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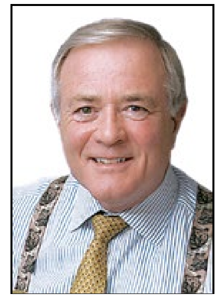

William Rutherford

Market rotation and Fed decisions shape a volatile month

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July brought a cooling breeze to the red-hot rally that defined the first half of 2024. The S&P 500's modest 1 percent gain in the month contrasted sharply with its blistering 14.5 percent advance during the first six months, when it set roughly three dozen record highs. This deceleration stemmed largely from a rotation from large-cap to small-cap stocks, blunting the market's earlier momentum.

The Dow Jones Industrial Average outpaced its peers with a 4 percent increase, while the tech-heavy Nasdaq Composite dipped slightly. This divergence highlighted the month's key theme: a shift from AI-driven tech giants to lagging sectors such as industrials and to smaller companies.

The Federal Reserve's actions played a pivotal role in shaping market sentiment. While the decision to hold interest rates steady at the July 31 meeting was widely anticipated, investors scrutinized Fed Chair Jerome Powell's press conference for future policy clues. Encouraging inflation data, coupled with a cooling yet resilient labor market, fueled expectations of potential rate cuts as early as September. The PCE price index rose by 2.5 percent year over year in June, edging closer to the Fed's 2 percent target, bolstering hopes for a "soft landing" scenario.

Markets reacted sharply in the days following the Fed meeting in July. The Dow Jones Industrial Average fell more than 600 points in a single day, reflecting investors' disappointment that the Fed hadn't moved more decisively toward rate cuts. This negative sentiment was compounded by a weaker-than-expected jobs report on Aug. 2, showing only 114,000 jobs added in July and unemployment ticking up to 4.3 percent. While supporting the case for future rate cuts, this data also stoked fears of a potential economic slowdown.

The market's volatile reaction underscored the delicate balance the Fed must strike. While lower rates could stimulate growth, premature cuts risk reigniting inflation. Stock traders, having priced in rate cuts, were forced to recalibrate their expectations, leading to the sharp sell-off.

Labor market data earlier in July had suggested gradual normalization. The JOLTS (Job Openings and Labor Turnover Summary) report showed job openings steady at 8.2 million in June, with unemployment at 4.1 percent, supporting hopes for a “soft landing.”

The anticipation of rate cuts sparked a notable market rotation. The Russell 2000 small-cap index surged 11 percent year to date, outperforming the Nasdaq Composite by 12.8 percentage points in July – the largest monthly lead since February 2001. This rotation came at the expense of large-cap tech stocks. Microsoft, Apple and Nvidia faced increased scrutiny and profit-taking, with Nvidia’s shares retreating 7 percent in a single day.

Despite this volatility, large-cap companies across sectors remain fundamentally strong, with robust balance sheets and positive cash flows. The market’s reaction reflects changing economic expectations rather than a shift in these companies’ long-term prospects.

Not all sectors benefited equally from this rotation. Consumer staples, typically a haven during volatility, unexpectedly underperformed other defensive sectors. Nestlé and Kimberly-Clark reported mixed earnings, highlighting concerns over changing U.S. consumer behavior and increased promotional activity, particularly among lower-income demographics.

July also highlighted the market’s vulnerability to technological disruptions. A significant bug in CrowdStrike’s cybersecurity software caused widespread outages, affecting millions of Microsoft Windows devices globally and disrupting operations worldwide. This incident led to a sharp, 11 percent drop in CrowdStrike’s stock price and rippled through the tech sector, serving as a reminder of the world’s interconnectedness and potential for localized tech issues to have far-reaching market impacts.

As we look ahead, investors should not be overly reactionary to day-to-day trading activity. The lessons of history remind us of the importance of maintaining a diversified, long-term approach to investing. While the market’s recent volatility may seem unsettling, it’s essential to see the forest through the trees. Just as investors may have overreacted to the AI hype earlier in the year, there’s a risk of excessive pessimism during market pullbacks.

The U.S. economy shows resilience, with GDP growing at a 2.4 percent annual rate in the second quarter. Consumer confidence, though slightly down, remains strong at 117.0 in July. These economic strengths, combined with potential Fed policy shifts, should provide support for equities in the coming months.

July 2024 reminded us that markets are multifaceted. While headline numbers suggested a quiet month, significant rotations occurred beneath the surface. Moving forward, maintaining conviction in high-quality companies across diverse sectors will be key to navigating market fluctuations.

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