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December 18, 2024

2024 Year End Review – Revisiting The Past Year's Thinking

I don't remember exactly when I started doing this "Year End Review" exercise, but I think the first edition was about 20 years ago during my Bear Stearns days. Needless to say, some years are easier than others to review, and we have seen all flavors of difficulty in recent years. In all honesty, we get a lot more out of this report than anyone reading it. It gives us an opportunity to review our thinking process and how it evolved over time. Worded differently, we learn more from what we got wrong than anything else. While it is easy to say, "*this was a difficult backdrop,*" the reality remains that there is never an easy one. It is almost always possible to add value from a macro standpoint no matter how unusual things may appear.

Portfolio Strategy Report Card For 2024

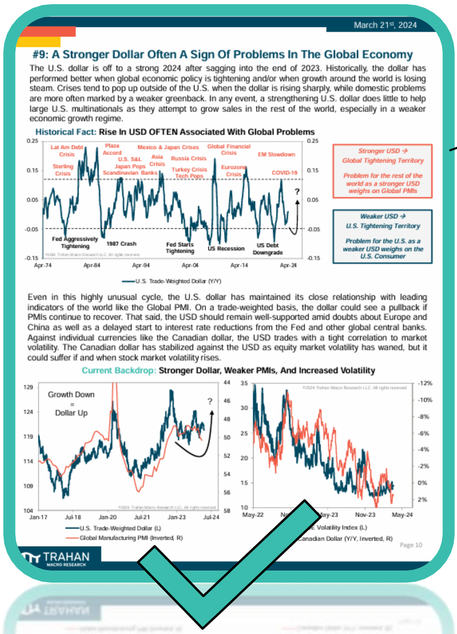
Theme	What We Said	Score
Currency	An Exceptionally Strong USD	✓
Labor Markets	Higher Unemployment	✓
Fed Action	Slow To Ease Policy	✓
Global	A Faltering Recovery In China	✓
Fixed Income	Overweight Bonds	=
Factor	Large Size, High Quality, U.S. Centric, Low Beta	=
Sector	Overweight Utilities & Underweight Growth	=
U.S. Economy	A Recession In H2 2024	✗
S&P 500	Bear Market Due To Declining EPS	✗

Our biggest wins of the year as I see it are the overweight recommendation in Utilities (a common occurrence at a peak in the fed funds rate), and our highest conviction call for 2024 – a call for a stronger U.S. dollar and U.S.-centric leadership. We also did a good job being skeptical of China's recovery, which was all the rave early in the year. We expected a currency devaluation (just starting to be discussed now), but the Chinese authorities opted for a stimulus bill mostly focused on bailing out provincial coffers.

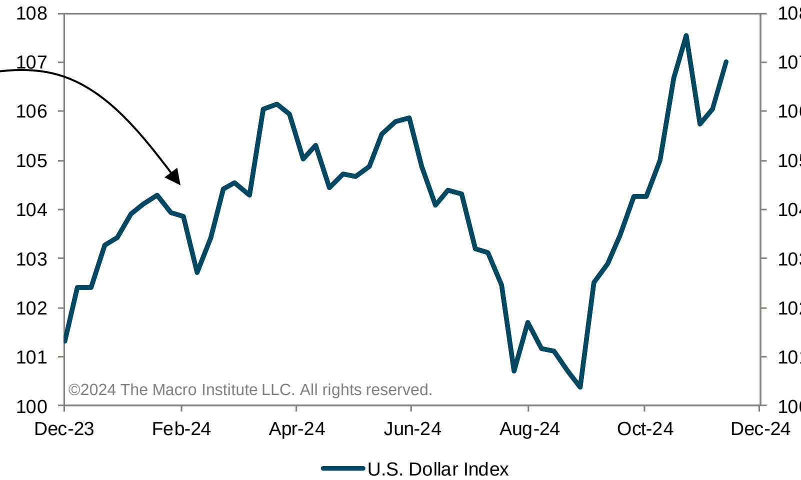
We were most surprised by the resilience of the U.S. economy in the wake of the Fed's tightening cycle. While earnings dipped lower in smaller and more cyclical indices like the Russell 2000, it was short-lived, and EPS never budged in the S&P 500. It's not unusual for stock prices to move higher at a peak in the fed funds rate, but that rally usually comes with an expiration date, which never happened this time around. There were extraordinary circumstances explaining this and we will cover these in detail in the back part of this report. We hope you find this exercise enlightening. Wishing you a great day. Best, Francois

A Stronger Currency & Weaker Labor Markets

We will spend the bulk of this report reviewing why the U.S. economy bucked our expectations in 2024, but before we tackle this year's mishaps, let's first begin with what we got mostly right. The call for a stronger U.S. dollar is what we hailed as our highest conviction call back in January. The reasoning was simple – the rest of the world's central banks would be quicker to ease policy considering they typically place more emphasis on headline inflation versus the Fed's focus on core inflation. The latter is an official lagging economic indicator, which helps explain why the Fed is often late in changing policy settings.

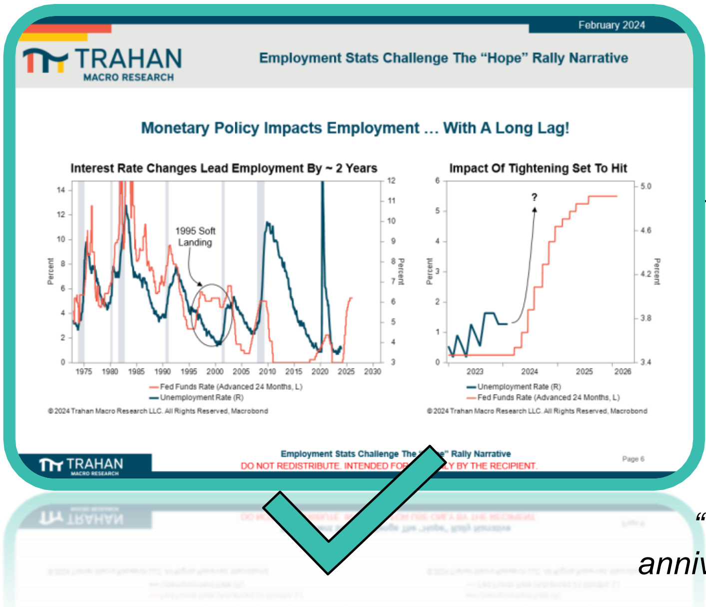


The Trade-Weighted Dollar Sits At This Year's Highs

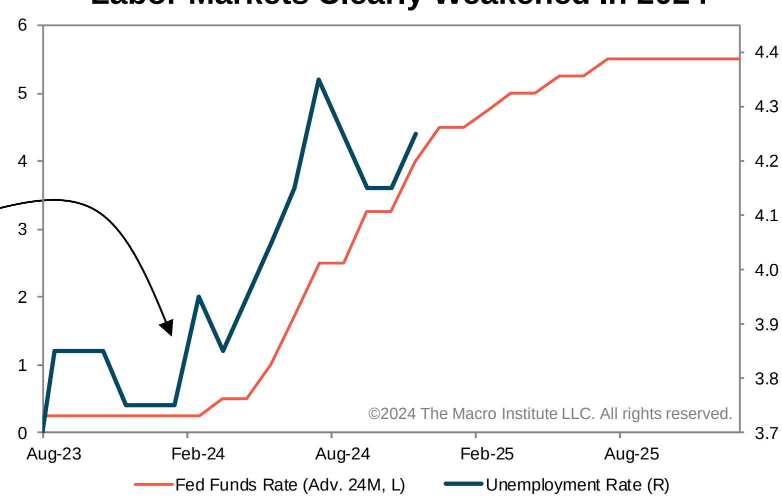


"The USD should remain well supported amid doubts about EU and China as well as a delayed start to interest rate reductions from the Fed."
– TMI March 2024 Report

One thing we got right about the U.S. economy this year was labor markets. Housing remained under pressure as we expected, but it is a tiny share of the economy that is often a rounding error for GDP growth. Labor markets are a different story, however, as it is difficult to find periods where the unemployment rate trends higher without a simultaneous slowdown in GDP growth. Yet, that is what we saw in 2024. We will get to the exceptional part of this story, the why, on page 7, but it's important to point out as we head into 2025 that many leading indicators of labor markets, even those that looked troublesome earlier in the year, now look more constructive as the year ends.



