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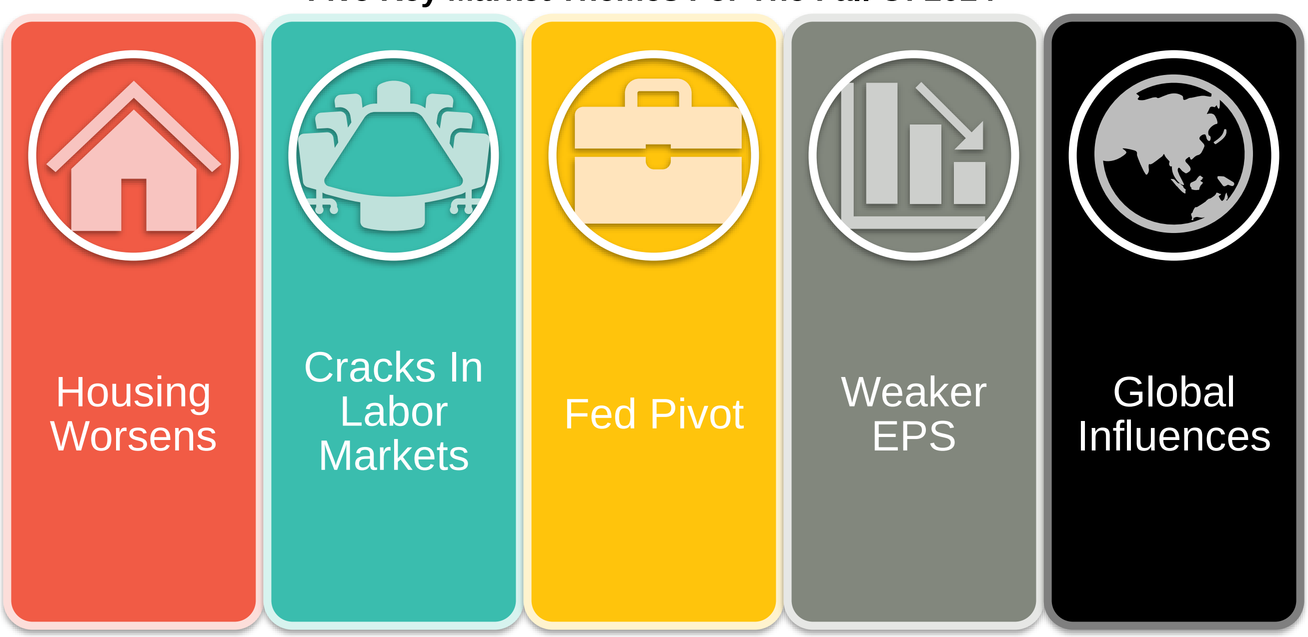
Five Key Themes Likely To Influence Markets This Fall

It's always hard to fully re-engage with markets as the summer comes to an end. I suspect some of you are on vacation this week, dealing with the beginning of the school year for your children, or prepping for the long weekend ahead. Irrespective, for most folks working in the money management industry Labor Day Tuesday marks the beginning of the sprint to year end. There are a lot of macro influences likely to impact financial markets this fall. Some directly (weaker earnings?), some not so directly (housing gets worse?). Regardless, we thought we would take this week to discuss some of the issues likely to matter between now and year end.

Five Key Market Themes For The Fall Of 2024



The biggest theme we foresee in the marketplace this fall is the return of volatility (think early August but on a bigger scale). Truth be told, this is commonplace in the wake of Fed tightening. Note that we will be doing a conference call on this specific topic on Thursday, September 5th at 10:30am (register here using this link). In this report we cover five macro influences likely to drive the rebound in volatility. Some have been in the works for a while whereas others will feel like an outright surprise. What is clear is that all are incompatible with the soft-landing narrative.

We can't cover five themes in detail in a 12-page report so this is just an overview of what we will be discussing in depth next week, and odds are, throughout 2024 and into 2025. If there's one thing that the month of August has taught us it is that consensus remains anchored to the soft-landing thesis for the U.S. economy. The markets' reaction to the July employment report and the trigger of the Sahm Rule make that clear. Nothing is impossible of course but economic data is hard to reconcile with a mid-cycle slowdown ending – for now anyway. Wishing you a great rest of your week and long weekend. All the best. Francois

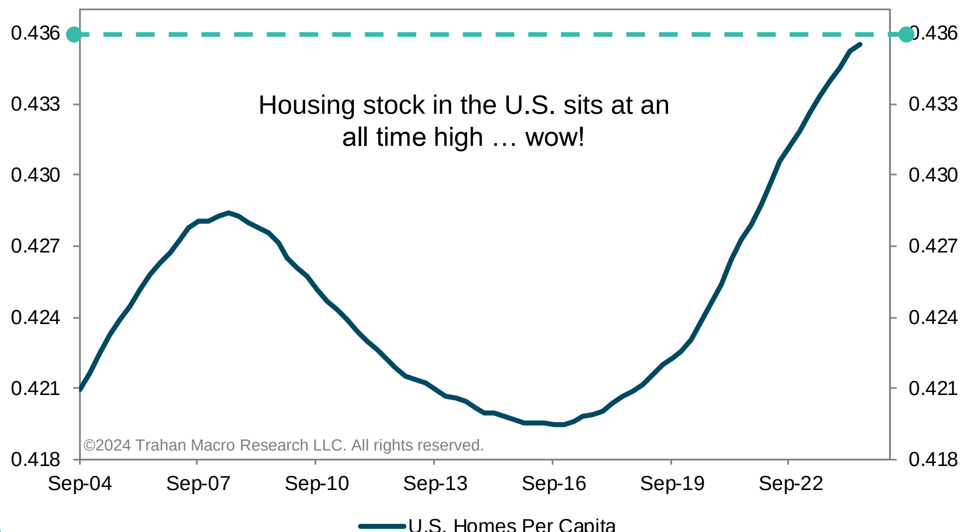
The Next Phase Of The Housing Downturn And Its Implications (1/2)

Housing has been somewhat controversial for years now. Many believe that the industry remains strong because prices have yet to really turn lower but, at the same time, transaction volumes are anemic from a historical standpoint. Drilling down to the most active markets during and following the pandemic, we can see a reversal of fortunes with inventories piling up as potential buyers combat record unaffordability and now also a shaky labor market. Below we see total existing homes for sale rising high-teens y/y as homeowners face stress from inflation and higher insurance costs and are generally looking to capitalize on appreciation from the last few years. This increase in supply leads prices lower and can result in a negative feedback loop as depreciation motivates the incremental seller to get their home sold ASAP.

Higher Inventories Should Stall The Home Price Rise

Housing supply has now entered the political discussion as the one-two punch of high interest rates and high prices has made homeownership a pipe dream for many Americans. It's often assumed that there's a U.S. housing shortage perpetuating this dynamic. In truth, there are actually more homes per capita in the U.S. today than ever before. So, to be fair, it's a lack of *affordable* housing that is the root cause of shelter-associated inflation. This supply glut suggests there's more downside ahead in terms of demand/pricing and its eventual flow through to the economy. Remember that "housing is the business cycle!"

There Are More Homes Per Capita In The U.S. Today Than Ever!



