ACG Insights: Ground Control to Major Powell

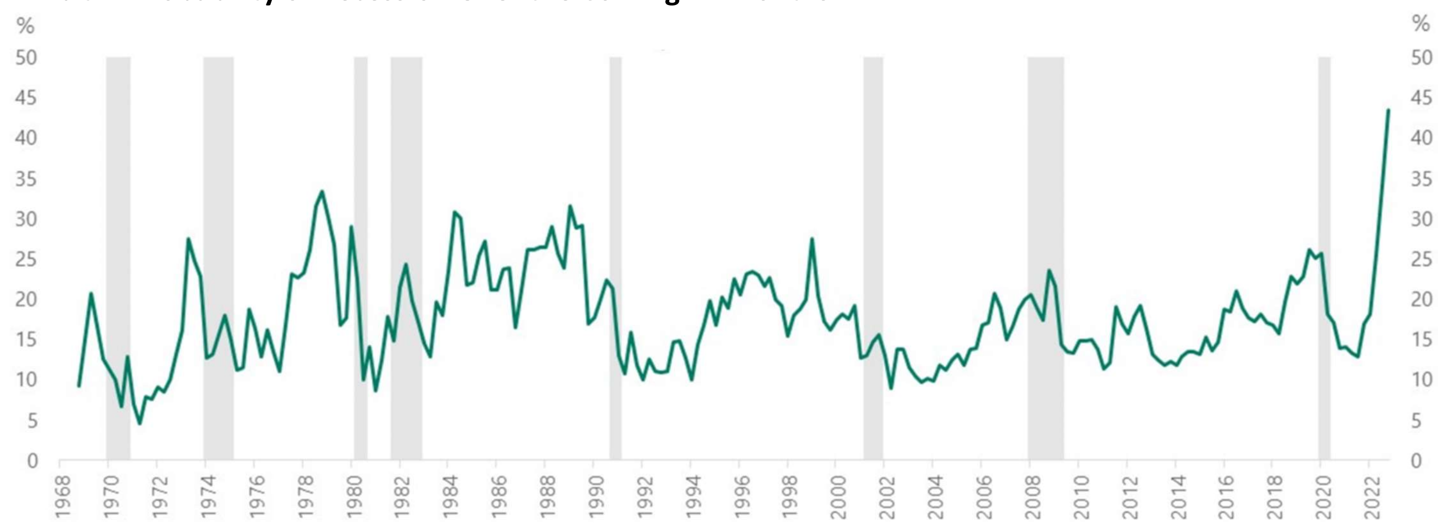
Executive Summary

- **What kind of landing can the US Federal Reserve conjure in the face of the most anticipated recession in US history (Exhibit 1)?**
- **Contrary to the headlines, the overall employment environment remains robust, and consumers continue to spend (Exhibit 3 & 4)**
- **Might the economy prove too resilient, forcing the Fed to be more aggressive in curbing the economy to combat inflation? Further rate hikes or not enough pose potential risks to markets**

Background: Commencing Countdown, Engines On

After a difficult year in financial markets, there was plenty of pessimism to usher in the new year. Indicative of this negative outlook, the probability of an impending recession hit a new high according to the Fed's Survey of

Exhibit 1: Probability of Recession Over the Coming 12 Months [1]



[1] Source: Federal Reserve Bank of Philadelphia, Haver Analytics, Apollo

Professional Forecasters (Exhibit 1). But what does a recession mean for the economy and financial markets?

In order to delineate between economic recessions and expansions, The National Bureau of Economic Research (NBER) keeps a chronology of US business cycles. So, while two consecutive quarters of negative gross domestic product (GDP) growth is a useful heuristic, it is not the official definition of a recession. NBER's Business Cycle Dating Committee emphasizes a recession to include "a significant decline in economic activity that is spread across the economy and lasts more than a few months.[2]" While there is no fixed rule about which measures contribute to the process, the committee relies on a range of monthly economic activity measures including nonfarm payroll employment, personal income less transfers, employment as measured by household survey, wholesale-retail sales, real personal consumption expenditures, and industrial production. Final judgement is completed retroactively to avoid the need for major revisions.

