Equity corrections are inevitable but difficult to time with the Fed cutting rates and no recession. Big Tech and Obesity Pharma remain mania candidates. “Smaller quality” is attractive. Biotech is on the edge of a breakout. Stay long bond duration. Treasuries offer a hedge against deflation risks, as do defensive equity sectors. Profit margins should hold up as unit labor costs remain tame.

ALPINEMACRO
A Unique Mind On The Markets

U.S. THEMES & STRATEGY

July 15, 2024

Equity Perfect Landing?

- Numerous indicators point to both economic growth and inflation in the 1-2% zone.
- Equity corrections are inevitable but will be difficult to time with the Fed cutting rates and no recession. Big Tech and Obesity Pharma remain mania candidates. “Smaller quality” companies with strong balance sheets are attractive. Biotech is on the edge of a breakout.
- Stay long bond duration. Our baseline scenario is less bullish for Treasuries than stocks. However, the former offer a hedge against deflation risks. Friday’s *Special Report* will thoroughly examine the potential for a “technical recession”.
- Defensive equity sectors also offer hedge value.
- Profit margins should hold up as unit labor costs remain tame.

“…elevated inflation is not the only risk we face, reducing policy restraint too late or too little could unduly weaken economic activity and employment.”

- Fed Chairman Jerome Powell

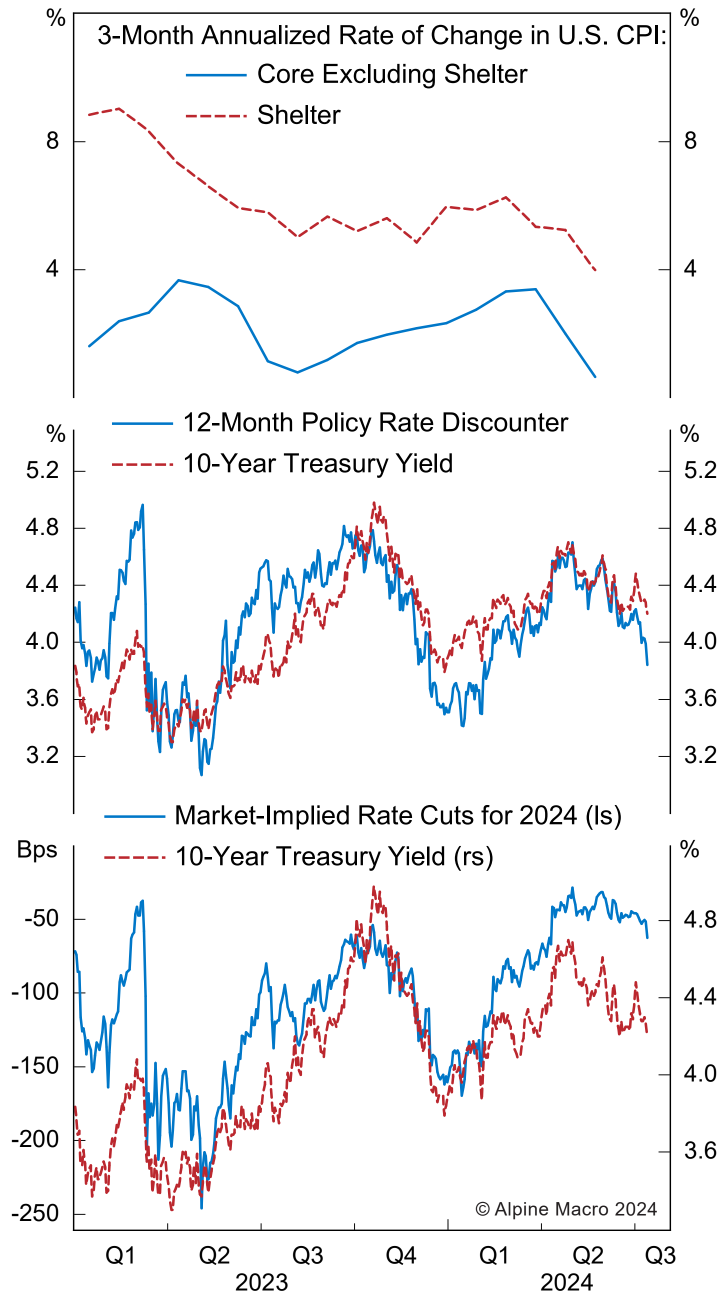
July 9, 2024 during U.S. Senate Testimony

Theme 1

Equity Perfect Landing?

U.S. economic indicators are consistent with a glide path of moderate growth, disinflation and rising productivity. The Fed will ease and inflation will drop more than investors anticipate.

Chart 1 Plenty Of Room To Cut Rates



ALPINEMACRO 2024 INVESTMENT CONFERENCE

NEW YORK | MONDAY, SEPTEMBER 16th **USD $1,995 - REGISTER NOW**

237 Park Avenue, New York, NY 10017

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

Agenda

08:10 - 08:30 **Opening Remarks : The Shifting Macro Landscape: Opportunities & Risks**
Chen Zhao, Chief Global Strategist

08:30 - 9:30 **Emerging Mega Trends: How Should Investors Be Prepared?**
Ruchir Sharma, Chairman of Rockefeller International and Founder and Chief Investment Officer of Breakout Capital

09:30 - 10:30 **Inflation, Disinflation and Fed Policy: Are We on the Right Path?**
Mike Dooley, Professor Emeritus at University of California, Santa Cruz and Chief Economist at Figure Technologies

10:30 - 10:45 Coffee Break

10:45 - 11:45 **Fireside Chat: Bull Bear Debate**
Francois Trahan, Founding Partner of The Macro Institute Versus
Jim Paulsen, Author of the Paulsen Perspectives research newsletter on Substack

11:45 - 12:30 **The Long and Shorts of U.S. Equities**
Gina Martin Adams, Bloomberg Intelligence Global Director of Portfolio Strategy, Chief Equity Strategist

12:30 - 14:15 **Luncheon Speaker: Biden Vs Trump: How The World Will Be Changed**
Greg Valliere, Chief U.S. Policy Strategist AGF Investments

14:15 - 15:00 **How Is AI Reshaping the Money Management Business?**
Gareth Shepherd, Co-Head of Voya Machine Intelligence (VMI) & Portfolio Manager, Voya Investment Management

15:00 - 15:15 Coffee Break

15:15 - 16:30 **Commodity Panel: Secular Trend, Energy and Prospect of ESG**
Tavi Costa, Partner/Macro Strategist at Crescat Capital
Lenka Martinek, Managing Partner, Sustainable Market Strategies, Nordis Capital
Adam Rozencwajg, Managing Partner, Goehring & Rozencwajg

16:30 - 17:30 **Cocktails & Networking**

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 2025 Growth And Inflation Consensus Should Adjust Lower

