

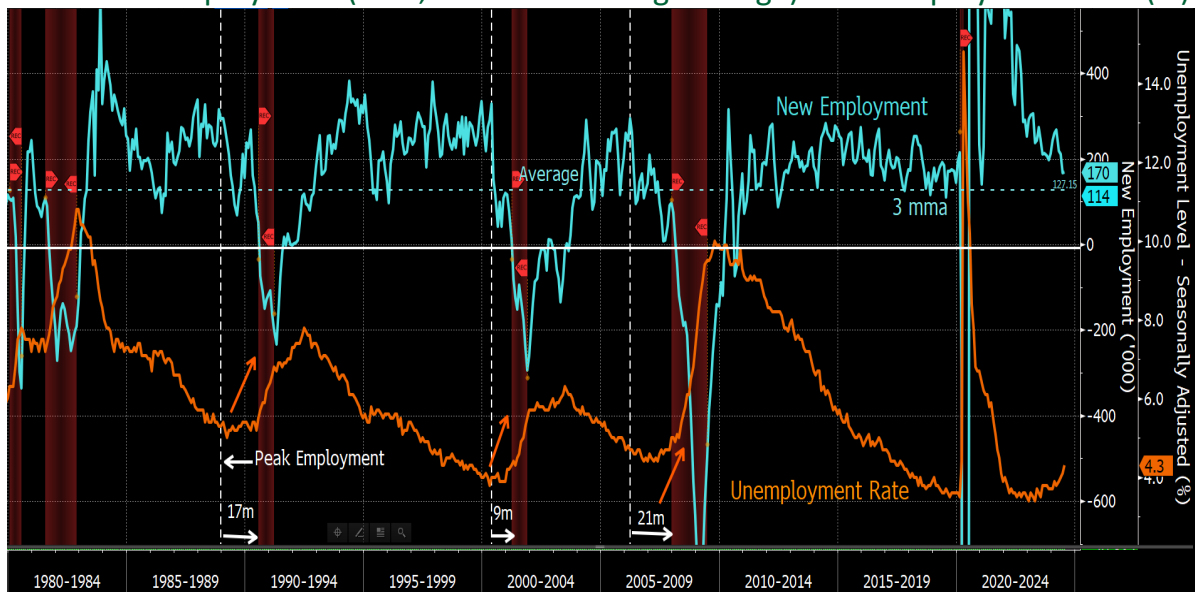
"The art of being wise is knowing what to overlook."

William James

1. US ECONOMY

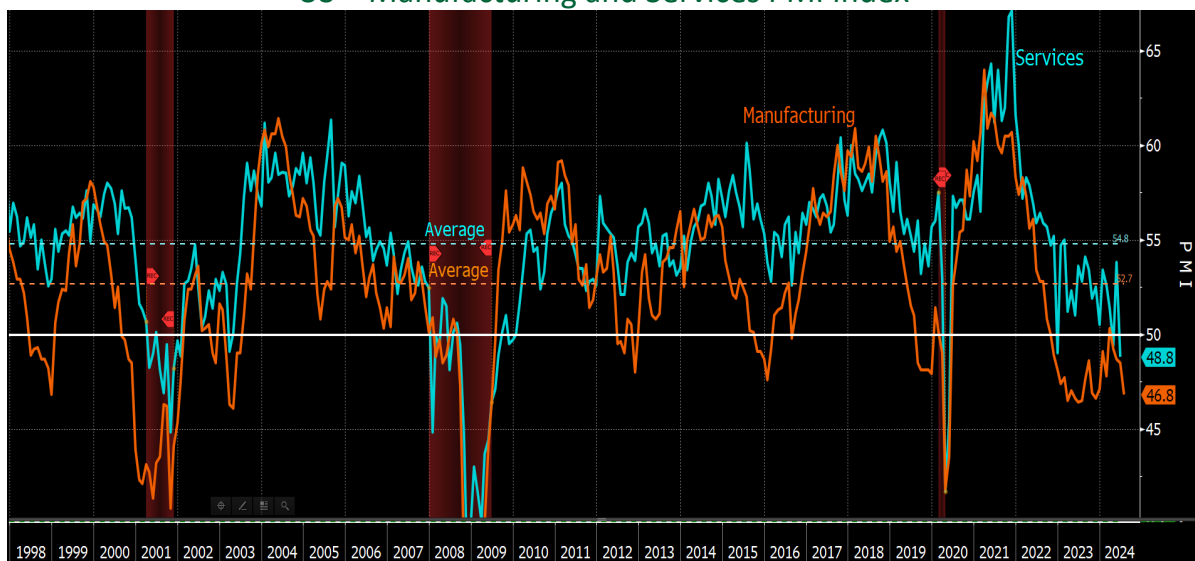
Investor focus has moved decisively from considerations around US inflation to those around US economic growth.

