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AN UPDATE FROM PAUL DIETRICH

NEW BULL MARKET/SOFT LANDING OR COMING BEAR MARKET/RECESSION?

Former Secretary of the Treasury, Robert Rubin, said last week that he has "never in his life seen so many major risks in the global economy as he does now."

He said that "investor complacency" in the stock market is now at an all time high.

He identified these risks at a conference in Aspen, Colorado: U.S. debt and runaway government spending; high credit card debt; high mortgage rates; food and oil prices spiking up; still too high inflation; unaffordable housing; commercial real estate banking crisis; America's broken political system; Trump's divisive scandals and indictments; global stress; war in Ukraine; deteriorating trade and relations with China; Chinese economic crisis: and, general U.S. and world economic slowdown.

The Business Press Says The Economy Is Strengthening & Predicts A Soft Landing

This is, of course, what they always predict right before each recession.

Dot.Com Recession 2001-2002: The S&P 500 Index peaked during a speculative frenzy in buying worthless internet stocks in September 2000; the recession that nobody saw coming started in March 2001.

Great Recession 2008-2009: The S&P 500 Index peaked during a speculative frenzy in home buying and mortgage-backed securities in October 2007; the recession that nobody saw coming began two months later in December.

Over the past month, a number of U.S. government economic reports showed better than expected results. What that means is the economy did not slow as much as analysts and economists expected.

It should be pointed out that there is a very large difference between the economy slowing less than expected and an economy that is growing and expanding.

Many of the headlines stated, "The Economy Gains Strength." But a strong, yet "cooling economy," is still a contracting economy.

Articles about the Federal Reserve in January 2008 vs. July 2023:

REUTERS

BUSINESS NEWS
JANUARY 17, 2008 10:48 AM / UPDATED 16 YEARS AGO

Bernanke: Fed is not forecasting a recession

By Reuters Staff

Bloomberg

July, 26th 2023
Economics

Powell Says Fed's Staff Is No Longer Forecasting a Recession

- Staff economists drop downturn forecast they debuted in March
- Fed chair cites recent 'resilience of the economy' for upgrade

Will There Be A Soft Landing?

The soft-landing folks say, 'the labor market is still strong, the stock market is still strong, the economy seems to be running okay now, and inflation is coming down, we're going to have a soft landing.'

A lot of pundits and analysts look at the recent gains of big tech stocks in the stock market and economic reports that were not as bad as they expected, and then make predictions on the future economy.

Those economic reports have raised hopes among investors that the United States can avoid a recession despite the Federal Reserve's aggressive pace of interest rate hikes.

Dropping inflation back to a 2% level without throwing the economy into recession is what's called a "soft landing," something the Fed has only achieved once in the past 60 years—although some researchers argue the central bank may have done it twice.

Data going back to 1948 shows that we have only had a soft landing in the context of rising interest rates when the Fed stopped tightening before the yield curve inverted. This was what Alan Greenspan did in the mid-1990s and Paul Volker did in the mid-1980s.

With the yield curve already severely inverted and signaling a recession, it is highly unlikely we can avoid a recession.

Investors Rarely See A Recession Coming Despite Warning Signals

The S&P 500 Index is up 14.7% year-to-date, but recession signals like the inverted Treasury yield curve and The Conference Board's Index of Leading Economic Indicators point to a serious downturn. Unfortunately, investors are continuing to ignore recession alarm bells.

Right up until the moment the economy goes into a recession, a lot of pundits and analysts have argued in the past that we will, in fact, avoid a recession and a drop in stock prices, and have a soft landing.

I did some research and found *Wall Street Journal* articles in 2007, 2000, 1989, 1980 and 1973 that highlighted a soft-landing scenario that never materialized.

All of the leading economic indicators point to an ongoing slowing in the economy, just like they have before prior recessions.

Maybe this time will be different, BUT I DOUBT IT!

