Citi Global Wealth Investments

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CIO Strategy Bulletin

Identifying Winners and Losers If the Fed Drives a Recession

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SUMMARY

- The US economy continues to grow in the face of higher interest rates and a curtailment of balance sheet credit. In fact, the labor force grew by 786,000 jobs, led by women, young and old, returning to the workforce as the unemployment rate increased to 3.7% from 3.5%.
- What is most heartening about these trends is the absence of wage inflation. Average hourly earnings rose 0.3% (3.6% annually) an ordinary pace of wage growth hardly symptomatic of a tight, "overheating" labor market.
- The Fed's policy impatience is a bigger risk to the US economy than slowing demand. The next time the Fed eases, it may not be a cure for a cyclical contraction. Rather, it is more likely to signal that they have "succeeded" in causing a major deterioration in employment and must react to it.
- Outside of the retailers and large US banks, corporate executives and sell side analysts still seem reluctant to acknowledge a more challenging macroeconomic policy backdrop when issuing guidance and earnings forecasts. While upgrades are no longer outpacing downgrades, an aggregation of their expected earnings growth rates for 2023 has barely budged despite the equity market correction so far this year.
- Recessions over the last 30 years have varied widely in their severity, duration and impact at the sector level. In this Bulletin, we consider market valuations after adjusting for a typical recessionary profits decline. By this measure, the market still looks somewhat expensive at over 20x EPS. Nonetheless, there are major differences between sectors that investors should be mindful of.
- Our equity portfolio strategy is geared to weather a potential earnings recession. Our core allocation to dividend growers continues to outperform as the market abandoned the wish for a Fed pivot. Further, our view that "Bonds are Back" and that investors should seek higher yields from better credits remains fully intact.

First, the Good News

The US economy continues to grow in the face of higher interest rates and a curtailment of balance sheet credit. In this past week's employment report, we saw evidence that labor supply was also growing to meet the needs of employers. In fact, the labor force grew by 786,000 jobs, led by women, young and old, returning to the workforce as the unemployment rate increased to 3.7% from 3.5%.

What is most heartening about these trends is the absence of wage inflation. Average hourly earnings rose 0.3% (3.6% annually) an ordinary pace of wage growth hardly symptomatic of a tight, "overheating" labor market (see figure 1.)

Inflation looks to be coming down again for August 2022. As we experienced in July, consumer prices were flat to down. Retail gasoline prices fell 13% during the month, food commodities were flat and other prices for consumer goods are moderating. This reflects an abundance of inventory (please see our forecast update in Quadrant - August 2022).

The combination of positive economic growth, lower inflation, a larger workforce and a gradual rise in wages is precisely the recipe for "healing" in a post-Covid world. Rebounding real incomes should help consumer confidence as exogenous shocks - from supply chain disruptions to commodity shortages - begin to fade. In an environment like this, employers are more likely to retain worker than fire them unless economic conditions deteriorate meaningfully.

ISM Manufacturing was 52.8 in August, a level comparable with June and July, showing that factory output remains positive, not yet reflecting the inventory build-up we have seen more broadly in the economy. The Conference Board's Consumer Confidence Index rose 7.9 points to 103.2 as inflation concerns moderated due to lower gas prices. This suggests that consumers will continue to spend and that as inflation abates and energy prices moderate, that spending will flow to more discretionary items.

Policy Impatience is a Bigger Risk than Slowing Demand

As we noted last week (Aug. 29 CIO Bulletin – Taming Inflation is Priority One), Fed Chair Powell said that despite inflation showing signs of abating, the Fed is set to deliver the largest policy rate hikes for a single year period in history. With both rate hikes and QT, the Fed appears set to tighten policy well into 2023.

If the Fed ignores positive inflation developments and continues on its rapid tightening path, we believe that only a decisive weakening in employment will cause it change course. Given the data presented herein, one can see that the Fed will have to sustain its higher rates for longer to intentionally diminish aggregate demand and point employment downwards. Forward-looking financial conditions – measured with both bank lending standards and US equities – already suggest a moderate contraction in employment will come in the year ahead.