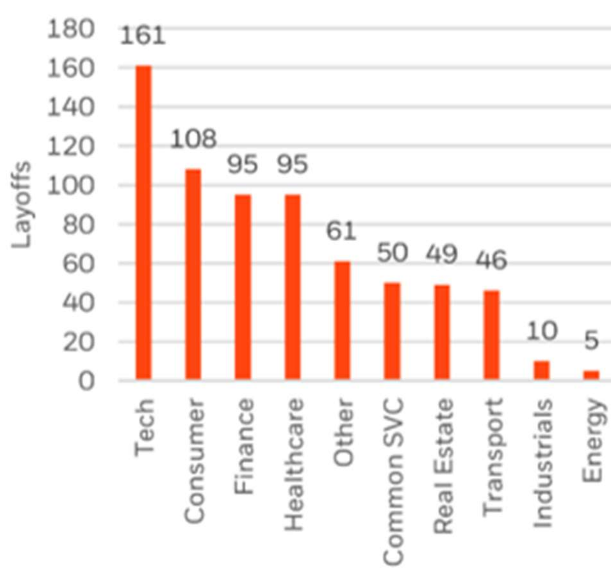
Given the complexity in understanding the current macro-economic environment, investors and media members have taken to using the phrases "hard landing" or "soft landing," alluding to the severity of an aircraft's touchdown, to describe the economic path ahead. To clarify, a "hard landing" would be characterized by inflation coming down only after a significant economic slowdown, i.e. recession, likely coinciding with a substantial increase in unemployment. Conversely, a "soft landing" sees inflation tamed with a lesser decline in economic activity and minimal job losses. What does the latest data suggest?

The Employment Picture: Headlines vs. Reality

A hallmark of a recession is a marked uptick in unemployment. Recently, there have been several high-profile companies announcing layoffs including Twitter, Goldman Sachs, and Amazon. However, this does not appear to be indicative of the entire employment landscape to this point. Layoff announcements have largely been concentrated to a few of the highest earning sectors (Exhibit 2).

Perhaps the combination of rate hikes and consumers returning to habits of pre-pandemic life have disproportionately affected the tech sector. The overall data bears a rosier picture. Despite significant financial tightening from the Fed, the US economy added 517,000 jobs in January, outpacing the monthly average of 400,000 in 2022 and the unemployment rate remains at a very low 3.4%. The employment situation in certain sectors such as education, health services, and leisure & hospitality are particularly robust. Even with greater demand for personnel, indicated by the number of job openings, employment within these sectors is still well below pre-pandemic trend levels (Exhibit 3). As a result of the pandemic's impact on early retirement among baby boomers, there are just not enough bodies to fill positions. Currently, there are nearly double the number

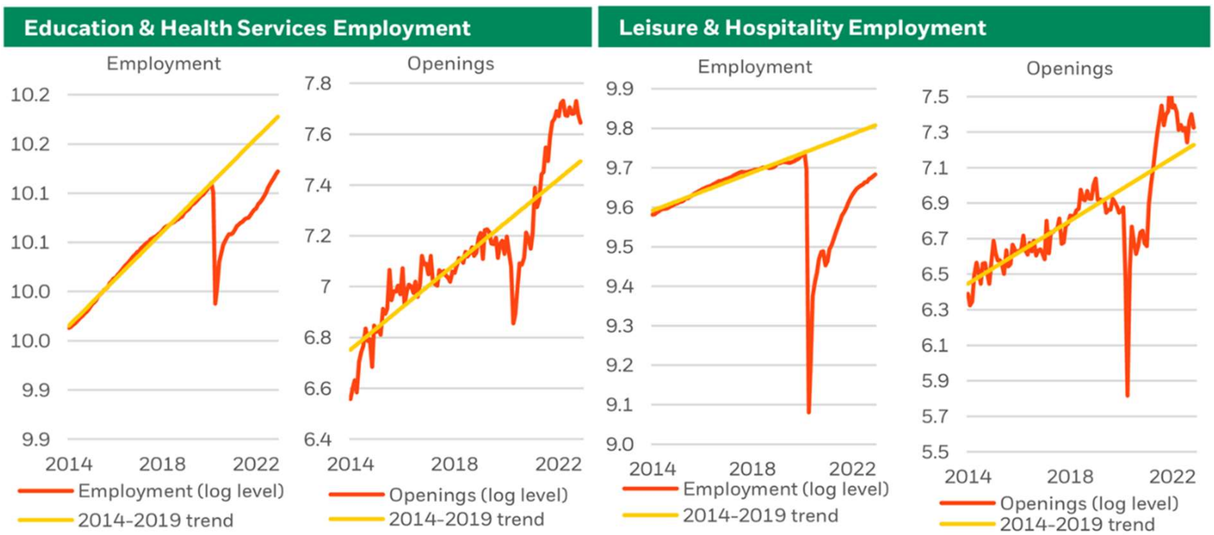
Exhibit 2: Layoff Announcements by Industry [3]



[2] Source: NBER
[3] Source: Piper Sandler as of 12/28/2022

of job openings relative to those unemployed, 11 million vs 5.7 million respectively. It is difficult to envision a "hard landing" when jobs are this plentiful.

