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Just over two years ago, it looked like global markets, and the U.S. stock market in particular, had made an important top. Setting aside the brief 2020 Covid lockdown hit, the economic expansion that emerged from the 2008-09 financial crisis had endured for an unusually long time. Not surprisingly, the unemployment rate had fallen to a historically low level, consumer price inflation and interest rates were starting to pick up, and equity markets had become expensive and speculative. Sure enough, as prices and interest rates accelerated to the upside, stock and bond prices accelerated to the downside, producing one of the worst years ever for a balanced portfolio of American stocks and bonds. At the same time, sharply rising prices and interest rates led to a slowdown in the world economy and caused a number of tried-and-true economic indicators to signal an oncoming economic recession in 2023 or, at the latest, in 2024. Furthermore, since stock prices typically do not stop falling until a recession is underway, it was widely assumed that additional stock market weakness was likely. It was an obvious and widely accepted scenario. Yet, as is often the case when economic and market scenarios become widely accepted, events took a different course. In this instance, the S&P 500 Index bottomed in October of 2022 in line with reported earnings and just prior to the release of Chat-GPT 3.5. For most of 2023, the rise in the S&P 500 was mainly about the "Magnificent 7" and especially Nvidia and anything connected to artificial intelligence (A.I.). To some extent, that is still true. In January of this year, A.I.-infused voice generation firm ElevenLabs reported that it had raised $80 million based on a $1 billion–plus valuation of the company a mere seven months after it did a financing that assumed a $100 million valuation. The two best performers in the S&P 500 so far this year have been Nvidia and Super Micro Computer, a go-to provider of A.I. servers, which has a multiple of 33 on forward earnings, up from 4 a year ago. Nvidia, meanwhile, recently traded at 37-times sales, coincidentally the same ratio Cisco, the darling of the dot.com bubble, sported at its peak. It is worth noting that, even though Cisco's sales and earnings have increased significantly since 2000, the stock price today trades more than 35% below its record high. At the end of February, the Magnificent 7 had a market capitalization that was 82% of the total market capitalization of China and India with their combined population in excess of 2.8 billion.

However, over the past 5 months, two new factors have entered the equation to propel equities and broaden the participation. First, the rate of inflation has been falling pretty steadily in most places around the world and central bankers have responded by cutting interest rates, in the case of Switzerland (to 1.5%) and Mexico (to 11%!), or by announcing plans to do so this summer (e.g. the U.S., U.K., Europe, Canada, Australia). There have already been 55 central bank rate cuts over the past six months and in 2024 the banks are projecting the most synchronized rate cuts since 2008. Of course, if interest rates were coming down because the world economy was tanking, as in 2008, it would hardly be cause for celebration. On the contrary, there have recently been a number of positive businesses datapoints. In the U.S., the Conference Board said in January, regarding its Index of Leading Indicators (LEI), which has a great track record in signaling recessions, "For the first time in two years, six of the ten components were positive (so that), as a result, the LEI does not signal a recession ahead (although we do expect real GDP growth to slow to near zero over Q2 and Q3)." Then, in February, the LEI rose for the first time since February 2022 (although it would have declined without the impact of rising stock prices). In the post-WWII era, only twice before has the LEI fallen for more than 12 consecutive months, never mind 23, and those two occasions were during the two biggest recessions since the 1930s. So, the fact the LEI is no longer signaling a recession is positive, but also a bit perplexing. Another indicator with a good track record is the ISM survey of manufacturers, which rose to 50.3 in March (50 plus indicating expansion),

the first expansionary print since October 2002. New orders also rose above 50 and the share of industries reporting growth rose to 50% from 33% a year ago. As with the LEI, it was not a completely clean sheet as backlogs continued to contract and much of the production went into inventory. Similar survey data out of China was equally encouraging. In Germany, the so-called IFO index of business confidence rose to its best level since last May and, in Japan, the Tankan survey of the service sector rose to its highest level in more than three decades! All-in-all, according to J.P. Morgan, global manufacturing is improving marginally. As a result, there has been a sea change in the attitude of investors and forecasters. In late 2022, a recession in the next 12 months was a virtual certainty for investors and a 45% probability on the part of forecasters, which was the highest ever by far. Now, a so-called "soft landing" is the base case with only 11% of investors visualizing a "hard landing" (i.e. recession).

