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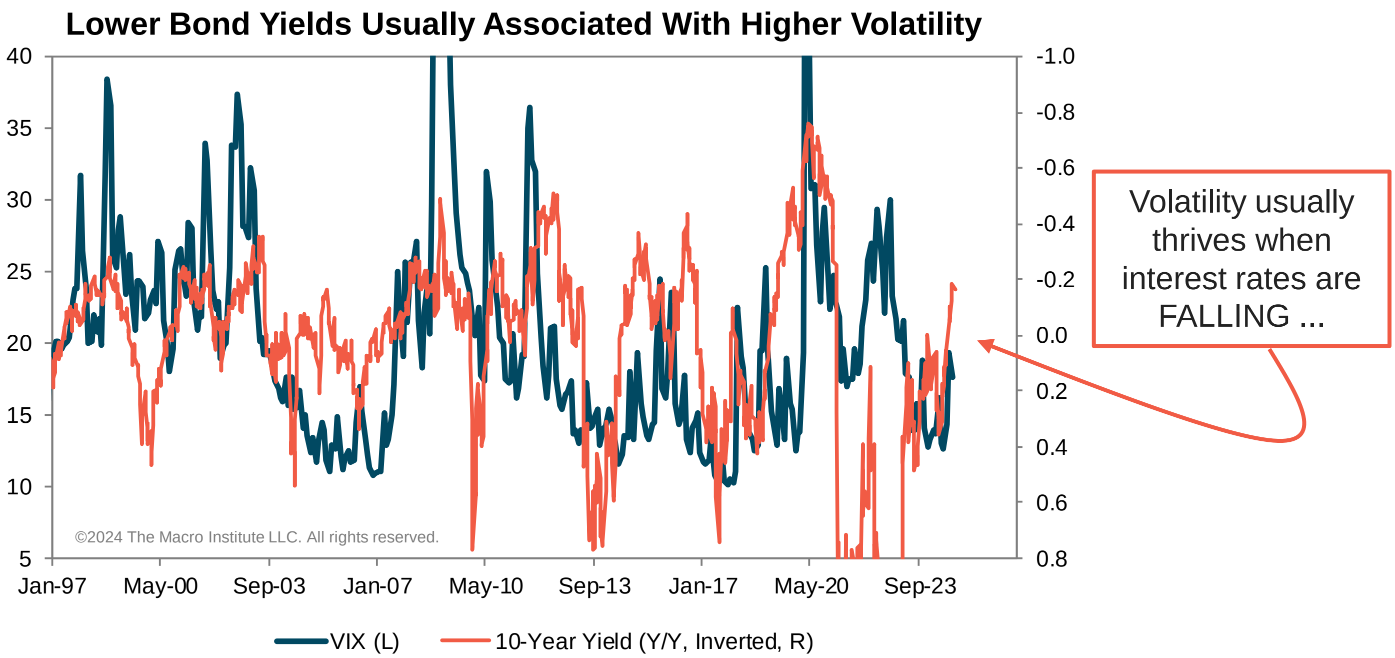
Client Questions That Made Us Revisit The Bearish Thesis

The questions we received in the wake of last week's conference call (replay link here) were very interesting and gave us many things to ponder. Admittedly, the September employment report fueled many of these comments/questions and it clearly had a positive impact on investor psyche. We will tackle the employment picture in this week's report as well as some of the other debates emerging or currently trending in the investment community. Just to be clear, we still believe that this is a poor risk/reward backdrop for equities and, as such, continue to favor Treasuries and Defensives when it comes to positioning.



The September employment report was well received by the investment community. It's fairly obvious that financial markets have been more attuned to labor markets in recent months so the upside surprise from the payrolls release was clearly interpreted as a supportive data point to the bullish thesis. Is it, though? Well, it was a certainly a strong print BUT it's important to remember that payrolls go through a number of revisions and those are typically to the downside in the wake of a Fed tightening cycle (more on that later). In that vein, the current cycle has been fairly normal given the substantial negative revisions in payroll data in 2024.

The first issue we want to tackle is the misconception about what a Fed easing cycle means for the markets. As the chart above illustrates, a backdrop marked by lower bond yields (i.e., a Fed easing cycle!) is usually associated with higher volatility. Note the inverse relationship between bond yields and volatility. The simple explanation is that lower rates, both official and market, are typically a sign of softer growth prospects. In essence, a Fed easing cycle might not be the "bull signal" many think it is as this is usually a time of weaker economic growth (i.e., a risk to earnings). We cover this in greater detail in the coming pages as well as a host of other interesting topics. Wishing you a great rest of your week. All the best. Francois

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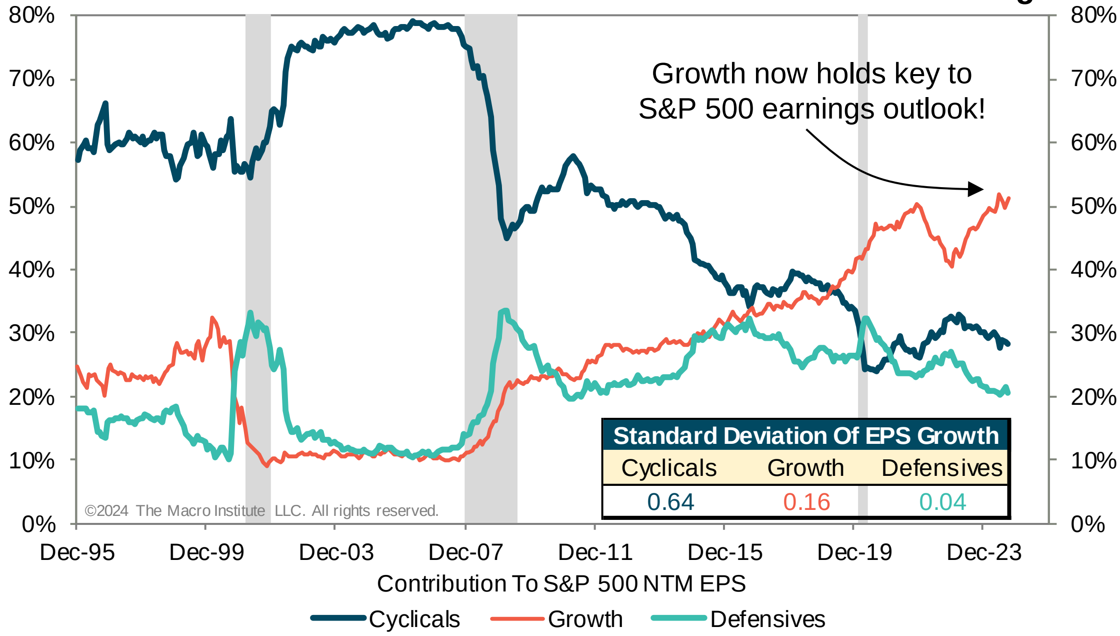
Is It Possible That S&P 500 EPS Are No Longer All That Cyclical?

