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Will it be a hard landing, a soft landing, a bumpy landing, or no landing?

3Q Review

U.S. equities rose again in Q3 for the fourth consecutive quarter (S&P 500 +5.5%, NASDAQ +2.6%, and Russell 2000 +8.9%). The S&P 500 hit all-time highs in mid-July, but slid in early August, rallying steadily for much of the rest of the quarter and finishing not far from new record levels. The equal-weight S&P 500 (+9.1%) fared better than the cap-weighted index, as some megacaps pared strong year-to-date gains. While 2Q24 was characterized by narrow market leadership and a hawkish repricing of Fed rate-cut expectations, 3Q saw solid performance from a wider spectrum of companies and increasing expectations for rate cuts in 2024. Behind this shift was a firming of expectations for an economic soft landing and a distinctly dovish Fed pivot that has the market now looking for ~100 bp in total Fed policy easing this year. There was a lot of concern on the jobs front after July nonfarm payrolls printed well below consensus, while the rising unemployment rate triggered the recession-forecasting Sahm Rule. S&P 500 companies saw 11.3% y/y earnings growth for 2Q, the highest level since 4Q21. Analysts are expecting S&P 3Q earnings to remain positive but only at a 4.3% y/y pace. The bull case remains founded on the Fed's continuing to ease, disinflation traction, a stable (if slowing) labor market, still-healthy consumer spending, continued earnings growth prospects, and the ongoing AI secular growth theme. Bears are focused on a weakening world economy, valuations remaining extremely high, consumer confidence fraying, and some worries about when the trend might flip from slower hiring to outright downsizing. Best sectors were Utilities (+18.5%), Real Estate (+16.3%), and Industrials (+11.2%); worst sectors were Energy (-3.1%), Communication Services (+1.4%), and Technology (+1.4%).

Recent developments

- The Fed's 50 bp rate cut has modestly increased the odds of a soft landing. However, our mainline scenario remains a significant economic slowdown or mild recession.
- Labor market conditions continue to deteriorate and credit growth remains weak. That underscores that monetary policy is tight and will remain so for a time even as the Fed cuts rates.
- The Fed has modestly raised the odds that disinflation will end or that inflation will, in fact, reaccelerate.
- The end of disinflation or the reacceleration of inflation would probably prove to be problematic for financial markets.
- China's policymakers have instituted significant measures to fight impending deflation.

Central banks, economies, and inflation

Central banks in the developed markets (excluding Japan) and China are providing monetary reflation to stimulate their economies. Under the impression that consumer price inflation is well-contained, DM policymakers are lowering interest rates to boost domestic growth conditions. This comes at a time when corporate profit growth is accelerating across the globe, rather than decelerating, and companies continue to enjoy historically wide profit margins. Effectively, central banks are acting in a way to significantly extend the Goldilocks environment for risk assets.

The world economy has been characterized by a strong U.S. expansion and sluggish growth conditions elsewhere, particularly in the euro area and China. Investors have worried in recent months that the primary growth engine (the U.S. economy) was deteriorating in response to "very restrictive" monetary policy, which Fed Chair Powell has asserted to be the case.

The U.S. economy is expanding at a pace above its long-term potential growth rate, and higher-frequency indicators are pointing to solid, rather than weaker, growth ahead. The central bank has pointed to a higher unemployment rate as justification for rate cuts. Employment demand has softened and consumers are reporting that jobs are now less plentiful, but there have been limited layoffs, in part due to solid corporate revenues and profits. Regardless, monetary policy is now easing even though there is limited evidence that it had been a major drag for the U.S. economy.

In contrast, the euro area economy has remained soft and continues to disappoint, albeit it is not recessionary as widely feared. The slump in global manufacturing and lack of a vibrant upswing in trade has undermined the German economy.

China policymakers substantially increased their monetary stimulus efforts, which was clearly supportive of risk-taking. Notable items included a large and potentially unlimited fund to finance direct purchases of Chinese stocks, and aggressive measures to reduce mortgage payments on all existing mortgage loans as well as easing downpayment requirements for second homebuyers. These measures are unlikely to provide a material boost for the domestic economy, but they take a sizable step in alleviating downside asset price risks and policy-related investor anxieties.

