Macro Calm And Energy Tail Risks

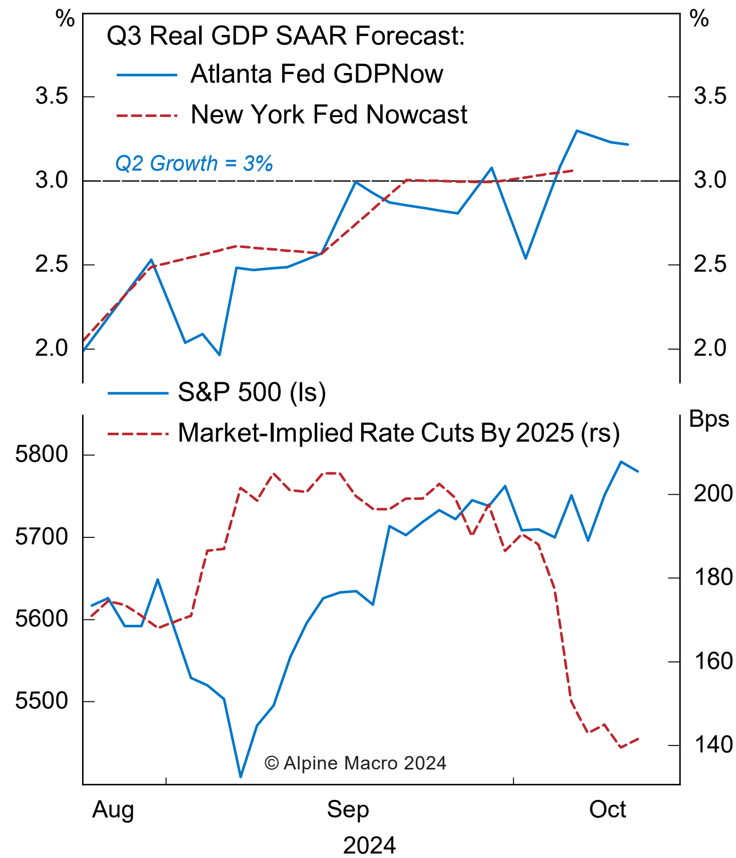
- Perfect macro landing remains our baseline forecast. By far, the biggest tail risk is a violent oil price spike, though it would no longer be a black swan event given media coverage.

- Profit margins should hold up and the odds of even a mild recession have declined further. The scaling back of Fed rate cut expectations, currently 145bps by December 2025, will add equity volatility. Barbell strategy still makes sense.

- Oil prices have cyclical downside risk unless an Israel-Iran confrontation impacts oil fields and the Strait of Hormuz. China has begun a meaningful policy reflation, but there is a window for economic weakness given earlier mistakes.

- Energy stocks offer an excellent hedge against a super-spike in oil prices. Barring such a spike, it is too soon to overweight on a 6-12 month horizon.

Chart 1 Q3 Growth Keeps Getting Revised Up



Theme 1
Macro Calm

Stronger-than-expected jobs and inflation data for September have taken pressure off the Fed to slash interest rates, but we still expect further cuts. **Chart 1** shows that the forecast for Q3 real GDP growth keeps getting revised upward in both Atlanta and New York Fed models. Both estimates are above 3%, after 8 consecutive quarters with growth of at least 1% before that.

Nevertheless, a period of "macro calm" is far more likely than economic acceleration and/or rebounding wage and price inflation. We define macro calm as neither economic boom nor recession; wage and price inflation not far from 2%; and the Fed gradually lowering interest rates.

Various leading indicators present the mixed picture that one would expect in an environment of subpar-but-positive growth and a lack of pricing power:

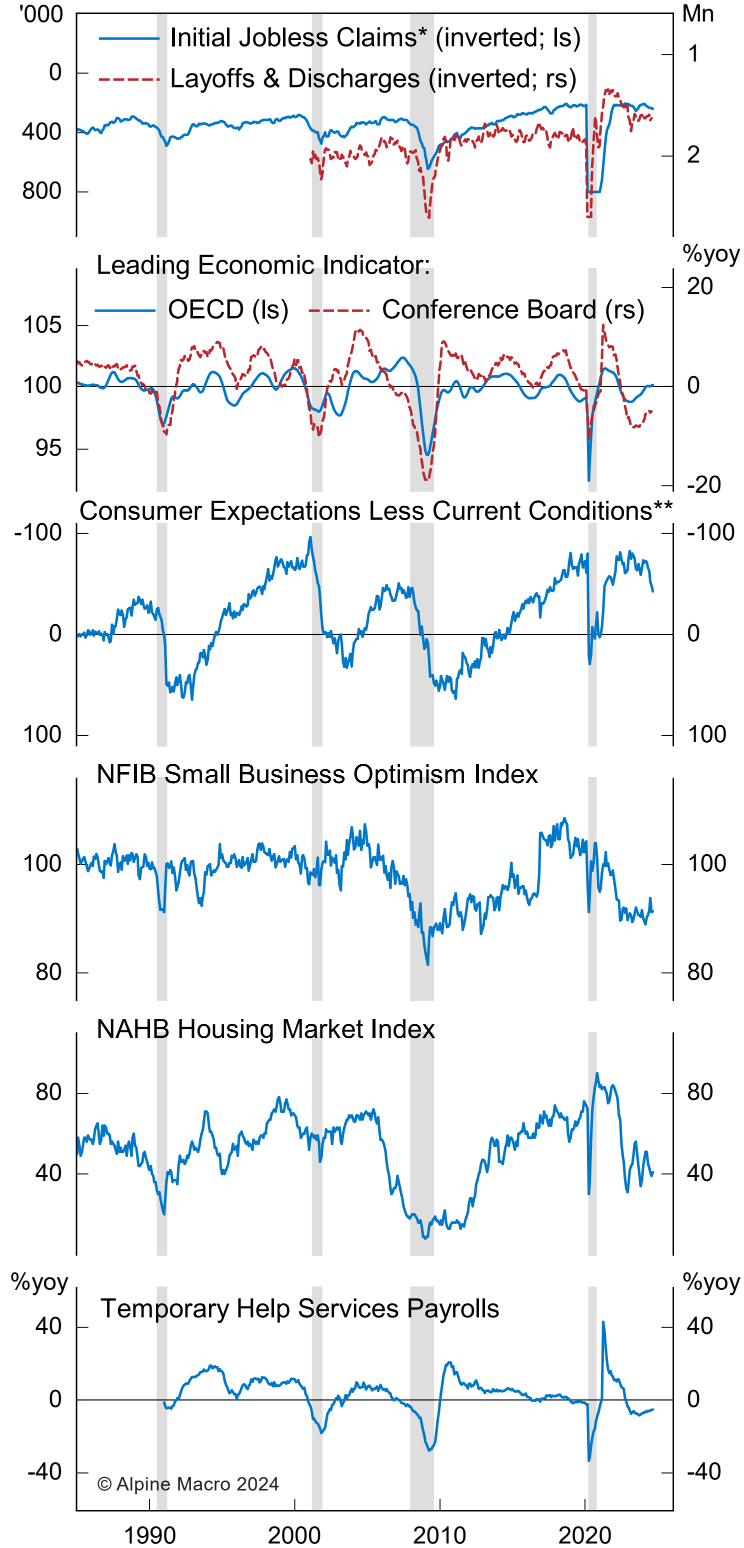
- **Macro leading indicators** (Chart 2): Many of these indicators are trendless. They incorrectly forecast a recession last year, but were likely distorted by post-pandemic influences that will abate going forward. Historically, indicators such as the NFIB and NAHB surveys have been excellent recession predictors.