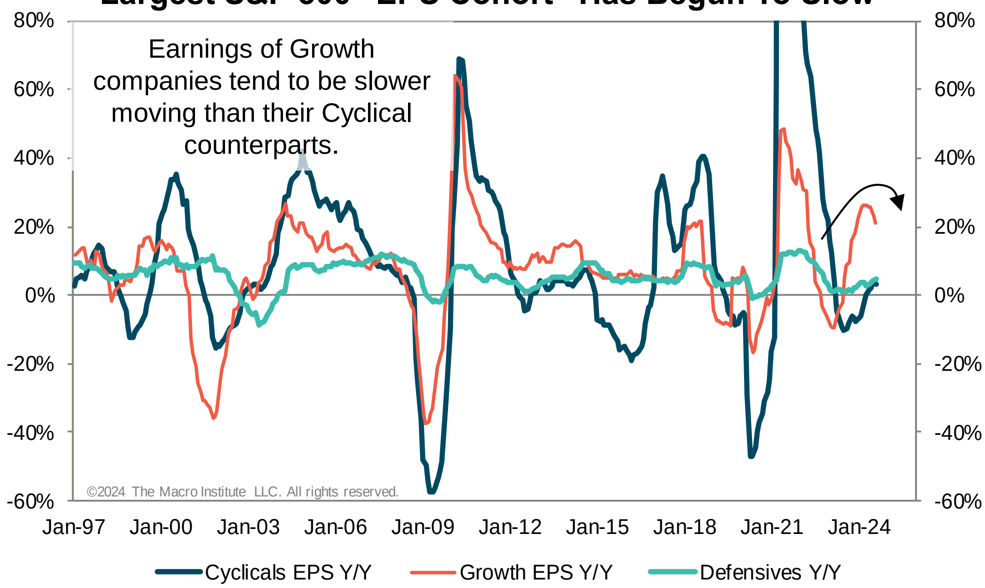
It's not unusual for investors to believe that the S&P 500 is no longer cyclical … this is typically consensus in the wake of Fed tightening as we wait for the lagged effects to kick in. That said, this might be the first time that there is merit to the discussion as S&P 500 earnings are clearly growthier than they have been in the past. Almost 80% of S&P 500 earnings came from cyclical sectors in the lead up to the 2008 financial crisis versus less than 30% today. This is not an insignificant change. It does NOT make the S&P 500 immune to the cycle, but it certainly dulls that relationship somewhat.

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

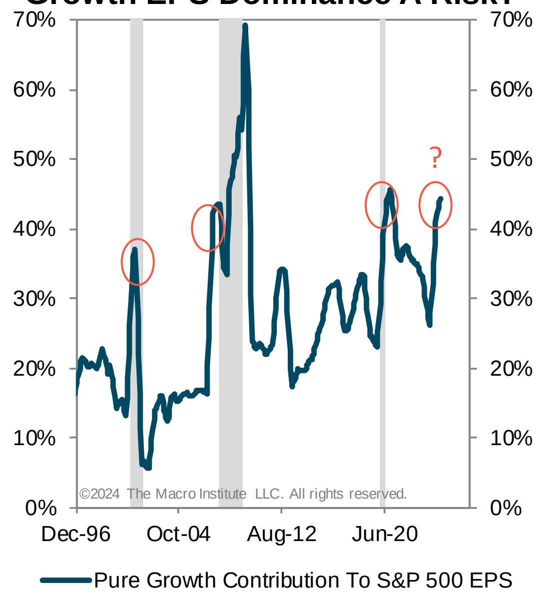


While Growth as a style factor is associated with a relatively more stable earnings profile than Value, Growth earnings are not immune from cycles, of course. The chart below left shows the frequency with which earnings growth for the three major styles turn negative. The data implies earnings **growth** for the largest style contributor to the S&P 500 (earnings & market cap) has potentially peaked this cycle and comparisons only get tougher moving into 2025. When Growth earnings become outsized relative to S&P 500 earnings, it's typically a sign of trouble ahead. Earnings from Cyclicals should inflect ahead of Growth, so it makes sense that its contribution to earnings tends to peak right before a recession.

Largest S&P 500 "EPS Cohort" Has Begun To Slow



Growth EPS Dominance A Risk?



Does The Un-inversion In The YC Play A Role In Timing A Recession?

Yes. First, remember that it is the un-inversion in the yield curve that typically signals recession – not its first inversion. Second, it depends a bit on our choice of maturities. Third, investors have about six months to wait between un-inversion to recession. The 10-year/3-month spread is the Fed's preferred metric, and it usually un-inverts about five months before recession while the 10-year/2-year spread usually un-inverts a couple months before that. This helps explain some of the action in bond yields lately. Regardless, we always see lower consumer confidence and higher unemployment during un-inversions.

Yield Curve Has Un-inverted, When Does The Recession Start??

Months From Un-Inversion To Start Of Recession						
Year	**1981**	**1990**	**2001**	**2007**	**2020**	**AVG**
10Y-3M	+4M	+11M	+2M	+7M	+4M	**+5M**
10Y-2Y	+3M	+13M	+3M	+9M	+6M	**+7M**

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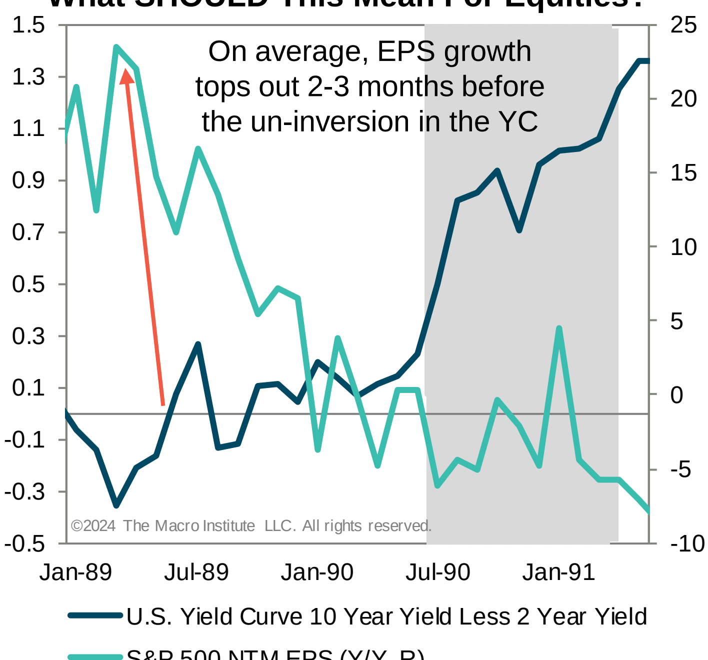
On average, **consumer confidence declines 12 points and the unemployment rate is always higher** during an un-inversion in the yield curve and ensuing recession.

