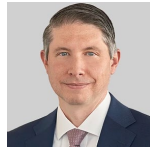


The Long View: The Rorschach Economy



Jeffrey Schulze, CFA
Director, Investment Strategist

Key Takeaways

- ▶ The ClearBridge Recession Risk Dashboard continues to weaken, with three negative indicator changes in September— Housing Permits and Profit Margins to yellow, and ISM New Orders to red — causing the overall signal to fall deeper into red or recessionary territory.
- ▶ Similar to past recessionary drawdowns, we believe the bottoming process for equities will take time, meaning investors should be prepared for countertrend rallies as well as downward earnings revisions.
- ▶ The lessons learned from the late 1960s when the Fed pivoted too quickly amid a tight labour market may prove illustrative for how much pain policymakers may be willing to endure at present. Importantly, this period also saw a red signal on the ClearBridge Recession Risk Dashboard.

Corporate and Macro Outlooks Telling Different Stories

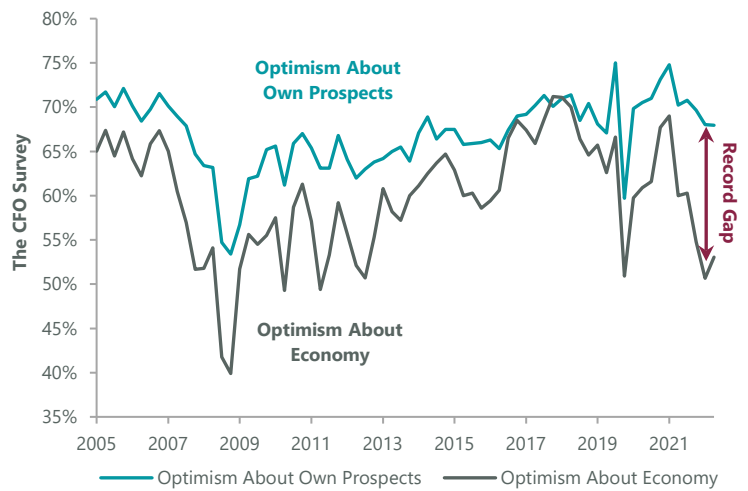
The U.S. economy is at an inflection point, with some data currently suggesting an imminent downturn (housing) whilst other data indicating a soft landing remains possible (the labour market). As in a Rorschach inkblot test, a projective psychological survey used to understand a person's personality characteristics and emotional functioning, observers can see whatever they're looking for in the data at the moment.

A good example of this is The CFO Survey run by Duke University in partnership with the Federal Reserve Banks of Richmond and Atlanta. Recent results show CFOs are constructive about the health of their own companies, but quite downbeat about the health of the broader economy. In fact, the gap between perceptions of their firms' own prospects and those for the economy recently hit record levels.

This gives way to an odd situation: at face value, the survey suggests businesses are doing well individually, but in aggregate (i.e., the economy) they are in terrible shape. Depending on one's preconceived notions, this "inkblot" could show a bull or a bear.

The CFO Survey suggests individual businesses are doing well, but an aggregation of businesses (the economy) is in terrible shape.

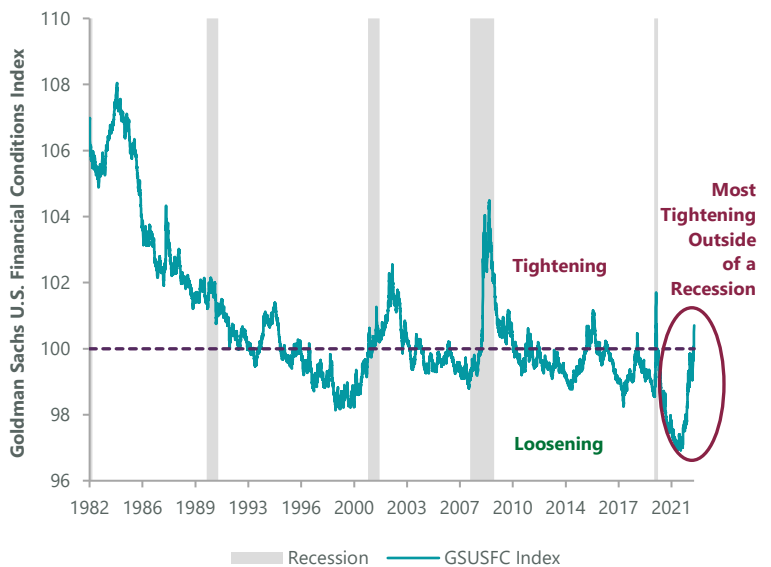
Exhibit 1: The Rorschach Economy: CFO Confidence



Data as at September 2022. Source: FactSet, Duke University and the Federal Reserve Banks of Richmond and Atlanta.

