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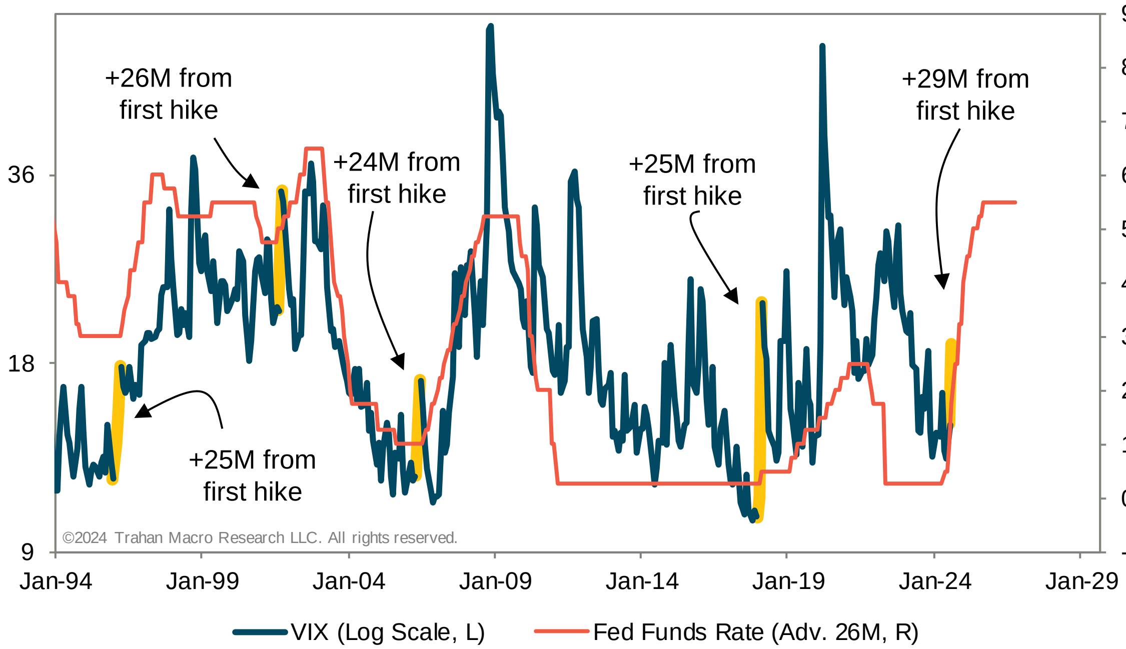
TRAHAN MACRO RESEARCH

September 12, 2024

The Most Interesting Pushback For The Bearish Thesis

We hosted our annual Labor Day conference call last week (see the replay here). While there seems to be more openness to the possibility of a recession ahead, it's still far from consensus at this stage. The Q&A following the call raised several interesting counterpoints to our bearish thesis, many of which we address in this week's report. We always appreciate it when someone takes the time to comment on our work, good or bad. At the end of the day, our thesis is only as good as how it stacks up against solid pushback, so the exercise of tackling your key questions after conference calls is extremely helpful to our work. Thank you.

Rebound In Volatility On Cue And Likely Just Getting Started



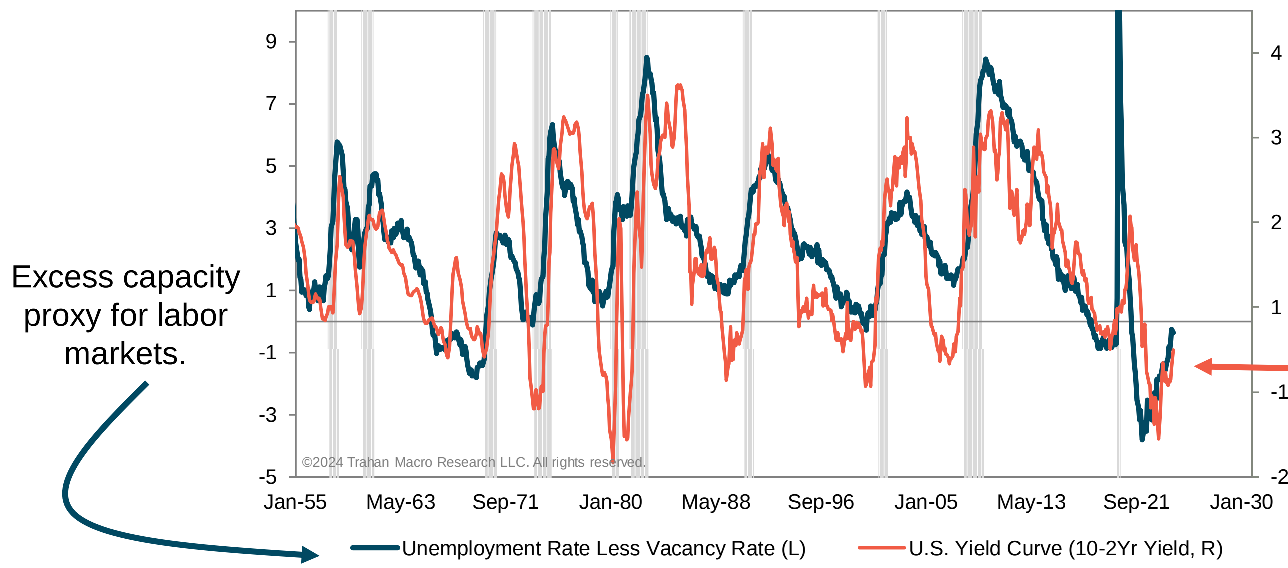
Our key theme lately is that financial markets are entering a new phase of the cycle. Indeed, we believe that the surge in volatility in early August, while brief, marked the beginning of a more *sustained* period of volatility for the markets. As the chart above illustrates, this is common in the wake of Fed tightening. We usually see an initial rebound in volatility about two years AFTER the initial Fed rate hike, which typically marks the starting point of a more challenging phase for equities. Note that this volatility bump started a little later than normal (~29 months), but what comes next is the same, regardless.