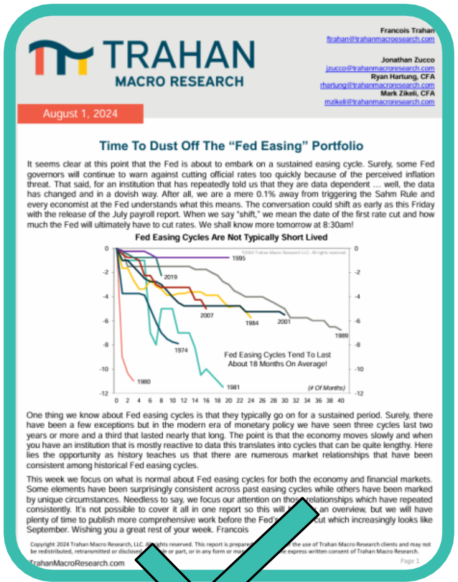
Labor Markets Clearly Weakened In 2024



"We are at the beginning of the two-year Fed tightening anniversary, the story should start to change on labor markets."
– February 2024 Voiceblast

A "Slow" Path To Fed Easing & A Lackluster Global Economy

I don't think anyone will be offended by the chart title below, as the Fed is typically slow in changing its tune on monetary policy. Some of this is explained by the fact that the institution places more emphasis on core inflation than other central banks, and core inflation is a slow-moving variable. After all, Services CPI is one of the Conference Board's official lagging indicators. The peak in the fed funds rate we just experienced was the second longest on record (the one preceding the GFC was a month longer). We believe the Fed will change its tune again in 2025, but that is a topic for our Outlook due out on January 6th.



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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 thos relationships which have repeated consistently. It's not possible to cover it all in one report so this will … an overview, but we will have plenty of time to publish more comprehensive work before the Fed's … cut which increasingly looks like September. Wishing you a great rest of your week. Francois

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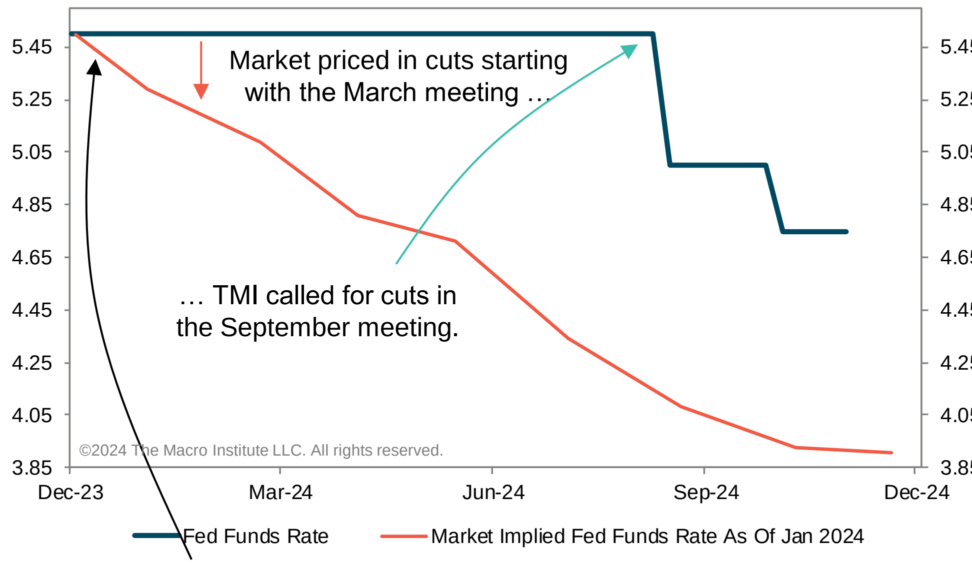
The Fed Was Slow In Changing Its Policy Stance



"When Fed Cuts Come, They Won't Be Early."
– January 2024 Outlook Call

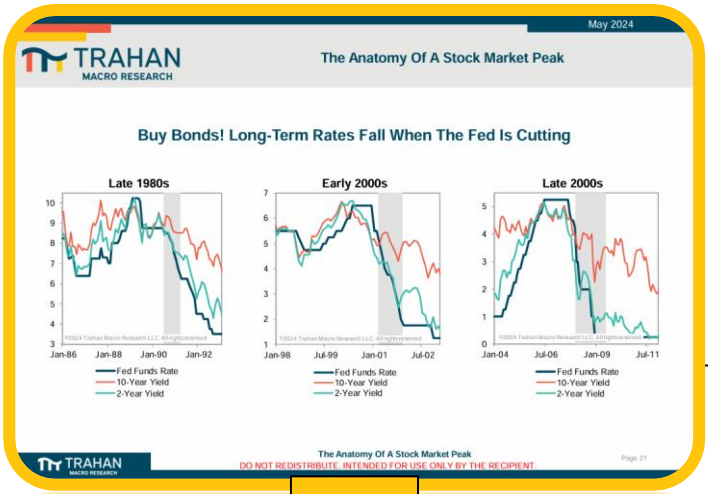
There is plenty to discuss on the international front, but our worries have been focused on China in recent years. The country's investment-driven economy, faced with loads of excess capacity, is not an easy situation to address and is ripe for policy mistakes. We figured out early on that the government would have to provide stimulus, and frankly, we expected more. There is a limit to how much stimulus one can provide before the bond vigilantes step in (remember the U.S. in September 2022?), and we thought that the authorities would favor a currency devaluation (especially with inflation so low). We think it is still coming.

A Devaluation Coming Soon For China?

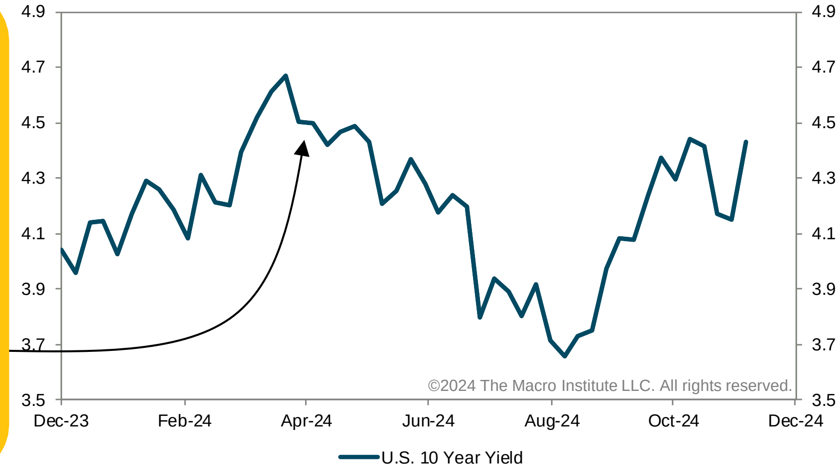
"Devaluation is going to be one of the only tools on hand they can turn to."
– July 2024 Voiceblast

Bond Yields Barely Lower & Utilities Surprise Investors

Bond yields typically move lower when the Fed is easing policy, that much is clear. So, this call did not feel out of consensus given the Fed's clear trajectory toward rate cuts earlier in the year. Still, we expected yields to end 2024 far lower than this. To be fair, it's not unprecedented for bond yields to move higher in the month or two after the Fed starts to cut rates, and in the context of the elections and the recent surge in economic surprises, it doesn't feel too unexpected. Again, this is a topic for our Outlook 2025 report, but we do see a path to a resurgence in inflation come 2025. This could be also playing a role here.

