Are We Getting a Recession or Not? – Market Commentary

August was negative for stock markets. The MSCI World Index was down -2.4% and the S&P 500 was down -1.6%. Considering the large weight of the US in the MSCI Index (close to 70%), other developed global markets performed poorly. In particular Scandinavian markets were poor, down close to -9.0%, the UK was down -7.1% and Japan was down -4.6% all in USD.

Value and Growth were in line for the month, though for the year-to-date Growth has returned +28.1% vs +5.0% for Value. This is largely due to the Nasdaq performance of +42.5%.

Emerging Markets underperformed at -6.2%. South Africa severely underperformed at -10.6% due to ZAR depreciation (the ZAR return was -4.8%). For the year-to-date South Africa is underperforming Emerging Markets by -10.4%.

These various results are summarised in Table 1 below.

Table 1. South African and global equity returns (USD) for August 2023*

	Aug-23	YTD 2023
FTSE/JSE ALSI (ZAR)	-4.8%	4.9%
FTSE/JSE ALSI (USD)	-10.6%	-5.8%
MSCI World	-2.4%	16.1%
MSCI EM	-6.2%	4.6%
MSCI Value	-2.8%	5.0%
MSCI Growth	-2.0%	28.1%
S&P 500	-1.6%	18.3%
Nasdaq 100	-1.5%	42.5%

*Total return indices, Source: Factset

The US economy has continued to perform well in recent months despite the sharp increase in short term and long term interest rates. This has prompted various commentaries explaining why this might be and why interest rates have not hurt the US economy as expected. One of several reasons provided is lower interest rates on corporate debt have been locked in and have not yet reset to the new regime. The prevailing view in ongoing debates appears to be no landing at all with an alternative for a soft landing.

Though we do not incorporate macro views in our investment process we nevertheless monitor developments and at times have firm views. Currently our view is that the laws of economics have not changed and the issue is not one of if but when. We do not subscribe looking for reasons why the economy has not responded as expected.

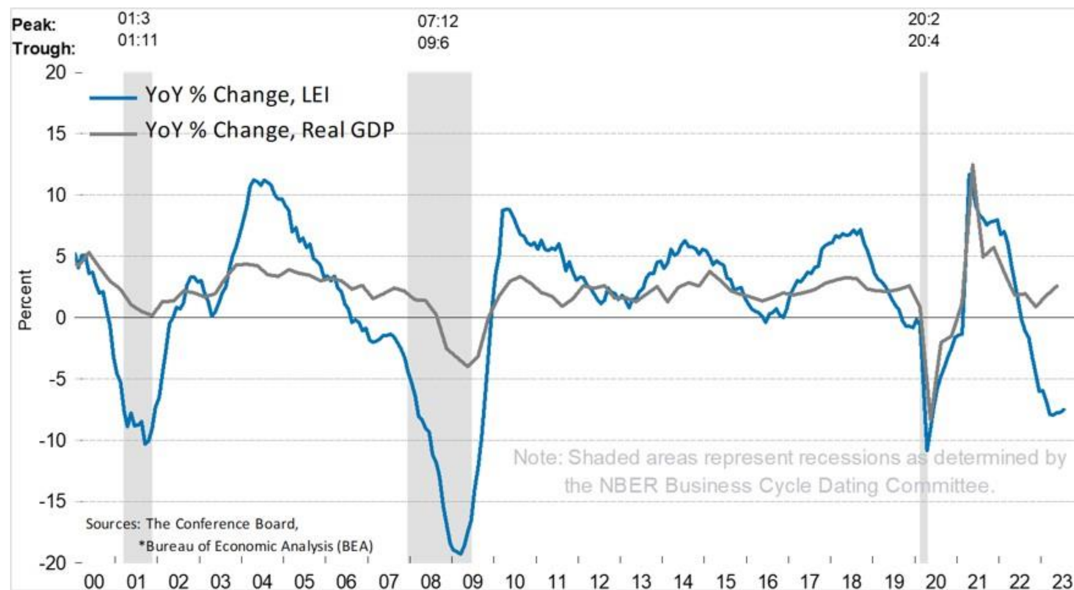
We consider some indicators below of what the future might hold and the implications for market performance.

The Conference Board Leading Economic Index is pointing to recession

The Conference Board is a US not-for-profit economic think tank operating since 1916. Its Leading Economic Index ("LEI") is widely followed and comprises 10 inputs including unemployment claims, new orders, US stock prices and the like.

We present the LEI in Chart 1 below.

Chart 1. Conference Board LEI



Source: www.conference-board.org

On past record over 20 years the LEI appears reliable, though the sample size for recessions is not large (an understatement). Nevertheless we can comment that GDP responds with a lag and in this sense the LEI is indeed leading. At its current level it does not bode well.

Monetary policy strongly contractionary

Monetary policy remains exceptionally tight. This has significant impact on economic activity but also with a lag (up to 18 months according to academic research).

Chart 2 below sets out US money supply growth as well as the policy rate.

Chart 2. US money supply growth (M2) and the Fed Funds Target Rate

Source: Factset

From Chart 2 above we can observe that the contraction in money supply is effectively unprecedented, even if one extends the period of investigation longer than that illustrated. One could also note the sharp rise in money supply during Covid which we believe to be the primary cause of observed inflation, along with supply chain constraints which followed the increase in money supply.

Concurrent to the contraction in money supply, the policy rate has increased from 0.25% p.a. to 5.50% p.a.

