Francois Trahan
ftrahan@trahanmacroresearch.com

Jonathan Zucco
jzucco@trahanmacroresearch.com
Ryan Hartung, CFA
rhartung@trahanmacroresearch.com
Mark Zikeli, CFA
mzikeli@trahanmacroresearch.com

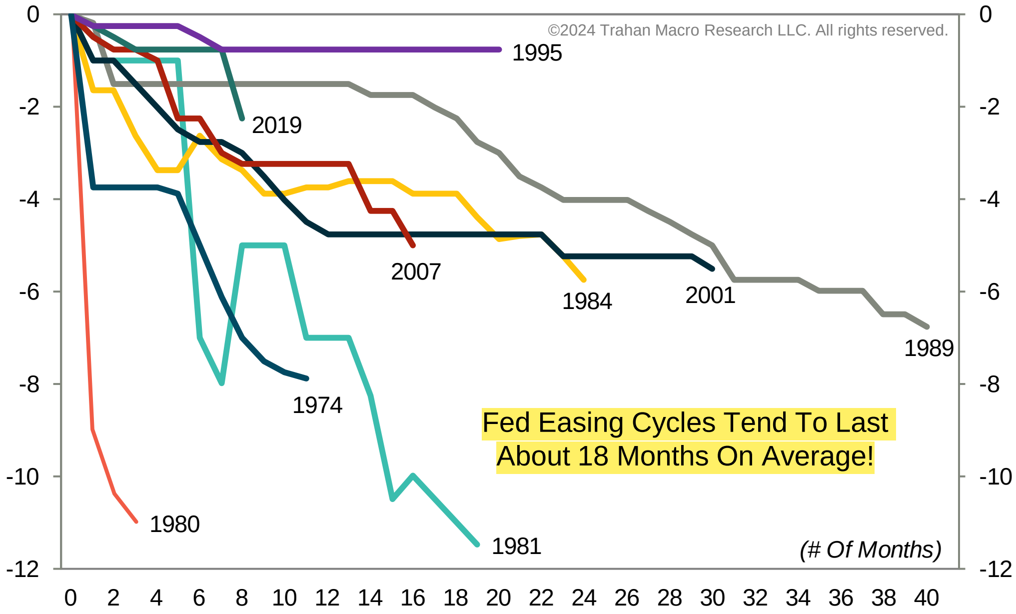
TRAHAN MACRO RESEARCH

August 1, 2024

Time To Dust Off The "Fed Easing" Portfolio

It seems clear at this point that the Fed is about to embark on a sustained easing cycle. Surely, some Fed governors will continue to warn against cutting official rates too quickly because of the perceived inflation threat. That said, for an institution that has repeatedly told us that they are data dependent … well, the data has changed and in a dovish way. After all, we are a mere 0.1% away from triggering the Sahm Rule and every economist at the Fed understands what this means. The conversation could shift as early as this Friday with the release of the July payroll report. When we say "shift," we mean the date of the first rate cut and how much the Fed will ultimately have to cut rates. We shall know more tomorrow at 8:30am!

Fed Easing Cycles Are Not Typically Short Lived



One thing we know about Fed easing cycles is that they typically go on for a sustained period. Surely, there have been a few exceptions but in the modern era of monetary policy we have seen three cycles last two years or more and a third that lasted nearly that long. The point is that the economy moves slowly and when you have an institution that is mostly reactive to data this translates into cycles that can be quite lengthy. Here lies the opportunity as history teaches us that there are numerous market relationships that have been consistent among historical Fed easing cycles.

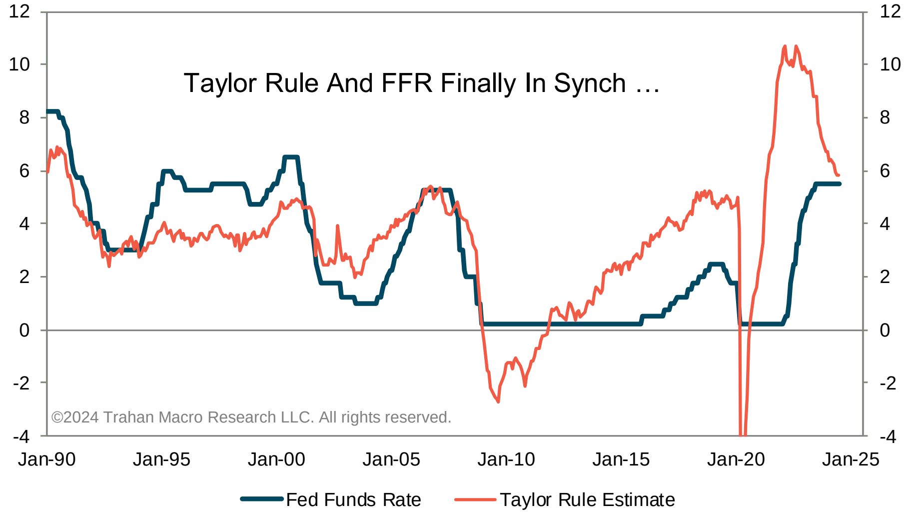
This week we focus on what is normal about Fed easing cycles for both the economy and financial markets. Some elements have been surprisingly consistent across past easing cycles while others have been marked by unique circumstances. Needless to say, we focus our attention on those relationships which have repeated consistently. It's not possible to cover it all in one report so this will be only an overview, but we will have plenty of time to publish more comprehensive work before the Fed's first rate cut which increasingly looks like September. Wishing you a great rest of your week. Francois

Copyright 2024 Trahan Macro Research, LLC. All rights reserved. This report is prepared exclusively for the use of Trahan Macro Research clients and may not be redistributed, retransmitted or disclosed, in whole or part, or in any form or manner, without the express written consent of Trahan Macro Research.

The Fed Looks Set To Embark On A Sustained Easing Cycle

It seems clear at this point that the Fed is about to embark on a path of easier policy. Truth be told, many indicators were already pointing in this direction before Chairman Powell and the Fed governors pointed to it. An old classic, the Taylor Rule, has been easing for some time and finally closed the gap with the official fed funds rate. The Taylor Rule fed funds rate was developed to approximate the Fed's policy reaction function.

The Taylor Rule Has Eased A Lot … More To Come!