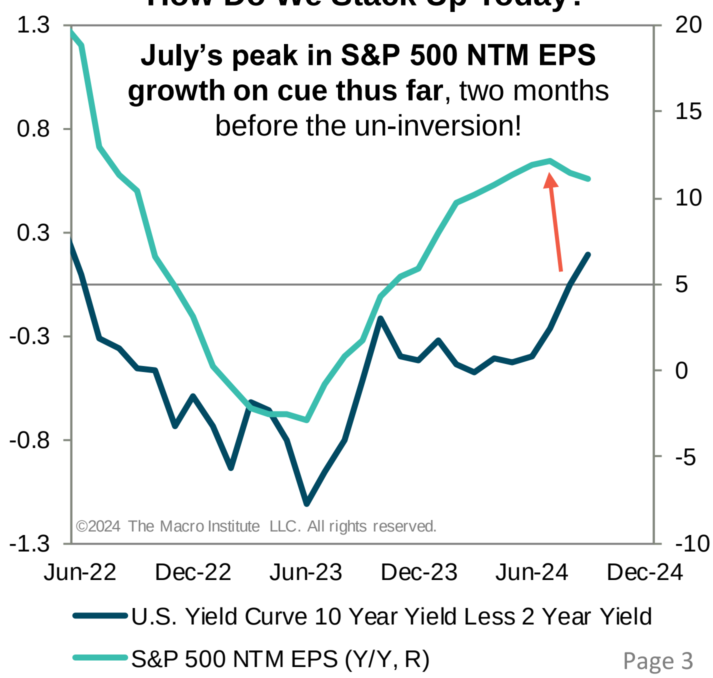
The 10-year/3-month spread, the Fed's preferred yield curve, has been timelier at warning of a recession than the 10-year/2-year version.

This is important because consumer confidence and unemployment flow directly to corporate earnings. In that vein, it makes complete sense that we see this consistent pattern on the lower left chart where S&P 500 EPS growth tends to peak a couple months **ahead** of un-inversion. Expectations of a cutting cycle and the associated downward pressure on the short end coincident with a peak in earnings is pretty intuitive. The recent un-inversion in the 10Y/2Y and deceleration in S&P 500 forward EPS growth since July suggests (so far) a textbook cycle (at least from these two factors).

What SHOULD This Mean For Equities?



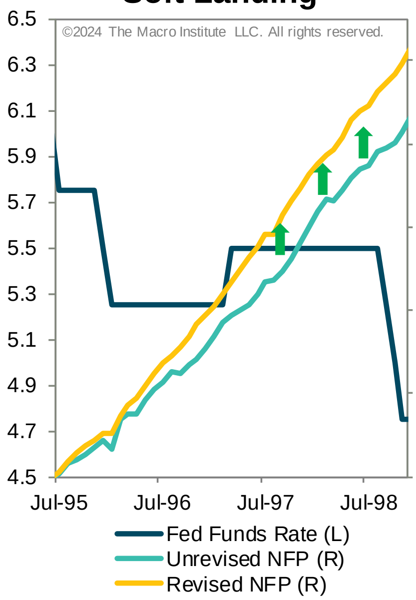
How Do We Stack Up Today?



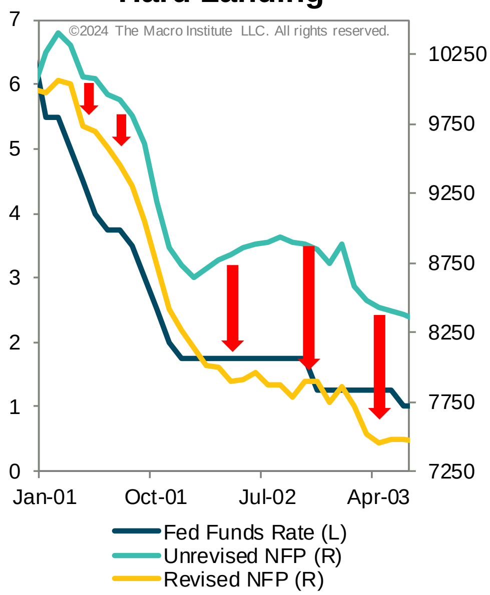
Are Payroll Revisions Normal Or Unusual In The Current Cycle?

For members of Camp "Hard Landing" (where I just might be the head counselor?) the Non-Farm Payrolls (NFP) downward revision cycle feels normal, in the right context. For reference, we are referring to the headline monthly NFP numbers and their associated monthly revisions. Below, we map the unrevised and revised NFP numbers from prior cycles in green and yellow, respectively. In soft landings, we tend to see consistent upward revisions. Hard landings entail downward NFP revisions.

