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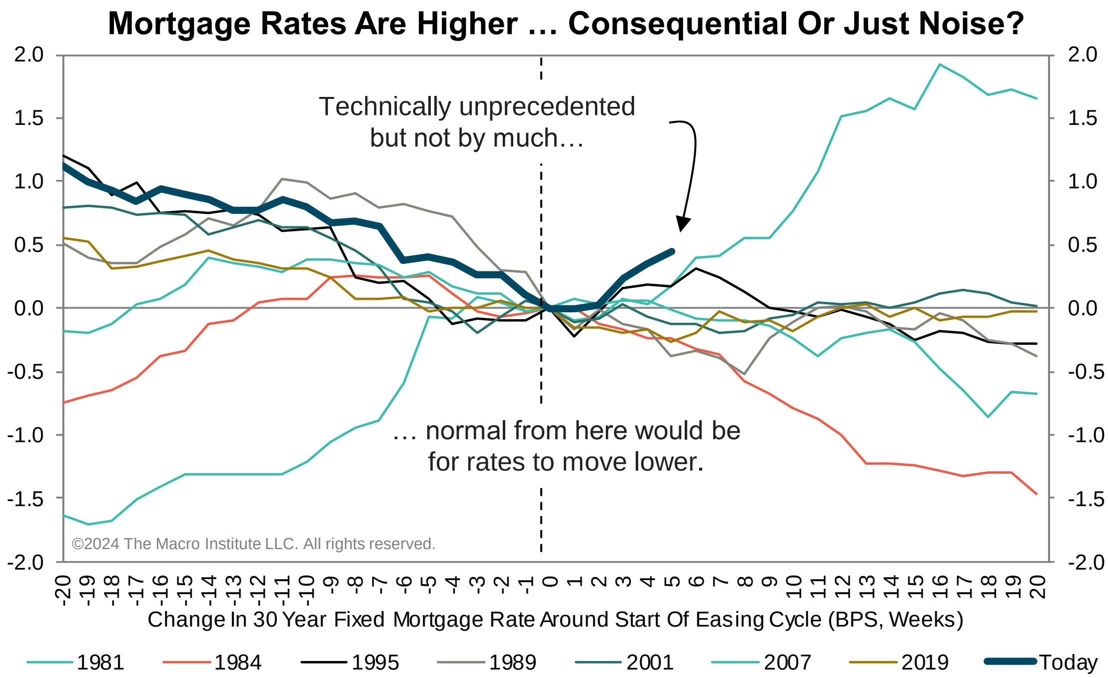
TRAHAN MACRO RESEARCH

October 31, 2024

What Is Different This Time For The Economy/Markets?

There is little doubt in our minds that the coming week (weeks?) are going to prove volatile for equity markets. Indeed, there is a slew of key market-moving data points on the docket (on Friday both the ISM AND employment for October are released on the same day) and of course elections are notorious for stoking the flames of volatility. We will address the election and its implications for financial markets early next week. At first glance, however, it seems clear that campaign promises from either party, IF fulfilled (and that is a big IF), would prove inflationary and problematic for the state of public finance. More on that later.



This week we decided to tackle the infamous topic of "It's Different This Time," or what some refer to with the acronym IDTT. Truth be told, every business cycle has had things that were peculiar. To be clear, unusual characteristics do not necessarily imply that the end game or conclusion will be different, but at the same time, some episodes ended up creating rarely seen outcomes. Regardless, it's helpful to ponder the uniqueness of a cycle and how it might impact the typical playbook. There are both positives and negatives in the topics we tackle, and the list is not exhaustive.

The first issue has to do with the behavior of interest rates in the wake of the Fed's first rate cut. Some view the recent rise in rates as a sign that a soft landing is in the offing while others view it as an impediment to a housing recovery. As the chart above illustrates, mortgage rates are indeed higher than typical but by itself it does not tell us much about what comes next. Interest rates were initially higher in the soft landing of the mid-1990s BUT they were significantly lower in the soft landing of the mid-1980s. This is certainly an unusual situation, but the arguments proposed to explain it are a bit of a stretch. We have a lot more unusual stuff to cover in the report. Best. Francois

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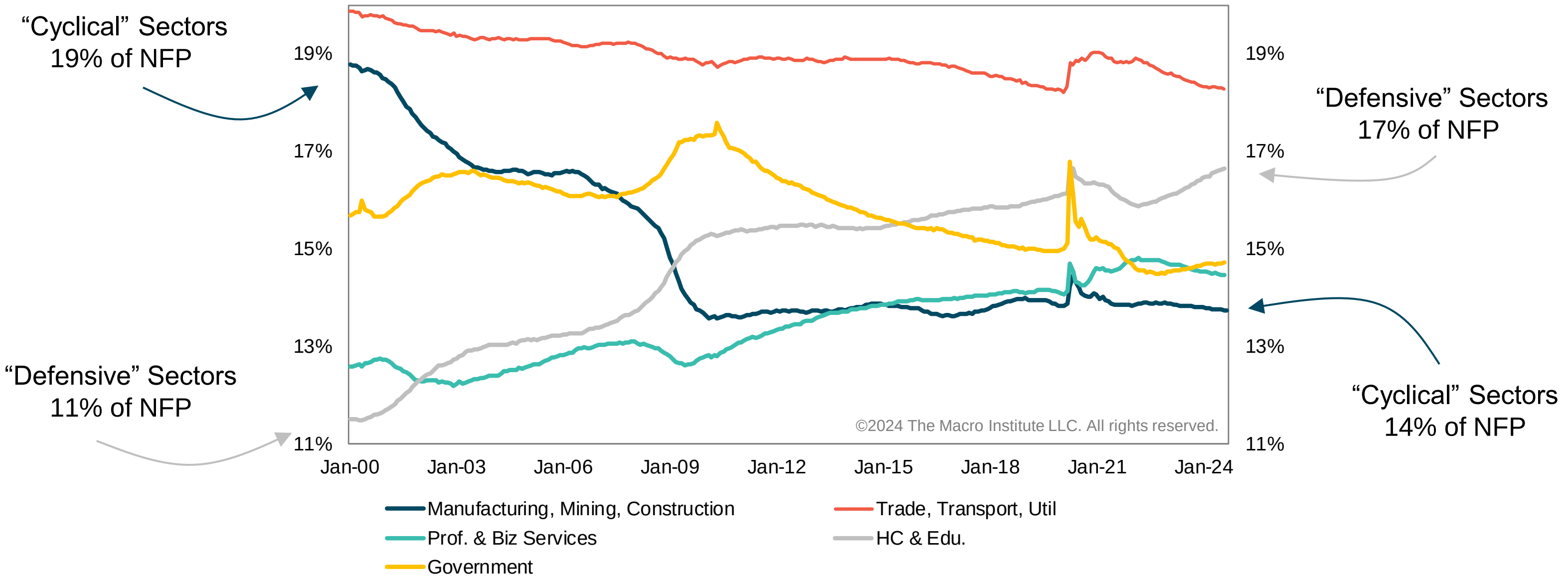
IDTT: U.S. Payroll Composition Less Cyclical Than In The Past

