Economic & Market Outlook

Executive Summary

~ The relationship between financial markets and the economy is complex; knowing the economic direction doesn't guarantee accurate market predictions.

~ On September 18th, the Fed cut policy rates by 0.5%, signaling a shift from restrictive to accommodative monetary policy amid ongoing inflation concerns.

~ A subtle deterioration in the labor market contributed to the Fed's decision to cut rates, with recent job gains averaging only 116,000 per month.

~ Following the Fed meeting, markets shifted to a “no landing” scenario, with rising Treasury yields and equity prices reflecting renewed optimism. The markets may even be on the verge of pricing in an overheated economy.

~ Successful investing involves reacting to market conditions rather than attempting to forecast them, focusing on downside risks and portfolio diversification.

A Quick Disclaimer

There is an old saying: the market is not the economy, and the economy is not the market. It's true - kind of. Financial markets and the economy are delicately intertwined, but knowing the direction of the economy doesn't mean you can predict the direction of financial markets. For instance, the historical correlation between changes in US GDP and changes in the S&P 500 is near zero. The same can be said for predicting the outcomes of elections and geopolitical events in advance; it simply isn’t enough.

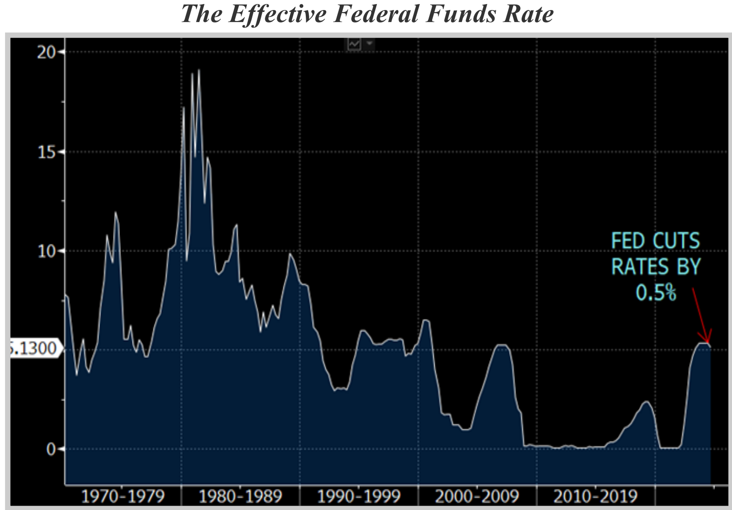
The problem is that financial markets are forward-looking and complex. They are "discounting machines." If stocks trade at rock-bottom valuations, they are likely pricing in bad news (like a recession), and it is plausible they won't correct if that bad news comes to bear, and vice versa. The same can be said for bonds. It’s not enough to know what the economy will do or who will win an election; you must also understand what is being discounted.

Even then, it may not be enough.

The End of an Era

It feels like a pivotal moment in macroeconomics. On September 18th, the Federal Reserve cut policy rates by 0.5%. Their decision to cut rates marks the end of an era - a transition from restrictive policy to accommodative monetary policy, and potentially a change in the credit cycle. From early 2022 to mid-2023, the Fed Funds rate climbed by 5.3%, an aggressive move by historical standards. Higher short-term rates shut down the mergers and acquisitions market and the commercial real estate market, as debt financing costs ballooned. Similarly, the residential real estate market, tied to longer-term rates, has also been frozen. The Fed’s first rate cut symbolizes the moment when all might change.

The Effective Federal Funds Rate



Source: Bloomberg

The Fed's decision to cut policy rates is also a great case study. How many times has the Federal Reserve loosened monetary policy when inflation was still above their 2.0% target rate and the economy was operating at or near full employment? Does Chairman Jerome Powell run the risk of being labeled the next Arthur Burns, the Federal Reserve Chair thought to have cut rates prematurely in the 1970s?

Lastly, the Fed decided to cut rates by 0.50% when they could have started with just 0.25%. Why the sense of urgency?

