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MACROCOSM

It's a Recession! Well, Maybe It's Just a Correction

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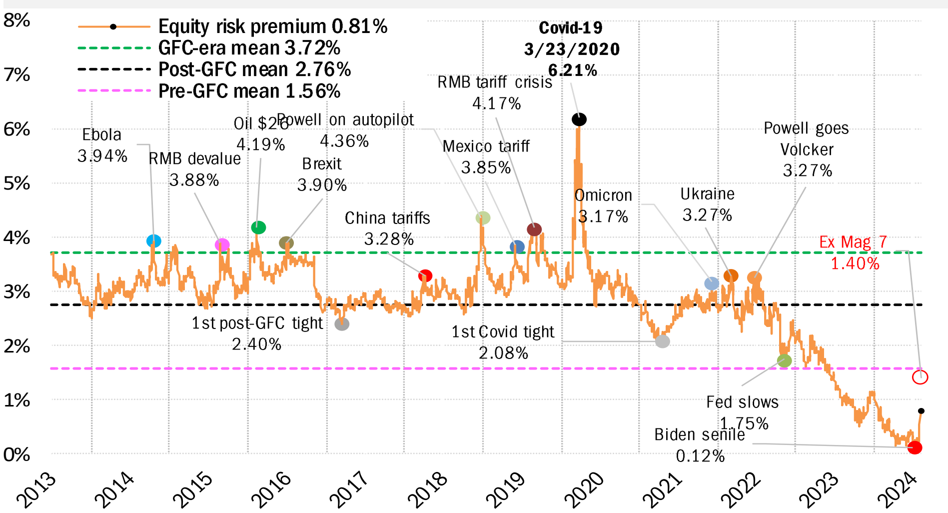
Donald Luskin

With the 2-10 disinversion and the Sahm Rule, we've got kinda sorta (not) recession calls.

We warned in the headline of our June 28, 2024 report that "If Biden is replaced, it will be an uncertainty event that will discomfit markets" (see "Our Hot Take on Last Night's Presidential Debate" June 28, 2024). We wish we'd warned louder. Can we agree that markets are discomfited?

- *We have discovered the lower boundary of the US equity risk premium* in a long period of narrow premia not seen for more than twenty years. We're putting an event marker at 0.12%, the level on July 2, 2024, three market days after our report, which we associate with the onset of the Biden senility crisis (please see the chart below, and "Data Insights: Global Equity Risk Premia" August 5, 2024).
- *At the same time, recession fears are back with a vengeance, and we'll get to all that in the moment*. But what's happening in markets is *a correction in sentiment* triggered not only by the alarming reality of a sitting president too disabled to run for re-election potentially having to deal with global crises like the one brewing between Israel and Iran. *Markets are dealing with the much more significant destabilizing psychological impact of having witnessed so many recent public events of great consequence that have*

S&P 500 equity risk premium, daily from mid-2013 (as of August 2, 2024)



Source: Various. TrendMacro calculations

Update to strategic view

US STOCKS, US BONDS, US MACRO, FEDERAL RESERVE: The US equity premium has showed us where the bottom is – at near-zero, on July 2 – when the Biden senility crisis was just beginning, and we warned that markets would be discomfited by it. The crisis has triggered a reexamination of beliefs, especially the perpetual growth power of the Magnificent Seven. With a non-zero ERP and long-term yields below sustainable levels in the post-pandemic epoch, a tactical asset allocation move toward equities is called for. The Sahm Rule was ambiguously triggered Friday, but only because the labor force expanded. Today the 2-10 yield curve briefly disinverted. Historically it is the disinversion, not the inversion, that gives the recession signal, but so far this cycle the curve has been the wrongest ever. ISM Services at 51.4 contradicts Friday's Manufacturing at 46.8. Forward earnings growth continues strong. Payrolls are growing. July CPI should report next week as outright deflation, making inflation is a solved…

