"The only function of economic forecasting is to make astrology look respectable."

-John Kenneth Galbraith, Harvard Professor, diplomat and author.

Next year will mark the 500th anniversary of the Great London Flood of 1524.

Three years earlier, astrologers had begun predicting that a mighty flood would rush up the Thames River and destroy the city. The main culprit was Luca Gaurico, a Vatican astrologer at a time when astrology was considered to be a sensible science. He wrote that "the waters of the Thames would swell to such a height as to overflow the whole city of London, and wash away ten thousand houses." He even forecast the exact date when this calamity would occur – February 1st, 1524.

The date was not idly selected, as it marked a Grand Conjunction of all seven planets that would cause massive tides and inundate the city. The previous Grand Conjunction had ushered in the Reformation and the upheaval that accompanied it, so it made sense (at the time) that the next one would be equally disruptive and deadly. Mass awareness of the impending doom was aided in no small part by the then recent development of the printing press, which spread the news farther than what would have previously been the case. Publications throughout Europe warned not only of the great deluge that was to come, but of the peasant revolts and social breakdown that would follow. There were reports of arks being built as far away as Germany and Italy by the wealthy who were determined to ride out the storm. In London, more than 20,000 people fled the city.

Of course, the fateful day came and went and the Thames continued to flow leisurely within its banks. The people were outraged and demanded an explanation as to how the astrologers' predictions could have been so far off, and it was Gaurico who provided the answer. He said that his prediction of the flood was correct, but his calculation of its timing was off. It would happen on February 1st, *1624*, not *1524.*

The lack of a coincidence between the new forecast date and another Grand Conjunction of the planets was evidently never explained.

It's easy to mock the absurdity of believing that astrologers could predict events by the alignment of the planets. But even today, business managers and investors continue to base their strategies on economic forecasts that are, at best, educated guesses. The assumptions that drive most economic models are inevitably derived from data that may be outdated or irrelevant to the current situation, and minor changes in just a few variables in an economy as large and complex as ours can skew results greatly over time. Add to that the fact that economic reports are subject to revision after the fact. So what is "known" one day and forms the basis of a forecast, is in a future day found to have been wrong.

Another problem with economic forecasts is that no matter how uncertain forecasters may be about their predictions, they too often tend to present their findings with a level of certainty that is unwarranted. While accepting the Nobel Prize for economics, Friedrich Hayek noted the tendency of economists to "present their findings with the certainty of the language of science, which was misleading and may have deplorable effects." Any 20-minute random sampling of the talking heads on the cable business channels should be enough to convince you that that is true. After all, they are paid handsome sums to claim to know what is unknowable.

<u>Epic Fails in Economic Forecasting</u>

Irving Fisher was a noted 20th century economist, who Milton Friedman called "the greatest economist the United States ever produced." In October 1929, Fisher claimed that "stocks have reached what looks like a permanently high plateau." The market crashed just three days later, plunging the world into the Great Depression.

In 1999, at the peak of the dot.com bubble, James Glassman and Kevin Hassett published *Dow 36,000: The New Strategy for Profiting from the Coming Rise in the Stock Market."* The book's introduction stated, "If you are worried about missing the market's big move upward, you will discover that it's not too late. Stocks are now in the midst of a one-time-only move to much higher ground – to the neighborhood of 36,000 on the Dow Jones Industrial Average." The Dow fell 37% in the two years following publication of their work. In fairness, they turned out to be right, eventually, but it took 24 years and turned out to be anything but a one-time-only move.

Economist Ravi Batra reached number one on the New York Times best seller list with his book, *The Great Depression of 1990*. As it turned out, the decade of the '90s was a period of welcome stability and strong economic growth.

In September 2007, former Fed Chairman Alan Greenspan released a memoir in which he claimed that the economy was headed towards double-digit interest rates due to growing inflationary pressures. As we now know, inflation was a non-factor for the next 15 years, and the 10-year Treasury yield remained below 3% for most of the period.

Peter Schiff is one of the cable talking heads we referenced earlier, who happened to predict the 2008 collapse in real estate prices two years before it happened. Since then, his frequent and failed predictions of hyperinflation and economic collapse have earned him the nickname in some quarters of Dr. Doom.

In 1968, Paul Ehrlich published a book, the Population Bomb, in which he argued that hundreds of millions of people would starve to death as a result of overpopulation. He went so far as to say that "the battle to feed humanity is over …, nothing can prevent a substantial increase in the world death rate (from starvation)." In fact, the hunger rate has been cut nearly in half from what it was when his book was published, even though the world's population has nearly doubled.

The Obligatory Economists Joke

Three economists were on a hunting trip when they spotted a large deer. The first economist fired and missed left. The second fired and missed right. The third shouted excitedly, "We got it!"

"There's a lot of uncertainty out there these days. Or not. Who knows?"

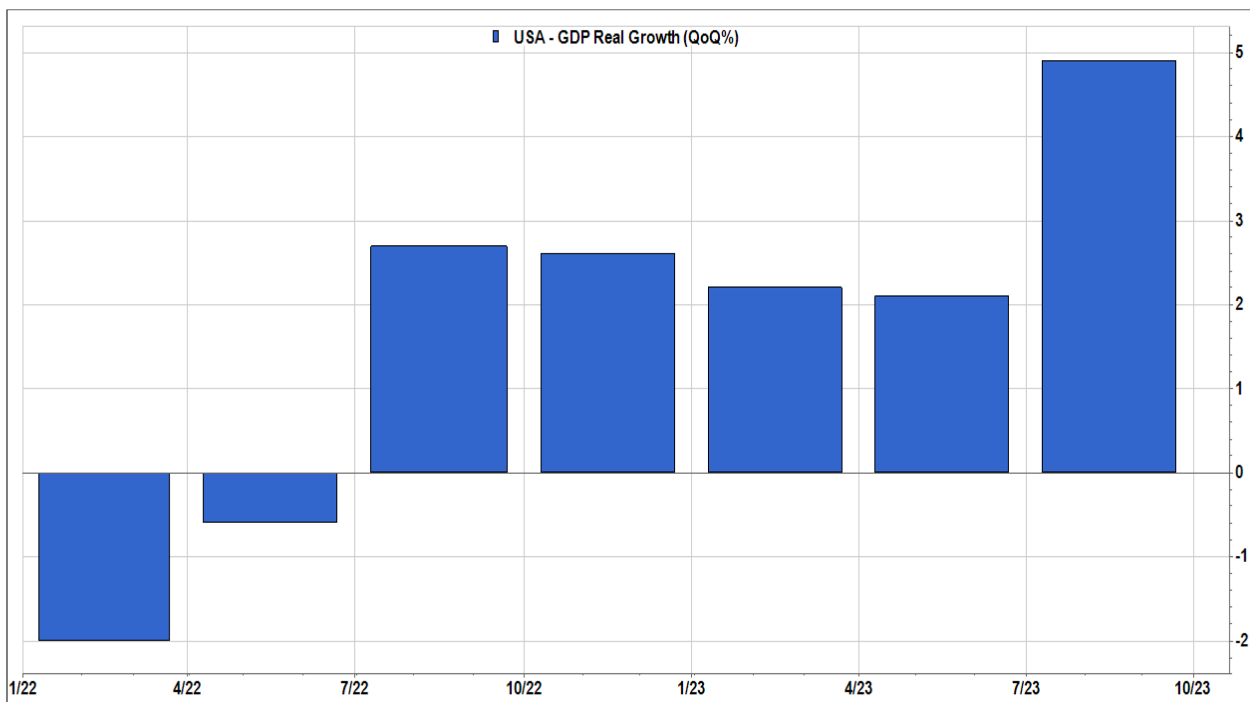
The Consensus Has Shifted

Last October, the *Wall Street Journal* published a survey of more than 60 leading economists from universities, businesses and Wall Street. The result of the survey, according to the *Journal*, was that the United States was "forecast to enter a recession in the coming twelve months as the Federal Reserve battles to bring down persistently high inflation, the economy contracts and employers cut jobs in response." The article went on to say that the economists surveyed expected real (inflation-adjusted) G.D.P. to contract at an annual rate of 0.2% in the first quarter and 0.1% in the second quarter. The survey also showed that unemployment, which was then at 3.5%, was expected to rise to 4.3% in the first half of 2023.

Of course, it all made sense then. The yield curve had been inverted since July, as the Fed drove short term rates higher at a record pace in a belated attempt to rein in inflation. As we have pointed out in every *Outlook* we have written over the last year, whenever the yield curve has inverted in the last 50+ years, a recession has ensued with a time lag that has varied from 6 months to 24 months. We do not believe that this is simply a case of "post hoc ergo propter hoc," as the reverse is also true - no recession has occurred during this period without the yield curve first inverting.

