Market Outlook

By Mark T Dodson, CFA

Sahm Rule Says a Recession is Underway

Market Risk Index fell to 87.2% on more improvement in our Monetary Composite. Psychology and Valuation were unmoved – animal spirits were unflappable in response to recent increases in market volatility.

The improvement in our Monetary Composite after July's CPI release is the result of a fresh round of Fed front-running. For the eighth time since the Fed has stopped raising rates, the bond market is betting on another Fed pivot and pricing in several Fed rate cuts over the coming 12 months. It has the 10s2s (10-Yr minus 2Yr) version of the Treasury Yield Curve close to reverting to a positive slope. However, our preferred version of the yield curve (10Yr minus 3M) will remain firmly inverted for the foreseeable future. We read one strategist who said the implication of a coming reversion was a soft landing. History says otherwise, but the strategist has an added incentive to keep his job with his employer. Our incentive is not to lose money.

Unemployment unexpectedly climbed to 4.3%, but it was an I told you so moment for market watchers who follow the Household survey of employment. That rise in unemployment officially caused the Sahm Rule to trigger a recession warning. The Sahm rule, named for economist Claudia Sahm, is clever in its simplicity. The rule signals recession when the unemployment rate rises by half a percent or more from its low over the last 12 months.

Like the strategist who can easily brush aside the history of the yield curve, don't expect many economists to suggest the economy is in anything other than an expansion right now. It's more palatable for an economist to paint a picture that this indicator is a warning to the Fed that a recession is avoidable, and the outcome rests in their hands. (It's unlikely that a 25 basis point cut in the Fed Funds rate in September fits the bill.)

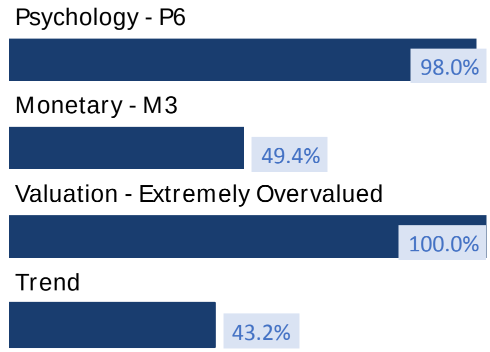
The challenge with that narrative, historically, is that the Sahm Rule is not a leading indicator. Every successful recession warning it has triggered occurred when the economy was already in recession. There is only one instance of the rule being a leading indicator of recession in 1959, but the rule gave another warning again six months later in 1960. At that point, the economy was already in recession.

Market Risk Index

Rec Allocation 25% Underweight

87.2%

Category Percentiles



Largest Psychology Influences

Leveraged Investments	Negative
Surveys	Negative
Flow of Funds	Negative
Consumer Confidence	Negative

Largest Monetary Influences

Interest Rate Spreads (Yield Curve)	Negative
Lending & Leverage	Positive
Monetary Velocity	Positive

Valuation

7-10 Year Equity Return Forecast	-0.2%
10Yr US Treasury Yield	4.2%

Market Trends

US Equities	Bullish Investment
Intl Equities	Bullish Investment
REITs	Neutral Trade
Broad Commodities	Bullish Investment

Market Risk Index scales from 0 to 100%. Higher readings correspond with higher risk markets based on our model & opinion. Scores below 25% are bullish. Scores between 25-75% are neutral, and scores above 75% are markets vulnerable to major drawdowns.

