MAM Insight No. 21

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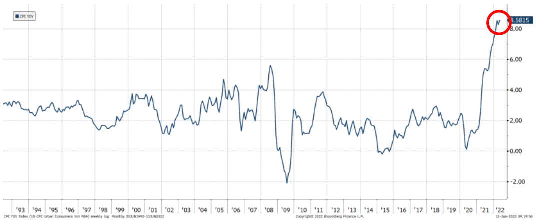
June 13, 2022

US Recession: “BRACE, BRACE”

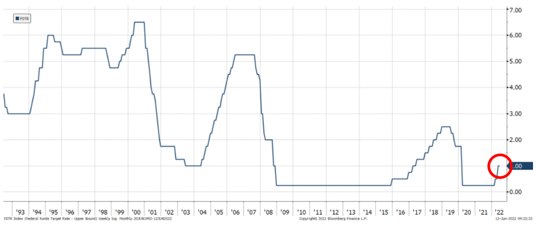
US May CPI inflation **(Chart 1)** came at +8.6% YoY against expectations of +8.3%, 40-Year high. Our “higher for longer” inflation thesis has been materializing. The Fed is behind the curve. US interest rates are too low **(Chart 2)**. Markets are now pricing a 175bps rate hike by the end of the third quarter, thus bringing interest rates near the neutral rate (2.75%) which is still overly accommodative. Evidently, the Fed will need to show determination to control inflation before it de-anchors. As eluded in our Q2 2022 Investment Outlook, Powell will be looking at the “Volcker moment” of 1979 as a template to bring inflation down though it may accomplished at the cost of a substantial decline in economic growth. Meanwhile the Fed still believes in its ability to achieve a “soft-landing”, we remain sceptical. We have been pointing at the risk of a US recession in H2 2022 for several months now. Digging further into this prospect, we seek to asses the risks and potential impact on portfolios.

Chart 1. US CPI Inflation YoY (Monthly)



Source. Bloomberg, MAM Research

Chart 2. US Fed Target Rate



Source. Bloomberg, MAM Research

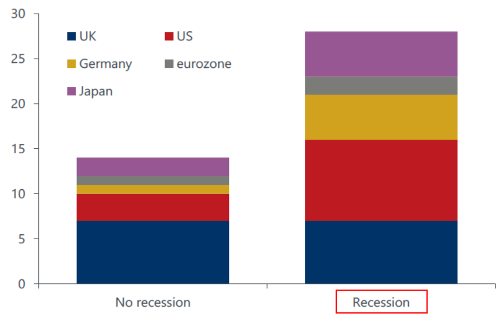
US Recessions History

Looking at 42 rates hiking cycles since the 1950s in the US, UK, Germany/Eurozone, and Japan, we find those associated with recessions outnumber those with no recessions by 2:1 **(Chart 3)**. Recessions tend to be more likely with larger rate hike cycles and higher initial peak inflation environments. Baseline forecasts for the major economies to 2025 suggest the tightening cycle will be fairly modest in size. However, accounting for the impact of quantitative tightening, the impact of policy normalization in the US, UK, and Eurozone is larger, raising downside risks.

There is a clear progression of recession risk based on the cycle peak level of inflation **(Chart 4)**. For peak inflation rates of 3.6%-7.1%, 3 out of 5 hiking cycles are associated with a recession. However, for cycles when inflation peaked above 7.3%, only 1 in 13 cycles is not a recession which was the UK in 1981 when it was only just dodged. Today, can central banks avoid a recession this time around?

Given the size of prospective monetary tightening cycles, focusing on the likely 2022-2024 rate increases, the cycles look quite modest: 250bps in the US, 140bps in the UK, and 100bps for the Eurozone. In terms of size, historically comparable cycles were associated with a roughly even split

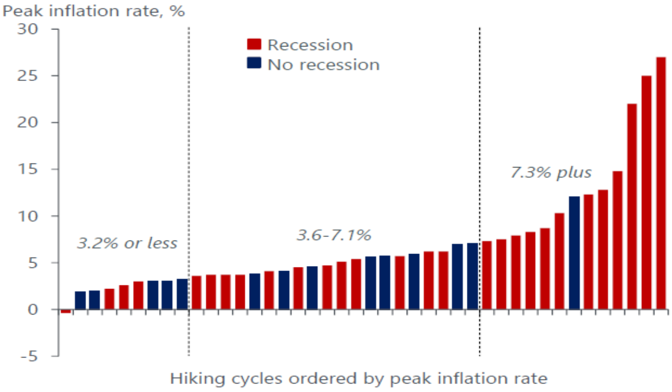
Chart 3. Hiking Cycles: Recession or Not?



