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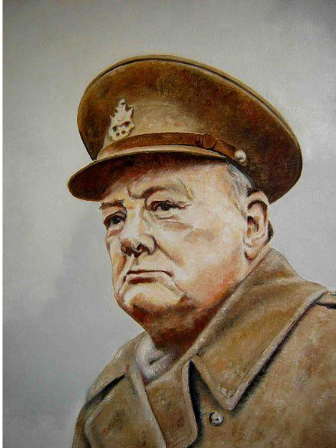
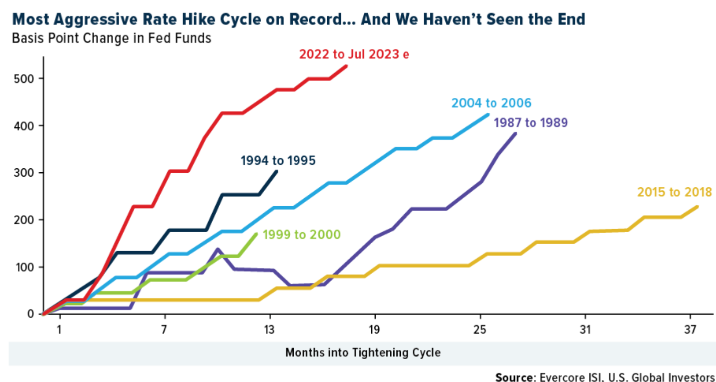
During a press conference in February of 1943, Winston Churchill was asked to predict the outcome of World War II. He replied by saying, "I always avoid prophesying beforehand, because it is much better policy to prophesy after the event has already taken place." [1]



For the past two years, most of the research coming out of the Wall Street and economic communities has revealed just how prescient Churchill's words could be, as it has been a time when many of the most proven and reliable economic and market-related indicators have consistently predicted one outcome, only to have the economy (and even the markets) do the exact opposite.

Many of these indicators are considered by both economists and Wall Street strategists as extraordinarily reliable, and yet they continue to predict an outcome that is directly contrary to what is happening in real time. This is a hard pill to swallow in the world of the capital markets, where analysts and portfolio managers have traditionally been taught, as a near-absolute truth, the sage advice of Sir John Templeton that "The four most dangerous words in investing are: 'this time it's different'."

While probably not so hard to predict as the outcome of World War II, the conflicting signals being generated by these normally reliable indicators have certainly made it much more difficult to predict the twists, turns and trends of both the markets and the economy. So, if things really are different this time, which we still view as an open question, it is important to understand just what has made them different.



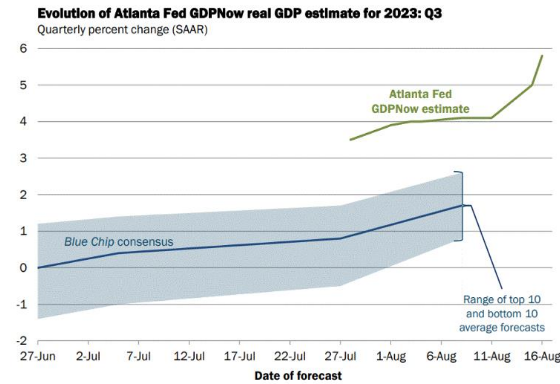
We have some thoughts in this regard, but would like to start this report by talking about the extraordinary dichotomy that is developing in the U.S., where the Federal Reserve has been implementing the most aggressive monetary policy in at least forty years, including not only raising short-term interest rates by 5%, an eleven-fold increase (from 0.50% to 5.50%), but also through their quantitative tightening policy, which is draining pandemic-era monetary stimulus out of the economy at the pace of $95 billion per month. By the end of this month, those liquidity reductions will have totaled $1 trillion. That's not even to mention the shrinkage in M2 money supply.

Broadly accepted economic theory says that such aggressively restrictive policies should be suppressing both economic growth and the appetite for risk-taking, and yet numerous very credible measures suggest that the economy is actually accelerating dramatically, while the S&P 500 recently found itself back to within 5% of its all-time high.