Simplified Taylor Rule Formula

$$r = p + 0.5y + 0.5(p - 2) + 2$$

Where:

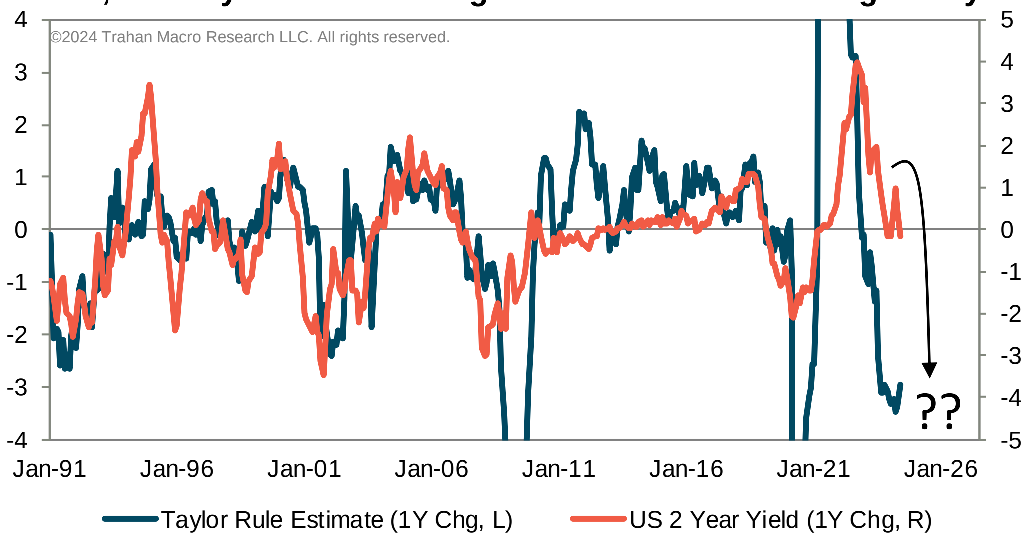
r = nominal fed funds rate

p = the rate of inflation

y = the percent deviation between the current real GDP and the long-term linear trend in GDP

The Taylor Rule is considered controversial in some circles but in our minds, it should absolutely be part of every investor's tool kit for analyzing monetary policy. The formula is shown above. It essentially looks at the deviation in inflation from the Fed's target as well as the deviation in economic growth from its potential. Note that some modified versions, like the one published on Bloomberg, replace the latter component with the deviation of the unemployment rate from NAIRU (Non-Accelerating Inflation Rate Of Unemployment). Some critics of the Taylor Rule concept will say that it deviates too much from official rates, and that is certainly true at times. That said, it provides a simple concept for understanding the key drivers of decision making at the Fed, and directionally speaking, it is quite helpful. In our minds, the proof is in the pudding, however. Indeed, we see legitimacy in this tool because it correlates quite well with short-term market rates, as the chart below illustrates.

