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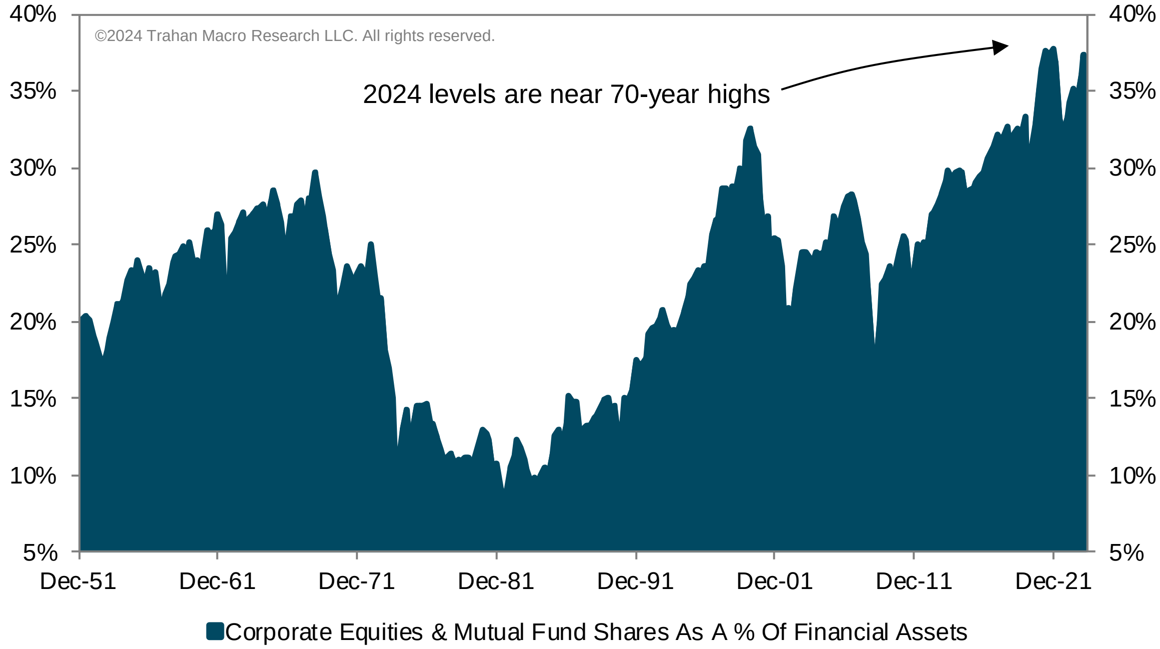
Interesting Charts To Ponder For The Last Weeks Of Summer

It certainly did not take long for the equity markets to forget about the Sahm Rule! It only took two weeks of better Initial Claims data to get stocks humming again. It's not surprising to see the markets rebound after such a sudden and steep sell off. Also true, we have five more employment reports to get through this year and they are unlikely to improve from here. One thing is clear, financial markets are hyper focused on labor data and that makes sense since employment is the macro equivalent of earnings. Another disappointment like we saw for July would likely rattle equities once again. Then there's August & September and so on.

Household Exposure To Equities Near All-Time Highs?!?



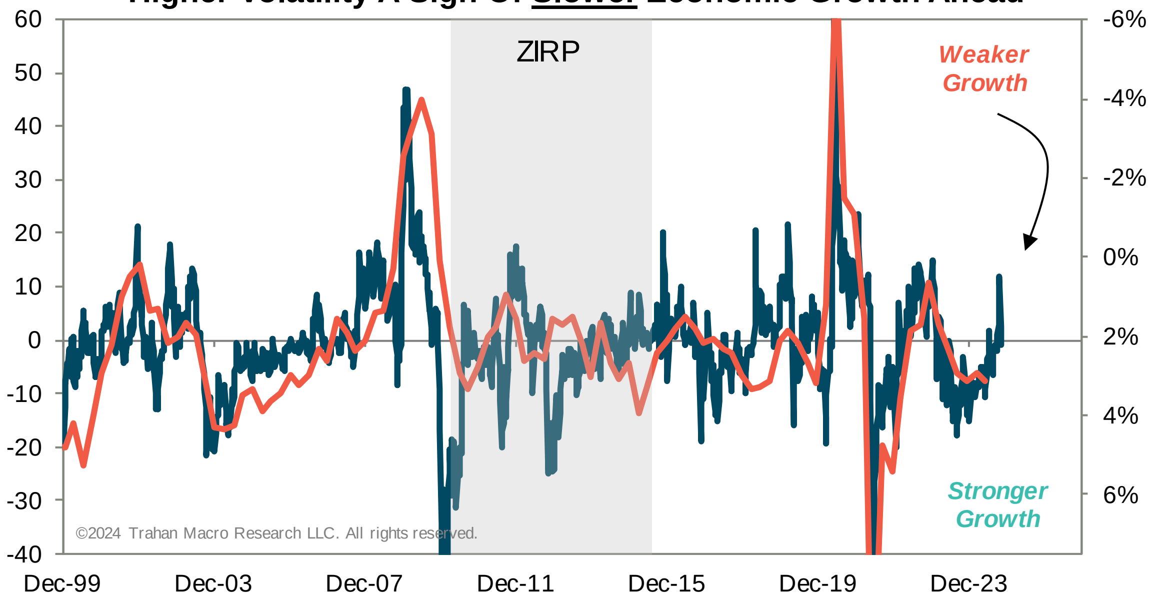
Surely, the sell-off felt significant as we were going through it. One explanation is that today's S&P 500 is heavily exposed to growth stocks. Growth stocks hold up well in the initial phase of a slowdown … until they crack altogether. One other variable at play as to why the early August sell-off felt so terrible (some were calling for emergency rate cuts from the Fed) despite the S&P 500 only moving 6% lower could be explained by the chart above. American households have rarely had this much exposure to equities. This is great when markets are rising but is going to sting in a correction.

There is no great wisdom behind this week's report. We thought we would use one of the last weeks of summer to publish some of the more interesting charts and concepts we have come across in recent months. Think of this as an amalgamation of things that are attention-grabbing and certainly worth pondering. We will get back to the serious stuff next week and on our September 5th conference call (register here). Surely, the fall will likely offer plenty of surprises. It seems clear to us that the tide has turned despite the rebound in recent weeks. Wishing you a great rest of your week. All the best. Francois

What's With The Swings In Market Volatility Lately?!?

