TRAHAN MACRO RESEARCH

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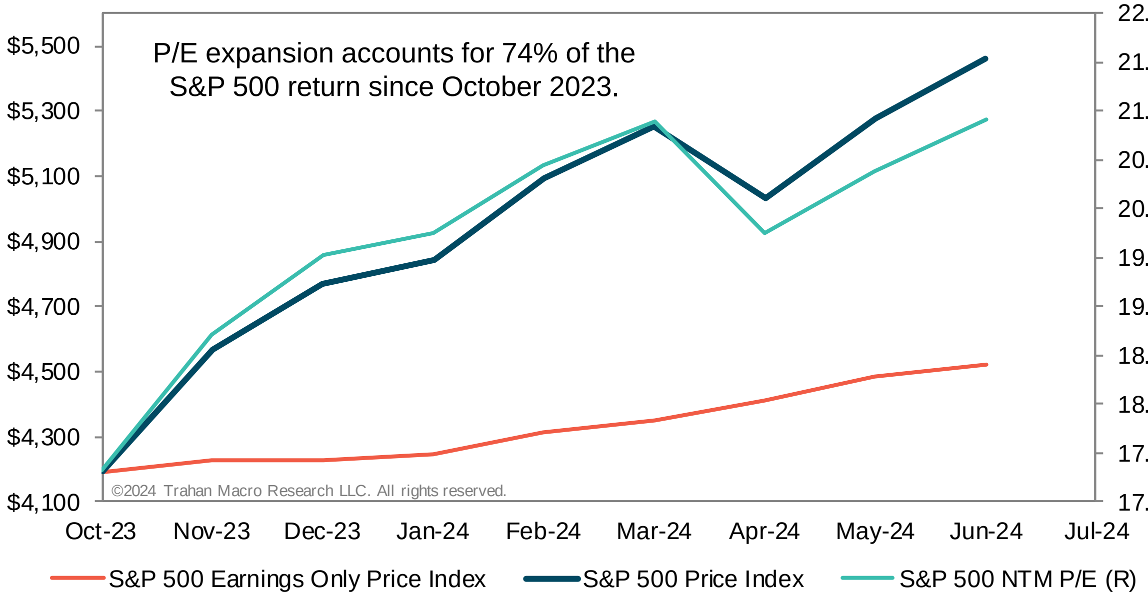
Entering A Different Phase Of The Fed Driven Rally

There is little doubt that last week's rebound in small-cap stocks has been impressive. We typically only see moves like this at the beginning of a bull market when they signal an economic recovery ahead OR at the tail end of bull markets when speculation is rampant. It's only been one week so it's important to take this in stride, for now at least. What we need to see is data that supports this move, and thus far it's been the opposite. Indeed, the number of data releases that have missed expectations in the last month has been breathtaking (the ISM Services Index especially). In our eyes, the rebound in small caps would become legitimate IF leading economic indicators also began to rebound … sustainably!

P/E Expansion Driving Returns Since The Peak In Rates



At this point, it looks more like the tail end of a Fed relief rally than anything else. After all, the Russell 2000 also exploded higher in September 2007 (11% in only 2 days!) and that was obviously not indicative of anything sustainable ahead. What we know thus far is that the rally has been fueled by P/Es, as all Fed relief rallies have been historically. Indeed, the S&P 500 would be almost 1,000 points lower if it was not for multiple expansion courtesy of lower bond yields. It's often said that these rallies come with an expiration date as they only run as long as earnings are growing.

So, what is going on exactly? Fed relief rallies are about a reduction in risk that lifts P/Es for some time. Initially, lower risk from the end of Fed tightening fueled the Mag 7. Now, it's reduced risk from imminent Fed easing that is helping the companies likely to benefit the most … small-caps and financials. This dynamic might continue for some time as we cover in the following pages. Even if this does run for a few months it would still be part of a very normal pattern. As always, we shall see what the future brings. Wishing you a great rest of your week. Francois

A Brief Review Of Recent Fed Relief Rallies (1/2)

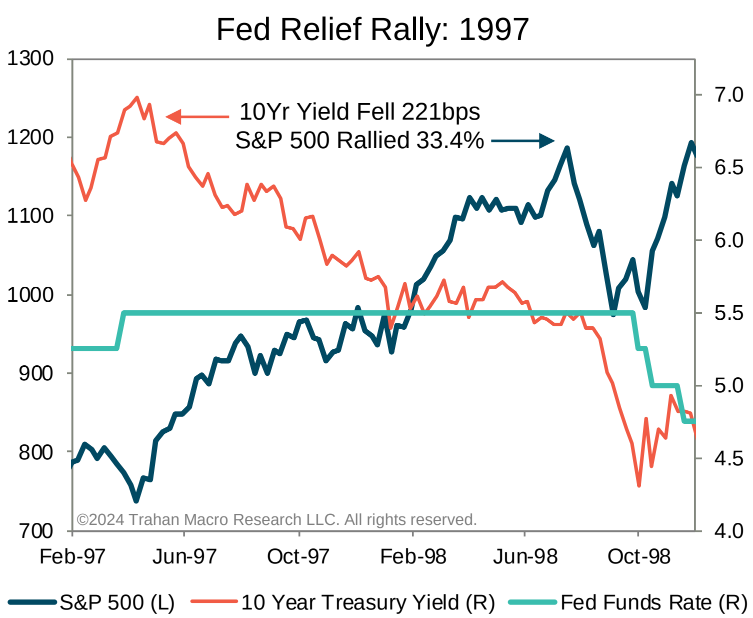
What is a Fed relief rally exactly? In short, it is the reduction in risk that comes from the end of Fed tightening and an eventual pivot toward easier policy. These rallies tend to be largely fueled by multiple expansion and can be quite powerful, as we have seen since early November 2023. Reduced risk lures investors who in turn push stock prices (and their P/Es) higher. This usually works UNTIL another risk eventually emerges, which is typically a decline in earnings.

