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Doll's Deliberations

Weekly Investment Commentary

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No Recession So Far

Why has recession not happened? After all, the Fed raised rates the most and fastest in modern history, the yield curve inverted, and money growth turned negative. That severely curtailed bank lending, as it normally does. So where did the money come from to sustain economic growth?

Fiscal stimulus and excess savings from the pandemic are certainly part of the answer. On top of that - and unique to this cycle - was the private credit spigot (which grew from zero to nearly $2 trillion over the last decade, with nearly half of that growth coming in the last couple of years). So does that just postpone a recession or avert a recession? Given the deterioration in leading indicators for the labor market (e.g., antiquated and therefore delayed data from the household survey – look at the significant negative jobs revisions in recent labor data, the NFIB hiring plans index deteriorating, and the decline in the Conference Board Employment Trends Index), our view is just a postponement of a recession. So far, the service portion of the economy has held up well.

What, Me Worry?

Solid U.S. economic growth, an improving global backdrop and high expectations for approaching policy rate cuts are sustaining the risk-on phase and spurring pockets of speculative fever. Hopes for a Goldilocks outcome will persist until an economic roadblock emerges. Global risk asset markets have soared this year, underscoring that liquidity conditions are still plentiful. The euphoria is likely only to end after bond yields resume their uptrend or economic/earnings growth disappoints.

It is becoming clear that monetary conditions are not as restrictive as the largest and fastest Fed increase in rates in modern history suggests, and thus the global economic expansion continues. Consequently, inflation will likely remain a cyclical, and probably a longer-term threat. Consistent with the broadening in the global equity market rally, there has also been a tightening in credit spreads around the globe. While the supply of debt continues to run at a historically rapid pace, demand has also been strong.

The hunt for higher yields has continued even though government bond yields have risen significantly in recent years. Importantly, default fears are running low because solid corporate profitability has persisted, encouraging investors to take credit risk. Positive profit trends have, in turn, sustained historically elevated hiring plans.

While U.S. equities have continued to lead the charge higher since troughing in October, other geographies are starting to catch up and hit new highs. In relative terms, the U.S. is still formidable, although some foreign markets are starting to match the U.S., notably the euro area and Japan. The global equity rally should broaden for the near-term future, as investors have become less fearful of a global recession. A rotation into select laggards is under way both within the U.S. equity market and globally, as investors seek better value and less downside potential.

Higher Rates and Good Economy *or* Lower Rates and Earnings Disappointments

A potential investment challenge ahead will be a sustained rise in bond yields and thus a less positive backdrop for risk asset markets. Fed indifference towards the escalating asset inflation backdrop has been somewhat surprising, and, therefore, the path of least resistance is rising risk asset prices. The other "extreme" would be a noticeable slowing in economic growth creating earnings shortfalls.

The U.S. consumer remains in solid shape, with remarkably little damage from the Fed's rate-hiking cycle. While surveys claim that consumers are worried about the future, this reflects non-economic and non-interest rate factors. Current consumer sentiment is historically upbeat as are employment conditions and job security. The rise in U.S. household's debt-servicing burdens has begun but has only been modest due to the large number of borrowers who locked in low borrowing rates when money was "cheap." There is a high hope/expectation that borrowing rates will soon be lowered, which has helped to sustain spending. We disagree with this interest rate forecast, but for now we would continue to bet on above-trend U.S. economic growth. There is not a lot of evidence that the economy is in need of interest rate relief.

While the inflation rate has decelerated in the past year, as the one-off price spikes that occurred during the post-pandemic period have unwound, it is still a challenge to determine what the underlying rate of inflation will be when the dust settles - and, of course, much will depend on the state of the global economic expansion going forward. We remain of the view that the underlying run-rate of DM inflation will be higher than was the case last decade. In fairness, this is not a high bar since last decade's prolonged deleveraging phase in the U.S. and euro area kept growth weak, and, therefore, inflation stayed depressed.

Inflation Remains Key

Most likely, the U.S. will have a somewhat higher inflation rate than elsewhere, since its economy has grown much more rapidly in recent years (and likely again this year). While all the major central banks have a 2% inflation target, the global inflation backdrop will be different among the major economies. The U.S. might average 3% in the next decade, compared with 2% in the 2010s. The euro area could average 2% for the next decade, compared with about 1% in the 2010s. Japan might even average 1% over the next decade, compared with about zero in the 2010s. Therefore, it is likely that interest rates in developed economies will need to be higher than last decade to contain inflation.

Conclusions

Multiple expansion has been the source of market appreciation (+28%) since the October stock market low as earnings estimates have hardly changed (P/E: 17x → 21.5). Future upward moves in stocks will probably require rising earnings estimates (which are already +11% for 2024 and +13% for 2025).

1. The bid under U.S. stocks will persist for as long as the economy/earnings are okay and bond yields don't rise in a disorderly manner. Having said that, high valuations are increasing risk levels.

2. High valuation and narrow corporate bond spreads suggest that monetary policy is not restrictive.

3. Earnings growth should broaden (as should the market), but growth expectations are full/excessive.

4. Inflation will remain sticky.

5. Outside the U.S., economies are picking up from recessionary or near-recessionary levels.

6. Global trade will pick up cyclically, even as the secular decline in globalization continues.

7. The dollar is likely to weaken as U.S. slows some and non-U.S. economies recover.

We are in a high-risk, highly valued bull market driven by momentum. Predicting the end of a momentum run is a fool's game. Equity investors should focus on earning predictability, earnings persistence, and good cash flow generation in equity selection.

- "Inflation is sticky; markets disagree or don't care."
  – Nancy Lazar, March 2024

- "Prices reflect near perfection, yet today's world is particularly imperfect and dangerous."
  – Jeremy Grantham, March 2024

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