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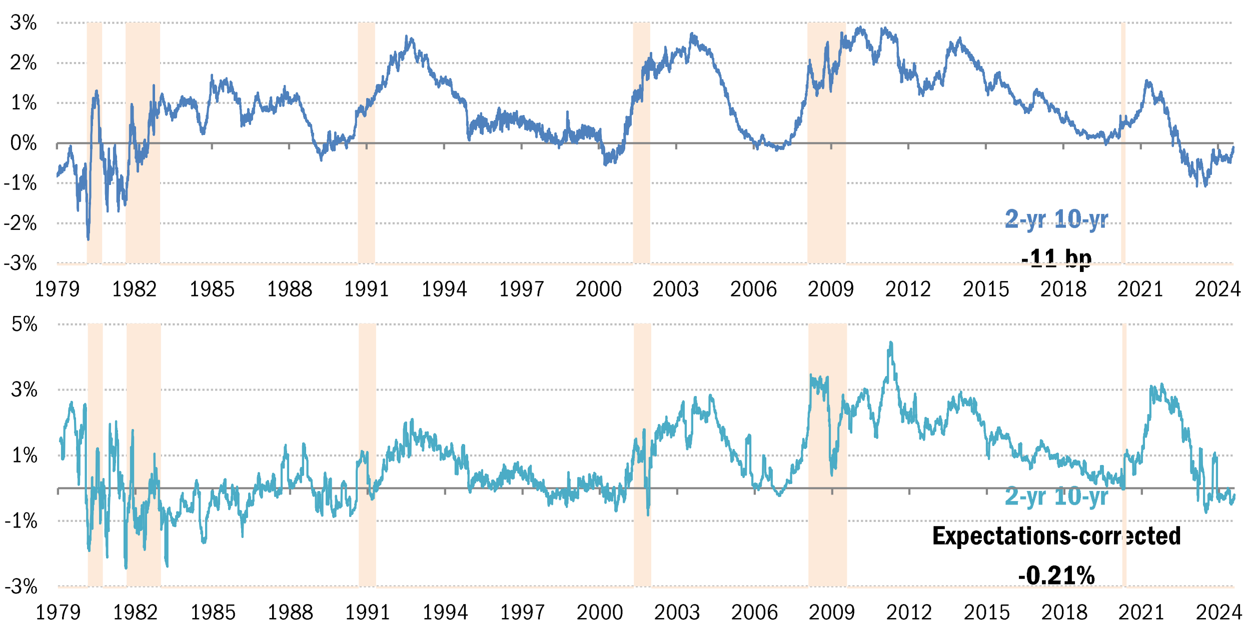
stripped away years of self-imposed denial – opening up previously closed mental pathways toward examining the unexamined, such as whether the Magnificent Seven's earnings power discounted to perpetuity is actually as strong as everyone seems to have unquestioningly thought. *Bull markets work better when you don't think about the details*.

- *We're probing now for valuations that are consistent with a little more examination of the details*. The suddenness and velocity of the move is disturbing – but it's just a correction.

Now about those recession fears…

- *We've been correct to push back against recession fears for over two years*, ever since April Fools Day when the 2-10 yield curve first inverted. Has anything really changed since then?
- For one thing, more than two years have passed, and the economy has moved closer to maximum employment. There is always less recession risk *below* maximum employment, because it's hard to fall out of the basement window. So now there is a height from which a fall is possible.
- *This morning the 2-10 yield curve briefly uninverted for the first time by a couple basis points, and as of this writing is now inverted again* (please see the top chart below). *Disinversion does not erase the warning of the yield curve, it intensifies it. As we have said many times, the better recession signal over history has come not when the curve inverts, but when it disinverts* (see "Video: What you're not hearing about the steepening yield curve" October 10, 2023). *So now we have that signal.*

Treasury yield curve (as of August 5, 2024, 12:43 pm EDT) Recession



Source: Bloomberg, University of Michigan, NBER, TrendMacro calculations

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…problem. Housing transaction values remain above the pre-pandemic trend. Capital expenditures remain near all-time highs, and debt-service ratios are near all-time lows. Bank lending is accelerating. The Fed will not respond to a market panic with an emergency cut. Unless more recessionary data comes out, we don't think the September cut will be more than 25 bp.

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- It is what it is, and we're not incognizant or disrespectful of it. But… this cycle the inversion has been about the wrongest in history – that is, assuming a recession sets in right now, it will have given its warning so early as to be utterly useless. So given that, and the widespread failure of so many time-tested and beloved economic indicators in this most unusual business cycle following a once-in-history high-frequency depression during the pandemic, why should the disinversion signal be taken as gospel?
- Furthermore, this yield-curve cycle has been unusual because it is the first one since the early 1980s when short-term inflation expectations were significantly above long-term inflation expectations, which straightforwardly lowers the spread between the 10-year (with lower inflation expectations built in) and the 2-year (with higher expectations built in). The deflationary consumer price data in Q2-2024 has led to a reversal of that situation, with short-term inflation expectations below long-term. Correcting for that anomaly leaves the expectations-corrected 2-10 curve still inverted, even today (please see the bottom chart on the previous page).
- The almost-disinversion of the 2-10 curve echoes the almost-triggering of the faddish "Sahm Rule" with Friday's jobs report (see "On the July Jobs Report" August 2, 2024). The so-called rule declares a recession when the three-month average of the unemployment rate is at least 50 bp above its lowest reading for the last 12 months. Using data rounded to one decimal place of precision, *the Sahm Rule is just barely triggered* – exactly at 50 bp. But unrounded (by dividing the raw number of unemployed persons by the raw number of persons in the labor force), it's only 46 bp, and it's not triggered. Yes, we're only arguing about a couple basis points. But so is the rule itself: even if we use the rounded numbers it has only been triggered by the tightest possible margin. That's always the problem with quantitative indicators, even ones that pretentiously style themselves as "rules" – the decision-tolerances around the triggers is necessarily arbitrary.
- More deeply, even thought the Sahm Rule has an excellent track record, unlike the yield curve and so many failed macro indicators in this cycle, there's really no saying it means anything this time around. And track record or no, we do have a fundamental quibble with its methodology. Because the unemployment rate is the ratio of unemployed (the numerator) to the labor force (the denominator), it can move for a variety of reasons, some malignant and some benign. In July, the number of unemployed persons rose by 352,000 – but it's not like 352,000 were fired from their jobs. 420,000 persons joined the labor force – so 68,000 got jobs, and 352,000 of them didn't (yet). Is it a bad thing that should be seen as symptomatic of recession that so many new entrants want to work?
- At the same time as the Sahm Rule was barely triggered on Friday, the ISM Manufacturing Purchasing Managers Index printed at 46.8 – triggering a flood of headlines that "US manufacturing extends slump" when in fact this index is not an output indicator, but only a sentiment indicator, and one that has been wrongly in the dumps since November 2022, while the economy has boomed. It has only

