The Long View: It's All About Perspective

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Key Takeaways

- While recent datapoints suggest U.S. economic growth is slowing, a longer-term perspective supports a different conclusion: the economy is healthy and normalizing from a period of elevated post-COVID growth.
- The ClearBridge Recession Risk Dashboard improved to an overall green signal this month with three underlying indicator improvements, supporting our view of continued economic normalization.
- Despite equity market valuations appearing lofty, an additional perspective shows that a handful of the largest benchmark constituents are distorting valuations. The typical stock trades at a much more reasonable multiple that is less than half a turn (0.5x) above the long-term average.

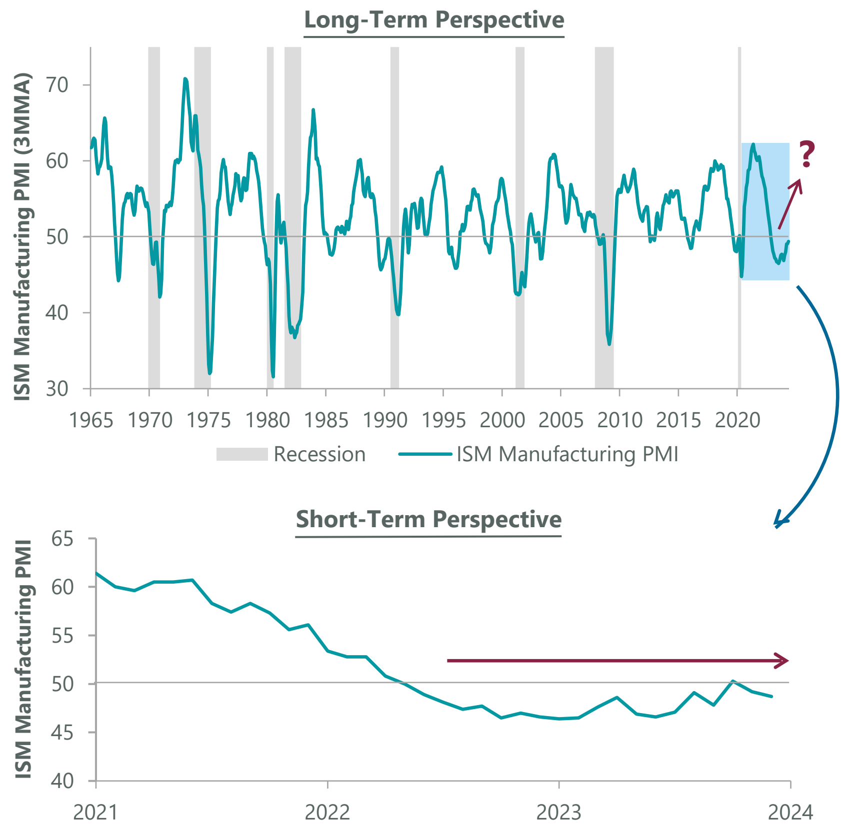
Slowdown or Normalization?

Perspective is defined as "the subjective evaluation of relative significance; a point of view." Perspective matters in all facets of daily life, and events both major (parenthood) and minor (a traffic jam) can change how a person sees the world. This is particularly true when analyzing economic and financial market data, with some of the best ideas emerging when analysts step back to re-evaluate and consider alternative perspectives. At present, an array of datapoints suggests the U.S. economy is slowing down. However, zooming out and adopting a longer-term perspective leads to a different conclusion: the economy remains healthy and is instead normalizing from a period of elevated growth following the recovery from the COVID-19 pandemic.

One example where a longer-term perspective leads to a different conclusion comes from the manufacturing sector. The headline ISM Manufacturing PMI survey provides insight into the evolution of the business cycle broadly and manufacturing activity specifically. After reaching its highest level (64.0) in nearly three decades in 2021, this survey slipped into contractionary territory (below 50) by late 2022 and remained there for over a year.

Investors with a short-term perspective might observe that the ISM Manufacturing PMI has been soft for over a year and contracted again during the second quarter after briefly expanding in March, a concerning development. However, investors with a longer-term perspective might instead conclude that the ISM's bottoming process is rarely smooth, and that an upward reversal is the historical norm once a bottom has formed. Further, the ISM didn't drop below the mid-40s during past soft landings, similar to 2023.

