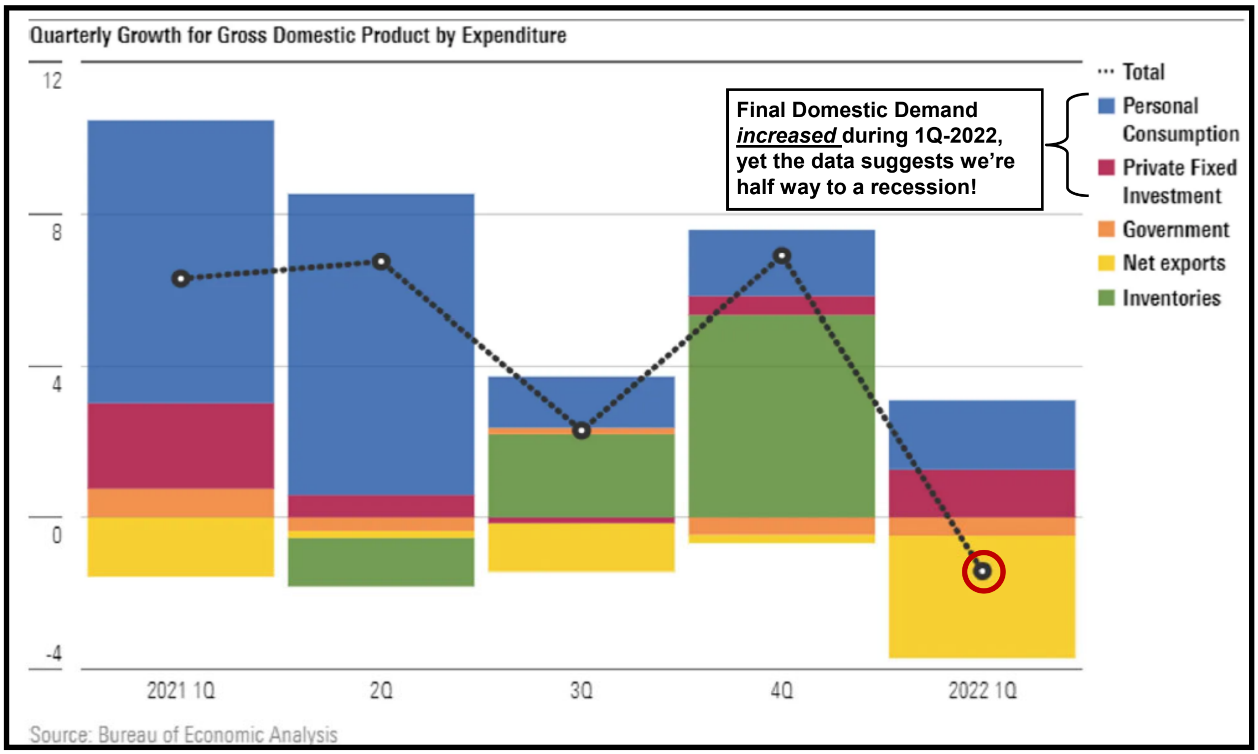
# TOO HOT ECONOMY CREATES RECESSION POTENTIAL

## HALF WAY TO RECESSION (TECHNICALLY)

I am occasionally asked if I think the U.S. is on the cusp of falling into recession. While shrugging, I sometimes infer from the question that it is assumed that a recession necessarily causes severe, long-lasting economic damage and/or that it might make sense to interrupt the investment process in some manner while the recession sorts itself out. Before laying out some of the thoughts that dart through my mind while on this topic, I'll first note that in inflation-adjusted terms, U.S. economic output as measured by gross domestic product (GDP) declined .36% during the first quarter of the year, or 1.44% on an annualized basis (circled below). If GDP is negative for the second quarter, the U.S. will technically be in its second recession since the beginning of 2020. (The last one, induced by pandemic fears, spanned February — April of 2020.)




