Laffer Tengler Commentary July 31, 2023

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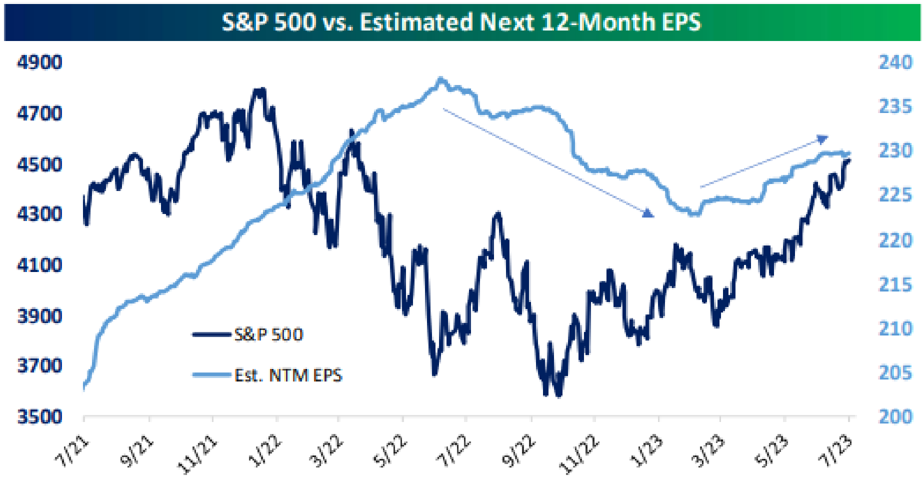
The Perfect (though not necessarily soft) Landing

A little over a week ago, during a routine Tahoe hike, I executed a perfect face plant. It's true. I landed on my nose which landed on a slab of granite. The doctor told me my nose served as an airbag protecting the rest of my face. Yes, the snout was broken—shattered may have been the word he used—but the eye sockets, my jaw, teeth—were all intact. They stitched me up, waited for the swelling to go down and on Friday he reset the bent beak and I am back in business.

Last week I learned a perfect landing is possible. If not somewhat painful. Will that be possible for the U.S economy?

Inflation is dropping like a rock, and we are nine months into a new bull market. Thanks to Don Rismiller's work we have pointed out for a year that inflation rises and falls in a mostly symmetrical manner, and that we hit peak inflation peak in June of 2022 when CPI breached the 9% summit. Ten months ago, our logic concluded that if inflation peaked in June, the Fed was closer to the end of the rate hike cycle than the beginning. We believed that was bullish for stocks. Many were hiding in defensive names (and still are). But we continue to like this risk-on rally (which is not to say there won't be volatility—we would buy the dips) in technology, industrials, energy and sections of consumer discretionary for many reasons including the most important: earnings estimates are on the rise.

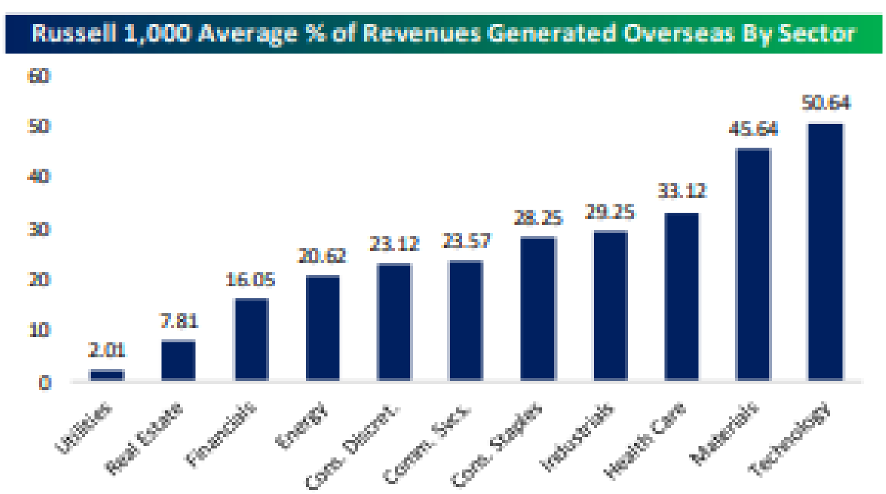


Source: Bespoke Investment Group, July 21, 2023

As our old friend Larry Kudlow says: earnings are the mother's milk of stocks. With the rally so far mostly due to multiple expansion, rising earnings estimates are needed to drive stocks further and sustainably.