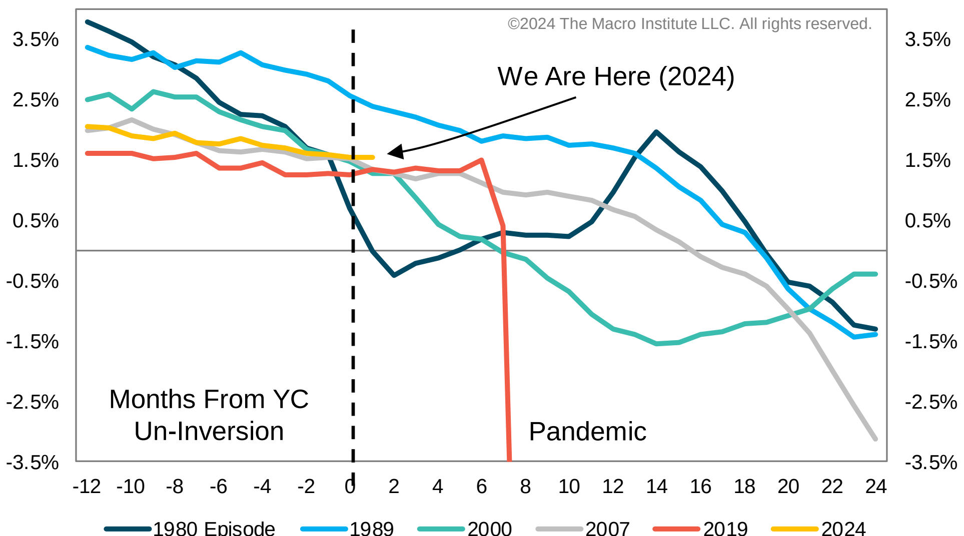
U.S. labor markets are one of the largest and most important items within the IDTT bucket as their evolution since 2000 has major implications for corporate earnings and gauges of monetary policy. The chart below represents major employment categories as a percent of total nonfarm payrolls. The data is extremely granular, so the relatively-smaller Manufacturing, Mining, and Construction categories were lumped together to form a cyclical employment proxy. This cohort comprised 19% of total NFP in 2000 compared to 14% today. Meanwhile, Health Services & Education, grew from 11% to 17% of NFP.

U.S. Payrolls Always In Flux And More Stable Nowadays



The implication from the chart above is that NFP, and ultimately U.S. labor markets, are LESS cyclical than in the past and more tied to secular trends in U.S. health care and aging demographics. That said, the evolution in total NFP prior to and since the un-inversion in the yield curve looks very consistent with prior episodes. Job growth is still positive, but it is decelerating as usual. The short-end tends to fall as policy reacts to slower employment. This is where we are today (T+1). If this pattern holds as the yield curve begins to steepen, we should expect a further slowdown in NFP growth. Keep in mind, these are the revised figures and on the next page we'll discuss if the series below actually reflects today's reality.

Evolution In Payrolls Well Within History's Boundaries



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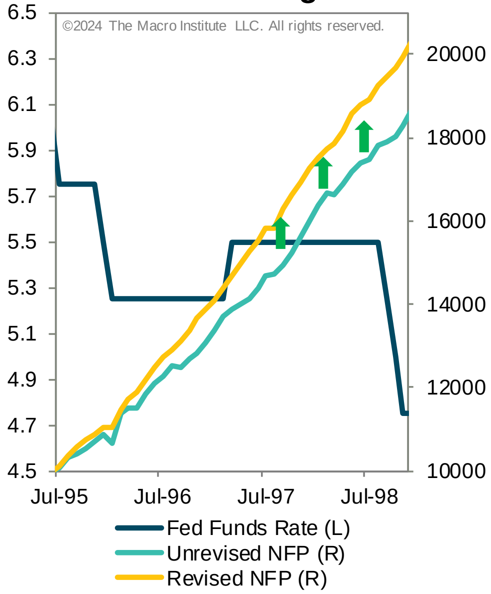
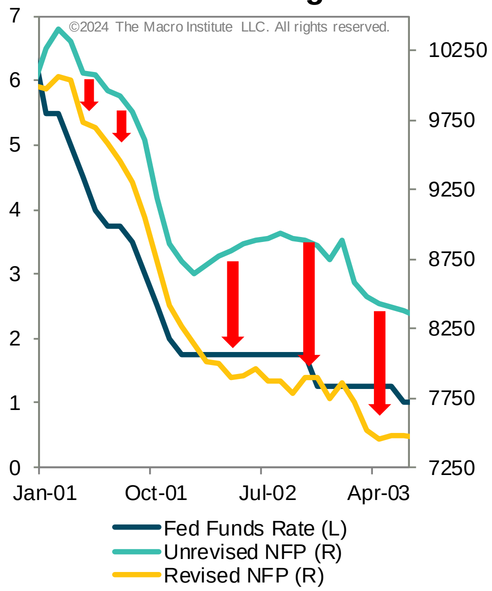
IDTT: Large Payroll Revisions More Normal Than Consensus Expects!

What can history tell us about this year's revisions to non-farm payrolls? On the left below, we see consistent positive revisions during the mid-90's soft landing episode. The right two clips are hard landings where we see consistency of downward revisions. It seems that downward revisions to payrolls tend to be consistent with slowing labor markets or what commonly happens as the yield curve un-inverts.

