

The Recession That Never Arrived

What happened? And where do we go from here?



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Recession Theory – Post Mortem

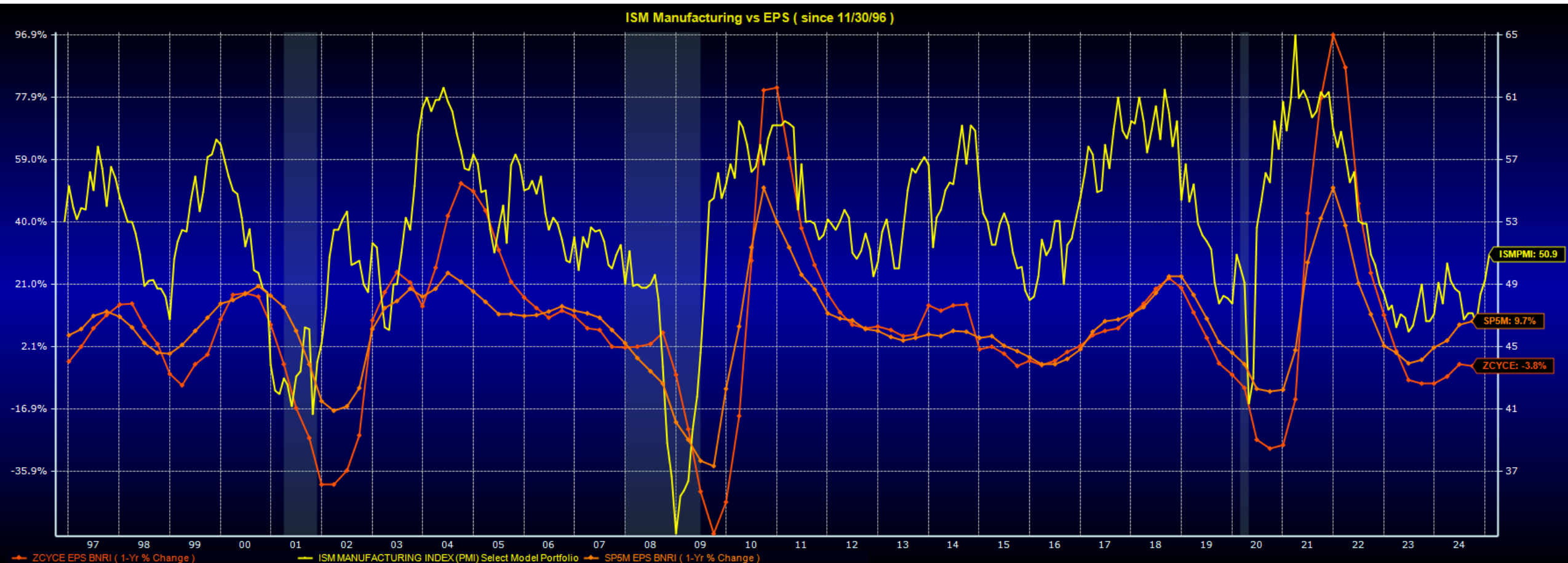


Since Q2 2023, I made the case for recession in the United States as I saw a series of **ten** market and economic **data** crossing thresholds that historically have only occurred during past recessions, with few to no false signals.

However, there's always a first for everything, and it turns out these recession signals collectively gave their first false flag, ever. And so I was wrong.

Let's take a look at each of these ten indicators that warned of recession, what went wrong, and why it's likely that they will simply recover to healthy levels consistent with bull markets.

False Flag #1: ISM Manufacturing





US Manufacturing has been in recession for 25 of the last 27 months now. The ISM Manufacturing PMI has historically been a leading indicator for S&P 500 earnings growth.

The extended contraction in ISM foretold an earnings recession for the SPX.

This worked for S&P cyclicals, which have indeed been in recession for nine quarters now, but did not work for the aggregate SPX, as the index is dominated by software & technology riding a strong secular bullish tailwind in AI investment.

ISM just returned to expansion in January for only the 2nd time in 27 months.

False Flag #2: Zacks Cyclical Proxy in Earnings Recession

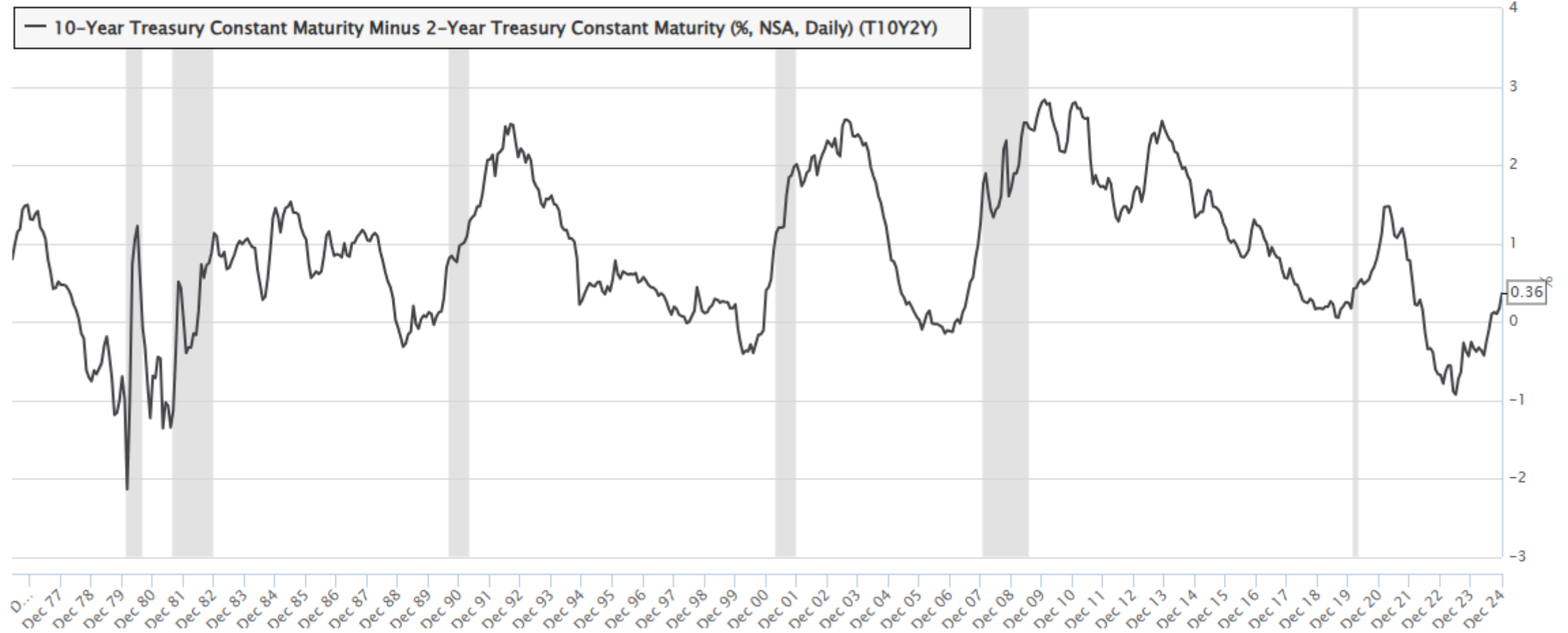




Zacks Cyclical Proxy is a subset of the S&P 500 with the greatest earnings variability. These are mostly mature businesses with limited growth potential. Its important to track these companies because their financial performance is a direct reflection of the state of the business cycle.

