Is Relief from High Interest Rates Near?

The U.S. economy is emerging from a period of record low unemployment and uncomfortably high inflation, due largely to government and Federal Reserve responses to the COVID recession of 2020. The responses at that time included massive fiscal stimulus resulting in federal deficits, and the Federal Reserve cutting interest rates to zero and increasing the size of its balance sheet, a process known as Quantitative Easing.

The country's abrupt transition from deep recession to V-shaped recovery followed by inflation, forced the Fed to reverse its policy of accommodation by implementing the most rapid series of interest rate hikes in more than 40 years. While the Fed has made significant progress in bringing inflation closer to its target rate, it has indicated in its public statements that more evidence of slowing inflation is necessary before it can ease its restrictive stance.

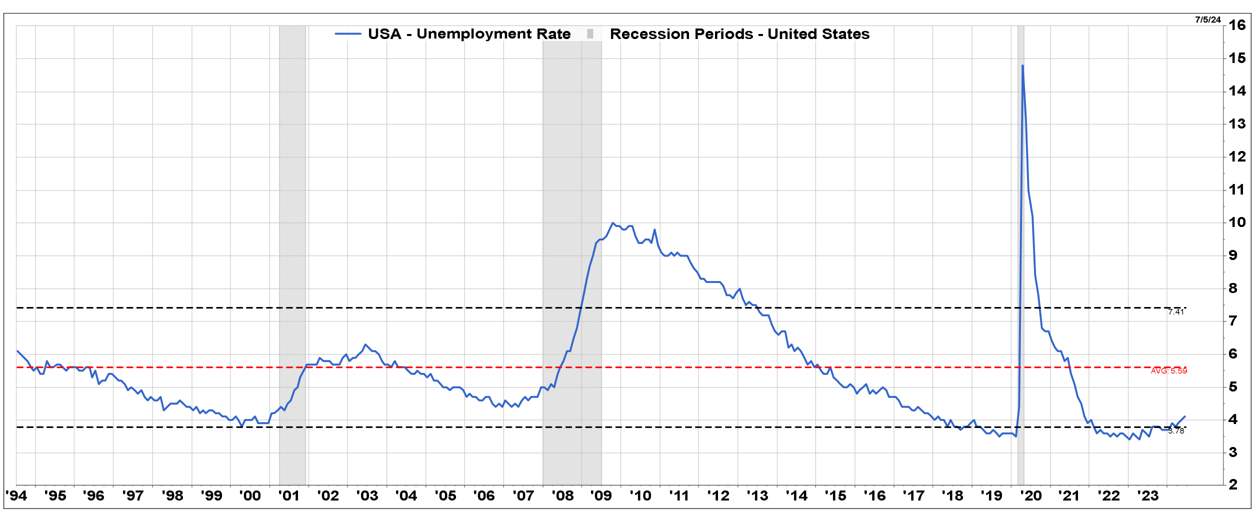
Chair Powell has recently said "We want to be more confident that inflation is moving sustainably down toward 2% before we start the process of reducing or loosening policy."

The Fed has repeatedly stated that its actions will be "data dependent", meaning that progress on containing inflation would need to be irrefutable. The Fed's goal is to not only to tamp down the inflationary fire, but also to douse any coals which might re-ignite inflation *expectations,* in order to avoid the stop-and-go economic and inflationary cycles which painfully marked the 1970s.

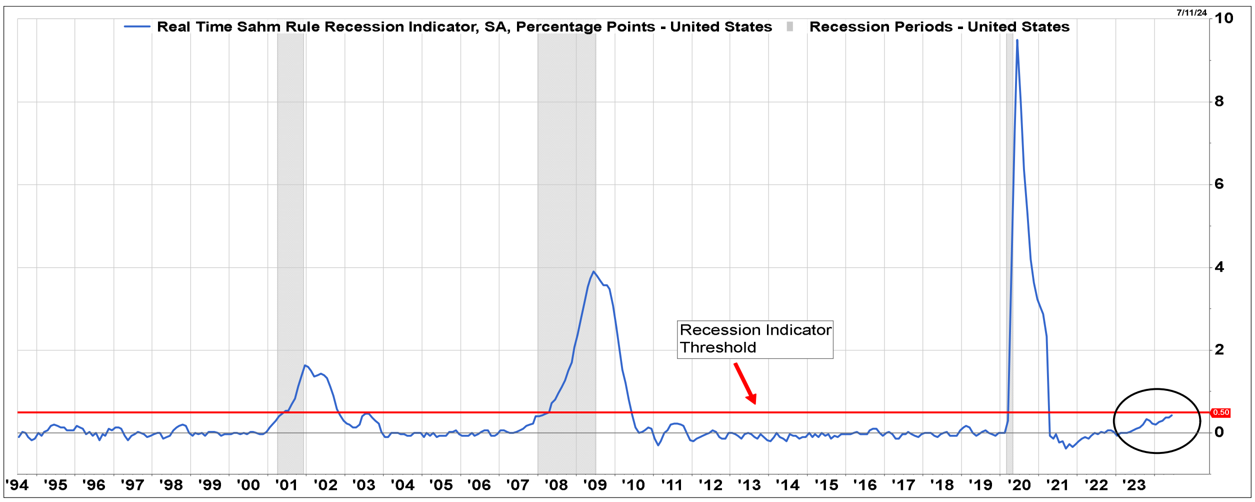
At this point, data does indicate some softening in the labor market and a continuing downward trend in inflation. Based on these trends, the market consensus now calls for an interest rate cut in September. However, real GDP growth accelerated in the 2nd quarter, raising the possibility that the consensus will be disappointed if the Fed points to continuing economic strength as a reason to leave rates unchanged.

Labor Market: Cooling, but Still Warm

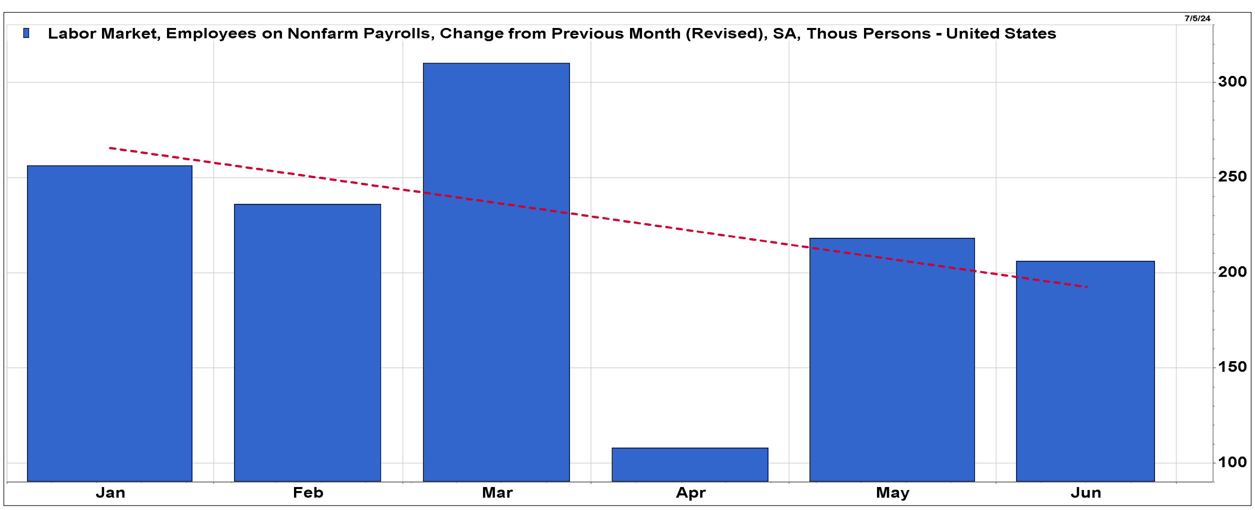
The unemployment rate for the month of June came in at 4.1%. On the surface, it would not seem to be a notable figure. However, a reading of 4.1% is well below the 30-year average unemployment rate and is still an outlier at one standard deviation below the average.



With no other context, it would seem that the labor market is healthy and comfortably at full employment. The area of concern stems from the steady upward movement in the unemployment rate from the current cycle's low of 3.4%. The significance of this increase is the potential violation of the so-called "Sahm Rule." Claudia Sahm, a former senior economist at the Federal Reserve Board of Governors, pioneered this measure which is regarded as one of the most accurate indicators of a recession. The rule postulates that there has never been an increase of more than 0.5% in the 3-month moving average of the unemployment rate over that same moving average 12-months prior, without a recession occurring. This is a somewhat different perspective because the rule does not focus on the absolute level of the unemployment rate, but instead focuses on the change in the rate. Basically, it measures not how good or bad things are, but how much worse they have gotten. In the context of the Sahm rule, the 4.1% unemployment rate is not as benign as it may seem. Compared to a year ago, the moving average has risen by 0.43%, and stands just 0.07% shy of the Sahm Rule threshold.



