

IN BRIEF:

Should Investors Brace for a Pending Recession and Position Portfolios Accordingly?

There are several headwinds simultaneously hitting the global economy - and there is the potential for a “technical” contraction in economic growth. However, the foundations supporting aggregate final demand are stronger than generally perceived, and there is limited scope for a self-reinforcing deleveraging cycle in the major global economies over the next 6 to 12 months. But the necessary elements that suggest investment portfolios should restructure for a more typical defensive investment strategy remain lacking.

Recessions – or rather, economic contractions - can differ markedly from cycle-to -cycle, and we have outlined the following characteristics that have been observed during prior periods.

- ❖ **Destabilizing Headwind:** Recessions are typically triggered by a meaningful headwind that becomes destabilizing for a crucial segment of the economy. This headwind is often restrictive monetary conditions, but can also be fiscal austerity, or an adverse shock such as an event like the demise of Long Term Capital Management (LTCM), an energy crisis, trade war, pandemic-related lockdowns, etc.
- ❖ **Self-Reinforcing Contraction:** Recessions usually begin with a retrenchment in at least one sector(s) of an economy. What is essential is that the spillover contagion from the weakened sector causes contractionary tendencies in other parts of the economy and ultimately leads to a broad-based and self-reinforcing fallout.
- ❖ **Purging Of Imbalances:** In the leadup to most past recessions, there has been a buildup in economic imbalances fueled by excessive leverage (such as corporate sector over-investment, housing bubbles, etc.). When the economic downturn begins, rebalancing forces act to cleanse or purge these imbalances via deleveraging, which is often why the recession becomes self-feeding.
- ❖ **Lagged Policy Response:** Past recessions have typically been triggered by policymakers (usually monetary authorities) trying to cool economic activity and/or curtail inflation (either CPI or asset prices). In turn, policymakers are usually slow to reverse course and provide stimulus, which allows for contractionary forces to gain further traction.
- ❖ **Forceful And Lasting Policy Reflation:** Policymakers are eventually forced to capitulate and provide sufficient offsetting reflation to mitigate the fallout in the weak or imbalanced sector(s) and redress the contagion to prevent a deflationary shock. This may include removing the initial destabilizing headwind and/or providing other forms of support to encourage increased final demand. Only then does the next economic expansion phase typically take hold. In other words, the authorities jolt businesses, households, and investors out of their pessimism by taking away perceived downside risks and subsidizing renewed risk taking. The faster forceful policy reflation is provided and the greater the amount, it typically translates into less purging of imbalances, helping to limit the fallout in the overall economy.

- ❖ **Resetting The Cycle:** When each of the essential elements of a recession occur, it typically resets the economic cycle by flushing out vulnerable imbalances while leaving sufficient spare capacity to create an extended period of disinflation along with good growth. This sets the stage for a subsequent multi-year economic and corporate earnings expansion. Also, the offsetting reflation provided (typically meaningful rate cuts and/or fiscal stimulus) resets the policy cycle. The cycle typically is slow to normalize since inflationary pressures have been curtailed. Finally, the recession-related selloff in equities (and other risk assets) and rally in government bonds leads to a substantial shakeout in the stock/bond ratio and resets the investment cycle. This provides the foundation for a multi-year bull run in equities and other risk assets. Typically, the deeper the fallout in both the economy and price of pro-growth assets, the greater the potential for the subsequent expansion and bull market to run longer and/or more pronounced.

The Great Recession in Retrospective:

While there are many past recessions over the past 100+ years that one could analyze, the Great Recession of the late-2000s provides a clear extreme example. In the years prior to that fallout, the U.S. and European economies became increasingly imbalanced, with housing bubbles fueled by excessive household and banking sector leverage. When monetary tightening impacted the relatively small subprime segment of the mortgage market, contagion quickly spread and the broader imbalances started to be purged, triggering a self-reinforcing downward spiral that was reinforced by deleveraging. Fiscal authorities were reluctant to respond initially in the U.S. (the original TARP holdout) and for much longer in the eurozone, while central banks initially hesitated to provide the necessary unconditional commitment. The lagged policy response allowed the fallout to become more entrenched until policymakers in the U.S. (by the late-2000s) and eurozone (in the early-2010s) capitulated and became willing to provide open-ended support. The depth of the Great Recession left massive slack in the global economy which helped dampen inflation throughout much of the 2010s. Also, the deep fallout dampened risk-taking among businesses and investors, especially since households continued to rebuild their balance sheets at the expense of consumption in the years following the recession. Together, this allowed policy to remain very accommodative and support a very long economic expansion and bull run in risk asset prices.

Investor Perceptions and the Investment Response:

As financial asset markets fluctuate during and following recessions, they are largely based on all six essential characteristics sited earlier. We have concluded that if any of these elements are missing, the appropriate investment strategy is to stay the course in equity exposure in lieu of a more defensive recessionary strategy, regardless of whether some sort of technical recession occurs.

