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# CIO Strategy Bulletin

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## Observations and Recommendations for a Rolling Recession

- For investors in 2023, the economic outlook and market actions appear disconnected. This suggests we are in a “Rolling Recession,” one where we see contraction and growth in different part of the economy at the same time
- We think the unusually long time it is taking labor markets to be impacted by Fed rate hikes may be misleading investors – and Fed officials – into thinking that there is no slowdown in the labor market coming.
- The absence of a major downturn in employment and the offsetting economic impacts of the Rolling Recession might result in another, more dangerous round of tightening financial conditions. This may occur when the current threat of US default ends, enabling the US Treasury to borrow again. If overconfidence on employment leads to a resumption of Fed tightening, it may raise the probability of a broader recession rather than the rolling recession now underway.
- We still believe the Fed’s aggressive fight against inflation and the current delay in labor market weakness will ultimately cause the Fed to reverse course toward the end of 2023. This suggests that the currently high overnight money fund rates and high yields of short-term T-Bills will not be available a year from now.
- Extending the duration of fixed income portfolios should be seriously considered after the debt ceiling issue is resolved.
- A backup in US bond yields and a temporary jump in the dollar could make for a potentially strong opportunity to add emerging market (EM) debt to portfolios.

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## The 2023 “Rolling Recession”

Often economic history repeats itself. Not this time. The two most recent recessions were unambiguous. For investors in 2023, the economic outlook and market actions appear disconnected. This suggests we are in a different type of recession, one that has elements that are contradictory in direction, but still material in size and scope. Such is the Rolling Recession of 2023.

In 2020, an extraordinary severe external shock that was treated with equally enormous stimulus. The recession was deep, short and disruptive. For two months, US employment collapsed broadly, but went on to grow ever since. US and global equity markets lost about 34% of their value in a month, but rebounded 44% in the following two months. US real GDP contracted at a record 30% annualized pace in 2Q 2020, but bounced back at a 35% pace in 3Q 2020. Never before was there such clarity about the difference between contraction and expansion. The speed of the rebound made investing look easy.

The last “natural” recession in 2008-09 was also distinctive. Then, monthly US job losses ran at an average of nearly 800,000 per month for half a year, the worst sustained employment declines since WWII. Over two years, the US unemployment rate doubled to 10%. The financial system nearly collapsed and needed a taxpayer financed recapitalization. But from that depressed point, US growth endured for a record 128 months, only ending due to the pandemic.

## Looking More Closely at 2023

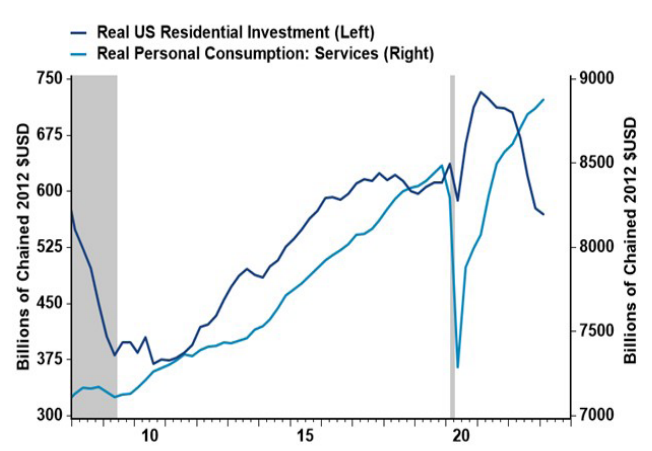
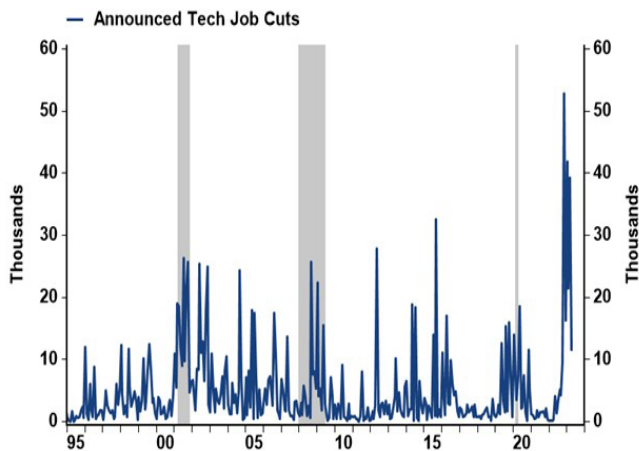
In 2023, the industries that signal recessions are contracting and new sources of restraint are building. As we have discussed previously (see our May 5 [CIO Bulletin](#)), tighter bank lending standards will lead to a deeper slump in commercial real estate investment. For the same reason, entrepreneurs will find it significantly more difficult to finance start up enterprises that are not quickly profitable. Layoff announcements in the IT sector have already surged (**Figure 1**). These are normal elements of typical recessions.

