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Investment Insights Monthly

From The Desk of Bill Hornbarger, Chief Investment Officer

March 2023

Leading and Lagging Indicators and Recessions

One of the topics many investors are grappling with is the impact of the Federal Reserve's current monetary policy. The Fed is deploying all the tools in its arsenal (rhetoric, interest rates, quantitative tightening) to combat inflation, which has proved to be stickier than previously thought. The Fed's move towards a more restrictive stance has been underway for 12 months, and the economy is now starting to reflect the cumulative effect. In his semi-annual report to Congress on monetary policy and the economy, Fed Chairman Jerome Powell surprised the markets by indicating that larger rate hikes, a higher terminal rate, and "higher for longer" rates are all on the table as possible scenarios. Stocks reacted poorly, with several large negative days, and the regional banks in particular reflected stress, exacerbated by one regional bank's need to raise capital after selling a portion of its investment portfolio at a loss to meet tech-heavy/Silicon Valley depositor outflows.

Powell's hawkish comments are in keeping with multiple Fed speakers and reflective of the opacity of the trajectory of the economy. In his prepared comments, the Fed chair said, "The data from January on employment, consumer spending, manufacturing production, and inflation have partly reversed the softening trends that we had seen in the data just a month ago." The stronger January data came on the heels of a disappointing 2022 in which real gross domestic product rose at a below-trend pace of 0.9%. All of this against inflation that has been declining, although still well above the 2% longer run Fed objective.

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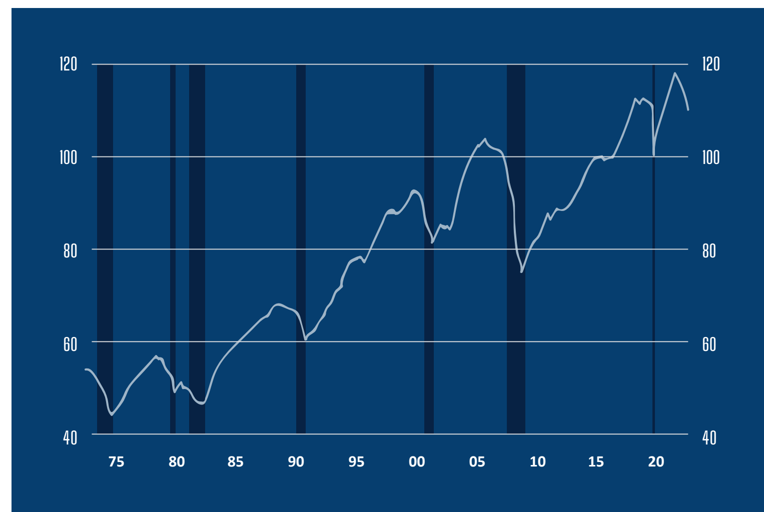
When viewing the economy, many investors tend to focus on employment, GDP, and inflation. And while GDP was disappointing for calendar year 2022, it was stronger in the second half of the year. That, coupled with an unemployment rate of 3.6% and CPI that is stubbornly persistent, has many investors believing that a soft landing is in the cards. Unemployment and inflation are lagging indicators, and GDP is a coincident indicator, and it is true that these (and other similar data series) paint a relatively positive picture. Leading indicators paint a different story.

In our opinion, three leading indicators are currently at levels consistent with a 2023 recession. These three are:

- **Leading economic indicators –** The index of 10 leading economic indicators has been negative for 10 consecutive months, and the diffusion index (the percent rising over six months centered) has been softening over the past year and currently stands at 0. This is consistent with observations from the seven recessions of the past 50 years.

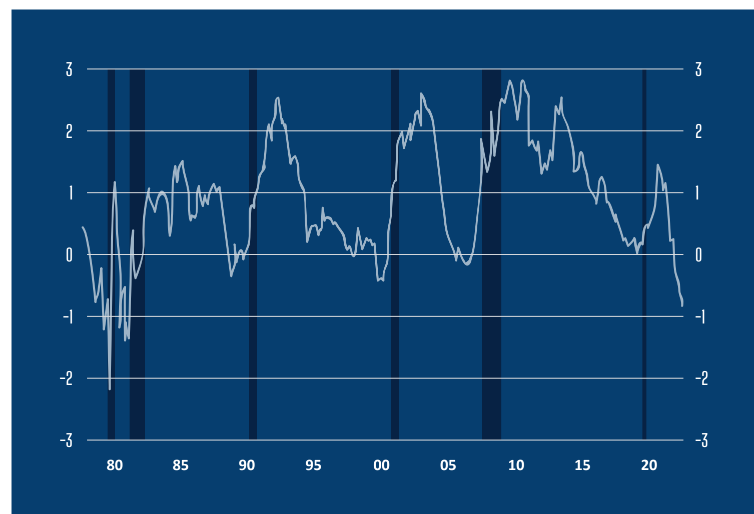
Composite Index of 10 Leading Indicators
2016=100



Source: The Conference Board/Haver Analytics

- **The yield curve –** The yield curve (between the 2-year and 10-year Treasury) inverted last June, and the inversion has deepened with that spread at a negative 92 basis points recently after reaching -108 bps, the steepest inversion in 40 years. The deepening inversion is a sign that investors are increasingly concerned about economic growth and is often – but not always – a leading indicator of recession.

