Apex Macro

Uncertainty Ahead

Danny Robushi, APEX MACRO Founder

September 21, 2024

A·pex (noun)

The highest or culminating point; summit

Summary

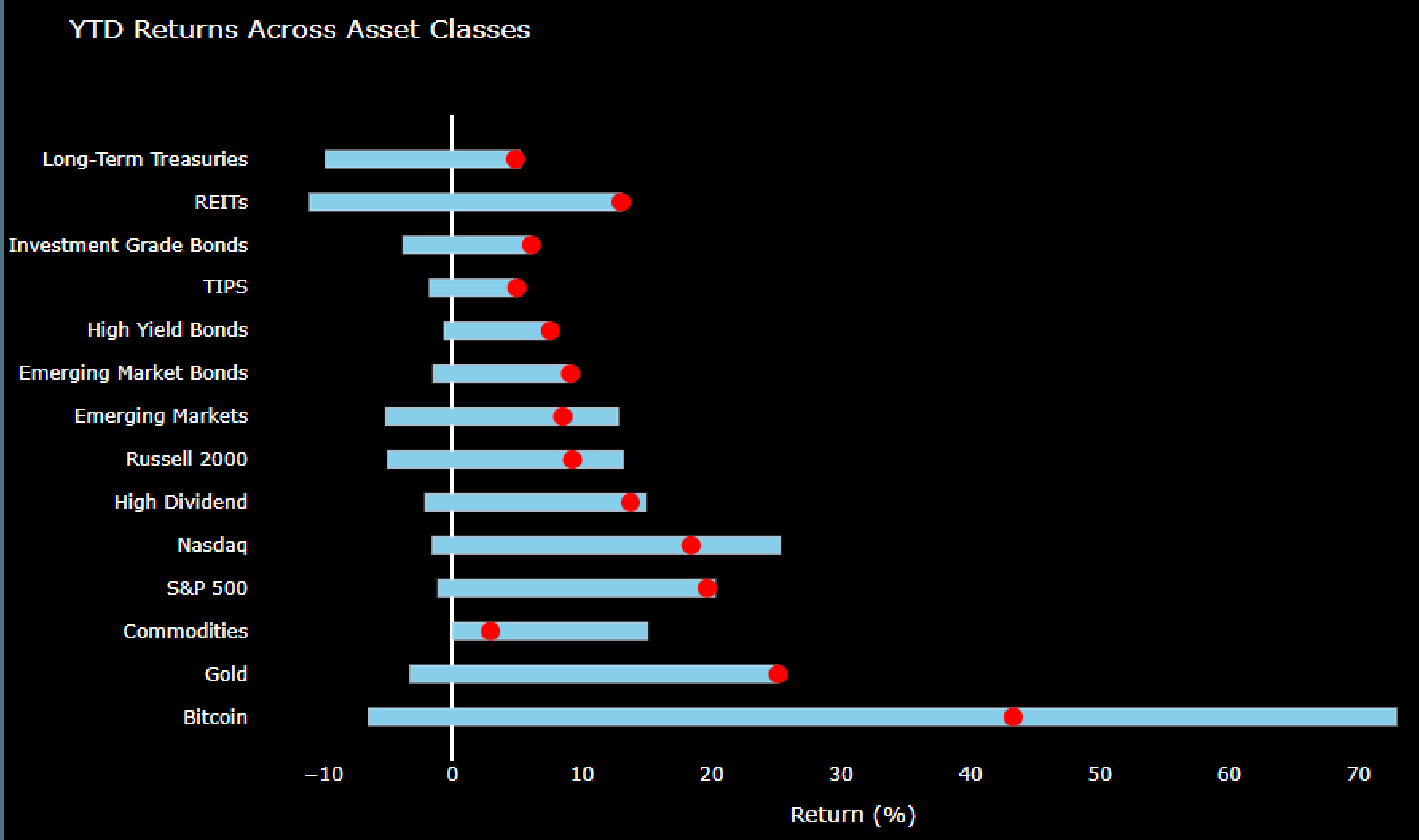
- The S&P 500 has diverged from its typical seasonal patterns but appears to be following the soft landing playbook, taking a path reminiscent of the last successful soft landing in the U.S. in 1995.

- U.S. Government debt expansion has extended the current business cycle by counterbalancing the reduction in private bank lending. While government spending generally exhibits less efficiency compared to private capital investment, the persistence of a $2 trillion deficit demonstrates the government's capacity to dominate these economic dynamics.

- While the headline employment figures don’t yet resemble prior recessionary periods, the underlying picture suggests deterioration. In our view, the canary in the coal mine will be employment within the housing market

- Deflation in goods has helped bring the headline inflation number down. However, shelter and services inflation have remained persistent, longer than the Fed would prefer, and they continue to pose a potential challenge as we head into a rate-cutting cycle.

- Gold and yields have already front-run the anticipated rate-cutting cycle. Gold has continued to rise despite positive real rates, signaling expectations of a forced cut by the Fed. Meanwhile, the spread between the 2-year and 10-year yields and the Fed Funds Rate has reached levels not seen in almost 20 years.



- Bitcoin has been the best performing asset this year even with it being stuck in a range between 50K-70K since March. Its initial rally to begin the year has kept it in the lead.

- Gold takes second even with real interest rates in positive territory and inflation coming down. The metal tends to perform well in tail events and the argument for hard or soft landing is still on the table. It may be a tell.

- Technology started off the year strong driven by the AI narrative and Nvidia jumping to up over 100% year over year. Since then, it has been all about defensive names as Tech has struggled in Q3.
- Utilities are traditionally defensive and have benefited from lower rates as they tend to have high amounts of leverage, but they are also a beneficiary of the AI narrative as data centers are needed to power LLMs

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- The S&P 500 has deviated from traditional seasonality trends this year. However, a takeaway here is the index tends to rally into year end.

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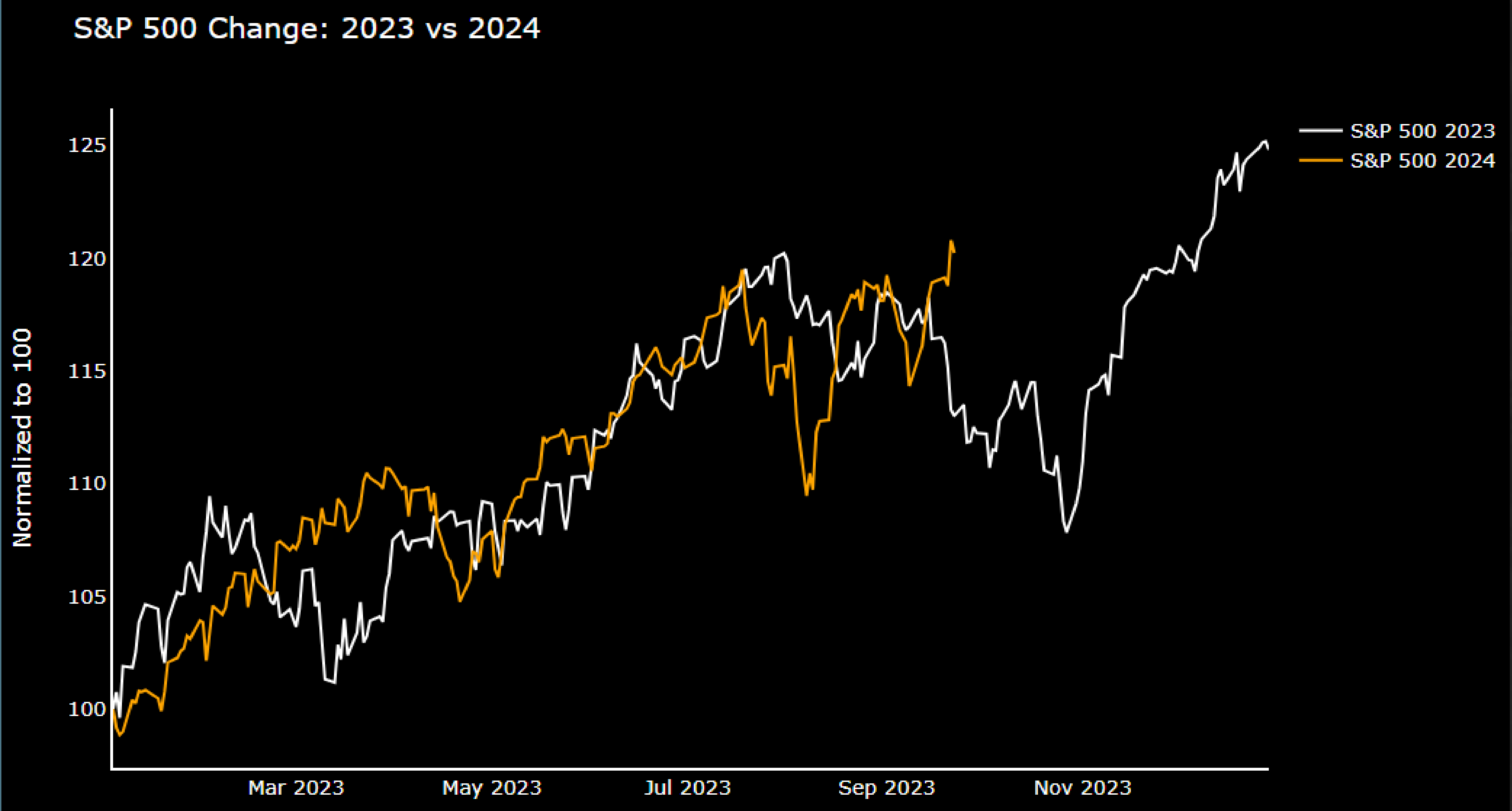

- While not tracking seasonality we have tracked the path the index took last year almost identically. The exception being we have now made a new high as of this past week. If volatility does not pick back up soon, we could see the end of year rally come early.

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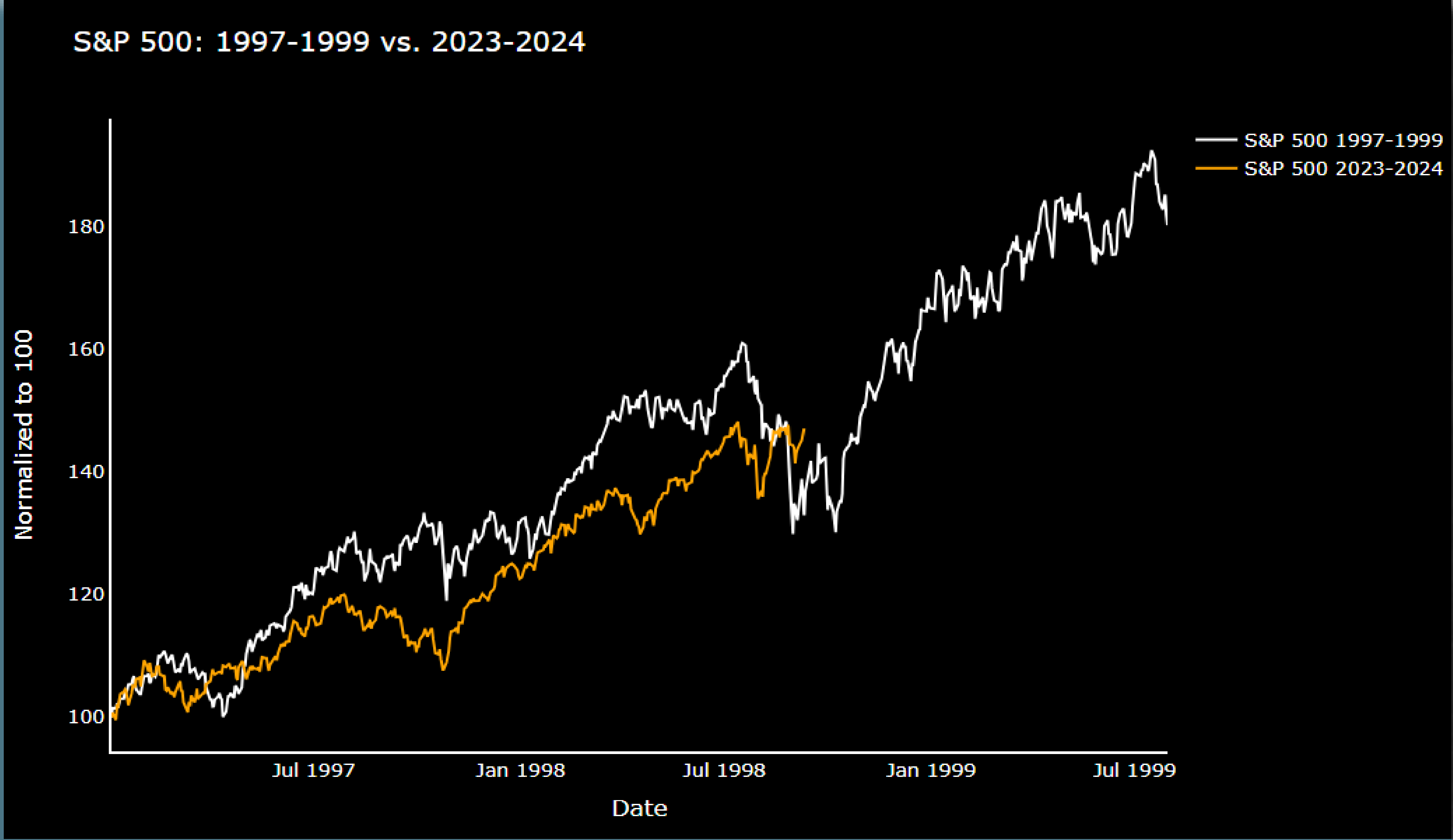

- In playing into the theme of soft landings we found a parallel to the last soft landing we had back in the 1990's. So far it has tracked pretty well and also tells us we could go lower from here before another extended rally.
- This coincides with the start of a cutting cycle and barring material deterioration in the labor market, another move higher in the broader indexes should not be counted out.

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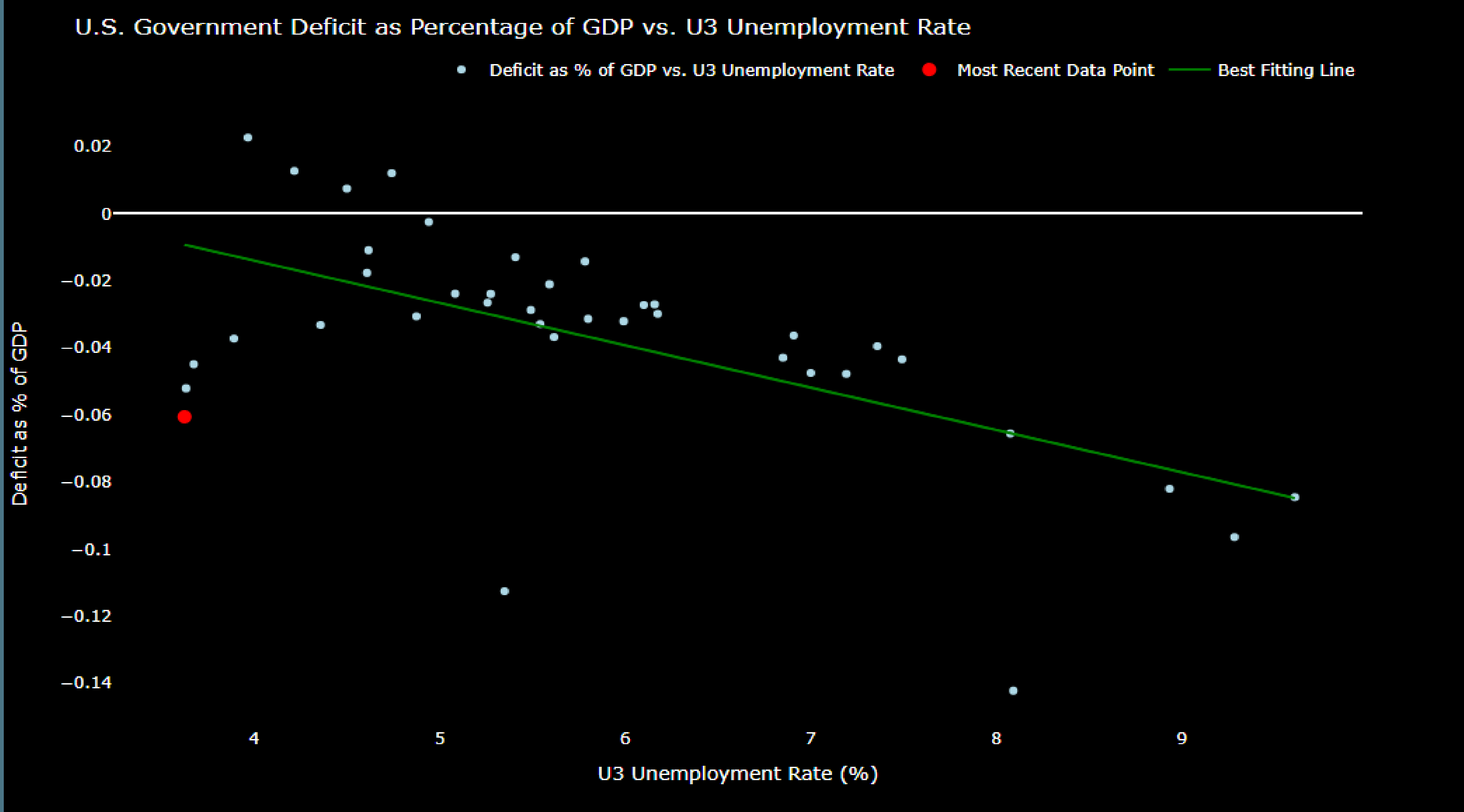

- GDP growth remains above the trend observed over the last decade, leaving many perplexed as to why a recession hasn't occurred despite multiple traditional recession signals. A key factor is that we've never run a deficit this large while maintaining full employment.

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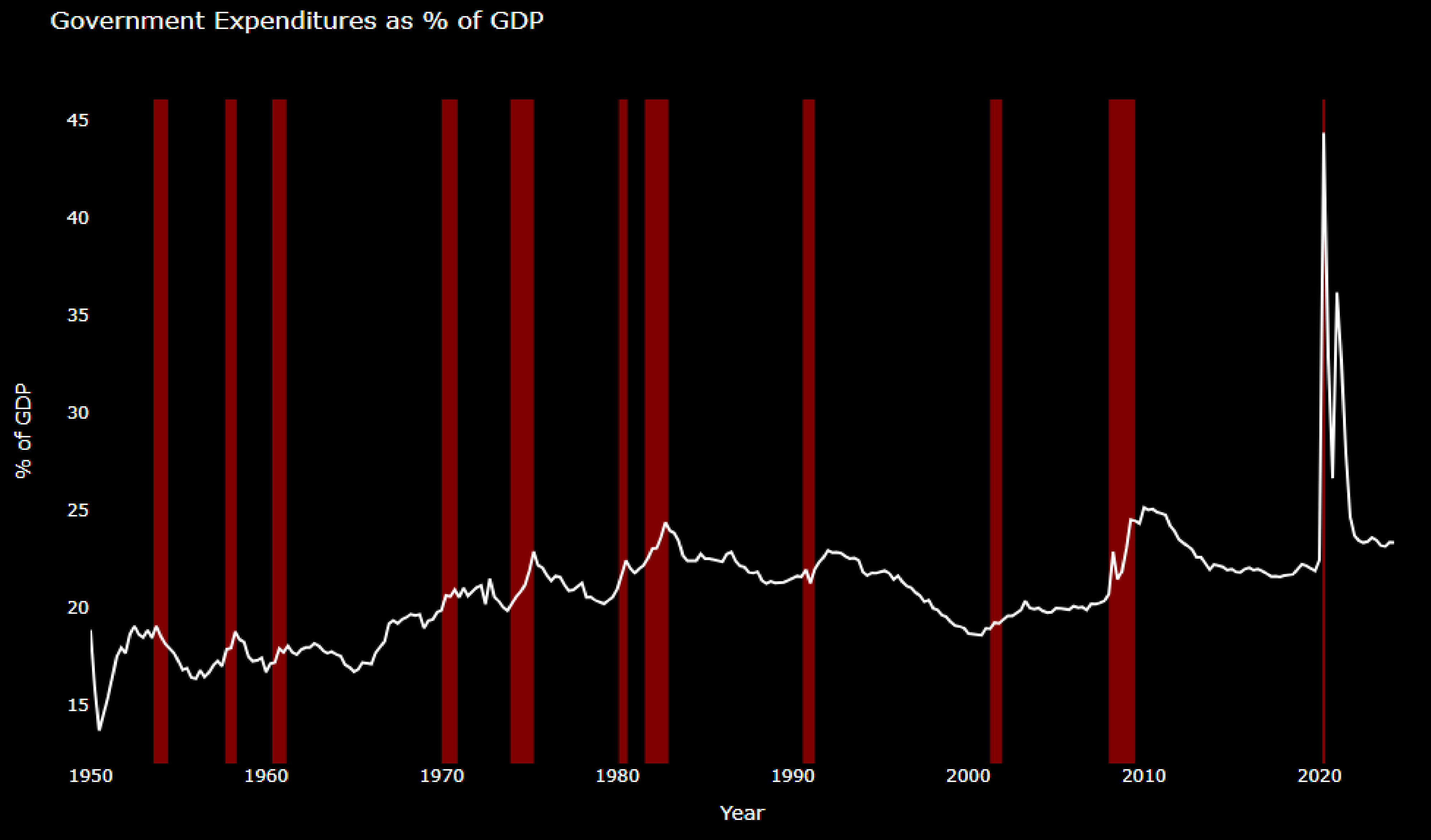

- Government expenditures currently stand at approximately 22% of GDP, while tax revenues have never exceeded 20% of GDP. As long as spending remains at this level, we are running persistent deficits, which tend to worsen during recessions when expenditures rise further. In the next downturn, we are likely to witness new record deficits.

