ClearBridge
A Franklin Templeton Company

The Long View: Here Comes the Sun?

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Key Takeaways

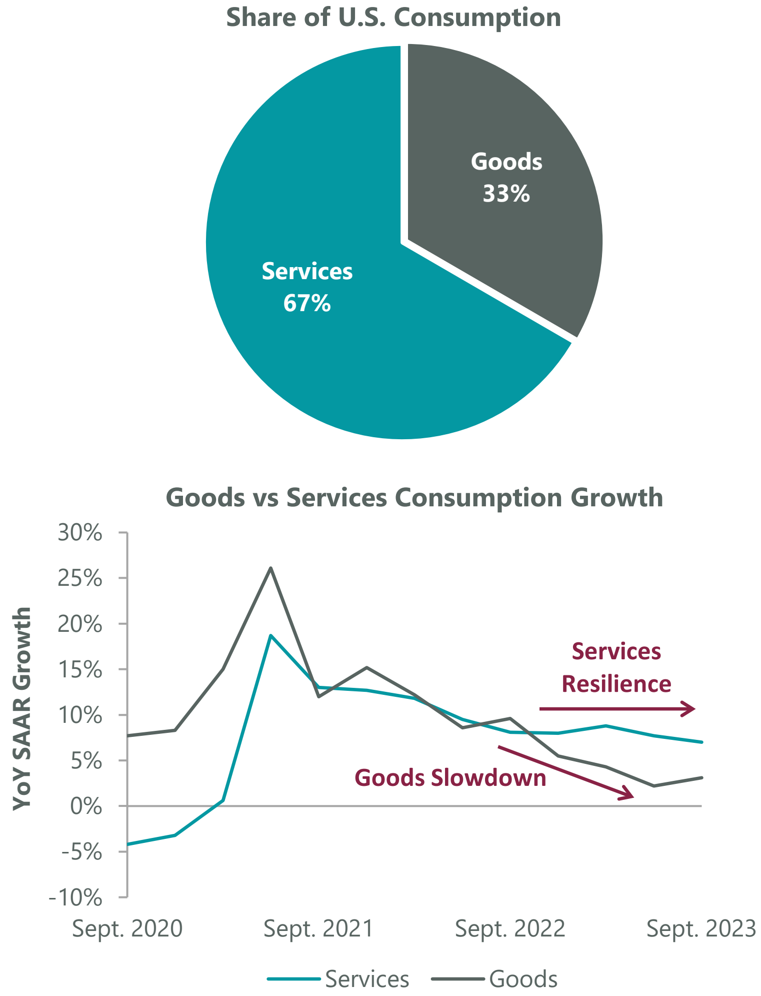
- Differing dynamics have made historical recession guideposts somewhat less reliable lately, yet many parts of the economy are showing signs of increased strain suggesting the economic cycle may have been elongated rather than eliminated.
- Several rays of light are showing through the macro clouds, including an increasing likelihood of a soft landing with the Fed being in a more flexible position as inflation moderates and three positive indicator changes for the ClearBridge Recession Risk Dashboard in the last quarter.
- Although we believe caution is warranted near term, positive economic momentum, broadening market leadership, and stocks on the doorstep of new all-time highs have all historically been favourable signs for long-term investors.

Will the Consensus Be Wrong Again?

The changing of the calendar affords a natural time to reflect on the previous year and imagine what could be different in the new one. Recent years have ended up differing substantially from consensus expectations. For example, investors could have been described as euphoric heading into 2022 with the S&P 500 Index trading at 21.3x next 12 months (NTM) EPS, a valuation that proved overly optimistic as generationally high inflation and the Fed's aggressive tightening cycle led to a -25% intra-year drawdown. By contrast, expectations heading into 2023 were much more pessimistic, with the "most anticipated recession ever" giving way to robust economic growth and equity market returns. With a soft landing firmly entrenched as the consensus viewpoint heading into 2024, we are left wondering if the opposite may once again occur.

The fundamental question that divides bulls and bears is whether "this time is different," perhaps the four most dangerous words on Wall Street. Several dynamics are in fact different, including the unique nature of the pandemic-driven recession and the unprecedented fiscal stimulus which drove a "checkmark" shaped recovery. The American consumer has shown staunch resilience, critical for the health of an economy where two-thirds of GDP is consumption. Demand for services has held up remarkably well even as goods demand wanes, which has short-circuited normally reliable recession indicators like the ISM Manufacturing PMI which focuses on the smaller, but more volatile, manufacturing sector.

