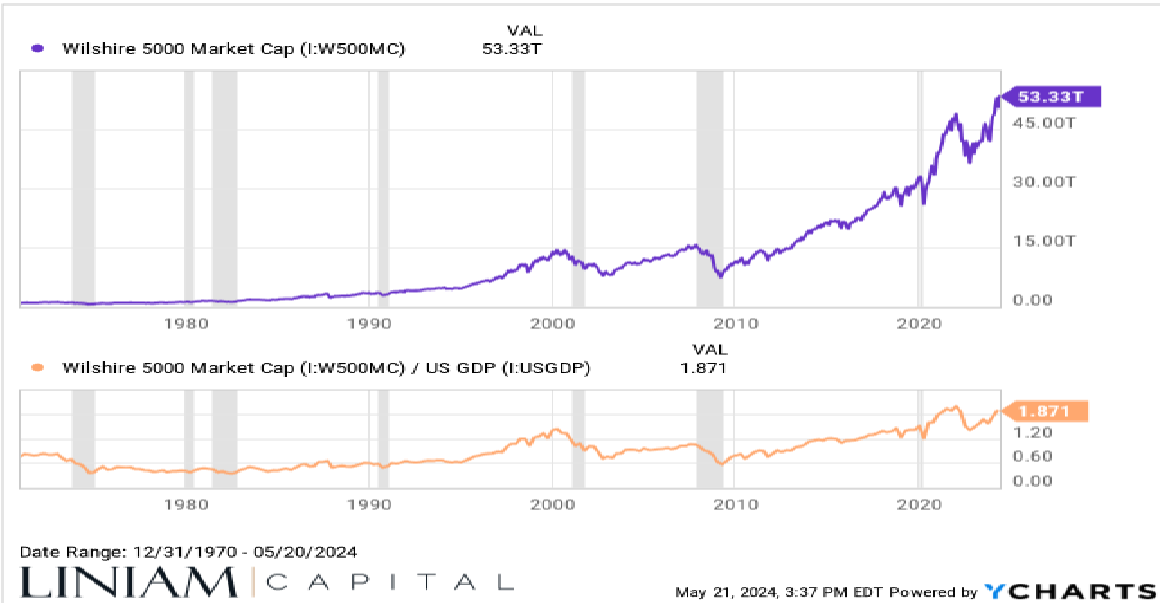
Market Update:

May 24, 2024

The weaker than expected April employment report and a less bad inflation report for April revived speculative market spirits for Federal Reserve interest rate reductions, has driven US equity markets to new highs in nominal terms and back to its previous high relative to GDP at approximately 1.9 times.



The speculative anticipation of easier monetary policy that has driven the equity market higher has also driven gold to new highs and other precious metal prices higher. The Bloomberg Commodity Index is up over 10 percent from its late February lows, despite oil prices retreating in the wake of the Iran/Israel exchange. This is obviously running counter to the goal of returning inflation to 2 percent.

The Fed funds rate has held at an upper bound of 5.50% since the Fed's final rate hike on July 26th last year. This plateau of nearly 10 months is a longer than average plateau of policy rates following a rate hike cycle. The longest interval was 15 months following the Fed's last hike in June 2006 and its first cut in September 2007. The futures markets currently have a rate cut priced for this September. If this were to occur the interval would nearly match that seen before the first rate cut in 2007. Given the inflation backdrop, such a cut is very unlikely absent a material weakening in economic growth.

Economic growth does appear to be slowing following much better than expected growth last year. Many pundits dismissed the weaker than anticipated 1.6 percent growth rate recorded in the first quarter of this year due to the one-off effects of trade and inventories. However, there has been a relatively broad range of weaker data in recent months including retail sales, payrolls, and industrial production. The ISM non-manufacturing index fell below 50 in April (meaning a slight contraction), which is an extremely rare occurrence outside of recessionary periods given the inherent stability in most service sector industries. The relative resilience of the economy during the second half of last year, in no small part due to fiscal largesse, has led Wall Street and the markets to become far too complacent about recession risks. The data cited above suggests we might be closer to such an outcome than most anticipate. Wednesday, a Harris poll showed a majority of Americans believe the economy is already in a recession. The corporate media of course suggests that these respondents are wrong because government statistics imply a robust economy and are dismissive of this indication of economic health.

