ClearBridge Investments

AOR Update: Recession or Red Herring?

September 6, 2022

Key Takeaways

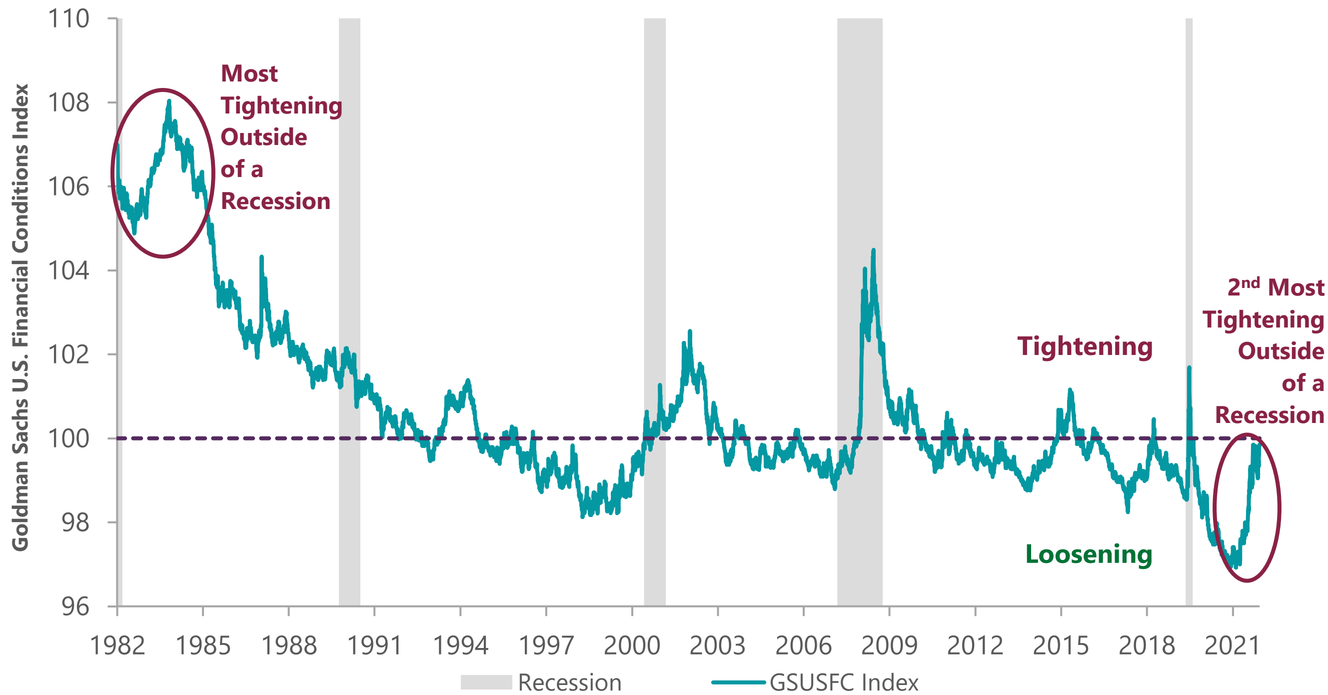
- The overall signal in the ClearBridge Recession Risk Dashboard has worsened from yellow to red, with the Money Supply indicator also changing from yellow to red and deterioration in several indicators that did not move enough to trigger signal changes.
- The Fed reaffirmed its intention to stamp out inflation in August, meaning policy is likely to remain restrictive for a prolonged period. Investors are grappling with whether the economy can weather this storm, particularly with a Fed less inclined to come to the rescue at the first sign of trouble.
- The timing of a recession is unclear and based on past red signals, could range from a matter of months to over a year. Once again, a recession is not a foregone conclusion, particularly if inflation rapidly cools and the Fed backs off earlier than anticipated.

Core Inflation Remains Uncomfortably High

As summer turns to fall, it's becoming quite clear the U.S. economy is facing its toughest hurdle since the start of the pandemic: red hot inflation. In order to do its job and bring inflation back toward the 2% target, the Fed has furiously increased interest rates and will continue to push them further into restrictive territory to cool demand and ultimately inflation. Higher rates and lower financial asset prices drive tighter financial conditions, the transmission mechanism for monetary policy to impact the economy. In the first half of the year, the Fed engineered the second strongest tightening of financial conditions in history outside of a recession, only for one-third of this move to unwind by mid-August.

