

### Three Burning Questions Light the Recession Fuse

- The three burning questions are When, What and How?
- **When** will the Fed Stop tightening? The “when” serves as a buy signal for the market – though a potentially misguided one given the “long and variable lags” of policy tightening expected in 2023.
- **What** will be the terminal policy rate level? The “what” indicates a potential bottom and provides the discount rate for future cashflows.
- **How** long will the Fed hold at that level? The “how” informs us about duration risk and will help to balance a portfolio properly.
- All in all, the fuse has been lit and it remains to be seen whether the recession will be deep or mild, where the jobs market will be the key detriment.

**Jim Caron:** Last week we saw two very important events that I think is really the culmination of what we're going to be talking about for the next several months. Namely Fed policy and the jobs market. We got both of those data points last week and there are three burning questions right now that are lighting the fuse toward recession. The three questions are when, what and how. First, when will the Fed stop tightening? Second, what will be the terminal policy rate level. Third, how long will the Fed hold at that level. Let's go through these in order.

When will the Fed stop tightening. This is obviously a key question as the market thinks of this as a risk-on/ buy signal. Once the Fed says they're done tightening people believe that it's going to be okay to get back into the market. But, this may be misguided because when the Fed stops tightening, Powell's “long and variable lags” of policy tightening needs to be dealt with and that's going to be dealt with for all of 2023. The Fed is expected to end their tightening cycle in the first quarter of 2023 and at that point the Fed will look at labor market conditions - rising unemployment rate and wage inflation – and hopefully wage inflation will be falling at that point. That's what the Fed needs to see. They will look at the recession risk profile, whether a mild or deep recession, where base cases indicate a mild recession because the jobs market is going to remain stronger than ordinary. They will also look at global risk factors like the U.S. dollar, any global slowdown, global recession, geopolitical events and the like.

That gets us to the next question, which is what will be the terminal policy rate level? This is going to tell us where the proverbial bottom may be, because cash flows are going to be discounted at that interest rate. Now based on the Fed funds futures market, a terminal policy rate between 5 and 5.25% is suggested, which we think is okay in terms of a price for valuations currently. That would still suggest a mild recession scenario due to a tightening of financial conditions from asset prices. It would also indicate a rise in default risks and spreads widening relative to historical recession experiences. And it

would also suggest a modest decline in earnings and multiples. Let's look at a 15 P/E, the long term average, and the Morgan Stanley estimate for earnings of \$212. The math gets you to 3200 for the S&P 500. Now this is not a forecast. I'm just multiplying those two numbers together and I'm just giving an estimate of the kind of risk that you might see in a modest recession with a modest rise in credit default risks. Again this is hopefully what the terminal policy rate may be answering for us. The other point to make is that the yield curve is likely to stay inverted until the Fed ends its tightening cycle and the more the Fed hikes the higher the likelihood of a deeper recession. We have to keep that in mind as well. The fact that the Fed may end their policy tightening cycle between 5 and 5.25% is a pretty important piece of information. In this scenario we can estimate a trailing fair value for U.S. 10-year Treasury yields at about 75 basis points below the Fed funds rate. This is just based on history of the difference between the 10-year yield minus the Fed funds rate. One finds it rarely ever gets below negative 75 basis points, meaning that the Fed funds rate is higher than the 10-year yield by 75 basis points. At a 5.25% funds rate that would imply a 4.5% 10-year Treasury yield. If the Fed funds rate only gets to 5% you get to about a 4.25% for the 10-year yield. But one needs to put this in a confidence range around each point because again, these are just estimates.

Now to the third question, how long will the Fed hold at these levels, this is going to tell us how to balance a bond portfolio. In other words, try to manage the duration, try to identify what duration risks are viable or worth taking. The pause may be the new pivot and that needs to be incorporated into the analysis. What we learned from the Fed meeting is that reaching a policy rate sufficiently above neutral and keeping it there, this is what Powell said is the prescription to bring inflation lower, not just to keep hiking interest rates until inflation falls. That's a very important nuance, that getting to a level and holding it, that is the prescription to bring inflation lower, not just hiking rates.

