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The Long View: Stick the Landing

Key Takeaways

- ▶ Upward revisions showing healthier U.S. consumers and corporations, the start of a rate-cutting cycle and an aggressive Chinese policy pivot all improve the chances that the Federal Reserve can “stick the landing” and extend the economic expansion.
- ▶ The long-awaited Fed cutting cycle has finally commenced, and history shows that this should lead to a bounce in economic activity in the first half of 2025. In past soft landings, investors have been rewarded for taking on equity exposure in the year following the initial rate cut.
- ▶ We believe the recent equity leadership rotation is a preview of what should continue to play out in the coming quarters, as an accelerating economy makes earnings growth less scarce and helps drive broader market participation.

Recent Catalysts Increase Likelihood of Continued Expansion

One of the most important aspects of a gymnast’s performance is whether they can “stick the landing” at the end of their routine by maintaining complete control and balance without stepping out of bounds. For a central bank, “sticking the landing” — extending an expansion — has been historically uncommon due to the lags of monetary policy, the unpredictable nature of exogenous shocks and the non-linearity of downturns. However, we believe that three key developments over the past month — 1) upward revisions showing a healthier consumer (and corporate America), 2) an aggressive Chinese policy pivot, and 3) the start of a rate-cutting cycle — all aid the Federal Reserve as they attempt to “stick the landing.”

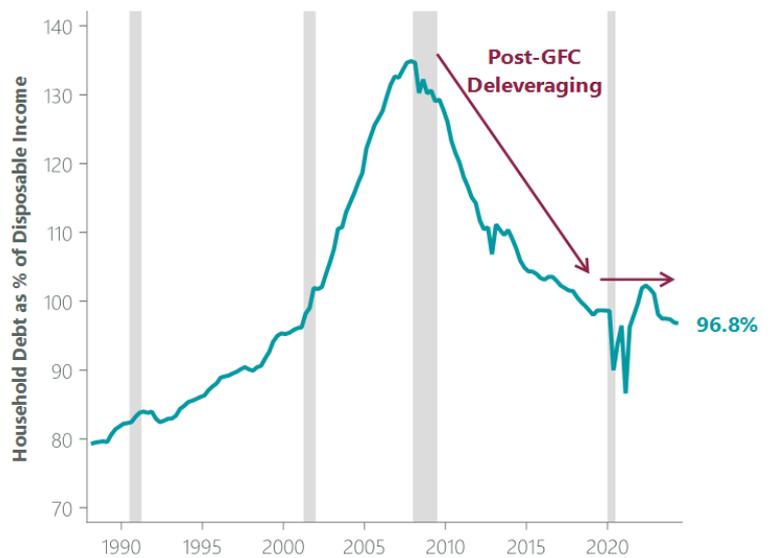
A Healthier Consumer and Corporate America

The first of these was the annual revisions to the national economic accounts, including U.S. GDP, which showed that the economy has been even stronger than previously understood, with stronger consumption, personal income and corporate profits. This trend looks poised to continue with the Atlanta Fed’s GDPNow estimate for third-quarter 2024 economic growth a healthy 3.1%.

Over the past several quarters, a narrative has emerged that the U.S. consumer was on their last legs and that Americans were having to tap credit cards and spend down savings in order to

keep making ends meet. The data refutes this notion, however, and in aggregate the U.S. consumer appears quite healthy. Household net worth has soared by \$47 trillion since just before the onset of the pandemic, while personal incomes have grown by 5.6% over the past year. With consumption growing at a similar but slightly slower pace, the savings rate was revised up to 4.8%, in-line with historic norms and a positive sign that the consumer is not as stretched as previously believed. This is also consistent with consumer leverage, which has been stable over the past five years following a substantial post-Global Financial Crisis decline that weighed on economic growth in the 2010s. Specifically, the household debt-to-disposable income ratio is currently at 96.8% and has been essentially flat since the onset of the pandemic.