Latest estimate: 5.8 percent -- August 16, 2023

The GDPNow model estimate for real GDP growth (seasonally adjusted annual rate) in the third quarter of 2023 is **5.8 percent** on August 16, up from 5.0 percent on August 15. After this morning's housing starts report from the US Census Bureau and industrial production report from the Federal Reserve Board of Governors, the nowcasts of third-quarter real personal consumption expenditures growth and third-quarter real gross private domestic investment growth increased from 4.4 percent and 8.8 percent, respectively, to 4.8 percent and 11.4 percent.

*The next GDPNow update is **Thursday, August 24**. Please see the "Release Dates" tab below for a list of upcoming releases.*



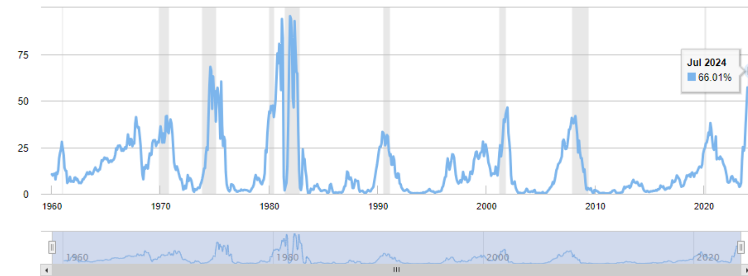
Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

To illustrate the point regarding the economy, several of the Regional Federal Reserve Banks offer "nowcasts" that, instead of predicting future growth, attempt to calculate the current rate of growth.

The most widely followed of these is probably the Atlanta Fed GDP Nowcast, which is estimating that the U.S. economy is currently growing at a blistering 5.8% rate, which is almost 4% faster growth than what is being estimated by the Blue-Chip Consensus of Wall Street economists and, if accurate, would represent the fastest non-pandemic quarterly growth rate in 20 years.[2]

Probability of U.S. Recession, Twelve Months Ahead of Term Spread Readings

Percent (monthy average)



Sources: Board of Governors of the Federal Reserve; National Bureau of Economic Research; authors' calculations.

Notes: Parameters estimated using data from January 1959 to December 2009; recession probabilities predicted using data through July 2019. The parameter estimates are α= -0.5333, β= -0.6330. The shaded areas indicate periods designated as recessions by the National Bureau of Economic Research.

While we suspect that the Atlanta Fed number is actually a bit quirky, and that it will adjust lower as additional data comes in, the New York Fed Nowcast is estimating growth of a somewhat cooler, but still very impressive, 3.8%.[3] At the same time, in what is probably only to be expected in this period of divergent economic opinions and diverging economic data, the St. Louis Fed Nowcast sees economic growth having slowed to an almost recessionary 0.47%.[4]

Two-Thirds See a Recession by the End of 2024

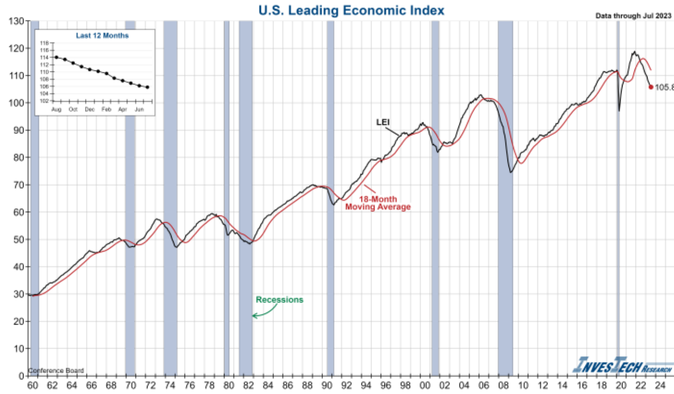
20% see a recession by end of this year

	Do you see the US economy entering a recession?
Yes, by the end of 2023	19.8%
Yes, in the first half of 2024	35.6
Yes, after the first half of 2024, but before the US Presidential election in November	9.8
There will be no US recession until after the 2024 US Presidential election	34.9

Source: Bloomberg MLIV Pulse survey July 31-August 4, with 410 respondents.

