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INVESTMENT MANAGEMENT

Mitch on the Markets

Portfolio Manager Investing Insights

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Can the U.S. Avoid a Recession in 2023?

Just about everyone thinks the U.S. economy will enter a recession this year.

According to a *Wall Street Journal* survey of 23 of the U.S.'s largest financial institutions, nearly 80% of their top economists think the economy will contract for two consecutive quarters in 2023.[1] They may be right.

Corporate earnings estimates for 2023 have been coming down considerably – companies now expect aggregate 2023 earnings to fall -9.2% from their 2022 peaks, or -11.9% if you exclude the Energy sector's positive contribution.[2] Falling earnings estimates and peaking profit margins generally imply an economic slowdown is underway, or very close. In previous columns, I have pointed readers to other key recession indicators, like the negative 6-month growth rate for the Conference Board's Leading Economic Index and the inverted 3-month/10-year U.S. Treasury yield curve, both of which continue to send relatively strong recession signals.

There are also other signs demand is waning – indexes that track business activity in U.S. services and manufacturing sectors have fallen to levels last seen around the 2020 pandemic-fueled recession, household savings have been trimmed considerably as consumers have largely spent through fiscal stimulus, and banks are tightening lending standards (even though overall loan activity remains strong).[3]

The upshot to these recession forecasts is that most believe the contraction will be mild and shallow, to the point where many Americans may not even notice it at all. I see this outcome as a distinct possibility as well. But I also think it's worth presenting a case for the U.S. avoiding a recession altogether, which I strongly believe is possible. Below I'll give you three reasons why.

1. **Real Disposable Incomes are Poised to Go Up in 2023, Not Down**

A historically strong labor market pushed wages higher in 2022. Nevertheless, real disposable income fell sharply in the first half of 2022 because of fiscal tightening and high inflation. In other words, Americans were making more in 2022 but had less purchasing power, which isn't a good setup for sustainable growth.

Looking ahead to 2023, ongoing strength in the labor market is likely to continue supporting higher wages, while inflationary pressures should subside significantly. We're already seeing the latter – price pressures related to supply chain disruptions have almost entirely faded, giving way to falling costs for semiconductors, used cars, gas, appliances, and a range of other goods that contributed significantly to last summer's inflation surge.

In my view, falling inflation combined with rising wages could push real disposable income up by 2% to 3% in the new year, which would buttress consumer confidence and lead to increased spending. As I wrote later last year, since spending accounts for roughly two-thirds of U.S. economic output, strong consumer finances could help the U.S. avoid recession.

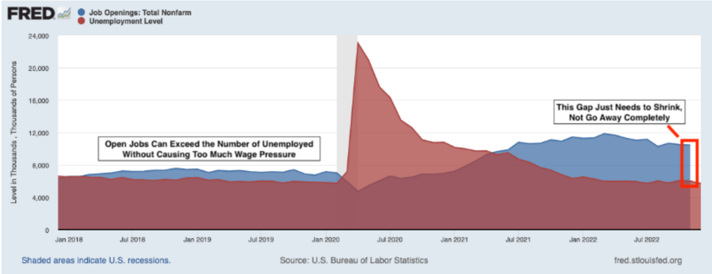
2. **Job Losses and Rising Unemployment May Not Be Needed to Tamp Inflation**

As mentioned in the previous section, "goods" inflation is trending solidly in the right direction, with further declines almost assured in the first half of 2023. But it is also true that one of the Fed's biggest concerns is not 'goods' inflation—which it acknowledges is improving—but 'services' inflation, which tends to have closer ties to the jobs market and wages.

In comments following the Fed's December meeting, Chairman Powell said "the labor market continues to be out of balance, with demand substantially exceeding the supply of available workers."[4] This imbalance puts upward pressure on wages, which can entrench inflation if it influences companies to raise prices to make up for higher costs.

So, many forecasters think the Fed will not stop monetary tightening until it sees significant cooling in the labor market. But in my view, this feat can be accomplished not by triggering massive layoffs, but by instead unwinding available job openings – which would be much less painful.

A key feature of this economic fundamental I think many misses: the number of Americans looking for work doesn't have to exceed the number of available jobs in order for wage pressures to ease. As seen in the chart below, from 2018 up to the pandemic, there were roughly 1.5 to 2 million more open jobs than available workers, and wage pressure was low during that time. In the current environment, I think the ratio of open jobs to available workers only needs to shrink to 2 million (from the current 4 million) to bring wage growth down to a rate compatible with the Fed's 2% inflation target:



***Source: Federal Reserve Bank of St. Louis*[5]**

3. **China's Economic Reopening Supplying Global Economic Tailwinds**

The end of China's "zero Covid" policy has so far been bumpy. China does not supply reliable data in terms of hospitalizations and how broadly the spreading of infection is disrupting daily life and economic activity. But safe to assume it has so far been hurting more than it's been helping.

I think that could change later in 2023. While China currently lacks natural immunity and vaccines there are not as effective, over time the impact on day-to-day life is likely to subside much as it has in the U.S. China's government has also been hinting at the possibility of stimulus to boost the economy, and there are several indicators that regulatory hostility towards hard-hit technology and education sectors could abate in the new year.