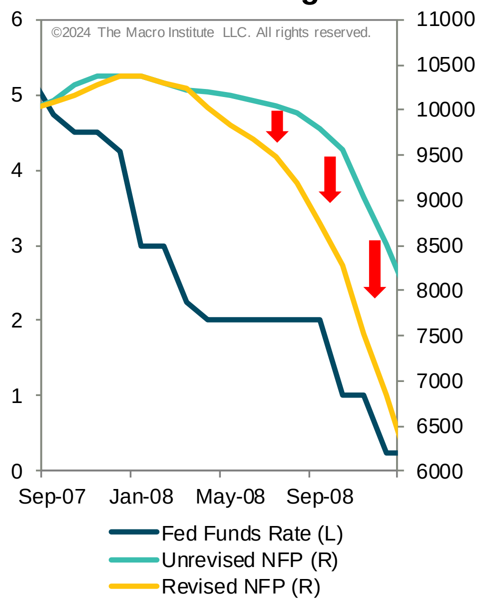
Soft Landing



Hard Landing

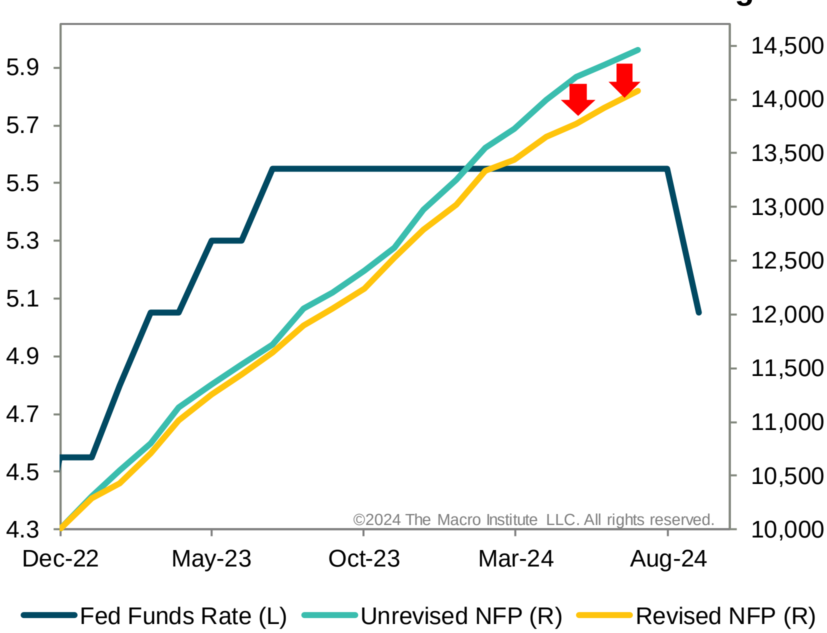


Hard Landing

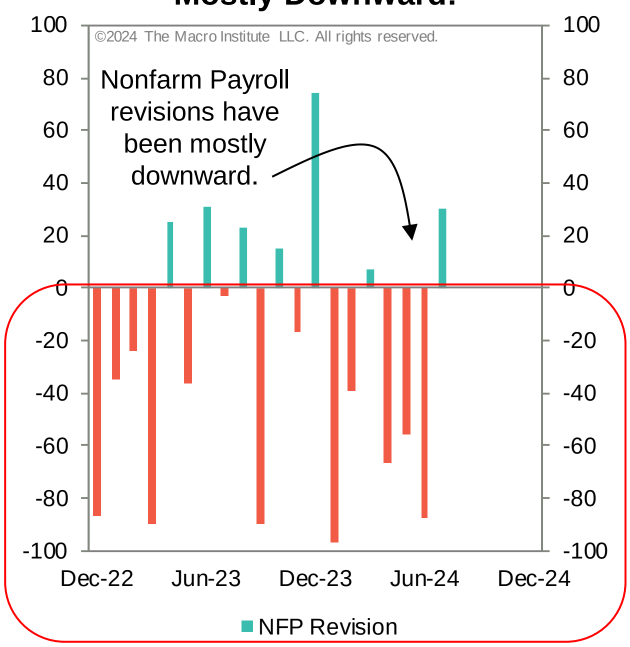


Since the Fed embarked on its tightening cycle in 2022, NFP has been consistently revised lower. Below left we see the unrevised NFP figure in green, or what financial markets tend to react to. The yellow series is the revised figure – both indexed at 10,000. The prevalence of downward revisions is more consistent with a hard landing than a mid-cycle slowdown. Our view on IDTT in terms of payrolls is that downward revisions are much more common than consensus believes. Chairman Powell even questioned the reliability of employment data during the September meeting and cited the downward-revised QCEW report as one factor supporting the rate cut decision.

Revisions Not Consistent With A Soft Landing



Mostly Downward!



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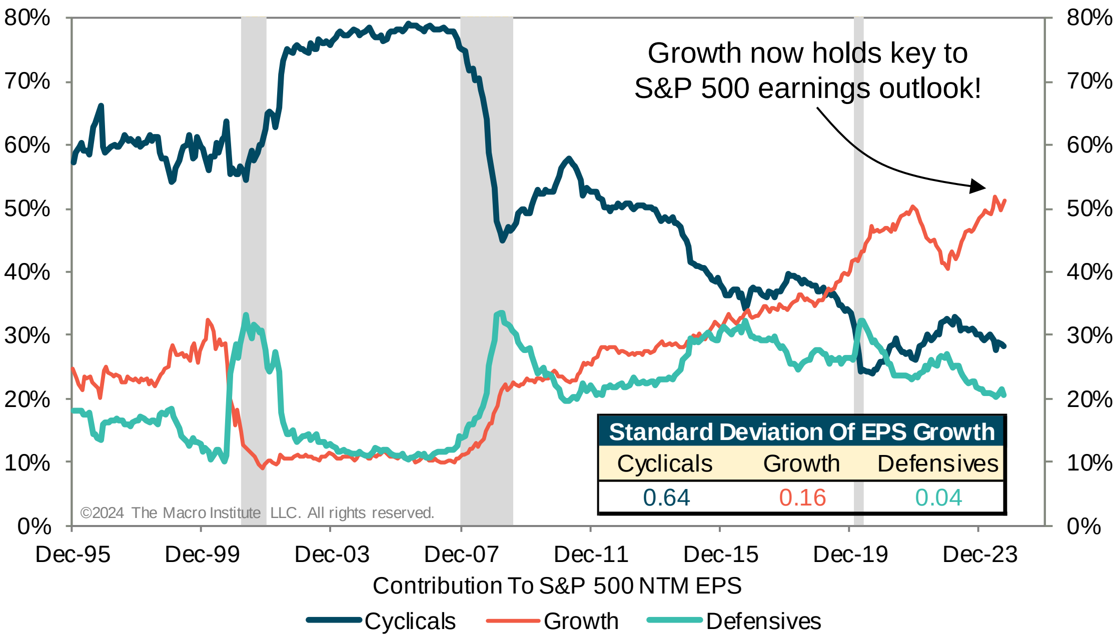
IDTT: S&P 500 Composition Now Growthier Than Ever

Financial market indices are another item in the IDTT bucket. Consistent with the NFP data, we see that in prior cycles Cyclicals compromised a much greater share of S&P 500 earnings. Remember that in the lead up to the GFC, the per barrel price of WTI eclipsed $140. This caused an outsized EPS contribution from the blue series (Cyclicals) below. The Cyclicals earnings and payrolls data aren't exactly apples to apples, but they look the same directionally and provide the same key takeaway – S&P 500 earnings are now much more reliant on the relatively-stable Growth sectors than in the past.