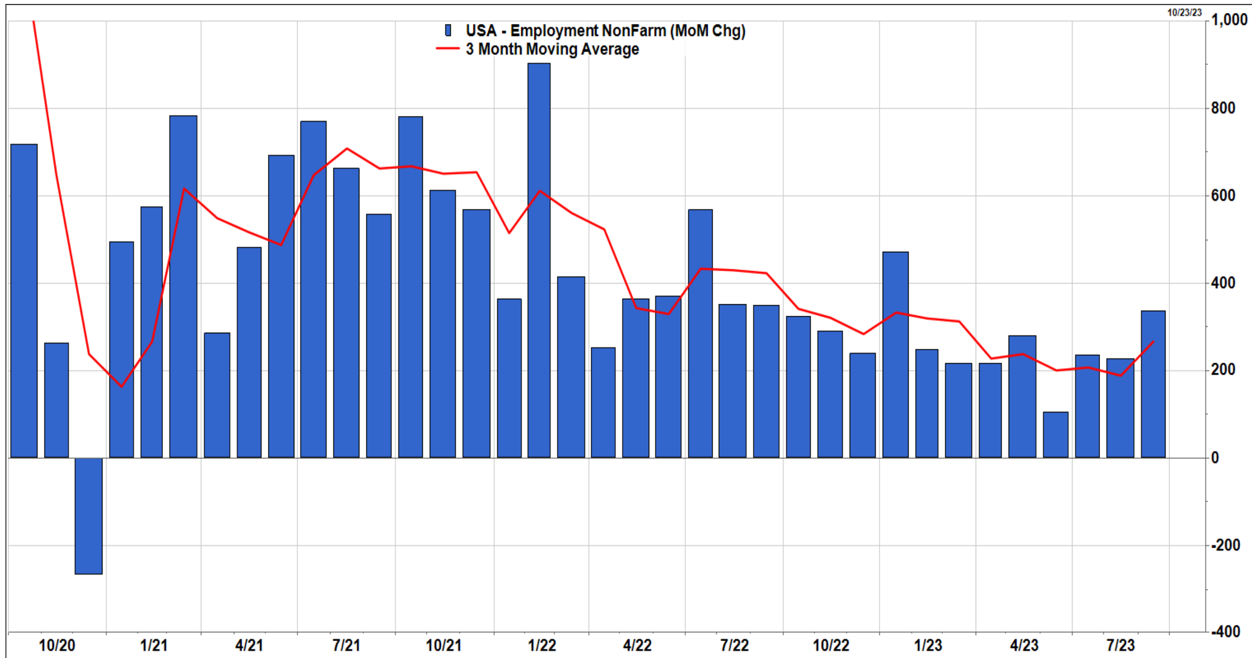
The forecasts for 2023, as we now know, have turned out to be off – way off.

After eleven interest rate increases that have driven the Fed's target rate to its highest level in 22 years – and with all of the leading indicators pointing to recession - the economy is not only continuing to grow, but is growing at rates that are unsustainable in the long term. Real GDP growth has exceeded 2% throughout the 2nd half of 2022 and into 2023, then accelerated to a better than expected 4.9% for the 3rd quarter of 2023. Consumer spending increased 4% during the 3rd quarter after rising just 0.8% in Q2, and was responsible for more than half of the overall growth in GDP. Demand for both goods and services surged in the third quarter, with goods up 4.8% and services up 3.6%.

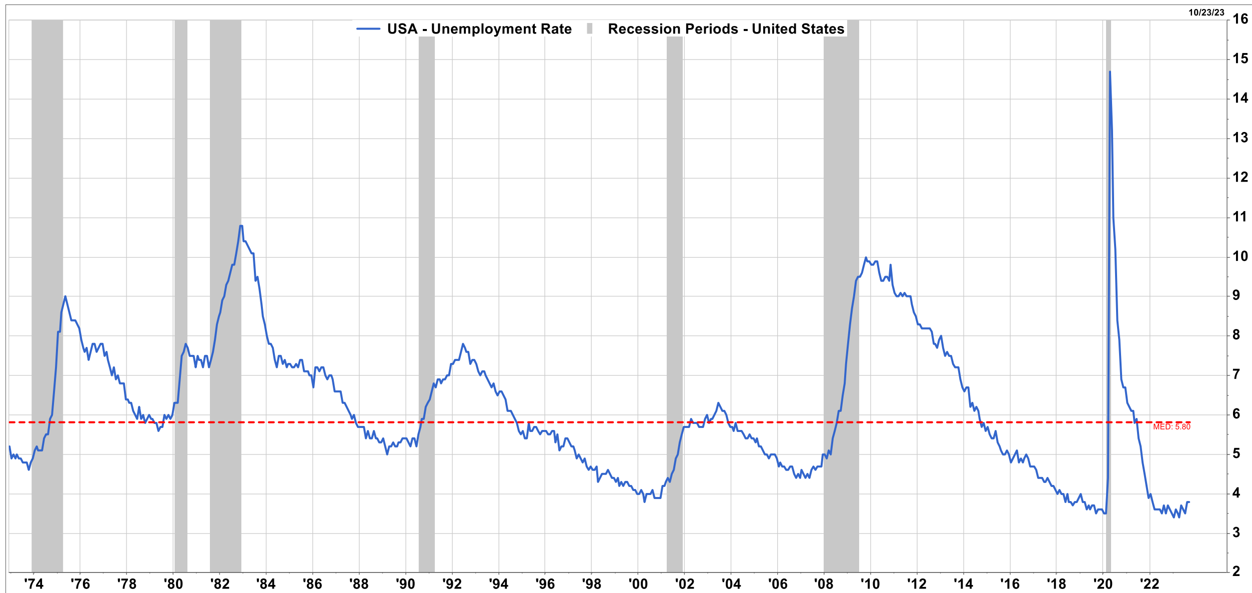


On the jobs front, employers have continued to create jobs at a rate that is consistent with the prior year's pace, defying expectations that unemployment was set to rise in 2023. September's increase of 336,000 net new jobs was almost twice what had been expected, and was the largest monthly increase in new jobs since January. Previously reported job gains for July and August were revised upward as well, adding to September's positive surprise. July's gains were revised up by 79,000 from the 157,000 originally reported, and August's total was revised up by 40,000

to a total of 227,000. The 3-month moving average of monthly job gains is also rising for the first time since late in 2022.

