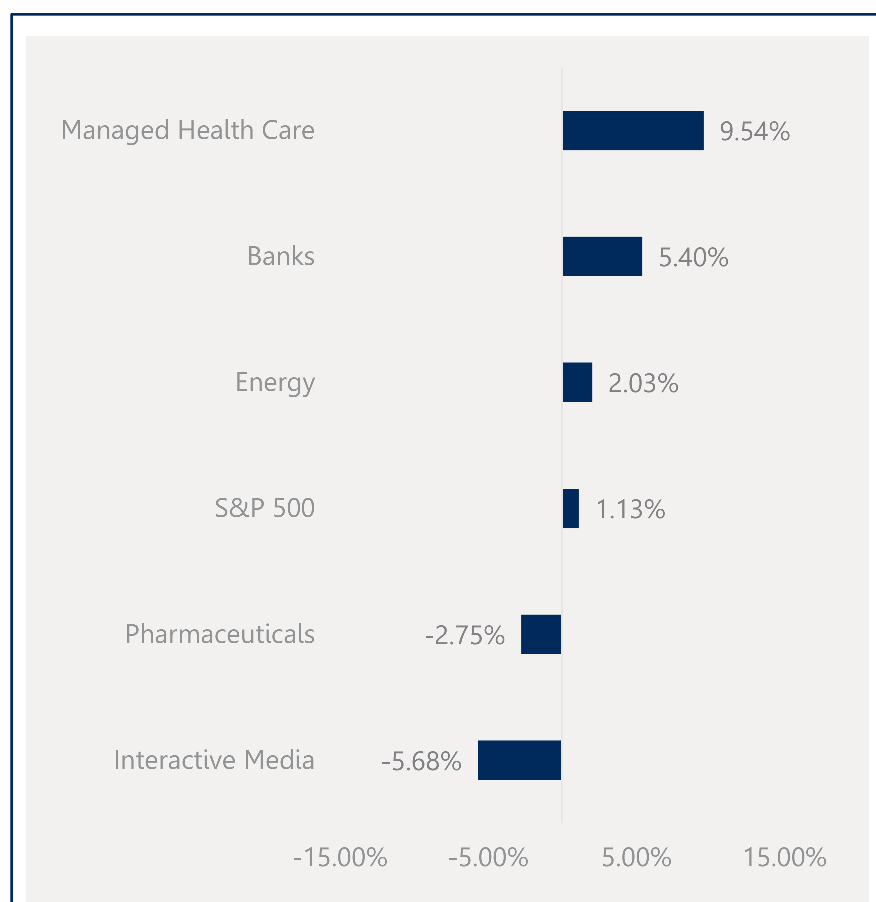
Over the period spanning June 28 through July 26, the small cap Russel 2000 (10.37%) outpaced the mega cap Nasdaq 100 (-3.35%) by nearly 14%, its widest margin of 4-week outperformance since May 2002. This follows a period of acute underperformance for U.S. small cap stocks dating back to regional bank turmoil in the late spring of 2023.

From March 1, 2023 through June 30, 2024, the Nasdaq 100's 63.5% return dwarfed the Russell 2000's 10.2% gain. The former was boosted by enthusiasm for generative AI demand, while the latter was challenged by concerns about elevated interest rates on regional lenders and cyclical companies with higher degrees of financial leverage.

A downside surprise in the June CPI report on July 10 seemed to be one of the primary catalysts of the recent bout of small cap strength as an accelerated pace of Fed rate cuts could disproportionately help small cap stocks via a lower interest cost burden and increased operational leverage. An extended period of small cap relative strength would likely require signs of an imminent "soft landing," including continued disinflation, resilient economic growth, and Fed rate cuts.

Trump Trade

Selected S&P 500 Industry July Price Return



Source: Bloomberg. Past Performance does not guarantee future results.

Rising expectations last month that President Trump could win a second term led investors to purchase stocks in industries that may benefit from Trump's policies. The portfolio repositioning referred to as the "Trump trade" began after the June 27th presidential debate heightened concerns about President Biden's age and the trade gained momentum after the July 13th Trump assassination attempt.

