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TRAHAN MACRO RESEARCH

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The Earnings Outlook … In The Right Context!

It is a little hard to visualize this right now, but I suspect this cycle will eventually become the premier example of what a peak in the fed funds rate should look like for financial markets. Let's recap. Stocks typically enter a "bad economic news is good stock market news" dynamic once becomes clear that the Fed is done tightening policy. This is what most refer to as the "Fed relief rally," and this has been one of the strongest historically. That said, the market has also had more time to rally than typical as this is one of the longest peaks in the fed funds rate we have ever seen.

The Four Phases Typically Seen During A Peak In The Fed Funds Rate

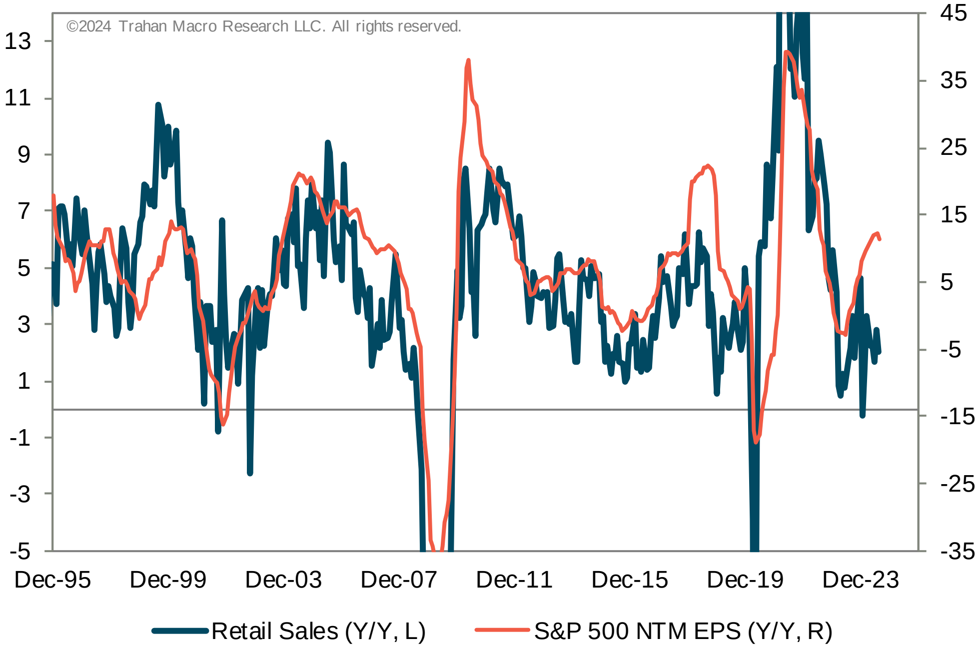
Sometime during a Fed relief rally we typically see a change in market leadership favoring more stable companies like defensives. In essence, the latter part of these rallies is somewhat risk-off and that usually comes with an expiration date. Clearly this process began in the spring as Utilities and Consumer Staples are two of the best performers since the beginning of Q2. Another sign that conditions are changing during a peak in the fed funds rate is when we start to see a change in the relationship between stocks and bond yields (i.e., they become positively correlated).

We are clearly seeing more and more days with higher yields and higher stocks, and vice versa, in recent months, which we rarely saw in 2022/23. This transition often comes with a volatile period for equities (sound familiar?), and it's a sign that markets are increasingly in tune with EPS and less so with interest rates. In that vein, this is the point in the cycle when EPS matter even more than normal. This heightens the importance of the recession versus soft-landing debate. We review recession risk indicators this week and think through the odds they predict. We also introduce our own version of the Sahm Rule. This is critical stuff in a historical context. Wishing you a great rest of your week. All the best. Francois

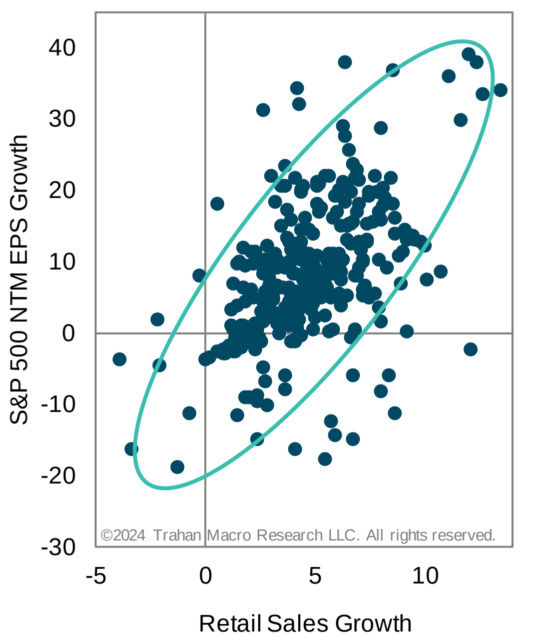
It's Difficult To Separate S&P 500 Earnings & U.S. Consumption Trends

One of the hallmarks of the transition we discussed on the prior page relates to earnings. Typically, earnings are still growing during a peak in the fed funds rate as strong labor markets support personal consumption and retail sales. Any negative economic data surprises are normally offset by expectations of an incrementally-more dovish fed. Thus, lower bond yields drive equity prices higher. As a result, the soft-landing thesis usually gains prominence. However, this is usually a temporary phenomenon.

Earnings And Consumption Are Closely Related



Yes, They Are Strongly Correlated



Consumption makes up nearly 70% of U.S. GDP, so it can support corporate earnings and equity markets as long as labor markets remain strong. Eventually, trends in employment tend to disrupt the existing correlation between bond yields and stocks. As the lagged effects of monetary policy trigger an increase in unemployment, personal consumption and retail sales tend to soften. This results in downward pressure on EPS and GDP. As investors face the reality that the Fed is late to the game, bad economic news tends to become bad market news, and the equity/bond yield relationship typically turns positive.