Growth Stocks Now Account For Over 50% Of S&P 500 Earnings



The spike in oil prices through mid-2008 was one factor that contributed to the 45.2% weight of Cyclicals in the S&P 500. This is obviously very different than today. Cyclicals are now about 25% of the S&P 500's weight and Growth sectors are more than half. If we impose today's S&P 500 weights on the index in 2007, we see earnings would have declined roughly 34% compared to 39% during the GFC. The larger mix of Growth sectors did not prevent S&P 500 earnings from falling but did mute the impact. The implication is that S&P 500 EPS could hold up better (i.e., decline less?) in the current cycle.

Index Composition Impacts Drawdowns

S&P 500 Weights	2007	Today
Growth	29.3%	51.7%
Cyclicals	45.2%	26.4%
Defensives	25.5%	21.9%

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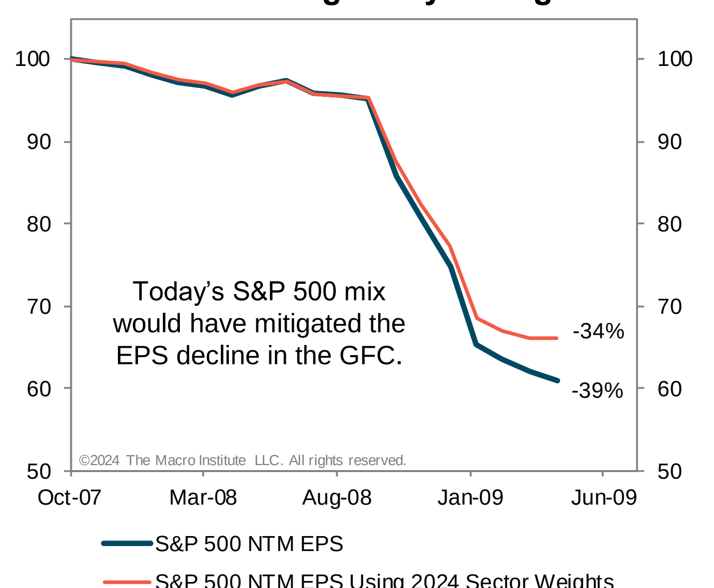
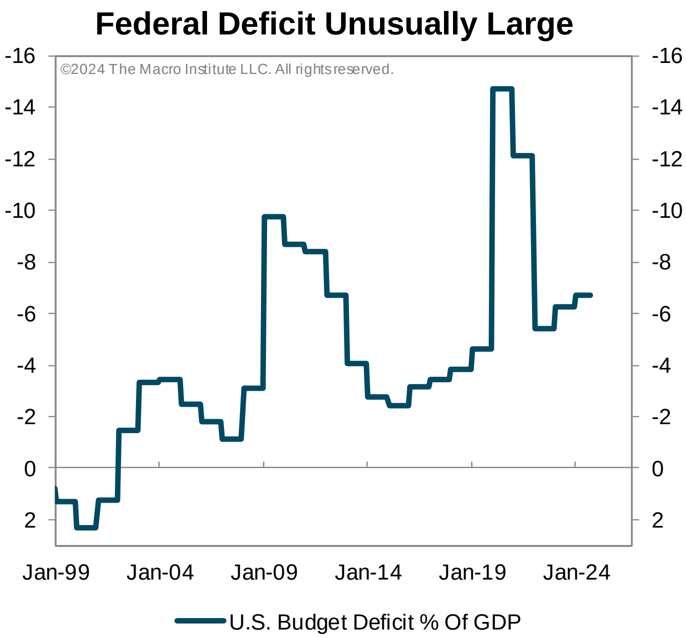
2008 EPS Using Today's Weights



IDTT: The State Of U.S. Public Finance Has Never Been This Dire (1/2)

The state of U.S. fiscal policy represents another large departure from what we've seen in prior economic cycles. Prior un-inversions in the yield curve serve as a great benchmark, as they portend rising unemployment and slowing GDP. It's important to recognize in the table below right that the denominator was at or around its peak for the cycle. This means the current 6.7% deficit, while outsized compared to history, is also based on peak GDP (i.e., it's likely understated). This is one reason why we see the series on the left spike during a downturn.



YC Un-Inversion Dates	Deficit % Of GDP
1989	-2.75%
2000	+2.34%
2007	-1.12%
2019	-4.62%
Current	**-6.73%**

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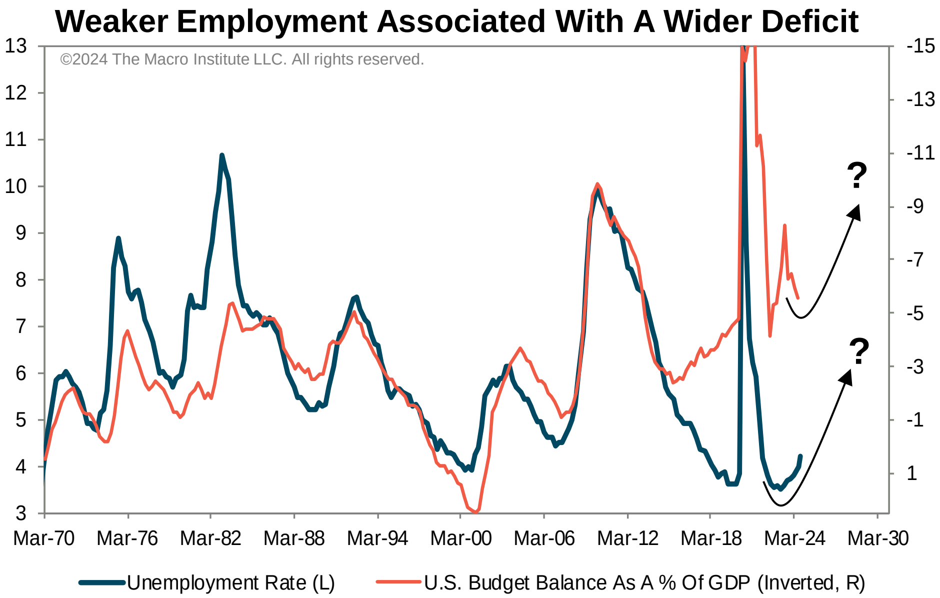
The cyclical downturn in employment pressures tax receipts which can also pressure the deficit. Below we see the tight and coincident relationship between these two series. IDTT as the U.S. should be running a near balanced budget at this stage of the employment cycle and not a ~7% deficit. As a result, a potential downturn in GDP implies that the deficit could reach historic levels and fiscal policy options are less available to stimulate the economy compared to prior cycles. That is of course assuming debt levels and inflation are a consideration for those enacting legislation in Washington.

