MAM
MONACO ASSET MANAGEMENT

Global Research & Investment Strategy

Recessions & Financial Markets

January 24, 2023

Incremental declines in bearishness amongst investors is fueling yet another bear market rally at the dawn of 2023. Worsening economic conditions and peaking inflation have been sufficient for the Fed pivot or pause narratives to run at full speed while recession estimates are being pushed back in time. However, the constructivism may be short lived as investors will soon be faced with economic reality percolating through corporate earnings and margins.

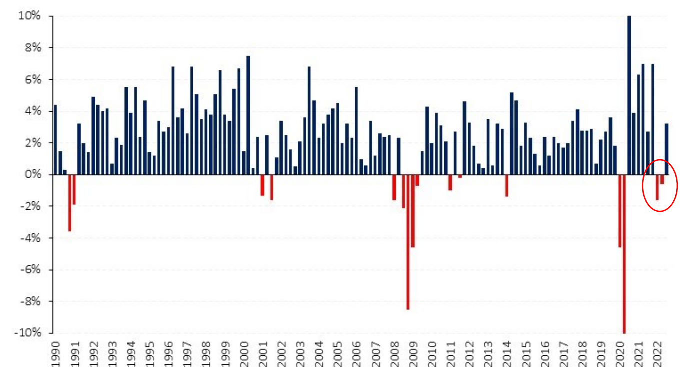
The Recession is Here

US GDP Growth turned negative two quarters in a row in 2022 (**Chart 1**), technically inferring the economy was in a recession. Yet, strength in the labor market and an energy shock linked to the war in Ukraine drove market medias to dismiss this recessionary episode. However, we believe the stage remains set for a more prolonged and severe recession in 2023. Money supply growth has turned negative for the first time in decades (**Chart 2**) and repercussions are broad based from asset prices to consumers, businesses, and employment.

Leading Economic Indicators are moving lower (**Chart 3**), and it is not a surprise. Over 40% of people regularly run out of money and have to rely on credit cards or family as the monthly streak of negative real earnings growth surpasses 21. Every time the US LEI turned meaningfully negative, the economy entered a recession. The missing piece of the puzzle is higher unemployment as the jobs market remains too tight. The real recession indicator is the US unemployment moving up over +30bps (**Chart 4**). As a lagging indicator, it is often the last shoe to drop. So far, employment data has failed to converge with the layoff headlines and small businesses commentaries.

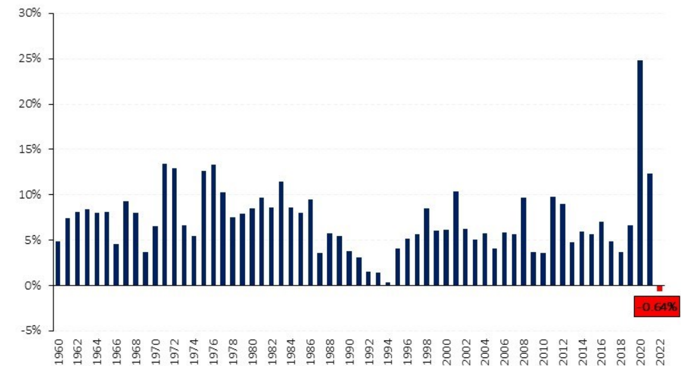
The Senior Loan Officer Survey is also a good recession lead indicator. When 2/3 C&I (Commercial & Industrial) questions are negative it precedes a recession (**Chart 5**). It is not coincidental, but causal, as banks tighten credit standards (cost of capital = ↑), economic activity slows. The problem is cyclical activity tends to auto-correlate, or self-reinforce. In other words, the tightening of credit leads to rising layoffs, delinquencies, and forcing banks to further tighten credit and so on and so forth.