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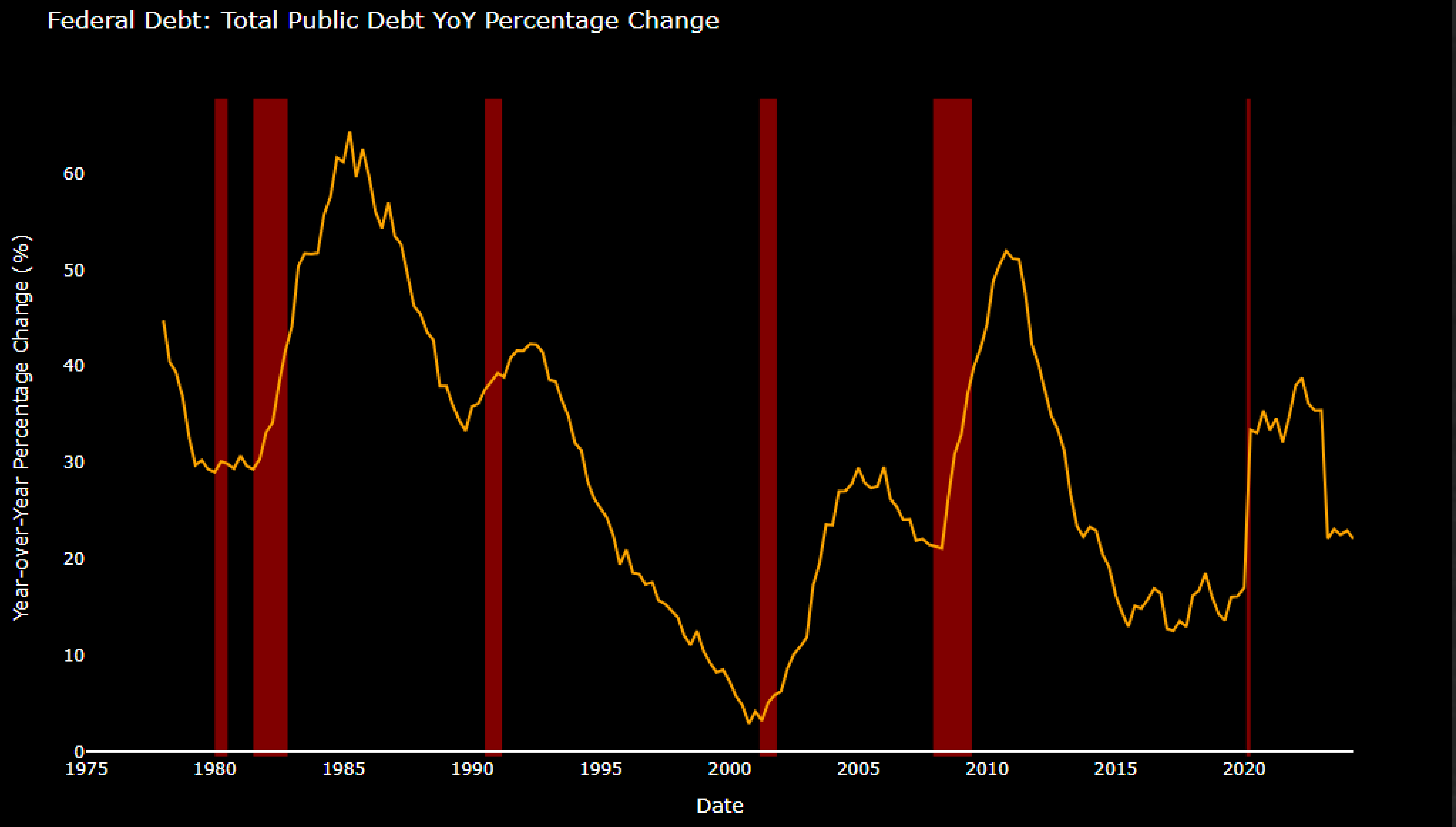
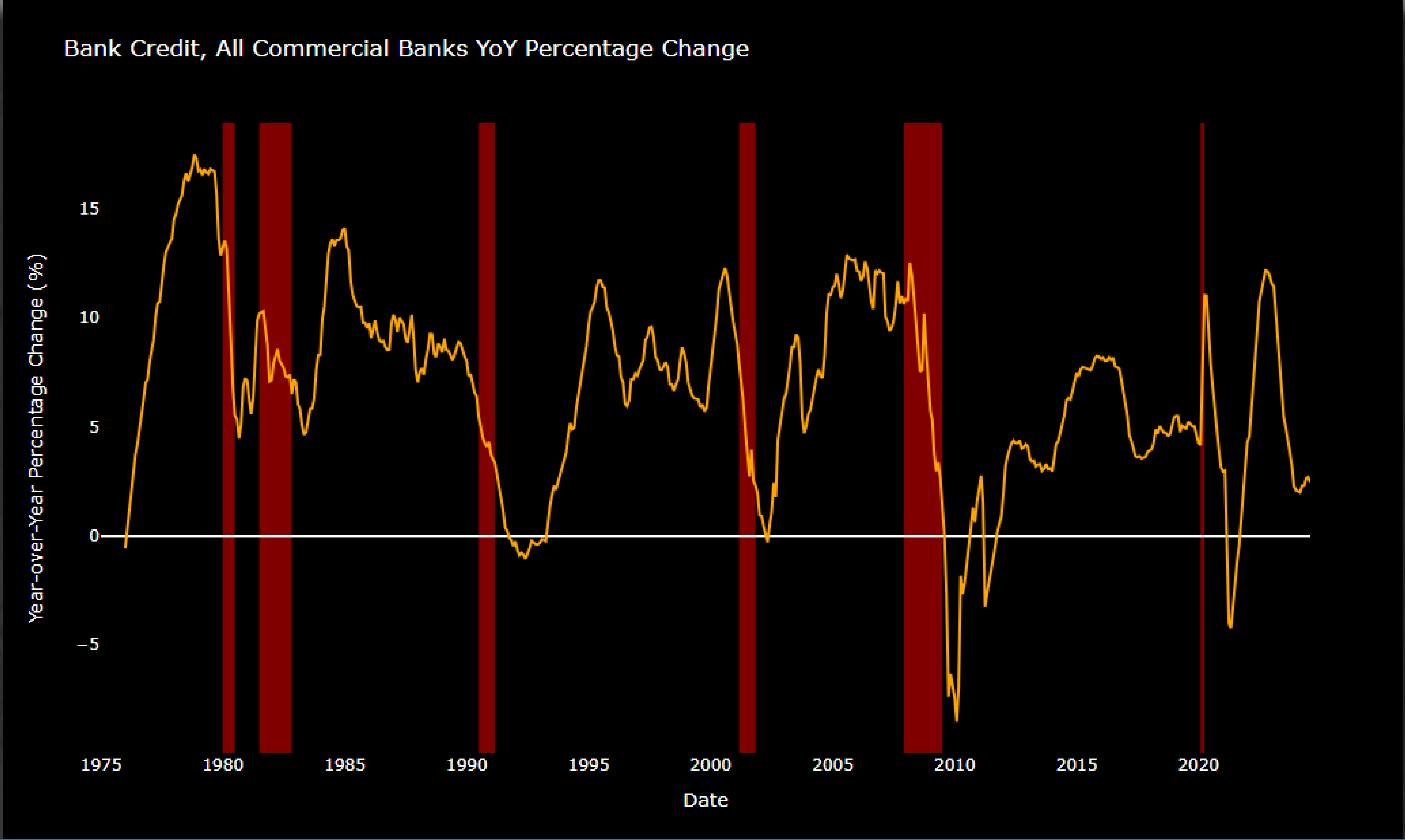
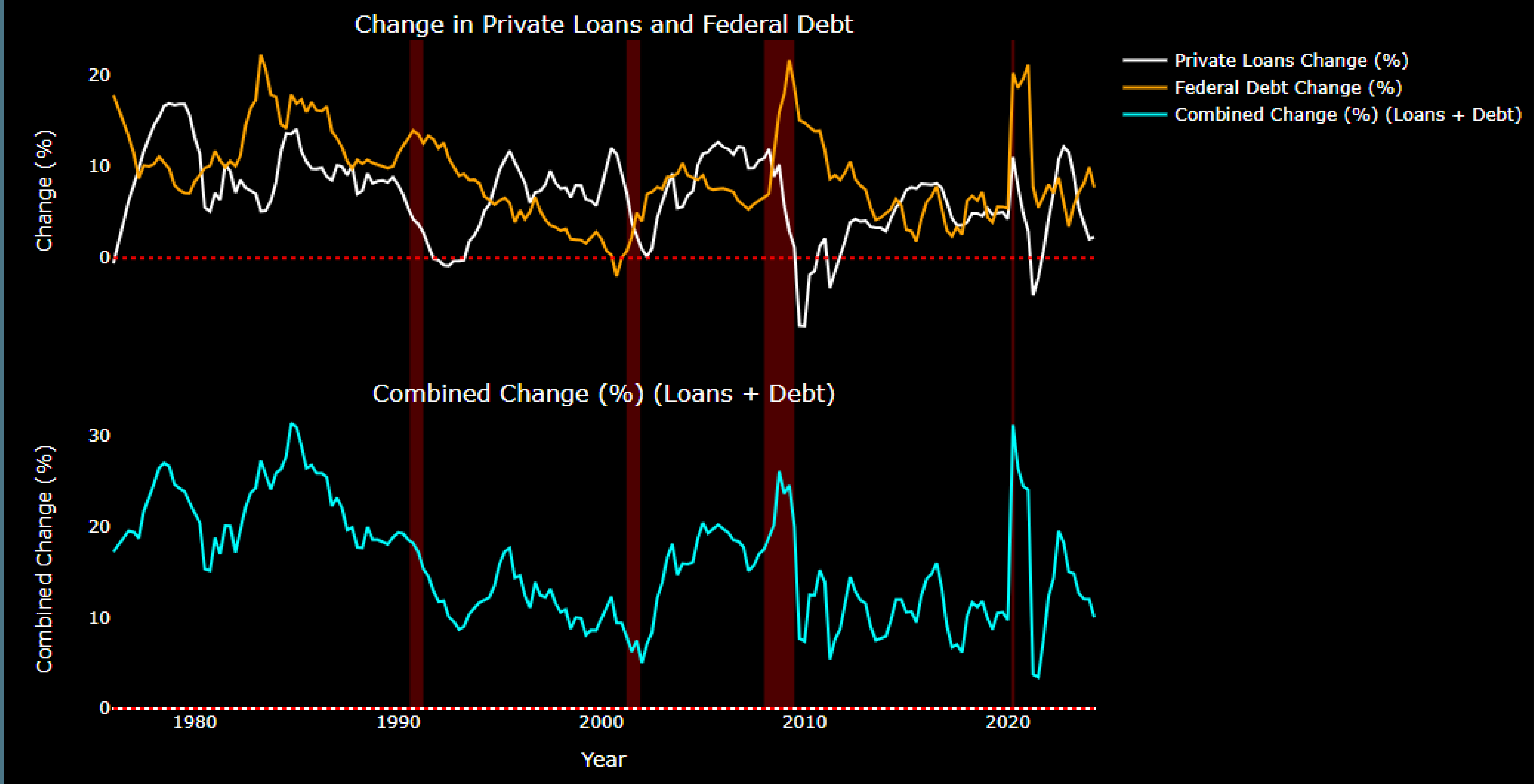


- Public debt year over year consistently rises during recessions but trends lower during periods of normalization. The rate of change has remained elevated post-pandemic, and it's important to note that this increase is occurring on a much larger nominal figure than we've experienced in the past.



- Bank credit has contracted since October of 2022, and this would normally precipitate a slowdown in the broader economy if it weren't for Government debt expansion.



- This combines both datasets, showing that the expansion of government debt has offset the contraction in private credit, preventing the overall credit contraction from being as severe.

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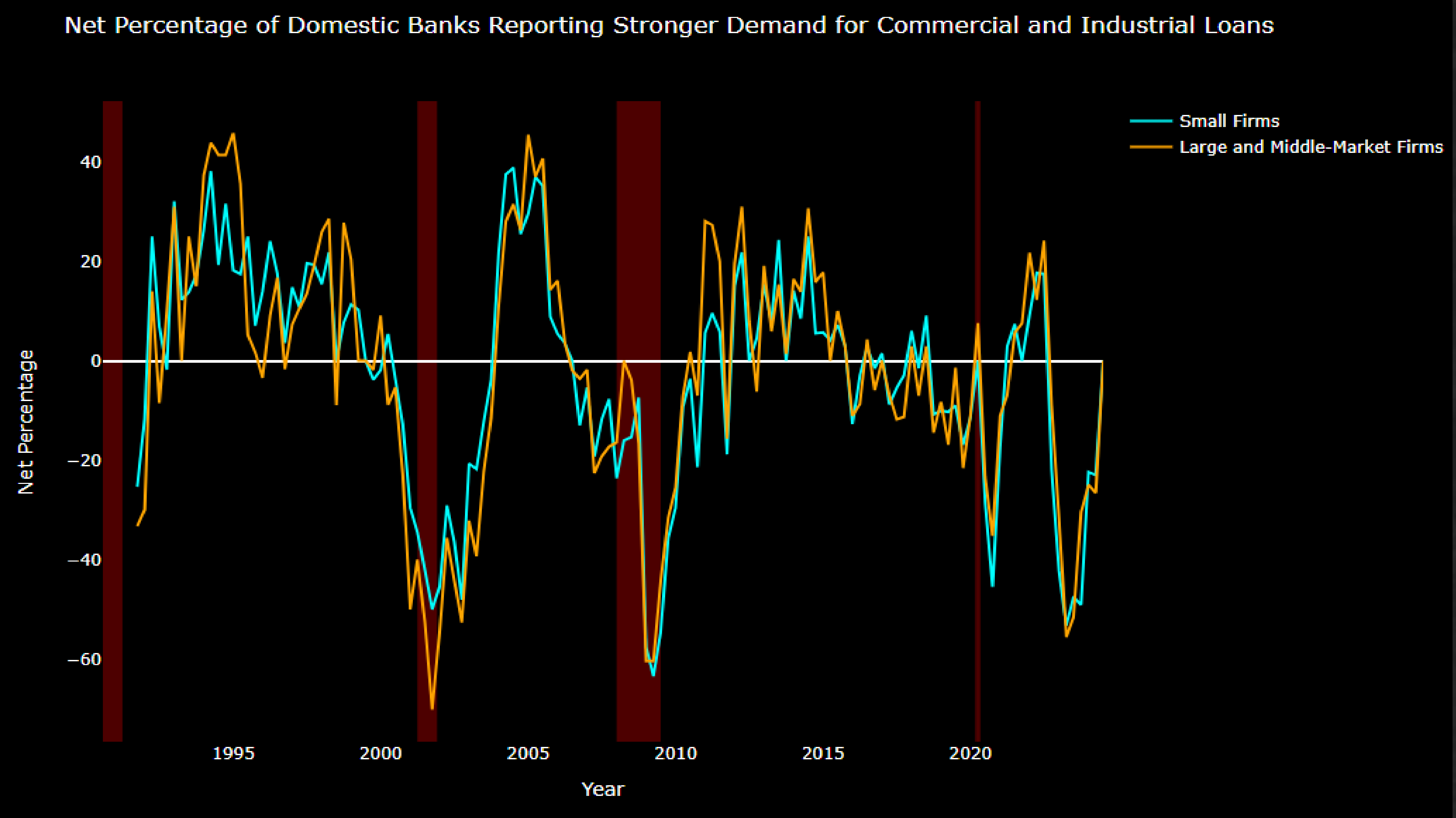
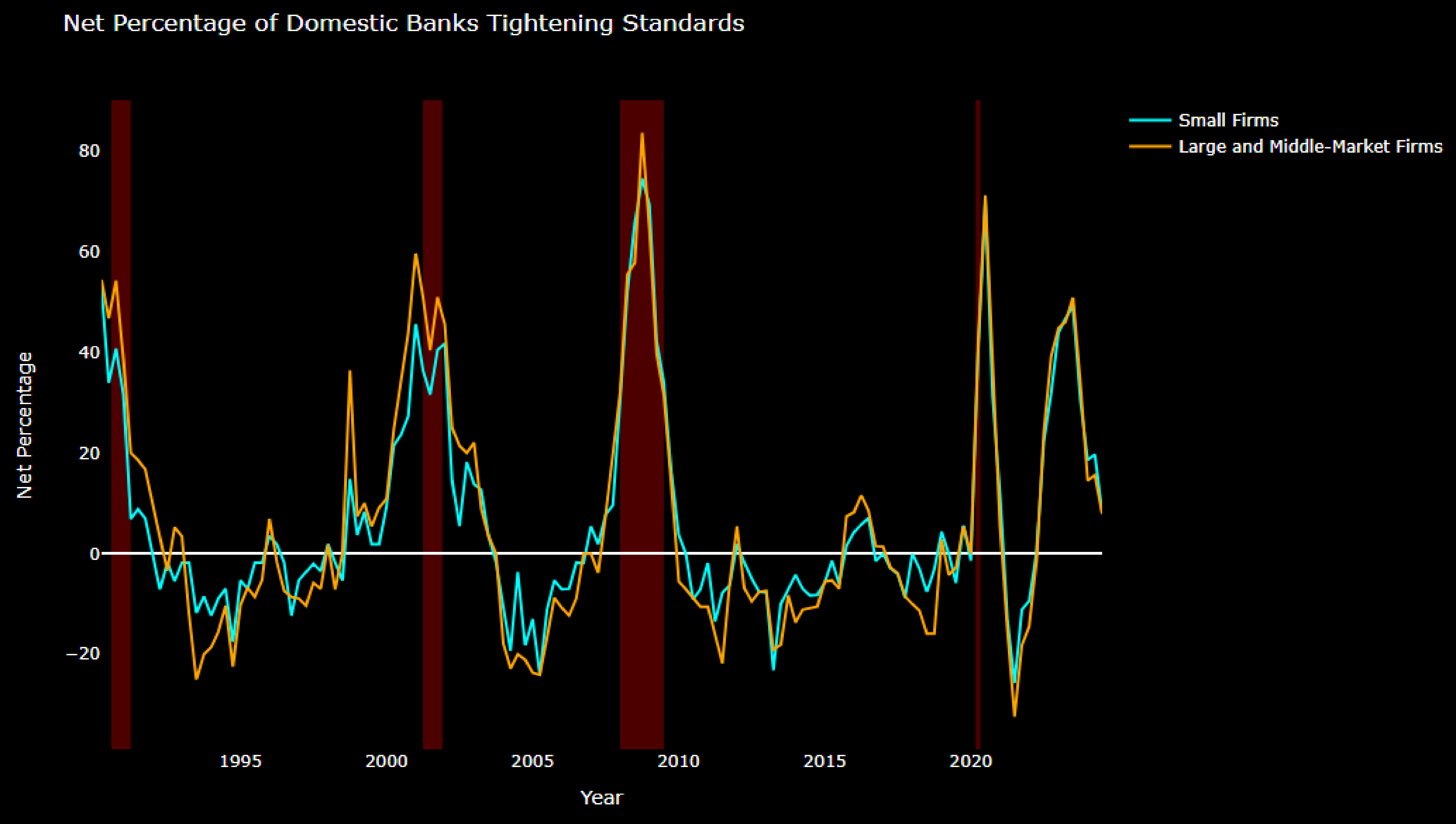
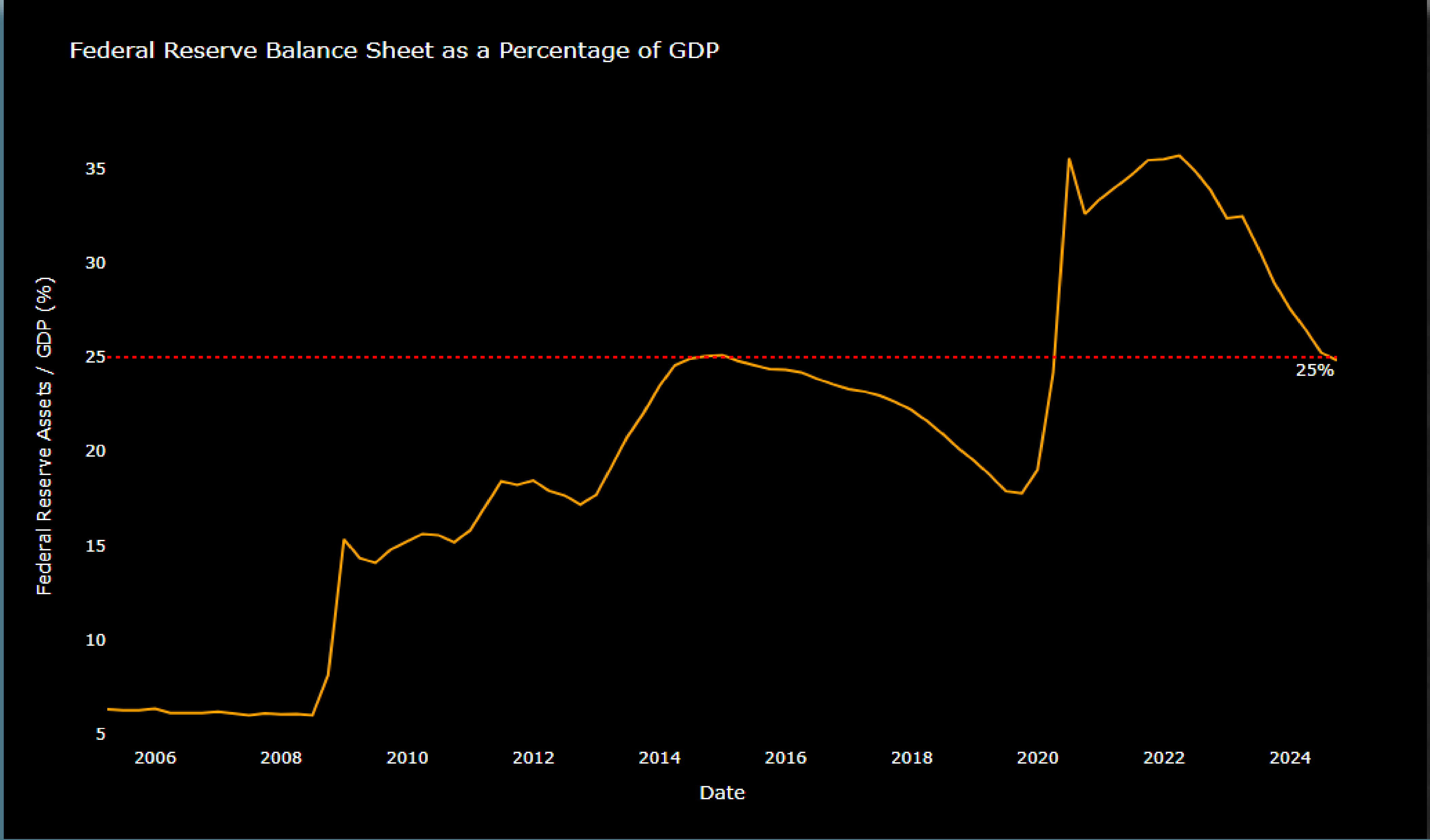


- Data from the Loan Officer Survey indicates that the net percentage of banks reporting stronger demand for loans is nearing positive territory once again. This follows a collapse in loan demand, which has historically signaled a recession the last three times it reached similar levels.



- Net percentage of banks tightening lending standards is also falling back to normalized levels. This too was in territory that would have traditionally meant recession back in 2022.



- Quantitative tightening has continued quietly at a pace of $25 billion per month in government securities and $35 billion per month in MBS. We've now reached a level, as a percentage of GDP, that matches the previous highs seen in 2014-2015. We anticipate that this runoff will begin to slow and likely come to a halt in the first half of next year.

