Morgan Stanley
INVESTMENT MANAGEMENT

Global Multi Asset Thought of the Week

The Most Contrarian Outcome: No Landing

GLOBAL MULTI-ASSET TEAM | MACRO INSIGHT | OCTOBER 1, 2024

Recession risks have been top of mind since early 2022[1] when headline inflation reached 9%, the Fed hiked 525bps in 18 months (the steepest pace in 40 yrs) and the yield curve inverted by more than 100bps. Such steep inversion has been a precursor to recession in the following year every time in the past six decades. But the US economy exceeded the consensus and our expectations in late 2022, 2023, and the first half of 2024, averaging 2.3% annual growth. Despite this, today the overwhelming majority of investors (79%) still expect a Soft Landing (i.e. sub-trend growth) in the next year, and 11% expect Recession.[2] In fact, **the most contrarian outcome for markets would be No Landing (i.e. above trend growth).**

Recently, cautiousness on the economy has been driven by weakening labor market data, but households are consuming and businesses are investing.[3] The consensus will likely face another positive surprise in Q3 with GDP likely to hit 3% vs 2% currently expected.[4] And there are some indications that the dichotomy between a weak labor market and strong spending could resolve in favor of the latter:

- **LABOR MARKET STABILIZATION:** Job openings have been stabilizing for the past four months to September 20th based on data from Indeed.com. This is confirmed by JOLTS data through August. In addition, wages for new Indeed postings rebounded to +3.3% from +3.1% in the spring.[5]
- **IMPROVING HOUSING ACTIVITY:** mortgage rates are down nearly 180bps from the October 2023 peak of 7.90%. As a result, new home sales rebounded more than 10% in the past 7 months,[6] permits for new construction are improving, and mortgage applications and are up 11% from a year ago.[7]

[1] According to the *Wall Street Journal* survey of economists, the estimated probability of recession over the next 12-months remained near or above 50% from July 2022 to October 2023.

[2] Bank of America Global Fund Manager Survey – September 17, 2024. 40% of investors surveyed see a US recession as the biggest tail risk, more than twice as many who see an inflation reacceleration as the key tail risk.

[3] Based on the latest retail sales, consumption may grow 3.5% in 3Q, and spending by businesses on equipment and intellectual property is expected to grow 8-9%.

[4] The Atlanta Fed's GDPNow forecasts 3.1% for Q3 and the New York Fed's NowCast 3.0%.

[5] Based on data from Indeed.com

[6] New home sales have increased +11% smoothed three months and +8% unsmoothed (Jan – Aug 2024)

[7] Permits for new home construction are up 2% from July, based on a trailing 3-month average. Mortgage applications data is trailing 4-week average.

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Bottom Line:

Given a strong consensus for a Soft Landing and lingering Recession fears, No Landing would be the most contrarian scenario for markets. In fact, there are some hints that the dichotomy between strong spending and weak labor markets could resolve in favor of No Landing. Rates and some segments of the equity markets have overpriced a Soft Landing and would be vulnerable in this scenario.

- **CONSUMERS HAVE MORE DRY POWDER THAN EXPECTED:** the BEA's annual update revealed that the latest quarterly household savings rate is 5.2% (not 3.3% as previously thought) given higher estimated income.

Of course, these are still only hints of stabilization in the labor market and of recovery in housing, and other risks to the economy remain, such as still-high rates and a likely drop in government-driven activity. Nonetheless, No Landing would likely be a significant surprise to markets. In particular:

- **TOO MANY FED CUTS PRICED IN:** in a higher than expected growth (and inflation) environment, the Fed may only need to cut rates to 3.5%-4%, implying a 10yr yield of 4.0-4.25% (vs. 3.74% currently) and TIPS closer to 1.8-2% (1.55% currently).[8] Some speculative areas in the market which have benefited from the expectation of much lower rates, such as gold (and crypto-currencies to a certain extent), might also come under pressure.

- **EXPENSIVE DEFENSIVES AT RISK:** in a No Landing scenario, the equity market's bias towards defensiveness and away from cyclicals might come under pressure. And the bias for large cap, expensive, quality stocks, might shift towards lower quality stocks at lower multiples, in neglected areas like small caps and value.

