September 2024

From the front page of today's WSJ:

AI Fever Abates In Stocks' Latest Quarter

Segments including utilities, industrials and financials all beat the tech sector

BY KAREN LANGLEY

AI fever has loosened its grip on the stock market.

Gone is the first half of 2024, when investors' passion for artificial intelligence drove the market skyward even as stubbornly high inflation dashed hopes that the Federal Reserve would begin cutting interest rates.

The third quarter brought a new order to markets. Investors began to look askance at big tech companies' heavy spending on AI. They took heart in a series of tamer inflation readings that led the Fed to finally lower rates. And many, seeing signs of economic strength, grew confident that the central bank had managed to control price pressures without driving the U.S. into recession.

It was a recipe for the broadening of a rally that many investors worried had grown precariously reliant on a fewbig tech stocks.

In the third quarter, broad swaths of the market, from utilities to industrials to financials, trounced the technology sector. (The following chart is from the online version of this article.) Value stocks beat growth stocks. Small-capitalization stocks emerged from their torpor to leave their large-cap peers in the dust.

Fatigue among the big tech stocks tends to weigh on the S& P 500, which gives greater influence to companies with large market values. But gains by a wide range of other stocks helped push major indexes higher. The U.S. large-cap benchmark advanced 5.5% for the quarter, bringing its 2024 gains to 21%. That was its best performance in the first three quarters of a year since 1997, according to Dow Jones Market Data.

Many investors think the economy looks healthy enough for stocks from a variety of industries to continue to run, potentially contributing to a more sustainable rally.

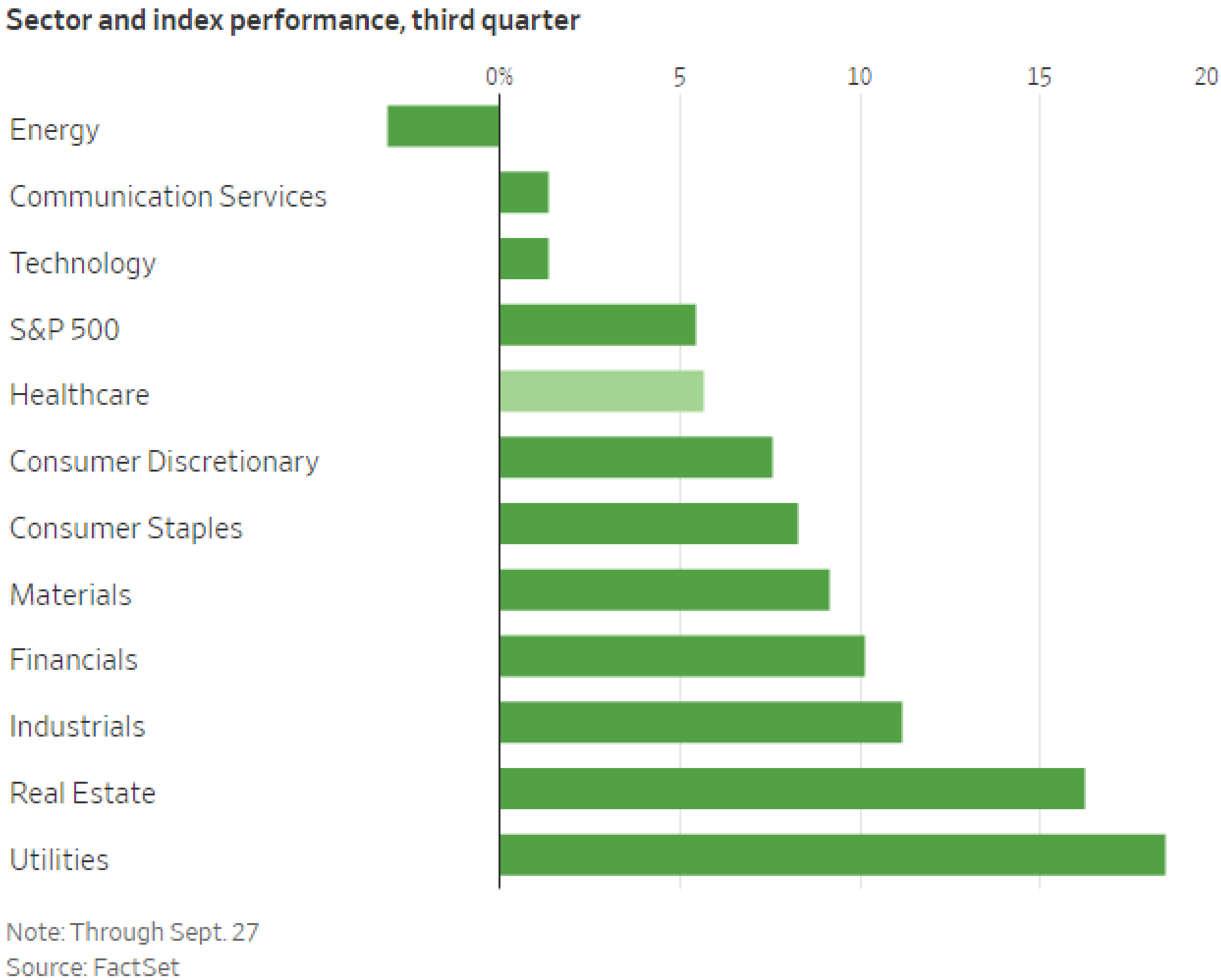
"It really does appear as though the Fed is pulling off a soft landing," said Ellen Hazen, chief market strategist and portfolio manager at F.L.Putnam Investment Management.

F.L.Putnam recently bought shares of industrial company Trane Technologies, believing the stock will do well if the economy avoids recession, Hazen said.

The big tech stocks in the Magnificent Seven went their own ways in the latest quarter. Nvidia, the chip maker at the heart of the AI boom, pulled back after its torrid advance in the first half, along with shares of Alphabet, Microsoft and Amazon. com. Apple, Meta Platforms and Tesla, meanwhile, ended higher.

Their near-uniform march upward was interrupted as investors questioned the vast amounts of money some companies are committing to their AI pursuits.

In recent months, Alphabet reported slowing growth in advertising sales at Google along with a near-doubling of capital expenditures from a year earlier, while Amazon forecast weakerthan- anticipated sales growth and



said it would boost spending to meet demand for AI services. The stocks declined 8.9% and 3.6% for the quarter, respectively.

“The narrative switched around to, ‘Are they going to make money with all this spending?’” said Jim Polk, head of equity investments at Homestead Advisers. “We believe there’s still a real story there and AI is going to happen, but certainly it got ahead of itself.”

Bond investors enjoyed a rally, too, as the Fed’s rate cuts finally began. The yield on the benchmark 10-year U.S. Treasury note, which falls when prices rise, dropped to 3.798% from 4.342% at the end of June, snapping a two-quarter streak of rising yields.

Declining rates have helped boost corners of the stock market that are often thought of as bond proxies because of their hearty dividend payments. The utilities sector ended the third

quarter as the S& P 500’s top performer with an 18% gain, while the real-estate group climbed 16%.

The latest quarter held another intriguing development in government bonds. Two-year U.S. Treasurys had been trading at a higher yield than 10-year notes, a phenomenon known as an inverted yield curve that has been a classic recession signal, since July 2022. Then, in September, the inversion disappeared, as the longer-term Treasury’s yield finally climbed back above that of the shorter-term note.

An inverted yield curve sometimes returns to normal just ahead of a recession, as traders bet on aggressive rate cuts from the Fed. But many investors are optimistic that this time, a recession isn’t in the offing.

More than half of respondents to Bank of America's September global fund-manager survey said they didn't expect a U.S. recession in the next 18 months.

To be sure, not everyone thinks the economic picture is rosy.

The unemployment rate has ticked up this year, and there are signs that lower-income consumers are struggling to pay their bills. ...

From Global Investment Strategy's September 27th's issue:

Fourth Quarter 2024 Strategy Outlook: Soft Landing Or Quicksand?

I. Macroeconomic Outlook

Hold the Champagne

Stocks cheered the Fed's decision to cut rates by 50 bps last week. The market's reaction harkened back to January 2001 and September 2007, which also marked the start of the two biggest easing cycles this century. In both cases, the Fed surprised investors by cutting rates by 50 bps. In 2001, the S&P 500 gained 5.0% on the day of the unexpected rate cut. In 2007, it gained 2.9%. Unfortunately, in both cases, stocks fell significantly over the subsequent months (**Chart 1**).

Back then, although it was not obvious at the time, the Fed was behind the curve. This time is unlikely to be any different. We continue to expect the US to succumb to a recession later this year or in early 2025.

Good versus Bad Unemployment

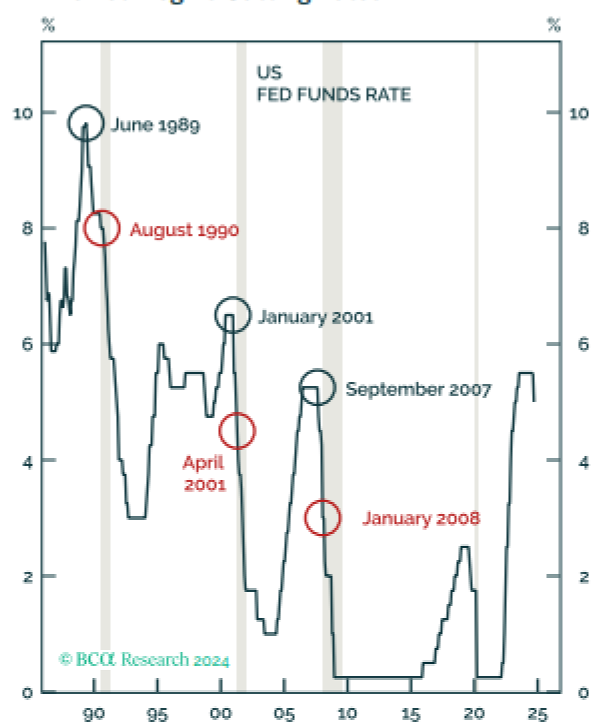
The US unemployment rate has already risen by enough to trigger the Sahm rule. Other recession indicators such as our Mel rule – which aggregates state-level unemployment rates to generate a cleaner picture of the jobs market – are also flashing red (**Chart 2**).

Optimists will contend that the recent rise in unemployment reflects positive developments – namely, that more people are joining the labor force and looking for work.

There are at least two problems with this argument. First, labor force growth slowed to 0.4% year-over-year in August from 1.9% a year earlier. How is it that all those new joiners were able to easily find work back then but cannot do so now? The only plausible answer is that labor demand has slowed.

