The Rasputin Effect

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MR. MICHAEL CEMBALEST: Good afternoon and welcome to the August Eye on the Market audio/video podcast. I'm not really in San Francisco; that's just a Zoom background. But I have this fancy new microphone, 'cause some of you have commented that the audio from my iPhone headphones is terrible, so I now have a professional Edward R. Murrow-style microphone. And you'll be able to see this on video if you're accessing it through our website rather than a Spotify or Apple podcast portal.

Anyway, welcome to the August Eye on the Market audiovisual extravaganza. So I like everybody else, I'm somewhat surprised that despite 400 to 500 basis points of tightening in the US and Europe and a very weak Chinese recovery, the equity markets are up globally about 18% this year, and Q3 GDP looks like it's globally going to hang in and still poised for around 2%.

So the reason I'm calling this the Rasputin recovery is if you remember the legend around Rasputin, which is almost certainly false, but he was I think beaten, poisoned, shot twice, and then finally drowned before he dies, it's a proxy for how I see the global economy right now. No matter what the central banks were throwing at it, it continues to exhibit some resilience, and the same goes for the equity markets as well.

How can we explain this? Well, the obvious catalyst is the decline in inflation surprises. So we've got a chart in here that shows for the US and globally, what those inflation surprises looked like just in the beginning of this year and they have collapsed, and whether you're looking at core inflation, trimmed inflation, sticky price inflation, median inflation, and then a bunch of other measures related to supply chains and the jobs/workers gap. The inflation outlook has cooled more or less the way the Fed thought it should. It just took them another year or so before it started to happen.

And that’s the obvious big catalyst, but I wanted to walk through six other important catalysts so that everybody understands where we are, why the markets are doing this well, and where we go from here. I think the biggest surprise to some people has been a chart that we have showing that on seven prior occasions, every time the yield curve inverted, you had a recession. And it was almost automatic, and there were very few, if any, false signals on where you had an inverted yield curve and you didn’t get a recession.

So we have a chart in here with these little red arrows showing that if you look at the yield curve inversion from three months to ten years, it was a really consistent signal. And as you can see, the yield curve is mega-inverted right now. But I don’t think this is such a great signal this time around, and I’ve been explaining to clients this year when I’ve been meeting them, that the reason why that inverted yield curve was such a successful signal, if you look back, was the yield curve was inverted, but that’s ‘cause the short end of the curve was really high relative to inflation. And if you look at a chart on the real cost of money associated with those yield curve inversions, you saw a real cost of money, 2%, 4%, 8%, maybe even 10%.

This time around, the real cost of money is still barely positive. So I think it’s premature to even look at this recession indicator inversion thing because the real cost of money this time around is barely positive at all, and it’s a sign of just how far behind the Fed got relative to inflation.

The other thing too is if you’re really into that kind of yield curve inversion always predicts a recession stuff, you’ve got to look at the corporate sector financial balance, which is kind of a broad measure of the profitability of the entire corporate sector, not just public companies, net of capital spending and other kinds of transfers. And in the past, you got a recession because that corporate sector financial balance went negative. This time around, it’s still substantially positive. So if you’re into kind of recession indicator tracking, the corporate sector financial balance would offset the yield curve inversion signal, even if you believed it, which I don’t.

The second thing is yes, the central banks are starting to take back some of the stimulus. But if you look broadly across the Fed and Europe and Japan, and the Swiss National Bank, Canada, Bank of England, and then the relevant comparable entity within China, only around 35% of the emergency stimulus from a monetary perspective has been withdrawn, so there’s still a lot of money sloshing around, and the real cost of money is not prohibitively high. Those are the first two takeaways in terms of why things are doing so well, despite 5% higher Fed funds rates than we started the year with.

The third factor is fiscal stimulus, and we have a chart here showing the spike, a really big spike in construction spending, not related to commercial real estate, but related to manufacturing. And that started to happen shortly after the semiconductor bill and the energy bill and the infrastructure bills were passed. There’s a lot of money getting spent here. And more broadly, this is the amazing part, the fiscal deficit in the United States is almost as large as it was at its peak level in 2009 when you had the global recession.