Exhibit 1: It's All About Perspective: Manufacturing

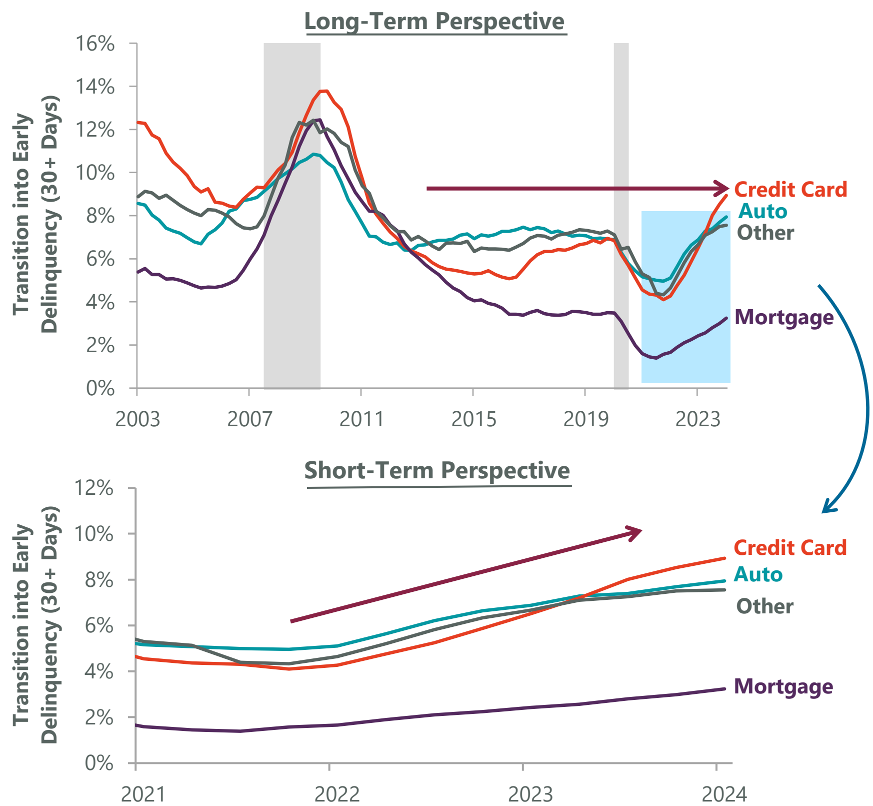


Data as of May 1, 2024, latest available as of June 30, 2024. Sources: ISM, NBER, and Macrobond.

A second area where perspective can impact an investor's conclusion is around newly delinquent debt, or the share of consumers starting to fall behind on loan payments. Delinquency rates have been on the rise since late 2021, with categories such as autos and credit cards surpassing their pre-pandemic levels. This leads to the worry that consumer financial health is deteriorating, and that consumption could slow as individuals are forced to retrench.

However, much of the deterioration comes specifically from loans issued in 2020 and 2021, when many previously subprime borrowers were in healthier financial shape given stimulus payments, loan and rent forbearance programs and strong low-income wage gains. More recently issued debt is not seeing the same dynamic with regard to delinquencies and, more importantly, the growth in delinquency rates peaked in 2023. Many bank management teams expect delinquency rates to plateau in the coming quarters, an encouraging sign supported by the latest data, which shows incrementally slower growth in newly delinquent loans. Finally, a longer-term perspective shows that delinquency rates are largely still in-line with pre-pandemic levels and, despite their recent march higher, are not yet in troubled territory. Through this lens, the headwind to consumption should be somewhat limited.

