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WHAT RECESSION?

A gentleman was heard muttering to himself as he carefully examined his visage in the mirror before him, “the only recession I see is my receding hairline.” We’ve all been aware of the chorus forecasting the looming risk of recession for a couple of years now. But as we have just witnessed, the GDP numbers for 2Q have not yet provided any confirmation of a recession for the “glass is half empty” crowd. Growth in the last quarter came in above expectations at 2.4%. Don’t get too giddy, our economic gurus still warn against dismissing the possibility of a recession. However, we note that Fed Chair Powell, last week, after increasing the fed funds rate by 0.25% (new range 5.25%--5.50%) stated that he may not need to raise the rates again in September, saying that it will be “data dependent.” He also stated that his staff is no longer forecasting a recession. They will still maintain the objective of reducing the level of inflation to the 2% area.

We should note that the annual Economic Policy Symposium will be held in Jackson Hole’s Grand Teton National Park, August 24th-26th. Markets will be focused on any comments made by Fed Chair Powell, who is scheduled to speak at the conference; the theme will be “structural shifts in the global economy.” Oftentimes in the past, comments made by the Fed Chairman were market moving.

David Lefkowitz, UBS' CIO, Head of U.S. Equities, issued a blog on 7/28/23, "S&P 500 EPS: A Better Tone." David states that he is feeling more comfortable with a relatively favorable forecast for this year and next. He notes that the 3Q S&P 500 EPS consensus is "holding up better than normal." Also, the bottom up forward 12-month estimate has been "ticking up." And the percentage of companies beating consensus earnings and sales estimates has been rising (now close to 80%). Further, companies are beating the estimates by "4.5% in aggregate." While profits are expected to be down year-over-year, David believes that 2Q will likely prove to be the bottom in earnings growth this year.

This is positive news for the market, but how much of this is already priced in? We all remember that Wall Street, at year-end 2022, was generally looking for a recession and a difficult environment for equities. But the market bolted out of the gates in January and never looked back. It was telling investors that Street forecasts were wrong. For the first half of 2023 the S&P 500 was ahead 16.89%, powered in no small way by the sharp swing in a group of tech companies (i.e., Alphabet, Google, Apple, Meta Platforms (formerly Facebook), Microsoft, Nvidia, Tesla). Their performance greatly influenced the rally for the S&P 500 in the first half of this year. That's due to the fact that the S&P 500 index is cap-weighted, not equal weight. The equal weighted performance was significantly lower. As we write the two have become much closer.

The seven growth companies that captivated investors' imaginations and their investment capital benefited from the growing buzz on the street that AI (Artificial Intelligence) would become the centerpiece of a new technology era which will create a sea change in the way businesses operate, people communicate, and transportation modes evolve. The gathering enthusiasm has become Jules Verne like in terms of the fantastic expectations of wonderous new applications.

It is expected to be as potentially world altering as were the inventions of the light bulb and the telephone back in the latter part of the 1800's. There have already been aspects of this shown in the way you can design and build products right on your computer.

There are many questions at present about whether AI related companies are selling at ridiculously high valuations relative to their realistic potential. On a recent conference call, our good friends at Edgewood Management, LLC, spoke to the valuations of many AI related companies and said although the valuations are high, they're not anything like Tech stock valuations at the turn of the century (2000-2001) when many companies sold at multiples of sales, not earnings— JDS Uniphase is a name that immediately comes to mind, a true victim of the dot com crash back in 2000.

The AI concepts are far reaching, and likely to be a completely transformative industry. Don't know if you're ready for autonomous vehicles but they are surely going to be a factor in transportation of the future. Many clients and friends that we have spoken with say they're not really comfortable with the concept of driverless vehicles. One disappointment, we suppose, could be that we no longer have those cabs down in NYC with a gruff foreign speaking individual at the helm playing music from some exotic land for added ambiance.