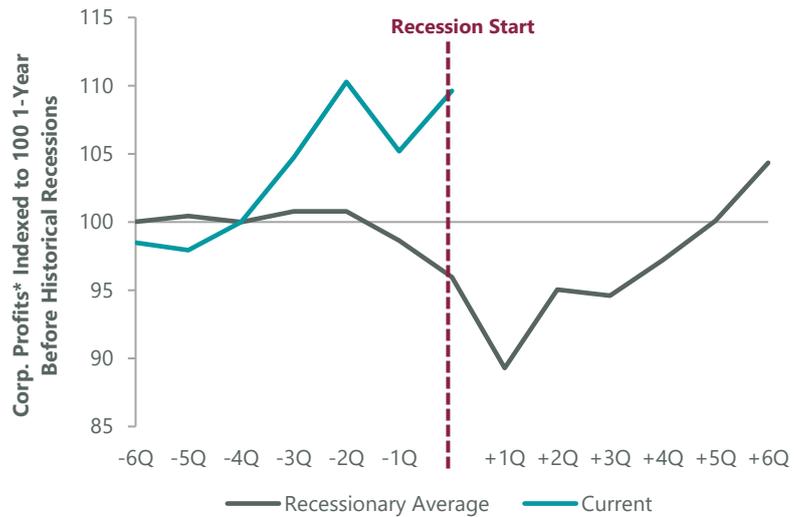
Exhibit 1: Consumer Deleveraging Done



GFC stands for Global Financial Crisis, grey shading marks recessionary periods. Data as of 12 September 2024. Sources: Federal Reserve, NBER, Macrobond.

Last week's GDP revisions also revealed a healthier than expected corporate sector. Profit margins were revised higher, which bodes well for a continuation of the U.S. economic expansion and for the equity market. Healthy and expanding profit margins suggest companies are under less pressure to reduce costs and lay off workers. Historically, profits plateaued over a year before the onset of recessions and on average have started to decline in the two quarters leading up them. The recent past appears quite different, by contrast, with corporate profits (and margins) expanding at a healthy clip.

Exhibit 2: Profits Don't Look Recessionary



*Note: Nonfinancial Corporate Profits w/ IVA and CCAdj (Gross Value Add), 1965-Present. Sources: BEA, Bloomberg, NBER.

In light of the GDP revisions, the prospect of a layoff cycle appears to be the primary risk facing the economy. Recent data suggests that layoffs are not accelerating, but in fact are slowing. We have long referred to the Initial Jobless Claims indicator on the ClearBridge Recession Risk Dashboard as our economic [canary in the coal mine](#). With jobless claims dropping off considerably as summer turned to fall, the canary appears to be chirping quite loudly, i.e., alive and well. Last month's [improvement to green](#) for this indicator remains the most recent signal change, with none occurring this month and the overall reading remaining in expansionary green territory.

Exhibit 3: U.S. Recession Risk Indicators

	September 30, 2024	June 30, 2024	March 31, 2024
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 2024. 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.

Chinese Policy Makes a U-Turn

The second key development was the policy shift from the Chinese government. Over the past several years China has been trying to cool its property market, which has weighed on economic growth, commodity prices and Chinese consumer and business confidence. However, last week appeared to mark an inflection with a bevy of monetary stimulus measures announced alongside the beginnings of a fiscal package. While more stimulus may be needed, this dramatic U-turn has already boosted the Chinese equity market and should provide a positive impulse for the global economy as well as U.S. multinationals that operate in China.

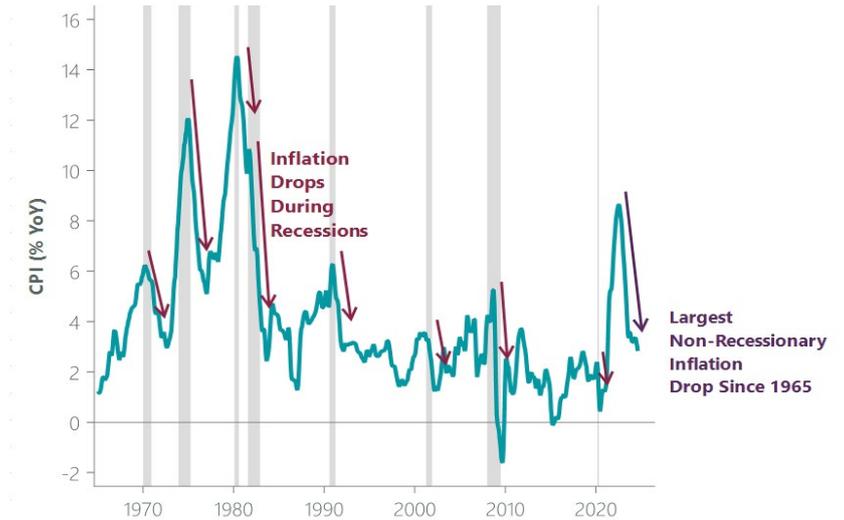
Rate Cut Lifts Odds of Soft Landing

Beijing's policy pivot comes in the wake of the Fed kicking off a rate-cutting cycle last month, the third key development boosting the prospects of a soft landing. The Fed aggressively raised rates to 5.5% and then held them there in an effort to combat generationally high inflation over the past few years. Typically, inflation falls after the Fed has kept rates in restrictive territory for a sustained period, but by then demand has cooled to the point that it is often too late for the economic cycle, and a recession ensues.

