Prepare for Landing

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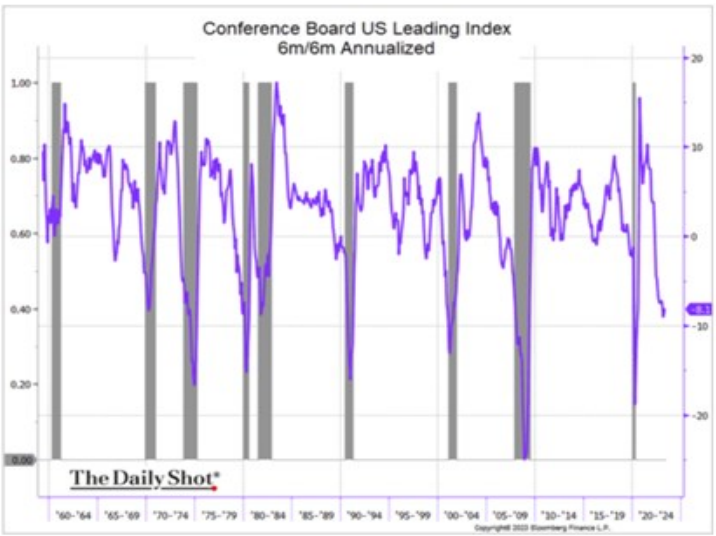
As the markets have continued to move higher, there is increasing chatter about the Fed succeeding in navigating the US economy to a soft landing and avoiding a recession altogether. The historical data, as noted in previous PCM Reports, suggests a recession is unavoidable when the yield curve has been this far inverted for an extended period of time. Wall Street optimists have created a narrative that "this time is different" but it remains to be seen if a soft landing following the Fed's historic rate hikes is possible.

The Conference Board's Leading Economic Index suggests a hard landing (recession) is far more likely as the chart indicates. Since 1960, there has not been a time where the LEI contracted by today's level without a recession following soon after. Fortunately, the construction of the Index is transparent in terms of what is being measured. Items such as average workweek, ISM data, consumer expectations, building permits, non-durable capital goods orders, jobless claims and stock market prices are among the 10 data points that comprise the index. As of late July, the only data point that is positive is stock prices, all others contribute to the negative reading. If stock prices were neutral, the LEI would have a decline of nearly 10% instead of the current 7.5% decline.



Another data points that suggest Wall Street optimists will be disappointed is the real interest rate on the 2-year Treasury. Over the last 30 years, the average spread between the yield on the 2-year UST and inflation has been just .04% according to Bloomberg data. The spread today has exceeded 2.0% and sits at a historically high level. The consequence of high real yields is the cost of financing, whether US government debt, corporate debt, or consumer debt, being extraordinarily high today. It may take time, but as household savings are diminished eventually there should be a drop in consumer spending leading to recession.

Lacy Hunt of Hoisington Investment Management has documented the impact of the surge of debt that accumulated in the government's response to the pandemic. Reckless or unproductive debt had been climbing for decades but accelerated to unsustainable levels between 2020 and 2022. The mountain of money created in 2020-2021 that fueled consumer spending and inflation is gone and real wages (adjusted for inflation) are actually lower than pre-pandemic levels. Banks and other lending institutions appear to see the writing on the wall and are expecting a wave of defaults in the near future. It is unprecedented for bank credit to contract at a time when real GDP is rising. A growing money supply typically results in greater bank lending. However, the 12-month rate of change in bank credit is actually -2.3%. The rate of change is also negative over 24 and 36-month periods. The expected result is an impending credit crunch where businesses and consumers struggle to remain current on their loan commitments. Real bank credit is typically a lagging indicator as seen by the fact that it did not contract until the end of the Great Financial Crisis recession of 2008-2009.

The point of the data is that the overwhelming likelihood of a recession in 2023 or early 2024 remains regardless of what the stock market is suggesting. John Mauldin has noted for years that the average peak to trough drop in equity prices during a recession is about 40%. If you take the current cycle high on the S&P 500 of 4766 set in late 2021 and reduce by 40% you would get a S&P level of 2860, about 35% below current levels. Of course, knowing where the markets are likely to be in the future is only part of the equation. As Depression-era economist Keynes stated, "*The markets can remain irrational longer than you can remain solvent*". It seems unlikely to me that the S&P will move above the December 2021 high before a recession, suggesting there is upside on equities of around 5% and potential downside of nearly 35%. Not as optimistic an outlook at stock market bulls would peddle.

