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Mid-Year Outlook: Our Unloved Bull Market in Equities

Wednesday, July 5, 2023

Donald Luskin

It's not just about AI. And it's not over.

Our bullish gameplan for US equities laid out in January (see "Surprises of 2023 Volume 4: Global Allocation, and the China Question" January 24, 2023) *has played well this year, and we expect it to continue to do so until mounting evidence of monetary deflation triggers a substantial correction from what will be higher highs* (see "Surprises of 2023 Volume 1: From Inflation to Deflation" January 3, 2023). For now, so far, after six quarters of relentless consensus doomsaying, the economy isn't showing signs of anything like a hard-landing (see "Recession? No Thanks, We've Already Had One" December 30, 2022).

- To be sure, *you can criticize this year's equity rally as being narrowly based and large-cap focused* – *and all the reporting has done nothing but*. That's especially so if you carefully pick the very worst starting and ending points. From the January 12 bottom in outperformance by large-cap (please see the chart on the next page) to the June 23 top, just seven stocks and 22.5% of market cap explain the entire S&P 500 gain of 10.0%. There were 308

Generative AI token: "Our Unloved Bull Market in Equities (style: origami)"

Source: DreamStudio running SDXL beta

Update to strategic view

US STOCKS, US MACRO, FEDERAL RESERVE: This year's bull market in equities is underappreciated by investors. From mid-January to mid-June, it has in fact been narrow, dominated by technology stocks. As we predicted in the beginning, generative AI has been an exciting theme that has reawakened growth expectations and risk-tolerance, driving performance not just in companies directly connected to AI, but to growth more broadly. From the bull market's bottom last October, performance has in fact been much more broad-based. The cycle of large-cap and growth outperforming small-cap and value has likely about run its course now. A slowdown in lending presents the first real threat to our long-standing no-landing scenario. But banks continue to have the confidence of savers, seen in the transition from overnight deposits to more risky time deposits. The Fed is likely done with rate hikes, as inflation continues to collapse. As inflation attains the…

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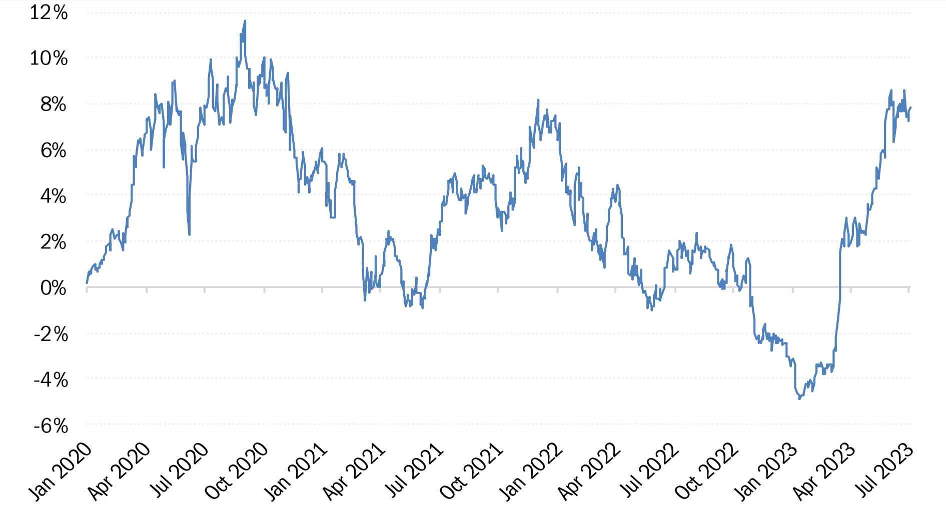
Relative performance cycle: cap-weighted S&P less unweighted S&P (indexed to Oct 12 '22)



Source: Bloomberg, TrendMacro calculations

other winners representing 43.1% of market cap, and 185 losers representing 34.4%. Of the net gain, 82.3% was due to the Info Tech sector – more than three times that sector's weight in the index. There were six other winning sectors and six losing sectors.