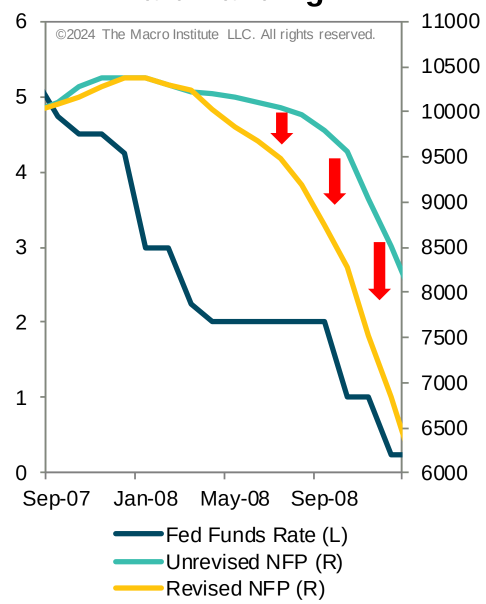
Soft Landing



Hard Landing

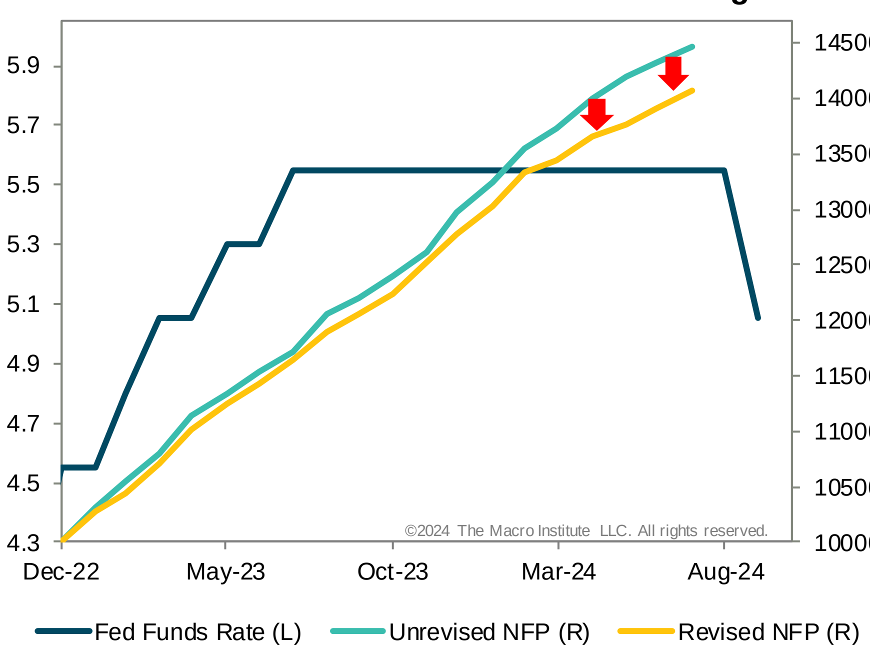


Hard Landing

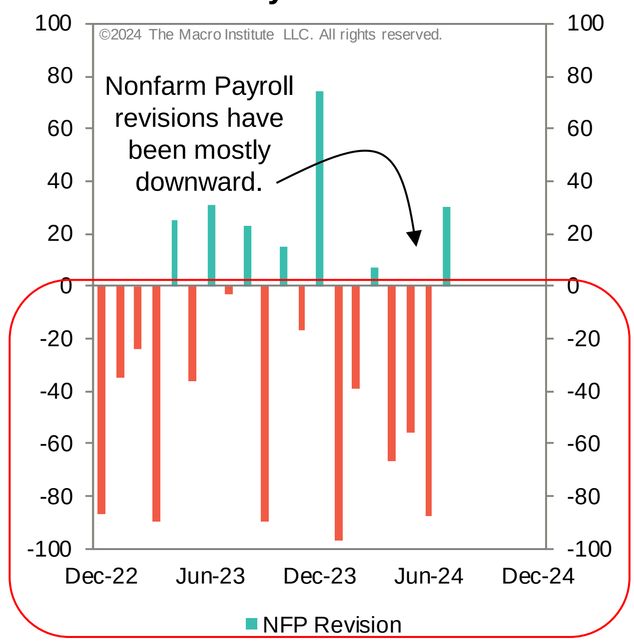


As the labor market began to deteriorate in 2023, as is common in the wake of Fed tightening, we started to see a difference emerge between reported, and eventually, revised NFPs. Our data represents the cumulative change in the monthly NFP series since the beginning of rate increases, indexed at 10,000. The consistent downward revisions to NFP this cycle are similar to what we've seen in past hard landings. While reported headline NFP appear unreliable lately, it was interesting to hear Jerome Powell mention the CES revisions in his dovish assessment of U.S. labor markets. It's clear some policy makers are now taking the monthly unrevised payrolls data with a grain of salt – it's not just us.

Revisions Do Not Look Like A Soft Landing



Mostly Downward!



The Financial Conditions Index Argues That Policy Is NOT Binding???

The explanation behind this title boils down to exactly what we're trying to measure. Truth be told, Financial Conditions Indices (FCI) are better proxies of current financial market conditions than genuine gauges of monetary policy. One terrific policy indicator is the HLW Model. It uses the neutral rate and real rates to directly address how restrictive/accommodative policy is – and it leads GDP. What we see in the composition of the FCI are many by-products of monetary policy and indicators that typically don't inflect until the full effects of policy lags are experienced. However, by then it's too late for investors.

Financial Conditions Indices Are Proxies Of Financial Markets And NOT Forward-Looking

Equity Market	**33.4%**
S&P 500 Share Prices	16.7%
VIX Index	16.7%
Money Market	**33.3%**
Ted Spread	11.1%
Commercial Paper/T-Bill Spread	11.1%
Libor-OIS Spread	11.1%
Bond Market	**33.2%**
Baa Corporate/Treasury Spread	8.3%
Muni/Treasury Spread	8.3%
High Yield/Treasury Spread	8.3%
Swaption Volatility Index	8.3%

