Why Are We Still Bullish?

In This Report

Stocks sold down hard last week, while 10-year Treasury yields melted to 3.8%. Recession fears have returned quickly as financial markets were spooked by more signs of labor market weakness. More selloff is likely as the overall market remains very overbought after the recent runup in prices.

We have been in the 'no recession' camp for some time and believe the Federal Reserve will very likely reverse its tight monetary policy before interest rates start to choke off economic growth and send the U.S. stock market into another major bear market.

There are views that are diametrically opposed to ours, arguing that a recession is inevitable and will happen either by the end of this year or in early 2025. With the equity market shakeout underway, many clients are getting increasingly anxious. Some have asked us to explain why we are still bullish.

Bearish Argument In A Nutshell

The bearish camp says that this cycle is essentially the same as all previous ones and therefore, will likely follow the old, time-tested script: Fed monetary tightening always "screws things up" by pushing the economy into a recession.

Bears point out that an inverted curve is the most reliable recession indicator, and "excess savings" from the pandemic bailout is already burned out, putting consumers in a precarious state. They say that credit quality is deteriorating sharply, quoting the rising credit card delinquency rate as evidence. They read the recent rise in the unemployment rate as a harbinger of something much worse than a cooling labor market, often citing the "Sahm Rule" to warn about how close we are to the recession threshold.

We have been bullish on U.S. equities since September 2022[1] and have disagreed with the recession call. In general, we differ from the recession proponents in several key areas.

The Origins Of The Covid Recession

The origins of, and policy response to, the Covid-induced recession are completely different from all previous recessions in peacetime history.

1 Alpine Macro *Global Strategy* "Flying Blind..." (September 26, 2022).

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Tipping Point In Financial Markets: A Melt-up or Meltdown?

Global financial markets are facing increasing challenges: the risk of recession is rising as tight monetary policy has entered its 28th month, while the bull market in big tech has turned parabolic and is due for a shakeout. However, inflation has fallen sharply, and the Fed is poised to ease at a time when political and geopolitical risks have greatly escalated.

At this critical juncture, Alpine Macro's strategists are joined by a group of highly respected outside experts to discuss the pressing issues facing investors, including:

- Are we at the tail-end of the bull market in equities, or does the bull have further to run? Which sectors should investors allocate their capital to, and what will be the new leaders in the marketplace?
- How should investors hedge against the rising risk of wars and conflicts?
- Harris vs. Trump: How will the election result change U.S. economic policies and affect financial markets?
- What's next for commodities and energy? Are we heading for a new super-cycle bull market, and is ESG dead?

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Guest Speakers + Alpine Macro Strategists


Ruchir Sharma


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Mike Dooley


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Lenka Martinek


Gina Martin Adams


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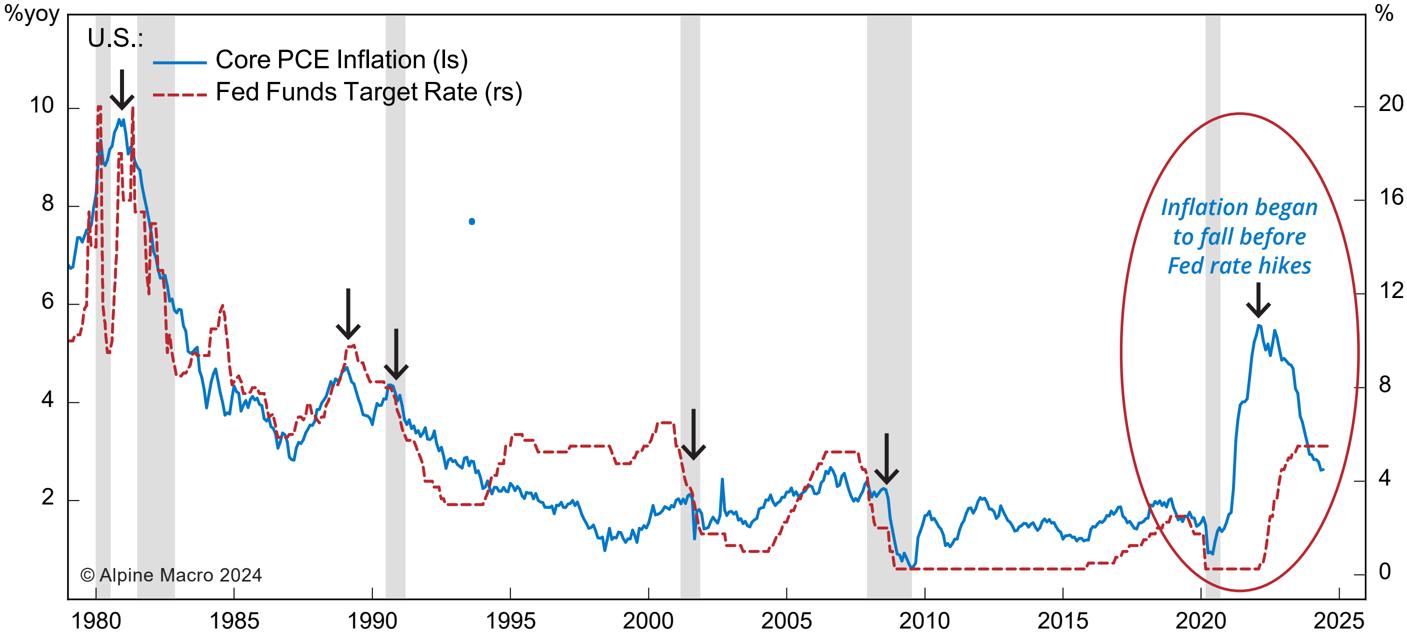
Conference Details & Registration: conference.alpinemacro.com | conference@alpinemacro.com | +1 (514) 558-1414

Chart 1 Inflation And Fed Policy In Historical Perspective



Note: Shading denotes U.S. recessions

To be precise, the origin of the 2020 recession was superimposed by government lockdowns rather than the natural progression of a boom-bust economic cycle.

The different origin of this recession has determined that supply-side disruptions are the key culprit behind the collapse in economic activity and soaring inflation. By the same token, the subsequent V-shaped recovery has also been mainly a supply-side response.

Of course, in macroeconomics, supply and demand are two sides of the same coin, and one cannot completely isolate the supply side from aggregate demand. Nevertheless, the different origins of shocks mean a world of difference in economic adjustments and their results: if rising inflation is primarily a reflection of supply-side disruptions, it will fall as the supply side recovers, with or without monetary tightening.