The Blind Side of Recessions

In the chart below, showing the S&P 500 Index price action leading up to recessions (shaded areas), one can see that stock markets climb before each recession and the severe sell-offs often don't start until a recession is known. In instances where stocks do start selling off briefly prior to a recession beginning, a majority of losses come after the recession formally starts.

Investors should become ready for a repeat of last year's slump in stocks, as investors wake up to the mounting risks in today's markets.

It is often said that those who do not learn from history are doomed to repeat it. It seems that many stock market investors have consistently proven this true by overlooking impending recessions despite glaring signals and indicators that have 100% historical records in predicting recessions.

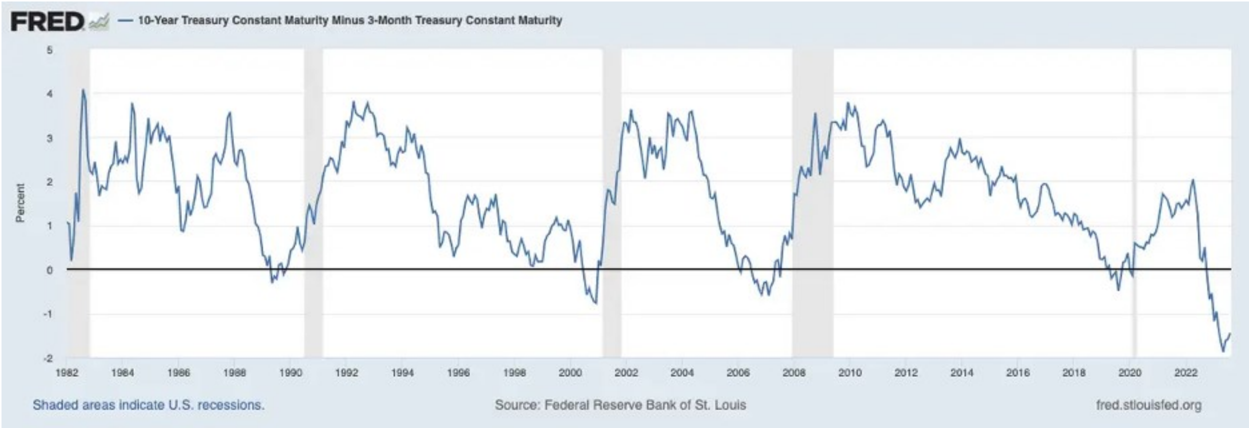
Across history, from 2007, 2000, 1989, to even as far back as 1973, the financial press wrote optimistic articles of "soft landings" even on the brink of downturns.

A recurring trend among stock market investors is their tendency to dismiss leading economic indicators while placing undue emphasis on lagging economic indicators like Gross Domestic Product (GDP) or job numbers, which reflect past or current scenarios rather than future trends.

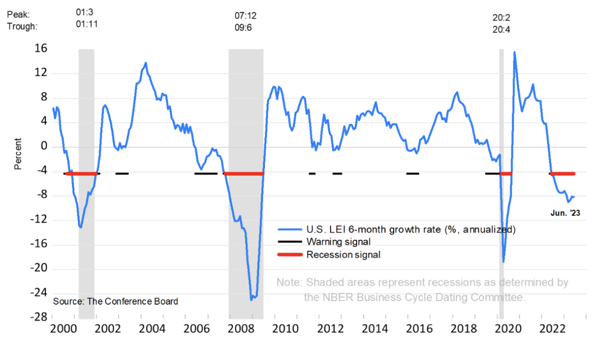
In contrast, forward looking leading economic indicators like the Inverted Treasury Yield Curve and *The Conference Board's Leading Economic Index®* provide more accurate signs of what's to come.

For instance, inversions of the 3-month Treasury bond and 10-year Treasury bond have historically foreshadowed every recession since the 1960s, emphasizing the importance of paying attention to these recession early warning signals.

Following is the current Inverted Treasury Yield Curve signaling a recession:



And then there's *The Conference Board's Leading Economic Index®*. The index compiles 10 components, including manufacturing activity, consumer sentiment, housing market activity, bond market activity, stock market performance, unemployment claims, and lending activity. It's been in recession territory since September 2022.