- **Capital market leading indicators** (Chart 3): Real-time financial market measures that should be sensitive to economic prospects have stabilized after rising sharply last year and then correcting around mid-2024. The yield curve is roughly flat, based on the 10-year/2-year yield spread. That is also the case for both the real (TIPS) and expected inflation (CPI swaps) yield curves.

- **Financial system leading indicators** (Chart 4): M2 and bank credit are barely expanding. Fed tightening is impacting auto loan and credit card delinquency rates. Nevertheless, overall debt service burdens have barely risen, because 70% of household debt is in mortgages, most of which have fixed rates. Bank lending standards are no longer getting more restrictive, but they still remain cautious after eight consecutive quarters of tightening.

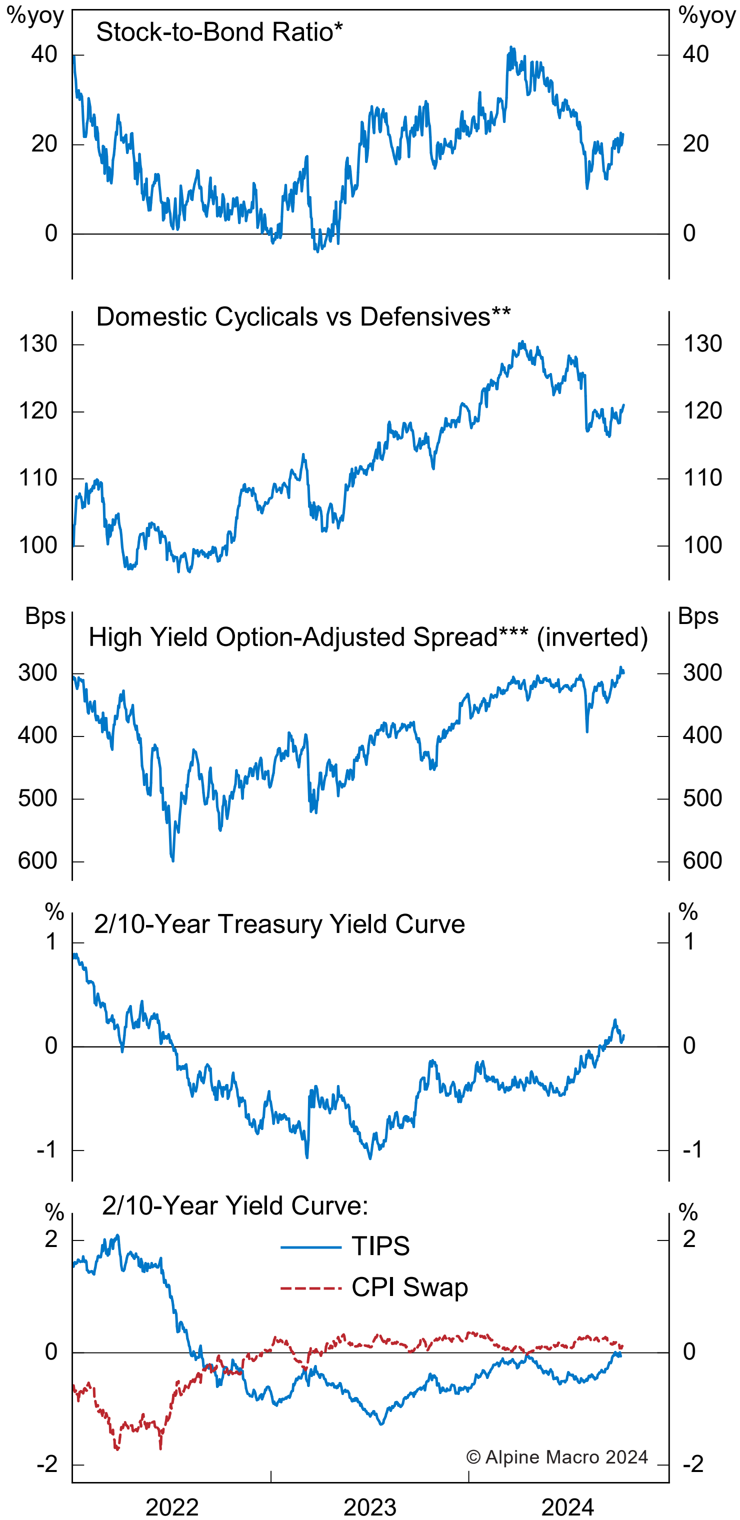
Moreover, the labor market is likely softer than the unambiguously strong September nonfarm payrolls report suggests. Chart 5 shows that the unemployment rate is off the bottom and it is getting tougher to find a job, judging from the Conference

Chart 2 Trendless Macro LEIs



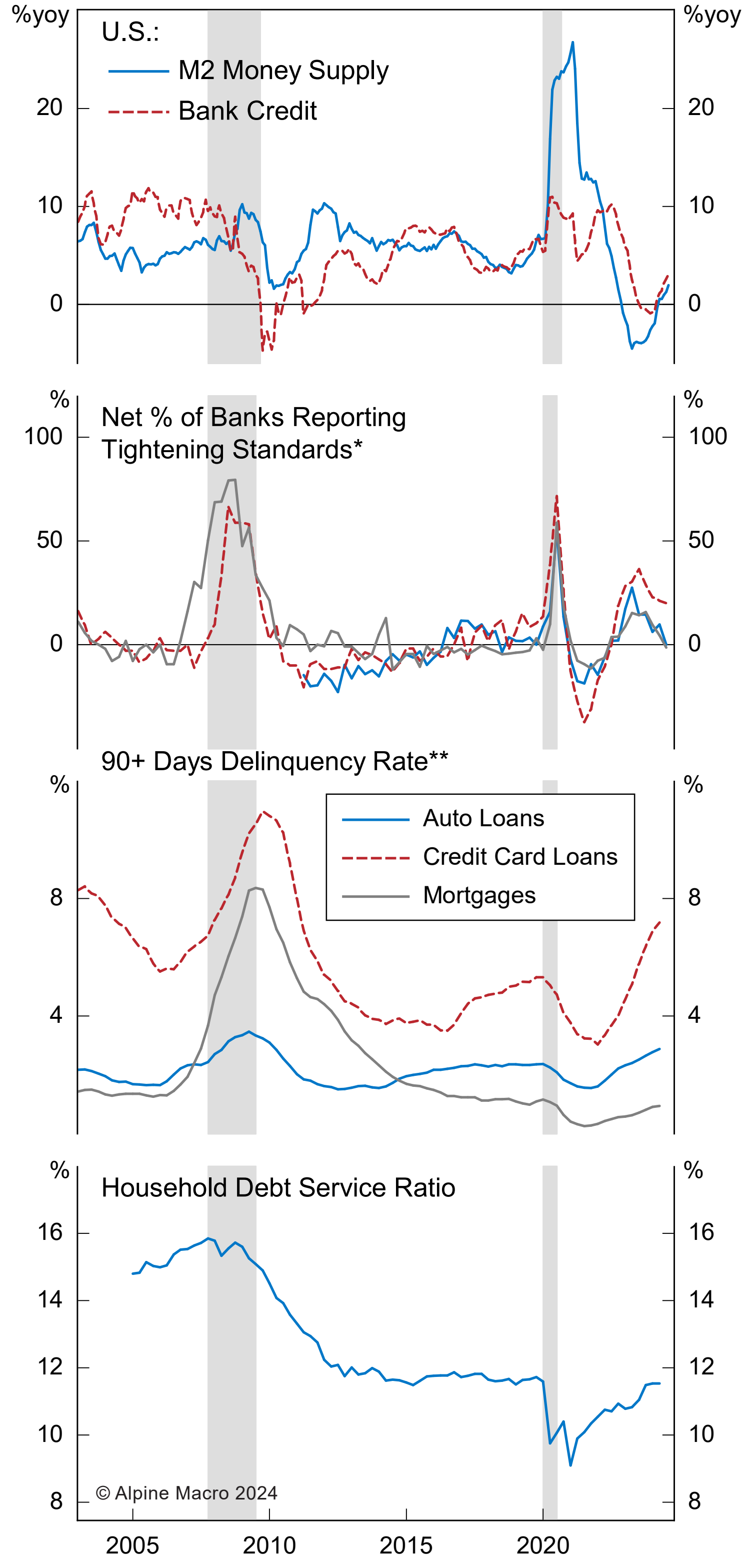
*Shown as 3-month moving average; truncated at 800
**Shown inverted; source: Conference Board
Note: Shading denotes U.S. recessions