These companies have collectively been in an earnings recession for 10 consecutive quarters. Never in history has this occurred without the broader economy falling into recession.

ISM Manufacturing PMI shares a 0.77 leading correlation with these companies, and correctly called their downturn. It however, may now be pivoting back to expansion with a strong January 2025 reading.

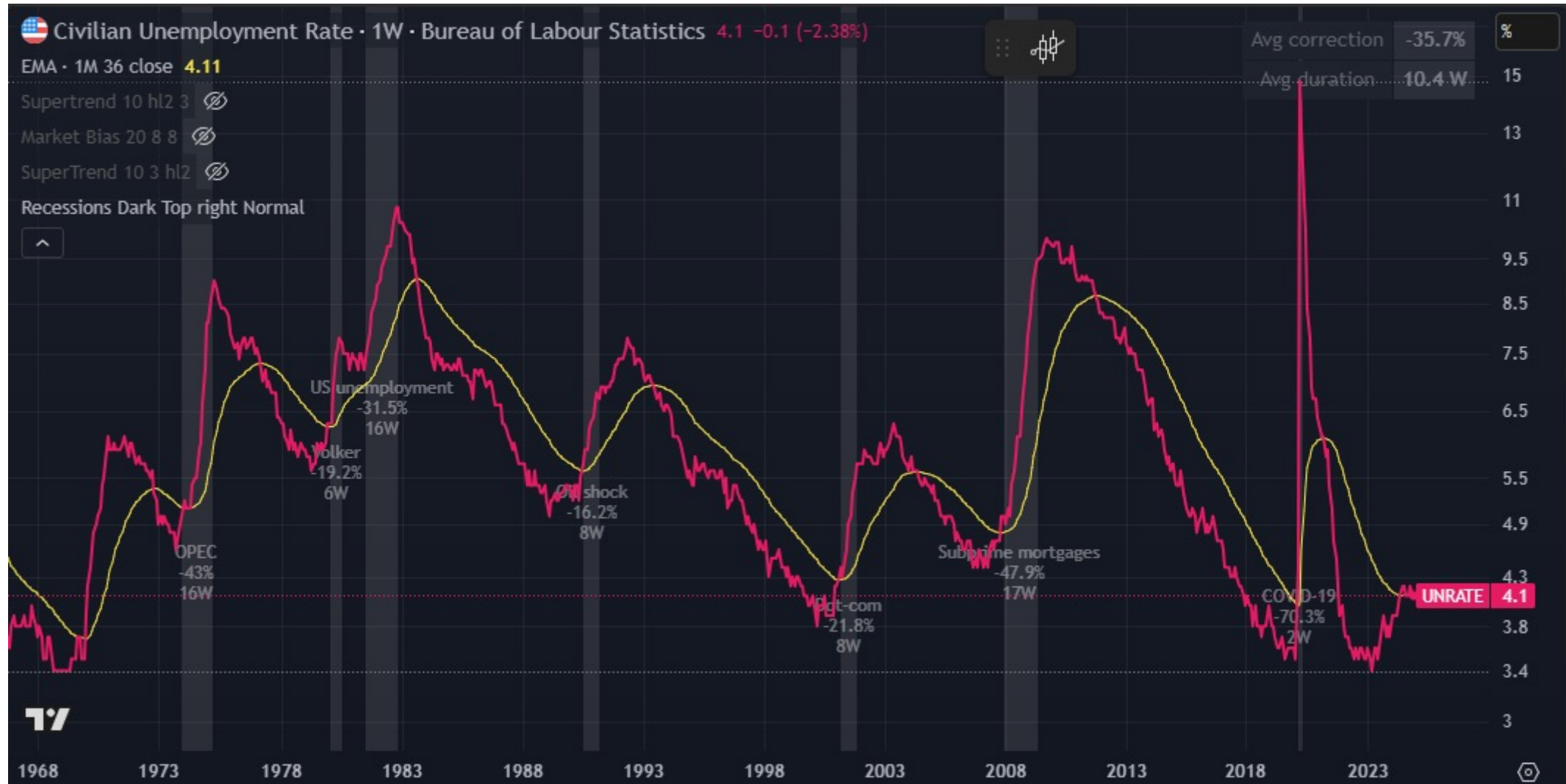


Source: Zacks Advisor Tools | zat.com



Never in over 5 decades has the 10-2 US Treasury Yield Spread inverted without a recession following within 6-24 months.

The inversion that began in July 2022 was the first exception to that rule.



Source: TradingView, US BLS, US BEA



Never in over 6 decades has the national unemployment rate crossed over its 3-year moving average without significant escalation into recession within 6-12 months.

The crossover that occurred in July 2024 has failed to gain any momentum. This was the first exception to that rule.