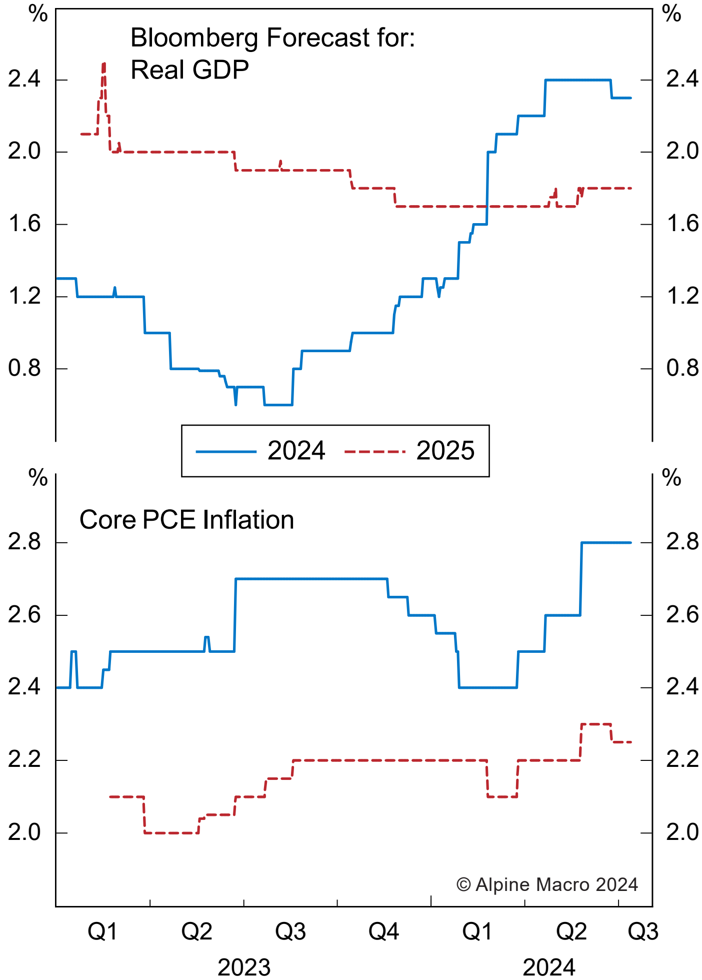
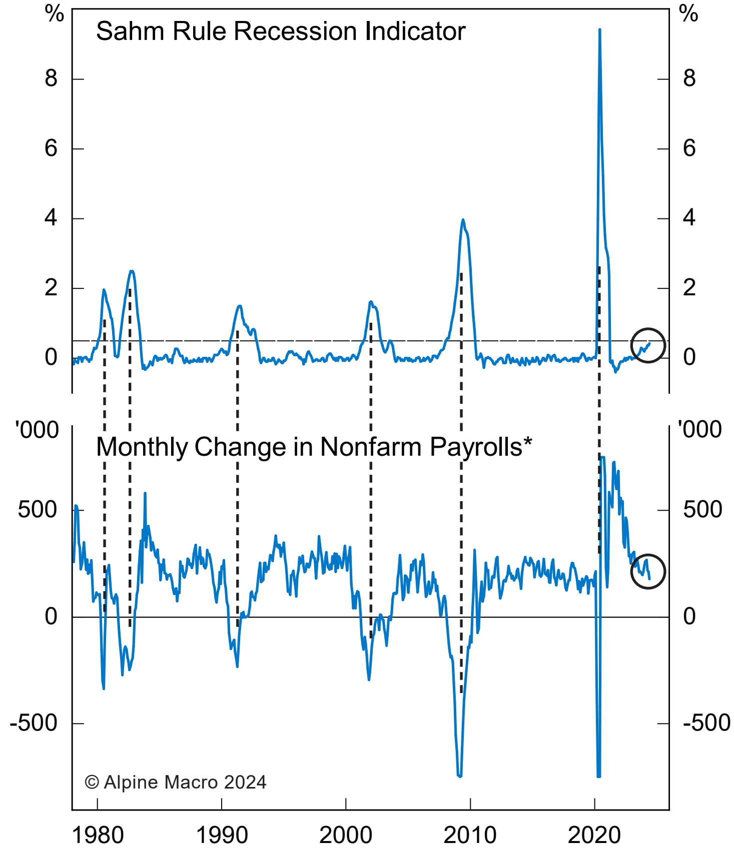


Chart 3 "Sahm Rule" Nearly Triggered, But Employment Still Rising



*Truncated at -/+ 750; shown as 3-month moving average

The latest indication of this glide path is the June CPI report. Chart 1 shows that both core ex-shelter and shelter inflation are mean reverting downward after a string of upside surprises earlier this year. Historically, inflation has been a coincident to lagging variable, but post-pandemic crosscurrents have made it unusually difficult to forecast.

Fed Chair Powell's testimony before Congress showed increased confidence that inflation is falling back to earth (see quote on p.1). Against this backdrop, both 2024 and 2025 consensus inflation and growth forecasts will be revised downward in the coming months, in turn increasing the magnitude of expected Fed rate cuts (Chart 2). That will boost equity multiples and encourage selected mania-like overshoots, without causing serious damage to margins as unit labor costs drop.

A perfect macro landing has long been Alpine Macro's baseline scenario.[1] The mixed message from labor market and consumer trends is consistent with subpar, but positive, economic growth. More specifically, the 3-month moving average of the unemployment rate has risen by 0.43 from its low point, close to the 0.5 that triggers the "Sahm Rule" recession signal (Chart 3). Unlike in

1 See Theme 1 from Alpine Macro *U.S. Themes & Strategy* "Perfect Macro Landing: Strategy And Risks (June 17, 2024).

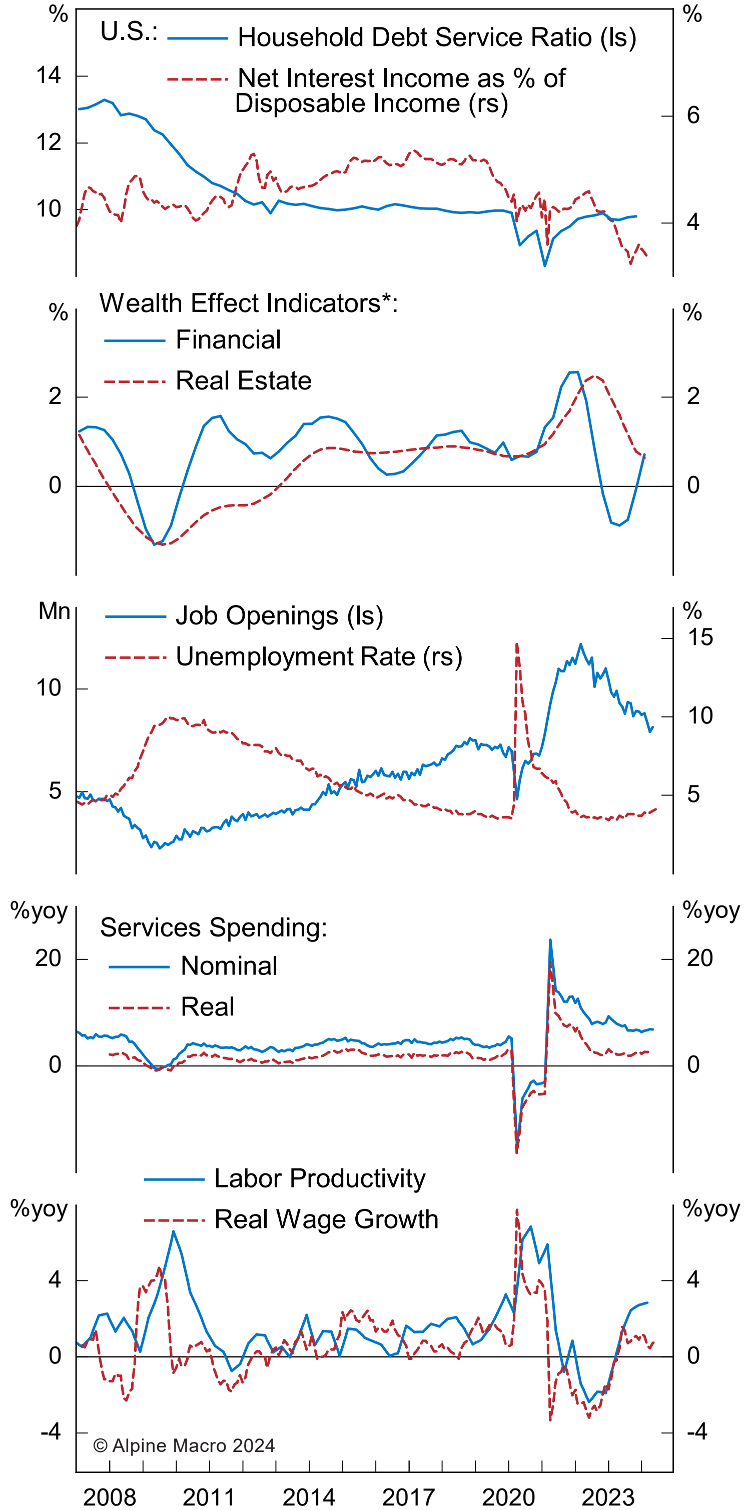
previous episodes, however, nonfarm payrolls are rising. The uptrend reflects rising labor supply on the back of strong immigration and prime-age workers returning to the labor force. Likewise, households have strong balance sheets and benign debt-coverage ratios, even though the mountain of excess savings accumulated from Covid subsidies has been run down and the personal savings rate is at a 2-year low (**Chart 4**).

Relative to our benign baseline scenario, we believe that the risks for both growth and inflation are to the downside. Friday's *Special Report* will explore how a "technical recession" could emerge, with implications for capital markets. Nevertheless, we do not expect monetary restraint to cause the severe economic and financial stress that usually triggers a bear market in risk assets.