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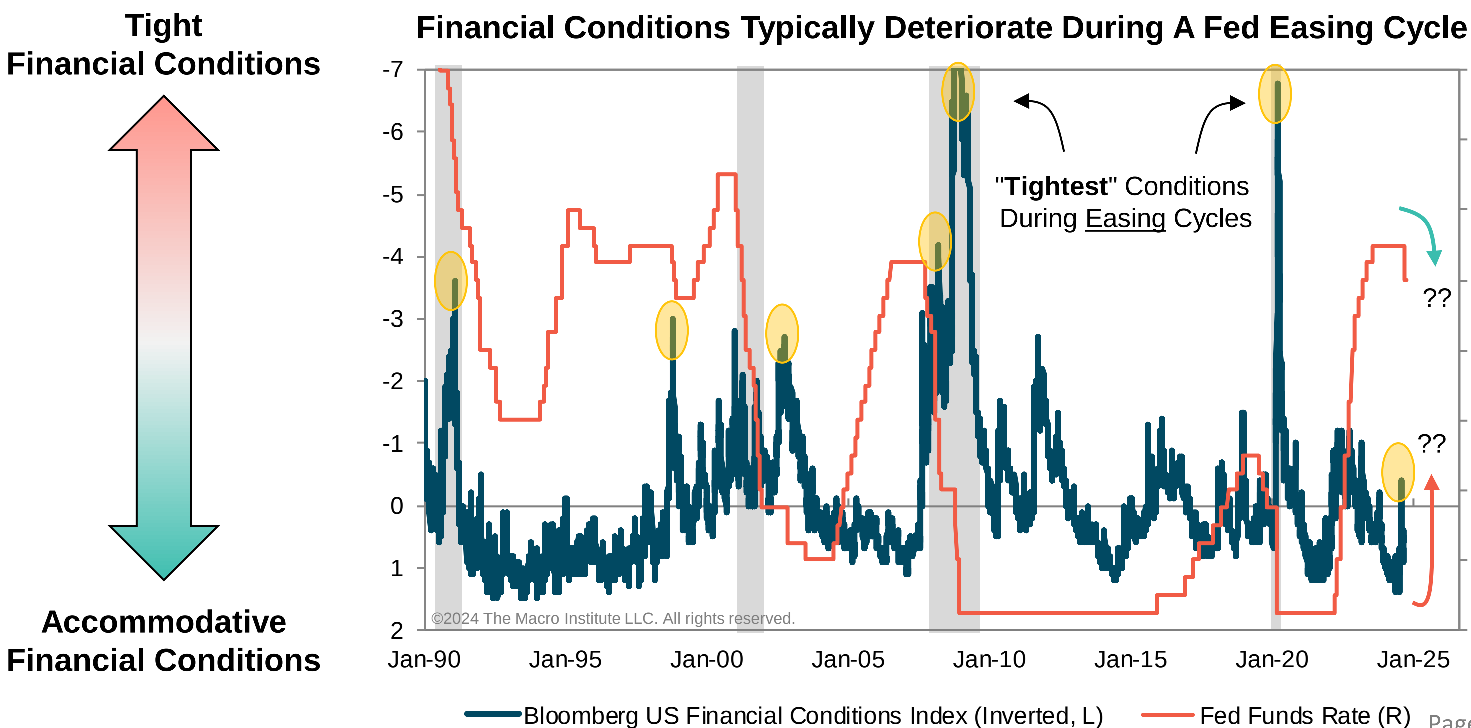
1/3rd of the Financial Conditions Index is comprised of equity returns and equity volatility. Given the strong returns and depressed volatility in recent years it's no surprise this component is not contributing to "tight" conditions.

2/3rds of the Financial Conditions Index is comprised of fixed income spreads, or the premium to take on credit risk. These spreads typically do not widen until periods of economic strain, which tend to coincide with Fed easing cycles. See below.

For FCI to be a pure indicator of monetary policy settings, we should see it turn negative (inverted on the chart below) ahead of, and during, increases in the fed funds rate. The relationship is inconsistent at best. The yellow circles indicate instances when the index suggested tight financial conditions. These episodic blowouts were coincident with rate **cutting** cycles. This reveals the major influence and interrelationship of credit spreads, equity markets, and the VIX on the index's direction. Interestingly, we can see the index move higher (tighter) during the recent 50 bps cut.

Financial Conditions Typically Deteriorate During A Fed Easing Cycle



How Should We Define Or Gauge A Soft Landing Anyway? (Part 1 of 2)

There is no exact definition for a "soft landing." According to most people, a fed tightening cycle that is not followed by a recession is a soft landing. Given that NBER recession declarations can happen many months after the fact, this is not very helpful today. When thinking of soft landings, many go back to the mid-1990s episode of Fed tightening that did not result in weaker employment data or lower equity markets. At TMR, we view a soft landing as a period following fed tightening where we do not see higher unemployment nor a shift in equity leadership and earnings growth from risk-on to defensives. In many ways, today's backdrop does not match that of the mid-90s.

Three Distinct Ways Of Thinking About A Soft Landing

How Is An Economic "Landing" Defined?		
Officially:	NBER	
Economy:	Employment	
Markets:	Sector Leadership	

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The indicators and process that the NBER uses to determine business cycle dating is detailed and intuitive, yet there's no fixed rule established that would help us front-run their announcement. As an example, on December 1st, 2008, NBER announced that a peak in economic activity occurred in the U.S. in December 2007. We know how that cycle ended! So, if the trough in economic activity already occurred (i.e., soft landing), we won't know about it per NBER until sometime in 2025 – by which time LEIs of employment and sector leadership would have already changed.

It's Official (After The Fact!): NBER Announces The Start And End Of A Recession

NBER Indicators To Determine A Recession
Real Personal Income Less Transfers
Nonfarm Payrolls
Real Personal Consumption Expenditures
Manufacturing Sales
Industrial Production
Unemployment Rate

Most important in recent decades according to NBER.

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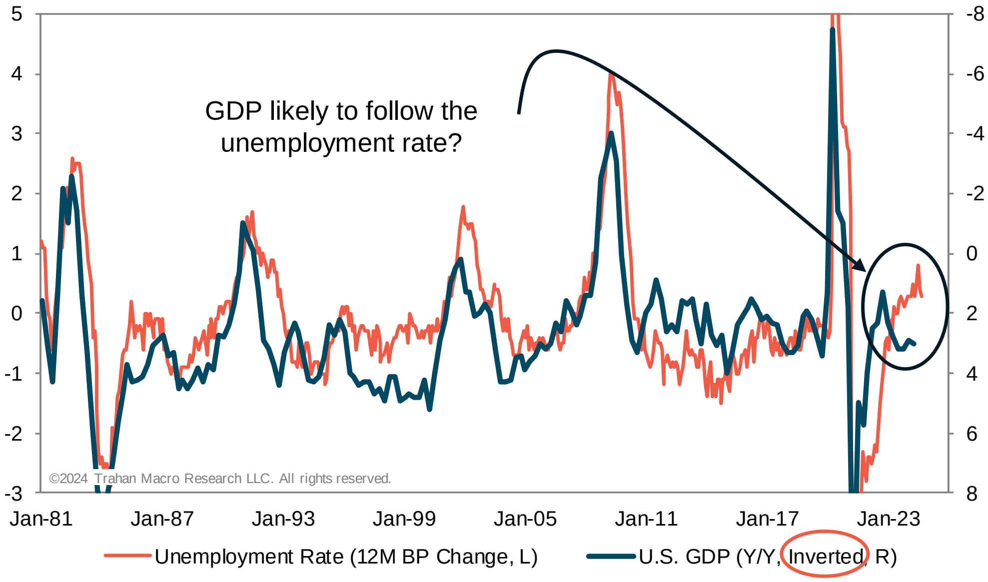
"The NBER's definition emphasizes that a recession involves a significant decline in economic activity that is spread across the economy and lasts more than a few months. In our interpretation of this definition, we treat the three criteria—depth, diffusion, and duration—as somewhat interchangeable….. There is no fixed rule about what measures contribute information to the process or how they are weighted in our decisions."

