Cornerstone Report

Special Report | **September 6, 2024** | **By: Jerry E. Tuma, MS, CFP®**

Topics:

- Election Blues?
- Geopolitical Concerns
- Stocks, Are They Priced To Perfection?

We're Out To Change The Way America Thinks About Investing.

Election Blues?

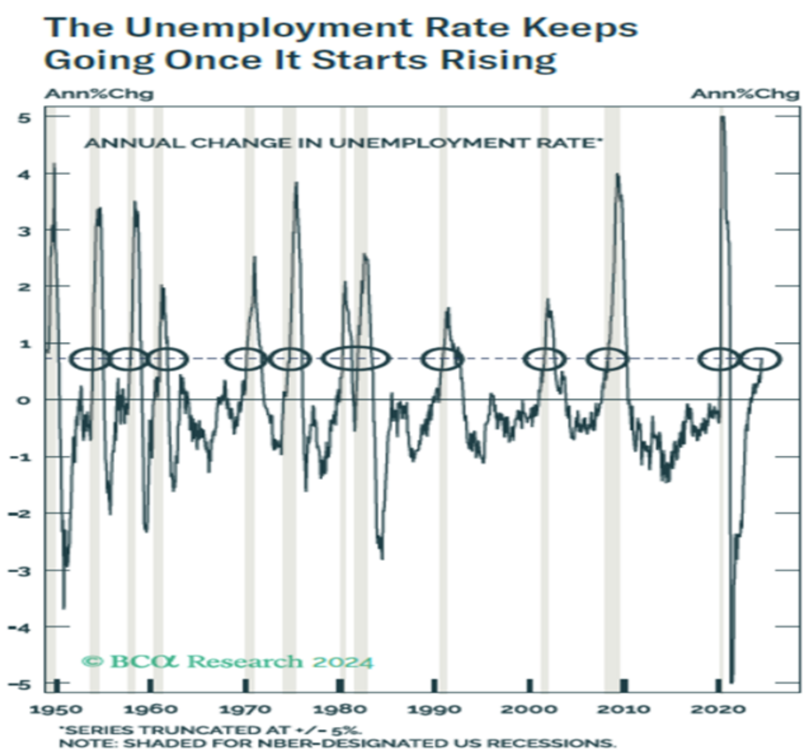
As we approach the upcoming presidential election, possibly one of the most substantial in U.S. history, the stock market and the economy appear to be shifting gears.

We've seen an enormous economic bounce post Covid, unleashing "pent up" spending by consumers. In addition, we saw record setting, unprecedented amounts of fiscal stimulus by Congress and monetary stimulus by the Federal Reserve.

Record budget deficits occurred as Congress and the president "threw caution to the wind" to make short work economically of the historic pandemic.

Since then, the economy has recovered nicely, real estate has rebounded sharply and stocks have hit new records. But the question from here remains, is everything good to go or are we headed toward another recession and bear market for stocks?

Real estate has already been in a correction, induced by historic tightening by the Federal Reserve. Interest rates shot up faster than any time in the last 50 years, with the exception of Chairman Paul Volker's strangling of inflation in 1979-80.



As you can see from the chart, once the unemployment rate picks up a certain amount of momentum, it has historically become a self-reinforcing cycle. The only two soft-landings we've experienced have been in 1966 and 1994, and as you can see from the chart in neither case did the unemployment rate reached the breakout point, as it has now done.

In this case once the unemployment rate rises to a certain level it becomes self-reinforcing and a recession appears inevitable. It would appear we have now reached that point. (Source: Bank Credit Analyst August 2024)

As I'm sure you're aware, inflation also shot through the roof post Covid, affecting the stock, bond and real estate markets, as well as the overall economy. While the rate of ***growth*** of inflation has certainly subsided and in some areas appears to be approaching "back to normal" levels, the Fed's massive tightening of the money supply and interest rate hikes may well end up not only causing inflation to subside, but also likely producing a recession.

Historically speaking, the pendulum of change rarely stops in the middle. In fact, if you survey the last 13 times the Federal Reserve has gone on a tightening spree (back to the mid 1950's) you'll find that 11 of those 13 instances produced a recession. The much vaunted "soft landing," where the economy slows but doesn't go into a recession is rare indeed. (Source: Bank Credit Analyst 2024)

The only times we've seen a true soft landing was in 1966 and 1994, and in both those instances the Fed raised rates significantly at first, and then backed off. Neither of those tightening cycles saw rates rise this far or fast.

