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Alan Brazil

SOM
Macro
Strategies

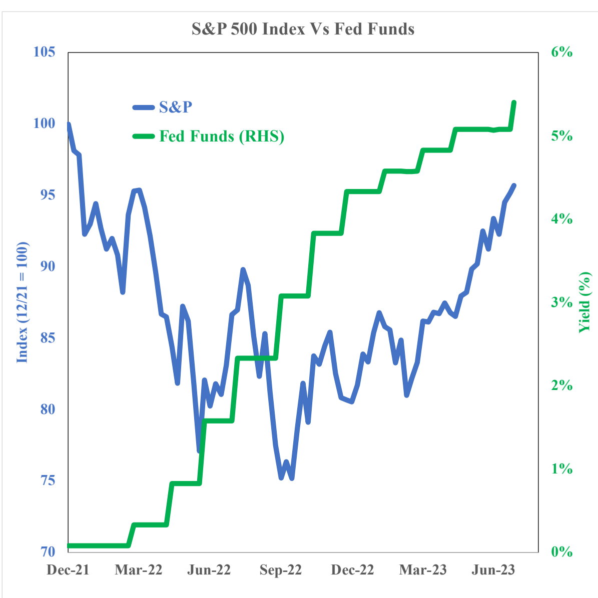
State of the Markets: Macro Commentary

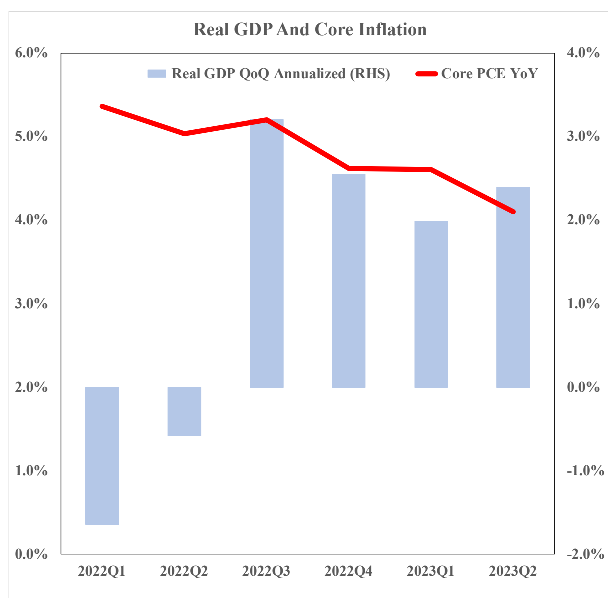
I Am Still Short US Equities

Well, I am still short US equities, though, by the end of the week, I may be alone in this recommendation. Other analysts recommended shorting equities have been tarred, feathered, and forced to retract their advice in the face of the continued rally in equities. I've had a few of my clients questioning my sanity as well. So, why am I still short?

Lots of reasons to be short. Look at Figure 1. Valuations are clearly at the top of historical ranges. Earnings are flat and could be falling.. The Fed might raise rates even further given that core inflation is still significantly above target, wages are still rising, and the economy is strengthening. All good reasons, but none of mine. My reason is that rates will be higher for longer. I am shorting equities because they have mispriced that factor. Equity valuations are back to levels before the spike in inflation and the Fed rate hikes. So, rates higher for longer will ultimately reprice equities lower. I've given you many pieces on rates higher for longer. But why do I think equities will decline and reflect higher for longer in interest rates? Here is why.

Figure 1.





The last time the Fed hiked rates to fight inflation, 1971-81, valuations reflected higher rates. I wrote about this period in a piece last year. Look at Figure 2 below. Equities were flat except during recessions—AKA "the hard landing" scenario--when they went down. Equities were flat even though earnings rose by a factor of 2.5. Now look at Figure 3. This figure looks at the recent period of 2021-23. In contrast to the 70s, equities have rallied between 40 and 70% from the start of this inflationary spike. As in the earlier period, earnings have risen as well. However, it is interesting that S&P earnings have increased about the same as Nasdaq, yet Nasdaq has rallied almost twice as much as S&P.

Figure 2.