Chart 3 Mixed Capital Market LEIs



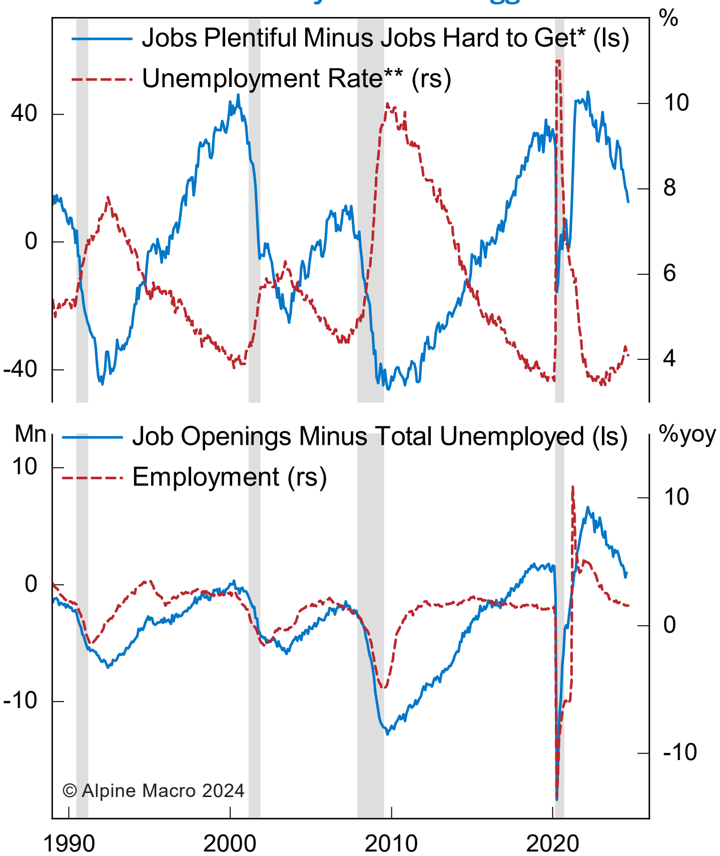
*S&P 500 total returns divided by 10-year Treasury total returns
**Rebased to Jan 2022=100; source: Bloomberg Finance L.P., Goldman Sachs
***Source: BofA Merrill Lynch

Chart 4 Money And Credit Crosscurrents



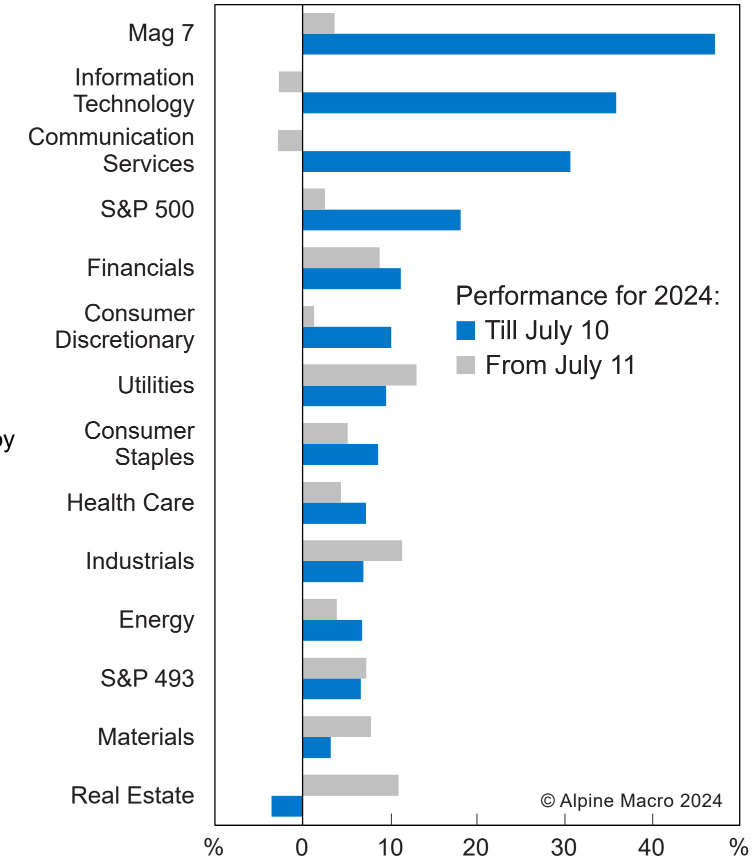
*Source: Senior Loan Officer Opinion Survey, Federal Reserve
**Source: Federal Reserve Bank of New York
Note: Shading denotes U.S. recessions

Chart 5 Labor Market Less Strong Than Payrolls Data Suggest



*Source: Conference Board
**Truncated at 11
Note: Shading denotes U.S. recessions

Chart 6 Rotation Since Mid-July



Note: A weaker-than-expected June CPI release on July 11 marks the beginning of "market rotation" into laggards

Board and JOLTS surveys. In addition, the labor force participation rate is close to an all-time high after adjusting for demographics. Combined with rising productivity, this will keep unit labor costs under control. Friday's *Special Report* will examine how the employment picture fits with our perfect landing scenario and bullish equity stance.

Bottom line: The Fed has massive room for maneuver. Money market expectations of 145bps of easing by December 2025 are "about right". Equities should benefit from rate cuts, albeit already anticipated, and subdued unit labor costs (see next **Theme**).

Theme 2
Macro Calm ≠ Equity Calm

Our baseline forecast of macro calm justifies our bullishness on stocks and overweight *vis-à-vis* bonds. However, it does not imply low equity volatility, even if the tail risk of an oil spike does not happen, as discussed on page 7. The third-quarter earnings season will provide insights, but we expect a volatile uptrend amidst continued improvement in equity breadth.