The triggering of the Sahm Rule with the July employment report rattled markets, if only for a short while. Interestingly, it did not seem to change consensus opinion all that much. We tackle the pushback to our view in this week's report. At the end of the day, our focus is the earnings outlook and its macro equivalent – employment. One thing seems clear, irrespective of where you stand on the economic outlook – assets associated with Fed easing cycles are already outperforming and gaining momentum, including our **"TMR Fed Easing Portfolio" on pages 9-10**. Wishing you a great rest of your week. All the best. Francois

Isn't The Lag Between Policy And The Economy Unusually Long? (1/2)

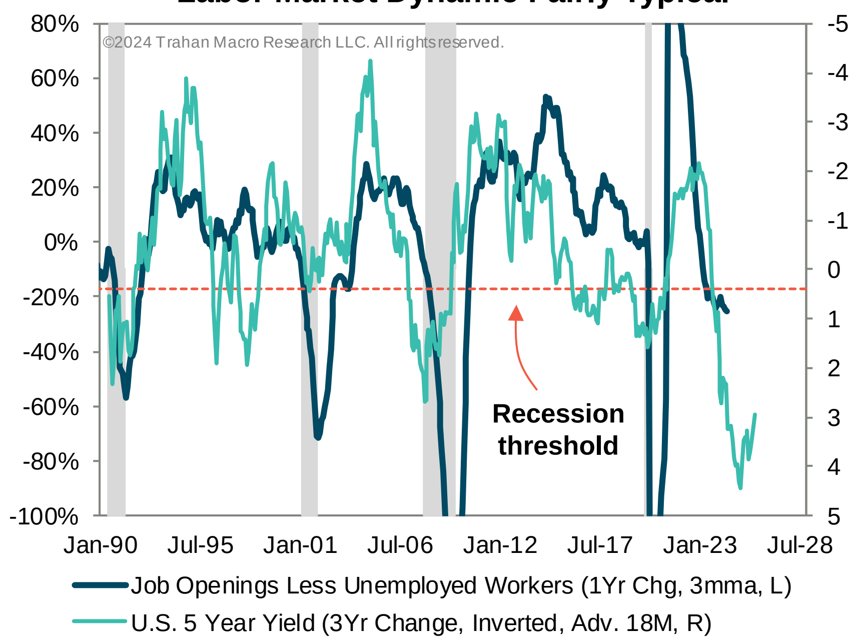
This is a great question, and the answer is not black and white. In some ways, this cycle looks pretty spot on. For instance, it normally takes about two years for the unemployment rate to start rising AFTER the Fed starts to raise rates (March 2022). In that vein, the today's dynamic is in line. At the same time, the yield curve has been inverted longer than normal, and the peak/plateau in the fed funds rate has been unusually long. Maybe the best way to sum this up is to say that the dynamic between policy and labor markets appears normal, however, the starting point for labor markets was unusually tight.

This Cycle Saw The Tightest Labor Market In Decades

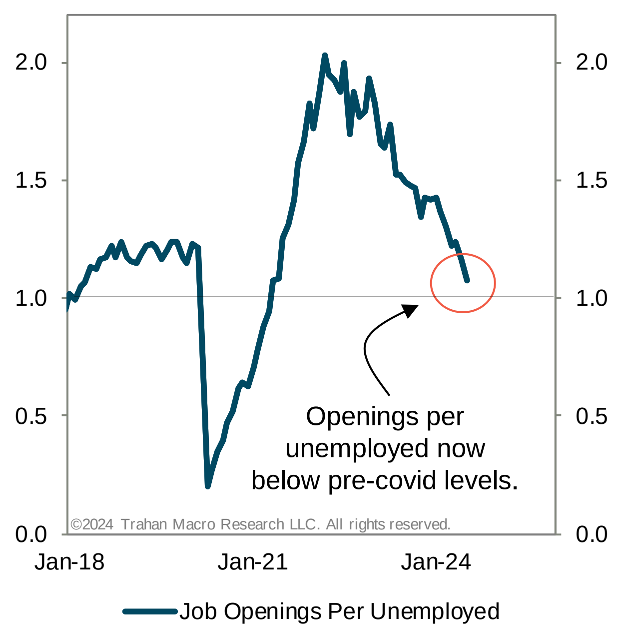


The two charts below have a lot to say about labor markets. They plot the spread between job openings and unemployed workers (i.e., a proxy of labor market tightness). We know that this series reached unprecedented levels in the current cycle, but the right clip shows that we are back to pre-pandemic levels. At the same time, the relationship between this proxy of labor market tightness and interest rates, shown in the chart below left, looks about as normal as can be. We simply started from an unusual level.

Labor Market Dynamic Fairly Typical



Back To Pre-Pandemic Levels



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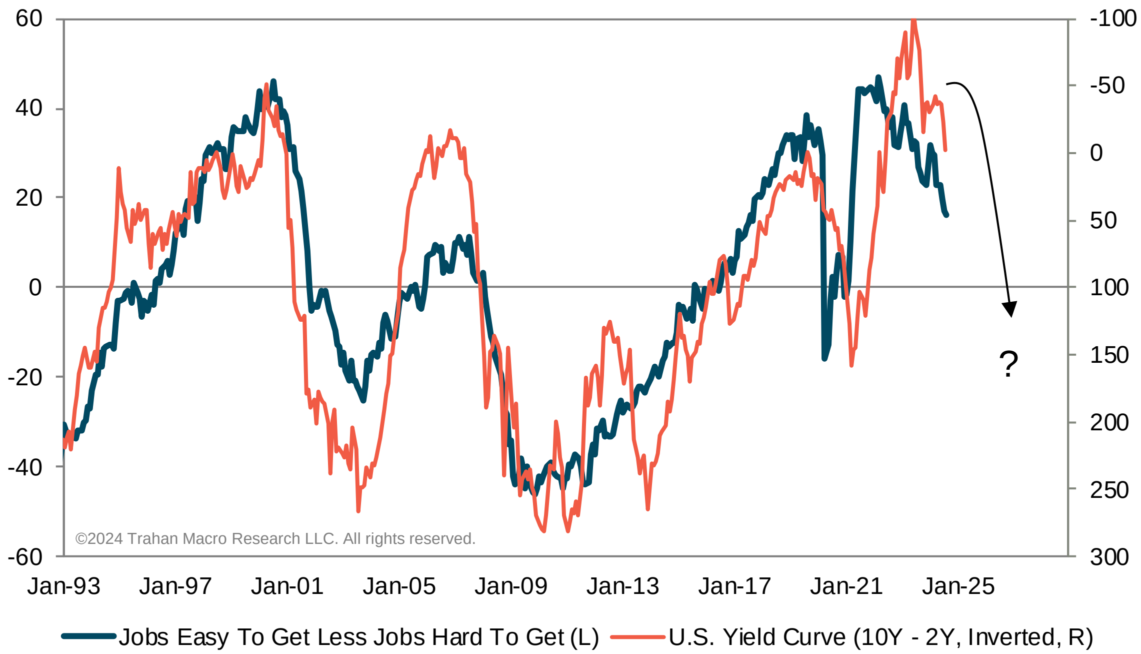
Isn't The Lag Between Policy And The Economy Unusually Long? (2/2)