Yes, The Taylor Rule Is A Legit Tool For Understanding Policy

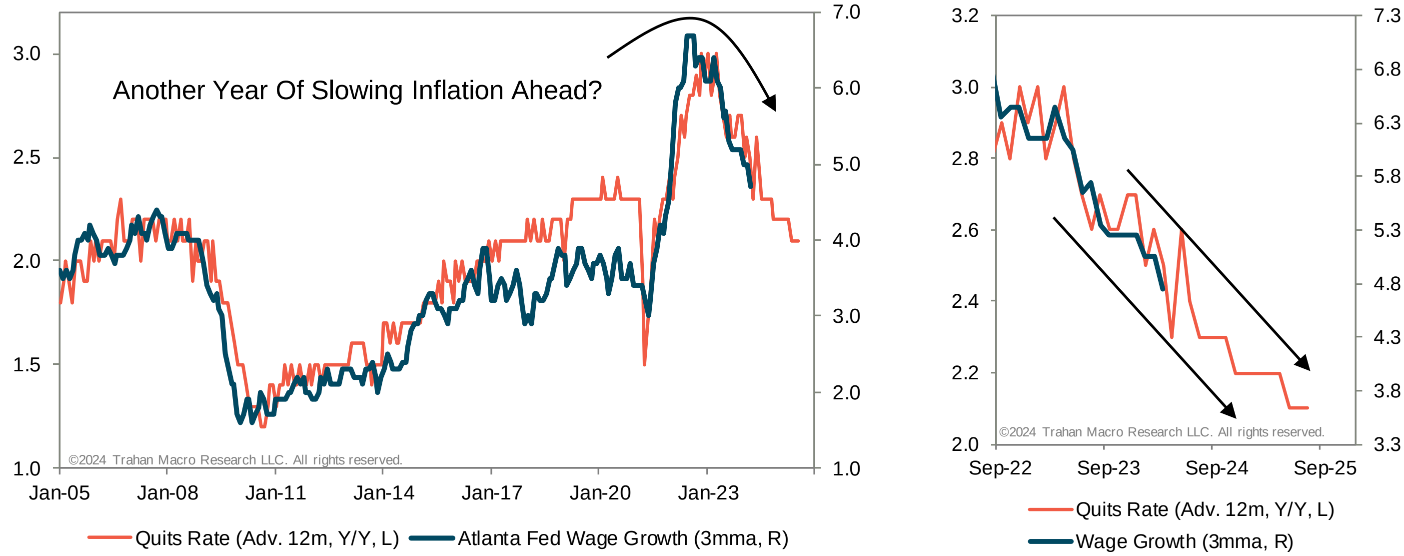


TRAHAN MACRO RESEARCH

The Fed's Reaction Function Staring At Increasingly "Dovish" Data

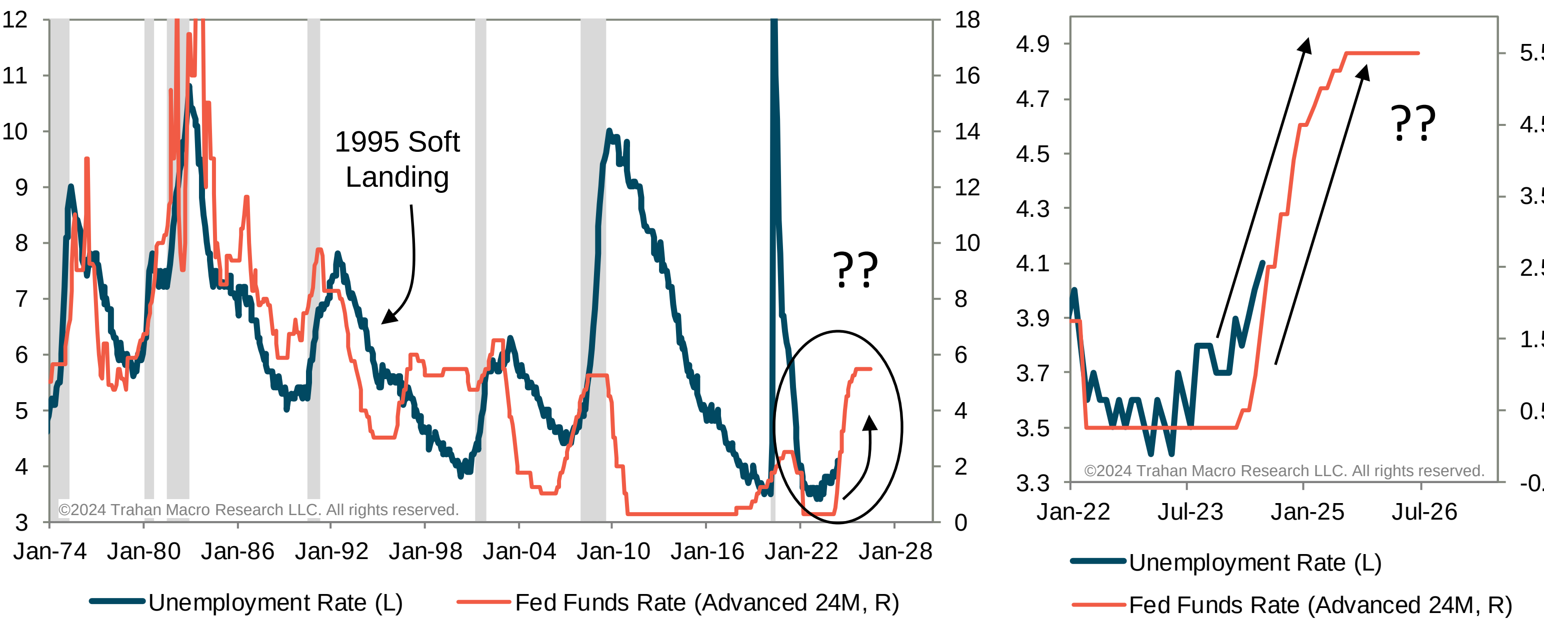
If there is one concept that matters more to Fed policy than any other, it's labor market tightness. After all, tight labor markets tend to lead to higher wage inflation, and vice versa. Most importantly, core inflation (the Fed's official focus) is closely correlated with wage inflation. In fact, they are often hard to differentiate. The good news is that gauges of labor market tightness like the Quits Rate have eased.

Gauges Of Labor Market Tightness Point To Slower And Slower Wage And Core Inflation



While the latest data point from the Quits Rate may sound trivial it argues for slower wage and core inflation for at least another year (see the clip chart above right). Moreover, labor markets are likely to get far looser as the lagged effects of prior monetary tightening start to catch up to labor markets. The chart below is probably the best example of this phenomenon as it shows that the unemployment rate tends to follow the trajectory of the fed funds rate with a lag time of about two years. This implies that the unemployment rate is unlikely to top out before 2026!

Labor Markets Finally Feeling The Lagged Effects Of Fed Tightening



TRAHAN
MACRO RESEARCH

What Does "Normal" Look Like At The Beginning Of Fed Rate Cuts?

What does the "economic" world typically look like at the start of a Fed easing cycle? Well, as the table below demonstrates, there is a lot of dispersion across cycles of the last 50 years. There is also consistency in some data series that can help us appreciate where we currently stand.

This is back of the envelope stuff at the end of the day, but it provides a snapshot of where we are versus historical averages. In today's context, Retail Sales are growing at a faster clip than typical BUT Industrial Production, trailing S&P 500 earnings growth, and overtime hours are all weaker than typical. It would be easier if all four series were consistent, but few cycles are that simple to analyze.

Is The Fed Already Behind The Curve?

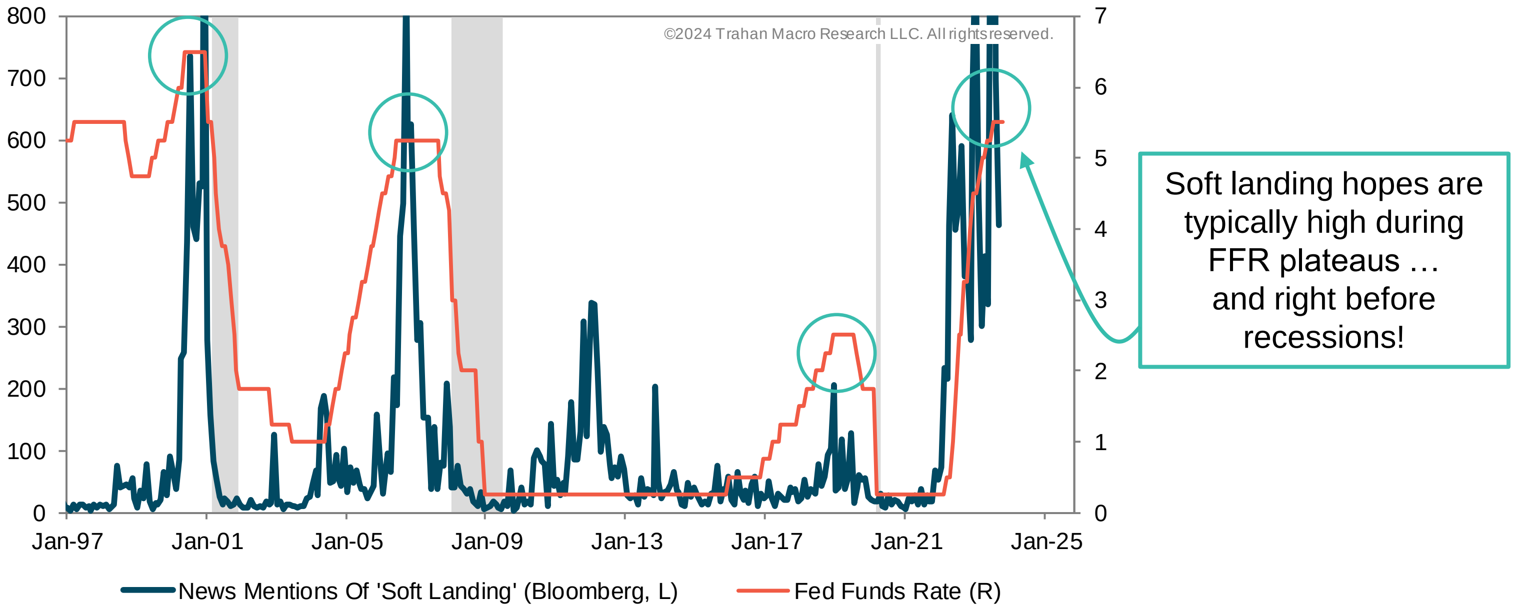
Growth Rate At The Start Of Fed Easing Cycles