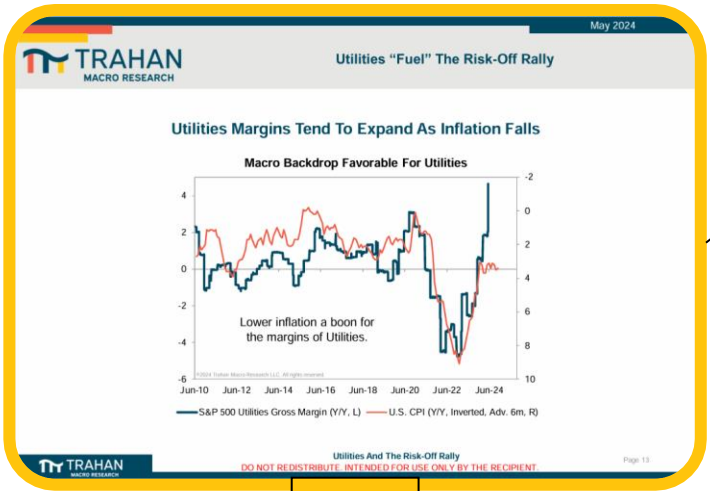


Bond Yields Lower BUT We Expected More

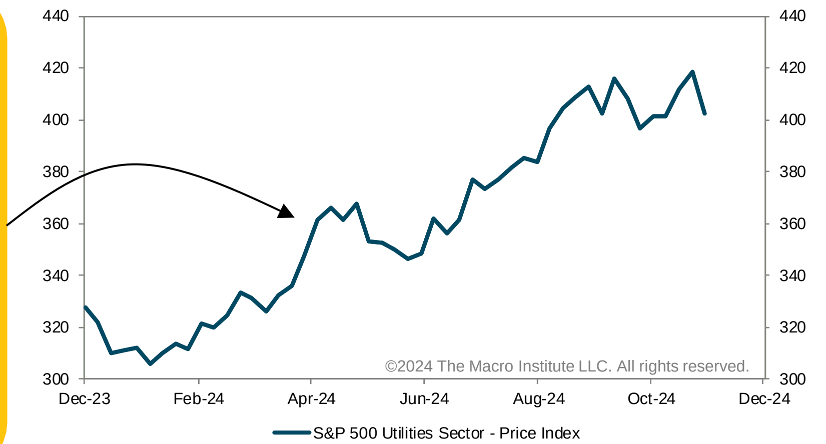


"Buy Bonds! Long-Term Rates Fall When The Fed Is Cutting."
– May 2024 Voiceblast

There comes a time at a peak in the fed funds rate when sector leadership turns more defensive, and Utilities finally get their time to shine. While this is not all that unusual, it was still hard to convince investors that this was in play in 2024. Let's face it, Utilities are a small sector and not nearly as exciting as other segments of the market (like Tech!). So, to see Utilities do well was not surprising, but to see them lead the overall S&P 500 as the index was RISING is very rare. It happens from time to time, but investors usually turn to Utilities as a relative play when they are concerned about the overall market. We suspect leadership will change in 2025 and we will expand on this in coming reports.



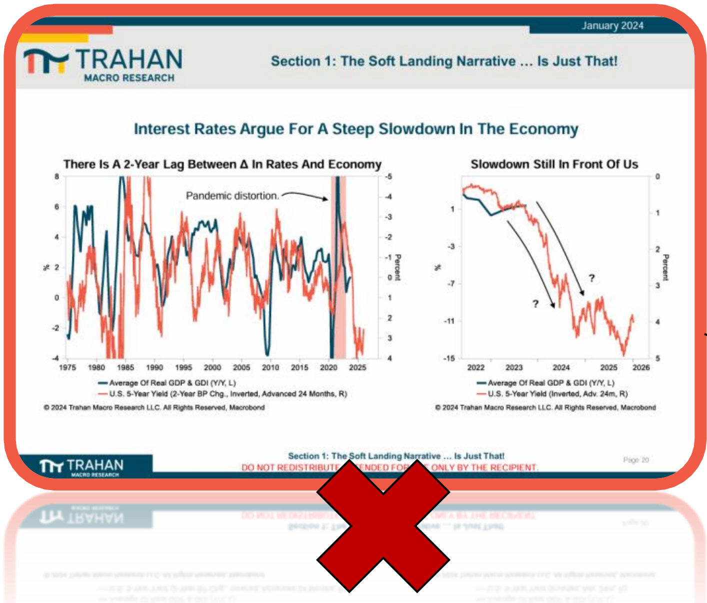
Utilities Biggest Sector Surprise For Investors!



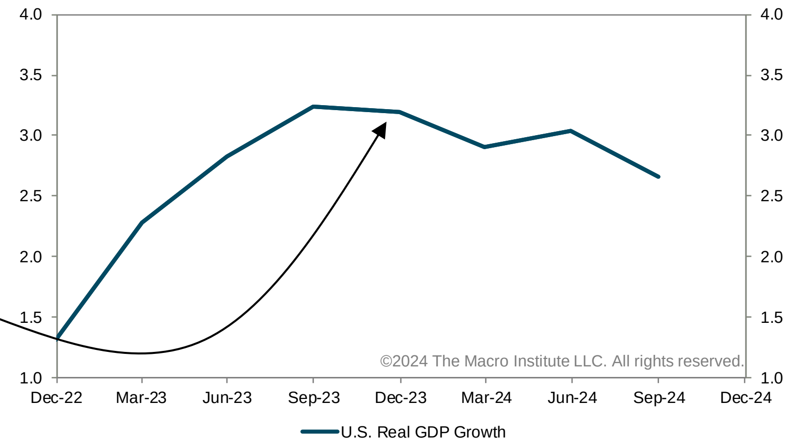
"This is a friendly operating environment in 2024 for Utilities."
– May 2024 Voiceblast

A Surprisingly Resilient U.S. Economy Keeps Earnings Afloat

Ok, surely not everyone was “surprised” by the strength in the U.S. economy as many expected a soft landing. On page 7 we will discuss exactly what helped the economy buck the traditional economic downturn typically seen in the wake of Fed tightening. Needless to say, we expected a bigger downturn than what occurred, but most of the arguments of the soft-landing proponents are not exactly on point. Our biggest concern earlier in the year was that industrial production, usually the most accurate data point near inflections in the cycle, was already low and following past patterns in interest rates.



