Making Plans for a Bull Market

"**Homogeneity breeds weakness**: *Theoretical blind spots, stale paradigms, an echo-chamber mentality, and cults of personality.*"
– V.S. Ramachandran

"*Data has an annoying way of **conforming itself to support whatever point of view we want** it to support.*"
– Clayton Christensen

"**We don't receive wisdom. We must discover it for ourselves** *after a journey that no one can take from us or spare us.*"
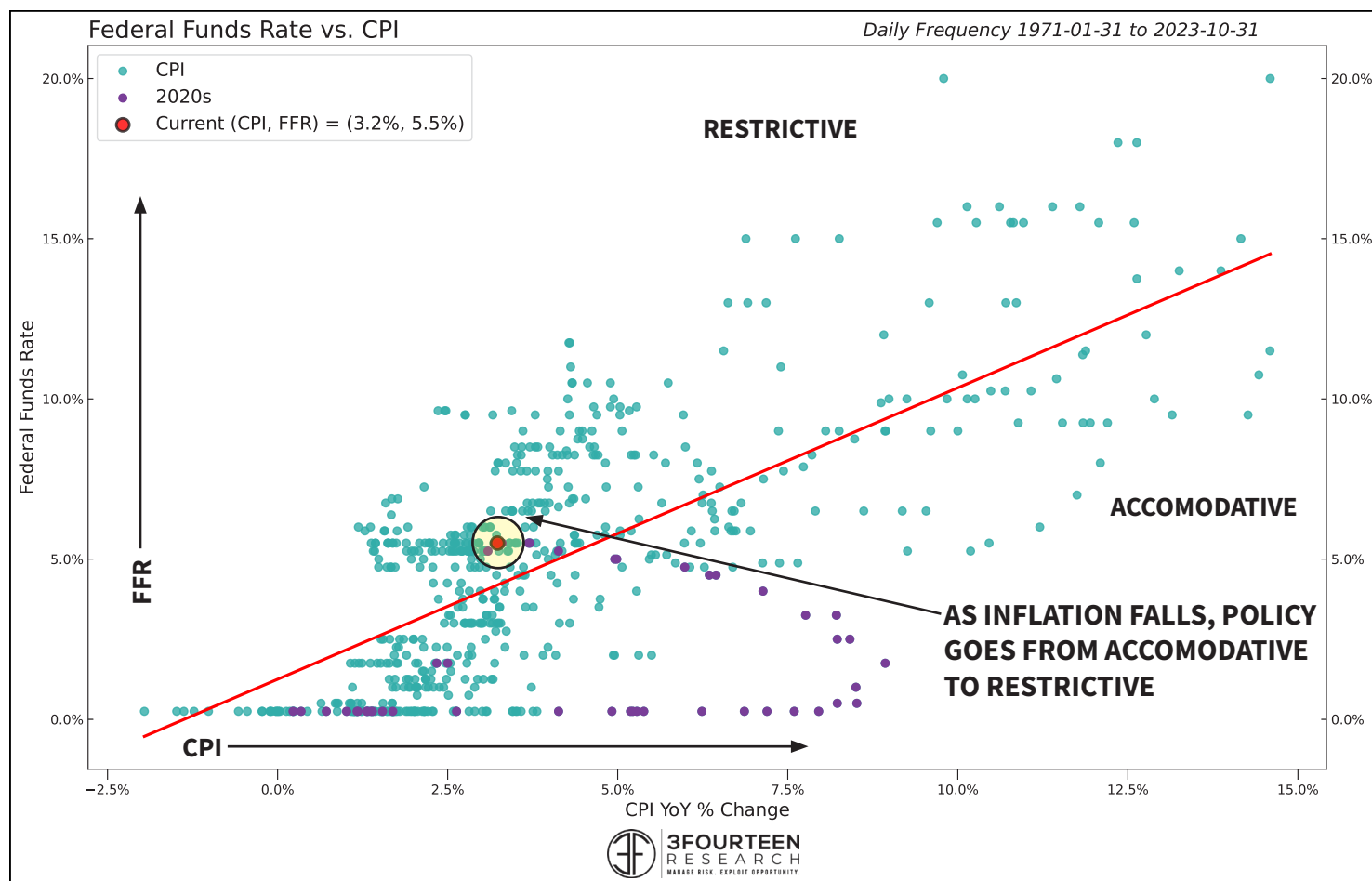– Marcel Proust

"**Being entirely honest with oneself** *is a good exercise.*"
– Sigmund Freud

"*There is **nothing encouraging** on the horizon.*"
– Response to the November 2023 Dallas Fed - Texas Manufacturing Outlook Survey

"**The outlook is troubling and unsettling**. *Caution is the strategy. The Federal Reserve is too aggressive.*"
– Response to the November 2022 Dallas Fed – Texas Manufacturing Outlook Survey

EXECUTIVE SUMMARY

- The Fed wants to go for a soft landing.

- Inflation data will give a window for cuts by next spring and the economy remains resilient.

- Reducing our bond overweight. Adding to stocks and cash.

Federal Funds Rate vs. CPI   *Daily Frequency 1971-01-31 to 2023-10-31*

RESTRICTIVE

ACCOMODATIVE

AS INFLATION FALLS, POLICY GOES FROM ACCOMODATIVE TO RESTRICTIVE

Legend: CPI · 2020s · Current (CPI, FFR) = (3.2%, 5.5%)

About two years ago, in a report titled: Making Plans for A Bear Market, we wrote the following:

"*Forecasts can be paralyzing. Anytime we venture a guess about the future, we give the market an opportunity to humble us. Being wrong—or more accurately admitting you are wrong—deeply wounds the ego. But, the ego is a survivor. It distorts the mind to shield itself from pain. Denial is the preferred armor.*" We went on: "*Thus, making a prediction leads to inflexibility. Inflexibility leads to poor strategy. This is one reason, at 3Fourteen, we lean on models. Even a simplistic system can at least act as a buffer to our ego. Said in very clear (and honest) terms: a model allows us to change our minds more easily because our 'ego investment' is lower. Yet, we are in the prediction business.* **The goal is to prevent our egos from getting wrapped into our forecasts.** *Whether permabulls or permabears, inflation hawks or doves,* **commentators that allow one prediction to become associated with their reputation are compromised. Their ego has fused with their forecast. As investors, we must avoid this fate.**"

That report, published August 2021, identified four bearish issues facing the market heading into 2022. They were:
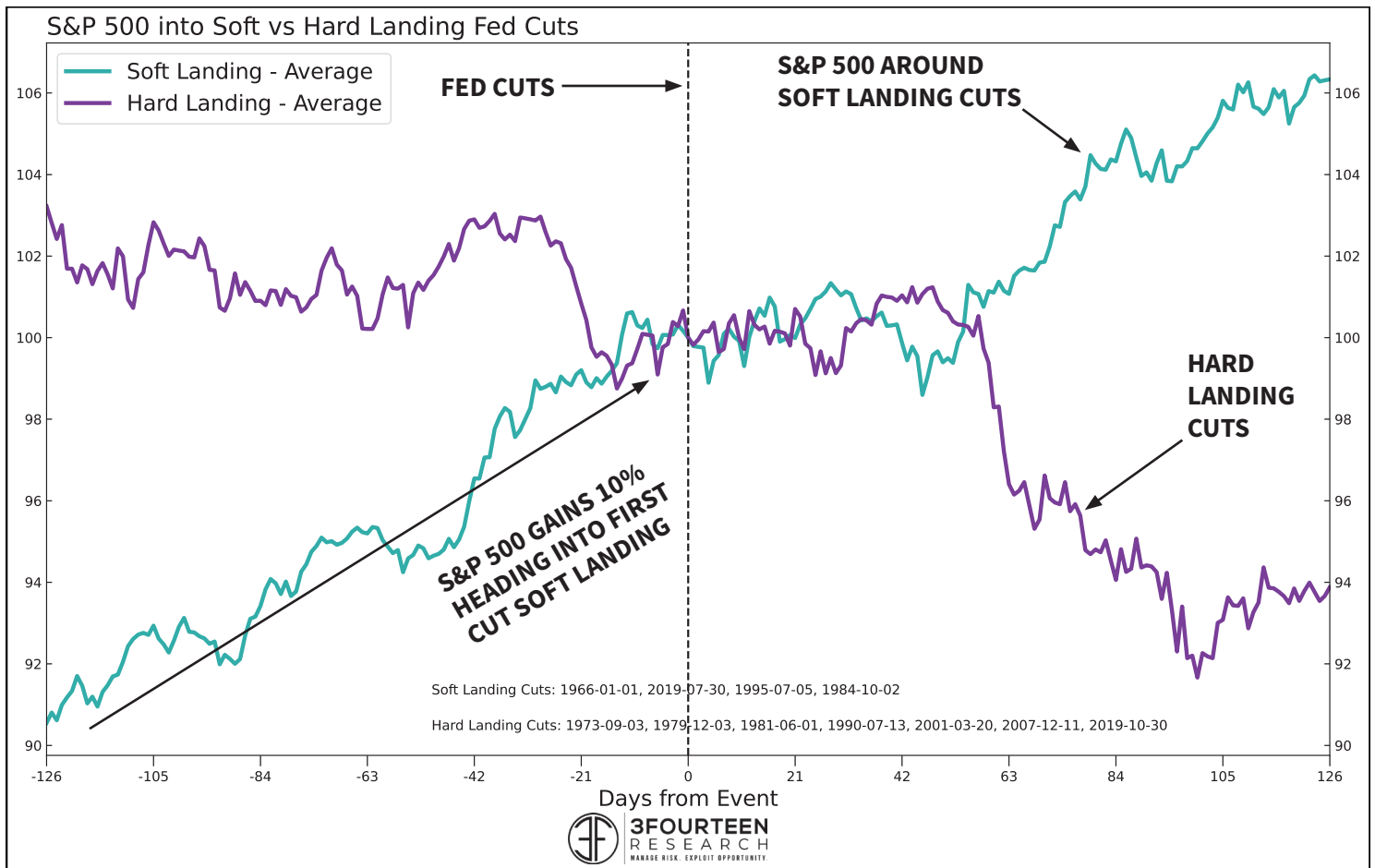
1. **Housing inflation** to bring on a significant Fed tightening.

2. **Macro Cycle** Peaking.

3. **Oil Market** tightening (squeezing consumers and Fed policy), and

4. A weak **Election Cycle** (midterm election year).

At the time, rates were at zero, the Fed was still BUYING bonds, and (more) fiscal stimulus was on the horizon (e.g. IRA). At 3Fourteen, we came into 2021 bullish, but by late summer, we could see clouds forming. Starting in late 2021, we transitioned to a defensive posture. For the most part, this is where we have remained. Since that August report, the S&P 500 is flat and has underperformed cash. As is well-documented, the S&P Equal-Weight (SPW) is down 7% and the Russell 2000 is down 20%. A bear market did arrive, but it was no Armageddon. The Fed fired a ton of ammo at the market and it held up relatively well. **Now, 27 months removed from our initial bear market warning, we feel compelled to issue a bull market warning. Back then, our nervousness focused on the coming change in Fed policy. Today, the bull case rests on the Fed rolling back (some of) this tightening while the economy avoids a recession. In short, the tightening of the past two years now has the potential to become catalysts.**

