Recession Primer

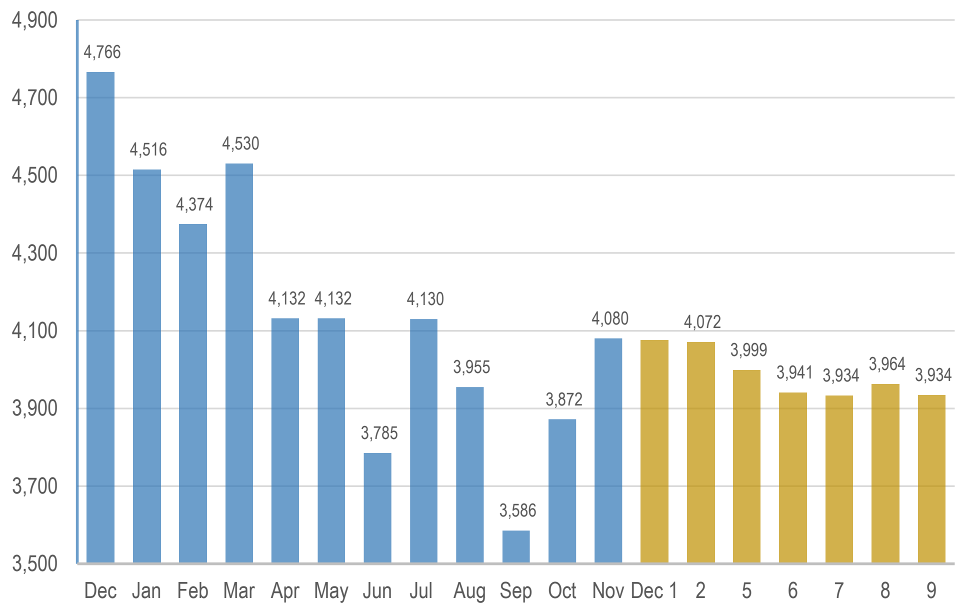
Weekender

December 10, 2022

Good morning and welcome to the *Weekender* for Saturday, December 10, 2022. With earnings for the third-quarter largely in the rear view mirror, US equity markets spent the week digesting current economic data and reading tea leaves to get a grip on possible economic scenarios for 2023. A week ago, Jerome Powell provided some relief for financial markets by suggesting that future rate increases could be milder than the seventy-five basis point trends, which by historical standards were aggressive. Economic data released over the past week gave support to an alternate narrative, that the economy remains strong and inflation hotter than predicted, which may prompt the Federal Reserve to keep rates higher for longer.

S&P 500 Month and Daily Levels

December 2021 - December 9, 2022



Fear of higher rates for longer, drove US equity markets, as measured by the S&P 500, lower by -3.4%. The Federal Reserve meets next week and, by all accounts, is expected to raise rates again by between 0.50-0.75%. Another increase is likely at the Fed's February 2023 meeting as well. Following Tuesday's meeting, financial markets will parse every word from the Fed's post-meeting press release. Nothing they do on Tuesday will have an impact this year and we are getting increasingly anxious to put a nail in 2022, which, at current levels, will be the worst year for the stock market since the early 1970s.

ARCHIMEDES
INSIGHTS & ANALYTICS

This will be an unusual *Weekender*. Our discussion will be noticeably general, which comes with risks. There are always exceptions and nuance when generalizing about very complex systems like an economy. However, in the main, we hope this discussion will provide a blueprint as we build an economic path forward into 2023 and beyond.

We will discuss three potential scenarios for the US economy. Scenario one assumes inflation can be tamed and brought in line with the Fed's targets without pushing the economy into a recession. Scenario two involves a mild recession driven by a drop in aggregate demand as consumers retrench without breaking the labor market. Scenario three suggests a recession that is persistent and deep with higher unemployment, deep debt and spending retrenchment, and a cure period lasting for years. In practical terms, no such tripartite distinctions exist. Instead, any economic outcome exists along a probabilistic continuum. But looking at three distinct options gives us discrete mental models in which to organize our thoughts.

Prior to the pandemic, the US economy was in what many considered to be a Goldilocks period. As a response to the Credit Crisis in 2008-09, the Federal Reserve created and deployed previously un-heard of monetary interventions designed to stem the unknown, but feared, catastrophic consequences of a global mortgage crisis. The free money band aid stayed on the sore long after the injury was mended, which laid a foundation for an extended period of slow but steady economic growth: low inflation, full employment, and consistent appreciation in fixed and financial asset prices.