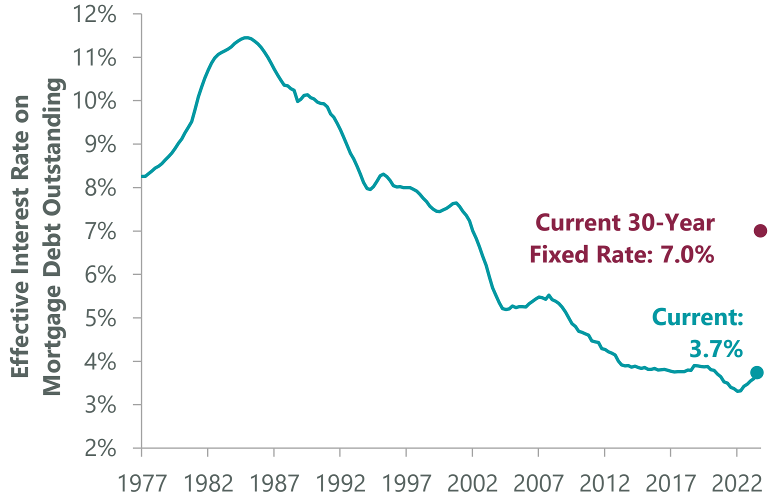
Exhibit 1: Services Holding Up



Data as of 30 September 2023, latest available as of 31 December 2023. Sources: BEA, FactSet.

Another key difference is that consumers (as well as corporations) are far less sensitive to changing interest rates. In the aftermath of the most aggressive Fed hiking cycle in over 40 years, the effective outstanding mortgage rate in the U.S. has risen to just 3.7% from a recent low of 3.3%. This is the result of homeowners taking advantage of the low rate environment early in the pandemic to term out their debt and lock in 15- and 30-year fixed rate mortgages. The unique structure of the U.S. mortgage industry has insulated many Americans from the bite of higher interest rates when it comes to their largest monthly outlay. Corporate America looks similar with many companies locking in their borrowing needs for multiple years at low rates.

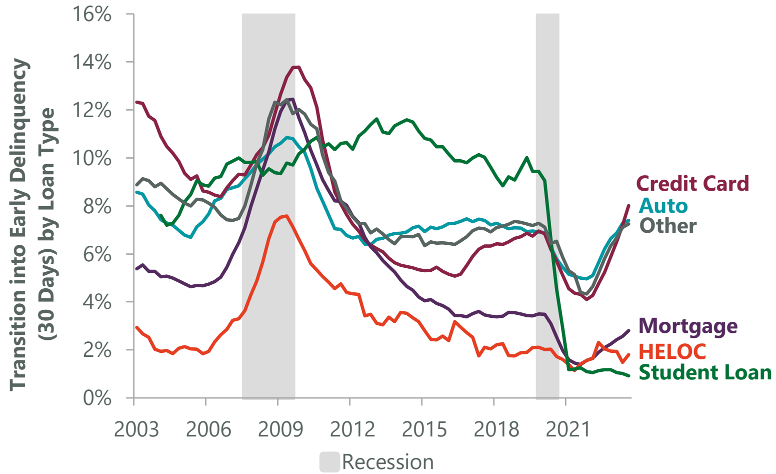
Exhibit 2: Consumers are Locked In



30-year fixed rate data as of 29 December 2023, effective interest rate on mortgage debt outstanding as of 30 September 2023, latest available as of 31 December 2023. Sources: FactSet, BEA, Mortgage Bankers Association.

However, not all companies termed out and locked in fixed rates, and not all Americans own their homes. In fact, 36% of households rent according to the Census Bureau's 2019 estimates, and the CPI rent sub-component has risen by 25% since 2019 which equates to a nearly $500/month increase for the national median monthly rental according to rent.com. Consumers are increasingly showing signs of balance sheet fatigue, with newly delinquent credit card and auto loans rising above pre-pandemic levels. The spike in delinquencies is notably higher for low-income households, which are feeling the pain of higher rents and credit card rates (+6% since 2019), as this cohort is the least likely to own their home and more likely to carry a balance on their credit card.