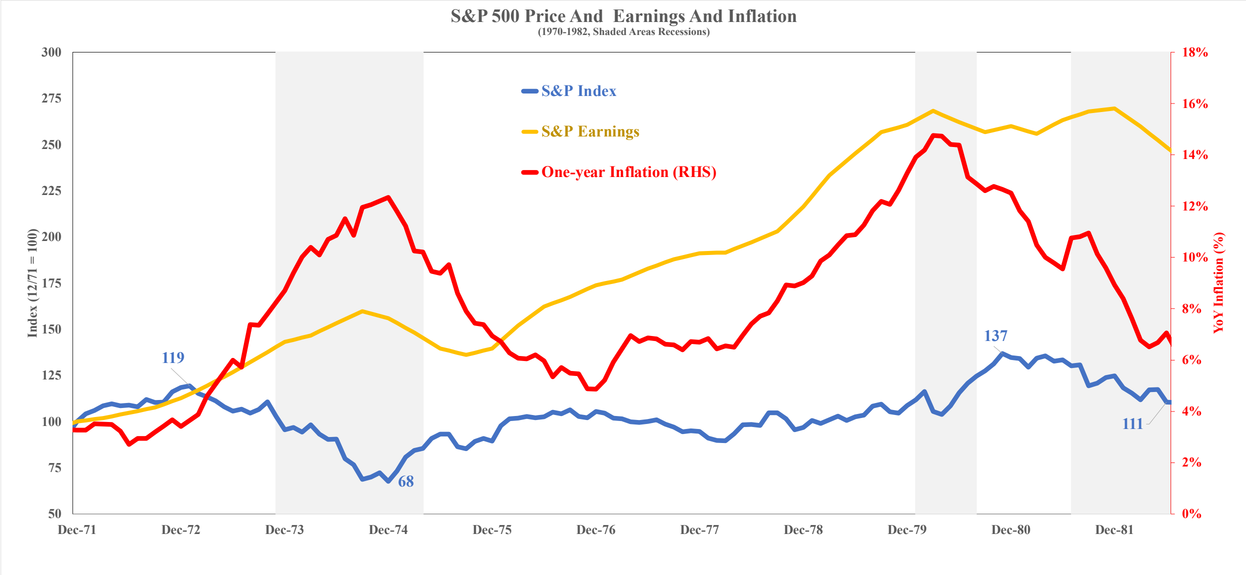
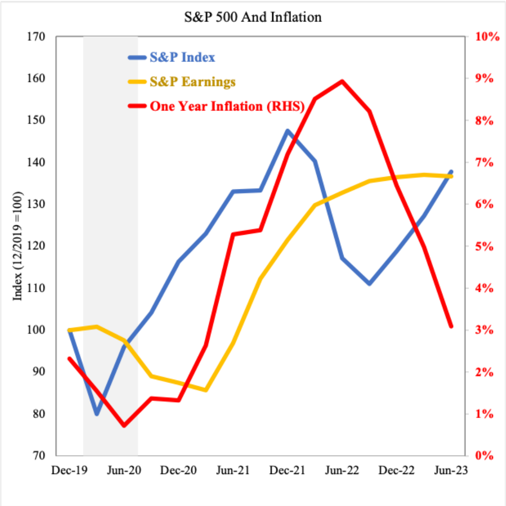


Figure 3.