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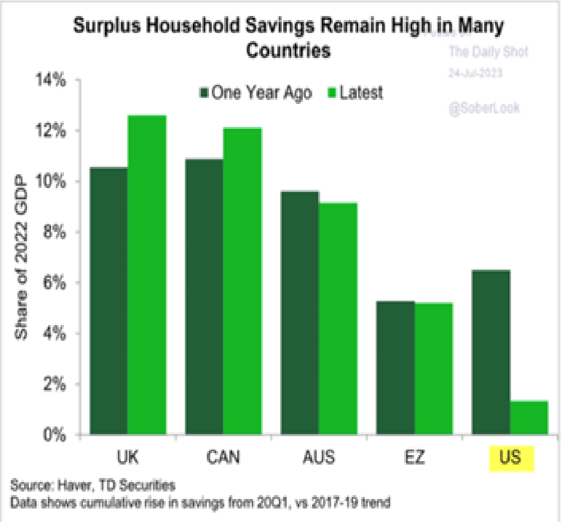
Fixed income investments would equally be impacted if a pending recession materializes. There has been an absolute disconnect in spreads on high yield bonds. As investor clamor for yields above inflation, the spread between Treasuries and high yield bonds has remained stable even as bankruptcy filing have risen from 2% in mid-2022 to over 12% today. Rising defaults will ultimately lead to much higher spreads than we see today and huge losses in high yield positions.

What we should take away from the current economic picture is to remain vigilant in terms of real diversification and hedging even if it means ignoring many of today's financial headlines.

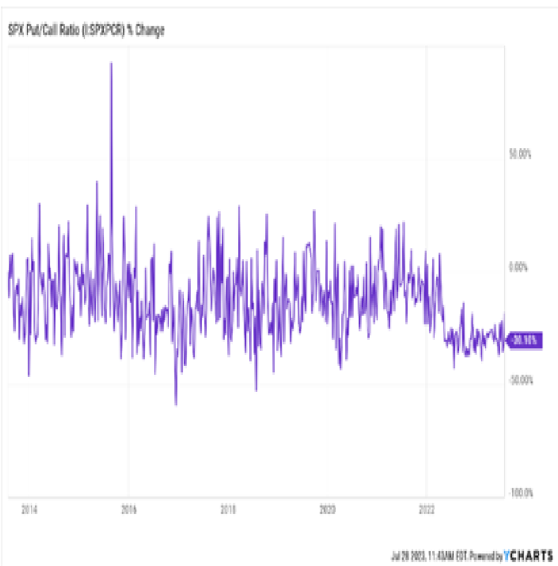
Bidding Adieu to Savings



Household savings are an important factor in a healthy and growing economy. Surplus savings serve as a ballast against short-term changes in household income. When savings are at healthy levels, unexpected expenses do not require the use of expensive debt or force a change to ordinary spending habits. Over time, surplus household savings tend to remain stable and often only change dramatically at inflection points in the economy. As the chart demonstrates, the household savings rate in the US has fallen dramatically from year ago levels, dropping from 6.5% to just 1.5% today. This data suggests there is little margin for US consumers to maintain their lifestyle if there is any interruption in their income or they face unexpected expenses. Falling savings rates are often a leading indicator to slower consumer spending.

- Most other Western economies have seen their savings rate either increase over the trailing 12 months or remain flat with UK savings rates among the higher in the West.
- Household savings rates surged during the COVID pandemic as governments provided massive transfer payments at a time when spending decreased due to shutdowns.
- The surplus savings created during the pandemic is expected to be exhausted by the end of 2023 as consumers have had to use savings to offset the impact of high inflation.

