



Episode #42: Recession Watch and Market Insights with Joe Kalish

Annika Traner:

Welcome to another episode of the Fairport Flash. This is Annika Traner, Digital Marketing Manager, bringing you the latest insights from the Fairport Investment Team. Today I'm joined in the studio by our Manager of Investments, Rick D'Amico. How are you today, Rick?

Rick D'Amico:

Doing great, Annika. Thank you.

Annika Traner:

Good, that's great to hear. Also, joining us today by telephone is Joe Kalish, the Chief Global Macro Strategist at Ned Davis Research. Thank you for joining us today, Joe.

Joseph Kalish:

Thanks. It's great to be here.

Rick D'Amico:

Well, hello everyone. As Annika said, we're very excited to have Joe Kalish, chief Global Macro Strategist for Ned Davis research on the Fairport Flash Investment podcast today. Joe has been studying financial and economic trends for the better part of 40 years and he and his team are responsible for the firm's fixed income and economic analysis. Joe is a member of the National Association for Business Economics, is regularly quoted and interviewed by the financial media and the US and internationally, and is also a often sought after speaker and presenter as a fixed income portfolio manager at Fairport. I know that over my career, Joe's research is something I've relied on heavily and really valued over the years. So Joe, thank you for joining us today, again.

Joseph Kalish:

Thanks Rick. Thanks for having me.

Rick D'Amico:

So let's kick things off by talking about expectations for Fed policy in the second half of the year. If you look at the CME Fed Watch tool, it appears the market is still expecting one to 2 25 basis point cuts, most likely in either September and December. I know you've noted that there no longer appears to be a path to a rate hike, but that the Fed may also be in a situation where they don't

necessarily have the confidence to cut rates either with recent data suggesting that inflation remains stickier than expected. We also just had the producer price index or PPI come in hotter than expected this morning and are for another important CPI print this week. What is your base case for Fed policy over the next six months, Joe?

Joseph Kalish:

Yeah, Rick, I think the market basically has this, right? Our base case is for one, but I could easily see how the Fed might be able to cut two times this year if the data cooperates. And so that's really what it's going to hinge on. I think if we get to September, and it's not really obvious because there's been a string of good inflation data or employment rate is suddenly going up more than people expected that the Fed may have trouble getting that confidence ahead of the election to do that cut, but they will cut if the evidence is there for them. And so that's why I have one is my base case, but two is certainly still on the table and still very possible.

Rick D'Amico:

Okay. And as far as inflation is concerned, in your view, do you see a path where we could get back to 2% inflation at some point or are we more likely to hover closer to the 3% range going forward?

Joseph Kalish:

Yeah, so here's where I think it depends on what your time horizon is. Short term, I'm still optimistic that inflation's going to come down and the primary driver of that is that we should start to see some improvement or further improvement in the shelter and rent components. So this is the really big driver and a really big piece that's been missing. Now we have made progress. We were seeing monthly increases of seven tenths, eight tenths of a month. Now we're seeing those increases about half of that, but we should still start to see some further improvement because house prices cooled off a lot at the beginning of last year. They tend to lead rents by about a year, a year and a half. We're seeing a tremendous amount of development in the multifamily space. There's a lot of units under construction. These units should be completed through the balance of the year and that's going to start to add some downward pressure on rents.

So that's the primary driver. We have seen some of the wage growth numbers start to cool a little bit on the average hourly earnings side, not so much on the ECI side your employment cost index side, but that will probably slow down a little bit and give us some help there. But over the intermediate term, I'm concerned that there are some other things that are going on. So first of all, we've also gotten a lot of improvement on the good side of inflation and I'm worried that as these improvements in supply chains have come through, that improvement's going to start to run out. And so that'll start to normalize and we won't see that disinflationary impulse that we've been seeing over the last few months. So that could go away. And then in terms of what really concerns me over the intermediate term is we are still going to be short housing and the supply of housing is nowhere near what it needs to be.