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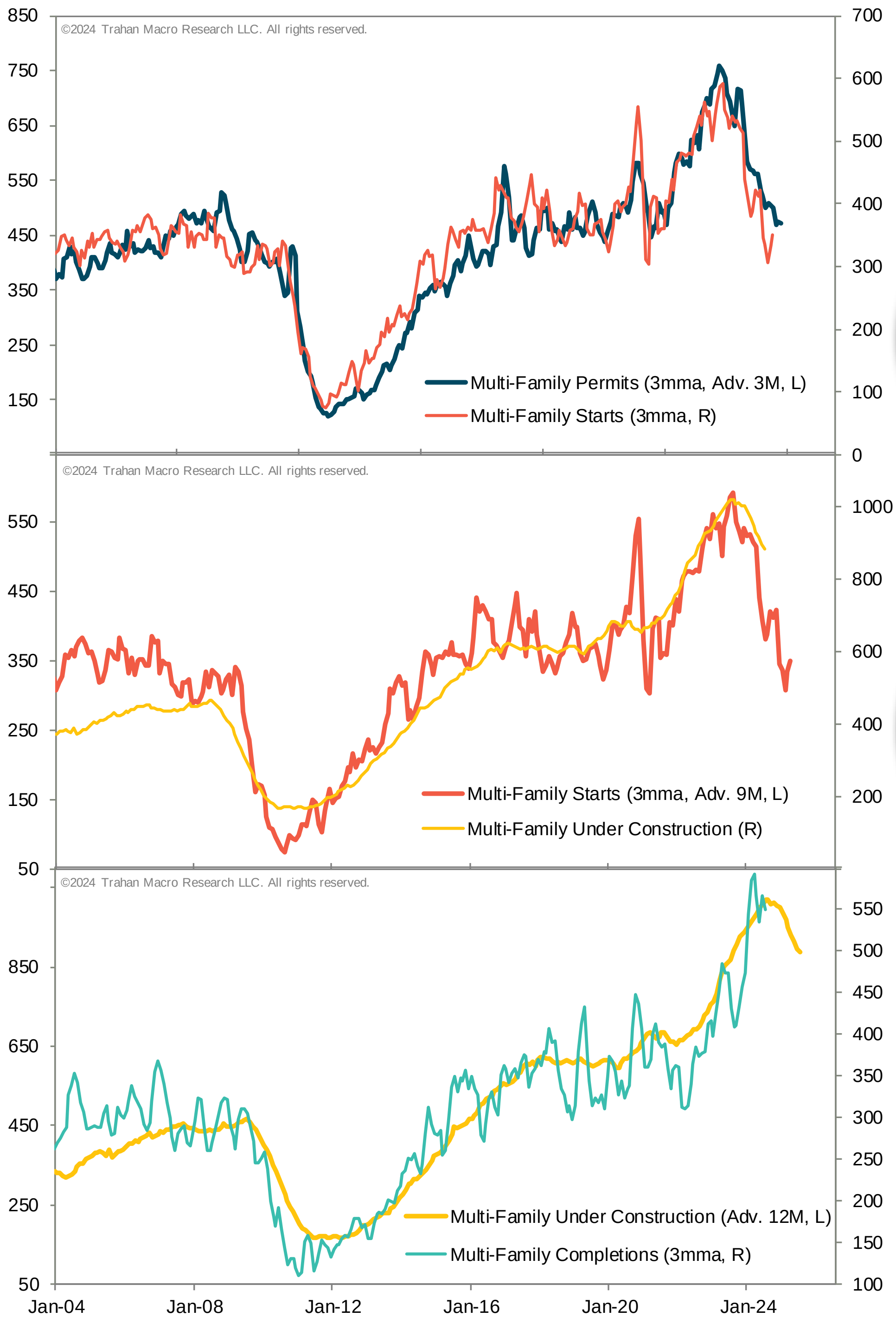
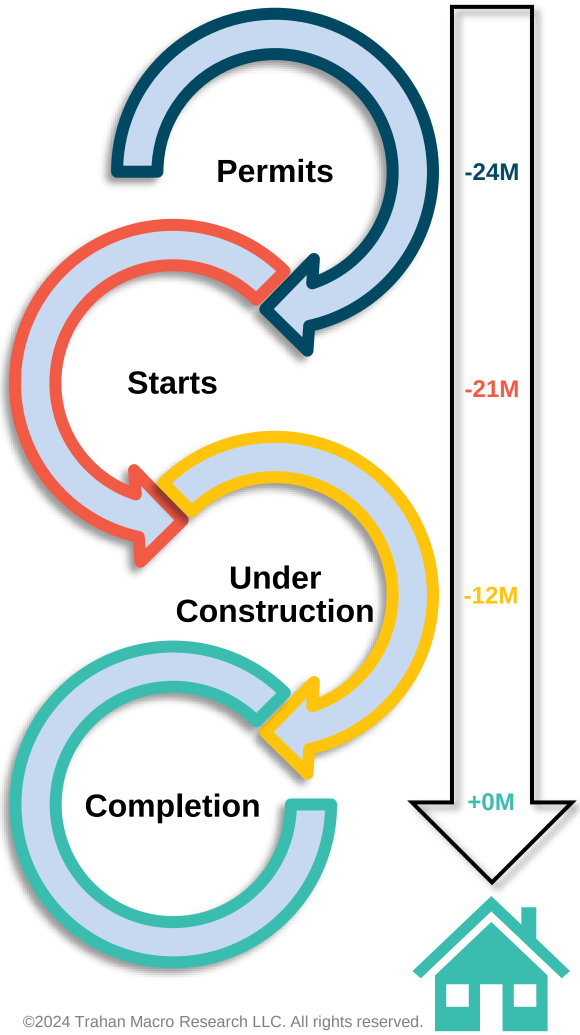
The Next Phase Of The Housing Downturn And Its Implications (2/2)

The Conference Board, what we affectionately call the "Official Data Arbiter," uses Building Permits as one its several non-financial LEI components. The issuance of a building permit begins the chain-reaction of the various economic activities that drive GDP, such as the hiring of labor and the purchase of raw materials. It is roughly a 24-month lead time from permitting to completion. The data here shows that headwinds to single-family activity on the prior page are happening in multi-family as well.

Tracking Construction: Permit To Completion





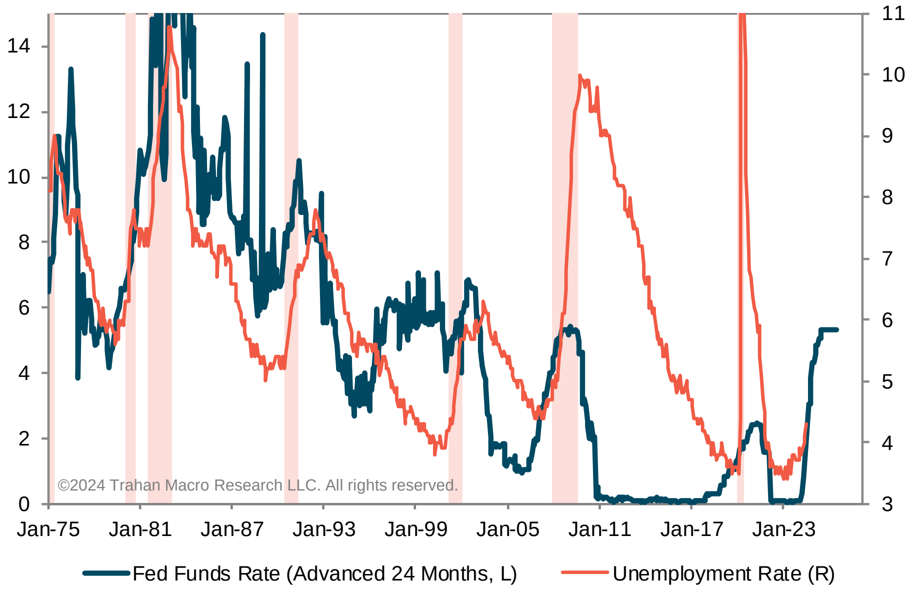
The end of 2022 appears to be the cyclical crest for new activity with Permits and Starts achieving stratospheric levels well above those seen in the pre-GFC days. This is one small factor supporting economic growth this year assuming the projects are not suspended. Yet this wave of new supply has helped the Fed with housing de/disinflation.

As we highlighted earlier, housing is a regional business and certain markets in the South may be better equipped to absorb new home supply due to post-COVID population growth while others in the Midwest and Northeast will not be so lucky. What is clear is that conditions change from here for activity.