Source. Oxford Economics

Chart 4. High Peak Inflation = ↗ Risks of Recession

Recessions and soft landings by peak inflation rates.



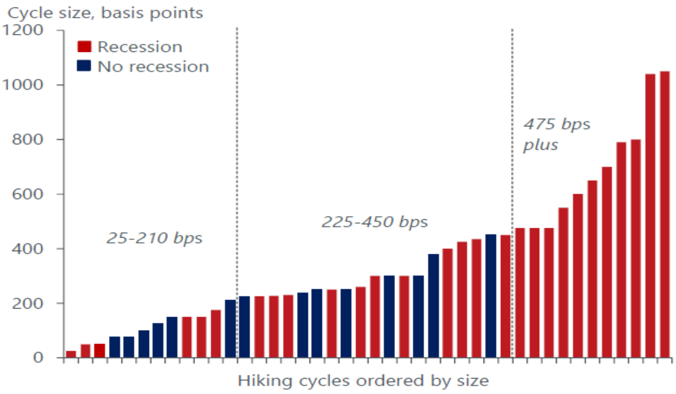
Source. Oxford Economics

between recessionary and non-recessionary outcomes. In the 1990s, rate cycles of comparable sizes mostly were not associated with recessions. However, simply looking at the prospective rate hikes does not give the full picture given central banks are planning to tighten monetary policy through balance sheet reductions, via quantitative tightening (QT).

Total QT across the Fed, BoE, and ECB in the current cycle will amount to 11-13% of GDP (2021 base), which is equivalent to an additional 70-140bps rate hikes. Assuming the higher end of the estimated range, the all-in monetary tightening cycles across the Eurozone and UK look similar in magnitude to the median 300bps hike. For the US, the all-in hiking cycle would be larger than the median at 400bps **(Chart 5)**. Headline CPI in Europe and the US now above 7.0% is bad news. Historically, these levels were associated with high recession risks as we enter into a tightening cycle. The combined high inflation and significant monetary policy tightening ahead means recession risks are potentially quite elevated.

Chart 5. Larger Hiking Cycles = ↗ Risks of Recession

Recessions and soft landings by size of hiking cycles.



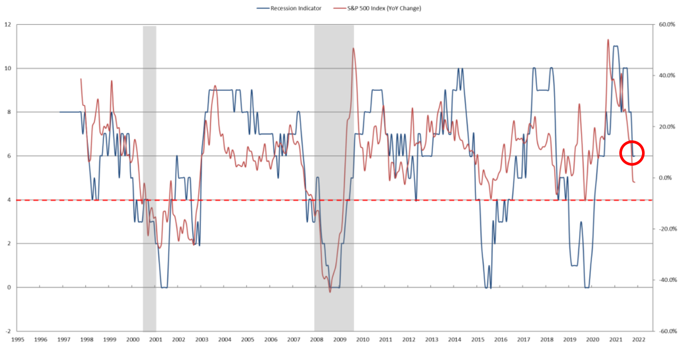
Source. Oxford Economics

Beyond historical analyses, we rely on a number of recession “signposts” to inform us on where we are in the current cycle.

Recession Signposts

We built a model composed of 12 market and economic indicator to predict a potential US recession. With 6 out of 12 indicators hinting at a recession, the probability of a recession occurring within the next 12 month is nearing 50% **(Chart 6)**. Historically (2000 and 2008), reaching 8 out of 12 indicators was sufficient to bring the probability of a US recession close to 100%. Today, we are fast approaching a similar level.