- OK, that's narrow, but there's a reason for it, and it's a cherry-picked time period.
- It's no coincidence that the starting date of that period was within five days of our highlighting the sudden mainstreaming of generative artificial intelligence in the form of ChatGPT (see: "Video: Surprises of 2023 Volume 3: What you're not hearing about the boom in generative AI" January 17, 2023). *We said at the time that this was going to be a land-rush,* that "by the end of the year everyone is going to be claiming to be in this space."
- In that cherry picked period, the two stocks making the biggest contributions to S&P 500 gains were the two companies most identified with AI: Microsoft at 2.73% of the S&P 500's 10.0% gain – the company that owns 49% of Chat GPT – and Nvidia at 2.48%, the company whose chips are best suited for AI processing.
- We don't see anything especially surprising about that. You'd expect investors to upwardly revise the valuations of companies involved in a new technology about which the worst thing you can say is that it's going to take over the world.
- And *we saluted AI as not just technology-specific, but rather as a harbinger of renewed risk-tolerance and growth expectations*. We said, "We're not here to call this a bubble. We think it's wonderful after last year's crash in speculative assets that investors are getting excited already about the next next thing."
- Indeed in that cherry-picked period Apple, which has little do to with AI directly, contributed 2.36% of the S&P 500's 10.0% gain, coming in third after Microsoft and Nvidia.
- AI-mania aside, the market narrowness during that period was helped along by the 0.99% *negative* contribution of the financial sector in the wake of the mid-March failure of Silicon Valley Bank.

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…Fed's targets over the summer, the bull market will move forward. But disinflation will turn into deflation, and a pessimistic narrative about it will drive an intense correction.

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- And stepping outside the cherry-picked boundaries of that period defined by rising interest in AI, S&P 500 returns have not been as absurdly narrow. It is more fair to start counting from October 12, 2022, the day before the recovery from an intra-day panic selloff that concluded an almost 26% bear market. From there, to June 30, 2023, it takes 200 stocks and 72.4% of market cap to explain the S&P 500 gain of 26.0%. There were 241 other winning stocks representing 16.02% of market cap, and 59 losers representing 11.6%. Of the net gain, 50.3% was due to the Info Tech sector – which means that sector was punching at twice its weight, (but not more than three times, as in the cherry-picked time period). There were no losing sectors, even Financials.
- *That's a true bull market in magnitude. But from our conversations every day with clients we can report that it is not very well appreciated, and certainly not well loved*. Yes, you can object that a *minority of stocks* made it happen – but it took a *majority of market cap*. And it's still early days. This bull market is not even nine months old yet.

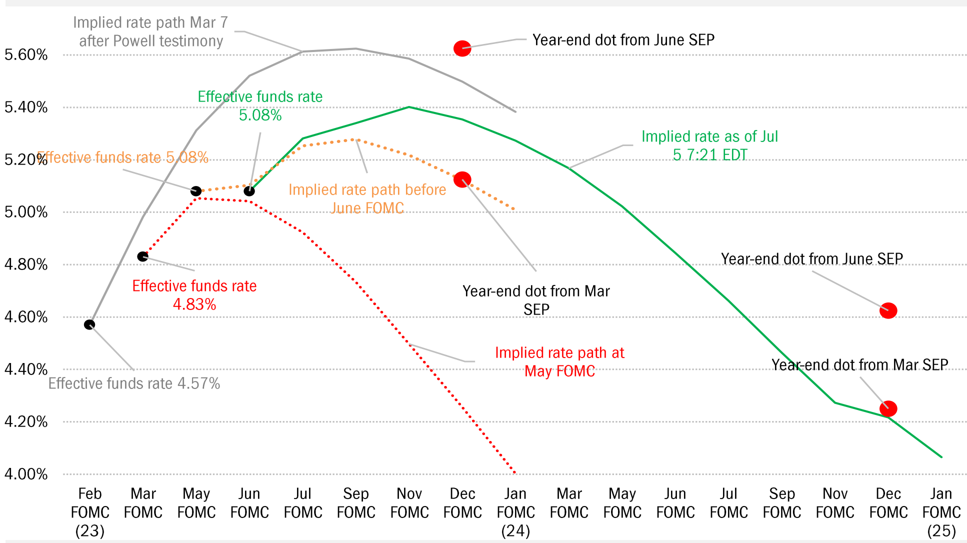
This bull market in equities began from the intraday panic lows of October 13, following a disappointingly hot September CPI report (see "Or How I Learned To Love September CPI" October 13, 2022). *We believe that's when it became clear we weren't going to actually experience the widely dreaded "hard landing" – and, indeed, were likely to have no landing at all. So far so good.*