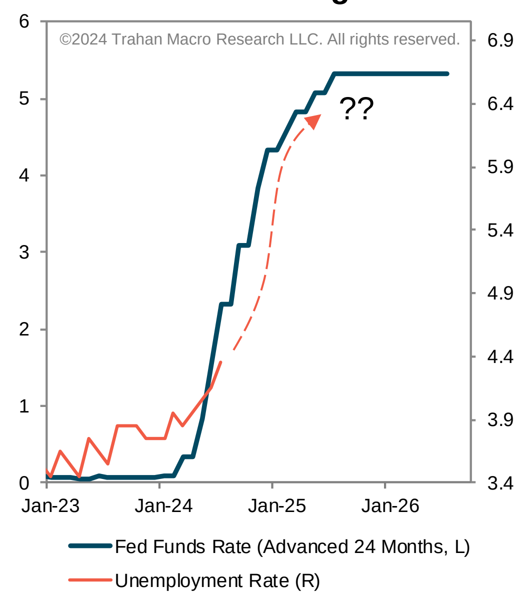
Labor Market Dynamics Are About To Change Everything (1/2)

Forecasting leads/lags associated with monetary policy is not always an exact science but even we are surprised with how neatly the unemployment rate is lining up with changes in policy so far in this cycle. The last payroll report saw the unemployment rate rise to 4.3%, triggering the Sahm Rule. Macro rarely works this simply, and we do not expect this tight of a relationship to persist each month, yet the labor market tends to move powerfully in one direction as the economic cycle inflects. Even with a 25bp cut in September, the prior tightening cycle will likely continue to pressure employment well into 2026.

Trends In Employment Follow Rates With A 24 Month Lag

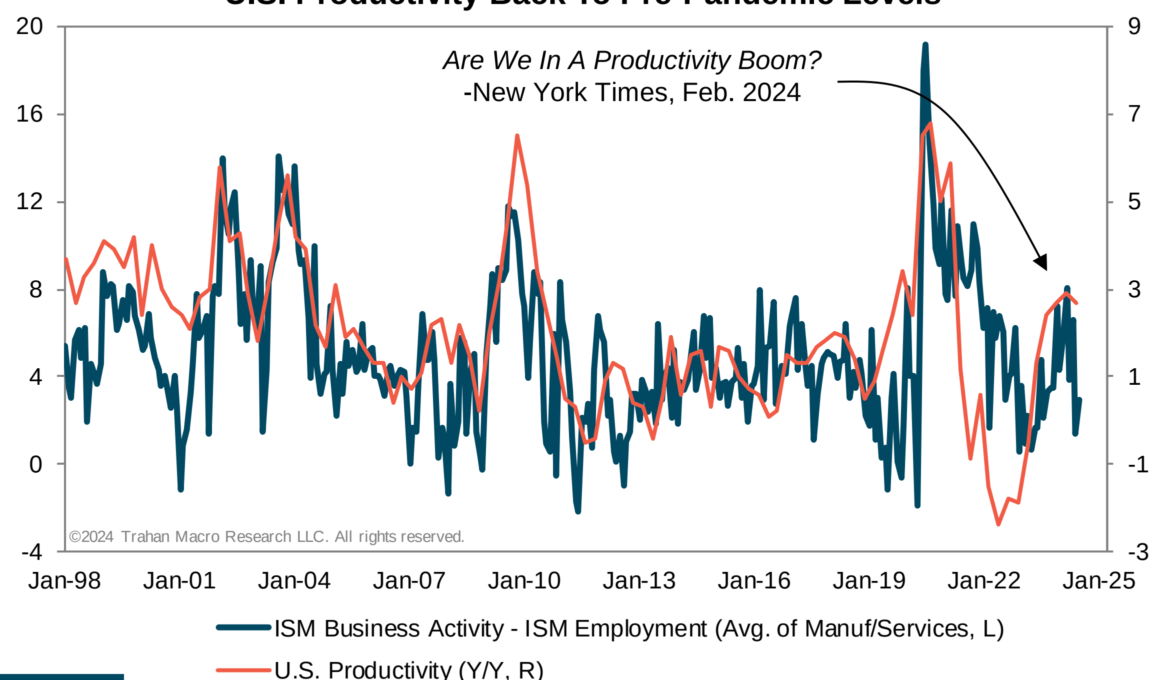


A Few Years Of Higher UR?



Much of the pushback we receive on our cautious macro view – and employment specifically – is about AI and the potential for a productivity boom that will allow the U.S. to sidestep a recession. The anecdotes are intriguing, but they are just anecdotes at this point in our view and not compelling enough to change our call on the next 12-24 months. Regardless, for now at least, the relationship between labor markets and productivity seems very much intact. Is it really true that AI explains the rebound in productivity? The chart below sure seems to challenge the current narrative.

U.S. Productivity Back To Pre-Pandemic Levels



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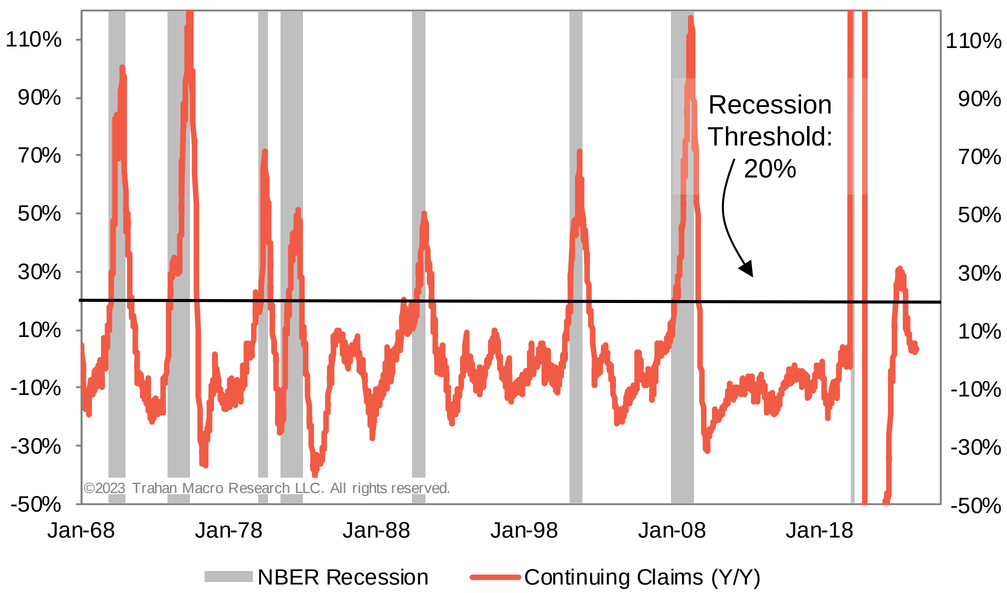
Labor Market Dynamics Are About To Change Everything (2/2)

The Sahm Rule has received media attention lately as the methodology has been a reliable recession indicator throughout history. But truly there are dozens of ways to slice and dice the copious amounts of employment-related data. What we see on the left below is the year-over-year change in Continuing Claims going back to 1968! Each time it has passed the +20% y/y threshold, there has been a recession as defined by the NBER. Keep in mind, it takes time for NBER to formally declare an official recession as the committee assesses Depth, Diffusion, and Duration for a determination.

Continuing Claims ALREADY In Recession Territory

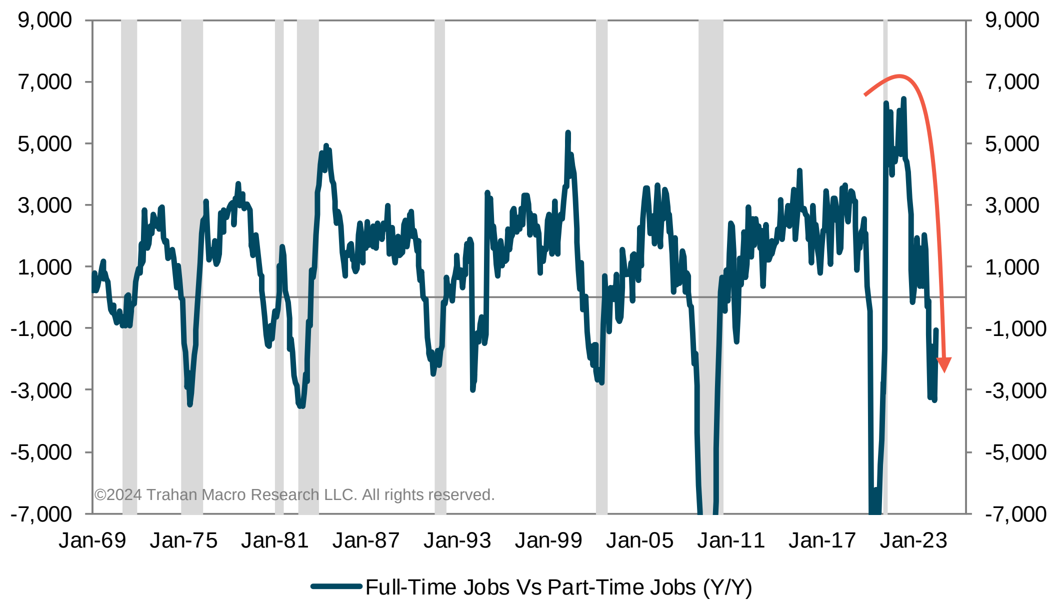


Recession Indicator Checklist

- ☑ **Tightening Of Monetary Policy**
- ☑ **Inverted Yield Curve**
- ☑ **Increase In % Of Gov't Jobs**
- ☑ **Deterioration In Housing LEIs**
- ☑ **Drop In Full-Time Employment**
- ☑ **Continuing Claims > 20% Y/Y**
- ☑ **Sahm Rule Triggered**
- ☑ **Fed Recession Model ~ 70%**