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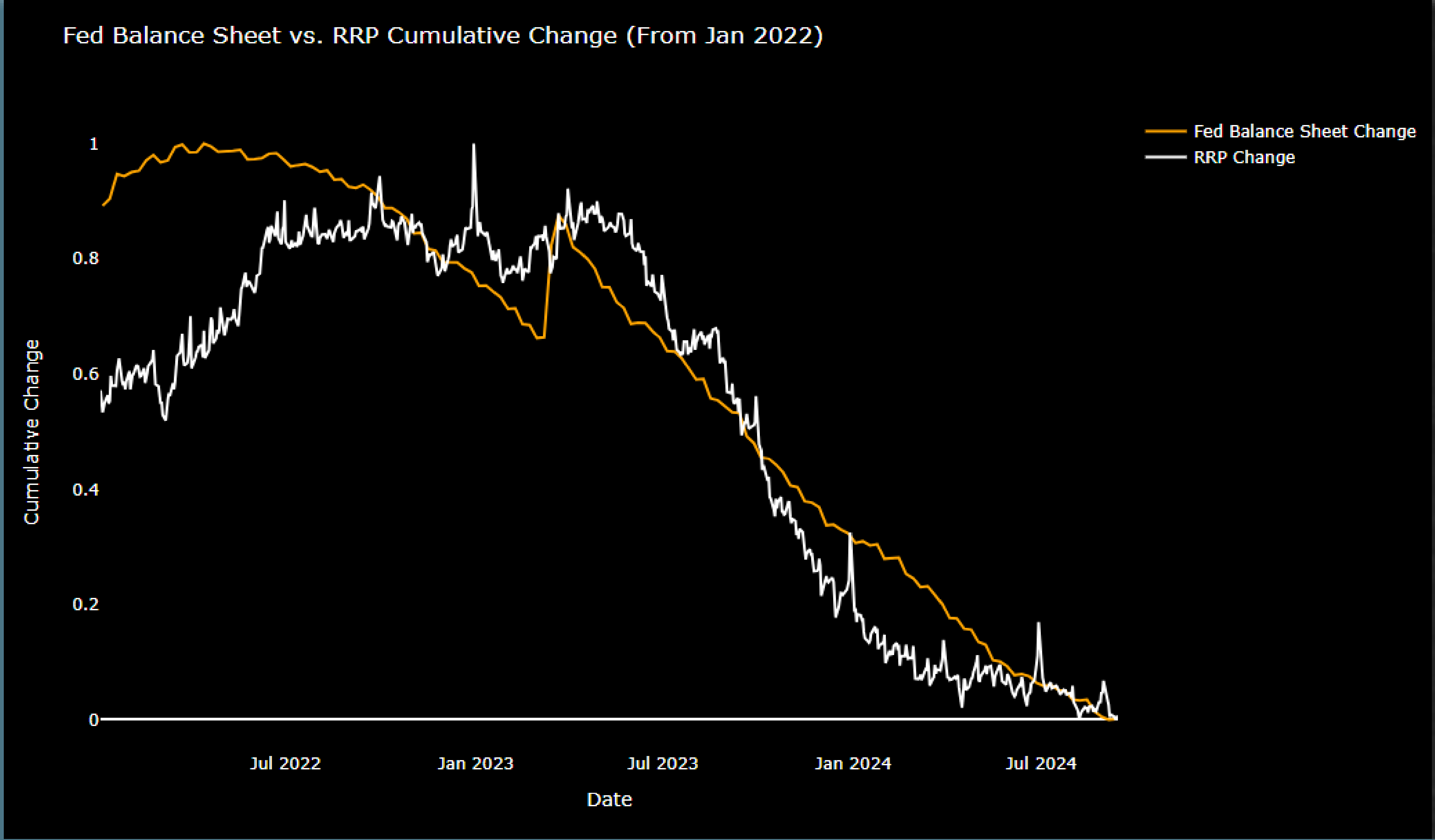
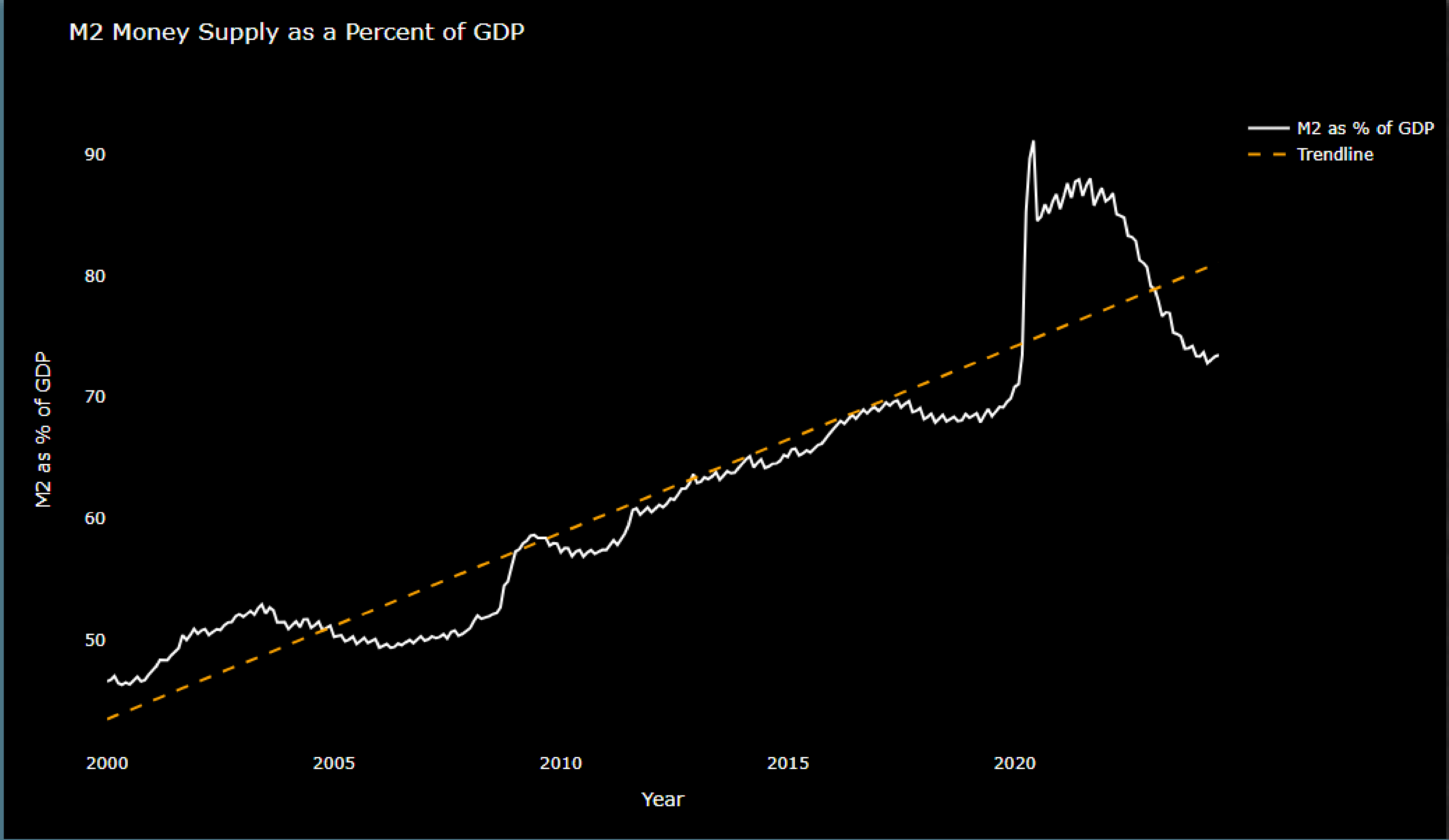


- The elevated issuance of debt from both the deficit and Fed Balance sheet runoff has drained the RRP. While not yet at concerning levels it plays a major role in how far the Fed will let QT keep running before deciding to begin buying back all securities that runoff the balance sheet.

- Janey Yellin's decision back in November of 2023 to pull issuance to the front end of the curve accelerated the drawdown in the RRP



- The decline in M2 on a year-over-year basis is noteworthy as it turned negative for the first time in decades, despite nominal levels remaining elevated due to pandemic-era liquidity injections. As a percentage of GDP, M2 is now back below its 20-year trend. Given that M2 captures money in checking and savings accounts, this decrease could begin to place stress on the banking sector and limit consumers' ability to spend, potentially slowing economic growth.

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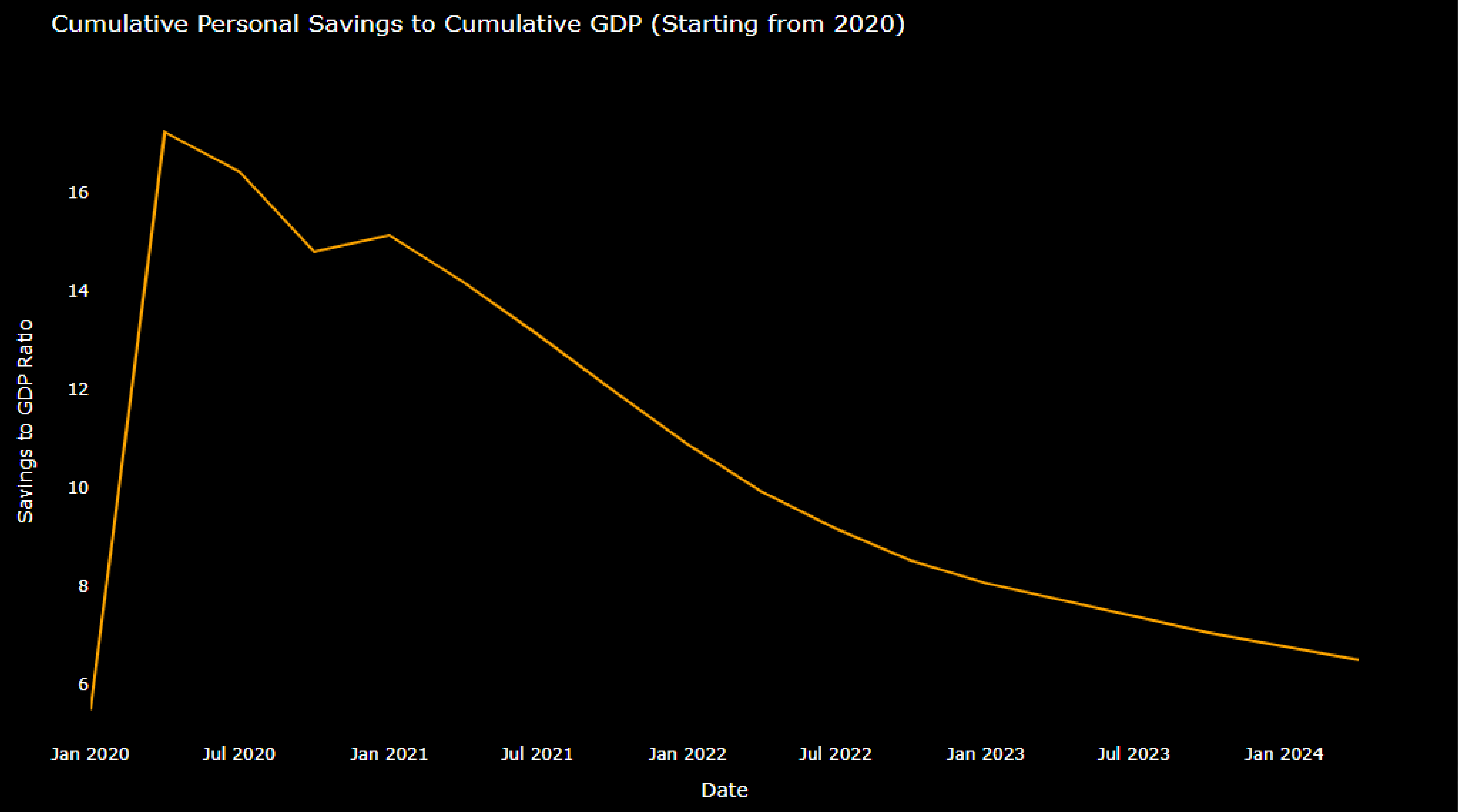
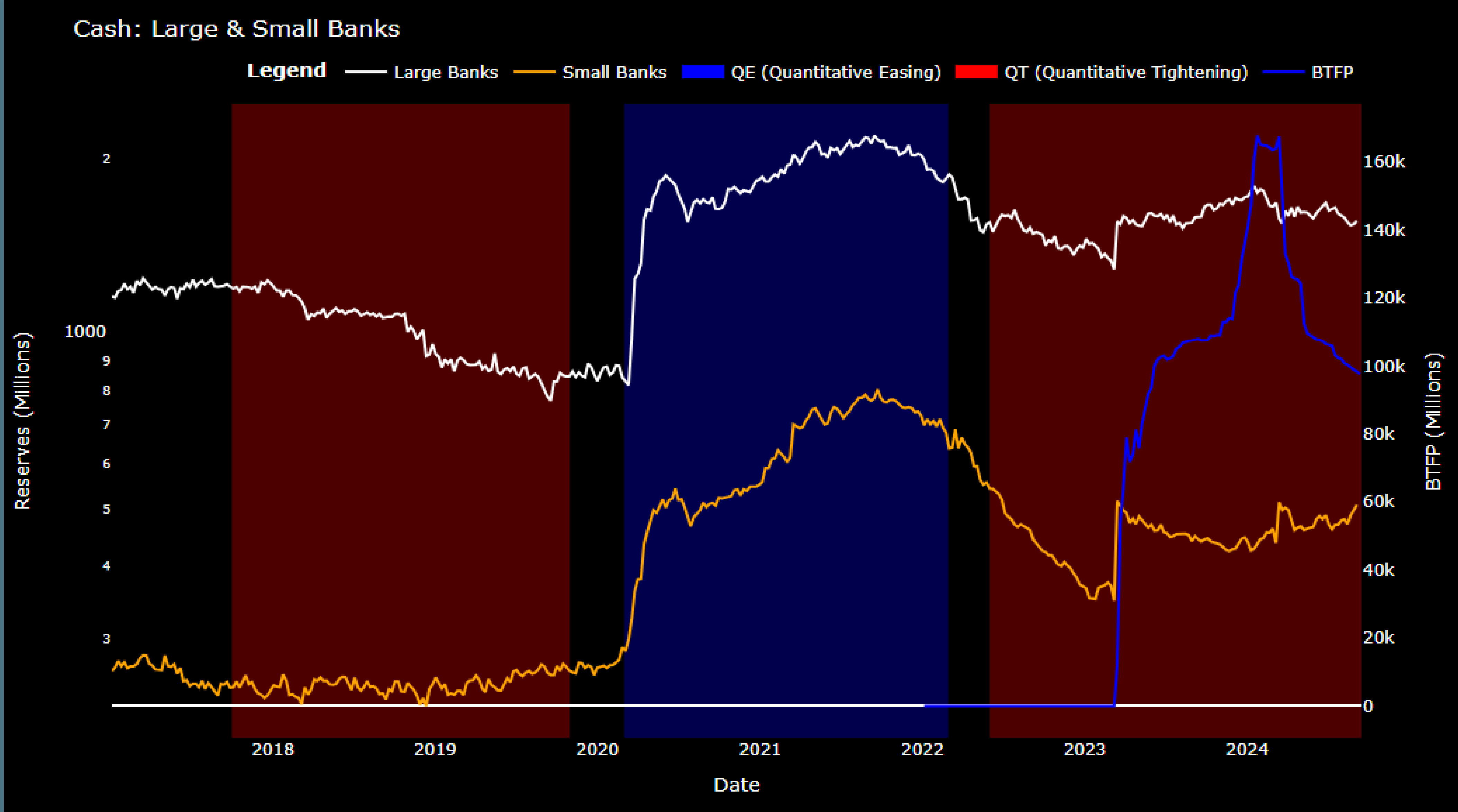
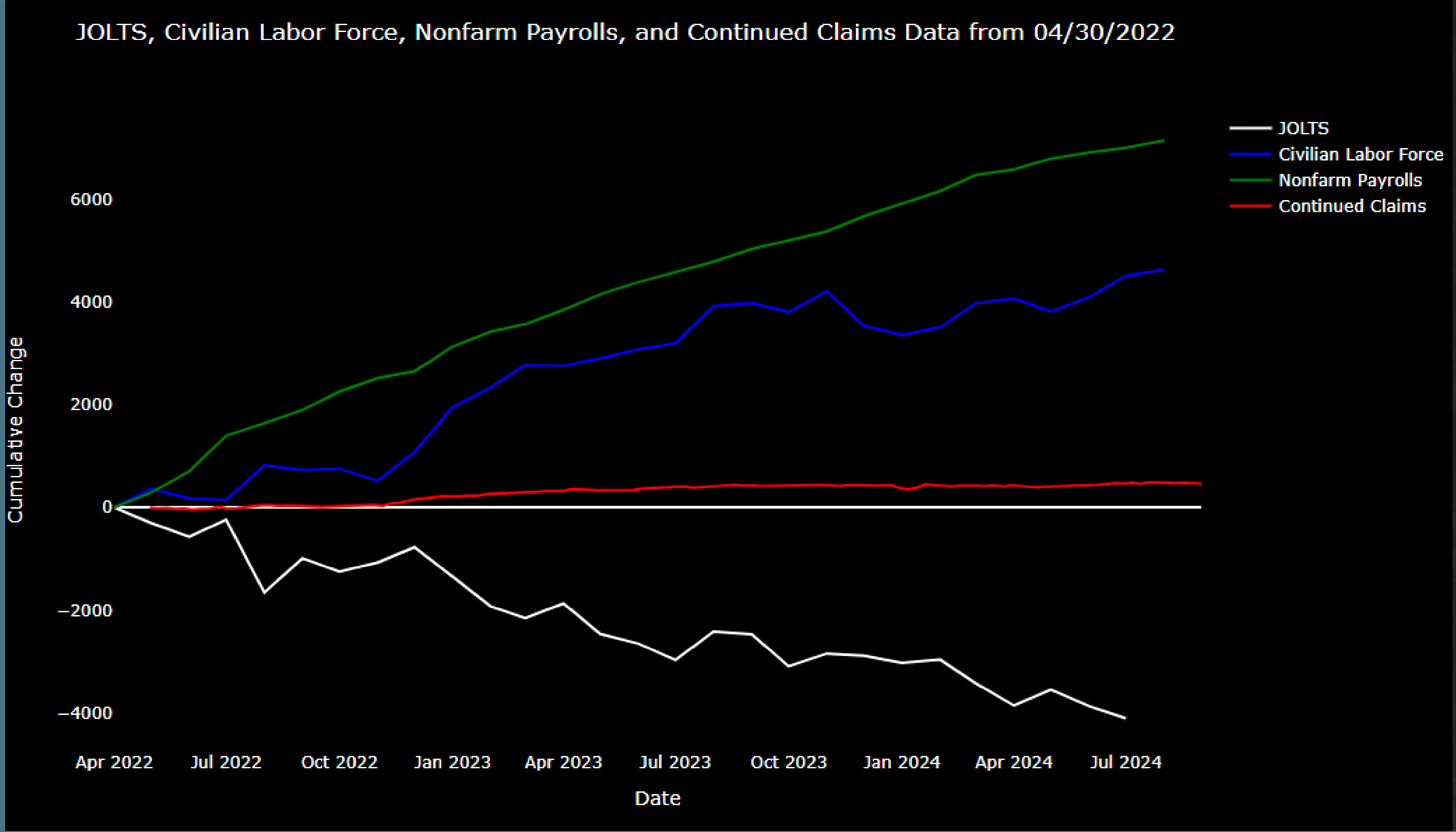


- The cumulative personal savings as a percentage of GDP has fallen back towards pre-pandemic levels, with the savings rate now at multi-decade lows around 3%. Historically, the average savings rate over the past 20 years has been closer to 6-8%.



- Quantitative tightening, the drawdown in reverse repo (RRP), and the normalization of M2 money supply have significantly impacted the cash levels on bank balance sheets. This vulnerability became evident during the banking crisis of March 2023, when the Fed had to inject liquidity by opening the Bank Term Funding Program to allow banks to exchange government securities for cash. While cash levels have since stabilized, the risk still persists.



- The labor market has remained resilient despite slowing job openings and a rising labor force. New entrants have been absorbed, and the supply/demand imbalance caused by the economic shutdown has helped create the capacity to integrate these new workers.

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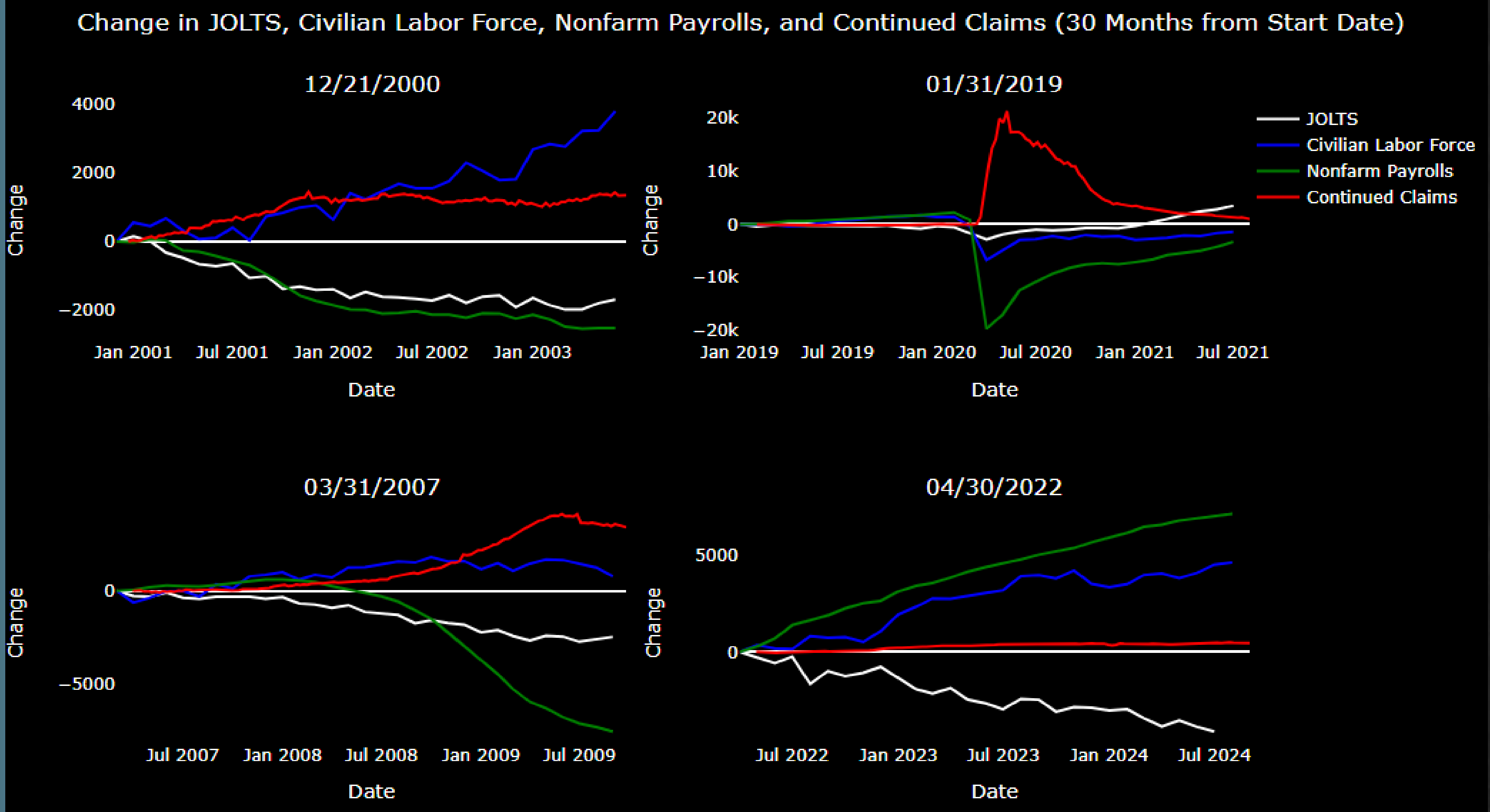

- Today's labor market does not yet resemble those of past recessions. In previous downturns, Nonfarm Payrolls went negative and continuing claims spiked, but so far, we’ve seen stabilization in continuing claims and downward revisions in Nonfarm Payrolls without any negative or sub-100K prints.

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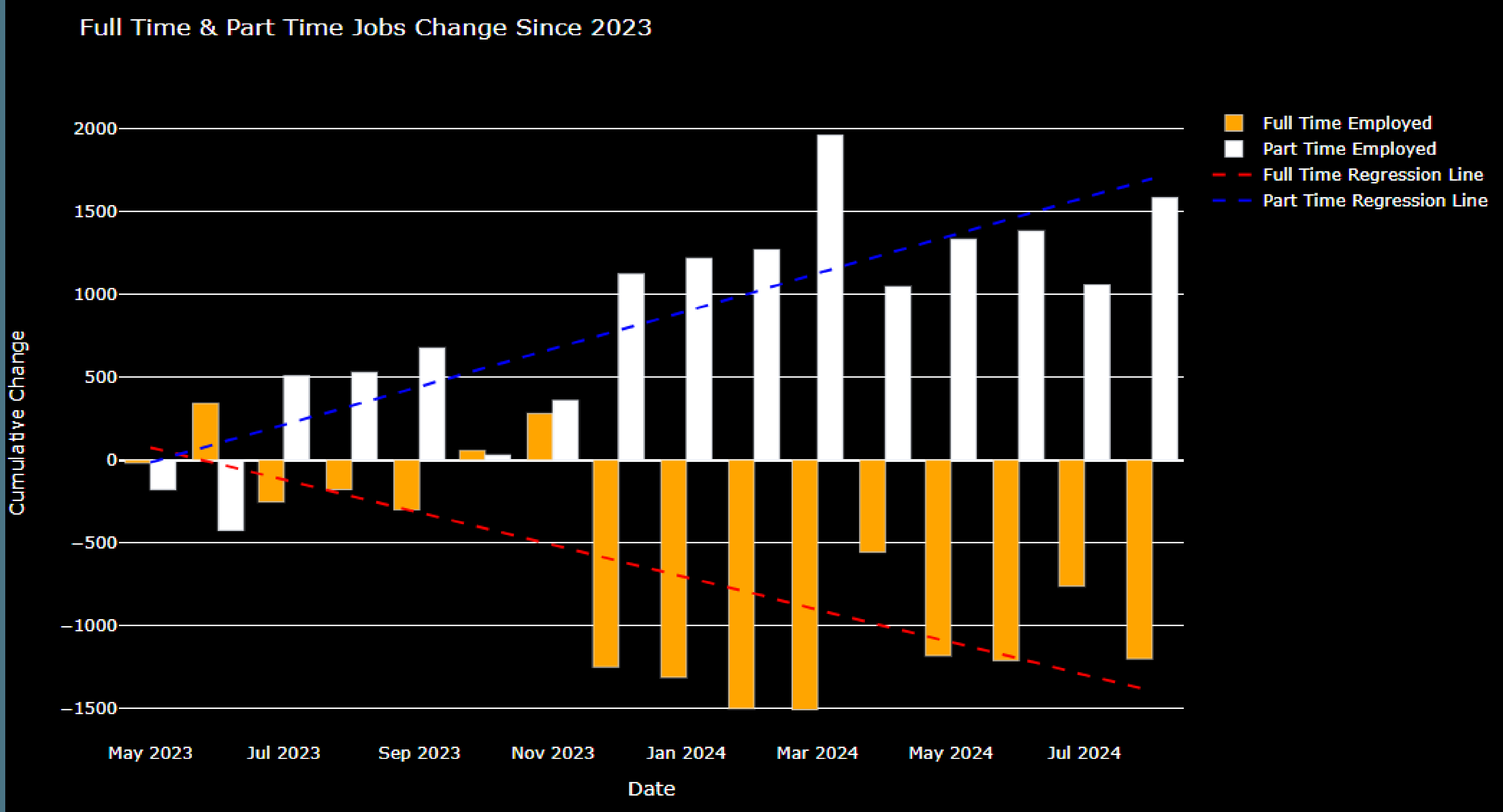

- There is no question that underlying weakness exists in the types of jobs being secured. Since May 2023, part-time jobs have increased by over 1.5 million, while full-time jobs have decreased by just over 1.2 million.