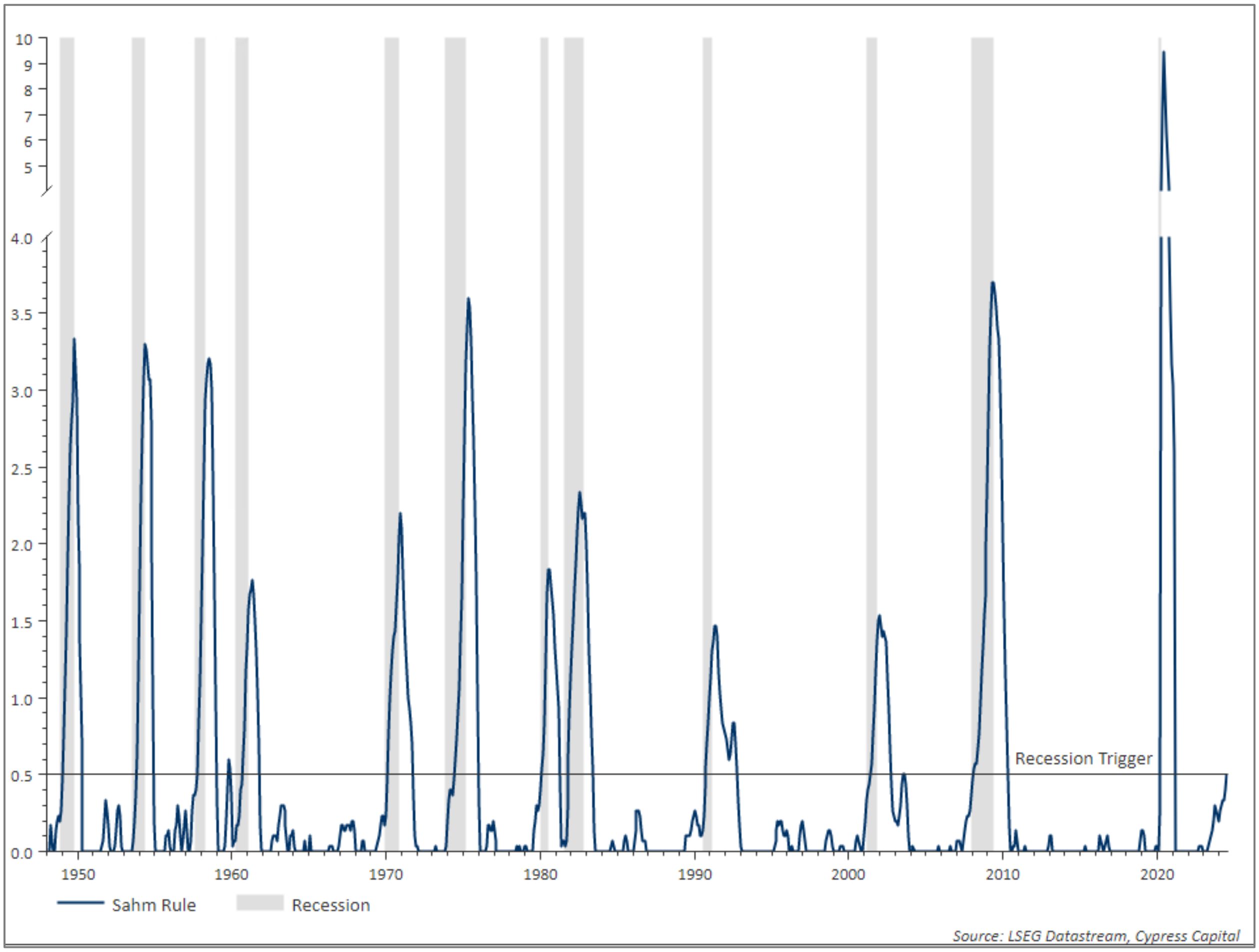
The Sahm rule has triggered 14 recession warnings going back to 1948, and 12 of them occurred while the economy was already in recession. One was a warning six months before a recession started, and one was an outright failure. That failure occurred in 2003 when the stock market had recently emerged from both a recession and a bear market, and the stock market was hitting 12-month highs.

Maybe the economists and investment strategists are correct, but we give historical precedent the benefit of the doubt over someone whose incentives may not align with ours. Outside of the Covid recession, we have never experienced a recession in our careers where the consensus agreed we were in recession until after it was almost over.

