Q2 2024 MARKET COMMENTARY

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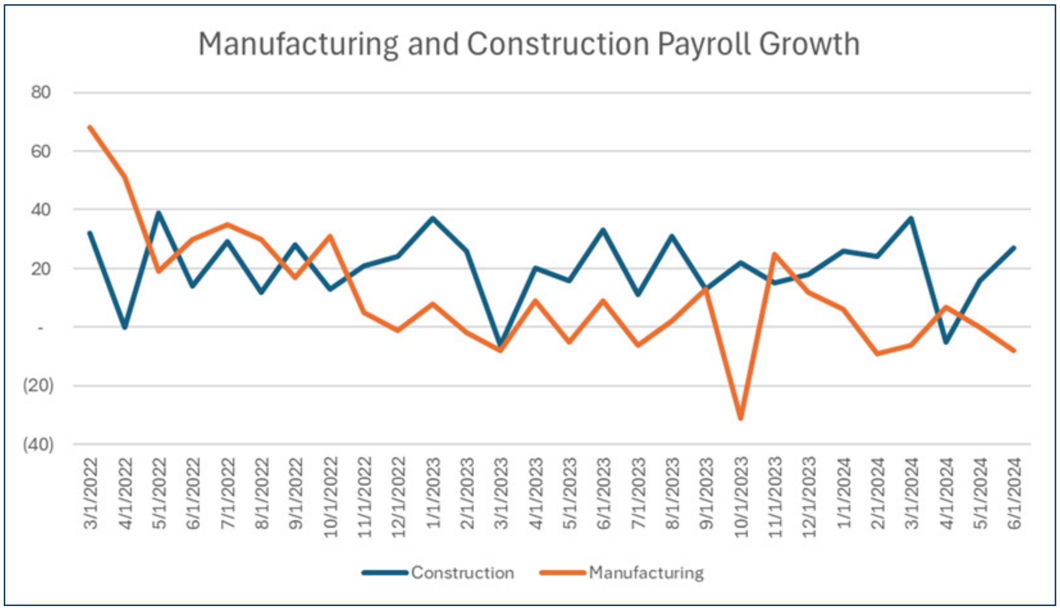
The Economy

Since our last economic commentary, the U.S. economy has continued to demonstrate resilience to a tight monetary policy that began in 2022. However, as we enter the 29th month in this tightening cycle, concerns over how long the U.S. economy can remain resilient begin to grow. Indeed, pockets of vulnerabilities are starting to appear, which could imply that unless the Fed begins to cut rates, the U.S. economy is likely going to cool. Nevertheless, near term risks are manageable and medium-term prospects remain benign.

Labor Market

We view the labor market as an important area of interest when it comes to understanding the economic cycle because weaknesses in the labor market have accompanied all 10 of the previous recessions (excluding Covid-19 recession). Specifically, the unemployment rate increases, and job growth turns negative. Given the importance, it is worth examining the current state of the labor market and its potential future development.

Since the start of the tightening cycle, the labor market has been on fire, adding approximately 7.8 million jobs while exceeding expectations 80% of the time. In the earlier stages of the Fed's tightening cycle, part of the strong labor performance could be attributed to the rebalancing of the labor market post-covid. Meanwhile, strong hiring activity in the later stages of the tightening cycle (where we are currently) have been supported by industries in healthcare, leisure, and the government. Interestingly, the construction and manufacturing industries which historically have been the interest rate sensitive parts of the labor market have held up relatively well in this tightening cycle. Hiring in manufacturing has been roughly flat since the start of 2023, while construction has consistently added around 20K jobs per month since March of 2022.