Our view has always been that the sharp spike in inflation since 2021 was primarily caused by supply-side disruptions, though aggregate demand might have contributed partly to rising prices. This means that disinflation is bound to happen anyway, even in the absence of monetary tightening.

Events that have transpired since 2022 have suggested that our assessment is largely correct. **Chart 1** reveals that core PCE inflation topped out in February 2022, followed by a sharp decline. However, the Fed only began to raise rates in March 2022. In other words, inflation was already on its way down before the Fed even started to raise rates.

Moreover, it takes 16-18 months for monetary policy to have any impact on the economy due to “long and variable lags”, and this sufficiently proves that disinflation has had very little to do with the Fed’s rate hikes, at least until the first half of 2023.

This crucially differs from all previous cycles where inflation only fell during or after the economy hit a recession. This is because inflation is a lagging variable and monetary tightening was always aimed at squeezing aggregate demand. However, the Fed frequently delivered too much monetary constraint, tipping the economy into a recession.

Our optimism rests on the fact that the supply-driven nature of the current disinflation process has opened a pathway for core PCE inflation to fall towards the 2% target without needing the Fed to inflict undue damage on aggregate demand.

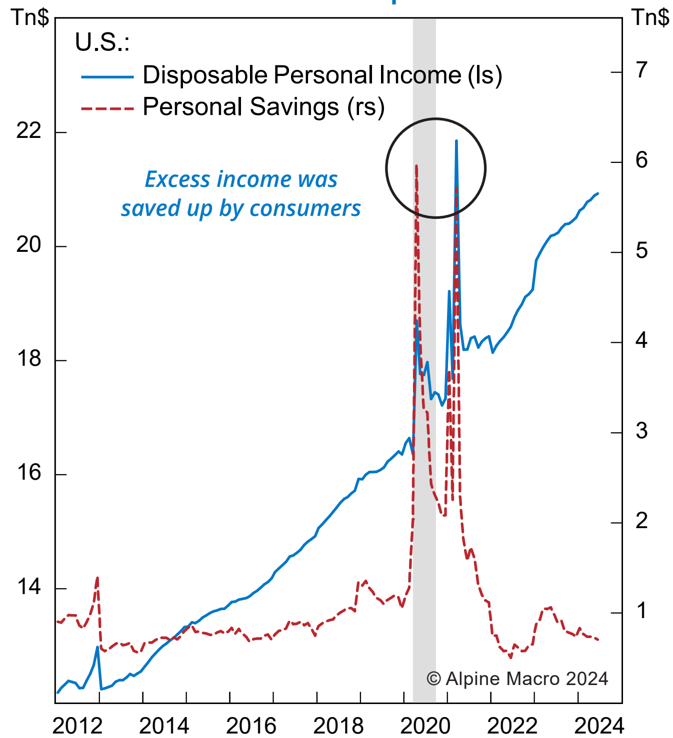
Of course, there is always a risk that the damage is already done, but so far there is no convincing evidence that Fed policy is choking off economic activities. The fact that the Fed is only a month away from easing at a time when the economy remains resilient (2.8% GDP growth for Q2) suggests that the economy has so far skirted a recession.

The Fallacy Of "Burnt-Out" Savings

The bearish camp often argues that strong consumer spending in 2023 was primarily caused by excessive savings from the gigantic income transfers during the pandemic crisis; as these excess savings are "burnt out", consumer spending will inevitably sag and a recession will follow. This is a misunderstanding of basic economic concepts.

Here, "excess savings" refer to savings in excess of consumers' trend levels of savings. The personal savings rate went through the roof at the height of the 2020 pandemic crisis as the U.S. government pushed large sums of money into households (**Chart 2**).

Chart 2 **Most Pandemic Income Transfers Were Saved Up**



Note: Shading denotes U.S. recessions

This suggests that much of the extra (or windfall) income was saved up by households.

With the pandemic crisis passing, income growth has gravitated towards normal levels, while the personal savings rate has also fallen quickly from the extraordinarily high levels, meaning that consumers now save much less of their incomes than they did during the pandemic.

However, at no time has consumer spending been supported by savings. In other words, consumers as a whole have never drawn on their savings to support their spending because the personal savings rate has never turned negative.

Therefore, to say that consumers have already "spent their excess savings" is theoretically flawed and

Chart 3 Explosive Surge In Cumulative Savings And Household Net Worth

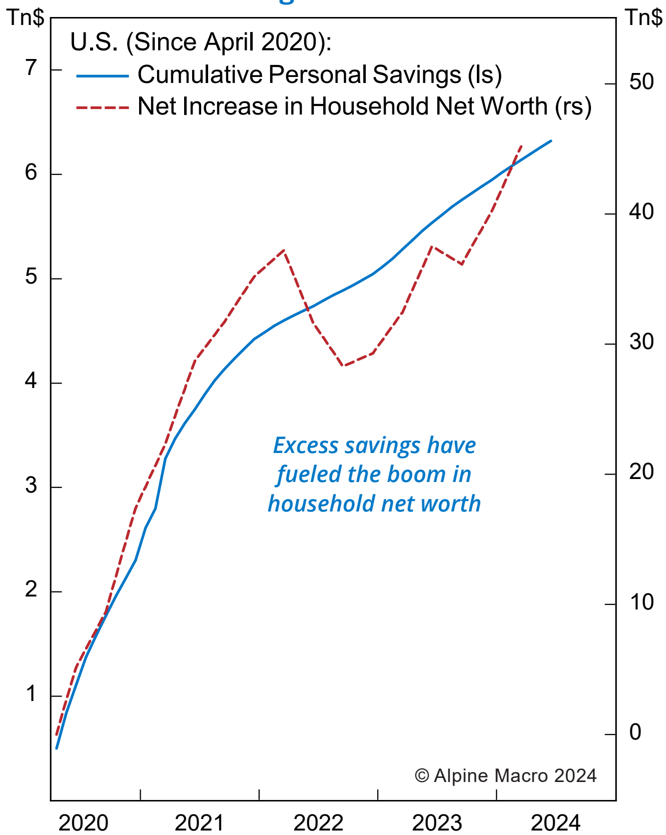
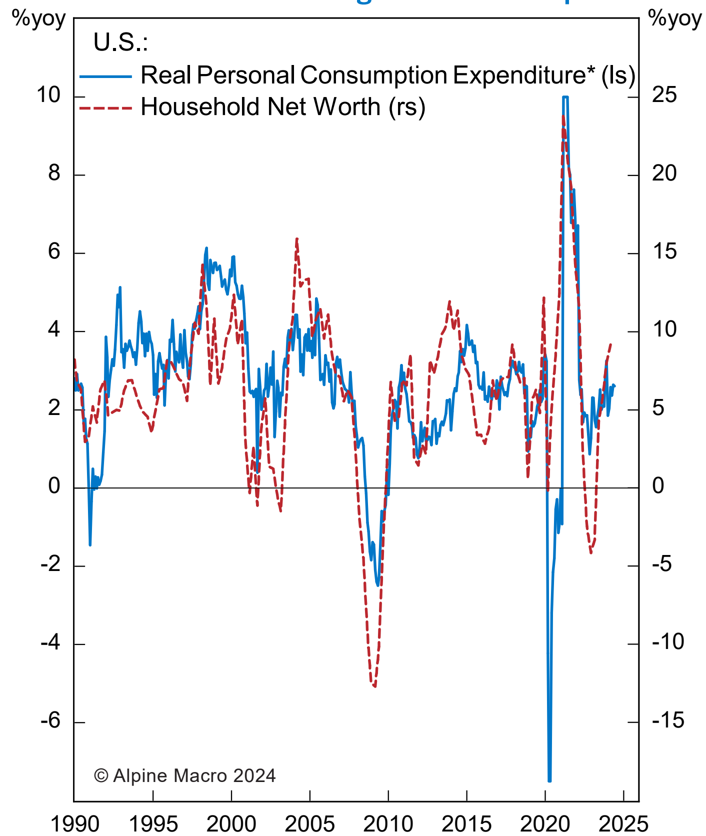