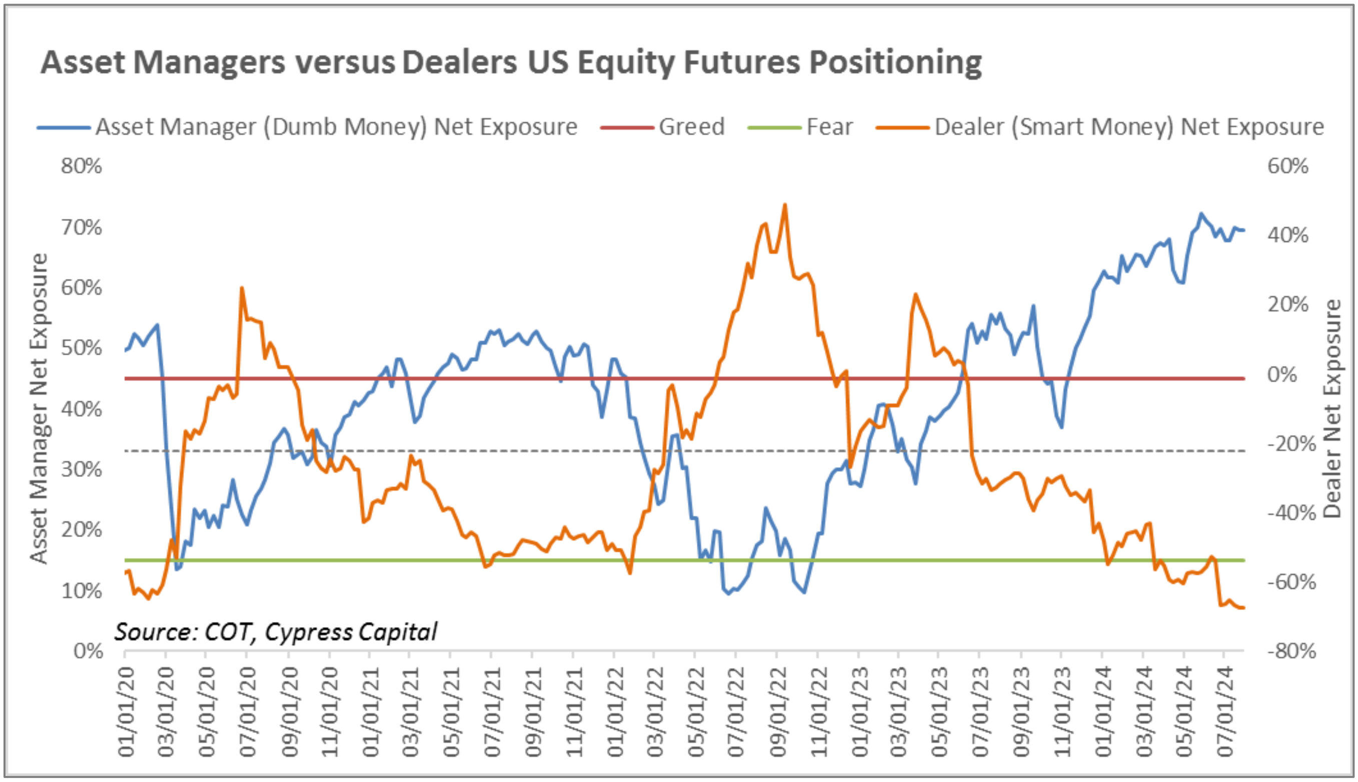
Investor sentiment remains euphoric – US equity valuations are near the highest levels we have seen in our careers – and Household equity allocations are at all-time highs. We believe the environment warrants more caution in equity allocations than the average investor maintains at present, regardless of any egg that might land on our face.

Charts of the Week

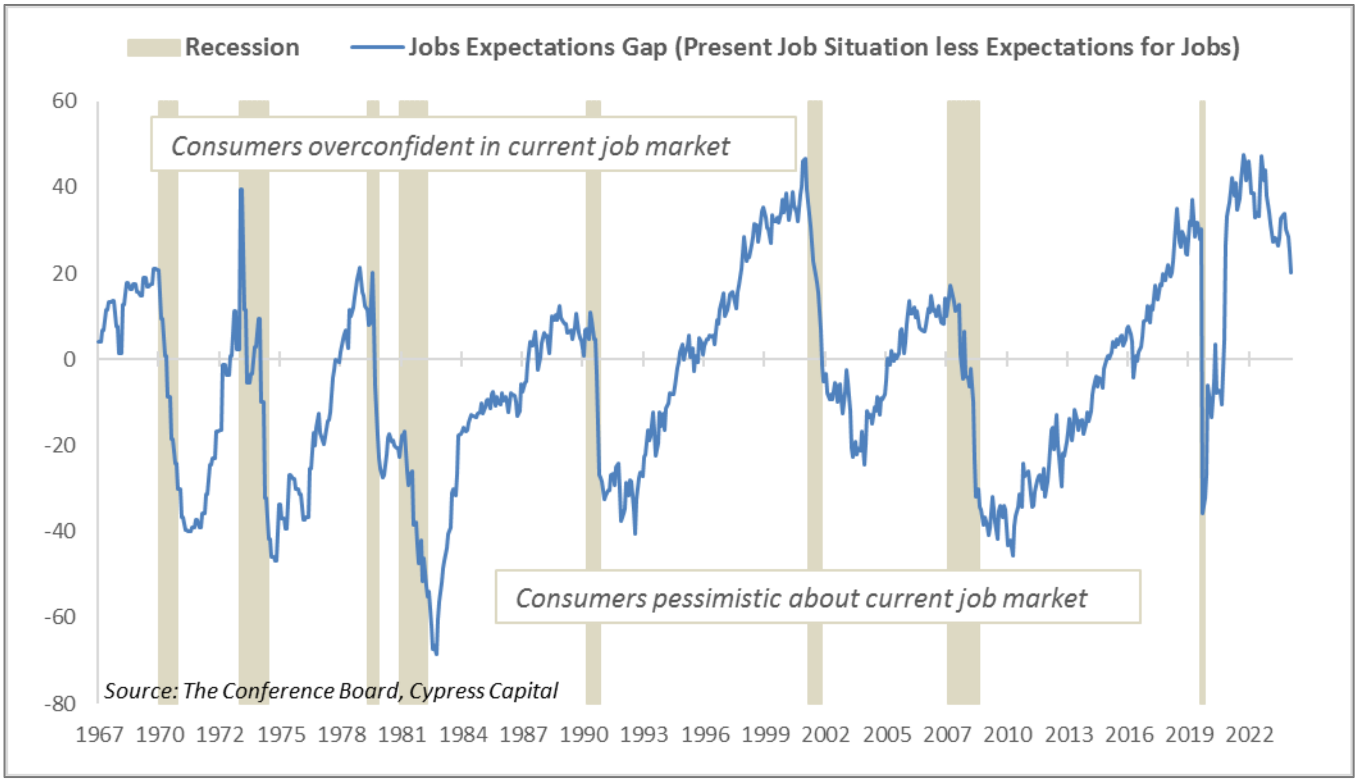
The Sahm Rule officially signaled a recession warning.
The rule is 13 for 14 in its recession warnings.