Chart 6 shows the change in equity leadership since mid-July when the tradeoff between inflation and economic growth improved. Since then, the

Chart 7 P/E And Bond Prices: Joined At The Hip

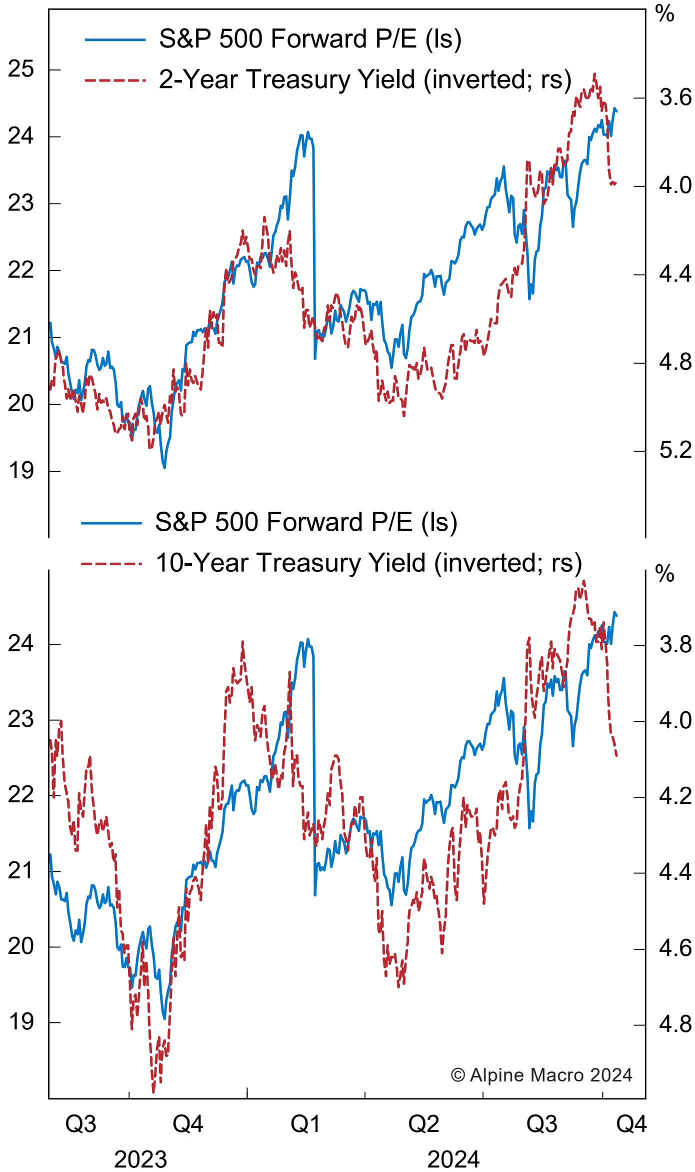
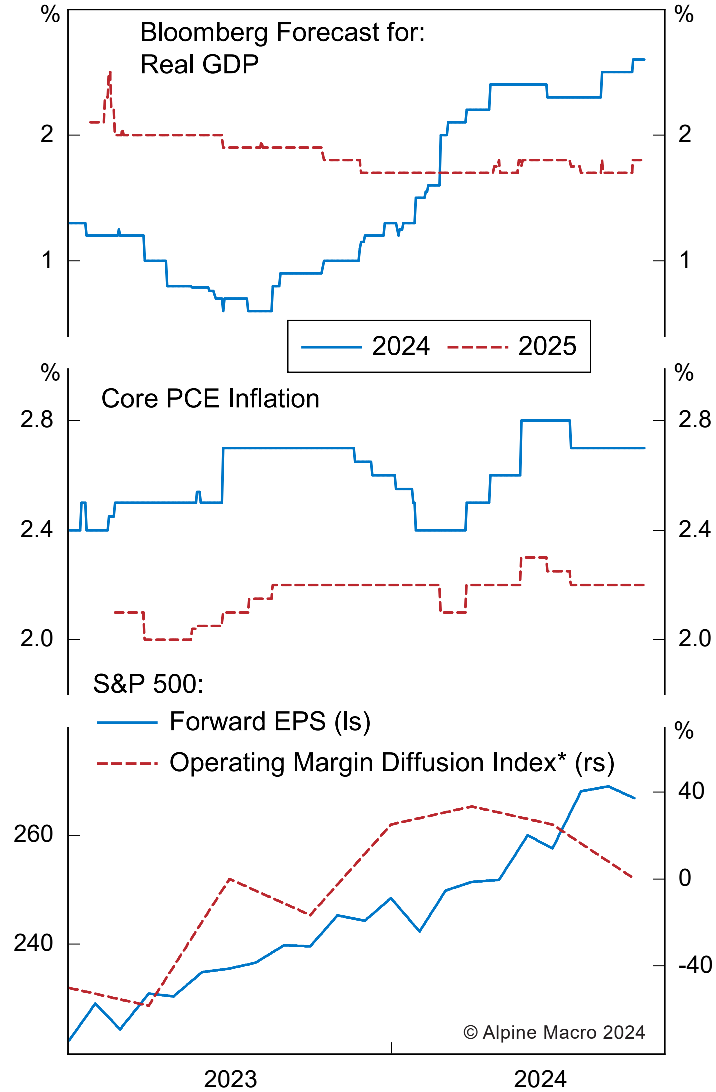


Chart 8 Complacent Consensus



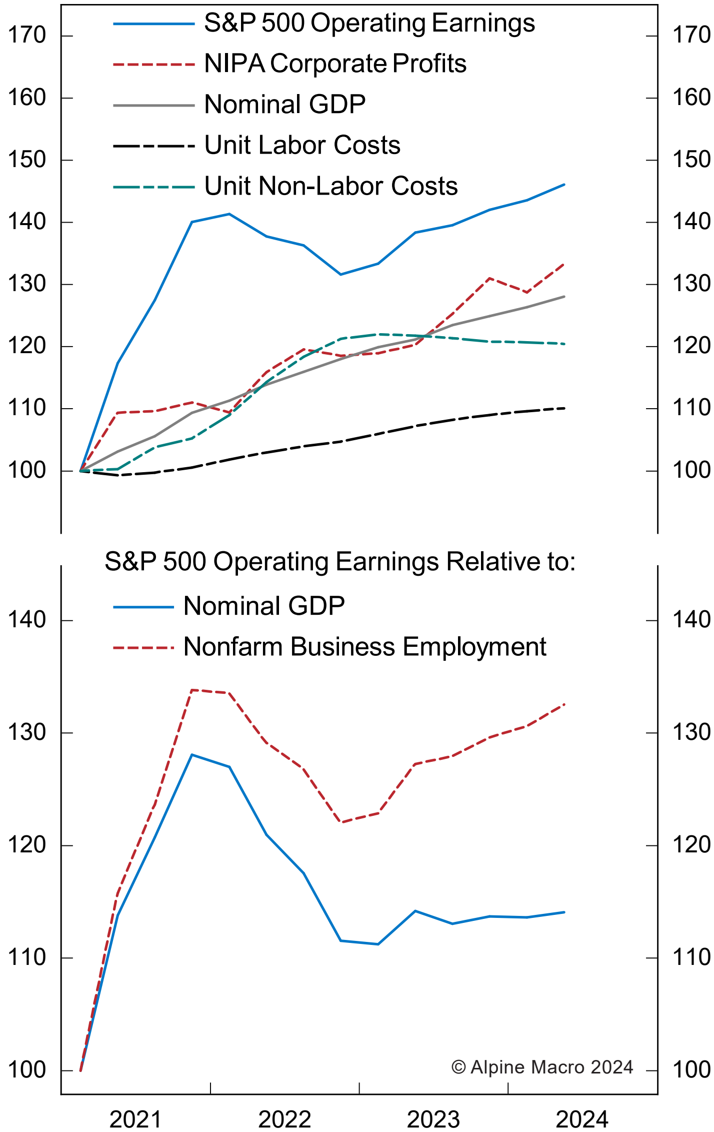
*% of industry groups with rising operating margins minus those with decreasing operating margins

Mag 7 tech stocks still have appreciated. But the bigger winners have been previous laggards: cyclicals and interest-rate-sensitive defensive sectors. This fits with our forecast of higher equity prices, as well as our risk-adjusted strategy of holding both Big Tech and selected defensives.

The equity uptrend is unlikely to be calm even if the macro environment is. Neither multiples nor profit margins have room for a major expansion. Forward earnings multiples are closely correlated with bond prices (**Chart 7**, with yields shown inverted), and we expect the latter to be flat to moderately higher.