Chart 1. US GDP Growth QoQ*



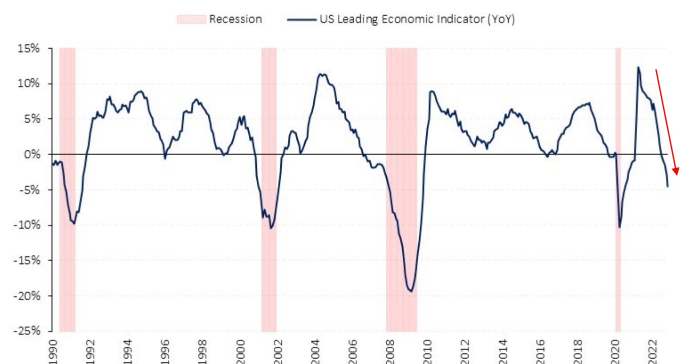
*Source. Bloomberg, MAM Research (*2020 Truncated)*

Chart 2. US M2 Money Supply Growth YoY



Source. Bloomberg, MAM Research

Chart 3. US Leading Economic Indicators



Source. Bloomberg, MAM Research

The MAM Composite US Recession Indicator stands at 4 (8/12 indicators signaling recession), therefore implying a high probability of recession within the next 6 months. For the signal to edge lower, we would need to observe further deterioration in inventory/sales ratios as well as corporate profits being revised lower. In our view, this is only a matter of months. A score closer to zero would justify a 2nd leg down in equity markets or -30/40% from the peak on the S&P 500 and higher credit spreads.

The Ghost of Inflation

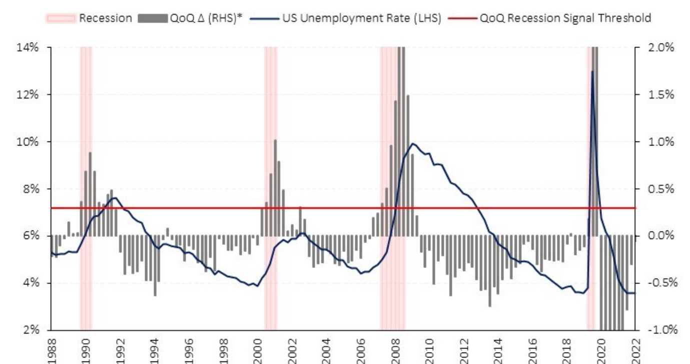
The Fed is haunted by the specter of the 1970s inflation. Afraid of blinking too early and history repeating itself, the central bank will keep rates anchored higher while pursuing QT (too few people are focusing on it), which is currently underappreciated by markets pricing rate cuts before year-end. Headline inflation has peaked but price growth in key customer cost centers remains anchored high (7.4%) (**Chart 6**). The risks with loosening financial conditions too early include a re-acceleration in the high velocity feed through items of inflation like energy. With markets hoping and pricing a "pivot" driving the dollar lower, commodities are surging with oil best performing asset last week and copper best performing asset YTD. The Fed's job is not done, it will either re-ignite inflation or crash the economy in an attempt to tame it. There is hardly any way around it.

Credit is <u>NOT</u> Cheap...

It is not because something is cheaper than it was that it makes it an attractive opportunity. Fixed income posted some of its worst returns ever last year. However, lower prices do not mean cheap. Over 80% (global average) of the negative returns in credit for the year 2022 can be attributed to higher policy rates (**Chart 7**). Bonds are not cheap, far from it, despite the poor performance in the last 12-months when factoring in risks of a recession.

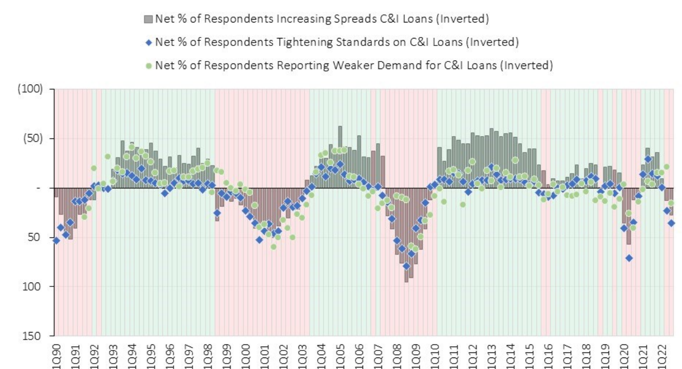
Clearly, credit spreads are too tight given the economic outlook (**Chart 8**). High Yield spreads for instance should in the 650-750bps range instead of 400bps currently. Consensus remains constructive on credit on the back of resilient (but backward looking) fundamentals, citing robust EBITDA vs. flat debt levels. Margins compressions will most certainly be one of the key drivers in sending spreads wider over the coming quarters.