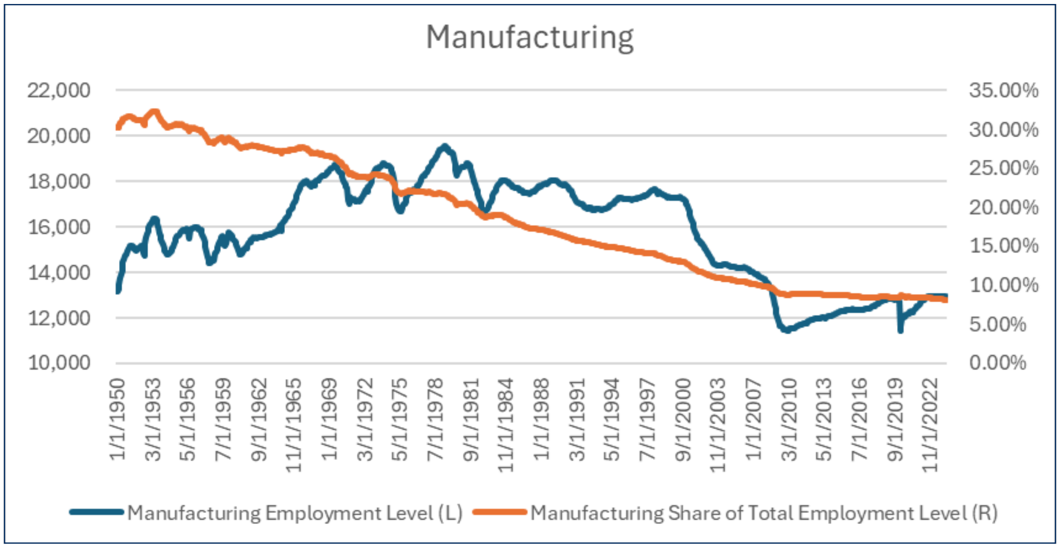


Source: Bureau of Labor Statistics through FRED, Liberty One Investment Management

In our prior commentary, we illustrated that both the construction and manufacturing industries are generally the first to see job losses as the economy enters a recession. Furthermore, both industries have been the largest contributors to cumulative job losses once in a recession, with most of the losses stemming from manufacturing. What is behind the resilience this time around? The interest rate insensitivity on construction can be attributed to government policy, specifically the Infrastructure Bill, and strong pipeline of housing under construction. Both factors are acting as a counterbalance to the interest rate environment by keeping the demand for construction workers at a healthy level.

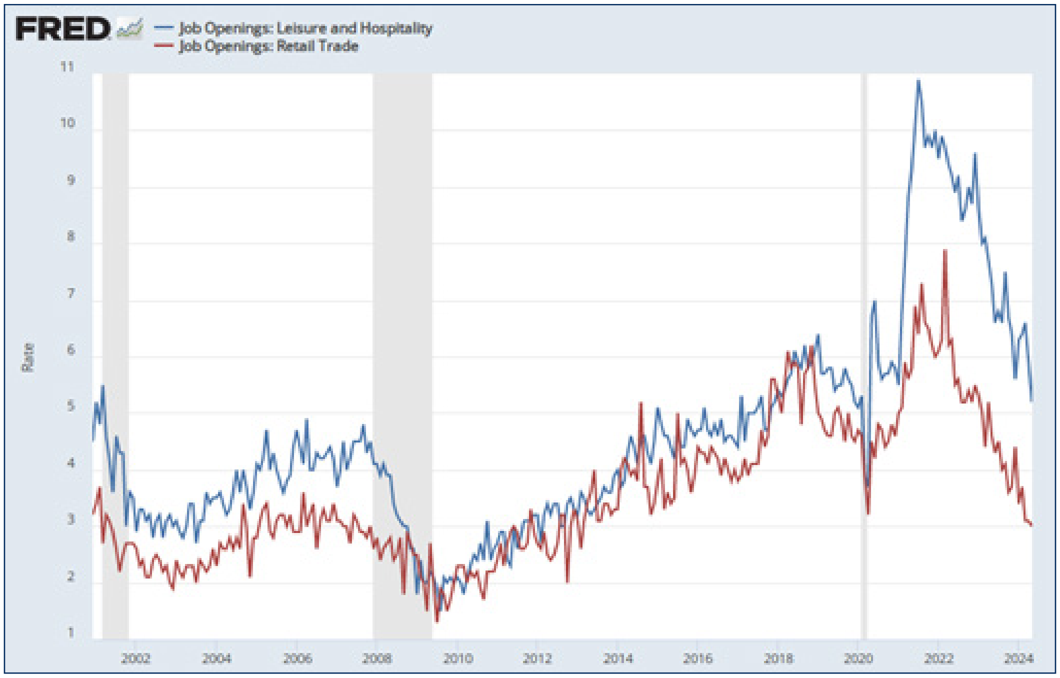
	Non-Farm Payroll Cumulative Loss (in Thousands)	Contribution to Cumulative Loss		
		Construction	Manufacturing	Combined
1953	(1,710)	-1%	92%	92%
1957	(2,214)	8%	66%	73%
1960	(1,256)	9%	68%	77%
1969	(832)	8%	176%	183%
1973	(1,460)	46%	138%	184%
1980	(960)	29%	105%	133%
1981	(2,830)	12%	74%	86%
1990	(1,572)	30%	40%	70%
2001	(2,598)	4%	99%	103%
2007	(8,694)	23%	26%	49%

