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Quarterly Economic and Market Comments
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The late great market analyst, Martin Zweig, put together his list of Investing Rules roughly 35 years ago. They were not that different from the wisdom passed down by the famous trader of the 1920s, Jesse Livermore, or from other successful market professionals of the past. His first rule was "The trend is your friend. Don't fight the tape" and rule number six was, "Don't fight the Fed" (which he considered less valid than rule number one). Perhaps not surprisingly, the influential research firm, NDR, recently noted that two of its top three Rules of Research are "Don't fight the Fed" and "Don't fight the tape". To the extent these "rules" are valid, the third quarter of 2024 provided a lot of ammunition to the bulls. In the summer of 2023, more than 90% of world central bankers were still tightening credit conditions. Today, two-thirds of central banks have cut their interest rates with the cumulative total rate cuts so far this year amounting to 3,750 basis points and the majority of central banks are in an easing mode for the first time since February of 2022. Seven of the G10 central banks have begun an easing cycle with two likely to join in and two (including Canada) perhaps increasing the pace of their cuts. Japan is the outlier, but then it has had microscopic interest rates for years. Name a country - Sweden, the Czech Republic, Mexico, Switzerland - and the odds are their central banks are cutting or are about to. Of course, the big daddy of central banks, the U.S. Federal Reserve, went large and made its first cut 50 basis points instead of 25. Markets liked the bigger cut, but the fact the Fed has started an easing cycle was no surprise. What was a surprise was China bringing out its monetary policy bazooka with its most significant stimulus package since Covid. A torrent of cuts to interest rates of all sorts, loans and issuance of government bonds to support the equity and real estate markets, and various yet-to-be finalized fiscal measures electrified the markets. From year-to-date losses of just over 7% in mid-September, China's benchmark stock index is now up 18% on the year. Nor was the excitement restricted to equities. Anticipating that these measures could jumpstart the sluggish Chinese economy, the price of commodities, such as copper and iron ore, which had been selling off, have risen by more than 20%. The chief economist of Grow Investment Group said, "This is an epic day in Chinese market history and one of the happiest days (in his 30-year career)." Financial conditions in the U.S. have been easing for some time; indeed, the National Financial Conditions Index is at its lowest level since late 2021, around the time of the last stock market top and just before the Fed began raising interest rates. As one example of the ample liquidity, spreads between lower quality bonds, including so-called junk, and U.S. Treasuries, remain historically low. When the dust settled, the number of policy rate cuts in September was more than any month of the past 25 years except for March and April of 2020 (Covid) and several months during the 2008-09 financial crisis.

Obviously, this was all good news for bonds in the third quarter, but it was also good for equities which rose pretty much across the board, except for Japan, which again was an outlier as it so often has been over the past 30 years. Assuming no big sell-off in the fourth quarter, 2024 is on track to be the second consecutive year where all, or virtually all, asset classes are in the green, as was the case in 2019-20 and 2016-17. In contrast, in 2018 and 2022, virtually everything was in the red. It is interesting to note that, in the down years, Bitcoin was the worst performer; whereas, in the up years, it has been the best performer. Of the major U.S. Indices tracked by NDR, all are above their 50 and 200-day averages, indicating the trend is up. The Dow Jones Industrials have broken 40,000 for the first time and the S&P 500 has hit a record high 43 times so far this year. Impressive as this is, it's not without a few caveats. The U.S. smaller cap Russell 2000 has yet to get back to its 2021 highs. The same is true for the Dow

Jones Transports and Utilities and the tech-heavy NASDAQ remains below its July highs which may or may not turn out to be significant. "Only" 25% of the world markets are within 5% of their highs.

"As long as the economy holds up, disinflationary rate cuts are rocket fuel for equities," noted one commentator recently. Two big assumptions, of course. Disinflation and no recession. In the short run, disinflation appears to be in the bag. Rates of inflation have been coming down for months towards the Federal Reserve's (and Canada's) admittedly arbitrary target of 2%. The inflation index that the Fed watches most closely – core PCE inflation – has been running at a 2.4% rate over the past six months. Another important inflation index, the Dallas Fed trimmed-mean metric has been running at a 2.3% rate over the past six months, but the month-to-month rate has slowed for seven straight months. The one big factor holding up the rate of inflation has been the cost of shelter which has been running at 5.2% in the CPI even as apartment rents have actually fallen by 0.8% on a yearly basis. Record new apartment completions should presumably keep downward pressure on rents. The price of oil remains a wildcard, especially given events in the Mid-East, but, if it stays around current levels, it will be a disinflationary force. So, disinflation, check. What about the economy? A year ago, 30% of U.S. fund managers expected a recession. That number has fallen to 10%. Interest rates and inflation are down. In addition, revisions to past economic data showed stronger growth in U.S. incomes, profits, and productivity and a higher savings rate than had been thought. These revisions did not change the basic picture, but they made life easier for those expecting a "soft landing". Roger Altman, founder of Evercore, a well-known investment banking advisory firm, recently lauded the Fed for creating "nearly perfect" economic conditions or, in the words of one economist, "Goldilocks – not too hot, not too cold." New stock market highs, nearly perfect central bankers, and a Goldilocks economy. What's not to like?