Inflation falling and central bankers cutting interest rates, even as the world economy is showing signs of life and A.I. is getting ready to turbocharge productivity. What's not to like? And, indeed, investors did like it in the first quarter of 2024 as the majority of indices rose by about 5%. The S&P 500 did better, fueled by A.I. stocks and the Magnificent 7 adding another $1.7 trillion of market capitalization. On the other hand, the defensive "value" sectors – real estate, utilities, consumer staples, and health care (ex. anti-obesity drug companies) – were laggards again. Oil rallied and a few other commodities (e.g. cocoa) did well, but most commodities treaded water, except for natural gas which was down 30%. Bonds were the worst relative performers, led by long-term Treasuries with a negative 3.3% return.

There is no question investors are becoming increasingly optimistic. The expression "goldilocks" (not too hot, not too cold) is being applied to the U.S. economy as people reach for a bullish storyline. One of Canada's banks has just published a piece entitled, "1995 – Déjà Vu", which ends as follows: "The U.S. economy is showing promising signs of achieving the second soft landing in peacetime history. The similarities to the 1995 situation…at the margins…are consistent with a moderate easing trajectory by the Fed and potentially strong productivity-led non-inflationary growth." This is a well-researched document, but it is always risky to compare cycles and there are some obvious differences the writer chose not to emphasize. To what extent should we buy into this narrative?

There are at least two reasons to be cautious. First, the "soft landing" scenario may not play out. On the one hand, inflation may prove to be "stickier" or more difficult to wrestle permanently to the ground than people currently assume. "Only the dead have seen the end of inflation", noted one writer recently, repurposing Santayana's great line, "Only the dead have seen the end of war", which seems only too sadly apt in 2024. The writer might have added, however, "since Nixon closed the gold window in 1971" because, from the restoration of King Charles II in England until World War I, when Britain was on the gold standard, the only inflation was during the Napoleonic Wars. More recently, in the U.S., between 1951 and 1962, inflation averaged 1.3% per annum. Then came the deficit financing of the Vietnam War without the discipline of gold and the CPI rose by an average of 7.7% in the 1970s. Since 1982, inflation has been much better behaved, but, nonetheless, from that time, consumer prices have risen by 217% and a 1983 dollar is worth 31 cents. The average annual U.S. inflation rate over the past 5 years has been 4.2% and, over the past 10 years, 2.8%. Dollar Tree kept its prices at $1 for 35 years. Then, in 2021, it "broke the buck" and bumped its primary price point to $1.25. Nine months ago, it imposed a $5 price cap and has just announced it will add scores of new items with price tags up to $7. Of course, a key driver of inflation today, as during the Napoleonic and Vietnam eras, with the crucial difference that the U.S. is not at war, is government deficit spending. In fiscal 2002, the U.S. budget deficit was $158 billion (1.4% of GDP compared to the current run-rate of almost 7% of GDP). A recent headline noted, "$168 billion added to the U.S. national debt in 20 days". None of this is to suggest that rates of inflation can't continue to fall on a cyclical basis, especially if the economy turns out to be weaker than investors

are currently expecting. Nor does it mean that central bankers will not cut interest rates until consumer price inflation is well and truly running at 2% or less, their supposed target. Indeed, in 1972, when the rate of inflation reached 3%, the Federal Reserve had already cut interest rates by 100 basis points and, in 2008, when inflation hit 3%, rates had been cut by 425 basis points. However, if governments continue running big deficits, and if 2% inflation is the acceptable floor, and if the Federal Reserve nevertheless wants to cut interest rates with a 4% unemployment rate and the economy supposedly chugging along, then inflation rates of more than 2% seem at least as likely an ultimate outcome as inflation rates of 2% or less.

