

Assessing the Likelihood of a Recession and Understanding the Impact on Portfolios

Is a recession coming to the U.S.? It's a question that has been asked since 2022, as the Fed's rapid rate hikes sparked concern that higher interest rates would lead to demand destruction and ultimately economic contraction. Nonetheless, here we are in the first quarter of 2024 and although the growth rate of gross domestic product has fallen, it is still positive. Unemployment remains at historic lows and inflation is falling. However, with the Fed unlikely to cut rates during the first half of the year and the full effect of the higher rate environment not yet settled, the recession threat still looms over the economy and markets. Given this background, the following paper presents three reasons for each side as to whether the U.S. may enter or avoid a recession in 2024, as well as recessionary implications across asset classes.

REASON #1 FOR A RECESSION: HIGHER INTEREST RATES

The first dynamic that could drive a U.S. recession is the massive run-up of the fed funds rate. Between March 2022 and July 2023 — a span of 16 months — the Federal Reserve moved rates from effectively zero to a policy range of 5.25–5.50% to fight rampant inflation. However, Chairman Powell and the board of governors have reiterated the long-held and historically proven principle that policy rates act with long and variable lags. Getting inflation to start falling is the easy part, but getting inflation to the Fed's long-term target is hard. Indeed, much progress has been made in two years, but the most recent inflation reading as measured by the Fed's preferred metric — PCE inflation — measured 3.2% in February. And although the Fed is still expected to cut three times in 2024, the overall level of rates will most likely remain elevated until inflation hits its target of 2%.



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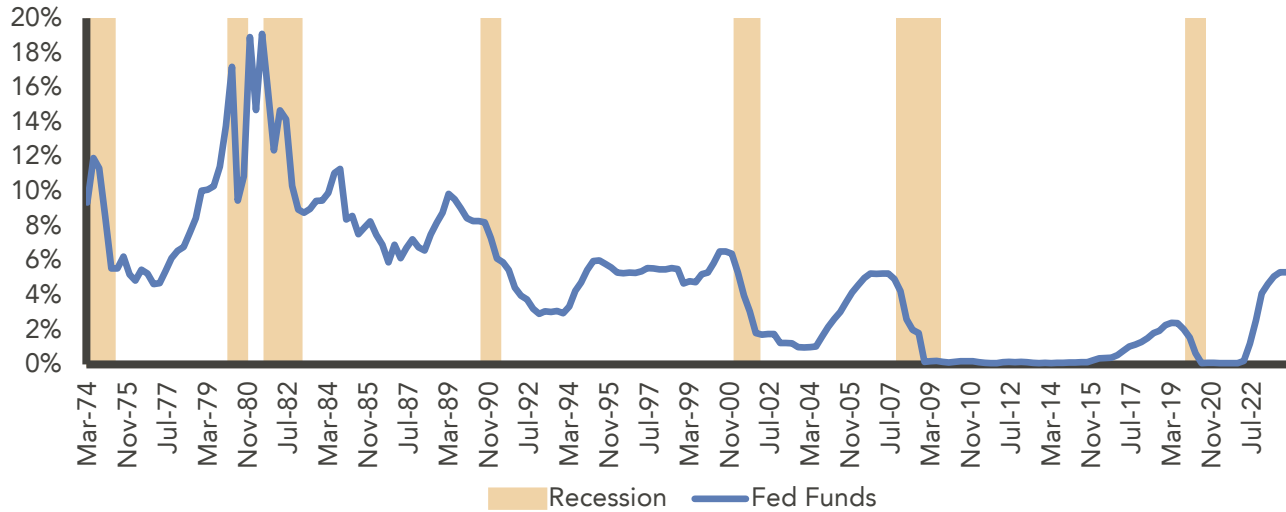
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Exhibit 1: Higher rates take time to hit the economy



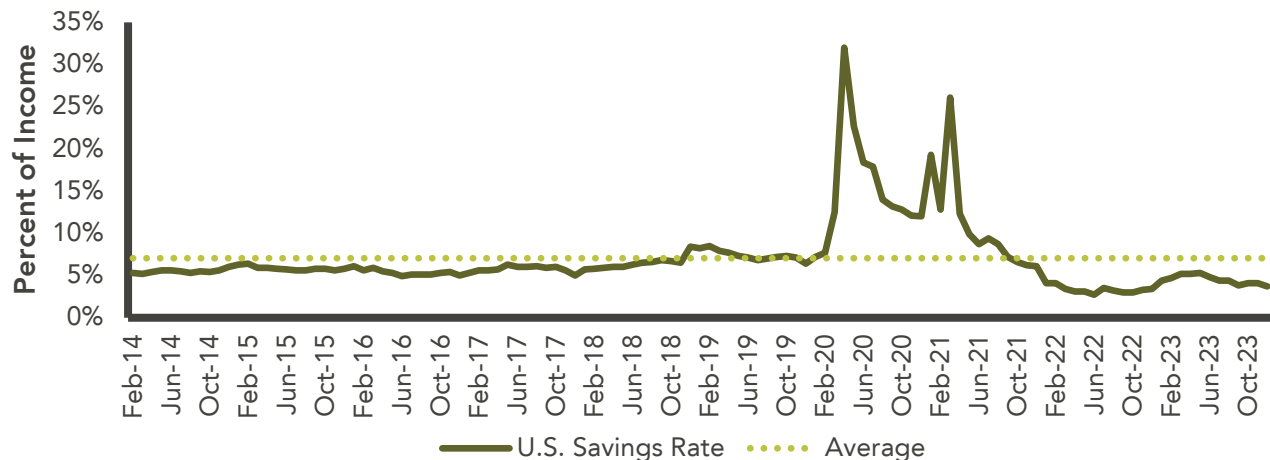
Source: Bloomberg as of December 31, 2023

