



GROWTH MORE IMPORTANT
NOT INTEREST RATE

When The FED Cuts, Cut Your Risk

CIO Insights
July 2024

When The FED Cuts, Cut Your Risk

... “elevated inflation is not the only risk we face”. Cutting interest rates “too late or too little could unduly weaken economic activity and employment”...FED Chair Powell

Optimism on the FED soon commencing a rate easing cycle has driven a rare small cap performance, absolute and relative on the premise that smaller companies benefit more from rate cuts. While this may be so on a relative basis, ultimately it's growth that drives share prices rather than interest rates or valuations. We focus on the “why” of a FED easing cycle, which inevitably is driven by growth concerns rather than softer inflation alone. History also suggests that equities decline when the FED starts cutting. This is all the more pertinent when the current cycle appears extended on multiple parameters. With the FED expected to start easing in Sep (or a surprise in July?), and equities priced to perfection, delivering on earnings expectations becomes that much more critical to retain a bullish agenda.



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How Strong Is Growth?

The 9.7-9.8% growth in 2Q'24 earnings for SPX are expected to come in at the highest growth rate since 4Q'21 (led by sales acceleration and margin expansion). This is however heavily concentrated amongst megacaps – four of these in particular are expected to deliver 56% growth with the rest of the index coming in at a more modest 5.6-5.7%. We remain optimistic on the growth stocks as long as they continue to deliver on earnings, although we do recognize that the current cycle is very long in the tooth.

Is There A Case for Small Caps?

Recent optimism notwithstanding, our analysis suggests that the headwind from growth is larger than the expected tailwind from easier interest rates. We tread with caution on the market's unidimensional focus on interest rates as the driver for small cap performance. The one scenario where small caps could continue to deliver absolute performance would be a "goldilocks" outcome where the FED eases as expected while growth trends remain intact – possible, YES, Likely, NO!

Large Caps On Sale

While the moniker of classifying large caps being on sale may appear misplaced given that many of these trade at over 60x PE, relative to growth expectations, the recent damage to share prices does represent better opportunities in growth megacaps, in our view.

Summary

- **Economic Growth Is Slowing** – While there are clear, early signs of growth pulling back, these are moderate at this stage. However, two of the strongest pillars, consumption and labor are the ones that are weakening. The key question is what tips this cycle over – in our view, its likely to be labor driving consumption, making the jobs market our keenest focus.
- **When Will the FED Cut and How Fast** - After a near one year pause, the FED appears all set to start easing rates from Sep'24 with a further cut in Dec'24. Given the increasingly dovish statements from the FED Chair, a surprise July rate cut should not be ruled out, even though not priced in.
- **Rate Cuts – Good or Not So?** - In the run up to the easing cycle, “bad news (economic)” is “good news (markets)” – when the FED starts easing, “bad news (economic)” becomes “bad news” for the markets.
- **Small Cap Optimism** – Driven by Rate Cuts – Is This Misplaced? - Small Cap absolute performance with need optimism on topline growth rather than just the benefit from easier monetary policy – that said, there does appear to be a case for outperformance vs. large caps, as interest rates decline.
- **Market Internals Better Than the Headline** - While the 14% decline in Mag-7 and a 20% pt underperformance vs. RUT may add credence to the unwind of exuberance, market internals appear more supportive. As before, valuations for SPX are expensive, mainly due to the Mag-7, but then so is earnings growth.
- **Earnings** – The Most Critical Variable - With a strong correlation to earnings, the outlook for SPX remains positive, AS LONG AS, companies do not miss.

Economic Growth Is Slowing

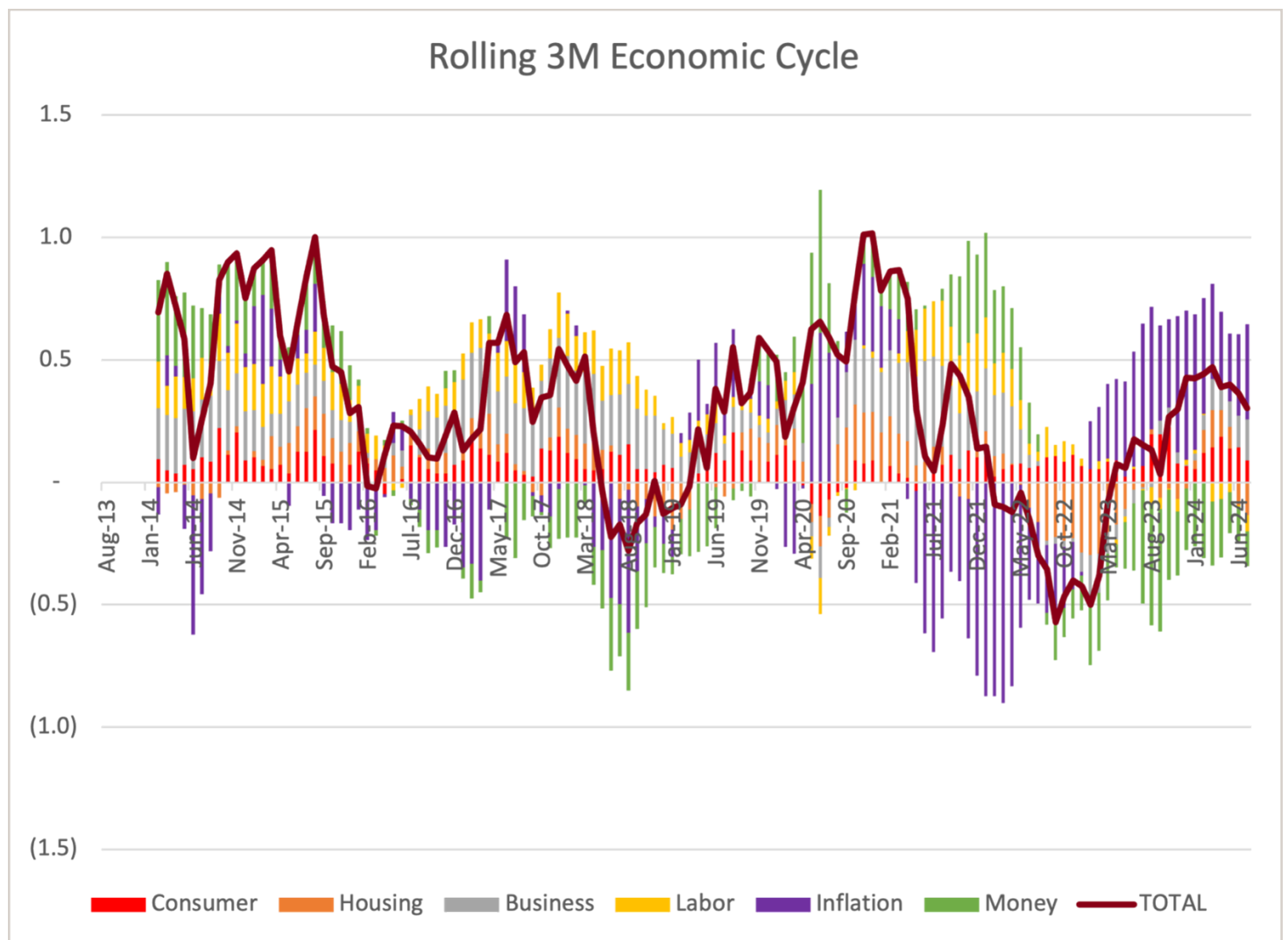
Our proprietary economic nowcaster has seen a moderate pullback following recent weakness in consumer and labor data sets.

Weaker Consumption – Consumption, accounting for nearly two-thirds of the US economy, is showing continued signs of deceleration as evidenced by weaker consumer confidence, slowing retail sales. Other data from card companies also suggests a slower pace.