What does this mean for equity strategy? Some of the perfect landing scenario is already reflected in capital markets (**Chart 5**). For example, there was significant outperformance of stocks to bonds, and of domestically oriented cyclical to defensive U.S. stocks, in 2023, but both have topped out in recent months.

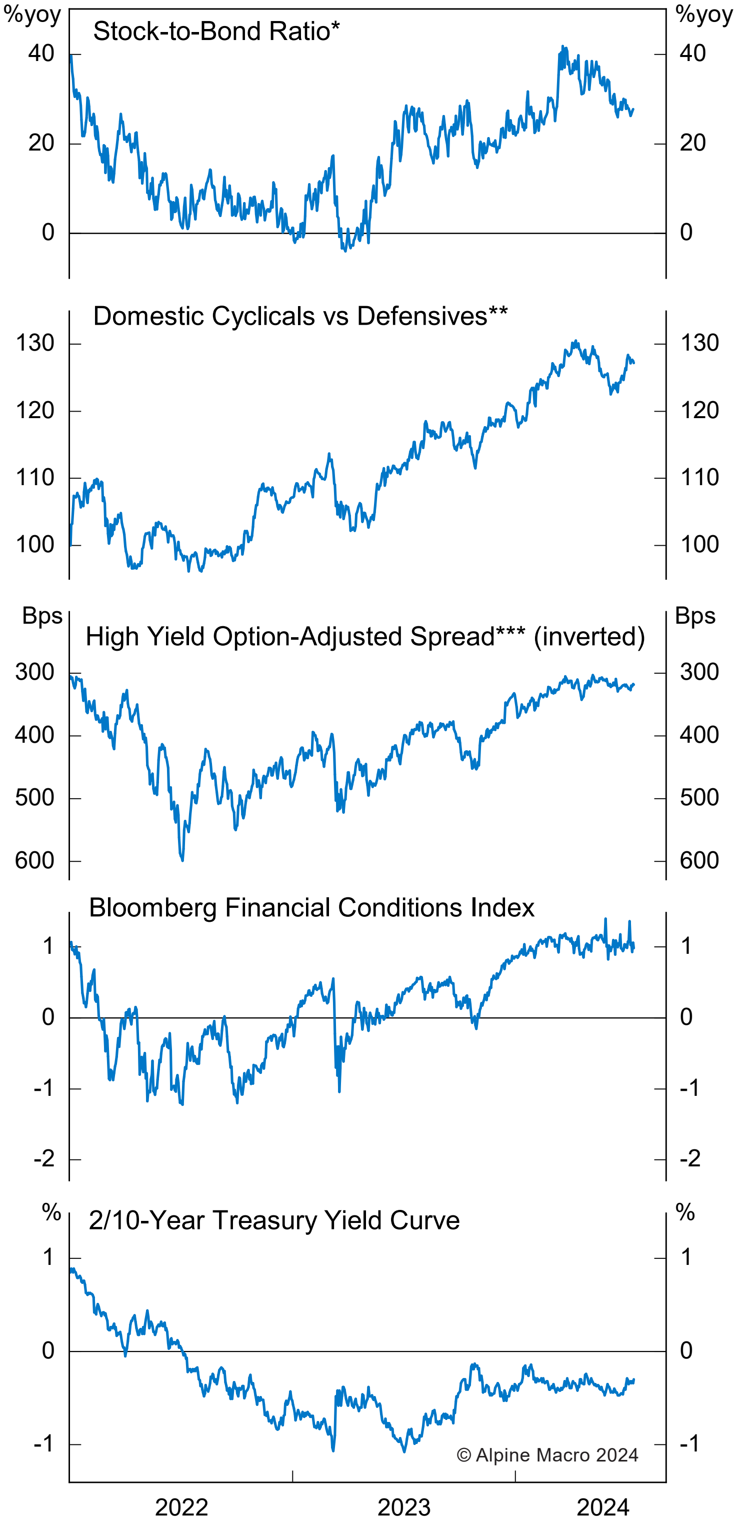
On balance, an equity correction looms, with almost every technical and positioning indicator that we monitor in overbought territory (**Chart 6**). Nevertheless, it will be hard to gauge both the timing and magnitude of the pullback, owing to the lack of a bearish macro catalyst. In fact, the Fed may lose control of its ability to rein in financial conditions as stocks and bonds front run inevitable monetary easing. In bull markets, stocks often spend extended periods in overbought territory; corrections and subsequent rebounds are hard to time.

Chart 4 Consumer Barometers Consistent With Perfect Macro Landing



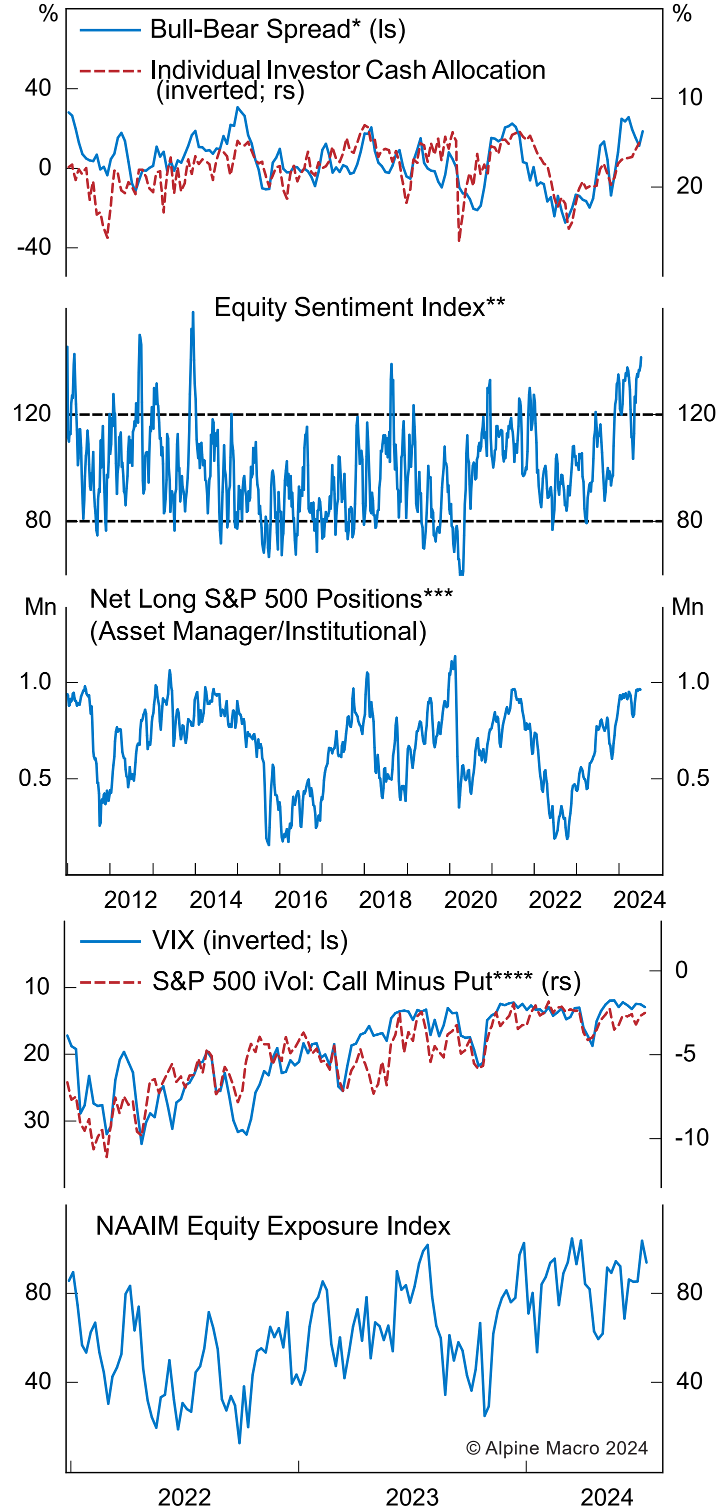
*Estimated contribution to nominal spending from previous wealth gains, as % of personal disposable income

