



Insigneo Weekly Dispatch

# Landing on an Aircraft Carrier

Our thoughts on the possibility of a soft-landing of the U.S. economy, the equity market's expectations of it, and how to approach the current situation.

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## Landing on an Aircraft Carrier

I have been flying airplanes since I was 15 years old. I had my pilot's license before I had my driver's license, so I remember having to get a ride with someone who could drive a car, to get to the airport to fly a plane. Over the years, I have landed on long runways, short runways, paved runways, and dirt runways, but something I have never done is land on an aircraft carrier. U.S. Naval Aviators are some of the most skilled pilots on the planet, and from speaking with people that have done it, I have heard that landing on an aircraft carrier is an extremely hard feat to achieve. Keep in mind that the landing area of a modern-day U.S. aircraft carrier is only about 500 feet (150 meters) long. Add to this the fact that the sides of this runway are packed with other airplanes, and achieving this landing seems nearly impossible...come up short or overshoot the landing area and you end up in the ocean, land on either side of the designated runway and you can end up crashing into other aircraft. Do not forget that this runway is also moving, as it is on top of a moving, albeit giant ship. Trying to bring a 50,000-pound airplane traveling at 150mph (240kph) to a full stop on an extremely narrow 500 feet of moving runway is simply mind blowing. I think of myself as a pilot with a reasonable level of skill. Although I am sure that the Fed is exponentially better at navigating the economy than I am at navigating the skies, I imagine that the incredibly difficult scenario of me successfully landing on an aircraft carrier would be akin to the Fed successfully achieving and holding a soft landing.

Much like safely landing on an aircraft carrier, achieving a soft landing of the economy involves many variables, all of which need to go as planned, with little room for error if they do not. As we know, the two main variables required for a soft landing are inflation that is under control and a strong labor market. For one, inflation needs to be trending lower and more importantly, staying lower. Inflation has trended lower from its recent high of 9.1%, as measured by CPI, in the summer of 2022, to 3.1% in January 2024. That is a steep drop of 6% in about a year and a half; however, it has not been a smooth ride. From the recent low in January, inflation has started to trend up again, currently sitting at 3.5%. Rent and housing inflation is proving to be stubbornly sticky, while wage inflation in the service sector is reluctant to come down. Some say that the last mile in the fight to tame inflation is the hardest mile, and this is certainly proving to be true this cycle. With inflation levels well above the 2% long-term level traditionally targeted by the Fed, Chairman Powell and his fellow members have a tough decision ahead: keep interest rates higher for longer in hopes of catching the elusive 2% level or begin a monetary easing campaign and accept a higher level near 3%. We think the Fed is still hoping to hit its 2% mark and is in no rush to cut rates. In any case, inflation is behaving like a stubborn child, not making the Fed's job easier, especially during an election year.

On the other hand, the labor market is behaving like a well-mannered child aiming to please its parents. However, as can sometimes happen with kids, there are times when you do not get the whole story of what is really going on. As the old

saying goes: "Silence is precious, unless you have children, then it is suspicious...". This could be said of the current state of the labor market. Currently at 3.8%, the unemployment rate has remained relatively muted, standing at some of the lowest levels of the past 20 years. Initial jobless claims have fluctuated from one month to another but have remained relatively stable overall. But what if we are not seeing the whole picture? An idea that we have been discussing recently is the possibility that the labor market could appear strong for the wrong reasons. In other words, unemployment could be artificially low, held down by a higher influx of workers stemming from higher immigration trends, which could be driving labor supply higher. This could be propping up the labor market and giving a distorted picture of what is really happening under the hood of the economy. An important issue to keep in mind when evaluating the labor market is that its metrics tend to be backward looking, so things appear to be good until, suddenly, they are not. Much like when things at home appear calm because the kids are quiet, only to find out that they have been quiet because they have been writing with permanent markers all over the walls. Just like at home, it is always good to investigate things in more detail to get the full picture.

After taking a closer look at the U.S. economy, our thinking is that it is very possible that economic conditions might not be as strong as they appear on the surface. Eight times a year, the Fed publishes the "Summary of Commentary on Current Economic Conditions by Federal Reserve District" commonly known as the Fed's "Beige Book". To compile the information needed for this

publication, the Fed reaches out to its numerous contacts throughout the economy to try to get a pulse on what is really going on out there. The most recent edition of the Beige Book was published yesterday, and its findings reinforce our view that things might not be as rosy as they appear on the surface. For one, the Fed noted that economic activity expanded “slightly”, while consumer spending “barely increased”. Let us remember that an apparently resilient consumer has been underpinning the strong economic growth we have heard about on the news. However, we believe that there is a very real possibility that the consumer is spending not from savings, which have been drained by past spending and inflation, but from credit card debt. We continue to see credit card debt rise, as well as delinquencies on that debt. Additionally, it is evident that the consumer is starting to feel the pinch of inflation, particularly those in the low to middle income tiers of the economy. The Fed noted “increased price sensitivity” from the consumer, also finding that companies are seeing that the “ability to pass along price increases to consumers has weakened”. At the same time, manufacturers continue to see “upside risks to inflation”. In other words, the consumer is shying away from higher prices, so companies can no longer simply just pass on higher costs to consumers, and manufacturers are not seeing prices come down any time soon. In time, this dynamic will lead to a loss of pricing power for many companies, which in turn should lead to margin erosion. Also important is the fact that 9 of the 12 Fed districts surveyed saw a “slow to modest” increase in jobs, with overall employment rising at a “slight pace”. This narrative stands in

stark contrast to the strong, even booming, labor market narrative that we have been hearing about in the media. The overall economic outlook from this survey was labeled as “cautiously optimistic” by its participants. Granted, this is just one series of data points and should be considered as such. However, it is congruent with other data points that we are seeing which indicate that the economy may not be as strong as expected. Datapoints hold little value on their own, but together they make trends. Studies show that the Beige Book has a good track record of predicting recessions, and although this latest edition does not call for one, it certainly does not portray the upbeat picture the markets have priced in.