Exhibit 3: Delinquency Rates Rising

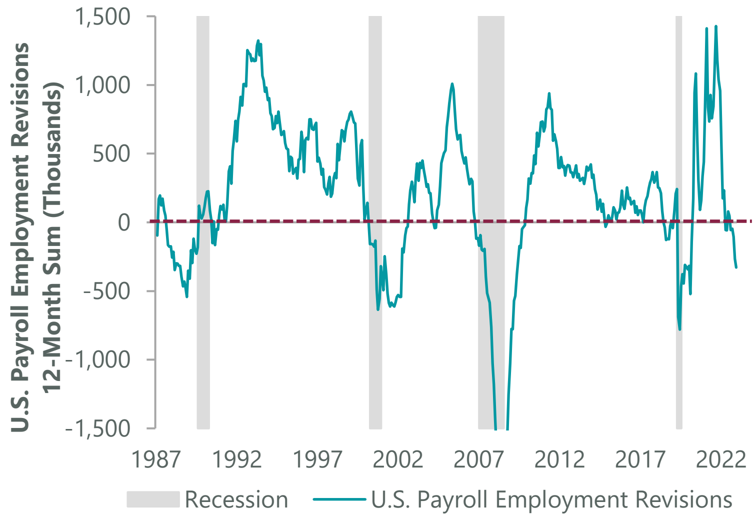


HELOC stands for Home Equity Line of Credit. Data as of 30 September 2023, latest available as of 31 December 2023. Sources: NY Fed, Equifax, NBER.

Importantly, other recessionary signals continue to flash warning signs, suggesting the economic cycle may have been elongated rather than eliminated. These include an inverted yield curve, contracting money supply, ongoing quantitative tightening, leading economic indicator weakness and a slowly but steadily softening labor market. While the overall pace of job creation remains healthy, the labor market is showing signs of deterioration beneath the surface.

One red flag for the labor market is downward revisions to the jobs report. Historically, labor revisions for the prior year turning negative indicates an economic downturn is on the horizon. Over the last 12 months, payrolls have seen a cumulative net revision of -329,000, firmly in the danger zone. Regardless of a hard or soft landing emerging, we may look back at this period and realise that job creation was much weaker than initially thought when all the revisions have been made, a process that takes a few years to fully play out.

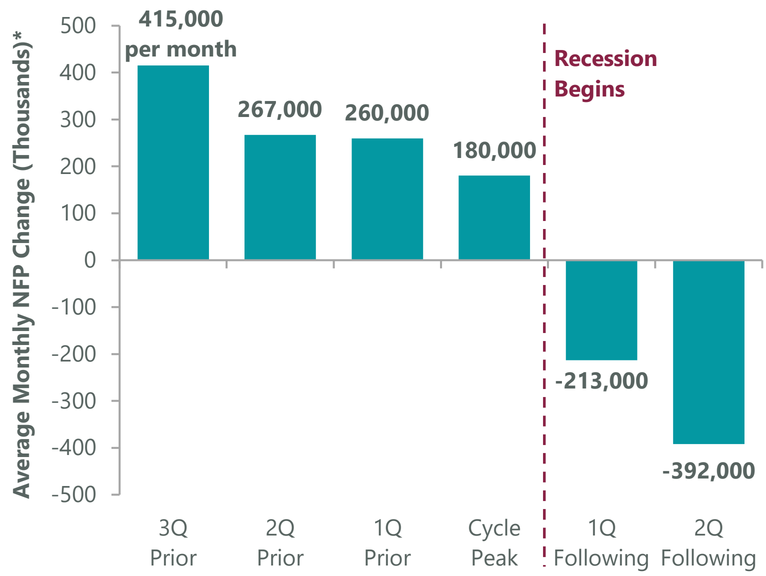
Exhibit 4: Labor Revisions Raise Alarm



Data as of 30 November 2023, latest available as of 31 December 2023. Sources: BLS, NBER, Federal Reserve Bank of St. Louis.

Although the fourth quarter saw mostly encouraging economic data, this does not rule out a recession. Historically, the economy tends to turn down non-linearly as a slowdown builds steam. This can be seen near cycle peaks in the labor market, with the economy quickly transitioning from strong job formation to outright losses. Since 1948, the average job creation is 180,000 per month (adjusted for the current size of the labor force) in the three months leading up to the cycle peak, and -213,000 per month in the three months after. Over the past three months, job creation has averaged 203,667, consistent with what has been seen ahead of past recessions. Put differently, strength in the labor market – a notoriously lagging indicator – does not mean we are out of the woods just yet.

