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MARKET SIGHT LINES

Softer economic data roils markets: Setting up for a breakout market.

By Michael O'Keeffe, *Chief Investment Officer*

My team and I have published about the recent market volatility at StifelInsights.com and in our CIO Weekly Insights, including our most recent Market Pulse and Weekly Market Perspectives. Market experts have been focused on a softening job market, weaker manufacturing, and a rate hike in Japan as drivers of these market moves. In this Sight|Lines, we review these catalysts for the recent market volatility and explore the potential for breakout markets going forward, in one direction or the other.

THE TAKEAWAY: SOFTER ECONOMIC DATA AND A JAPAN RATE HIKE ROIL MARKETS

We've been talking about a slowing consumer and the potential for a market rotation, and recent economic data and the market's reaction reinforce that such a rotation has begun. In summary:

- The ISM Manufacturing Purchasing Managers' Index (PMI) signaled contracting manufacturing activity for the fourth consecutive month, and construction spending unexpectedly declined in June.
- The Federal Reserve (Fed) discussed a softening job market at its July meeting, and a recent jobs report provided evidence that this may be happening faster than economists had expected.
- Since mid-July, the S&P 500 declined close to correction territory, with much of the downward move in August as this news unfolded.
- In a classic "flight to quality" move, the 10-year Treasury yield fell, driving bond market returns higher.
- During this period, the Bank of Japan raised its key rate 0.25% to combat inflation, and several hedge funds and other investors moved to reverse a "carry trade" involving the yen, amplifying the equity market selling pressure and adding to volatility.
- Six of the "Magnificent Seven" reported second quarter earnings with mixed results, also adding to nerves in the markets.
- Even as markets have stabilized, we look forward to a number of upcoming data releases that may serve as future catalysts of another significant market move, possibly negative or positive.
- Long-term investors will be well served to stay the course, with a focus on rebalancing back to a diversified strategy with a focus on quality.

IN-DEPTH: A SOFTENING JOB MARKET AND WEAK MANUFACTRING DRIVE EQUITY MARKERS LOWER, WITH INVESTOR REACTION TO A JAPAN RATE HIKE AMPLIFYING VOLATILITY

The consumer may be slowing, adding to a market rotation, that started in July. Recent economic data and market volatility seem to be reinforcing the rotation. Going deeper:

- The ISM Manufacturing PMI signaled contracting manufacturing activity and declining construction spending:
    - The ISM Manufacturing PMI was 46.8, well below 50, signaling a contraction.
    - Construction spending declined 0.3% in June, when an increase of 0.3% was expected.
- The Fed's comment about a softening job market was reinforced by the data:
    - The unemployment rate increased from 4.1% to 4.3%.
    - The economy created 114,000 jobs in July, significantly below the forecasted 175,000.
- In the wake of this news, the S&P 500 declined from July 16 to August 5:
    - The index was down 8.4% over that period, approaching the correction level of down 10%.
- In a "flight to quality" move, the 10-year Treasury yield fell, and the bond market posted positive returns:
    - This benchmark yield fell from 4.3% on July 24 to 3.7% on August 5.
    - The Bloomberg Aggregate Bond Index posted a positive return of 3% over that period.
- On July 31, the Bank of Japan raised its key rate by 0.25% to combat inflation:
    - Several hedge funds and other investors moved to reverse a "carry trade" with a notional roughly estimated at $200 billion, amplifying the equity market selling pressure and adding to volatility.
- Six of the "Magnificent Seven" reported second quarter earnings with mixed results, which also added to nerves in the markets.
- Even as markets have stabilized, we look forward to a number of upcoming data releases:
    - The July consumer price index and producer price index reports next week will be in focus:
        - If inflation remains under control, the Fed may cut rates in September, possibly adding to a relief rally for stocks.
        - If inflation resurges, investors will worry that the Fed won't cut rates, adding to downward equity market pressures.
    - We'll see retail sales and consumer sentiment and confidence, each a potential catalyst for an equity market move.
    - Ultimately, the Fed meeting concluding on September 18 will be in focus, with market experts expecting a 0.5% cut at that meeting.

CONCLUSION

StifelInsights.com and our CIO Weekly Insights contain some of what we've published on recent market volatility, like our most recent Market Pulse and Weekly Market Perspectives. A softening job market and weaker manufacturing served as a catalyst for markets to move lower, with hedge funds and other investors responding to a rate hike in Japan, adding to the selling pressure. While markets have stabilized, we've identified a number of upcoming data releases that can move the market one way or the other. Long-term investors will be well served to stay the course, with a focus on rebalancing back to a diversified strategy with a focus on quality.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com
www.stifelinsights.com

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