Period	Retail Sales	Industrial Production	LTM EPS	Overtime Manf. Hours
1974	-3.0	1.2	20.0	-13.2
1980	-5.5	-1.2	12.2	7.7
1981	2.1	5.1	0.5	20.8
1984	5.9	6.4	24.5	0.0
1989	2.1	0.9	27.1	-5.1
1995	4.3	3.9	27.4	-8.0
2001	1.7	0.5	13.8	-14.3
2007	2.0	2.7	17.4	0.0
2019	4.3	-1.2	12.5	-6.7
Average	1.5	2.0	17.3	-2.1
Today	2.6	1.6	6.6	-2.8

©2024 Trahan Macro Research LLC. All rights reserved.

Economic data, while decelerating, is still generally seen as "good enough" by market participants at this stage in the cycle. It isn't until after the unemployment rate (somewhat of a lagging indicator) inflects higher that consensus generally warms up to the idea of recession. This is evidenced by the relationship between Bloomberg mentions of "Soft Landing" and the fed funds rate, shown below. During each fed funds rate plateau, mentions of soft landing tend to skyrocket as the pending rate-cutting cycle is anticipated to immediately support the economy. This suggests a dismissal of the lags inherent to monetary policy. Investors tend to convince themselves that "this cycle is different" yet the path of interest rates suggest otherwise (see page 3).

Consensus Typically About Soft Landing As Fed Talks Rate Cuts

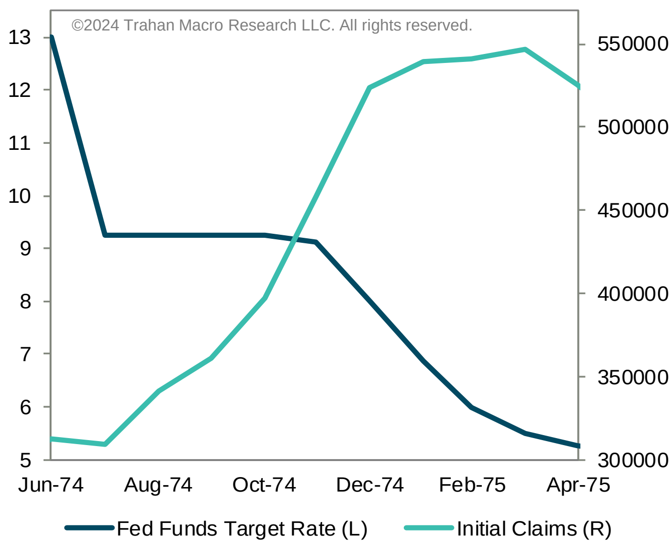


TRAHAN MACRO RESEARCH

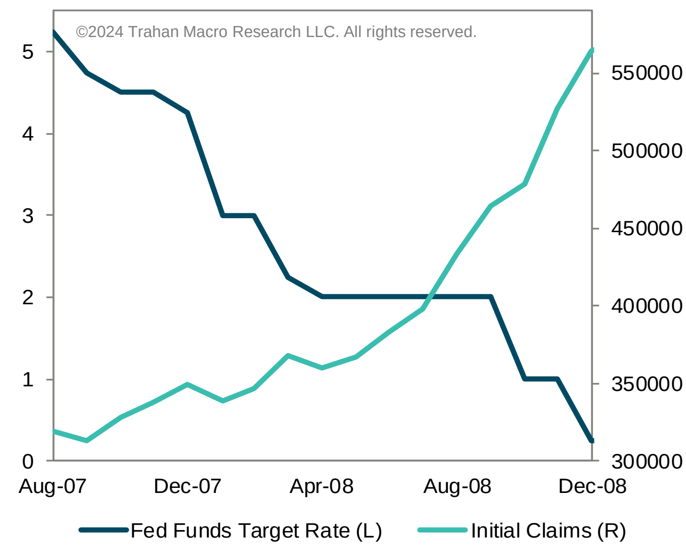
Some Key Series To Watch During A Fed Easing Cycle …

There’s a litany of economic data we’ll be publishing over the course of the easing cycle – we couldn’t fit it all here – but in our view Claims is the most consequential series in the near term. It’s a leading indicator of employment and thus feeds into the Fed’s reaction function. As a reminder, the Fed operates with a dual mandate – inflation and employment – though based on the Chairman’s statements since mid-2021, you’d think they forgot about the latter. Employment is impacted by monetary policy with a lag of about two years. The economic flow through from the prior tightening cycle tends to hit claims coincident with the Fed cutting rates, meaning the policy change is typically ineffective at staving off higher unemployment and market volatility.

