



PROSPERITY MARKET UPDATE

Experienced market analysis builds investment confidence.

August 5, 2024

Don't look now, but over the last week the stock market has experienced significant volatility and negative performance, with the S&P 500 down -4.7%. Let's explore the market moving events that have transpired, along with the potential implications and why we believe market volatility is not to be feared but is part of being an investor.

As we are reviewing the data points, keep in mind that the stock market isn't even down ~9% from ALL TIME HIGHS. As of intraday Monday August 5th, the S&P 500 is up +9.4% year-to-date and 17.3% over the last twelve months. But just listening to the "professional gossip" you would think it's down 20%+.

What's Behind the Market Selloff?

We are seeing a global risk-off sentiment with investors nervous over economic growth worries following last week's softer-than-expected July nonfarm payrolls and ISM manufacturing reports. The weakness is being exacerbated by the continued unwinding of the yen carry trades following last week's Bank of Japan rate hike.

For years, investors would borrow Yen at ultra-low rates, such as ~0.4%, and use this Yen as a form of leverage. Investors could convert these Yen to US Dollars or other currencies and get *almost* free margin to purchase other risk assets such as U.S. stocks. Japan's stock market was at an all-time high exactly 17 trading days ago. In just 17 trading days, Japan's stock market has erased 25% of its ENTIRE value. In just the last 2 days, Japan's Nikkei 225 index is down over 18%, posting its largest 2-day drop in history. The question becomes if the Bank of Japan will intervene here. Many are betting that they indeed will.