This recession indicator checklist may seem like a collection of arbitrary indicators to some but it's simply byproducts of tighter monetary policy and its influence on the business cycle. Some of these triggers occur earlier (yield curve) while some are later (employment). While the labor market is traditionally the economic *coup de grace* of the cycle, we can look at various components like claims (above) and parts of payrolls (below) as slightly-more leading indicators of labor. When we see full-time employment falling relative to part-time, it's another strong signal that the employment market is cracking.

Early Sign Of Recession … More Part-Time Than Full-Time Jobs



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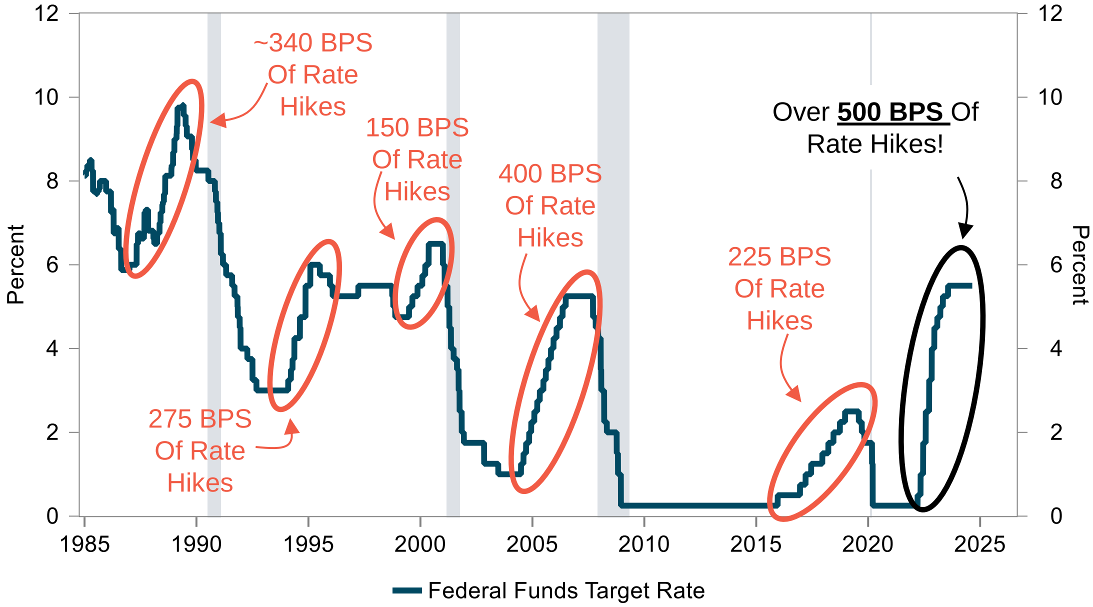
The Fed Pivot → "Time Has Come" – Jerome Powell (8/23/24) (1/2)

Back in January 2024 investors expected the Fed would deliver a series of interest rate cuts by now. Yet, it took until last Friday for the Chairman to formally pivot policy in response to weaker growth and a deteriorating job market. The initial equity market reaction was a move higher as investors still believe the Fed is engineering a 1994-style soft landing. We've written about the numerous differences between that cycle and the current, one of which is the amount and rapidity of Fed tightening in 2022-2023 and no inverted yield curve, as well as many others.

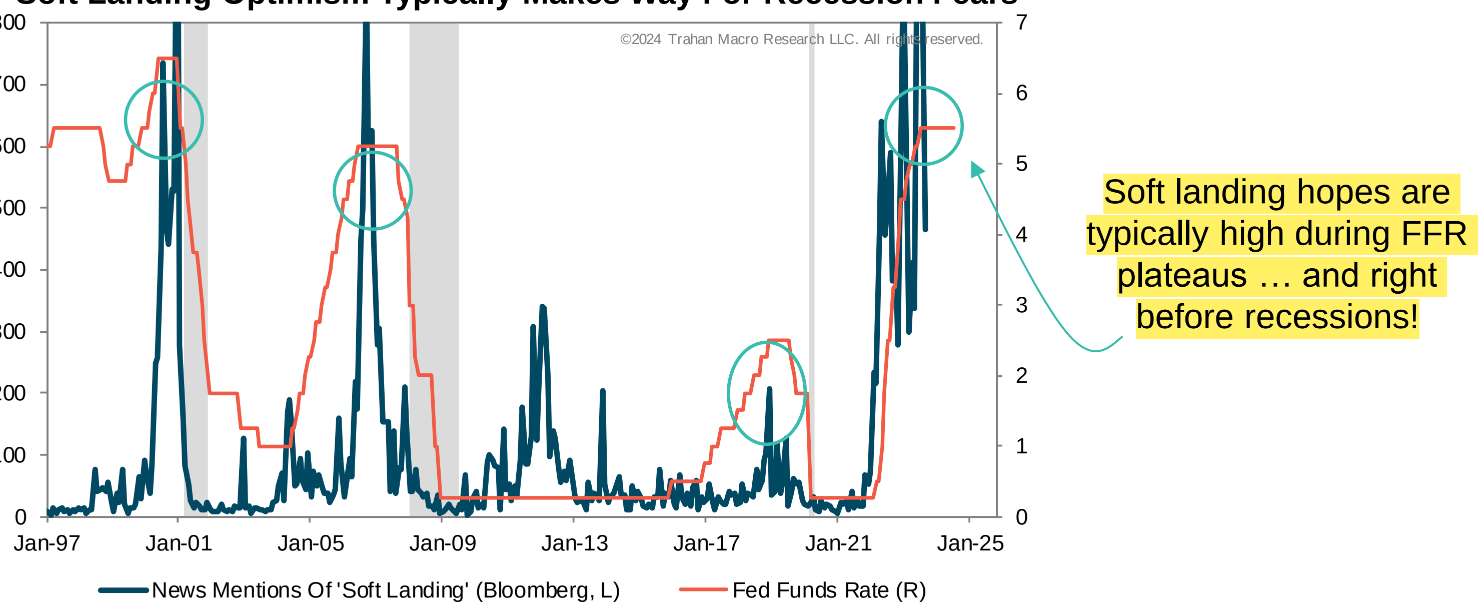
The Most Potent Fed Tightening Cycle Since The Volcker Era



Start Of Tightening	ISM Fell Below 50	GDP Recession
1954	Yes	Yes
1958	Yes	Yes
1961	Yes	Yes
1967	Yes	No
1972	Yes	Yes
1977	Yes	Yes
1980	Yes	Yes
1983	Yes	No
1988	Yes	Yes
1994	Yes	No
1999	Yes	Yes
2004	Yes	Yes
2015	Yes	Yes
2022	**Yes**	**?**
Frequency	**14/14**	**10/13**