So yeah, there’s a lot of monetary tightening taking place, but there’s a lot of fiscal easing offsetting that. Our partners in the Investment Bank, they have a great economics team. And Mike Feroli and his team wrote a piece on analyzing what’s driving the US deficit. It’s a lot of little bits and pieces, but lower income and payroll tax receipts, drop in remittances from the Federal Reserve to the Treasury, more cost-of-living adjustments, higher Medicaid and Medicare outlays, higher interest on the federal debt, and then, of course, don’t forget about the last one, which is increased FDIC payments to depositors after the bank failures that occurred earlier this year. But the bottom line is there’s a lot of fiscal stimulus taking place.

The fourth factor that has helped contribute to this Rasputin market and Rasputin economy is, it’s going to take a while for higher interest rates to feed into the corporate sector and the household sector. And so there’s a chart in here, and I’ll be honest with you, I can’t tell you exactly why this is happening, ‘cause it’s remarkable. But it shows, we have a chart that shows that every time since the early ‘70s when the Fed funds rate went up, in other words, when policy rates went up, corporate interest payments, as a percentage of their profits went up too.

This time, not only is that net interest payment ratio not rising, it's still falling. And there's a number of things that could be contributing to this. Notably, companies that have a lot of short-term excess cash are reinvesting and earning higher rates. And those same companies, one can infer extended duration massively at the lows in rates.

But how ironic is it that the corporate sector understood the assignment when rates were, when ten-year rates were at 1.5, the corporate sector extended duration, whereas some of the banks, who you would assume were experts in asset liability management, some of the banks, as you now know, extended their asset duration at the lows in rates while the corporate sector got it right and extended their liability duration. I think it's kind of ironic. But you can see in this chart that the corporate sector is not really getting hit right now from higher interest rates. Most certainly that has something to do with having, they were having extended duration when rates were much lower.

Same for the household sector. Look at the rate on outstanding mortgages. That rate has come down steadily and is now around, let's say around 3.5%. So in contrast to Europe, most homeowners in the United States have fixed-rate, long-duration fixed-rate mortgages. And while mortgages look prohibitively expensive for new home buyers, existing homeowners have locked in really low rates, which is one of the reasons why the debt-service-to-income ratio of the US household sector has gone up a little bit with higher rates, but is still close to the lowest levels that it's been at since 1980. So not just the corporate sector has been resilient to higher rates, but also households.

And housing's gotten hit pretty hard in terms of starts and permits and mortgage applications and the normal stuff that you'd look at. But housing would've looked much worse, if not for the fact that we have very tight inventory levels in terms of single-family homes. We have a chart in here showing that we're still close to the levels of the last 40 years or so in terms of the supply of existing single-family homes.

So that tight supply, now there's all sorts of problems related to that in terms of productivity and employment and labor mobility, but this time around it's made the housing markets more resilient than it might have been to rising interest rates.

So if we step back and look at the US consumer, in January of this year, the consensus forecasts were a consumer-led recession by the summer. All of the factors I've just walked through have helped prevent that from happening so far. And now when you look at those same forecasts, the decline has pushed out a little bit, but notably doesn't go negative on any kind of year-on-year or quarter-on-quarter basis. So the forecast of the consumer slowdown has changed in terms of both timing and magnitude.

And the other thing, and this gets discussed a lot and I think it should, households are still burning off massive amounts of excess savings that they got during COVID via both fiscal stimulus means and monetary stimulus means. Here are three different forecasts from three different parts of J.P. Morgan we have in this chart, and they're all pointing to the same thing, which is some time in 2024, that runs out. But that still gives you at least a few months of cushion where households will have the ability to spend in excess of their earned income.

Now even with all of that, just wait, right. The leading indicators are still projecting weakness this fall, Q4, Q1. We have a chart in here showing you can split leading indicators into coincident indicators, meaning the stuff that's happening now. And leading indicators, which is the stuff that's expected to happen in a few months. And the coincident indicators all look fine, whereas the leading indicators still look pretty weak.

And so we take a closer look than just at these aggregate baskets. And we track 20 or so long-dated leading indicators that give us a sense for what might be happening anywhere from three months to six months, nine months, 12 months. They don't look terrible. We have a color-coded table in the Eye on the Market that shows roughly what we're expecting based on each one. And there's a modest slowdown expected later this year, early first quarter, that I would put at something like 1% growth rather than recession. But that does have implications for how large an equity market drawdown you might expect, even if there is one. And a lot of these signals look a lot less malevolent than they did a few months ago.