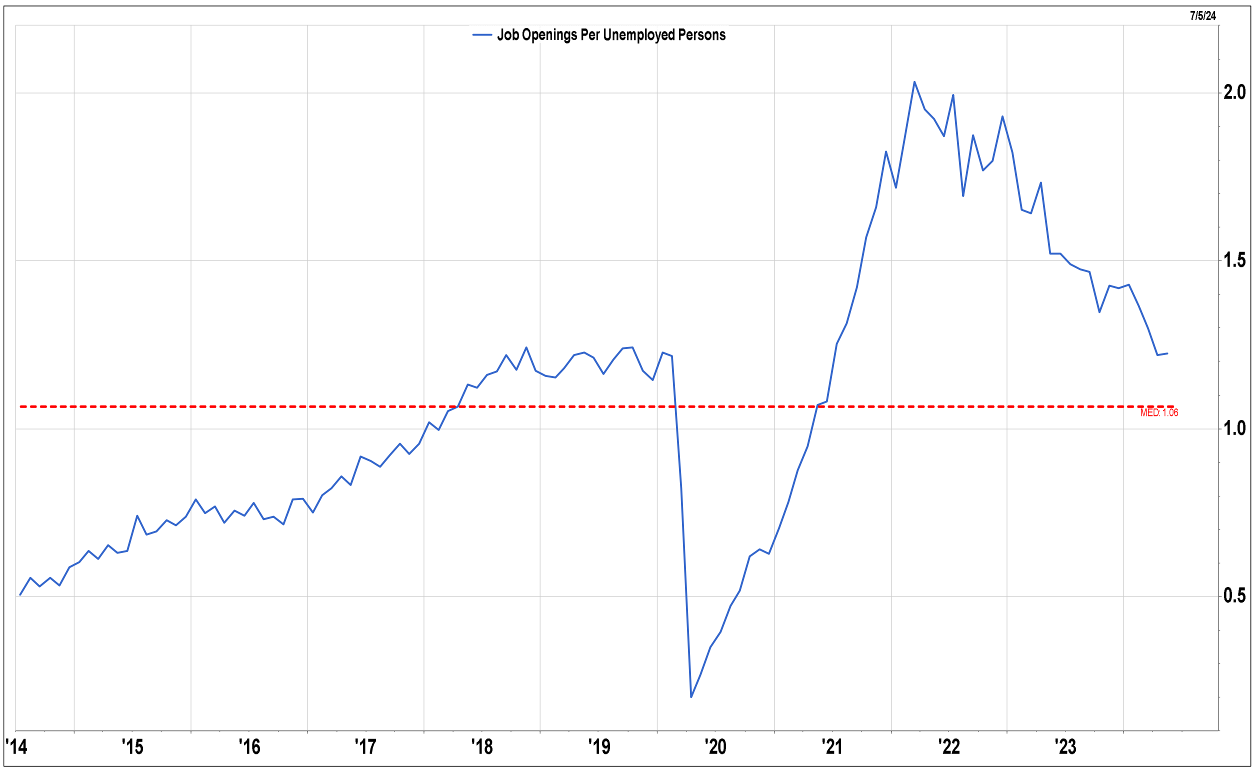
The pace at which the economy is adding new jobs has also been slowing, albeit from a fairly high level. In June, there were 206,000 new jobs added to nonfarm payrolls. This was down from the previous month's revised reading of 218,000 jobs.



In keeping theme with the unemployment rate, the absolute level of new jobs added is indicative of a strong labor market, but it is the *trend* in the pace of new jobs that is causing some angst.

For the first five months of the year, the initial reported new jobs figures were revised downward for four of those months, with aggregate downward revisions of 260,000 jobs. Only in March was there an upward revision, and it was marginal at 7,000 jobs. June's payroll figure has not had any revisions applied yet.

The ratio of job openings to unemployed persons has now declined to similar levels experienced before the pandemic. Currently, there are about 1.2 jobs available for every unemployed person. This is a far cry from the 2022 peak when there were more than two jobs available for every unemployed person, providing evidence that some balance has returned into the post-COVID labor market.

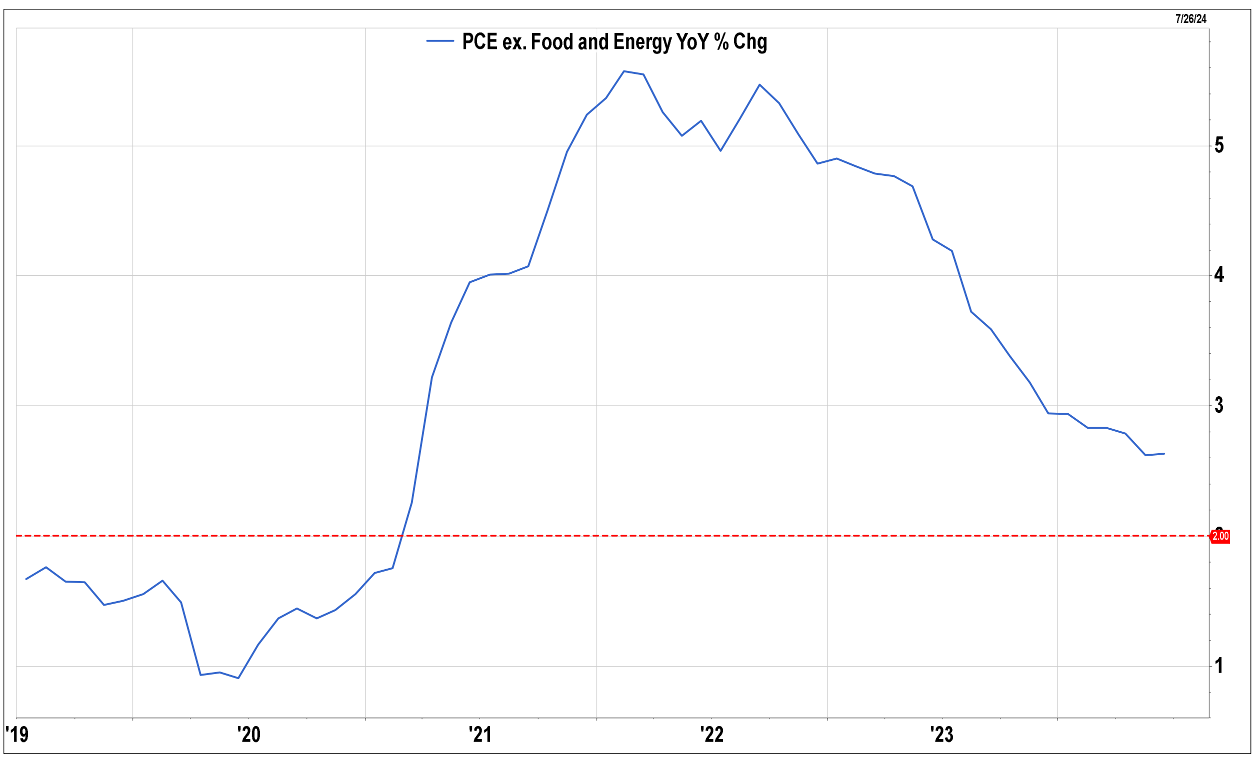


Both components of the ratio have shifted in moving the labor market back toward a more balanced state, with fewer jobs available and more people looking for work. In addition to the unemployment rate moving up, the number of job openings, as measured by the JOLTS data, has declined by about 750,000 jobs during the first half of the year. While a decline in the number of job openings and a rise in the unemployment rate may both seem negative, the Federal Reserve likely does not view it that way. A labor market with more slack has shifted some of the wage bargaining power away from workers. Wage inflation, measured by average hourly earnings, has handily outpaced core PCE inflation since the middle of 2021, much to the concern of the Fed. A high rate of wage inflation can become a self-fulfilling prophecy resulting in a wage-price spiral. As wages rise, employers raise the cost of their goods and services to maintain profitability. As the cost of goods and services rises (normal inflation), workers demand higher wages to maintain the real purchasing power of their wage. The potential that this type of scenario occurs is dissipating and the Fed can breathe a very small sigh of relief.

Inflation

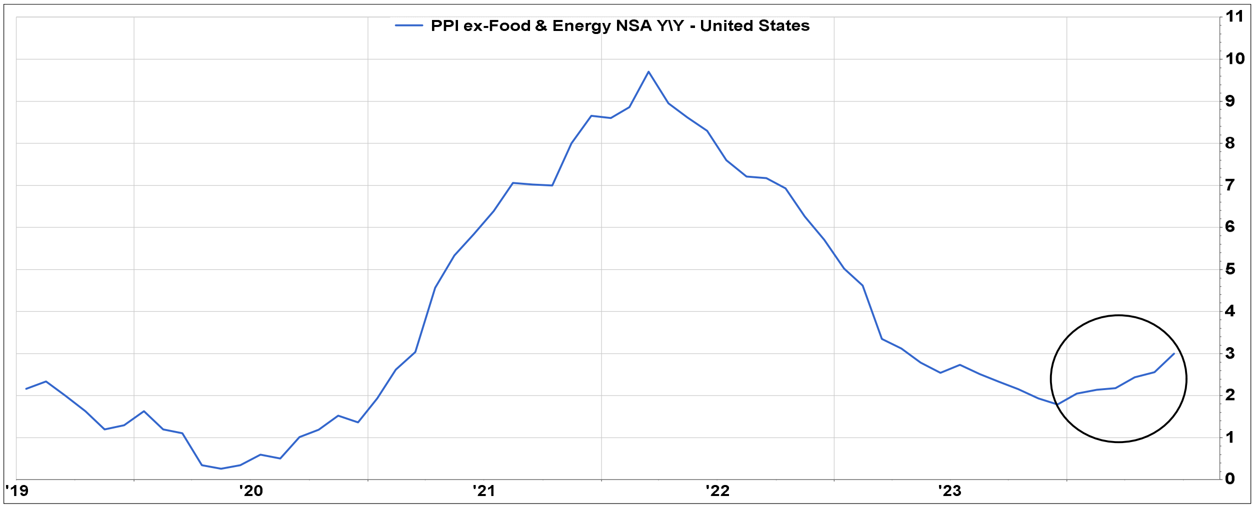
June's headline CPI report surprised on the downside with a month-over-month decline of 0.1%, compared with the forecasted increase of 0.1%. This decline brought the year-over-year headline inflation rate slightly below 3.0%, the first sub-3% reading since April of 2021. The Federal Reserve tends to focus its policy decisions on core inflation readings, which exclude the more volatile food and energy components of inflation. Core CPI increased by 0.1% in June, which was below the consensus estimate for a 0.2% increase. Core CPI on an annual basis has now declined to 3.3%. Again, this is the lowest core CPI print in more than three years.

