ClearBridge Investments

AOR Update: When To Expect A Recession?

1 August 2023

Key Takeaways

- Despite improving economic sentiment now leaning the consensus view toward a soft landing, macro data and the ClearBridge Recession Risk Dashboard suggest continued caution with a recession still the most likely outcome.
- A resilient equity market has a checkered history in correctly sniffing out a recession. In fact, the market has delivered a positive return 42% of the time in the six months prior to the start of a recession and been positive 25% of the time in the three months prior.
- Through the lens of real interest rates, monetary policy only became restrictive in late 2022. Considering a typical policy lag of six to 18 months and the timeline from initial rate hike to contraction, the horizon for a recession could be between mid-2023 and mid-2024.

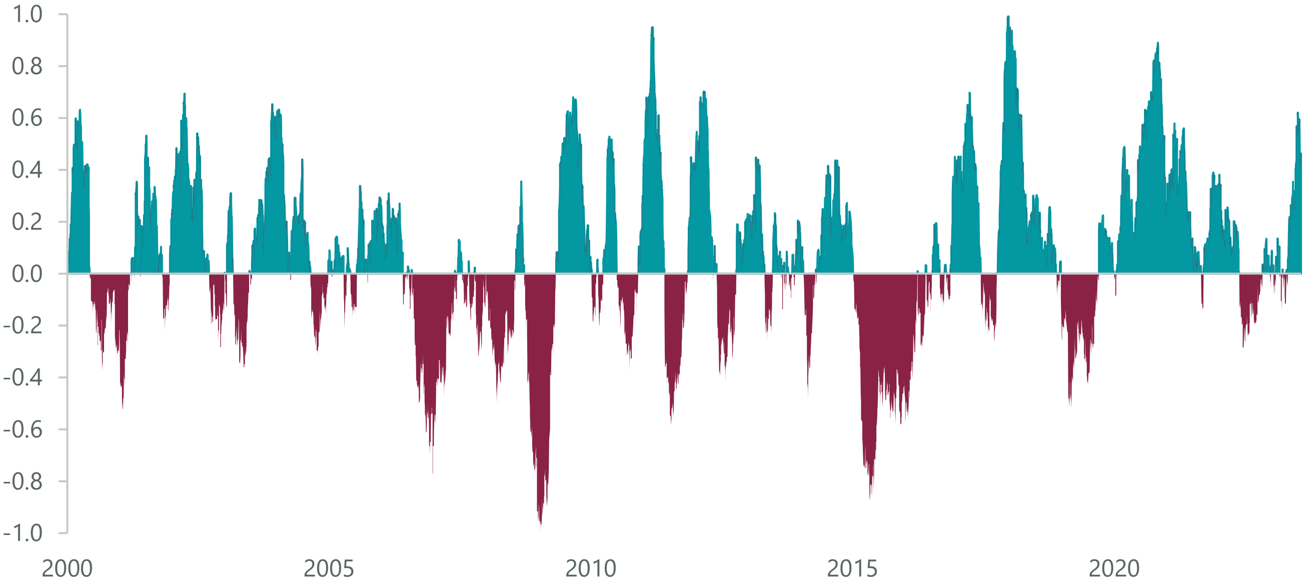
Wall Street Optimism Kicks Recession Talk Down the Road

The soft-landing narrative has taken the reins since mid-May, buoyed by an 11% rally in U.S. equities. Simultaneously, several high-profile Wall Street strategists have capitulated, updating their outlooks to reflect a higher likelihood of a soft landing and/or raising their price targets for the S&P 500 Index. However, a review of the data suggests continued caution is warranted despite improving sentiment, and that views of an imminent recession over the past few quarters may have been misplaced. We have long thought that the potential timeframe for a recession would be in the second half of the year, a view we maintain whilst acknowledging the timeframe could slip to the first half of 2024.

The median year-end 2023 price target for the S&P 500 has risen to 4,300 from 4,000 in mid-May, with 14 of 24 firms surveyed by Bloomberg raising their targets. This move higher has coincided with both a rally in U.S. equities and a string of economic data that has exceeded consensus expectations. In fact, the Bloomberg Economic Surprise Index in July reached its highest level since the initial post-lockdown recovery during the summer of 2020 and crossed into the top decile of its historical range – a level from which it often rolls over as a string of economic disappointments ensue (Exhibit 1).

