ClearBridge Investments

AOR Update: Soft Landing Head Fake or the Real McCoy?

1 March 2023

Key Takeaways

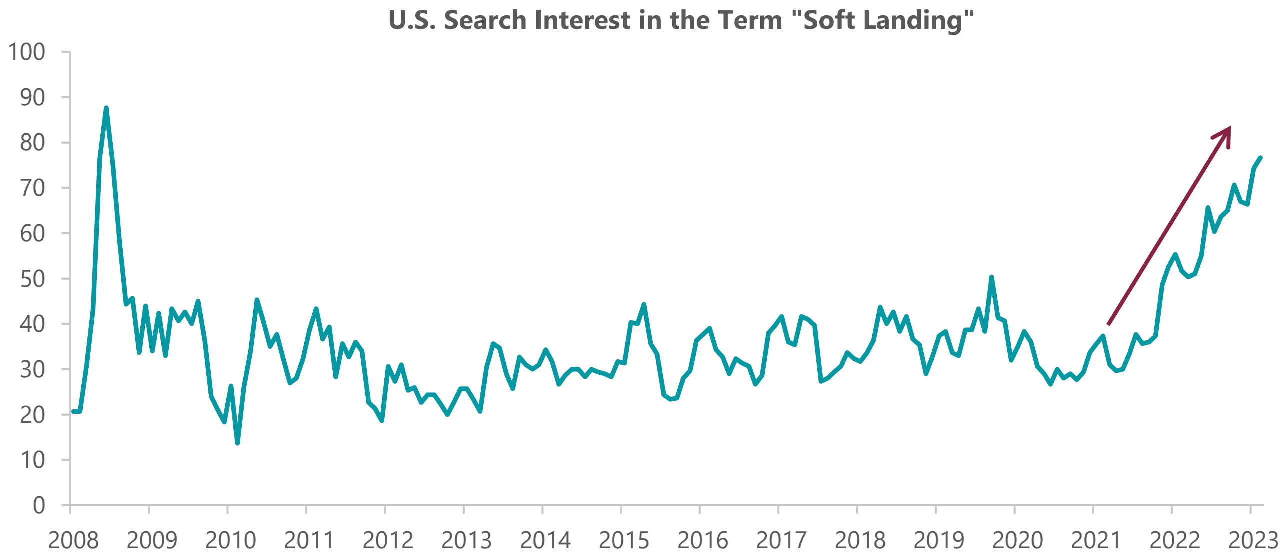
- A string of positively surprising economic releases including robust jobs and retail sales reports has caused Wall Street and even some FOMC members to more firmly embrace the soft landing narrative.
- We continue to believe a recession is more likely than a soft landing, given many of these data points are lagging or coincident in nature. A recessionary red overall signal on the ClearBridge Recession Risk Dashboard supports this view.
- Leading indicators continue to erode, portending market volatility in the coming months. This could lead to a reversal in market leadership with a return to favor for the stalwarts of the 2022 bear market, including high-quality dividend growth stocks.

Improving Economic Data Suggests Reacceleration over Recession

The first two months of the year have been anything but boring when it comes to the prevailing economic narrative. Coming into 2023, consensus was convinced a recession was imminent. By mid/late January, a soft landing became the primary storyline following cooler inflation and wage prints, with several FOMC members reinforcing this possibility. Given firming inflation data and an economy that appears to be reaccelerating, today the main narrative centers around whether the Federal Reserve is (once again) behind the curve. In a more "normal" environment, one could shrug off this potential uptick given one of the fastest starts to a hiking cycle in modern history. However, this cycle has been anything but normal, with the pandemic altering many "typical" business cycle dynamics over the past three years.

The improvement in economic data over the last month has been robust and broad-based, including but not limited to nonfarm payrolls, job openings and retail sales. Tellingly, the Citi Economic Surprise Index started the month at -6.1 and rose to +38.6 in February, indicating a series of better-than-expected economic data releases. On the back of this renewed economic momentum, many investors adopted the view that a soft (or no) landing will materialise. In fact, when looking at Google search trends, searches for "soft landing" jumped to a 15-year high last month. Search activity was last at (or greater than) current levels in May 2008, a few months prior to Lehman's bankruptcy and the beginning of the Global Financial Crisis. While today's backdrop is clearly different, this should serve as an important reminder that many head fakes and pockets of optimism occur along the way as the economy moves toward and through a recessionary period.