Exhibit 2: It's All About Perspective: Delinquencies

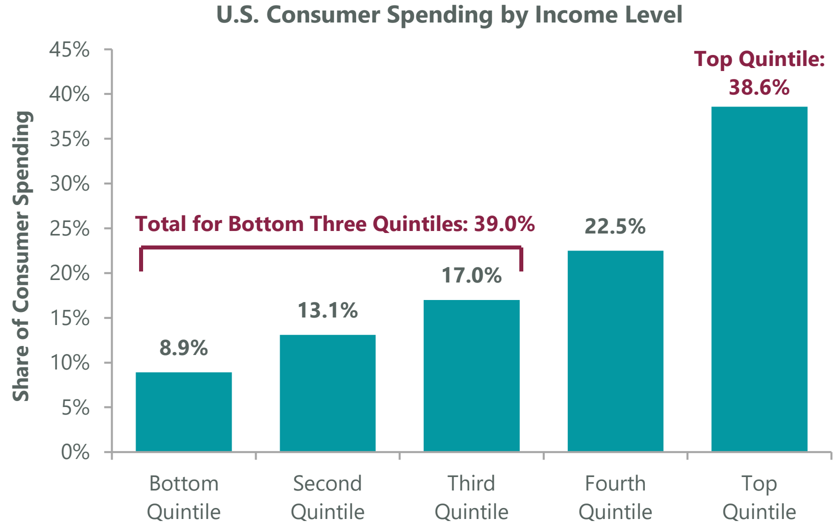


Data as of May 14, 2024, latest available as of June 30, 2024. Sources: Federal Reserve Bank of New York, Macrobond, NBER. Gray shading reflects recessionary periods.

Lower-income consumers are the most likely to fall behind on their debts. However, we are seeing some positive developments: the lowest-earning Americans (measured in quintiles) have seen the strongest wage gains over the past few years, up 31% since the onset of the pandemic, while inflation (CPI) has risen just 19.4%. This has helped support their spending even in the face of the increased cost of day-to-day living. While this group remains under pressure, it accounts for less than 10% of overall consumption. In fact, the bottom three quintiles (60%) of the income spectrum combined account for as much spending as the top quintile (20%) alone.

While wages for higher-income cohorts haven't risen substantially faster than inflation over the past few years, these individuals have benefited from wealth effects with financial markets and home prices seeing considerable appreciation. Combined with lower debt loads, this cohort is in a position to offset any weakness in spending by lower-income consumers and help keep the economy expanding.

Exhibit 3: High Earnings, High Spending



Data as of Sept. 8, 2023, latest available as of June 30, 2024. Sources: U.S. Bureau of Labor Statistics (BLS), Macrobond.

Much of the outsize wage gain for lower-income Americans came during the reopening from the pandemic when finding workers was perhaps the largest challenge facing many employers. High wages, receding pandemic risks and strong immigration have all helped to boost labor supply, all of which has occurred more recently against a backdrop of moderating labor demand. The result has been more modest wage gains over the past two years.

The pace of wage increases has now cooled enough that the Wage Growth indicator on the ClearBridge Recession Risk Dashboard has improved to a green reading. This improvement comes alongside the Profit Margins indicator moving to green and the Money Supply indicator moving to yellow. These changes, combined, have shifted the overall signal emanating from the dashboard back into green territory for the first time since 2022, indicating a likelihood of continued economic expansion.

Exhibit 4: U.S. Recession Risk Indicators

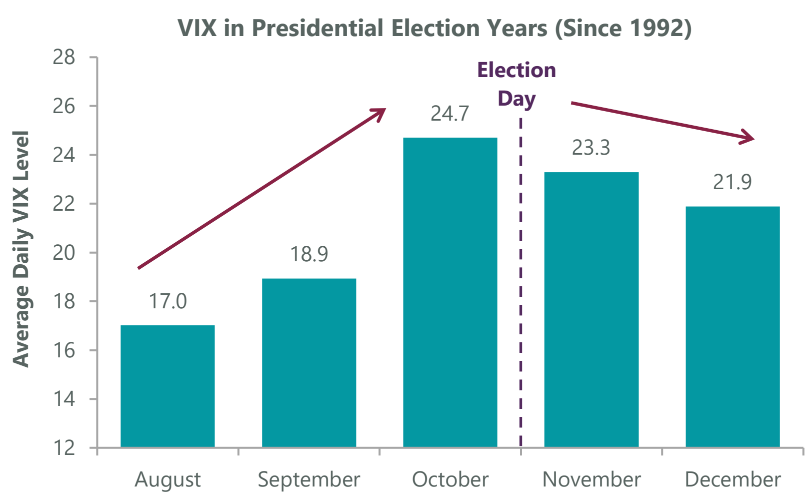
		June 30, 2024	March 31, 2024	December 31, 2023
Consumer	Housing Permits	Caution	Caution	Recession
	Job Sentiment	Recession	Recession	Recession
	Jobless Claims	Caution	Caution	Caution
	Retail Sales	Caution	Caution	Caution
	Wage Growth	Expansion	Recession	Recession
Business Activity	Commodities	Caution	Caution	Caution
	ISM New Orders	Caution	Caution	Recession
	Profit Margins	Expansion	Recession	Recession
	Truck Shipments	Caution	Caution	Caution
Financial	Credit Spreads	Expansion	Caution	Caution
	Money Supply	Caution	Recession	Recession
	Yield Curve	Recession	Recession	Recession
	Overall Signal	Expansion	Caution	Recession

Expansion Caution Recession

Data as of June 30, 2024. Sources: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, Bloomberg, CME, FactSet and Macrobond. The ClearBridge Recession Risk Dashboard was created in January 2016. References to the signals it would have sent in the years prior to January 2016 are based on how the underlying data was reflected in the component indicators at the time.