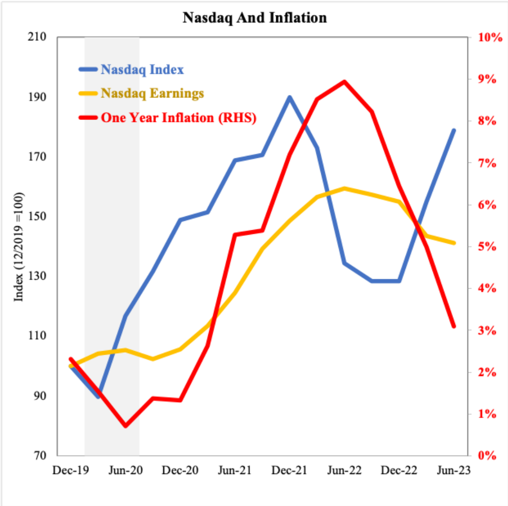


Figure 4 shows that earnings in the 70s grew substantially on a nominal basis but were flat after adjusting for inflation. That would imply that corporations could use their pricing power to pass on inflationary cost hikes to their consumers. In my past work, I have discussed this part of the 70s inflationary cycle. Now look at Figure 5. During the current inflationary process, corporates have also been able to pass along inflationary costs to their customers, as real earnings have risen substantially in the last two years. This is a crucial observation about my view of rates and inflation this time vs. the previous 30 years. Corporations and labor have pricing power without the constraint of China and Eastern Europe. This is central to my view that rates and inflation stay higher for longer.

Figure 4.

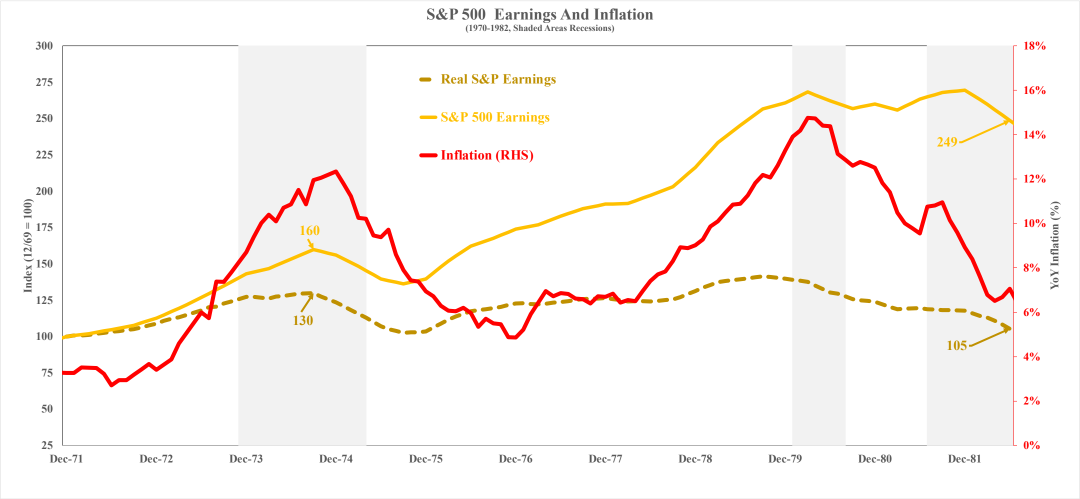
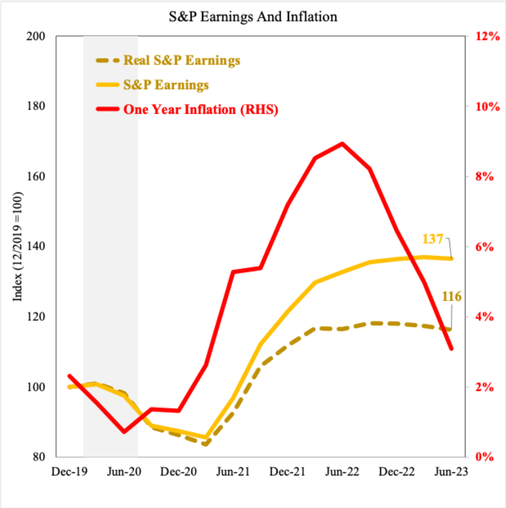
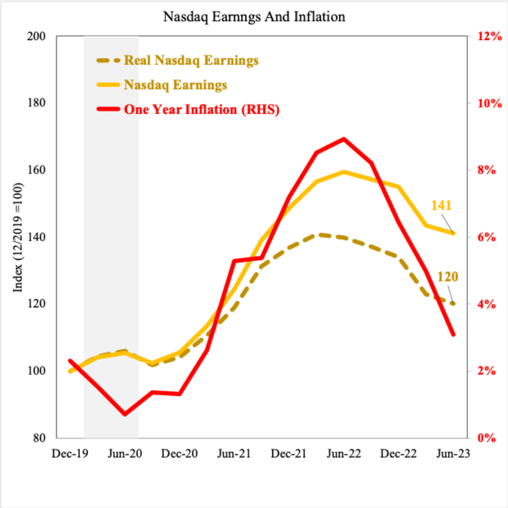


Figure 5.