Labor Market Weakens, not Alarmingly Yet – Labor market, a key pillar of strength in the current cycle, is also showing signs of weakness. Declining job vacancies (and a narrowing gap between vacancies and offers), lower quits rate provided early signs which have now been followed up in a trend of rising continuing jobless claims as well as a tick up in unemployment. **While the labor market has weakened, it does not appear to have reached a tipping point, yet.**

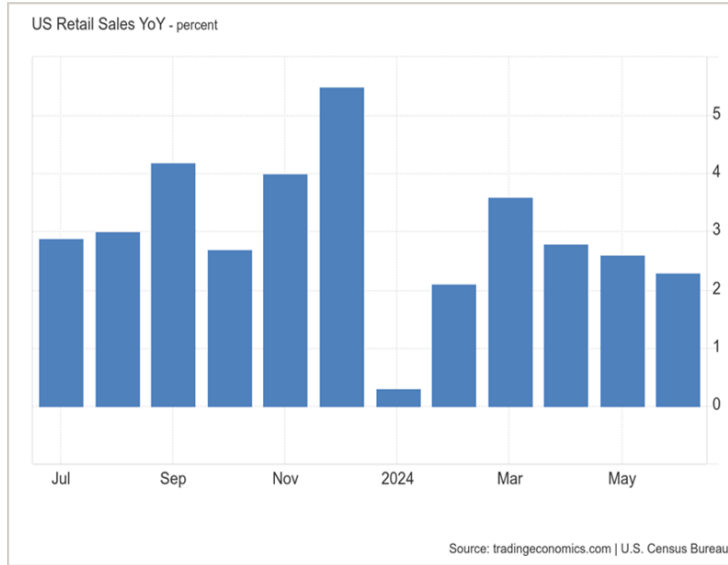
While there are clear, early signs of growth pulling back, these are moderate at this stage. However, two of the strongest pillars, consumption and labor are the ones that are weakening. The key question is what tips this cycle over – in our view, its likely to be labor driving consumption, making the jobs market our keenest focus.

Lighthouse Canton Proprietary Nowcaster

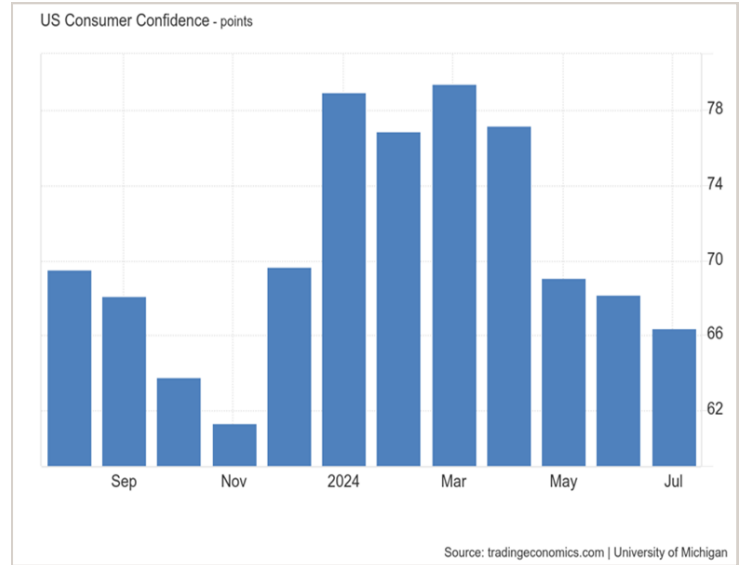


Source: Lighthouse Canton

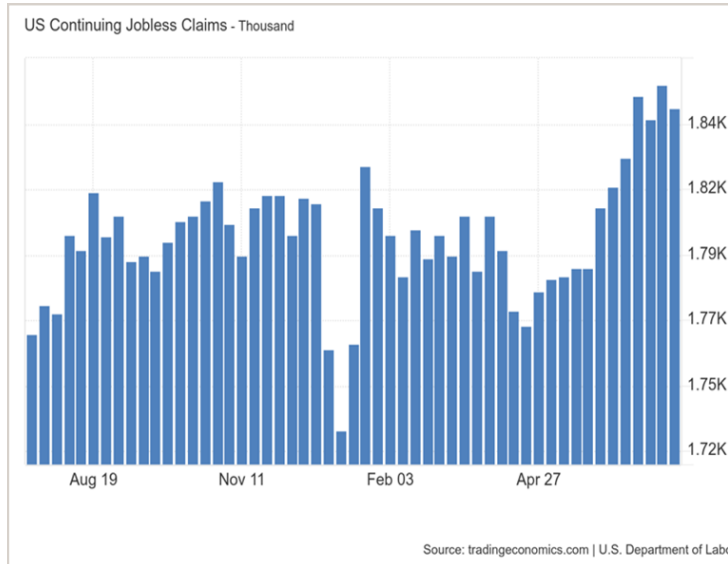
US Consumer Growth Is decelerating



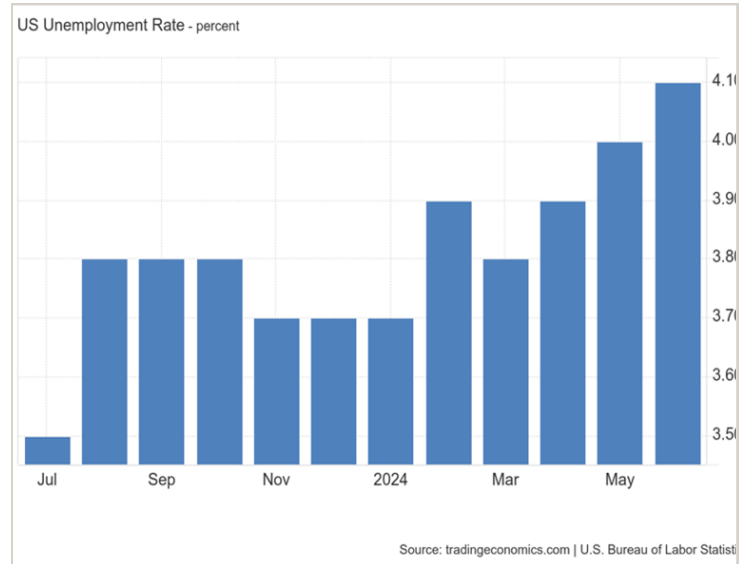
Source: Tradingeconomics.com



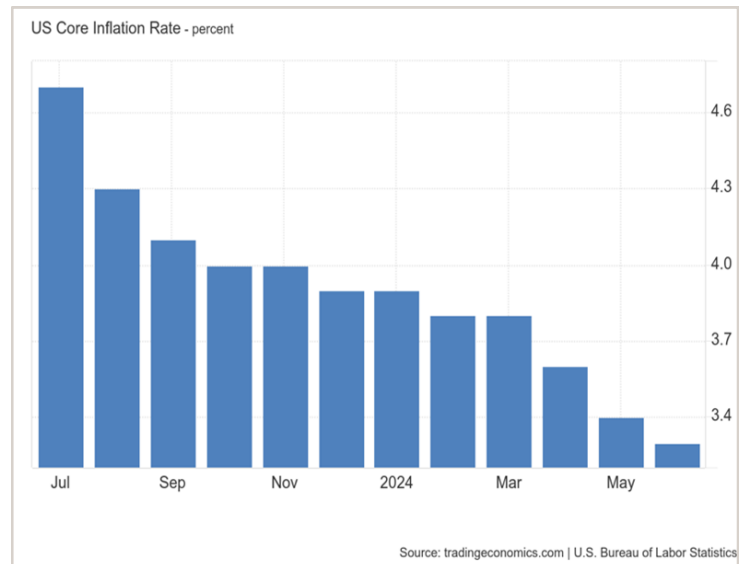
Labor Market is Showing Initial Signs of Deterioration



Source: Tradingeconomics.com



Job Openings Continue to Come Off as Inflation Slows Down



When Will the FED Cut and How Fast

With inflation slowing, and while not quite yet at the FED's 2% target, recent statements from the FED chair suggest their focus on economic growth as well as inflation, with the former likely requiring "pre-emptive" monetary easing.