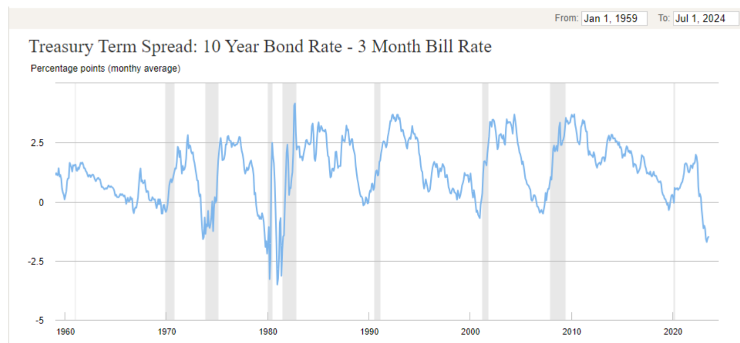
All the while, the New York Fed Recession Model is still assigning a 66% likelihood of recession within the next 12 months, and the Bloomberg Markets Live Pulse Survey of Wall Street economists shows that two-thirds of them expect a recession by the end of next year and almost 20% of them expect for a recession to start before the end of this year. This fairly pessimistic outlook makes more sense, even against the backdrop of soaring growth, when one looks at many of the traditionally most-trusted "leading indicators".

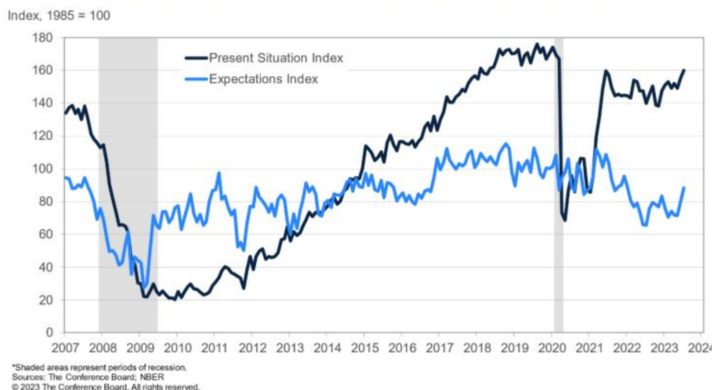
The most appropriate place to start is arguably the Conference Board's Index of Leading Economic Indicators, which is a composite of different factors that historically tend to move both in advance of, and in the direction of, the economy and includes, as examples, hours worked, unemployment claims, new orders, building permits, consumer expectations, interest rate spreads and even stock prices.



You can see how well downturns in this indicator have predicted recessions (as noted by the thick grey vertical lines). On average, this indicator peaks 11-12 months ahead of the peak in the business cycle.[5] In this instance, according to Justyna Zabinska-La Monica, Senior Manager, Business Cycle Indicators, at The Conference Board, "The US LEI—which tracks where the economy is heading—fell for the sixteenth consecutive month in July, signaling the outlook remains highly uncertain."[6]

Another leading indicator with a remarkable track record of predicting recessions is the yield curve, which measures the difference in yield between long-term rates and short-term rates (in this instance, 10-year Treasury bonds versus 3-month Treasury bills). When long-term yields are lower than shorter-term yields (like now), it is called an "inverted yield curve" and predicts an impending recession (an inversion is indicated by the blue line falling below the "0" line). Recessions are again illustrated with grey vertical lines.





On average, the time between the initial inversion of this yield curve to the start of the recession has been 487 days[7], which suggests that the average expected start date for a recession would be sometime in late November of this year.

This same theme that things look great now but look more troubling over the longer term is echoed in the Conference Board's Consumer Confidence Survey, which shows that Americans feel very confident and optimistic about their current situation (akin to the currently booming economy) (dark blue) but are rather depressed in regard to their future expectations (like the leading indicators) (light blue).