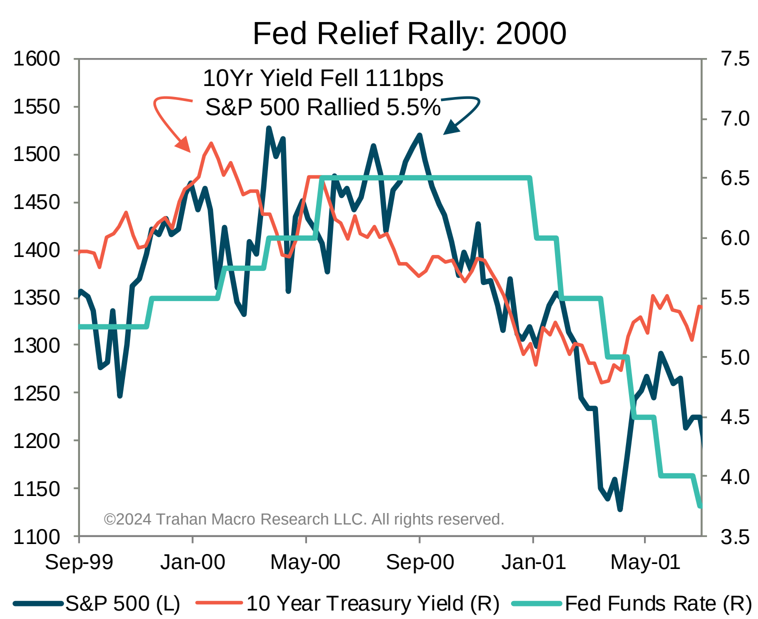
Declining Interest Rates, Real And Nominal, The Fuel Behind Fed Relief Rallies

Period	Nominal Change In U.S. 10Yr Yield	Real Change In U.S. 10Yr Yield	S&P 500 Return
2024	-0.74	-0.68	32.9%
2018	-1.63	-1.82	24.1%
2006	-0.55	0.03	25.5%
2000	-1.11	-1.77	5.5%
1997	-2.21	-1.26	33.4%
Average	-1.25	-1.10	24.3%

We tend to measure the performance of a Fed relief rally as the return between the peak in bond yields (usually a few months before or close to that last rate hike) and the eventual peak in the stock market (usually during a peak in the fed funds rate or around the time of the Fed's first rate cut). The table above shows that there is a correlation between the decline in nominal/real rates and the returns of the stock market (2000 was a bit of an exception with its "stealth bull market"). Interestingly, THIS Fed relief rally has delivered greater returns than history would suggest given the magnitude of the decline in rates thus far. That said, this could merely reflect the fact that the S&P 500 is much growthier today than it has been in the past.

Fed Relief Rallies Can Vary In Magnitude But Follow Similar Dynamics

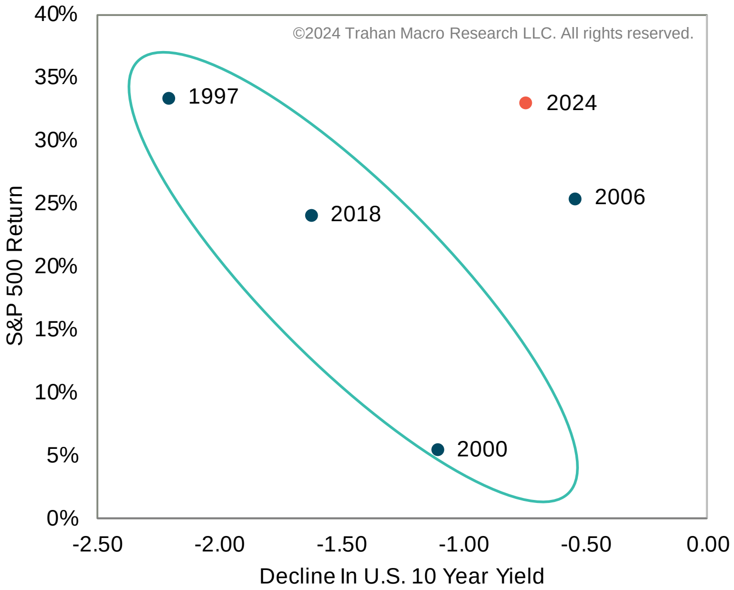




A Brief Review Of Recent Fed Relief Rallies (2/2)

There are a couple of callouts when we compare this Fed relief rally to those of the past. First off, there is nothing unusual about stocks moving higher during a peak in the fed funds rate. Second, the S&P 500 has gone up more than history would suggest considering the decline in bond yields. As mentioned on the prior page, this could be explained by the unusual composition of the Index today. Lastly, from a dynamic perspective, this one looks most like the 1997 rally. This might be mere coincidence but returns and the drivers of those returns are unusually similar.

How Does Today's Fed Relief Rally Stack Up?



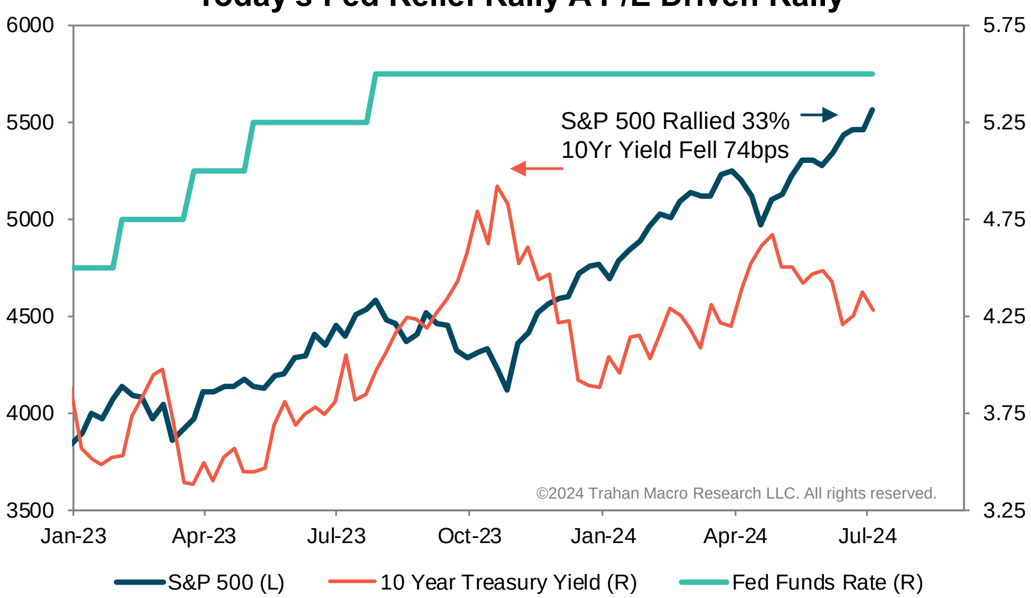
S&P 500 Returns Driven By Multiple Expansion

Fed Relief Rally Return Composition		
Period	EPS Contribution	P/E Contribution
2024	26%	74%
2018	8%	92%
2006	52%	48%
2000	110%	-10%
1997	26%	74%

Like the late 1990's, today's Fed Relief Rally is largely driven by P/E Expansion.