10-Year Teasury less 2-Year Treasury (%)



Source: Haver Analytics

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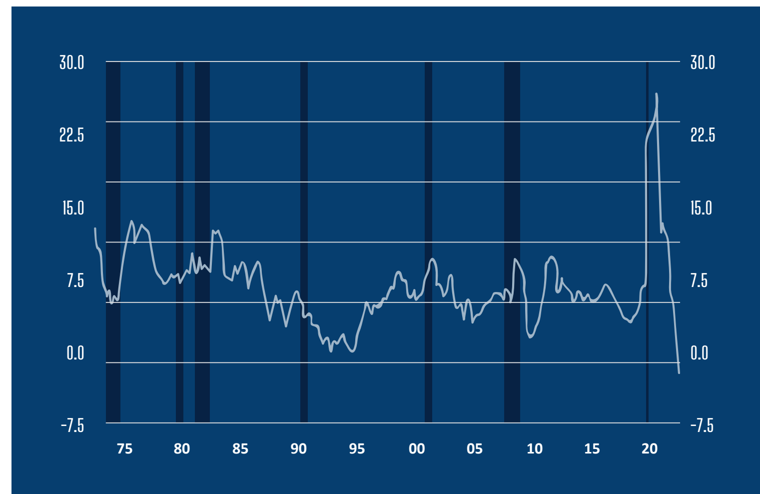
- **Money supply –** M2 has been negative in terms of year-over-year growth for the past two months, after the unprecedented gains of the last two years. Recessions tend to be preceded by periods where the money supply is declining, and there is a school of thought that declines in money supply actually cause recession (with a lag).

Money Stock: M2
% Change - Year to Year - SA, $



Source: Federal Reserve Board/Haver Analytics

From our vantage point, it appears that parts of the economy are already in recession including housing, manufacturing, and the tech industry. The current situation has been called, by some, a "rolling recession," and to date that is a fair description. Our concern is that continued Fed tightening – or some other surprise, such as a pronounced spike in energy prices – could result in a much harder landing. The Bloomberg consensus forecast of 42 economists puts the odds of recession at 60% this calendar year. It is important to note that recessions are dated after the fact, in some cases more than a year after the fact.

In terms of the markets, when viewed point-to-point from the beginning of the year to the end, we believe that stocks will post returns of +/- 5%-7%, with the risk that if the Fed is too restrictive, or the recent events surrounding a large regional bank spreads, it could be something worse. We do feel, however, that the near-term outlook has become more negative, and recent news and market activity suggests more volatility and increasing odds that we will revisit last year's lows and possibly break through them. A couple of reasons we believe this are the fact that the CBOE options volatility index (VIX) was recently at 26, and in our experience, bear markets end when the VIX is above 40. Our work also suggests that stocks usually see the lows after short rates peak, and with the Fed indicating more hikes to come, that doesn't appear to be the case.

Being resistant to panic and euphoria is a vital quality for successful long-term investing, and now is a time to be conscious of that. Shelby Cullom Davis (American businessman, investor, and philanthropist) once said, "You make most of your money in a bear market, you just don't realize it at the time." We strive to be balanced in our views and communications surrounding them, and we are conscious that in recent weeks they have become more negative. We would balance our comments surrounding the equity markets by pointing out that this is the best environment for a fixed income investor in more than a decade. Treasury bills and other shorter term instruments yield in excess of 5%, credit quality remains solid. And while it is certainly too early to signal all clear and by an extension a 'pivot', the Fed is closer to the end of this tightening cycle than the beginning, a view visible in both the futures markets as well as the Fed's dot plot. Stock markets tend to bottom during recessions, not after the all clear signal has been given.

