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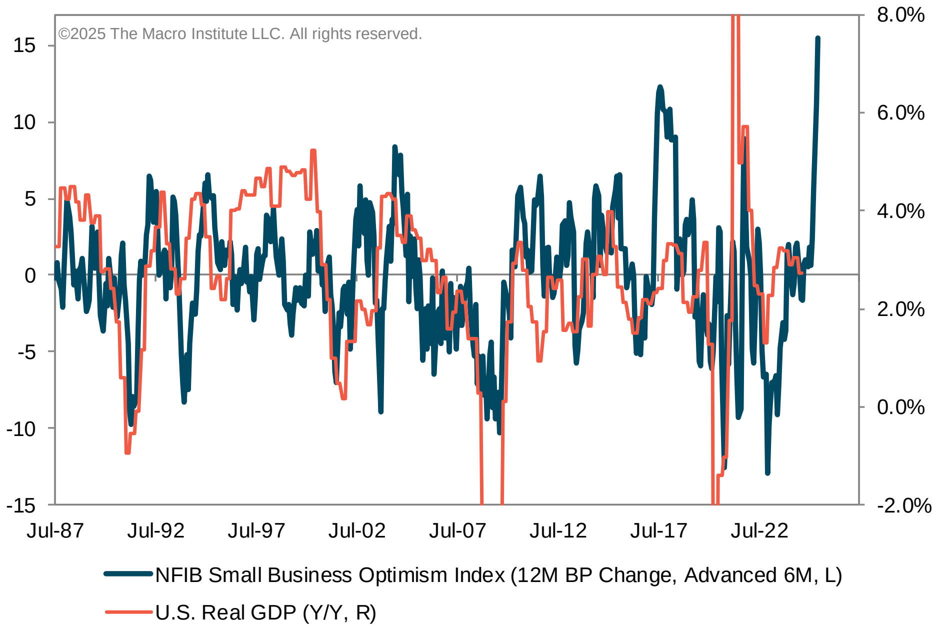
TRAHAN RESEARCH
THE MACRO INSTITUTE

January 16, 2025

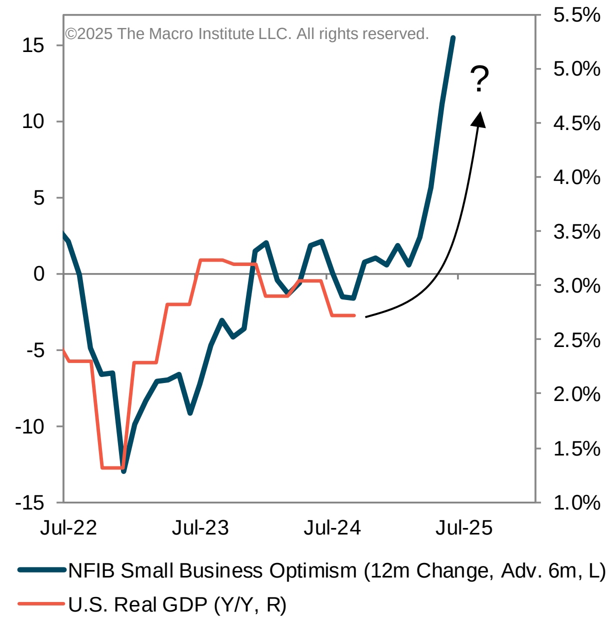
Best Client Questions From Last Week's Conference Call

We received more questions than typical in the wake of last week's conference call (see replay here). It's January, after all, and in my experience, this is *the* time of the year when investors are most focused on macro. Also, this is not your run-of-the-mill backdrop. The pandemic recovery was unusual, as was the Fed's tightening cycle. Then there are the policies being proposed by the incoming administration. This is one of the most interesting macro backdrops I have seen in my career. The report tackles some of the questions about the road ahead that we feel are more likely to be consequential this year.

↑ Small Business Optimism = ↑ GDP Growth Ahead?



Accelerating Growth In 2025?



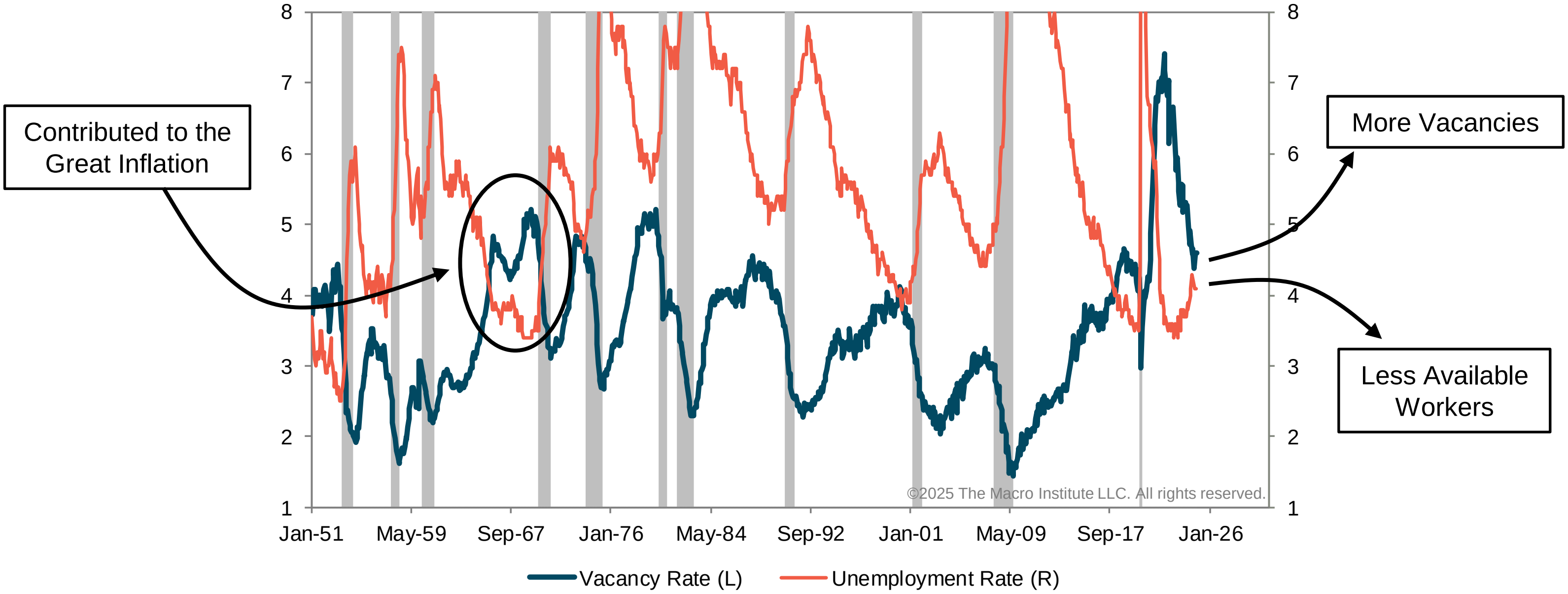
We released a brief voice blast on Tuesday (see link here) to address the question we felt we should begin with: *What changed in your view since mid-2024?* We devoted 16 pages to answering it, so we won't dwell on it here, but the simple answer is ***time*** and ***the data***. It has now been 18 months since the Fed's last rate hike and that is typically when leading indicators start to improve. In the history of business cycles, if we have not gotten a recession by now it is not likely going to happen – at least for the time being! There are also the Fed's rate cuts which make this argument event more likely.