Chart 4 The Higher The Net Worth, The Stronger The Consumption



*Truncated at -7.5 and 10

factually wrong. All personal savings have become a part of cumulative wealth, adding to household net worth. The excess saving cannot be "burnt out".

Chart 3 shows that cumulative gross savings from the household sector have shot up by \$6.3 trillion since April 2020, while household net worth has grown by over \$45 trillion. The difference between the two reflects asset price appreciation over time, among other factors. In other words, the excess savings accumulated during the pandemic have already become capitalized value of household net worth.

If anything, the enormous jump in cumulative savings and its resulting rise in household net worth are a boon rather than a bane for consumer spending. **Chart 4** clearly shows a positive correlation between household net worth and consumer spending. With household net worth at a record high, consumers are much more willing to spend their income than before – a key reason that the savings rate today is much lower than what it was in the previous decade.

In fact, the 1.7 percentage point drop in the consumer savings rate last year added roughly 1.2% of GDP growth. Going forward, although the savings rate will likely stop falling and begin to stabilize at some point, it is entirely possible that it will stay low. A rapid rise in net worth is a clear disincentive for households to ramp up their savings rate, unless layoffs start to accelerate.

Chart 5 Households Have Largely Deleveraged

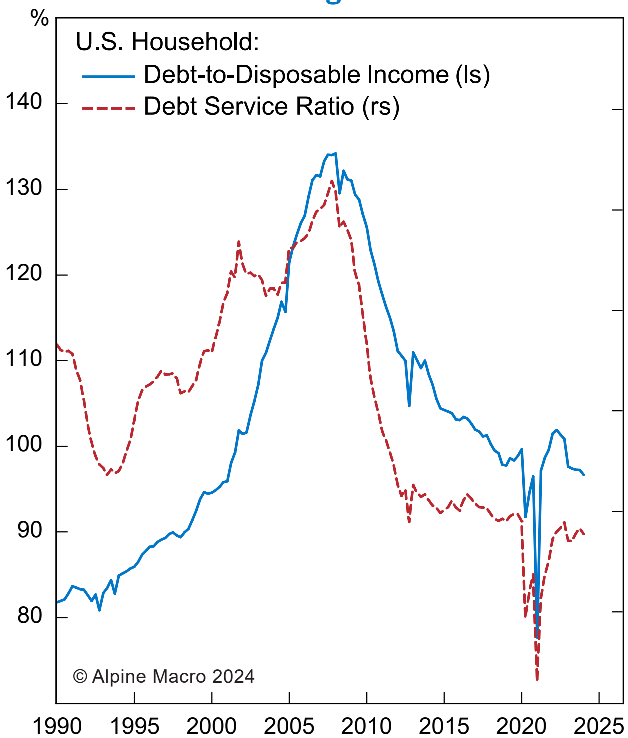
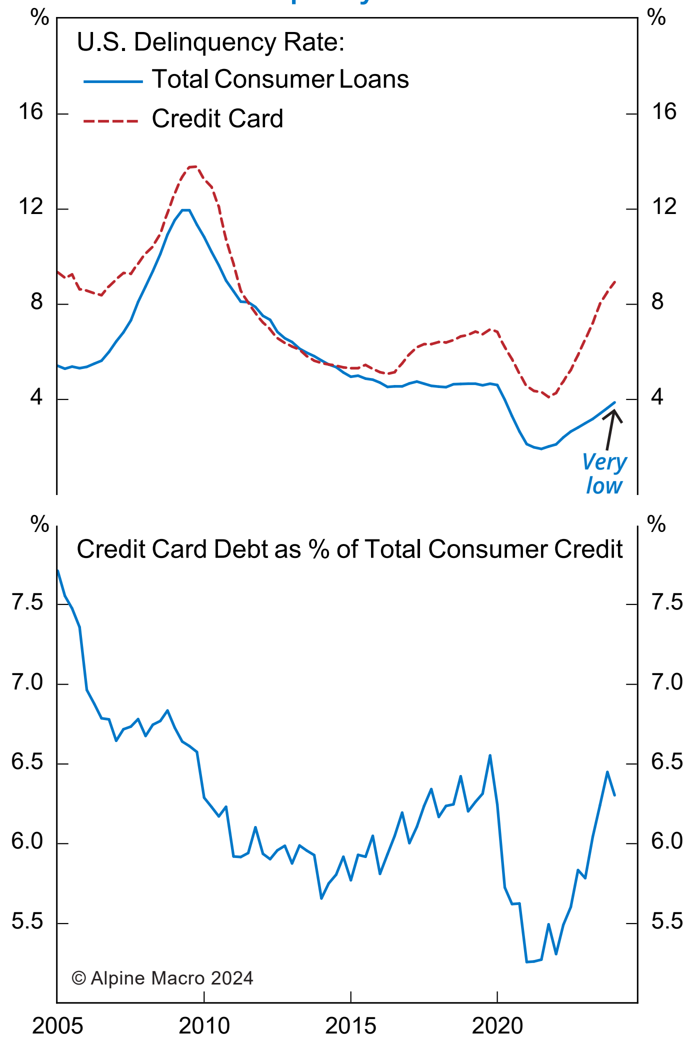


Chart 6 U.S.: Consumer Credit Delinquency Rates



Are Households Stressed?

