MARKET MONITOR

ROYAL ASSET MANAGERS, LLC MARCH 2023 VOLUME XVIII ISSUE 1

After 15 Months of Recession Watch, Market Bears Say They Will Be Right—Eventually

BY: MICHAEL ALEXENKO, CFA

What is going on with our economy? We've been expecting a recession for about 15 months and there has been no official call, as of yet, that a recession is in the works. It seems like everyone is dressed up and ready for the recession gala but they have nowhere to go. Or, rather than a gala, we probably should think of recession as a funeral and the Mark Twain quote comes to mind about the reports of his demise being greatly exaggerated. Either way, the next recession has been assured, but it remains **MIA**.

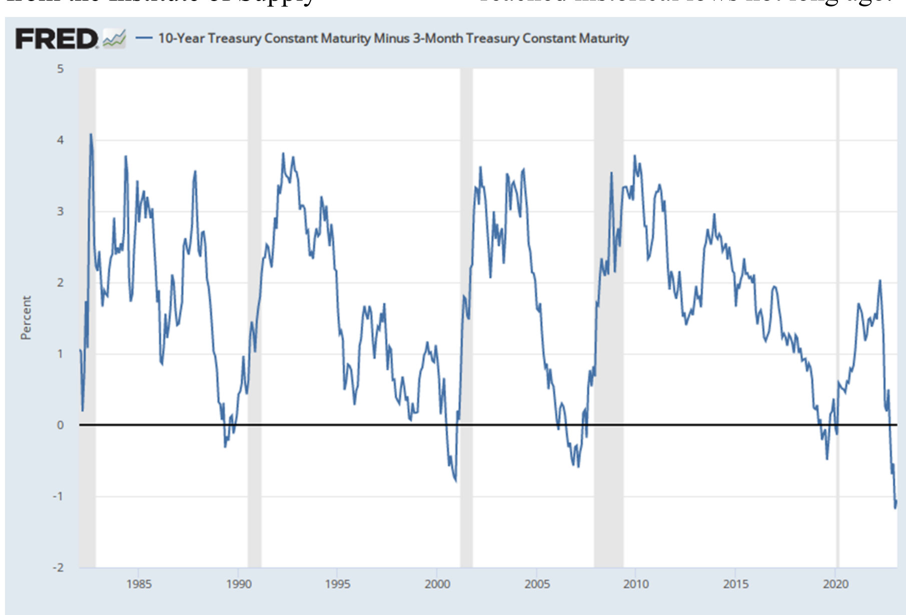
Wall Street seems to want to attend somebody's funeral because there is no shortage of bears pounding the recession drum. Morgan Stanley, Goldman Sachs, J.P Morgan and Bank of America all are pointing to countless fundamental and technical indicators that are screaming recession and have been doing so for quite some time.

One of the most popular and closely watched fundamental indicators is the *U.S. Treasury yield curve inversion*. This isn't just an indicator but it's considered to be a *leading* indicator which means that it has strong predicative power and it's hard to argue with its track record. The first line in the sand is the difference between the two year and ten year Treasury note rates: When the two year note is higher than the ten year the market's alarm bells go off and stocks lose value, as they did last year. When things get really ugly, the three month Treasury rate exceeds the ten year. Well, this very thing occurred in October 2022, and has remained so since. It's no coincidence that the stock market hit its low for this bear market in October because a three-month/ ten-year inversion in the minds of many on Wall Street makes a recession a *fait accompli*. See the graph that shows the yield curve inverting shortly before recessions.

Related to yield curve inversion is the Federal Reserve monetary policy that has everyone on edge. The Federal Reserve doesn't have a very good success rate of trying to tame inflation and a hot economy without over doing it and causing recession. The recession debate is split between those who believe that the Fed will stop raising rates soon and successfully engineer a soft landing and those who believe inflation will remain hard to defeat and the Fed will have to cause a recession to win the inflation battle.