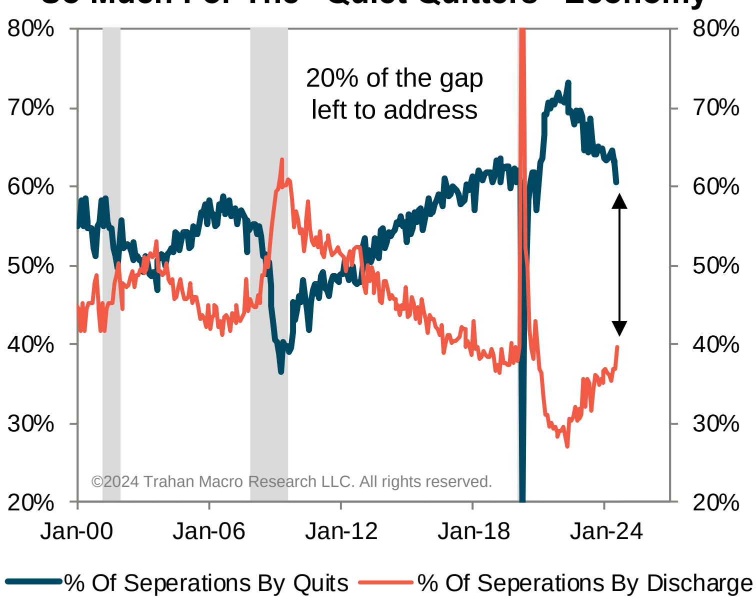
Yes, this is indeed one of the longest inversions of the yield curve we have ever seen. At the same time, we also began this cycle with the tightest labor markets in the post-WWII era. In simple terms, it takes looser labor markets for the Fed to ease policy, which in turn steepens the yield curve. The extended inversion of the yield curve tells us that monetary policy stayed binding for an unusually long period of time BECAUSE it had historically tight labor markets to address.

Softer Labor Markets Trigger An Un-Inversion In The Yield Curve

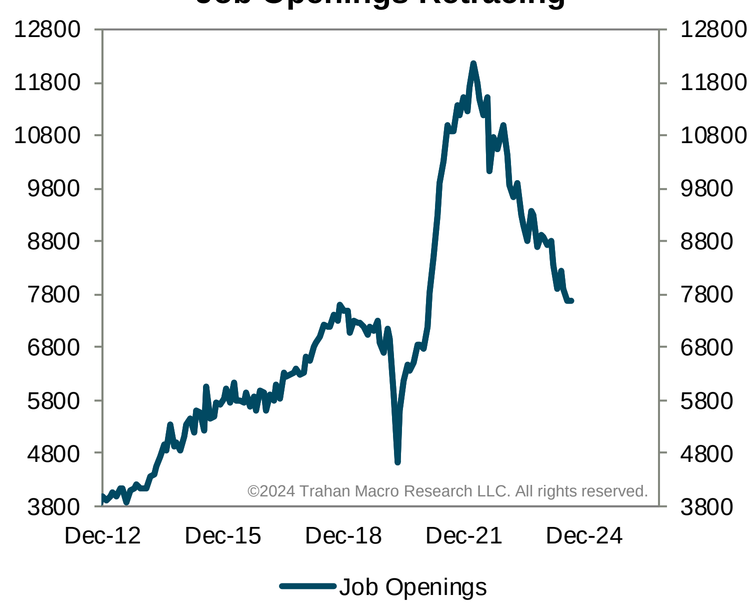


It's not just headline employment that has slowed. A quick look beneath the surface reveals that this is a completely different labor market than it was a year ago. We know there are more part-time jobs than full-time jobs being created at this time, and we also know that the government has been an increasingly larger share of payrolls in recent months. Neither of these are encouraging. More importantly, perhaps, this labor market is now more about layoffs/separations than it is about "quiet quitters."

So Much For The "Quiet Quitters" Economy



Job Openings Retracing



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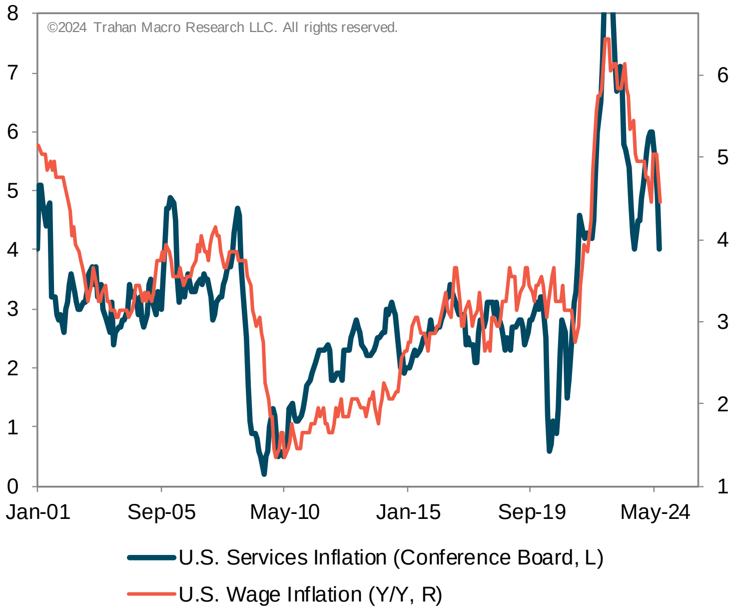
What Are The Odds Inflation Reignites When The Fed Begins Easing?

