AOR Update: Red Light, Green Light

November 3, 2021

Key Takeaways

- While some investors are worried about the prospects of stagflation and a "Great Resignation," the economy appears more robust with companies delivering solid third quarter earnings results so far and the ClearBridge Recession Risk Dashboard continuing to flash an overall green signal.
- The Wage Growth indicator has worsened to yellow from green with wage gains elevated and accelerating recently. However, expectations are for hiring to re-accelerate and we would not be surprised to see wage gains cool in 2022.
- Seasonality favors staying invested as November and December tend to be among the best periods for stocks, especially when the first 10 months of a year have been strong.

Stakes for Expansion Not at *Squid Game* Levels

The series *Squid Game* has taken the world by storm, reaching over 100 million viewers and becoming the biggest launch in streaming history. Although the consequences are less dire, investors are currently faced with several Red Light, Green Light dilemmas regarding the health of the current economic expansion and market rally. These include the potential of stagflation and the "Great Resignation." Importantly, the overall green signal emanating from the ClearBridge Recession Risk Dashboard remains despite one indicator (Wage Growth) deteriorating from green to yellow this month.

Exhibit 1: ClearBridge Recession Risk Dashboard

		Oct. 31, 2021	Sept. 30, 2021	June 30, 2021
Consumer	Housing Permits	⬆	⬆	⬆
	Job Sentiment	⬆	⬆	⬆
	Jobless Claims	⬆	⬆	⬆
	Retail Sales	⬆	⬆	⬆
	Wage Growth	●	⬆	⬆
Business Activity	Commodities	⬆	⬆	⬆
	ISM New Orders	⬆	⬆	⬆
	Profit Margins	⬆	⬆	⬆
	Truck Shipments	⬆	⬆	⬆
Financial	Credit Spreads	⬆	⬆	⬆
	Money Supply	⬆	⬆	⬆
	Yield Curve	⬆	⬆	⬆
	Overall Signal	⬆	⬆	⬆

⬆ Expansion ● Caution ✖ Recession

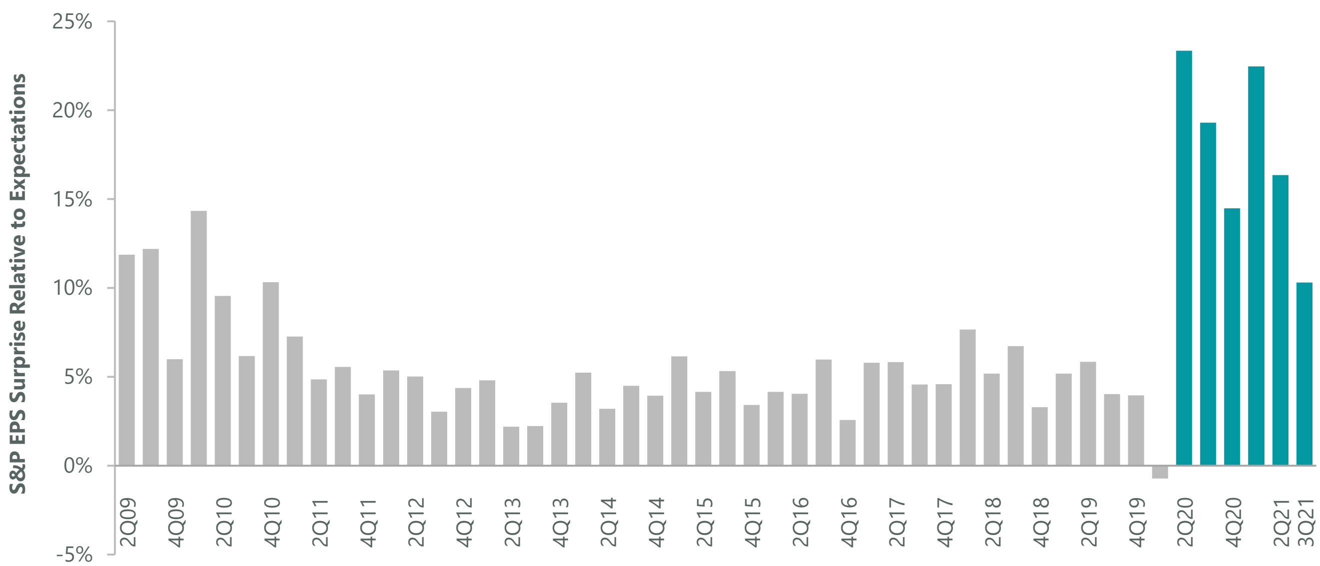
Source: ClearBridge Investments.