Exhibit 5: Job Market Can Turn Quickly

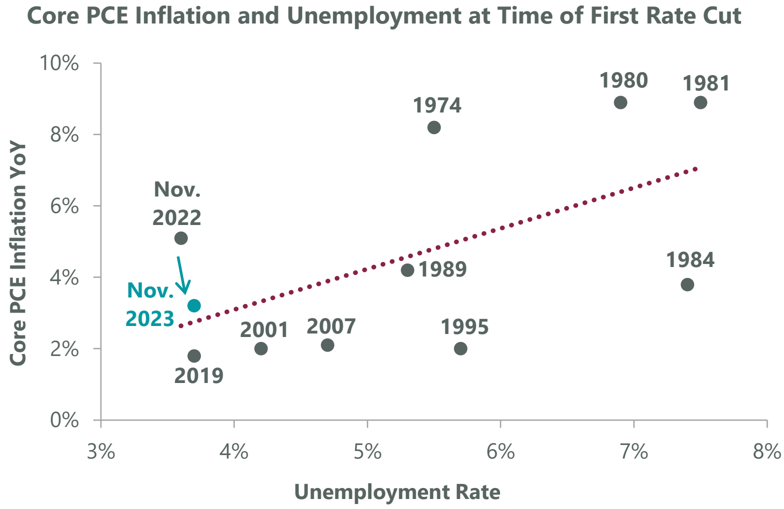


*Average monthly non-farm payrolls (NFP) change based on three-month historical average change (relative to cycle peaks as defined by NBER) as a percentage of total NFP adjusted for the current size of the labor force. Data as of 30 November 2023, latest available as of 31 December 2023. Sources: BLS, NBER, and Bloomberg. Note: 1948-present; 2020 recovery excluded due to pandemic distortions.

This is not to say that a soft landing can't, or won't, occur. In fact, we believe the odds of a soft landing have increased over the last quarter on the back of improving economic data, a faster pace of disinflation and a potentially less restrictive Federal Reserve. Core PCE – the Fed's preferred measure of inflation – has come in at 1.9% on an annualised basis over the last six months, indicating that the Fed is on track to return inflation to its 2% target in 2024. This gives the Fed much more latitude to focus once again on its dual mandate of price stability and maximum sustainable employment. After last year's rapid progress on the inflation front, the Fed is now in a position to cut rates from their currently restrictive level, which should help support the economy. With inflation nearing target, the Fed has additional flexibility to cut rates even further in the case of outright job losses (Exhibit 6).

However, just like a strong labor market doesn't necessarily prevent a recession from occurring, rate cuts don't either. The Fed lowered policy rates by 100 bps before the economy slipped into a recession in 2007 and 150 bps prior to the cycle's peak in 1990. While the market has cheered a more accommodative Fed recently because it increases the chances of a soft landing, the economy is not fully clear of recession risk quite yet.

Exhibit 6: Inflation No Longer Primary Consideration



Data as of 31 December 2023. Sources: FactSet, BLS, BEA, FOMC, Bloomberg.

The Skies Are Clearing…Slightly

Our guarded optimism comes back to our belief that the crux of this cycle's journey lies ahead, with the economy still feeling the lagged effects of the tightening cycle and the previous support from fiscal policy fading. Although we have upgraded our assessment of the economic outlook, we continue to believe a recession is more likely than a soft landing, although only slightly more so. As we move through the next six months, we expect a clearer picture to emerge regarding trend growth.

The ClearBridge Recession Risk Dashboard continues to improve both under the surface and above it, with December experiencing two positive indicator upgrades with both Credit Spreads and Commodities improving from red to yellow. With these changes, the dashboard has seen three individual indicator upgrades during the fourth quarter, and the overall signal is moving closer to yellow territory. While it's still too soon to waive the all-clear flag, it would not be a surprise to see the overall signal move from red to yellow should recent momentum continue. We are closely watching for continued improvement of additional underlying indicators such as ISM New Orders and Housing Permits. However, economic growth is expected to slow in 2024, which could halt or even reverse the recent progress. We will continue to monitor these trends closely.

Exhibit 7: ClearBridge Recession Risk Dashboard

		December 31, 2023	September 30, 2023	June 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

Data as of 31 December 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.