Quite a bit, actually. The first problem is the notion that, because interest rates are falling, risks have diminished or even been eliminated. Let's travel back to 2007 when, coincidentally, the Federal Reserve began a rate-cutting cycle on the same date and from the same level and for the same amount as it did this year. The Dow Jones Industrials had its largest gain in four years – equivalent to about 1000 points today – and shares of Lehman Brothers were among the leaders, rising around 10%. Three weeks later, the stock market peaked. A recession began in January 2008 and the Fed cut rates six more times before Lehman became the largest ever U.S. bankruptcy. In the wake of Lehman, the Fed, in three steps, slashed rates effectively to zero. The S&P 500 rose a dramatic 4.7% only to give it all back in less than a week and it subsequently went to new lows, ultimately down 57%. Of course, it could be argued that the 2007-09 experience was unique, but, in fact, what was unique about it was its brutality. Between January 2001 and June 2003, the Fed cut rates from 6.5% to 1.0%, even as the S&P 500 fell by 51%. Of the eight instances since 1970 when the Fed ended up cutting rates by more than 200 basis points, seven involved recessions and bear markets in stocks. The only exception was in 1984 which was different to the current cycle in many ways, including the fact 10-year Treasuries were yielding 12.3% when the Fed cut rates by 50 basis points. Goldman Sachs strategist, David Kostin, noted recently that the trajectory of growth is a more important driver for stocks than the speed of the rate cuts. His work indicates that, if the economy is headed into a recession before the first rate cut, then the S&P 500 has fallen on average by 14% in the coming year. Conversely, if it wasn't headed into a recession, the result was the inverse. His work confirms studies by the OECD and others showing that a U.S. recession and a global economic slowdown have led to negative returns for the MSCI World Stock Index.

So, what are the odds that the U.S. is going into a recession? Few expect it, at this point, but that means nothing. In August of 2007, the Chief Economist of Bear Stearns wrote an op-ed in the Wall Street Journal entitled "Don't Panic About the Credit Market" in which he stated, "Unlike the 1998 seizure in credit markets… global liquidity (is) overflowing. The deep 1997-98 Asian crisis has been

replaced with an all-cylinder boom." Several months later, after five interest rate cuts, his firm was the first high-profile casualty of the credit meltdown. Not that he was alone, although he was presumably in a better position than most to understand what was happening at his own firm. On the cusp of the biggest economic downturn in decades, blue chip U.S. economists put the odds of a recession at one in three. In the 1920s, the two leading economists of the time and of all-time, Keynes and Irving Fisher, respectively and famously said, "We will not have anymore crashes in our time" and "Stock prices have reached what looks like a permanently high plateau." So, the fact that "the crowd" is not calling for a recession does not, in and of itself, mean that there will or won't be one. What we can say is that interest rates have risen faster in this cycle than at any time in the last 40 years at least, but the impact on the real economy has, for a variety of reasons, been less than was expected. In October 2022, 3-month T-bill rates moved above 10-year U.S. Treasury yields (i.e. the yield curve became inverted). Since 1968, every recession was preceded by such an inversion. The fact that the yield curve has been inverted for so long without a recession materializing has caused many to suggest that the yield curve is no longer working; however, a study by the National Bank of Belgium concluded that "Commentators have (typically) tended to downplay the signals given by the yield curve." Now, yield curves around the world are beginning to uninvert (i.e. short-term rates falling below longer-term rates). This has historically been a sign of imminent economic weakness. Another indicator with a flawless track record of forecasting recessions is the "Sahm Rule" which kicks in when the 3-month average in the U.S. unemployment rate increases by 0.5% from its 12-month low. As with the yield curve, many, including the developer of the rule herself, are questioning the accuracy of the rule in this cycle. Finally, an index of leading indicators of economic activity, which also has a great track record of predicting recessions, has been negative for 30 consecutive months. The skepticism towards these and the many other indicators pointing towards economic weakness basically comes down to the length of time the various indicators have been sending negative signals with few signs that the overall economy is contracting. As one economist asks on looking at real GDP in the U.S. over the past eight quarters, "Where is the slowdown?". The economist, David Rosenberg, pushes back on this, noting that the average of the cycles over the past 35 years, from the time of the first interest rate hike to the recession, is 31 months and, from the first cut to the recession, 6 months. This would imply a recession starting in the U.S., probably before the end of the year, if it's going to happen. Perhaps Rudiger Dornbusch's great quote, referenced recently by Howard Marks, is timely, "In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could."