The data has also changed. The same LEIs that flagged caution in mid-2024 are now calling for improving economic activity. Some LEIs like the NFIB have really turned the corner. If anyone had doubts that prospects of deregulation could be a boost to the economy, then please look at the NFIB report released this week. As the chart above shows, it argues for an acceleration in real GDP growth come spring. There are a lot of other moving parts to this backdrop, of course, but inflation should be front and center on everyone's mind. On that note, let's tackle some key questions. All the best, Francois

Q – What Historical Period Does This Backdrop Resemble Most?

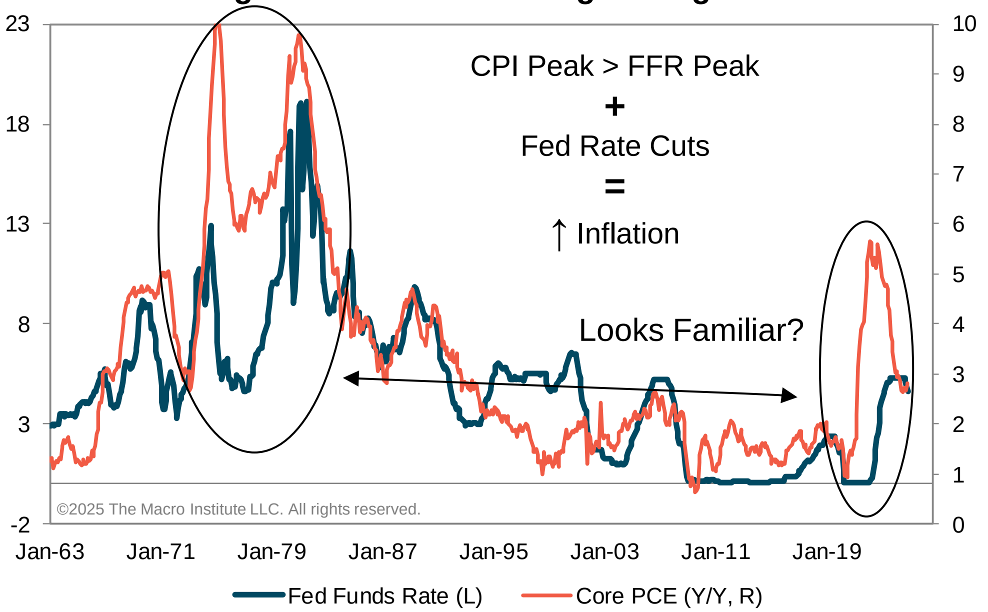
There are a few things that stand out to us when we think of this question. Let's start with labor markets, where we have rarely seen an imbalance like what we are currently witnessing. Indeed, there are more job openings than unemployed workers and this is after several years of payroll expansion. This is unusual, and the only episode with a similar setup was in the 1960s and early 1970s. Needless to say, it does not take much stimulus in this backdrop to revive inflationary pressures.

Labor Marketing Tightening From Levels Last Seen In The 1960s

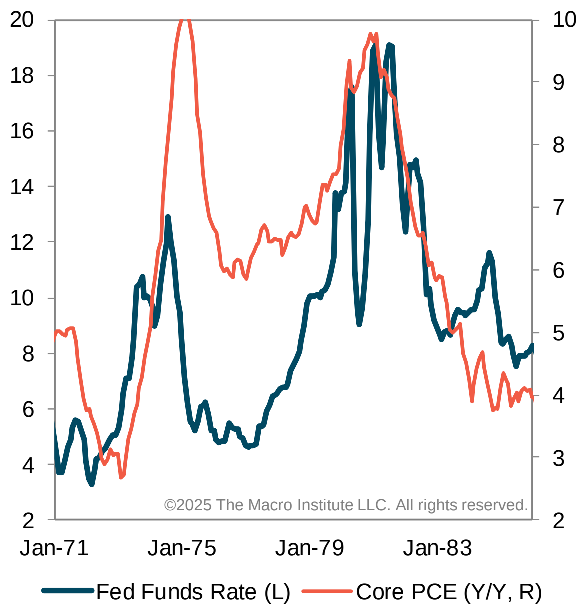


Now let's tackle the same question from a policy perspective. There are no exact comps, but there are a few historical instances when the Fed began to slash official rates only to see inflation bottom earlier (and higher) than expected. The Fed then resumed tightening policy in short order. The best example of this is probably Paul Volcker's first easing cycle. Official rates came down quickly in that instance, but inflation did not follow suit. The Fed turned hawkish again and, in the end, official rates rose to even higher levels. Not a perfect comp but an example of Fed actions that changed quickly.

