

“Dead Ahead”

Is a Recession dead ahead? Or Stagflation? Either will result in a Bear Market. Famous last words: **"But as long as the music is playing, you've got to get up and dance. We're still dancing."** - Charles Prince, CEO Citigroup, July 9, 2007

From WSJ:

Spotting Clouds in a Carefree Summer Market

Investors should be concerned about the health of the economy, elevated stock valuations—and politics

By *James Mackintosh*

Aug. 15, 2025

On a sunny summer's day, you might think of going to the beach. Or you might list the things that ought to be worrying investors, and mostly aren't. Your scribe chose the latter, as regular readers might expect.

The list of what is actually giving investors pause is remarkably short, itself a reason for concern. If stocks climb a wall of worry, they may be approaching the top—and the nasty slide down the slope of hope.

What *should be* concerning them divides into three: the economy, stock valuations and politics.

The economic outlook boils down to one neat question: Will the president's hike in tariffs to their highest since the Smoot-Hawley Tariff Act in the 1930s matter? Investors have swung in their answer. They initially treated [the “Liberation Day” tariffs](#) as a disaster for growth and inflation, before concluding that the [tariffs at the mostly lower rates](#) eventually imposed don't much matter—in large part because the feared effects have barely shown up in the data.

Futures traders now think a Federal Reserve rate cut is a slam dunk next month, something usually good for stocks when it isn't due to weaker growth.

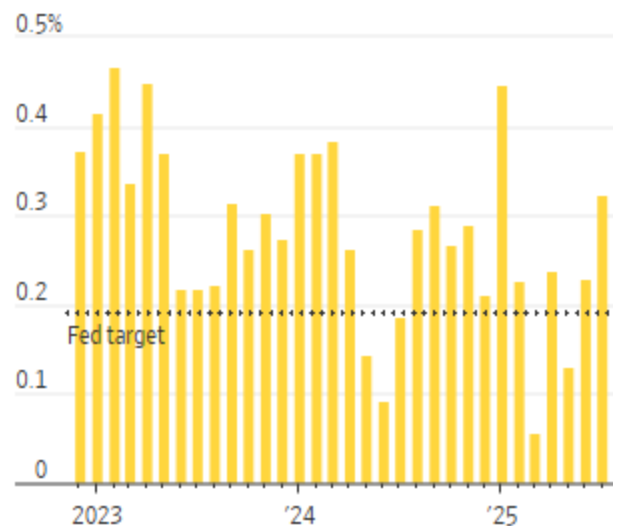
Yet take off the rose-tinted sunglasses and there's a risk that the markets are ignoring. Far from coming down, core inflation excluding volatile energy and food rose last month to the highest level since President Trump's inauguration. Other measures that try to tease out the trend also point to an inflation issue, albeit nothing like the spike after [the Biden administration's Covid-19 stimulus](#).

Take the Atlanta Fed's gauge of hard-to-change, or “sticky,” prices and the Cleveland Fed's measure of the median item in the basket of items used to measure inflation. As of last month, both metrics were rising at an annual rate of well above 3%.

Wholesale prices jumped last month by the most in three years, suggesting that tariff effects are working their way through the

Core Inflation Jumped in July

Month-on-month change in consumer prices, excluding food and energy



Note: The Fed's 2% PCE target equates to about 2.3% annual consumer-price inflation, or 0.19% a month.

Source: Federal Reserve Bank of St. Louis

supply chain and will eventually push up inflation. Maybe tariffs are just taking longer than expected to hit.

The jobs market is also concerning. Private-sector job creation has stalled, with the report showing this infuriating the president so much he [fired the head of the Bureau of Labor Statistics](#), which also produces the inflation figures.

A move toward mild stagflation, or weaker growth and higher inflation, is far from certain. But the data suggest it is absolutely a risk, and it is even visible in Wall Street earnings forecasts, if you squint. It just doesn't show up in stock prices.

The consensus for S&P 500 earnings in 12 months is 6% higher than at the start of the year, which—if believed—would justify rising stocks. But earnings upgrades have been heavily skewed toward three successful sectors: tech, communication services (where [Meta](#) and [Alphabet](#) sit) and financials. Four out of 11 sectors—energy, materials, healthcare and consumer staples—have been downgraded this year, and another two are barely changed.

One plausible explanation: The artificial-intelligence boom and data-center construction is hiding pain in other areas. That's not a great foundation for record-high stocks.

Stress-screen factor: 30.

Valuations show no worry at all. Stocks' price-to-earnings ratio, using forecast profits for the next 12 months, last month hit 22.5. That is the highest in data since 1985 apart from during the dot-com bubble of 1999-2000 and the SPAC/cannabis/clean-tech bubble of 2020-21.

