ALPINEMACRO
A Unique Mind On The Markets

U.S. THEMES & STRATEGY

September 9, 2024

Macro Divergences = Perfect Landing?

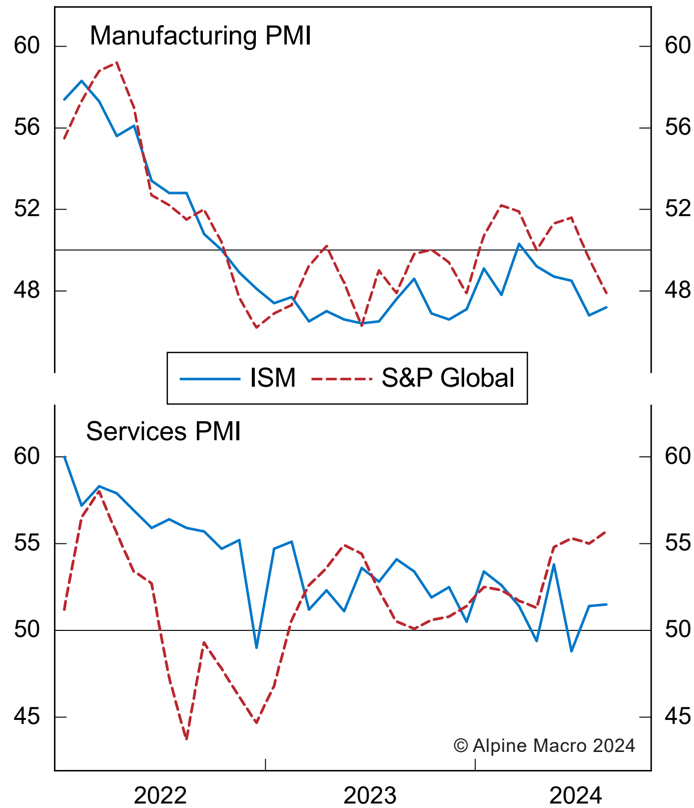
- The equity bull is intact. Market breadth should widen as the Fed begins an easing cycle, but a Mag 7 mania remains a distinct possibility. Volatility also will increase as pricing power deteriorates and the economy slows.
- The job market is cooling, but the U.S. consumer should hold up, as will be discussed in Friday's *Special Report.* Clean balance sheets, rising household wealth and firm productivity all support to this view.
- The rest of the world (ROW) will continue to lag the U.S. economy. Oil is at near-term downside risk. It is too soon to bottom-fish materials stocks or commodities.[1]
- Defensive equity sectors and long-term government bonds retain hedge value. Real yields have more downside than inflation breakevens, though the latter would benefit if oil drops sharply.

Theme 1

Macro Divergences = Perfect Landing?

The U.S. economy is slowing, as is job creation. Is this good or bad news for equities? That depends on whether the slowdown evolves into a severe recession and/or systemic stress event, as often happens in the late stage of a Fed tightening cycle. We still believe that this time will be different, in the form of a perfect landing: Fed interest rate cuts, tame inflation and an economy that is expanding, but below potential growth.

Chart 1 Domestic/External Divergences



Macro divergences beneath the surface support our baseline scenario. More specifically, there are several signs that the U.S. consumer will not retrench much even as fragility in the ROW undermines sales and pricing power in globally exposed U.S. businesses:

1 Alpine Macro *Equity Strategy* "Not Yet A Materials World" (July 24, 2024).

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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?

Come and join us for a day of debate, discussion, and brainstorming on the big macro themes and how to capitalize on them in this highly uncertain environment.

This is an in-person only event, and seats are already 70% sold out. If you are interested in this event, please register now.

Click here for a detailed conference agenda.

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Guest Speakers + Alpine Macro Strategists

