James Investment Research, Inc.

# Market Commentary

September 2024

JAMES
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## Key Insights

- **Market Volatility and Recovery:** August 2024 saw extreme market volatility, with the S&P 500 plummeting 8.45%, followed by a rapid 12.2% recovery, highlighting the unpredictable nature of short-term market movements.
- **Federal Reserve Policy Shift:** The Fed signaled a pivot towards a more accommodative monetary policy, emphasizing labor market concerns over inflation, demonstrating the significant impact of central bank decisions on market sentiment.
- **Investor Psychology:** Behavioral biases such as loss aversion, herding, and anchoring play a crucial role in exacerbating market volatility, often leading to suboptimal investment decisions during turbulent times.
- **Market Timing Fallacy:** Analysis of S&P 500 performance from 2014 to 2024 illustrated the near impossibility and high risk of successfully timing the market, with missing just the 40 best days reducing returns by over 75% compared to staying fully invested.
- **Long-Term Strategy Superiority:** The events underscore the effectiveness of a patient, long-term investment approach that embraces market volatility, rather than attempting to avoid it through market timing or reactive decision-making.

## Monthly Recap

### August Market Volatility: First the Crash, then the Bounce

In early August 2024, global financial markets experienced a period of dramatic volatility reminiscent of the 2008 financial crisis. This turbulence, which interrupted what would have been the S&P 500's longest winning streak in 20 years, was triggered by a combination of factors that sent shockwaves through markets worldwide.

The initial spark for the sell-off came from a series of disappointing U.S. employment reports. These reports, which showed the U.S. economy adding only 114,000 new jobs in July compared to expectations of around 175,000, raised alarm bells about the health of the world's largest economy. The data suggested that the robust post-pandemic recovery might be losing steam, potentially signaling an impending recession. This negative sentiment was further exacerbated by a sharp 12% drop in the Tokyo stock market, which was partly attributed to the unwinding of the yen carry trade.

The yen carry trade, a long-standing strategy where investors borrow in low-yielding yen to invest in higher-yielding assets elsewhere, began to unravel following the Bank of Japan's decision to raise interest rates. This move, while modest by global standards, represented a significant shift in Japan's monetary policy and caught many investors off guard. The resulting turbulence in Japanese markets quickly spread globally, highlighting the interconnected nature of today's financial markets.

As these events unfolded, the CBOE Volatility Index (VIX), Wall Street's "fear gauge," reacted with unprecedented intensity. The VIX experienced its largest intraday jump on record, briefly surpassing 65 - a level typically associated with extreme market panic. This spike was particularly notable as it followed an extended period of market calm.

The market turmoil reflected growing fears that the U.S. Federal Reserve (Fed) might have delayed rate cuts for too long. The narrowing gap between market rates in Japan and the United States, following the Bank of Japan's rate hike, led to a spike in the yen and a "punishing unwind" of popular trades.

Additionally, investors began reassessing the recent rally in big tech stocks, particularly the "Magnificent Seven" (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla) that had driven much of the market's gains earlier in the year. Concerns arose about these companies' ability

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to meet high expectations and provide returns on their substantial artificial intelligence (AI) investments.

The market downturn was severe, with the S&P 500 plummeting 8.45% from its July 16 high to August 5. The decline was particularly pronounced among the "Magnificent Seven" stocks (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla), which collectively dropped 14.66%. NVIDIA (NVDA) experienced an even steeper fall of 20.50%. The broader market, represented by the S&P 500 excluding the Magnificent Seven, showed more resilience but still declined by 5.6%. Small-cap stocks were also hit hard, falling 9.88%. In contrast, bonds, as represented by the AGG (aggregate bond index), provided a safe haven, gaining 2.14% during this period.

The market turmoil reflected growing fears that the U.S. Federal Reserve might have delayed rate cuts for too long. The narrowing gap between market rates in Japan and the United States led to a spike in the yen and a "punishing unwind" of popular trades. Additionally, investors began reassessing the recent rally in big tech stocks, particularly the Magnificent Seven, questioning these companies' ability to meet high expectations and provide returns on their substantial AI investments.

