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The Federal Reserve Has Taken the Punchbowl Away - We Are Worried About a Hangover

We suspect most people think getting inebriated is more fun than sobering up. After the post-pandemic boom times driven by checks in the mail and easy money, we are now dealing with the hangover.

- Falling stock and bond prices
- Higher mortgage rates
- Decreased home prices and sales
- Falling job openings
- Constant media focus on recession and recession risk

Two thirds of business economists think we are already in a recession or likely to be in one in the next 12 months. In a recent survey, 98% of CEOs say they are preparing for a recession.*

For those who prefer TL;DR (too long; didn't read), we provide a bullet point summary at the end of the blog.

What is a Recession Exactly?

The National Bureau of Economic Research (NBER) defines a recession as a sustained slowdown in economic activity lasting more than a few months - not simply two negative quarters of GDP growth. If GDP (gross domestic product) was the only measure, we would have experienced our recession earlier this year and already be on the road to recovery. Instead, the two measures the NBER pays the most attention to are changes in personal income and employment, which have yet to substantially decline. Ironically, the NBER declares a recession after it has occurred, leaving the rest of us trying to figure it out while it is happening.

Why do Recessions Occur?

Recessions *most often occur* when the Federal Reserve steps in after a speculative boom. In order to slow an overheated economy, the Federal Reserve raises interest rates and ruins the party (aka taking the punchbowl away), generally followed by a recession 6 to 18 months later. Think of 1929, 2001, 2008 and today.

Recessions can also happen in response to significant world events such as:

- Demobilization after WWII - going from a war economy to a peacetime economy
- The OPEC oil embargo in 1973-75 and President Nixon's wage-price controls
- The COVID pandemic in 2020

What are Common Recession Signals?

- **An inverted yield curve.** If the 3-month Treasury bill yield rises above the 10-year Treasury note yield for several months, a recession happens most of the time. See our prior blog on the shape of the [yield curve](#).
- **The unemployment rate rises half a percent above the year ago level.** Any rise of this magnitude or more has been a signal that the economy is either in a recession or on the cusp of one, with no exceptions in post-war history.**
- **Falling real income** – personal income adjusted for inflation goes down substantially.

We may not have seen enough of the above signals yet, but **the following have already occurred...**

- The Federal Reserve has raised interest rates at the fastest pace in the last 35 years.
- In periods where the Fed is hiking and food and energy inflation rose above 5%, the economy has always gone into recession.***
- Every time we have had unemployment below four percent and inflation above four percent, we have had a recession within the next two years****.
- Money supply growth has fallen dramatically, a typical precursor to recessions. Real M2 (a common measure of money supply) is the most negative since the 1973-74 recession and bear market.
- Consumer expectations have declined 10% - history has shown drops of this level lead to recessions.

If We Have a Recession, Who and What Impacts Its Severity?

The Federal Reserve. The more the Fed raises rates and the longer they keep them elevated, the higher the risk of a severe recession. While Fed policies can impact financial markets immediately, there is a lag of 6 to 18 months before the actual economy responds. This lag means it's possible the Fed will keep going longer than necessary, especially if they are focused on backward looking economic indicators such as rent and owner equivalent rent.

Inflation. Persistent inflation can affect the severity of a recession if it causes the Fed to be more restrictive for longer.

What May Be Unique About This Recession?

There is likely a lid on how high unemployment can go. Our population is aging, low birth rates keep us from replacing ourselves, and we don't currently bring in immigrants to fill the gap. Businesses, because they struggled for two years to find enough employees, are more likely to hang on to them in a downturn.

Housing may suffer less. After the 2008/9 housing crisis, many homebuilders went out of business and underbuilt housing for a decade. "America's fallen 3.8 million homes short of meeting housing needs... and that's both rental housing and ownership" according to the nonprofit group Up for Growth (July 2022). Lack of supply may put a floor under the housing market.

Unlike typical recessions, we think inflation will persist (see our recent [inflation blog](#)). There will likely be similarities to the slow growth, persistent inflation of the 1970s and early 1980s, but without the spikes in unemployment which rose as high as 10.8% in 1982.

How do Recessions Affect Stock and Bond Markets?

The economy slows down in a recession so companies don't grow or earn as much. Their ability to pay back debt may weaken, causing some corporate bonds to go down substantially in price. Stock prices go down an average of 30%, and the market is more volatile. Recessionary bear markets don't necessarily go down more than non-recessionary bear markets, but they typically last longer. Given our current inflation problem, see how markets react to inflationary recessions:

- **Price/earnings multiples come down as interest rates rise**, i.e. the amount of money people are willing to pay for a company's earnings falls. So far this year, multiples have fallen from 22 P/E to 16 P/E, partly due to inflation.
- **Value stocks tend to outperform growth stocks**. Value stocks typically have current cash flow which is worth more to investors than growth stocks whose cash flows may be far out in the future.
- **Stock and bond markets both go down**. Bond prices fall as yields increase.