So, the real question of the day is, to borrow a phrase from the movie Dirty Harry, "do you feel lucky?"

Will this economy have a true soft landing, which historically has only happened 15% of the time in the last 50 years, or will the Fed's massive tightening produce the inevitable recession that it normally produces.

We will give you the evidence in this newsletter and let you draw your own conclusions, but for my money I think we are headed for a recession probably relatively soon, and a bear market for stocks as well.

Recently the Bureau of Labor Statistics revised downward the unemployment numbers for 2024. While I certainly would not disparage the integrity of the BLS, some would be suspicious, since this is an election year. It appears based on their recent numbers that they overstated the number of new jobs according to the ***Payroll Survey***, by a ***mere 800,000+*** jobs so far in 2024. The BLS has significantly understated the number of layoffs from big corporations this year, as the Payroll Survey only polls large corporations.

On the other hand the ***Household Survey*** telephones some 60,000 households to find out if people have a job. This survey determines the "unemployment rate," which has been rising sharply (page 1).

Historically speaking the "pendulum of change" doesn't usually stop with a minor increase in unemployment when the economy is slowing, especially with the amount of "tightening" that the Fed has done this cycle.

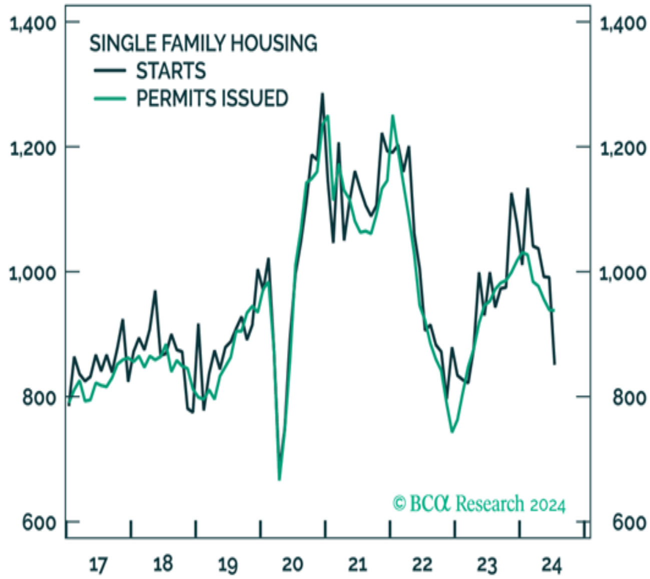
This has been one of the fastest and most severe tightening cycles of the last 50 years. Economics 101 tells us that there are long and variable lag times, from when the time the Fed starts raising rates until it has its full impact on the economy, often as long as 24 months or longer. So, if you consider that the Fed started raising rates March 2022, we are probably just now hitting the point where the tightening cycle is really starting to bite.

There are a number of indicators which have historically pointed to the "point of no return" of when the Fed's tightening is almost certain to cause a recession. We may be there now.

The way the cycle normally works is that the Fed raises interest rates, ***which first tends to slow down certain industries which are very interest rate sensitive.*** Housing would be one example.

As housing sales slow, especially for new houses, economic activity slows with it. Keep in mind that housing is not just about building a house which includes lumber, plumbing, electricity, etc. but also appliances, carpet, paint, you name it.

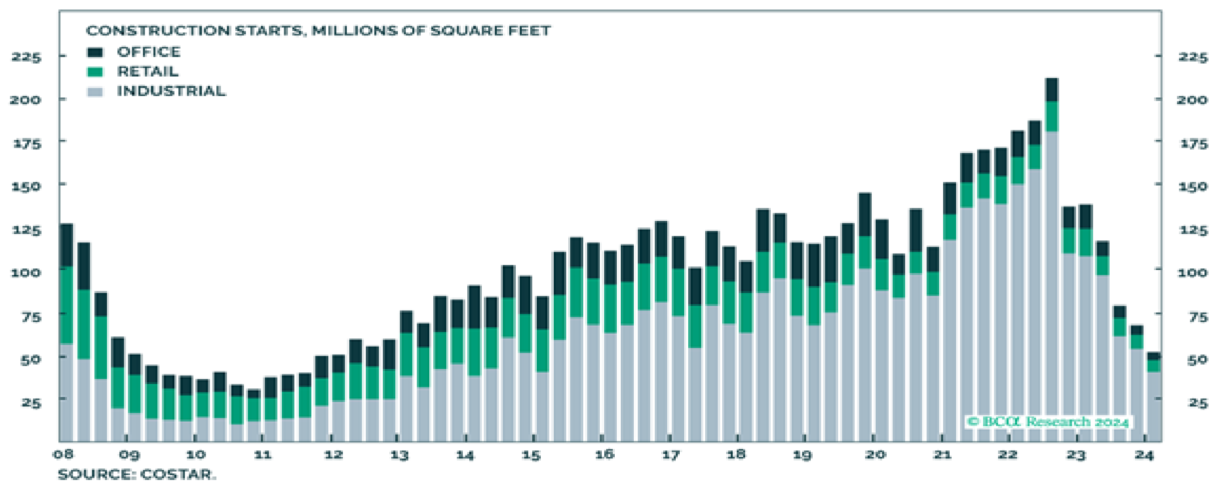
When someone buys an existing home, it does not generate ***near*** the economic growth of building a new home. While some buyers of existing homes may decide to remodel, buy new appliances, carpet, etc., a certain amount of economic activity will be generated. But the biggest economic boost to GDP comes from new homes being



