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Aptus 3-Pointers: July 2024 Highlights

Market Overview

July witnessed significant market activity characterized by political fireworks and a dramatic rotation from large to small caps. The PMI data released in late July highlighted slowing growth in both the manufacturing and services sectors, which put on pause on the outperformance of small caps and recent turmoil to start August caused a reversal in the small cap outperformance that had been experienced.

Interest Rates and Policy

Questions have arisen about potential policy mistakes due to the Fed not cutting rates amidst weakening data. Inflation is moving back down, but unemployment is ticking up, indicating the lagging effects of policy decisions. The market had expected rate cuts earlier this year, and the Fed's hesitation might have been a misstep. The two-year Treasury yield dropped nearly 60 basis points, and the ten-year yield dropped almost 50 basis points in July. This significant movement is worth noting. Additionally, there's speculation that the Fed may have overstayed its welcome, waiting too long to lower rates, affecting both international and U.S. economies. The recession narrative, largely absent since early 2024, seems to be creeping back into market discussions.

Small Caps Performance

Small caps have underperformed large caps for several years but have recently rallied to match the NASDAQ's year-to-date performance. The market's performance discrepancy between small caps and the NASDAQ was significant, driven by de-leveraging and expectations of rate cuts. Despite historical trends, small caps are currently trading at a 30% discount to large caps, suggesting a re-rating lower. Active management in the small-cap space is crucial due to the high variable-rate debt and upcoming debt maturity wall. Strategies focusing on yield and growth in the small-cap sector are recommended.

Fixed Income Insights

The S&P typically performs well when the Fed cuts rates into a softer landing environment. Real rates are currently around 3%, which is high compared to the past few decades. The term premium for long-term bonds has moved lower, with the CBO projecting 6% deficits for the next decade, making bonds at less than 4% yields less attractive. Investors are advised to focus more on equities rather than relying heavily on bonds. The current environment favors stocks over bonds due to ongoing fiscal deficits and potential productivity gains from technological advancements. Small rate cuts, and the anticipation of such policies, can also matter significantly, providing a mid-cycle adjustment rather than an emergency response.

Earnings and Market Dynamics

Valuations are becoming a focal point for investors. Companies with extended valuations, such as Snap, are getting hit hard despite okay earnings. On the other hand, stocks like Visa, which had

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poor earnings but reasonable valuations, saw limited declines. This indicates that valuations are becoming more important in the current market. Commentary on AI and CapEx spending has impacted stocks, with discussions on the long-term profitability and return on investment for companies investing in AI. Simplistic investment approaches focusing on broad asset allocation are recommended to benefit from the AI narrative.

Closing Remarks

Looking ahead, the market's resilience is being tested, but the focus remains on whether the economy can continue handling high rates. Future discussions will revolve around key economic indicators, earnings reports, and the Fed's potential rate cuts. The upcoming months will be critical as the market navigates through these challenges, and investors should stay informed and be prepared for potential fluctuations.