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## AOR Update: As Good as It Gets?

4 March 2025

### Key Takeaways

- ▶ Surging policy uncertainty has dented consumer and investor sentiment, raised inflation expectations and stalled the equity market rally. Should policy uncertainty ebb in the coming months, we believe risk assets will rebound.
- ▶ The ClearBridge Recession Risk Dashboard saw two negative indicator changes in February — ISM New Orders and Yield Curve — but remains in green, expansionary territory overall, while the U.S. consumer remains resilient.
- ▶ The current period of digestion for equities has coincided with a broadening of market participation, an encouraging development for active managers.

### Souring Sentiment Could Be Contrary Indicator for Markets

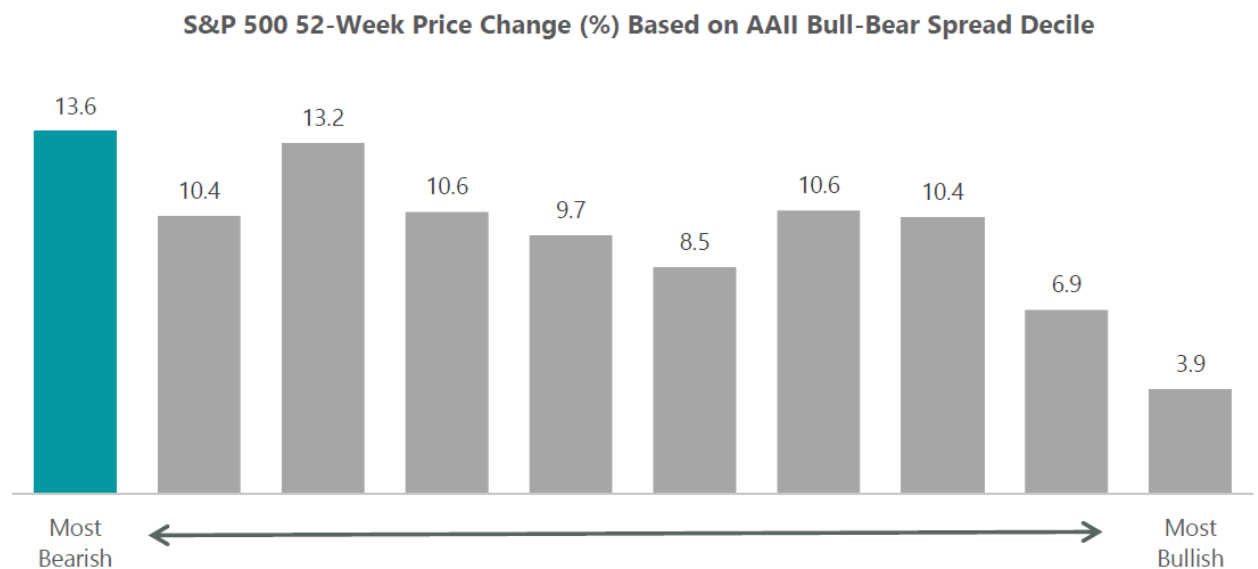
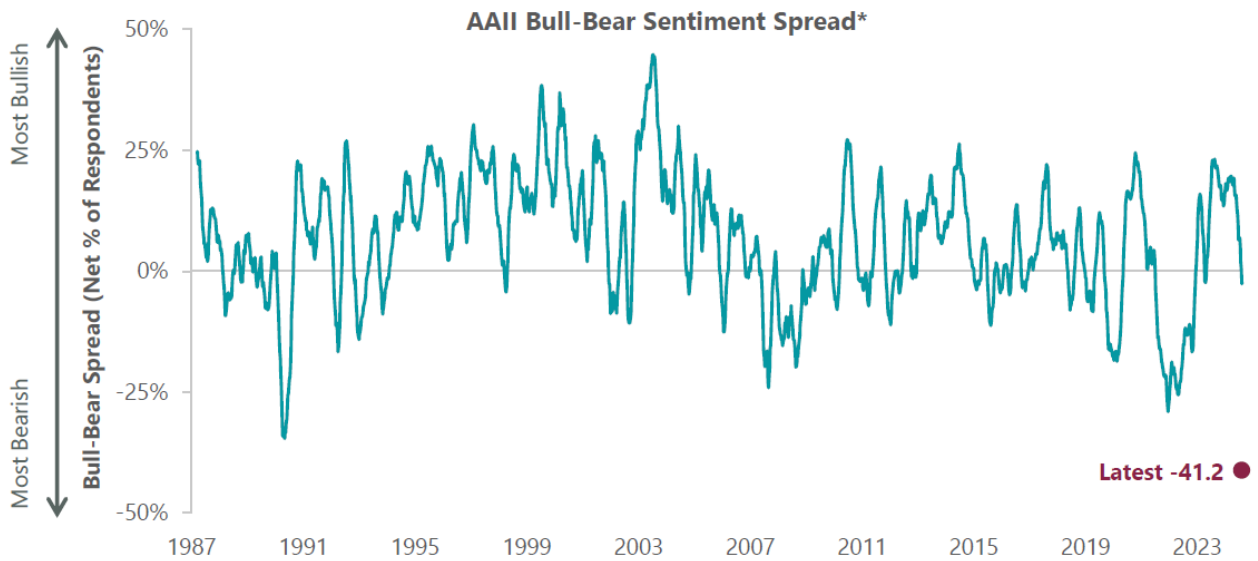
U.S. equity markets have been choppy and rangebound since the election, with the S&P 500 Index ping-ponging in a roughly 175-point range. With an ongoing market leadership tug-of-war [limiting a decisive breakout](#), some investors are questioning if the current rally's best days are behind it and whether this is as good as it gets.