S&P 500 into Soft vs Hard Landing Fed Cuts

Soft Landing Cuts: 1966-01-01, 2019-07-30, 1995-07-05, 1984-10-02

Hard Landing Cuts: 1973-09-03, 1979-12-03, 1981-06-01, 1990-07-13, 2001-03-20, 2007-12-11, 2019-10-30
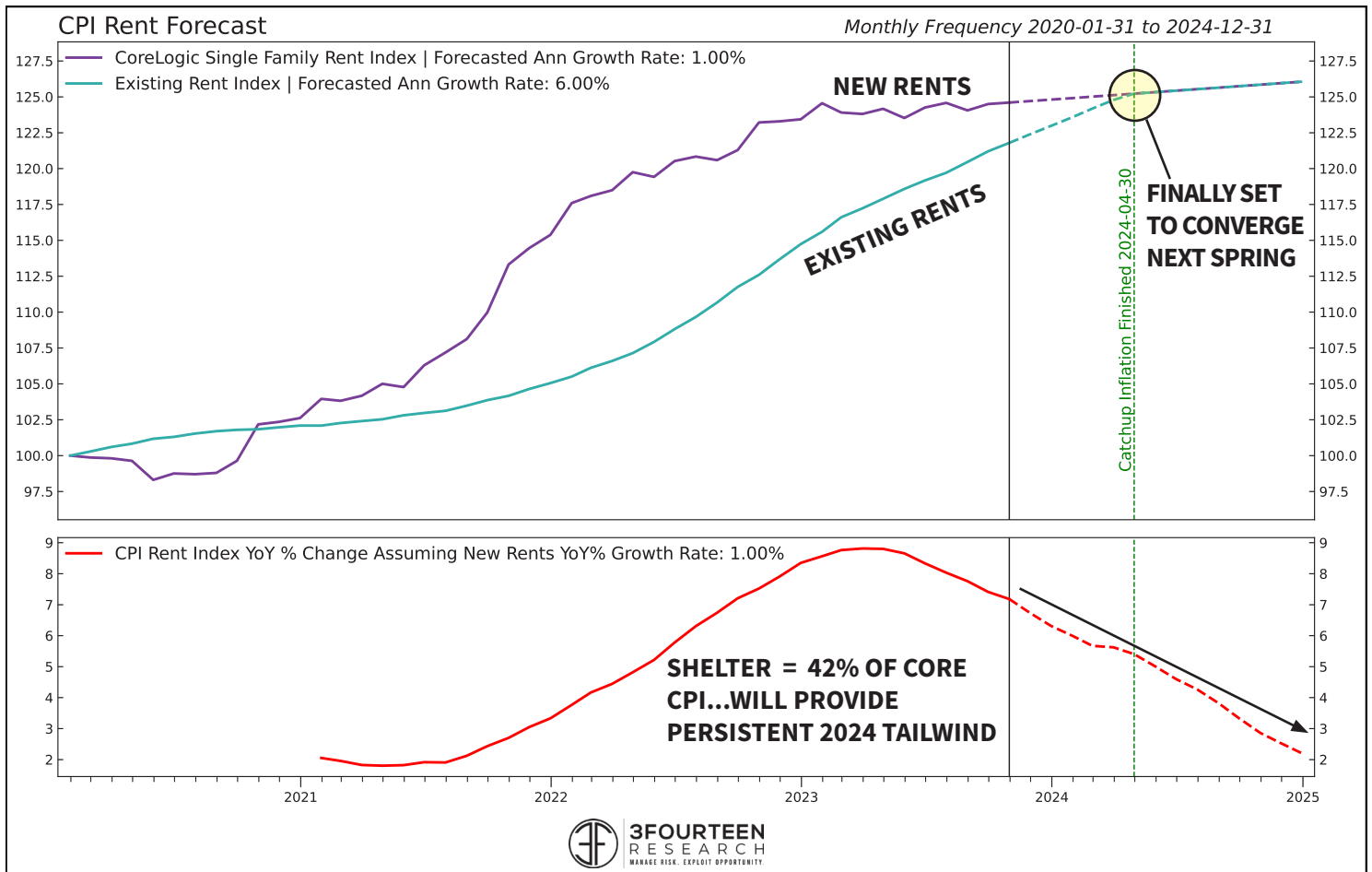
Days from Event

To be clear, we are not becoming raging bulls (moving to benchmark weight, see Conclusions). Stocks are overbought and overvalued. As an analogy, we published our initial bear market warning in August of 2021, but did not position defensively until the end of 2021. Instead, this report is an acknowledgement of the growing bullish evidence and an exercise in appreciating the risks to our current equity positioning. Based on client discussions, it seems the majority of 3Fourteen clients lean bearish (75/25 bears). **An important part of our service is to push clients to think. If the idea of a broadening bull market evokes negative emotions, then it is time to at least consider the opposing evidence.** In these times, data must guide our decisions. So, where does the 2024 bull case begin? Coincidentally, in the same spot the 2022 bear case did: Housing Inflation.
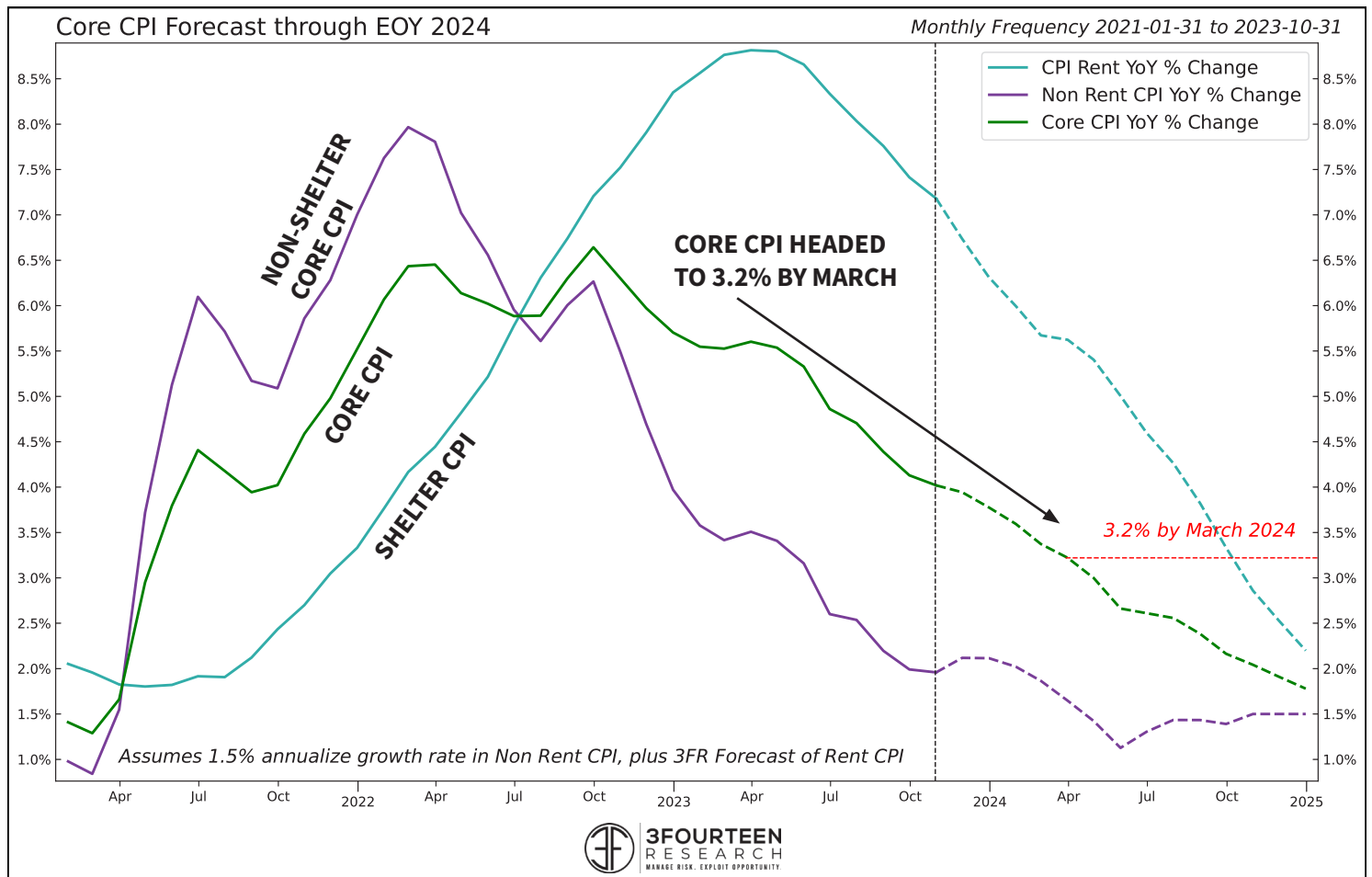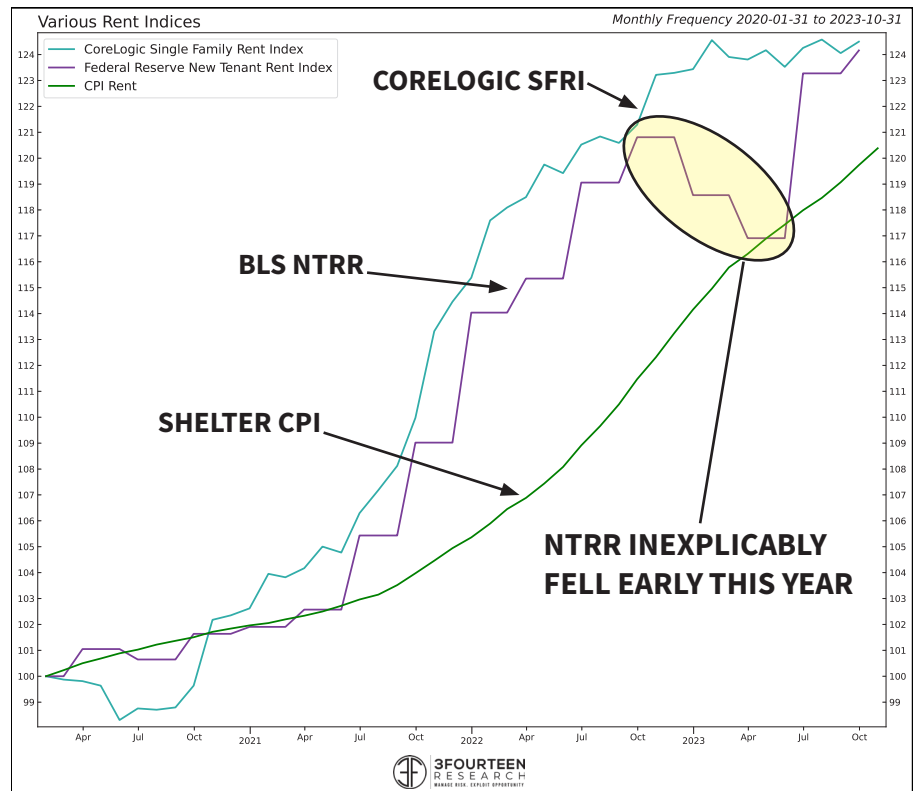
SHELTER INFLATION = IMPORTANT TAILWIND

The 2024 bull case requires a soft landing. Disinflation is the foundation of a soft landing. At 42% of Core CPI, shelter disinflation underpins the entire thesis. [Back in October of last year](#), we made the case that shelter inflation would remain high throughout 2023 (currently at 6% YOY). Our reasoning rested with an understanding of how the government calculates rent inflation (which has been closely tied to OER this cycle – see the previous report for details).

Based on BLS writings, CPI Rent is comprised of 20% new rents and 80% existing rents. Common sense, and experience, teaches us that the new rental market moves much faster than existing rents. The higher new rents go, the longer it takes existing/renewed rents to catch up. This dynamic is at the heart of the shelter CPI's classic lag. The chart below visualizes this dynamic. Here, we plot the new rental market (using CoreLogic's Single-Family Rental Index – purple line) and assume that new rents will rise at a 1% annualized rate. We then calculate and plot our Existing Rent Index (blue line). **By the first half of next year (April), the long-awaited convergence of new and existing rents will be upon us. The upshot is that shelter CPI will be on a glide path (aggressively) lower throughout 2024.**

CPI Rent Forecast *Monthly Frequency 2020-01-31 to 2024-12-31*

— CoreLogic Single Family Rent Index | Forecasted Ann Growth Rate: 1.00%
— Existing Rent Index | Forecasted Ann Growth Rate: 6.00%