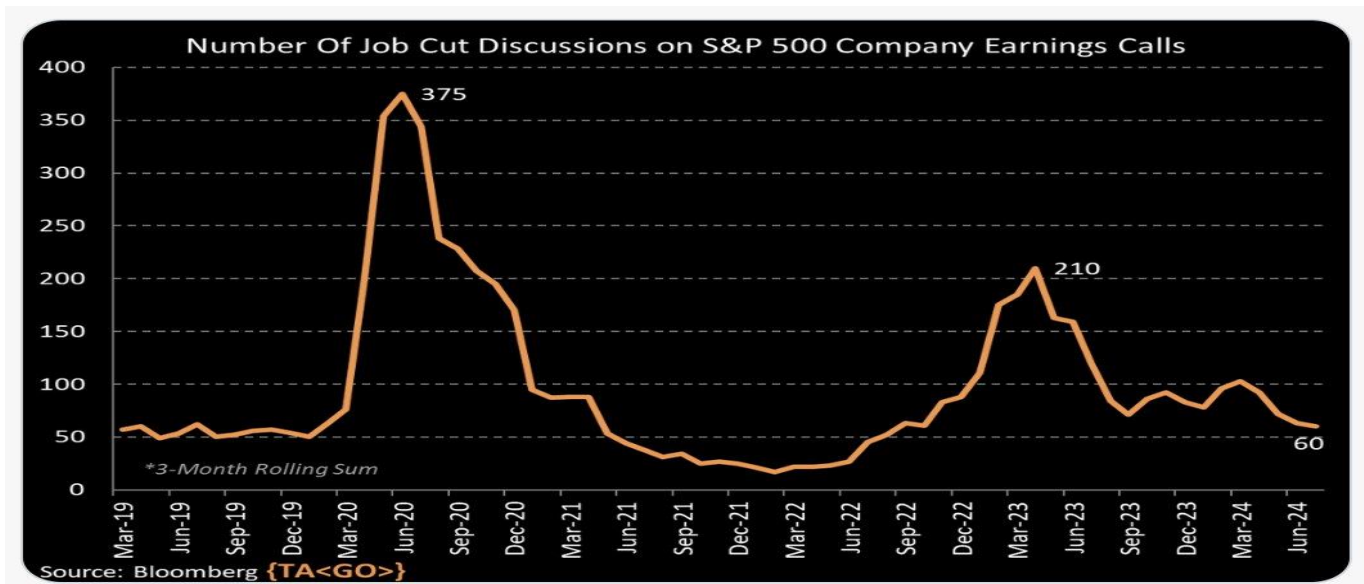
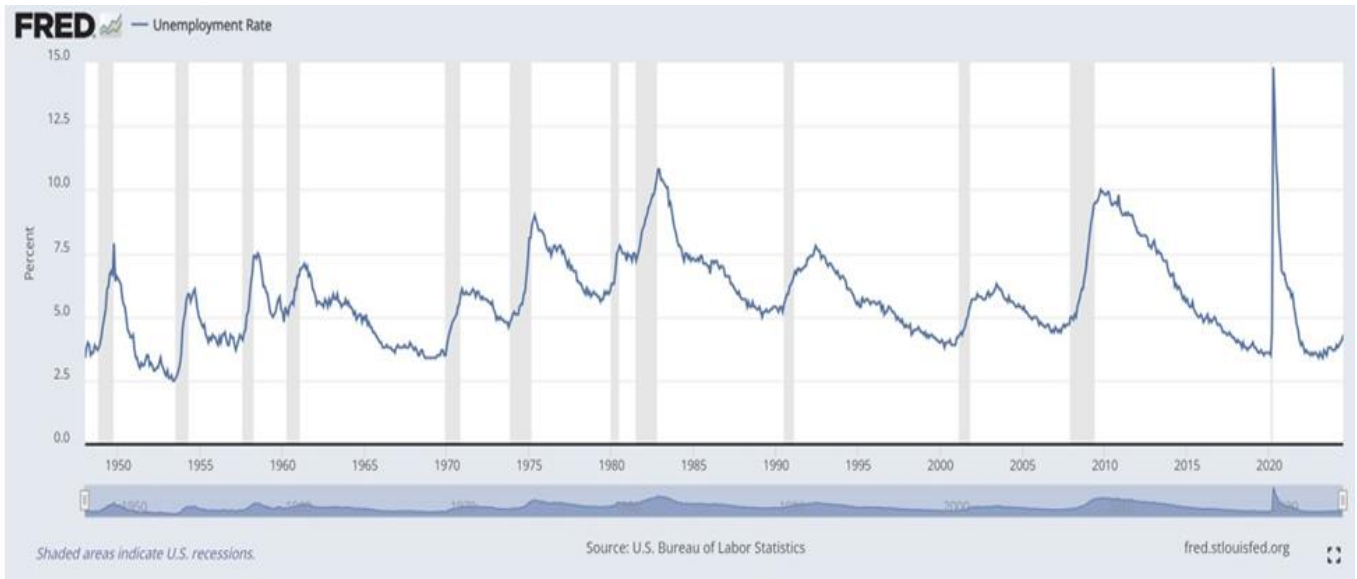
In addition, the ongoing scrutiny over the profitability of Artificial intelligence coupled with Middle East tensions, US political uncertainty, and negative seasonality are additional bearish talking points. The sell-off is triggering lots of "Fed behind the curve" chatter and speculation of an inter-meeting Fed rate cut. The talk is centering around 50 basis point cuts at the next 2 Fed meetings followed by 25 basis point cuts thereafter.

Unemployment

Indeed, recent unemployment figures weren't great, but there is more to the story in our opinion. The labor market softened in July as Nonfarm payrolls increased by 114K, missing expectations of +175K. The unemployment rate rose to a 33-month high of 4.3% (see chart below). However, what may be getting lost in the unemployment data according to the BLS household employment survey, 1.54 million workers were either not working or working only part-time due to weather in July, many because of Hurricane Beryl. That was up from 280,000 in June and one of the top five monthly readings for workers impacted by weather since 2018.

What we do know is current unemployment is still near the lowest levels in the past 70 years.

Unemployment is still well below the long-term average of 5.7%. Job Cut discussions are falling during S&P 500 company earnings calls, hitting the lowest level since August 2022 in July (chart below). We will continue to watch the trend in jobs. But, alarm bells aren't ringing just yet.