Similarly, on one hand, financial conditions have only recently crossed over into restrictive territory and are not at absolute levels consistent with past recessions. On the other hand, this year has witnessed a rapid tightening of financial conditions with a change that is already larger than what occurred during both the 1990 and 2020 recessions.

Exhibit 2: The Rorschach Economy: Financial Conditions



Data as at 26 September 2022. Source: Goldman Sachs and Bloomberg.

One tool we use to help interpret conflicting data is the ClearBridge Recession Risk Dashboard. The dashboard continues to show an overall recessionary or red signal, suggesting elevated chances the U.S. economy will enter a recession in the coming year. The dashboard's rapid deterioration over the last three months continued in September with both Housing Permits and Profit Margins worsening from green to yellow signals and ISM New Orders worsening from yellow to red. We expect further weakening in the coming months as the lagged effects of Fed tightening

continue to bite and the Fed continues to raise rates in its quest to curb high inflation.

Exhibit 3: ClearBridge Recession Risk Dashboard

	Sept. 30, 2022	August 31, 2022	July 31, 2022
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	×	×	●

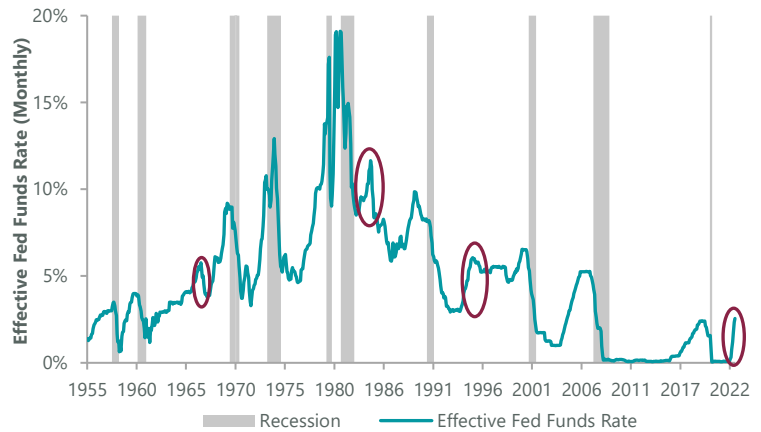
↑ Expansion ● Caution × Recession

Data as at September 2022. Source: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg. The ClearBridge Recession Risk Dashboard was created in January 2016. References to the signals it would have sent in the years prior to January 2016 are based on how the underlying data was reflected in the component indicators at the time.

Like any tool, the ClearBridge Recession Risk Dashboard has its strengths and its weaknesses. It has done a good job at identifying key economic inflection points but has also signaled an overall yellow or cautionary reading three times (1995, 1998, 2016) and a red signal once (1966) when the economy did not ultimately enter a recession, [a dynamic we explored last month](#). When evaluating those periods, a dovish Fed pivot was a common theme. At the current juncture, the 1966 non-recessionary red signal may be the most relevant period to examine.

The late 1960s saw one of three successful soft landings in the dashboard’s history, where the Fed embarked upon an interest rate hiking cycle that did not end with a recession. The other soft landings were engineered in 1985 and 1995. All three periods were marked by robust employment gains, but 1966 is unique in that there was a substantially tighter labour market at the time of the pivot with unemployment at 3.8% vs. 7.3% in 1985 and 5.7% in 1995. This is an important distinction, as ample labour market slack in 1985 and 1995 helped prevent inflation from picking up in the years following the Fed pivot, whereas a tight labour market in 1966 contributed to a re-acceleration of inflation in the years following, ultimately to over 6%. With a tight labour market today reminiscent of 1966, the Fed risks a period of higher inflation down the road if it pivots too early. Put differently, a little pain today may be better than more pain tomorrow.

Exhibit 4: Don't Make the Same Mistake Twice



	Overall Recession Signal	Total Fed Rate Cut	Core Consumer Price Index YoY Percent Change			Unemployment Rate	
			Fed Pivot (or Current)	+12 Months	+36 Months	Fed Pivot (or Current)	Labor Market
December 1966	✘	-2.0%	3.3%	3.8%	6.2%	3.8%	Tight
September 1984	✚	-5.8%	5.1%	4.0%	4.3%	7.3%	Excess
July 1995	●	-0.8%	3.0%	2.7%	2.2%	5.7%	Slack
Current			6.3%			3.7%	