From the closing of the Credit Crisis in 2009 to the beginning of the pandemic in January 2020, the US experienced its longest continuous economic expansion since the end of World War II. In like manner, over the same period, US equity markets logged the longest bull market in history.

Beginning in early January 2020, the COVID-19 pandemic disrupted the smooth workings of an interconnected global economy, forty years in the making. A flood of fiscal and monetary stimulus created unusually strong demand for products and services that were in scarce supply. The imbalance of demand and supply pushed price inflation to its highest level in a generation.

As a response to pandemic unknowns, monetary and fiscal stimulus lifted the economy above its normal run rate. Today, fiscal stimulus has evaporated and monetary accommodation has shifted into reverse. Looking into 2023, US and global economies will all be searching for a sustainable equilibrium that reflects a set of four unfamiliar structural realities. First, supply will remain a greater concern than demand. Second, the era of free money is ending. Third, financial markets will be increasingly fragile lighting little non-systemic fires ablaze around the world. Fourth, the new world order is disintegrating. We will be addressing each of these in detail as part of our year-end Weekender published on December 31, 2022.

Equity markets, by their nature, tend to lead or at least anticipate future economic performance. They rose as stimulus was applied and fell when it was taken away. In the United States, equity markets have corrected to valuations that prevailed prior to the pandemic. However, they have not yet handicapped the future economic environment expected in 2023.

If the Federal reserve is able to negotiate a soft landing, in which inflation returns to their target range without a recession, equity markets will stabilize without considerable declines from where they currently sit. A mild recession will create a 5-10% reduction in corporate profits and probably a similar reduction in the current level of stock prices. A more severe recession will result in a fall in profits and stock prices of 10-20% that could take years to recover.

Recession

During periods of economic expansion, jobs are plentiful and wage rates and incomes rise pushing consumption higher. Stronger consumption increases production, corporate profits, and personal incomes which encourage consumers to take on more debt, buy cars and homes, and keep up with the Jones'. All business cycles eventually peak. A precipitating cause is rarely apparent, but a herd mentality seems to form, coalescing around a narrative that it may be time to retrench, resulting in reduced spending and the reverse of the factors that drove the expansion.

During expansionary periods, excessive demand stokes inflationary pressures which pressure the Federal Reserve to raise interest rates. The naked purpose of higher rates is to reduce demand pressures on inflation by slowing the economy, usually through a softening of the labor market.

The US economy, in many ways, sits in an enviable position. Consumer demand, which accounts for 70% of economic output, is strong. The labor market is fully employed. Higher interest rates have completely shut down the residential real estate market, but the carnage has yet to create any systemic catastrophes (similar to the credit crisis) due to a limited amount stranded real estate available in the market. Product inflation is falling rapidly, and by mid-Summer 2023, will likely be in contraction. Housing prices are softening, but not enough to turn around the industry, which will likely remain in contraction for years to come. Wages, which by their nature, are upward sticky, continue to expand at an unhealthy rate. In all, if the Fed could afford to be patient, inflation would be mostly sorted by the end of 2023.

What do we mean by sorted? It won't fall to the Fed's target of 2% for a long while. But, it could settle close to 3-3.5% which is a level consistent with strong economic growth, strong financial markets, and profitable lending.

Scenario One

Today's inflation is caused by a series of transitory income gains from government stimulus that lifted aggregate demand, accentuated by supply chain shortages from pandemic-related work stoppages. Stimulus payments have ceased, and supply chain challenges are almost all mended. Consequently, we expect the primary drivers of inflation to moderate significantly on their own over the next year. Higher interest rates have shut down demand for interest rate-sensitive products and services which will help hold down inflation.

The labor market has not yet capitulated to higher interest rates. This, if it continues, bodes well for scenario one. For scenario one to emerge as a dominant outcome requires the Fed to step back from rate increases early in 2023 and watch the compounding impact of its increases as they work their way through the economy. We do not believe the Fed has the stomach for such an approach.

Scenario Two

The longer inflation exists the more it becomes ingrained in prices. While commodity prices are usually quick to fall, as they have done, some inflation is considered upward sticky. Like wages. Wages are currently rising faster than inflation. The only effective way to control wage inflation is to break the labor market. To do this the Fed will need to keep rates higher for longer. We expect scenario two is currently the dominant option.