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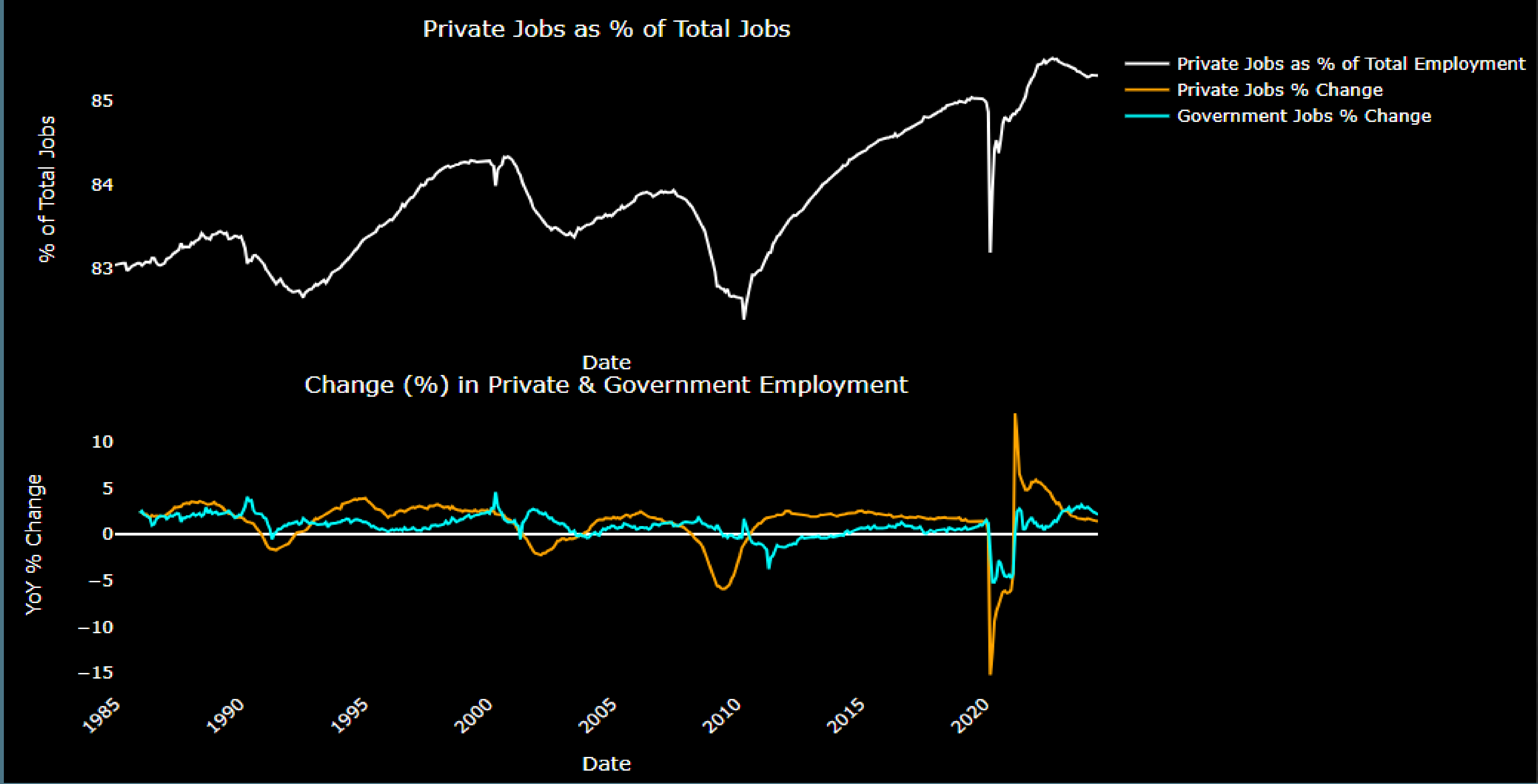
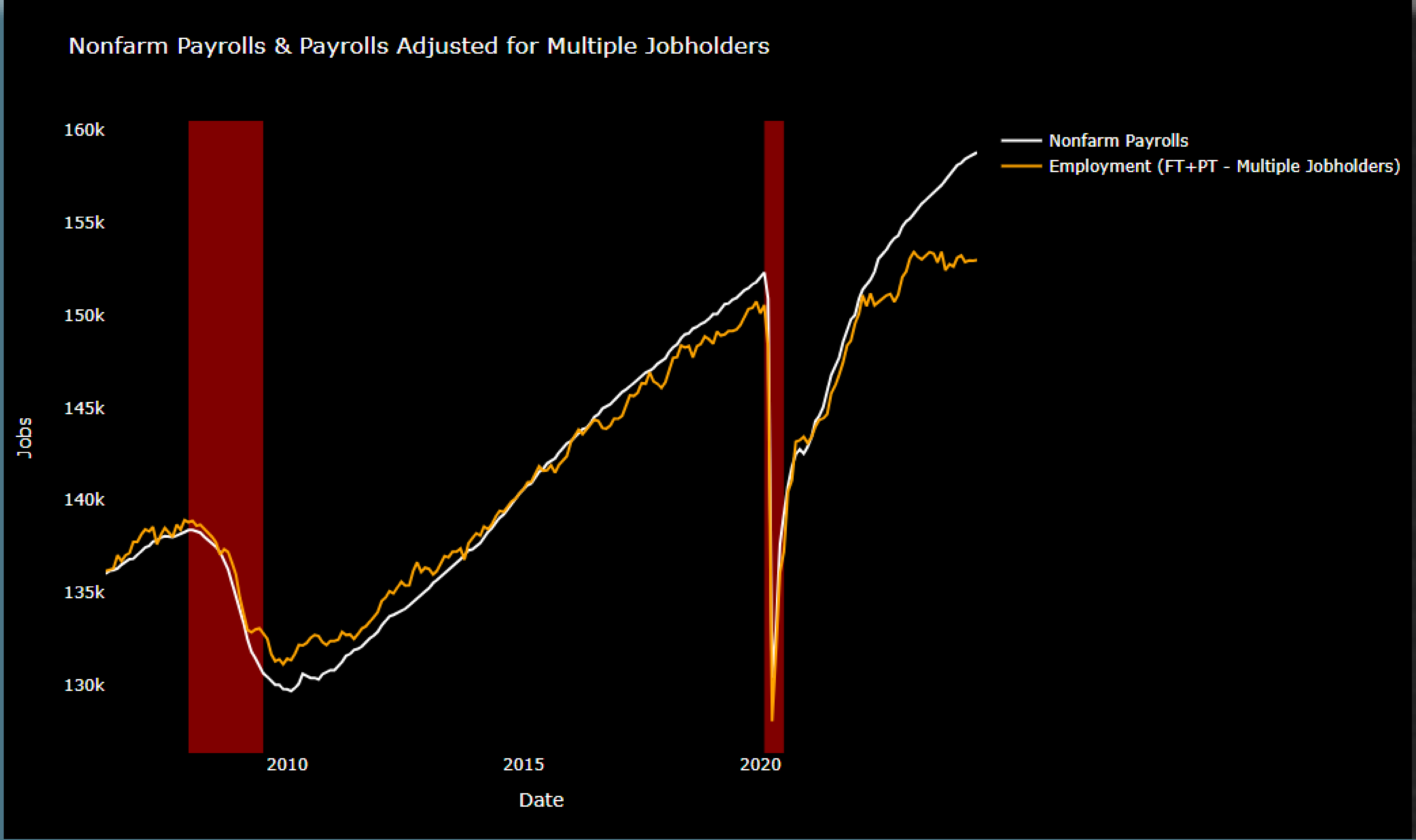


- Private sector jobs as a percentage of total jobs have trended lower over the past few years, with government hiring outpacing private sector hiring, accounting for over 50% of recent job gains.



- Nonfarm Payrolls double-count individuals working multiple jobs. If we adjust for this, employment has been flat for over a year and remains more than 6 million below the total reported by Nonfarm Payrolls.

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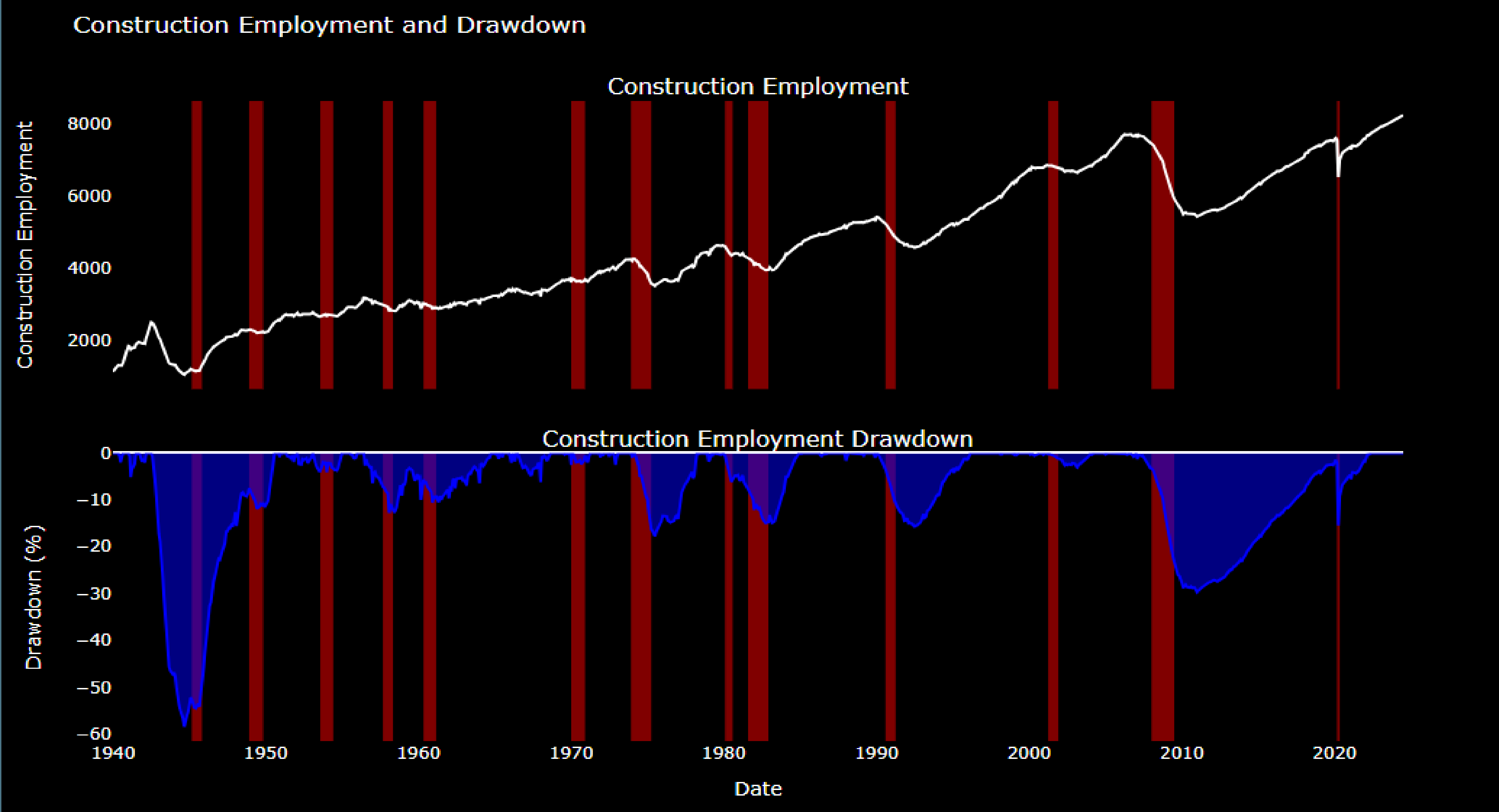
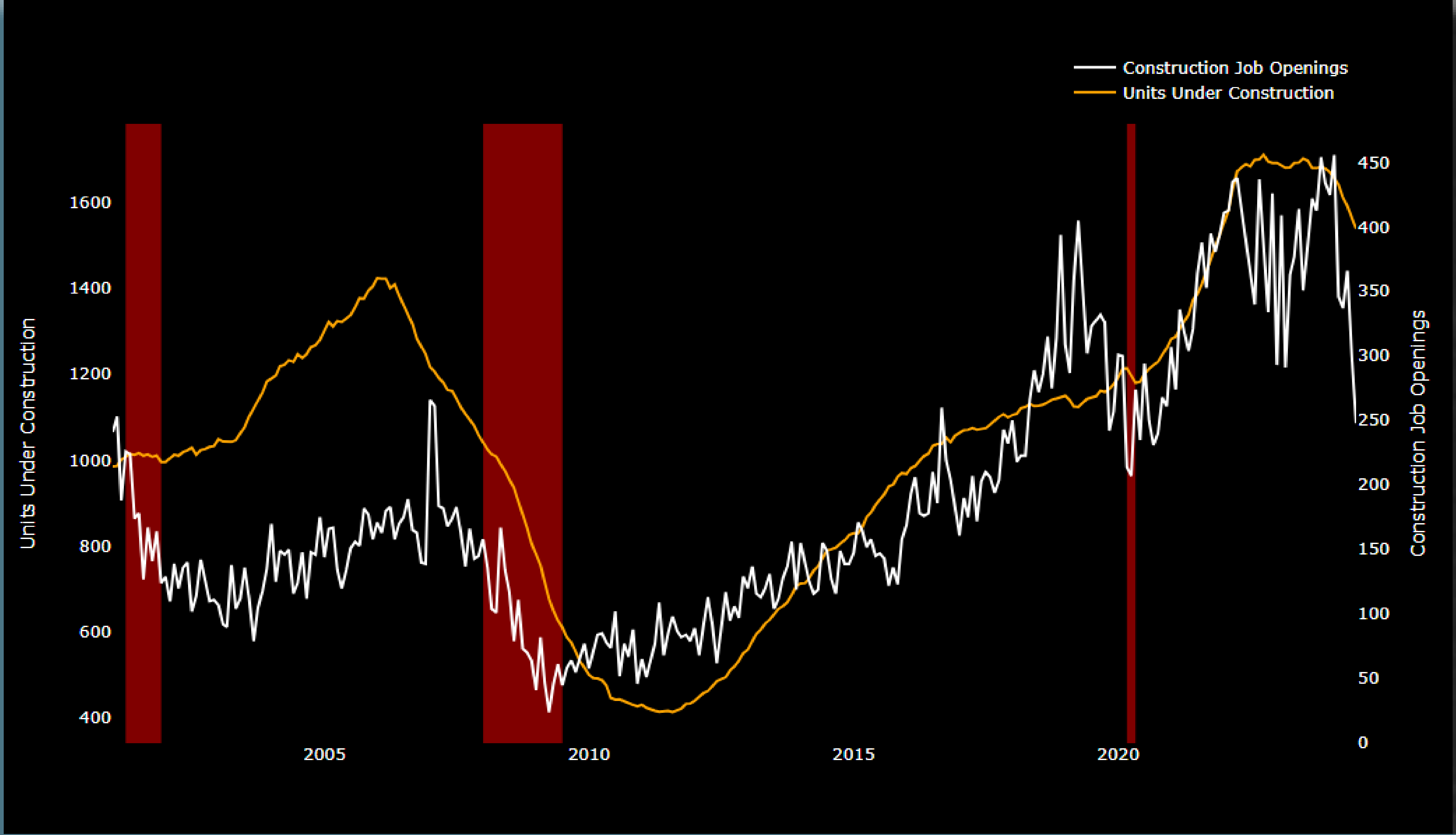


- Construction Employment is still our key indicator to watch if you're positioning for a recession. We continue to see positive payroll numbers in the sector, and until there is an 8-10% drawdown, we don't believe we're in recessionary territory. The economy is clearly slowing but not yet recessionary.



- To continue on the theme of construction employment, job openings in the sector have plummeted over the last few months. This is a leading indicator for Units Under Construction. As fewer units are being built, fewer construction employees are needed, which would create the type of downturn in the sector we are monitoring.

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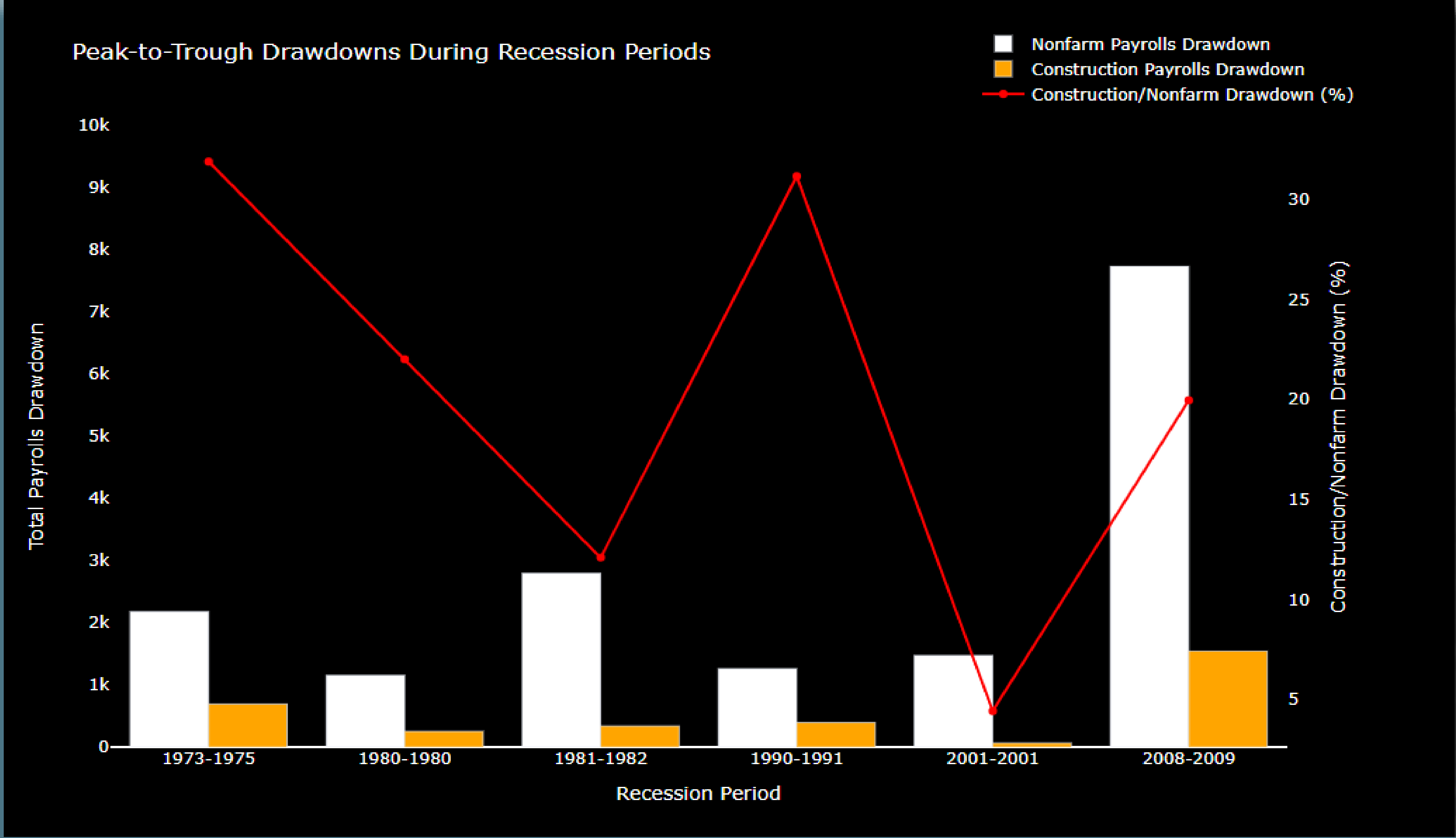

- During recessions dating back to the 1970s, construction employment has accounted for over 10-15% of total jobs lost in every instance except the 2000s recession, despite making up only 3-5% of total employment in the economy.

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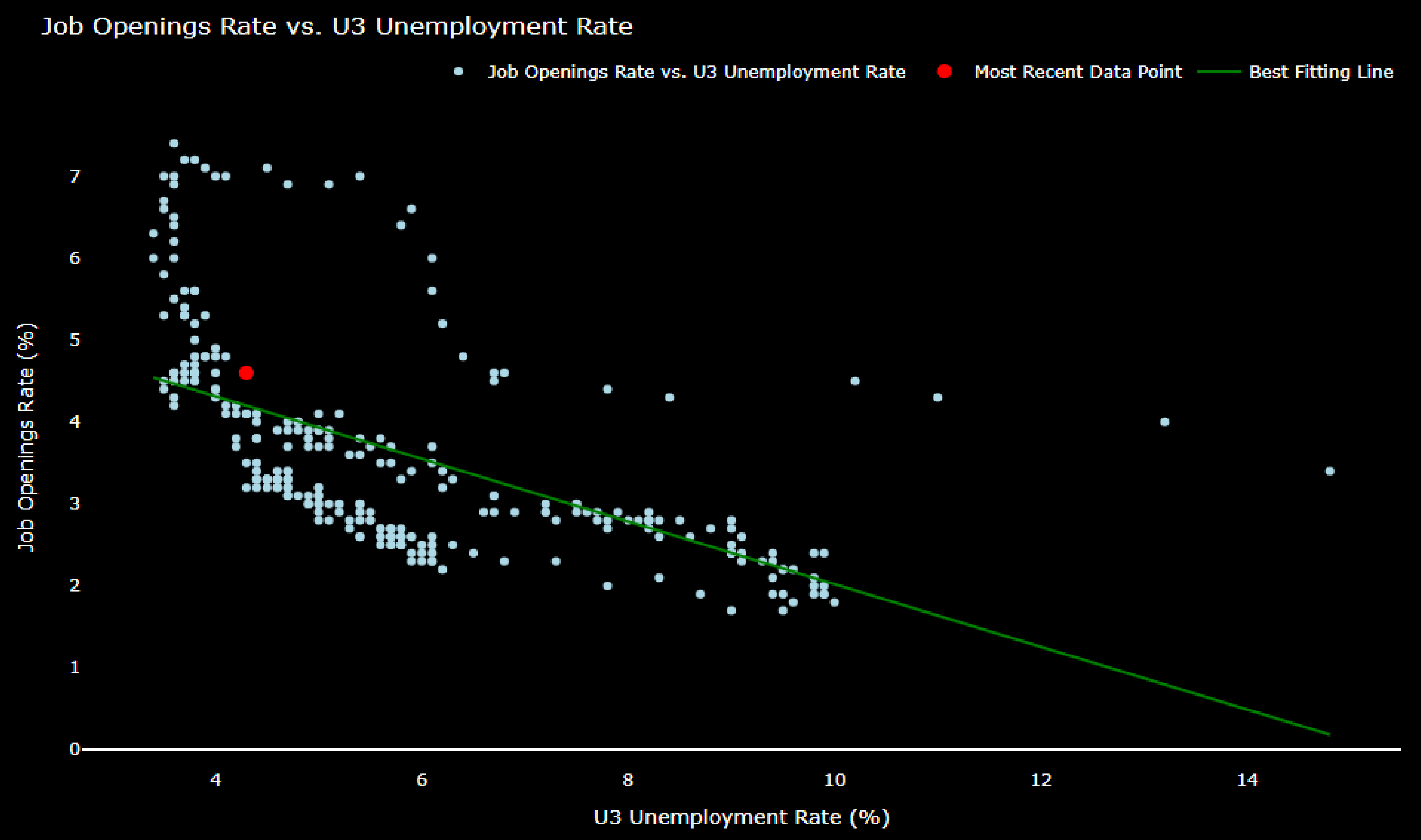

- Jerome Powell, in his recent speech, highlighted that the Federal Reserve does not seek or welcome further cooling of the labor market. The Beveridge Curve supports Powell's sentiment, indicating that historically, a further decline in job openings has been associated with rising unemployment rates.

