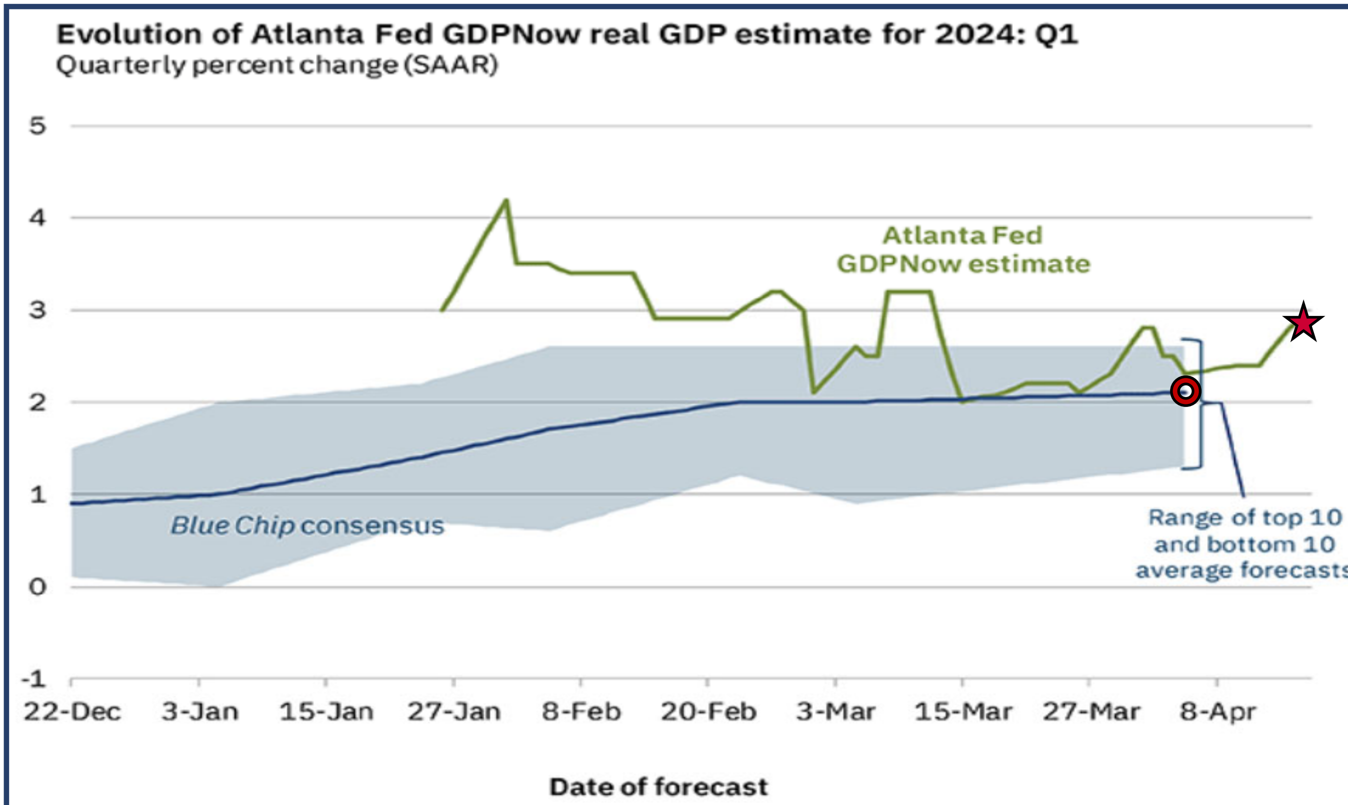
# STILL NO RECESSION BUT EQUITIES RICHLY VALUED

In my previous letter, I noted that although the Federal Reserve Bank of Atlanta expected the U.S. economy to grow at an annualized rate of about 2.3% during the fourth quarter of 2023, the consensus estimate of private, "Blue Chip" forecasters was for a much more modest annualized growth figure of only 1.5%. More importantly, many forecasters were expecting fourth quarter results to begin the slide toward the negative/recessionary GDP figures that so many had been anticipating for so long. **Instead, the U.S. economy posted a surprisingly strong annualized GDP growth figure of 3.3% for the fourth quarter of 2023**, **more than doubling the consensus, Blue Chip forecast of 1.5%.**

**For the first quarter of 2024, those Blue Chip forecasters are now expecting U.S. GDP growth to improve to an annual rate of 2.1%** (bullseye). Their forecast for this quarter is less than the 3.3% figure the U.S. economy posted for the previous quarter, but it **still signals an improvement in the relative optimism** of this group of forecasters. And even though the Fed's 2.9% estimate for first quarter GDP growth (star) is lower than the actual fourth quarter figure of 3.3%, **the Fed's first quarter growth estimate of 2.9% represents a similar improvement in optimism versus the 2.4% growth rate it had estimated for the fourth quarter of 2023**.