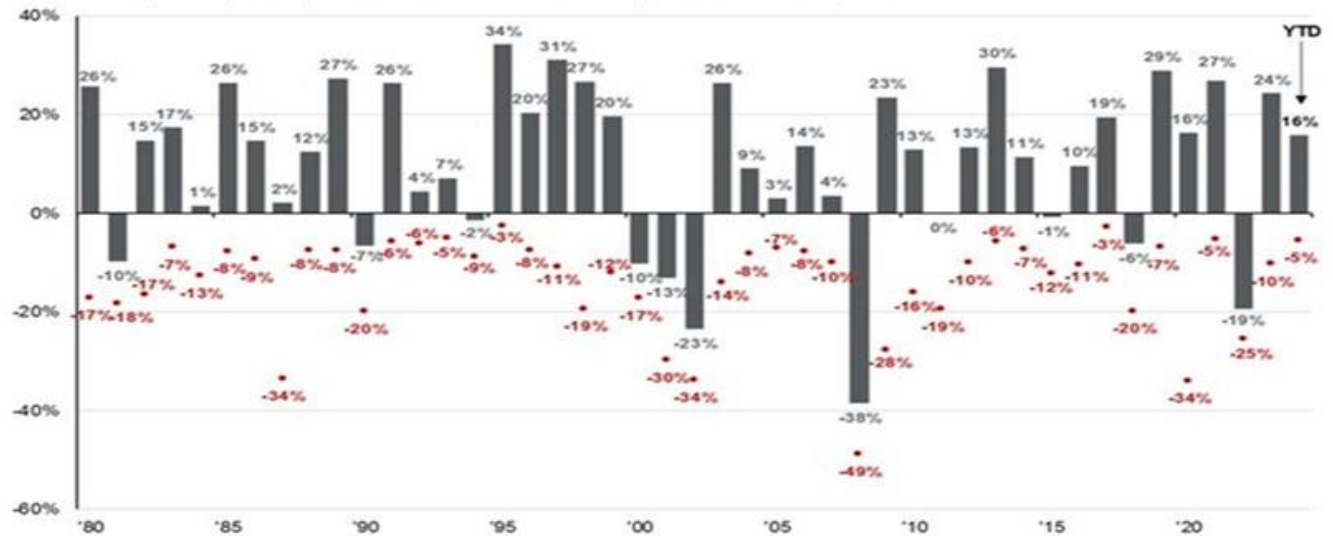


Market Was Due For A Pullback

Pullbacks in the market are never comfortable. We aren't surprised that the market declined. But this current drawdown is part of a normal functioning market. In any one year, the market typically experiences 3-4 5% pullbacks on average and an average intra-year drawdown of 14% (illustrated on the bar chart below). Up until this most recent pullback, the market had only experienced one pullback year-to-date with a max drawdown of ~5%. Until this recent down move, the S&P 500 has gone more than 350 days without a 2% decline – which was the longest stretch since 2006. The market was due for a pullback at some point. Pullbacks do happen in continued up trends. Greater volatility is not unusual. In fact, as investors, we must accept near-term risk for long-term potential reward.

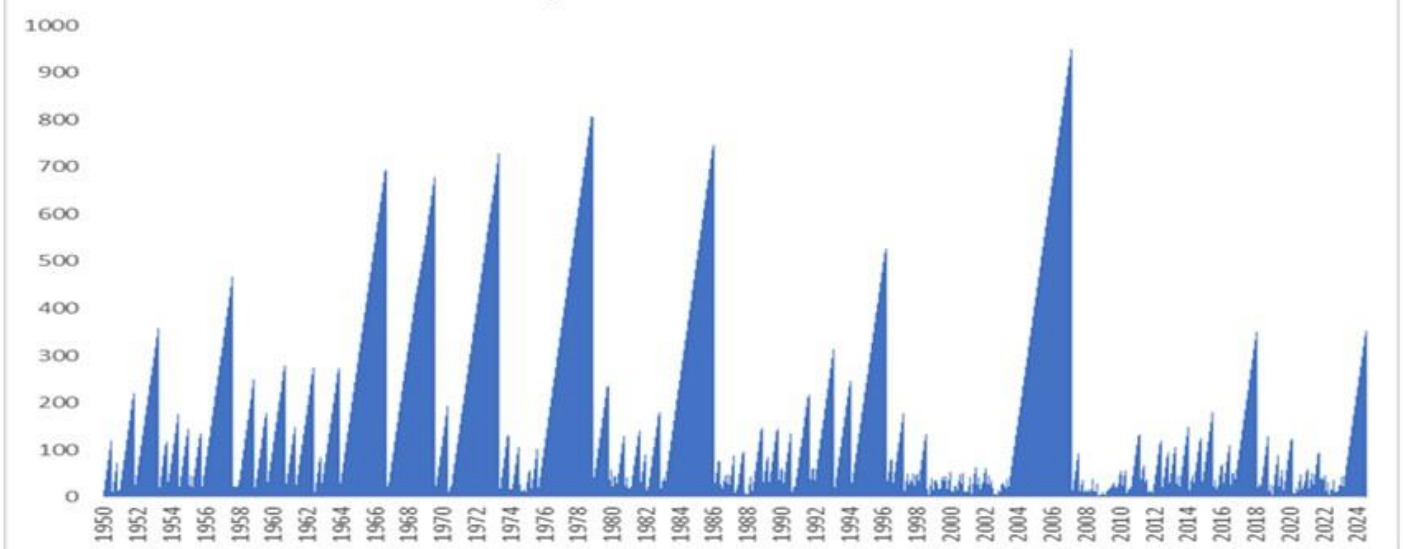
S&P intra-year declines vs. calendar year returns