While the media focuses on the CPI report, the Fed relies more on the Personal Consumption Expenditure (PCE) measures of inflation. It believes that PCE measures a more representative basket of goods and services and also captures changes in consumer behavior as a result of price increases. PCE is also not limited to prices paid in urban areas, unlike the CPI inflation series. The June Core PCE report came in at a 0.2% increase over the prior month, which was modestly above the consensus expectation. On an annualized basis, Core PCE effectively remained unchanged at 2.6%. Even though the inflation reading didn't offer the continued decline that was expected, the Fed has made considerable progress at slowing the pace of inflation back to their 2% target rate.



In the midst of the largely positive inflation data, there was one negative surprise. The core Producer Price Index (PPI) in June surprised to the upside with a month-over-month print of 0.4% compared with the expectation for a 0.2% increase. This follows the May Core PPI reading that was substantially lower than the consensus forecast. One negative (upward) surprise on an inflation print alone is not necessarily concerning, but it is the trend over time which is important.

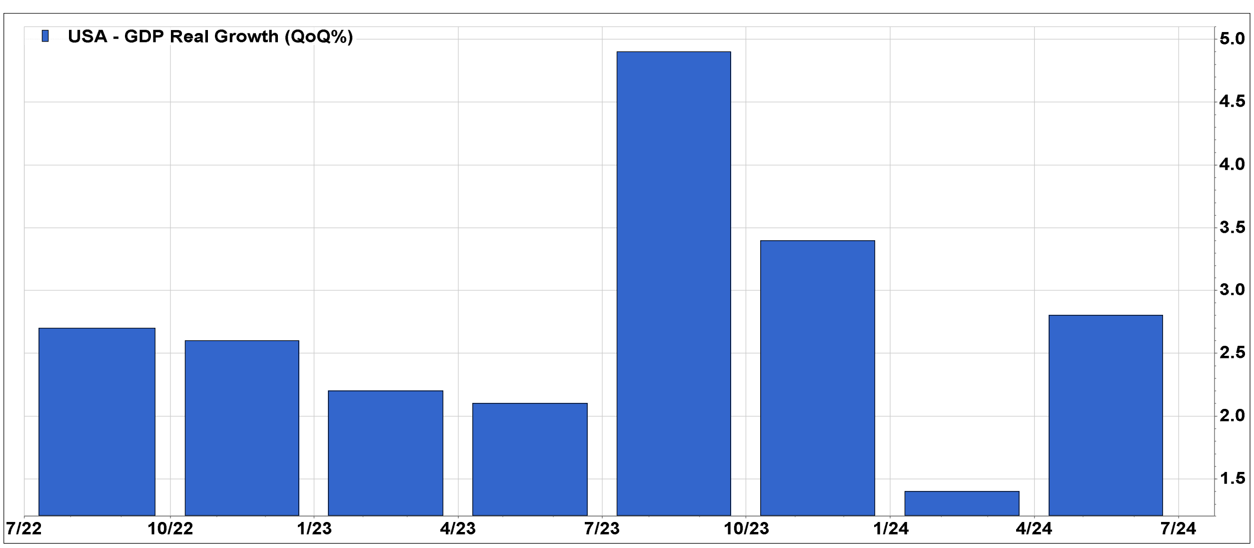
Core PPI has been steadily increasing since the December 2023 low of 1.8%. Some of this may be attributable to the base effect, where a tougher year-over-year comparison artificially puts upward pressure on the rate of change in producer prices.



Regardless of the exact reason, an increase in Core PPI gives some cause for concern. There is a school of thought that producer prices are a leading indicator of consumer prices. Producers will raise the cost of goods in response to the higher input costs that they are facing, and thus consumers will face a higher level of prices. This is referred to as cost-push inflation. While this intuitively makes sense, the relationship between consumer prices and producer prices are not always linked in a simple manner, due to business's ability or inability to pass on higher prices to consumers. Whether the relationship holds this time or not, the increase in core PPI is something that the Federal Reserve will be watching closely.

<u>Economic Growth Stronger than Expected</u>

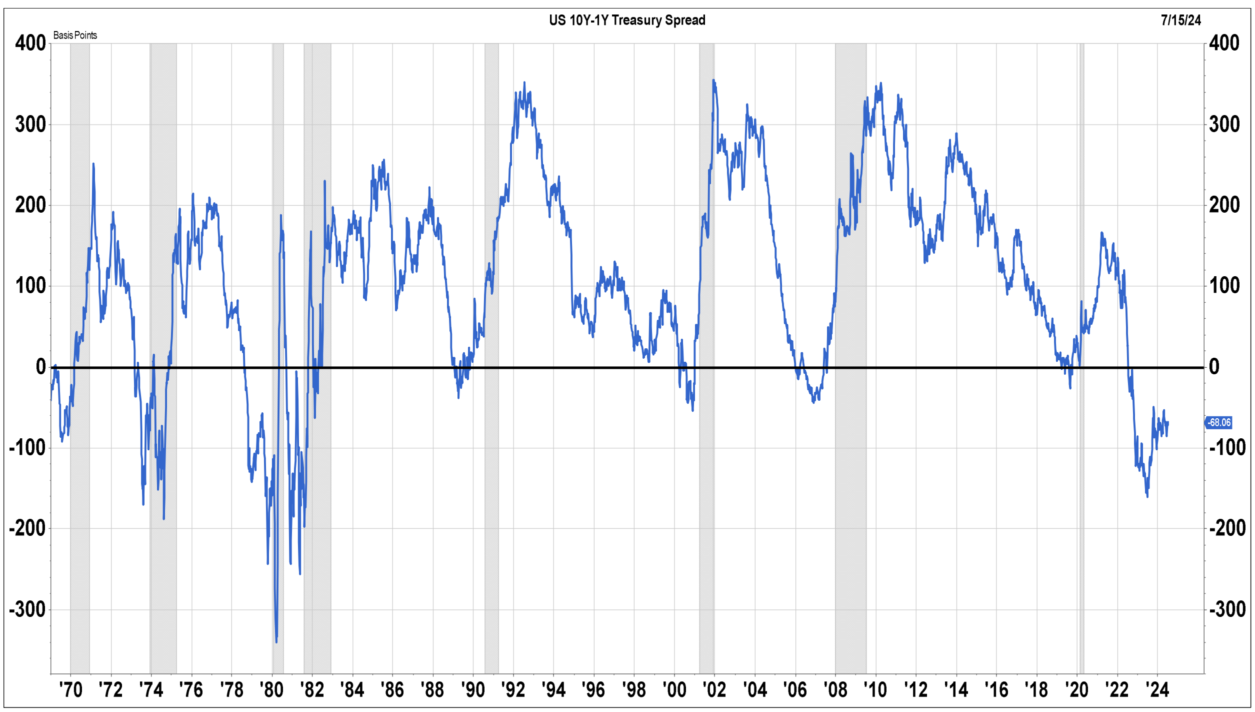
The preliminary second quarter real Gross Domestic Product (GDP) report showed the economy growing at a rate of 2.8%. This was a strong upside surprise compared to the consensus growth estimate of 1.9%. Not only was this ahead of expectations, it also signaled an acceleration in growth, compared with the prior quarter's result of 1.4%.



Strong personal consumption, especially in the durable goods segment, and private domestic investment propelled growth during the quarter. Imports, which are a detractor from GDP, grew at the fastest pace since the first quarter of 2022. The report indicated that consumers still have an appetite to spend, and businesses did not pull back on their investment activity. Not to take away from the significance of the report, but a word of caution is necessary. The GDP report is a backward-looking measure of economic activity, not a forecast of future growth. The leading economic indicators present a better picture of the path for future economic activity. The current strength in the economy, coupled with less favorable leading indicators, are adding a measure of uncertainty to the current investment landscape.