built from scratch, which effects lumber, cement, wiring, a wide variety of commodities, appliances, etc.

New home sales generate far more economic activity than the purchase and sale of existing homes, and while new home sales were certainly stronger earlier in this cycle, they appear to be plummeting again. This affects not only realtors and home prices but all of the auxiliary industries which feed off of new home sales.

As you can see, housing starts were recovering nicely earlier this year but are now falling off the map. It now appears that housing has entered a renewed recession.



As you can see, construction starts of all types have plummeted back to post-2009 numbers.

While homes are certainly not the only area of the economy affected radically by interest rates, they're amongst the easiest to spot, and in turn they affect many other industries as well. This is just one example of how the Fed raising rates negatively affects the economy.

The issue is that you can't afford to lose economic momentum in a recovery. Historically, once a person loses their job or is laid off, they will spend less money, even if they are getting unemployment benefits, due to income loss, uncertainty, etc.

As they reduce their spending, the economy weakens further (less consumer spending) thus other areas of the economy begin to experience challenges as they hit a weak spot as well.

Thus starts the self-reinforcing cycle. Once the unemployment "snowball" gets started it is very difficult to reverse. This means job losses, which produce less GDP, which in turn produce even less spending. This then slows other areas of the economy as well, and becomes a self-reinforcing cycle of job losses, less spending, and thus more job losses, etc.

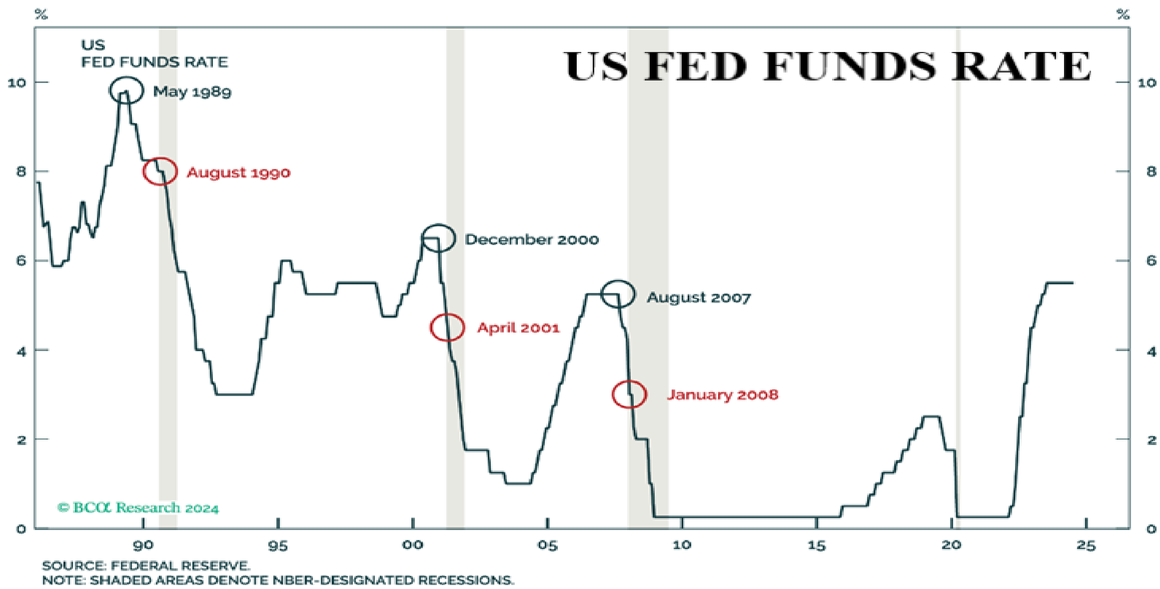
Once the unemployment rate reaches a certain point, historically, it tends to just "take off," as it now appears to be doing (see chart page 1). Reduced consumer spending means fewer corporate profits, which then produces more job losses and on and on until the bottom of the cycle is reached.