Ruchir Sharma

Greg Valliere

Mike Dooley

Gareth Shepherd

Francois Trahan

Tavi Costa

Jim Paulsen

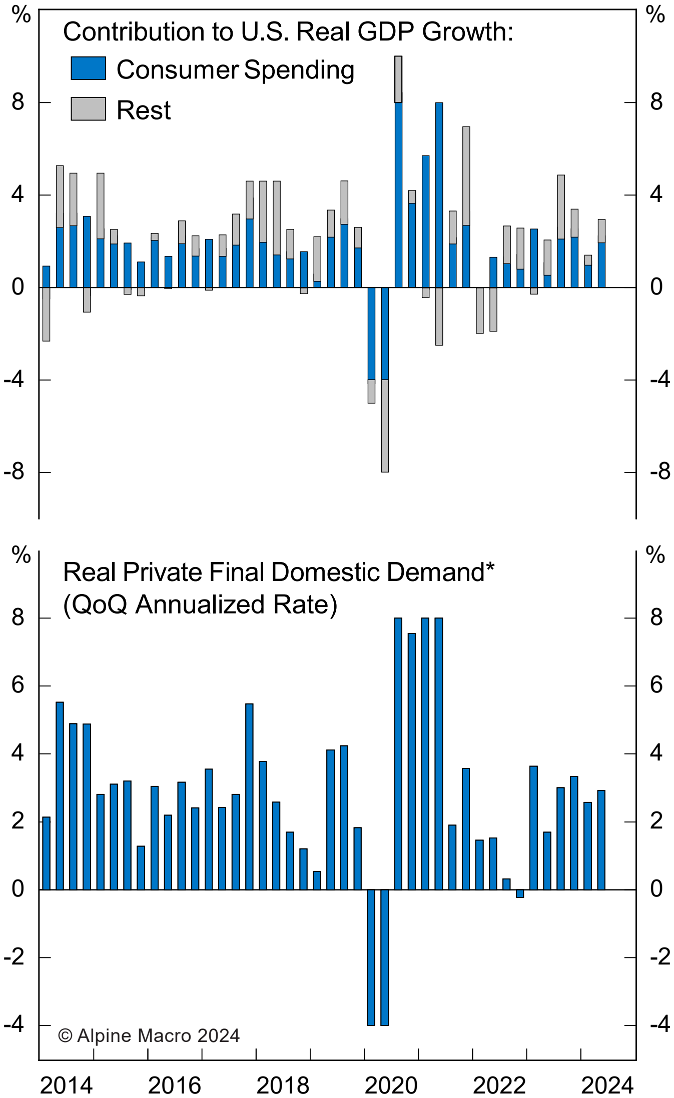
Lenka Martinek

Gina Martin Adams

Adam Rozencwajg

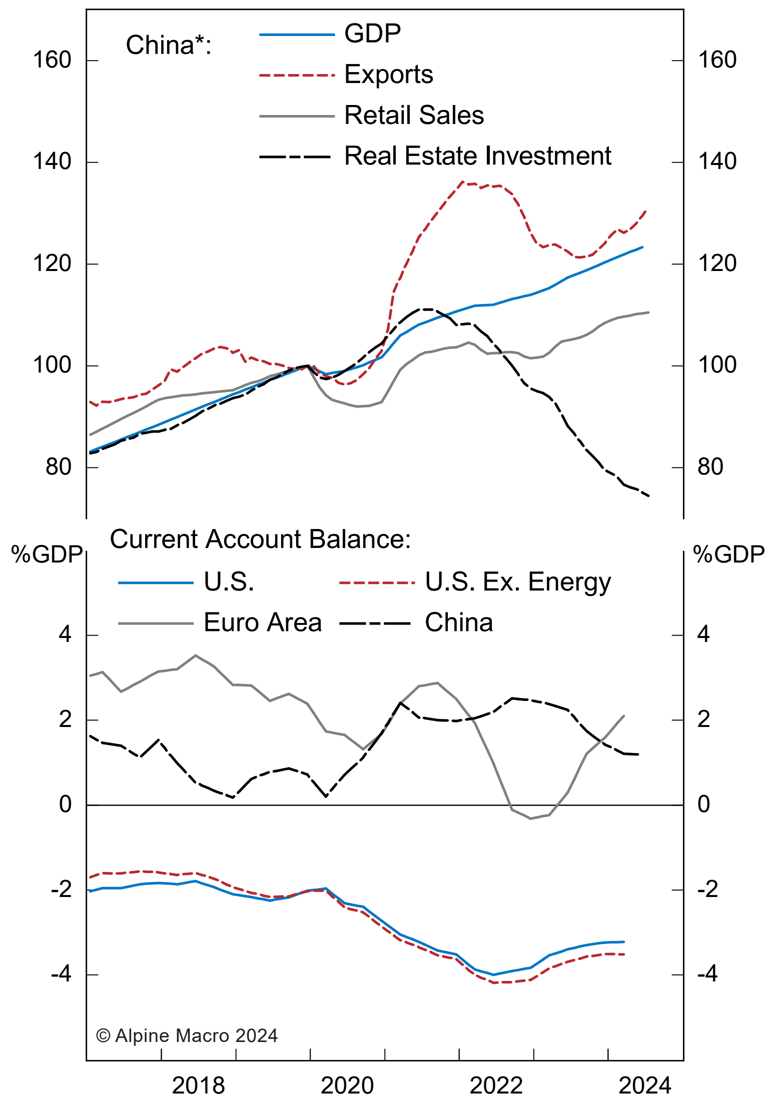
Conference Details & Registration: conference.alpinemacro.com | conference@alpinemacro.com | +1 (514) 558-1414

Chart 2 **Steady Consumer Contribution**



*Sum of final consumption, investment and stock building expenditures by the private industry, referred as "core GDP"
Note: Both series are truncated at -4 and 8

Chart 3 **ROW Needs U.S. Consumer**



*Rebased to Dec 2019=100

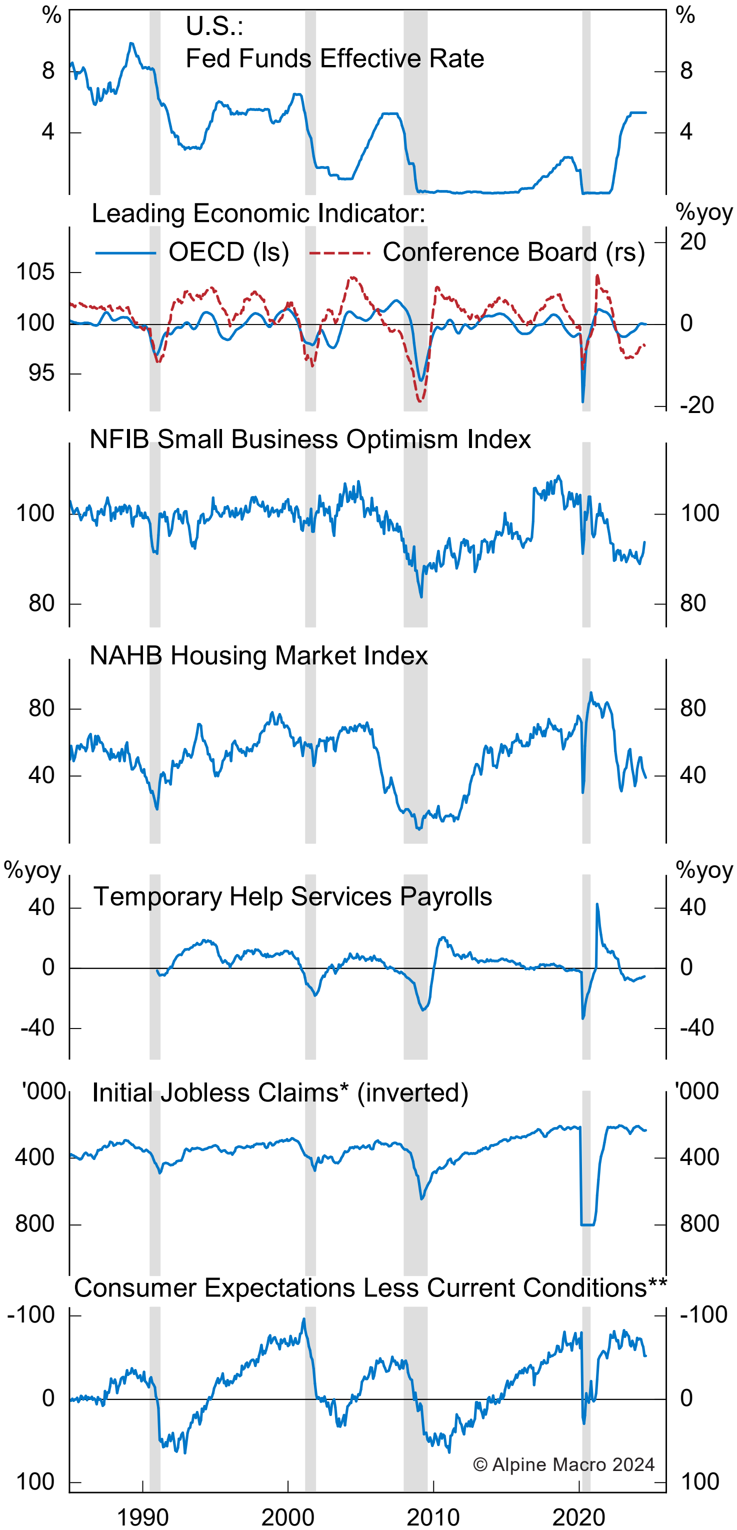
- **Manufacturing/services PMI divergences:** Manufacturing is far more exposed than services to world trade. Both ISM and S&P Global manufacturing PMIs are below the boom/bust 50 line, while the two services measures are above 50 (**Chart 1**).

- **Consumer growth contribution:** The contribution of consumer spending (69% of GDP) has been remarkably steady over the past year, in contrast with economic slowdowns in 2015 and 2022 (**Chart 2**).

- **GDP trackers:** Q3 SAAR growth rates are 2.1% for the Atlanta Fed's GDPNow model and 2.6% for the New York Fed's Staff Nowcast model.