Chart 4. US Unemployment Rate and QoQ Δ*



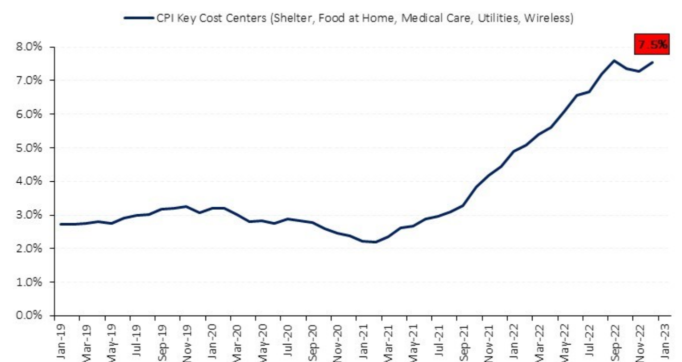
*Source. Bloomberg, MAM Research (*Truncated)*

Chart 5. C&I Lending: Spreads, Standards, & Demand



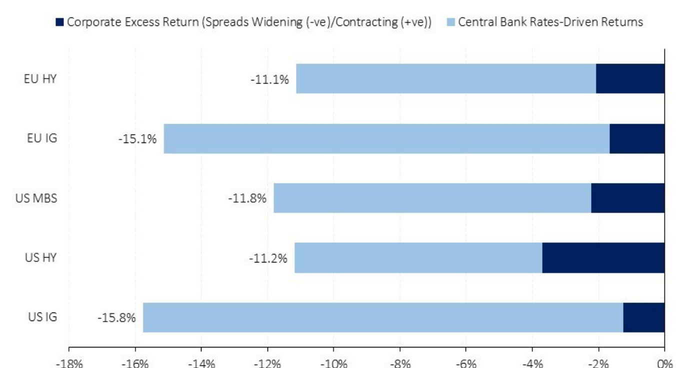
Source. Bloomberg, MAM Research

Chart 6. Price Growth in Key Customer Cost Centers



Source. Bloomberg, MAM Research

Chart 7. Credit Market Performance Attribution 2022



Source. Bloomberg, MAM Research

… Neither are Equities

Cyclical and economic-sensitive segments of the market have been suffering from the effects of tighter financial conditions. The liquidity-infused bubbles in unprofitable tech and other sectors are imploding. Consumer staples have outperformed consumer discretionary stocks by more than 37% since late 2021 (**Chart 9**). Underneath the surface, a bear market is well at play and probably just about 50% done. Historically, bear markets lasted around 1-1.5 years, we are 50-75% through. However, the more painful part is yet to come. Earnings revisions.

Bottom-up consensus remains overly optimistic with a mere -4% decline in earnings modelled (**Chart 10**) in at this stage. Goldman Sachs reporting earnings down 60% and missing consensus estimates by 40% this quarter is a good indicator that investors are not ready for what comes ahead. Because the first guide is typically never the last, we would expect a new wave of revisions to be the catalyst sending markets lower towards our target range of 3,000-3,300 on the S&P 500.

FOMO is an abbreviation that should be very present in the mind of investors. 0DTE options (same day options) volumes have skyrocketed (**Chart 11**) and illustrate this need to chase to the upside by fear of missing out after a very difficult 2022. Capitulation and behavioral resets are needed for the bear market to arrive to completion.