NEW RENTS

EXISTING RENTS

Catchup Inflation Finished 2024-04-30

FINALLY SET TO CONVERGE NEXT SPRING

— CPI Rent Index YoY % Change Assuming New Rents YoY% Growth Rate: 1.00%

SHELTER = 42% OF CORE CPI...WILL PROVIDE PERSISTENT 2024 TAILWIND

⊕ 3FOURTEEN
RESEARCH
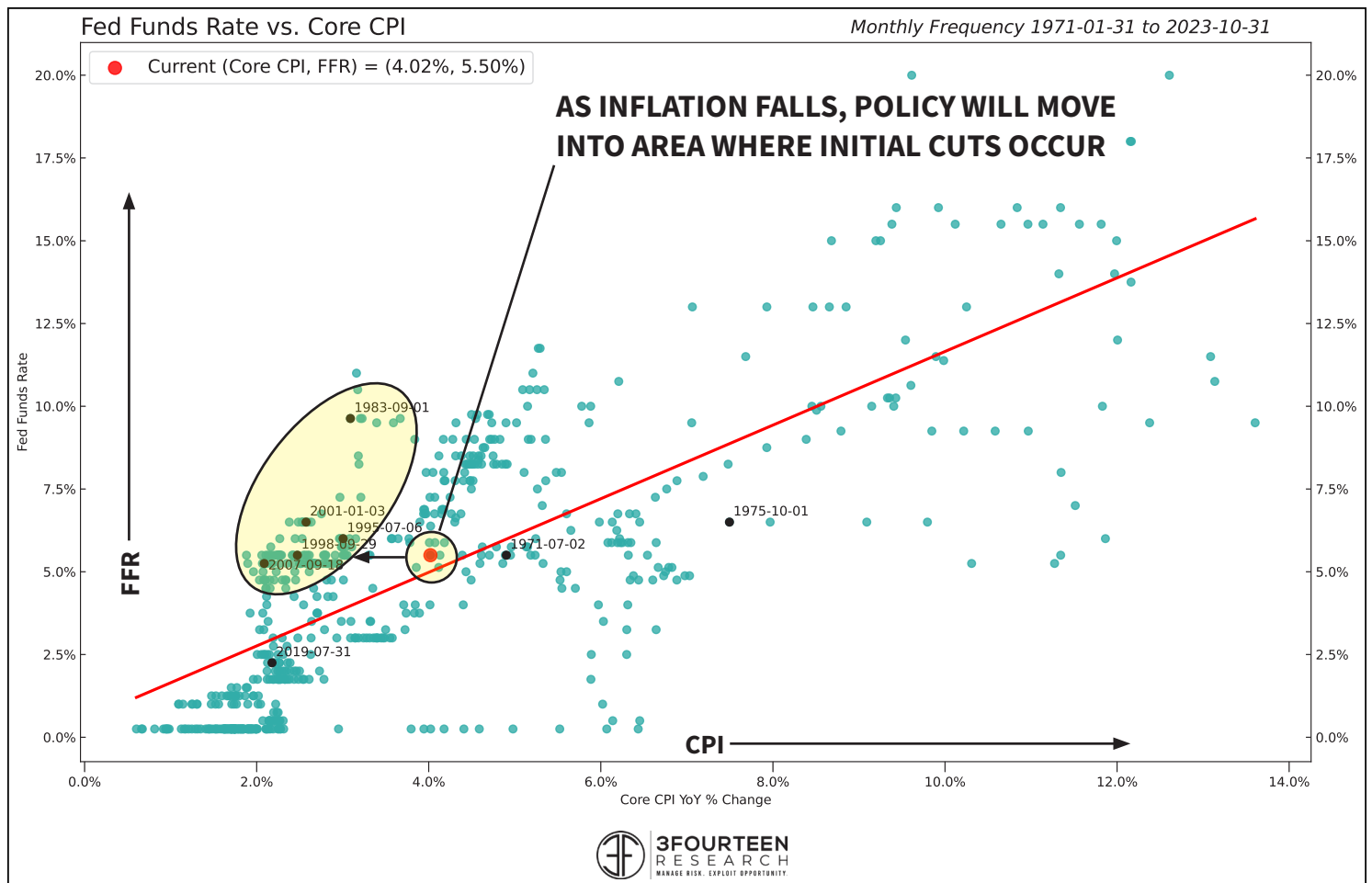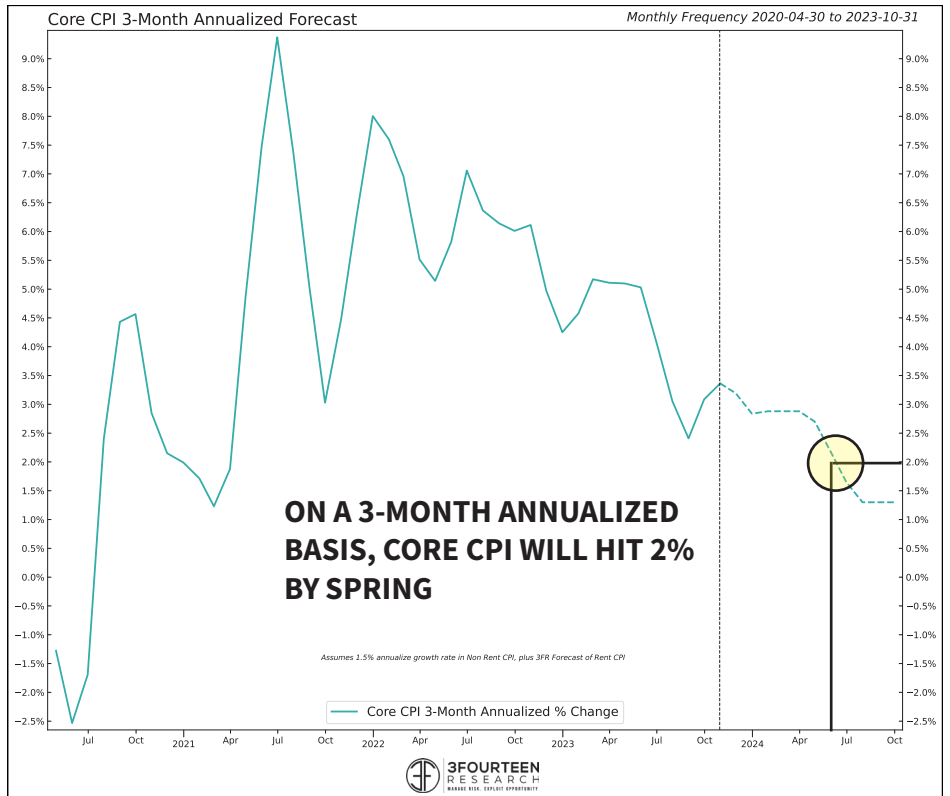MANAGE RISK. EXPLOIT OPPORTUNITY.

Our shelter CPI analysis borrows heavily from the October 2022 BLS paper "*Disentangling Rent Index Differences: Data, Methods, and Scope*." With the release of that paper, the BLS referenced an internal index it used for new rents—the New Tenant Renewed Rent (NTRR) Index. Notably, the BLS has not yet begun regularly updating the NTRR, but they occasionally highlight it in public presentations. Earlier this year, the BLS published a version of the NTRR that showed the gap between existing and new rents had already closed. This struck us as odd and, quite frankly, caused us to doubt our previous analysis. So, we began a dialogue with the BLS. They advised us that the NTRR is still a work in progress and that CoreLogic's SFRI is a better proxy. In the chart to the right, we compare the SFRI, NTRR and CPI rental indices. For the data nerds following along, notice the NTRR kink is gone.

Various Rent Indices — Monthly Frequency 2020-01-31 to 2023-10-31

CORELOGIC SFRI

BLS NTRR

SHELTER CPI

NTRR INEXPLICABLY FELL EARLY THIS YEAR

Legend:
- CoreLogic Single Family Rent Index
- Federal Reserve New Tenant Rent Index
- CPI Rent

Core CPI Forecast through EOY 2024 — Monthly Frequency 2021-01-31 to 2023-10-31

NON-SHELTER CORE CPI

CORE CPI

SHELTER CPI

CORE CPI HEADED TO 3.2% BY MARCH

3.2% by March 2024

Assumes 1.5% annualize growth rate in Non Rent CPI, plus 3FR Forecast of Rent CPI

Legend:
- CPI Rent YoY % Change
- Non Rent CPI YoY % Change
- Core CPI YoY % Change

Why is this shelter discussion so important? The bottom chart on page 4 puts it all together. Here, we deconstruct the Core CPI and layer in our shelter assumptions. Projections are dashed. The blue line is our Core CPI projection on a YOY basis (same series as the bottom clip - page 3). The purple line is non-shelter Core CPI pushing the trends of the past six months out into the future (~1.5% annualized growth rate). Finally, the green line is our Core CPI projection. Mixing it all together, Core CPI will be back to 3.2% by March of 2024. By June, it will fall to 2.5%. To be clear, the chart on page 4 displays a year-over-year (YOY) change. The chart to the right flips to an annualized three-month change. **By next spring, three-month annualized core inflation will be at the Fed's 2% target. The key question: How will the Fed respond?**

Core CPI 3-Month Annualized Forecast — *Monthly Frequency 2020-04-30 to 2023-10-31*

ON A 3-MONTH ANNUALIZED BASIS, CORE CPI WILL HIT 2% BY SPRING

Assumes 1.5% annualize growth rate in Non Rent CPI, plus 3FR Forecast of Rent CPI

— Core CPI 3-Month Annualized % Change

Fed Funds Rate vs. Core CPI — *Monthly Frequency 1971-01-31 to 2023-10-31*

● Current (Core CPI, FFR) = (4.02%, 5.50%)

AS INFLATION FALLS, POLICY WILL MOVE INTO AREA WHERE INITIAL CUTS OCCUR

Fed Funds Rate
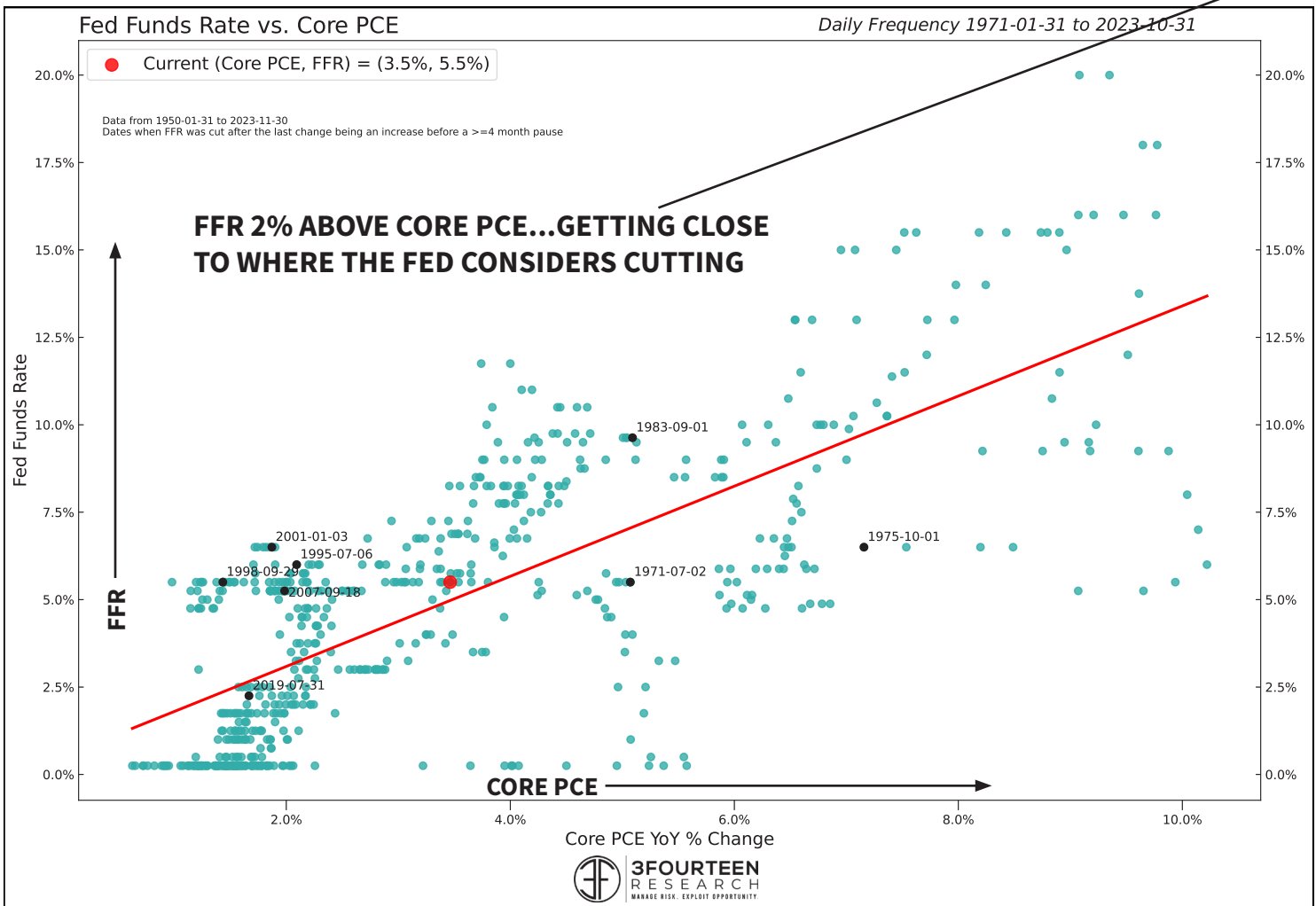
FFR

CPI

Core CPI YoY % Change

HYPER-REACTIVE FED?

Increasingly, Fed members seem poised to cut soon. On December 18, the Fed releases its next Summary of Economic Projections (SEP). For now, we must work off the September dots and projections. In addition, committee commentary, and history, provides clues to how the Fed may respond to continued disinflation. Beginning with history, an interest rate cut could be closer than many assume. The scatter plot below (along with the chart on page 5) compares core inflation (x-axis) to the Fed Funds Rate (y-axis) historically. The chart on page 5 uses Core CPI. The chart below swaps in Core PCE. Next, in both charts we highlight the first cuts following a pause/ hike cycle. We list all of these cases, along with relevant statistics, in the table to the right. A few key insights emerge.