-NBER

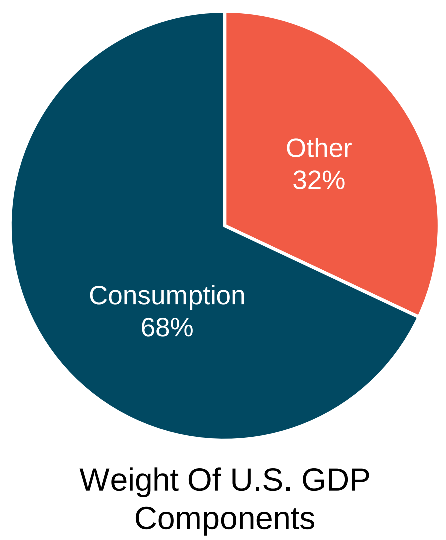
How Should We Define Or Gauge A Soft Landing Anyway? (Part 2 of 2)

A soft landing will be evident directly in employment statistics such as the unemployment rate. Below we see a very tight historical relationship between the change in U.S. GDP and the change in the unemployment rate. The link here is the consumption-centric nature of the U.S. economy with its 68% contribution to GDP. The recent increase in unemployment (along with a host of other labor market indicators) in the wake of fed tightening suggests downward pressure on GDP. Keep in mind, the mid-90's soft landing was achieved following the third **least** aggressive policy tightening episode going back to 1965 (it was ~300bps vs. ~500bps this cycle).

Economy: Soft Landing About Stronger Employment Trends

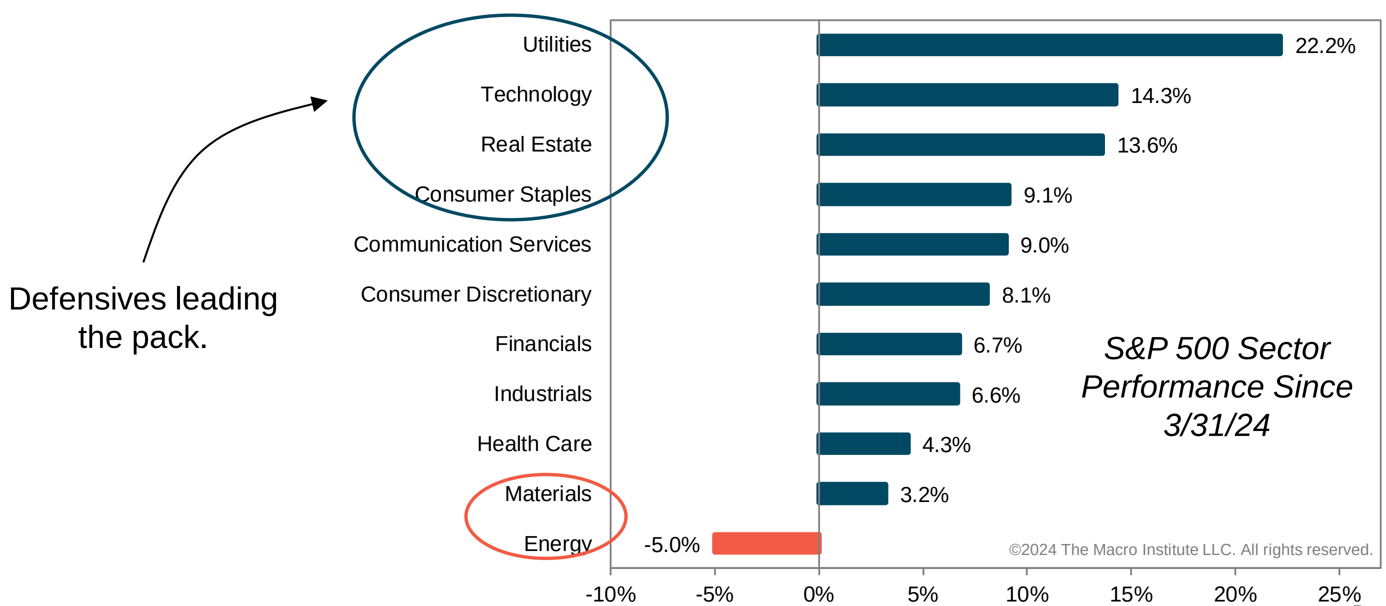


Consumption A Full 68% Of GDP



A soft landing should be evident in sector and factor leadership as well. We would theoretically see outperformance by more cyclical sectors (Industrials, Materials, Energy) and the most risk-on factors (High Beta, Small Cap, Leverage). Sector performance since the end of March does not support this scenario. Utilities, Technology, Real Estate, and Consumer Staples have outperformed the broad market as investors rotated into perceived defensive/stable sectors and those benefitting from lower rates (Utilities, Real Estate, High P/E Tech). Materials and Energy are the two worst sector performers.

Markets: Soft Landing About Cyclical Stock Leadership?



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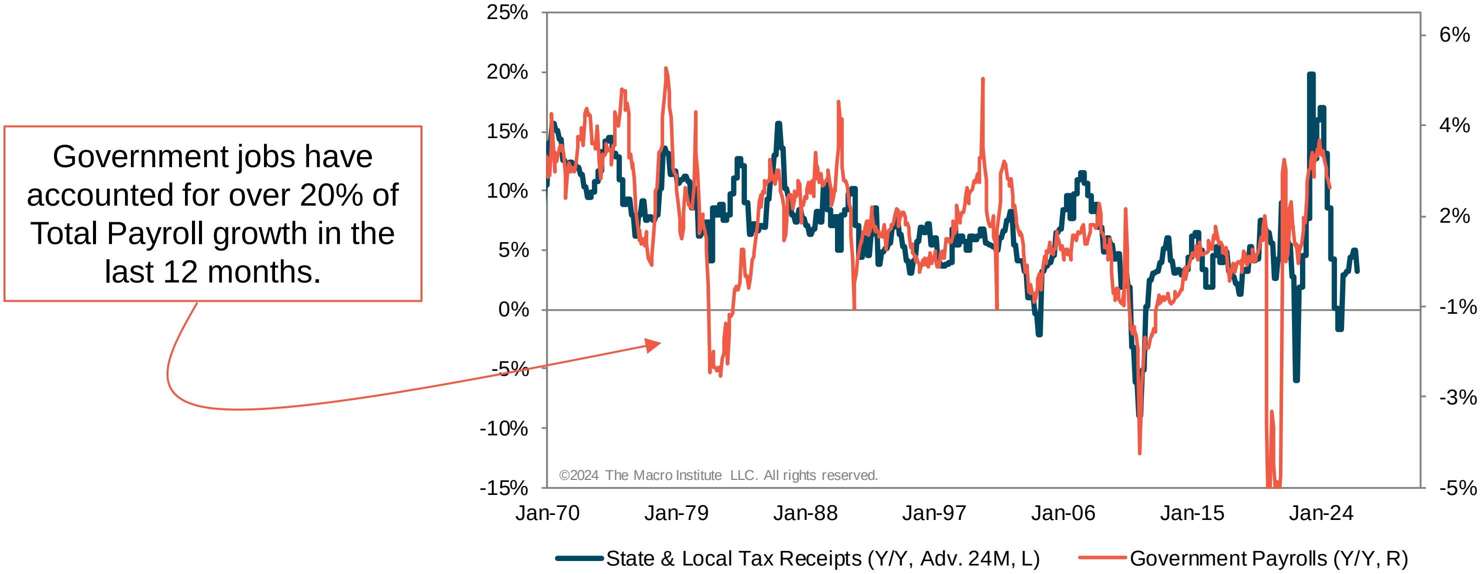
What Are The Bright Spots And Concerns About Employment?

