ClearBridge Investments

The Long View: The Crux

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Key Takeaways

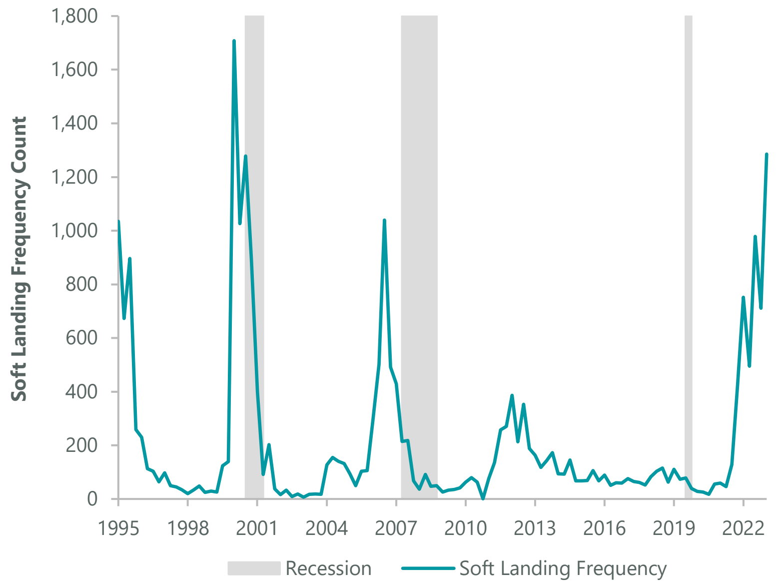
- We believe the toughest test for investors lies in the coming quarters as fiscal stimulus and consumer resilience fade while the lagged effects of monetary tightening take hold.
- Any tailwind from higher fiscal spending could be weakened or non-existent should government spending caps go into effect. The other lever to stave off a slowdown, monetary easing, also appears to be off the table as the Fed remains hamstrung by inflation and a tight labor market.
- Unusually narrow market breadth and tepid small cap performance a year removed from recent market lows suggest the current rally could be short lived, leading us to favour growth and defensive equity positioning until more economic clarity emerges.

Soft Landing Scepticism Warranted as Macro Cracks Emerge

Investing and mountain climbing are both judged by the ability to move higher. The journey higher is never smooth, and experienced climbers understand that heightened concentration is paramount once the crux, the toughest part of a route where the hardest moves and challenges are concentrated, is reached. While the consequences of failure in the stock market pale in comparison, we believe the crux for investors lies in the coming quarters as fiscal stimulus and consumer resilience fade while the lagged effects of monetary tightening take hold. We worry that many investors have fully embraced the soft landing narrative and are facing potentially the most dangerous part of this cycle's climb with their guard down.

U.S. economic data has held up better than we expected coming into 2023, driving many investors to abandon their calls for the "most anticipated recession ever." However, history shows that hopes of a soft landing often take hold before the economy hits the skids, with the term commonly used in corporate filings, transcripts and presentations ahead of both the 2001 and 2007-9 recessions. By this measure, the peak in the soft landing narrative was reached a few quarters before the actual onset of recession in both 2001 and 2007, meaning investors may be best served by remaining sceptical that the economy is already out of the danger zone.

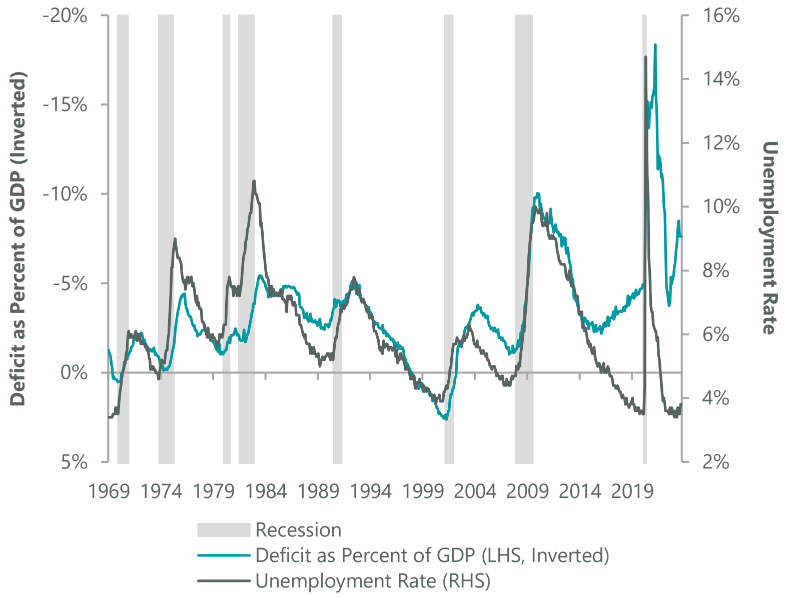
Exhibit 1: It Always Starts as a Soft Landing