- *Why? Because that's when we knew we'd broken the back of inflation, and that's when we knew the Fed was going to slow down the torrid pace of rate hikes*.
- While that day's CPI report was disappointing for a single month, compared to where inflation had been just three months prior, it was self-evidently on the way down (as we had forecasted right at its top: see "Why Inflation Is on the Way Down" July 25, 2022). *Whatever the Fed may or may not do about it, high and volatile inflation is itself a recession risk-factor. Its cessation takes straws off the camel's back in this business cycle expansion.*
- At the same time, October 12 was the day that the US Treasury sent letters to the top US banks querying them as to interest in Treasury's potential buy-back of illiquid issues – that is to say, for Treasury to initiate quantitative easing. Then two weeks later, on October 25, Senator Sherrod Brown (D-OH), chair of the Senate Banking Committee – the committee with the advice and consent power on Fed appointees – sent a strong four-page letter to Fed Chair Jerome Powell – urging him to slow down. Other senators and representatives soon piled on. Then days later the Fed did indeed announce slowing the pace of rate hikes (see "On the November FOMC" November 2, 2022), which it has honored to the point of "skipping" one in June (see "On the June FOMC" June 14, 2023). *Cessation of rate hikes – indeed, even slowing their pace – also takes straws off the camel's back.*

What could prove us wrong? What could trigger the much over-advertised hard landing and reverse this bull market?

- Even if we are right that the turnaround in inflation and the slowing pace of Fed rate hikes take straws off the camel's back, *the mere passage of time makes every remaining straw heavier to bear as the camel takes his next step forward through the desert.*
- *This is especially true of Fed policy.* Last year's *pace* of hikes was responsible for Silicon Valley Bank's failure – it didn't have time to adapt its balance sheet to the rapidly rising cost of deposits (see "It's Over For SVB – And the Fed" March 13, 2023). But with the Fed having slowed down, and now pausing – or at least "skipping" – chair Jerome Powell himself admits the funds rate is already at a restrictive level. How long can the credit system nourish the economy if rates "restrict" borrowing and lending? *That restriction doesn't have to be a shock, or a tipping point, or a final straw. It just has to sit there long enough, delivering a death of a thousand cuts* (or in this case, a death of *failure* to cut – rates, that is).
- *We do think the Fed is done – a "skip" is a "pause" and a "pause" is a "stop," considering that inflation is visibly collapsing to the point where CPI is likely to print at only slightly more than 3% year-on-year next week.*
- Already, the goods component of the Fed's preferred Personal Consumption Expenditures Price Index – making up about 45% of the index, and itself the trigger for the Fed's panic one year ago (see "On the June FOMC" June 15, 2022) – has fallen far below the Fed's 2% target, at a mere 1.05% (see "Data Insights: PCE Price Index" June 30, 2023).
- *In the face of that, why dear God, why, would the Fed maintain or worsen an admittedly restrictive rate?*
- All the Fed rhetoric from the June FOMC onward has been

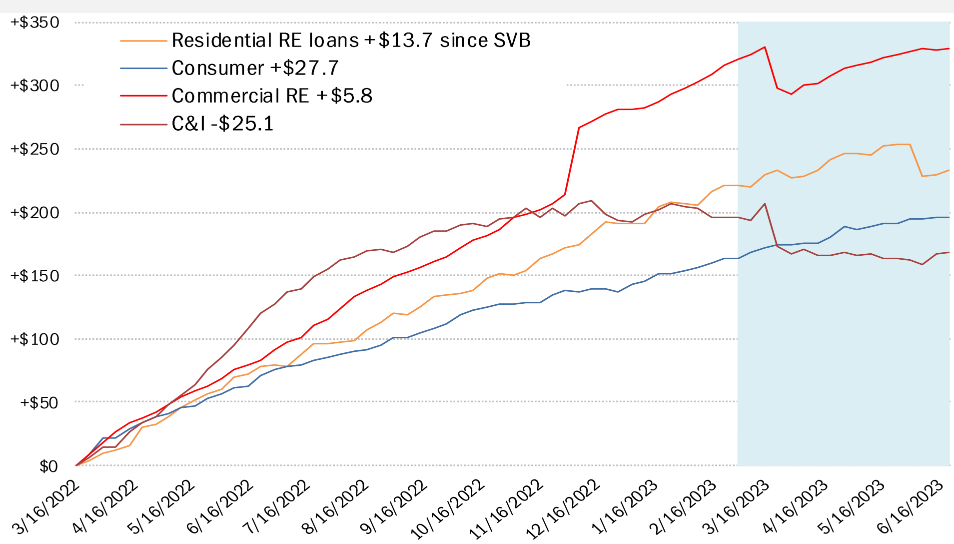
Futures-implied effective funds rate, by FOMC meeting



