Market Commentary

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Lies, Damned Lies, and Statistics

Mark Twain popularized the phrase "lies, damned lies, and statistics", referring to figures that would beguile him. Within that same spirit, as investors, we must resist the lure of putting too much weight on individual data points, that can be very valid in their own right, but might also lead to unwarranted conclusions without considering the broader picture or at least corroborating data. Last month, markets reacted negatively to a number of factors, including a U.S. July unemployment reading that triggered the Sahm rule, quickly spreading fears of a recession starting. Even the rule's creator, Claudia Sahm, tried to put context to (downplay) the predictive power of this statistic. Following a quick pullback and recovery in the market we think it is important to emphasize that relying on a single data point can be misleading. It's crucial to consider the broader picture utilizing multiple indicators from different aspects before drawing conclusions and making investment decisions.

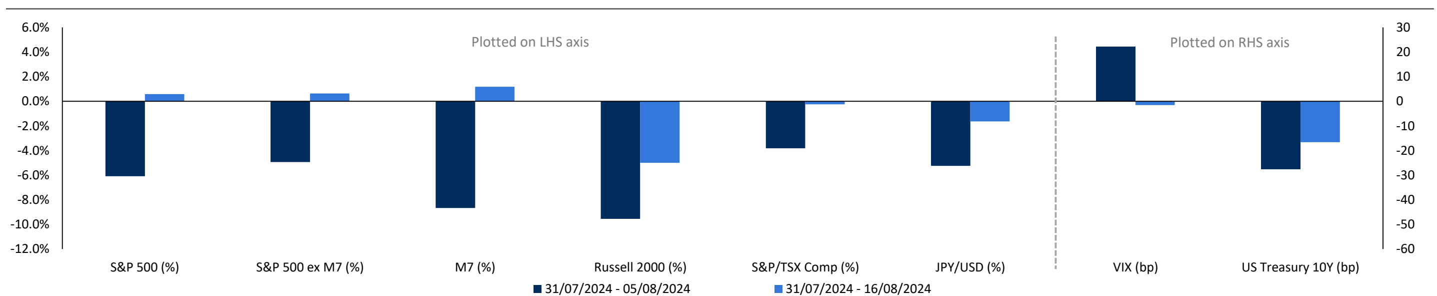
Recent Equity Market Pullback Recap

As we've noted in previous reports, the equity markets are likely to experience increased volatility as we approach the end of the year. After delivering a total return of 15.1% from the start of the year until the day before the U.S. July employment report was released, the S&P 500 index fell by about 4.8% over the following two trading days. While there were multiple factors attributing to this decline, including the unwinding of the yen carry trade, a key spark was the unemployment rate increasing from 4.1% to 4.3%, triggering the Sahm rule, a historically strong recession indicator. With a soft landing in doubt due to cracks in the labour market, these fears soon spilled over into other developed markets. The S&P/TSX Composite also dropped by around 3.3% on August 2 and August 6 combined.

However, it didn't take long for the markets to realize that they may have overreacted to the employment report. After all, only a few indicators showed significant weakness, while most macroeconomic indicators and the latest large-cap company earnings still support the base case for a soft landing. In the following two weeks, several positive data points, including better-than-expected initial jobless claims for the first week of August, a mildly encouraging CPI print, and strong retail sales for July, helped large-cap equity indices rebound and calm the markets, bringing the VIX back to normal levels.

That said, if investors had simply closed their eyes for two weeks, the returns on their accounts would likely have remained largely unchanged from the end of July (Chart 1). The exception is small-cap stocks represented here by the Russell 2000, which, as of the time this report was written, have not yet recovered to their pre-pullback levels. This aligns with our expectations, as we noted in the August 2024 Insights & Strategies: Is It Time to Broaden Our Focus?, that small caps are more sensitive to macroeconomic uncertainties. We need to see further fundamental improvements in small-cap earnings to be convinced that they are positioned for sustained outperformance—anticipated Fed rate cuts alone are not enough to drive continued rotation into these stocks.