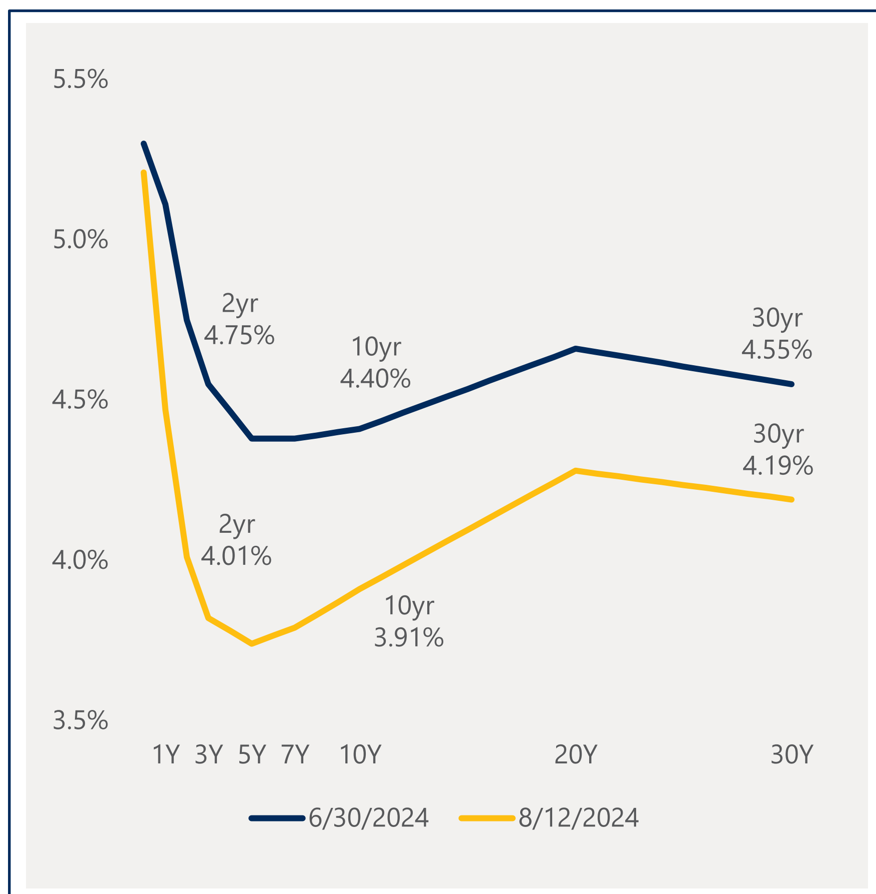
Trump's policies including less regulation and potential executive orders (EO) might benefit companies in the banking, health care, and energy industries, while hurting pharmaceutical and social media companies. A second Trump term might include EOs directing financial regulators to scale back or pause implementation of the Biden administration's financial regulations. Trump may issue an EO to expand health care options to include plans that do not have Affordable Care Act restrictions prohibiting use of age and health to determine premiums and benefits.

Drug prices could be targeted with an EO directing Medicare to adopt a rule to negotiate U.S. drug prices similar to prices in other countries which are often lower. Trump may attempt to weaken social media platforms' legal liability shield, Section 230 of the Communications Decency Act, by directing the FCC to adopt a narrower view of the law. Trump showed support for both these policies in 2020.

Fixed Income

Yields Shift Lower

U.S. Treasury Yield Curve: June 30 vs. August 12



Source: Bloomberg. Past Performance does not guarantee future results.