Claims = FFR During Mid-70s

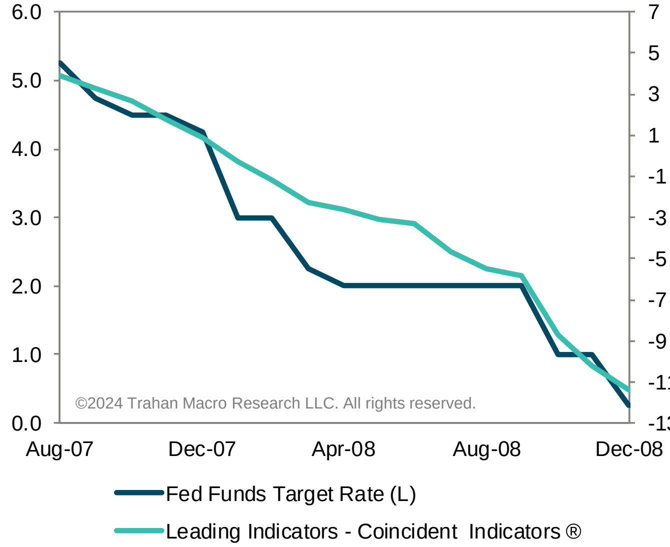


Claims = FFR During GFC

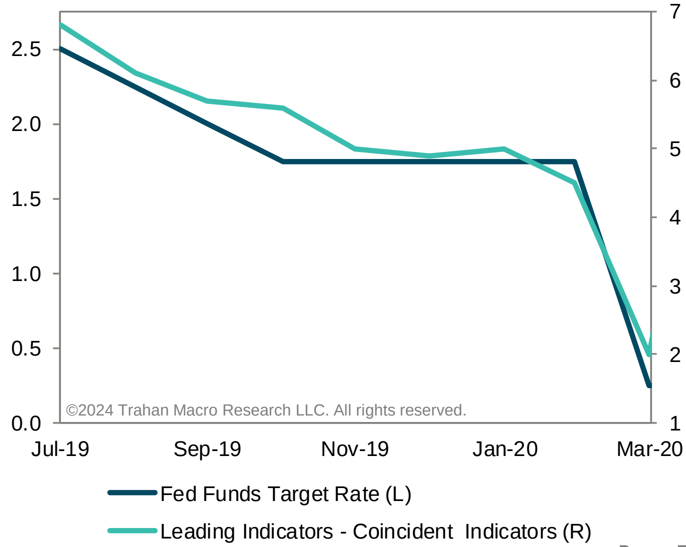


Another dynamic we’ll be paying close attention to is the relationship between Leading (LEIs) and Coincident Indicators of the economy (CEIs) as measured by The Conference Board, the arbiter of economic data. The data is by no means perfect and can be heavily criticized, but it is very useful, as we see below, to characterize the dynamics of an easing cycle. When easing begins, it’s normal to see a large gap between LEIs and CEIs, but it tends to narrow as monetary policy lags impact the economy and the Fed cuts rates. Soft survey data, the equity market, and confidence all tend to erode faster than CEIs like employment despite the accommodative policy shift, and the LEI/CEI spread shrinks.

Data Dynamic Also Key …



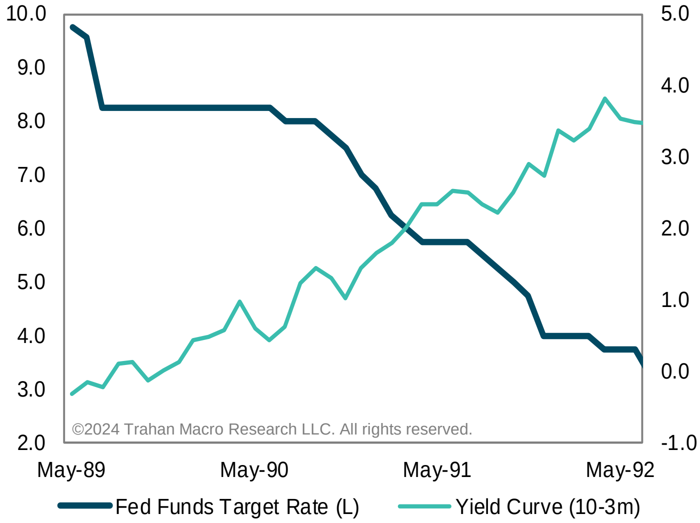
… During Fed Easing Cycles!



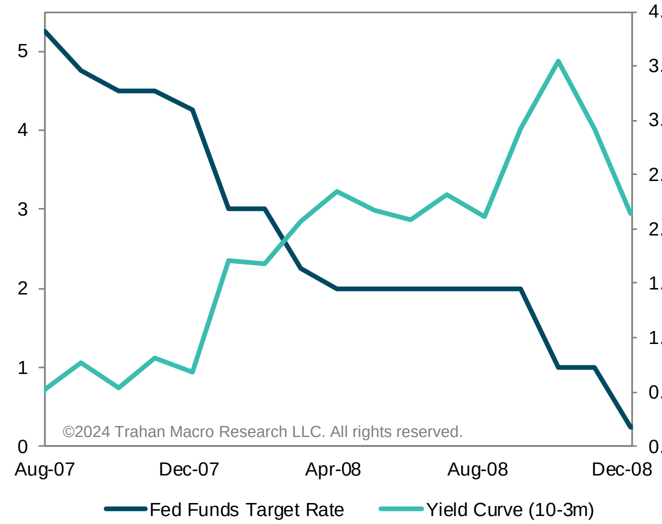
A Staple Of Fed Easing Cycles … A Steepening Yield Curve!

Another dynamic that we expect to unfold with the coming monetary policy shift is fixed income land. One of the classic signs of a Fed easing cycle, as we saw in 1990-91 and the GFC, is a steepening yield curve. This tends to occur as the Fed's rate cutting cycle exerts downward pressure on the short end of the curve which we approximate with the 3-Month Treasury Bill below in the two clips. Remember, policy operates with a lag and the Fed is traditionally cutting rates as economic data deteriorates so the steepening effect is not immediately stimulative.

