NATIXIS INVESTMENT MANAGERS | SOLUTIONS

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PORTFOLIO ANALYSIS & CONSULTING

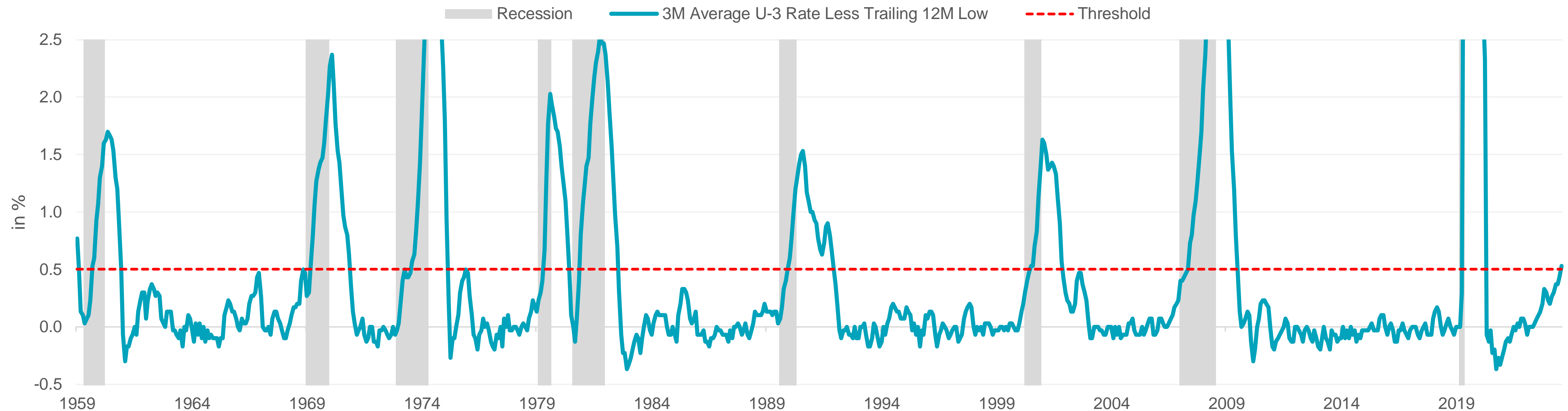
Charts and Smarts®

Jack Janasiewicz, CFA® – Portfolio Manager and Portfolio Strategist

Garrett Melson, CFA® – Portfolio Strategist

All Along the Watchtower

Sahm Rule (12/31/59–7/31/24)



Recessionistas rejoice: with the July employment report, the Sahm Rule has finally triggered as the 3-month average of the U-3 unemployment rate has risen more than 50 basis points above its trailing 12-month low. It now sits 90 bps above the cycle low. While one could argue that it technically hasn't triggered on an unrounded basis, that is of little consequence. The basis of the Sahm Rule rests on the nonlinear risks that exist within labor markets. The unemployment rate is inertial and almost never just moves sideways. And when it begins to trend in a direction, it tends to begin slowly and then accelerate as feedback loops kick in. Nonetheless, those bears who were predictably licking their chops may want to think twice before venturing out of their dens. The rule is an empirical relationship, or as Chair Powell stated at his July presser, a "statistical regularity". It is not a law of nature, nor is it predictive in nature. More importantly, there's a strong case that the current trigger is overstating the weakness in labor markets. As we highlighted late last year when the Sahm Rule watch began in earnest, the unique dynamics of this cycle, which has seen a remarkable surge in labor supply, suggest investors should proceed carefully in their search for a recessionary silver bullet. That exercise has already seen many a traditional recession indicator fail spectacularly over the past few years. To be sure, the labor market has rebalanced and softened, which inherently reduces buffers to rising downside risks. The hawks on the FOMC simply have nothing left to justify holding policy restrictive and needlessly risk causing undue damage to labor markets. Fortunately for the bulls, the solution is easy: recalibrate policy back to a less restrictive stance to stabilize conditions and protect the impressive gains we've achieved on the labor side of the mandate.

