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PORTFOLIO ANALYSIS & CONSULTING

Charts and Smarts®

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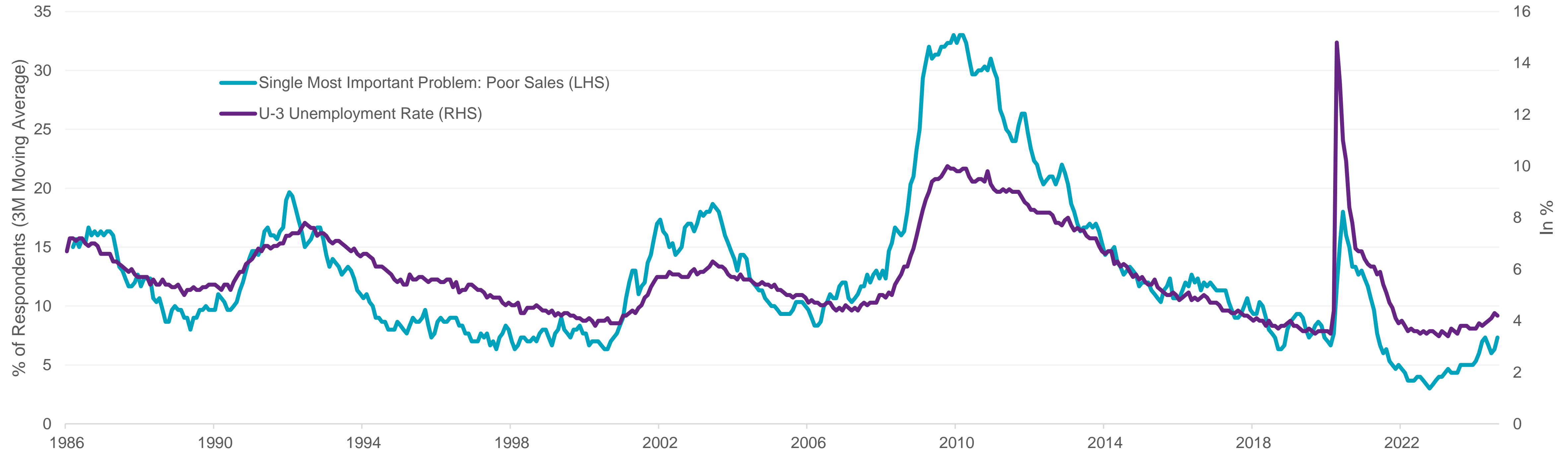
Am I Losin'

Unemployment Rate vs NFIB Poor Sales (3/31/86–8/31/24)



Much attention has been paid to the 90-basis-point rise in the unemployment rate since the cycle lows reached in April of 2023, which triggered the Sahm rule along the way. We've exhausted considerable ink and breath discussing that move and the role increasing labor supply has played in that increase, which suggests cause for skepticism that the rule is indeed sending the same recessionary signal as prior triggers. To be sure, the labor market has cooled and, while unemployment undoubtedly tends to be inertial, you need to have a reason as to why that trend of softening continues. The linkage typically comes in the form of a negative feedback loop of softer consumption. Softening income growth translates to slower consumption, falling revenues, tighter margins, and lower profitability leading to cost cutting and headcount reduction, which further weighs on incomes and consumption, and around and around we go. But firms don't layoff without cause. With nominal aggregate incomes growing solidly at 5%, at the upper end of the pre-pandemic range, despite the cooling in payrolls and wage growth, there's little reason to see a wave of aggressive layoffs to continue fueling that upward move in the unemployment rate. Revenue growth remains healthy, margins are expanding, and businesses are not worried about sales as indicated by the NFIB small business survey. Without the need for further rationalization of headcount, perhaps the softening is simply a normalization from the pandemic-induced distortions.

Source: Portfolio Analysis & Consulting, Bloomberg. NFIB is the National Federation of Independent Business. The Sahm Rule is an empirical observation that signals the start of a recession when the three-month moving average of the unemployment rate rises by 0.50% from its trailing 12 month low.