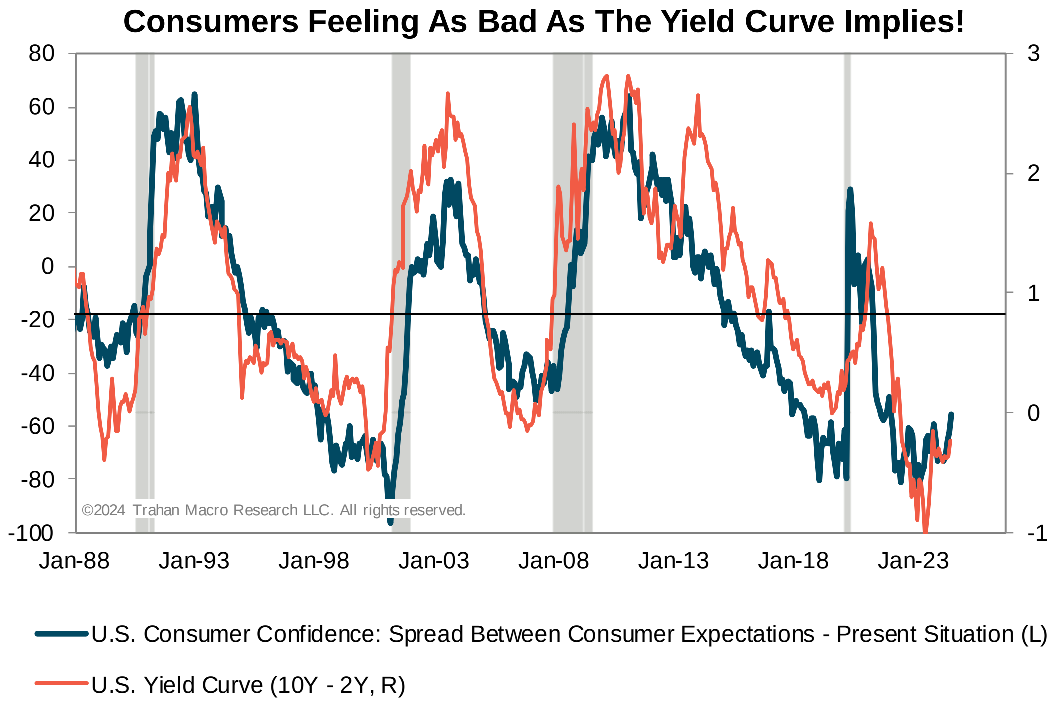
Unfortunately, investors tend to ignore the lagged effects of monetary policy and at each fed funds rate plateau we seem to have the same conversation. At this stage in the business cycle the economy always looks good enough – and it should! It's not until the two-year anniversary of rate hikes that we typically see deterioration in labor markets. Below is the number of news mentions of "soft landing" by Bloomberg plotted against the fed funds rate. Investors will continue to believe in the soft-landing narrative until earnings – or its macro-equivalent, employment – start to deteriorate undeniably.

Soft Landing Optimism Typically Makes Way For Recession Fears

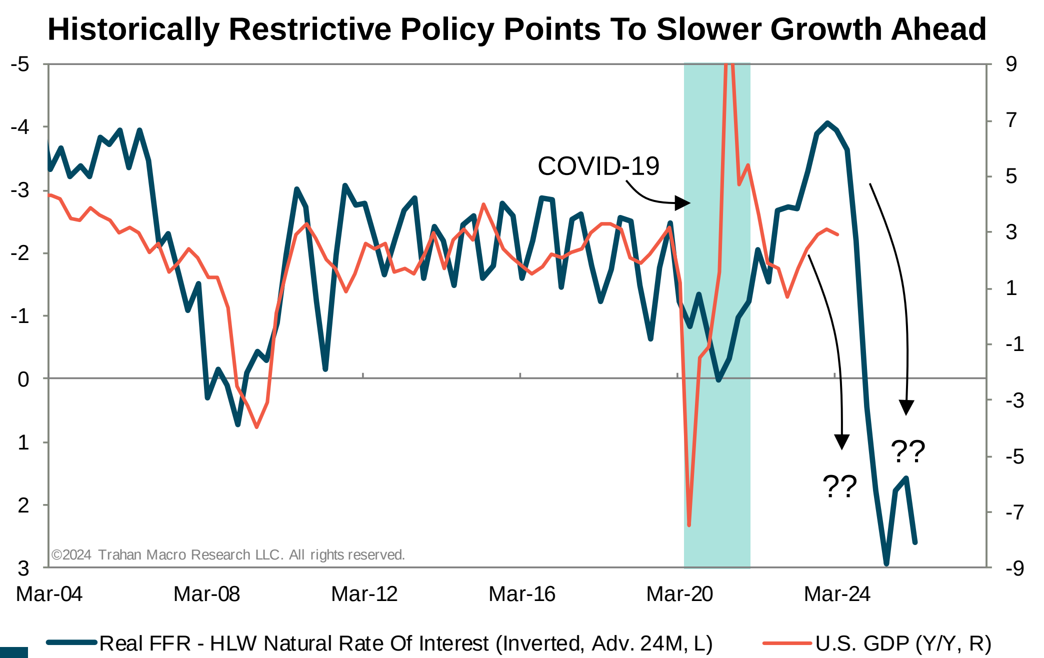


The Fed Pivot → "Time Has Come" – Jerome Powell (8/23/24) (2/2)

You couldn't tell by looking at equities lately, but consumers are about as bearish as they have been in some time. An upcoming election, cumulative inflation levels, and most importantly deteriorating employment are the culprits. The blue series represents the spread between expectations and one's present-day situation which maps nicely with the yield curve. The point here is to show that the yield curve is NOT impaired, as many believe, and it is indeed flashing a legitimate warning sign about what comes next. IF it was impaired it would not be correlating with economic series to this degree.



Consumers are the lifeblood of the U.S. economy and account for nearly 70% of GDP. The expectations spread above is just one of many ways for us to chart the path forward for growth. Below is the difference between the real fed funds rate and the "R-Star," or so-called "Neutral Rate," which is a proxy for how accommodative or restrictive policy is relative to where it *"should"* be (i.e., its "natural" state). The series is at nearly +3.0 right now (left scale, inverted) suggesting policy is quite restrictive. Again, changes in the FFR operate with a lag so this gives us a good idea of the likely trajectory of GDP growth.



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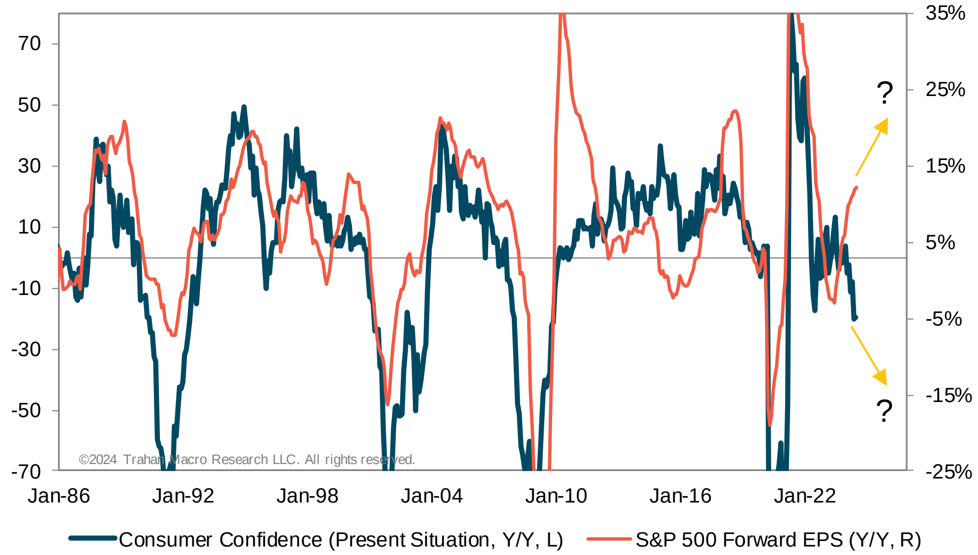
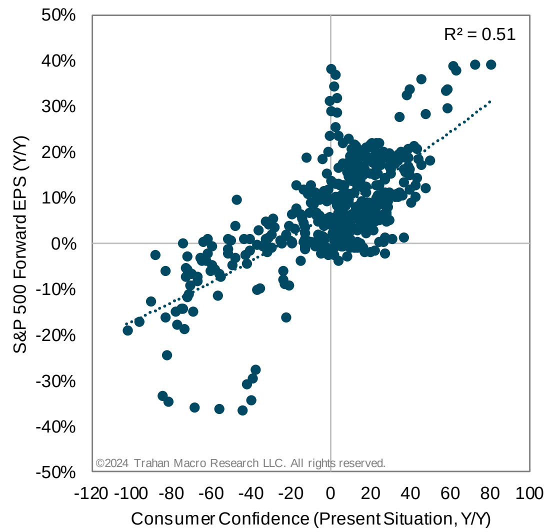
Weaker Employment Inevitably Leads To Weaker Earnings (1/2)

Earnings have always been the lifeblood of the equity market, and it's difficult to get a true bear market without an outright decline in earnings. Surely, there have been P/E-driven corrections in the past, but generally earnings drive the direction in equity prices. In similar fashion, it's hard to separate earnings from employment statistics given that consumption accounts for 68% of GDP in the U.S. In that vein, the disconnect we are seeing between S&P 500 earnings expectations and trends in consumer sentiment are unlikely to last. Something must give and history has shown it is earnings.