The Markets Before FOMC Day

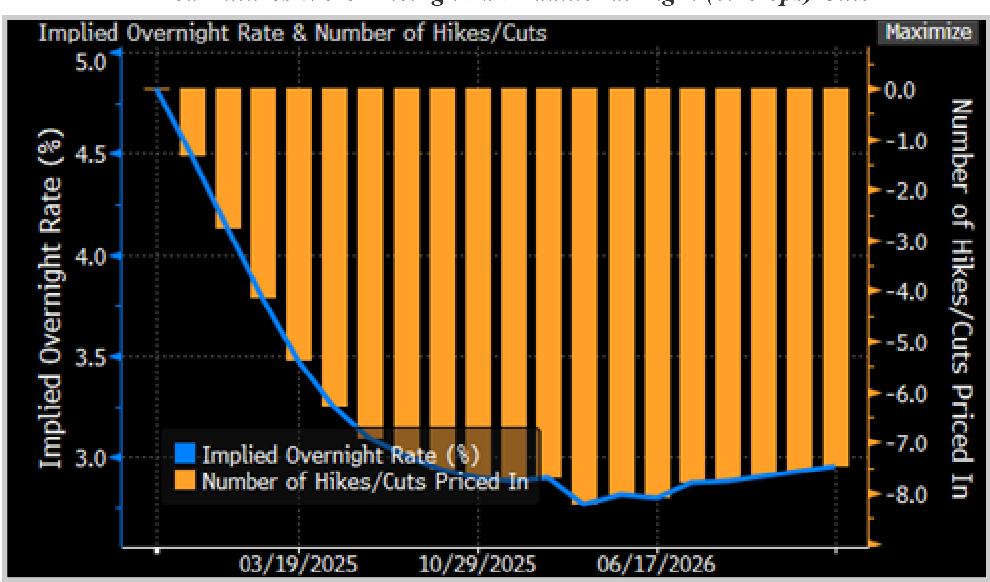
Prior to the September FOMC meeting, markets were pricing in some level of deceleration. Inflation swaps were discounting sub-2% inflation just one year out, and 10-year Treasuries hovered around 3.6%, a level you would not anticipate if you thought inflation above the Fed's target was likely to persist.

Forward One-Year Inflation Swaps Were Pricing in 1.97% Inflation

Source: Bloomberg

Furthermore, the markets were betting on several more rate cuts to come - a total of eight quarter-point cuts -which would bring the Federal Funds rate down to 2.8%. Note that the effective Federal Funds rate previously peaked at 5.3%. Players in the interest rate market anticipated economic deceleration and placed their bets on continued Fed easing.

Fed Futures Were Pricing in an Additional Eight (0.25 bps) Cuts



Source: Bloomberg

So, What Spooked the Fed?

What caught the Fed's attention, and likely the markets, was a subtle deterioration in the labor markets.

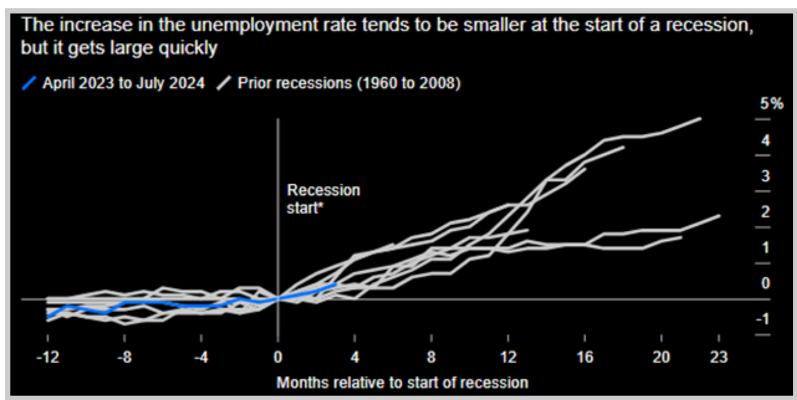
"In the labor market, conditions have continued to cool. Payroll job gains averaged 116,000 per month over the past three months, a notable step down from the pace seen earlier in the year… Nominal wage growth has eased over the past year… The labor market is not a source of elevated inflationary pressures… Our monetary policy actions are guided by our dual mandate to promote maximum employment and stable prices… Inflation is now much closer to our objective, and we have gained greater confidence that inflation is moving sustainably toward 2 percent. As inflation has declined and the labor market has cooled, the upside risks to inflation have diminished, and the downside risks to employment have increased."

To be clear, we do not believe the Fed was worried about an impending recession. They view their dual mandate as a balancing act; and at the time of the cut, the scale tilted towards labor market concerns, but it wasn't as though one side of the scale was touching the floor.