Our forecast update last month incorporated a sub-1% 2023 GDP gain for the US, with a likely period of economic contraction during the first half 2023. We expect global growth next year to be the weakest of the past 40 years apart from the COVID shock and 2009.

This is why policy impatience is a bigger risk than slowing demand. The next time the Fed eases, it may not be a cure for a cyclical contraction. Rather, it is more likely to signal that they have "succeeded" in causing a major deterioration in employment and must react to it.

Follow Earnings

While the Fed is focused on labor markets as a forward-looking risk for inflation, the business cycle already shows ample and growing downside risks from excess consumer goods and housing inventory. The record pace of retail inventory gains will logically result in a production and trade contraction in the coming year that drives US corporate profits down by about 10% overall (Figure 2). But we need to look sector by sector to see pockets of strength and weakness. Cyclical industries bear the brunt of EPS declines during recessions.

Figure 1: US Average Hourly Earnings Month/Month % Change

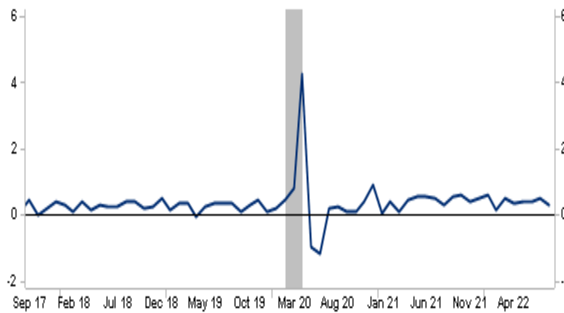
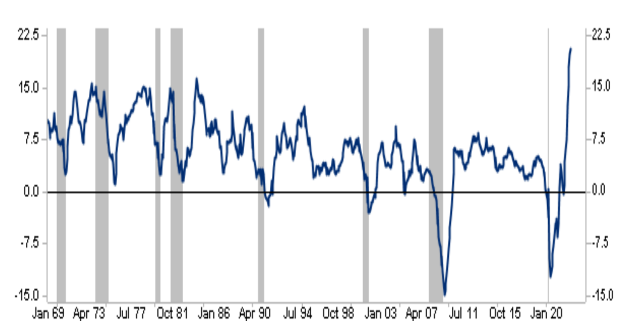


Figure 2: Nominal US Retail Goods Inventories Y/Y%



Source: Haver Analytics, September 3, 2022. Note: Shaded areas are recessions. 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.

Analysts Remain Overly Bullish

With Q2 earnings season behind us and Q3 results not due for another six weeks, investors are left to contemplate how a worsening macro backdrop may impact profits over the next several quarters. Outside of the retailers and large US banks, corporate executives and sell side analysts still seem reluctant to acknowledge a more challenging macroeconomic policy backdrop when issuing guidance and earnings forecasts. While upgrades are no longer outpacing downgrades, an aggregation of their expected earnings growth rates for 2023 has barely budged despite the equity market correction so far this year (figures 3-4).

Figure 3: S&P 500 earnings revisions

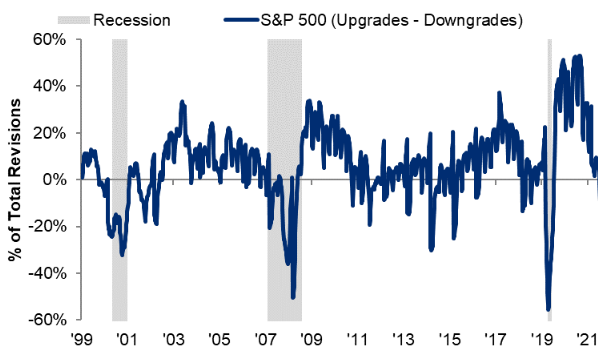
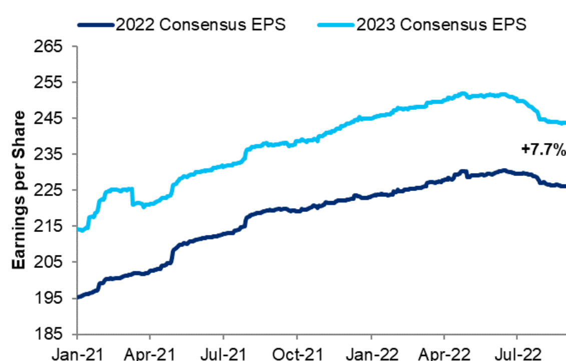


