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WEALTH MANAGEMENT

MACRO MUSINGS

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When Markets and Metrics Diverge: The Stock Market vs. Leading Economic Indicators

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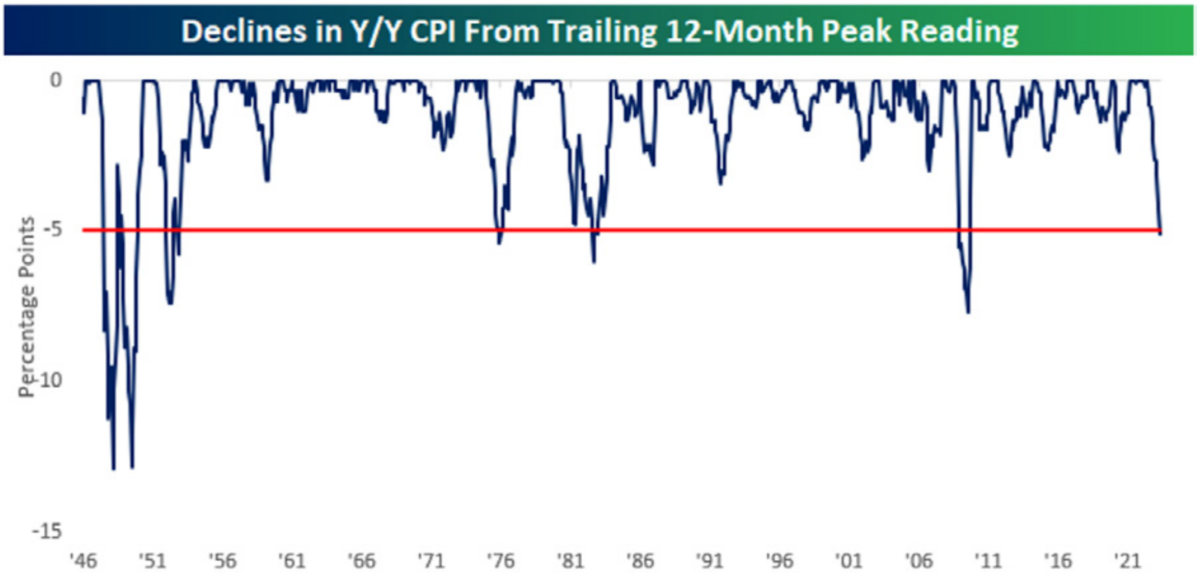
SUMMARY

- The **macro**cast™ score suggests the probability of a recessionary bear market remains elevated. The position of **micro**cast™ remains at its base allocation.
- The stock market, as measured by the S&P 500, is set to finish the first half of the year with double-digit gains. This is in stark contrast with leading economic indicators, which suggest a recession is still a high probability.
- It would be highly unusual for the market to be positive ahead of a recession. Historically, the market has not performed this well in the months leading into economic downturn.
- We maintain our view that a recession is likely to occur by early next year. Yet as each month passes without a downturn, the odds of dodging a recession altogether increase, as opposed to it just being "postponed.

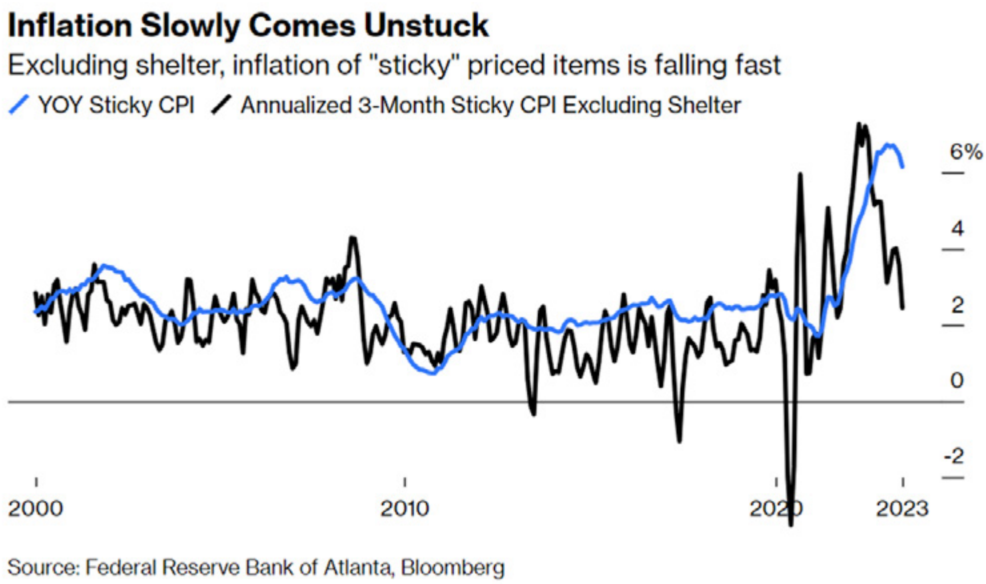
A QUICK UPDATE ON **INFLATION AND THE FED**