You can start to appreciate why analysts and economists have been predicting a recession for over a year, albeit with those expectations getting pushed further and further into the future, and why this phenomenon of near-term confidence and longer-term concern makes sense in light of the current dichotomy, where most of the concurrent data remains very strong, while the traditional forward-looking indicators are consistently sending caution signals.

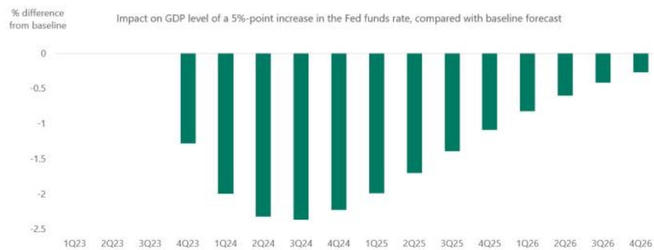
Fed Rate Hikes 2022-2023: Taming Inflation

FOMC Meeting Date	Rate Change (bps)	Federal Funds Rate
July 26, 2023	+25	5.25% to 5.50%
May 3, 2023	+25	5.00% to 5.25%
March 22, 2023	+25	4.75% to 5.00%
Feb 1, 2023	+25	4.50% to 4.75%
Dec 14, 2022	+50	4.25% to 4.50%
Nov 2, 2022	+75	3.75% to 4.00%
Sept 21, 2022	+75	3.00% to 3.25%
July 27, 2022	+75	2.25% to 2.50%
June 16, 2022	+75	1.50% to 1.75%
May 5, 2022	+50	0.75% to 1.00%
March 17, 2022	+25	0.25% to 0.50%

What is much harder to explain is why the current data remains so strong in the face of the Fed pursuing such aggressively restrictive monetary policies.

We can think of only three possible explanations. The first of these is that, in light of the trillions of dollars of fiscal and monetary stimulus injected into the economy to offset the economic impact of the pandemic, interest rates are still not high enough to cool off the economy. If this turns out to be the case, it is an interpretation that neither the stock nor bond markets are going to be happy about, as it suggests that the Fed still has more work to do and that short-term interest rates are likely headed higher.

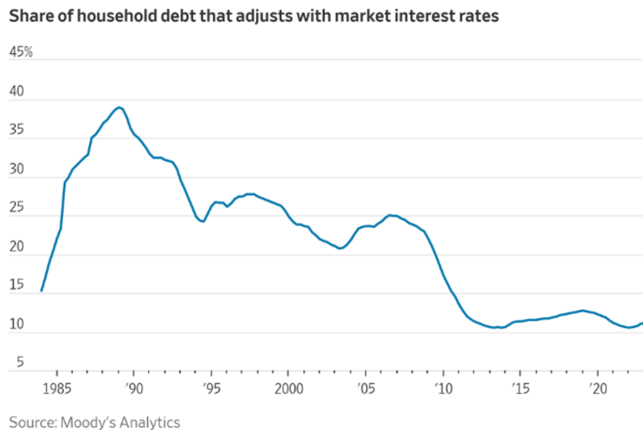
Fed Chairman Powell acknowledged this possibility in his August 25th Jackson Hole Speech, when he said, "But we are attentive to signs that the economy may not be cooling as expected. So far this year, GDP (gross domestic product) growth has come in above expectations and above its longer-run trend, and recent readings on consumer spending have been especially robust. In addition, after decelerating sharply over the past 18 months, the housing sector is showing signs of picking back up. Additional evidence of persistently above-trend growth could put further progress on inflation at risk and could warrant further tightening of monetary policy".[8]



A second possible explanation is that the impact of much of the monetary tightening to-date has yet to have its full impact on the economy. This makes some sense based upon the broadly accepted premise (made famous by Milton Friedman) that the effects of monetary policy are subject to a "long and variable lag." More specifically, it has long been believed that it takes between 9 and 18 months for the full effect of a change in interest rates or liquidity to impact the economy, in which case as much as 60% of the impact of the Fed tightening to-date is still potentially left to be felt. Chairman Powell also acknowledged this in his August 25th speech, when he noted that "The wide range of estimates of these lags suggests that there may be significant further drag in the pipeline".[9]

Importantly, there is a growing opinion among economists in general, and Fed officials in particular, that the so-called monetary lag has been significantly shortened by the Fed's increased openness, its explicit forward-guidance regarding future monetary policy and its reduced dependency on interest rate changes as its most substantial policy tool.