That gives us a sense as to what level creates more stress in financial assets. I would argue that a level of policy rates above 5.5% is really where valuations become stressed and that's where you get a deeper recession scenario, you get a sharper downturn in earnings and higher default risks in wider credit spreads. We still believe a barbell approach is the best way to manage duration, meaning own some shorter duration assets to hedge against a further rise and policy rates and then also balance that by owning some longer duration assets to hedge against recession risk. Ultimately when we weight these two things together, we see that about a three-year duration is still the sweet spot in this barbell approach, along with exposure to higher quality assets. We explained this through what we discussed over the past couple of months and what we call our R.I.P. Cycle framework which is recession, inflation and policy risks. We also have to incorporate the fact of a cost benefit or risk management as the Fed puts it to all of this policy. The way the Fed looks at it is that the cost of hiking too much is that the unemployment rate may rise too much. The benefit of holding rates sufficiently above neutral for extended period of time is that it may do less damage to the labor market. Again, the cost of policy is measured in terms of the unemployment rate.

Okay, so we got through those three burning questions. Now we talk about lighting a fuse toward recession, where many people expect there to be a recession at some point in 2023. It's just a question of how deep it will be or mild or even if at all. But what we can see is that global PMIs continue to fall as do industrial production and confidence data. In the U.S. I would say that if we look at the October ISM

Manufacturing PMI it fell to 50.2 from 50.9 and that's the lowest level since May of 2020. At that point clearly it was much more extreme times as that level got to 43.5. But the fact that you start to get close to that 50 threshold or below 50, well, that's where problems start. The Fed's press release characterized the manufacturing environment is continuing to expand, but at the slowest pace since the recovery began. We're in contraction once again and this was in part due to the persistent dollar strength.

With the strength of the dollar, let's talk about Europe and let's take Germany for example. What we're seeing there is that the rapid pace of inflation is crushing confidence of both businesses and consumers in Germany and it's also squeezing real purchasing power. What we also have to note is that Europe is structurally more rigid than the U.S. and it needs to get inflation under control even more so than the U.S. has. In other words the U.S. can increase wages because the U.S. can lay off workers more easily and they can bring down wage costs that way more easily. That's not necessarily true across Europe. So high inflation really cuts into real purchasing power in Europe more so even than in the U.S. So next year we could see the German economy contract, go into a recession and might even contract by 2-3%. This would turn the former engine of growth of the eurozone into a drag for the region. That's something for us to consider and think about in terms of some of the global risks that are out there.

But now focus on the U.S. jobs market. The number did come in at 261,000 jobs for October, non-farm payroll release which was above consensus. But we do have to look under the surface because that's where the data becomes more meaningful. The unemployment rate actually rose to 3.7% from 3.5% and the labor force participation rate fell to 62.2% from 62.3. It's moving in the wrong direction. We want more people to come into the labor market not leave the labor market. So this is not viewed as something very positive. A lot of it was due to the fact that there was a 22,000 decline in the labor force in October after falling 57,000 in September. And if we look at the household survey, which is a more direct survey of individuals that fell 328,000 in the month of October on a month over month basis. For October with the number of unemployed up 306,000. Now wage growth did come in at 0.4% month over month in October, which led to a year over year deceleration in wages to 4.7% from 5%. But this is certainly move in the right direction for the Fed. But the pace of decline is not enough, wage growth still remains well above levels. That would be consistent with the Fed's 2% inflation target. So the Fed still has more work to do. At least that's the way I think that they would read this number and his wages fall and layoffs mount and we're seeing this data and headlines, especially from the tech sector these days, it's going to be more difficult for corporations to pass through higher costs, which will inevitably shrink margins and also hurt earnings.

But by how much is the key question, and is this already in the price or do more nefarious surprises lie ahead? Effectively we see a lit fuse toward recession and the question is really how deep or is it just mild? The jobs market is a key determinant of this and the Fed may likely only, and I put only in air quotes, hike 50 basis points at the December meeting. 50 basis points is still a pretty sizable rate hike, but they may only hike 50 basis points at the December meeting, but we can't rule out a 75 basis point hike either. So the question is, how high does the policy rate effectively get right? Again, we're thinking 5 to 5.25% and that's essentially what the markets are pricing. Then, how long will the Fed hold those levels? That creates a litany of other risks and the jobs market is going to be quite telling.

All of these are factors that we're going to start to incorporate into thinking about what type of a slowdown we have in 2023. Putting this all together, we think that the three year duration point in a balanced fixed income portfolio is right. It's a question of how do you get there? And again, we like that barbell strategy, so we think that's appropriate for the current risk environment that we're in today.

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