G. Kevin Spellman ("Coach"), PhD, CFA
Senior Advisor, ISS EVA
Professor of Practice & David O. Nicholas Director of Investment Management, University of Wisconsin-Milwaukee
Adjunct Professor, IE Business School
kevin.spellman@issgovernance.com
608-334-2110

Macro Strategy

What's The Market Thinking?

After moving sideways to down for a couple months as inflation perked up its ugly head, the market is back to an all-time high following weaker-than-expected employment and inflation reports in May. Value is driven up by higher profits, higher growth, and lower risk, and the market appears optimistic about each.

$V_0 = EVA_0 * (1+g) / (WACC – g) + IC_0$ (**equation 3**)

Bad news is good news. The story line is as follows. The economy is slowing, so that brings down inflation, but the slowing is temporary, and the long-term future is bright due to advancements in artificial intelligence (so EVA and "g" are high). Lower inflation brings down the cost of debt and risk-free rate, and the better economy drives down the risk premium, so WACC heads down. Oh, and let's not forget that business will invest in capital, which drives up IC.

Perhaps this narrative is right, maybe it is wrong, but undoubtedly, sentiment has risen substantially.

Value Driven by Profitability, Growth, and Risk

1. Value = present value of free cash flow (FCF)

   $V_0 = FCF_1 / (1+WACC)^1 + FCF_2 / (1+WACC)^2 + …$

   $+ FCF_\infty / (1+WACC)^\infty$ (**equation 1**).

2. If growth and WACC are constant, the model simplifies to:

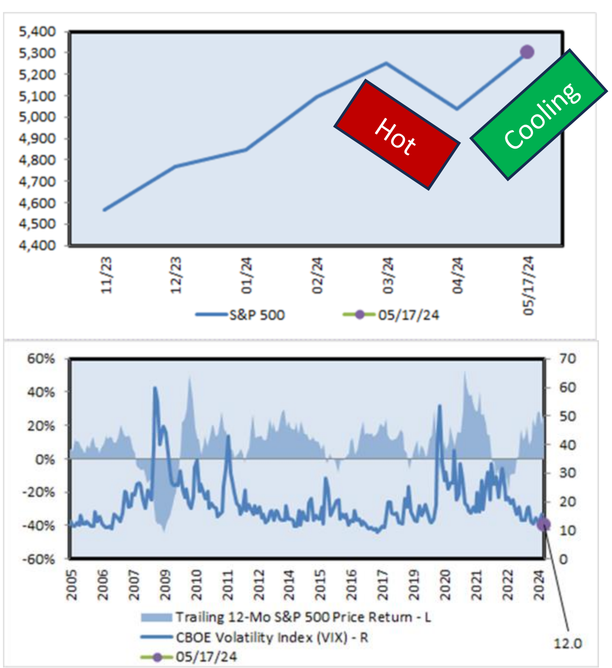
   $V_0 = FCF_0 * (1+g) / (WACC – g)$ (**equation 2**).

3. In "How EVA Can Enhance DCF and P/E Analysis: A Case Study," it is shown how equation 2 can be rearranged to:

   $V_0 = EVA_0 * (1+g) / (WACC – g) + IC_0$ (**equation 3**).

   Value equals the present value of EVA plus the capital invested (IC_0). EVA = (return on capital – WACC) times the amount of capital.

Market at High and Volatility at Low



ISS EVA, FactSet, CBOE, S&P

THE WALL STREET JOURNAL.

May 15 **Cooling**
Inflation Eases as Core Prices Post Smallest Increase Since 2021
Results are in line with expectations. Investors cheer, sending stocks higher.

May 3 **Cooling**
Slower Hiring Boosts Hopes of a Late-Summer Rate Cut
Employers added 175,000 jobs and the unemployment rate ticked up to 3.9% in April

April 10 **Hot**
Stock Market News, April 10, 2024: Indexes Drop, Yields Rise After March Inflation Tops Forecasts
Latest CPI report clouds rate-cut outlook; March meeting minutes released

April 5 **Hot**
Strong Jobs Report Still Leaves Wiggle Room for the Fed, but Not Much
Expanding supply of workers lets the economy add jobs without overheating, but will that be enough to keep rate cuts on track?

March 12 **Hot**
Inflation Picks Up to 3.2%, Slightly Hotter Than Expected
A focus at the next Fed meeting will be whether most officials

March 8 **Hot**
Stock Market News, March 8, 2024: Indexes End Lower After Payroll Gains Top Forecasts, Unemployment Ticks Up
U.S. employers added 275,000 jobs in February; Indexes post weekly losses

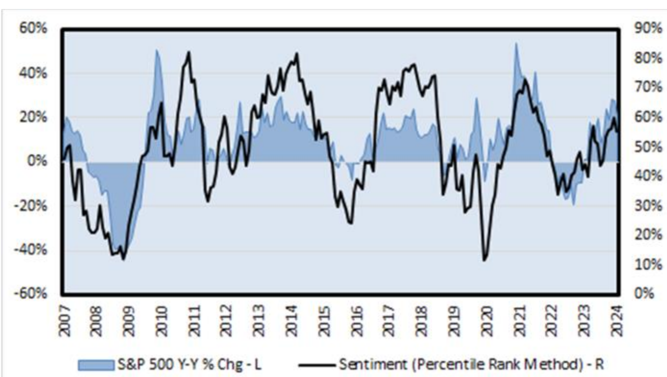
Feb. 13 **Hot**
Hotter-Than-Expected Inflation Clouds Rate-Cut Outlook
Consumer prices rose 3.1% in January, ahead of economist forecasts

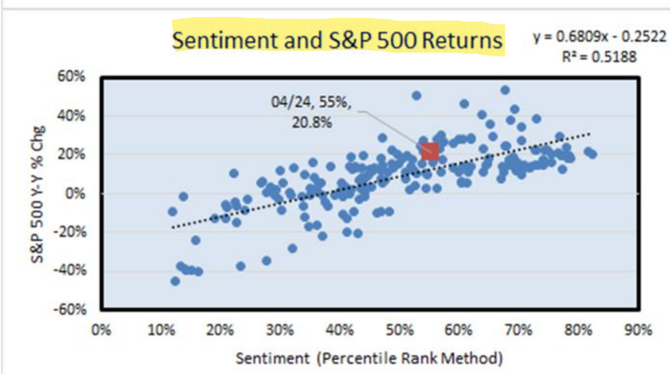
If You “Feel” Good, Be Careful – Five+ Months to Go?