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reflected the reality of the boom over the last two years once – a single reading above 50 in March 2024. It has been lower than Friday's supposedly horrific level of 46.8 five times. No recession.

- *It was starkly contradicted this morning by the Services PMI, at 51.4* (see "Data Insights: Global PMI" August 5, 2024).
- Manufacturing is 15% of the economy. Services is 85%. So assuming the PMI framework is a valid forecasting tool to begin with, are we going into a recession? You make the call.

Having thrown stones at recession indicators we don't like, what about the ones we do?

- S&P 500 one-year-ahead forward earnings continue to soar. They reliably fall ahead of recessions.
- The implied earnings growth rate over eight quarters is over 10% per annum, while the historical average is 6%.
- Payrolls continue to grow. Unlike the unemployment rate (used in the Sahm Rule), payrolls simply measure jobs unpolluted by changes in the size of the labor force.
- To be sure, the 114,00 net payroll gains reported Friday for July missed expectations (see "Data Insights: Jobs" August 2, 2024). But the dial-tone for our maximum employment economy is something like 90,000 – and we beat that. And we beat April's 108,000, so it's not like we haven't seen a payroll number like that without having a recession (indeed, April kicked off a quarter with 2.8% real Gross Domestic Product growth – see "Data Insights: GDP" July 25, 2024).
- Disinflation continues. Based on the "Truflation" real-time estimate, we expect July CPI to report next week as outright deflation (please see "Data Insights: High Frequency Post-Virus Recovery Monitor" August 1, 2024). In the mood that prevails now, that will probably be interpreted as recessionary. But trust us on this – there's nothing recessionary about curing the worst inflation in two generations, and giving consumers the gift of a little relief from it.
- Housing transaction values remain slightly above the pre-pandemic trend. Household debt service ratios are near the lowest in the history of the data. Capital expenditures remain near all-time highs. Bank lending is expanding (for all three, see "Data Insights: A Few of Our Favorite Things" July 25, 2024).
- And now we have an equity risk premium well above the near-zero we have flirted with for the summer so far. The ERP for the 493 stocks other than the Magnificent Seven was already back to the pre-GFC mean Friday, even before today's price decline.
- That's not just because stock prices have fallen. It's because long-term yields have fallen, too, to below what we consider to be sustainable levels in the post-pandemic post-"secular stagnation" epoch. It's getting to be a good time to shift tactical asset allocations toward equities and away from bonds.

Oh, and the Fed… There are calls everywhere now – indeed, a consensus – for a 50 bp cut at the September FOMC. Some are calling for an emergency inter-meeting cut. Fat chance on the latter, the former is a possibility, with the Fed once again caught flat-footed by over-relying on transitory data and ignoring underlying cause-and-effect relationships (we're talking about the false alarm on inflation in Q1-2024, falling for which should deeply embarrass the Fed, and might be enough to motivate a sense of urgency – see "On the July FOMC" July 31, 2024).

- But the Fed's not going to panic simply because the stock market is. They're going to want to see more actual data indicating imminent recession. We don't think they will get that. So for the moment we're sticking with expecting just a 25 bp cut in September.

Bottom line

The US equity premium has showed us where the bottom is – at near-zero, on July 2 – when the Biden senility crisis was just beginning, and we warned that markets would be discomfited by it. The crisis has triggered a reexamination of beliefs, especially the perpetual growth power of the Magnificent Seven. With a non-zero ERP and long-term yields below sustainable levels in the post-pandemic epoch, a tactical asset allocation move toward equities is called for. The Sahm Rule was ambiguously triggered Friday, but only because the labor force expanded. Today the 2-10 yield curve briefly disinverted. Historically it is the disinversion, not the inversion, that gives the recession signal, but so far this cycle the curve has been the wrongest ever. ISM Services at 51.4 contradicts Friday's Manufacturing at 46.8. Forward earnings growth continues strong. Payrolls are growing. July CPI should report next week as outright deflation, making inflation is a solved problem. Housing transaction values remain above the pre-pandemic trend. Capital expenditures remain near all-time highs, and debt-service ratios are near all-time lows. Bank lending is accelerating. The Fed will not respond to a market panic with an emergency cut. Unless more recessionary data comes out, we don't think the September cut will be more than 25 bp.