The June CPI report seems to have galvanized small caps and Financials. It's interesting to see these segments surge higher as semis remained flat for the last month. Some will say funds are just moving from one part of the market to the other, and this would not be completely off base. Inflation essentially changed the Fed narrative from one of "higher for longer" to "about to ease." Admittedly, the rise in the unemployment rate in recent months has also contributed to this. Financials and small caps are the biggest beneficiaries of this development (in the near term) and thus they are the stocks fueling this charge. It could continue for a short while until EPS start to disappoint.

Today's Fed Relief Rally A P/E Driven Rally

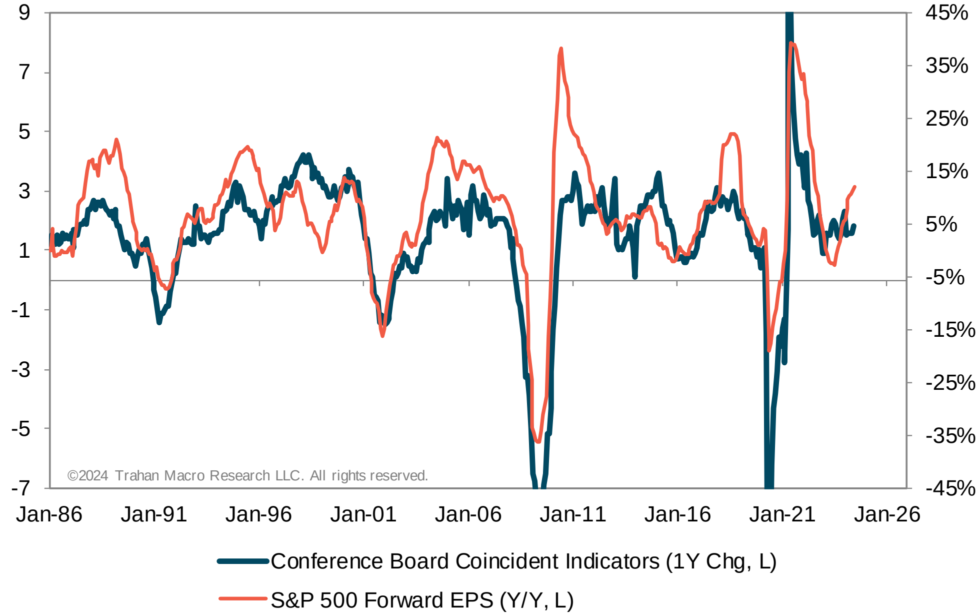


P/E expansion accounts for 74% of the S&P 500 return since the peak in rates.

A High Bar For Q2 Earnings Season?!?

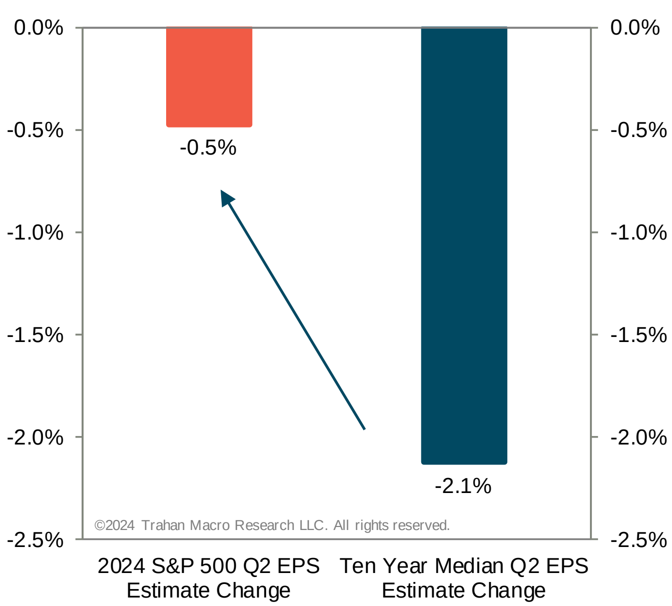
Earnings are the lifeblood of the equity market. Indeed, a bull market only lasts as long as earnings are growing which is why the debate on "soft landing vs recession" is so critical. The chart below illustrates this point quite well as it shows the strong correlation between economic growth and S&P 500 earnings growth. IF one believes that the economy hums along here then they should be bullish as this would support continued growth in earnings. To be fair, that would be unusual in the wake of Fed tightening (and not our view!) but it is not without precedent as it did happen once in the mid-1990s.

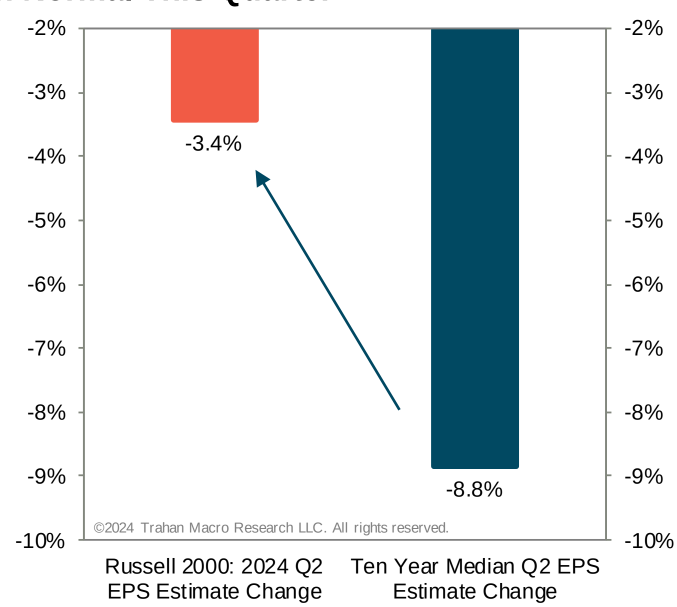
Forward EPS Growth Outpacing Coincident Economic Indicators



One interesting characteristic about Q2 2024 earnings season is that we did not see the erosion in estimates that usually happens in the run-up to the end of a quarter. Some will argue that this is a positive sign as it implies that earnings are on sound footing BUT this would be completely inconsistent with the dynamic of economic releases lately which have missed the mark to a greater degree than usual. Our first reflex was to think that the bar was a little higher than normal for what is usually a non-event. We will know soon enough with earnings season kicking into gear this week.