Figure 4: Consensus (bottom-up) EPS estimates



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The Most Vulnerable Sectors

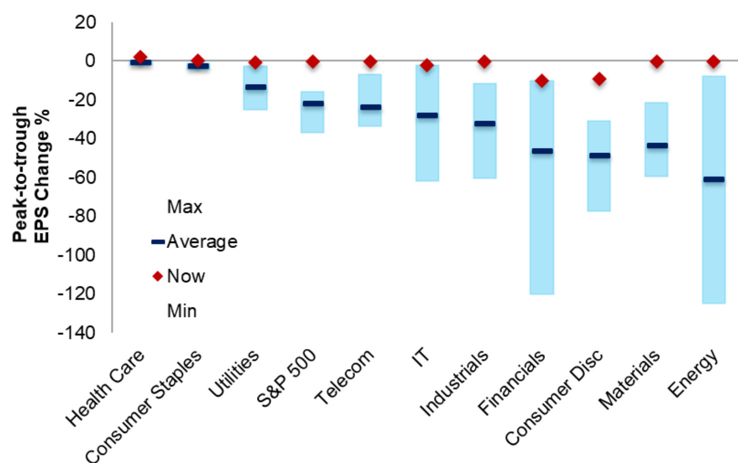
Given the roughly 50% odds of "full blown" recession next year, we have adjusted portfolios to reflect our concerns. In August – ahead of Powell's speech at Jackson Hole – we reduced our broad exposure to energy and materials, which have yet to price in a meaningful drop in profits. We've retained defensive assets likely to exhibit more resilient underlying earnings and shareholder payouts in a recession.

Recessions over the last 30 years have varied widely in their severity, duration and impact at the sector level. While the dot-com bust in the early 2000s was led by a sharp drop in tech spending, digital technologies surged during the V-shaped pandemic period. The recession of the early 1990s was fairly mild in nature and driven by a combination of Fed tightening and an oil shock (sound familiar?). Meanwhile the US housing market collapse in 2007/08 precipitated the most severe global economic downturn in almost a century.

Sector Performance Ranges

The range of sector-level profits declines associated with recessions varies from 1990 to the present (Figure 5). In red, we overlay the current level of profits relative to their peak over the last 12 months. Outside of financials and retailers, few sectors have even begun to report falling earnings through the first half of 2022. While we do not expect a profits contraction similar to the severe 2008/09 period, even shallow recessions consistently lead to double digit EPS declines in more economically sensitive industries.

Figure 5: Range of earnings declines during recessions since 1990



Source: Bloomberg, IBES as of September 2, 2022. Past performance is no guarantee of future results. Real results may vary.

Interpretations

It is, of course, possible that we are being too conservative, as a profits recession can be avoided in the event that the Fed looks more practically at future inflation trends, rather than lagging indicators in setting policy. But a more likely explanation is that corporate executives - and the analysts who follow their words - reflect mostly on current business trends rather than the future impact of central bank policy tightening. Indeed, continued profits strength in Q2 confirms that there was no early 2022 recession, in spite of two quarters of negative real GDP growth.

Yet continued Fed tightening has always led to a slowdown in the US labor market and profits. A surge in inventories and slowdowns in new orders are all forward-looking consequences.

Beware Energy and Materials; Beloved Health Care and Staples

At the sector level, energy and materials stand out as most vulnerable to a correction as cooling global demand dents commodity prices (Figure 6). Slowing Chinese economic growth, a continued reduction in new orders out of the US and potential production cuts ahead of European winter could all have the effect of reducing energy, metals and chemicals demand into year-end.