Yes, a dose of monetary stimulus would likely lead to an eventual reacceleration in inflationary pressures, as has ALWAYS been the case. When someone asks this question, however, it's often implied that we are talking about inflation of the magnitude seen in recent years. While this is certainly possible, it is improbable, and in the near-term highly unlikely. Worded differently, the monetary tightening we have in the pipeline is just beginning to impact labor markets and the economy and all of this points to LOWER inflation in the near term. Core inflation is largely about labor markets at the end of the day.

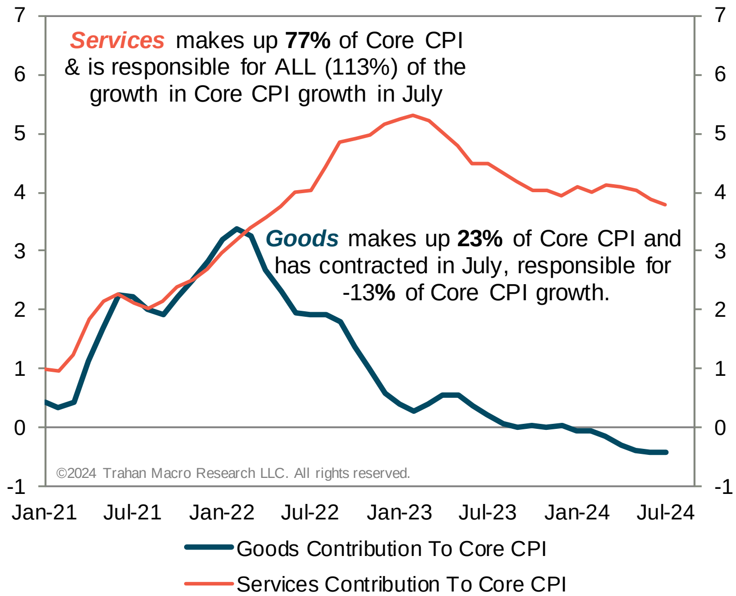
Wage Inflation ≅ Services Inflation



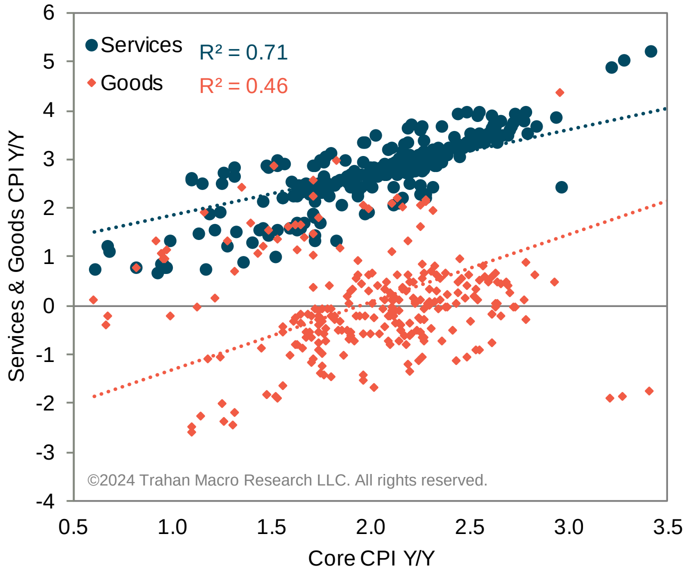
Wage Growth Heading Lower?!?

Labor markets ultimately set the price of wages in the U.S. That should be obvious. Also obvious is the tight relationship between wage inflation and services inflation historically. The chart above left reveals that it's difficult to tell which series is which most of the time. The key statistic is that the services component accounts for 77% of core inflation. Mathematically, core inflation is going to look a lot like services inflation which itself looks like wage inflation. All of this helps explain why the Fed spends so much time discussing labor markets.

Services Makes Up ¾ Of Core CPI



Services Dictates The Direction Of Core CPI



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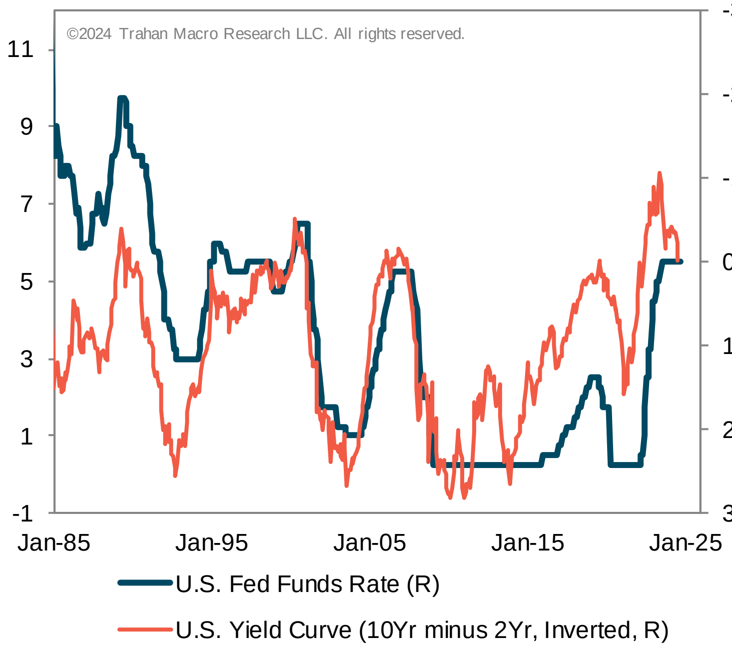
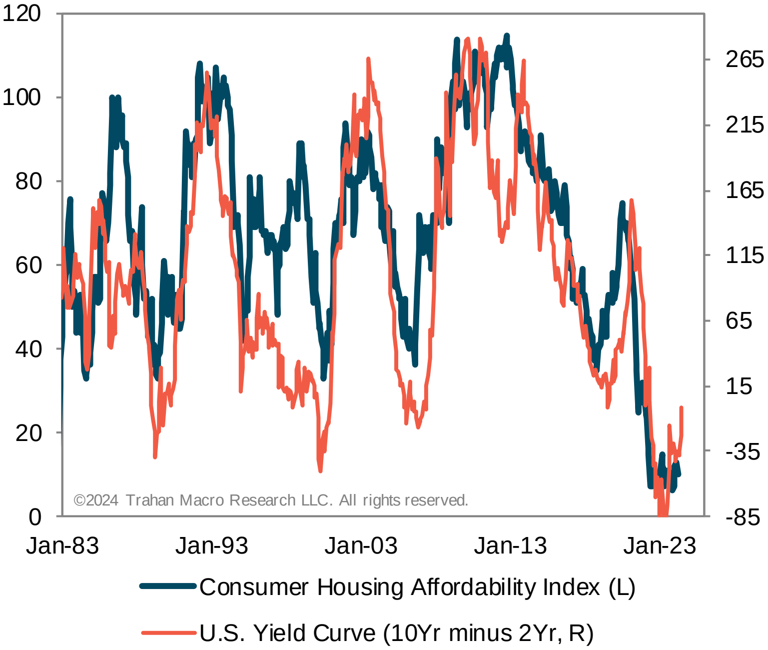
What Happens To Housing As The Fed Easing Cycle Begins?