Chart 5 Capital Markets Did Not Expect A Recession In 2023



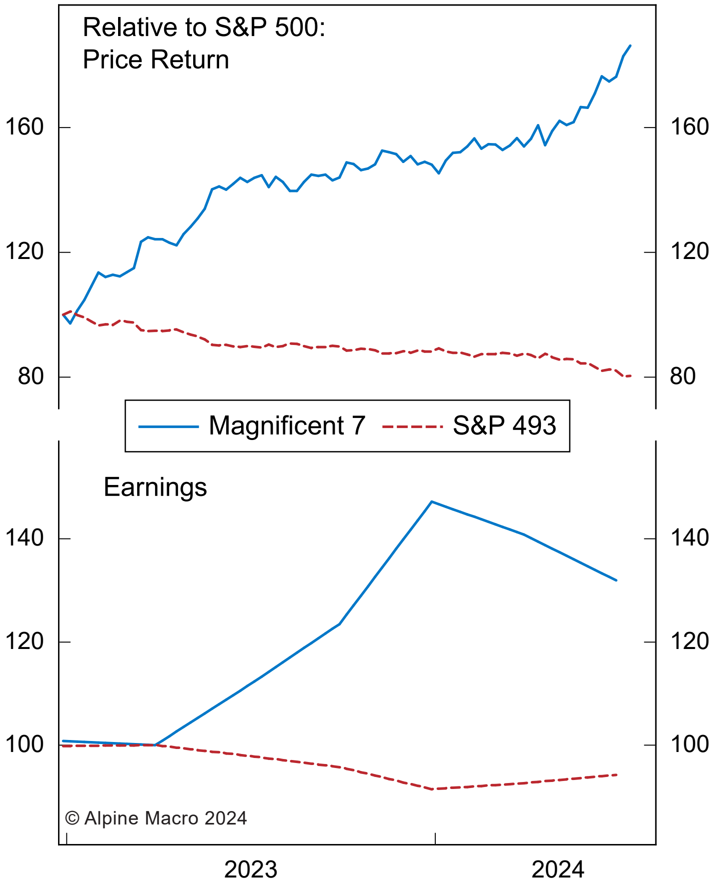
*S&P 500 total returns divided by 10-year Treasury total returns
**Rebased to Jan 2022=100; source: Bloomberg Finance L.P., Goldman Sachs
***Source: BofA Merrill Lynch

Chart 6 Every Equity Positioning And Technical Indicator Is Overbought



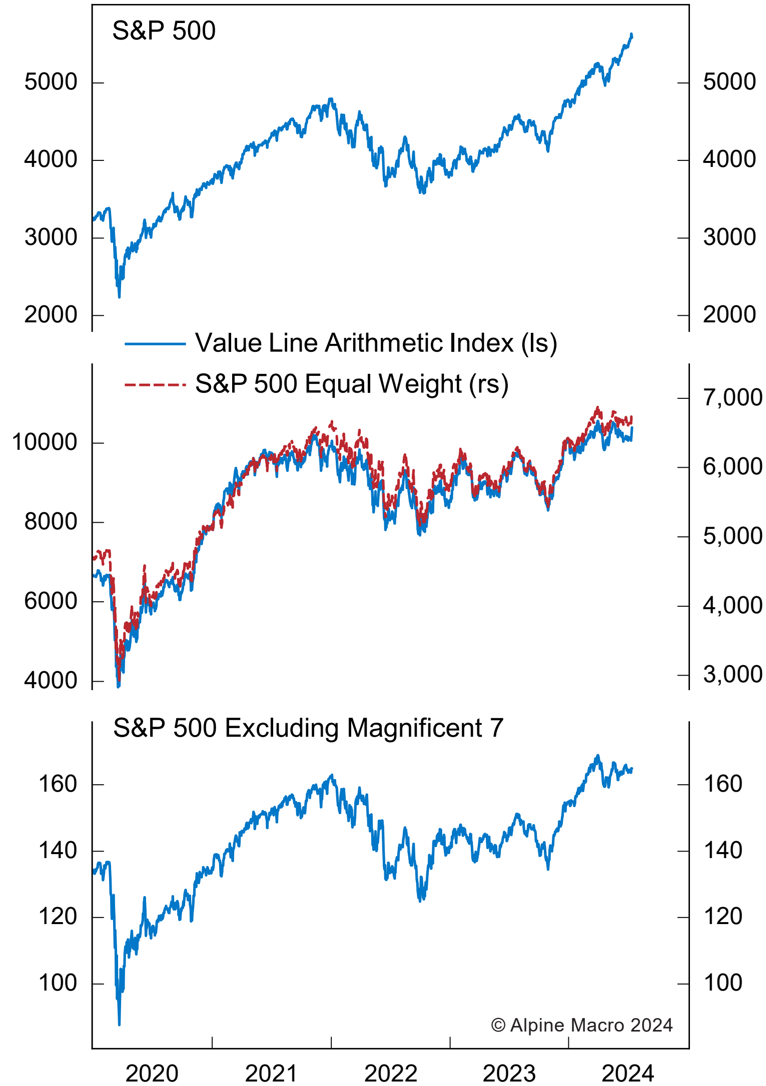
*Shown as 3-month moving average; source: AAII
**Shown as 4-week moving average; source: ISE
***Shown as 2-week moving average; source: CFTC
****25-Delta 2nd month contract; source: Bloomberg Finance L.P.

Chart 7 Mag 7: Huge Price And Earnings Outperformance



Note: All series are rebased to Jan 2023=100; includes earnings estimates for Q2 2024; source: Bloomberg Finance L.P.

Chart 8 Breadth Could Increase



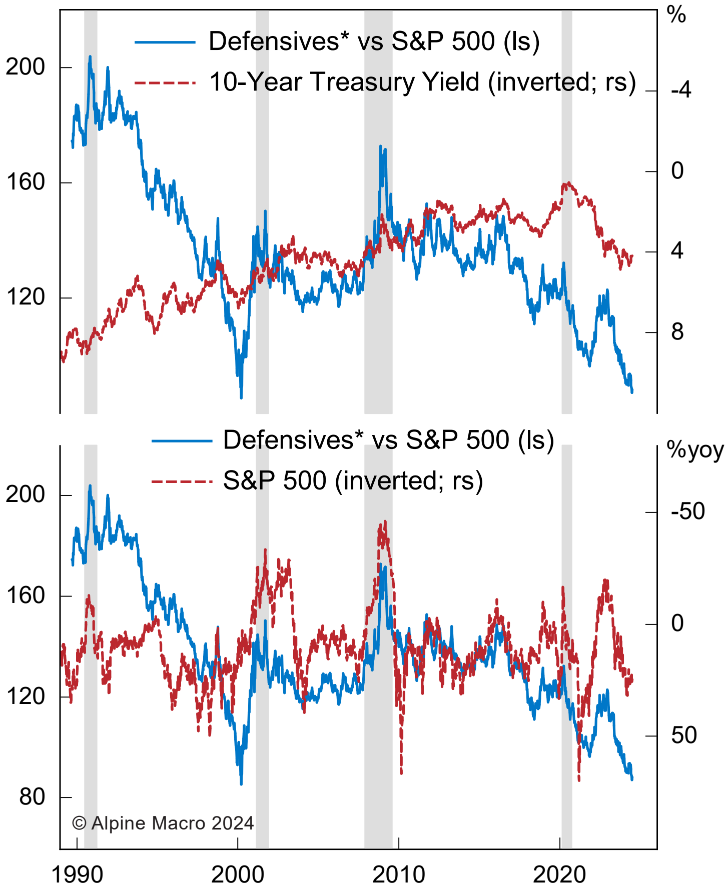
Big Tech and Obesity Pharma remain classic mania candidates, despite powerful price uptrends. These large cap companies have already been bid up, but the quality and profitability of the best performers among the S&P 500 companies have never been higher (Chart 7).

Eventually, there will be a leadership shift to cheaper, lower-quality, lower-profitability companies, but that requires a catalyst, as was the case when the late 1990s tech bubble burst. Small and mid cap biotech companies are unprofitable, but they are a bullish exception, as discussed in our February *Feature Report*.[2] The bellwether XBI ETF is on the verge of a breakout above the $95-100 resistance zone (current level $99).

In the interim, overlooked small and mid cap quality stocks may well play catch-up and increase the breadth of the bull market. Breadth may widen and boost lagging equal-weight indexes such as the Value Line Arithmetic Index (Chart 8).