The Bar Is Set Higher Than Normal This Quarter





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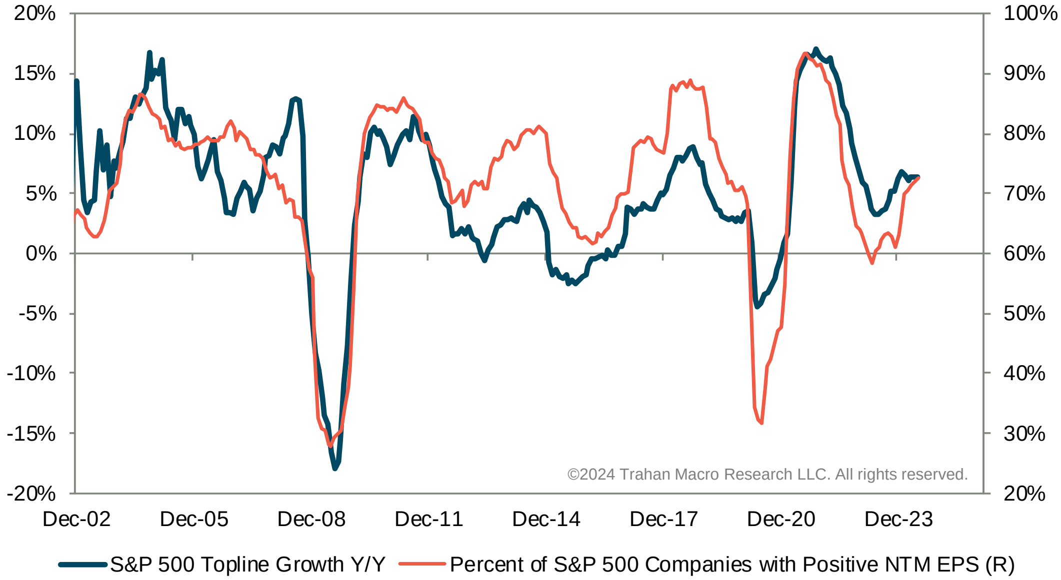
A Few Economic Indicators Flagging Caution For Earnings Ahead (1/3)

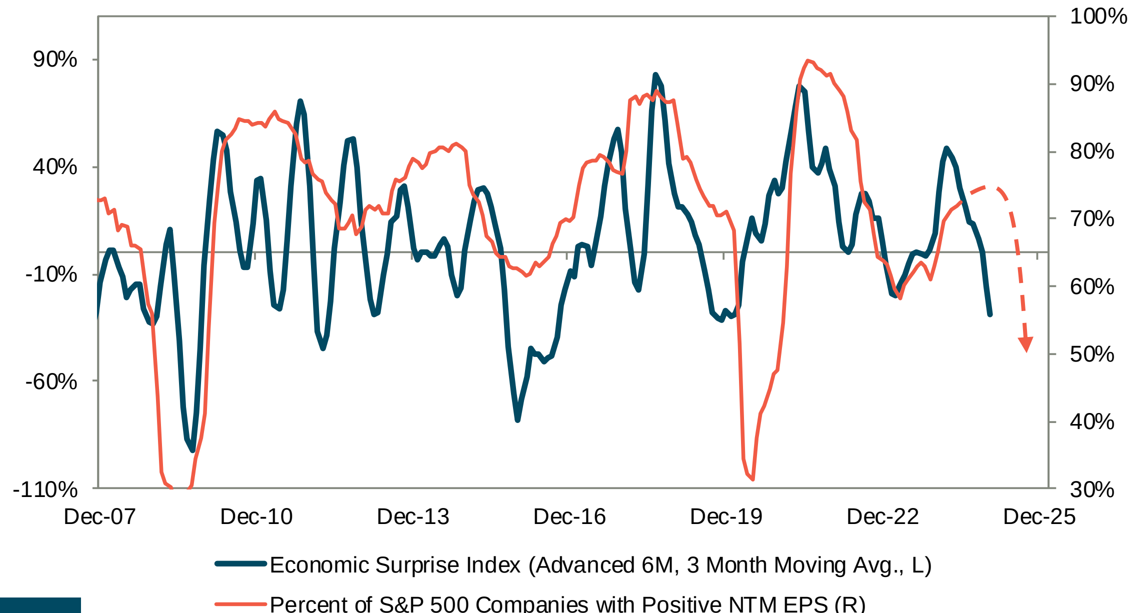
Note that we used the word "caution" in the page title and not something more sinister. First things first, it is usually top line that drives the earnings story. As the chart below illustrates, the increased breadth in S&P 500 earnings growers has come on the back of better top-line assumptions. This is ultimately what explains the surge in stocks since last November as without earnings growth there would have been no Fed relief rally. The key question at this stage of course is whether this can continue, and if not, when will it ultimately end?

Revenue Growth And Number Of EPS Growers



An unusual dynamic that has gone largely unnoticed lately has been the large number of economic data points that have missed consensus estimates. As we mentioned earlier, this is one development that gives us pause about the recovery in Financials and small-caps. The chart below shows the correlation between the Economic Surprise Index and breadth in S&P 500 earnings (i.e., the number of companies with positive earnings expectations). The ESI is smoothed so we don't see how much it has declined but even this average is approaching levels not reached in over a decade. It's not a perfect fit but it does raise some questions, nonetheless.

Economic Surprises Back To 2020 Levels

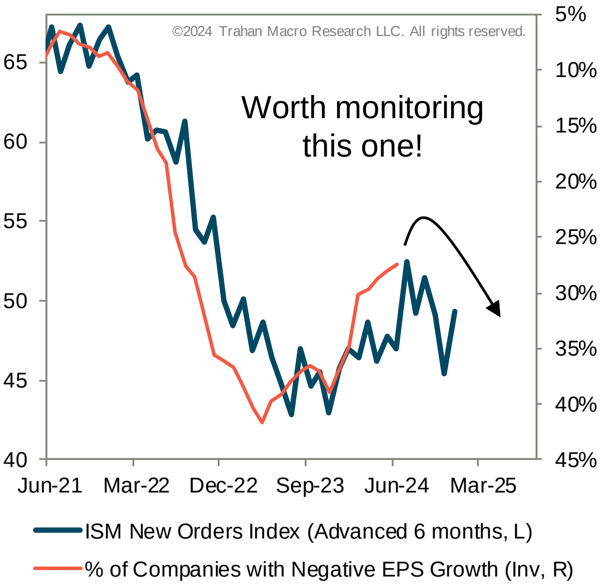


A Few Economic Indicators Flagging Caution For Earnings Ahead (2/3)

We highlighted the dire-looking Economic Surprise Index on the prior page, but our go-to ISM Manufacturing Index is also flagging warnings signs. The ISM does not look nearly as bad as the ESI, and it even moved higher last month. Still, historically speaking, the ISM leads various proxies of S&P 500 earnings expectations by about six months. In the chart below, we see the ISM Manufacturing Index plotted again the number of S&P 500 companies with negative earnings expectations. The key point here is that the ISM topped out six months ago, arguing that we are staring at high tide for EPS

ISM Points To Narrower S&P 500 EPS Breadth Ahead

EPS Contraction In 2025?