The U.S. household sector has dramatically cut down its indebtedness since the 2008 housing crisis. As **Chart 5** shows, the household sector debt to disposable income ratio is at a 25-year low. The debt service ratio, which consists of interest cost and principal repayment as a share of income, remains lower than any time pre-pandemic. This is why consumers are not unduly stressed despite of a sharp rise in borrowing costs.

There is no question that the consumer credit card delinquency rate has risen noticeably in recent months in response to higher rates, but this should not come as a surprise. The Fed's monetary tightening should cause certain interest rate sensitive sectors to retrench and those with excessive credit card debt are stressed.

However, credit card debt is a very small portion of total consumer debt, only 6.3%. As **Chart 6** shows, the delinquency rate for overall consumer debt remains very low. To say that U.S. consumers as a whole are seriously stressed is factually incorrect.

Finally, there is no sign of financial disintermediation. Lending institutions seem to be in good shape and banks are beginning to lend money again, as evidenced in **Chart 7**. Expanding bank credit is not consistent with an economy that is about to drop into a recession.

Chart 7 Banks Have Begun To Lend Money Again

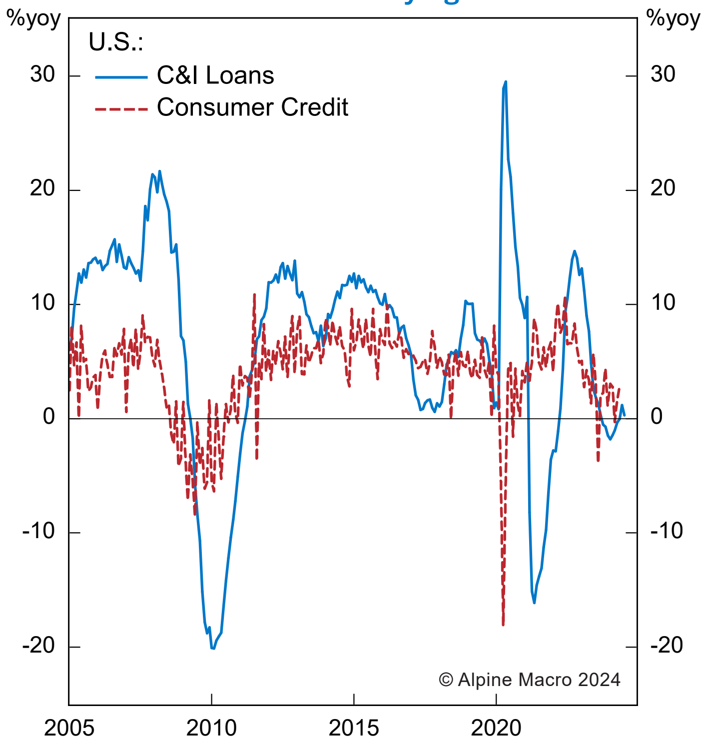
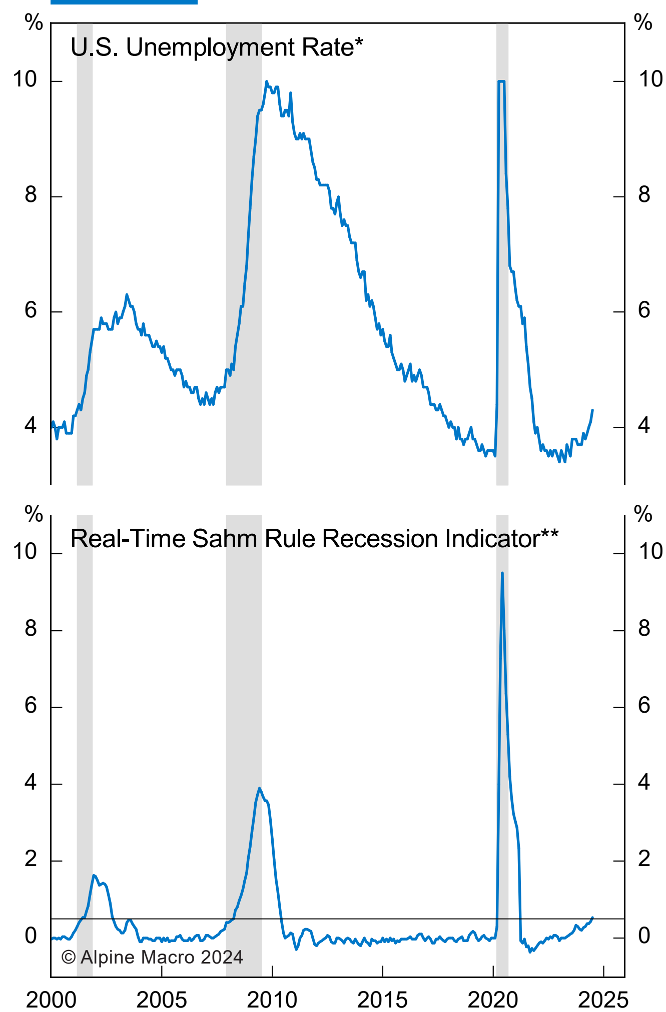


Chart 8 Will The Sahm Rule Work?



*Truncated at 10
**Horizontal line denotes the Sahm Rule trigger point at 0.5%;
source: Federal Reserve Bank of St. Louis
Note: Shading denotes U.S. recessions

The “Sahm Rule” & The Labor Market

Many have warned that the recent cooling in the labor market could mark the beginning of a sudden surge in the unemployment rate. The so-called “Sahm Rule” is back in vogue. It says if the three-month moving average of the unemployment rate rises half a point in the last 12-month period, it marks the beginning of a recession (Chart 8).

The U.S. financial markets have been clearly spooked by the rising unemployment claims and the renewed drop in the ISM Employment Index. Last Friday’s job report also confirms a softening labor market (Chart 9). With the unemployment rate rising to 4.3%, the so-called Sahm Rule is triggered.