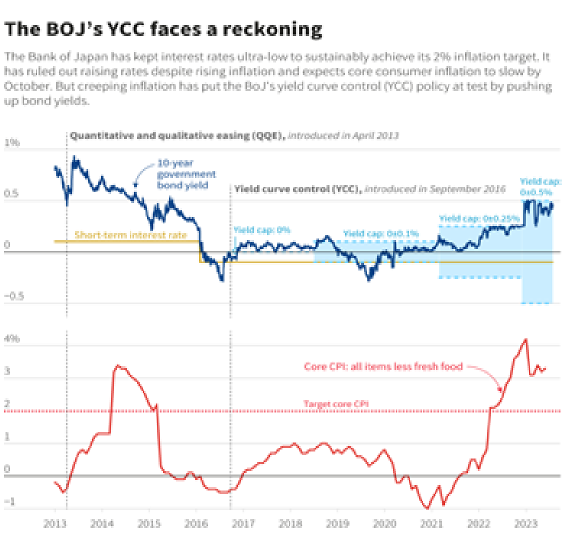
Market Sentiment – Put/Call Ratio



The put/call ratio on the S&P 500 Index is often used as a gauge of market sentiment and measures the ratio of put option volume to call option volume on the S&P 500 Index. If the ratio is above one, then there is more put option volume than call option volume, and the sentiment is bearish. The higher the ratio goes the more bearish the sentiment. Conversely, if the ratio drops below one, the sentiment is bullish as call option volume surpasses put option volume. Based on the chart, the average put/call ratio over the past ten years is roughly 1.7, although the data somewhat skewed by 2015. At bullish extremes, such as in 2013, the ratio fell to roughly 0.8.

- Sentiment has improved this year compared to 2022. The average put/call ratio in 2023 is roughly 1.3 versus an average ratio of roughly 1.6 in 2022. During the onset of COVID, the put/call ratio averaged roughly 1.8 for 2020.
- The improved sentiment is likely due to recent economic data which suggests that economic growth (as measured by GDP) has been better than expected, unemployment is below 5% and corporate earnings are expected to improve in the second half of the year. Still the markets are slightly bearish given uncertainty regarding interest rates.

Policy Shift



Last week, both the Fed and ECB decided to raise interest rates by 25 basis points. Currently, the ECB's main rate sits at 3.75%, while the Federal Funds target rate is 5.25-5.50%. However, in a move what some analysts said could be a seismic shift for global financial markets, the Bank of Japan decided to loosen its grip on bond yields by keeping the target for 10-year yields at around 0%. It also maintained guidance allowing the 10-year yield to move 0.5% around the 0% target but said those would now be "references" rather than "rigid limits". While some investors had expected a modest change in the BOJ's guidance, the announcement shook financial markets which have grown used to years of its ultra-conservative policy. Japanese investors, who hold vast amounts of U.S. fixed income, including treasury notes and other debt securities, could begin to see a higher level of yields offered domestically. Higher yields for Japanese investors could then prompt heavy liquidations of those U.S. fixed income positions, and then replace with their own domestic securities.

- The BOJ said it would offer to buy 10-year Japanese government bonds at 1.0% in fixed-rate operations, instead of the previous rate of 0.5%, signaling that it would now tolerate a rise in the 10-year yield to as much as 1.0%.
- The yield on the 10-year JGB has traded above 0.4% but remained below the 0.5% cap. Continued interest rate rises by the Federal Reserve and other major central banks in the past year have raised worries that the 10-year JGB yield could test the limit.
- News of the policy tweak snapped the Dow Jones Industrial Average's longest consecutive winning streak since 1987 after the 10-year Treasury yield surged back above 4%.