As you can see historically from the chart on page 1, the Fed normally raises rates too far and then is forced to backtrack and later begins to cut rates. However, due to the lagging effect of their policies, they usually wait too long to cut, until the self-reinforcing cycle has started downward and becomes very difficult to reverse.

As a matter of fact, as you can see from the chart enclosed, the last several recessions did not actually get started ***until after the Fed had already started cutting rates.*** *(Source: Bank Credit Analyst 2024)*

So, historically, the Fed is usually behind the curve. First, they tend to wait too long to raise rates, and then wait too long before they begin to cut rates and the cycle of recession and bear markets reoccurs.

In all, my best guess is that we will likely go into a recession some time before February of next year, possibly as soon as this fall.



"First, recessions have historically started shortly after the Fed began cutting rates. The Fed started cutting rates in January 2001 and a recession ensued just 3 months later. Similarly, the Fed first cut rates in August 2007 and a recession began 4 months later. Of course, in both cases, Fed rate cuts did not cause the recession. Rather, the Fed was simply behind the curve and easing monetary policy. Our Global Investment strategists do not expect this time to be any different.

Second, even if the Fed does cut rates more than is currently priced in, the impact will only be felt with a lag. The average mortgage rate that homeowners pay will almost certainly rise next year, as low-rate mortgage debt rolls off and is replaced with higher-rate debt.

Finally, our Global Fixed Income Strategy team highlights that central banks have not historically managed to surgically deliver a soft-landing after aggressive bouts of monetary policy tightening."

(Source: Bank Credit Analyst August 2024)

Geopolitical Concerns

While most investors have tended to discount geopolitics in this cycle, I see a lot of potential danger. Putin appears to be backed into a corner by Ukraine's invasion of Russian territory with their counteroffensive. Rather than comment on this let me quote one of our geopolitical experts, Matt Gertken of ***Bank Credit Analyst*** pertaining to his concerns about Russia and Iran:

Middle East conflict will escalate. Israel may accept a ceasefire but then it would pivot its military forces to deal with Hezbollah and Iran. Iran and Hezbollah will retaliate for Israeli assassinations.

The stock market is ignoring immediate risks to global stability stemming from the US election, which is a pivotal moment in US and global history. Russia is likely to intervene through oil embargo or sabotage. To clinch its strategic objective of neutralizing Ukraine requires a ***change of party in the United States***.

Ukraine is invading Russian territory near Kursk and embarrassing Vladimir Putin's government. Putin has spent his career trying to neutralize Ukraine and push back NATO.

Russia views Ukraine as the spear tip of a western military alliance, believing that if Ukraine joins the EU and NATO then Russia will lose both strategic security and political legitimacy.

Defeat would humiliate the regime, lead to Putin's fall from power and imprisonment or death, and thus it will not be tolerated at any cost.

NATO has expanded and a Democratic victory would result in the US leading the West to double down on Ukraine's military and financial support. Ukraine would launch a new counteroffensive with better support in 2025 or beyond.

Russia is already curtailing oil production and exports – that could hurt voters in the last two months.

Bottom Line: It is not clear that Russia can materially impact the US election but it will try and the results may cause wild market swings.

If Russia interferes and it succeeds, then the odds of a Republican sweep go up. If it fails, then the odds of a Democratic sweep go up.

In addition, the situation between Israel and Iran appears to be a potential tinder box which could really heat up possibly before the election. Again, let's quote Matt:

Violence, unrest, and extremism will remain a factor, as confirmed by the assassination attempt on President Trump. Foreign intervention has already been identified with an Iranian plot against Trump and against his campaign.

Investors should expect Israel to be very aggressive. If it fails, then the US will be forced to assist. If it succeeds in pushing back Hezbollah, then it achieves better long-term national security. If it succeeds but a major war starts, the opportunity to stop Iran's nuclear program may emerge as well. And if the US administration happens to lose the election in the process, well, the Republicans would be more supportive of Israel.

The reason for doubting a ceasefire is clear. Why would Bibi sacrifice his domestic base and Israel's northern security to plume Biden's legacy and help get Harris elected, when Harris could then turn around and make new demands? She is rumored to have said she would consider an arms embargo on Israel. Bibi will save his concessions for later.