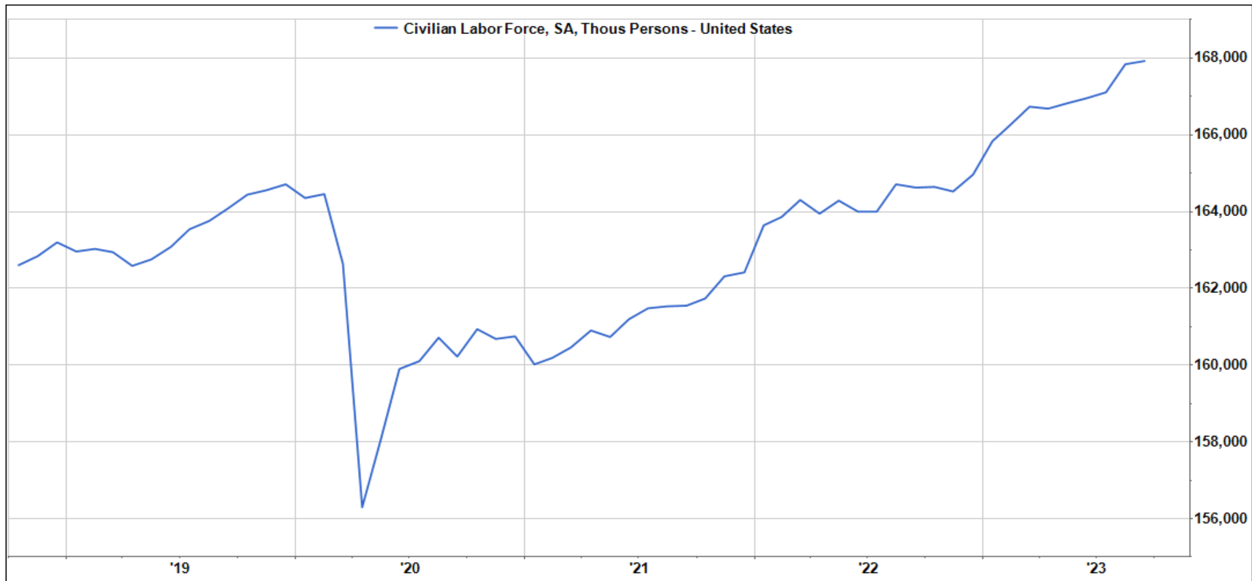


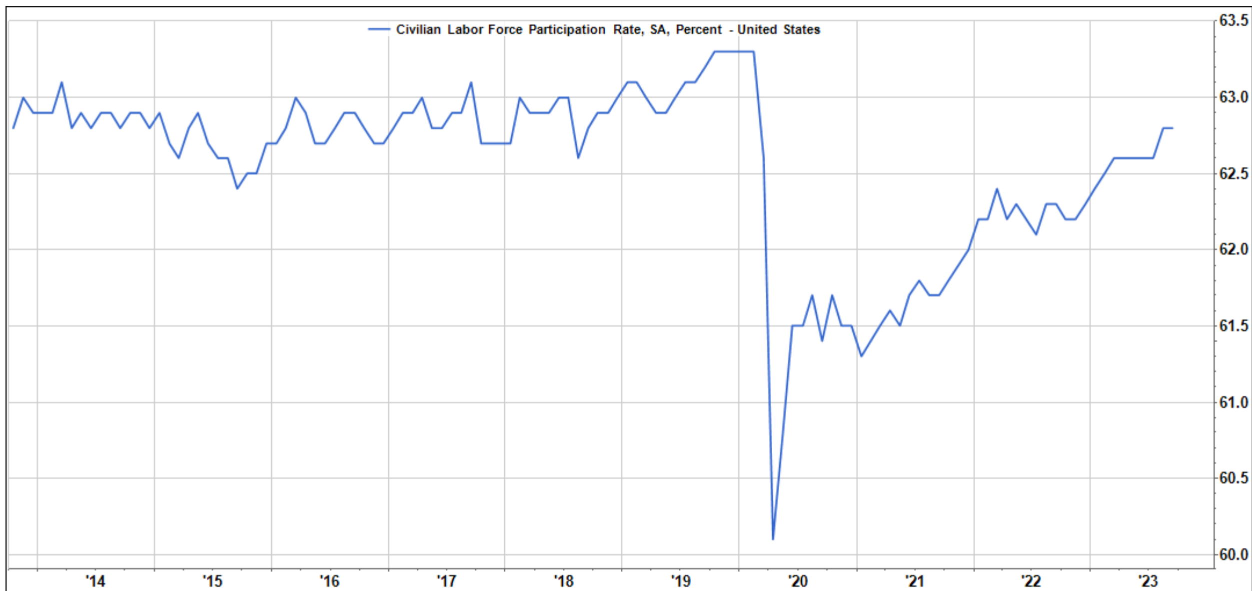
The August jobs report also showed that the unemployment rate jumped by 0.3% to 3.8%, the highest level since February 2022. But even this was more a sign of strength than weakness in the labor market. The increase in unemployment was entirely the result of an influx of new job seekers, encouraged by continued strong hiring and rising wages.



In fact, the labor force has grown dramatically over the last year, reversing a post COVID-19 phenomenon that had come to be called The Great Resignation or The Big Quit.

In the U.S., more than 47-million people quit their jobs in 2021, and 50-million more quit theirs in 2022. But 2023 numbers suggest that the "quits" rate has slowed, and is approaching pre-pandemic levels. Part of this is simply the due to the fact most of those who quit in search of more desirable employment have settled into their new jobs and/or lifestyles. Also, headlines about Artificial Intelligence (AI) taking away jobs in many industries are causing many people to re-think leaving their jobs. But mostly, growing uncertainty over the future outlook for the job market – even with the current numbers remaining strong – is making more people think twice before voluntarily leaving their job. Whatever the cause, there is more stability on the supply side of the labor market than there has been in the last three years. Both the size of the labor force and the participation rate – the percentage of working age people either working or actively looking for work – are once again at or above pre-COVID levels.



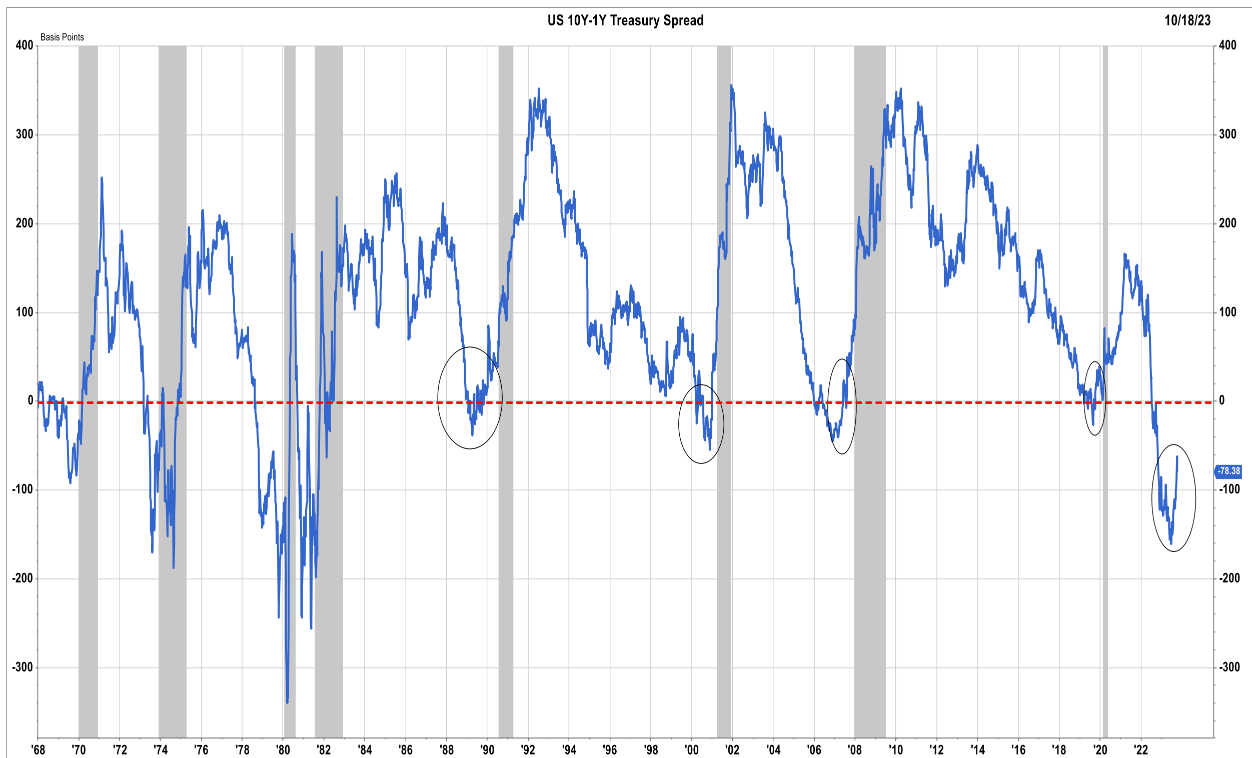


We Still Believe that Recession is the More Likely Outcome

While the consensus has shifted in the direction of a soft landing, we continue to believe that a mild recession is the most probable outcome in the first half of 2024.