The post-COVID unemployment rate bottomed at 3.4% in April 2023; today, it sits at 4.1%. There isn't a strict definition of maximum employment, but today's level is close. As we said, the deterioration in labor markets was subtle. So, why preemptively cut rates?

Economic conditions can change quickly, particularly in labor markets, due to feedback loops in the economy. When the economy slows, a small subset of the employed population may lose their jobs initially. This small subset of newly unemployed individuals must curtail spending, which has the potential to further weaken our economy, leading to more layoffs. You can see how this spirals out of control. In other words, changes in unemployment matter far more than the absolute level of unemployment itself.

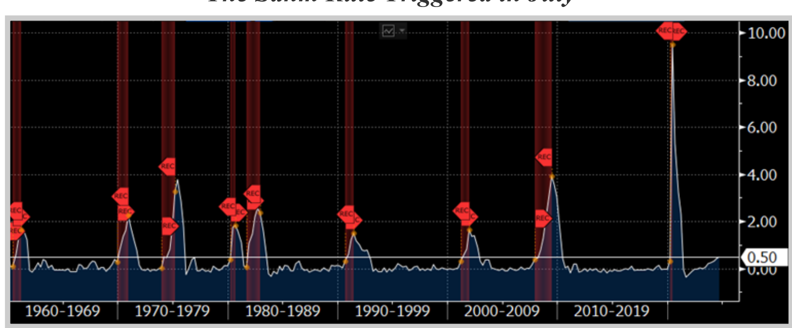
Unemployment Rises Gradually, Then Suddenly



Source: Bloomberg

In July, two months before the Fed meeting, the unemployment rate temporarily spiked to 4.3%, triggering the Sahm Rule. This rule serves as an early warning signal, measuring the breaking point at which unemployment spirals out of control, derived from prior recessions. It activates whenever the 3-month average unemployment rate rises half a percent above the 12-month low in unemployment. It has never been triggered without a subsequent acceleration in unemployment.

The Sahm Rule Triggered in July

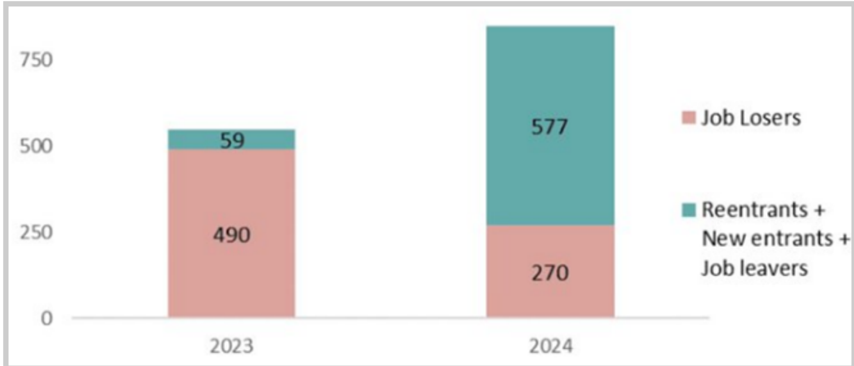


Source: Bloomberg

Before you panic, it's worth noting that Claudia Sahm, the rule's author, believes the most recent trigger is a head fake. We can't say if she's correct, but we commend her ability to prioritize objective analysis over her own celebrity. We also caution against sticking rigidly to a single economic indicator. Now, back to our point. Part of her argument for why this time might be different relates to immigration; individuals are migrating to the U.S. faster than new jobs can be created, contributing to higher rates of unemployment.

