Folly of the Crowds

By Edward Lim

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Have you ever paid a few hundred dollars to see your favorite artist perform live only to have the occasion marred by fellow revelers holding up their phones to record the entire concert and blocking the view of everyone else including themselves? You ask yourself should I follow the crowd and record the moments, or should I ignore and live in the moment? What kind of concertgoer are you? It is carpe Diem for me.

At the start of the year, in The Indomitable Human Spirit Navigator, our central thesis for overweighting Treasuries and high-grade debt centers on our view that inflation will fall precipitously. But central bankers' tunnel vision to restore their lost cred in fighting inflation will push the global economy into a recession, and they will have to pause their tightening by 2Q-3Q23 and reverse course by the end of the year or early first quarter of next year. We were looking to reverse our long-standing underweight in equities sometime in 2Q23 following the contours of our view of inflation and policy rates but have caveated this decision with the global economy not slipping into a severe recession. However, the view to overturn our underweight in Equities was truncated by the US banking crisis in March and the dissolution of Credit Suisse in the same month.

We opined in Down in the valley to pray in March and Everything, everywhere, all at once in April that these developments will likely tilt the US from a mild-moderate recession into a moderate-severe one. We were surprised that there are still more than 4,000 banks in the US and even more shocked that the smaller banks in the US have enjoyed regulatory arbitrage for so long. This has allowed them to grow significantly faster than the GSIB banks like JP Morgan or Bank of America and they have played an outsized role in providing credit to the US economy. For example, smaller banks with assets below $250bn hold 80% of the commercial real estate loans in the system. Furthermore, we reiterated our long-standing view that decades of easy money have led to a colossal bubble in real estate and this bubble is global in nature. We collated our months-long discussions with various fund managers and companies spanning across different real estate asset classes from publicly listed REITs to a mezzanine financier in commercial real estate in Germany and they reinforce our view this bubble is bursting in many arrays.

With this backdrop of a slowing economy riddled with more bank bankruptcies to come accompanied by fraying real estate, it has become even more exigent to determine the probability of a recession and the kind of recession we might be in. Of course, predicting a recession, let alone the severity of one, is a career suicide job. If you are wrong, you be called an alarmist and if you are right, you will be fired. As we have highlighted in various Navigators, our approach to predicting a recession is multi-prong. First, we look at the consensus economic forecast. The consensus is expecting a recession in the US to commence in 3Q23 and last till the end of the year. But they are expecting only a mild one with a cumulative decline of just 1.0% contraction from the peak in 2Q23.

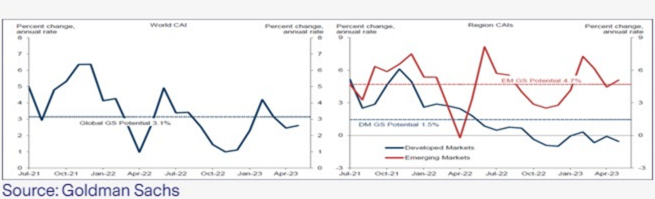
Consensus economic forecast expects a mild US recession to commence hereon

	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23	4Q23	1Q24	2Q24	3Q24
Real GDP (QoQ% SAAR)	-0.6	3.2	2.6	1.3	0.6	-0.5	-0.4	0.8	1.6	1.9

Source: Bloomberg

The second method is to look at the Nowcasting model which considers current economic data to estimate what is the current state of the economy. The Nowcasting model tells us the global economy is already growing below 3.0%, which is the threshold between growth and recession. Developed markets are already in negative growth reinforced by the recent news that the Eurozone has entered a technical recession. Emerging markets are barely growing above its potential and China will pose a significant drag in the coming quarters for the region and the globe. Its recent policy responses have been measured and targeted but they are not enough to lift its growth back to its target of 5%; at best we think China will grow 3-4% this year.

Nowcasting says we are already in a global recession



Source: Goldman Sachs

The third method is analyzing Forecasting indicators which attempt to predict the state of the economy in the coming 1-2 quarters. However, forecasting indicators are conflicting with the OECD G7 Indicator indicating zero growth in the coming quarters for the grouping but the more widely followed PMI shows services and manufacturing powering into expansionary phase after miring in contractionary levels for much of the second half of last year.

S&P performances during recession are equally split between positive and negative returns

	S&P 500 % Gain Per Annum	Real GDP Contraction %
Nov 48 – Oct 49	9.6	-1.5
Jul 53 – May 54	21.9	-1.9
Aug 57 – Apr 58	-5.9	-3.0
Apr 60 – Feb 61	20.4	-0.7
Dec 69 – Nov 70	-5.8	-0.2
Nov 73 – Mar 75	-10.0	-3.1
Jan 80 – Jul 80	13.6	-2.2
Jul 81 – Nov 82	4.3	-2.5
Jul 90 – Mar 91	8.2	-1.4
Mar 01 – Nov 01	-2.7	-0.1
Dec 07 – Jun 09	-26.8	-3.8
Feb 20 – Apr 20	-8.2	-8.5
Average	1.6	-2.4
Median	0.8	-2.0

Source: Bloomberg

How can S&P generate positive returns as it runs counterintuitive to a dreadful economy? We venture two reasons. First, the stock market is not the economy. As shown by the charts below. The two largest constituents of the S&P500 are technology (31%) and Healthcare (14%) but from a GDP breakdown, Financials are the largest at 20% of total GDP in contrast to its 9% representation in the stock market. While the narrower definition of technology in GDP definition as IT, which is 6% of GDP but is 31% in the stock market.