Labor Markets At The Heart Of Consumption Trends

Inverse Relationship

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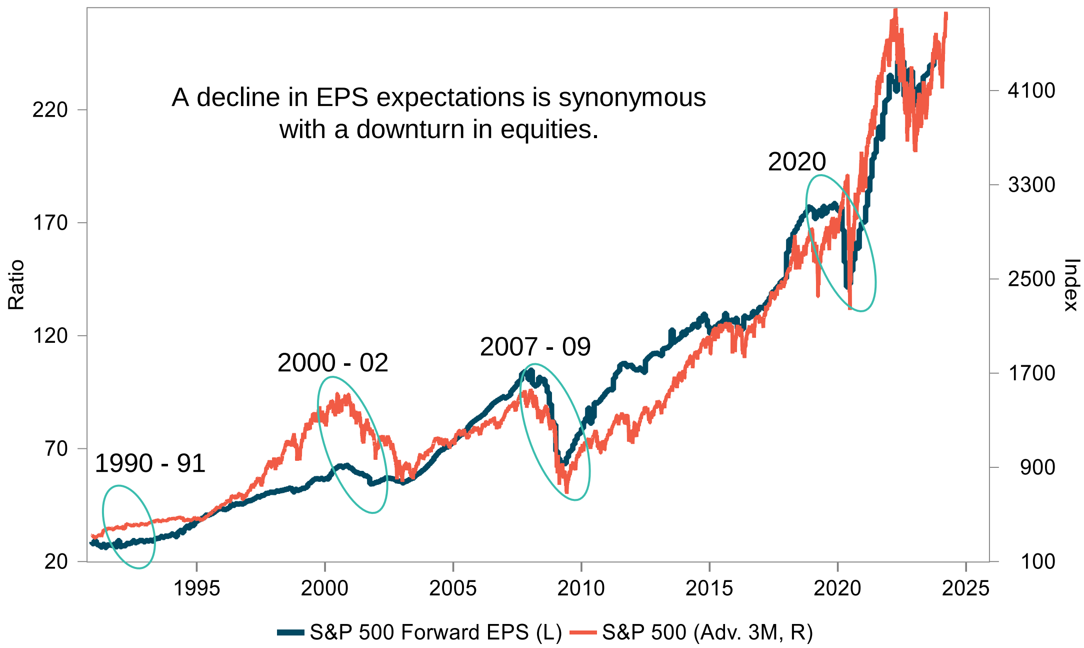
Employment Drives Earnings – The Lifeblood Of Equity Markets!

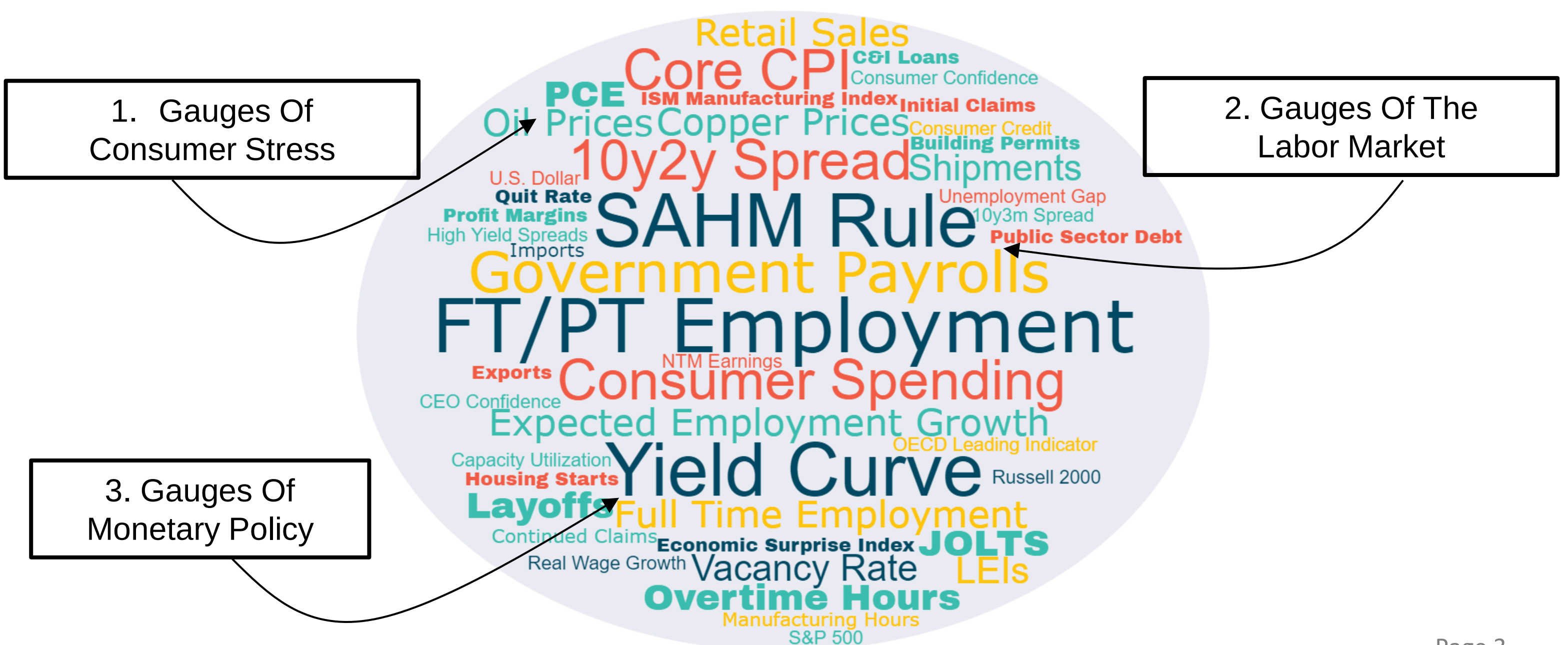
The transition into the last phase of the fed funds rate plateau hinges on the progression of earnings. Bear markets – and the positive stock/bond correlation – generally does not appear until EPS are set to decline. What we see below is the tight and slightly leading relationship of the S&P 500 Index, which is advanced 3 months, against forward earnings expectations. Stocks act as an LEI here – and the most punishing drawdowns have historically occurred when EPS was falling.

A “Legit” Bear Market Generally Occurs When EPS Decline



As we hinted before, the fates of the cycle and equity markets at this stage in the plateau are highly sensitive to changes in labor markets – they are the fuel for consumer spending and therefore U.S. growth. To gauge recession probabilities, we can track and develop various recession indicators through three avenues: **1)** consumer stress **2)** labor markets **3)** monetary policy. Today’s report will focus on recession gauges of the labor market.