Earnings Estimates Deviating From Consumer Sentiment?

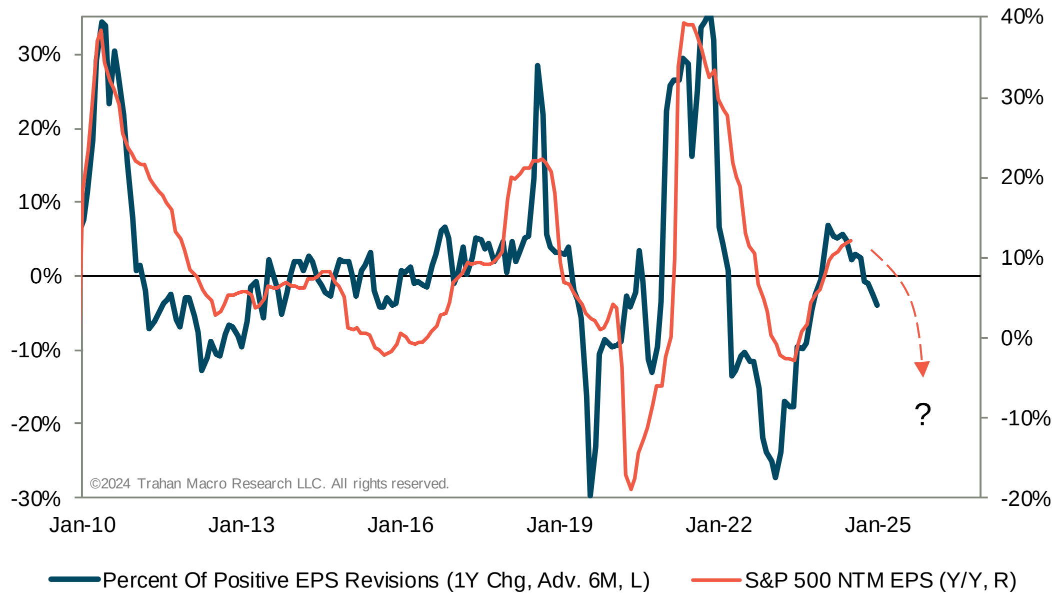


Historically Tight Relationship



However, consumer confidence is not the only series flashing warning signs for S&P 500 earnings. It's pretty easy to find indicators that question the sustainability of EPS trends at this juncture. Generally, it's also easier to see a turning point in earnings in more cyclical segments of the market. This helps explain why we often look at data for the Russell 2000 or the S&P 600 Small-Cap Index at inflection points. In similar fashion, breadth in S&P 500 EPS data is helpful at times like these as it captures what is happening to smaller, more economically volatile companies, and we have a deteriorating situation there. If this holds in the current cycle, then broader S&P 500 EPS should be slowing soon.

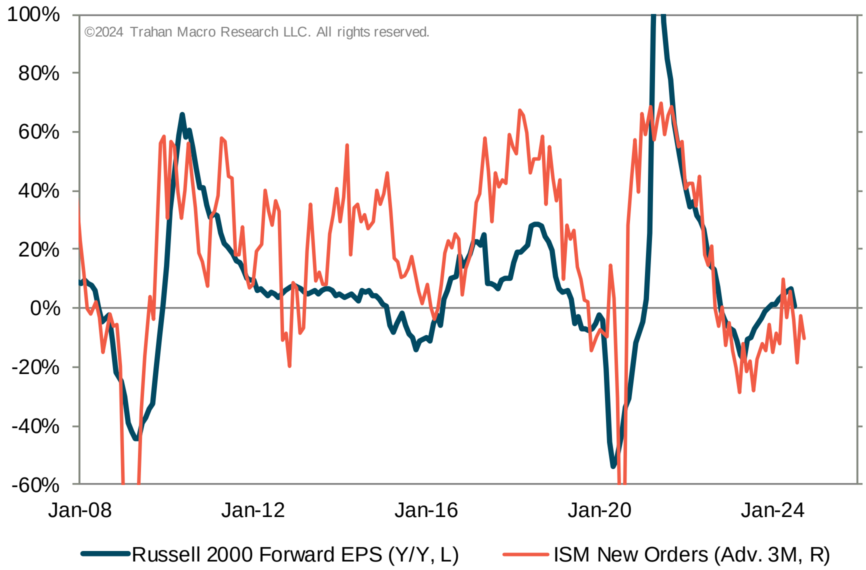
breadth* **Breath In EPS Revisions Point To Broader Earnings Issues**



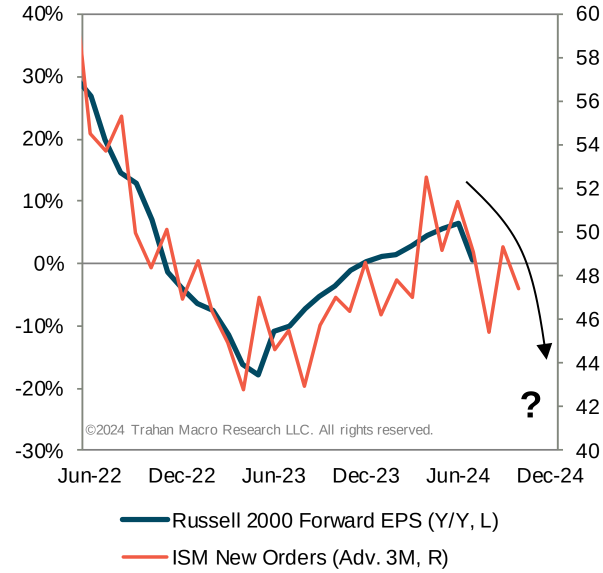
Weaker Employment Inevitably Leads To Weaker Earnings (2/2)

Earnings expectations for the S&P 500 behave mostly like a coincident indicator of economic activity. In that sense, we are able to get a heads up on EPS trends from some LEIs like the ISM New Orders Index (one of 10 official LEIs according to the Conference Board). Below we use it as a leading indicator of Russell 2000 forward earnings growth. Interestingly, small-cap earnings trends are flat-ish from year-ago levels after rebounding for some time. At this stage, the ISM data argue that EPS for this cap segment will continue to ebb lower in the fall months. Keep an eye out for the ISM August reading next Tuesday.

Small Cap Earnings At Risk According To LEIs

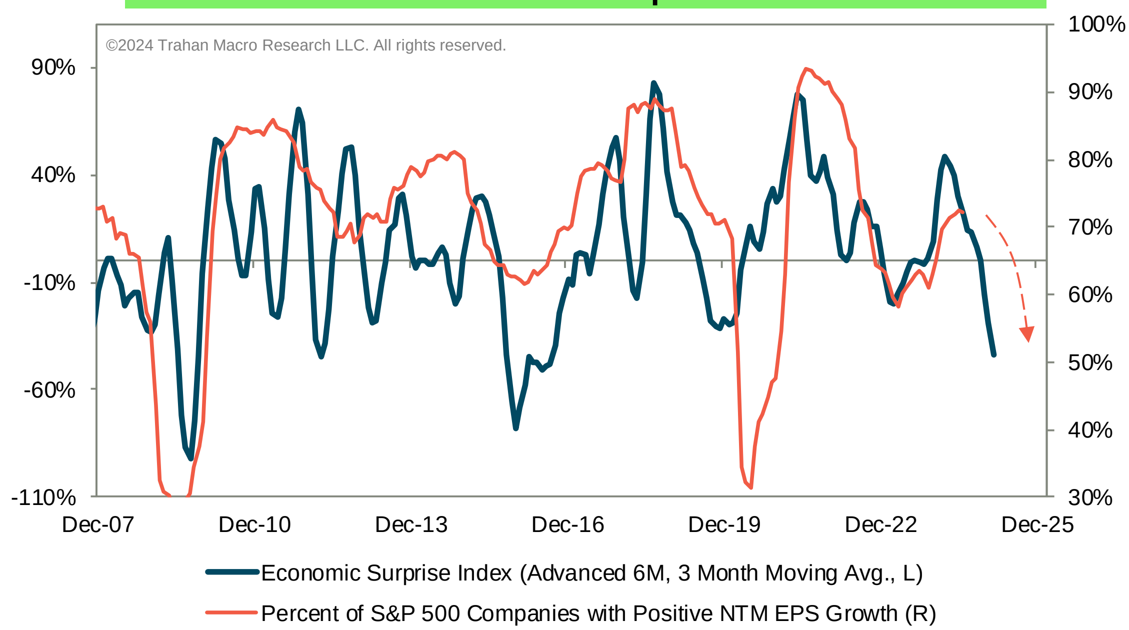


Earnings Contraction Ahead?