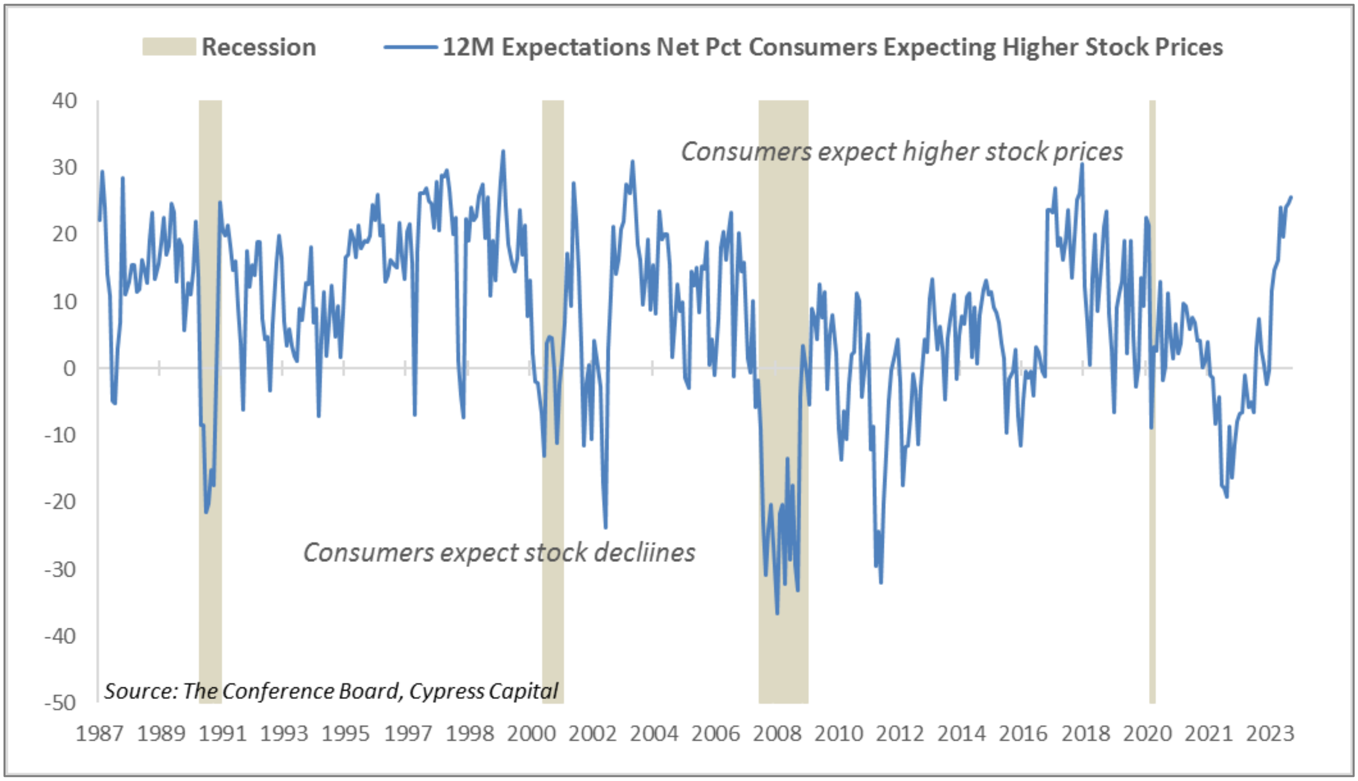
Smart Money set another cycle record in their net short exposure using US Equity Futures.