First Rate Cut in Sep? – FED Funds Futures suggest a near 100% probability for the first rate cut.

Two Rate Cuts by Year-End and Five over the Next 12 Months – Despite the "dot-plots" indicating only one rate cut for 2024, FED Funds Futures are now pricing in two rate cuts with the second one a near consensus in Dec 2024. Equally, over the next 12 months, the market is now pricing in an aggregate 125bp rate cut.

Will The FED Cut in July 2024? – Neither is this priced in nor is this our base case. YET, we raise the possibility of a rate cut in July, more driven by Mr. Powell's suggestions of being "pre-emptive".

"elevated inflation is not the only risk we face". Cutting interest rates "too late or too little could unduly weaken economic activity and employment"
FED Chair Powell

After a near one year pause, the FED appears all set to start easing rates from Sep'24 with a further cut in Dec'24. Given the increasingly dovish statements from the FED Chair, a surprise July rate cut should not be ruled out, even though not priced in.

FED Funds Futures Suggested Probabilities

	CME FEDWATCH TOOL - AGGREGATED MEETING PROBABILITIES					
MEETING DATE	400-425	425-450	450-475	475-500	500-525	525-550
31/07/2024	0.00%	0.00%	0.00%	0.00%	6.20%	93.80%
18/09/2024	0.00%	0.00%	0.00%	12.20%	87.80%	0.00%
07/11/2024	0.00%	0.00%	0.00%	76.08%	23.92%	0.00%
18/12/2024	0.00%	0.00%	69.34%	30.66%	0.00%	0.00%
29/01/2025	0.00%	40.20%	59.80%	0.00%	0.00%	0.00%
19/03/2025	22.27%	77.73%	0.00%	0.00%	0.00%	0.00%
30/04/2025	80.20%	19.80%	0.00%	0.00%	0.00%	0.00%
18/06/2025	100.00%	0.00%	0.00%	0.00%	0.00%	0.00%
30/07/2025	100.00%	0.00%	0.00%	0.00%	0.00%	0.00%

Source: cmegroup.com

Rate Cuts – Good or Not So?

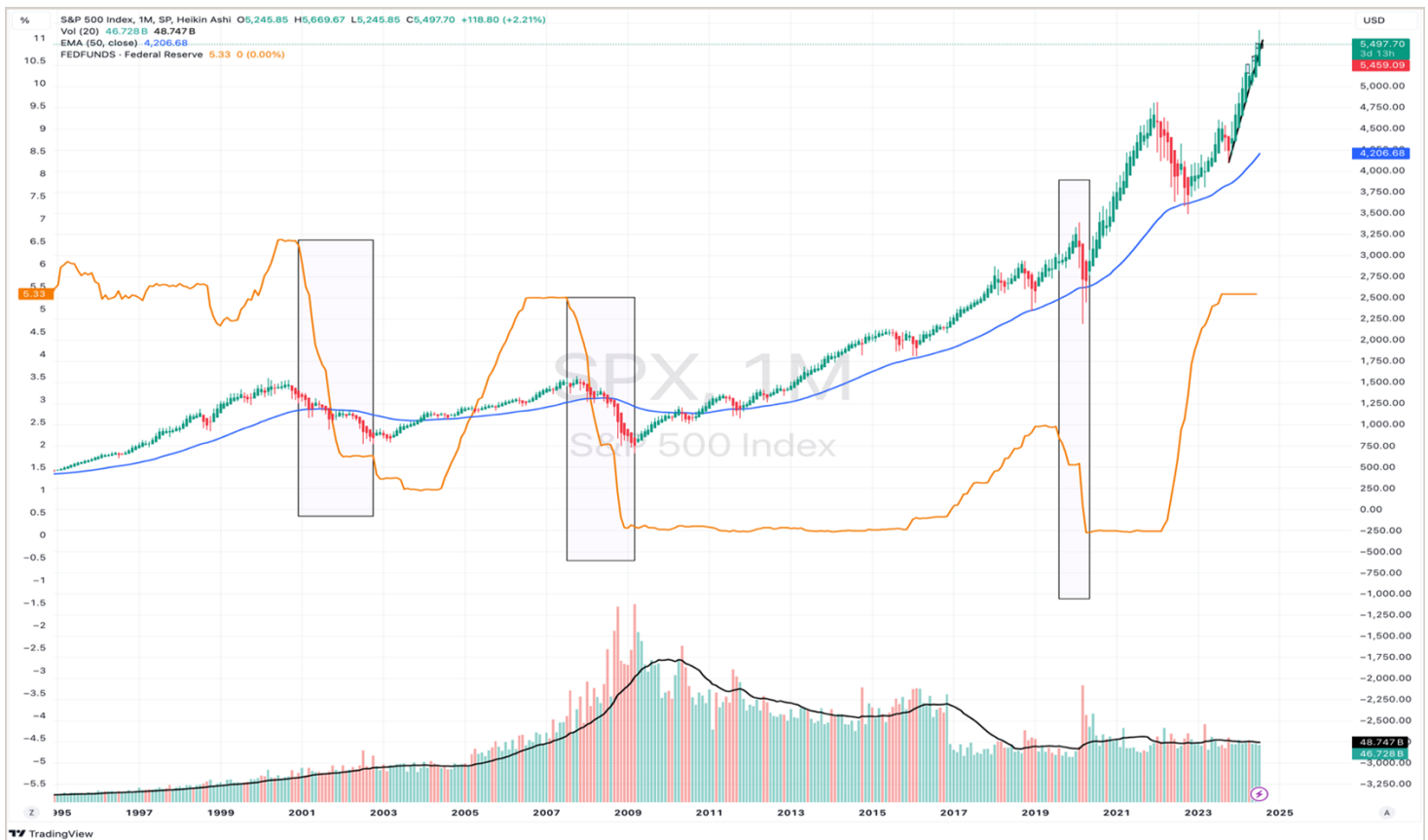
Following the FED pause on Oct 2023, equities unleashed an exceptional rally before recent peak in early July 2024. Should this optimism carry on into the actual rate cutting cycle?

Focus on the “Why” of Rate Cuts – Just as a restrictive monetary policy is designed to ease growth (& inflation), driving risk assets lower, an easier monetary stance should be stimulatory – however, we focus on the “why” of FED policy stance – rate easing cycles are almost always driven by concerns on growth rather than a simple comfort with inflationary trends. **While easing monetary policy is eventually stimulatory, there is a lag effect.**

When The FED starts cutting, Markets Fall – As the figure below shows, the commencement of a FED easing cycle coincides with equities starting a meaningful decline. We see this as a logical outcome since FED easing cycles are mostly driven by growth concerns (as also suggested by recent FED statements) – **weaker growth is a bigger headwind than the tailwind from lower interest rates – at least initially.**

In the run up to the easing cycle, “bad news (economic)” is “good news (markets)” – when the FED starts easing, “bad news (economic)” becomes “bad news” for the markets.

Equities Decline When the FED Starts to Cut



Source: Tradingview.com

Small Cap Optimism – Driven by Rate Cuts – Is This Misplaced?

A sharp reversal in absolute and relative performance for small caps (Russell 2000, RUT) has been driven by the optimism on an imminent easing cycle, especially following recent statements from the FED chairman. **The argument that lower interest rates will benefit the under-performing small caps more appears to have driven this optimism.**

Small Caps – Far More Sensitive to Growth Than to Interest Rates – As the charts below suggest, RUT's performance has followed a similar path as the large cap SPX – positive correlated with rising interest rates and much more sensitive to growth. We see the linkage to growth as logical given that a slowing top line matters more than the benefit from lower interest costs.