In short, global monetary conditions have not been restrictive as generally believed, nor posed a credible recessionary threat for the U.S. and global economy. Nonetheless, the major central banks are determined to remove any potential headwinds for economic growth. This is a clear ongoing endorsement for greater asset inflation, especially equities and corporate credit, as well as housing markets provided some other non-monetary force does not curb growth, such as a dramatic escalation in geopolitical tensions or another trade war following the U.S. election.

A significant caveat is that while many developed market central banks are determined to ease policy, sticky inflation will ultimately prevent deep rate cuts from extending throughout 2025 as is currently expected by the forward markets. The consensus appears to have utmost confidence that all roads will eventually lead back to inflation averaging near 2%. However, this view fails to recognize that the pre-pandemic era of low and stable inflation was created by a huge increase in globalization, a technology revolution, massive economic slack, and dramatic deleveraging drags in the U.S. and Europe. These dampening forces no longer exist, or at least not at the same intensity.

The possibility of inflation resurfacing or even holding well above the Fed's 2% target remains one of the most non-consensus views in the markets today. Yet pandemic-related distortions have already unwound, and the U.S. economy has limited slack. The euro area has more economic slack after the past two years of expanding below the longer-term potential growth rate, but this will be insufficient to return underlying consumer price inflation sustainably to 2%.

Putting it all together

Any caution toward equities has admittedly been wrong or at least premature. The onset of economic weakness/recession has been delayed by the deployment of a historically large stock of excess savings. To a lesser extent, stimulative fiscal policy and locked-in low mortgage rates for many U.S. homeowners contributed as well, but the spending of ample excess savings was the main reason why the U.S. has avoided a recession. Recent government revisions (rarely important but also rarely of this magnitude) have certainly delayed any economic weakness. (The BEA's comprehensive annual update showed that the U.S. savings rate is meaningfully higher than previously thought due to higher income growth. This is a positive in the sense that households have had access to more income than we previously knew.) Excess savings have likely been nearly depleted, and labor market weakness is now apparent.

Labor market conditions continue to deteriorate:

1. The private sector quits rate continues to decline and has now returned to late-2016 levels.
2. The number of Americans only able to find part-time work is rising.
3. The breadth of nonfarm payroll growth has also slowed significantly.

More bullish interpretations include:

1. There is evidence of weakening labor demand, which is why the Fed was justified in moving forcefully.
2. The Fed is, in fact, behind the curve, and that is why significantly more easing is likely to come soon.
3. The Fed's recognition of the slowdown in the labor market and its determination to prevent further weakness is the reason that a soft landing is likely to occur.

We disagree that the job of bringing inflation back to target levels is complete, and thus the Fed's actions have modestly raised the odds that disinflation will end or that inflation will, in fact, reaccelerate. We do not dispute that inflation is trending lower, and that the Fed has succeeded in bringing inflation down significantly from its post-pandemic highs. We dispute the assumption that this will necessarily continue even as the Fed is cutting rates aggressively.

Forward earnings expectations are elevated and are almost never this strong except during the early phase of an economic recovery following corporate tax cut legislation, or equity bubbles such as during the late-1990s.

The measures announced by China are likely to stabilize the credit impulse and prevent it from falling further, but it is far from clear that they will lead to a significant acceleration in credit growth. China's property market woes and ongoing liquidity trap point to monetary measures as "pushing on a string."

Conclusion

Our market assessment remains "a high-risk momentum-driven bull market," implying investors need to participate but also need to be extra judicious in equity selection, focusing primarily on earnings quality, earnings persistence, and strong free cash flow.

The wall of worry

1. Labor market deterioration.
2. Falling consumer confidence.
3. Falling consumer savings/rising consumer debt.
4. Yield curve normalizing after long inversion (often the sign of a recession).
5. Too-high earnings growth expectations (+10% in 2024; +15% in 2025; +12% in 2026).
6. High valuation levels.
7. Massive and rising federal debt/interest expense levels.
8. Very close election.
9. Rising geopolitical tensions.
10. Threat of trade wars.

The offsetting positives

1. Decline in inflation.
2. Central banks lowering rates.
3. Still good economic growth.
4. Strong earnings growth expectations.
5. AI/productivity.

Source: FactSet as of Oct. 4, 2024

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