Note: Soft landing frequency is the count of mentions of the term "soft landing" in company filings, transcripts, and presentations since 3Q95. Data as of 30 September 2023. Source: NBER and Bloomberg.

Over the last year, the timing of a possible recession has drifted later and later. With the benefit of hindsight, investors likely underappreciated the recent surge in fiscal spending. Historically, the deficit has tracked the unemployment rate, shrinking in good times as tax receipts rise (and fewer need to tap into social safety nets) and expanding during recessions as tax receipts fall and Congress moves to bolster the economy. A different dynamic has emerged over the last decade, however, with the deficit moving opposite to the unemployment rate during the latter half of the last economic expansion (2015-19) and again since mid-2022.

Exhibit 2: Huge Deficit, Low Unemployment?



As of 30 September 2023. Source: BLS, BEA, NBER, U.S. Treasury, Bloomberg.

Both of these periods were overshadowed by simultaneous monetary tightening by the Federal Reserve that created challenging investment conditions. Looking ahead into 2024, the fiscal stimulus appears likely to be smaller. The debt ceiling deal reached earlier this year included agreements to cap discretionary federal spending in 2024 and 2025, which the Congressional Budget Office projects would shrink the deficit by $170.8 billion. While the size of the fiscal 2024 federal budget remains to be seen, we believe that the change in spending is more important to near-term economic growth than the size of the deficit itself. As a reminder, it's the additional spending above prior levels — or fiscal thrust — that creates higher economic activity. If spending caps go into effect, the growth in fiscal spending will shrink even as the deficit remains high. Put differently, the recent spending binge is unlikely to be a tailwind for economic growth in the new year.

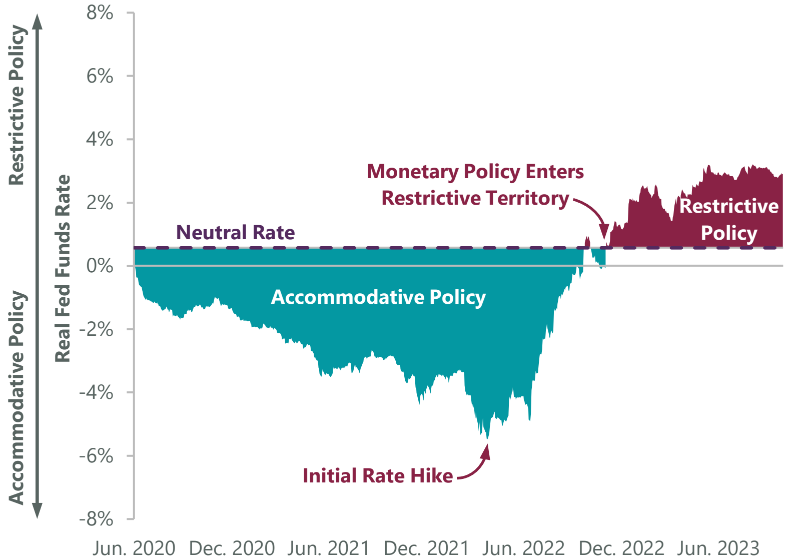
Another surprise has been the resiliency of the U.S. consumer as the labor market cools and excess savings dwindle. The pace of job creation and wage gains have continued to slow this year, meaning labor income can drive less consumption growth. Meanwhile, the San Francisco Fed estimated that excess savings would be fully depleted during the third quarter.[1] With borrowing metrics also normalising, consumers' ability to spend more diminishes. In fact, the revisions to GDP last week showed that consumption only grew by 0.8% in the second quarter, down from the 1.7% gain estimated previously, suggesting the consumer may already be in a fragile position.