Source: Bloomberg, TrendMacro calculations designed to condition the market for two more 25 bp hikes (again, see "On the June FOMC"). Market expectations strongly favor one more, so *markets are splitting the difference between our view and Powell's, at least as far as hikes are concerned (please see the chart on the previous page).*

- But the market gives no probability for a cut until the December FOMC, and that from a higher level (again please see the chart above). *We think the cuts start sooner than that, in November or even September, depending on how rapidly inflation starts to visibly turn into deflation.*
- Even assuming we're right, will a 5-3/8% funds rate – or, for that matter, even today's 5-1/8% rate – maintained until then be enough pressure on the post-Silicon Valley Bank credit market so that the economy slides, at last, into some kind of recession?
- Never mind (for now) the potential contractionary effects of the monetary deflation we are sure is going to start to become visible in the fourth quarter. That, in the fullness of time, may turn out to be a good thing – a form of "optimal control" (see "Video: What you're not hearing about the coming deflation" June 23, 2023).
- *No, the first order issue is simply the functioning of credit markets, and unfortunately they are already showing some degree of chilling*.
- In the three-and-a-half months since Silicon Valley Bank's failure, total credit in bank loans and leases has grown by $22.1 billion. Well, at least that's growth – which is remarkable considering the fearful atmosphere since SVB, and commercial and industrial is the only category showing a decline (please see the chart below, and "Two Months After SVB, So Far So Good" May 19, 2023).
- But in the pre-SVB period of comparable length, loan growth was $194 billion (in that prior period, C&I loans were again the only category showing decline).

Growth in bank loans from March 2022 Fed lift-off (USD billions) Post SVB failure