Small Cap absolute performance with need optimism on topline growth rather than just the benefit from easier monetary policy – that said, there does appear to be a case for outperformance vs. large caps, as interest rates decline.

Small Caps – Outperformance More Likely Though – We do note that while absolute performance is more aligned with growth trends, relative to the large cap SPX, easing monetary policy does appear to have a larger impact.

Early Days in Outperformance – Can It Sustain – On a daily time frame, analysing rotational trends based on value, growth and size, there is a clear move towards “small caps” and “value”, away from “growth” – however, on a weekly time frame, growth and large caps continue to outperform – **sustaining recent outperformance will be critical for small caps.**

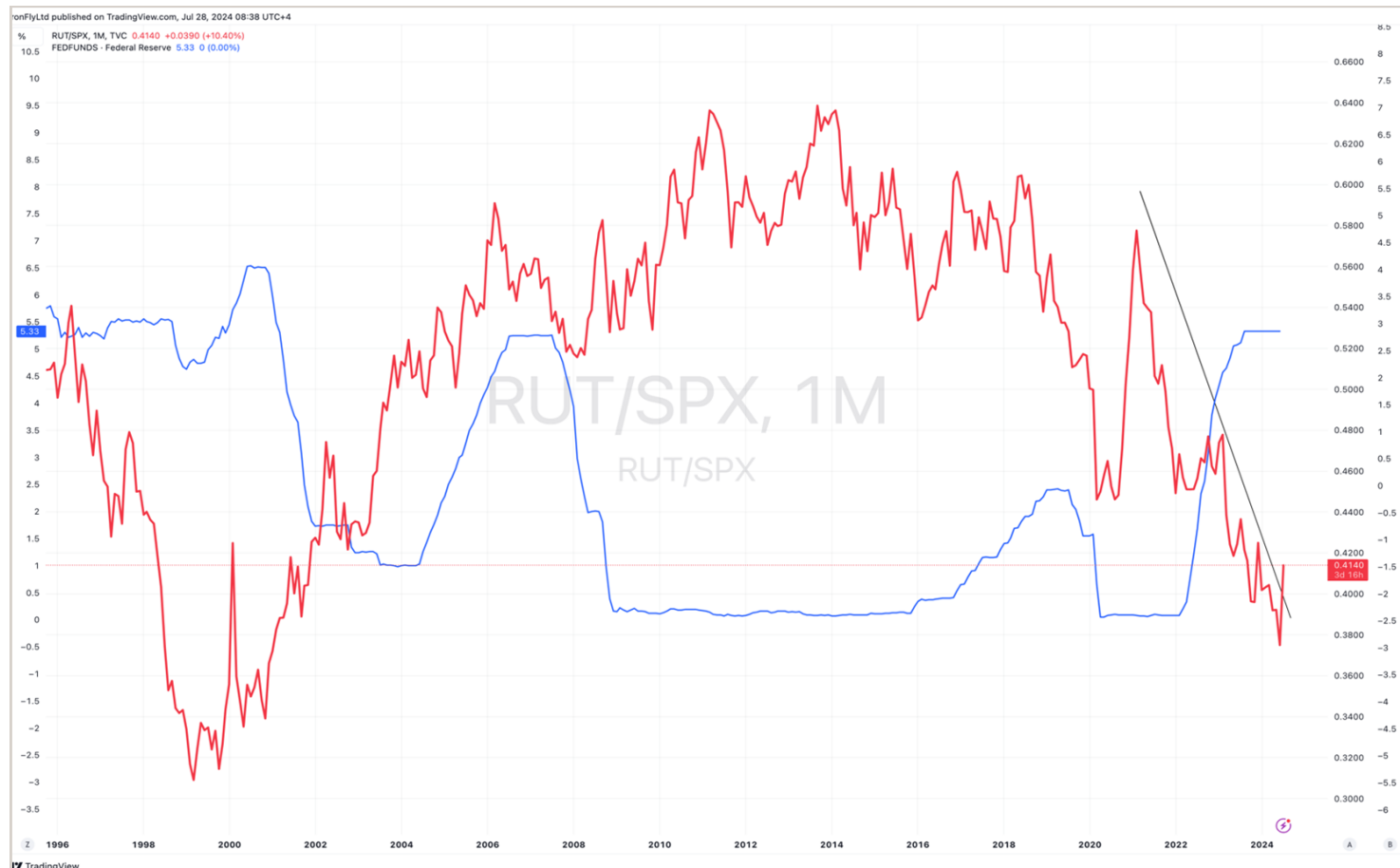
Small Caps – Far More Sensitive to Growth Than to Interest Rates



Source: Tradingview.com

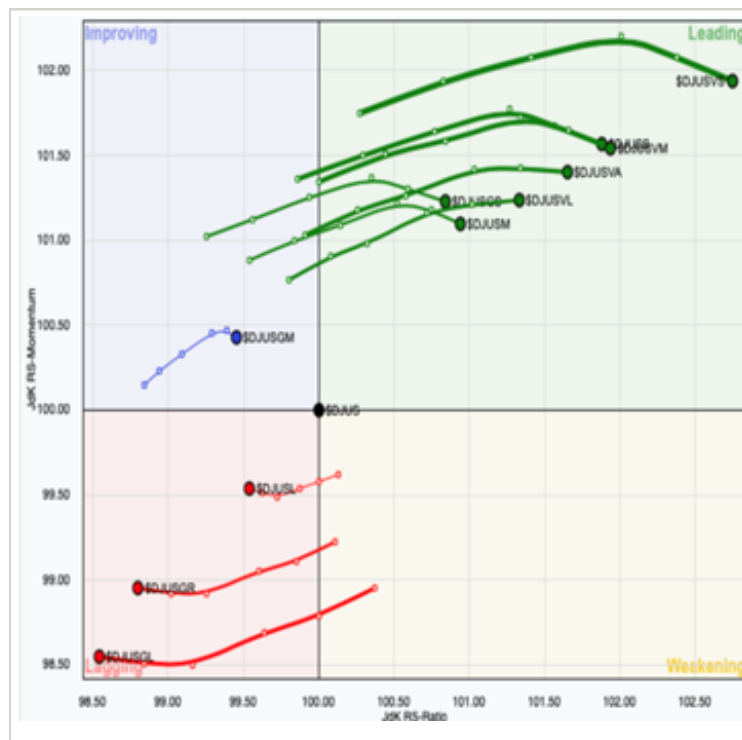
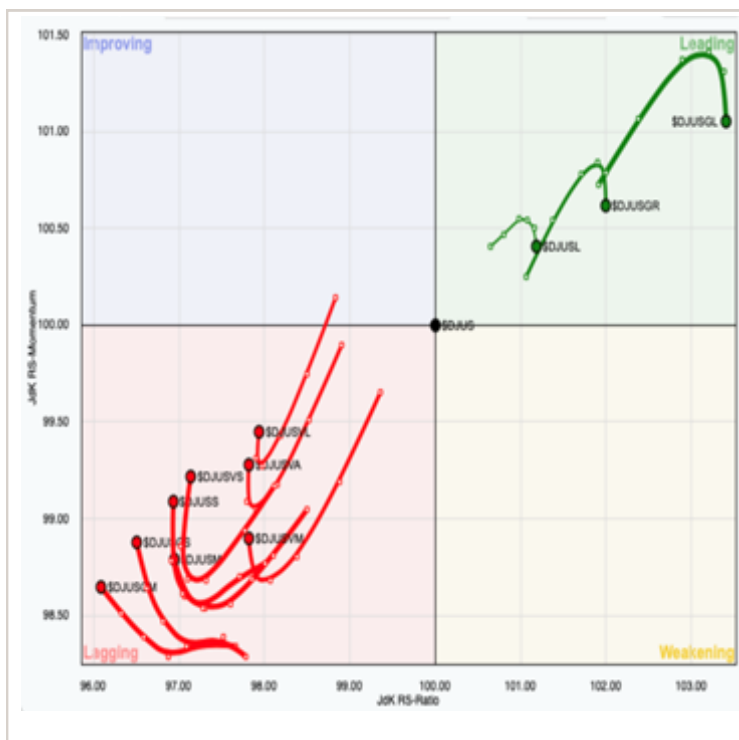


