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The Risk Shift

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The markets have officially shifted gears from inflation to recession being Concern #1.

Only a week or two ago the consensus seemed to be that a soft landing was in the cards. We have been talking about a soft landing for a very long time and mused that the biggest concern was that everyone was on the same side of the boat recently, with similar opinions and positioning. When that happens, it does not take much of a wave to rock the boat. It seems that some well-timed waves have come early in the third quarter, in the form of weaker economic data. Stock prices have declined, resulting in a dash of fear taking over for greed with investors.

The Fed has rightly been vigilant in fighting inflation, keeping interest rates high after the inflationary uptick during the first quarter. The goal is a soft landing – slowing the economy enough to break inflation but not enough to cause a recession, historically a difficult task. The inflation measures have eased during the second quarter, and the economic growth measures are strong (2.8% Q2 GDP versus 1.4% Q1). The concern is that some recent, more forward-looking indicators are weaker than anticipated, and the employment situation has worsened. Economic surveys of manufacturing (PMI and ISM) have been hovering at levels in line with slower than average growth. On Friday 8/2 a softer than expected jobs report was released, a report the Fed probably wishes they had two days earlier at their July meeting when they decided to stand pat on policy. Payrolls were weaker than expected, the May and June statistics were revised lower, and the unemployment rate rose two tenths to 4.3%. While on the softer side, both the manufacturing surveys and the labor report are still well with the "soft landing" range of data, although they introduce recession to the chat as something that is on the table for discussion.

Up until this point, weak data was welcomed as a sign of modest economic slowdown and a taming of inflation. Now, suddenly weak data is taken as a warning of recession. Ten-year Treasury yields dropped from 4.2% to 3.8% on the week, a very substantial move, and market expectations are now for large 50 basis point (0.5%) rate cuts in both September and December. I even heard one analyst, who shall remain nameless, postulate that the Fed will need to have an emergency meeting to cut rates since the next is not until six weeks from now, which at this point is a ridiculous notion. That said, let's look at this from a couple of angles.

Have we learned nothing over the past fifteen years? Stimulating the economy is no problem for the Fed. A global pandemic that shut down the global economy for a year could not overwhelm the stimulus brought by central banks.

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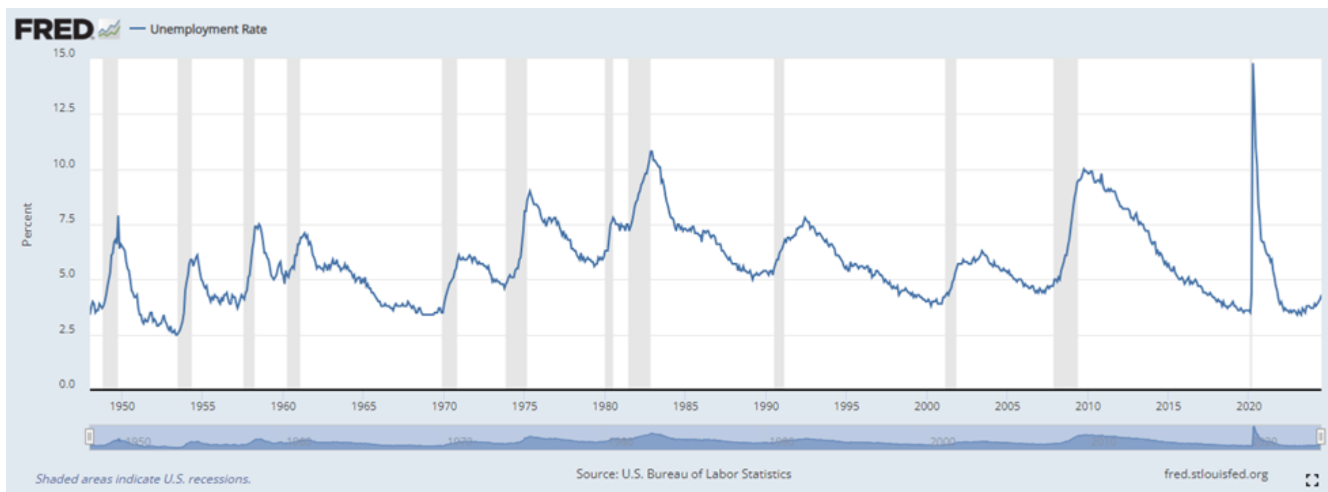
Between emergency action, open market purchases of securities, QE, and capital injections, the Fed sure knows how to buoy markets. All should be fine if inflation continues to subside because without that roadblock the Fed can push the gas pedal for the economy. That could be a big “if”, especially if something were to happen with supply chains again (geopolitical problems with China). Another fly in the ointment is that upward pressure on bond yields could occur if concerns about the debt and deficit ever come home to roost.

Recessions tend to sneak up on economies. While the level of unemployment is low by historical standards at 4.3%, this is not uncommon historically shortly before recessions have hit. You can see this from the long-term chart of the unemployment rate from the St. Louis FRED website that also shows recessionary periods in the grey regions. Sharp rises from low levels are a precursor for recession.



That said, we all need to keep perspective. Economic statistics are jumpy. The road to a soft landing, if there is one, could be volatile, with periods of recessionary concern and then other periods of worry about an inflation resurgence. That is exactly what has been happening this year. Inflation as Concern #1 in the first quarter, and recession taking the top spot now. We are certainly not giving up on a soft landing yet, but the market could be right to start to price in some potential for recession. At the very least, stock price corrections are normal and expected. They happen, on average, about once per year. There was a correction last year in October, in what was still a strong year. A correction now still leaves markets in positive positions for the year and could provide an opportunity for long-term investors. Whether this is a quick dip in prices, or the beginning of something more nefarious for the economy, nobody knows yet, but we continue to measure and monitor, ready to position portfolios in an effort to provide the best long-term investment experience possible for our clients.

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