ClearBridge Investments

The Long View: Who's Right?

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Key Takeaways

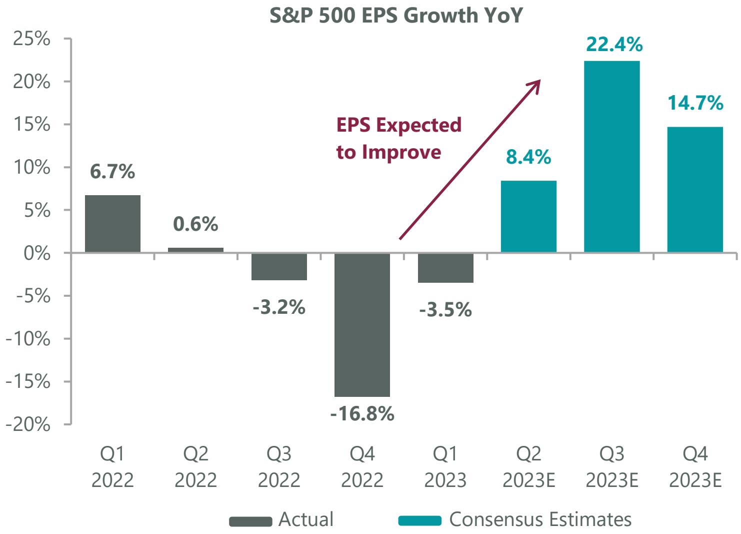
- Following a solid first-half rally, the second half of 2023 is set up as a tug of war between still optimistic market expectations for a soft landing and more cautious economic forecasts that call for contraction.
- We continue to believe a recession is the most likely outcome given the continued deep red reading of the ClearBridge Recession Risk Dashboard and the speed with which economic momentum can deteriorate.
- The robust rally for U.S. equities stands in contrast to more muted gains across most other economically sensitive financial markets, including oil, copper and high-yield bonds.

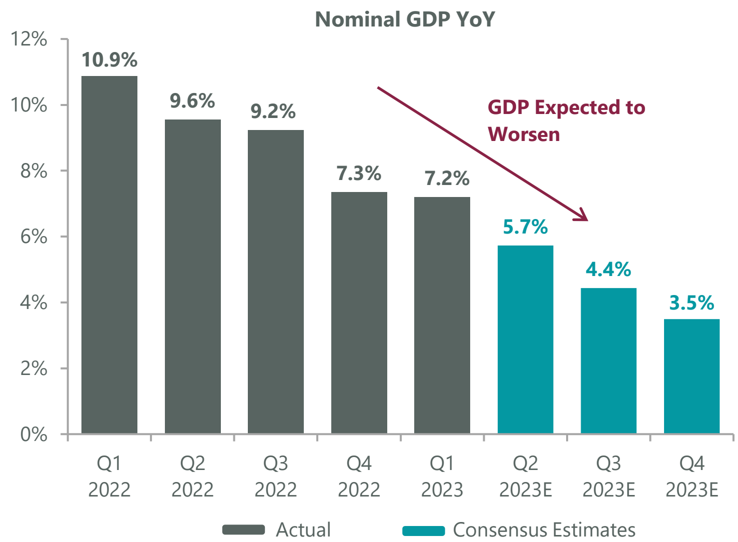
Bear Market Rally or New Bull Emerging?

The year's midpoint is a natural time to reflect on how events have unfolded relative to expectations. This is a key element of success for many investors, and an endeavor we undertake regularly. Six months ago, 2023 was expected to witness the most anticipated recession ever, a view strengthened three months ago by three of the four largest bank failures in history. Equity markets have been unfazed by the regional banking crisis, rallying 15% since Silicon Valley Bank's collapse and seizure in mid-March. In fact, the S&P 500 Index is 9% above the average strategist forecast coming into the year and just a stone's throw away from reclaiming all-time highs. The key question for the second half of the year is whether we are in the midst of a historically large and long bear market rally, or are we in fact witnessing the early days of a new, durable bull market?

The answer is muddied given strongly divergent outcomes implied by consensus estimates for the market and the economy. Bottom-up consensus shows U.S. equities pricing a return to positive EPS growth in the second quarter and a sharp acceleration through the second half. By contrast, economists' forecasts suggest GDP growth will continue to slow in the coming quarters. While nominal GDP growth is expected to remain positive, this is largely a function of inflation, which is expected to cool further but remain well above the Fed's 2% target through 2024. This conflicting view presents a dilemma for investors on which camp has a more accurate read on how the next six months will unfold.

Exhibit 1: Who's Right?