Fed Easing = Steepening YC In 90/91

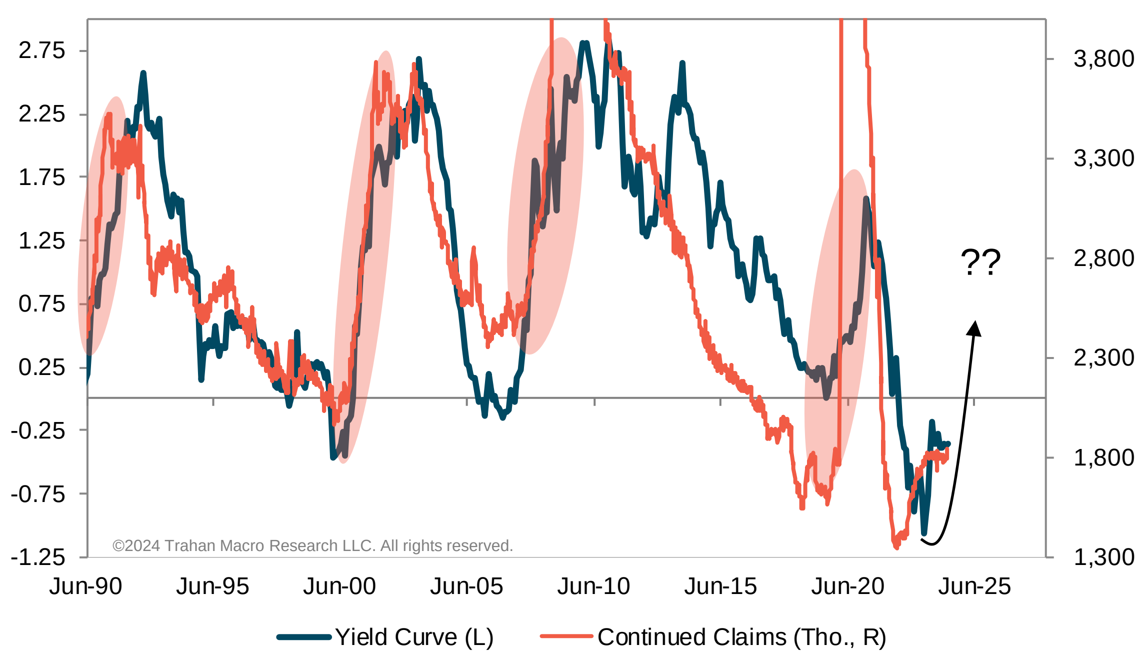


Fed Easing = Steepening YC In GFC



The yield curve, regardless of how one chooses to quantify it, is the premier proxy of the labor market. As we stated above, the steepening of the curve via the short-end is not usually a welcome sign for the economy or investors. It essentially implies that unemployment is moving higher, Fed policy is overly restrictive, and the easing cycle will not provide immediate relief to labor markets. Below we show the yield curve in the classic 10Yr-2Yr spread form against Continued Claims. The labor market tends to deteriorate violently and coincident with a Fed-induced steepening of the curve.

Closing The Circle => YC And Labor Markets One And The Same



TRAHAN MACRO RESEARCH

Sector Performance During Easing Cycles Is NOT Always Clear Cut

The remainder of this report is dedicated to the construction of an equity portfolio positioned for an easing cycle. Below we show the relative sector performance during four previous easing episodes. Health Care and Staples were consistent outperformers in each cycle, but it was not our expectation that sector performance would be uniform. In our view, the famous 1995 soft landing was a function of a stable employment market and monetary policy that had never become restrictive. The 2001 Stealth Bull Market was characterized by a falling S&P 500 (Tech & Comm Services), yet Cyclicals were robust.

History's Take On Fed Easing And Sector Performance

Relative Sector Performance During Fed Easing Cycles

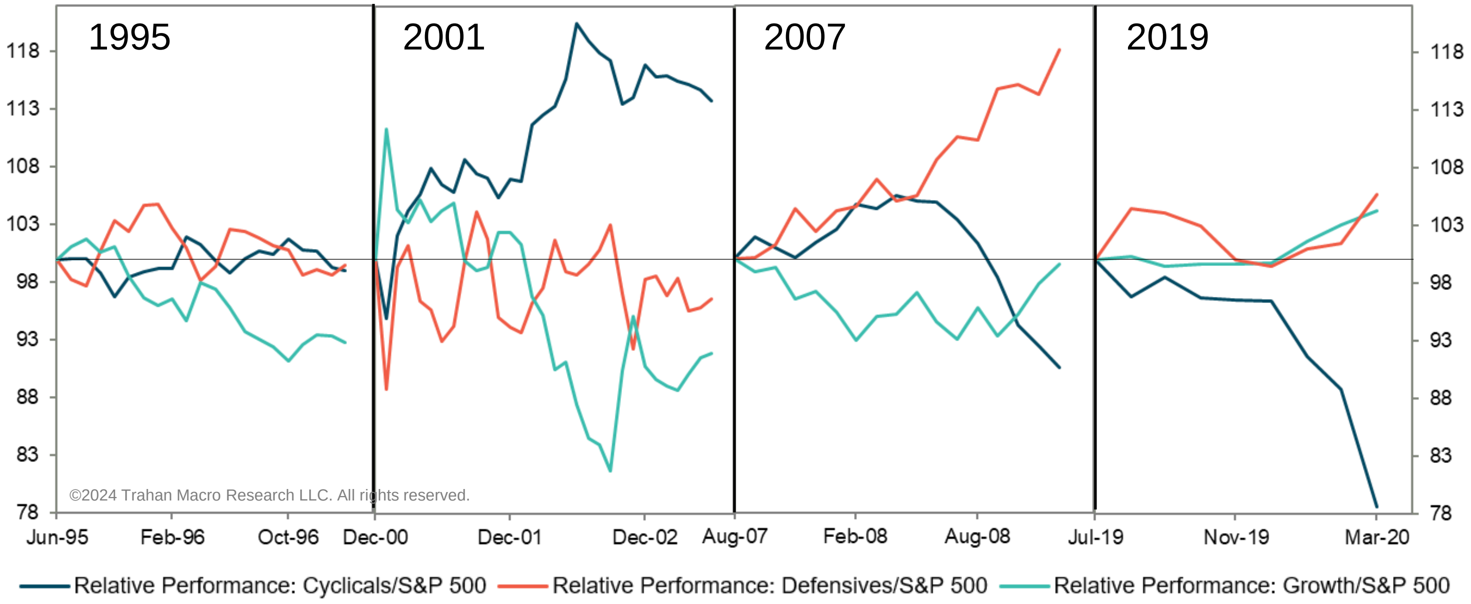
Sector	1995	2001	2007	2019	Average
Energy	-8.6	12.1	7.5	-35.4	**-6.10**
Financials	32.2	12.1	-22.6	-10.7	**2.76**
Com. Svcs.	-15.1	-21.8	3.4	1.9	**-7.91**
Industrials	-2.2	2.8	-3.7	-9.9	**-3.22**
Materials	-23.8	28.3	-6.4	-8.4	**-2.57**
Real Estate	N/A	N/A	-12.5	-8.9	**-10.70**
Health Care	22.2	12.6	16.0	10.4	**15.30**
Tech	0.3	-25.3	-2.9	13.2	**-3.68**
Discretionary	-23.2	8.0	-0.7	-4.0	**-4.96**
Staples	16.8	21.2	25.9	1.9	**16.44**
Utilities	-29.5	-13.6	13.9	0.9	**-7.09**

The only sectors to consistently outperform the S&P 500 during every Fed easing cycle since 1990 are Health Care and Consumer Staples.