Small Caps Outperform as Rates Ease



Source:
Tradingview.com

Rotational Trends Favor Small Caps on a Daily Time Frame – Need to See Sustainability



Source: Stockcharts.com

Market Internals Better Than the Headline

The recent pull back in SPX, especially the headline “Mag-7” stocks has renewed the spectre of a “dotcom” style collapse, led by unwinding of the “irrational exuberance” surrounding AI. **We focus on market internals to see how much should we be concerned with these recent concerns.**

Equal Weighted S&P Appears Solidly Positioned – The equal weighted S&P (represented by RSP) neither displayed the meteoric rise since Nov’23, nor has it swooned as much as Nasdaq, suggesting that the broader market remains relatively robust, with the rout concentrated amongst a narrow group of stocks (just as the rally was).

SPX Defends key Trend Line and Sits on Critical Support Levels – Despite the sharp reversal in the week ending 26th July, SPX appears to have defended the uptrend from early Nov’23 lows. For now, both on the important 50dma, as well as recent congestion zone, SPX appears to have found initial support. **For a bullish argument for SPX to remain valid, defending the uptrend, key support levels (in the 5450 area) will be critical.**

Breadth is Supportive – The % of US stocks trading above 50dma has risen over the course of July, suggesting upside momentum for the broad market. No doubt this has been helped by the small cap performance – but as noted previously, even for S&P, the relatively benign performance of the equal weighted index suggests breadth is robust.

Mag 7 – Suddenly not so “magnificent” – The recent swoon appears to have been heavily dominated by the sharp decline in AI focused stocks, particularly the Mag-7 (in aggregate 30% of SPX). This is also the part of the market that has seen the most underperformance vs. the Small Cap index, RUT.

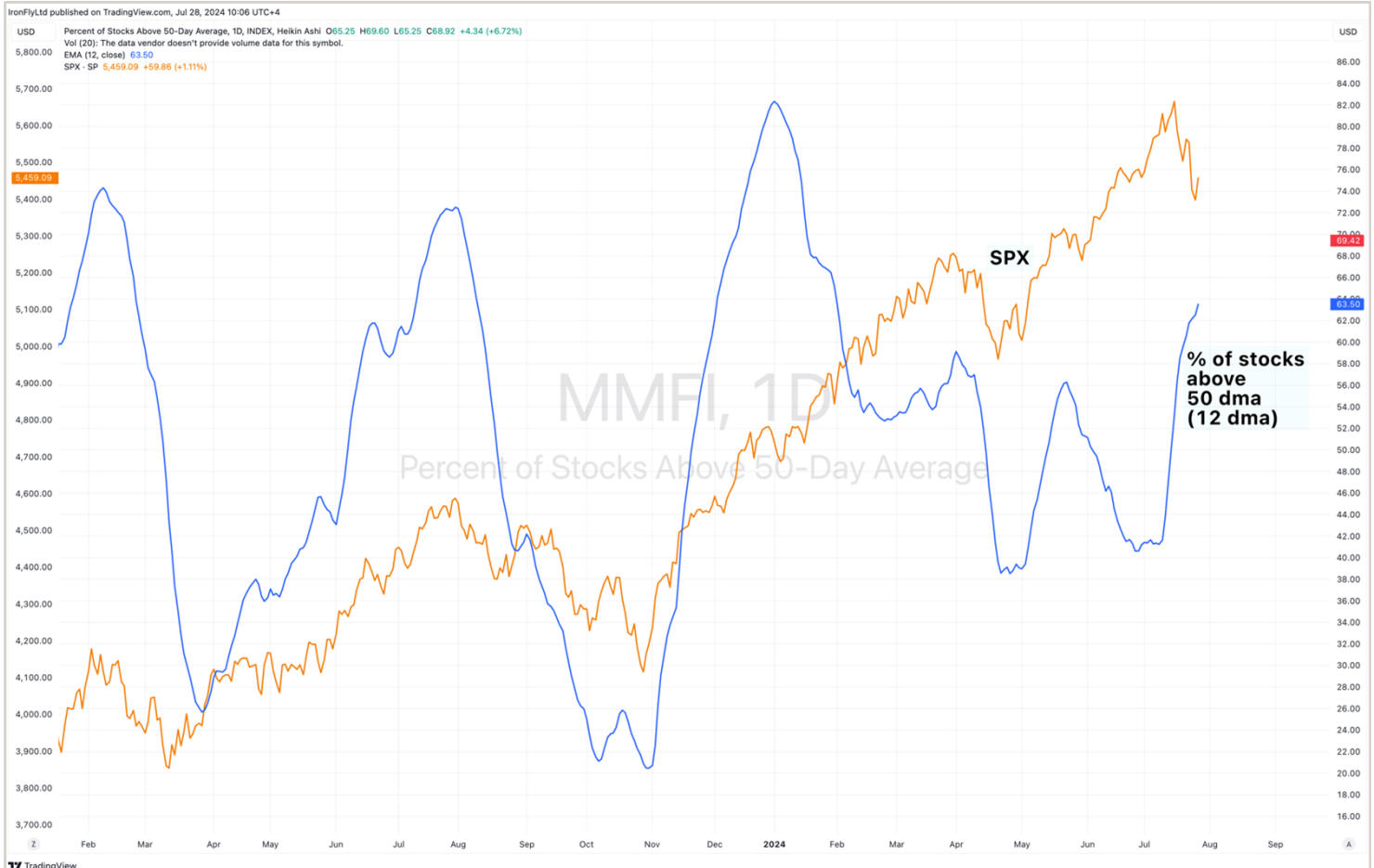
While the 14% decline in Mag-7 and a 20% pt underperformance vs. RUT may add credence to the unwind of exuberance, market internals appear more supportive. As before, valuations for SPX are expensive, mainly due to the Mag-7, but then so is earnings growth (which we discuss next).

Equal Weighed S&P – Remains Solidly Positioned/ SPX Sits on Critical Support



Source: Tradingview.com

SPX Breadth Remains Positive & Supportive



Source: Tradingview.com

Mag 7 Key Factor Leading the Decline



Source: Tradingview.com



Earnings – The Most Critical Variable

As we noted in our recent note “Price is What You Pay, Value is What You Get”, S&P has a correlation of over 90% with earnings – **as long as earnings come through, expensive valuations aren’t a catalyst in their own right.**

SPX More Correlated with Earnings Than Valuations - Charts below show a strong correlation between SPX and Sales and Earnings. A correlation of 0.91 with sales and 0.94 with earnings is not only significant, but also logical. Even at an individual security level, faster earnings growth is closely associated with share price appreciation.