<see graphic on following page>

Decomposition of the Rise in Unemployment



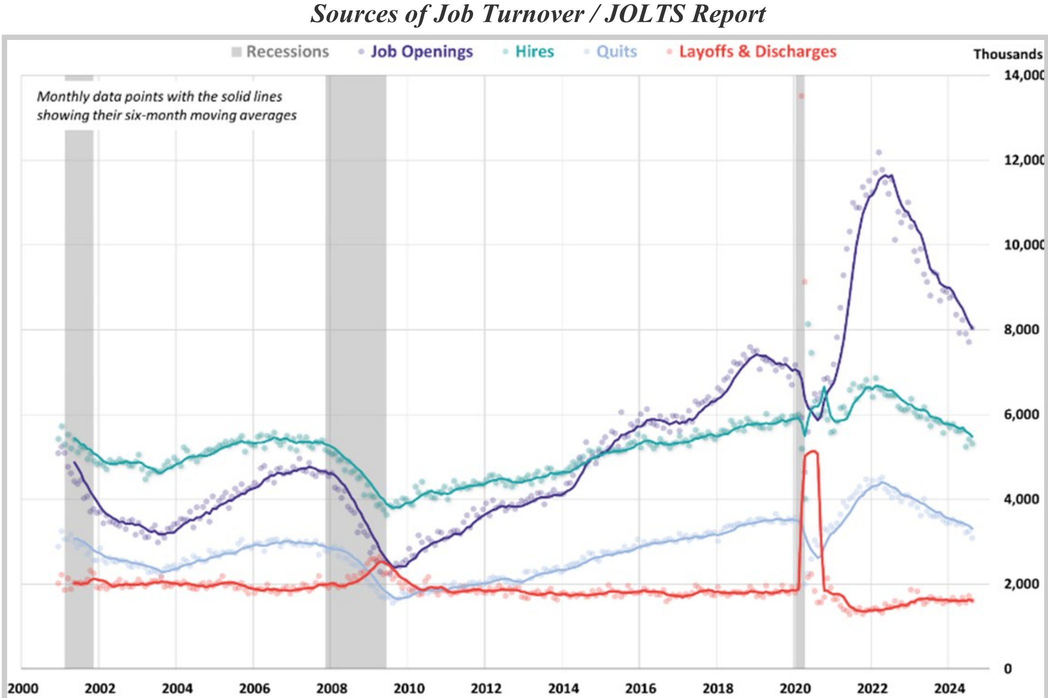
Source: Bloomberg, Elva Capital

She even wrote an op-ed in the Economic Times to clarify her views: "*My recession rule was meant to be broken… The US is not in a recession, despite the indicator bearing my name saying it is. The Sahm Rule, which was triggered with Friday's (August 2nd) weaker-than-expected jobs report, joins a long list of economic tools skewed by the unusual disruptions of the past four and a half years. That said - and I say this with a mixture of humility and concern - the Sahm Rule is still relevant. The risk of a recession is elevated, strengthening the case for the US Federal Reserve to cut interest rates."*

We would add that Chairman Powell shared this nuanced view when asked about job creation: *"It depends on the inflows. If you're having millions of people come into the labor force and you're creating a hundred thousand jobs, you're going to see unemployment go up. It really depends on the trend underlying the volatility of people coming into the country. We understand there's been quite an influx across the borders, and that has actually contributed to the rise in the unemployment rate. The other factor is the slower hiring rate, which we also monitor closely. So, it depends on what's happening on the supply side."*

Actual layoffs aren't spiking, but the labor market is in a more vulnerable state. The number of job openings is down, hiring rates are falling, and those who have lost jobs are finding it challenging to resume employment. Demand for temporary help is also down. The data suggests a labor market that isn't yet firing, but it isn't hiring either. The FOMC's 50-basis-point rate cut on September 18th was likely intended to preempt any weakness, in hopes of securing a soft or even a no-landing outcome.