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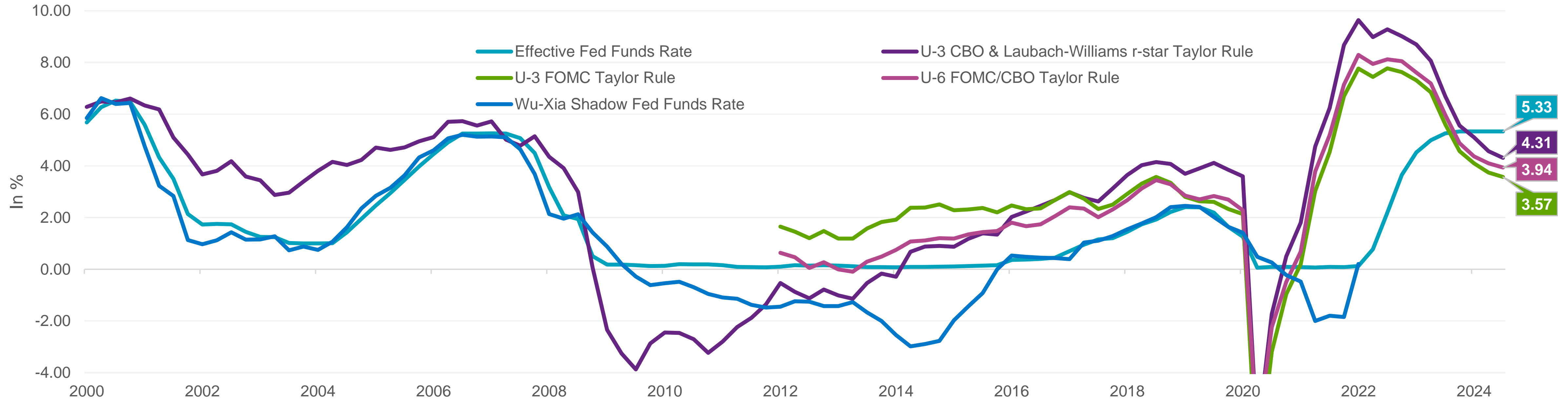
Simple Man

Taylor Rule vs Fed Funds Rate (2/15/00–8/15/24)



While there's certainly sufficient evidence that the softening in labor markets is a function of normalization and the natural self-governing effects of an economy at full employment, downside risks have certainly mounted. A robust labor market is a powerful buffer to any downside shocks to the economy, but as labor market tightness has abated, those buffers have shrunk. And as inflation has rapidly converged back toward target, the balance of risks has flipped. Downside risks to employment are greater than upside risks to inflation. As we've stated before, this is in many ways a Taylor Rule Fed, a central bank guided by the policy rule developed by famed economist John Taylor. The Taylor Rule is a framework by which to guide appropriate policy, based on the unemployment gap and the inflation gap. In other words, it provides an estimate of the appropriate level of policy rates as determined by the distance between prevailing inflation and the Fed's target, and the unemployment from its estimated natural rate. No rule is perfect, and the Taylor Rule is no exception as it relies on assumptions of the real neutral rate, or the rate at which policy is neither restrictive nor accommodative, and the non-accelerating inflation rate of unemployment (NAIRU). In this regard, the tool is less useful in prescribing the exact appropriate level of policy rates, but certainly has utility in directionally guiding where policy should be headed. If policy was restrictive when the Fed reached the terminal rate of 5.33%, there's simply no justification to remain as restrictive today with inflation quickly approaching target and unemployment sitting at the Fed's longer-run estimates. The inflation gap is rapidly closing, and the unemployment gap has already closed, all while inflation risks remain skewed to the downside with unemployment risks skewed to the upside. The time has come to adjust policy, and the Fed has plenty of ammunition to move rapidly back to a more neutral stance.

