INVESTMENT PERSPECTIVES

JUNE 2024

Key Takeaways —

- Will they save or will they spend?
- An examination of the r* factor.
- A closer look at cap-weighted vs. equal-weighted.

THE MEANS OF CONSUMPTION

Mark Luschini, Chief Investment Strategist

Consumption accounts for over two-thirds of U.S. economic activity. Over the years, we have focused on the consumer in many of our reports, reasoning that it offers the best vantage point from which to take a litmus test about the economy's health. Our conviction that the consumer was in good financial shape drove the bullish take we expressed in our Annual Outlook published at the end of 2023. After all, consumers had a stiff tailwind in the form of job stability, wage growth, and an abundance of excess savings.

Fast forward to today, and the tailwind has lost some of its velocity. Consider, for instance, that households can draw from three income buckets to fund consumption: past income they haven't yet spent (savings), present income (compensation and investment income), and future income (accessed by borrowing). Past income has been a potent driver of consumption since households began drawing down their excess pandemic savings in earnest at the beginning of 2022. Excess pandemic savings are a finite resource, however, and the most recent analysis produced by the San Francisco Federal Reserve argues that from its peak of more than $2 trillion in late summer of 2021, it is fully depleted at this juncture. If that is the case, then present and/or future income will have to fill the void if consumption growth is going to maintain its current heady pace.

The latest edition of the Federal Reserve's Senior Loan Officers' Opinion Survey (SLOOS), a quarterly solicitation conducted by monetary authorities asking lending agents to qualify their credit terms as well as the demand for it, showed the trend in banks reporting tight or tightening lending standards has extended to seven quarters. Additionally, the majority report that household loan demand remains tepid. Perhaps the scars from the Great Financial Crisis linger as a new consumer re-leveraging cycle has not yet emerged. Our read-through from that admission suggests future income (borrowing) is not likely poised to fill the incremental consumption gap that will be left by the decline of past income (excess savings).

Indeed, the savings rate today stands at just over 3%, a level that is about half as much as the five years preceding the pandemic. That is not to say savings cannot be drawn on further to support spending. However, we will be watching the sentiment surveys regarding job certainty and subsequent household savings reports to detect if consumers choose to replenish their savings bucket by retrenching their spending behavior. Should that occur, we would expect the economy's pace of growth to moderate, perhaps measurably. Ultimately, given the lack of imbalances that trigger a deep or protracted economic contraction, the next recession may come in with a whimper instead of a bang.

The savings rate can be a proxy for households' willingness to deploy their cash for consumption. While we anticipate it will normalize toward the pre-pandemic level of around 6%, what if the savings rate has decreased? In that case, the economic expansion could persist without concern that the key fuel for the economy is at or near exhaustion. Demographics offer a sound basis for a theory that holds we should expect a persistently lower savings rate. As the population ages and an increasing share of Americans become dis-savers, consonant with the savings life cycle, the savings rate may be expected to grind lower over time.

However, that does not seem imminent since the Baby Boomer generation, the oldest of which entered their mid-60s more than 10 years ago, imparted no detectable diminution in the savings rate.

What are we testing for? Signs that the consumer, due to depleted savings, job insecurity, or diminished borrowing, is spending less forcefully, which could lead to a recession. Corporate earnings rarely fall outside recessions, and bear markets are uncommon outside of one. A more defensive posture may be warranted when bracing for a typical recession-induced decline, but we believe that stance is premature. Moderating growth is to be expected, along with tempering expectations that the year-to-date double-digit gain in the S&P 500 index gains should be extrapolated to recur over the next five months. Still, we remain tactically bullish while waiting to see the evolution of consumer-influencing data before recommending that asset allocators position portfolios defensively. ■

STUCK ABOVE NEUTRAL

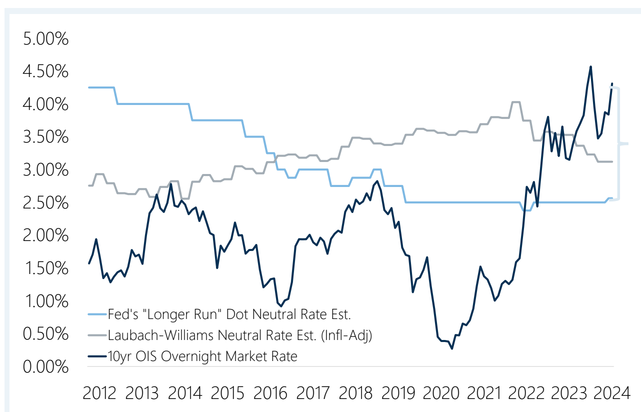
Guy LeBas, Chief Fixed Income Strategist

The neutral rate of interest, often referred to as r*, is the theoretical interest rate at which monetary policy is neither stimulative nor restrictive to the economy. In other words, the short-term interest rate is expected to prevail when the economy is at full strength and inflation is stable. For the United States, estimates of r* provide meaningful insight into the proper stance of monetary policy and have significant implications for various financial markets.

In recent years, discussion around r* gained prominence as the Federal Reserve (Fed) embarked on an aggressive rate hike cycle and, in the year since, a period of policy stability. After raising rates by roughly 5% in just over 12 months, Federal officials began to indicate that policy was approaching a "sufficiently restrictive" level. At the same time, measures of inflation receded from 40-year highs, job growth slowed, and recession chatter emerged as a primary topic of conversation among economists. These are precisely the conditions in which estimates of r* are most useful, as they help guide monetary policymakers to an optimal economic outcome.

