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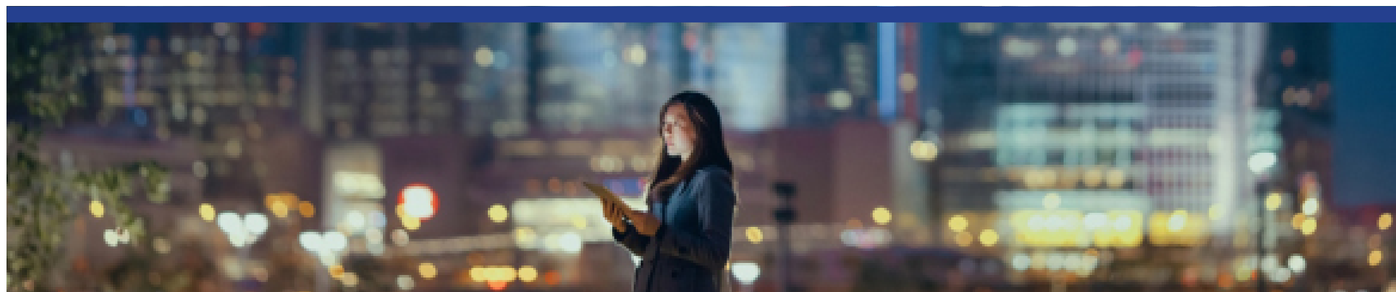

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CIO Strategy Bulletin

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The Signals and the Noise

SUMMARY

- Today's bear market rally looks very different than a cyclical bull market. Cyclical bull markets are typical in periods when the economy can grow at an above-trend pace. Such growth requires labor market slack after a recession or contraction. This allows the labor resources to be redeployed in the economy at a faster, non-inflationary rate. This is not such a moment.
- In recent weeks, strong equities and credit markets have effectively provided easing while the Fed continues tightening. The odd aspect of the early-year performance for financial markets is that "lower quality" assets have led the rally.
- Looking at reams of objective data, one can see today's economy as a glass half full or half empty. Conflicting and confusing (even incredible) data have been reported recently. Could the historically most reliable signal of a future recession – the inverted yield curve – fail us this time?
- There is enough history and current evidence to suggest that underneath the animal spirits of January lurk the latent impacts of the strongest monetary medicine ever given to a modestly growing economy. The Fed's dramatic turn toward monetary restraint begun just 11 months ago is still working its way through the economy.
- While the underlying data for the labor market have held up stronger than expected, corporate profits have been weaker and declined sooner than even we anticipated. With analyst estimates showing a "recession already over," this makes the likelihood of a Goldilocks outcome less plausible, in our view. Either growth will slow sharply, or the Fed is likely to stay restrictive until unemployment is materially worse.

When Up Is the New Down

Is it a bust? Or is it a boom? The short answer is yes! Looking at reams of objective data, one can see today's economy as a glass half full or half empty. Conflicting and confusing (even incredible) data have been reported recently. What does it all mean? In short, while we believe investors have experienced the worst of the bear market in 2022, we do not believe it is "all clear from here."

In recent weeks, strong equities and credit markets have effectively provided easing while the Fed continues to tighten. The odd aspect of the early-year performance for financial markets is that "lower quality" assets have led the rally. The lowest rated tier of the junk bond market has led high-yield returns (**Figure 1**). Last year's laggards -- unprofitable companies -- have crushed industry leaders year-to-date (**Figure 2**).

Meanwhile, strong economic data suggests the Fed has a ***longer*** way to go to fight inflation. That would mean higher rates for longer in Fed-speak. Remember that the Fed will not ease when "good news" is in full swing. In short, recent market performance is inconsistent with a Fed still tightening to restrain the economy.

Could the historically most reliable signal of a future recession – the inverted yield curve – fail us this time? Of course, it's still possible a recession won't happen. On the positive side, despite slow progress, the gradual easing of inflation pressures has been stabilizing for the world economy. The clearest example of this has been in deflating the energy supply shock in Europe (see the January Quadrant). And US consumer spirits have bounced from recessionary lows.