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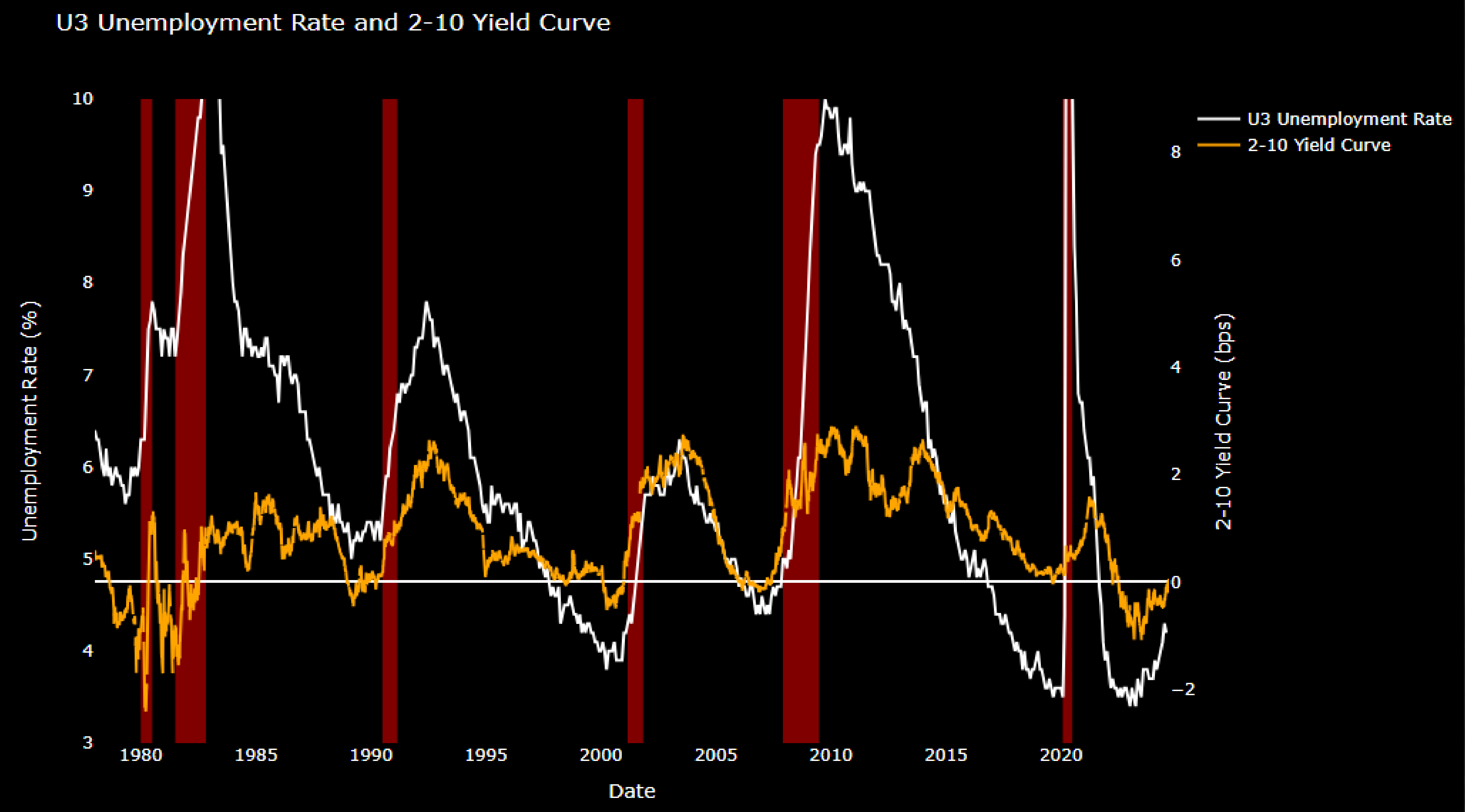

- The Yield Curve remains a significant topic of discussion, particularly as it un-inverts. Historically, unemployment tends to rise after these inversions, and while some might see the current un-inversion as a positive signal, it's essential to remain cautious. Declaring victory may be premature, as previous instances of un-inversion have often signaled more challenges ahead, particularly regarding labor markets.

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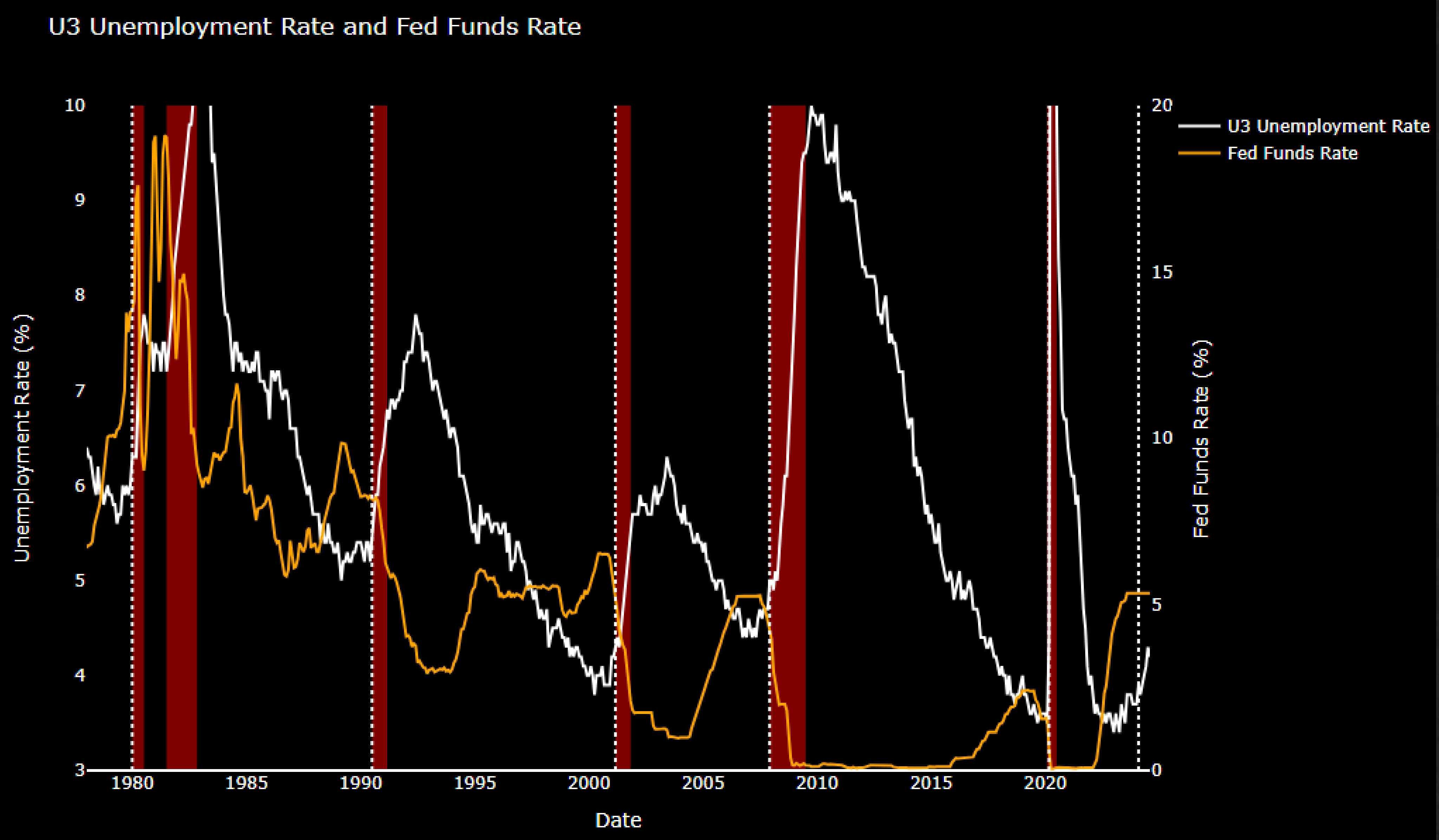
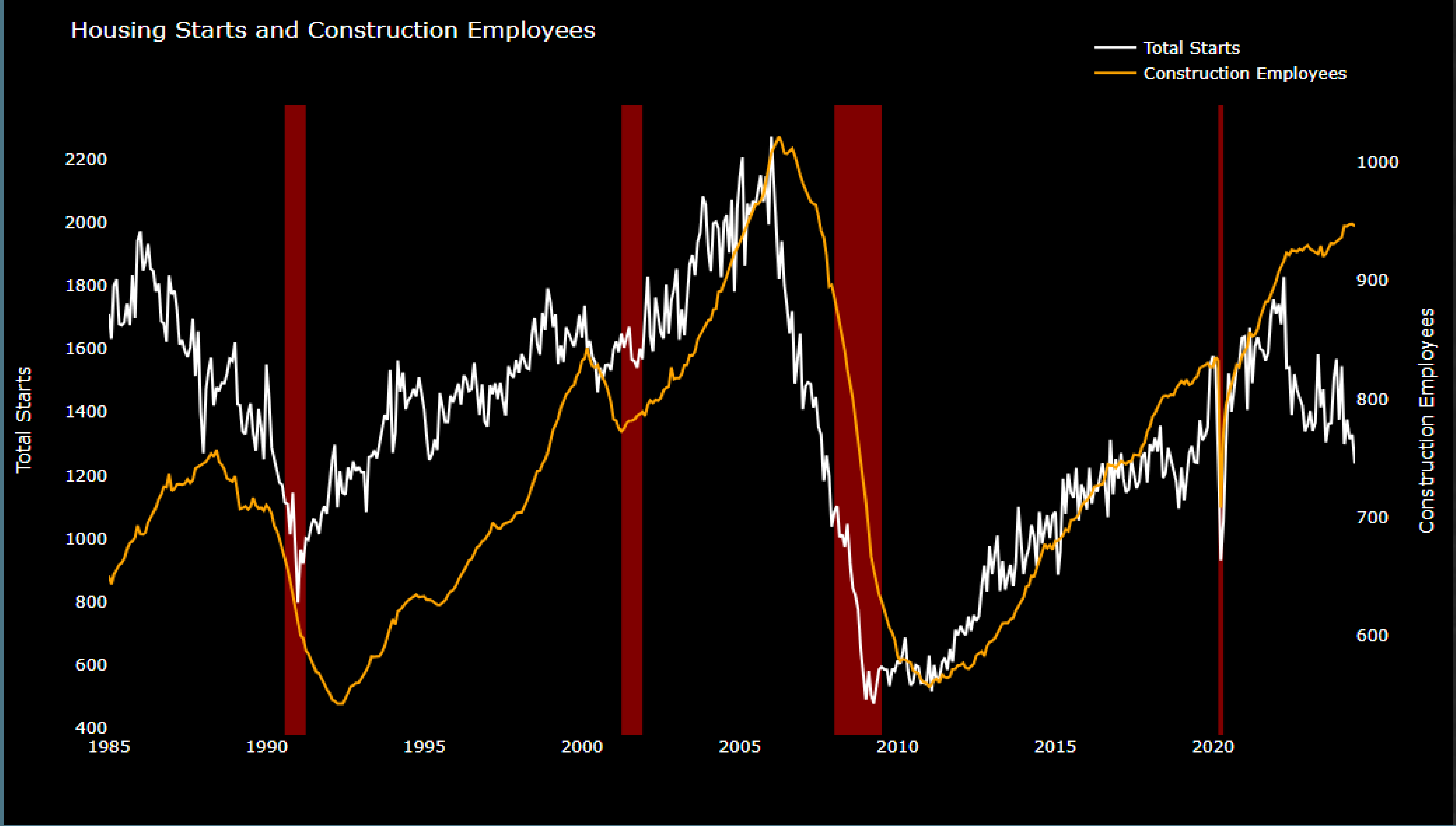
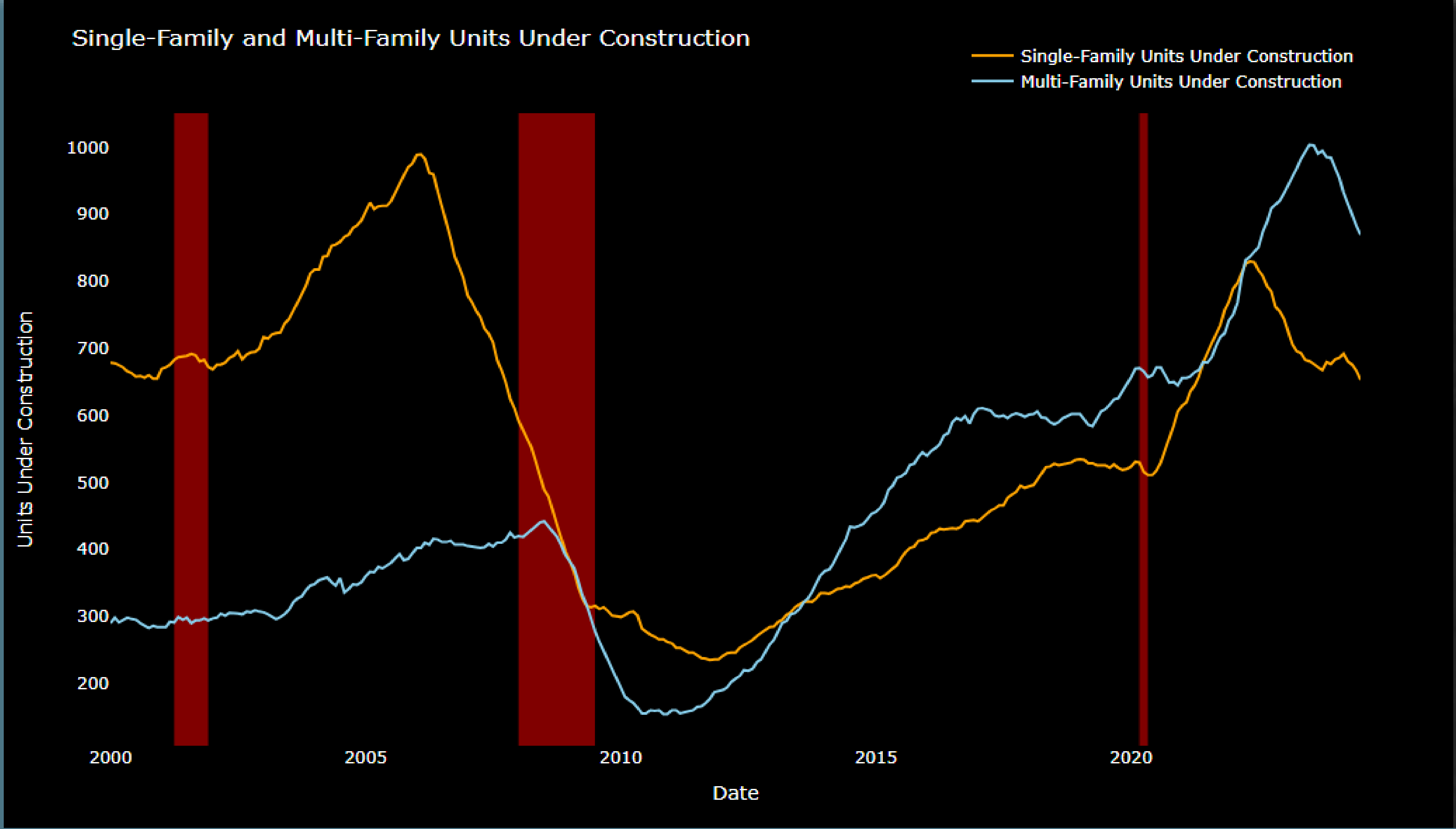


- The white vertical lines on this chart signify a 50 basis point rise in the U-3 unemployment rate from its trough. All of these instances occur at the beginning of a Fed cutting cycle and in all the Fed was behind the curve.

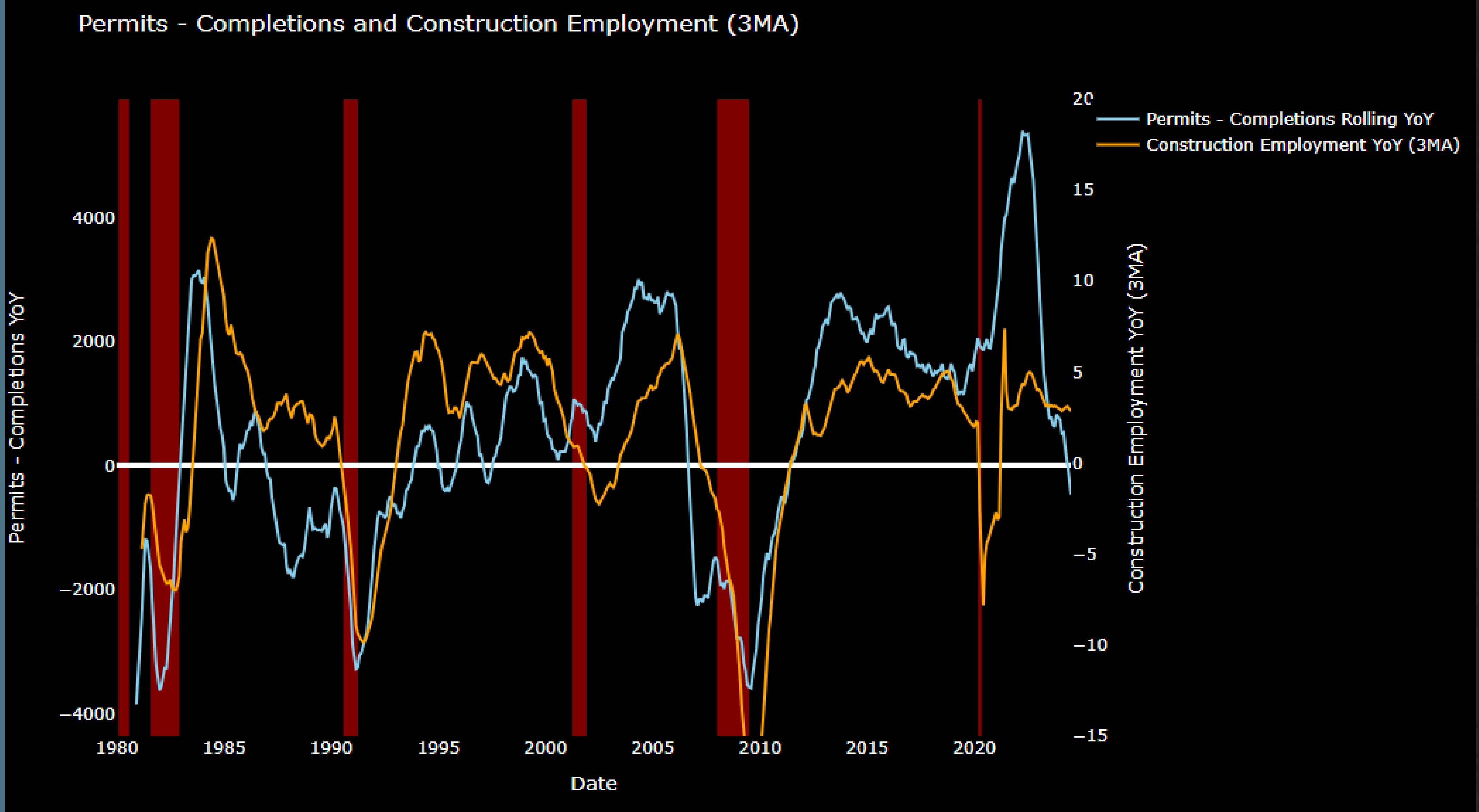
- The latest SEP from the Federal Reserve forecasts the U-3 Rate to peak at 4.4% in 2025. We have never had an instance of 100 bps rise in unemployment while also avoiding a recession



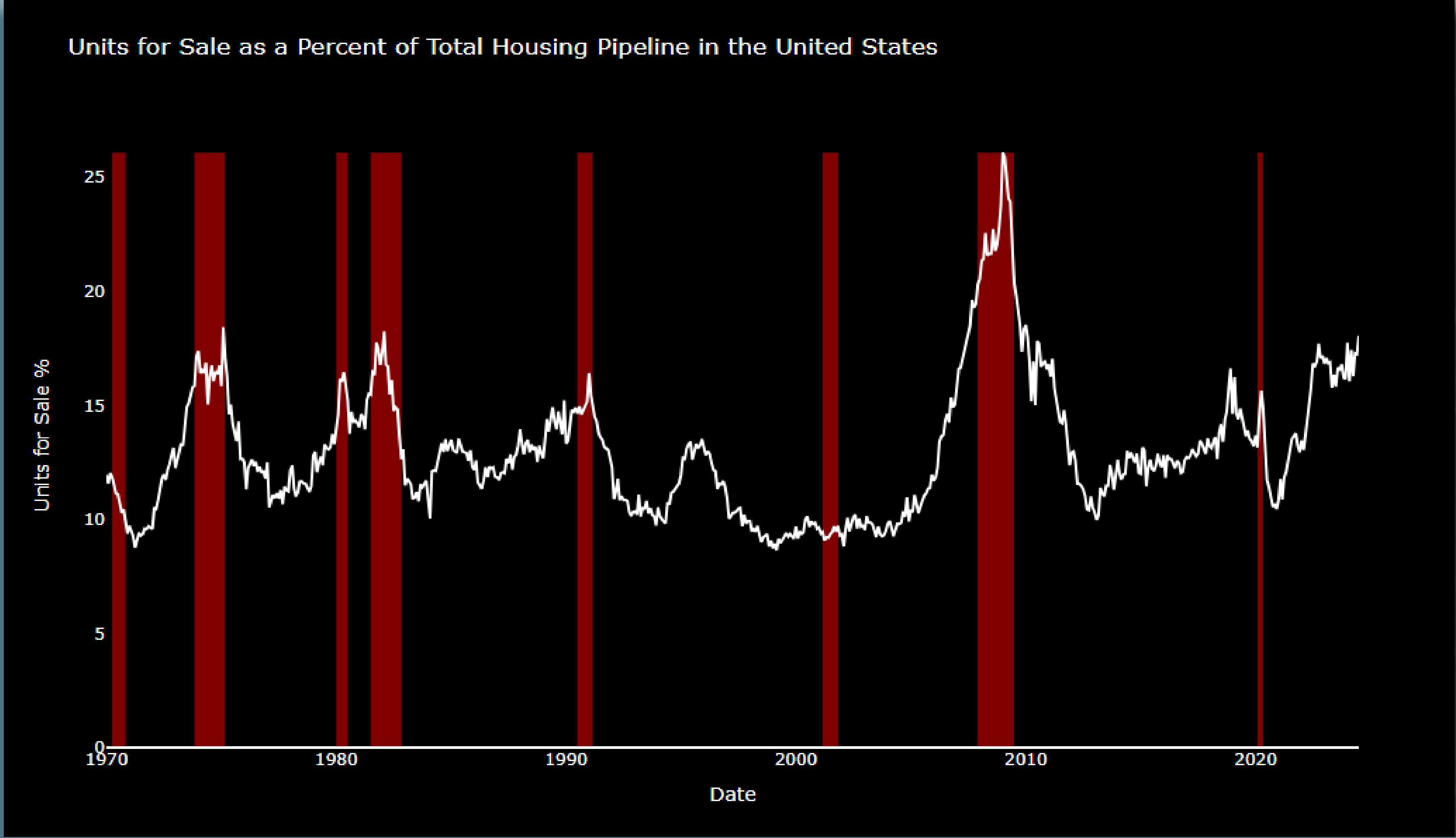
- Construction employment has remained resilient throughout this cycle so far, despite early signs of stress in leading indicators such as housing starts, which have begun to decline sharply. The concern is that as housing projects near completion, and with fewer new developments in the pipeline, the construction industry workforce may soon face a slowdown in job creation as demand for new labor decreases



- Both single-family and multi-family units under construction have now peaked and begun to decline. Earlier in the year, an increase in single-family construction raised the possibility that it could offset the decline in multi-family projects. However, with both segments now falling simultaneously, the industry faces a greater challenge. To navigate towards a soft landing, lower mortgage rates, currently just above 6%, will be necessary to help revitalize demand.