It is hard not to see the warning signs: China's economic crisis, oil and food price inflation because of Russia, the prospect of increased U.S. borrowing following Moody's bank credit downgrades, the banking credit crunch, higher borrowing costs for the U.S. government after the Fitch credit downgrade, and the imminent student loan payments resuming this September. These economic headwinds, coupled with extremely overvalued S&P 500 and NASDAQ Indexes, are signs of problems ahead.

We have seen this economic scenario before. There are haunting parallels to the economic exuberance that prefaced the 1929 crash, the 2000s' dot-com bubble, and 2008's housing market collapse. Moreover, with American consumers reaching into their savings and accumulating credit card debt against a backdrop of still too high inflation and steep interest rates, one can't help but sense we are looking at another significant downturn.

Yes, But The Stock Market Is Up This Year

Stocks have soared in recent months, as investors wager the inflation threat is over, the Federal Reserve will soon reverse its hikes to interest rates, and the U.S. economy will escape a recession.

Investors may be celebrating the 'Happy Talk' way too soon!

Here's why:

- I believe inflation is stickier and more entrenched than many market analysts suggest. Especially with gasoline prices and food commodities starting to skyrocket.
- I also believe there will be at least one more rate increase before the end of the year—and possibly one more in 2024. I predict the Fed will keep rates higher for longer and not cut rates until late 2024 or early 2025. Incidentally, this is also the current official prediction of the Fed.
- Inflation spiked to a 40-year high of 9.1% last summer but has dropped sharply to about 3% in each of the last two months. A key reason for the decline is that the Fed has raised its benchmark interest rate from almost zero to 5.25% since last year.
- Higher rates deter spending, hiring, and investing, which can slow the pace of price increases. However, they can also sap growth, pull down asset prices, and drag the economy into a recession.

Over the years, stock market investors have often been blindsided by economic downturns, consistently failing to heed the many warning signs. As history has shown, and as experts now suggest, our current situation might not be any different, potentially setting investors up for significant losses.

With a plethora of signs pointing toward a potential recession, it's paramount for investors to be vigilant. As the classic early warning bells ring out once more, it would be wise for investors to heed them.

Let's Look At A Few Major Drivers Of The U.S. Economy

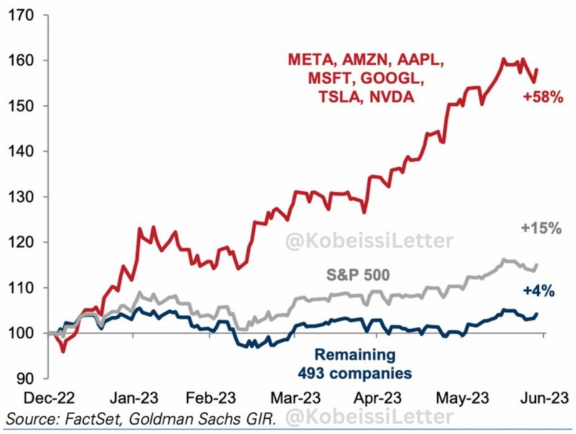
Last month the business press and business cable TV cited economic reports they said pointed to a strengthening economy. As I mentioned before, they showed an economy contracting and declining at a slower pace than they expected.

Below is what they generally did not tell you.

The 2023 stock market was reminiscent of the exuberance of the late 1990s going into the 2001-2002 dot.com recession.

The Surge of 7 Tech Stocks in the 2023 Stock Market: An AI-driven Bubble?

Seven tech giants, now fondly known as the "S&P 7," have grown in strength to represent an astonishing 28.6% of the entire S&P 500 Index. These tech stocks surged by 58% this year alone, taking their combined market cap past a staggering $11 trillion – *a figure that dwarfs Germany's entire GDP.*



There's no denying it. Artificial intelligence's transformative potential is not only headline-grabbing but has also inflated market valuations—possibly beyond sustainable levels. The prevailing sentiment is a potent concoction of genuine technological potential and even more speculative mania.

