

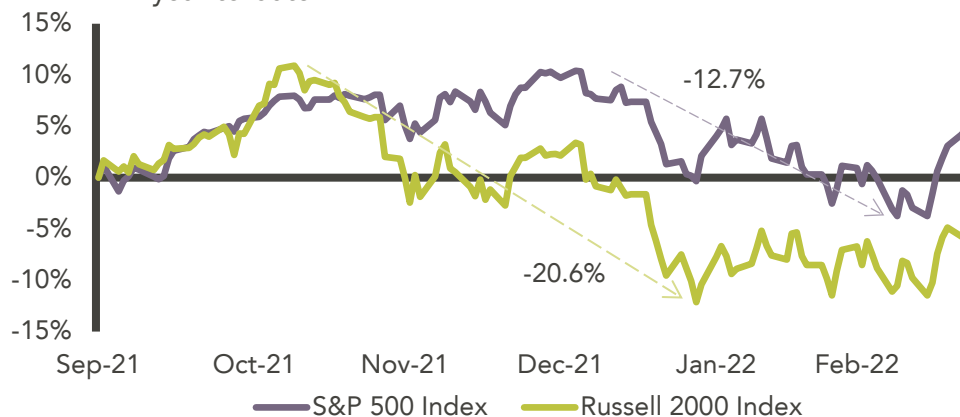
The Rising Possibility of Recession

Over the last several weeks, the risk of an economic downturn in the United States has increased with inflation continuing higher, Russia's invasion of Ukraine triggering unprecedented sanctions, and the Fed beginning its rate hiking cycle. While inflation and the anticipation of rising rates have been driving markets for several months, the invasion of Ukraine in February and the resultant economic sanctions on Russia have added a new dynamic to the equation, driving up commodity inflation and making the Fed's job of controlling pricing pressures without triggering an economic slowdown even trickier. With many U.S. stock indices dipping into correction territory this year (*Exhibit 1*), every new data point and indicator will be heavily scrutinized. While not reasons for a recession in and of themselves, a spike in oil prices, an unemployment rate below 4%, and an inverted yield curve have all historically coincided with economic downturns. In the last month, oil jumped 78.5% on a rolling 6-month basis, unemployment hit a post-COVID low of 3.8%, and the 2/10 year spread has compressed to just 23 basis points. In this newsletter we examine these dynamics and try to provide perspective as it relates to the current market environment.



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▾ **Exhibit 1:** Setting the stage: U.S. equity performance marked by a sell-off year-to-date