- This chart illustrates the relationship between housing activity and employment, using the metric of permits minus completions. As housing completions increase and fewer new homes enter the pipeline due to declining permits, the pressure builds on the construction workforce, eventually leading to a decline in construction employment.



- Consistent with the previous charts, units for sale as a percentage of total housing units in the pipeline—denoted by permits, housing starts, units under construction, and completed units—typically increase late in the economic cycle.

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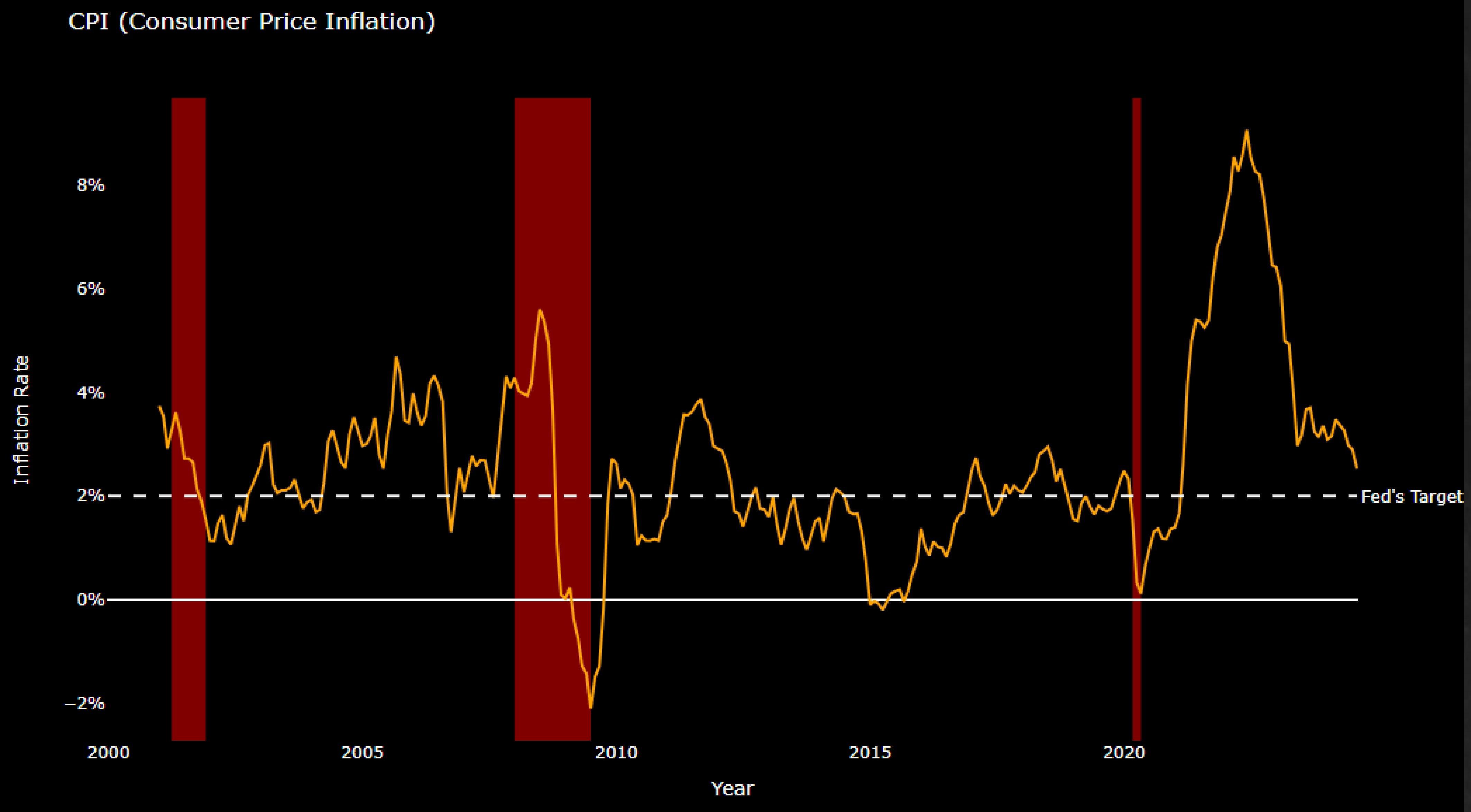
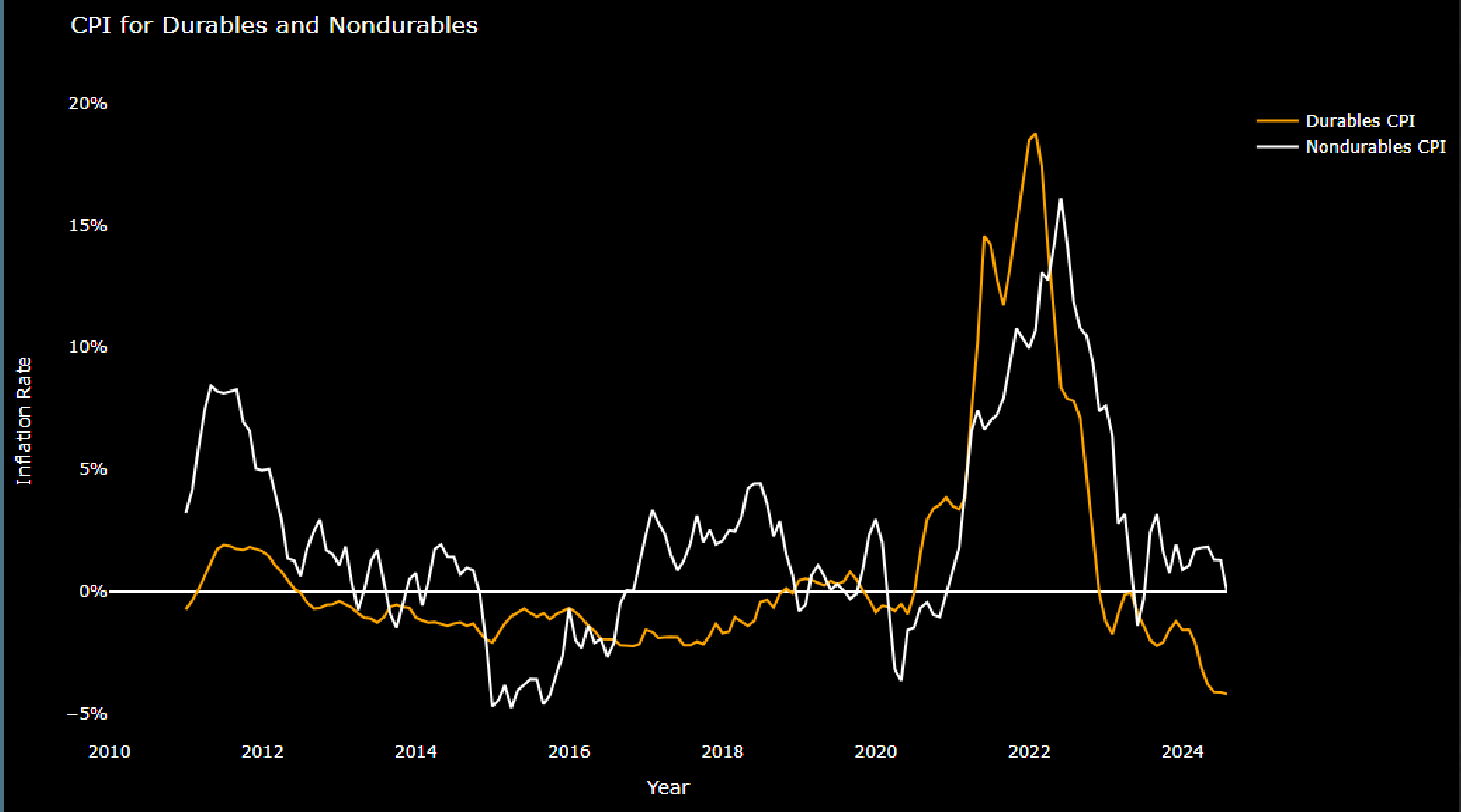


- The Fed has shifted from a focus on their price stability mandate, to a dual mandate and now to a focus on the labor market.
- The 50 basis point rate cut this month can be seen as a victory lap on inflation, even as it remains at 2.6%. In his speech, Powell emphasized that the Fed expects inflation to continue trending lower and views deflation as a greater concern at this point than inflation moving higher



- The goods sector has played a significant role in guiding inflation lower, with durable goods prices deflating by around 4% year-over-year. Economic struggles in China have led to a situation where they are exporting excess capacity globally. While this results in cheaper goods and adds a headwind to inflation, it also places domestic businesses at risk, as demand increasingly shifts toward imports.

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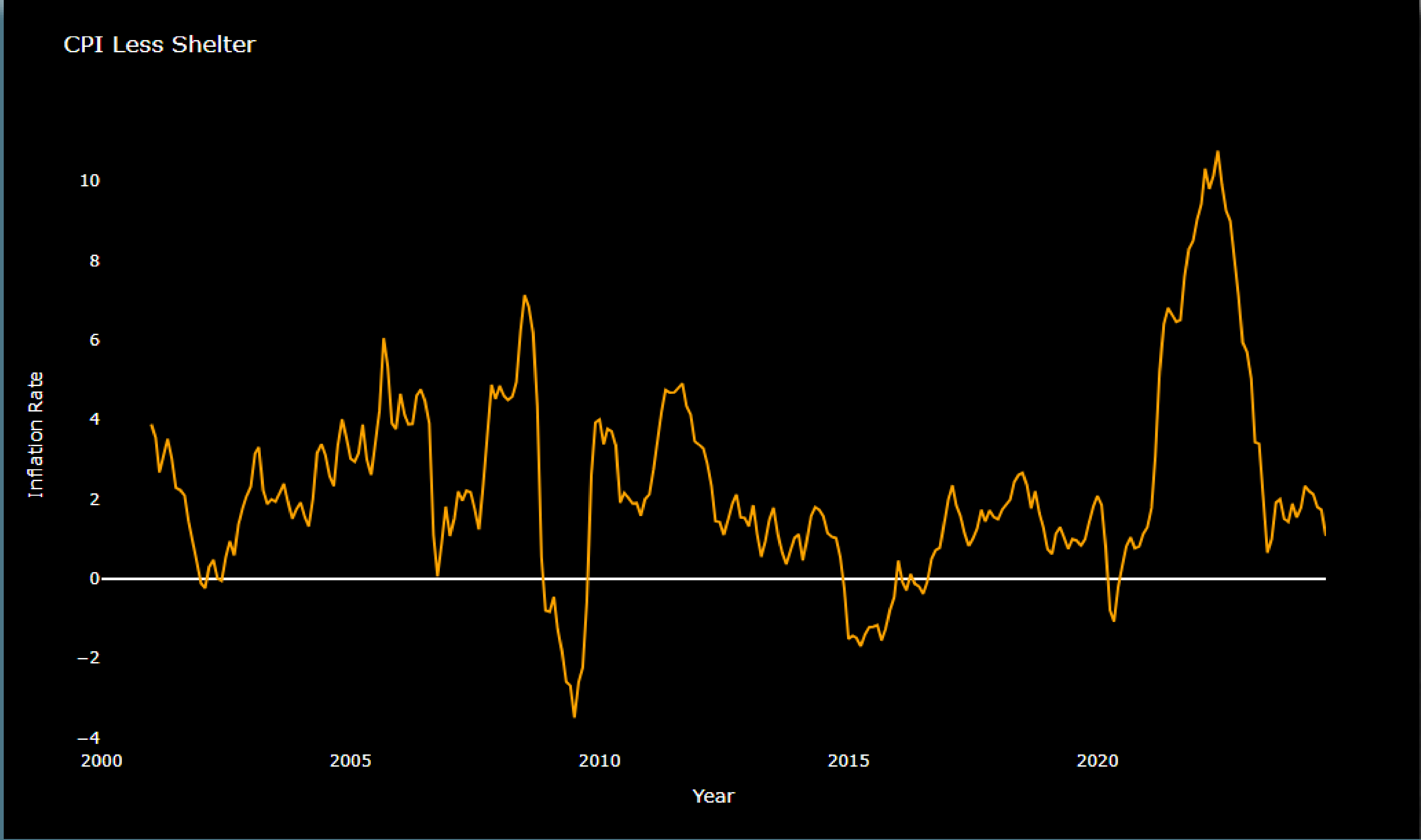
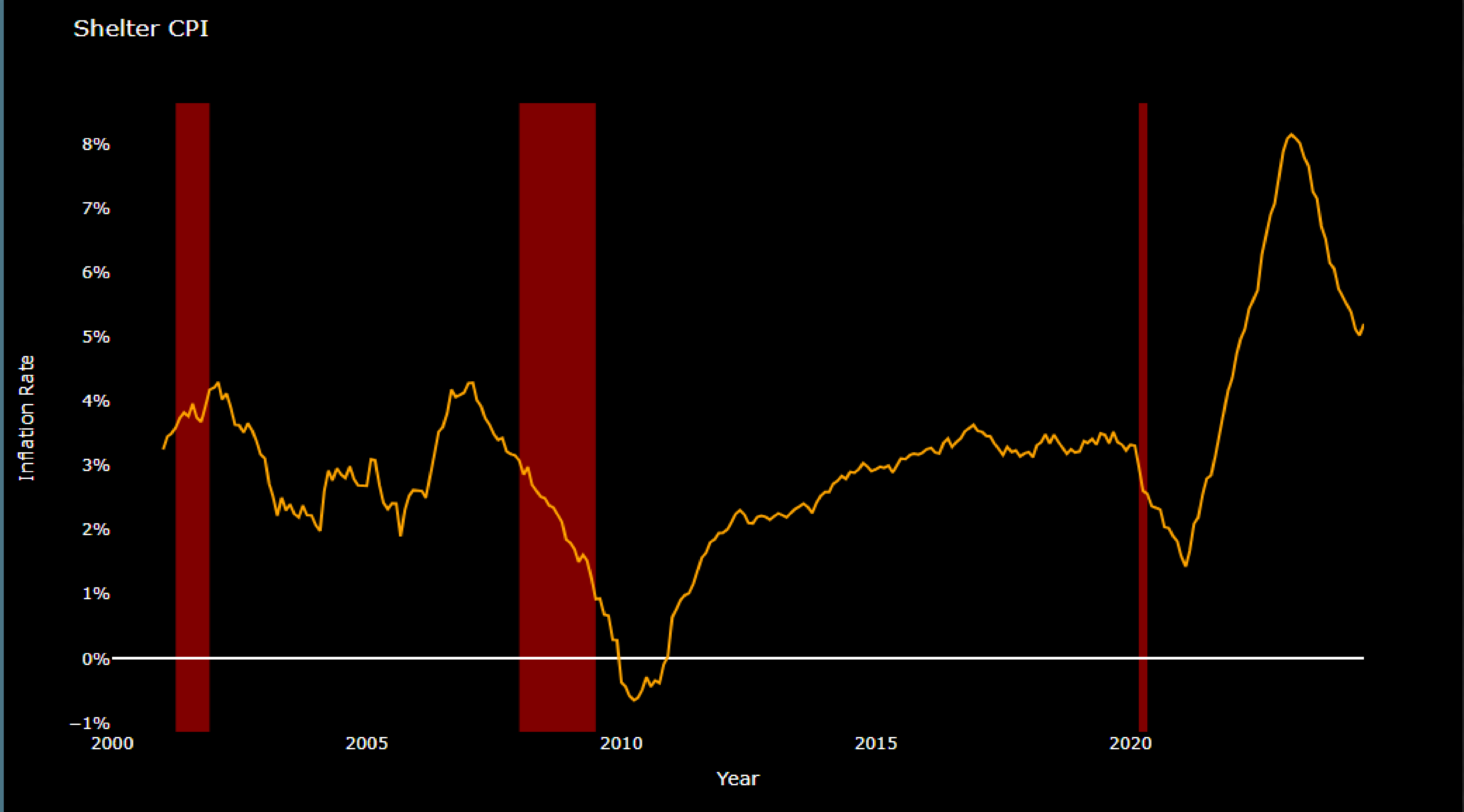


- CPI less shelter has been below the Fed's target for the better half of 2 years.



- Shelter CPI came in at 5.2% year-over-year in August. Due to the way shelter CPI is calculated and integrated into the broader CPI, it tends to adjust with lags. While it does track home prices (on a lag), in a soft landing scenario where demand returns to the market alongside lower mortgage rates, shelter costs could keep headline inflation elevated.

- Core services CPI includes housing, but also covers areas such as transportation services, medical services, education services, and more. This metric remains elevated at 4.9%, with notable pressure coming from insurance costs. For example, auto insurance has surged by 16.7% year-over-year.

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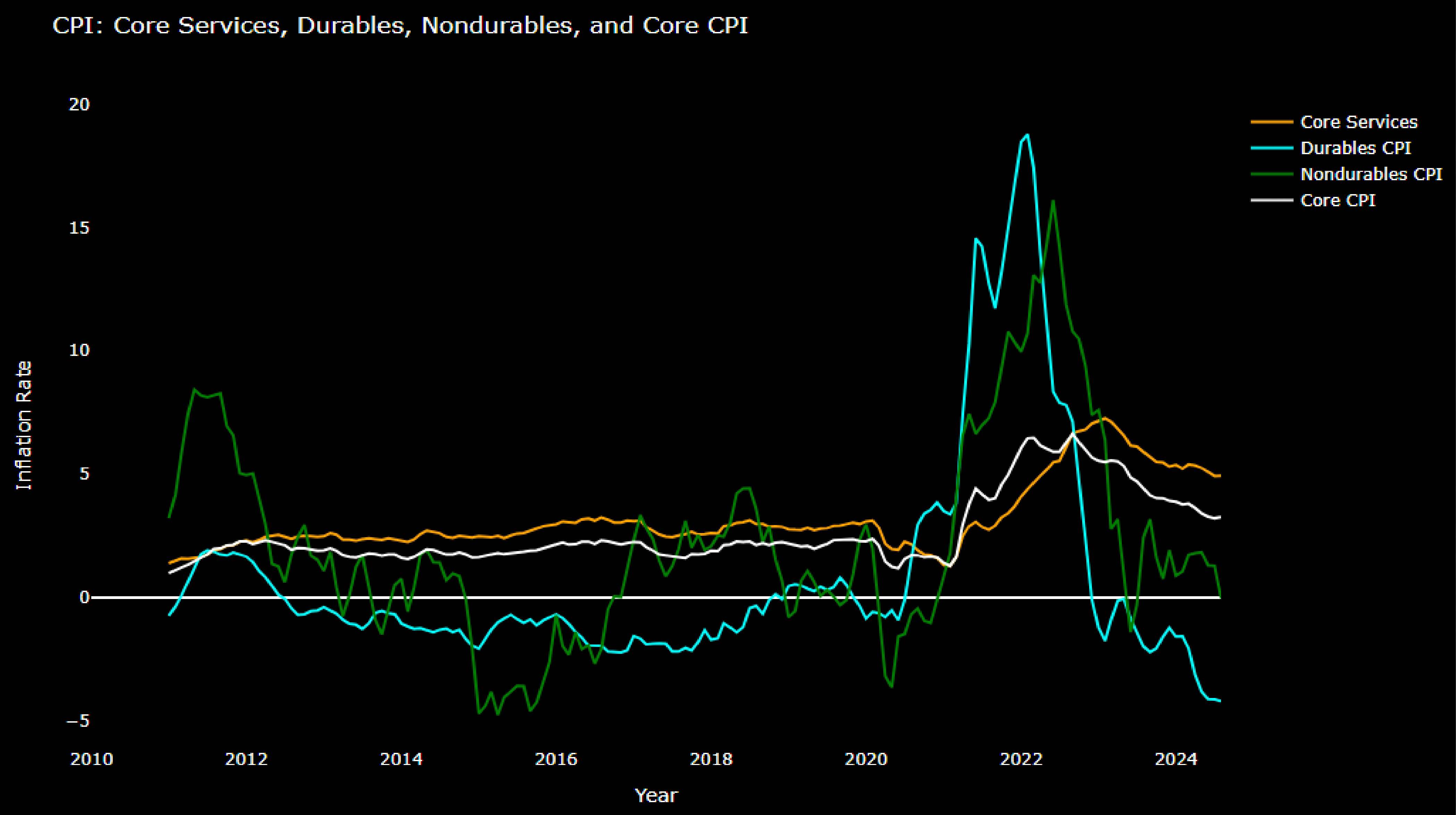
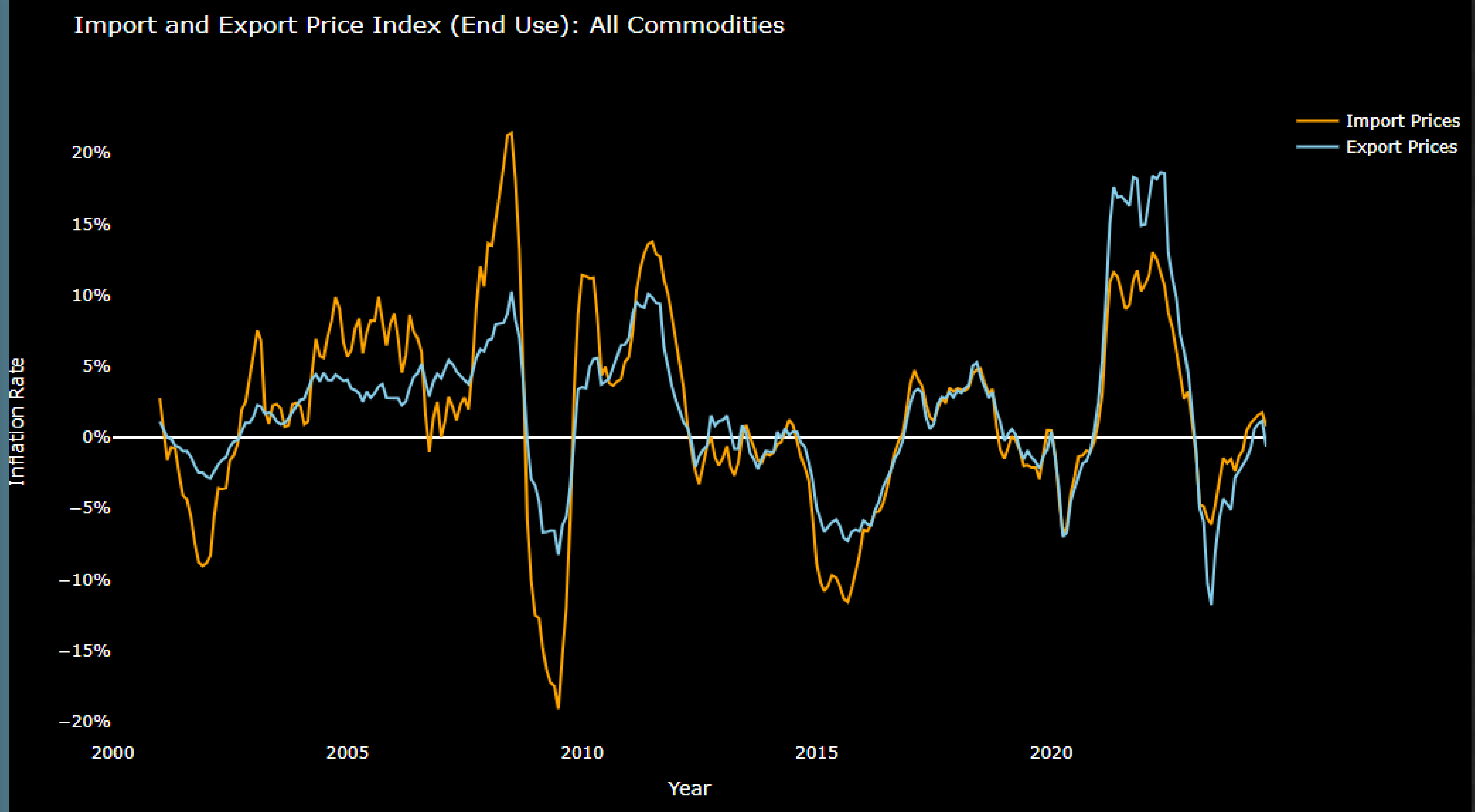
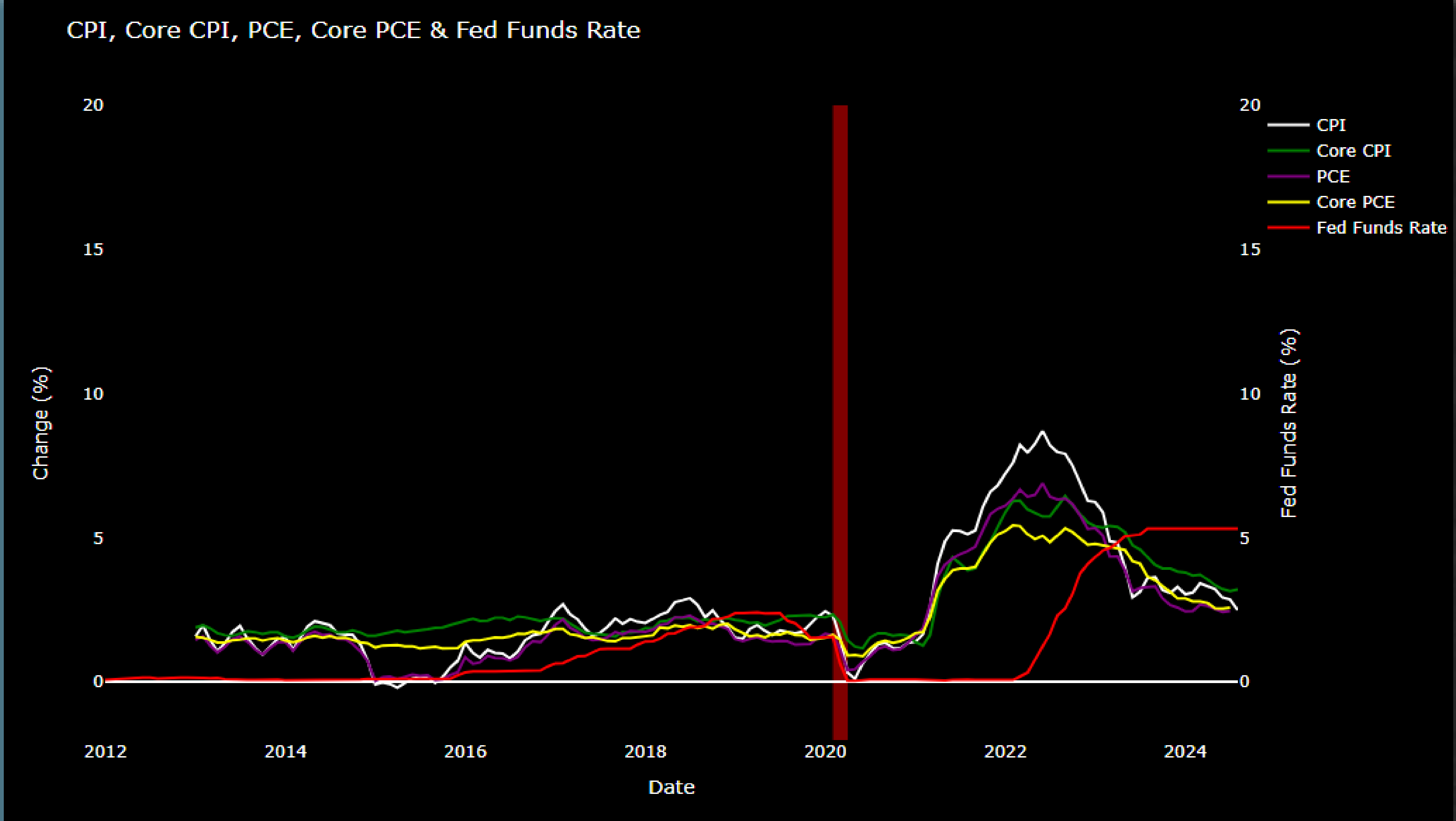