Second, as a factual matter, new entrants and reentrants account for only two-fifths of the increase in the unemployment rate from its lows. The rest can be chalked up to job loss.

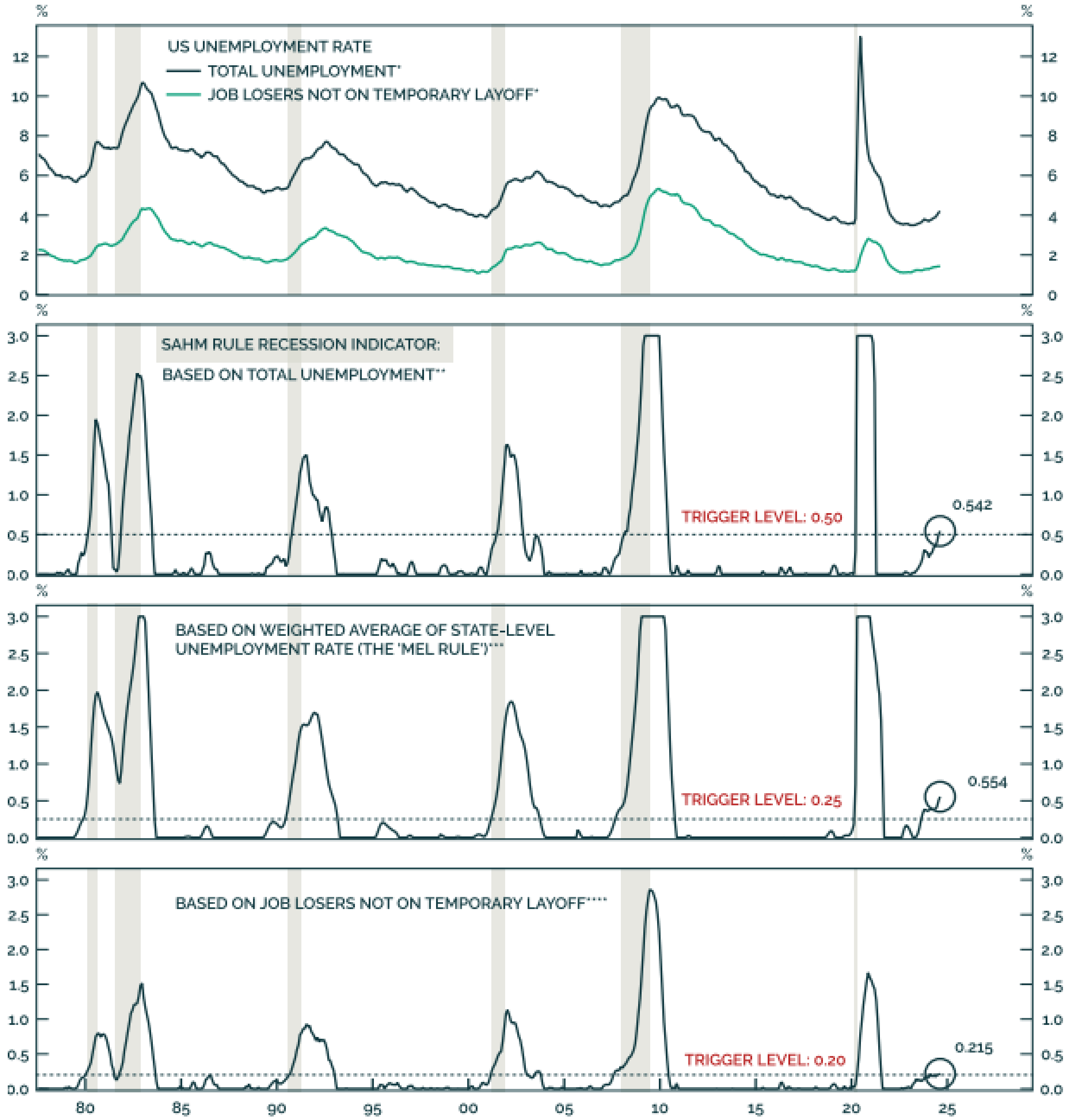
CHART 1
Recessions Often Start Not Long After The Fed Begins Cutting Rates



SOURCE: FEDERAL RESERVE.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

CHART 2

The Unemployment Rate Has Breached Several Recession-Trigger Rules



* SHOWN AS A 3-MONTH MOVING AVERAGE.
** THE SAHM RULE BASED ON TOTAL UNEMPLOYMENT SIGNALS A RECESSION WHEN THE 3-MONTH AVERAGE UNEMPLOYMENT RATE RISES 0.50 PERCENT ABOVE THE LOWEST 3-MONTH MOVING AVERAGE RATE OVER THE PREVIOUS 12 MONTHS. SERIES SHOWN TRUNCATED AT 3%.
*** THE MEL RULE SIGNALS A RECESSION WHEN THE UNEMPLOYMENT RATE CALCULATED BY AGGREGATING STATE-LEVEL DATA RISES 0.25 PERCENT ABOVE ITS 18-MONTH LOW. STATE-LEVEL DATA BEGIN IN 1976. SERIES SHOWN TRUNCATED AT 3%.
**** THE SAHM RULE BASED ON JOB LOSERS NOT ON TEMPORARY LAYOFF SIGNALS A RECESSION WHEN THE 3-MONTH AVERAGE OF THIS RATE RISES 0.20 PERCENT ABOVE THE LOWEST 3-MONTH MOVING AVERAGE RATE OVER THE PREVIOUS 12 MONTHS.
SOURCE: BUREAU OF LABOR STATISTICS (BLS).
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

In fact, relative to the size of the labor force, the number of people who are unemployed because they lost their job has risen by 0.21 percentage points from its 12-month low. While that may not sound like a lot, there has never been a case over the past 50 years where this metric has increased by more than 0.20 percentage points without a recession occurring.

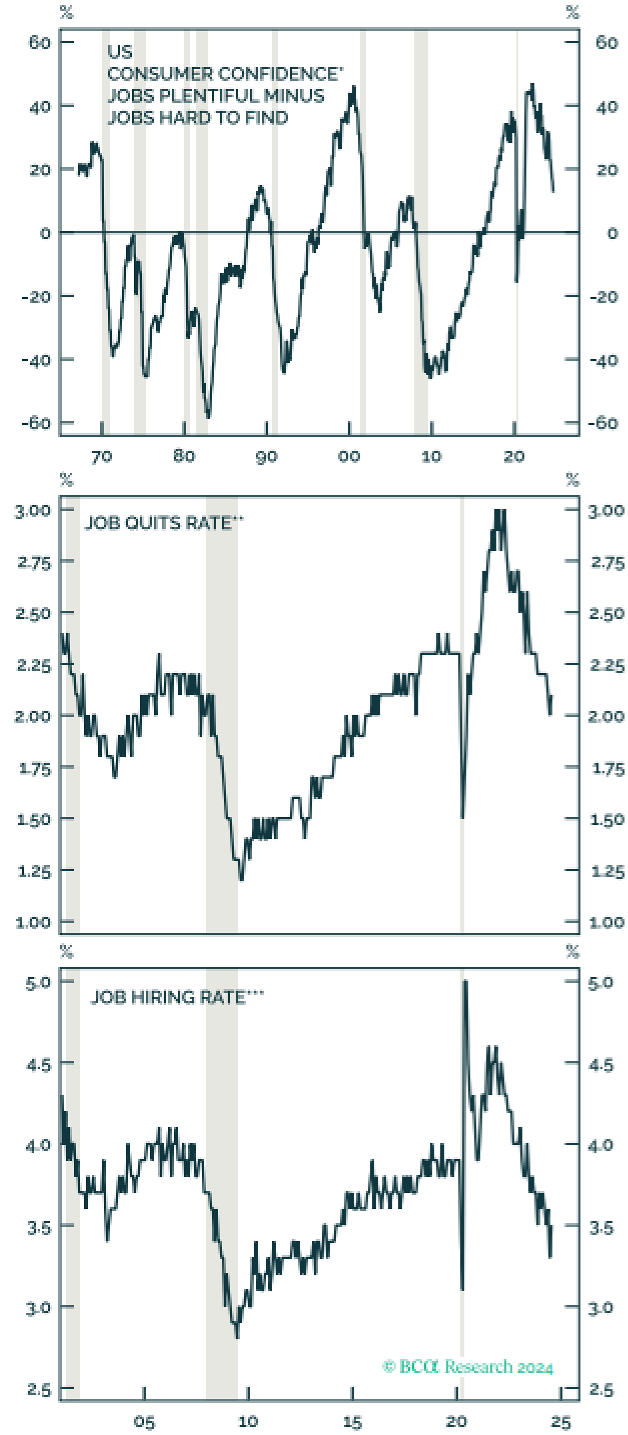
The reason that unemployment did not rise in 2022 when the Fed was hiking rates was because, as we emphasized at the time, job openings were extraordinarily high. Most people who lost their job back then could simply walk across the street to find new work. However, the job openings rate has now fallen to 4.6% from a peak of 7.4% in March 2022. ...

Reflecting this development, the gap between the number of respondents in The Conference Board survey who think jobs are plentiful and those who think they are hard to get fell 3.3 pts to 12.6% in September and is now well below the 2019 average of 33.2%. Likewise, both the quits rate and the hiring rate are well below pre-pandemic levels (**Chart 6**).

If the labor market is truly deteriorating, why have initial unemployment claims not risen more? One plausible answer is that many people are joining the gig economy after losing their jobs rather than filing for unemployment insurance.

As evidence ... the number of people working part time because they could not find full-time jobs is trending higher. As a share of the working-age population, the number of full-time employees has begun to fall sharply.

CHART 6
Mounting Evidence Of A Slowdown In The Labor Market



* SOURCE: THE CONFERENCE BOARD.
** SOURCE: JOB OPENINGS AND LABOR TURNOVER SURVEY (JOLTS), BLS.
*** TRUNCATED AT 5%. SOURCE: JOB OPENINGS AND LABOR TURNOVER SURVEY (JOLTS), BLS.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

US Consumption Growth to Slow

Following the latest revisions to the national accounts data, and with today's PCE update in hand, it appears that real disposable personal income grew 3.1% year-over-year in August, with wage and salary income up 4%.

Income growth is likely to fall over the coming quarters, which should curb spending growth. Recall that earned income is just the product of compensation-per-employee and the number of employees. Compensation-per-employee is decelerating because more people are working part time, wage growth is slowing, and the average length of the workweek is shrinking in response to a cooling labor market.

Employment growth will weaken further because at this point, almost everyone who left the labor force during the pandemic has reentered it (**Chart 9**). Illegal immigration has also declined in recent months, albeit from extremely high levels (**Chart 10**).