First, it is often assumed that the Fed will push back against an equity rally. The reasoning goes stock prices are an important component of "financial conditions." Thus, by definition, rallies loosen financial conditions and are counterproductive to the Fed's inflation battle. This all makes sense (and I'm pretty sure I've casually suggested this in past conversations/interviews). But, history does not support it. **Instead, the Fed routinely cuts rates near all-time highs (ATHs). Scanning the table to the right, most initial Fed cuts occur within 10% of ATHs.**
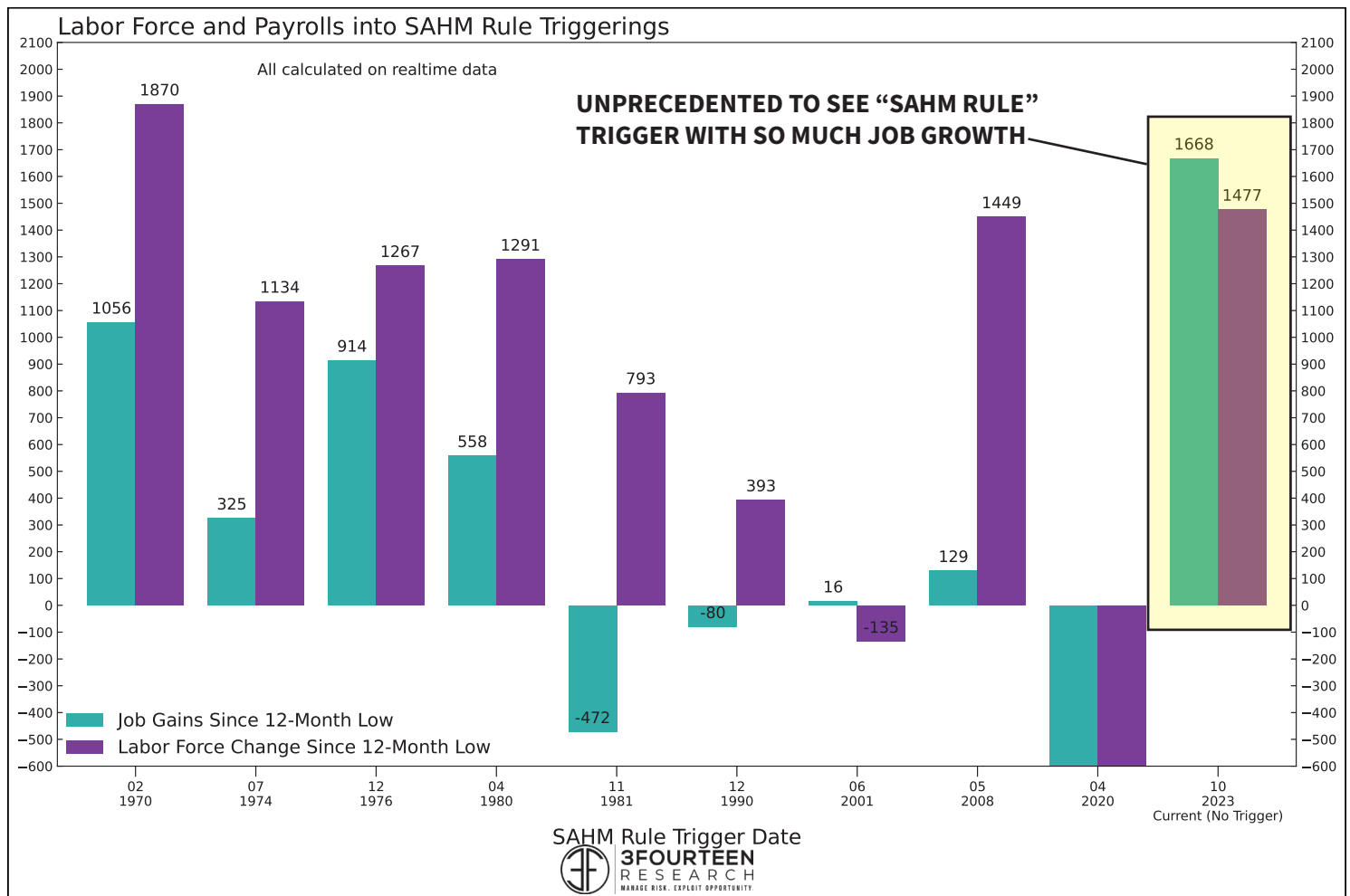
S&P 500 INITIAL FED CUTS FOLLOWING A PAUSE								
DATE	FFR CUT	S&P 500 6-MO % CHG	CORE CPI 12-MO % CHG	CORE CPI 36-MO % CHG	UE RATE	UE CHG	S&P 500 DIST FROM ATH	REAL FFR
1971-07-02	-0.25	9.5%	4.9%	18.2%	5.9%	3.4%	92.1%	0.3%
1975-10-01	-1.62	1.7%	7.5%	23.0%	8.4%	5.0%	69.0%	-2.6%
1983-09-01	-0.13	6.9%	3.1%	23.1%	9.5%	6.1%	96.0%	6.4%
1995-07-06	-0.25	20.3%	3.0%	9.5%	5.6%	0.6%	100.0%	2.7%
1998-09-29	-0.25	-4.8%	2.5%	7.5%	4.5%	0.2%	88.4%	2.8%
2001-01-03	-0.5	-6.8%	2.6%	7.1%	3.9%	0.1%	88.2%	3.4%
2007-09-18	-0.5	7.7%	2.1%	7.2%	4.6%	0.8%	97.9%	2.7%
2019-07-31	-0.25	11.2%	2.2%	6.2%	3.7%	0.1%	98.5%	0.1%
2023-11-27		8.2%	4.0%	15.6%	3.9%	0.5%	94.9%	1.5%

Fed Funds Rate vs. Core PCE   *Daily Frequency 1971-01-31 to 2023-10-31*

Current (Core PCE, FFR) = (3.5%, 5.5%)

Data from 1950-01-31 to 2023-11-30
Dates when FFR was cut after the last change being an increase before a >=4 month pause

FFR 2% ABOVE CORE PCE...GETTING CLOSE TO WHERE THE FED CONSIDERS CUTTING

So, despite the popular narrative, cutting at, or near, ATHs is a regular occurrence. **What, then, is restraining the Fed from cutting next year to facilitate a soft landing? Of course, there is the 2% target. However, if we read between the lines, it is clear the Fed will cut before inflation is all the way back to 2%.** In his press conferences, Powell parrots the same line repeatedly: "*We are committed to achieving a stance of monetary policy that is sufficiently restrictive to bring inflation sustainably down to 2 percent over time, and to keeping policy restrictive until we are confident that inflation is on a path to that objective.*" Put simply, Powell is looking for a path to 2%, not necessarily a 2% print. The 2% target is a nominal target. The case for cuts rests with real rates. The September SEP is instructive. Recall, each quarter FOMC participants record their economic and policy projections. These projections become "dots" on the dot plot. **The September SEP shook markets because the 2024 FFR projects rose from 4.6% to 5.1%. More specifically, the projected policy rate went higher but the median inflation projection remained the same (2.6% Core PCE). Said differently, the Fed sent a strong message of higher real rates compared to the June SEP (2.5% vs 2%).** Setting policy based on real rates is something that New York Fed President John Williams has argued for throughout this cycle. In an August NY Times interview, he described how—if inflation begins decelerating—cutting could keep policy restrictive under this framework. To quote Williams: "*I think of monetary policy primarily in terms of real interest rates, and we set nominal rates. We're setting the Fed funds target. And, assuming inflation continues to come down next year, as many forecasts, including the economic projections show, then if we don't cut rates at some point next year, real interest rates will go up, and up, and up…**So, I do think that from my perspective, to keep maintaining a restrictive stance may very well involve cutting the FFR next year**.*"

Now, it seems the doves are starting to win the intellectual battle. Earlier this week, the typically hawkish Christopher Waller gave a speech titled "*Something Appears to Be Giving*." The title says it all. In essence, Waller backed off additional hikes, acknowledged that the labor market was loosening, and that Fed policy is indeed restrictive.

Labor Force and Payrolls into SAHM Rule Triggerings

All calculated on realtime data

UNPRECEDENTED TO SEE "SAHM RULE" TRIGGER WITH SO MUCH JOB GROWTH

Legend:
- Job Gains Since 12-Month Low
- Labor Force Change Since 12-Month Low

SAHM Rule Trigger Date

SAHM Rule Trigger Date	Job Gains Since 12-Month Low	Labor Force Change Since 12-Month Low
02 1970	1056	1870
07 1974	325	1134
12 1976	914	1267
04 1980	558	1291
11 1981	-472	793
12 1990	-80	393
06 2001	16	-135
05 2008	129	1449
04 2020	(below -600)	(below -600)
10 2023 Current (No Trigger)	1668	1477

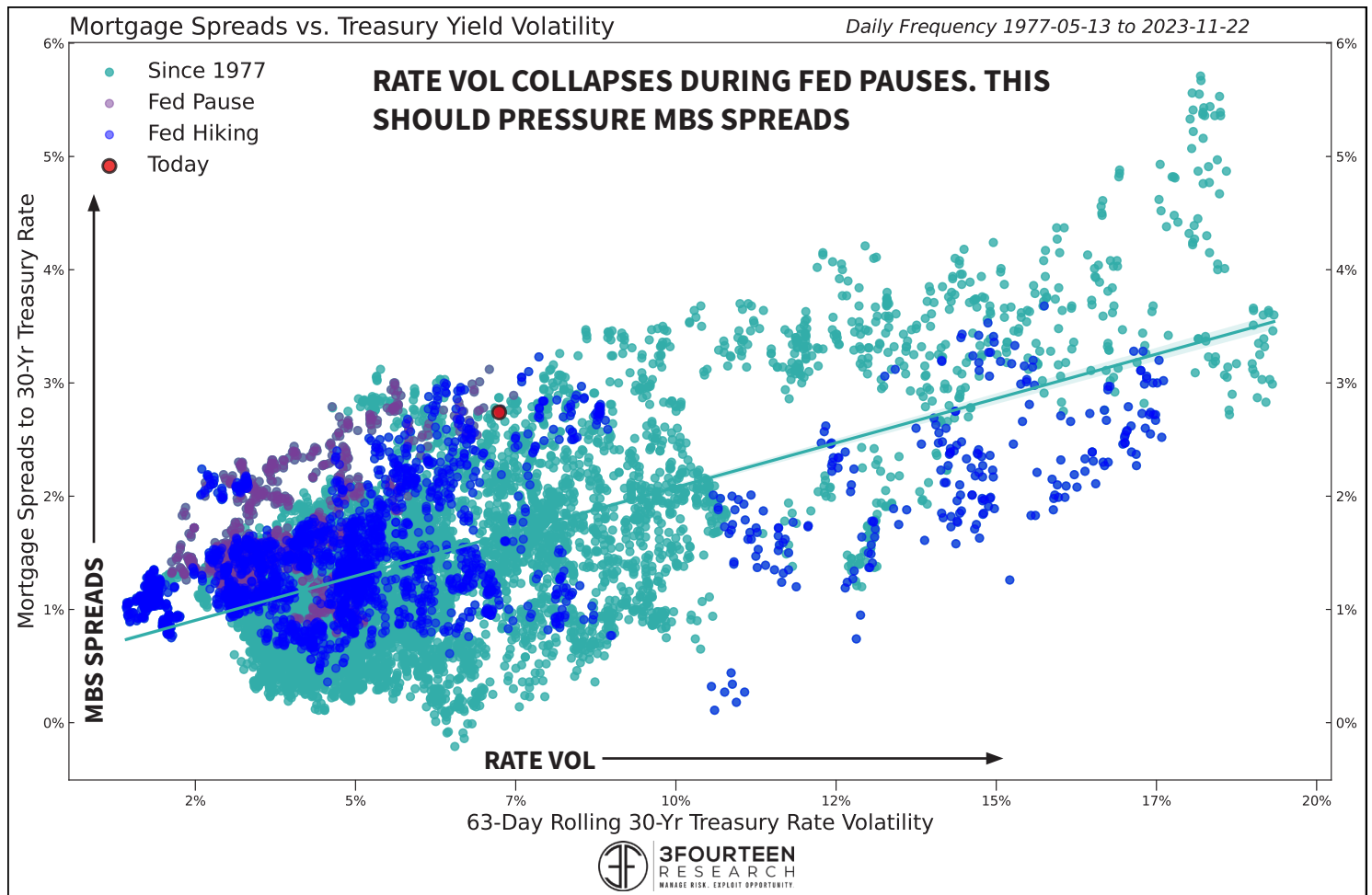3FOURTEEN RESEARCH — MANAGE RISK. EXPLOIT OPPORTUNITY.