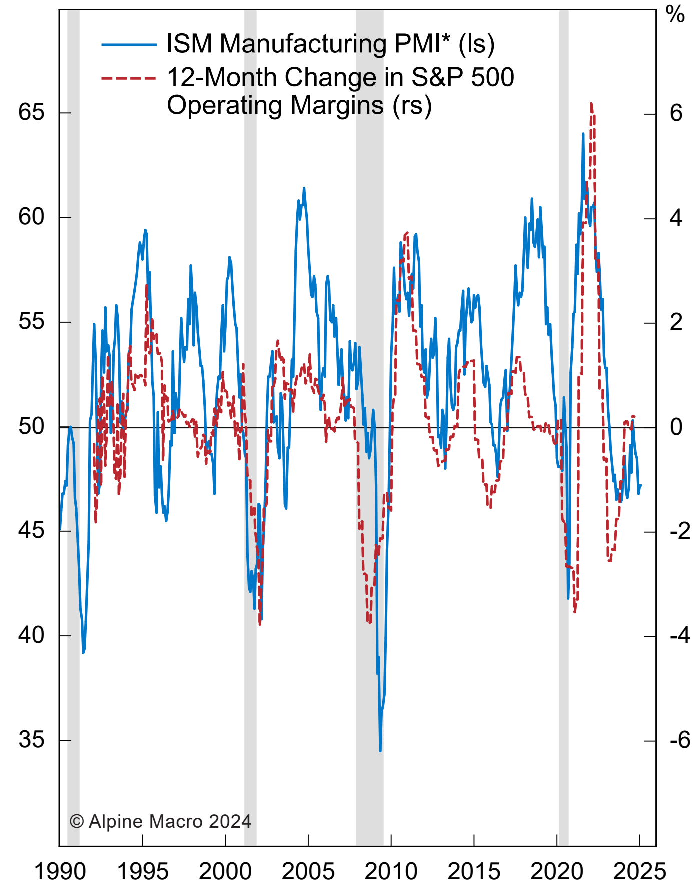
In addition, consensus forecasts for growth and inflation in 2025 already have converged with our "perfect macro landing" baseline (**Chart 8**).

Chart 9 Operating Earnings Benefit From Flat Unit Labor Costs



Note: All series are rebased to Q1 2021 =100

Chart 10 Constraint On Margin Upside



*Advanced by 5 months
Note: Shading denotes U.S. recessions

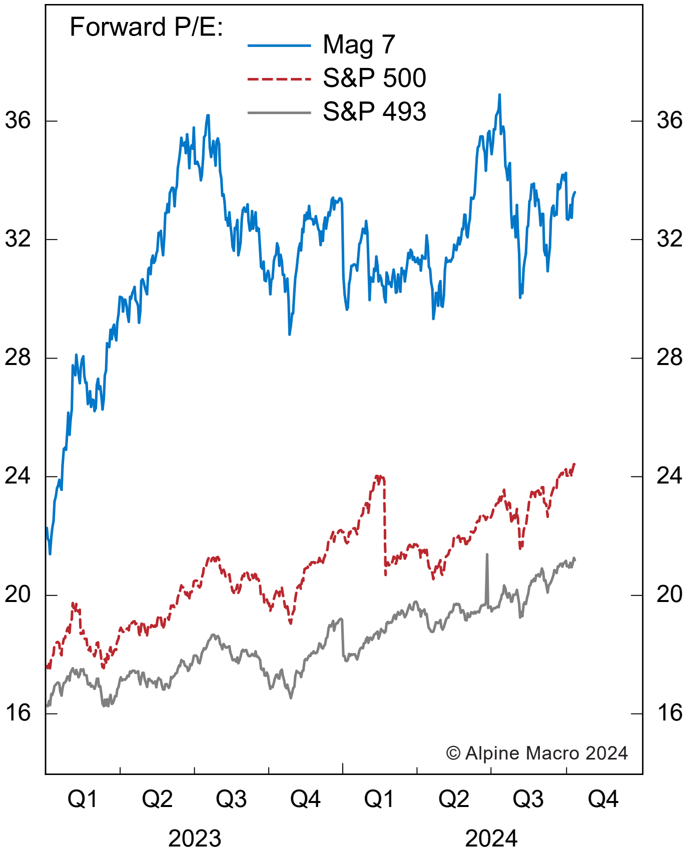
Year-ahead EPS estimates have been rising for the past two years at a time when our operating margin diffusion index is hovering around zero. Finally, soft manufacturing activity is also consistent with a lack of pricing power and inability to expand margins (**Chart 9**).

We do not expect these trends to threaten the equity bull market. Operating earnings continue to outperform nominal GDP because increasing productivity is suppressing unit labor costs (**Chart 10**). In fact, a bubble-like overshoot in the Magnificent 7 (and two "Obesity Big Pharma") stocks remains possible, despite the high forward P/E assigned to these stocks (**Chart 11**).[1]

Nevertheless, the potential for higher volatility and tail risk warrants exposure to our recommended "barbell portfolio". Put another way, our equity strategy is more defensive than would be expected if there is a period of macro calm as discussed in

1 Alpine Macro *Monthly Special Report* "Mania Roadmap: AI And Macro Drivers" (April 17, 2024).

Chart 11 Mag 7 Multiple Could Stay High



Source: Bloomberg Finance L.P.

Theme 1. Chart 12 shows that defensive equity sectors are inversely correlated with Mag 7 and the former outperformed dramatically during the late 2021/2022 "stealth bear market".

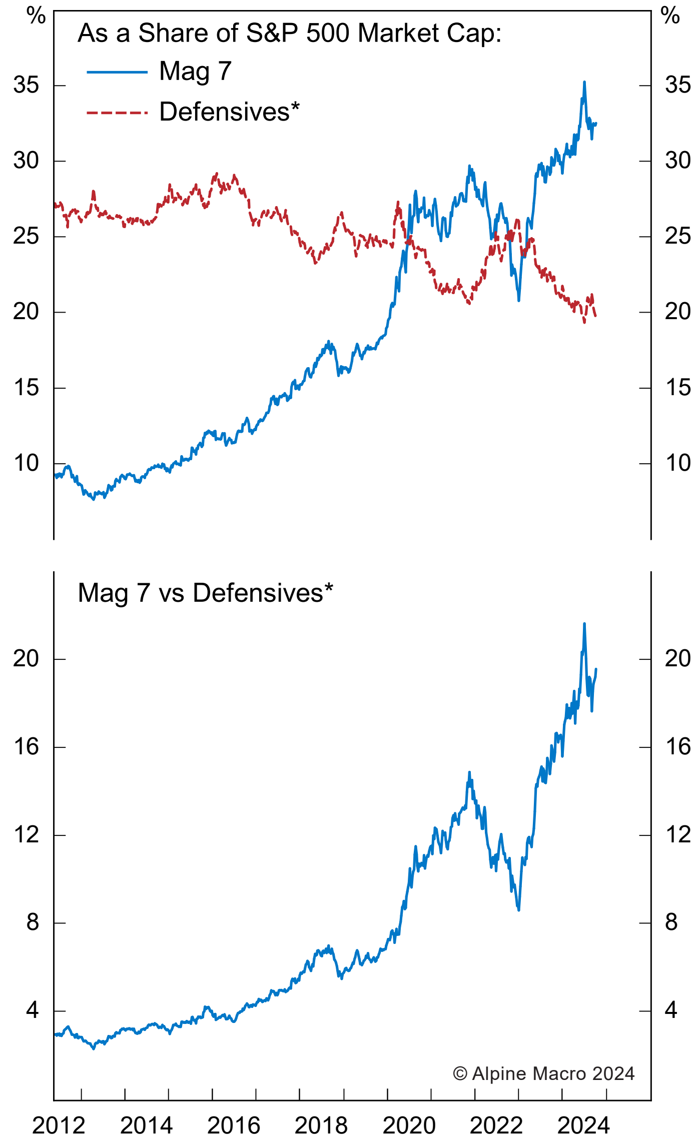
Bottom line: Equity volatility has bottomed even if macro volatility stays low. Barbell strategy still makes sense, even though Big Tech has bubble potential.

