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AOR Update: Soft Landing Coming into View

2 February 2024

Key Takeaways

- ▶ The likelihood of a soft landing for the economy continues to increase, with notable improvement in several “soft” data points, including consumer and business surveys in January, while “hard” data such as the jobs report continue to show strength.
- ▶ ISM New Orders improved from red to yellow in January and the overall reading of the ClearBridge Recession Risk Dashboard, while still in red or recessionary territory, is nearing the threshold for yellow.
- ▶ The equity outlook remains mixed as a soft landing is unlikely to be accompanied by substantially lower interest rates, suggesting the upside from multiple expansion could be limited. Meanwhile earnings expectations have already priced in a soft landing, with little room for market-moving upward revisions.

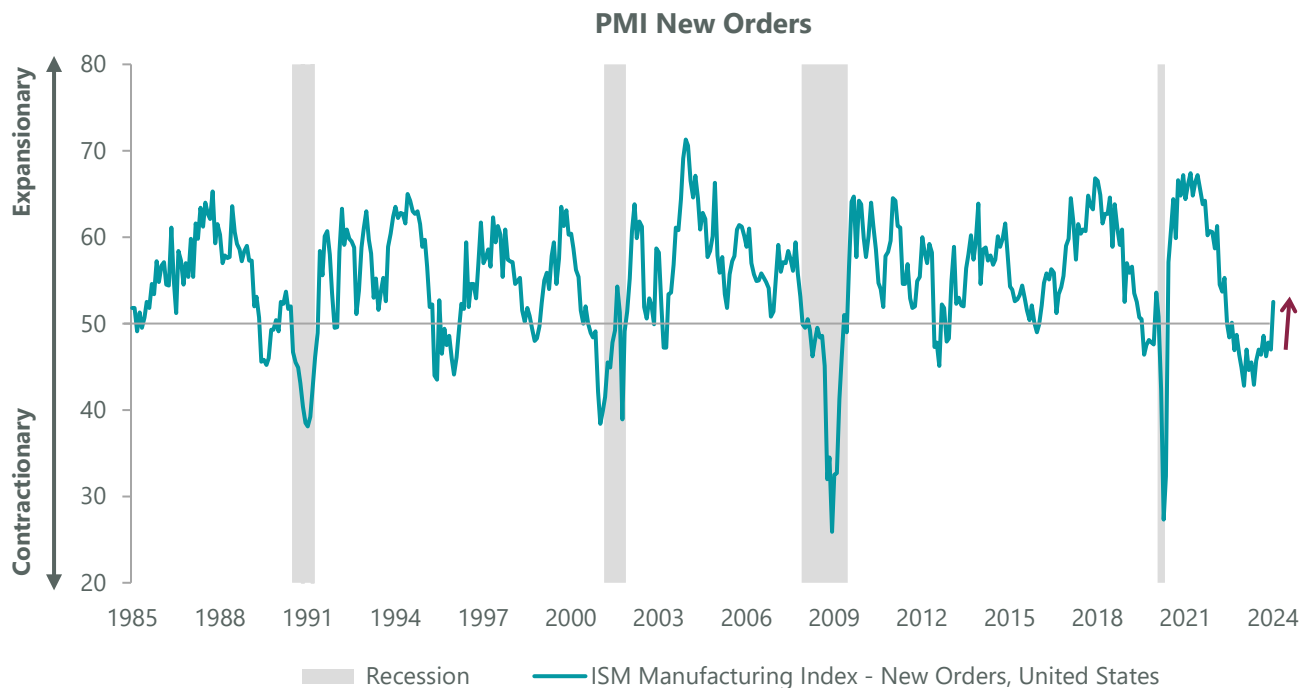
Remember, the Stock Market is Not the Economy

Economic data has continued to surprise to the upside over the past month. As we approach the midway point of [the crux](#), most evidence has supported the case for a soft landing — so much so that it, rather than a recession, now appears to be the more likely outcome. However, the stock market is not the economy, and a soft landing appears to already be priced into equity markets. While we are incrementally more optimistic on the economy than we were [at year end](#), we remain cautious on equities due to earnings and valuation concerns.