## RECESSIONS DON'T OFTEN EXHIBIT INCREASING DEMAND

Note that since the last quarter of 2021, when annualized GDP was on the order of 7%, "Personal Consumption" held steady while "Private Fixed Investment" actually increased substantially. Together, these two components comprise Final Domestic Demand or, more colloquially, demand. During the first quarter of this year, demand grew at an annualized pace of 2.5%. **Although the U.S. might very well be in recession once second quarter GDP figures are released, recession is not typically associated with *increasing* demand.**

## INVENTORY NORMALIZATION ALSO LEADS TO POOR GDP FIGURE

Notably absent from the first quarter 2022 data on the previous page is any contribution from the growth in inventories (shaded green). This absence indicates that business inventories neither grew nor shrank versus fourth quarter levels which makes sense since inventory levels had already increased substantially during the second half of 2021. **In essence, inventories grew faster than necessary during the second half of 2021 which caused some of the GDP that might have been reported this year to have already been captured in 2021's GDP figure.**

In terms of adding a bit of nuance to the contraction of the first quarter, Final Domestic Demand (red & blue shaded areas) has continued to increase at an annual rate of 2.5% and inventory levels have remained steady after businesses padded them during 2021. **Again, this is not the type of data that suggests the U.S. economy is falling apart**.

## DECLINE IN NET EXPORTS HURTS GDP BUT SUGGESTS DEMAND

Because the change in government spending (orange area) is relatively minor, I'm going to ignore it to instead focus on the trickier topic of net exports (yellow area). It is true that net exports declined in the first quarter of this year versus the last quarter of 2021. And while it is true that a negative net export figure leads to a lower GDP figure, I believe the subcomponents of this net figure provide more useful information about the relative health of our economy than the aggregated net exports figure does.

The following data compares official, Federal Reserve economic data for the first quarter of 2022 to the final quarter of 2021:

- U.S. Exports: +$78 billion (+2.9%) = **more** global **demand** for U.S. goods & service
- U.S. Imports: +284 billion (+7.8%) = **more** U.S. **demand** for foreign goods & services

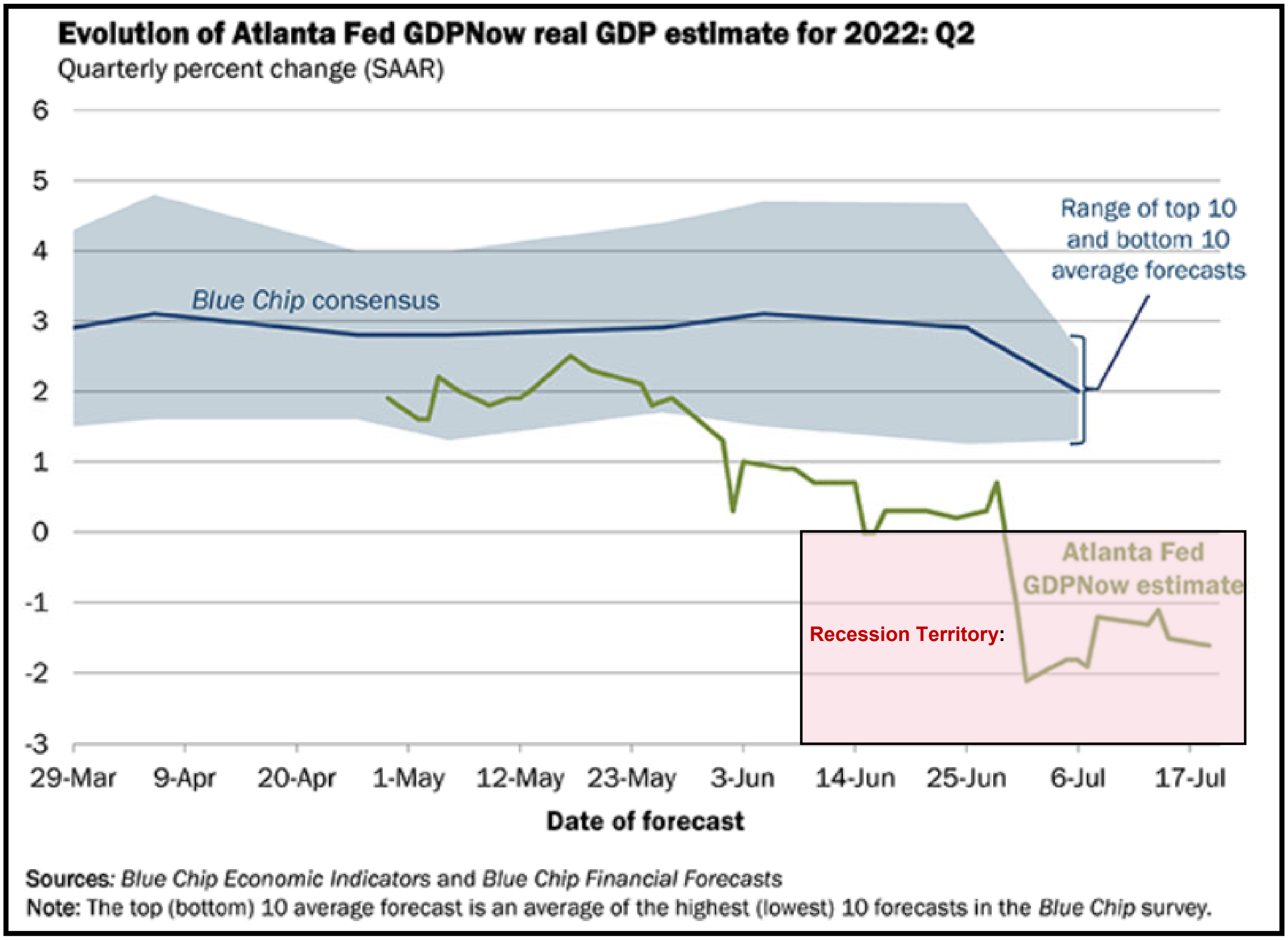
**Despite both of these metrics reflecting an increase in demand**, the fact that imports to the U.S. increased more than exports from the U.S. did, **results in a <u>negative contribution to first quarter GDP</u>**, as depicted in the area shaded yellow on the previous page.

