Why It Doesn't Matter If We Enter A Recession

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A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales (National Bureau of Economic Research).

We've already seen one quarter of economic decline, but whether we cross the technical threshold of a recession is inconsequential.

For most investors, recession fears are rooted in their association with downward markets. Historically, a bear market has accompanied, or is accompanied by, a recession. We entered bear market territory on Friday, May 20th.

Will we continue to see market turbulence, or is the economy in good enough shape to bounce back and support a market recovery?

While no one can say for certain, the economy is facing strong headwinds, which are not easily fixed. The most notable of these is excessive inflation. That's why we think the inflation discussion is the most relevant one for advisors and investors today.

Let's take a deeper look at the current inflation picture to get a better idea of what we're likely to see in the economy and the markets moving forward (which we share at the end).

Quick Review: How'd Inflation Get This Bad?

Year-over-year inflation rose by 8.3% in April 2022. While slightly lower than the previous month (8.5%), inflation has run rampant for more than a year. How'd we get here? The simple answer is more money in the system, accompanied by loose monetary policies, and topped off with supply chain bottlenecks.

Essentially, more money is chasing fewer goods.

Inflationary Challenges Today

The components contributing to inflation, as well as inflation itself, have created a number of challenges for investors in 2022. Let's look at a few of the more notable issues affecting investors today.

Supply Chain Issues Haven't Been Fixed

The supply chain has yet to normalize from the pandemic-spurred industrial shutdown.

We've seen prolonged chip shortages, which plague a variety of industries—from autos to appliances and cell phones. These supply chain difficulties have become a familiar talking point in the earnings calls of most companies.

The resurgence of COVID and subsequent shutdowns in China threaten to further compound global trade woes. Add to that a growing trend of de-globalization (as a de-risking strategy), and we're seeing widespread support for higher prices in the medium- to long-term.

Additionally, the war in Ukraine has placed a kink in global oil supply (through Russian sanctions). The war seems more and more likely to become a drawn-out affair, and OPEC hasn't indicated a major ramp up to meet rising oil needs. And while permits for oil exploration have increased recently in the United States, barring a major policy shift, our domestic production won't fill the gap. This too will support higher prices, for both trade and consumers.

Inflation Has Reduced Discretionary Income

Wage growth is normally a tailwind for consumption, but we're seeing increased income essentially cancelled out by inflation. As wages increase, the cost of production also increases. To combat this, companies that have pricing power are forced to pass increased costs along to consumers in the form of higher prices.

Despite the persistent and increasing inflationary pressures, thus far consumption has been strong. This consumption has helped bolster economic growth, as shoppers looked past higher prices. But in tandem, consumer credit has also skyrocketed. This tells us that current consumption levels aren't sustainable in the long run. People are borrowing more to purchase the same amount of goods. As rates rise and the cost of servicing debt rises, we could see consumption falter.

Recently, we've seen strong growth in services and discretionary spending. However, as necessities consume a greater proportion of American's income, we would expect an eventual decline in discretionary spending, along with a fundamental shift in consumer behavior (less travel, greater consumption of generics, etc.).

Interest Rate Hikes Don't Control Money Supply

All eyes are on the Federal Reserve, as they continue to increase interest rates to stymie inflation. But there's a core problem that is often overlooked.

While the Fed can control the short-term lending rate and baseline money creation (M0), it cannot force banks to lend or borrowers to borrow. Even the unprecedented zero reserve requirement has not forced the issue.

The Fed had pumped an enormous amount of liquidity into the system, before and through the pandemic. **As we've commented in previous commentary**, to normalize their balance sheet, the Fed would need to sell $6 trillion in bonds. To normalize the Fed Funds Rate (considering inflation), they would need a nominal rate of 9%. We doubt these extremes would be contemplated.

Another half-point rate increase would likely tighten financial conditions, but in context with the current environment, it'd would be similar to scooping a bucket of water out of an Olympic-sized swimming pool. There's a lot of liquidity in the system.

