MARKET OBSERVATIONS
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Destruction

In the current efforts to lower inflation, policymakers have shied from including "recession" in their commentaries and prognostications. Instead, more frequently, the phrase "demand destruction" has been used. It is an acknowledgement that a primary cause of higher inflation at this time is demand outstripping supply. Seen earliest in the supply chain disruptions, the focus now is on excess demand in the labor market. Certain indicators provide insight on potential economic recession ahead which in turn indicates the timing of stock market cycles shifting from bear to bull. A review of key variables can provide perspective for investing amidst the potential demand destruction ahead.

PERSPECTIVE

The consensus expectation is for a U.S. recession to occur in 2023 with timing and magnitude uncertain. Chart I tracks expectations over time for recessions ahead. The data comes from a quarterly survey conducted by the Federal Reserve Bank of Philadelphia. Respondents are asked for their probability of a recession occurring in the current and subsequent four quarters. These cumulative probabilities have tended to spike in and around recessions, and a spike is now evident. Probabilities in the current and subsequent four quarters of 2023 are 36%, 47%, 49%, 46%, and 44% respectively. These levels are well above historical averages of 19%, 19%, 18%, 17%, and 18%. Current probabilities suggest recession in early to mid 2023 with magnitude uncertain.

The determination of actual periods of recession falls to the National Bureau of Economic Research. The pronouncements often come well after a recession has begun and ended. As a result, there is high interest in finding indicators with a more timely signal. Initial unemployment claims are one such indicator. Chart II shows the trend in weekly claims relative to periods of recession. Claims above 350,000 have been an indicator of recession ahead with about a one quarter lead. In addition to being an indicator to monitor, they suggest the challenge at hand for policymakers. Demand destruction for the labor market means rising claims and unemployment generally. With claims currently at 225,000, further monetary policy tightening and higher interest rates lie ahead.

Another reliable recession indicator has been yield curve inversions, i.e., short-term interest rates higher than long-term rates. The spread between three-month and ten-year U.S. Treasury yields relative to periods of recession is shown in Chart III. Shown as well is the growth of the S&P 500. Yield curve inversions generally have occurred with a reasonable lead to the beginning of recession. The current inversion has become more pronounced in the last month. The timing of stock market turns from bear to bull are highly correlated with periods of recession. The turn most often occurs when recession is underway.

INVESTMENT IMPLICATIONS

The year-to-date has seen the destruction of capital with material declines in both bond and stock markets. While magnitude and timing of recovery are uncertain, restoration of portfolio values most certainly lies ahead with one caveat. Any recovery can benefit most asset allocations. But maintaining prior portfolio allocations is necessary if a full recovery in portfolio values is to be achieved. Certainly, asset allocations should reflect goals, horizons and risk tolerance. However, now may not be the best time to become more conservative.

CHART I

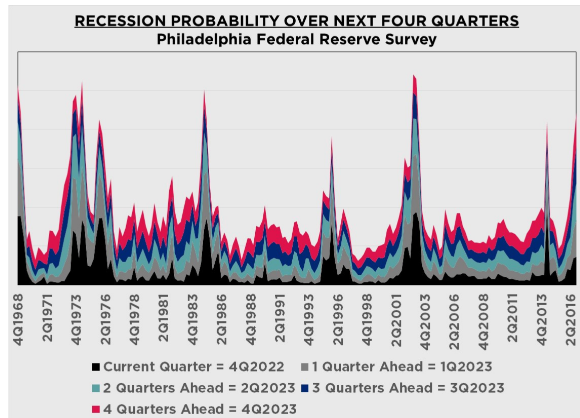


CHART II

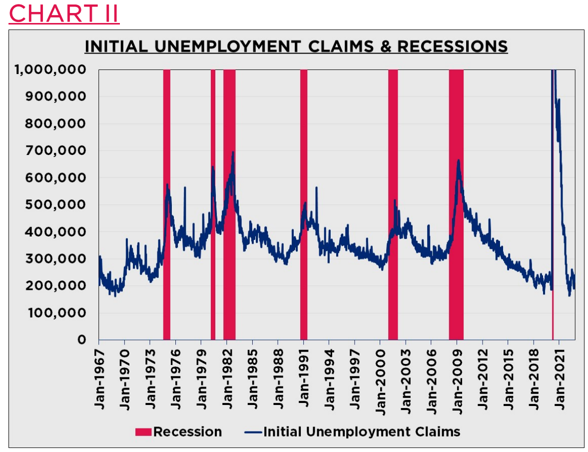
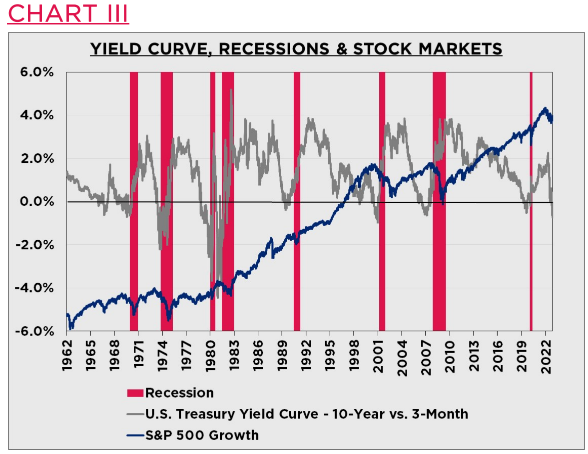


CHART III



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