**To illustrate the need to interpret GDP components of GDP carefully, a collapse in U.S. exports coupled with an even larger collapse in U.S. imports, both of which would be indicative of a <u>decline in demand</u>, would have resulted in a <u>larger</u> GDP figure**. So while the news media does a good job of hammering recession fears into the public consciousness, its coverage lacks nuance.

## FED'S "GDP NOW" TOOL PREDICTS RECESSION

Like weather forecasts that attempt to forecast the weather a given locale will experience in the next few hours, the Federal Reserve Bank of Atlanta has created a model that attempts to forecast the next GDP figure which, for now, is for the second quarter of this year. As previously mentioned, economic recession is typically defined as two sequential quarters of negative economic growth and, regardless of mitigating explanations, last quarter's GDP figure gets us halfway to recession-related headlines.

As shown in this next image, professional forecasters had been predicting second quarter GDP to approximate a seasonally adjusted annual rate (SAAR) of about 3% until late June (shaded blue) when they began trimming their second quarter GDP expectations to about 2% per year. However, **the Fed's GDPNow tool** began forecasting lower figures about a month prior to that and **is now forecasting a negative, second quarter GDP figure** (boxed in pink).

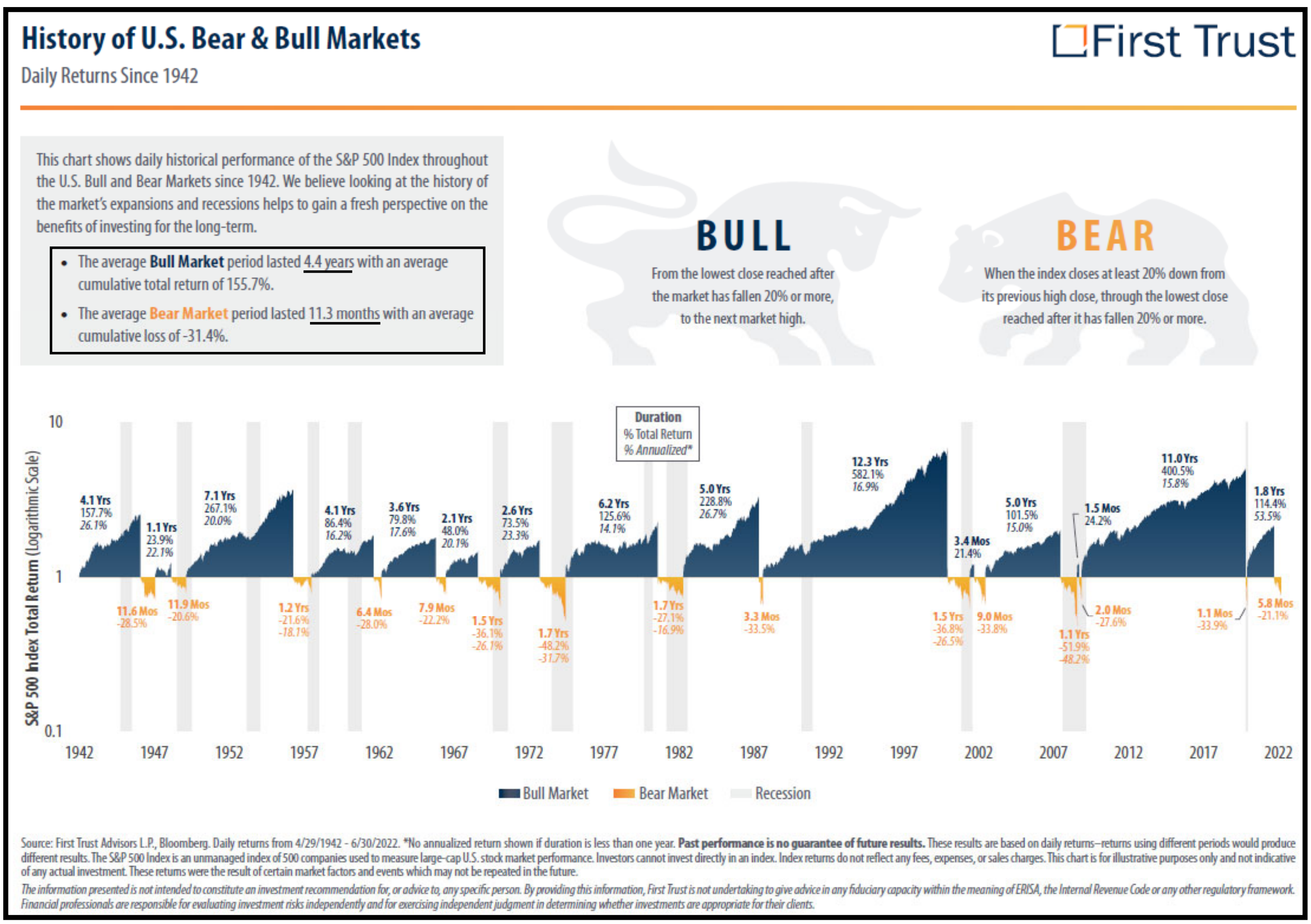