Sentiment is elevated. People feel good. That’s exactly the time to be cautious. As Warren Buffet once said, it’s wise to “be fearful when others are greedy.” Howard Marks added, “…extrapolating trends is one of the most dangerous things an investor can do.” So far, we’ve avoided the dreaded recession that most people forecasted in 2022, but as I noted in “Employment Isn’t as Good as the Headline Implies,” we are not out of the woods yet. Plus, perhaps ironically, the better the jobs report and the more immigration rises, which holds down wage inflation, the sooner job openings to the number unemployed become balanced and recession worries rise.

There’s a plethora of reasons people ignore risks until it’s too late. Perhaps they are too confident, as after-all, stocks are up. They often forecast using the rear-view mirror and think – “Hey man, don’t spoil the party with negative thinking. HAHAHA Employment is still strong, and the overall inflation trend is still down.” I suppose my neighbors didn’t like me warning of the housing bubble (before it burst) at the neighborhood gathering, either. People tend to overweight the most recent information in forming their expectations, which are for a soft or no landing.

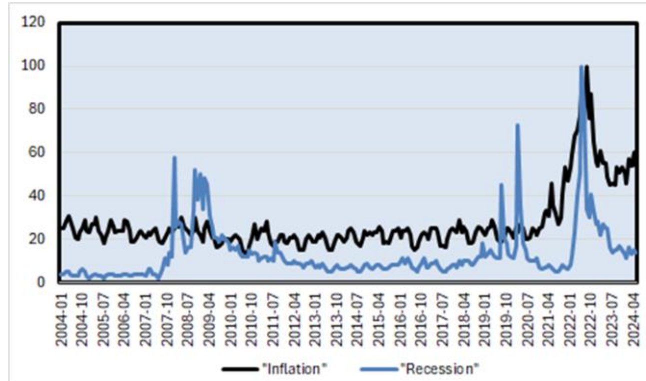
Sentiment is High and Up with Stock Prices





Spellman, FactSet, AAII, Conference Board, CBOE, CRB, DOL, Federal Reserve, ICI, ISM, NFIB, University of Michigan, S&P

People Not Worried About a “Recession”, but Inflation Worries Ticking Back Up



ISS EVA, Google Trends, web search

Here’s some math from “Employment Isn’t as Good as the Headline Implies,” but updated for data through May.

> 2.0 in early 2022

8.5 mil job openings
6.5 mil unemployed
2.0 net and jobs-to-unemployed ratio of 1.31

People are cheering immigration as possibly being the reason why wage inflation did not spike with good employment numbers. That’s the good news. The bad news is it means the day when the net is zero and the unemployment rate rises comes nearer.

Assume that the participation rate is unchanged (the 25-54 year old participation rate is back to 2007 highs), the labor force grows 0.6% per year (from 170 mil) or 1,020,000 per year or 85,000 per month (pre-pandemic, this number was perhaps higher but with AI it may be lower), and the 6.5 million unemployed is unchanged until it begins to rise.

1. Let’s say the job report is 285,000 per month, so each month net job openings decline by 200,000. In 10 months, we have a problem as the net job openings becomes zero (2 mil net/200,000).

+

2. If immigration is underestimated, then the jobs number above is as well. The CBO/Brookings estimate is that there were 3.3 million immigrants in 2023, up from 1.0 million before the pandemic, or 200,000 more each month. If businesses cannot accommodate this influx, immigrants take some of the existing job openings.

=

Five Months to Go?

3. The net declines by 400,000/month → in five months the job openings to unemployed is 1.0.

Feel free to contact me with questions or contradictions!

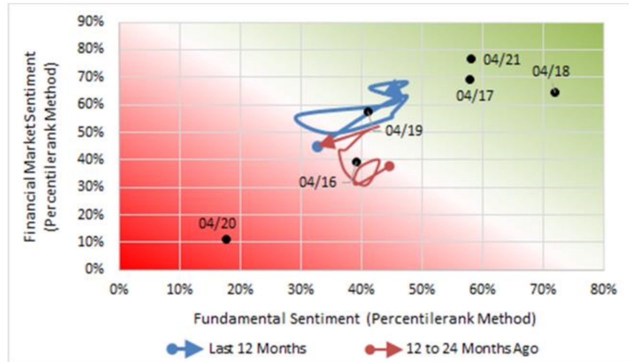
Financial Sentiment Up More Than Fundamental Sentiment

Financial market sentiment is up more than fundamentals. My sentiment (expectations) model has 26 variables, categorized first by fundamentals and second by financial markets. All variables are converted to percentiles based on three-year trend (approximately half an economy cycle) and weighted.

Fundamentals measure business and consumer sentiment. For instance, business sentiment includes what's happening, and one survey. The PMI manufacturing, lending, and fixed investment measure what's occurring, and the survey is on small business optimism. The consumer is measured by two sentiment indexes and investment. The AAII bull-bear survey, stock/bond allocation, and fund flows focus on investment.

The financial market sentiment indicators range across equities, fixed income, and alternative investments. Valuation, revisions, advance/decline, and how far the price differs from its average measure equity sentiment. Credit sentiment focuses on the real rate, bond spreads, inflation expectations, and credit spreads. Finally, lower values for alternatives such as the dollar, gold, VIX, and the put/call ratio indicate higher sentiment, while higher values for oil, commodities, and leverage indicate optimism.

Financial Sentiment Up More than Fundamentals



Spellman, FactSet, AAII, Conference Board, CBOE, CRB, DOL, Federal Reserve, ICI, ISM, NFIB, University of Michigan, S&P

Fundamentals		
Business	**Consumer**	
Business Surveys	Cons. Conf. Surveys	
Fixed Investment	AAII Surveys	
Comm. Loan Growth	Stock-Bond Flows	
Financial Markets		
Credit	**Equity**	**Alternatives**
Real Risk-Free Rate	Valuation (Multiples)	Currency
Inflation Expectations	Revisions	Commodities
Yield Curve	Advance-Decline	Volatility Index
Credit Spreads	Price Bands	Safety/Risk Ratios