Higher Inflation ≅ Fed Tightening Ahead



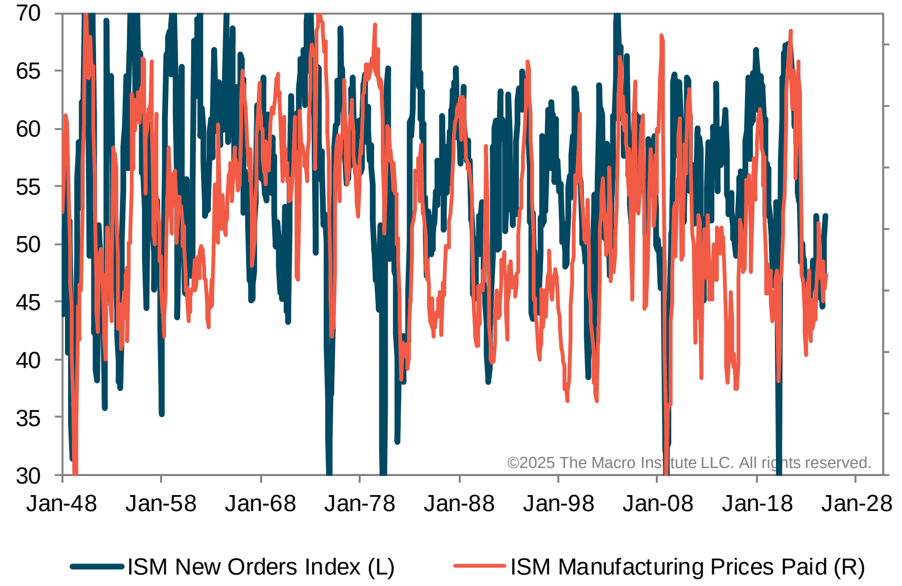
Cuts And Then Quick Hikes!



Q – Is The Economy Less Sensitive To Inflation Than It Used To Be?

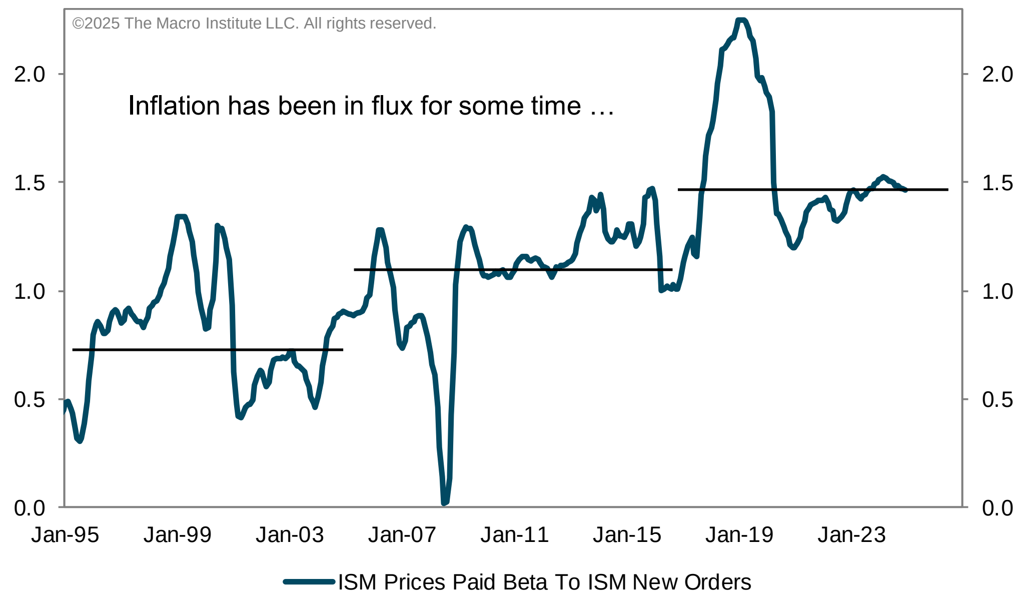
It is well documented that inflationary pressures tend to ebb and flow with economic activity. The simple explanation for this is that demand typically recovers quickly while it usually takes time for supply to catch up. Our favorite way to illustrate this concept is by overlaying the ISM New Orders Index alongside the Prices Paid series from the ISM survey. These two have trended together for much of the last 70-odd years. That's the cyclical part of the story.

Economic Activity And Inflation Intrinsically Linked



What the chart above does not tell us is whether the relationship behind these two variables is evolving. If we look at the beta of inflation to economic activity, which is easy to calculate using these two series, it is clear things have changed. The U.S. economy does not require as much activity to generate a unit of inflation as it once did. In essence, the economy is more structurally geared toward inflation than it used to be. This process has been evolving for some time, but it makes it clear that we should expect inflation to be a more common phenomenon going forward.

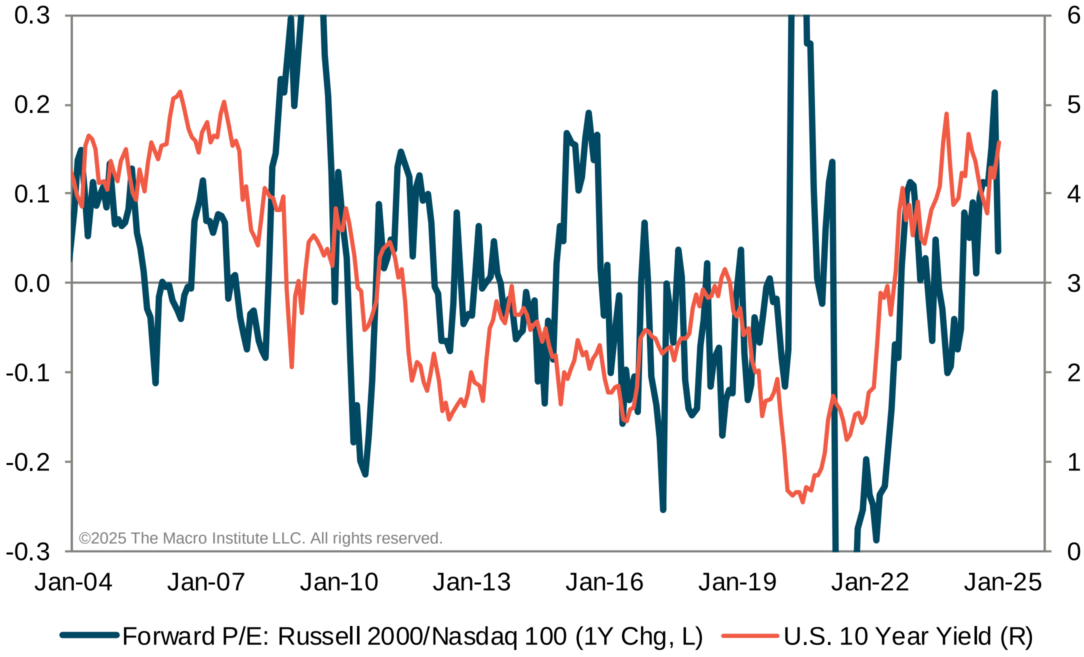
U.S. Economy's Inflation Beta Structurally Higher



Q – Are Small Caps Not Also Vulnerable To Higher Rates/Inflation?

