

## On the Cusp of Cuts?

Jul 2024

Markets rose again in August – though early month returns were sharply negative as fears of a hard landing resurfaced and a few popular trades unwound (more on which in a moment). By the end of the month, though, many markets were in the black. In USD terms, the MSCI ACWI Index rose +2.5% as central bankers held their annual gathering at Jackson Hole, WY, and generally concluded imminent rate cuts were on the table, if not effectively guaranteed. Though developed markets led, emerging markets were likewise broadly positive, including China, which has struggled year to date with a sluggish economy.

Early in the month, the combination of a slower-than-anticipated US jobs growth report and the unwinding of popular trades – namely, the yen carry trade – was broadly blamed for sending markets into a steep dive. The Bank of Japan, which faces the ongoing challenge of unwinding decades of ultra-loose monetary policy, decided to raise interest rates on July 31, bolstering the currency and forcing many investors who'd borrowed in cheaper yen to invest in ostensibly higher-returning areas. With the interest-rate hike and the resultant increase in the yen's value, some investors were forced to sell securities (including US technology names, among others) to cover those trades. Accordingly, among the worst decliners were some of the market's previously biggest gainers – namely, mega-cap technology names. The selloff was compounded by investors' seemingly anticipating an economy that would weaken faster than thought. However, bolstered by subsequent economic data which showed not only the US economy, but also other major global economies, on relatively firmer footing, markets rebounded and closed the month in positive territory.

Among the economic data lending confidence to investors: US retail sales were relatively sound, inflation slowed more than expected and weekly unemployment claims stayed steady; in the euro zone, inflation declined to +2.2% and moderated in Spain, Germany and France; UK inflation rose less than expected, shop prices fell for the first time in three years, wage growth was at its lowest in two years and business activity surprised to the upside. However, there were also ongoing signs of relative economic malaise in developed economies. For example, France's economic growth disappointed. Furthermore, there continue to be conflicting signals about where prices are headed – e.g., while wages fell in the UK, they soared in Germany.

Uncertainty aside, central bank heads mostly remained committed to forthcoming interest-rate cuts, with Fed chief Jerome Powell all but promising a September cut. The European Central Bank (ECB) cut interest rates for the second time in three months in September. Bank of England governor Andrew Bailey, on the heels of the BoE's first rate cut in four years in August, also seemed to be feeling more sanguine about the inflationary outlook, going so far as to suggest the UK might achieve the elusive soft landing everyone is striving for.

China continues dealing with the fallout from its significant property sector slowdown – and in July, it notched its slowest industrial output growth in four months. Complicating China's attempts to boost economic activity are ongoing trade tensions with developed countries, including Europe, the US and, recently, Canada. Canadian prime minister, Justin Trudeau, announced in August the country would impose steep tariffs on Chinese electric vehicles (EVs) and steel, following in the US's footsteps. However, tariffs aside, Chinese steel exports are poised to reach an eight-year high this year, flooding global markets, pushing steel prices down and threatening to further roil already tense trade relations. Meanwhile, China has curbed its exports of germanium and gallium – key components in semiconductor manufacturing as well as military and communications equipment production – which could lead to semiconductor supply chain constrictions.

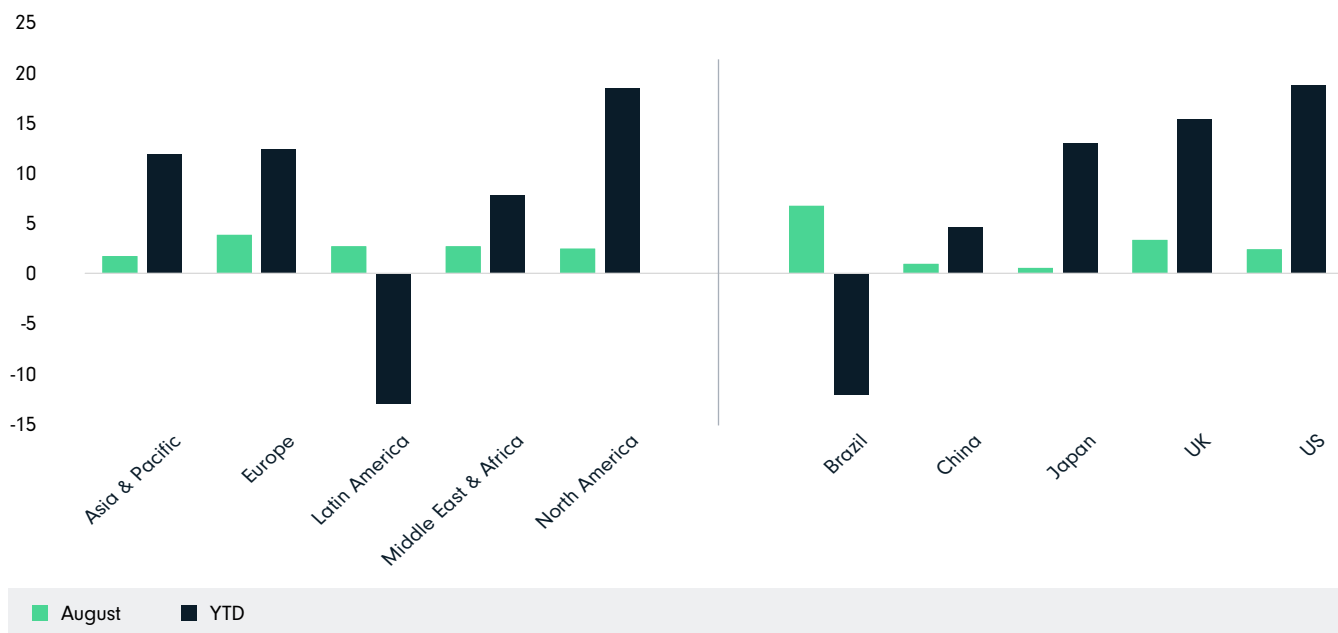
Geopolitical tensions remain top of mind outside of China, too – with ongoing war between Russia and Ukraine as well as in the Middle East. In Latin America, Venezuela’s supreme court certified the results of what is broadly considered a fraudulent election, leaving President Nicolas Maduro in power. Elsewhere, political violence tied to mass migration roiled the United Kingdom. And as the presidential election approaches, some anticipate growing political violence in the US as well – though the Democratic National Convention, held in late-August in Chicago – was overall more peaceful than anticipated.