Hahaha

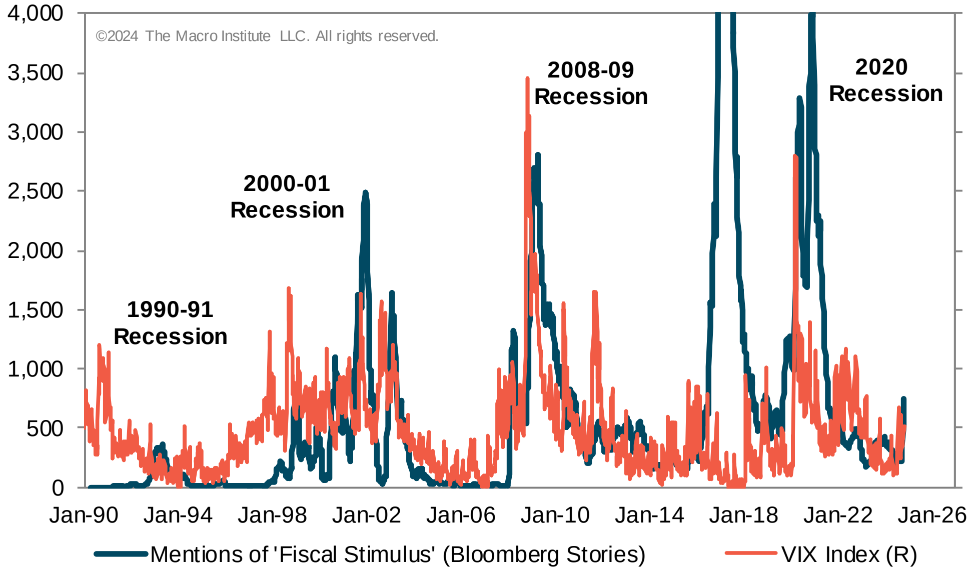


History shows that the federal budget deficit tends to widen when the unemployment rate is moving higher.

IDTT: The State Of U.S. Public Finance Has Never Been This Dire (2/2)

Another way to assess the dire state of current U.S. fiscal policy is through the lens of total debt, which stands at ~$35.8T, or close 120% of GDP as of Q2'24. Slowdowns and crises tend to result in various mechanisms of fiscal stimulus as policy makers enact counter-measures to support the U.S. economy and financial markets. This typically happens with little regard to the long-term consequences. It should not be surprising, but new fiscal stimulus mentions often coincide with financial market volatility.

Higher Market Volatility Usually Revives Interesting In Stimulus



Current policy proposals from the campaign trail would add an estimated $3.5T-$7.5T to the debt (2026-2035) according to a study by the Committee for a Responsible Federal Budget. Regardless of Tuesday's outcome, the near-term outlook for public policy suggests that debt as a percent of GDP will likely surpass levels in the WWII economy. These new fiscal stimulus measures imply heightened market volatility ahead, especially if bond yields continue to rise at their current pace.

Policy Proposals	Harris Plan (Billions)
Extend TCJA (<$400K Income)	-$3,000
Child & Earned Income Tax Credits	-$1,400
ACA Premium Subsidies	-$550
Affordable Housing Support	-$250
Exempt Tips From Tax	-$200
Improve Border Security	-$100
Small Business Support	-$150
Pre-K & Child Care Funding	-$700
Paid Family & Medical Leave	-$350
Quality Education Support	-$350
Long-Term Care Funding	-$200
Revenue & Spending Reductions	+$4,250

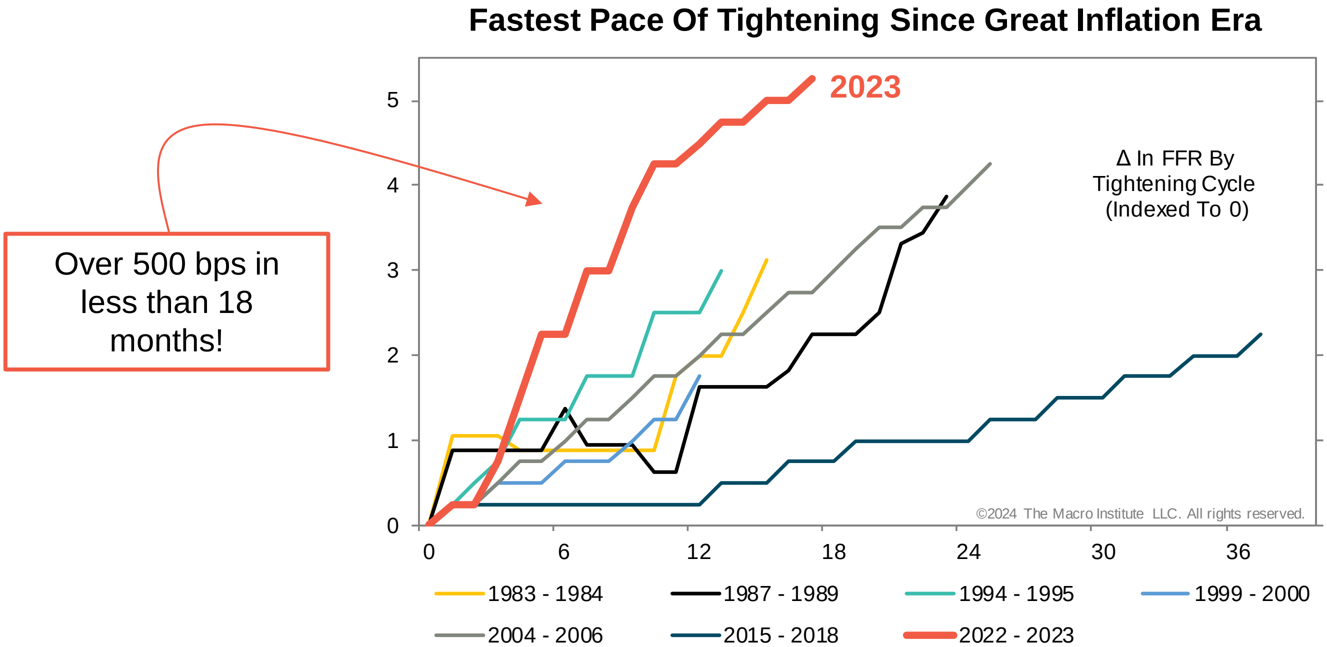
Source: Committee for a Responsible Federal Budget

