GIBRALTAR ASSET MANAGEMENT

STOCKBROKERS & INVESTMENT MANAGERS

# Market Commentary - August 2024

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| **FTSE 100** | **8,174** | S&P 500 | 5,346 |
| Resistance | 8,370 | Gold | $2,425 |
| Support | 8,000 | GBP/EUR | 1.1661 |
| VIX | 23% | GBP/USD | 1.2777 |

## Introduction:

Share prices have been hit by a global sell-off as weak US jobs growth stoked fears of a sudden downturn in the world's largest economy. The tech-heavy Nasdaq index dropped by more than 2.4% in just one day, dragged lower by Intel and Amazon, after the companies reported disappointing results. The US added 114,000 jobs in July, far fewer than the 175,000 expected, and their unemployment rate rose to its highest level in nearly three years. The figures suggest the long-running jobs boom might be coming to an end. Investors were already worried about high borrowing costs and unsettled by signs that a long-running rally in share prices, fuelled in part by optimism over artificial intelligence, might be running out steam.

## Market Outlook:

**Over the long term** *(since 1962), the FTSE All-Share has returned 7.2% per annum and that does not include the average 3.8% dividend yield earned on top. Therefore, 'strategically', it pays to be in the market. Also, considering inflation averaged 6.2% over the same period, it is vital that an investor invests in equities in order to preserve the purchasing power of their money. However, markets can be subject to swings in the interim and investors should be mindful of these with a view to protecting their capital and thus maintain a 'tactical' view.*

**Our allocation to the stock market remains at equalweight**. The VIX (also known as the *"Fear Index"*) has doubled in the past month, with political thunderbolts, an assassination attempt, technology meltdowns, ongoing military conflicts and non-stop interest-rate drama playing on investor's fears. And now we have entered the month of August, where low trading volumes can lead to increased volatility. Who can blame any investor from taking a cautious stance?

The stock market was due a pullback, and it certainly has had one, experiencing its worst week since 2022. It has enjoyed a big run, partly because corporate earnings are rebounding from a year of negative comparisons. While equity valuations appear attractive, stocks will appear pricey if earnings fail to grow as anticipated. Thankfully, companies are generally reaffirming the moderately positive outlook for the full year, which is still trending toward high single-digit to low double-digit EPS growth.

Analysts are also attributing the recent selling to a much-needed correction in extremely overbought names. In broad terms, the nearly two-year rally in stocks has been too narrow. As AI mania gripped the stock market, the *"Magnificent Seven"* of assumed AI beneficiaries dominated the rally. These seven stocks (Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia and Tesla) make up ~30% of the S&P 500 index. When a single sector or a single cluster of stocks is dominant, it usually does not end well. Past examples include Energy, which is now one-quarter its peak market weight. Analysts are divided as to how long the seven can remain magnificent.

# Market Commentary

## Market Outlook (cont):

Meanwhile, the major geopolitical event of 2023 - the war between Israel and Hamas - continues to plague market sentiment. In France, nationalism is vying to displace leadership from traditionally socialist parties whilst the UK is experiencing race rioting in the wake of the horrific child murders in Southport. Well after the end of pandemic lockdowns, China continues to experience uneven economic recovery that economists now recognise as demographic as well as cyclical.

In terms of market segments, we continue to recommend long-dated gilts, small caps and growth stocks as beneficiaries of a falling interest rate environment. Looking through the short-term volatility of the third quarter, we anticipate that an expanding economy, growing earnings, and declining inflation and interest rates can boost share prices as we move into the final three months of the year.

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## Recommended Investment:

**L&G Russell 2000 US Small Cap ETF**

Following easing inflation figures, US small caps rose 10% in July 2024, crushing the S&P 500 which ended flat for the month. Investors are predicting the Federal Reserve will cut interest rates three times before the end of 2024 thanks to favourable inflation and employment data. That will reduce the yield on risk-free assets, pushing investors into growth assets. That's great news for the overall market, but it's particularly positive for the Russell 2000, an index featuring approximately 2,000 of America's smallest listed companies. Smaller companies often need financing to fuel their growth. Falling rates increase their borrowing power, and smaller interest payments boost their earnings. Meanwhile, lower interest rates increase the present value of future earnings of companies, thereby making their share prices more valuable.

The valuation of the Russell 2000 is currently very attractive relative to its large cap sibling. It trades on a price-to-earnings (P/E) ratio of 17x, a substantial discount to the 24x P/E ratio of the S&P 500. If small caps do get an earnings boost from interest rate cuts, investors might be willing to pay a higher valuation for stocks, thereby helping to close the gap. Eleven different sectors of the US economy are represented in the S&P 500, but the index is dominated by technology, which has a 32% weighting. The Russell 2000 is more balanced, with industrials making up 16.3% of the index, followed by financials at 15.7%, and healthcare at 15.6%.