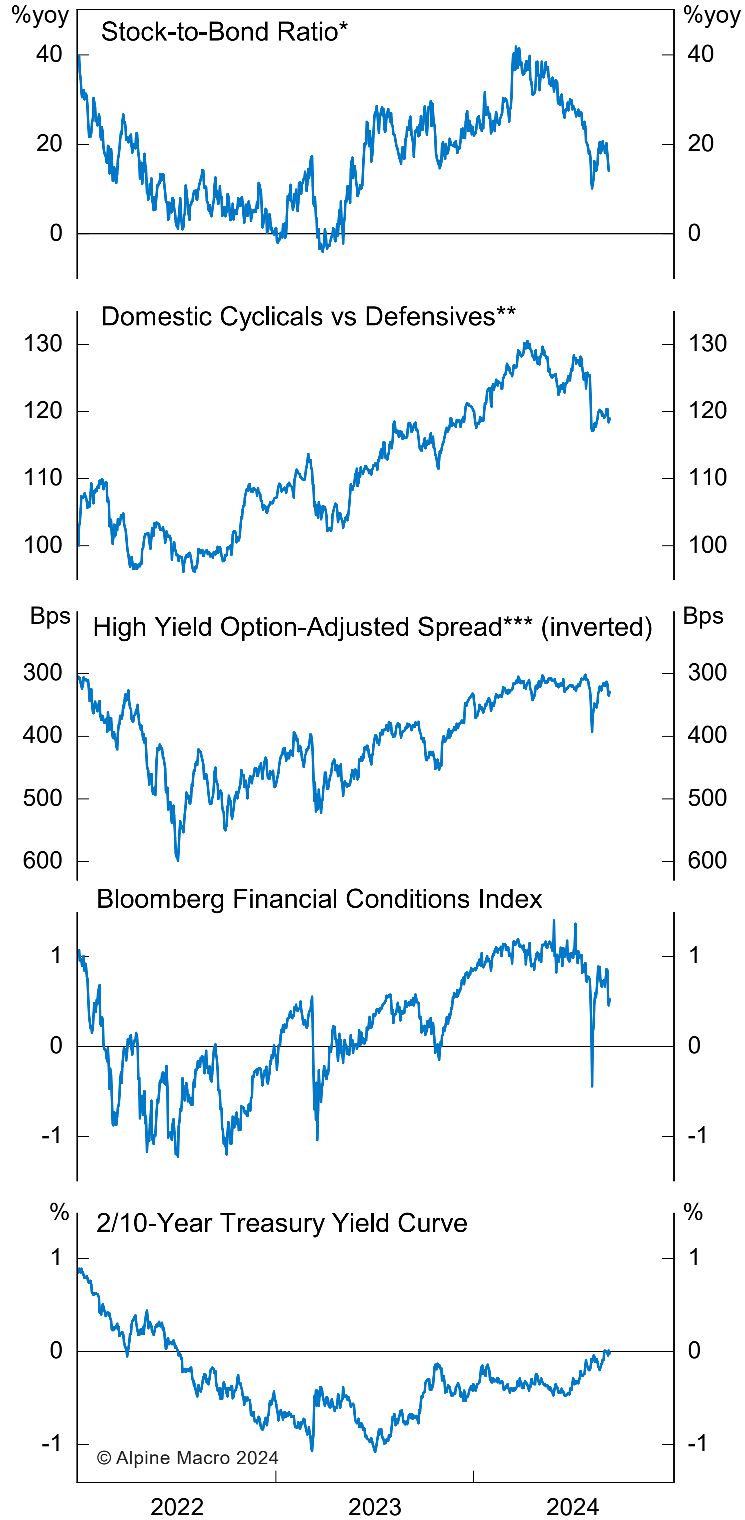
- **Global reliance on the U.S. consumer** (**Chart 3**): The U.S. consumer is the only game in town.

Chart 4 Macro LEIs Directionless



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

Chart 5 Capital Market Indicators Unclear



*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

Chinese exports are accelerating as supply ramps up but domestic spending remains lacklustre. However, the expanding euro area current account surplus warns that excess supply is not limited to China. Ergo, any pullback in U.S. spending would be met with price-cutting and lower bond yields to "convince the consumer to keep buying".

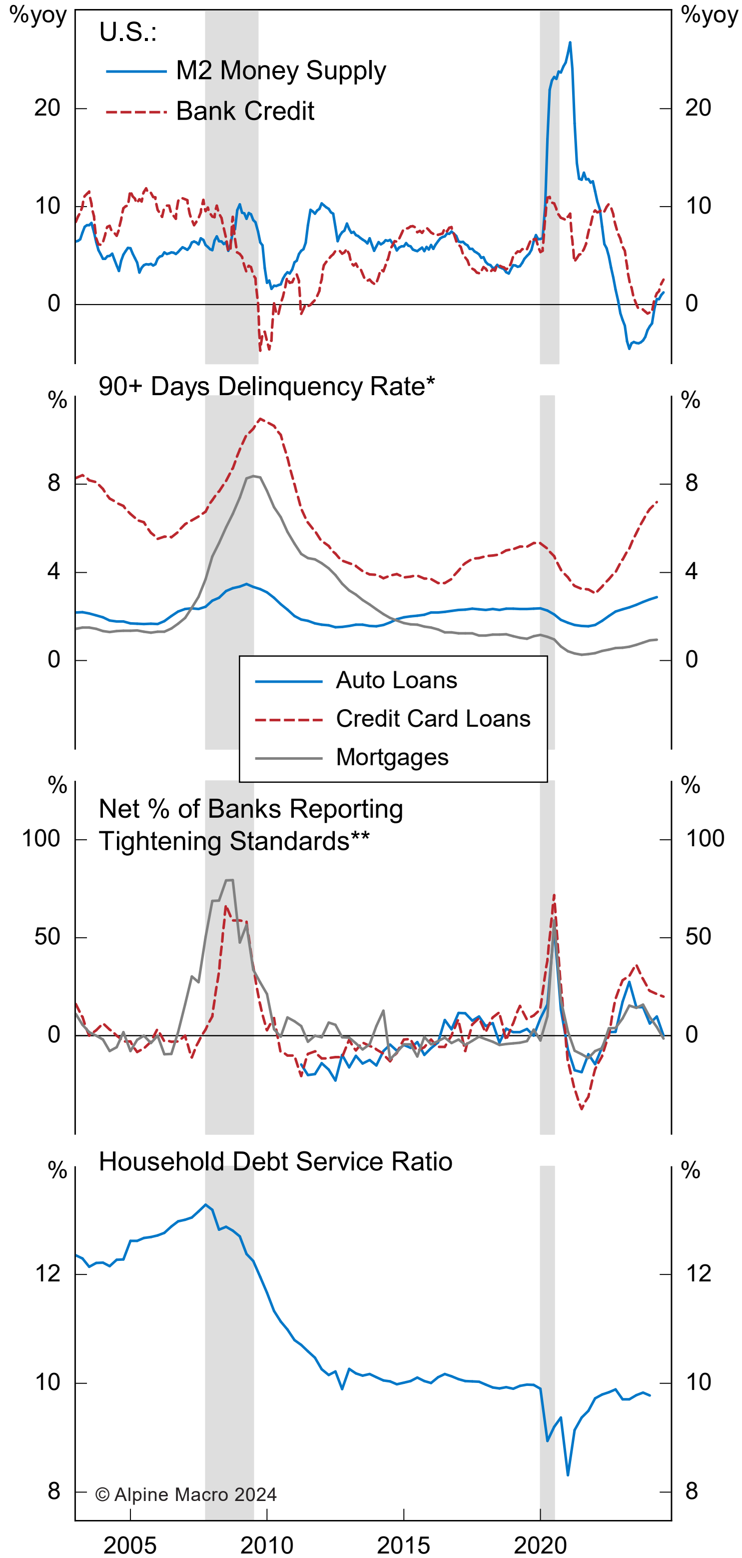
- **Stabilizing macro LEIs** (Chart 4): Most traditionally reliable leading indicators of recession gave false signals in 2023. Since then, however, they have gone sideways.

- **Unclear capital market LEIs** (Chart 5): Market-based macro indicators are mixed after correctly signaling no recession in 2023. The 10-year/2-year Treasury yield spread has disinverted for the first time in 26 months, while signals from stock/bond and cyclical/defensive ratios are unclear.

- **Steady financial system barometers** (Chart 6): M2 and bank credit are both expanding, though at a slower rate than during previous economic expansions. Consumer debt delinquency rates are rising sharply, but only in categories that carry floating interest rates. Mortgages (70% of household debt) are mainly at fixed rates. Banks have significantly slowed the rate at which they are tightening lending standards.