Source: Portfolio Analysis & Consulting, Bloomberg. FOMC represents Federal Open Market Committee.

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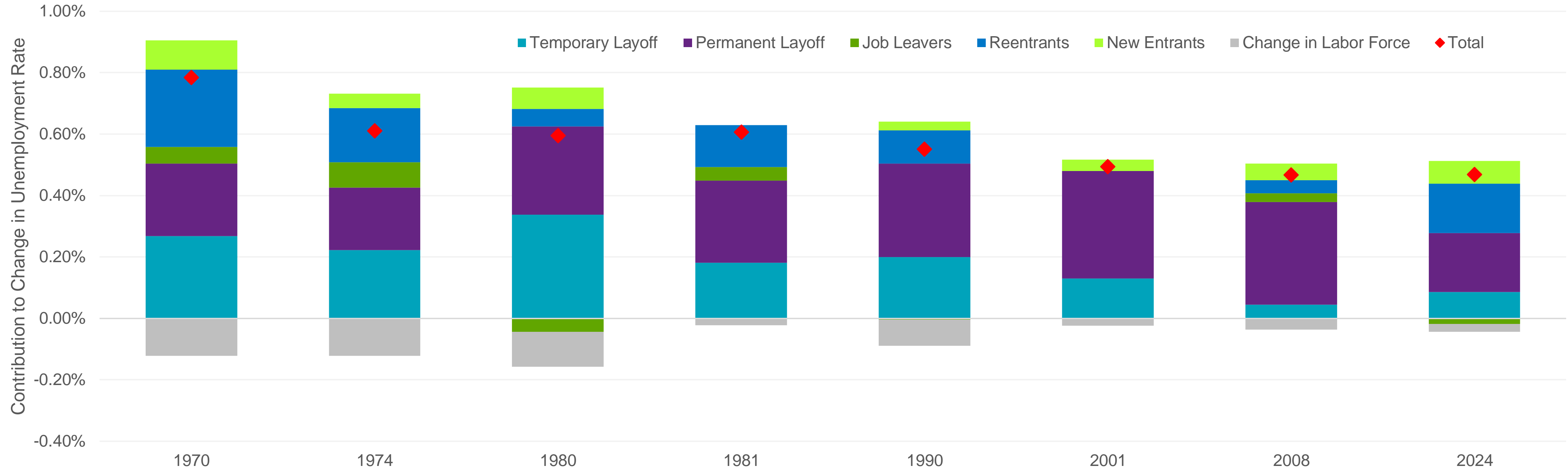
Purple Haze

Contribution to Increase in Unemployment Rate Triggering Sahm Rule (1970–2024)



Just as we noted last year as the Sahm Rule entered the market's focus, it's important to understand why the unemployment rate is rising. There's no question that the Sahm Rule triggering at the very least warrants some caution with respect to the economic outlook, but looking at the drivers of the rise in the unemployment rate off the cycle lows tells a very different story than prior periods when the rule triggered. In the past seven examples where the Sahm Rule triggered, excluding the 2020 COVID induced recession, the bulk of the rise in the unemployment rate has been a function of rising layoffs, with the most recent examples being heavily driven by permanent layoffs. The current environment, however, has seen just over half of the rise in unemployment fueled by new entrants or reentrants to the labor force. In other words, while we have indeed seen an increase in permanent and temporary layoffs, a meaningful portion of the rise has been the result of increasing labor supply meeting longer matching times, as hiring rates have fallen below pre-pandemic levels. Labor supply inflows from immigration and labor force entrants and reentrants is certainly not a dynamic one, as typically seen to this degree if the economy was on the verge of a negative feedback loop. Instead, it suggests a labor economy that remains resilient, but in a sort of stasis as demand for labor has certainly eased materially. With inflation rapidly heading back towards target and the unemployment rate already running above the Fed's 2025 year-end estimate, the weight of evidence suggests that policy need no longer remain in restrictive territory.