On the economic front, we have seen “soft” survey data — which tends to lead “hard” actual data — improve substantially. The Conference Board’s Consumer Confidence Survey measure has risen to 114.8 from 101 two months ago and is now at its highest level since the end of 2021, while the University of Michigan’s Index of Consumer Sentiment survey has reached its highest level since mid-2021. The ClearBridge Recession Risk Dashboard evaluates a subcomponent of the Conference Board survey that focuses on the outlook for the job market — [the Job Sentiment indicator](#) — which improved substantially in the latest release and is nearing yellow territory.

One survey-based indicator did improve enough to see a switch from red to yellow last month: ISM New Orders. The latest overall Institute for Supply Management (ISM) Manufacturing PMI survey showed improvement and appears to have formed a trough, as did the new orders subcomponent, which tends to lead the headline figure. This dataset picked up last summer, only to turn lower in the early fall, suggesting investors have been treating recent strength with some skepticism. Further caution is warranted based on other ISM Manufacturing subcomponents like prices paid (strong) and employment (weak), which we are closely monitoring. However, in total, the ISM Manufacturing survey and the new orders subcomponent specifically are now consistent with a yellow signal rather than a red.

Exhibit 1: Manufacturing New Orders is Signaling Expansion



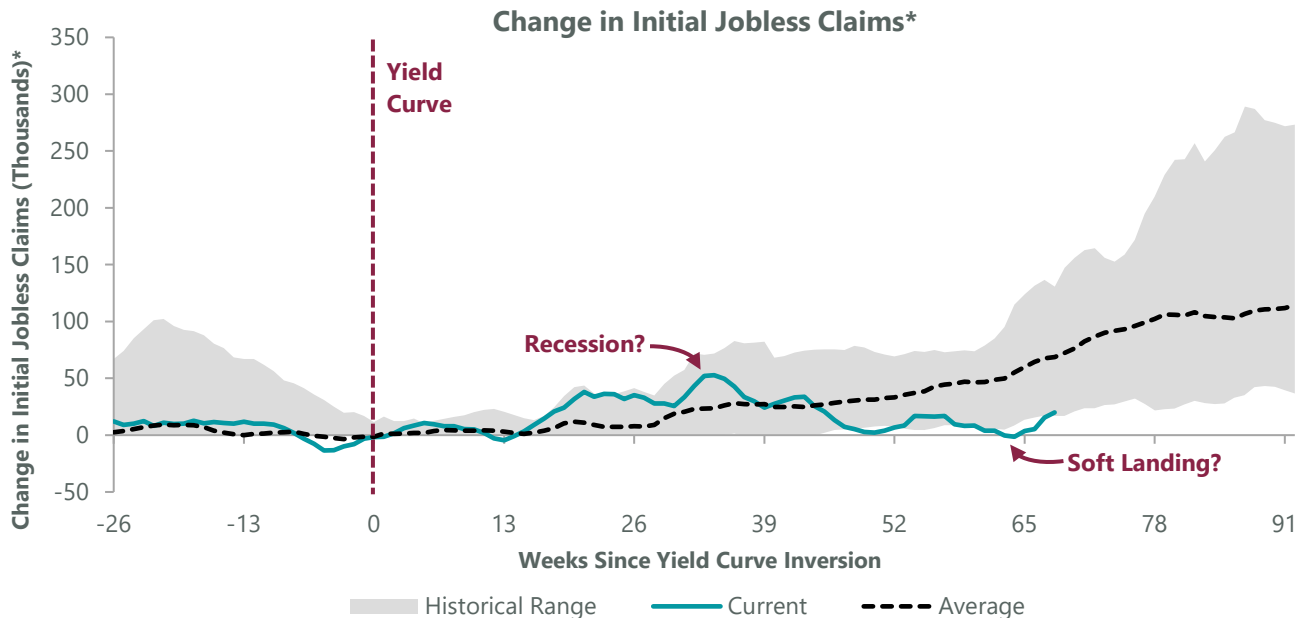
Data as at 31 January 2024. Source: Bloomberg.