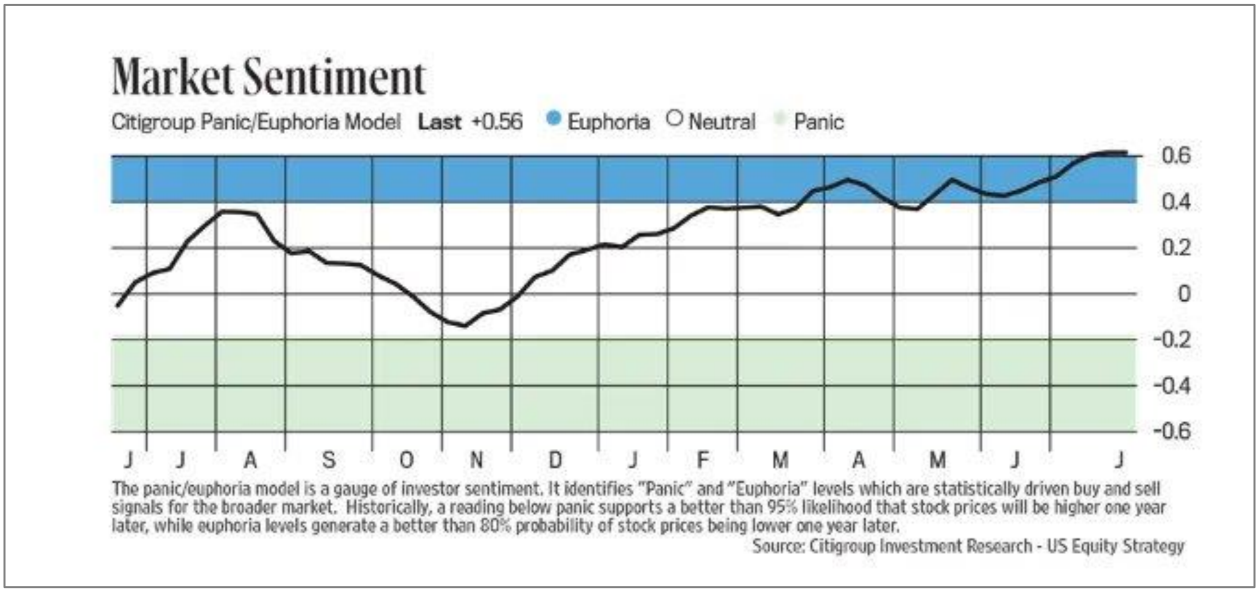
Sharp drop in Consumer Confidence in the Jobs Market in July.



Complacency – Consumer Confidence that stock prices are headed higher set a new cycle high.

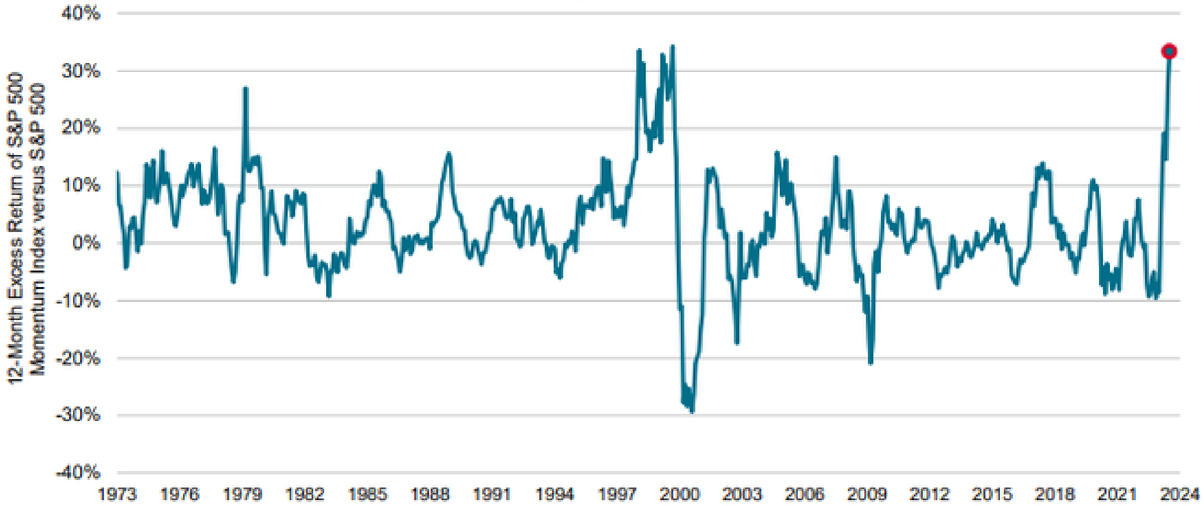


Citigroup's Panic/Euphoria is off the chart into Euphoria.



Momentum Factor is historically extended.