(BTW: many are arguing that the rally is not reliable since only 7 or 8 stocks have driven this bull—no breadth. But it is important to note that 80% of stocks just traded above their 50-day moving average for the first time this year. The rally is widening out.)

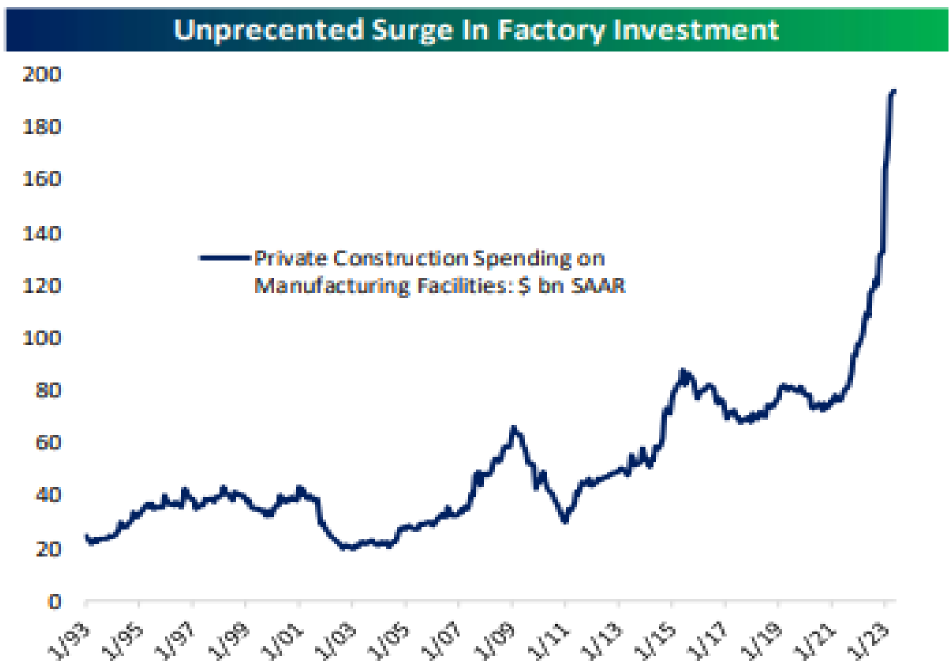
$$$: The sell-off in the dollar since the fall is a further tailwind to multinational earnings. A weaker dollar improves earnings as overseas sales are repatriated to the US at a lower exchange rate.



Source: Bespoke Investment Group, July 21, 2023

Technology, materials and industrials are major beneficiaries of a weaker dollar.

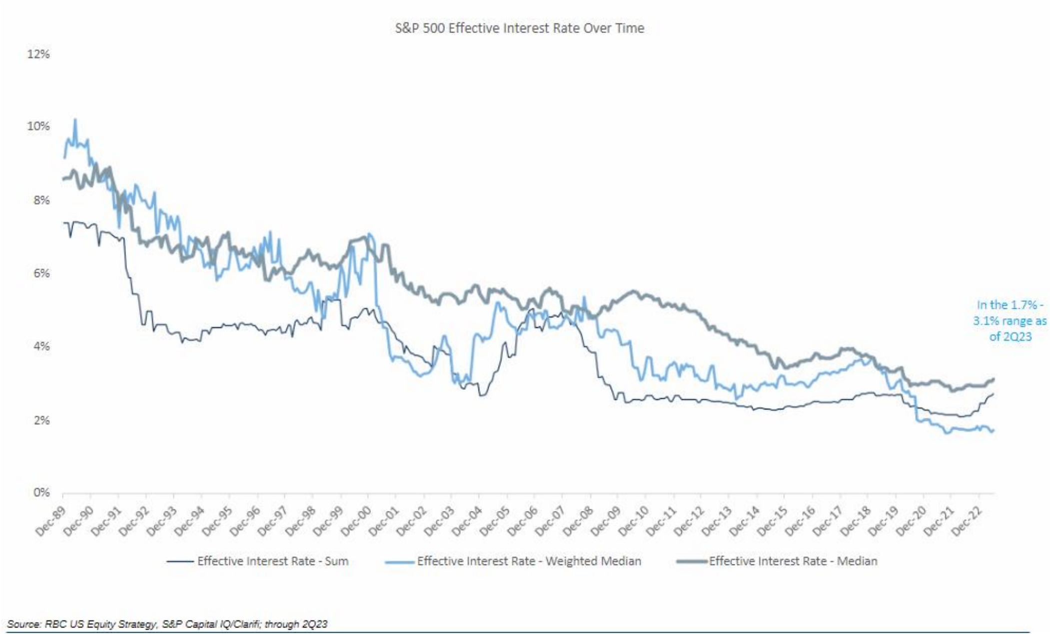
Trillions in infrastructure spending can go a long way. The May year over year increase in U.S. factory construction is76.3% and has more than doubled over the past two years. We are in the early days of spending from the infrastructure bill and Inflation Reduction Act. Not to mention all the green energy spending allocations yet to be doled out. The implications for economic growth are meaningful and the multiplier on manufacturing jobs and construction jobs is 3-4x.



