

Macro Update: March 2024

Are we blowing a equity market bubble when corporate profits are vulnerable?



Presented by:

Mayur Thaker, CFA
Equity Strategist
March 2024

Disclosures



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A growing number of valuation metrics are warning we are entering territories not seen since 2000, while there are persistent risks present to SPX earnings.

Why I still believe we are entering recession



- **MANUFACTURING:** has been in recession for 16 months
- **INVERTED YIELD CURVE:** 10y-2y UST yield curve inversion has persisted for 21 months
- **LEADING ECONOMIC INDEX:** Conference Board Leading Economic Index in contraction for 21 consecutive months
- **EXCESS SAVINGS** well below trend and forecasted to be depleted by 1H 2024
- **GDI:** leading indicators of GDP entering contraction: real GDI
- **EMPLOYMENT:** Leading indicators of employment entering contraction: cyclical employment, full-time jobholders and gap between Establishment and Household Surveys
- **CREDIT:** credit contraction, rising loan loss provisions, tightening credit standards, rising credit card delinquencies
- Unlike past market environments, **the Fed is not supportive of stocks OR bonds right now and wont be until we see a sizable decline**

Why I believe valuations are entering unsustainable bubble territory



- **CYCLICALLY ADJUSTED P/E:** lowest CAPE yields since 2000
- **MARKET CAP / GDP:** higher today than the 2000 market peak
- **EQUITY RISK PREMIUM:** SPX forward earnings yield minus the 3-month Treasury yield is now negative; first time since 2000

However, traditional forward P/E, P/FCF and EV/Sales are still within reasonable ranges.

Total Market Capitalization / GDP At All-Time Highs



Zoom 1m 3m 6m YTD 1y 2y 3y 5y 10y 20y Max

From

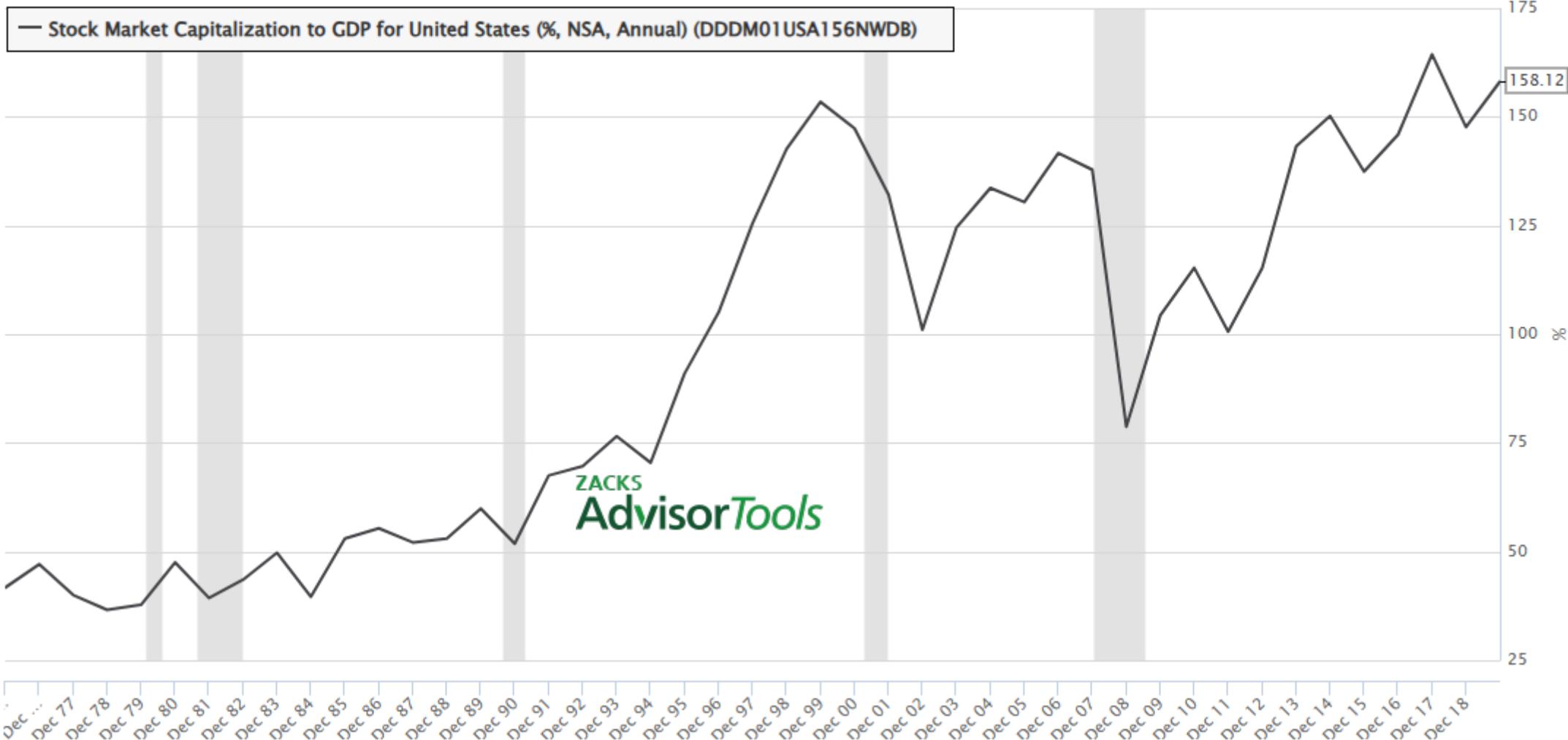
To

Data Format: Raw Value

Options

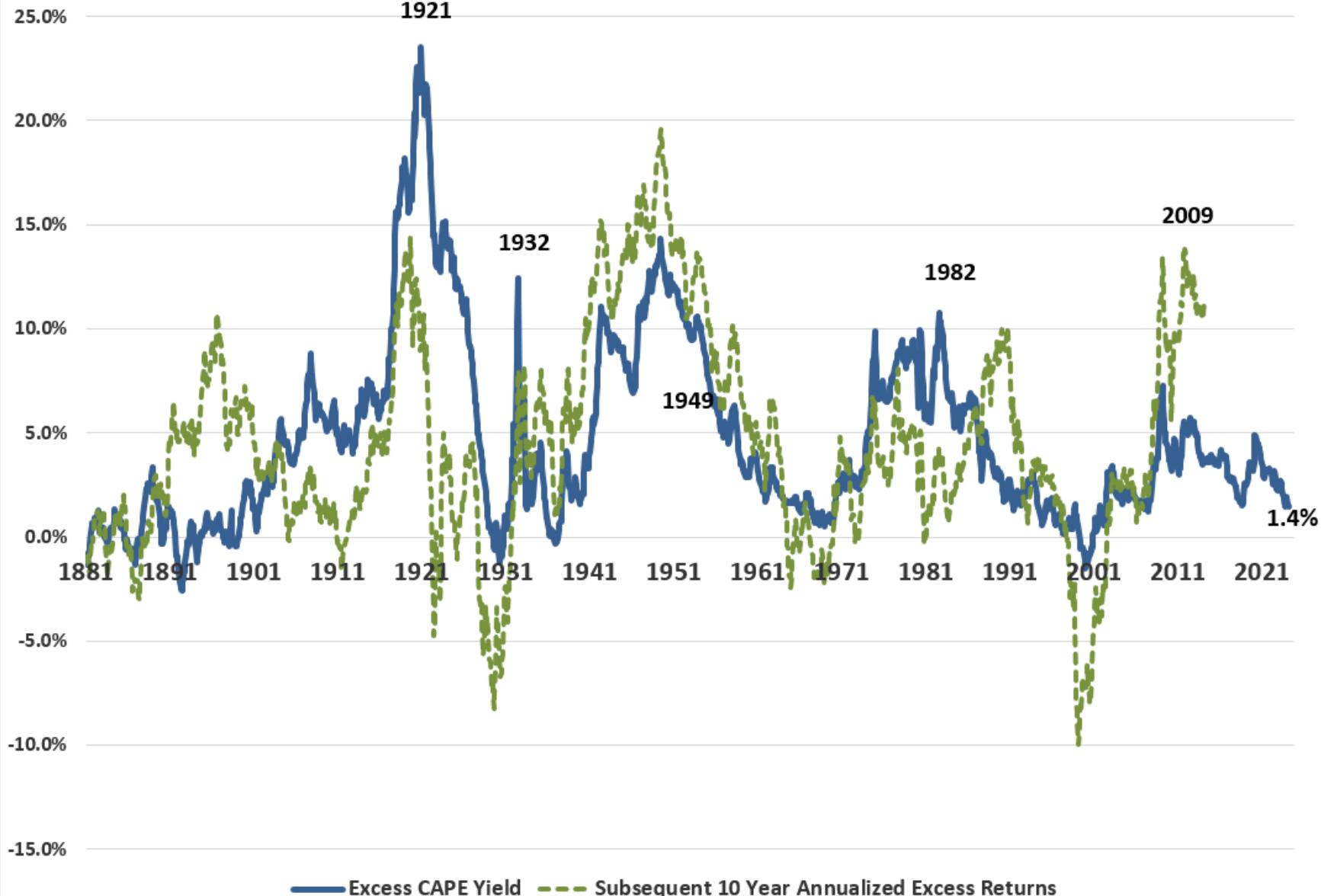
Start Date:

End Date:





Excess CAPE Yield (ECY) and Subsequent 10 Year Annualized Excess Returns





Equity Risk Premia S&P 500 Forward Earnings Yield Spread





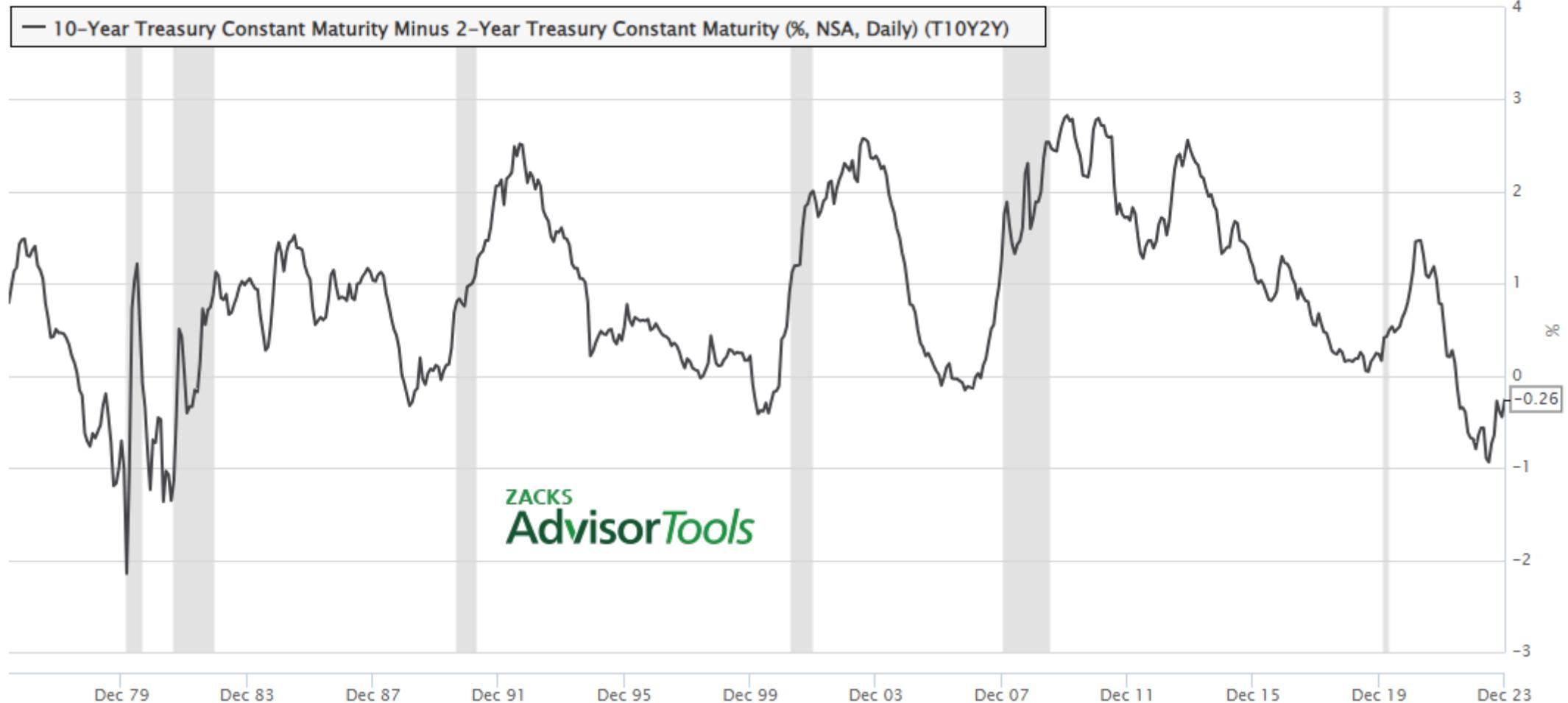
Market valuations are approaching the bubble territory of 1999-2000, but still a ways away from their worst levels. Traditional P/E, P/FCF or EV/EBITDA are still far lower today than in 2000.

This despite rising threats to corporate earnings is a major reason to be *cautious* and recognize that market returns mostly due to multiple expansion are not sustainable.

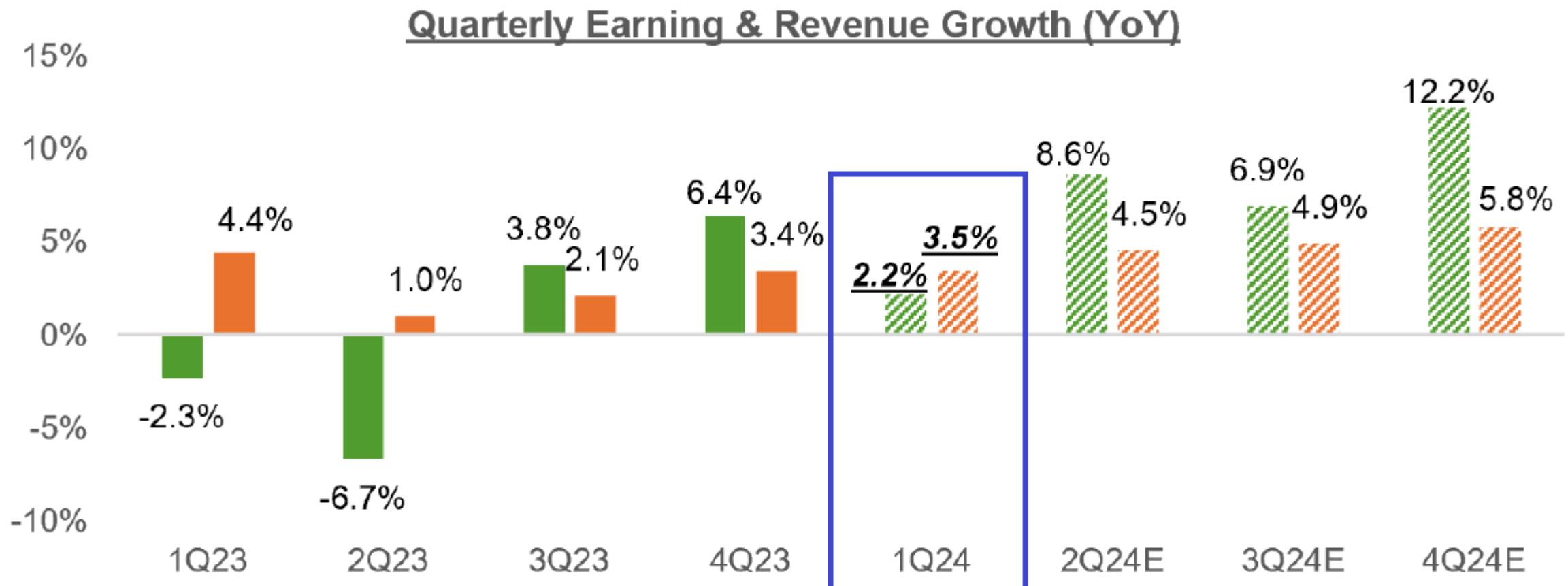
March 2024 will be the 21th month of 10yr-2yr UST Yield Spread Inversion



Start Date: 06/01/1976 End Date: 01/01/2024



EPS and Revenue Growth Are Expected to Accelerate

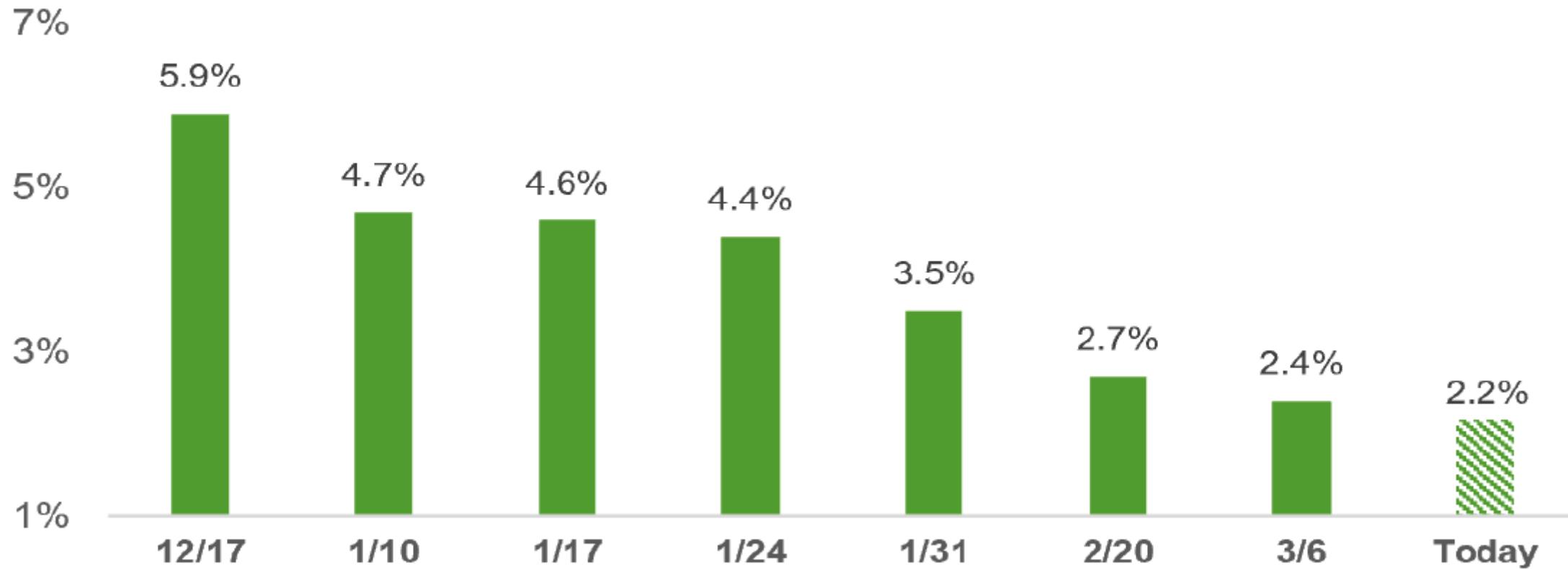


Source: Zacks Investment Research, Inc.