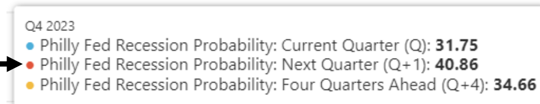



**Sources:** *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
**Note:** The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

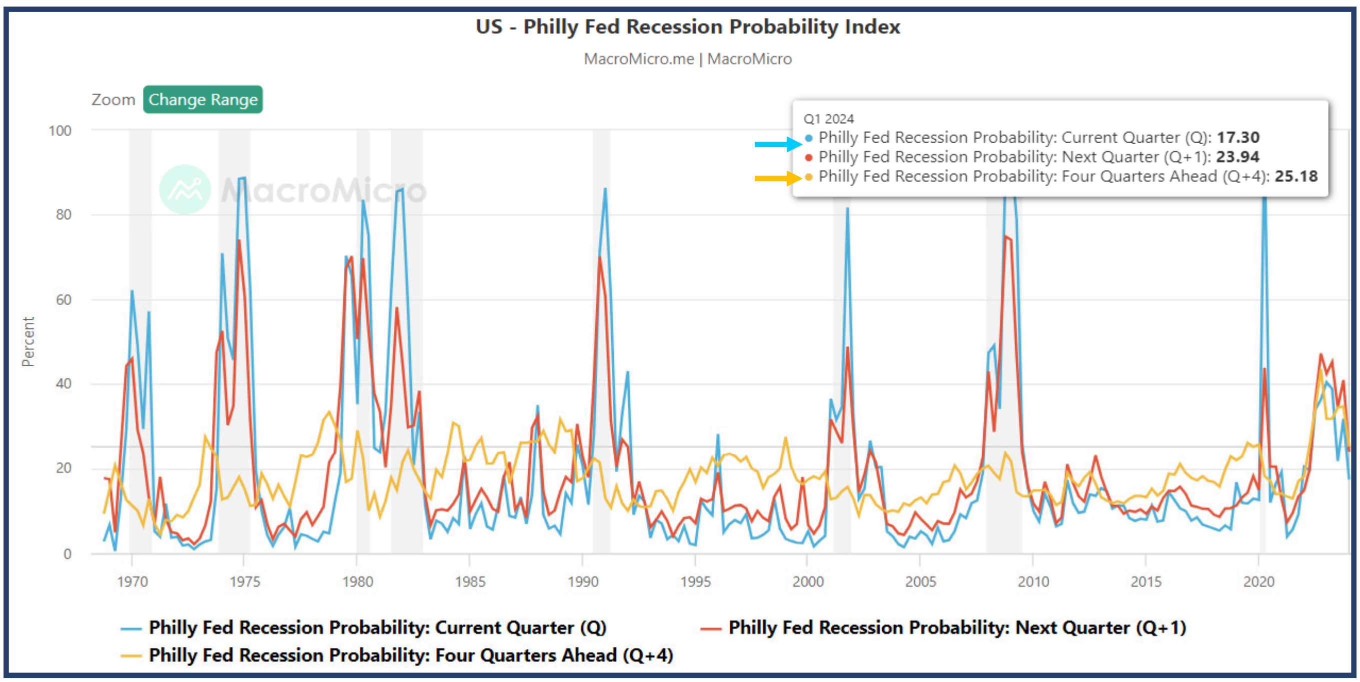
## RECESSION RISK CONTINUES TO WANE AS PER PHILLY FED

The Philadelphia branch of the Federal Reserve Bank maintains an index that aims to assign probabilities of the U.S. devolving into recession during the current quarter, during the next quarter, and during the quarter four quarters ahead. When I alluded to data from the Philly Fed's Recession Probability Index **in my previous letter**, data was as of the fourth quarter of 2023 and that **data suggested that the highest probability of recession would manifest during the first quarter of 2024** which, at that time, was "now," as shown here:

**Maximum estimated recession risk is … *now*.**




The data that appears below is current as of late April. As such, **the Fed's estimated probability of recession for 1Q-24 has declined from the 41% shown above** (black arrow) **to 17%** (blue arrow). The probability of recession occurring anytime within the next 12 months has also declined markedly from about 35% shown above to about 25% shown below (yellow arrow).