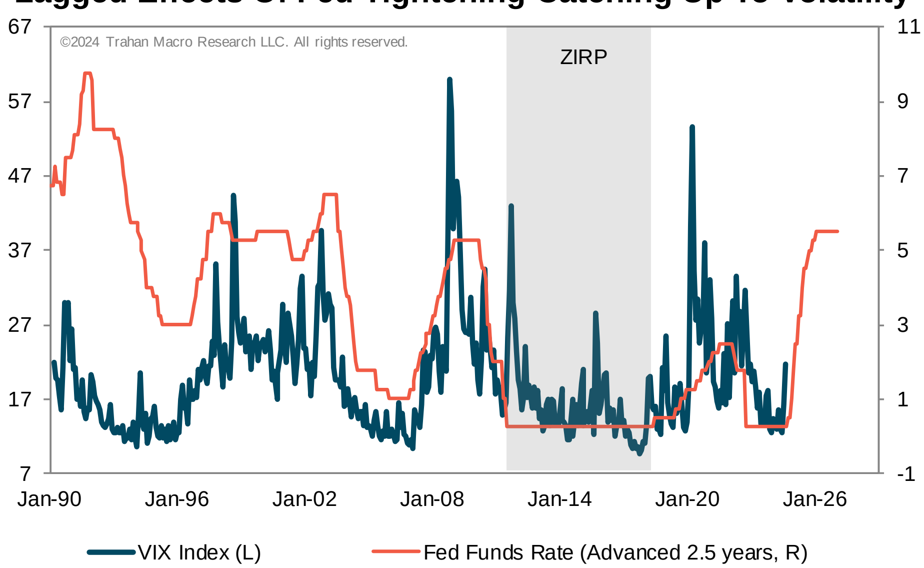
What happened in early August? Well, put simply, economic data disappointed to the downside (see economic surprise index this year!) and volatility shot up. This is pretty normal stuff at this stage in the cycle when the lagged effects of Fed tightening starts to catch up to markets and the economy in short order. As the chart below illustrates so well, a spike in volatility is typically a sign that the economy is about to shift into lower gear in a quarter or so. This is the market's way of telling us that things are bound to change as we get into the fall. We shall see.

Higher Volatility A Sign Of Slower Economic Growth Ahead

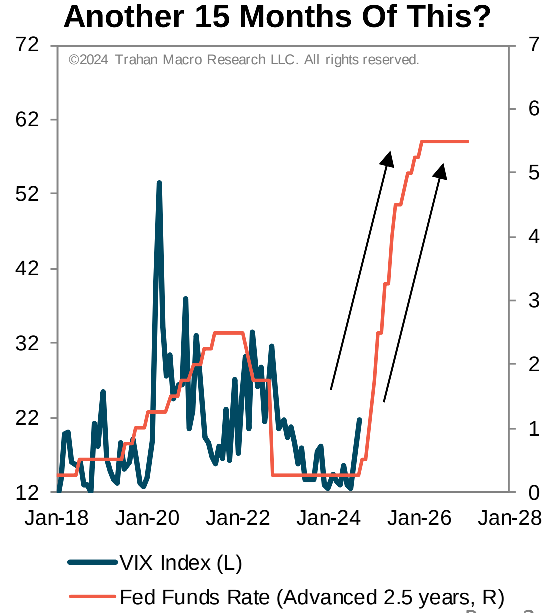


The key thing to understand about volatility is that is tends to follow trends in policy with a lag of two to two and half years. In that context, what we all experienced a few weeks ago is not out of bounds from a historical perspective. The most important thing to understand, however, is that this is just the beginning of the story. At its longest, it could take 2.5 years AFTER the Fed's first rate cut for volatility to truly top out for the cycle and markets to rebound sustainably. I think we can all do the math here but assuming the Fed cuts rates in September it could be late 2026 or even 2027 before that happens.

Lagged Effects Of Fed Tightening Catching Up To Volatility



Another 15 Months Of This?