Though it may be debatable how much higher rates contributed to the GFC and COVID-induced recessions, the trends in Exhibit 1 suggest that rate hikes have helped to foster a recession, albeit with a delayed impact. Since 1977, it has taken 29 months on average for the U.S. to enter a recession from the initial move in rates (March 2022). Alternatively, it takes an average of seven months for the U.S. to enter a recession after the fed funds rate peaks (July 2023). Given these averages, concerns over today’s rate environment and its potential recessionary impacts seem fair.

REASON #2 FOR A RECESSION: CONSUMER RESILIENCY FINALLY FADES

The strength of the consumer has helped fuel economic growth and up to this point has been the primary reason the U.S. has skirted a recession. In 2020, consumer savings skyrocketed on the back of government stimulus and low expenses due to home confinement, and because certain debt burdens such as student loans were suspended. As the economy reopened, consumers spent down a lot of those excess savings and helped drive economic growth. Today, though, the savings rate is much lower and leads one to wonder if future consumption patterns will be negatively impacted. Furthermore, expenses such as student loan payments have now resumed and are another headwind for growth.

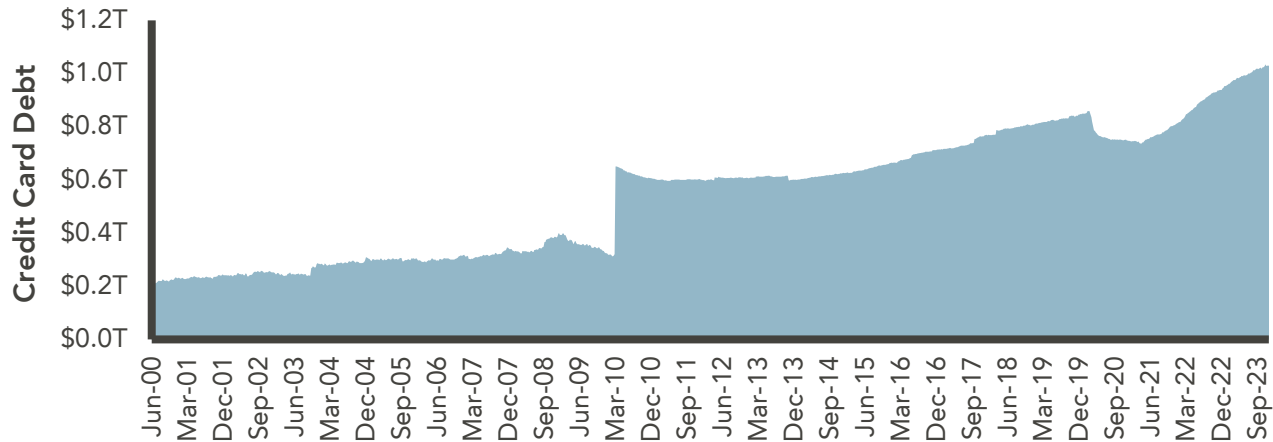
Exhibit 2: Savings rates are lower than pre-COVID



Source: Bloomberg as of December 31, 2023

As consumers spent down their savings and rates rose, it has become more expensive to maintain the same level of consumption. Higher rates and debt payments have forced some consumers to borrow the needed funds to keep their consumption levels constant. For example, credit card balances dropped during 2020's lockdowns, but started picking up in 2021 (Exhibit 3). Furthermore, there has been an uptick in loan delinquencies. These trends are not supportive of broader growth and bear watching.