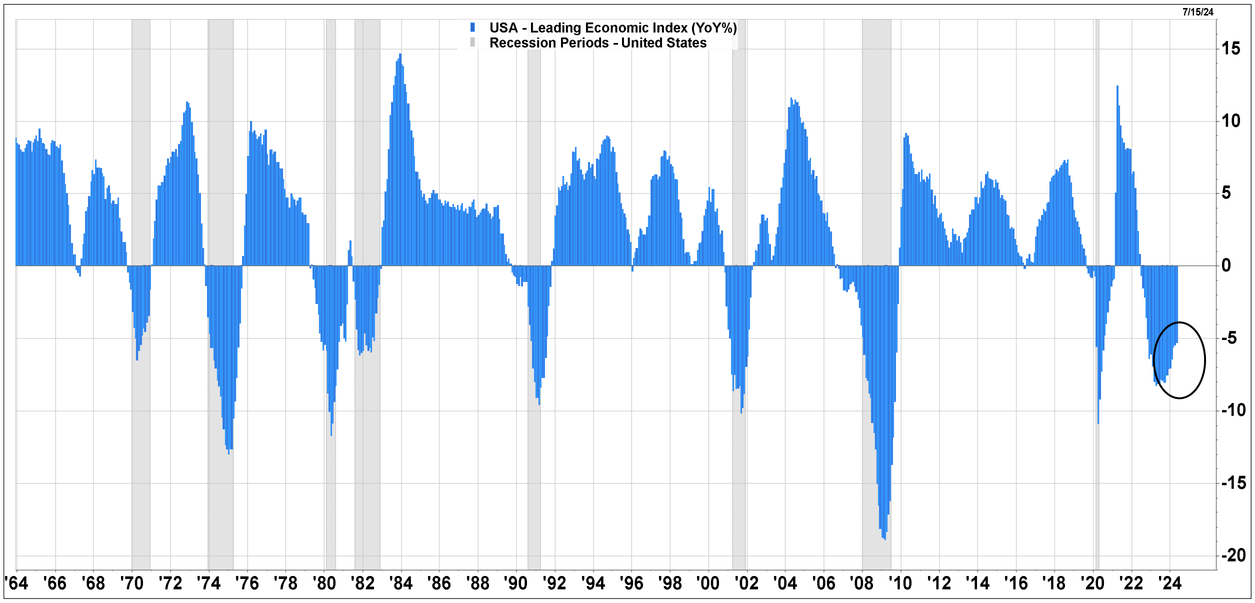
Economic Indicators

The indicator that has arguably had the most success in predicting the occurrence of a recession has been the inversion of the yield curve. Since 1970, there have been eight recessions that have occurred in the United States. Every one of these recessions occurred after the yield curve inverted. Even though the yield curve has had a perfect record of indicating an oncoming recession, timing the recession based on the inversion is difficult.



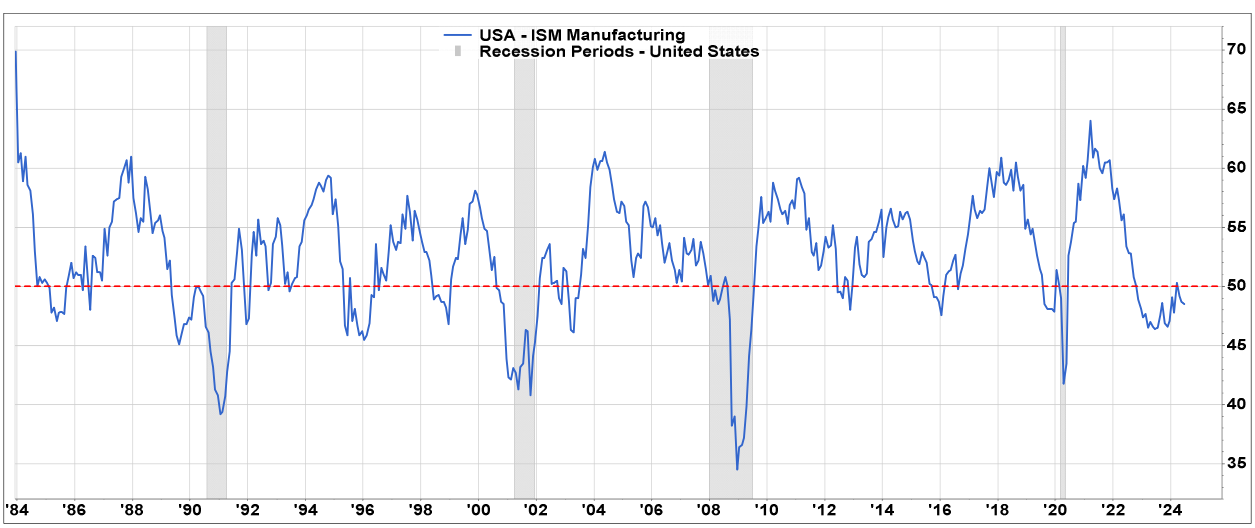
Historically, a recession has occurred within 6 to 24 months after the initial inversion, with an average timeline of about 12-13 months. The yield curve, using the 10-year and 1-year treasury spread, inverted on July 13th, 2022 during this current economic cycle, which means we are now *outside* of the historical range of when a recession should have occurred. While not to diminish the significance of violating this range, it is important to remember that this yield curve inversion happened during the largest fiscal and monetary stimulus in US history. Almost 30% of US GDP was passed in stimulus to support the economy during the COVID-19 shutdowns. If there ever was a case to be made that a potential recession would take longer to occur than historical norms would suggest, it is this time. And as we have said in past *Outlooks*, if longer goes on long enough, it becomes different.

The composite index of leading economic indicators (LEI) has also been signaling a potential recession since the middle of 2022. This index is made up of ten different components that are meant to be a broad sampling of the financial markets and economy. The financial components measure data points like stock prices, interest rate spreads, and a leading credit index. The non-financial components focus on consumer expectations, employment data, and manufacturing.

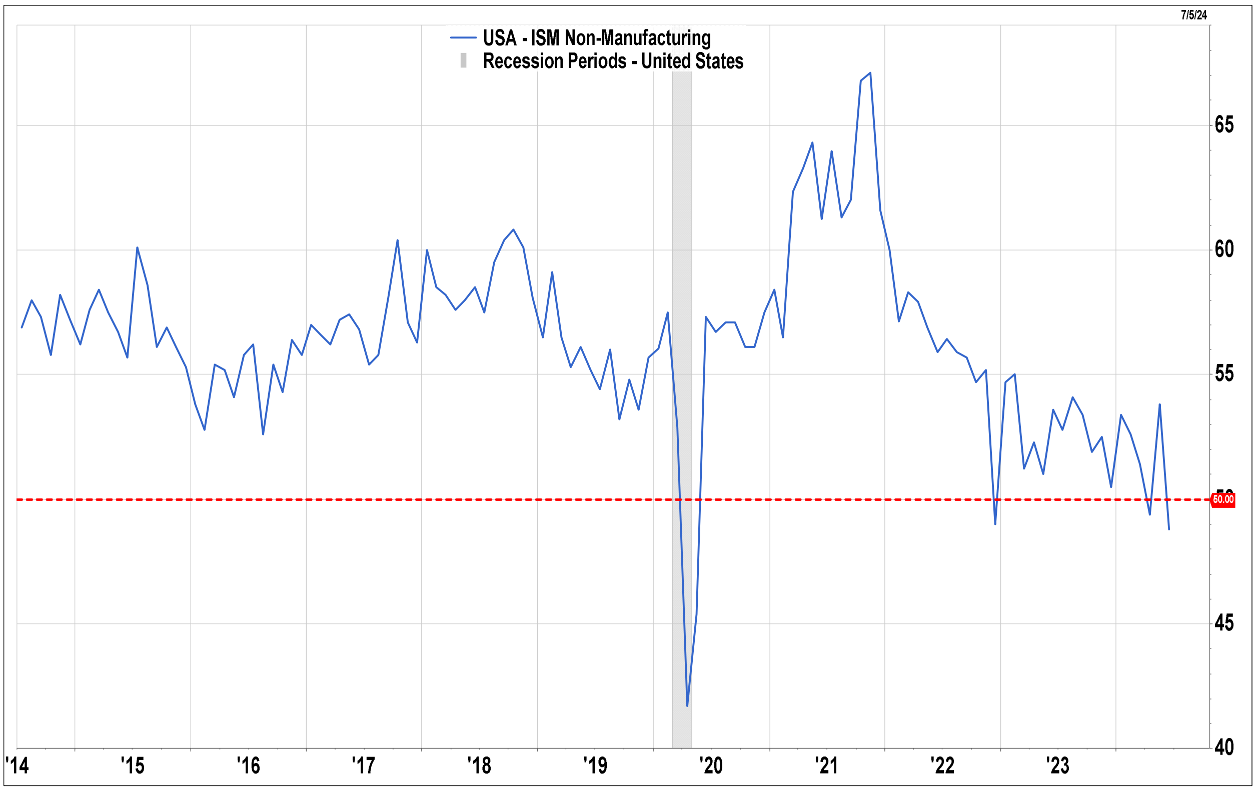


The LEI index has improved from its low point that occurred in April of 2023, but it remains negative. This is unique in that there has never been this significant of an improvement in the index before the onset of a recession. There was a mild improvement before the 2008 recession, but only by about 0.7%. Typically, there is no improvement in the index before an oncoming recession. The LEI index has improved by almost 3% during this current cycle, causing questions of whether the leading indicators have provided a false signal of a recession.