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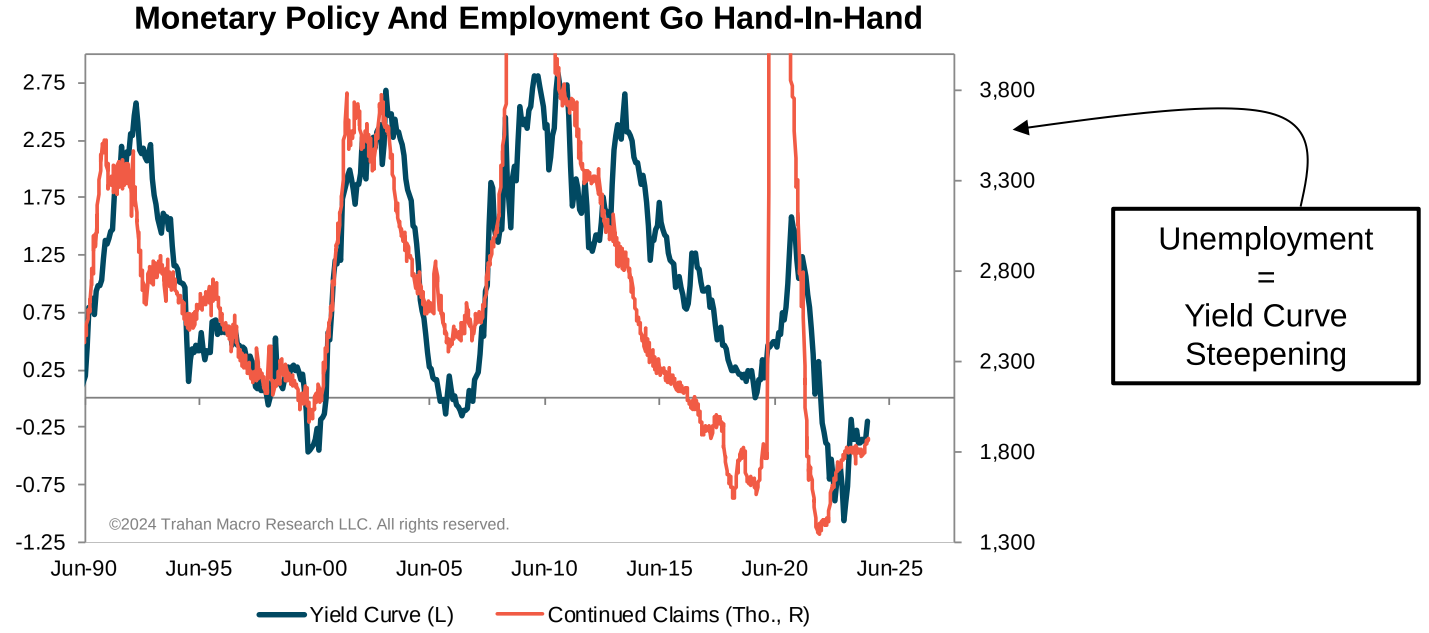
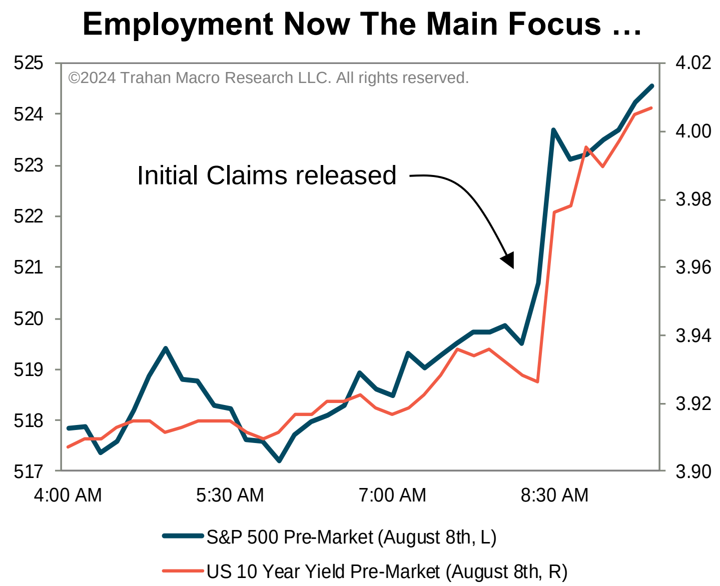
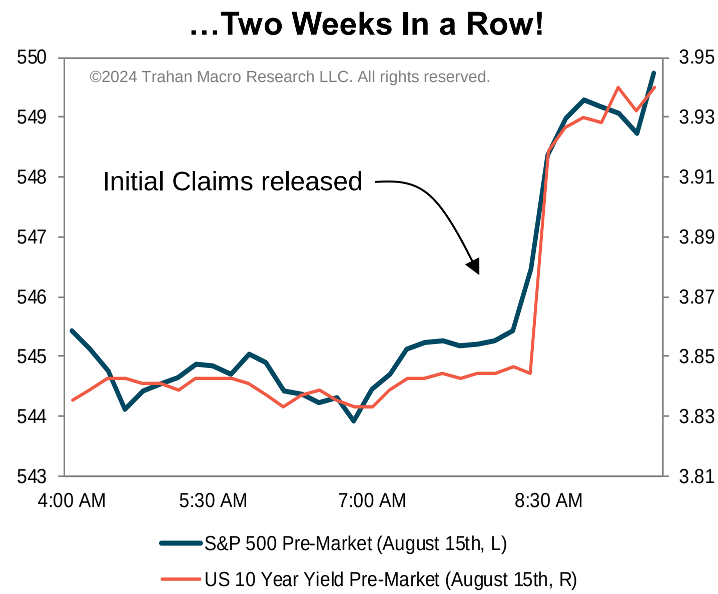
Financial Markets Hyper Focused On Employment Data

There has been a lot of talk in this cycle about how the inverted yield curve is not the problem. Rather, it is when the curve un-inverts that markets tend to suffer. This is true and that is why a Fed easing cycle (i.e. an inverted yield curve that is now steepening) is rarely kind to equity markets. As the chart below illustrates so well, the yield curve and labor markets are actually correlated across history. Weaker labor markets (in this case continuing claims moving higher) will usually result in a dovish Fed and a steepening yield curve. If sustained, it will also pose a problem for S&P 500 earnings.



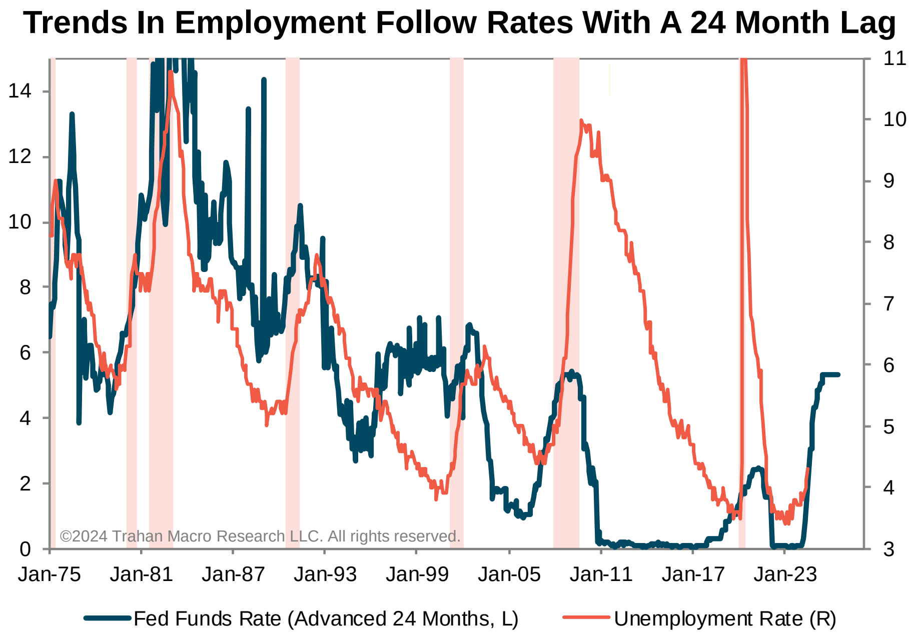
If we put the events of August in context we quickly realize how weird a month it's been. I can't recall ever seeing the stock market react to Initial Claims the way it has in the last two weeks. To recap, a disappointing employment report in July triggered the Sahm Rule and a correction in equities AND better claims in the last two weeks has reversed much of that decline in stock prices. If there is one thing that is super clear at this stage it is that equity markets are hyper focused on labor markets and the implications they bring to the earnings outlook. Needless to say, a sustained rise in the unemployment rate would like lead to weaker earnings and a classic bear market.