Despite average intra-year drops of 14.2%, annual returns were positive in 33 of 44 years



Source: JPM Guide To Markets

Consecutive Days Without 2% Decline In S&P 500



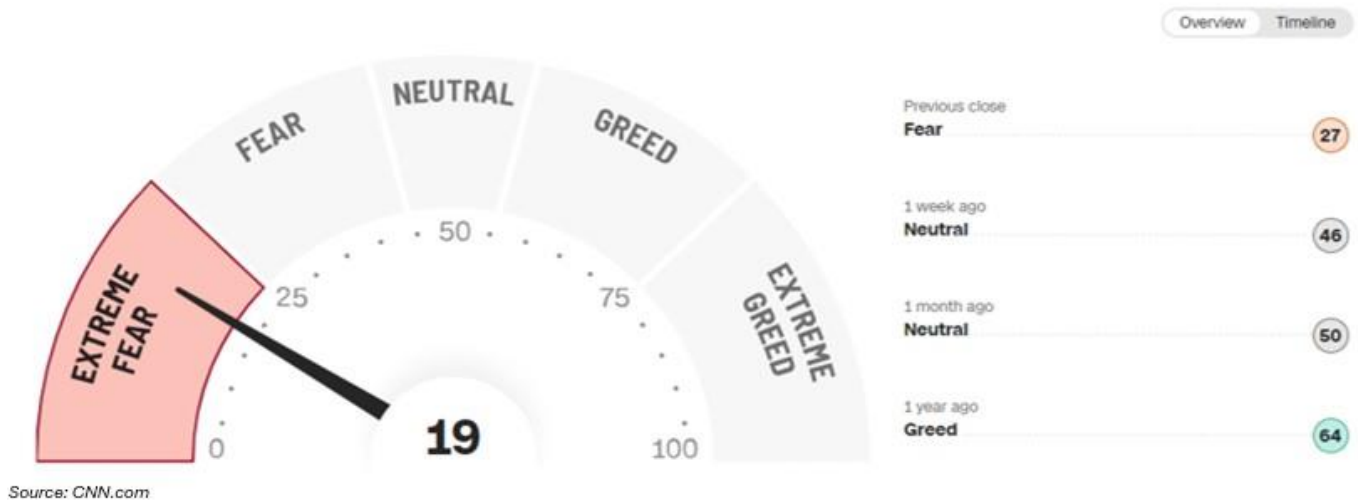
Source: Bloomberg data.