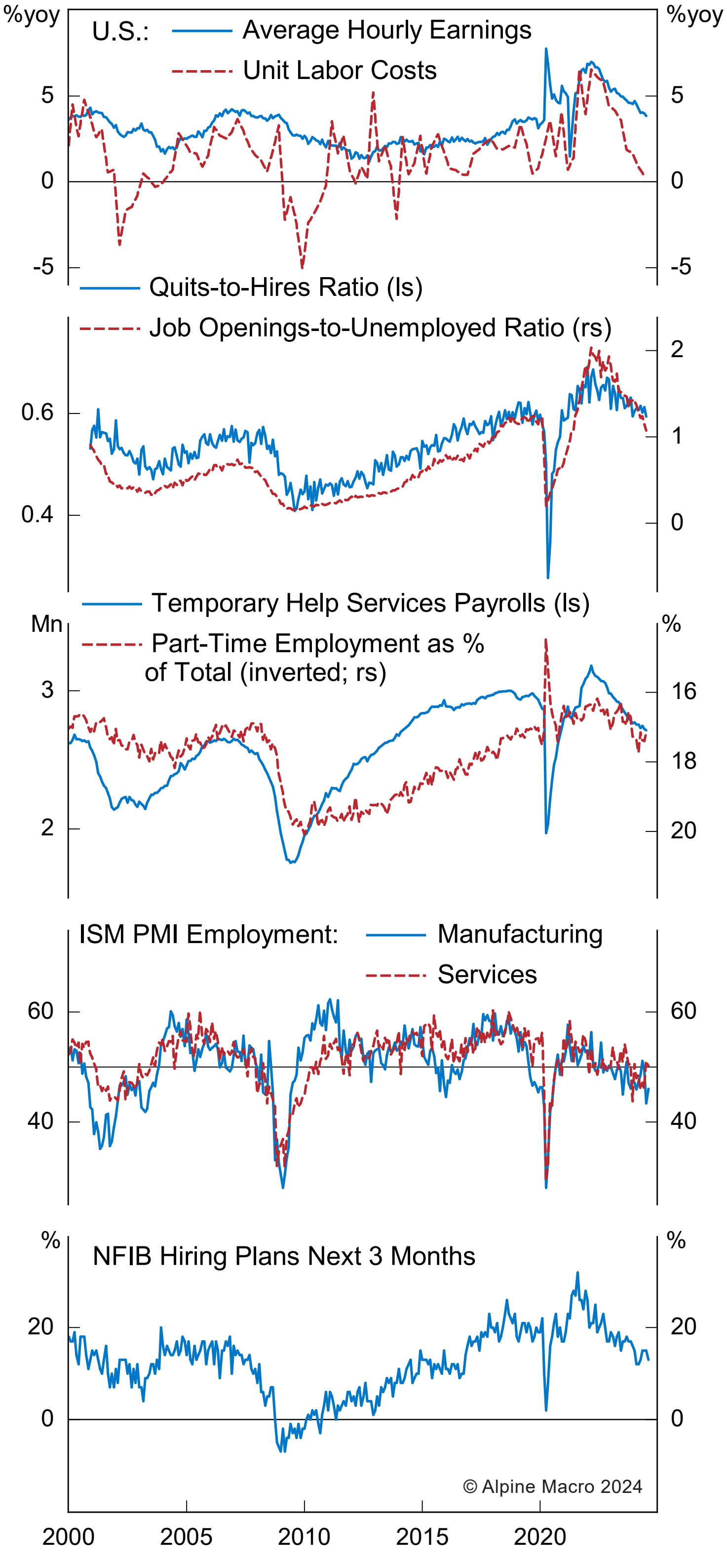
- **Labor market leading indicators** (Chart 7): All these indicators point to higher unemployment, consistent with recent nonfarm payrolls data. However, the pace of decline is moderating for some indicators, such as the ratio of quits-to-hires and the share of part-time employment.

Chart 6 No Warning Of Systemic Stress



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

Chart 7 Unemployment Headed Higher



At the same time, layoffs remain subdued as rising productivity and flat unit labor costs reduce the incentive of firms to slash headcounts.

Needless to say, all of these indicators need to be monitored in real time. Earlier Fed tightening will cause economic headwinds even after the rate-cutting cycle begins, given that monetary policy works with a lag. There will be days or weeks when economic data appears fully consistent with recession. Our July 19 *Special Report* ("Of Technical And Nominal Recessions: Lessons From 2022 And 2015") argued that a technical or nominal recession, as happened in 2022 and 2015, respectively, cannot be ruled out.

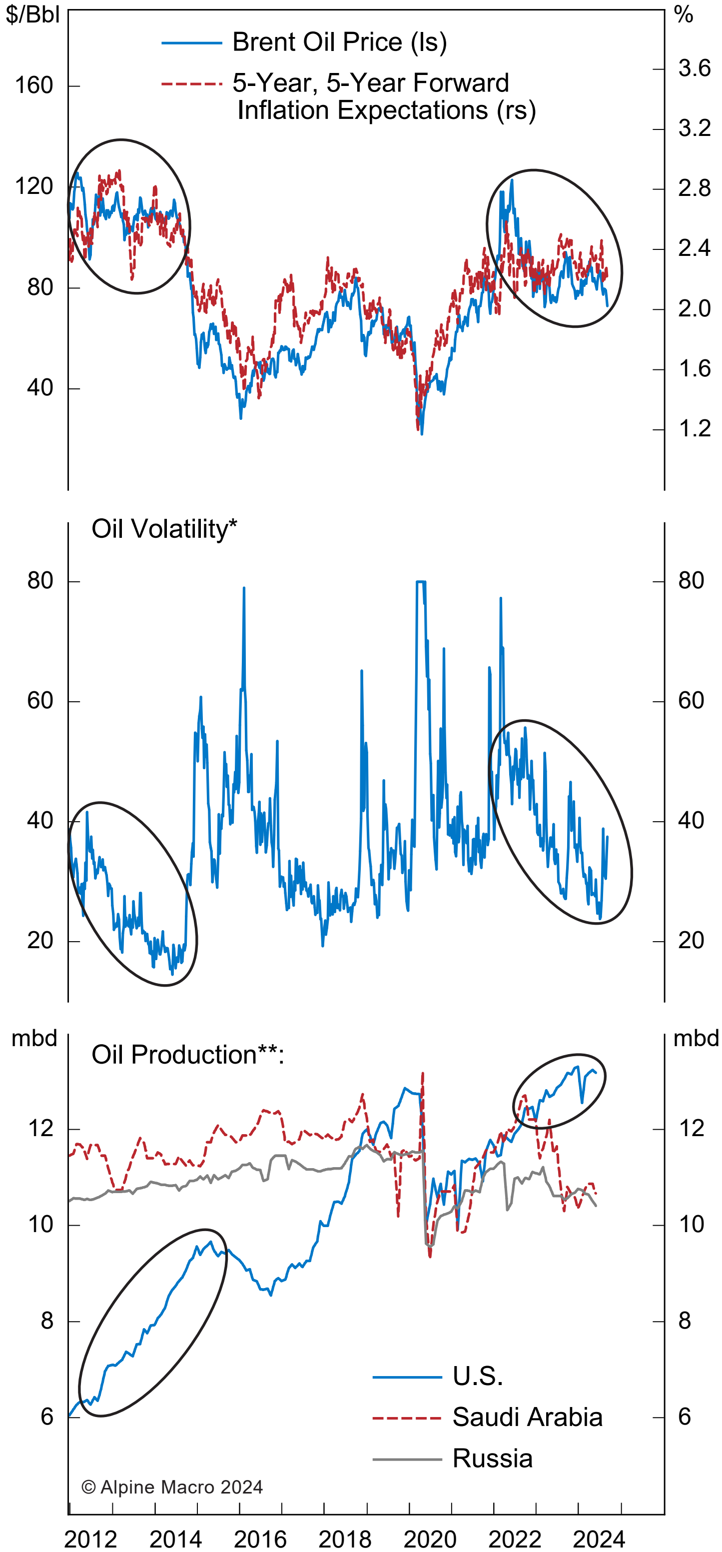
available on MDA

Nevertheless, the Fed has plenty of bullets and Chair Jay Powell made clear in the July 31 post-FOMC meeting press conference that rising unemployment is on their radar screen. This contrasts sharply with the "sour spot" the Fed faced in late 2021/early 2022, when a rotating economic recession began, but inflation was surging and real interest rates were negative.