The current earnings season will be crucial in deciphering what companies are seeing versus what the market is expecting. During the first quarter of 2024, the market was pricing in a nearly 100% chance that the Fed was going to start cutting rates in June and would do this three, maybe four times this year. The possibility of a soft landing by the Fed, which we have long argued against, was taken as a near certainty by the markets. Stocks were priced for perfection with lofty earnings expectations. But as we have seen many times in the markets before, things can change very quickly. The market now believes that the Fed will not begin cutting rates until September of this year, pricing in only 2 cuts. Some believe that the Fed will not need to reduce rates at all, and a small group of voices is saying that the Fed could even raise rates in 2024. To be clear, we do not believe that the Fed will raise rates again in 2024. Although we think that the most likely scenario is that the Fed will cut rates

this year, we believe that it is certainly in no rush to do so. Many of its members, including Powell himself, have come out recently and stated this in no uncertain terms. Additionally, the possibility of no rate cuts in 2024 is certainly on the table. In fact, Neel Kashkari, president of the Federal Reserve of Minneapolis, spoke about this yesterday, qualifying this scenario as a possibility. Regardless of what the Fed does, we have written extensively of the dangers of chasing a market that had convinced itself that it knew exactly when and by how much the Fed would cut rates, predicted a soft-landing with near certainty, and expected the continued achievement of lofty earnings expectations by companies in its indices. From a mathematical, economic, and just plain logical standpoint, the expectation of those three events happening all together at once did not make sense. But as we know, a euphoric market can quickly become driven by emotions, not logic.

By the end of the first quarter of this year, the S&P 500 was up 10.6%. From that point, after the first 18 days of the second quarter elapsed, the index had dropped 4.6% by the time of this writing. Said a different way, it took 90 days to gain over 10% on an investment in this index but took only 18 days to give back almost half of that gain...puts things in perspective. A recent report from J.P. Morgan shows that if the market were to bounce back next week and continued higher for the rest of the year, its current 4.6% drop would be the second smallest intra-year pullback going back to 1980. The same report shows that the average intra-year drawdown going back to 1980 is approximately 14%. Interestingly, the smallest intra-day drawdown was 2% in 1995, and the

largest was 48% in 2008. To be clear, this does not mean that the market closed 48% lower in 2008. It means that the largest pullback the market experienced during the course of that year was 48%. However, an investor, motivated by fear, could have potentially sold his or her position at the bottom of that 48% pullback, locking in that loss. It pays not to be reactive.

The key to successful investing is to keep an eye on the long term, and when you can, being proactive, not reactive. Acting based on logic, not emotion, is a critical ingredient in this exercise. Being proactive does not mean exiting the stock market in turbulent times and running for the hills. It just means taking the proper precautions to protect your portfolio. In previous writings this year ([“Promises, Expectations, and Probabilities”](#), [“The Picks and Shovels of Artificial Intelligence in the Context of the Current Market Back Drop”](#), [“Momentum is a Powerful Force”](#) [“The Nvidia Phenomenon”](#) and [“Are we in a Bubble?”](#)) we have argued that the market was pricing in expectations that had a low probability of being met, which created a high probability of a pullback as these expectations began to unravel. We still believe that a further pullback in the equity market is highly likely. For context, as of the time of this writing, the S&P 500 sat near 5,010. We believe that in a best-case scenario where we see no recession, the index could end the year between 5,000-5,200. At the high end of this range, this target would imply a rise of approximately 4%. However, if a moderate recession were to occur, we would expect the index to end the year between 4,100-4,300, which is approximately 15%-20% lower than its current level.

With an eye on being proactive, in the pieces above we suggested the importance of taking the proper precautions to protect positions, such as de-risking portfolios by purchasing “insurance” or “shock absorbers” using derivatives such as put options on the S&P 500 as an example. Furthermore, shifting a portfolio’s exposure towards quality-oriented holdings, or reducing concentrated positions and increasing diversification to other asset classes, as needed, also may be prudent. We believe that these proactive strategies are still valid depending on the individual needs of different portfolios, to the extent that we have implemented some of these strategies in some portfolios within the firm. The idea is to protect our investments when we see the storm coming, not when it is already raining. Again, we are by no means encouraging investors to hit the panic button and run for the hills. In fact, we are saying the opposite, encouraging investors to stay calm in the face of turbulent markets, being proactive in protecting their portfolios, and keeping an eye on the long term.

As with the original scenario involving my successful landing on an aircraft carrier, we can see that many variables are acting to affect the Fed’s ability to successfully achieve a soft landing, despite the market’s still relatively high expectations. The developing situation in the Middle East, which is changing by the day, adds yet another volatile variable. Landing on an aircraft carrier is quickly becoming landing on a carrier in the middle of a storm. I can honestly tell you that I would not be betting on my successful aircraft carrier landing scenario. In the face of uncertainty, it pays to be proactive.



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