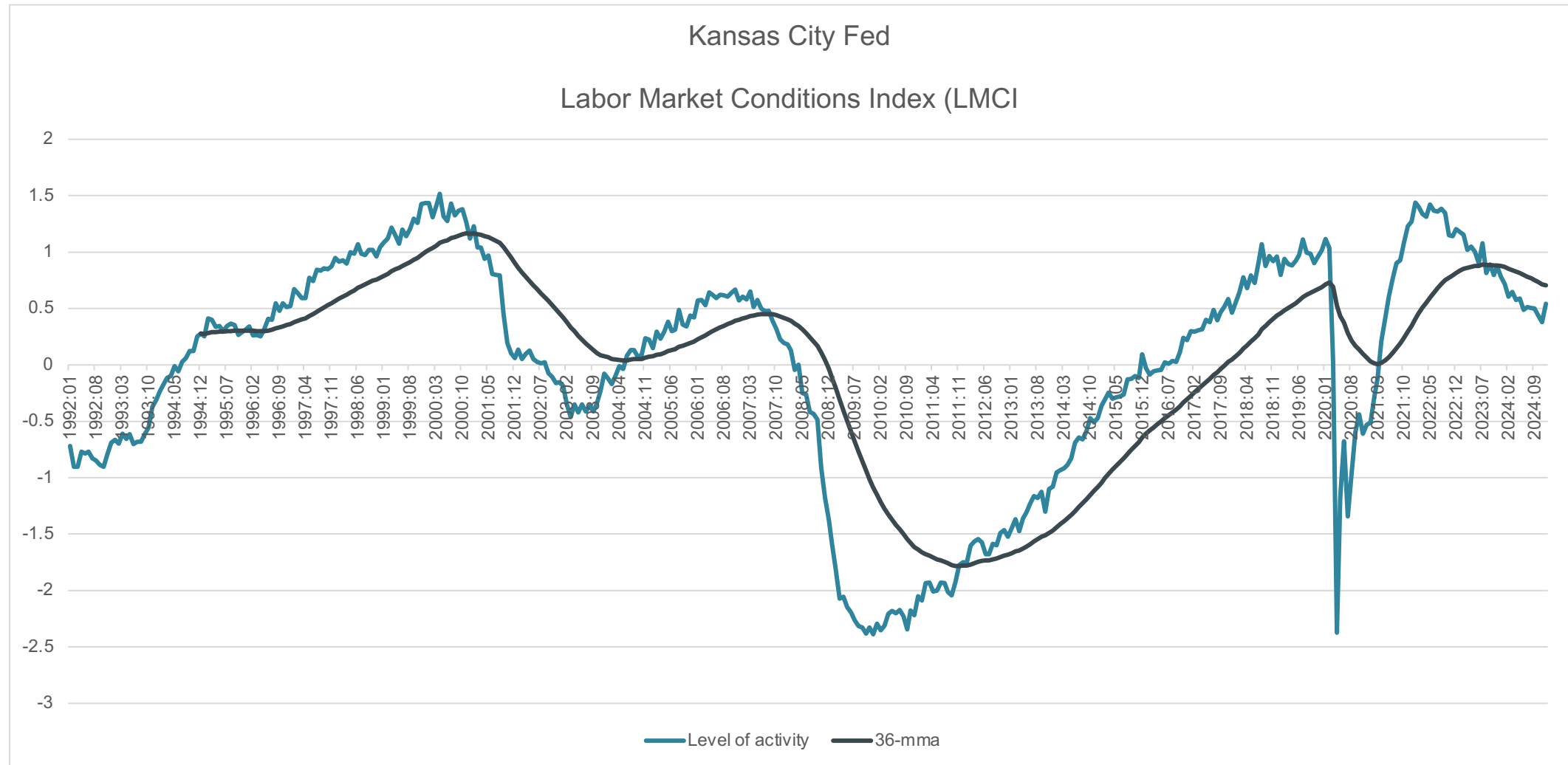


Source: TradingView, US BLS



Never in over 3 decades has permanent job losers crossed over its 3-year moving average without significant escalation into recession within 6-12 months.

The crossover that occurred in January 2024 has failed to gain any momentum. This was the first exception to that rule.



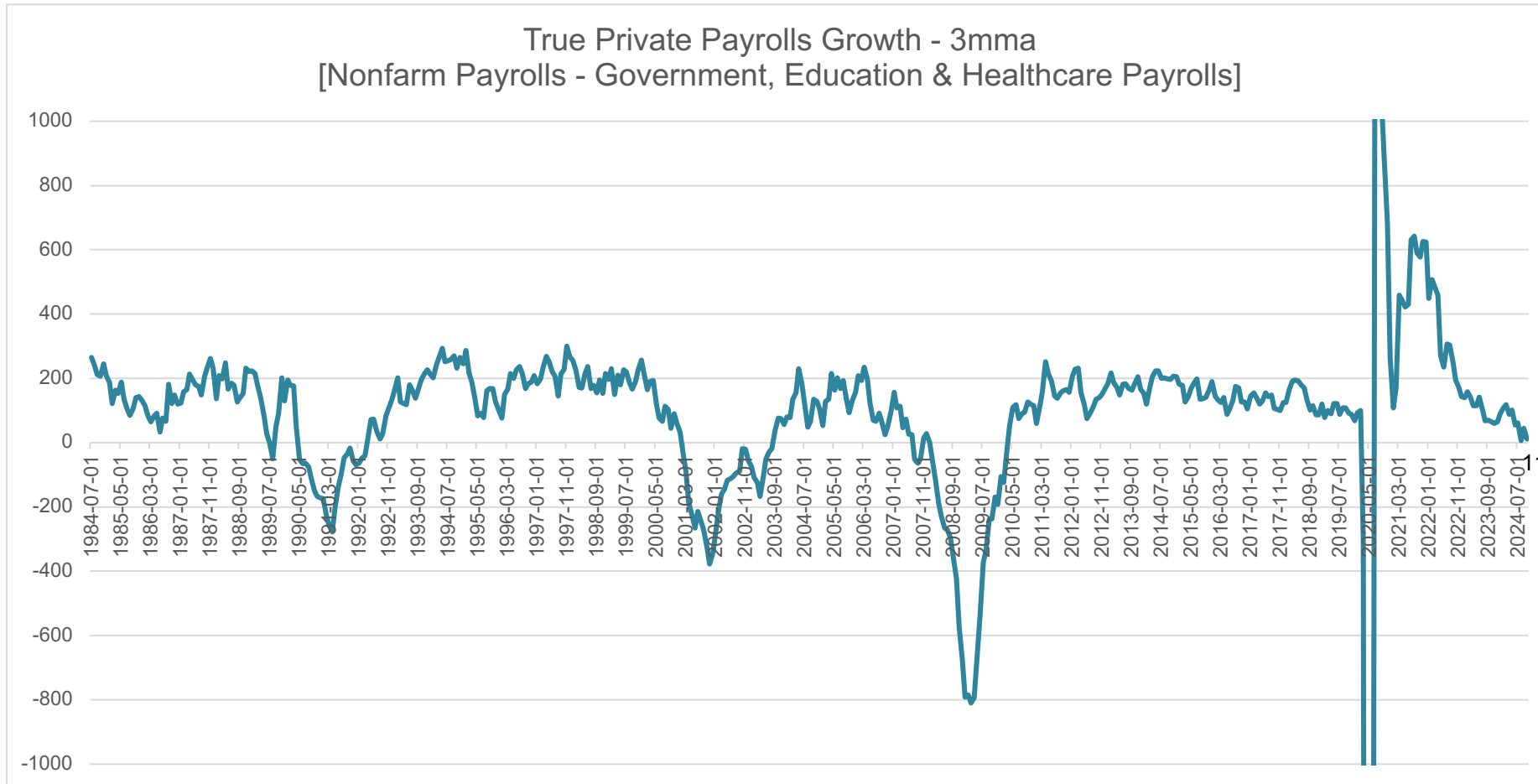
Source: Kansas City Fed, Zacks Calculations



The Kansas City Fed Labor Market Conditions Index (LMCI) is perhaps the most comprehensive index constructed from 24 leading & coincident indicators that measure the strength and breadth of the job and labor market.

Never in its 30-year history has the index fallen below its 3-year moving average without a recession following.

The crossover that started in August 2023 was the first false signal.