Real rates are historically high

In addition to the high short-term rate and the contracting money supply, longer term real yields are now also relatively high. We set out the US 10-year Treasury Inflation-Protected Security ("TIPS") real yield in chart 3 below.

Chart 3. US TIPS 10-year yield

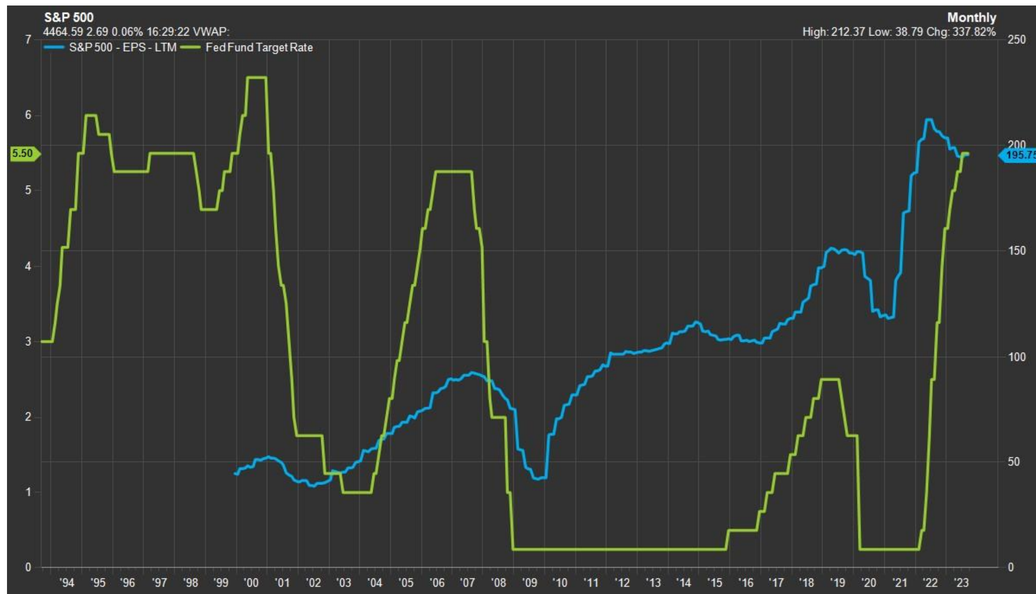
Source: Factset

From Chart 3 above we can observe that the real yield now approaching 2% is at its highest since the financial crisis. This also has implications for nominal bond yields. Investors selling TIPS in expectation of low inflation risk are pushing real yields higher which in turn push nominal yields higher. We think it is this dynamic rather than expectations of higher-for-longer inflation that is currently driving nominal yields upwards and may play into Bill Ackman's short bond position (https://www.m1capital-funds.com/pdf/Insight-23-07.pdf).

Rising rates are bad for company profits

We present in Chart 4 the Fed Funds Target rate against earnings per share ("EPS") for the S&P 500.

Chart 4. Fed Funds Target vs the S&P 500 EPS



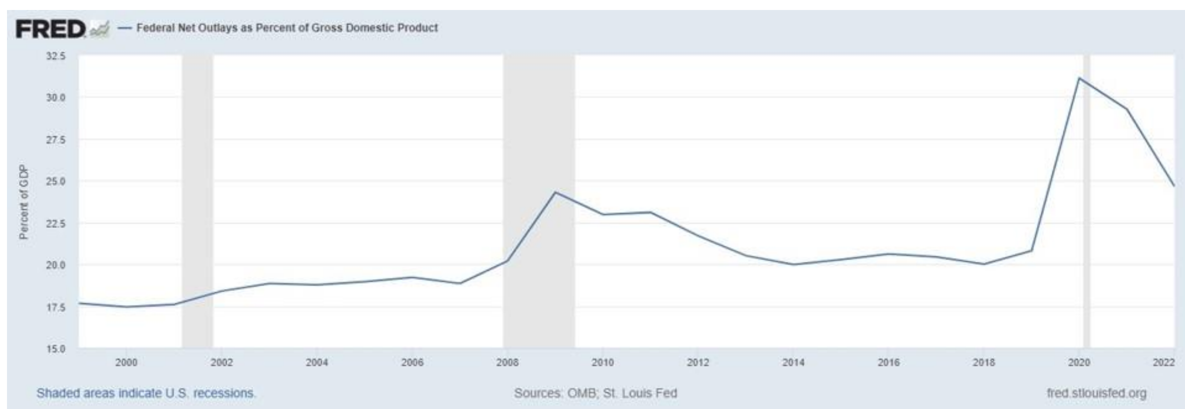
Source: Factset

Per Chart 4 above, a correlation appears very clear – following every tightening cycle EPS stagnate and decline. With the exception of the current tightening cycle where EPS have already been declining for more than a year.

But Fiscal policy remains stimulatory

In contrast fiscal policy remains stimulatory. We present the US Government budget deficit as a proxy for Government spending in Chart 5 below, and suggest that it is Government spending that has supported the US economy in its recent performance.

Chart 5. US government budget deficit



Source: St Louis Fed, FRED

What does it all mean?

Despite ongoing stimulatory fiscal policy, monetary policy remains exceptionally tight. Real rates at the longer end of the real curve are also relatively high. We expect impact on economic activity however this usually occurs with a lag of up to 18 months.

As far as the stock market is concerned two variables are of importance – interest rates and earnings. Interest rates are high and impact valuations. They also impact profits. In contrast to previous tightening cycles where EPS decline with a lag, company profits have been in decline for some time already.

Watch out for turbulence ahead.