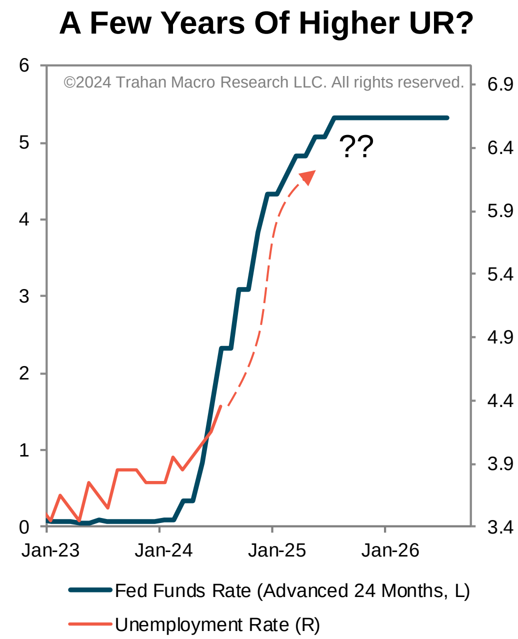




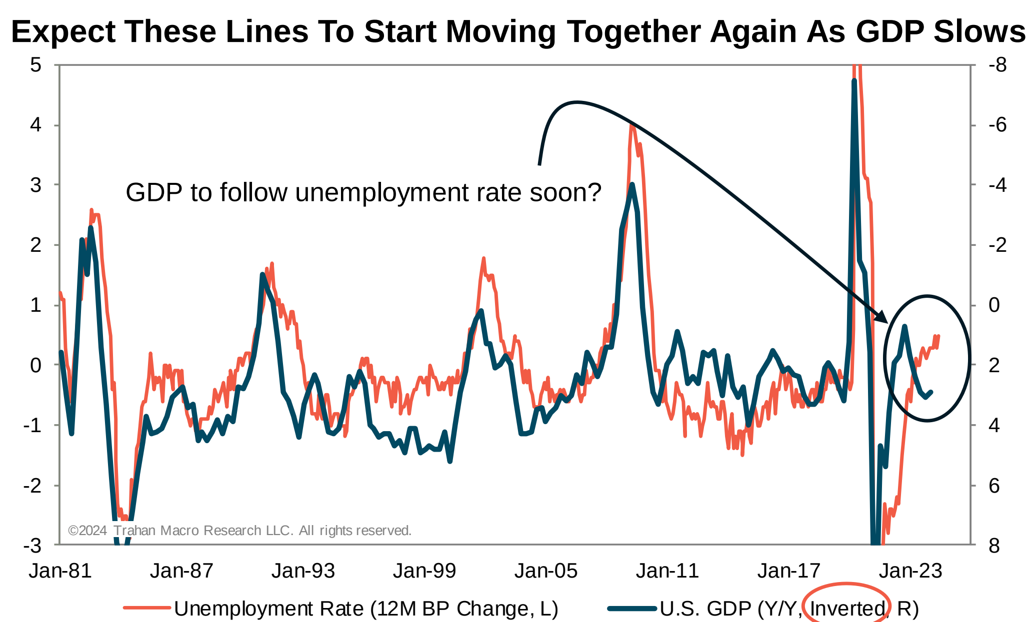
Employment To Quickly Become The Fed's Next Problem

It's not always exact but it typically takes about two years for a change in monetary policy to impact labor markets. In that vein, we passed the two-year anniversary of the Fed's first rate hike of the cycle back in 2022 just this spring. Worded differently, we better get used to the type of employment reports we saw in July as this relationship argues that things get worse for some time before they can improve sustainably. That will require Fed easing and a long lag to boot. It will not be a straight line but we are in the window where the trend in the unemployment rate is higher sustainably.





The relationship below should not be surprising but there exists a strong relationship between trends in the unemployment rate and GDP growth. After all, 68% of U.S. GDP comes from consumption and labor market trends have an enormous influence. It's fairly easy from there to connect all of this to S&P 500 earnings. We typically say that employment is the macro equivalent to earnings and that is fairly accurate historically. In essence, the unemployment rate should continue to digest the lagged effects of policy and trend higher, putting pressure on GDP growth and S&P 500 earnings. This is the dynamic that usually leads to a bear market in equities.



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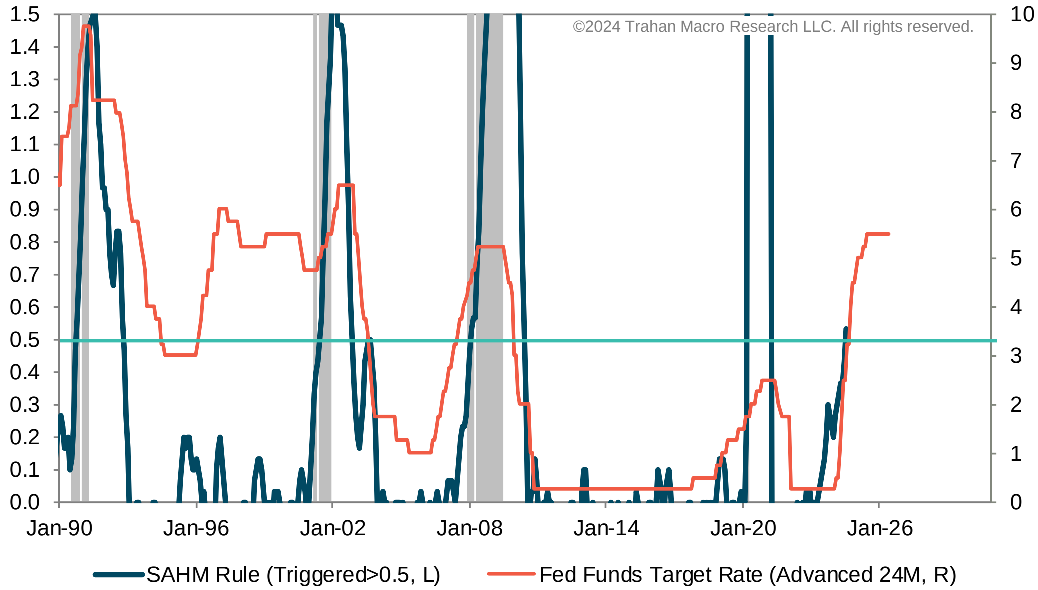
The Sahm Rule Is Just One Problem For The Soft Landing Thesis

The math behind the Sahm Rule is not overly complicated. Most investors are familiar with this concept since it has gained prominence in recent years. Importantly, perhaps, it too follows trends in monetary policy and with roughly the same lag as we see with the unemployment rate (i.e., 24 months). The bullish crowd loves to point to the mid ‘90s where the Fed raised rates and unemployment failed to react. Now look at the chart below and ask yourself whether the current data points look like that mid ‘90s episode or some of the others? Enough said.