Seeing financial conditions go in the opposite direction of plan, a drumbeat of Fed officials culminating with Chair Jay Powell's Jackson Hole speech left no ambiguity that the central bank is committed to taming inflation and will likely hold interest rates higher for longer to achieve this outcome. This tough talk helped drive a reversal in financial conditions, which are now back near the mid-June peak.

Exhibit 1: Financial Conditions Rapidly Tightening



Data as of Sept. 5, 2022. Source: Goldman Sachs and Bloomberg.

Further, NY Fed President John Williams recently highlighted how the Fed – wary of repeating the mistakes of the 1970s where monetary policy never stayed restrictive enough to fully tame inflation – should aim to keep policy in restrictive territory for the next several years. This is a stark contrast to the Fed of the post-GFC era, which was quick to loosen conditions amidst a weak growth and low inflation environment to avoid the economy slipping into a recession. Instead, the current Fed appears to be willing to tolerate economic cracks emerging or even a shallow recession in order to avoid a repeat of the 1970s. The "Fed put" being replaced by the "Fed call" is a reality investors are still adjusting to and something we highlighted earlier this year.

The dramatic move in financial conditions is consistent with the Fed's actions to curb inflation. Coming into the year, the central bank was only expected to raise interest rates by around 75 bps. Instead, it has already hiked by 3x that amount (225 bps) with approximately 140 bps more currently priced into Fed Fund futures. The potential result is total tightening approaching 4.5x the size of initial 2022 expectations. That dramatic shift has been picked up by the ClearBridge Recession Risk Dashboard, which has gone from 10 (of 12) green signals at the start of the year to just five today. This rapid shift has mirrored the swift pace of rate hikes from the Fed, which are designed to curb inflation by cooling the economy through the reduction of excess demand to better match supply.

Beyond rate hikes, the Fed has also undertaken a quantitative tightening program to remove excess liquidity, which has now reached its steady state $95 billion monthly pace. With this in mind, it is hardly surprising that the Money Supply indicator has deteriorated from yellow to red this month. Combined with deterioration beneath the surface in other indicators including Housing Permits, Job Sentiment, Profit Margins, Credit Spreads, and the Yield Curve, the overall signal has also worsened from yellow to red, although it is in shallow red territory.

Exhibit 2: ClearBridge Recession Risk Dashboard

		August 31, 2022	July 31, 2022	June 30, 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

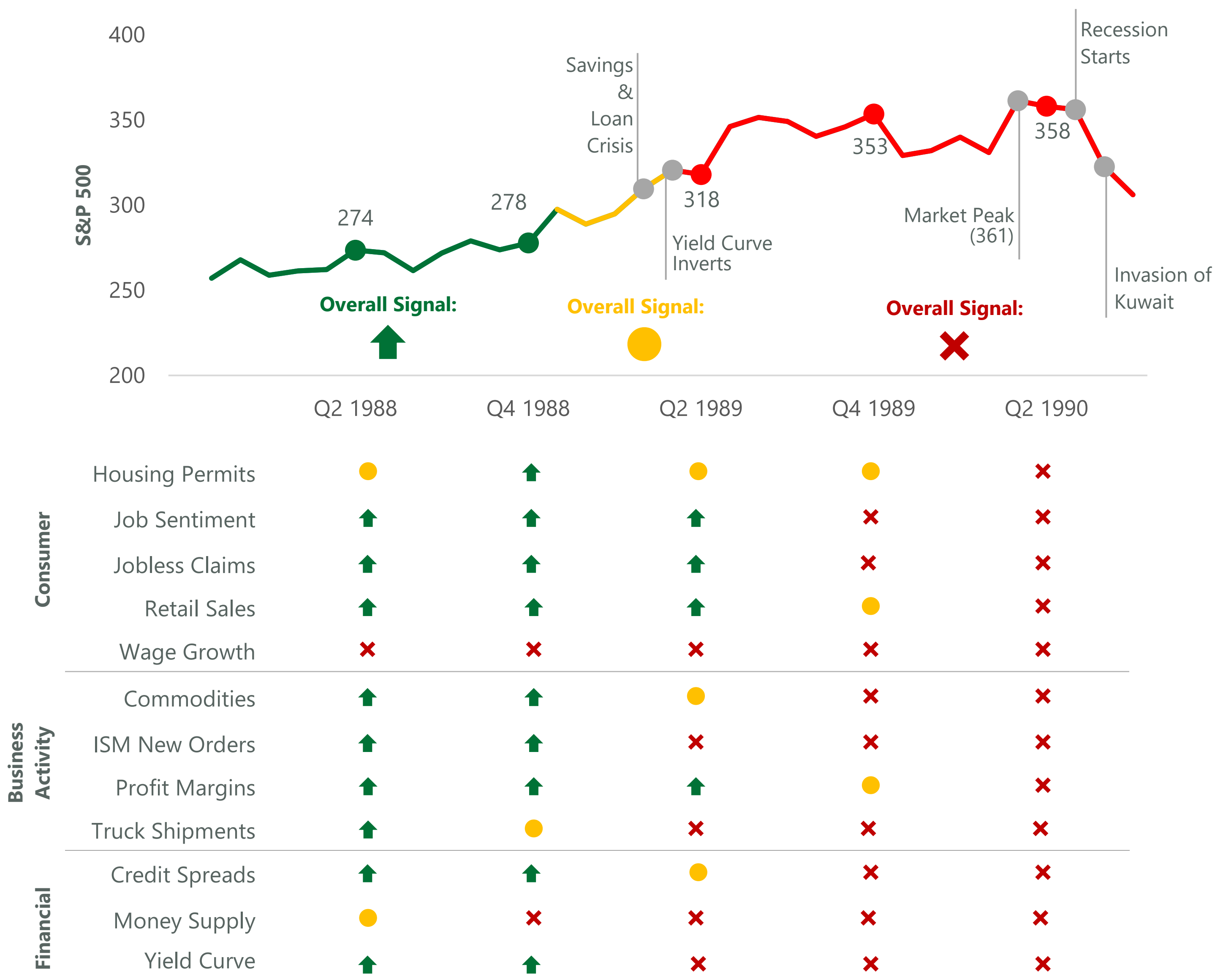
Source: ClearBridge Investments.