Chart 6. MAM US Recession Model



Source. MAM Research

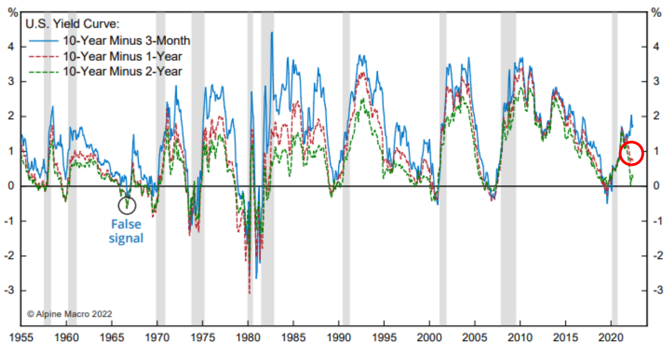
Beyond this analysis, we are monitoring three signposts.

<u>The Yield Curve</u>

The seminal work on the yield curve and recessions was done in the 1980s by Campbell Harvey, a Canadian economist. The basic premise was simple, an inverted Treasury curve implies bond markets believe the Fed has lifted short-term rates to an overly restrictive level. Tighter policy slows growth, thus triggering a recession that then requires the central bank to reverse course and cut rates. The 10-2 Spread **(Chart 7)** is our preferred indicator, which inverted in April 2022 and is now back into negative territory. It is worth noting the 10-5 spread has been inverted for the past 3 months.

In the last 10 recessions since 1957, the yield curve inverted on average 12 months before (range: 6-23 month). Based on the aforementioned, we believe the yield curve is starting to hint at a US recession scenario before mid-2023.

Chart 7. US Yield Curve and US Recessions

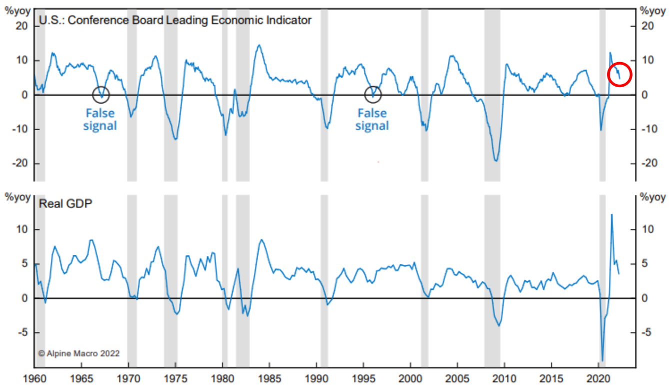


Source. Alpine Macro (Shaded Areas = Recessions)

The Leading Economic Indicators

The Conference Board's Leading Economic Indicator (LEI) is designed to signal peaks and troughs in the business cycle **(Chart 8)**. The LEI consists of ten components, including the yield curve and a credit measure. Thus, there is some overlap. According to the Conference Board, the LEI leads inflection points in the business cycle by about 7 months. A recession typically follows when the year-over-year change in the LEI drops below zero. Today, the LEI is decelerating. However, its annual rate of change remains positive. Hence, GDP growth is slowing but there is no recession signal just yet.

Chart 8. The Conference Board LEI & US Recessions



Source. Alpine Macro (Shaded Areas = Recessions)

The Unemployment Rate

It is by far the most important signal. In the post-war period, the US economy has always fallen into a recession whenever the 3 month moving average of the unemployment rate has risen by more than one-third of a percent (e.g., 0.33%) from the cycle low **(Chart 9)**. The track record is flawless, there has never been a false signal (e.g., no false positive).