However, in a remarkable display of market resilience and volatility, this bearish sentiment reversed course dramatically in the following two weeks. The period from August 5 to August 19 witnessed a vigorous surge in stock prices, not only recovering from the earlier declines but surpassing them significantly. The S&P 500 surged by an impressive 12.2% in just 14 days, bringing the index within striking distance of its all-time highs.

This rebound was particularly striking for the Magnificent Seven, which bounced back with a 12.12% gain. NVIDIA, which had been among the hardest hit during the selloff, led the charge with an astounding 29.42% recovery from its August 6 low. This rapid turnaround occurred less than two weeks after the disappointing payrolls data that had initially sparked the market panic.

Interestingly, while many of the large-cap technology stocks and the broader S&P 500 recovered strongly, small-cap stocks and the S&P 500 excluding the Magnificent Seven did not participate as robustly in this rally. Their performance remained relatively unchanged from the depths of the early August selloff, highlighting the concentrated nature of the market's recovery.

This period of extreme market volatility and subsequent recovery underscores the unpredictable nature of financial markets and the outsized influence of a small group of tech giants on overall market performance. It also demonstrates how quickly investor sentiment can shift, turning "extreme negative momentum" into a bullish resurgence in a matter of days, while emphasizing the complex interplay of global economic factors, monetary policy shifts, and investor sentiment in shaping financial market dynamics.

### The Fed's Pivot

Amidst this market turmoil, the Federal Reserve's interest rate stance became a crucial factor in shaping investor sentiment. In a pivotal speech at the Kansas City Fed's annual conference in Jackson Hole, Federal Reserve Chair Jerome Powell signaled a significant shift in the central bank's monetary policy stance. After maintaining high interest rates at a 22-year peak of 5.3% to combat inflation, Powell indicated that the Fed is now prepared to cut rates, potentially as soon as September. This move marks a substantial change towards a more accommodative monetary policy, reflecting a new confidence in the economic landscape.

Powell's declaration that "The time has come for policy to adjust" underscores this shift, which notably emphasizes one half of the Fed's dual mandate: promoting maximum employment. The Federal Reserve is tasked with the dual mandate of fostering maximum employment and maintaining price stability. Highlighting concerns about potential job market weakness, Powell stated, "The upside risks to inflation have diminished, and the downside risks to employment have increased." This focus on employment represents a clear pivot from the Fed's previous prioritization of inflation control, which had been the dominant concern in fulfilling the price stability aspect of the mandate. Powell's statement signals a recalibration in the Fed's approach to balancing these two key objectives, reflecting the evolving economic landscape and the need for a more nuanced policy response.

The Fed's new approach allows for greater flexibility in responding to signs of labor market deterioration. Powell's remarks also suggested cautious optimism about achieving a "soft landing" - cooling inflation without causing significant economic harm. This recalibration reflects the Fed's delicate balancing act between its dual mandates of price stability and maximum employment.

As inflation shows signs of moderating, the Fed appears poised to protect job market gains, marking a new phase in its monetary policy approach. This shift demonstrates the central bank's adaptability in navigating complex economic conditions, aiming to support sustainable growth while maintaining price stability. While the Fed claims not to watch the stock market or base policy decisions on market movements, the interplay between

monetary policy and market reactions remains a topic of keen interest and debate among economists and investors alike.

## Topic of the Month: Market Volatility

### Investor Behavior

The market's dramatic swings during this period underscored the pivotal role of investor psychology in amplifying market movements. In times of heightened volatility, investor behavior often shifts from rational decision-making to being driven by emotional biases. This psychological aspect of investing can significantly intensify market fluctuations, creating a self-reinforcing cycle of fear and exuberance that further fuels volatility. Several key behavioral biases come into play during such times, often leading to suboptimal investment decisions. Loss aversion, a cognitive bias where investors feel the pain of losses more acutely than the pleasure of equivalent gains, can lead to panic selling and the locking in of losses at market bottoms. This bias often causes investors to act against their long-term interests in an attempt to avoid short-term pain.

Herding behavior, another common bias, causes investors to follow the crowd, potentially exacerbating market movements in both directions. During sell-offs, this can lead to a self-reinforcing cycle of selling, pushing prices far below fundamental values. Conversely, during market recoveries, herding can fuel excessive optimism and asset bubbles.