Bottom Line: The Middle East crisis and global instability will escalate. The Biden-Harris administration will struggle to balance deterrence and election odds. Until a ceasefire is signed and Hezbollah and Iran manifestly stand down, Harris's bounce in opinion polls should not be trusted.

The US, UK, and Germany ordered citizens to evacuate Lebanon, major airlines suspended flights, and Israel launched strikes killing both Hezbollah's second in command, Fuad Shukri, in the militant group's stronghold in Beirut, and Hamas's political leader, Ismail Haniyeh, in Tehran.

Iran will retaliate against Israel for violation of its sovereignty while Hezbollah will retaliate for such an invasive and threatening strike at its leadership. These retaliations will hit Israeli soil, prompting further retaliation, especially if more Israeli citizens die.

Earlier this summer the Israeli Defense Forces approved an operational plan to conduct a campaign against Hezbollah to ensure that residents in northern Israel can return to their homes by September 1. Residents evacuated in the wake of last October's Hamas attacks.

Netanyahu is not operating on the US electoral calendar and does not accept Iran's denials of involvement.

If Israel and Hezbollah engage in full-fledged conflict, then Iran is highly likely to support Hezbollah militarily. Our decision tree gives 80% odds to Iran intervening. The US Chairman of the Joint Chiefs of Staff Charles Brown's recent statement reinforces these odds.

Iran's goal is to isolate and destabilize Israel without provoking direct American confrontation. But Iran is primarily making decisions for its own regional interests, including trying to force the lame duck Biden administration to withdraw troops from Iraq, so it is willing to take actions that undermine the Democrats.

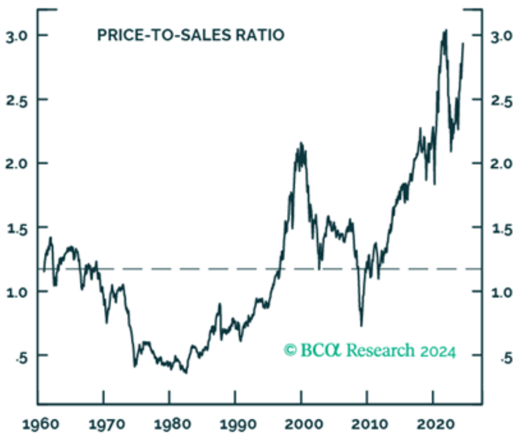
Assuming Israel and Hezbollah go to war, Israel will need to attack Hezbollah's lines of communication in Syria and Iraq, raising the odds that Israel will hit Iranian assets supporting Hezbollah, as occurred on April 1. And in that case, Iran will retaliate on Israeli soil, in accordance with the new rules…

Generally speaking you don't want to pin your investment hopes on a geopolitical outcome which could change radically. However, given the current situation of a potentially volatile presidential election and possible regime change in Washington this could get very interesting.

Coincidentally, very often a major spike in oil prices plays a big role in triggering recessions in the U.S. economy. It often is similar to firing the starting pistol on a race, where the runners are all lined up already and just needed a spark to get going.

Stocks, Are They Priced To Perfection?

* EXCLUDING FINANCIALS, UTILITIES AND TRANSPORTS PRIOR TO 1977.
NOTE: HORIZONTAL DASHED LINES INDICATE MEDIAN (1960 - PRESENT).



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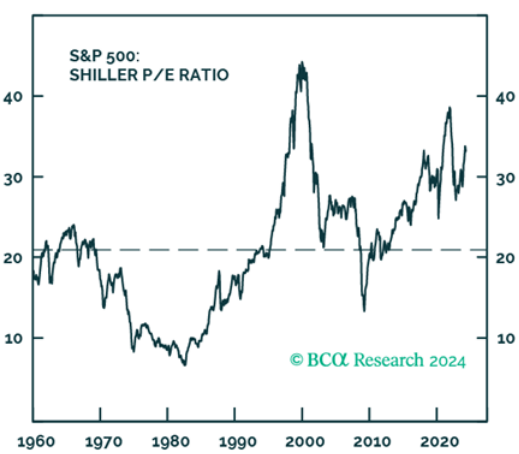


NOTE: HORIZONTAL DASHED LINES INDICATE MEDIAN (1960 - PRESENT).

To the left you see some longer-term valuation indicators pertaining to the U.S. stock market. Historically, valuations are not good "timing" indicators but they tend to give you a good perception of whether stocks are expensive (overvalued), or whether they're a bargain.