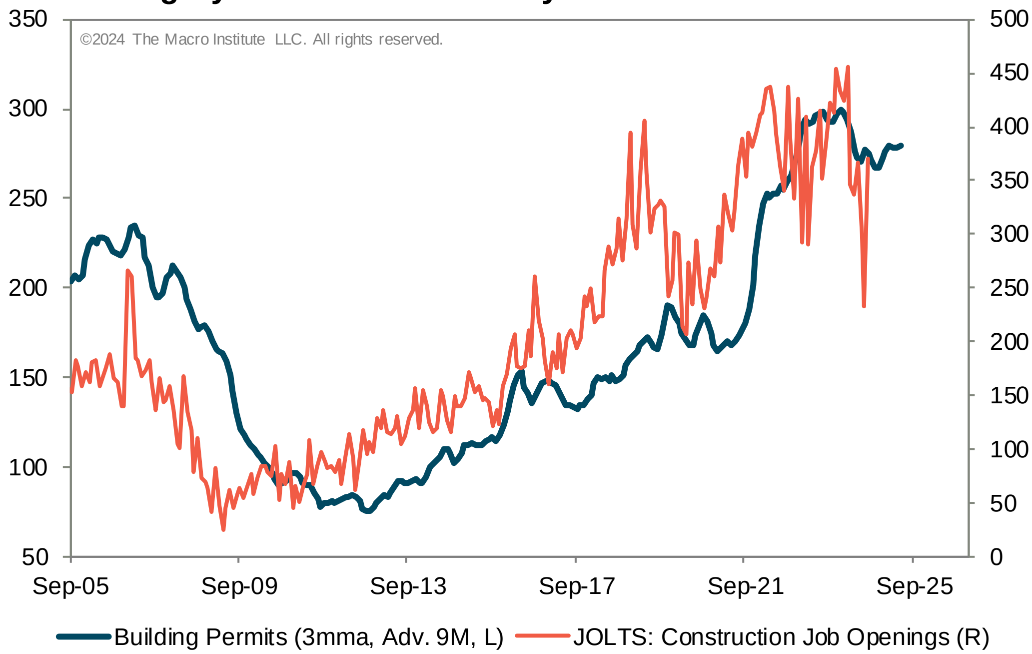
One of the hallmarks (a bright spot?) of a slowdown in employment is the stable contribution of government jobs. In fact, a rise in the percentage of payrolls that come from government employment is a time-tested recession/risk indicator. A rise in this ratio has preceded most recessions for close to a century (since the 1930s). Note that this ratio is currently moving higher, so the government has certainly helped sustain employment amid the rise in the unemployment rate. A concern is that government employment tends to follow revenues and tax receipts have been under pressure. At some point, even government employment will likely start to disappoint.

Government Job Growth Set To Slow In 2025???



We covered this at length in last week's conference call, but housing is the one bright spot when it comes to a Fed easing cycle. Indeed, early-cycle industries are where we see signs of "green shoots" when the Fed is easing policy and housing is the ultimate early cyclical. This will not happen overnight, but lower interest rates usually revive housing sentiment. This eventually translates, with the appropriate lags, into stronger construction activity. This will likely occur as the rest of the economy struggles.

Easing Cycle Should Eventually Revive Construction Jobs



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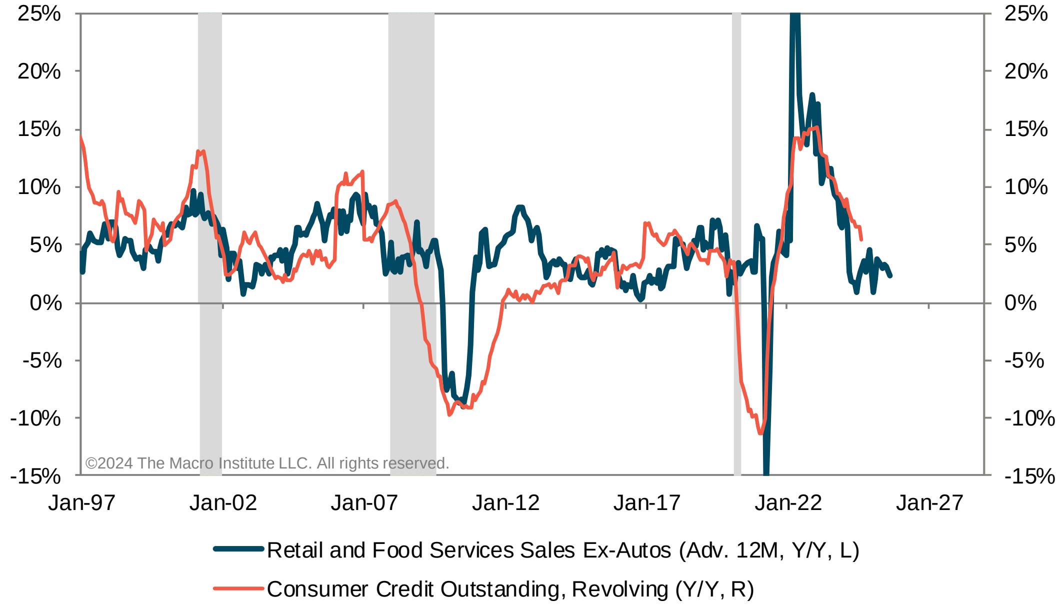
Any Weird Misconceptions Out There … Good Or Bad?