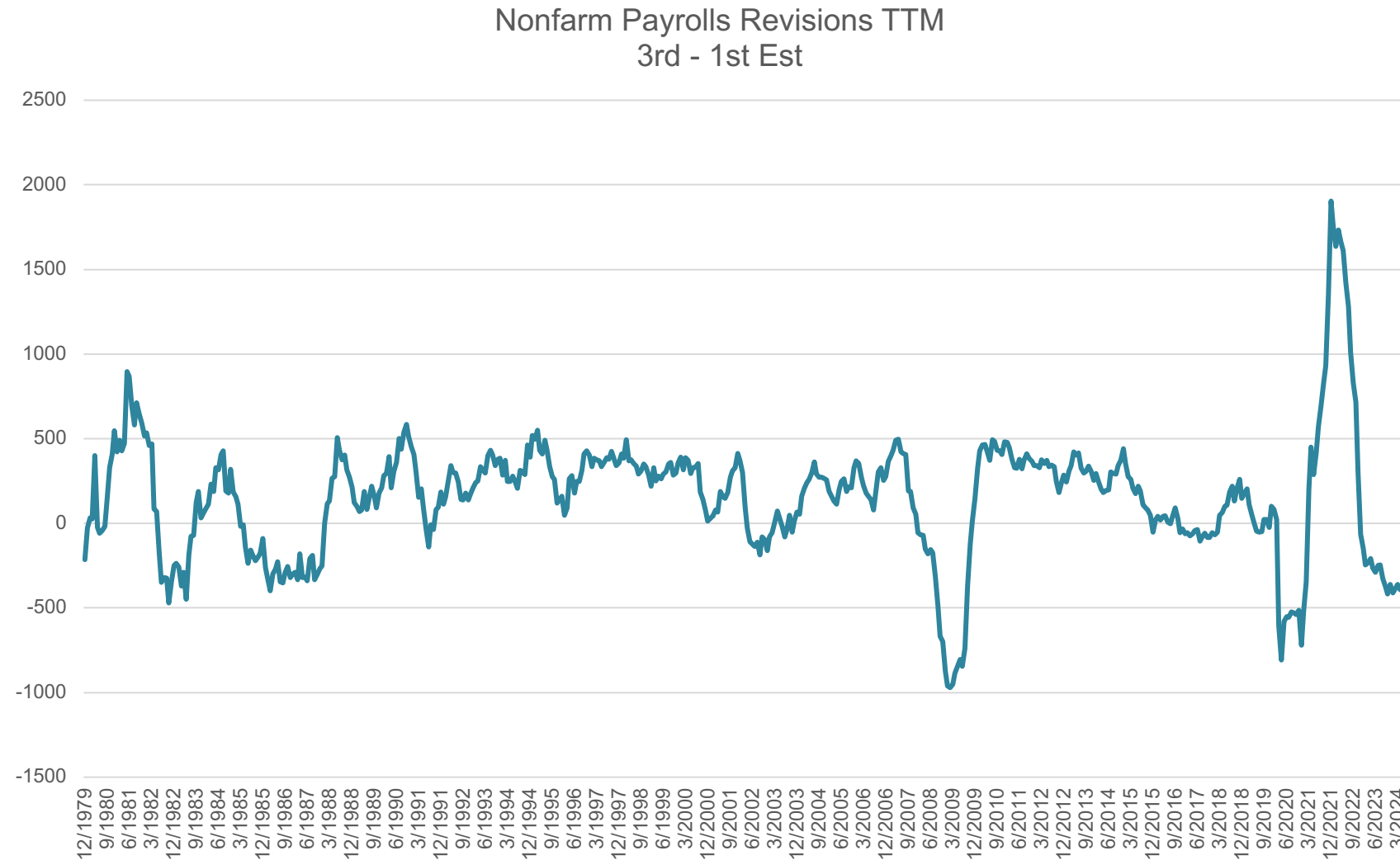
Source: US BLS, Zacks Calculations



Never in its 40 years of history has the 3-month moving average of 'true private' payrolls, defined as total nonfarm payrolls minus government, healthcare and education jobs, went into contraction without a recession following. We reached it in August 2024.

Similarly, never in 50 years has government's contribution to total job gains crossed above 60% without a recession following. We reached 64% in August.

August 2024 was the first false signal.



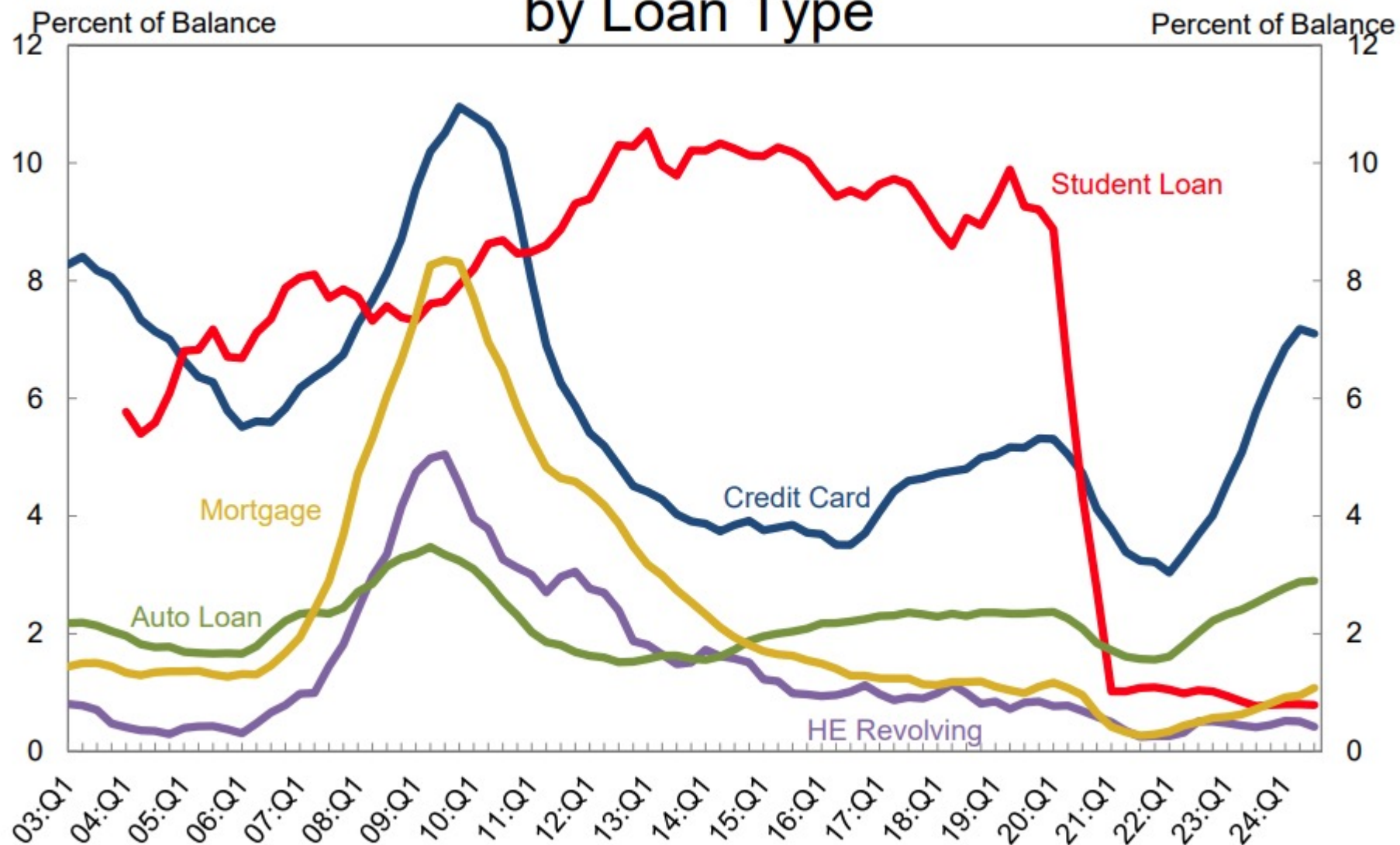
Source: US BLS, Zacks Calculations



Never in the last 50 years has the extent of prior month nonfarm payrolls revisions been this negative for such an extended period of time without a recession following.

November 2023 was the first false signal.

Transition into Serious Delinquency (90+) by Loan Type



Source: New York Fed Consumer Credit Panel/Equifax

Note: 4 Quarter Moving Sum
Student loan data are not reported prior to 2004 due to uneven reporting

Source: New York Federal Reserve



Credit card and auto loan delinquencies, both as a % of total outstanding balance and as a % of accounts transitioning into serious delinquency, hit levels not seen since we entered the Great Financial Crisis in 2008.

Capital One, American Express, and Discover Financial – all bellwethers of consumer financial health – were all reporting the highest loan loss reserve ratios since the GFC.