So we're still short by my estimates, anywhere from two and a half million housing units, commodities can be a problem as well. So this goes back to something I had talked about a couple of

years ago called a new world order that we're moving from an age of relative abundance in commodities to an age of relative scarcities and scarcity in terms of lack of investment. We're certainly seeing that now in copper, but also climate change. We're seeing some impacts there in some of the agricultural commodities name cocoa and coffee and things like that. And then geopolitical risk, which has certainly been increasing. Then we have this emphasis of security over efficiency, and so we're moving more toward emphasizing defense security, cybersecurity, AI security, internet security, satellite security. We're moving some of this production out of China into other areas of the world. So all of this security, all this done in the name of building resiliency is all costly.

And then the fourth item is labor and labor markets are tight. They're tight around the world and so it's been challenging to get labor costs down to target, which is where they would need to be. So that's the intermediate term, but over the long term, there still is a very real possibility that we could get back to 2% and that has to do with these new technological developments going on in artificial intelligence and robotics. So longer term, I'm not convinced that inflation is going to move terribly far away from the 2% level, but I think that's going to be a challenge over the intermediate term to get down to 2% and stay there without going through a recession.

Rick D'Amico:

Okay, thanks Joe, that's a great summary. So longer term, optimistic that we could get closer to that 2%, but it sounds like there's some concerns in the intermediate term very well summarized back to the Fed a little bit now investors have been very focused on that first rate cut and for good reason according to your research, which suggests that 10 year treasury yields tend to peak about two to three months prior to the first cut and then typically remain range bound thereafter. So as far as the timing is concerned with a potential September rate cut, we could be in the ballpark with a peak in rates. Are you expecting more of the same this time around? And if so, what are your expectations for fixed income investors for the remainder of 2024? It's been a challenge this far with the Bloomberg Barclays aggregate bond index down close to 2% year to date. And I believe NDR is currently underweight fixed income by 5% relative to your target allocations.

Joseph Kalish:

Yeah, so in a balanced portfolio, we are underweight on just pure fixed income portfolios. I'm at benchmark duration because of this. Basically the market prices stuff in ahead of the event, and Rick, you probably know this, but a lot of people don't realize, but bond investing is actually harder than stock investing because it all gets priced in before the actual events or most of the move gets priced in before the actual events. That's not necessarily the case in equities. And so it's a little bit more difficult in the fixed income side. But where we are now in terms of yields, let's call it roughly 4.5% on a 10-year treasury, this is a much better position than where we were coming into the year and there were a lot of people calling for six or seven rate cuts. We weren't among them. And so we pushed back against that and we said that we had almost hit our year-end target by the time we had gotten for 2024 by the time we had gotten to December of 2023.

And so we just said this was just getting a little too out of hand. But there were a couple of things that happened a couple of weeks ago that were somewhat encouraging to me about the longer-term

outlook. So first of all, Powell and the Fed pretty much capped their short-term policy rate, the Fed funds rate at this five and a quarter to five and half percent. Powell has said they're willing to hang at that level longer, but it's unlikely that they're going to raise rates. So that gives us some confidence that rates are not going to be raised on the short end anymore and that's good. Then the second thing that I thought was significant was that the Treasury Department announced that it didn't foresee any changes in their coupon issuance over the next several quarters, which sounds like a long time that we have an election coming up, but that tells us there is not going to be this increasing amount of supply that needs to get digested by the market.

And so that likely caps term premiums and likely caps 10-year yields at those peaks of where we were last year at around 5%. So now my downside or in bond prices or my upside in yield is fairly limited. And what we've been saying is if you can see a 10-year treasury yield above four- and three-quarter percent, you probably should be interested in buying that. That's probably a pretty good level and it's pretty close to where we think fair value is going to be over the intermediate term given all those risks that I mentioned before. So, this is a much better place to pick up bonds now until we get clarity, the bond market's going to chop around, but there's no need to really rush in until those two to three months before we have that clarity. And so if that is September, I really don't need to do anything maybe until July, but by the time we get to June meeting, we'll have a better idea of where the Fed is and when that might be. But the worst case now to me, this is more of a choppy trading range and we can probably just continue to accumulate interest income in that with a potential of gains if we actually get some clarity about when the Fed's democrat.