Exhibit 3: Momentum Was also Historically Extended in the S&P 500

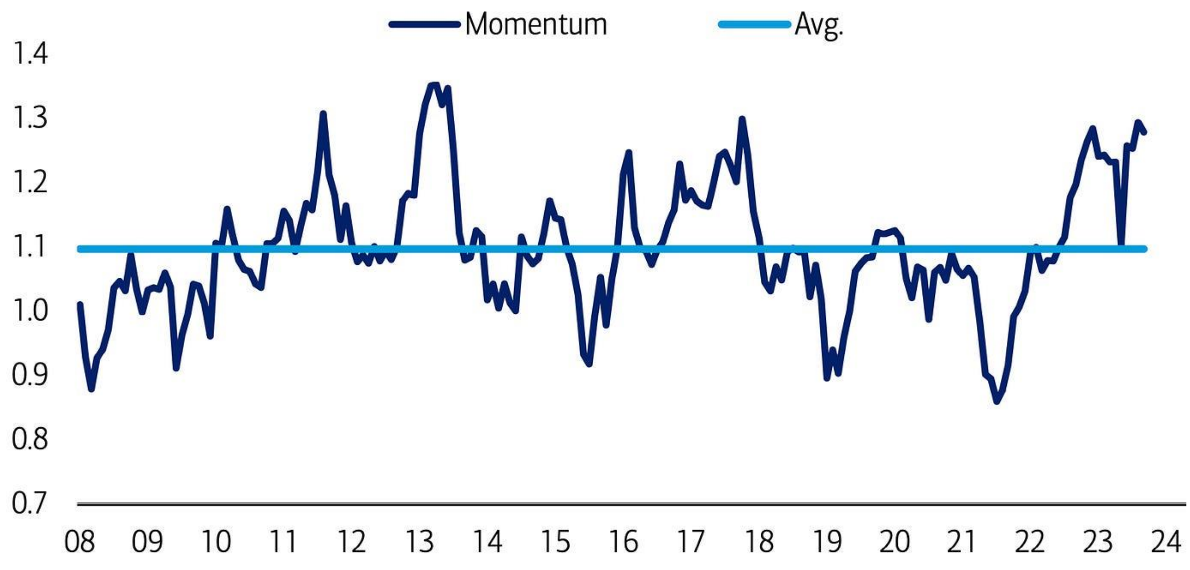


Source: S&P Dow Jones Indices LLC. Data as of June 28, 2024. Index performance based on total return in USD. The S&P 500 Momentum Index was launched Nov. 18, 2014. All data prior to index launch date is back-tested hypothetical data. Past performance is no guarantee of future results. Chart is provided for illustrative purposes and reflects hypothetical historical performance. Please see the Performance Disclosure at the end of this document for more information regarding the inherent limitations associated with back-tested performance.

And, active fund managers are heavily overweight momentum.

Exhibit 5: Active funds are overweight Momentum factors by ~30% vs. the S&P 500

Long-only funds' average relative weight in Momentum factors vs. the S&P 500 (2008-5/24)