Nevertheless, we should put soft data in proper perspective. Monthly payroll growth of 114K would be considered “normal” prior to the pandemic crisis. The labor force participation rate is still climbing. While part-time jobs are down 325K, the full-time segment is up 448K. Importantly, there are not a lot of layoffs, but the labor force participation rate is moving higher.

so is mark meldrum

We are doubtful about the Sahm Rule’s empirical validity for this labor market cycle. We all know that an acute labor supply shortage has plagued the U.S. labor market ever since the post-pandemic

Chart 9 Labor Market Slowdown In Perspective

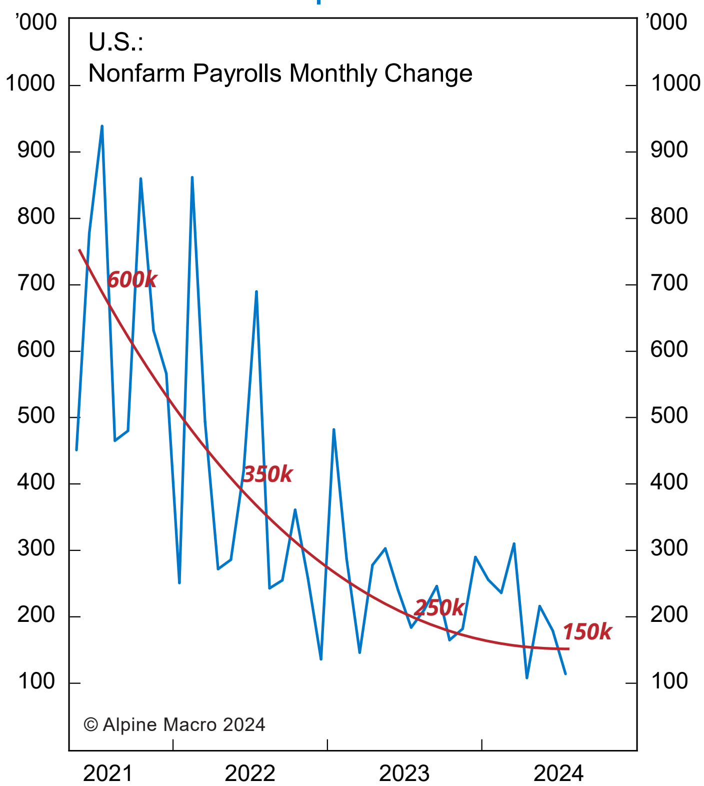
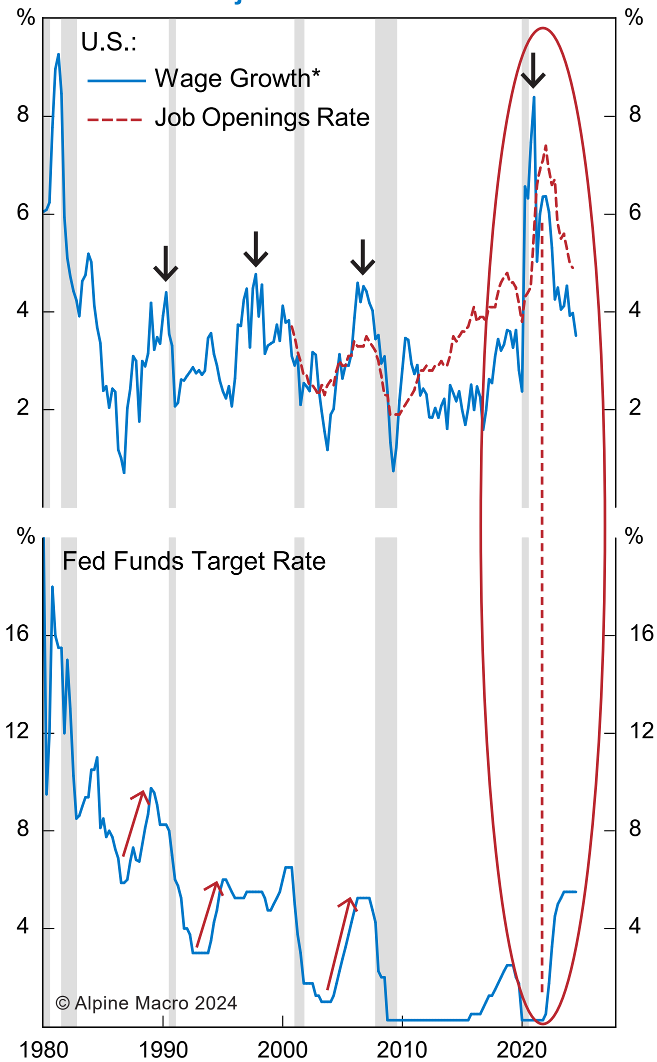


Chart 10 The Different Labor Market Adjustments



*Nonfarm private business average weekly earnings
Note: Shading denotes U.S. recessions

economic recovery. As a result, the wage rate took off and job vacancies, which highlight unfulfilled labor demand, skyrocketed.

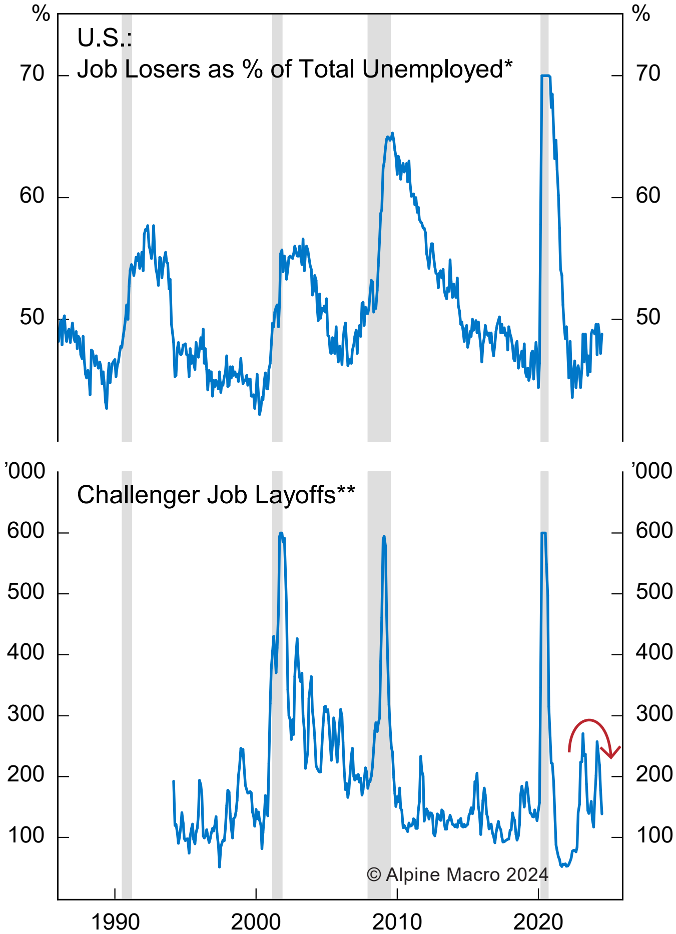
However, the severity of the labor market shortage began to ease in March 2022, when both the job vacancy rate and wage growth started to fall. Keep in mind that this was the same month the Fed began to raise rates (**Chart 10**).