Exhibit 3: Debt-fueled spending has resumed

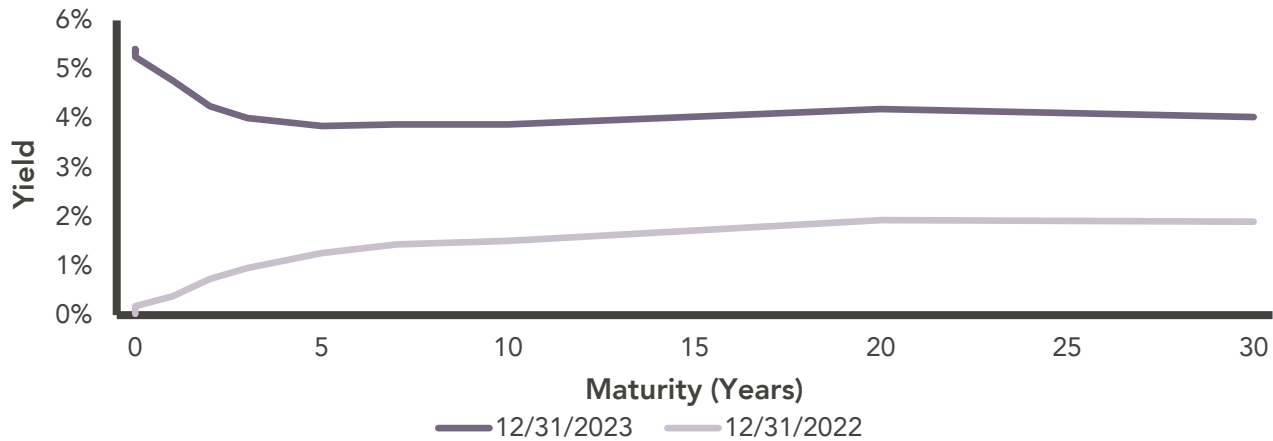


Source: Board of Governors of the Federal Reserve System as of December 31, 2023

REASON #3 FOR A RECESSION: UNSUSTAINABLE FISCAL POLICIES IN THE U.S.

Finally, current fiscal policies in the U.S. seem unsustainable. This is not a new phenomenon. What is new is the cost of financing those policies. The U.S. has long relied on debt to finance the shortfall between tax revenues and governmental spending and when rates were at historic lows, that debt used to be relatively free. Treasury Bills, which represented about 25% of borrowing, were a de minimis cost to finance the gap.

Exhibit 4: Yields have risen across the curve



Source: Bloomberg

Today, there is a cost to service that debt. Treasury Bills (less than one year to maturity) are now yielding over 5% and the whole curve is around 4%. The continual shortfall and increased cost to finance it threatens to create a death spiral. The majority of borrowing is facilitated via Treasury Notes (1–10 years), and the cost to issue those bonds has more than doubled. As the curve has inverted, the Treasury has shifted borrowing away from Bills to avoid issuing the highest cost instruments, but has not shifted more because it does not want to lock higher rates for an extended runway. The debt service cost is now an increasing portion of

governmental spending. It is estimated that it will consume 11% of the 2024 fiscal budget. This is up from 8% in 2019.

Exhibit 5: Treasury debt

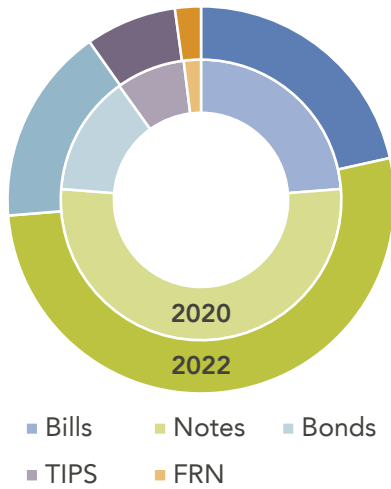
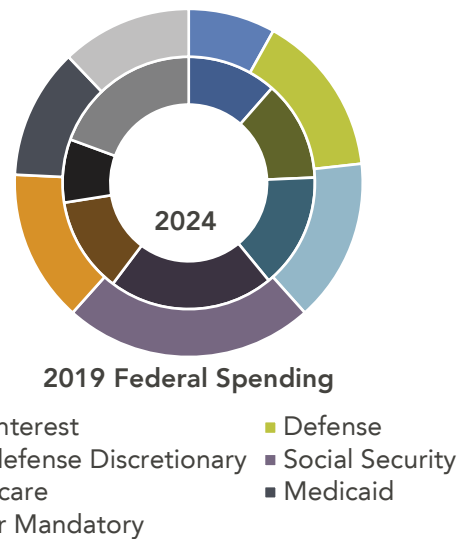