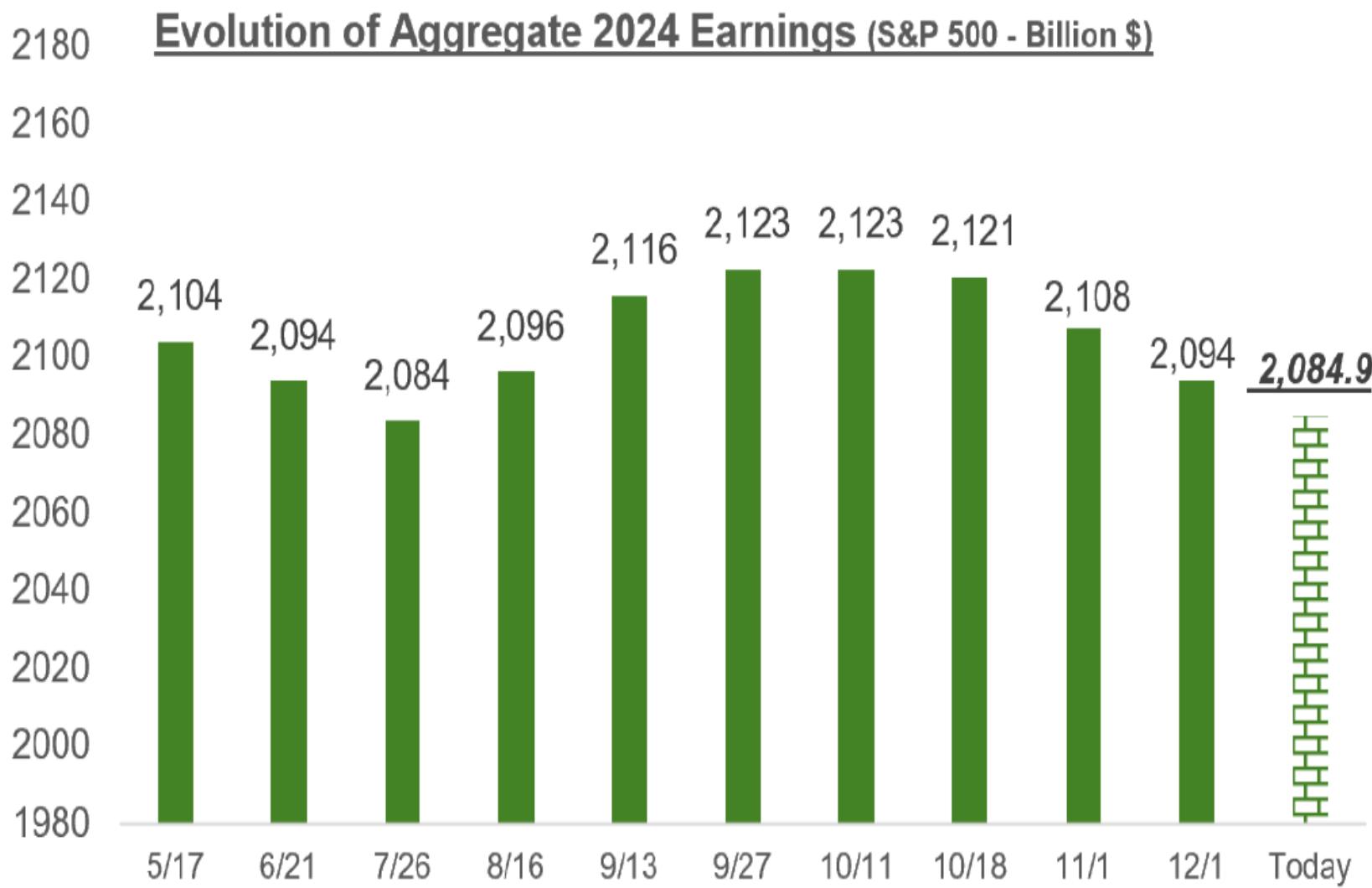
...But Estimates Are Beginning to Come Down



Evolution of 2024 Q1 Earnings Growth Estimates



Source: Zacks Investment Research Inc.

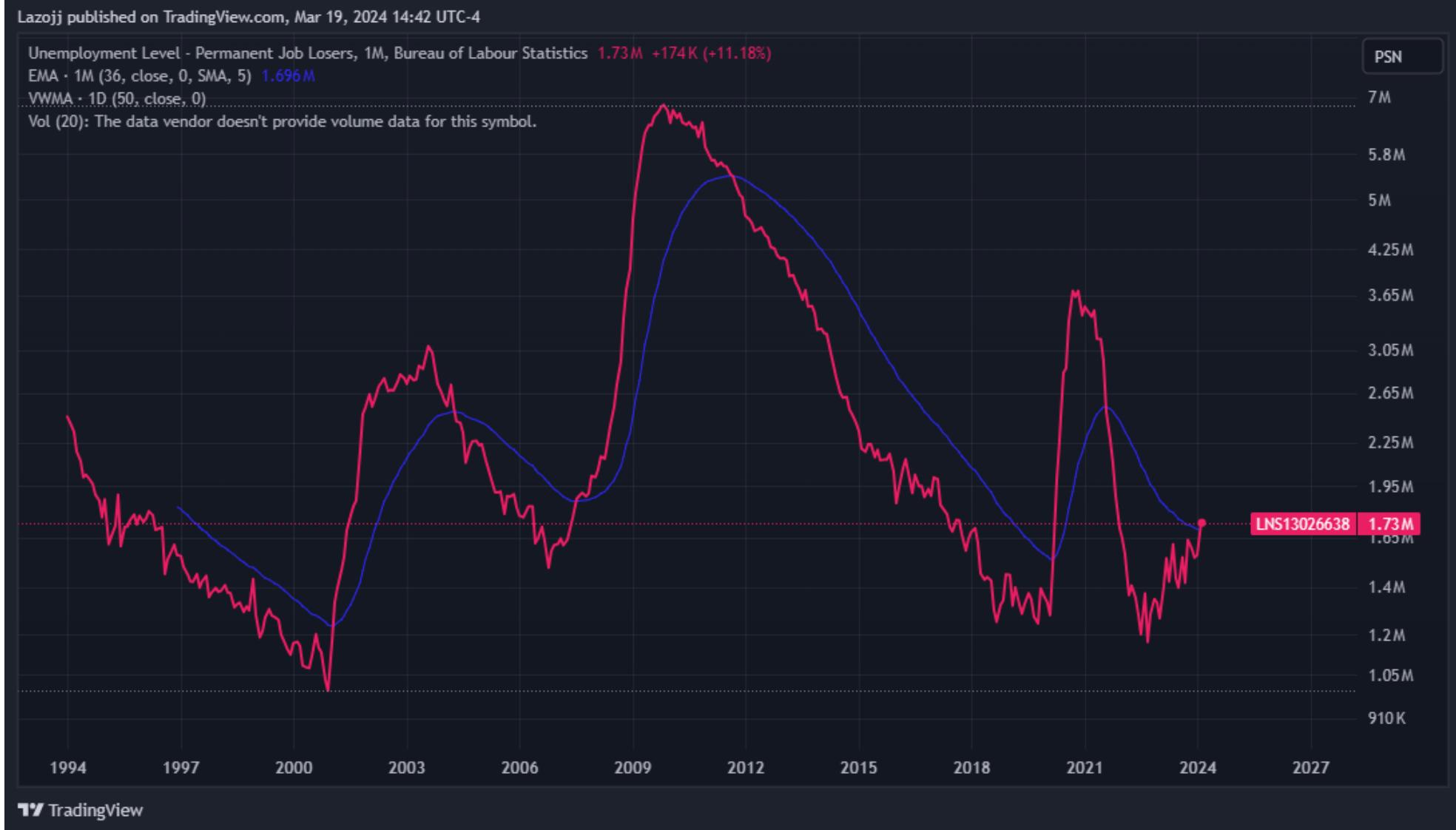


Source: Zacks Investment Research, Inc.

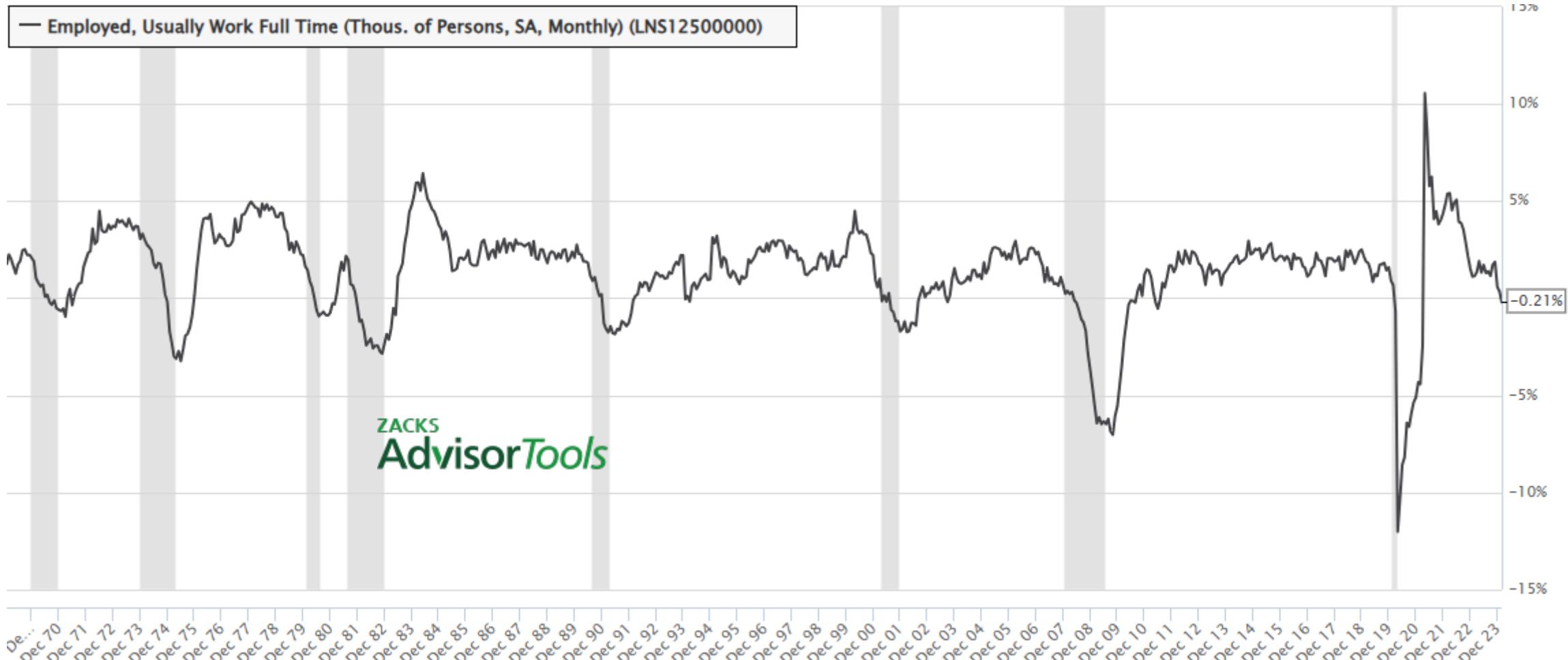


JOB MARKET

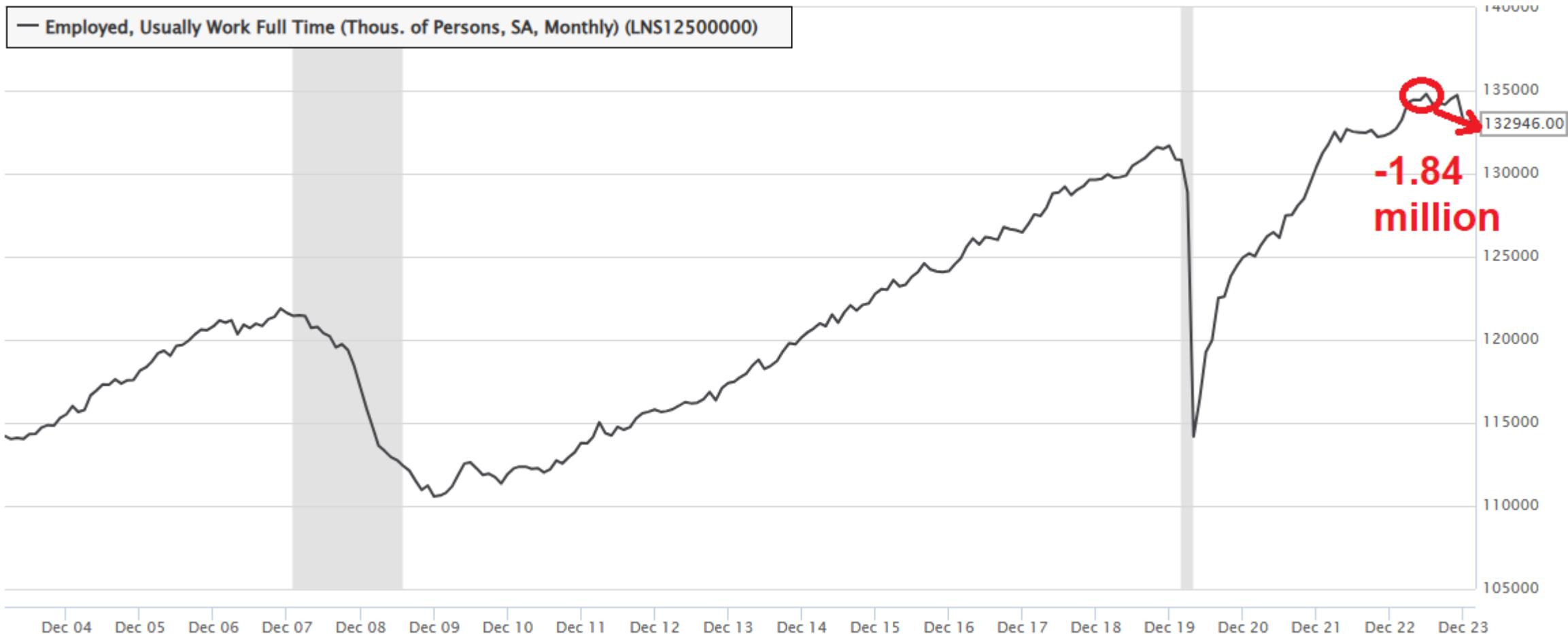
Permanent Job Losers Crosses Above 3-yr Moving Avg