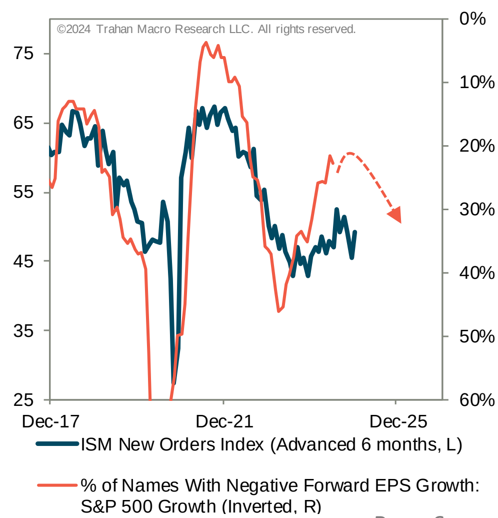
If there is one misconception I have encountered throughout my career it's the belief that some segments are immune to a slowing economy. That is simply not true. Of course, there are some segments that are less sensitive to the business cycle. After all, consumers are more likely to cut out restaurants before they stop buying toothpaste. Interestingly, as the charts below illustrate, even the earnings expectations of growth stocks correlate with the business cycle. Surely, the scales are a little different than in the cyclicals chart, but dynamically-speaking it is not that different. The bottom line is the economy slows and all segments of the market start to look a little different.

No Market Segment Is Immune To The Business Cycle

Cyclicals

Defensives

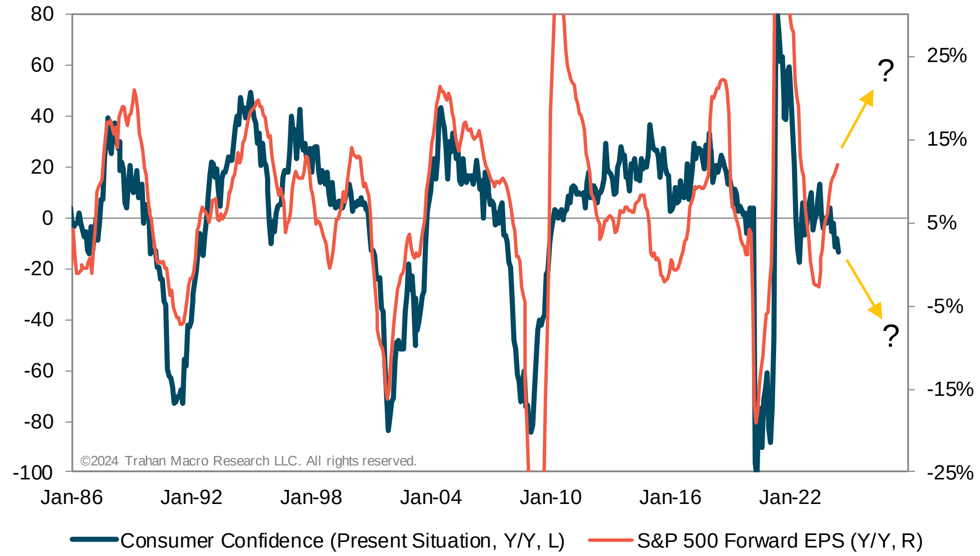
Growth



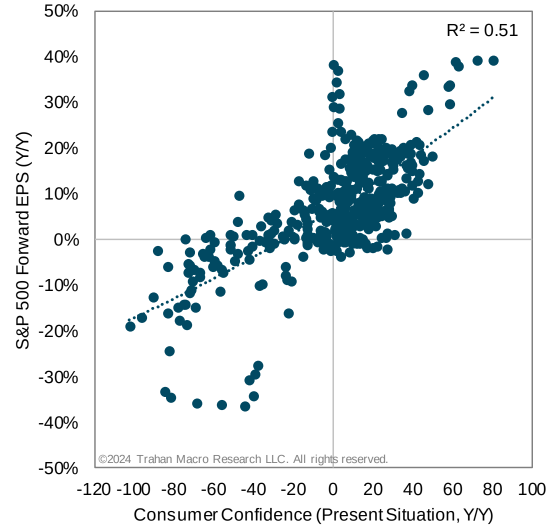
A Few Economic Indicators Flagging Caution For Earnings Ahead (3/3)

I am not trying to be overly negative, but our job is to point out risks. When it comes to S&P 500 earnings there are plenty of data series that look unusual. The decline in consumer confidence is disturbing. This series is an illustration of how consumers feel at the end of the day, and since consumption makes up 68% of U.S. GDP it plays an important role in S&P 500 earnings. The recent divergence between consumer confidence and earnings expectations is troublesome because they are both essentially measures of sentiment and investors feel different than consumers do. Those divergences never last forever, if history is a guide.

Earnings Estimates Deviating From The Consumer?!?!