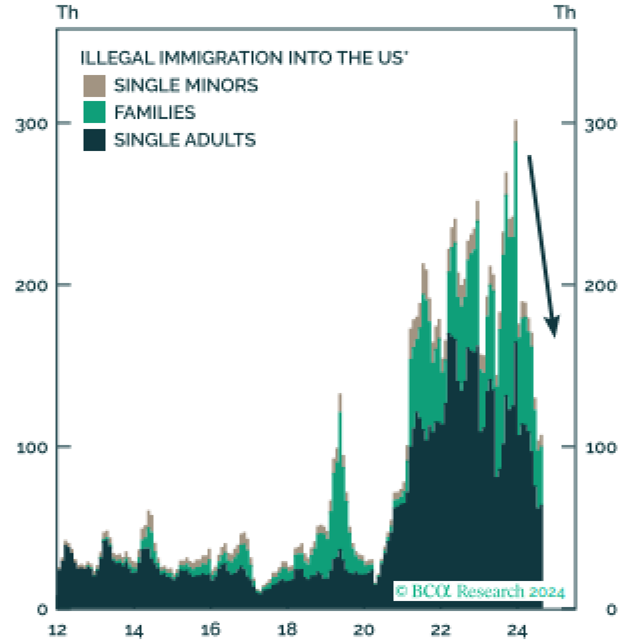
The good news is that after the revisions, the personal savings rate no longer looks unsustainably low. It clocked in at 5.2% in Q2 and fell only modestly to 4.8% in August.

Could the savings rate decline further, allowing spending growth to exceed income growth? It is possible, but we would bet against it.

CHART 9
Little Upside Left In The Prime-Age Participation Rate

SOURCE: BUREAU OF LABOR STATISTICS (BLS).

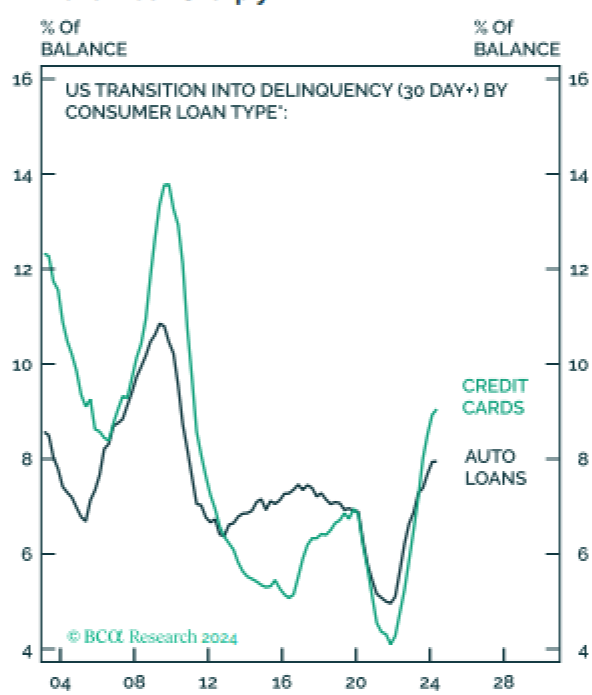
CHART 10
Flow Of Illegal Immigrants Into The US Has Abated



* SOUTHWEST LAND BORDER ENCOUNTERS. JANUARY-SEPTEMBER 2012 DATA ON SINGLE ADULTS INCLUDES FAMILY ENCOUNTERS.
SOURCE: US CUSTOMS AND BORDER PROTECTION.

Consumption was supercharged over the past two years as households spent down their pandemic savings. Even after this week's upward revisions to income, the San Francisco Fed estimates that these savings have been fully depleted, so it is doubtful that households will be able to boost spending out of current income. Nor is it likely that they will substantially increase their borrowings. Although household debt burdens are not terribly onerous these days, credit card and auto loan delinquency rates have still managed to rise back to where they were in 2010 – a year when the unemployment rate averaged 9.6% (**Chart 12**).

CHART 12
Credit Card And Auto Delinquency Rates Have Risen Sharply



* SHOWN AS A 4-QUARTER MOVING TOTAL.
SOURCE: FEDERAL RESERVE BANK OF NEW YORK.

Banks have responded to rising delinquency rates by tightening lending standards and lifting interest rates on credit card loans to the highest levels in history. Not surprisingly, credit card debt growth is slowing.

Granted, delinquency rates on housing-related loans are still low. However, banks have showed little interest in significantly expanding home equity lines of credit (HELOCs) in recent years. HELOC debt stood at 1.3% of GDP in Q2 2024, down from 5% of GDP at its peak in 2009.

Real Estate Risks

Unlike in the pre-GFC period, there is no glut of single-family homes in the US. That is good news.

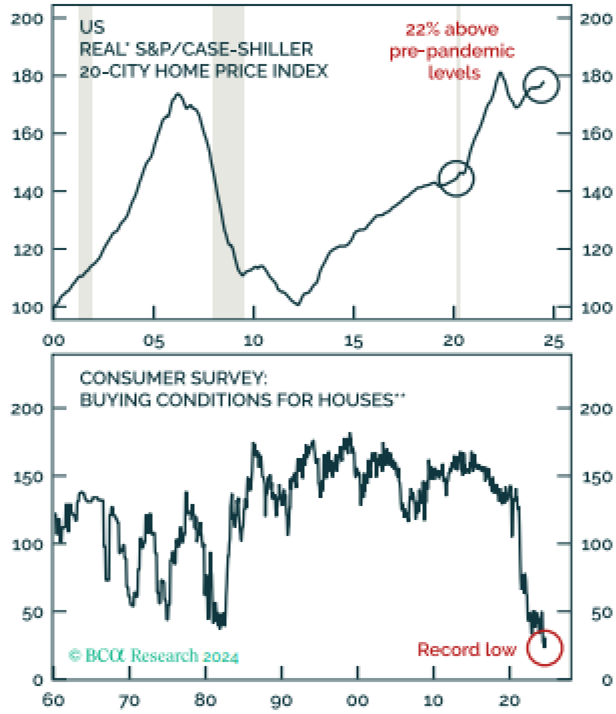
There is, however, a price imbalance. Real home prices are 22% above where they were on the eve of the pandemic (**Chart 14**). Despite the decline in mortgage rates over the past year, the fraction of respondents in the University of Michigan survey who think "now is a good time to buy a house" hit a record low in August. And while mortgage refinancings have rebounded, mortgage applications for purchase remain near rock-bottom levels.

Encouragingly, both housing starts and building permits rose in August. However, the number of residential housing units under construction declined by 1.9% on the month and is down 10% since the start of the year. This bodes poorly for construction employment, which rose by 34K in August, well above the average of 19K over the prior 12 months.

The outlook for commercial real estate remains bleak. Office vacancy rates have soared to record highs (**Chart 17**). According to the IMF, a broad index of US commercial real estate prices was down 8.9% year-over-year in Q1 2024, the worst showing since the GFC (**Chart 18**).

Rising delinquencies on CRE loans have spread from offices to other segments such as multi-family real estate, shopping malls, hotels, and most recently, industrial properties.

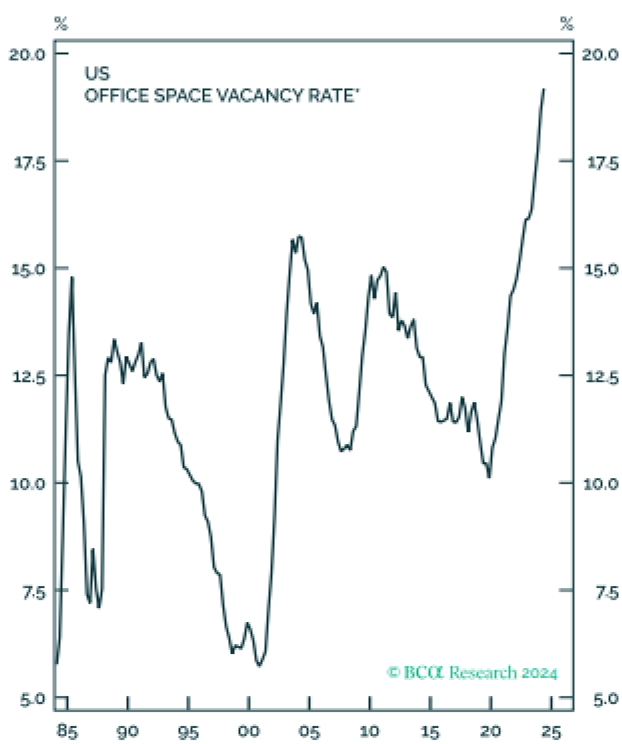
CHART 14
Home Prices Are Too High For Many Americans



* DEFLATED BY HEADLINE CPI, REBASED TO JANUARY 2000 = 100.
** QUESTION POSED: GENERALLY SPEAKING, DO YOU THINK NOW IS A GOOD TIME OR A BAD TIME TO BUY A HOUSE?
SOURCE: UNIVERSITY OF MICHIGAN, SURVEY OF CONSUMERS.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

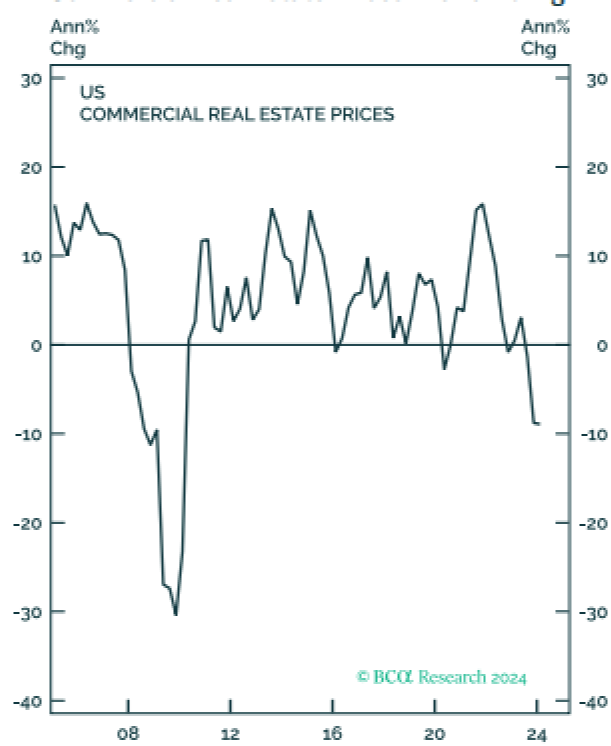
Regional banks are especially exposed to CRE. Unlike the largest US banks, the loan-to-deposit ratio for small banks has seen little improvement since the GFC. It is likely that we will see another round of bank failures.