Source: Bureau of Labor Statistics through FRED, Liberty One Investment Management
Note: Years refer to the starting year of a recession.



Source: Bureau of Labor Statistics through FRED, Liberty One Investment Management

For manufacturing, the resilience could be explained by globalization. The U.S. economy has outsourced a lot manufacturing jobs over the last two decades; thus, reducing the economic exposure to the respective industry. Manufacturing currently employs approximately 13 million people compared to 17 million seen at the turn of the century, and accounts for 8% of total jobs held today compared to 13% in 2000 and 30% in 1950. However, this does not suggest that the industry is immune to the economic cycle, instead, what this suggests is that the industry may be more tolerant of a higher rate environment than in the past as employers are running leaner operations with less labor overcapacity.



Source: U.S. Bureau of Labor Statistics • myf.red/g1pSBU

These developments in part help explain why interest rate sensitive parts of the labor market have been more resilient relative to past experiences. However, this resilience may not last forever, especially for manufacturing. Furthermore, the longer the Fed waits to cut rates, the more vulnerable other parts of the labor market become, especially industries that are influenced by the spending environment, such as retail trade and leisure and hospitality. Indeed, the job opening rates for both are back to their pre pandemic level, indicating the demand for workers in the respective industries has slowed, leaving existing positions exposed to layoffs should business conditions slow.

Warning Signs

While the labor market and the general economic environment has been relatively resilient thus far, some early warning signs do point to the formation of potential pockets of vulnerability. Within the labor market, part-time employment has been on the rise. Furthermore, the most recent jobs report in June 2024 saw an uptick in the unemployment rate from 4% to 4.1% for non-layoffs reasons (that is the rise in unemployment due to quits, new entrants and reentrants to the labor force), indicating that it may be more difficult to find a job.

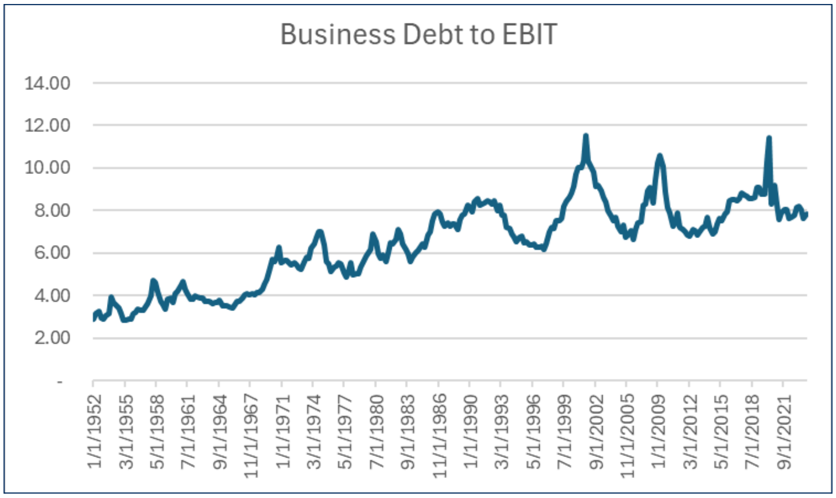
On the spending front, a sizable drop in the ISM Services subindexes in June- Current Business Activity from 61.2 to 49.6 and in New Orders from 54.1 to 47.3 – is a concern given the magnitude of the drop (although one month is not a trend and this decline could be noise). Economic activity in services has been strong throughout the Fed's tightening cycle, so a cooldown in services spending could result in layoffs in what has been the growth engine of the US economy in the last two years.