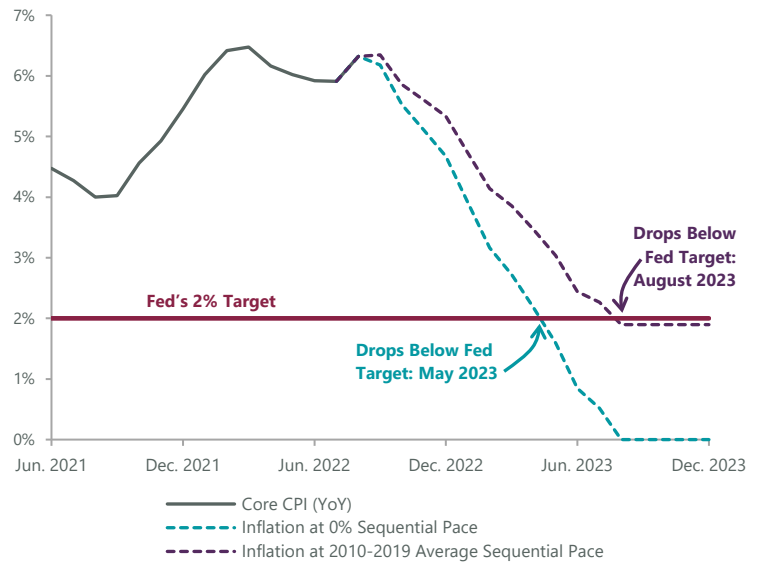
As at 30 September 2022. Source: Ibbotson Small Cap Index-Morningstar, Bureau Labour Statistics, FactSet.

Fed Chair Powell has repeatedly stressed that he is not keen on repeating errors of previous Federal Open Market Committees (FOMC). A slowdown in the pace of rate hikes will occur at some point, but an easing move to lower rates prematurely risks repeating past FOMC mistakes. Powell touched on this at his Jackson Hole speech in August, saying one of the three important lessons learned in the wake of the high inflation 1970s and 1980s is that “we must keep at it until the job is done. History shows that the employment costs of bringing down inflation are likely to increase with delay,” and “the successful Volcker disinflation in the early 1980s followed multiple failed attempts to lower inflation over the previous 15 years.”

As a result, a Fed pivot — a precondition for prior soft landings — appears to be unlikely, barring market dysfunction, similar to what was recently seen in England. After all, a central bank’s founding principal is to be the lender of last resort in order to maintain orderly market function.

What will more likely lead the Fed to back off will be success in its mission to curb inflation (or a large enough rise in the unemployment rate). On that front, core inflation is unlikely to reach the 2% target in the near term. Economic forecasts show consensus well above that figure in 2023 and marginally above it in 2024. If the monthly change in core CPI were to come in at 0% going forward, this measure would not reach 2% until May 2023. Any higher prints would push that date out even further; simply averaging the pace of inflation seen from 2010–19 would add three months to the timeframe to reach 2%. Even this may be too optimistic with the Cleveland Fed’s Inflation Nowcast tool currently projecting a whopping 0.5%, or over 6% at an annual rate, for September’s CPI release.

Exhibit 5: Getting Back to Target



Data as at 31 August 2022, latest available as at 30 September 2022. Source: Bloomberg, BLS.

Beyond a Fed pivot, there is still some hope the economy can weather tighter monetary policy. In the near term, GDP appears to be hanging on, with the Atlanta Fed's GDP Nowcast reading 2.4% for the third quarter. Strong consumer and corporate balance sheets, along with a move to lock in low rates on debt in recent years, suggests the impact of rate hikes may be smaller than they have been historically. While this may seem like good news, it likely means the Fed will need to adopt an even more aggressive path of rate tightening than is currently forecast, which will weigh on financial assets via even higher discount rates.

Bottoming Process Will Take Some Time

With a recession looking more and more likely, the question on many investors' minds is when a durable bottom may be formed. Although quite a bit of pessimism regarding future earnings is discounted into current market pricing, we believe the bottoming process will take some time, similar to past recessionary drawdowns. In fact, markets don't usually bottom until almost two-thirds of the way through a recession on average. Recent labour market data suggests the recession has not even begun, meaning markets are likely to remain volatile as unknown risks start to unfold.

There will almost certainly be market head fakes for investors to sort out along the way. These are known as countertrend rallies, pockets of market strength that ultimately give way to a lower low during bear markets. Investors just lived through one: some believed the July rally pointed to a soft landing, then had those hopes dashed at Jackson Hole in August. Although the magnitude of this summer's countertrend rally was notable at +17%, two of the past three recessions endured even larger countertrend rallies before the final market lows were seen.

Exhibit 6: Cart Before the Horse?