Exhibit 1: Soft Landing Searches are Spiking



Note: 3-Month Moving Average; Search Interest is a relative measure where a value of 100 represents peak popularity and 50 means the term is half as popular.
Data as of 28 February 2023. Source: Google Trends.

When faced with conflicting data, we come back to the ClearBridge Recession Risk Dashboard as a guiding light when evaluating the most likely path for the economy. The dashboard has maintained an overall recessionary red signal since August 2022 and has continued to weaken under the surface in recent months. At present, the dashboard shows only three non-red signals and had no indicator changes in February. Despite improving economic momentum, we continue to believe a U.S. recession is in the cards this year.

Exhibit 2: ClearBridge Recession Risk Dashboard

		Current	Rapid Summer Deterioration		
		February 28	**August 31**	**July 31**	**June 30**
Consumer	Housing Permits	✖	⬆	⬆	⬆
	Job Sentiment	●	⬆	⬆	⬆
	Jobless Claims	⬆	⬆	⬆	⬆
	Retail Sales	✖	✖	✖	●
	Wage Growth	✖	✖	✖	✖
Business Activity	Commodities	✖	✖	✖	●
	ISM New Orders	✖	●	●	●
	Profit Margins	✖	⬆	⬆	⬆
	Truck Shipments	⬆	⬆	⬆	⬆
Financial	Credit Spreads	✖	✖	✖	✖
	Money Supply	✖	✖	●	●
	Yield Curve	✖	●	●	⬆
	Overall Signal	✖	✖	●	⬆

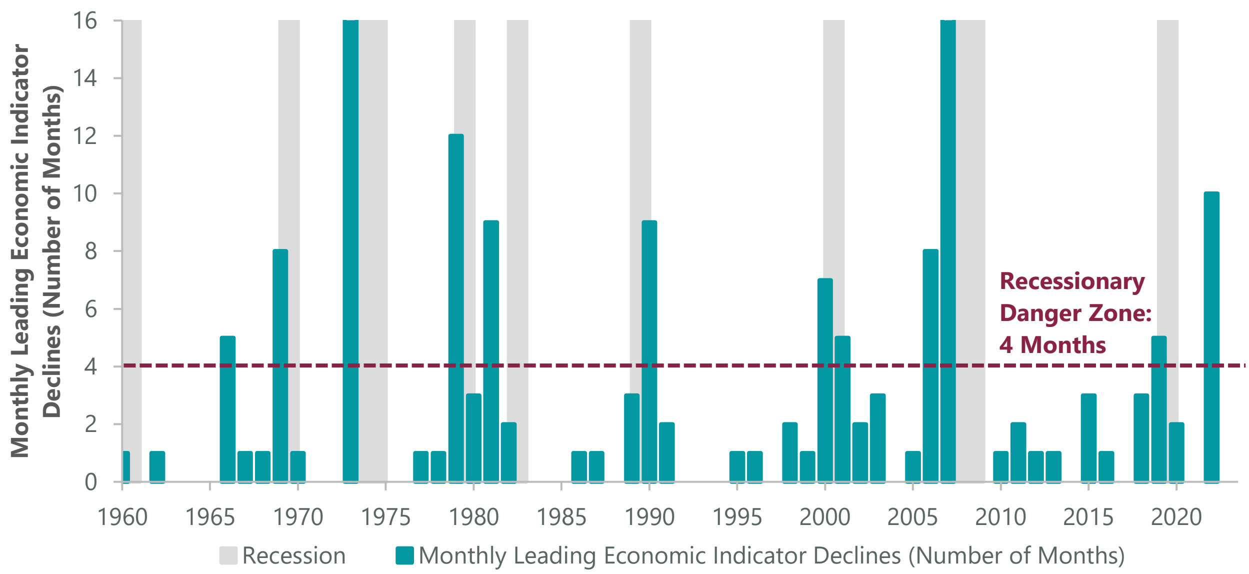
⬆ Expansion ● Caution ✖ Recession

Data as of 28 February 2023. Source: ClearBridge Investments.

We think a recession is more likely than a soft landing given the nature of the economic data that has been surpassing expectations. Most of the reports that have surprised to the upside have been lagging or coincident in nature, telling us more about where the economy has been rather than where it might be headed. Nonfarm payrolls, for example, is a coincident indicator that is useful in interpreting what is happening in real time. However, payrolls demonstrate non-linearity in recessions, collapsing rapidly as a recession takes hold. As a result, healthy payroll readings in one month do not mean much in terms of where they may be in the next quarter or two. This suggests investors should temper their enthusiasm about what a healthy labor market means in terms of the economic outlook for 2023. Put differently, we believe emerging signs of a soft landing are more of a head fake than the real McCoy.