Marks notes in a recent memo that, "The investment world might be less unstable if there were immutable rules – like the one covering gravity. But there are no such rules, since markets aren't built on natural laws, but rather the shifting sands of investor psychology." Most often, "Don't fight the tape or the Fed" is good advice. Sometimes it isn't. Sometimes you would be better off listening to NDR's third rule – "Beware of the crowd at extremes" – or Bob Farrell's fifth rule – "The public buys the most at the top and the least at the bottom." In 1982, the Dow Jones Industrials were trading about where they were 75 years before, adjusted for inflation. In the previous 50 years, U.S. stock prices had reached a new high just over once every four years. So, equities had advanced in nominal terms, kept pace with inflation, and spun off decent dividends, but given the volatility and the yields available on cash at the time, most investors were not interested. It was, as the Business Week cover notoriously stated, "The Death of Equities." The cyclically-adjusted price-to-earnings ratio (CAPE) was close to the record lows recorded in 1921 and 1932 and the Wilshire 5000 Index was trading at 0.33 of U.S. GDP, but few cared. Stocks represented just over 10% of household financial assets and households' free liquidity (non-equity liquid assets less liabilities) was 150% of the Wilshire 5000 market capitalization. Risk aversion was totally in control. Fast forward four decades during which time the S&P 500 made a new high on average every two out of three years. True, there have been some big drawdowns, to use today's euphemism, but, with the exception of the very rocky decade from 2000-2010, prices have

always bounced back relatively smartly. “Buy the dip” is the mantra as it is assumed that, if there are any serious speed bumps, central bankers will flood the markets and the economy with liquidity as the Peoples Bank of China is doing today. Risk aversion is out; risk taking is in. The following is a list of recent articles from one day linked to an investing website: “Capital preservation May Be Your Worst Retirement Plan”; “Playing It Safe with Retirement Savings Could be a Mistake”; “How the Financial System is Becoming More Stable”; “Rational Optimists Must Report on the Beautiful World”; “Don’t Play It Safe in Today’s Market”. Comments on Twitter include “Opportunities like these (the July 15- August 5 dip in the NASDAQ) are a godsend” and “Stocks will go up no matter what. Not even God can stop this.” The NDR Crowd Sentiment Index has been in the extreme optimism zone 85% of the time so far in 2024. Each week Investors Intelligence Advisory surveys its members to get their views on the stock market. Recently, roughly 65% were bullish and 15% bearish. This disparity has only been in place 0.5% of the time over the past 40 years. Given this level of ebullience, it’s not surprising that households have a record proportion of their financial assets in equities and their free liquidity is down to just over 30% of the Wilshire’s market cap, near a record low. This even though the Wilshire 5000 is trading at a record 2 times U.S. GDP and the CAPE ratio is 36 compared to the median since 1880 of 16.5. Perhaps one of the best indicators of investors’ willingness to embrace risk is their willingness to buy Bitcoin, a speculative asset with no intrinsic value that has moved more than 5% on 27 days this year and has had four declines of more than 75% since 2010. The correlation between crypto and U.S. stocks is high and has only been higher at the peak in 2021.

Before he died in 2009, Peter Bernstein, money manager, author of a highly regarded prize-winning book on risk, and the first editor of the Journal of Portfolio Management, gave an interview with Jason Zweig of The Wall Street Journal. Part of what he said was, “There is a tendency…. for people to expect the status quo to last indefinitely or to provide advance signals for shifting strategies. The world does not work like that. Surprise and shock are endemic to the system. People should always arrange their affairs so they will survive such events. The riskiest moment is when you’ve been right… because you tend to overstay good decisions. In general, survival is the only road to riches. Let me say that again: Survival is the only road to riches.”

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