Chart 1 - Changes In Selected Financial Markets (31/07/2024 - 05/08/2024 vs. 31/07/2024 - 16/08/2024)

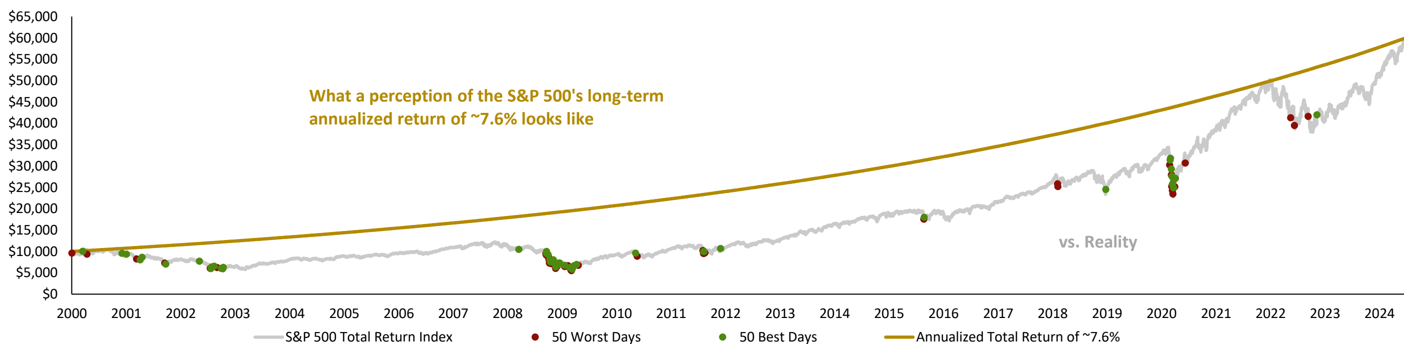


Source: FactSet; Capital Economics; Raymond James Ltd.; Data as of August 16, 2024.

The triggering of the Sahm rule and weakness in the ISM manufacturing sector do send cautionary signals about the current economy, and these warnings should not be ignored, as we see many indicators that point to the economy slowing, but still must emphasize that we do not see any kind of imminent precipitous decline or mass layoffs.

However, if investors relied solely on a few data points to judge whether the economy was in a recession, prompting them to sell off their holdings due to the swirling narratives, they would likely miss out on the rebound and end up realizing losses that hurt their overall returns. Market overreactions are not uncommon, and in many market cycles, the best trading days have followed closely after the worst ones (Chart 2). Therefore, during volatile periods, it's essential to keep perspective, stay focused on long-term goals, and remain invested.

Chart 2 - Growth of 10K - Market's Best Trading Days Tend to Occur Shortly After the Worst Trading Days



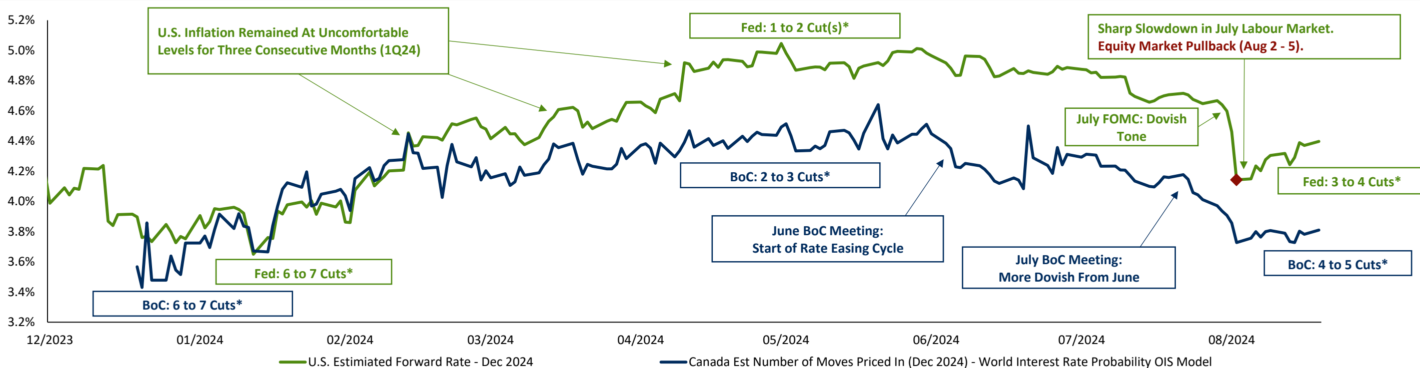
Source: FactSet; Raymond James Ltd; Data as of August 16, 2024. Initial investment of USD 10,000 on January 1, 2000.

