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# Market Strategy:

## Recession and Fed *Cuts* On the Docket for 2023

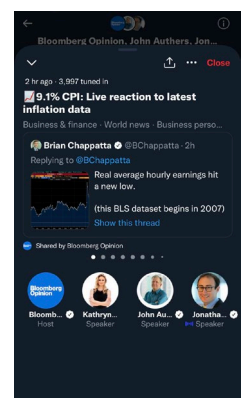
The specter of recession is looming large in the minds of policymakers, investors, and households, as inflation has eroded the real purchasing power of households and the Fed signals that it is willing to drop a Volcker-type bomb on the economy in a bid to re-anchor inflation. Demand destruction is what it will take to get inflation down from 9.1% as of June 2022 to the Fed's 2% target.

The Fed is likely going to hike 75bps in the next meeting later this month with the risk for 100bps. The 2s/10s US Treasury yield curve is again inverted. The Fed's Nowcast sees 2Q22 real GDP printing a second consecutive contraction. We too expect two quarters of negative economic growth in 2022 without the labor market even rolling over. The labor market will, however, roll over (we forecast unemployment rising to 4.2% within 12 months) and with it, consumption, leading to recession. These are themes for 2023. **If 2H2022 is deemed a recession by NBER, then 2023 will mean a double dip.**

Expect Wall Street to make big downward revisions both to economic forecasts in 2022-23 and for earnings for the rest of 2022. Earnings growth estimates remain at a high 10%+ y/y (basically unchanged) for 2H22. Revenue growth and margins are dropping, inflation is biting, and estimated are going to have to follow suit. 2Q earnings S&P 500 5.7% expected. Guidance will be lowered. The Fed...



*Inflation came on point with our forecast of slightly above 9% y/y for the month of June. Listen to our inflation analysis for Bloomberg Opinion (7/13/22) here:*





has to hike more, taking the economy into contraction in order to stamp out the inflation for which it is in part responsible (by overextending bond purchases and low rates to support a labor market that was already at full employment.) The labor market overheated. Now economic contraction is the only thing to stamp out inflation.

We see a good chance of recession in 2023 and a Fed that is forced to either cut rates and/or chooses to resume QE. A resumption of QE brings risks given that its use has been confined to Goldilocks economic environment not a stagflationary one. We recommend protecting with inflation hedges including precious metals for this risk. We recommend preserving some cash on the sidelines for the eventuality that the Volcker-bomb is larger than anticipated.

Headline CPI came in at 9.1% y/y for the month of June, the highest level seen since 1981, meaning we are living within an inflation climate that before now, was out of living memory for a large number of investors, both institutional and retail.

## Equity Valuations Have Come Back To Earth

The index-level PE Ratio for the S&P 500 is trading at around 17.0, which is below the historical average over the last 30 years of around 17.4. However, we believe that this slightly undersells the case. Since the beginning of 1990, the tech sector has more than doubled in importance to the index, growing from around 10% of the market weight of the SPX to more than 30% in 2020, before returning to its current levels of around 20%.

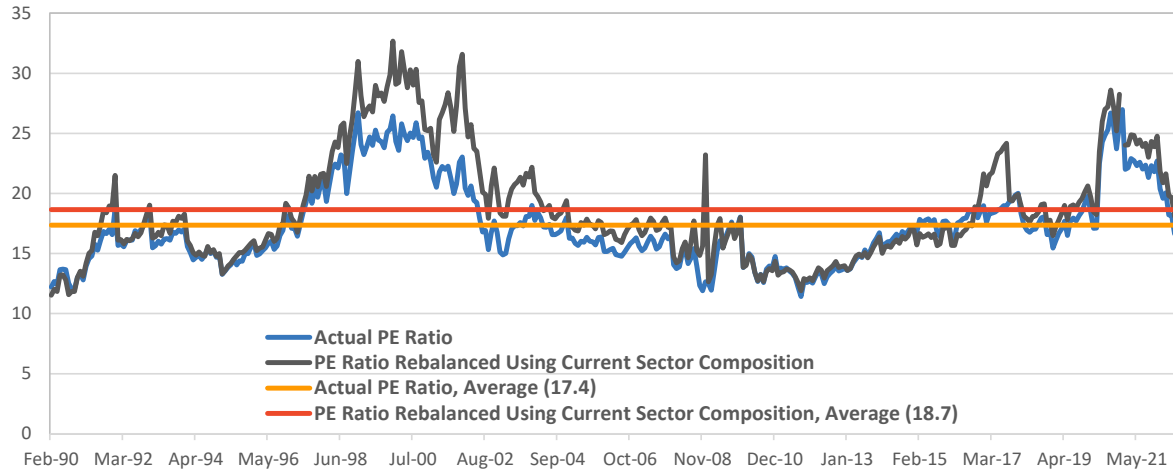
A higher weighting to growth-oriented stocks, including many found in the tech sector, should logically mean that the 'fair' PE ratio should be higher now than it was historically. Indeed, when we rebalance the historical PE ratio using a static sector breakdown (based on today's weightings), we find that the historical average PE Ratio is significantly higher, at 18.7. Under this rubric, the current PE ratio of around 17.0 becomes much more attractive.

**We expect that PE ratios will begin to climb as earnings growth diminishes amid sluggish economic growth and negative real wages.** For the time being, these headwinds have been mitigated by a tight labor market, with unemployment still near historic lows. That is likely to change.

In the second half of 2022 we do expect economic growth to print positive after 1H22 prints negative. We think the markets have priced in the extent of what the Fed will do this year on rate hikes and we think there is a good chance the Fed does not roll off assets at the pace and magnitude it has suggested. As a result, for the remaining next 6 months of the year, we see S&P 500 moving a bit higher to 4,100 by end-2022, but near-term drops and bouts of volatility should be expected.



