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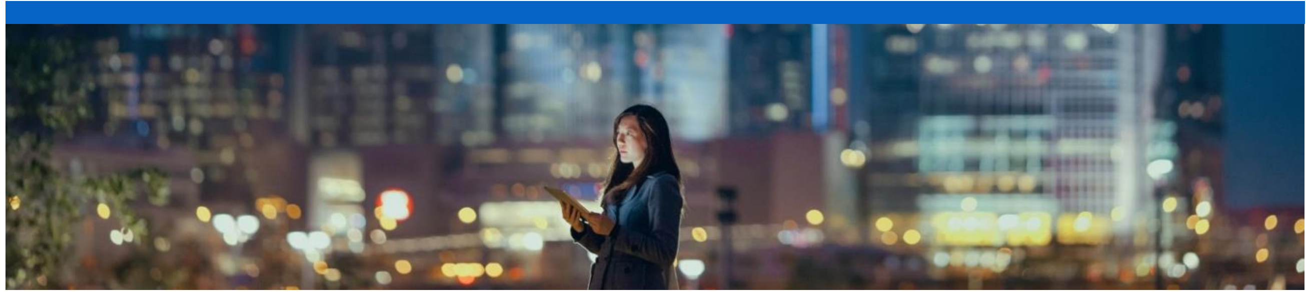

July 31, 2022

CIO Strategy Bulletin

What Powell and Markets Are Telling Us

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SUMMARY

- **Many argue that financial markets now price in a recession. We disagree. In our view, markets do not price in a collapse in the economy or corporate profits. For markets to "stay in the black" from here, a true recession – one with net US job losses measured in millions - would best be avoided.**
- **Whatever the semantics over the term "recession," observers should be more concerned about the outlook for both labor markets and corporate profits beyond the slowing that has already transpired.**
- **The Fed is beginning to see signs that the economy is more vulnerable, and therefore may be less brash in calibrating policy than its more recent highly confident views suggested. This alone reduces some of the risk of a severe recession.**
- **And just to make things more complex, we think GDP could turn positive as inflation cools in Q3 2022. Though jobless claims will rise, there is likely to still be net job creation, higher wages and sustained consumer spending, albeit at very modest levels. We also expect price declines at the retail level for many discretionary consumer goods that have now been stockpiled.**
- **At our last Global Investment Committee meeting, we raised our US bond overweight to nearly 10% in medium risk global portfolios. We did not underweight quality equities, however. We severely underweighted Japanese and European bonds instead.**
- **We believe equity markets have discounted higher interest rates, but have not adequately discounted severe weakness in cyclical industries apart from discretionary consumer spending. We are therefore emphasizing ownership of equities in non-cyclical industries and those with extremely high credit quality.**
- **Eventually, the extremes of any business cycle weakening will mean recovery for the most beaten down components in a new or "refreshed" business cycle recovery (see figure 10). We would not, however, want to jump to the conclusion that this is already underway. We look forward to taking greater portfolio risk when conditions are right.**

WHEN BAD NEWS IS GOOD NEWS AND VICE VERSA

Is this a recession or not? The answer is “yes” for some and “maybe” for others.

The Fed raised rates by 75 basis points for the second time in six weeks. Over just four months, its actions exceeded the cumulative raises it made across the whole 2010-19 economic expansion.

Negative consumer sentiment slowed consumer spending, but inflation-adjusted consumer outlays still managed to grow 1%.

The upheaval in the world economy over the past two years has broken many “rules of thumb.” Whatever the semantics over the term “recession,” investors should be more concerned about the outlook for both labor markets and corporate profits *beyond the slowing that has already transpired.*

Inflation remains high. Exogenous factors explain part of the hot inflation that is weighing down the economy; supply constraints, energy prices and food shortages being the big three. The Fed’s higher rates have actually accelerated inflation in housing costs.

Given all that has been thrown at the US and global economy, there are meaningful factors that suggest it is still growing. Real GDP in the US has contracted for two consecutive quarters. But net job losses have yet to occur, creating great hand wringing over what to call the current period. The headline GDP reflects the economy measured after inflation (“real” terms versus nominal dollar spending). Government spending, business investment and residential outlays all contracted in real (unit) terms in Q2.

Forward-looking indicators indicates more slowing in the labor market to come than the Fed suggests. US employment gains in the first half were a very strong +456,000 per month, slowing to a still strong +375,000 per month in 2Q. However, monthly gains and losses in employment ranged from an unprecedented -20 million to +5 million per month since the pandemic struck. At this moment, US employment is just back to its early 2020 level.