- Core CPI remains above 3%, with upward pressure primarily coming from the non-cyclical services sector. The key concern is that if the current deflation in goods starts to reverse while services inflation remains sticky, it could present a significant challenge for a Fed that has shifted its focus away from inflation.



- Import and export prices were both in deflationary territory over the past few years but have recently rebounded toward positive levels. We monitor these trends because rising import prices can increase pressure on CPI, as consumers are purchasing goods from abroad, including inputs used in domestic manufacturing. On the other hand, falling export prices means reduced foreign demand and squeeze the profit margins of domestic producers.

- On a 4-year rolling basis, inflation has risen 22%, far exceeding the Fed's mandate of price stability around 2% annually. Over a 4-year period, the Fed's target would be for prices to rise by roughly 8%, but we've experienced nearly three times that amount. This effectively compresses 11 years of inflation into just 4 years. The Fed's biggest concern now is a drop in prices (deflation), meaning prices will remain elevated and only increase at a slower pace rather than return to previous levels.



- In terms of restrictive territory for the Fed Funds rate, it currently sits above all key headline metrics the Fed uses to gauge inflation, and we've been in this zone since 2023. The question now is whether we've stayed in restrictive territory long enough to secure a sustained decline in inflation, or if the Fed is moving too quickly by guiding towards 100 basis points of cuts by year-end.

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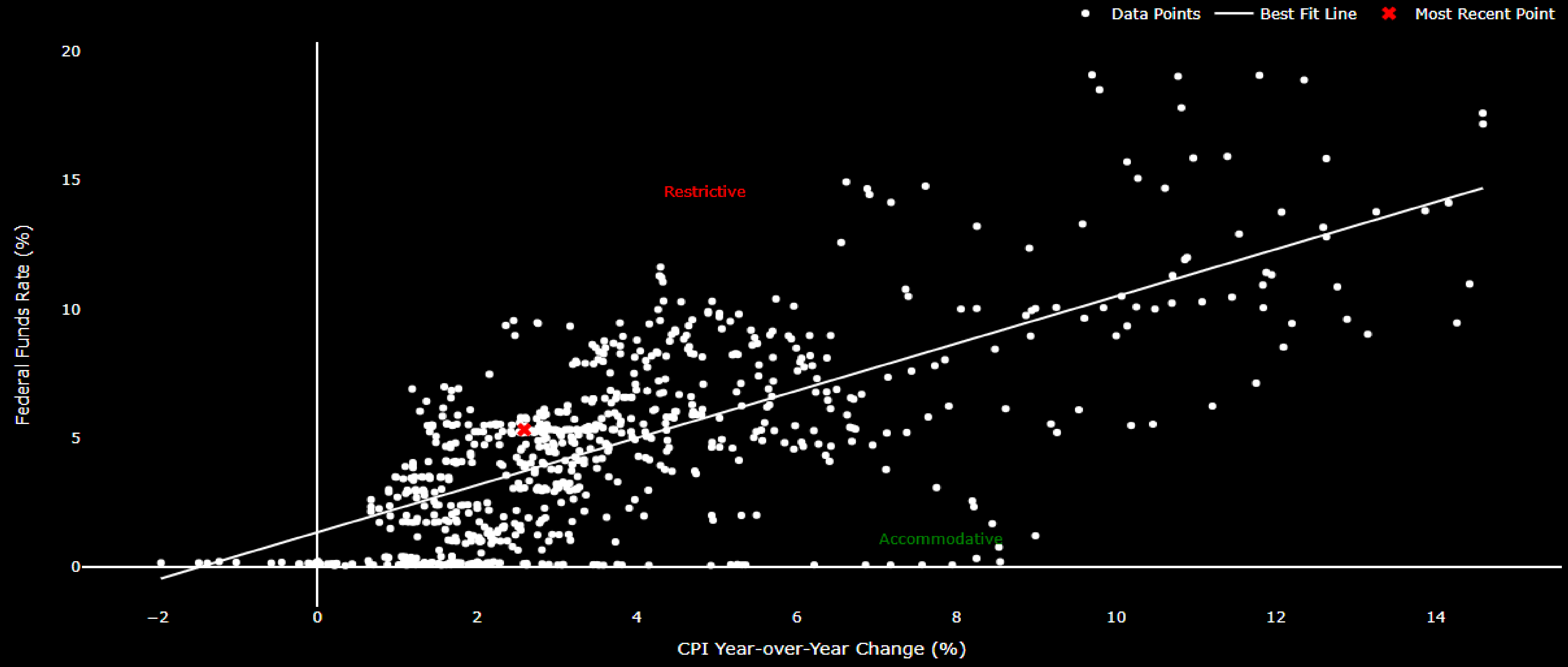
CPI & Federal Funds Rate



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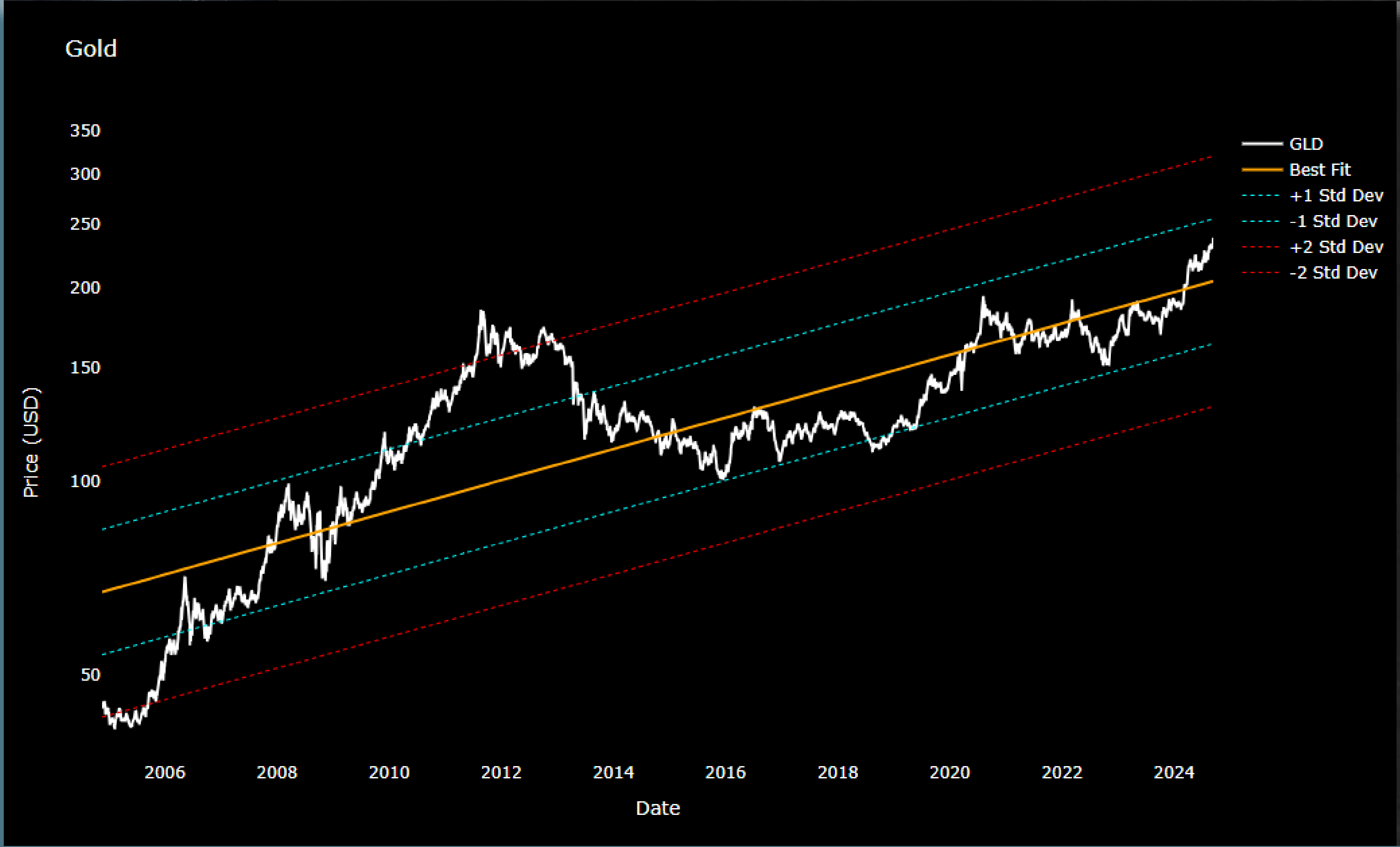

- Gold has outperformed all assets this year, with the exception of Bitcoin. Interestingly, flows into Gold ETFs have been negative, indicating that retail investors are not driving the price action. Instead, the demand is coming from central bank buying. With the U.S. running $2 trillion deficits on a rolling 12-month basis and seizing foreign assets (such as Russia's treasury holdings), foreign investors are opting to buy gold rather than U.S. Treasuries. It's evident that negative real rates will likely return as a means to inflate away the debt, and gold is responding to this expectation.

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- The Gold/Silver ratio briefly looked like it might breakdown into Silver's favor early this year but, Gold's trend has outpaced all other metals.

GLD/SLV Ratio & 5 Yr. Expected Inflation

- A rise in inflation expectations would benefit both gold and silver, but in terms of performance, silver tends to outperform gold when inflation expectations become unanchored. However, when those expectations plummet (left tail risk), gold typically performs better.

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- The Gold/Copper ratio has broken to the upside in favor of gold. Typically, copper prices are supported when global growth is rising, but that hasn't been the case recently. In the U.S., if you're looking for a signal on the future growth outlook, stocks are priced as if there will be no recession, while bonds are pricing in a hard landing. Meanwhile, the economic data is slowing, but where the trough is remains uncertain.

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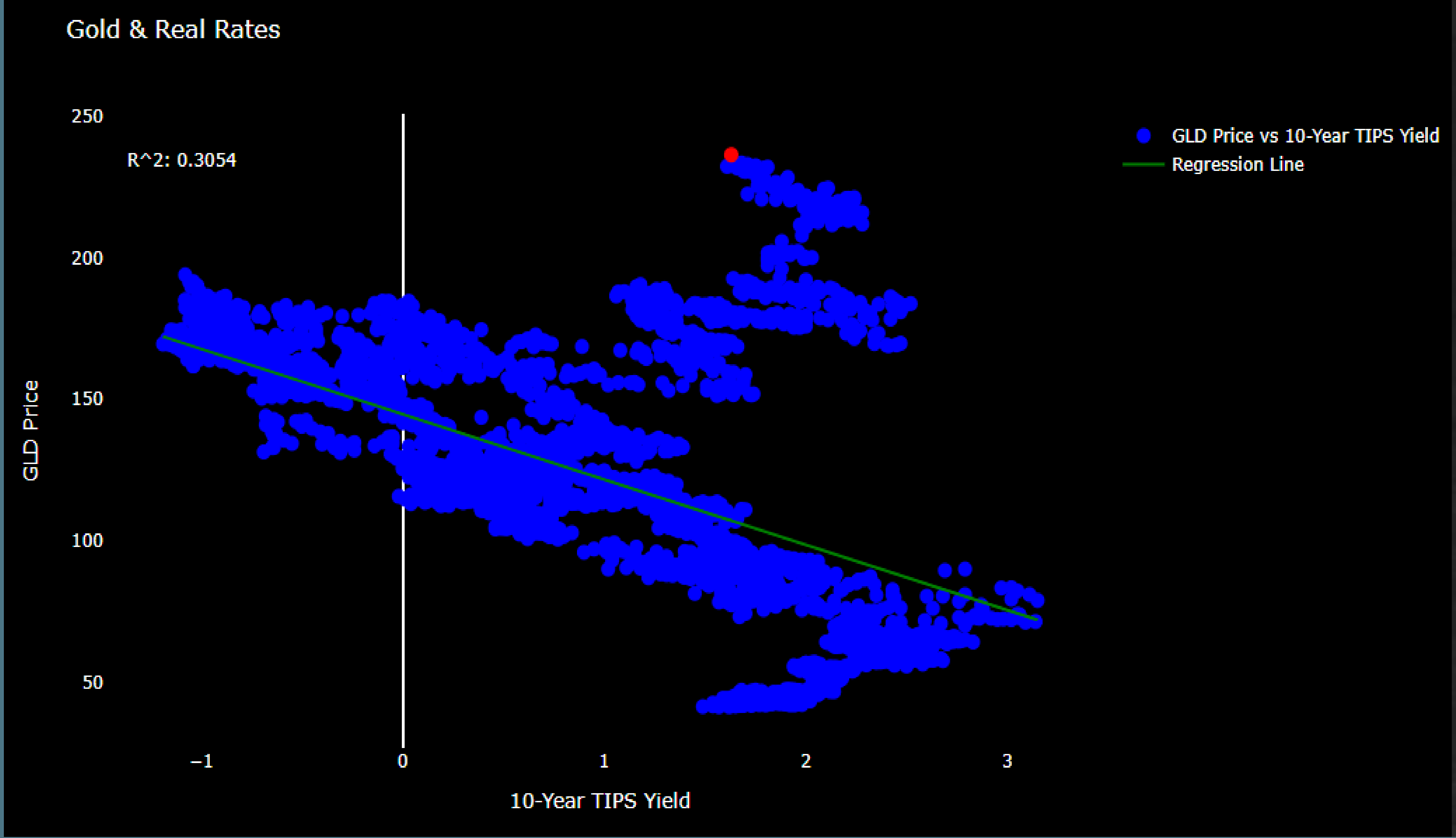
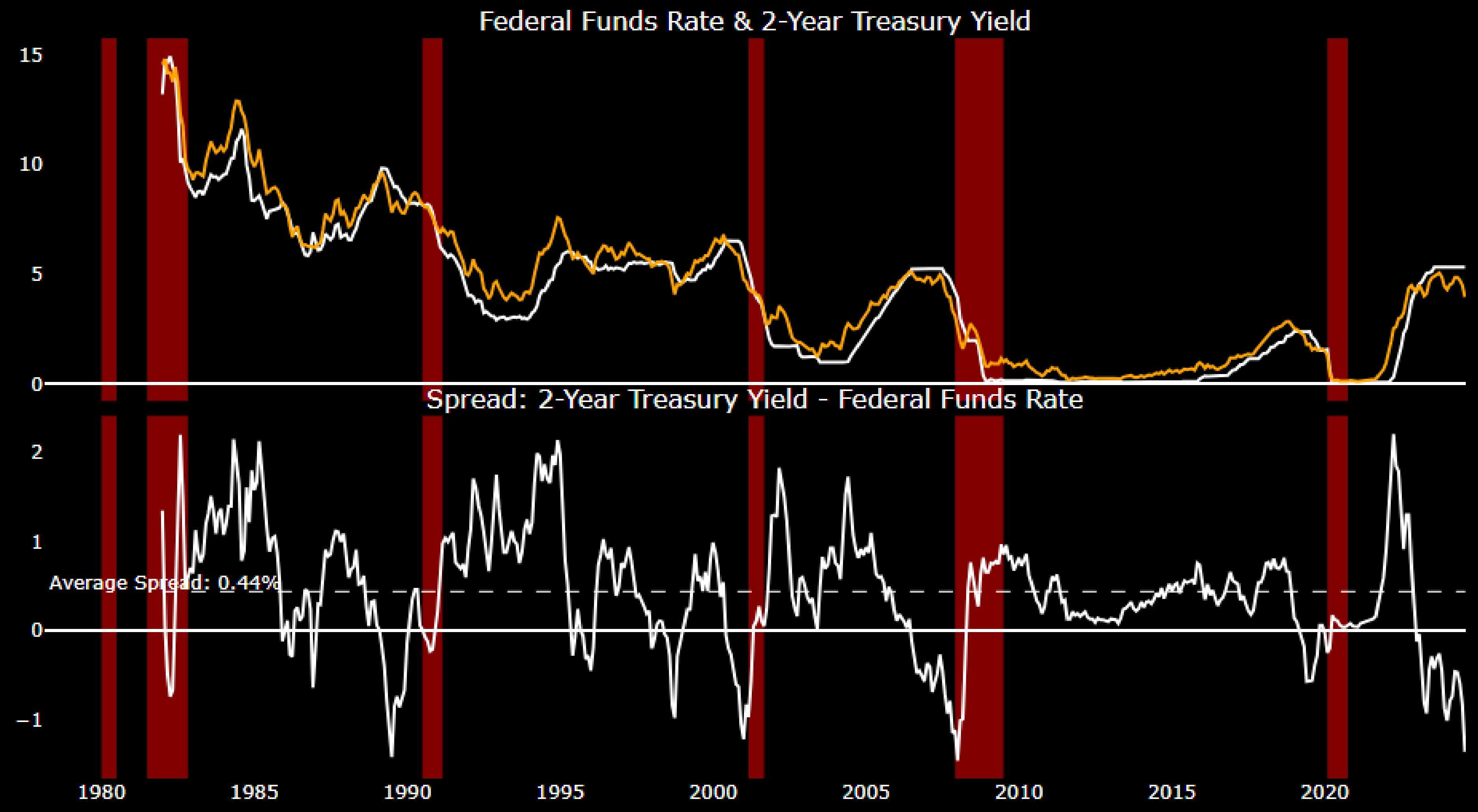
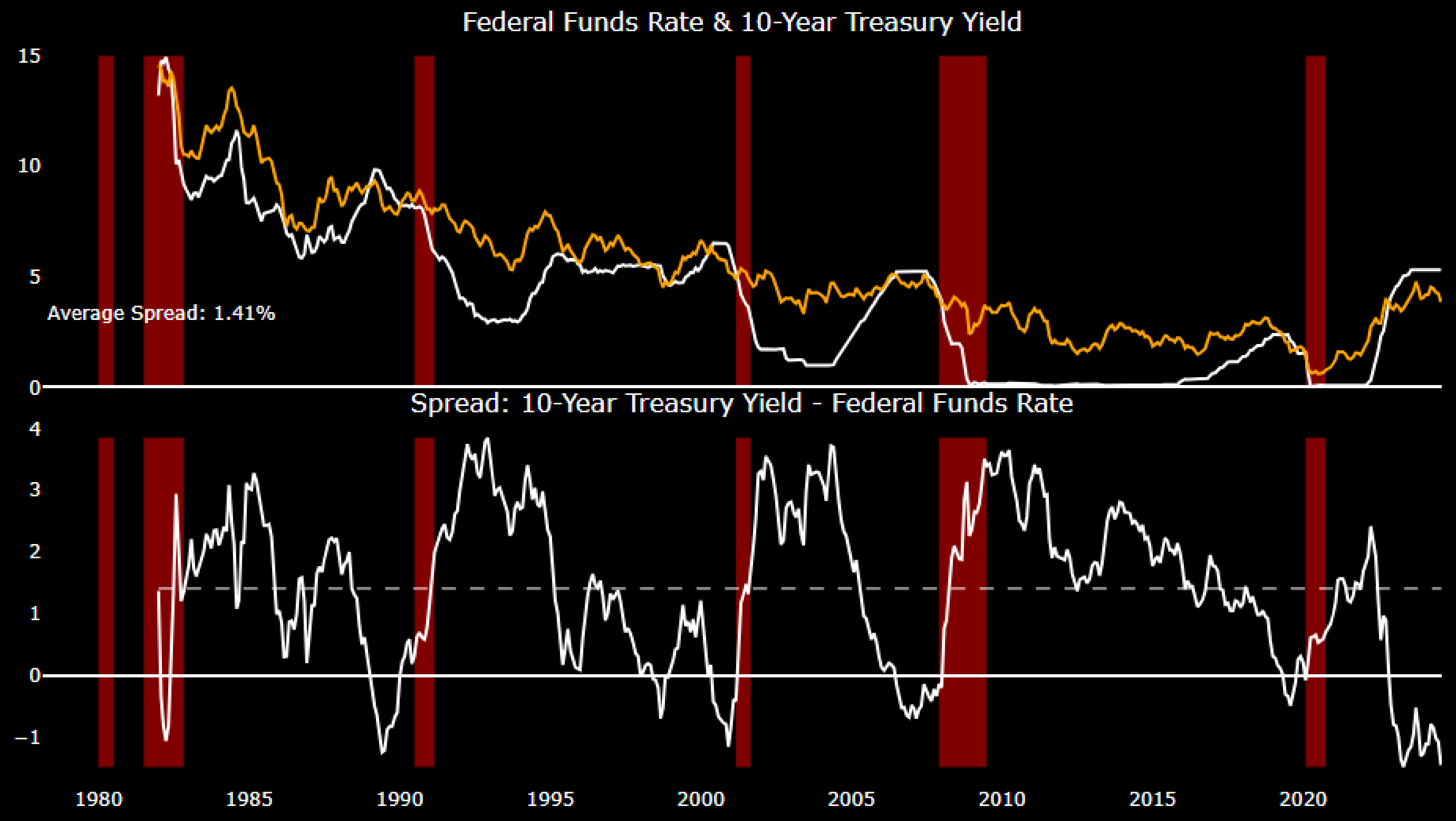


- This chart spans 20 years of data, and gold's current price relative to real interest rates is an anomaly. The traditional relationship between real rates—whether positive or negative—and gold prices (lower with positive rates, higher with negative rates) has completely broken down in recent years. As noted earlier, this shift stems from new sources of demand entering the gold market. If retail investors were driving the price, we would likely see a lower gold price today based on ETF flows.