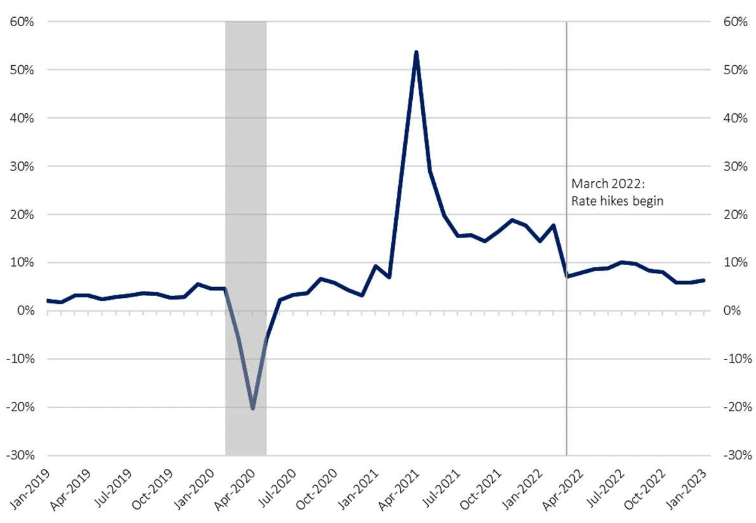
Exhibit 3: Strong Employment Demand Within Service Sectors [4]



Better Than Anticipated Consumer Spending

Typically accounting for over two thirds of US GDP, consumer spending is the lifeblood of the US economy. With the Fed trying to cool inflation by cooling the economy, how has aggregate consumer demand faired?

Exhibit 4: Year Over Year Retail Sales & Food Services [5]



The Advance Monthly Retail Trade Survey provides an early estimate of monthly "retail sales." The survey is an excellent barometer for consumer demand of both durable and non-durable goods. January retail sales were quite strong, registering 6.4% year-over-year growth. Although this is lower than the 7.1% recorded when the Fed began raising rates in March of 2022, it is still higher than pre-pandemic growth of 4.6% in February of 2020 (Exhibit 4).

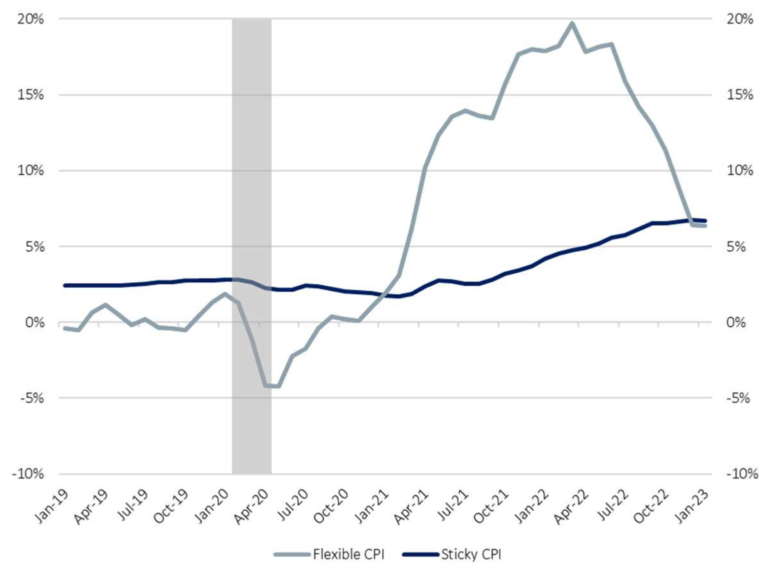
With ample employment opportunities and excess savings built up during the pandemic, consumers are continuing to spend. With many positive economic indicators, if inflation were to come down at this point it would certainly indicate a "soft landing." Could we have another case of economists predicting nine out of the last five recessions?