Scenario Three

A deep recession requires a significant policy mistake by the Federal Reserve. Policy mistakes are the Fed's stock in trade. A policy mistake may be keeping rates too high for too long or giving up too soon resulting in a need to lift rates again later. To be fair, luck plays a powerful role in this process. We believe that the unprecedented strength of the labor market makes scenario three the least likely of all.

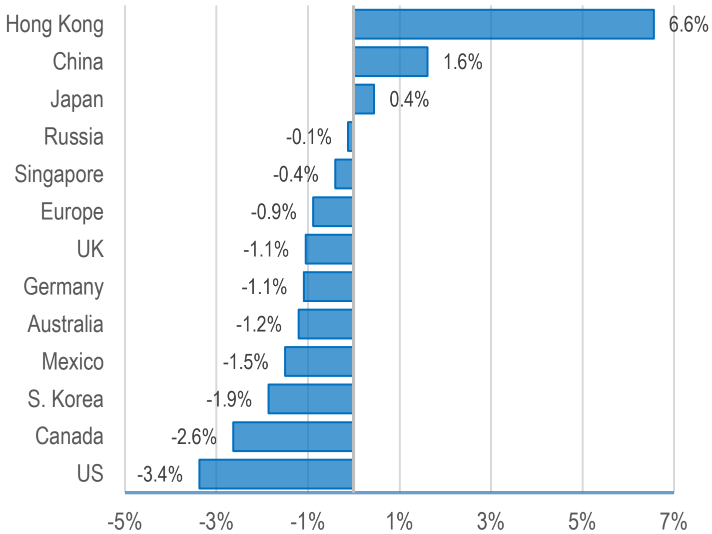
We expect a light recession, a return to a new normal, with inflation that persists above the Fed's target rate. Slower consumption combined with peak wholesale and retail inventories will constrain corporate margins and profits which will continue to put pressure on earnings estimates going into the first two quarters of next year. We do not expect an explosive recovery in equity markets once a new equilibrium is achieved. Instead, we believe some stocks, with strong fundamentals, will dramatically outperform others.
Look toward companies with unit sales growth, pricing power, and strong balance sheets.

Countries

For the week, the best performer was, once again, Hong Kong, followed by China. News of a softening in the Country's Zero Covid policies pushed the country forward ahead of all others. The United States was the poorest performer followed by other members of the OECD family.

Country Returns

December 5 - 9, 2022



Instruments

Among investment instruments, crude oil was weakest by a large margin while currency instruments, Bitcoin, the dollar, and gold were the best performers. Although still slightly negative, bonds continued to provide a risk cushion against equity.

Instrument Returns

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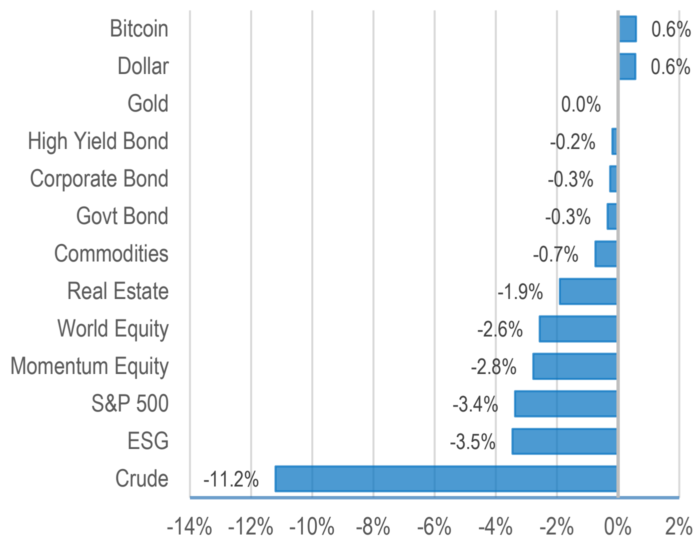

Emerging market equities posted a slight gain while all other global equity categories were soundly negative. Macroeconomic prospects of higher interest rates took all equity categories to the wood shed. Smaller company performance was more negative than bigger players.