Combining these disparate Fed statements, a path to early-2023 cuts opens. Both hawks (Waller) and doves (Williams) agree current policy is restrictive. At the time of Waller's speech, the FFR was at 5.5% while Core CPI was at 4% and Core PCE 3.7% (now 3.5%). This means that roughly a 1.5-2% level of real rates is restrictive enough for one of the more hawkish Fed officials. **If, as we project, Core CPI falls to 3.2% by March of next year, then—all else equal—real rates will rise to 2.3%. Going back to the table on page 6, this is in the neighborhood of previous initial cuts. Since the '90s, the median real rate (FFR minus Core CPI) at these pivots has been 2.7%.** The rise in the unemployment rate is already on the high side for a modern Fed pivot and is driven by new entrants into the labor force (chart page 7). Scan through the scatter plots on pages 1, 5, and 6 and envision a 1% decline in whatever inflation metric you prefer. The current dot shifts to the left. In other words, policy goes from appropriate to tight. If the Fed embraces this framework, then the path to a soft landing is open. As a side note, this is NOT a commentary on whether the Fed SHOULD try for a soft landing (and risk reigniting inflation). Rather, given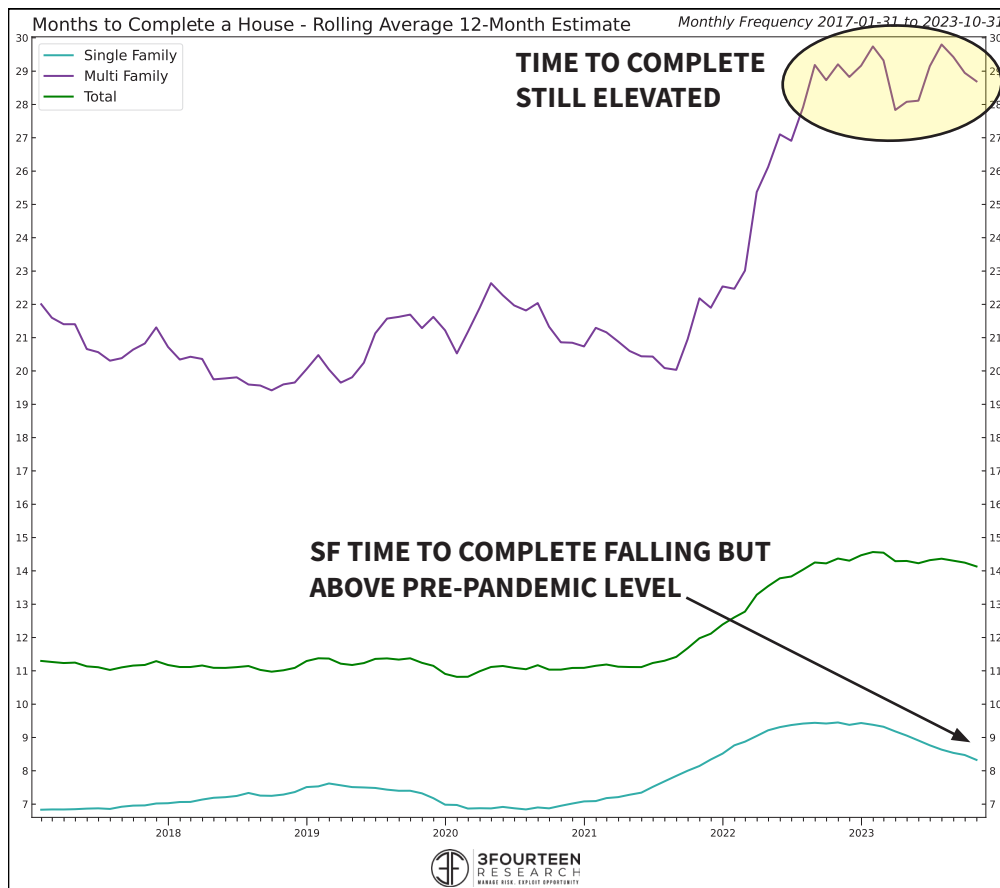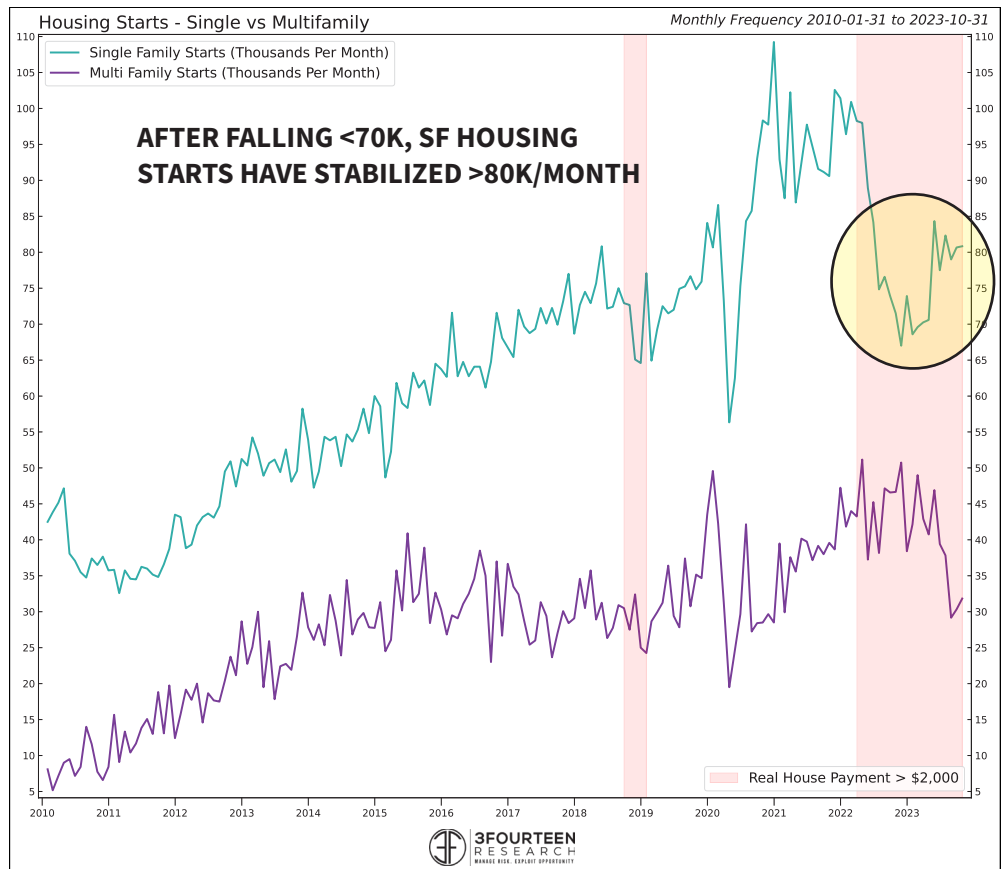 the tenuous state of inflation psychology, we view this as a somewhat reckless path. But, how we believe the Fed SHOULD react has no influence on making money.

SOFT LANDING PROBABILITY RISES

Back in January, we described our two-part recipe for a soft landing: Rapid disinflation + a hyper-reactive Fed. At the time, we pegged the odds of a soft landing at 25%. Back then, the consensus was for an imminent recession. Some respected commentators insisted that the recession began in late 2022 and that the NBER would backdate the start any day. Our view was that disinflation was likely, but the Fed would be hesitant to react soon enough to engineer the soft landing. In the interim, the economy has proven resilient and the Fed is eager to start cutting. **The mere assurance of a pause is already creating positive feedback loops into the economy.** In the chart below, we measure 63-day interest rate volatility versus the MBS spread to 30-year Treasuries. This was a key chart for us back in January. During hike phases (blue dots), interest rate vol expands, which causes MBS spreads to widen. In pauses (purple dots), rate vol subsides and spreads narrow.

Mortgage Spreads vs. Treasury Yield Volatility — Daily Frequency 1977-05-13 to 2023-11-22

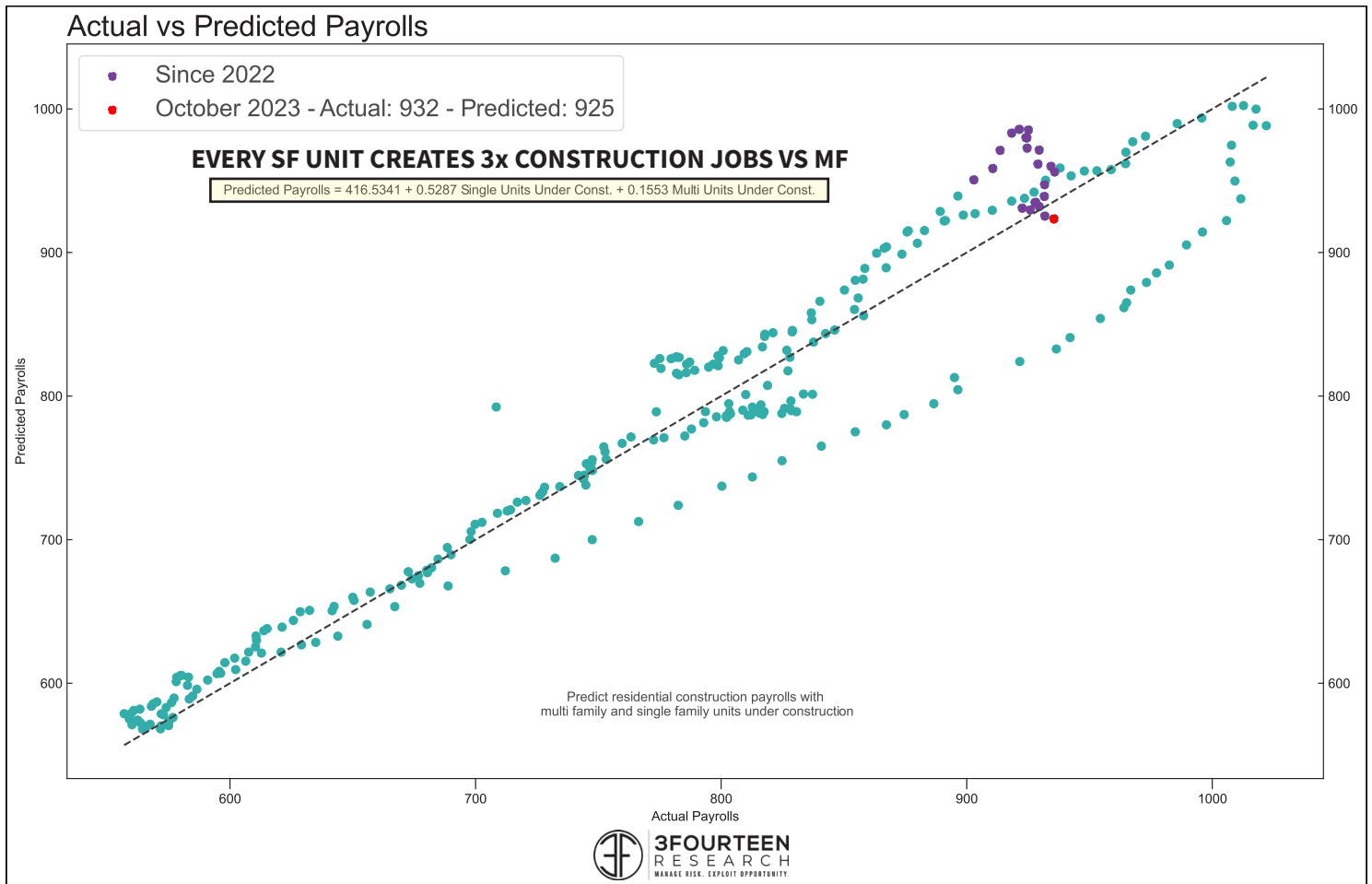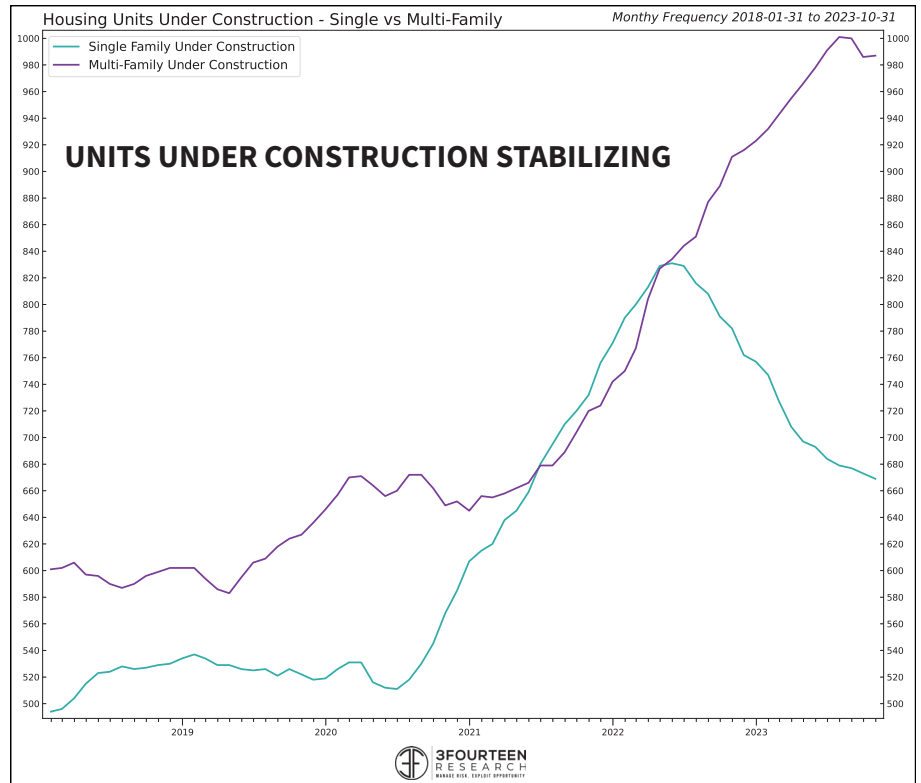RATE VOL COLLAPSES DURING FED PAUSES. THIS SHOULD PRESSURE MBS SPREADS