Investors Have Turned Fearful

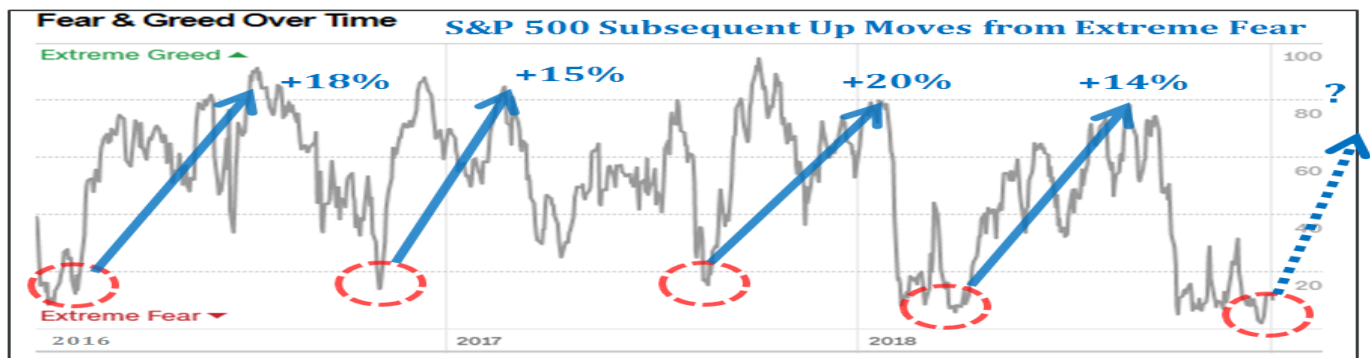
The Fear & Greed Index is used to gauge the mood of the market. Many investors are emotional and reactionary, and fear and greed sentiment indicators can alert investors to their own emotions and biases that can influence their decisions. When combined with fundamentals and other analytical tools, the Index can be a helpful way to assess market sentiment. The highly watched investor sentiment measure hit 19/100 = EXTREME FEAR level. This is the lowest level in over 2 years. Moments of extreme fear in the market can present golden opportunities for those prepared to act against the tide. The adage "Be fearful when others are greedy, and greedy when others are fearful," attributed to Warren Buffett, encapsulates a core tenet of investing. Over the last eight years, we have seen extreme fear levels reached a handful of times. The extreme fear was often followed by positive double digit market returns.

