

Monthly Market Update

Navigating Uncertainty: A Tale of Markets, Policy Shifts, and Economic Realities

In the ever-shifting landscape of global markets, investors often find themselves caught between optimism and caution, interpreting new signals through the lens of their existing convictions. As Warren Buffett astutely observed, humans excel at bending new information to reinforce preconceived beliefs. This dynamic was on full display following Federal Reserve Chairman Jerome Powell's recent speech at the Jackson Hole symposium, where markets erupted in a bullish frenzy, seemingly glossing over the speech's more nuanced, hawkish undertones. For those seeking clarity in today's volatile environment, a deeper dive into Powell's remarks and broader economic indicators reveals a complex story—one of shifting monetary policies, weakening economic fundamentals, and persistent inflationary pressures that could reshape the investment landscape.

The Fed's Subtle Pivot: From FAIT to FIT

Powell's speech marked a pivotal shift in the Federal Reserve's monetary policy framework, moving from Flexible Average Inflation Targeting (FAIT) to Flexible Inflation Targeting (FIT). This change, though technical, carries profound implications. FAIT allowed the Fed to tolerate periods of above-target inflation to compensate for past undershoots, fostering a more accommodative stance to support employment. FIT, however, signals a sharper focus on controlling inflation without the "makeup" strategy, prioritizing price stability over time-averaged goals. This shift, coupled with Powell's careful choice of words, base case indicates tariff-driven inflation as "relatively short-lived" rather than "transitory"—suggests a Fed increasingly wary of persistent price pressures. Far from a clear endorsement of aggressive rate cuts, Powell's remarks underscored a cautious, data-dependent approach, with the Fed prepared to hold rates steady if inflation proves stickier than expected.

The market's exuberant reaction, with the S&P 500 climbing 1.5% in midday trading, reflects a selective focus on Powell's acknowledgment of a softening labour market and the possibility of rate cuts as early as September. Yet, the hawkish undertones, particularly the Fed's commitment to preventing a "one-time" price increase from becoming an ongoing issue, probably suggest that investors may be underestimating the Fed's resolve to keep inflation in check, even at the cost of economic growth.

A Fragile Labour Market: Beneath the Surface

While consumer confidence surveys paint an optimistic picture, their "feel-good" metrics often lack statistical rigor, masking deeper vulnerabilities in the U.S. jobs market. Continuing claims for unemployment benefits are creeping toward the 2,000K mark, a level signaling prolonged unemployment for those out of work.

Powell himself noted that these conditions could lead to a sharper downturn if hiring remains sluggish, a sentiment echoed by Fed governors like Christopher Waller and Michelle Bowman, who dissented in July, advocating for a rate cut to protect jobs. While I remain in the rate-cutting camp, expecting the Fed to deliver at least 75 basis points by year-end, the labour market's fragility suggests that more aggressive action may be necessary if conditions deteriorate further.

Housing Market Woes: A Canary in the Coal Mine

The U.S. housing market, a critical barometer of economic health, continues to flash warning signs. Inventory for new single-family homes has risen to 9.2 months of supply at the current sales pace, reflecting softening demand amid persistently high mortgage rates. While these rates, influenced by the Fed's restrictive stance, have yet to trigger a full-blown crisis, the combination of elevated borrowing costs and growing inventory could precipitate one if trends persist. The housing sector's sensitivity to interest rates underscores the delicate balancing act Powell faces: easing too soon risks fueling inflation, while delaying cuts could exacerbate economic slowdown.

Retail Resilience Amid Tariff Pressures

In the retail sector, Q2 earnings reports reveal a mixed picture. Companies have navigated tariff pressures by selectively raising prices and absorbing cost increases through diversified supply chains. However, consumer price elasticity remains a concern, as demand may wane if price hikes stretch budgets too far. Despite these efforts, inflationary pressures are far from resolved, and only a significant economic reset, potentially a recession may alleviate the mounting strains. Cooling wage growth, which remains elevated, will also be critical to stabilizing the broader economy.