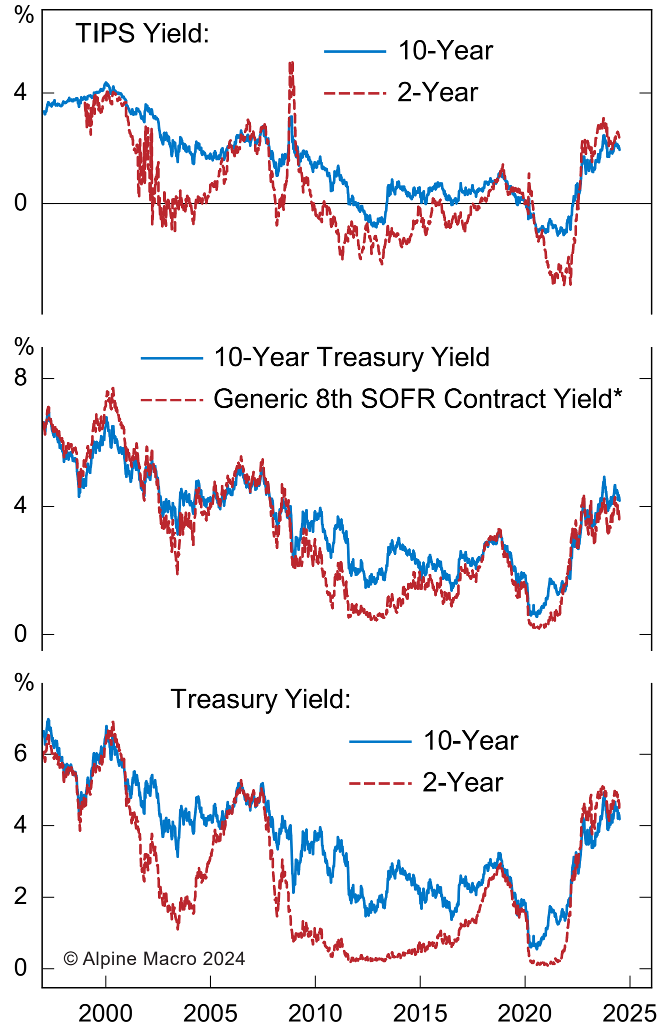
2 Alpine Macro *Feature Report* "Biotech: How Big An Overshoot?" (February 21, 2024).

Chart 9 Defensives Are Bond Proxies



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

Chart 10 Fed Has Distorted Real Rates



*Generic 8th Eurodollar contract yield before April 14, 2023

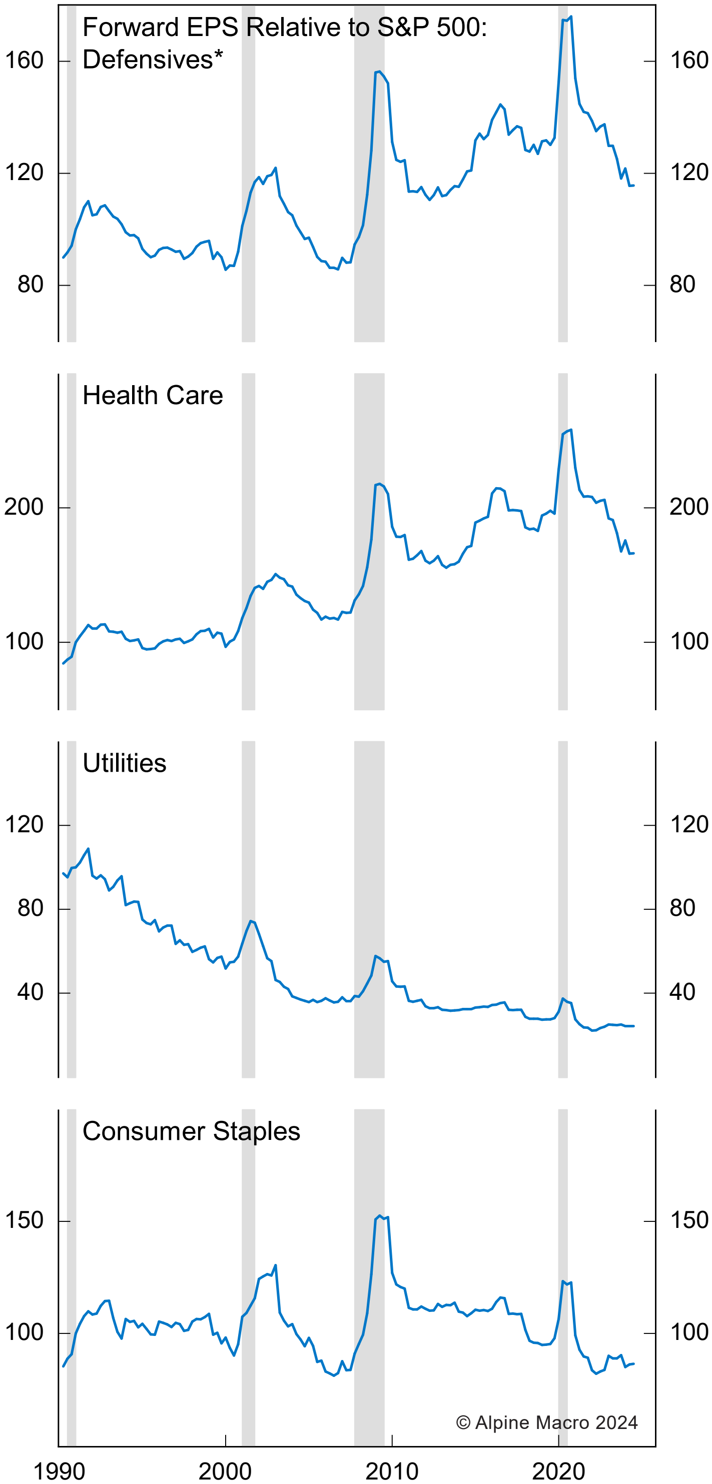
Bottom line: Equity corrections will be technical in nature and market breadth is likely to expand over the next 6-12 months. Quality companies are preferred, but biotech is also on the verge of a breakout. Stay overweight Big Tech and Obesity Pharma, but consider beaten-down defensive hedges to control risk (see next **Theme**).

Theme 2
Where Defensives Fit In

Defensive equity sectors such as healthcare (HC), utilities and consumer staples will underperform under the Alpine Macro baseline of a perfect macro landing. However, they still are attractive because risks are skewed on the side of economic growth disappointment and a lack of pricing power.

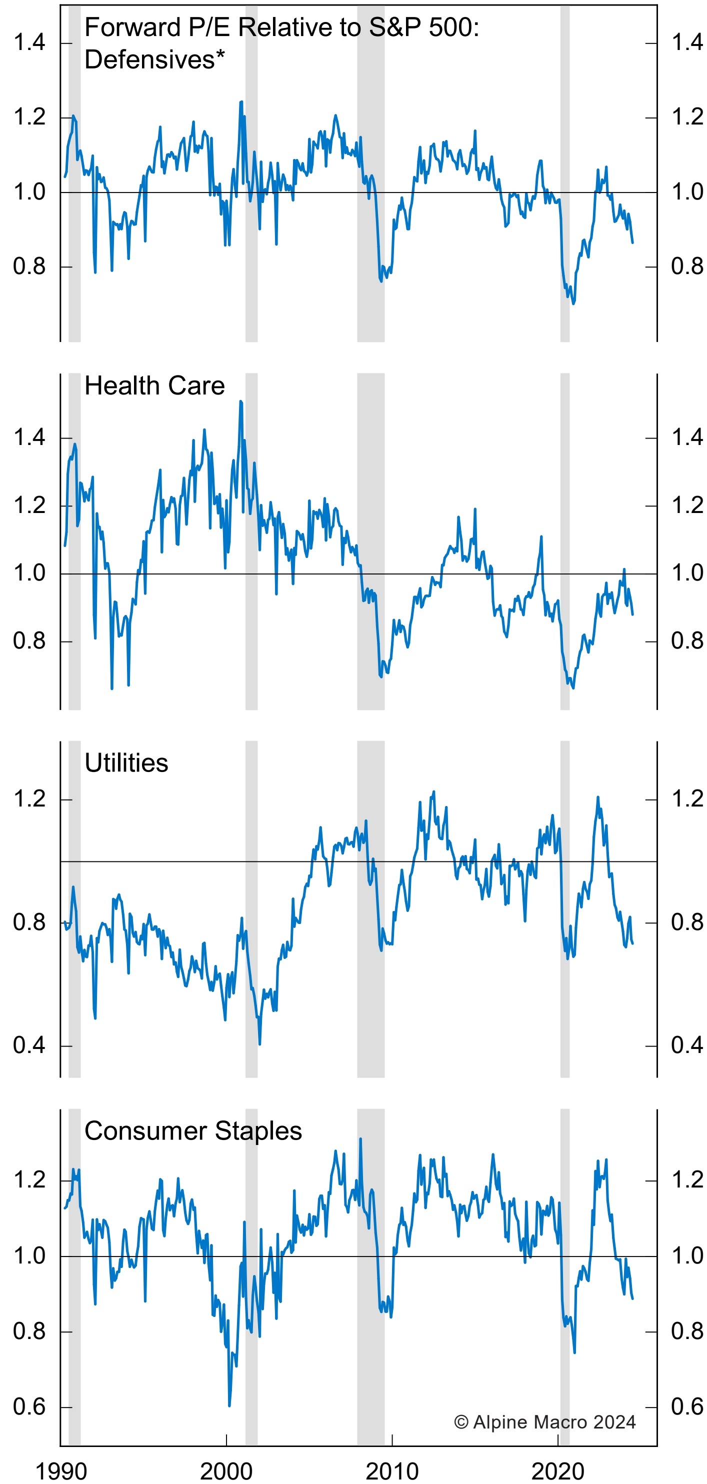
First, defensive equities are bond proxies. Chart 9 shows that their relative performance tends to be inversely correlated with bond yields, and they always outperform during equity bear markets and in the runup to, and early stages of, recessions. Currently, the real yield component of Treasuries has been distorted upwards by the Fed tightening cycle. Chart 10 shows that 10-year TIPS yields move in lockstep with 2-year TIPS yields, which are