Source: Bloomberg

The second reason is the stock market is forward-looking. It tends to peak 6-7 months before the start of a recession, trough 2 months after a recession has started, and by the time the recession ends, the market has rebounded 9% from its bottom.

Stock market is forward looking. Peaking before a recession starts and troughing before it ends

From a style perspective, Growth, Quality and Large-Cap perform better. As expected, Consumer Staples performs the best as the sector offers defensive earnings quality, though surprisingly Financials and Consumer Discretionary performances are close to consumer staples. Healthcare is the other sector that performs well because of its recession-proof business model.

Opting for Quality, Larger Cap, Growth stocks **and Consumer Staples, Healthcare**

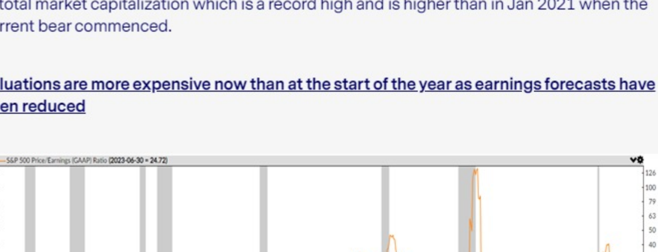
Style returns by regime	Global Momentum	Value	Growth	Quality	Min Vol	Large Cap	Small Cap
Recovery	-17%	-2%	2%	-4%	-19%	-1%	11%
Expansion	3%	0%	0%	-1%	-4%	-1%	6%
Decline	3%	-1%	1%	3%	4%	0%	-2%
Contraction	-2%	-6%	5%	9%	8%	1%	-2%

Source: Principal Asset Management

S&P 500 Sectors	Performance
Health Care	11.3
Utilities	10.2
Industrials	7.9
Consumer Staples	14.9
Communication Services	10.3
Energy	7.6
Financials	13.0
Materials	8.0
Consumer Discretionary	13.0
Information Technology	3.4

Since the start of the year, EPS for 2023 and 2024 have been revised downwards by 2-3% for both years leaving EPS growth of -1% for 2023 and 9% for 2024. With the S&P500 up 14% in the first half, this implies the entire driver of performance was due to valuation multiple expansion, not earnings momentum. This leaves valuation very rich with S&P trading at 25x trailing PE and 20x 1-year forward PE. These levels are higher than their long-term averages of 17x. And if a recession is the base case, S&P500 has historically traded at 14x trailing PE. These facts underpinned our preference to remain underweight equities given that there is no room for disappointment. Accentuating the risk is the narrow market rally with the top eight stocks now accounting for 28% of total market capitalization which is a record high and is higher than in Jan 2021 when the current bear commenced.

Valuations are more expensive now than at the start of the year as earnings forecasts have been reduced



The underweight in equities have been reduced compared to the start of the year where the general construct is to be underweight US, Europe and now China and with Japan as our only meaningful overweight. For our growth expressions, we have also substituted our tech exposure to a covered call expression on NASDAQ given its substantive performance YTD while augmenting with single names like turnaround tech names in the semiconductor space and in Japan electronic manufacturing ETF. Our growth expression extends to our holding in an environment-focused equities manager. For Quality expression, we have adopted an active and systematic ETF that focuses on Quality. We are still keepers of large US banks on valuation grounds and European and Japanese banks given their high earnings sensitivity to their central banks' policy actions. The larger part of our equities expression remains in fundamental long-short equities managers across the US and Asia.

Fixed Income remains overweight in US Treasuries and Investment Grade given they have historically performed better both on relative and absolute basis during recessions. Furthermore, there is no ambiguity to the path of Treasuries yields in contrast to equities when recessions happen. US yield falls all the time as the economy enters a recession with an average decline of 256bps in yield from the start to the end of a recession. Moreover, US yields generally peak ahead of a recession and drift lower even as the recession has ended as the bond market participants are more conservative than equities investors in pricing a recovery.

US Treasury Yields often peak before start of recession and always decline during one

Recession Start	Recession End	Bond Yield Peak	Bond Yield Trough	Bond Yield Peak (%)	Bond Yield Trough (%)	Decline (BPS)	Peak Months Rel to Start of Recession	Trough Months Rel to End of Recession
		Date		Level				
Apr-57	Apr-58	Oct-57	Jun-58	4	3	-100	6	2
Apr-60	Feb-61	Jan-60	May-61	5	4	-101	-3	3
Dec-69	Nov-70	Dec-69	Dec-71	8	6	-199	0	13
Nov-73	Mar-75	Sep-75	Jun-77	8	7	-128	22	27