Source: Bloomberg as of March 22, 2022

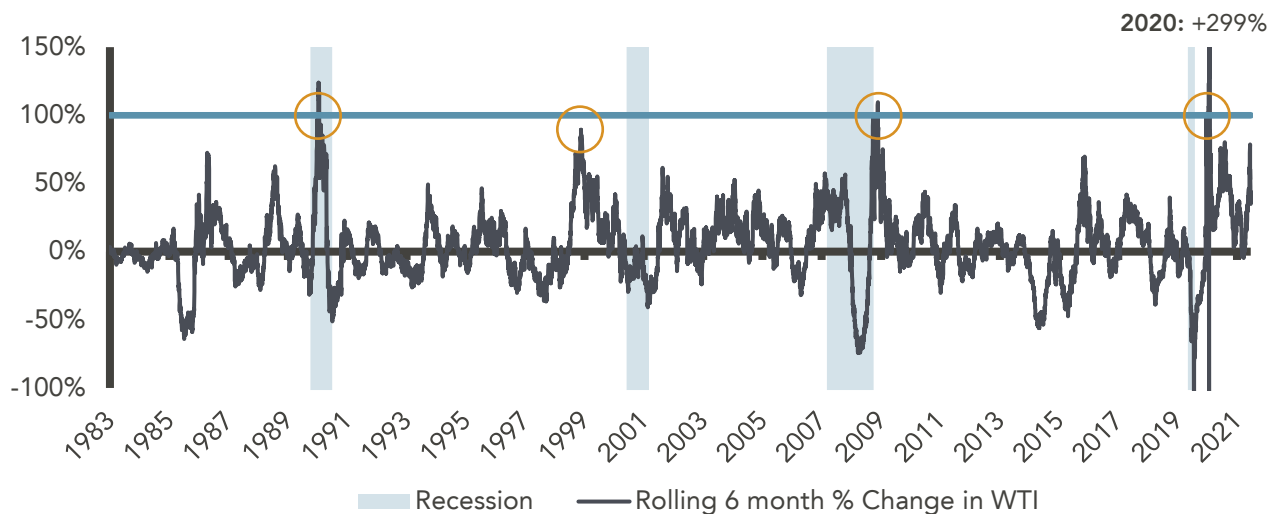
INFLATION

Commodities

As of the end of February, the U.S. Consumer Price Index had surged 7.9% over the prior year, the highest rate of inflation since 1982. Energy represented more than 20% of that increase, with prices up 25.6% year-over-year. While February was previously hoped to be the peak in year-over-year inflation, with COVID-induced supply chain disruptions starting to normalize, the worst from energy is still to come with oil and derivatives spiking sharply in March. Consumers can see the erosion of purchasing power at the pump, where the average cost of a gallon of gasoline in the U.S. reached an all-time high of \$4.30 last week.¹ While the direct impact of elevated gas prices on consumers is observable, it remains to be seen what the rise in the price of oil will do to the bottom lines of businesses. Unlike other commodities impacted by the COVID-19 pandemic, gasoline is a vital input for companies across all sectors of the economy. Though many Fortune 500 businesses may be able to maintain pricing power and sustain margins, this will further exacerbate costs borne by consumers.

Simply elevated oil prices have not historically necessitated poor stock performance. The S&P 500 continued to climb higher as West Texas Intermediate (WTI) crude hovered around \$100 a barrel from 2011 through the summer of 2014. What does seem to have a more direct impact on equities, however, is a sharp spike in oil prices. Looking back over the past several decades (*Exhibit 2*), the stability of equity markets has been threatened when the price of oil has roughly doubled over a short period of time. While the timing is not always consistent, it makes sense that economic shocks that result in elevated energy prices tend to compress consumer savings and complicate supply chain logistics for most companies. In the last forty years, the U.S. has experienced four recessions, each of which was triggered by unique and idiosyncratic developments in the global economy. Each recessionary period, however, also saw the price of WTI crude approximately double just before, during, or after the downturn.

▣ **Exhibit 2:** Extreme short-term movements in the price of oil associated with economic turbulence



Source: Bloomberg as of March 18, 2021; Y-axis truncated to +150% to -100% to preserve scale

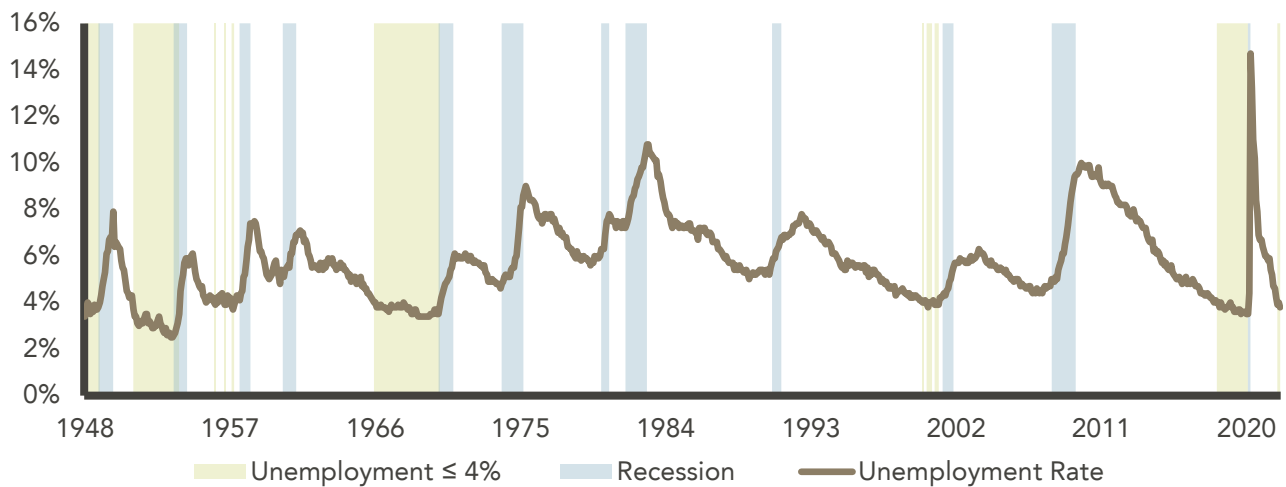
The disruption caused by the 1990 Persian Gulf War is a noteworthy case study given today's environment. The movement of Iraqi forces into Kuwait in August 1990 sent the S&P 500 tumbling more than 15% and the price of oil up more than 120% in a matter of months amid widespread concern that Iraq was seeking to dominate Middle Eastern oil supplies. While this was certainly not the driving force behind the Russian invasion of Ukraine, Russia's status as a top-three global oil exporter makes the economic sanctions levied