CHART 17
Office Vacancy Rates Keep Climbing



* SOURCE: NCREIF.

CHART 18
Commercial Real Estate Prices Are Tumbling



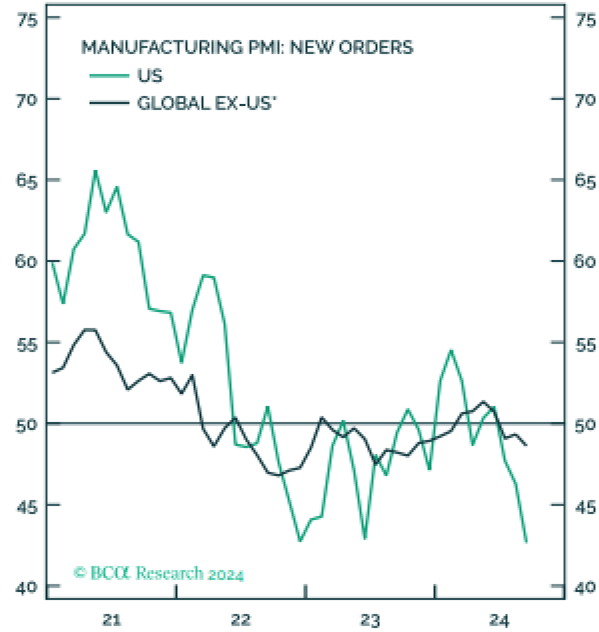
SOURCE: INTERNATIONAL MONETARY FUND (IMF).

Manufacturing Blues

After a half-hearted attempt at a recovery, ISM manufacturing new orders have relapsed, falling to 44.6 in August, the worst reading since May 2023. The new orders component of the S&P Global US flash manufacturing PMI hit a 21-month low of 42.7 in September. The manufacturing PMIs outside the US also remain downbeat (**Chart 20**).

CHART 20

After A Muted Recovery, Manufacturing Is Once Again On A Downswing



* GLOBAL EX-US ESTIMATE FOR SEPTEMBER IS BASED ON FLASH ESTIMATES FOR AUSTRALIA, EURO AREA, UK, AND JAPAN.
SOURCE: S&P GLOBAL.

One major headwind facing the US manufacturing sector is that so much consumer durable goods spending was brought forward during the pandemic. While spending has declined over the past few years, it is still running above its pre-pandemic trend. Until this imbalance is rectified, demand for consumer durable goods will continue to stagnate.

The ISM manufacturing index is highly correlated with capex intentions. Given the weakness in the former, it is not surprising that the latter remain downbeat. Meanwhile, construction spending subsidized by the CHIPS Act and the IRA, while still high in absolute terms, has peaked and will decline over the coming quarters.

Fiscal Policy to the Rescue?

Don’t Count On It At the state and local government level, spending will slow sharply next year. According to the National Association of State Budget Officers, state spending is expected to shrink by 6.2% in fiscal 2025 after growing by 14.4% in fiscal 2024 and 7.2% in fiscal 2023. The decline in spending reflects sizable one-time expenditures made in 2023 and 2024 that will not be repeated next year.

The decrease in spending will have a meaningful impact on growth. In inflation-adjusted terms, state and local government spending has added 0.46 percentage points to GDP growth over the past four quarters, well above the average of 0.18 percentage points over the prior ten years. State and local governments have increased payrolls by nearly 40,000 per month over this period, six times faster than average.

At the federal level, the path for taxes and spending hinges on which party prevails in November. Regardless of who wins, however, there will be very little scope for countercyclical fiscal policy. As **Chart 25** illustrates, today’s federal budget deficit of 7% of GDP is unprecedented for an economy that is still close to full employment.

The Fed: This Ain’t ‘95

Given the uncertainty over the course of fiscal policy, the responsibility of keeping the economy out of a recession has fallen on the Fed.

Many investors have pointed to the mid-1990s as an example of when Fed easing paved the way for an economic boom. However, there are at least three differences between now and then:

• The 1994-95 tightening phase was fairly mild. The Fed raised rates by a cumulative 300 bps between February 1994 and February 1995. This time around, the Fed hiked rates by 525 bps.

• The unemployment rate fell from 1993 onwards. In contrast, unemployment is already increasing.

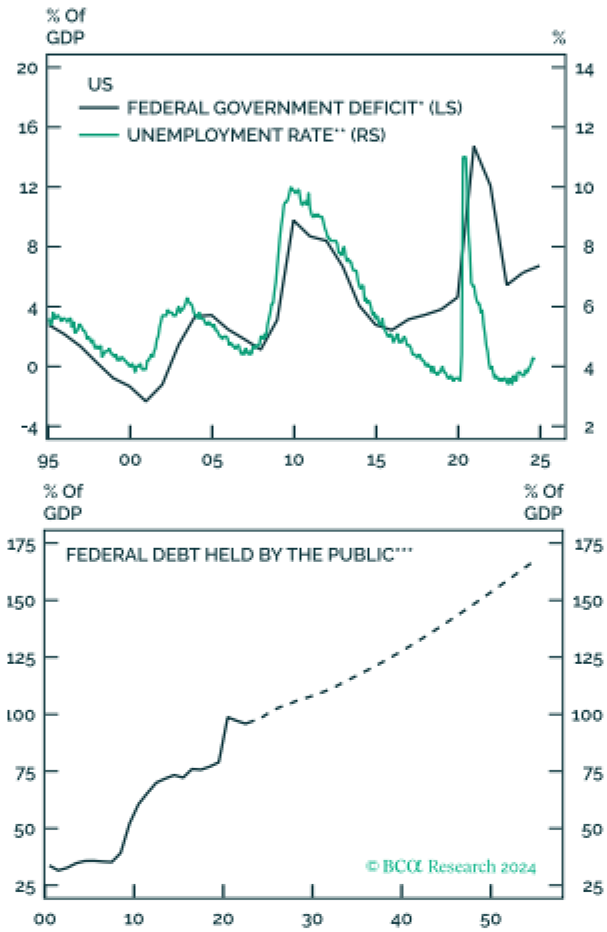
• The second half of the 1990s featured a massive disinflationary capex boom coupled with rapid productivity growth. Although things could change, nothing comparable is evident in the data so far.

Despite the 50 basis-point rate cut, the market's expectation of where the fed funds rate will be at the end of 2025 has remained unchanged since the FOMC meeting. The 10-year Treasury yield has risen by 8 bps.

This speaks to a broader problem, which is that the market already expects a lot of easing. In order to push down yields, the Fed would have to cut rates more than is discounted. That might be difficult to do outside of a recession.

Moreover, even if long-term bond yields and mortgage rates fall from current levels, the average interest rate that homeowners and businesses face may still go up. ...

CHART 25
A Dire Fiscal Outlook Limits The Scope For Countercyclical Fiscal Policy



* SOURCE: US CONGRESSIONAL BUDGET OFFICE.
** SHOWN TRUNCATED AT 11%. SOURCE: BUREAU OF LABOR STATISTICS (BLS).
*** SOURCE: US CONGRESSIONAL BUDGET OFFICE. DASHED LINES DENOTE FORECASTS.

China: Rearguard Action

China's underlying problem is that it produces much more than it consumes. Its national saving rate is the highest among the major economies (**Chart 29**). The lack of spending is feeding into deflation. It is also contributing to a swelling trade surplus in goods, as the country tries to shift its excess production to the rest of the world.

China's housing bust is only making things worse. After years of overbuilding, housing starts, sales, and prices are all tumbling (**Chart 30**). Housing construction has not weakened as much as starts because there is still a pipeline of projects that developers are working through. However, once those projects are completed, construction activity will weaken further.

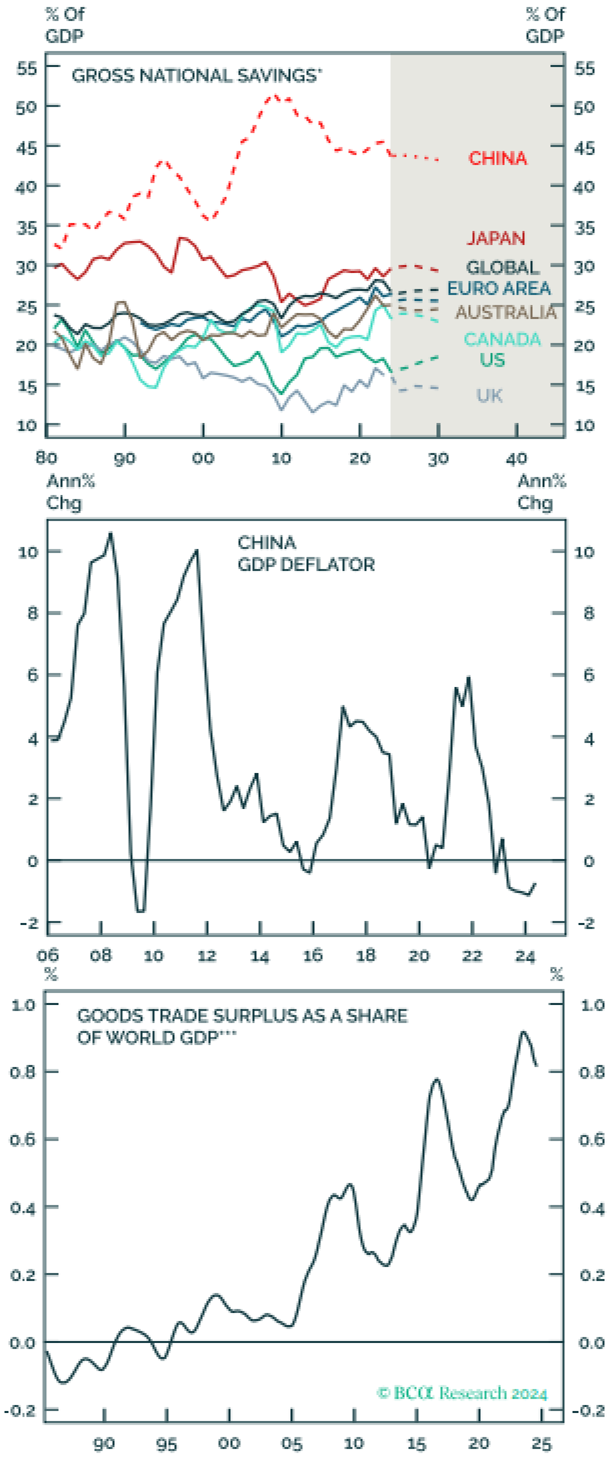
Underlying demand for Chinese homes will decline for years to come. The UN foresees a 70% drop in the working-age population by the end of the century (**Chart 31**).