Chart 11 Defensive Relative EPS Have Been Revised Downward



*Market cap weighted average of health care, utilities and consumer staples
Note: All series are rebased to Q1 1991=100; shading denotes U.S. recessions; source: Bloomberg Finance L.P.

Chart 12 Defensive Relative P/Es Have Been Revised Downward



*Market cap weighted average of health care, utilities and consumer staples
Note: Shading denotes U.S. recessions;
source: Bloomberg Finance L.P.

influenced by overshoots and undershoots in monetary policy. Real yields should move lower as the Fed distortion unwinds in the face of subpar growth. However, these yields would plunge if a technical recession and/or equity bear market emerges, leading to outsized defensive equity performance.

Second, defensive equity sector earnings already are beaten down and reflected in relative forward P/E ratios that are below historical averages (**Charts 11** and **12**). Moreover, catalysts for relative earnings improvement may well emerge in HC and utilities sectors, as discussed in recent *Special Reports*.[3]

Third, defensive equity sectors offer an excellent hedge to large cap tech and obesity pharma exposure that we hesitate to abandon because of their overshoot potential. A barbell equity portfolio consisting of mania candidates and interest rate sensitive non-cyclical sectors is attractive from a risk/reward perspective.[4]

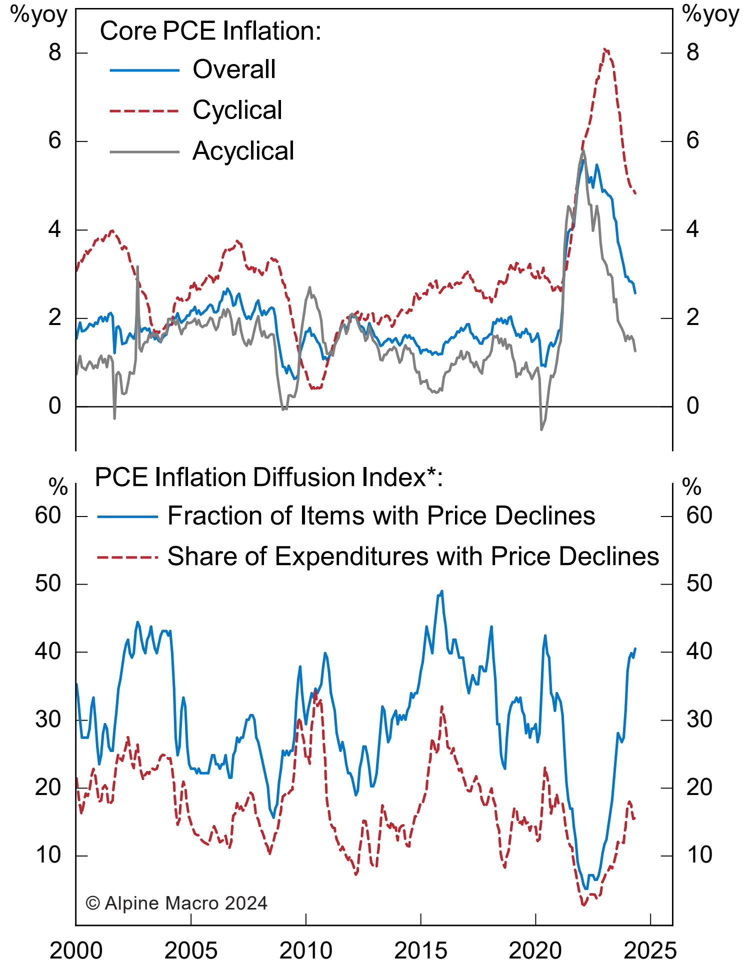
Finally, defensive equities are at oversold extremes relative to both the Magnificent 7 and the rest of the S&P 500 ("S&P 493"). More specifically, they are at the low end of two historical ranges: the falling share of market cap *vis-à-vis* Big Tech, and the rising channel relative to the S&P 493.

Bottom line: Defensive equity exposure provides diversification against nontrivial deflation risks, especially HC and utilities. Long bond duration also makes sense for similar reasons.

3 Alpine Macro *Monthly Special Report* "Three Healthcare Equity Themes" (June 21, 2024) and *Special Report* "The Utes Are Alright" (June 12, 2024).

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

Chart 13 Cyclical Inflation Following Acyclical Disinflation With A Lag



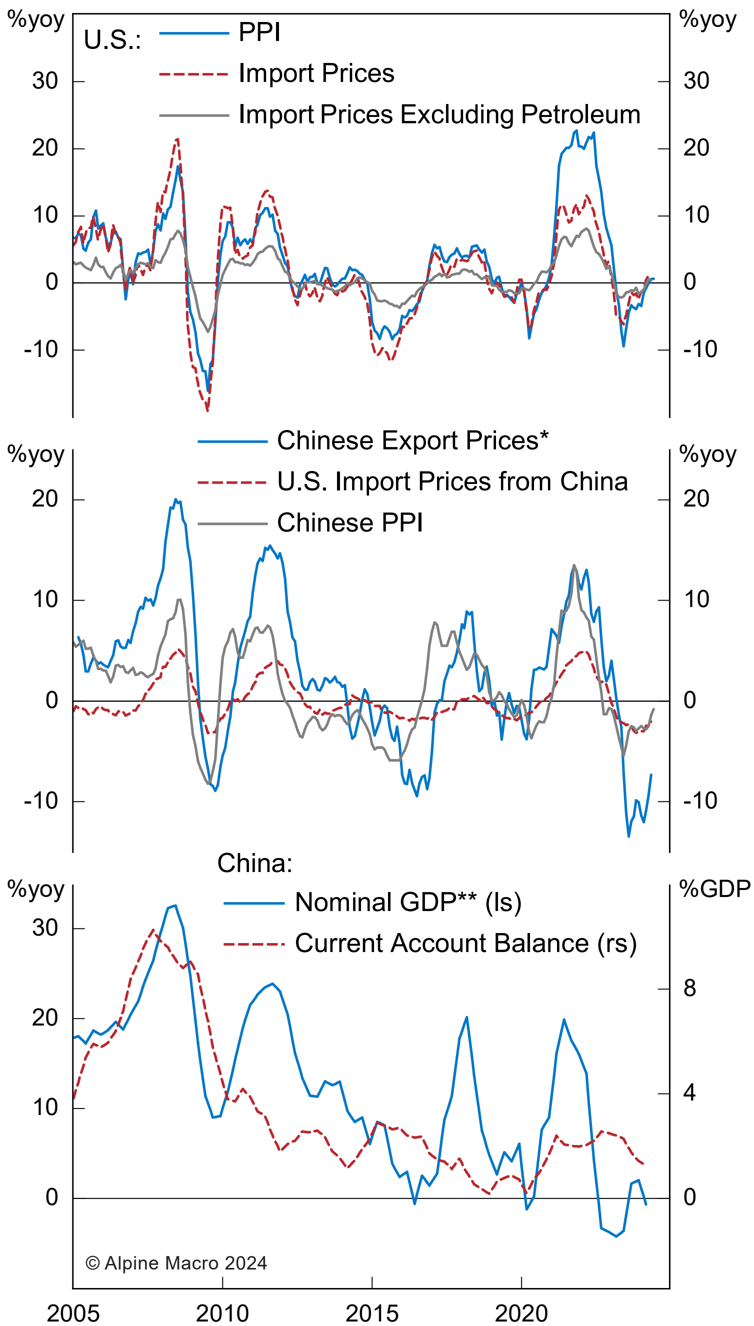
*Shown as 3-month moving average
Source: Federal Reserve Bank of San Francisco