China is the second largest economy in the world, so a snap back to stronger growth trends would serve as a tailwind to global GDP and likely boost other emerging market economies.

Bottom Line for Investors

It is important for investors to remember that bull markets typically start during a recession and *before* corporate earnings reach a low point. That's because the stock market is a discounter of future economic and business conditions. In other words, if you expect the U.S. economy to struggle in the first half of 2023 and to improve later in the year or even into 2024, it would make now the time to own stocks, in my view. And since corporate earnings estimates have already come down considerably, and some level of economic weakness is anticipated in the new year, then I think that puts us closer to inflection points and opportunities for investors – not further away.

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. January 2, 2023. https://www.wsj.com/articles/big-banks-predict-recession-fed-pivot-in-2023-11672618563

[2] Zacks.com. December 15, 2022. https://www.zacks.com/commentary/2029325/have-earnings-estimates-come-down-enough

[3] Wall Street Journal. January 2, 2023. https://www.wsj.com/articles/big-banks-predict-recession-fed-pivot-in-2023-11672618563

[4] Wall Street Journal. December 15, 2022. https://www.wsj.com/articles/jerome-powells-grim-inflation-outlook-is-at-odds-with-markets-11671072877?mod=djemRTE_h

[5] Fred Economic Data. January 4, 2023. https://fred.stlouisfed.org/series/JTSJOL#

IN FOCUS THIS WEEK

- **Status on the U.S. labor market**
- **The recent oil and gas boom**
- **U.S. trade weakens**

December Jobs Report Underscores Resilience in U.S. Labor Market

The U.S. Labor Department reported that 223,000 nonfarm jobs were added in December, making 2022 the second-best year for job growth in recorded history (2021 was the best year). The three-month average of job growth is 247,000, putting December on trend and underscoring the ongoing resilience of the labor market. The unemployment rate fell to 3.5%. Another bright spot in the report was that wage growth continued to slow, which came as a relief to markets given the Federal Reserve's focus on the effect that higher wages are having on services inflation. Average hourly earnings grew by 0.3% from November to December, and 4.6% year-over-year. Both of these data points mark improvements from previous month-to-month and year-over-year readings, which give further hope that a peak in wages may be in the rearview mirror. According to economists at the job-search website Indeed, posted wages were up 6.3% in December, which is of course higher than Labor Department estimates. The good news, however, is that Indeed's figures are an improvement from November's 6.5% increase and the apparent March 2022 peak of 9%. While job growth remains steady, it is worth noting that layoffs are starting to creep higher in certain segments of the market, namely in technology and other white-collar sub-industries, like real estate. The question for labor markets in the next few months is whether these layoffs spread to blue-collar industries where job growth has otherwise been strong and where job openings remain relatively high. In our view, there is still slack in the labor market where job openings can fall and the unemployment rate can remain relatively steady, easing wage pressures in the process.[1]

What's Behind the Unexpected Oil and Gas Boom?

Investors and traders were worried last year that the ongoing Russian invasion of Ukraine – and efforts by western countries to stem the flow of Russian oil globally via bans and price caps – would lead to a sustained surge in oil and gas prices. For a time, last summer, that's what happened, with the price of natural gas rising to $9 per million British thermal units and crude oil jumping past $100 a barrel. The high prices didn't last. Higher prices predictably spurred producers back into action, and the prospect that Russian oil and gas exports would be limited in the future had many producers eager to gain new market share up for grabs. U.S. production of natural gas has now eclipsed record levels, as have exports, while domestic crude oil production is also hovering around peaks. Prices have responded to increased production in kind, with natural gas back down to around $4 per million British thermal units and the price of a barrel of crude trading around $80. The surge in production looks different than the last fracking-driven boom circa 2015, when companies were loading up on debt and overinvesting in rapid-fire growth. Now producers are being more cautious about capital expenditures and disbursing more money to shareholders via dividends.[2]

U.S. Trade Weakens Ahead of a Possible Economic Slowdown

Many market watchers tend to focus on whether the U.S. is running trade surpluses or deficits with the rest of the world, but the real metric to keep an eye on is total trade, in our view. Rising trade volumes in aggregate signal growing global demand, regardless of whether the U.S. trade deficit is growing or shrinking. On the flip side, if total trade is falling then it likely means that global demand for goods and services is falling too, generally a harbinger of economic weakness or even recession. In November, U.S. exports fell by 2%, while imports dropped by even more (6.4%), signaling that global demand for goods and services hit a soft patch. More data is needed to confirm the trend, however, as seasonal forces could also be in play and the effect of "zero-Covid" lockdowns took its toll. China has since ended these restrictive policies, which could result in a trading rebound in the coming months.[3]

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[1] Wall Street Journal. January 8, 2023. https://www.wsj.com/articles/as-white-collar-layoffs-rise-blue-collar-resilience-faces-test-in-2023-11673132989?mod=djemRTE_h

[2] Wall Street Journal. January 10, 2023. https://www.wsj.com/articles/oil-and-gas-are-back-and-booming-11673363006?mod=djem10point

[3] Wall Street Journal. January 5, 2023. https://www.wsj.com/articles/u-s-trade-deficit-narrowed-sharply-in-november-as-global-demand-cooled-11672926977?mod=economy_more_pos7

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