the advisor

Winter 2022

There Will Be Pain

"We have got to get inflation behind us. I wish there was a painless way to do that, there isn't ... there will be pain."
Jerome Powell
Chair, US Federal Reserve

Welcome to the age of dearer money.

Thanks to resurgent inflation, the US Federal Reserve has raised interest rates more aggressively than at any time since the 1980s, dragging along other central banks in its wake.

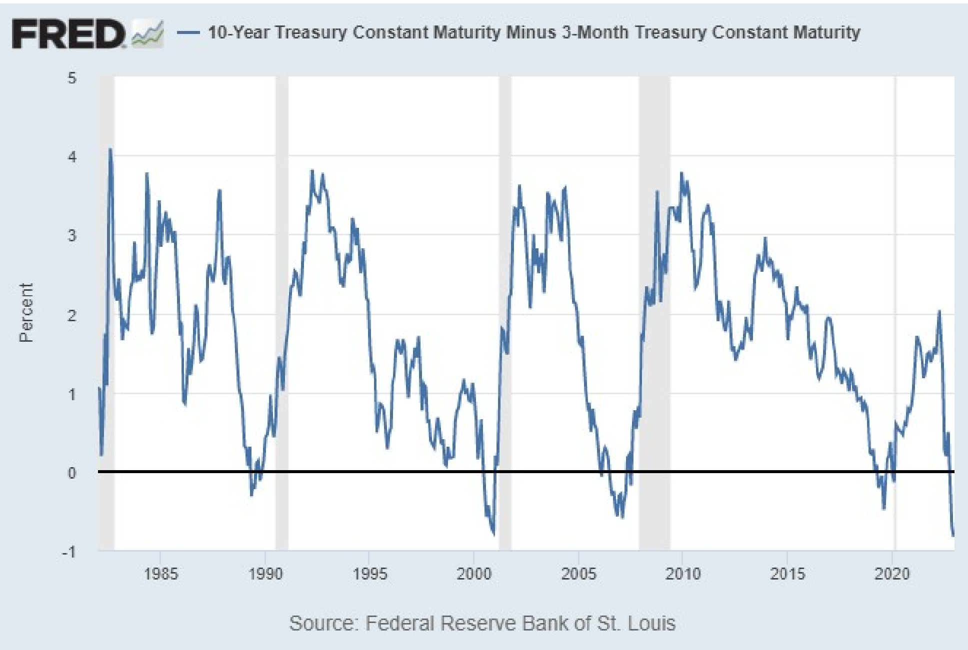
Investors must transition this regime change to one of higher interest rates and scarcer capital. Adaptation may not be easy, but taking the long view could help. The new regime has history on its side; it was the era of cheap money that was so out of the ordinary.

That era - from the global financial crisis in 2008 to the onset of the pandemic in early 2020 - was marked by ultra-low interest rates and an unusual macroeconomic environment. Those low rates were accompanied by quantitative easing or purchases of bonds by the Fed to inject liquidity into the economy. The effects were dramatic: frothy asset prices and a fear-of-missing-out psychology amongst investors. But that was then.

Today the Fed is adamant it will continue to hike rates and keep them there until its inflation battle is complete. The effects of this year's steep rise in rates have been remarkable. The 20% drop in both stock and bond markets has been painful and may not be finished. No rule stipulates that asset prices which have fallen a lot cannot fall further still. So markets are rightly jittery as they await signals from the Fed about the pace of further interest-rate rises.

With economic activity impacted by higher rates and inflation, the odds of a slowdown or a recession are elevated. Anything, including stagflation, is possible. How likely is America to enter a recession? And if so, when?

Let's first of all define a recession.



While many economists refer to two consecutive quarters of negative GDP growth as the principal confirmation of a recession, the US National Bureau of Economic Research (NBER) prefers to examine a broader range of economic activities, such as real personal income and personal expenditures, employment, inflation-adjusted retail sales, industrial production and corporate profits. In other words, NBER focuses on consumers, the labour market and corporate activities for signs of recession. Keep in mind they report retrospectively, that is after the fact.

According to NBER, consumer spending and the labour market - while tight - slowed down in the last quarter. America isn't in an obvious recession, and there have been no widespread job losses or significantly negative earnings growth. Yet, the direction of the economic trend is certainly lower.

The yield curve and credit spreads are well-documented indicators of where we're at in the business cycle. In normal economic conditions, investors are rewarded with higher interest rates for holding bonds over longer time periods, resulting in an upward sloping yield curve. This is because these longer returns factor in the risk of inflation and of default over time. When interest rates on long-term bonds fall lower than those of short-term bonds, it results in an inverted yield curve. Notably, an inversion of the yield curve is essential to market outcomes and to the onset of a recession.