Rick D'Amico:

Okay, great. So from a valuation perspective, within fixed income credit spreads appear tight when compared to their historical means. Investment grade credit at 88 basis points is tight relative to its historical mean of 150 basis points and high yield at 300 basis points appears historically tight relative to its average of 522 basis points. Are there any sectors within fixed income from a valuation perspective that you view as attractive? And what part of the yield curve do you believe investors should target? I know not too long ago you felt the two-year part of the curve looked attractive. Is that still the case?

Joseph Kalish:

That is still the case. Again, if you think about what we just discussed, Rick, in terms of this asymmetric risk profile from the Fed where it's going to be difficult to get another rate increase and much easier to get rate decreases, then I want to buy two-year yields. If they get close to 5% or what I said is if you can buy them above 5%, that would be a pretty good opportunity. So we do have a curve steeper on, which means we do expect yields on the short end will fall faster than yields on the long end. And so that's another reason for favoring sort of that short, intermediate portion of the curve because we do expect the curve to steepen. So that's in terms of the maturity. In terms of the sector positioning, there've been two areas that I have liked.

One of them has been agency mortgage-backed securities and the yields had backed up along with the treasury rates. But this is something that will benefit as bond volatility, which has actually been somewhat elevated. If it's come down, but it's still somewhat elevated compared to history that will

actually benefit investors in mortgage-backed securities because there's an embedded option in there. I don't want to get too technical, but basically the value of that as the value of that option comes down, the price of the mortgage-backed security goes up. So having some clarity about the Fed is going to help mortgage-backed securities. So that's one area that we've liked. The second area that I've focused on more recently has been in leverage loss. And so you mentioned the tight spreads in IG and high yield, but the spreads actually had gotten pretty wide in loans compared to high yield. You could get 150 to 170 basis points of yield pickup by going into loans. And as long as the economy wasn't going into recession and the Fed was pushing out rate cuts, I'm still going to be getting that interest income. And the third area that I was liked has been emerging markets, and this has been a long-term overweight for us. We've had it on since the beginning of last year, and this is an area that continues to perform quite well. So those are three sectors that I favor.

Rick D'Amico:

Okay, great. That's very helpful onto the economy. Now as far as the economy is concerned, if you look at the most recent Atlanta Fed GDP, now real GDP estimate for Q2, it's tracking at a pretty solid rate of 4.2%. Does Ned Davis research believe we are out of the woods as far as a recession is concerned? What type of odds would you put on a recession at this point?

Joseph Kalish:

Yeah, we have very low odds of a recession. We use something called our recession watch report, which has 10 of our favorite indicators for calling recession. Only one of those 10 is warning of recession risk right now. So if you want to just use that report, that gives us a 10% risk. But I think it's important, Rick, to understand why people got this call wrong. So this is probably the best call we didn't make last year is we didn't call for recession. We didn't have enough indicators providing the recession, but what people have fixated on were things like the inverted yield curve. We tried to point out that it didn't have a perfect record, although some people wanted to make it out to be that it did have a perfect record. Second thing, people were pointing to the fact that the Fed raised rates 5 25 basis points and that we had to go into recession because of all that.

And we pointed out that we never started out with the real Fed funds rate minus 500. So we never started a tightening cycle with that deep in the hole. The worst we'd seen is maybe minus a hundred and most tightening cycles started when real yields were in positive territory. So that was another thing that people were pointed to that didn't sit well with me. And then the third thing is that people kept pointing to the leading economic indicators and that they were negative for like 23 months in a row. And you go and look at what was in the leading economic indicators, it was chockfull of things that had to do with the good sector of the economy. And so most of the economy service sector and people were spending less money on goods and more on services, and so the economy wasn't breaking. Then we have these three other things that really helped to support the economy, and one was the amount of fiscal stimulus.

