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Sujet traité : Le chemin étroit vers un atterrissage en douceur / The Narrow Path To A Soft Landing

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Strategy Report

The Narrow Path To A Soft Landing

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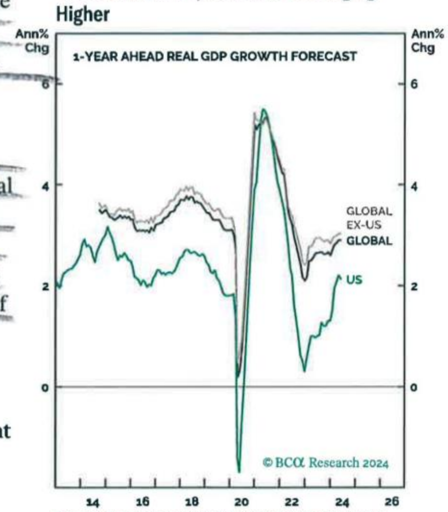
Executive Summary

- There is a path to a soft landing, but it is a narrow one. We estimate that there is only a 20% chance that the US will avoid a recession before the end of 2025.
- Many things need to go right to avert a recession: The labor market needs to rebalance, cyclical spending needs to stabilize, loan delinquency rates need to stop rising, inflation needs to fall back to target, and growth in the rest of the world needs to improve.
- We moved from overweight to neutral on global equities at the start of this year. Our MacroQuant model shifted to bearish in early April. Following the model, we expect to downgrade stocks to underweight during the summer.

Global Growth Expectations Are Edging Higher



SOURCE: BLOOMBERG FINANCE L.P. AND BCA CALCULATIONS.

- In the meantime, we favor a defensive equity sector allocation. Our preferred sectors are health care, utilities, and consumer staples.
- We are currently overweight bond duration on a 6-to-12 month horizon. After flagging the risk of higher yields in early April, MacroQuant's Bond Buddy model turned more positive on Treasuries two weeks ago.

Bottom Line: Everything that can happen to the global economy will happen, but the fraction of "world lines" where a soft landing occurs is unlikely to be very high. Stocks could still rally for a few more months if concerns over inflation subside before concerns over a recession resurface. However, the equity bull market is getting long in the tooth.

The Narrow Path To A Soft Landing

Dear Client,

Next week, in addition to our MacroQuant Monthly Update, we will be sending you a Special Report by BCA Research former Chief Economist Martin Barnes following up on his 2011 report on the Debt Supercycle.

Best regards,
Peter Berezin
Chief Global Strategist

Everything Which is Not Forbidden is Allowed

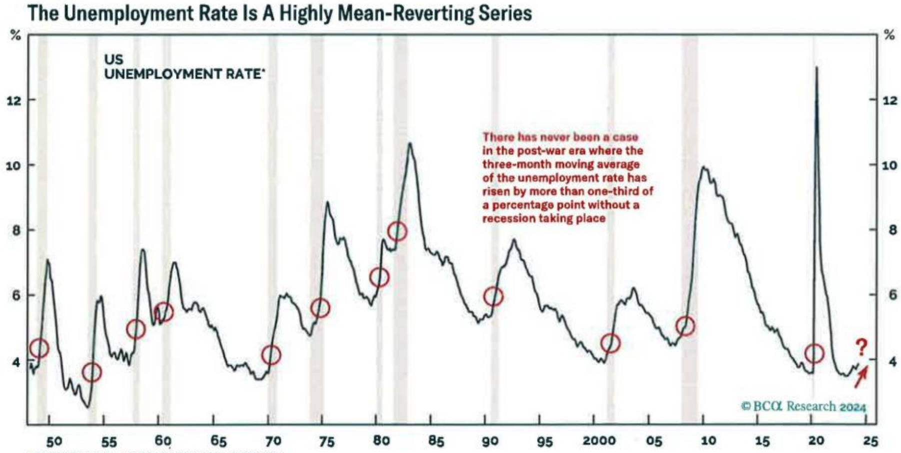
When I was a young child, I was very bothered by the idea that some things exist while others do not. "Why aren't there unicorns?" I'd ask. The answer "It's late. Go to sleep" was never satisfying for me.

As I grew up, I learned that the simplest mathematical interpretation of quantum mechanics is that everything that can exist does exist, and the more ways in which something can exist, the more often it will exist.

As I discussed in Waddington's Landscape, Many Worlds, And The Folly Of Economic Forecasting, this has important implications for more down-to-earth questions such as whether the global economy will achieve a soft landing.

Some of the world lines that you inhabit will definitely result in a soft landing. But what fraction? That depends on whether many things need to go right to achieve a soft landing or just a few.

CHART 1
The Unemployment Rate Is A Highly Mean-Reverting Series



* SHOWN AS A 3-MONTH MOVING AVERAGE.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS; CIRCLES IN THE CHART DENOTE THE TIMES WHEN THE 3-MONTH MOVING AVERAGE OF THE UNEMPLOYMENT RATE INCREASED BY MORE THAN ONE-THIRD OF A PERCENTAGE POINT FROM PRIOR LOWS.

We lean towards the "many things" camp, which leads us to think that the probability is reasonably high – around 80% – that the US and many other major economies will succumb to a recession by the end of 2025.