Interestingly, the total market cap of the Russell 2000 is only as large as one of the multiple $3 trillion market-cap stocks in the *"Magnificent Seven"*. But let's not spoil the party, as its constituents have been posting some historical returns on massive trading volume. As they say, *"volume equals validity"*. The index has broken out of a massive 3 ½ year consolidation and, as the old adage goes, *"the larger the base, the higher in space"* (meaning when a security breaks out of a long base, it has the potential to move significantly higher).

Despite the strong gain in the Russell 2000 over the past month, it is still trading in a bear market because it hasn't surpassed its all-time high from 2021. The index only needs to gain another 7% to get there, and with economic conditions turning in its favour, it could be back in bull market territory sooner rather than later.

UK investors with a higher attitude to risk can easily obtain exposure to this theme through the L&G Russell 2000 US Small Cap ETF (RTWP.L), a low-cost ETF which trades on the London Stock Exchange in sterling and replicates the Russell 2000 index. As most ETFs tend to be passive in nature (they try to track a benchmark, rather than outperform it), the fees are very low - just 0.30% in this case. For investors with US Dollars in their portfolios, the RTWO.L version trades in USD.

# Market Commentary

## Post of the Month:

*"A new study from the University of Amsterdam has found that people get too hopeful when things are uncertain. This is worth bearing in mind. It might be tempting to gravitate towards the narrative that looks most favourable but that doesn't necessarily mean it will be correct"*

In a set of experiments, more than 1,700 participants were shown various patterns, such as sets of stripes or coloured dots. Some of these patterns were linked to a negative outcome: the willing victims were either given a mild electric shock (in the lab), or a loss of money (online) each time one appeared.

You might expect participants to become hypervigilant to these unpleasant patterns, but the opposite was true. The study consistently found that people were less likely to identify patterns associated with shock or loss, and misinterpreted such patterns as aligning with a more desirable outcome. According to neuroeconomics professor Jan Engelmann, the study demonstrated very clearly that *"the negative emotion of anxiety about an outcome leads to wishful thinking"*.

The dangers of such thinking have been well documented for years. In 2011, a study by Oxford University economist Guy Mayraz sorted volunteers into two separate groups: farmers and bakers. Both were asked to observe a chart of historical wheat prices and guess what came next. Farmers stood to profit from higher wheat prices, while bakers faced higher costs. Crucially, both groups were also offered a performance bonus depending on the accuracy of their prediction. The study found that farmers made significantly higher price predictions than the bakers. People were more likely to expect price rises when they made them better off.

For individual investors, the risk of wishful thinking is clear. The Dutch academics warned that the phenomenon of people becoming overly optimistic in the face of uncertainty can happen with issues such as climate change, personal health situations and financial market fluctuations. They also think their results can help to explain factors as broad as why people seek comfort in religious belief, and why financial professionals ignore red flags about their portfolios.

Mayraz concluded that in times of uncertainty, there is, in short, *"evidently significant potential for wishful thinking to materially affect decisions"*. This is worth bearing in mind today. It might be tempting to gravitate towards the narrative that looks most favourable for markets. That doesn't necessarily mean it will be correct.

Gibraltar Asset Management

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## Quote of the Month:

*"Invest for the long haul. Don't get too greedy and don't get too scared"* - Shelby M.C. Davis

Shelby M.C. Davis is a prominent American investor and philanthropist known for his long-term investment philosophy. This quote reflects his approach to investing and offers valuable advice for individual investors. Davis emphasizes the importance of investing for the long haul. This means that rather than trying to make quick profits through short-term trading or speculative activities, he advocates for a patient approach over several years. Greed can lead to taking unnecessary risks or making impulsive investment decisions outside your best interest. Fear of investing can lead to panic selling or avoiding investments altogether during market downturns or periods of volatility.

## Economics:

The Bank of England's first interest rate cut in more than four years will help to foster a cautious sense of optimism about Britain's long-struggling economy. The BoE lowered its benchmark rate to 5.0%, from a 16-year high of 5.25%, offering a bit more relief to households and businesses who are emerging from the inflationary shocks of the COVID pandemic and Russia's invasion of Ukraine. The lowering of the Bank Rate from its 16-year high and the signs of economic recovery after a shallow recession in 2023 are helpful for new Prime Minister Keir Starmer, who has made economic growth - chiefly via reforms to boost the country's weak productivity growth - the top priority of his government. Michael Browne, chief investment officer of Martin Currie, said the likelihood of further BoE rate cuts would help to foster the sense of a turnaround in Britain. *"In this environment, we continue to favour the interest rate-sensitive sectors of house builders, real estate, utilities and in particular the green energy sector,"* he said.