And second thing is the transmission mechanism of monetary policy is much less effective in the US than it's in places say such as Europe. Because look, most homeowners, I'm sure most of your clients refinance their mortgage when they could at around 3%. They're not willing to give that up. They're in good shape, they're not feeling these effects from higher rates. A lot of corporations did something

similar and they refinanced their debt at lower rates. And so the immediate impact for people that have existing debt is very little, right? And so it's only the people are taking out new debt or those who are living on floating rate debt that see those impacts. And so it's been much less, that transmission mechanism has been much less effective this cycle. And then the third thing is that people have jobs, and the worst thing you can do is bet against the US consumer.

This has really not been a good bet unless one or two things happens. There's some sort of shock or there's a financial crisis in, there's massive job loss. So barring those two conditions, the consumer is going to continue to spend and that's what we continue to see. So we put this at pretty low odds right now, that 4.2% from the Atlanta Fed is probably going to come down as we work through the quarter, but the fact that I think Powell said this earlier, that we're still tracking to about 2%. We've up our forecast for this year to a range of one and half to 2% that's not recession, and we don't anticipate a recession this year.

Rick D'Amico:

That's good to hear. I know you mentioned your recession watch indicator right now is there's only one out of 10 components that's flashing the possibility of a recession. Looking back like six months, nine months ago, what's the highest level that ever got to?

Joseph Kalish:

We got to about half, I think about a year ago, and then it started to slide, slide back down, but we did get a few of the indicators warning of a recession, and those again tended to be more goods oriented, more goods related indicators and confidence indicators than real activity indicators from the services sector.

Rick D'Amico:

Okay. Well good to see that headed back in the other direction. Finally, as we wrap up the podcast, are there any large macro risks or any other risks investors should be focusing on? We've heard a lot about commercial real estate in the press recently with property valuations, whether they've been inflated or not. Any thoughts, anything else that we could be missing that you're concerned about?

Joseph Kalish:

The biggest risk I think that we face for the remainder of this year is if we just, and I'm just not just talking us, but economists in general or whatever, but if inflation comes in persistently higher than people expect or even re-accelerate, if inflation expectations were to break out to the upside, then that would present a big risk to the economy because that would be the type of condition where the Fed would have to put rate hikes back on the table. They cannot have an unanchoring of inflation expectations, so that would keep them restrictive for longer and even maybe cause them to hike rates again. So that would be my biggest risk. In terms of the commercial real estate, it's a risk, but I think it's a manageable risk. There will be no doubt some property owners that will be hurt. There will be some banks that will be hurt, but the system as a whole, the systemically important institutions will not be impacted to a great degree.

So I'm not particularly worried about that. The third thing that has really come up a little bit more in my thinking in terms of the riskiness for more the second half of the year, it really has to do with the political and geopolitical landscape. And we have an election this year as everybody knows, but what will be the results of that election? Will there be a split Congress? Will there be smooth and a peaceful transition of power? I mean, all these question marks around the geopolitical outlook and the political, domestic political outlook and then the geopolitical outlook. We've seen a number of problems in the geopolitical landscape over the last six months or so and do those escalate or not? And it certainly seems like the world isn't getting to be a safer place, and we all need to be thinking about these geopolitical risks and how they might impact us. And so those are really the risks that I'm looking at for the second half of this year.

Rick D'Amico:

Well, thank you very much, Joe. We really appreciate the time that you've spent with us. Covered a lot of different topics from the Fed to the economy to any large risks that remain in the second half of the year. Really appreciate and value your research and the time that you've spent with us today. So thank you very much.

Joseph Kalish:

Well, thanks again, Rick.

Annika Traner:

Thank you again for joining the podcast today, Rick and Joe, and as always, thank you to you, our listeners. If the topics discussed in our episode today sparked any burning questions, please don't hesitate to reach out to a member of your Fairport Wealth team. For the latest updates from our Investment Team, you can follow us on LinkedIn, Facebook, or Twitter, and look for the hashtag, #InvestingWithFairport. Join us next month for a very special episode of the Flash featuring Deborah Feldman, Managing Director and Wealth Advisor from our Fairport Chicago office, AND the infamous author of our widow-centric blog, [Rebuilding Home](#). Until then, enjoy the summer sunshine!

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