Recession Start	Recession End	Length (Months)	Market Low During Recession?	Distance from Recession Start (Months)	Distance from Recession End (Months)
Nov. 1948	Oct. 1949	11	Yes	6	-5
July 1953	May 1954	10	Yes	1	-9
Aug. 1957	April 1958	8	Yes	2	-6
April 1960	Feb. 1961	10	Yes	6	-4
Dec. 1969	Nov. 1970	11	Yes	5	-6
Nov. 1973	March 1975	16	Yes	10	-6
Jan. 1980	July 1980	6	Yes	2	-4
July 1981	Nov. 1982	16	Yes	12	-4
July 1990	March 1991	8	Yes	2	-6
March 2001	Nov. 2001	8	No	18	10
Dec. 2007	June 2009	18	Yes	14	-4
Feb. 2020	April 2020	2	Yes	1	-1
Average:		10.3		6.6	-3.8

Note: Distance from Recession Start and Distance from Recession End do not add to Length due to rounding. Source: S&P, FactSet, and Bloomberg.

Ultimately, the path forward for equities will be determined by the trajectory of the economy and its effect on future earnings. As mentioned in [July's Long View](#), there are two phases to a bear market: multiple compression and declining earnings expectations. While lower P/E ratios have largely driven the market's performance year to date, the cycle for negative earnings revisions has only just begun, with next 12-month expectations down only -1.4% from peak. Over the past three recessions, earnings expectations have moved down 26% on average, although the lows in earnings expectations typically came following the market lows. Even if we were to assume a shallower than average decline in earnings (that is, putting aside the outsize impact of the global financial crisis (GFC) on that average), earnings in a "typical" recession are likely to drop by something more like 15%–20%, much larger than we've seen so far.

Exhibit 7: Countertrend Rallies Are Commonplace

Largest Historical Recessionary Countertrend Rallies

Recession Begin	Recession End	Largest Countertrend Rally
Dec. 1969	Nov. 1970	6%
Nov. 1973	Mar. 1975	10%
Jan. 1980	July 1980	4%
Jul. 1981	Nov. 1982	12%
Jul. 1990	Mar. 1991	6%
Mar. 2001	Nov. 2001	19%
Dec. 2007	June 2009	24%
Feb. 2020	Apr. 2020	9%
Average:		11%
Current:		17%

S&P 500 Countertrend Rallies: 2007-2009



Data as at 30 September 2022. Source: National Bureau of Economic Research, FactSet.

Exhibit 8: What's the Path for Earnings?

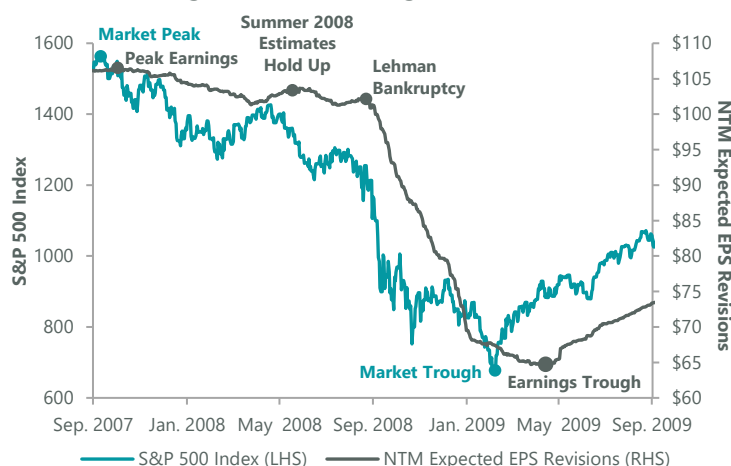
NTM EPS Behaviour

Market Peak	EPS Peak	# of Days	Market Trough	EPS Trough	# of Days	EPS Peak – Trough	Market Peak – Trough
Recessions							
3/24/2000	8/7/2000	136	10/9/2002	12/17/2001	-296	-17.5%	-49.1%
10/9/2007	11/1/2007	23	3/9/2009	5/8/2009	60	-39.3%	-56.8%
2/19/2020	1/30/2020	-20	3/23/2020	5/15/2020	53	-20.6%	-33.9%
Average GDP Recession:		46			-61	-25.8	-46.6
Non-Recessionary EPS Declines							
7/17/1998	9/29/1998	74	8/31/1998	1/4/1999	126	-2.6%	-19.3%
5/21/2014	10/7/2014	139	8/25/2015	2/6/2015	-200	-5.5%	-7.2%
11/3/2015	9/8/2015	-56	2/1/2016	3/1/2016	29	-3.2%	-13.3%
9/20/2018	12/6/2018	77	12/24/2018	2/1/2019	39	-2.3%	-19.8%
Average GDP Recession:		59			-2	-3.4%	-14.9%
Current*							
1/3/2022	7/12/2022	190	9/30/2022	9/30/2022	0	-1.4%	-25.2%

*Current reflects the 2022 Peak-Trough from the market close on 3 January to 30 September 2022. Data as at 30 September 2022. Source: S&P, FactSet, NBER, and Bloomberg.