Common Recession/Risk Indicators



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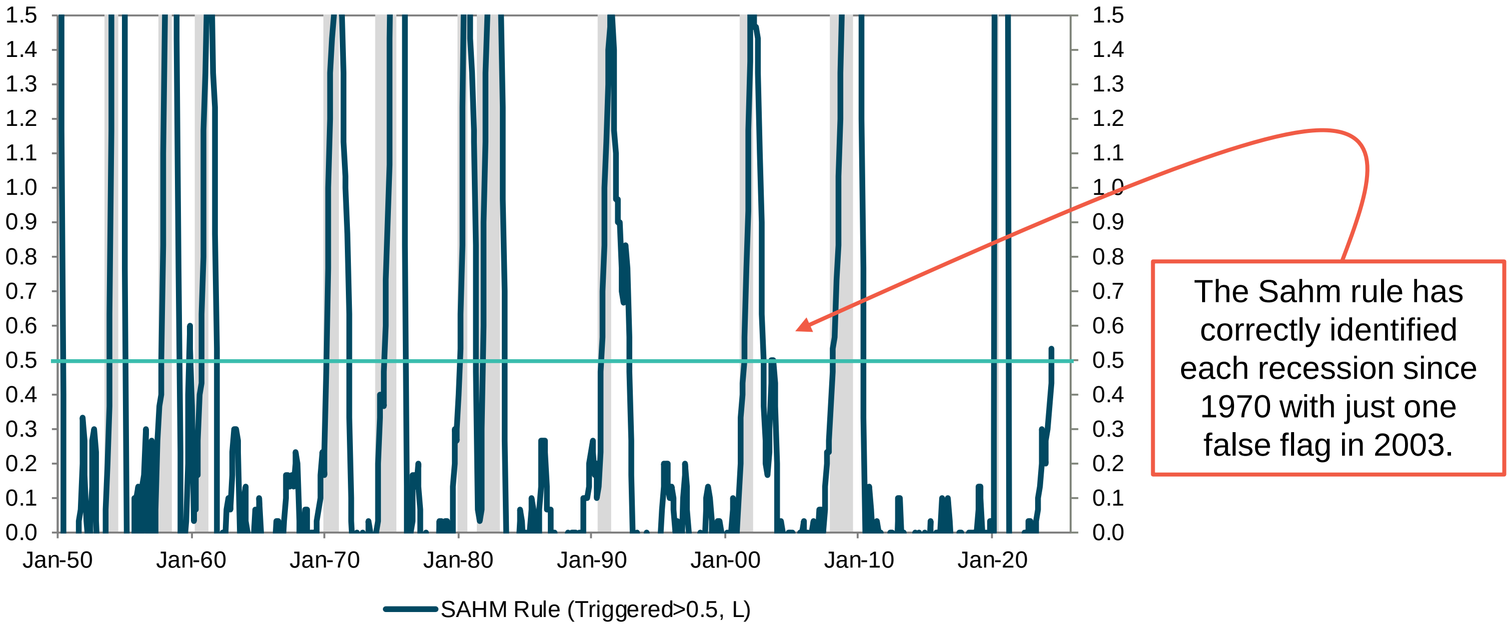
Ignoring Recession Indicators Is Nothing New – The Sahm Rule

One of the most reliable recession indicators in terms of labor market is the popular Sahm Rule, which has correctly flagged all but one recession since 1970. As of August, this indicator broke through the recession threshold. However, it has largely been ignored by equity markets. Even the indicator's creator has been backing away from its current conclusion. Our take is that ignoring tried and true indicators is more a sign of behavioral biases rather than broken fundamentals. Indeed, it's more comfortable psychologically to ignore flashing risk indicators than to contemplate the downside associated with them.

The Sahm Rule Has A Consistent Record Of Identifying Recessions



It's common to see economists and investors ignore recession indicators or come up with explanations as to why they are no longer valid. As we can see from the quotes below, the data and various indicators are often dismissed around inflection points in the cycle. The quotes here are from 2001 & 2008 and they speak to the rate of change in employment that is critical to the Sahm Rule.

The Last Two Sahm Rule Triggers …

"Strong Data Hint Economy Is Stabilizing; Report May Influence Fed on Rate Cuts"
-WSJ 6/27/2001

"TD Bank's Drummond Says Jobs Report Is Not Proof Of Recession"
- Bloomberg 2/1/2008

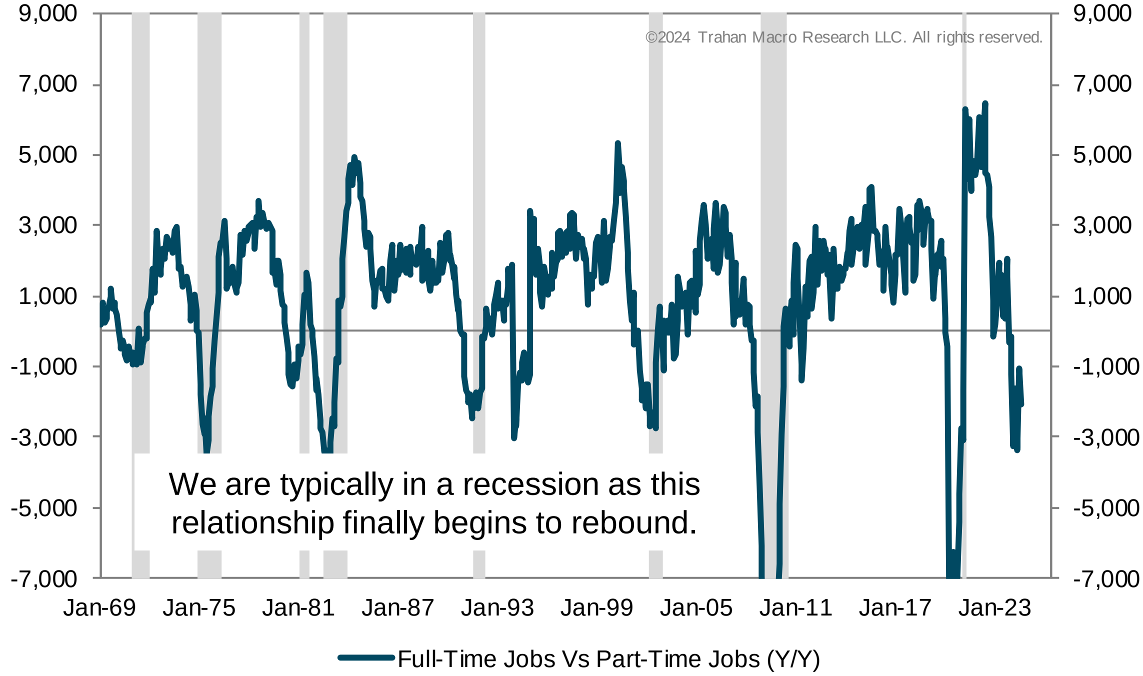
"Faced with favorable corporate news and unfavorable economic news, investors chose the corporate news and pushed up stocks again."
-WSJ 6/6/2001

"Investors received more signals that a recession is brewing, but stocks nudged a little higher anyway, as some market participants bet that they have already done enough to discount the risk of downturn."
- WSJ 2/8/2008

Ignoring Recession Indicators Is Nothing New – Full-Time/Part-Time

While the Sahm Rule has garnered most of the media attention since the beginning of the summer, it's hardly the only labor market-related recession/risk indicator. Another data series that tends to turn in the lead up to an eventual recession is the growth in full-time vs. part-time employment. We typically see part-time jobs displace full-time employment heading into, and during, a recession, as companies shy away from full-time salaried positions and prefer to bring in flexible hourly workers instead.

