Capital Market Update
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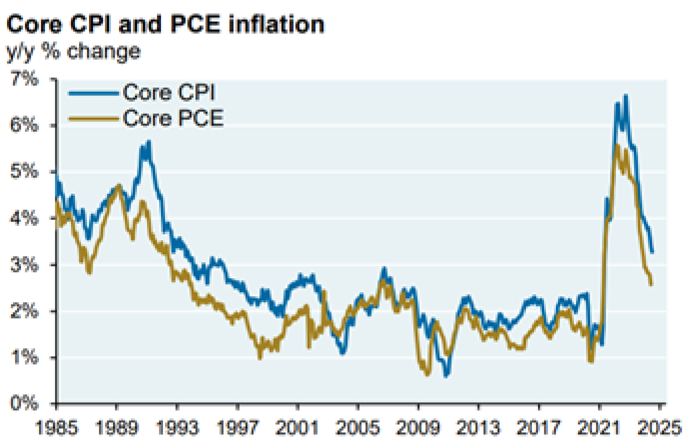
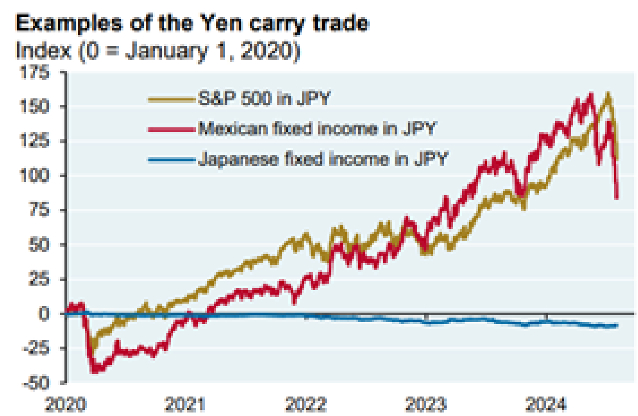
Following last week's job report, which showed the labor market was beginning to lose momentum, investors globally began to rethink expectations around recession probability. On the positive side, the unemployment rate remains near historic lows at 4.3%, recent ISM services data has shown that activity has expanded more than expected, and core inflation has been materially trending lower since April. However, concerns around the jobs report coming in below expectations (112k vs. 150k expected) have investors asking if the Fed has been too slow to decrease interest rates and if the US economy is heading towards a recession. US and International markets have reacted negatively over the last few days, with major indexes declining. However, market volatility and corrections are normal. They can be welcomed as an opportunity to rebalance portfolios or buy quality investments at a cheaper price.



Source: BLS, BEA, June 2024

As investor sentiment has decreased, we've seen the beginning of a rotation from equity into bonds, driving down yields by almost 65 basis points since the end of June. This is a good time to highlight the importance of bond duration to hedge equity risk. As a reminder, duration is a bond's sensitivity to interest rate changes. Longer duration means a bond is more sensitive as rates move up or down. Conversely, shorter duration will mean a bond is less sensitive to rate changes. More broadly, the relationship between interest rates and bond prices can be described as inverse, meaning that when rates go down, prices will go up. Whether a recession occurs or not, the market believes it likely that the Fed will look to cut rates in September (what they do beyond that will depend on how economic data continues to come in), and higher quality fixed income becomes a more attractive investment opportunity. A few factors are driving this; bonds have typically acted as a low correlated diversification option to equity (as we saw during Covid, this is not always the case), potential rate cuts in the future will serve as a tailwind for bond prices, and current equity valuations remain rich to historic levels.

While International markets are watching the health of the US economy closely, the sharp one-day decline in Japanese equities appears to go deeper than that. Recently, investors have been making money by betting against the Japanese Yen and putting their money in US Dollars instead. This strategy has been particularly popular because interest rates in the US are higher than in Japan, making it more profitable to hold dollars. However, the value of the Yen has been rising quickly, causing investors to reverse these bets. This sudden change has put added pressure on Japanese stocks. Simply put, as investors rushed to buy back Yen, it made Japanese stock's less attractive, leading to the sharp decline we saw.



Source: Bloomberg, JPMAM, August 5, 2024

Recession risk is certainly a concern among investors, but the bigger concern is that the Fed has been slow to react on rate cuts. However, the calls for emergency or multiple rate cuts for the remainder of the year seem aggressive; as we've mentioned, the economic picture is not entirely doom and gloom at this point. It's important to remember that the Fed's ultimate focus, or "dual mandate," is on employment and inflation; While there could be a scenario where they provide liquidity to markets, their priority is not to influence or prop up equity markets. Whether this is a shorter-term market correction or a longer-term broader economic issue is yet to be seen; it will be driven by the economic data that continues to be released. Considering this uncertain outlook, it is essential to remain calm and rely on portfolio diversification to do its job and protect in challenging market environments.

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