Exhibit 6: Government spending

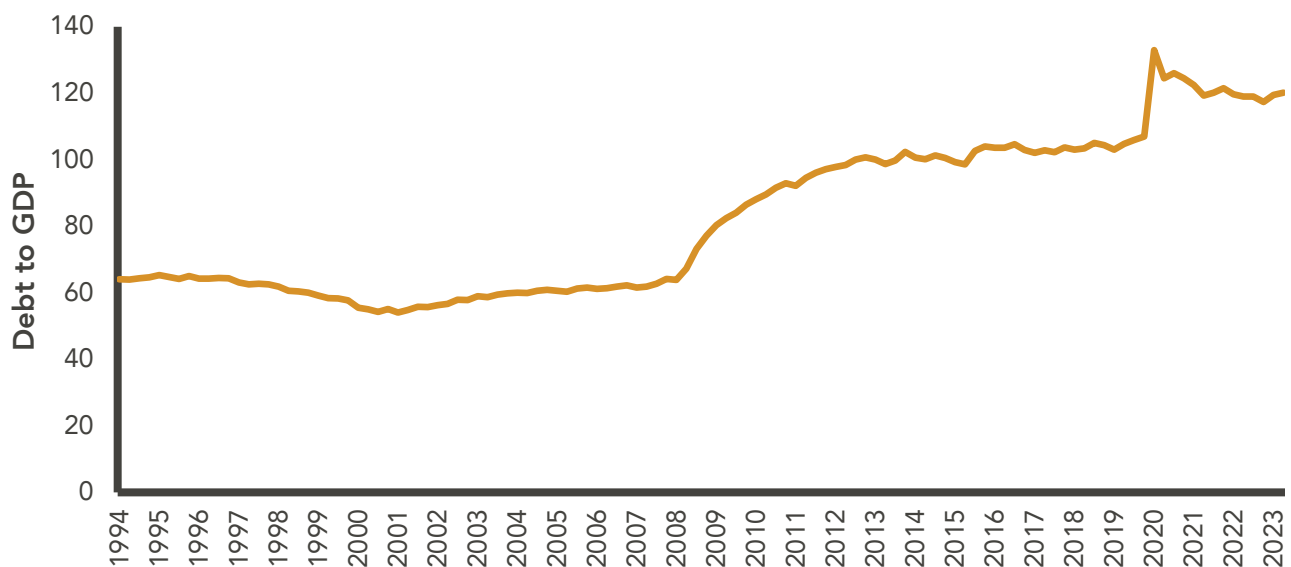


Source: U.S. Department of the Treasury

Source: Office of Management and Budget

What can the U.S. do? None of the solutions are a political slam dunk: Raise taxes (opposed by Republicans), cut defense spending (opposed by Republicans), cut foreign aid (opposed by Democrats), and/or cut entitlements (opposed by Democrats). Otherwise, the deficit must be funded by more borrowing. As borrowing increases, debt to GDP increases, which in turn should make interest rates rise further due to increased credit risk, which then fuels higher debt service costs and exerts further pressure on the U.S. government. Eventually, the market will force the government to take action. Whether the government increases taxes, reduces spending, or a little of both, the policy decisions will likely have a negative impact on growth.

Exhibit 7: Debt to GDP is reaccelerating after post-COVID declines

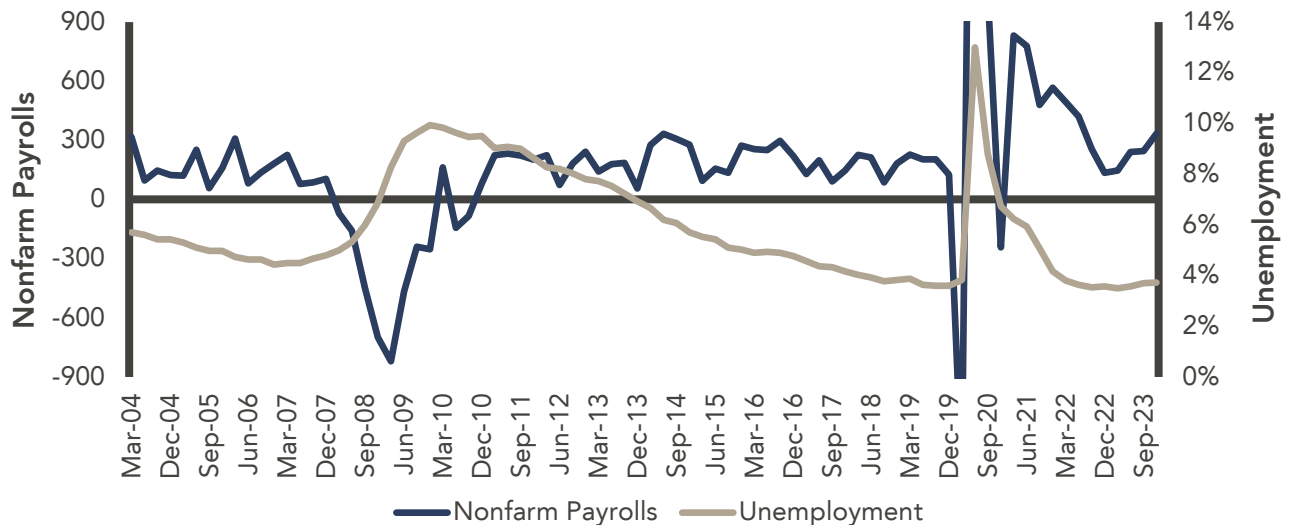


Source: Bloomberg as of July 31, 2023

REASON #1 WHY THE U.S. AVOIDS A RECESSION: LABOR MARKET STRENGTH

The outlook is not all doom and gloom and there are multiple bright spots to reference, with the labor market shining brightest. In short, the labor market is outperforming all expectations. While there have been layoffs — particularly in technology and finance — hiring is outpacing projections and the increase in available jobs has brought unemployment to historic lows. Looking forward, this current supply/demand dynamic is likely to persist as the labor market saw a significant number of early retirements during COVID which reduced the supply of qualified employees. Given the projected flat population growth in the U.S., the unemployment rate is likely to stay low. Historically, unemployment has risen going into a recession, but when unemployment is low — as it is currently — it is rare to see a dip in growth.