Source: Portfolio Analysis & Consulting, Bloomberg. Federal Reserve Bank of Atlanta. The Taylor Rule is an equation that prescribes a value for the federal funds rate based on the values of inflation and economic slack. U-3 CBO (Congressional Budget Office) & Laubach-Williams r-Star Taylor Rule uses Laubach-Williams One-Sided Estimate of Natural Interest Rate and CBO's estimate of Natural Rate of Unemployment. U-3 FOMC (Federal Open Market Committee) Taylor Rule utilizes U-3 unemployment rate and median long-run dot and U-3 estimate. U-6 FOMC/CBO Taylor Rule uses FOMC long-run median dot and CBO's estimate of Natural Rate of Unemployment.

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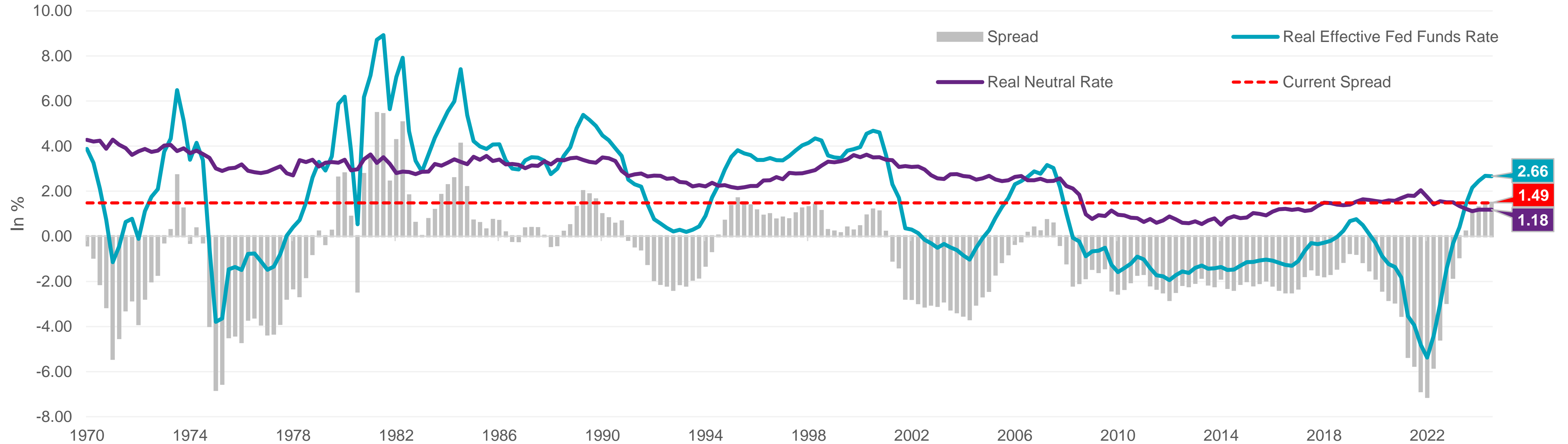
Comin' Home

Real Fed Funds Rate vs Real Neutral Rate (2/15/70–8/15/24)



While it's clear the Fed will commence its easing cycle at the September meeting, the magnitude of that first cut, and of the easing cycle as a whole, remains up for debate. Markets are currently pricing in over 100 basis points of easing by the end of the year, with a total of 225 basis points of cuts by June 2025. We continue to hear refrains that markets are pricing in excessive levels of cuts, given the resilience in growth and inflation that remains above target. Our readers know well our stance on inflation, which remains on a durable trend back to target. And while we maintain a constructive view on the growth outlook, the level of easing priced into rates markets may not be as far fetched as it sounds. Real rates have mechanically ratcheted higher as the nominal fed funds rate has held steady for over a year, as inflation has continued to cool. As a result, the gap between the current level of the real fed funds rate and a broad range of estimates of the real neutral rate of interest now stands at its widest point of the cycle, and at the tightest levels since the late 1990's. In other words, by keeping policy rates unchanged since last summer, the Fed has been passively tightening as both growth and inflation have cooled. That level of restriction is no longer needed given the shift in the balance of risks, and the longer it takes to move back toward neutral, the more that downside risks can build, suggesting front loading the recalibration of policy is the ideal strategy from a risk-management perspective. And while the market may be a little overzealous in its pricing of the magnitude of the easing cycle, it may not be as off base as some claim, given how far the Fed now finds itself in restrictive territory, a gap that only widens further as inflation continues to cool to target.