Focus Has Shifted from Inflation to the Labour Market

The equity market wasn't the only area experiencing volatility in early August — market expectations for central bank policy rates by the end of 2024 have also been rapidly shifting in response to economic headlines (Chart 3). In the U.S., the number of rate cuts expected for 2024, as implied by forward rates, decreased from six or seven at the start of the year, to just one or two after inflation remained stubbornly high throughout the first quarter. However, the July jobs report triggered panic, and suddenly the market priced in two additional cuts on the day of the report's release. Pundits shouted for a 50 bps cut in September and even for a dramatic inter-meeting cut. Calmer heads have now prevailed, but the rapid shifts in sentiment highlight how markets have moved their focus from inflation to the labour market and economic growth, and returned to a "good news is good news" mentality. As confidence has grown in inflation being under control, the Fed has put more emphasis during its June and July meetings on the other side of its dual mandate, employment. We believe U.S. labour market conditions will gradually become the primary driver of rate decisions for the remainder of this cycle.

In Canada, expectations for rate cuts this year have followed a similar pattern. Due in part to strong immigration, Canada's labour market cooled down ahead of the U.S., and the potential of more economic strain from a wave of mortgage renewals has perhaps led the Bank of Canada (BoC) to adopt a more dovish stance compared to the Fed. Now, with greater certainty around a Fed rate cut in September, the BoC also has less to worry about regarding interest rate differentials, specifically, the risk of a depreciating loonie pushing up inflation from imported goods. This gives the BoC more room to cut rates if that's what the domestic economy needs.

Chart 3 - Market Expectations for Central Bank Policy Rates Have Been Rapidly Changing Amid Economic Uncertainty



Source: Bloomberg; Raymond James Ltd.; Data as of August 19, 2024. *Number of 25 bp rate cut(s) by the end of 2024.

One thing to keep in mind is that as inflation decreases, the real rate (the policy rate minus inflation rate), will rise and become more restrictive on the economy if the policy rate remains unchanged. So, even if the economy is currently resilient, it's crucial for central banks to cut rates to keep pace with disinflation, reducing the risk of the economy slipping into a recession due to an overly restrictive environment. Therefore, we expect the BoC to continue cutting rates by 25 basis points twice, or more, in the remaining three meetings this year, ending the year with a policy rate (upper bound) between 3.75% and 4%. In the U.S., we anticipate the Fed will also cut rates twice or more this year, ending 2024 with a policy rate (upper bound) between 4.75% and 5%.

Cracks in the Labour Market: What Are Other Indicators Telling Us?

The condition of the labour market is crucial because a strong labour market underpins healthy consumer spending, which accounts for more than half of GDP. As mentioned earlier, while the triggering of the Sahm rule should not be overlooked entirely, a comprehensive understanding of the labour market requires looking beyond just one or two measures. Timely data, especially those based on sampling surveys, often rely on modeling assumptions and are subject to revisions. For example, the recent annual Bureau of Labor Statistics (BLS) benchmark revision revealed that U.S. non-farm payroll data for the 12 months ending March 2024 required downward adjustment of 818,000 jobs created, the largest downward revision since 2009, indicating that the labour market was not as strong as might have previously been accepted using that one measure. The number of average jobs created over that period was therefore 173,500 rather than 242,000 each month. Given the potential for such large revisions, it's crucial to connect the dots with other indicators to better understand the situation. Interestingly, this revision narrowed the difference between that BLS benchmark and the Establishment and Household Survey from 2.5 mln to 1.7 mln, further emphasizing the need to look beyond one data series.

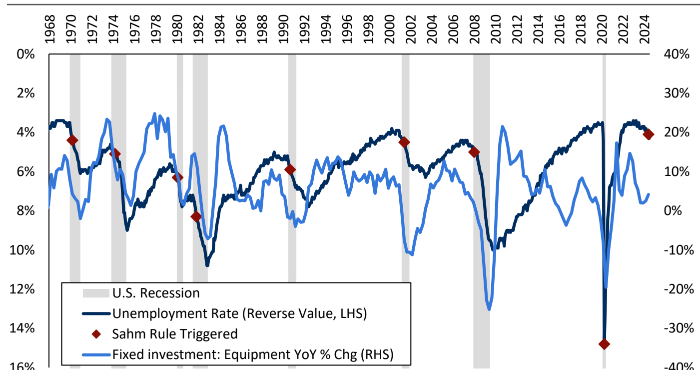
In Chart 4, we examine the U.S. unemployment rate alongside the year-over-year percentage change in fixed investment in equipment, a component of GDP. The unemployment rate is shown on a reverse axis on the left, with red markers indicating each time the Sahm rule was triggered. We noticed that the growth rate of fixed investment in equipment often decreases before the unemployment rate begins to rise (go down on the graph) and even prior to the Sahm rule being triggered during past recessions or slowdowns.