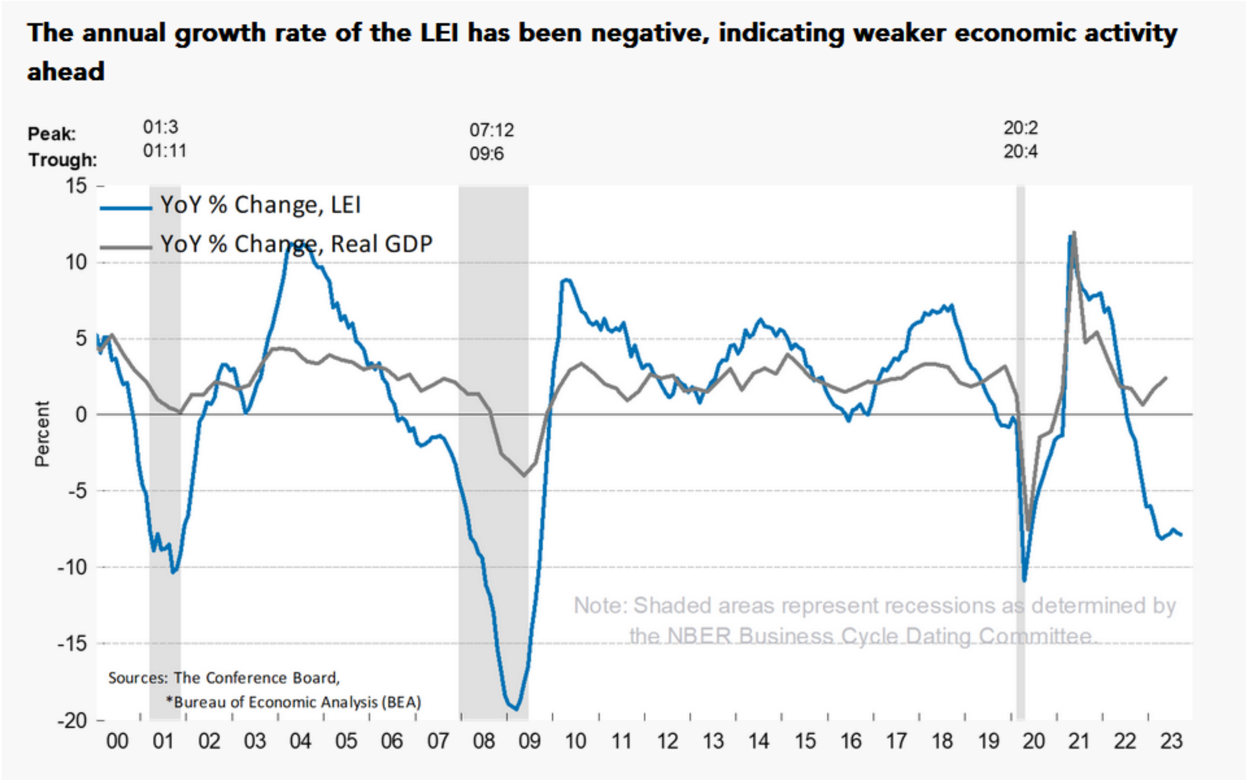
Admittedly, this view is unsupported when one looks at current data with respect to GDP growth, jobs gains, retail sales and rising consumer demand for both goods and services. But we must remember that these are all *co-incident* indicators that, by definition, are strongest at the peak of the economic cycle. In other words, they are strong until they aren't. Most of the *leading* indicators of future economic activity are still at levels that have not existed absent a recession going back 50 years, or more.

The yield curve has now been inverted for 15 months, with short-term rates at 20-year highs - and higher than long-term rates. As pointed out earlier in the *Outlook* (and in every *Outlook* since the yield curve first inverted), there is no time when such an inversion occurred and the economy did not fall into recession within a 6-24 month period. Soft landing proponents are pointing to the fact that the curve has "un-inverted" somewhat in recent months, but we would make the following points in response. First, the curve began to un-invert in advance of the last four recessions, as well, but they happened anyway. And second, it matters how and why the curve is un-inverting. It's one thing if the un-inversion was the result of the Fed reversing course and lowering short term rates to ward off a recession. But this is a case of long-term rates rising, which is more likely going to have a negative effect on the economy going forward.



The Conference Board's Index of Leading Economic Indicators (LEI) fell again in September, marking 18 months of consecutive declines since April 2022 – one month after the Fed began its series of rate hikes. This Index charts trends in credit, interest rates, consumer confidence, manufacturing new orders, housing and unemployment claims that have proven to be predictive of future changes in the economy's direction.

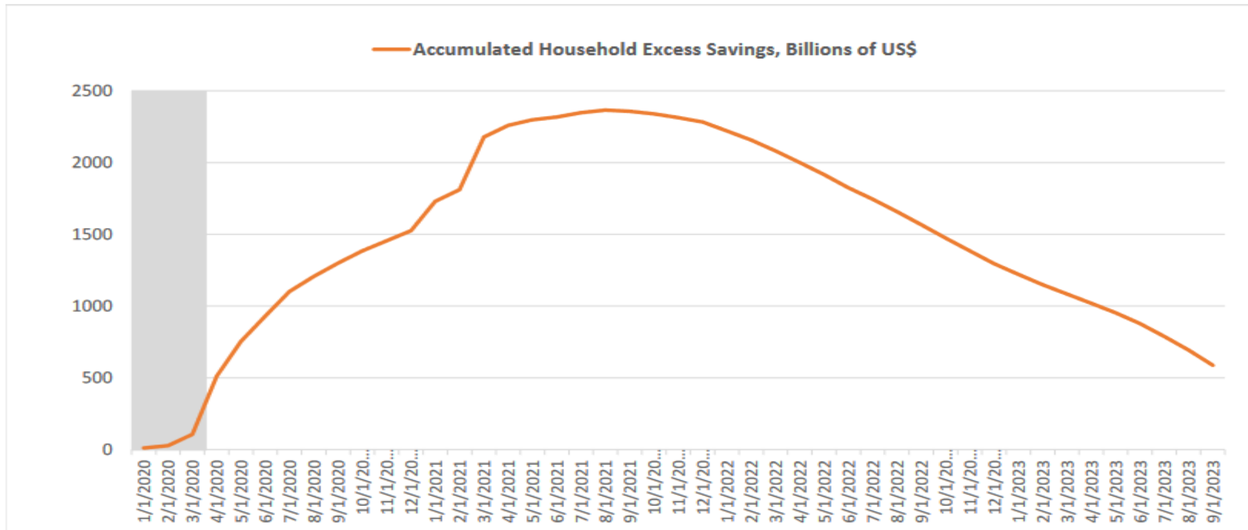
The Conference Board's commentary that accompanied the release of the September report, stated that "So far, the U.S. economy has shown considerable resilience despite pressures from rising interest rates and high inflation. Nonetheless, The Conference Board forecasts that this trend will not be sustained for much longer, and a shallow recession is likely in the first half of 2024."



Not surprisingly, the Conference Board's Coincident Economic Index (CEI) and Lagging Economic Index (LAG) remain in strong uptrends. But as Bob Dylan once wrote, "You don't need a weatherman to tell which way the wind blows."

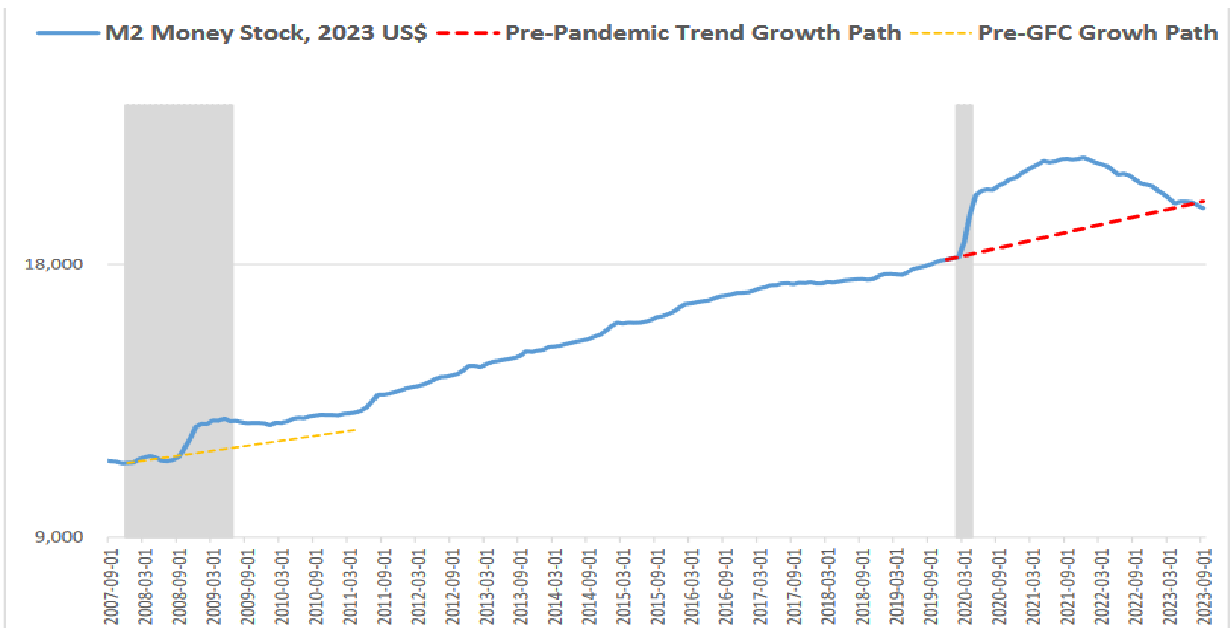
A strong jobs market and rising consumer demand go hand-in-hand, of course. As consumers spend down their excess savings, demand for goods and services is expected to wane, reducing jobs growth and thus begins the downturn. So far, this eventuality has been delayed far beyond what was forecast due to the excess savings built up during the government's unprecedented stimulus measures enacted in response to the COVID-19 pandemic.

However, robust consumer spending has depleted about three-quarters of those excess savings, and current trends suggest that they will be depleted by the first half of next year.



Source: Federal Reserve; Roth MKM

Similarly, the growth in the money supply (M2) in 2020-21, which resulted from both expansive Fed policies and massive doses of fiscal stimulus, has now fallen back below its pre-pandemic growth path. And all of these declines in the various liquidity measures have been accompanied by declines in commercial bank credit and a Fed that is committed to “high for longer’ interest rates.