Credit Sentiment is High

April	3-Yr				Higher Hot or	
Reading	Average	Min	Max	%'tile	Lower Hot	Variable
Business						
49.2	52.6	46.4	61.7	44%	Higher	ISM PMI Mfg Index
4.7%	-3.4%	-19.4%	45.7%	78%	Higher	ISM PMI Mfg Index Y-Y % Chg
89.7	93.3	88.5	102.5	14%	Higher	NFIB Small Business Economic Trends Optimism Index
5.5%	8.2%	3.1%	17.6%	25.0%	Higher	US Fixed Investment Growth % Chg YOY Q End
2.3%	5.1%	-4.2%	12.2%	33.3%	Higher	Commercial Bank Loans and Leases Y-Y % Chg
Consumer						
97.0	107.8	95.3	128.9	2.7%	Higher	Consumer Confidence Index
77.2	67.4	50.0	88.3	83.3%	Higher	University of Michigan Consumer Sentiment Index
19.8%	4.0%	-50.1%	48.2%	63.8%	Higher	1-Yr Chg in AAII Bull-Bear
55.5%	52.4%	48.0%	57.2%	80.5%	Higher	AAII Stock-Bond Allocation
-70554	-33285.9	-105651	50093	8.3%	Higher	ICI Stock-Bond Flows ($ Mil)
Credit						
1.7%	-2.2%	-6.4%	1.7%	100.0%	Higher	Fed Funds-CPI Core
2.4%	2.4%	2.1%	2.9%	61.1%	Higher	10-Yr US Treasury - 10-Yr US TIPS
-0.2%	0.0%	-0.9%	1.5%	50.0%	Higher	10s2s
-1.4%	-2.0%	-2.4%	-1.4%	100.0%	Higher	10 Year US Treasury - Moody's BAA
-1.2%	-1.7%	-2.2%	-1.2%	100.0%	Higher	10 Year US Treasury - US Corporate Industrials 10+ Year
Equity						
24.0	21.9	16.9	29.5	75.0%	Higher	S&P 500 P/E (Excluding Negatives)
4.49	4.21	3.52	4.76	75.0%	Higher	S&P 500 P/B
49	54	-70	234	58.3%	Higher	S&P 500 Up-Down Revisions (3-Mo Avg)
-258	-135	-1138	780	36.1%	Higher	A-D Number (3 Months)
1.14	0.59	-2.36	2.07	50.0%	Higher	S&P 500 Standard Deviation from 12-Mo Avg
Alternatives						
117.5	112.8	101.9	123.2	13.9%	Lower	Nominal Trade-Weighted Dollar Index
$83	$82	$64	$114	63.8%	Higher	WTI
586.2	597.5	505.9	786.5	52.7%	Higher	GSCI
$2,303	$1,896	$1,641	$2,303	0.00%	Lower	Gold
16.1	19.8	12.7	30.0	75.0%	Lower	VIX
0.99	0.95	0.75	1.13	36.2%	Lower	CBOE Market, Equity Leaps, Put/Call Ratio
111614	-22366.9	-298175	281387	77.7%	Higher	1-Yr Chg in Debit Balances in Margin Accounts ($ Mil)

Spellman, FactSet, AAII, Conference Board, CBOE, CRB, DOL, Federal Reserve, ICI, ISM, NFIB, University of Michigan, S&P

Business: Fixed investment and lending growth have slowed, and the level of PMI is low while the annual change is high

Consumer: Mixed on consumer confidence, with different weights for employment and inflation, but general investor bullishness

Credit: Hot-to-above-average readings for real Fed Funds, inflation expectations, and the yield curve, and sizzling readings for credit spreads

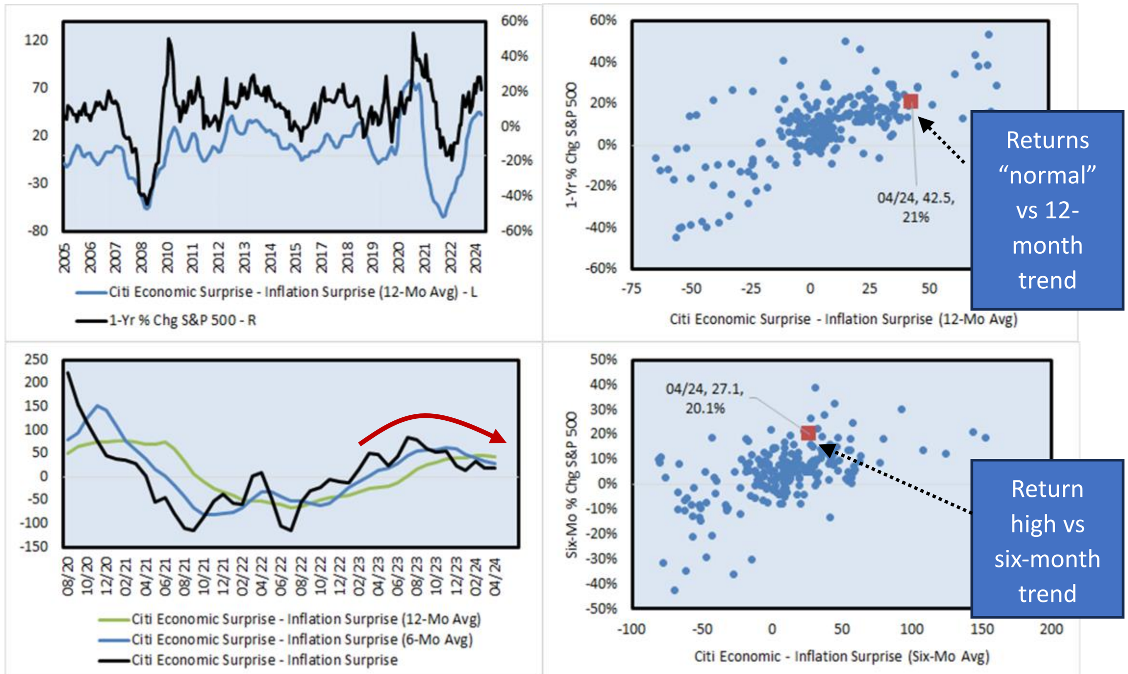
Equity: Valuation is high, but revisions and price deviation from its average are moderate

Alternatives: Mixed bag, as gold and the dollar suggest risk off while the put-to-call ratio is toward the low end, oil and commodities are slightly high, and the VIX and leverage are nearing hot

Market Fixed on 12-Mo Trend, and Not Current Readings

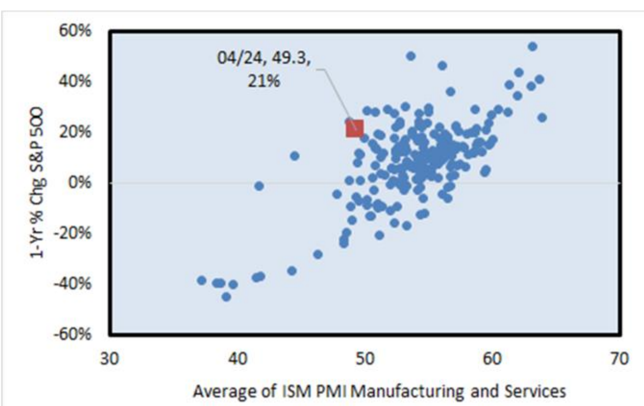
The one-year return of the market is up, right in line with “normal” movements based on the 12-month average of surprises for the economy and inflation; however, the market appears to be ignoring the recent downward trend. While economic surprises have been positive (six-month average of 36), inflation surprises have turned from -14 in October to +12 in April, moving the overall six-month net economic – inflation surprise average down. The market is ignoring this, as returns are in the upper-range versus the six-month average of net economic – inflation surprise.