This situation is in stark contrast with all previous cycles where wage growth and the job vacancy rate only began to fall after the Fed had long jacked up rates, and/or the economy was falling into a recession.

All of this implies that the rapid adjustment in the labor market is primarily reflective of a return of labor supply rather than a rapid fall in labor demand. This suggests that the so-called Sahm Rule will likely fail for this cycle because a creeping unemployment rate has been largely caused by rising labor supply rather than falling labor demand.

Chart 11 shows that job losses account for less than 50% of the unemployed. Historically, a recession is flagged only when a rising unemployment rate is predominantly caused by surging job losses.

Chart 11 The Labor Market Is Not In Distress



*Truncated at 70
**Shown as 3-month moving sum; truncated at 600; source: Challenger, Gray & Christmas, Inc.
Note: Shading denotes U.S. recessions

Since the beginning of the year, unemployment has increased by 895K, out of which 419K is from an increase in re-entering job seekers.[2]

The rising labor force participation rate for prime-aged workers, together with a large number of undocumented workers, have both contributed, either directly or indirectly, to the increase in the unemployment rate.

Various estimates put undocumented workers at anywhere between 15 to 20 million. Although these workers do not affect the unemployment rate directly, they could take up jobs that would otherwise be available for the labor force.

The bottom line is that so far, it is mostly increasing labor supply, rather than weakening labor demand, that has helped drive down wage growth and reduced the job vacancy rate. These adjustments are bullish for economic growth and stock prices, in our view.

What About The "Kink"?

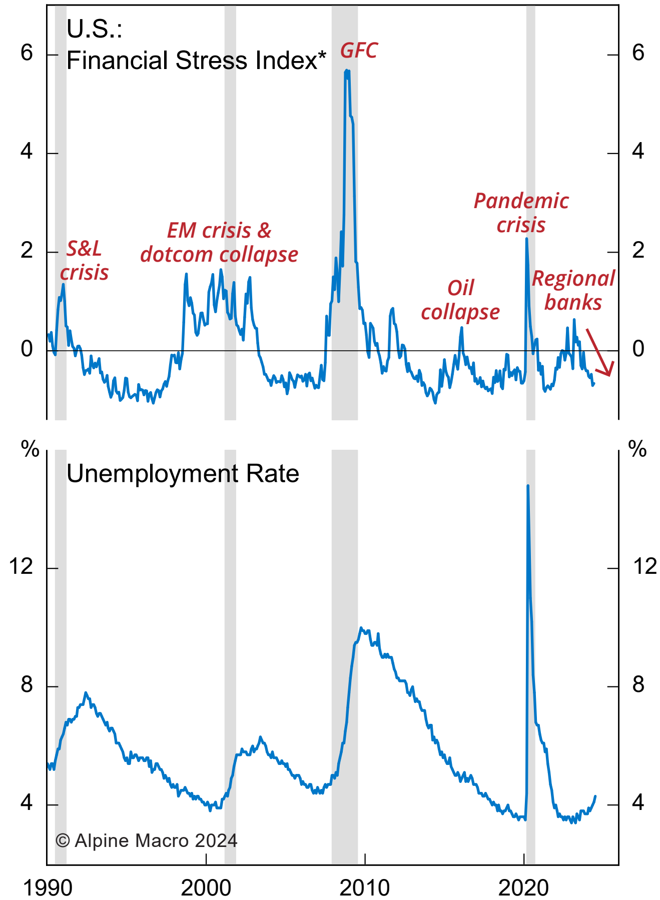
The progression of a business cycle is never smooth: discontinuity and breaks often occur along the way. Nevertheless, there is nothing mysterious about these "kinks" or "breaks" – they are always the results of financial crises.

Many have noticed that economic recessions in the U.S. are always preceded by financial crises and these crises are both the signals and the natural results of monetary policy overkills. Chart 12 documents how monetary tightening leads to rising financial stresses and crises, which in turn push the economy into recession.

In fact, economic or financial crises are a necessary condition for the U.S. economy to fall into recession. This is because financial or economic crises often freeze up economic activities, forcing businesses to liquidate assets and lay off workers. In the meantime, consumers tend to save more and spend less as job losses surge and a self-feeding vicious circle usually takes hold, causing aggregate demand to contract.

2 Alpine Macro *U.S. Bond Strategy* "Labor Market New Normal: Forget The Sahm Rule" (July 25, 2024).

Chart 12 No Crisis, No Break (Kink)



*Source: Federal Reserve Bank of Kansas City
Note: Shading denotes U.S. recessions

At that point, all economic curves become kinked: the unemployment rate suddenly breaks higher, consumer spending plunges and capital investment collapses. Therefore, the causality is policy errors leading to financial crises and economic seizures, which in turn generate "kinks", or breaks, in various demand curves.

The good news is that financial stress has been easing since early this year, based on the Kansas Fed Financial Stress Index. Of course, this does not guarantee that there will be no financial shocks coming out of blue, but so far, we don't detect any particular sector that is in severe financial stress.

Two Measures Of Monetary Conditions

Is money too tight? The yield curve gives a confirmative answer. Indeed, the inversion of the yield curve in the post-war period has almost always provided a good prediction of a recession.

Nevertheless, as we discussed earlier, this cycle is anything but typical. We suspect that the predictive power of the traditional yield curve may not be as strong as when dealing with a supply-driven cyclical process. Only time will tell.