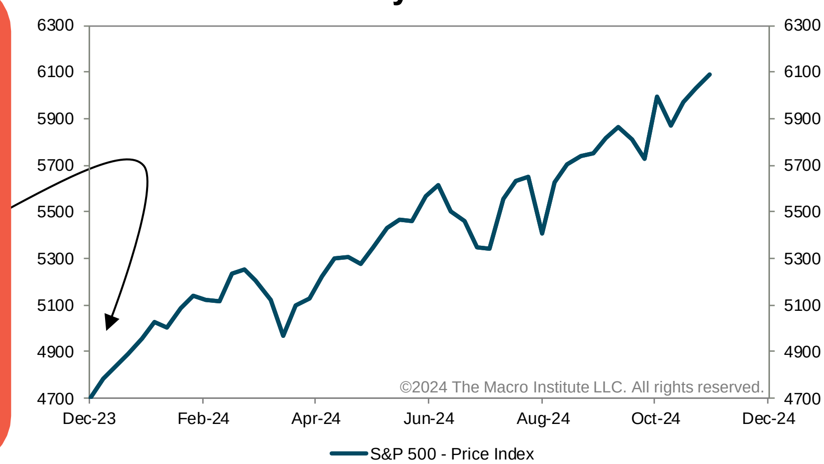
U.S. Economy Slows VERY Slowly!



“The clock is ticking on a recession in 2024, and our starting point is not very good.”
– January 2024 Outlook Report

A brief recap: we expected the U.S. economy to slow more significantly than it did, and this was likely to put downward pressure on earnings and ultimately engineer a more-or-less classic bear market in equities as the Fed eventually eased policy. We are not surprised that the market went up earlier in the year – it always rallies after the Fed is finished raising rates, so that part is quite normal. The shift in sector leadership toward Defensives that took place in Q2 is also fairly typical. The part that is missing is the decline in earnings that simply never happened. Now, part of that is explained by the Growthier nature of the S&P 500 nowadays (Russell 2000 EPS were lower for a while), but also by the resilience of the U.S. economy. More stable earnings certainly helped, but growing revenues was the more important aspect (said with hindsight).

A Fed-Relief Rally That Never Ended …

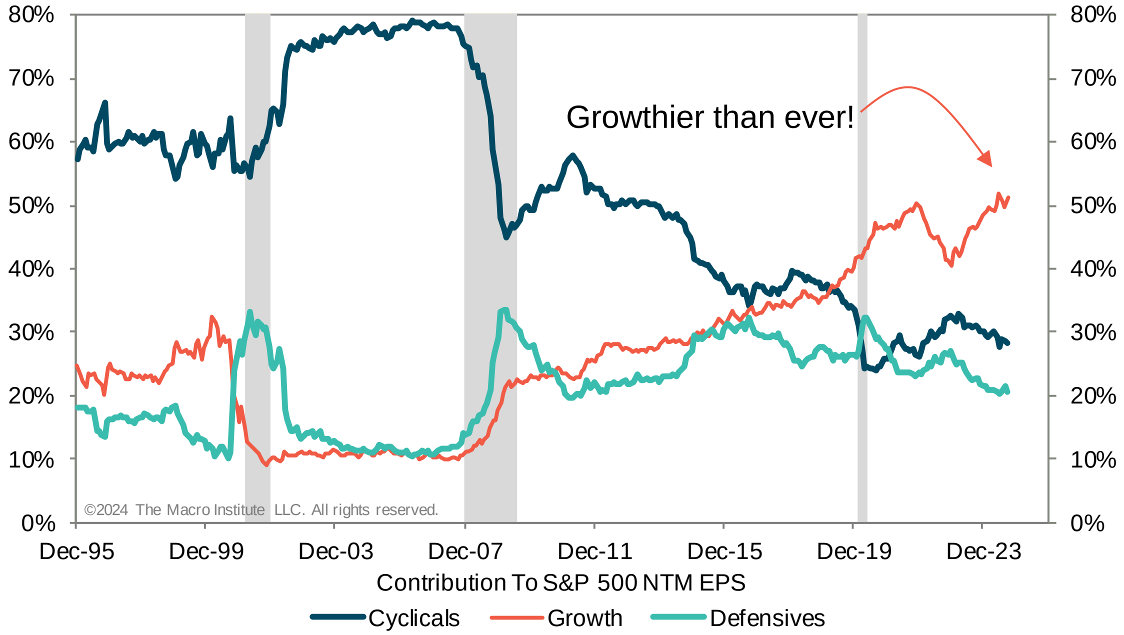


“We are bearish on equities for 2024.”
– January 2024 Outlook Report

The Current Composition Of S&P 500 Earnings Unique Historically

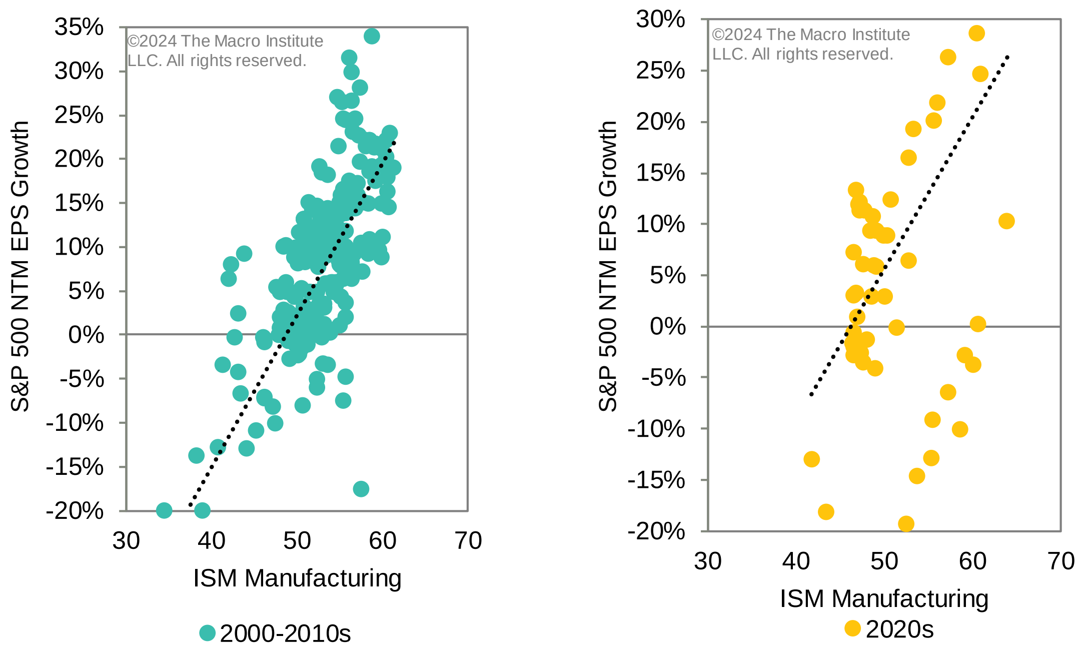
Ok, so there are two main reasons behind the performance of the S&P 500 in 2024 (i.e., higher despite the Fed easing policy). The first one is the composition of the S&P 500 itself and its growth bias specifically. We clearly knew about this one so in this case we must admit we should have made a bigger deal out of it. After all, we made a huge stink about this very point in our 2022 Outlook when we pointed out that the uniqueness of the S&P 500 would alter traditional relationships. It did in 2022 and AGAIN in 2024!

An Historical Anomaly … Growth Accounts For Over 50% Of S&P 500 EPS



Many people highlighted the gap between LEIs like the ISM Index and the S&P 500's performance. Some have even said that the ISM no longer works?!? It still works, it just works differently because of the nature of the S&P 500 today. We used to worry about weaker S&P 500 EPS when the ISM hit 50-ish, but the Growth-ier Index now requires an even lower ISM reading before we see EPS truly weaken. The reality is that we barely got there in 2024. More on that in the coming pages.