And just to make things more complex, we think GDP could turn positive as inflation cools in Q3 2022. Though jobless claims will rise, there is likely to still be net job creation, higher wages and sustained consumer spending, albeit at very modest levels. We also expect price declines at the retail level for many discretionary consumer goods that have now been stockpiled.

MARKETS LIKED THIS?

This past week’s optimism reflects higher expectations for a so-called soft landing. This implies that the Fed will get it “just right,” raising rates to drive down demand just enough to cool inflation meaningfully, but not so much as to cause the economy to spiral downward.

The severity of this downturn is a policy choice. While the Fed remains overly optimistic about the strength of consumer spending and labor markets, it was encouraging to hear Fed Chairman Powell acknowledge that growth is weakening. The Fed is beginning to see signs that the economy is more vulnerable, and therefore may be less brash in calibrating policy than its more recent highly confident views suggested. This alone reduces some of the risk of a *severe* recession.

The bond market tells the stock market’s story. The 10-year Treasury fell to 2.65% from a high of 3.47% just 7 weeks ago. At the end of last week, a recession-flashing “inverted yield curve” steepened slightly.

Equity markets liked this. Though the Fed is still expected to raise rates an unprecedented third time by 50 or 75 basis points in eight weeks, markets rallied mightily in July. The S&P has achieved its biggest gains since November of 2020 after a plunge of nearly 21% in the first six months of 2022.

That’s because the market expects that the Fed will have to stop raising rates sooner than previously thought. And why would they? To avoid an economic calamity. Get it?

Perhaps Powell should be viewed as a kind of phenom, showing his flashy determination to attack inflation with all he's got, while acknowledging just how much the economy is slowing in some sectors, like housing. He did this by saying the *magic words:* The Fed's actions would be "data dependent." That the Fed will actually look at the data is normal practice, but that shows you just how much investors thought the Fed would raise rates enough to crush inflation with no other regard.

RECENT IMPROVEMENTS IN BOND YIELDS ARE A BIG DEAL, BUT…

Investors are confused by the economy's recent current resilience and its future outlook. The US Treasury yield curve does not point to immediate economic weakness, but rather a future drop. The average lead time between significant curve inversions and recessions has been about 10 months (see figure 1.) How seriously the Fed takes this is an open question.

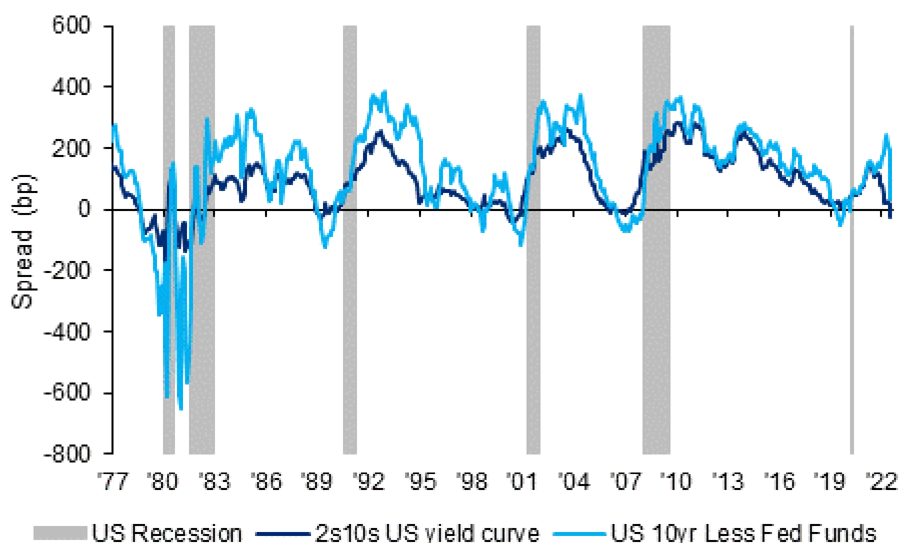
While an economic collapse is not certain, the depth and duration of the coming period of economic weakness remains unclear. High current levels of US corporate profits are truly at risk with central banks darkening business activity (see figures 2-3). While the 47% gain in US corporate earnings per share in 2021 makes current equity valuations look reasonable, it is much harder to grow profits after a boom.

Many argue that financial markets now price in a recession. We disagree. In our view, markets do not price in a collapse in the economy or corporate profits. For markets to "stay in the black" from here, a true recession – one with net US job losses measured in millions - would best be avoided.