In October the interest rate spread between the 10-year Treasury note

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There Will Be Pain (cont'd)

and the 3-month Treasury bill inverted. This has been a precursor to the past eight recessions stretching back to the 1960s, with no misses or false positives thus far. (See chart previous page). Timing is vague as this indicator leads recessions by 6 - 18 months on average. Recession sometime in the spring or in late 2023?

Hedge fund manager, Alfonso Peccatiello, employs several useful indicators to determine the potential timing of recessions.[1]

The October update of Peccatiello's ... "Global Credit Impulse index points to a further deterioration of the pace of real-economy money creation. The global credit impulse leads S&P 500 earnings growth roughly 9 -10 months, and given its rapid decline in 2022 it's now pointing to negative YoY EPS by March 2023…" Historically, rapid declines to negative levels in this indicator have preceded year over year earnings contraction in the 10% - 15% range.

Another forward looking index is published by the US Conference Board. It incorporates the top ten statistically significant leading indicators for the US economy. "Its track record in anticipating recessions is very solid: over the last fifty years, every time the year over year series of this index printed in negative territory for two consecutive months a recession occurred. The most recent trigger was hit in August 2022, and the median lead time is seven months, [which puts the] start of the recession at March 2023."

Housing-related jobs and economic activity represent 12% - 15% of the American economy. The interest-rate sensitive nature of the property business makes it prone to respond quickly to changing economic conditions and sentiment. The National Association of House Builders housing index leads trends in US unemployment rate by roughly twelve months. According to the Federal Reserve's 'Sahm Rule', "… a recession starts when the three-month moving average of the US unemployment rate (U3) rises by 50 basis points (bps) relative to its low during the previous twelve months. In this case, 4.2% unemployment rate is the target. Looking at the sharp deterioration in housing activity and the usual twelve-month lagged effect it has on the labour market, that target unemployment rate could be surpassed by [summer 2023]. The unemployment rate might rise to the 6% - 7% area by late 2023, almost double where it stands today."

The Philadelphia Fed survey is another valuable indicator. This survey goes out to roughly one hundred chief executives of select companies and tends to have a good sense of where economic activity is going. "One of the most important parts of that survey is the 'Forecast for New Orders' subsection, where CEOs are asked about what they see ahead for business activity. Over the last forty years, every time the 12-month moving average of the Philly Fed New Orders dropped below 15 for two consecutive months, a recession followed. That trigger was hit in September 2022, and the average lead time for a recession is 8 months, so May 2023?"

Tracking the trend and the rate-of-change in commodities give us a real-time look at broader demand pressures. For instance, the Copper-to-Gold Ratio tells us whether the real economy is set to accelerate or decelerate in growth. According to Peccatiello, "… the Copper/Gold ratio against the year over year EPS growth in the S&P 500 companies suggests earnings should soon flatline and head into negative territory by March 2023." Continued industrial commodities underperformance against precious metals would be a red flag.

While America recorded two quarters of negative GDP growth in the first half of 2022, the upcoming economic contraction is likely to involve job losses and negative earnings growth - hence fulfilling the NBER criteria for a recession. The base case of Peccatiello's favourite indicators suggest a recession starting in the spring of 2023.

The stock market has not yet priced in a recession. With rates and inflation eroding economic activity, forward earnings estimates should adjust lower. In an average recession, earnings typically drop by 30%, so stocks will have to reprice lower too. In anticipation of economic difficulty, the bond market has priced in the Fed cutting rates by ~50 bps in the second half of 2023.

The past year has demonstrated just how poorly the Fed's economists understand inflation, including both what causes it and what causes it to persist. It is likely that those same economists will also struggle to predict when inflation will abate.

Optimists hope that prices will take investors by surprise, with inflation slowing sooner than expected. Because of supply constraints and the war in Ukraine, it seems more likely that elevated inflation will persist even as the economy slows. That will leave policymakers with a delicate choice: squeeze the economy tighter or let inflation spiral.

If a recession takes hold, interest rates will decline on the long end of the curve. This will lead to a greater inversion in yields until 'something' breaks. Something might be a recession (how bad) or a credit event (how low will asset prices have to go first). Only then will the Federal Reserve begin to cut interest rates. Most bear markets occur *after* a policy pivot by the Fed.[2]

The age of dearer money should result in healthier financial markets and in a stronger economy. However, the transition to the new regime could be protracted and will be difficult.

The pain could be with us for a while.

Sources:

1. Alfonso Peccatiello, "When Recession, Sir", The Macro Compass, 23 November 2022
2. Lance Roberts, "The Fed Broke Something, Part 2", Real Investment Advice, 13 December 2022
3. Chart page one: Federal Reserve Bank of St. Louis, December 2022

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