US – New Employment ('000, 3-month moving average) vs Unemployment Rate (%)



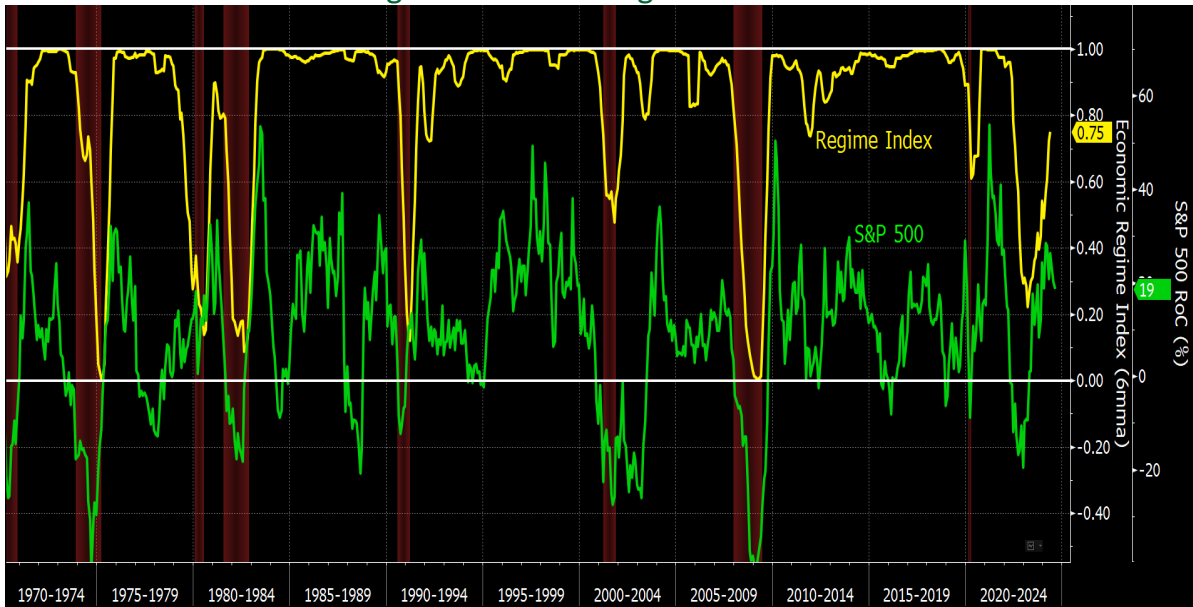
The unemployment rate in July rose well above the psychological 4.0% barrier to 4.3% (the orange line in the above chart), and the new employment number of only 114,000 (the second lowest since the Pandemic after April's 108,000). Investor consciousness about a potentially weakening US economy is suddenly a front of mind issue.

US – Manufacturing and Services PMI Index



Both the Manufacturing and Services PMI Indices are currently in contraction territory, with the former now dropping after a recovery period. It is clear that the sustainability of current economic growth is coming under question.

Bloomberg US Economic Regime Index vs S&P 500



Bloomberg's Economic Regime Index (the yellow line) considers several economic activities (e.g. changes in Capacity Utilisation and Jobless Claims, Consumer Sentiment, etc.). A downward trend indicates growing odds of a recession. The current positive trend has not raised such an alarm yet. Likewise, the trusted Conference Board Leading Economic Index currently also has a positive trend.

We are careful to make judgement on one month's employment numbers, but with these contradictory indicators, we believe the US economy is in a late phase of expansion and that odds are for it to cool from this quarter.

2. FED TASK

With US inflation seemingly under control (even though it still has some way to go to the Federal Reserve (Fed)'s target rate of 2%), the sustained health of the US economy is becoming a focus point. It is clearly a critical task for the Fed to consider their potential stimulus at the right time to prevent a potentially too quickly cooling economy evolving into a recession.

