Market Perspective from the Investment Advisory Group

Our view of recession and why this is a better place to trim equities

July 28, 2022

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Highlights

- Talk of recession seems strange when looking at the labor market, even though it's a lagging indicator. However, it isn't unusual to see employment growth in the early stages of a recession.
- Regardless of whether we call it a recession or not, the important message is the economy is slowing and that is set to continue.
- From a market perspective, we see equities stuck in a range.
  - At this point, the market has rebounded over 10% from the mid-June lows. But, given an ongoing slowdown in the economy and earnings risks, our view is that the S&P 500's near-term upside is limited in the 3% to 6% range (4200-4300) from its current level near 4070.
  - Conversely, the low end of the range, ~3650, should be well supported with the moderation in interest rates helping to cushion price-to-earnings (P/E) ratios. Still, the bottom end of the range represents about a 10% decline from current levels.
- **Near the mid-June lows, we discussed that we would not be selling equities given how oversold the market had become. However, with the strong equity rebound since then and our view that the near-term upside is capped, for those investors who are overallocated to equities relative to their long-term targets, this would be a more reasonable place to trim exposure.**

What happened

The initial reading of second quarter U.S. gross domestic product (GDP) came in at -0.9%. This marks the second consecutive quarter of negative economic growth.

Our take

Many people think of back-to-back quarters of negative GDP growth as a recession. However, this is **not** an official definition of recession in the U.S. Instead, the Business Cycle Dating Committee at the National Bureau of Economic Research (NBER) is the official arbiter of the business cycle. It calls a recession based on many factors, including four primary indicators – Industrial production, nonfarm payrolls, real personal consumption expenditures, and personal income excluding transfer receipts. These indicators are considered coincidental, as opposed

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to leading, but they **currently suggest the U.S. is not yet in a recession, or at least wasn't in one during the first half of the year**.

While the jobs market is a lagging indicator, in some ways it seems strange to be discussing recession when looking at how strong employment has been. In the first half of the year, the U.S. economy added an average of **456 thousand jobs per month, the second highest ever, after last year.**

For perspective, in 2019, the last year before the pandemic, monthly jobs averaged **160 thousand**. Still, while unusual more recently**, it's not unprecedented to see employment continue to rise during a recession. For example, in the recession that began in 1973, monthly employment stayed positive for nine months early in the recession**.

Regardless of whether we are in a recession or not, the important message is the economy is slowing.

While a recession is not a forgone conclusion, our team puts recession risk over the next 12 months at greater than 50% based on several factors:

- The Federal Reserve (Fed) continues to tighten monetary policy into a weakening economy in order to tame elevated inflation. If this results in a recession, it believes the tradeoff is worth it.
- Historically, once inflation exceeded 5%, it typically took a recession to bring it back down; inflation as measured by the Consumer Price Index or CPI is currently at 9.1%.
- The yield curve has inverted.
- Financial conditions have tightened.
- Leading economic indicators are down for four consecutive months.
- Consumer sentiment (Michigan survey) is at its lowest level in history.
- Initial jobless claims have been rising from depressed levels.
- Consumers are being hurt, especially the lower income cohort, by the triple hit of higher food prices, housing prices, and gas prices.
- Consumer excess savings remain elevated, but the savings rate is moving lower and revolving credit is moving higher.
- The Fed is projecting a rise in the unemployment rate.

What we've historically seen in a recession

The average recession since 1950 has lasted 10 months; the longest one was the global financial crisis at 18 months, while the shortest was the 2020 COVID-induced recession at two months.

If we have a recession, a reasonable assumption is that it will be relatively mild (two quarters or so) given the strong shape of the consumer, low debt service levels, and excess cash. That said, the recession's downside and duration could be worse than this view if inflation stays stickier, similar to the 1970s.

Market implications

At the June lows, the S&P 500 was down almost 24%, which is in line with the median decline of past recessions. Granted, the average decline is 29%, and we could overshoot that, but at least some of today's economic slowdown was reflected in stock prices. Thus, the second quarter's negative GDP print was taken in stride.

Where to next – Equities stuck in a range but now at the upper end

Near the mid-June lows, we discussed that we would not be sellers at those levels given the S&P 500 moved to one of its most oversold levels in the past 30 years and also saw one of its sharpest year-over-year P/E contractions. Less than 5% of stocks were above their 50-day moving average, for example. Since then, stocks have moved a long way in a short period of time —the S&P 500 is up more than 10%.

Given an ongoing slowdown in the economy and earnings risks, **our view is that the S&P 500's near-term upside is limited in the 3% to 6% range (4200-4300) from its current level near 4070**. Already, based on current forward estimated earnings, the S&P 500's forward P/E has rebounded from **15.3x in-mid June to roughly 17x,** its 10-year average.

Conversely, the low end of the S&P 500 range, ~3650, should be well supported with the moderation in interest rates helping to cushion P/E ratios. Still, that level represents about a 10% decline from current levels.

Thus, the short-term risk-reward does not look that appealing, in our view. This is even as our work suggests that generally stocks have a **more favorable outlook over the next three years and longer after a 20% decline. That's why individual time frames are so important; as is having an asset allocation aligned with ones' goals and risk tolerance**.

Bottom line

Regardless of whether we call it a recession or not, the important message is the economy is slowing and that is set to continue. Near the mid-June lows, we discussed that we would not be selling equities given how oversold the market had become. However, with the strong rebound and our view that near-term upside is capped, for those investors who are overallocated to equities relative to their long-term targets, this would be a more reasonable place to trim exposure.

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CN2022-4877583.1