
False Narratives Will Cost You Money

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'The US stock market has likely put in a bottom. We expect a rotation out of growth to value. Will S&P 500 make all-time highs by the end of the year? It is quite possible,' writes Marko Papic, chief strategist at the Clocktower Group and our guest columnist.



You know that recession narratives abound when Cardi B is tweeting “When y’all think they going to announce that we going into a recession?” Even more pronounced is the “stagflation” hysteria.

Major investment banks are publishing stagflation primers; an institutional investment client has asked us for custom research on the topic. Unsurprisingly, the bull-bear ratio very much remains skewed towards “The End of Times,” with a reading lower than at the height of the pandemic.

We are taking the other side of the bearish bet after being definitively alarmists since our November 2021 missive. While stagflation is likely the end point of the current cycle, we are not there... yet. The world remains very much in a high nominal growth macro context that we have dubbed the Hydrogen Economy.

The gap between nominal GDP growth and the Fed’s response—simulated by the T-bill yield—remains vast. Yes, the Fed is flagging three further 50bps hikes, but it is doing so off a low base with inflation expectations at multi-decade highs. [For the complete version of this article, with charts, click [here](#).]

Nominal GDP growth matters. It is the price paid for goods and services. The “real” GDP only begins to matter when consumers can no longer afford to pay for the nominal prices. Yes, a segment of the population is starting to hurt, but not the segment that actually pays for the vast majority of goods and services.

On a macro level, cumulative personal savings are at \$2.6 trillion higher than pre-pandemic trend, with consumers more than happy to eat into those savings to afford to keep pace with nominal price moves. What’s more, the private sector is beginning to re-leverage after a decade of deleveraging, with no sign of delinquency anywhere in the system.

At these levels of CPI—and given our view that inflation is likely to ease by year end—consumers have more than enough savings accumulated thanks to the Buenos Aires Consensus orgy of 2020-2021 to keep up with higher prices. This is particularly the case with gasoline, whose share of the overall consumer expenditure is much lower today than in the days when presidents won and lost their elections at the pump (i.e., the 1970s).

The market is already signaling the bottom, with growth sensitive indexes and sectors putting in a bottom over the past month. Part of the reason for the relief may also be that yields have peaked, as we have argued over the past two months. The too much, too fast move in the 10-year yield is likely to pause, with both the US growth slowdown and the carnage in China contributing to the moderation in yields, giving stocks room to breathe.

At some point, the combination of rising borrowing costs, exhausted savings, and real income decline will arrest the cycle, but we don't see that moment on a 12-month horizon. Especially with 5-year real yields still deeply negative and financial conditions tightening, but still easier than the pre-pandemic levels.

This is where the bears would point out that the Fed is engineering a recession: That precisely because financial conditions have not tightened sufficiently, the Fed must go "full Volcker." That the Fed must raise its policy rate above neutral as quickly as possible in order to anchor inflation expectation.

We are not Fed experts so we remain open minded about this Apocalyptic scenario. However, there are two reasons to expect the Fed to think twice about raising interest rates as fast as it has currently flagged.

First, the obvious reason. The S&P 500 correction is flagging that the US economy will be flirting with a recession by year's end. Are investors supposed to believe that unelected technocrats are willing to be blamed—in this Age of Populism—for ushering in a recession? (Side question: What is worse... paying \$7 a gallon for gasoline out of a declining real wage or not paying \$3 a gallon for gasoline because one is unemployed?)

We just don't believe that the Fed has the guts to go all the way and cause a deep recession. As such, investors are experiencing peak hawkishness at this particular moment.

Second, we also don't believe that the Fed should raise interest rates as fast as they are flagging. Now, this is a tricky argument. "Should" is a four-letter curse word for the denizens of the Clocktower Group Strategy Team. As such, a caveat is in order.

We do not mean that it is pareto optimal to run the economy “hot.” Rather, we mean that if the Fed’s goal is to ensure that inflation is corralled over the long term—say the rest of this decade—then causing a recession now would be folly.

In fact, we would go as far as to guarantee to our readers that raising interest rates now and causing a recession would ensure that inflation spikes later in the decade.

Bottom line: The US stock market has likely put in a bottom. We expect a rotation out of growth to value. Will S&P 500 make all-time highs by the end of the year? It is quite possible given our view that the Fed will ease the pace of rate hikes as inflation ebbs and growth slows.

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