Within construction, building permits on new housing have been trending lower, pointing to a weaker pipeline in the future. Finally, credit spreads on high yield bonds (CCC or below) have risen by 100 basis points since March 2024. However, the rise has come from relatively tight credit spread levels historically.

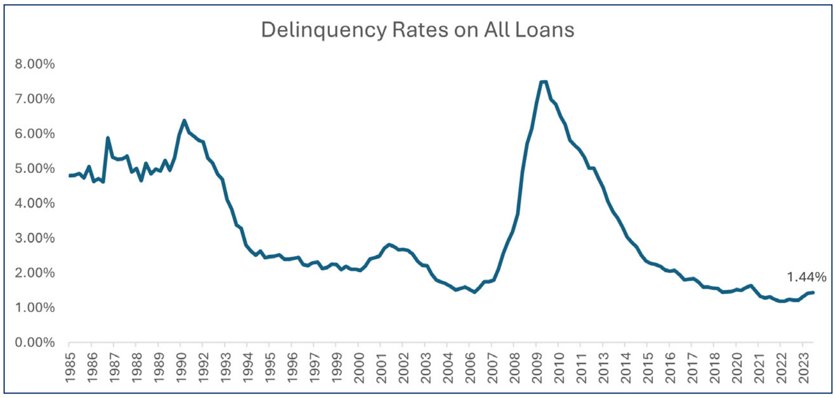
Recession or no Recession?

As inflation continues to moderate and economic weaknesses begin to appear, the balance of risk may tip from an inflationary fight to a recessionary battle. The Fed may need to cut rates sooner than later to avoid tipping the economy into a recession. Should the Fed wait until economic weakness is apparent, cutting rates may not be enough to bring the economy into a soft landing. This is partly because the impact of a rate cut takes time to be filtered through the economy, and that lag may prove too little too late for the economy.

On the bright side, should the economy tip into a recession, we believe that it will likely be less severe compared to recessions in the past. Firstly, the banking sector is well capitalized and household balance sheets are in good shape. Households have deleveraged after the Great Financial Crisi and have benefited from the recent rise in asset prices (equities and housing). Furthermore, the aging population has shrunk the labor force, which should lead to a quicker recovery in the employment picture following the onset of a recession. Finally, business debt levels, profitability, and return on capital are all in relatively good shape.



Source: Board of Governors of The Federal Reserve System, 2024.

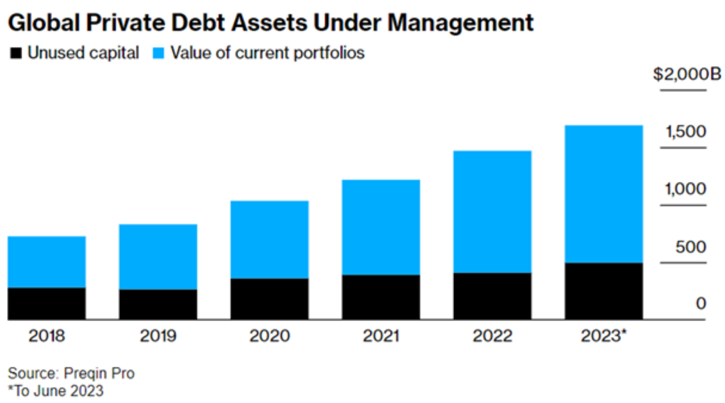


Source: Board of Governors of The Federal Reserve System, 2024.

Additional risks to consider

One perplexing area of strength in the economy has been the lack of reported corporate defaults even as the Fed embarked on one of its fastest hiking cycles in several decades. One would assume that delinquency rates on loans would rise as financing costs increase. However, default rates today are not only sitting below pre-pandemic levels, but they are also close to their all-time lows. Simply put, bank loans appear to have become less sensitive to movements in interest rates, which have kept market volatility relatively at bay.

However, we believe that there are underlying risks that may not seem obvious at first but could have major implications for investors and the financial system at large. One reason that could help explain the unusually low default rate is that debt markets have become increasingly privatized over the last several years. Global private debt assets under management have doubled since 2018 and are estimated to have grown to $1.5 trillion dollars today. Some of the largest asset managers like BlackRock are increasingly investing heavily in their private credit offerings through acquisitions of private debt managers and alternatives platforms.