Any red signal is consistent with elevated chances of a recession in the coming year, but importantly a recession is still not a forgone conclusion, regardless of depth. While Fed officials have been unyielding with their comments recently, they have also stressed that they will remain data dependent. This means new information could lead a shift in direction, which would substantially reduce the odds of a policy-driven recession. A broad-based and sustained decline in inflation would need to occur in order for the Fed to stop raising interest rates.

A Fed pivot is not the only way a recession could be avoided. Fed policy aside, the economy is returning to normal following a period of post-pandemic strength. The recovery has had starts and stops, making the separation of noise from signal even more challenging, a fact the dashboard is not totally immune from. A good example of this can be seen in Credit Spreads, which are in red territory as they normalise from extraordinarily tight levels in 2021, driven by both fiscal and monetary stimulus that was designed to create excess liquidity. While spreads have tightened considerably from the lows (driving the red signal), they remain at an absolute level consistent with economic expansion. Although the model could be confusing a normalisation following a period of extremely strong growth, given the magnitude of tightening yet to come as well as the speed of the deterioration with the overall signal moving from green to yellow to red in just two months, we must respect what the model is telling us rather than assume this is a "red" herring.

The timing of a potential recession is also unclear. Historical red signals have come three months ahead of recessions on average, however, there is a wide variety of outcomes ranging from 13 months prior to two months following. Given the strength of the labor market as well as the potential for lower interest rate sensitivity of the economy as individuals and corporations took advantage of low rates in recent years to lock in cheap financing, this downturn could be toward the longer end of the historical range. The longest lead time for the dashboard came ahead of the 1990 recession, which saw further deterioration from a similarly mixed dashboard in shallow red territory initially as well as a market rally before the rollover occurred.

Exhibit 3: Evolution of Dashboard 1988 -1991



Source: ClearBridge Investments.

Ultimately the future path of the economy as well as financial markets are unknowable. We will be focused on the potential for further deterioration in the dashboard and a deeper red signal. While the past 15 years saw a series of violent selloffs followed by V-recoveries as the Fed put kicked in, the current Fed regime could invoke a very different market environment. Both bulls and bears could be frustrated in the coming months if the market remains rangebound and volatile before further clarity leads to a breakout in either direction. In the past, similar environments have been favorable for active stock pickers. Given that the balance of risks points toward elevated chances of a recession, we continue to favor tilts toward defensive, high-quality equities.

About the Authors

Jeffrey Schulze, CFA
Director, Investment Strategist
- 17 years of investment industry experience
- Joined ClearBridge Investments in 2014
- BS in Finance from Rutgers University

Josh Jamner, CFA
Vice President, Investment Strategy Analyst
- 13 years of investment industry experience
- Joined ClearBridge Investments in 2017
- BA in Government from Colby College

ClearBridge Investments
clearbridgeinvestments.com.au

Performance source: Internal. Benchmark source: Standard & Poor's.