FEAR AND GREED INDEX

FEAR AND GREED INDEX



CNN FEAR GREED INDEX

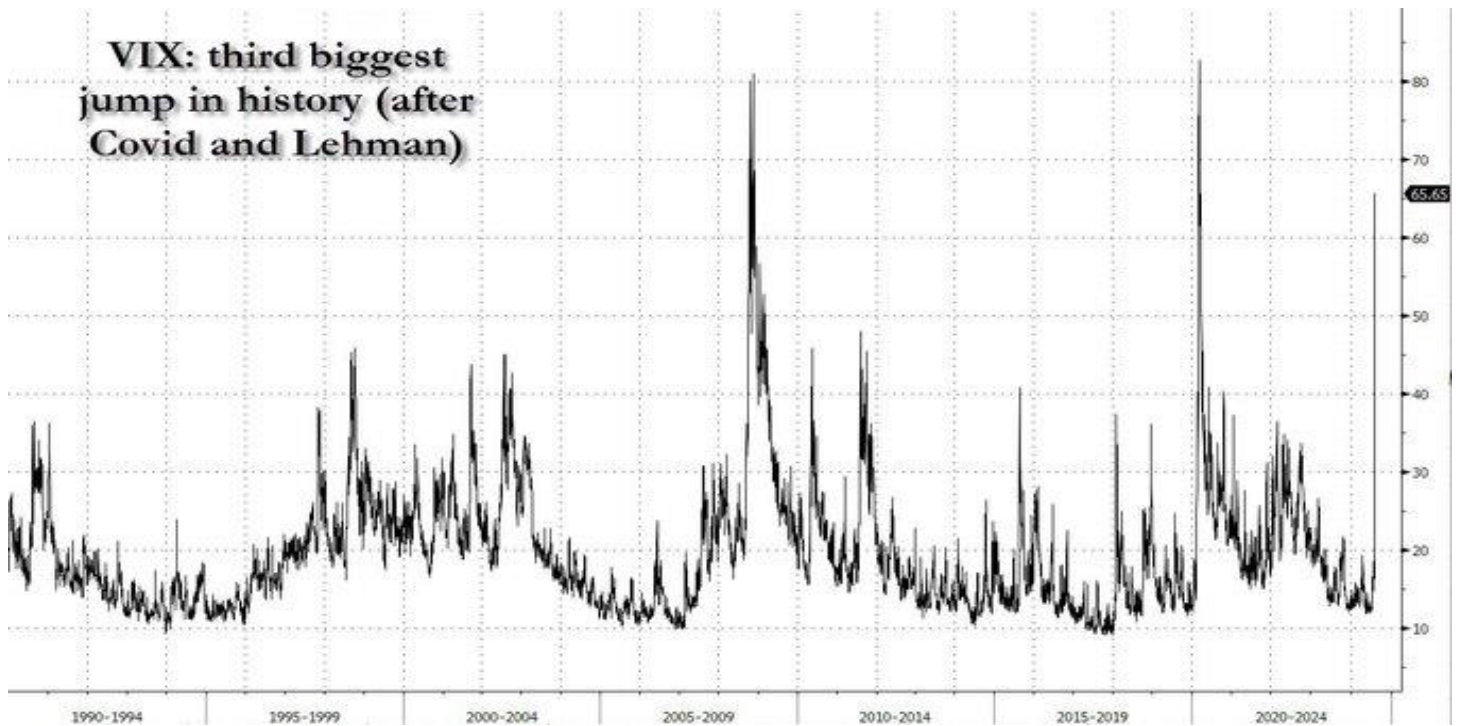


When fear hits the extreme level, typically a stock market up move follows.

Source: money.cnn.com/data/fear-and-greed

Volatility At Extreme Levels

The volatility index or VIX is a real-time market index representing the market's expectations for volatility over the coming 30 days. Investors use the VIX to measure the level of risk, fear, or stress in the market when making investment decisions. VIX is at 65 right now, up from 23 at Friday's close. If that were to hold it would be the biggest 1-day % increase in history and one of the highest closes ever. Only periods with higher levels of implied volatility: October/November 2008 and March 2020. 3rd biggest crisis in history with the third biggest jump after COVID-19 and Lehman. Only 1 time has VIX spiked to 40+ over a 3-week-period and S&P 500 delivered a negative return 12 months forward. Thus, historically high VIX levels have correlated with good buying opportunities.