Whilst the run of better economic data was certainly a positive development, history shows the economy often experiences a sharp deterioration in momentum as recessionary forces arrive. Simply put, a more robust economy today has little bearing on what happens in the future. Further, investors who have taken recent equity strength as a signpost that a recession is less likely should keep in mind that the market has delivered a positive return 42% of the time in the six months prior to the start of a recession and been positive 25% of the time in the three months prior.

Exhibit 1: Bloomberg Economic Surprise Index



Data as at 1 August 2023. Source: Bloomberg.

The key drivers supporting a soft landing scenario are debatable under closer examination. This leaves investors to ponder when a recession "should" be expected, if one in fact materialises. Coming into the year, we targeted a 2023 recession in the second half of the year. Last September we flagged the potential for a one year or more lead-in from the initial overall red signal from the ClearBridge Recession Risk Dashboard to a recession similar to what was experienced ahead of the 1990s downturn. We have continued to adhere to this view, with the ClearBridge Recession Risk Dashboard's deep red overall signal being our guiding light. There are no changes to the dashboard this month.

Exhibit 2: ClearBridge Recession Risk Dashboard

		Current	Deepening Red Signal		
		July 31, 2023	Mar. 31, 2023	Dec. 31, 2022	Sept. 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

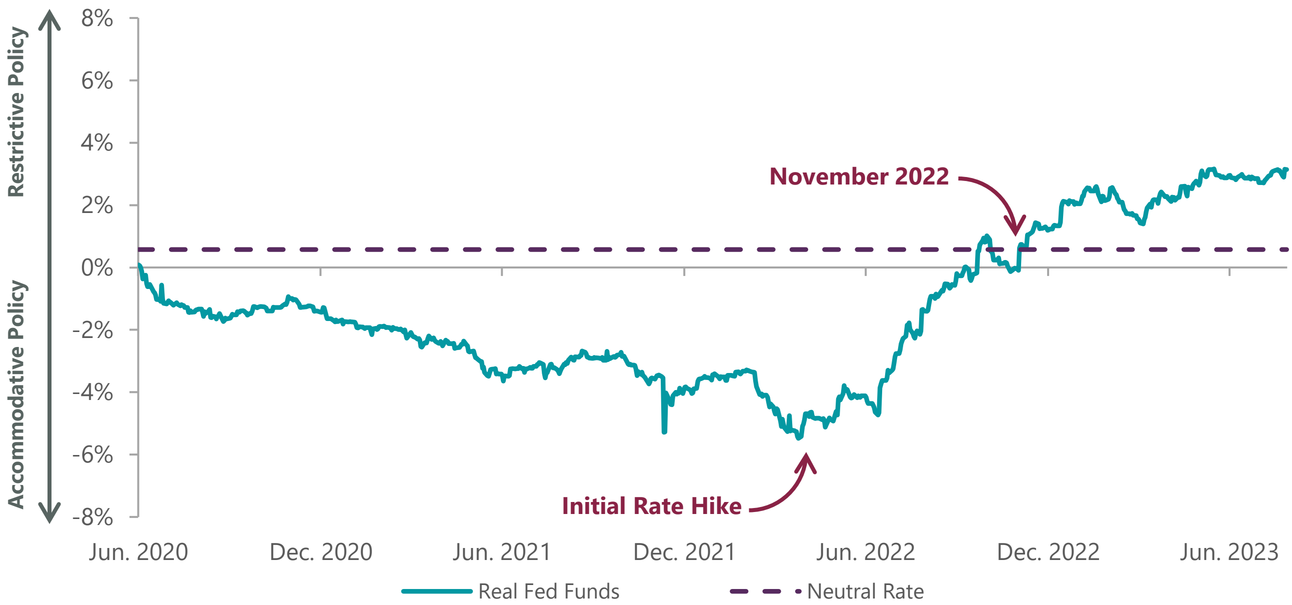
Source: ClearBridge Investments.