Equity Instrument Returns

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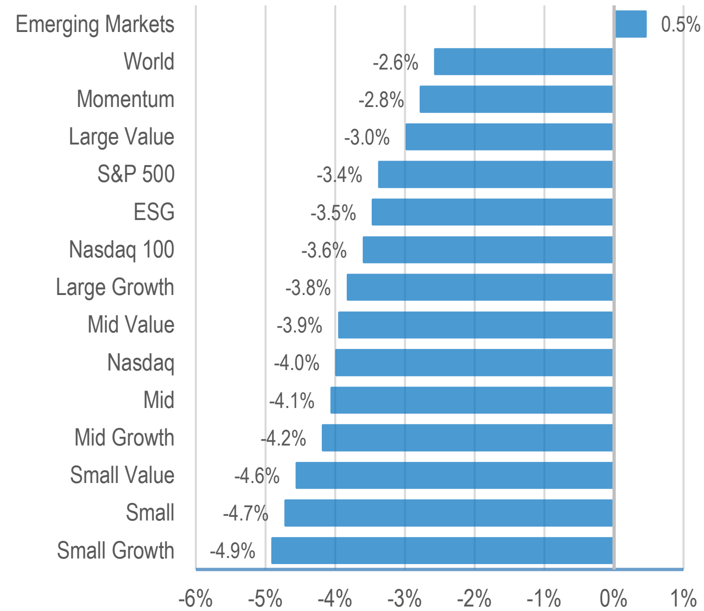

Sectors

Among sectors, protection continued with outperformance of utilities, healthcare, and staples. Energy was the poorest performer in line with declines in crude oil.

Sector Returns

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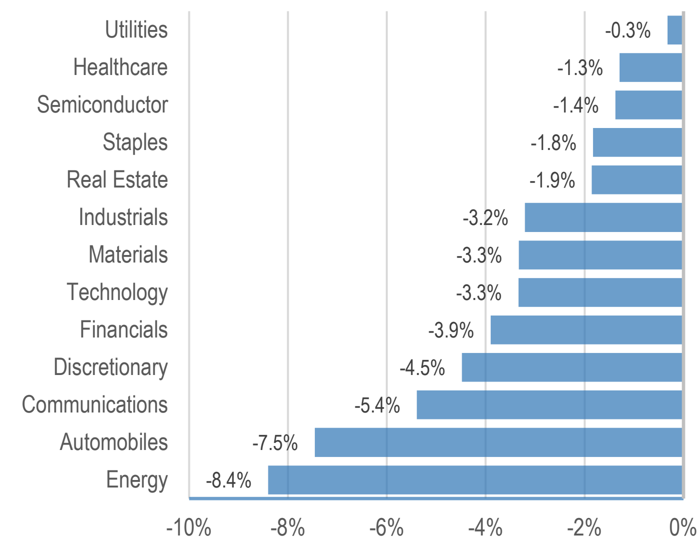

Themes

China-related themes were the best performing in a soundly negative week for all themes.

Theme Returns

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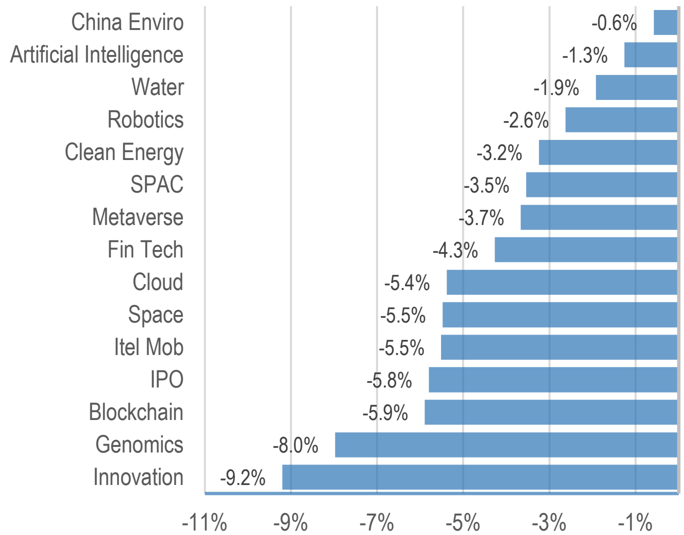

Conclusion

That's it for this *Weekender*. As a look ahead, we will not publish a *Weekender* on December 17th or 24th. On December 31, we will publish our investment outlook for 2023. We will also publish our first investment magazine called *The Bucket List.*