To review, a soft landing requires rapid disinflation and a hyper-reactive Fed. Against the odds, both pieces are moving into place. **Obviously, there is a third, so far unspoken, requirement: economic resilience**. In many ways, this is the trickiest part of a soft landing. The economy must decelerate without contracting. We remain at the late-cycle point where a hard and soft-landing look the same. Navigating this next part of the cycle requires a probabilistic, data-driven, approach. There are no crystal balls…only imperfect frameworks and data. Long-time clients know that our preferred recession framework focuses on the housing market. **Our hypothesis is that residential construction payrolls will lead overall non-farm payrolls. Modern recessions start after residential construction payrolls have drawn down by ~8-10%.**

Housing Starts - Single vs Multifamily — Monthly Frequency 2010-01-31 to 2023-10-31

AFTER FALLING <70K, SF HOUSING STARTS HAVE STABILIZED >80K/MONTH

Months to Complete a House - Rolling Average 12-Month Estimate — Monthly Frequency 2017-01-31 to 2023-10-31

TIME TO COMPLETE STILL ELEVATED

SF TIME TO COMPLETE FALLING BUT ABOVE PRE-PANDEMIC LEVEL

There are details and nuances to the data, but, at a high level, units under construction dictate residential construction payrolls. Going one level deeper, units under construction are a function of housing starts and the time it takes to complete a unit. At present, housing starts are lingering around ~110k units/month. The underlying breakdown is 80k single-family (SF) and 30k multi-family (MF) (chart above). Heading into the year, SF starts had dipped all the way below 70k per month, but, since mid-year, they have stabilized at 80k. Without a further shock to rates, this appears to be the new trend. Entering 2023, our expectation was that—as supply chains normalized—the time to build a unit would fall to a pre-COVID norm. However, time to complete has remained stubbornly high at just over 8 months for SF units and 29 months for MF projects (chart left).

In our previous research, we have noted that SF units employ ~3x as many workers as a MF unit (see regression equation in scatter below). Therefore, we must adjust our model to account for the labor intensity of each unit type. Since 2022, MF projects have come to dominate the market. At present, MF accounts for a record +60% of total units under construction. Early in the year, we felt comfortable projecting a sharp fall in MF starts (as has occurred). If SF starts remained around 70k per month and MF fell to its current level of 30k, then job losses would have picked up steam. Instead, SF units rebounded and have stabilized above 80k starts per month. **Bottom Line: Stronger-than-expected SF starts and elevated times to complete mean that total units under construction are not declining fast (or deep) enough to force more layoffs.**

Housing Units Under Construction - Single vs Multi-Family — Monthy Frequency 2018-01-31 to 2023-10-31

UNITS UNDER CONSTRUCTION STABILIZING

Actual vs Predicted Payrolls

EVERY SF UNIT CREATES 3x CONSTRUCTION JOBS VS MF

Predicted Payrolls = 416.5341 + 0.5287 Single Units Under Const. + 0.1553 Multi Units Under Const.

- Since 2022
- October 2023 - Actual: 932 - Predicted: 925

Predict residential construction payrolls with multi family and single family units under construction

RECESSION CANCELLED?

Housing entered 2023 initiating ~110k starts per month. Surprisingly, it seems, housing will exit 2023 at the same level. However, 12 months ago, housing starts were split 70k/40k SF/MF. Now, the mix has shifted 80k/30k. **The upshot: Today's 110k starts are more labor intensive than the 110k coming into the year.**
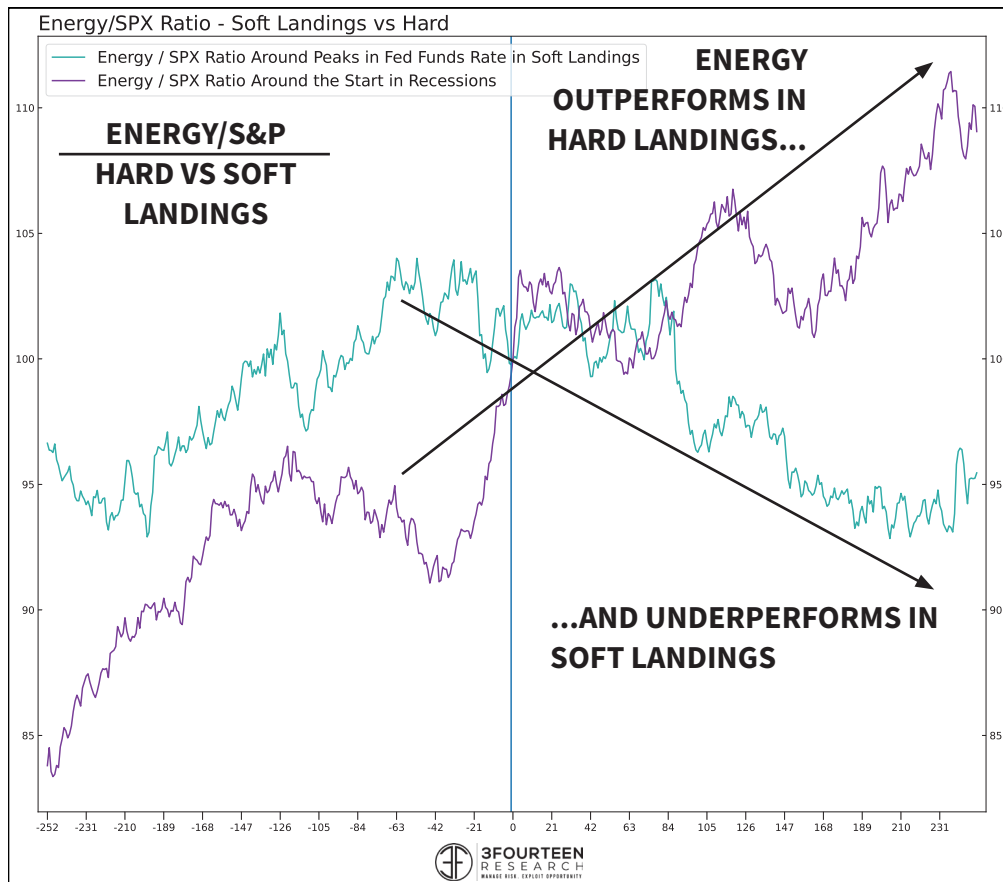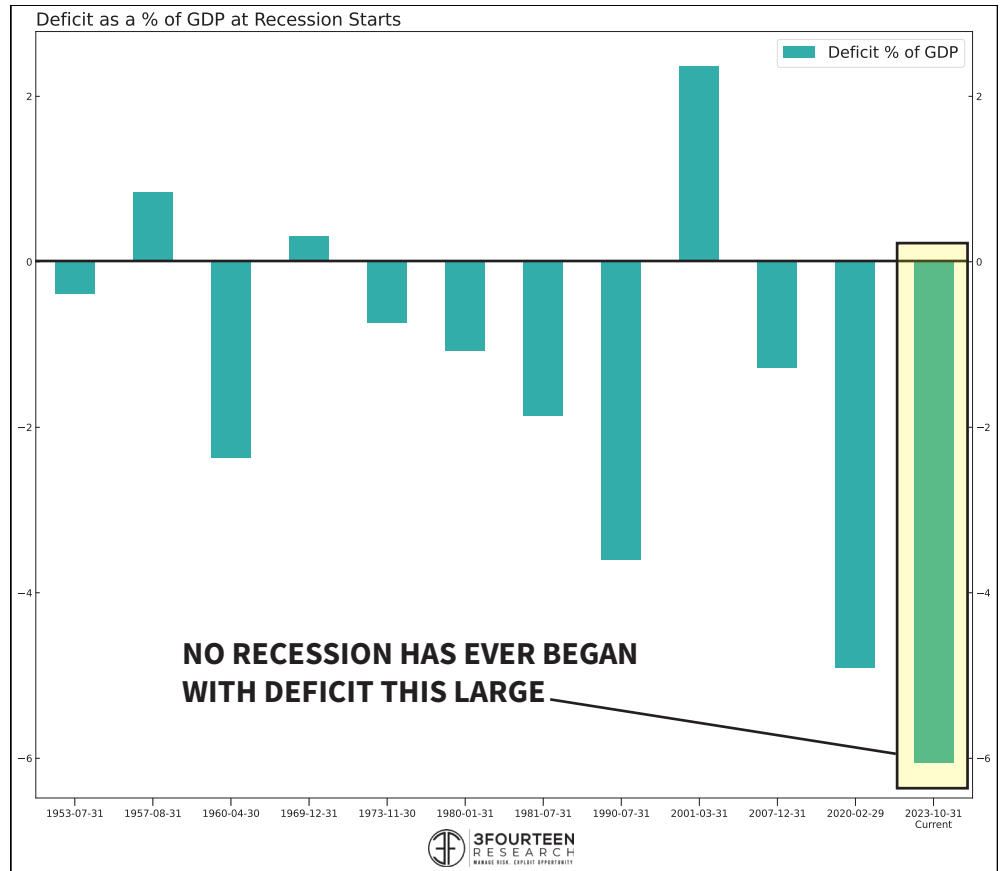
Before we move on to the conclusion, let's review our rules and what we have said in the past. Residential construction payrolls peaked at 936k back in January of this year. To hit our 8% drawdown threshold, the economy would need to shed about 75k residential construction jobs…call it 860k (see chart below). Based on current data (remember revisions spike at turning points), July marked the low-water mark at 922k jobs. October put us only 1,000 jobs below the January peak…935k. This number may be a bit overstated (i.e. will be revised lower), but **the overarching point remains: Despite mortgage rates as high as 8%, housing construction is extraordinarily resilient. What does this all mean for the future? Based on current data, we cannot predict** a recession occurring within the next year.

Entering the year, our expectation was that higher rates would bring housing starts down to 85k per month. By mid-year, we revised this to 100k. Now, the Fed is on pause. Cuts are coming next year. History says that rate vol will come down, which will narrow the MBS spread (see page 8). Against this backdrop, we must update our housing assumptions and projections. It is no longer appropriate to assume that SF housing starts will fall so precipitously. Given the stabilization around 80k per month, this becomes our new base assumption. Our MF assumption comes down to 30k per month. Finally, we assume a continued normalization of the time to build a house (7.5 months for SF and 27 months for MF). The chart below puts these assumptions together and projects out residential construction payrolls based on the mix and number of units under construction. **Put simply, based on today's numbers, the data does not support a 2024 recession call (red dashed line).** Our bear scenario (70k/25k SF and MF starts) points to payrolls reaching recessionary levels by H2 2024.