On a valuation front, in Figure 6, I show that the PE ratios fell during 1971-81 and offset the surge in nominal earnings resulting in little change in equity prices. In contrast, in Figure 7, I show that PE ratios are roughly unchanged, if not higher than levels before COVID and inflation.

Figure 6.

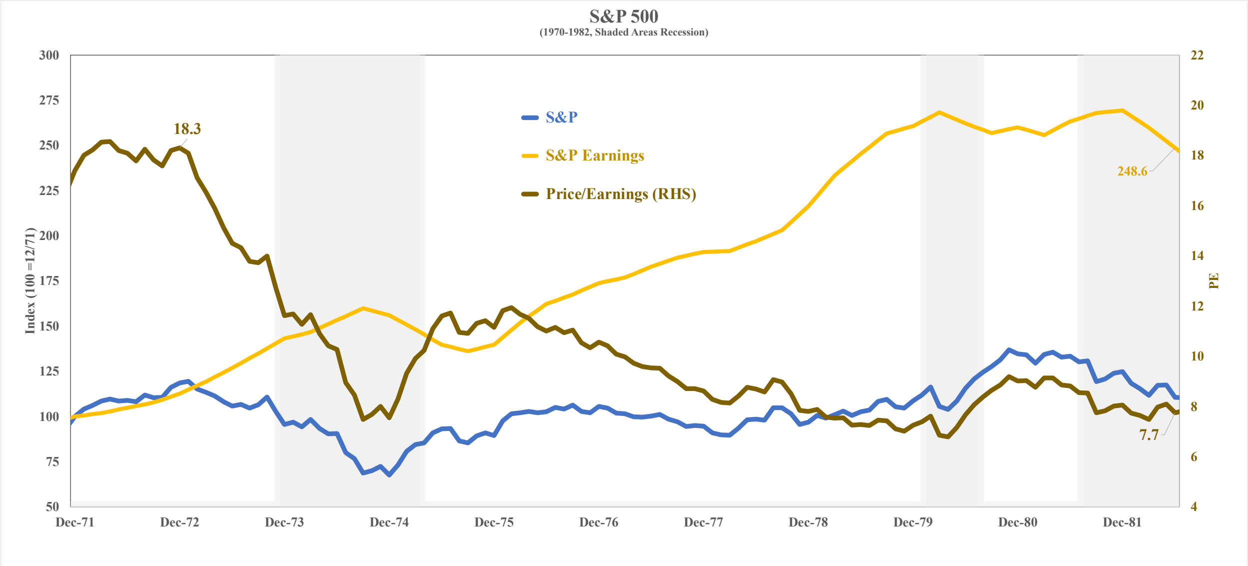
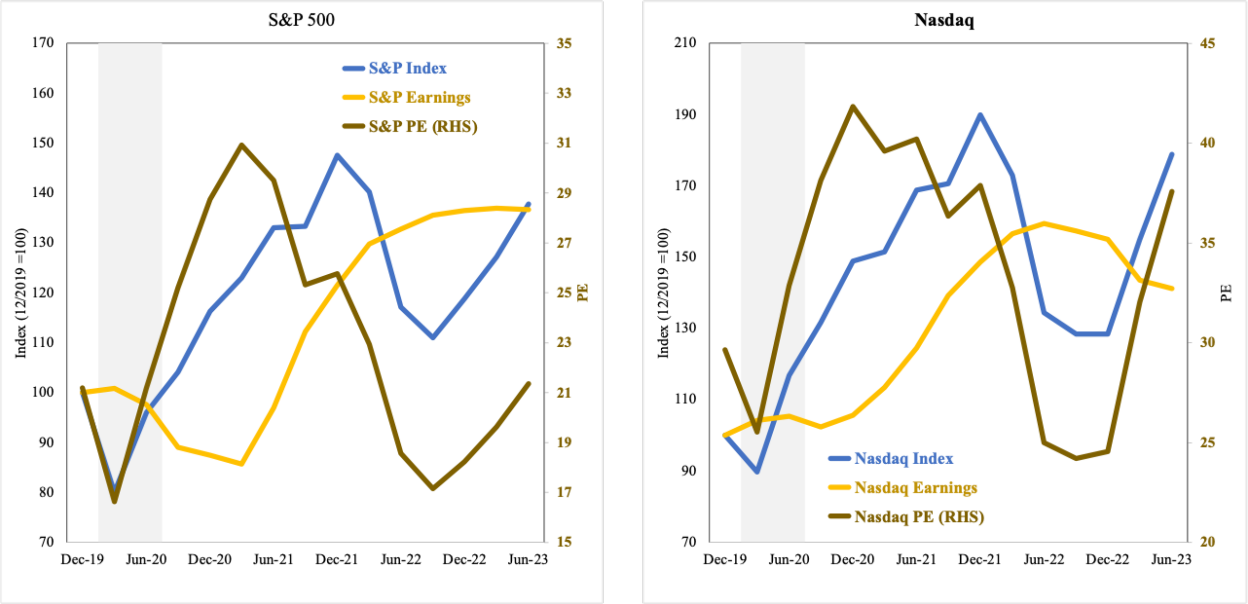