Other indicators you may have heard about over the past months are those that gauge economic activity, such as Services and Manufacturing surveys from the Institute of Supply Management (**ISM**), or the Purchasing Managers' Index (**PMI**). Anytime these reports log numbers that are below 50 it means that economic activity is contracting. We have seen many sub-50 numbers from these surveys over the past year.
Another prelude to recession is when banks begin to tighten credit standards. Loan requirements in the past quarter have been getting tougher which means that bankers are concerned about future loan repayments, so they make it a little harder for borrowers to get financing. More Mark Twain humor for this is "… a banker is a gentleman who will lend you his umbrella but at the first sign of rain he wants it back…"

Extra evidence of recession warnings comes from dismal readings of consumer and individual investor sentiment. These numbers, like the one from the University of Michigan, reached historical lows not long ago.



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Ignore the Noise and Stick with Your Strategy

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Which means it's not just Wall Street and bankers that are stoking recession fears but consumers who know that their wages aren't growing as fast as food, energy and housing prices which makes them worse off. Even though there might not be an official recession, it sure feels like one to them.

Is it possible that some investment shops are simply just "talking their own book?" Maybe perma-bears like Morgan Stanley's Chief Investment Officer are doing this? He made a great call least year, but this year is a different story. At this point might he be trying to talk up recession and talk stocks down to keep Morgan's clients happy who he has underinvested in stocks?

Goldman Sachs' for several months has been mostly negative, but Goldman's recent forecasts are confusing and conflicting. On February 6th Bloomberg News had two reports that Goldman believes that the chance for recession has dropped from 35% to 25% but it then forecasts that the S&P 500 will lose value between now and year end by about 4%. It's hard to reconcile these two calls because a lower chance of recession should have a parallel relationship with a rising stock market. Maybe the pressure of trying to get the call right is causing them to try to straddle the fence and claim victory regardless of actual outcome?

Another possibility is that we as a nation and the world created unique uncertain economic conditions by shutting down economies worldwide and used debt to finance the luxury of paying people not to work. This has created an unusual situation where inflation is high, economic activity is weak, while employment numbers remain strong. It's a strange combination and this is what likely keeps the ivory tower people at the National Bureau of Economic Research (NBER) who are the official arbiters of recession from calling one last year when the economy shrank long enough to satisfy the standard measure of recession.

It's been written in this newsletter many times that investment strategy is the main guiding force to help us make good investment decisions. This is a moment in time that proves this principle. If the investment gurus who are reading the tea leaves can't provide any reasonable timeframe for when recession will hit then listening and acting on the noise that comes from Wall Street to make investment decisions is not a good path to follow. At least a broken clock is right twice a day, but the recession call has been wrong every day for the last 15 months. It might feel like a recession is coming and there are many good reasons to believe that the risk is high, but investment strategy is the best way to deal with elevated risk without making things worse.

Market Snapshot:

Good Cases Can Be Made for Bearish or Bullish Outcomes

By: Michael Alexenko, CFA

All the indicators in the recession article pointed to negative trends that would imply recession. But there is some good news happening in the markets that even if a recession does hit, it's not out of the question that the market has already priced in all the bad news. Meaning we don't necessarily have to make new market lows. Consider the extreme investment rotation that is going on through mid-February. Many of the riskiest asset categories that got wiped out last year are leading the market this year. This is good news! Employment numbers remain strong and show little sign of deteriorating. The value of the dollar has dropped over the past 60 days as stocks have risen. Whereas last year as stocks dropped, the dollar climbed higher. For those who like to watch stock charts, the market has formed a "golden cross," which is when the 50-day average price surpasses the 200-day average price. Last year the opposite was true when a "death cross" formed. Lastly, the premium for risky hi-yield bonds isn't too high. This means that investors are buying junk bonds without demanding high rates to compensate for perceived risk. Which set of data and indicators wins out is hard to tell and this is a good reason to not get too bearish or bullish. Stick with strategy!!

Publication courtesy of:

Royal Asset Managers, LLC

1576 N. Fifth Avenue Saint Charles, IL 60174

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