Sign Of Recession Risk … More Part-Time Than Full-Time Jobs



Since 1969, this indicator has correctly warned investors of all 8 recessions, providing just two false signals in 55 years.

Again, we look can look back at news stories from 2001 and 2008 to see economists and policy-makers interpreting recession-like data with skepticism. The NYT article from June of 2008 looks eerily similar to the situation we're confronted with today, where increases in labor supply are blamed for the rise in unemployment and the underlying trend is essentially dismissed.

News Stories At The Time Of Prior Full-Time/Part-Time Triggers

"U.S. Bonds Fall as Investors See Economy as Avoiding Recession"
- Bloomberg 4/4/2001

"U.S. Business Economists View Recession as 'Unlikely' This Year"
- Bloomberg 5/9/2001

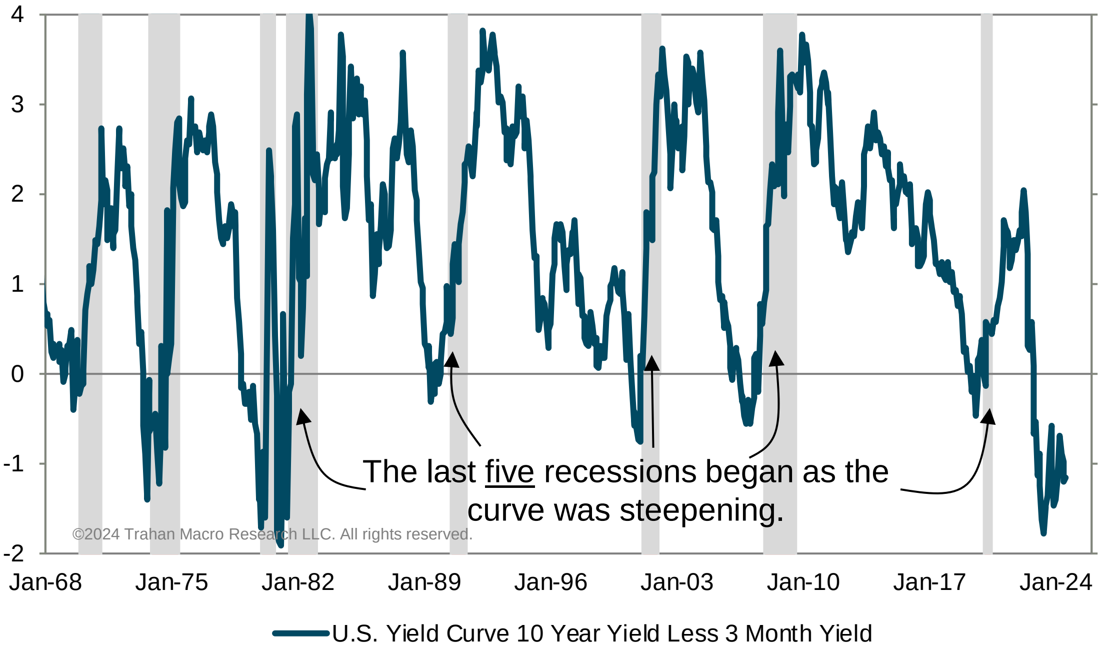
"The White House and some economists questioned the validity of the spike in unemployment, noting that most results from a surge in people entering the labor force."
-NY Times 6/7/2008

"We might see gains in this traditionally tough period," …because the Federal Reserve's seven-month-old campaign of cutting interest rates and injecting billions into the banking system has halted fears of the financial system seizing up, he said.
-CNN Money 5/1/2008

Ignoring Recession Indicators Is Nothing New – Yield Curve

The debate over the efficacy of the yield curve as a recession/risk indicator is a story as old as time. As we live through each episodic inversion, and un-inversion process, we hear a litany of new reasons why it has lost its predictive nature. Most of the questions that we field on this topic stem from a misunderstanding of how we use the curve as a leading indicator. We don't get a signal until deteriorating labor markets force the Fed to dramatically cut the short-end and the 10Y - 3M **un**-inverts.

Softer Labor Markets Trigger An Un-Inversion In The Yield Curve



In the last 55 years the 10Y - 3M YC, the Fed's preferred measure, has had a perfect hit rate. The curve has accurately warned of ,each of the last eight recessions.

Given the prolonged duration of the curve's inversion without recession, we often hear that the Fed's role in the Treasury market has distorted yields. The claim is that the higher absolute level of rates at the long end will change its relationship with the cycle. According to a Reuters poll in March, 22 of 34 bond market experts said the curve's predictive power is not what it once was. However, these statements are normal at an inflection point in the cycle. We can look back through history to see institutions dismissing the curve's efficacy time and time again.