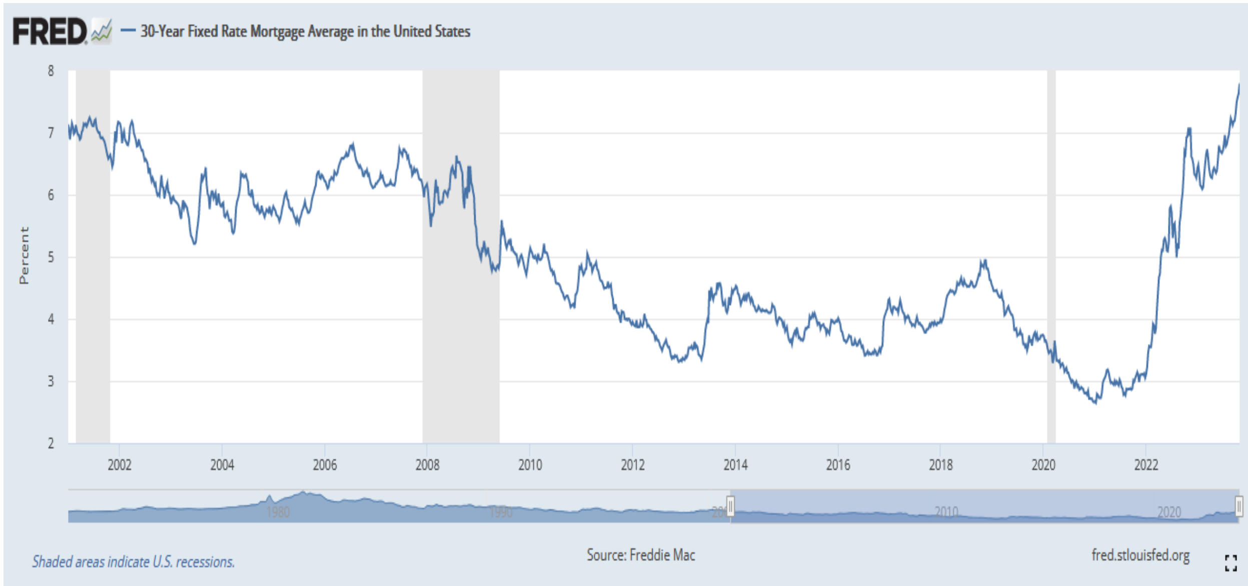


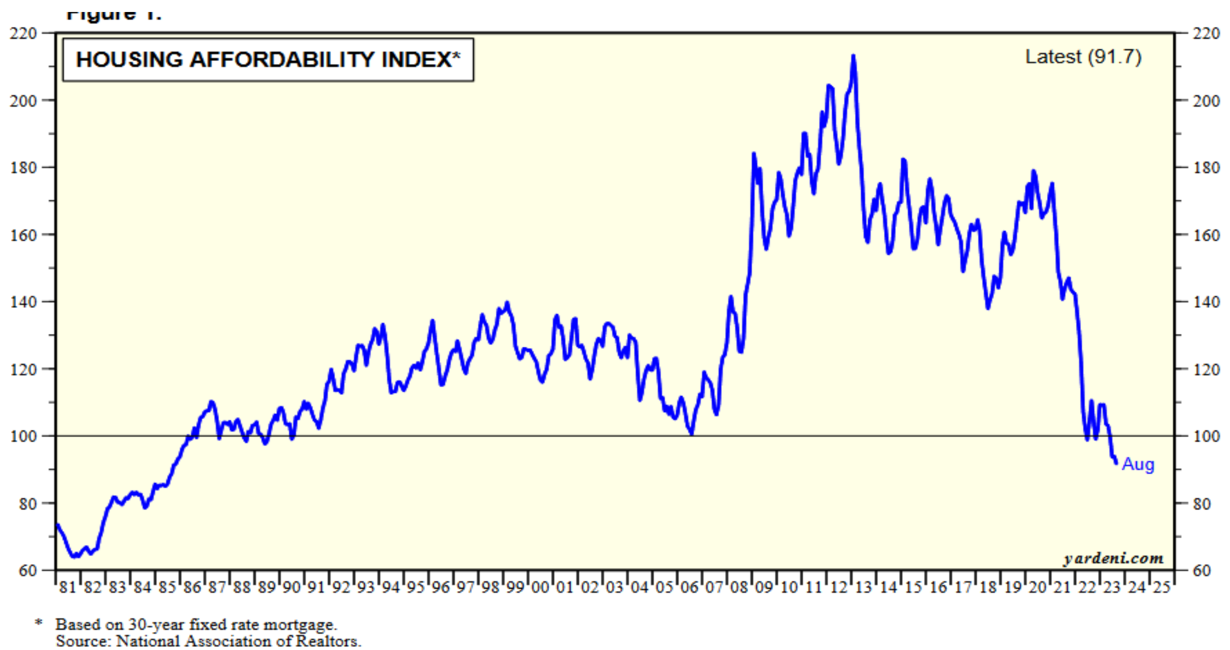
Source: Federal Reserve; Bloomberg

Finally, we must point out that a resumption in student loan repayments and soaring mortgage rates are going to have an increasingly negative effect on demand growth going forward.

43-million Americans have federal student loans, amounting to $1.63-trillion of debt. The resumption of student loan repayments is expected to shave off between 0.4% and 0.6% from consumer spending. On its surface, that appears to be a minor matter, but it may loom large at the margin if other consumer headwinds also pick up, as we expect.

Meanwhile, mortgage rates have more than tripled in the last 2 years, and are now at their highest level since at least 2001. And the Housing Affordability Index, which measures the average household's ability to qualify for a 30-year fixed rate mortgage, is at its lowest level since the mid 1980s.

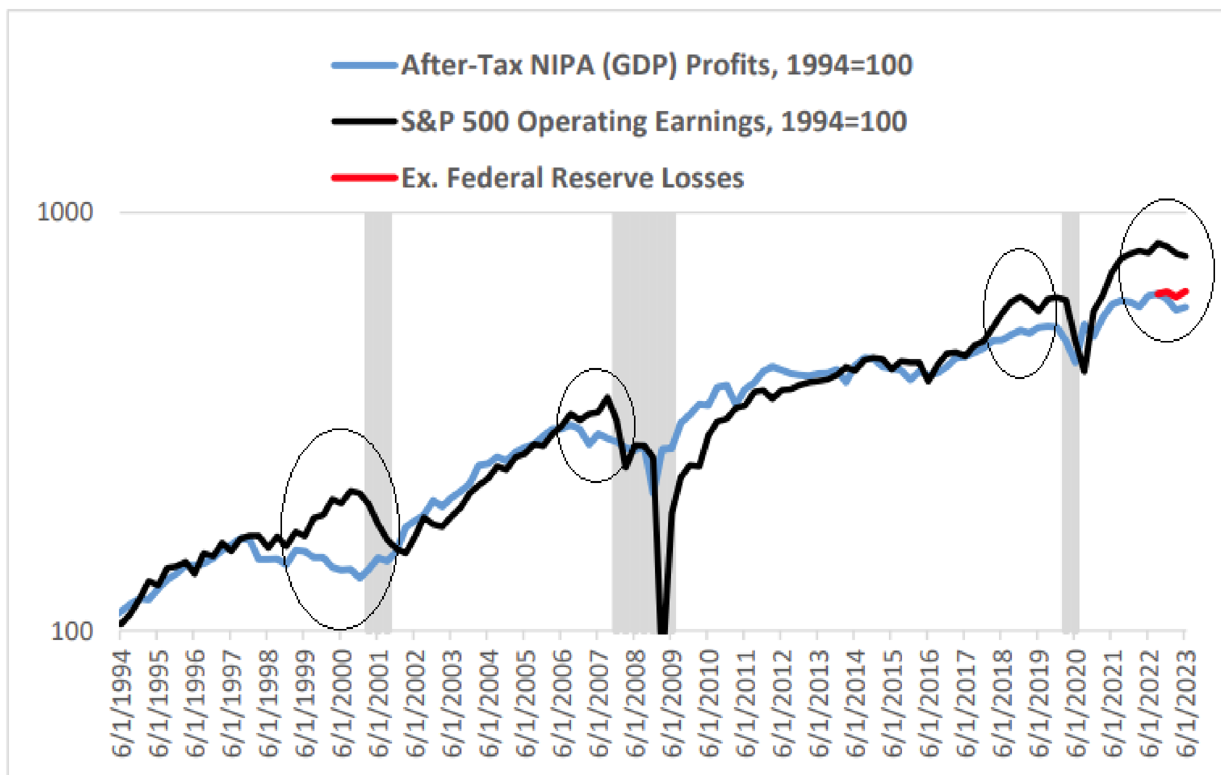




An Under-Reported Leading Indicator

In this as well as past *Outlooks*, we've presented a wide variety of economic indicators that have traditionally signaled a looming recession. Since July of 2022, there likely has been an instance in every quarterly piece which discusses the inverted yield curve or the decline in leading economic indicators to some degree. While these indicators are well followed and useful, there is another, less traditional and less discussed measure that has provided valuable information about the future path of the economy. That is the trend of S&P 500 operating profits compared to NIPA profits.