	2Q 2023 (%)	YTD 2023 (%)
Dow Jones Industrials	3.97	4.97
Standard & Poor's 500	8.74	16.89
NASDAQ Composite	13.05	32.32
Russell 2000	5.21	8.09
Russell MidCap	4.76	9.01
Russell 1000 Growth	12.81	29.02
Russell 1000 Value	4.07	5.12
Barclays Capital Govt./Corp. Bond	-0.93	2.21
Barclays Capital 5 Year Municipal Bond	-0.72	1.19

Source: Morningstar

In deference to our friends and clients, who are attempting to enjoy the rest of their summer, we will not dwell on the obvious above. We do note that growth, after being thoroughly pounded last year, thanks to the Fed's 500 basis point rise in rates and the greater than anticipated spike in inflation, has had a rather nice recovery in both the NASDAQ and Russell 1000 Growth indices (only for you Latin scholars). Inflation levels have pulled back to around 3% (CPI) and the Fed has let it be known that they may be done raising rates, if not now, possibly by year-end.

We also note that the value side of things has definitely been lagging, against the possibility of a recession and slower growth globally. China is still not showing much of a turn yet, although recent headlines suggest some nascent signs of a modest increase in economic activity. We will comment on the global outlook in our economic comments that follow.

Bondholders were not particularly happy with the Fed's sharp spike in rates last year. We outlined that in our letter dated February 10th of this year. The chart on page 2 showed that, in addition to equity markets enduring negative returns, bonds also suffered on the year. The chart provided showed that the BBG aggregates declined by 13%, the BBG Muni Index declined by 8.5% and the BBG 5-Year Muni Index fell 5.3%. You'll note that this year those same indexes are a positive 2.21% and 1.19% respectively.

As we have mentioned to many of you this year, bonds are very attractive at present. The ingredients of a more benign Fed, along with gradually declining inflation, creates an environment favorable to returns for fixed income securities.

For example, we have advised and continue to advise you to consider adding to your municipal holdings. There are decent current yields available of 4.25-4.5% tax free federally, which for those of you in the highest tax brackets, is a taxable equivalent return of about 8%. It would be hard to find any taxable AA/AAA bond yields that high.

There are risks, we grant, should the Fed decide to increase rates further. That would only happen if they believed inflation was going to come roaring back. But remember, much of this last bout of inflation had a lot to do with COVID closures, short supplies and an incredible injection of liquidity into the economy by the Fed in an effort to counter the negative effects of Covid. It would seem reasonable to expect that we will not be revisiting those issues anytime soon (we hope!).

We also continue to look at alternatives that can offer lower correlation to equity markets and attractive returns.

Some of you, your team included, have been invested in the Nineteen 77 Global Merger Arbitrage fund managed by Blake Hiltabrand, who we consider to be a very capable lad. His returns over the COVID years where things were frozen for the better part of 2020 were negatively impacted—clearly not his fault. And the sharp rate spike in 2022 also impacted the M&A universe. Try getting financing managed in a hostile rate environment, not to mention the regulatory environment, where for a time the Federal Trade Commission under Lina Khan's leadership was very hawkishly against several proposed mergers. But after losing a couple of notable cases in court, she seems to be more balanced in her approach. We'll see where the proposed Microsoft acquisition of Activision goes. UK regulators have granted it an okay. And observers believe it will ultimately be approved in the US. Should that occur, Blake believes that the environment for M&A activity will improve. The spreads available on proposed deals now are the widest that Blake has seen. The job of regulating these businesses is not just to "knee-jerk" reject all deals that come before them, but to evaluate carefully what the merger or acquisition can mean for consumers, communities and employees. We are staying with our commitments in the M&A space. We haven't forgotten that in the years prior to COVID and hawkish regulation, Blake had generated returns for clients of about 8% annually with low correlation to equity markets. We note again that the spreads are higher than they've been in many years. It's not out of the question that returns for some years could exceed the historical 8% area.

FROM MODEST TO MODERATE BUT STILL "DATA DEPENDENT"

The world economy continued its controlled slowing during the last quarter.

It looks like growth will be in the low 2% range, vs the 6.5% experienced in 2021 as the world emerged from COVID. Interest rate hikes by central banks throughout most of the world (with the notable exception of Japan) have put a damper on growth but have not forced any major economy into crisis mode. Accordingly, our economics team continues to expect sub 3% real GDP growth globally in both 2023 and 2024. Not great, but certainly still growing.