The first potential red light is the specter of stagflation. Stagflation was a term born in the 1970s to characterize the high inflationary decade which in turn caused persistently anemic (and at times negative) real economic growth and high unemployment. While this backdrop scarred a generation, today bears little resemblance with elevated near-term inflation co-existing alongside solid real economic growth and a healthy labor market. Even though inflation readings are currently raised with September's Consumer Prices' Index (CPI) reading coming in at 5.4%, real gross domestic product (GDP) continues to be positive albeit at lower levels than seen earlier this year. For example, GDP slowed in the third quarter to 2.0% from 6.7% in the second quarter.

While this may seem worrisome relative to the high inflation reading, it can be explained by how the two measures are calculated. GDP is reported as a quarterly rate of change that is then annualized, while CPI is typically quoted year-over-year (YoY). Recalculating CPI using the same mathematical calculation applied to GDP, CPI also slowed in the third quarter to 4.7% from 9.7%. If we were to look at core CPI in the same way, the slowdown is even more dramatic: to 2.7% from 10.6%. This decline in both real growth and inflation suggests that a broader Delta-induced slowdown, rather than stagflation, was the culprit in the third quarter. Comments from both the Federal Reserve's (Fed) Beige Book as well as corporate management teams reporting third quarter results suggest that activity slowed meaningfully in late summer as Delta cases surged but re-accelerated in late September as this latest wave of the pandemic receded.

Although inflationary pressures are unlikely to abate in the near term, some pressures may be peaking such as supply chain bottlenecks while commodity prices are beginning to roll over. Perhaps most importantly, 3Q earnings results have been robust despite ample worry. With over half of the S&P 500 by market cap having reported, aggregate margins are set to expand and contribute 21% to bottom-line results. Equally important, demand remains robust with constituent company revenues set to grow 15% YoY, suggesting little demand destruction has occurred thus far. Finally, earnings surprises remain robust, a welcome development that has helped drive the rally from early October lows.

Exhibit 2: Historic Earnings Surprise



Data as of Sept. 30, 2021. Source: FactSet.