Back then, the result was a brutal stealth equity bear market in "anything tech" and "anything small" as the Fed jacked up interest rates. Currently, the main concern of investors is deflation. Any signs that a recession will be avoided, even as the Fed cuts interest rates, would lead investors to increase risk exposure and leverage.

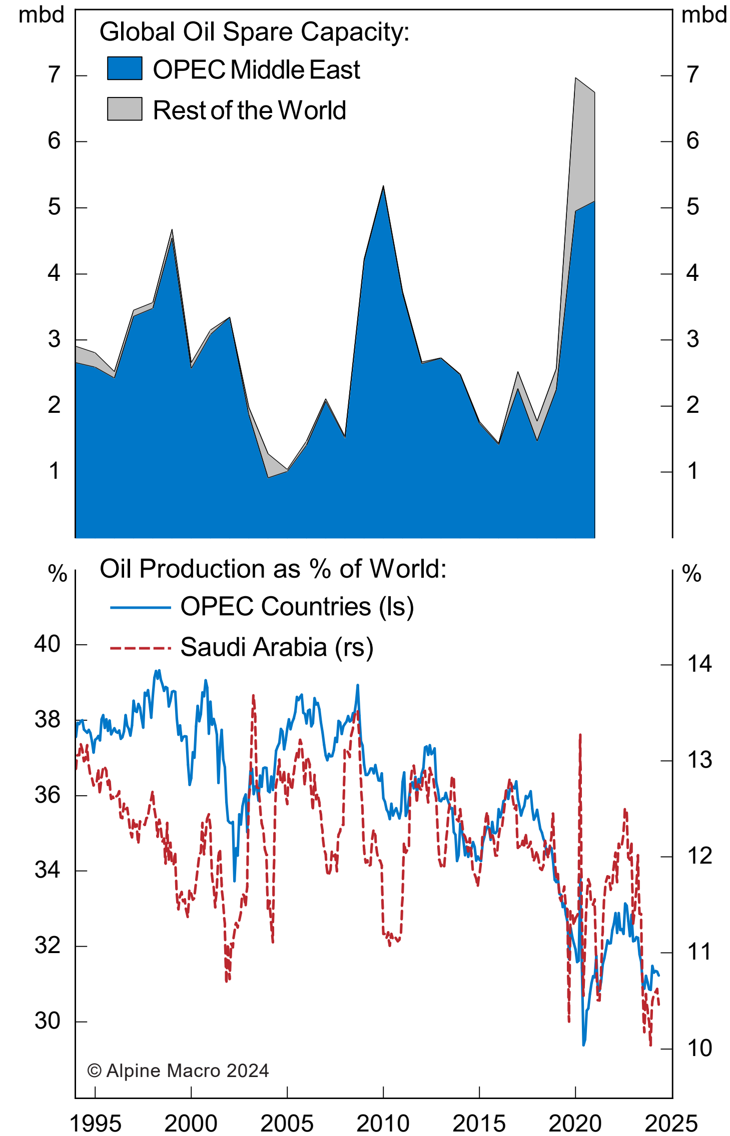
Oil will influence whether a deflation scare emerges, given its tight correlation with inflation breakevens (Chart 8). Even though we are medium-term bulls, ROW fragility warns that prices could go down before they go up. The "quiet" trading range amidst

Chart 8 Oil Similarities With 2014



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

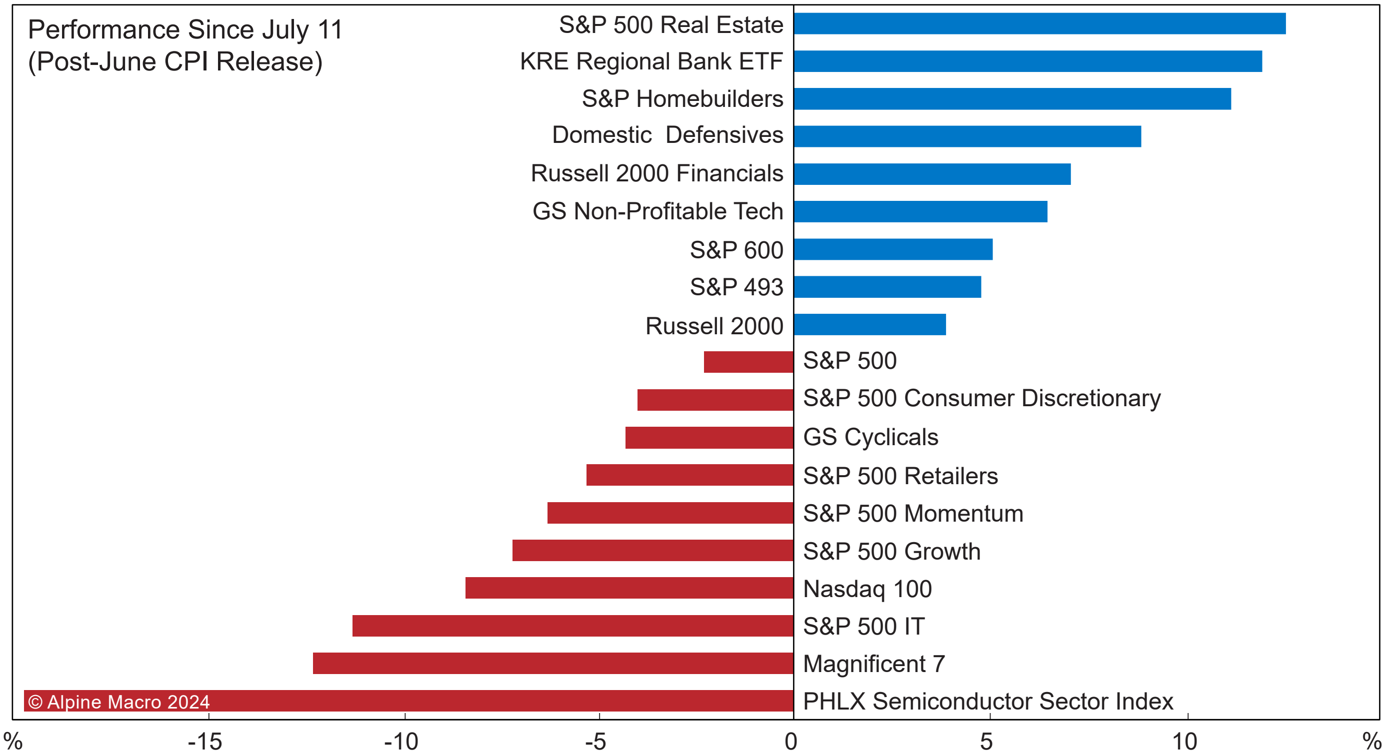
Chart 9 Plenty Of Excess Oil Supply



Source: EIA

rising U.S. production and soft Chinese demand shares resemblances with the period prior to the 2014 price collapse. At the same time, global oil spare capacity is elevated; the Saudi share of world production is at an all-time low; and Russia continues to pump oil to finance its invasion of Ukraine (Chart 9).

Chart 10 Early Cyclicals And Defensives Leading



Bottom line: The U.S. consumer should remain buoyant even though unemployment will rise further. Softer U.S. growth will undermine pricing power, especially if ROW weakness intensifies downward pressure on oil and traded goods prices. This leaves room for a deflation scare, but also gives the Fed massive room for maneuver.