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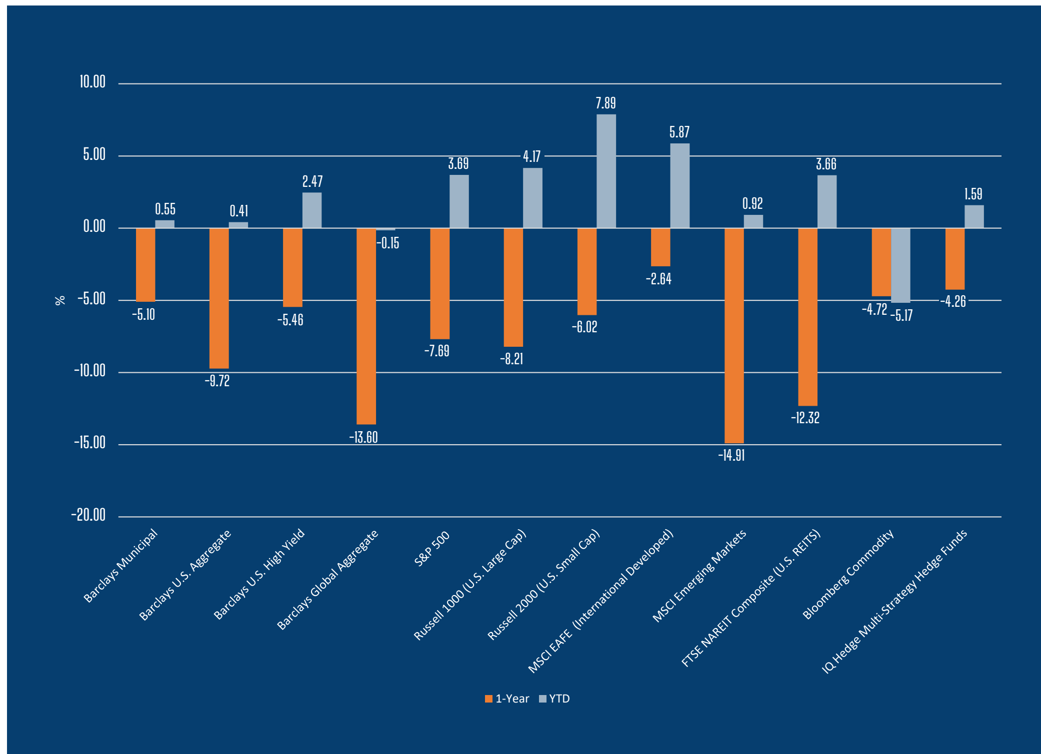
Asset Class Returns as of February 28, 2023

Comparing Recent 1-Year and Year-to-Date Total Returns



Source: Morningstar

Fixed Income

- After collapsing in January, yields moved higher in February on the back of hotter inflation data.
- Core fixed income and municipal bonds lost ground in February.
- Credit showed some resilience last month with modest losses in both investment grade and high yield and small gains in floating rate loans.
- Bonds outside the U.S. were hit hard by the combination of rising rates and a rebound in the U.S. dollar.

Equities

- U.S. equities fell across the board in February led by weakness in value.
- Across the market cap spectrum, growth beat value for the second consecutive month.
- Small caps provided relative outperformance compared to large caps.
- Non-U.S. equities exhibited weakness last month with significant losses in emerging markets.
- Unlike what occurred in the U.S., growth lagged value, and small caps trailed large caps.
- Emerging markets fell over 6% led by losses in Asia/China and Latin America.
- The strong U.S. dollar cost investors 271 bps in the EAFE Index (international developed) and 183 bps in the emerging market Index.

Real Assets

- REITS struggled through a difficult month with higher bond yields taking their toll.
- Despite lower oil prices, MLPs posted solid gains while the broader commodity index was lower.