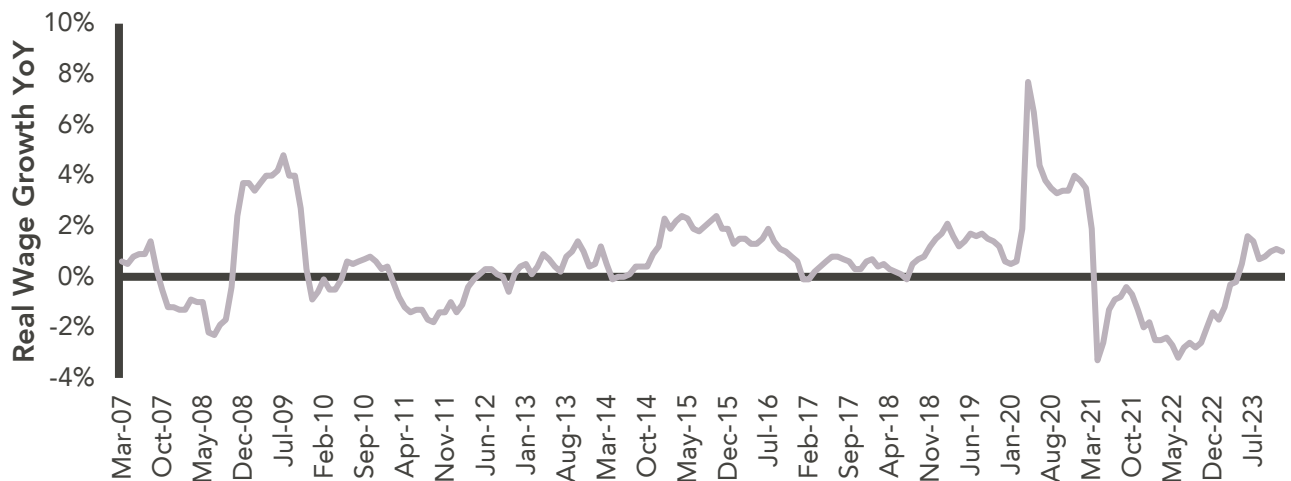
Exhibit 8: Strong job growth has pushed unemployment to historic lows



Source: Bloomberg as of December 31, 2023

In addition, wage growth is now exceeding inflation after lagging for more than two years. Real wage growth was positive for much of the decade before COVID but went negative as inflation picked up and wages lagged. As inflation has fallen, real wage growth has again turned positive, which increases buying power and keeps the consumer strong.

Exhibit 9: Real wage growth positive for first time since 2021



Source: Bloomberg as of December 31, 2023

REASON #2 WHY THE U.S. AVOIDS A RECESSION: THE RISE OF THE SERVICE ECONOMY

Next, the rise of the service economy has reduced the effects of higher rates. In the 1980s, GDP from goods and services was relatively balanced. The goods economy is largely unchanged, but the service economy has grown substantially. Now, services constitute more than 77% of private gross output.

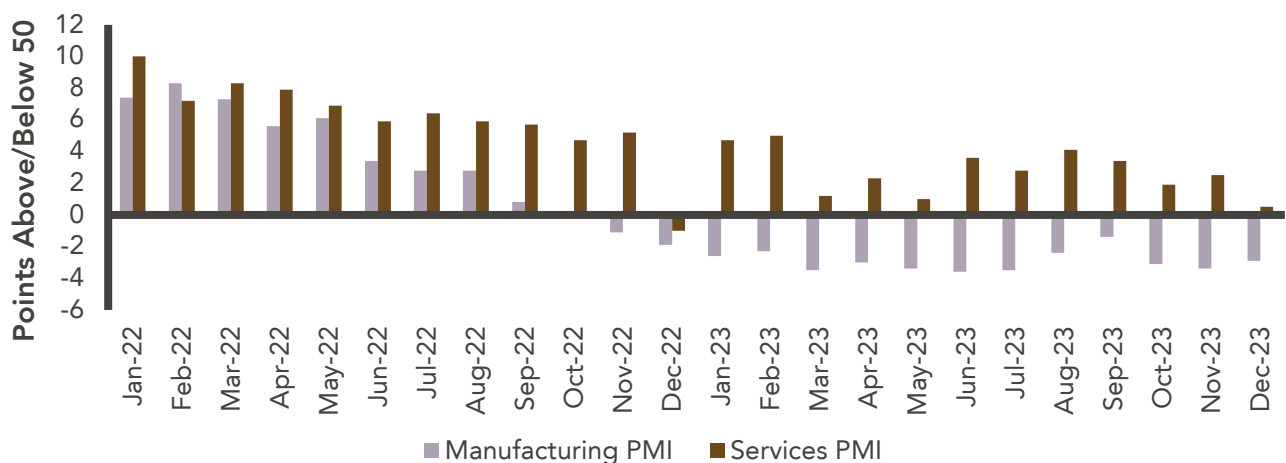
Exhibit 10: The U.S. is a service economy



Source: U.S. Bureau of Economic Analysis

Raising interest rates is intended to reduce investment and slow growth. In addition, higher rates should reduce demand because consumers need to borrow the funds necessary to make major (and often, minor) purchases. Some sectors, like construction and manufacturing, are very sensitive to changes in interest rates. Services, on the other hand, tend to be less capital intensive and are less likely to be financed. This sector and the U.S. economy (by way of the increased proportion) thus may also respond less quickly to rising interest rates than in prior economic cycles. For example, the Purchasing Managers' Index ("PMI") is a measure of prevailing business conditions, including inflation trends. The PMI is split between manufacturing and services. The first rate hike in March of 2022 started to bite manufacturing almost instantly; it moved into negative territory before the end of that year and has remained negative ever since. Services is another story, as it has dipped a little bit but remains positive, supporting the claim that the services sector is less impacted by higher rates and thus less of a drag on growth.