Data as at 30 June 2023. Source: Bloomberg, BEA, FactSet, S&P.

We continue to believe the economy is headed for a recession later this year. The guiding light for this view remains our ClearBridge Recession Risk Dashboard, which experienced no signal changes this month and continues to exhibit a deep red or recessionary overall signal.

The case for a soft landing has been buoyed by recent strength from the U.S. housing sector, one of the most interest-rate sensitive areas of the economy. Housing starts experienced their largest monthly pickup in over three decades in May, whilst the S&P/Case-Shiller U.S. National Home Price Index has bounced in its two most recent readings. This strength has bolstered the idea that the U.S. economy could experience a series of rolling recessions in specific sectors, partially the result of post-pandemic normalisation (which impacted different areas of the economy at different times). In this scenario, the overall economy might never enter a recession as pockets of strength in one sector offset weakness in another.

Exhibit 2: ClearBridge Recession Risk Dashboard

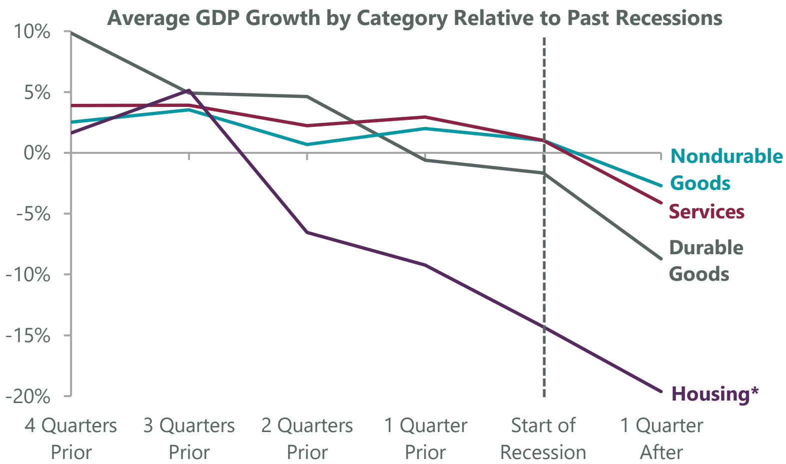
		Current	Deepening Red Signal		
		June 30, 2023	Mar. 31, 2023	Dec. 31, 2022	Sept. 30, 2022
Consumer	Housing Permits	✖	✖	●	●
	Job Sentiment	✖	●	●	⬆
	Jobless Claims	●	⬆	⬆	⬆
	Retail Sales	✖	✖	✖	✖
	Wage Growth	✖	✖	✖	✖
Business Activity	Commodities	✖	✖	✖	✖
	ISM New Orders	✖	✖	✖	✖
	Profit Margins	✖	✖	✖	●
	Truck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

⬆ Expansion ● Caution ✖ Recession

Data as at 30 June 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.

Historically, many past downturns have initially resembled rolling sector recessions with a more synchronised downturn like 2020 much more the exception than the rule. Economic sectors such as housing and durable goods typically contract before the economy enters a recession, with less cyclical areas like non-durable goods and services only contracting after the recession's onset. Importantly, it is not unheard of for sectors to see a bounce within their larger downturn both in the lead-up to and during past recessions. Further, the economy can enter a recession whilst the housing market remains healthy, as happened in 2001. Ultimately, many past recessions were preceded by rolling sector recessions; one of these might result in a soft landing in the coming quarters.

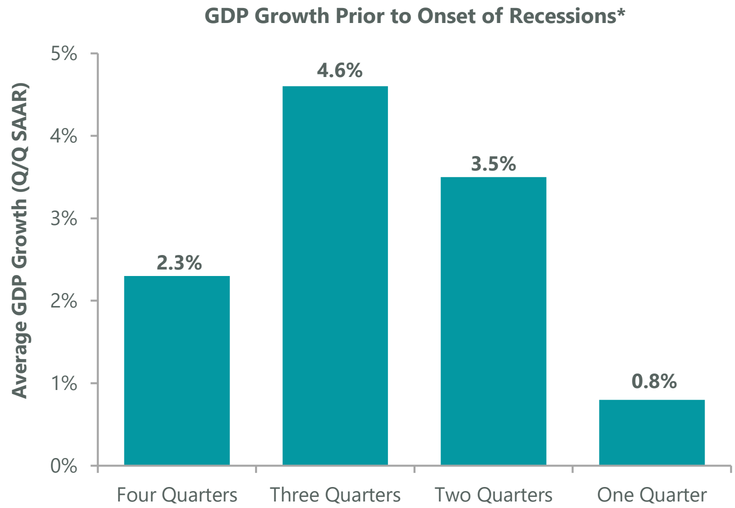
Exhibit 3: Recessions Aren't Synchronised



*Housing is Residential Fixed Investment. Data reflects the period from1965-Present, as at 30 June 2023. Source: BEA, NBER and Bloomberg.