We see the probability of our RESILIENT and RECESSION scenarios as (disconcertingly) about equal. Which way events unfold will depend on whether corporate profits flounder or actually sink. We also see a ROBUST gain in profits as the lowest probability. (See our Bulletin from March 27, "Three Scenarios for the Economy and Markets.")

For now, the bond market is stabilizing. In our May 29 CIO Bulletin, "Why We Believe Bonds Are Back," we described this as a necessary pre-condition for stability in the equity market. We also believe that credit costs and credit spreads will have to remain contained for there to be a subsequent improvement for equities.

Figure 1: US 10s-Fed Funds yield curve vs recession periods: Average lead time between curve inversions and recessions has been 10 months



Source: Bloomberg as of July 27, 2022. Shaded areas note recession. Past performance is no guarantee of future results. Real results may vary.

Figure 2: S&P 500 EPS vs trend

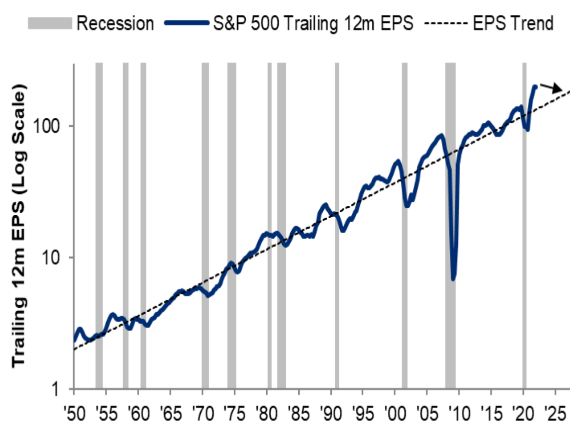


Figure 3: 2-year change in US 10-year Treasury yield (leading 18 months) vs S&P 500 EPS

Source: Bloomberg as of July 27, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. Grey areas note recession.

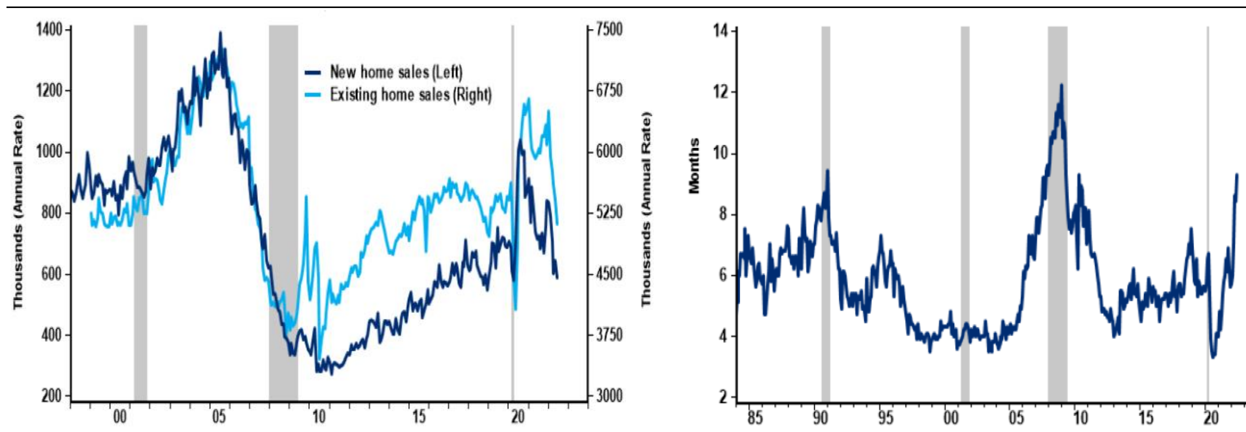
KEEP YOUR EYE ON THE US HOUSING MARKET

Clues to the depth and duration of any downturn may be visible in the housing market. (See our June 25 CIO Bulletin, "A Big Chill? Housing, Inflation and the Fed"). The pace of aggregated new and existing home sales has already fallen 26% (see figures 4 and 5). In just a few months, there has been a jump in unsold inventories of newly constructed dwellings that will weigh on construction ahead.

The absolute gains and losses in the housing market in the recent past and likely future pale in comparison to the 2006-2009 period. This suggests a mild recession in comparison to that period. However, investors should still be wary of housing's broader signal for future consumer spending and employment (see figures 6 and 7). The drop in housing activity will lower the need for housing-related merchandise and even auto sales. This will slow US imports, and transmit some US weakness to the world economy. It will also slow the demand for labor to produce these goods in the US and abroad.