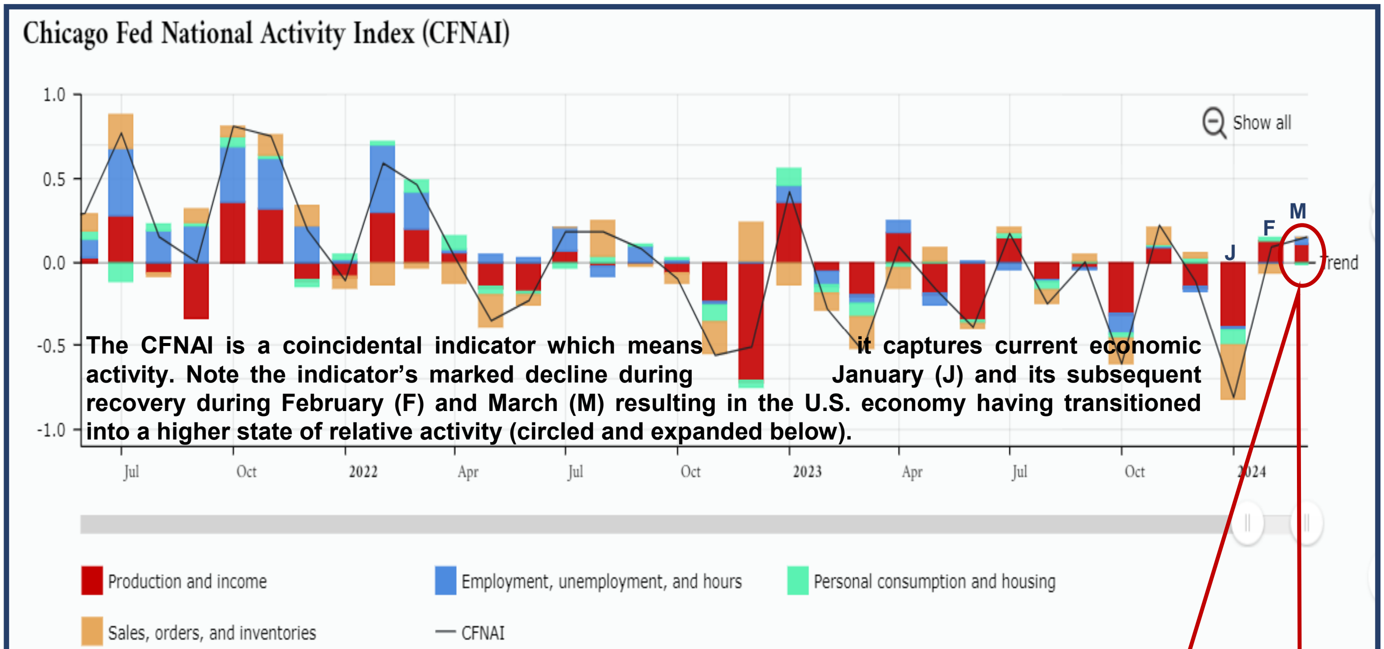


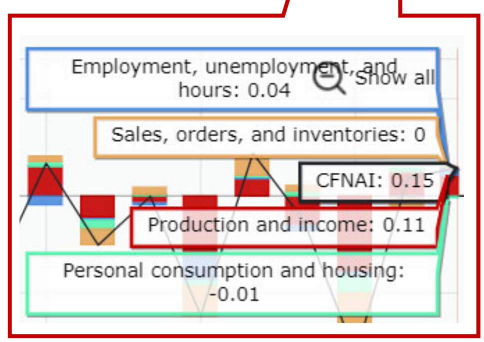

## NATIONAL ACTIVITY INDEX ALSO SEES ECONOMIC IMPROVEMENT

The Federal Reserve Bank of Chicago publishes the Chicago Fed National Activity Index (CFNAI). I've included it because it's a weighted index comprised of 85 separate growth indicators that are drawn from four broad categories of data:

1) Production and income (consisting of 23 data points),
2) Employment, unemployment, and hours worked (24 data points),
3) Personal consumption and housing (15 data points), and
4) Sales, orders, and inventories (23 data points).