12-Month Returns Up with 12-Mongh Economic Surprises, But Surprises Deteriorating and Market Up More Than Justified Based on 6-Month Trend



ISS EVA, FactSet, Citigroup

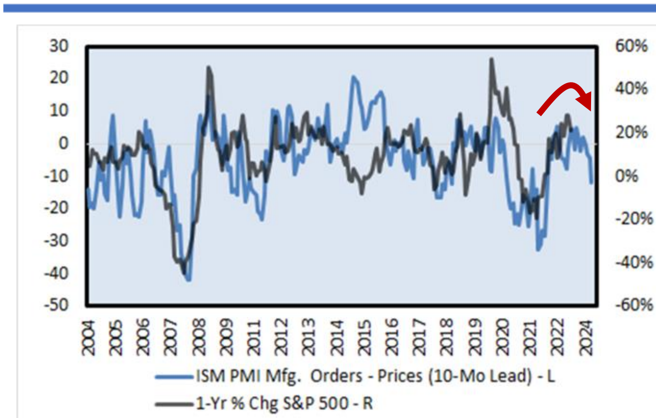
Market Up More Than PMIs Suggest



ISS EVA, FactSet, ISM

Bad news is good news if it means inflation continues to slow. The market normally moves with the ISM PMIs, but the average for manufacturing and services PMIs is 49.3 and the market is up 21%. Furthermore, the services PMI cooled from 53.4 in January to 49.4 in April, and the manufacturing PMI is down to 49.2 after briefly turning positive (50.2) in March.

Trend Deteriorating and Leads Market



ISS EVA, FactSet, ISM

While the market is cheering bad news, it may not be looking ahead. Orders versus prices are deteriorating, and this tends to lead the market by about 10 months. It’s a pretty volatile series, but the six-month trend provides the same conclusion. Note that orders less pricing leads the overall PMIs by about 19 months, so maybe the hook down isn’t a short-term worry.

Surveys Suggest Economic Conditions Worse Than Reported

Index	Quarterly Y-Y EPS Growth 2023/3C	2023/4C	2024/1C	2024/2C	2024/3C	2024/4C
S&P Composite 1500	4.1%	4.9%	4.7%	8.2%	8.3%	15.8%
S&P 500	6.2%	5.0%	6.6%	9.8%	8.4%	17.4%
S&P Mid Cap 400	-10.7%	12.9%	-7.2%	-0.4%	7.8%	-1.6%
S&P Small Cap 600	-12.4%	-16.0%	-13.6%	-10.5%	10.7%	20.7%

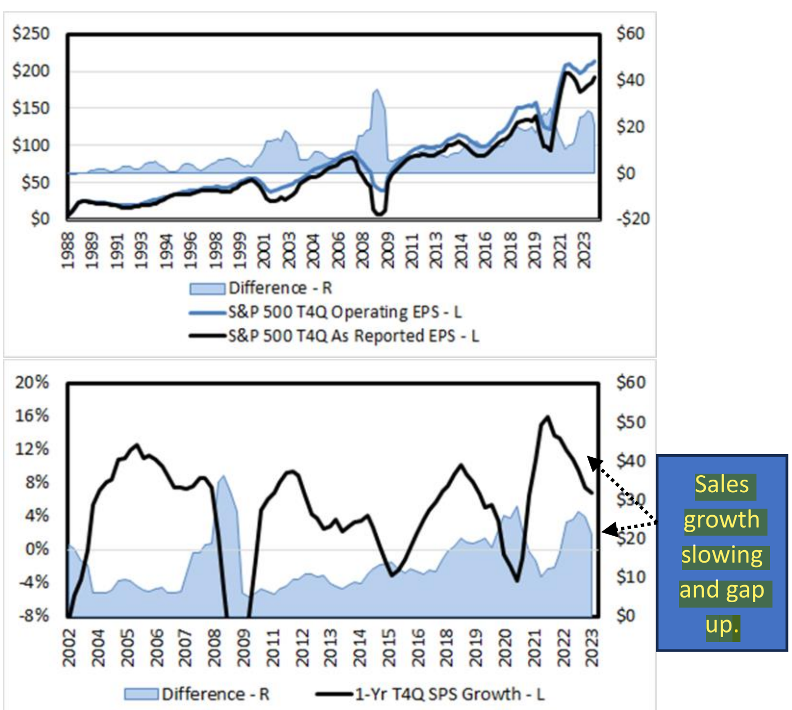
ISS EVA, FactSet

Surveys of executives at large and small firms suggest they've become less pessimistic, so perhaps this justifies the market's returns. The hook up implies the economy may be bottoming, but their outlooks are much lower than normal based on current conditions, so maybe this means that there is not much room for improvement?

Earnings are up for large companies, but that is skewed by the Magnificent 7. Small companies are quite pessimistic, which reflects negative earnings growth. Still, analysts are most optimistic about a rebound in small cap earnings. Will they be right? Earnings growth expectations for 2024 for small-cap fell 15.4% over the last six months, versus a 1.9% drop for large cap.