Then, there are unusual economic events. Consumer services spending is growing solidly (though less rapidly) in recent months, whereas residential construction spending has collapsed 19% over the year through 1Q 2023 (**Figure 2**). The travel and leisure industries cannot get enough employees while technology related businesses are seeing layoffs. Major stock indices have risen, but the vast majority of stocks are flat to down on the year. This is atypical.

It appears that contracting industries are *beginning* to make progress in reducing inventories (**Figure 3**). As inventories fall early in a recessionary cycle, it provides fuel for an eventual recovery. The situation is indicative of a rolling recession for the US economy. We see these rolling recessionary elements occurring across the world economy, too.

**Figure 1:** US announced layoffs in technology

**Figure 2:** Real US residential investment vs consumer spending on services



Source: Source: Haver Analytics, as of May 25, 2023. Shaded areas are recession.

**Figure 3: Real business inventories Y/Y%**



Source: Haver Analytics as of May 25, 2023. Shaded areas are recession.

## A Pandemic Hangover

In 2023, we are suffering the aftermath of “shock and overstimulation”, a time when simultaneous growth and contraction are occurring within the economy. Here is a simple illustration of complex tailwinds and headwinds. The fact that these contradictory conditions exist is responsible for the elongation of our entry into and out of what will be a shallow recession (**Figure 4**).

**Figure 4: Conflicting positives and negatives for the US equity market outlook**

Tailwinds	Headwinds
Resilient employment in services sustains consumer spending	High Fed policy rates, Quantitative Tightening (QT), Reduced bank lending, restrained capital for entrepreneurs
Inflation slowing	Weakening commercial real estate fundamentals, spillovers to SMID banks
Strong corporate balance sheets, private credit availability	T-Bill issuance to surge post-debt ceiling agreement
Inventories are heading down (housing and manufacturing), “working off” a recession.	Falling labor productivity to weaken labor market.
Historic high equity short positions and large cash balances	China and EU economies gain less than expected on initial China reopening.
	Estimated EPS far above achievable corporate profit gains (record high expected by 4Q 2023)

As one can see, there are quite a few offsetting positive and negative developments for investors to consider. This is why the 2023 rolling recession makes it difficult to identify an obvious recession/recovery pattern that would make for easy investment choices.

## The Employment Head Fake

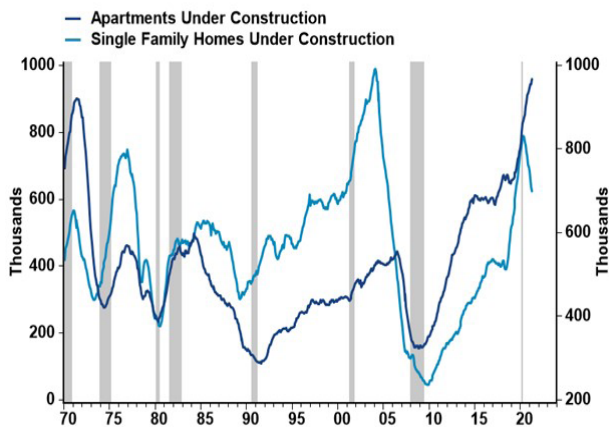
The US economy has been experiencing both expansion and contraction in various industries at the same time. However, we think the unusually long time it is taking labor markets to be impacted by Fed rate hikes may be misleading investors – and Fed officials – into thinking that there is no slowdown in the labor market coming.