News Stories At The Time Of Prior Yield Curve Inversions

"OECD Sees Slowdown In U.S. but No Recession"
-Bloomberg 6/30/1989

"A 'Soft Landing' Is Forecast"
-Bloomberg 5/26/1989

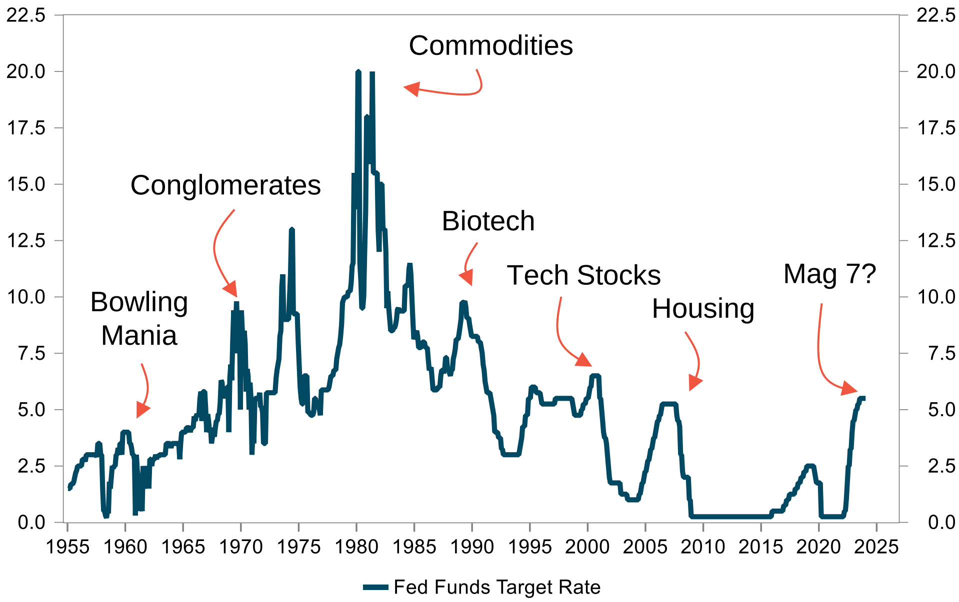
"..when the yield curve reversed during the last week of December: Few people paid attention. Stocks dipped, but the sell-of was nothing that would indicate widespread recession fears."
-Bloomberg 1/16/2006

"Bottom line, taken together, the evidence suggests that the recent inversion of the yield curve may not pose a threat to bank safety and soundness.""
-Richmond Fed Spring 2007

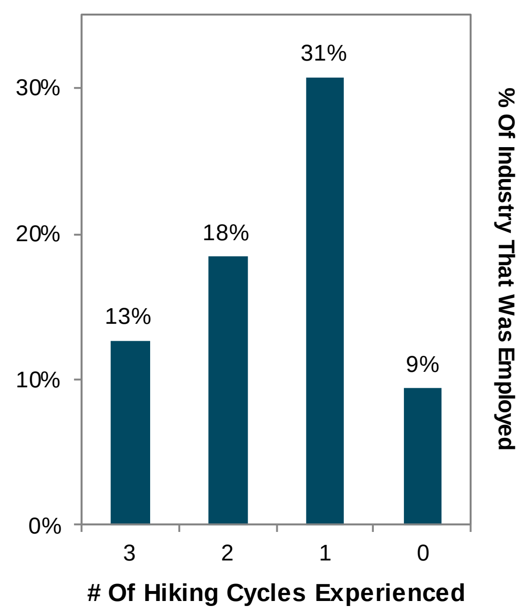
Why Do Investors Tend To Dismiss Recession Warnings?

One of the things we know empirically is that crises tend to unfold in the wake of a fed tightening cycle. Unfortunately, these systemic risks are usually overlooked for some time as equity price appreciation creates the illusion of safety. Investors tend to create false narratives to justify the price action – such as, "housing prices always go up." This phenomenon tends to go on until the lagged effects of monetary policy tightening impact earnings and employment. Unfortunately, few investors have experience with restrictive policy shifts as we estimate that just ~13% of investors were trading through the last 3 cycles.

Crises Usually Occur At The End Of A Fed Tightening Cycle

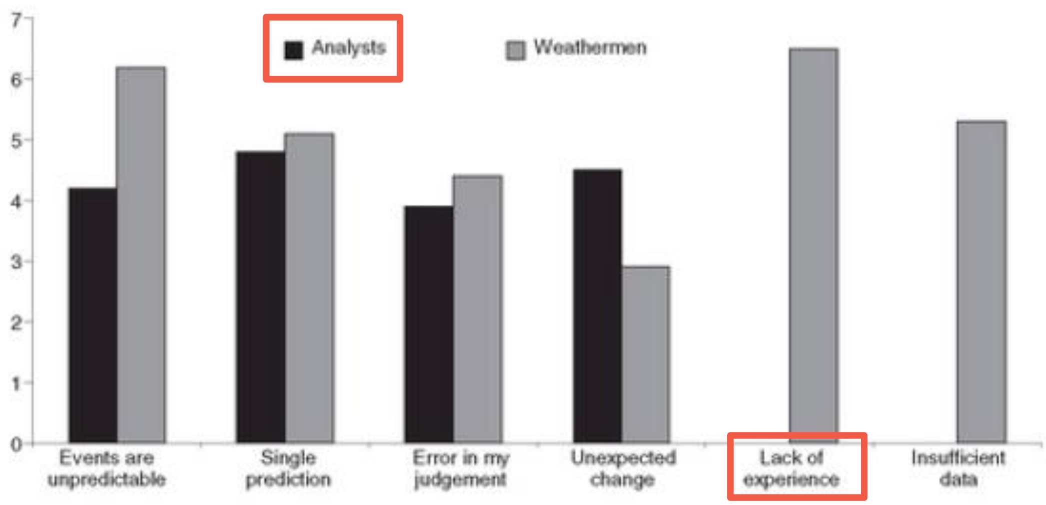


Tightening Is New For Many



Why is this important? Experience teaches us about the potential risks of and eventual fallout in the wake of Fed tightening. Investors, however, believe that inexperience is **not** a disadvantage in forecasting. An academic study surveyed financial analysts and weathermen who incorrectly forecasted their subject matter on the justification of inaccuracy on an 8-point scale. The relatively overconfident analyst group pointed to everything BUT lack of experience as a reason, while the more modest weathermen group cited lack of personal experience as the primary driver of forecast failure.

