Zacks INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

WEEKLY CLIENT COMMENTARY November 4, 2022

What to Expect in the Next Recession

The U.S. economy posted two consecutive quarters of negative GDP growth in Q1 and Q2 of this year. While this technically meets the definition of a recession, a recession is not what the U.S. economy has endured.

The National Bureau of Economic Research (NBER) – which is the body that classifies recessions – did not declare one, because they also consider a wide range of factors beyond GDP, like productivity, gains or losses in the jobs market, and wages. These non-GDP fundamentals trended positive while output plateaued, signaling the economy was not necessarily 'contracting' but was more 'holding its own.'[1]

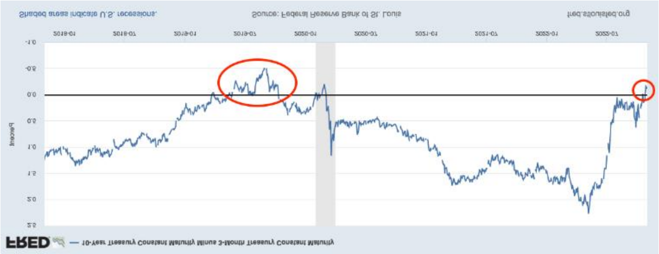
Fast forward to Q3, and the U.S. economy grew by 2.6% according to last week's initial release by the U.S. Commerce Department. Many naysayers point to the fact that a surge in exports contributed the most to the third quarter's output, a temporary boost that will fade quickly, they say, and eventually, give way to the recession almost everyone is anticipating. We see this pattern a lot when sentiment is as negative as it is today – positive news gets ignored, framed as negative and/or temporary, or dismissed as a fluke. Yes, the economy grew, but "just wait."

Regular readers of my column know I am not suggesting the U.S. economy will certainly avoid a recession in the coming quarters. My two preferred recession indicators—the 6-month growth rate for the Conference Board's Leading Economic Index and the 10-year/3-month U.S. Treasury yield curve—are essentially signaling recession conditions ahead:

U.S. LEI 6-Month Growth Rate

Source: The Conference Board[2]

U.S. Yield Curve (10-Year Treasury Bond Yield Minus 3-Month Treasury Bond Yield)



Source: Federal Reserve Bank of St. Louis[3]

Where I differ from the mainstream is in assessing what the next recession could look like. Investors may hear in the news that massive layoffs are coming, the housing market is poised to implode, inflation and interest rates are heading higher, and all of this means we would be wise to prepare for an "economic hurricane." The follow-on implication is usually that stocks have lower to go.

But in my view, these gloomy outlooks all make the same cognitive error that we see a lot in behavioral economics: *recency bias*. Memories of recent events – or in this case, recent recessions – will cause investors and economists to assume that the next recession will look like the last one. But that's not always the case, and in fact, is rarely the case.

According to the National Bureau of Economic Research, there have been 34 recessions in the U.S. since 1857, and they have ranged from lasting two months to over 5 years – and everything in between. Sometimes unemployment goes up by a lot, sometimes it doesn't. Sometimes output falls off a cliff, but other times the U.S. economy experiences a contraction so mild and quick that few people outside of the financial profession even notice.

Because the housing market is weakening, job openings are falling, and inflation and interest rates remain elevated, some assume that the U.S. economy could be headed for another Great Recession, on par with what we experienced from late 2007 to 2009. But that's just recency bias at work, in my view.

I see far more signs that the U.S. could experience a mild recession versus a severe one – a so-called economic soft landing. In the latest GDP print, consumer spending – which accounts for close to two-thirds of total economic activity – edged higher, underscoring the U.S. consumers' resilience in the face of rising inflation. Another key metric that measures underlying demand in the economy, called the final sales to private domestic purchasers, moved 0.1% higher in Q3 as compared to Q2. Banks' balance sheets remain healthy, and the legacy of low-interest rates is keeping debt service costs historically low for a majority of Americans. There are also still more open jobs than there are unemployed Americans, a condition you do not see in economic hard times.

Economic conditions look nothing like they did during the Great Recession or leading up to it, and I seriously doubt they ever will in this cycle.

Bottom Line for Investors

Historically, recessions are best characterized by a decline in production and output, a rupture in the credit markets and household finances, and some amount of job loss. As I write, we have not seen any meaningful sign of these negative factors appearing yet.

That is not to say the U.S. economy will avoid recession. Leading economic indicators point to a weaker economy if not now, soon. But that does not mean the next recession has to be a severe one, where unemployment rises to double-digits as it did during the pandemic and also during the Great Recession. Economic contractions can take many forms, and investors should remember that the next one is not likely to look like the last one.