- Pent-up demand from the unusually severe collapse in 2020 has meant hiring in industries such as hospitality and leisure that have yet to reach pre-Covid employment levels.
- A shift in the composition of residential construction activity towards longer-cycle multi-family apartment projects means that employment in the construction industry will take longer to peak. Multi-family housing units still under construction are at an all-time high and will take an average of 17 months to complete. This is in contrast to single-family home building, with an 8-month average construction time. Single-family projects under construction have already fallen by 16% in 2023 with further declines to come (**Figure 5**).

US employment dropped by a record amount in 2020 and the economy recovered rapidly that year, but many employers could not find basic labor. Many firms in 2023 are still hoarding labor as a result. You can see this in the data. Over the past year, demand ebbed and worker output fell 1%, yet total hours worked by new and existing employees rose 2.3% over the same period. This has resulted in falling productivity and weaker corporate profits (**Figure 6**). On the other hand, this has sustained real personal income and spending gains, more so as inflation has fallen (**Figure 7**). This, in turn, will help cyclical industries work off inventories, mitigating their future impact once services spending slows.

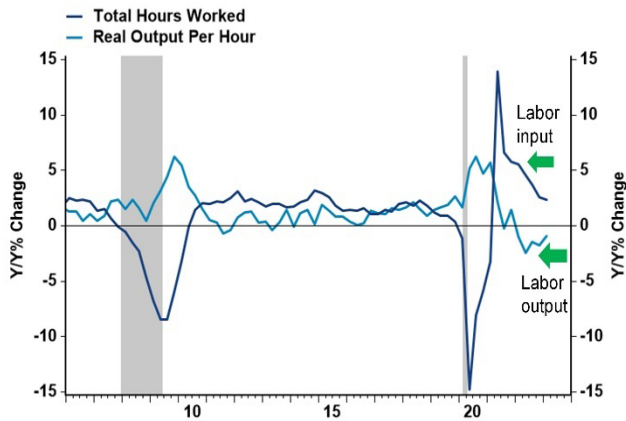
The absence of a major downturn in employment and the offsetting economic impacts of the Rolling Recession might result in another, more dangerous round of tightening financial conditions. This is when the current threat of US default ends with an agreement to raise or suspend the debt ceiling, enabling the US Treasury to borrow again.

**Figure 5:** Single vs multi-family US housing units under construction

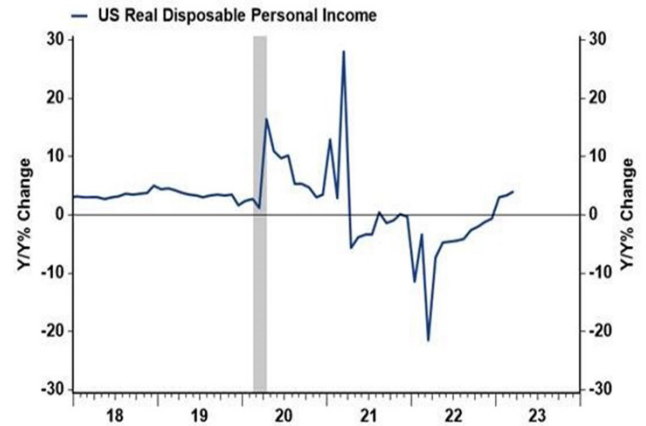


Source: Haver Analytics as of May 25, 2023. Shaded areas are recession.

**Figure 6:** Labor hoarding gives way to falling US labor productivity



**Figure 7:** US real disposable income



Source: Haver Analytics as of May 25, 2023. Shaded areas are recession.