Unsurprisingly, this rudderless period for markets has coincided with the emergence of an economic soft patch. A key driver of this weakness has been a surge in policy uncertainty, particularly on the tariff front. Both the Conference Board and University of Michigan consumer surveys have now more than fully retraced their post-election bounces. Further, the potential for higher prices has caused near-term inflation expectations to climb in both survey data as well as market-priced instruments. For example, in February the 1-Year zero coupon inflation swap reached its highest level since March 2023, when CPI inflation was still 5% and we were less than 12 months removed from the 9.1% peak.

Investor sentiment has started to sour too, with the AAll Bull-Bear Spread notching one of its 10 worst readings in its nearly 40-year history last week. While some may be debating repositioning their portfolios more defensively, we do not yet believe such action is warranted. For starters, the AAll Bull-Bear Spread has historically been a contra indicator, with extreme bearish readings giving way to elevated market returns. In fact, when the survey output has been in the bottom decile (most bearish) like today, the S&P 500 has historically delivered a 13.6% return on average over the subsequent 12 months (Exhibit 1).

Furthermore, a period of market choppiness was not entirely unexpected coming into the year. Following 2024's strength, many (including us) [called for a period of digestion](#) that now appears to be playing out. Importantly, this digestion has coincided with a broadening of market participation, with the S&P 500 equal weight index outperforming the cap weighted version by 1.4% year to date. This is an encouraging development for active managers, who have a larger opportunity set when market participation is broader.

Exhibit 1: AAI Bull-Bear Spread



\*Note: 3-month moving average. Data as of 28 February 2025. Sources: AAI, Bloomberg, S&P.

One thing that was not expected coming into the year was non-U.S. markets pulling ahead of the U.S., with the MSCI EAFE outpacing the S&P 500 by 5.9% in the first two months of 2025. Much of this performance gap emerged in February, as policy uncertainty led to mounting fears that U.S. economic growth will slow. However, we believe this dynamic may reverse in the coming quarters, [as U.S. exceptionalism re-asserts itself](#).

Core to this view is the premise that policy uncertainty in the U.S. should ebb in the coming months, giving way to the more investor-friendly elements of the new administration’s agenda such as deregulation and tax cuts. While policy headlines have come at a fast and furious pace over the past several weeks, cutting through the noise shows that the underlying fundamentals are often less dire than the headlines suggest. For example, about 77,000 federal workers have accepted the Department of Government Efficiency (DOGE) buyout so far, which keeps them on the payroll for the next six months. Importantly, this is roughly one-third the number of workers in the U.S. that file for unemployment benefits for the first time in any given week. Put differently, the scale of government workforce reductions so far appears digestible and represents more of a modest economic headwind than a shift in trajectory.