The reasoning behind this is that, unlike fixed investments in structures and intellectual property, investment in equipment is highly cyclical and closely tied to a company's short-term cash availability and/or outlook. When investment in equipment rises, it generally signals business growth, leading to increased hiring and a decrease in the unemployment rate. Conversely, during economic downturns, companies tend to cut back on equipment investment due to earnings pressure and cash constraints. If conditions worsen, they may have to lay off workers, causing the unemployment rate to increase.

In the current cycle, the growth in fixed investment in equipment slowed in 2023 but picked up again in the first two quarters of 2024. Since this is a leading indicator for the unemployment rate, its recent acceleration gives us confidence that the labour market remains strong despite the disappointing July job numbers. If this positive trend continues, we expect the unemployment rate to avoid significant deterioration.

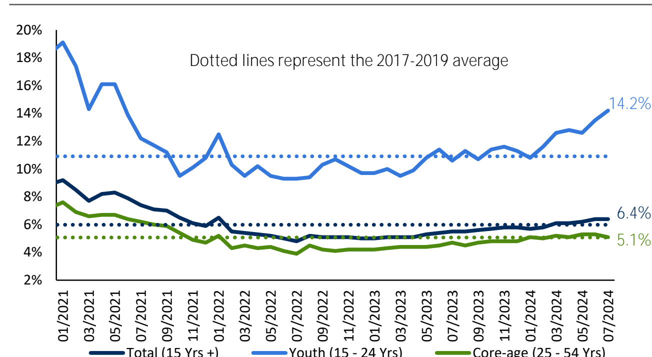
Additionally, other macro indicators, such as the ISM services PMI and control group retail sales, are still holding up well, and banks have eased up on tightened lending standards, which should support business lending and investment. Finally, U.S. consumers have been more bifurcated during the rate-hiking cycle, with higher-income households, who have less debt and spend more on investments, boosting their net worth. This could help sustain consumer spending and prevent a sharp decline. Taking all this into account, we believe the overall data still points to a soft landing, though the increased risk of a recession means we need to monitor the situation carefully.

Chart 4 - The Sahm Rule Is Triggered…But Is This Time Different?



Source: U.S. Bureau of Labor Statistics; Raymond James Ltd.; Data as of July 31, 2024.

Chart 5 - Canada Unemployment Rate Trends by Age Group



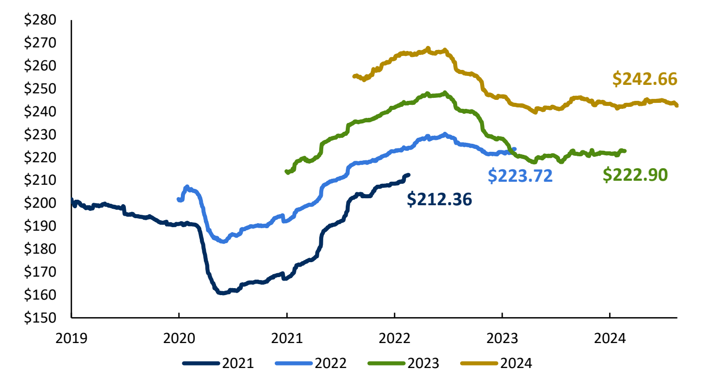
Source: Statistics Canada; Raymond James Ltd.; Data as of July 31, 2024.