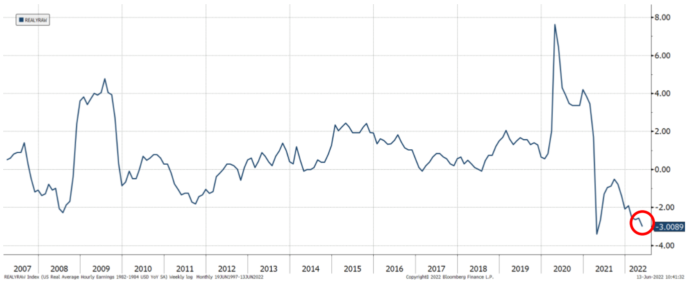
Chart 9. US Jobless Claims Picking up

Source. Bloomberg, MAM Research

The labour market is a well known lagging indicator. As such, investors should not wait for this signal before adjusting their investment strategy. Rather, it should be viewed as one of the final sign confirming a recession is already under way. The US unemployment claims **(Chart 10)** are a much more frequent data point, published weekly. We look at the year-over-year rate of change. Whenever it moves above 5.0%, the risks of a recession are very high. Should claims remain unchanged for the next few months, then US claims will flash a recession risks by December 2022. We know this to be conservative when we read Tesla is reducing its workforce by 10%.

The consumer is the backbone of the US economy. However, too often, we hear the consumer is in great shape therefore a recession should be avoided. Real average earnings are down more than 3% **(Chart 10)**, sharply reducing purchasing power. In fact, 73% of Americans with an annual income below $40k doubt their ability to pay monthly bills **(Chart 11).** As a result, consumer credit is exploding. Credit card debt has risen at the fastest rate in 25 year. Consumers turn to credit to meet their needs. Mortgage rates are surging. Consumers are squeezed. It is no coincidence that the University of Michigan consumer sentiment index reached an all-time low of 50 **(Chart 12)**.

Chart 10. US Real Average Earnings (YoY)



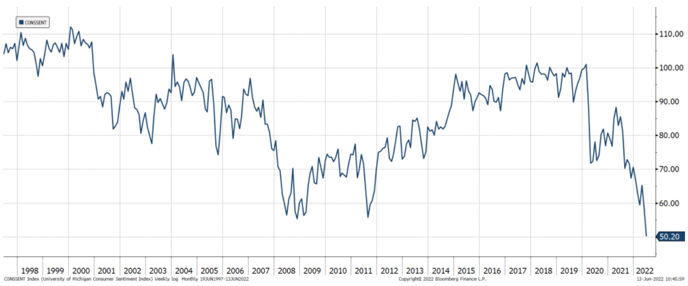
Source. Bloomberg, MAM Research

Chart 11. Survey on Lower Income Households

	Less than $40,000		
	2021	2022	ΔY/Y
Not having enough to pay normal monthly bills	56	73	+ 17
Maintaining the standard of living you enjoy	51	66	+ 15
Paying rent, mortgage or other housing costs	47	59	+ 12
Making minimum payment on credit cards	27	38	+ 11
Not having enough money for retirement	63	75	+ 12
Paying medical costs for normal healthcare	62	72	+ 10
Paying medical costs for serious illness or accident	53	62	+ 9
Paying for your children's college	39	37	- 2

Source. Hedgeye, Gallup

Chart 12. University of Michigan Consumer Sentiment Index



Source. Bloomberg, MAM Research

We maintain our long-held view for the rising probability of a US recession likely to happen over the next 6-12 months. The depth of the recession will largely be dependent on the scale of the hiking cycle. Based on historical precedents, a 3% GDP contraction is a possible scenario in the next 12-months.

What it Means for Financial Markets

The Fed tightening into an economic slowdown is a recipe for further financial market weakness. While our analysis will be more expansive in the Q3 outlook to be published in a few weeks, we wanted to give some perspective on the potential impact of a US recession on key financial assets.

US Equities

The S&P 500 trades on a 1-Year forward P/E ratio of 15.6x **(Chart 13)**, a large de-rating from the 21.7x highs in Q4 2020. It is lower than the 10-Year average of 16.1x but higher than its 14x lows from the precious crisis. One could argue markets have priced 77% of the valuation multiple de-rating required to reach prior trough valuations. However, it fails to consider what will happen to corporate earnings. The consensus is still expecting an 18% increase in S&P 500 earnings. Under a US recession scenario, we conservatively bring this number back to 0% (translating into an S&P EPS of $200). This would raise the P/E ratio up to 19.5x, at the higher end of its range. It also suggests a potential correction of -28% on the S&P 500 in the coming year. Although the S&P 500 is down 20% YTD, significant pain potentially remains ahead. Our initial S&P 500 target remains at 3,400 (-14%), its pre-Covid highs (a logical first step). At that point, we would need to re-assess our view. Goldman Sachs recently published a report stress-testing S&P levels against different scenarios **(Chart 14)**. The worst case scenario is for the S&P 500 to drop down to 3,150 (-20%).