Sky-High Expectations

S&P 500 price as a multiple of expected earnings for the next 12 months



Source: LSEG

This valuation gauge is down a bit this month because analysts have upgraded their profit forecasts by the most in more than a year, but is still extraordinarily high. Lofty valuations also show up in gauges such as the Shiller P/E, and ratios of prices to free cash flow and to book value.

The good news is that high valuations are no barrier to short-term performance. But they show marked optimism about future profits, raising the risk of disappointment and low long-term returns, especially if the economy or AI fail to fulfill hopes.

The bad news is that the high valuations are combined with profit margins expected to hit a new high for listed companies in data going back to 2002. Investors expect the best of all possible worlds.

Stress-screen factor: 50.

Politics suggest we may not get the best of all possible worlds. Sure, tariffs turned out less bad than feared. Even if the most extreme claims of Democrats that democracy is dying turned out to be right, investors have long been able to make good returns from stocks in autocracies, so long as the autocrat doesn't fall foul of more-powerful countries.

But the president's firing of the BLS head and attacks on the Federal Reserve mean the U.S. is [less likely to get decent data](#) on its most important statistics or nonpolitical interest-rate setting.

The risk shows up in long-run inflation expectations, measured as the gap between standard Treasury yields and those on Treasury inflation-protected securities for the five years starting in five years' time. These jump every time Trump wades in—but not that severely. Investors are alert to the danger, but still expect Trump to leave a functioning system in place.

The danger to investors is that the Fed loses its independence. If that happened, even if Trump set rates exactly right, Treasuries would be likely to attract a political risk premium, with knock-on effects on financing costs across the economy.

Stress-screen factor: Unknown, between 0 and Argentina.

All these are merely risks, and everything could work out fine. Maybe I'm the guy on the beach sitting in the shade complaining about the heat. But when obvious dangers are ignored, it isn't usually a good time to invest for the long run.

From Friday's WP:

This number is bad news for the economy

Forecast U.S. profit margin 12 months ahead



Note: Uses LSEG Datastream U.S. total market index
Source: LSEG

Low unemployment is great, but only if it's due to lots of new jobs, not an evaporating labor force.

By Mark Zandi

Mark Zandi is chief economist at Moody's Analytics.

The [unemployment rate](#) has historically been the go-to barometer for the economy's performance. At just over 4 percent, unemployment remains low, and it has edged only a bit higher since the start of the year. Taken at face value, the economy is doing just fine.

But it's not. If the labor force had increased this year at the pace it did last year, the unemployment rate would be headed toward 5 percent. Of course, low unemployment is great, but only if it is due to lots of new jobs, not an evaporating labor force.

And the [labor force](#), which includes all those working and looking for work, is sounding the recession alarm bell. It has flatlined so far this year. Compare this with last year, when the labor force grew by well over 1 million workers, or the year before, when it increased by almost 2.5 million. Without more workers, it is tough for the economy to grow: A recession is more likely.

It's no mystery what ails the labor force; it is the severe restrictions on immigration. The surge in undocumented immigrants that occurred during much of the Biden administration undoubtedly put financial and societal pressures on many communities across the country. However, many of these immigrants quickly applied for work authorization, received it and started a job less than a year after arriving.

The timing of this immigration surge was fortuitous in one crucial respect. It came when the Federal Reserve was aggressively ramping up interest rates to cool off the red-hot job market and rein in runaway inflation. There is a reasonable argument that without the immigration surge, the Fed would have had no choice but to push rates up even higher and induce a recession to quell the inflation.

Immigration policy has since been flipped on its head, beginning at the end of Joe Biden's presidency with his executive order to [restrict asylum seekers](#). President Donald Trump's policies have since shut down the southern border, and many immigrants are leaving the country either forcibly or through self-deportation.

Thus, the immigrant labor force has waned. This time last year, the [foreign-born labor force](#) expanded at an extraordinary 5 percent yearly pace, translating into more than 1.5 million additional workers every year. In recent months, it has declined. The [native-born labor force](#) has picked up, but not enough to fill the void left by fleeing immigrants.

A labor force flat on its back has many implications — none of them good. It means disruptions to businesses that rely on immigrant labor. Agriculture and construction are especially vulnerable, but manufacturing, transportation, hospitality, retail, and child and elder care also depend critically on immigrants. Without these workers, labor costs will increase, adding to the inflation fueled by the tariffs. This is a compelling reason for the Federal Reserve to be cautious in resuming its interest rate cuts, and once it does, to go slowly.

More broadly, it means the economy's potential growth — the pace of growth consistent with stable unemployment and inflation — is much lower. The economy can sustainably grow only as fast as the labor force and its productivity grow. With the labor force stuck in place, unless [productivity](#) growth ramps up, the economy's growth will consistently fall well short of the pace we've come to expect and are counting on for the future.