Up until this week, the government's response to sluggish domestic demand growth was clearly insufficient. The combined credit/fiscal impulse was mired in negative territory. Historically, this metric has been an excellent leading indicator for Chinese growth.

Against this backdrop, it is not surprising that the government had to act to defend its 5% growth target.

CHART 29

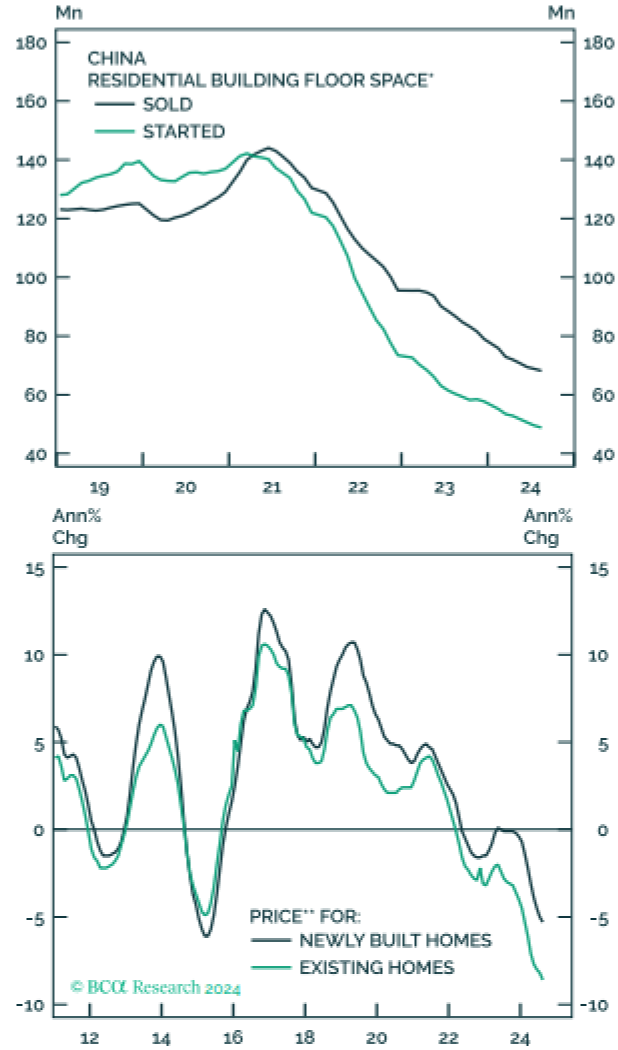
Chronic Excess Saving Has Pushed China Into A Liquidity Trap



* SOURCE: IMF WORLD ECONOMIC OUTLOOK (APRIL 2024). SHADED AREA DENOTES PROJECTIONS.
** SOURCE: NATIONAL BUREAU OF STATISTICS, CHINA.
*** SERIES SHOWN AS A 12-MONTH MOVING AVERAGE. SOURCE: CHINA CUSTOMS STATISTICS INFORMATION CENTER (CCS) AND IMF.

CHART 30

China: Ongoing Collapse In The Housing Market



* COMMODITY BUILDING FLOOR SPACE. SHOWN IN MILLION SQUARE METERS AND AS A 12-MONTH MOVING AVERAGE.
** FOR 70 MEDIUM AND LARGE CITIES. SOURCE: NATIONAL BUREAU OF STATISTICS, CHINA.

While the measures announced this week, first by the PBOC on Tuesday, and then by the Politburo on Thursday, will bolster investor confidence in the near term, we doubt that they will jumpstart growth.

The PBOC has been cutting reserve requirements and lowering interest rates for a while. However, there is little evidence that these actions have had a material effect on growth. This is largely because the economy has already fallen into a liquidity trap. Households and businesses do not want to borrow because they are fixated on paying back debt. As was the case during Japan's lost decades, lower rates are unlikely to jumpstart credit growth.

As for the Politburo's statement, it was long on aspirations but short on details.

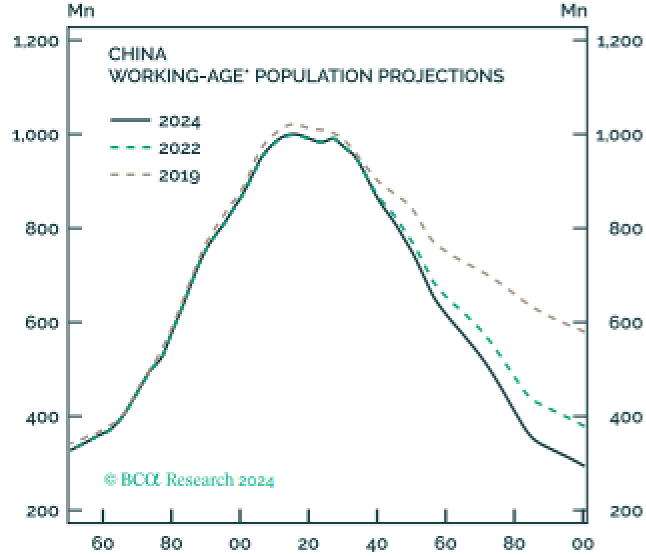
When it comes to fiscal policy, a key problem is that local governments account for nearly 90% of all government spending in China. Historically, local governments have derived around one-third of their revenues from land sales, and these have dried up.

The anti-corruption campaign has also ramped up again in recent months, which has caused local government officials to sit on their hands lest they be accused of any improprieties.

The central government still has money to spend, but it has a habit of channeling its funds into investment projects. These are increasingly facing diminishing returns.

CHART 31

Demographic Trends Point To Declining Underlying Demand For Chinese Homes



* ESTIMATED POPULATION BETWEEN 15-AND-64 YEARS OF AGE.
SOURCE: UN POPULATION DIVISION.

What China needs is more consumption. However, there seems to be a deep-seated resistance to policies that could boost consumer spending on a large scale, as they are seen as emblematic of the decadent West. Ultimately, China will adopt such policies – probably in conjunction with efforts to boost the flagging birth rate – but for now, we do not expect any major consumer-focused stimulus efforts.

Europe: Stuck in a Rut

Unlike in the US, euro area households still have plenty of excess savings. The savings rate stands at around 15%. This gives consumers the wherewithal to spend more.

Real incomes are also recovering thanks to lower energy prices. Reflecting these developments, consumer sentiment has improved.

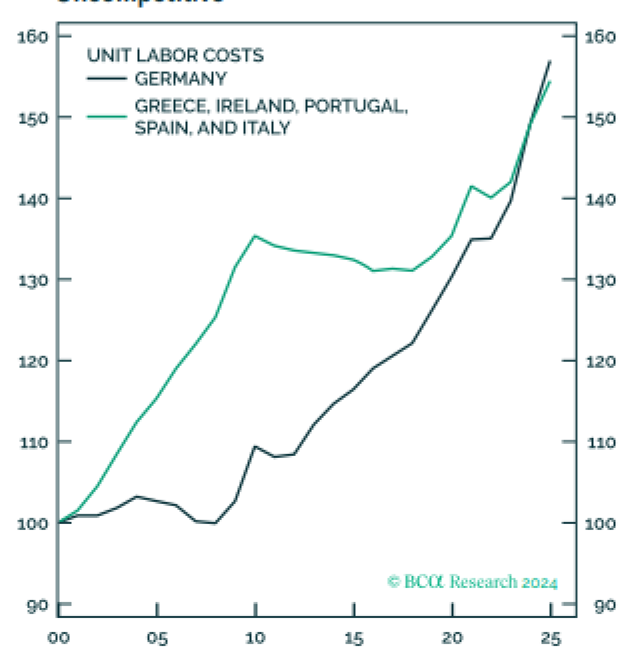
In addition, the ECB is cutting rates, which will provide some relief to borrowers. The pace of tightening in bank lending standards has slowed. This should help support credit growth.

Nevertheless, there are dark clouds on the horizon. Job openings in the euro area continue to trend lower, with Q2 seeing the biggest drop of this cycle thus far. If openings keep falling, the unemployment rate – which has hovered in the mid-6% range since April 2023 – will start rising, prompting households to curtail spending

Euro area businesses are also struggling. The composite flash euro area PMI fell to 48.9 in September, 1.7 points below consensus expectations. The services component dropped to 50.5, the lowest print in seven months. The manufacturing PMI declined to a 9-month low of 44.8. The German manufacturing PMI fell to 40.3.

CHART 38

Germany Has Become Increasingly Uncompetitive



SOURCE: EUROPEAN COMMISSION.
NOTE: ALL SERIES REBASED TO DECEMBER 1999 = 100.

Germany's business model once relied on selling capital goods to China, manufactured with the help of cheap Russian energy. That model is now obviously defunct. Exacerbating matters is the fact that German wages have risen much more rapidly than wages elsewhere in the euro area over the past decade, leading to a loss of competitiveness (**Chart 38**).

After experiencing a technical recession in the second half of 2023, UK growth bounced back in the first half of 2024. Recent data, however, suggest that the economy is slowing again. According to the UK's Office for National Statistics, GDP was stagnant in June and July. While the unemployment rate has come down over the past two months, job openings continue to trend lower.

II. Financial Markets

A. Global Asset Allocation

It may seem natural to assume that monetary policy is easier to conduct when an economy is at equilibrium – that is, when unemployment and inflation are at their target levels.

In fact, the opposite is true. If unemployment is too high and inflation is too low, it is obvious what the central bank should do: Keep rates below any reasonable estimate of neutral. Similarly, if unemployment is too low and inflation is too high, the central bank should keep rates above neutral.

When an economy is at equilibrium, however, the central bank must maintain rates at neutral in order to prevent it from either cooling or overheating. Given the lags in monetary policy and uncertainty over the level of the neutral rate, that is very difficult to do.

The challenge that many central banks face harkens back to Milton Friedman's "fool in the shower" metaphor, which featured a frustrated person trying to find the correct water temperature, unaware that there was a long lag between when the dial is turned and when the temperature changes.

Going into last week's FOMC meeting, our bias was that the Fed was behind the curve. We still feel that way, although the Fed's decision to cut rates by 50 basis points rather than 25 bps did move its policy stance a bit closer to where we think it ought to be. Accordingly, we lowered our 12-month recession probability from 80% to 70%.

That remaining 30% does not fully encompass a soft landing, however. We would split the 30% between 15% odds of a very benign outcome where the economy manages to achieve full employment with target inflation; and 15% odds of a less benign outcome where either inflation starts to reaccelerate, or the Fed is unable to cut rates by nearly as much as markets expect due to fears of overheating.