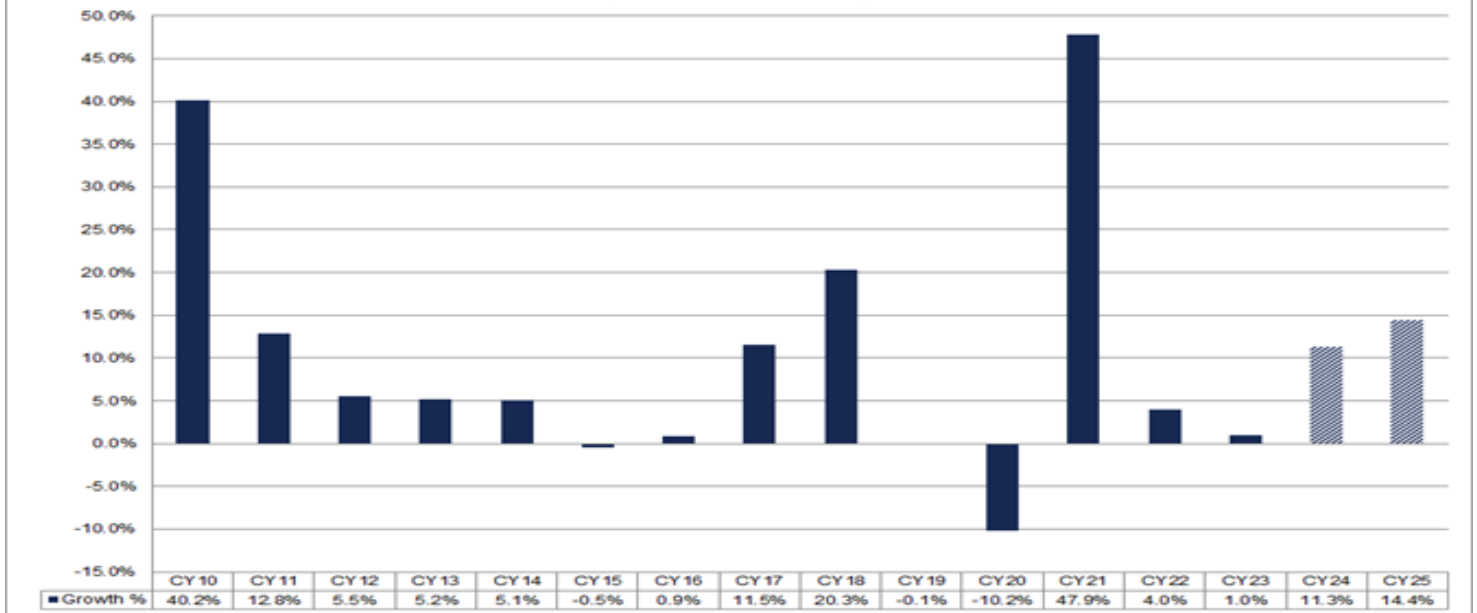
Source: Bloomberg

Earnings Growth Remains Robust

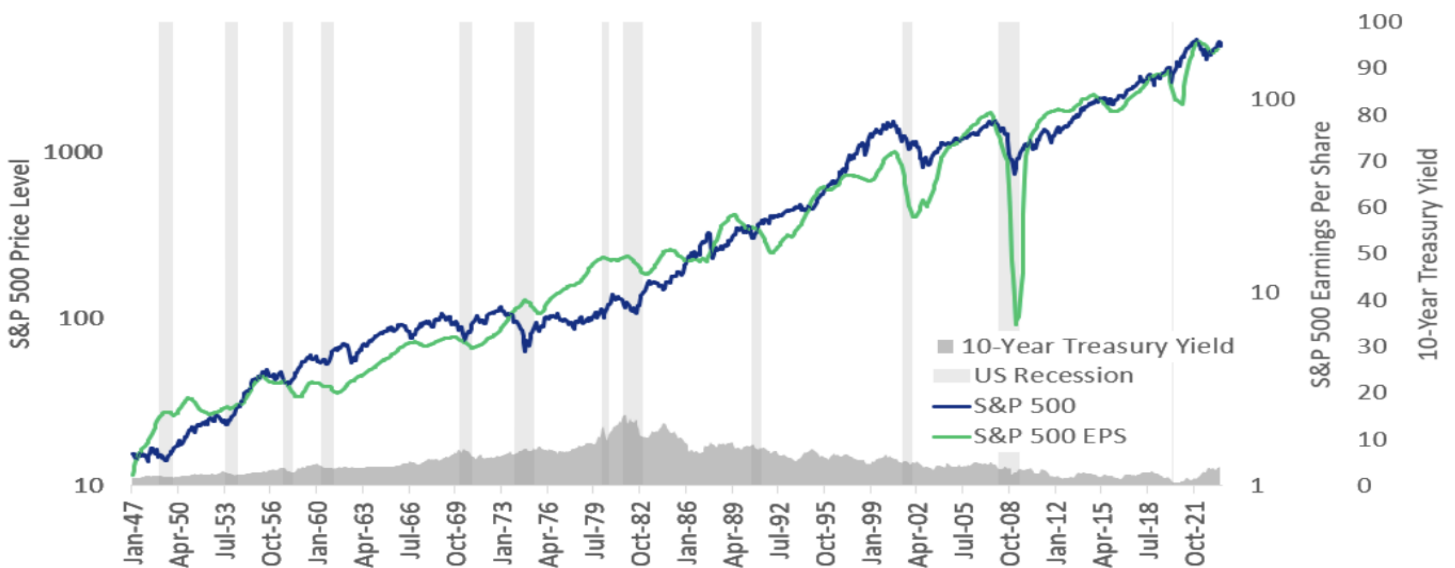
Company revenue and earnings projections remain robust looking out over the next two years. The chart below illustrates that S&P 500 earnings are projected to increase 11.3% in 2024 and an additional 14.4% in 2025. For 2025, all eleven market sectors are predicted to report (year-over-year) earnings growth. Eight of these eleven sectors are projected to report double-digit growth, led by the Information Technology driven by artificial intelligence (19.5%) and Health Care (18.5%) sectors. On December 31, 2023, the estimated earnings growth rates for the S&P 500 for 2024 and 2025 were 11.2% and 12.7%, respectively. Thus, analysts have increased earnings estimates in aggregate for both years over the past six months.