Japan's Inflationary Challenge: A Global Perspective

Across the Pacific, Japan's economic narrative adds another layer of complexity. The 30-year government bond yields have surged to a 20-year high, driven by persistent inflationary pressures. July's core consumer price index (CPI) rose 3.1% year-on-year, exceeding the Bank of Japan's (BoJ) 2% target for over two years. This inflation, fueled by wage growth and a positive output gap, raises questions about whether it's a transitory spike or a structural shift. The BoJ's cautious approach to monetary tightening, combined with global uncertainties like tariffs and currency fluctuations, adds further ambiguity to the outlook. Investors must weigh whether Japan's rising yields signal a broader global trend toward higher rates or a localized response to domestic dynamics.

China's "neijuan" or Involution

The term "involution" has gained prominence in Chinese sociology to describe a state of intense, self-defeating competition in which participants exert ever-increasing effort with diminishing or negligible returns. This concept resonates in today's China, where the economy faces mounting challenges: slowing GDP growth, ongoing uncertainties around tariffs and access to advanced AI chips critical for driving productivity in artificial intelligence and the green transition, stagnant consumer prices, and youth unemployment hovering in the double digits.

Yet, despite these headwinds, Chinese equity markets—including the Hang Seng Index—have demonstrated notable resilience, buoyed by stronger-than-expected GDP readings in the first half of the year. This divergence between macroeconomic fundamentals and market performance recalls Jesse Livermore's observation: "Markets are never wrong, opinions often are." It suggests that beneath the surface, there may be forces at play signaling the potential for a shift in sentiment or the emergence of new growth drivers.

Nvidia – AI Leader

Following NVIDIA's recent earnings report, CEO Jensen Huang projected that AI infrastructure investments could reach \$3–4 trillion by the end of the decade, reflecting strong optimism about the sector's long-term growth. This bullish outlook underscores the increasing demand for computational resources, particularly GPUs, to support AI training and inference workloads. However, the company's current-quarter forecast was relatively cautious, tempered by uncertainties such as the unclear strategy for the Chinese market, which remains a significant variable due to geopolitical and regulatory complexities.

Market sentiment on AI's trajectory is polarized. One perspective views AI as overhyped, with skeptics arguing that current valuations of AI-driven companies, including NVIDIA, are unsustainable given the modest near-term guidance. The opposing view sees AI as a transformative, enduring force, with its potential only beginning to unfold. I align with the latter perspective, believing AI is poised to reshape industries over the long term. However, current valuations appear inflated, likely driven by market exuberance. This aligns with a common pattern in technology adoption, where near-term expectations are often overestimated, while long-term impacts are underestimated. The compute market, particularly for AI, is expected to grow significantly, but investors should approach valuations with caution.

Finding Refuge in a Volatile World

We recommend maintaining an underweight position in U.S. equity markets due to elevated valuations and sector-specific risks. The S&P 500's price-to-earnings (P/E) ratio stands at 23.5x trailing 12-month earnings, significantly above its historical average of 18x, indicating overvaluation.


In contrast, selective opportunities in non-U.S. markets offer better risk-adjusted return potential:





- **Hong Kong:** The Hang Seng Index low valuations (P/E ratio of 9.8x vs. S&P 500's 23.5x). Technology sectors, particularly AI and semiconductor firms, benefit from strong retail investor inflows and a favourable risk-on sentiment.
- **Japan:** The Nikkei 225 P/E ratio of 14.2x and a 10-year Japanese government bond yield of 1.61% suggest undervaluation relative to U.S. markets. The increased inflationary pressure supports Equity growth.
- **South Korea:** The Kospi Index, with a P/E ratio of 12.5x, offers exposure to technology giants like Samsung. South Korea's 11% weighting in the MSCI Emerging Markets Index and its classification as a developed market by FTSE enhance its appeal.
- **European Markets:** The MSCI Europe Index's P/E ratio of 14.5x is two standard deviations below its long-term average relative to the S&P 500, indicating significant undervaluation.

- **DXY:** We project the U.S. Dollar Index (DXY) to continue its downward trajectory, with a potential target of 89 over the next 12 months, reflecting a bearish bias driven by asymmetric risk factors. Investors should consider EM exposure unhedged.
- **XAU:** Allure for Gold continues in the current environment. Global central bank purchases, particularly by China and India (adding 1,050 metric tones to reserves in 2024 and 800 metric tones for 2025), and strong retail demand in Asia continue to bolster prices.
- **Fixed Income:** Our discerning clientele is fully cognizant of our perspicuous viewpoint, rendering superfluous, any reiteration of the axiomatic (sorry could not resist this gobbledygook).

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