[4] Source: BLS, BlackRock as of 12/31/2022
[5] Source: U.S. Census Bureau

No Landing and a Hawkish Fed

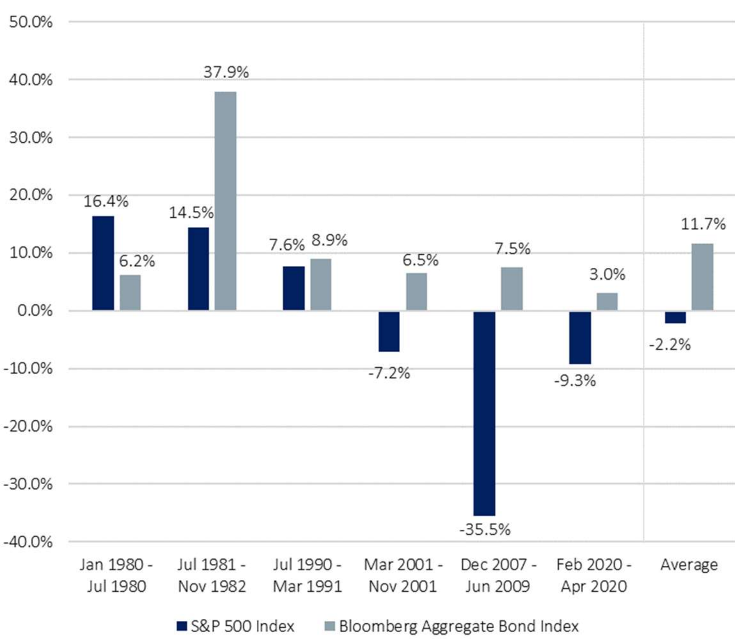
With the US economy's surprising resilience in the face of numerous rate hikes, reducing inflation presents the final hurdle in engineering a "soft landing." After consecutive Consumer Price Index (CPI) reports in November and December indicated slowing inflation, the January report came in hotter than expected with headline CPI increasing 6.4% year over year. The Atlanta Fed produces a Sticky-Price CPI that sorts components into either sticky or flexible based on how rapidly prices adjust (ex. housing = sticky, consumables = flexible). To date, flexible prices have come down considerably, but sticky prices have yet to decline (Exhibit 5).

Exhibit 5: Flexible and Sticky CPI [6]



With inflation well above the Fed's 2% target and appearing to remain stubbornly high, a "no landing" scenario is possible wherein elevated economic growth and inflation persist. With this backdrop, the Fed would be forced to remain hawkish for longer, which could have a negative impact on financial markets.

Exhibit 6: Stock and Bond Performance During Past Recessions [7]



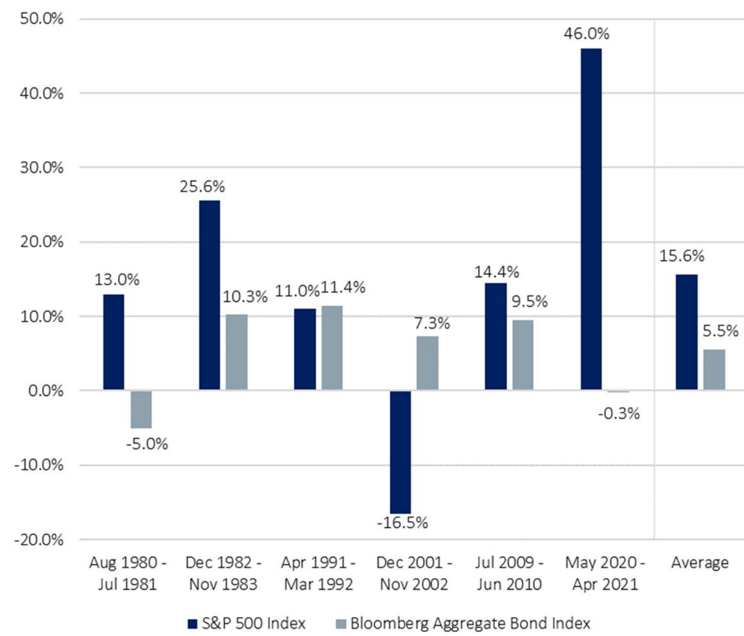
Market Implications

How can we expect markets to perform should we have a "hard landing" in 2023? Exhibit 6 displays S&P 500 Index and Bloomberg Aggregate Bond Index performance during the last 6 recessions as well as the average. Mild declines and perhaps even positive S&P 500 returns may come as a surprise.

This is largely a function of timing, as stock markets frequently reach their peaks prior to the turning point in economic cycles and can even stage significant recoveries while the economy is still in a downturn. So while recessions and equity market declines frequently overlap, the timing and duration can be quite different.

[6] Source: Federal Reserve Bank of Atlanta
[7] Source: NBER, Morningstar Direct

Exhibit 7: Stock and Bond Performance 12 Months Following Recessions [8]



As recessions are determined in hindsight, selling stocks and buying bonds upon a NBER pronounced recession would prove to be an ill-time strategy. In addition, time periods following declared recessions have often produced above average stock market returns (Exhibit 7). Markets are complex adaptive systems where agents rapidly adjust their behavior based on ever evolving information. This makes predicting the economy to predict financial markets an immensely challenging proposition.

Conclusion: Floating in a Most Peculiar Way

There is an extensive amount of readily available data that can provide insights on employment, consumer spending, inflation, etc. The Federal Reserve has the unenviable task of analyzing this data to balance the risks of doing too much, "hard landing," with doing too little "no landing." For investors, however, leading indicators and economic reports are generated from past data and will thus lag forward-looking financial markets. The best course of action for long-term investors is to understand how markets perform in various environments, including recessions, to have some statistical context to evaluate against risk tolerances and return objectives. In the short-term, we cannot know with absolute certainty what the future will bring (hopefully less aeronautical idioms).

[8] Source: NBER, Morningstar Direct

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