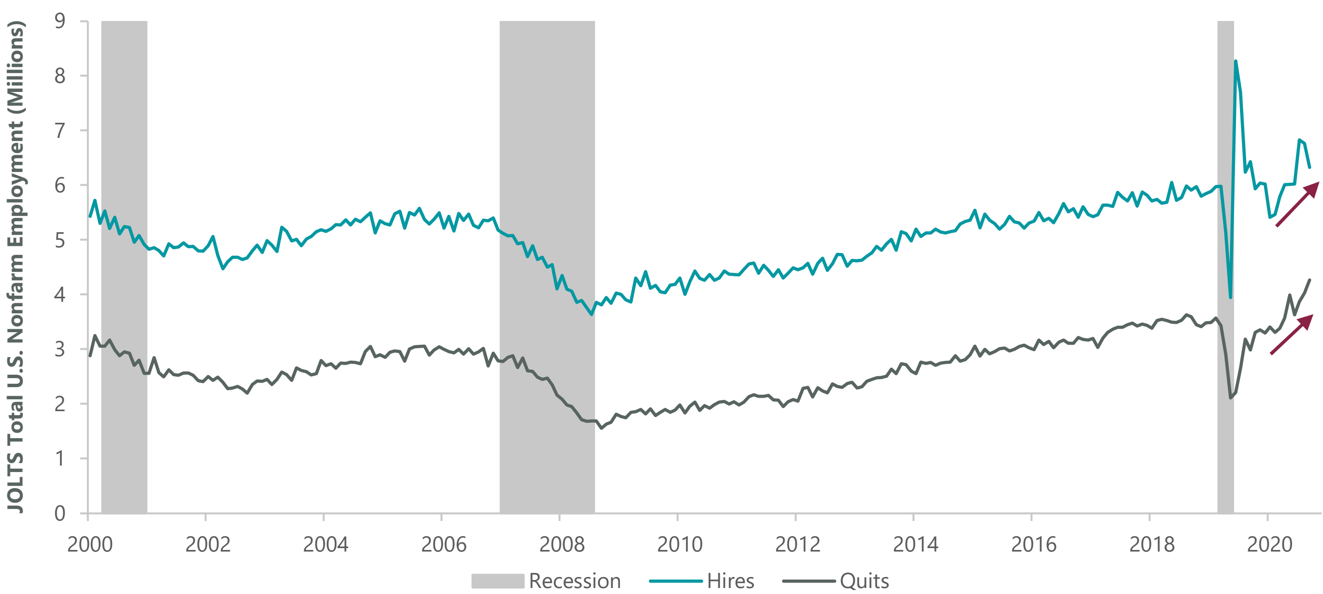
A second potential red light is the Great Resignation. The Job Openings and Labor Turnover Survey (JOLTS) shows a record number of Americans left their jobs in August, nearly 4.3 million of them. Many firms are reporting difficulty finding workers and the news is full of stories about companies having to raise wages in order to attract workers. What is less reported, however, is that the same survey showing 4.3 million quits in August shows even more job hires/offers: 6.3 million. These data do not delineate between workers leaving a job and exiting the workforce and those leaving a job because they have another one (often more attractive) lined up. With the survey showing 2 million more hires than quits, we believe the Great Resignation narrative to be somewhat misplaced.

A Buyer's Market for Job Seekers

What might be happening is elevated churn within the labor market, as some workers leave their jobs in pursuit of higher wages. While this has consequences for corporate earnings (hiring and training workers is not inexpensive), it paints a less dire picture of economic health. Wage gains have been accelerating in recent months, which has led to the Wage Growth indicator on the dashboard moving from green to yellow this month. Average hourly earnings are up 4.6% YoY, and while this metric is susceptible to distortions from compositional changes in the labor force (mix-shift), other metrics such as the Atlanta Fed's median wage tracker (+4.2% YoY) and the Employment Cost Index (+3.7%) are also accelerating.

Although wage growth is not currently pressuring margins, this remains a risk. Wage growth historically has been one of the longest leading indicators on the dashboard, however, given the unique drivers of wage gains right now in light of the pandemic, we would not be surprised to see easing wage pressures in 2022. To that end, current expectations for this Friday's jobs report are for a re-acceleration of hiring following the last two weaker prints and a slower pace of monthly wage gains (annual gains should continue to rise given easy comps). This seems a reasonable expectation given the substantial decline in continuing jobless claims in recent weeks, a sign that more unemployed workers may be finding work.

Exhibit 3: JOLTS Quits and Hires



Data as of Aug. 31, 2021, latest available as of Oct. 31, 2021. Source: U.S. Bureau of Labor Statistics (JOLTS).

One potential reason to disregard these red lights is seasonality. Since 1950, November represents the best month for S&P 500 Index performance, while December ranks third best overall. Further, history suggests that strength begets strength. When price returns through the first 10 months of a calendar year are in the top quintile (as is the case in 2021), the index typically rises an additional 5% on average over the remaining two months of the year with a positive return 92% of the time. Regardless of how the near term plays out, we believe these potential red-light fears will dissipate as we move through 2022, providing a green light for further market upside as this new bull market matures.

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