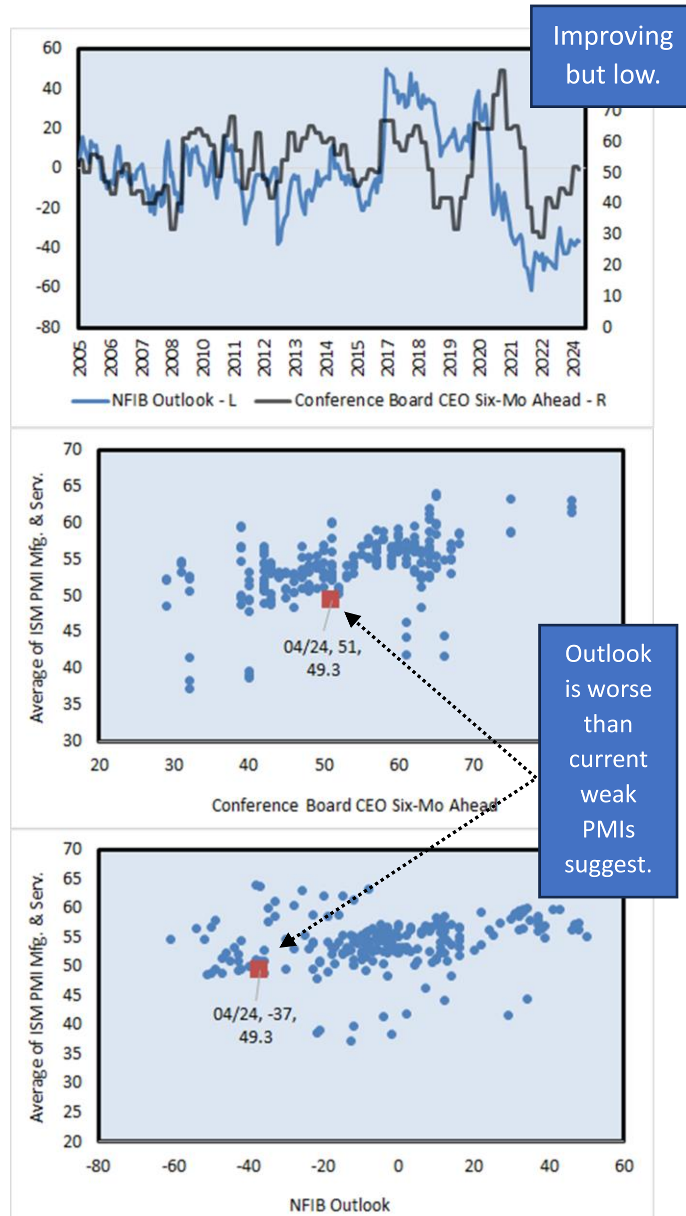
Earnings quality has deteriorated as the gap between operating (make believe) earnings and reported earnings has widened ($53.90 vs $47.79 in 4Q 2023). The gap tends to widen as sales growth slows (and as sales surprises decline) as management is forced to make up results to hit their numbers. Maybe I am being too harsh; maybe management believes this made-up stuff if they are overconfident.

Earnings Quality Deteriorates with Sales Growth



ISS EVA, FactSet, S&P

While the Outlook Appears to Have Bottomed, the PMIs are Higher Than Normally Associated with this Level of Optimism

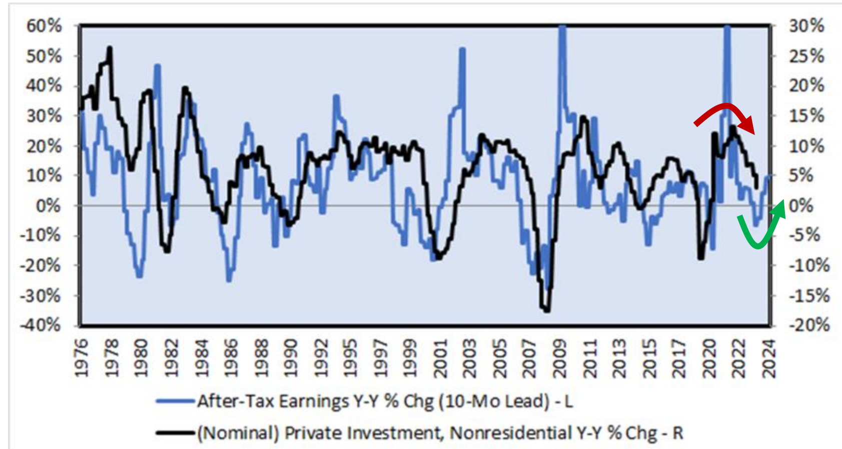


ISS EVA, FactSet, Conference Board (large company CEO survey), ISM, NFIB (small company survey)

Corporate Mood is Deteriorating

Capital spending growth is slowing. The surest way of measuring corporate executive confidence is by their actions, and one of the most common actions they take is business expansion. Capital spending growth is an excellent contrary indicator. Capital spending follows earnings. CEOs fail to heed the advice, "Don't let that cash burn a hole in your pocket." When earnings are high, management is often overconfident, and they extrapolate the past in their projections, ignore risks (non-confirming evidence of their commanding position), and expand. Expansion is a lagging – not leading – indicator of the future.

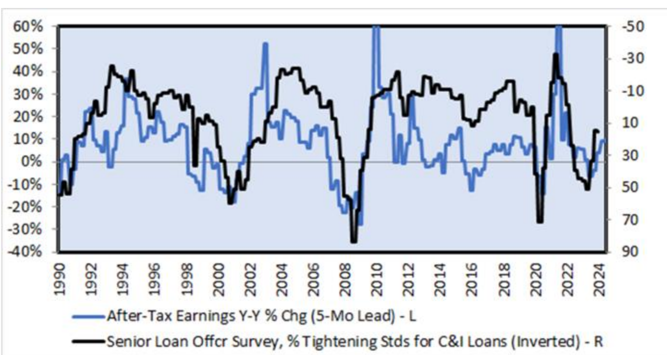
Capital Spending Is Slowing

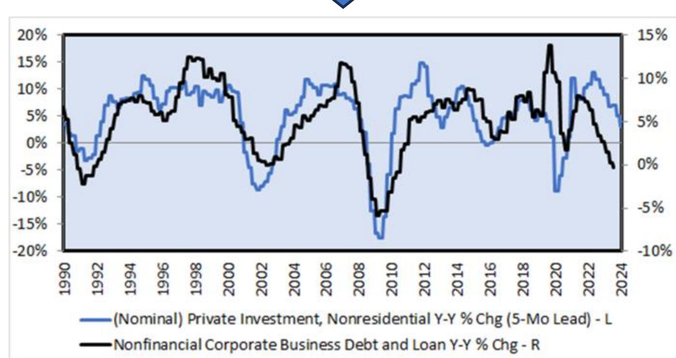


ISS EVA, FactSet, BEA

Loan Growth Deteriorating

Step 1: Earnings → Step 2: Lending Standards → Step 3: Investment → Step 4: Loan Growth





ISS EVA, FactSet, BEA, Federal Reserve

Last year, I provided 10 reasons that we'd avoid a recession (I also gave 10 reasons for a recession), and investment spending was one of them, at least for the time being. Deglobalization, creating just-in-case inventory, investment to combat global warming, and government initiatives could lead to high capital spending growth. This helped sustain the economy, but it's beginning to slow as earnings have deteriorated.