Source: Portfolio Analysis & Consulting, Bloomberg. Real Neutral Rate represented by Laubach-Williams One-Sided Estimate of Natural Rate of Interest. Real Effective Funds Rate is deflated by core PCE.

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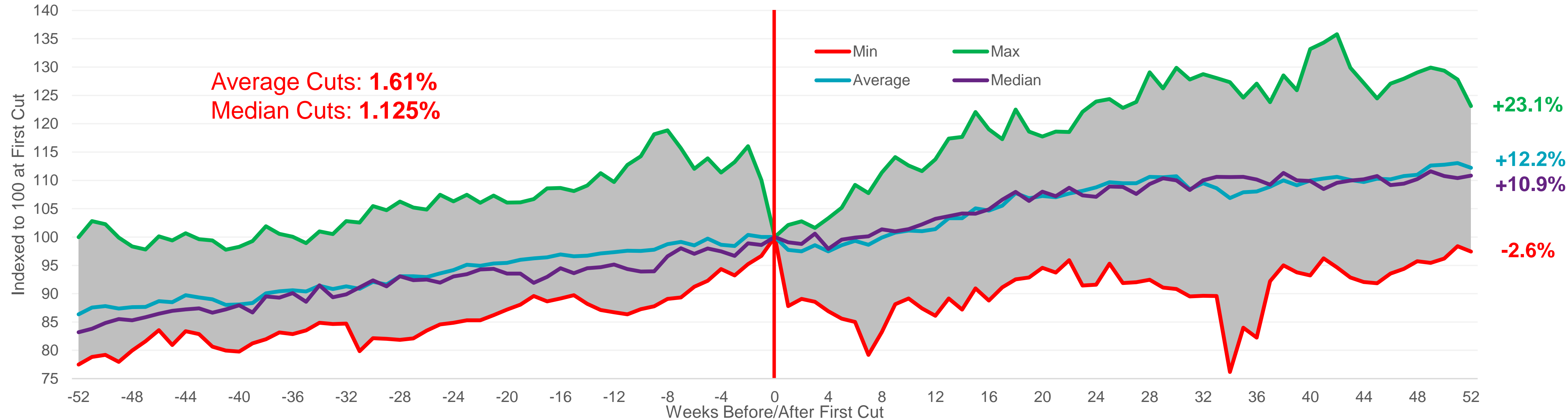
Free Bird

S&P 500® Performance Around Mid-Cycle Adjustments (1/1/71–9/13/24)



Perhaps the time has finally come to put the soft landing term to bed. Inflation has closed within striking distance of the Fed's target, while labor markets and growth have remained resilient, prompting the Fed's looming recalibration of policy. The soft landing has been achieved, but what comes next? There's no true finish line when it comes to economic outcomes, only continuous evolution. And while there remains plenty of uncertainty with respect to the path ahead, the next phase in our economic journey looks a whole lot like a mid-cycle adjustment. We've long argued that the mid-1990's soft landing was the most logical comparison to today's environment, and that cycle provided a useful roadmap for both policy and markets. A common refrain we've heard through the past few years, as we clung to our soft landing call, was there were very few examples of soft landings in our economic history. That may be true, but there are considerably more examples of mid-cycle policy adjustments in the midst of ongoing expansions. The latest hot topic in markets has been historical performance for markets after the Fed's first cut, but these studies tend to ignore the nuance of the type of easing cycle. Not all cycles end with rates falling down the elevator shaft. Of course, those environments where the Fed cut aggressively – on the order of over 500 basis points as the economy fell headlong into recession – portended loses ahead for equity markets. But if the path ahead looks instead like one of those 8 mid-cycle adjustments we've seen since 1971 where the Fed simply recalibrates policy more modestly, the future remains bright for equities as markets posted median returns north of 10% in the subsequent 12 months. Despite the uncertainty, the outlook remains constructive for equities.

Source: Portfolio Analysis & Consulting, Bloomberg. Mid-Cycle Adjustments include easing cycles beginning in August 1971, October 1984, December 1985, October 1987, June 1989, July 1995, September 1998, and July 2019. Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results.