February 28, 2023	MTD	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Fixed Income Indices							
Barclays U.S. Treasury Bill 1-3 Month	0.35%	0.69%	0.69%	2.21%	0.84%	1.32%	0.80%
Barclays Municipal	-2.26%	0.55%	0.55%	-5.10%	-1.60%	1.66%	2.11%
BBgBarc U.S. Govt/Credit Intermediate	-0.74%	0.05%	0.05%	-2.51%	-0.75%	1.00%	0.87%
Barclays U.S. Aggregate	-2.59%	0.41%	0.41%	-9.72%	-3.77%	0.53%	1.12%
Barclays U.S. High Yield	-1.29%	2.47%	2.47%	-5.46%	1.34%	2.87%	4.09%
S&P/LSTA Leveraged Loan	0.82%	3.51%	3.51%	2.87%	3.94%	3.75%	3.88%
Barclays Global Aggregate	-3.32%	-0.15%	-0.15%	-13.60%	-5.14%	-1.74%	-0.27%
JPM GBI EM Global Diversified	-3.16%	0.99%	0.99%	-6.11%	-4.29%	-2.96%	-1.97%
U.S. Equity Indices							
DJ Industrial Average	-3.94%	-1.13%	-1.13%	-1.59%	10.96%	7.77%	11.34%
S&P 500	-2.44%	3.69%	3.69%	-7.69%	12.15%	9.82%	12.25%
NASDAQ Composite (Price)	-1.11%	9.45%	9.45%	-16.70%	10.17%	9.51%	13.74%
Russell 1000	-2.38%	4.17%	4.17%	-8.21%	11.92%	9.68%	12.09%
Russell 1000 Growth	-1.19%	7.05%	7.05%	-13.34%	12.06%	11.54%	14.26%
Russell 1000 Value	-3.53%	1.47%	1.47%	-2.81%	10.96%	7.22%	9.60%
Russell Mid Cap	-2.43%	5.68%	5.68%	-4.99%	11.46%	8.40%	10.68%
Russell 2500	-2.35%	7.42%	7.42%	-5.42%	11.48%	7.67%	9.96%
Russell 2000	-1.69%	7.89%	7.89%	-6.02%	10.08%	6.01%	9.06%
Russell 2000 Growth	-1.08%	8.76%	8.76%	-7.92%	6.51%	5.06%	9.31%
Russell 2000 Value	-2.31%	7.02%	7.02%	-4.40%	12.87%	6.38%	8.46%
Non-U.S. Equity Indices							
MSCI World	-2.37%	4.57%	4.57%	-6.86%	10.43%	7.43%	9.36%
MSCI ACWI	-2.83%	4.16%	4.16%	-7.80%	9.31%	6.35%	8.48%
MSCI ACWI Ex-U.S.	-3.50%	4.35%	4.35%	-6.70%	5.75%	2.10%	4.42%
MSCI EAFE	-2.08%	5.87%	5.87%	-2.64%	7.34%	3.14%	5.32%
MSCI EAFE Growth	-2.79%	5.47%	5.47%	-6.84%	5.93%	3.91%	6.00%
MSCI EAFE Value	-1.39%	6.25%	6.25%	1.30%	8.12%	1.93%	4.38%
MSCI Europe	-0.61%	8.03%	8.03%	-0.44%	8.95%	4.24%	5.70%
MSCI Japan	-3.83%	2.14%	2.14%	-8.93%	3.80%	0.42%	5.46%
MSCI AC Asia	-5.76%	1.31%	1.31%	-12.26%	2.38%	-0.24%	4.53%
MSCI EAFE Small Cap	-2.15%	5.16%	5.16%	-9.25%	5.71%	1.08%	6.47%
MSCI ACWI Ex-U.S. Small Cap	-2.54%	4.49%	4.49%	-9.20%	7.48%	1.81%	5.61%
MSCI Emerging Markets	-6.48%	0.92%	0.92%	-14.91%	1.34%	-1.50%	1.89%
MSCI EM Asia	-6.86%	1.18%	1.18%	-14.94%	1.94%	-0.49%	3.92%
MSCI China	-10.37%	0.18%	0.18%	-16.00%	-6.09%	-5.35%	2.64%
MSCI EM Eastern Europe	-1.55%	6.50%	6.50%	-64.25%	-37.52%	-24.63%	-12.34%
MSCI EM Latin America	-6.19%	3.10%	3.10%	0.29%	2.75%	-1.81%	-1.60%
MSCI EM Small Cap	-2.84%	2.94%	2.94%	-8.95%	10.75%	1.78%	3.49%
MSCI Frontier Markets	-2.47%	1.92%	1.92%	-18.28%	-0.74%	-2.62%	3.04%
Hedge Fund Indices							
IQ Hedge Long/Short	-3.50%	0.58%	0.58%	-8.08%	3.30%	2.13%	--
IQ Hedge Multi-Strategy	-1.72%	1.59%	1.59%	-4.26%	0.49%	0.96%	2.30%
Real Assets Indices							
FTSE NAREIT Composite	-6.02%	3.66%	3.66%	-12.32%	2.80%	6.96%	6.60%
Alerian MLP	-1.19%	5.34%	5.34%	18.45%	19.33%	6.14%	1.22%
Bloomberg Commodity	-4.70%	-5.17%	-5.17%	-4.72%	15.51%	5.27%	-1.63%
S&P Global Infrastructure	-3.35%	1.51%	1.51%	-0.15%	5.13%	5.40%	6.37%
Other							
Oil Price Brent Crude	-0.71%	-2.35%	-2.35%	-16.93%	18.42%	4.98%	-2.87%
CBOE Market Volitility (VIX)	6.70%	-4.48%	-4.48%	-31.34%	-19.79%	0.84%	2.93%

Source: Morningstar

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