Exhibit 11: Higher rates have dragged on manufacturing but have little impact on services

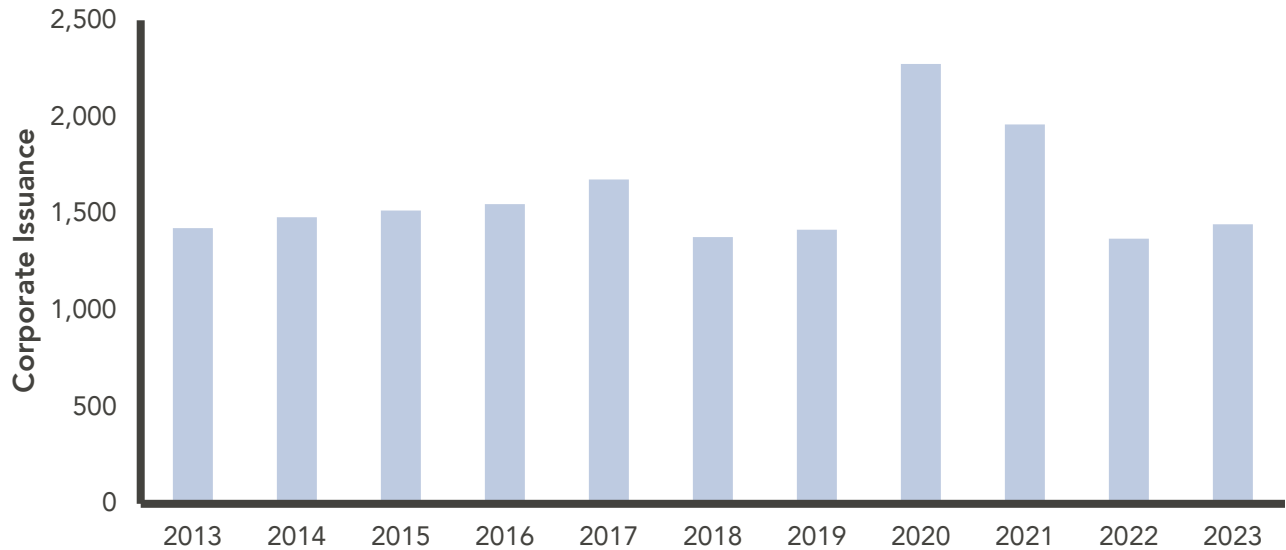


Source: Bloomberg as of December 31, 2023

REASON #3 WHY THE U.S. AVOIDS A RECESSION: STRONG BALANCE SHEETS FOR CONSUMERS AND CORPORATIONS

Finally, consumers and corporations still have strong balance sheets. Corporations assumed historic levels of debt from 2020–2021 to lock in ultra-low rates, issuing about \$500 billion more than normal during that period. Furthermore, close to 98% of corporate bonds are fixed rate instruments, so today’s higher rates are less of a concern than if the majority was floating rate debt. Not surprisingly, corporate issuance over the last two years has fallen off significantly as a result of already-assumed debt levels as well as higher rates.

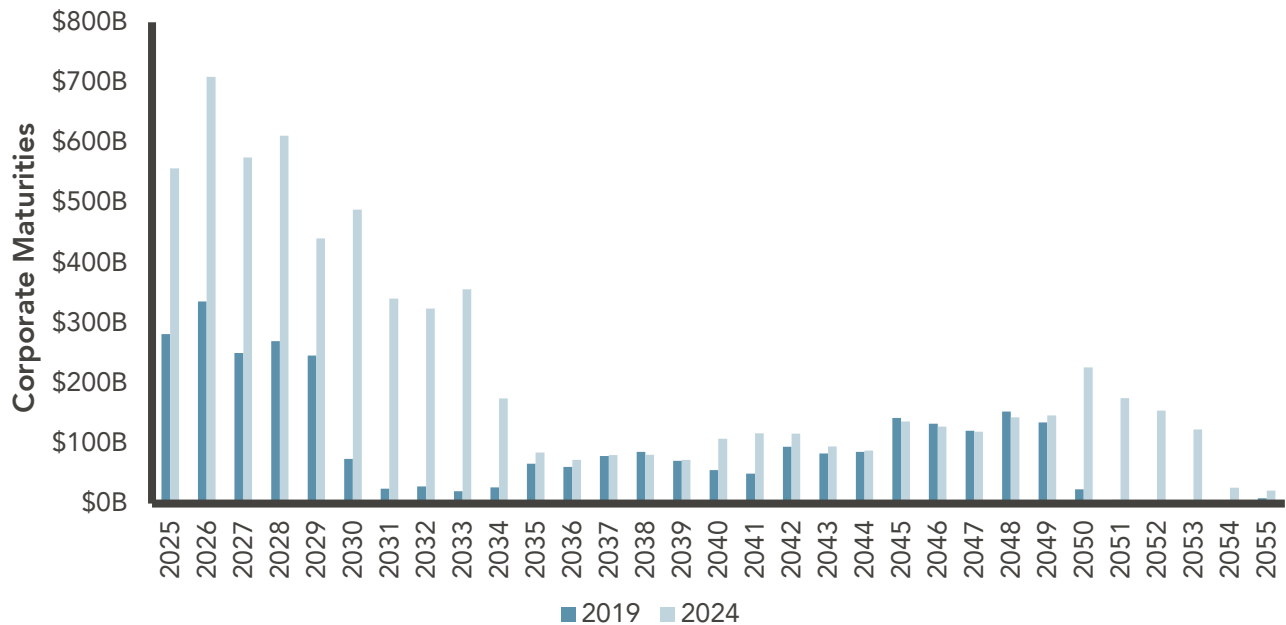
Exhibit 12: Companies rolled forward debt issuance to get favorable terms