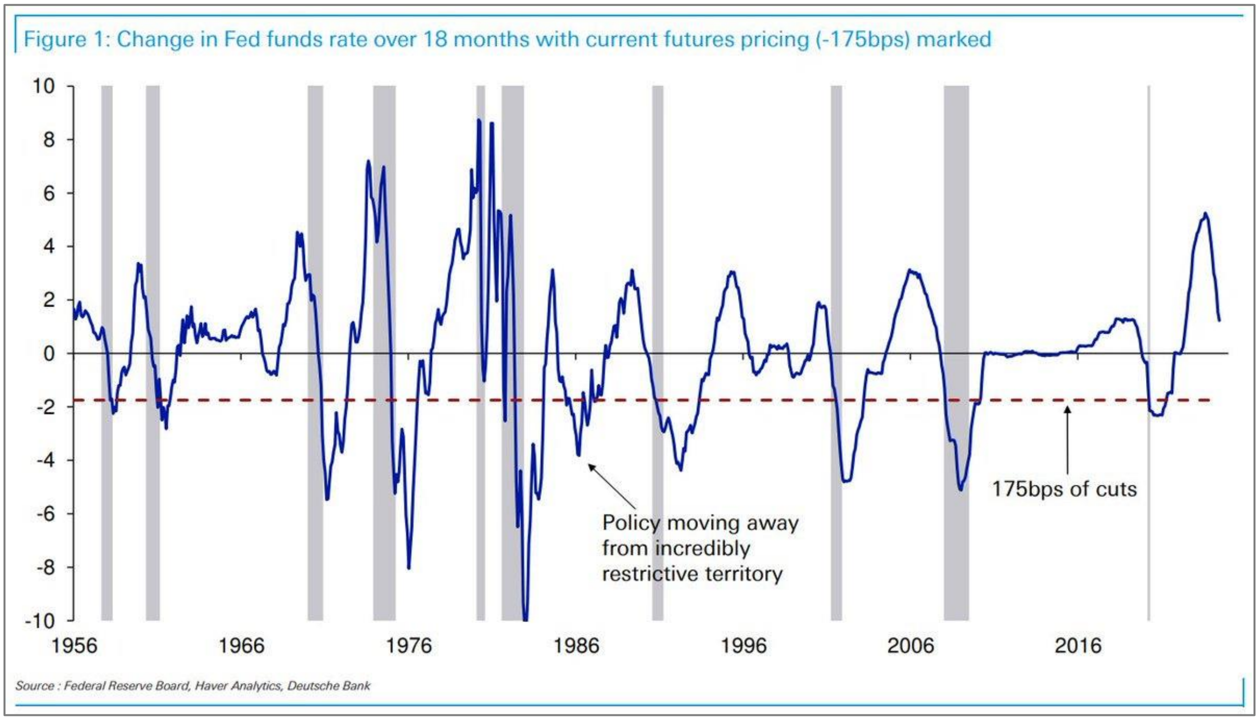


Source: FactSet, BofA US Equity & Quant Strategy

BofA GLOBAL RESEARCH

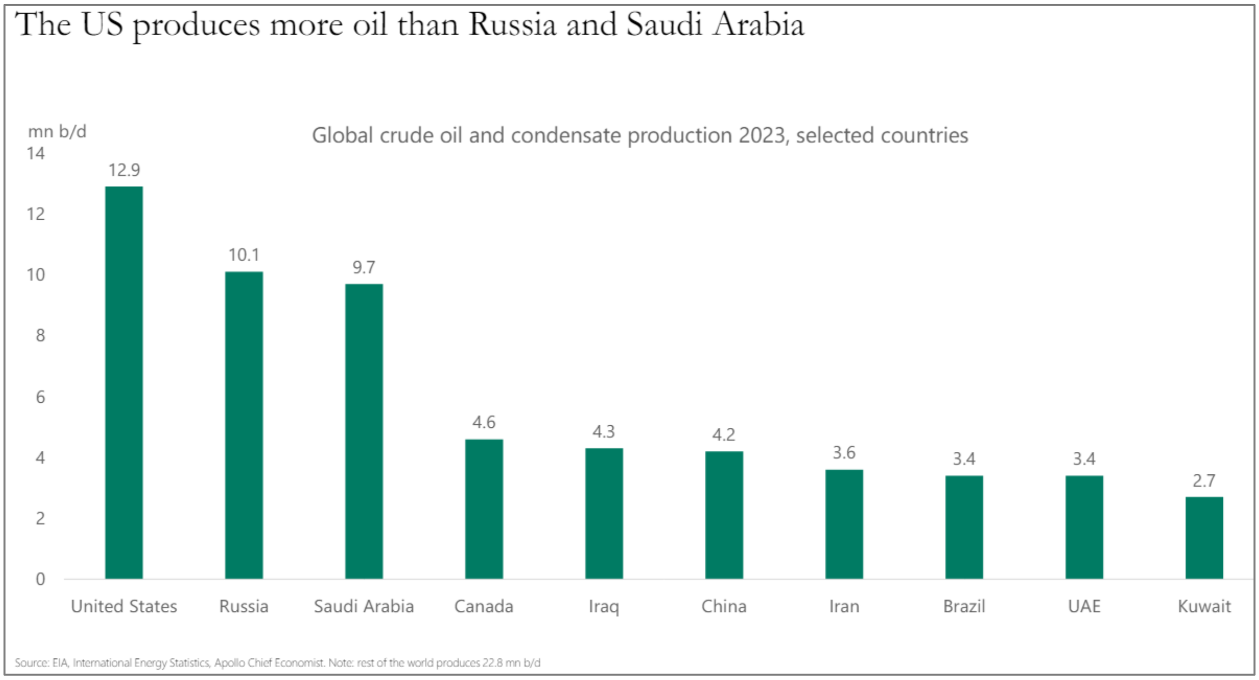
Fed policy is a popular topic on corporate earnings calls.

Markets are pricing in 175bps of cuts over the next 18 months.