Chart 13. S&P 500 Consensus P/E Ratio

Source. Bloomberg, MAM Research

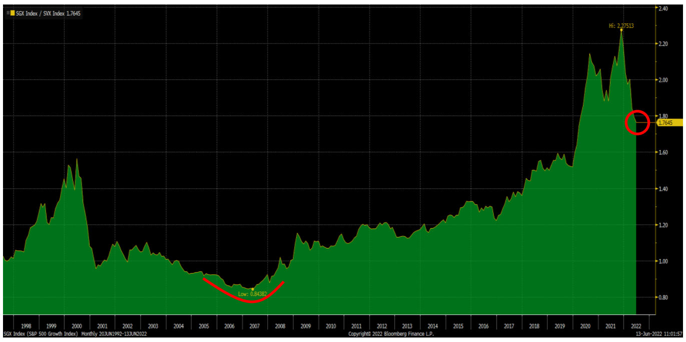
Chart 14. S&P 500 YE'22 Price based on P/E & EPS Scenarios

		2023 EPS scenario			
		Cons. estimate	GS top-down est.	2019 margins	Median recession
		$251	*$239*	*$220*	*$200*
		Est. at YE 2022 assuming halfway revision			
		$251	*$245*	*$235*	*$225*
Forward P/E	18x	4500	4400	4250	4050
Current	17x	4250	4150	4000	3850
15y avg	16x	4000	3900	3750	3600
	15x	3750	3650	3550	3400
	14x	3500	3450	3300	3150

Source. Goldman Sachs

Equity markets dynamics will change. During recessions, the cyclically exposed sectors (i.e., banks, materials, industrials) underperform meanwhile growth-oriented equities tend to outperform. Though the S&P 500 Value Index outperformed the S&P 500 Growth Index by over 27% in the past 6 months, a reversal of fortune with value stocks underperforming again is a high probability scenario **(Chart 15)**. Many high growth stocks have fallen 70%+ from their cycle highs. The Small Cap Growth Index is back at its pre-Covid levels **(Chart 16)**. This segment of the stock market bottomed 6 month before the S&P 500 Index during the Great Financial Crisis. While we had tilted portfolios towards value stocks, a switch in allocation may be warranted over the coming months. The trajectory of interest rates will be our guide on timing.

Chart 15. S&P 500 Growth/Value Index



Source. Bloomberg, MAM Research

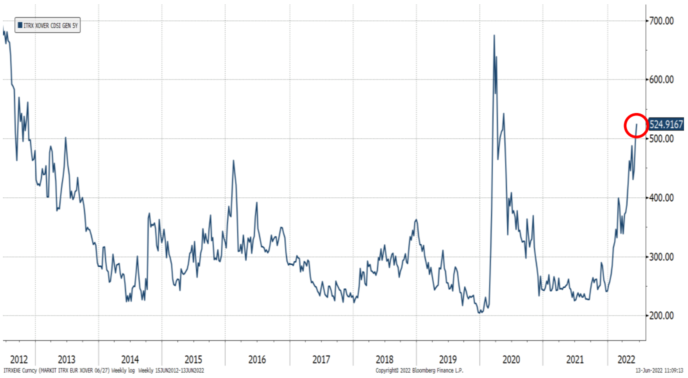
Chart 16. US Small Cap Growth Index (Weekly)

Source. Bloomberg, MAM Research

US Corporate Bonds

The MAM Insights No. 20 published a few weeks ago tackled the issue of US corporate bonds. We continue to recommend an underweight allocation to developed market credit and most notably US HY. The macroeconomic environment is a strong source of headwinds for the asset class. A stronger than expected, or longer than anticipated, recession would drive credit spreads wider and lead to higher default rates. Cyclical sector overrepresentation is also a negative attribute in today's market. While US high yield credit spreads have widened to 525 **(Chart 17)**, we expect them to reach >700bps in a recession scenario (Covid highs).