Weak immigration and labor force growth plague other parts of the world. Take Japan and Germany, countries that struggle to attract immigrants sufficiently to expand their workforces. Their economies are seemingly almost always flirting with recession. Will this be our future, too?

Of course, we aren't these other countries. We are leading the way on many technologies, especially artificial intelligence, which promises significant productivity gains. (By the way, consider who is running many of our most successful AI companies — yes, immigrants.) Yet even the most ardent AI proselytizers don't expect AI and other technologies to diffuse through the economy fast enough to make up for the imminent shortfall in growth.

Lawmakers could agree on substantive immigration reform. As recently as this time last year, they nearly passed bipartisan legislation allowing more immigrants with needed skills to come here. Presidential election politics waylaid that effort, and though another political window for these reforms might open again, it won't happen quickly enough.

Given the current immigration policy, it seems increasingly unlikely that the moribund labor force will come back to life soon, and more likely that a recession is dead ahead.

"Nobody can consistently time the market, and those who try it usually fail." - Burton G. Malkiel, the renowned emeritus professor of economics at Princeton and author of the 1973 classic "A Random Walk Down Wall Street: The Time-Tested Strategy for Successful Investing", a gift from my grandfather to my Father, and one of the first books both of us read on investing. From NYT:

The Stock Market Is Getting Scary. ~~Here's What You Should Do.~~

Aug. 15, 2025

By Burton G. Malkiel

Mr. Malkiel is an American economist and financial executive. His 50-year-old book, "A Random Walk Down Wall Street," is widely credited with popularizing stock index funds.

Stock markets regularly go to irrational extremes, and their volatility has caused economic hardship and financial pain. Now, jubilant investors are pushing our market to historic highs despite President Trump's tariffs and tax and spending policies that will increase the level of unsustainable budget deficits.

No one can know for sure where the stock market will go next. But there are worrisome signs that investor optimism may have gotten out of hand. The recent exuberance of investors raises the question of whether they are making the same mistakes they made in the past — errors that could prove very costly down the line. If history is repeating itself, what can we do to protect our financial futures?

In the stock market bubble of the late 1990s, investors believed that the internet would usher in a golden period of extraordinary economic growth — until they didn't, sparking a recession and a roughly 40 percent decline in the S&P 500 between 2000 and 2002. Less than a decade later, a housing bubble led to the worldwide financial crisis and the deepest recession since the 1930s. The S&P 500 lost roughly half its value. The financial wreckage to individuals' retirement savings was so pervasive that some worried whether they ought to own equities at all.

This past spring, the stock market appeared to be in free fall as investors worried that Mr. Trump’s threatened tariffs, some almost as high as 150 percent, and future tax policy would crater the economy. The S&P 500 stock index dropped by about 12 percent in a single week following the April 2 “Liberation Day” tariff announcements.

But just as quickly, the uncertainty seemed to disappear; the tariffs were delayed, negotiations were offered and on April 9, the S&P 500 had its best day in almost two decades. The market continued to soar as the “big, beautiful” tax bill was enacted and tariff deals were announced with several major trading partners.

These days, stock market valuations (such as the multiple of stock prices to average corporate earnings) are at one of the highest levels in its 230-year history when normalized. Not only have investors come to believe that an “all clear” signal has been announced, many have also embraced the idea that the artificial intelligence boom will turn out to be far more important than the internet and usher in a new golden age of prosperity. In July, the chipmaker Nvidia, the exemplar of the A.I. revolution, rose to a record market valuation of over \$4 trillion. Only in the late 1990s and early 2000s was the tech market more richly valued, peaking in March 2000 — by October 2002, it had cratered by almost half.

I worry that investors may, as they have at times in the past, be misreading the current situation. The market is ignoring several risks that normally could be expected to restrain stock prices.

We still do not know what the final tariff regime will be. A “permanent” level of tariffs of 15 percent or more is still considerably higher than recent levels, and there is no certainty regarding their ultimate unhealthy effects on inflation and economic growth. Tariffs lead to higher prices unless they are totally absorbed by business, effectively shrinking their profit margins. Tariffs also act as a tax on consumers, causing them to spend less on goods and services. Thus, tariffs worsen inflation while simultaneously suppressing economic activity.

Mr. Trump’s policy bill has been no help in resolving our unsustainable federal budget deficit. We are on track to run unprecedented government deficits over the next several years, and our national debt and related interest payments will rise to unsupportable levels. We do not know when the next financial crisis will occur, but if nothing is done to rein in the deficit, a crisis is inevitable. Yet despite the presence of all these risks, stock market valuations are at one of their highest levels in history. ...