This index is intended to compare the U.S. economy's long-term, sustainable rate of activity to its actual rate of activity. The sustainable rate of activity for the economy at any given time is represented by the flat/horizontal "Trend" line, and the actual rate of activity (the CFNAI) is represented by the jagged black line. Anytime the CFNAI is above the trendline, economic activity within the U.S. is or was above its long-term trend, and whenever the CFNAI plots below the trend line the U.S. economy is either growing at a rate below its long-term trend, or possibly shrinking outright if the CFNAI plots far enough below the trend line.




The data pertaining to March (above) appears to the callout to the right such that the four major components that comprise the CFNAI are apparent along with the latest overall reading (.15) of the actual Chicago Fed's National Activity Index.

The component data and the CFNAI itself are presented in terms of standard deviations, so interpreting the CFNAI reading of .15 along with its subcomponent readings is a bit beyond the scope of this note. Instead, my goal is to make these points:

⇒ Only the Personal Consumption and Housing component of CFNAI is expanding at a rate that's slower than typical, and then by only the slimmest of margins (-.01 Std. Dev.).

⇒ The National Activity Index suggests that **the slowdown that occurred near the end of 2023 has reversed itself**.

⇒ The last time this index showed two consecutive, positive readings was last summer.

## CFNAI DIFFUSION INDEX IMPROVES AGAIN IN MARCH

Before I move on from the Chicago Fed National Activity Index, I'd like to share with you a sub-measure of this index which is called the CFNAI Diffusion Index. In short, this diffusion index sorts all 85 data points of the CFNAI as to whether they are making positive or negative contributions to the index. A few quick points:

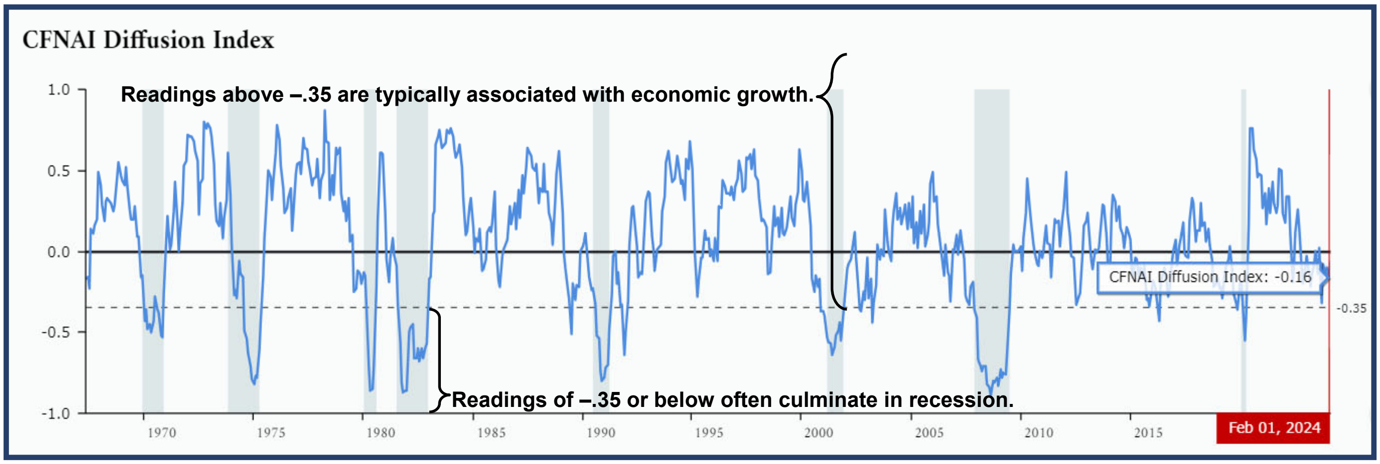
⇒ Recession is associated only with diffusion readings that are *substantially* negative.

⇒ Diffusion readings above *negative* .35 have been associated with economic growth.

⇒ The **CFNAI Diffusion Index stood well above that recessionary threshold in February**.