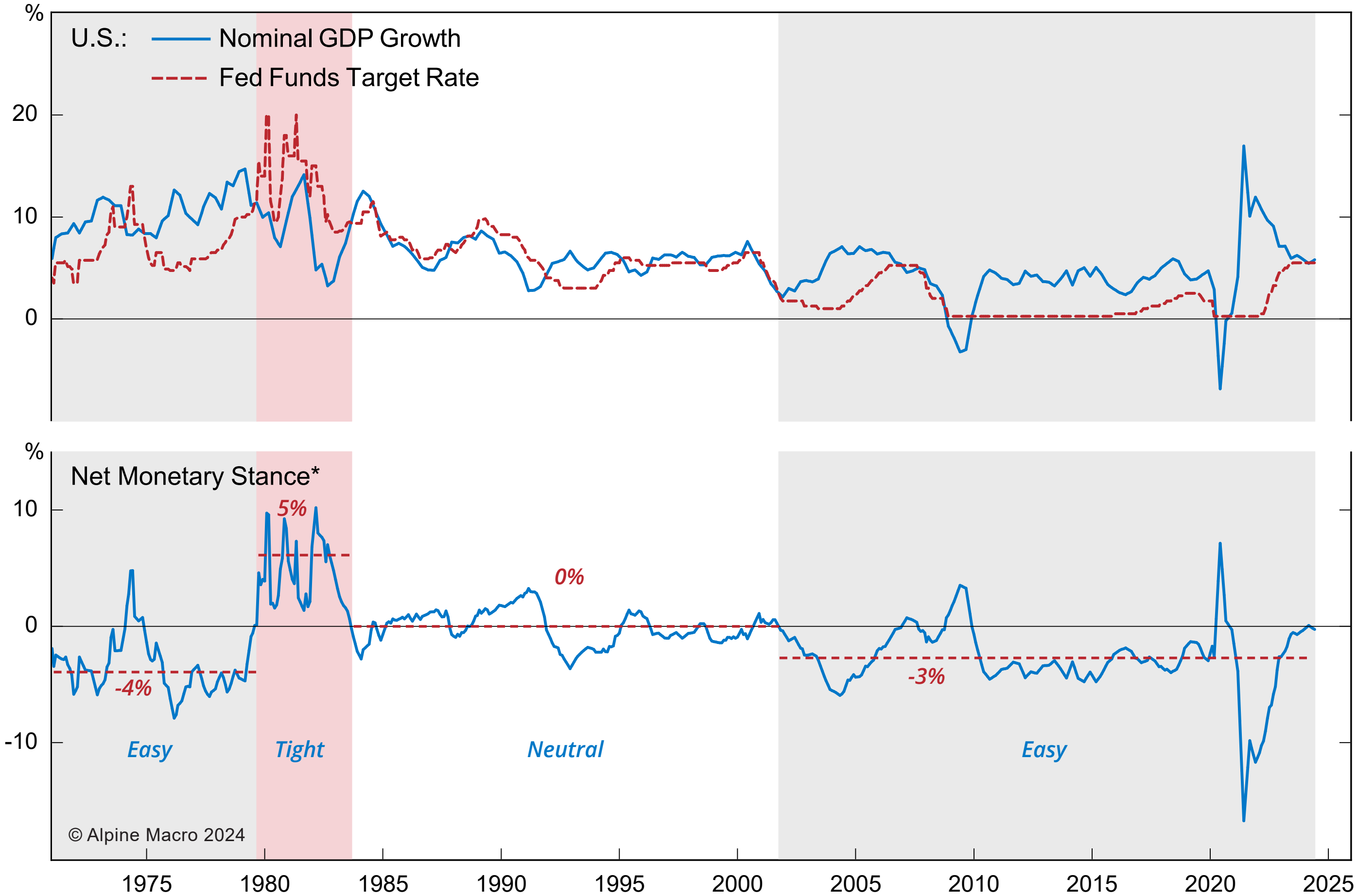
Chart 13 is another key measure of the monetary stance. It measures the gap between nominal GDP growth and the fed funds rate. The rationale here is that when the policy rate falls below nominal growth, policy is expansionary, and *vice versa*.

By this metric, policy was very easy in the 1970s, and then became very restrictive between 1979 and 1984 under Paul Volcker's Fed. From 1985 to 2000, policy was largely neutral, with the gap between the two variables fluctuating along the zero line. This was followed by a long period of zero rates and easy money in the 2010s and during the pandemic crisis.

Since 2022, the Fed has lifted its policy rate to levels that are very close to nominal GDP growth. Clearly, policy is tighter than before, but not necessarily unduly tight, given inflation and nominal growth are much higher than at any time in recent decades. This assessment is consistent with an economy that is still generally resilient, but rate-sensitive sectors are rapidly cooling.

Nevertheless, the message for policymakers is also clear: they need to drop rates sooner than

Chart 13 **Is Money Too Tight?**



*Fed funds target rate minus nominal GDP growth

later because disinflation will push nominal growth below the policy rate, making policy too tight. We read the sharp selloff in stocks and the big rally in bonds as a warning shot for the Fed that policy-makers don't have much time or space left before acting too late.

but the Fed DOES NOT work for stock prices

Our View: A Bubbly 2025

While many strategists are looking for a recession next year, we believe that the world economy already experienced one in 2022. Our rationale is that both the 2020 pandemic and subsequent recovery were atypical, representing a five-sigma move in both directions.

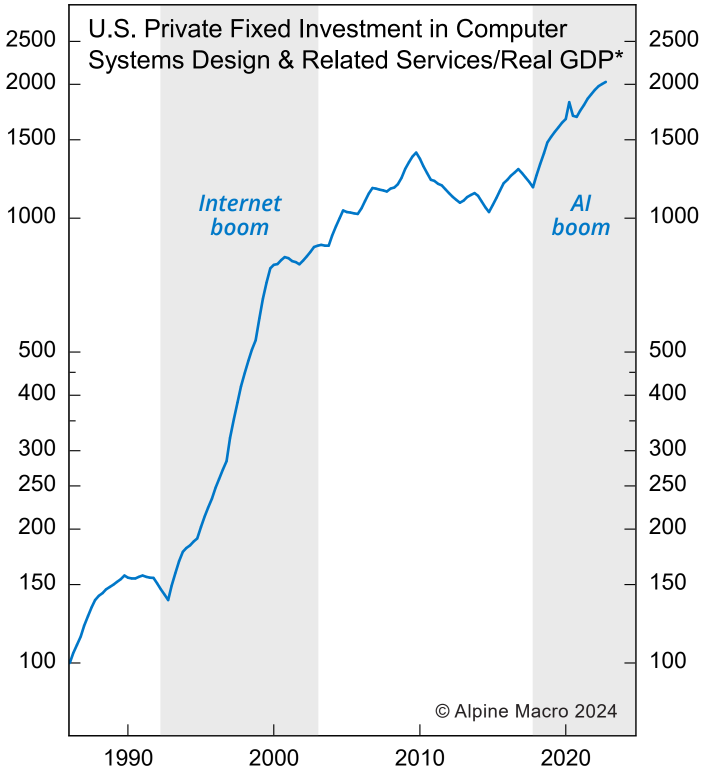
In 2022, when the U.S. economy tried to resettle back to its steady state after the post-pandemic boom, a technical recession happened, with GDP contracting for two consecutive quarters in a row, corporate profits falling by 10%, commodity prices dropping by 35% and tech sector layoffs skyrocketing.

