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insight

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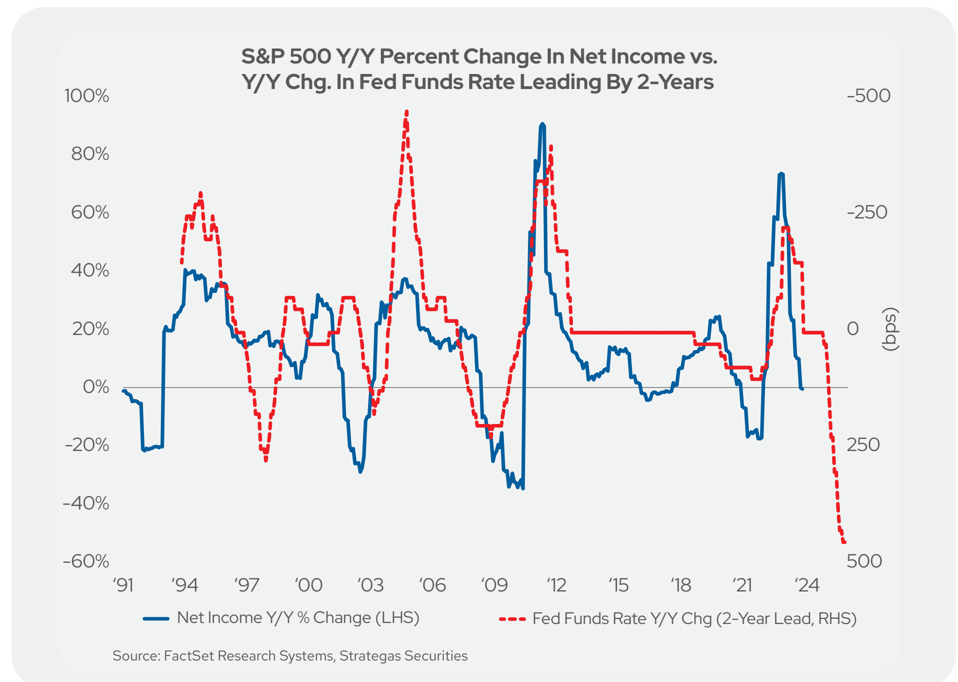
Labor & Liquidity vs. Earnings & Interest Rates



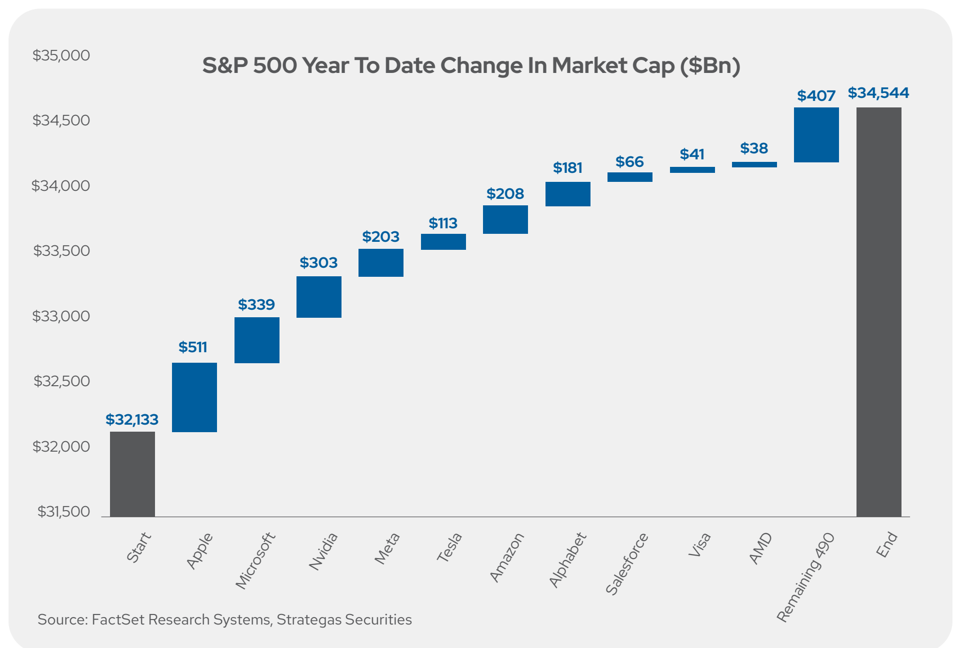
This year's tape is confounding to many investors. On the one hand, we have pronounced Index-level strength in the equity market and, on the other, perhaps the most broadly anticipated recession in history. Who's right? Will both the optimists and the naysayers have their day? Perhaps most importantly, how best to position portfolios for an environment seemingly devoid of a recent historical analogue?