The first four elements almost always are required to cause global equities to selloff by a dramatic magnitude (over 30%) that investors typically associate with recessions. In other words, to create enough damage to the economy and corporate earnings to cause such a shakeout, there needs to be sizable domestic imbalances that come home to roost and cause a substantial self-reinforcing contraction in overall activity, that policymakers are initially reluctant to stop. If the slowdown does not morph into a self-inflicting spiral or policymakers quickly overreact to the problem (as was the case with LTCM in 1998 for example), it seems appropriate to set an investment strategy as if the economy is experiencing a mid/late cycle slowdown (i.e., expect a much shorter and milder correction phase), regardless of whether the economy contracts for a couple of quarters. If a self-feeding spiral or recession does develop, then the fifth item on our list is crucial for eventually bringing it to an end and marking the bottom in risk asset prices. Aggressive and open-ended reflation will typically halt the selloff in equities and kickstart a market rally. At that point, investors will front-run the eventual economic improvement, even if the current macro data remains weak.

The last scenario outlined is essential in determining the duration of the expansion period for risk taking, and which equity sectors/regions are likely to outperform. This is a point that is worth stressing: just because you have a recession does not mean you reset the cycle and start fresh. Indeed, assuming that the economic and investment cycle were reset in response to the pandemic-related technical recession in 2020 was a major mistake made by investors and policymakers.

It is important to mention that for a global recession to develop (rather than isolated to an individual economy), it requires several economies or drivers of final demand to succumb to recessionary forces simultaneously. This typically means a break in at least two of the three major global economies, namely the U.S., Eurozone and China which collectively account for more than half of global GDP. It bears mentioning that the remaining smaller economies which tend to be reliant on exports to the other three major economies occasionally could develop a crisis that can cause destabilizing contagion to spread as has been seen with emerging market crises in the past.

A Comment on the August Consumer Price Index (CPI) Report:

The recent CPI report highlighted renewed strength in services inflation, and no respite from rising goods prices, marking a reversal from July's trends. The data put pressure on the Fed to maintain its aggressive rate-hiking cycle, corroborating the policy takeaway from the last strong payroll report. This, in turn, has signaled that the Fed will eventually push the policy rate at 3.5 to 4% terminal rate that the forward market is now anticipating. There also appears to be no clear relief from the post-pandemic surge in goods inflation and suggests that a brief policy pause by year-end is slowly fading. On Wednesday, we believe the Fed will press ahead with a 75-bps hike at the FOMC meeting. The odds of a similar hike in November are rising. The two Fed mandates on inflation and employment are currently in agreement, signaling that the economy warrants and can weather higher interest rates. We believe that the Fed should take their foot off the policy brake next year, once the supply-driven strength of inflation unwinds. Such a policy shift would likely require a decisive labor market slowdown that brings inflation down towards 3%. If the Fed stays vigilant on the inflation target of 2.0%, it most likely will cause a deeper recession, removing any possibility of a softer landing.

Corporate Profits:

It's becoming increasingly evident that the boom in U.S. corporate profits is peaking, but we still expect the coming deceleration should be more moderate rather than pronounced, and thus earnings should remain supportive of equities valuation levels. Recession has become an “ugly” word among investors since these events are typically associated with a deep fallout in equity prices, sizable losses in credit and widespread contraction in corporate earnings. Although government bonds could rally in this scenario, multi-asset portfolios still suffer meaningfully. That said, a common mistake made by investors is that they often prematurely position for a recession and get whipsawed by what turns out to be merely a growth scare.

In Conclusion:

There have been many recession scares over the past decade, but none incorporated all the items we have outlined above including, the 2020 pandemic-related fallout. In turn, the economic and investment cycles continued rather than being reset. Fears of self-reinforcing contractions led to policy overkill (too much reflation), while betting on the typical recession fallout proved costly for investors.

The case for recession is still either lacking or premature. Although the consensus has solidified on an expectation of a pending recession in the U.S. and global economy, we have taken a non-consensus view. The calls for a U.S. recession continued to grow throughout the first half of this year and remains prevalent as domestic growth has begun to moderate. The case for recession is predicated on expectations that the Fed will push policy rates materially into restrictive territory.

However, as pointed out in our recent research, this view is based on overly depressed estimates of neutral policy rates. If we are correct that the choking level of interest rates is higher than generally appreciated, then there is a low risk of restrictive monetary policy in the next 6-12 months, and the destabilizing headwind is removed. Elevated inflation is not sufficient on its own to trigger a recession since corporate profits remain strong, real wages (i.e., even adjusting for inflation) are positive or will be shortly as headline CPI eases, and energy prices are now retreating. Likewise, there is a lack of private sector imbalances to be purged and the public sector austerity is unlikely anytime soon.

The U.S. economy will likely undergo a post-pandemic rebalancing from goods to services, which has already been a bumpy transition and lead to temporary softness, reinforcing recession fears. But the service sector comprises a much bigger share of consumer outlays than goods, and still has a lot of ground to recover.

Lastly, household surveys still signal lots of pent-up demand and an intent to spend over the next year, across the income spectrum, despite indicators claiming that consumers are depressed. Thus, while the near-term data may appear to show that the economy is stalling from a growth perspective, it is better characterized as a period of recalibration or payback after a boom, as the level of activity returns to a still rising upward trend

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