Loan growth is cratering. Giving management some "credit," they may expand at cyclical peaks due to the availability of credit. As shown later, credit spreads are low – investors are optimistic – and while lending standards are tight, they are loosening. The cycle starts with earnings growth accelerating, and then management plans cap ex. Before getting out the picks and shovels, they contact lenders. Bank lending standards decrease and financial market credit spreads decline because earnings are plentiful (lenders are confident just like management) – lending standards ease with a five-month lag to increasing earnings growth, and vice versa. Five months after easing lending standards, capital expenditures commence, and about five months later, debt outstanding grows.

Market Expects the Best Scenario

1. Price = present value of dividends

   $P_0 = D_1 / (1+r)^1 + D_2 / (1+r)^2 + \ldots + D_\infty / (1+r)^\infty$ (**equation 1**).

2. If r and growth are constant:

   $P_0 = D_0 * (1+g) / (r - g)$ (**equation 2**).

3. Realize $D_0 = E_0$ * payout where payout = D_0/E_0:

   $P_0 = E_0$ * payout * $(1+g) / (r - g)$ (**equation 3**).

4. Divide both sides by E_0:

   P_0 / E_0 = payout * $(1+g) / (r - g)$ (**equation 4**).

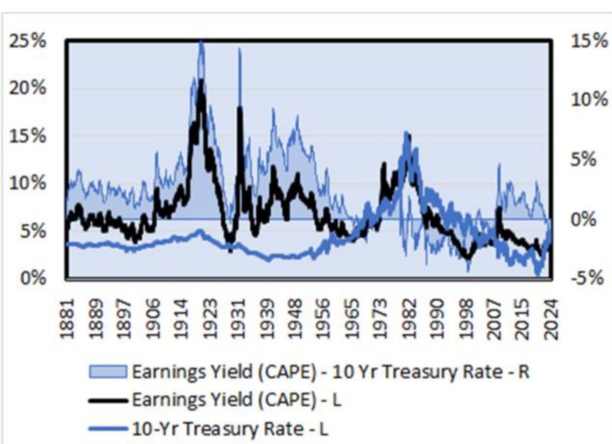
   Value dependent on growth, risk, and payout, but remember higher payout means less investment for growth, so growth and risk dominate.

Last week, I finished teaching a seminar on behavioral finance (my doctorate is in this field), and we discused what people do in ambiguous situations – they choose the default option. The last eight years have been uncertain and volatile, and therefore, very ambigious. We've had (1) a very contentious political environment, (2) a Trade War, (3) COVID-19, with deaths and uncertainty, (4) massive fiscal and monetary stimulus, (5) inflation rates not experienced since the 1970s, (6) a rise in the age at which the worker has bargaining power over employers, (7) new global interest in ESG and new initiatives and investments to combat global warming, (8) war in Ukraine and in Gaza, (9) a massive rise in interest rates and fears of a recession, (10) a near banking crisis in the US, (11) the rise of AI and its benefits, etc.

The market is very optimistic about the future and seems to be ignoring all caution. Given the very ambiguous environment, people are choosing the default option in masses. Normally, markets rise, so that's the default. Plus, recent news about the economy is positive, so that's the default expectation as well. People are generally optimistic (the most documented behavioral bias), so when faced with uncertainty and the lack of a recession, slowing inflation, and the rise of AI, it's normal to go with the status quo, which is that everything is just great. Despite greater uncertainty, strategists at Morgan Stanley (Mike Wilson) and Piper Sandler (Michael Kantrowitz) show that earnings estimate dispersion is down – or agreement is up – and Mike also pointed out that economic estimate dispersion is down.

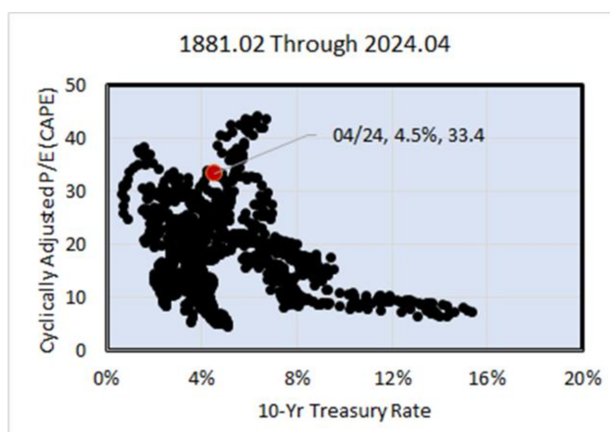
1. The equity risk premium (ERP) is very low, which reflects a high P/E perhaps because of expectations for declining interest rates and/or high growth. Last fall, I wrote on my Cyclically Adjusted Implied Growth Rate (CAIGR) model. It derives growth expectations (currently high) by solving for "g" after normalizing the variables in equation 3 (see box).
2. Even if we adjust for low interest rates, Shiller's CAPE (Cyclically Adjusted P/E) is high.
3. This is despite the ambiguity and the increased volatility of earnings (see next page), which should lower the P/E.
4. A high CAPE is normal when past growth is high (see next page), but Warren Buffett said, "An investor does not profit from yesterday's growth." As noted above, that's typically the default option to forecast growth when one extrapolates.

ERP is Low (ERP = Earnings Yield – 10-Yr Treasury)



ISS EVA, Shiller

CAPE is High Even Adjusted for Low Interest Rates



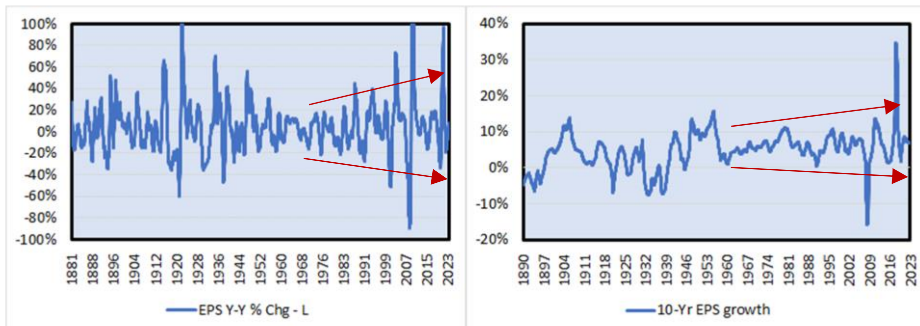
ISS EVA, Shiller

Market Expects the Best Scenario (Continued)

Is volatility up because of the issues I noted on the last page or something else? Has social media resulted in more herding, division, and the possibility of excesses? Look at what has been happening with AMC and Gamestop recently. See what happened to bitcoin after the ETF was introduced (new financial vehicles often propel bubbles). Or, has volatility risen because of the substitution of capital for labor? Capital has fixed depreciation and interest costs. A more capital-intensive and leveraged (leverage has increased) balance sheet results in more volatile earnings.