Sources of Job Turnover / JOLTS Report

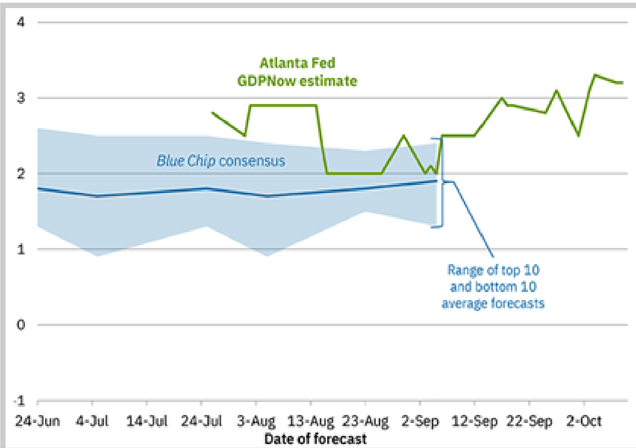


Source: BLS, Advisor Perspectives

Ten Days After FOMC Day

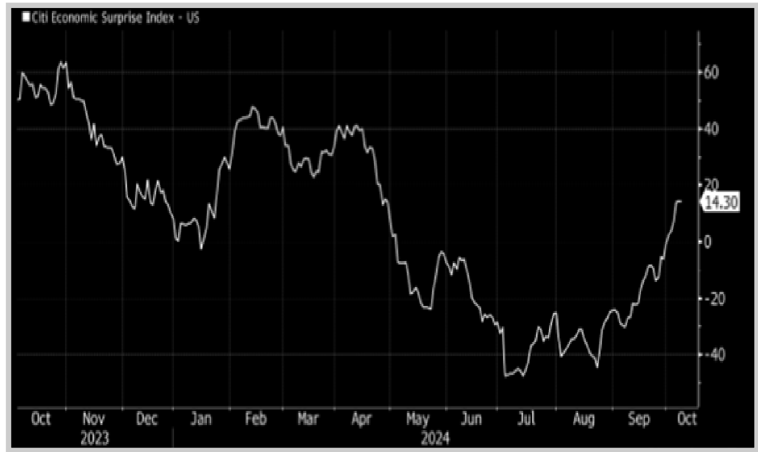
Just ten days after the September FOMC meeting, an unexpected report emerged: the unemployment rate fell by 0.2%, and the unemployment rates for the prior two months were revised lower. For the time being, the market's concerns regarding the state of labor markets appear to be misplaced. The report was unequivocally positive, and other encouraging data releases since have raised the question: "Did the Fed really need to cut by 50 bps?" Unfortunately, we will never have the counterfactual information necessary to answer that question.

Q3 GDP Estimates are Climbing



Source: Atlanta Federal Reserve

Economic Releases are Surprising to the Upside Again

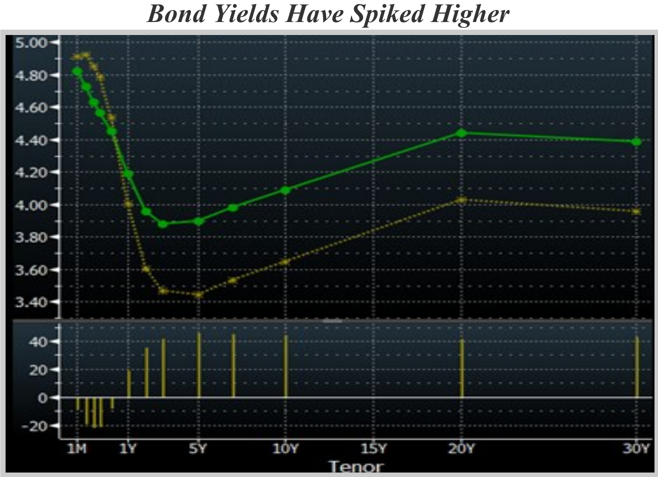


Source: Bloomberg

A Few Weeks After FOMC Day

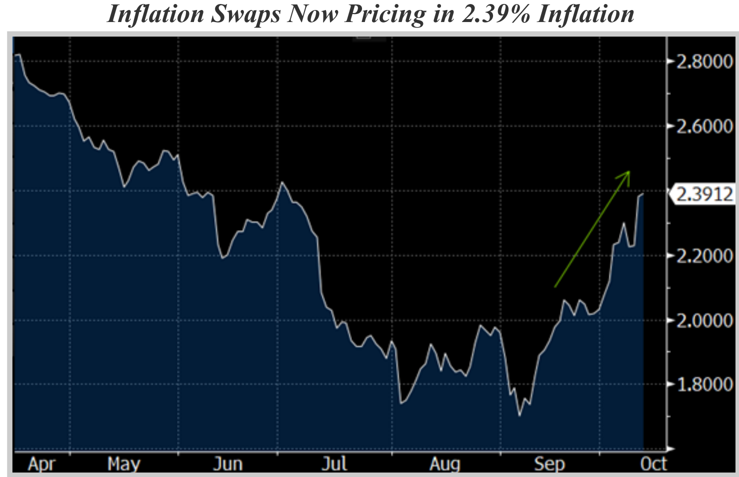
As you might have guessed, markets have now flip-flopped and are pricing in a "no landing" scenario, and may be on their way to pricing in an overheated economy. Treasury yields for all maturities greater than one year have moved notably higher. The inflation swaps we previously mentioned have jumped 0.4%. The swaps market is betting inflation will sit at 2.4% over the coming year, implying we are stuck at today's level of inflation, which is 0.4% above the Fed's target.