Source: Portfolio Analysis & Consulting, Bloomberg. As of 7/31/24.

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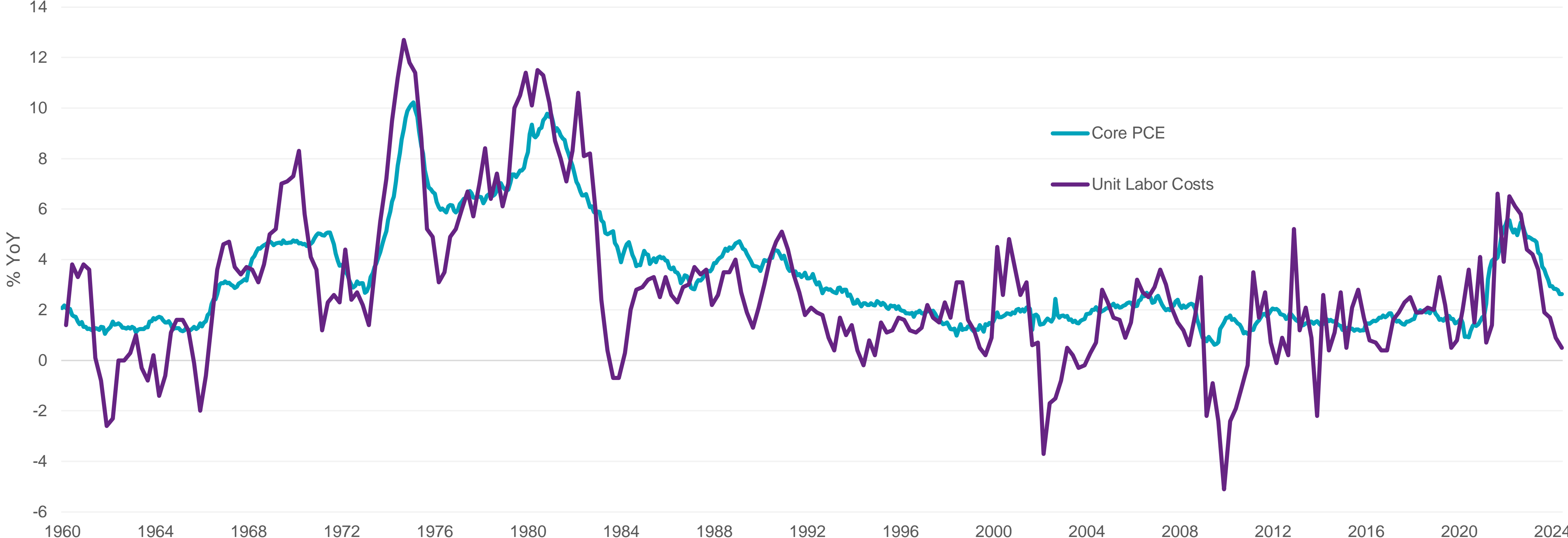
Castles Made of Sand

Unit Labor Costs vs. PCE (1/31/60–6/30/24)



While the market's myopic focus has clearly shifted from inflation to the growth backdrop, it's worth noting the implications of a rebalanced labor market on inflationary dynamics. We've stressed for over a year now that the labor market is no longer providing an inflationary impulse, and that's only grown increasingly true with the further rebalancing we've witnessed in recent months. Cooler labor markets portend slower wage growth, which not only softens demand but also reduces labor costs for firms. A rebalanced labor market with reduced churn also translates directly to increased labor productivity, which is further aided by capital deepening. The result: cratering unit labor costs as firms do more with less. With unit labor costs hardly growing just 0.5% over the past year, the lowest level since before the onset of the pandemic, the onus is on the hawks to explain how inflation is set to reaccelerate let alone stall out unacceptably above target. We've said it before, and we'll say it again: labor market risks are skewed to the upside while inflation risks are skewed to the downside. The policy prescription amidst that backdrop is clear.