US – Fed Number of Target Rate Cuts in 2024 vs Treasury Yield (%)



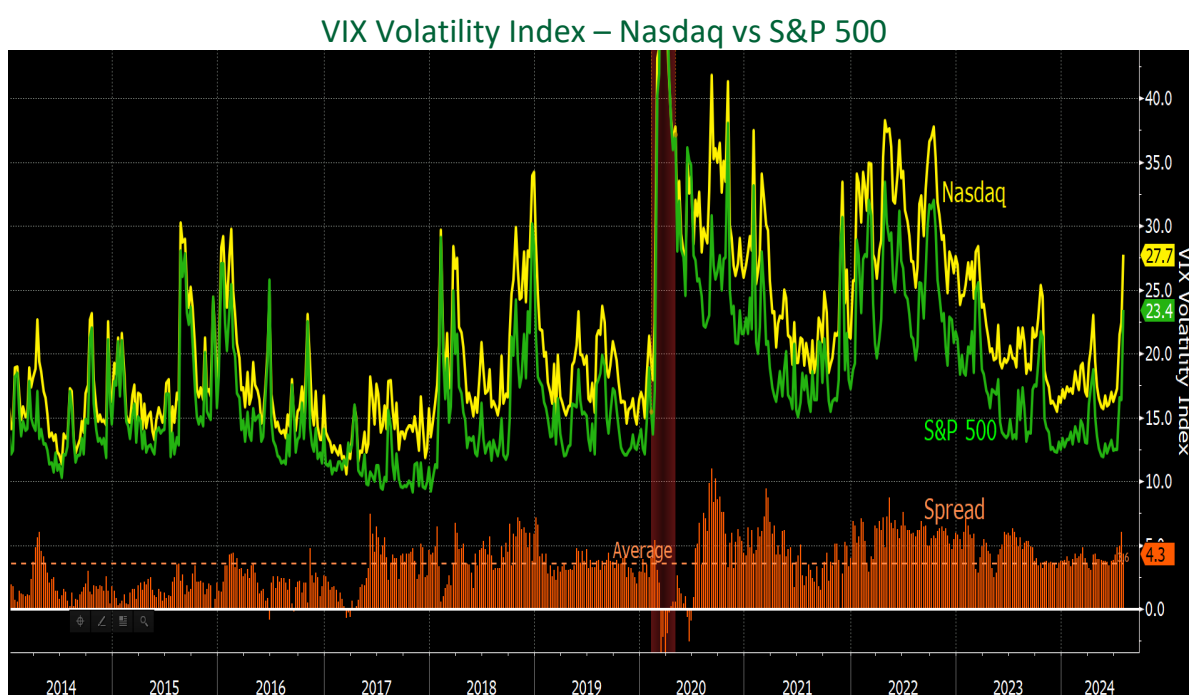
The green line in the preceding chart depicts the number of Fed target rate cuts expected this year, as derived from futures models. Whilst the trend has been slightly positive for two months now, it has recently spiked sharply to 4.6 times. This spike follows the constructive US inflation and softer employment numbers. There are only four Fed meetings remaining this year. Assuming quarter point cuts, this indicates a total of around a 1% cut with the target rate at 4.5% at the end of the year.

We also take cognisance of the sudden sharp drop in US interest rates – see the ten-year Treasury Yield in the chart (the orange line). This reflects investor reservations about the economy and has weakened the Dollar. A weaker Dollar may support the US economy to be more competitive in the international market.

We can expect pressure from the public on the Fed to be timeous with their easing process, and to keep the US economy on course.

3. MARKET VOLATILITY

The change in the US economic outlook has caused a quick and volatile reaction in the stock market. Investors switched from their higher-valued large capitalisation growth stocks to lower-valued and small capitalisation stocks. This reaction is based on the premise that these lower quality businesses will find it easier with lower interest rates and is already known as The Great Rotation. It has particularly affected Technology related stocks.