Anchoring bias may cause investors to fixate on specific reference points, such as a stock's previous high or the price at which they purchased it, rather than focusing on fundamental values and future prospects. This can lead to holding onto losing positions for too long or selling winning positions too early.

### The Illusion of Perfect Timing: A Tale of Two Market Strategies

These market gyrations once again thrust the perennial debate about market timing into the spotlight. The allure of perfectly timing stock market movements has captivated investors for generations, promising outsized returns to those who can master it. However, a compelling analysis of the S&P 500's performance between August 2014 and August 2024 vividly illustrates why this strategy, despite its appeal, is fraught with risk and practically impossible to execute successfully.

Two scenarios from this period demonstrate the potential rewards and pitfalls of market timing, underscoring the challenges faced by even the most astute investors in predicting short-term market movements.

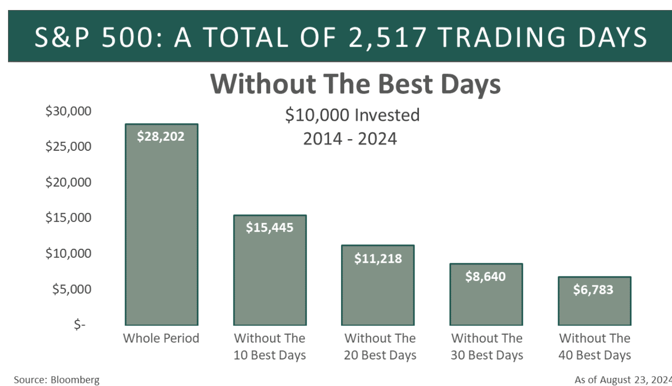
Let's start with a baseline: A $10,000 investment in the S&P 500, held throughout this entire period, would have grown to $28,202. This represents a solid return, nearly tripling the initial investment over a decade. However, what if an investor could cherry-pick their days in the market?

In our first scenario, we examine the impact of missing the market's best days:

- Missing just the 10 best days reduces the final value to $15,445
- Missing the 20 best days leaves only $11,218
- Missing the 30 best days results in $8,640
- And missing the 40 best days yields a mere $6,783

The stark contrast is clear. Missing a mere 40 days out of 2,517 trading days – less than 1.6% of the total time – would have reduced returns by over 75% compared to staying fully invested.

S&P 500: A TOTAL OF 2,517 TRADING DAYS

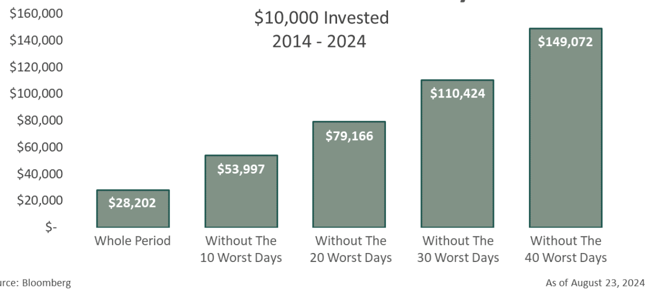



Now, let's flip the coin and consider the opposite scenario: avoiding the market's worst days:

Without the 10 worst days, the investment grows to $53,997

- Without the 20 worst days, it reaches $79,166
- Without the 30 worst days, it climbs to $110,424
- And without the 40 worst days, it skyrockets to $149,072

## S&P 500: A TOTAL OF 2,517 TRADING DAYS




These figures are undoubtedly enticing. By avoiding just 40 bad days, an investor could have increased their returns more than fivefold compared to staying fully invested.

However, herein lies the crux of the market timing dilemma. While these scenarios paint dramatically different pictures, they both rely on an impossible premise: the ability to precisely predict which days will be the best or worst in advance.

In reality, the best and worst days often occur in close proximity, particularly during periods of high volatility. Attempting to avoid the bad days frequently leads to missing the good days as well. Moreover, these critical days often happen during times of economic uncertainty when many investors are tempted to exit the market, potentially missing out on subsequent recoveries.