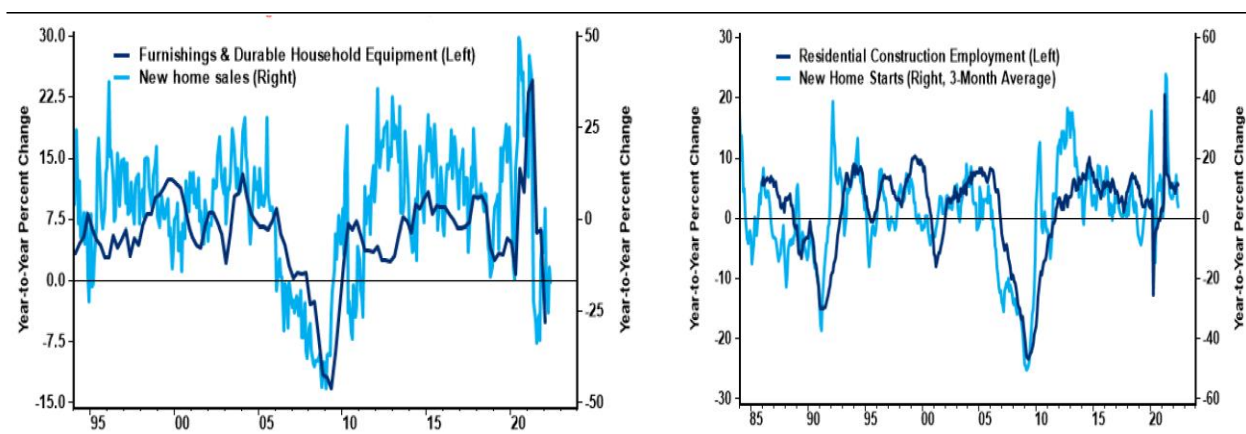
The Fed's rapid interest rate increases have crushed residential sales, but this will (ironically) increase inflation in the near term as the lack of affordability drives rents higher. Eventually, but perhaps too late, overall housing inflation measures will fall.

Figure 4: New and existing home sales down 26% from peak **Figure 5: Supply of new homes in months**



Source: Haver Analytics as of July 27, 2022. Grey areas note recession.

Figure 6: US Consumer Spending on Housing Durables and New Home Sales **Figure 7: Residential construction employment vs US Housing Starts**



Source: Haver Analytics as of July 27, 2022. Grey areas note recession.

OUR INVESTMENT STRATEGY

We are certainly not out of the woods regarding corporate profits and the direction of the stock market. As we discussed in the July 9 CIO Bulletin, "Assessing This Bear Market's Depth and Duration," we believe the current reporting period for corporate profits will still net a 4% gain from 2Q 2021. The full year 2022 is likely to show mid-single-digit corporate profit gains. In contrast, share prices are down 16% since the start of the year.

Equities must discount both higher capital costs and weaker profits. With a near 200-basis-point rise in most corporate bond yields this year, we believe they have largely discounted higher interest rates. Future profits, however, depend on the economy's path going forward and this is uncertain based on the Fed's future rate hikes and further tightening via QT. We believe the Fed chronically underestimates the impact of its shrinking balance sheet on lending conditions. Private sources of credit availability are already showing signs of contraction. This will harm weak borrowers and raise capital costs (and therefore lending yields) for all.

At our last Global Investment Committee meeting, we raised our US bond overweight to nearly 10% in medium risk global portfolios. We did not underweight quality equities, however. We severely underweighted Japanese and European bonds instead.

IT IS ALL ABOUT QUALITY

We believe equity markets have discounted higher interest rates, but have not adequately discounted severe weakness in cyclical industries apart from discretionary consumer spending. We are therefore emphasizing ownership of equities in non-cyclical industries and those with extremely high credit quality (see figures 8-9).

Eventually, the extremes of any business cycle weakening will mean recovery for the most beaten down components in a new or "refreshed" business cycle recovery (see figure 10). We would not, however, want to jump to the conclusion that this is already underway.

Furthermore, we believe that the underperformance of growth shares vs cyclicals has already played itself out (see figure 11). It does not, however, mean that technology investors should expect an acceleration in profits near term.

Whether we have a full-blown recession or an economic malaise, the ensuing recovery will look nothing like the 2020-2021 period. Back then, we believed that right after economic activity and corporate profits sank to a depressed level, huge stimulus would drive profits higher. They sure did.

Now we need more data to assess whether a new period of cyclical acceleration is possible or whether deeper declines in activity will come first. In either event, we look forward to taking greater portfolio risk when conditions are right.