Figure 7.



Now here comes my rationale for shorting equities and the linkage of valuations to level of interest rates. During 1971-81, Figure 8, PEs fell as they followed the Fed rate hikes to fight inflation. I show this by inverting the PE axis (inverted PE is earnings yield). However, as shown in Figure 9, during the recent inflationary spike, PEs followed the rate path but rebounded back to pre-Fed and COVID levels.

Figure 8.

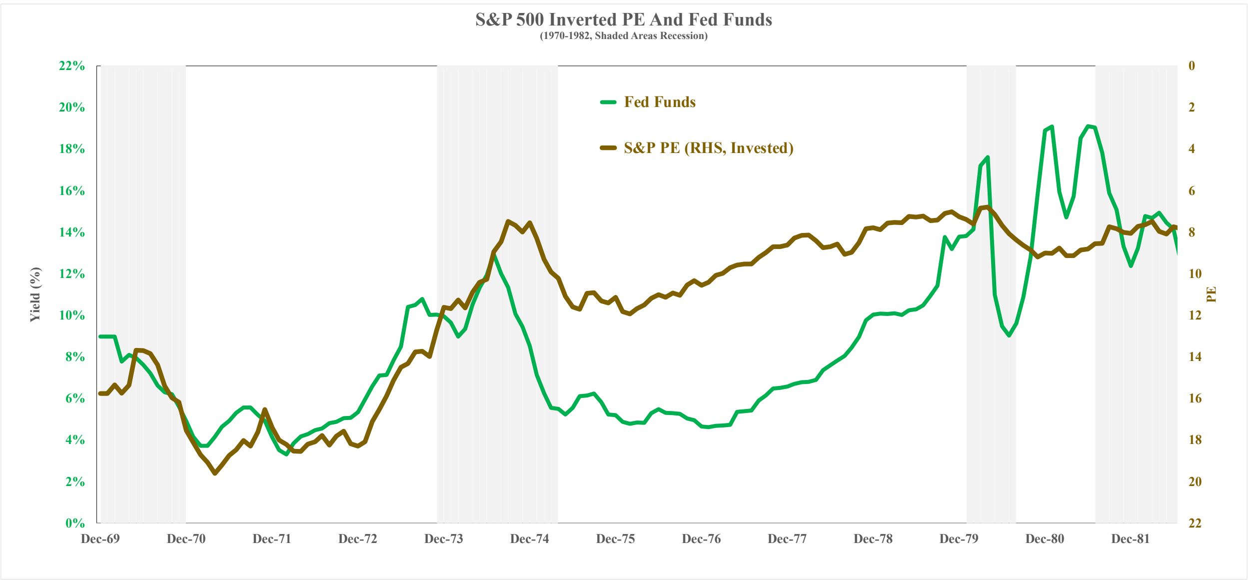
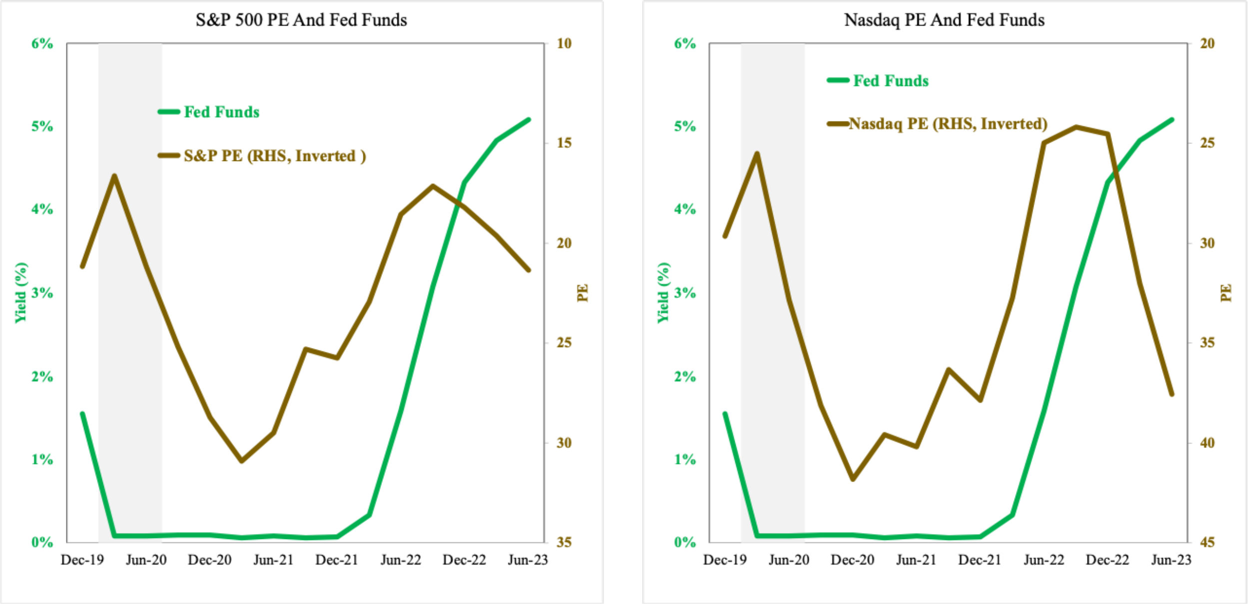