Unfortunately, there is a lot of complacency reminiscent of the dot-com and housing bubbles of yesteryears. While AI-driven stock prices defy gravity, indicators on the economic frontline are flashing RED amidst bankruptcy filings at their fastest growth since 2009, a historic strain in the commercial real estate sector, and other global and domestic risks.

The Nasdaq Composite is currently up over 28% year-to-date, the S&P 500 Index is up 14.7% year-to-date and the Dow Jones Industrial Average is up 4.8% year-to-date.

Yet, amidst these stock market gains, other leading economic indicators tell a different story of a serious slowdown in the U.S. and global economy.

The chart below shows how overvalued the S&P 500 Index is in comparison to its long-term trend 200-day moving average:

How Can You Have Three Quarters Of Earnings Declines & The Stock Market Going Up?

Q2 2023 will be the third consecutive quarter of earnings decline for the S&P 500 Index. Two consecutive quarters of earning declines is officially called an "Earnings Recession."

In college Economics 101 you learn that in the short term anything can drive the stock market up or down.

But in the long term the stock market is a "weighing machine" and, in the end, the market always follows the long-term trend of the underlying economy—i.e. earnings.

In Q2 2023, the S&P 500 Index's earnings registered a significant year-over-year decline of -5.2%. This descent is reminiscent of Covid's impacts on Q3 2020 when the earnings dipped by -5.7%, making the recent downturn the most severe since then.

This downward trend doesn't end there. After assessing results from more than 80% of the index's constituents, it has been found that the S&P 500 Index is set for its third successive quarter of declining profits.

Originally, Wall Street had anticipated a nearly 5% profit growth in Q3 2023 and an almost 10% surge in Q4, according to FactSet's early year projections.

However, the current forecasts from FactSet predict another quarter of declining earnings for Q3. Refinitiv takes a more bearish outlook, anticipating a decline in earnings for the final Q4 quarter of this year. That would mean we could see a total of six successive quarters of declining earnings for the S&P 500 Index.

Stock investors wonder how it is possible that corporate earnings are declining, while the stock market has been going up.

This was primarily fueled by government economic reports that detailed better than expected results—even though the economy continues to slow—just not as much as the analysts predicted.

The market optimism was also fueled by the anticipation of a change in the Federal Reserve's monetary policy. They expected the Fed to start lowering rates—not raising them.

Still, concerns loom. Historical data suggests that stocks are very overvalued by traditional valuations based on Price Earnings Ratios. There's growing anxiety that the Federal Reserve's past rate hikes might still have negative implications for earnings, and rising bond yields might also make stocks less appealing.

With these concerns in mind, many analysts are still predicting a possible recession.

Inflation May Not Recede Quickly

Rising Oil Prices

Recently, U.S. gas prices soared to a 10-month high, nearing the $4 a gallon mark. These prices have not been seen since October 2022.

This surge in energy prices will affect inflation reports over the next few months as the higher prices work through the economy.

This uptick in U.S. gas prices mirrors the global surge in oil prices. The increase is chiefly caused by substantial supply reductions by Saudi Arabia and Russia. Both Brent Crude and the West Texas Intermediate (WTI) are now trading above the $80 per barrel benchmark.

Despite witnessing a fall in "headline inflation" (which includes volatile energy and food prices) from its peak 40-year highs in mid-2022 to around 3% in June, the potential for the U.S. inflation rate to rise again in August and September is very high.

The role of Saudi Arabia and Russia in these global price shifts is pivotal. These two nations have opted to extend their 1 million barrel-a-day production cuts into September, with the possibility of further extensions or even deeper cuts.

Many oil analysts believe the current trajectory suggests a potential return to $100 a barrel oil prices. However, global economic slowdowns and various other macroeconomic factors remain wild cards in these predictions.

Consumer Price Index (CPI)

In a twist that is bound to recalibrate the nation's economic compass, the latest data reveals that the U.S. inflation rate for July ticked up to 3.2%, marginally missing the anticipated 3.3%.