This is a great question. It's not that we like small caps so much – we like cyclicality as a theme, and it is easier to find in smaller indices nowadays. To be fair, small caps are very volatile and influenced by interest rates (all stocks are!). Still, the more cyclical an index is the more immunity it will have to higher inflation. They key point here is that indices like the Russell 2000 or S&P 600 are less threatened by higher interest rates than large-cap growth stocks with lofty P/Es (i.e., Nasdaq 100).

Small-Cap P/Es Less Sensitive To Higher Rates?!?



I realize this is a tough one to believe after the events of 2022 when small-cap stocks performed poorly as interest rates moved higher. That said, 2022 was also a year where earnings were under pressure across all equity indices. The relationship between small-cap P/Es and interest rates does change when earnings are growing (which we expect in 2025). Indeed, the cyclical nature of these types of stocks gives them earnings leverage which acts as a major offset to the pressures of higher rates on P/Es. Growth stocks and their more "stable" earnings are not so fortunate. This is a bit of a fine point, but small caps did great in the latter part of the 1970s when the economy faced an inflationary recovery.

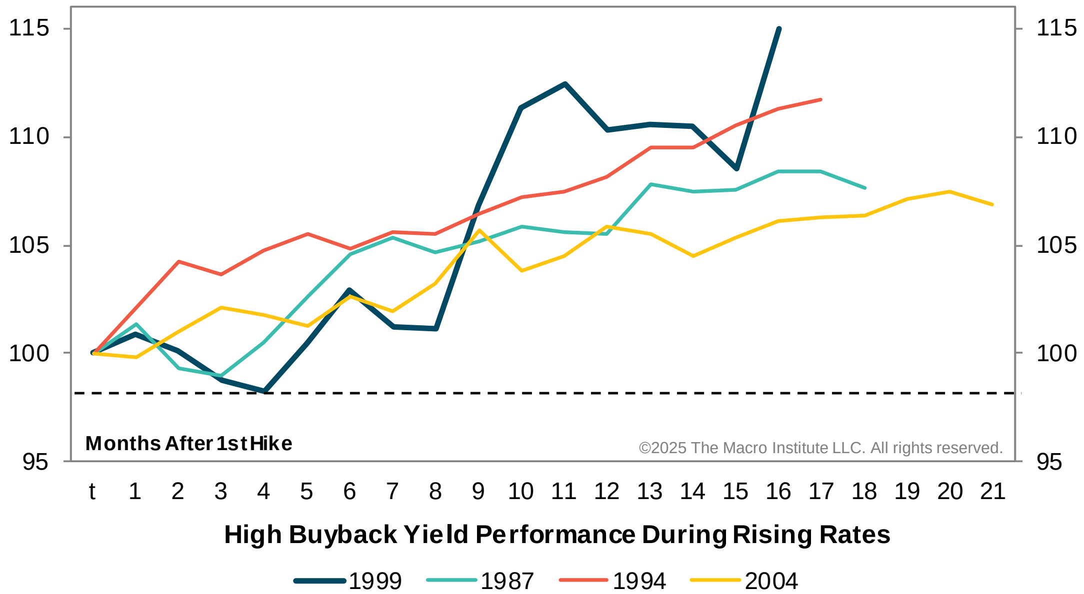
Earnings Play A Large Role In P/E Sensitivity To Interest Rates

Index	Forward P/E	Sensitivity To ∆ In Rates When EPS Are Rising	Sensitivity To ∆ In Rates When EPS Are Falling
S&P 600	15.26	0.55	0.05
Russell 2000	24.03	0.24	0.10
Dow Jones	19.35	0.16	-0.04
S&P 500	21.25	0.10	-0.22
Nasdaq 100	26.12	-0.26	-0.41

Q – Would Free Cash Flow Yield Work Just As Well As Buybacks?

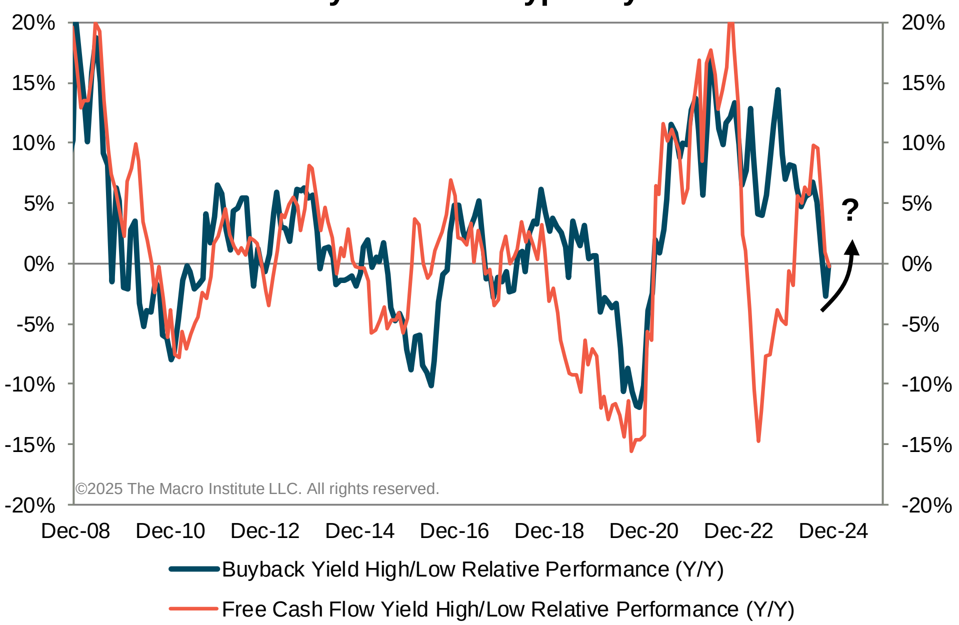
We know that Buybacks as a stock selection factor has worked well during Fed tightening cycles in the past. Hence, this is one investors should be focused on this year given our views that inflation moves higher and eventually nudges the Fed into tightening policy once again. The question we received in the Q&A session at the end of the conference call was whether Free Cash Flow Yield would also work well in this backdrop. The simple answer is yes. They are proxies of each other in this backdrop.