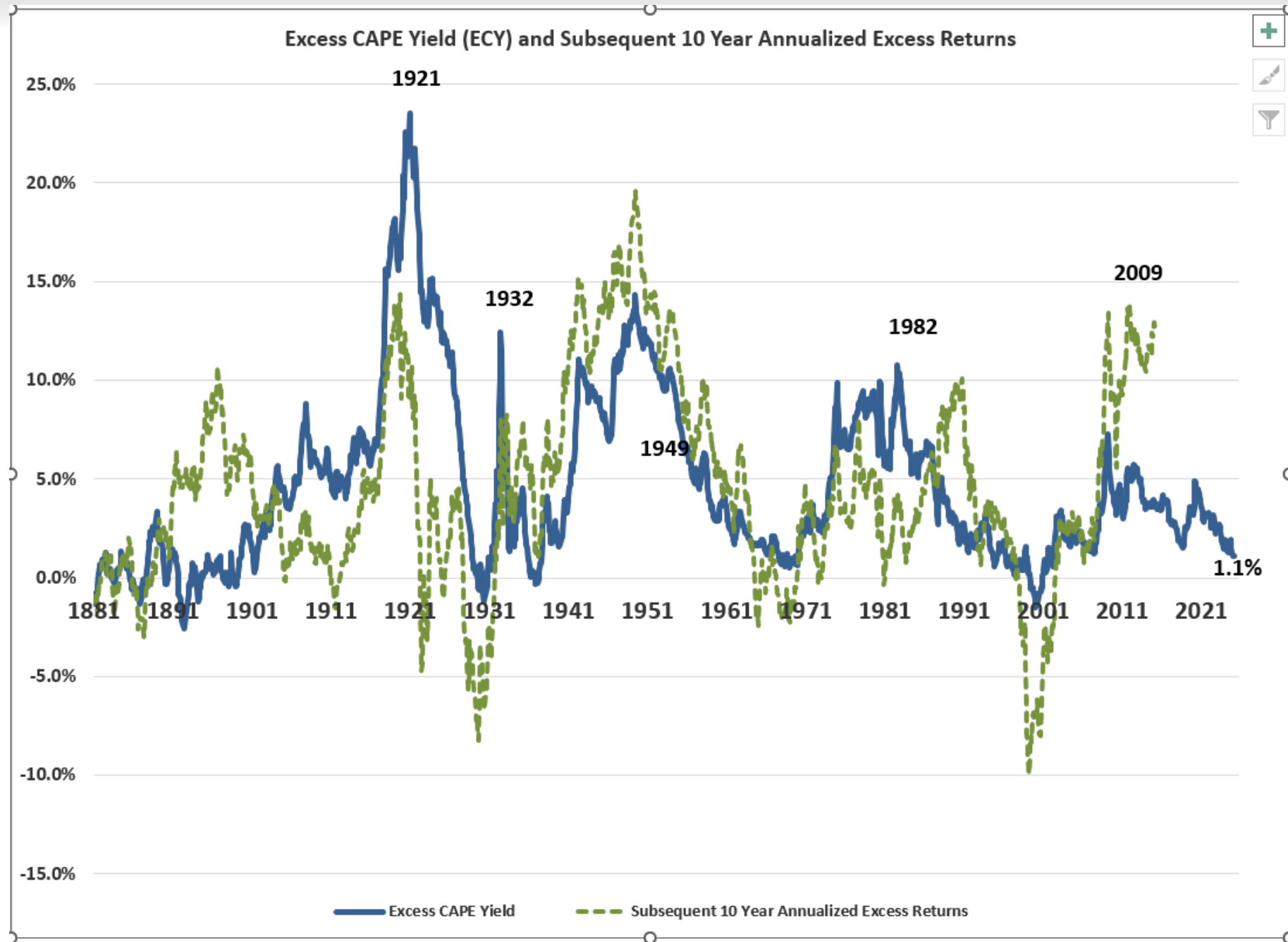
This was a false signal.



So if these broad-based indicators have backed off of recession, where do we go from here?



Valuation risk remains the top concern



Source: Robert Shiller, Yale University

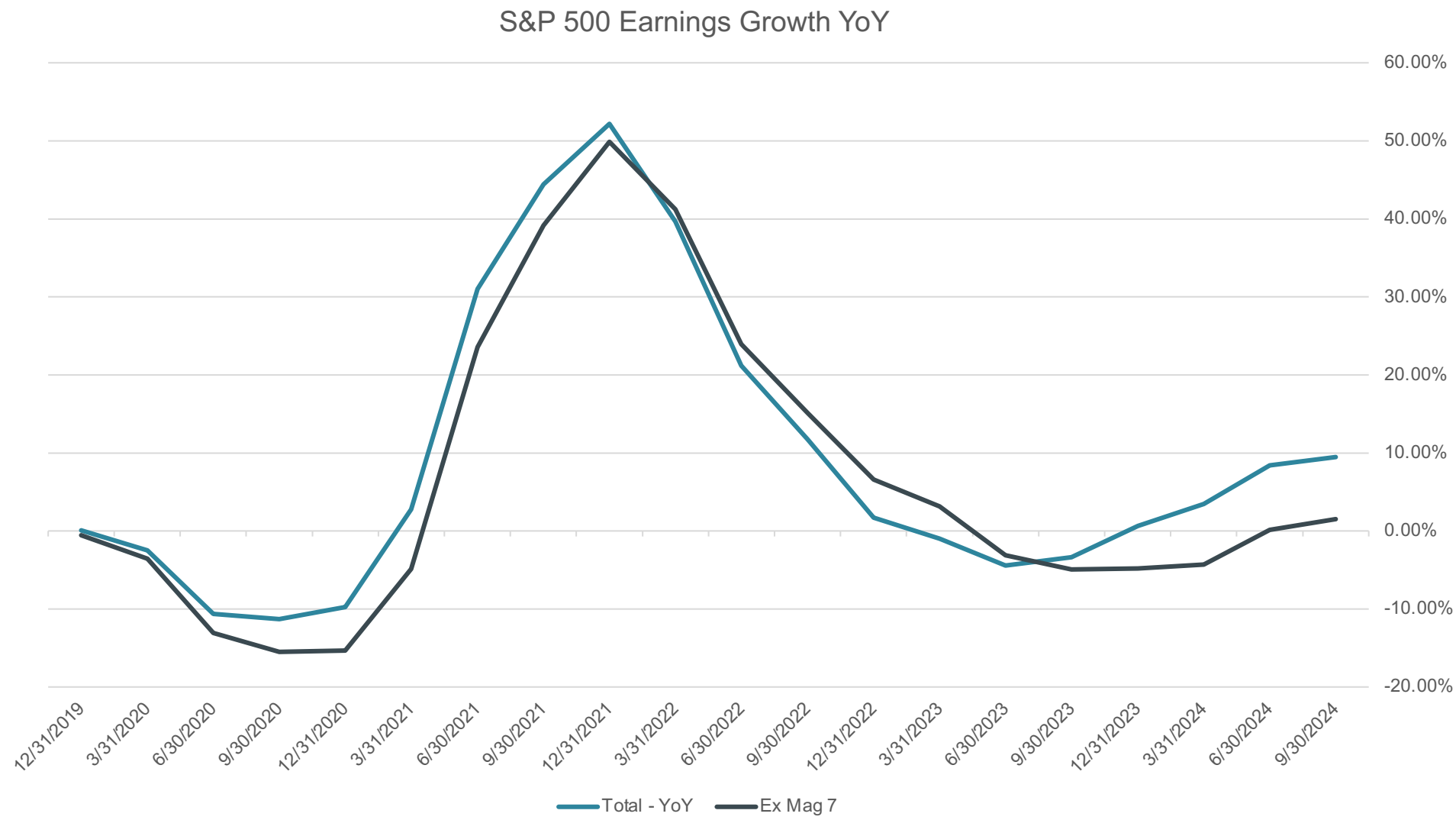


Valuations are currently implying significant earnings acceleration.