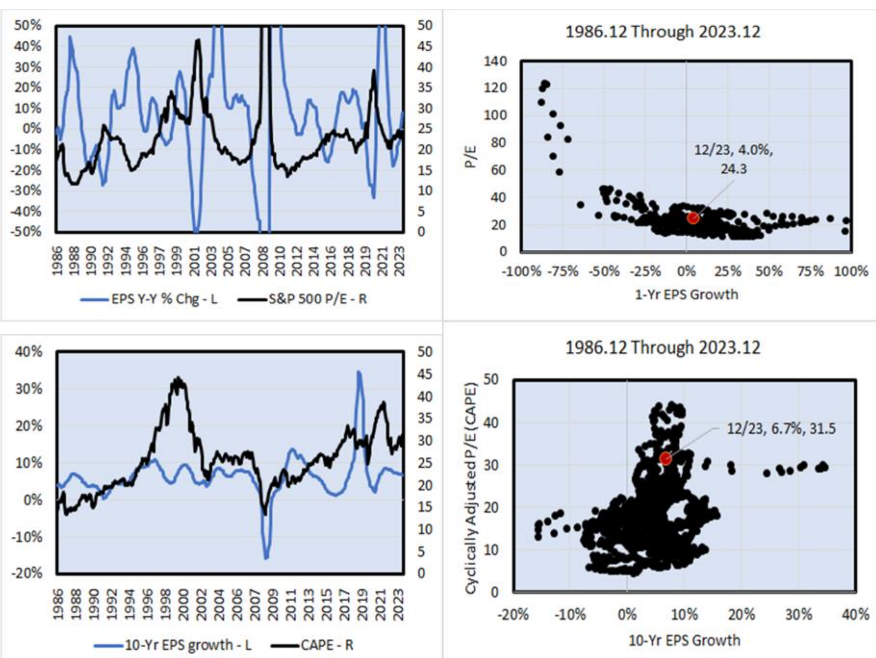
Of course, investors who are programmed – as humans are programmed – to be optimistic, normally ignore risk and focus instead on growth. They also – correctly – provide the highest P/E to earnings when they are the lowest. That's because they project a turnaround. Currently, the P/E is about in line with "normal" based on past 1-year growth.

The High CAPE Is Despite the Fact That Volatility – Risk – Has Risen



ISS EVA, Shiller

P/E Is Normal vs 1-Yr and 10-Yr Trends in EPS, But That's Not Necessarily Reasonable if Markets Overreact



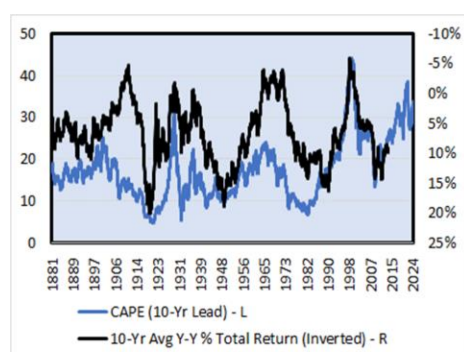
ISS EVA, Shiller

On the other hand, CAPE is highest when past 10-year growth is highest. The longer and stronger the trend, the more people ignore risks and extrapolate. Besides the blip with COVID-19, the Fed has manufactured a long period of solid returns, so the CAPE is at normal – high. Yet a high CAPE is associated with lower future returns. And now everyone is bullish.

Let me pose a few questions. Do you believe AI is revolutionary? If yes, do you believe it will significantly reduce costs? If yes, please realize that many people it will replace (financial, health care, technology, etc.) make and spend the most money. Technology adoption has quickened and high-wage workers cannot easily retrain for new similar-paying jobs, so AI could cause significantly higher unemployment, unrest, and a severe recession. I'm not saying this will occur, but I am saying it is possible and being ignored.

Will AI cause a recession?

A High CAPE (High Expectations) Normally Precedes Lower Returns



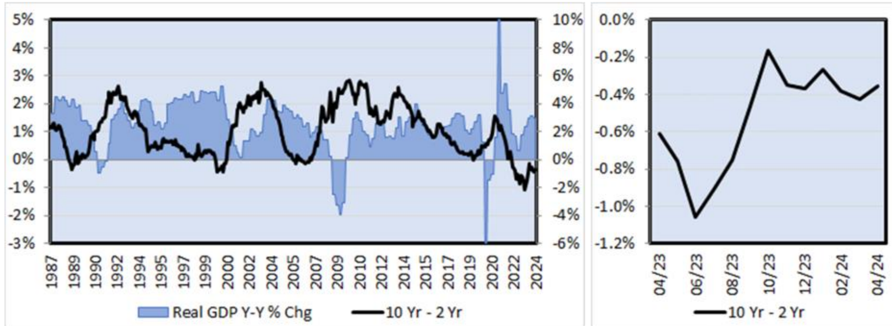
ISS EVA, Shiller

Many Risk-On Corners of the Market Are Optimistic

Besides the risk-off Treasury market, many other corners of the market – credit, equities (prior two pages), individuals, options and futures – are optimistic. Even the Treasury yield curve has turned less pessimistic as the inversion has shrunk.