High-Buyback Yield Performs Well In Rising Rate Environments

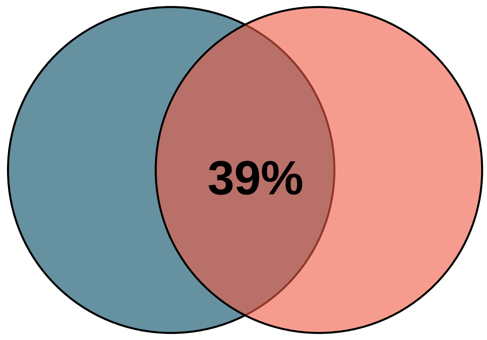


The chart below shows that the performance of FCF Yield and Buybacks is usually correlated. At its most simple, you typically need to generate FCF to be able to do Buybacks. Surely, some buybacks were financed via debt historically, but that is harder to pull off in today's interest rate backdrop. In fact, the top quintile for both factors in the S&P 500 reveals an overlap of 39%, which is significant. At the end of the day, we like Buybacks when the Fed is tightening policy, and we usually emphasize FCF Yield when economic prospects are improving. We see both of those happening in 2025.

FCF And Buybacks Are Typically Correlated



~40% Overlap Between High Buyback Yield And High FCF Yield



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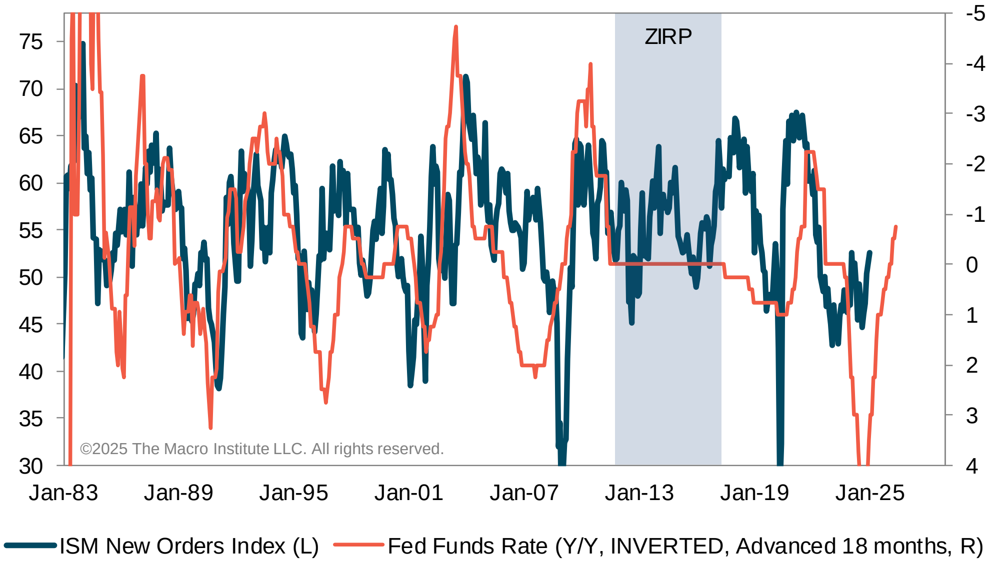
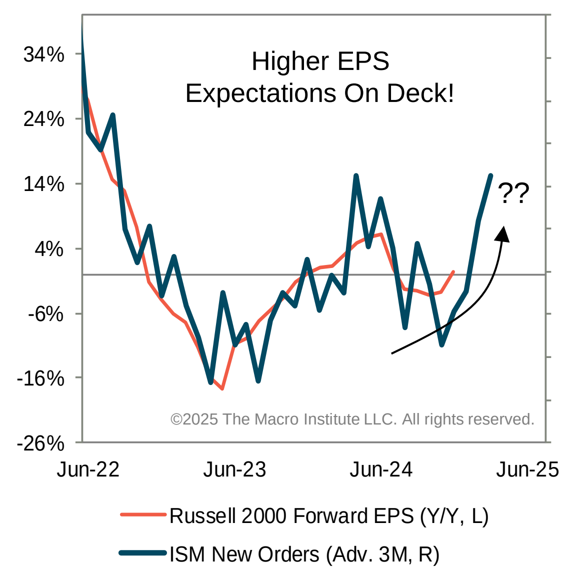
Q – Will EPS Still Recover Given That The Starting Point Is Higher?

The short answer is … yes. First, we know that monetary policy is turning supportive of LEIs like the ISM New Orders Index in the chart below. This usually takes place about 18 months AFTER the end of Fed tightening, and here we are. S&P 500 earnings did not decline as much as we have seen in the past when the ISM New Orders was at these levels. This is likely explained by the large Growth contingent in the Index today. The situation for small caps or more cyclical indices is a little different. Those segments did experience a decline in EPS expectations in this cycle, at least a bit!