Justification Of The Forecast Failure

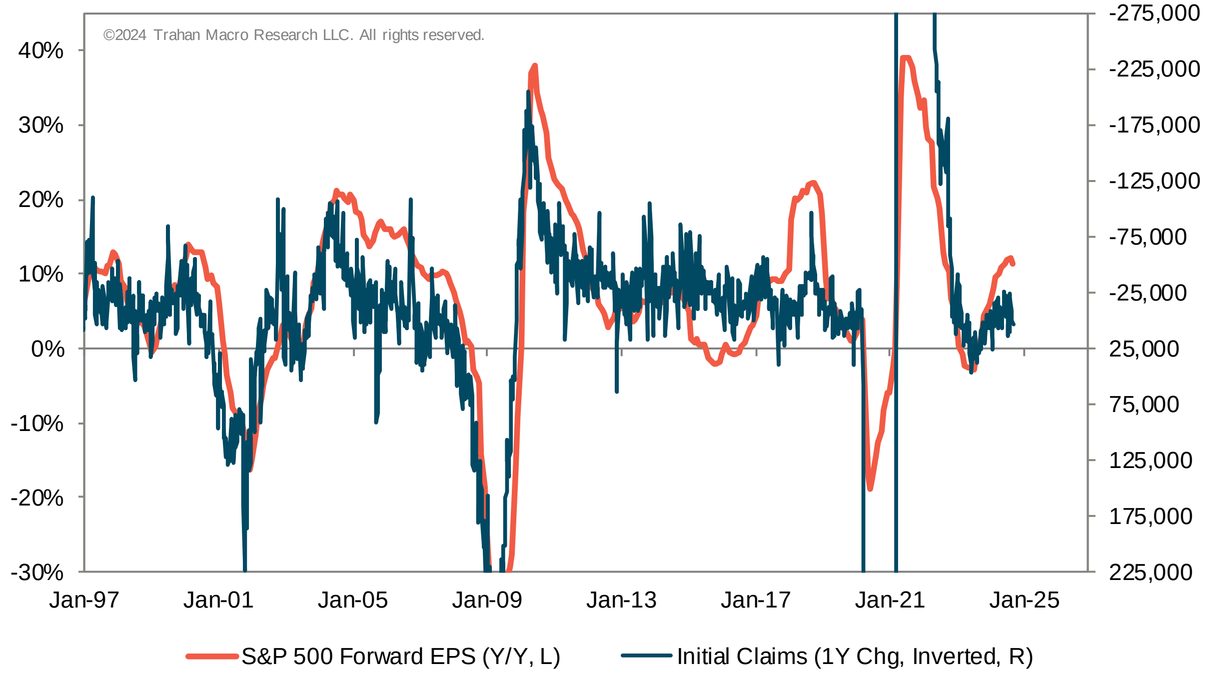


Sources: Tyszka and Zielonka (2002), Montier (2007)

When It Comes To EPS Or Recession Risk, It's All About Employment!

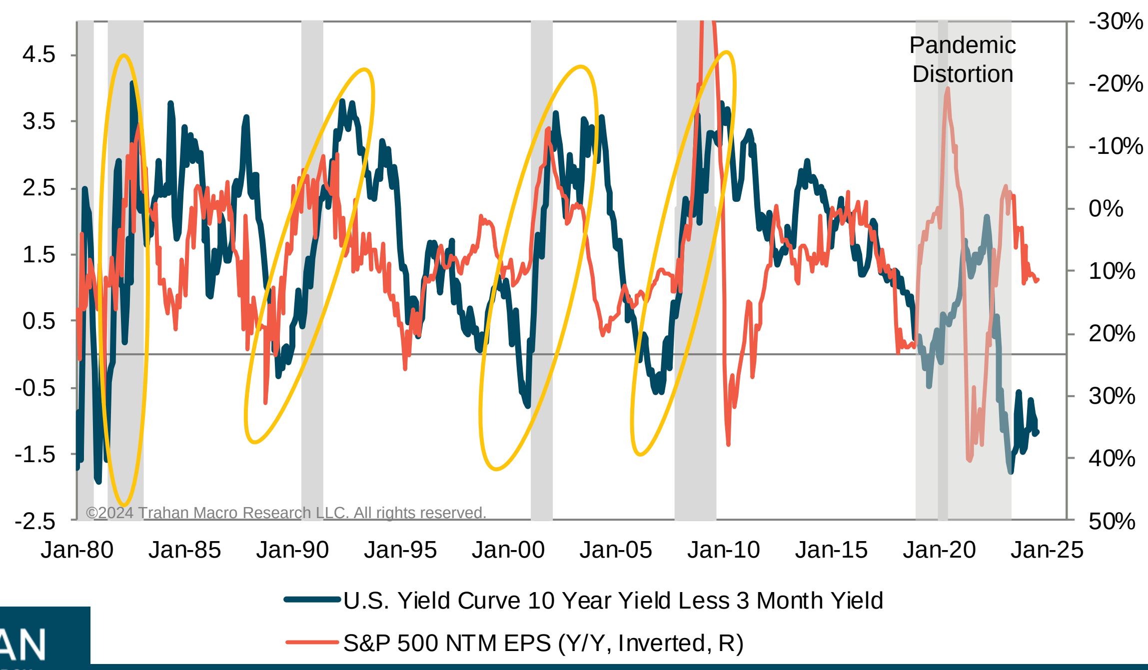
Without prior tightening cycle experience, it's easier to believe that the U.S. economy is resilient to tightening with still-positive forward earnings expectations and solid trailing equity returns. Not until labor markets deteriorate do we usually see earnings expectations come under pressure, as monetary policy works with long lags. We can see the flow through from the commencement of tightening to labor markets roughly 24-ish months later. Once initial claims start to climb sustainably year over year (an LEI of employment), earnings expectations tend to drop.

Earnings Expectations & Employment Go Hand In Hand



We can partially explain the link between employment and earnings expectations by the large role that consumption plays in the GDP equation. When labor markets stall, consumers pull back on discretionary spending, which puts downward pressure on corporate earnings. Again, this dynamic takes time to unfold, so we can look at the yield curve (10Y-3M) as an indicator of when earnings expectations are typically cut. Again, only when the Fed-driven un-inversion at the short end occurs do we typically see Wall Street reduce estimates. Why is the Fed cutting? Because things are bad!