ABOUT MITCH ZACKS

Mitch is the CEO & Senior Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

[1] Wall Street Journal. October 27, 2022. https://www.wsj.com/articles/us-gdp-economic-growth-third-quarter-2022-11666830253

[2] Conference Board. October 20, 2022. https://www.conference-board.org/topics/us-leading-indicators#:~:text=The%20Conference%20Board%20Leading%20Economic,over%20the%20previous%20six%20months

[3] Fred Economic Data. October 31, 2022. https://fred.stlouisfed.org/series/T10Y3M#

Weekly Market Update

Important Market News We Think Worth Considering

IN FOCUS THIS WEEK

- **Federal Reserve rate hikes**
- **A tight labor market keeps pressure on inflation**
- **American household savings**
- **A decline in natural gas prices**

As Expected, the Federal Reserve Raises Rates Again

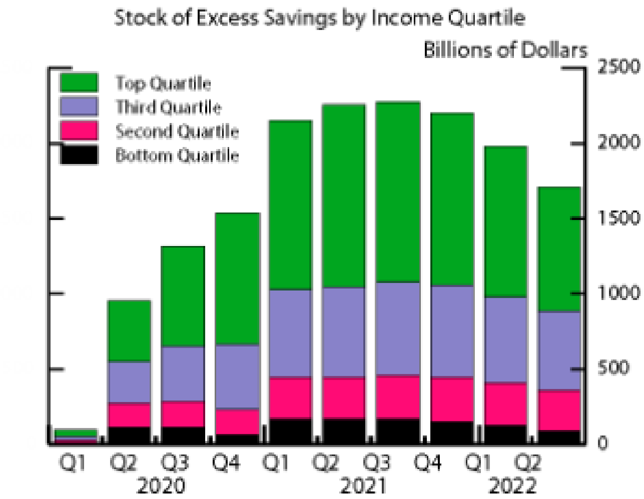
The Federal Reserve announced another 75-basis point increase to the fed-funds rate last week, in a move widely expected by markets. The move placed the benchmark fed funds rate at a range between 3.75% and 4%. Investors were hoping for signs the Fed was making plans to slow or even pause rate hikes in the not-too-distant future, but that is not necessarily the news Fed Chairman Jerome Powell delivered. While the Fed did not release updated projections for the projected path of rates, Chairman Powell did suggest that future rate hikes could be smaller but that the Fed will likely need to stay in the tightening cycle for longer. In Powell's own words, "the question of when to moderate the pace of increases is now much less important than the question of how high to raise rates and how long to keep monetary policy restrictive." In layman's terms, what Powell is saying is that the Fed may implement smaller rate hikes in the future, but that the market should expect the terminal rate – which is where fed-funds will eventually peak in this tightening cycle – to be higher. Markets reacted adversely to Powell's comments, marking yet another instance where the market's expectations for peak interest rates were presumably too low.[1]

A Tight Labor Market Keeps Pressure on Inflation and the Fed

Strength in the U.S. jobs market is a problem for the Fed because tight labor conditions place upward pressure on wages – which is itself inflationary. The "data-dependent" Fed is focused on year-over-year and month-over-more core inflation readings (of course), but it is also highly sensitive to ongoing strength in the labor market because it means inflation pressures could persist. The September jobs report didn't help. The Labor Department reported that demand for workers continues to far outstrip the number of unemployed Americans seeking a job. Total job openings climbed from 10.3 million in August to 10.7 million in September, which is slightly more than double the number of unemployed Americans seeking work (5.8 million). To be fair, however, the number of job openings has been in steady decline since its March 2022 peak of 11.9 million, so notwithstanding September's slight increase, the economy has been slow-stepping in the right direction for the Fed. If the Fed is looking for meaningful signs that inflation is falling, the jobs market is loosening, and U.S. consumers are starting to pull back, it has not received them to date.[2]

Households Continue to Hang On

Americans boosted savings in the wake of the Covid-19 pandemic, as stimulus checks and reduced spending on travel and tourism bolstered bank account balances. At its peak in the middle of 2021, household savings topped $2 trillion, up from barely $100 billion in the first quarter of 2020 (before the pandemic). Households have since tapped into these excess savings, but the cushion is still meaningfully large. According to estimates from Fed economists, Americans still have about $1.7 trillion in stashed savings, though the figure has been trending downward as inflation eats into budgets.[3]



Federal Reserve[3]

Households Continue to Hang On

There may be some good news coming to households this winter, in the form of lower-than-expected heating bills. The war in Ukraine and subsequent volatility in commodity markets led to many dire projections about access to oil and natural gas this winter, but it appears the worst of those fears can be put to rest. Natural gas prices have declined by nearly half since late August, as a warmer-than-usual autumn and strong domestic production have refilled storage facilities and boosted supply. Lower natural gas prices could ease winter heating bills for consumers while also lowering costs of production at manufacturers.[4]

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[1] Wall Street Journal. November 2, 2022. https://www.wsj.com/articles/jerome-powell-to-markets-the-destination-matters-not-the-journey-11667427735?mod=djemRTE_h

[2] Wall Street Journal. November 1, 2022. https://www.wsj.com/articles/job-openings-hiring-economy-september-2022-11667249735?mod=djemRTE_h

[3] Federal Reserve. October 21, 2022. https://www.federalreserve.gov/econres/notes/feds-notes/excess-savings-during-the-covid-19-pandemic-20221021.html

[4] Wall Street Journal. October 30, 2022. https://www.wsj.com/articles/natural-gas-prices-have-plunged-into-autumn-11667084564?mod=djemRTE_h

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