Bond Yields Have Spiked Higher



Source: Bloomberg

Inflation Swaps Now Pricing in 2.39% Inflation

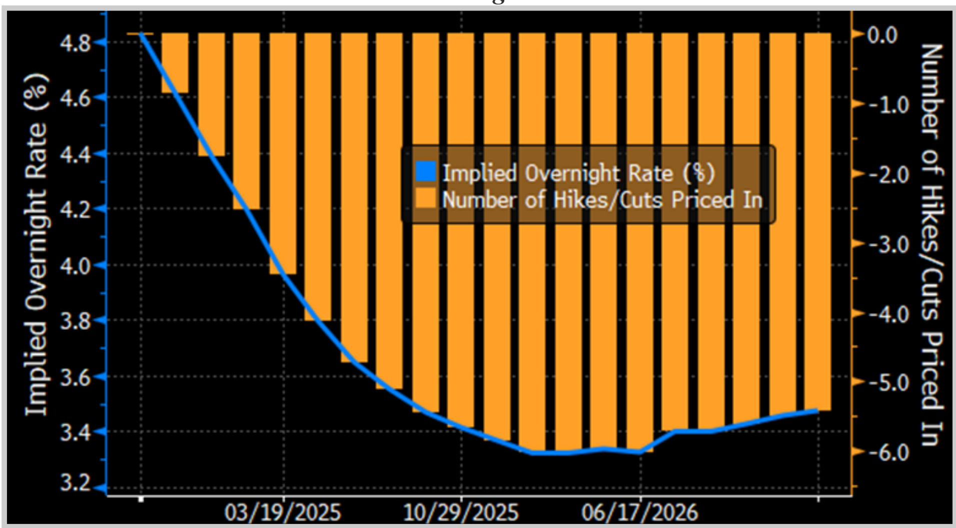


Source: Bloomberg

Risk asset pricing is equally interesting. Equity markets have jumped an additional 4.0% and now trade at roughly 25 times this year's anticipated earnings—not a multiple you would expect if labor markets were about to hit the skids. Most remarkable has been the compression in corporate credit spreads, which, since the Fed announcement, have moved dramatically lower and are nearing the historic lows of the mid-1990s.

And on cue, the market is calling for a pause or slowdown in Fed rate cuts. Recall, the market was pricing in eight quarter-point cuts, resulting in a terminal rate of 2.8%. Well today, the market is only pricing in six quarter-point cuts, resulting in a terminal rate of 3.3%. That is a notable change in market expectations.