1.5 Million Fewer Full-Time Jobholders Since June 2023 Peak; +0.3% Growth YoY is Among the Slowest Outside of Recessions



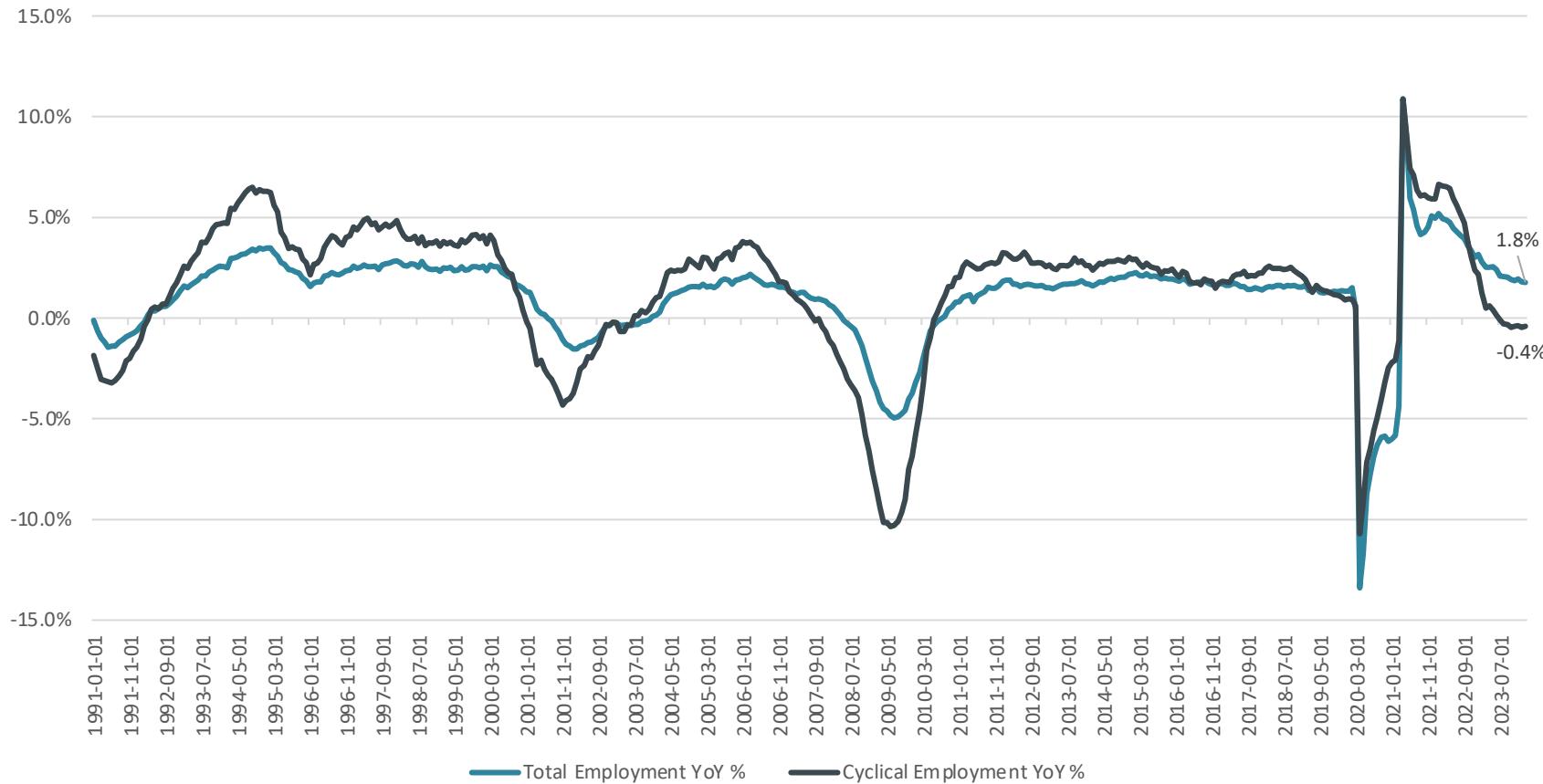
Full-Time Jobs Down -1.84 million from June 2023 Peak & Well Below Pre-Pandemic Trend



Aggregate Payrolls at +1.8% YoY Despite Downward Revisions, But Cyclical Employment Posts 8th Consecutive Month of YoY Contraction

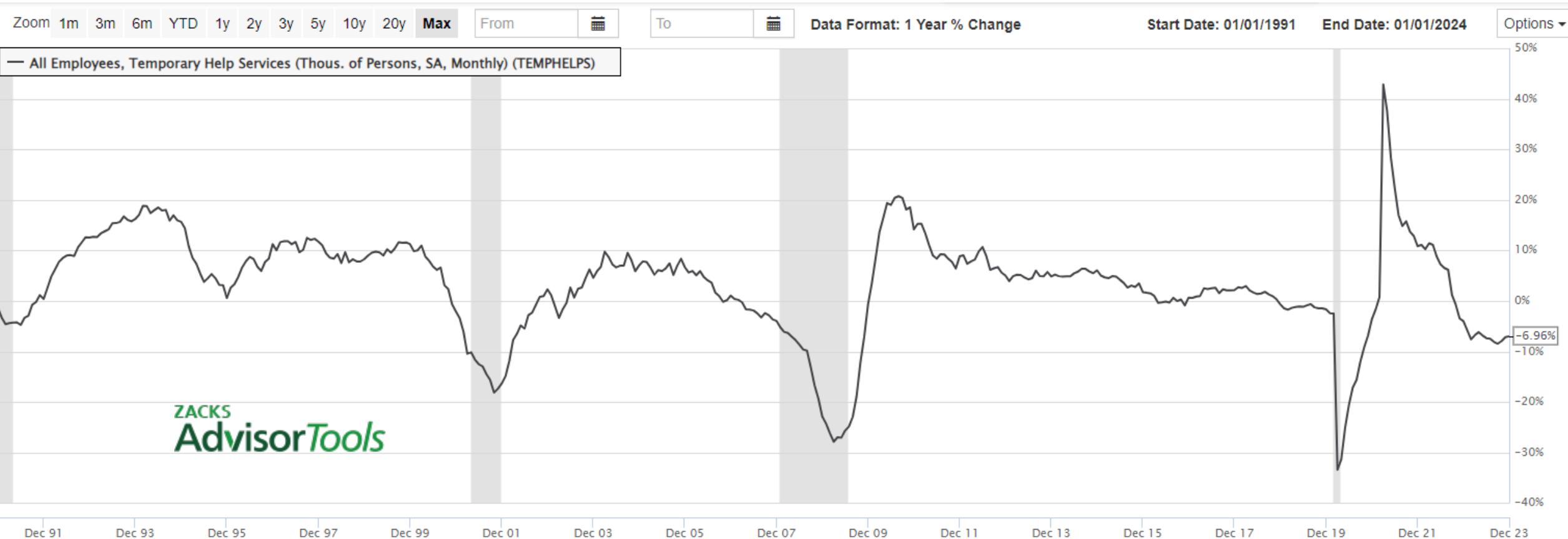


Cyclical Employment vs Aggregate Payrolls
YoY % Chg

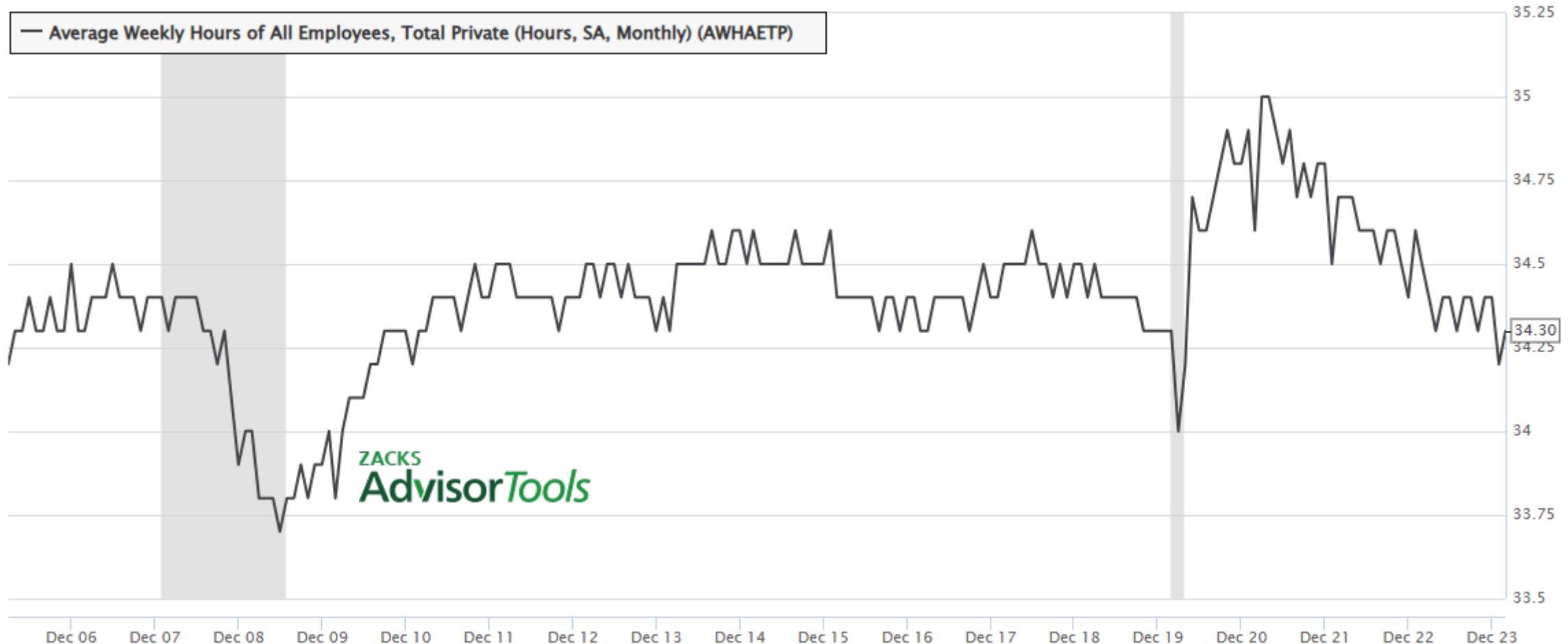




Temporary Help Services is an example of a cyclical leading employment indicator

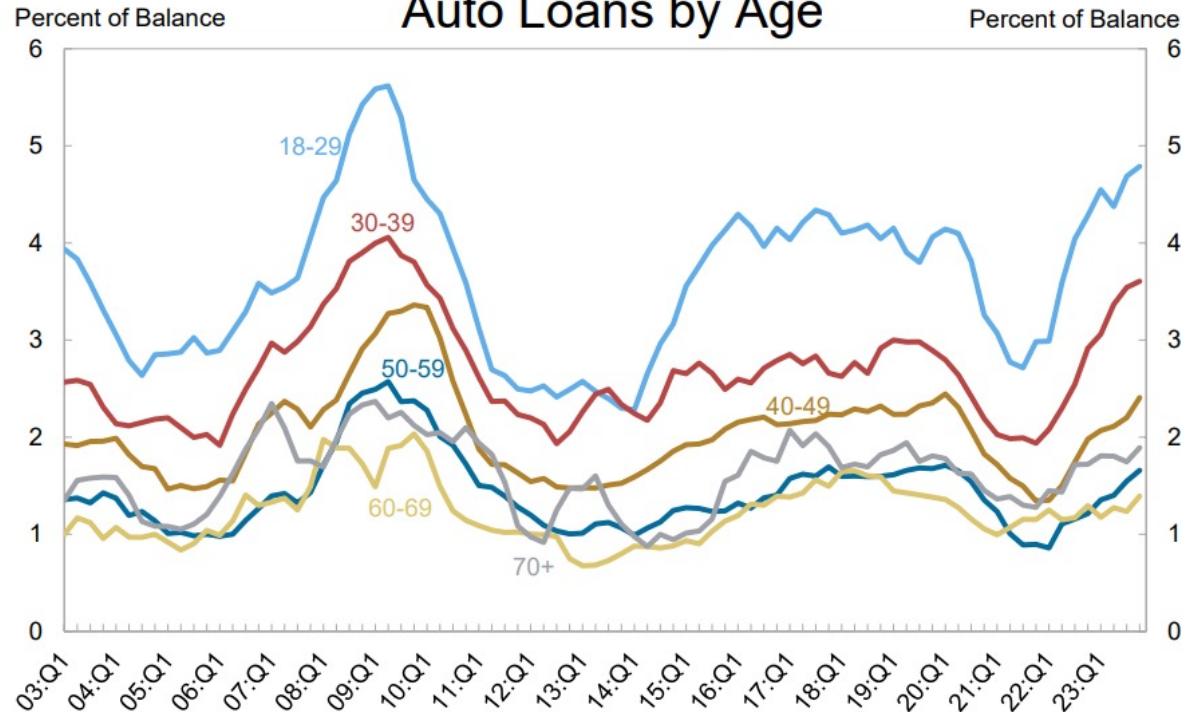


Average Weekly Hours Therefore In Rapid Decline, Consistent with Recession



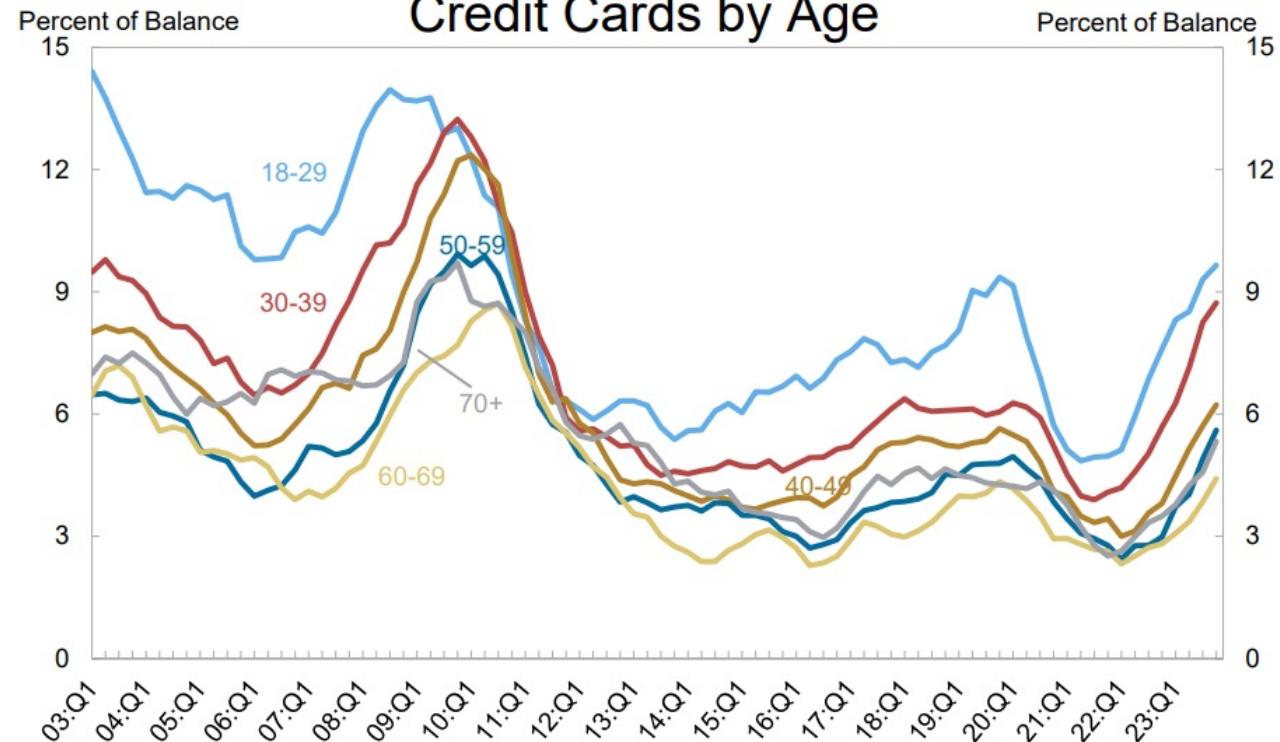


Transition into Serious Delinquency (90+) for Auto Loans by Age



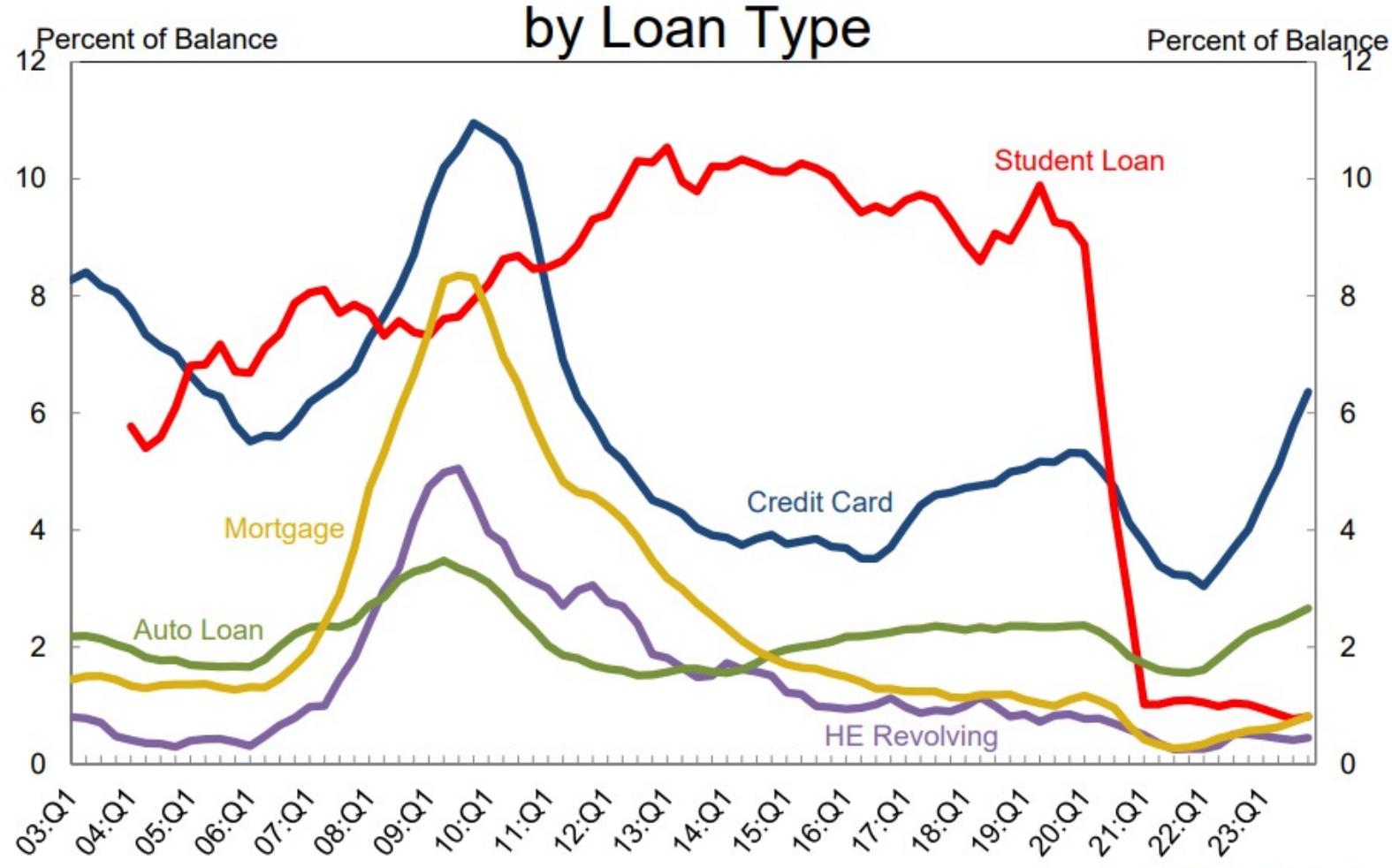
Source: New York Fed Consumer Credit Panel/Equifax