As you can see according to these longer-term valuations, stocks are not only very expensive but some of the most overvalued measures in market history. Only the dot-com era of 2000 and the early 2020 market prior to Covid had valuation readings this high.

That said, valuations are best used as risk indicators, meaning, valuations can be either high or low for months or even years, but they tend to also tell you when the market is hitting extremes. We now appear to be at new levels of extreme valuations for stocks.

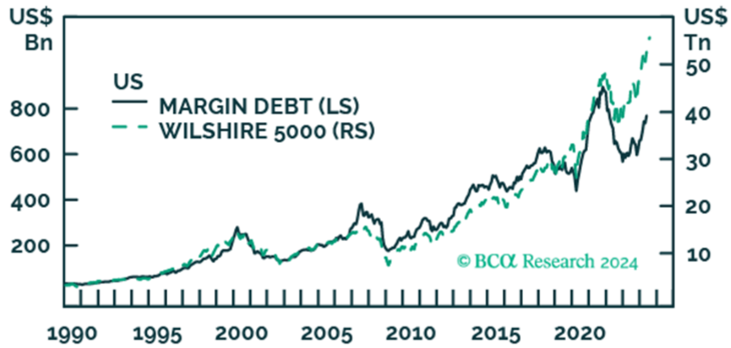
The question is are these valuations justified? In other words, are we at another very overvalued level and possible inflection point for the market? Are market extremes about to give way to a big bear market, which will then pull stocks way back down?

In my opinion, we are likely headed into another major bear soon.

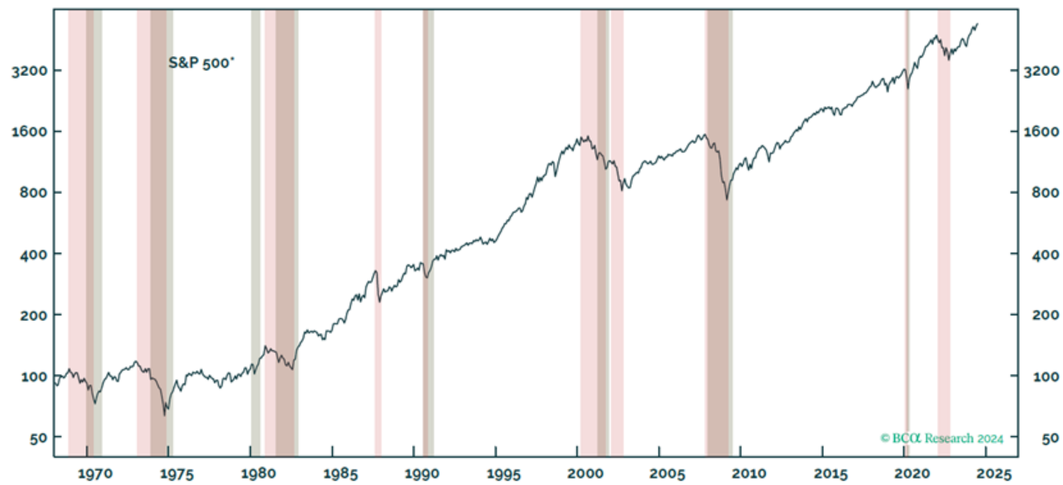
On page 6 you see margin debt, which tends to be toxic to the market and highly emotional. Margin debt normally peaks near the top of the stock market and then becomes "built in selling pressure" as the market goes down and people are forced to sell their stocks.

For example, if someone is 50% margined, that could mean that they have $1,000,000 in the market but only invested $500,000 cash and borrowed the other $500,000 from their broker. Not counting interest expense, this means that a margined account will lose money twice as fast as if they had not borrowed money at all. Thus, high levels of margin debt are toxic to the market in bear markets. If we are truly entering a bear, high levels of margin are dangerous and tend to produce self-reinforcing selling pressure.

