CAPITAL INVESTMENT SERVICES, LLC

2023 Market Outlook Update: Rolling Recessionary Pressure Impacts

Recently, I was asked about the market volatility and why the US economy has not been classified as "in recession". My argument is that we are already experiencing recessionary pressure and it has been entrenched since mid-2022.

Consider this question- When is the last time housing was down for a full year, industrial production down two months, and real spending down two months and the economy was not in a recession?

Here is the answer – It has not occurred until now!

The US economy is still wrestling with the fallout from the pandemic and the governmental response. The infectious challenge to the economy came in the form of inflation which has created significant issues though the economic spectrum. Like the pandemic itself, the economic recovery was felt differently by various sectors and the US economy is now experiencing growing pains as it returns to a normalized position. The Federal Reserve's delayed action on inflation caused them to respond fiercely once they started. The instruments of choice to fight the inflation battle has included measures of quantitative tightening like significantly higher interest rates. Some sectors are winning while others are losing, a situation that brought constraints into the economy and has pushed the US into a rolling recession.

The economy may not fit the definition of a recession, but certain sectors are certainly in contraction. This rolling recession can be much harder to treat because different parts of the economy are contracting at very different rates. From the capitalist perspective, a recession is a period during which economic output shrinks rather than grows. A rolling recession comes from the way contracting pressures create an economic downturn that moves through the economy affecting different areas at different times.

An example of this condition is found in the January 2023 jobs report, which exceeded expectations by revealing 517,000 new jobs. This was nearly triple the amount that forecasters had predicted. While the technology sector has announced significant layoffs, the services sector of the economy is still hiring strong enough to outweigh the announced layoffs. The rolling recession, therefore, is currently taking hold in the technology sector and it will likely move on to other areas of the economy in the coming months. Both technology and the housing market have experienced a sharp decline in the past 12 months, however, some sectors are holding up well. Recent signs from the holiday spending in 2022 suggest the consumer is weakening. In many ways a rolling recession is worse than a hard recession that forces the Fed to an easy money policy through lower interest rates and quantitative easing.

Consider this- Long periods of stagnant growth is not exactly an accelerant to corporate profits. It leads to collapsing margins until companies respond with expense management and higher productivity.

Looking Further into 2023

The Fed raised the target range for the fed funds rate by 25bps to 4.5%-4.75% in its February 2023 meeting. In January 2023, the market projected the expected terminal rate is peaking at 5.00% in June 2023 followed by two or three 25-basis point cuts all the way to 4.25% by year end. On March 1, 2023, the expected terminal rate is 5.5% peaking in September with rates still at 5% by year end. This is a big difference especially with the terminal rate nearing 6%. From my perspective, the Fed Funds Rate at 6% becomes a stalling mechanism for economic momentum. The number of rate hikes is of interest, but the most important data point to focus on is the terminal rate. A further move in the terminal rate brings a hard recession into focus.

As it relates to companies, revenue fluctuations, expense management and margin compression will also be in focus to determine which sectors of the economy are challenged at different points in time. This rolling recession dynamic will take time to run through the economy. Investors will need to be patient and look to different areas of the markets for return as we journey through 2023. Money Market accounts have become a solid defensive holding for portfolios. As the Fed raising rates plateaus, intermediate term corporate bonds and municipal bonds will become in favor for defensive holdings. The expectation for the stock market remains range bound between 3700 – 4400 on the SP500 with intermittent volatility remaining. A careful balance of risk and reward will need to be continually assessed considering the volatility in the bond market and the stock market.

At CIS, we will remain actively involved with the risk structure and investment holdings in portfolios. We expect that the “noise in the markets” to remain elevated until the Fed pauses on interest rates and the rolling recession works itself through the broad economy. It will be critical to remember that the recovery of the bond and stock markets will begin before the economy is strong again. Due to this, the negative sentiment of investors and consumers will not peak out until much later in the cycle. 2023 will take a willingness to be flexible in portfolios and patient with markets. This season in the markets will lead many investors to reassess the amount of risk they are willing to carry. Please know that we are here to guide you through, and we intend to be active in this market as the balance swings between risk and reward.

Thank you,

Bobby Lumpkin
President, CIS
Founder, *investingsimply*
Financial Advisor, RJFS