By contrast, many leading indicators look far more precarious at present. January marked the 10th consecutive monthly decline in the Conference Board's Leading Economic Index (LEI), more than double the string of declines seen ahead of past recessions (four months). Combined with the recessionary red signal emanating from the dashboard, which focuses more on leading indicators, this affirms our view that a recession is looming on the horizon later in 2023.

Exhibit 3: Leading Indicators Point to Recession

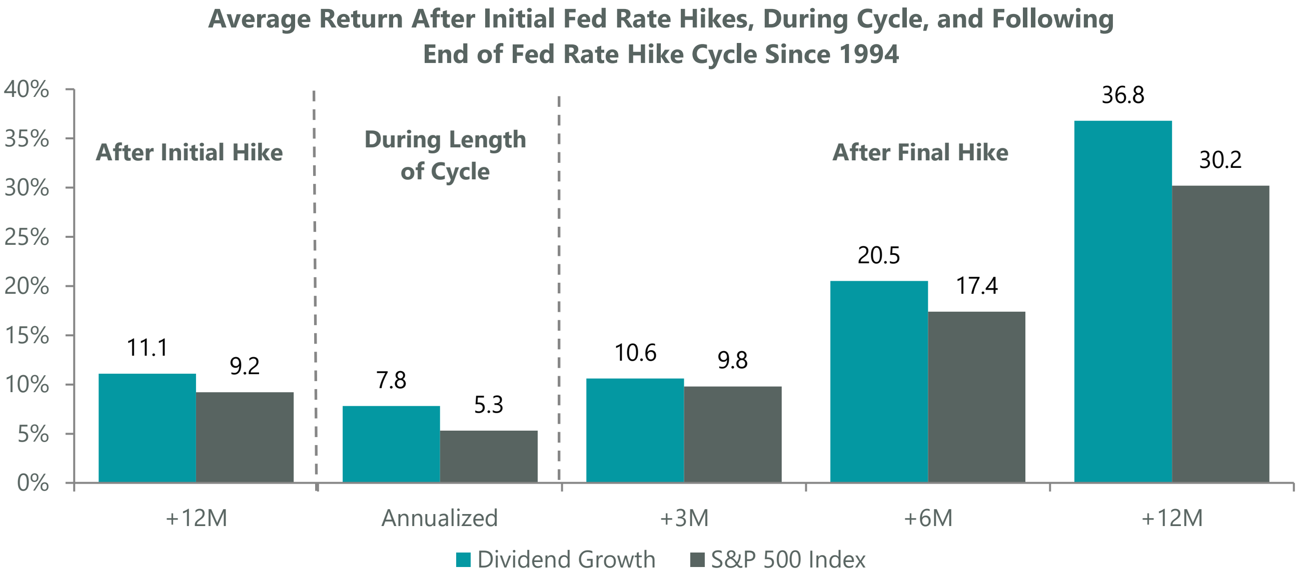


Data as of 30 January 2023, latest available as of 28 February 2023. Source: Conference Board US and FactSet.

With recession risks remaining elevated, we continue to see a choppy year for equities. With financial markets discounting less of a recession over the last few months, we believe a tactical opportunity is emerging in high-quality dividend growers. The 2023 rally has been led by 2022's laggards (growth stocks) with investors buying (and/or covering shorts) in the most beaten-down areas of the market based on an improving outlook. At the same time, better economic data points have helped to create a bid for more cyclical areas of the market, meaning defensives and quality have been relative laggards so far this year.

If our recession call for 2023 is correct, a reversal of the recent leadership should ensue, supporting blue chip dividend growth stocks. Such stocks have historically outperformed during and after the onset of monetary tightening cycles. Separately, equities demonstrating these characteristics could also do well in a "no landing" scenario in which the Fed would need to hike rates even further than currently anticipated due to overly resilient economic growth and elevated inflation, similar to much of 2022.

Exhibit 4: Dividend Growers Have Historically Outperformed



Source: BMO Capital Markets Investment Strategy Group, FactSet, Compustat, FRB. Dividend Growth Screening Methodology: S&P 500 stocks screened each month end, no dividend cuts in the past five years, latest one-year dividend per share growth greater than the S&P 500, current dividend yield greater than the S&P 500, free cash flow yield greater than the dividend yield, dividend payout ratio lower than the S&P 500.

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