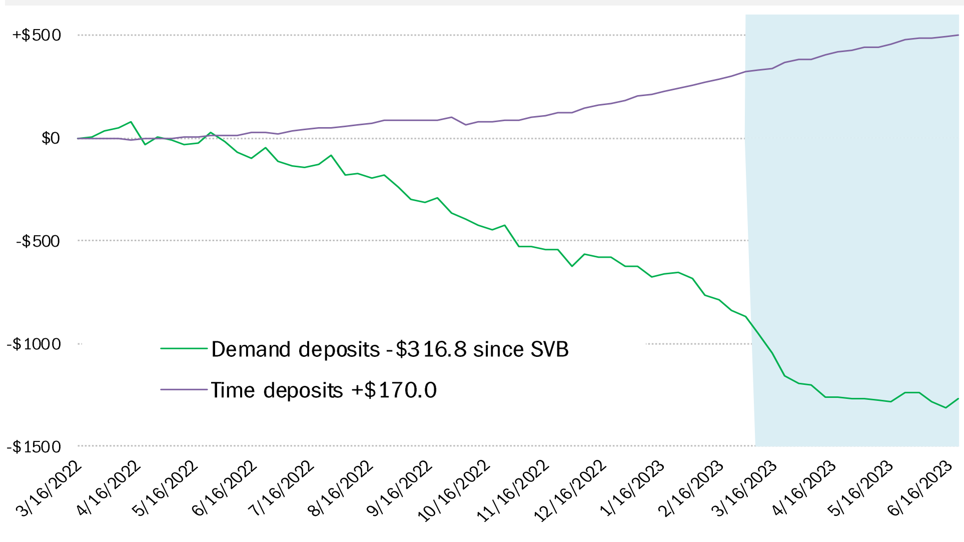


Source: Federal Reserve H.8, TrendMacro calculations

TrendMacro

- *So that's a credit chill – but it's not a credit freeze*. But a chill endured long enough can be just as lethal eventually.
- *And for the banks, a thaw is necessary to be able to durably deal with the issue that brought Silicon Valley Bank down*. At today's higher cost of deposits, banks have to keep originating new loans at today's higher rates in order to close up their negative net interest margins. Those negative margins lead to losses, which lead to capital diminution, which leads to emergency capital raises, which leads… to hell.
- *At least the banks have the gift of time in terms of depositor confidence*. Considering the well-advertised loss of $317 billion in demand deposits since the SVB failure, you may wonder what we mean by that. *We think that drop in demand deposits is more a function of savers seeking higher rates than banks are willing to pay – because deposits had already fallen by $955 billion before SVB failed, starting from March 2022 when the Fed first raised the funds rate form zero.* And over the last eleven weeks as the rate hikes have slowed to a stop, demand deposits haven't fallen at all (please see the chart below).
- It can't be a matter of lost confidence, at least not entirely, because since the Fed's liftoff in March 2022, while demand deposits have fallen $1.27 trillion, time deposits – that is, CD's – have grown by $500 billion. And there's been no interruption in the rate of growth of CD's since SVB failed, making up for more than half the losses in demand deposits (again, please see the chart below). *If savers were scared of banks, they wouldn't be increasing their risk exposure to them by lengthening the term of their savings commitments. No, this is completely consistent with simply seeking higher yields.*
- To be sure, bank deposits overall are down. The growth in CD's has not entirely offset the contraction in demand deposits. But that

Growth in bank deposits from March 2022 Fed lift-off (USD billions) Post SVB failure

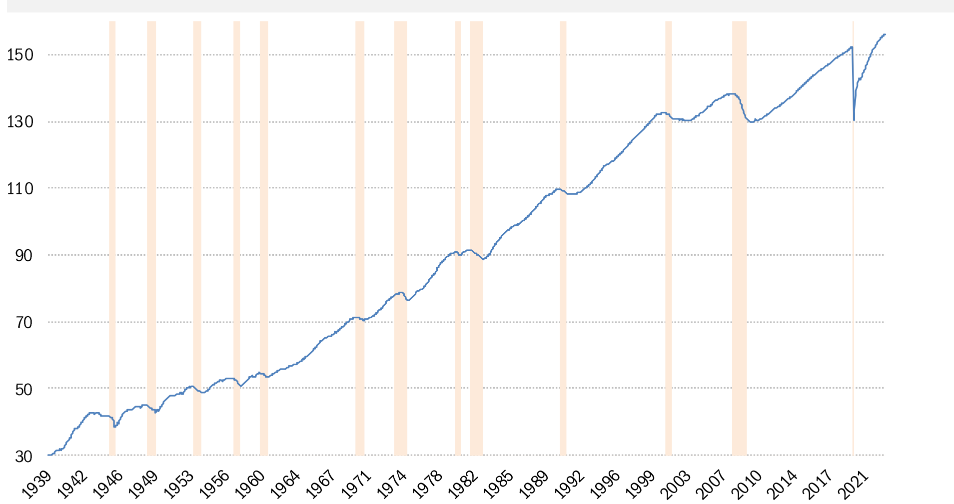


Source: Federal Reserve H.8, TrendMacro calculations was happening *before* savers had SVB's failure to be scared of. And the trends haven't changed in the aftermath of SVB's failure.

- *The point is that no bank can survive without confidence – and even fragile banks can survive with confidence. The US banking system has confidence.* That's at least a solid platform on which the economy can stand while all the other dynamics play out and either cause a recession or not.

Our call remains that there will be no hard landing. Not even a soft landing. But of all the risks that have arisen over the last six quarters of consensus recession expectations, the current credit chill – in the face of which the Fed still doggedly orients its rhetoric to conditioning the market for more hikes – is the most salient threat we've seen.

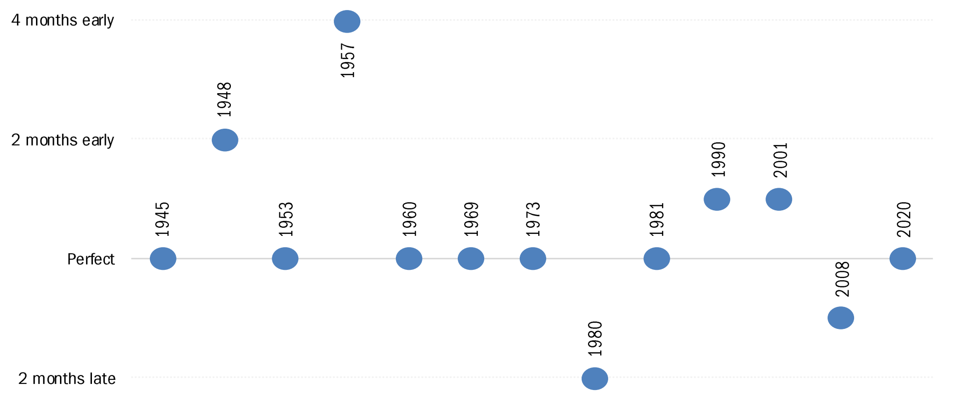
- If recession comes, how will we know – and how will we know in time?
- In this post-pandemic era in which most macroeconomic patterns are scrambled into uselessness by fluctuations of never-before-seen magnitude and velocity, just watch payrolls (see "Video: What you're not hearing about the recession signal in temporary payrolls" January 30, 2023). Payrolls will always perfectly indicate the end of a business cycle expansion and the onset of recession because, historically, they are what amounts to the very definition of those concepts.
- Since 1939, as long as there has been an official US payroll survey, payroll growth has been a perfect indicator of the longevity of business cycle expansions (please see the chart below).