Source: Securities Industry and Financial Markets Association

By rolling debt issuance forward, companies were able to term out their debt and do not need to borrow as much today at higher rates. This makes them less sensitive to higher rates in the near term.

Exhibit 13: Companies pushed maturities out

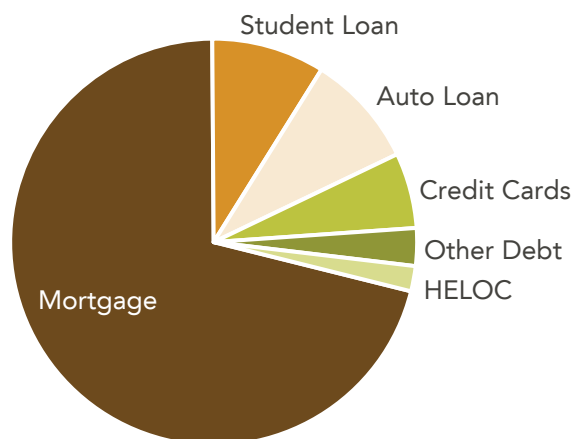


Source: Bloomberg

A similar story holds true for consumers. Almost all consumer debt is fixed rate, and existing debt is not impacted by higher rates.

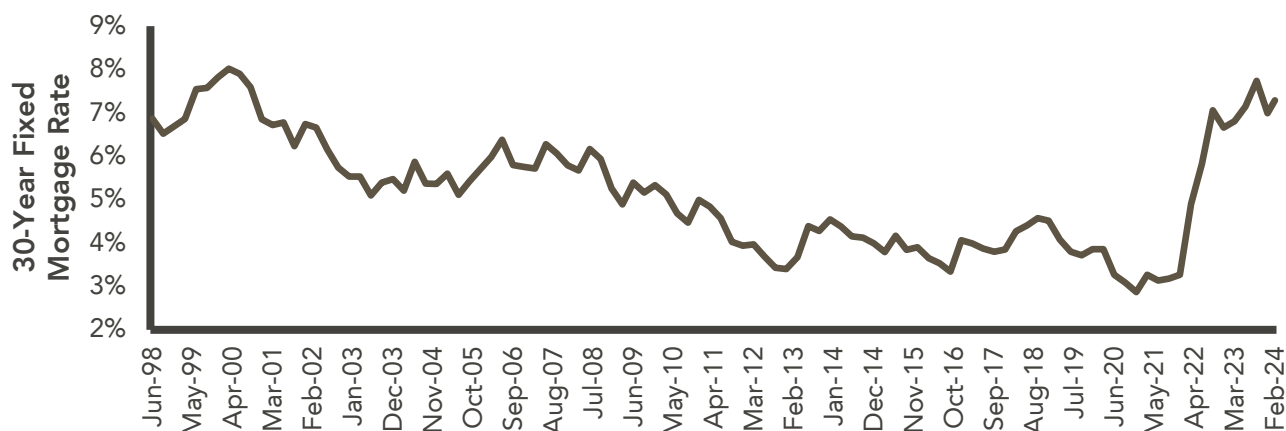
In particular, the primary source of debt for consumers is their home mortgage, which is fixed rate debt. Many borrowers locked in 30-year mortgages when rates were around 3% and thus their payments will remain at that low rate until they are forced and take out a new mortgage. According to the Federal Reserve Bank of St. Louis, 92% of mortgages are fixed rate, which strengthens the argument that today's higher rates should not materially impact consumers' current mortgage costs.

Exhibit 14: Consumer debt is mostly fixed rate



Source: New York Fed Consumer Credit Panel

Exhibit 15: Mortgage rates have spiked over 7%



Source: Bloomberg as of February 20, 2024

PORTFOLIO IMPLICATIONS

Only time will tell if this was the most telegraphed recession ever or the recession that never happened. Higher interest rates, depleted savings, and fiscal turmoil could inhibit growth and put the economy in a recession. However, a strong labor market, a steady and still growing service economy, and low fixed rate debt could keep the economy moving along. Regardless of whether the economy dips into a recession or not, how can portfolios be expected to perform across the two dynamics? The second part of our paper examines that question from a fixed income and equity perspective.

