

Have Glory Days Passed You By? Maybe Not.

- The market narrative has been calling for a sharp slowing of the economy and a recession expected to start in Q4 2024. *So goes the narrative.*
- The catalyst for the recession narrative is that earnings are likely to slow, margins to fall and companies to lay off workers at a rapid pace to reduce costs and preserve margins. *So goes the narrative.*
- Under such circumstances equity earnings should fall and multiples decline, default risks would rise and credit spreads widen. In other words, financial Armageddon. *So goes the narrative.*
- With all this in mind many investors question if "Glory days [of investment returns] have passed them by."
- Have they? Maybe not. Let's get into it!

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Have glory days passed you by? Well, maybe not. The market narrative has been calling for a sharp slowing of the economy and a recession to start in the fourth quarter. *So goes the narrative.* The catalyst for a recession narrative is that earnings are likely to slow, margins to fall and companies to lay off workers at a rapid pace to reduce costs and preserve margins. *So goes the narrative.* Under such circumstances, equity earnings should fall and multiples decline, default risks should rise and credit spreads widen. In other words, financial Armageddon. *So goes the narrative.* With all of this in mind, it leaves many investors to question if glory days - and I'm really referring to the glory days of investment returns - have passed them by. But maybe not. Let's get into it.

So what's going on? We have a lot of sympathy with taking a cautious view toward market risk. After all, we recently took down our overweight to U.S. equities to neutral. But to be clear, this is not because we're turning bearish, but because we think the market can have a correction and we want to have plenty of dry powder to add to risk positions. Simply put, we think consensus estimates for earnings at \$280 in 2025, which represents a 14% growth rate over 2024 expected full-year earnings, seems a bit ambitious to us, at least on a risk-adjusted basis – and at this time, in other words, we don't think investors are being compensated well enough to take the risk of buying into those valuations. In our estimate, we would be more comfortable buying into a downward revision of those earnings to say \$265 or \$270, with a 19.5 multiple, which equates to a correction in the equity market in and around the 5,200 level for the S&P 500 index. Let's call this our base case view for now. But we could be wrong.

So where could we be underestimating the upside? Let's start with the fact that the Fed is expected to cut rates with inflation running close to 3% and the Atlanta Fed GDPNow estimates are close to 2.5%. Under ordinary circumstances, the Fed wouldn't cut rates. So why then are they? Well, it's because the Fed is worried that the unemployment rate could rise and accelerate quickly higher and that policy is too tight relative to economic conditions. Cutting interest rates is viewed as a hedge and a way to stave off a deeper downturn. But what if they're wrong? It could be that Fed cuts and inflation in 2025 starts to

bump higher. This would drive nominal earnings higher too as inflation tends to do. With the current increase in labor supply in part due to immigration and also in part due to many fiscal benefits ending for the do jobless, labor costs may also stay low as earnings rise, which could accelerate a widening of profit margins. This is certainly not how the narrative is going today, but this is a risk to the bearish views. If it plays out like this, then \$280 earnings in 2025 may be too low and investors would be willing to pay a higher multiple say 20 or 21 times for those potential cash flows. And this puts the S&P 500 around the 5,900 neighborhood. Again, not our base case, but a risk to the upside. Again, this is not consensus, but neither is it an insignificant probability for it to occur. As we like to say, upside in market is a risk and like any other risk it needs to be hedged. So who gets hurt? Well, bond investors. Bond yields are discounting a rate cut in the order of about 225 basis points by July of 2025. There's a possibility that the Fed does not deliver this and bond yields rise, albeit modestly toward the mid-4% range, but still low enough to support equity valuations.

So yes, maybe glory days have not yet passed you by, a clear reference to The Boss (aka Bruce Springsteen) and sometimes The Boss is right. Thank you all for listening and I'll be back with another Caron's Corner for an update.

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