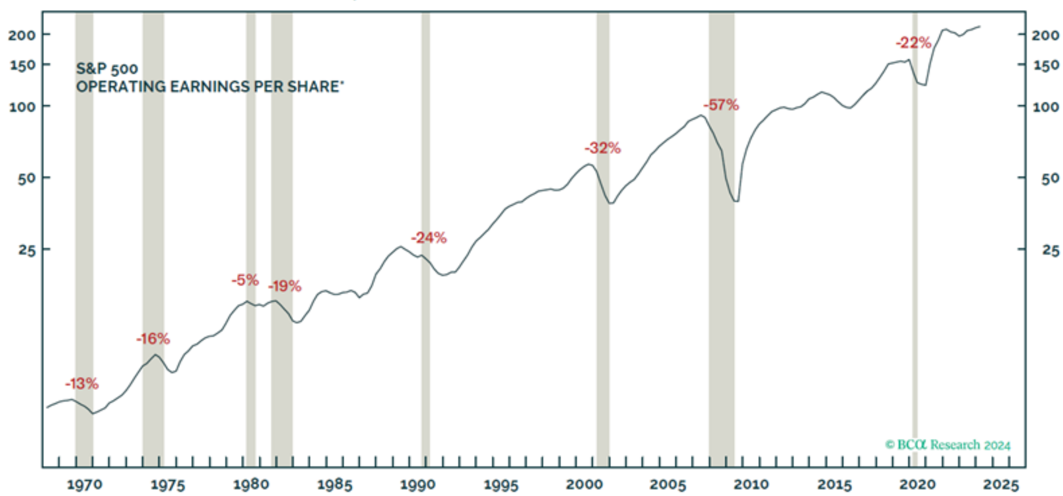
As stocks fall, investors must put up more cash to hold their positions or else their brokers will be forced to sell them out. Forced selling tends to produce more selling as margined investors are losing money twice as fast as non-margined investors. Thus, these highly leveraged margin accounts tend to produce a snowball effect as the market declines.



Excessive margin debt tends to exacerbate market declines as investors who borrowed money speculating in stocks are quickly forced to sell, as they may be losing money twice as fast as the market is going down.



*SHOWN IN LOG SCALE.
NOTE: LIGHT RED SHADING DENOTES BEAR MARKETS; GREY SHADING DENOTES NBER-DESIGNATED RECESSIONS.



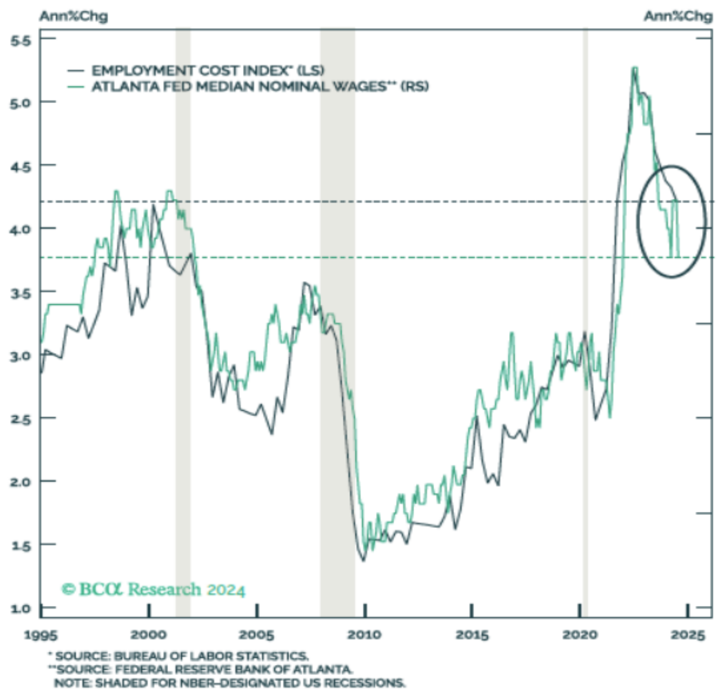
*SOURCE: STANDARD AND POOR'S; SHOWN AS A 4-QUARTER MOVING TOTAL
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

As you can see from these long-term charts of the market and earnings, economic recessions normally produce a decline in corporate earnings, which at times can be extreme. Historically speaking, the more severe the recession, the more severe the decline in earnings will be and correspondingly the bigger the market declines will tend to be, as you can see in the 2001 and 2008 bear markets.

The real question for this market will be, how big of a decline in earnings will we see if we indeed do have a recession.

Conclusion

In all, it appears that we are headed towards a classic recession. The Fed may well have overtightened, as it has historically done before almost every economic recession. Remember that monetary policy from the Fed affects the economy and the market, but with widely variable lag times. It looks to me like we are right on schedule.