Historically, the Institute of Supply Management (ISM) Purchasing Managers Index (PMI) manufacturing survey data had strong predictive power about the future path of the economy. Readings on the survey that are below 50 indicates that the sector is declining, while above 50 indicates that the sector is expanding.



The ISM manufacturing data has remained below 50 in all but one month since October of 2022. The data had been improving, but the last several surveys have moved the index measurably below the 50 mark again. This is likely not as reliable of an indicator as it has been in the past. The manufacturing sector of the US economy has been steadily shrinking and is now dominated by the services sector, which makes up about 70% of the US economy. The services PMI data has largely held up better than the manufacturing data over the past several years. However, the June Services PMI came as a shock with a reading of 48.8 against the consensus of 53.8. This is the lowest reading since May of 2020.



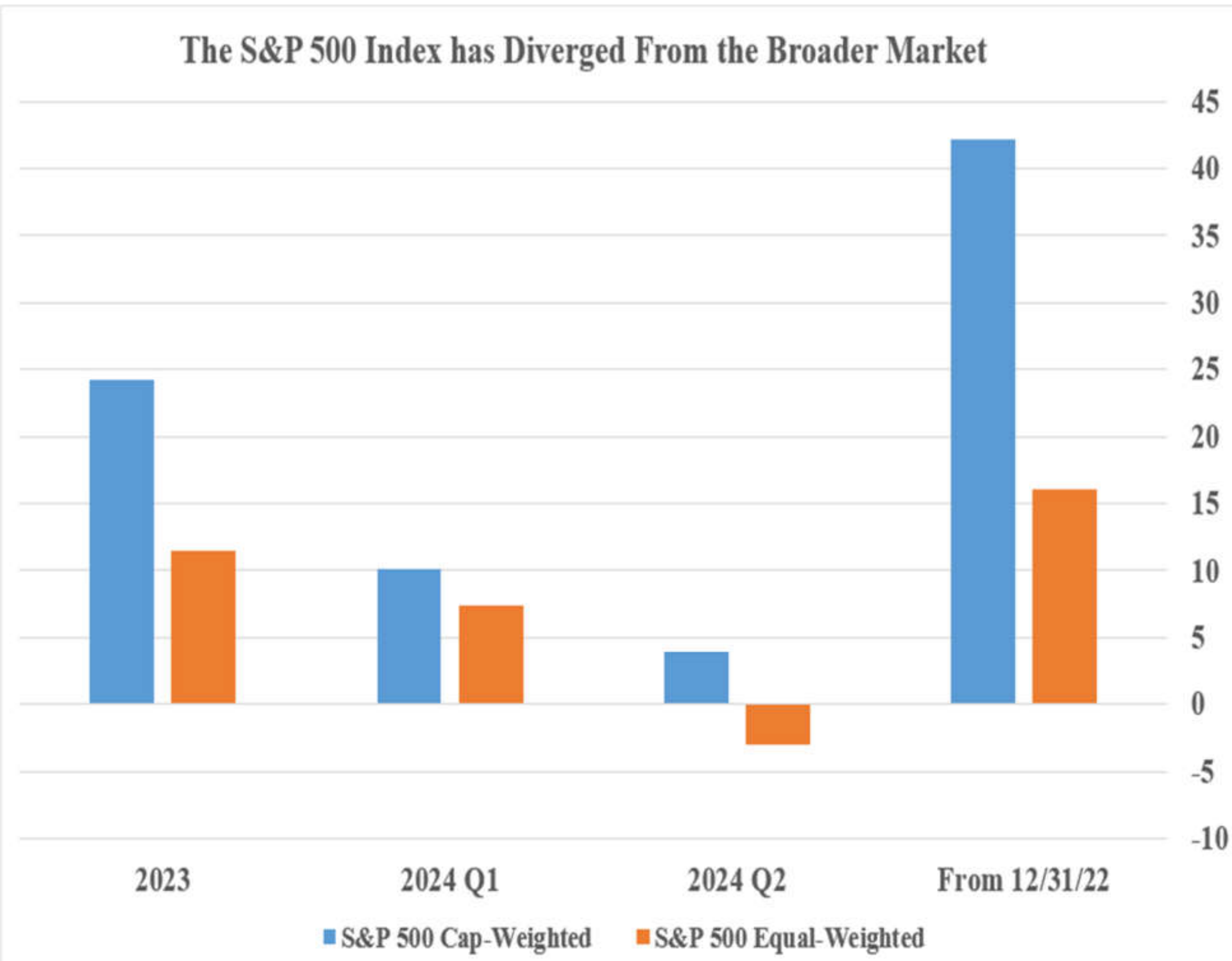
PMI data tends to be quite volatile from month to month, so this is another series where the trend overwhelms the importance of the individual data points. We have not seen a clear trend that the services sector is in a prolonged contraction that would be evidenced by multiple consecutive readings below 50. It is unlikely that a true recession will form without the service sector also declining, given its size relative to the total US economy.

When the employment, inflation, and economic indicators are viewed in their totality, the picture for the future path of the economy is somewhat unclear – as it often is. For any number of points that can be used as evidence to the strength of the economy, contra-indicators are also plentiful. The same data that is supporting the decline in inflation can also be an early sign that the economy is slowing. The softening of the labor market which the Federal Reserve needed to aid in lowering inflation could also be a precursor of a coming recession. Compared with past quarters, the risk to future growth has grown. This is not a prediction, but simply an acknowledgment that data is somewhat softer than in previous quarters. This softening of the data was deliberately engineered by the Federal Reserve, but now only time will tell if we have indeed "stuck" the fabled soft landing.

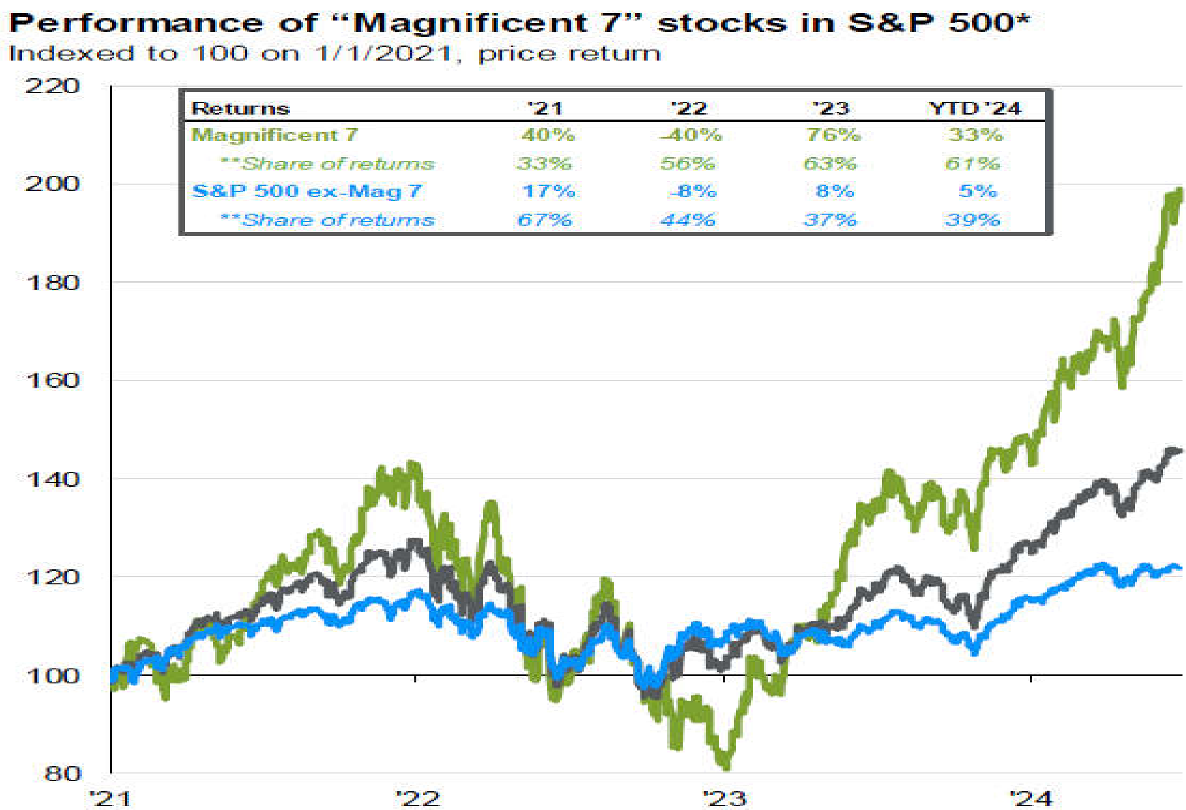
The Stock Market - The Magnificent 7 Rides On

The paths of the Standard & Poor's 500 Index and the broader market diverged even further in the second quarter, as the cap-weighted Index rose 3.9% while an equal-weighted average of the same 500 companies *fell* 2.6%.