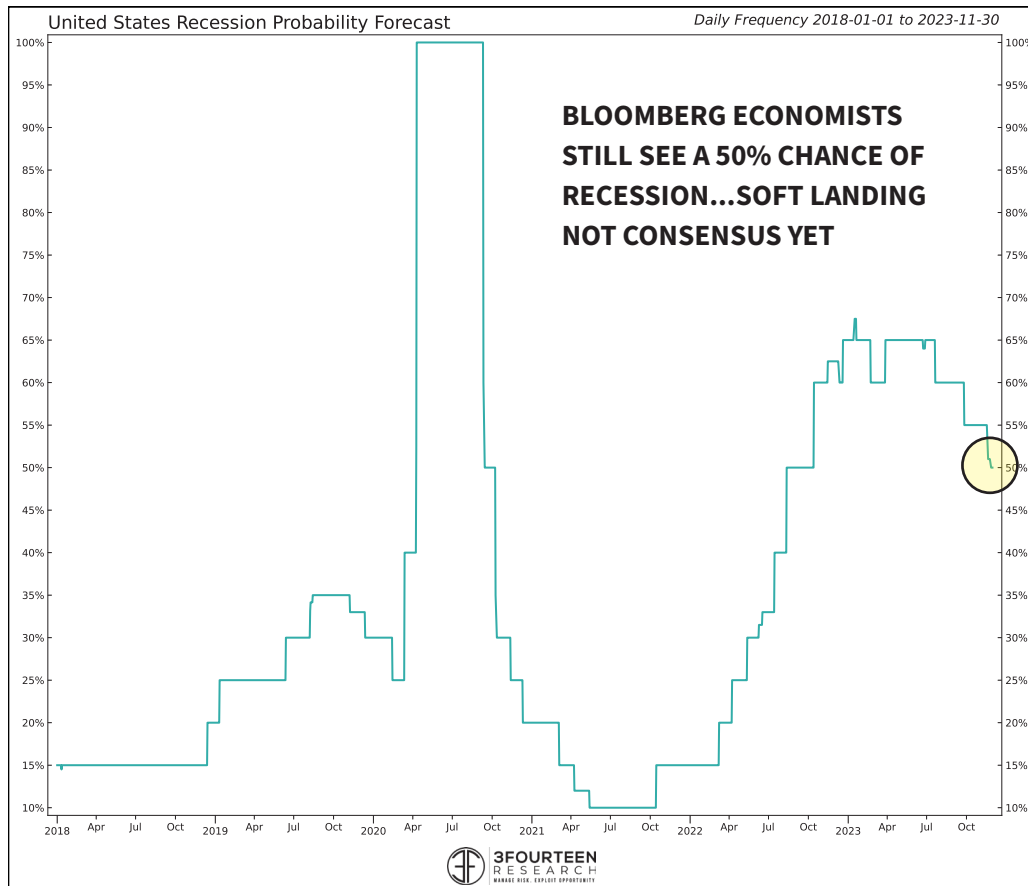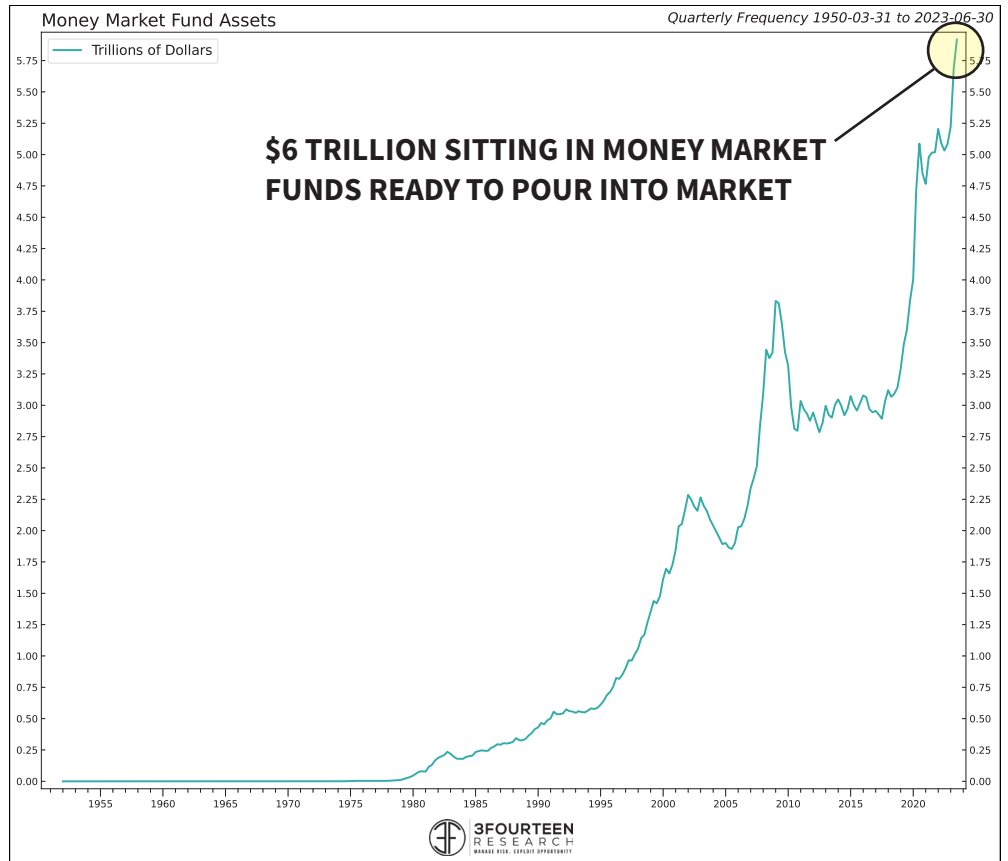Residential Construction Payrolls Forecast — Monthly Frequency 2020-01-31 to 2025-12-31
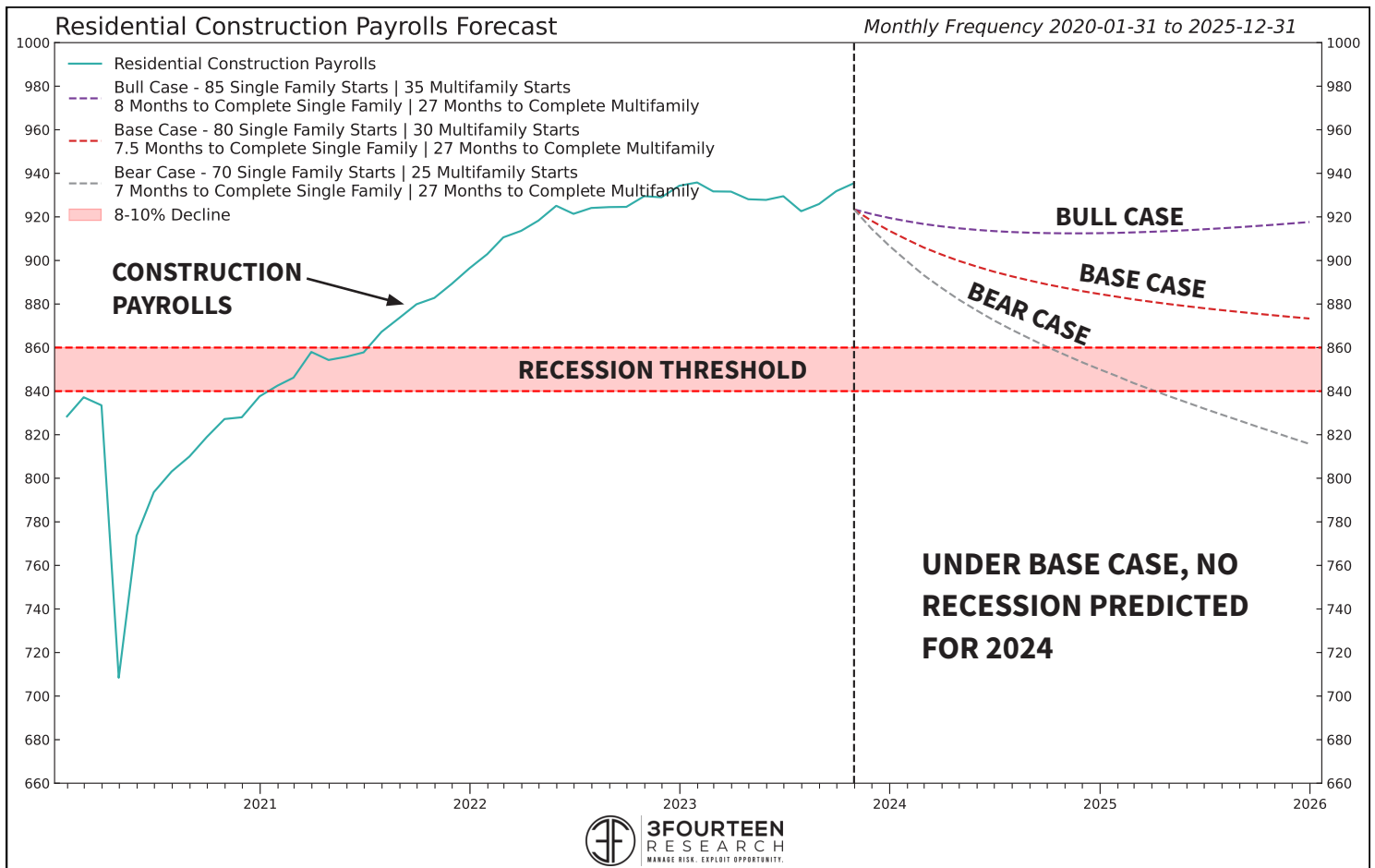
Investing, especially in a late-cycle environment, tests our tolerance for ambiguity. Good investors can hold competing views in their minds simultaneously. Having the ability to operate rationally within ambiguity is an investing superpower. With that said, recessionary evidence is easy to find. As we have documented, negative payroll revisions are piling up. No soft landing has occurred while the yield curve has remained inverted. And, growth is decelerating. There will always be mixed signals. This is the nature of the beast. Going back to our opening comments, we must follow the data wherever it leads. For now, it is pointing towards a decelerating, yet resilient, economy. **The soft-landing case has a few other things going for it as well. First, and foremost, fiscal policy remains supportive. The deficit has NEVER been this large entering a recession (chart right).**