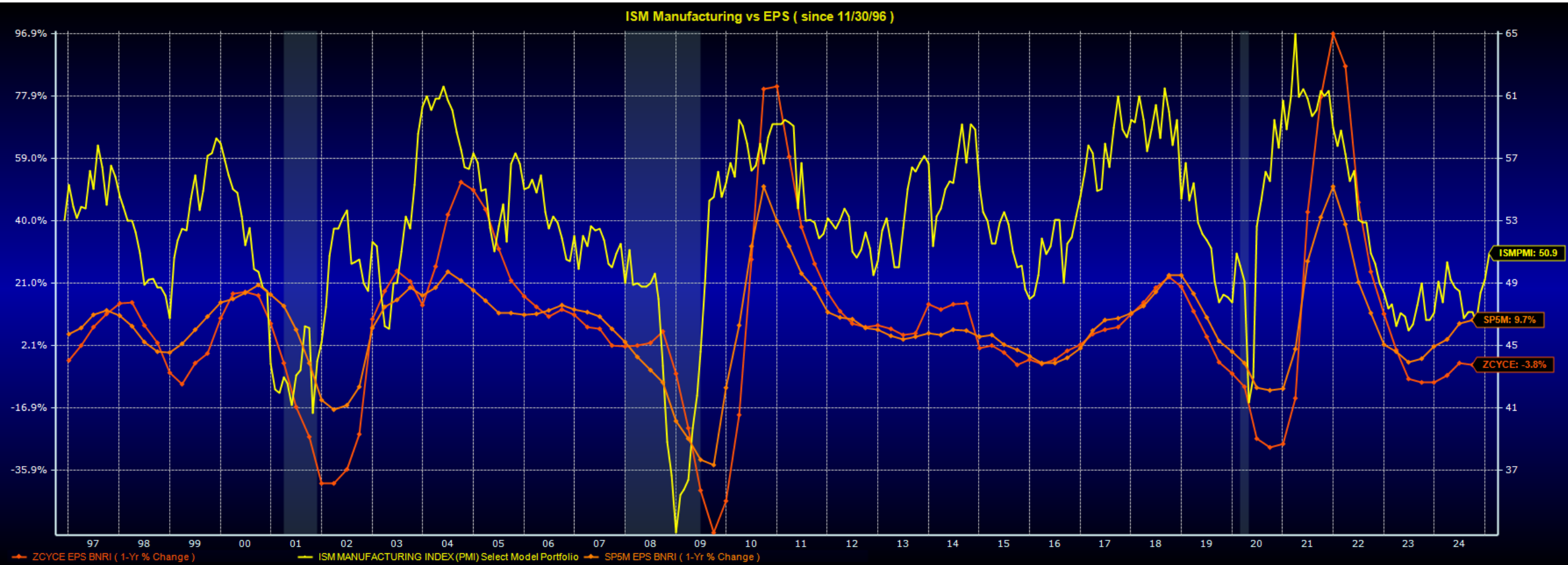
Thus far, the vast majority of S&P 500 earnings growth have been from the top 10 companies, which have reached an unprecedented 40% of the index.

Earnings growth has been concentrated in a very small group: Mag 7





...however....



ISM Manufacturing PMI has shared a 0.77 leading correlation coefficient with S&P 500 cyclicals



If manufacturing sustains the recovery, we could be at the very early stages of a cyclical earnings recovery for transportation, retail, consumer discretionary, and industrials.

This would *significantly* ease the burden on the “Mag 7” carrying the market solely on its shoulders by widening breadth.



Trump Administration 2.0 Economic Policy Agenda

- Department of Government Efficiency (DOGE) to bring large scale cuts to federal headcount
- Renegotiation of trade deals
- Tariffs on countries who place restrictive tariffs on American exports
- Extending + adding to the Tax Cuts and Jobs Act of 2017
 - Potential for further reductions in the corporate tax rate from 21% to 15%
 - Potential for tax code simplification and lower personal tax rates
- Deportations of illegal immigrants, ending “birth right citizenship” and providing a pathway to citizenship for “dreamers”



Bullish Aspects of the Trump Agenda (Bearish for Gold):

Renegotiating trade deals to either make American exports more attractive abroad, or incentivize foreign companies to set up shop in the US

Bringing the Corporate Tax rate to potentially 15%, making the United States the lowest among OECD countries. This would be a magnet for investments and business formations.

Mass layoffs & cost controls to right-size the federal government, enabling further tax cuts

Simplification of the Tax Code & National Register

Back to economic fundamentals: savings, not debt, fuels growth

Stronger US Dollar, lower inflation as a result of all of the above

Bearish Aspects of the Trump Agenda (Bullish for Gold):

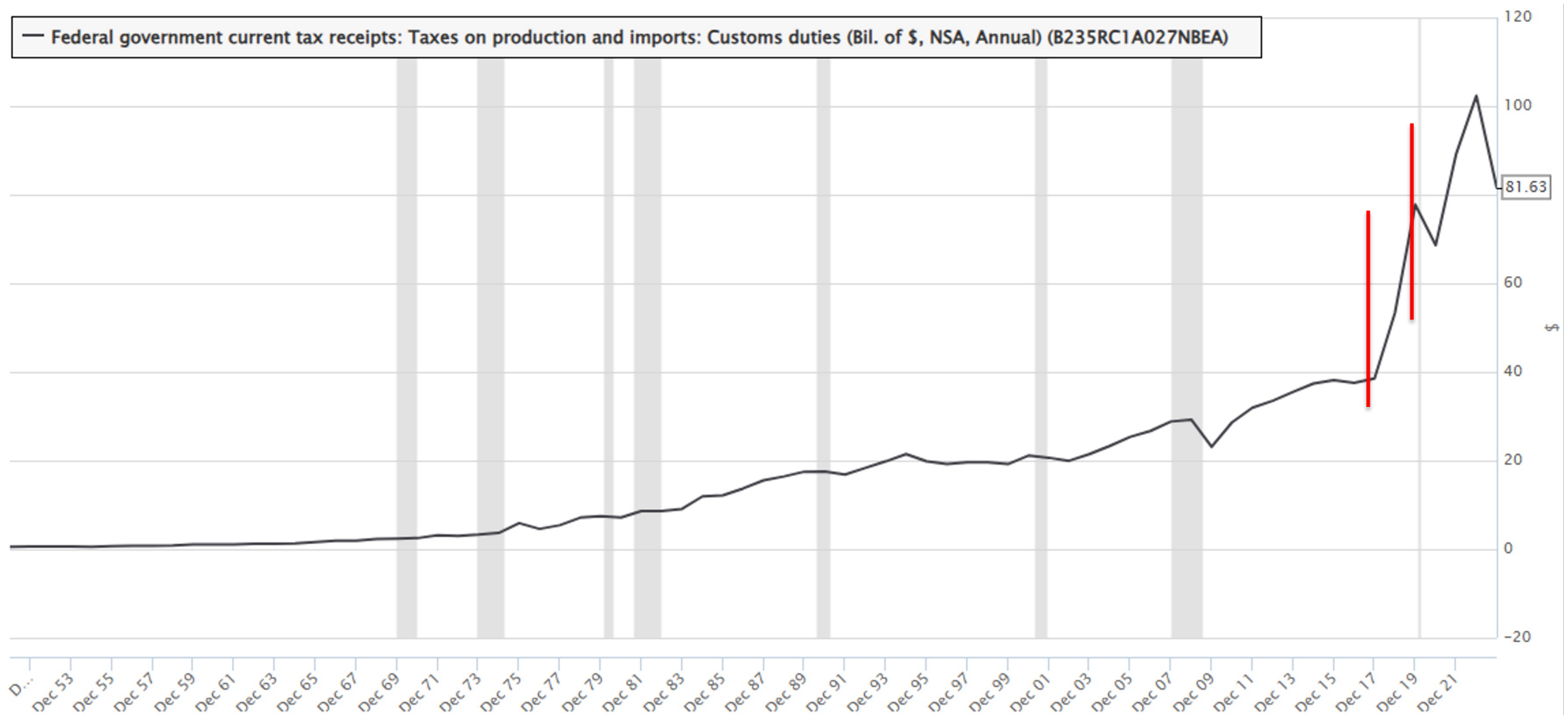
🔍 Mass deportations of illegal immigrants

This will have positive long-term effects, but may cause significant short-term pain.