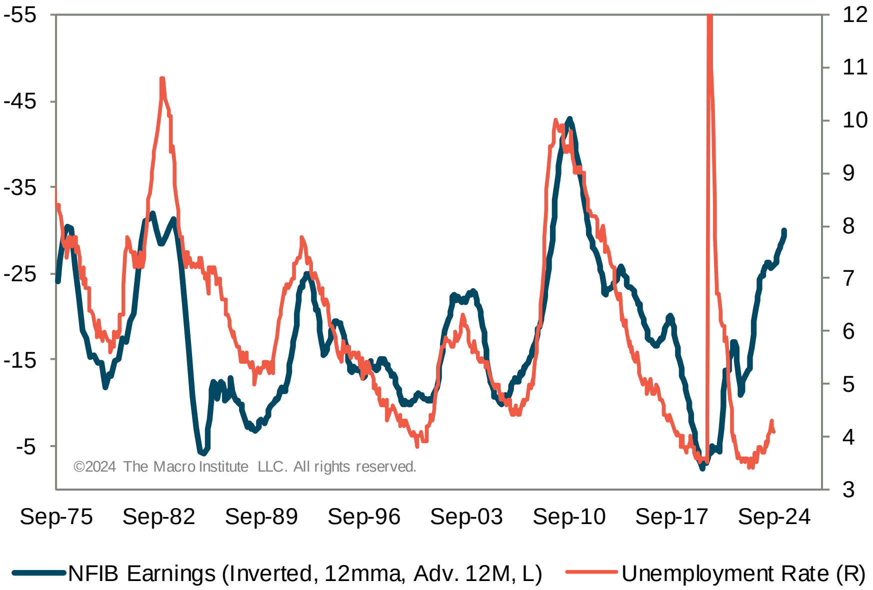
There are plenty of misconceptions out there when it comes to economic data. To be sure, many of today's investors have little experience with Fed easing cycles and what they typically imply for the economy. This of course leads to some misperceptions. That said, they aren't all negative. One misperception, in our minds, has to do with the slowdown in outstanding consumer credit and how it is perceived to be a positive. It's not exactly a negative BUT revolving credit tends to follow trends in retail sales. When retail sales are hot, credit outstanding increases, and vice versa, of course.

Credit Outstanding Shrinking Due To Lackluster Spending Trends

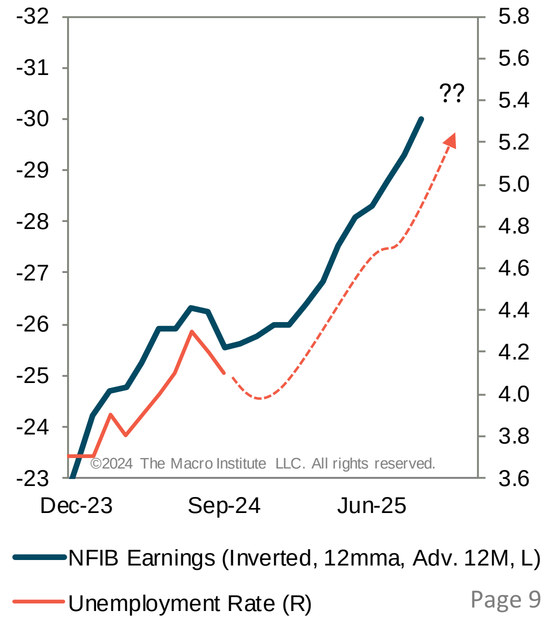


One series that is troubling and largely ignored is the earnings outlook data from the NFIB. Friendly reminder that the NFIB has over 100k members and small companies almost always inflect before those in the S&P 500. In a typical cycle, we see this NFIB series deteriorate early. Companies usually react by focusing on costs and some of that implies layoffs and job cuts. This process eventually broadens to the rest of the economy and that's why this series has been a great leading indicator of the unemployment rate historically (50+ years!).

NIFB Earnings Outlook Just Noise…



…Or Canary In The Coal Mine?



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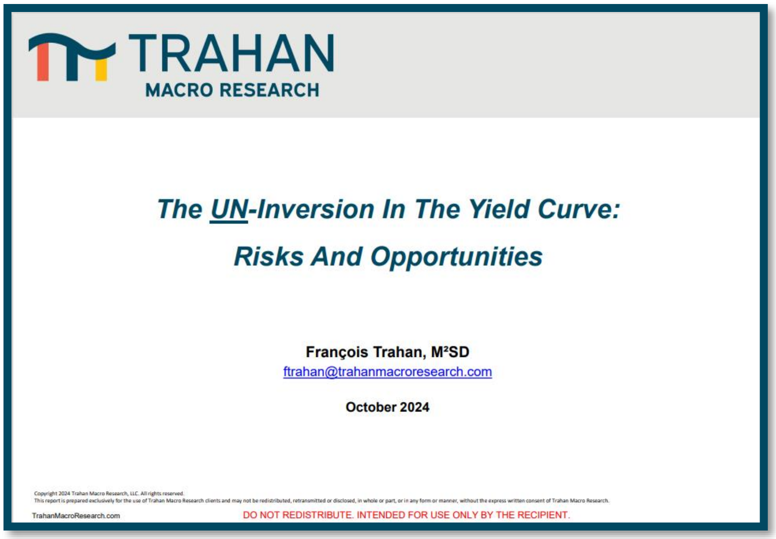
It's Not Too Late – The Conference Call Replay Has Shelf Life!

The content from this week's report was almost all fueled by the Q&A that followed last week's conference call. We are always grateful for comments and questions as they only make our work better, either because it leads us to change something in our thesis or helps us address the pushback. Note that the conference call replay is still available and has shelf life so don't hesitate to revisit it.



Click Here To Download Slides

Click Here To Watch Replay

The most important content we have published in the last three months has been the "Fed Easing Portfolio" which focuses on five factors that have systematically generated alpha in prior easing cycles. The portfolio has worked as expected in recent months and we believe it's worth monitoring until the Fed is officially done cutting rates which we suspect will not be until 2026. We shall see.

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	1	2	6	2	2	1	Consumer Staples
SBUX	Starbucks Corporation	1	5	3	5	2	1	Consumer Discretionary
NSC	Norfolk Southern Corporation	[illegible]	8	3	5	3	1	Industrials
SHW	Sherwin-Williams Company	1	3	6	6	3	1	Materials

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

Email quant@trahanmacroresearch.com or visit trahanmacroresearch.com/screens