Theme 2
Equity Market Dynamics

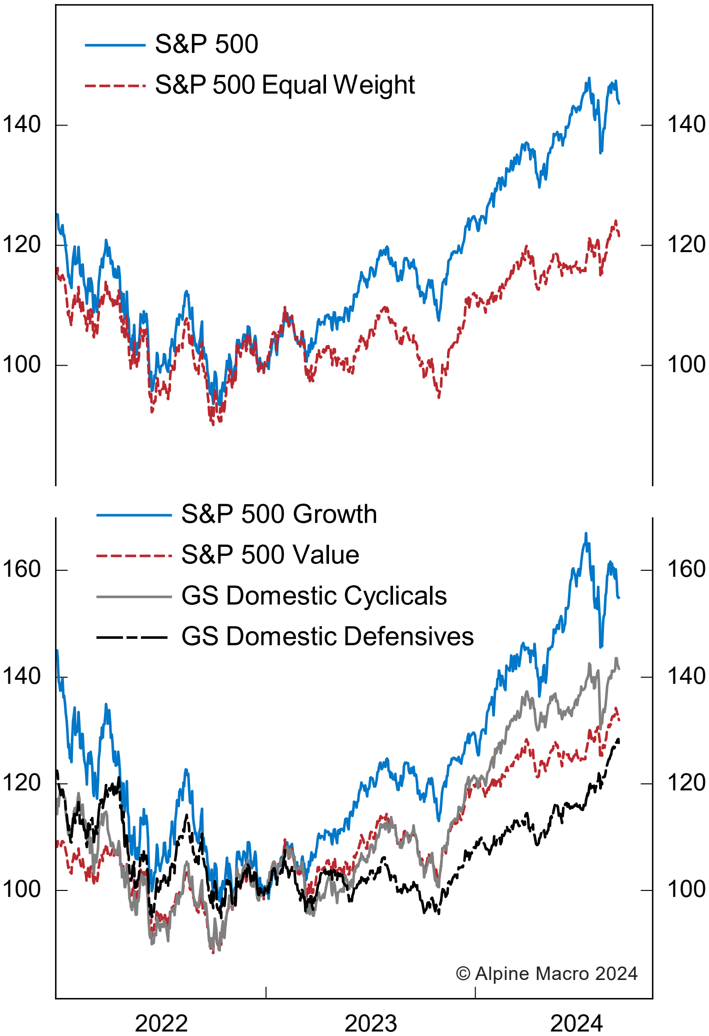
The equity bull has broadened, but also has become more volatile, especially at times when economic data surprises to the downside. However, since Mag 7 relative performance peaked on July 10, early cyclicals like banks and homebuilders have consistently outperformed, as have defensive sectors (Chart 10).

This is exactly the combination that should be expected in an overbought market facing a gradual economic slowdown with prospects for Fed easing. Our key assumption for equity strategy remains that there will be no severe recession or systemic financial stress.

The resulting equity investment strategy rests on four pillars:

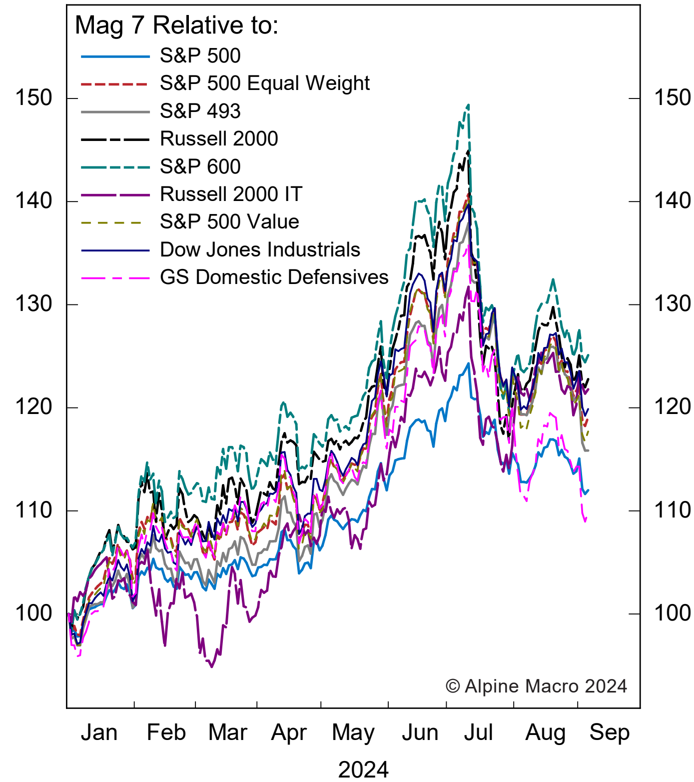
- The equity uptrend will broaden, not just measured by the number of stocks participating, but also in terms of sector and size. This fits with persistent relative strength in the equal-weighted S&P 500, as well as new highs in large cap value, and both cyclical and defensive domestic-oriented stocks (Chart 11). Recommended overweights include small cap quality, regional banks and biotech.

Chart 11 Equal-Weighted S&P 500 Outperforming



Note: All series are rebased to Jan 2023=100
Source: Bloomberg Finance L.P.

Chart 12 Mag 7: Round Trip



Note: All series are rebased to Jan 2024=100

- A bubble-like overshoot in the Mag 7 (and two "Obesity Big Pharma") stocks still cannot be ruled out despite their recent underperformance against "almost everything" (**Chart 12**). In fact, the selloff, despite solid financial releases, may well ingrain a "buy the dips" mentality similar to what spurred the tech mania of the late 1990s. Back then, vicious corrections quickly reversed as investors equated lower price levels with cheap valuations.

- It is too soon to "go global". Sectors such as basic materials and resources are not able to benefit from a weaker dollar because of soft demand in China and Europe that shows no signs of reversing (**Chart 13**).

- Strategy is more defensive than our baseline forecast would dictate. There is room for defensive sectors in equity portfolios, even though they would detract from overall performance if there is a perfect landing (see next **Theme**).

Bottom line: We continue to view the violent pullback in August as a correction, rather than a bear market. The bull market should broaden but it will also become more volatile as pricing power deteriorates.