LEIs Usually Start To Recover ~18 Months After Last Rate Hike

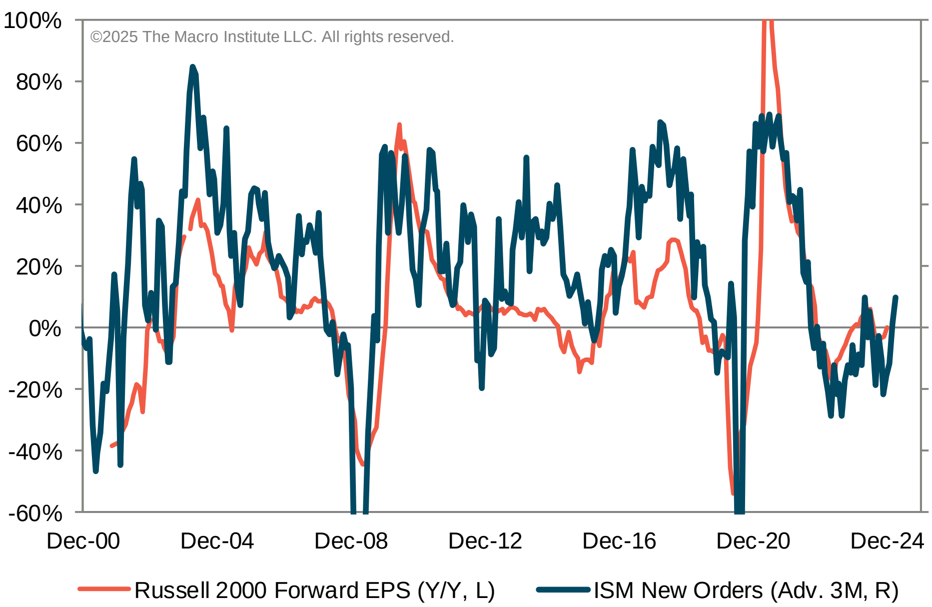


Rising LEIs Should Benefit EPS

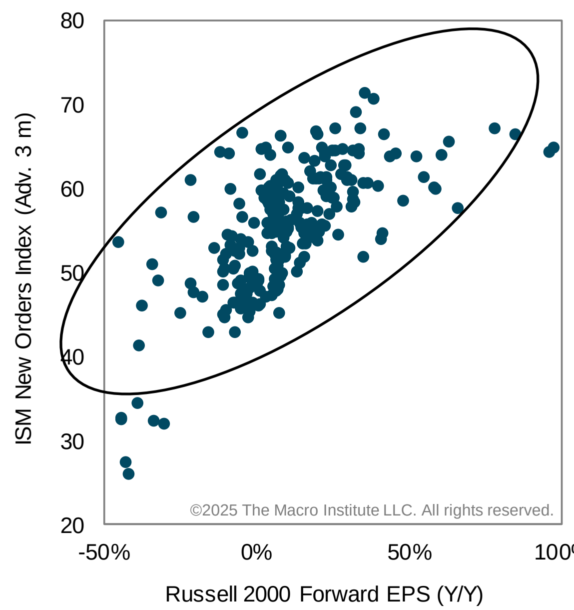


In our minds, the usefulness of data series like the ISM Index is all about the correlation it has with earnings expectations. Now, it used to be a better fit in the past than it is today with the high-Growth constituency of the Index, but the relationship stands. Better economic activity does still lead to better earnings growth. This is more visible in an Index like the Russell 2000 or the Dow than in the S&P 500, but the relationship still holds. Policy argues for an increase in LEIs which eventually leads to better economic activity and earnings expectations.

Trends In Small-Cap Earnings And LEI Very Correlated



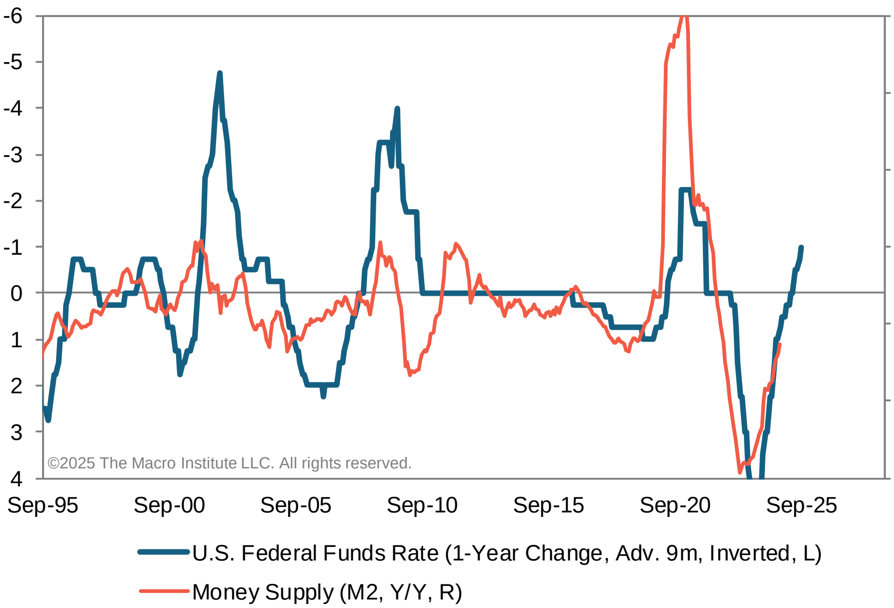
Higher PMIs = Higher R2K EPS



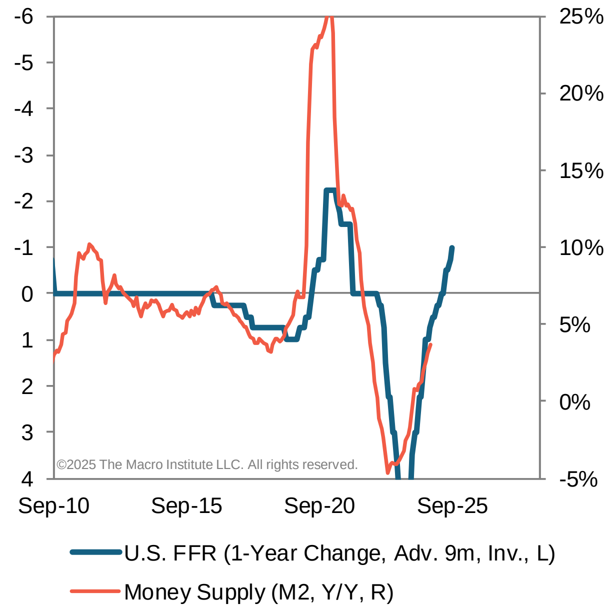
Q – How To Square Inflation Re-Acceleration With M2 Dwindling

This is a great question. Money supply exploded higher in the wake of the Fed's efforts early on in the pandemic. What followed, of course, was higher inflation. This is a CLEAR sign that the inflation story at the time was largely about soaring demand and not just about supply chain issues as the Fed argued with all the "transitory" talk. Irrespective, money supply is currently re-accelerating courtesy of the end of the Fed tightening cycle and the rate cuts that followed. Inflationary!