Going forward, we believe the bull market in equities will likely evolve into a bubbly situation similar to the late 1990s:

- The Fed usually cuts rates on recession cues; the only time the Fed eased in an expanding economy was in 1998 on fears of recession

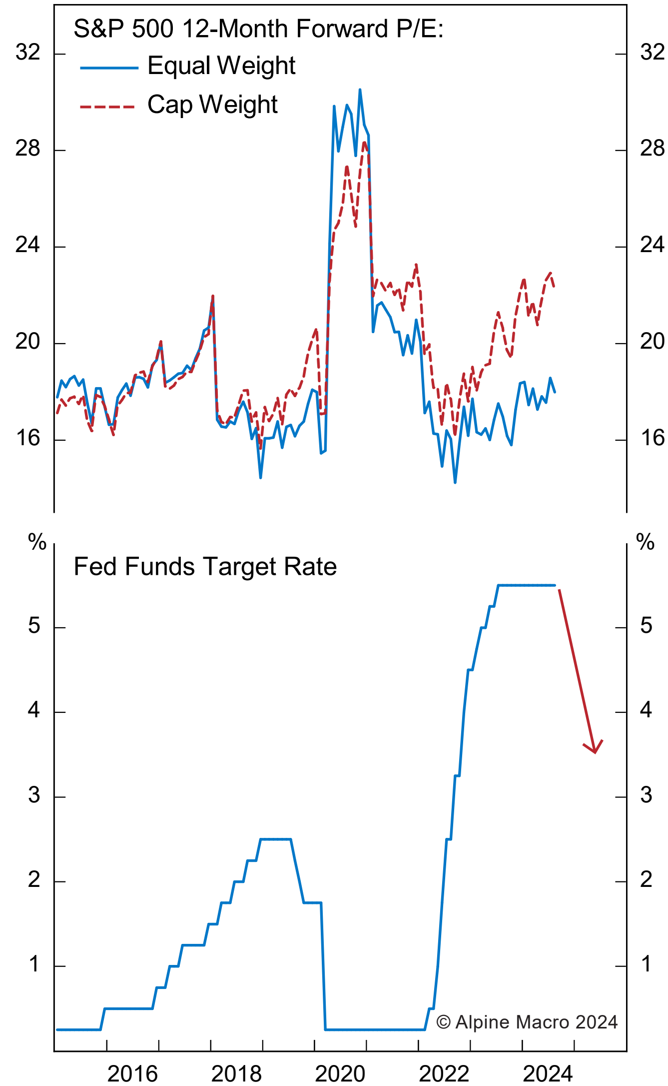
WRONG! They cut because of LTCM

Chart 14 IT Boom: Now Versus Then



*Rebased to Jan 1986=100

Chart 15 Are Stocks Expensive?



and falling inflation. This set the stage for the parabolic move in stock prices, with dotcoms leading the way. Today, we are dealing with the same macro, policy and market conditions.

- The internet bubble in the 1990s was supported by soaring IT investment and enormous gains in labor productivity. Today, we are experiencing an identical boom in AI and a sharp rise in labor productivity. **Chart 14** shows that we are at the cusp of another major investment cycle as AI technology proliferates. Labor productivity growth has been soaring in recent quarters.

- As paradoxical as it may sound, the pandemic crisis has thrust the economy into a new cycle of innovation and labor productivity growth. For example, working from home has not only reduced labor market friction to near zero but compressed business operating costs tremendously. There are many other examples of how innovations are pushing up output per hour or sharply reducing unit labor costs.

- The vast number of stocks have barely risen over the past two and a half years and their multiples have been suppressed by rising interest rates (**Chart 15**). With Fed easing in sight and bond yields plunging, these sectors and stocks should

SPY still overvalued. maybe @ 470s it would be fairly priced have more gains to come. Small caps, financials and eventually industrials will do well in 2025, while the Mag 7 could be inflated even more and move into bubble territory. huhh!!?? like it isn't already!

- The bifurcated nature of the U.S. equity market, by definition, means higher price volatility, but investors should remember the old *cliché* that “a bull market climbs a wall of worry”. In the 1990s, stock market corrections and shakeouts were steep and vicious, but the subsequent rise in prices was equally furious. We expect a similar pattern to be repeated in the current stock market cycle.
- On Treasury bonds, we recommended that clients go long duration on June 10.[3] Although 10-year Treasury bond yields have plunged to 3.8%, we believe that the non-recessionary lows for the long end of the curve should be around 3.5-3.7%. Therefore, we recommend that clients move to benchmark duration.

Housekeeping

- Institute a stop at 35,000 for our Long Nikkei 225 trade. Remove the yen hedge.
- Move the stop for our Long TLT trade to $95.

Chen Zhao
Chief Global Strategist

3 Alpine Macro *Global Strategy* "A "Soft Patch" Ahead?" (June 10, 2024).

Investment Recommendations						
Tactical Investment Positions (3 - 6 months)						
Recommendations	**Open Date**	**Open Levels**	**Stop**	**Closing Date**	**Closing Levels**	**P&L Since Inception**
Long 10-Year German Bunds/Short 10-Year JGBs	08/07/2023	2.6%/0.62%	Rolling -1%	-	-	7.9%
Long U.S. Regional Banks (ETF: KRE)	12/04/2023	48.12	51.2	-	-	14.6%
Long Russell 2000 (ETF: IWM)	01/08/2024	196.73	208	-	-	6.8%
Long Gold (ETF: GLD)	04/01/2024	207.82	-	-	-	8.4%
Long S&P 500 Energy (ETF: XLE)	03/25/2024	93.26	88	-	-	-4.5%
Long Italian Equities (ETF: EWI)[1]	04/08/2024	37.36	37	07/29/2024	37.00	1.5%
Long Nikkei 225 Unhedged[2]	05/06/2024	38,835	35,000	-	-	-7.5%
Long Long-Dated Treasury Bonds (ETF: TLT)[3]	06/10/2024	90.98	95	-	-	8.8%

Note: P&L is calculated using daily closing prices.

[1] Our Long Italian Equities (ETF: EWI) trade was stopped out on 07/29/2024 with a profit of 1.5%.

[2] We are adding a stop point at 35,000 and removing the yen currency hedge from our Long Nikkei 225 trade.

[3] We are tightening the stop for our Long Long-Dated Treasury Bonds (ETF: TLT) trade from $91 to $95.

A Unique Mind On The Markets