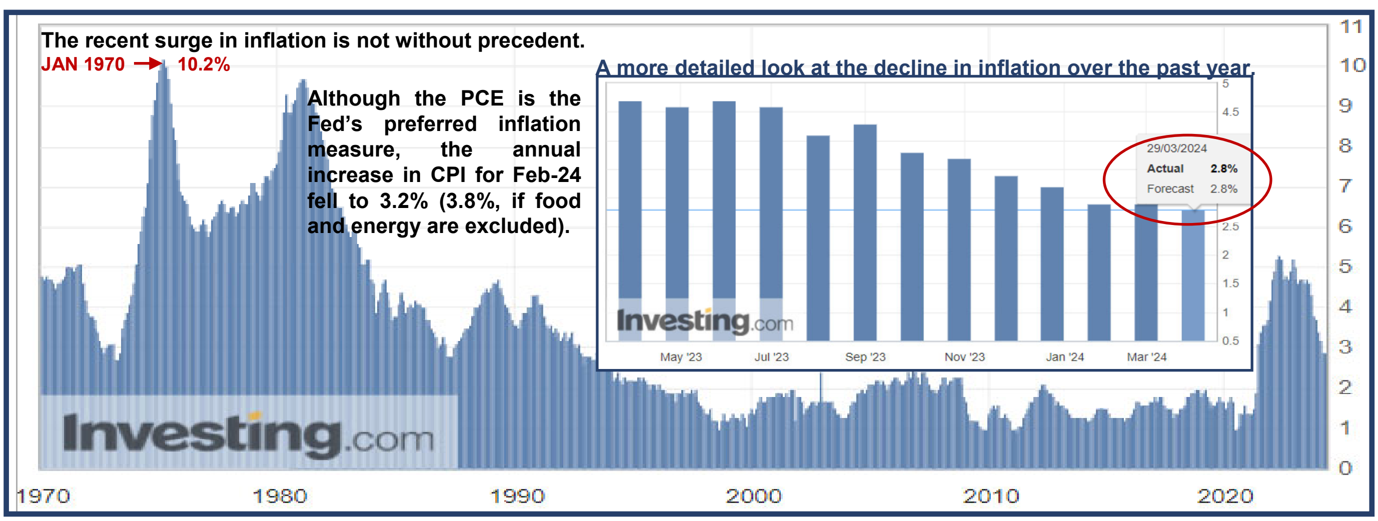
⇒ The **CFNAI Diffusion Index further improved in March** to –.06 Std. Dev. (not shown).

⇒ The **Federal Reserve has done an admirable job of slowing the U.S. economy over the past couple of years in its quest to tame inflation without forcing the U.S. economy into recession**.




## PERSONAL CONSUMPTION EXPENDITURES INDEX

The Fed continues to have success taming inflation as it aims for its target of 2% per year.



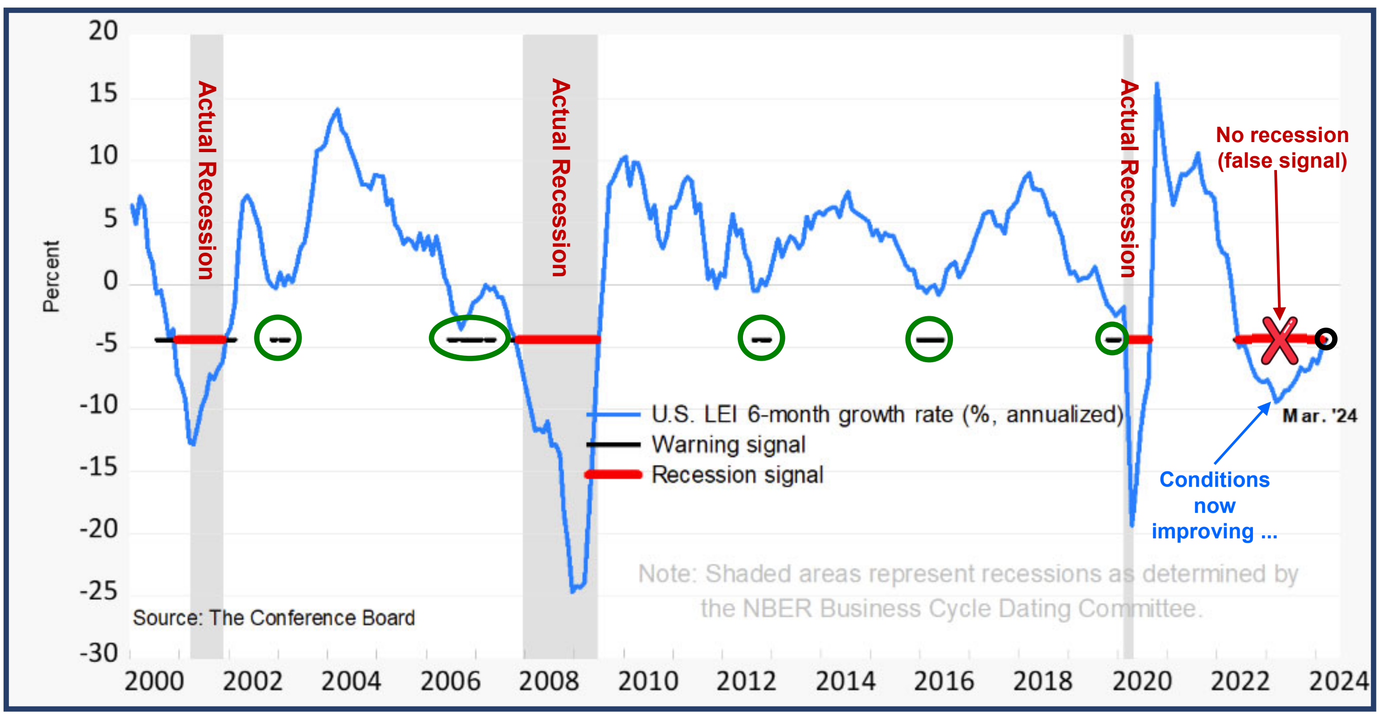
## LEADING ECONOMIC INDEX® NO LONGER FLASHING RECESSION