The sectors where we are likely to see much less variability in profits include health care and staples (Figure 7). Even though these sectors have already outperformed the market thus far in 2022 by 5% and 11% respectively, we find it difficult to justify shifting portfolios towards a more cyclical allocation before profits have even begun to decline for most of these segments.

Figure 6: S&P 500 Energy EPS vs WTI Crude

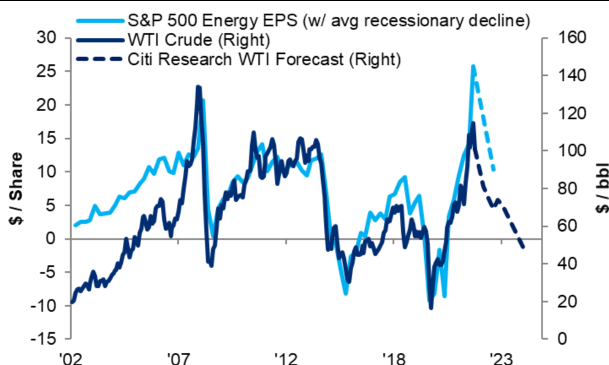
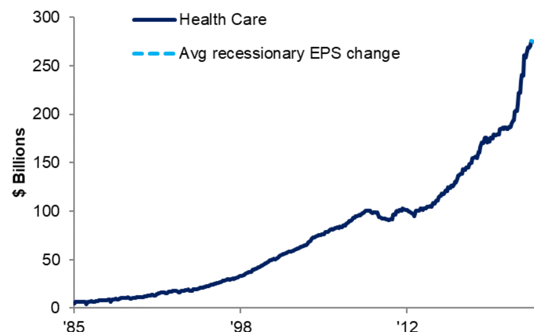


Figure 7: Health care earnings per share



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Earnings Analysis: What Happens in a Recession?

With long-term rates unlikely rise meaningfully further, earnings will become the key focus for equity investors for the remainder of 2022. We believe that both trailing and consensus estimates are too high for the next 4-6 quarters. Therefore, we prefer to consider market valuations after adjusting for a typical recessionary profits decline (Figure 8-9). By this measure, the market still looks somewhat expensive at over 20x EPS. In particular, while energy seems cheap relative to the last 12 months' earnings, the sector's outlook is less rosy if a global recession drives oil prices meaningfully lower.

Figure 8: S&P 500 sector valuations assuming recessionary EPS

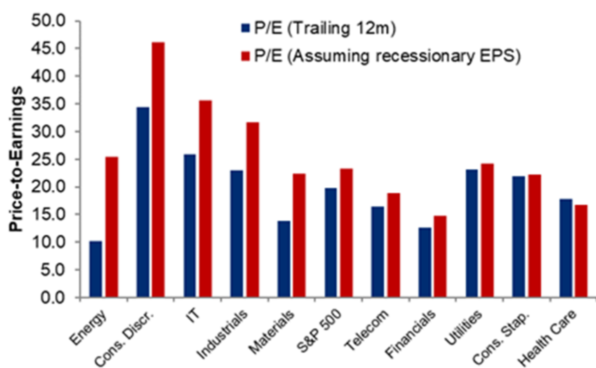
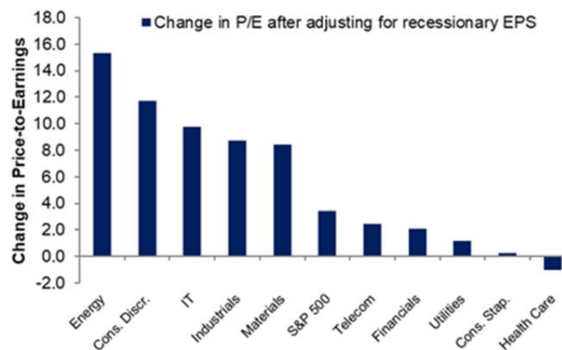


Figure 9: Change in valuation after EPS adjustment



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Bank Earnings Reflect Likely Fed Actions

The one cyclical sector that does not appear over-valued after adjusting for a potential earnings decline are Financials (Figure 8, above). This is in part due to the fact that banks are among the few sectors proactively preparing for a more challenging year ahead, with the major financial institutions all preemptively raising loan loss reserves in Q2 resulting in real-time EPS declines. Senior credit officers are

also acknowledging that they've tightened lending standards – both out of prudence and as a result of this year's regulatory stress tests – which has a lagged impact on earnings for the broader market (Figure 10).