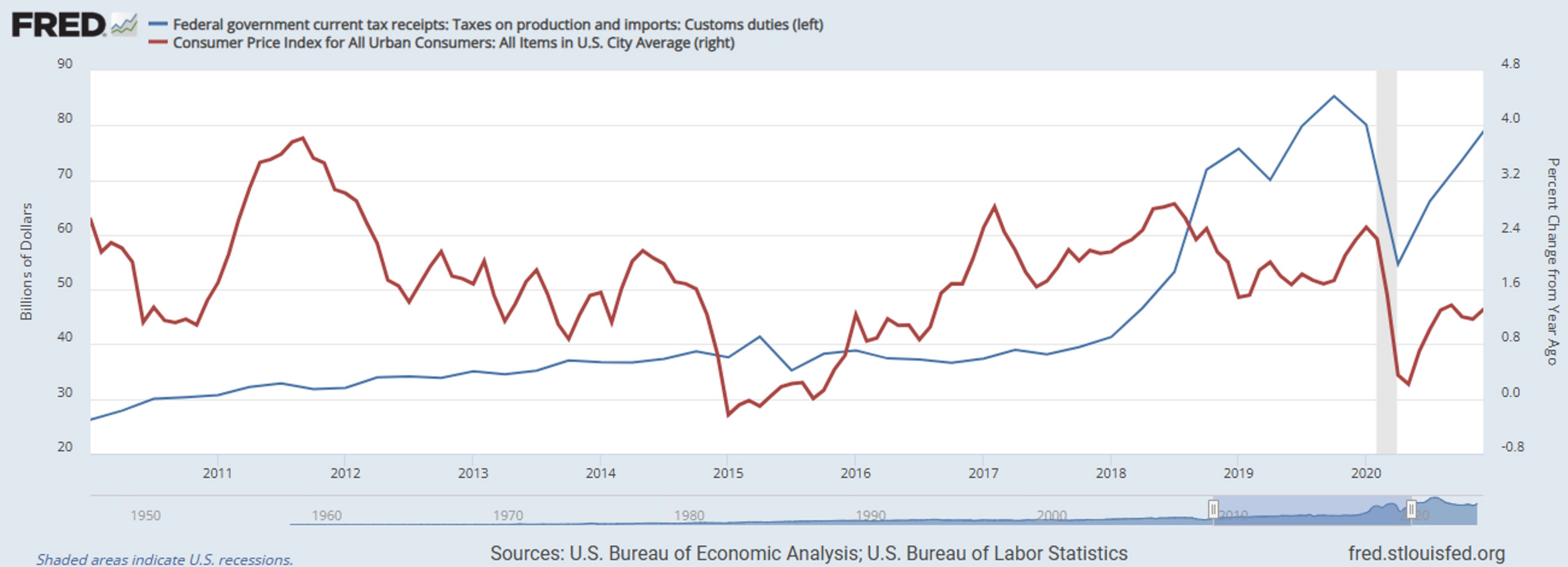


Do not fear the tariff – it is meant to negotiate better terms or to encourage companies to circumvent the tariff by directly investing in the United States for manufacturing & hiring.

Tariffs: the Cornerstone of Trump's Economic Policy



Federal Tariff Revenue Doubled In Trump's First Term With No Impact on CPI



'Tariffs' Are The Key to Trump's Pro-Growth Agenda



- The threat of targeted tariffs are President Trump's preferred negotiation tactic in order to secure more favorable trade deals with nations
- Tariffs are anti-growth and inflationary if the goal of the policy is to actually extract revenue
- Tariffs can be extraordinarily pro-growth and noninflationary if the goal of the policy is to force foreign countries to reduce their import tariffs on American exports
- Tariffs can also be pro-growth if they successfully convince companies to invest in America
- Ultimately, the point of high tariffs is for very few companies to actually pay them because they successfully open up new geographic markets for American companies to sell into OR to incentivize companies to manufacture in the US
- This becomes even more bullish for US-based capital investment and hiring if the policy is paired with favorable tax rates for businesses. Initial discussions suggest a 15% corporate tax rate, which would be very bullish in my view.

The #1 Risk of the Trump 2.0 Administration: Deportations



- President Trump has said he intends to engage in mass deportations of millions of illegal immigrants
- This would require a large-scale police & military operation across every locality in the US, break apart families and give rise to complex situations
- Many of these illegals work jobs and are productive members of society
- The removal of labor (most of which is cheap) and consumer population is a negative for GDP
- It remains to be seen how practical this exercise will be.
- If President Trump focuses solely on deporting illegals who have committed crimes, that wouldn't be so bad.
- But if President Trump commits to deporting millions of illegals, this would be a notable hit to GDP



As I no longer believe recession is the base case, it makes sense to remain long the S&P 500, but I still favor the Zacks Earnings Certain and Zacks Deep Value Portfolios



ECP: high quality steady compounders

DVP: high quality cyclicals + deep multiple
compression



Takeaways

- ❖ S&P 500 trades at a highly elevated 22.5x forward P/E with very bullish growth expectations next year. The bar is extremely high—in the top decile over the past 30 years.
- ❖ As such, the forward earnings yield of the market is at parity with the 10-year yield. Historically, market returns over the following 5 years have been poor at these levels.
- ❖ However, ISM Manufacturing looks like it has turned a corner, which would be very bullish for S&P cyclicals. If cyclicals (finally) return to earnings growth, the breadth of the market could expand dramatically, making the current market valuation not as expensive as it may seem.
- ❖ Remain long the S&P 500 as long as it remains above the 100-day EMA, but in my view, the best gains over the next 4 years are going to come from high quality cyclicals with strong balance sheets, high ROIC, and attractive valuations.