Another argument for a continuation of this expansion is that the economy is holding up better and therefore economic momentum should help the U.S. avoid a recession. This is seen in economic surprise indexes, which measure the frequency with which data releases are beating (positive) or missing (negative) expectations. These series tend to be mean-reverting and are currently in their top decile, a level from which they typically roll over. A string of disappointing data later this year could remove an important support for the prospects of a soft landing and earnings growth. History shows that the economy often experiences a sharp deterioration in momentum as recessionary forces coalesce. Although the economy appears to be on solid footing today, its health can change dramatically in just a few quarters.

Exhibit 4: Economy Can Turn Quickly



*The chart includes data from recessions according to NBER, starting with the recession that began on December 1969. Data as at 31 March 2023, latest available as at 30 June 2023. Source: FactSet, U.S. Bureau of Economic Analysis, NBER.

Another pillar in the soft landing case has been the strong move in equity markets so far this year. Markets are forward looking, but they are not always right. In modern history (since World War II), the market has experienced a positive return 42% of the time in the six months prior to the start of a recession and been positive 25% of the time in the three months prior. Returns during both periods have typically been muted, with investors clinging to the bull case until the very end. Simply put, positive price action (and the absence of a large downturn in equity markets) does not preclude the economy from slipping into recession.

Questions remain as to the durability of the current rally. Positioning is less of a tailwind with both retail and institutional investors more heavily invested than coming into the year. Sentiment has flipped from extremely negative to bullish. Valuations are elevated at just over 19x forward earnings, which, as noted above, implies an optimistic path ahead for growth. Further, other financial markets are sending a different signal. Some of the most economically sensitive assets (that are often used to discern the market-priced growth outlook) including oil, copper, small cap stocks, financial stocks and high-yield bonds, have not bounced as much as following past major market lows. This divergence suggests that the S&P 500 may in fact be the outlier, as the pricing in other asset classes implies more caution.

Exhibit 5: Markets Don't Always Lead

S&P 500 Performance

Start of Recession	Six Months Prior	Three Months Prior
Nov. 1948	-11.6%	-7.7%
July 1953	-6.2%	0.5%
Aug. 1957	4.5%	-4.7%
Apr. 1960	-5.5%	-2.2%
Dec. 1969	-5.8%	-1.1%
Nov. 1973	-9.4%	-7.6%
Jan. 1980	10.9%	13.1%
July 1981	1.1%	-1.5%
July 1990	8.2%	7.7%
Mar. 2001	-19.2%	-12.1%
Dec. 2007	-2.3%	-3.8%
Feb. 2020	1.0%	-5.9%
% Positive	**41.7%**	**25.0%**
Average	**-2.9%**	**-2.1%**

Source: FactSet, S&P.

Exhibit 6: Equity Market Flying Solo

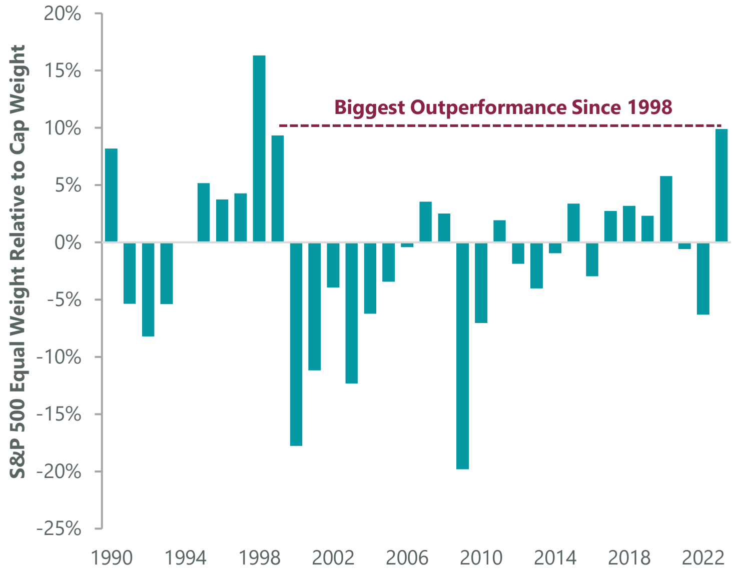
Macro Risk Indicator Returns +8 Months from Major S&P 500 Lows