If banks look cheap, boast strong balance sheets, and are already closer to pricing in recession-level earnings, why aren't we more constructive on bank shares? In the post-GFC era, bank returns have been highly dependent on their ability to return capital to shareholders in the form of dividends and buybacks. With recession potentially looming, banks have already suspended buybacks and stand at the mercy of US regulators when it comes to dividend payout growth. That said, more restrictions to common shareholders are likely *good news* for investors in bank securities higher in the capital structure. Indeed, we prefer to play Bank financials strength via preferred shares, which now pay a higher dividend than the total payouts being made to common shareholders (Figure 11).

Figure 10: Bank lending standards and S&P 500 EPS

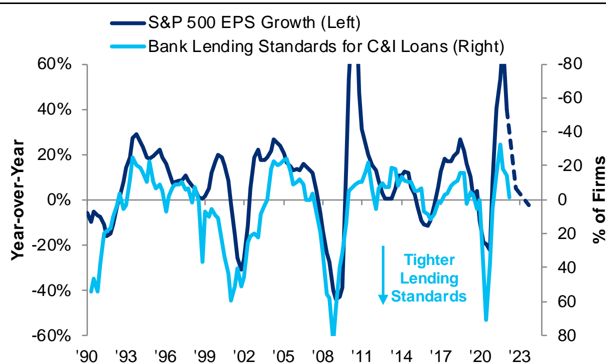
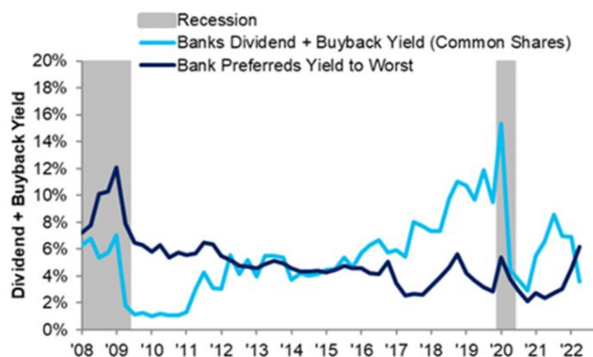


Figure 11: Bank common vs preferred payout yields



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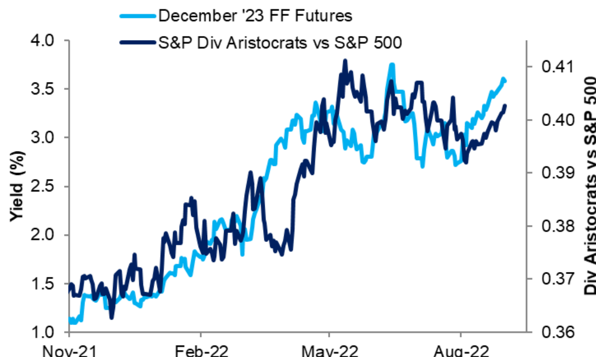
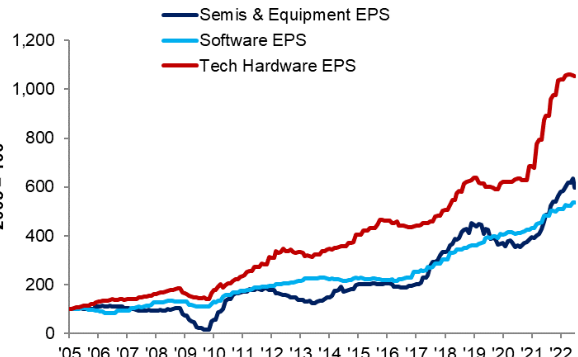
Conclusions: The Value of Stability is Greater Now

Our equity portfolio strategy is geared to weather a potential earnings recession. Our core allocation to dividend growers continues to outperform as the market abandoned the wish for a Fed pivot (Figure 12). Within health care, global pharmaceuticals should be less cyclical than other segments like health care equipment and medtech. In Information Technology, we prefer software over semiconductors. Areas like cyber security and enterprise software tend to operate with stickier contracts and generally less economically sensitive business models than hardware makers (Figure 13).