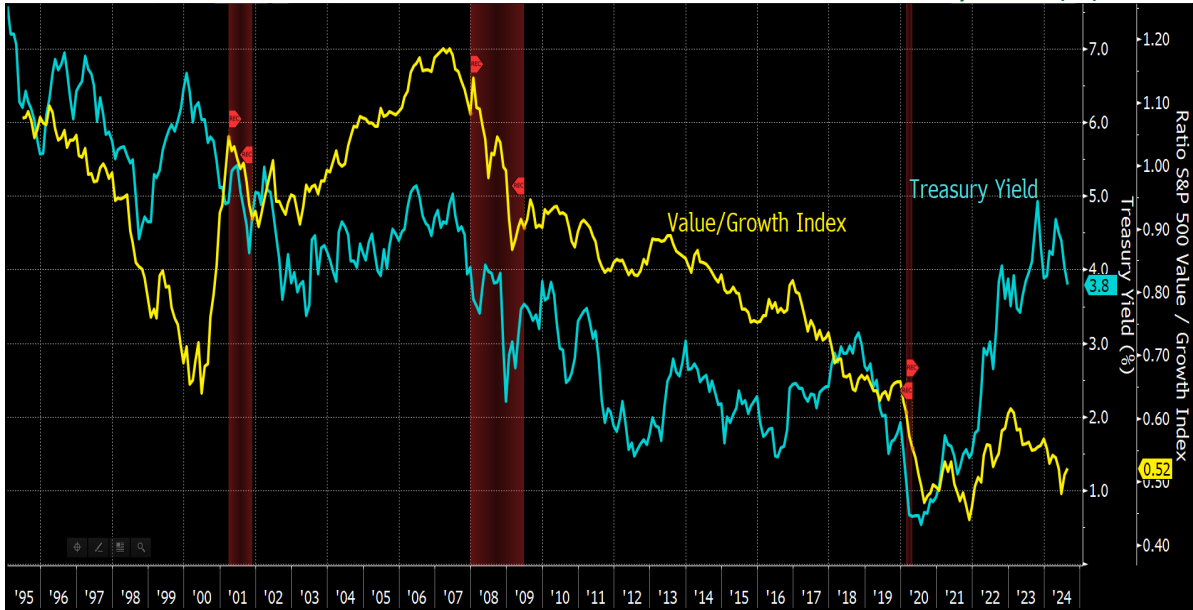


Whilst the volatility recently increased materially for both the Nasdaq and the S&P 500 indices (the yellow and green lines in the above chart), it seems relatively normal for the post-Pandemic period of higher volatilities. The spread between the two indices’ volatilities (the orange bars) stayed relatively close to average, implying a normal volatility period and nothing particularly untoward. This is a topical point for those concerned about their technology stocks.

To indicate the extent of the rotation in favour of small-cap stocks, the Russell 2000 Index outperformed the S&P 500 by 14% in July, but has since lost 5% of the relative performance. We show on the following page the relative performance of the S&P Value Index, compared to the S&P Growth Index, with the drop in interest rates. Bottom-to-top, it has also outperformed the Growth Index by almost 14% in July.



Relative Performance – S&P Value / Growth Index vs Treasury Yield (%)



Considering the historic correlation between the two series in the chart, lower interest rates have argued in favour of Growth at the cost of Value investing. Seeing the dull economic outlook and expectations of lower interest rates, we believe we can look forward to Growth resuming its outperformance in the not-too-distant future.

4. CORPORATE BOND MARKET

The corporate bond is a good proxy of changes in investor perceptions.

US – High Yield Spread (with Treasury Yield) vs S&P 500



The High Yield Spread has been in constructive territory for a while (between average and -1 standard deviation), but has recently spiked upwards, along with the stock market volatility. Whilst the current reading remains in constructive territory, with its historic inverse correlation with the stock market, investors should take cognisance of this spike. Should it persist, it may be a signal for more caution.



5. EARNINGS

The second quarter earnings season is well under way, with three quarters of the S&P 500 constituents already having reported. On a consolidated basis they have delivered revenue growth of +5% and bottom-line earnings growth of +11%. This is respectively +1% and +5% better than consensus expectations and shareholders can generally be happy with operational performances. Those companies that disappointed on their results or outlook comments have been severely punished by the market.

S&P 500 – Consensus One Year Forward Earnings vs Valuation (\$)



Consensus earnings expectations continue to trend upwards (the green line in the above chart), indicating an expectation of +12% growth over the next twelve months. The important issue, clearly, is how these expectations may change over time.

S&P 500 vs 12 Month Forward Consensus Valuation



The S&P 500 Index follows the consensus target valuations closely over time. The upside on the Index on this basis is currently +15%. This exceeds the average upside of +12%. Should earnings expectations be maintained, the chances are that valuations may increase based on lowering interest rates. On this basis alone, the market is somewhat better than just fairly valued and may offer opportunities during the current volatility.



6. US ELECTION

With the US election campaigns having started in earnest, investors look forward to more information of their respective promises and more clarity on the potential effects on capital markets.

PredictIt Probability of a Trump US Election Victory (%)



According to the above chart, chances are currently even between a potential Harris or a Trump victory. That said, investors recall quite a stock market reaction when Trump won unexpectedly in 2016.