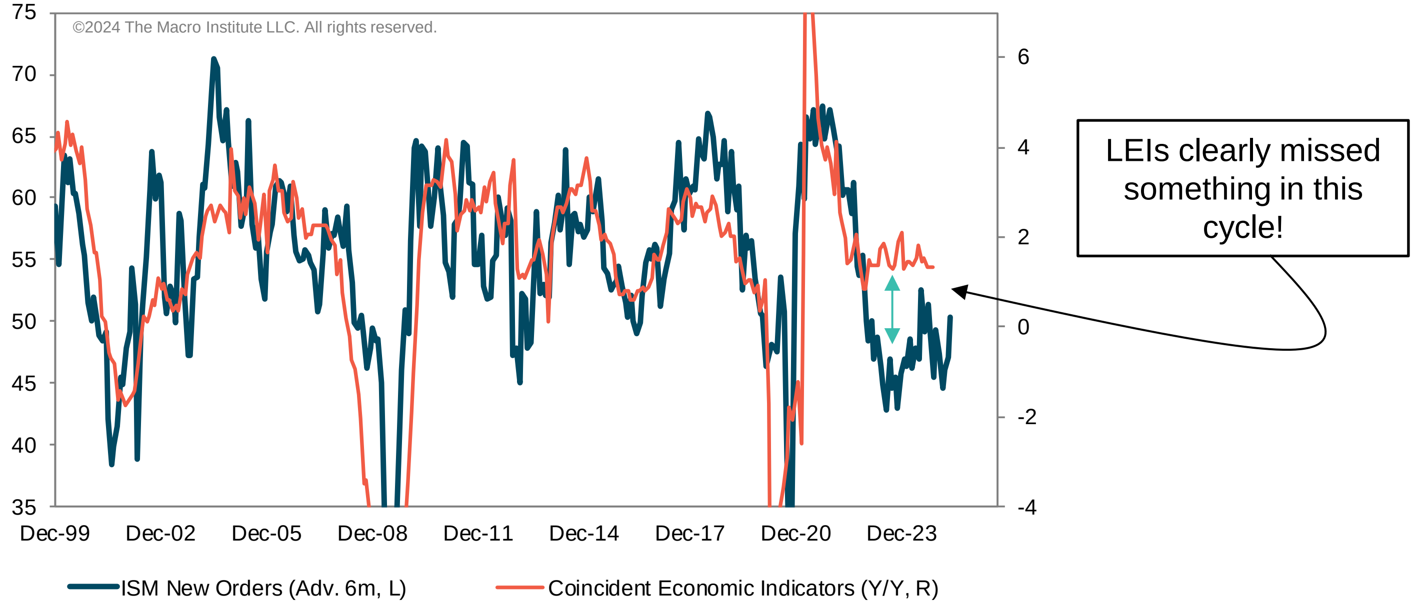
ISM / EPS Relationship Has Changed Alongside S&P 500 Composition



An Unusually Strong Economy In The Wake Of Fed Tightening

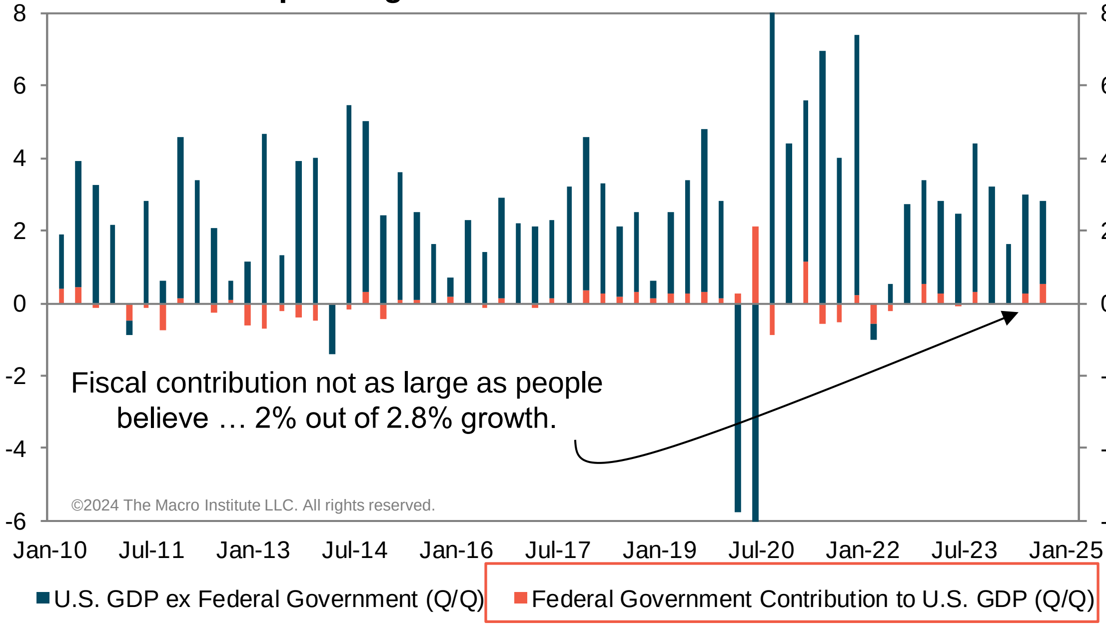
Yes, it was an unusual cycle, but all cycles are in some way. In virtually every cycle of the last 60 years there was always something unique that investors can identify. We were clearly wrong on this one and our own post-mortem taught us a lot. Interestingly, some of the causal explanations behind the economy's performance are not part of the soft-landing narrative so some of those folks got the right call but perhaps not for all the right reasons. Irrespective, it has been a strange cycle on many fronts but there are some influences that we should have seen coming.

LEIs Clearly Not Capturing All Influences In The Economic Cycle



When asked about why they expected a soft landing, most investors will say "fiscal stimulus" and point to the size of the deficit to help explain why the economy performed well. This is misguided in our opinion. Interestingly, the contribution of government spending to economic growth has been pretty average, all things considered. Surely, the deficit is wide but much of that is structural in nature so we can't assume that this is stimulative. The bottom line is that the story of U.S. economic performance in 2024 is a little more complicated than just "government spending" and has a lot of moving parts.

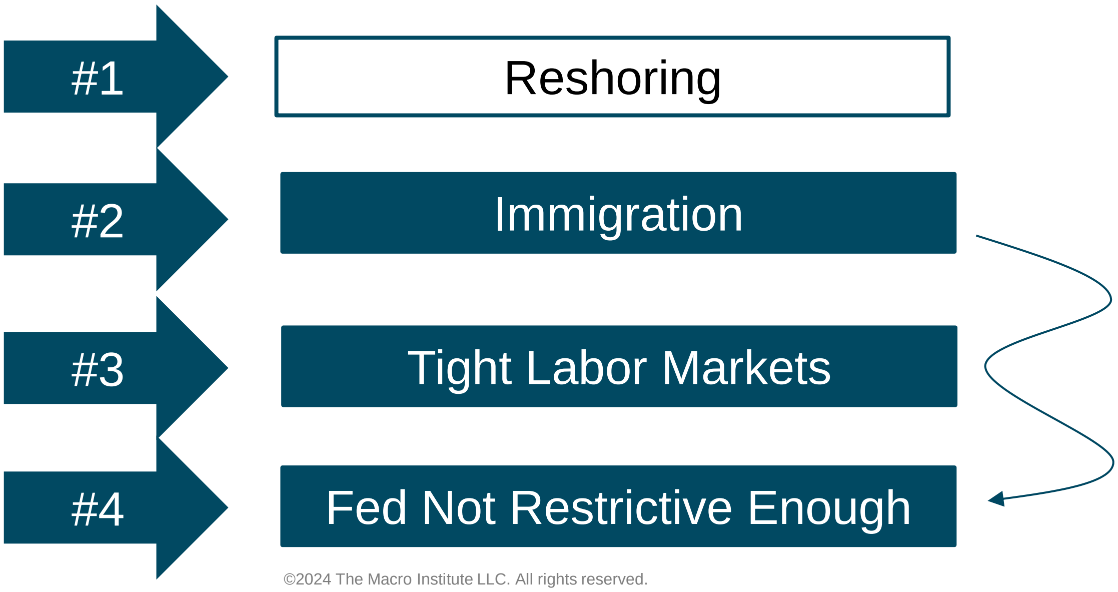
Government Spending NOT As Stimulative As Consensus Believes