On the other hand, if inflation could turn out to be more intractable than anticipated, it is also possible that the economy could be weaker than anticipated, particularly over the next year or so. Perhaps, a recession is not off the table after all. In fact, apart from the so far marginal flips in the March manufacturing surveys in China and the U.S. and in the U.S. LEI, most of the business data around the world continues to point to recessionary economic conditions. The biggest of these is the yield curve, which always inverts before a recession, although the lead time can vary significantly. Currently, the yield on 2-year U.S. Treasuries has exceeded the yield on 10-year Treasuries continuously since July 2022, the longest such inversion on record and the biggest with the exception of the 1970s. The New York Fed's recession indicator, which calculates the probability of a downturn within the next year based on the yield curve, still shows a roughly two-in-three chance of a recession in the U.S. Then there is the spread between consumers' "expectations" and their "present situation" which has an impeccable record in forecasting recessions and which continues to flash a red light. Bank credit has shrunk on a year-over-year basis for only the second time since 1950 and the cumulative change in the federal funds rate in this cycle has been the most in at least 40 years. Meanwhile, for all the hoopla about how strong the American economy is, most of the data suggests otherwise. In the first two months of 2024, housing starts, real retail sales, and industrial production all declined. According to Rosenberg Research, the odds of this happening when the economy is not in a recession are less than 3%. While the most recent survey of U.S. manufacturers may have struck a positive note, data coming out of the various regions – Kansas City, Dallas, Richmond, Philadelphia, and Chicago – have all been downbeat. While real U.S. GDP rose 2.5% in 2023, GDI (the income side of the equation, as opposed to the spending side) rose by only 0.5%. Averaging the two lowers U.S. growth in 2023 to 1.5%, down from 2.0% in 2022. Historically, when the rate of change in full-time employment falls below zero, the U.S. economy has entered a recession. In February 2024, the U.S. had 132.9 million full-time jobs, down from 133.2 million a year earlier. All the job growth over the past year has been in part-time jobs. Meantime, employment in temporary help services, a trusty leading indicator, has decreased every month for the past 23 months. Real wage growth in the U.S. over the past four years has averaged 0.7% per annum, four times weaker than the previous four years. Then there is the bear market in commercial real estate that has seen a 21% price decline over the past two years. A trophy office tower in Los Angeles recently sold for a price 50% below the building's debt load. On the residential side, a U.S. homebuyer needs an income of $113,500 to afford the median-priced home for sale. Unfortunately, that's 35% more than the median household income.

Nor are economic caution flags restricted to the U.S. China continues to struggle, notwithstanding the green shoots in March. In February, new bank loans were down nearly 20% from the prior year and bad loans have climbed to a record high. Property giant Country Garden Holdings announced that it will miss a deadline for reporting its annual results and new home sales fell 46% year-over-year in March. Shipments of iPhones in China fell 33% year-over-year in February on the heels of a 39% decline in January. Reflecting this economic weakness, steel and iron ore prices have cratered in 2024. Manufacturing data out of industrial Asian powerhouses Japan, South Korea, and Taiwan have so far failed to impress and the Eurozone seems to be making a habit of narrowly avoiding a technical recession.

Real output shrank by 0.1% in the third quarter of 2023, followed by stagnation in the last quarter. A similar pattern is playing out in 2024. Of course, if this widespread economic weakness continues, central bankers can be expected to cut interest rates, perhaps sooner and more vociferously than they are currently letting on or the markets are expecting. However, while investors, consumers, and business people will undoubtedly cheer lower rates, they may be less enthusiastic about the reason rates are falling.