Theme 3
Pricing Power And Profits

Inflation should drop below 2% over the next year, even if there is merely an economic slowdown, let alone an outright recession:

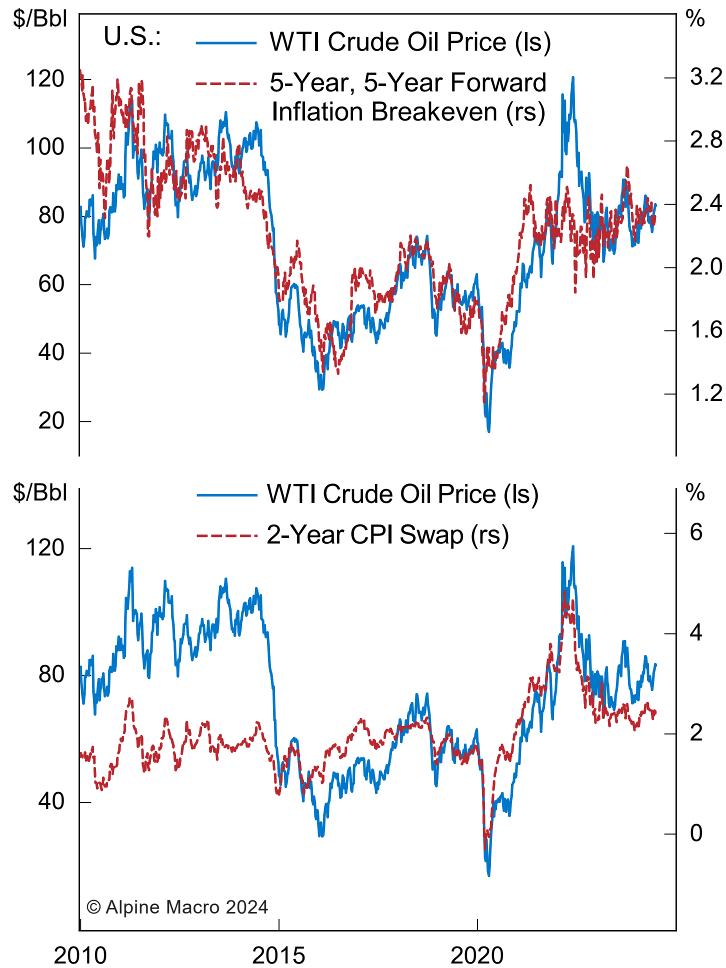
- **Acyclical and cyclical disinflation** (**Chart 13**): The component of inflation not closely correlated with the business cycle ("acyclical") moved below 2% 10 months ago. The cyclical component peaked 18 months ago and will continue to drop now as the economy slows.

Chart 14 Flat U.S. Import Prices, Chinese Deflation



*Shown as 3-month moving average; in US$ terms
**Shown in US$ terms

Chart 15 Oil Will Impact Breakevens



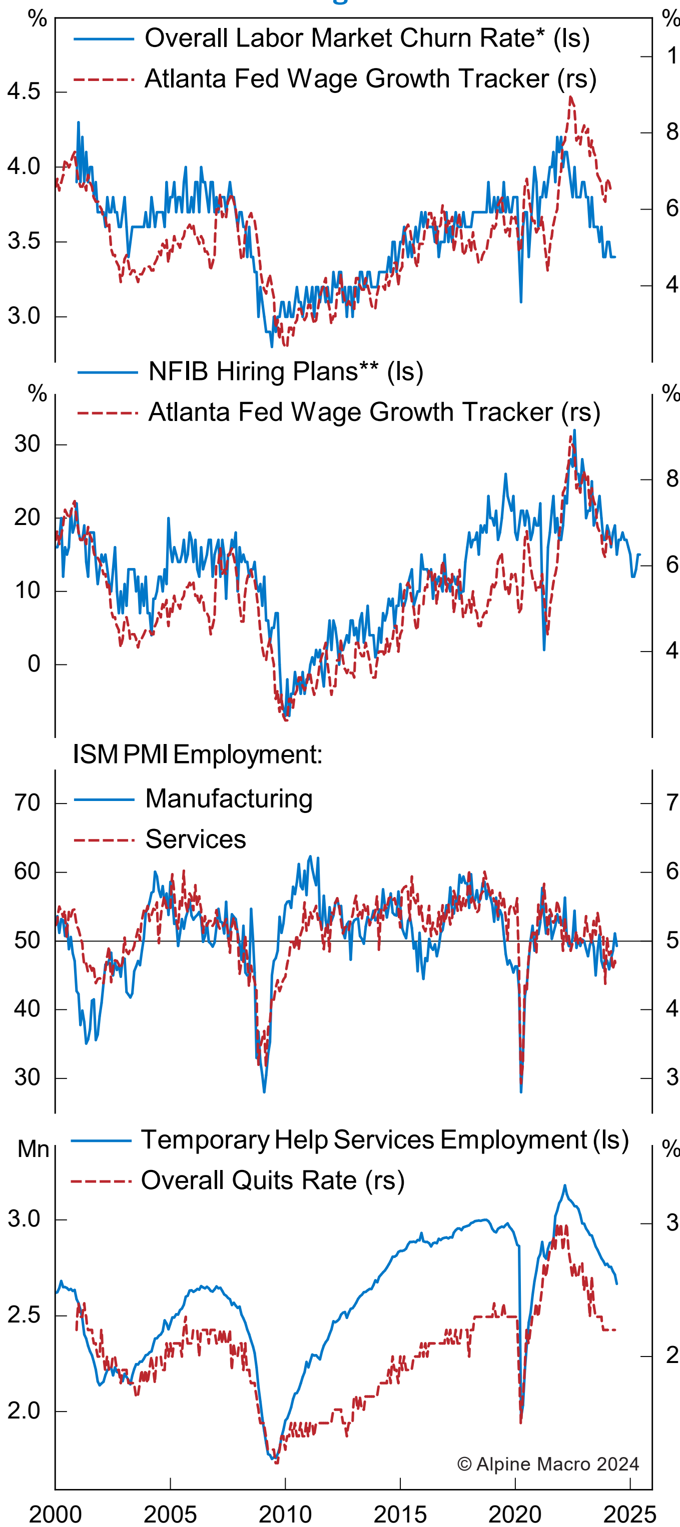
- **External influences:** U.S. ex-oil import prices are flat and may well begin contracting again in the face of a slowing U.S. economy and Chinese economic disappointment (**Chart 14**).

- **Oil:** Crude prices are stuck in a range at a time of high OPEC+ excess supply capacity. Inflation bond breakevens tend to move closely with oil prices (**Chart 15**).

- **Shelter disinflation:** Leading indicators of shelter inflation, such as new tenant rents and apartment vacancy rates, point to further declines after the smallest CPI shelter monthly increase since January 2021 in the latest release. Consistent with this, the July 17 *Feature Report* with Joe Gyourko discusses excess rental supply in Sunbelt states, as well as the expensive level of house prices in much of the country.