Zacks Earnings Certain Proxy: Recession-Resistant, Durable Moat-Protected, Low Volatility, Steady Compounders





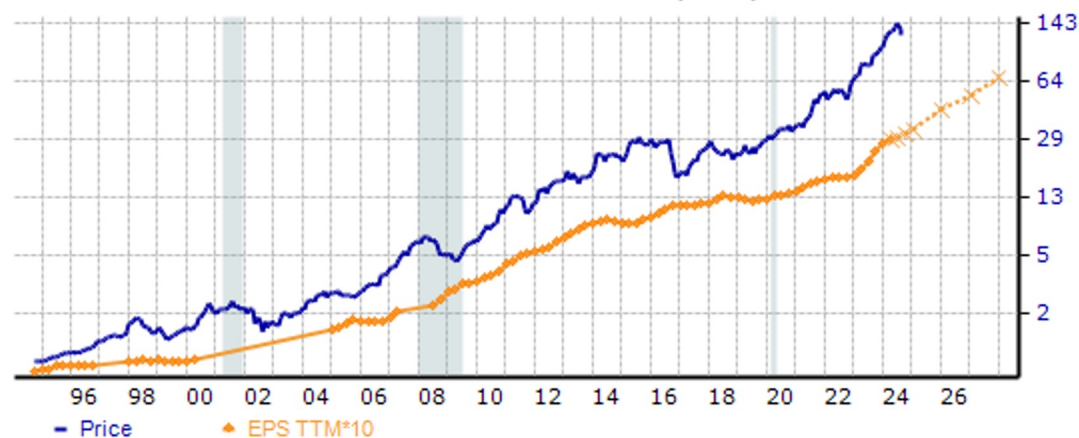
Price & Earnings
CHECK PT SOFTW (CHKP)

Price \$ | EPS*10



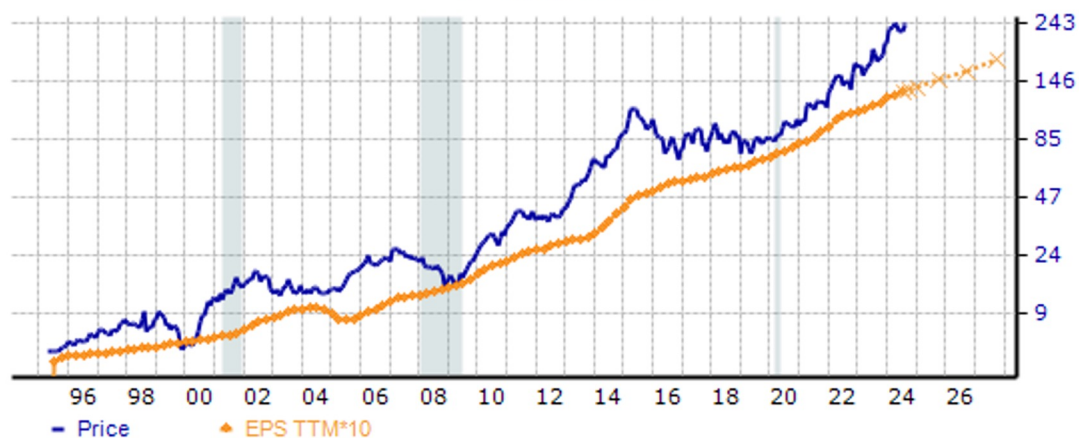
Price & Earnings
NOVO-NORDISK AS (NVO)

Price \$ | EPS*10



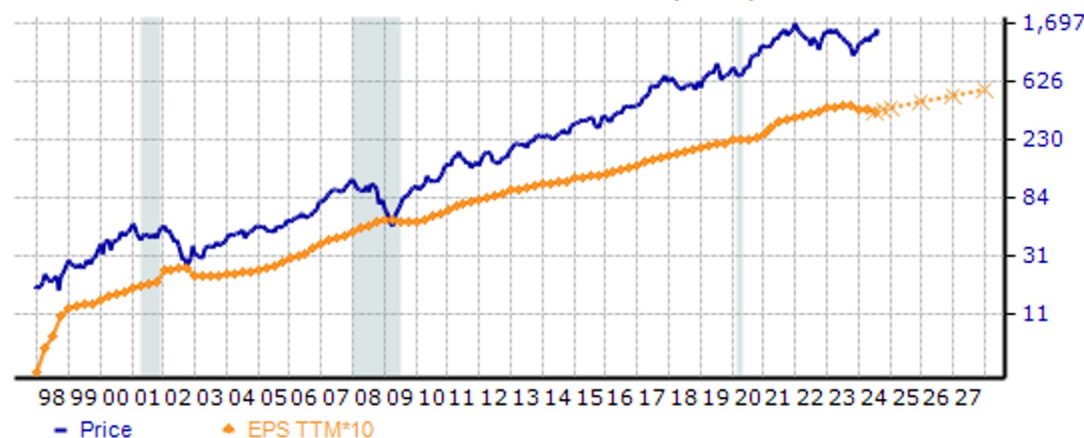
Price & Earnings
CENCORA INC

Price \$ | EPS*10

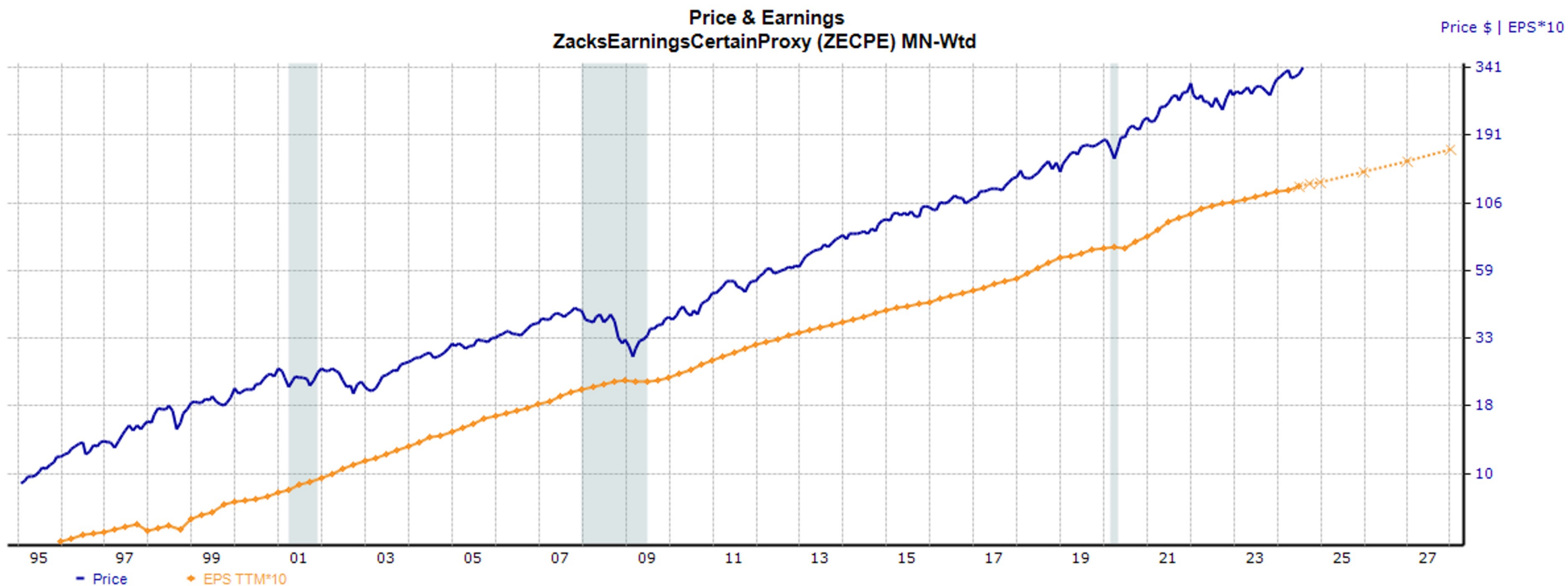


Price & Earnings
METTLER-TOLEDO (MTD)

Price \$ | EPS*10



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Top Ideas in Deep Value Cyclical



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