**If I were pressed to guess, I would expect professional forecasters' second quarter estimates to continue to converge toward the Atlanta Fed's GDPNow estimate and that the headlines will soon be that the U.S. is in an official recession**. As with cancer, however, recessions also vary greatly in terms of their impact, so if or when those headlines arrive, remember that nuance matters when assessing the next recession's potential severity.

## UNLESS TIME IS SHORT, BEAR MARKETS ARE OPPORTUNITIES

The U.S. is experiencing its 15th "bear market" which is defined as a 20% drop in value (captured below, in yellow) since 1942 and, based upon what I've already written, we also seem set to experience our 15th recession. As per the image below, however, bear markets and recessions have overlapped only about half of the time. No one enjoys a market drop, but unless one believes one's investment time horizon is particularly short, I'm not convinced it makes sense to try to invest "around" a recession or bear market. Instead, I think it makes more sense to grab some deals along the way as they present themselves.

Not that history should be expected to be entirely predictive, but of the previous 14 bear markets the longest one lasted 1.7 years (1982) with an average duration of only 11.3 months. Interestingly, **12 of the 13 recessions the U.S. has experienced since 1942 have occurred either during or at the onset of a subsequent bull market that overwhelmed the losses incurred during the recession**. The lone exception occurred in 2002 where the initial stock market recovery experienced something of a false start before, once again, overwhelming those losses with subsequent gains.