Policy Proposals	Trump Plan (Billions)
Extend TCJA	-$5,350
Exempt Overtime Income From Tax	-$2,000
Exempt Social Security From Tax	-$1,300
Lower Corporate Tax Rate To 15%	-$200
Exempt Tips From Tax	-$300
Strengthen Military	-$400
Secure Border And Deportations	-$350
Housing Reforms	-$150
Boost Support For Health Care	-$150
Revenue & Spending Reductions	+$3,700

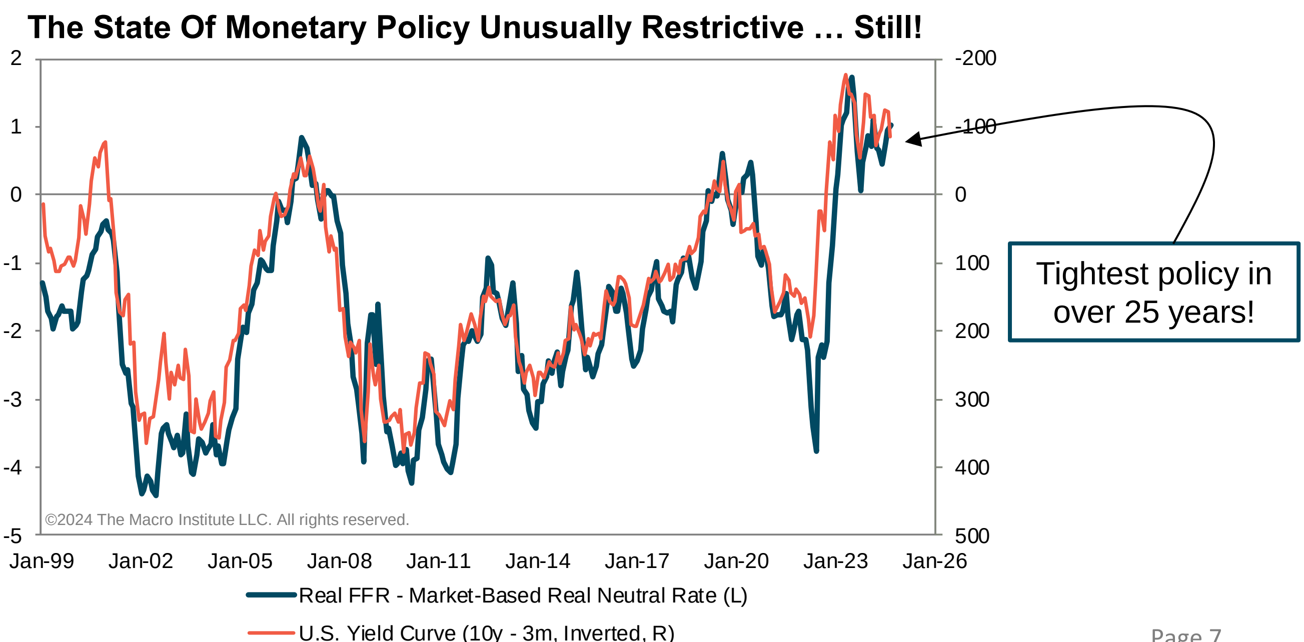
(Billions)	Harris Plan	Trump Plan
Estimated Budget Impact	**-$3,500**	**-$7,500**

IDTT: An Unusually Steep Rise In The Fed Funds Rate

The most consequential IDTT comes from monetary policy – the 2022-2023 hiking cycle was conducted at its most aggressive pace since the Great Inflation of the 1970s. The Federal Reserve increased the fed funds rate by ~500bps in a little less than 18 months. Below we see the pacing of six other tightening cycles since the 1980's, all of which were generally more measured. This is important because the lagged effects of monetary policy place downward pressure on growth and inflation. Monetary policy works with a lag and we are just beginning to see the byproducts of the 2022-2023 tightening in the employment data (more on this later).



How does the change in the fed funds rate translate into monetary policy settings? One of the IDTT arguments is that monetary policy was never restrictive enough to provoke a recession. The two series below show how monetary policy was and is unusually restrictive. The blue series is a proxy of the real fed funds rate and shows how it reached levels rarely seen in the past in the current cycle. This is consistent with the message from the yield curve that reached an inversion only seen in extreme slowdowns of the past. This was an unusual tightening cycle by any measure.



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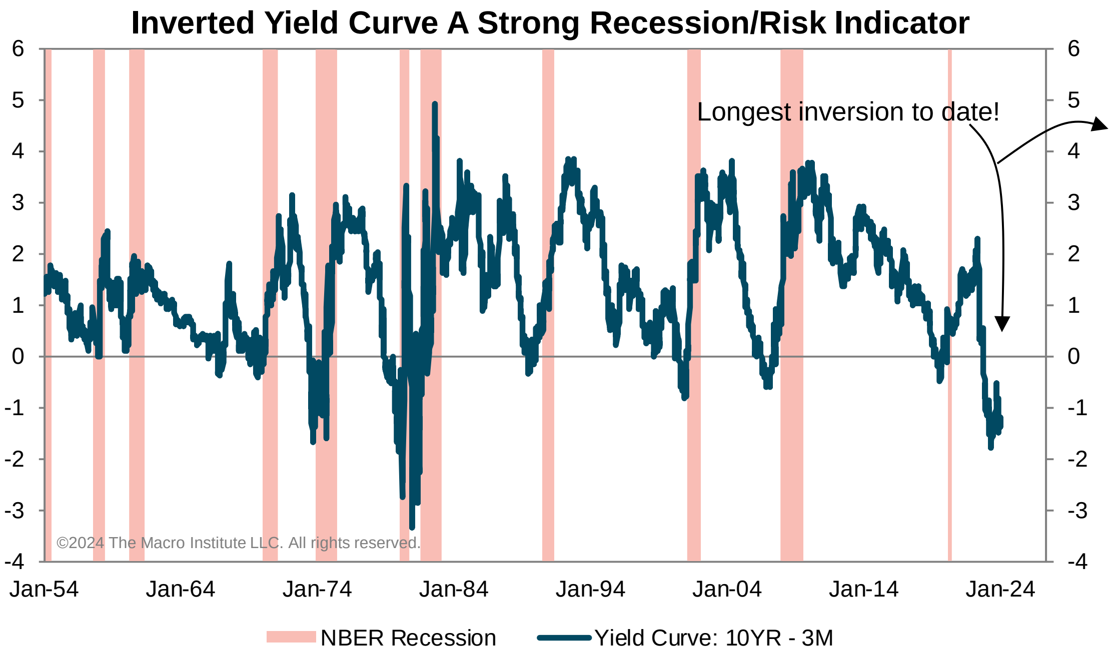
IDTT: An Unusually Long Inversion In The Yield Curve (1/2)

The yield curve's behavior was peculiar in the current cycle. Indeed, we saw it invert to a deeper level than anything since the 1970s and early 1980s – not exactly an ideal economic backdrop. The reflex from Wall Street in the current cycle has been to simply dismiss its message (i.e., heightened recession risk). At the end of the day the yield curve has always been viewed suspiciously by the investment community but it's not easy to dismiss such a time-tested indicator.