Chart 13 Commodities And Materials Unable To Take Advantage Of Softer Dollar

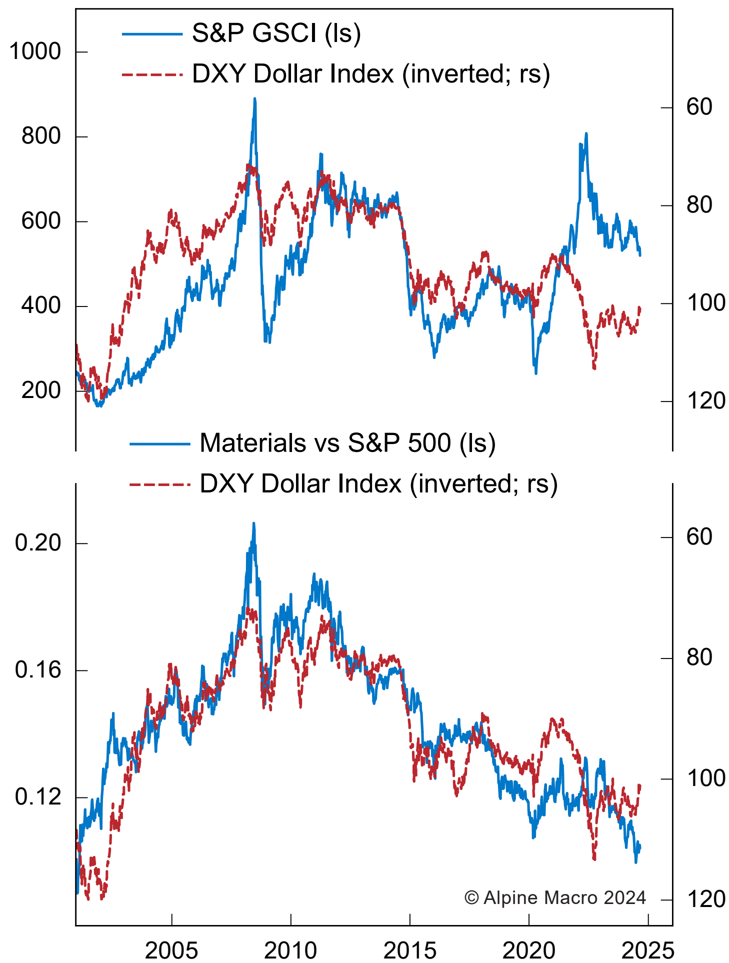
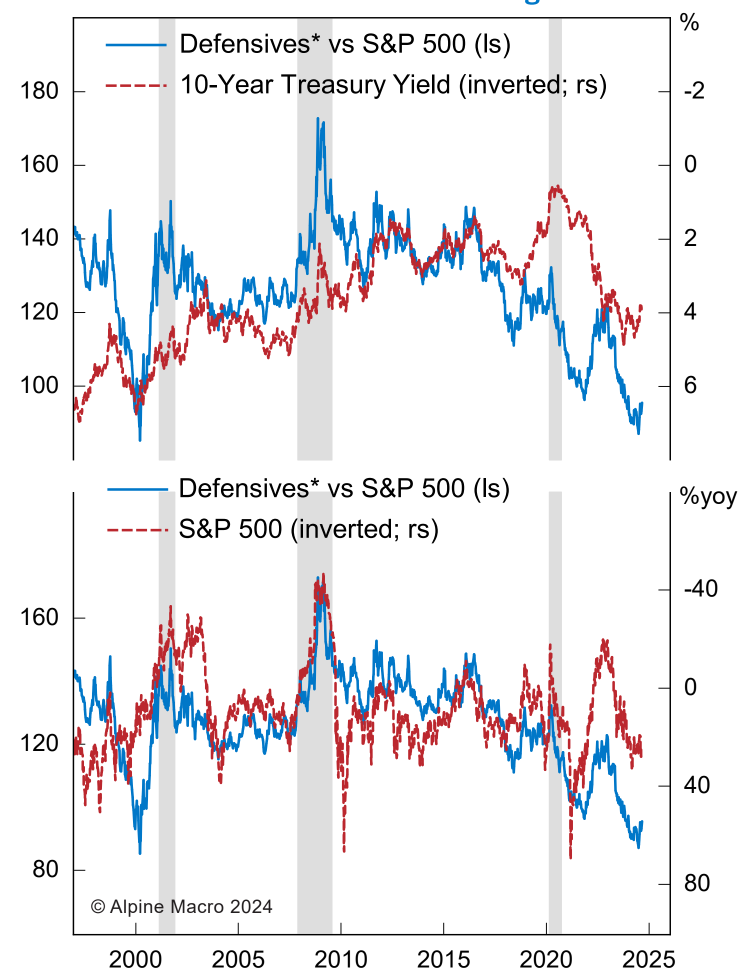


Chart 14 Defensive Equities: Valuable Deflation Hedge



*Average of healthcare, utilities and consumer staples
Note: Shading denotes U.S. recessions

Theme 3

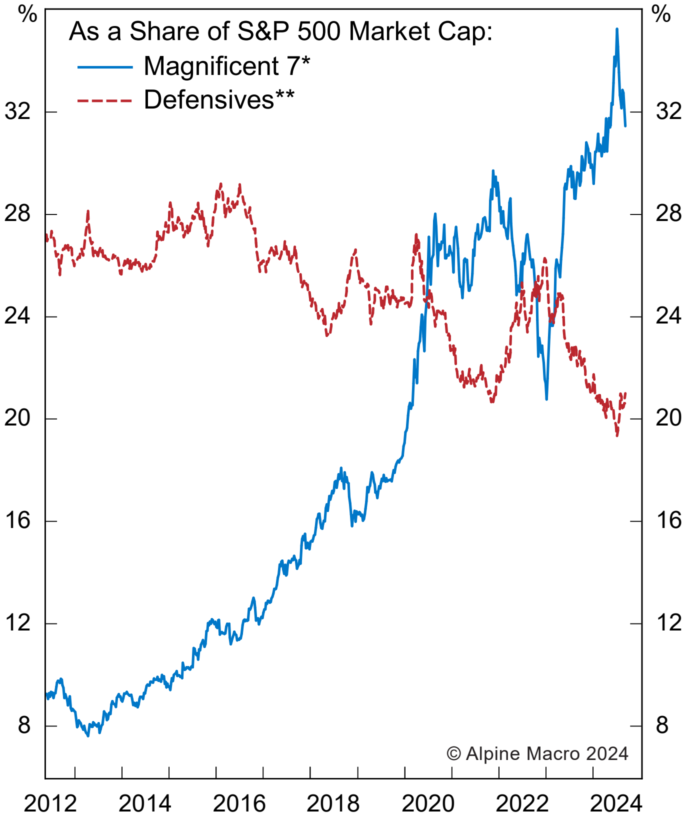
Bonds And Deflation Hedges

Long bond duration and defensive equities still have a place in investor portfolios. Granted, these assets would detract from overall performance under the Alpine Macro baseline forecast of a perfect landing. However, they will also cushion the downside under our main risk scenario of a mild recession and deflation.

Defensive equities almost always outperform in bond bull markets and/or equity bear markets (**Chart 14**). This time around, they will provide an added hedge in the event that the Mag 7 stocks are closer to a burst bubble phase than we expect (**Chart 15**).

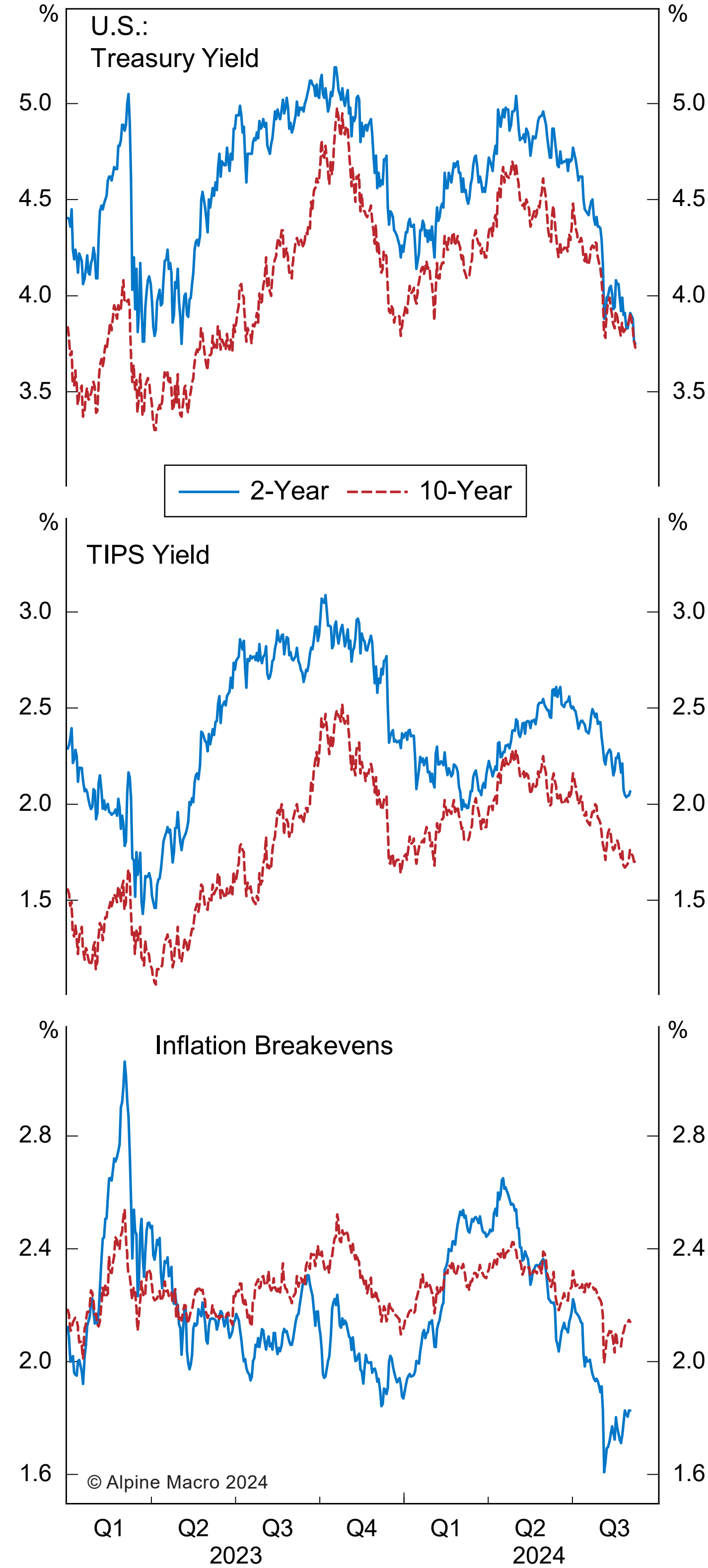
What about bonds? Our strategic bias is firmly on the long duration side, though we await a pullback to the 4.0-4.25% zone in the 10-year Treasury yield to make a tactical shift back to long from bench-mark weighting. We expect long duration to pay off over the next 6-12 months, even before taking into account the hedge value in balanced portfolios related to asymmetric deflation risk.

