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The Brevity Series – Recession Odds

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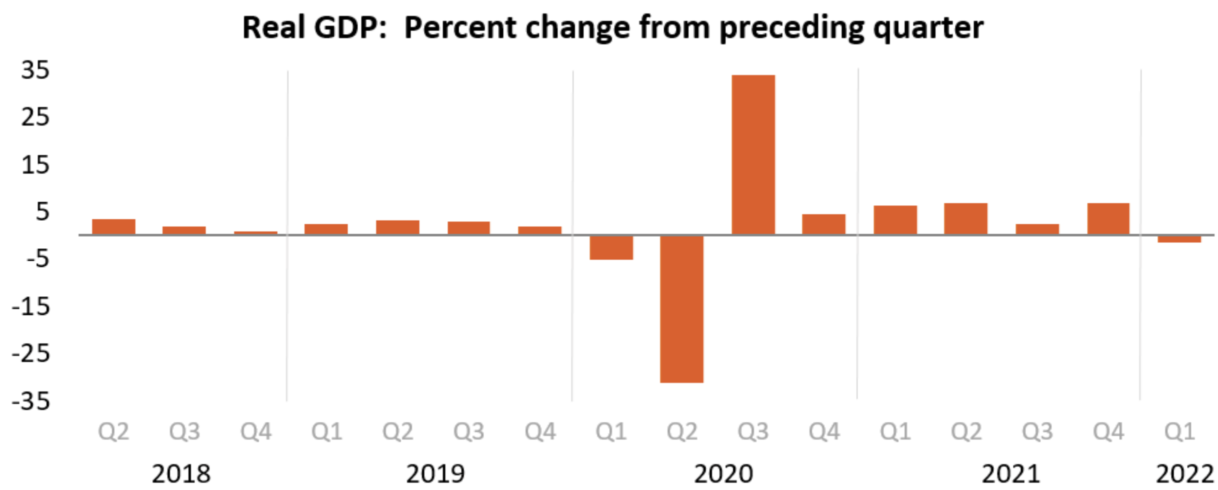
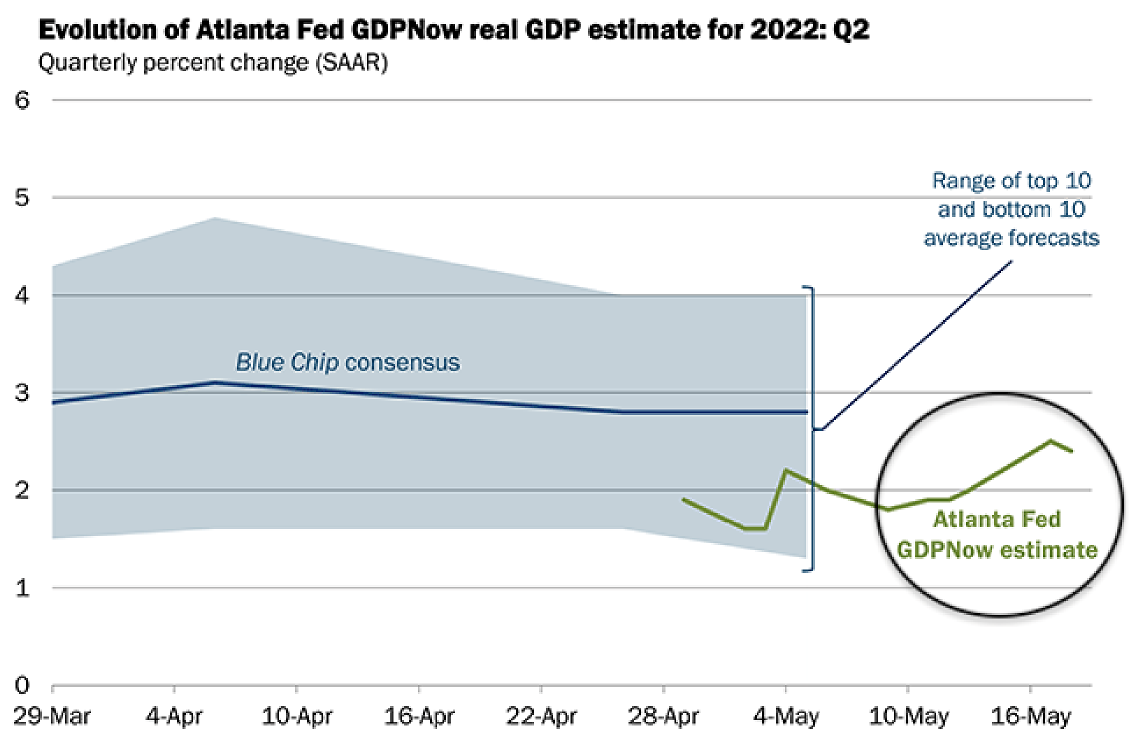
Our previous commentary compared bear markets and corrections. We observed that the official definitional differences between these 2 stock market incidents were somewhat arbitrary and simplistic. We would have preferred a definition that highlighted the different economic characteristics of bull markets and corrections. We then offered our own definition.

