JSB Capital Management, LLC

Pro-active Wealth Management

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On Friday the U.S. stock markets were blindsided when the July monthly employment data (non-farm payroll growth and the unemployment rate) came in unexpectedly weak. The market's knee-jerk reaction was to produce a significant selloff during the first few hours before coming back a bit in the last hour or so. Then in typical fashion, the markets saw continued weakness on Monday.

The selloff was primarily triggered by a sudden switch in the prevailing economic narrative from “soft landing” (an economic slowdown without any recession) to “hard landing” (a higher chance of a recession). The Federal Reserve Bank took most of the blame as they have stubbornly maintained what some economists feel are unnecessarily high interest rates for too long a period of time.

What Were the Catalysts for Today’s Market Decline?

There are four likely reasons for the market’s decline globally and then here in the U.S.:

1. Goldman Sachs analysts declared that the chances for a U.S. recession rose from a 10% chance to a 25% chance “sometime in the next 12 months!”

2. Berkshire Hathaway, a widely followed barometer of stock market attractiveness, announced after the Friday market close that they had reduced their holdings of one of their biggest positions, Apple, by half.

3. While a bit of an obscure indicator outside of economist’s dinner parties, “the Sahm Rule” states that a recession is likely underway when the three-month moving average of the U.S. unemployment rate rises by 0.5 percentage points or more relative to its low during the previous 12 months. That indicator was reached on Friday.

4. Adding to the mix was an overall fear that the technological stock-based run-up in the markets over the Artificial Intelligence boom was overdone and needed to experience a normal correction.

Also, currency analysts are blaming some of the carnage on the Bank of Japan raising their short-term interest rates to shore up the Japanese Yen, thereby disturbing a multi-trillion-dollar valued trade position known as the “Yen Carry Trade.” The trade involves

borrowing huge sums of Yen-denominated debt and then buying U.S. Treasuries (usually) using the higher interest rate bearing Treasuries to pay off the Japanese debt.

It is believed that financial markets are supposed to capture the “wisdom of the crowd,” but on Monday the crowd from all over the globe ran in all directions waving its hands in the air shrieking and panicking. Japan’s stock market fell the most in 37 years and the U.S. measure of stock market volatility, the VIX index, had the second-biggest rise in data back to 1990.

What Does This All Mean?

Most of the catalysts are likely one-and-done. The panic should be relatively limited in time, as the majority of the recent earnings reports for the larger companies have been very good. Although the Sahm Rule has a pretty good track record of indicating recessions, there’s little reason to panic sell stocks right now.

In addition, the Federal Reserve Bank, through its FOMC, is highly aware of the precarious nature of the current economy (influenced greatly by their insistence on keeping rates “higher for longer”) and is certainly going to make some kind of stabilizing gesture if there is a prolonged weakness in the overall markets. Many are calling for an intra-meeting rate cut of up to 0.50% with some insisting that a 0.75% rate cut in September is appropriate. That kind of benign sentiment is likely to curtail extended stock selloffs for the near term.

The Bottom Line

While some analysts are stretching to compare the last two days of stock market weakness to previous declines such as “Black Monday” in 1987, or the Long-Tern Capital Management bond debacle of 1998 when the LTCM hedge fund was crushed when Russia’s domestic debt default created a flight to safety, or even the “Great Recession” of 2008 when numerous banks failed as their balance sheets were decimated by the toxic waste known as “Collateralized Debt Obligations.”

A. In 1987 the S&P 500 Index was up 36% in the first 9 months of the year, similar to the 33% increase that the same index saw at this year’s high-water mark. As in 1987, this year’s gains came despite tight monetary policy and higher bond yields. That’s where the similarity ends as the most lucrative trades this year (the Magnificent Seven technology stocks) have already experienced 30+ percent selloffs.

B. The LTCM fund threatened to bring down many of the other highly-leverage hedge funds as well as the overall stock market, but The Fed cut rates three times and rallied a group of big banks to rescue the firm and wind down its trades slowly. Stocks took just four months to recover.

C. While the 2008 plunge took years to recover, a similar catalyst of toxic waste doesn't exist today. There have been some banks in the last couple of years that have had to be acquired because of pathetic risk management, but there isn't anything close to what caused the Great Recession. The largest banks are much less leveraged than they were in 2008, and the system is less exposed to a liquidity crisis, as private lenders have taken on much of the risk that used to sit in banks.

Game Plan

As of this writing, there is no reason to make any changes to the portfolios as they have been substantially hardened over the last 18 months or so and the allocations to 5-plus percent yielding U.S. Treasuries and low volatility preferred stocks have been very prudent and rewarding.