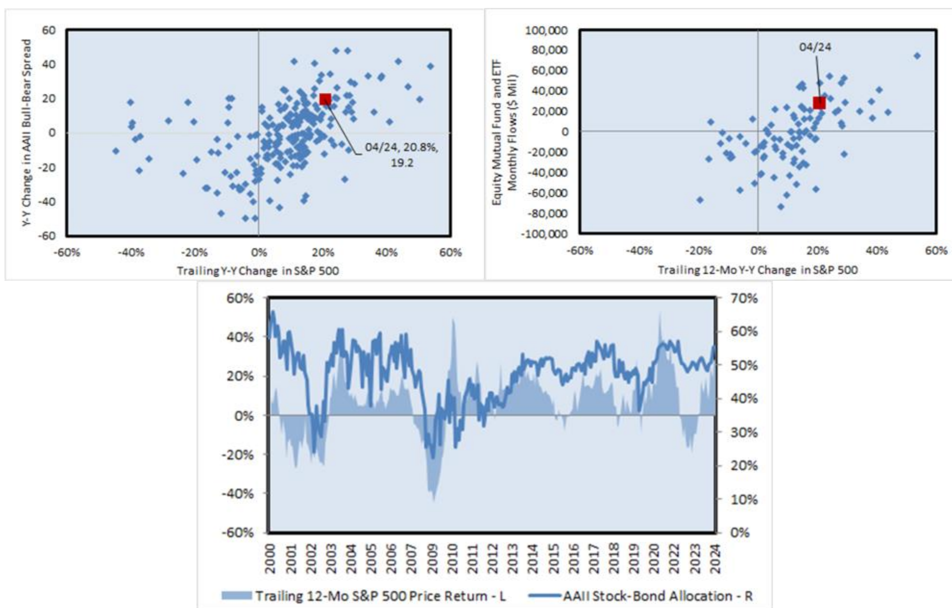
1. ***Equities markets are positive!***
2. ***Individual investors are positive!***
3. ***Those buying on leverage are positive!***
4. ***Futures speculators are positive!***
5. ***Credit investors are positive!***

Risk-Off Treasury Market Still Expects a Recession, But Less Pessimistic



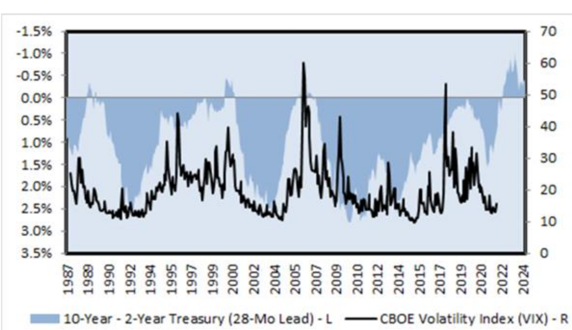
ISS EVA, FactSet

Bull-Bear Spread High and Equity Fund Flows Up and Stock Allocation High (with Returns)



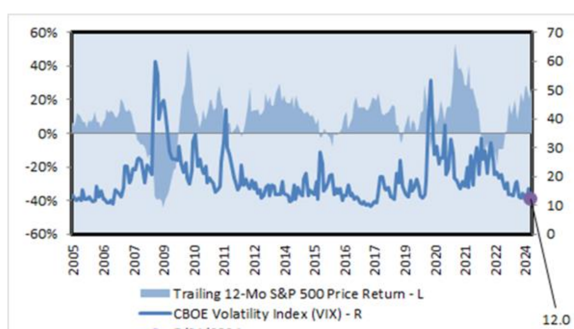
ISS EVA, FactSet, AAII, ICI

Give Yield Inversion Time → Volatility Rises



ISS EVA, FactSet, CBOE

But Volatility Is Very Low (with High Returns)



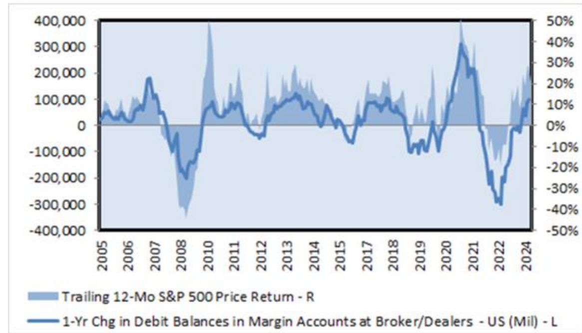
ISS EVA, FactSet, CBOE, S&P

All Risk-On Corners of the Market are Optimistic (Continued)

Speculative S&P 500 Futures Rising (with Returns)

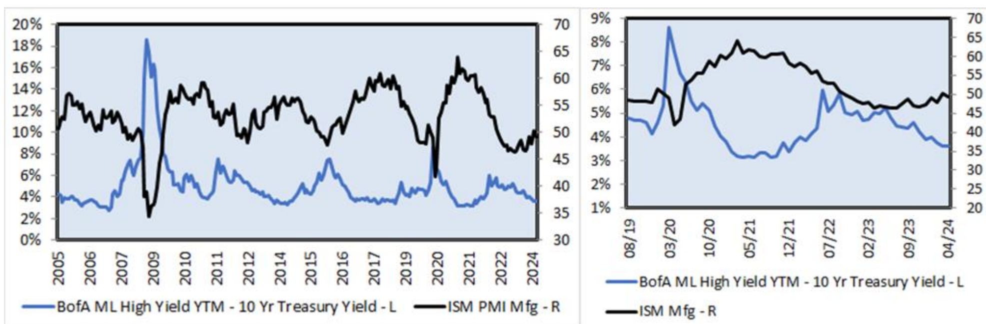
ISS EVA, FactSet, CFTC, S&P

Leverage Is Up (with Returns)



ISS EVA, FactSet, Conference Board, S&P

Credit Spreads Are Down (Anticipating a Rising ISM PMI Manufacturing)



ISS EVA, FactSet, ICE BofA, ISM

The goal of this piece is to help you gauge expectations. I am not necessarily saying that there will be a recession or that the market is about to crater; however, I am saying that it appears financial markets are ignoring a possible – with much higher odds than prices imply – recession. Right now, bad news is being interpreted as good news if it leads to the narrative that inflation is coming down, but the economy is on good footing. Still, with the market elevated, a true negative surprise being interpreted as bad news could cause a much larger correction. The higher the market rises the further it can fall, and maybe quicker as well.

If you have questions, don't hesitate to contact me. Love to chat.

Have a good day!

Coach

We empower investors and companies to build for long-term and sustainable growth by providing high-quality data, analytics, and insight.

GET STARTED WITH ISS EVA

Email sales@issgovernance.com or visit issgovernance.com for more information.

Founded in 1985, the Institutional Shareholder Services group of companies ("ISS") is the world's leading provider of corporate governance and responsible investment solutions alongside fund intelligence and services, events, and editorial content for institutional investors, globally. ISS' solutions include objective governance research and recommendations; responsible investment data, analytics, and research; end-to-end proxy voting and distribution solutions; turnkey securities class-action claims management (provided by Securities Class Action Services, LLC); reliable global governance data and modeling tools; asset management intelligence, portfolio execution and monitoring, fund services, and media. Clients rely on ISS' expertise to help them make informed investment decisions.