That said, one development worth monitoring is the jump in initial jobless claims during the last week of February. A rise in newly fired workers tends to foreshadow a slowdown in consumption and ultimately can lead to a recession, which is why it's a top variable in the ClearBridge Recession Risk Dashboard. However, this dataset can be volatile in any single week, which is why we (and many others) evaluate it on a four-week moving average basis.

Importantly, last week's jump does not appear to be a sign of more widespread DOGE-related layoffs, as initial claims actually fell in total across the three areas most likely to be impacted by cutbacks in government spending: the District of Columbia, Virginia and Maryland. While the catalyst for the recent move higher remains unknown, the jobless claims indicator remains firmly in expansion territory, suggesting that fretting over labour market weakness is premature.

The confidence crisis from policy uncertainty has recently begun to impact business sentiment as well as consumer and investor sentiment. The ISM manufacturing survey slipped slightly in February amid a number of comments within the report citing tariffs. However, the internals of the report were less supportive, with the New Orders sub-component that the dashboard focuses on falling from 55.1 to 48.6, bringing the measure back into yellow territory this month. Additionally, the 10-year less 3-month portion of the Yield Curve re-inverted late in February, bringing the signal back to red.

Both of these indicators had improved in recent months, and their steps backward are a good reminder that economic conditions do not move in a straight line. There are no other changes to the dashboard this month, and the overall signal remains solidly in green territory. The aggregate picture suggests that while some warning signs may be re-emerging, overall recession risks remain muted for now.

Exhibit 2: ClearBridge Recession Risk Dashboard

	February 28, 2025	January 31, 2025	December 31, 2024
<b>Consumer</b>	Housing Permits	↑	↑
	Job Sentiment	×	×
	Jobless Claims	↑	↑
	Retail Sales	↑	↑
	Wage Growth	↑	↑
<b>Business Activity</b>	Commodities	↑	↑
	ISM New Orders	●	↑
	Profit Margins	↑	↑
	Truck Shipments	●	●
<b>Financial</b>	Credit Spreads	↑	↑
	Money Supply	↑	●
	Yield Curve	×	●
<b>Overall Signal</b>	↑	↑	↑

↑ Expansion      ● Caution      × Recession

Source: ClearBridge Investments.

Whether the current confidence shock metastasizes into something worse will only be known with the benefit of hindsight. Decreased confidence and choppy markets reflect the increased possibility of unfavourable outcomes emerging, a risk bolstered by the emergence of a budding economic soft patch. While historically this has been concerning, the signal value from consumer surveys has been diluted in the post-pandemic world as weak sentiment has not translated to weak spending over the past several years. Put differently, today you need to watch what consumers do, not just what they say.

The consumer has been on solid footing, supported by a strong labour market and healthy individual balance sheets. Furthermore, extreme weather has likely distorted the true pace of U.S. economic momentum with the country experiencing its coldest January since 1988. As more clarity emerges in the coming months, and importantly as positive policy dynamics such as the extension of tax cuts come into view, confidence is likely to be bolstered and economic growth expectations should improve. Should this materialise, the current period of digestion would give way to the resumption of this bull market. As such, the current bout of volatility may represent a buying opportunity for long-term investors.

### About the Authors



**Jeffrey Schulze, CFA**

Managing Director, Head of Economic and Market Strategy | *ClearBridge Investments, LLC*

- 20 years of investment industry experience
- Joined ClearBridge Investments in 2014
- BS in Finance from Rutgers University



**Josh Jamner, CFA**

Director, Senior Investment Strategy Analyst | *ClearBridge Investments, LLC*

- 16 years of investment industry experience
- Joined ClearBridge Investments in 2017
- BA in Government from Colby College

## ClearBridge Investments ClearBridgeInvestments.com.au

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