A final explanation for the economy's surprising strength may be the recognition that the period of truly restrictive monetary policy has lasted less than a year. Although the Fed began hiking 18 months ago, policy only entered "restrictive" territory — the point where rates are expected to slow economic growth — around year-end 2022. Given the traditional six to 18-month lag associated with monetary policy, the economy will likely face restrictive headwinds through mid-2024, just as we are moving through the cycle's crux.

Against this backdrop, our North Star — the ClearBridge Recession Risk Dashboard — continues to emanate an overall red or recessionary signal. There have been no signal changes for the dashboard in six months.

1 https://www.frbsf.org/our-district/about/sf-fed-blog/excess-no-more-dwindling-pandemic-savings/.

Exhibit 3: When Did The Fed Headwind Arrive?



Note: Real Fed Funds is Fed Funds Rate less 1-Year Zero Coupon Inflation Swap; Neutral Rate is current estimate of Holston-Laubach-Williams Model. Data as of 30 September 2023. Source: Federal Reserve and Bloomberg. Past performance is not a guarantee of future results. Investors cannot invest directly in an index, and unmanaged index returns do not reflect any fees, expenses or sales charges.

Exhibit 4: ClearBridge Recession Risk Dashboard

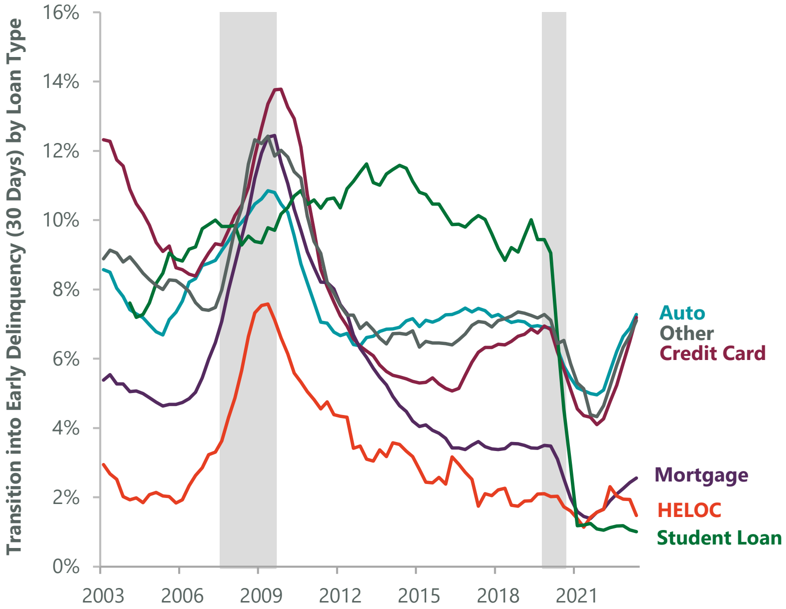
		Current	Deepening Red Signal		
		Sept. 30, 2023	Mar. 31, 2023	Dec. 31, 2022	Sept. 30, 2022
Consumer	Housing Permits	×	×	●	●
	Job Sentiment	×	●	●	⬆
	Jobless Claims	●	⬆	⬆	⬆
	Retail Sales	×	×	×	×
	Wage Growth	×	×	×	×
Business Activity	Commodities	×	×	×	×
	ISM New Orders	×	×	×	×
	Profit Margins	×	×	×	●
	Truck Shipments	●	⬆	⬆	⬆
Financial	Credit Spreads	×	×	×	×
	Money Supply	×	×	×	×
	Yield Curve	×	×	×	●
	Overall Signal	×	×	×	×

⬆ Expansion ● Caution × Recession

Data as of 30 September 2023. Source: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg. The ClearBridge Recession Risk Dashboard was created in January 2016. References to the signals it would have sent in the years prior to January 2016 are based on how the underlying data was reflected in the component indicators at the time.

As supportive macro tailwinds fade, cracks in the economy continue to appear. Consumer balance sheets continue to show increasing signs of strain, with delinquency rates for credit card, auto and other loans on the rise. An economic bull would note that these rates may be normalising from very low levels. However, a pessimist would point out that auto and credit card delinquency rates are already above the peaks seen during the last economic expansion, and student loan delinquencies are poised to rise as the repayment moratorium has expired. Given the challenges consumers are facing, these strains could grow worse in the coming quarters.