Figure 12: Dividend growers relative performance vs Fed Funds futures pricing

Figure 13: Tech EPS by industry group





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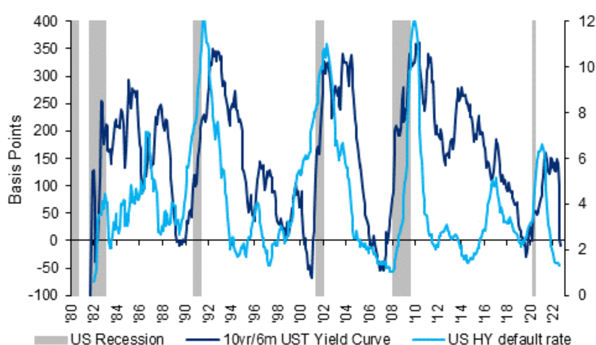
For Credit, An Early Warning Indicator – Stick with Quality Only

The Fed's near-term policy actions are likely to drive a weakening credit environment in the coming year (see Figure 14). As Fed credit is withdrawn and as banks tighten lending standards, the slowing economy will stress companies with thin balance sheets. A transition to slower growth and weaker credits will likely drive interest rates for high quality bonds down, but drive up yields for the weakest quality borrowers.

Overall, US bond yields now well exceed US equity dividend yields (figure 15). This leaves us with a higher tactical allocation to US investment grade bonds than US equities in asset allocation portfolios. "Bonds are Back" is our message for investors who can take advantage of higher market rates after the first half 2022 Fed-driven rout.

Figure 14: US Yield Curve (10s less 6 Month bills) and Corporate Default Rate

Figure 15: US Aggregate Bond Yield vs S&P 500 Dividend Yield (%)



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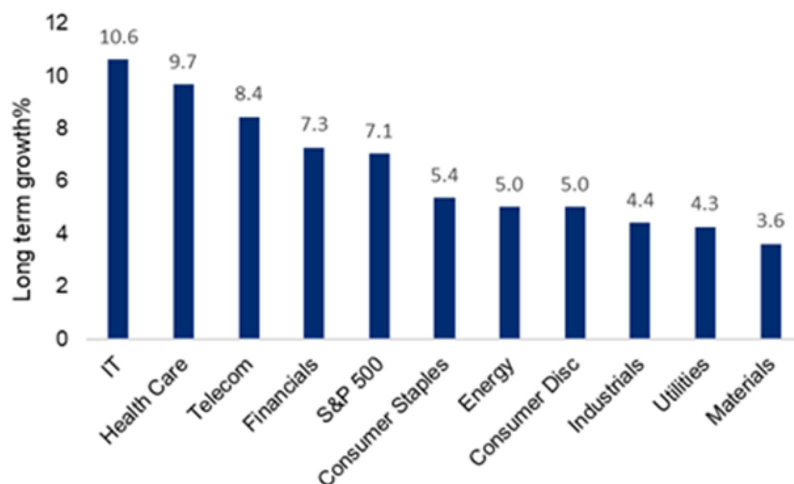
It is the expectation of rising profits and dividends that give equities their value and ultimately drive their stronger *long-term* returns. This is merely interrupted during cyclical contractions. For both bonds and equities, sector and quality allocations that swerve from cyclical risks appear better suited for the environment just ahead.

With that in mind, investors seeking to market time by trading wholesale in and out of equities risk missing out on not only compounding dividend income but also the eventual recovery in profits that very well may be the story of markets a year from now (see figure 16).

Figure 16: Annualized EPS growth by sector (since 1995)



Source: Bloomberg as of September 2, 2022. 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.

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