Caron's Corner Transcript – 7.10.2023

In Through the Out Door: Does the Market Have it Backwards?

- Never a dull moment in these markets, in the sense that consensus expectations for a recession this year **has now moved out to next year**.
- As I've previously addressed, the hardest part in determining what may happen next has more to do with asking the right questions.
- In my mind, the market has been fixated on the wrong question in the first half of 2023, namely **WHEN** a recession may occur.
- The better question to ask was **HOW DEEP** would a recession be if we had one.
- In fact, the market believed that if we had a recession it would likely be mild or soft, essentially any scenario other than a hard landing. This informed investment decisions.
- So, is the market still asking the wrong questions today? We think it might be.

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. Well the market never ceases to amaze and the question as always is, does it have it backwards? As I mentioned in a recent audiocast, the hardest part of figuring out what may happen in the future has more to do with identifying the right questions to ask. Finding the answers is the easy part, but you need to be asking the right questions. I highlighted that the market was fixated on the wrong question in the first half of 2023 which was "when will the recession happen?" The better question to ask was actually "how deep a recession may be if we had one?" So, is the market still asking the wrong question today? We think it might be, so let's get into it.

We're going to start by looking at manufacturing data because this is really the important topic. In almost every single research report you read these days, you can't find one without a manufacturing PMI chart with readings below 50 prominently featured. And that actually makes sense. Manufacturing data is cyclical and weak readings below 50 have had a strong coincident relationship with a recession. Many research reports will show that asset valuations and price changes have a close relationship with a manufacturing PMI soundly below 50 today. It shows that it's not only a matter of time before we have asset prices fall. This has many analysts asking the same question of <u>when</u> a recession may occur and asset prices fall sharply. But could it be that the wrong question is being asked once again?

This time, yes, the wrong question is being asked about manufacturing PMI data. In fact, the GBaR team thought it would be very important to reframe the manufacturing question. Given the substantial and sharp weakness in the manufacturing PMI data, the question really is "then why aren't we already seeing a recession right now?" The data has been substantially below 50 for an extended period of time, really calling for a hard landing. But, calls for a hard landing today are actually receding. This is the conflict and the reason why we want to ask the question differently. Maybe this there is a better question to ask and answering it provides different insights.

Perhaps the COVID-19 shock, supply chain disruptions and massive monetary response created what we call a “rolling recession.” Sectors of the market were slowing, but at different times instead of all correlating and happening at once. I was exploring this topic with the GBaR team head of research, Ewa Turek, and she said something that was insightful - and quite frankly out of the box – that was “maybe the PMI manufacturing data is part of the rolling recession and is actually bottoming right now.” Maybe manufacturing is going to rise to meet the service sector data and people are just thinking about it the wrong way around. So I invited Ewa to join this audiocast so you can hear it from the source. Ewa, what made you think about it this way?

Ewa Turek: Hi Jim. The first point is that manufacturing PMIs in developed markets are already very depressed, so for manufacturing activity to fall more we'd need to see a deep and broad global recession. Historically PMIs have only fallen to lower levels than today’s when there are large, synchronized shocks such as the subprime crisis or the pandemic hitting the global economy at the same time. As you know, we don't expect that kind of outcome, but remain in the soft-landing camp. Secondly, the details of the PMI indicate that businesses are already demonstrating substantial caution and prudence. In other words, recessionary behavior. New orders are being pushed out into 2024 and inventories are contracting. In fact, the latest manufacturing PMI showed inventories contracting at a faster rate vis-a-vis the May print (data). These adjustments actually accommodate future demand. And finally, what's becoming apparent is that we're not in the midst of a traditional recession as you touched on. Instead, the recession is rolling through the economy one sector at a time. The durable goods sector looks like it was in recession last year, in 2022. Goods demand actually dipped negative, though it was down 0.6% year-on-year in November. That compares to historical median growth of 5.5%, so you can see there's a substantial difference.

In a soft-landing scenario, where we don't see a spike in unemployment, durable goods demand is likely to improve rather than decline. Another data point that corroborates this view is the increased activity we're seeing in the U.S. housing sector. High mortgage rates coupled with elevated inflation likely resulted in a deferral of home purchases. But you can't delay household formation indefinitely. So as people start buying houses again, demand for goods to construct those houses (capital goods) and furnish those houses (durable goods) is likely to pick up.

Jim Caron: Thanks Ewa. I think that's super interesting. In summary, what you're saying is that manufacturing could be the macro data point that supports the market and manufacturing activity is moving higher to meet services rather than vice versa. I think that's a different way to think about things. It certainly does present some risk to the markets if people aren't thinking about it that way. It could be a big surprise and certainly something we want to watch.

Again, the question is, does the market have it backwards? I do think it's an interesting way to think about it because it would certainly constitute a big positive surprise if this scenario plays out. Thanks Ewa for reframing the question and giving us something to think about and monitor. Look the markets keep surprising us. This is the lesson learned in 2023. As we like to keep saying, it’s better to be balanced and defensive, as there are fat tails on either side of the risk distribution. It's better to be well-positioned for both sides rather than just picking one.

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