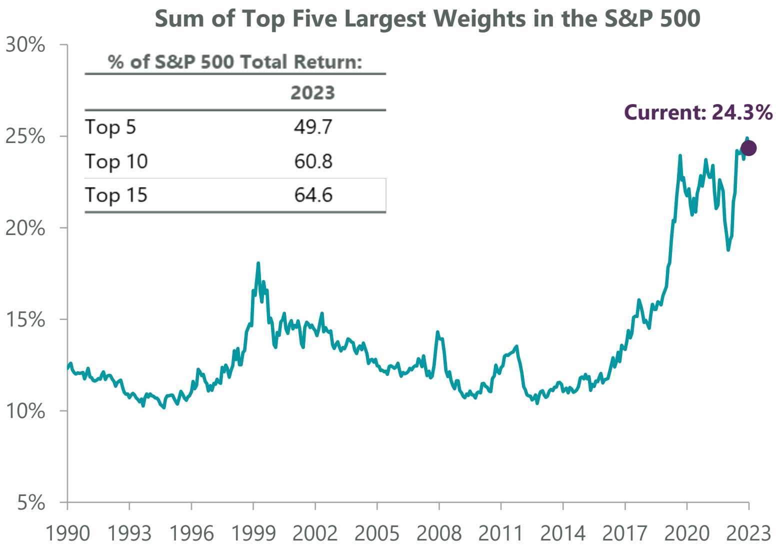
The recent uptick in the dashboard has coincided with a strong run for the stock market, which has now fully priced in a soft landing. The S&P 500 Index is currently trading at 19.5x NTM EPS, and those EPS expectations imply double-digit growth in 2024. With forecasts leaving little margin for error, the market may need a digestion period regardless of the economic outcome. One positive sign has been the broader participation across equity markets since the October 27 lows, with the Russell 2000 and Russell Midcap indices outperforming the Magnificent Seven that dominated market performance for most of 2023. Encouragingly, everyone else (the S&P 493) as well as the Russell 1000 Value have not been far behind during the recent period of improving market breadth.

Exhibit 8: The Mag 7 and Everyone Else

*Magnificent 7 data is cap weighted and refers to the following set of stocks: Microsoft (MSFT), Amazon (AMZN), Meta (META), Apple (AAPL), Google parent Alphabet (GOOGL), Nvidia (NVDA), and Tesla (TSLA). Data as of 31 December 2023. Sources: FactSet, Russell, S&P.

Broader leadership is typically a good sign for the health of a bull market, and we expect a continued rotation into smaller cap stocks and more cyclical names should a soft landing materialise. Active managers are well-positioned to capitalise on rotations such as these due to the extreme concentration in the S&P 500, with the top five names representing nearly a quarter of the benchmark. Although index concentration could get more severe, history suggests the more likely outcome is a reversion to the mean with relative outperformance of the average stock in the coming years.

Exhibit 9: Trouble Concentrating?



Data as of 31 December 2023. Sources: S&P, FactSet, and Bloomberg.

After a strong Santa Claus rally, it would not be surprising to see the markets undergo a period of digestion in the new year. We believe this could coincide with a soft patch of economic data which may lead to a growth scare or perhaps even signal the start of a recession. Given the lack of excess in the economy and a Fed that is no longer hamstrung by inflation, we believe any downturn and corresponding market selloff could be benign as the markets "look through" a potential soft patch in favour of greener pastures later in 2024.

As such, we believe long-term investors should take advantage of any significant equity weakness that emerges. Although heightened caution may be warranted near term, the S&P 500 is on the doorstep of eclipsing its all-time highs for the first time in over a year. In the previous 14 instances when the S&P 500 set a new all-time high for the first time in over a year, the rally continued over the subsequent 12 months 93% of the time with an average return of 13.9%. Like anything, this is not foolproof – one instance occurred ahead of the Global Financial Crisis in mid-2007 – however, history has been on the side of long-term investors at past junctions similar to today.

Exhibit 10: Strength Begets Strength

1st All Time High in 12+ Months	Subsequent S&P 500 Price Return (%)		
Date	**3 Months**	**6 Months**	**1 Year**
Sept. 1954	10.4%	13.0%	41.8%
Sept. 1958	8.7%	12.4%	14.1%
Jan. 1961	6.9%	8.8%	11.3%
Sept. 1963	1.3%	7.7%	13.6%
May 1967	1.6%	**-2.7%**	4.6%
Mar. 1972	**-0.5%**	1.6%	4.9%
July 1980	8.3%	11.0%	7.7%
Nov. 1982	1.0%	13.6%	14.4%
Jan. 1985	3.4%	11.4%	17.4%
July 1989	0.0%	**-3.6%**	5.3%
Feb. 1995	8.9%	16.0%	35.9%
May 2007	**-4.7%**	**-3.2%**	**-8.5%**
Mar. 2013	2.4%	7.8%	18.4%
July 2016	0.0%	6.5%	13.5%
Average	**3.4%**	**7.2%**	**13.9%**
% Positive	**71.4%**	**78.6%**	**92.9%**

Data as of 31 December 2023. Sources: FactSet, S&P.