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Another Good Quarter Leaves Valuations Stretched

Equities advanced in Q2 (S&P 500 +8.7%), making the third straight up quarter. The NASDAQ was the standout (up 17%). Treasuries were weaker with ten-year yields rising 31 basis points to 3.81%. Crude fell nearly 7%, after losing 6% in Q1. A pickup in soft landing expectations, disinflation talk, better than expected Q1 earnings, the AI secular growth theme, and easing regional bank stresses were among the tailwinds. Bearish commentary included a more aggressive Fed and global tightening cycle, negative money growth, tightened lending standards, narrow breadth and valuation. Outperforming sectors included technology (+17.2%), consumer discretionary (+14.6%), and communication services (+13.1%). Sectors falling in Q2 included utilities (-2.5%), energy (-0.9%), and consumer staples (+0.5%).

Introduction

- Rising real wages and a sharp slowdown in the pace of monetary policy tightening contributed to a pickup in economic activity in the first half of this year, and that has delayed the onset of a recession.
- We are not yet convinced that the U.S. economy will continue to expand for another year, unless the Fed begins to cut interest rates before the unemployment rate has started to move higher, which we view as very unlikely.
- Excess savings and the sustainability of U.S. consumer spending are at the core of the current debate regarding the economic outlook. Some estimates of the level of excess savings point to a depletion of these savings in a year's time, but other estimates point to a much earlier end point.
- The bottom line for investors is that the recessionary clock is ticking – we just do not know for certain how much time is left. While we still have our doubts about the sustainability of the equity market rally even over the shorter-term, it is possible that global stock prices will continue to rise for some time before unambiguous recessionary signs emerge.
- We advise against chasing the market if the rally continues. At this point in the economic cycle, we value capital preservation over return maximization as a portfolio goal. We continue to recommend that investors stay defensively positioned.

The Economy

Global growth, especially in the U.S. has been resilient with inflation steadily easing. The fear of an approaching recession has been a dominant theme impacting asset markets over the past year. Ironically that fear and related suppressed bond yields have acted to support economic activity since late-2022, working against the goals of central banks and helping to put a floor under inflation. The fear of future demand weakness has helped to lower energy prices to relatively depressed levels, which is ultimately supportive of global growth.

We believe a soft economic landing remains unlikely: – 1) The downtrend in U.S. unemployment has clearly ended and is set to rise over the coming months, 2) The private sector quits rate, an important indicator of excess labor demand is almost back to its pre-pandemic level, 3) U.S. monetary policy remains restrictive, and may become more restrictive soon, and 4) U.S. inflation is slowing, but not fast enough to allow the Fed to begin to ease monetary policy.

The net impact of investor behavior and asset pricing has been to prolong the economic and policy cycles. A recession will eventually occur, but it will develop after monetary conditions finally become restrictive and/or a major financial accident or some other major economic shock occurs. Neither of these conditions exist, nor do they seem likely to develop as long as central banks are cautious and bulls continue to dominate bond markets. Ironically, by constantly betting on recession and significant disinflation, bond bulls are ensuring that these outcomes do not occur, or at least are pushed further into the future. We expect that it will become apparent that underlying inflation is levelling off well above pre-pandemic levels (and well above central banks' target level of 2%). Sticky global inflation and resilient economic activity will eventually force monetary policy to become restrictive and end the investment, economic and policy cycles. However, the path to this end point is unlikely to be a straight line, nor does it seem imminent.

A key factor prolonging the policy and economic cycles has been the lack of concern about the longer-run inflation outlook. This is remarkable since inflation rose significantly and labor markets are tight. Investors are not demanding any extra insurance against a different inflation outcome, and are still willing to back the secular stagnation and low inflation narrative. This complacency is also reflected in central bank expectations, which is that all roads lead to 2% inflation. Only the timing is in doubt, albeit it keeps getting pushed into the future. The short-term good news is that if bond investors do not demand insurance against higher inflation, then the economic expansion will continue longer than the consensus expects. The same will be true for the rate-hiking cycle, which is why we expect higher policy rates and for longer. To this end, the FOMC has already lifted its projected terminal rate four times this hiking cycle, and we do not believe that it is finished.