## The Rolling Recession Meets the Debt Ceiling: What happens when the US Treasury borrows again?

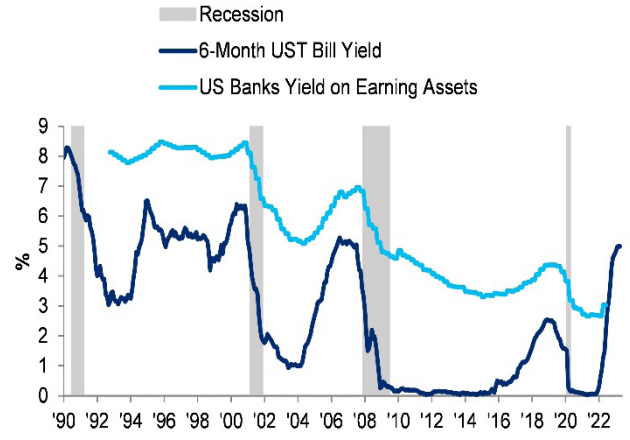
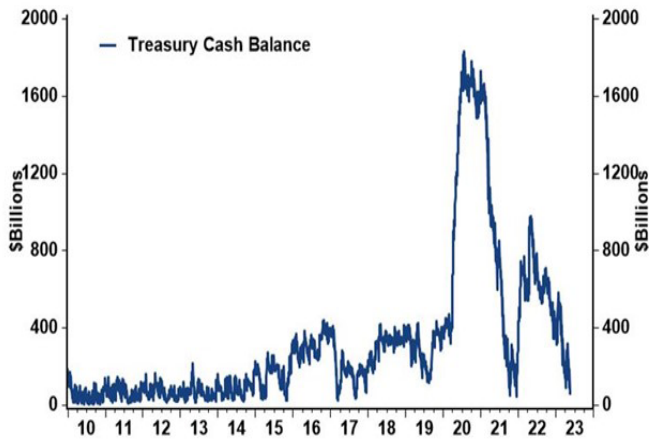
The debt ceiling negotiations are ongoing. Though the path to and timing of any agreement is uncertain, the probability of an agreement is high. So, what happens after any agreement is reached?

- Unlike 2011, when US equity markets fell by 15% after a debt ceiling agreement was reached, the present bearish positioning of investors suggests markets will likely see at least a short relief rally when a deal is struck. There is more cash on the sidelines, in bank deposits, Treasury bills and money market funds than ever before.
- Shortly after an agreement, the Treasury will issue an enormous amount of T-bills to replenish its cash balance. Within a month, the supply of 1-12 month bills should swell by at least \$300 billion in addition to normal redemption/issuance. Overall, net US Treasury borrowing by the end of 3Q 2023 is likely to be about \$1.3 trillion. While there is much cash on the sidelines, this has the potential to generate outflows from other asset classes – including bank deposits --given that these bills will, on average, yield north of 5%.
- This could put pressure on weaker banks as their deposit rates cannot easily compete with Treasury yields and money funds. We might see additional bank stress as a result, especially among smaller banks with large exposures to commercial real estate or those with high levels of uninsured deposits (Figures 8-9).

Markets have *priced out* the chance of an emergency Fed rate cut in the near term. If a debt ceiling agreement and overconfidence on employment leads to a resumption of Fed tightening – even the mere discounting of it – it may raise the probability of a broader recession rather than the rolling recession now underway.

**Figure 8: US Treasury cash balance needs to recover**

**Figure 9: Restrictive Fed policy means competitive yields, particularly at the front end**



Source: Haver Analytics as of May 25, 2023. Shaded areas are recession.

## Potential Investment Opportunities in a Rolling Recession

We still believe the Fed's aggressive fight against inflation and the current delay in labor market weakness will ultimately cause the Fed to reverse course toward the end of 2023. This sequence of events suggests that the currently high overnight money fund rates and high yields of the shortest-term T-Bills will not be available a year from now.

Extending the duration of fixed income portfolios should be seriously considered after the debt ceiling issue is resolved. Rates are likely to rise for a short time just after the negotiations end. If that occurs, it will be an ideal time to move from cash and cash equivalents to bonds that can maintain today's high yields for longer. Particularly on any yield spike, we believe investors should consider Investment Grade intermediate bonds, intermediate duration municipal bonds, and Investment Grade US preferred securities.