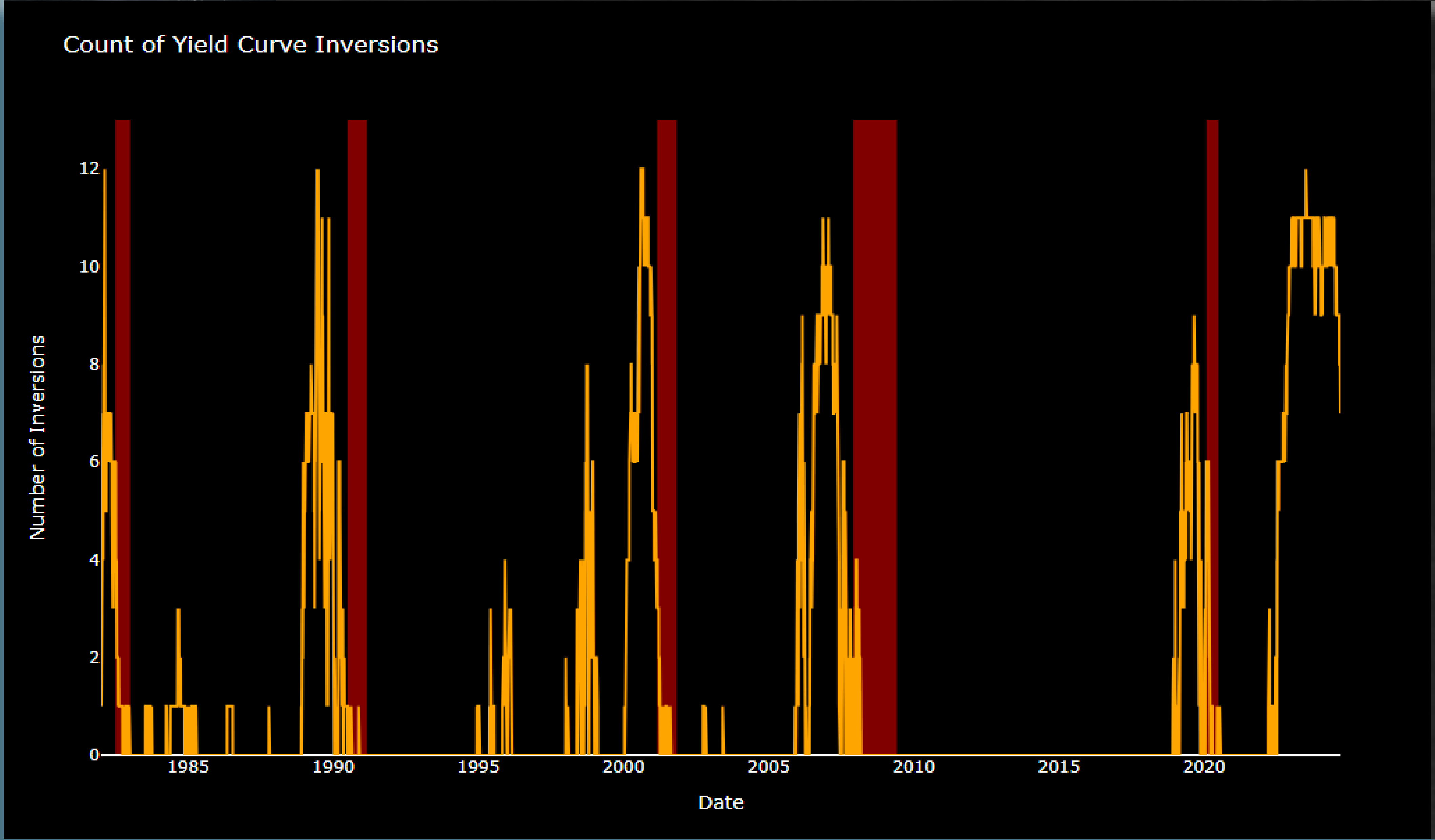
- 2-Year Treasury yields have fully priced in this rate-cutting cycle. The spread between the 2-Year yield and the Fed Funds Rate is now wider than it has been since 2007, reflecting the market's expectations for the pace of future rate cuts. This may also explain why the market reacted negatively after Jerome Powell delivered the 50 basis point cut—the move was already priced in.



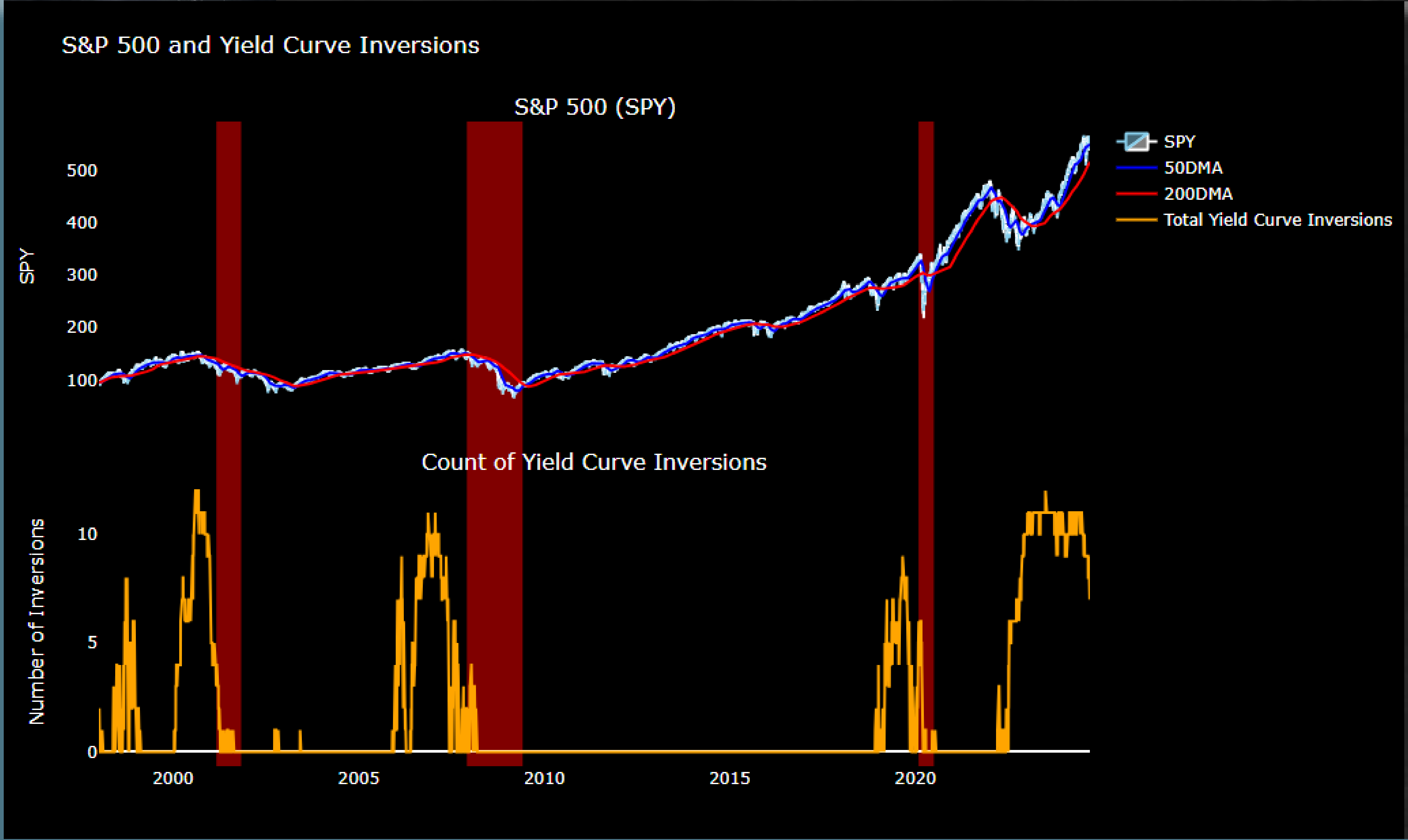
- The 10-Year Yield is pricing in rate cuts more aggressively than at any time since the Dotcom bubble. The discrepancy arises with the 10-Year Yield at 3.72% as of Friday—if you're anticipating a soft landing based on the Fed's SEP forecast of 2% GDP growth and 2% inflation, yields may have already overshot to the downside. This could set the stage for a bear steepener in the intermediate term. The long end of the curve is driven by expectations for growth and inflation, and it would take slower than 2% GDP growth to justify a sub-3.5% 10-Year Yield

- The Term Premium in the 10-Year Yield is essentially nonexistent. As the rate-cutting cycle begins, there may be some incentive to push cash further out to capture more duration, but a near-zero term premium doesn't strongly support the case for buying longer-dated bonds unless you expect a significant growth slowdown.

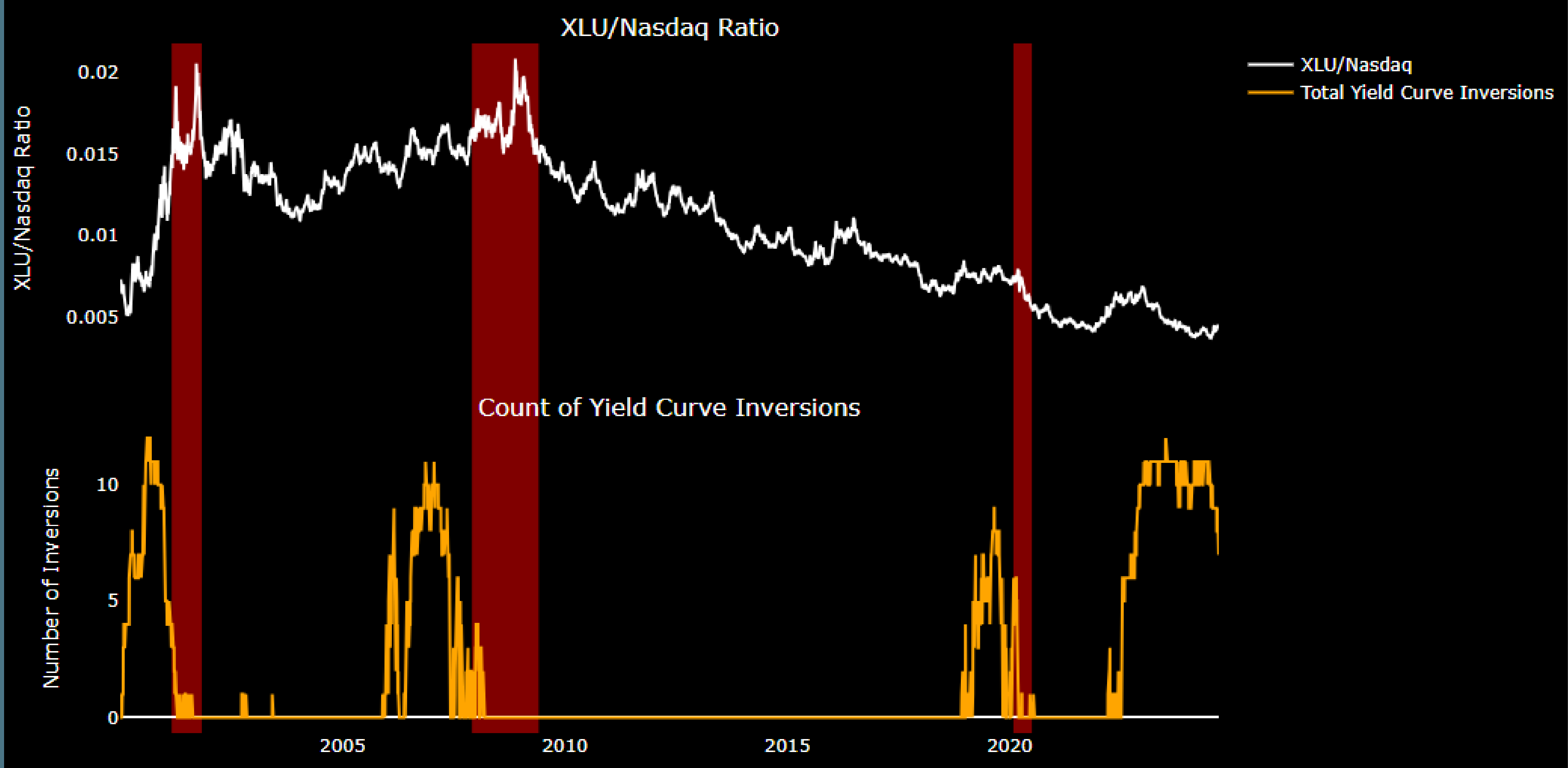
Danny Robushi, APEX MACRO Founder



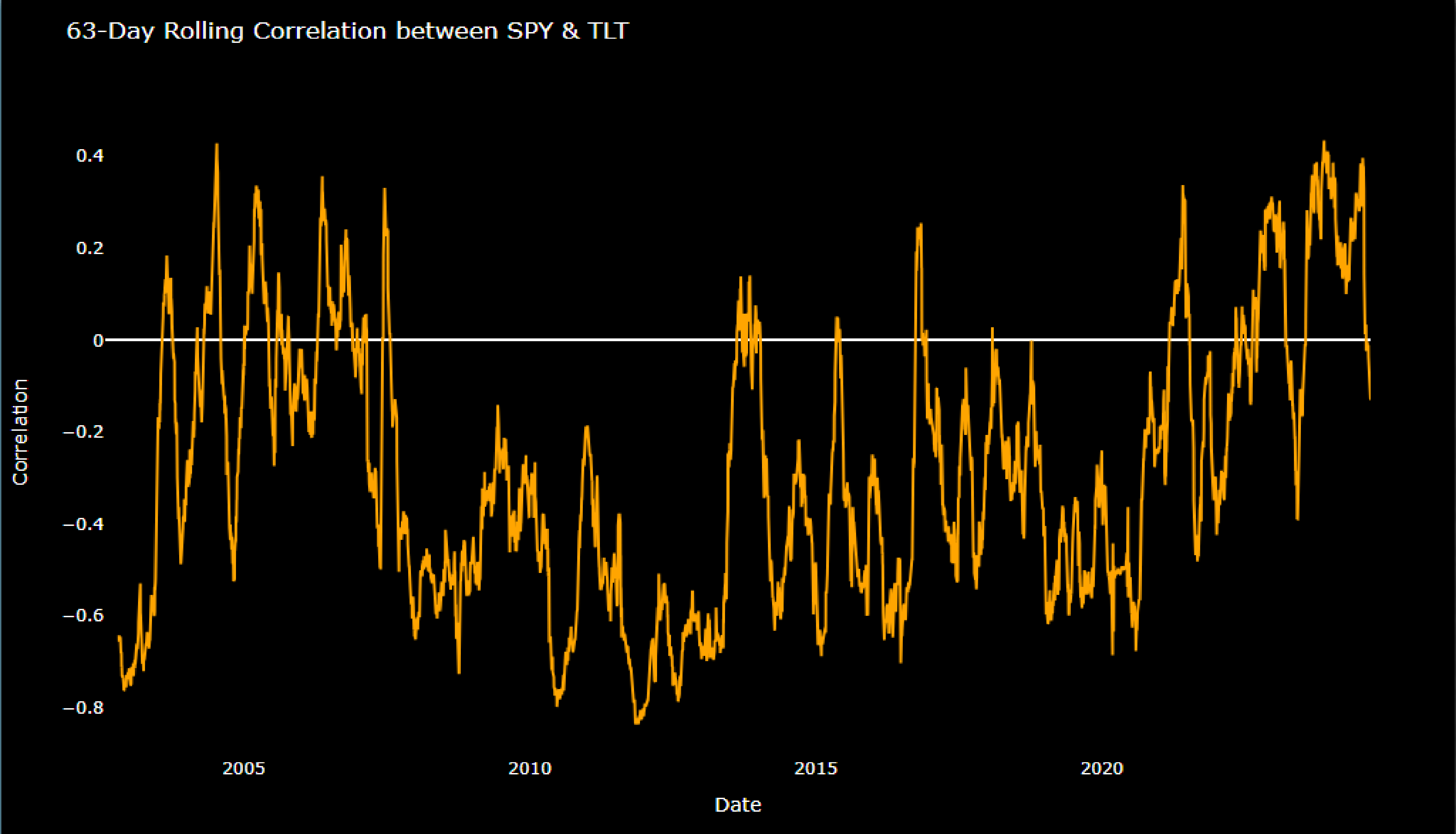
- Our count of 12 different yield curve inversions shows that 7 are still inverted. Historically, once all curves have un-inverted, a recession has typically followed. The only exception where more than 50% of curves un-inverted without a recession occurred during the soft landing of 1995.



- The previous three instances where more than 50% of the yield curves we track inverted occurred during the Dotcom Bubble, the Great Financial Crisis, and just before the Pandemic. The number of curves that inverted and the duration of the inversion this time would make the current cycle stand apart—especially if the Fed manages to engineer a soft landing

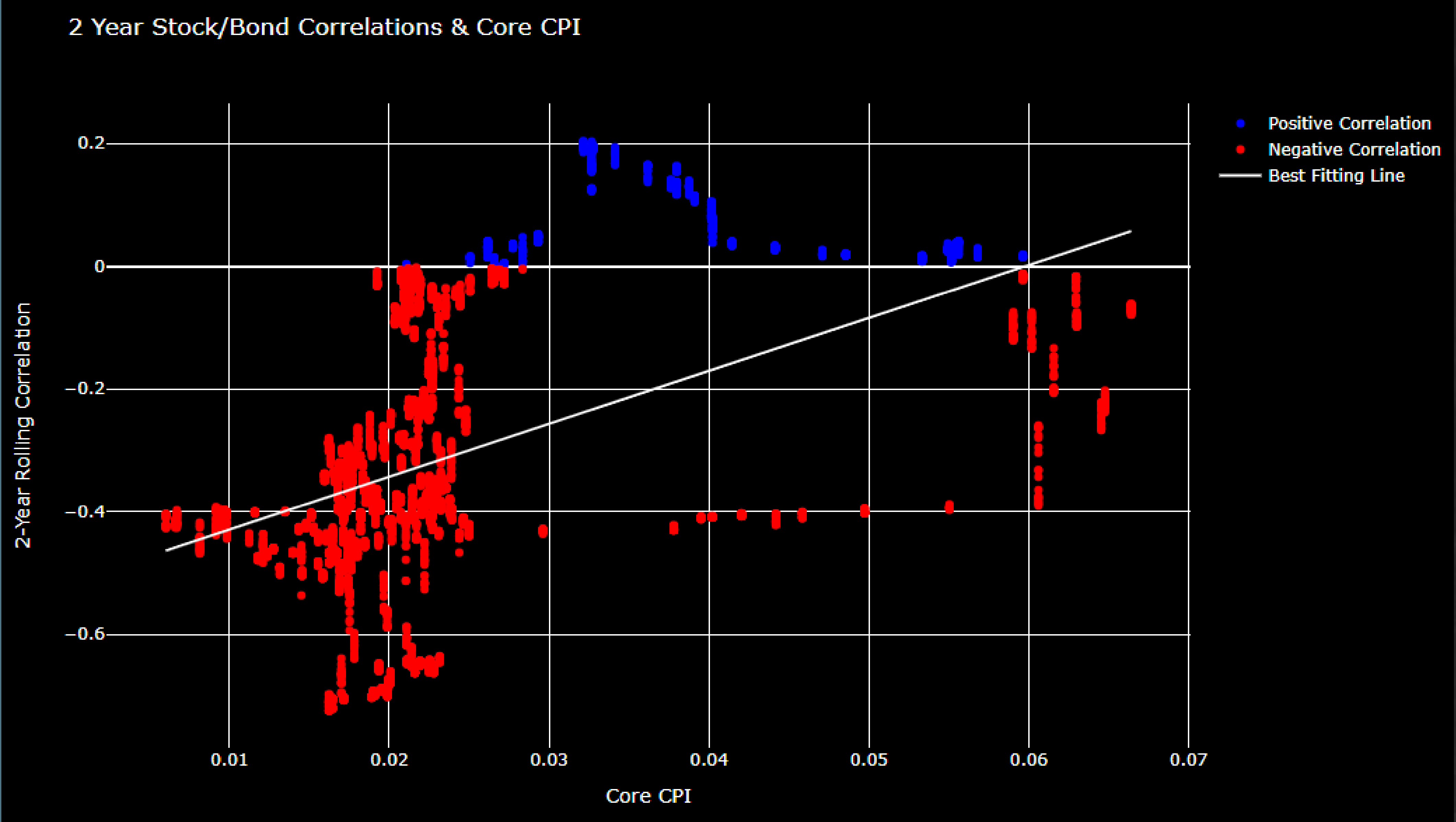


- When the yield curve un-inverts, stock prices tend to fall simultaneously. However, lower beta sectors, such as Utilities, offer a buffer by declining less than the broader market. Positioning accordingly is crucial for outperforming during periods of downside risk.



- The Stock/Bond correlation, which had been negative for 15 years before flipping back to positive due to elevated inflation, has now dropped back below zero. This shift signals that the market's primary concern has transitioned from inflation to growth, mirroring the Fed's focus. Bonds are now viewed as a safety trade in the face of an economic slowdown, with money moving from stocks to bonds as economic data softens. This suggests that the market's current worry is more about labor than inflation.

Danny Robushi, APEX MACRO Founder



- The scatter plot illustrates the relationship clearly. It shows the Stock/Bond correlation against Core CPI. When Core CPI rises above 3%, we tend to see a more positive correlation. However, when it falls below 3%, bonds begin to act as a diversifier in a portfolio with stocks once again.

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