As has been the case for most of the last 2 years, the Index's rise was driven entirely by the Magnificent 7 stocks, even though one of its members, Tesla, is down 13% year-to-date. The Mag 7 stocks as a group rose by a weighted average of 17.5% during the quarter, contributing 5.4% to the Index's rise during the quarter. Nvidia, by itself, accounted for almost 60% of the Index's 3.9% rise. The not-so-magnificent 493, on the other hand, detracted -1.5% from the Index's gain. More than 73% of the stocks that make up the Index under-performed it, and nearly 60% of all stocks posted negative returns for the quarter.

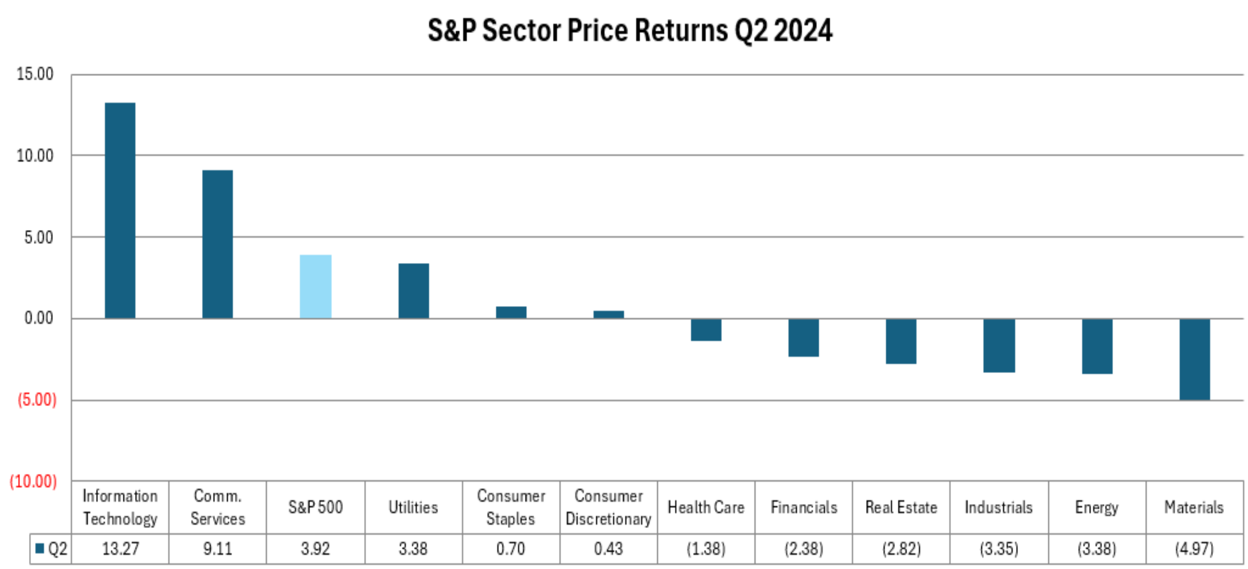


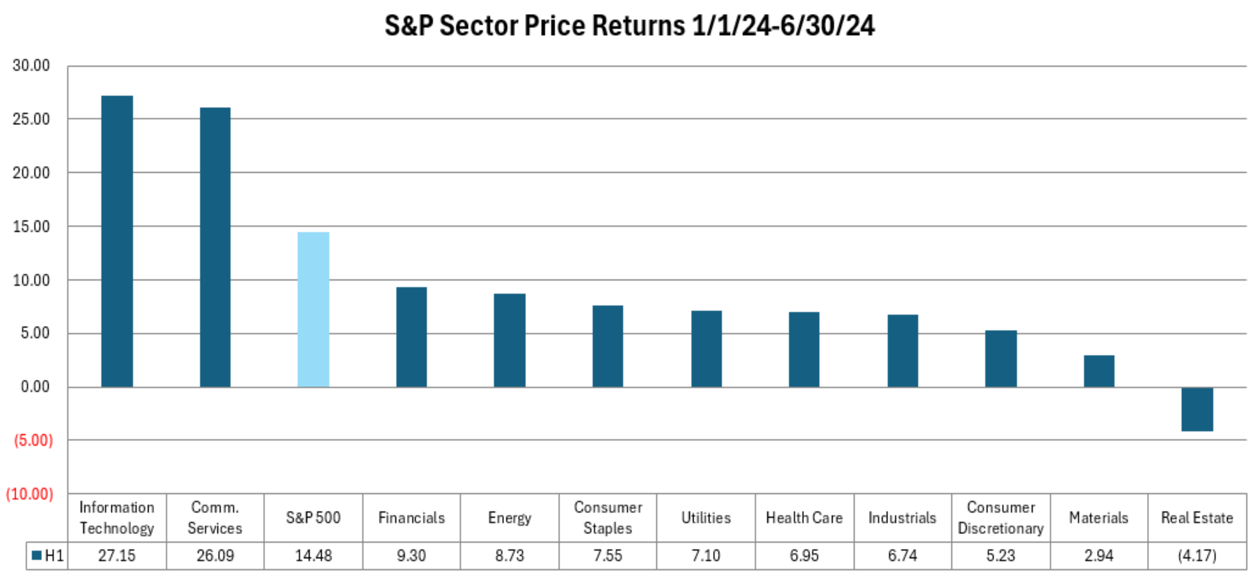
The story is much the same year-to-date, as it has been since the end of 2022. The S&P 500 Index rose 14.5% in the first half, while 40% of all stocks were down and the average S&P stock was up less than 5%. Three-fourths of all stocks have under-performed the Index through June. The Magnificent 7 stocks accounted for 61% of the Index's rise so far this year, with Nvidia,



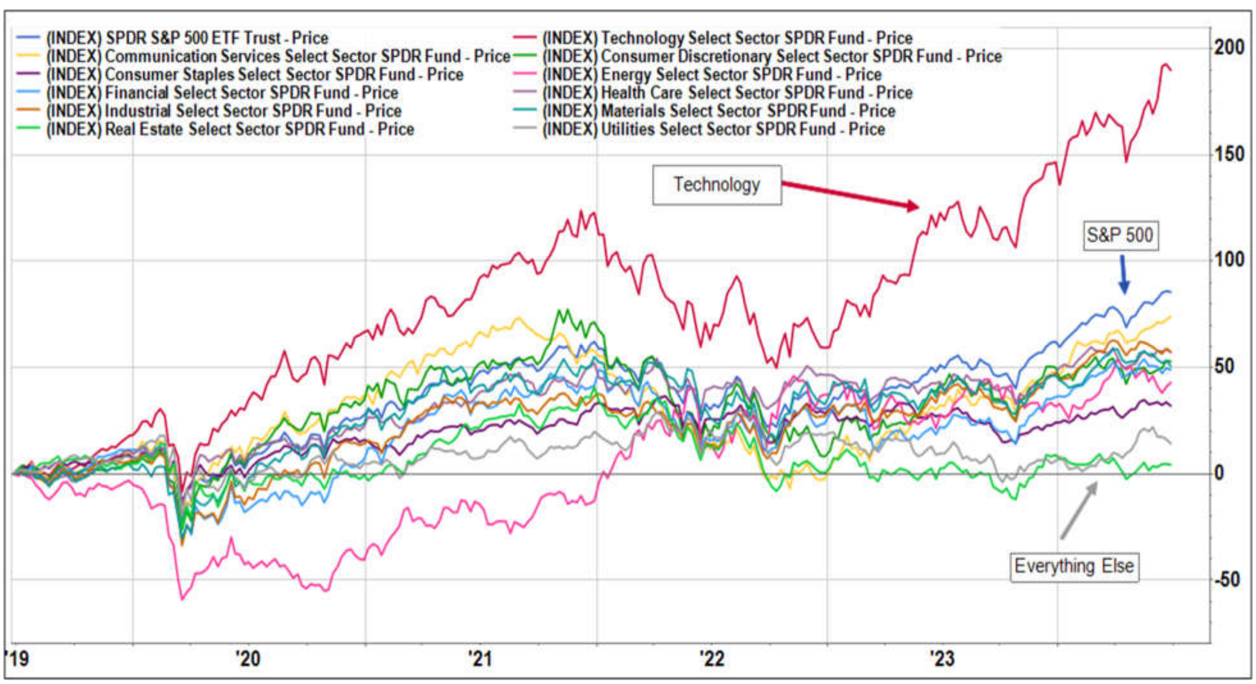
alone, contributing 39%. For the record, Nvidia's stock price has appreciated 149% so far in 2024, and its weighting in the S&P 500 Index has more than doubled from 3.1% to 6.6%. Also for the record, Nvidia's stock price is up more than 900% in less than 2 years since its October 2022 low – and that's after its recent 23% decline.

As you might expect, returns for the quarter and year-to-date have been concentrated in the sectors where the Mag 7 stocks reside, namely Information Technology and Communications Services. None of the other sectors have come close to matching the Index, and 6 of the other 9 S&P sectors were actually down during the 2nd quarter.