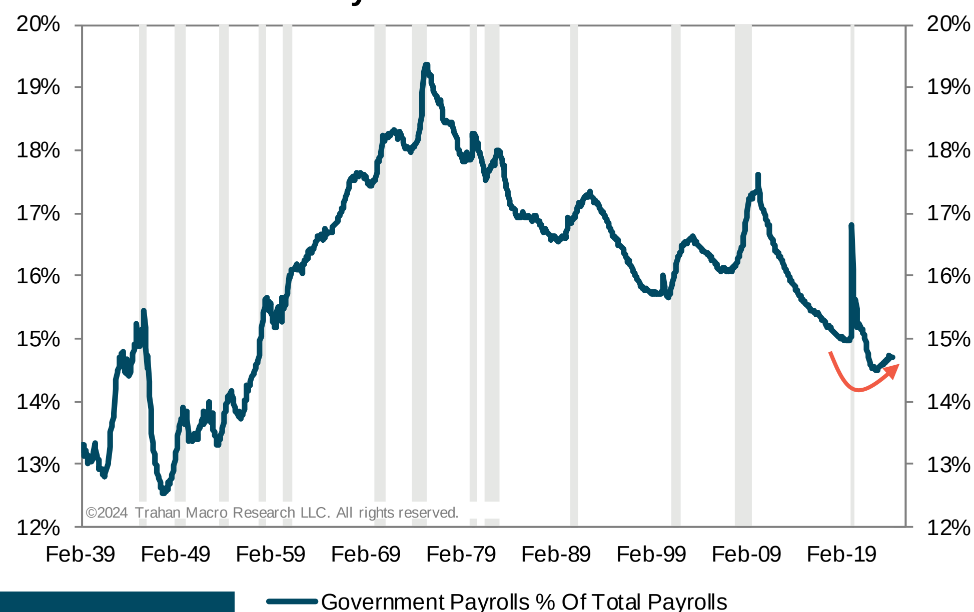
Rates Argue The Sahm Rule Will Only Get Worse From Here



Unemployment would have to fall from 4.3% to 3.9% in the August print to un-trigger the Sahm rule.

It’s not just the Sahm Rule that is flagging caution. There are many “recession risk” indicators that come from labor market data. We often look at continuing claims as an alternative to the Sahm Rule. When claims are up over 20% we usually see a recession unfold. We have also shown that full-time employment is a great recession indicator and it too is flagging risk. The chart below shows the percentage of employment gains coming from government jobs. This ratio tends to rise ahead of recessions and has a very consistent track record all the way back to the 1930s. In total, there are four labor market indicators flagging recession risk ahead.

Government Jobs Usually Gain Market Share Ahead Of Recessions



Government payrolls has accurately forecasted the last 14 recessions, giving a false positive just twice in the last 85 years.

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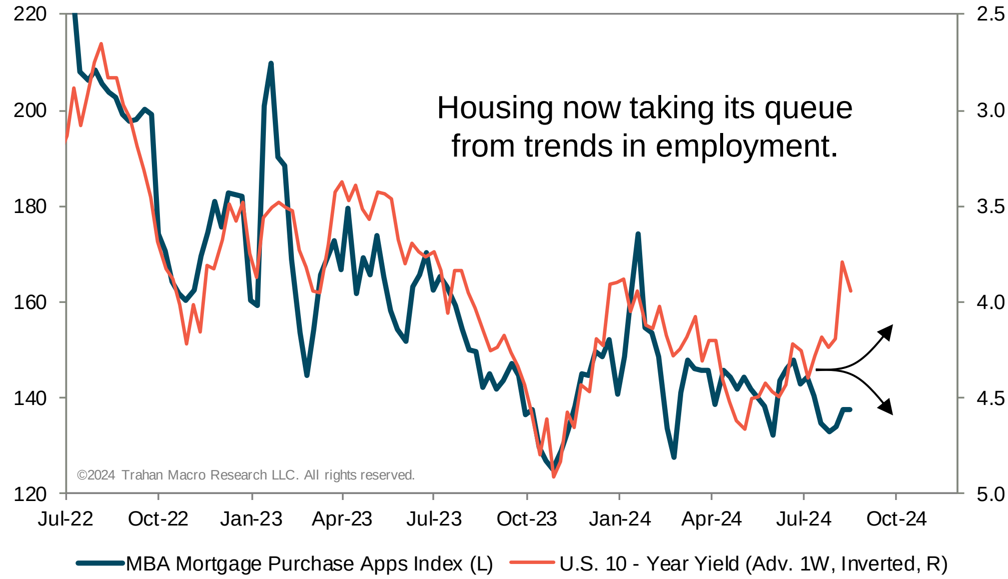
Housing Dynamic Changing … For The Worse?!?

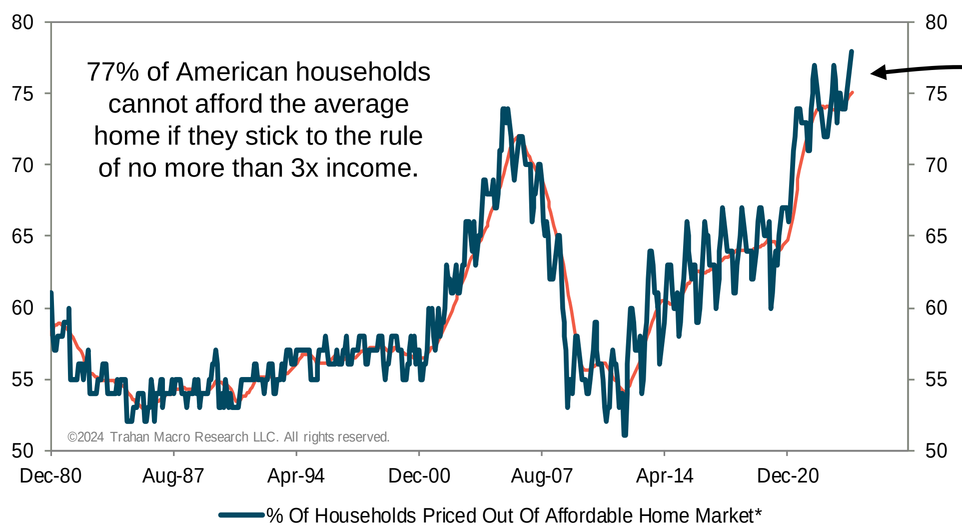
Housing is also flagging risks for the economy. Ed Leamer documented the efficacy of housing starts as recession indicator in his 2006 paper, "Housing Is The Business Cycle." A lot has been said lately about the increase in housing supply (especially in the southern states). The most important thing to understand about the housing dynamic is that it is now far less sensitive to interest rates than previously. It is now far more correlated to labor market data. History is clear on this front --- rates are no longer the driving force of housing when the unemployment rate starts to rise.