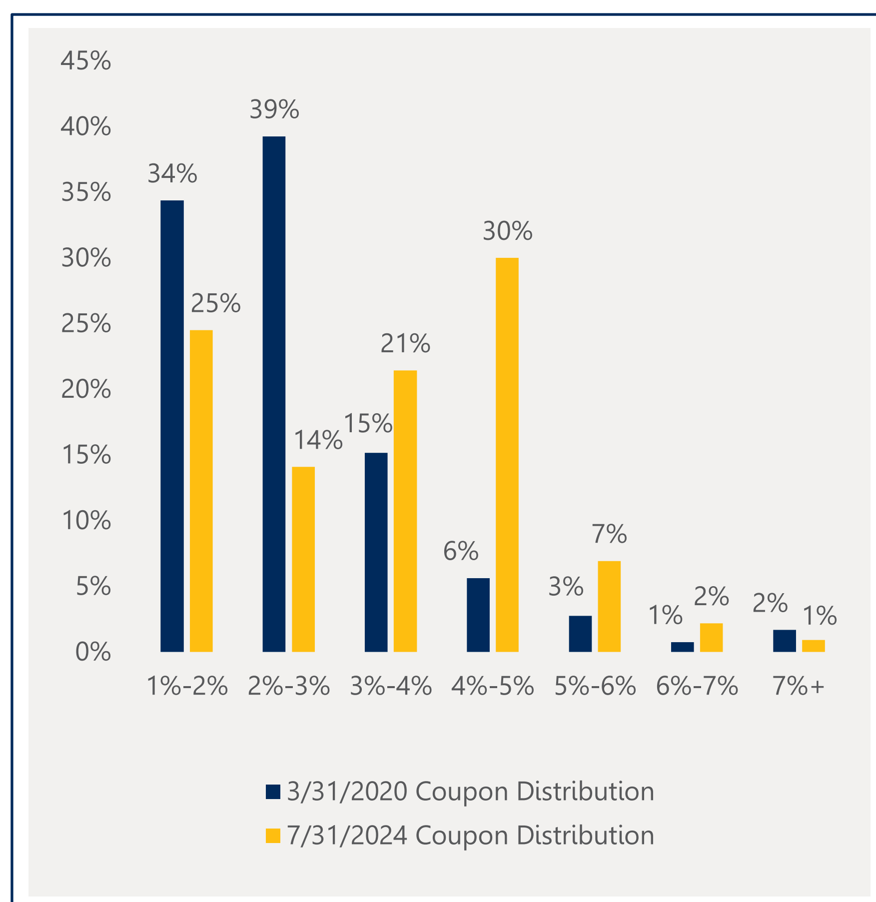
The U.S. Treasury yield curve has experienced a "bull steepening" over the last seven weeks as continued signs of slowing inflation and a softer labor market have caused short-term yields to decline more than long-term yields. For a brief period on the morning of Monday, August 5, the 2-year-to-10-year portion of the yield curve de-inverted around the 3.65% level for the first time in two years.

The downside surprise in July payrolls on Friday, August 2 ostensibly caused bond market participants to shift their primary area of concern from elevated inflation to weakening growth. This change in tone led markets to pull forward expectations of Fed rate cuts.

On July 1, market pricing assigned a 61% probability of an initial quarter-point Fed rate cut at the September 17-18 FOMC meeting and just 0.50% of cuts by year-end. By the second week of August, the market was projecting 75% odds of a 0.50% rate cut in September and 100 basis points of policy easing by the end of the year.

The Coupon Buffer

Coupon Buckets: Bloomberg Int. Gov/Credit Index



Source: Bloomberg, Morningstar. Past Performance does not guarantee future results.

Coupons on U.S. government and corporate bonds issued have trended higher over the last several years as the Federal Reserve lifted its benchmark policy rate by 5.25% from March 2022 through July 2023. All other things equal, higher-coupon bonds can help reduce the interest rate sensitivity of a bond portfolio and provide downside protection in a rising rate environment.

As of July 31, approximately 40% of the issues in the Bloomberg Intermediate Government/Credit Index had coupon rates of 4% or above, compared to just 11% in the first quarter of 2020. A majority of the index (51%) now sport coupons between 3% and 5%. Over the last year, most A-rated and BBB-rated corporate issuances have come to market with coupons between 4% and 5.5%.

During a historically poor stretch for high-quality bonds from January 2021 through September 2022, coupon income offset only a small percentage of negative total returns. With the sharp upward reset in yields likely behind us and a Federal Reserve likely on the cusp of rate cuts, gradually growing coupon income has become a much more important component of fixed income returns.

Disclosure

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