Deficit as a % of GDP at Recession Starts

NO RECESSION HAS EVER BEGAN WITH DEFICIT THIS LARGE

Energy/SPX Ratio - Soft Landings vs Hard

ENERGY/S&P HARD VS SOFT LANDINGS

ENERGY OUTPERFORMS IN HARD LANDINGS…

…AND UNDERPERFORMS IN SOFT LANDINGS

Second, oil prices remain subdued. After a Q3 rally, Energy stocks have gone from leading to lagging the market. As we have shown before, Energy leads into recessions and lags into soft landings (chart left). **Finally, next year is a presidential election year. The market has only declined in three presidential election years historically (positive 83%) and two of these required major external shocks (GFC + COVID).** Every piece of tightening that has occurred over the past two years now becomes a potential catalyst. The Treasury could continue issuing more bills relative to duration or spend down the TGA. We have already discussed rate cuts, but maybe Quantitative Tightening (QT) hits the chopping block earlier than consensus expects? Fiscal and monetary authorities are likely to pull out all the stops to keep the music playing through next November.
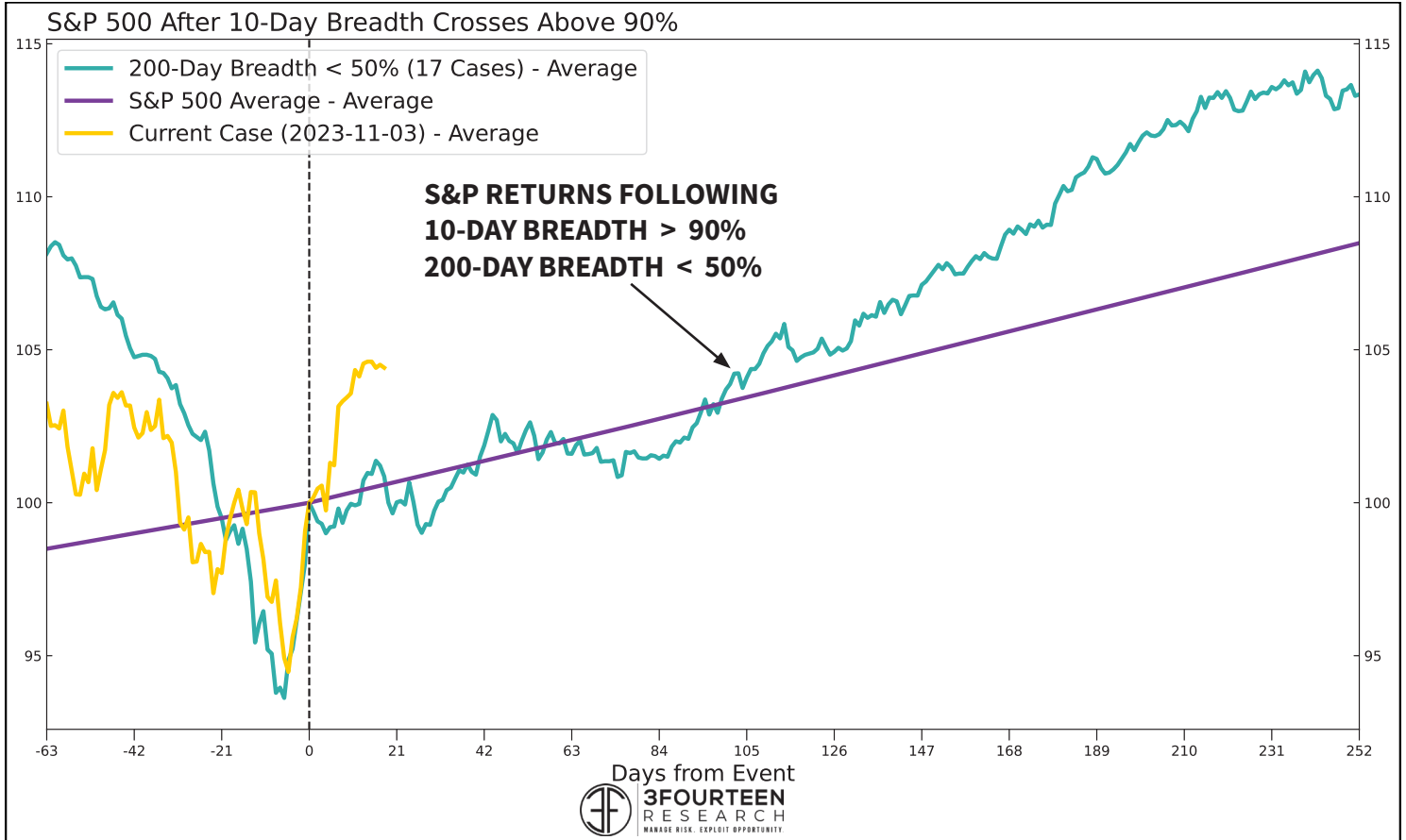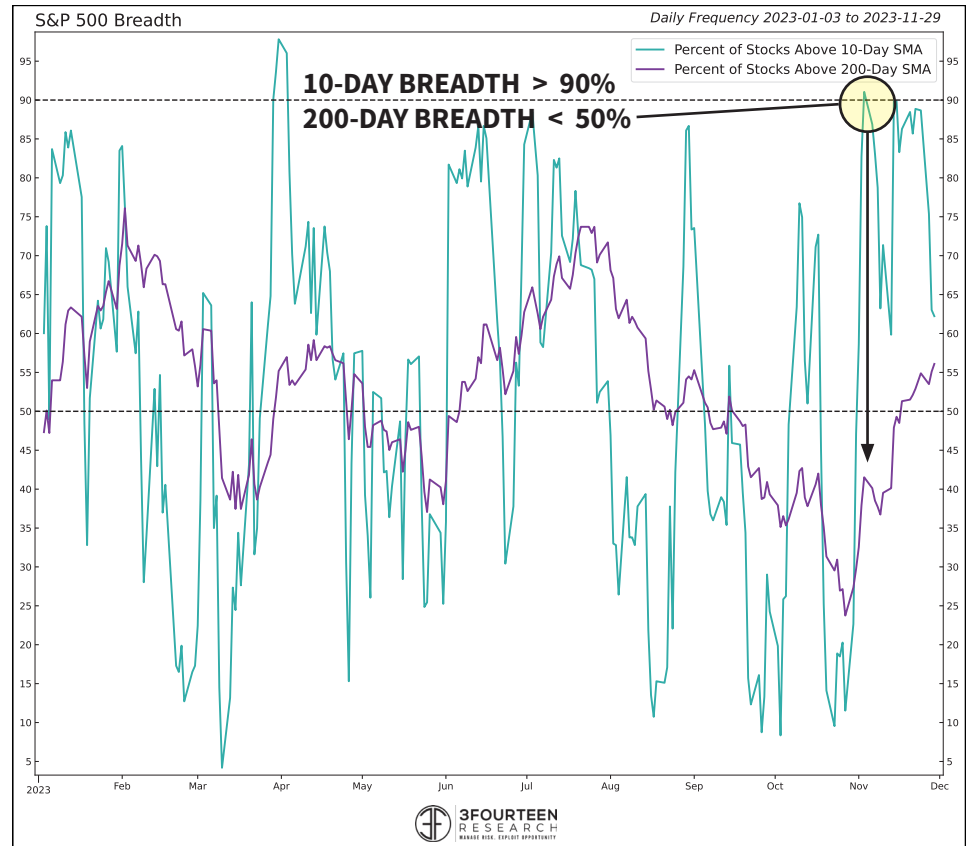
If the Fed is done tightening, then every restrictive policy can be transformed into stimulus. In simple terms, the Fed is in the process of transitioning from a headwind to a tailwind ("Don't fight the Fed"). In this strange world, getting the policy balance right is going to be difficult. About $6 trillion is sitting in money market funds. If the Fed begins talking about a "mid-cycle adjustment" (i.e. cutting in an attempt to engineer a soft landing), we expect a wave of this dry powder to flow into asset markets. Being underweight equities at that time will not feel good.

Money Market Fund Assets   *Quarterly Frequency 1950-03-31 to 2023-06-30*

Trillions of Dollars

$6 TRILLION SITTING IN MONEY MARKET FUNDS READY TO POUR INTO MARKET

United States Recession Probability Forecast   *Daily Frequency 2018-01-01 to 2023-11-30*

BLOOMBERG ECONOMISTS STILL SEE A 50% CHANCE OF RECESSION...SOFT LANDING NOT CONSENSUS YET

While the "soft landing" chatter is getting louder, Bloomberg's survey of economists shows a 50/50 chance of recession over the next year. Given the late-cycle fog, the coin-flip odds are understandable. On the other hand, it shows there are plenty of skeptics. If the economy does avoid a recession next year, by the time it becomes consensus, equities could be significantly higher. For reference, scroll back to page 2 and check out the S&P 500's average gain in the six months prior to the first Fed cut in soft landing cases (~10%). From a positioning perspective, recession holdouts are plentiful (chart left) and there is cash on the proverbial sidelines (chart above).

TECHNICALS: CHECKING BOXES

Back on 10/19 (when rates were peaking at 5% on the 10-year), we upgraded bonds to overweight. At the time, we judged the equity rally to be too narrow. To quote: "*How would we know the equity rally is broadening out? It would first show up in the percentage of stocks above their 10-day SMA...Ideally, greater than 90% of S&P 500 stocks would surge above their 10-day SMA, while 50% remain below their 200-day.*" Earlier this month, the market checked both of these boxes (chart right). This combination (>90% above 10-day/<50% above 200-day) has only occurred 15 other times historically going back to 1957. On average, stocks are higher by 14% in the year following these breadth expansions (compared to the long-term average of 8%).

S&P 500 Breadth — Daily Frequency 2023-01-03 to 2023-11-29

- Percent of Stocks Above 10-Day SMA
- Percent of Stocks Above 200-Day SMA

10-DAY BREADTH > 90%
200-DAY BREADTH < 50%

S&P 500 After 10-Day Breadth Crosses Above 90%

- 200-Day Breadth < 50% (17 Cases) - Average
- S&P 500 Average - Average
- Current Case (2023-11-03) - Average

S&P RETURNS FOLLOWING
10-DAY BREADTH > 90%
200-DAY BREADTH < 50%

Days from Event

STRATEGY

With the release of today's report, we are making a couple of strategy adjustments. First, we are reducing our bond position by 10% from overweight (35%) to underweight (25%). [We moved bonds to overweight back on 10/19.](#) This happened to be the peak in yields (bottom in bonds) to the day. Our premise was that bonds were a better bet compared to stocks for a Q4 rally. Depending on how you chose to play it, we feel good about how that call has unfolded. Since 10/19, TLT is up by ~12%. In comparison, SPY is up by ~7% (chart below). The Treasury still has a bundle of bonds to sell and this was close to a top 1% monthly move for fixed income. Digestion should be expected and cash still offers better yields.

With that 10%, we are increasing our equity weight by 5% to 55% (benchmark weight) and our cash position by 5% to 15% (overweight). **With breadth widening, the Fed poised to cut, and no recession in our forecast, it does not make sense to maintain an equity underweight any longer. Put simply, the upside risks in a soft-landing scenario are too great. Stocks are overbought, but the risk of a melt-up into year end are significant.**
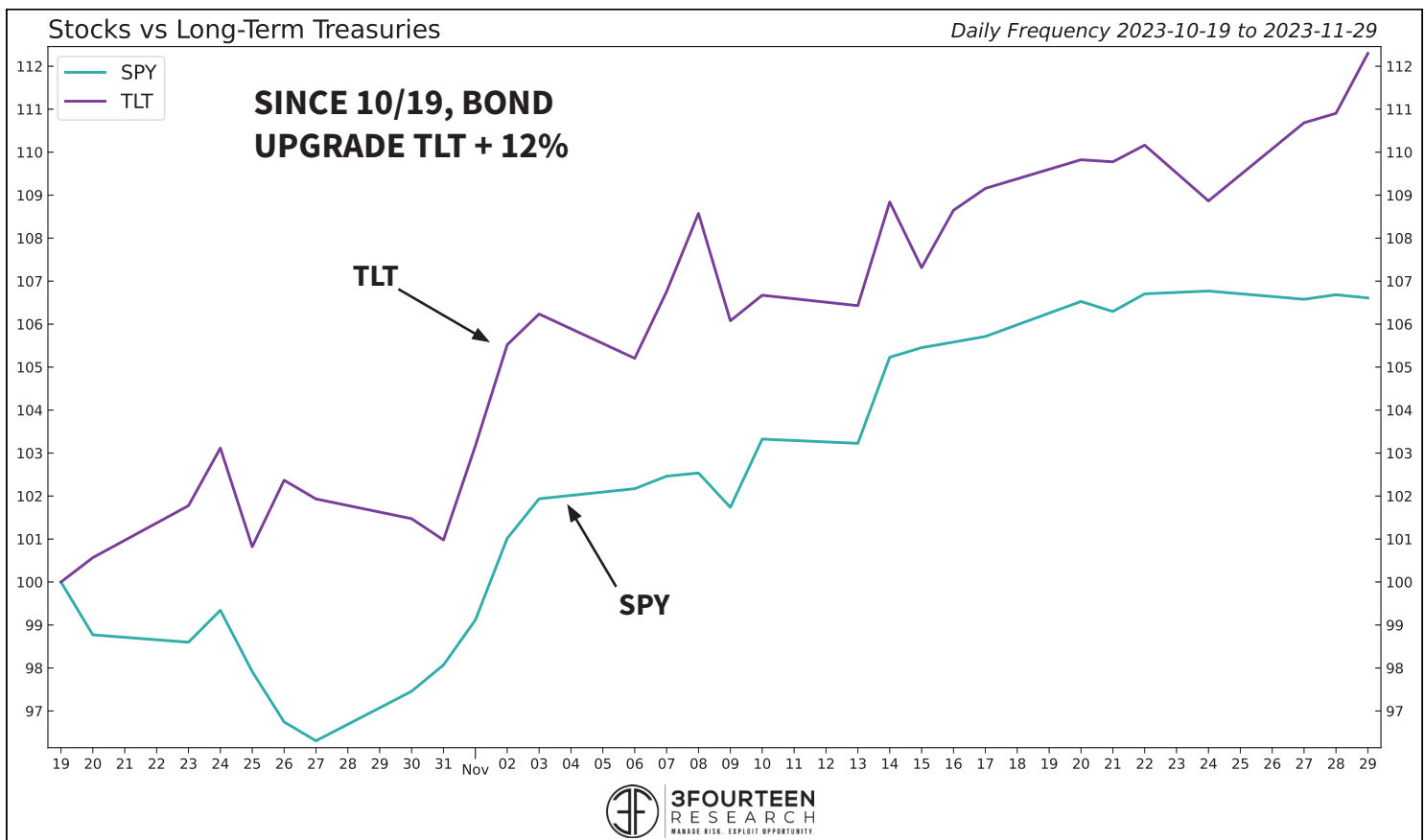
What about valuations? Quite frankly, nothing is attractively valued. Across the board, risk premia are compressed (credit and equities). On the bond side of the ledger, term premiums are back

3FR STRATEGIC AA RECOMMENDATIONS				
ASSET	RECOMMENDATIONS	BENCHMARK %	MAX	MIN
US Stocks	55% (BMW)	55%	70%	40%
US Bonds	25% (UW)	30%	45%	15%
Commods	5% (UW)	10%	25%	0%
Cash/Bills	15% (OW)	5%	20%	0%

UW = Underweight; BMW = Benchmark Weight; OW = Overweight

near zero. In our year-ahead outlook (published 12/13), we will provide more specific trade ideas for 2024.

CONCLUSIONS

- **The Fed wants to go for a soft landing.**

- **Next year is a presidential election year (positive 83% of time).**

- **The economy has defied the odds.**

- **In this environment, yesterday's tightening becomes tomorrow's stimulus. The odds of a bull market have increased.**

Stocks vs Long-Term Treasuries — Daily Frequency 2023-10-19 to 2023-11-29. SINCE 10/19, BOND UPGRADE TLT + 12%

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