Now of course, the sixth, last and the sixth factor is what's been driving the market this year is the return of risk appetite in a big way, right. So just be aware of that. This is not an earnings-led recovery. First of all, the market cap of the largest seven companies, is at its highest level since the 1970s. It's even now - - market leadership than during the TMT bubble during 2000. And you've all read about this, we've written about it before, the crowding and growth factor investing has reached the 97 percentile, eclipsed only in the year 2000. There was a very good piece that the Investment Bank, J.P. Morgan's Investment Bank, put out last week by the US Equity Strategy team that gets into detail on this. I cited in the Eye on the Market the name of that piece in case you want to look at it.

And for those of you that are fans of the Eye on the Market, just be aware the YUCs are back. So we track the percentage of overall market cap made up of the YUCs, which are the young, unprofitable companies. One of the signals that I wrote about a lot, that I was very worried about where markets were valued in 2021 and early 2022, is how high this was. It corrected in 2022 in the fall, but now is going up again. And so just be aware, rising YUC shares of the overall market is, there's a reason we call it YUC. I'd rather not be seeing this in terms of how stable this rally is.

And then I think the most important chart in some ways in the piece we have is one that looks at the rise in the valuation multiple on the P/E ratio for the S&P compared to long-term earnings growth forecasts. Now sometimes long-term earnings growth forecasts take a while to change. Corporate guidance and the analyst community have to kind of get on board and reflect what they're seeing.

But undoubtedly, the chart we've got here shows the valuation multiple has gone up almost four points, maybe three-and-a-half points, without any movement higher in long-term earnings growth forecasts. That's unusual; that doesn't happen a lot. And there's no escaping the fact that there's a lot of good news priced into the markets right now and not a lot of room for negative developments should they come from Russia-Ukraine war, global energy and food prices, or anything else.

So I think there's a reasonable foundation for the rally that's taken place this year because inflation has outperformed almost everybody's forecasts in terms of how quickly it would fall. Wage inflation is declining a little bit more slowly. And a lot of people were underinvested at the end of 2022. They added risk; I get it. But I think it's important to understand exactly where we are at this point in a kind of earning-less appreciation cycle that's taking place in a handful of stocks.

So just a couple more things. First, I think this is the best time for risk-averse investors in 20 years. So why do I say that? We have a chart at the end of the piece that looks at the earnings yield on the S&P, which is basically earnings divided by price. And we compare that to the short-term returns on corporate bonds and Treasuries, and they've all converged to somewhere around 5 to 5.5%. The last time you earned more money on Treasuries than you did on equities was in early 2000. So it's been over 20 years since a risk-averse investor could look at the fixed-income markets and consider them roughly comparable in earnable yield terms compared to equities, and that's where we are right now.

So one last thing I wanted to mention, and I hope I'm not running out of time, but I normally, I don't do any press, I don't have a lot of time for that. And our compliance people generally get very nervous when I'm put in front of press people, which I can understand. But I agreed to do this video podcast of a money manager called Josh Brown. And he does an in-depth 90-minute video podcast a couple times a month, and I joined over the summer.

And the reason I'm mentioning it is at the end of the podcast, he asked the people that joined for that session to name a book and a movie that they liked. And I started thinking about Bidenomics, which is essentially the United States having an industrial policy for the first time really in 50, 60 years. And there's a lot of money that's going to be spent in terms of direct government spending or tax expenditures on infrastructure, energy, semiconductors.

I have questions about the long-term inflationary consequences here. How much will it eventually cost to produce semiconductors in Arizona versus Taiwan? What's going to be the cost of energy once you have both the cost of storage and backup thermal power added onto the cost of a high renewable system, things we explore in the energy paper.

So I've got some questions about the inflationary consequences of this, but one thing I am optimistic on is the ability for Bidenomics to reverse some of the damage that was done to manufacturing communities in the United States after China joined the World Trade Organization. I showed some research a couple of years ago. Then after China joined the WTO and then started engaging in currency intervention, US manufacturing employment and wages plummeted, and opioid use started rising specifically in the counties that had the most intense competitive economic pressures with China.

And so I'm hopeful that the battery belt that will stretch from Georgia up to Michigan and some of the other monies that get spent here alleviate some of the pain and suffering in those communities. And on the podcast, I mentioned the book Empire of Pain, about the history of the opioid crisis and the family behind it. And I mentioned the movie The Third Man with Orson Welles, 'cause there's a scene where he's explaining his justification for his tainted penicillin scheme, and I thought that that was a nice way to wrap the whole message up together. Anyway, thank you for listening/watching. I hope this all worked, and we'll see you sometime in September. Thank you.

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