Transition into Serious Delinquency (90+) for Credit Cards by Age

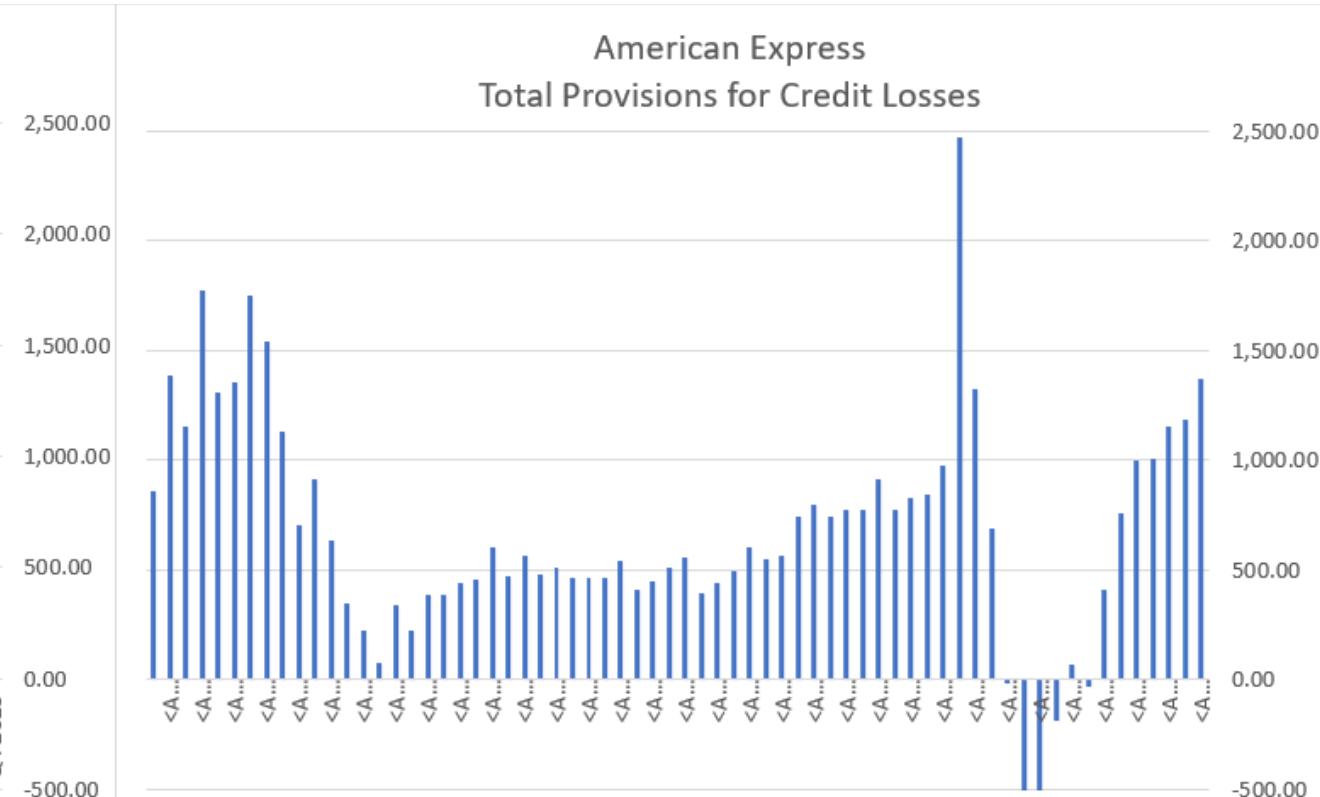
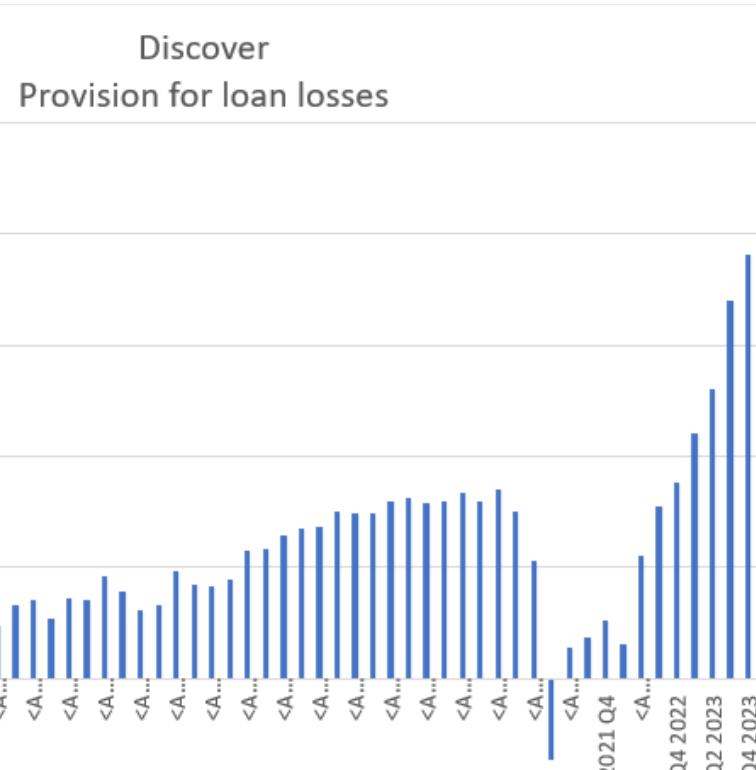


Source: New York Fed Consumer Credit Panel/Equifax

Mortgage Debt Still Very Healthy, Which is Keeping Overall Delinquency Rate Low But This Masks Problems Brewing Beneath the Surface Transition into Serious Delinquency (90+)



Warnings from credit card lenders American Express and Discover reporting sharply rising delinquencies

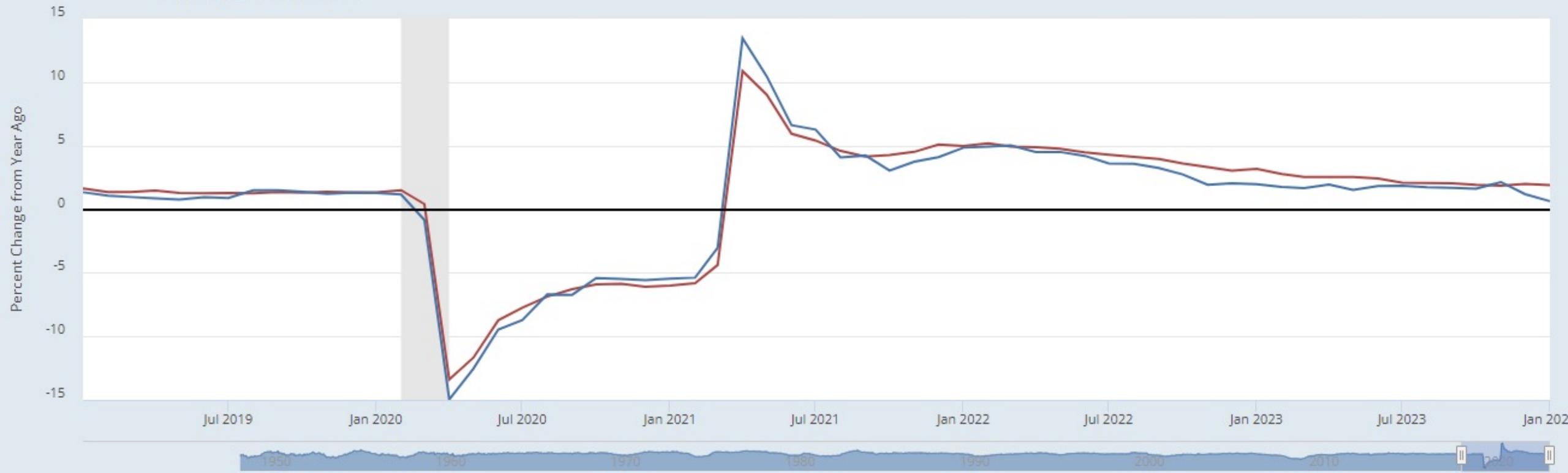


Large Gap Between Household and Establishment Surveys Suggests Job Market Much Weaker than it Appears



**FRED** 

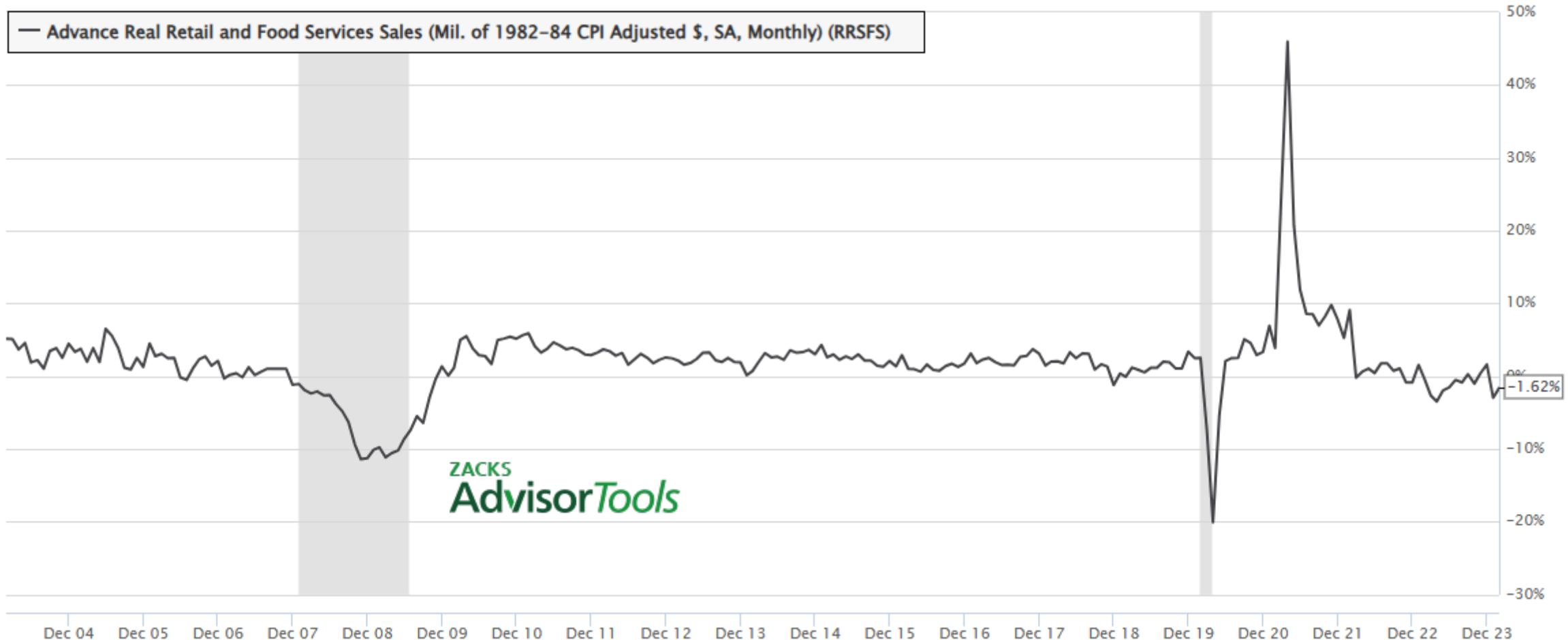
— Employment Level
— All Employees, Total Nonfarm





If the full-time job contraction is due to attrition, demographics changes, etc., that could be very bullish for S&P 500 operating margins.

But the decline in real average weekly earnings, with personal savings well below trend, is bearish for forward-looking retail sales.



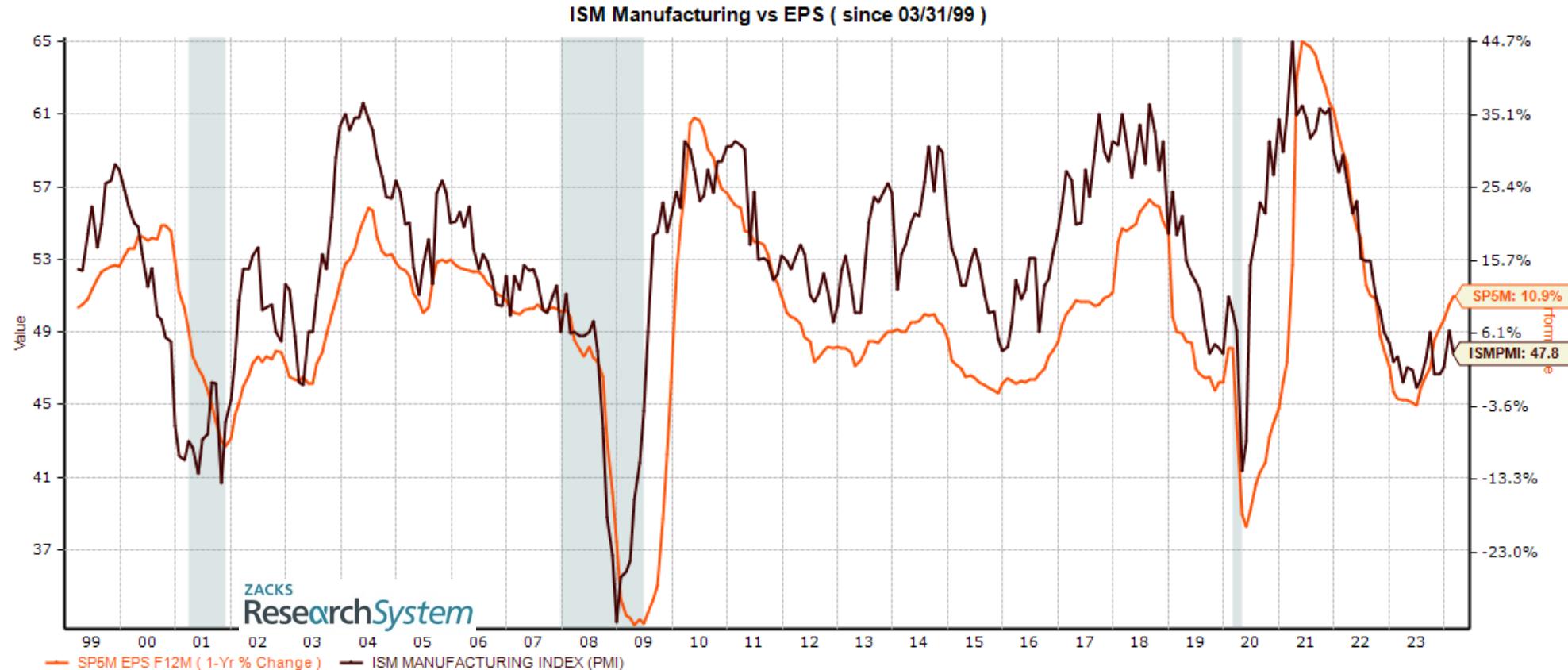


MANUFACTURING

ISM Manufacturing PMI Similarly in Recession Territory

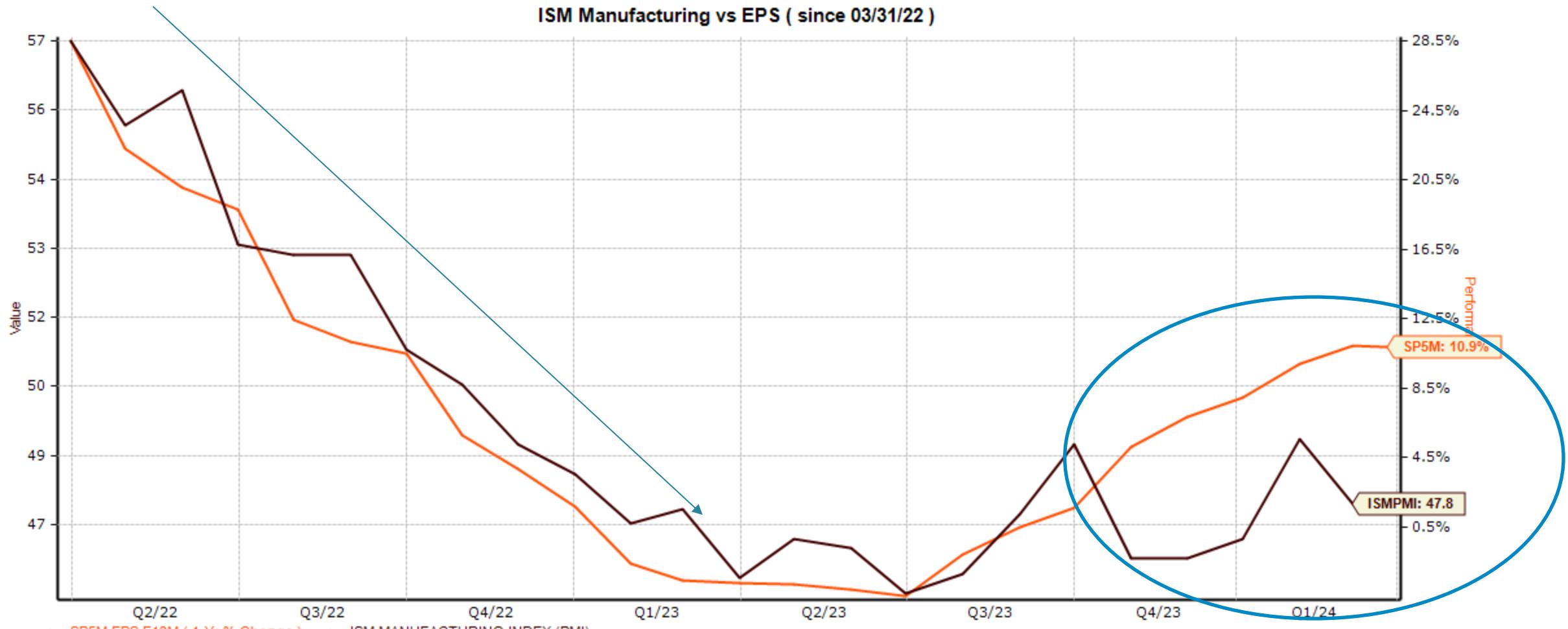


Index has been in contraction for 16 consecutive months, bearish divergence with forward EPS