Yet the slowdown in manufacturing, residential construction, imports and goods shipments all point the other way. Sure, there were reasons to doubt the intense weakness seen in so many data points for both November and December. Reports on US retail sales and employment upwardly "corrected" for these trends. But seasonal adjustments are, in the end, smoothing curves, not changing trends.

Impatient Forecasters

It is unwise to be an impatient forecaster. There is enough history and current evidence to suggest that underneath the animal spirits of January lurk the latent impacts of the strongest monetary medicine ever given to a modestly growing economy. The Fed's dramatic turn toward monetary restraint begun just 11 months ago is still working its way through the economy (**Figure 3**). And again, in historical context, the recent bullish performance of financial markets after the Fed inverts the US yield curve is far from unprecedented (**Figure 4**).

After a pandemic, a war in Ukraine and divergent policy decisions by the world's largest economies, it is understandable that clear economic signals are hard to identify. We are seeing peak seasonal swings in the economy, particularly after a time of great instability and upheaval. This makes the government's job of providing consistent and useful readings on the monthly performance of the economy much harder (**Figure 5**). To be fair, though, this cuts in both directions. Both the strongest and the weakest reports deserve equal scrutiny.

A Housing Recovery Already?

A look at the share prices of homebuilders would make you think the recession has passed and we were passing through the trough of a poor housing market. Last week, we highlighted the extreme low marked in prospective US homebuyer traffic near the end of 2022. In the first two months of 2023, a few more buyers showed interest. A bottoming in the housing industry would seem to suggest that the Fed's "rate shock and awe" is passing. Yet, the low real activity levels associated with housing, manufacturing and international trade are all consistent with a far worse labor market than the one featured in government reports for early 2023. To be clear, we are referring to employment in the same industries that are reporting economic contraction during the past year, not something broader.

Falling Corporate Profits Are Upon Us

While the underlying data for the labor market have held up stronger than expected, corporate profits have been weaker and declined sooner than even we anticipated (**Figure 6**). With analyst estimates showing a "recession already over," this makes the likelihood of a Goldilocks outcome less plausible, in our view. Either growth will slow sharply, or the Fed is likely to stay restrictive until unemployment is materially worse.

Final Observation of the Week

It is optimal for the economy to avoid both booms and busts, to keep workers fully employed. Experience drives upward mobility. New entrants to the labor market provide growth. Unfortunately, the upheaval in the economy of recent years and wild swings in macroeconomic policy still leave us skeptical that the road ahead with be smooth and up.

We will watch unemployment insurance claims data closely in coming weeks and the market reaction to the February employment data. This information might clarify the persistence of labor market strength or the extent to which January data exaggerated it.

Today's bear market rally looks very different than a cyclical bull market. Cyclical bull markets are typical in periods when the economy can grow at an above-trend pace. Such growth requires labor market slack after a recession or contraction. This allows the labor resources to be redeployed in the economy at a faster, non-inflationary rate. This is not such a moment.

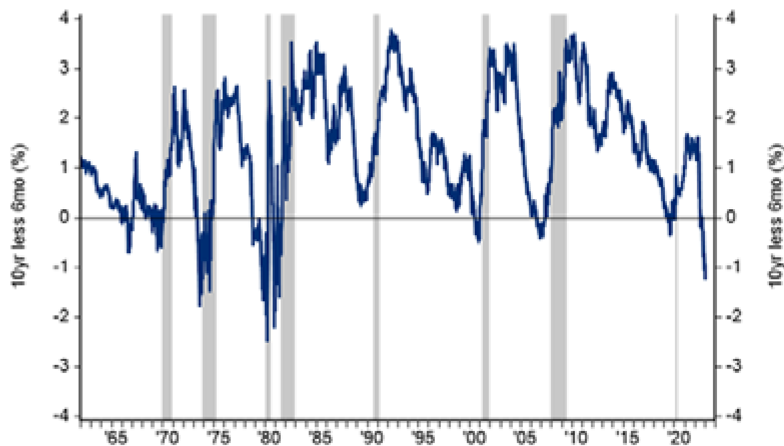
With this in mind, we are still erring on the side of caution in fully invested portfolios, seeking to earn investment grade bond and dividend income to generate returns even as markets speculate about a return to bull market conditions that we think seems premature.