NIPA (National Income and Profit Accounts) profits are a broader measure of economic earnings compared with S&P 500 profits due to their inclusion of private corporation and S corporation profits. NIPA profits aggregate the income earned by U.S corporations domestically and globally, and excludes the income earned by foreign corporations in the United States. The two data series tend to move together, and large divergences between the two have preceded recessions. This can be seen during the 2000s tech bubble, the Great Recession of 2008-09, and the recent pandemic (chart, below). In the middle of 2021, the two series began to diverge again, and are now experiencing a relatively wide deviation. As with most economic indicators when viewed in isolation, the timing of a recession is very difficult. However, the existence of this divergence when viewed in the context of past recessions and current negative leading indicators is a further cause for concern.



Source: Bloomberg

Corporate Profits

If one is looking to current or expected weakness in S&P 500 earnings for early signs of economic weakness, one will have to look elsewhere.

Exactly half of S&P 500 companies have reported third quarter results, and 78% of them have reported a positive earnings surprise. If the current trend continues, overall Q3 earnings will end up 2.7% above the same quarter last year, marking the first quarter of year-over-year positive earnings growth for the index in the last 4 quarters. Third quarter earnings had been expected to be 0.3% below last year's total.

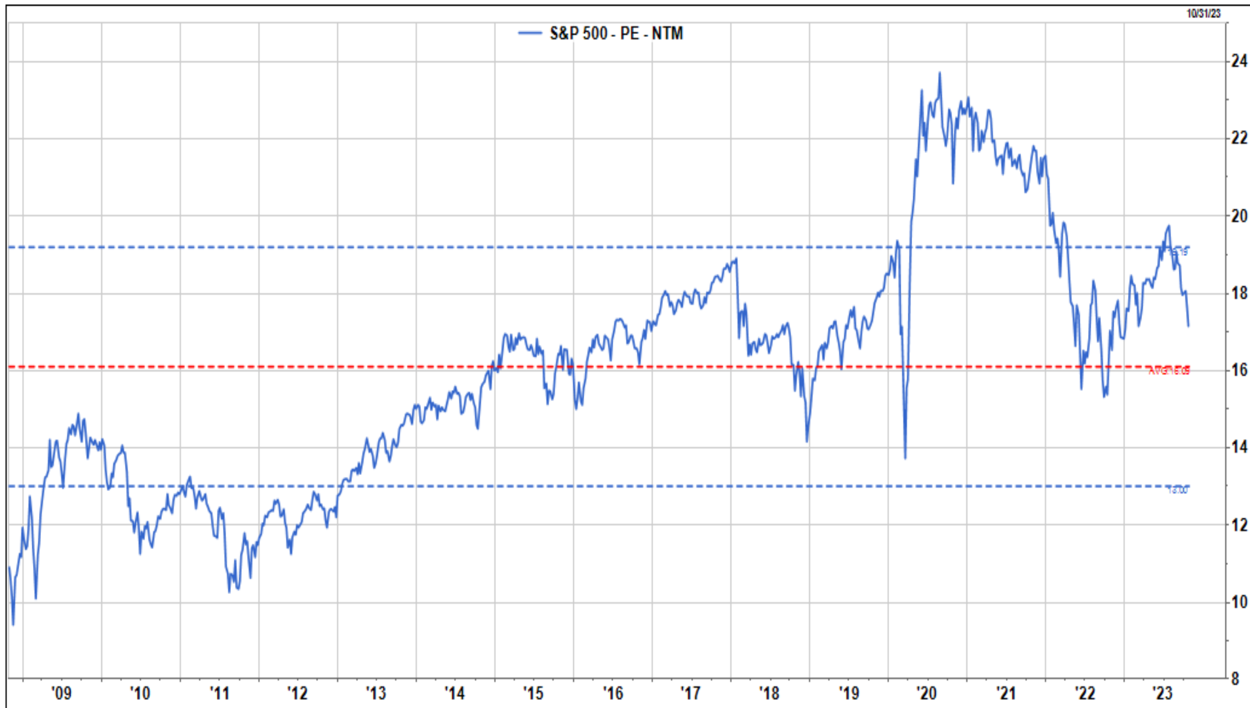
The energy sector has been the biggest detractor from S&P earnings, with both Chevron and Exxon Mobil reporting results that were below estimates and significantly below last year's results. Chevron's earnings were 40% below the same quarter last year and Exxon's earnings were off by 52%. Excluding energy, earnings for the remaining 10 sectors of the index are now expected to rise more than 8% above the third quarter of 2022.

S&P 500 earnings for all of 2023 are now expected to come in at $220 per share, which would represent only a slight increase over 2022's level of $218 per share. But the consensus forecast for 2024 is that S&P earnings will rise to $245, which would represent an 11% increase over this year's results. It's interesting that 2024 estimates have barely budged since last February, even as the consensus has shifted away from a probable recession to a soft landing scenario.

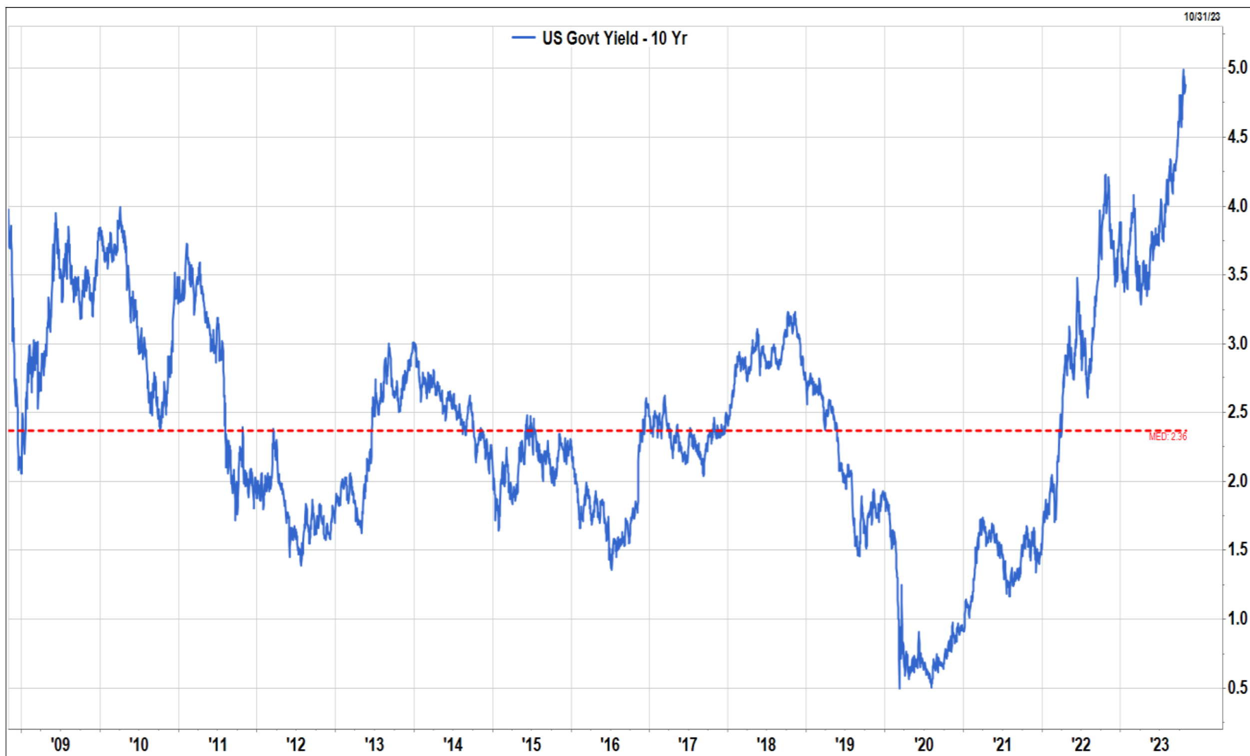
The last 12 recessions going back to 1957 have seen an average decline in S&P earnings of 15%, and earnings have risen during a recession on just 2 occasions – the 1973-75 recession and the 1980 recession. So if the economic consensus turns out to be wrong (again) and the leading indicators turn out to be right – as they always have – there is potential for significant earnings disappointments in the year ahead. Even a mild recession (or economic shock) that would reduce earnings by just 10%, would bring S&P earnings down to near $200, and the index itself down 18% to 3,400, assuming that the market's current price/earngs ratio held steady at 17. The problem is that the market's P/E has traditionally contracted during recessions, often significantly. But, again assuming even a modest contraction to 15 times 2024 earnings of $200 would imply an S&P level of 3,000, 28% below its current level and a decline consistent with past recessions.