Chart 17. US High Yield Credit Spreads (Weekly)

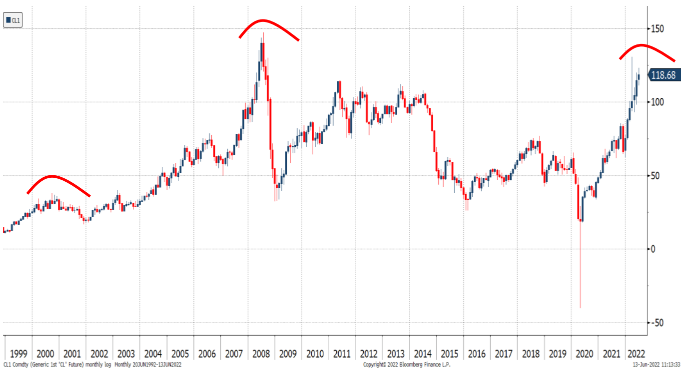


Source. Bloomberg, MAM Research

<u>Commodities</u>

Fundamentally, the oil outlook is bright with the re-opening of China's economy after stringent lockdowns and continued lack of supply. As we enter summer driving season, demand forecasts are strong for products, regardless of recessionary fears. Yet, we need to balance this view with our recession scenario. Indeed, oil prices **(Chart 18)** fell during each of the past three recessions and this time may not be different. We believe there is a strong case to be made for oil prices to remain elevated for longer until Q4 2022 when evidence of a recession will increase. This potential fall in oil reinforces our view that reducing exposure to "value" stocks such as energy stocks is the right strategy in H2 2022.

Chart 18. US WTI Oil Prices (Monthly)

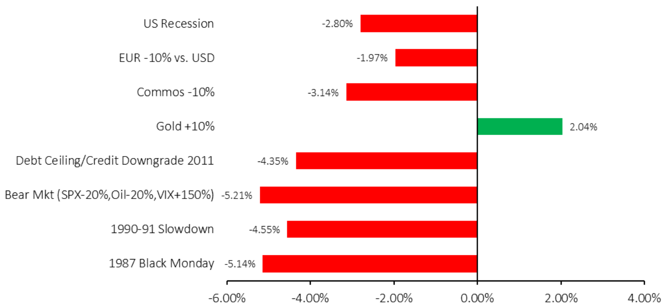


Source. Bloomberg, MAM Research

Stress Testing Portfolios

Given our current macroeconomic outlook and rising probabilities for a recession in the coming months, we proactively stress tested our current portfolio exposure under different set of market conditions **(Chart 19)**. Based on our models, portfolios would be at risk of losing up to 5.2% in the event of another bear market whereby the S&P 500 Index would drop another 20% from current levels, which would imply a 35% drop for the index from its cycle peak. Under a tailored US Recession scenario (please see note), portfolios would be down 2.8%. In either case, our overweight to energy is the greatest concentration of risk. Under the bear market scenario energy exposure would contribute to 37% of the decline and 61% in the US Recession one. Energy has been the best performing sector this year and strongly supported portfolio performance. However, as the risk of recession looms and demand destruction kicks in, oil prices could be down meaningfully. As the risk-reward on the trade fades, we are progressively reducing the overall portfolio overweight to energy. In turn, this would improve the results on the realized stress tests and further protect portfolios.

Chart 19. Stress Testing the MAM EUR Model Portfolio



Source. Bloomberg, MAM Research

Note: US Recession = S&P 500 -20%, Nasdaq Composite -25%, SHCOMP flat, Oil -25%, and Gold +10%

Investment Implications

We have been pro-actively hedging portfolios since Q4 2021 against the risk of a financial market downturn. Recently, we rolled our put spread strategies (50% equity exposure) from June 2022 to September 2022, providing portfolios some protection until then. As the risk is moving away from interest rate and inflation sensitivity to a broader and more prolonged "risk off" environment, our attention turns to the remaining equity exposure in portfolios. We are currently reducing "value" stocks exposure by 30% by selling some energy sector exposure. We also ensured no residual exposure to European Banks, which are historically some of the worst performers during a global recession.

Please, let us know if you have any questions.

Kind regards,

MAM Investment Team

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