As we continue our quest to create our own dictionary, we will do the same for the word "recession". The rage these days in the financial media is to argue vehemently over whether or not there will be a recession. One commentator will put the odds of a recession at 80%, another argues back the odds are only 20%. It's must-watch T.V. Some might even call it bingewothy. The official definition of "recession" is 2 consecutive quarters of negative real GDP growth. We think a better definition of *recession* would be a "systematically contracting economy due to a deteriorating business cycle".

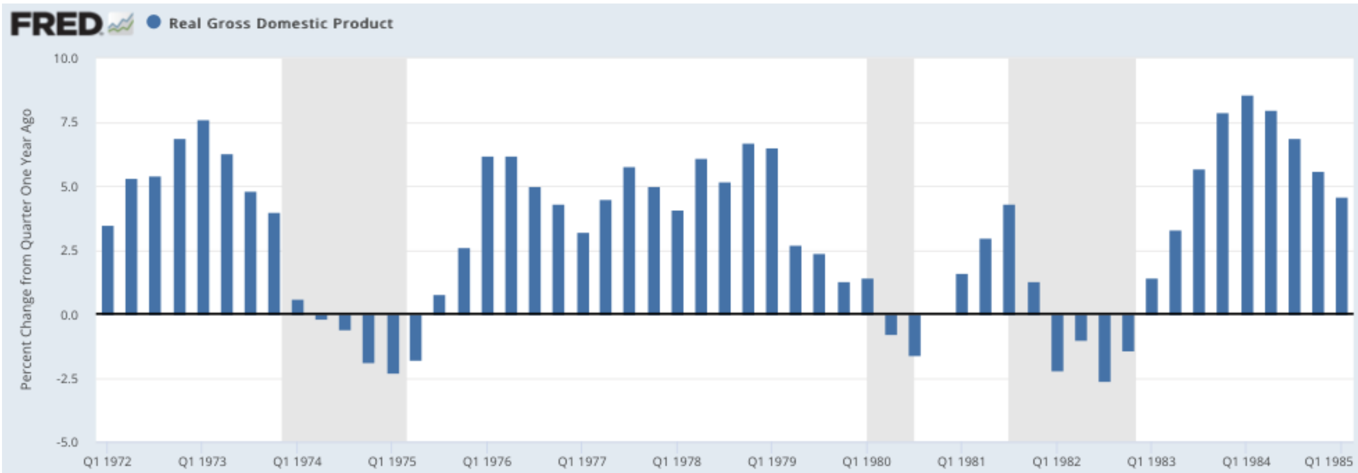
2022 Q1 GDP was -1.4%. If 2022 Q2 GDP is also negative, we will have had a recession. If Q2 GDP is positive, the clock resets and we are safe from an official recession for at least 6 more months (2 consecutive quarters). Our point is that it doesn't matter much whether we reach the technical definition of a recession. What does greatly matter is whether or not we are entering a sustained period of a systematically contracting economy. We don't see the current economic data supporting this scenario. Many investors disagree with us and are unloading their stocks.