In the US, things also continue to slow but not as quickly as expected. On an annual basis, our economics team expects the US economy to grow by 1.8% in 2023 but struggle to grow in 2024. That is not much change since we last wrote. What has changed is most economists are pushing out the time when they believe a recession could happen, our economists included. Since our team was always in the mild recession camp, their thoughts of which quarters grow and which don't, can be a little academic. What hasn't changed is their thought that by Q2 2024 real US GDP will be expanding toward a 2% rate and continue that growth throughout the remainder of the year. Between now and then they expect growth will slow from its current 2.4% pace and may turn negative late this year or early next.

The Fed's recent pronouncements reflect the fact inflation is slowing, the economy has had better staying power than expected, labor markets are still tight but losing some momentum and the banking system is strong given recent stress testing and the handling of some mis-managed banks earlier this year. All good news.

Looking at other data, housing seems to have bottomed earlier this year and has shown strength recently, the consumer continues to spend and has a balance sheet that will continue to allow that to happen, and the services sector continues to show growth.

Given that the Fed has just raised rates by 0.25%, to a range of 5.25-5.50%, the key question among investors is "Will the next interest rate change by the Fed be a cut or a hike?" Chair Powell isn't showing his cards saying either remains a possibility "depending on the data". Which could mean that, the Fed will see two more CPI prints and an ECI (Employment Cost Index) report before the next rate decision which is currently scheduled for September.

Although all indicators are currently moving in the right direction for the Fed to be less aggressive, the volatility within each economic series shows why the Fed is taking a cautious stance with its words. Probably the most positive data series is inflation. CPI has dropped from the 9% level to the 3% level recently. "Core CPI" has made less progress, but the progress it has made recently (getting to the mid 4% area) is impressive. The Fed's conundrum is core CPI has provided two separate "head fakes" over the last two years. In the July – September 2021 period it fell significantly only to reverse and increase significantly over the next year. It happened again in the October – December 2022 period when after a significant slowing, the following five readings reaccelerated to much higher levels.

So here we are again. We just witnessed another, our first month of a material slowing in core CPI. The Fed probably wants to see a few more data points before they declare victory. Not unreasonable. Our economics team believes the Fed is through hiking rates for this cycle. The pace of rate cuts (should they happen) will be the next focus of the Fed and investors. We know the Fed is laser focused on getting inflation to their 2% target. We'll be watching the data closely as September approaches (next Fed meeting scheduled for the 19th and 20th of September).

A quick look around the rest of the world shows that Chinese GDP growth slowed sequentially after a quick pop in Q12023 (as they left lockdown mode), Europe is struggling to keep growth positive, and Japan continues to follow its generally accommodative economic policies in the face of slowing global demand, although the most recent statements from the BOJ suggest a willingness to allow the ten-year to trade up toward 1%.

To us, the Chinese "below expectation" growth of 6.3% in Q2 2023 was not unexpected. Emerging from lock down mode will be volatile. It was in the US, and it will be in China. We believe the Chinese economy will grow in the mid 6% range in 2023 and settle toward the high 5% to low 6% range in 2024. Our economics team expects the Chinese government to selectively support elements of their economy rather than provide the "across the board support," reminiscent of years past. The Chinese are not through trying to figure out how to balance entrepreneurism with communism, their property issues, or the leverage in regional government entities. Given that backdrop, it is reasonable to expect government support in those areas of the economy.

Europe continues to do an admirable job of avoiding recession as the Ukrainian conflict grinds on and China works to reaccelerate its economy. We have always thought the winter of 2023 will be the next "critical" test for Europe as heating season unfolds. We can write more about that in future letters if necessary.

And finally, Japan continues to go its own way with supportive monetary policy and decent growth (for them!)

All in all, things haven't changed materially since we last wrote. Inflation, rates, banking stability and removal of the debt ceiling all represent positives. The potential for recession primarily driven by poor "hard" economic data remains the area of concern. The Fed has threaded the needle successfully post COVID. The next few months will help investors understand if they can keep the streak alive.