Money Supply FOLLOWS Trends In Monetary Policy



Money Supply Rebounding!



Our expectations for higher inflation this year are not based on money supply. It does play a part, however. The story is simply that stimulus – money supply is a sign of stimulus – with little excess capacity is a recipe for a rebound in inflationary pressures. We do track money supply, and it does work well as a leading indicator, but it is not the best tool available. This is not a secret as the Conference Board used to include money supply in its official Leading Economic Index before swapping it in favor of the yield curve back in the 1980s after money supply's heyday.

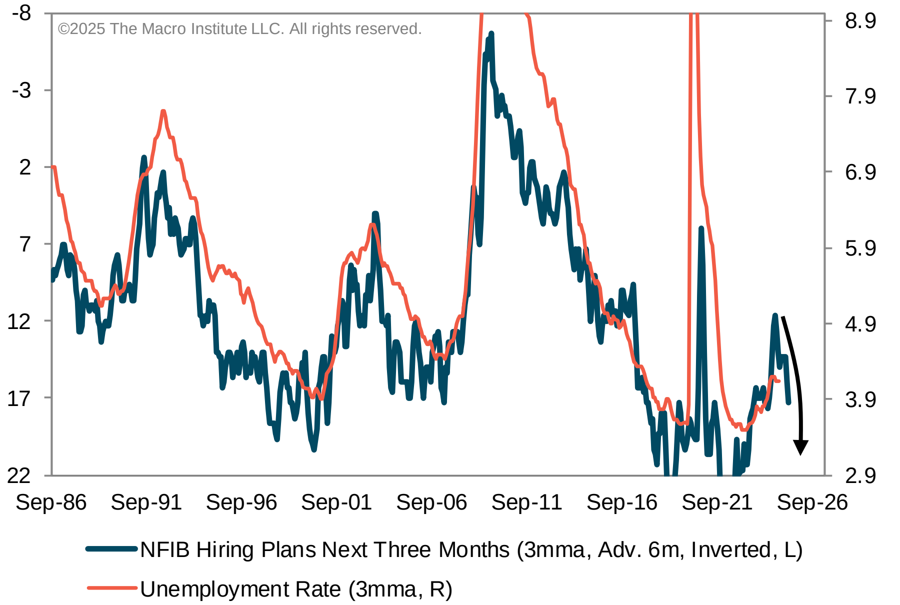
Leading Economic Index (LEI)
1. Initial Claims
2. Nondefense Capital Goods Orders
3. ISM New Orders
4. Building Permits
5. S&P 500
6. Leading Credit Index
7. Consumer Expectations
8. Consumer Goods Orders
9. Manufacturing Weekly Hours
10. Interest Rate Spread

Money Supply used to be a member of the Conference Board's LEI but was removed from the index in the late 1980s.

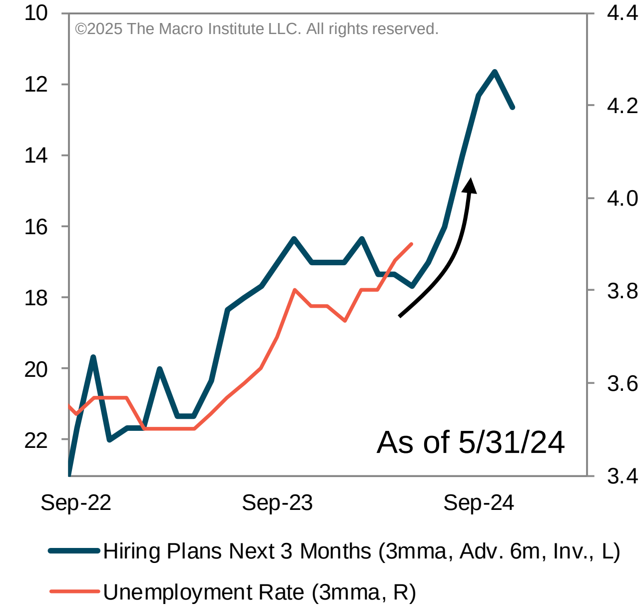
Q – What Has Changed The Most In Your View From 6M Ago?

The biggest change in the economic data since the middle of last year is in labor markets. At the time of our mid-year conference call in 2024, most recession/risk indicators were flashing red and leading indicators of employment were pointing to weaker labor markets. Considering that consumption accounts for 68% of GDP in the U.S. and the role that employment plays, this was a legit risk at the time. One of our favorites, the NFIB hiring intentions series, has changed drastically since then.

NOW: Hiring Intentions On The Rise



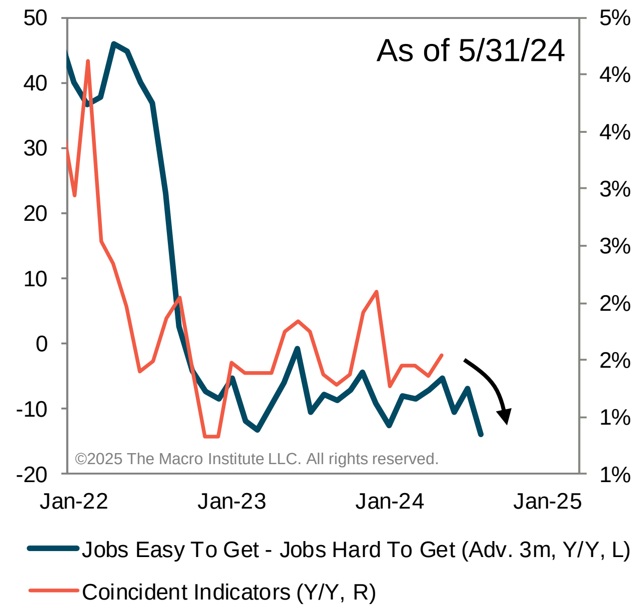
Mid-2024: Hiring Weakening



We find some of the best leading indicators of employment in the NFIB database, but we look at many more series. Another gauge of markets we like to track is the spread between "Jobs Easy To Get" and "Jobs Hard To Get" from the Conference Board. This net indicator tends to give a pretty good heads up on near-term economic activity, as shown in the chart below. This was pointing to weaker growth in the middle of last year and now points to a re-acceleration in GDP as does the NFIB chart on the cover of the report.