S&P 500 Low Date	S&P 500	Oil	Copper	Small Caps	Financials	High Yield
Oct. 1974	49.1%	10.4%	-12.8%	--	--	--
Aug. 1982	52.1%	-4.1%	23.7%	72.9%	--	--
Dec. 1987	21.4%	-19.1%	-2.9%	41.1%	--	--
Oct. 1990	29.0%	-51.7%	-13.0%	46.8%	58.2%	18.1%
Oct. 2002	25.6%	7.0%	16.0%	36.0%	33.2%	27.8%
Mar. 2009	61.6%	69.0%	81.0%	72.6%	138.1%	56.7%
Dec. 2018	21.1%	19.2%	-4.9%	15.2%	16.6%	7.3%
Mar. 2020	59.9%	83.9%	55.1%	81.4%	56.4%	30.3%
Average	40.0%	14.3%	17.8%	52.3%	60.5%	28.0%
Oct. 2022	21.3%	-23.6%	9.5%	11.0%	9.2%	5.5%

Data as at 30 June 2023. Source: FactSet, S&P.

Much ink has been spilled in recent weeks about the narrowness of the equity rally, with returns dominated by a handful of the largest names in the index. This has resulted in the market-cap-weighted S&P 500 beating the equal-weighted version by 10%. If this gap held through year end, it would be the largest since 1998. It is worth remembering that after several years of narrow market leadership and pronounced mega cap outperformance, the early 2000s saw a large drop in valuations of those stocks and a broad shift in market leadership.

Exhibit 7: S&P 500 Equal vs. Cap Weighted



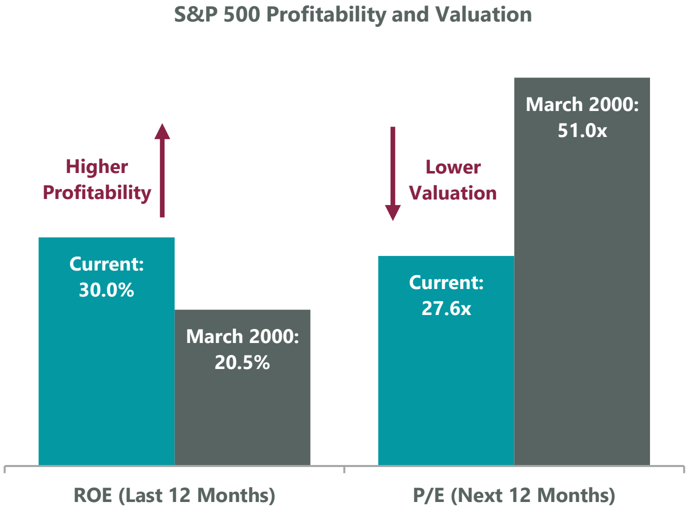
Data as at 30 June 2023. Source: FactSet.

These past periods of mean reversion have proven fruitful for active managers, given their flexibility to avoid pockets of overvaluation or overly lofty embedded expectations and instead focus on areas that have been neglected. Market participation has broadened in recent weeks, although if economic surprises begin to turn in the second half, recent broadening into more cyclical areas of the market could well stall out.

If markets do in fact turn lower, a wild card will be artificial intelligence (AI). The AI narrative is quite appealing: the emergence of a technological innovation that can transform businesses by boosting productivity and enhancing margins in the process. Large, cash-rich tech leaders appear well-positioned to benefit from the deployment of these new tools, which have theoretically gigantic addressable market opportunities. While some may argue this is a redux of the dot-com bubble, valuations actually remain well below those heady times. Importantly, companies are much more profitable today with higher returns on equity, which should provide a partial buffer to share prices should AI prove to be less of a game changer in the next few years than is currently priced in.

As we reflect on the past six months, we find our broader views little changed despite all that has happened. We certainly did not expect such strength in U.S. equities, and thought earnings expectations would have slipped more by now, as has happened with economic forecasts. On the other side of the coin, several of our views have been proven correct, including that expected rate cuts were highly unlikely with the markets underappreciating the shift in the Fed's response function and commitment to higher for longer monetary policy in the face of stubbornly high inflation (which we thought the market was too optimistic about, particularly in the early part of the year).

Exhibit 8: Not the Dot Com



Data as at 30 June 2023. Source: FactSet, S&P.

We will not know for some time if a soft landing or a recession will emerge to determine who is right: optimistic stock market investors or more cautious economists. At this juncture, we continue to believe a recession is the most likely path forward for the U.S. economy.