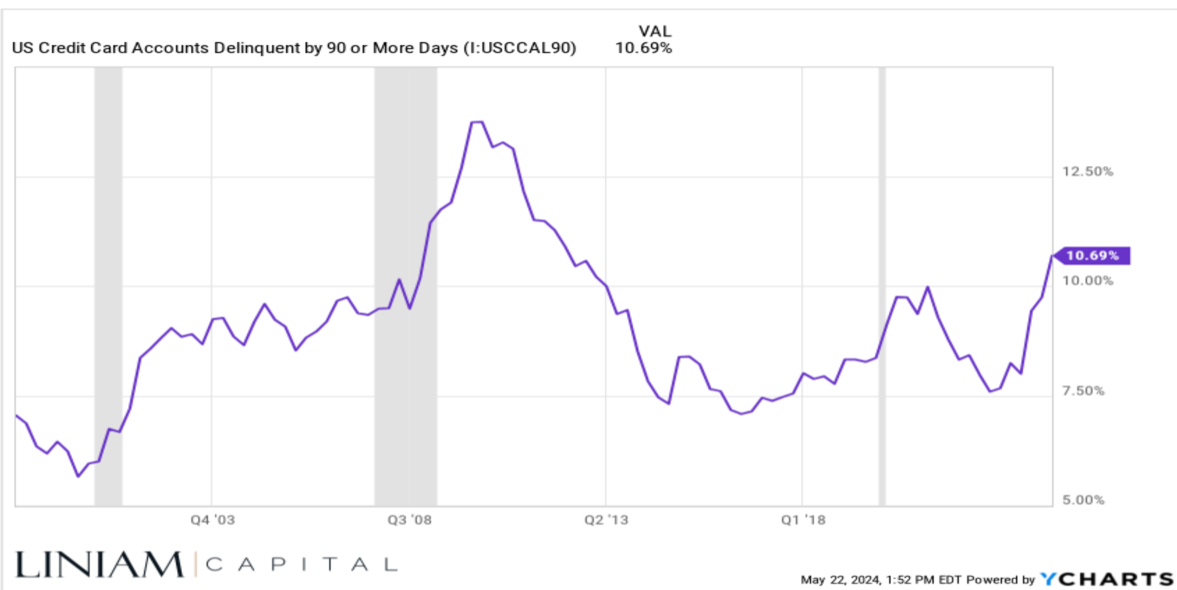
ECONOMY

A majority of Americans polled believe the economy is in a recession — but it isn't

Matthew Fox May 22, 2024, 1:03 PM CDT Share Save

Source: Business Insider

There are several other ancillary indicators that suggest pressure is growing on consumers. Consumer sentiment remains depressed, which is remarkable with unemployment near multi-decade lows, the stock market at all-time highs and household balance sheets buoyed further by elevated home prices. The household sector is clearly bifurcated with the upper segment still buoyant, but the middle- and lower-income segments stressed by declines in real income, depleted excess savings from pandemic era programs, poor housing affordability and credit capacity limited by higher credit balances and the higher cost of servicing debt. This is apparent in the sharp increase in delinquency rates for credit card and auto loans over the past few quarters. Serious credit card delinquencies are at their highest level since the financial crisis in 2008.



The yield curve has now been inverted for more than 500 days. There are 3 previous periods when the curve has been inverted for such an extended duration: 1929, 1973, and 2008. Inversions are typically resolved by reductions in short term rates and in each case a recession has followed. The instances of protracted inversions preceded deeper than normal recessions with unemployment rising to at least 9 percent in each case. The US equity market experienced a decline of 50 percent or more in each of these cases, and at the onset of the prior declines the valuation of the market was not nearly as extended as it is today.

Market Thoughts

US Equities: The market is now back to being the most expensive ever, highly concentrated, and has been lifted by assumptions that are likely to prove false. We are not alone in our views. Warren Buffet has taken a huge position in cash vs equities, Jamie Dimon won't repurchase JPM shares at this price. Well regarded BCA Research last week called for a long term underweight to US equities. A Dow theory non-confirmation is in effect with Dow Transports negative YTD while Dow Industrials hit a record high earlier in the month. We remain very selective in equity exposure.

Longer Term US Interest Rates: Yields are currently modestly below their long-term average level and fair value based on current inflation and growth rates. Fed rate assumptions built into the futures markets are for the funds rate to be cut by 1 percent by September of next year to 4.25% to 4.50%. Upside risks to the embedded market view are the persistence of economic growth and inflationary pressure. Downside risks are the potential for recession. The Fed is unlikely to be restrained in cutting rates if unemployment begins to materially rise even if inflation remains elevated. In the near term it is more likely than not that longer term rates will gravitate modestly higher. On a 6-to-12-month horizon it is more likely than not the economy will succumb to the effects of lax and then tight monetary policy and bring in a new easing cycle in excess of what the futures markets have currently priced, leading longer-term yields materially lower than where they sit today.

Commodities/Currency/Credit: Despite gold hitting new all-time highs retail flows have been relatively subdued. Foreign central banks at odds with the West have been major buyers and are likely to remain buyers as efforts to establish a credible alternative to the dollar continue, especially as dollar reserves have been confiscated from Russia in response to the Ukraine war. Anticipated Fed easing earlier this year under inappropriate circumstances was also a factor supporting the impressive move in gold prices. Highly indebted and incrementally less stable governments across the Western world should be supportive of demand for precious metals moving forward as well. Geopolitical tensions that are also likely to remain in place should be supportive of energy prices on an intermediate term basis. The need for governments to attempt to inflate their way out of the debt incumbrances that have accelerated in recent years should provide a longer-term catalyst for higher fiat-based prices of precious metals and natural resources.

We are avoiding credit exposures and banking stocks. Pricing for corporate debt is unfavorable, there are large unrealized losses sitting on bank balance sheets due to the earlier rise in longer term interest rates, and imbalances in a number of sectors such as office real estate have yet to result in material realized losses.

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