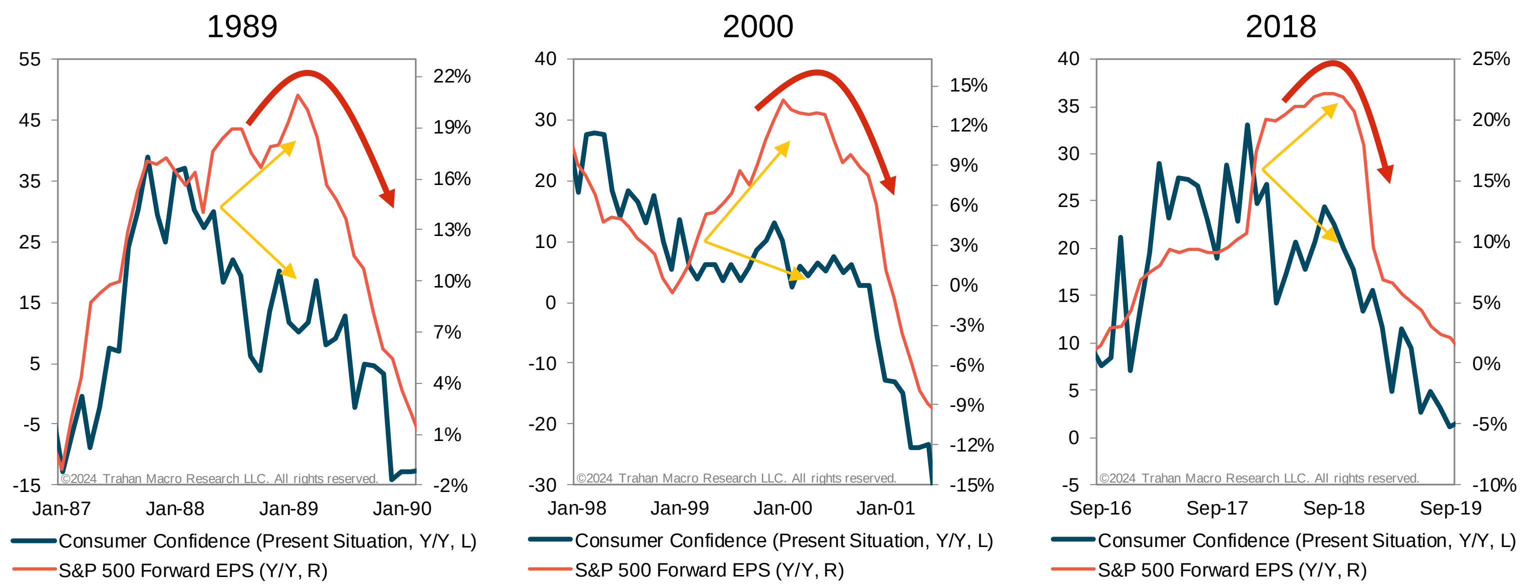


Historically Tight Relationship



There are not many examples of deviations between earnings expectations and consumer confidence. But when it did occur, they were generally resolved with earnings following the consumer and not the other way around. Most interesting, the majority of these deviations occurred at a peak in the fed funds rate when investors were waiting for a Fed pivot and a soft landing. In that context, the deviation we are currently seeing should be taken seriously. None of this guarantees a particular outcome but it does argue that risks are present when it comes to the earnings outlook.

History Has Shown That We Should Listen To The Consumer



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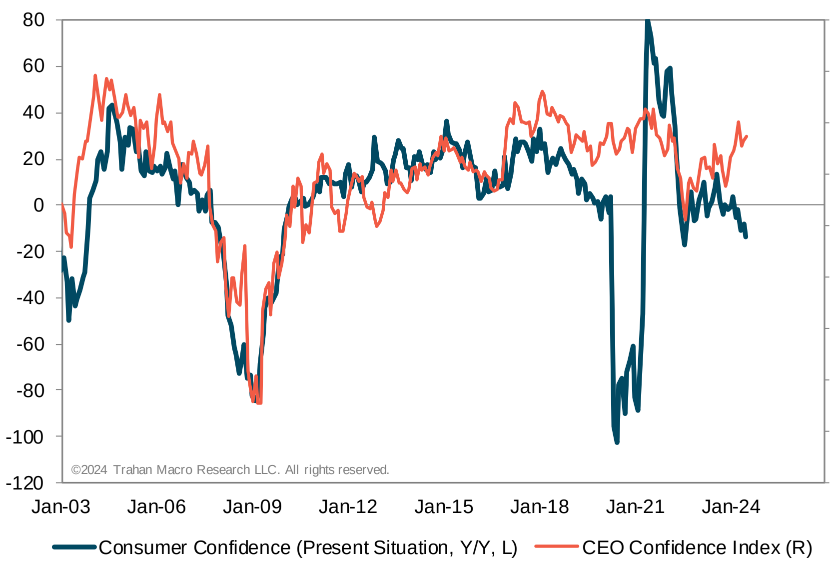
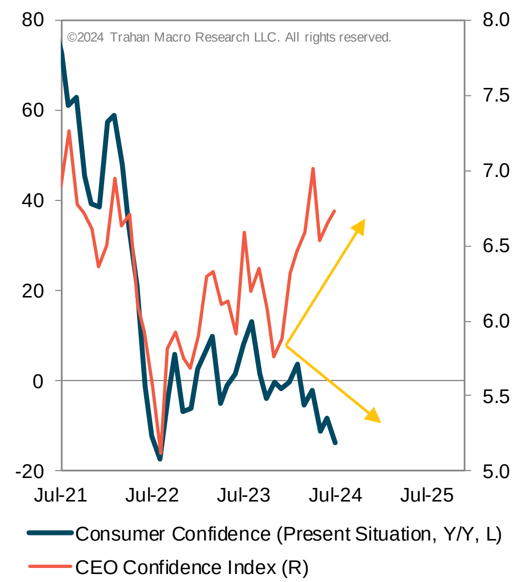
CEOs And Consumers Are At Odds About The Economy

Consumer confidence is not only at odds with earnings – it also diverges from CEO confidence, which is certainly closer to the upper end of its historical range. CEOs of course are very influenced by earnings so it makes sense that this series would look like S&P 500 earnings expectations. The clip chart below on the right shows just how significant this decoupling between CEOs and their customers has been. Surely, inflation has played a role here but recent softness in labor markets is also likely having an impact.