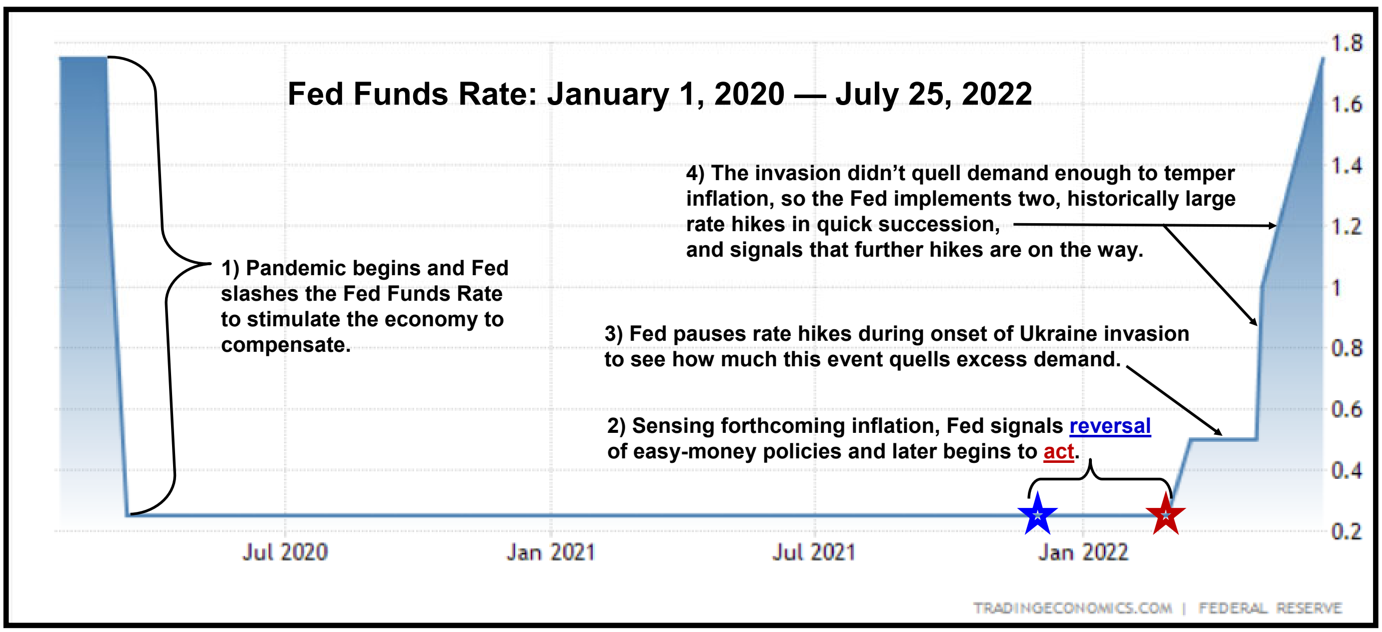


## FED CAN ADDRESS ONLY DEMAND SIDE OF INFLATION PROBLEM

In previous notes, I've outlined how the injection of trillions of stimulus dollars into the U.S. economy during the pandemic helped mitigate the economic damage while also setting the stage for inflation once the economy recovered. Now that the U.S. economy has more than rebounded from the effects of the pandemic, all the extra money sloshing around has resulted in demand for goods and services exceeding supply which, of course, has caused inflation to spike.

The Federal Reserve signaled its intent to address this issue last year and began doing so this spring in earnest as it began raising the target rate at which banks borrow and lend among themselves (i.e., the Federal Funds Rate). To the extent banks pay more to obtain loanable funds, they pass those increases through to customers who are subsequently apt to borrow, buy, build, and invest less.