The goods news on the housing front is that monetary easing sows the seeds of an eventual recovery in the economy, and housing is no exception. It takes about two years for rate cuts to show up in the broader economy, but they impact early-cycle industries like housing more quickly. We know that Fed easing leads to easier conditions (a steeper yield curve). The chart below right reveals that the yield curve and housing affordability, or sentiment, are strongly correlated. Worded differently, Fed easing sets in motion the revival in housing, although even here it will take time to gain traction.

Yield Curve Reflects Fed Tightening

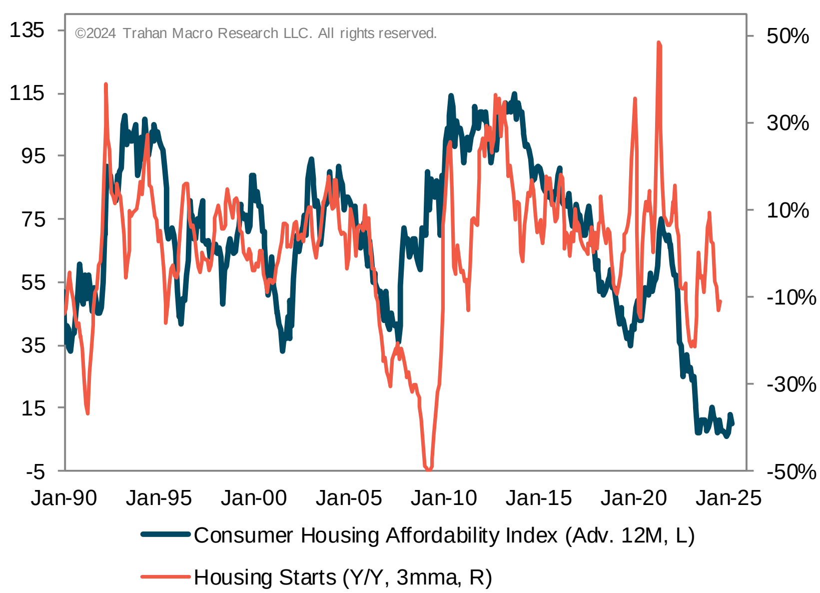


Housing Conditions Reflect Yield Curve

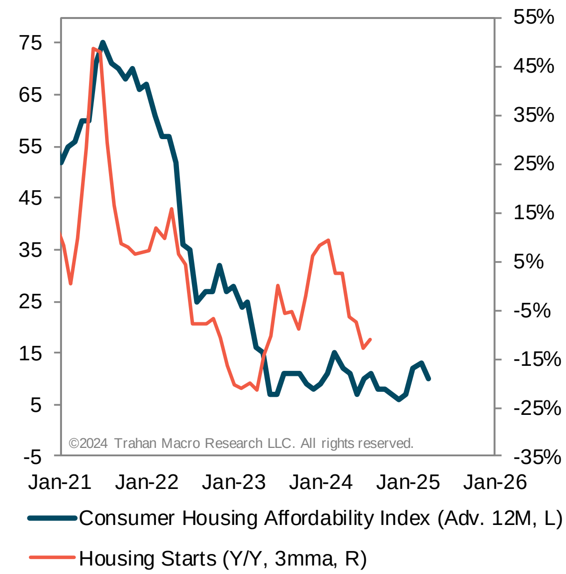


Easier policy should lead to a steeper yield curve and a simultaneous rebound in housing affordability. This is the good news. The charts below show that it takes about a year for an improvement in housing affordability to revive housing starts (and about another year or so to get from starts to home completions). Clearly, Fed easing is a positive as it marks the beginning of the next cycle. They key is seeing a rebound in housing affordability. This will get the timer going on an eventual housing rebound.

Housing Affordability Leads Starts By 12 Months



12 Months Of Depressed Activity?



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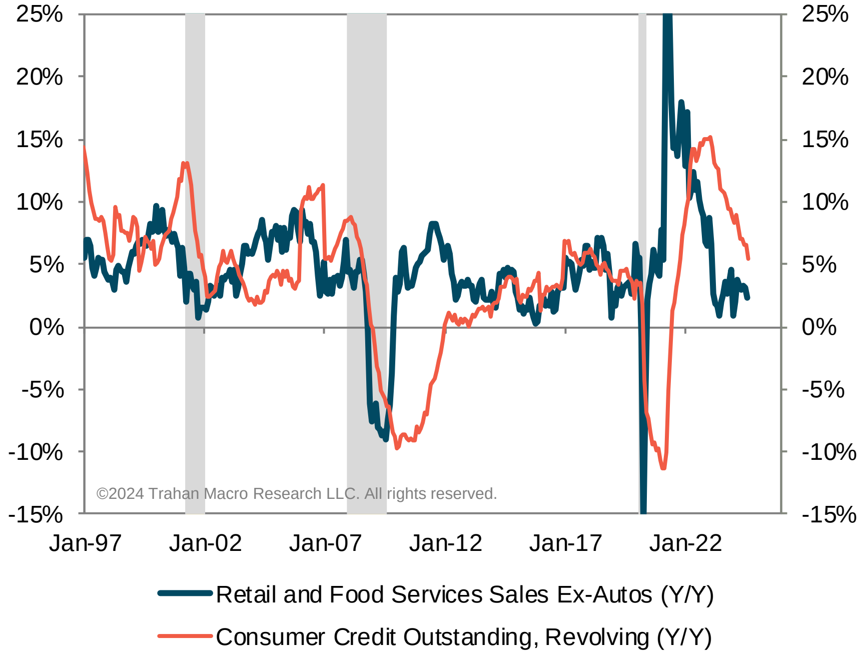
What Are Other Important Consequences Of Weaker Labor Markets?