CEO Expectations Not Aligned With Their Consumers

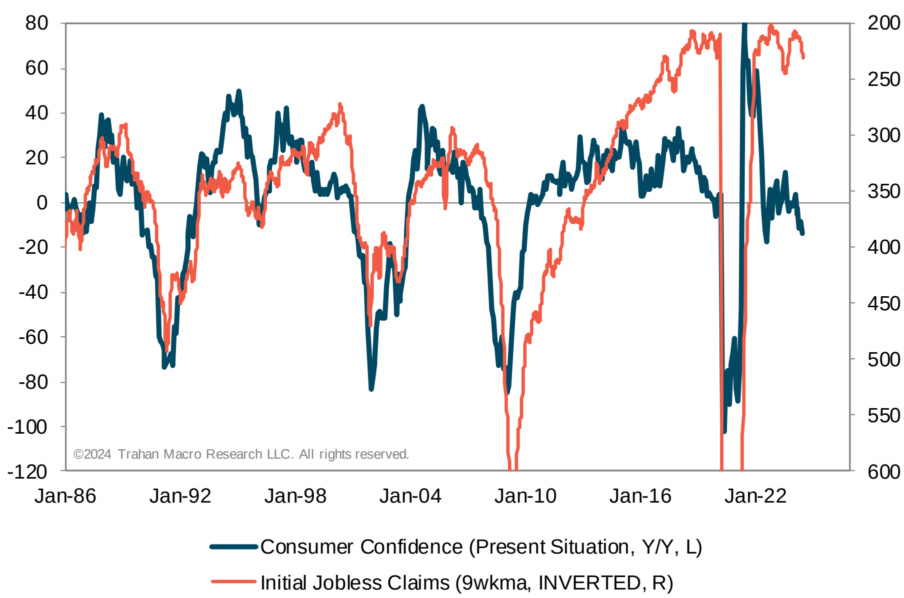


An Odd Divergence?

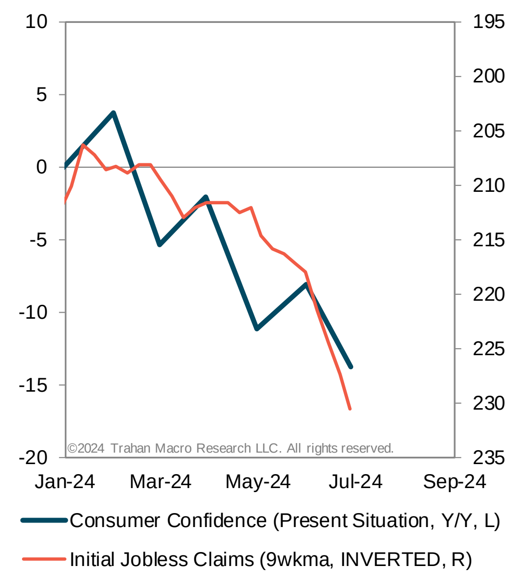


Why do consumers feel so weak when CEOs are so optimistic and earnings expectations so strong? For context, if we strip out the pandemic decline then this is the weakest consumer confidence has been since the Global Financial Crisis. The biggest issue for U.S. households in recent years has been inflation. While CPI is lower now, in the eyes of consumers inflation is still a lingering issue. Consumers know that they are paying much more for everyday items than they did just a few years back. Additionally, softer labor markets are also likely playing a role here. Continuing claims are near cycle highs and the unemployment rate is above the Fed's year end target.

Consumer Confidence A Reflection Of Employment …



… Which Is Now Slowing!



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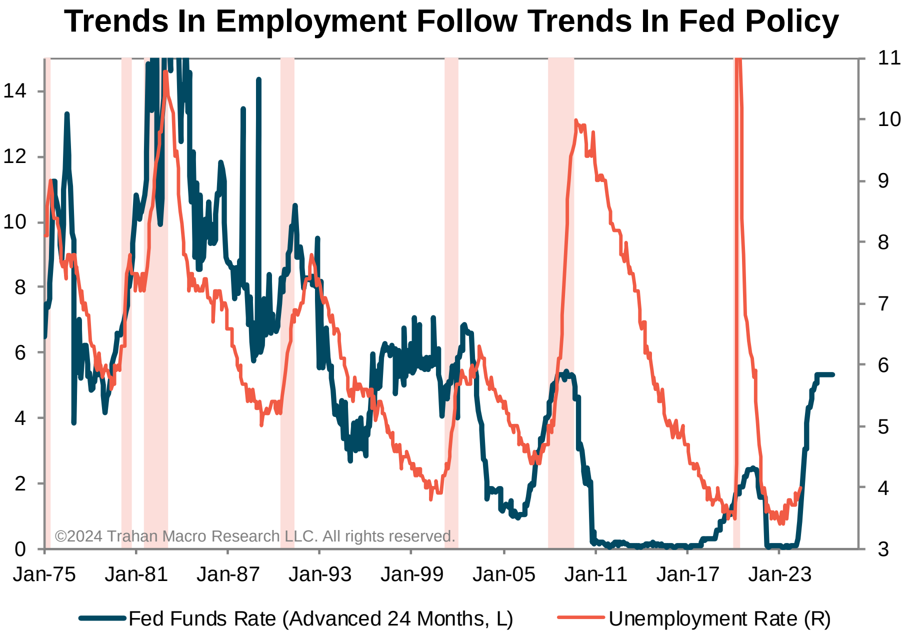
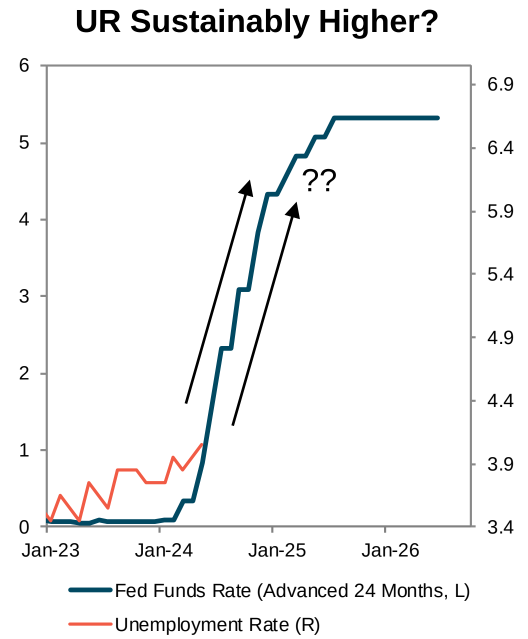
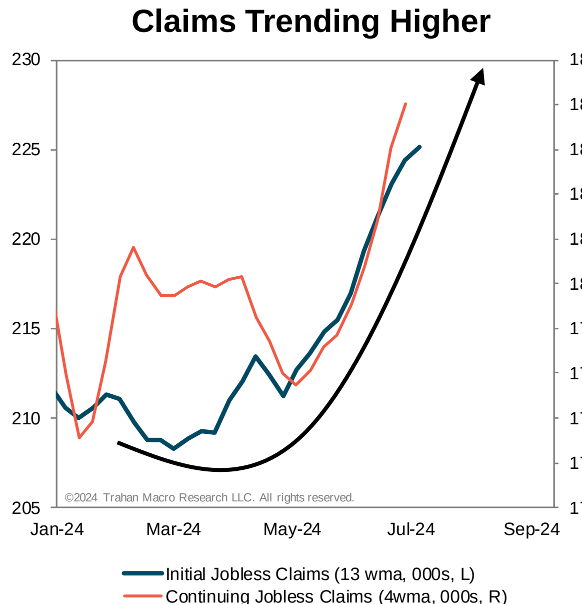
Labor Markets Hold The Key To Earnings And The Economy