Source: Board of Governors of The Federal Reserve System, 2024.

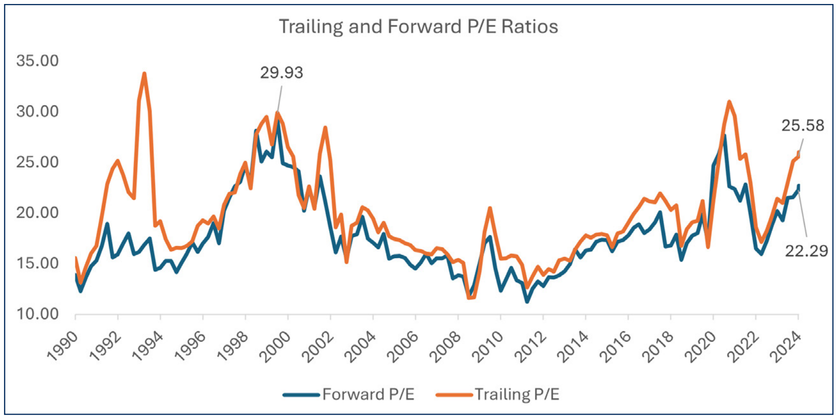
The increasing share of private financing is primarily due to increased regulations for publicly listed financial institutions. Risks in certain types of lending that banks used to take are now being taken by investors in private markets. Pension funds, endowments, family offices, and ultra-high net worth individuals are becoming more directly involved in lending through non-bank institutions. Because the lending is outside the visibility of public markets and funds typically lock in investors' capital for a period, problems that do develop have less chance of being reported and cause contagion. The pension funds and insurance companies invested in these private-credit funds are unlikely to ask for their money back tomorrow, reducing the risks of sudden stop in financing. Given that context, should problems arise with companies that rely on private debt for financing, these private institutions could negotiate terms with the companies to help extend a lifeline and increase their recovery rates. That playbook was commonly used during the Covid-19 lockdowns and proved to be effective.

However, unreported challenges within private credit could be brewing. Loans in private markets are harder to value and the lack of transparency and liquidity could hide issues. Private debt comes mostly with floating rate yields and has a higher spread due to the illiquidity and risker lending to borrowers. Companies relying on such debt could already be distressed (with rates sitting at a 20-year high) but are going unreported because the funding terms are usually kept private. Additionally, valuations for the book value of loans are rather discretionary and at the discretion of the private credit lenders. As a result, some private credit lenders have barely altered the book value of some of their loans even as rates have gone up and their borrowers unable to pay. Finally, private credit funds have blasted through their hurdle rates, generating returns in the mid-teens over the last several years. This attracts more money into the asset class which increases competition to source deals. The increased competition between private credit funds and banks could encourage riskier debt deals and lower underwriting standards, which could potentially lead to more defaults.

The growth in private credit may become macro critical and could amplify negative shocks. The private credit ecosystem is also opaque and could come with layers of leverage in the chain of investors. Despite the risks, regulators are happy to attract more private capital to finance the types of lending that they see as too risky for banks. The Fed has commented that they see the risks within the shadow banking system thus far as limited. However, that evaluation should be skeptically questioned, as the private credit market remains opaque and assessing widespread default risks is extremely difficult.

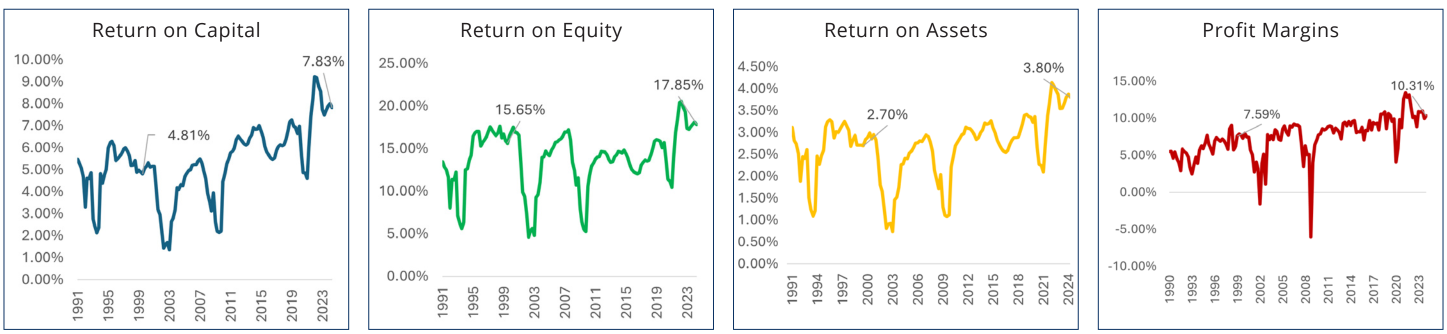
Is the Stock Market In A Bubble?