From Wednesday’s Markets A.M.:

This Week’s Least-Surprising News

By Spencer Jakab

A funny thing happened Monday in the market: not much, despite President Trump’s announcement that he would again [delay heavy tariffs on China](#).

The surest way to make money trading this year—even better than scouring social media for [the next meme stock](#)—had been to guess in advance what the president would say on his Truth Social account. Much of it, needless to say, was about tariffs.

Unlike most official government releases or corporate announcements, updates have sometimes come during regular trading hours. On April 9, for example, when “Liberation Day” levies were postponed, the S&P 500 rallied by as much as 11% intraday—its typical return for a year.

Big moves were the pattern for months, starting shortly after Trump’s swearing-in when he slapped fentanyl-related tariffs on Canada, Mexico and China and then delayed them weeks later. The S&P 500’s average daily change, positive or negative, following major tariff news between February and May was 2.8%. That’s about seven times the historical daily average.

But reactions have become less potent. Stocks actually added slightly to their losses after Monday’s midafternoon announcement. On Tuesday the cost of protecting against stock volatility using options hit its low for 2025. Why?

It isn’t quite a “Boy Who Cried Wolf” effect: Many levies, including on China, were enacted. The Yale Budget Lab [estimated last week](#) that America’s tariff rate is now 18.6%, which is the highest since 1933. Investors have punished some stocks and rewarded others, but they’ve left the overall market at a record high.

That’s reassuring to any administration since the S&P 500 is something of an unofficial presidential report card. But it also shows how much investor psychology has evolved.

The muted reaction might be because every announcement should be considered an extreme opening gambit in a negotiation—an explanation Trump himself gave [when told about the “TACO” acronym](#) making the rounds.

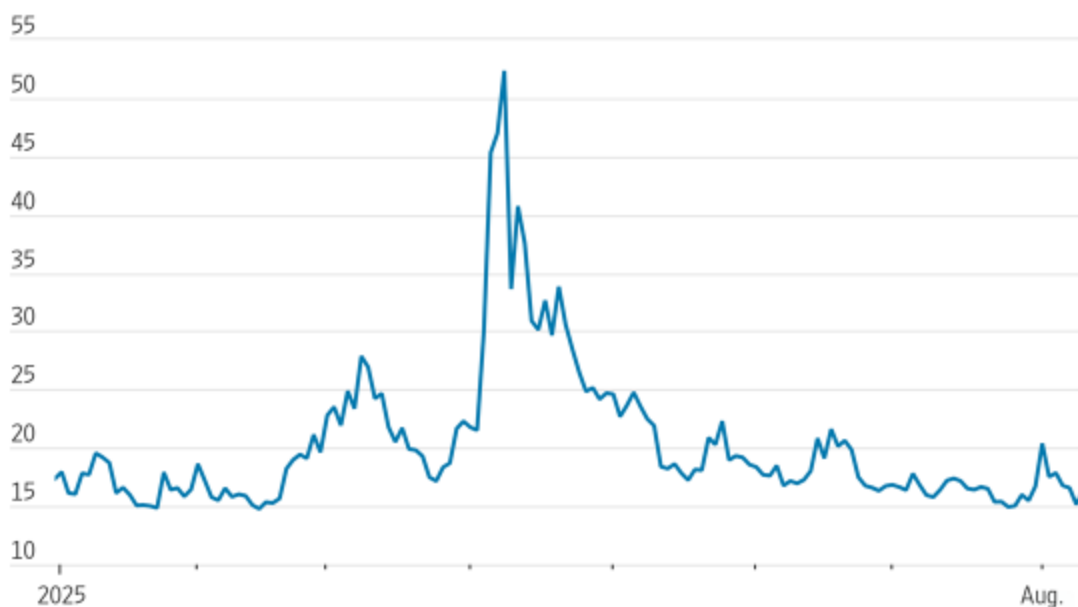
It also could just be fatigue. At some level, high and frequently shifting trade barriers are the new normal. Economies have adapted to much worse.

A calmer reaction to bold headlines is fine. This is a market that [shed more than a trillion dollars in value](#) one day in January because a Chinese AI model, DeepSeek, seemed pretty good. But muted responses combined with general complacency—high valuations, tight credit spreads and low implied volatility—point to two dangers.

One is that the dealmaker-in-chief, seeing markets call his bluff, might feel the need to up the ante. Remember the 145% tariff on China, which would have frozen trade almost completely?

Another is that investors are overly reassured by the muted market response, in a potentially misleading feedback loop. Buoyant stock prices and resilient economic indicators have wrongfooted investors before many

Cboe Volatility Index



Source: FactSet

downturns. Is July's tepid labor market data an early sign that frequent U-turns in trade policy, and tariffs themselves, are taking a toll?

Don't be surprised.