Theme 3

Oil, Tail Risk And Bonds

A geopolitically driven oil price spike is the main risk to our baseline forecast of macro calm and a continued, albeit volatile, equity bull market. How

Chart 12 Defensive Sectors Offer Hedge Appeal

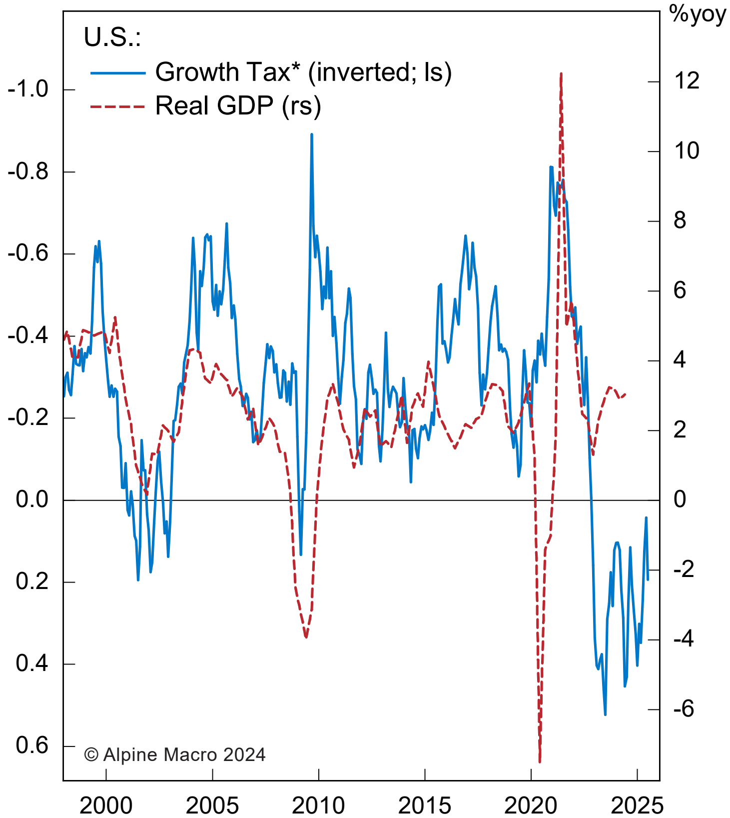


*Consists of healthcare, utilities and consumer staples

tensions in the Middle East could play out was discussed at length in a report by our *Geopolitical Strategy* service.[2] This is not a time to be dogmatic. What we can say is that an oil price surge would significantly weaken both U.S. consumer and business confidence, even though it is a net energy exporter. Our Growth Tax measure that combines

2 Alpine Macro *Geopolitical Strategy* "The Middle East: Major Escalation Is Likely, Either Now Or Later" (October 4, 2024).

Chart 13 Oil Spike Would Impose Big Growth Tax



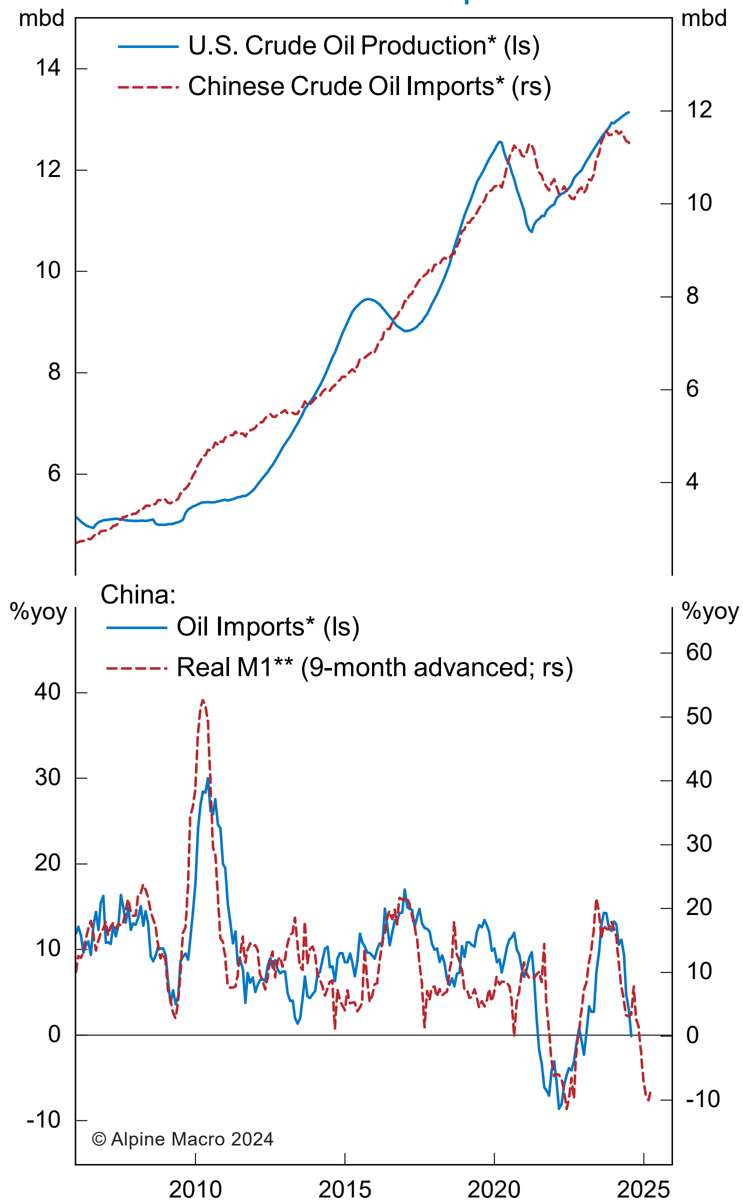
*Combination of the dollar, brent oil price and interest rates; standardized and advanced by 9 months

the dollar, oil and interest rates influences already presents headwinds (**Chart 13**). The Growth Tax from an oil spike would be much worse for Europe, Japan, China and India, which are major importers.

In contrast, the underlying cyclical supply/demand environment is much less supportive for crude prices:

- Chinese policy reflation will take time to boost oil demand. Real M1 trends warn that oil imports will remain soft at least until the end of the year. Meanwhile, U.S. crude production is close to an all-time high. This combination tends to precede lower oil prices over a 3-6 month horizon (**Chart 14**).