An Unusual List Of Economic Influences In 2024 Set To Matter In 2025

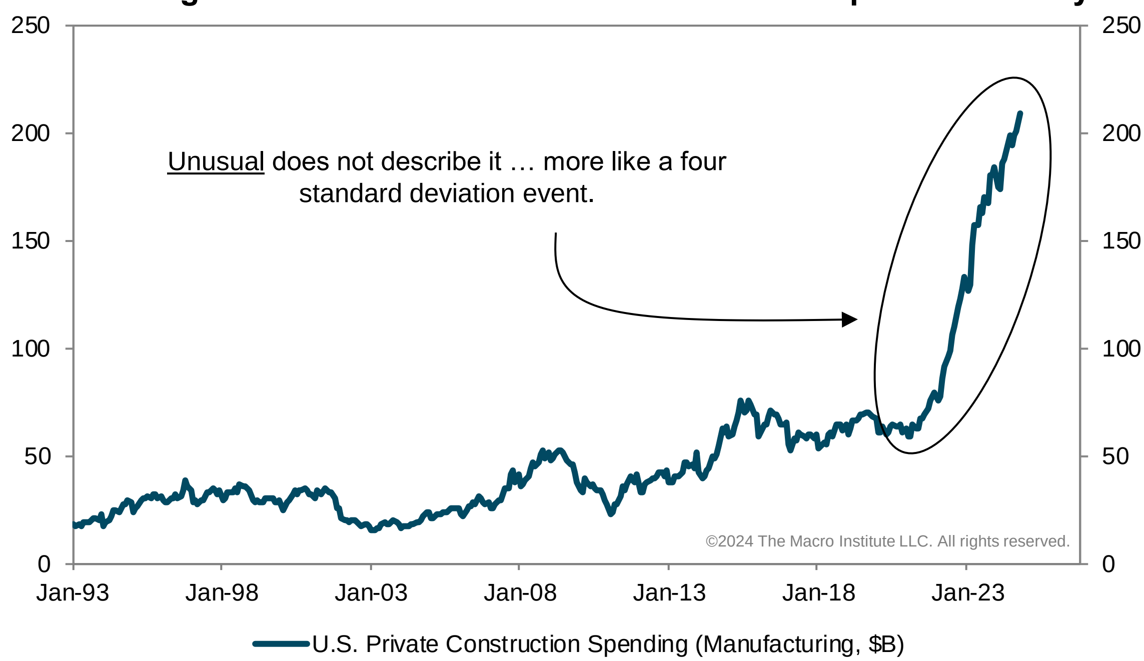
While every cycle has unique aspects, it's rare to see those peculiar features completely alter the end game. In that sense, this is the type of cycle investors remember after the fact, given that it did not follow the typical playbook. It's important to acknowledge that there are a lot of moving parts to the economic story of 2024 – we cover what we believe are the most important pieces of the puzzle, but this list is hardly exhaustive. Join us for more on this topic on our Outlook 2025 call set for Wednesday, January 8th at 10:30am (register here).

The Major Influences Explaining Economic Performance In 2024



There are a lot of strange looking charts in this cycle. Some of this should not be surprising given how unusual the pandemic downturn was and the ensuing recovery. Moreover, the Fed's delayed reaction to the surge in inflation in 2021 also led to some weird looking relationships. The one 4-standard deviation event, however, is the explosion in Private Construction Spending. You don't need an econometrics degree to see that this one is a little different than normal. The hard part is modeling this into a GDP forecast as it is truly unprecedented. You know it's there but pinning exact numbers to it is "back-of-the-envelope" at best.

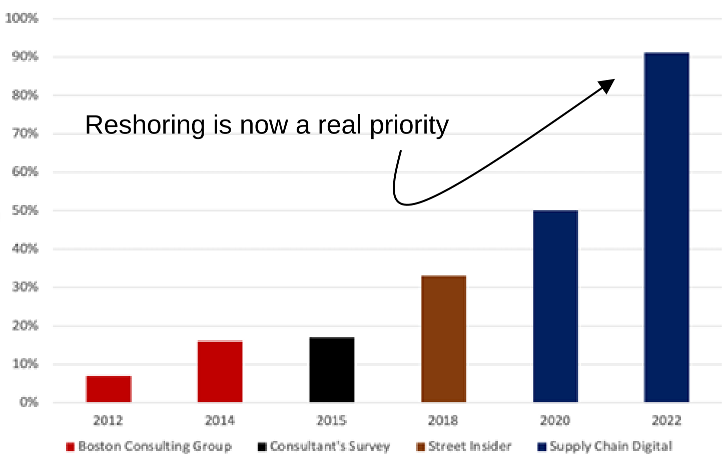
Reshoring Has "Recession Proofed" Private Consumption In This Cycle



Reshoring Altering The Typical Fed-Tightening Economic Playbook

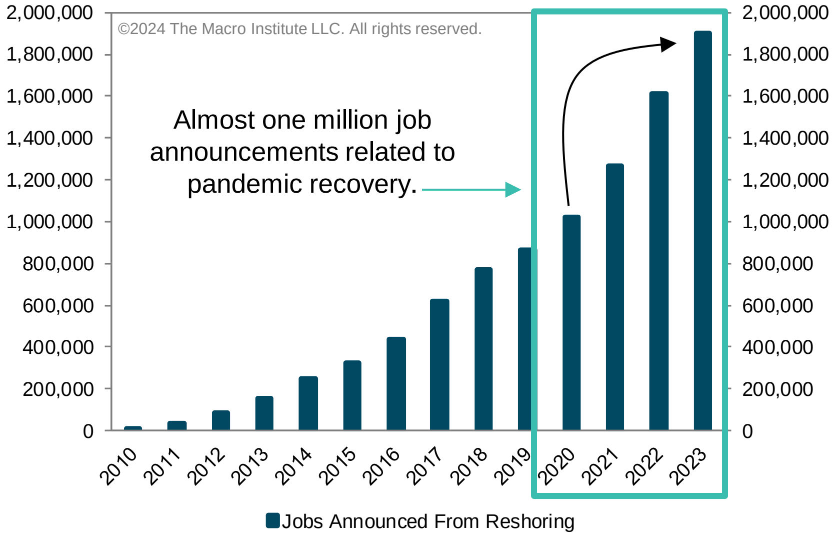
It's pretty clear to us that reshoring WAS and WILL be an influence for some time. It's not like we did not know this was happening … quantifying the phenomenon is the challenging part, and we have not seen anyone do a convincing job on it (please let me know if you have). After all, 90% of companies surveyed claim to be reshoring already or about to do it, and we have seen almost a million jobs attributed to reshoring in recent years. In essence, this is an ongoing trend that does not end with 2024.