By our lights, it is hard to discount the importance of ***earnings*** and ***interest rates*** as the keystone building blocks for stock prices. Moreover, if the market places such foundational importance on both series when the going is good, it seems intellectually inconsistent to discount the prevailing trend when the going gets tough... To that end, the current data is hard to ignore. The just underway 1Q'23 earnings season has, as always, offered some selected corporate highlights, but the broader theme has seen the continuation of the general trend in profit weakness that began last fall. The result, two sequential quarters (4Q'22 and 1Q'23) of negative Y/Y profit growth, the sharp compression of aggregate S&P 500 profit margins, and the continued downward revision of full-year 2023 consensus earnings estimates (now ~$220 as of this writing). On top of it, the Fed's campaign to normalize the emergency policy accommodations of the last decade plus and then tighten conditions to arrest elevated inflation considerations back to an acceptable level has, if past is prologue, only just begun to impact the operating environment of most economic sectors.

On the flipside, the market has been resilient. It is tough to look through the strength in the ***labor*** market. Unemployment remains low. Wages have continued to rise Y/Y and are now, by some measure, increasing at rates that exceed the headline rate of inflation. Though it could be argued qualitatively that there has been some tightening of the labor market, job opportunities remain generally plentiful for those looking to work or improve their vocational condition. A strong labor market underpins consumption. Though credit conditions have deteriorated – both in the availability of credit, its cost (i.e., interest rates), and the ratio of consumers' debt to assets and/or income – it has not stopped us from shopping. Shaking off concerns about

an impending recession (or any other "costs" accruing against a decade of economic imbalance) investors have leveraged a strong cross current of ***liquidity***, particularly from the fiscal side of the ledger, helping stocks off the Most Wanted list and back into investors' portfolios. Or have they? A look under the hood reveals that market leadership this year has been particularly narrow, with just ten stocks accounting for most of the positive price action.

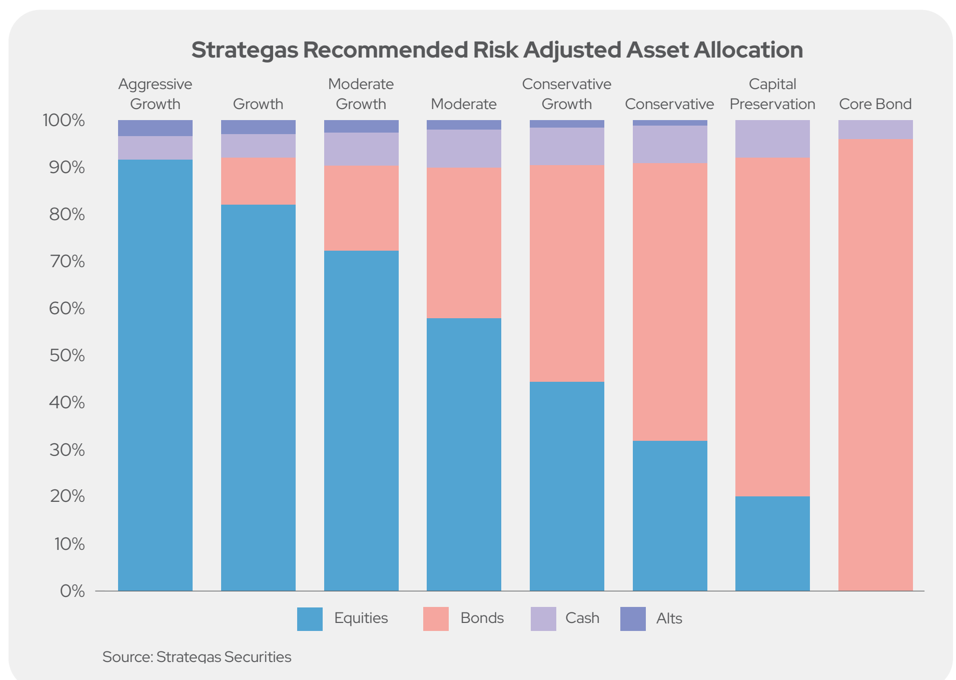
In an environment where investors have become accustomed to anticipate "v-shaped" outcomes, we're inclined to consider an alternative. Given the degree of asset inflation built into the system after nearly 15 years of profligate policy adjudication, it may be that the next truly bullish phase will need to be built on the footing of solid fundamentals. Before that can occur, however, it would stand to reason that the annualized rates of change in and volatility of expectations for the various and sundry price measures would need to be brought back to a level consistent with neutral monetary policy. Moreover, before organic drivers of growth can take root and induce capital from the sidelines – whether from operators looking to reinvest in and expand their franchise or from investors seeking appropriate risk-adjusted returns – the system needs to de-lever and valuations level set. As Strategas' Chief Investment Strategist, Jason Trennert, has highlighted, the market has <u>never</u> bottomed before a recession has started. This argues against the supposition that investors will just look through the most anticipated recession of all time and, in turn, suggests that the market may be in for some tough sledding if the economy deteriorates. Looking through a recession may wind up being harder than it sounds if downward earnings revisions and



