CROSSMARK
GLOBAL INVESTMENTS

Doll's Deliberations

Quarterly Edition | October 9, 2023 | Issue 3.40

The Easy Part of Taming Inflation is Behind Us – Now Comes the Hard Part

Introduction

The S&P 500 achieved a year-to-date high of 4589 on July 31, but fell 7% to its quarterly low and down 3.7% for the quarter. The NASDAQ (-4.1%) and small stocks (Russell 2000 -5.5%) fell even more. The August decline accelerated in September as the S&P 500 fell below its 50- and 100-day moving averages. The equal-weighted average lagged the cap-weighted average once again. Big tech was mixed with Apple down 11.7% despite new product launches. Among the culprits for the equity decline were higher interest rates and oil (WTI +28.5%). Ten-year Treasury yields rose nearly a full percentage point achieving their highest yield in 16 years. The only positive sectors were energy (+11.3%) and communication services (+2.8%); the worst sectors were utilities (-10.1%) and real estate (-9.7%).

Our guess is that the July 31 high may have been the high for the year. We established a 4200 S&P 500 target for year-end – the low end of the 4200-4600 trading range we have been in for several months. Fed policy remains a significant discussion item. (Are they done? Will they go again in November or December? Will they have to raise rates further in 2024? When will they begin cutting rates?) So far the dialogue continues to focus on higher rates for longer, with rate cuts constantly pushed out in time. A few visible union wage settlements and strikes continue to argue for stubborn wage inflation. And yet consensus expectations remain for a soft landing. We continue to think a recession is in our not too distant future. (See Whitepaper entitled "Will A Recession Ever Materialize?" dated September 2023.)

What Happened in Q3?

Equities sold off in September in response to a surge in long-maturity government bond yields. The rise in bond yields is symptomatic of a sharp reduction in market expectations for a soft-landing economic outcome, which underscores that the U.S. and other DM economies are on an ultimately recessionary path. The September FOMC meeting clarified that half of the Fed's previous forecast of easing next year was due to expectations of a higher unemployment rate. The Fed is still telegraphing rate cuts next year, but now by a trivial amount. This strongly suggests that investors will need to see a sustained period of core inflation below the Fed's end-2024 target for meaningful rate cuts to occur. Without imminent rate cuts, a soft-landing outcome seems highly implausible. Those cuts will likely come too late to save the U.S. economy from a recession.

It is not the short end of the curve that is driving long maturity yields higher, nor is it due to a rise in inflation expectations in response to higher oil prices. A more plausible argument is that the long end of the curve has moved higher this month because of a higher neutral rate estimate on the part of investors. The neutral rate of interest is certainly higher than the FOMC's long-run Fed Funds rate estimate, but it is clear that long-maturity yields have not only moved well past these estimates, but also past reasonable estimates of nominal potential growth. While long-term Treasury yields are at risk of a further rise over the shorter-term, we think that investors focused on a 6-12 month time horizon should be using any additional yield increases as an opportunity to extend fixed-income duration further in advance of a coming recession.

Oil prices have managed an impressive rally despite ongoing concerns about the Chinese economy and global growth in general. Pure supply-driven oil price bull markets are a drag on global growth, and thus a monitoring of energy market conditions is warranted. So far, however, our assessment has been that prices have lifted due to both better demand expectations and modest restraints on supplies. One clear negative development related to the rebound in oil and gasoline prices is that the deceleration in headline inflation has likely ended, at levels well above 2%. In addition, oil prices have a meaningful impact on short-term and long-term inflation expectations, and any further lift in the latter would be a concern to central banks (and the bond market).

The cause of the recent rise in oil prices is not a surge in demand. Rather, production cuts from OPEC are projected to push the global oil supply/demand balance into deficit in the back part of this year. Our sense is that OPEC has taken the opportunity to squeeze prices higher in response to recent signs of economic strength in the U.S. Russia's incentives concerning oil production and prices are clear: Vladimir Putin is seeking a change in leadership in the U.S. next year in the hopes that a new administration will be less inclined to support Ukraine. Oil prices have increased significantly over the past three months, with Brent crude oil having risen from roughly $75/bbl in late-June to close to $100/bbl today. The fact that U.S. headline inflation ticked higher in August due to a pickup in energy prices has caused some angst that a reacceleration of U.S. inflation may be in the cards. This is potentially true even for core inflation due to feed-through effects should energy prices remain strong for a sustained period.

Where Do We Go From Here?

The next few months are likely to be confusing as investors grapple with signs of sticky underlying inflation and bond yields rising to new highs yet central banks being on hold at a time of heightened uncertainty about the durability of the economic expansion. After stronger Q3 GDP, the economy will add to the confusion with the possibility of a weak Q4 due to strikes and a possible government shutdown. Importantly, strikes and government shutdowns while disruptive, rarely change the underlying economic trajectory because they are temporary in nature. Strikes and shutdowns however, will reinforce two longer-term negative factors for global financial asset markets via increased wage gains and the risk of further entrenching inflation, as well as highlighting the increasingly dysfunctional U.S. political backdrop and the challenge of rolling back ever-larger government debt burdens. Next year's U.S. presidential election promises to further reinforce the challenging political backdrop.