Exhibit 5: Delinquency Rates Rising

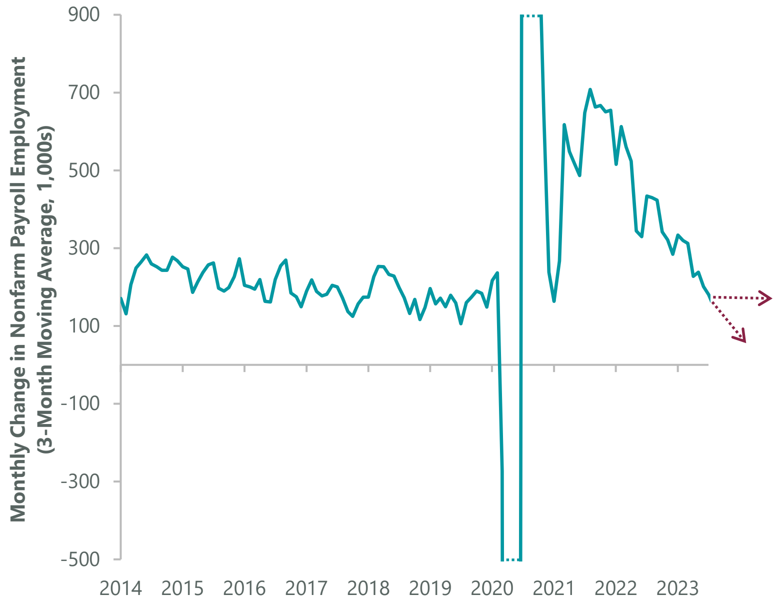


HELOC stands for Home Equity Line of Credit. Data as of 30 June 2023, latest available as of 30 September 2023. Source: NY Fed, Equifax.

Another crack is evident in the labor market itself. While the economy continues to add jobs, every payroll release this year has been revised lower, and the preliminary benchmark revision last month reduced the March baseline by a further -306,000 jobs. Put differently, 2023 employment growth has not been as strong as initially thought. Large downward revisions to the labor report have historically clustered around economic inflection points, with a similar streak of negative revisions occurring in 2007 in the run-up to the Global Financial Crisis. This data should not set off an immediate recession alarm, but rather is a sign that the labor market may be weaker than perceived.

We believe the path of the labor market will determine whether the economy continues along the soft landing path or slips into recession. Payroll gains have normalised to an average of 150,000 over the last three months, a drop from the 320,000 pace seen six months ago and 430,000 pace a year ago. At this point, job creation is in the range seen at the end of the last economic expansion when the unemployment rate fell below 4%. While this has been a positive development, the slowdown in job creation will need to stop in short order. If not, the soft landing will have just been a stop along the path to a recession.

Exhibit 6: Labor to Stabilise or Continue Lower?

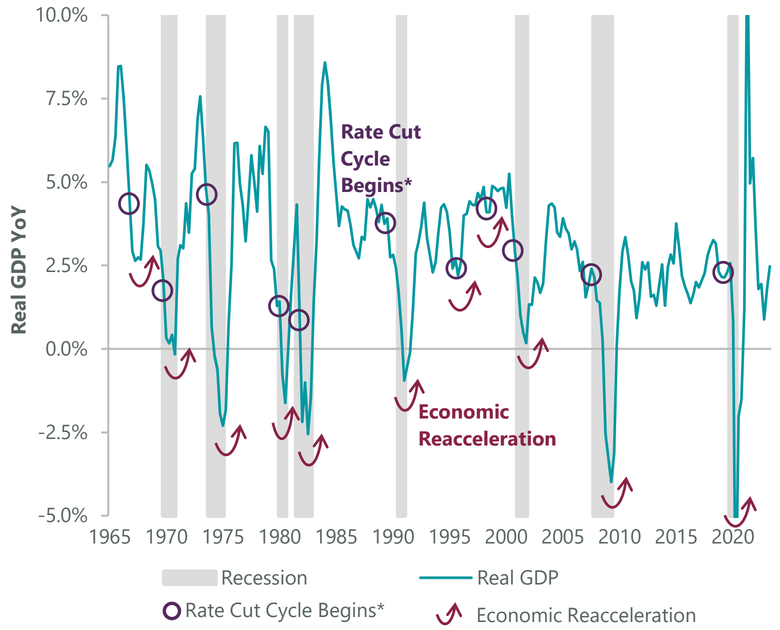


Data as of 31 August 2023, latest available as of 30 September 2023. Source: BLS, Federal Reserve Bank of St. Louis.