Title	High	Low	Median	Current	Cumulative Return	Annualized Return	Start Date	End Date
S&P 500 Composite Market ETF (SP5M) EPS F12M (1-Yr % Change)	44.73%	-32.63%	8.20%	10.87%	514.16%	7.13%	03-31-1999	03-19-2024
ISM MANUFACTURING INDEX (PMI)	64.70	33.30	52.85	47.80	-8.78%	-0.36%	03-31-1999	02-29-2024

ISM Manufacturing vs EPS (since 03/31/22)



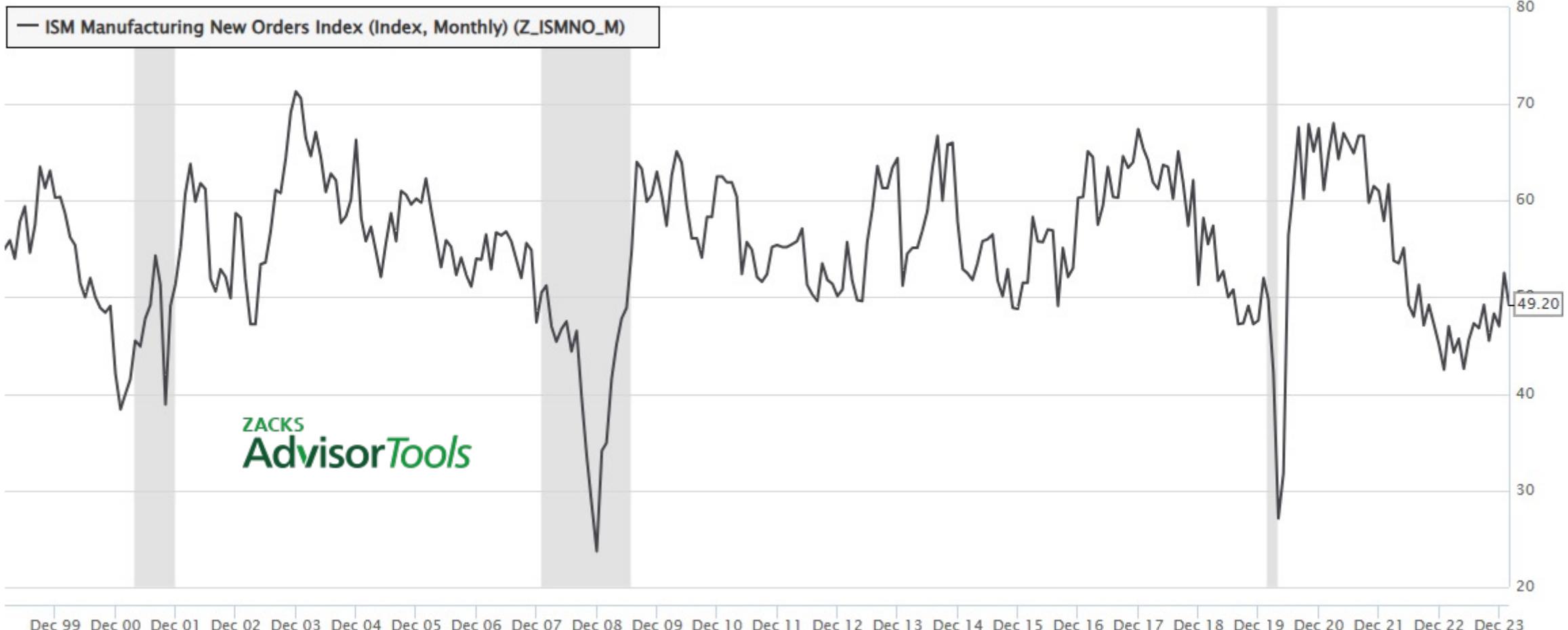
Title	High	Low	Median	Current	Cumulative Return	Annualized Return	Start Date	End Date
S&P 500 Composite Market ETF (SP5M) EPS F12M (1-Yr % Change)	28.48%	-3.49%	5.80%	10.87%	38.53%	11.60%	03-31-2022	03-19-2024
ISM MANUFACTURING INDEX (PMI)	57.10	46.00	48.10	47.80	-16.29%	-8.85%	03-31-2022	02-29-2024

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ISM Manufacturing New Orders Back in Contraction



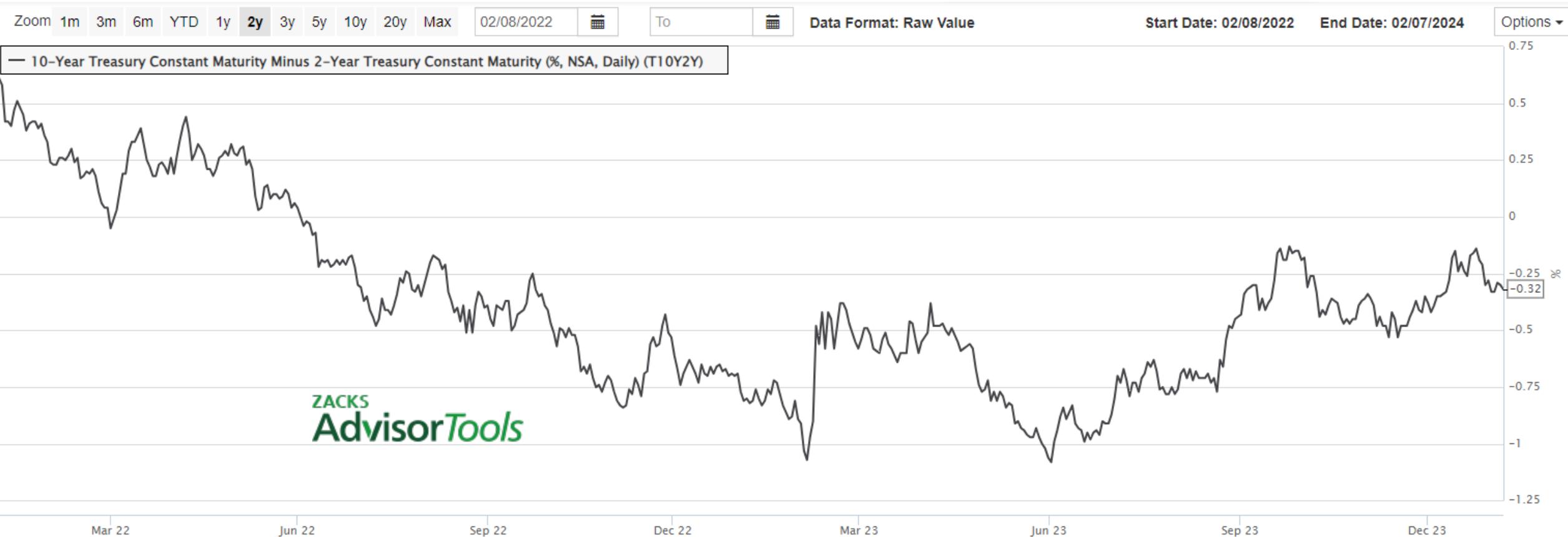
Streak ended in January at 18 consecutive monthly declines, but falls again in February



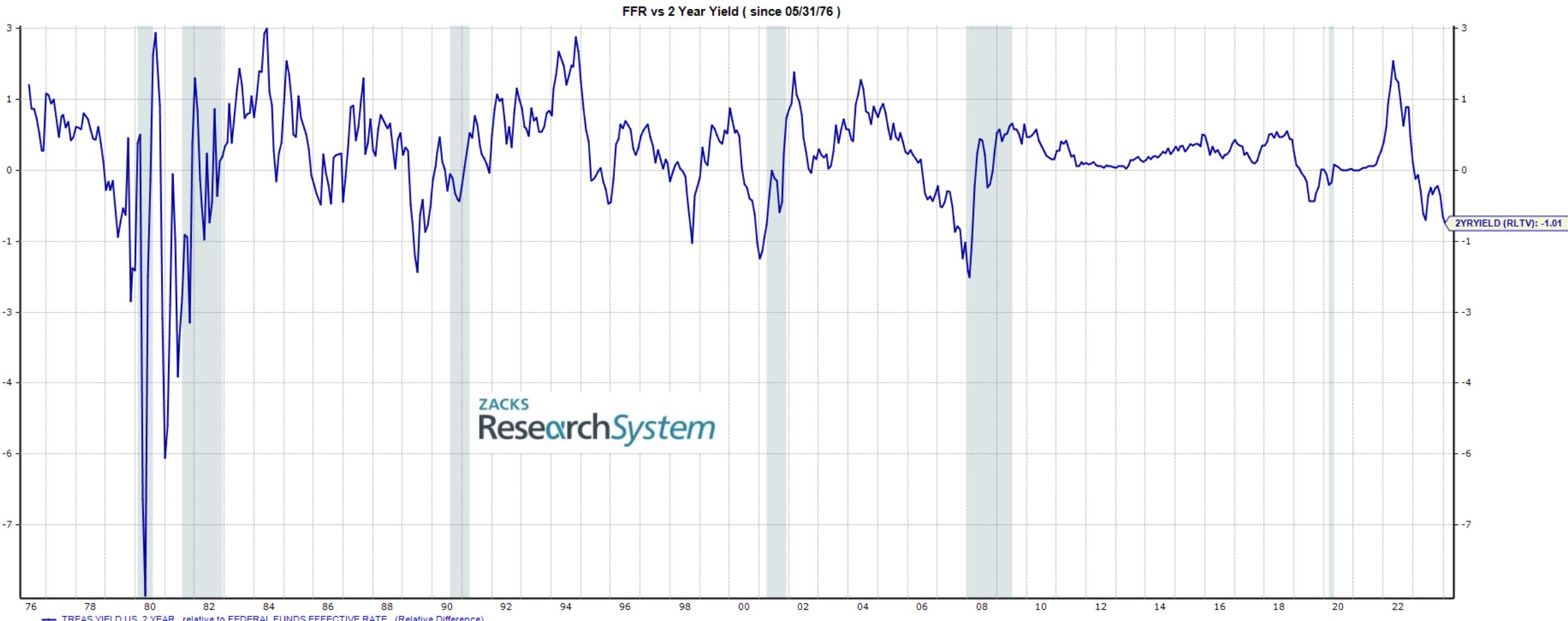
Factories Continue Slashing Workweek Hours to Recessional Levels



Yield Curve Beginning to Re-Steeperen, But Continues to Signal No Imminent Recession



History Has Shown Forced Inversion Breaks Things



Title	High	Low	Median	Current	Start Date	End Date
TREAS YIELD US 2 YEAR relative to FEDERAL FUNDS EFFECTIVE RATE (Relative Difference)	2.85	-8.36	0.42	-1.01	05-31-1976	01-31-2024

LEADING ECONOMIC INDEX



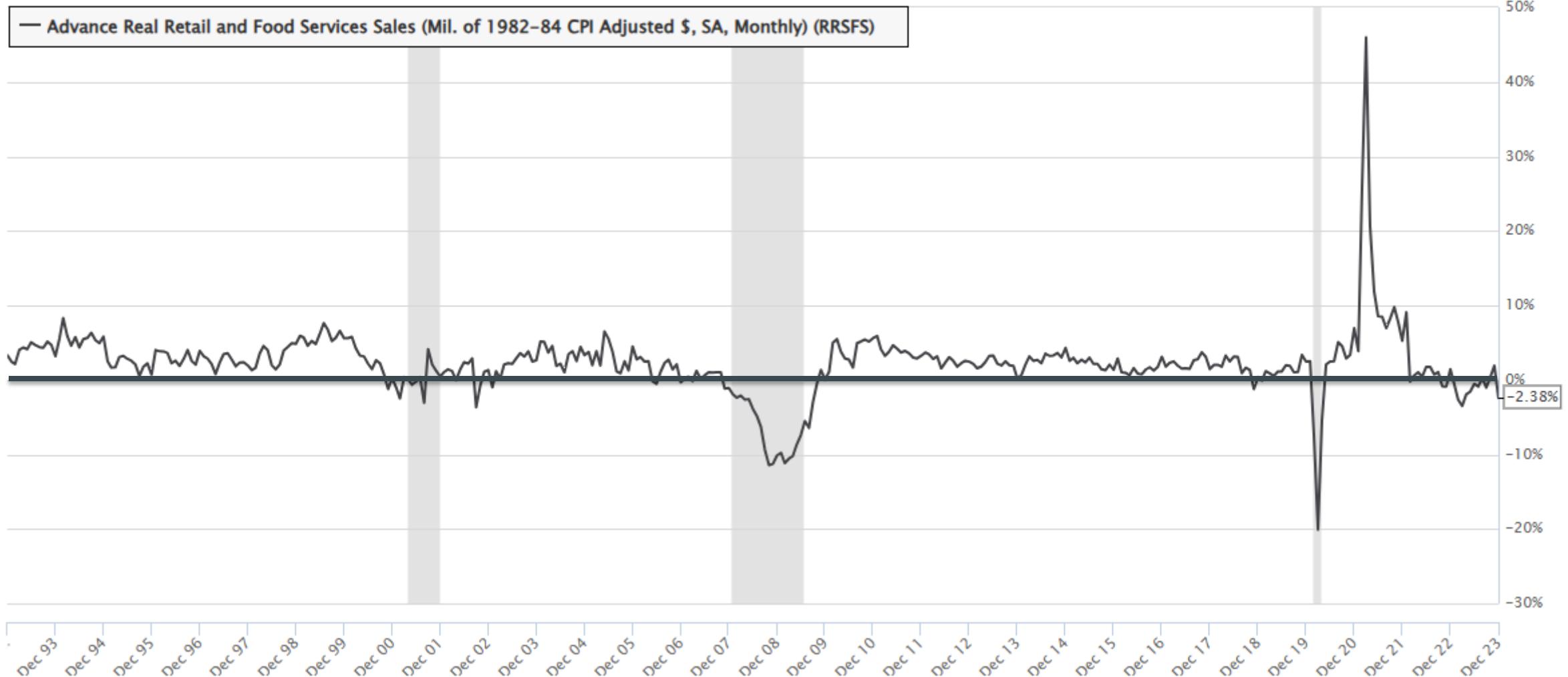
Conference Board's Leading Economic Index has now been in decline for 22 consecutive months.