Yield Curve Inversions

Year	Months
2022	**23**
1978	17
1973	14
2007	11
1981	10
2019	7
2000	6
1969	6
1989	4
1966	4
Average	**9**

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There is no doubt in our minds that the concept of the yield curve is misunderstood by the investment community. This does not mean that the community could not get it wrong at some point (it inverted in the 1960s with no recession) but the arguments against its efficacy today are not very compelling. The main issue people have against the yield curve at this time is that it's been inverted, and we have not seen a recession (it's been a longer lag than typical). This is not that different from the experience of the GFC when it looked like an inverted yield curve did not matter much UNTIL it eventually did. In context, the yield curve is doing what it should be doing.

The Sequence Of A Slowdown & Monetary Policy Reaction

Episode	1st YC Inversion	1st Recession Month	1st Rate Cut
1978	August-78	+17 Months	+14 Months
1980	September-80	+10 Months	+4 Months
1989	January-89	+18 Months	+4 Months
2000	February-00	+13 Months	+11 Months
2005	December-05	+24 Months	+20 Months
2019	August-19	+5 Months	+5 Months
	Average (Months)	**15**	**10**
	Average (Ex Covid)	16	11
2022	**July-22**	**??**	**+25 Months**

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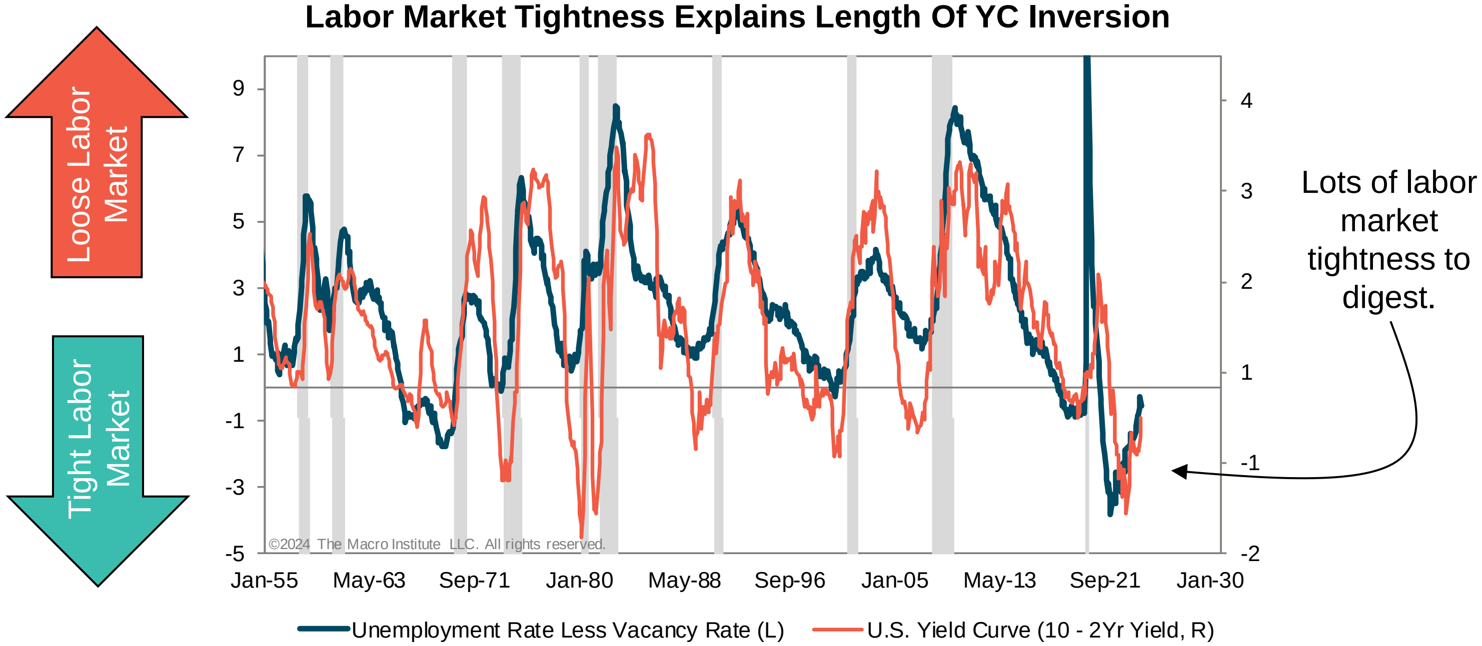
IDTT: An Unusually Long Inversion In The Yield Curve (2/2)