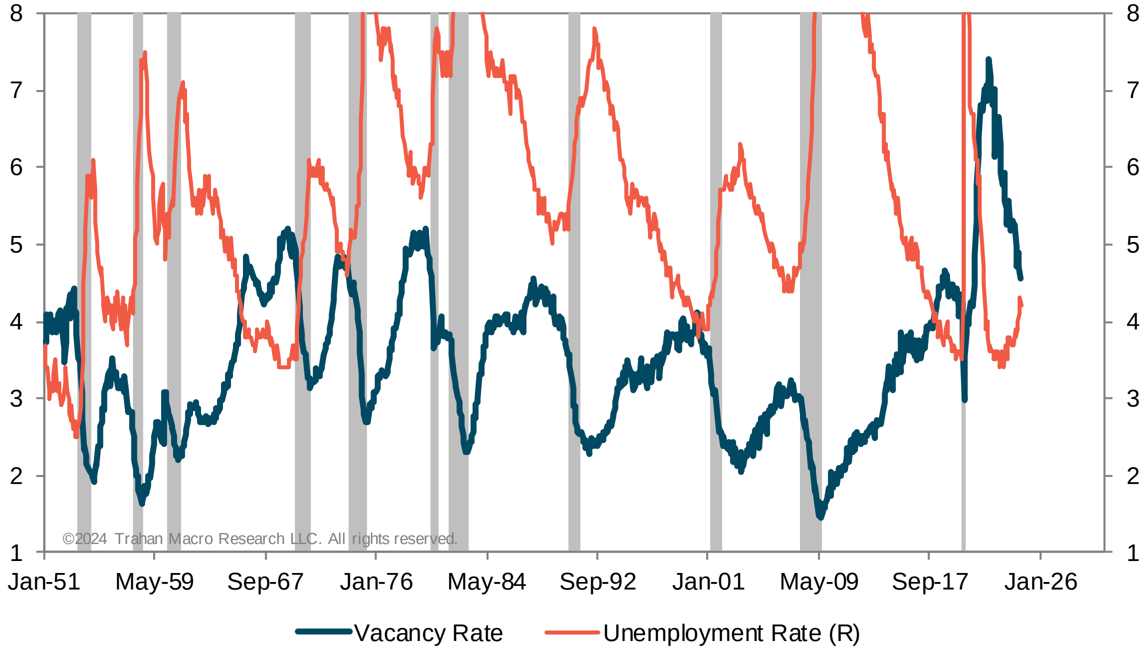
Earnings Tend To Deteriorate As The Yield Curve Steepens



A Great Recession/Risk Indicator With A Flawless Track Record (1/2)

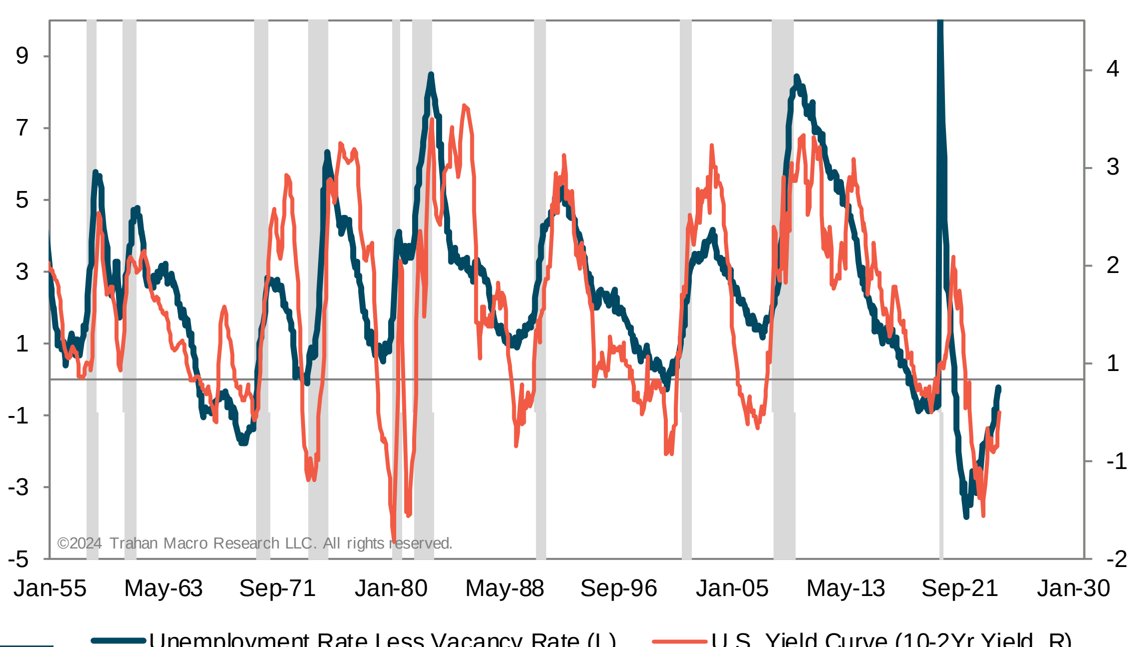
In light of the attention on the Sahm Rule and the unemployment rate, one related data series that has been overlooked is job vacancies. The vacancy rate, plotted in blue below, represents the number of job openings as a percentage of the labor force. This series has fallen sharply since 2022 when peak labor market tightness drove high-single-digit wage growth. It suggests job-seekers no longer have the bargaining power they did two years ago. We can see this series tends to move down sharply coincident with an eventual recession when the job market slows and unemployment rises.

Labor Market Is Clearly Softening And Losing Momentum



Below we show the net of the unemployment and vacancy rates, which moves coincident with the classic 10Y-2Y curve spread. As the net figure moves higher, it indicates a deteriorating employment market (more unemployed with fewer openings) which means short-end yields are falling as they sniff out an impending easing cycle. This labor series tends to move sharply higher alongside the yield curve and the start of a recession.

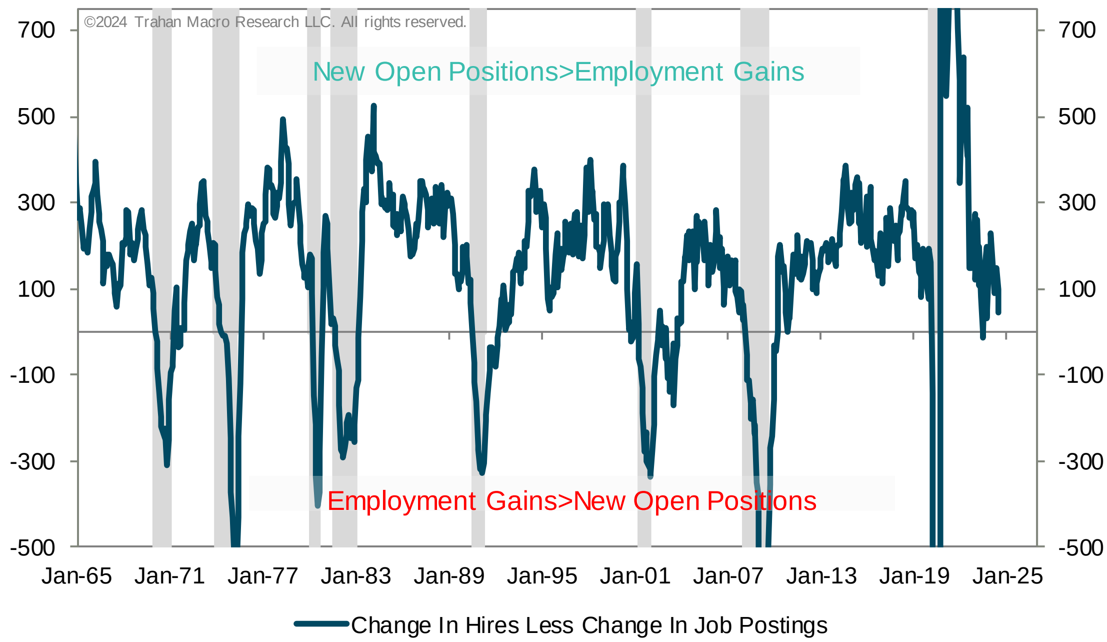
Recessions Arise As The YC Un-Inverts And The Labor Market Softens