This time around, however, supply disruptions were a key driver of the post-pandemic inflation spike — an atypical dynamic. As supply chains have healed and the economy normalised from the pandemic shock, inflation has moved down in a durable manner over the past few quarters. In fact, this is the largest non-recessionary drop in inflation since 1965 and, over the last three months, headline CPI has come in at an annualised pace of just 1.2%, well below the Fed's 2% target. This has opened the door for the Fed to begin normalising policy toward a more neutral stance.

While cooling inflation allowed the Fed to begin cutting rates, the pace and ultimate destination for monetary policy appears to be more influenced by the maximum employment half of the Fed's dual mandate. Although consumption and real economic activity continue to defy expectations of a slowdown, the labour market has shown some recent softness that has refocused the Fed's attention and jumpstarted the normalisation process with an outsize 50 basis point move. Historically, layoff cycles have moved *in a non-linear fashion*, meaning frontloading cuts to help stem the prospects of a downward spiral in labour is merited from a risk management standpoint. To that end, Chair Powell clearly stated in his speech at the annual Jackson Hole symposium in August that "we do not seek or welcome further cooling in labour market conditions."

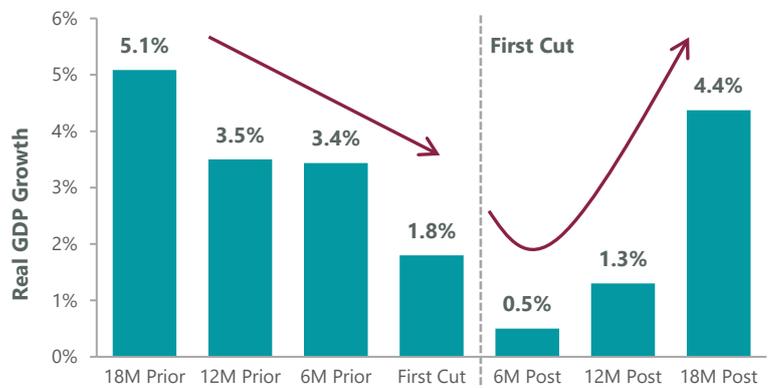
Exhibit 4: This Inflation Drop IS Different



Grey shading marks recessionary periods. Data as of 11 September 2024, latest available as of 30 September 2024. Sources: U.S. Bureau of Labor Statistics (BLS), NBER, Macrobond.

Typically, Fed cuts come as the economy is already losing momentum. Monetary policy famously acts with long and varying lags, and history shows that the economy typically begins to respond to rate cuts six months later. While future data will dictate the ultimate path of monetary policy, several more cuts are likely, which sets up the prospect of an acceleration in 2025.

Exhibit 5: Economy Needs Fed Resuscitation

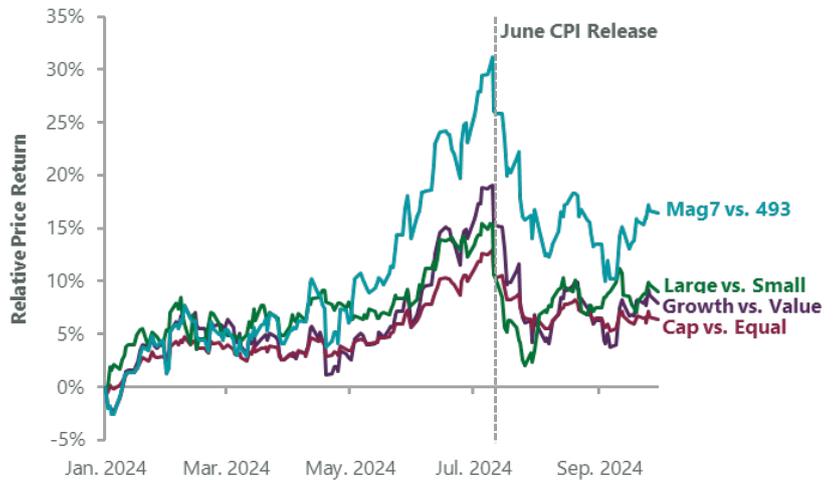


Rate cut cycles of at least 75 bps that did not occur within broader hiking cycles. Data as of 30 September 2024. Sources: BEA, Federal Reserve, FactSet.

Markets appear to have sniffed out the coming shift in Fed policy, with a leadership rotation beginning to unfold in mid-July following the unexpectedly favourable June CPI release. This data paved the way for the Fed to embark on the cutting cycle, and over the past two and a half months market leadership has been very different from what was seen in 2023 and the first half of 2024. Specifically, investors are beginning to favour areas that will benefit from an economic reacceleration as well as lower rates, including value over growth, small over

large, equal-weighted over cap-weighted indexes, and the broader market (the S&P 493) over the Magnificent Seven.