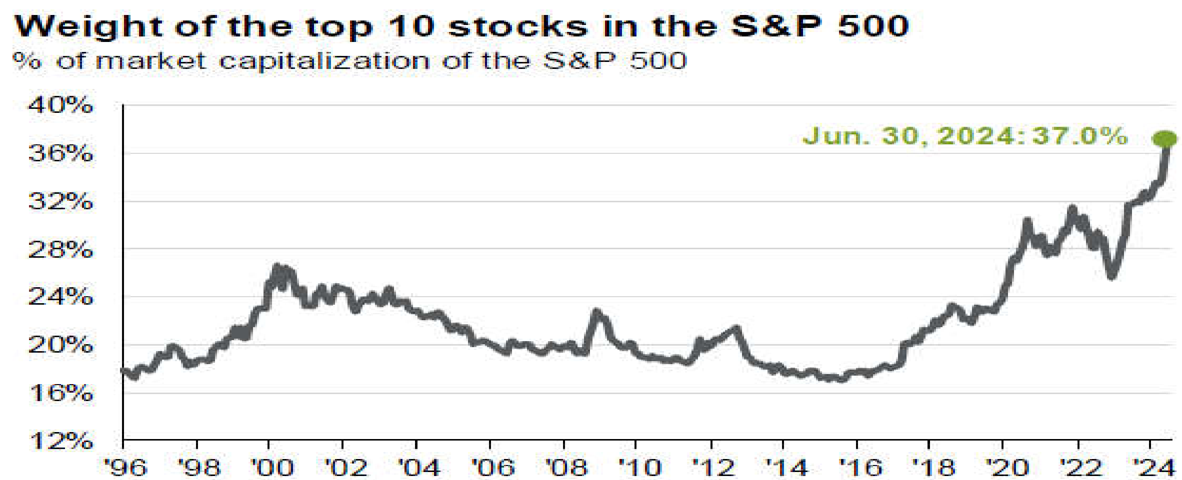




At the risk of beating this horse to death, we need to add that the historic concentration of returns on a small number of stocks in a single sector has been so severe as to distort long-term comparisons to the point of absurdity. The chart, below, shows the gains achieved by each of the eleven S&P sectors over the last 5 years, and none of the other 10 sectors were able to generate even a fraction of the returns earned by the tech sector. All of the other market sectors have under-performed the S&P 500 Index, itself; and nearly all of this dispersion has occurred over the last 7 quarters!



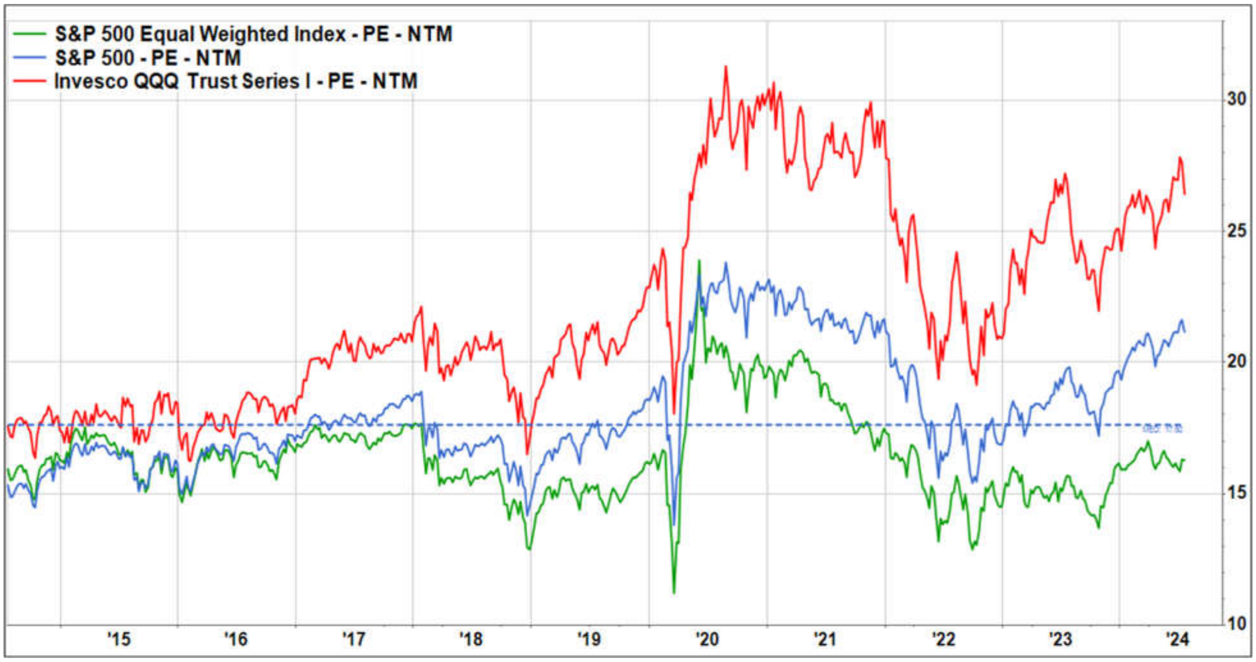
Largely because of the out-performance of this handful of mega-cap technology companies, the S&P 500 Index has become concentrated as never before. Over the last 30 years, the 10 largest companies in the Index have accounted for between 17% and 23% of its total capitalization. Until now, that level of concentration had never even approached 27%, except for the dot.com bubble of 2000-01, hardly a time to be fondly remembered. Today, the 10 largest S&P 500 companies account for an unprecedented 37% of its total capitalization, well above the peak of the dot.com bubble. In addition to the Magnificent 7, the 10 largest companies include Broadcom (another tech company), Warren Buffett's Berkshire Hathaway and Eli Lilly. The Mag 7 accounts for 32% of the top 10's 37%, and Microsoft, Nvidia and Apple by themselves account for more than 21% of the S&P 500's market value.



It should also be noted that while the 10 largest companies in the Index account for 37% of its value, they contribute less than 27% of its earnings. At the prior peak in 2001, those measures were 27% and 18%, respectively. This brings us to the matter of valuations.

__Valuations – Reasonable Overall, Absurdly Over-valued at the Top__

The S&P 500 currently trades at around 22x forward 12 months' expected earnings, a hefty premium to its 10-year median P/E of less than 18x. Since the Magnificent 7 stocks and technology stocks, in general, have accounted for so much of the market's rise over the last 6 quarters, it is reasonable to expect that they also account for much of the market's apparent over-valuation. The tech-heavy Invesco QQQ ETF, that replicates the Nasdaq 100 Index trades at 27x forward earnings, while the Mag 7 carries a weighted forward P/E multiple of 35x. Meanwhile, the average S&P stock trades at around 16x forward earnings, a significant discount to the Index and closer to the bottom of the market's range than its top.



The fact that value still exists in sectors of the market left behind by mega-tech mania may not matter in the short run if the Mag 7 collapses under its own weight. Historically, the market has shown much greater correlation during downturns than in upturns, as managers tend to lower market risk indiscriminately while adding risk selectively. So it is feared that even value investors might get trampeled if the market were to decide that the tech mania had run its course, though probably to a lesser degree than the Mag 7 itself.

The Magnificent 7 stocks have soared to bubble-like valuations, evoking memories of the dot.com era and its ugly aftermath. Microsoft, Nvidia and Apple have each exceeded $3-trillion in market value at different times this year, and combined are currently valued at almost $10-trillion. Keep in mind that no American company had approached even $1-trillion until Apple breeched that threshold in 2018, just 6 years ago. These three companies represent 21.5% of the entire market capitalization of the S&P 500, and are larger than the capitalization of the *entire* S&P 500 as recently as late 2011. Including Google, Amazon, Meta and Tesla, the Magnificent 7 have a combined market value of $16-trillion, which is greater than value of the entire S&P 500 as recently as 2016.

Any one of the Big 3, Apple, Microsoft or Nvidia, by itself is now 50% larger than the market capitalization of the entire German DAX stock market index or the UK FTSE 100 stock market index.

At one point this year, Nvidia passed Microsoft to become the largest company in the S&P 500. Microsoft is valued at 14x trailing sales and 39x trailing earnings, but these valuations, rich as they are, pale in comparison to Nvidia's absurd multiples of 42x sales and 78x earnings. Microsoft and Nvidia have roughly the same market capitalizations, but Nvidia's revenues are less than one-third those of Microsoft. Even if Nvidia were to grow its revenues over the next 5 years at the rate analysts are forecasting, its revenues would still be less than Microsoft's current level and its price/sales multiple would still be higher – even if its stock price remained unchanged! And Microsoft, itself, is probably overvalued.

At its peak, Nvidia was trading at 100% above its 200-day moving average. The largest such spread any company had achieved while being the largest company was 80%, achieved by Cisco Systems in 2000. So Nvidia's rise to the top is truly unprecedented in terms of its rapidity. It's an eerie coincidence that the company that Cisco passed in 2000 to become the largest was also Microsoft, but the comparisons don't end there. Cisco rose 4,460% in the 5 years leading up to becoming the most valuable company, while Nvidia has risen a remarkably similar 4,280%. But Cisco's price/sales multiple never rose above 25x (vs. Nvidia's 42x), and Cisco's share price has never risen from its 2000 level and has, in fact, fallen 40% over the last 24 years while the S&P 500 has more than tripled.

A Brief Pause to Really Appreciate the Numbers

We have grown accustomed to tossing out numbers in the millions and billions – and now trillions – to the point that we have lost some perspective on just how large they are. We found these illustrations interesting.

The difference between a million and a billion is this; a million seconds is less than 12 days, a billion seconds is more than 31 years. A trillion seconds ago, the planet was in the grip of the ice age.