The S&P 500 has more than doubled in value since the bottom of March 2020 and has returned approximately 14% per year since 2010 when including reinvested dividends, which is about 5% more per year than its long-term historical average. As the stock market continues to make new highs driven by optimism of Artificial Intelligence (AI), one could wonder if we are indeed due for a pullback or even worse, are we in "bubble territory'. One way to evaluate this is to compare the markets today to an undeniable bubble, The Dot-Com Era of the late 1990s.



Source: Bloomberg, Liberty One, 2024.

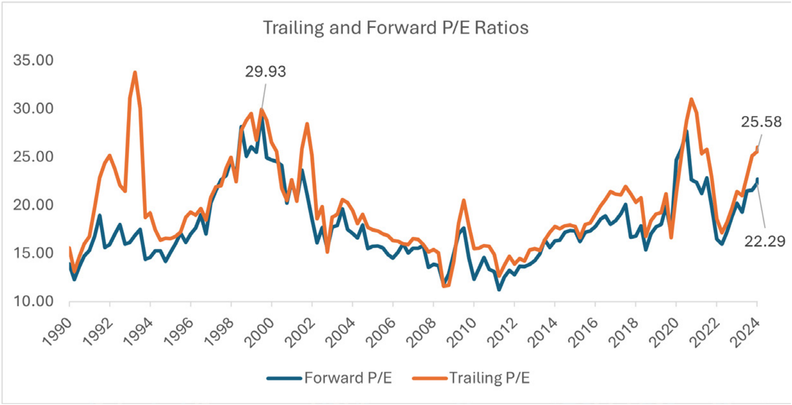
The good news is that today's market seems cheaper than the peak of the dot-com era when measured in price-to-earnings multiple on a trailing and forward basis. The S&P 500 trades at 22x one-year forward earnings compared to 30x in December 1999 and 26x trailing earnings today compared to 30x trailing earnings in 1999. The market is not only cheaper but also of higher quality. As a group, the companies in the S&P 500 are more profitable than they were in 1999. Return on assets is 41% higher, return on equity is 14% higher, and return on capital is 63% higher. The balance sheets of companies are also much stronger as companies deleveraged after the 2008 financial crisis. The S&P 500's debt to equity ratio is nearly half of what it was in 1999.



Source: Bloomberg, Liberty One, 2024.

Compared to 1999, the top 50 most expensive stocks in the market today are also cheaper than they were in 1999. The top 50 most expensive stocks in the S&P 500 commanded a PE multiple of 196x in 1999 whereas the top 50 most expensive stocks today command a PE multiple of 83x. As a share of the overall market, the top 50 most expensive stocks made up close to a quarter of the market in 1999 where today, they comprise approximately 17% of the overall market. Because of these reasons, it is probably premature to use the word "bubble" when referring to today's market, but valuations today are by no means cheap.

Historically, there is a strong inverse relationship between starting valuations and subsequent medium-term returns. High valuations tend to lead to below-average returns and vice versa. Returns are driven primarily by three forces: earnings, dividends, and valuation multiple expansion. With the S&P 500 dividend yield at barely over 1% today, S&P 500 investors must rely on earnings growth and valuation expansion to power returns.



Source: Bloomberg, Liberty One, 2024.