Source: Bespoke Investment Group, July 21, 2023

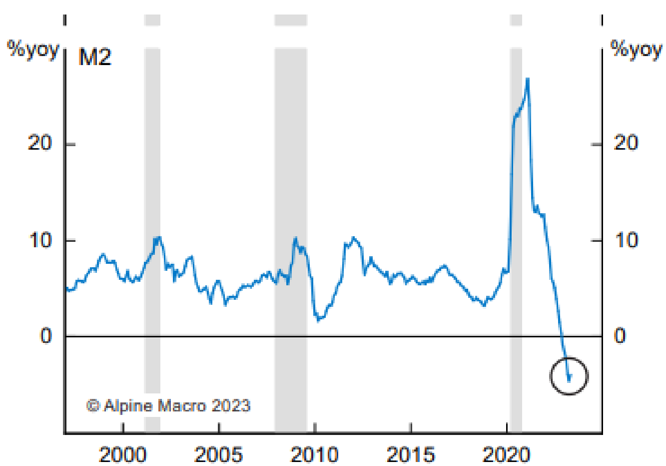
Of course, there are plenty of indicators flashing recession—the most complex investing environment in my career to be sure. It is important to remember that this is not a credit driven slowdown, but a self-inflicted inflation exacerbated slowdown spurred by profligate fiscal policy and monetary policy missteps. This may explain why some of the tried-and-true recession indicators have yet to result in a recession.

Also, it is possible the punch of rising interest rates has been mitigated by consumers and corporations benefiting from decades of low interest rates. Corporations had plenty of time to finance debt in the era of zero interest rates. And they took advantage. Balance sheets are solid and debt servicing levels are low. And according to yahoo!finance, 91.8% of U.S. homeowners with mortgages have an interest rate below 6% (mid-June 2023). 62% have a sub-4% rate according to Redfin and just about 25% of homeowners have a mortgage rate below 3%. In other words, the long and variable lags of monetary policy have less effect if consumers and businesses are not borrowing at higher rates.



Source: RBC Capital Markets, July 30, 2023

The yield curve is inverted, leading economic indicators have declined for 15 straight months and money supply has contracted after years of expansion. In our view, a restrictive signal. But after all the distortions of COVID fiscal and monetary policies, it is difficult to rely on historical signals. OR, as some have argued maybe the recession has already occurred. Perhaps it is a rolling recession or a mild, not yet detectable recession.



Source: Alpine Macro, July 17, 2023

Soft landing? Hard landing? The perfect landing? No one knows. But it doesn't stop the pundits from spilling ink and consuming airtime speculating and opining. I am not sure it matters. Companies have surprised Wall Street again this earnings season. Revenues and earnings are surprising to the upside more than not and even margins are showing signs of life. With PPI (the input costs) having led CPI up and (now) down, savvy management teams are preserving and even expanding margins modestly.

It is just possible that the economy stuck the perfect landing. Or may still land. As I learned this past week, the perfect landing may not be without pain--but it may be as good as we get. And that may be enough.

Note: We are watching the shutdown/bankruptcy filing of trucking firm, Yellow Corp. announced over the weekend that thirty thousand jobs and potential disruption to economic growth as the oldest and third-largest less-than-truckload carrier in the U.S. ceases operations.

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