The main cyclical risk factor for investors remains the likelihood of even higher government bond yields and, eventually, outright restrictive monetary conditions. Since 2022, bond yield uplegs have eventually triggered risk-off phases, and indeed a whiff of such an outcome developed in late September. Nevertheless, the upside in bond yields has been held back by the widespread belief that policy rates will head lower next year. We continue to disagree with this assessment, believing that inflation will be sticky enough to prevent Fed cuts for most, if not all, of 2024.

The key takeaway for investors from the September Fed meeting, as well as recent market behavior, is that the U.S. economy is probably not going to experience a soft landing – in line with what we have been arguing for several months. That outcome requires monetary policy to become neutral or easy quickly enough to avoid the impact of past tightening, and the Fed has just signaled the opposite view. In the meantime, job growth continues to slow, services activity is flagging, and excess household savings are dwindling. Until strong evidence of a soft-landing outcome emerges, we maintain our base case view that the U.S. is on a recessionary path, justifying conservative portfolio positioning that is focused on capital preservation rather than return maximization. Further upside in long-maturity government bond yields cannot be ruled out, but any neutral or short-duration positions assumed by fixed-income investors should be tactical with a very short leash. For investors focused on a 6-12 month time horizon, we recommend using the opportunity of higher yields to further increase duration exposure.

We have repeatedly noted that U.S. consumers have both healthy balance sheets and income statements, and have not quite fully exhausted their excess savings built up during the pandemic, although that excess savings seems to be nearing an end. The Conference Board's present situation and jobs plentiful less jobs hard-to-get indexes are below their peak readings, but still historically high and, thus, are supportive of good growth. One interesting aspect of the debate about the speed at which monetary tightening hits the economy is that U.S. household debt servicing burdens are still historically low. This reflects the success most mortgage holders had in locking in low longer-term rates before the sharp rebound in rates and yields over the past 18 months.

While energy prices may move even higher over the near-term, we doubt that this will be sustained for long. At a minimum, rising energy prices reduce the odds of the soft-landing economic outcome in the U.S., and it is possible that they could bring forward the onset of a recession in developed market economies. Aggressive near-term bets against energy prices are not warranted, but we would advise investors to be somewhat cautious over a 6-12 month time horizon.

In Summary

The U.S. consumer will likely determine whether or not the economy enjoys a "soft landing." In this regard, we are not optimistic. At the high-end, we see the "wealth effect" fading and the virtuous mini-cycle of rising stock prices and upside economic surprises starting to unwind. Further, forward-looking employment indicators are rolling over, "excess savings" is ending, and student loan repayments have just restarted. While nonfarm employment is slowing, the labor market is still holding up. On the surface, this dynamic is positive for the economy and risk assets as it suggests that inflationary pressures are continuing to ease without causing a significant deterioration in the economy. However, the full impact of the Fed's tightening cycle has not yet been transmitted to the economy. We expect the labor market to continue deteriorating and the unemployment rate to rise. Non-farm payroll growth averaged approximately 300,000 per month in 2022, 200,000 in the first half of this year and is already approaching 100,000, which is the monthly rate necessary to keep the unemployment rate from rising.

Given the lagged effects of monetary policy, and the stickier persistence of inflation and valuation levels, it is difficult to build a bullish narrative. Until a recession is more obvious, we expect the stock market to tread water between S&P 500 4200 and 4600 as it has done since June. Not knowing when a recession might start, but that a slowdown will become more evident, we are using a 4200 S&P 500 target for year end. Should a recession develop and earnings estimates get cut, further downside is likely. Breaking the October 2022 low is unlikely, but possible – unlikely because we expect any recession to be mild due to 1) reasonably good consumer balance sheets, 2) pretty healthy corporate balance sheets, and 3) credit problems on bank balance sheets less than usual. Therefore, breaking that October 2022 low (S&P 500 3574) will hopefully be avoided. Stock selection should focus on earnings predictability, earnings persistence, good and growing cash flow, and reasonable valuations.

Conclusions:

1. Outsized equity performance this year has been very significantly driven by concentration effects from AI-related stocks. Stocks have outperformed and financial markets continue to challenge our view that the U.S. economy is on a recessionary path.
2. The available evidence supports the notion that U.S. monetary policy is tight, which argues against the "no-landing" economic scenario. It also underscores that the recessionary clock is indeed ticking unless the monetary policy stance eases soon.
3. The "soft landing" narrative has recently been boosted by the June and July inflation data. However, these readings may have been depressed by odd seasonal adjustments.
4. It is an open debate whether the Fed will meaningfully cut interest rates if inflation falls in line with the Fed's forecasts but the unemployment rate has not yet begun to rise.
5. Improving real wage growth and the prevalence of excess savings are the two factors that have supported U.S. growth and labor demand this year. Both factors are likely to be fleeting, and recent labor market data points to increasing odds that incrementally weaker labor demand will show up in the form of higher unemployment (precipitating a recession).
6. Until we see concrete signs that the soft-landing economic scenario is materializing, we will continue to recommend that investors maintain defensive portfolio positions and prioritize capital preservation over return maximization.
7. Equity selection should focus on earnings predictability, earnings persistence, good and growing cash flow, and reasonable valuations.

Source: BCA Research, MRB Partners, FactSet / Crossmark