The eurozone's GDP rose 0.3% in the second quarter, slightly higher than forecast. Bert Colijn, senior economist at ING, said the data indicated that the region's economy is somewhat recovering. *"After stagnation for all of 2023, this is a relief and shows that the economy has started to cautiously recover,"* he said, adding that the economy was now in a better situation than a year prior. *"The question remains where the economy will head from here and recent data do not provide much confidence that the eurozone economy is further accelerating"*. Indeed, the eurozone's largest economy Germany unexpectedly shrank by 0.1% in the second quarter. Klaus Wohlrabe, head of surveys at ifo, said in a Wednesday note that the German economy was *"stuck in crisis"* and that it was also not expected to improve much in the third quarter.

The US economy added just 114,000 jobs in July, far fewer than the 175,000 expected, while the unemployment rate rose to 4.3%, its highest level in nearly three years. *"Now the question isn't will the Fed cut in September, but by how much,"* said Jay Woods, chief global strategist at Freedom Capital Markets. Seema Shah, chief global strategist at Principal Asset Management, said the latest jobs figures raised questions about whether the Fed had waited too long. *"Job gains have dropped below the 150,000 threshold that would be considered consistent with a solid economy,"* she said. *"A September rate cut is in the bag and the Fed will be hoping that they haven't, once again, been too slow to act."*

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## **Seasonality:** *"History doesn't repeat itself, but it does rhyme" - Mark Twain*

The January Barometer

Historically, the returns in January have signalled the returns for the rest of the year. If they are positive, the returns for the whole year tend to be positive and vice versa. First mentioned by Yale Hirsch in the Stock Trader's Almanac in 1972, a variant has it that returns for the whole year can be predicted by the direction of the market in just the first 5 days of the year. *Judging by the first 5 days, 2024 is likely to be a negative year for the stock markets.*

August

August is the 7th best performing month, rising 58% of the time, with an average return of 0.4%. It can, however, also see large falls. As it's a month for holidays, trading volumes tend to be low, which in some years can lead to some increased volatility.

Third Quarter

The FTSE 100 has risen 25 of the 40 years (63%) between 1984 and 2023, posting an average gain of 0.6%.

Sell in May and go away; don't come back till St Leger Day

Delaying re-entering the market from St. Ledgers Day to Halloween has yielded statistically significant outperformance with the FTSE All-Share rising an average 13.4% from Halloween to May Day since 1965. There is a 1-in-2,000 chance of this arising by chance in random data. One explanation for this is that as the nights draw in during winter, we become anxious and depressed, which means share prices fall and expected returns rise. This then leads to a decent winter rise.

Fourth-Year US Presidential Cycle

The stock market tends to bottom out during the second year of each new presidential term and then recover strongly in the final two years. This is due to each Administration ensuring that the economy is strong by re-election time. Unfortunately, the excessive stoking of the economic fires creates excesses, including over-priced stocks, leading to poor stock market returns in the first two years of the next term.

Chinese New Year - Year of the Dragon

The Chinese calendar revolves around a 12-year cycle where each year is associated with an animal (rat, ox, tiger, rabbit, dragon, snake, horse, goat, monkey, rooster, dog and pig). Each New Year starts between 21st January and 21st February, the exact date being dependent upon a variety of complex factors. The best performing animals since 1950 have been the goat and dog. The worst performing animals have been the rooster and snake. *The Year of the Dragon is believed to foster growth, progress, and abundance. For investors in Chinese stocks, that would be a most welcome break from the past few years.*

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## Investment Calendar:

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| 1st August | BoE Meeting |
| 4th August | New Moon (markets tend to reach a high point around this time) |
| 16th August | Options Expiry Day |
| 19th August | Full Moon (markets tend to reach a low point around this time) |

## Technical Analysis:

We are neutral on the stock market at this time. The market is down just 29 points since last month but has fallen 193 points in just the last few days. Whilst the market has continued to make new highs, it does not manage to hold onto them for very long. The RSI has fallen to the neutral level of 50% (neither overbought nor oversold), the market is trendless (the ADX is just 12%) and August is a month that can see large falls. As it's a month for holidays, trading volumes tend to be low, which can lead to increased volatility. Upside appears to be capped at the upper Bollinger band (8,370), with support at the lower Bollinger band (8,095) and further support at the psychologically-important 8,000 level.

*"The illusion of randomness gradually disappears as the skill in chart reading improves" – John Murphy*

## Chart Legend:

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| 20 day moving average | (signifies the short-term direction of the security. prices tend to gyrate around their 20 day m/a) |
| 50 day moving average | (signifies the medium-term direction of the security) |
| 200 day moving average | (signifies the long-term direction of the security - whether it is in a bull or bear market) |
| | (an indicator that measures 2 standard deviations away from the 20 day m/a) |

## Technical Analysis Guide:

RSI (relative strength index) - indicates whether a security is overbought (above 70) or oversold (below 30). Also when the RSI moves above 50 that is considered bullish (or vice versa).

ADX (average directional index) - indicates whether a security is in a trend (above 20) or not in a trend (below 20). For trending markets moving averages work best when considering lines of support/resistance. ending markets Bollinger Bands work best (sell at upper band, buy at lower band).

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