Why is earnings growth important? Looking at the data below, we see that stock market returns and earnings track each other closely over with temporary dislocations. Said another way, earnings growth drives a majority of stock returns.

S&P 500 Annual Earnings Growth: CY10 - CY25
(Source: FactSet)



S&P 500 Price and Earnings Move Together



Source: FactSet, Robert Shiller, NBER, Conference Board, Nasdaq Economic Research

Market Pullbacks Are Normal

Market declines and scary headlines understandably create nervousness and confusion. These jitters give rise to a vicious cycle of markets dropping as fearful investors sell. Fortunately, market corrections are usually a short-term event, and historically, that loss has been recovered over a period of about four months. In the grand scheme of things, a correction can be little more than a blip (see chart on the negative market events and market performance over the long term) on the radar for investors with a long-term focus. It's important to note, however, that each situation is different, and it's impossible to know exactly when the markets will turn around. Those who remain calm and keep things in perspective are less likely to be swept up in this negative feedback loop. Individuals who don't panic during corrections are in a strong position to fare well. Those who sell during a correction lock in their losses and could run the risk of missing out on any bounce back.

This chart shows the growth of \$10,000 based on S&P 500 Index performance over the last several decades. We believe looking at the market's overall resiliency through major crises and events helps to gain a fresh perspective on the benefits of investing for the long-term.

The average annual total return of the S&P 500 Index for the period shown below was 10.83%.



Source: Bloomberg, First Trust Advisors L.P., 12/31/1969 - 3/28/2024. Past performance is no guarantee of future results. This chart is for illustrative purposes only and not indicative of any actual investment. The S&P 500 Index is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index. Index returns do not reflect any fees, expenses, or sales charges. Stocks are not guaranteed and have been more volatile than the other asset classes. These returns were the result of certain market factors and events which may not be repeated in the future.

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Portfolios Designed For Client Goals and Risk Tolerance

Now is a good time to remember that client portfolios have been designed with a mix of assets aligned to the client's risk tolerance and long-term goals. At the end of the day, your risk tolerance, with the assistance of your financial advisor, has guided you to the right personal investment mix. Sticking with that mix, and reassessing from time to time, is key to meeting your financial goals and greater financial confidence. If you have any questions on your specific risk tolerance and asset allocation, we recommend you consult with your personal financial advisor.

Bonds Are The Ballast

If your risk tolerance and portfolio allocation calls for fixed income, then there is a silver lining. The recent market selloff shows that bonds are once again acting as a hedge against a stock market pullback. That is fueling one of the biggest bond market rallies since fears of a banking crisis flared in March 2023. The advance has been so strong that the policy-sensitive two-year Treasury yield tumbled last week by half a percentage point to less than 3.9%. Recall, yields and bond prices move inversely.

Conclusion

Currently, Inflation is slowing and though the risk of economic slowdown should never be ignored, most economic indicators remain fairly strong. The only certain thing with investing is uncertainty. And perhaps the most troubling part of corrections is that they tend to happen at times of seemingly invincible markets. When an incredible performance is interrupted, it's natural to wonder how long the interruption will last. But it's always important to remember that the simple concept of "buy low, sell high" is impossible without "low" times.

In today's fast-paced and unpredictable world, the investment landscape is constantly evolving. From economic downturns to global events, investors are faced with a myriad of challenges that can impact their investment portfolios. Navigating these changes and making informed decisions is crucial to achieving long-term financial success. It is difficult to make predictions about the future, especially as it relates to short-term movements in the stock market. When stocks fall, our emotions make us think they will fall even further. And when stocks rise, our emotions make us believe they are going to rise even more. This is why we are such a big proponent of having an investment plan that you can stick with through a wide range of market and economic environments. This is a proven strategy that may assist you in achieving your goals.

As always, we will be closely monitoring market conditions and may alter portfolio positioning based on our methodically reached views on the markets.

We hope this email helps bring calmness. Enjoy the rest of your summer!

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