MARKET PERSPECTIVE

AUGUST , 2022

IN FOCUS:

A Closer Look at U.S. GDP and an Imminent Recession:

There is little evidence in the current economic data to support the claim that a U.S. recession is imminent in 2022. This is important because investors will begin to ratchet down estimates based on a recession scenario - and put a cap on expanding stock valuations and share prices as a result of weaker than expected earnings forecast in the second half of the year. Contrary to popular belief, two consecutive quarters of negative GDP growth should the final GDP numbers for Q2 remain in negative territory does not necessarily qualify as a recession.

The U.S. economy is a long way from meeting the National Bureau of Economic Research (NBER)'s actual definition of a recession, defined as a significant decline in economic activity that is spread across the economy, and that lasts more than a few months. As we have outlined in previous quarterly commentaries, the U.S. economy is currently undergoing a transition away from a pandemic-fueled surge in consumer goods spending to a post-pandemic pickup in consumer services spending. This transition has fueled investor pessimism, especially since the stock market is dominated by the goods-producing side of the U.S. economy. However, it is important to emphasize that goods manufacturing along with trade only account for about a quarter of the economy, according to Morgan Stanley's Economic Research team.

Unless the services sector's momentum cracks and activity contracts, a downturn in goods demand alone should not be broad enough to drive the U.S. into recession. This was not the case in the Great Financial Crisis of 2007 when the housing sector was enough to take down the economy due to its deep interconnections with the financial system, as well as spillovers to consumption and manufacturing. The ongoing post-pandemic transition of goods to services also means that quarterly GDP tracking estimates must be taken with a grain of salt, since these GDP models draw from historical relationships between high frequency economic data and quarterly GDP estimates. The shortcoming of these models is that the goods side of the economy is over-represented in economic data releases.

These estimates are bound to underestimate economic momentum when the services economy is far more important, which we know to be the case at present. We saw a perfect example of these crosscurrents recently, when a weakened signal coming from the June ISM goods manufacturing survey refuted the recent Atlanta Fed's model. The Fed slashed its estimate of Q2 real PCE growth from 1.7% to 0.8%, even though over 60% of spending will be determined by services consumption. It is our belief that there is a reasonable chance that actual Q2 consumer spending may surprise on the upside when finally settled due to solid services spending.

Keep in mind that even if GDP does contract in Q2, investors should note that the NBER recession committee has specifically stated that it does not consider two consecutive quarters of a contraction in real GDP as an automatic marker of a recession. The 2001 recession never featured two consecutive quarters of declining real GDP growth. The Great Recession which began in December 2007 saw consecutive quarters of real GDP declines only in Q4 2008.

Importantly, the NBER committee states that it gives equal weight to quarterly real GDP and real GDI, or Gross Domestic Income, given that the gap between GDP and GDI was particularly important in timing the recessions of 2001 and 2007–2009. This matters a lot, because the gap between real GDP and real GDI is historically very large at present. This suggests that GDP may be underestimating actual economic activity, and the consequence it could have on the Fed hawkish stance, along with the stock market reaction to a delayed pivot away from tight monetary policy. Historically, the GDP tends to be revised toward the GDI over time, and not vice versa according to MRB Partners Macro Research Board.

Finally, it is important to note that real GDP contracted in Q1 due to slower inventory accumulation, a greater reliance on imports and a drop in government expenditure. Real final sales to domestic buyers did show progress increasing by 1.9% annualized in Q1, a rate which is far from recessionary.

The National Bureau of Economic Research Perspective:

The NBER recession dating committee takes a number of indicators into consideration when dating business cycles - and taken in aggregate, these indicators still do not look recessionary at the moment, compared to their performance at the beginning of recessions. In recent decades, the committee has put the most weight on real personal income less transfers and nonfarm payroll employment, which still look reasonably solid (the former, certainly on a year-over-year basis).

Although there is anecdotal evidence of layoffs rising, the most recent report of 528,000 new jobs suggests that there is no evidence yet of meaningful breadth to cutbacks in employment that would forebode a contraction in total nonfarm payrolls. There has been a slow rise in unemployment insurance claims in recent weeks, which is unusual outside of pre-recession periods. Then there is a recent Dallas Fed study highlighting that the pandemic has distorted seasonal factors which have skewed adjusted initial claims higher in recent weeks. Accounting for this distortion, claims don't appear to be trending upward but are generally stable at historically very low levels.

Our Focus:

In addition to key leading economic indicators like manufacturing new orders, PMIs, heavy truck sales, home sales and construction, it is going to be extremely important to keep an eye on additional evidence of economic activity that underscore the breadth of any economic weakness ahead. For instance, nonfarm payroll gains may soften ahead in the manufacturing and construction sectors, but this would be less of a concern if payrolls remain buoyant within the services sector. This distinction in 2019 was very helpful in alleviating fears of a manufacturing-driven recession at the time.

At present, it is too early to conclude this is happening since the recent jobs release rules out any possibility that the Fed Chairman Powell will pivot anytime soon. Measures of state-level economic activity confirm the breadth of an economic strength and lack of any recessionary trends.

Concerns of a recession by consensus have mounted, with strong inflation reports hinting at the eventual shift away from the Fed's policy tightening. However, provided inflation moderates over the remainder of this year, we still see a path for the economy to avoid a hard landing in the next year. There is no evidence in the economic data to suggest that the economy is already in a recession, or that a recession is imminent. Even if real GDP contracts in Q2, the NBER committee is unlikely to declare a recession until there are clear signs of deep, broad and persistent economic weakness, including measures of income and employment, both of which look solid at the moment.

CONCLUSIONS:

The current consensus is an expectation of a pending recession in the U.S. and global economy. The primary catalyst is viewed to be restrictive monetary conditions, as the Fed and other developed world central banks grow determined to contain the largest outbreak of consumer price inflation in 40 years. Other contributing factors have added fuel to the recession fire, particularly the war in Ukraine and related impacts on key energy/commodity prices and additional supply chain woes.

Although now becoming widely accepted, we believe the global recession view lacks credibility when examining both the mechanics and path leading to an economic contraction, as well as the perceived depth of the potential fallout. Yet, these issues are essential in understanding the ramifications for global consumer price inflation, as well as future policy and financial asset market performance.

On balance, we generally agree with consensus that the next global economic downturn will develop due to restrictive monetary conditions. However, such concerns are premature and vastly underestimate the durability of the global economy as well as the level of the cost of capital that would choke out the expansion. It would be historically unusual for the world to sink into recession at a point when global real interest rates are deeply negative, corporate profitability is robust and employment conditions are so strong. Indeed, the more likely outcome over the next year is a pronounced mid- or late-cycle slowdown, amplified by some idiosyncratic instances, followed by a continued although somewhat choppier economic expansion.

Market Ramifications:

U.S. growth stocks appear oversold, as the third quarter unfolded relative to their value counterparts. And we are expecting a near-term bounce in their relative performance in the months ahead coupled with a relief rally in bonds, as yields continue to ease. However, until there is greater clarity about the outlook for tech earnings and central banks pivot to less open-ended forward interest rate guidance, relative rallies in growth stocks will be faced with severe headwinds. The valuation gap between growth and value stocks remains large by historical standards, and leaves growth stocks more vulnerable to continued price pressures in a volatile equity market. As a result, we believe it is still premature to position portfolios in the "growthier" segments of the equity market and hence maintain a procyclical low PE value bias.

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