A Great Recession/Risk Indicator With A Flawless Track Record (2/2)

We know that when the yield curve "un-inverts" we really need to pay attention to this stuff. We also know that this is usually pretty close to the time when the job vacancy rate overtakes job creation in the economy. These two really go hand in hand. The current spread between the vacancy rate and the unemployment rate is still technically positive but clearly trending toward a likely recession signal. It's easy to see that when this "net" figure turns negative, a recession is likely.

Hiring Intentions Slowing Faster Than Job Creation … A Sign Of Risk!



The "net" of the vacancy rate and the unemployment is pretty good on its own, as the chart above reveals. It has identified all recessions of the last 60-odd years correctly, but it did give confusing signals on two occasions. No single indicator is ever truly flawless in our experience. We would like to add an additional rule to the above indicator when it comes to a recession calls: are government payrolls gaining as a share of employment? If the "net" gives a signal and the answer to that question is "yes" then recession/risk is indeed very high. We will monitor this in real time in the coming weeks and months.

The 2nd Step To The TMR Recession/Risk Rule About Government Jobs

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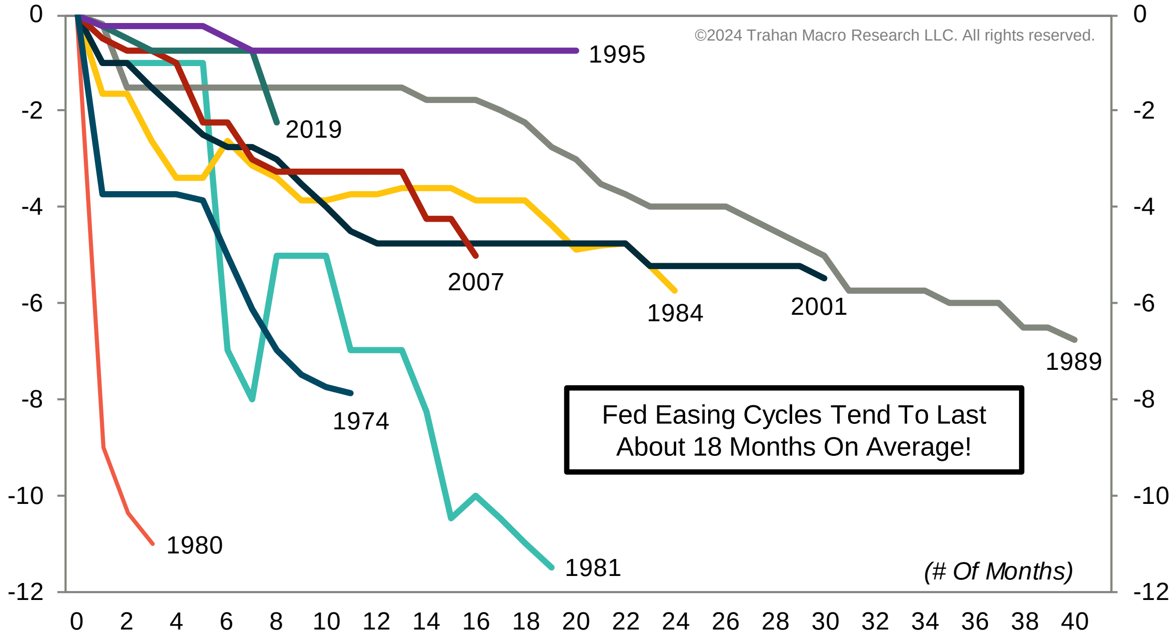
The Fed Easing Trade Is Already Working, And Likely Just Beginning!

As a reminder, we created a stock-selection model that performs well during Fed easing cycles. Our Fed Easing Portfolio is a simple 5-factor screen that focuses on the stock selection criteria that have generated consistent alpha across many past easing cycles. These include proxies of profitability, risk, and of course sensitivity to the economic cycle. This screen skews toward the more stable names in the equity space.

Fed Easing Cycles Are Not Typically Short-Lived



The full screen for the TMR Fed Easing Portfolio is available for the S&P 500 as well as other common indices. Simply email quant@trahanmacroresearch.com for the full list. Again, this is a simple screen of 5 factors that has systematically generated alpha in prior easing cycles. We will keep updating this one for the next year and probably longer. After all, the average Fed easing cycle has lasted about 18 months and some cycles have been even longer.

A Sample Stock Listing Of The Five Factor Fed Easing Portfolio

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Universe: S&P 500
TMR Fed Easing Portfolio

Lower Values Rank Better In All Categories

Ticker	Name	Portfolio Rank	Profitability	Cyclicality	Sentiment	Governance	Operating Efficiency	Sector
MCD	McDonald's Corporation	1	1	1	1	1	1	Consumer Discretionary
VZ	Verizon Communications Inc.	1	4	1	2	1	1	Communication Services
BRK.B	Berkshire Hathaway Inc. Class B	1	8	3	2	1	1	Financials
AMT	American Tower Corporation	1	3	6	3	1	1	Real Estate
IBM	International Business Machines Co	1	7	1	9	1	1	Information Technology
MRK	Merck & Co., Inc.	1	2	1	2	2	1	Health Care
PG	Procter & Gamble Company	[illegible]	2	6	[illegible]	[illegible]	1	Consumer Staples
SBUX	Starbucks Corporation	1	5	3	5	2	1	Consumer Discretionary
NSC	Norfolk Southern Corporation	[illegible]	[illegible]	[illegible]	[illegible]	3	1	Industrials
SHW	Sherwin-Williams Company	1	3	6	6	3	1	Materials

For complete list, different benchmark, or monthly model updates:

Email quant@trahanmacroresearch.com or visit trahanmacroresearch.com/screens

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