Lower Rates No Longer Lifting Housing?!?



How bad could it get for housing? That's a million dollar question. The chart below gives us a good sense of just how stretched affordability metrics are, and the University of Michigan survey of consumer confidence shows that housing sentiment is near historic lows. That's a lot of potential gravity for this early cycle industry. At the end of the day, a lot of this will depend on just how high and sustained the rise in the unemployment rate is. Thus far, the unemployment rate seems to be following its traditional relationship with past policy trends, which argues that the trend is higher into 2026 and possibly beyond. That would give housing a lot of time to correct to more acceptable levels.

Housing UN-Affordability At The Highs Of Housing Bubble



*Rule of thumb for housing affordability is 3X income

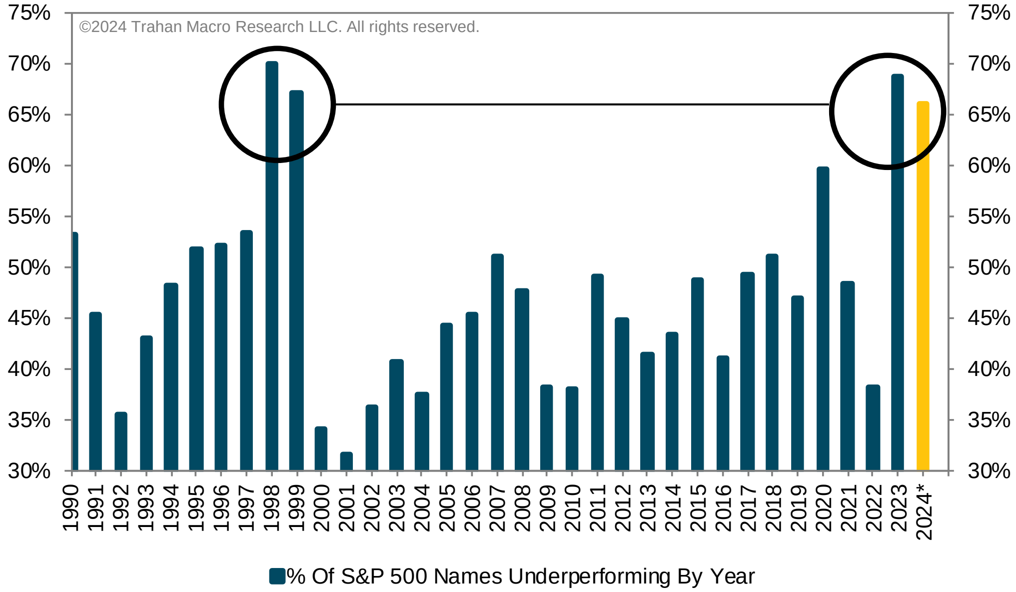
Today's housing market is slightly worse than that seen in the 2000s. The Fed raised rates 17 times to stem inflation during that period.

Note that inflation was far lower than what we are dealing with now.

An Unusually Narrow Set Of Market Leaders In The S&P 500 … Still!

We just updated this data to see where things stand after the sudden market correction and subsequent rebound. In some ways it looks the same as it did when we last looked at it back in June and in others it looks very different. The data on the percentage of stocks that have outperformed the overall S&P 500 Index this year is still unusually high. Indeed, 66% of stocks have lagged the overall Index this year. That is not an easy backdrop for managing money … unless you have owned the Mag 7. The current profile looks awfully similar to what we saw in the late 1990s?!?

We Have Not Seen Narrow Markets Like These Since????



Thankfully, there are not many portfolio managers that are measured against the Nasdaq. How could one manage money with 88% of stocks underperforming the index?!? The figures are not great for the S&P 500 but they are absolutely dismal for the Nasdaq. The one thing that has changed since June are the smaller-cap indices. Indeed, the S&P 400 Midcap Index, S&P 600 Small Cap Index, and Russell 2000 have 50ish percent of stocks outperforming their respective indices, which is far better than what we saw back in June.

A Difficult Market To Keep Up With?!?

Index	# Positive	# Negative	% Underperforming	YTD Perf.
S&P 500	367	131	66%	17.6%
Nasdaq	1318	1705	88%	19.1%
S&P 400	256	142	55%	9.3%
S&P 600	348	251	52%	4.9%
Russell 2000	1033	901	57%	7.8%

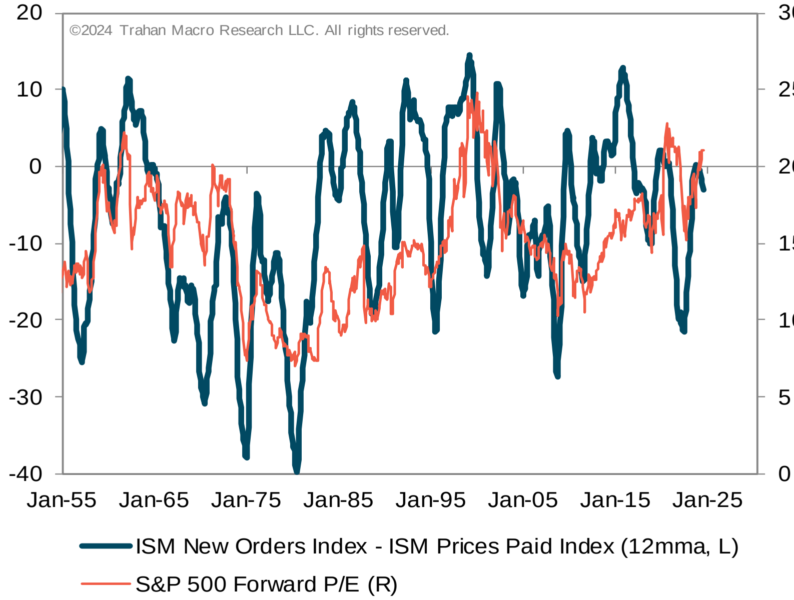
Through 8/20/2024

Some will argue that concentrated markets are actually good for portfolio managers, but in our minds those folks have likely owned the Mag 7 in the last year. We know from history that when more stocks are beating the benchmark, the greater the performance of the money management industry. In other words, more portfolio managers are able to beat their benchmarks.