Source: BEA, NBER, TrendMacro calculations

- *Over 13 recessions, the peak in payrolls has only lagged the business cycle peak twice – once by one month (2008) and once by two months (1980)* (please see the chart on the following page). It has been early four times, never by more than four months (unlike the yield curve, which is typically years early). *It has been perfect in 7 of 13 cycles*, with an average error of 15 days early.

Payroll peak versus last month of official business cycle expansion



Source: BEA, NBER, TrendMacro calculations

- There has only been one false alarm, in Q3-1951, in which payrolls fell notably for three months – and then instantly recovered – and there was no business cycle peak.

In the meantime, unless some powerful new causal factor emerges – or unless or until an effect-measure like payrolls tells us otherwise – *we're continuing to assume no landing: hard, soft or anything else.*

- So our view to the back half of 2023 is that the present bull market in equities will continue. Based simply on the cyclical nature of the convection pattern between large-cap and small-cap – or, similarly in this instance, between growth and value – our rough-and-ready guess is that *it's about time for small-cap and value to bounce back in the context of broad gains overall* (again, please see the chart on the second page).
- But that's a call for the third quarter, during which evidence of the conquest of inflation will become undeniable. Markets will correctly conclude that the Fed is done. Powell will be celebrated as the maestro of maestros.
- *And then the disinflation will curdle into deflation*. It's absolutely inevitable based on the first-in-modern-history decline in the money supply (see "Inflation Has Peaked -- Get Ready for Deflation" May 24, 2023).
- Then a new scare-narrative will emerge. Larry Summers, Mohamed El-Erian and all the usual suspects who glom onto any putative crisis in order to get booked on CNBC – as they have over the last year with inflation – will glom onto deflation.
- You know what they will say. They will say central banks can't fight deflation effectively because of the zero-bound on policy rates. They will say that consumers can turn deflation expectations into self-fulfilling prophecies simply by deferring purchases. They will say that deflation erodes nominal corporate earnings. They will say that deflation leads to defaults (they will surely refer, gravely, to Irving Fischer's famous 1933 opus, "The Debt Deflation Theory of Great Depressions").

- They are smart people, so they won't be wrong on any of these points. But we think they are wrong to drop the context in which this deflation will take place. *This deflation will take place after a large and brief inflation shock following forty years of no inflation to speak of*. We think that the present inflation hasn't lasted long enough to become embedded in the contract-structure of the economy – so a little deflation will not be a whipsaw, but rather a corrective that will move the price level back to the trend for which the economy had been prepared all along. *It will undo more damage than it will do*.
- This is a narrower market call than we normally make, but here goes: we think the deflation scare-narrative, arriving amidst a celebratory atmosphere based on liberation from inflation, will be a shock to market sentiment. From stock market levels higher than today's, there will be a considerable correction while the deflation scare is processed.
- If we are right, and the deflation turns out to be more good than harm, then this will be a very buyable dip.

Bottom line

This year's bull market in equities is underappreciated by investors. From mid-January to mid-June, it has in fact been narrow, dominated by technology stocks. As we predicted in the beginning, generative AI has been an exciting theme that has reawakened growth expectations and risk-tolerance, driving performance not just in companies directly connected to AI, but to growth more broadly. From the bull market's bottom last October, performance has in fact been much more broad-based. The cycle of large-cap and growth outperforming small-cap and value has likely about run its course now. A slowdown in lending presents the first real threat to our long-standing no-landing scenario. But banks continue to have the confidence of savers, seen in the transition from overnight deposits to more risky time deposits. The Fed is likely done with rate hikes, as inflation continues to collapse. As inflation attains the Fed's targets over the summer, the bull market will move forward. But disinflation will turn into deflation, and a pessimistic narrative about it will drive an intense correction.