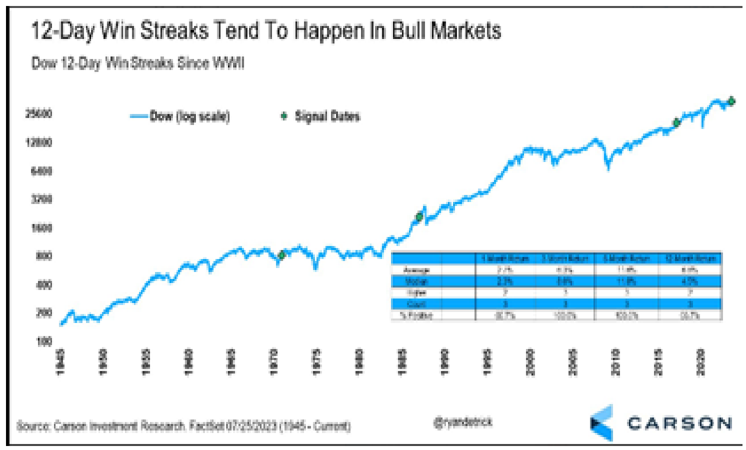
Quinn VandeKoppel

Macro View – And Another One

Last week, the FOMC raised their Fed Funds Rate by another 25 basis points, but carefully made sure not to provide any clear signal about its intentions for a September meeting. This latest interest rate increase now leaves the current target rate at 525-550 basis points. Looking ahead, many economists continue to expect that yesterday was the final hike of the cycle as inflation should subside further between now and the September meeting. According to the CME's FedWatch Tool, the probability of no change in interest rates at the September meeting is 76%. While the Fed still remains data dependent, they appear likely to skip a rate increase during their September meeting and then conclude in November, contingent that inflation has slowed enough to make an additional hike unnecessary.

Taking Stock – Dow's Historic Positive Streak

Since 1950, the Dow Jones Industrial Average (DJI) has only had three separate instances where the major index has had a positive streak of 12 consecutive days or more. However, for the fourth time in history, the DJI surpassed 13 consecutive days last week. But what is the significance of the rally if there even is one? If you look at the chart below from Carson Investment Research, for both the three and six months following this milestone, the index rose higher in every instance. And while history often repeats itself, it does not always rhyme. Therefore, given the current economic environment, one should be cautious as both the Federal Reserve has yet to finalize their interest rate hiking campaign and many economists still predict a recession towards the end of the year.

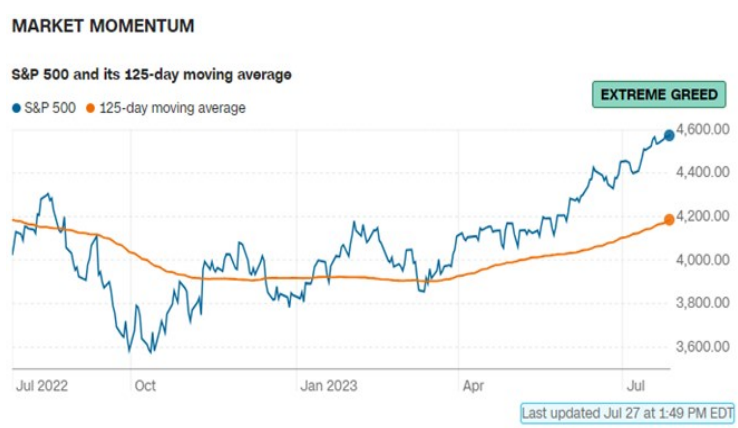


Fixed Income – Risk Premium

Historically when calculating the value of stocks, one must look at the company's earnings yield by dividing a its expected earnings over the next year by its price, and then compare that number to the yield on government bonds. The difference between the two, often considered "equity-risk premium", shows how much investors are being compensated for the additional risk of investing in stocks. Last week, the chart below shows the gap between the earnings yield of the S&P 500 and the yield on the 10-Year U.S. Treasury dropped to around 1.1%, the narrowest it's been in the last 20 years. With the major index only 5% away from its previous all-time high, investing in bonds, specifically short duration T-bills yielding north of 5% for example, appears to be a more attractive risk-to -reward option for investors than stocks at this time.

Technical – Extreme Greed

Over the last few months, the technology sector, fueled predominantly by the "AI rally", has been on an absolute tear. As of the time of this writing, the Nasdaq Composite is up more than 40% for the year, while the S&P 500 Index is up 18% over the same period. However, after only being 0.50% from June 22' levels on the S&P 500, one could believe markets have become too extended. The chart below shows the S&P 500 and its 125-day moving average. When the S&P 500 is above its moving average of the prior 125 trading days, that's a sign of positive momentum. But if the index is below this average, it shows investors are getting skittish. However, when the spread between the two widens significantly, as you can see on the chart below, it indicates there is extreme greed in the markets.



