THE PARTY IS NOT OVER YET
BUT THE JOYS WILL BE VOLATILE

Last year, in August, it was the rating agency Fitch, downgrading the US debt note from AAA to AA+, that had shaken market optimism. The major firm's economists still considered the outlook for the US stable but were concerned about "fiscal deterioration over the next three years, a high and rising public debt burden, and erosion of governance" relative to other major economies. The backdrop was inflation, admittedly falling, but still sustained, considered sticky especially in the last mile. The market rally had to wait until October and a correction, for the S&P, of over 10%. Slowing inflation, growth that surprised on the upside, the artificial intelligence narrative and better-than-expected corporate results fuelled the rally that seemed unstoppable. The concerns expressed by Fitch are now even more topical than a year ago, with an even more insidious governance and public debt problem. But not enough, at least so far, to challenge the bull market, an expression of a US economy that has managed to grow despite rates above 5%.

In this month of August, summer worries return to spoil the holidays of investors and asset managers. The latter realized that this year they did not even need a big rating agency to complicate their sleep. All it took was a macroeconomic indicator with a history of great forecasting success behind it: the Sahm Rule Recession Indicator. This tool, created by Claudia Sahm in 2019 as part of her research work at the Federal Reserve, signals in real time the likely onset of a recession when the quarterly moving average of the unemployment rate rises by 0.50 percentage points or more from the low of the previous 12-month quarterly averages. And this happened with the latest payroll data for July, which, excluding the agricultural sector, increased by 114 thousand, while expectations were for 176 thousand. The unemployment rate jumped from 4.1 per cent to 4.3 per cent in July, the highest level in three years. The Sahm

Rule thus rose to 0.53%, after having risen to 0.43% in June, suggesting that recession in the US will arrive in a couple of months: the indicator's accuracy rate, going back to every recession since the 1970s, is 100%. Also confirming this signal was the Ism manufacturing index which fell to 46.8 (expected 48.8) recording the black mood of purchasing managers and which, below the 50-point threshold, enters the contraction zone.

All this contributed to raising hell in the markets. The Nasdaq, with a loss of 2.5% on the last trading day of the month, recorded a total decline since the beginning of July of more than 10%, entering correction territory. The Magnificent 7, having left a capitalization of 3.3 trillion on the ground from their respective highs, are as if they had wiped a stock like Apple off the market radar. The European stock markets, with their 4.6% drop in the last week of the month, have lost 10% from their March highs. Switzerland, thanks to Roche's strong rally, contained its losses from period highs to around 5%. And even the Tokyo stock exchange, with -5.7%, experienced its worst session in almost a decade. Not to mention the bond market (which has been signaling the approach of recession for some time), saw the yield on the ten-year bond fall to 3.8% despite the Federal Reserve continuing to keep rates at 5.25%.

In the August heatwave, many are wondering whether the party in the markets is over, even though historical habit suggests that summer's annoyances should be viewed in relative terms. Claudia Sahm herself, interviewed by Fortune, stated that “no one should be panicking today, even if it looks like someone might be”.[1] Sahm, who is now chief economist at investment firm New Century Advisors, notes that household income continues to grow, while consumer spending and business investment remain resilient: there are key measures of the economy that “still look very good”. The July unemployment figure could be influenced by labor market distortions that will return. “This time - says Sahm - it could really be different. The Sahm Rule may not tell us

[1] Will Daniel, “This recession indicator is flashing red, but the ‘Sahm Rule’ creator says ‘this time really could be different’”, *Fortune*, 2 agosto 2024, https://fortune.com/2024/08/02/recession-indicator-claudia-sahm-rule-trigger-unemployment-rate-jobs-report/

what it has told us in the past, because of these fluctuations, from labor shortages, with people leaving the labor force, to the arrival of immigrants recently. All this may translate into changes in the unemployment rate, which is at the heart of the Sahm Rule”. [2] Nevertheless, the economist concludes, the indicator has always been very accurate and therefore “should not be ignored” noting that “recessions can develop slowly and then come quickly”. [3]

The shock in late July/early August is probably part of the vision of a bull market entering a new phase in which optimistic market expectations are looking for tangible reality. But the market remains tonic because we have seen a healthy sectoral rotation, with the technology sector, the driver of the upturn, experiencing the largest declines. While the financial, real estate and energy sectors have started to recover. For now, we can see that the US economy, which was very strong in the first half of the year, is beginning to moderate. This leads to a more rapid decline in inflation and wage growth, which paves the way for the final easing of monetary policy by the Federal Reserve.

As the gaps in economic conditions, inflation, and bond yields between the US and other countries narrow, the relatively strong dollar and treasury bond yields have finally receded, freeing up liquidity in the market. We are likely to see a shift from gains driven by solid economic fundamentals to a scenario characterized by moderate economic growth, falling inflation and central bank easing. What will drive markets in the coming months will therefore be liquidity, which will have to offset the effects of macroeconomic slowdowns. In such an environment, volatility is likely to remain high. Markets will tend to wonder whether the Federal Reserve waited too long to cut rates. While the reaction to expectations of easier liquidity should also boost AI stocks, which will be increasingly valued in their ability to boost the productivity of the economy. When this bull market ends, one will probably remember August 2023 and Fitch's stance more than August 2024.

[2] Idem.

[3] Idem.

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