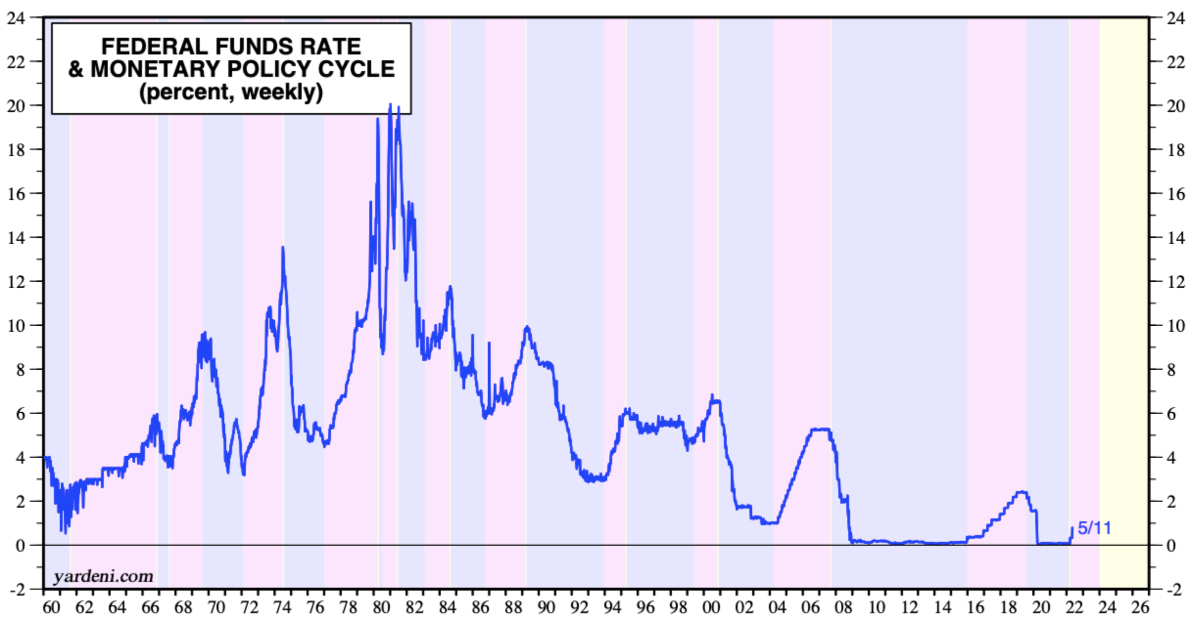
The Atlanta Fed's most recent GDPNow forecast is for GDP to increase by 2.4% in Q2, up from 1.8% two weeks ago. The GDPNow forecast is a running estimate of GDP growth based on available leading economic data. There are no subjective adjustments made to GDPNow—the estimate is based solely on the mathematical results of the Atlanta Fed's model. Based on this model, the forecast for Q2 GDP has been consistently increasing. Our own economic frameworks are producing similar results.



Historically, prolonged bear markets have been caused by a systematically contracting economy due to a deteriorating business cycle. During the bear markets of the 70s' and again in the early 80s', we experienced 5 consecutive quarters of material negative GDP growth.



Persistent inflation, in particular wage inflation and high energy costs, eroded corporate earnings during the 70s' bear markets and recessions. The early 80s' recession and bear market were intentional. Then Fed Chair Paul Volcker announced he needed to crash the economy in order to get inflation under control. He dramatically raised the Fed Funds Rate to 18% in order "break the back of inflation". (Blue shaded areas are easing monetary cycles and purple shaded areas are tightening.)



This type of Fed tightening scenario is what appears to be driving investor fears, at least on Wednesday (S&P -4%). On Tuesday investors weren't worried (S&P 500 +2%). It also appears that investors are viewing a potential recession in the same binary manner as the technical definition and media do, it's all or nothing. The economy will either crash or be fine. We see the far more likely scenario as mediocre economic growth while the Fed moderates inflation through tighter monetary policy. A modern-day version of stagflation. In this scenario, we view stocks as undervalued.

According to yesterday's post-mortem, what spooked markets on Wednesday were Target and Walmart making headlines over concerns about their future earnings. That seems a little contrived given their earnings and comments came out pre-market and markets didn't sell off until later in the day. Regardless, at the aggregate level, actual Q1 earnings for the S&P 500 continue to come in better than industry analyst expectations. Through the end of last week, S&P 500 earnings are up 11.7% YOY. Analysts also continue to raise their earnings estimates for Q2, Q3, and Q4.

Short-term market volatility continues to be exceptionally high (thank you Dr. Obvious). We are 4 1/2 months removed from market highs. We don't anticipate our definition of a recession will be realized, "a systematically contracting economy due to a deteriorating business cycle".

It's also not likely this volatility, higher or lower, will subside anytime soon. A clearer economic picture will need to develop in order for markets to settle down. As always, call, write, visit, fax, etc. We are always available.

The Mommaerts Mahaney Team

Jon C Mommaerts, CFP®: Jon is a Principal of Mommaerts Mahaney Financial Services, Inc. He has over 30 years of experience working with professionals and those about to retire. He is a member of the Financial Planning Association, as well as a member of the Preferred Financial Advisors.

J. Matthew Tuccini, CFP®: Matt has over 17 years of experience working in the financial services industry with vast experience in retirement planning, tax strategies, and financial planning.

Robert Kea, CFA: Bob has over 30 years of experience in portfolio management. He was a founding member and Co-Head on Putnam's Asset Allocation Group, which managed $12Bn in both retail and institutional assets.

Jason Rolling, Financial Advisor: Jason has been in the financial services industry for the past 15 years. His financial experience includes retail banking, consumer & commercial lending, bank management at the local, regional and SVP level, wealth management, and financial planning.

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Mommaerts Mahaney Financial Services, Inc. provides advisory services through ERTS Wealth Advisors, LLC, a registered investment advisor.
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