If such a perceived reduction in the monetary policy lag proves to be factual, that would suggest that most of the Fed's aggressively restrictive policies have already had their impact on the economy, and that the Fed will likely need to either move rates higher, or at least keep them higher for longer than is currently being priced into most stocks and bonds.

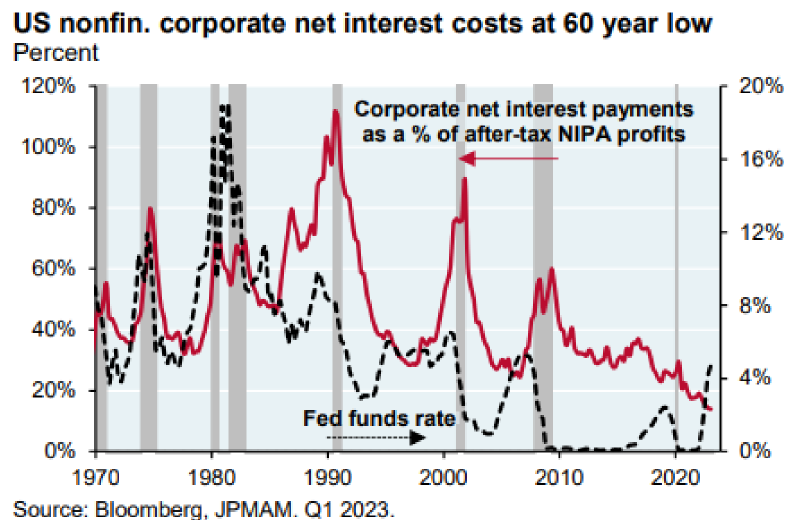


From our perspective, the third, and perhaps most promising explanation for why the economy continues to run at full bore, despite the Fed's aggressive policies that are specifically designed to slow it down, is that the economy is simply less sensitive to interest rates than it has been in the past.

Why? Because the Fed drove interest rates down to near 0% and kept them there for years, which allowed both consumers and businesses to replace most of their adjustable-rate debt with fixed-rate debt, and to also lock-in some of the lowest rates in modern history. For example, 85% of mortgages were refinanced in 2020 and 2021.[10]

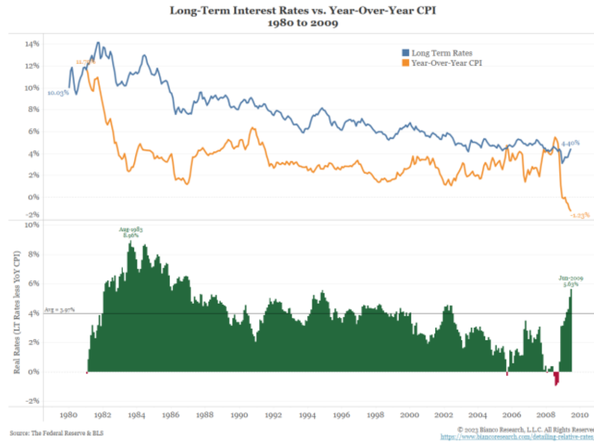
The result is that only about 12% of consumer debt is subject to fluctuations in interest rates. This is hugely important, when you consider that consumer spending represents almost 70% of the U.S. economy.[11]

Similarly important, businesses were able to refinance their debt to much lower and increasingly fixed rates to such an extent that the cost of servicing their debt burden has fallen sharply (red line) compared to their profits (i.e., their ability to service those debts).