And think of this if you've ever thought of trying to surpass Elon Musk as the world's richest person: if you had earned $100,000 per day from the time the great pyramids were built 5,000 years ago, you would still need another 1,900 years to get to Elon's level.

So Is this the Dot.Com Bubble Revisited?

It's natural to compare the valuations of today's Magnificent 7 with the dot.coms of 2000, but there are differences between then and now that are worth noting.

The most important difference is that, while the valuations of the Magnificent 7 as a group – and Nvidia in particular are "bubble like," they are not in any way comparable to the dot.coms of 25 years ago. It wasn't just that the dot.coms were over-valued, it was that they lacked many of the basic metrics that valuations are based on – like earnings or in some cases revenues.

A bubble implies something unsubstantial l, but the Mag 7 (arguably excluding Tesla) are high quality companies with pristine balance sheets, wide moats and reasonably well-defined earnings prospects. It is highly likely that they will survive and prosper for the foreseeable future, but it is much less likely they will still dominate the S&P 500 Index anywhere close to this degree 5 or 10 years from now.

The Mag 7 have been impervious to high and rising interest rates over the last two years for the simple reason that they are not reliant on borrowing. Perhaps the prospect of imminent rate cuts is encouraging investors to focus on other sectors, including small cap stocks, which will benefit from lower interest rates and whose valuations are less extended. Or perhaps investors are beginning to question the hype around artificial intelligence and are focusing elsewhere.

Whatever the reason, we are finally beginning to see signs of weakness in these stocks. Nvidia is down almost 23% from its June high. Alphabet (Google) is down about 12%, and Microsoft and Apple are each off about 10%. The Technology Sector ETF is 11% off its high and the QQQ Trust has fallen by 9%. These declines have occurred in a period where the S&P 500 index, itself, is less than 5% below its high, the average S&P 500 stock has fallen just 2%, and the Russell 2000 index of small cap stocks is up 11%!

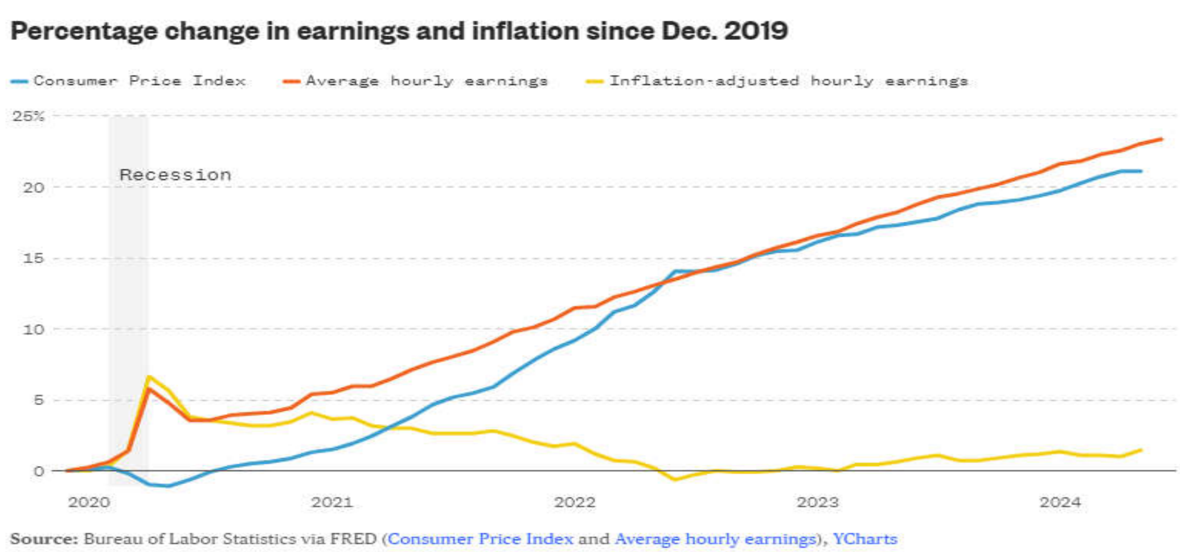
Comparisons of the Mag 7 to the dot.com era bring with them the fear that these stocks have become such large drivers of market returns that they would bring the rest of the market down with them when their bubbles burst. But so far, the early indicators are that the Mag 7 may be able to find their "fair" values without major collateral damage to the rest of the market.

Closing Thoughts

If the stock market can, indeed, avoid collapsing under the weight of the Magnificent 7, then the greatest remaining risk would seem to be a recession. But here, there are hopeful signs as well, as we set out in detail earlier in this *Outlook*. Many leading indicators of a recession are still flashing red even two years after the yield curve first inverted, and the labor market is indeed weakening. But weaker is a long way from weak, and the coincident indicators remain strong.

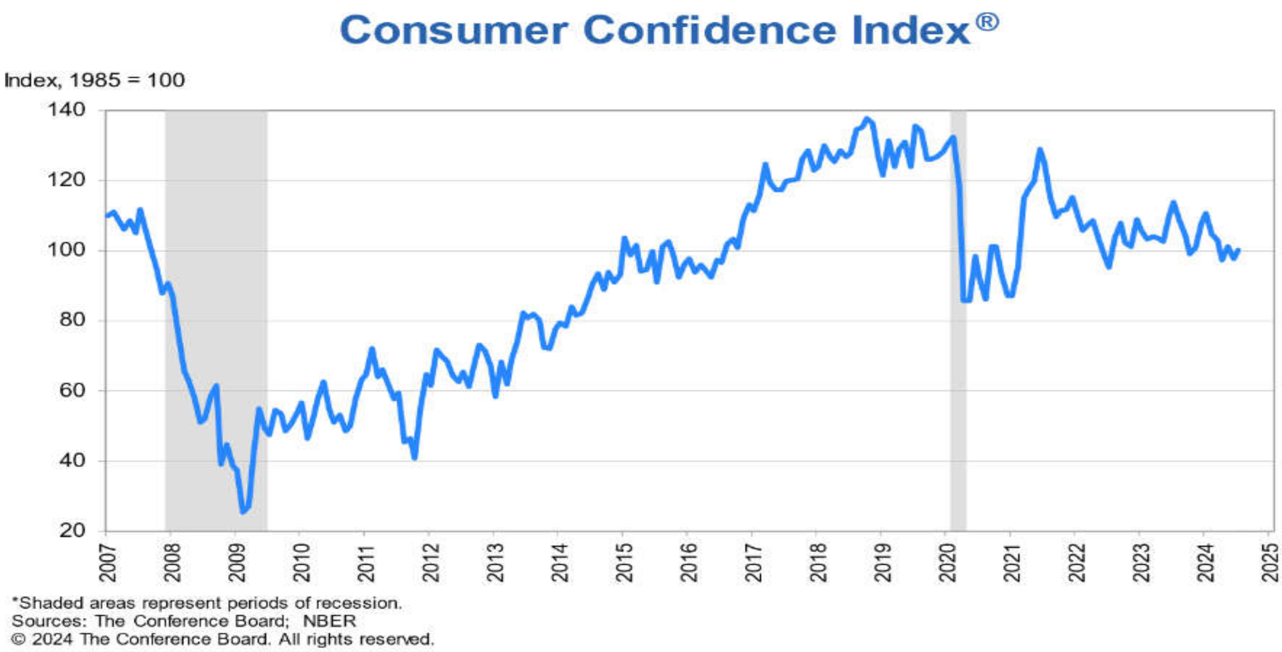
Economic growth in the first half of the year was solid, and GDP growth of 2.8% (annualized) in the 2nd quarter was much stronger than the consensus had predicted. Businesses are continuing to invest and consumers are still spending, despite some softness in the labor market. With inflation slowing further toward the Fed's 2% target, it appears that the economy may stick its "soft landing", a feat rarely accomplished over the last 70+ years. Given the Fed's hawkish stance over the last two years, a cut in rates at the Fed's September meeting would give investors confidence that the central bank believes inflation is under control, while giving much needed relief to businesses and prospective home buyers.

In closing, it's fair to take a moment to step back from the hyperbole and misinformation of a heated election year and acknowledge that policymakers - including the Federal Reserve - have done a commendable job of steering the economy through a volatile and perilous period.



Yes, prices are higher than they were before COVID, but wages have risen more than prices; and yes, the Federal Reserve waited too long to respond to signs of inflation, but acted boldly once it did respond and is in sight of achieving its goals.

The inflation that occurred in COVID's wake and became problematic in the middle of 2022, was in part the result of supply chain interruptions; and in greater part the result of fiscal policy responses that were successful in keeping the economy afloat during a global health crisis, thus preventing an economic calamity that could have taken decades to recover from. Whatever consequences that may now exist because of these actions, pale in comparison to what might have been, had our policymakers not acted as they did. Yet Consumer Confidence is lower than it was before COVID, and has not really recovered much from the COVID recession low.



If you had asked people in 2020 - when 22-million jobs were disappearing, the unemployment rate was soaring toward 15%, and the stock market was down 35% - whether they would be satisfied if, in 4 years, the economy would be at full employment, inflation would be at 2.6% and the stock market would be up 100%, most would have eagerly responded yes. But as Oscar Wilde once wrote, "When the gods wish to punish us, they answer our prayers."

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