Beyond the surveys, hard data for the labor market continue to show strength. The January jobs report was a blowout with payrolls coming in at 353k, nearly double consensus and above the high estimate of 300k. Although the internals of the report suggest a bit less strength than the headline due to potential distortions from the weather, the overall print was more than solid in our view. Importantly, there were substantial positive revisions to the 2023 payroll figures as a part of the normal annual process with the running total of revisions over the last 12 months dropping from -427,000 to -84,000. This upward revision clears up some of the uncertainty regarding current labor market strength. Further, temporary workers — often the first to be let go when times are tough — saw positive payroll gains for the first time in 11 months. Taken together, this helps alleviate some concerns about the strength of the labor market, which looks like to have been even stronger in 2023 than previously believed.

The labor market does not show many signs of slowing. Recent layoff announcements are not surprising, as this time of year typically sees the largest amount of workforce reductions. This is a function of seasonal hiring trends and annual budgeting processes typically being tied to calendar years. Although jobless claims — our economic canary in the coal mine — have been on the rise recently, they are coming back from a historically low level and would need to rise meaningfully in order to cross back into red or recessionary territory. In fact, their recent pickup has only brought them back into the very low end of the range associated with past recessions based on the duration of the yield curve inversion (Exhibit 2).

This is a good reminder that, while a soft landing is appearing increasingly more likely, a recession is still not out of the question given historical precedent and the traditional lags of monetary policy. While the overall reading of the ClearBridge Recession Risk Dashboard is still in red or recessionary territory, it is getting close to the yellow threshold (Exhibit 3).

Exhibit 2: Following Which Script?



*Based on % change in Initial Jobless Claims, adjusted to number of claims at October 2022 yield curve inversion. Note: 1968 through Present; Evaluates Major Inversions of the 10Y-3M Yield Curve excluding 2020; 4-week moving average. Data as at 31 December 2023. Sources: BLS, NBER, and Bloomberg.

Exhibit 3: ClearBridge Recession Risk Dashboard

	January 31, 2024	December 31, 2023	November 30, 2023	
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

Source: ClearBridge Investments.

Although our outlook for the economy has improved, the old adage that the stock market is not the economy is important for investors to keep in mind. We continue to believe the balance of risks for equity markets is less favorable given lofty valuations and earnings expectations that have already fully priced in a soft landing. The S&P 500 Index is trading at 19.8x next-12-month earnings expectations, well above historical averages. While some of this can be attributed to compositional changes in the benchmark's growth concentration and improvements in profit margins and free cash flow conversion, a P/E of nearly 20x leaves little margin for error should any hiccups emerge. Even if an unforeseen hurdle doesn't trip up the market, a soft landing is unlikely to be accompanied by substantially lower interest rates, suggesting meaningful upside to equities from multiple expansion could be limited.

Beyond valuations, the other potential source of upside for equities is improving earnings expectations. At present, a bottom-up aggregation of sell-side analyst estimates shows an expectation of 10.9% EPS growth for 2024 and 13.1% for 2025. These figures are consistent with a soft landing, but do not appear to have much room for sizeable upward revisions that could power stocks higher near term.

As we approach the two-thirds mark for reporting season, results so far have been solid, with over 70% of companies beating estimates by nearly 7% in aggregate. However, guidance from several bellwethers has been disappointing and accompanied by substantial moves lower for the stocks. This has caught our attention; so far companies that miss expectations for both sales and earnings are seeing a larger-than-normal share price penalty, while beats are not being rewarded any more than normal (or, in fact slightly less). We believe this supports our view that high expectations have been baked into stock prices, warranting continued caution and a focus on quality.

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