A Perspective on Valuation

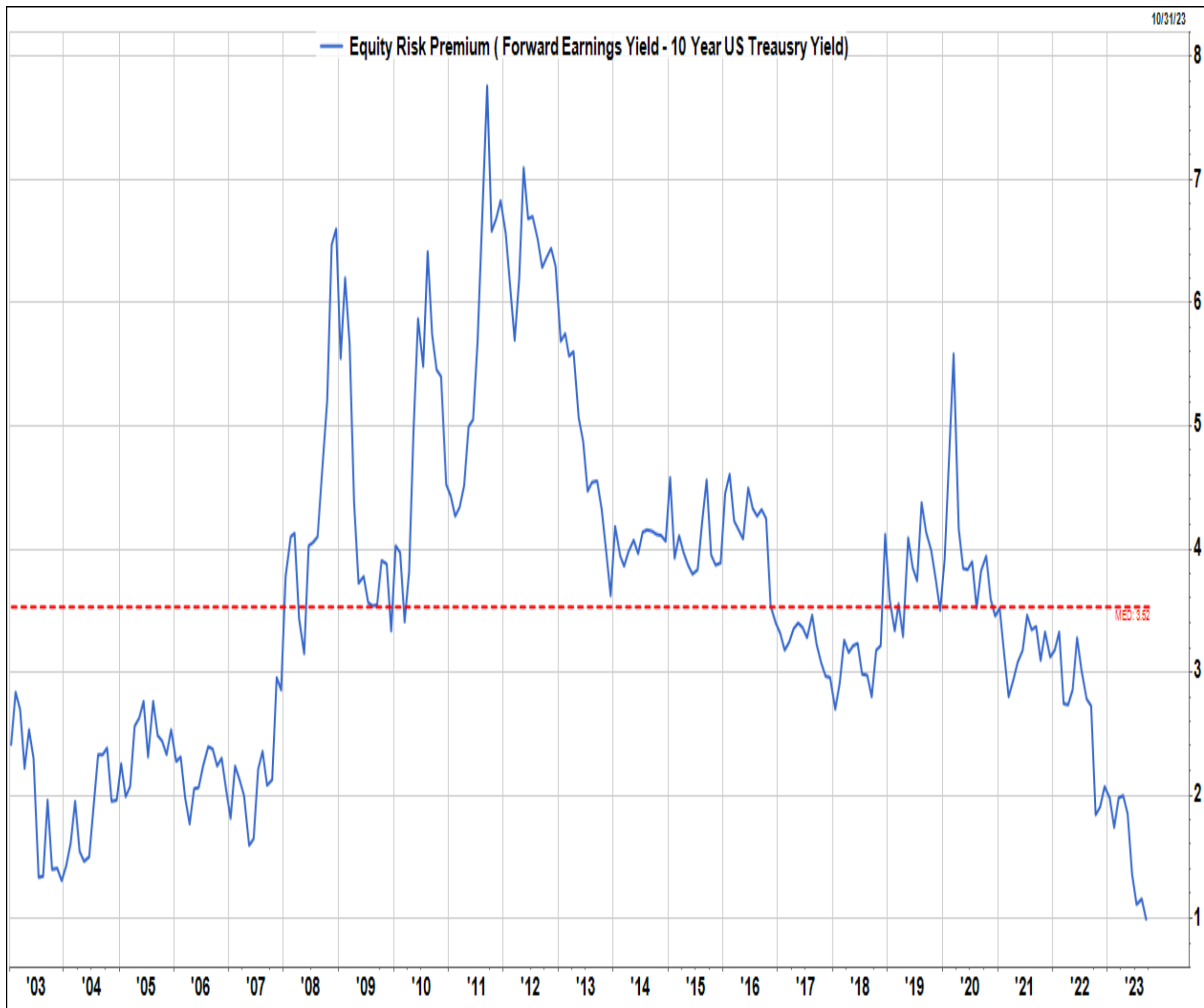
Despite its year-to-date gains, the S&P 500 index briefly entered correction territory in October, falling just over 10% from its July high. At its current level, it remains 14% below its all-time high of 4,796 reached in January 2022. As earnings have continued to grow, however slowly, the market's P/E multiple has fallen back within what would be considered a normal range, at least historically. The market's current P/E of 17 times earnings is in line with its average of 16 times, which the S&P traded at for most of the period following the financial crisis of 2008-09.



The problem is that the 10-Year Treasury yield averaged less than 2.5% over the same period, and seldom reached even 3% after 2011 until inflation and the Fed began to drive rates upward in 2022. Bonds have thus not provided an attractive alternative to stocks for at least the last 10 years, during which the S&P 500 index has returned 11.9% annually while the Bloomberg Aggregate Bond index has returned just 1.1% annually.

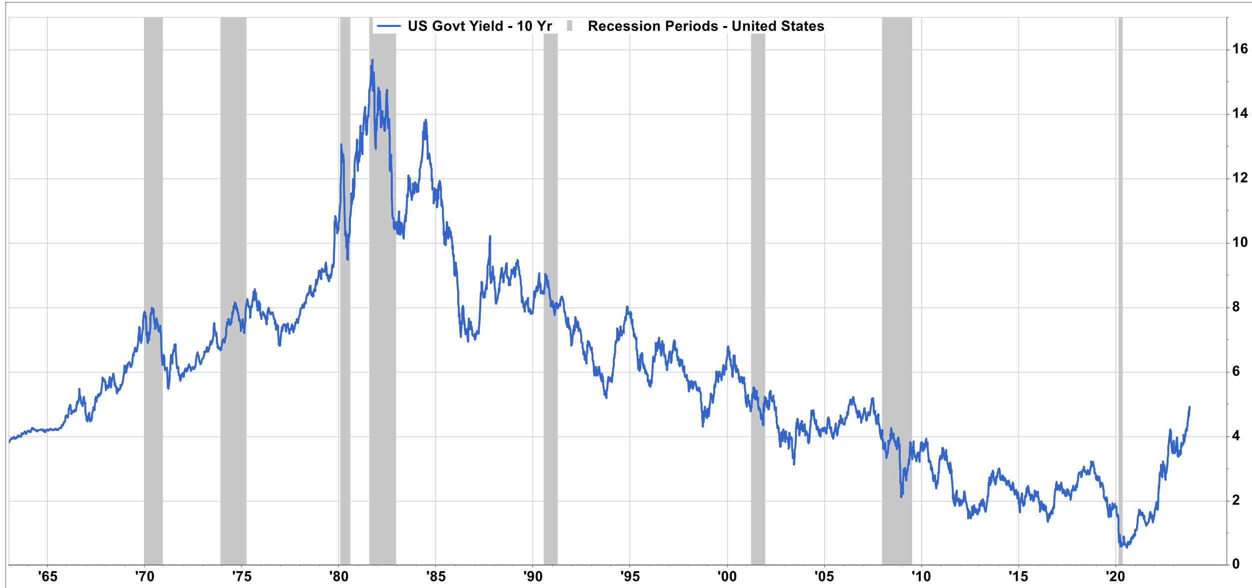


The dramatic rise in interest rates, however, has now made bonds and risk free investments more attractive relative to stocks than at any time in at least the last 20 years. The forward earnings yield of the S&P 500 (the inverse of the P/E multiple, or forward earnings divided by price) is 5.8%, less than 1% higher than the 10-Year Treasury yield. While the market's earnings yield is back within its historical range, its premium relative to bond yields has shrunk to almost nothing. In other words, stocks present almost no expected return advantage relative to bonds, despite their greater risk.