Still, that leaves 20% of world lines on which no recession occurs. Focusing on the US, here is what we are hoping to see in order to gain more confidence in a soft-landing scenario:

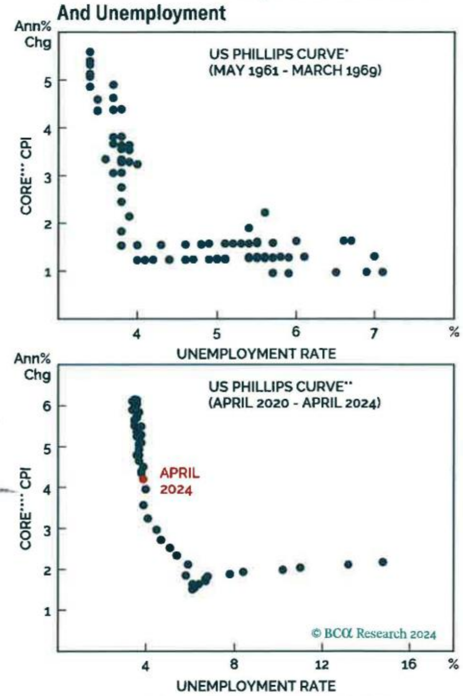
1. Soft Landing for the US Labor Market

The US unemployment rate is a highly mean-reverting series. Usually, when it reaches very low levels, it starts rising again (**Chart 1**). Thus, anyone betting on a soft landing – tantamount to betting on the unemployment rate moving sideways for an extended period – is implicitly making the case for "this time is different."

Why can't the unemployment rate go down and stay down? The reason has to do with our kinked Phillips curve framework. When unemployment is very low, inflation becomes very sensitive to changes in the degree of slack in the economy (**Chart 2**). This means that central banks need to calibrate monetary policy almost perfectly to keep the economy from either overheating, or cooling down so much that rising unemployment begins to feed on itself.

Could the Fed stick the soft landing this time? The unemployment rate has been below 4% for 27 straight months. Payrolls have grown by an average of 242K over the past three months and, coincidentally, by exactly the same number, 242K, over the prior six months. That is all good news.

CHART 2
A Nonlinear Relationship Between Inflation And Unemployment



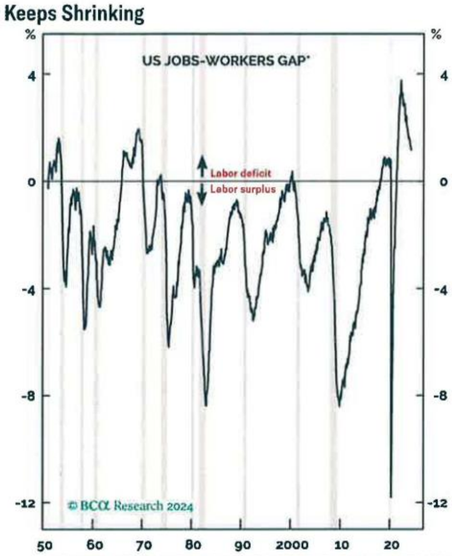
* DATA SHOWN FOR THE MAY 1961 - MARCH 1969 PERIOD.
** DATA SHOWN FOR THE APRIL 2020 - APRIL 2024 PERIOD.
*** EXCLUDING FOOD AND ENERGY.
**** EXCLUDING FOOD AND ENERGY. SERIES SHOWN SMOOTHED.

Unfortunately, there is a catch: For the past two years, bountiful job openings insulated the labor market, allowing both newly unemployed workers and new entrants to easily find gainful employment. However, the jobs-workers gap – the excess of job openings over unemployed workers – has fallen by three-quarters from its peak (**Chart 3**). If the trend continues, there will be more unemployed workers than job openings by early 2025. At that point, the unemployment rate could start rising rapidly.

CHART 3

The Gap Between Labor Demand And Labor Supply Keeps Shrinking

NOTE: LABOR DEMAND IS THE SUM OF JOB OPENINGS AND CIVILIAN EMPLOYMENT, WHILE LABOR SUPPLY IS THE CIVILIAN LABOR FORCE. HISTORICAL JOB OPENINGS DATA ARE EXTENDED USING THE COMPOSITE HELP-WANTED INDEX ESTIMATED IN REGIS BARNICHON, "BUILDING A COMPOSITE HELP-WANTED INDEX", ECONOMICS LETTERS VOLUME 109, ISSUE 3, (DECEMBER 2010). JOB OPENINGS SINCE JUNE 2022 ARE BASED ON BLS JOLTS JOB OPENINGS, AND ESTIMATES USING LINKUP AND INDEED JOB POSTINGS INDEX.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.



* JOBS-WORKERS GAP IS THE DIFFERENCE BETWEEN LABOR DEMAND AND LABOR SUPPLY AS A PERCENT OF LABOR SUPPLY.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

Admittedly, job openings are difficult to measure accurately. To supplement the official series published by the Job Openings and Labor Turnover Survey (JOLTS), we look at private-sector sources such as *Indeed* and LinkUp (**Chart 4**). Both sources show that openings are declining, implying that the labor market continues to cool.

The drop in job openings is mirrored by the Kansas City Fed Labor Market Conditions Indicator, which incorporates 24 national labor market variables (**Chart 5**). The series weakened further in April, although it still remains above its historic average. The series would need to stabilize near its long-term mean to generate a soft landing.

Relatedly, 17 of the 31 leading US labor market indicators in our MacroQuant model are sending a bearish signal for the S&P 500, compared to 10 which are sending a bullish signal (**Chart 6**). We would like to see the net number of bullish signals rise to zero or above to feel confident in the soft-landing narrative.