90% Of Companies Already Reshoring …



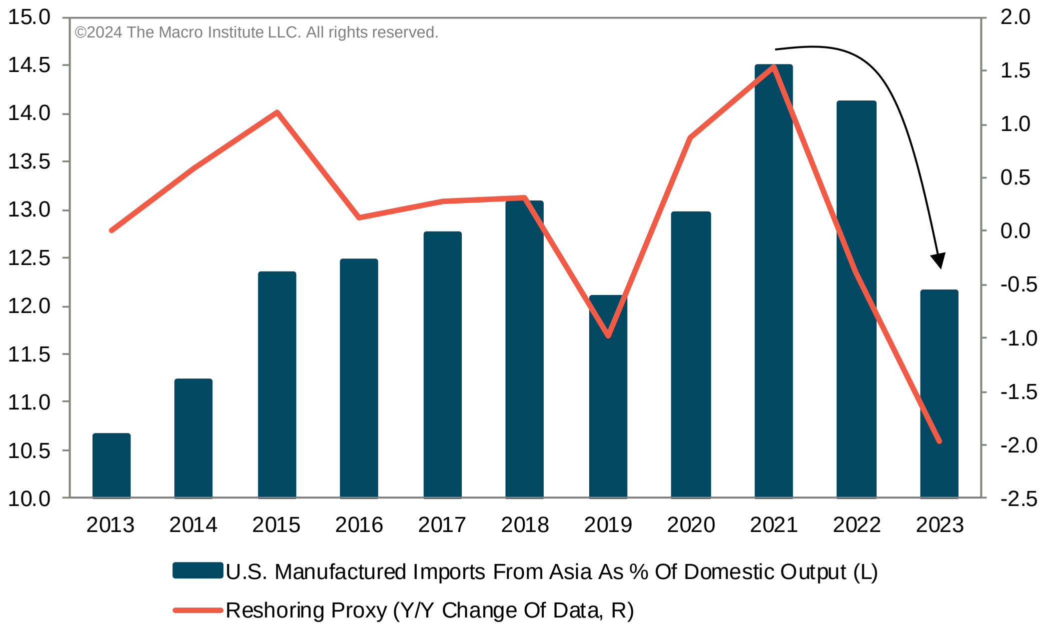
Source: Reshoring Initiative

… And Creating Jobs In The U.S. Economy



It's hard to find data on reshoring because it is not a common occurrence. It is a structural trend that surfaced after a series of events, but it is simultaneously having a cyclical effect. The Kearney Institute has some intriguing data on the phenomenon. The chart below shows their "reshoring proxy" and how it has soared in recent years to a degree we have never seen, at least not in the era of globalization and free trade. Interestingly, this reshoring has coincided with a decline in imports from Asia, so this has clearly been the most negatively impacted geography thus far.

U.S. ALREADY Less Dependent On Asia For Trade

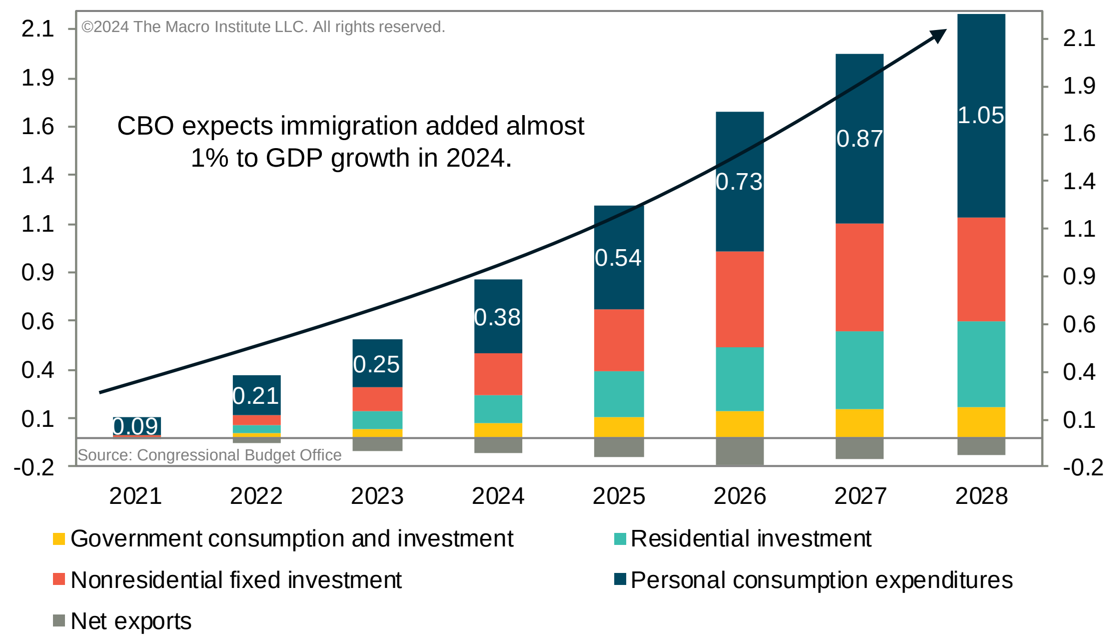


Source: Kearney Institute

Surge In Immigration Also Played An Unappreciated Role In This Cycle

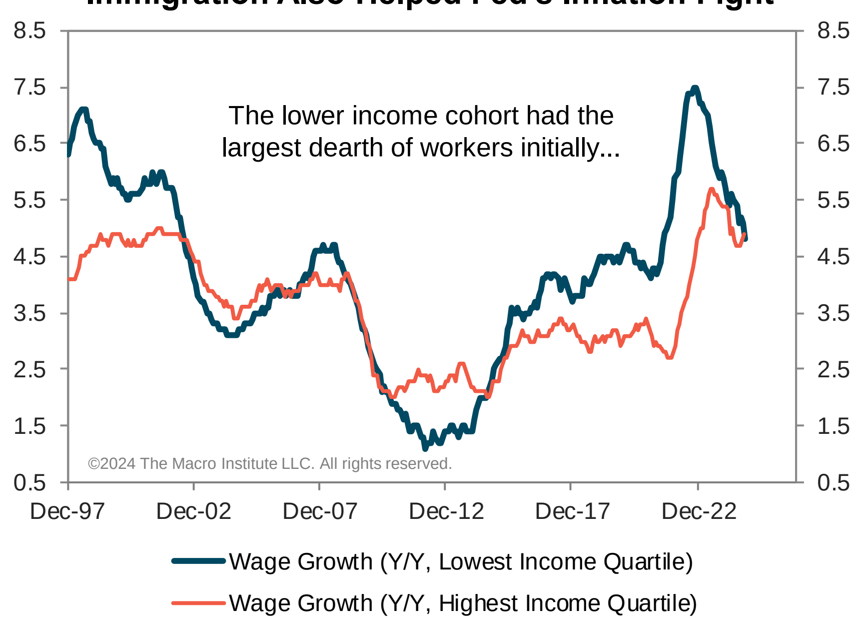
While reshoring has been a hot topic for some time, we have not seen the impact of the immigration surge covered as broadly this year. Friendly reminder that we do NOT discuss politics, only policies. This one is considered controversial in some circles but according to the Congressional Budget Office the surge in immigration that occurred during the pandemic recovery added close to 1% to GDP growth in 2024. That puts it up there with the impact of reshoring. While it is hard to get accurate numbers on border crossings it is still clear that these folks spend money on necessities, and it all adds up to economic activity.