In the Inflation Years, Stocks & Bonds Declined Together



Strategas Technical and Macro Research

- **If inflation is present, commodity stocks tend to outperform**, particularly if recessions follow a period of capital underinvestment by commodity companies. The chart below shows how commodities have performed in 2021 and YTD 2022. This year, energy and agriculture commodities went up even when the S&P declined.

Exhibit 1: Bloomberg Commodity Index Forecast

BCOM Index	Dollar Weight	Historical Performance			Forecast		
		2020	2021	2022 YTD ¹	3m	6m	12m
BCOM	100.0	-3.1	27.1	14.1	8.0	14.3	20.5
Energy	36.7	-42.7	52.1	51.8	14.2	20.6	30.1
Industrial Metals	12.1	16.3	30.3	-16.2	-7.3	6.3	23.8
Precious Metals	16.9	25.6	-6.1	-12.6	13.0	21.2	25.8
Grains	23.0	19.3	21.0	16.5	2.2	4.8	8.6
Softs	5.9	2.9	44.0	-3.6	13.9	20.5	12.2
Livestock	5.4	-23.4	8.6	4.5	3.0	2.2	-9.5

¹ YTD returns through Oct 18, 2022

Source: Goldman Sachs Global Investment Research

Exhibit 2: S&P GSCI® Forecast

S&P GSCI Commodity Index	Dollar Weight	Historical Performance			GS Forecast		
		2020	2021	2022 YTD¹	3m	6m	12m
S&P GSCI	100.0	-20.6	45.0	25.8	12.8	21.1	34.9
Energy	62.6	-38.3	61.1	46.2	18.8	27.7	46.7
Industrial Metals	11.2	15.1	30.2	-18.3	-5.6	9.3	29.0
Precious Metals	4.1	23.5	-5.1	-11.1	12.8	20.5	23.8
Agriculture	15.4	12.7	29.7	12.8	5.6	10.5	13.4
Livestock	6.7	-23.3	13.3	1.1	3.6	2.7	-9.2

¹ YTD returns through Oct 18, 2022

Source: Goldman Sachs Global Investment Research

How do Recessions End?

In the post-war economy, most recessions end because of a change in monetary policy. Commonly called a 'Fed Pivot', the Federal Reserve reverses course and lowers interest rates to stimulate the economy. The Fed can pivot for a number of reasons:

- The Fed achieves its policy goals - in this case lowering inflation.
- Something breaks - a large institution or country runs into a financial problem that creates systemic risk for markets and the economy. Think of the housing crisis in 2008/09.
- The stock market abruptly tanks – think end of 2018.

Given the Fed's history of success, market participants try to anticipate the Fed pivot and start buying stocks. This year, investors have been too quick to anticipate a change in Fed direction, driving the market up only to have it fall back down again – 4 separate times.

What Do We Recommend?

In recessions, value stocks, defensive stocks, and high quality companies with earnings tend to outperform. In the current inflationary environment, commodity stocks may outperform as well. In terms of investment alternatives this means:

- Value ETFs or mutual funds
- Health Care stocks/ETFs – for defensive positioning as healthcare is always needed
- Dividend growth stocks/ETFs – for high quality companies with cash flow
- Energy stocks/ETFs – for exposure to commodities with scarce supply vs. demand

What Doesn't Kill You, Makes You Stronger

Not to be Pollyanna, but there are some silver linings to recessions. Recessions change our mindset as people are reminded of the importance of living within their means and saving for a rainy day. In the corporate world, businesses are forced to be more efficient, often setting up for better performance when the economy rebounds.

TL;DR

1. We have a high chance of going into a recession.
2. Recessions are a sustained slowdown in economic growth characterized by slowing gross domestic product (GDP), falling income and rising unemployment.
3. Recessions are most often caused by the Federal Reserve slowing down an overheated economy but can also be caused by significant events like the pandemic.
4. If we have a recession, we think unemployment will rise less and housing will hold up better than typical recessions. This recession will likely have similarities to the recessions in the 1970s and early 1980s where inflation persisted.
5. Recessions end when economic growth returns, typically when the Federal Reserve lowers interest rates to stimulate growth. Investors try to anticipate renewed growth by buying stocks.

Footnotes:

- * Conference Board Measure of CEO Confidence, October, 2022
- ** Michael Darda, Chief Economist & Market Strategist, MKM Partners October 7, 2022
- *** Piper Jaffrey, Macro Economics, October 17, 2022
- **** Former U.S. Treasury Secretary Larry Summers statement.

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