Even the core CPI inflation, which skews away from the volatile food and energy costs, settled at 4.7%, a shade under the forecasted 4.8%.

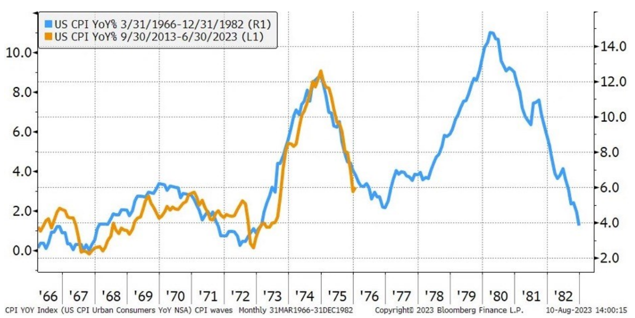
But if you're a homeowner or seeking to rent a place, the figures aren't particularly comforting.

Inflation rates for shelter stand at a stark 7.7%. Rental inflation isn't much better, with figures registering at 8%. And if you're thinking of enjoying a meal outside, brace yourself – inflation rates are pegged at 7.1% for dining out. The escalating cost of these staples paints a picture of an environment where previously ordinary items now carry a luxe price tag.

Digging deeper, the U.S. government's July budget report displayed some daunting numbers.

U.S. interest payments in July 2023 alone rose to $73.3 billion, pushing the year-to-date tally to a staggering $726 billion. Concurrently, there's a decline in tax receipts over the trailing twelve months by nearly 8%, widening the U.S. deficit.

Historical data comparisons offer some insight. A chart provided by Charles Schwab's Chief Investment Strategist drew parallels between today's CPI year-on-year percentages and those between 1966 and 1982. And while there were silver linings in the report, it brought to light the challenges the Federal Reserve faces, especially as inflationary pressures rise.



With gas prices on an upward trajectory, higher inflation might be reflected in the upcoming August data.

There have been pronounced shifts in food and energy costs this summer. Items like meat, fish, eggs, and dairy saw a price upswing in July, reversing two months of decline. Concurrently, Brent Crude oil prices have surged by 17% since June, and the average gas price has seen a 7% hike.

The Leading Economic Indicators Are Signaling A Recession

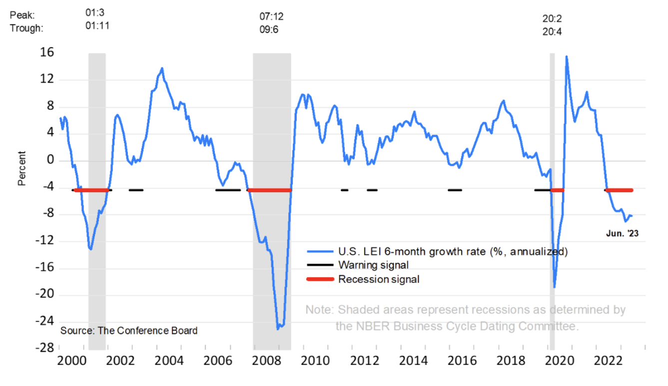
The Conference Board's Leading Economic Index® (LEI)—which measures U.S. business cycles—again dropped to its lowest level since November 2020, consistent with worsening economic conditions ahead. Its 15th consecutive monthly decline is the longest since the 2007-2009 recession.

The LEI is a crucial barometer for the economy's health. It continues to flash a recession warning sign, indicating an economic downturn in the U.S. will start in the near future.

The importance of the Leading Economic Indicators is that it has historically signaled a recession 9-12 months before a recession starts. This is an extremely valuable early warning system as to when a recession is about to begin.

That would mean we should be able to expect the recession to start sometime between now and October 2023.