The improvement in the overall dashboard reading to a shallow green signal is a welcome development. However, the economy is moderating and the risk of a soft patch remains. If investors over-extrapolate from the current normalization and expectations morph into a recession scare, equity markets could experience a period of consolidation. In fact, a bout of market choppiness in the coming months would be consistent with history as volatility tends to pick up as a presidential election nears.

Exhibit 5: The Pre-Election Jitters

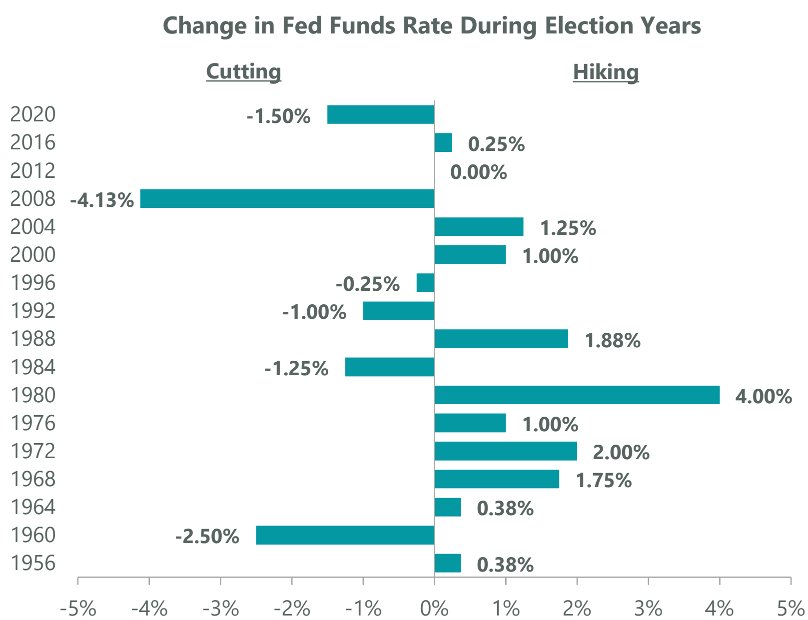


Data as of June 19, 2024, latest available as of June 30, 2024. Sources: FactSet, CBOE.

While no one is rooting for a market pullback, slowing economic growth would likely further ease inflationary pressures, which would be a welcome development for the Fed. A patch of even softer growth could help kick off the long-awaited interest rate cutting cycle. Common wisdom dictates that the Fed will be hesitant to change rates so close to the election in an effort to retain independence and avoid the appearance of meddling.

However, history shows that the Fed has adjusted interest rates during every presidential election year since 1956 with only one exception. And in fact, while the central bank did not adjust the federal funds rate in 2012, it did announce a third round of quantitative easing in September, less than two months before the election.

Exhibit 6: Elections Don't Deter Fed



Sources: Bloomberg, Federal Reserve Bank of St. Louis.

The commencement of a cutting cycle — if it occurs — should bolster the chances of a soft landing. History shows that soft landings are hard to achieve, with just two in the past 45 years. However, the current cycle is unique by many measures and a number of factors suggest that the Fed could be able to stick a soft landing.

Should that occur along with the commencement of rate cuts, investors have historically benefited from stepping out along the risk curve. Equities broadly (large and small, growth and value) have outpaced cash in the year following the first rate cut when past soft landings occurred, with the Russell 1000 Growth index delivering the best performance on average at 16%.