According to MacroQuant's present value model, the S&P 500 is currently 50% overvalued (**Chart 40**). Even in a true softlanding scenario (15% outcome), the index would

CHART 40
The S&P 500 Is Trading At A Large Premium

* BASED ON PRESENT VALUE OF EXPECTED EARNINGS.
SOURCE: MACROQUANT 2.0 (STOCK COACH).

probably not rise much above 6000. In all other scenarios, the index would fall a lot. As such, we think it still makes sense to underweight stocks.

B. Equities

Beep Beep

Since the late 1960s, US stocks have peaked, on average, six months before the start of recessions (**Table 2**). There is, however, quite a bit of variability in these results. In the lead-up to the Great Recession, the S&P 500 peaked only two months before the recession began.

TABLE 2

On Average, Stocks Have Peaked Six Months Before The Onset Of A Recession

RECESSIONS	S&P 500 PEAK* (MONTHS)	S&P 500 TROUGH* (MONTHS)	PEAK-TO-TROUGH DECLINE (%)
DEC '69 - NOV '70	-13	+6	-36%
NOV '73 - MAR '75	-11	+10	-48%
JAN '80 - JUL '80	0	+2	-17%
JUL '81 - NOV '82	-8	+12	-27%
JUL'90 - MAR '91	-2	+3	-20%
MAR '01 - NOV '01	-7	+18	-49%
DEC '07 - JUN '09	-2	+14	-57%
AVERAGE	-6	+10	-36%

* RELATIVE TO THE START OF NBER-DESIGNATED RECESSIONS.

The stock market is currently experiencing a "Wile E. Coyote" moment. Like the coyote, the US economy has run off the cliff; but rather than noticing the canyon below, investors are entranced by the shiny light of Fed easing. ...

How Low Could The S&P 500 Go?

In our base-case recessionary scenario, we foresee the S&P 500 dropping to 3800 in 2025. Although that sounds like a dire target, to reach it, the forward P/E ratio would only need to fall slightly below 16 and forward earnings estimates would need to drop by 10% (**Table 3**).

Neither assumption is that aggressive. A decline in the forward P/E multiple to slightly below 16 would simply restore it to where it was, on average, between 2012 and 2019 – a period which did not even encompass a recession (**Chart 43**).

Analysts currently expect S&P 500 earnings to rise by nearly 14% over the next 12 months. Thus, a 10% decline in forward earnings estimates from current levels would still leave earnings higher than they are today. If earnings estimates were to fall by 20% – which is closer to what normally occurs during recessions – the S&P 500 would drop to 3400.

TABLE 3

In A Recession, The S&P 500 Could Fall To 3800

Forward PE	Hypothetical Change In Forward Earnings Estimate From Current Levels (%) -30	-20	-10	0	+10	+20	+30
10	1861	2127	2393	2659	2925	3191	3456
11	2047	2340	2632	2925	3217	3510	3802
12	2233	2552	2872	3191	3510	3829	4148
13	2420	2765	3111	3456	3802	4148	4493
14	2606	2978	3350	3722	4095	4467	4839
15	2792	3191	3589	3988	4387	4786	5185
16	2978	3403	3829	4254	4680	5105	5530
17	3164	3616	4068	4520	4972	5424	5876
18	3350	3829	4307	4786	5264	5743	6222
19	3536	4041	4547	5052	5557	6062	6567
20	3722	4254	4786	5318	5849	6381	6913

NOTE: AS OF SEPTEMBER 27, 2024. SOURCE: REFINITIV / IBES.

The fact that profit margins are near record highs adds to the downside risk to earnings. Trailing S&P 500 margins currently stand at 12.5%, compared to 8.1% at their peak in 2000. While stocks are cheaper on a price-to-earnings basis than they were back then, on a price-to-sales basis, they are 26% more expensive.

It is worth noting that expected earnings have risen much more than trailing earnings over the past few years. Specifically, 12-month forward EPS estimates have increased by 20.6% since December 2021; whereas actual operating profits have increased by 5.2% and GAAP profits have declined by 1.0% through to the second quarter. Based on Q2 2024 GAAP earnings, the S&P currently trades at 29.3. This leaves very little room for error. ...

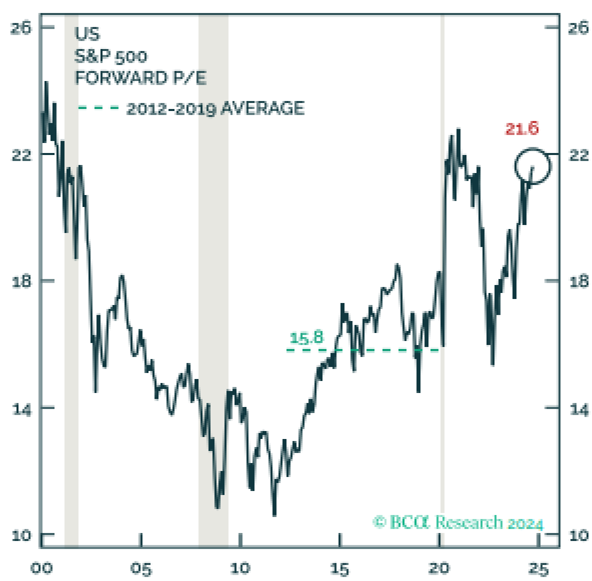
Within the Small Cap Realm, Favor the S&P 600 Over the Russell 2000

While we would not be surprised if small caps rally over the next few months, they are likely to underperform once the recession gets underway. In general, smaller companies are more cyclical and more reliant on bank financing than larger companies. This makes small caps particularly vulnerable to economic downturns.

For investors looking to maintain exposure to small caps, we recommend the S&P 600 over the Russell 2000 (as, once again, does HCM. However, there is a better alternative as shown below.). The latter index has many more unprofitable companies, and hence scores lower on most quality measures. Reflecting this, the Russell 2000 has seen much slower earnings growth and price appreciation than the S&P 600 (**Chart 47**).

CHART 43

A Decline In The S&P 500 P/E Ratio To Around 16 Would Just Bring It Back To Where It Was Between 2012 And 2019



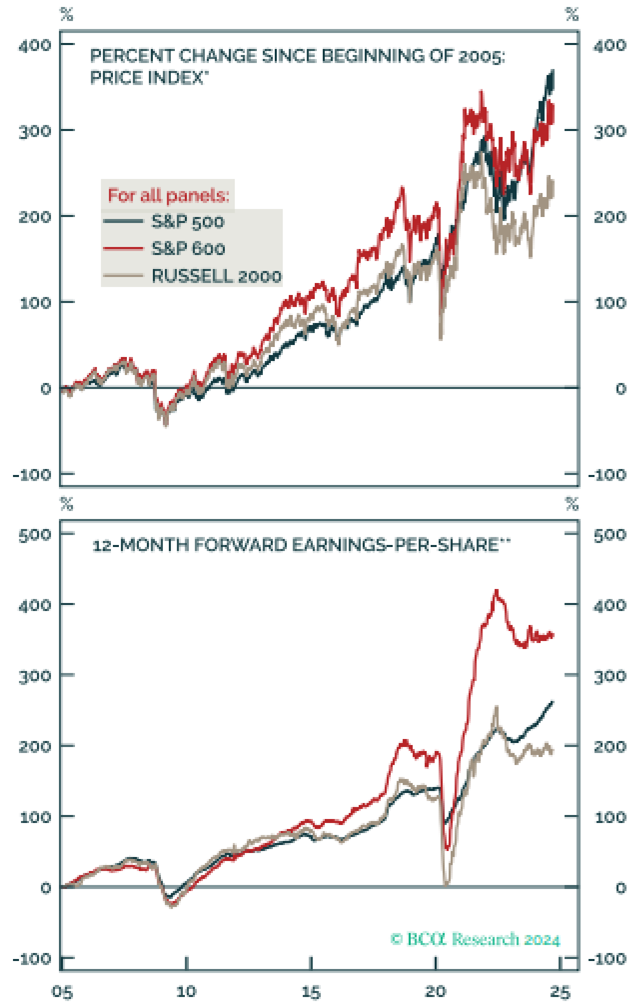
SOURCE: REFINITIV / IBES.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

US Equities Should Outperform During the Next Recession, But Not By Much

We are currently underweight US stocks but expect to upgrade them once clear signs of a recession emerge. In general, US stocks are less cyclical than non-US stocks. The US dollar also tends to strengthen during times of global economic stress, which reduces the value of foreign stock markets when converted back into US dollars.

While our base case is that US stocks will outperform during the coming global recession, we do not think they will do so by a wide margin. US equities are very expensive in relation to non-US stocks. Moreover, as we discuss later, the US dollar's appreciation will be somewhat muted during the next recession. ...

CHART 47
The S&P 600 Is The Smarter Play In The Small Cap Realm



* SERIES REBASED TO JAN. 2005 = 0%.
** SOURCE: REFINITIV / IBES. SERIES REBASED TO JAN. 2005 = 0%.

C. Fixed Income

...

Long-Term Risks to Bond Yields

Looking beyond the next recession, a variety of forces will affect government bond yields. Potentially pushing yields higher is the possibility that waning globalization amid geopolitical tensions will reduce the ability of firms to source inputs more cheaply from abroad, leading to higher prices.

An exodus of baby boomers from the labor market could also put upward pressure on wages. In the US, baby boomers hold more than half of all household wealth. As they spend down their wealth, equilibrium real interest rates could rise.

On the flipside, artificial intelligence could expand the economy's supply-side capacity. Unless demand keeps up with supply, millions of workers might find themselves out of a job. To preclude such an outcome, central banks would need to ease monetary policy.