on the country all the more impactful, drawing comparisons to the sanctions leveled on Iraq post Kuwait. While the market reaction to the Iraq/Kuwait conflict never reached bear market territory, American involvement in the crisis did throw the U.S. economy into an eight-month recession.

Labor

Another potential indicator of recession that may be less intuitive is full employment — or perhaps better said — employment levels that are non-optimally high. The unemployment rate most conducive to economic productivity has historically ranged between 4% and 5%, with economic growth potentially challenged when unemployment dips below that threshold. While the causal relationship between ultra-low unemployment and recession remains somewhat unclear, it may be that as unemployment levels fall it becomes more difficult for employers to fill vacant positions. In these types of environments, companies may be forced to increase wages in order to entice candidates to enter the work force or change roles, adding to inflationary pressures. Exhibit 3 highlights this interesting relationship over the last several decades, with periods of unemployment below 4% typically followed by a recession.

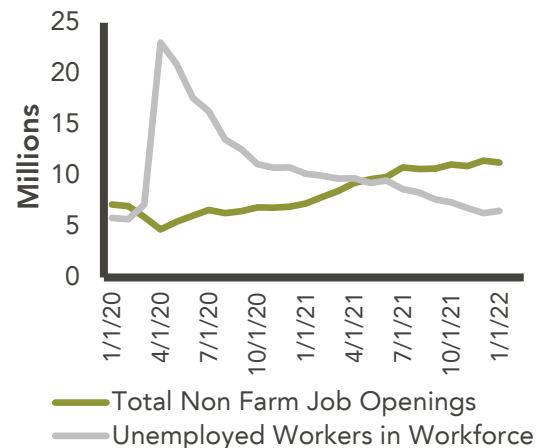
▣ **Exhibit 3:** Ultra-low unemployment can lead to wage inflation, which may ultimately lead to downward pressures on economic growth



Source: Federal Reserve Bank of St. Louis as of February 28, 2022

It is important to point out that labor market strains do not necessarily portend immediate economic slowdowns, as unemployment rates of 4% or lower have historically persisted for years prior to recessions. However, today’s environment represents a unique situation exacerbated by the fact that labor force participation today remains 1.1% lower than it was prior to the outbreak of COVID-19. This means more than 1% of the American workforce seems to have exited the traditional labor market in the last two years, and it remains to be seen if those individuals will return. As a result of these dynamics, the number of unfilled jobs in the U.S. continues to rise. Exhibit 4 shows how the relationship between job openings and unemployed workers has shifted since the beginning of 2020.