Forecasted GDP Tailwinds From Immigration Surge Largely Consumption Driven

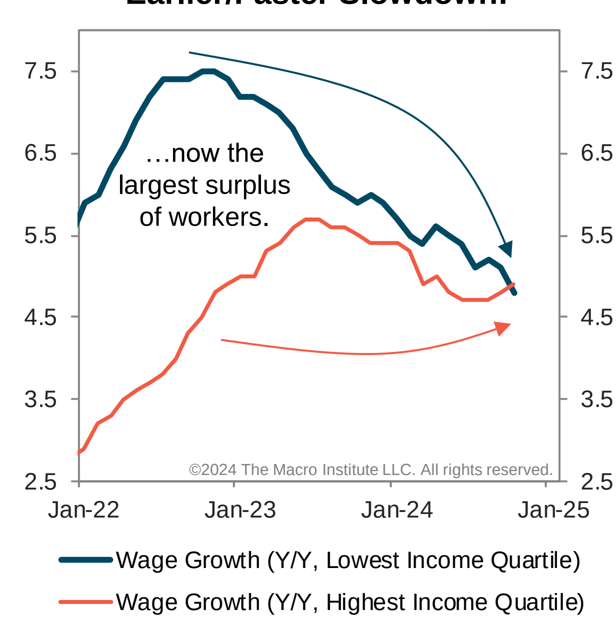


We know that the surge in immigration has added to economic activity, all other things equal. It is also clear that it has helped lower inflation given just how tight labor markets have been. Indeed, the strongest surge in wage inflation (and dearth of workers early on) was in the lower wage category. Interestingly, amid the immigration wave this subset also saw the biggest deceleration in wage inflation. In essence, this category played a disproportionate role in containing wage inflation overall, and while it's hard to quantify exactly, the large wave of immigrants crossing the border clearly played a role in all of this.

Immigration Also Helped Fed's Inflation Fight



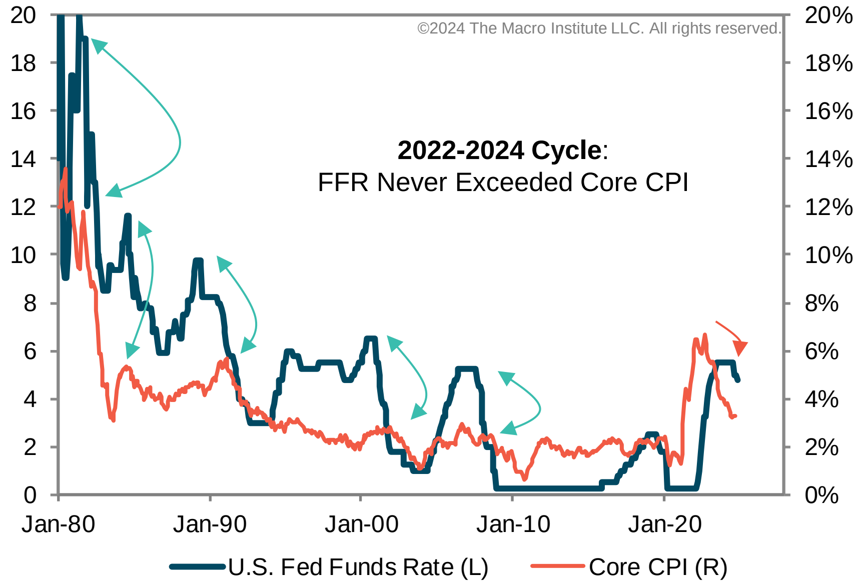
Earlier/Faster Slowdown!



Wildcard: Fed Policy Never Got Tight Enough Given The Circumstances

I would say that overall, we were not too surprised by the contribution of reshoring to economic activity. The role of immigration did surprise us somewhat, or at least it was not something we had factored in. What surprised us the most (and made us change our forecast) has to do with the Fed. While this was the most significant Fed tightening cycle in over 40 years, policy settings were just not as tight as we have seen historically. As the table below right shows, the Fed typically raises official rates beyond the core inflation rate, and often by a factor of 2X. Chairman Powell deviated from history in this regard.

Powell's Uneasy Relationship With Inflation

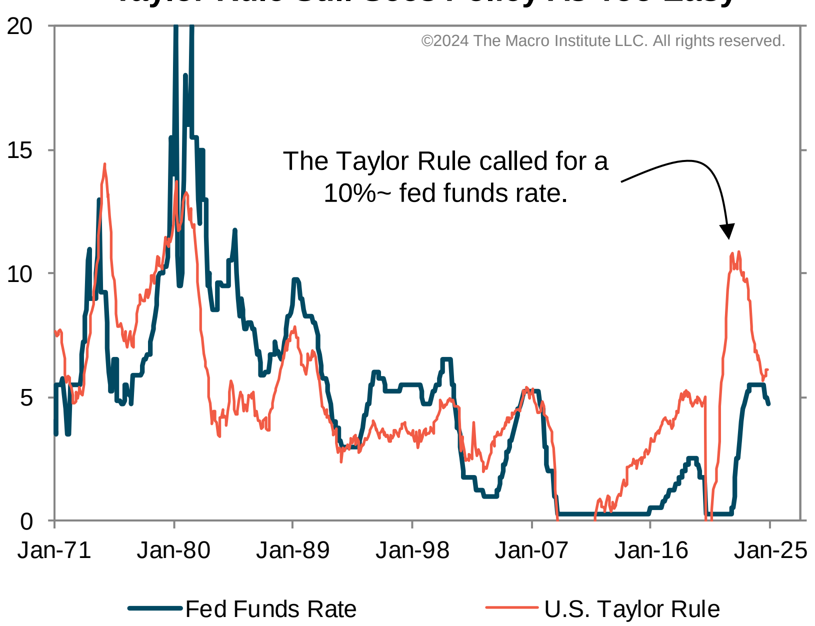


FFR Peak Usually > Core CPI Peak

Period	Core CPI Peak		FFR Peak
2022-24	6.6%	>	5.50%
2006	2.9%	<	5.25%
1999	2.8%	<	6.50%
1989-91	5.7%	<	9.75%
1984	5.3%	<	11.63%
1980	13.6%	<	20.00%

The Taylor Rule also deviated from the actions of the Fed this time around. The cleanest way to illustrate this mismatch in policy settings in the current cycle is by looking at official rates versus trends in core inflation. The table below right is the same as the one above except that it compares peak fed funds rates with peak rates of inflation as measured by core PCE. Powell has mostly kept up with core PCE, BUT his predecessors typically pushed official rates to twice that level, thereby ensuring inflation was nipped in the bud and not likely to rebound as soon as the economic cycle recovered. More on that to come.

Taylor Rule Still Sees Policy As Too Easy



Powell At Odds With Fed History

	Peak In FFR	Peak Core CPE	Ratio
Volcker/Inflation Fed			
1980	20.0	9.8	**2.0**
1984	11.8	4.7	**2.5**
Great Moderation/Disinflation Fed			
1989	9.8	4.7	**2.1**
1995	6.0	2.9	**2.1**
2000	6.5	1.9	**3.4**
2006	5.3	2.7	**2.0**
Powell Fed / Inflation Fed			
2018	2.4	2.0	**1.2**
2023	5.4	5.6	**1.0**

Powell's ratio was not nearly as restrictive as prior cycles.

2024's Unique Features Set To Have An Economic/Markets Impact In 2025

Join us for our 2025 Outlook Call, where we'll discuss the sectors and factors we believe are best positioned for success in the coming year. We will also explore the potential for inflation to reemerge as a key theme and its implications for markets. Please join us on Wednesday, January 8th at 10:30am EST. Click the link below to register and receive your unique dial-in information.

Register Now!

TMI Outlook Call

Wednesday, January 8th at 10:30 EST

The Great Inflation Comeback Of 2025

Host: Francois Trahan

Registration is required:

Click Here To Register

If you have any problems with the link please copy and paste into your browser:
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