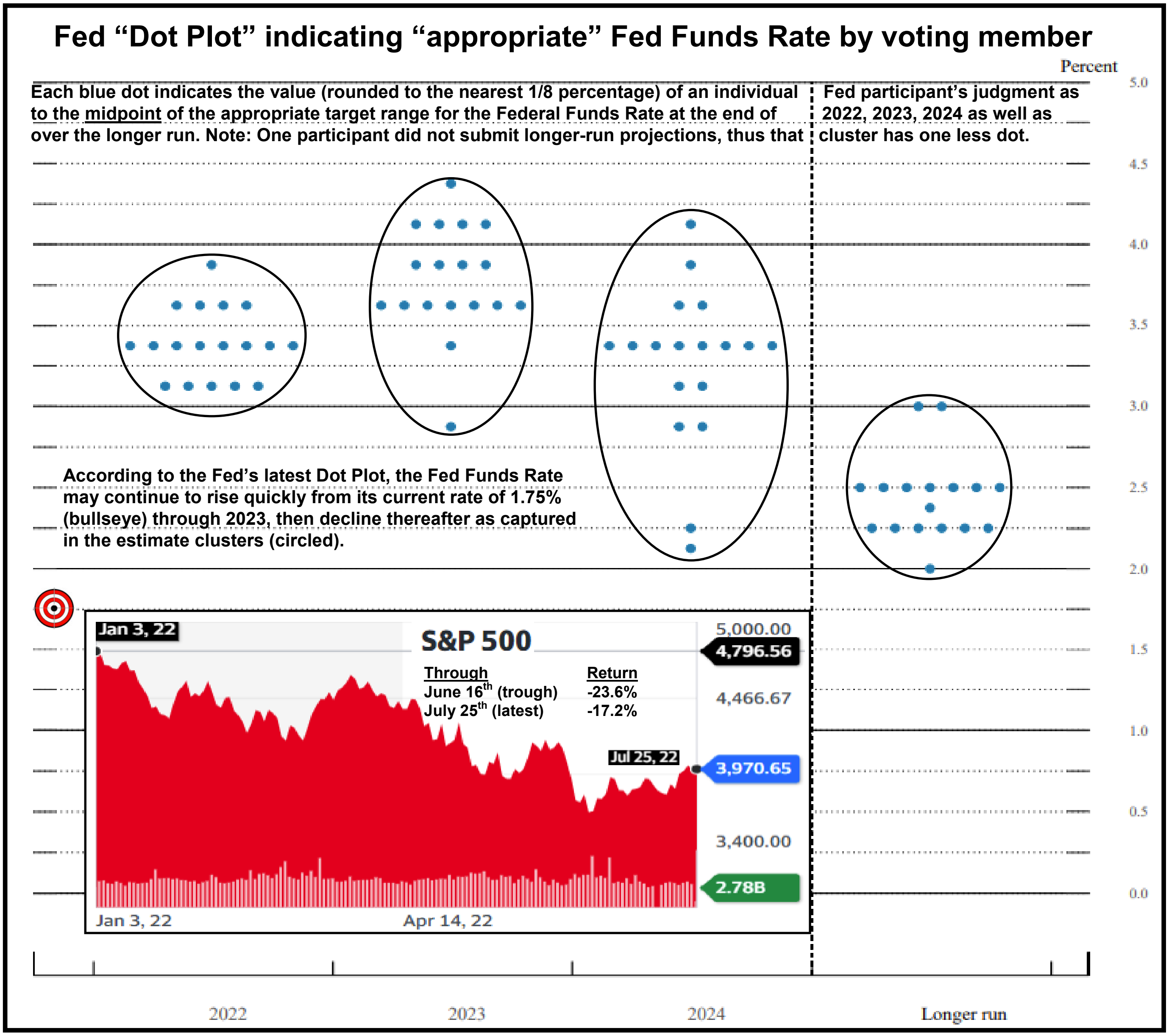
The following image depicts the Fed Funds Rate prior to the onset of the pandemic. Fed officials have recently noted that the US economic outlook warrants moving to a restrictive policy stance, and they recognize the possibility that an even more restrictive stance could be appropriate if elevated inflation pressures were to persist. Fed officials understand that Fed measures could slow economic growth for a time, but the Fed sees a return to a 2% inflation rate as critical to achieving maximum employment on a sustained basis.




The Fed has historically raised rates in quarter-point increments, so the recent hike of .75% signals the Fed's seriousness since it's crucial to prevent expectations for rampant inflation to become entrenched and normalized in the public psyche.