NOW: Labor Markets Set To Reinvigorate Economy

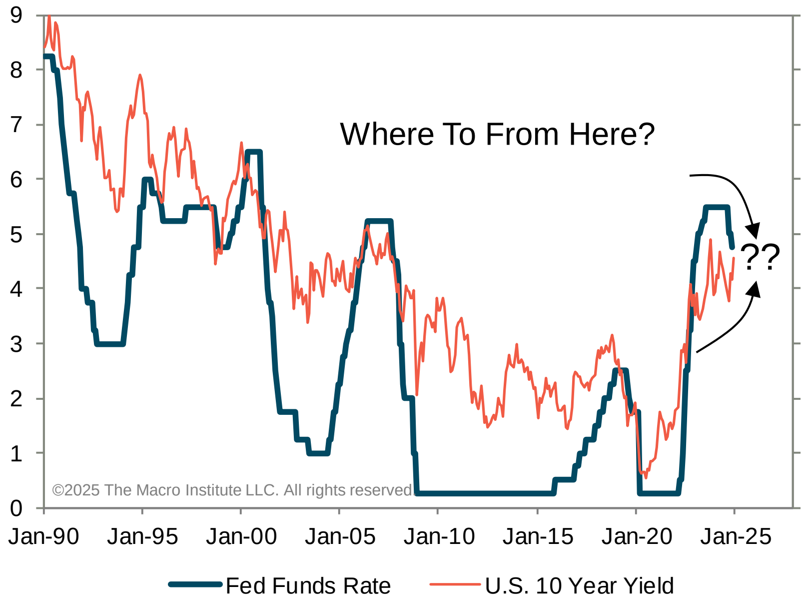
Mid-2024: Pointing To Weaker Growth



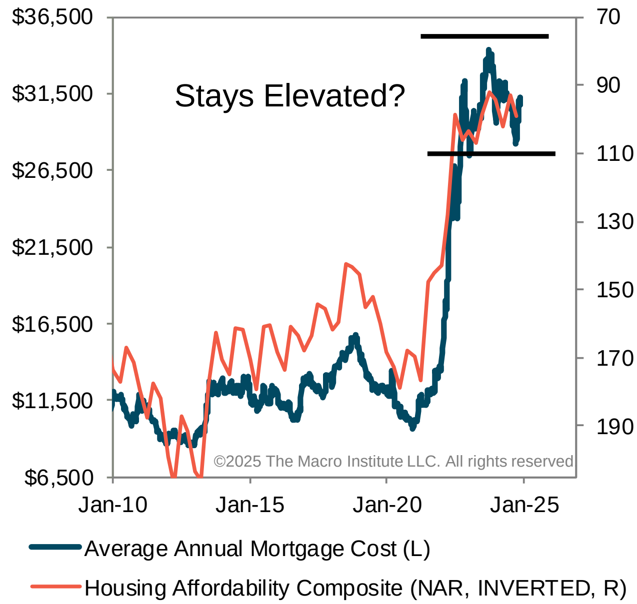
Q – Can We Also Expect The Housing Market To Recover In 2025?

Unfortunately, if we are correct about inflation rebounding this year and what it means for Fed policy and interest rates, not likely! Market-based interest rates, including mortgage rates, are highly influenced by the Fed's actions, and we suspect rate hikes are in the offing DESPITE the December CPI report released yesterday. The largest contributor to housing affordability per the clip on the right below is mortgage rates. Fed rate hikes imply sticky mortgage rates and little affordability relief for housing.

Interest Rates Usually Follow Fed Policy Stance

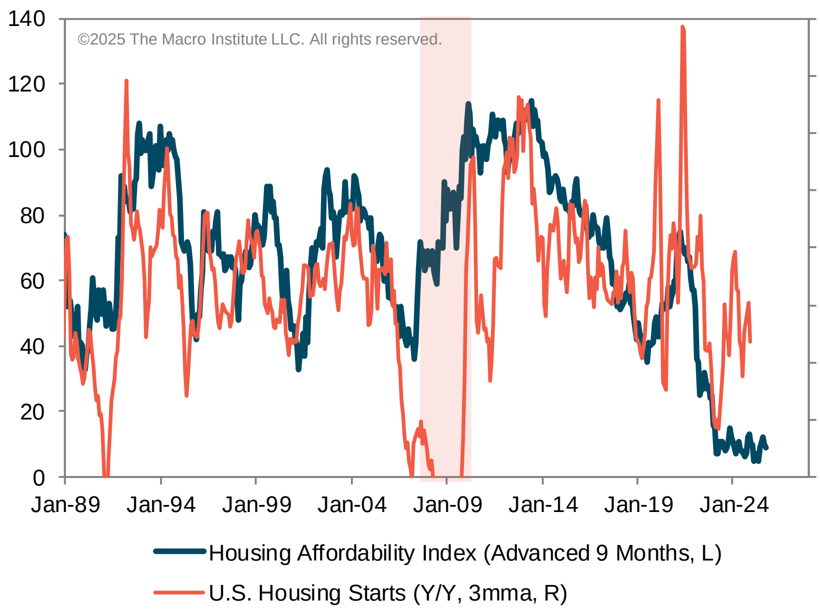


Mortgage Rates Not Headed Lower?



A true recovery in housing, meaning one that is broad-based and not just centered on higher-end housing, requires an improvement in housing affordability. The chart below reveals that housing affordability leads housing starts by about 9 months. In essence, we first need to see mortgage rates move lower before we can even think about a broad-based recovery in housing, and as we sit here today, it looks unlikely in 2025. Housing is a bit of a victim of the soft landing in this regard because without a recession there is no excess capacity and no sustained decline in interest rates.

Housing Affordability Leads Housing Activity



Slowdown In Starts Has A Way To Go

Conference Call Replay Is Available

The replay from last week's conference call is still live and has shelf life. Yes, we are worried that last year's success (the soft landing) turns into this year's problems as the Fed now pumps stimulus into an economy with little to no excess capacity (see the unemployment rate). In the end, this leads us to revisit the dynamics of 2021/22 when the economy initially performed well only to see the Fed raise rates in a panic. We do wonder if tariffs end up being this year's "supply chain issues" in the eyes of the Fed.

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