There are a lot of variables impacted by weaker labor markets but ultimately what matters the most is what happens to consumers. Remember that consumption accounts for 68% of U.S. GDP so there is no recession without a weaker consumer just as there is no possible recovery without a healthier consumer. It’s just math. We already know that retail sales have slowed BUT that is typically not the best gauge of consumer health at this stage in the cycle. Credit can keep retail sales looking healthy for some time even IF the underlying consumer dynamic is deteriorating.

Retail Sales Continues To Slow



“Unemployment ticked up, inflation keeps eating away at disposable income, and I think people just took a pause as we progressed through the quarter … because of these macro uncertainties.”

-Home Depot, 8/13/2024

"Customers are expanding their consumption (on low-margin essentials) while contracting their spending on discretionary items because of macro belt-tightening“

- Dollar Tree, 9/4/2024

There are some indicators and data series that can help separate the wheat from the chaff in uncertain times like these. One that we don’t use often but that is value-added in this specific context is the Performance Index from the Restaurant Industry Association. Think of this as the ISM-equivalent for the restaurant business. The latest datapoint hit a level rarely seen outside of the depths of economic downturns. This is certainly at odds with retail sales and yet hard to dismiss all the same.

Restaurant Industry Feeling Like … It’s The GFC Again?!?

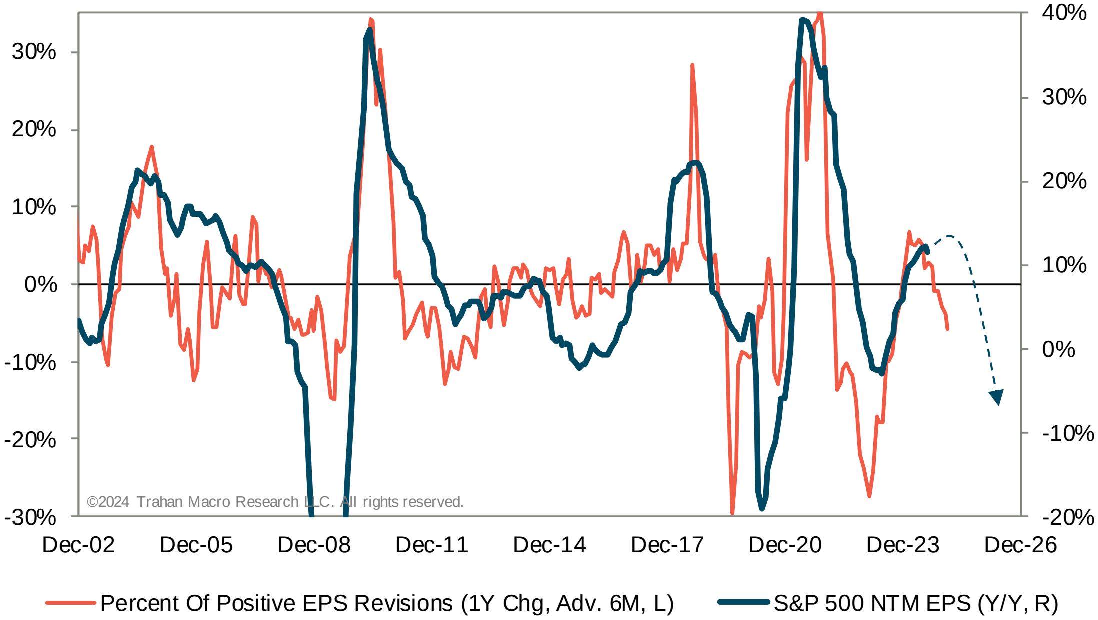
“Resilient U.S. consumers, who largely shrugged off rising interest rates to fuel the post-pandemic economy, may be starting to lose some momentum.”

- National Restaurant Association, 6/18/2024

Market Outlook Ultimately Boils Down To The Direction In Earnings

At the end of the day, the stock market outlook boils down to whether one expects earnings to continue to trend higher or instead turn lower. While there are other developments that could weigh on U.S. equities – such as a crisis elsewhere in the world? – a backdrop marked by growing earnings is typically a solid foundation. That said, it's normal for earnings to turn lower in the wake of Fed tightening and there are plenty of signs of cracks in the plaster. Given the unusually large influence of the Growth segment on the S&P 500, it is unlikely to give an early signal when it comes to earnings.

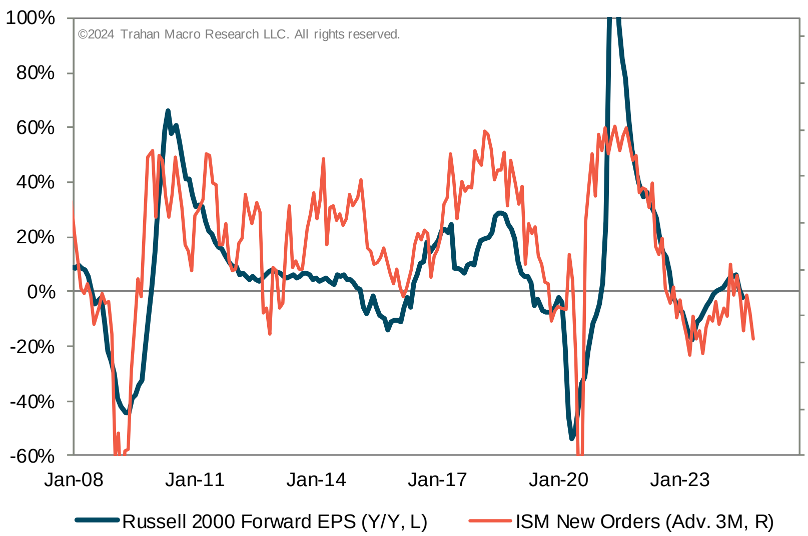
Breadth In Forward EPS Revisions Continues Losing Steam