Fed Futures are Pricing in Far Fewer Cuts

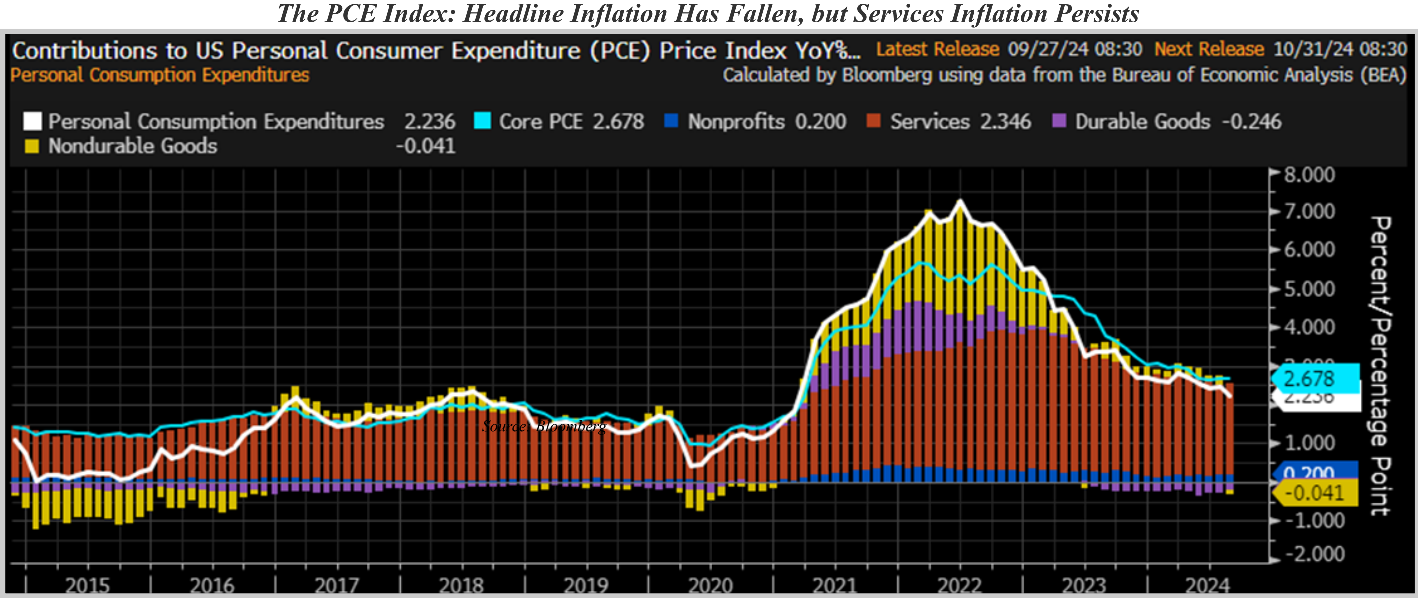


Source: Bloomberg

Will Inflation Reignite?

We wish we knew the answer to this question. It is far too hard to answer, for reasons we will discuss later, but here is what you should know. The Fed's preferred measure of inflation is the Personal Consumption Expenditures (PCE) Index, which reflects a basket of goods and services consumed by the typical US household. Last month, the PCE Index registered 2.2%, a new post-COVID low, well below its June 2022 peak of 7.5%, and close to the Fed's 2.0% target.

The PCE Index: Headline Inflation Has Fallen, but Services Inflation Persists



Source: Bloomberg

PCE inflation can be broken down into two categories: goods and services inflation. Goods inflation has been nonexistent for almost two years. This isn't surprising. You may have heard the saying, "the best cure for high prices is high prices." When the price of goods rises, producers produce more, which in turn lowers prices. While the supply chain disruptions caused by COVID delayed this corrective process, they did not prevent it. In short, capitalism is pretty good at dealing with this type of inflation.

Services inflation, however, is a different animal. In August, services inflated 3.6% year-over-year, which was a slight acceleration from the prior month. Assuming goods inflation continues to oscillate around 0.0%, services inflation must average 3.1% for us to reach the Fed's 2.0% inflation target.

Many services, such as healthcare and education, have inelastic demand. Additionally, the primary cost driver for most services is labor (wages), which are challenging to adjust in a tight labor market. The simple act of slowing wage growth can cause you to lose employees, and lastly, any corporate executive with a soul doesn't feel good about restraining employee compensation.

The connection we want to draw your attention to is that services inflation is directly tied to wage inflation. The minor slack witnessed in the labor market gave the Fed cover to cut rates. If that slack dissipates in the form of increased job openings and hiring rates, then all bets are off. Furthermore, growing inflation expectations (see the inflation swaps) pose an additional challenge, as workers are likely to demand higher wages, the so-called wage-price spiral.