STRATEGY GROUP SEES "A BETTER TONE"

That sentiment is expressed in the most recent blog from the UBS Chief Investment Office (7/28/23).

While you can always get a couple of "jokers" in a forecasting deck, it appears to our strategy team that we're in pretty good shape. "The busiest week of the 2Q earnings season is now in the books." Consumer spending is remaining mostly resilient (including travel, restaurants, and new home construction). Even previously slower groups are enjoying improvement in revenues such as PCs, digital advertising, cloud, and life sciences (Tools). And "many companies are talking about opportunities in AI."

David Lefkowitz says that forward guidance has continued to improve over the past month or so. He points out that normally, about this time of year, companies often start to lower expectations and proceed to beat those earlier numbers during reporting season. Not so this time around. Also, David notes that the 12-month forward numbers are moving up and the percentage of companies beating estimates is also improving.

More than half of the market cap of S&P 500 companies have now reported. Notably about 80% of those companies are besting estimates by 4.5% and profits are expected to be down about 3-5%, which is better than 5% decline that was expected back in May. We have likely seen the worst in year-over-year earnings growth and pressure on margins “seems to be easing.” It is expected that earnings improvement going forward should become even more supportive of equities.

The forward P/E is now 19.5 x earnings which is not “cheap” but at the high end of reasonable. Some very visible earnings are coming out in the next few days. Amazon is one of them who’ll report after the close on 8/3/23. The Street looks for $131.5 billion (revs) which would be up 8.5% over last year. Note: at press time Amazon reported numbers that blew away estimates. Revenues were $134.5 billion versus a $131.5 estimate. Earnings came in at a 65 cents per share vs the 35 cents per share estimate.

David’s S&P 500 estimate is $215, a decline of 2.5% in 2023, and growth of 9.5% in 2024 to $235. Further his S&P 500 target is 4400 for June of 2024, which would be down slightly from the 4500 currently. That implies a multiple of around 19 x earnings.

As we have said many times, we don’t get too wed to target prices. They’re simply a mathematical approximation of a fair value looking out over the year ahead. We always prefer to look at ranges. David mentioned the highest consensus estimate out there presently is $245 for 2024 (vs. his estimate of $235).

If inflation continues to moderate in the year ahead, and the Fed does, as they’ve suggested, start to cut rates, then multiples will receive more ability to stabilize around current levels. The S&P is trading around 4500 now. Cash yields are today around 5% Treasuries 2 years and 1 year out yield 4.89% and 5.38% today. The average between the two is around a 5.13% yield. If you take David’s estimate of $235 for 2024 and divide by the current price of 4500, you get a yield of 5.22%. That’s called an earnings yield. Remember the place where Fed did the most “damage” was all on the short end (fed funds, etc.). Financial assets (like equity markets) always have to compete with interest rate markets. Granted, it’s not that simple, we understand. There are other risks that can determine equity valuation levels. But competing interest rates will always be one of the primary factors.

So, if the S&P 500 is earning $235 for next year, and the market is selling at 4500, it is a 5.2% earnings yield. With short term rates also around 5.2%, the pressure on equity prices can be mitigated by having an earnings yield of comparable magnitude. Should the Fed cut rates, it would put more of a floor under equities.

There are many other factors in this kind of analysis that have very complex formulas. What we are really saying is financials asset valuation levels and yields are related and one can benefit by understanding these relationships.

We look at current levels as the higher end of a range of 4100-4700. Multiples are a challenge at these levels, hence we'd prefer to keep this range in mind and look to add to equity positions near the lower end. And one should re-deploy cash to take advantage of the current yields, which are likely to decline over the year ahead, benefiting fixed income securities.

One suggestion to all of you is to get out your favorite book, marinate some ice cubes, perhaps in a Cape Codder (or your favorite tea) and enjoy the beach, over the remaining days of summer, for they too are receding. The salt marshes are beginning to turn golden; the terns are aggressively hunting fish. And this team hopes to join you dear friends and clients, in enjoying the waning days of summer.

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