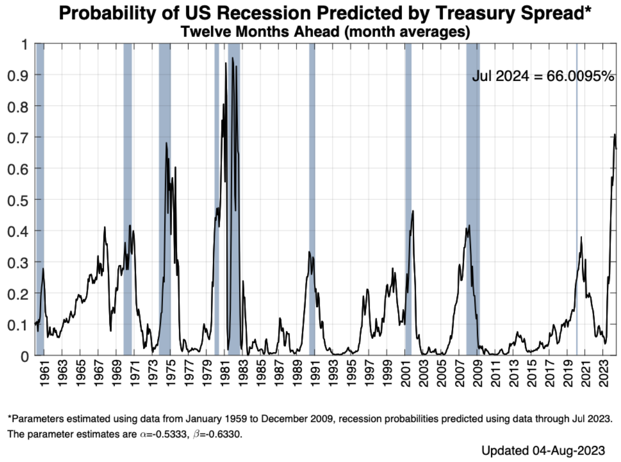
Below is *The Conference Board's U.S. Composite of Leading Economic Indicators*.



On average, this index signals a recession when it declines below the red bar about nine months to a year ahead of a recession, according to The Conference Board. **They announced their recession signal in September 2022.**

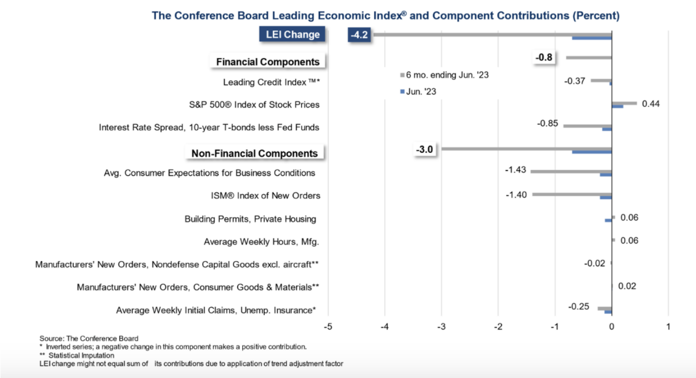
"The US LEI fell again in June, fueled by gloomier consumer expectations, weaker new orders, an increased number of initial claims for unemployment, and a reduction in housing construction," said Justyna Zabinska-La Monica, Senior Manager, Business Cycle Indicators, at The Conference Board. *"The Leading Index has been in decline for fifteen months—the longest streak of consecutive decreases since 2007-08, during the runup to the Great Recession. Taken together, June's data suggests economic activity will continue to decelerate in the months ahead.* ***We forecast that the US economy is likely to be in recession from Q3 2023 to Q1 2024.*** *Elevated prices, tighter monetary policy, harder-to-get credit, and reduced government spending are poised to dampen economic growth further."*

The New York Fed's Recession Probabilities Model also suggests the odds of a downturn are at their highest since 1982. The model's May reading shows a 66% chance of a recession.



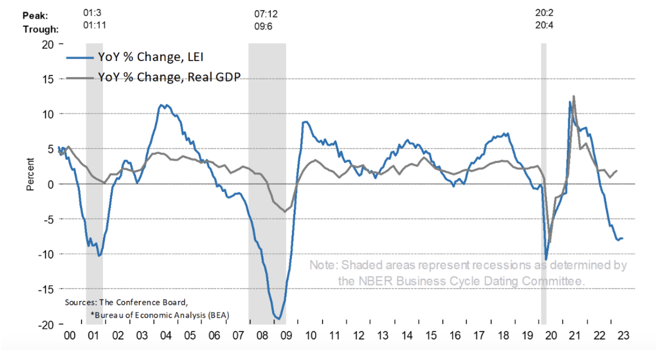
The chart below shows that seven out of the ten LEI components contributed negatively to the Composite.

Most components contributed negatively to the LEI in June



The following chart illustrates year-over-year changes.

The annual growth rate of the LEI remained negative, signaling continued slowing in economic activity



Putting The Recession In Perspective: When Will The Recession Finally End?

Historically, the stock market bottoms before the recession ends. Typically, the market bottoms in 'capitulation selling' (remember March 9, 2009?) about 70% through the actual recession.