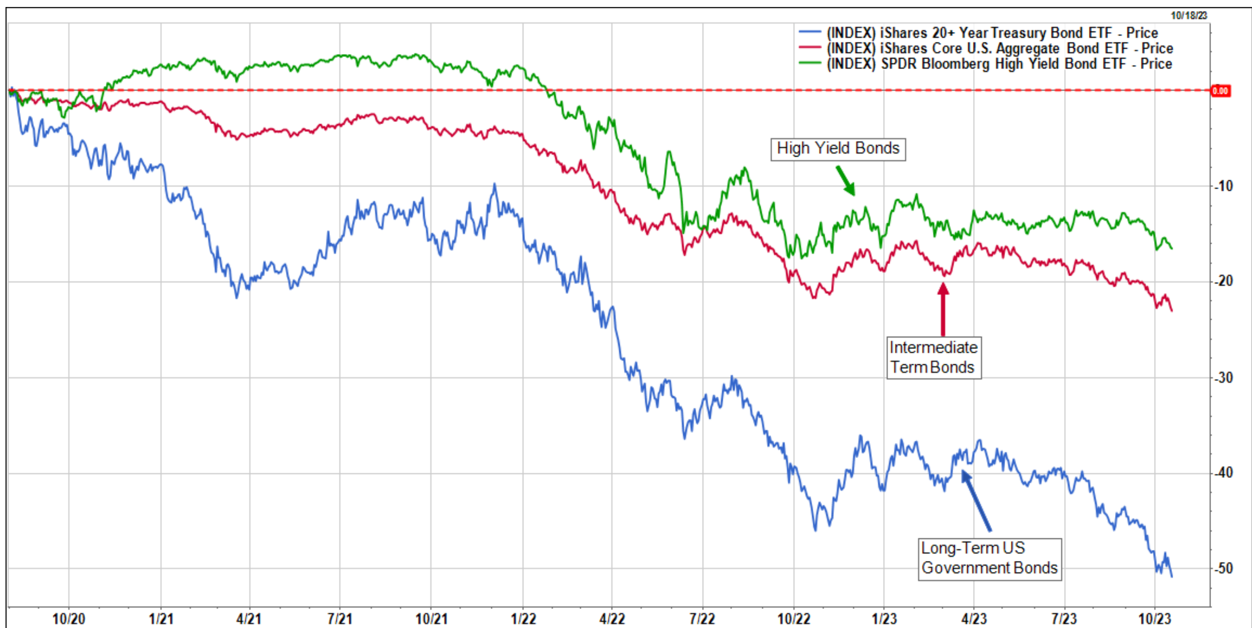
Speaking of Bonds …

The carnage experienced in the bond market over the last 3 years is unprecedented in our history, or at least as far back as bond indices have existed. When analysts today speak of soaring interest rates, those of us who have been around any length of time understand that today's high rates are still below the levels that have existed for most of our modern history. The anomaly



occurred – as so many anomalies have – in the depths of the once-in-a century COVID recession when the Fed drove short term rates to zero, and the 10-Year Treasury rate fell to around 0.6%.

From that point to now, investors in intermediate term, investment grade bonds have seen the value of their bonds decline by more than 20%, while earning back almost nothing in current income. Investors in long-term bonds have fared even worse, losing more than 50% of their principal over the same time period. Even the soaring interest rates of the early 1980s didn't result in losses of such a magnitude, as the rise in rates then began from much higher levels.



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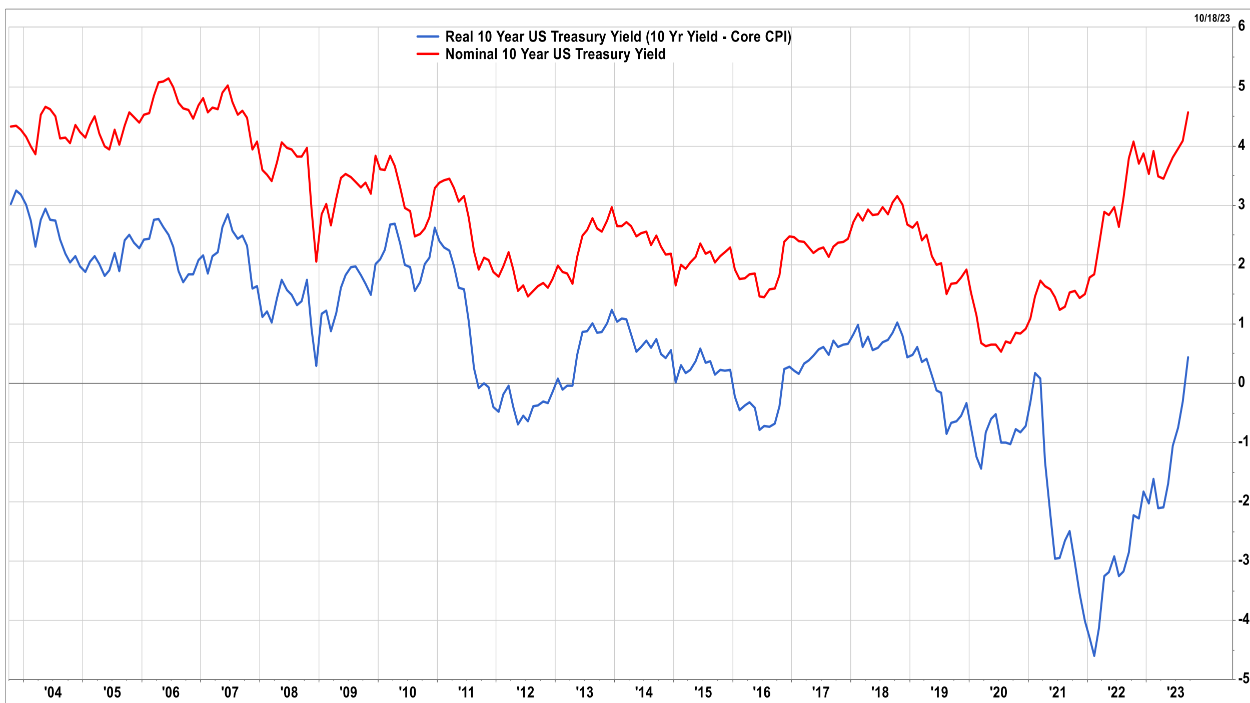
As a side note, equity investors have not experienced losses of this magnitude over a three year period since 1932!

While the rise in yields has made bonds more attractive than they have been in many years, we think it is still too early to make any major new commitments or to "lock in" current rates. Nominal yields may have moved back above the levels that have persisted throughout much of the last 15 years, but "real" rates (relative to inflation) are barely above zero, and are still well below recent norms.



The Elephant in the Room

Finally, there is an elephant in the room that we haven't mentioned yet, and will not even try to factor in with any degree of specificity because it is too far above our pay grade. It is that geopolitical risks are rising, and there is an unspoken but unmistakable sense that events could spiral out of control. China, alone, was a manageable concern inasmuch as neither side's interests were well served by risking open conflict. The war in Ukraine has so far remained a regional concern, and its effects on the global economy have been muted. But the war in Gaza seems to be an entirely different matter, involving ancient hatreds, and which risks spilling over into a wider war involving nuclear powers in a volatile part of the world that is critical to the global economy.

As we said, we cannot factor the course of these events into our thinking, but we can't ignore them, either.

Final Thoughts

We continue to maintain our base case that a recession in 2024 – with all of the attendant risks it presents to equities - is still more likely than not. It's an uncomfortable view, admittedly, as it is no longer the consensus view which has shifted in favor of a soft landing. But Professor Galbraith, who authored our opening quote on the virtues of economic forecasts, also said that, "It's safer to be wrong with the majority than to be right, alone."

Of course, we're far from being alone in holding to this view. The analysts and firms whose guidance we have trusted over the years have also remained cautious as the majority have grown more optimistic. But we're also not clinging to our cautious stance just because we believe our soothsayers and star gazers can predict the future better than the other guys.

It's because the analysts we follow base their expectations more on leading indicators than coincident ones which are, well, coincident, or lagging indicators which are, well, you know … And the leading indicators which have proven to be most reliable in the past still point to an economic downturn in 2024.

Clearly, the massive amounts of government stimulus flooded into the economy during the pandemic have increased the lag time between the Fed's tightening policies and the economy's slowdown, but we don't think that the Fed's effects have been negated entirely. Those who moved quickly to reduce risk levels in their portfolios, including ourselves, moved too quickly as it turns out. But to re-introduce a greater level of risk back into portfolios at this point for fear of "missing out" seems to us to be imprudent.

By remaining cautious, we are also using a calculation here that has more to do with the consequences of being right or wrong than it does of the odds of being right or wrong.

The risk-free interest rate has soared to its highest level this century at almost 5.5%. If we become aggressive and are wrong, our clients will almost surely lose principal. If we remain cautious and are wrong, our clients will still earn positive returns. And even if the consensus is

right and a soft landing is achieved, there is no guarantee that that will result in positive returns in the stock market. In the first place, that is the outcome that the market already seems to have priced in. And continued strength in the jobs market and other economic data would likely only serve to undermine the Fed's efforts to bring inflation down to its 2% target, forcing it to maintain its "higher for longer" policy for longer still. The market – and soft landing adherents – seem to have lost sight of the fact that the real fight is the fight against inflation, not recession.

And the inflation fight has not yet been won.

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