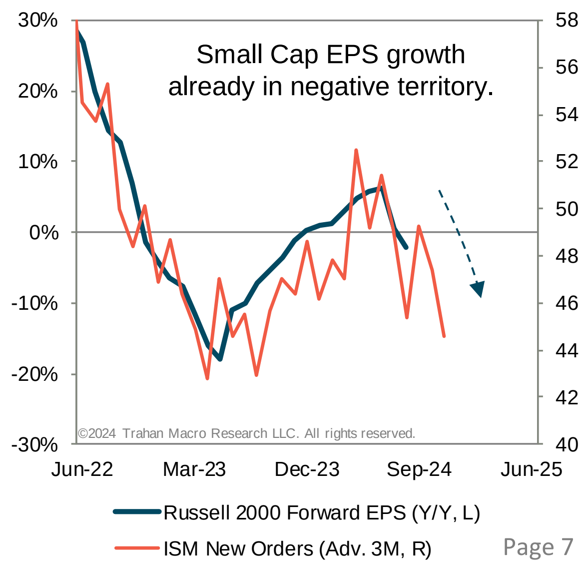
The breadth of upward forward earnings revisions tends to lead forward EPS growth by roughly six months.

The concept of "breadth" is most helpful near inflection points in earnings trends. It captures what is happening with some of the more economically-sensitive stocks, and those are rarely the largest in an Index like the S&P 500. The chart above shows that the breadth in earnings revisions has slowed in the S&P 500, which typically is a sign of an eventual slowdown in broader earnings. Similarly, smaller indices like the Russell 2000 or the S&P 600 are more cyclical and typically reflect changes in the economy earlier. The charts below show that earnings expectations are already lower in the R2K and leading indicators like the ISM New Orders Index argue that conditions deteriorate further from here.

ISM New Orders Also Points To Lower NTM EPS



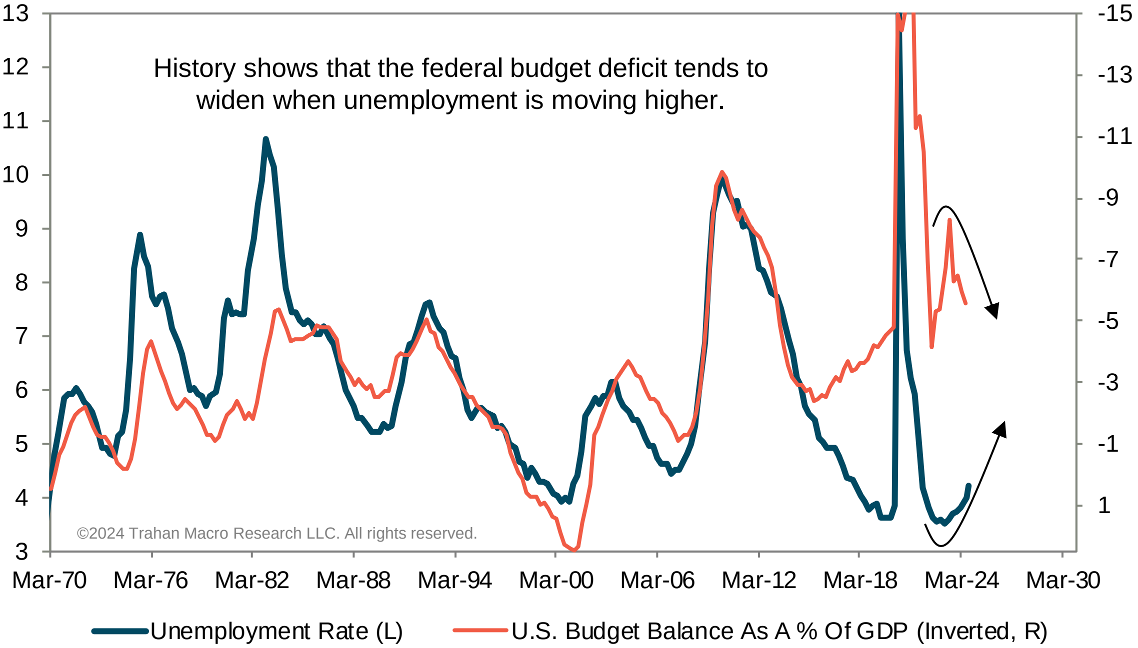
EPS Contraction Through Year End



What Happens To Fiscal Policy Under Harris Or Trump Presidency?

There is a LOT to discuss when it comes to the state of public finance in the U.S. economy. At a high level, the fiscal deficit is so large that it seems clear that whoever is in the White House come January will be forced to address the issue. If it is ignored, it won't take long for the rating agencies to remind everyone that the issue cannot linger forever. In essence, politicians can make all the promises in the world while they are campaigning but the debt/deficit issue boils down to math at the end of the day.

Weaker Employment Tends To Lead To Wider Deficits



The good news (?) is that the deficit has been narrowing recently. This is good for the deficit, but it also tells us that the government is plowing less into the economy. We know that the correlation between the state of labor markets and the deficit is strong. A world of rising unemployment is one where government revenues are under pressure as expenditures rise with more and more civilians looking for benefits. In essence, IF the unemployment rate is going to do what it normally does in the wake of Fed tightening (rise!) then we may very well see the U.S. face growing fiscal problems (crisis?!).

Where Will The Deficit Be By End Of The Downturn?