Since recessions generally last 9 to 18 months, if the recession were to begin during the third quarter of 2023, a nine-month recession could see a stock market bottom during the first quarter of 2024. If this turns out to be an 18-month recession, we could see a market bottom in the summer of 2024.

The good news is that this recession is not the world's end. Because of the strong jobs market, this is not 2008. Yes, revenues will be off. Earnings will be off. The U.S. economy will slow because of inflation and Fed rate increases, resulting in a good old-fashioned earnings recession with inflation.

With patience, we will get through this.

While I still expect the S&P 500 Index to trade down to the 3200 level, representing a potential downside of about -25% from now, I also expect an eventual recovery sometime in early 2024 through the third quarter of next year.

Investors Need To Be Patient—And Realistic

As an analyst, I am not a permanent Bull or Bear. I am neither optimistic nor pessimistic. I look at the facts and data and see where I am now within the larger business economic cycle.

We are entering into a global recession and a contracting business economic cycle.

It is time to be defensive in your investing. Don't take any risks. Hunker down and try to preserve the capital you have.

Acting appropriately to what you are facing is like battening down the hatches during a storm or hurricane. This is just common sense.

These are natural economic cycles like the day follows night, and spring follows winter.

Investors need to take a deep breath and realize they are living through a natural cycle that has played out for hundreds of years in world economies and stock markets.

When Should We Get Back Into The Stock Market?

The leading economic indicators will show us when the next bull market is starting.

The table below provides current data on the two major composites of U.S. leading economic indicators and their composite indicator components. I've included a column to show the trailing 12-month directional trends and whether each is currently declining, plateauing, or recovering.

This updated monthly table shows investors the long-term directional trends of the significant composites and individual indicator components of the leading economic indicators.

On a personal note: As an investment manager, I have relied on this table through three previous recessions and will do so again in this upcoming fourth recession. It has never let me down.

I have been managing investment strategies for over 25 years and through three recessions, not counting the one that will start this year. I have benefited most from dispassionately focusing on data based not on the stock market but on the underlying U.S. and global economy. The data is what it is.

The good news is, at some point, when the U.S. leading economic indicators start to turn up again—as they always do—I expect that as I retire my defensive investment strategies and let my offensive strategies take the field once again, my investments will be worth more as the economy recovers and corporate America resumes another expansionary path.

U.S. LEADING ECONOMIC INDICATORS (AUGUST 2023)

Source: YCharts

U.S. Leading Economic Indicators	Trailing 12-Month Directional Trend	Declining / Plateauing / Recovering
Conference Board Composite of Leading Economic Indicators	Recession Signal	Declining
ECRI Composite of Weekly Leading Index	Recession Signal	Declining
Major Leading Economic Indicator Components		
10 Year-3 Month Treasury Yield Spread	Directional Trend Down	Declining
US ISM Manufacturing New Orders Index	Directional Trend Down	Declining
US ISM Services New Orders Index	Directional Trend Down	Declining
S&P 500 Real Price	Directional Trend Down	Declining
US Index of Consumer Expectations	Directional Trend Down	Declining
US 4-Week Moving Average of Initial Claims for Unemployment Insurance	Directional Trend Down	Declining
US Consumer Goods New Orders	Directional Trend Down	Declining
US Construction Materials and Supplies New Orders	Directional Trend Down	Declining
US Manufacturing Average Weekly Hours	Directional Trend Down	Declining
US Manufacturing New Orders	Directional Trend Down	Declining
US Nondefense Capital Goods Excluding Aircraft New Orders MoM	Directional Trend Down	Declining
US Building Permits (SAAR)	Directional Trend Down	Declining
US Weekly Economic Index (NSA)	Directional Trend Down	Declining

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Paul Dietrich is focused on managing investments for private investors, retirement funds and private institutions throughout the United States. He also serves as an on-air commentator and contributes market analysis to business and financial media including *CNBC, Fox Business, Bloomberg TV, CNN, The Wall Street Journal, Yahoo! Finance, Reuters* and *The Washington Post.*

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