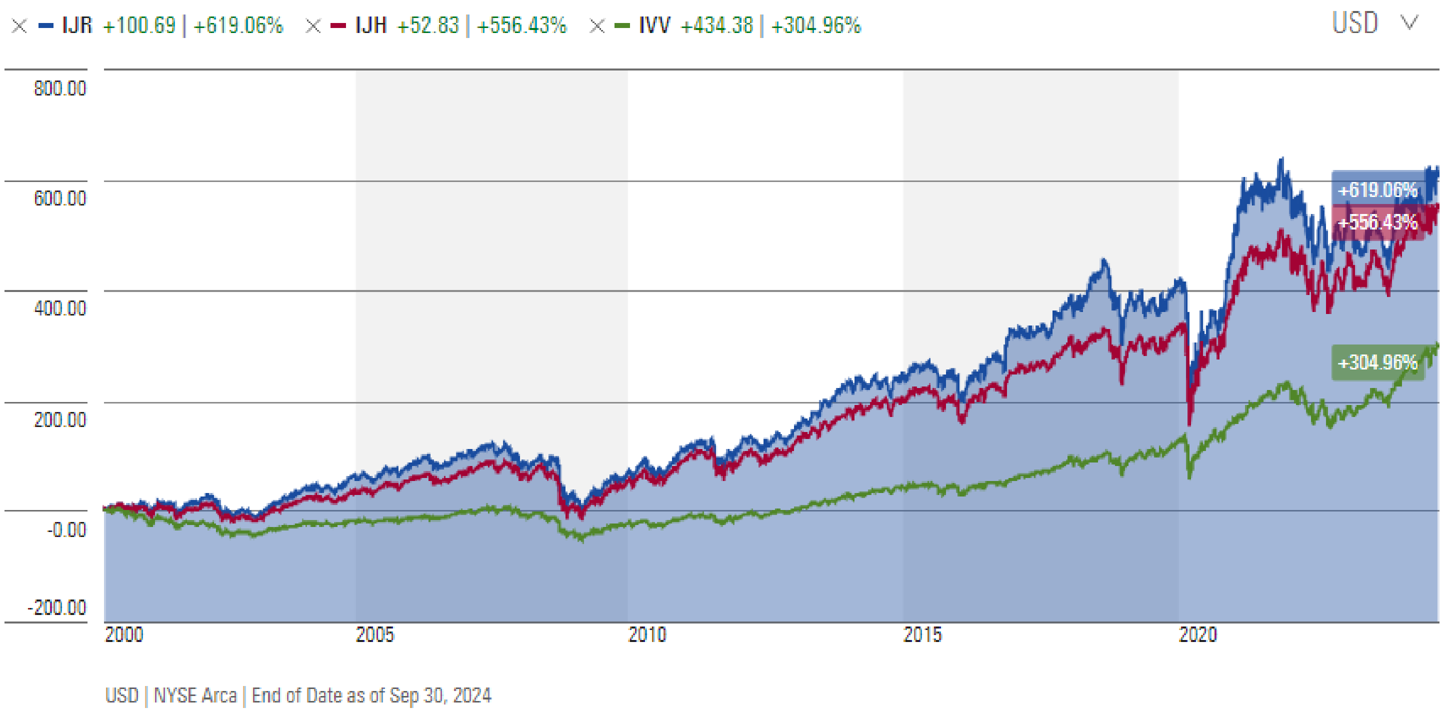
In addition, if China's economy continues to stagnate, this could impart a deflationary impulse on the rest of the world.

Then there is the large overhang of government debt. Although faster economic growth would help reduce the debt burden, some difficult choices will still need to be made. On the one hand, if governments cut spending or raise taxes, that would be good for bonds.

On the other hand, if they put pressure on central banks to buy bonds and/or keep interest rates low to suppress financing costs, that could be good for bonds for a while, but would ultimately sow the seeds for inflation and much higher rates.

Neither austerity nor inflation are politically popular, so the most likely outcome is that governments will kick the can down the road until the market forces a reaction. It is impossible to know when that day will come, but eventually it will arrive.

As we have shared on numerous occasions, the S&P 1500 is comprised of the large cap S&P 500 (IVV), mid cap 400 (IJH), and small cap 600 (IJR). Despite the S&P 500's far superior performance, lead by tech, since the small cap Russell 2000 (IWM) peaked in November, 2021, if we go back to IJR's inception, it has still outperformed IJH, and both have trounced IVV.

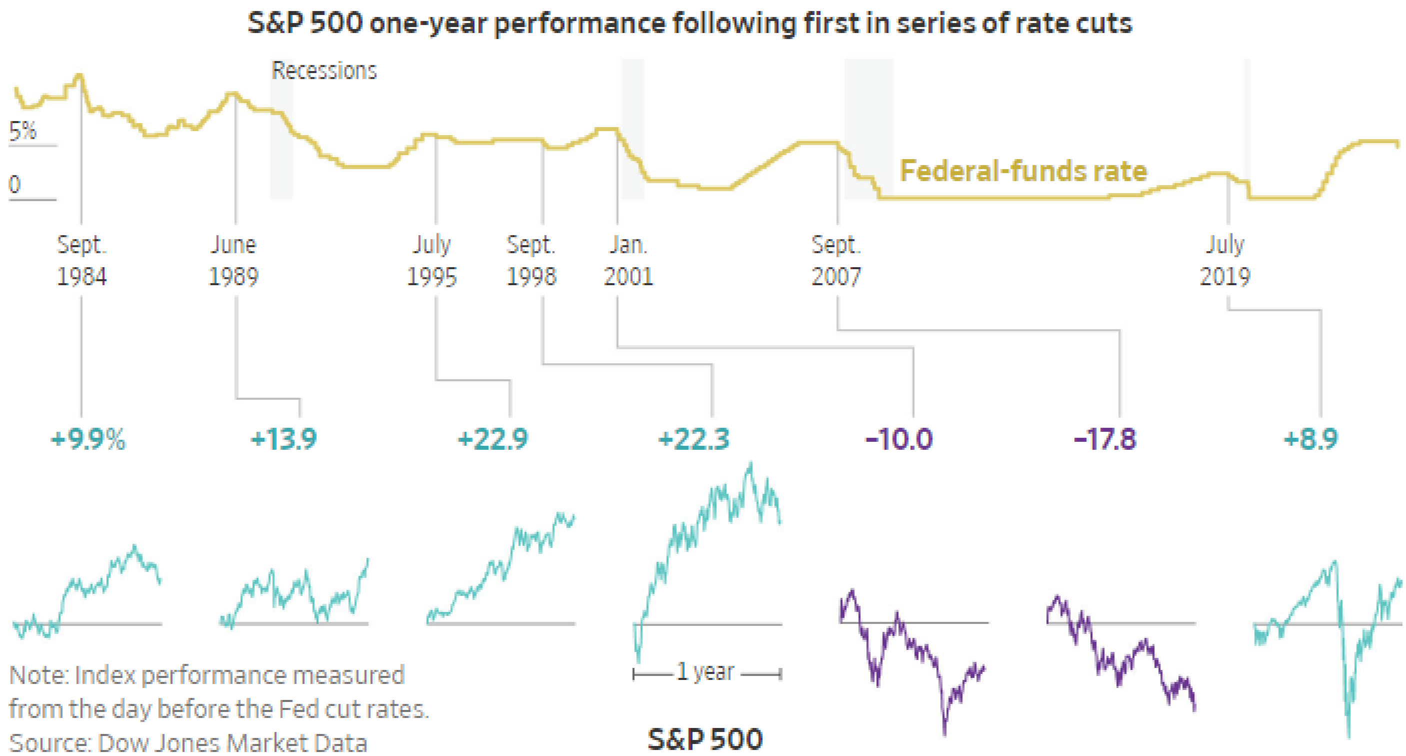


While IJR has outperformed IWM since inception due to its Profitability (a Quality Factor) requirement for inclusion, our preference for Fund Only clients has been SMLF, a Multifactor Small Cap Fund.

Two from the WSJ:

Here's What Happens to Markets When Interest Rates Fall, in Charts

History shows some of the prospects for stocks, bonds and other investments



By *Sam Goldfarb*, *Vicky Ge Huang* and *Peter Santilli*
Sept. 23, 2024

The Federal Reserve's big interest-rate cut last week is rippling through markets. With additional cuts expected in the months ahead, investors are looking to history to gauge what's next.

First, the good news: Since the 1980s, investments such as stocks and corporate bonds have tended to perform well in the 12 months after the Fed begins to cut rates.

That all depends, however, on how the economy fares. When growth holds up, or gets boosted by rate cuts, corporate profits tend to be strong. But if the cuts aren't enough to stave off a recession, investments of all kinds tend to suffer sharp declines. Think of the aftermath of the dot-com bubble and the 2008 global financial crisis.

Typically, the start of a rate-cutting cycle marks a period of uncertainty for companies and investors. As time goes on, it usually becomes clearer whether the economy is going to enter recession or not. That helps explain why the S&P 500 index has historically performed well in a rate-cutting cycle.

Many small companies get an extra benefit because they tend to have more floating-rate debt than their larger peers—meaning that rate cuts directly lower their borrowing costs. As a result, the Russell 2000 index of small and medium-size businesses has often outperformed the S&P 500 after the Fed starts cutting rates. ...

The Intelligent Investor

Solving the Mystery of an Investment That's Too Good to Be True

Chasing the promise of a 17.1% return reveals nonexistent companies, illusory returns and unlicensed salespeople making absurd claims

By Jason Zweig
Sept. 20, 2024

Until you try to solve a financial puzzle, you never know how many levels it can have.

In a column published Aug. 30, I highlighted a peculiar investment called the Mega High-Yield Term Deposit, which claimed to offer up to a 15% guaranteed annual return for 10 years.

With the Federal Reserve's rate cut on investors' minds, high returns have become even more tempting than usual, so I dug in to see if the investment could possibly make sense. It didn't—and what I've learned in the ensuing weeks is even crazier. It's a tale of nonexistent companies, illusory returns and unlicensed salespeople making absurd claims.

The Mega, or Odyssey, "term deposits" were described on several websites whose logos and names invoked Yield Wealth and Yield BNK, startups launched by Kenneth Boyle of Duluth, Ga.

Boyle dissolved the Yield entities and took their websites offline at the beginning of this month, after my column was published. Nevertheless, these ultra-high-income investments are still being marketed widely—even though Yield no longer exists.

Searching for Yield

This week, YieldWealthManagement.com was still promoting "Colossal Yields – Without the risk," with "fully insured guaranteed" returns of up to 17.1%. The site claims to be for Yield Wealth Management LLC, "an SEC-regulated wealth management firm."

This week, YieldWealthManagement.com featured investments offering "Colossal Yields – Without the risk," including this product.

The Securities and Exchange Commission's public database of registered investment-advisory firms has no listing for Yield Wealth Management LLC.

Boyle says he withdrew the SEC registration for his firm, whose full name was Yield Wealth Ltd., earlier this month; the regulator's website for financial advisers confirms that the registration was terminated on Sept. 5.

Nevertheless, insurance agents are telling investors the Yield products are still available, trumpeting risk-free returns of 10.5% and up.

This week, YieldWealthManagement.com featured investments offering “Colossal Yields – Without the risk,” including this product.

One seller shared with me screenshots of what he described as an online sales leaderboard for the products. The screenshots show that at least 49 salespeople have collectively sold no less than $59.1 million of the high-yield products in 2024.

One salesman, an insurance agent in Nebraska named Sean Privitera, emailed a Wall Street Journal reader about the “Yield Term Deposit” on Sept. 13, eight days after Yield Wealth Ltd. had ceased to exist.

It said in part: “Here’s the email that I usually send out it’s got all the Documents you would need below As well as the sign up form if you want to get rolling on your initial investment! ….10 Year 10.5% compounding interest for a total of 2.7x. if you leave the interest in for the full term….Fully insured for principal & interest up to $10MM per account….”