The Conference Board publishes several indexes designed to signal peaks and troughs in the business cycle. Its Leading Economic Index (LEI) is intended to provide such signals six months or more in advance of an actual peak or trough.

In general, the LEI will generate the black warning signal that appears in the image below anytime enough of its components pieces are simultaneously negative. That black warning signal essentially indicates that conditions are becoming relatively favorable for a recession to develop. As shown below, the LEI has flashed a number of warning signals over the years (green circles) without a recession (a shaded area) actually developing.

If the LEI flashes that black warning signal after the actual LEI index (the blue line) has declined by at least 4.4% over the past six months, that black warning line/signal is then overwritten with a red warning line/signal that suggests that a recession may *already* be in progress even though it might take the National Bureau of Economic Research quite some time to retrospectively officially confirm the existence of that recession. **The LEI has an enviable record of signaling the development of recession in real time, … except for the most recent signal which has, so far, turned out to be false (red X) and for the first time in many months, the LEI did not signal a recession in March** (black circle). However, the Conference Board does still regard future prospects for the U.S. economy as being "fragile."

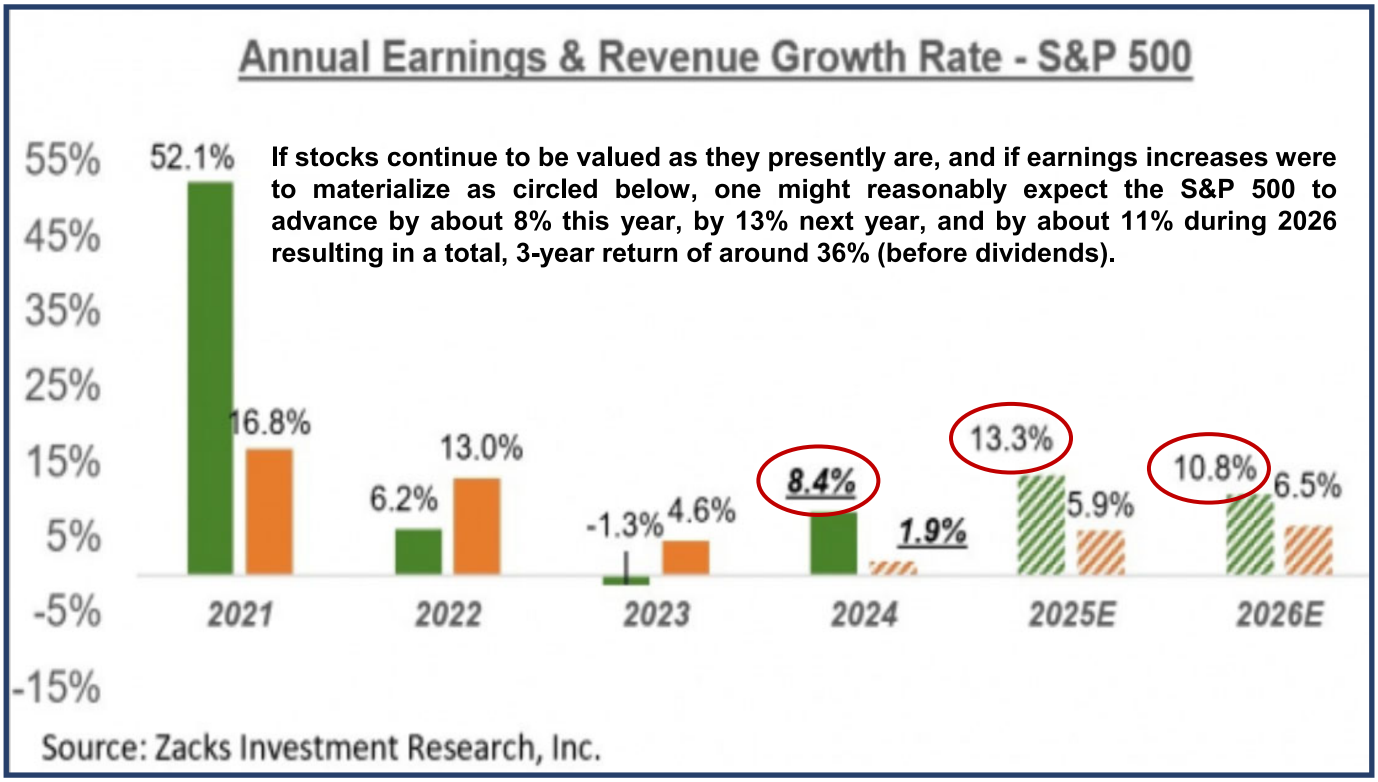
## CONFERENCE BOARD'S LEADING ECONOMIC INDEX®



