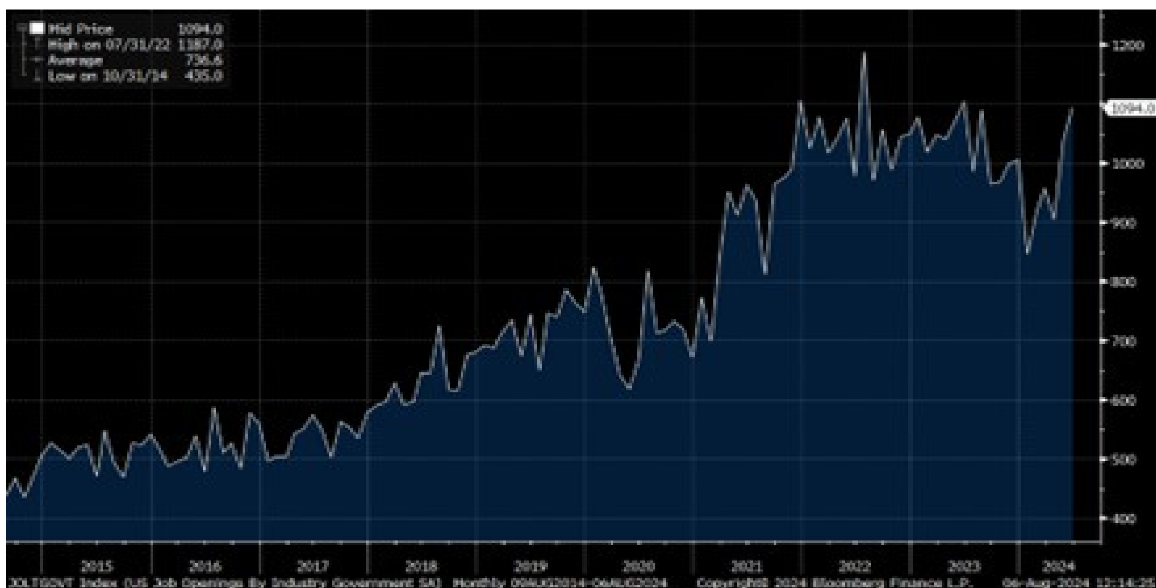
DAVIS COMMODITIES LLC

July 2024 Macro Commentary

After the first quarter of the year surprises with higher inflation readings, the second quarter and beginning of the third quarter have come more into line with the macro outlook. Inflation has been slowing as CPI has moved steadily lower from the elevated Q1 level of ~3.5% annualized to ~3%. With the Fed currently employing real rates of over 2% and energy prices moving down, it appears that one half of the Fed's dual mandate is coming under control.

Regarding employment (the other half of the Fed's mandate), data has been softening. Like the inflation readings, the first quarter came in strong and data since then has been weakening. The data from the JOLTS (Job Openings and Labor Turnover Survey) continues to move lower from the post pandemic high. The chart on the left shows the JOLTS total job openings. As you can see, it has moved from an extremely elevated level to something more normal. The right-hand chart is the change in private sector job openings with a similar pattern.

A truly interesting dynamic in the labor sector is the sheer number of government jobs. Not that this is much of a surprise, but there is definitely a bull market in government (chart below).



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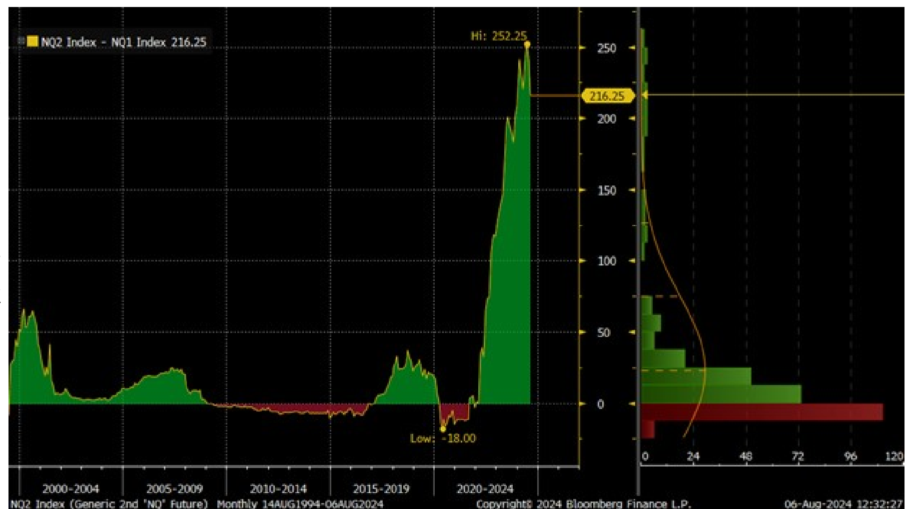
While the JOLTS continues to move lower, what truly got the market's attention was non-farm payrolls. The change in July was 114k vs expectations of 175k and revisions of -29k for the previous two months. The lower than expected addition of jobs and a higher labor force participation rate bumped unemployment up to 4.3% from 4.1%. In addition, hourly earnings and hours worked were both lower than expected. To sum it up, you have a higher unemployment rate with people working fewer hours and earning less money than expected. While none of this is catastrophic, it does point to the simple fact that the Fed's monetary policy could be overly restrictive as both inflation and employment weaken. As of today, the market is pricing in 1.7 cuts (0.43%) to the Fed Funds rate by the September 18 meeting and 3 total cuts by the November 7 meeting. Over the past month, the yield steepening trade has been working nicely. As the Fed embarks on its rate cutting spree, look for the yield curve to move from inverted to a more normal contango (chart here for reference).

In addition to the yield steepening trade, the bear spread in the Nasdaq 100 has been added to the portfolio. While a recession is certainly not the base case, certainly we are looking at a slowing economy. When the market thinks that earnings will grow for eternity, the back month of the futures moves to a premium to the front as earnings should be larger in the future. As you can see in the chart below, the market is pricing in a massive increase in earning power for the Nasdaq 100. A simple slowing of economic growth should return this spread to a more normal spread of 50-75 over the next few months. This is a limited risk trade with a relatively high reward.



Sincerely,

Stephen Davis
August 6, 2024

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