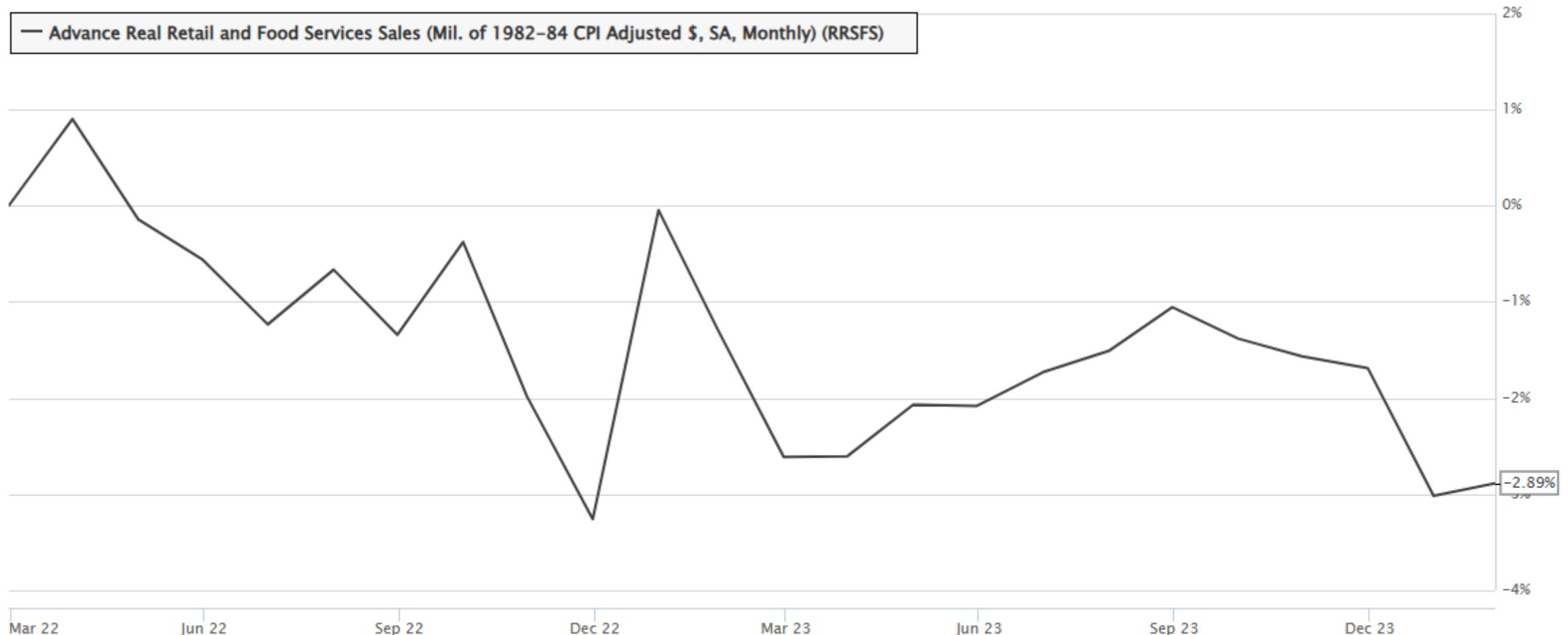
Firmly at recession levels, led by weakening credit growth and manufacturing new orders. March update due tomorrow.



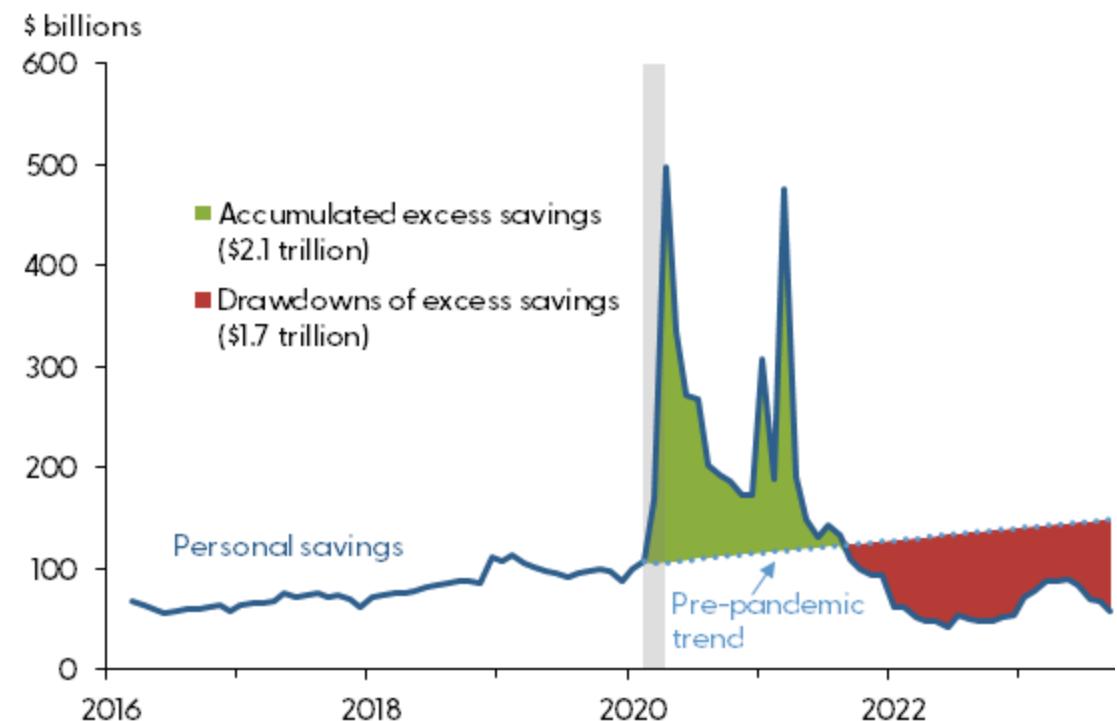
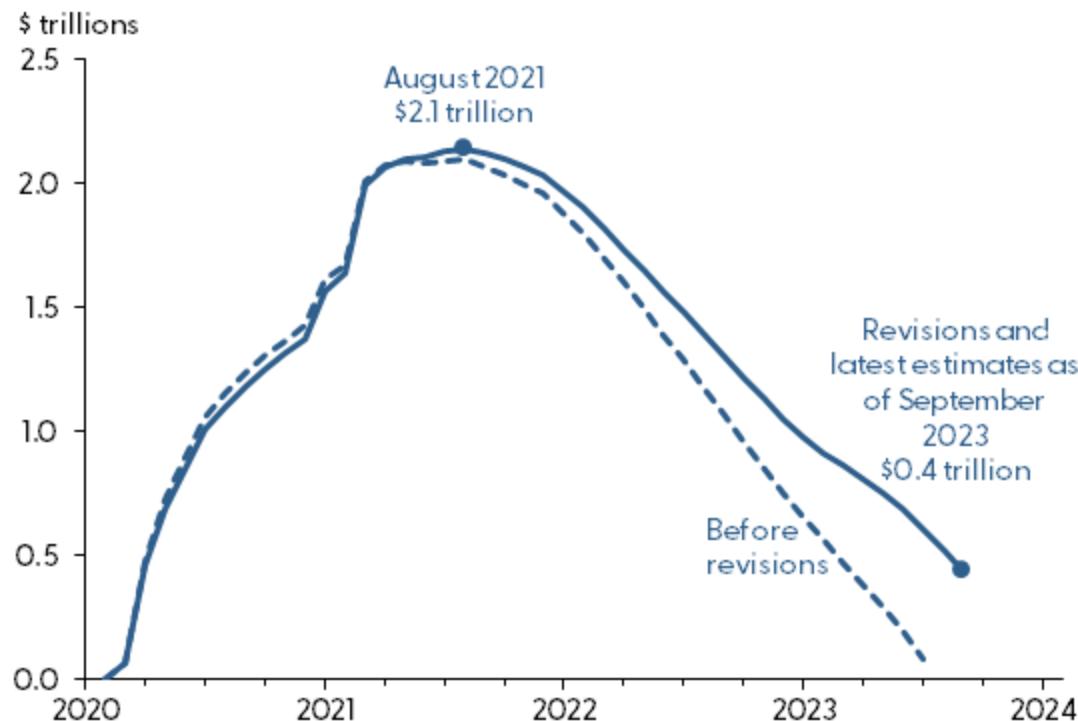
EXCESS SAVINGS

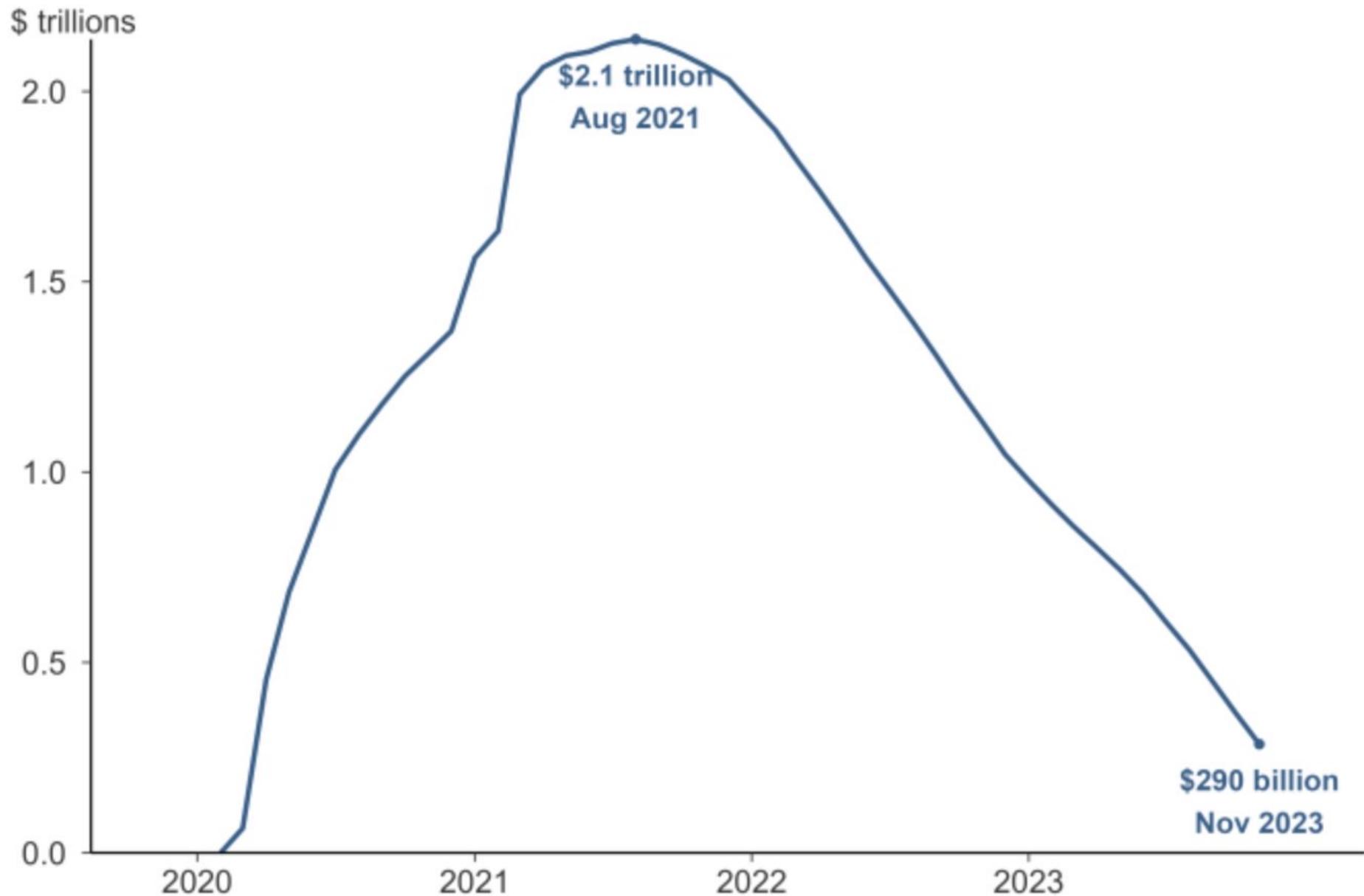
Real Retail Sales Starting to Come Under Pressure Again





Real Personal Consumption > Real Personal Income, which means pandemic-era excess savings have been drawn down and will be exhausted by 1H 2024





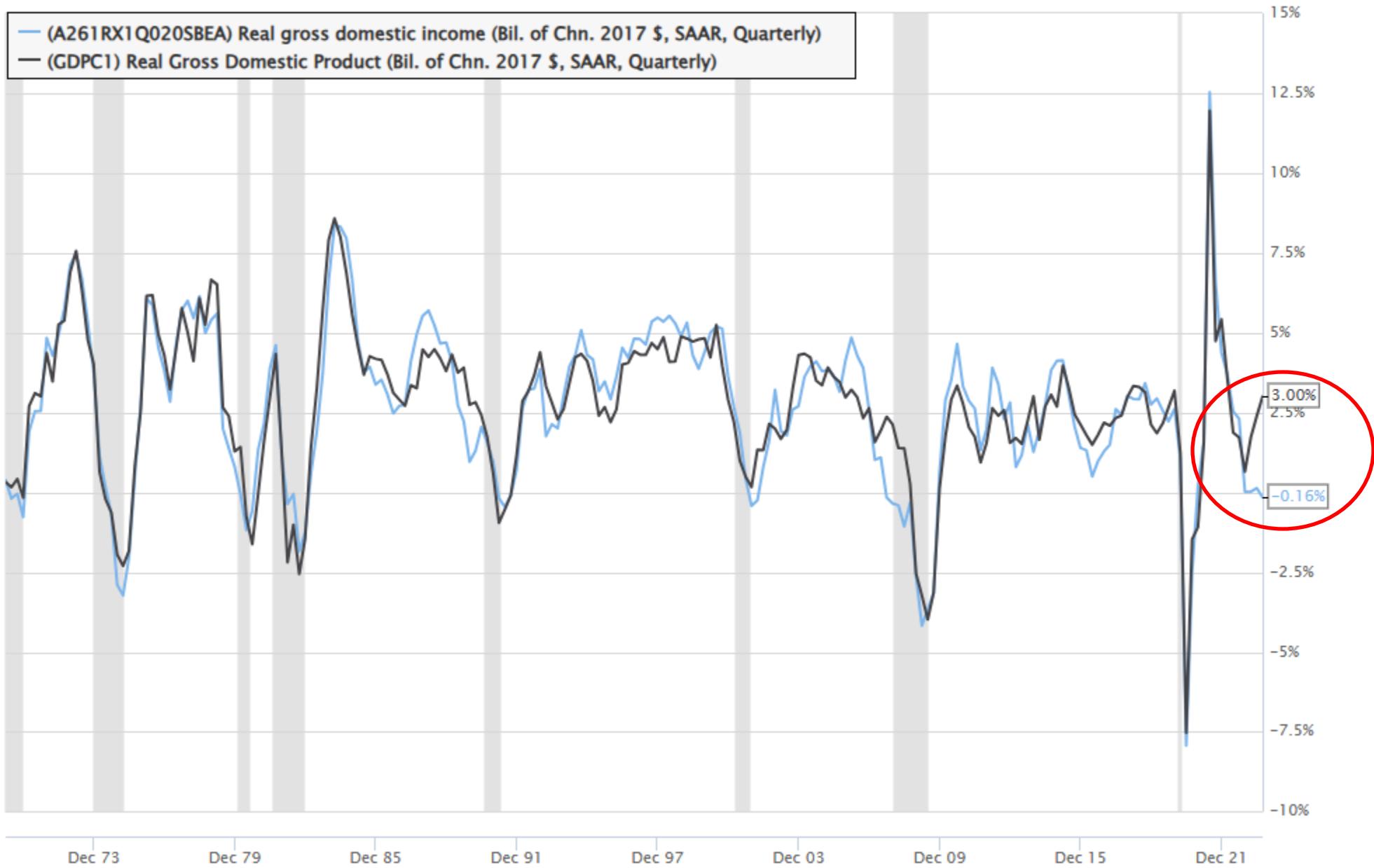
Gross Domestic Income Continues to Undermine GDP