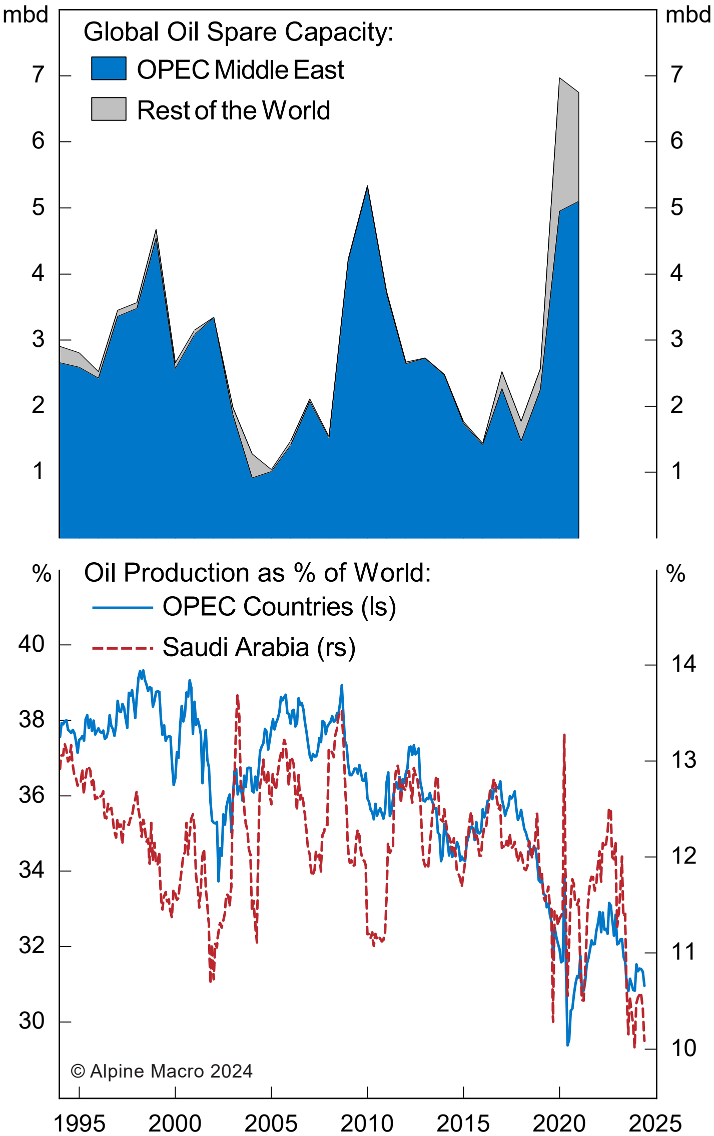
Chart 14 Chinese Imports Down, U.S. Production Up



*Shown as 12-month moving average
**Deflated by PPI

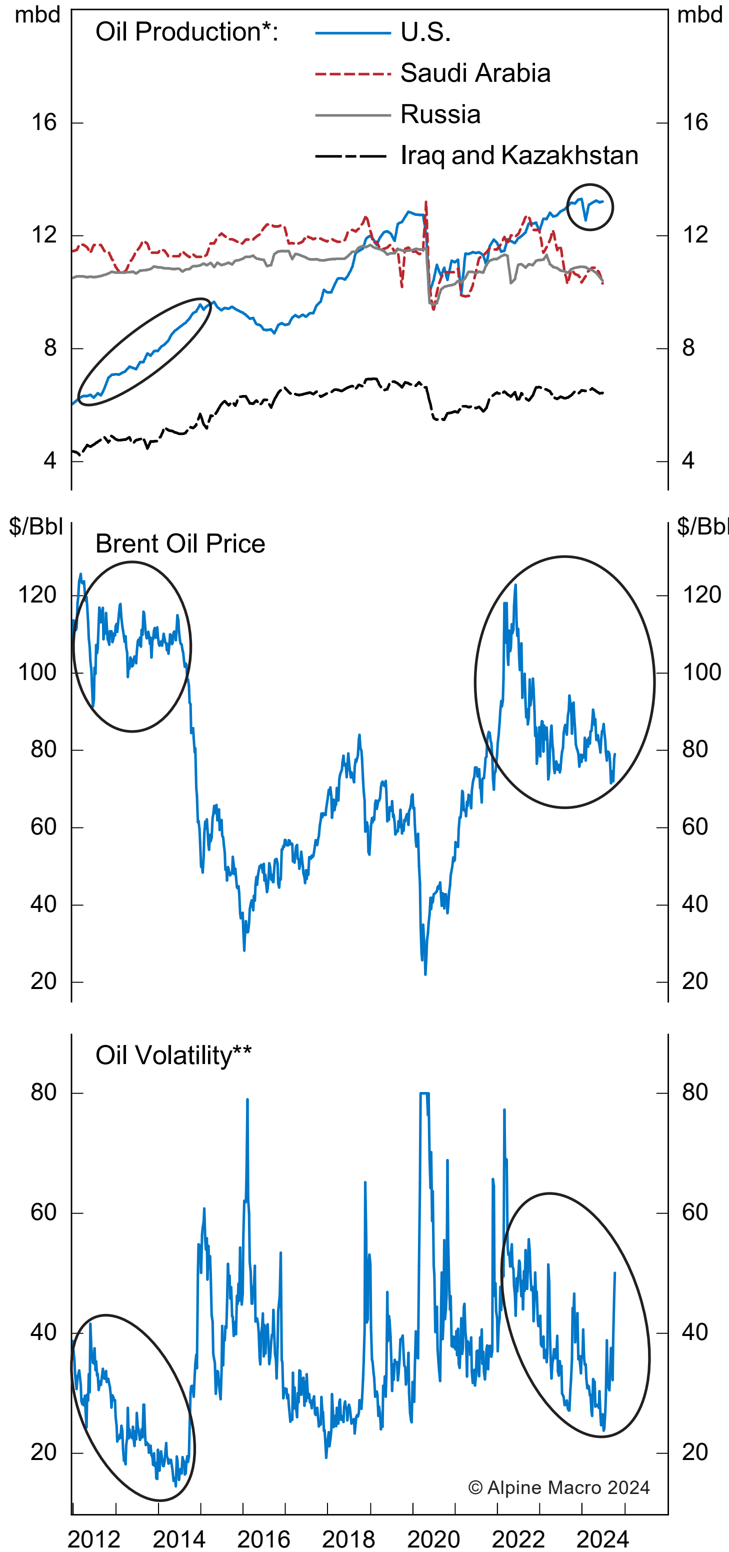
- Saudi Arabia, the traditional OPEC policeman, is growing impatient with "free riders". Global spare capacity of oil supply is high, while Saudi market share has plunged to a record low (**Chart 15**).
- Related to the previous point, Iraq, Kazakhstan and Russia have sustained crude production

Chart 15 Saudi Market Share Has Collapsed



Source: EIA

Chart 16 Oil "Free Riders"



*Source: EIA
**Truncated at 80; CBOE Crude Oil Volatility Index (OVX)

even as the Saudis cut back (Chart 16, top panel). This will be irrelevant if oil production and exports are significantly undermined by the Israel-Iran military conflict. Barring that, however, the previous period of complacency reflected in declining oil price volatility allows for a temporary downside move below the tight range of the past two years.