So, one reason investors should not be too quick to embrace the "goldilocks" scenario is that the economy may turn out to be "too hot" (inflationary) or "too cold" (recessionary). However, the second reason to be cautious is that, even if goldilocks arrive, it may already be largely discounted in the markets. The current cyclically-adjusted P/E (CAPE) ratio of 34 is in the top 1% of its history going back to 1880 and has only been higher at the market top in 2021 and during the dot.com bubble. While the overall CAPE was higher in 1999-2000, the number of stocks in the S&P 500 with a P/E ratio above 20x is higher today and 43% of the stocks had a P/E of 15x (the historical average) or less then compared to 25% today. Most other reliable valuation metrics confirm the CAPE ratio. For example, the Q ratio, which compares market value to the replacement value of the assets, is 75% above its mean of the past 70 years and has only been higher at the 2021 market high and in the mid-1960's. While book value is no longer considered a reliable valuation metric, at least for the S&P 500, it is interesting that the price-to-book ratio fell from a record 5 times in 1999 to 1.5 times in 2009, only to rebound to 5 times today. Only 3% of S&P 500 companies trade below book compared to 67% and 37% of the companies in Korea's Composite and Japan's Nikkei 225 respectively. Of course, one of the main reasons for the high valuations placed on American stocks, apart from the power, liquidity, and profitability of American companies and of the U.S. economy in general, is the even higher valuations bestowed on those companies and sectors with especially appealing outlooks. For example, the SOX (semiconductor) index is trading at a price-to-sales ratio of 8x compared to 3x for the S&P 500. On one day of trading in the first quarter, Nvidia added $153 billion of market capitalization. This is roughly equivalent to the total market capitalization, accumulated over decades, of such iconic American companies as Nike, Union Pacific, Morgan Stanley, or American Express. The social media company Reddit, which is still losing money, came to market recently sporting a price-to-sales ratio higher than Meta's (which is almost 10).

Clearly, current valuations do not present a problem for investors. Nor is valuation the only clue that investors have bought into a goldilocks outlook or some version thereof. U.S. household allocations to equities is around the record levels reached in 1999. The average recommended allocation to cash by Wall Street strategists is at an all-time low of around 2% down from 10% fifteen years ago. The allocation to defensive sectors by ETF investors has fallen to a record low 25%, down from about 40% when Trump became President. Equity markets are not the only place where investor complacency is evident. Credit spreads are about as narrow as they get, seemingly too narrow relative to current and prospective default ratios. The yield spread between BAA Corporate Credit and 5-year U.S. Treasuries recently fell to a record low. Meantime, the S&P 500's one-year return has beaten the one-year return of long-term U.S. Treasuries for 40 consecutive months, the longest streak at least since the 1970s. However, to gauge the extent to which investors have embraced risk, we need look no further than cryptocurrencies and their cousins, non-fungible tokens (NFTs). This is a world where investors are willing to put real money into things with names such as Dogwifhat, CryptoPunks, and Pudgy Penguins. One of the knocks against cryptocurrencies, specifically Bitcoin, is the inability to put a rational valuation on it. For speculators, this is a good thing, since it is possible to justify big gains (or losses). So it is that there are credible people with a price target on Bitcoin of $5,000 and others with a target of $165,000. Over the past 6 or 7 years, Bitcoin's trajectory has mirrored the triple-levered Nasdaq 100 ETF. Of course, the fact there are investors willing to buy a triple-levered ETF is also pretty amazing. Bitcoin was slammed in 2022, like

the stock market, only more so, falling from roughly $69,000 to $15,500. It bottomed more or less with the S&P 500 and has since risen to a record high above $70,000 for the first time.

The S&P 500 has risen for five consecutive months from November to March, something that has happened 11 times since 1950. On average, the market has risen a further 11% over the rest of the year. There is no question that equity markets have a lot of momentum and credible bullish scenarios based on artificial intelligence, central bank easing, and other factors can be articulated. Nevertheless, it is worth noting that, since 1950, the average return on the S&P 500 when the U.S. unemployment rate was more than 8% and investors were worried has been seven times the return when the unemployment rate was less than 4% and investors were complacent, as is the case today.

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