Estimates of long-run r* vary but generally fall in the 2.0–3.0% range. At the same time, Federal officials—most recently Governor Chris Waller in this speech—have suggested a temporary increase in neutral rates of perhaps 0.5% or so. In other words, the neutral rate relevant for policy decisions today is likely in the 2.5–3.5% range, suggesting the current 5.25–5.50% federal funds rate is notably above neutral. Despite these estimates of neutral interest rates, the fact that economic growth remains robust in the face of this supposedly restrictive environment is evidence that r* could be even higher. In the speech above, Waller noted that multi-decadal changes in global savings trends are one reason r* could be on the rise.

Chart 1: Market Interest Rates Now Well Above Most Estimates of "Neutral"



Source: Janney ISG; Federal Reserve Bank of NY; Federal Reserve Board; Bloomberg

Even assuming a broad range of neutral interest rates in the 2.5-3.5%, there are positive implications for the fixed-income markets. In the long run, market interest rates should gravitate towards (or at least fluctuate around) the level of neutral interest rates. Why? A 10-year bond is economically the same as a one-day bond rolled over for 3,650 days. As such, the interest rate on a 10-year bond should be roughly the same as the expected overnight interest rate. In turn, the expected overnight interest rate should, in the long term, be equal to the neutral rate, r*. With 10-year Treasury yields now around 4.50% and r* even optimistically at 4.0%, there is some downside to interest rates from here. However, realizing that move might take the catalyst of actual rate cuts.

The bottom line is that r* is a highly relevant benchmark for policymakers and investors. The Federal Reserve's best assessment of neutral rates acts as a guidepost for the future path of monetary policy. At the same time, market participants can use r* to gauge the impact of Federal actions on the real economy. In the current environment, a 2.5-3.5% r* and above-average real yields suggest that monetary policy is still contractionary for today's economy. ■

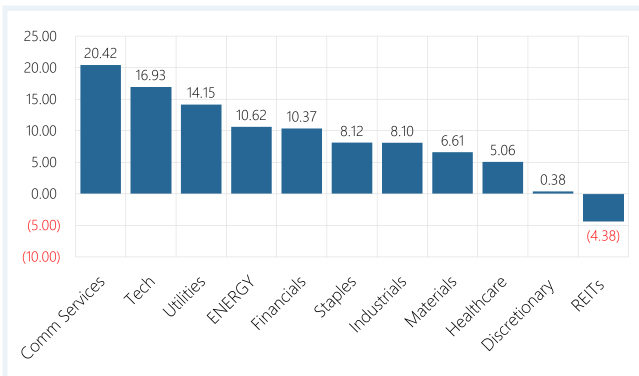
IS THERE A CAP TO THE GAP?

Gregory M. Drahuschak, Market Strategist

The final line of May's Investment Perspectives said the high for the S&P 500 is still ahead, and indeed it was, as the S&P 500 posted its eighth-best May result since 1950 and set multiple all-time highs along the way.

NVIDIA (NVDA) became the key to sentiment about artificial intelligence. Substantially surpassing the consensus earnings estimate, declaring a 10-1 stock split, and announcing its first-ever cash dividend strongly reaffirmed its role in this rapidly evolving technology. This, in turn, added to the Technology sector's significant performance this year after topping the S&P 500 (SPX) for all of 2023.

Chart 2: Year-to-date 2024 Sector Percentage Changes



Source: Janney ISG

Since 1950, the SPX in June has had the fourth lowest average monthly result but had a gain in 44 of the previous 74 years. Three of the 20 best June results have yet to be achieved in election years. On the other hand, nine of the 30 losses in June were during election years. The most relevant aspect of June trading is the frequent shift into typically defensive sectors like Staples. Since 1990, the SPX gained an average of 1.1% from Memorial Day to Labor Day. Healthcare, Real Estate, and Technology sectors posted above-average gains, while Communication Services, Energy, and Materials posted the poorest performances.

The market's rally off the late 2023 October low was accomplished in a manner that would rank highly in any seasoned investor's assessment, but how it got there is important.

For the first two months of 2023, the performance of the cap-weighted S&P 500 and an equally weighted version of the index matched. After March 9, 2023, the cap-weighted S&P 500 (SPX), which by weighting is dominated by the Technology, Consumer Discretionary, and Communication Services sectors, began outperforming the equally weighted version by an increasingly large amount. After the cap-weighted SPX outperformance reached 1,534 basis points in November 2023 and was cut roughly in half a month later, it looked like the performance gap between the two market measures would continue to narrow toward a more normal relationship. Instead, the outperformance by SPX widened again to reach a highly unusual spread of 2,009 basis points by May 31, 2024.

The accompanying chart, covering March 3, 2023, to May 29, 2024, shows that both market measures have moved higher. However, the degree of outperformance by SPX is very unusual, and eventually should narrow. How this plays out could have a major impact on market sentiment.

Chart 3: S&P 500 Large Cap Index

Source: Janney ISG

How the market deals with interest rates will be essential to whether or not the stock market will fare well in the summer months. The rise in interest rates in late May, which pared some of the gains for the month, we do not believe was the start of a change in the rate cycle. The Federal Reserve has made it abundantly clear that its bias is to lower rates at some point.

Also, stocks might get a boost from the election cycle. On average, in election years, the S&P 500 tends to move up in June through August before election jitters weigh on the market in September and October.

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