YTD Equity Performance Review

Clint Pekrul, CFA

The first half of 2023 has delivered a mixed bag in terms of performance. After a tumultuous 2022, when most asset classes were repriced lower due to Fed interest rate policy, this year has offered some reprieve. The broad-based S&P 500 Index has surged roughly 20% for the year, but this rally could be deceiving.

This Year's Rally

As mentioned before, the S&P 500 Index is up nearly 20% in 2023. Rallies of 15% or more over the first seven months of the year have happened for the S&P 500 Price Index 16 times going back to 1950. The Table below highlights these rallies and subsequent one- and three-year returns:

S&P 500 Index Rallies (15% or Greater Over First Seven Months of the Year; 1950-2023; Source: YCharts).

Year	Rally Percent	Beginning P/E Ratio	Subsequent One-Year Return	Subsequent Three-Year Return
1987	31.6%	16.72	-14.6%	3.8%
1975	29.4%	9.11	16.6%	4.3%
1997	28.8%	19.13	17.4%	14.5%
1989	24.6%	11.69	2.9%	7.0%
1954	24.5%	9.88	40.9%	15.8%
1995	22.4%	15.01	13.9%	25.9%
1955	21.0%	12.99	13.5%	2.7%
2023	19.5%	22.23	N/A	N/A
2019	18.9%	18.94	9.8%	11.5%
2013	18.2%	16.49	14.5%	8.8%
1958	18.0%	11.87	28.2%	12.3%
1967	18.0%	14.47	3.2%	-6.3%
1991	17.4%	15.47	9.4%	5.7%
2021	17.0%	38.23	-6.0%	N/A
1983	15.6%	11.13	-7.3%	13.3%
1998	15.5%	32.60	18.6%	2.6%

The takeaway from the table above is that we cannot necessarily draw conclusions about forward returns over the near term based on how much we have rallied so far this year. However, in most cases historically, rallies continued to plow forward over the one-year and three-year subsequent periods.

When the market has risen by at least 15% over the first seven months of the year, the average return over the subsequent one- and three-year periods is 10.7% and 8.7%, respectively. One noteworthy observation, however, is the average price-to-ratio for the S&P 500 Index when the rally starts. On average, the starting PE ratio is roughly 17x. Today, the S&P trades at a PE of roughly 22x.

There were two occasions historically when the starting PE was above 22x – 1998 and 2021. We know what ultimately happened during the dot.com bubble when unsustainable valuations led to a 45% selloff in the S&P 500 Index. We know that the rally of 2021 was taken out with the selloff in 2022. Only time will tell if earnings will support the current rally, but we did start from a relatively high valuation.

Factor Performance

What is deceiving about this year's equity market rally is how narrow the support has been outside the mega-cap growth stocks. The chart below illustrates the year-to-date performance of various equity factors year-to-date:

When the S&P 500 rallies and is supported by only a few mega-cap stocks, equity factors can underperform. For example, after outpacing the S&P 500 Index for the better part of the last decade, low-volatility stocks have struggled recently. The reason is simple – the volatility of mega-cap stocks prevents their inclusion in the factor (i.e., they are collectively underweight versus the S&P 500). Likewise, the multiple levels where mega-cap stocks trade prevents their inclusion in the value factor.

We might expect momentum to provide outperformance versus the broader market given the current rally. However, momentum strategies take time to reposition their holdings. Consider that the stocks that are leading the rally today were in many cases the names that struggled in 2022. To start the year, when the rally intensified and market sentiment rotated from defensive positioning to growth, momentum was caught on the wrong side. In other words, momentum succumbed to a classic whipsaw.

Obviously, the small-cap factor would not include mega-cap growth names. The high-quality factor, however, does maintain material exposure to mega-cap stocks because in many cases, these companies have solid balance sheets. The high-quality factor does not incorporate price volatility, trends or valuations as screening criteria.

The ideal setup for stocks for the remainder of the year would be for earnings to come in better than expected to support current valuation and for inflation to continue to subside closer to the Fed's target. This backdrop should provide a framework for broader rally participation and a sustained upward trend for stocks.

Q: What will be the next move for the Fed?