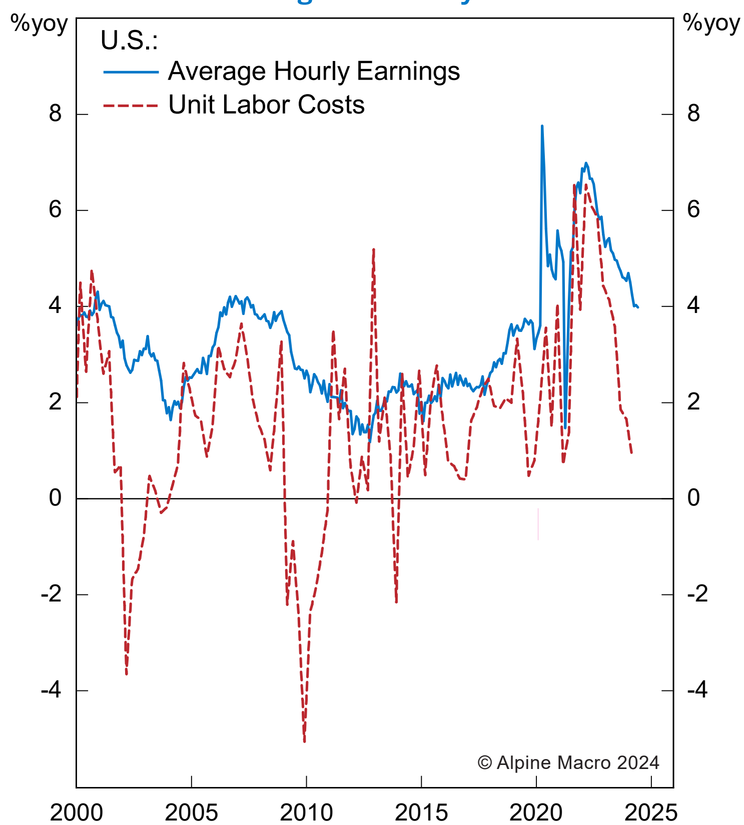
will send this report/webcast too soon iA

Chart 16 All Leading Labor Market Indicators Are Easing



*Calculated as the minimum of hiring rate and separation rate, both of which include layoffs and quits
**Advanced by 1 year

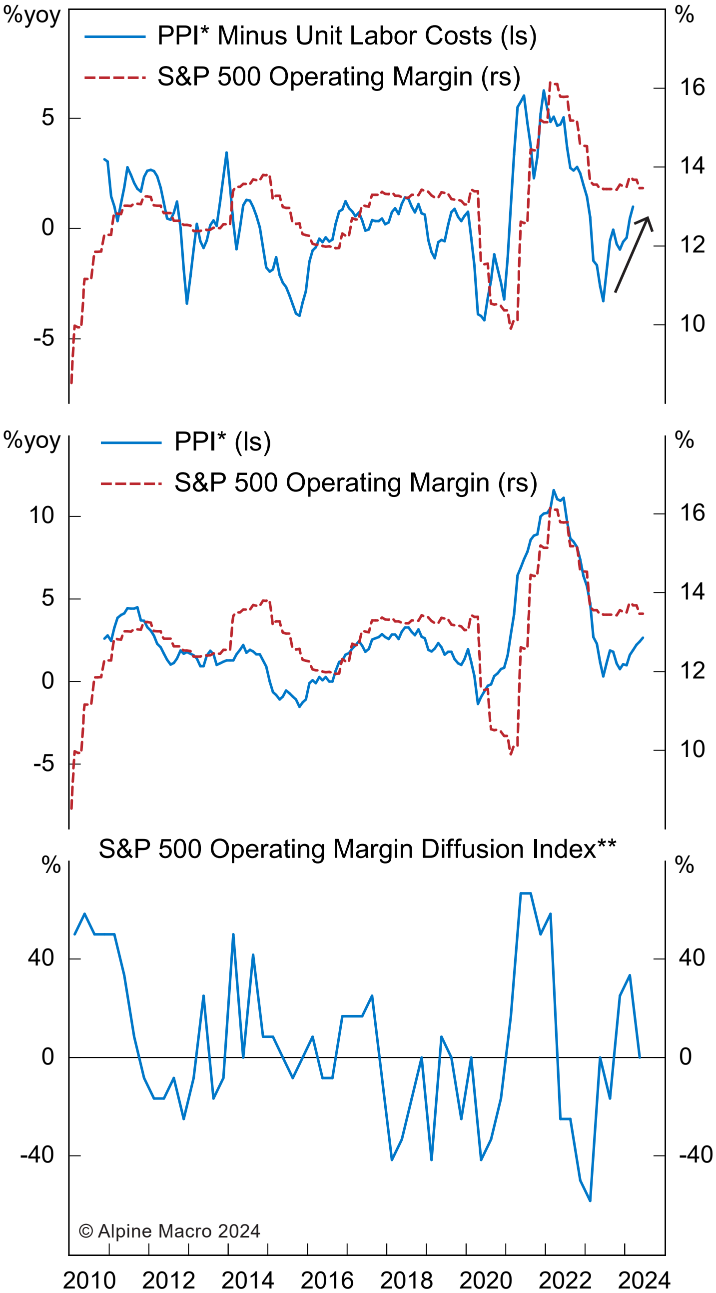
Chart 17 Falling Wage Inflation, Rising Productivity



- **Labor market slack:** Every leading indicator we monitor points to lower wage inflation (**Chart 16**). Moreover, the prime-age (25 to 54 years old) labor force participation rate continues to hit new highs. Add to this stronger productivity growth, and unit labor costs should be tame (**Chart 17**).

Eroding pricing power runs a risk of triggering downward profit revisions as Q2 earnings season begins with lofty expectations. Profit margins tend to move with overall inflation trends since price and wage inflation are highly correlated (**Chart 18**). However, this may not significantly impede profit margins as much as in the past, because productivity is improving and wage growth is falling faster than producer price inflation.

Chart 18 Margins May Not Shrink Much



*PPI Final Demand
**% of industry groups with rising operating margins minus % of industry groups with decreasing operating margins
Source: Bloomberg Finance L.P.

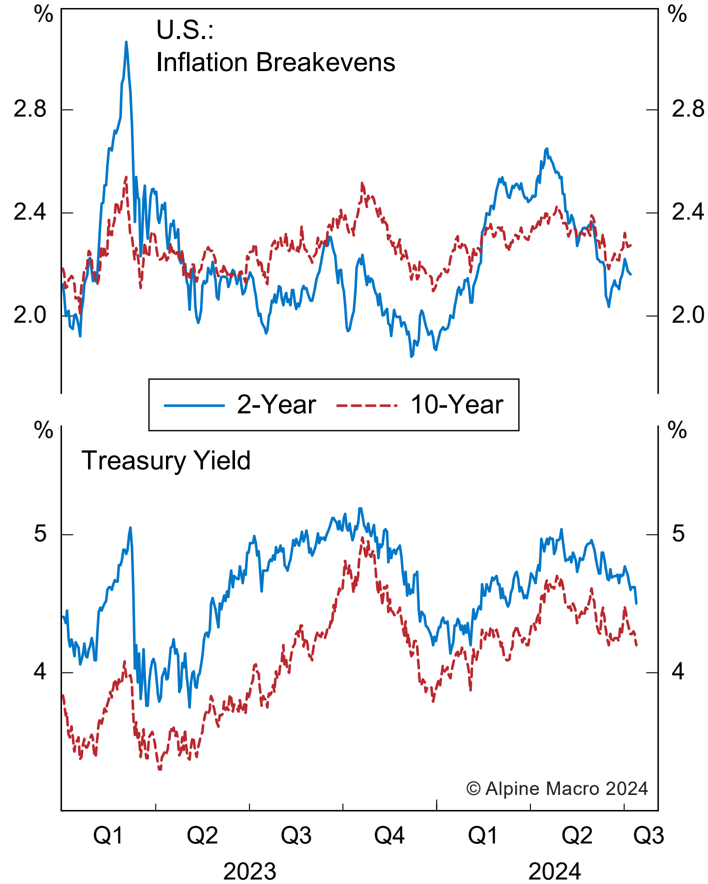
Bottom line: Inflation is headed below 2% in the coming months and will stay low into 2025. Inflation breakevens, still above 2%, have moderate downside (**Chart 19**). Profit margins should hold up better than in previous disinflationary episodes. The Fed may well ease more aggressively than money markets anticipate.

honestly v much possible

David Abramson

Chief U.S. Strategist & Director of Research

Chart 19 Moderate Downside For Breakevens



A Unique Mind On The Markets