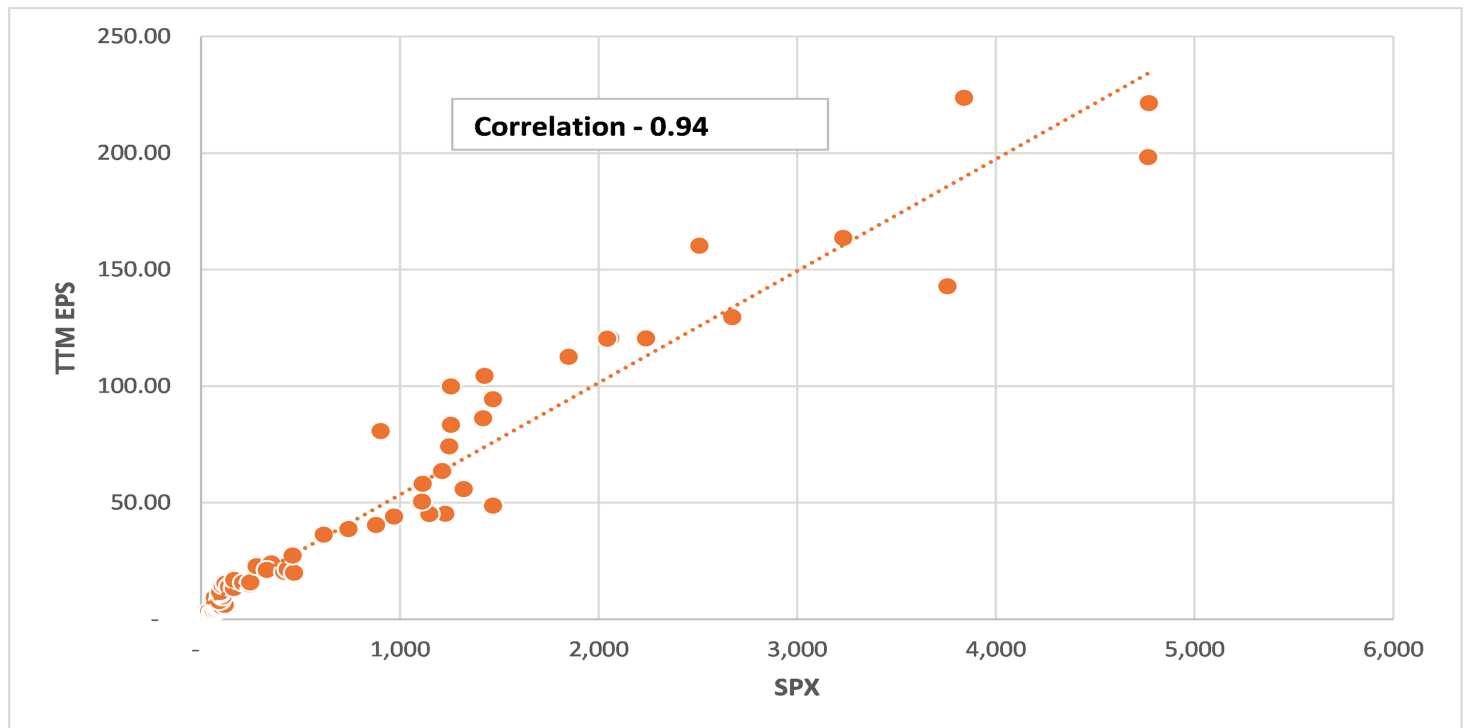
Proprietary Nowcaster Shows Optimism – Our earnings nowcaster shows an upward trend as sales and earnings growth accelerate, driving an upward trajectory in revisions.

Strong Margin Trends & Growth Projections – For 2Q’24, SPX earnings are expected to grow by 9.7-9.8%, the fastest since 4Q’21. Top line growth is expected to accelerate from 4% in 1Q’24 to 4.7% in 2Q’24. Margin trends also show a continuation of upside momentum for the third quarter running.

Priced to Perfection – No Room to Miss – While there is clearly optimism on the earnings outlook, this also appears to be substantially priced in – any miss on earnings (or guidance) has been asymmetrically punished by the market – a trend we saw in 1Q and continuing in 2Q’24 as well.

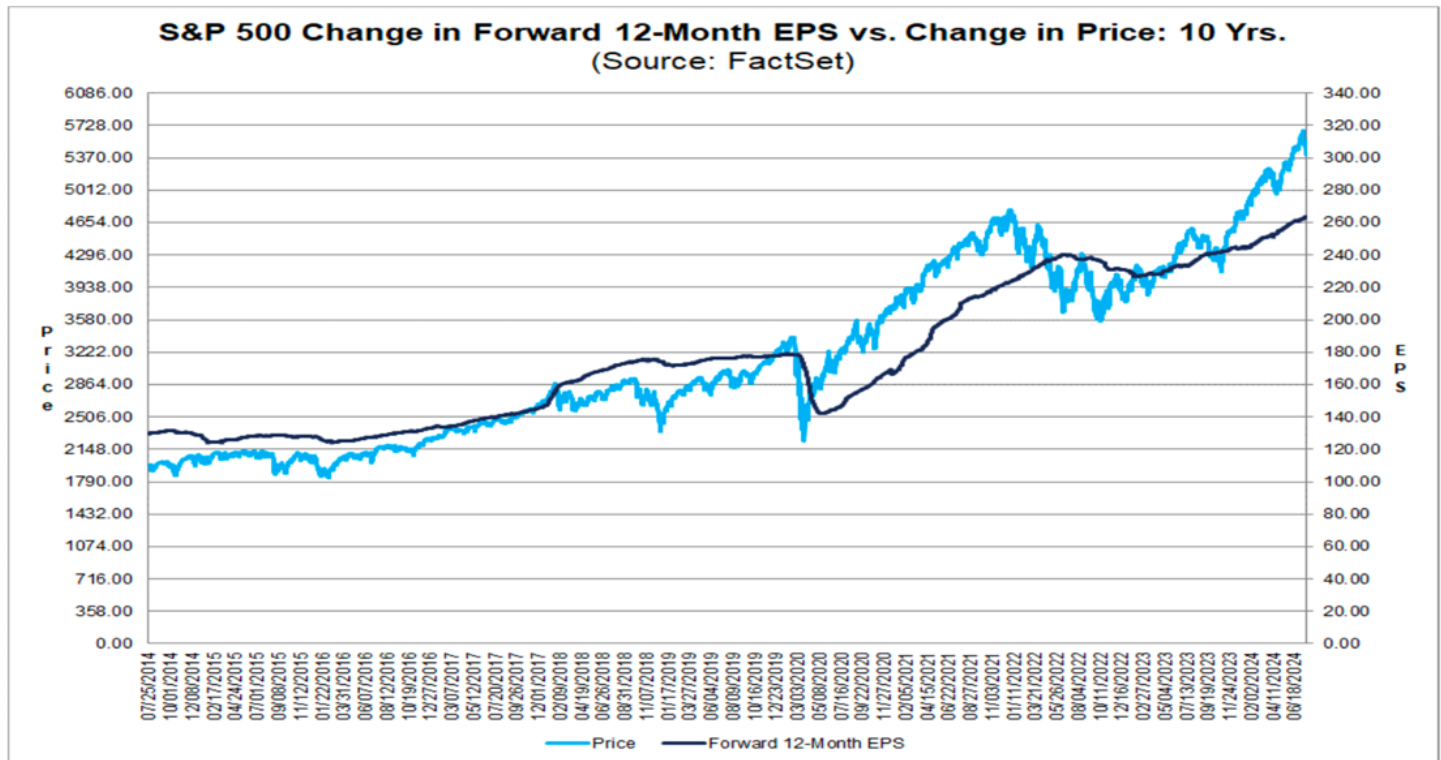
With a strong correlation to earnings, the outlook for SPX remains positive, AS LONG AS, companies do not miss.