Chart 17 Oil Drives Inflation Breakevens

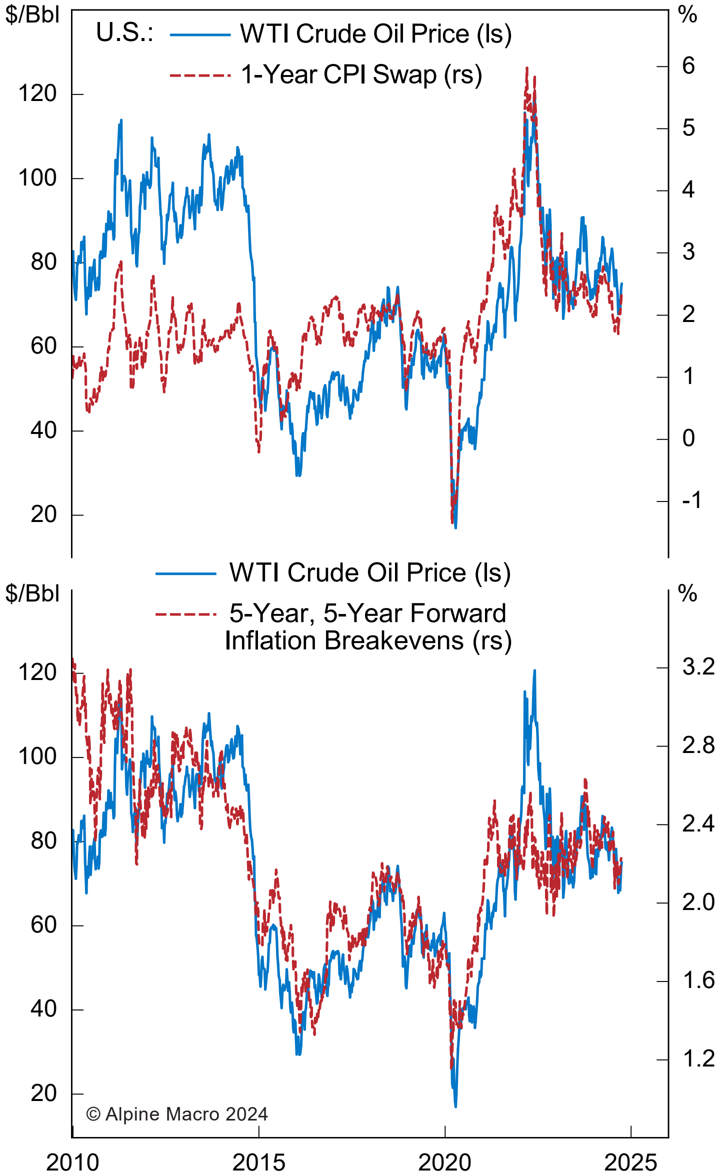
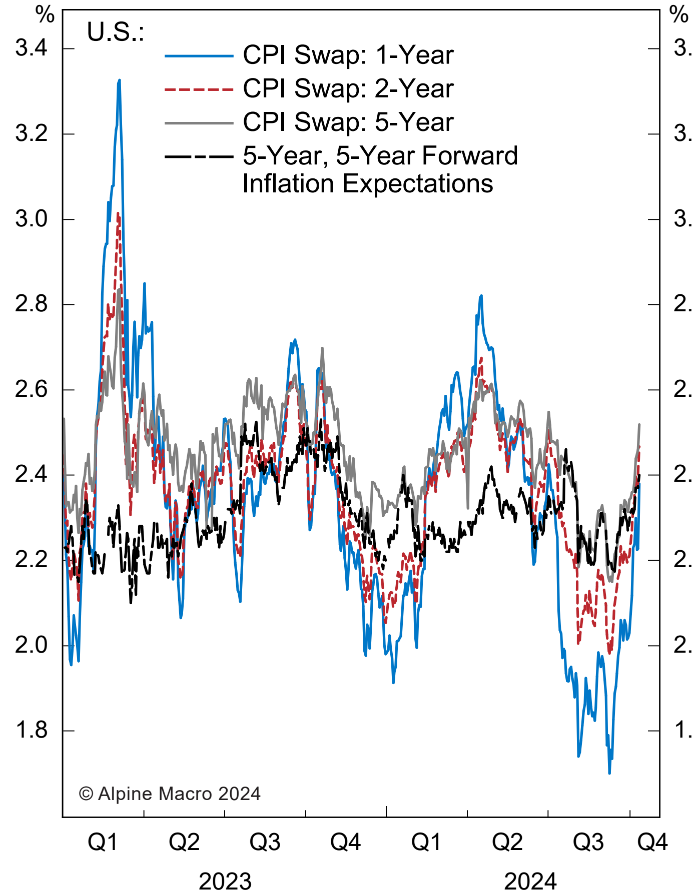


Chart 18 Expected Inflation Up To 2.4%



Oil crosscurrents have implications for Treasury bonds. A super-spike in prices would cause higher bond yields, despite the growth-draining implications of this aggregate supply shock. Expected inflation would get marked up more than real yields get marked down. The oil price backup already has boosted the expected inflation component of yields all the way from 1-year CPI swaps to 5-year/5-year forward inflation breakevens (Chart 17). The resting spot for CPI inflation is around 2.4%, with the 1-year CPI swap up 50bps in the past month (Chart 18).

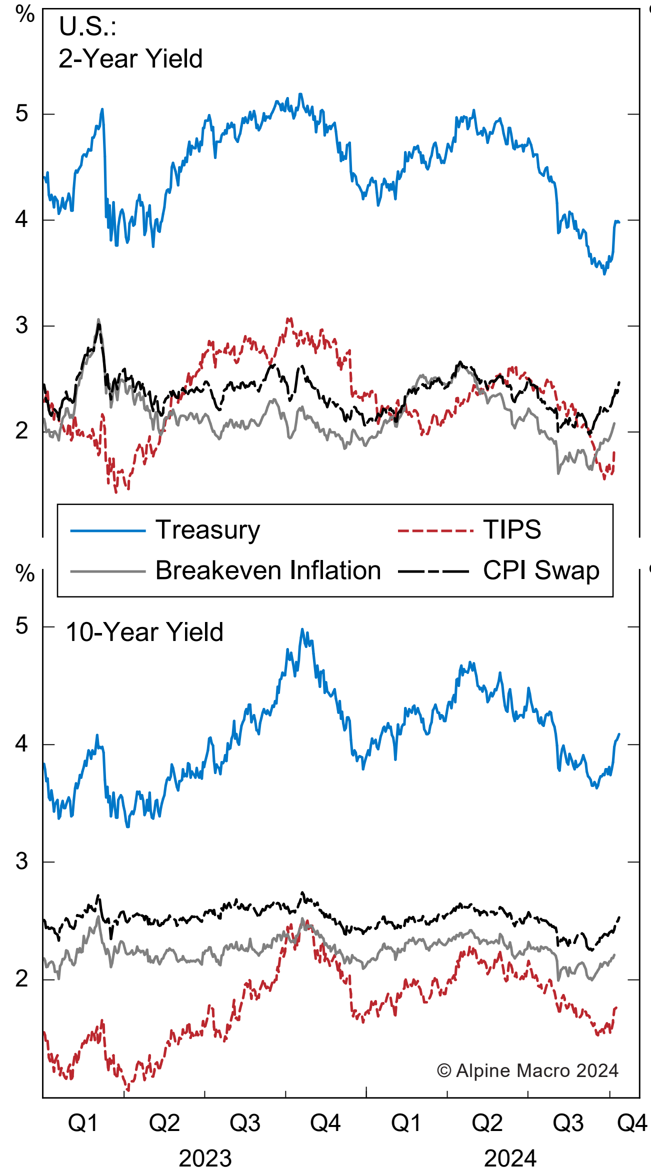
However, expected inflation should quickly return to a 2% center of gravity if Israel/Iran tensions abate for a time, or once an oil shock runs its course. **Chart 19** shows that the bulk of the selloff has been in the inflation component, which is sensitive to energy prices. Nevertheless, the recent rise in 2-year and 10-year yields has been highly correlated, suggesting that higher-than-expected jobs and inflation data played a role *via* a reduction in expected Fed easing. These trends should not be extrapolated, as discussed in **Theme 1**.

Bottom line: Looking to add bond duration on a backup in yields. The main risk relates to an oil price spike after an extended period of low volatility. In the absence of such a spike, underlying cyclical fundamentals are moderately bearish and 10-year bonds are attractive beyond 4.25%. Energy stocks are an excellent hedge against an oil spike, but otherwise we expect a better entry point over the next 6 to 12 months.

David Abramson

Chief U.S. Strategist & Director of Research

Chart 19 Short-Term And Long-Term Yields Move Together



A Unique Mind On The Markets