Source: Portfolio Analysis & Consulting, Bloomberg.

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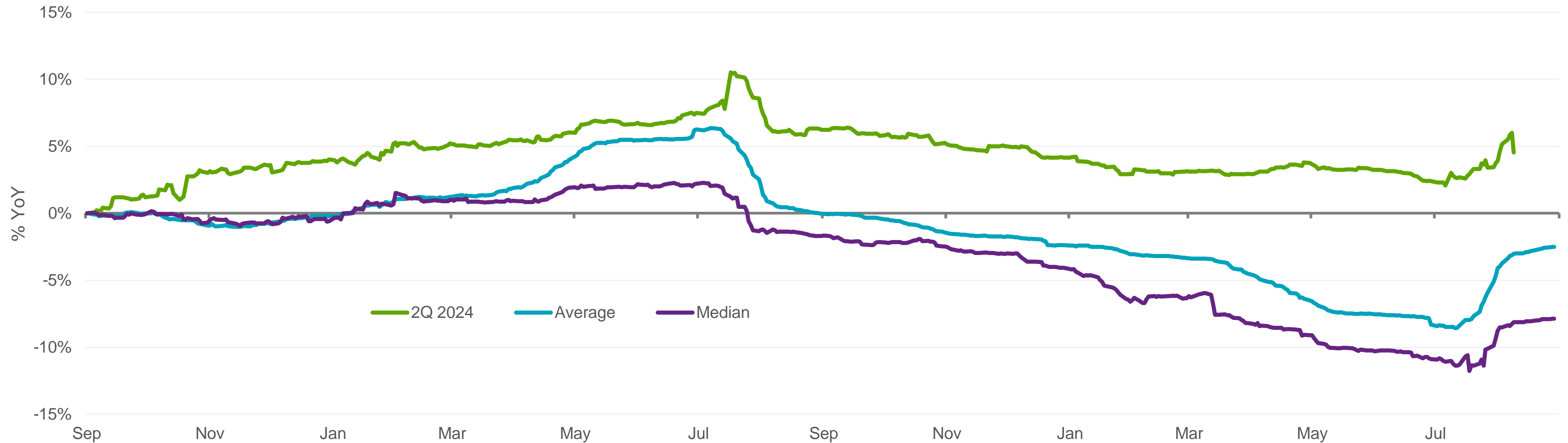
Are You Experienced?

S&P 500® Q2 Earnings Evolution (2011–2024)