2016 US Election - Trump Trade vs S&P 500 (\$)



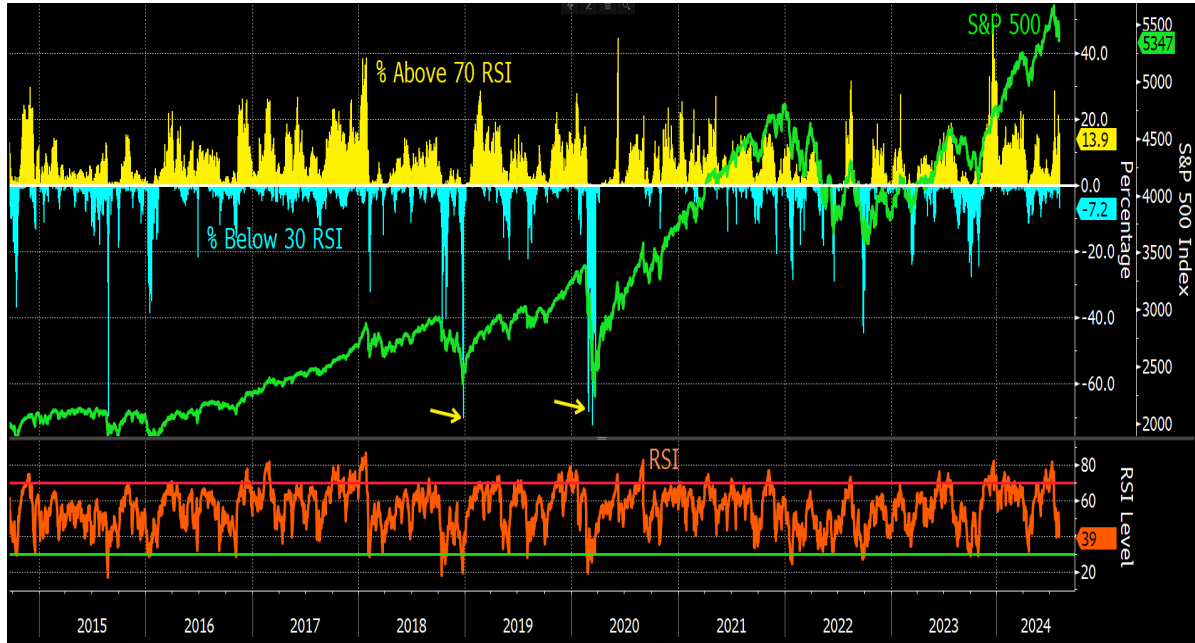
The stock market had a favourable reaction following the 2016 election with Industrial type of shares doing particularly well for a short spell, at the cost of stable type of businesses (the orange line depicts the Industrial Index relative to the Utilities Index). That experience was repeated a year later when he cut the corporate tax rate from 35% to 21% and allowed corporations to repatriate certain of their foreign incomes tax free. These 'Trump Trades' in both instances quickly unwound after the sharp spikes, while the overall stock market continued to perform well, barring the end of 2018 with the Fed tightening and the global economic slowdown.

Should Trump win again, he clearly does not have the same tools this time. One can expect a similar orientation, with risk of his administration interfering with some of the current Biden subsidies. That being said, we do not think it is a good idea to reposition our portfolio in anticipation of any politician's campaign comments.



7. TECHNICAL PICTURE

S&P 500 – Price Index vs % of Constituents Above/Below their 70/30 RSI Levels



With the high market volatility, the overall S&P 500 RSI has dropped materially, getting close to the oversold 30 RSI Index level (the orange line). Only 7% of the constituents are below that level (the blue bars), and as such not yet indicating an oversold picture.

Nasdaq – Price Index vs 50- and 200-Day Moving Average and RSI Level



The Nasdaq has made a technical break below its 50-day moving average (the blue line), with its RSI at a low level of 35 (the purple line). 14% of its constituents are below the 30 RSI level. It seems technology shares are somewhat more oversold than the S&P 500, but not yet at extreme levels to warrant immediate action.

Gerrit Smit

**Partner - Head of Global Equity Management
Stonehage Fleming Investment Management Limited**

6 St James's Square
London
SW1Y 4JU

T +44 20 7087 0000
Email gerrit.smit@stonehagefleming.com
www.stonehagefleming.com/gbi



RISK DISCLOSURE

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