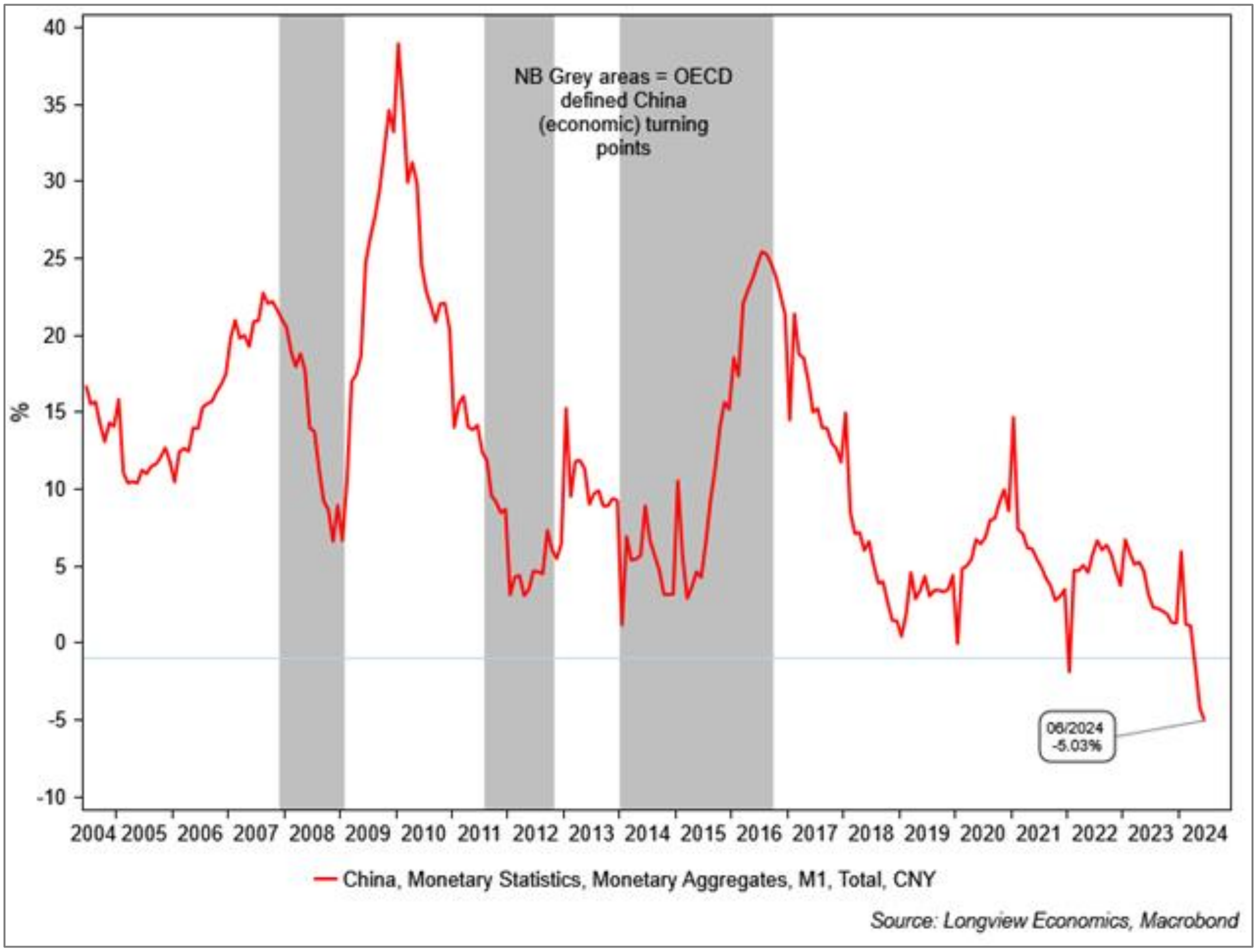


Post-Covid Fiscal Policy – keep running recession-level budget deficits.

Will the United States get an invitation to join OPEC at some point?



M1 Money Supply in China is shrinking.



Asset Management – Portfolio Lineup

The essence of investment management is the management of risks, not the management of returns.
– Benjamin Graham

Select Dividend – Bottom-up risk-managed dividend portfolio of up to 40 stocks that can hold Cash and fixed income when markets aren't presenting attractive individual equity opportunities. A portfolio built upon Cypress Capital's metrics that measure dividend quality and safety. The portfolio is divided 75/25 into payers and growers. Payers are stocks having above-average yields with a long-term history of paying dividends, where the dividend is perceived to be safe. Growers are companies with high total shareholder yields and perceived to be high-quality, franchise companies. The portfolio is generally made up of familiar, household names.

Global Allocation – Multi-asset class portfolio that invests in low-cost exchange-traded funds across eight asset classes based upon the margin of safety offered by each asset class to avoid significant drawdowns.

Strategic Income – Disciplined, value-biased income portfolio that practices patience in awaiting excellent risk-reward opportunities in fixed income. Disciplined in its refusal to reach for yield and put capital at risk of permanent impairment.

Asset Neutral – Absolute return-focused multi-asset class portfolio that allocates assets based upon the margin of safety offered in each asset class. The portfolio can go defensive and hold up to 100% cash in some environments.

US Opportunity – Concentrated value portfolio of up to 50 stocks that increases allocations to Cash and fixed income when the margin of safety offered by equities is too narrow. Portfolio quantitatively buys the cheapest, highest quality stocks that it can find. Quantitative sell discipline sells individual holdings based on value and momentum factors.

Contact us for more information.