Inflation data was released on June 13th, with the numbers in line with forecasts. Headline CPI increased 0.1% in the month of May (+4.0% y/y) and was lower than the 0.4% increase in April (+4.9% y/y). Headline inflation is now down 5% from its 12-month high (chart from Bespoke):



Core inflation, which excludes food and energy, is still 5.3% higher than a year ago. However, this is the lowest annual rate since November 2021. Core CPI is expected to continue its gradual decline in the coming months, due in part to the lagged effects of housing costs.

Furthermore, "sticky" inflation, which includes a subset of goods and services in the CPI that change price relatively infrequently, is rolling over. These components of inflation are thought to incorporate expectations about future inflation to a greater degree than the more volatile components of CPI. Encouragingly, outside of housing, "sticky" CPI prices are falling fast (chart from Bloomberg):



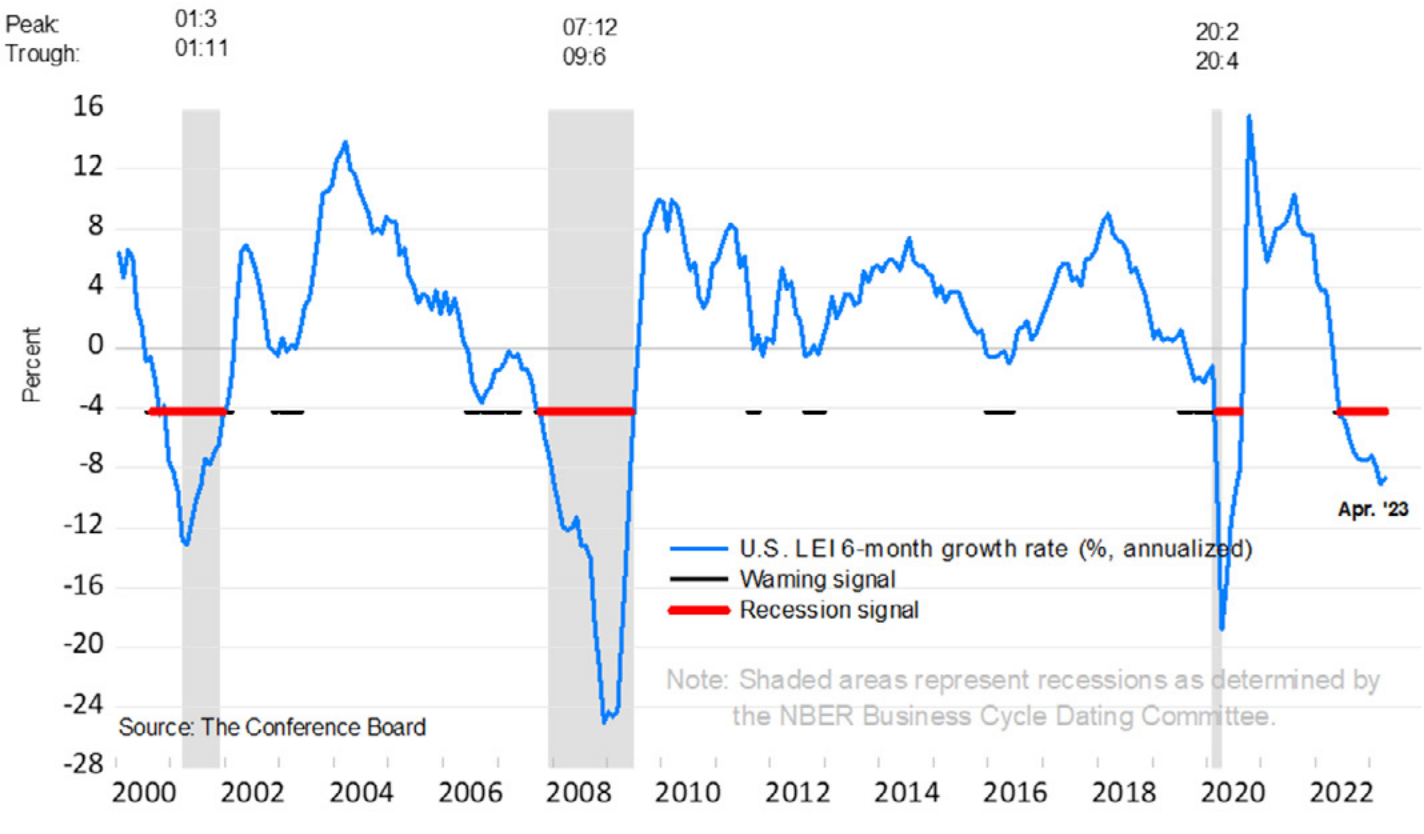
Overall, these trends suggest that inflation is moving toward a more favorable level.

