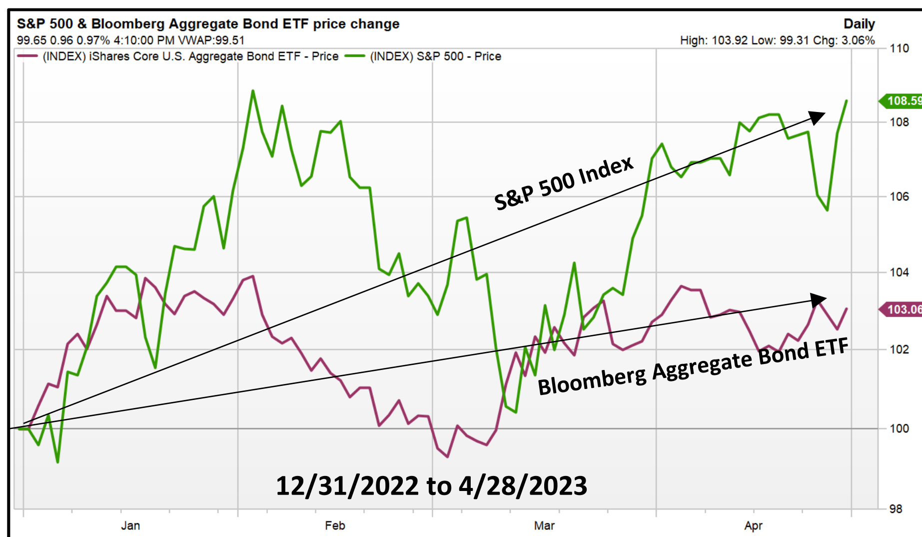
FINANCIAL MARKET OBSERVATIONS

May 2, 2023

Recession? Maybe!

Positive Financial Markets

Despite a good deal of rhetoric, including some from the Federal Reserve's own staff about the specter of a recession looming over the U.S. economy, the first four months of 2023 ended (4/28/23) on a positive note for investors. The major stock (S&P 500) and bond (Bloomberg Aggregate Bond) indexes achieved total returns of +8.59% and 3.82%[i] respectively while the NASDAQ and long-maturity U.S. Treasury exchange traded fund (TLT) had returns of +16.82% and +7.74%[ii]. Recession?



Source: FactSet Research Systems

The Outlook

So many expect a recession soon that it will be surprising if one doesn't occur. In fact, if one does occur, it may be the most anticipated recession in history. Will we have a recession? We will know only after-the-fact. We believe the U.S. is currently in a slowing economic growth environment.

It is the responsibility of the National Bureau of Economic Research to determine when a recession begins and ends. The Bureau defines a recession as *a significant, widespread, and prolonged downturn in economic activity*[iii]. In simple terms, a recession is considered at least two consecutive quarters of negative GDP (economic) growth. The average length of a recession is 17 months, but the last six have lasted less than ten months[iv]. Thus far in 2023, we are not experiencing that environment. Although the economy slowed during this year's first quarter, when compared to last year's 4th quarter (+2.6%), it remained positive at +1.6%.[v]

Recession?

The Federal Reserve has been raising interest rates for more than a year to slow demand and tame inflation. Manufacturing is slowing in several sectors, credit has become more expensive and difficult to obtain, the housing market has contracted, and three banks have declared bankruptcy.

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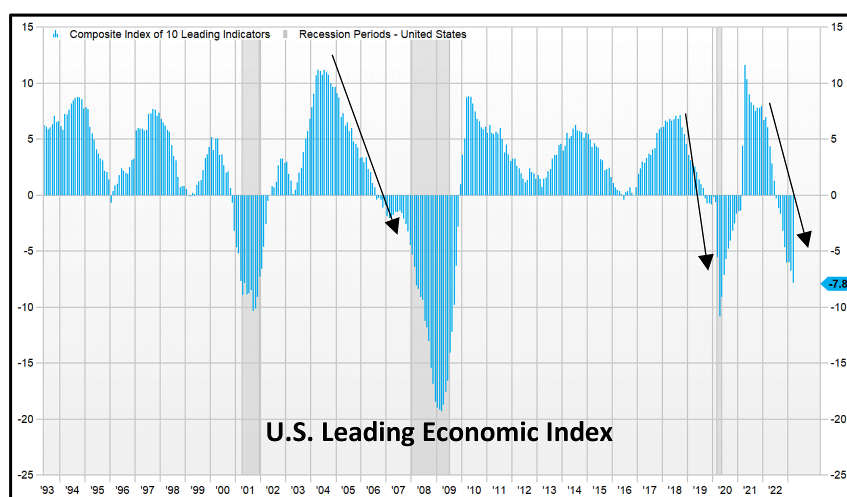
The index of Leading Economic Indicators and an inverted yield curve (short interest rates above longer maturity interest rates), two historically prescient indicators of recession, are also pointing in that direction.