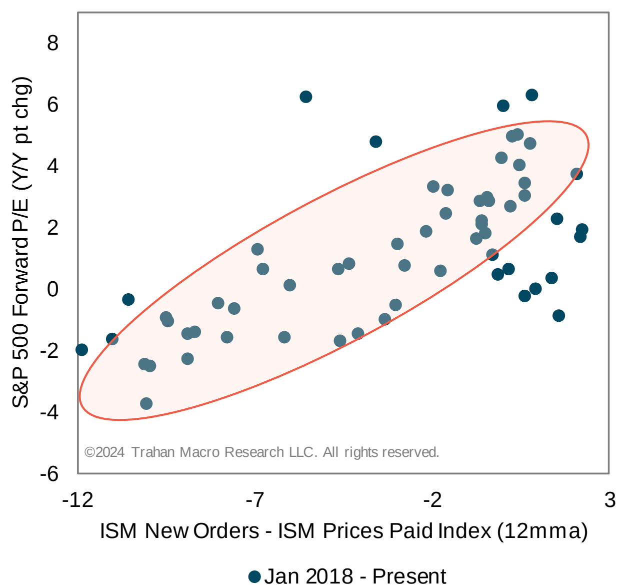
A Few Thoughts On Current Equity Market Dynamics

There is no doubt that lower inflation has helped market multiples recover. Moreover, we are not used to seeing inflation at the levels of this cycle so some of this is new territory for today's investors (yours truly included). Interestingly, inflationary pressures have fallen faster than leading indicators (like the ISM New Orders Index), which has created a P/E-friendly dynamic despite mediocre economic news. The key question is can it continue? It is hard to make that case since inflation has already retreated while economic data is just starting to really feel the pressure of tightening.

Lower Inflation A Boon For P/Es

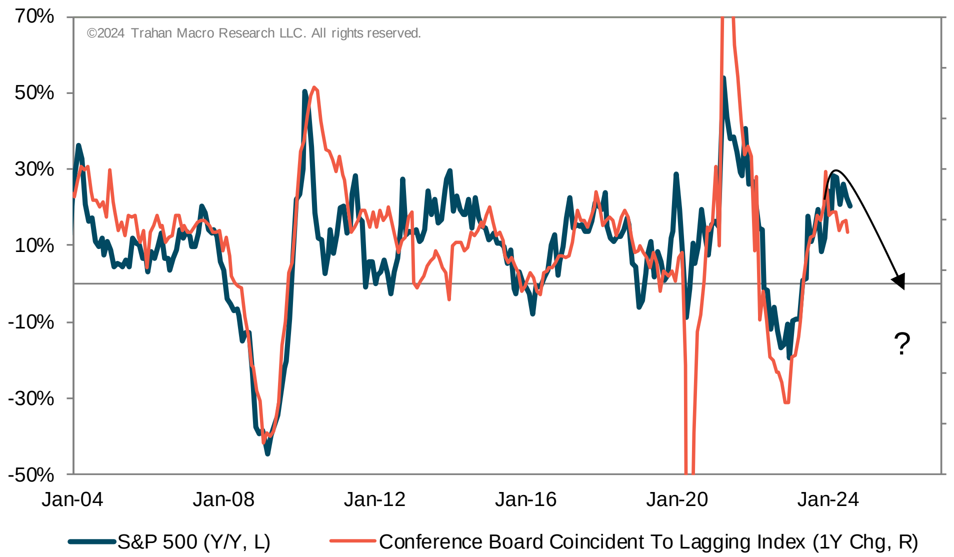


Not A Bad Relationship Historically?



Another great relationship between macro data and equity prices can be found in the chart below. It plots a ratio of coincident to lagging indicators from the Conference Board alongside with the S&P 500's return across time. It is when coincident economic indicators (GDP, industrial production, employment growth, etc.) start to lose momentum relative to lagging economic indicators that the stock market typically starts to lose steam. This makes sense intuitively since we know that S&P 500 earnings are ultimately correlated with GDP growth and other coincident economic indicators. Still, this ratio can be used to confirm signals from other leading indicators of earnings growth.

Peaking Coincident Indicators Something To Keep An Eye On



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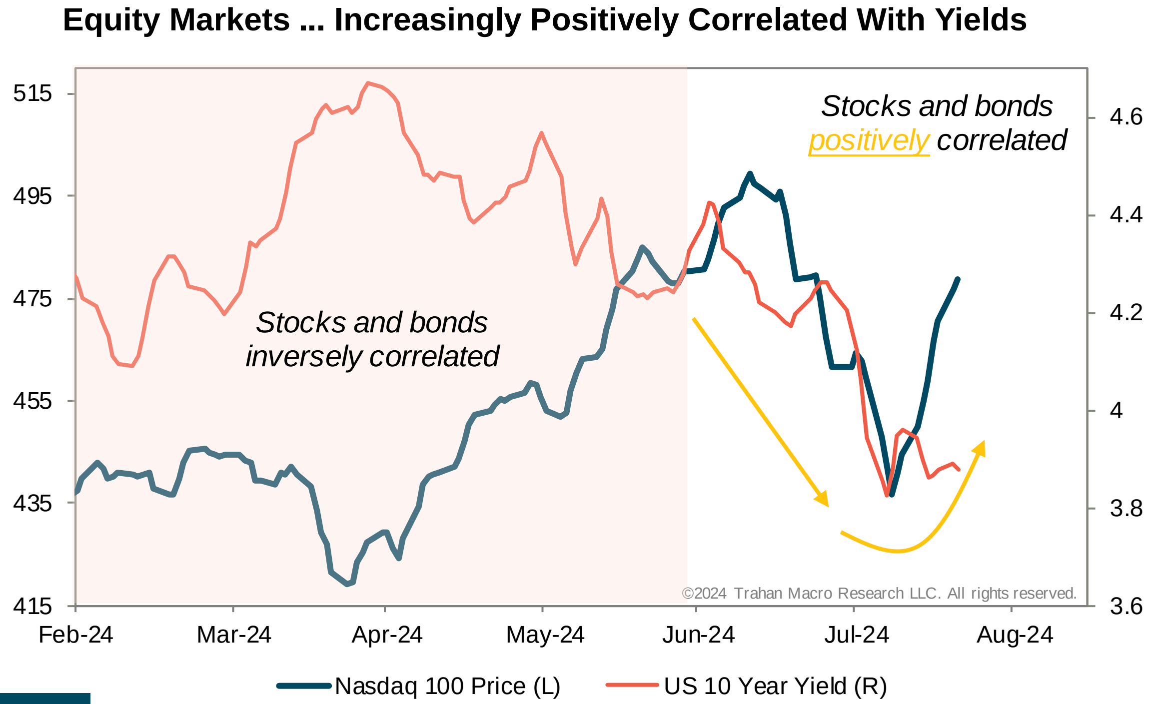
Interesting Market Relationships With An Important Message