Figure 1: Lowest tier high-yield leading credit returns

Figure 2: Unprofitable tech beating quality in 2023

Source: Bloomberg as of Feb. 15, 2023. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Past performance is no guarantee of future results. Real results may vary.

Figure 3: US yield curve (10s-6mos) and recessions



Source: Bloomberg as of Feb. 15, 2023. Grey areas note recessions.

Figure 4: Performance of S&P 500 while yield curve is inverted and recession has not yet begun

Start of Inversion	End of Inversion or Prior to Recession Beginning	S&P 500 Performance During Period	S&P 500 Performance 6 mths After End of Inversion or Prior to Recession Beginning	S&P 500 Performance 12 mths After End of Inversion or Prior to Recession Beginning
Sep-59	Feb-60	-5.84%	1.50%	13.04%
Dec-65	Feb-67	-5.27%	7.91%	2.97%
Apr-68	Nov-69*	4.00%	-18.40%	-7.05%
Mar-73	Oct-73*	-3.04%	-16.60%	-31.76%
Sep-78	Dec-79*	4.50%	5.84%	25.77%
Sep-80	Jun-81*	7.22%	-6.60%	-16.46%
Feb-89	Sep-89	17.37%	-2.64%	-12.34%
Apr-00	Dec-00	-11.90%	-7.26%	-13.04%
Jan-06	May-07	22.62%	-3.23%	-8.51%
Aug-19	Sep-19	-0.12%	-13.17%	12.98%
Avg		2.95%	-5.27%	-3.44%
Median		1.94%	-4.92%	-7.78%

*Denotes inversion continued but recession began the following month

Source: Haver Analytics and Bloomberg as of Feb. 15, 2023.

Figure 5: Are we clear about this? Retail sales boomed in January (seasonally adjusted)

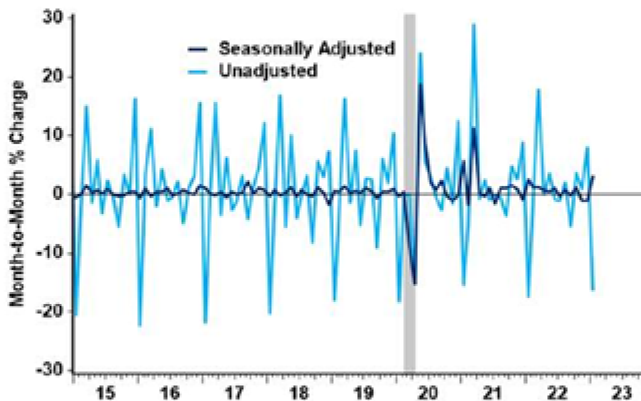
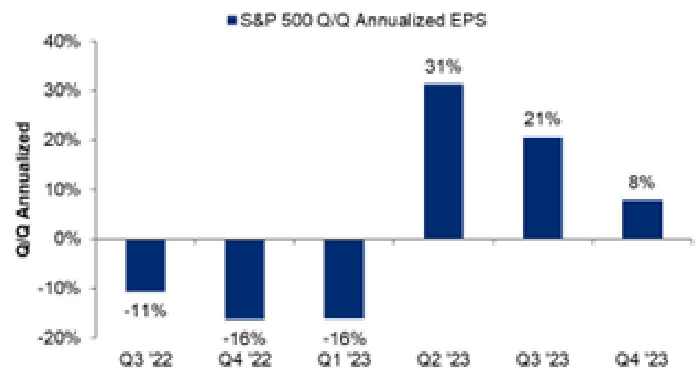


Figure 6: Quarterly % change in S&P 500 EPS and bottom-up analyst estimates



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Medium grade	Baa	BBB	BBB
Not Investment Grade			
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Low grade (speculative)	B	B	B
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Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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