U.S. consumer confidence has not only failed to deteriorate, but has actually risen modestly this year from already high levels. U.S. consumers continue to spend at a solid pace, although the areas of strength have shifted from goods to services. Being negative about the future seems to reflect the pessimistic press and worries about the general economic outlook, but is not reflected in most people's personal circumstances. Employment opportunities and job security remain elevated. Income growth is solid and excess household savings built up during the pandemic when governments were overly generous with handouts that are still running down.

Financial Markets

The global financial market outlook has settled into a no-man's land, where neither a significant positive nor negative outcome seems probable in the near term. This implies that most markets will track sideways. Catalysts for a sizable move in either direction are not evident near-term. No major asset category is notably cheap, and most are also not particularly expensive either (with the notable exception of the U.S. equity market). Further Fed rate hikes are likely with the curve suggesting rate cuts in 2024 (which have been denied by the Fed).

Fixed Income

Long-term government bond yields have been flat-to-lower since last autumn in most countries somewhat blunting the impact of tightening monetary policies. We expect U.S. ten-year Treasury yields to move toward their October high of 4.25%. The Fed's updated projections showing two more expected hikes this year were triggered by an upgrade to their core PCE inflation forecast for the end of this year (to 3.9%). We are not convinced that this will be the end of Fed tightening.

Equities

Equity and credit markets have benefited from relatively calm bond markets since late-2022, expectations for policy easing down the road, and acceptable corporate profits. Stock market gains have not been broadly-based and there is the seemingly omnipresent fear that a recession could develop at any time. Challenges exist for equities with valuations not conducive to holding overweight exposure given the still bearish inflation and policy backdrop. Yet, supportive liquidity conditions and the ongoing rise in corporate profits should continue to prop up prices until the bond market sells off and/or central banks go too far. The rebound in stocks since late-2022 is now looking extended and at the risk of pausing or reversing out since recent gains have relied on a handful of mega-cap and AI-related stocks. Tactically, we remain invested with tight stops, as we do not expect the investment cycle to fundamentally improve. Rather, we expect the opposite, with eventually-rising bond yields and another downleg in risk asset markets. Of course, the timing is still uncertain.

Summary

If financial asset markets were discounting much higher policy rates and bond yields offered a healthy cushion against higher future inflation, then we might be willing to buy long-term bonds. But this is not the case. And until we are bullish on the bond market outlook, it is risky to overweight equities, since there are good odds of first another de-rating phase and then a recession that is necessary in order to sustainably reverse inflationary pressures. The crosscurrents of resilient global economic activity yet easing inflation imply trading ranges in most asset markets, as investors wait to see if/when the long-forecasted recession arrives and whether underlying inflation returns to pre-pandemic levels. We expect both a recession and a failure of inflation to achieve targeted central bank levels. Cyclically, it is getting late to short bonds, but still too early to buy. We recommend equity investments with tight stops, but looking to downgrade once policy/bond markets push monetary conditions into restrictive territory. We are mildly bearish on the U.S. dollar and overweight international markets within a global equity portfolio.

Conclusions:

1. We expect a mild recession to commence between Labor Day and year-end.
2. The weakest GDP quarters are ahead of us.
3. The resilient labor market is beginning to show some cracks.
4. Inflation remains a significant problem and isn't falling fast enough.
5. Fed is likely to follow a higher-for-longer path.
6. Corporate profit estimates remain too high.
7. Sentiment has moved from bearish to bullish.
8. Valuation levels are high (given inflation and interest rates).
9. Stock risk/reward is unfavorable.
10. Domestic and geopolitical risks are multiple.

What To Do?

1. Expect choppy markets (buy dips/trim rallies).
2. Own some bonds.
3. Diversify across asset classes and geographies (more non-U.S.).
4. Focus on free cash flow and high predictability in earnings.
5. Own high quality value and less expensive growth.
6. Consider an absolute return strategy to complement market exposures.
7. At the moment, one has to choose between fighting the Fed and fighting the tape. Accordingly, avoid extreme positions.

Source: BCA Research, MRB Partners, FactSet

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