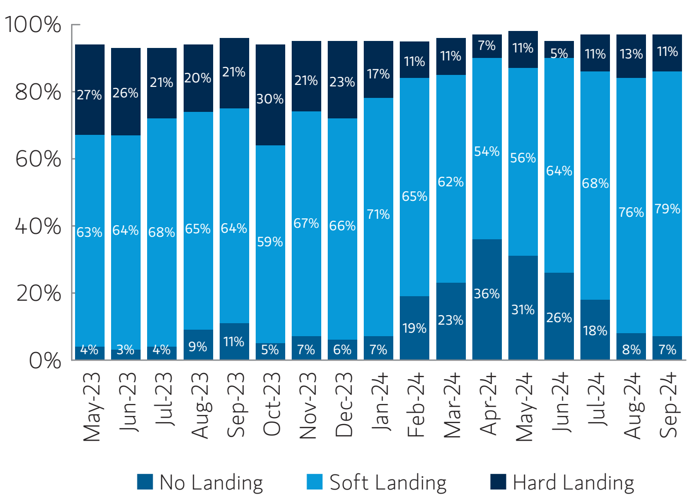
- On the other hand, current investor preference for US over international assets could stay well-supported, though record valuations are already worrisome.

BOTTOM LINE: Given a strong consensus for a Soft Landing and lingering Recession fears, No Landing would be the most contrarian scenario for markets. In fact, there are some hints that the dichotomy between strong spending and weak labor markets could resolve in favor of No Landing. Rates and some segments of the equity markets have overpriced a Soft Landing and would be vulnerable in this scenario.

DISPLAY 1

Few Investors Expect No Landing

BofA Global Fund Manager Survey: Most Likely Outcome in Next 12 Months



Source: MSIM Global Multi-Asset Team Analysis, FactSet, Haver Analytics and Bank of Americas. Data as of September 26, 2024.

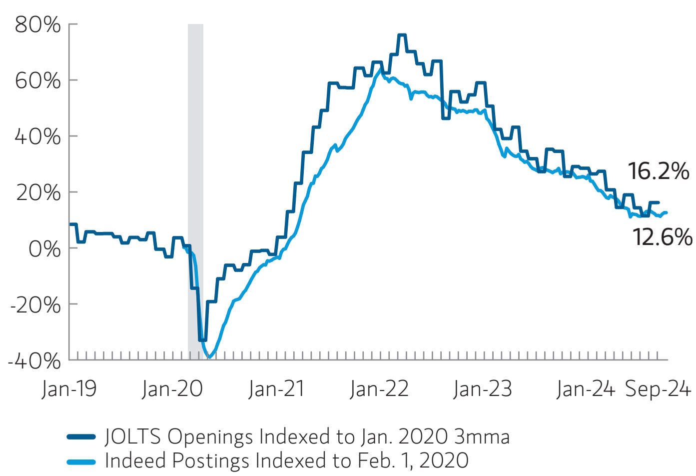
The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment.

Past performance is no guarantee of future results. Forecasts/estimates are based on current market conditions, subject to change, and may not necessarily come to pass.

DISPLAY 2

Job Openings Beginning to Stabilize

JOLTS Job Openings vs Indeed Job Postings



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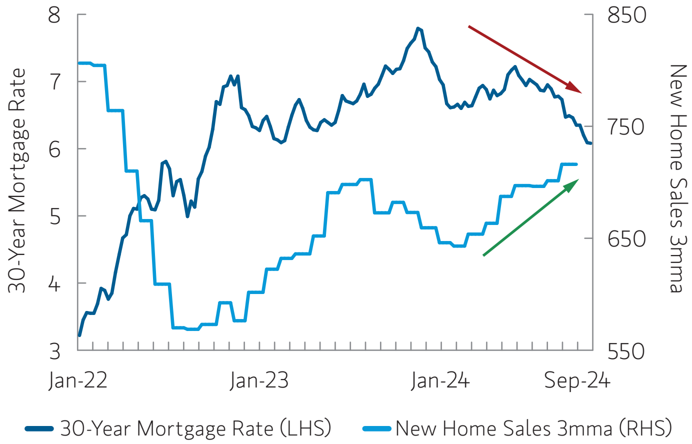
[8] The Fed's SEP (Statement of Economic Projections) indicate that the long-term equilibrium Fed Funds rate is 2.875% while rates markets have priced 2.85% Fed Funds by September 2025.

DISPLAY 3

Falling Mortgage Rates Support Housing Market

30-yr Fixed Mortgage Rate vs New Home Sales



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MIDDLE EAST

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