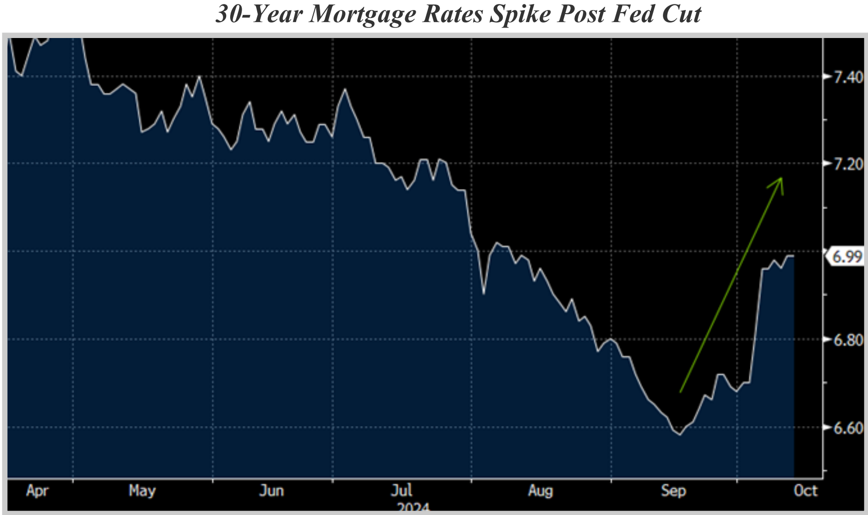
Why We Can't Forecast Inflation

No one is very good at forecasting inflation, and even if you are good at forecasting inflation, you likely aren't good enough. One of the problems with macro forecasts is they must be better than the market's forecast to matter. It's like sports betting. You can't just pick the winning team; instead, you must identify the team capable of covering the spread.

There are other challenges, particularly in today's market. We are less than one month from an election, with two candidates ready to enact radical agendas. We just witnessed two back-to-back hurricanes that, unfortunately, devastated Florida and parts of Appalachia, which will lead to distorted economic data for months to come. There is also growing conflict in the Middle East that has turned into an all-out war between Israel and Iran. That's a lot for any individual to comprehend, but it isn't even the toughest challenge.

In science, particularly physics, there is a principle referred to as "the observer effect." This principle states that the mere act of observing a phenomenon can influence its outcome. A similar effect holds true for economic variables. The market's act of pricing in higher inflation expectations or a no-landing scenario, changes the probability that said scenario will play out. Think about it for a second: if the market perceives higher expected inflation, then it will demand higher rates of compensation, as evidenced by higher Treasury yields. Those higher rates will have their own influence on the economy. Corporations may find it less attractive to refinance debt, and consumer loans (like auto loans) might reprice higher, restricting economic growth and, in turn, inflation. It really isn't an observer effect, but rather second, third, and fourth-order effects playing out in real time. And the direction of these multiple-order effects isn't always clear. Higher rates leading to a more restrictive auto-financing market seems clear, but what about the residential real estate market? Mortgage rates are priced off 10-year yields, which have risen in response to higher inflation expectations. Will the recent jump in mortgage rates restrict housing supply/affordability, providing fuel for inflation?

30-Year Mortgage Rates Spike Post Fed Cut



Source: Bloomberg

The long and short of it is our economy (labor markets, inflation, etc.) is a complex system. There is no simple formula or regression that can accurately forecast any of it, and there certainly isn't a formula or regression that can forecast it better than the financial markets in aggregate.

The Plymouth, England Livestock Fair

The book Wisdom of Crowds popularized a story about Francis Galton, a famous statistician. The actual details of the story are suspect, but the basic premise holds true. In 1906, Francis Galton attended a livestock show, where there was a slaughtered ox on display. Fair attendees could submit tickets guessing the weight of the ox in hopes of winning a prize.

Roughly 800 people participated in the competition. Galton noted that the average guess of all participants was 1,197 lbs - only 0.08% away from the ox's actual weight of 1,198 lbs. Furthermore, the mean guess of all participants was better than any single participant's guess in isolation.

The crowd's guess was far superior because each participant's guess was independent of the other participants. It didn't matter if participants had expertise in guessing the weight of an ox or not. Just as many participants were likely to overestimate the weight of the ox as there were participants likely to underestimate it. The net result was that the participants' errors canceled each other out, and the average of all guesses was quite accurate.

You can apply this analogy to markets. The US rates market is the largest and most liquid bond market in the world. What is the probability that you can handicap inflation and the myriad other variables influencing Treasury yields better than the market itself?

React / Don't Predict

We realize we write this often, but it is central to our philosophy and process. Great investors spend far more time reacting to variables than predicting them. On any given day, the market will offer you some form of remuneration for taking on a risk. In the case of buying a 10-year Treasury, you are being offered a 4.1% nominal yield. The risk you are taking is the probability that rates - maybe due to elevated inflation expectations - will push higher. The key question to ask is: do you feel you are being adequately compensated for that risk? And does taking that risk confer greater diversification benefits to your portfolio?

Most of the time, risks appear to be adequately priced, and you may simply hold the asset as part of a diversified portfolio. On rare occasions, you can identify true mispricing (great deals), typically in less efficient markets, and capitalize on them. There is more to the story, but we will stop here for now.

As always, we appreciate the trust you have placed in us. It is a privilege to work for you and study financial markets for a living.