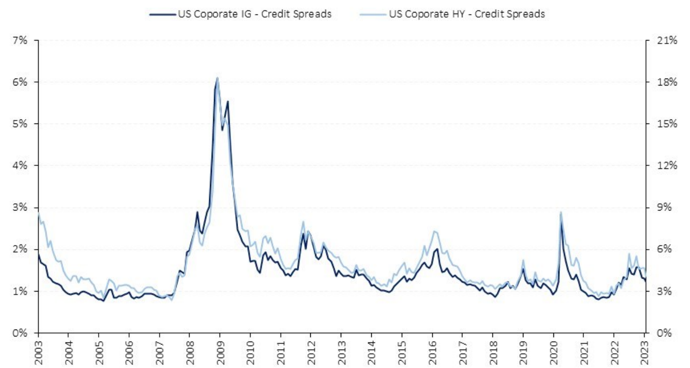
Investment Implications

Despite the recent bear market rally, we maintain our defensive allocation to both equities and fixed income. Recession risks are simply not reflected in prices with investors overpaying for the risk they are taking. Recent investors have been exposed to V-shaped recoveries but economic cycles take time. We did not see a proper default cycle in over a decade, but may be nearing one.

We remain attentive to credit but wait for spreads to widen materially before considering deploying capital in the IG segment of the market. In equities, we look for prices to fall towards 3,000-3,300 prior to turning more constructive over the medium-to-long term.

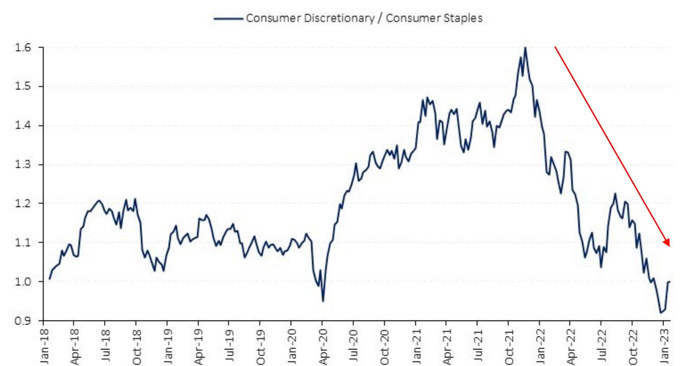
Using the low volatility, we bought an ATM June 2023 put option on the S&P 500 ETF (SPY) for 50% of our total equity exposure.

Chart 8. US IG and HY Credit Spreads



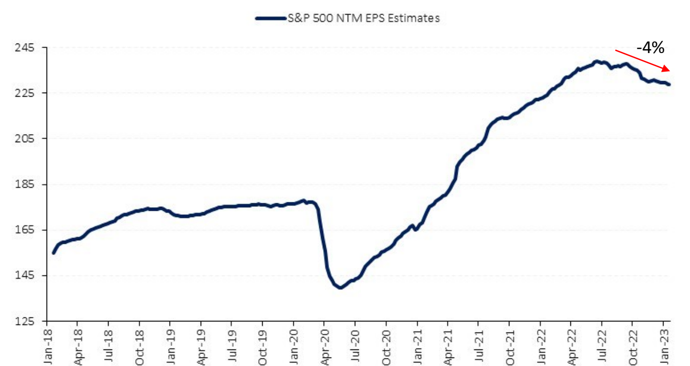
Source. Bloomberg, MAM Research

Chart 9. Consumer Discretionary vs. Staples



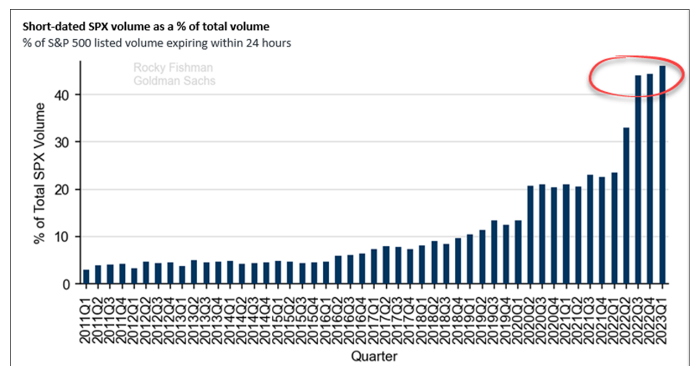
Source. Bloomberg, MAM Research

Chart 10. S&P 500 NTM EPS Estimates



Source. Bloomberg, MAM Research

Chart 11. The Speculative Bubble Remains Alive



Source. Bloomberg, MAM Research

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