During last week's Federal Open Market Committee press conference, Chair Jay Powell talked about the long and variable lags to monetary policy, specifically referencing that the real (inflation-adjusted) federal-funds rate is now in meaningfully positive territory (higher than inflation). This means monetary policy should be tight enough to slow economic growth and curb inflation. This is an important concept as most investors focus simply on the level of interest rates, but most academic research and the Fed's own models focus on the level of interest rates relative to inflation.

Powell's preference when calculating the real rate was to use a mainstream measure of near-term inflation expectations as opposed to actual inflation. This is something we also believe, as investors and corporate decision makers typically focus much more on what they think will happen in the future than what has happened in the past when making capital allocation decisions. For example, consumers are much more likely to buy a house or a car today if they think prices will be higher in a year's time, and they will focus less on what's recently transpired with prices.

On this basis (using market pricing for a 1-year inflation swap), the Fed only brought rates into restrictive territory — above the neutral rate or the point at which interest rates are neither supporting economic expansion nor curbing growth — in late 2022. This is important because monetary policy famously acts with long and variable lags. If interest rates only reached the point where they should be expected to slow down the economy around year-end, then investors considering a policy lag of between six and 18 months (which most academic research supports) should expect a recession between mid-2023 and mid-2024.

Exhibit 3: How Restrictive is Monetary Policy?



Data as at 1 August 2023. Source: Federal Reserve and Bloomberg. Real Fed Funds is Fed Funds Rate less 1-Year Zero Coupon Inflation Swap; Neutral Rate is Holston-Laubach-Williams Model.

History also suggests it may still be too early in the hiking cycle to expect a recession, even though it may feel like the Fed has been in tightening mode for an eternity. The initial rate hike occurred in mid-March last year, only 16.5 months ago. Historically, a recession has started 23 months after the first increase of a persistent hiking cycle. In fact, only three of the last 12 persistent hiking cycles (since the late 1950s) saw a recession begin by this point. Given how far behind the curve the Fed was coming into this hiking cycle with nearly double-digit inflation and federal-funds rate starting at 0%, it is understandable that recession headwinds need more time to coalesce (Exhibit 4).

Importantly, economists and strategists might be premature in declaring "all-clear," as the lagged effects of monetary policy should begin to truly slow economic growth in the coming quarters. We are struck by the improvement in economic sentiment in recent weeks, just as the window for a recession may (finally) be beginning.

Exhibit 4: Long and Variable Lags

Start of a Persistent* Hike Cycle	Start of Recession	Recession Within 3.5 Years?	Duration of Hiking Cycle (Months)
Nov. 1958	April 1960	Yes	17
July 1963	Dec. 1969	No	76
Nov. 1968	Dec. 1969	Yes	12
Jan. 1973	Nov. 1973	Yes	9
Aug. 1977	Jan. 1980	Yes	29
Aug. 1980	July 1981	Yes	11
March 1984	July 1990	No	75
March 1988	July 1990	Yes	27
Feb. 1994	March 2001	No	85
June 1999	March 2001	Yes	20
June 2004	Dec. 2007	Yes	41
Dec. 2016	Feb. 2020	Yes	38
		Average for All Hiking Cycles	**37**
		Average When Recession Started within 3.5 Years	**23**

*A Persistent Hike Cycle is the period when the majority of Fed rate hikes occur in a tightening cycle. The date of the initial rate hike in the tightening cycle may not align with the start of the Persistent Hike Cycle. Source: FactSet.

This juxtaposition moderately reinforces our view that a recession is the more likely outcome over the next year given that sentiment measures typically work best as contra signals. In fact, with the benefit of hindsight, this was the case coming into the year, with everyone expecting the "Most Anticipated Recession Ever." With investors (in our view misguidedly) embracing a soft landing, it could happen yet again. Whether our view ultimately proves correct, it is based on our process and a set of indicators that have historically been effective in anticipating the onset of a recession. Whilst much less anticipated by the consensus than eight months ago, we continue to believe a recession is on the horizon.

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