Positive Trends That Could Alleviate Recession Fears And Strengthen Markets

While it's true that there are more tailwinds than headwinds for inflation, the economic picture isn't totally bleak. There are a few scenarios to watch for that could help spur growth.

Continued Strength In Corporate Earnings

Q1 2022 earnings reports have been widely positive, led by Energy, Industrials, and Materials. Continued positive earnings growth would be indicative of growth in the economy. Increased cost of labor and freight will remain a headwind for corporations (as cited in the earnings calls of many companies), and inflation could increasingly differentiate businesses and industries with pricing power.

Reduced Supply Constraints

The last few years have been marred by bottlenecks in the global supply chain. As we move further from the pandemic, we should see the supply chain normalize over time.

This is why the situation in China is so important to monitor. A major lockdown in China has renewed pressures on the supply chain. If the shutdown is short and industry resumes, we could see the bottleneck loosen.

How Is Advanced Asset Management Advisors (AAMA) Positioned Today?

We remain committed to our fundamental market pricing and sector valuation process.

The market keeps demonstrating the benefits of fundamental investing. Netflix's January stock plunge showed the risk of fundamental weakness in high growth stocks, **which we wrote about here**. In the first quarter market decline, unprofitable companies that were trading on expectations of growth were punished while more stable businesses suffered less (covered in our **Q1 market commentary**). And the fixed income market has demonstrated weakness, with greater-than-expected correlation to the equity markets and negative real yields.

Through our fundamental process, AAMA's equity portfolios are generally focused on large cap companies, making sure that more defensive sectors are represented. The Healthcare sector, in particular, continues to stand out in **the cooling, yet still over-valued market** with a median valuation and above-market earnings growth forecast.

Our fixed income portfolios are positioned in short-term and high-quality debt instruments to reduce the risk to principal that occurs in a rising rate environment.

Our Thoughts On The Recession Probability And Strength Of The Markets

Like many things, there is no crystal ball that can predict a recession or market trend. Each instance is unique, and the best we can do is look at the available data to identify the scenarios that might be more likely to see in the future.

So what does the data say?

As of this writing, GDP is projected to grow by 2.4% in the second quarter (Federal Reserve Bank of Atlanta). And as mentioned earlier, spending patterns indicate that the consumer is strong, albeit with rising credit. And corporate earnings have been widely positive, even with the recent hiccup in retail. These would indicate a low chance of a near-term technical recession.

On the flip side, we are contending with sustained high inflation and a Federal Reserve whose singular objective has shifted to controlling it, which portends action that could greatly curtail positive momentum supporting economic expansion. Retail earnings, while not abysmal, have highlighted challenges around inflation (labor, freight) and unforeseen shifts in consumer purchasing trends. Consumers are being forced to allocate more dollars toward necessities and less toward discretionary purchases, leaving retailers with inflated inventories. As such, real inventories have risen well above the pre-pandemic trend—a positive for consumers seeking discounted goods, but a potentially negative leading indicator for corporate margins.

All in all, we think there is a moderate chance of recession, though we might not see it materialize in 2022, and almost certainly not in the first half of the year. Morgan Stanley maintains a recession probability tracker, which currently sits at 35%. While it's important to note that each situation is unique, the current rating is nearing those recorded in 2000 and 2007 (between 40% and 50%). Each of those periods were followed by an economic recession and market downturn.

Just how vulnerable is the market to downside shock? We recently wrote about **how we use the forward P/E ratio to contextualize risk**. The S&P 500 index's forward P/E ratio sits around 17.5, down 20% from its January peak, but still above its 20-year average of 15.5. That tells us that a lot of air has been let out of stock prices (as inflation, supply issues, and slowing economic growth is priced into the market). The market is less vulnerable to further shock than the beginning of the year. So while we may not be at the bottom, investors can find solace in the fact that the market is far less overvalued today, and that the downside looks far less steep than before.

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