Exhibit 6: The Rotation Has Begun



Data as of 30 September 2024. Sources: S&P, Russell, UBS, and Bloomberg. Note: Mag7 vs. 493 is the UBS Magnificent 7 relative price return vs. UBS S&P ex Magnificent 7; Cap vs. Equal is the S&P 500 relative price return vs. S&P 500 Equal Weight; Large vs. Small is the Russell 1000 relative price return vs. Russell 2000; Growth vs. Value is the Russell 1000 Growth relative price return vs. Russell 1000 Value.

In fact, the Magnificent Seven have underperformed the S&P 493 (the rest of the index) by -11% since that release. Importantly, the S&P 500 Index has continued to advance, disproving the notion that stocks can't move higher without the Magnificent Seven leading the way. While the overall index returns may remain more muted as rotations continue to play out beneath the surface, it's important to note that U.S. equities have outperformed cash by a wide margin in the year following past cutting cycles that resulted in soft landings. Given falling money market yields and the increasing likelihood of a continued economic expansion, we believe investors will move out along the risk spectrum in the coming quarters.

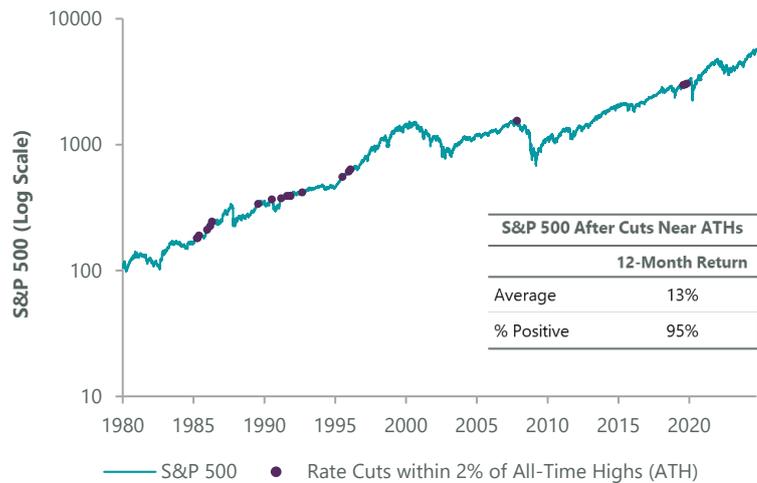
Some investors may be wary of deploying cash into equities with the S&P 500 at all-time highs. However, history shows that this fear may be misplaced. When the Fed has cut rates while the S&P 500 was within 2% of an all-time high since 1980, the benchmark was positive 12 months later 95% of the time with an average return of 13%.

Exhibit 7: Equity Leadership Following the Cut

Initial Rate Cut	Economic Outcome	Subsequent 12-Month Price Return				
		Cash (3M T-Bills)	Russell 1000 Growth	Russell 1000 Value	Russell Mid Cap	Russell 2000
Apr. 1980	Recession	13.5%	39.0%	30.1%	51.41%	66.3%
June 1981	Recession	15.9%	-18.4%	-15.2%	-18.35%	-20.5%
Oct. 1984	Soft Landing	8.9%	9.5%	10.8%	11.96%	8.5%
June 1989	Recession	8.7%	17.5%	4.2%	4.50%	-1.5%
July 1995	Soft Landing	5.5%	22.5%	18.2%	17.26%	19.1%
Jan. 2001	Recession	4.4%	-15.6%	-5.7%	-3.08%	5.3%
Sept. 2007	Recession	3.2%	-17.6%	-25.4%	-19.29%	-12.8%
July 2019	Recession	1.5%	24.9%	-9.2%	-0.71%	-5.7%
Average		7.7%	7.7%	1.0%	5.5%	7.3%
Recessionary Average		7.8%	5.0%	-3.5%	2.4%	5.2%
Soft Landing Average		7.2%	16.0%	14.5%	14.6%	13.8%

Note: Rate cut cycles of at least 75 bps. Data as of 30 September 2024. Sources: FactSet, Bloomberg, S&P, Russell, ICE BofA, NBER.

Exhibit 8: Cuts Near All-Time Highs a Good Omen



Data as of 30 September 2024. Sources: FactSet, Federal Reserve, S&P.

We believe the recent leadership rotation is a preview of what should continue to play out in the coming quarters, as an accelerating economy makes earnings growth less scarce and helps drive broader market participation. While we laid [this view out last quarter](#), the three key positive developments since — upward revisions showing a healthier consumer (and corporate America), an aggressive Chinese policy pivot and the commencement of a rate cutting cycle — should help the Fed “stick the landing.”

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