Just as a disclaimer; note that I am not a fan of charts that overlay equities today with patterns of the past. Since humans trade stocks, there will be patterns that repeat over time (think asset bubbles and their similarities). Still, this type of exercise often leads to massive behavioral biases where we see what we want to see. That said, I published this chart earlier this year and it is uncanny how much it resembles the peak in the fed funds rate from 2007.

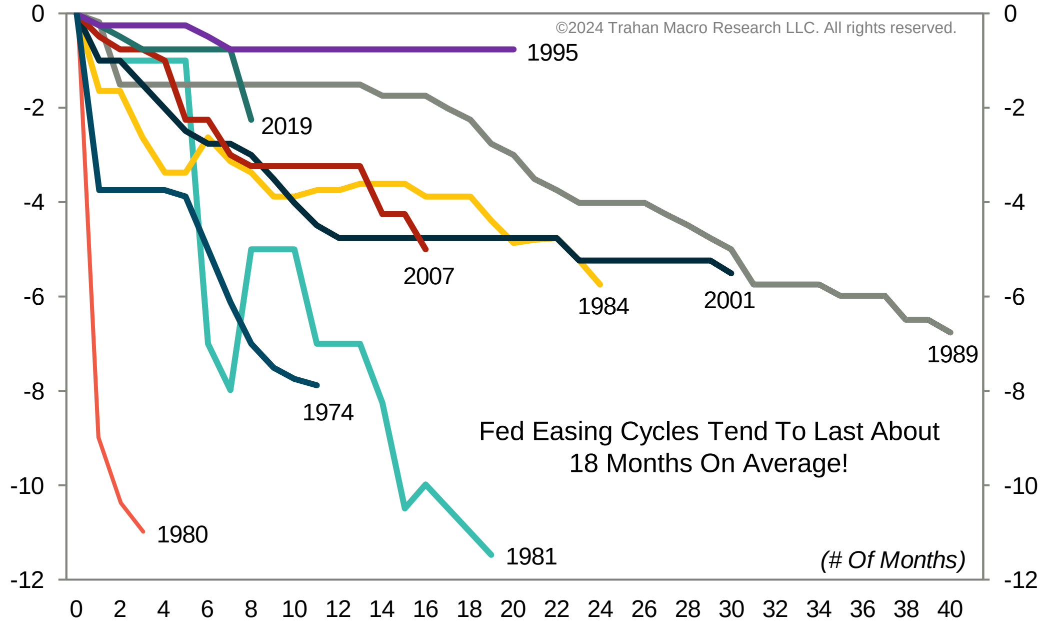
The bigger story when it comes to stock market trading patterns right now is the changing relationship with bond yields. This does not always happen on a dime, but it is normal behavior at a peak in the fed funds rate alongside a change in market leadership (remember utilities in Q2). This generally marks the end of the Fed-relief rally and of the "bad economic news is good stock market news" dynamic that usually prevails once the Fed is done raising rates. We are now entering a world where bad economic data becomes a threat to stock prices as it likely implies weaker earnings ahead.



Sector Performance During Easing Cycles Is NOT Always Clear Cut

One really important point to note when it comes to Fed easing cycles is that they tend to last for quite some time. The chart below illustrates just how pervasive some have been. The Fed tends to cut rates for an average of about 18 months. Interestingly, the cycles with steep declines in the fed funds rate tend to be on the shorter side. They do provide more stimulus but it comes in a short burst and not a prolonged cycle like we saw in the wake of the Tech bubble of the early 1990s.

Fed Easing Cycles Are Not Typically Short-Lived



The above chart is important because there are stock traits that tend to outperform systematically during a Fed easing cycle. Knowing that these cycles tend to last for some time gives us an opportunity to rotate toward those investments known to perform well when the Fed is in easing mode. The table below shows us that the Consumer Staples and Healthcare sectors have systematically outperformed during the easing cycles of the last 30-odd years. It should make sense intuitively that more defensive sectors would perform best since Fed easing cycles are typically associated with recessions and/or a decline in S&P 500 earnings.

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.

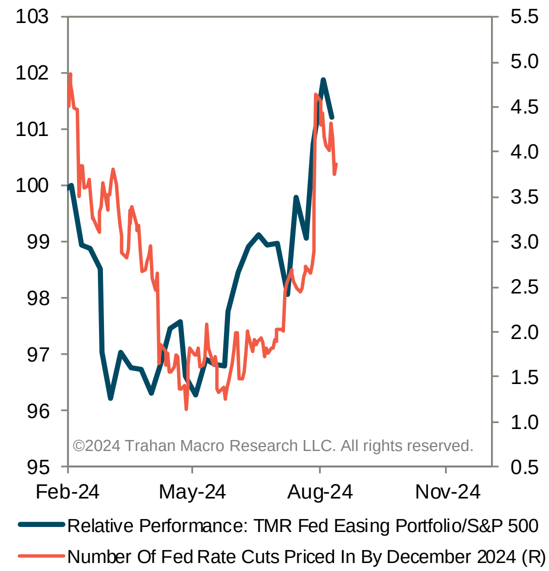
A Stock Screen For The Fed Easing Cycle … Of 2024 And 2025?!?

A few weeks ago, we introduced the TMR Fed Easing portfolio. It uses five factors that have proven to be consistent outperformers in easing cycles of the past. This cycle is no exception. The portfolio has performed extremely well amid weaker economic data which is likely to be the catalyst that ushers 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 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	2	2	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

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

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