The result, at least thus far, appears to be that, while the Fed is pursuing policies that would crush most economies, the Fed's decision to keep short-term rates near 0% for such an extended period seems to have significantly diminished the impact and utility of the Fed's single most important tool—the Fed Funds Rate.

Moreover, if you buy this premise that the economy has become less interest rate-sensitive, it may help to explain the historic divergence between current conditions and future expectations, as many of these predictive, forward-looking indicators include interest rate-related factors as major components. It could potentially be that these predictive models are not working (or as we think, are just too early) because the economy is less interest rate-sensitive than it has been in the past, and that it is thus taking longer than normal for the impact of higher interest rates to have their effect.



In a dramatic example of just how off-kilter the current environment is, while interest rates and inflation rates almost always move in near lockstep with one another, over the past 12 months, the inflation rate has collapsed by a stunning 5.3%, while the yield on the 10-year Treasury note has soared by 1%, which is an approximately 30% increase in yield.[12]

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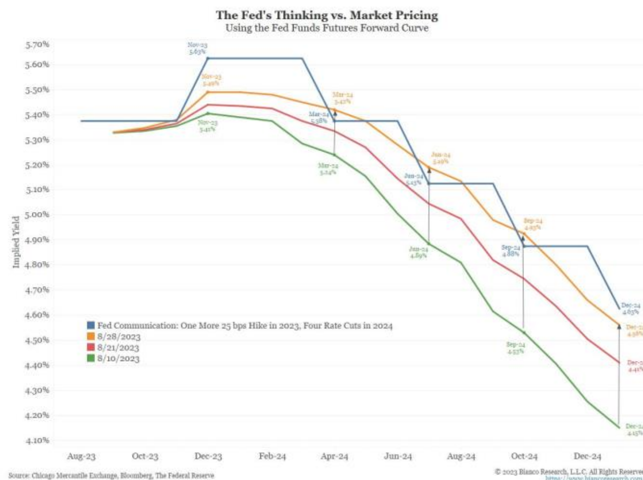
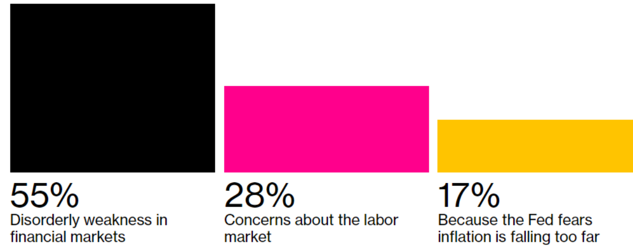
Meanwhile, Fed Funds futures markets are pricing in aggressive rate cuts for 2024, under the premise that the Fed will lower rates in response to falling inflation. However, that is not how things have historically worked.



Normally, the Fed only cuts rates in the face of a significant recession, a surge in unemployment, actual deflation (i.e., broadly falling prices) or a financial crisis. As the old expression goes, "the Fed cuts rates once it breaks something".

Frankly, we would be shocked if the Fed cut rates (particularly aggressively), at a time when inflation remains well above their stated targets, when the economy appears to be running at full bore, and when the labor market is exceptionally tight, which continues to put upward pressure on service-sector inflation.

If we are correct, it means that certain sectors of the debt and equity markets are being priced for a much more market-friendly outcome than we are actually likely to see, particularly if you ask an economist. Indeed, as shown in the most recent Bloomberg Live Markets Pulse Survey of Wall Street economists (see below), a very strong majority continue to doubt that the Fed's inflation-fighting job is done, and still believe that investors are too optimistic, and that interest rates are going to remain elevated for much longer than investors expect.

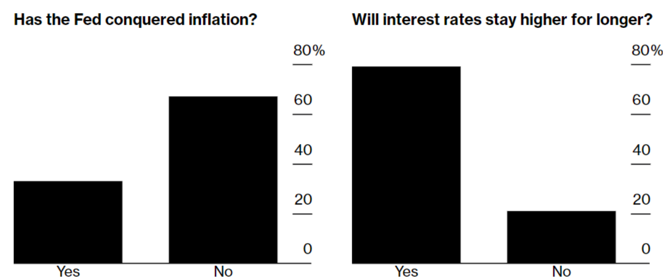


Source: Bloomberg MLIV Pulse survey Aug 14-18 with 602 respondents.