## CORPORATE EARNINGS EXPECTED TO ADVANCE NEXT 3 YEARS

Despite all the other forces and factors that can influence stock valuations, companies that can consistently increase the cash they generate for shareholders will typically be rewarded with stronger demand for their shares and rising stock prices. The most sustainable way to increase cash flows to shareholders is to increase earnings. All else being equal, an increase in earnings of some percentage will tend to beget an increase in the value of share price by some similar percentage.

Zacks Investment Research tracks analysts' earnings estimates for the 500 companies that comprise the S&P 500 to create consensus estimates for that index. As of late April, Zacks' consensus **earnings estimates indicate that analysts expect corporate earnings to rise 8.4% during 2024 and to continue rising through at least 2026** (circled).




## STOCKS RETURNS UNLIKELY TO COINCIDE WITH EARNINGS

Because all else rarely is equal, it is exceedingly unlikely for returns from stocks to exactly parallel an underlying increase in earnings because investors value equities differently in different circumstances. For example, an increase in political tensions here and/or abroad would likely increase investor wariness which might then manifest in a reduction in the aggregate appetite to hold equities. In contrast, a future environment of lower interest rates would likely increase investors' aggregate appetite to hold equities. The factors at play is almost without limit.

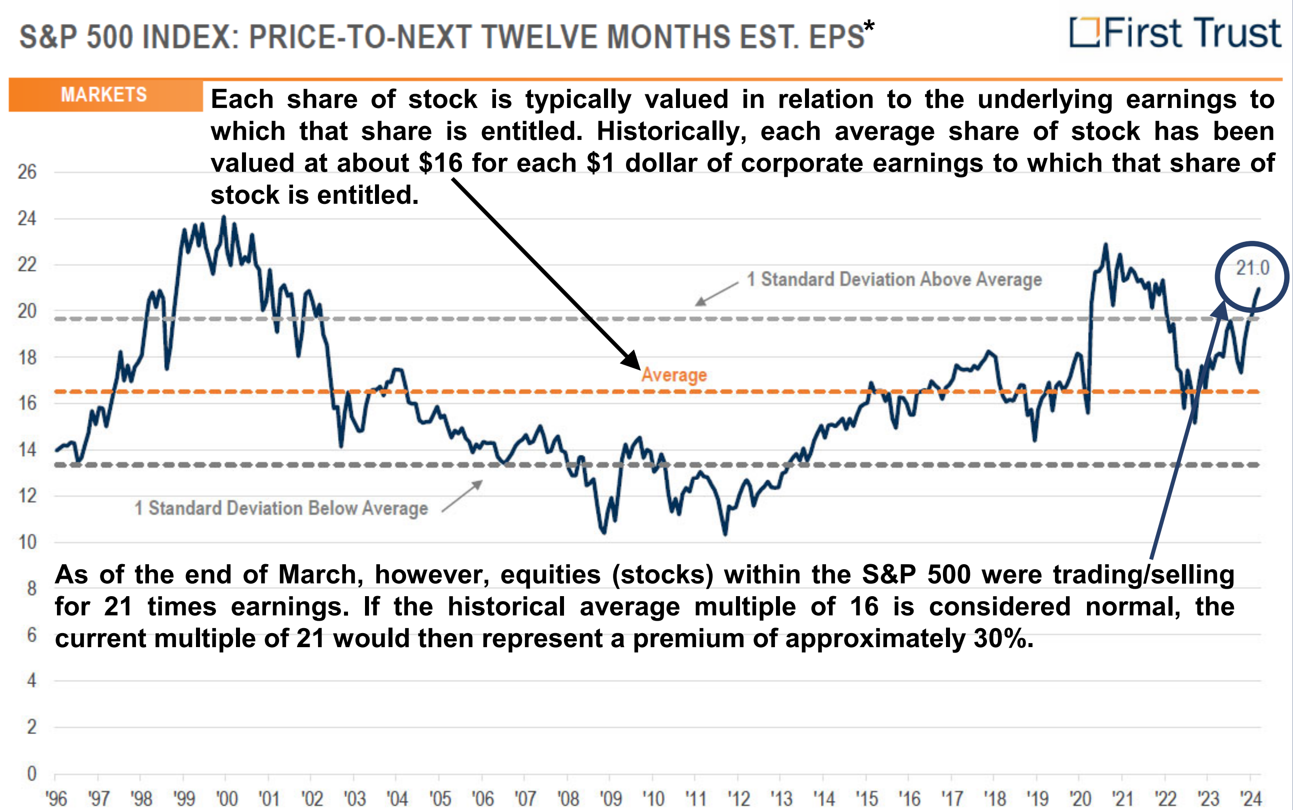
## STOCKS ALREADY RICHLY VALUED BY HISTORICAL STANDARDS