The resumption of Fed tightening, or markets anticipation of it, will likely cause the US dollar to jump. Yet ultimately, we don't think the Fed will be able to sustain a restrictive monetary policy as labor markets weaken. A backup in US bond yields and a temporary jump in the dollar could make for a strong opportunity to add emerging market (EM) debt to portfolios.

## The Upcoming Case for Emerging Market Debt

After a substantial yield rise – and perhaps more to come after a US debt ceiling agreement – the case for adding to EM debt (USD-denominated) is building. For a smaller portion of an overall fixed income allocation, investors might also consider local currency bonds either directly (where available) or through global local currency index funds.

The overall USD “hard currency” index is comprised of about 2,000 bonds from sovereign, quasi-sovereign, and corporate bond issuers. About 65% of the issuers have investment grade ratings, and the index's average yield is 7.59% at a duration of six years (**Figure 10**).

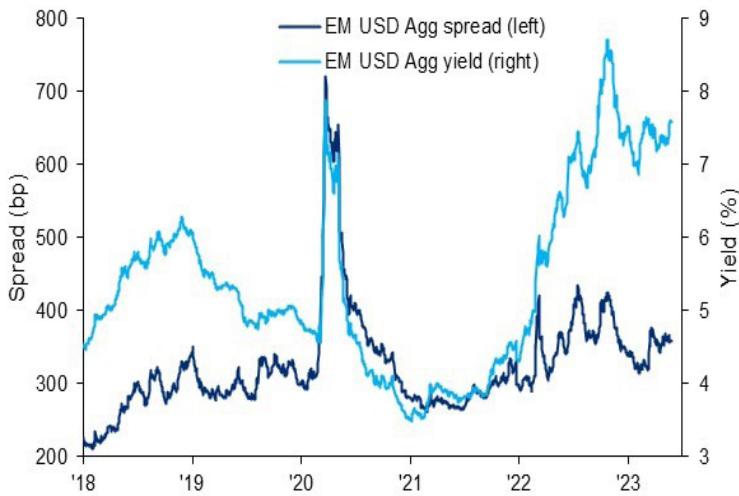
EM spreads have been widening recently because of uncertainty over US recession and commodity demand. The US dollar is also spiking again on liquidity precaution around the world and rebounding US rates. However, our rolling recession outlook should lead to a weaker dollar. This should benefit EM dollar bonds, particularly high-yield bonds, which historically have tracked USD strength and weakness over long periods of time (**Figure 11**). A weaker USD might also result in favorable returns for selected local currency investments. We expect commodity demand to be relatively stable compared to past cycles.

Emerging Markets fixed income is a truly “global” asset class. Regionally, benchmark indices are quite diversified, with 10% of issuers from North America, 19% South and Central America, 30% from Asia-Pacific, 30% from Africa and Middle East, and the remaining 10% from Eastern Europe and Central Asia.

There is some high yield-rated concentration risk to be aware of, which could impact returns should local events prove unfavorable. For example, the B3-rated Turkish Government is 3% of the index, while the B1-rated state-owned oil company of Mexico is 2.26% of the index. However, we think there’s substantial diversification among ratings and issuers to mitigate against individual issuer risk.

An alternative (or complement) to taking broad index exposure is to focus on individual bonds and countries. While it’s not within the scope of this Bulletin to discuss every country about which we have favorable views, one country we favor is Brazil (we recently added Brazilian equity exposure to our [GIC portfolio](#)). Brazil is a large commodity exporter, and there are many corporates with low debt leverage metrics that export commodities and yield in the 6-7% range for USD-denominated intermediate maturity debt. It’s also an interesting country to consider for local currency investment, due to extremely high local rates. The central bank’s policy rate is 13.75% with inflation at 4.2% over the past 12 months and decelerating. Brazil’s currency has not meaningfully appreciated despite those high rates.

**Figure 10: EM index bond spread and bond yield**



Source: Bloomberg as of May 24, 2023. The indexes 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. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results.

**Figure 11: EM USD high yield bond spreads vs USD f/x index (DXY) past 10 years**



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High quality (very strong)	Aa	AA	AA
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Medium grade	Baa	BBB	BBB
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Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
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