Correlation – SPX & TTM EPS



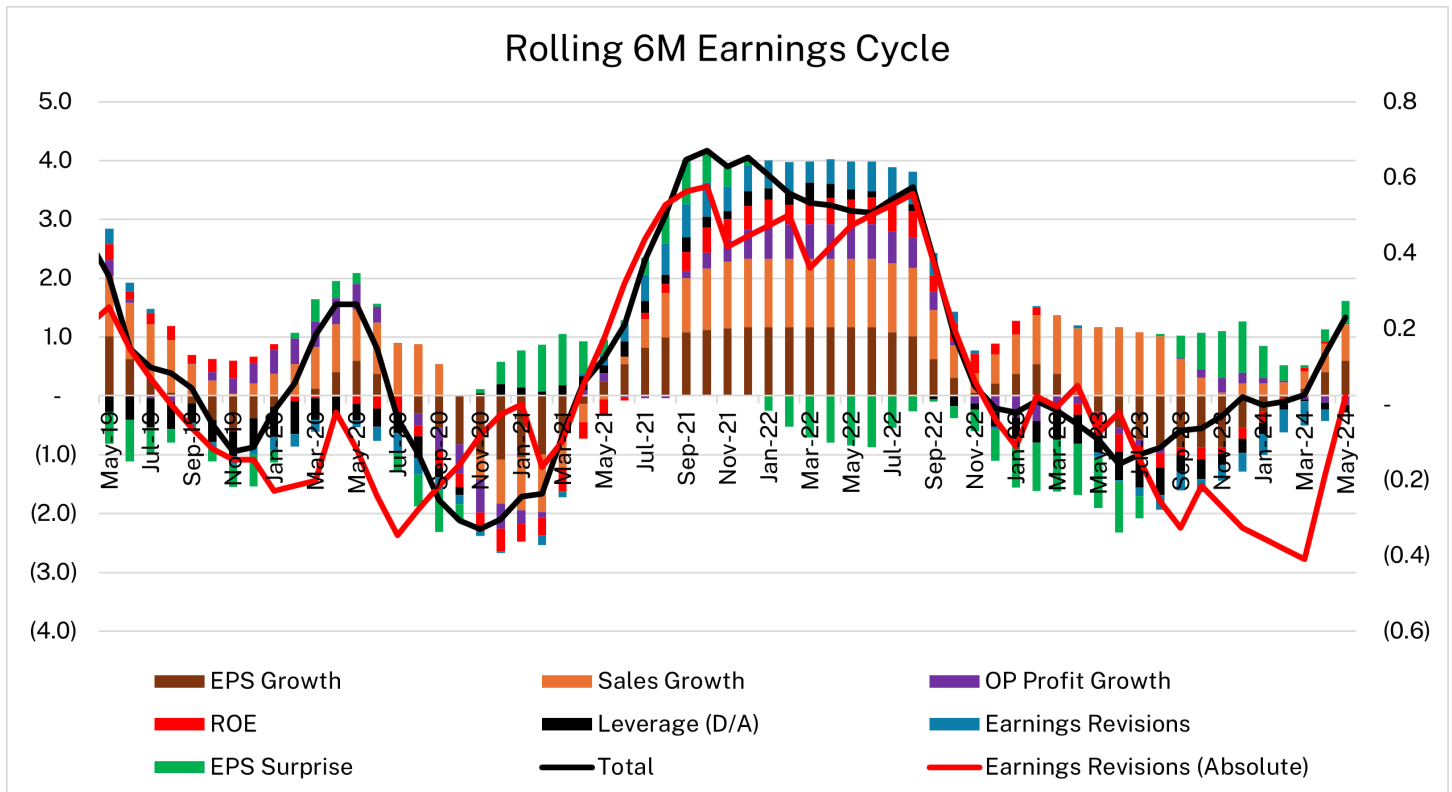
Source: Lighthouse Canton

SPX – Positive Correlation with Forward EPS Trends



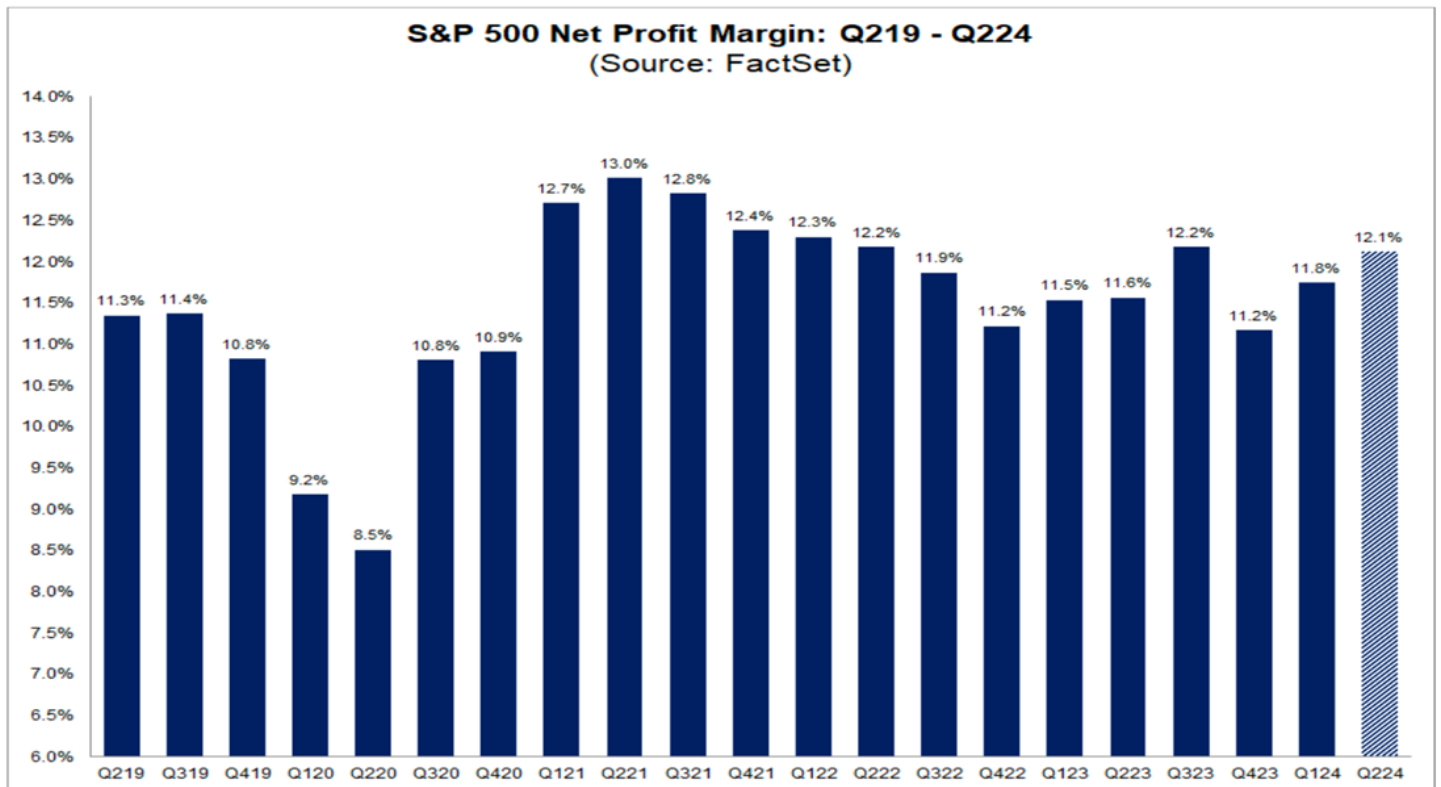
Source: factset.com

Proprietary Earnings Nowcaster Suggests Optimism, Led by Positive Revisions



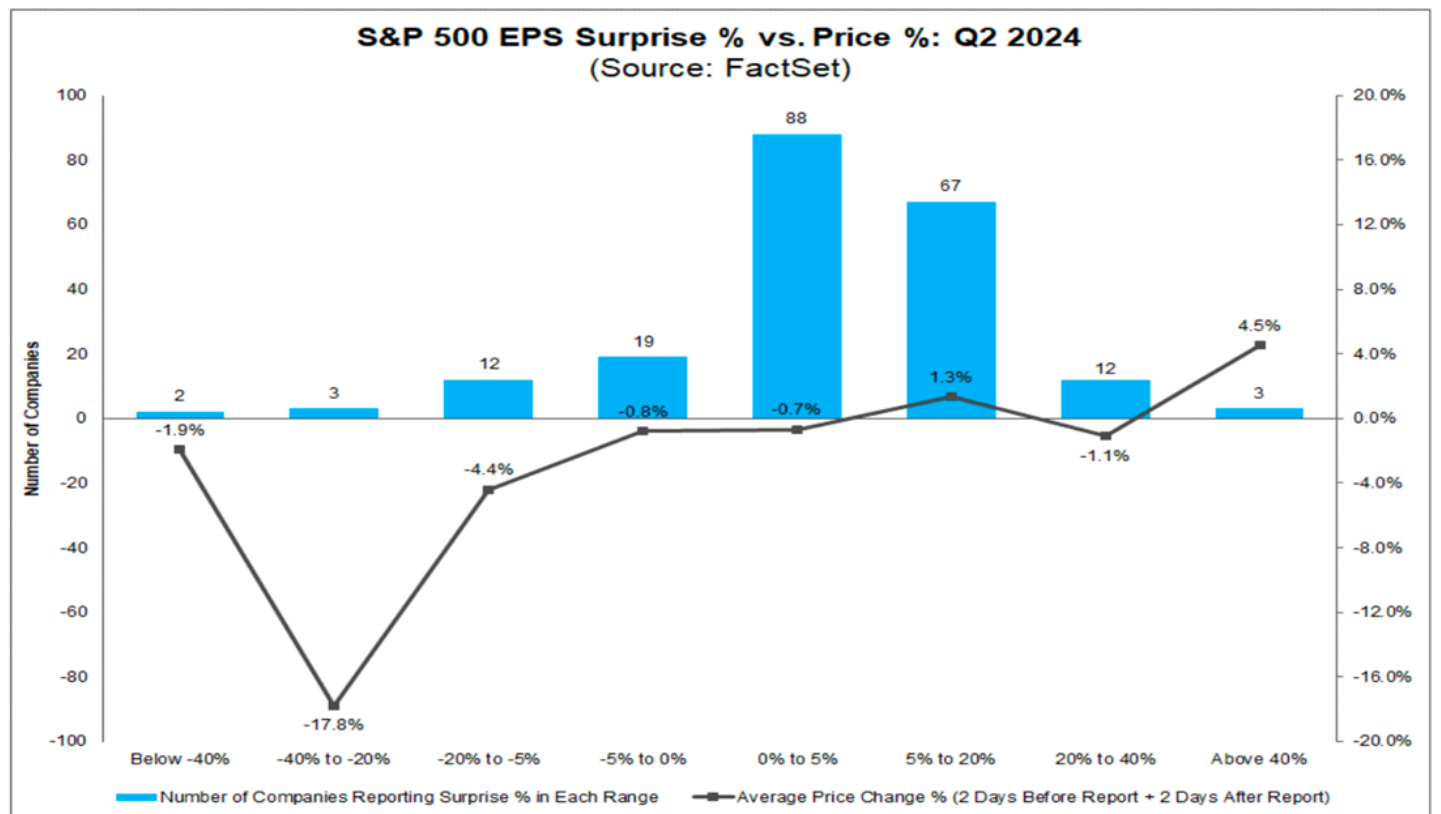