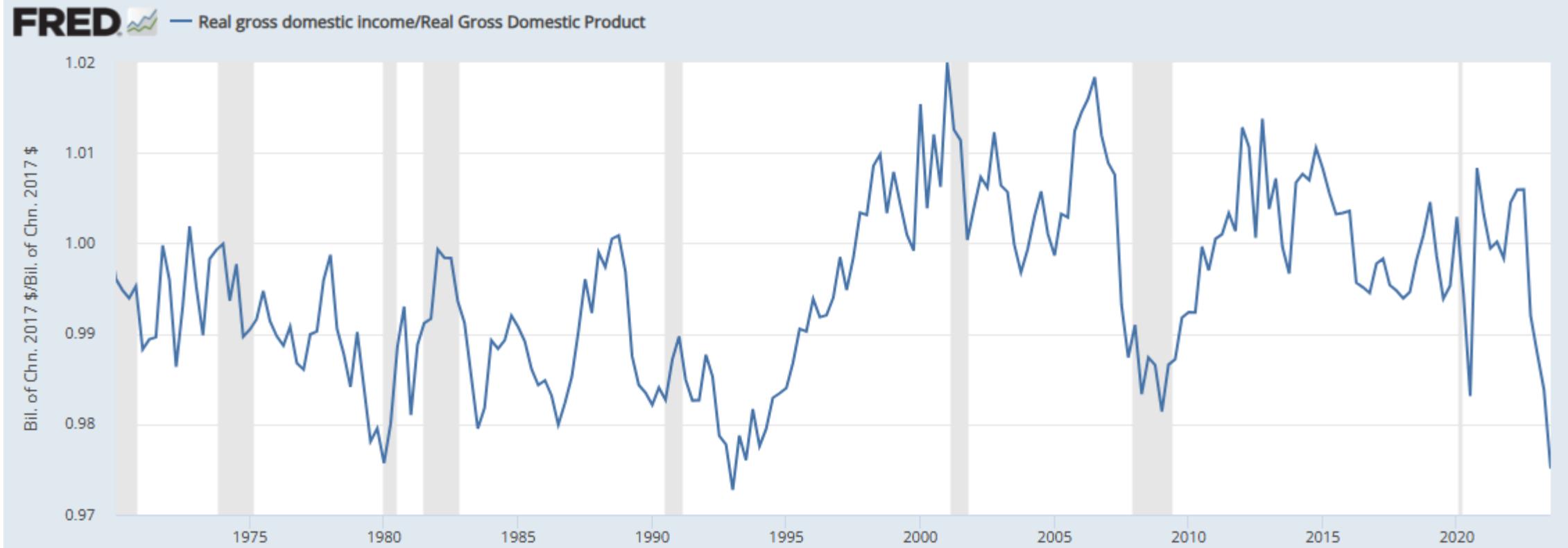


January 25, 2024

Table 6. Real Gross Domestic Product: Percent Change from Quarter One Year Ago

Line		2020				2021				2022				2023				Line
		Q1	Q2	Q3	Q4													
1	Gross domestic product (GDP)	1.2	-7.5	-1.5	-1.1	1.6	11.9	4.7	5.4	3.6	1.9	1.7	0.7	1.7	2.4	2.9	3.1	1
2	Personal consumption expenditures (PCE)	0.8	-8.6	-1.5	-0.8	3.0	16.4	7.6	7.2	5.0	2.2	1.9	1.2	2.1	1.8	2.2	2.6	2
3	Goods	3.0	-0.9	8.4	8.8	13.6	20.3	6.0	6.6	2.3	-1.2	0.8	-0.6	1.0	1.2	2.6	3.5	3
4	Durable goods	1.6	-0.9	15.3	15.3	28.4	32.8	4.5	5.8	-0.2	-3.7	3.0	0.1	3.1	3.2	4.7	6.1	4
5	Nondurable goods	3.7	-0.9	5.0	5.4	6.4	13.9	6.8	7.0	3.8	0.2	-0.5	-1.0	-0.2	0.1	1.4	2.2	5
6	Services	-0.2	-12.1	-6.0	-5.1	-1.8	14.4	8.5	7.6	6.4	4.0	2.5	2.1	2.7	2.2	2.0	2.2	6
7	Gross private domestic investment	-2.0	-16.8	-2.2	2.1	3.9	19.8	4.7	7.9	10.5	9.0	2.9	-2.4	-6.1	-2.2	2.1	1.8	7
8	Fixed investment	1.9	-7.9	-3.1	0.7	3.8	14.4	7.0	3.8	3.3	1.8	1.1	-0.8	-1.8	-0.5	1.3	3.1	8
9	Nonresidential	0.6	-9.3	-6.4	-3.7	0.4	11.8	6.8	4.9	5.3	4.3	5.8	5.6	4.4	4.9	4.1	4.1	9
10	Structures	4.7	-10.8	-16.3	-14.9	-12.1	0.1	1.4	-0.9	-3.1	-3.4	-2.7	0.8	8.1	12.3	15.7	14.8	10
11	Equipment	-7.8	-19.2	-9.4	-3.7	2.5	18.4	4.6	1.4	4.9	3.5	7.2	5.3	0.2	0.9	-1.6	-0.1	11
12	Intellectual property products	7.9	3.3	3.4	3.4	5.9	12.2	11.9	11.6	10.3	9.0	9.0	8.3	6.4	4.9	3.6	2.6	12
13	Residential	6.7	-2.7	8.8	15.9	14.8	22.7	7.3	0.4	-2.4	-5.0	-11.4	-17.4	-18.1	-15.4	-7.2	0.0	13
14	Change in private inventories	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	14
15	Net exports of goods and services	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	.....	15
16	Exports	-4.3	-24.1	-14.5	-9.7	-5.7	20.3	7.1	6.7	5.2	7.4	11.1	4.3	7.3	21	-0.4	2.1	16
17	Goods	-2.2	-24.1	-9.7	-4.4	-3.4	27.2	5.6	5.5	3.1	5.6	11.3	3.2	8.6	17	-1.3	1.5	17
18	Services	-8.2	-24.2	-22.9	-19.3	-10.2	8.4	10.0	9.2	9.9	11.5	10.5	6.7	4.4	26	1.6	3.2	18
19	Imports	-5.5	-22.1	-8.4	0.1	5.7	30.4	13.6	11.1	12.7	11.8	8.2	2.1	-1.0	-3.9	-1.7	-0.2	19
20	Goods	-4.9	-19.8	-3.8	5.3	10.3	31.9	10.7	8.7	10.1	9.6	7.1	0.9	-2.0	-4.1	-0.9	0.4	20
21	Services	-8.0	-31.5	-27.3	-20.9	-13.8	23.4	29.3	23.9	27.2	23.4	13.6	8.2	4.1	-2.6	-5.2	-2.6	21
22	Government consumption expenditures and gross investment	4.4	5.0	2.2	1.1	1.4	-1.8	-0.6	-0.2	-2.3	-1.6	-0.6	0.8	2.7	41	4.8	4.3	22
23	Federal	4.3	10.2	5.2	4.5	7.6	-1.9	-0.4	0.6	-5.2	-4.0	-1.9	-0.1	3.0	43	5.7	4.0	23
24	National defense	3.0	3.4	1.7	3.2	0.3	-1.1	-1.8	-5.0	-4.9	-3.5	-2.8	0.2	2.5	29	5.0	3.3	24
25	Nondefense	6.3	20.3	10.6	6.4	18.3	-3.0	1.4	8.6	-5.6	-4.5	-0.8	-0.6	3.5	61	6.7	4.7	25
26	State and local	4.5	1.9	0.4	-0.9	-2.2	-1.7	-0.7	-0.6	-0.4	-0.2	0.2	1.3	2.6	40	4.3	4.5	26
	Addenda:																	
27	Gross domestic income (GDI) ¹	1.1	-7.9	-2.5	0.2	1.6	12.5	6.6	4.4	3.7	2.5	2.3	0.0	0.0	0.1	-0.1	.....	27







BEA to release update on Q4 real GDI on March 28

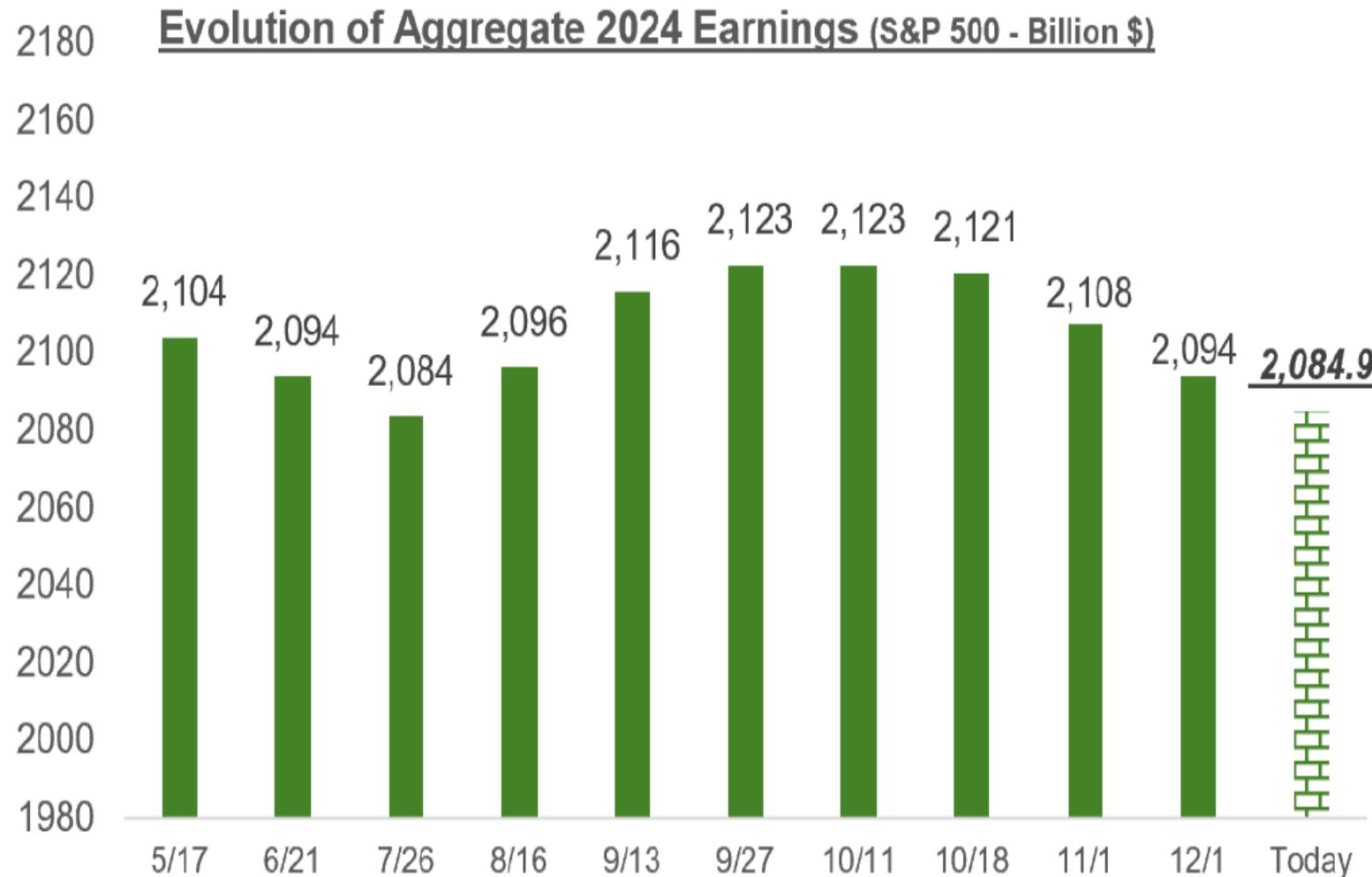


Analysts are still expecting +10% EPS growth in 2024, but I believe the leading indicators of earnings suggest these expectations are vastly overstated.

EPS forecasts will be marked down, in my view, as the sharp rise in the cost of capital will inevitably lead to rising delinquencies, defaults, bankruptcies, and ultimately job cuts.



Estimates Are Starting to be Revised Down



Source: Zacks Investment Research, Inc.



Recessions are always a slow buildup of many things.

But if we see a rapidly steepening yield curve, this may be a sign of rapid deterioration which can lead to someone being caught 'offsides'



Banks Continue to Face Tremendous Difficulty:

Large unrealized losses on HTM securities

- + Increasing depositor withdrawals
- + Declining commercial real estate prices
- + Rising loan loss provisions

= Tightening credit availability

NBER: 14% of all loans and 44% of office loans are in 'negative equity', leading to potentially up to 300 regional banks at risk of solvency runs.

Monetary Tightening, Commercial Real Estate Distress, and US Bank Fragility



Erica Xuewei Jiang, Gregor Matvos, Tomasz Piskorski & Amit Seru

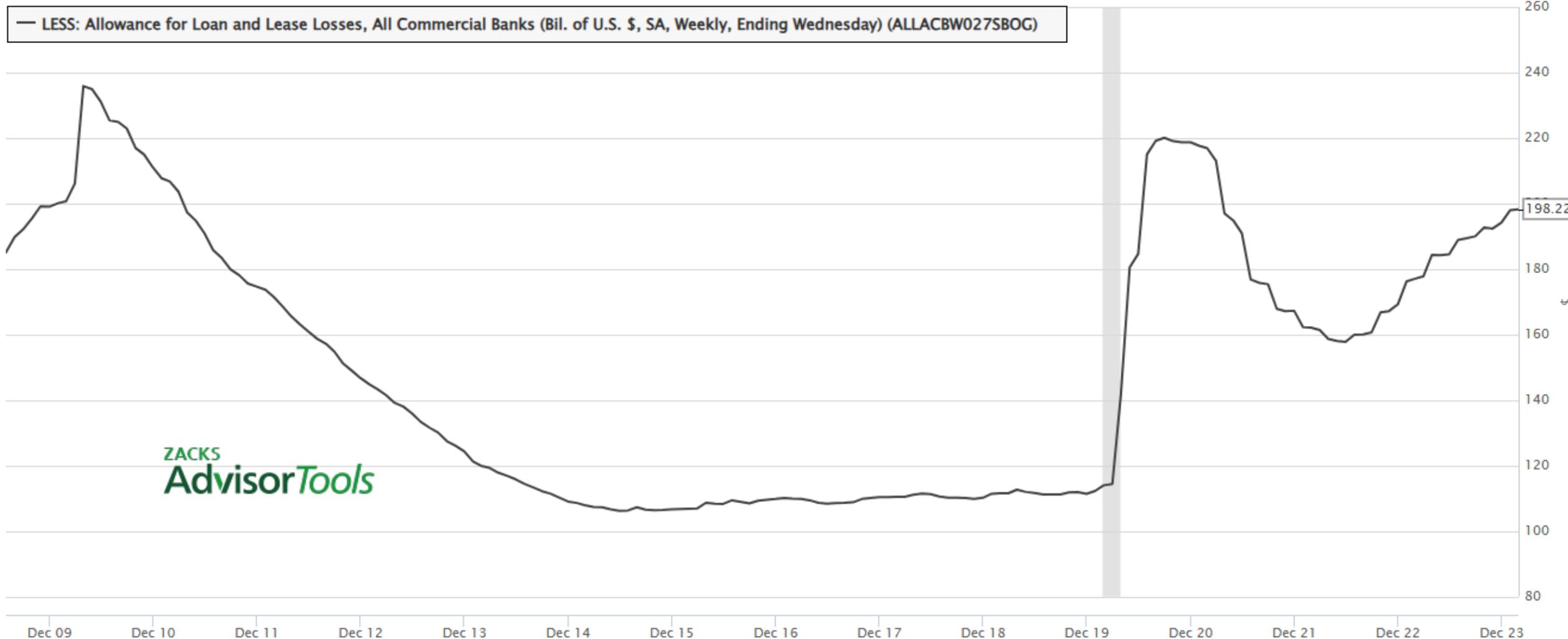
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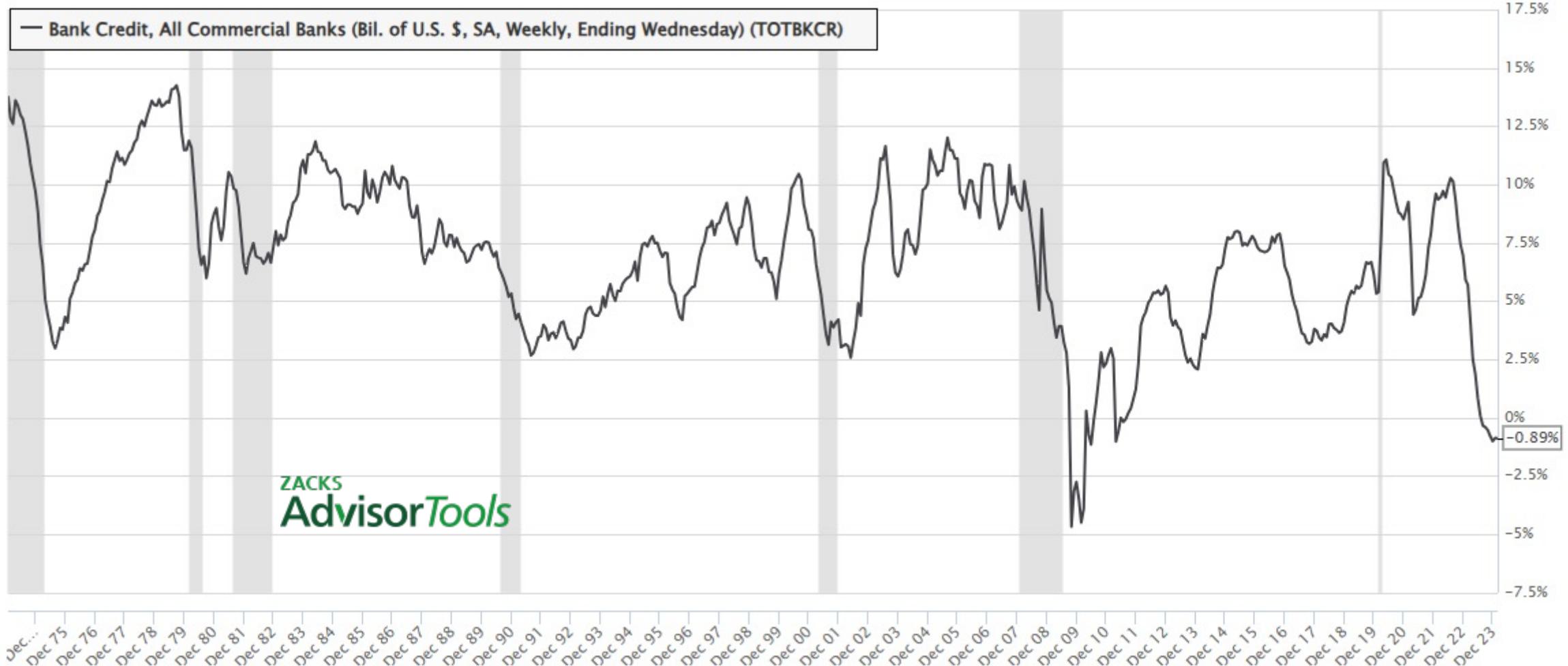
ISSUE DATE December 2023

Building on the work of Jiang et al. (2023) we develop a framework to analyze the effects of credit risk on the solvency of U.S. banks in the rising interest rate environment. We focus on commercial real estate (CRE) loans that account for about quarter of assets for an average bank and about \$2.7 trillion of bank assets in the aggregate. Using loan-level data we find that after recent declines in property values following higher interest rates and adoption of hybrid working patterns about 14% of all loans and 44% of office loans appear to be in a "negative equity" where their current property values are less than the outstanding loan balances. Additionally, around one-third of all loans and the majority of office loans may encounter substantial cash flow problems and refinancing challenges. A 10% (20%) default rate on CRE loans – a range close to what one saw in the Great Recession on the lower end -- would result in about \$80 (\$160) billion of additional bank losses. If CRE loan distress would manifest itself early in 2022 when interest rates were low, not a single bank would fail, even under our most pessimistic scenario. However, after more than \$2 trillion decline in banks' asset values following the monetary tightening of 2022, additional 231 (482) banks with aggregate assets of \$1 trillion (\$1.4 trillion) would have their marked to market value of assets below the face value of all their non-equity liabilities. To assess the risk of solvency bank runs induced by higher rates and credit losses, we expand the Uninsured Depositors Run Risk (UDRR) financial stability measure developed by Jiang et al. (2023) where we incorporate the impact of credit losses into the market-to-market asset calculation, along with the effects of higher interest rates. Our analysis, reflecting market conditions up to 2023:Q3, reveals that CRE distress can induce anywhere from dozens to over 300 mainly smaller regional banks joining the ranks of banks at risk of solvency runs. These findings carry significant implications for financial regulation, risk supervision, and the transmission of monetary policy.