Source: FactSet Research Systems, Strategas Securities

layoff announcements pick up.

We have been cautious on the outlook for the economy and the markets for the better part of a year and remain so. The uneven application of fiscal policy throughout coupled with the injection of emergency monetary support during the banking system's liquidity squeeze last month has been generally supportive of risk – albeit a narrower subset. We anticipate a further deterioration in the fundamental underpinnings of the economy commensurate with recession. Though uncomfortable at times, by our lights, we would describe the business cycle as thematically in the throes of a "pre-recession progression." We continue to recommend clients underweight both Equities and Fixed Income relative to their risk-adjusted benchmark. We have used a small allocation to Commodities and an above-benchmark allocation to Cash (with Gold as a subset) in an attempt to inoculate our tactical allocation portfolios from the headwinds of inflation and broader economic weakness.



Source: Strategas Securities

About Strategas

Strategas is a global institutional brokerage and advisory firm. The Firm provides macro research, capital market and corporate advisory services, and investment management solutions to institutional investors and corporate executives in more than twenty countries around the world.

Founded in 2006 by Jason DeSena Trennert, Nicholas Bohnsack, and Don Rissmiller, the Firm was acquired by Baird Financial Group in 2018. Strategas operates independently as a wholly-owned subsidiary of Baird and offers institutional securities services through Strategas Securities, LLC, a broker-dealer, and investment management solutions, including this commentary, through Strategas Asset Management, LLC, a registered investment advisor.

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Index Overview & Key Definitions

Fed, The Fed or FED refers to the Federal Reserve System, the central bank of the United States. Fed Funds Rate, the interest rate at which a depository institution lends funds maintained at the Federal Reserve to another depository institution overnight. The Gross Domestic Product (GDP) rate is a measurement of the output of goods and services produced by labor and property located in the United States. Real Gross Domestic Product (GDP) is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year. Nominal Gross Domestic Product is gross domestic product (GDP) evaluated at current market prices. The S&P 500 Index is an unmanaged index comprised of 500 widely held securities considered to be representative of the stock market in general. The Russell 1000 Index is a market capitalization weighted benchmark index made up of the 1000 largest U.S. companies in the Russell 3000 Index. The Russell 2000 Index is an unmanaged index considered representative of small-cap stocks. The PCE (Personal Consumption Expenditure) Index of Prices is a US-wide indicator of the average increase in prices for all domestic personal consumption. Using a variety of data including U.S. Consumer Price Index and Producer Price Index prices, it is derived from personal consumption expenditures; essentially a measure of goods and services targeted towards individuals and consumed by individuals. The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services. FAANG is an acronym for the five of the market's most popular tech stocks, namely Facebook, Apple, Amazon, Netflix and Alphabet's Google. The North American Free Trade Agreement (NAFTA) is an agreement signed by Canada, Mexico, and the United States, creating a trilateral trade bloc in North America. The Seasonally Adjusted Annual Rate (SAAR) is a rate that is adjusted to take into account typical seasonal fluctuations in data and is expressed as an annual total. SAARs are used for data affected by seasonality, when it could be misleading to directly compare different times of the year. The Atlanta Fed GDPNow forecasting model provides a "nowcast" of the official estimate prior to its release by estimating GDP growth using a methodology similar to the one used by the U.S. Bureau of Economic Analysis. GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available data for the current measured quarter.

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