Source: Lighthouse Canton

SPX – Margin Trends Are Favorable



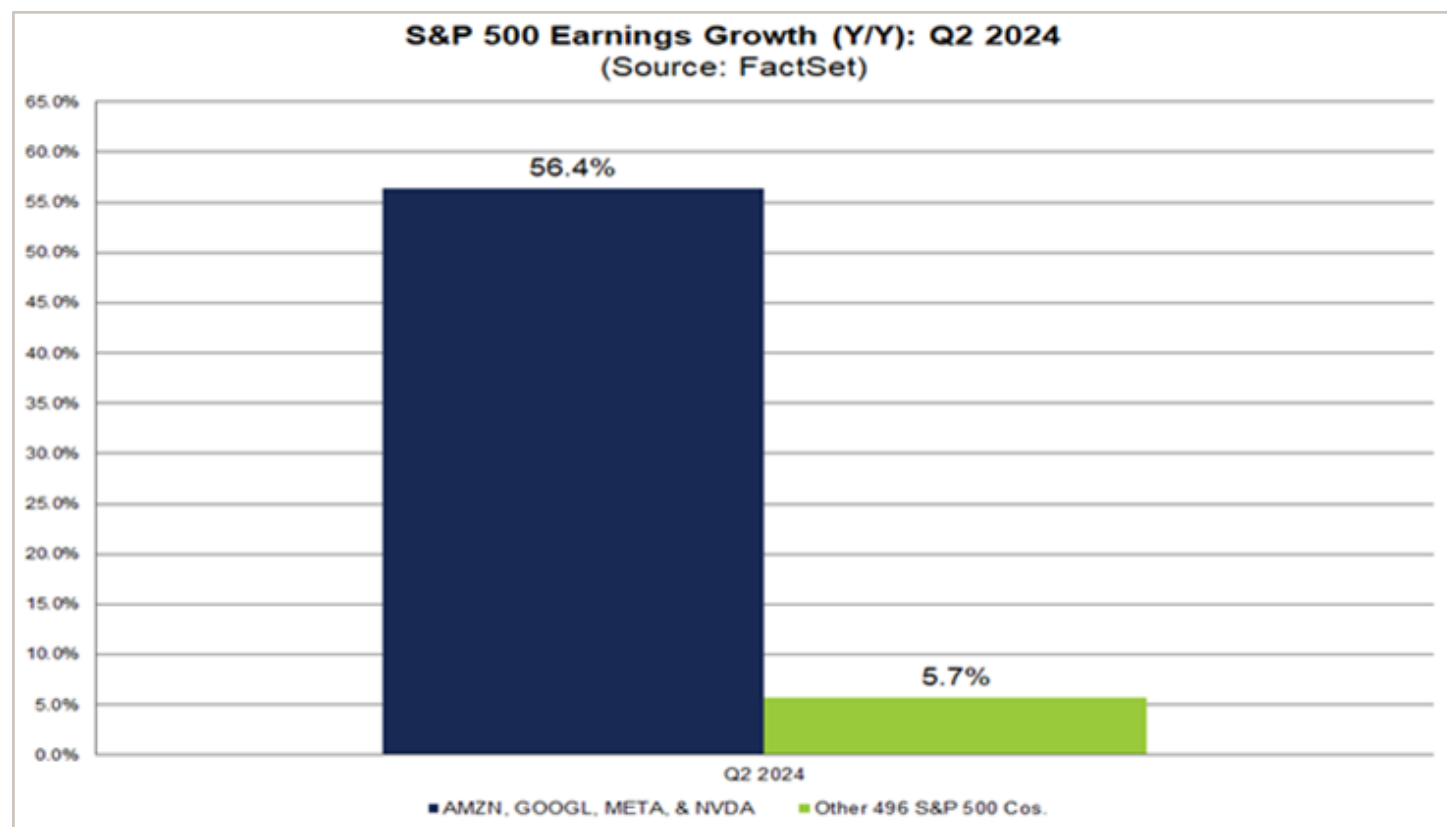
Source: factset.com

SPX – Priced to Perfection – Asymmetric Impact of Earnings Misses



Source: factset.com

Earnings Growth Powered By 4 Megacaps



Source: factset.com

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