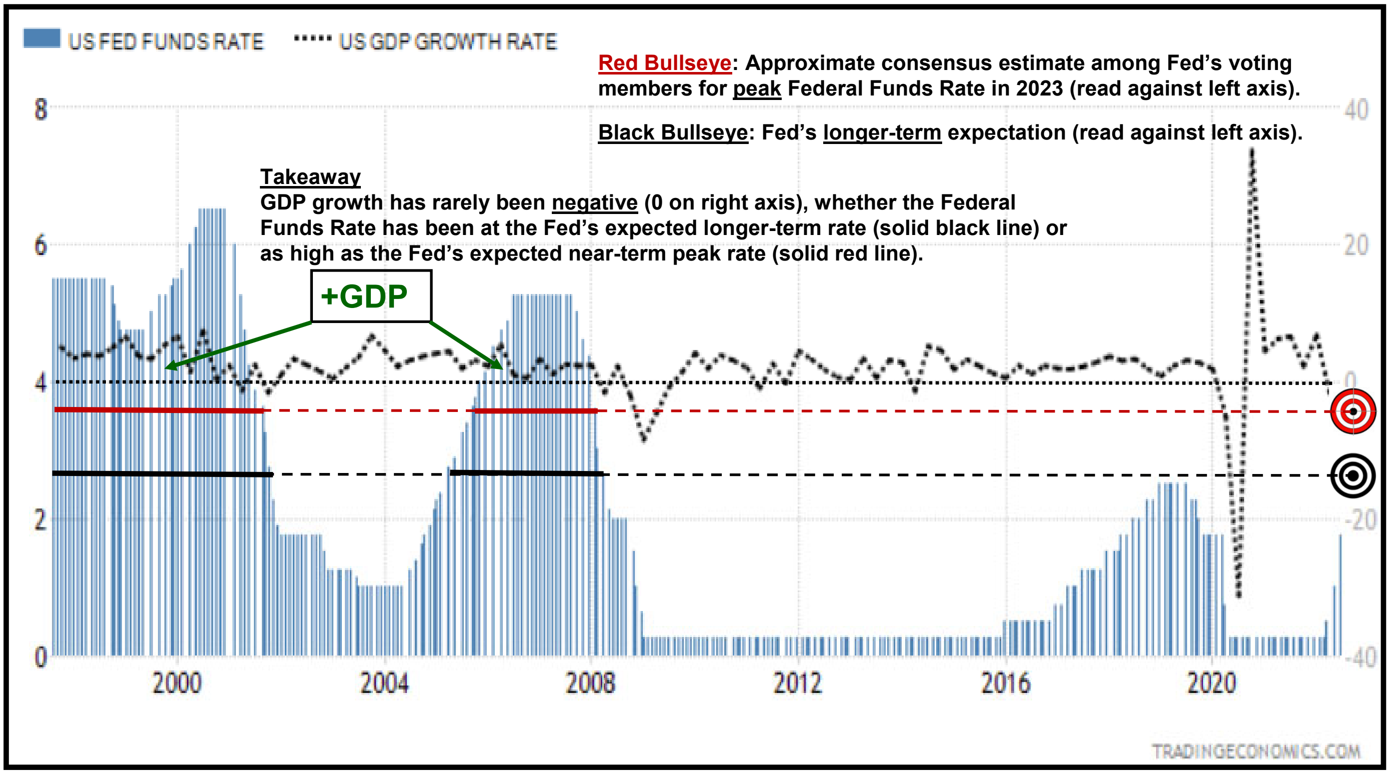
## RATE HIKES SPOOK INVESTORS AS FED PLANS FURTHER HIKES

The S&P 500 shed over 23% between the beginning of the year and mid-June as investors attempted to judge whether the Fed could put the brakes on the economy deftly enough to remove some excess steam without inadvertently wiping away more future economic growth than intended. Since then, investors have grown a bit more confident (see S&P data below) even as the Fed is set to raise interest rates further through 2023.




Although the rate increases depicted above certainly have unnerved investors, it makes sense to view these increases in a historical context. Assuming the Fed follows through with these rate increases, the Fed Funds Rate would still be relatively accommodative to long-term economic growth and, by extension, corporate earnings increases, as captured in the following image.

## INTEREST RATES VS GDP GROWTH — HISTORICAL CONTEXT




## AS WITH GDP, EARNINGS BETTER THAN DATA SUGGESTS

For the 60 S&P 500 companies that had reported second quarter results as of July 20th, revenues increased a solid 6.6% from a year ago while earnings actually *declined* 11%. Since revenues are the broth from which earnings flow, that earnings decline deserves further scrutiny.