Chart 15 Defensive Equities: Valuable Mag 7 Hedge



*Apple, Microsoft, Google, Amazon, Nvidia, Meta and Tesla
**Consists of healthcare, utilities and consumer staples

Chart 16 TIPS Should Outperform Breakevens Unless Oil Plunges



In terms of the split between real yields and inflation breakevens, both have participated in the recent rally (Chart 16). However, with 240bps of Fed rate cuts already priced into the Fed funds forward curve by the end of 2025, a perfect landing is unlikely to cause a significant rally in either component (Chart 17).

Barring a breakdown in oil prices, TIPS offer more attractive capital gains potential than inflation breakevens. Chart 18 shows that 5-year/5-year forward inflation breakevens are in the middle of their range of the past 20 years (excluding the GFC), while 10-year TIPS yields are at the high end of this range. Consistent with this, research by our

Chart 17 240 Bps Of Fed Rate Cuts Already Priced In By End Of 2025

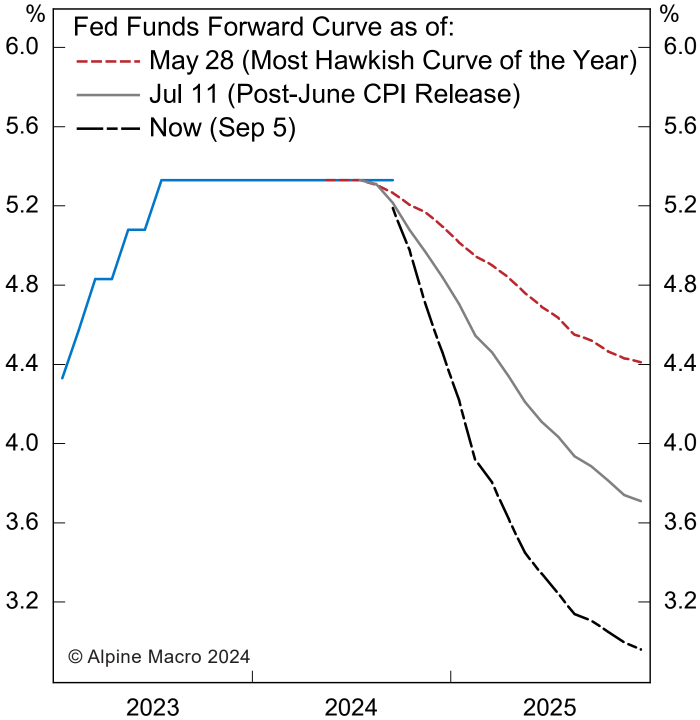
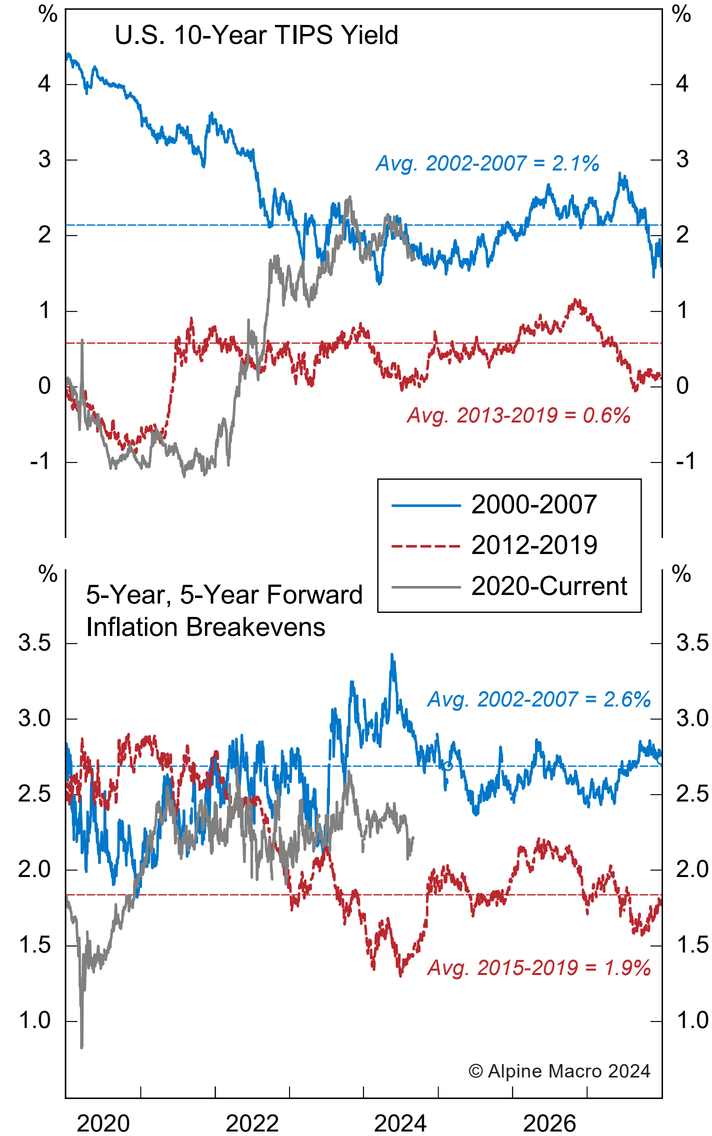


Chart 18 TIPS Yields At High End Of 20-Year Range



U.S. Bond Strategy team shows that in an economic slowdown/recession, the Fed tries to quickly lower real short-term interest rates, which in turn brings down longer-dated TIPS yields.[2]

Bottom line: Defensive equity sectors are attractive for risk management purposes as part of our recommended "barbell equity portfolio". We remain strategically biased towards long bond duration as the economy slows. Both inflation breakevens and TIPS yields have downside, even under our perfect landing baseline scenario, but the latter have greater potential for capital gains.

David Abramson

Chief U.S. Strategist & Director of Research

2 Alpine Macro *U.S. Bond Strategy* "Inflation Breakevens Or TIPS" (September 5, 2024).

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