Fiscal Deficit As A Percent Of GDP

Q4 2024	Unemployment Rate								
Average Real GDP & GDI Y/Y	2%	3%	4%	5%	6%	7%	8%	9%	10%
5%	-4.6%	-5.4%	-6.2%	-6.9%	-7.7%	-8.4%	-9.2%	-9.9%	-10.7%
4%	-4.9%	-5.7%	-6.5%	-7.2%	-8.0%	-8.7%	-9.5%	-10.2%	-11.0%
3%	-5.2%	-6.0%	-6.8%	-7.5%	-8.3%	-9.0%	-9.8%	-10.5%	-11.3%
2%	-5.5%	-6.3%	-7.1%	-7.8%	-8.6%	-9.3%	-10.1%	-10.8%	-11.6%
1%	-5.8%	-6.6%	-7.4%	-8.1%	-8.9%	-9.6%	-10.4%	-11.1%	-11.9%
0%	-6.1%	-6.9%	-7.7%	-8.4%	-9.2%	-9.9%	-10.7%	-11.4%	-12.2%
-1%	-6.4%	-7.2%	-8.0%	-8.7%	-9.5%	-10.2%	-11.0%	-11.7%	-12.5%
-2%	-6.7%	-7.5%	-8.3%	-9.0%	-9.8%	-10.5%	-11.3%	-12.0%	-12.8%
-3%	-7.0%	-7.8%	-8.6%	-9.3%	-10.1%	-10.8%	-11.6%	-12.3%	-13.1%
-4%	-7.3%	-8.0%	-8.8%	-9.5%	-10.3%	-11.0%	-11.8%	-12.5%	-13.3%
-5%	-7.6%	-8.3%	-9.1%	-9.8%	-10.6%	-11.3%	-12.1%	-12.8%	-13.6%
-6%	-7.9%	-8.6%	-9.4%	-10.1%	-10.9%	-11.6%	-12.4%	-13.1%	-13.9%
-7%	-8.2%	-8.9%	-9.7%	-10.4%	-11.2%	-11.9%	-12.7%	-13.4%	-14.2%
-8%	-8.5%	-9.2%	-10.0%	-10.7%	-11.5%	-12.2%	-13.0%	-13.7%	-14.5%
-9%	-8.8%	-9.5%	-10.3%	-11.0%	-11.8%	-12.5%	-13.3%	-14.0%	-14.8%
-10%	-9.1%	-9.8%	-10.6%	-11.3%	-12.1%	-12.8%	-13.6%	-14.3%	-15.1%

An unemployment rate of 4.5% and an average GDP/GDI of 1% would raise the deficit/GDP by 200bps from the current level!

What Should Investors Turn To During A Fed Easing Cycle?

We introduced the **TMR Fed Easing portfolio** almost two months ago – a portfolio built to outperform in a backdrop with Fed easing. The Health Care and Staples sectors were consistent relative outperformers during the previous four easing episodes, as shown in the table below. Though we didn't expect sector performance to be uniform, it's not surprising that defensive sectors tend to outperform as most easing cycles begin with deteriorating economic data. In our view, the 1995 soft-landing cycle was a function of stable employment markets and monetary policy that had never become truly restrictive. Not sure the same can be said today regarding the labor market, but time will tell.

History's Take On Fed Easing And Sector Performance

Relative Sector Performance During Fed Easing Cycles

Sector	1995	2001	2007	2019	Average
Energy	-8.6	12.1	7.5	-35.4	**-6.10**
Financials	32.2	12.1	-22.6	-10.7	**2.76**
Com. Svcs.	-15.1	-21.8	3.4	1.9	**-7.91**
Industrials	-2.2	2.8	-3.7	-9.9	**-3.22**
Materials	-23.8	28.3	-6.4	-8.4	**-2.57**
Real Estate	N/A	N/A	-12.5	-8.9	**-10.70**
Health Care	22.2	12.6	16.0	10.4	**15.30**
Tech	0.3	-25.3	-2.9	13.2	**-3.68**
Discretionary	-23.2	8.0	-0.7	-4.0	**-4.96**
Staples	16.8	21.2	25.9	1.9	**16.44**
Utilities	-29.5	-13.6	13.9	0.9	**-7.09**

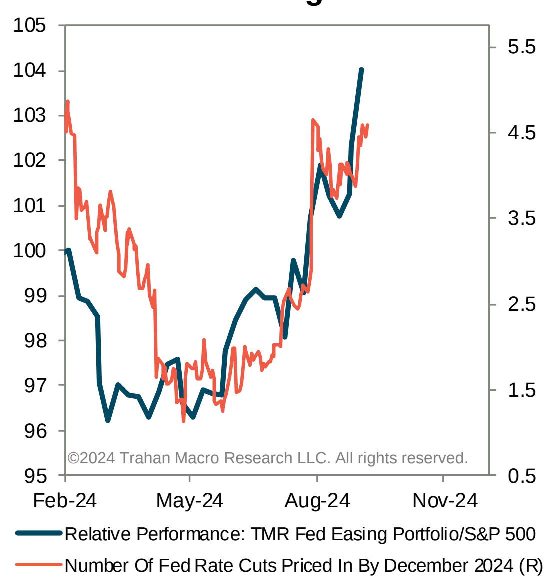
The only sectors to consistently outperform the S&P 500 during every Fed easing cycle since 1990 are Health Care and Consumer Staples.

The TMR Fed Easing portfolio uses five factors that have proven to be consistent outperformers in prior easing cycles. We believe this cycle is no exception – in fact, since the market began pricing in rate cuts the portfolio has outperformed. The chart below illustrates the relationship between the portfolio's relative performance and the number of rate cuts priced in. The portfolio has performed extremely well amid weaker economic data, which is the catalyst that ushers in the next fed easing cycle.

Lagged Effects Of Fed Tightening Catching Up To Volatility

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%

TMR Fed Easing Portfolio!



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

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. We will 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.

A Sample Stock Listing Of The Five Factor Fed Easing Portfolio

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Universe: S&P 500

TMR Fed Easing Portfolio

Lower Values Rank Better In All Categories

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	1	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

Last week we held our September conference call, ***The "Key" Market Theme This Fall ... Volatility!,*** which examined the themes we expect to drive market direction this fall. For those of you that missed the call, or those that would simply like to take another look at the accompanying slides, you can find links to both the slides and replay below.

Click Here To Download Slides

Click Here To Watch Replay

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