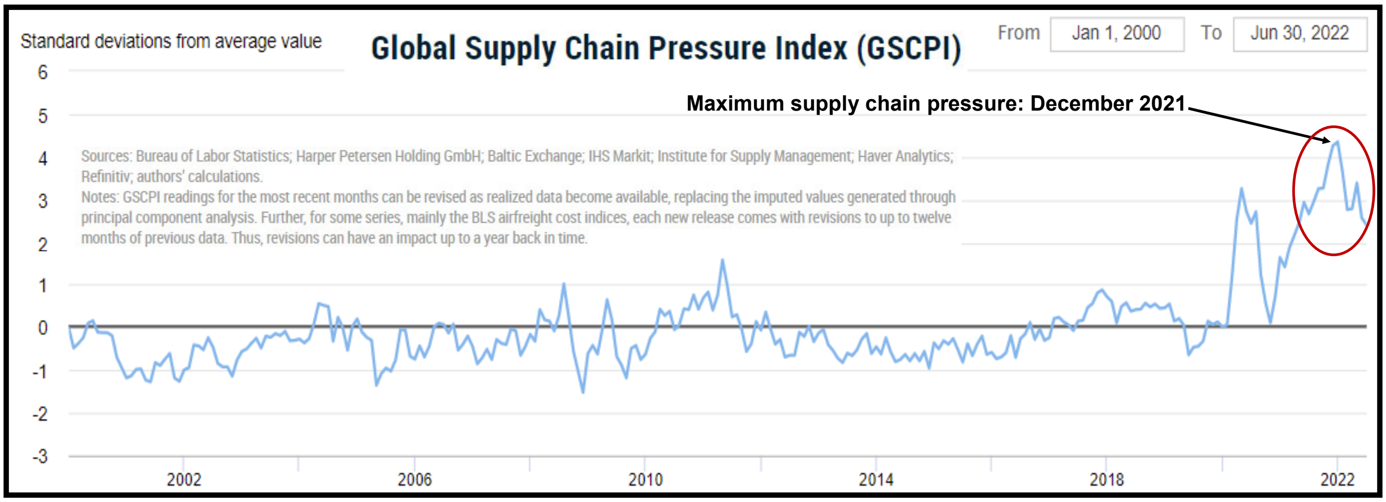
As the pandemic unfolded banks and other lenders established reserves to cover future loan losses. After it became apparent that losses would be less than envisioned, those institutions released the excess portion of those reserves back into earnings **which artificially inflated last year's reported earnings**. Adjusting for this one-time, non-recurring event, reported earnings for the second quarter of this year would have been flat versus last year which is relatively comforting in an environment where the Fed is trying to remove some frothiness from the economy and where supply chain challenges remain.

According to Zack Research, **corporate earnings of the 500 largest domestic companies are expected to increase 8.3% this year, even when compared to last year's artificially inflated earnings figures, and an additional 8.2% in each of the next two years.** If these estimates were to come to fruition and stock valuations were to follow earnings growth, stock valuations might then rise by about 27% by the end of 2024.

## FED RECEIVES HELP AS SUPPLY CHAIN PRESSURES EASE

At the top of page 5, I mentioned that the Fed can address only the *demand* side of the U.S.' inflation problem. Since pandemic-related stimulus has resulted in demand outstripping available supply, **the Fed's rate-hiking actions are intended to bring supply and demand back into equilibrium, but only by *reducing demand* (and risking recession)**. In cases where supply is *also* constrained, which continues to be the case as a result of pandemic-related interference to the global supply chain, it further exacerbates the current inflation problem.

**To the extent global supply chain pressures ease, supply would then increase, equilibrium prices would decline, and there would be less pressure on the Fed to siphon excess steam from the U.S. economy through additional rate hikes.** In fact, **this has been occurring since the end of 2021** as captured in the following image.




## FINAL THOUGHT ABOUT EQUITIES

The following image aggregates six equity valuation models into one, aggregated index which suggests equities are very near their fair value (circled). I regard this and the expectation for continued earnings growth to be positive signs during this period of adjustment. - Glenn Wessel