▣ **Exhibit 4:** An imbalance between job openings and workers



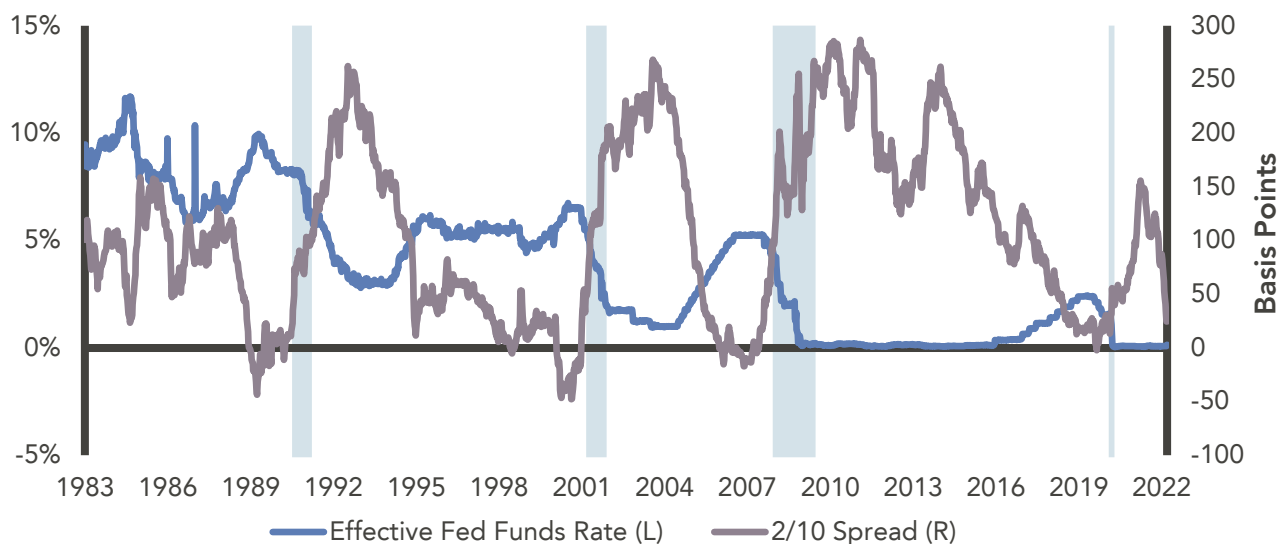
Source: Bloomberg as of January 31, 2022

Over the last 22 years, the labor market in the U.S. has typically seen a surplus of 4.5 million unemployed workers relative to the number of available jobs at any given time. Today, companies are more challenged than ever, as job openings exceed the quantity of available workers by 4.7 million. Until this situation is reversed, we may see continued wage inflation and downward pressure on economic productivity, potentially compressing prospects for economic growth should those dynamics persist into the future.

RATES

To combat inflation, the Federal Reserve raised its benchmark federal funds rate last week for the first time since 2018, from near zero to a range of 0.25–0.50%. The Federal Open Markets Committee (FOMC) expects to raise rates further at each of its six remaining meetings this year to end the year near 2.0%. While the Fed focuses on reining in inflation, there is a risk the Committee overshoots and raises rates to a point or at a pace that triggers an economic slowdown, especially now with the world contending with the impact of evolving geopolitical tensions and trade controls. That possibility seems to be reflected in the yield curve and the spread between yields on the 2- and 10-year Treasury notes, another historically reliable bellwether of recessions. With short-end rates more heavily influenced by monetary policy, the 2-year yield has risen faster than the 10-year, compressing spreads (*Exhibit 5*) and flattening the yield curve. While we have not yet seen an inversion — where 2-year rates are higher than 10-year rates, implying that the outlook for the future is less favorable than that of the present — it is a concern given the Fed’s expected path. While an inverted yield curve does not necessarily cause a downturn, the 2/10 spread inversion has occurred within two years of each U.S. economic recession dating back to the mid-1970s, including the 2020 pandemic-induced downturn.

▣ **Exhibit 5:** Narrow spreads may increase the chance of inversion



Source: Federal Reserve Bank of St. Louis as of March 18, 2022

Moreover, the Fed has left itself with very little room to cushion the economic landing in the event of a greater-than-anticipated slowdown in the pace of growth. During the Global Financial Crisis, over a 16-month period from late 2007 through 2008, the Fed lowered the federal funds rate from 4.75% to a range of 0–0.25%. The central bank did not start raising rates again until December 2015, and not in earnest until 2018, ending that year at a range of 2.25–2.50%. A market sell-off in late 2018 led the FOMC to pause, and concerns about growth stemming from President Trump’s trade war with China had the Committee back to cutting rates late in 2019. The spread of COVID in early 2020 led to the sharpest cut

since 2008, with the central bank quickly taking rates back down to 0–0.25%. Now up just 25 basis points from that low, the Fed has few tools to reverse course, lowering rates in order to encourage growth, if need be.

CONCLUSION

As the year unfolds and market participants gain more clarity on the economic impact of the conflict in Eastern Europe, as well as current labor and commodities markets dynamics, it is important for investors to remember to remain disciplined while adhering to stated policy objectives. Market turbulence caused by exogenous factors can cause security prices to move significantly in both directions, meaning panicked equity sales on a bad day could mean missing the opportunity to capture a subsequent rebound. Marquette will continue to monitor market movements and the macroeconomic landscape, particularly those variables that have historically served as indicators of recession and provide counsel accordingly. ■

NOTE

¹ American Automobile Association

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