ASSET CLASS IMPACT IF A RECESSION DOES HAPPEN

In the event of a recession, it is likely that the Fed will cut rates to stimulate growth, which has been the usual playbook in past recessions. Predictably, this will have an impact across asset classes, with fixed income the most natural beneficiary. Given the inverse relationship between bond prices and rates, a drop in rates should support price appreciation for most bond instruments, particularly those with significant allocations to investment grade, agency mortgage, and Treasury securities. Below investment grade securities, however, would likely be a different story. Although falling base rates would help offset losses, the other component of yield — spreads — would likely rise materially more than the amount by which Treasuries fall. The combined effect for below investment grade bonds could very likely push returns negative for these sectors.

For equities, there figure to be relative winners and losers, even in the event of a broad market decline. At the highest level, companies with the most resilient earnings streams and the ability to grow through the recession should lead the pack. We would expect defensive and quality-oriented stocks to lead in a recession and although Healthcare has not acted defensive in recent years, it is typically less economically sensitive so it may perform well. Finally, despite the massive run-up in the Magnificent Seven and other technology-oriented names, a recession should not automatically spell trouble for these stocks. As long as such companies continue to deliver earnings growth and meet expectations, it would not be surprising to see further strength from these holdings.

On the non-U.S. equity front, quantitative easing weakens the U.S. dollar and removes one of the primary headwinds that non-U.S. equities have faced over the last two years. Given the impact of commodity exports on emerging market stocks, a weaker dollar could be a notable tailwind for emerging market equities, though the lower overall growth in the U.S. could mitigate that effect. Beyond the currency effect, we would expect similar patterns across sectors and factors as noted in the U.S. equity section. Finally, in any type of risk-off market, dividend payers and bond proxies become more attractive, which could be a tailwind for non-U.S. stocks: The dividend yield for both developed large caps and emerging markets is hovering around 3%, which is almost double that of U.S. markets, and non-U.S. markets have slightly more exposure to Utilities (typically considered a bond proxy).

ASSET CLASS IMPACT IF THE U.S. AVOIDS A RECESSION

If growth remains positive and a recession is averted, it seems that a lot of the guidance and expectations will be “business as usual,” consistent with the current environment, minus future rate hikes. In fact, even if growth stays positive, the Fed is still expected to cut rates in the second half of the year. Furthermore, recession risk is always present; although the probability will be lower, it will still remain a “what-if” consideration in market expectations.

In terms of asset classes, fixed income should be expected to deliver positive returns across most sectors as a product of current yield levels, solid fundamentals, and low defaults. Issuers in the below investment grade space have termed out their debt and even if defaults rise, it is only towards their long-term averages (which is the current market expectation) and spreads should stay relatively stable, thus limiting any price drag from spread widening. Returns will primarily be driven by yields and prices should be steady.

For U.S. equities, avoiding a recession likely equates to more market breadth. For the most part, markets have been driven by a small handful of mega-cap, growth-oriented stocks, as investors piled into these companies as a perceived safety play amid ongoing macroeconomic uncertainty, particularly the Magnificent Seven. The flip side is that small-cap companies tend to be more domestically focused, so they are more sensitive to U.S. economic indicators including inflation, interest rates, and GDP growth, which explains their relative underperformance last year against the backdrop of an uncertain rate trajectory and the possibility of a recession. Without a recession, confidence in the economic outlook could increase investor risk appetite, with capital flowing into companies trading at attractive valuations, especially small-cap and value equities which trade at a discount to their large- and growth-equity counterparts. On the other hand, the absence of a recession means there will be fewer rate cuts, and higher for longer interest rates may continue to pressure interest rate sensitive sectors, including Real Estate, which have a larger allocation in small caps. Finally, Industrials may see support in either regime with the implementation of the Inflation Reduction Act and reshoring; it is worth noting that small-cap equities carry greater exposure to Industrials relative to large caps. Ultimately though, earnings growth is the only real long-term support mechanism for sustainable stock market rallies, so the companies that deliver the strongest earnings growth will continue to lead the market.

A lot of the same sentiment is true for non-U.S. equities, starting with interest rates. Though the Fed is still expected to cut later this year, the cuts will be less meaningful than in a recession. Relative to a recession in the U.S., the dollar should be stronger, which is a headwind for non-U.S. stocks; not a fatal one, but more of the same dynamic that has challenged returns over the last two years. Also similar is the outlook for value equities: Sectors such as Financials and Industrials may outperform given that they typically benefit from higher rates, are viewed as more cyclical, and have historically done well towards the end of market cycles. It should be noted that the non-U.S. market is more value-oriented relative to the U.S. market, and within the non-U.S. market, the EAFE index (developed large caps) is more value-heavy than the Emerging Markets index. As it relates to emerging markets overall, a non-recessionary risk-on environment should be supportive of the asset class given its dependence on foreign demand, particularly from the U.S.

CONCLUSION

Predicting a recession and timing portfolio decisions around it is equally as difficult — if not more so — as timing interest rates and equity markets. That said, it is important for investors to understand which elements of their portfolio can be expected to outperform in such a scenario, as well as where potential pain points may lie. As always, a well-diversified portfolio that adheres to a disciplined rebalancing program is best equipped to deliver superior long-term performance and smooth out any ill effects from dips in the economy and financial markets. We will be closely watching the recession drivers and mitigators that were discussed in this paper, and expect those forces to exert material influence on the trajectories of U.S. growth as well as capital market returns over the remaining nine months of the year. ■

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