Source: FactSet Research Systems

On the other hand

Conversely, inflation continues to decline, interest rates may have "topped out," companies continue to report revenue and earnings growth, retail sales are positive, and the labor market remains strong. The current Unemployment Rate of 3.4% is lower now than it was when the Federal Reserve began raising rates fourteen months ago and the lowest in 60 years.[vi] Despite a recent spate of layoff announcements, a Bureau of Labor Statistics report (5/2/23) showed the number of open jobs in the U.S. is 9.6 million or 1.6 jobs for every unemployed person! Non-farm payrolls increased again in April by a surprisingly large amount. During an interview earlier this year, Janet Yellen, U.S. Treasury Secretary said, "You don't have a recession when you have 500,000 (additional non-farm) jobs and the lowest unemployment in more than 50 years"[vii]. She later added that a "soft landing" (no severe recession) was a definite possibility. Last week (5/3/23), Fed Chairman Powell said that "Avoiding a recession is, in my view, more likely than having a recession". Our outlook is quite similar, but the intensity of focus on important economic/financial market indicators has not diminished.

We find support in our outlook when we see that the *International Monetary Fund*, *The Economist*, *Yardeni Research*, and *The Conference Board*, continue to forecast positive economic growth for the U.S. in 2023. Goldman Sachs is forecasting less than a 50% chance of recession this year[viii]. As the structure of the U.S. economy has changed (more service/less manufacturing/more technologically advanced) the accuracy of traditional tools to measure the likelihood of recession, and its severity have diminished.

Not Unusual
No one wants a recession because they are associated with increases in unemployment, stock price volatility, consumer malaise, and their length cannot be reliably forecast. However, due to the peaks and valleys of supply and demand, recessions are a regular part of the economic cycle.

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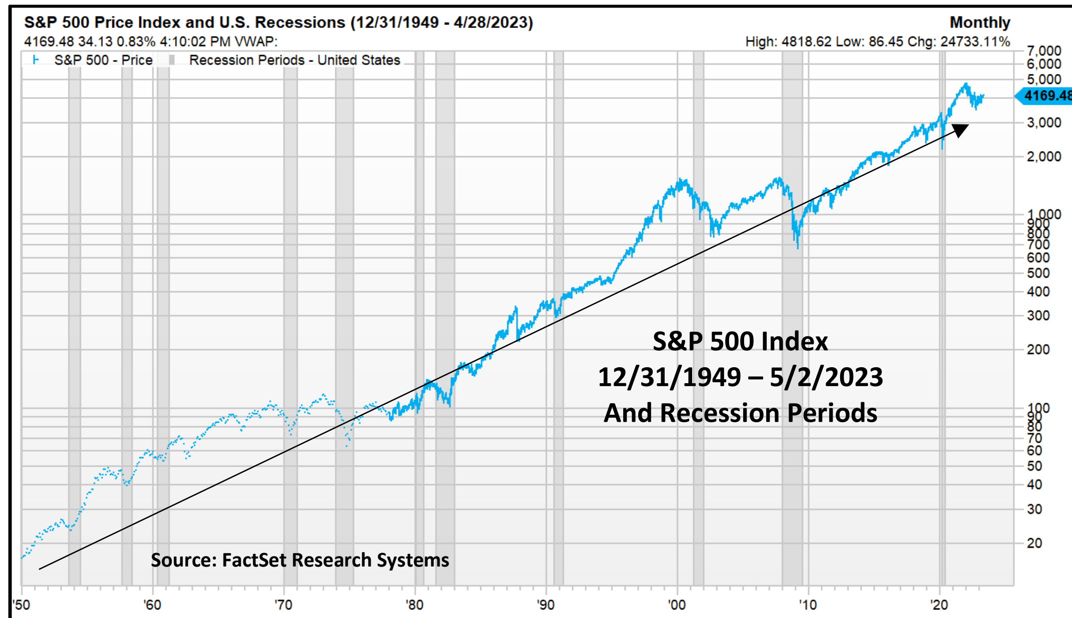
The reoccurrence of U.S. recessions and the resilience of the country's economy, as reflected by the direction and magnitude of change in the S&P 500 Index, are displayed below.



