July 2022

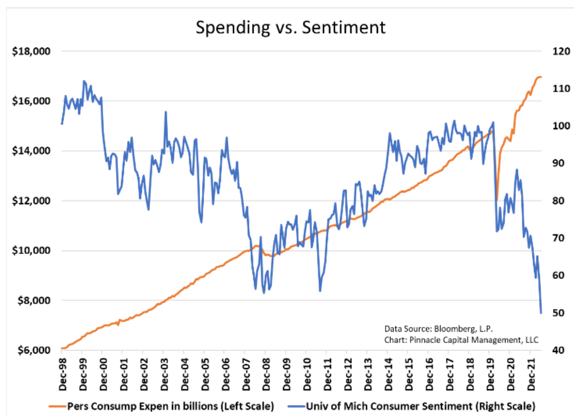
Recession Fears and Opportunity

Fear is in the air. With inflation at 40-year highs and predictions of recession looming, stocks have fallen to bear market territory – defined as a 20% or greater fall in the equity index. Are the dark days of the 1970s upon us? Will inflation and rising interest rates crush the economy? Pessimism is echoing through the media. But we think there are plenty of opportunities for patient investors.

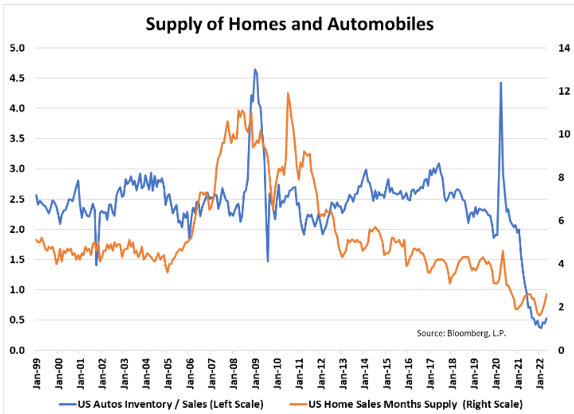
Starting with the bad, the June Consumer Price Index (CPI) saw a 9.1% increase year over year. It's been over 40 years since we last saw inflation this high. And interest rates have been rising too. The 10-year U.S. Treasury yield exceeds 3% as of mid-year 2022, up from a low of 1.17% less than a year ago. The average 30-year mortgage rate, which bottomed at just below 3% at that same time, zoomed to over 6% according to Bankrate.com in June before falling by about ½ a percentage point as recession fears accelerated.

GDP surprisingly fell 1.6% in the first quarter. While 2nd quarter GDP figures are not available as we write this, retail sales fell in May after a strong first four months of the year. This occurred as the University of Michigan's Consumer Sentiment Index reached record lows. As the definition of a recession is two or more consecutive quarters of negative GDP growth, it is very possible that the recession of 2022 will be declared as you read this.

But something is amiss. The negativity is occurring as we see several broad areas of strength. Starting with the chart below we can see that consumer spending has accelerated as sentiment plunged. Overall, the consumer is in very good shape as



measured by household net worth. While consumer spending may have recently dipped slightly, it still vastly exceeds the peaks established prior to 2020. It's true that rising interest rates have the potential to dampen demand, especially for housing and automobiles. But as the next chart shows, these are two areas of the economy that are in very tight supply. While some will be unable to afford a new car or home, there are plenty in line waiting to take these individuals' places. We expect, therefore, only a slight impact in these crucial sectors of the broad economy. Speculation will likely abate, but the volume of transactions is unlikely to see a major contraction. There aren't many other areas of consumer spending where the Fed is likely to have a large impact. So with



employment remaining strong, any consumer spending slowdown appears to be just that – a slow down – and not a major retrenchment.

But what about businesses? Are they not feeling the impact of rising prices and interest rates? The answer is, it depends. While rates have risen substantially, the real rate of interest – the nominal rate less inflation – is still less than zero for most businesses. Borrowing costs are still very cheap. Businesses still have every incentive to invest in improved labor productivity, increased inventories, multiple sources of distribution and supply, and new sources of manufacturing.

Many businesses, though not all, are able to pass through increased prices. Some as a competitive strategy will absorb some cost increases, keep a lid on their prices, and thereby gain market share vis-à-vis their competitors. Other businesses, indeed, will find the profit margins shrinking due to higher costs. But overall, inflation is not something that in of itself is bad for business.

There is, however, a strong positive for business spending. The supply disruptions of the past two years have exposed weakness that need to be addressed. The corporate world is already spending on expanding their manufacturing, distribution, and supply chains as well as on productivity improvements to cope with ongoing labor shortages. This spending will be a tailwind for economic growth for several years to come. Ironically, drawdowns in inventories along with increased imports to satisfy demand account for more than 100% in the drop in GDP in the first quarter. These negatives will be eventually reversed and represent a source of growth moving forward.

Despite a spending slowdown in the near-term, consumer and business spending suggest we are in what is usually a healthy economic environment. What could go wrong? While the Fed's ability to regulate consumer spending is likely more limited than in the past, so too is their ability to limit inflation. The risk is that they slam on the monetary brakes even harder. If rates rise too much or too quickly, the disruptions could cause both consumers and businesses to pull back. We suspect this fear is why the markets have performed so poorly in 2022.

The other risk is fear itself. Consumer sentiment is at record lows – below the levels immediately after September 11, 2001, the peak of the 2007-2008 financial crisis, and March 2000 when Covid deaths were spiraling. While spending has not been positively correlated with consumer sentiment, we are not oblivious that pessimism can be potentially self-fulfilling.

But for those who have patience, there are opportunities in the years to come. A strong capital spending cycle will be beneficial to corporate, and especially industrial, America. Consumer spending should continue to grow, albeit with temporary hiatuses, as job markets remain robust. There are segments of the equity markets, especially the long-ignored value sector, that remain compellingly cheap. Interest rates should continue to rise, which bodes poorly for near term fixed income returns. But those same higher yields will make it easier before long for investors to benefit from higher income from those same fixed income portfolios.

In summary, we're at a difficult point with high inflation, rising interest rates, and poor consumer sentiment. But things are not dire, and the issues facing investors are neither long term nor insurmountable. The road may be bumpy, but we like what we see ahead.

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