Despite headwinds gathering, the Fed appears firmly committed to a higher for longer policy path. This is a shift from the recent, low inflation past when the central bank was quick to deliver accommodative policy at the first sign of macro strain. This is important because history shows the Fed has been instrumental in re-accelerating GDP growth regardless of whether the economy was headed for a soft landing or a recession. The economy has never meaningfully picked up until after the Fed started easing. Today, generationally high inflation and a tight labor market leave the Fed hamstrung and likely slower to react to unfavourable data and more targeted when it does. A frozen Fed presents a significant risk to economic growth, elevates the chances of a recession, and could even allow what might have otherwise been a mild recession to metastasize into something worse.

The market backdrop has largely mirrored the economic one this year, with a surprisingly strong surge concealing weakness beneath the surface. As we approach the one-year mark from the October 2022 lows, market breadth has yet to reach levels consistent with the start of past bull markets. Since the late 1950s, all but one new bull market has seen more than 80% of stocks participate (as measured by the number trading above their 200-day moving average) at some point in its first year, with many exceeding 90%. However, the peak in breadth during the current rally has been just 75%, achieved back in February. With fewer stocks participating in the market's move higher, this is a troublesome sign for the health of the fledgling bull.

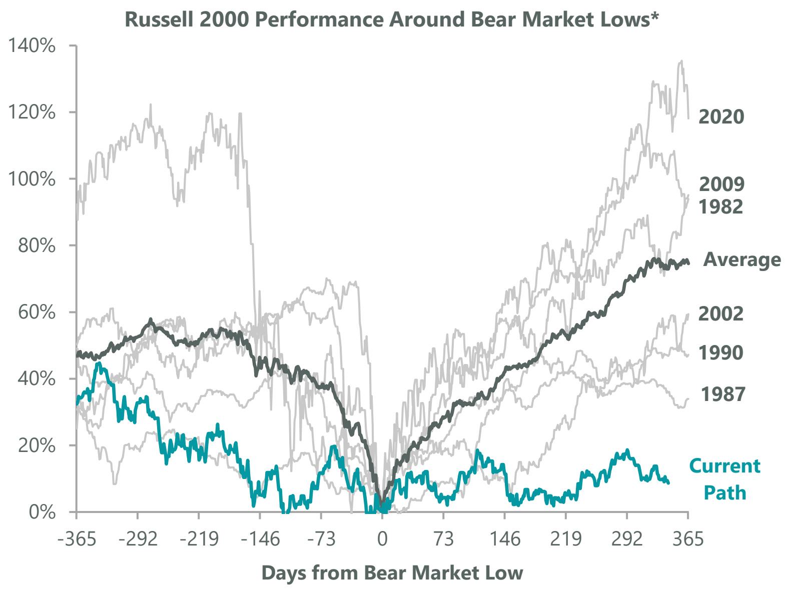
Exhibit 7: Economy Needs Fed Resuscitation



*Rate Cut Cycles of at least 75 bps that did not occur within broader hiking cycles.
Data as of 30 June 2023, latest available as of 30 September 2023. Source: BEA, Federal Reserve, FactSet.

Another dent in the armour of the bull market comes from small caps, which have been lacklustre since the lows. Historically, small caps have gained an average of 75% in the first year from the bull market lows. Small caps, however, have lagged their larger brethren over the last year and are up just 6% since the S&P 500's lows. This is their worst stretch at the start of a new bull market in 40+ years. Since small cap earnings are generally more U.S.-centric than large cap earnings, this may indicate pessimism about the sustainability of the current expansion.

Exhibit 8: Small Caps Struggling



*Bear Market Low is day 0, based on S&P 500. Source: S&P, Russell, FactSet.

In summary, widening cracks across the economy and capital markets could short circuit the current rally. That path should become clearer in the coming quarters as we move through the crux. In the meantime, we continue to recommend tilts toward growth and defensive positioning until more clarity emerges on the economic path forward.