The Journal reader says Privitera told him over the phone that he’s sold $2 million worth of the investment.

Privitera didn’t respond to my requests for comment.

The email he sent the Journal reader, however, linked to a form that Yield’s term-deposit entity had filed months ago with the SEC, as well as to an old Yield private-placement memorandum, or offering document.

Such products generally can be marketed to the public only by people who are licensed to sell securities.

Most of the nearly two dozen people I’ve identified from the sales leaderboard don’t have securities licenses. Nor does Privitera.

An Obamacare investment?

Many of the sellers, according to two I’ve interviewed, are deeply in debt and desperate to earn high commissions so they can get themselves back in the black.

One insurance agent told me he earned commissions between 9% and 12% on these products and that some agents may have earned up to 21%.

Another told me he has sold about $2.4 million of the product this year. It “acts a lot like a [bank] CD does,” he said, largely because it is “backed up by Lloyd’s of London.”

He said the investment produces its 15% returns partly because it is “the biggest purchaser of Obamacare policies…. What happens is, you buy a policy from the government, and they pay a certain percent every day, and it breaks even after seven weeks.”

The returns can hit 17.14% annually, he told me, if you leave all your money in for 10 years.

Is it “a lot like” a bank certificate of deposit? CDs are insured by the Federal Deposit Insurance Corp., a U.S. government guarantee. These so-called term deposits, on the other hand, aren’t even deposits; their offering documents call them limited partnership units, which can’t be traded and are subject to an early-withdrawal penalty of at least 10%.

Is it “backed up” by Lloyd’s of London? Lloyd’s doesn’t comment on policies or policyholders, but the original Yield disclosure document warned that “this offering is speculative and involves a high degree of risk,” including the possibility of “total loss.”

It isn’t likely that any insurer would agree to guarantee 15% annual returns on a speculative asset that carries a high risk of total loss.

Does this investment buy Obamacare policies? A spokesperson for the Department of Health and Human Services, which administers the insurance marketplaces created for individuals and small businesses under the Affordable Care Act, says Obamacare coverage can’t be traded by third parties. The U.S. government doesn’t sell or repurchase ACA insurance coverage.

The next level

The driving force behind all this appears to be Paul Regan, head of Next Level Holdings, which says it’s headquartered in Miami with an office in Medellín, Colombia.

Earlier this year, investment bankers introduced Yield to Michael McAlpin, managing partner of Intellicapital Advisors in Ponte Vedra Beach, Fla., as a possible business partner. Regan represented Yield in the negotiations; Kenneth Boyle’s name never even came up.

On a video call from what McAlpin says appeared to be an impressive “megastructure house” in Colombia, Regan told him that a network of 584 salespeople, most of them not securities-licensed, would sell the Yield products. Suspicious, McAlpin called off the possible merger in August.

Regan’s Next Level has been offering investments that supposedly produce 15% annual returns. These appear to be what the salespeople are calling the “Yield term deposits.” Next Level’s website described them with the identical words and punctuation as a brochure for the aborted Yield offering: “while our investors are enjoying these index crushing returns; they remain protected under the blanket of full Insurance Protection!”

Last year, Next Level announced “absolute return hedge funds backed by dedicated insurance policies from top-rated insurance carriers” claiming to offer “iron-clad guarantees” of 24% annual returns.

Regan has said he produces these stupendous returns partly by capturing differences in the price of gold across global markets.

Is that credible?

According to the World Gold Council, trading volume in global gold markets averaged nearly $163 billion a day in 2023. That makes it unlikely that meaningful pricing differences can persist. Since 1971, gold has returned an average of 8.25% annually.

Regan’s claims of glittering performance also seem tarnished by his previously hidden past.

Under the name Henry Paul Regan Jr., he was barred from the securities industry for life in 2004 for failing to respond to inquiries from what is now known as the Financial Industry Regulatory Authority, which oversees the brokerage business.

In 2005, Henry Paul Regan Jr. was fined $60,000 by Oregon state securities regulators for allegedly stealing more than $140,000 from an elderly customer with dementia. He also allegedly forged documents, including the signature of the client's dead wife.

Regan never disputed those findings, nor did he ever pay the fine, according to a spokesman for the Oregon Division of Financial Regulation.

Regan also falsely claimed in his LinkedIn profile, since removed, that he had worked at Goldman Sachs.

Regan initially emailed me that "you most definitely do not have your facts straight." But in a later email for my Aug. 30 column he "regretfully" confirmed that he was Henry Paul Regan Jr., adding that "I deeply regret my past." He said Boyle, Yield and even his own company, Next Level Holdings, had previously been unaware of his infractions.

This week, Regan didn't return calls or reply to my emails, which included detailed questions.

But he seems to have exploited Yield and Kenneth Boyle, using them as a front to legitimize what may be an illegal, and is surely an unethical, investment scheme.

'Nefarious purposes'

As of Sept. 17, YieldWealthManagement.com said Yield Wealth Management LLC is an "SEC-regulated" firm that uses Charles Schwab as custodian for the safekeeping of its customers' assets.

Not only is there no record of an SEC registration for Yield Wealth Management LLC, but a spokesperson for Schwab says it has no custodial relationship with any firm by that name. On Sept. 18, the references to Schwab disappeared.

Boyle, a software developer with no experience as an investment manager, says he has nothing to do with Yield Wealth Management LLC or its website. He says his former firms, Yield Wealth Ltd. and Yield BNK, never took in any money from any high-income offerings, which he suspended before ever launching them.

He told me on Sept. 13, "any marketing, communication, or selling of Yield proposed products were done without Yield's or my consent and thus done illegally."

He added last weekend, "If they find victims that were defrauded of money or who lost investment, it will be clear that no funds were ever sent to Yield Wealth Ltd."

Boyle said regulators should follow the money that investors have sent "to the company that's essentially stolen the brand I created and is using it for nefarious purposes. I sincerely hope they find the individuals responsible."

Follow-ups

We repeatedly warned against buying Trump Media (DJT), which closed today at 16.16, down 72 % from its close on its first day of trading. Now here he goes again, as reported by the WSJ on 9/20:

Q: What does Trump's promotion of crypto mean for his candidacy?

In recent years, Donald Trump has shifted his stance on crypto. Now he wants to be the crypto president. WSJ's Vicky Ge Huang spoke to us about his newfound support of digital currencies and what it means as he makes another run for the White House.

A: “Just a few years ago, Donald Trump dismissed bitcoin as ‘based on thin air’ and called it a ‘scam against the dollar.’ These days, he’s telling crowds that he wants to make the U.S. the ‘world capital for crypto and bitcoin.’

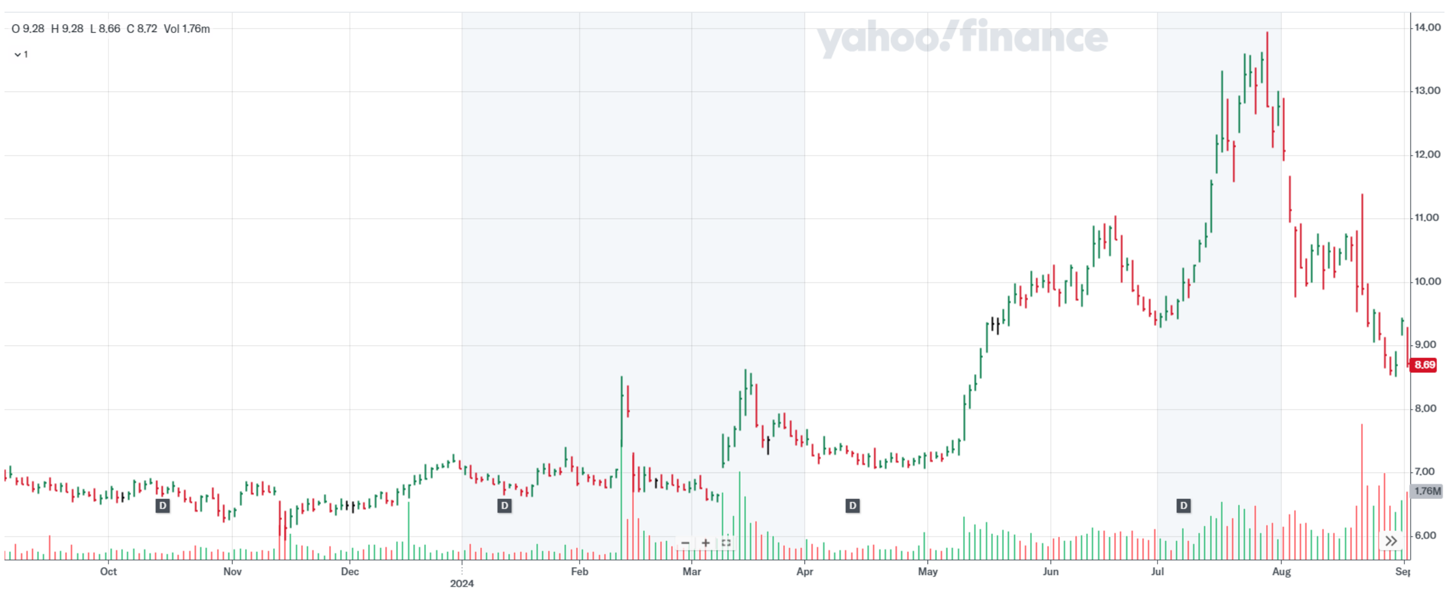
The Republican presidential candidate’s pivot to embracing crypto came after he saw an opportunity to make money off non-fungible tokens, crypto’s version of trading cards. During a livestream on the social-media site X on Monday evening, Trump said his children Donald Trump Jr., Eric Trump and Barron Trump also opened his eyes to the niche asset.

The event was for the launch of his latest crypto venture, World Liberty Financial, which said it wants to ‘make crypto and America great by driving the mass adoption of stablecoins and decentralized finance.’ The team behind the crypto business, including Trump’s two elder sons, hasn’t shared details about how it will work. But they did say it would sell and distribute a token to wealthy investors who meet certain income and net-worth criteria.

The Trumps’ potential involvement in a digital currency would create a new swath of conflicts of interest for the former president if he is re-elected in November. He has been courting the money and votes of the crypto industry, which hopes to see favorable legislation for the space passed under a new administration.”

Positions

IMMR - We added 2% positions in this Application Software IVA System pick for 4 clients on 9/3 @ 8.86:



Insider Buying:

Trade Date	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)
08/28/2024	2	Wasch Frederick, Martin Wil...		6,155
08/27/2024	2	Singer Eric, Martin William		65,000