Corporate management teams have recently begun to cut guidance leading to similar downward revisions by sell-side analysts, but this trend has been relatively modest so far. Some of this is a function of when during the year management teams typically update and release guidance. However, the 2007–09 period also highlights how at the time of the Lehman Brothers bankruptcy, sell-side analysts (taking their cues from corporate management teams and guidance) had only cut estimates by 4% on a next 12-month basis, despite the recession having started over nine months earlier. The point is not to draw a comparison to the GFC, but rather to highlight that little solace should be taken in the fact the earnings have been holding up quite well so far. They are likely to become a headwind in the coming quarters.

Exhibit 9: Earnings Revisions During the Global Financial Crisis



Data from 30 September 2007 to 30 September 2009. Source: FactSet, S&P.

Despite ongoing volatility, it would not be surprising to witness another countertrend rally after a rough September and a washout of investor sentiment. The American Association of Individual Investors (AAII) Sentiment Survey in late September saw the fourth-worst bull-bear spread in its 35-year history at -43.2 and remained among the 10 lowest readings in its history last week. Historically, such pessimistic investor sentiment has been a sign of retail capitulation, signaling a near-term buying opportunity. In fact, average returns following the survey’s worst 10 readings have been +2.7% and +6.0% over the subsequent one month and three months, respectively.

Since the GFC, most market drawdowns have been followed by V-shaped recoveries. This was in part a function of the slow-growth, low-inflation regime. When financial conditions tightened, the Fed needed to step in rapidly in order to head off a recession, boosting financial markets in the process. However, the current economic backdrop is different, and easing financial conditions are counterproductive to the current aims of policymakers. With a different response function (the Fed call replacing the Fed put), the recovery is also likely to look different. For equity investors, this could

mean a recovery that sees false starts followed by subsequent selloffs. As a result, we continue to favour portfolio tilts toward quality and defensives until a clearer path forward for economic activity and earnings emerges.

Important Information

While the information contained in this document has been prepared with all reasonable care, ClearBridge Investments Limited (ABN 84 119 339 052, AFSL No. 307727) and its related companies ("ClearBridge") accept no responsibility or liability for any errors, omissions or misstatements however caused. Any views expressed in this material are given as of the date of publication and such views are subject to change at any time.

This information is not personal advice. It has been prepared without taking account of individual objectives, financial situations or needs. Where an investment product is mentioned, potential investors should seek independent advice as to the suitability of the product to their investment needs. Reference to shares in a particular company, is not a recommendation to buy, sell or hold that stock. Investors should be aware that past performance is not indicative of future performance.

This information may contain forecasts, including in regard to targets, expected returns, PE ratios and dividend yields. Any such statements are based upon research undertaken by the ClearBridge investment team. This research incorporates ClearBridge's reasonable assumptions and beliefs concerning future developments and their potential effect but are subject to risks and uncertainties that may be beyond ClearBridge's control. Returns can be volatile, reflecting rises and falls in the value of underlying investments. Accordingly, ClearBridge does not provide any assurance or guarantee that future developments will be aligned with ClearBridge's expectations, and actual results may differ materially from those expected by ClearBridge at the time of writing.

The distribution of this document may be restricted in your jurisdiction. This document does not constitute an offer or solicitation in any jurisdiction in which to make such an offer or solicitation would be unlawful. It is your responsibility to ensure that any such product, security, service or investment outlined is available in your jurisdiction.

Issued and approved outside Canada and the United States of America by ClearBridge Investments Limited ("CIL"), registered office Level 13, 35 Clarence Street, Sydney, NSW 2000, Australia (ABN 84 119 339 052; AFSL 307 727).

In Canada and the United States of America, issued and approved by ClearBridge Investments (North America) Pty Ltd ("CINA"), registered office Level 13, 35 Clarence Street, Sydney, NSW 2000, Australia (ACN 138 069 191). Neither CIL nor CINA are registered as a dealer in any province in Canada. CIL and CINA are not offering the securities of any investment fund that may be described in the materials in Canada or the United States. This material has not been approved or verified by the SEC, OSC or the Autorité des marchés financiers.

ClearBridge is wholly, indirectly owned by Franklin Resources, Inc., and part of ClearBridge Investments, LLC.