©2024 Trahan Macro Research LLC. All rights reserved.

When we slice this data by equity leadership, we can see how unique the 2001 easing cycle was with Materials (+28.3%) supporting the performance of Cyclicals. In each of the three other episodes, Materials and Cyclicals succumbed to negative performance. For this upcoming cycle, we would reiterate positioning in Defensives (HLC, STA, UTS) based on the premise of a deteriorating U.S. labor market and its flow through to investor sentiment and ultimately corporate earnings. Furthermore, the expectation of falling interest rates typically acts as a tailwind for interest-rate sensitive sectors such as Utilities - the sector remains one of our top picks for the remainder of 2024.

Equity Leadership Across Fed Easing Cycles



Factor Exposure In Fed Easing Cycles … Mostly About Profitability!

Let's look under the hood of these sectors to see if we can identify which factors tend to shine during an easing cycle. Profitability, regardless of how it is quantified (Op/Gross Margin, ROE) stands out as the most consistent pillar as investors tend to bid up proxies of quality during periods of volatility.

Profitability Is The Attribute Investors Want To Emphasize

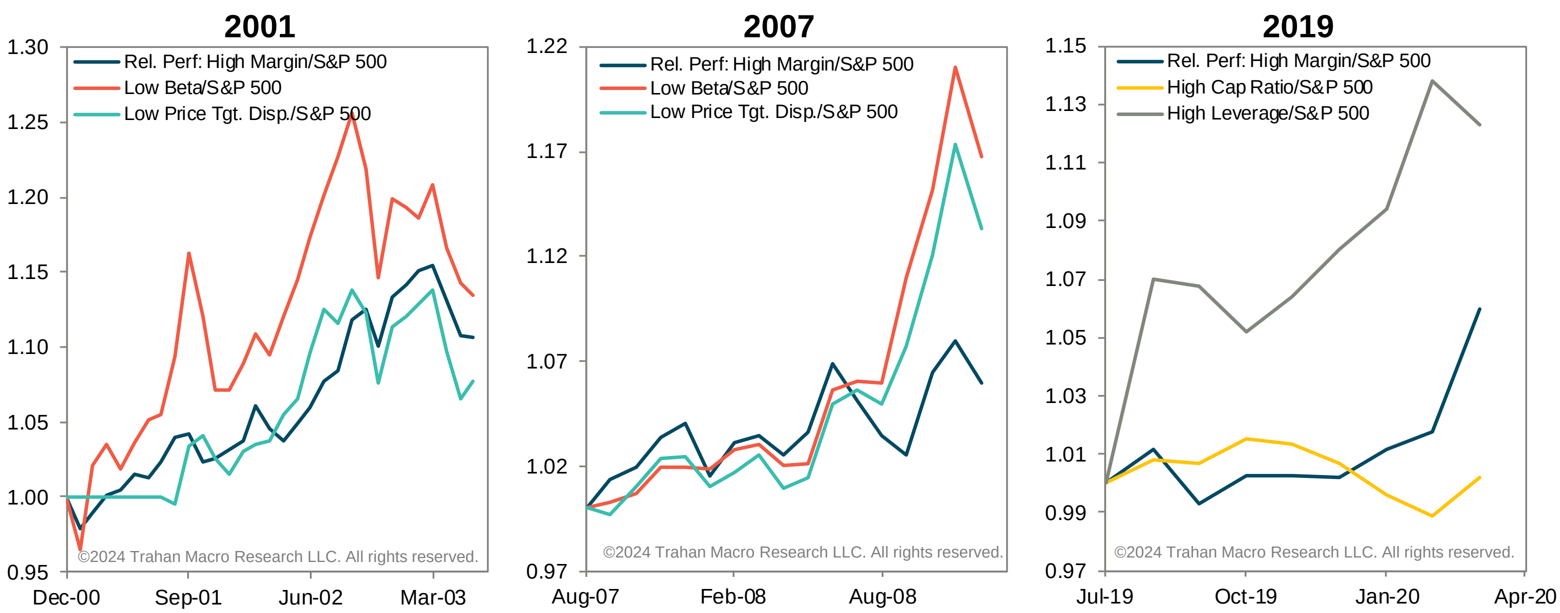
High/Low Relative Performance During Easing	2001	2007	2019	Average	
Operating Margins	**24%**	**36%**	**10%**	**23%**	Profitability
ROA	6%	40%	24%	23%	
CF ROIC	8%	44%	16%	23%	
Gross Margin	21%	20%	11%	18%	
ROE	3%	40%	15%	19%	
ROIC	-2%	49%	23%	23%	21.5%
Degree of Operating Leverage	**5%**	**19%**	**10%**	**12%**	Operating Efficiency
Current Ratio	-19%	-11%	9%	-7%	
Asset Turnover	-5%	5%	13%	4%	
Capital Intensity	6%	-5%	-11%	-4%	
Working Capital	-15%	-11%	6%	-6%	
Inventory Turnover	-23%	7%	3%	-4%	**-0.9%**
Beta	**-36%**	**-36%**	**-18%**	**-30%**	Risk
Price Target Dispersion	**-12%**	**-31%**	**-9%**	**-17%**	
Capitalization Ratio (Debt/(D+E) Debt to Capital	**-22%**	**-14%**	**-5%**	**-14%**	
1M Volatility	-29%	-34%	-13%	-25%	
Size	-41%	21%	22%	1%	
Momentum	-40%	29%	27%	5%	**-13.4%**

©2024 Trahan Macro Research LLC. All rights reserved.