Figure 9.



My Rational For Shorting Equities

The question is, why are equities markets not pricing in the current level of rates? My conclusion is that markets are not wrong; after all, markets are efficient (what else could I argue given my Ph.D. in economics from Chicago) but rather they are pricing in an improbable scenario. This is the "nirvana" scenario of much lower interest rates after the Fed cuts rates with inflation back to target and with a soft economic landing. All three must be valid for current valuations to be consistent with the level of future interest rates. And that is my reasoning for shorting equities because this "nirvana" scenario is improbable.

First, there is still the probability of a hard landing, which is unlikely but still a significant probability. Equities will crash even after the Fed cuts rates and inflation is back to target in this event. Second, core inflation could remain higher for longer given that wages are still rising—look at the UPS settlement—and the housing market rebound. Third, most importantly, the Fed is unlikely to cut rates even if inflation gets back to target and there is a soft landing-- 2% inflation and 1.5% real growth. Do you think the Fed will cut rates after winning the inflation battle without pushing the economy into a recession with rates in the mid-5%? Would they then say we won; let's cut rates and drive the economy higher even though it is at full employment, risking another round of inflation? That strategy did not work out well in the 70s. Or would they, in this Nirvana scenario, say don't rock the boat; our rate hikes worked, so why cut? Particularly given what happened in the 70s. My conclusion: Nirvana is unlikely, short equities.

My strategy for the short equity position was to buy six-month, 30 Delta puts on S&P. I placed an options trade rather than an outright with a stop because I was uncertain of the timing of the repricing, but I believe it will happen before the end of the year. Further, time value was cheap given the historically low implied vol. Options give me the luxury of staying in a trade even if it goes against me. And it has gone against me with the trade down about 2/3rds. So, I could have chosen a better entry point. But I still like the trade. In addition, I am using built-up cash from my long high yield to pay for the option.