The Fed held its meeting on Wednesday, and the committee left interest rates unchanged. The respite comes 16 months after the Fed began its most aggressive rate hike cycle since the early 1980s, increasing the Fed Funds rate from 0 to a 5%-5.25% range.

Although the Fed refrained from hiking rates in June, they left the door open for at least 2 additional increases sometime in 2023. This was unexpected. The press release reiterated the desire to see inflation move towards the Fed's 2% target. During his press conference, Chairman Powell said the July meeting was "live," meaning that the Fed is open to raising rates at the very next meeting.

THE MARKET IS UP, **WHILE LEADING ECONOMIC INDICATORS ARE DOWN**

While the market has seen double digit gains year-to-date, leading economic data remains weak. The Conference Board LEI is still signaling a recession over the coming year (chart from The Conference Board):



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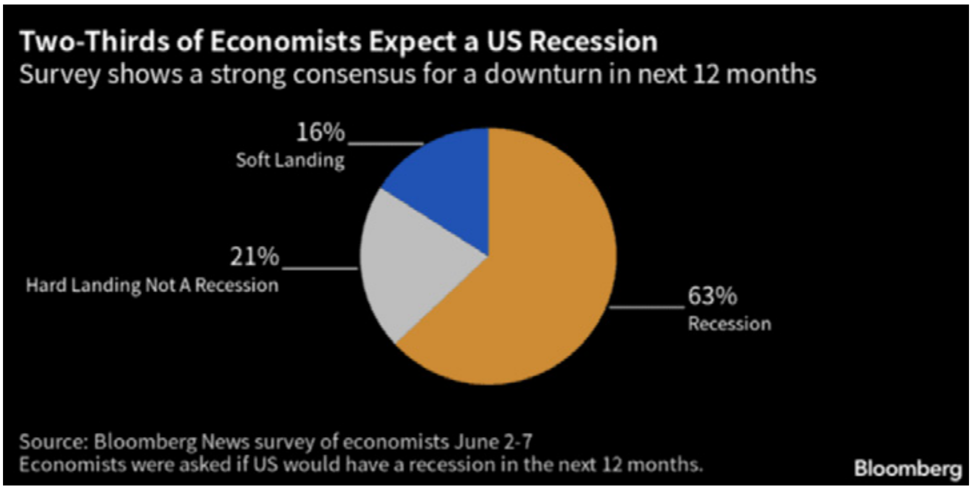
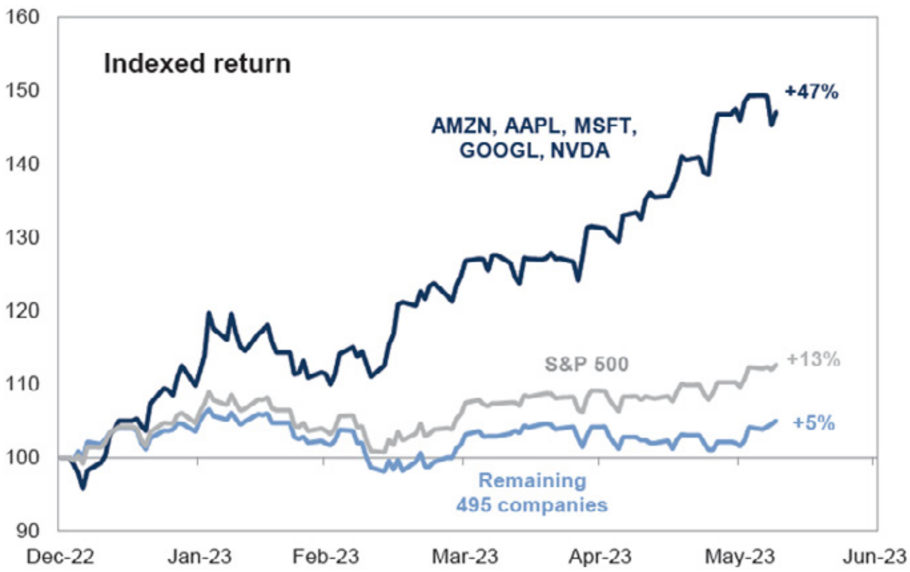
And a majority of economists are still expecting a recession (from Bloomberg):