In Canada, the labour market began loosening earlier than in the U.S. However, since the rise in the unemployment rate was mainly due to labour force growth outpacing job creation, rather than widespread layoffs, we still expect a soft landing for Canada, although the risk of a recession remains. Another factor suggesting that the 6.4% unemployment rate may not be as concerning as it appears, when compared to the lower U.S. rate, is that the weakness has been concentrated among 15 to 24-year-olds, while employment for the core-age group has remained stable throughout the year (Chart 5). Therefore, while an imminent recession seems unlikely, the spike in youth unemployment should prompt the BoC to consider cutting rates more proactively to avoid falling behind the curve. If the economy deteriorates further, layoffs could follow the current hiring freezes. Additionally, according to BoC's Staff Analytical Notes from April, the unemployment rate for 15 to 24-year-old males is most strongly linked to CPI-trim inflation among 41 indicators. This spike in youth unemployment should provide the BoC with more confidence that disinflation will continue as expected.

Considering the broader perspective, consumer spending in Canada is declining across the board, as retail sales are cooling, and there are warning signs in business investment. On the positive side, rapid population growth is bolstering consumption as new arrivals purchase necessities. While this support is temporary, it is helping to prevent the economy from slipping into a more imminent recession. Additionally, the completion of the Trans Mountain pipeline expansion project is expected to boost exports, with Vancouver crude exports increasing fourfold in June. This should help exports contribute more to GDP growth as consumer spending slows.

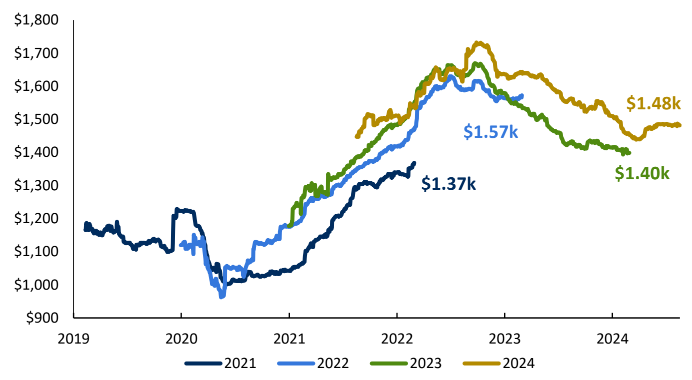
Outlook for S&P 500 and S&P/TSX Composite

Chart 6 - S&P 500 Headline EPS Estimates (Annual)



Source: Bloomberg; Raymond James Ltd.; Data as of August 16, 2024.

Chart 7 - S&P/TSX Composite Headline EPS Estimates (Annual)



Source: Bloomberg; Raymond James Ltd.; As of August 16, 2024.

As the second-quarter 2024 earnings season wraps up, the consensus annual earnings growth estimates for 2024 stand at around 9% for the S&P 500 and about 4% for the S&P/TSX Composite, compared to 2023 actuals (Chart 6 and 7), aligning with their long-term averages. However, the earnings expectation for the S&P 500 seems more achievable than for the S&P/TSX Composite.

The S&P 500 posted year-over-year EPS growth of approximately 7% and 11% in the first two quarters, indicating that the S&P 493 is gradually recovering from last year's earnings recession. To recap, 2023's earnings growth was flat, with the Magnificent Seven driving impressive gains to offset the S&P 493's declines. Given the strong earnings growth for the S&P 500 so far this year, it could meet its annual target if it generates earnings similar to those in 2Q24 for the remaining two quarters. However, it's important to note that much of the good news is already priced in, and with the S&P 500's trailing P/E ratio trading above the 90th percentile, any negative surprises in economic data or earnings could lead to a contraction in multiples, hurting its performance.

On the other hand, while the S&P/TSX Composite also experienced an earnings recession in 2023, its rebound this year has been less robust compared to the S&P 500. To hit the full-year consensus expectation of $1,480, both the third and fourth quarters would need to deliver earnings that are 10% higher than the second quarter, which seems ambitious given the current economic slowdown. However, this doesn't necessarily imply that the S&P/TSX Composite will decline for the rest of the year. With its P/E ratio at a reasonable level and potential strong demand for energy and materials, we might see some multiple expansion that could support the index's performance. Overall, we continue to favour defensive sectors in both S&P 500 and S&P/TSX Composite and expect a rotation into these sectors to persist.

All in all, it can be very stressful when various headlines grab our attention and the equity market pulls back during the late stages of an economic cycle. However, when assessing economic conditions, it's crucial to consider data in context and from various perspectives to gain a comprehensive understanding. We should also remind ourselves that market pullbacks are normal, and the best trading days often follow the worst ones. Therefore, it's essential to stick to your long-term plan, as history shows that staying fully invested has generally paid off for investors.

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