The folks who make policy within our Federal Reserve system have already expressed their intent to begin reducing interest rates once they are satisfied that inflation no longer poses a threat to price stability. I already mentioned that an environment of lower interest rates may increase investors' collective appetite to hold stocks. I won't attempt to prove anything here, but this notion is supported by historical data (and math).

**Because markets and the investors who animate them are naturally forward looking and because:**

1) the Fed has already signaled its wish to begin reducing interest rates this year,
2) corporate earnings are expected to rise materially over the next few years, and
3) equities are generally worth more when interest rates are lower ...

… **one might expect equities to have performed relatively well *prior* to the time these events come to fruition, and they have. Therefore, these events may be why equities are already valued relatively richly by historical standards**.




***EST. EPS = Estimated earnings per share of stock**

**Past performance is no guarantee of future results.**
Source: FactSet. Data from 1/31/1996 to 3/28/2024. Standard Deviation is a measure of price variability (risk). There can be no assurance that any of the projections cited will occur. This chart is for illustrative purposes only and not indicative of any actual investment. Price-to-Next Twelve Months earnings is price divided by FactSet consensus forecasted earnings per share over the next twelve months. The S&P 500 Index is an unmanaged index of 500 companies used to measure large-cap U.S. stock market performance. Investors cannot invest directly in an index.

## IMPLICATIONS OF STOCKS SELLING AT A 30% PREMIUM

It must first be recognized that the 30% premium mentioned on the previous page may or may not be relevant. For example, **a case could be made that stocks *should* sell at some historical premium if some combination of the following comes to fruition**:

⇒ **Interest rates decline and remain low**. The more they are expected to decline and/or the longer they are expected to remain low, the higher the justifiable premium.

⇒ Corporate **earnings growth continues**. The higher the growth rate, the higher the justifiable premium. As profitability improves, investors may "pay up" to own equities.

⇒ Corporate **earnings become smoother and/or more predictable**. The smoother and/or more predictable they become, the higher the justifiable premium.

⇒ **The world becomes a less risky place**. The greater the derisking, the higher the justifiable premium.

The implied 30% premium that appears on the previous page takes none of this into consideration. Instead, it simply compares the current asking price of stocks (21 times earnings) to what the average asking price has been since 1996 (16 times earnings) without trying to adjust for any differences in conditions. **If some combination of the conditions I've listed above do materialize, stock prices might reasonably be expected to continue to increase along with corporate earnings**. **However, if they don't materialize, investor impatience may morph into selling pressure that dissipates some or all of the current premium**.

Of course, **if corporate earnings were to increase 36% over the next three years as analysts anticipate (page 7), that alone would erase the current premium of 30% <u>without stock prices needing to decline at all</u>**. Stockholder returns may or may not be skinny during that time, but stockholders could at least take solace knowing that the stocks they own have, once again, reestablished headroom to trade higher in the future while they continue to collect dividends.

## FINAL WORD

The Fed has had success taming inflation within a U.S. economy that was overheated on stimulus money, and it has done so without pushing the economy into recession. That recession may still be brewing, but so far so good.
— Glenn Wessel