I think everyone knows that if we thought last week's small-cap rally was truly sustainable then we would be bullish on the economy. Small caps are in many ways the truest expression of economic expectations. The problem is that we have seen similar rallies at the exact wrong time (September 2007!), so context is key. At this stage, we are just a few months into digesting the lagged effects of the Fed's most aggressive tightening cycle in decades. The chart below shows the relationship between the fed funds rate and its eventual impact on the unemployment rate.





IF the historical relationship holds, then we should be seeing the UR trend higher sustainably from here. It's unlikely to head lower on a sustained basis until at least two years AFTER the Fed begins to ease policy. Needless to say, if things work out this way, then the story for earnings will change along the way as consumer retrench and the economy suffers. Most investors are focused on headline payrolls, but other gauges of employment don't look nearly as constructive. For one, private employment is down from year ago levels. That is surprising even to us. Moreover, this is happening when initial and continuing claims are at cycle highs and pointing to more weakness ahead.



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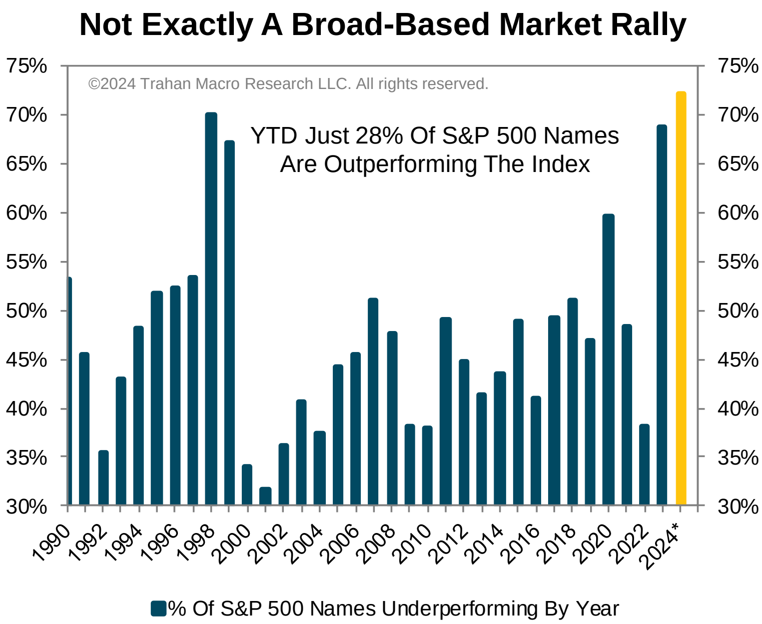
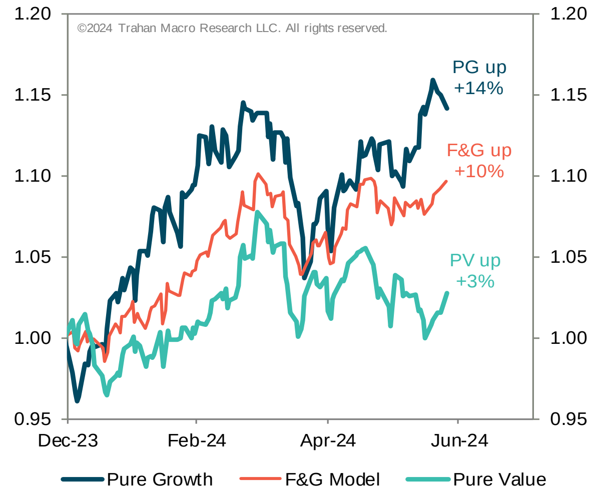
A Macro-Agnostic Stock Model For An Uncertain Outlook

For the record, we do not think that the outlook is that uncertain but admittedly nothing is ever guaranteed in this industry. This year has seen many firsts. For one, the first half of the year gave us the narrowest market rally since 1990. We have highlighted a number of macro-agnostic models this year, but the F&G is one of our favorites. It is merely a combination of some of the best factors from Piotroski's F-Score model for Value and Mohanram's G-Score model for Growth.



Since 1999 The **TMR F&G Model Has Outperformed The S&P 500 58% Of The Time** On A Monthly Basis.



The F&G model is up about 10% this year, which is quite a lot for half a year. While it has not kept up with Growth's 14% impressive returns, the model was never designed to do so. It was built to maintain performance while investors wait for a transition in the economic outlook and market leadership. For those looking to hedge their portfolios for economic uncertainty, the full list of rankings can be found on our website OR by simply emailing quant@trahanmacroresearch.com. We think of macro-agnostic models like this as an important part of the tool kit as they are incredibly useful in periods of uncertainty or economic transitions.

A Sample Of The TMR F&G Model

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Lower Values Rank Better

Universe: S&P 500

TMR FG-Score Model

Ticker	Name	Portfolio Rank	Price	Market Cap	Sector	Industry
A	Agilent Technologies, Inc.	1	$ 131.01	38223.6	Health Care	Life Sciences Tools & Services
ABNB	Airbnb, Inc. Class A	1	$ 147.22	93461.6	Consumer Discretionary	Hotels Restaurants & Leisure
ADBE	Adobe Inc.	1	$ 565.71	250835.8	Information Technology	Software
ALL	Allstate Corporation	1	$ 166.91	44050.1	Financials	Insurance
AMP	Ameriprise Financial, Inc.	[illegible]	$ [illegible]	[illegible]	Financials	Capital Markets
APTV	Aptiv PLC	1	$ 72.26	19659.2	Consumer Discretionary	Automobile Components
ARE	Alexandria Real Estate Equities, Inc.	1	$ [illegible]	[illegible]	Real Estate	Health Care REITs
AXP	American Express Company	[illegible]	[illegible]	[illegible]	[illegible]	Consumer Finance

For complete list, different benchmark, or monthly model updates:
Email quant@trahanmacroresearch.com or visit trahanmacroresearch.com/screens

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