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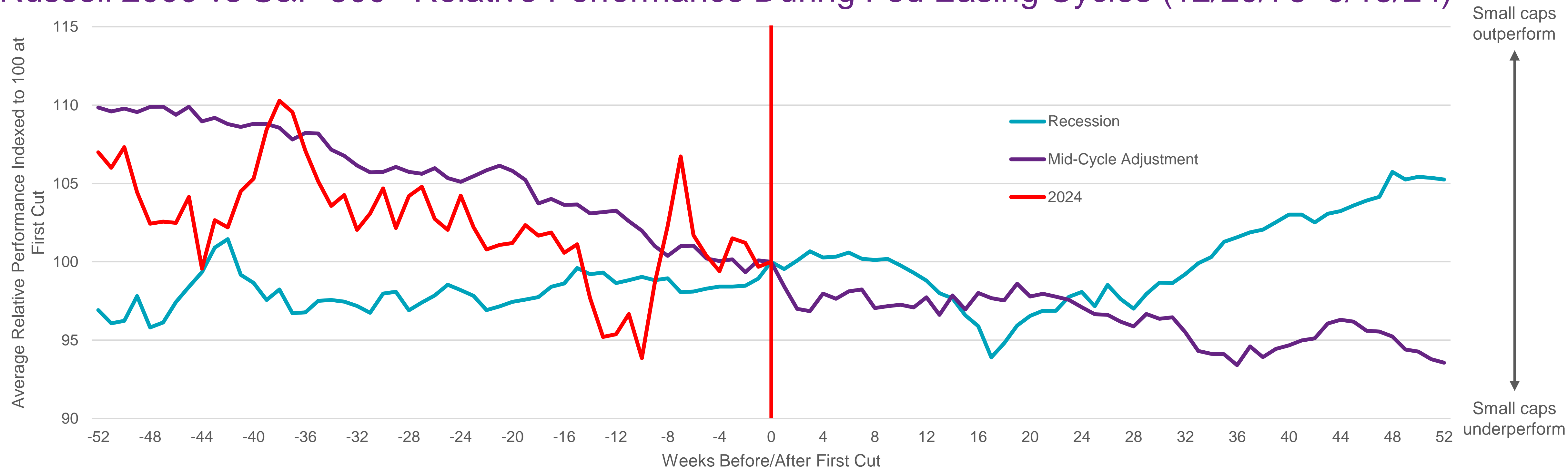
I Got The Same Old Blues

Russell 2000 vs S&P 500® Relative Performance During Fed Easing Cycles (12/29/78–9/13/24)



While mid-cycle adjustments have generally been supportive for the equity backdrop across the cap spectrum, the extent of that support is not the same. Although we've seen bouts of outperformance from small caps this year, the group continues to lag behind their large cap counterparts, particularly as fears around the growth outlook have taken center stage. Although mid-cycle adjustments are certainly supportive in that they help to trim left tail risks and ease financing costs, those benefits have historically been outweighed by the lack of a pro-growth impulse to really drive material and durable outperformance for small caps over large caps. It's only when clear evidence emerges of a reacceleration in growth, such as out of the depths of a recession, that small caps tend to sustainably outperform. Despite the Fed embarking on its policy recalibration, growth is likely to continue moderating in the near term as income growth cools, with little room for further compression in savings rates, housing activity remains muted, fiscal impulse fades, and capex and inventory investment stays on hold. While there's certainly scope for short spurts of outperformance, given the starting relative valuations and light positioning, persistent growth concerns are likely to continue holding back small caps in relative terms. But as that outlook begins to shift with a brighter backdrop for 2025 taking shape, we may finally see that long-awaited catch-up trade come to fruition.

Source: Portfolio Analysis & Consulting, Bloomberg. Mid-Cycle Adjustments include easing cycles beginning in October 1984, December 1985, October 1987, June 1989, July 1995, September 1998, and July 2019. Performance data shown represents past performance and is no guarantee of, and not necessarily indicative of, future results.

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