If you include the "Hard Landing Not A Recession" votes as recessionary (what's the difference??), nearly 85% of economists expect a downturn between now and Summer 2024.

Despite these prevailing uncertainties in the economic backdrop, the stock market has experienced a robust rally year-to-date. It's important to highlight that the majority of these gains are attributable to the performance of the five largest stocks in the index. These stocks — Amazon, Apple, Microsoft, Google, and NVIDIA—are large, tech-centric corporations that, combined, make up more than 20% of the S&P 500 index (chart from Goldman Sachs):

Exhibit 1: The five largest stocks have led the market higher YTD
as of June 8, 2023



Source: FactSet, Goldman Sachs Global Investment Research

Still, even without the huge lift from the top 5 names, the rest of the index is positive for the year. This is not what you expect to see if a recession was about to begin.

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To illustrate this point, the following table shows market returns in the 12, 6, and 3 months before the last 7 recessions (from LPL):

Lackluster Stock Market Performance Ahead of Recessions

S&P 500 Index Gains/Losses Before Start of Recessions (since 1973)

Recession Start Date	Recession End Date	12 Months Before	6 Months Before	3 Months Before
11/30/1973	3/31/1975	-17.8	-8.6	-8.0
1/31/1980	7/31/1980	14.2	10.0	12.1
7/31/1981	11/30/1982	7.6	1.1	-1.4
7/31/1990	3/31/1991	2.9	8.2	7.7
3/31/2001	11/30/2001	-22.6	-19.2	-12.1
12/31/2007	6/30/2009	3.5	-2.3	-3.8
2/29/2020	4/30/2020	6.1	1.0	-6.0
	Mean:	-0.9	-1.4	-1.6
	Median:	3.5	1.0	-3.8

Source: LPL Research, Ned Davis Research 06/06/23

Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

Average gains were negative across each timeframe, while the median returns were also poor.

Contrast that with today's data. Through June 9th, the returns over the past 12, 6, and 3 months were approximately 12%, 10%, and 12%, respectively.

The adage "the stock market is not the economy" is often heard on Wall Street. However, historical trends show that stocks typically underperform when the economy is in a downturn or heading toward one. We do not seem to be there just yet.

HOW WE ARE THINKING ABOUT THIS CYCLE **VS PREVIOUS SLOWDOWNS AND RECESSIONS**

While leading indicators continue to point toward recession, the stock market seems to be pricing in a soft landing. Our base case remains that a recession is likely by Spring 2024.

If there's no recession by early next year, we might dodge one completely, not just "postpone" it again. Eventually, the global business cycle will turn up, and growth will start anew. If that happens, the downturn that began in late 2021 will look more like the economic slumps of 2011 and 2015 rather than the full-blown recessions we saw in 2008 (Global Financial Crisis) or 2001 (Dot Com Bust and 9/11). The key difference between slowdowns and recessions? Jobs. In 2011 and 2015, unemployment didn't really rise. In 2001 and 2008, it did. If the labor market can remain healthy while we continue to make progress on inflation, a recessionary outcome becomes less likely.

In summary, the most recent inflation data continues to show a slow but clear decline. The Fed held rates steady this month but indicated they expect two more rate hikes this year. Despite weak leading economic data pointing towards an impending recession, the stock market has remained resilient, staging a strong rally this year that has largely been driven by the top 5 tech corporations. Historically, stock markets underperform during an economic downturn, but this pattern is yet to emerge. We still believe there are decent odds of a recession by Spring 2024, but if it doesn't materialize early next year, we might evade it altogether.

Thank you for reading our latest Macro Musings and for your continued partnership and trust.

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