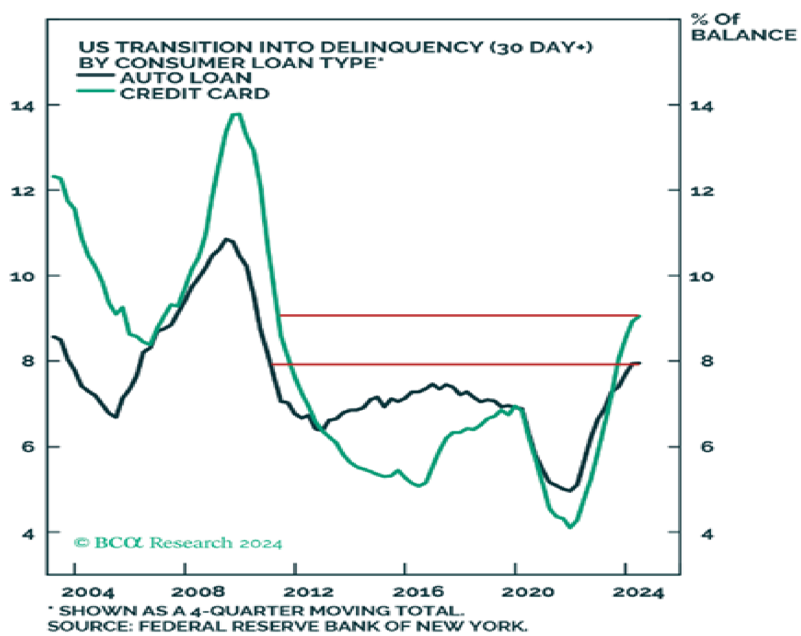
I believe that we will soon be entering a bear market. ***Bank Credit Analyst*** has targeted roughly the 3,500 level of the S&P 500 if the bear market ensues as expected (page 10).

This represents about a 35% drop in the S&P, but as we know if the S&P 500 drops 35% many other sectors of the market will drop significantly more. I would encourage each of you to reevaluate your current positions.

As you can see from the chart on the left, employment costs are still very elevated and this remains the most important component of inflation as employment costs typically make up close to 65% of the average corporation's cost. So even though inflation is falling you could easily make the case that the inflation battle is nowhere near completed.

Even as the Fed begins to cut rates in an attempt to prevent a recession it appears that inflation may be too entrenched this cycle, and that a recession may be necessary to wring inflation out this time. This is classic stagflationary behavior (like the 1970's) — rising inflationary pressures in spite of a weakening economy.

To the right, you see that U.S. auto loans and credit card loans delinquencies are spiking. This is typical pre-recessionary behavior and demonstrates that the giant savings buffer built up by America post-Covid due to government subsidies, etc. appears to have been consumed, at least by the lower income sector of the economy.



As you can see from the above chart, consumer delinquencies are shooting up for auto and credit cards, typical pre-recession behavior and now approaching 2008 numbers.

Above you see the trend channel that the S&P 500 has been in since the market bottom in 2009. Currently, Bank Credit Analyst is projecting that the S&P could drop as low as the vertical line around 3,500. If it drops that low it will break the bottom of the trend channel which could mean a different type of market entirely after that. Time will tell.

Remember, the combination of extremely high valuations for stocks, historic amounts of margin debt and the potential for recession makes up a highly toxic brew.

The bulk of Wall Street and most investors have been drinking the “soft-landing” Kool-Aid, I hope there’s not a hint of poison in the brew.

During his Jackson Hole speech, Chair Powell dispelled any remaining doubts about a September rate cut. Still, easing monetary policy is unlikely to result in a soft landing.

First, recessions have historically started shortly after the Fed began cutting rates. The Fed started cutting rates in January 2001 and a recession ensued just three months later. Similarly, the Fed first cut rates in August 2007 and a recession began four months later. Of course, in both cases, Fed rate cuts did not cause the recession. Rather, the Fed was simply behind the curve in easing monetary policy. Our ***Global Investment*** strategists do not expect this time to be any different.

The market is currently expecting the Fed to cut rates by 220 bps over the next 12 months. For long-term bond yields to fall significantly from current levels, the Fed would need to ease more aggressively than the bond market is already discounting, which is unlikely unless there is a recession.

Second, even if the Fed does cut rates more than is currently priced in, the impact will only be felt with a lag. The average mortgage rate that homeowners pay will almost certainly rise next year, as low-rate mortgage debt rolls off and is replaced with higher-rate debt.

Finally, our ***Global Fixed Income Strategy*** team highlights that central banks have not historically managed to surgically deliver a soft-landing after aggressive bouts of monetary policy tightening. While the initial impact of rate hikes on loan growth was muted in this cycle, the lagged effects were first reflected in a significant slowdown in investments, and a slowdown in consumption growth now appears to be unfolding.

(Source: Bank Credit Analyst September 2024)

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