Figure 8: Stability for Defensives: Pharmaceuticals vs Industrials Share prices Y/Y%

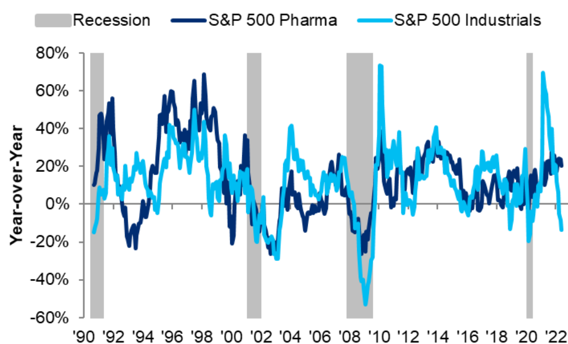
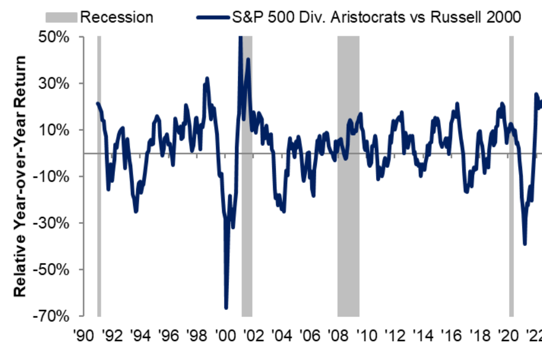
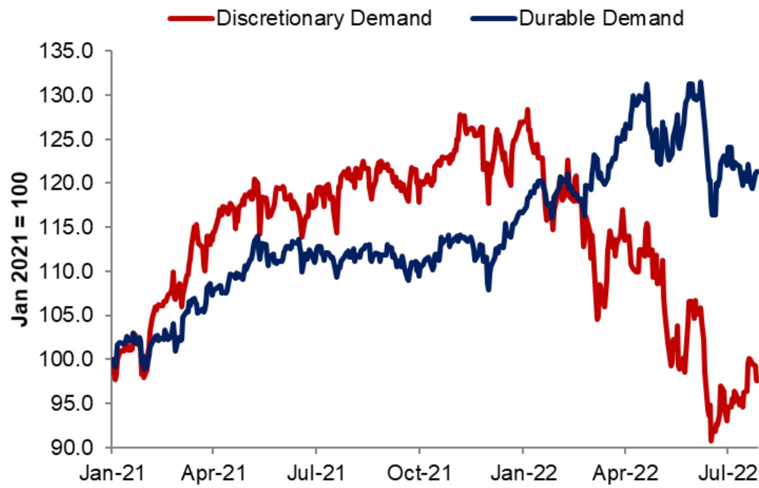


Figure 9: Dividend Aristocrats Relative Performance vs Small, Mid-Cap Shares



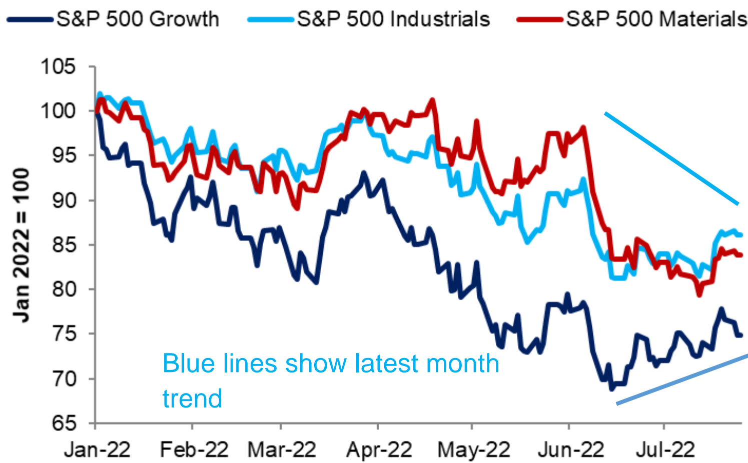
Source: Haver Analytics through July 27, 2022. Note: Dividend Aristocrats are US firms that have raised dividend payments for 25 or more consecutive years. SMID is Russell 2000 Index. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Past performance is not indicative of future returns. For illustrative purposes only.

Figure 10: Essential vs discretionary demand shares



Source: Bloomberg as of June 2, 2022. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary. Note: Discretionary demand industries are household durables, specialty retail, textiles, apparel & luxury goods, residential RETs, Hotels, Restaurants & Leisure, Financials and Airlines. Durable demand industries are Food, Beverage & Tobacco, Energy, Utilities, Health Care, Telecommunication services.

Figure 11: Cyclicals vs growth, relative performance



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