Back in that bizarre window of time, when domestic interest rates were near 0% and most global debt actually paid negative interest rates, most market veterans knew that such an anomaly would have far-reaching implications but, because it was so unprecedented, nobody really knew what they would be. The answer may be that it has, at least temporarily, desensitized the economy to higher interest rates, which would mean (in all deference to Sir John Templeton) that something is indeed different this time. Unfortunately, it is still just too early to tell.

However, for as long as the economy and markets remain so seemingly inured to higher rates, there is very little incentive for the Fed to bring them back down again (at least in any substantial way). Moreover, it seems increasingly likely that the days of uber low interest rates are never to be seen again, and that the short-to-intermediate term outlook for bonds is likely to be increasingly challenged.

It was, after all, an aberration to have interest rates well below the inflation rate (and, in many parts of the world, even lower than 0%), and it ultimately created an unhealthy environment that punished savers, encouraged market speculation, pushed stock and bond prices to historically very high valuations, encouraged indebtedness, and caused a misallocation of capital across the global economy.



Source: Bloomberg MLIV Pulse survey Aug 14-18 with 602 respondents. About the interest rates, the exact question was: What is your outlook for interest rates in 5 years? 79% said interest rates and inflation will be higher for years to come.

We suspect that the Fed would prefer to keep rates around where they are, as it gives them flexibility. Indeed, back when interest rates were near 0%, there was a potential risk that the Fed lacked the tools necessary to stimulate the economy out of a future recession or economic crisis.

On the other hand, if the aforementioned leading economic indicators ultimately turn out to be right (albeit somewhat early) and the U.S. economy does experience the recession that they are predicting, that should be a game-changer for bondholders, as a recession should both further dampen inflation and motivate the Fed to reverse course and start lowering rates. It would also suggest that the economy was not so immune to higher rates after all.

In the meantime, markets are pricing-in rate cuts for early next year, which makes no sense to us for so long as inflation remains too high, the economy is running too fast, and the labor market remains incredibly tight. Indeed, we suspect that it will take either some sort of financial market dysfunction or a surge in unemployment to motivate them to start cutting rates in any meaningful way.

In regard to equities, faster growth likely means better earnings, higher inflation and higher-for-longer (and perhaps even nominally higher) interest rates. It also likely means lower price-to-earnings multiples, which is an environment that should favor factors like lower valuations, quality balance sheets, cyclicality (economic sensitivity), high free cash flow, large scale, and financial stability.

In a time of such uncertainty, it is perhaps noteworthy that Chairman Powell concluded his Jackson Hole Speech by saying that the Fed is "navigating by the stars under cloudy skies. In such circumstances, risk-management considerations are critical".[13] That is probably not bad advice, all things considered.

Disclosures

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Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than their original cost. Current performance may be lower or higher than the performance quoted.

Definitions

The Standard & Poor's 500 (S&P 500) is a market-capitalization-weighted index of the 500 largest publicly-traded companies in the U.S with each stock's weight in the index proportionate to its market. It is not an exact list of the top 500 U.S. companies by market capitalization because there are other criteria to be included in the index.

Real gross domestic product (GDP) is a comprehensive measure of U.S. economic activity. GDP measures the value of the final goods and services produced in the United States (without double counting the intermediate goods and services used up to produce them). Changes in GDP are the most popular indicator of the nation's overall economic health.

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.

Core CPI refers to inflation based on the consumer price index (CPI), covering the inflation of all the goods and services except the volatile food & fuel prices, excise duties, income tax, and other financial investments.

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(7) Source: "The Yield Curve as a Leading Indicator", Federal Reserve Bank of New York, As of 08/28/2023, https://www.newyorkfed.org/research/capital_markets/ycfaq.html#/interactive