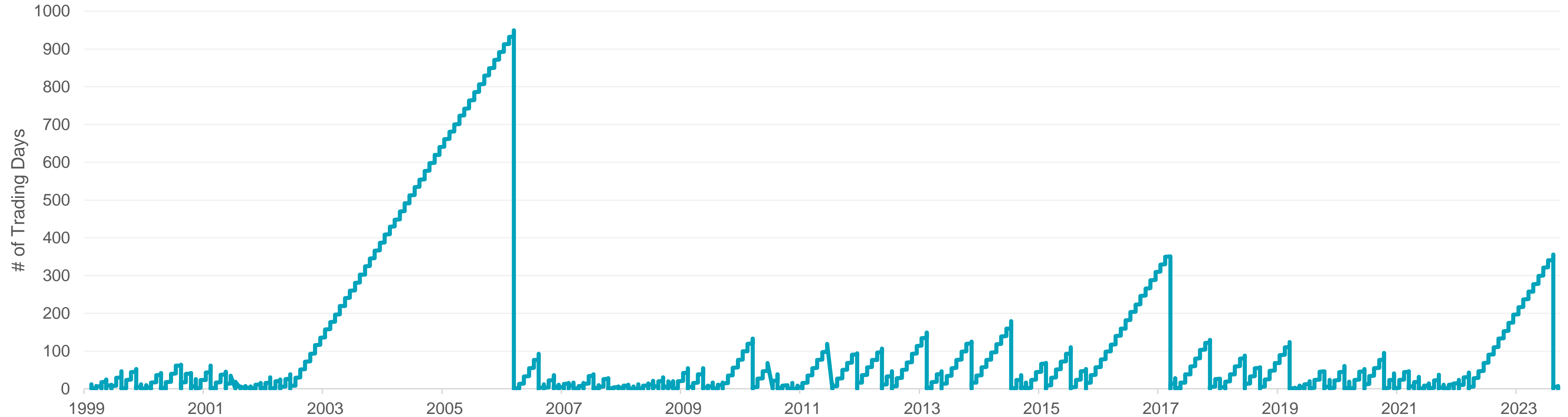


Low unit labor costs aren't just a positive for the macro economy, but also for corporate earnings. Revenue growth may be cooling off as nominal growth slowly slows back towards trend, but corporates are still able to drive stronger bottom line growth as margins are holding up just fine. This year has seen an unusual pattern play out with respect to earnings estimates. The game between management teams and analysts typically sees consensus estimates revised down anywhere from 5-10% below initial estimates before the beats begin rolling in and estimates move sharply higher - the earnings fishhook. The first quarter, however, saw estimates enter the earnings confessional season at the low end of that range, down just 5% from initial estimates, before completing the typical fishhook. The second quarter has been a complete outlier to that pattern and presented one of the key risks we've been monitoring through the summer: an earnings growth scare. Consensus estimates for Q2 earnings growth entered the earnings season over 2% higher than initial estimates. Yes, this was below the high water mark, but still far stronger than the typical earnings season. Despite the greater than usual risk for downside surprises, all told this earnings season has been decent, or perhaps not nearly as bad is it could have been. In fact, we've still seen a modest fishhook with estimates drifting up 2.5% since the beginning of the reporting, and stronger than expected margins have been the driving force behind those upside surprises. Corporate management teams remain as dynamic as ever while cost pressures continue to abate as inflation fades and the Fed is set to begin recalibrating policy. It's hard to get too bearish on earnings, even if the bar is higher than usual.

Source: Portfolio Analysis & Consulting, FactSet. As of 8/9/24.

Fire

Trading Days Without a S&P 500® 2% Drawdown (1/3/00–8/9/24)



Just a week into August and oh, how things have changed. The vicious July rotation which saw small caps, cyclicals, and rate sensitive areas of the market surge has gone up in smoke as a growth scare has taken control of the narrative. Explanations were all over the map, as pundits scrambled to pin the blame for the vicious Monday morning selloff of August 5 on anything from the Fed falling further behind the curve, to a dispersion trade blowup, to an unwind of the Yen carry trade. While the blame game is always fun, the root of the selloff, which saw the VIX spike to its third highest level on record, was less a function of fundamentals and more the result of risk appetite and market structure. We've written for years now that systematic levered strategies drive the marginal bid in the market, and can dampen volatility in trending markets and exacerbate in sharp selloffs as risk triggers and margin calls kick in. As the dust has begun to settle, it's becoming increasingly clear that gross de-risking by these exact strategies were a key culprit behind the wild moves. But the foundation of the move was in the remarkably low volatility environment we've seen over the past year and a half. Late July finally saw the end to the second longest streak of trading days without a 2% drawdown for the S&P 500®. In the words of the economist Hyman Minsky, "Stability breeds instability." There's nothing like a relentless run higher in prices with volatility grinding lower to spur a pickup in risk appetite. And when that risk appetite perks up, it drives more and more assets into the trades that have worked leading to increasingly crowded positioning in a handful of trades. All you need is a spark. It's a tale as old as time. Fortunately, technical washouts such as this tend to exhaust themselves once positioning and sentiment reset. And with the fundamentals still supportive, risk appetite can begin to recover in tandem with prices.

Source: Portfolio Analysis & Consulting, Bloomberg.

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