While Loan Loss Provisions Are Rising



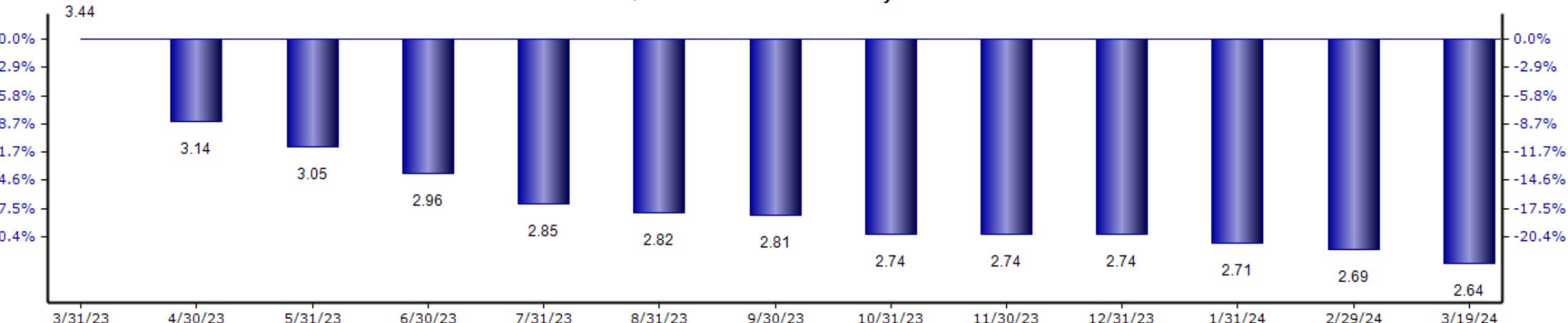
Bank Lending Rarely Contracts Outside of Recessions



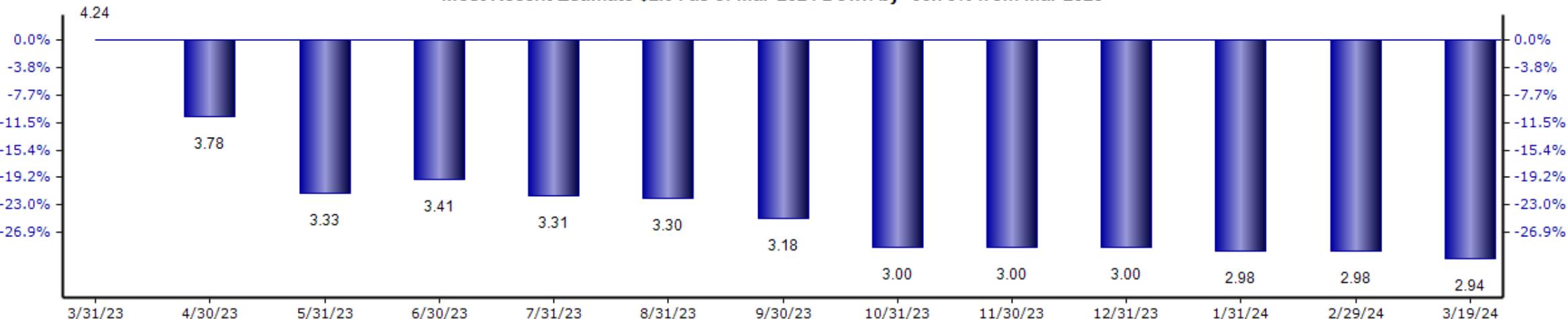
...still no bottom for EPS estimates for regional banks



Spdr S&P Regional Banking ETF Composite (KRE.S) S-Wtd. F1 - Dec 2024 EPS Estimate Revisions
Most Recent Estimate \$2.64 as of Mar 2024 Down by -23.30% from Mar 2023



Spdr S&P Regional Banking ETF Composite (KRE.S) S-Wtd. F2 - Dec 2025 EPS Estimate Revisions
Most Recent Estimate \$2.94 as of Mar 2024 Down by -30.70% from Mar 2023



Discover Financial Services (DFS) shares declined -10% following Q4 earnings after the credit card network & lender more than doubled credit loss provisions to \$1.9 billion (vs \$900m a year ago) on sharply rising delinquencies.



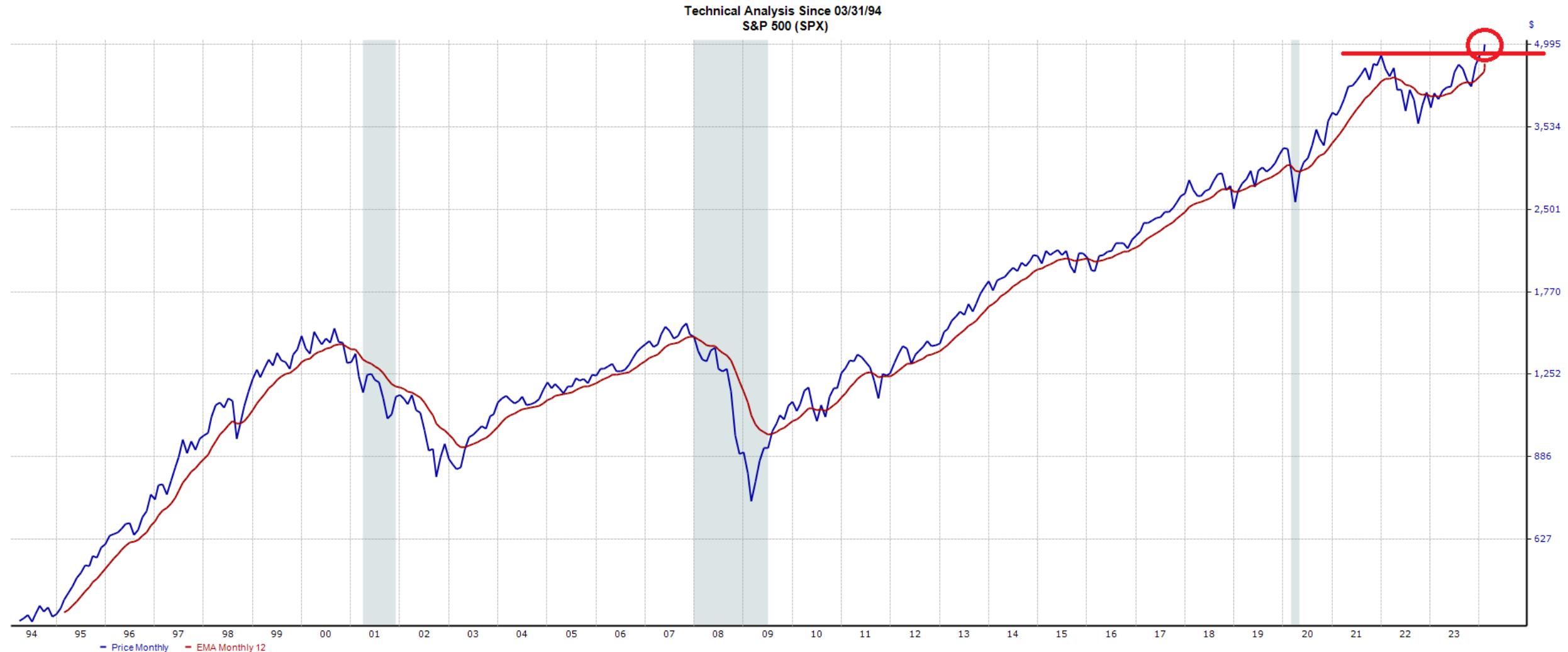
Discover is a bellwether of the health of the American middle class with over 60 million cardholders, mostly of middle incomes.

Shockingly, Capital One (COF) offered to buy out Discover for \$35 billion.



Regional banks are dealing with these fires simultaneously. I believe the banking crisis is not yet over.

However, the SPX Chart is Extremely Bullish



EPS Estimates Remain Strong, Analysts Expect Cyclical Recovery After 6 Quarters of Decelerating Growth



Strong evidence of disinflation across various measures: housing, used cars, and commodities

Easing long-term yields

Together, a 'goldilocks' blend of conditions fueling powerful market rally

My primary conclusions:



1. the *direction* of leading fundamental indicators (including the rising cost of capital), at the margin, implies negative pressure to S&P earnings. This means analysts *will* mark down both FY 2023 and FY 2024 EPS forecasts.
2. Markets are priced for strong earnings growth at a forward P/E of 20x and equity risk premiums at 20-year lows
3. If that doesn't happen, there will be a substantial bear market.

PLAN of ACTION:



- The Big 3 indicators I am watching:
 - Permanent Job Losers
 - 10yr vs 2yr US Treasury Yields
 - SPX, QQQ vs their respective 200-day exponential moving average (EMA)

If we see all three of:

 - **Permanent Job Losers rise above its 36-month EMA**
 - **2yr US Treasury Yield crosses below the 10yr US Treasury Yield**
 - **S&P 500 and/or Nasdaq 100 falls below its 200-day EMA**

Then it's time to go full-blown defensive. The first one just triggered in February, but the next two haven't yet.
- My Optimal Defensive Portfolio:
 - 1-3 Year Treasury ETF (SHY)
 - Money Market Mutual Funds
 - Investment Grade Short-Term Corporate Bonds, such as the JP Morgan Ultra Short Income ETF, ticker JPST
 - Zacks Earnings Certain Portfolio
 - Focus especially on the companies with:
 - Lowest beta
 - Dividend growth and/or share buybacks
 - Low Shiller P/E
 - Position for a low-growth environment with a combination of recession-resistant growth (ZECPE) + income (1Y Treasuries).

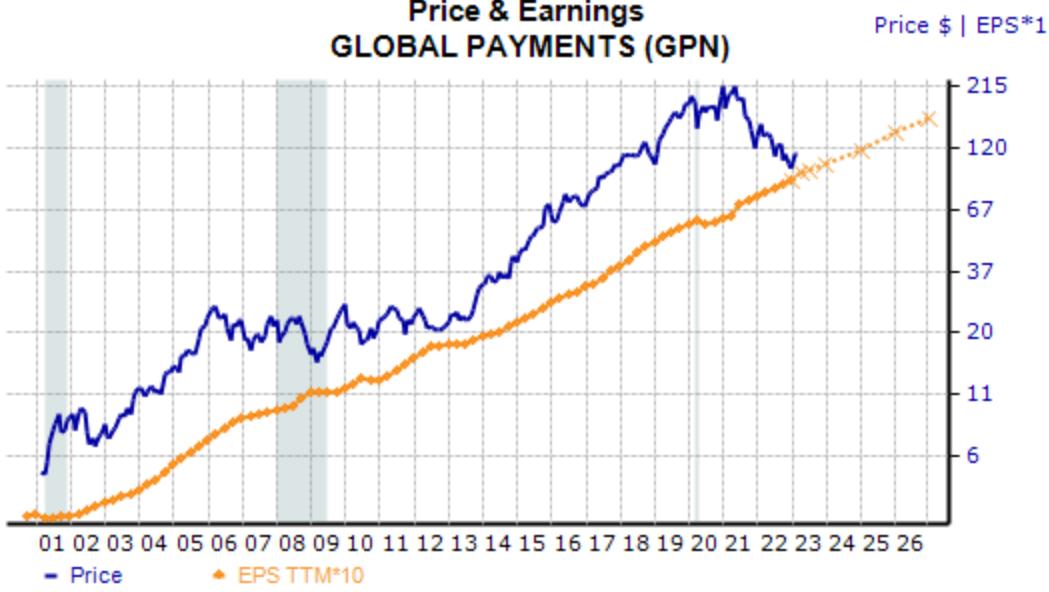
Zacks Earnings Certain Businesses



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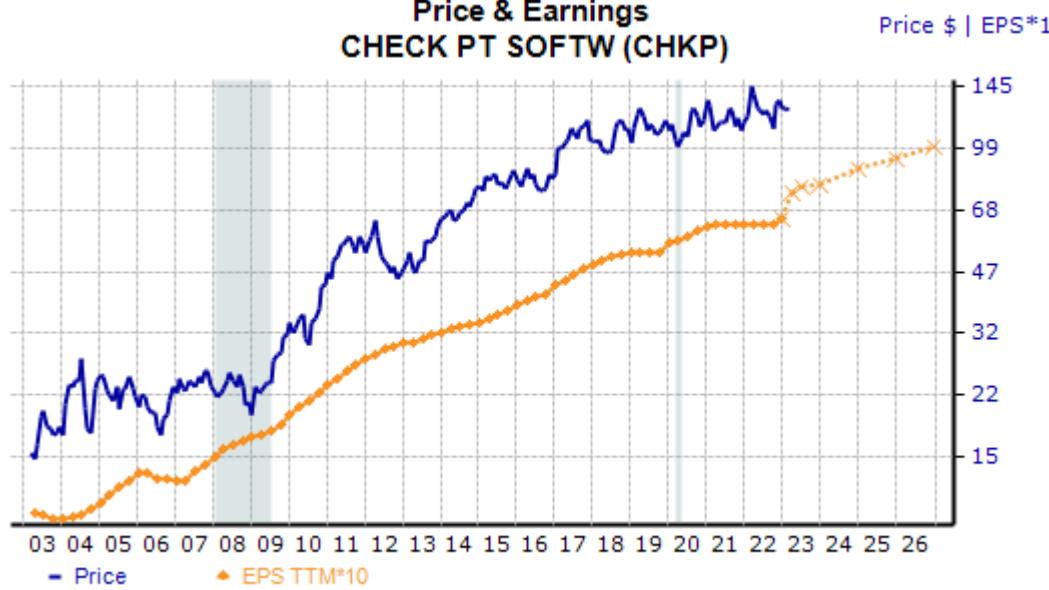
Price & Earnings
GLOBAL PAYMENTS (GPN)



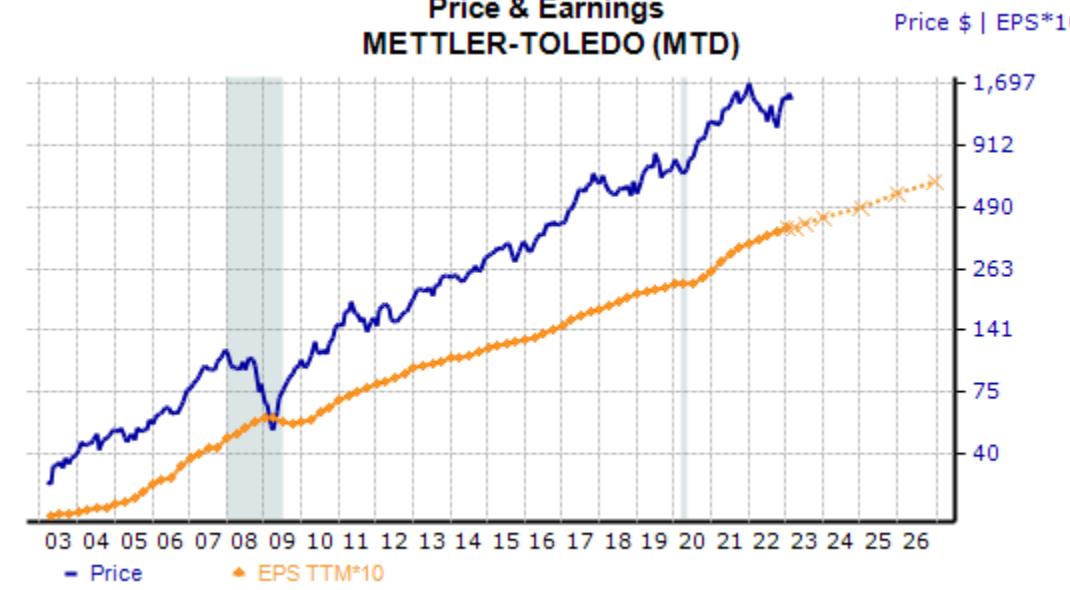
Price & Earnings
NOVO-NORDISK AS (NVO)



Price & Earnings
CHECK PT SOFTW (CHKP)



Price & Earnings
METTLER-TOLEDO (MTD)



Thank You for Attending!



Mayur M Thaker, CFA

Equity Strategist

Zacks Professional Services

Support: 866.794.6065 | info@Zackspro.com

Twitter: @freshjiva

[linkedin.com/in/mayur-m-thaker-cfa-86234235/](https://www.linkedin.com/in/mayur-m-thaker-cfa-86234235/)

866-794-6065

strategycall@zackspro.com

www.zackspro.com



Zacks Professional Services



@ZATools