Since 1950, the U.S. has experienced eleven recessions (gray shading), or about one every six and one-half years. Despite these recessions and other significant challenges during that 73+ year period, the S&P 500 has provided investors with a price only (shown on the chart) compound annual rate of return of +7.73%[ix]. With dividends included, the annual rate of return increases to +11.14%[x].

Seventy-three years is a long time! However, if one looks at shorter periods, they would be further encouraged to have patience and maintain a longer (non-trading) viewpoint because of data from Dimensional Fund Advisors, a well-respected research and management company. The DFA data shows that if one calculates the S&P 500's annualized rate of return (including dividends) beginning with the first day of the month after a recession begins, the average annual rates of return are:

1 year = +6.4%   3 years = 12.1%/yr.   5 years = 10.4%/yr.   10 years = 12.0%/yr.[xi]

The returns above are long-term averages and there are variations among them, but impressive non-the-less. History is helpful in making decisions, but it does not necessarily predict the future. However, if investors maintain a broad, strategically diversified investment portfolio, U.S. and global economies continue to grow, and capital markets function as expected, the likelihood that returns will be positive, and most objectives met, is quite strong.

Moving Forward

During these first four months of 2023, we have been opportunistic and further diversified stock portfolios by initiating positions in several new, high-quality, consistent growth companies. Additional investment action involved enhancing the quality of bond portfolios by increasing the percentage invested in AAA rated U.S. Treasury securities .

Recession? Maybe!

While optimistic in our outlook for anything other than a mild, "rolling" recession, and positive portfolio returns in 2023, we are conscious of the need to closely monitor factors that may impact the economy and financial markets. Those factors include data that can influence action by the Federal Reserve, the need to reach a meaningful compromise on the U.S. Debt ceiling, the direction of inflation, geopolitical events, and general consumer sentiment and confidence. The price of energy is always a crucial factor. Despite OPEC+'s February decision to keep crude oil prices firm by curtailing (1MM bbl. per day)[xii] production, the price has declined modestly since the first of the year, but that can change at any time and impact consumer spending.

The investment actions we take are always with the objective of achieving positive, real (inflation adjusted) returns for clients. We continue to emphasize active management, tax minimization, diversification, and investment in high quality bonds, and consistent growth companies. Most important though is to maintain a reasonable investment time horizon and avoid reacting to what may be short-term "noise."

After reading these thoughts, please do not hesitate to contact us if you have any questions, comments, or critique. We highly value the relationship we have with you and look forward to the next time we speak or meet.

There is no guarantee a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio.

Diversification and asset allocation do not protect against market risk. International investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and bonds are subject to availability and change in price. Bond yields are subject to change. Certain call or special redemption features may exist which could impact yield.

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[i] Barron's Magazine, 5/1//2023
[ii] Barron's Magazine, 5/1/2023
[iii] Bureau of Economic Analysis, definition of terms
[iv] Forbes Magazine, 7/29/22
[v] Bureau of Economic Analysis, 4/27/2023
[vi] Bureau of Labor Statistics, 5/5/2023
[vii] Treasury Secretary Janet Yellen, Good Morning America, 2/6/2023
[viii] Forbes Magazine, 3/18/2023
[ix] Info.com, S&P 500 return calculator
[x] Info.com, S&P 500 return calculator
[xi] Dimensional Fund Advisors, Marlena Lee, Barron's Magazine 5/1/2023
[xii] Reuters, 4/3/2023