At the factor level, we see that performance is more consistent relative to our expectations compared to what we saw at the sector level. It makes sense to see the factor High/Low Profitability outperforming, and High/Low Risk factors doing poorly pretty much across the board. High Beta stands out as a great factor to be short during a rate-cutting cycle as investors rotate into safe-havens.

Below we take a lookback at the prior three easing cycles – high operating margin as a factor consistently outperformed the S&P 500. Another Risk-Off factor investors should consider is Low Beta, which we'll find scattered throughout the three Defensive sectors mentioned on the prior page. While Risk in general stands out as a consistent underperformer, we see debt levels as one of the peculiarities. In the 2019 episode, High Cap Ratio performed poorly, while High Leverage outperformed even the High Profitability factor. That said, if our macro call comes to fruition, high debt is not a factor we would expect to be dependable.

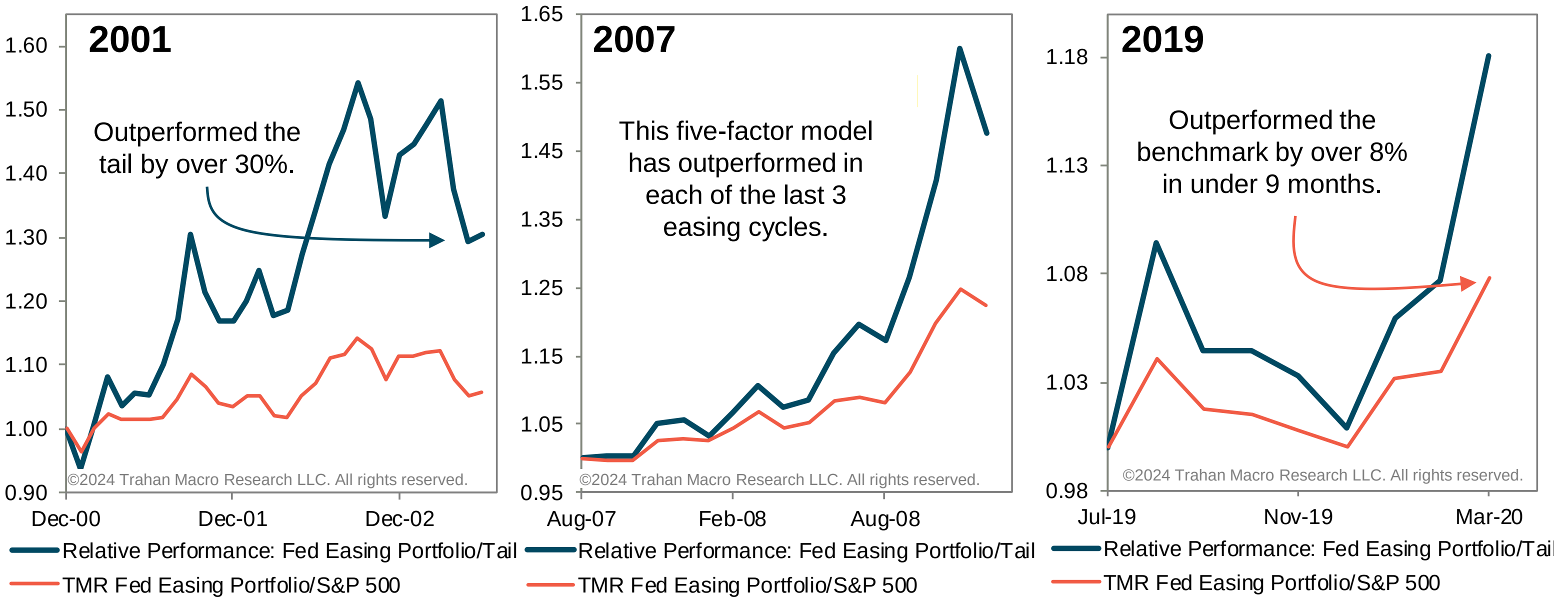
History's Stock Selection Strategy For Fed Easing Cycles



A Stock Screen For The Fed Easing Cycle … Of 2024 And 2025?!?

With the Fed poised to begin cutting rates in the coming months, we examined which factors have consistently outperformed in past easing cycles. We arrived at a balanced five-factor model consisting of Profitability, Cyclicality, Sentiment, Governance, and Operating Efficiency. The model focuses on the most effective factors from each category. Historically the results are quite impressive throughout the easing cycle. The TMR Fed Easing Portfolio has already begun to outperform the index as the Fed has started to take a more dovish stance given recent PCE data.

The Five-Factor Fed Easing Portfolio Across The Cycles … Interestingly Consistent!?!



The TMR Fed Easing Portfolio was built to outperform during Fed easing cycles, a period that is typically marked by lower rates and weaker economic and employment data. The portfolio has already begun to outperform the S&P 500 as investors begin to price in Fed cuts. For those looking to bolster their portfolios for the coming Fed interest rate cuts, the full list of rankings can be found on our website OR by simply emailing quant@trahanmacroresearch.com, other benchmarks available at request.

A Sample Listing Of The Five Factor Fed Easing Portfolio

TRAHAN MACRO RESEARCH

Lower Values Rank Better In All Categories

Universe: S&P 500
TMR Fed Easing Portfolio

Ticker	Name	Portfolio Rank	Profitability	Cyclicality	Sentiment	Governance	Operating Efficiency	Sector
MCD	McDonald's Corporation	1	1	1	2	1	1	Consumer Discretionary
GEN	Gen Digital Inc.	1	2	1	2	3	1	Information Technology
ESS	Essex Property Trust, Inc.	1	2	1	4	7	1	Real Estate
PG	Procter & Gamble Company	1	2	6	2	2	1	Consumer Staples
SO	Southern Company	1	3	2	6	1	1	Utilities
NSC	Norfolk Southern Corporation	1	3	3	5	3	1	Industrials
D	Dominion Energy Inc	1	3	[illegible]	[illegible]	2	[illegible]	Utilities
MDLZ	Mondelez International, Inc.	1	3	5	3	3	1	Consumer Staples
SHW	Sherwin-Williams Company	[illegible]	3	6	6	2	1	Materials
[illegible]	American Tower Corporation	1	[illegible]	7	5	1	1	Real Estate

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

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

TRAHAN MACRO RESEARCH