On a basic level, what drives earnings higher are sales growth and expanding profit margins. Sales growth has averaged 4% per year over the past three decades and in the absence of a secular surge in global growth, it can be expected to remain as such moving forward. Profit margins have expanded over the past several decades with productivity improvements and more efficient allocation of resources with the rise in globalization. The adoption of AI and new technologies could help improve productivity gains but that too will take time for it to be reflected in companies' bottom line. Therefore, if corporations improve profit margins by 1%, sales growth at 4%, and dividend yields 1.3%, the expected future market returns can reasonably be estimated to be 6.3% over the next decade based off earnings and dividends. Expansion or contraction in valuation multiples add to the final piece of the puzzle in expected future market returns. Valuation multiples today are already above its long-term average. Multiples have historically shown a strong tendency to revert to its long-term average. This could help explain why higher starting valuations tend to lead to below-average future returns and vice versa. Should multiples revert to its long-term average, it could create an approximate 2.2% drag to future expected returns, bringing the expected future market returns to 4.1% over the next decade, which is particularly close to the 10-year Treasury yield at 4.3% today, albeit with greater volatility.

Although higher valuations and lower dividend yields today are making stock investments seem less attractive, the good news is that this applies to the broader general market, and that opportunities remain plentiful beneath the surface. For starters, higher valuations for the S&P 500 are being skewed by a handful of more expensive stocks that make up a larger share of the market. For example, the current forward PE ratios for the Magnificent 7 stocks currently sit at approximately 30x, while the remaining 493 stocks are trading at 19x. The earnings growth potential and dividend yield of each individual stock also vary greatly from one another, providing active investors with the ability to carefully curate a portfolio of stocks that are trading at more reasonable valuation levels with the potential of still generating positive earnings and dividend growth. As a result, we believe that this environment will set up active investors well over the next decade.

Outlook

The 1990s expansion ended in a crash after companies overextended, hoping for those dot-com riches. In the 2000s, it was households that overextended their borrowings against expected gains in housing prices. This time round, it has been the federal balance sheet that has played an unusually large role in the expansion. Government spending and investment contributed its highest share to GDP growth in 2023 in more than a decade, and of course it has been financed with debt- which stood at 99% of GDP as of fiscal year 2024. Government debt is considered risk free because it is safer than household or company debt as federal authorities have the power to increase taxes. This means leveraging up the federal balance sheet is inherently less dangerous than a surge in borrowing in the private sector. However, there is a limit to how much a government can borrow before getting into trouble. The UK government found that out in 2022 when yields spiked when investors balked at plans for large, unfunded tax cuts. Rising interest rates are also inflating the US government borrowing requirements, putting the US on an unsustainable fiscal path. However, if there is a tipping point to this debt limit, it is unlikely that we are at it right now.

The debt-fueled growth has helped the US economy defy the odds of an economic recession. Resilient consumer spending, active private investment environment, and strong fiscal support have been significant contributors to the strength of the US economy. Nonetheless, signs of cooling and weaknesses are beginning to surface as both policy and economic conditions begin to normalize. As a result, we are likely to see the first rate cut in 2024 but the verdict is still out on whether the Fed will do so or if they are holding out for longer. Either way, higher interest rates have had less of an impact on areas that were historically more sensitive to rates due to factors discussed in the commentary above.

The cooling of the economy but still positive growth could help support markets in their upward trajectory. This, in conjunction with moderating inflation and a looser monetary policy could spur economic activity and revisions to earnings estimates as well.

On the financial market front, the S&P 500 is a representation of a ten-stock market, not a five-hundred stock market this year. The top ten stocks accounted for over 80% of the market gains so far this year. The biggest stocks in the market are commanding such an influence that the outperformance of the market-cap weighted index relative to the equal-weighted index is at its widest level since 1998. (Year-to-date, the market-cap weighted index is up +15.29% vs equal-weighted index up +5.08%). Markets are certainly expensive when compared to history, but we would stop short of calling it a bubble. The recent rise in markets have been supported by earnings growth in Mega Cap Tech names but the narrative is making the markets more expensive based on multiples. Markets today are also of higher quality but command a cheaper multiple compared to the dot-com era.

Large and mid-caps that are less tied to the economic cycle may continue to do well if they can deliver on earnings expectations. Cyclical parts of the market may not participate meaningfully unless there is a spark in reaccelerated consumption, one that could possibly be catalyzed by the loosening of monetary policy.

DISCLOSURES