PMIs and the ISM are not the only series that have weakened in recent months --- there have been many disappointments. So many disappointments that the Economic Surprise Index (ESI) has been absolutely melting and looks as anemic as it has in years. History teaches us that when economists are systematically surprised to the downside by economic data, we tend to see a similar dynamic take place in earnings estimates. If it was just one series pointing to problems ahead it could be dismissed but there are a host of historical data points now arguing for a turning point in EPS. Typically, the Fed begins cutting rates after earnings turn lower. We shall see if this holds this time around.

Recent Meltdown In Economic Surprises Also A Risk To EPS



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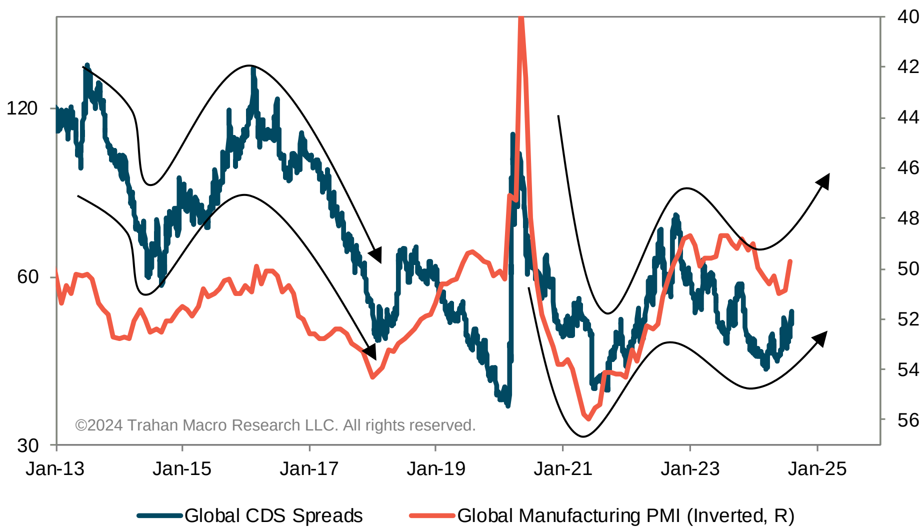
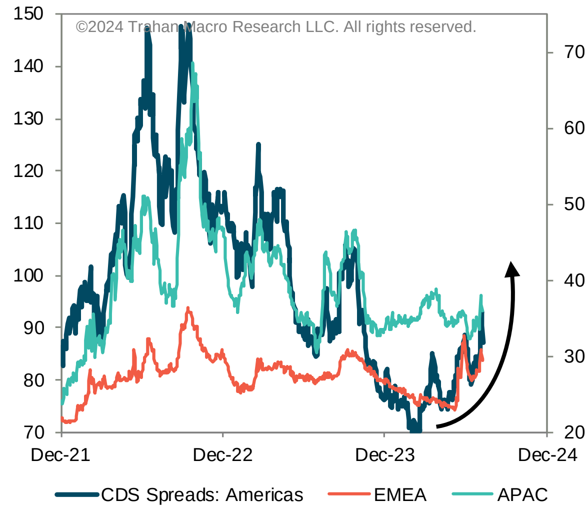
Rest Of The World Could Also Be A Problem For U.S. Equities (1/2)

The main issue we foresee for U.S. equity markets is weaker earnings. This helps explain why we have been so adamant about the soft-landing versus recession debate. At the end of the day, however, the outlook for stocks is not as binary as it might sound. Indeed, there are other influences that could impact the U.S. stock market. History is littered with events in the rest of the world that end up affecting U.S. stocks almost irrespective of what is going on in the U.S. economy. Risks from the rest of the world should be front and center in 2024-25.

Global Manufacturing Activity Slows Along Rising Risks

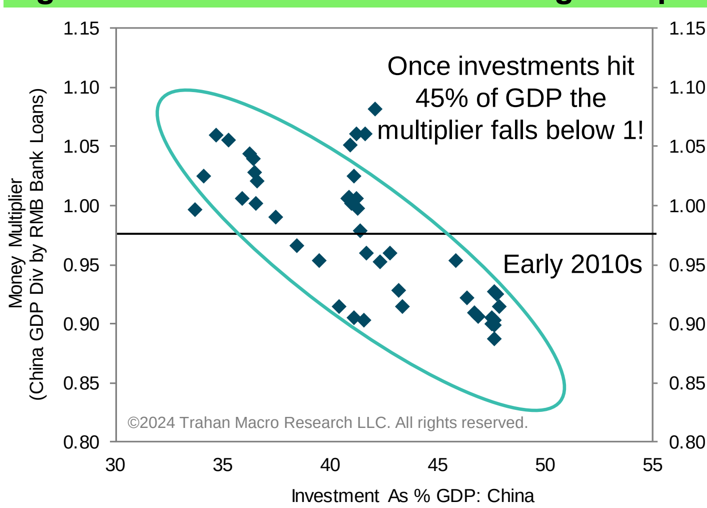


Spreads Marginally Wider In 2024

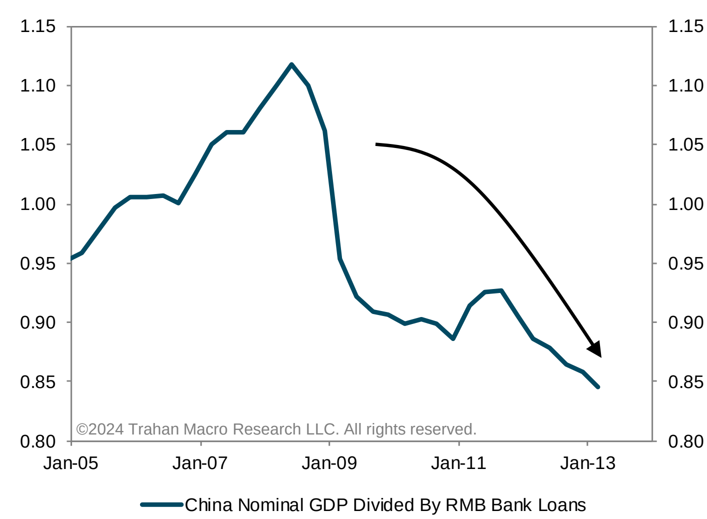


There are many countries that could pose risks to U.S. equities in the current cycle, and they don't have to be huge to be a problem (remember Greece in 2015?). China is at the top of our list. China's issues have been long in the making. China had great success initially pushing an investment-driven economy – and maybe a little too much success. Like most investment-driven economies before it, problems started brewing when excess capacity emerged in the years following the GFC. In essence, the multiplier effect began to sink. Worded differently, it took a lot more dollars of credit to generate a dollar of GDP growth. It was not obvious at the time but it's clear as day with hindsight in 2024.