The unpredictability of these extreme days is further underscored by their outsized impact. In both scenarios, we're talking about a minimal number of days – just 40 out of 2,517 – having a profound effect on long-term returns.

This data serves as a powerful reminder of the futility of trying to time the market. While the idea of capturing only the upside while avoiding the downside is appealing, it's a practical impossibility. The risks of getting it wrong are substantial, potentially leading to significantly diminished returns.

Instead, these scenarios make a compelling case for a patient, long-term investment strategy. By staying invested through the market's ups and downs, investors position themselves to capture the full spectrum of returns. This approach not only potentially leads to better long-term outcomes but also alleviates the stress and potential mistakes associated with trying to predict short-term market movements.

In conclusion, while the perfect timing strategy remains an enticing theory, the reality of investing is far more nuanced. Time in the market, not timing the market, has historically been the more reliable path to long-term financial growth, though future outcomes cannot be guaranteed. For most investors, a consistent, disciplined approach that embraces market volatility rather than trying to avoid it tends to yield better results in the long run.

So, while market volatility can be unsettling and even frightening for investors, it is a normal and inevitable part of the investment landscape. By understanding the factors that drive market movements, recognizing common behavioral biases, and adhering to sound investment principles, investors can navigate turbulent times more effectively. The key lies in maintaining a disciplined approach, focusing on long-term goals, and avoiding reactive decisions based on short-term market fluctuations. As history has shown, those who can stay the course through periods of volatility are often rewarded with better long-term investment outcomes.

## Conclusion

The financial market turbulence of August 2024 offers valuable insights for investors seeking to navigate the often-unpredictable world of investing. This period, marked by a sharp market downturn followed by a rapid recovery, underscores the importance of maintaining a long-term perspective and understanding the various factors that influence market dynamics.

One of the key takeaways from this event is the futility of attempting to successfully time the market. The analysis of S&P 500 performance from 2014 to 2024 vividly illustrates how missing just a few of the market's best days can significantly diminish returns. Conversely, avoiding the worst days could lead to exceptional gains. However, the crux of the matter lies in the impossibility of accurately predicting these pivotal days in advance. This realization strongly supports the wisdom of staying invested for the long-term rather than trying to outsmart the market through timing strategies.

Investors would do well to recognize and guard against common behavioral biases that can lead to suboptimal decisions, especially during volatile periods. Loss aversion, herding behavior, and anchoring bias can all contribute to panic selling or ill-timed market exits, potentially locking in losses and missing out on subsequent recoveries. By understanding these psychological pitfalls, investors can strive to make more rational, long-term oriented decisions.

The Federal Reserve's pivot towards a more accommodative stance in response to labor market concerns serves as a reminder of the complex interplay

between economic indicators, monetary policy, and market performance. Investors should stay informed about these macro-level factors without overreacting to every piece of news or short-term market movement.

Regular portfolio rebalancing is another valuable practice illuminated by this period of volatility. As certain sectors or stocks (like the “Magnificent Seven”) outperform, they can become overweighted in a portfolio. Periodic rebalancing helps maintain the desired asset allocation and manage risk.

For those finding market volatility particularly stressful, it may be worthwhile to reassess risk tolerance and adjust asset allocation accordingly. The goal should be to find a balance that allows participation in market growth while providing comfort during inevitable downturns.

Ultimately, the events of August 2024 reinforce the importance of focusing on personal financial goals rather than attempting to beat the market. A consistent, disciplined approach that embraces market volatility rather than trying to avoid it tends to yield better results in the long run. This may involve strategies like dollar-cost averaging, which can help mitigate the impact of market volatility by investing a fixed amount at regular intervals.

For investors who find themselves unsure about how to apply these lessons or adjust their investment strategy, seeking advice from a qualified financial professional can be a prudent step. A professional can provide personalized guidance based on individual circumstances and goals.

In conclusion, while market volatility can be unsettling, it is an inherent part of investing. By maintaining a long-term perspective, understanding behavioral biases, diversifying portfolios, staying informed without overreacting, and focusing on personal financial goals, investors can navigate turbulent times more effectively. The key lies in developing and adhering to a sound, long-term investment strategy that can weather the storms of market volatility while capitalizing on the long-term growth potential of financial markets.

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