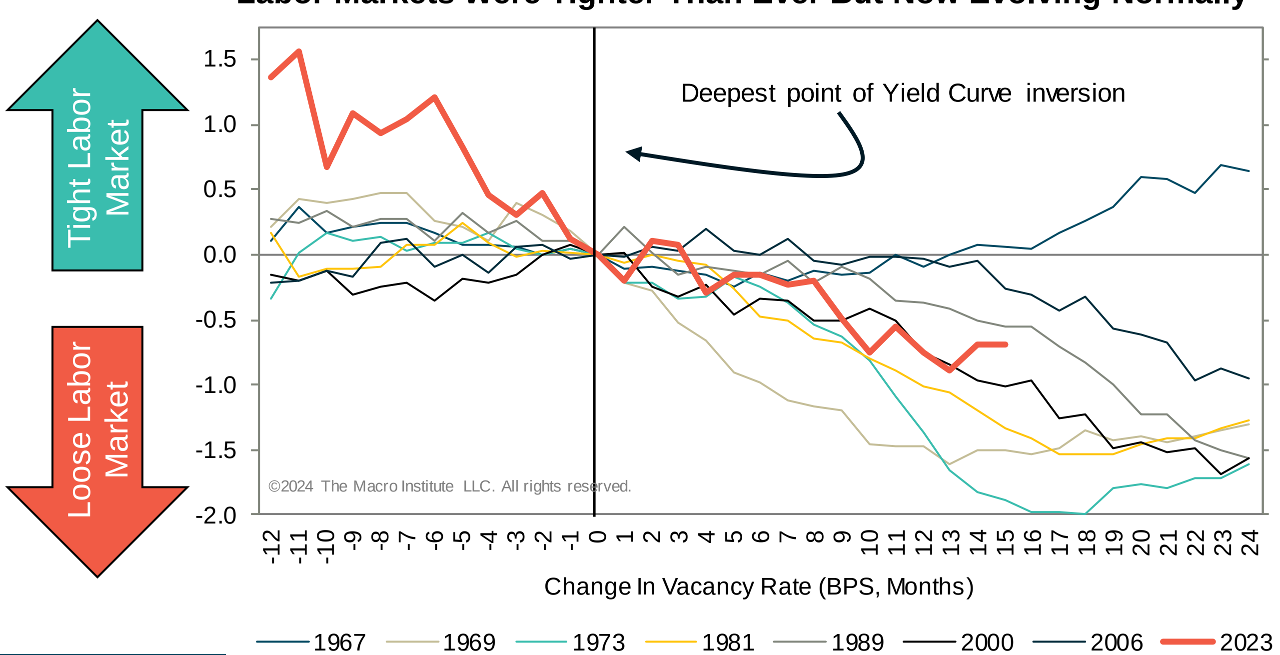
The length and depths of inversions in the yield curve are not random across history. The state of the yield curve at a given point in time is merely a reflection of monetary policy and those are usually in response to trends in labor markets. In essence, the yield curve is just a proxy of labor market tightness – at least most of the time. As the chart below illustrates, we had a deeply inverted yield curve because we just experienced the tightest labor markets in the history of U.S. data.

Labor Market Tightness Explains Length Of YC Inversion



The chart above shows that the yield curve is a great anchor for economic research. We know the yield curve behaved in an unusual manner in the current cycle, but then again so did labor markets, and those two things go hand in hand. What potentially complicates this story is that while levels in employment and the yield curve were unusual in this cycle, the dynamic we are seeing now is about as normal as it gets. The chart below shows that the vacancy rate (job openings as a % of the labor force) has been deteriorating as it typically does when the yield curve begins to re-steepen.

Labor Markets Were Tighter Than Ever But Now Evolving Normally



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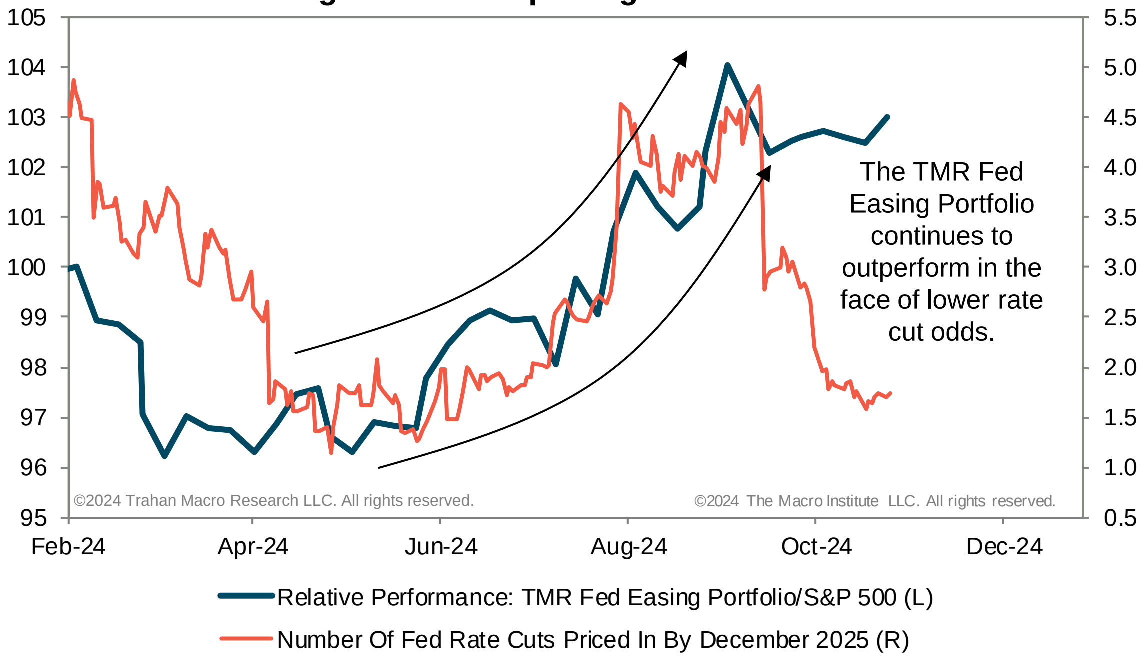
It's NOT Different This Time: The Fed Easing Trade

The Fed Easing Portfolio is a simple 5-factor screen that focuses on the stock selection criteria that have generated consistent alpha over many past easing cycles. Since introducing this portfolio in early August, it has outperformed the S&P 500 by 237 bps. The TMI Fed Easing Portfolio was built to outperform during Fed easing cycles, which is a period typically marked by lower rates and softer economic and employment data. Continued outperformance despite investors no longer pricing in an aggressive rate-cutting cycle suggests markets are positioning for softer economic data.

Fed Easing Portfolio Capturing Fears Of Softer Data?



The full screen for the TMR Fed Easing Portfolio is available for the S&P 500 as well as other common indices. Simply email quant@trahanmacroresearch.com for the full list. Again, this is a simple screen of 5 factors that has systematically generated alpha in prior easing cycles. We will keep updating it for the next year and probably longer. After all, the average Fed easing cycle has lasted about 18 months and some cycles have been even longer.

A Sample Stock Listing Of The Five Factor Fed Easing Portfolio

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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	1	1	1	Consumer Discretionary
VZ	Verizon Communications Inc.	1	4	1	2	1	1	Communication Services
BRK.B	Berkshire Hathaway Inc. Class B	1	8	3	2	1	1	Financials
AMT	American Tower Corporation	1	3	6	3	1	1	Real Estate
IBM	International Business Machines Co	1	7	1	9	1	1	Information Technology
MRK	Merck & Co., Inc.	1	2	1	2	2	1	Health Care
PG	Procter & Gamble Company	[illegible]	2	6	[illegible]	2	1	Consumer Staples
SBUX	Starbucks Corporation	1	5	3	5	2	1	Consumer Discretionary
NSC	Norfolk Southern Corporation	1	[illegible]	3	[illegible]	3	1	Industrials
SHW	Sherwin-Williams Company	1	3	6	6	3	1	Materials

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