Higher "I" As A % Of GDP = Declining Multiplier



Multiplier Effect Hit New Lows In 2013



LESS investment = Higher money multiplier

MORE investment ... Lower money multiplier

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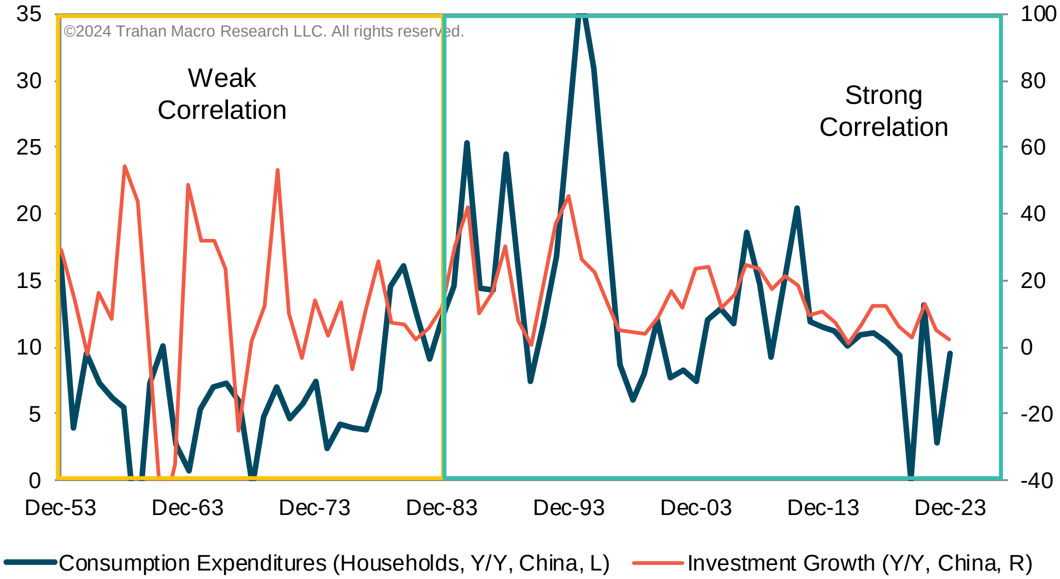
Rest Of The World Could Also Be A Problem For U.S. Equities (2/2)

China's goal a decade ago was to reassure investors with a plan to transition away from investments and toward consumption. While that sounded great on paper, the reality is that the shift China was trying to engineer has NEVER been accomplished successfully. Indeed, Investments are so labor intensive that any de-emphasis there leads to job losses that ultimately weigh on consumption. The result is that the country has wasted precious fiscal resources and accumulated a lot of debt trying to manage this transition. That now leaves China in a very precarious position.

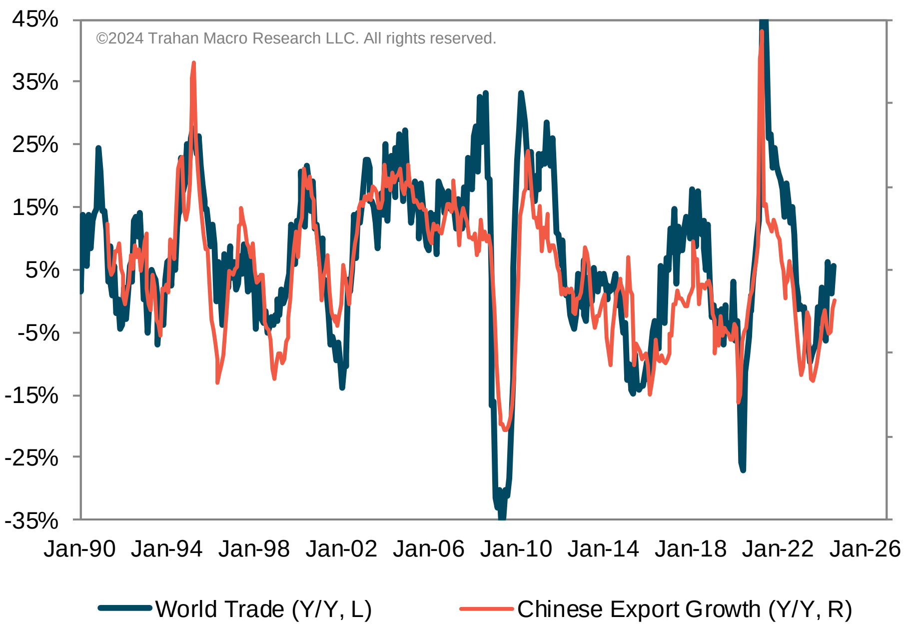
Consumption Growth Linked To Investment Growth



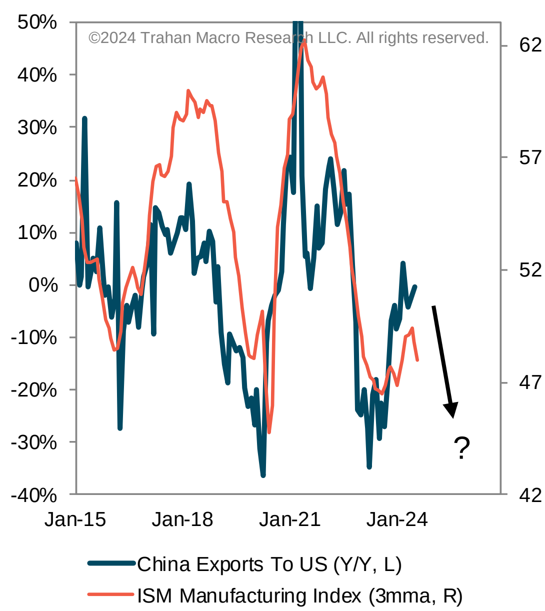
China became a much more investment-centric country in the mid-1980s.

Every country we could find that at some point grew investments to 40% of GDP or more (China got to 48% at the peak) ended up relying on exports as a solution for its problems. You can't count on investments due to excess capacity, and the weaker employment that brings weighs on consumption. This is happening as debt is through the roof, therefore limiting fiscal options. The only components of GDP left are trade or exports. Countries with similar issues in the past became heavily dependent on the rest of the world for growth – and China is no different. Now, imagine what happens if the U.S. and the rest of the world heads into recession in the coming year. That would be abysmal for China.

Chinese Exports Dependent On World Trade Activity



U.S. Slowdowns Impact China



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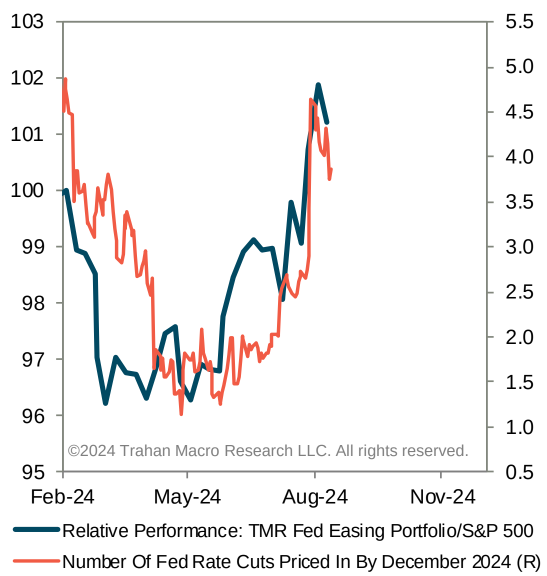
Fed Easing Cycles Are Long-Lasting And An Opportunity For Investors

A few weeks ago, we introduced the TMR Fed Easing portfolio. It uses five factors that have proven to consistently outperform in easing cycles of the past, and this cycle is no exception. The portfolio has performed extremely well alongside the weaker economic data that is ushering in the next Fed easing cycle. I don't think anyone would be surprised to hear that the factors are somewhat defensive, and for the most part countercyclical. The chart below illustrates the relationship between the portfolio and the number of rate cuts being priced in.

Profitability – A Key Factor During Easing Cycles

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%

Fed Easing Portfolio!



The full stock screen is available for the S&P 500 as well as other common indices. Simply email quant@trahanmacroresearch.com for the full list. We will likely keep updating this one 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. Once you have the Excel file, feel free to tweak it as you see fit.

A Sample 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	1	2	6	[illegible]	[illegible]	1	Consumer Staples
SBUX	Starbucks Corporation	1	5	3	5	2	1	Consumer Discretionary
NSC	Norfolk Southern Corporation	1	3	3	5	3	1	Industrials
SHW	Sherwin-Williams Company	1	3	6	6	3	1	Materials