Exhibit 7: Equity Leadership Following the Cut

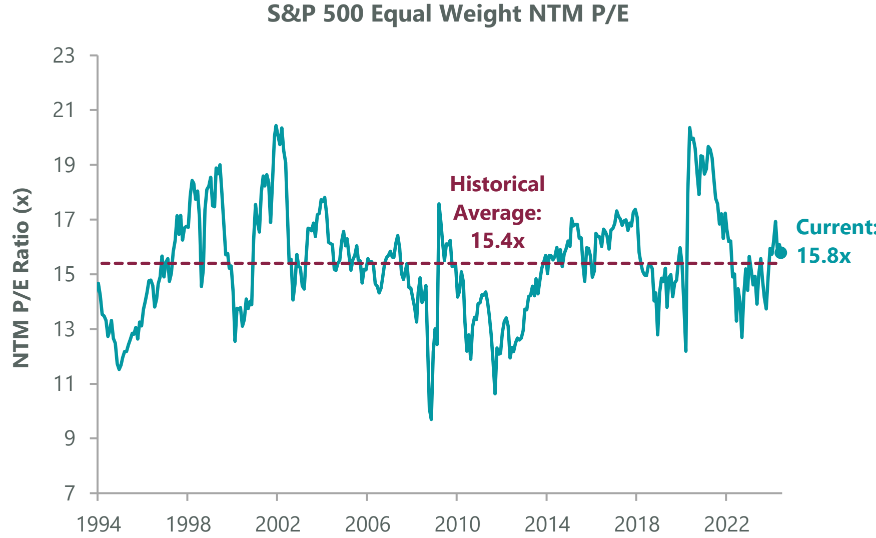
Initial Rate Cut	Economic Outcome	Subsequent 12-Month Price Return: Cash (3M T-Bills)	Russell 1000 Growth	Russell 1000 Value	Russell Mid Cap	Russell 2000
Apr. 1980	Recession	13.5%	39.0%	30.1%	51.41%	66.3%
June 1981	Recession	15.9%	-18.4%	-15.2%	-18.35%	-20.5%
Oct. 1984	Soft Landing	8.9%	9.5%	10.8%	11.96%	8.5%
June 1989	Recession	8.7%	17.5%	4.2%	4.50%	-1.5%
July 1995	Soft Landing	5.5%	22.5%	18.2%	17.26%	19.1%
Jan. 2001	Recession	4.4%	-15.6%	-5.7%	-3.08%	5.3%
Sept. 2007	Recession	3.2%	-17.6%	-25.4%	-19.29%	-12.8%
July 2019	Recession	1.5%	24.9%	-9.2%	-0.71%	-5.7%
Average		**7.7%**	**7.7%**	**1.0%**	5.5%	7.3%
Recessionary Average		**7.8%**	5.0%	**-3.5%**	2.4%	5.2%
Soft Landing Average		**7.2%**	**16.0%**	14.5%	14.6%	13.8%

Note: Rate cut cycles of at least 75 bps. Data as of June 30, 2024. Sources: FactSet, Bloomberg, S&P, Russell, ICE BofA, NBER.

Some investors have expressed hesitance to deploy capital into equities at present given lofty valuations. Last quarter we laid out the case for the S&P 500 Index to trade above long-term average multiples due to superior fundamentals and a shift in the composition of the benchmark toward more growth and defensives, which tend to trade at a premium. However, there are other reasons why valuations shouldn't be viewed as a reason for hesitancy — at least for most index constituents. A handful of the largest companies are having an outsize impact on the benchmark's valuation (21.0x NTM EPS), creating a meaningful gap between the 10 largest stocks at 29.3x and the other, generally fundamentally healthy 490 at a more reasonable 17.8x.

This valuation backdrop is another area where perspective matters. Another way of looking at valuations for the "typical" stock is to look at the equal-weighted S&P 500 as opposed to simply removing the 10 largest stocks. This version of the benchmark, which treats all companies the same from a weighting perspective, is trading less than 0.5x above its long-term average. An environment where the benchmark is valued richly while at the same time the typical stock is much more reasonable presents an opportunity for active managers. Although passive investors can't sidestep the lofty valuations embedded into the benchmark's largest members, active investors can be more selective in taking advantage of mispriced opportunities.

Exhibit 8: Average Stock Valuation is… Average



Data as of June 30, 2024. Source: UBS.

In summary, the ClearBridge Recession Risk Dashboard has improved to an overall green signal following three underlying indicator improvements this month. This is occurring as the economy is slowing, which we believe is best characterized as normalization following a period of elevated strength. This softer patch could be over-extrapolated by investors who typically experience pre-election jitters, setting up the possibility of a choppier summer for equities. Ultimately, we believe that a longer-term perspective shows that the destination markets and the economy are headed for is the one many believed was the most likely outcome two to three years ago — a return to normal. It just took a little longer to get there.