MH & ASSOCIATES • SECURITIES MANAGEMENT CORPORATION

INVESTMENT VIEWS

JULY 31, 2024

TAKING A BREADTH

If there has been one common thread being discussed for quite a while by market analysts and in our very own newsletters, it is the narrow nature of the gains in the market this year. Finally in July the market started to broaden out as money moved out of semiconductor and other technology stocks. This rotation was started when the July CPI report missed expectations, thus leading to the belief that the Fed would indeed begin to cut rates in September. Lower rates can definitely benefit smaller stocks as the cost of capital will come down, a much bigger issue for small companies than the mega caps. Investors and hyperscalers/algorithms latched onto this idea and sold the high flyers for the laggards.

In fact, it took just one month for the Russell 2000 index to match the year to date gains in the NASDAQ 100 (a tech heavy index). This was a combination of good returns from the Russell and the NASDAQ 100 erasing half of its year to date gains in the last half of July.

What happens if the Fed does not cut rates in September will be very telling. The odds of a cut are currently 100%, so it is priced into the market at this point. Recent economic reports have been weakening and we expect comments from the Fed to trend more dovish going forward. The Fed started raising rates too late in their last tightening cycle and did it too quickly. We expect the Fed would prefer to get ahead this time, but that has not been their traditional strategy as they tend to be reactionary instead of anticipatory.

VALUE ANSWERS THE CALL

Part of the improving breadth story we discussed above has been the outperformance of value stocks relative to growth. In an article in last months newsletter we stated the need for there to be rotation in the market. Growth has been a dominant investment category for the better part of a decade, but even in that stretch there are times when value is the superior investment. Previous periods of outperformance by value names since 2015 have lasted nearly twelve months. This is generally a time when stock picking becomes even more crucial to the performance of an equity portfolio. It is not very surprising that value started it reawakening this month as it has outperformed growth in every one of the last 10 years in July. Even more, over the last 20 years it has had superior performance 80% of the time. The current value trade does appear a little stretched, but as air comes out of the AI balloon we would expect it to find its way into stocks with more reasonable valuations.

DOW THEORY

In today's modern economy, some have turned to technology stocks to judge its health. Charles Dow created the Dow Theory in which a key component comes from comparing the Dow Jones Industrial (producers) Index to the Dow Jones Transportation (distributors) Index. When one of those rises, you want to see it confirmed by the other index rising. When the two diverge, there are problems under the surface. Thus, the correlation between the two indices are generally positive (they move together). When the correlation turns negative, probably a time to become cautious.

The transports index has been essentially traded sideways since peaking in late 2021. Both the Dow Jones Industrial and the S&P 500 indices broke out above their 2021 peaks in late 2023 and early 2024 respectively. The transports are telling a different story as they have failed to make new highs. Divergences can remain for a while, but eventually they need to resolve. Either the transports finally make a new high or we can expect further weakness in the equity markets.

ELECTRICITY CRISIS IN THE MAKING

The electric power generation industry in this country has been under pressure for a number of years. A combination of an aging transmission and distribution infrastructure and increased demand (recently from manufacturing and crypto operation) is putting a strain on the industry. Regionally, we have already seen costly grid failures and rolling blackouts due to transmission constraints.

The situation has become more dire and will grow in its intensity as a wave of new demand is facing the market. Until recently (2021), consumption of electricity in this country has been stagnant for over 20 years. Today, the industry is facing potentially significant growth from electric vehicle charging and data centers due to increasing artificial intelligence (AI) energy requirements. AI searches use 10 times the electricity of a typical internet search. From an almost 0% growth rate, the rate of growth is expected to jump almost 5% per year for the next 5 years.

To deal with this problem significant additional investment will be needed in a wide range of areas. Two of those areas that we believe will benefit is natural gas and nuclear. We are well represented in both areas, owning natural gas producers, pipelines and on the nuclear front, a wide array of companies from producers and processors of uranium to builders of nuclear power plants.

A TITANIC UPDATE

Yes, the Titanic is still at the bottom of the ocean, but this has nothing to do with the sunken cruise liner. In January we discussed the Titanic Syndrome, a bearish signal that occurs when an index (in this case the NASDAQ) have recently been at a high, but then there is a sudden jump in new 52-week lows versus new 52-week highs. The signal was triggered in July and this was not the first signal of the year. A one-off signal can happen, but the danger is when we get signals in clusters. The January signal was just the first but there have been several since, raising the caution flag even higher. The last cluster of signals was in mid-2023 and preceded a nearly 4 months correction, with the NASDAQ 100 losing over 12%. Prior to that was a flurry of signals in late 2021, prompting a selloff that lasted nearly all of 2022 and the index losing over 35% of value. While the market has certainly taken a pounding over the last few weeks, these "Titanic Syndromes" tend to prompt a reaction that lasts longer than your normal cruise vacation.

TECHNICALLY *Speaking*

Volatilty has been relatively tame throughout the year so far, until recently. The S&P recently had its first day in which it fell more than 2% since Feb 2023. As you can see from the chart of the Volatility Index (VIX), the trend in volatility has been downward with continued lower highs in the VIX during sell-offs. The concerning aspect however is the momentum which is measured in the bottom chart. This measure has been slowly rising throughout 2024 and when it reaches over 25, that indicates extreme fear in the market. The recent selloff got close to that and we are not certain that it is over just yet.

Recommendation List: A list of all previous specific investment discussions published over the past 12 months will be provided upon request. Please email lara@mhandassociates.com or call our office for this list.

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