Regionally, European stocks led in August, up +3.8% and led by Finland (+5.6%), Spain (+4.9%) and Italy (+4.9%). Germany also rose nicely, up +4.8%, and the UK was up +3.3%. Only three European countries were in the red in the month: Turkey (-10.0%), which continues struggling with rampant inflation, Greece (-1.9%) and the Czech Republic (-0.1%).

In the Middle East and Africa, stocks were also in the black, up +2.7% for the month and led by Israel (+8.1%), Egypt (+5.6%) and South Africa (+3.6%). Kuwait was the sole decliner, falling a modest -0.5%. Latin American stocks were just behind, rising +2.7% led by Brazil (+6.7%) and Chile (+3.4%). Mexico was the sole decliner, falling -5.3%.

North America was up +2.4%, with the US driving most of that gain, also rising +2.4%. The Asia and Pacific region similarly made smaller gains, rising +1.7% and led by strong returns from the Philippines (+10.4%), Indonesia (+9.9%), and Malaysia (+9.8%). Korea was the region’s worst performer, declining -2.2%, while China was up 0.9% and Japan was modestly up 0.2%.

**Exhibit 1 – August Returns for Major Markets (USD) (%)**



Source: FactSet, as of 31 August 2024.

At sectors were in positive territory in August, led by health care (+6.3%) and real estate (+4.8%) as investors anticipated an improved environment as interest rates start to moderate. Communication services (+4.2%) and consumer staples (+3.7%) were also nicely positive. Materials (+0.4%), energy (+1.3%) and technology (+1.6%) delivered the month’s most modest gains – the latter noteworthy given some of the previous popular trades for large technology names unwound to some degree during the month.

Though the month started in volatile fashion, by most measures, the decline didn’t quite reach what is typically considered correction territory (represented by a peak-to-trough decline of -10%). However, it certainly did seem to rattle some nerves – until it didn’t. Markets overall continue riding the general belief global central bank heads are going to successfully thread the needle of bringing interest rates down without reigniting inflation and before economic activity slows altogether. As ever, time will tell whether this faith is warranted. And in the meantime, expect further turmoil in the months ahead as US election season heats up and ongoing sources of tension around the world remain in the headlines.

Volatility and turmoil aside, we maintain our conviction in our time-tested approach to investing, which is intentionally designed to see beyond today's headlines to a sufficiently long-term outlook that the noise is dulled. However, such an approach requires a highly disciplined, fundamentally oriented, bottom-up approach to identifying high-quality companies which we believe are well-positioned to weather whatever environment prevails. As such, we will remain disciplined in the months and quarters ahead, doing our best to distill the news from the noise and identify investment candidates with the highest possible likelihood of delivering attractive long-term returns.

**MSCI ACWI Index** measures the performance of large- and mid-cap stocks in developed and emerging markets. **MSCI ACWI ex USA Index** measures the performance of large- and mid-cap stocks in developed (excluding the US) and emerging markets. The indexes are unmanaged, market capitalization weighted, include net reinvested dividends, do not reflect fees or expenses (which would lower the return) and are not available for direct investment. Index data source: MSCI, Inc. See [diamond-hill.com/disclosures](https://diamond-hill.com/disclosures) for a full copy of the disclaimer.

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