The Fed hiked in July as expected after their pause in June so they have remained mostly on script to this point. The market is more divided about whether the Fed would be done with this cycle of rate hikes or if they would continue to tighten monetary policy until they see evidence of 2% inflation as measured by the PCE. As noted in the Introduction of this report, stock prices are the only leading indicator out of ten indicators that suggest the economy is expanding with many of the other nine indicators at levels consistent with prior recessions. I think the Fed will have to awaken to the reality that with a 12-15 month impact lag on rate hikes, the eventual consequence of the highest real interest rates in a generation will lead to a recession where inflation is almost certain to fall below 2%.

If I was a betting man (which I am not), I would bet the Fed's next move is a 50-basis point drop in rates that probably occurs in late Q1 or Q2 of 2024. Everyone has understood the Fed's need to move quickly when inflation was reaching double-digits as a result of their own hubris in believing rising inflation in 2020 was transitory. Any additional hikes and the Fed will be very susceptible to hindsight suggestions they went too far with rate hikes and did more damage to the economy than necessary to contain inflation.

As I'm writing this and observing the bond market, the yield on the 10-year U.S. Treasury Bond just traded above 4% again on news that second quarter GDP grew at a 2.4% rate versus an estimate of 2.0%. Meanwhile, the consumer price index now stands at a shade under 3%. It's much closer to the central bank's target rate now compared to a year ago. The unemployment rate is 3.6%, below the 5% rate that economists consider full employment. The central bank just raised the funds rate to a target of 5.25% to 5.50%, the highest level since before the global financial crisis in 2008.

The Fed will be data dependent, but I think the central bank will increase perhaps one or two more times for a terminal target of around 6%. The one scenario the Fed does not want to happen is for inflation to heat up again after showing signs of subsiding. GDP growth has exceeded expectations for two straight quarters and the unemployment rate is low. The Fed might look at the current situation and conclude that it is too early to take their foot off the pedal, so to speak. There is enough kindling to flare up inflation and make the Fed's task of hitting their two percent target even tougher. But I wouldn't expect the Fed to surprise the market with incremental increases beyond 25 basis points.

Q: Is Reshoring going to save the US economy?

With respect to where I believe the economy is headed over the next 24 months, sadly no, I do not expect reshoring (jobs moving from overseas to the US) to make much of an impact. Looking at the data, the ISM Manufacturing Index is the most likely data point to confirm reshoring's impact on the economy. ISM Manufacturing was last at 50 in October 2022 and has been declining since and hit a new cycle low of 46 last month. As a result of the massive supply chain interruptions during the pandemic, many companies discussed the need to create more secure supply chains and move manufacturing back to where they had more control. While it sounded great in theory, when corporate leaders began to understand the cost of implementing redundant supply chains or moving manufacturing back to the US the cost of doing so became a major hurdle. For many companies, a strategy of hoping another pandemic does not occur for decades was opted for.

I do expect reshoring to occur but mostly in limited areas of the economy. Examples would include mining for rare earth minerals that have become very important, manufacturing and development of computer chips that virtually every aspect of the economy relies upon, as well as production of certain medications that while commonplace, the US found itself in very short supply during COVID. Some jobs will be created by reshoring but likely not enough to make the impact some are suggesting will occur.

After the onset of COVID in 2020, the global economy came to a sudden halt amid lockdowns to help contain the virus. In the process, supply chains were greatly disrupted. This breakdown led to supply and inventory disruptions as demand was supported by government stimulus. The result was a surge in prices for many goods and services. Businesses began to question their operations, particularly for the use of overseas sourcing for the production and manufacturing of products. Instead, businesses rationalized that they could reduce costs by producing their products closer to the point of sale and minimize the risk of supply chain disruptions.

Reshoring is the term used to describe the process of increasing domestic manufacturing (made in the USA). Reshoring would give producers more control over their own supply chains. The trend over the past several decades was globalization in search of cheap labor and materials. But technology has come a long way and companies are more operationally efficient. In the long-run having a more self-sufficient economy is the path to take, but it will come at a near-term cost as companies have to reshore their operations. This could mean temporary supply chain disruptions and capital expenditures today for the benefit of efficiency in the long-run.

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