S&P 500 PE Ratio, Adjusted And Unadjusted



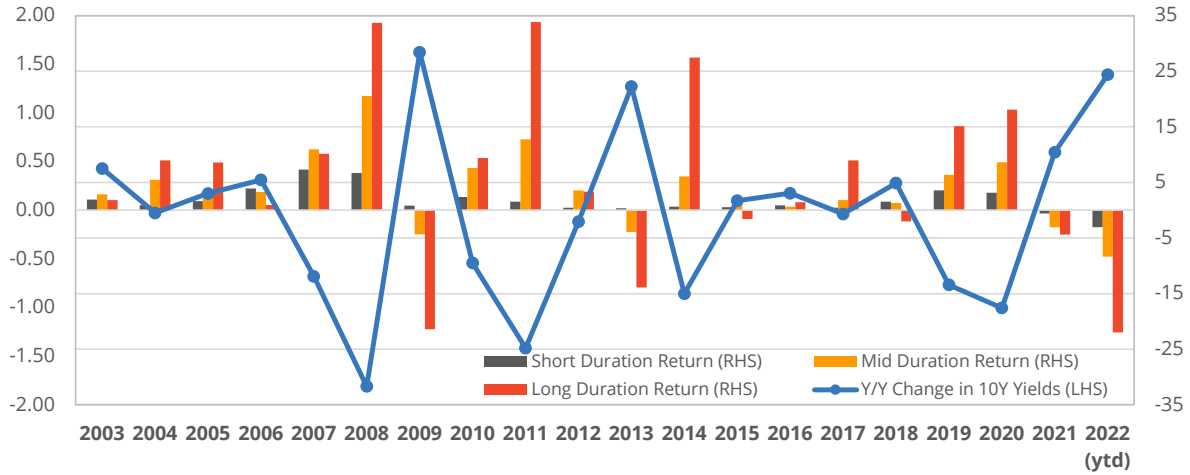
## Fixed Income Market Flashing Warning Signs

Meanwhile, this year has proven to be one of the worst in decades for fixed income, as yields have sharply risen across all maturities as investors price in the prospect for more aggressive rate hikes. The 10Y UST yield has increased by 150bps ytd, leading to a more than 20% decline in the value of long-duration bonds. **The interest rate futures market is pricing in a fed funds rate of at least 3.50% by year-end (up 175bps from current levels), versus a rate of 0.75% being priced in at the beginning of the year. Never in the history of the Federal Reserve has such an aggressive strategy been pursued and not resulted in a recession.** The only question now is how severe, how protracted, and when it will really start to bite (particularly in the labor market).

Charting the move in the 10Y UST yield versus the relative outperformance in long-term vs short-term bonds shows a clear negative correlation between yield rises and the relative performance of high-duration bonds (as one would expect).

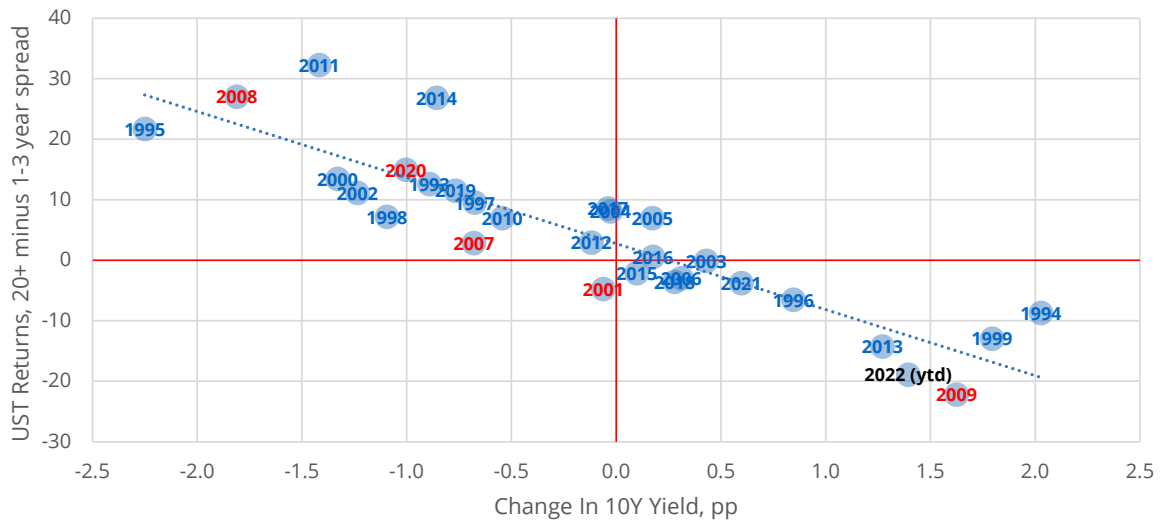


Duration Returns Vs 10Y Yield Changes



However, it is also interesting to note that high duration bonds in years that underperform *even taking interest rate moves into account* (those which are substantially below the fitted line in the chart below, including 2007, 2009, 2001) are all years which were characterized by recession.

Duration Return Spread Vs 10Y Yield Change By Year  
(Red Indicates At Least Part of the Year In Recession)



Year-to-date, 2022 is already counted among these underperforming years. This suggests that at least on a relative basis the bond market has already largely priced in a recession, and the relative underperformance of long-duration bonds should subside within the fixed income space moving forward. Indeed, as recession risk begins to make its mark, we expect that investors' investment strategy should be much more focused on credit risk, versus duration risk.



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